WITH BOND REGARDS, LOVE CHINA

With the launch of new trading program in July, overseas fixed income investors won easier access to the US$9.3 trillion bond market of the world's second-largest economy

The farmland is fertile, coal mines are productive, and trade with nearby Russia is growing in northeastern China's remote Heilongjiang province.

What's still needed in this far-flung corner of the country is fresh financial backing for infrastructure construction and economic development projects.

Now, for the first time, institutional investors from around the world have been invited to provide that financial support by buying provincial government bonds. In August, via the Shanghai Stock Exchange, Heilongjiang started taking bids from domestic and foreign investors for local government bonds. The province hoped to raise US$2.86 billion.

Heilongjiang's fundraiser was far from unique in China. Similar invitations have been extended by local governments, companies and banks nationwide now that the China Interbank Bond Market (CIBM) is open to foreign fixed income investors through a trading program called Bond Connect.

Bond Connect launched in July to expand overseas capital flows into a fixed income market valued by the official China Central Depository and Clearing Co. (China Bond) at US$9.3 trillion. China's already huge bond market — the world's third-largest, behind only the U.S. and Japan — is thus poised for further growth.

(Continued on page S5)

TRADEWEB'S EFFICIENCY PLAY DRIVES CHINA BOND TRADING

The first-ever fully electronic access to the interbank bond market is a cornerstone of Bond Connect.

Global bond holders think in practical terms, trusting in what they can see. When new opportunities arise in an emerging bond market, they look for a clear view of the trading landscape.

The electronic infrastructure through which global institutional investors are now buying and selling on China's bond market is that kind of window.

One of the infrastructure's designers and its primary trading link is Tradeweb Markets, a world leader in building and operating electronic marketplaces. Tradeweb pioneered straight-through processing in fixed income, and supports marketplaces for more than 25 asset classes with electronic execution, processing, post-trade analysis, and market data in an integrated work flow.

In China, Tradeweb was chosen as the offshore gateway to Bond Connect, giving non-Chinese investors their first fully electronic access to the nation's interbank bond market.

Tradeweb worked closely with Chinese and Hong Kong stakeholders for two years before Bond Connect launched in July, investing time and resources to build a workflow infrastructure that balances investors' interests and Chinese government requirements. Its electronic system is thus the principal means by which an offshore bond investor can link to Bond Connect.

"Because we were involved from the beginning, and because we were willing to make that investment, we are the first and only offshore trading platform that provides access for international investors to the Bond Connect program," says Li Renn Tsai, the Singapore-based head of Tradeweb's Asia division.

TRADEWEB MARKETS AT A GLANCE

Serving institutional, retail, and wholesale clients, Tradeweb Markets is a pioneering developer and operator of the electronic architecture that's revolutionized trading in fixed income, derivatives, and ETFs. Here's a company snapshot:

- Clients from 2,000+ institutions
- $400 billion+ average daily trading volume across all Tradeweb Markets
- Asset classes: 25+
- Clients in 55+ countries
- Global employees: 850+
- Staff technologists: 250+

"China's bond market is the third-largest in the world, and projected to double in size over the next 10 years. Access to this market is crucial."

Tradeweb's clients from more than 2,000 institutions worldwide and 12 years of experience in Asia laid the groundwork for the company's mainland debut. The firm's electronic trading platform already processes a significant share of Japanese government bond trades, and it offers global products to clients in Hong Kong and Singapore. Worldwide, the firm serves dealer-to-customer markets, interdealer trading, and the American retail fixed-income community.

Experience also plays into Tradeweb's ability to train users of the Bond Connect platform in areas such as electronic requests for quotes. Users learn to search for and select bonds to buy or sell, choose settlement dates (T, T+1, T+2) and notional amounts, and connect with all eligible dealers at the same time. Requests are processed by up to 10 dealers simultaneously so that users can compare bids after a single quote request.

Because users can access dealers and quotes in one fell swoop, the need for phone calls or messages to each dealer is minimized or even eliminated. Tradeweb calls the process "an efficiency play." Price information delivery is consistent and uniform; a dealer sees exactly what each client wants, with no vagueness, and how many parties it's competing against.

Since the launch, Bond Connect and Tradeweb have mutually benefited. The number of participating dealers has risen to 24, and "we continue to onboard new clients at a very rapid pace," Tsai says. "The distribution of participants is starting to round out very nicely, with European and U.S. firms coming on board.

"We are very encouraged by the progress of Bond Connect," he adds. Contributing to that progress are practically minded bond traders in China, who increasingly realize the benefits of transacting the onshore bond market via Tradeweb's electronic network of the world's largest financial institutions. ●

In addition, the program's government sponsors have promised to give Chinese investors their first-ever access to bonds issued in Hong Kong. Indeed, Bond Connect has been designed for two-way deal making between the mainland and Hong Kong. So far, though, the program has only a "northbound" component for steering investment into China. "Southbound" trading is on the agenda, but a start-up plan has not been announced.

Northbound trading volume on July 3, the program's opening day, topped US$1.05 billion, according to the China Foreign Exchange Trade System (CFETS), an affiliate of the People's Bank of China (PBOC) and the director of Bond Connect operations through a joint venture with stock exchange operator Hong Kong Exchanges and Clearing Ltd. (HKEX).

Since then, only a smattering of Bond Connect turnover data has been released to the public. HKEX, for example, said foreign holdings of mainland bonds rose by US$5.67 billion during the program's first month. And according to China Bond, foreign banks in July increased their mainland bond investments by US$1.47 billion.

Overseas investors can tap the program to access all types of bond securities tradable on the CIBM, including Chinese government treasury bonds, local government bonds, central bank paper, financial bonds, corporate credit bonds, commercial paper, and asset-backed securities.

Bond Connect is not the only channel through which foreign capital is allowed to enter China's fixed income market. Overseas investors can also trade onshore bonds through the Chinese government's Qualified Foreign Institutional Investor (QFII) and Renminbi Qualified Foreign Institutional Investor (RQFII) schemes, which launched in 2002 and 2012, respectively. So-called "dim sum bonds," denominated in yuan and issued in Hong Kong by Chinese banks and a few overseas entities since 2007, are also foreign friendly.

However, unlike China's qualified investor schemes, which are entirely onshore, Bond Connect custody operations are based in Hong Kong. Another difference between the schemes is that Bond Connect players are not tied to trade quotas or time-related repatriation restrictions.

