Schroders

Marketing material for professional investors and advisers only

Weightlifting China – how big will it get?

March 2019

China is woefully under-represented in investors' portfolios, given the size of its asset markets and economy. However, improvements in access mean this no longer has to be the case. Index providers are responding and China's weight in benchmarks is rising. Significant investor inflows are likely to follow – we project $200 billion into both local equity and bond markets in our half-way house scenario and $400 billion into each if they go further. How should investors respond? Benchmark providers are not masters of the universe and being governed solely by their moves in a market like China strikes us as illogical. The opportunity is alive today for investors who want to pursue it.

Duncan Lamont
Head of Research and Analytics

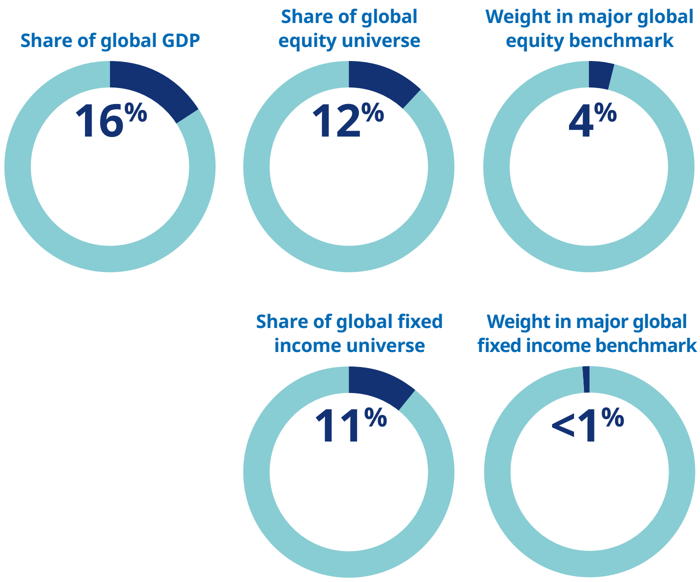
China punches below its weight in global capital markets...

China's debt market is the third largest in the world at around 11% of the global market[1], while its equity market is around 12% of the global universe[2]. However, only a small proportion of these markets is currently accessible to international investors. Chinese equities represent a mere 4% of the free-float-adjusted MSCI All-Country World Index and its external USD-denominated bonds barely half a percent of the Bloomberg Barclays Global Aggregate index (Figure 1). Meanwhile, its local RMB-denominated bond market, valued at over $11 trillion, has been excluded entirely from the main fixed income benchmarks.

...but things are changing

The key reason that Chinese assets have been so poorly represented in major benchmarks is that the Chinese authorities have wished it to be so. Stringent regulations restricting foreign ownership of Chinese companies and tight currency controls made it incredibly difficult for international investors to access local Chinese markets. Chinese state motivations were grounded in a desire to maintain control and over genuine concerns about stability of the currency and economy if their markets were to be opened more fully. Until relatively recently, local Chinese asset markets were not easy to invest in and thereby failed a key test of a good benchmark. However, as described later, this is changing. This has been most notable in equities but significant progress is also now underway in the fixed income market. While benchmark providers have moved slowly to add Chinese assets, active investors are already able to access the opportunities available in these markets.

Figure 1: China is remarkably under-represented in global indices



The major global equity benchmark is the MSCI All-Country World Index; the major global fixed income benchmark is the Bloomberg Barclays Global Aggregate.

GDP data cover 2018 calendar year; share of global equity universe is as at 29 January 2019; share of global fixed income universe is as at third quarter 2018; weights in major equity and fixed income benchmarks are as at 31 December 2018.
Source: Bank of America Merrill Lynch, Bloomberg, IMF, MSCI and Schroders.

1 Bank for International Settlements, as at third quarter 2018.
2 Bloomberg and Schroders, January 2019.

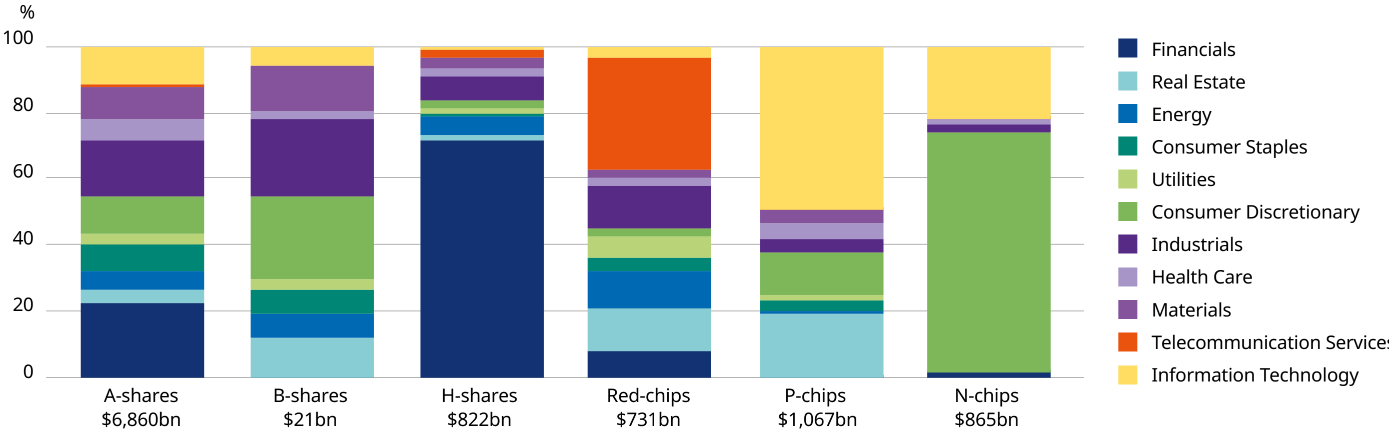
Figure 2: An alphabet soup of share classes

