

Bridgewater®

Daily Observations

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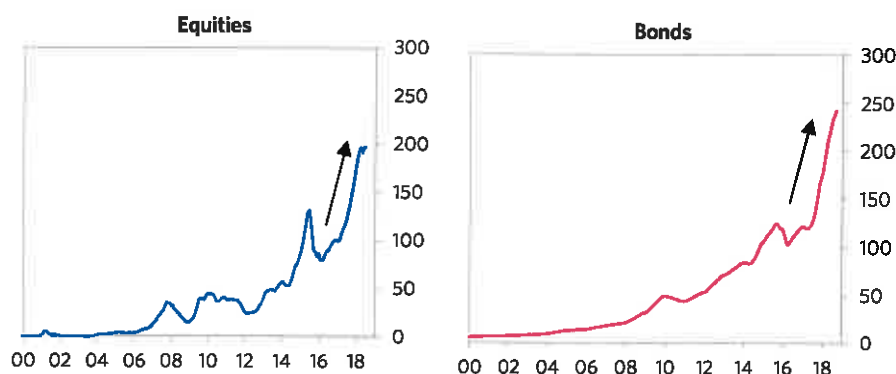
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The Shift to Chinese Assets Is Beginning

Most global investors are underweight China relative to the size and importance of the Chinese economy and its financial assets. Over the last year, we have seen indications of this beginning to shift, with a notable recent acceleration in foreign purchases of bonds and stocks. These moves are reflective of the ongoing steps China has taken to make their markets more attractive to foreign investors and of the gradual inclusion of Chinese assets in major global indices. In this context, there have been a variety of improvements in Chinese asset markets that we thought were worth pointing out. With respect to bonds, in recent months policy makers have implemented a series of important market reforms (clarifying foreigners' tax treatment, block trading, adding delivery versus payment) in preparation for China's announced addition to the Bloomberg Barclays Global Aggregate in 2019. With respect to Chinese stocks, FTSE's decision last week to begin phasing A-shares into its Global Equity Index next June marks another milestone. The recent acceleration in foreign inflows into both asset classes is reflective of the ongoing progress, though foreign holdings remain a fraction of where they would be if allocations were in line with the size of China's markets and economy.

Foreign Holdings of Chinese Assets (USD, Bln)



The motivations for China to open up their markets are clear, and if they do so, we expect foreign interest will continue to grow. China wants foreign capital to deepen their capital markets, help further develop their economy, and bring in flows that will allow them, over time, to relax capital controls and create a two-way currency market. The table below highlights the major steps we have seen along the path to opening and reforming Chinese markets and increasing foreign participation. While there have been some stops and starts along the way—particularly following the 2015 stock crash—the underlying trend has been one of meaningful reform to open up and bring domestic capital markets closer to international standards.

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Major Steps in the Opening of Chinese Markets

| Date | Step |
|----------------|--|
| November 2014 | Stock Connect: Shanghai-Hong Kong Stock Connect launches, allowing mutual market access subject to restrictions. |
| August 2015 | Stock Market Intervention: CSRC clarifies the circumstances and duration of shares suspended from trading. |
| February 2016 | CIBM Direct: Foreign investors can participate in the onshore interbank bond market (CIBM). |
| December 2016 | Stock Connect: Shenzhen-Hong Kong Stock Connect opens. |
| May 2017 | Bond Connect: Foreign investors can access China's bond market via the Hong Kong exchange, removing the need for onshore settlement. |
| June 2017 | MSCI Inclusion: MSCI announces that China A-shares will be included in MSCI ACWI, MSCI EM, and MSCI China indices. |
| March 2018 | Bloomberg Inclusion: Bloomberg Barclays Indices announces plan to include Chinese bonds in Global Aggregate starting March 2019. |
| | RDVP Settlement: The CCDC circulates details for real-time delivery versus payment settlement for Bond Connect transactions. This eliminates the lag between delivery of bonds and the cash payment, a prior source of counterparty credit risk. |
| August 2018 | Block Trading: Tradeweb, the platform used to trade bonds on the Bond Connect, now allows managers to allocate block trades to multiple client accounts prior to the trade. Tax Treatment: For a tentative three-year period, policy makers waive taxes on interest income and value-added taxes on policy bank notes for foreign bond market investors. |
| September 2018 | FTSE Index Inclusion: FTSE announces the inclusion of China A-shares in their indices at a 25% inclusion factor. MSCI Inclusion Factor: MSCI circulates a consultation paper that considers raising the A-shares inclusion factor from 5% to 20%. The same paper considers counting mid-cap companies toward China's investible market cap, which would increase the full weight of Chinese equities that can be included in the indices. |