And while Bond Connect transactions are based on offshore yuan-foreign currency exchange rates, which tend to hover below the onshore rates that apply to participants in the qualified investor schemes, Bond Connect has generally made it easier for foreign fixed income investors to move their money into and out of China.

On opening day, five state-owned companies sold corporate bonds worth a combined US$190 million to Deutsche Bank, HSBC, and other investors, according to China's National Association of Financial Market Institutional Investors (NAFMII). The issuers, each from the front row of China's state enterprise class, include the power companies China Huaneng Group Corp., China Three Gorges Corp. and State Power Investment Corp.; telecom operator China Unicom; and Aluminum Corp. of China Ltd.

The Hong Kong division of the Beijing-based investment bank China International Capital Corp. (CICC) was among the major financiers active on Bond Connect's first day. "We are closely engaged with the Chinese regulators promoting these cost-effective financing products to Chinese issuers," said Liu Qingchuan, a Managing Director and Head of the Bond Origination, Investment Banking Department, at CICC.

A NEW BEGINNING

First-day bond buyers came from all over the global map. "The types of overseas investors are diversified, covering central

ICBC RUNS TO WIN AS BIGGEST ASSET MANAGER FOR CHINA BONDS

Leveraging ICBC's size and importance as a market maker gives ICBC AM tremendous influence in serving investors and issuers.

The first asset manager out of the gate when a new race for China bond investing began July 3 was a firm that's been competing in the fixed-income field for a long time — and winning.

Industrial and Commercial Bank of China's Hong Kong subsidiary ICBC (Asia) Investment Management Co. Ltd. (ICBC AIM) was among the first to arrange bond deals on opening day for the Bond Connect mechanism, which now lets foreign investors trade mainland bonds through Hong Kong.

The successful subscriptions for policy financial bonds "reflect ICBC's competitiveness," says Gu Jian'gang, General Manager for the Beijing-based bank's Asset Management Department (ICBC AM).

It's a competitiveness rooted in experience. ICBC is the largest and most important market maker, underwriter, and investor for mainland bonds, which means ICBC AM has more influence than any other asset manager serving investors and issuers in the China interbank bond market.

ICBC AM works with every fixed-income instrument available on the market, from treasuries to corporate bonds, asset-backed securities, and convertible bonds. It stresses stability and focuses on bonds rated AA+ and above, while taking advantage of strong relationships with state banks, major financiers such as CITIC Securities, and corporate giants including State Grid and PetroChina.

ICBC AM's investment volume was 2.41 trillion yuan as of July, with bond investments representing 1.19 trillion yuan, or nearly 50 percent, of that


Gu Jian'gang of ICBC AM

amount. Through Bond Connect, ICBC AM's investment volume is poised to climb. Working with ICBC AIM's Bond Connect team, foreign institutional investors can build mainland portfolios via ICBC AIM's Global Total Return Bond Fund and Global RMB Fixed Income Fund. These funds complement ICBC's established China bond market channel for overseas clients through the Qualified Foreign Institutional Investor scheme.

In China, Gu says, ICBC and its asset management unit "have always ranked first in the banking and financial industry with the most comprehensive product offerings and the most stable returns." Money market instruments, bond allocation arrangements, treasury futures arbitrage, and derivatives hedging are a few of the strategies ICBC AM offers its diverse client base. Yields for bond strategies typically exceed benchmark rates.

China bond yields are "significantly higher than in developed countries" and thus "clearly attractive" to foreign investors, Gu says. Another attraction is China's debt liquidity, which "after years of steady and healthy development... has significantly improved," he says, adding that 91 percent of foreign bond holdings in China are tied to reliable government debt. Yet there's room for expansion, as overseas investors control only 2 percent of China's 64 trillion yuan bond market, the world's third-largest.

Bond Connect's launch underscores China's commitment to opening its financial market through new initiatives, Gu says. Also conducive to attracting foreign capital inflows are the yuan's internationalization and the fact that China's long-term bonds offer high returns.

"In terms of the current window for bond allocation, foreign investors on the domestic market are now in a significantly better position" than anytime in the past, Gu says. Globalization has made yuan assets a good choice for portfolio diversification, he adds, particularly since risk and volatility have been held down as China is still in the process of capital account opening. Moreover, foreign investors can lean on ICBC's size, influence, and deep market experience to profit from interbank bonds.

"Based on ICBC's strength as the largest debt-investment institution in China," Gu says, "ICBC AM will continue offering major foreign institutional investors key advantages for accessing the mainland bond market through investment research, policy opportunities, and service." ●

banks, commercial banks, securities companies, insurance companies, and asset management institutions," according to NAFMII, which added that the international buyer mix underscored "strong interest in China's corporate credit bonds."

NAFMII hailed Bond Connect's first day as "the beginning of a new stage in the opening up of China's bond market."

The opener also pleased Li Renn Tsai, Asia Division Head for Tradeweb, an electronic marketplace provider that built and now operates Bond Connect's offshore-onshore trading system.

"Tradeweb has launched many electronic markets in the past, and we were very impressed by the first day activity numbers," Tsai said. "Ensuing volumes have maintained momentum, and we continue to be confident in the program's long-term success."

Some negative comments were heard in the wake of the closely watched opening day, but the criticism was muted, as it appeared the investment community was ready to give the fledgling offshore-to-onshore system time to work through teething issues and toward its potential.

REFORM PATH

Bond Connect is just the latest manifestation of China's ongoing "reform and opening up," an expression used by mainland officials to describe the gradual blending of the country's government-controlled economy and market forces. The program is following a familiar, reform-related path by directing foreign investors into onshore, fixed income products through the liberal market hub of Hong Kong.

Since the Bond Connect plan was floated two years ago, the system's construction and supervision have relied on cross-border cooperation. Its chief sponsors are PBOC on the mainland, and the Hong Kong Monetary Authority (HKMA). Each has broad responsibilities as a foreign exchange supervisor for respective currencies.

HKMA manages bond transaction settlements for offshore traders in conjunction with two onshore depositories — China Bond and the Shanghai Clearing House. Bond Connect trading and offshore bond trader support services are provided by a CEFTS-HKEX joint venture called Bond Connect Co. Ltd.

