Issued: June 2017
MARKET COMMENTARY

Ashmore

China's MSCI index inclusion: the sound of inevitability

By Jan Dehn

MSCI's inclusion of Chinese stocks into its index is another inexorable step towards China's entry into and eventual dominance of the global financial system. All but the most myopic and deluded investors should recognise that the significance of China's inclusion in the MSCI EM stock market index extends far beyond mere symbolism: this is an extremely significant event.

Let there be no doubt. The commitment on the part of China's leaders to the country's inclusion in the global financial system is unequivocal. This commitment is not driven by some ideological whim, but rather by a simple realisation that entry into global capital markets is essential to China's future growth and development.

To see why, remember that China is rotating its growth model to one based on consumption and technical progress and away from the old model, which was based on exports and raw capital accumulation. This rotation is designed to shield China from decline of her erstwhile export markets in the over-indebted Western consumer economies as the latter inflate and devalue their way out of their debt.

Index inclusion fits into this rotation because higher domestic demand implies future current account deficits in China, which in turn have to be financed via an opening of the capital account. Index inclusion is likely to guarantee capital inflows given the index hugging nature of most global capital.

The absolute and well-founded commitment on the part of China's leaders to enter the country into the global financial market means that investors can assign a very large probability to the outcome that China's share of the MSCI index will continue to rise over time. Not only will the number of large cap stocks in the index rise from the (better than expected) 222 initially targeted for inclusion, but inclusion factors will also rise steadily. With time mid-cap and small cap stocks will also enter the indices.

In addition, investors should now assign a larger probability to China's large bond market being included in the main global and EM fixed income indices. Between them, these index inclusions should ensure that hundreds of billions of Dollars flow into the Chinese capital market over the next few years.

But the significance of MSCI inclusion does not end there. Based on very conservative growth estimates, we believe that China's economy will be 2-3 times larger than the United States by 2050. It follows that China's financial markets will also grow to become much larger than the US markets over the same period. While market size is certainly not a guarantee of profitability – for example the BRICs acronym was a great sales gimmick, but did not guarantee investor returns – there is one important respect in which market size does matter: global financial markets love to benchmark themselves against the largest and most liquid markets. Given China's likely rise to dominant status in both economic and financial terms over the next couple of decades it is clear to us that markets will eventually have to benchmark their global fixed income and currency exposures against Chinese government bonds and the Renminbi. That is not to say that the US Treasury market and the Dollar will cease to matter, far from it, but we believe the US markets are destined to take second place in the rankings behind China (exactly the same way that the British Pound and the UK Gilt market lost its dominant status to US markets in the years between the two World Wars). Long-term investors such as pension funds, insurance companies and sovereign wealth funds should already be building positions in the Chinese markets, regardless of the pace of index inclusion.

The flows into the Chinese markets in the coming years due to index inclusion will be important for the rest of the world in many ways. Clearly, the ability to access a dynamic, growing and highly diverse market like China is reward in itself, but there will also be benefits in the rest of the world. Chinese investors, like investors elsewhere, have pronounced home bias, but they still want to invest some of their money abroad. The Chinese authorities are keen to let them do so, but this poses a challenge to the Chinese authorities on account of the still extreme reluctance of foreign investors to countenance investments in China. The inflows due to index inclusion will now begin to erode this asymmetry in flows and hence the rest of the world should also begin to benefit from greater flows of capital from China.

Continued overleaf

Index inclusion is also likely to have another under-appreciated positive effect. As mentioned in the previous paragraph, sentiment towards China among international investors remains very negative bordering on funereal at times. This is why views on China tend to lurch from hard landing fears to angst about overheating with seemingly nothing in between. Yet, the economic reality of China has for many years been one of relatively stable growth and inflation rates, a firm commitment to reforms and very little political uncertainty. We expect that index inclusion – which implies that investors will now have to take actual positions rather than just pontificate – will force commentators to abandon their often baseless pessimism and outright prejudice about China in favour of more mature, well-grounded views of the country and where it is heading. We also hope that index inclusion will improve prospects of greater involvement of foreign institutional investors in the Chinese market.

Prospects of greater international participation in onshore markets will improve further once global bond index providers finally include Chinese local currency government bonds in their own index products. This remains a key strategic objective for the Chinese authorities and will hopefully happen in the next year or so.

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