A-shares	Shares in Chinese companies which are traded on the Shanghai or Shenzhen exchange and which are denominated in renminbi. Covering around 3,500 stocks with a value of almost $7 trillion, these are the largest part of the Chinese equity market by some margin, representing around 70% both by number of companies and market capitalisation. A-shares also have the most balanced sector composition (Figure 3).
B-shares	Shares in Chinese companies which are traded on the Shanghai or Shenzhen exchange but denominated in a foreign currency e.g. US or Hong Kong dollars (HKD). At only 0.2% of the total Chinese equity market capitalisation, these represent a dwindling part of the market.
H-shares	Shares in Chinese companies which are traded in Hong Kong in HKD. Almost 75% of this market relates to the financial sector. It is common for companies which issue H-shares to have a dual A-share listing, whereas dual B-share listings are far less common. H-shares are around 9% of the overall Chinese equity market and state approval is required for the issuance of new shares.
Red chips	Shares in Chinese state-owned enterprises (SOEs), which are incorporated outside of mainland China and traded in Hong Kong in HKD. At 27% of the index, China Mobile dominates this market. In aggregate, red chips are around 9% of the overall Chinese equity market.
P-chips and N-chips/US-listed ADRs	Shares in non-Chinese incorporated companies which operate in China and are traded in Hong Kong and New York in the corresponding domestic currencies. N-chips are also sometimes referred to as US-listed American Depositary Receipts (ADRs). P-chips and N-chips sometimes have a majority Chinese owner which retains control. They include companies such as Tencent (P-share) and Alibaba (N-share). These classes can have inferior voting rights to those in the parent company and their legal status has never been formally recognised by the Chinese authorities. They are respectively 13% and 4% of the overall Chinese equity market.

Other smaller classes also exist, such as S-chips, which are listed in Singapore, and L-chips, which are listed in London. Source: Schroders, Wind, CICC Strategy research. Data as of February 2019.

Figure 3: The A-share market is the biggest and most diverse Chinese equity market

Sector split



Source: Schroders, Wind, CICC Strategy research. Data as of February 2019.
Note that sector breakdown above uses the FTSE sector classification which differs from MSCI. FTSE classify Alibaba as a consumer discretionary stock where MSCI classify it as IT.

Equities: a rich array of options

The complexities of the regulations governing Chinese capital markets have given rise to an alphabet soup of share classes, spread across several countries, each exhibiting variations in size, depth, liquidity, sector make-up and ownership rights (Figures 2 & 3).

A-shares have been a relatively recent addition to major benchmarks and, even then, only to a limited degree. In contrast, international investors have been able to buy and sell H shares, red chips, P-chips and N-chips and, with a little more effort, B-shares. These have therefore formed the main constituents of major benchmarks such as the MSCI China Index, which has in turn been a component of widely followed global indices such as the MSCI Emerging Markets and MSCI All-Country World indices. The combination of these share classes is dominated by large technology companies, especially Tencent (16%) and Alibaba (12%), and financial stocks, many of which are state-owned enterprises. The MSCI China represents over 30% of the MSCI Emerging Markets Index but this translates into only 3.6% of the MSCI All-Country World Index.

One consequence of the historical exclusion of A shares from major benchmarks is that the A-share market has been dominated by local retail investors - in 2017, they owned almost 90% of the market[3]. This made it a volatile market that was vulnerably to changes in sentiment. However, this has been changing. MSCI first admitted A-shares from 226 companies to its main benchmark in June 2018. Companies which had been suspended from trading for more than 50 days in the previous 12 months, as well as small and mid cap stocks, were not eligible for selection. At first, only 5% of their market capitalisation was approved for inclusion (2.5% initially, followed by a subsequent 2.5%) but there is currently a consultation underway regarding a proposal to increase this to 20%. This consultation is also considering whether 20% of the market capitalisation of mid cap stocks should be eligible for inclusion and whether stocks on the technology-focussed ChiNext market should be eligible. Domestic Chinese stocks currently make up only 0.7% of the MSCI Emerging Markets index but the direction of travel is clear. This percentage is set to grow over time.

3 Shanghai Securities Exchange Yearbook, CICC Research, May 2017

Increasing foreign ownership and participation are also likely to drive incremental changes, including further institutionalisation of the A-share market, and potentially encouraging better governance and standards. Our internal research has confirmed that this may already be happening. We have started to observe a shift towards fundamental factors becoming more important in the A-share market since the Stock Connect scheme was launched to ease overseas access[4].

Stock Connect has been a game changer

There are three main ways that international investors have been able to gain access to A-shares: the Qualified Foreign Institutional Investor (QFII) or Renminbi Qualified Foreign Institutional Investor (RQFII) programmes, which have been in operation since 2002 and 2011, respectively or, more recently, through Stock Connect. Stock Connect is the trading system that links the Hong Kong with the Shanghai and Shenzhen exchanges. The key similarities and differences are set out below (Figure 4).

Both the QFII and RQFII schemes are confined to qualifying investors, who must obtain a licence to trade in mainland China. They are also governed by quota restrictions and used to also be affected by strict repatriation limits. These constraints limited participation in the market but have been lessening over time. For example, three-month lock-up periods and repatriation limits were abolished in June 2018.

Stock Connect, which initially covered Shanghai but was expanded in December 2016 to also cover Shenzhen, has been a game changer. It allows investors to trade in eligible A-shares via Hong Kong without the need for a local Chinese licence (and for domestic Chinese investors to invest overseas through the same channel). Restrictions on repatriation have been lifted and aggregate quotas abandoned – although daily quotas continue to apply, these have quadrupled in the past two years and are, at present, not an obstacle. These changes have considerably broadened the scope for international investors to access Chinese A-shares. Northbound flows (to the A share market) and southbound flows (to Hong Kong) have picked up considerably as a result.