Under this arrangement China's bond market and Hong Kong's financial services sector have room to benefit mutually, as they have since the Shanghai-Hong Kong Stock Connect program began three years ago, giving foreign investors access to Shanghai stocks, and Chinese investors access to Hong Kong equities. A tie-up linking Shenzhen's exchange and Hong Kong started last year.

"The mutual market access program which pioneered in 2014 continues to contribute to China's capital market development and consolidate Hong Kong's gateway position connecting China and the rest of the world," said Julien Martin, General Manager, Bond Connect Co. "With the successful launch of Bond Connect ... another significant milestone was reached by providing international investors with access to the mainland bond market via Hong Kong."

Extending the stock connect concept to cover mainland bonds has underscored the Chinese government's commitment to supporting Hong Kong's economic development and its status as a financial "intermediary" for promoting "collaboration" between the city and mainland, according to a statement issued by PBOC at Bond Connect's launch.

Building Bond Connect was also "a key move in the reform and opening up of China's bond market," according to the central bank. "Bond Connect enables overseas investors to invest in the China interbank bond market more effectively through mutual access between Hong Kong and mainland financial infrastructure institutions with respect to trading, custody, and settlement."

Two-way trading is already in place for the stock connect schemes, with regulators enforcing quota levels to keep capital flows under control. Bond Connect's current northbound trading means that, for the time being, only foreign investors can participate. Neither a date nor possible timetable for a southbound start-up has been announced.

At a Bond Connect opening day ceremony, PBOC Deputy Gov. Pan Gongsheng said the southbound leg would take affect only after "a factual assessment of [northbound] market demand."

Southbound trading "will be explored at a later stage," according to a HKEX statement. "This is in line with the principle of orderly and prudent implementation, based on

market demand. Starting with northbound trading only enables Bond Connect to accumulate experience for implementing two-way trading."

Martin said Bond Connect's staff is now "working closely with market participants as well as mainland and Hong Kong financial infrastructure institutions to further streamline and enhance operational flows and arrangements of the scheme, and on the addition of new access platforms."

EASY DOES IT

Reflecting the gradual nature of China's decades-long financial reform campaign, the Bond Connect project was designed to be executed in stages. For example, the amount of capital from overseas investors is expected to rise in "increments ... over the long term," according to an analysis by Ping An Asset Management Co. (Ping An AMC), a Chinese firm with about US$374 billion under management as of June 30.

From the perspective of domestic fund-raising development, Bond Connect's arrival was well-timed. A search for financial support in the months leading up to its launch prompted major Chinese companies and banks to sell bonds on non-Chinese platforms.

Bank of China, for example, in April issued bonds worth about US$3 billion overseas. The state bank said it would use the cash to beef up its lending pool for companies pursuing trade or construction projects tied to the Chinese government's Belt and Road initiative, which is aimed at expanding China's commercial ties to other countries in Asia, Africa, and the Middle East.

Corporate bond issues abroad have also risen since a 2016 decision by the government's State Administration of Foreign Exchange to let Chinese companies convert into yuan any foreign currency amassed through offshore bond issues. Such repatriations of offshore funds had previously been restricted.

Chinese regulators have gradually grown familiar with the nuances of global bond issues and trading by sponsoring the so-called "panda bond" market, which launched in 2005. It lets foreigners sell onshore bonds to mainland investors. Through June, some 26 foreign borrowers from a German car manufacturer to a Canadian provincial government had altogether raised more than US$10 billion worth of yuan from investors in panda bonds, which are managed by NAFMII.

Nevertheless, Chinese government restrictions on foreign bond investing and the institutional gap between the mainland's system and international fixed income markets has kept overseas bond investment activities to a minimum.

"At the moment, the size of foreign investors' investment in China's domestic bond market is about 850 billion yuan (US$ 127 billion), accounting for less than 2% of the market share of the total China bond market," according to the Ping An AMC report, which added that amount "is far lower than that of developed countries and other emerging markets."

But the comparatively low level in China is "indicative of high growth potential in the foreseeable future," according to Ping An AMC.

Foreign investors currently tend to lean toward safe bets in China, such as government bonds and policy financing bonds. However, interest in corporate bonds is expected to rise over time as investors become more familiar with China's financial markets and ways of doing business. Local governments including provinces and cities are also wooing investors from abroad.

Each of the qualified investor schemes built up foreign participation. Today, QFII counts more than 300 foreign entities from pension to sovereign wealth funds with permission to invest up to a combined US$81 billion in mainland equities and bonds. RQFII has more than 170 participants working with a combined quota worth US$77 billion.

Indeed, foreign holdings of Chinese corporate and government bonds have been dwarfed by domestic investments. In a May report, Credit Suisse's Hong Kong-based analyst Vincent Chan said "foreign holdings of Chinese bonds are reasonably large in absolute terms, but still rather small compared to the size of China's bond market."

The Ping An AMC report highlighted the advantages of Bond Connect over what were previously the only means by which foreign institutions could directly access CIBM. "When foreign investors invest through Bond Connect," it said, "the requirements concerning the scope of investors

CHINA'S BOND MARKET PARTNER CICC: IT'S ALL ABOUT ACCESS

As a key advisor to China's bond market, CICC provides a window to global investor demands and market navigation to potential issuers

Choosing China for an overseas bond financing project was a relatively easy decision for one of the world's biggest aluminum companies. After all, the company's executives reasoned, China's US$9.3 trillion bond market is the third-largest on the planet. The market is maturing and expanding rapidly. And it's supported by an increasingly wealthy class of Chinese retail and institutional investors.

But a real clincher for the Russian aluminum giant UC Rusal, which announced the successful issuance of a 1.5 billion yuan "panda bond" in a series of two tranches, emerged as China placed new focus on bond market accessibility.

Rusal worked closely with the nation's premier investment bank, China International Capital Corp. (CICC), to fulfill regulatory requirements and arrange meetings with investors in Beijing, Shanghai, and Shenzhen before successfully raising funds through China's panda bond program. One of the positive outcomes was that investor interest vastly exceeded expectations: The total commitment came to twice Rusal's target.

"We are very pleased to see such strong support from Chinese investors," said company CEO Vladislav Soloviev. "Our initial plan was to proceed with 500 million yuan, but we ended up with 1 billion yuan."

"With the accelerated pace of renminbi internationalization and opening up of the China bond market for foreign borrowers and investors, China's bond market is indeed more accessible than ever," said Mr. Bi Mingjian, CEO of CICC.

