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Bringing China into focus

UBS Asset Management | Index inclusion

Reforms have opened China's financial markets to international investors, now index inclusion across equity and fixed income means investors can participate in China's ongoing growth story.

The world remains underinvested in China

China equities

– 234 A-shares entered MSCI's EM benchmark on June 1, 2018—the first step in a long journey to fully include Chinese equities in global benchmarks.
– This initial stage of index inclusion will bring an estimated USD 18.4 billion of investment to onshore markets, and full inclusion could bring up to USD 370 billion[1].
– MSCI inclusion creates opportunities to invest in fast-growing 'new economy' sectors, such as IT, consumer, and healthcare industries.
– A-shares are reasonably valued and offer good diversification benefits against global markets.

China fixed income

– Global benchmarks like Bloomberg/Barclays are bringing China onshore bonds into their indices from 2019.
– It is likely that this may force fund managers to allocate to China, which may spark a wave of global capital into onshore markets, estimated at between USD 250 billion to USD 300 billion[2].
– But it's also an opportunity: onshore fixed income brings higher yields, shorter duration, and lower volatility compared with global markets.
– Investors need to consider allocating now, because the mass buying triggered by index inclusion will likely decrease yields and boost bond prices.

The world is waking up to the reforms China has made to open its financial markets and the investment opportunities available as China moves to overtake the US as the world's largest economy by 2025.[3]

With these issues in mind, global benchmarks in both equity and fixed income spaces are bringing Chinese markets into their indices.

Combined, inflows into Chinese markets from full index inclusion have been estimated at more than USD 600 billion.

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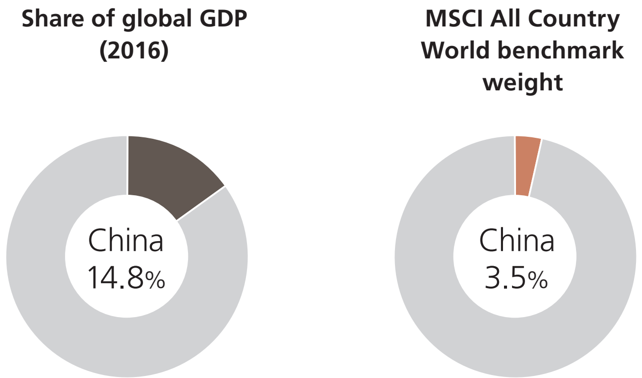
Exhibit 1: China's share of global GDP and global benchmarks



Source: Global GDP from IMF, as at Dec 2016. MSCI data as at Dec 1, 2017.

[1] Source: UBS: China Equity Strategy: What can we expect from MSCI A-share inclusion? May 14, 2018.
[2] Source: Standard Chartered, December 2017.
[3] Source: Centre for Economics and Business Research.

China A-shares and MSCI inclusion

From June 1, 2018, China's A-share market, which is made up of companies listed on Shenzhen and Shanghai exchanges, will start a journey that's estimated to ultimately bring up to USD 370 billion of flows from overseas investors.[1]

234 large-cap A-share stocks will be included into MSCI's Emerging Markets equity benchmark, with those companies having an average market cap of RMB 109 bn, concentrated in the financials, consumer, industrials, IT, and healthcare sectors.

Inclusion will happen in two stages: with a 2.5% weighting being brought in on June 1, and a second 2.5% weighting of eligible stocks being included in August 2018.

The start of a process
Bringing 234 A-share stocks into MSCI's benchmark is, we believe, a first step in a process that could lead to full inclusion of China A-shares in MSCI's benchmarks.

This first step has been estimated to bring approximately USD 18.4 billion[1] of overseas capital into A-shares. If, as we expect, MSCI moves to full inclusion in the future, an estimated USD 370 billion of overseas capital will flow into onshore markets[1].

Three key messages for investors
Importantly, MSCI's inclusion of A-shares in its index sends three key messages to global investors:
- firstly, that reforms have successfully opened up China's equity markets;
- secondly, that the water is 'safe to swim'; and,
- thirdly, that Chinese equities now become a mandatory, rather than optional, investment.

