HOW WE'RE POSITIONING FOR A REBOUND IN CHINA

March 2019

Chinese equities have ripped higher this year. But we see catalysts to support further gains. MSCI recently announced plans to add more Chinese A-shares stocks to its traditional China-focused indexes and its broader emerging market and regional indexes. This will add further buying to Chinese equities throughout the year.

Chinese A-shares only have a 5% inclusion factor currently in their indexes—but MSCI is upping the A-shares weight in three equal tranches to 20% by the end of November 2019.

This adds to a few other catalysts:

Reasons for recent outperformance

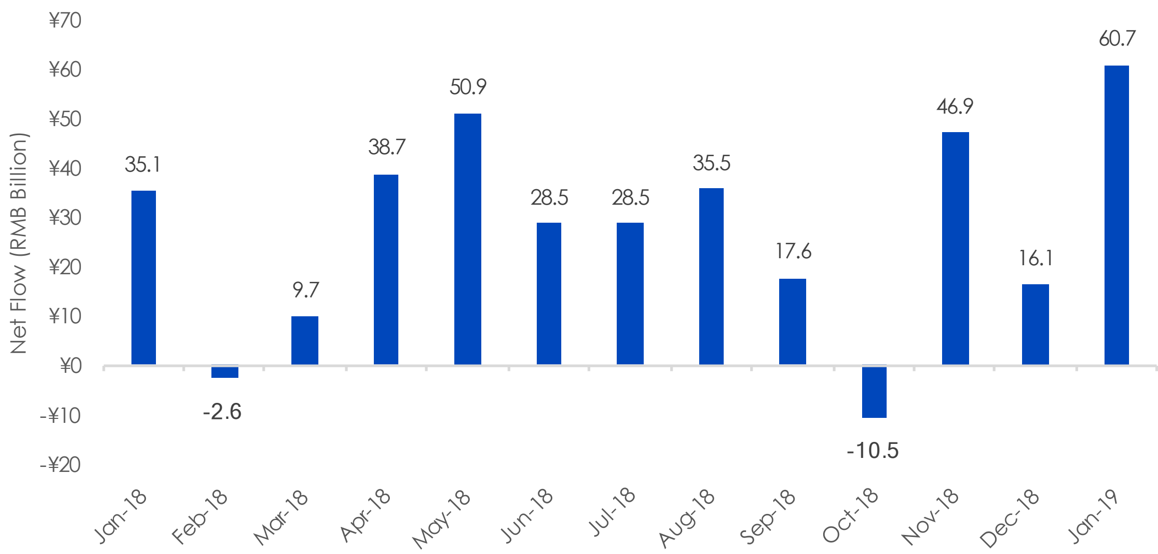
1. **US-China Trade Deal:** Pessimism of a long-lasting trade war has abated. While there are fundamental differences in the worldview between the US and China, we believe President Trump is likely to follow a similar approach to how he negotiated trade deals with Canada and Mexico -- particularly after his "No-Deal" trip to Vietnam.
2. **Chinese stimulus:** Concerned about the growth slowdown of Gross Domestic Product (GDP), the Chinese government has taken several measures to stimulate growth by increasing liquidity and borrowing. In Q4, China launched the Target Medium-Term Lending Facility (TMLF) that offers a lower interest rate than the existing Medium-Term Lending Facility (MLF) to specifically support small and private firms' growth. In January 2019, the People's Bank of China has taken further steps to release $116 billion into the market by cutting required reserve ratios by 100 bps [1].
3. **Fed's Pause:** The Federal Reserve (Fed) has lowered its expectations for the pace of rate increases this year. Similar to the 2016 pause, we believe risk assets can continue to rally as fears of a recession are pushed into the future.

Tracking money flows into China

While 2018 was a disappointing year for returns, China's Stock Connect program was a huge success. In the chart below, we track net flows from foreign investors into Chinese stocks on mainland exchanges.

