

Inclusion of China in Bloomberg's Global Aggregate Bond Index Boosts Pressure on Investors to Figure Out How They Will Deal with the Opening of Chinese Markets

MARCH 27, 2018

GREG JENSEN
PAUL PODOLSKY
SEAN MACRAE
NICHOLAS BERNOLD

Most global investors have very small allocations to China that do not appropriately reflect the size and importance of the Chinese economy or its assets. We expect that will change significantly over the next few years, and Bloomberg's inclusion of the Chinese bond market at a bit over 5% weight is the first material shift by one of the major indices to boost exposure to Chinese onshore financial assets. Many more moves like this are coming and will reshape global portfolios, and we would encourage investors to think proactively about the exposure they want to China now.

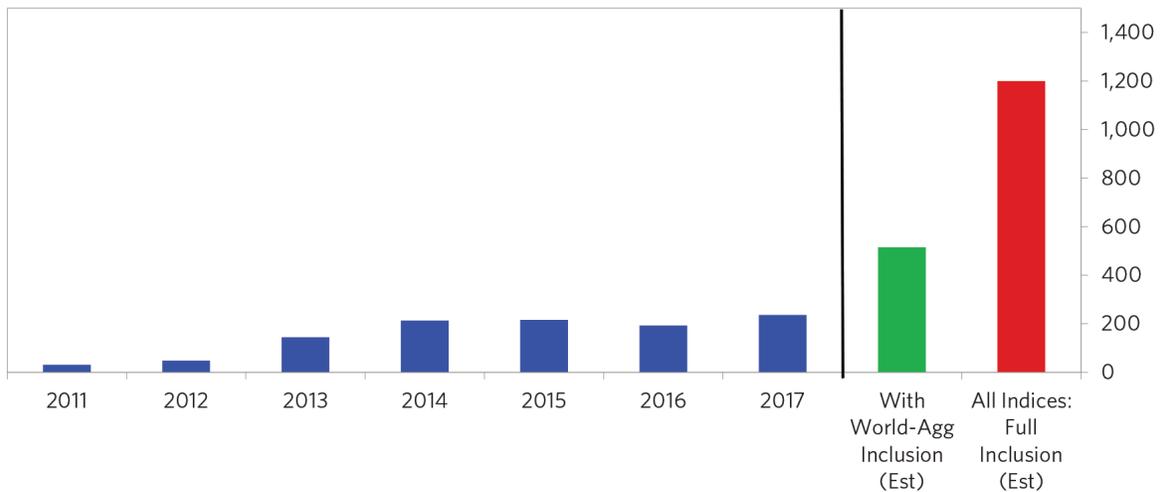
The availability of Chinese assets provides a meaningful opportunity for diversification. Chinese assets have a fairly low correlation to global assets because the Chinese economy is largely driven by domestic demand, which in turn has its own idiosyncratic drivers. The motivations for China to open up their markets are equally clear. China wants foreign capital to deepen their capital markets, help further develop their economy, and bring in flows that will allow them, over time, to relax capital controls and create a two-way currency market. The launch Monday of an RMB-denominated oil future open to international investors is another step in the same direction. The oil exchange reflects a desire to harness financial markets to more efficiently allocate capital, and doing so will improve global commodity liquidity. While the bond inclusion is the bigger deal, both of these developments highlight the fact that going forward Chinese assets will play a significant role in most investor portfolios. While today foreigners have a tiny share of their portfolios invested in Chinese assets, particularly relative to the size of the Chinese financial markets and economy, we expect this to change dramatically in coming years.



