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The China Investment Dilemma

Risks for U.S. Investors During a Turbulent Time

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China's rise as an investment destination has occurred amidst a significant deterioration in the U.S.-China relationship. Nicholas Borst examines how U.S. investors can navigate the dilemma of investing in China, a market that is too big to ignore but full of new and complicated risks. He offers a disciplined approach to evaluating how the challenges posed by the volatile U.S.-China relationship can impact investment returns.

Driven by the growth of its economy and capital markets,

China is rapidly emerging as a major investment destination for global investors. The country has experienced a dramatic rise in foreign investment inflows, and its weight in global bond and stock indices is increasing. Americans now own hundreds of billions of dollars of Chinese securities, and China is one of the largest single-country exposures for U.S. investors.

This moment ought to be a triumphant one for both China's capital markets and U.S. investors seeking greater exposure to the country's economic success. Instead, investing in China has become more fraught than ever, as a result of the deteriorating relationship between China and the U.S. The growing economic and security tensions between the two countries have spilled over to the equity markets, with deleterious consequences for a wide swathe of companies. Now as the COVID-19 pandemic buffets global financial markets, both countries seem more interested in assigning blame than working together to address the crisis. Navigating the risks and opportunities of investing in China will be one of the most important challenges facing globally minded U.S. investors for years to come.

China's Financial Rise

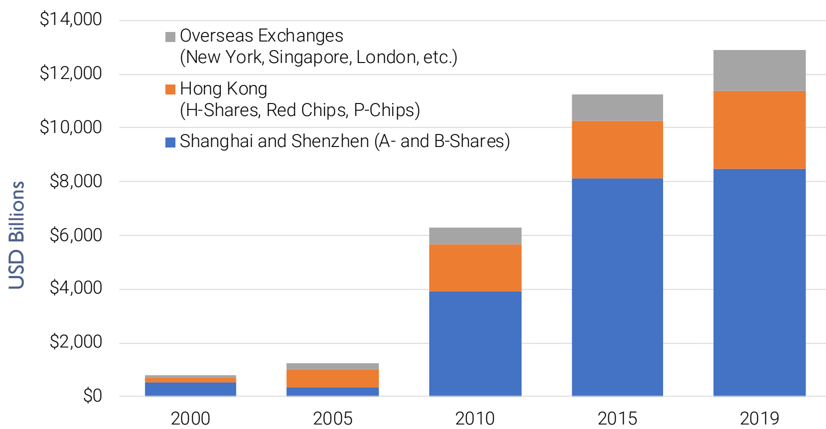
China's economic ascent is one of the most important events shaping investing in the 21st century. China is now the world's second-largest economy and the main source of global economic growth, having contributed about 28% of the world's growth on average since 2010.[1] What has been less well appreciated is China's emergence as a financial superpower, driven by the size and increasing openness of its capital markets.

Globally Important Capital Markets

In the span of just a few decades, China's equity markets have grown to become among the largest in the world. As shown in **Figure 1**, the Shanghai and Shenzhen stock markets have a combined market capitalization of about 8.5 trillion USD-equivalent, making China the world's second-largest national equity market after the U.S. Together, the Shanghai and Shenzhen markets are now similar in size to the combined market capitalization of the London Stock Exchange and the Euronext exchanges.[2] Chinese companies listed on the Hong Kong exchange add another 2.9 trillion USD-equivalent to the total market capitalization of Chinese companies. The combined market capitalization of all listed Chinese companies – companies listed domestically and on overseas exchanges – exceeds 12 trillion USD-equivalent.

China has the second-largest equity market after the U.S.

Figure 1. Market Capitalization of Chinese Companies
As of year end



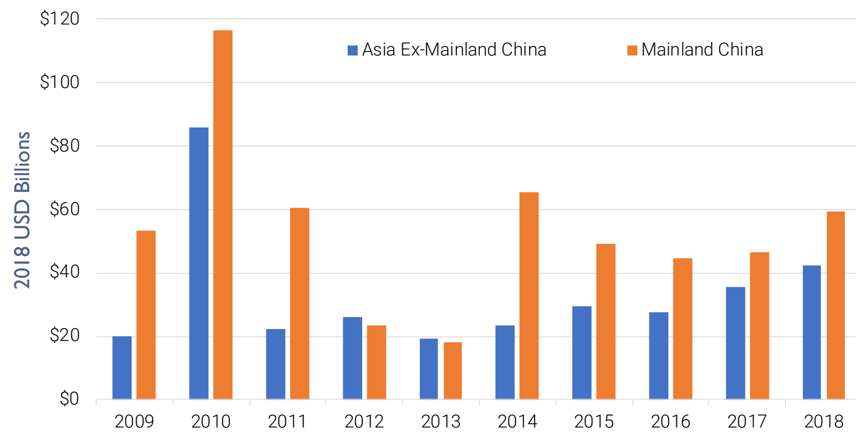
Sources: Wind Information, Thomson Reuters, UBS.

This increase in stock market capitalization has been driven both by the listing of new companies and the expansion of existing Chinese companies into some of the largest corporations in the world. Over the past decade, China led the world in initial public offerings (IPOs), as more than 2,500 Chinese companies went public, more than twice as many as in the U.S.[3] During this period, IPOs of Chinese companies raised more money than IPOs in the rest of Asia combined (**Figure 2**).[3]

China accounts for the second-largest share of the world's top 100 companies by market capitalization, after the U.S.

