In Case You Missed It: CSOP's Weekly China Wrap-Up

New MSCI proposal increases chance of June inclusion for limited number of A-Share names

MSCI is requesting feedback on a newly-published proposal to add a limited number of A-Shares to their Emerging Markets index in 2017. 169 names are under consideration in the new framework, down from the 448 names under advisement in 2016. Only large-cap stocks accessible through the Stock Connect schemes will be eligible for inclusion in this year's deliberation.

A significant compromise

The new proposal is important because it significantly enhances the possibility of A-Share inclusion in 2017 while addressing lingering concerns held by the international investment community.

On the one hand, MSCI recognizes China's progress in the past year to liberalize capital market access through programs like Shenzhen-Hong Kong Stock Connect. However, the index provider is also cognizant of concerns about repatriation restrictions and haphazard suspension. To reconcile these two positions, MSCI's 2017 proposal relies on accessing equities through Stock Connect, which has no aggregate quota or repatriation restrictions. The 2016 proposal relied on RQFII/QFII programs to access names, which subjected overseas investors to 20% QFII repatriation restrictions. Moreover, the new framework eliminates stocks suspended for more than 50 days in the past 12 months, a stricter requirement than that proposed in 2016.

Taken together, the new requirements would result in an A-Share weight of ~0.5%, compared to a 28.1% H-Share weight. Although the new weighing is small, it is nonetheless important. Global investment houses believe the modified proposal greatly increases the chance of MSCI inclusion in June: Morgan Stanley cites a >50% chance, Jefferies wagers 60%.

PBOC tightening leaves over-leveraged players scrambling

China's central bank drained RMB 30 billion net (USD 4.4 billion) on Friday, sending a strong tightening signal to debt laden market participants. As short-term rates jumped above 5%, highly leveraged players scrambled to liquidate positions or find new funding sources.

Why the short-term rate hike is so painful

Struggling to attract deposits, China's small and midsize banks have increasingly turned to inter-bank borrowing as an alternative fundraising channel. Banks often borrow short-term funds (one year or less) through a tool called negotiable certificate of deposits (NCD). They use these NCD to invest in long-term bonds or high yielding credit assets. Evidencing the widespread search for yield, NCD issuance has surged from RMB 34 billion in 2013 to RMB 13 trillion in 2016 according to Wind, a CAGR of 626%. In instances where NCD cost 5% and bond yields are only 4%, banks may have to liquidate the leveraged trades by offloading bond portfolios, rendering the weak fixed income market even more fragile.

The PBOC's endgame

Since the stock market turmoil in 2015, the Chinese government has been cautious to avoid debt-fueled price rallies across asset classes. By inching up short-term rates, the PBOC aims to punish market players who over-borrow to enhance investment return. The PBOC is shrewd, however. Unwilling to jeopardize the precarious economic recovery, the central bank has instructed state-owned banks to standby as a source of last minute liquidity should the tightening prove too harsh. Therefore, events like the June 2013 liquidity crisis-- where widespread panic pushed overnight borrowing costs to a record 25%-- are unlikely to happen in near future.

Russia moves to establish RMB clearing center in Moscow, another step toward RMB internationalization

Russia's central bank announced creation of a RMB clearing center in Moscow, a move which precedes plans to issue USD 1 billion equivalent of RMB-denominated bonds in China. The announcement was made during a ceremony to celebrate creation of an overseas representative office in Beijing, the first such international office for Russia's central bank.

Benefits for China: ongoing RMB internationalization

The expansion of RMB clearing services to Moscow is another strategic step for the internationalization of China's currency after it secured SDR inclusion in October 2016. In announcing the plans, Moscow joins a roster of major cities such as Hong Kong, Singapore, London, Frankfurt, Seoul, Paris, Luxembourg, Doha, Toronto, Sydney, and New York which have worked diligently to build RMB settlement infrastructure in the past several years.

A new ally for a lonely Russia

For Russia, the issuance of RMB-denominated bonds represents an important new fundraising channel in an environment of plummeting energy prices and growing Western skepticism toward the country. The diversification is important. At present, Putin's government remains heavily reliant on Western markets for capital and is moving to mitigate the dependence. Cooperation between Russia and China has been notably accelerating in recent years; a USD 400 billion natural gas deal and RMB 150 billon 3-year currency swap deal in 2014 are but two examples. Although trade between China and Russia reached USD 59.5 billion in 2016, cooperation in the financial service sector has lagged. The overseas representative office is expected to serve as a window for financial institutions in both nations to craft deeper understandings of their counterparts' notoriously complex capital markets.

Chinese software company shares skyrocket, regulators blame Stock Connect loophole

Shares of a Chinese photo-editing software company, have surged 130% since the company secured inclusion in the Shenzhen – Hong Kong Stock Connect scheme in early March. Regulators in both China and Hong Kong have reportedly begun investigating the firm. Onlookers believe that the investigation is related to a potential loophole in Stock Connect that is being exploited to evade China's capital controls.

Stock Connect 101: a closed system

The Stock Connect schemes were originally designed to offer a closed system of cross-border investment between China and Hong Kong. Through the program, Chinese investors can use their Mainland accounts to trade stocks listed in Hong Kong. When they sell their positions, the principal and profit/loss is credited back to their Mainland accounts. As a result, the RMB remains in China.

A potential loophole?

Because of the photo editing stock's dizzying ascendance, it is thought that investors have discovered a way to exploit the Stock Connect scheme to move money out of China. The scheme is believed to function as follows:

1. An investor/group of associates have control over one Mainland trading account and one Hong Kong trading account
2. The investor targets a company **listed in Hong Kong** and is accessible through Stock Connect. The scheme works best when the targeted company's shares are concentrated.
3. The investor purchases the targeted company in his/her **Hong Kong** stock account
4. The investor aggressively purchases the targeted company in his/her **Mainland** account through Stock Connect, resulting in an elevated stock price
5. The investor sells the stock in his/her **Hong Kong account** at the inflated price, leaving the principle and profit in the Hong Kong account. The loss is left in the Mainland account.
6. Effectively, the investor has moved capital from the Mainland to Hong Kong in the form the profit taken by the Hong Kong account
7. Because Hong Kong has no capital controls, investors can freely move money out of their Hong Kong account and use it as they please

So far, none of the targeted company's leadership has been charged with fraudulent dealing.

American Airlines in talks to take stake in China Southern Airlines

American Airlines (AA) is reportedly in advanced discussion with China Southern Airlines (CSA) to take a USD 200 million stake in the SOE. If confirmed, the deal would give AA around 2% of CSA's total outstanding shares and one non-voting board seat.

Mixed ownership brings results

The deal indicates China's determination to accelerate mixed ownership reform of SOEs. Last December, China's Central Economic Work Conference urged SOEs in aviation, telecom, railway, energy, and military sectors to work more aggressively to bring in private investors. Chinese airlines have been the most committed to this directive. Air China sold an 18% stake to Hong Kong-based Cathay Pacific. Similarly, China Eastern boasts Delta among its major shareholders. China Southern is the last of the "big three" airlines to bring in a non-mainland Chinese strategic investor. As a reward for the airlines' commitment to divestment, Hong Kong-listed aviation stocks have seen a 30% rally this year, yielding a return three times larger than the Hang Seng's during the same period.