[1] https://www.reuters.com/article/us-china-economy-rrr-cut/china-slashes-banks-reserve-requirements-again-as-growth-slows-idUSKCN1OY0RL

FIGURE 1: NET FLOWS OF FOREIGN INVESTMENTS THROUGH STOCK CONNECT PROGRAMS



Source: HKEX, as of 25 February 2019. Net flow of foreign funds is calculated by summing the net flow of Northbound Shanghai Stock Exchange and that of Northbound Shenzhen Stock Exchange. **You cannot invest in an index. Historical performance is not an indication of future results and any investments may go down in value.**

With many investors needing to continue to buy mainland shares on account of MSCI China benchmark changes, we believe flows into A-shares will continue to accelerate. And we believe investors should be overweight A-shares as demand continues to increase.

Chinese beta

While many investors spend a great deal of time deciding when and if to go overweight on China, we believe they often make a mistake about what to do with this view.

We think China remains in the early innings of its path to financial market liberalization. And many index providers have a different definition of which types of Chinese stocks should be eligible for inclusion. So Chinese beta could be comprised of 7 share classes trading on 4 different exchanges.

Due to companies' decisions about where to incorporate and list their stock for trading, each share class has its own distinct characteristics. As we show below, this can lead to a wide dispersion in returns.

FIGURE 2: THE SHARE CLASS OF CHINESE EQUITY EXPOSURE HAS HAD A MASSIVE IMPACT ON RETURNS

2008	2009	2010	2011	2012	2013
-46.4% Red Chips	137.8% B-Shares	59.9% N/S-Shares	0.6% N/S-Shares	27.8% B-Shares	76.0% N/S-Shares
-50.8% H-Shares	134.2% P Chips	33.0% B-Shares	-9.1% Red Chips	26.4% Red Chips	29.8% P Chips
-50.8% MSCI China	96.7% A-Shares	11.2% Red Chips	-18.4% MSCI China	26.4% P Chips	24.3% Red Chips
-61.8% A-Shares	95.9% N/S-Shares	4.6% MSCI China	-20.8% H-Shares	22.8% MSCI China	3.6%MSCI China
-63.9% P Chips	67.5% H-Shares	3.1% H-Shares	-22.8% P Chips	20.5% H-Shares	0.8% A-Shares
-66.0% B-Shares	62.3% MSCI China	-2.2% P Chips	-22.9% A-Shares	9.5% A-Shares	-1.3% H-Shares
- N/S-Shares	31.0% Red Chips	-4.4% A-Shares	-34.4% B-Shares	-9.8% N/S-Shares	-25.5% B-Shares

2014	2015	2016	2017	2018	YTD
46.5% A-Shares	9.6% P Chips	10.7% P Chips	107.1% P Chips	-3.6% Red Chips	18.8% N/S-Shares
15.2% H-Shares	7.1% A-Shares	2.7% H-Shares	71.9% N/S-Shares	-12.3% H-Shares	11.1% MSCI China
11.9% N/S-Shares	2.6% N/S-Shares	0.9% MSCI China	54.1% MSCI China	-16.7% B-Shares	10.0% P-Chips
9.5% B-Shares	-2.0% Red Chips	-2.2% N/S-Shares	30.3% H-Shares	-18.9% MSCI China	9.1% H-Shares
8.0% MSCI China	-7.8% MSCI China	-5.3% Red Chips	20.8% Red Chips	-24.8% P Chips	8.7% A Shares
1.7% P Chips	-15.5% H-Shares	-19.1% A-Shares	20.3% A-Shares	-33.0% A-Shares	6.1% Red Chips
-1.1% Red Chips	-23.1% B-Shares	-32.5% B-Shares	-13.8% B-Shares	-35.8% N/S-Shares	2.2% B-Shares

