

# Bridgewater®

## Daily Observations

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### The Opening of Chinese Credit Markets Means That Foreign Investors Can Build a Balanced Portfolio in China; This Will Be a Big Deal

As you are likely aware, we have been deeply engaged in China for over 30 years. Throughout this time, we have built a rich understanding of the Chinese economy and markets and we have developed meaningful relationships with Chinese clients and policy makers. China is in the process of opening up and restructuring its capital markets, and its markets are on pace to become some of the most important liquid, publicly traded markets in the world. As most global investors are underweight Chinese assets relative to the size of the economy and markets, the opening up will likely lead to significant restructuring of global portfolios.

Chinese assets work fundamentally the same way as assets in other countries do, but China's economic conditions are often different. As a result, Chinese assets are a valuable source of diversification. As the credit markets open up alongside the equity markets, there is a greater ability for investors to create balanced portfolios of Chinese assets as well. By balancing Chinese assets that have offsetting sensitivities to shifts in the Chinese economic environment, investors can expect to produce more consistent returns than an investment in just equities. The following highlights our thoughts on the opening up of the markets, which we expect will lead to a wave of inflows.

### Chinese Asset Markets Are Large and Liquid

It is unprecedented that such large markets become available to investors so quickly. For perspective, the recent opening of Chinese markets is roughly equivalent to the German, French, and Italian asset markets all becoming available to investors in the space of less than two years. China now has the world's second-largest equity market and the third-largest sovereign bond market, as shown in the table below.

**Global Rankings of Asset Markets (USD, Bln)**

Rank	Equity Market Cap		Gov't Bonds Outstanding	
1	United States	\$27,469	United States	\$14,180
2	China	\$9,291	Japan	\$9,540
3	Japan	\$5,444	China*	\$5,828
4	United Kingdom	\$3,074	Italy	\$2,295
5	France	\$2,417	France	\$2,285

\* Includes policy bank bonds

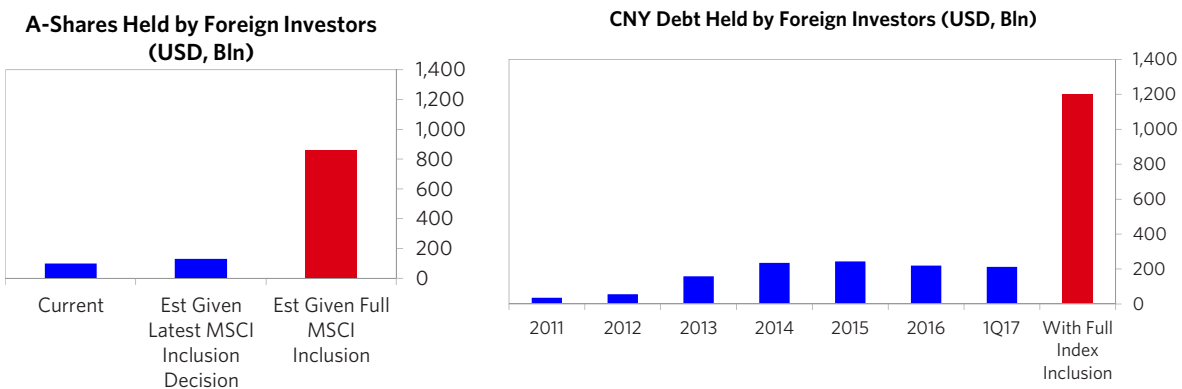
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Over the past several years, these markets have gone from being essentially closed to foreign investors to almost completely open to foreign investors. While in 2015 only about 10% of Chinese capital markets were accessible to foreigners, today that figure is close to 80%, or about \$13 trillion.



From the standpoint of Chinese policy makers, this evolution makes sense and is consistent with the gradual moves underway since 1978. Opening capital markets will attract stable pools of global institutional investment, deepen capital markets, and create two-way flows in the currency.

For global investors, this now means their portfolios are inadvertently significantly underweight Chinese markets relative to China's size and accessibility. With Chinese assets increasingly being incorporated into the larger benchmark indices, foreign holdings of Chinese assets could rise by nearly two trillion dollars over time, as shown in the charts below.