Current Holdings of Chinese Assets Are a Fraction of What They Would Be If China Were Held in Proportion to the Size of Their Markets and Their Economic Importance

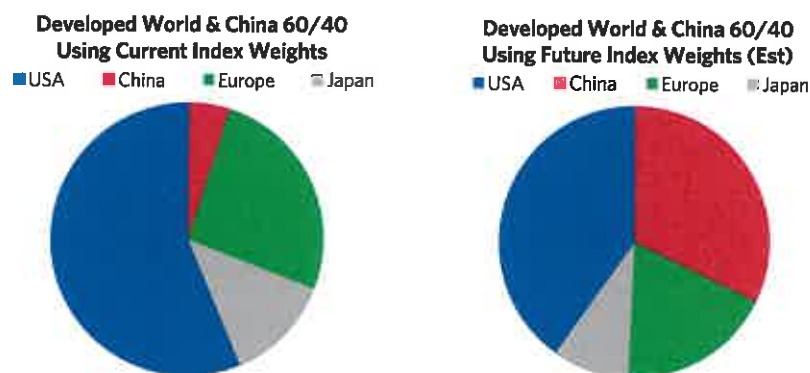
The gradual inclusion of Chinese bonds into global indices reflects the steps that China has taken to improve their market infrastructure and accessibility, detailed above. This is a big deal for global capital allocation, as trillions of dollars track these indices explicitly and trillions more use it as an important reference for their allocation. To put perspective around the size of a shift related to just the mechanical flows, below we show the increase in foreign holdings of Chinese bonds that would occur with full inclusion across indices.



While the moves to include A-shares in global indices have been small, they reflect the significant progress policy makers have made to address foreign investors' concerns. FTSE will include A-shares at a 25% inclusion factor in the FTSE Russell EM index, phased in between now and March 2020. MSCI's proposal would increase the inclusion factor of China A Large Caps to 20% in the next year and expand the set of eligible securities to include China Mid Cap and ChiNext stocks. China is being added to all of FTSE's and MSCI's major benchmark indices—we show the shifts in their flagship EM indices below.

| MSCI EM Equity Index Country Weights | | | | | FTSE Russell EM Equity Index Country Weights | | | |
|---|---------|---------|---------|----------------|---|---------|---------------|----------------|
| | Current | Aug '19 | May '20 | Full Inclusion | | Current | 25% Inclusion | Full Inclusion |
| China H-Share | 31% | 29% | 28% | 22% | China H-Share | 34% | 32% | 27% |
| China A-Share | 0.7% | 2.8% | 3.4% | 18% | China A-Share | 0% | 6% | 19% |
| Korea | 15% | 14% | 14% | 12% | India | 12% | 12% | 10% |
| India | 9% | 9% | 9% | 8% | Brazil | 7% | 7% | 6% |
| Brazil | 6% | 6% | 5% | 5% | South Africa | 7% | 7% | 6% |
| South Africa | 6% | 6% | 6% | 5% | Others | 39% | 37% | 32% |
| Others | 33% | 34% | 35% | 30% | | | | |

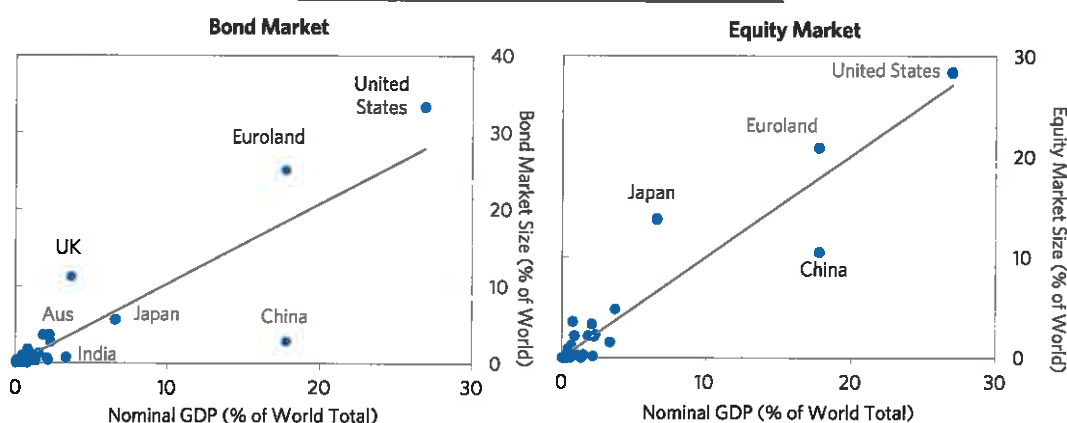
The charts below look further out into the future to how the allocation of the traditional global asset mix will look in a future where China is held at full market weight.



