Opportunities Ahead in Chinese Markets
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The asset management industry in China is growing at a rapid pace. With capital markets expanding in multiple avenues, China is becoming increasingly important to global investors. Specific areas of development include derivatives, which we believe have the potential to deliver new opportunities.

True Partner Capital actively monitors developments on the world’s major financial markets. Given the interconnectedness of global capital markets and supply chains, this includes not only those markets we currently trade, but also those that can influence our traded markets, or which may be suitable for inclusion in our opportunity set in future. At the moment, one of the markets in this group has been seeing significant developments: China. China is by any measure one of the world’s most important economies, with major influences on global markets. Having had an office in Hong Kong for over 10 years, but also an international presence in the US and Europe, we have long followed developments in China. Through our strategic relationship with Holland & Muh, we also have a presence in onshore China, which we expect to bring additional opportunities over time.

China’s financial markets, which include some of the largest and most liquid in the world, offer potentially strong sources of diversification and are also becoming more accessible. As derivative markets develop, a growing suite of more sophisticated strategies will be applied to them. There are also vast pools of retail and institutional capital seeking more advanced investment management solutions, and asset managers can now apply their investment processes and business models to Chinese markets, via majority or wholly owned local management companies.

Equity markets

Chinese public equity markets, worth over $10 trillion (or closer to $20 trillion including Hong Kong and US-listed ADRs), now rank second only to the US market capitalisation at around $50 trillion. They are global leaders for liquidity: the turnover ratio of around 300% for Shanghai and Shenzhen shares is between
two and six times higher than for US or European equities, and in effect makes them the world’s most liquid equity market.\(^1\) However, surveys suggest most foreign investors have small positions or no position at all,\(^2\) though inflows have recently been increasing.\(^3\)

Chinese equity markets are also growing fast due to a buoyant IPO (and secondary offering) calendar. The tally of public companies has more than doubled over the past decade to around 4,000 listed on China’s Shanghai and Shenzhen exchanges, and there are another 8,000 OTC listed companies. In contrast, while the market capitalisation of US public equity markets has grown substantially over time, the breadth has narrowed, as the number of public companies in the US has roughly halved from approximately 8,000 in the mid-1990s to a little over 4,000 today. Greater China leads the world in IPOs:\(^4\) in 2020, China’s Shanghai and Shenzhen exchanges recorded 383 new listings, while Hong Kong saw 140, according to KPMG. On the mainland bourses, replacing the old approval system with a new registration-based regime has streamlined the process. Overall, the IPO pipeline has contributed to the significant growth of market capitalization over the past years, as is reflected in the graph below.

**Chinese equities have a bigger market cap than many other globally significant equity indices**

Equity derivatives are developing both inside and outside China. Onshore equity index futures were historically restricted to hedging but can now be used for directional trading. Furthermore, regulators want to encourage more institutional participation in futures markets, CSRC Chair Fang Xinghai told the FIA in December 2020.

However, listed futures and options are currently limited to indices and ETFs, but that could change: Hong Kong’s Financial Services Development Council has proposed augmenting the Stock Connect schemes with more derivatives and structured products linked to mainland equities.\(^6\)

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1. 10 things to know about China equities, Allianz Global Investors, accessed June 2020
2. “The merits of a standalone equity allocation to China”, Willis Towers Watson, November 2020
3. “International investors flock to Chinese assets”, Financial Times, 15 July 2021. One factor affecting the share of assets in Chinese markets may be restrictions on foreign access to Chinese domestic markets. These have historically been significant but many barriers to such access have been reduced or removed in recent years.
4. China to dominate world IPO league in 2020, Nikkei Asia, December 18, 2020
5. Sources: Bloomberg, True Partner. Data from Jan 2007 to July 2021
6. Expanding Access to the A Share Market, Hong Kong Financial Services Development Council, September 2020

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Some brokers also offer shorting via swaps. And overseas exchanges are listing Chinese equity index futures: for instance, Eurex in June 2021 launched futures on the MSCI China Tech 100 Index, as well as futures and options on the MSCI Hong Kong Listed Large Cap and the MSCI China Hong Kong Listed Large Cap indexes.

Not only are the Chinese equity markets interesting given their sheer size, they also tend to behave somewhat differently from most of their global peers. The chart below shows that while the correlation between Chinese markets and the S&P 500 has increased following the Stock Connect, the correlation remains significantly lower than the correlation of other global markets with the S&P 500. From this perspective, China still offers the potential for significant diversification benefits.