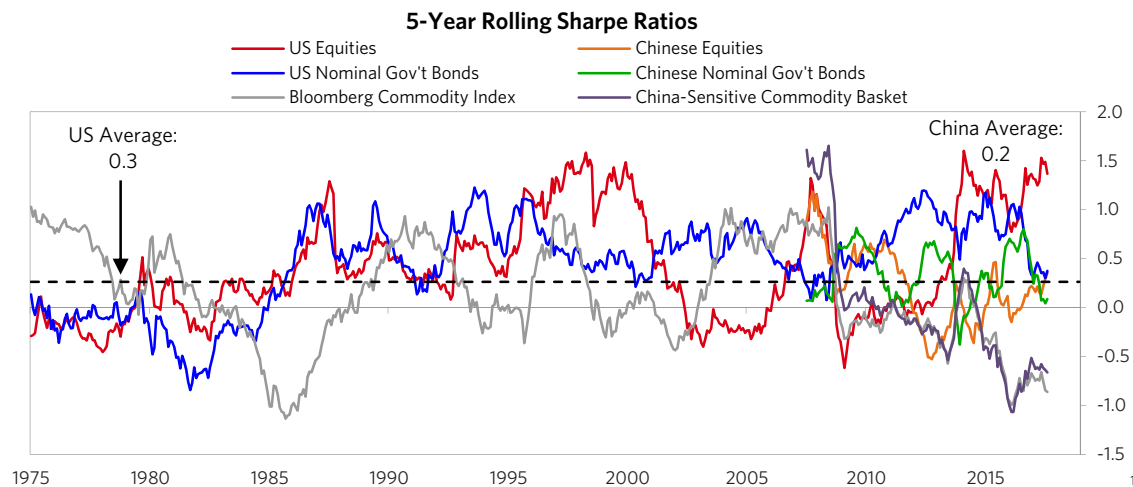
## Chinese Assets Work the Same Way as Global Assets

In the most important ways, assets behave similarly across countries. In general, assets that have higher risks than cash have risk premiums relative to cash. And the relationship between economic environments and assets is universal because it is based on the fundamental nature of the assets' cash flows (i.e., bonds are fixed cash flows, equity cash flows move with earnings, and so on).

Assets generally have a risk premium relative to cash. Below, we illustrate this relationship since 1970 in the US and the corresponding picture in Chinese asset markets since 2005. As you can see, assets have similar Sharpe ratios (the ratio of return above cash relative to volatility) over the long term. However, as the bottom chart shows, individual asset class performance can vary significantly over shorter periods. The history of Chinese assets is relatively short, but the average Sharpe ratio across assets is positive, like that of US assets over a much longer time frame.

### Historical Asset Performance (US: January 1970–Present, China: August 2002–Present)

		Equities		Nominal Gov't Bonds		Commodities	
		US	China	US	China	Bloomberg Index	China-sensitive
Return and volatility differ across asset classes	Total Return	10.2%	7.3%	7.3%	3.9%	7.4%	4.8%
	Volatility	15.4%	29.7%	6.2%	5.6%	16.0%	18.3%
But return relative to risk is similar	Sharpe Ratio	0.31	0.16	0.34	0.25	0.14	0.12