China is now home to some of the world's largest listed companies. China accounts for the second-largest share of the world's top 100 companies by market capitalization, after the U.S.[4] China's largest companies include a mix of private sector tech giants, such as Alibaba and Tencent, and state-owned firms, such as the Industrial and Commercial Bank of China (ICBC) and the China Construction Bank.

Figure 2. Proceeds from IPOs by Company Home Jurisdiction
As of year end



Annual amounts are in 2018 USD Billions.
Sources: Organization for Economic Cooperation and Development (OECD).

Beyond mere size, China has significant corporate depth. One way to quantify corporate depth is to look at the number of listed companies a country has in a given sector. Figure 3 shows the results of this exercise when applied to the MSCI ACWI Investable Market Index (IMI), which includes more than 8,000 companies and is representative of a very broad investment universe. (To screen out the potentially large numbers of very small companies, a threshold of 500 million USD market capitalization was used for inclusion.)

Figure 3. Top 10 Countries by Number of Listed Companies with Market Cap > $500MM
As of 12/31/19

	Communication Services	Consumer Discretionary	Consumer Staples	Energy	Financials	Health Care	Industrials	Information Technology	Materials	Real Estate	Utilities	Total
United States	95	255	95	109	380	330	330	304	112	174	67	**2251**
Japan	48	187	100	10	88	69	269	133	96	77	18	**1095**
China	43	94	50	26	108	89	142	96	89	61	33	**831**
United Kingdom	21	57	26	11	46	18	61	22	17	34	10	**323**
Taiwan	6	33	11	1	31	9	29	126	31	10	1	**288**
South Korea	16	45	30	3	30	39	51	31	30		2	**277**
India	11	38	15	10	46	23	37	13	38	9	13	**253**
Canada	10	17	9	35	32	8	31	11	51	28	16	**248**
Australia	8	26	14	12	28	15	21	15	41	23	4	**207**
Germany	11	23	6	2	16	18	40	17	18	16	5	**172**

The investment universe is constituents of the MSCI ACWI Investable Market Index (IMI) with a market capitalization threshold of $500 million and above.
Sources: Bloomberg, MSCI, Seafarer.

No other emerging market comes close to China in terms of having companies of all sizes in all major industries. Even among advanced economies, only the

U.S. and Japan have greater corporate depth than China. The breadth and depth of listed companies reflects the size and diversity of the Chinese economy. China's equity markets are newer than markets in the other countries in Figure 3. As China's equity markets continue to develop, the level of corporate depth will increase even further.

China's bond markets have also grown, in both size and prominence. Its bond market (government and corporate) is the world's second-largest, having recently surpassed that of Japan.[5] Its corporate bond market is the world's second-largest; it is roughly half the size of the world's largest bond market, the U.S.[5] Chinese sovereign debt is increasingly held by central banks as foreign exchange reserves, following inclusion of the renminbi (RMB) in the International Monetary Fund's Special Drawing Rights basket, in 2016. Though far behind the dollar and the euro, global foreign exchange reserves of renminbi assets now exceed 200 billion USD-equivalent.[6] Total holdings by foreign investors of Chinese renminbi-denominated bonds are now worth about 300 billion USD.[7]

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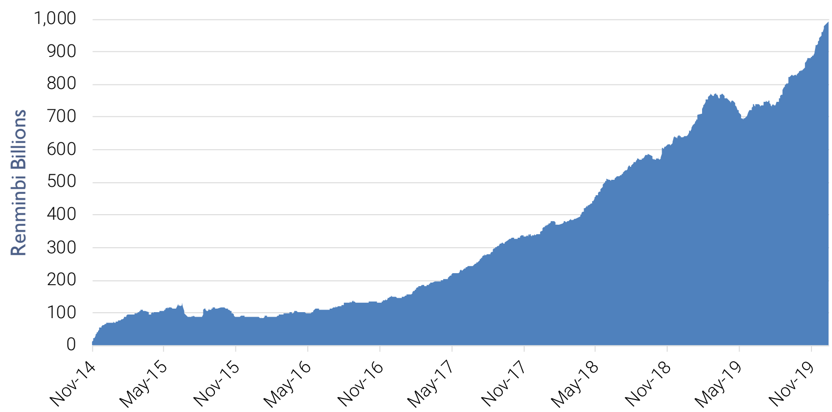
Increasingly Open Capital Markets

Until recently, China's capital markets were difficult for foreign investors to access, requiring a lengthy registration process and subject to a quota under the Qualified Foreign Institutional Investor (QFII) program. Although China's capital account still remains closed for many financial flows, portfolio investment has become easier over the past several years, thanks to a spate of new capital account reforms.

The creation of Stock Connect is the most important reform affecting China's stock markets. Established in 2014, with a link between the Shanghai and Hong Kong stock exchanges, it provides foreign investors with access to most of China's domestic equity markets, as measured by market capitalization. In 2016, a similar link was created between the Shenzhen and Hong Kong exchanges. Via the Stock Connect programs, a foreign investor with a brokerage account in Hong Kong can purchase stocks of domestically listed Chinese companies without needing to register with mainland authorities. China has scrapped the total aggregate quota for the program that was initially in place. Stock Connect still has a daily quota, but it has been expanded significantly since launch and has never been fully utilized, despite significant uptake by foreign investors.[8] By the end of 2019, the value of net foreign inflows via Stock Connect reached nearly 1 trillion RMB (143 billion USD), as shown in Figure 4.

Figure 4. China Stock Connect Accumulated Net Inflows
11/17/14 – 12/31/19



Includes the Shanghai-Hong Kong Stock Connect and Shenzhen-Hong Kong Stock Connect. Sources: Wind Information, Seafarer.

