21 June 2017

China's A-Shares Added to MSCI

On 20 June (US time), MSCI announced the inclusion of China's A-shares in their global equity indices (i.e. MSCI Emerging Market Index and MSCI ACWI Index)[1]. After three previous rejections, MSCI's decision is expected to have medium to long-term implications for China's equity markets. Ronald Chan, Chief Investment Officer, Equities, Asia (ex-Japan), believes that inclusion has symbolic significance. It will also lead to better sector diversification, and is a vote of confidence for China to further financial reforms and capital market development.

Summary

On 20 June 2017, MSCI announced that beginning in June 2018, China's A-shares would be included in its global equity indices. It will now account for 0.7% of the MSCI Emerging Market Index, inclusive of 222 companies. The decision reflects a notable step forward for China's capital markets. The country was previously rejected for inclusion three times due to concerns over capital repatriation restrictions for QFII, effectiveness of stock suspension oversight, and pre-approval requirements of MSCI.

In the first quarter of 2017, MSCI announced that consultations to include China A-shares would be reopened following the launch of Shenzhen Stock Connect in December 2016. Although many of the previous obstacles remained, such as removal of the 20% repatriation limit, concerns over implementation of the new trading suspension treatment, and removal of anti-competitive measures, the proposal then included revised provisions for inclusion.

- Reduction of A-shares in the pro-forma MSCI China Index to 169 (large cap) versus the previous proposal that would have included 448 (both mid and large cap). These companies are also available via the Hong Kong- China Stock Connect program.
- Greater sector diversification to represent the Chinese economy. Financial shares were reduced from 28% to 23% of the proposed inclusion, while increased allocations were given to consumer discretionary, consumer staples, and real estate companies.
- Dual-listed A/H share securities will be excluded, as will securities suspended for more than 50 days within the last 12 months.

With the announced inclusion, an initial 5% partial inclusion factor would have limited overall impact given the sheer size of the onshore A share markets. In addition, the disruption to liquidity will be manageable given current average daily volume.

Implications for China's equities

The inclusion of A-shares in MSCI is expected to have several notable benefits on a gradual basis. In the short term, the A-share market may garner moderate capital inflows as funds

[1] MSCI, 20 June, Results of MSCI 2017 Market Classification Review.

that track the relevant index align their weightings; more importantly, sentiment is expected to improve.

In the medium to long term, we anticipate the weighting of A-shares in such an international index will be increased as the industries covered by A-shares are more diverse. The universe to choose from is much larger in the domestic Chinese market compared to that of Hong Kong. We also expect that foreign investors will need to pay more attention to A-share market developments as it becomes more relevant in a global context moving forward.

Internationally over the long-run, the pace at which an emerging stock market is included in the MSCI Emerging Market Index is related to the magnitude of liberalization of its capital market. Markets implementing foreign exchange control are usually included in the MSCI Emerging Market Index on a gradual basis, which can take about seven to ten years[2].

[2] MSCI, March 2014, "Consultation on China A-Shares Index Inclusion Roadmap."