Source: WisdomTree, Zephyr StyleADVISOR, as of 31 January 2019. Red Chips: Company based in mainland China but incorporated internationally and listed on the Hong Kong stock exchange. H-Shares: Companies incorporated within the People's Republic of China that trade on the Hong Kong stock exchange. A-Shares: Chinese incorporated companies that trade on either the Shanghai or Shenzhen stock exchanges. They trade in Renminbi and can only be traded by 1) residents of the People's Republic of China 2) under the Qualified Foreign Institutional Investor rules 3) under the Renminbi Qualified Foreign Institutional Investor rules or 4) under the Stock Connect Programs. P-Chips: Companies controlled by mainland Chinese companies or individuals, with the establishment or origin of the company within Mainland China. It must be incorporated outside the People's Republic of China and must trade on the Hong Kong stock exchange, with most of its revenue or assets derived from Mainland China. B-Shares: Securities of Chinese incorporated companies that trade on either the Shanghai or Shenzhen stock exchanges, and they can be traded by non-residents of the People's Republic of China with appropriate foreign currency dealing accounts. N/S-Shares: An S-Chip is a company controlled by Mainland Chinese companies or individuals, with establishment or origin of the company in Mainland China, traded on the Singapore stock exchange. An N-Share is a company controlled by Mainland Chinese companies or individuals, with establishment or origin of the company in Mainland China, traded on the New York Stock Exchange, NASDAQ stock exchange or NYSE American stock exchange. **You cannot invest in an index. Historical performance is not an indication of future results and any investments may go down in value.**

In our view, investors seeking broad based exposure to China should consider a total market access product across all listings -- something like the S&P China 500 Index.

By including all available share classes, investors are able to allocate to China in the same way they benchmark to US markets via the S&P 500.

Comparing the S&P China 500 Index with MSCI China Index

When it comes to Chinese beta, many investors have defaulted to the MSCI China Index. However, our view is the S&P China 500 Index gives a more accurate measure of the Chinese market not only by offering a comprehensive coverage of all Chinese share classes, but by taking a large stake in A-shares.

Comparing to MSCI China's current 4.71% weight in A-shares, the S&P China 500 Index's 40.73% weight indicates its focus on the Chinese domestic market. While MSCI just recognized A-shares' value with the announcement to increase their weight to 20% in November, the S&P China 500 Index has already incorporated A-shares as an essential component.

FIGURE 3: MEASURING SHARE CLASS DIVERSIFICATION ACROSS CHINA INDICES

Share Class	S&P China 500 Index	MSCI China Index
A-shares	40.73%	4.71%
B-shares	11.92%	0.08%
H-shares	17.14%	33.89%
Red Chips	6.06%	12.53%
P Chips	14.98%	27.75%
N-shares	8.62%	20.91%
S-shares	0.08%	N/A
NULL	0.47%	0.12%
TOTAL	100.00%	100.00%

Source: WisdomTree, as of 28 February 2019. A "NULL" exposure represents securities not currently covered within WisdomTree's database of equity positions.

The fundamentals between the S&P China 500 Index and MSCI China Index are similar. However, across the board, the S&P China 500 Index has higher value, better quality, and a lower price.

FIGURE 4: SIMILAR FUNDAMENTAL METRICS DEFINE THE TWO DIFFERENT "BETA" BENCHMARKS

Index	Dividend Yield	Price-to-Earnings (P/E) Ratio	Forward (P/E) Ratio	Return on Equity	Return on Assets	Price-to-Book Value (P/B) Ratio	Price-to-Sales (P/S) Ratio	Price-to-Cash Flow (P/CF) Ratio
S&P China 500 Index	2.41%	12.36	11.70	12.83%	1.48%	1.71	1.23	6.50
MSCI China Index	2.27%	12.81	15.91	12.39%	1.42%	1.71	1.42	6.70

Source: WisdomTree, as of 31 January 2019. **You cannot invest in an index. Historical performance is not an indication of future results and any investments may go down in value.**

CONCLUSION

China is an important market—the world's second largest economy behind the US. As the process to liberalize China's capital markets continues, we believe there are opportunities for differentiated exposures to China's equity markets. From this piece it is quite clear that not all Chinese equity benchmarks are created equally.

Definitions:

+ A-shares: Stocks traded in Chinese Yuan, and whose companies are incorporated in China and listed in China
+ Targeted Medium-Term Lending Facility (TMLF): a new type of People's Bank of China lending to Chinese banks that can be used up to 3 years
+ Medium-Term Lending Facility (MLF): a type of People's Bank of China lending to Chinese banks typically with maturity from 3 months to 1 year
+ Stock Connect: a program connecting Hong Kong, Shanghai, and Shenzhen Stock Exchanges

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