Investing in China's bond market has also become more accessible to foreign investors. Starting in 2015, foreign central banks, sovereign wealth funds, and institutional investors were given direct access to China's interbank bond market, which accounts for 90% of total bond volume.[9] Another major opening of the bond market occurred in 2017, with the creation of the Bond Connect program. Like Stock Connect, it allows foreign investors with brokerage accounts in Hong Kong to buy and sell mainland Chinese bonds via a streamlined registration process. As of September 2019, more than 1,300 institutional investors had enrolled in the Bond Connect program. Average daily turnover was about 15 billion RMB.[10]

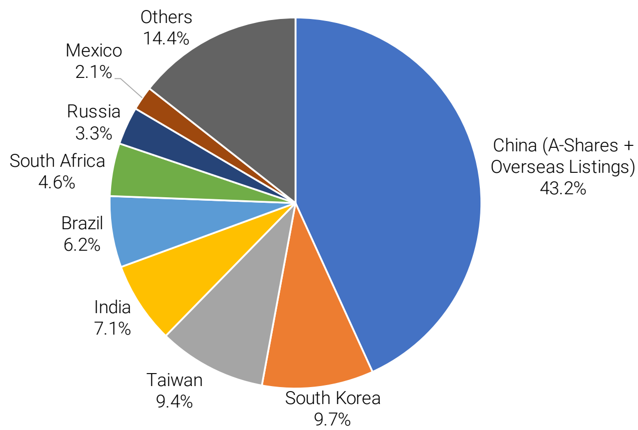
China recently reformed the QFII program, the original method by which foreign investors could access China, to make it more attractive. The program had been hamstrung by an arduous registration process, long lock-up periods for invested funds, quotas, and restrictions on the frequency of redemptions. Most of these concerns have now been addressed, with the elimination of the initial lock-up periods, allowance of daily redemption, and removal of the 20% monthly redemptions cap and the quota system.[11,12]

Growing Weight in Global Indices and Investor Portfolios

As China's capital markets have expanded and become more open, the country's weighting in global investment indices and investors' portfolios has increased. In 2017, MSCI, a major global index provider, announced that Chinese A-shares would be included for the first time in its emerging markets index. This change generated headlines and was matched by actions of other index providers, including FTSE Russell and S&P Dow Jones, to include A-shares in their indices.

China now accounts for 34% of the MSCI Emerging Markets Index. Because of MSCI's methodology, the majority of China's weighting is based on Chinese companies listed in overseas markets, such as Hong Kong and New York; domestic A-shares account for just 4% of the index. This weighting is set to increase over time, however, as China further reforms its domestic stock markets.[13] If Chinese A-shares reach a 100% inclusion rate (the current weighting is 20%), China will account for 43% of the index, equivalent to the next seven countries (South Korea, Taiwan, India, Brazil, South Africa, Russia, and Mexico) combined (**Figure 5**).

Figure 5. MSCI Emerging Markets Index Country Weightings
Potential 100% Inclusion of Chinese A-Shares
As of 11/8/19



Sources: Goldman Sachs, Seafarer.[14]

A similar trend has occurred with China's inclusion in global bond market indices. China was added to the Bloomberg Barclays Global Aggregate Bond Index in 2019, and JP Morgan announced that China will be included in its Government Bond Index – Emerging Markets in 2020. As with the equity indices, the initial weighting of onshore bonds is low relative to the size of the market but is expected to grow over time. The FTSE is the only major index provider that has yet to include Chinese onshore bonds in its indices.

Based on an estimate of holdings of Chinese companies listed domestically and on foreign exchanges, U.S. investors own more than 500 billion USD worth of Chinese securities, making China the fourth-largest foreign exposure for U.S. investors, falling just behind France.[15] As China's weighting in global investment indices increases, the share of China holdings for passive investors will increase. Active investors have more flexibility regarding their level of China exposure, but many have chosen to invest an even larger share of their portfolios in Chinese securities compared with the indices because of the country's economic and financial importance.

China is the fourth-largest foreign exposure for U.S. investors.

The Rocky State of the U.S.-China Relationship

China's rise as an investment destination has occurred amidst a significant deterioration in the U.S.-China relationship. Broader than a trade war, the two countries are engaged in conflict and competition across a variety of fronts. The U.S. and China have experienced many periods of friction over the decades, but the current trajectory of the relationship leaves little room for optimism.

The worsening of bilateral relations can be attributed to three major trends: China's growing assertiveness on the world stage, China's failure to enact significant economic and political reforms, and growing support in the U.S. for a more aggressive approach to countering China's rise.

China's Growing Assertiveness on the World Stage

China's ascendance as a global power has been both long-predicted and disconcertingly rapid. Under the Xi Jinping administration, China has become more willing to use its growing economic and military power to advance its interests around the world.

Nothing encapsulates this phenomenon better than China's Belt and Road Initiative (BRI). Providing economic assistance to and investment in more than 100 countries, the BRI is designed to mark China's emergence as a major economic power and strengthen its economic and trade relations with the rest of the world.[16] The subtext of much of the activity associated with the BRI is creating closer links between China and strategically important countries. BRI-linked aid and support are also strengthening China's tight relationship with many authoritarian regimes around the world.