Not only have overseas companies and sovereign wealth funds benefited from the panda bond scheme, which has raised a combined 180 billion yuan since launching in 2005, but Rusal's experience points to the value of quality market advice from CICC.

CICC, whose client base includes thousands of global institutional investors with significant China exposure, is at the forefront of the Chinese bond market's ongoing, progressive development.

The firm's fixed income teams advise and guide overseas clients seeking yuan-denominated financing through panda bonds. They help domestic and overseas investors enrich their portfolios with Chinese corporate paper and government bonds, and via investments in Chinese convertible bonds and exchangeable bonds. Beijing-based CICC also provides a window to global investor demands and market conditions as a key advisor to the Chinese government regulators responsible for ongoing bond market reform.

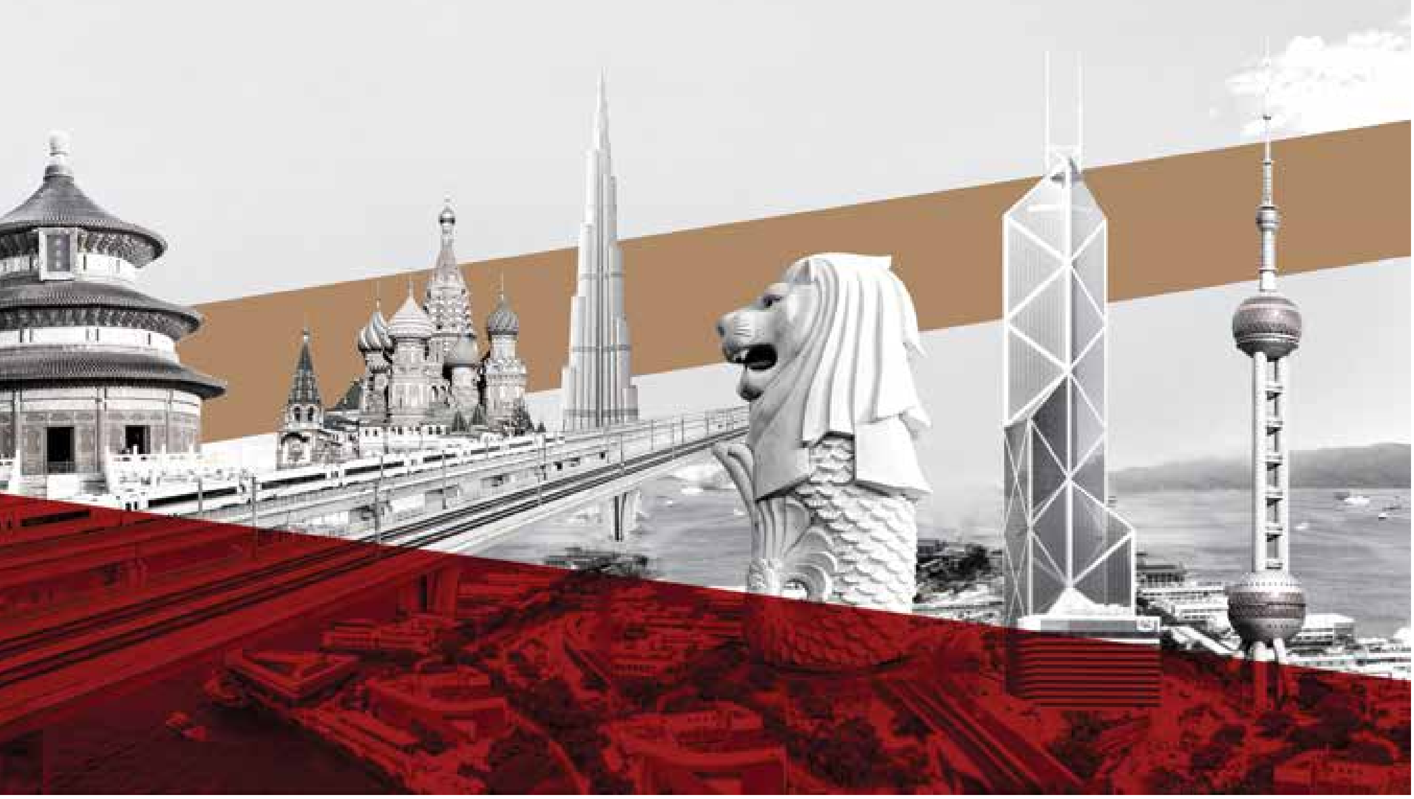
In the panda bond market alone "the composition of issuers has become more diversified, and the amount of the issuers is trending higher," said Mr. Liu Qingchuan, head of bond origination at CICC IB. "We see a very fast learning curve for Chinese investors. And as Chinese investors learn more about foreign issuers, they are more open to them, more open to buying."

"On the other hand, we see Chinese bond market regulators are very open-minded now," Liu added. In the early days of foreign access to bonds, the regulators were "very strict with the standards, only allowing certain Hong Kong (accounting) standards to be applicable for qualified panda bond issuance. But now they're letting companies use other standards to issue panda bonds.

"CICC's research and experience allow us to identify the mismatch between the habits or standards of foreign companies and the Chinese capital market," Liu explained. "We've given both regulators and clients a lot of suggestions in order to build mutual understanding and to bring these two worlds together."

Panda bond development has accelerated over the past three years not only as an aspect of financial reform and opening up in China, but also in harmony with the Belt and Road initiative introduced by Chinese President Xi Jinping in 2013. Foreign entities including government agencies can issue yuan-denominated panda bonds and use the proceeds to finance contracts with Chinese companies building or supplying goods for Belt and Road projects outside China.

CICC is also a go-to firm for convertible bonds and exchangeable bonds issued by Chinese companies and banks. It's a complicated process that issuers simply can't navigate



alone. Mr. Alan Li, head of equity-linked origination at CICC IB, noted that an H-share convertible project requires pre-approval from three Chinese regulators: The National Reform and Development Commission, the State-owned Assets Supervision and Administration, and the China Securities Regulatory Commission.

"These procedures require a lot of communication with the government agencies," Mr. Li explained. "CICC is in the best position to support issuers, and we've been doing just that, especially since the beginning of last year. We've closed a lot of landmark transactions. And right now, we are well recognized by investors and potential issuers."