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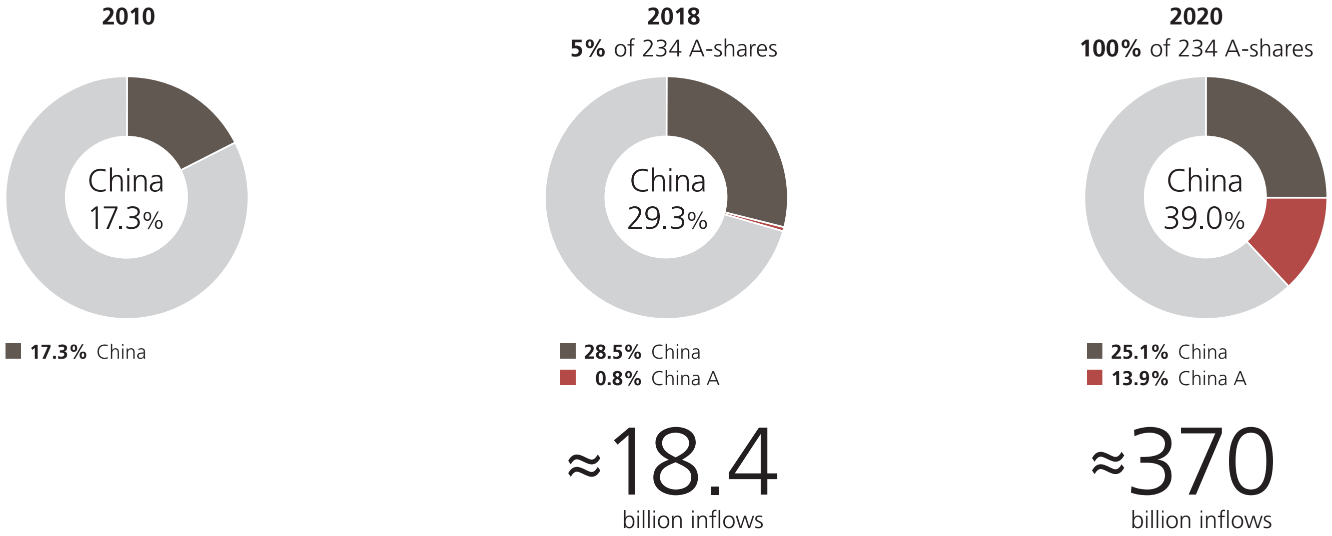
Exhibit 2: The journey to full MSCI inclusion



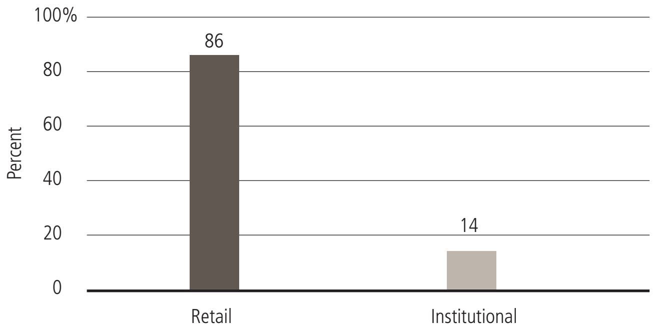
Based on free float market-cap of A-share stocks to be included, and a 30% upper limit of foreign ownership.
Source: UBS, MSCI, May 2018.

A positive change for the market
MSCI inclusion brings benefits too.

As more global investors are attracted to the A-share market, different investment strategies, i.e. long-term oriented and fundamentally-driven, will become more influential and may change the structure of the market.

That's because China's A-share market is dominated by retail investors, and an influx of institutional capital may reduce volatility and make the market more fundamentally-driven.

Exhibit 3: Retail vs. institutional trading volumes on A-share markets



Source: UBS, May 2018.

