INVESTMENT BRIEF

Q1 2019

Strategic Investment Group®

China's Market Liberalization

China's prominence as the world's second largest economy, dynamic engine of global growth, voracious consumer of commodities, and aggressive exporter of manufactured goods is well established. In contrast, its domestic capital markets, while also quite large, have remained largely closed. We analyze below the implications of China's initiatives to liberalize its capital markets and place them in the context of its much broader economic restructuring program.

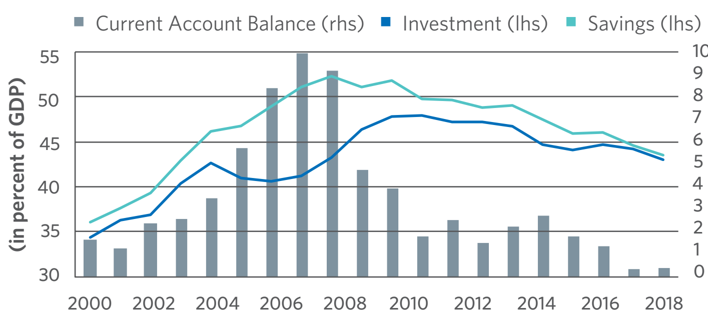
Unsustainable Economic Growth Drivers

The Chinese economy has more than doubled in real terms since 2009. This breakneck pace of growth has a shaky foundation: high levels of domestic savings and investment, and rapid credit growth. China's domestic savings represents 45% of GDP, largely reflecting household savings driven by a fledgling social safety net and aging population. Investment, at 43% of GDP, is almost as high and equally unsustainable (Exhibit 1). Domestic savings have largely been intermediated through the financial sector, fueling rapid credit growth. Credit since 2009 has expanded at twice the pace of the economy, propelling the stock of debt of the non-financial sector to over 250 percent of GDP, much of it extended to inefficient state enterprises and sectors with excess productive capacity.

EXHIBIT 1:

China's Savings and Investment Imbalances

Source: IMF, WEO Data Base, April 2019 Vintage.



China's Capital Markets Opening

Recognizing that growth based on excessive savings, investment, and debt is unsustainable, China has embarked on an ambitious liberalization program. This program aims at reducing savings in favor of consumption, reining in investment and credit growth, freeing the exchange rate, improving financial market regulation, and opening capital markets, including its domestic equity market.

Tight quotas, onerous qualification requirements, and strict currency controls impeded foreign participation in China's domestic equity market. The high volatility of a market dominated by retail investors and capriciously imposed trading controls further deterred foreign interest.

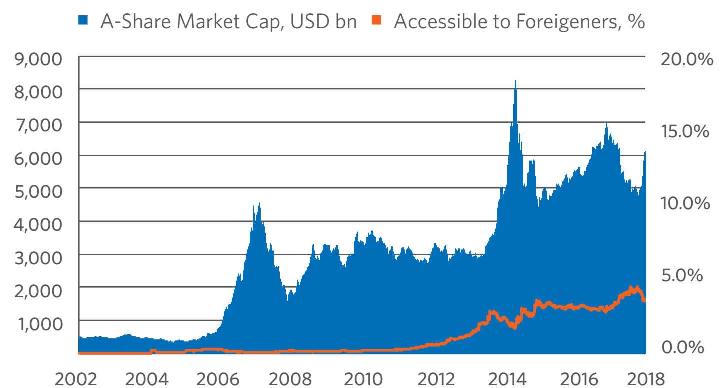
However, because of China's reforms, the domestic A-Share market is becoming increasingly accessible and attractive to foreigners. MSCI's recently announced plan to increase the proportion of China A-shares in the MSCI EM Index to 3% in November 2019 from only 0.35% in March 2018 represents a milestone in the liberalization process. (Including the offshore market, Chinese equities will increase to 32% from 30%.)

China's A-share market has a capitalization of $6.1 trillion, about 7% of global GDP, and is the world's second largest equity market after the U.S. ($32 trillion). Yet only about 3.5% of the China A-shares market is open to foreigners (Exhibit 2).

EXHIBIT 2:

China's A-Share Market and Foreign Participation

Source: Bloomberg.



Opportunities and Risks

Strategic has been investing in the China-A share market since March 2018. We currently target a 5% overweight to the market in our emerging equity portfolio. Our overweight is motivated by the market's outsized scope for added value and diversification benefits. We also anticipated that early entrants would benefit from further market opening.

Over the long run, the increased integration of the Chinese equity market in global capital markets will likely reduce market inefficiency and the opportunities for active management, and increase the correlation of the Chinese market with others, thus reducing its diversification benefits. For now, however, China-A shares have a low correlation with other markets, offer opportunities for active management, and are fairly valued.

Note: This material is for informational purposes only and should not be construed as investment advice or an offer to sell, or the solicitation of offers to buy, any security. Opinions expressed herein are current as of the date appearing in this material and are subject to change at the sole discretion of Strategic. This document is not intended as a source of any specific investment recommendations.

1001 Nineteenth Street North, 16th Floor
Arlington, VA 22209 USA

+1 703.243.4433 TEL
+1 703.243.2266 FAX

strategicgroup.com

STRATEGIC INVESTMENT GROUP IS A REGISTERED SERVICE MARK OF STRATEGIC INVESTMENT MANAGEMENT, LLC.
© Copyright 2019, Strategic Investment Management, LLC. No part of the materials provided may be copied, photocopied or duplicated in any form, by any means, or distributed or retransmitted without the prior written consent of Strategic Investment Management, LLC.