China's latest fixed income market reform project is Bond Connect, an international investor highway leading to the mainland bond market through Hong Kong. Since July, Bond Connect has opened the full range of Chinese bonds to investors who formerly were restricted to accessing the market through the Qualified Foreign Institutional Investor program (QFII).

"The Chinese government is encouraging foreigners to participate in the Chinese bond market as either a borrower or an investor, to accelerate the reform process," said Mr. Wang Sheng, executive head of CICC IB.

CICC is now working with well-established QFII clients to invest through Bond Connect's so-called "northbound" channel for overseas access. In the future, the firm plans to serve foreign fundraising projects that tap a "southbound" element, which is poised to give Chinese investors access to foreign bonds issued in Hong Kong. Officials say Bond Connect's southbound channel will open once the northbound road has been soundly established.

Although onshore convertibles and exchangeables are not currently included in northbound Bond Connect, they have not been ruled out. Future reforms could include schemes that give offshore investors an inroad to convertible and exchangeable bonds issued in Shanghai or Shenzhen. And Chinese investors may eventually be allowed to access offshore convertible and exchangeable bonds.

"Offshore investors have a lot of interest in the onshore market," Mr. Wang said. "Some of the features of A-share convertible bonds are really attractive for them. I think if Bond Connect includes these products in the future, it will definitely drive up offshore demand."

No matter what the future holds, given its deep experience in guiding Chinese bond issues on overseas markets and support for offshore clients seeking access to mainland markets through panda bonds markets, QFII and now Bond Connect, the professionals at CICC will be ready to provide whatever it takes to succeed.

Mr. Bi recalls how CICC assisted Rusal through its bond project, which was the first international private placement on the Shanghai Stock Exchange. CICC was the sole underwriter and book runner for the landmark deal. CICC arranged pre-issue investor meetings that were critical to the deal's success.

The bond issuer "met a lot of Chinese investors," he said. "In the process, we were proud to take part in the historical development of the bond market." ●

China International Capital Corporation Limited
28th Floor, China World Tower 2,
No. 1 Jianguomenwai Ave.
Beijing, China
+86 (10) 6505-1166
www.cicc.com

CICC
中金公司

HOW CHINA'S REGULATORS AND MSCI LEARNED TO DANCE

Laying the groundwork of collaboration has been an arduous and sometimes awkward process for stock market regulators in China and the global markets indexer MSCI. But now that a dance date has been set, China is stepping up cooperation with MSCI while growing overseas investor participation in its financial markets.

MSCI said in June it would add a select number of China A-shares to its global emerging and regional markets stock indices on June 1, 2018. Picks currently include 236 major company stocks listed on the Shanghai or Shenzhen exchanges.

That number could change. In comments reflecting the indexer's ongoing scrutiny of Chinese market oversight, an MSCI spokeswoman noted "this list will be maintained on an ongoing basis."

China hopes additional A-shares will be added in the future, and that the 5 percent market cap weight now assigned for selected stocks will be vastly increased. Indeed, mainland securities regulators have been prodding MSCI for years, consistenty insisting that China deserves full-blown inclusion.

"We are willing to discuss the matter with MSCI," Fang Xinghai, Deputy Chairman, China Securities Regulatory Commission, said in February shortly before inclusion got a green light. "Any emerging market stock index, either MSCI's or another index, is very incomplete without Chinese stocks."

But MSCI, whose benchmarks influence investments and ETF configurations, is calling the shots. It has done so ever since creating the MSCI China A Index in 2005, as a first step toward A-share inclusion.

For years, the indexer has both emphasized its commitment to A-shares and bluntly expressed misgivings. China was often told inclusion hinged on bringing stock markets in line with international standards in areas such as trade suspensions, capital mobility, and investment quotas.

A 2016 MSCI survey of instiutional investors found many objected to including A-shares in the EM index because Chinese exchanges let companies arbitrarily suspend their own stock trading. Shanghai and Shenzhen exchange operators have since mended their ways, and trade suspensions have fallen off dramatically.

"Domestic institutional investors have similar concerns" about trade suspensions, Fang says. "So we will promote reform and opening up." According to a Shanghai exchange statement, "Standards for stock suspension and resumption of trading will be more integrated and consistent."

Stocks selected for global indexing include state banks, airlines, property developers, insurers, and China's biggest liquor companies. Each is among the 878 currently listed on the MSCI China A International Large Cap Pro Index. The A-shares are set for inclusion in the MSCI Emerging Markets, MSCI ACWI and MSCI Asia Pacific ex-Japan indices, among others.

Current Chinese contribution to MSCI EM and ACWI are mainland company equities denominated in non-Chinese currencies, such as U.S. dollar-linked Shanghai B-shares and ADRs in the U.S.

China's financial sector has been energized by the inclusion decision. The nation's biggest asset manager, ChinaAMC, called it "a milestone event" that "signifies foreign investors' acknowledgment of the accessibility, transparency, and liquidity of the Chinese stock market," adding that the stocks represent "the most sizable and liquid names" among A-shares.

"On the other hand," the firm said, "this is the start of a monumental task toward full inclusion of the A-share market."

HEAVY HITTERS

Of the 236 stocks picked for MSCI indexing, these will have the heaviest weights.

Agricultural Bank of China
Bank of China
Bank of Communications
China Merchants Bank
China Minsheng Bank
China Pacific Insurance
China State Construction Engineering
China Vanke
China Yangtze Power
CRRC
Hangzhou Hikvision
ICBC
Kweichow Moutai
Midea
Ping An Bank
Ping An Insurance
SAIC Motor
Shanghai Pudong Development Bank
Wuliangye Yibin

SOURCE: MSCI

INVESTORS EYEING MSCI INCLUSION TURN TO CHINA ASSET MANAGEMENT

Years of preparation have ChinaAMC well positioned to serve global investors after a historic decision.

Patience is the watchword for the financial sector in China, where doing business requires working with the nation's gradual reform process as well as adjusting to external conditions.

A steady hand and long-term perspective are especially important now that an initial batch of China A-shares has been tapped for inclusion in the MSCI Emerging Markets Index and related benchmarks.

China Asset Management Co. Ltd. (ChinaAMC) is confident that its patient approach to investing, links to regulators, and nearly 20 years of experience in emerging China will foster results from MSCI inclusion opportunities.