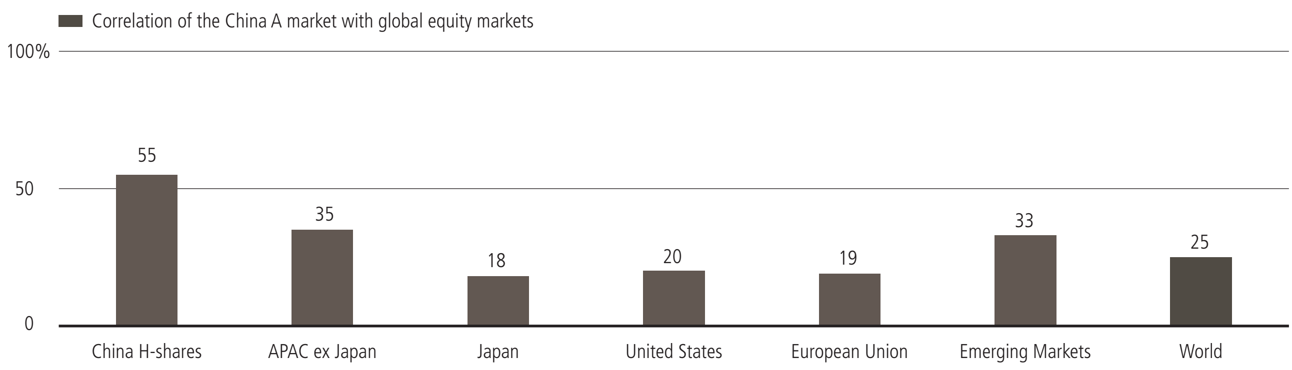
The MSCI opportunity
For investors, MSCI inclusion brings access to companies in China's fast-growing sectors, such as IT, consumer, and healthcare industries, which are well-positioned to benefit as China shifts to a 'new economy' model where services and consumer demand drives growth.

Importantly, there are many unique sectors in the A-share space, like baijiu, traditional medicine, and home appliances, that can only be invested in via onshore markets, so MSCI inclusion opens more opportunities for investors.

Index inclusion also positions investors in a market that we see as primed for long-term growth. Chinese companies capacity to innovate will be a key driver here, and we see the steady growth in R&D spending in China, plus new innovations like drones and online payments, as signaling China's longer-term potential, which we feel investors must prepare for.

Additionally, average valuations for A-share companies look reasonable compared to other markets across the globe. China A shares have a 12-month forward price-to-earnings ratio of 12.5, compared with 16.6 for US markets, 15.5 for the MSCI World, and 14.2 for Europe.[5]

Exhibit 4: China A—correlations with global equity markets



Note: Calculated by taking average of correlations of one index to each of the other local indices, past 5 years.
Source: Bloomberg, MSCI, Goldman Sachs Global Investment Research, as of Jul 2017.

[4] Source: FactSet, MSCI, UBS Asset Management, data as of end April 2018.

A-share exposure also brings diversification benefits since the A-share has low average correlations with global equity markets. That's a valuable aspect of the A-share space, particularly since volatility has returned to global markets.

As overseas investors become more active in the market, so listed companies in China will be under tougher scrutiny and they'll have to bring their disclosure and governance practices into line with international standards.

And that's good news for investors and the market's long-term development because improved disclosure enables closer analysis of companies and gives fundamental investors better insight into corporate quality.

That's particularly valuable in China, where retail investors are dominant in the A-share market and their trading behavior can create market pricing inefficiencies and volatility, which fundamental investors focused on corporate quality can exploit.

Put together, we believe the inclusion of A-share equities, like China's growth prospects, brings investment opportunities that investors simply can't ignore, so it's time to start thinking seriously about how to position in the China equity space.

China fixed income—joining the club

But index inclusion isn't just limited to equities because China's fixed income markets will also be brought into global benchmarks in the coming years. Citigroup began adding onshore bonds to its emerging markets and Asia bond indices in March, and we expect inclusion in its World Government Bond Index in the future.

March 23, 2018—A 'Big Bang' moment for China's bond markets

From April 2019, Bloomberg has proposed to begin a 20-month process of adding over 300 bonds from policy banks, the government, and some credit bonds into its Bloomberg Barclays Global Aggregate Bond index benchmark.