China's old maxim of "hide your strength, bide your time" (韬光养晦) has given way to sharp assertions of military power and economic influence. In territorial disputes with Southeast Asian countries in the South China Sea over the past several years, China has taken a forceful and uncompromising position. In 2016, when South Korea allowed the deployment of U.S. anti-missile capabilities in its territory, China subjected South Korean companies to an intense, albeit unofficial, campaign of economic sanctions and administrative harassment.[17] In 2019, a retweet in support of the Hong Kong protests by the manager of the Houston Rockets led the Chinese government to pull NBA games from state-run television and reportedly demand the firing of the team's manager.[18]

In the corporate world, Chinese companies have become global competitors in a variety of sectors, such as e-commerce, digital payments, 5G technology, autonomous vehicles, and facial recognition. Local firms now dominate these areas in China's domestic market. Abroad, Chinese firms are competing with U.S. companies not only in global markets, such as Europe and Southeast Asia, but also in the U.S.

> Many investments by Chinese venture capitalists have targeted companies developing cutting-edge or strategic technology.

Chinese firms have also engaged in high-profile overseas investments and acquisitions, and Chinese investors have become a major source of venture capital. Many investments by Chinese venture capitalists have targeted companies developing cutting-edge or strategic technology. Many venture capital groups are controlled by Chinese state-owned enterprises (SOEs) or receive funding from state-owned financial institutions, leading to accusations that their investments are motivated by politics rather than pure business interests.[19] These claims are buttressed by the stated goals of the Chinese government to develop or acquire technology in strategic areas and the massive government resources supporting this initiative.[20] China is not unique among developing countries in seeking foreign technology through both legitimate and illegitimate means, but the scope and aggressiveness of its actions are unique.

Adding to frustrations over the emergence of Chinese firms as global competitors is a widespread belief that the Chinese government engages in economic espionage in order to benefit domestic enterprises and advance national political objectives. On several occasions, the U.S. government has brought charges against government-affiliated hacking groups that have targeted U.S. companies, alleging that trade secrets were stolen to benefit domestic firms.[21,22] As a result, many Americans believe that Chinese companies are now not only a competitive threat but also the recipients of unfair support from the Chinese government.

In the economic, political, and security realms, China is vying with the U.S. for power and influence around the world to an unprecedented degree. Many Americans are apprehensive about the ways China will use this new power and influence to advance its interests.

China's Failure to Enact Significant Economic and Political Reform

The dramatic slowdown in the pace of China's economic and political reform is a major factor in the deterioration of U.S.-China relations. From the U.S. perspective, the foundations of the bilateral relationship have long rested on the belief that China would gradually reform to embrace a more open political and economic system. Early in the tenure of Xi Jinping, there was widespread hope that he would usher in a new period of significant reforms.[23] Since then, progress on the economic front has been limited, and Xi's efforts to centralize power and decision-making have shattered the notion that China is moving toward a more open political system.

Inadequate Economic Reform

In the economic realm, several major sources of dispute have emerged. They include the failure to reform state-owned enterprises, continued restrictions on foreign investment and the operations of foreign businesses in China, and an increasingly lopsided trading relationship.

The failure of state-owned enterprise reform represents a major setback to the process of creating a more open and market-based economic system in China. Starting in the late 1990s and continuing throughout much of the 2000s, China embarked on a major campaign of SOE reform. With the ascent of new leadership in China in 2012, these reforms abruptly slowed. Instead of shutting down inefficient state-owned enterprises and giving more space to private firms, the Xi Jinping administration sought to merge them into larger and more powerful national champions.[24] This approach has been largely a failure. SOEs continue to decline in efficiency and are serving as a major drag on the country's growth. U.S. businesses operating in China also complain that state-owned enterprises receive subsidies and preferential treatment and therefore do not compete on a level playing field. The lack of progress on SOE reform is evidence that China is not committed to free market principles.

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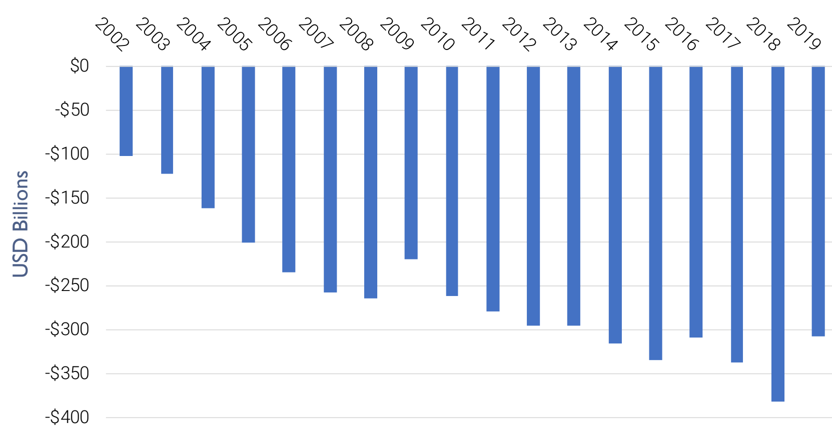
Barriers to foreign companies operating in China are another significant irritant in the bilateral relationship. China maintains restrictions on foreign investment in several areas of the economy, particularly the service sector. It has gradually reduced the number of industries subject to the "negative list," which prohibits or restricts foreign investment, but the slow pace of progress has frustrated many foreign businesses operating – or seeking to operate – in China. Beyond official restrictions, foreign businesses claim that authorities in China engage in frequent unofficial actions that disadvantage them relative to domestic firms. One major complaint is that foreign firms are pressured to form joint ventures with Chinese companies and to transfer their technology to their Chinese partner.