ChinaAMC is the nation's leading asset manager with USD$145.26 billion AUM as of June 30. As one of China's first asset managers, it has provided comprehensive China exposure for global investors through access to equity and fixed-income markets for more than 15 years.

ChinaAMC is now fielding calls from global investors eager to benefit from A-share inclusion, which was announced in June and takes effect next year.

"ChinaAMC has been preparing for this historic moment for a few years," says Richard Pan, head of the firm's International Business unit. "Since the MSCI decision, we are seeing an increased interest from prospective investors around the world."

Since its founding in 1998, ChinaAMC has played a pivotal role in financial market development. It also serves as a conduit between the market and key regulators, who often tap ChinaAMC for feedback. Decision makers appreciate its diverse team of 900 professionals, global perspective, and "research creates value" investing principle.

> "LIBERALIZATION OF THE STOCK MARKET WILL BE A GRADUAL PROCESS. THE REGULATOR'S PRIORITY WILL ALWAYS BE STABILITY FOR THE WORLD'S SECOND-LARGEST EQUITY MARKET."

ChinaAMC CEO Tang Xiaodong, who previously worked on Wall Street and spent six years at the China Securities Regulatory Commission, today serves on the MSCI Editorial Advisory Board, offering insight and promoting his firm's international business.

MSCI inclusion caps years of reform efforts aimed at making China a foreigner-friendly investment target. Prominent reforms in recent years include the Stock Connect and Bond Connect avenues for foreign investing in equity and fixed-income products.

ChinaAMC clients have benefited from Stock Connect-related products launched since last year. The fund's 2016–2017 return of more than 20% was among the highest among peers.

MSCI's decision also accelerated the development of ESG investing in China. ChinaAMC is proactively working with companies and regulators, as well as foreign and domestic investors, to improve corporate governance, transparency, and business strategy.

Future plans call for expanding into specific niche strategies, including ESG and quantamental investing. Investing in Chinese capital markets provides global investors with exposure to the anticipated wave of Chinese conglomerates that is now rising. Such investment would positively impact asset flows and provide opportunities for foreign investors to diversify portfolios and improve risk-return profiles.

MSCI's initial move to include 236 A-share stocks, with more to come, is the result of active efforts between Chinese regulators and global market participants. Major initiatives were taken to improve A-share market accessibility and liquidity issues. The inclusion process will continue as relevant parties gradually resolve outstanding issues, and as the market stands the test of time.

Historically, full inclusion in a new market takes about a decade. In China, "the length of the process may differ because of the size of the market and various complexities," says Pan.

"Liberalization of the stock market will be a gradual process," he says. "The regulator's priority will always be stability for the world's second-largest equity market, and to ensure sustainable, long-term growth for the Chinese economy."

Meanwhile, ChinaAMC's prudence, expertise, and patience are giving foreign investors a clear vision and better understanding of China's financial market. ●

For more information, please contact Di Tang at ib@chinaamc.com

ChinaAMC

and trading instruments are consistent with the previous requirements of foreign investors investing directly in CIBM. But Bond Connect is more convenient and efficient."

Before Bond Connect, any foreign investor who wanted to trade onshore bonds had to navigate a time-consuming account application and opening process. A first step was to be entrusted with an interbank bond market clearing agent that, in turn, had an international settlement business capacity. Every investor was also expected to have a comprehensive understanding of China's market-related laws and regulations, as well as the overall market environment.

Now, after qualifying and signing up to trade, a bond investor can "click and access" the market directly through "the infrastructure interconnection and multi-level hosting of mainland China and Hong Kong… with a significant enhancement in efficiency," according to Ping An AMC.

ECONOMIC FACTORS

Bond Connect's long-term success as a conduit for foreign capital will naturally hinge on global institutional investors' appetite for Chinese debt. Over the past year, that appetite has been tested in the face of slowing growth for the world's second-largest economy, local government debt tied to infrastructure construction and other stimulus projects, and uncertainty surrounding bank efforts to roll over or offload state companies' non-performing loans.

Potential bond investors are watching to see how "the Chinese economy, most notably how the de-leveraging of the financial sector and real economy, will be handled," Chan wrote. "There is still a lot concern among investors over the stability of China's financial system, as well as its economy slowing further."

Yet the sheer size of the nation's collective debt burden — and often-heard warnings of a flood of loan defaults triggered by some sort of day of reckoning — has not darkened the general, near-term outlook for the economy. The government has a system for disposing of non-performing loans tied to state companies and banks that many say is working. And the financial system, led by state banks, continues to successfully manage trillions of dollars in local government debt that's been around since the 2008 global crisis.

Analysts such as Zhao Yang, Nomura's Chief China Economist, have predicted a slow cooling off for economic activity through the end of 2017. Many expect the trend to continue at least through the first half of next year.

"China's economy is pretty stable right now" but "we are probably going to have a very gradual slowdown in the rest of this year," Yang said in July. "If you look at where we are in the economic cycle, I would say we are about to pass the peak of the recent rebound of economic growth."

In Yang's opinion, the speed of the slowdown will depend on the Chinese property market's development. Investment in residential and commercial property is "resilient" and has been strengthened by government regulators, he said.

But what about debt burdens, including non-performing loans on state bank books, and trillions of dollars in outstanding loans issued over the past decade to local governments? Although Yang notes credit growth figures heavily into domestic investment, which accounts for nearly half of the nation's GDP, he said outstanding debt "does not present a significant threat."

Yang's take is that "China is facing a high debt problem rather than a large leverage problem."

The economy enjoyed a fresh growth spurt between the second half of 2016 and early this year, triggering talk of a possible end to the gradual slowdown for GDP growth in China that's been under way since 2010. Behind the improvement was "a rebound in property, commodities and upstream manufacturing," said Dr. Shen Minggao, Chief Economist, GF Securities.

But the rebound was only "temporary" and "hardly sustainable," Shen said. "The factors driving the short recovery are now dragging the economy down."

Indeed, the spurt ended abruptly last spring after the government took steps to control property market inflation by tightening home buying rules. The rules made residential purchases more difficult in select cities, which in turn cooled prices as well as the property market overall.

At the same time, the economy was affected by slackening demand for commodities in the face of flattening government spending on infrastructure projects and manufacturing sector pressure. Shen said "overcapacity in manufacturing and high costs" for labor, taxes and capital have been "eating into profitability."

As of the third quarter, Shen was maintaining a bearish outlook. "The economy still has downside pressure," he said. "And the pressure of deflation still exists."