One area that has seen visible improvement is the level of voluntary suspensions among A-shares. This occurs when companies decide to stop trading in their shares for extended periods of time, often without warning. When this happens, investors are unable to get their money out. As of September 2018, there were no large or mid-cap stocks and only two small cap stocks suspended within MSCI's eligible universe. This represents a dramatic improvement from a few years ago when MSCI commented that suspensions were "by far the highest in the world".

These improvements and the successful functioning of Stock Connect were behind MSCI's announcement in December 2018 that they were considering including A shares on a larger scale than at present. This announcement came much sooner than we had expected.

Figure 4: There are multiple routes to accessing local Chinese equities

	Stock Connect	RQFII	QFII
Quota size	– No quota limit	– RMB 1,740 billion (USD 253 billion)	– US$300bn
Eligible investor	– All investors	– Only licensed investors based in selected eligible locations where the RQFII scheme is available	– Only licensed investors that meet certain operation and AUM requirements
Quota requirement	– No requirement	– Quota linked to asset size or investment requirements. To be approved by SAFE – Unused quota within a year will be cancelled	– Quota linked to asset size or investment requirements. To be approved by SAFE – Unused quota within a year will be cancelled
Capital mobility	– No restriction – Daily investment quota of RMB 52bn (USD 7.6 bn) for both northbound and southbound channels	– *Repatriation:* Daily – *Lock-up:* None – *Remit Period:* None – *Others:* Quota required to be used within 1 year upon approval	– *Repatriation:* Daily – *Lock-up:* None – *Remit Period:* N.A. – *Others:* Monthly repatriation cannot exceed 20% of NAV of previous year
Eligible investment	– 1480+ stocks listed on Shanghai and Shenzhen Stock Exchanges	– All securities listed on Shanghai and Shenzhen Stock Exchanges	
Currency	– Offshore RMB (CNH[5])	– Offshore RMB (CNH)	– Onshore RMB (CNY)

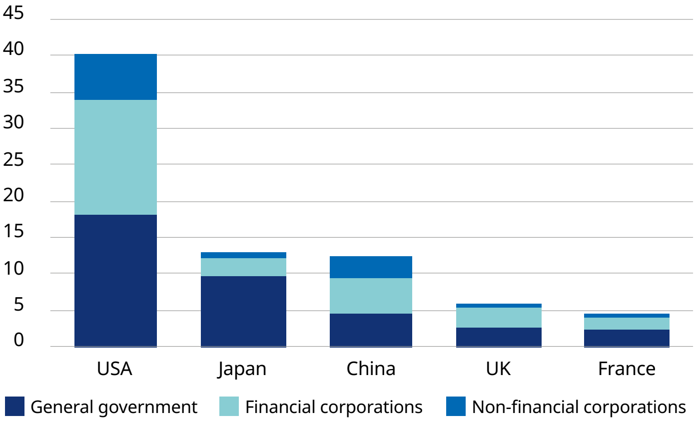
Source: QFII quota was doubled from $150bn to $300bn in January 2019. RMB/USD exchange rate is as at 31 December 2018. All other data is sourced from CICC, as at August 2018.

4 This will be a subject of subsequent research output
5 CNH is the currency code for renminbi when traded outside of China in markets such as Hong Kong. CNY is the code for the onshore equivalent, which is used interchangeably with RMB.

Fixed income

The Chinese onshore bond market is the third largest in the world at around 11% of the global market (Figure 5) and is projected to become the second largest by the end of 2019.

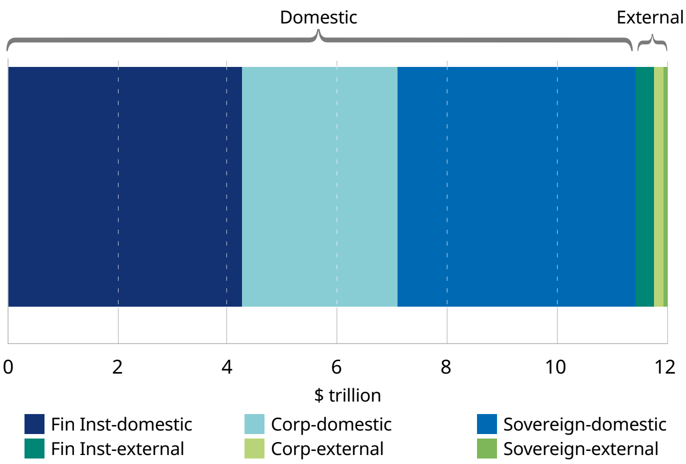
Figure 5: Largest debt markets in the world ($ trillion)



Source: Bank for International Settlements. Data as at Q3 2018. Excludes international debt.

A key distinction is between the onshore (domestic) and offshore (external) markets. Like the domestic equity market, the onshore fixed income market has historically only been tradable in mainland China among mainland domiciled investors, with the offshore market tradable overseas. Securities in the offshore market are mainly denominated in US dollars and, since 2007, "offshore Renminbi" (CNH). This distinction is important because the offshore market is readily accessible by international investors, yet represents only 5% of the total (Figure 6). The other 95% has been excluded entirely from major international fixed income benchmarks. However, here too, as with the equity market, things are changing. On 31 January 2019, Bloomberg became the first major fixed income benchmark provider to confirm that it would start including local Chinese bonds in its flagship Global Aggregate index[6]. Qualifying government and policy bank[7] (financial) bonds will start to be added from April 2019, with the allocation gradually increasing to a projected total of around 6% by November 2020 (based on market values as at 24 January 2019). this will make it the fourth largest currency component of the benchmark.

Figure 6: The onshore market dwarfs the external market



Source: Bank of America Merrill Lynch, 30 July 2018.