*Chinese equity markets have had a low but evolving correlation to other key equity markets*

And interestingly, Chinese markets not only provide diversification in terms of correlation. The magnitudes of market movement, as reflected in realized volatilities also differs from other key global markets. The chart below highlights the volatility differences, with both periods in which Chinese markets moved disproportionately (such as late 2015), or in which these markets were somewhat shielded from global movement (such as in early 2020).

*Chinese equity volatility has a dynamic relationship with US and European markets*

7. Sources: Bloomberg, True Partner. Data from Jan 2007 to July 2021.
8. Sources: Bloomberg, True Partner. Data from Dec 2006 to July 2021
Commodity markets

China’s commodity markets include three of the world’s biggest five exchanges. According to the Futures Industry Association’s 2020 exchange and contract rankings, Shanghai, Dalian and Zhengzhou rank within the top five largest commodity exchanges, as measured by their trading volumes, along with CME Group and ICE. Focusing on individual contracts, 14 of the top 20 agricultural contracts are in China while 11 of the top 20 metals contracts, and five of the top 20 energy futures contracts are in China. China’s soybean meal and soybean oil contracts are now bigger than CBOT’s.

A growing number of commodities can only be traded in China or have their key markets there, including steel rebar, hot rolled steel, coking coal, thermal coal, PTA (purified terephthalic acid), PVC (polyvinyl chloride); PP (polypropylene), LLDPE (linear low-density polyethylene), apples and eggs, some of which are not traded on other international exchanges. In 2020, China introduced 12 new commodity derivative products, and exchanges soon plan to add carbon futures amongst other potential new products. Zhengzhou Futures Exchange chairman, Lu Dongsheng, addressing the China Futures Association, announced plans readying a wide range of new futures products, including peanuts, chicken, steel billet, caustic soda and paraxylene – and might develop contracts in potatoes, sunflower seeds, garlic, cement and propylene.

China is also internationalizing more commodity futures. At least seven contracts are available to overseas investors: bonded copper futures, crude oil, TSR 20 rubber and low-sulphur fuel oil on the Shanghai International Energy Exchange; iron ore and palm oil on the Dalian Commodity Exchange, and PTA (purified terephthalic acid) on the Zhengzhou Commodity Exchange. There is a long pipeline of other contracts that should soon be internationalised: alumina, ferrochrome, synthetic rubber, refined oil, natural gas, naphtha, corrugated paper, woodfree paper and electric power, Shanghai Futures Exchange (SHFE) Chairman Jiang Yan said at the 18th Shanghai Derivatives Market Forum.

China is also adding a growing number of options on commodity futures: 18 over the past three years, with aluminum and zinc options added in 2020. The long-term plan is for all commodity futures to have associated options, according to Fang Xinghai, vice-chairman of the China Securities Regulatory Commission. Crude oil options trading on the Shanghai IFE has just started in June 2021.

[9. China opens futures markets further to outside world, Futures Industry Association, November 25, 2020](https://www.fia.org/articles/china-opens-futures-markets-further-outside-world)
Bonds, rates and credit

China’s onshore bond market is the second largest in the world, at $15 trillion,\(^\text{11}\) of which $9.2 trillion is rates (government bonds, municipal bonds, policy bank bonds and central bank bills) and $5.8 trillion is in corporate bonds (including corporate bonds, enterprise bonds, financial bonds, debt financing instruments and asset backed securities). China’s domestic corporate bond market is second only to the US, which has $10 trillion, and is a similar size to the entire European investment grade market. China’s offshore corporate bonds of $750 billion make up around one third of Asia Pacific corporate debt markets.

Despite offering a useful yield pickup, China’s bond markets remain largely undiscovered territory for overseas investors. Although foreigners can access the main venue – the interbank bond market – via CIBM Direct, foreign ownership is below 1% (3% if one includes government bonds) and derivatives such as credit default swaps (CDS) and repo’s for corporate bonds are somewhat nascent.\(^\text{12}\) This is changing fast: in April 2021 BNY Mellon became the first US bank to offering triparty repo’s, using Chinese debt bought via Hong Kong’s Bond Connect as collateral.\(^\text{13}\)

Accelerating derivatives development and foreign participation

Whereas the aforementioned market for credit derivatives is in its relative infancy, regulators in China are committed to further developing all financial derivatives markets. “Currently, China’s financial futures and options market is at an early stage of development. It far lags market participants’ growing needs to manage their risks. It also fails to keep pace with China’s economic development and financial reforms,” Fang Xinghai, vice chairman of the China Securities Regulatory Commission, told the China Futures Association in December 2020.

At the second Bund Summit in Shanghai also in 2020, he promised to further open capital markets and products, as well as securities, funds and futures.