But the Chinese economy may have

an ace in its hand in the form of a rising consumer market closely linked to what mainlanders call the "new economy" encompassing consumer finance, services, and online retailing companies such as JD.com and Alibaba.

"Even if Chinese economic growth slows down and has a negative impact on consumption," Shen said, "the average growth in consumption over the next five years will still be quite decent."

"A friend working for an airline told me the percentage of young passengers traveling in first and business class is climbing fast," he added. "Auto financing is quite popular among the younger generation, too."

China has been working for about five years to shift its traditional, export-driven economy to consumer-based growth. "If the transformation is successful, China will likely enter a sustainable but slower growth period," Shen said. "At that time, consumption will still be a good choice."

All signs point to China hitting or exceeding the government's 6.5 percent target for 2017 GDP growth, which officials set below last year's 6.7 percent. Most forecasters see the cool-off accelerating next year.

The IMF in June revised upward its China forecast for all-year 2017 to 6.7 percent. But the growth rate is expected to fall to 6.2 percent next year, IMF said, and average 6.4 percent yearly between 2018 and 2020.

Gene Ma, the China Chief Economist, Institute of International Finance, said at a July hearing of the China Economic and Security Review Commission in Washington, D.C. that corporate leverage is high and "demographics are working against" economic growth in China, as the contributions of young women in manufacturing and migrant labor "have probably peaked."

Shen agrees that a significant slowdown is imminent — and yet that's not necessarily a negative scenario. "I see no big problem if Chinese authorities are able to tolerate around 4–5 percent growth so that they don't have to overstimulate the economy," he said.

RATES AND RATINGS

More factors than the economy are on the radar among foreign investors considering whether to head down the Bond Connect road. For example, how the yuan's value plays against the U.S. dollar and other currencies.

"There is a general perception that the (yuan) could continue to depreciate, which would limit the interest of overseas investors in (yuan)-denominated bonds," Chan said.

Also factoring into investor appetite is China's system for corporate bond ratings, which relies on domestic agencies rather than the international firms more familiar to the global investment community.

Credit rating agencies that participate in China's interbank bond business are required to accept the regulation and supervision of the PBOC "concerning their credit rating business," the central bank announced August 7, "or the credit rating regulator in the host country or region has signed [with PBOC] a cooperation agreement on credit rating regulation." Moreover, an eligible foreign agency must have a subsidiary in China that's registered with PBOC or one of its branches in a major city, such as Shanghai.

The rules effectively steer most of the credit rating business to domestic firms little known outside China, such as Shanghai Brilliance Credit Rating & Investors Service Co., Dagong Global Credit Rating, and China Lianhe Credit Rating Co. Heavy reliance on domestic credit rating agencies is considered by many in the mainland investment community as a benefit that foreign investors should welcome.

Domestic firms are said to understand all-important "Chinese characteristics" of a bond issue, such as the relationships between bond-issuing state companies and government agencies that may provide implicit guarantees of financial support during times of trouble.

Critics, however, say domestic agencies may be too easy on bond issuers, especially state companies and local governments. Overseas analysts have called the credit system "the Achilles heel" of the China bond market.

"About 95% of corporate bonds have an AA or above rating from domestic rating agencies, which is much higher than the usual rating distribution of international rating agencies," Chan noted. "Indeed, many domestic investors have indicated that they cannot rely that much on the ratings of domestic agencies, and have to do a lot of internal research work to make on their own credit assessments."

It's arguable whether a domestic credit agency would

consider downgrading China's overall credit rating, which is what the international ratings agency Moody's did in May. While forecasting slowing economic growth and rising debt levels over the coming years, Moody's lowered China's rating to A1 from Aa3 and changed its outlook to stable.

The Ping An AMC report acknowledged foreign investor concerns, but said "once the basic problem of domestic credit ratings is resolved, credit bonds investment will be a long-term trend, as foreign investors will like to achieve higher returns."

Indeed, just three months after announcing the downgrade, Moody's praised the "refreshed commitment to facilitate reforms" that emerged from the government's National Financial Work Conference, a July meeting in Beijing where officials set a five-year course for the nation's financial policies.

POLICY PROJECTS

A 2016 policy circular from the government's top economic planner, the National Development and Reform Commission (NDRC), called on local governments to provide subsidies and other incentives to support bond financing for environment-improving projects.

The market's response to the NDRC's directive has been overwhelmingly positive, with Chinese companies and onshore investors climbing on board by participating in green project financing, including green bonds.

The total value of China green bond issues in the first half of 2017 topped US$11 billion, the report said, "accounting for about 23% of global green bond issuance for the same period." Terms for most of this paper ranged from three to five years. State-owned enterprises issued about two-thirds of these bonds, the report said, with the rest issued by local government-linked city commercial banks.

Another emerging arena in which the Chinese bond market could play a major role in the future involves the Belt and Road initiative, a Chinese government-led effort to boost infrastructure development in and bilateral trade with countries in Africa, Central Asia, Southeast Asia, and the Middle East. Onshore bonds and offshore convertible bonds available in Hong Kong — perhaps in conjunction with Bond Connect's future southbound component — may be issued by domestic companies and foreign entities working together on Belt and Road projects.

At this stage, even China's financial sector heavy hitters can't be sure when, or even if, convertibles will be included as a Bond Connect investor option.

"We don't know if convertibles will be added to the securities portfolio of Bond Connect in the near future," said CICC's Liu. "While currently some foreign investors do participate in A-share convertibles through QFII, if Bond Connect does include convertible bonds, it will provide foreign investors another avenue to access onshore papers."

NARROWING GAP

What's next for Bond Connect? No one doubts deal-making will accelerate in coming months as the trading system matures and global investors become more familiar with the program's opportunities.

Tsai expects a modest uptick for trading volumes in the near-term, followed by continued growth and wider adoption. "In the short- to medium-term, the distribution of Bond Connect members will continue to diversify, and more European and U.S. accounts will get on board."

A new market normally experiences "a gradual buildup with volume starting lower initially, and then a gradual buildup over time, and that eventually follows the old adage, 'Liquidity begets liquidity,'" he said. "And one day, that market finally takes off."