6 https://www.bloomberg.com/company/announcements/bloomberg-confirms-china-inclusion-bloomberg-barclays-global-aggregate-indices/
7 Banks which undertake the policy operations of China's state-owned professional banks. They include the China Development Bank, the Agricultural Development Bank of China and the Export-Import Bank of China.

There is a marked contrast between the constituents of the onshore and offshore markets. Within the onshore market, Chinese government, municipal and policy bank (financial) bonds dominate. In contrast, corporate bonds tend to dominate the offshore market (Figure 7). This has been partly driven by the Chinese government's relatively limited historical need to borrow, given its ability to self finance locally and because of substantial surpluses generated by the central government.

Figure 7: The two Chinese debt markets offer very different constituents

Market size ($ bn)	Domestic	External
Sovereign	4,326	55
Non-financial corporates	2,816	242
Financials	4,277	321

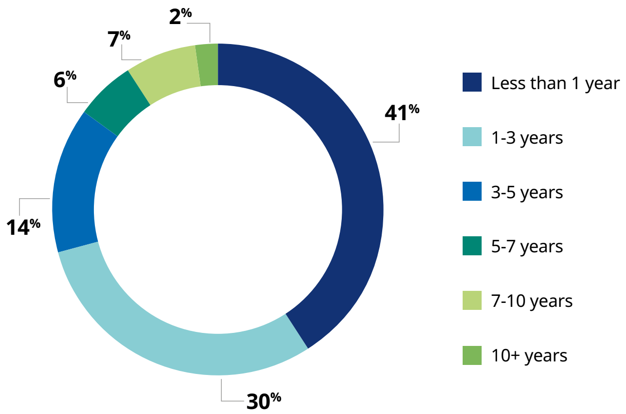
Source: Bank of America Merrill Lynch, 30 July 2018

The onshore corporate bond market

Attention so far has focused on integrating Chinese government debt and policy banks in international benchmarks, with local non-financial corporate bonds being somewhat neglected. However, given the size of the market, this seems unlikely to remain the case for long.

A peculiarity of the local Chinese corporate bond market is that it tends to be very short dated. Most bonds have a maturity of less than one year, which is much shorter than international norms (Figure 8). This can result in higher levels of portfolio turnover and increased research demands, given the need to continually refresh portfolios.

Figure 8: The Chinese corporate bond market is very short dated

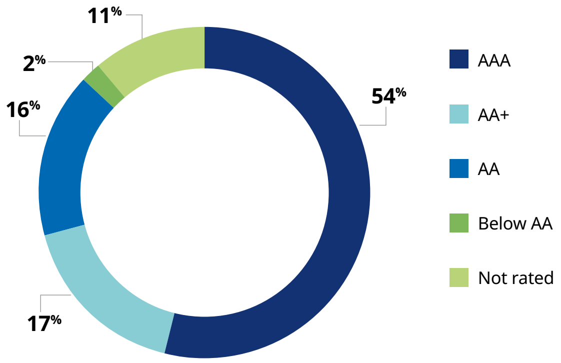


Source: Schroders and WIND, as of 31 December 2018

In addition to the constraints on access which have held back investors in the onshore government bond market, there have also been issues specific to the corporate bond market. These include: accounting standards that were different to international accounting standards, hence requiring additional work by investors; opaque capital structures; weaker financial disclosure; dearth of credit ratings by international rating agencies; and constrained liquidity.

International investors have been particularly sceptical about the credit ratings assigned by Chinese rating agencies. At the end of 2018, 54% of the market was rated AAA and a further 33% was AA+ or AA, putting 87% in one of these highest categories (Figure 9).

Figure 9: Realistic credit ratings?



Source: WIND and Schroders, as of 31 December 2018.

A 2017 research paper from the Bank for International Settlements found that Chinese ratings agencies rated the same borrower six to seven notches higher than global ratings agencies[8]. Cases where issuers have retained a AAA rating inside China despite international agencies rating them as if they were at risk of impending default are not unheard of. Differences of opinion on the relative importance of matters such as state-ownership, leverage, profitability and asset size have all played a part in these discrepancies. Conflicts of interest also abound. Regulation constrains many local institutions to investing only in bonds rated AAA or AA, resulting in a bias towards securities being granted one of these ratings. In our experience, the quality of the research carried out by the local agencies can actually be very high, but with a bias in many cases to higher rated categories. Our view is that most bonds rated AA- or lower share more characteristics with high yield debt than investment grade.

It is no surprise that international investors have been mistrustful. This lack of confidence has been compounded by the fact that, until July 2017, global agencies were not permitted to rate locally-issued debt. Only debt issued by Chinese companies in overseas markets, such as the US, has been open to scrutiny. A sign of the Chinese desire to encourage international participation in its bond market has been Standard & Poors' recent success in gaining approval from the Chinese authorities to rate local debt instruments[9]. Fitch has also confirmed that it is seeking a similar licence. This move is likely to increase confidence among international investors and should result in a closer alignment of ratings over time. Local regulators have also been clamping down on bad behaviour by the local ratings agencies. One of China's three main ratings agencies, Dagong, was recently suspended from bond market business for a year due to poor corporate governance, conflicts of interest and other problems[10]. This more hard-line approach should further improve the confidence that international investors have regarding the integrity of the local ratings system.

Various access routes to the bond market are possible

Access to the bond market shares some similarities with the equity market, but also some important differences. As with equities, international investors have been able to directly access the local Chinese fixed income market through the QFII (2002) and RQFII (2011) schemes for a number of years, subject to the same requirements as equities. Unlike equities, indirect exposure to Chinese interest rates has also been possible using "non-deliverable interest rate swaps"[11]. The RQFII offers more relaxed terms, which has spurred international interest. Only registered investors in a handful of countries have been eligible to apply, but investors have been able to invest in an eligible pooled vehicle or fund run by an asset management company that holds the licence.