The lopsided trading relationship between China and the U.S. is a further source of contention. Following China's accession to the World Trade Organization, in 2001, the bilateral trade deficit between China and the U.S. expanded rapidly, as shown in Figure 6.

Figure 6. U.S. Goods and Services Trade Balance with China



Source: U.S. Bureau of Economic Analysis.

China's management of its currency was a major driver of the trade surplus between the mid-2000s and 2012. During this period, the exchange rate was set at a level that was widely believed to be undervalued, giving Chinese exporters an advantage. The People's Bank of China subsequently reduced its intervention in the currency market, and the currency now trades at a level largely in line with economic fundamentals.[25] Despite this change, U.S. officials continue to cite China's management of its currency as a key reason for the large bilateral trade deficit and has labeled China a currency manipulator. The more likely contributors to the trade deficits include China's large role as an assembly point for many products sold to the U.S., persistent low savings rates in the U.S., and nontariff barriers facing U.S. exports to China.

Inadequate Political Reform

Deterioration in the political relationship between the U.S. and China stems primarily from a conclusion among many U.S. policymakers and politicians that China is no longer moving toward a more open and pluralistic political system. The Chinese political system has become more closed and repressive over the past decade. One clear indication of this reversal is the renewed assertion of the primacy of the Communist Party in all aspects of public life. It plays a leading role not only in politics but also in science, the media, culture, and other important aspects of Chinese society. No alternative political groups are permitted to organize, and debate within the Communist Party on many topics is highly circumscribed. China's turn away from political openness and reform can be linked to the initial coverup of the COVID-19 virus.[26] In a system where the flow of information is tightly controlled, officials have both the ability and motivation to hide bad news.

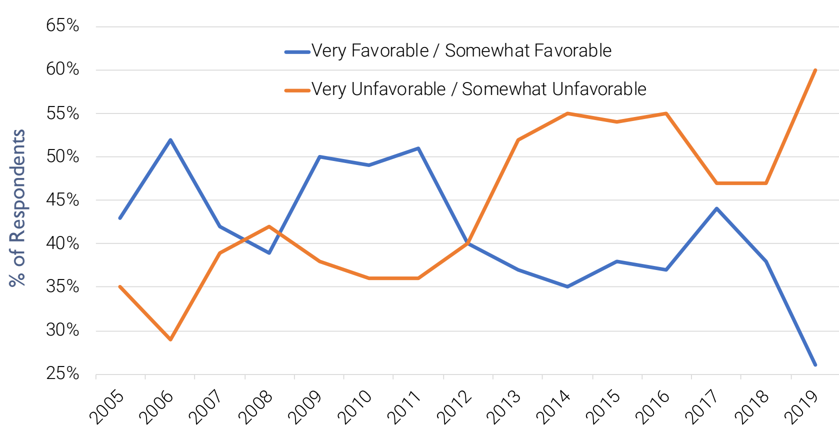
China is no longer moving toward a more open and pluralistic political system.

Another major blow to the belief that China was converging toward a more open political system was the elimination of term limits for China's president. Since the start of the reform era under Deng Xiaoping, the peaceful and regular transition of power between Chinese leadership generations has been the bedrock of China's political stability. In 2017, this system was cast aside with the removal of term limits for the president. The new system, with no clearly defined limitations on term in office, puts China's legacy of peaceful political transitions in jeopardy. China may now be entering a period in which a strong leader, such as Xi Jinping, may hold on to power for an extended period, raising the possibility that future leadership successions may be less stable and that competent and honest officials may have fewer opportunities to rise through the system.

Growing Support in U.S. for a More Aggressive Approach toward China

The increasing tension in the relationship between the U.S. and China cannot be attributed solely to actions by China. In the U.S., support for engagement with China has deteriorated rapidly over the past several years in favor of a more hardline approach. This shift is supported by public opinion polling data that show the number of Americans with a somewhat unfavorable or very unfavorable view of China increasing significantly (**Figure 7**).

Figure 7. Views of U.S. Public Toward China



Source: Pew Research Center.[27]

The shift in opinion has been influenced by many of the factors mentioned above, including China's growing assertiveness on the world stage and its failure to pursue key economic and political reforms. But the change also reflects the growing influence of a more hawkish group of academics and policymakers in the U.S. Many former advocates of engagement with China have joined the ranks of this group after being bitterly disappointed with the country's lack of progress on political and economic reforms over the past decade. The hawks argue that China should be treated as a strategic rival and cooperation between the two countries limited. The failure of China to engage in desired political and economic reforms is used as evidence that the previous U.S. policy of constructively engaging with China failed. Now that China is beginning to compete with the U.S. as a peer in many domains, they argue, disputes and conflicts with it should no longer be ignored or minimized.

The influence of China hawks rapidly expanded with the election of Donald Trump. Having vigorously criticized China during his campaign for president, President Trump staffed his administration with officials sympathetic to these positions and began to implement a more confrontational China policy. Emblematic of this shift was the 2017 National Security Strategy, which declared that China (and Russia) "challenge American power, influence, and interests, attempting to erode America security and prosperity. They are determined to make economies less free and less fair, to grow their militaries, and to control information and data to repress their societies and expand their influence."[28]

The headline initiative of this new hard line toward China is the trade war. In early 2018, the U.S. imposed the first round of tariffs on Chinese goods; the U.S. government's goal was to force concessions by China that would result in a reduction in the bilateral trade deficit. The Chinese quickly responded with matching tariffs on U.S. imports. Over the following months, the U.S. continued to escalate the dispute, and the Chinese responded in kind. As a result, most goods traded between the countries became subject to tariffs.