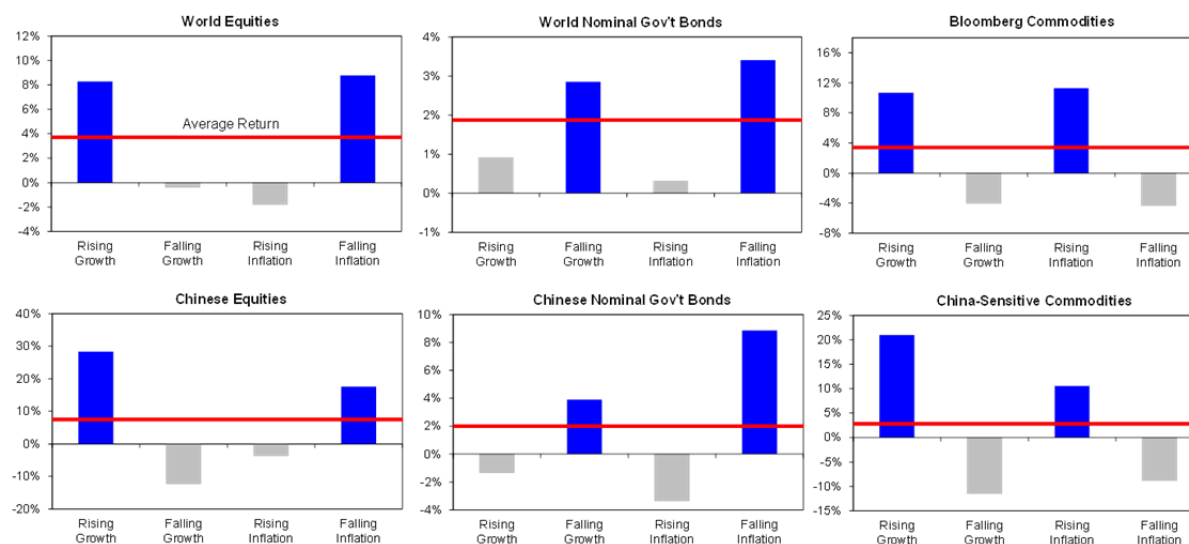


Changes in asset prices are primarily caused by economic surprises, specifically growth and inflation surprises. This is because asset returns are logically linked to the volume of economic activity (growth) and the pricing of that activity (inflation). These sensitivities are logical consequences of the assets' cash flows, and independent of the country of issuance. For example, you would logically expect stocks and bonds to have opposite biases to growth surprises. Stocks give you a claim on future earnings, so they are worth more when earnings and the economy are stronger than expected. Bonds give you a fixed stream of payments and discount a forward path of interest rates for valuing those payments, so they do better when interest rates fall due to unforeseen economic weakness.

<sup>1</sup> Data for US assets from January 1970 through August 2017 in USD. Data for Chinese assets from August 2002 through August 2017 in CNY.

Note that nothing in the above logic is dependent on geography—it is universally true based on the very nature of the asset classes themselves. This allows one to construct a portfolio that is balanced to economic surprises with global assets or with the assets of a single country. As shown below, both global and Chinese assets have historically performed consistently with these logical expectations.

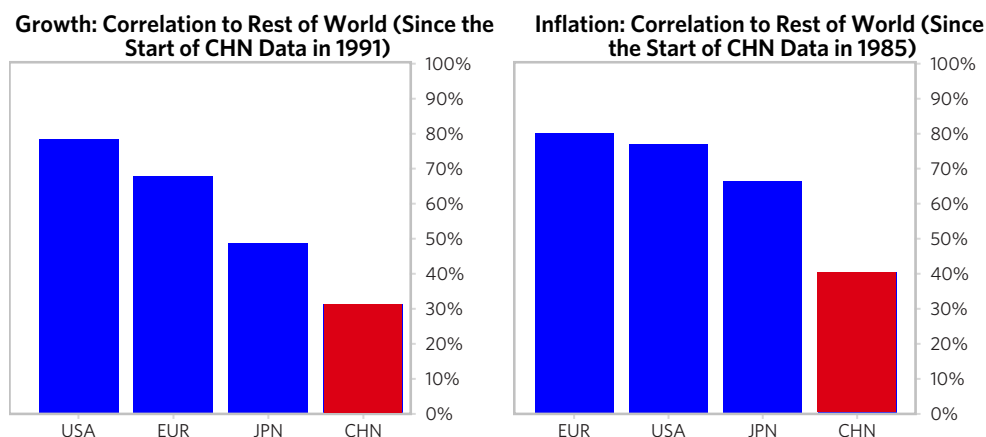
### Annual Asset Class Returns in Different Growth and Inflation Environments