International interest in investing in the onshore China bond market increased further following the relaxation of rules set by the People's Bank of China. The scheme, called "CIBM Direct", allows foreign investors access to the China Interbank Bond Market (CIBM). The CIBM is the wholesale over-the-counter market where a majority of bonds are traded once they are issued. Furthermore, the application process has been simplified and repatriation restrictions lifted. Whereas the QFII and RQFII channels allow access to the bond exchanges where bonds are initially issued, the CIBM market is mostly where secondary trading occurs. Investors with QFII and RQFII licences are required to apply for a separate licence to access the CIBM market, in order to participate in both the primary and secondary markets.

In the wake of experience gained in the equity market, the Chinese authorities have also made it easier for foreigners to access the CIBM market through a "Bond Connect" scheme, without the need to take the lengthy CIBM direct route. This is similar to the equity equivalent, in that it allows quota-free access with no lock-up periods or restrictions on repatriation. Registration, trading and settlement can all take place in Hong Kong. It is also a faster route to market than through RQFII or CIBM as there is no need to obtain a licence from the authorities. It also avoids the need to fill in application documents in Chinese. However, unlike Stock Connect, which facilitates two-way trading, Bond Connect currently permits international investors to invest in mainland Chinese bonds but not local Chinese to invest overseas (although this is a plan for the future).

Bond Connect also provides access to a more limited range of fixed income instruments than CIBM, most notably concerning interest rate derivatives (bond futures and onshore interest rate swaps). Bond Connect's inability to use interest rate derivatives in the onshore market to hedge interest rate risk is its key disadvantage. While investors can still hedge interest rate risk with non-deliverable interest rate swaps, pricing is currently less attractive. Transaction costs can also be higher when using Bond Connect due to fees being paid to the exchange in Hong Kong on a per trade basis.

8 BIS working paper 618, Credit ratings of domestic and global agencies: What drives the differences in China and how are they priced? June 2017.
9 https://www.ft.com/content/b95471d8-23a8-11e9-b329-c7e6ceb5ffdf
10 https://www.ft.com/content/1be968d4-a1ff-11e8-85da-eeb7a9ce36e4

11 An instrument where no Chinese currency actually changes hands but investors earn a return based on whether Chinese interest rates move higher or lower than the level priced into the market.

The current state of play: China's weight in bond benchmarks

The US dollar (USD) denominated external debt (offshore) weights in major benchmarks are shown in Figure 10. JP Morgan is the most widely recognised emerging market debt (EMD) benchmark provider and the "Diversified" versions of its benchmarks are the most commonly used – these limit the weights of those countries with larger debt stocks by only including a specified portion of their debt. We have also shown the weights in the non-diversified versions in brackets for comparison purposes. As is to be expected, China is much larger in these indices.

Figure 10: US dollar-denominated Chinese debt already features in some major benchmarks

Chinese debt	Benchmark	Allocation (%)
USD-denominated sovereign debt	Bloomberg Barclays Global Aggregate	0.7
	JP Morgan EMBI Global Diversified	4.7 (8.0)
USD-denominated corporate debt	JP Morgan CEMBI Broad Diversified	8.2 (24.6)
Asian USD-denominated debt*	JP Morgan Asian Credit Index	50.9

Source: Bloomberg and JP Morgan. Data as at 31 December 2018. * Index includes sovereign, quasi sovereign and corporate debt.

Although local debt is currently missing from major benchmarks, Bloomberg's announcement that it will start to add it from April 2019 means this will not be the case for much longer. Given that a projected weight of 6% would make it the fourth largest currency allocation in the index, this is a momentous move. It is likely that others follow suit.

The other major global government bond benchmark is the FTSE Russell World Government Bond Index (WGBI), which was previously run by Citigroup. A parallel version with an approximate 6% allocation to Chinese debt has been running since 2017 - the WGBI-Extended (which also includes Korean bonds). In addition, the emerging market, Asian and Asia-Pacific government bond indices from the same family have all included China since early 2018.

JP Morgan is also consulting on whether to include China in its flagship sovereign local EMD index, the GBI-EM Global Diversified Index. The market has been on "index watch" for potential inclusion since March 2016. Only the most liquid bonds are currently under consideration, which would give China an estimated weight of around 7%[12]. One of its other indices, the GBI-EM Broad Diversified index, already has a 10% allocation to Chinese bonds (37% in the non-diversified version). Furthermore, Asian-focused local currency indices have been including China for a while.

These shine a light on how Chinese local bond exposure could evolve over time if the various obstacles to greater integration can be overcome. The WGBI only includes Chinese government debt, while the Bloomberg Barclays index only captures government and policy bank debt. As a result, these materially understate the true scale of the market opportunity by ignoring the majority of the local corporate bond market.

12 https://uk.reuters.com/article/uk-gulf-bonds-jpmorgan/jp-morgan-consults-on-including-gulf-states-in-key-bond-index-idUKKBN1JM1QY

How might China's presence in the benchmarks evolve?

There is no good historical precedent we can turn to for guidance as to how China's growing presence in the benchmarks will evolve and what that means for financial markets and investors. Some limited parallels can be drawn (e.g. Korea), but they are at best imperfect and none are on the scale of an economic and financial market the size of China. Rather than making bold predictions, we prefer to consider a number of different plausible scenarios.

Political, economic and operational/structural factors will all influence the evolution and openness of China's capital markets. However, recent moves by MSCI and Bloomberg make it clear that they are comfortable increasing exposure to domestic Chinese assets without the need for any additional openness. The current set-up is deemed sufficient. However, other benchmark providers remain on-hold and certain operational/structural factors are likely to be be required for further integration. Some of these have been described in more detail earlier.