When completed, international investors that track the benchmark will have to allocate to China's onshore markets, and that amounts to a large commitment because the bonds included will account for an estimated 5.49% of the total index, or a projected market value of $2.94 trillion, according to Bloomberg data as of January 31, 2018.[5]

Other index providers set to include China fixed income

In mid-2018, JP Morgan will conduct a yearly review of its Government Bond Index - Emerging Markets. China bonds are expected to be up for review and if included at a weight of 10%, it's been estimated that USD 20 billion of inflows will be brought into onshore markets.

Also, FTSE Russell will review its World Government Bond Index in Q4 2018. If added at an expected weighting of 5.3%, it will trigger an estimated USD 159 billion of inflows.[6]

[5] Source: PR Newswire: *Bloomberg Launches New Fixed Income Indices Covering China Bonds.* https://www.prnewswire.com/news-releases/bloomberg-to-add-china-to-the-bloomberg-barclays-global-aggregate-indices-300618676.html
[6] Source: FT: *Foreigners lured by yield warm to China's untapped bond market.* https://www.ft.com/content/2ebfba6c-5911-11e8-bdb7-f6677d2e1ce8

The onshore opportunity

While index inclusion will force benchmark following funds to reallocate to China, it also brings attractive opportunities into focus.

Chinese onshore fixed income historically brings higher yields, shorter duration, and lower volatility compared with US and global markets more generally (see exhibit 5).

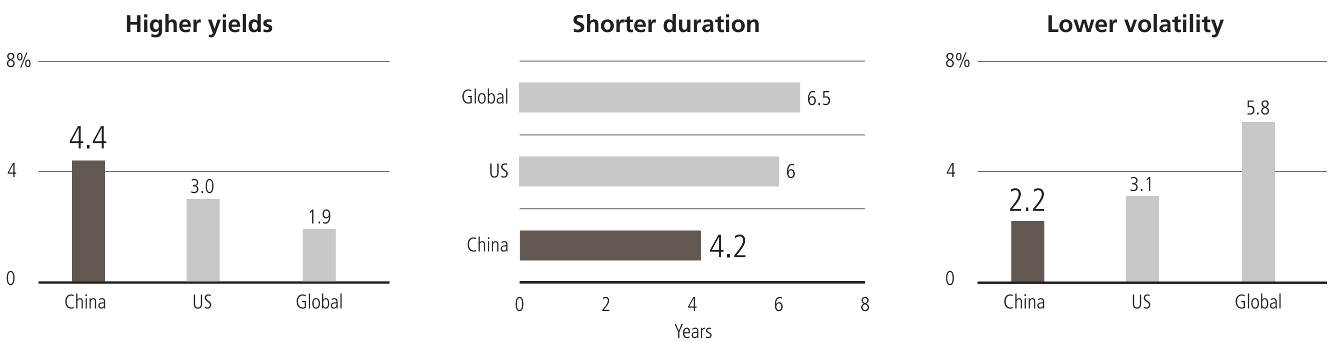
The kinds of bonds going into benchmark indices are also important to consider as an opportunity. The ones that are getting included are agencies, government bonds, utilities, financials and some of the corporates which are already rated by western rating agencies.

Chinese government bonds in particular offer A-rated, high nominal yield in the world's third largest bond market. The onshore market is liquid—seeing RMB 100 trillion of turnover YTD at the end of November 2017—and represents a safe investment since China is the second largest creditor nation in the world.

Beating the rush

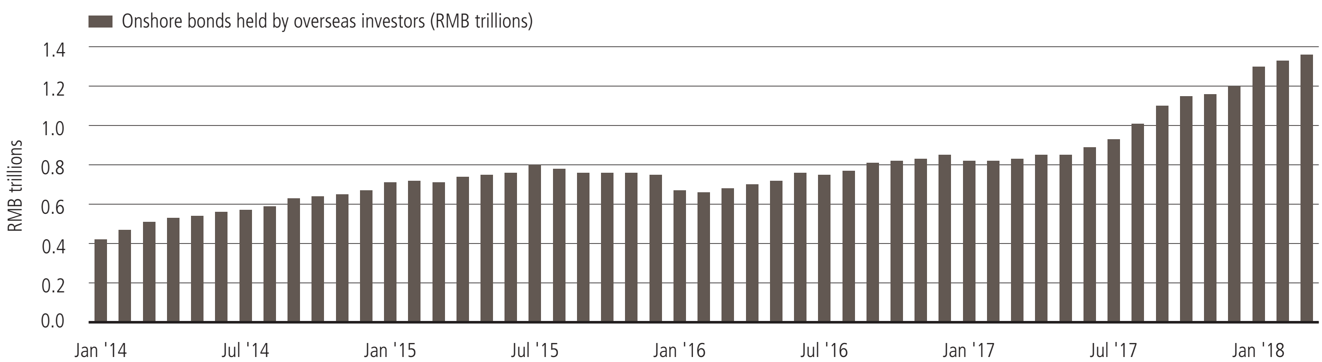
And with a significant amount of capital making its way into onshore markets as index inclusion progresses, it's time to position now, because the weight of capital coming in will likely squeeze yields in the future.