Chinese Markets Are Some of the Largest in the World, and Their Liquidity Is Rapidly Growing

Chinese markets are already some of the largest in the world, but given both the size of outstanding financial assets and economic clout, there is substantial room for them to grow larger. Market size in this context is the capacity of markets to absorb trade flows without large moves in prices, which we estimate by combining the outstanding quantity of assets with typical daily trading volumes and other indicators of market activity. When we assess Chinese markets in this way, both the equity and bond markets stand out as quite large in an absolute sense, though China's equity market is a fair bit further along. By our market size measures, it is the fourth largest equity market in the world. Both markets have substantial room to become more liquid, which would also bring their practical size further in line with China's economic importance.

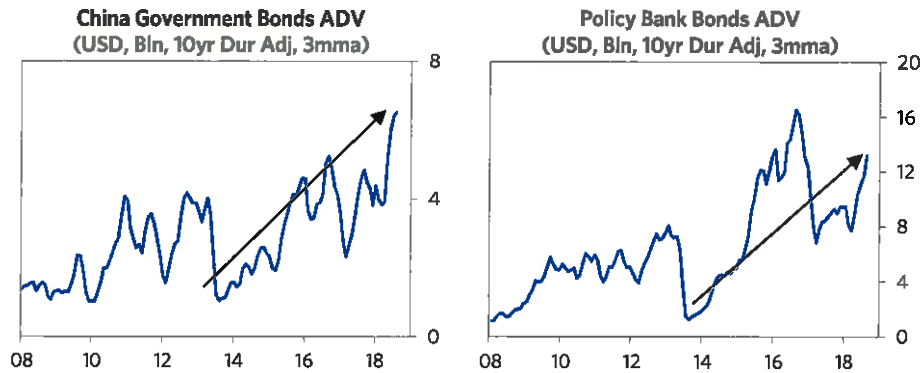
Market Size vs Economic Size (Share of World)



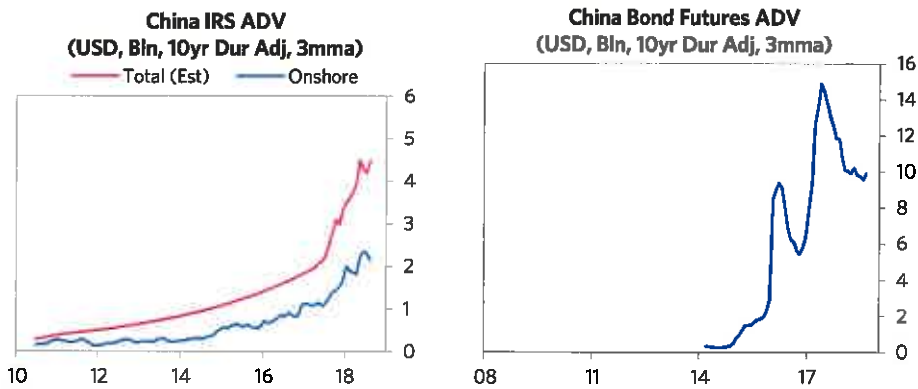
To give another sense of the absolute market size of the bond market, we show trading costs below. Chinese bond trading costs are fairly cheap relative to Korea, India, Brazil, or Mexico, but are still higher than those of developed nations.

| | Average Bid/Ask Spread (yield bps) | Average piece sizes (USD Mln) |
|-------------------------|---------------------------------------|----------------------------------|
| China Government Bonds | 1-3 bps | 15 |
| Policy Bank Bonds | 1-2 bps | 15-25 |
| Korea Government Bonds | 1-1.5 bps | 20 |
| India Government Bonds | 0.75-3 bps | 15 |
| Brazil Government Bonds | 2-3 bps | 15-20 |
| Mexico Government Bonds | 1.5-2 bps | 10-20 |
| US Treasuries | 0.25-1 bps | 50-100 |
| German Bunds | 0.25-1 bps | 50-100 |
| UK Gilts | 0.5-1 bps | 50-100 |

The picture today reflects meaningful improvements in trading activity and market liquidity in recent years. In aggregate, Chinese government and quasi-government bonds trade on average \$20 billion per day, a sixfold increase during the last decade. For reference, US treasuries trade around \$210 billion in cash securities, UK gilts around \$40 billion, and JGBs around \$60 billion a day. Both China Government Bonds and Policy Bank Bonds are liquid, but Policy Bank Bonds are more actively traded, owing to higher concentration in on-the-run issues with greater secondary issuance.