Chinese Bonds to Enter the Index Next Year and Be Phased In to Full Weight

Beginning in April 2019, China will be included in the Bloomberg Global Aggregate. By 2021, Chinese bonds will make up about 5.5% of the aggregate. This is a big deal for global capital allocation, as trillions of dollars track this index explicitly and trillions more use it as an important reference for their allocation. Given that investors already hold some government bonds, this means hundreds of billions of dollars will likely move into the bond market. In a statement, Bloomberg said Chinese bonds now meet inclusion criteria that the bonds be investment grade, freely tradable, allowed to be currency hedged, and “free of capital controls.” If other flagship indices follow suit, we estimate that very roughly something like \$1.2 trillion will flow into the bond market, as we show in the red bar below.

China RMB Debt Held by Foreign Investors (USD, Bln)

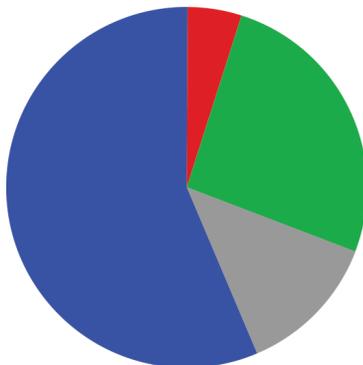


If China Continues on Its Current Path, Chinese Assets Are Likely to Represent Roughly One-Third of Investor Portfolios

An even bigger flow will occur as Chinese stocks also gain inclusion to equity indices. To illustrate the point, if Chinese bonds and stocks are given a market weight in global indices, we will move from the chart on the left to the chart on the right. As of June, onshore Chinese stocks will join the major MSCI indices (the offshore H-shares are already in the index). Though the inclusion weight will initially be very low, we expect onshore equities to eventually be included at their full weight (about 17% of global market cap). This would represent a staggering shift in the source of global returns.

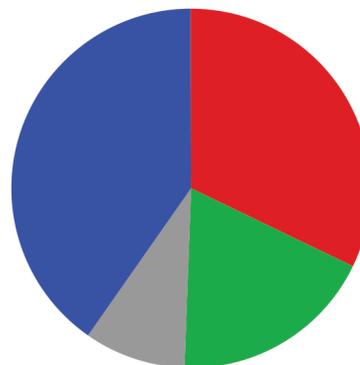
Developed World & China 60/40 Using Current Index Weights

■ USA ■ China ■ Europe ■ Japan



Developed World & China 60/40 Using Future Index Weights (Est)

■ USA ■ China ■ Europe ■ Japan



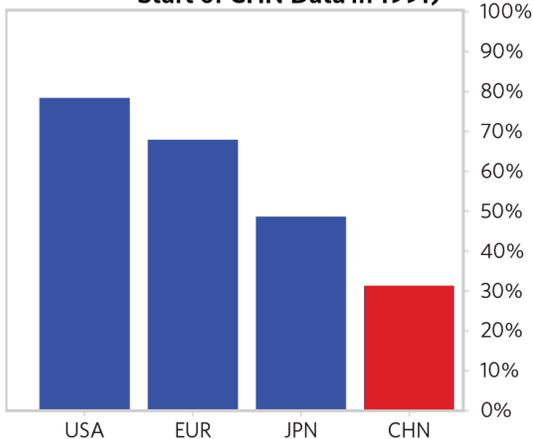
Opening China's Markets Makes Sense for China...

Chinese policy makers have been working assiduously toward opening their markets for years. The stock and bond connects, working with outside investors to deal with issues like currency hedging and intervention, fit into a chain of reform that stretches back to 1978, an evolution we have described elsewhere. The key thing for foreigners to recognize is that opening their markets serves China's interests. To continue to reform and reach their own growth targets (becoming a "moderately prosperous society"), China needs to deepen their capital markets and transform them into a source of capital for increasingly private-sector-driven savings (i.e., insurance and pension funds) and investment by households and innovative private sector businesses.