While an agreement to reduce tensions was signed in January 2020, its success remains to be seen.

In addition to launching a trade war, the U.S. has taken other actions to apply pressure on the economic relationship. U.S. policymakers have taken forceful action against Chinese firms accused of violating sanctions on North Korea and Iran, implemented new rules to limit Chinese investment in the U.S. and reduce the sale of advanced U.S. technology to Chinese firms, and adopted new regulations to prevent Chinese companies from entering the U.S. market. U.S. officials have also put pressure on allies to limit investments by Chinese firms in sensitive areas of their economies. Of particular concern is the possibility of firms (like Huawei) building out the critical communications infrastructure necessary for new technologies, such as 5G. These efforts have met with varying success, with some allies, such as Britain, resisting U.S. pressure to ban companies like Huawei.[29] U.S. policymakers want to prevent Chinese companies from becoming entrenched in the global telecommunications system in order to prevent possible spying by the Chinese government. The U.S. secretary of state has described Huawei and other Chinese technology companies as "trojan horses for Chinese intelligence."[30]

A TEMPORARY TRUCE ON TRADE?

The pressure of the trade war abated somewhat in January 2020, when the U.S. and China signed a "Phase I" trade and economic agreement.[31] The agreement sets out an ambitious target for China to increase its import of U.S. goods and services by at least $200 billion over the next two years, using imports in 2017 as a baseline. Meeting this target would increase total imports by China about 65% by the end of 2021.[32]

The agreement also addresses several areas of contention, including protection of intellectual property, the forced transfer of technology, agricultural imports, opening up the financial services sector, and China's management of the exchange rate.

Reaction to the agreement has been mixed. The ability of China to meet the import target is likely to require state intervention in the economy and may possibly violate China's trade agreements with other countries. Moreover, without modification, the targets seem out of reach given the economic disruption caused by the COVID-19 pandemic. Some of the other terms outlined in the agreement represent progress; others are restatements of China's previous reform commitments.

There are several reasons to believe that the Phase I agreement represents only a temporary reduction in trade and economic tensions. First, the agreement does not address Chinese government subsidies to state-owned enterprises, a major complaint voiced by the Trump administration. This issue was put off for negotiation in the Phase II agreement, the date of which has not been set.

Second, most U.S. tariffs on Chinese goods remain in place. The agreement allows for tariffs on $120 billion of goods to be lowered from 15% to 7.5%. However, tariffs will remain in effect on the majority of China's exports, and the average tariff rate on Chinese exports will be 19%.[33]

Third, the agreement contains a dispute resolution mechanism that allows either party to suspend obligations or implement countervailing measures for violations of the agreement following a brief consultation period.[31] Either side may withdraw from the agreement if it feels that the actions described above were undertaken in bad faith. Given the lack of trust between the two sides, the possibility for escalation via the dispute resolution mechanism is high.

If the Phase I agreement is successful, it will help address some of the bilateral economic frictions between the two countries; however, a range of conflicts will remain in the economic, political, and security spheres. If the agreement fails, it may increase distrust on both sides.

Risks for U.S. Investors

U.S. investors face an unprecedented dilemma: how to grapple with a country that is too large to ignore but locked in an increasingly confrontational relationship with the U.S.

U.S. investors face an unprecedented dilemma: how to grapple with a country that is too large to ignore but locked in an increasingly confrontational relationship with the U.S. The U.S. has had contentious relations with other economic powers, including Germany and Japan before World War II and the Soviet Union during the Cold War. None of those countries matched China's current size and importance to the global economy, however.

As China grows as a share of the investable universe and occupies a larger portion of investor portfolios, the challenges posed by this dilemma will be increasingly difficult to navigate. Key risks include punitive actions against Chinese companies by U.S. policymakers, market volatility during periods of heightened tensions, political efforts to limit investment in China, and moral quandaries and fear of reputational risks from investing in China.

Punitive Actions against Chinese Firms by the U.S. Government

As a result of the deterioration in the U.S.-China relationship, Chinese companies face a growing array of punitive actions by U.S. policymakers. The most widespread and well-publicized of these restrictions are the tariffs facing Chinese exporters. Tariffs have been imposed on a wide variety of goods, ranging from almonds to aircraft parts, with rates as high as 25%. The two countries recently made some progress in resolving the dispute as part of the Phase I agreement, but significant tariffs will remain in place for the foreseeable future – and Chinese companies remain exposed to the imposition of new tariffs with little notice. In addition, Chinese firms that are part of global supply chains are under pressure, as many multinational companies consider shifting production to other countries to avoid sanctions.

Alongside tariffs, Chinese companies face a broad range of restrictions from U.S. policymakers, including stricter regulations on investments in the U.S. and limitations on their ability to transact with U.S. customers and suppliers:

- The Office of Foreign Asset Control (OFAC), housed within the U.S. Treasury, has imposed penalties and restrictions on Chinese companies that violate U.S. and United Nations sanctions. These sanctions range from heavy monetary penalties to full exclusion from transactions with U.S. persons and entities.
- The U.S. Department of Justice has launched the China Initiative, a campaign aimed at curtailing China's acquisition of U.S. technology and trade secrets.[34] FBI Director Christopher Wray has described China as "threatening the U.S. economy – and national security – with its relentless efforts to steal sensitive technology and proprietary information from U.S. companies, academic institutions, and other organizations."[35] One prominent example of these efforts is that of Fujian Jinhua, a state-owned semiconductor firm. After being indicted for theft of trade secrets and banned from buying U.S. technology, the firm is reportedly on the verge of halting production altogether.[36]
- The Committee on Foreign Investment in the United States (CFIUS), a government body responsible for screening sensitive foreign investments, has

dramatically increased scrutiny over Chinese foreign direct investment into the U.S.[37] As a result, new Chinese investment into the U.S. has plummeted, falling from about 40 billion USD in 2016 to less than 10 billion USD for the 12-month period ending in June 2019.[38] CFIUS has also forced Chinese companies to divest from existing U.S. investments due to national security concerns.[39]