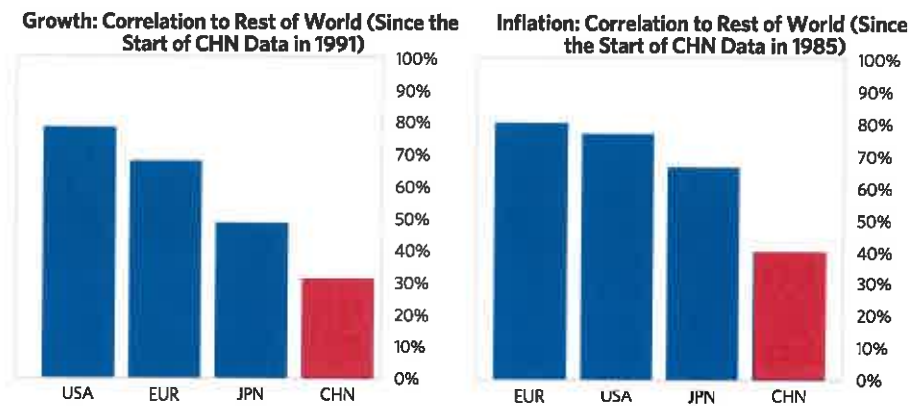


Derivative instruments in Chinese rates are increasingly supporting liquidity in the cash markets, but remain in the early stages of their development and likely have a lot of room to grow. RMB IRS have rapidly increased in volume after central clearing was required in 2014. Today, IRS trade above \$2 billion in 10-year duration terms onshore. The growth of onshore bond futures (5-year and 10-year) launched in 2013 is also particularly noteworthy. They trade today around \$10 billion, solely on the back of domestic liquidity, as these contracts remain closed to foreign participation. Bond futures are still substantially limited as a result of restrictions on participation by local banks as well.

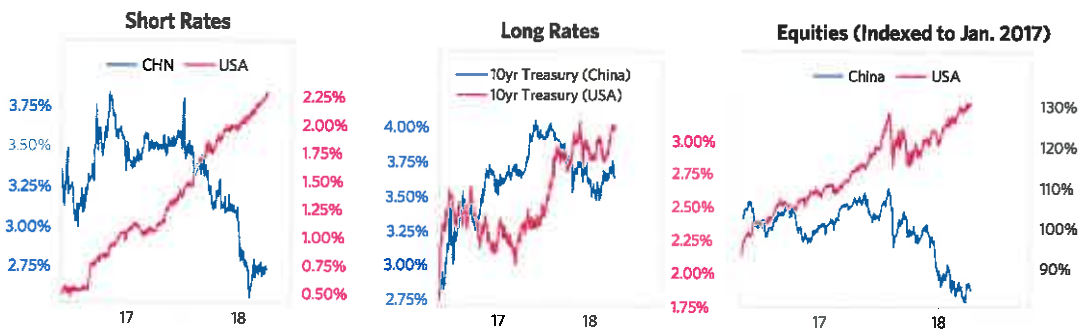


China's Independent Monetary Policy Is Primarily Driven by Domestic Conditions. The Recent Experience of China Easing When Most of the World Is Tightening is a Good Example.

For international investors, Chinese assets offer unique diversification benefits. The Chinese economy is largely driven by domestic demand, and its fundamentals are relatively uncorrelated with the rest of the world. The PBoC is largely able to run its monetary policy in line with the needs of its domestic economy. While we expect that as foreign players enter the market the relationship between Chinese and global bonds will increase, China's domestic economy is massive and domestically focused enough to be the dominant driver of the movements in Chinese assets over the medium and longer term. As shown below, Chinese fundamental conditions such as growth and inflation are lowly correlated to the rest of the world.



These diversification benefits are clear today. China is at a different point in both the short-term and long-term debt cycles than much of the developed world. These divergent conditions have driven different policy responses recently. In 2017, the Fed was gradually withdrawing liquidity as private credit growth continued to replace money, while Chinese policy makers were aggressively tightening across monetary, fiscal, and regulatory fronts to bring down financial leverage and target excesses in unsustainable sectors. This tightening led to a meaningful decline in credit and a modest slowdown in growth, and Chinese policy makers have now been easing to offset this, while the US continues its tightening.



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