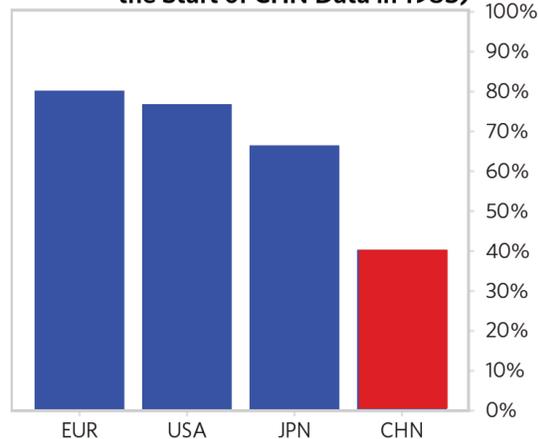
...and for Foreign Investors

China represents an almost unprecedented opportunity for investors to diversify their portfolios. While China has a large influence on other major economies and vice versa, growth is primarily driven by the domestic economy and domestic drivers. For starters, China's short-term and long-term debt cycles are at different points relative to most of the developed world. Japan, Europe, and the US all have debt levels over 300% of GDP, interest rates close to zero, large central bank balance sheets, and growth well below 5%—none of which is true in China. Of course, as a consequence of global capital flowing more freely, in the future the correlation between Chinese and foreign assets will likely rise somewhat as ebbs and flows in global liquidity begin to have more impact in China. Still, we expect the fundamentally diversifying effects of Chinese assets will persist. All of these factors mean that conditions in China look different than in the countries that dominate institutional portfolios, as shown in the charts below.

Growth: Correlation to Rest of World (Since the Start of CHN Data in 1991)

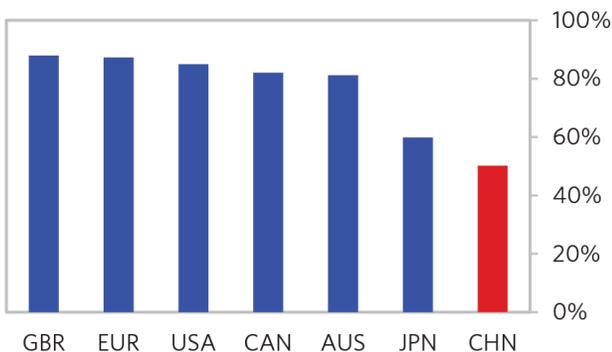


Inflation: Correlation to Rest of World (Since the Start of CHN Data in 1985)

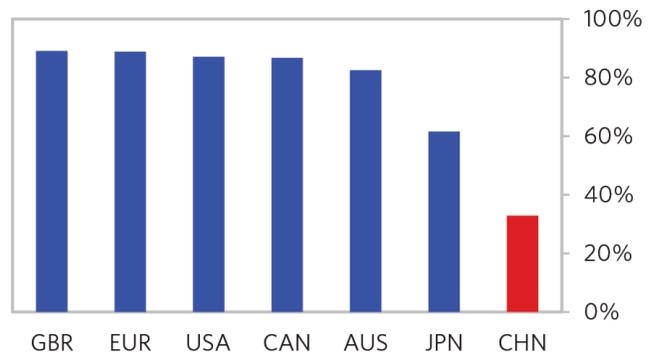


Given that conditions are lowly related, it isn't surprising that asset class returns have been lowly related as well. This means that adding these assets to a portfolio is significantly diversifying.