Exhibit 5: Bond markets compared, March 31, 2018



Note: Aggregate bond indices
Source: Barclays Live, as of March 31, 2018. Correlation, return and volatility are based on 10 years of monthly total return.

Exhibit 6: Onshore bonds held by Offshore investors (RMB trillions), Jan. 2014–Mar. 2018



Note: Calculated by taking average of correlations of one index to each of the other local indices, past 5 years.
Source: Bloomberg, MSCI, Goldman Sachs Global Investment Research, as of Jul 2017.

And current trends shows this shift is beginning, with overseas investors upping their onshore holdings 55% y-o-y to RMB 1.36 trillion at the end of March 2018.

More importantly, investors may consider positioning for the long-term because we're expecting China's onshore market to grow significantly in the coming years. The government is putting in reforms to establish a diversified system of financing, and bonds are at the centre of this.

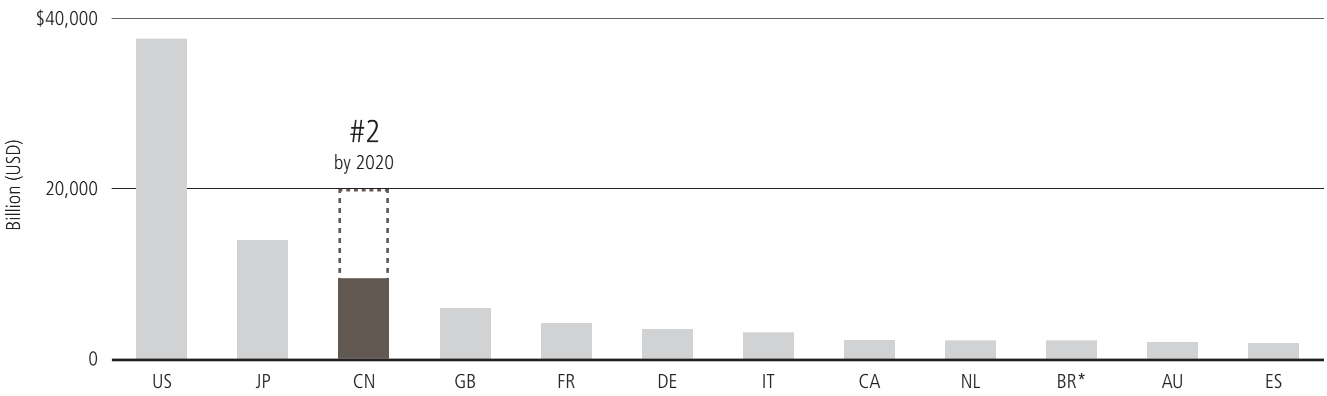
Furthermore, we see increased demand for RMB assets in the future as China moves to internationalise its currency, and build a RMB-denominated oil trading system. These factors will propel China's onshore markets into the second largest in the world, and that's something investors should be preparing for.

Conclusion

So, with China's financial markets increasingly integrated into the global economy, plus a range of attractive opportunities on offer, it is time to think about your allocation.

With an established presence in China, extensive research resources, plus a large and expanding product suite featuring our equity and fixed income expertise, UBS-AM is well-positioned to help you invest in this market.

Exhibit 7: Bond markets compared



Source: Standard Chartered Bank. As of 3Q 2016 (BR 2Q 2016) from data as of May 2017.

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