- The U.S. Commerce Department has placed several Chinese companies on the Entity List, which restricts U.S. suppliers from selling to them. The reasons for addition to the list range from alleged theft of U.S. technology, to violation of U.S. sanctions regimes, and engagement in activities contrary to the foreign policy interests of the U.S.[40] For companies that rely on U.S. inputs, such as technology firms, being cut off from U.S. suppliers severely hinders their business operations and could even force some companies to shut down.

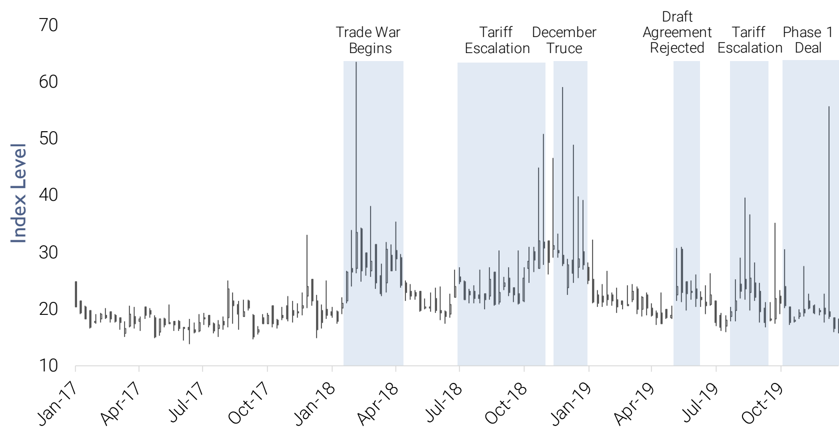
- The U.S. has blocked some Chinese companies from entering the U.S. market or transacting with U.S. firms out of security concerns. The telecom industry has emerged as a focus of these efforts. In May 2019, President Trump issued an executive order invoking the International Emergency Economic Powers Act to allow the secretary of commerce to bar U.S. firms from purchasing information and communications technology (ICT) from Chinese companies.[41] U.S. regulators also erected barriers to keep Chinese firms from entering the market and selling their products to government agencies and the military.[42] The Commerce Department recently proposed rules that would institutionalize the powers set out in the executive order to identify, assess, and address risks to the ICT supply chain in the U.S.[43] This new set of powers would grant it broad authority to prohibit transactions involving Chinese companies that were determined to endanger the national interest.

Increased Market Volatility

The more confrontational U.S.-China relationship is increasing market volatility. The stock market in China has reacted to periods of heightened tension with broad sell-offs. Correspondingly, during periods of rapprochement and easing of tensions, China's markets surge higher. The whipsaw of markets extends beyond just the companies that are most exposed to the U.S.-China conflict. Sectors across the economy face the prospect of significant price movement as a result of developments in the relationship

Figure 8 shows the weekly movements of the Cboe China ETF Volatility Index, a measure similar to the VIX Index in the U.S. The index aggregates the weighted price of puts and calls over a range of strike prices for the iShares Trust FTSE China 25 Index, which tracks the performance of large-cap Chinese companies. Spikes in the index occur when market participants anticipate price volatility; lower values indicate periods during which market activity is more subdued. Throughout 2018 and 2019, the index showed huge spikes when there were significant developments in the U.S.-China relationship, including escalations of tariffs, the imposition of sanctions on Chinese companies, and the breakdown and resumption of talks between the two countries. Event-driven studies show that negative news related to the trade war was closely linked to market declines on the Shanghai and Shenzhen Stock Exchanges.[44]

Figure 8. Weekly Movement of Cboe China ETF Volatility Index
1/6/17 – 1/2/20



Past performance does not guarantee future results.
Sources: Bloomberg, Seafarer.

Restrictions on the Ability of Americans to Invest in China

Multiple efforts are underway to restrict the ability of Americans to invest in China.

Multiple efforts are underway to restrict the ability of Americans to invest in China. At the company level, the U.S. Treasury may impose financial penalties and force divestment by U.S. investors in sanctioned entities. Sanctions on Russian and Venezuelan companies have already forced U.S. investors to divest their stakes.[45,46] U.S. investors are permitted to sell their stakes only to foreigners, and they must typically divest by a prespecified date. These measures often result in a steep decline in the value of the asset being sold.

Similar sanctions have not yet been applied to a major listed Chinese company, but several unlisted Chinese companies have been sanctioned,[47] and several large listed Chinese companies have come dangerously close to having this type of sanction imposed. Subsidiaries of the COSCO Group, a major state-owned shipping company, were sanctioned for their connection to Iran, although they subsequently received limited duration waivers.[48] A subsidiary of China National Petroleum Corporation, Bank of Kunlun, was sanctioned and barred from accessing the U.S. financial system.[49] Chinese telecommunications giant ZTE suspended trading of its shares on the Hong Kong and Shenzhen exchanges for an extended period while it worked out a settlement with the U.S. government over violations of sanctions on Iran.[50] A U.S. judge is subpoenaing three major Chinese banks – the Bank of Communications, the China Merchants Bank, and the Shanghai Pudong Development Bank – for their alleged role in helping North Korea bypass U.S. sanctions.[51] It remains a distinct possibility that a major Chinese company will face OFAC sanctions that require divestment by U.S. investors.