Equity Returns: Correlation to Rest of World



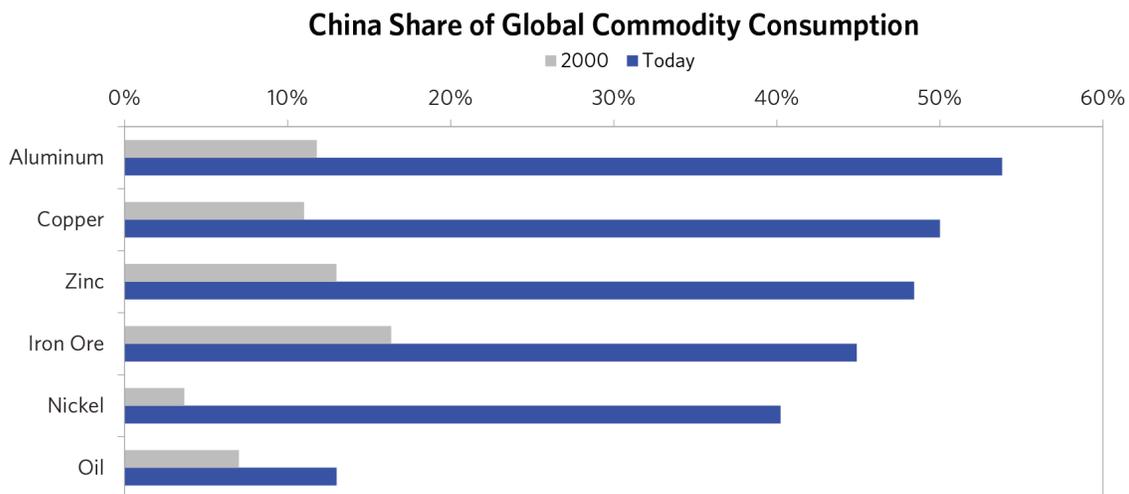
Sov Bond Returns: Correlation to Rest of World



We've also noted previously that China has "fuel in the tank" to ease, should they need to do so. That question, which once seemed like a distant consideration, is now suddenly more front of mind, given recent turbulence around both trade and late-cycle dynamics. While we have our own tactical views on such matters, our core perspective is that it is best to spread one's bets. The opening of China's markets and now the inclusion of Chinese bonds will increasingly drive many investors to do just that.

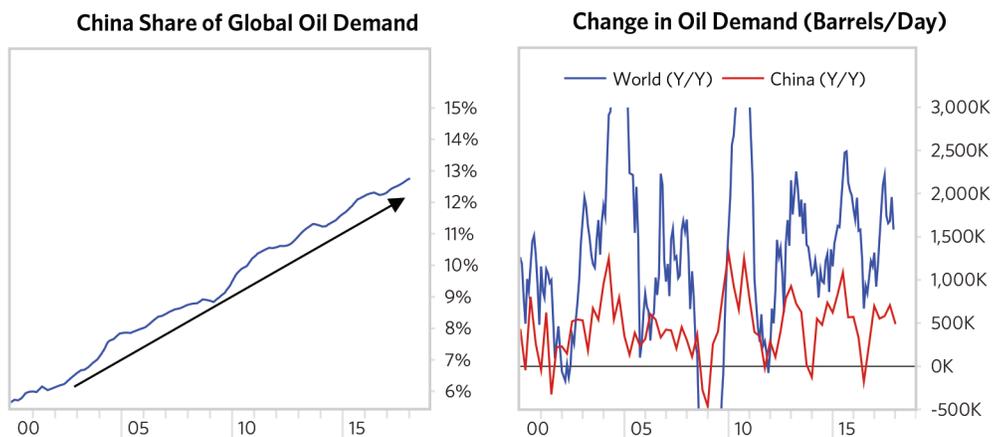
Monday's Launch of an RMB Oil Future Available to Foreign Investors Is Another Opening Up

Given the news over the bonds, it would be easy to miss another important milestone—the Monday opening of RMB oil futures available to foreigners. China is a huge player in global commodity markets (as illustrated below), so developing onshore commodity futures markets makes sense. China already allows trading of a gold future denominated in RMB.



The parameters of the Shanghai contract are largely similar to crude oil futures currently traded in London and Chicago, with the notable difference that they are denominated in RMB (though foreigners can post margin and take profits in dollars) and have a tighter cap on daily price moves (plus or minus 4%).

RMB futures will allow onshore market participants like oil companies, large consumers, and asset managers (some of whom are currently prohibited from trading commodities, but we expect this will eventually change) to either hedge or gain portfolio exposure to oil without going through the process of converting their local currency into dollars. If onshore investors begin to use oil futures in their investment portfolios, China could become an even more important component of the marginal demand for oil. The chart below on the left shows China's increasing share of oil consumption, and the chart below on the right shows that a significant share of the global shifts in oil demand come from China. Given this, creating a commodities trading hub in China is logical.