Figure 11: Equity and fixed income markets need to change before they are fully welcomed into all major benchmarks

Equity specific	Fixed income specific
– A greater alignment of the China A-shares market with international market standards – Continued evidence that trading and settlement via Stock Connect are operating as they should – Loosening of restrictions on the creation of index-linked investment vehicles – Adoption of international accounting standards and the publication of financial reports and accounts in English	– Evidence that trading and settlement via QFII/RQFII/CIBM Direct/Bond Connect are operating as they should – Evidence that currency hedging can take place cheaply by allowing onshore hedging – Closer alignment of credit ratings between local and global ratings agencies – English language disclosures in bond documentation

Source: Schroders, MSCI.

We set out in Figure 12 three alternative scenarios for how China's presence in benchmarks may evolve in the coming years.

Figure 12: Alternative scenarios for how China's place in benchmarks develops

Full integration	– China completely opens up its capital markets and asset-specific issues are resolved – Chinese asset markets become fully integrated in benchmarks and their benchmark weights soar – While this should not be ruled out as a longer term outcome, it is difficult to envisage in the near term
The halfway house	– China gradually opens up its capital markets further and/or certain asset-specific issues are resolved – China's presence in benchmarks continues to creep up at a slow but regular pace, though it never comes close to its full potential[13]
No change	– Integration of Chinese capital markets stalls

Source: Schroders.

13 Assumes Bloomberg adds local Chinese bonds in line with its recently announced plans.

China's weight in equity and fixed income benchmarks would vary depending on which of these outcomes materialise, as shown in Figure 13, which is based on the size of China's asset markets today. For the global aggregate we have assumed that, in the full integration scenario, local corporate bonds and government bonds are included in the index[14]. Even this significantly understates the potential market opportunity as bonds with less than one year to maturity, the largest part of the Chinese corporate bond market, currently fail index inclusion criteria. As the US dollar-denominated sovereign and corporate debt markets are already open for international investors, these would not be impacted by any changes in capital market openness.

Figure 13: Potential future benchmark weights

For EMD indices, weights in diversified indices, the main EMD benchmarks, are shown[15].

	Full integration (%)	The halfway house (%)	No change (%)
Global equities	7	5	4
Emerging market equities	44	37	30
Local EMD	10	7	0
Hard EMD (USD)	5	5	5
Corporate EMD (USD)	8	8	8
Global aggregate	10	7	1*
WGBI	6	3	0

Equity figures also assume that Saudi Arabia joins the MSCI Emerging Markets index, in line with the 2018 market classification review.
Source: Bloomberg, FTSE Russell, JP Morgan, MSCI, Schroders. Figures and estimates as at 31 December 2018.

*The Bloomberg Barclays Global Aggregate has a 0.7% allocation to Chinese debt as at 31 December 2018.

Potential inflows are significant

Although some of the percentage differences may seem small, the sums of money involved could be vast, as shown in Figure 14. An estimated $4.1 trillion is benchmarked against MSCI's global equity benchmark and a further $1.8 trillion is benchmarked against the EM benchmark[16]. A move to full integration could translate into almost $400 billion flowing into the A-share market. The halfway house scenario could result in almost $200 billion entering the market.

A far smaller amount is benchmarked against local EMD benchmarks, but integration here could drive around $20 billion of inflows. However, Bloomberg's move to start adding local Chinese bonds to the Global Aggregate is set to be the big game changer. Our half-way house scenario incorporates this change. An estimated $2 trillion of assets are benchmarked against the Global Aggregate[17] so around $120 billion of passive inflows could be on the cards between April 2019 and November 2020. Around $3 trillion is benchmarked against the WGBI[18] so, if FTSE Russell follow suit and make a partial allowance for Chinese bonds within this benchmark, then total inflows of over $200 billion could result. If Bloomberg also start to include local corporate bonds and FTSE Russell incorporate its full allowance of sovereign bonds then the local bond market could experience inflows of around $400 billion.

Another way of looking at the size of potential inflows is to consider how much foreigners hold of the market and how that might change over time. Whereas less than 4% of the Chinese local government bond market is currently held by foreigners, figures of 10-30% are more common elsewhere and the average across the EM universe is 20%[19]. Even if foreign ownership were to rise to only 10% of the $4.7 trillion local government bond market, this could result in around $300 billion of inflows. On every possible level, moves to greater inclusion of the Chinese market in global benchmarks would drive substantial inflows.

Markets are unlikely to stand still

The analysis above is based on the current size of Chinese asset markets, but these could evolve very differently in each scenario, as could their characteristics.