For instance, China has drafted a new Futures Law, which was supported by the US-based Futures Industry Association. The FIA and its members have requested some clarifications and additions to the law, and are working collaboratively with the National People’s Congress, the China Securities Regulatory Commission, the China Futures Association and others to hone and refine the new law. There are also initiatives to link the interbank and Shanghai/Shenzhen exchange venues for trading bonds in order to widen access.

During the 12th Lujiazui Forum 2020, the Chairman of the CSRC reiterated the message that China is inviting investors globally to participate more widely and deeply in the Chinese

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Potential growth of assets

China’s savings of CNY 120 trillion (USD 18.8 trillion) are already around one third of the US total of USD 57 trillion, and China’s savings pool could catch up quite quickly as some predict it could treble to CNY 320 trillion (USD 50 trillion) by 2030.\(^\text{14}\)

Historically, China’s gargantuan savings ratio was deployed conservatively into relatively familiar and predictable areas: property, bank account savings and various guaranteed return products. Retail investors have also been taking rather more risk with varied results actively picking and trading stocks. Now that wealth management products/cash management products cannot guarantee principal nor promise higher returns than deposits or money market funds and are subject to stricter risk criteria on leverage, credit quality, liquidity, and diversification, investors and banks are moving to NAV based products and accept that they need to tolerate some volatility in their search for higher returns. The explicit objective of the new rules is to educate investors about the risks they are taking. Investors will likely seek diversification in both traditional and alternative strategies.

Control of local asset management companies

The participation of foreign companies may help offer a wider range of investment strategies and a broader variety of business models in terms of culture and governance. Having initially been restricted to minority participation in joint ventures, they can now have full or majority ownership of an asset management, wealth management, securities or futures company in China, including companies advising retail investors, known as fund management companies (FMCs). This opens up access to a wider spectrum of savings pools: including retail fund management, private asset management (segregated accounts), qualified domestic institutional investor (QDII) and offshore investment pending both licensing and quota availability, investment advisory, and possibly basic pension, enterprise annuity investment management, social security fund investment management, and insurance funds.\(^\text{15}\)

Foreign firms can also get involved in securities investment advisory, funds investment advisory, and issuance of securities research reports. In other cases, however, asset managers may still prefer a minority joint venture and some of the largest western asset and wealth managers have entered into distribution partnerships with the biggest Chinese banks, in order to access networks of thousands of branches and millions of customers. It is also now easier for asset managers to avail of the QDLP programme to raise assets onshore to invest outside China.

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14. Data from Oliver Wyman cited in “Foreign asset managers are eyeing China’s vast pool of savings”, The Economist, June 12, 2021

15. China market liberalisation for global asset managers, HSBC, July 16, 2020
https://www.gbm.hsbc.com/insights/securities-services/china-market-liberalisation
Conclusions

Given the size and global importance of China’s economy, its wealth and the scale of its capital markets, it already has a major influence beyond onshore markets. Therefore, even where investors are not directly trading China’s onshore markets, it is important to be aware of developments. We believe that China’s financial markets offer an unusual combination of liquidity and diversification benefits, that could make them attractive places for global investors, both for strategic exposure and for exploring directional and relative value alpha opportunities.

The availability and liquidity of financial derivatives, initially focused on commodities, has already expanded to some areas in equities and fixed income. Furthermore, China is steadily taking steps towards opening its financial derivatives markets to the outside world. We believe that as China’s markets become more open to offshore investors, the experience of following their evolution over time will help to provide important context. We expect China’s markets to present attractive opportunities in the future that will be accessible to both onshore and offshore investors. By following market developments today, we believe investors may be better placed to take advantage of opportunities as China’s derivatives markets further open up.
About the authors

Mr. Govert Heijboer, Co-CIO of True Partner, has been active as a market maker trading in the European and Asian derivatives markets as well as positional trading since 2003. Govert started as a trader/researcher at Saen Options in Amsterdam and rose to become the director of derivatives trading and a member of the executive team in 2007. In 2008 he moved to Hong Kong to set up and assume responsibility for all trading activities in the new Saen Options Hong Kong branch office. Govert holds a PhD in Management Science and an MSc in Applied Physics from the University of Twente, Netherlands. He is a founding partner and has worked on the launch of the True Partner Fund since March 2010.

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About True Partner Capital

True Partner Capital is a team of former market makers and IT specialists that have been working together for more than 15 years.

Their combined expertise on trading, execution and risk management as well as the proprietary trading technology, allows the team to identify and capitalize on trading opportunities.

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