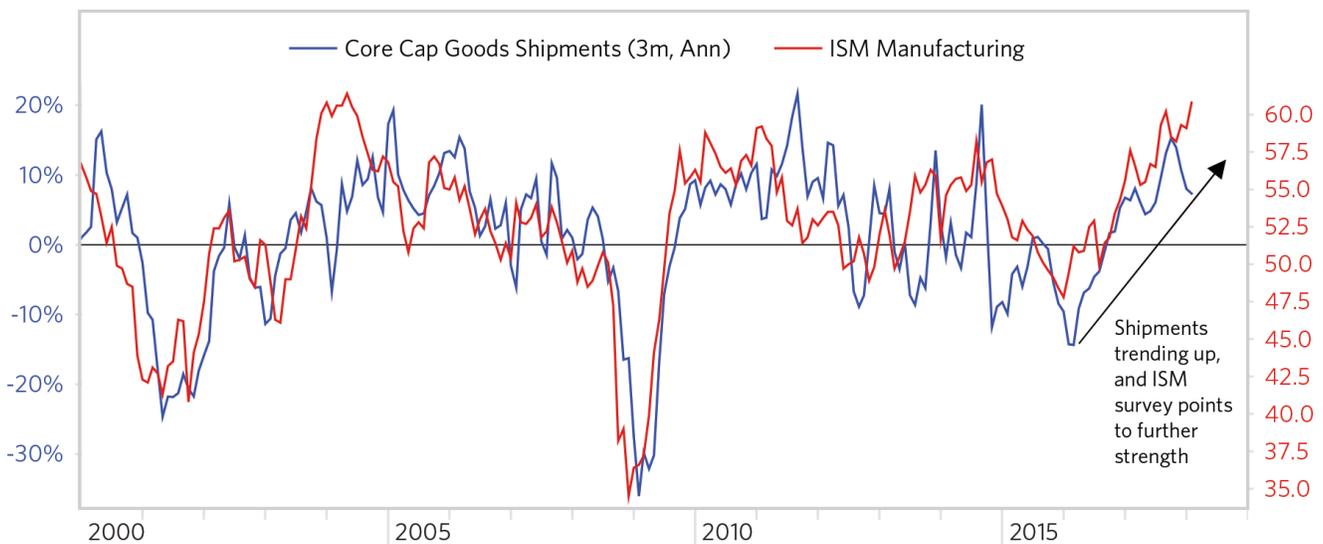


US Durable Goods Report Is the Latest Sign of US Business Investment Reinforcing the Ongoing Expansion

