

CHINA A-SHARES: A NEW MILESTONE

Following four years of intense consultation and three failed attempts, MSCI has just added China A-Shares into its international indices. We view this as expected and in some ways, long overdue. Although the initial size of the inclusion is symbolic in nature, the implications are far reaching.

Limited near-term market impact

With implementation scheduled for May/August 2018, the current inclusion implies that A-shares will only make up 0.7% of the MSCI Global Emerging Markets Index, 0.8% of MSCI Asia Ex-Japan, 2.6% of MSCI China and less than 0.1% of the MSCI All Country World Index.

220 stocks will be included in this phase, with a total market capitalisation of USD700bn. This is miniscule in the context of the overall domestic Chinese stock market which has more than 3600 companies and a market capitalisation of USD6.9tn.

Secondly, only stocks which can be traded through the Stock Connect programme in Hong Kong are included. Based on estimates, a total of USD7bn of flows will come through on implementation. This represents less than 10% of one day's trading turnover in China.

Hence, we believe the market impact is likely to be muted considering the size and the long timeline to implement this.

Major implications for China as a global capital market

In spirit, the move by MSCI to include domestic China shares into its global indices marks the first step to potential internationalisation of the China's capital markets.

If China continues on this pathway, it should eventually lead to the opening up of its capital account. The opening up of stock markets is usually a pre-cursor of bigger things to come. Each time China tries to open up its economy or markets, it will test it on a small scale and only open the door wider once it is confident of success.

Over the past decade, China has been slowly but gradually opening up its capital markets. For currency, quotas are given for trading in multiple countries especially in Hong Kong. For equities, the access is through QFII, RQFII and Stock Connect programmes. There is also potential for a more significant opening up of its onshore bond market.

Considering that China is now the second largest economy in the world and the Shanghai and Shenzhen stock markets together form the second largest stock markets in the world

after the US, China is heavily under-represented on all measures in MSCI indices.

Notably, domestic China shares are to be added at a mere 5% inclusion factor. If given full factor inclusion, China's weighting, including offshore HK-listed shares, could potentially quadruple to an estimated 8%. Even in that scenario, China will still remain the most under-represented country in the Index, compared to its economic significance.

New milestone for the opening of China's capital markets

The historical precedence for full inclusion is approximately ten years. Taiwan and Korea are the most recent showcases of the time it takes for full inclusion in MSCI indices. In the 1990s, it took Taiwan and Korea almost nine years to be fully included. At one point, Taiwan and Korea accounted for more than 40% of the MSCI Global Emerging Markets Indices.

China is larger and arguably, more complicated than Taiwan or Korea. However, with the rapid advancement in technology and information flow, and with political will, we believe China is likely to reach full inclusion in international indices.

Until then, we believe that the move by MSCI to include China A-shares to its indices is a new milestone for China's capital markets.

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