Future inclusion of yuan-denominated Chinese bonds in global bond indices would likely encourage even more foreign investment. The Ping An AMC analysis predicted yuan-bond demand "in the international market will be significantly increased" if inclusion becomes the norm, and the capital increase could be "about US$250 billion once the China bond market is [included in] key global bond indices."

That process is already underway. Citigroup recently announced an "inclusion eligibility validation process" aimed at adding Chinese onshore bonds to emerging market and regional government indices. Once validated, China would be added to the firm's World Government Bond Index-Extended. Separate indices for government bonds in emerging markets, Asia, and the Asia-Pacific were also opened to China. — *Eric Johnson*

GROWING CONSUMPTION WILL DRIVE CHINA GROWTH

Q&A: Dr. Shen Minggao, Chief Economist, GF Securities

As one of China's most influential securities companies and a leader in investment banking and asset management, GF Securities has unique insights on what is arguably the world's most important economy. The company is pursuing an ambitious international strategy that includes globally integrated services. For example, the company is vigorously expanding its FICC business, and continues to build out its FICC investment platform, mainly through GF Global Capital, its indirectly wholly owned subsidiary, with assets allocated to 20 countries and regions, including Asia, Europe, and the U.S., and covering diversified investment fields, including, among others, bonds and structured products. The company has also actively developed counterparties of cross-border underlying assets, and was the first securities firm to conduct OTC options transactions linked with overseas underlying assets under the Securities Association of China agreement.

Here, the firm's new chief economist, Dr. Shen Minggao, shares his thoughts on growth potential in China.

China wants to open the door wider than ever before to foreign investment, but currency is a challenge. Do you see this changing?
Renminbi depreciation, with weak growth in the background, and capital control are two major concerns for foreign investors investing into the Chinese market. Though A shares are to be included in MSCI, these concerns still exist, for short-term investors in particular. Some kind of market clearing or short-term pain is expected in China, though investors may have different opinions on the scale and intensity.

The Chinese government attaches great importance to stability. It has no intention of compromising the GDP growth target of 6.5 percent. As a result, market clearing has continuously been delayed. This issue is self-perpetuating; the fear of renminbi depreciation results in stricter capital control, and thus less willingness to enter the market, which then leads markets to greater fear of further depreciation pressure. Two possibilities will help break the cycle. First, the market clears and investors think the downside risks are manageable and start to enter the market. Second, the government takes effective measures to make the negative effects controllable during the market clearing. If reform supports are there, meaning the downside risks are manageable, investors may start to show some interest even before the market clearing.

What should long-term investors do to prepare for the day when doubts about the renminbi are resolved?
Get prepared earlier. For long-term investors like pension funds, the secret to outperforming the market is counter-trend trading — seeing value where many others don't. They have two concerns: How deep is the correction? And when will the correction happen? If they are relatively certain about the timing, they could start preparing for investment. It's not that they cannot take risks; they take risks for good reasons. If you have a judgment for the depth of the correction, the only question is timing.

What are some of the business sectors in China that should appeal to investors?
My advice is to focus on consumption and avoid investment-driven sectors. The momentum of China's consumption is much stronger than the expectation of many investors. Another perspective is the new economy. Relatively speaking, China's new economy, like the innovations in internet industries, is much more dynamic than in many other countries. People are accustomed to electronic payment. In Beijing, I can arrange my breakfast delivery before getting out of bed. Bike sharing blossoms overnight. Not every innovation can succeed, but you can see the momentum, and the urge of innovation thrives.

Assuming China's global leadership role continues to grow as the U.S. retreats from globalization, what will this mean for those seeking to invest in China?
This is a good question. China has to

do its "home" work very well if it wants to lead the world. For investors, if they believe China will have a bigger role in the world, they should have confidence in China's economy, and should accordingly increase their allocation in renminbi assets. I can't imagine any other way in which a greater global leadership role will be achieved.

Two characteristics will be fundamental in this process: a more internationalized renminbi, and the rise of China's consumerism. China can't lead the world by increasing exports. It can only lead the world by its growing consumption. China can't lead the world in U.S. dollars. It has to lead the world in renminbi. Investors should consider a reasonable allocation in renminbi assets. And you should invest in Chinese and global winners who can ride on China's growing consumption. If this transformation is successful, China will likely enter a sustainable but slower growth period.

China's internal infrastructure ambitions continue to grow at the same time that the Belt and Road initiative gathers momentum. How will that shape investors' perspectives?
It's unrealistic to expect investment in any single area — for example, property, infrastructure, or even capacity investment in manufacturing — to fuel the growth of such a huge economy. The momentum of investment-driven sectors will weaken, not just because China's development has come to this stage, but because technological progress and the evolution in information technology allow for light investment models instead of heavy investment models.

To which storylines that could affect China's economy will you be paying the most attention?
The reason why China's economy has risen successfully in the past four decades lies in its institutional or policy flexibility. There are two meanings to the flexibility I'm talking about. The first one is leeway. The second one is a willingness to make necessary adjustments in policies so that they can better adapt to local and current circumstances. For example, when the planned economy couldn't work anymore, China shifted to a market economy. I think the Chinese economy is always hopeful as long as the country doesn't shut its door.

Among the things I worry about are interest rates getting out of control during the future market clearing. Therefore, I think liquidity management is an important storyline for individuals, for corporates, and for the PBoC. The third storyline is the property market. It will be remarkable if the bubble in China's property prices doesn't burst, but there are different ways for that to occur. If these issues are addressed well by policies, a market clearing will come, but its negative effects will be controllable.

You've worked with many great research teams in your career. What makes GF Securities research teams different and better?
The GFS research team was ranked second in China last year, empowered by a few unique features: an adaptive governance structure; a research team that keeps clients grounded; and strong business lines, including investment banking.

More than 99 percent of our researchers have a master's degree or higher, and we are in the process of growing the team, particularly in Hong Kong. There are great opportunities ahead for Chinese brokers, and Hong Kong is a harbor where outbound and inbound funds park. The story has really just begun. We are best positioned to exploit the opportunities based in Hong Kong.

There are more advantages going forward that should help Chinese brokers. The first advantage is the connection of onshore and offshore markets. The second is that Chinese brokers are the best tellers of local stories, and we compete with international banks at the front line. Ultimately, it's the economic power we are depending on. As long as China succeeds in its transformation, local knowledge will become increasingly important. Hong Kong is the best place for strategic asset allocation, where you have access to various investment vehicles and uncorrelated assets. ●