MATTHEW KARASZ | BRENNAN ROBBINS | RUTENDO CHIGORA

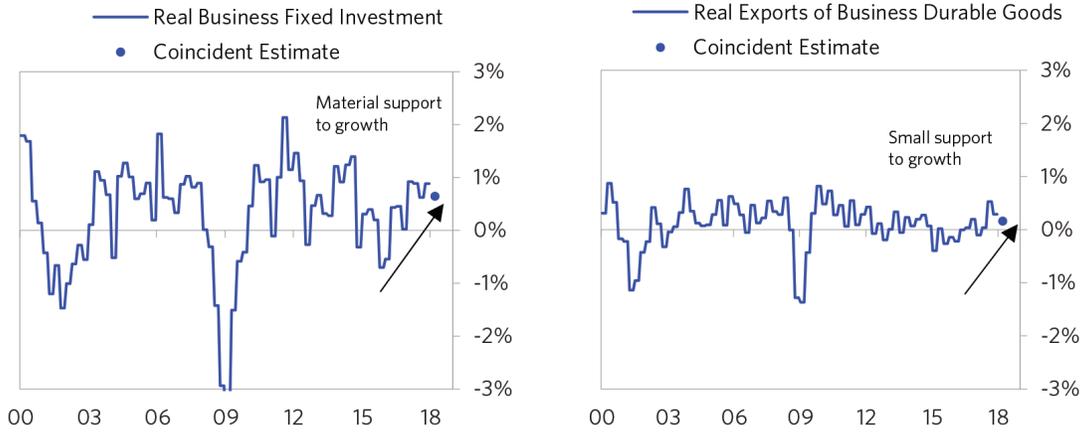
US business investment has been picking up for some time, and as we look ahead we expect it to continue to reinforce the already strong US expansion. So far, it appears that US companies are responding to the normal cyclical pressures as one would expect: businesses have faced strong demand for some time, they are increasingly under pressure to expand capacity, and they are flush with cash. In line with this, US business investment has picked up, and the durable goods report suggests that this trend continued through February. Looking ahead, we expect these cyclical supports to remain in place, and we think that the recent US tax cut is likely to provide a further boost now that companies have clarity about it. The likely acceleration in business spending is one reason why we expect overall US growth to remain well above potential, even as the Fed moves to reduce stimulation. Of course, one clear and mounting risk to global business spending and the US expansion more broadly is the threat of a trade war, especially now that tensions with China have been increasing. However, as we mentioned in Friday's *Observations*, the restrictions announced on Thursday so far have been small, and the bigger threats we're watching are an escalation by the US or more significant retaliation by its trading partners.

The first chart below shows a timely read on US business investment. Shipments of core capital goods—a measure of the items used in businesses investment, excluding volatile shipments of aircraft and defense equipment—continued to trend up through February, reflecting the strength in the broader economy. This measure has risen somewhat less quickly in recent months, but other measures of business activity (like the ISM manufacturing survey) are somewhat stronger.

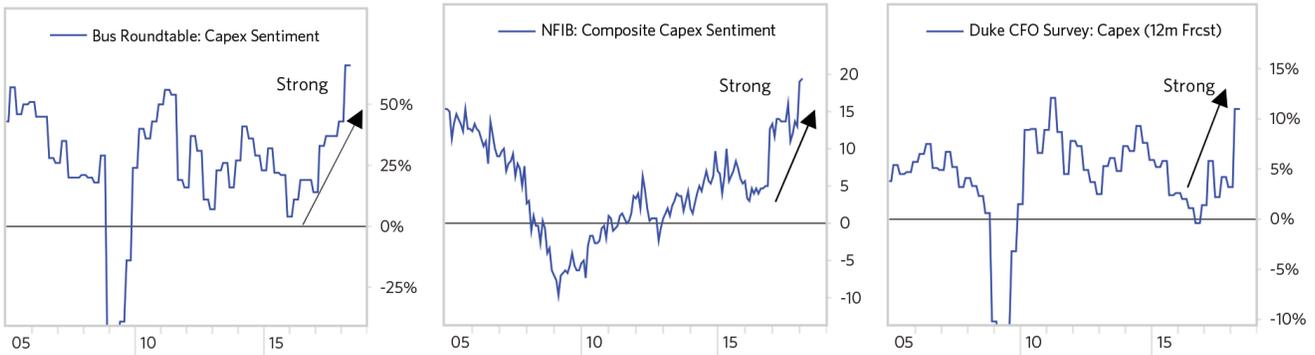


The durable goods report reflects both domestic investment in equipment and foreign demand for US business goods exports. The recent strength primarily reflects domestic investment. As the chart below on the left shows, this has provided nearly a 1% support to growth. Businesses abroad have also hiked investment in response to strong demand, and this has provided a further marginal support to US growth, since US businesses export many of the capital goods needed for investment abroad.