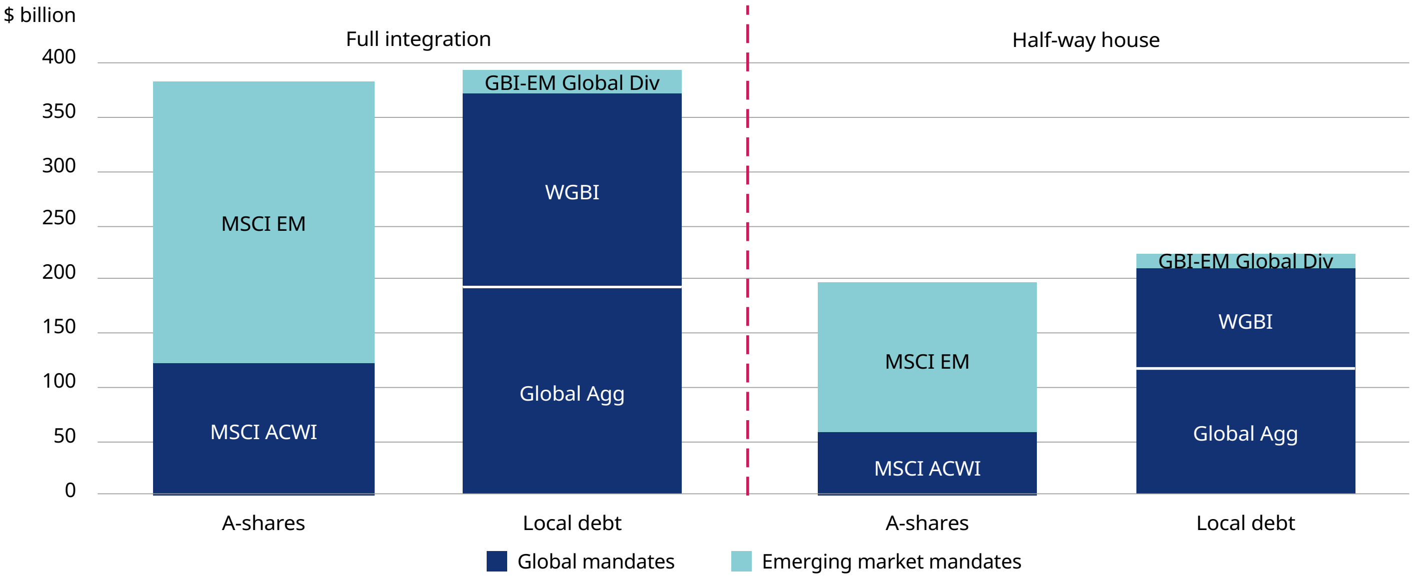
For example, in the full integration scenario, China's capital markets could grow rapidly if they converge towards a similar size relative to GDP as in other markets. Convergence to developed markets would require a 40% expansion and even reaching South Korean levels would demand a 10% pick-up. In this scenario, we would also likely see a significant increase in the number of foreign companies issuing renminbi-denominated debt. It is very common for companies to issue debt in developed currencies that are not their own (almost half of the par value of US dollar-denominated corporate debt outstanding has been issued by non-US corporations), but this market is largely non-existent in China due to capital controls. However, this is beginning to change with the emergence of the so-called "Panda bond" market. Agency and state issuers in this onshore market include the International Finance Corporation, the Asian Development Bank and the Polish Treasury. Furthermore, some corporates, like Maybank of Malaysia, have also started to issue bonds onshore in China to diversify their funding sources.

In contrast, the "no change" scenario could see the Chinese equity and corporate bond markets shrink, while the government bond market increases in size, as no progress is likely to be consistent with some form of economic stress.

On top of all that, investors also have to contend with currency movements. For example, if the local market has grown but the currency has depreciated, then the increase will not fully translate into a larger benchmark weight, and vice-versa. The benchmark weight will also be heavily influenced by how the factors detailed above have varied amongst the members of the benchmark. If all are experiencing similar levels of growth, then the weights will not vary significantly from the levels in Figure 13.

14 Calculated by assuming that the full Bloomberg Barclays China aggregate index is incorporated in the Global Aggregate.
15 Figures would be much higher for the non-diversified versions. As an indication of the potential scale, China is currently 43% of the JP Morgan GBI EM Broad index. It would command an even higher weight in the GBI EM index on full integration as the sample of countries is smaller for that index.
16 MSCI, as of June 2018
17 Barclays Research, March 2018
18 Barclays Research, March 2018
19 IMF Sovereign Investor Base Dataset for Emerging Markets, as at second quarter 2018

Figure 14: The potential inflows into Chinese asset markets could be vast



Source: Bloomberg and Schroders. Estimates as at 31 December 2018.

How should investors respond?

At 30% of the MSCI emerging markets index, China is already a very large part of most emerging market equity portfolios. However, the domestic A-share market remains a small part of that. It represents only 2% of the MSCI China index and this is only set to grow to around 10% by May 2020, assuming MSCI proceeds with the plans set out in its December 2018 consultation. This is despite the fact that A-shares represent around 70% of the Chinese market by market capitalisation and number of companies. It will take several years before A-shares form a significant part of investors' portfolios, if they wait to follow MSCI's lead. We believe that there is a strong case for investors to act now, and supplement a traditional allocation to emerging market equities with a separate allocation to A-shares. Such an approach would grant investors access to the more diverse, domestically-focussed, and consumer-oriented companies in the A share market. It would also open the door for alpha generation on a scale that is unfathomable in other markets. The median A-share equity manager outperformed its benchmark by 6% a year in the five years to 31 December 2018, while top quartile managers outperformed by over 10% a year, net of all fees and expenses. This is a subject that will be covered in more detail in a forthcoming research paper.

In fixed income, Bloomberg's decision to start adding local Chinese bonds to the Global Aggregate means that they will start to form part of many investors' portfolios imminently, growing to become the fourth largest currency in the index by November 2020. However, the absence of Chinese corporate bonds from the Global Aggregate and lack of any indication that this is set to change means that it will fail to capture the full onshore Chinese fixed income opportunity. This need not be the case, as this market is already accessible. We believe that the need is already upon us for investors to unshackle themselves from traditional fixed income benchmarks and consider allocating to Chinese fixed income on a stand-alone basis. It is a large, diverse and relatively inefficient market, where companies in the same sector with the same rating are priced very differently. It also has a very low correlation to all other major fixed income markets and offers a yield pick-up over other markets. As with equities, it deserves to be treated differently. A key judgement in both cases is whether global investors have the skills and experience to extract significant alpha from the Chinese markets or whether specialist local expertise will be required.

As a general rule, benchmarks are all well and good as a yardstick by which to measure performance, but it is far more questionable that our investing decisions should be governed solely by whether MSCI, Bloomberg or other index providers decide to increase their allocation to China. In a market like China, it makes no sense to follow benchmark weightings slavishly and buy something just because it has been included in an index or avoid other potential investments just because they are not. Investors should be encouraged by the potential for attractive risk-adjusted returns, not have their hands tied by benchmark providers.