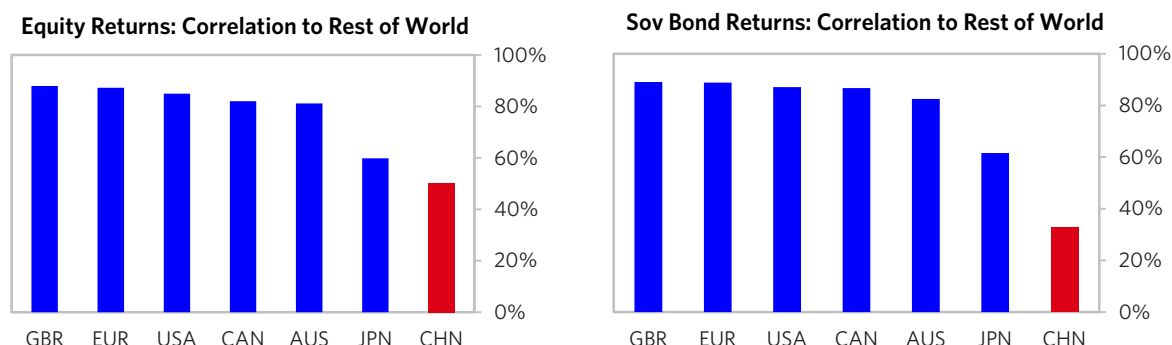
The differences in how assets perform in different environments allow one to put together a balanced portfolio of assets that diversifies away the environmental bias of any one asset and achieves a more consistent return stream.

### Chinese Conditions Are Different, Meaning Chinese Assets Are Diversifying to Global Assets

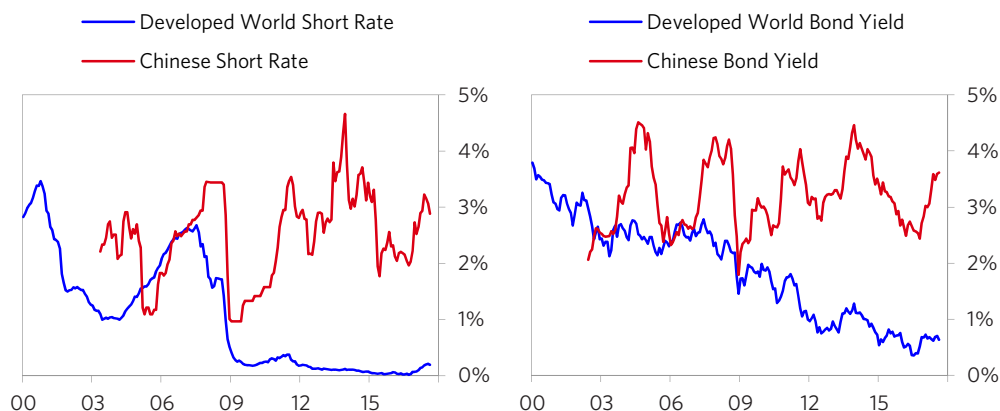
While China has a large influence on other major economies and vice versa, growth is primarily driven by the domestic economy, not exports, and China is at a different point in the long-term debt cycle than the developed world. Japan, Europe, and the US all have debt levels over 300% of GDP, interest rates close to zero, large central bank balance sheets, and growth well below 5%—none of which is true in China. All of these factors mean that conditions in China look different than in the countries that dominate institutional portfolios, as shown in the charts below.



Since changes in conditions are the primary driver of changes in asset prices, the differences between Chinese conditions and global conditions imply that you would expect Chinese assets to be lowly correlated to the assets that make up most institutional portfolios. Historically, this has been true, as seen in the charts below. As China's markets continue to open up and global capital flows more freely, correlations will likely rise somewhat as ebbs and flows in global liquidity begin to have more impact, but we expect the fundamentally diversifying effects of Chinese assets will persist.



Another big difference between Chinese conditions and global conditions is the monetary “fuel in the tank”—the capacity for the central bank to ease should conditions require it. This is a consequence of China and the developed world being at different points in the long-term debt cycle. In developed economies, the lack of fuel in the tank is probably the single biggest risk to all beta portfolios. In the event of a downturn in which central banks need to ease and lack the “fuel” to do so, risky assets could perform extremely poorly. In China, this risk is minimal, as there is room for rates to fall both at the short end and the long end of the curve.



While Chinese labor and goods have reshaped the world in the past few decades, we expect Chinese capital markets to reshape the global financial landscape in the next decade. Given the opening of Chinese asset markets and the ability to invest in a responsible, balanced way, we expect that a wave of investment into Chinese financial assets is inevitable and imminent.

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