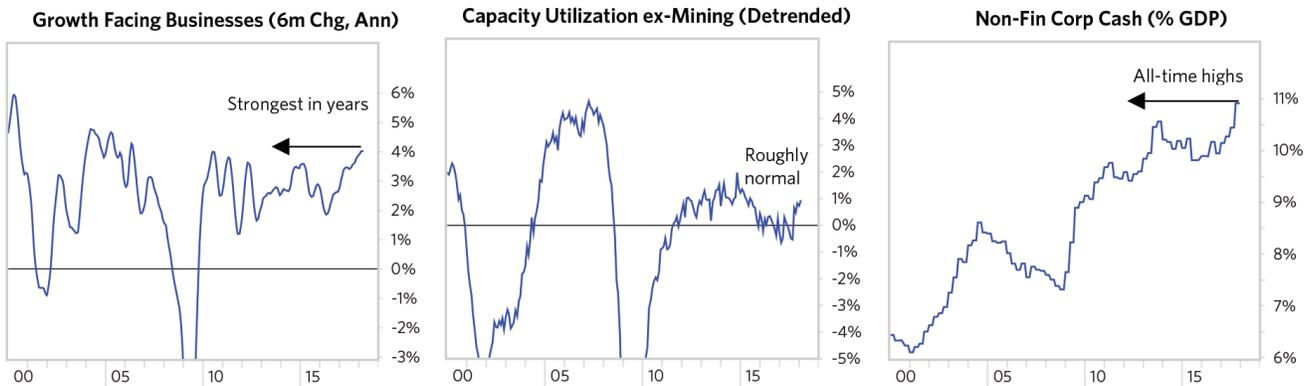
Contribution to US RGDP (Q/Q)



Another clear reflection of the pressures on businesses to increase investment is the strength in business capex surveys. As the charts below show, all of the major surveys of capex plans have surged since the passage of the tax cut late last year.