Important Information: The views and opinions contained herein are those of the authors as at the date of publication and are subject to change due to market and other conditions. Such views and opinions may not necessarily represent those expressed or reflected in other Schroders communications, strategies or funds.

This document is intended to be for information purposes only. The material is not intended as an offer or solicitation for the purchase or sale of any financial instrument or security or to adopt any investment strategy. The information provided is not intended to constitute investment advice, an investment recommendation or investment research and does not take into account specific circumstances of any recipient. The material is not intended to provide, and should not be relied on for, accounting, legal or tax advice. Any references to securities, sectors, regions and/or countries are for illustrative purposes only.

Information herein is believed to be reliable but Schroders does not represent or warrant its completeness or accuracy. No responsibility or liability is accepted by Schroders, its officers, employees or agents for errors of fact or opinion or for any loss arising from use of all or any part of the information in this document. No reliance should be placed on the views and information in the document when taking individual investment and/or strategic decisions. Schroders has no obligation to notify any recipient should any information contained herein changes or subsequently becomes inaccurate. Unless otherwise authorised by Schroders, any reproduction of all or part of the information in this document is prohibited.

Any data contained in this document have been obtained from sources we consider to be reliable. Schroders has not independently verified or validated such data and they should be independently verified before further publication or use. Schroders does not represent or warrant the accuracy or completeness of any such data.

All investing involves risk including the possible loss of principal.

Third party data are owned or licensed by the data provider and may not be reproduced or extracted and used for any other purpose without the data provider's consent. Third party data are provided without any warranties of any kind. The data provider and issuer of the document shall have no liability in connection with the third party data. www.schroders.com contains additional disclaimers which apply to the third party data.

Past performance is not a guide to future performance and may not be repeated. The value of investments and the income from them may go down as well as up and investors may not get back the amounts originally invested. Exchange rate changes may cause the value of any overseas investments to rise or fall. This document may contain "forward-looking" information, such as forecasts or projections. Please note that any such information is not a guarantee of any future performance and there is no assurance that any forecast or projection will be realised

European Union/European Economic Area: Issued by Schroder Investment Management Limited, 1 London Wall Place, London EC2Y 5AU. Registered Number 1893220 England. Authorised and regulated by the Financial Conduct Authority.

Note to Readers in Australia: Issued by Schroder Investment Management Australia Limited, Level 20, Angel Place, 123 Pitt Street, Sydney NSW 2000 Australia. ABN 22 000 443 274, AFSL 226473.

Note to Readers in Canada: Schroder Investment Management North America Inc., 7 Bryant Park, New York, NY 10018-3706. NRD Number 12130. Registered as a Portfolio Manager with the Ontario Securities Commission, Alberta Securities Commission, the British Columbia Securities Commission, the Manitoba Securities Commission, the Nova Scotia Securities Commission, the Saskatchewan Securities Commission and the (Quebec) Autorite des Marches Financiers.

Note to Readers in Hong Kong: Schroder Investment Management (Hong Kong) Limited, Level 33, Two Pacific Place 88 Queensway, Hong Kong. Central Entity Number (CE No.) ACJ591. Regulated by the Securities and Futures Commission.

Note to Readers in Indonesia: PT Schroder Investment Management Indonesia, Indonesia Stock Exchange Building Tower 1, 30th Floor, Jalan Jend. Sudirman Kav 52-53 Jakarta 12190 Indonesia. Registered / Company Number by Bapepam Chairman's Decree No: KEP-04/ PM/MI/1997 dated April 25, 1997 on the investment management activities and Regulated by Otoritas Jasa Keuangan ("OJK"), formerly the Capital Market and Financial Institution Supervisory Agency ("Bapepam dan LK").

Note to Readers in Japan: Schroder Investment Management (Japan) Limited, 21st Floor, Marunouchi Trust Tower Main, 1-8-3 Marunouchi, Chiyoda-Ku, Tokyo 100- 0005, Japan. Registered as a Financial Instruments Business Operator regulated by the Financial Services Agency of Japan. Kanto Local Finance Bureau (FIBO) No. 90.

Note to Readers in People's Republic of China: Schroder Investment Management (Shanghai) Co., Ltd., RM1101 11/F Shanghai IFC Phase (HSBC Building) 8 Century Avenue, Pudong, Shanghai, China, AMAC registration NO. P1066560. Regulated by Asset Management Association of China.

Note to Readers in Singapore: Schroder Investment Management (Singapore) Ltd, 138 Market Street #23-01, CapitaGreen, Singapore 048946. Company Registration No. 199201080H. Regulated by the Monetary Authority of Singapore.

Note to Readers in South Korea: Schroders Korea Limited, 26th Floor, 136, Sejong-daero, (Taepyeongno 1-ga, Seoul Finance Center), Jung-gu, Seoul 100-768, South Korea. Registered and regulated by Financial Supervisory Service of Korea.

Note to Readers in Switzerland: Schroder Investment Management (Switzerland) AG, Central 2, CH-8001 Zürich, Postfach 1820, CH-8021 Zürich, Switzerland. Enterprise identification number (UID) CHE101.447.114, reference number CH02039235704. Authorised and regulated by the Swiss Financial Market Supervisory Authority (FINMA).

Note to Readers in Taiwan: Schroder Investment Management (Taiwan) Limited, 9F, 108, Sec.5, Hsin-Yi Road, Hsin-YI District, Taipei 11047 Taiwan, R.O.C. Registered as a Securities Investment Trust Enterprise regulated by the Securities and Futures Bureau, Financial Supervisory Commission, R.O.C.

Note to Readers in the United Arab Emirates: Schroder Investment Management Limited, 1st Floor, Gate Village Six, Dubai International Financial Centre, PO Box 506612 Dubai, United Arab Emirates. Registered Number 1893220 England. Authorised and regulated by the Financial Conduct Authority.

CS1098