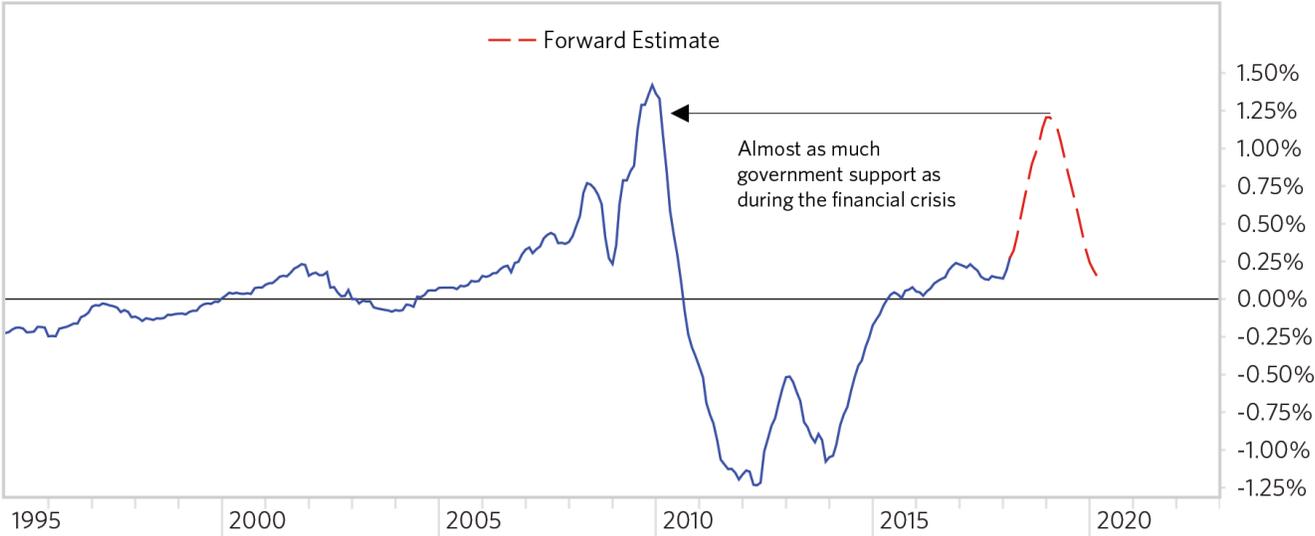


The ongoing pickup in domestic business investment makes sense to us when we look at underlying business conditions in the US. By this point in the expansion, businesses have faced strong demand for some time, they are increasingly under pressure to expand their capacity, they're flush with cash, and they now have clarity around the tax cut. As the charts below show, the demand facing businesses is the strongest it has been in years, at a time when capacity utilization is roughly normal. Taken together, these conditions are encouraging businesses to invest in additional capacity to meet new demand, at a time when high levels of cash on balance sheets and the recent tax windfall have given them ample ability to do so.



Thus far, US business investment has mostly risen in line with the strong demand businesses have faced, but going forward, we see the possibility of a more material acceleration. One main driver that could cause an acceleration is the significant support to growth from fiscal easing that is just starting to come online now. As the chart below shows, the recent tax cut and budget expansion will likely boost the US economy by as much as 1.25% of GDP over the next year, an aggregate fiscal stimulus roughly as big as the one enacted in 2009 during the most acute phase of the global financial crisis. A big part of this boost is likely to come through additional corporate spending, as the tax cut provides direct incentives to increase investment (through accelerated depreciation), and the tax windfall will give corporates more cash to do so.

Government Impact on Growth



This research paper is prepared by and is the property of Bridgewater Associates, LP and is circulated for informational and educational purposes only. There is no consideration given to the specific investment needs, objectives or tolerances of any of the recipients. Additionally, Bridgewater's actual investment positions may, and often will, vary from its conclusions discussed herein based on any number of factors, such as client investment restrictions, portfolio rebalancing and transactions costs, among others. Recipients should consult their own advisors, including tax advisors, before making any investment decision. This report is not an offer to sell or the solicitation of an offer to buy the securities or other instruments mentioned.

Bridgewater research utilizes data and information from public, private and internal sources, including data from actual Bridgewater trades. Sources include, 4Cast Inc., the Australian Bureau of Statistics, Asset International, Inc., Barclays Capital Inc., Bloomberg Finance L.P., CBRE, Inc., CEIC Data Company Ltd., Consensus Economics Inc., Corelogic, Inc., CoStar Realty Information, Inc., CreditSights, Inc., Credit Market Analysis Ltd., Dealogic LLC, DTCC Data Repository (U.S.), LLC, Ecoanalitica, EPFR Global, Eurasia Group Ltd., European Money Markets Institute - EMMI, Factset Research Systems, Inc., The Financial Times Limited, GaveKal Research Ltd., Global Financial Data, Inc., Harvard Business Review, Haver Analytics, Inc., The Investment Funds Institute of Canada, Intercontinental Exchange (ICE), Investment Company Institute, International Energy Agency, Investment Management Association, Lombard Street Research, Markit Economics Limited, Mergent, Inc., Metals Focus Ltd, Moody's Analytics, Inc., MSCI, Inc., National Bureau of Economic Research, North Square Blue Oak, Ltd , Organisation for Economic Cooperation and Development, Pensions & Investments Research Center, RealtyTrac, Inc., RP Data Ltd, Rystad Energy, Inc., S&P Global Market Intelligence Inc., Sentix GmbH, Shanghai Wind Information Co., Ltd., Spears & Associates, Inc., State Street Bank and Trust Company, Thomson Reuters, Tokyo Stock Exchange, TrimTabs Investment Research, Inc., United Nations, US Department of Commerce, Wood Mackenzie Limited World Bureau of Metal Statistics, and World Economic Forum.

The views expressed herein are solely those of Bridgewater as of the date of this report and are subject to change without notice. Bridgewater may have a significant financial interest in one or more of the positions and/or securities or derivatives discussed. Those responsible for preparing this report receive compensation based upon various factors, including, among other things, the quality of their work and firm revenues.