In addition to moves targeting individual companies, efforts are underway to restrict investment in Chinese securities at a broader level. The U.S.-China Economic and Security Review Commission, an influential congressional commission, has called for delisting Chinese companies from U.S. stock

COVID-19 SHAKES GLOBAL MARKETS

Tensions between the U.S. and China are making global problems more difficult to manage and creating significant market volatility in the process. In prior years, it was widely believed that the two countries had a shared interest in resolving important international problems, including climate change, financial stability, global health and transnational terrorism. The current animosity in the relationship makes solving these issues more difficult and increases the possibility they grow into international crises that are damaging to the global economy and financial markets.

A recent example of this trend is the COVID-19 pandemic. After an initial cover-up, the severity of the outbreak of the virus in China became known globally. Infectious disease experts from the U.S. sought access to China to study the disease and better prepare for its possible spread. Reports state that the U.S. Centers for Disease Control (CDC) sought for weeks to send a team of experts to China without receiving approval from the Chinese government.[52] As the number of infections in China grew, senior U.S. officials publicly criticized the response of the Chinese government to the outbreak and the transparency of the figures it was reporting.[53]

Once the virus spread globally, including in the U.S., both sides engaged in bitter accusations over responsibility for the pandemic. An official in the Chinese Ministry of Foreign Affairs alleged that the U.S. military could be responsible for the outbreak, leading to an angry response from the U.S. Secretary of State.[54] Meanwhile, a member of the U.S. Congress compared the outbreak to "Chernobyl" and demanded that China be held accountable for the damage it was causing.[55] President Trump has enraged many in China by frequently referring to the virus as the "China Virus" rather than by its official name, COVID-19.

In March 2020, the virus crippled financial markets and threatened to put the global economy into a recession. As policymakers around the world took actions to tackle financial instability and stimulate their economies, evidence of coordination between the world's two largest economies (the U.S. and China) was scant. Tellingly, when the Federal Reserve announced coordinated efforts with 14 other central banks to enhance U.S. dollar liquidity and ease strains in global funding markets, the People's Bank of China was absent from the list.[56]

It is likely that the virus would have spread across borders and damaged economies regardless of the state of U.S.-China relations. However, the acrimony between the two countries contributed to a situation where the world was less prepared to deal with the crisis. Instead of openly sharing information, expertise, and coordinating a global economic stimulus, the two countries are mired in recriminations and distrust.

Even if stock markets around the world eventually recover from the COVID-19 pandemic, as they have after other crises throughout history, it's clear that U.S.-China tensions increasingly represent a barrier to effectively resolving international problems.

exchanges if they fail to share audit work papers with U.S. auditors or use a variable interest entity (VIE) structure, a common structure used by China's technology companies.[57] It has also recommended that Chinese companies be required to disclose their connections to the Chinese government and Communist Party before being allowed to issue an IPO in U.S. markets.[57] A prominent U.S. senator has called for MSCI, a major index provider, to remove Chinese companies from its indices.[58] Doing so would force passive investors that track these indices to exit their China holdings. Officials in the White House have also reportedly considered limiting investment by U.S. investors in China's domestic capital markets.[59] Pensions and other institutional investors have faced pressure to divest from specific Chinese companies or cut China out of their portfolios altogether.[60] As the relationship between the two countries continues to deteriorate, these calls for limiting the ability of Americans to invest into China will grow stronger.

Moral Quandaries and Reputational Risks Associated with Investing in China

As tensions between the two countries have increased, policymakers, think tanks, the media, and advocacy groups have increased their scrutiny of China. This scrutiny focuses on many activities, including human rights abuses, privacy infringement, theft of intellectual property, environmental pollution, and potential threats to U.S. interests, particularly in the security realm. Some of the more extreme voices have argued that investing in China is akin to supporting companies that "help suppress human rights, support the Chinese army, and may be spying on the U.S."[61]

The growing tensions between the world's two largest economic powers are impossible to ignore and will shape investment returns in new and unpredictable ways.

Investors now face a situation in which specific companies or even whole industries may become classified as nefarious or illegitimate in the court of public opinion. Chinese companies that participate in these activities may be branded as tools of a repressive regime, even if the activity subject to criticism is only tangential to the company's core business operations. Investors in these companies may be accused of helping to finance and reward these activities, regardless of the original reason for investment.

Equally important, investors that venture into China without conducting due diligence may find themselves connected to companies that violate their own values. Companies may be engaged in activities that investors find morally reprehensible. Although this risk is present when investing anywhere, it is greater in China, given the stark divergence in values between China and the U.S.

How to Navigate a Tumultuous U.S.-China Relationship

At a time when passive and quantitative approaches to investing are in vogue, it seems almost anachronistic to discuss the impact of foreign policy on portfolio management. However, the growing tensions between the world's two largest economic powers are impossible to ignore and will shape investment returns in new and unpredictable ways.

No silver bullet or magic formula will eliminate the risks from investing in China. Given the degree of risk and complexity, financial advisors and individual investors may want to use a fund manager with experience and knowledge in this area rather than grapple with these challenges alone.

For investors who do decide to venture into China, a disciplined approach to evaluating and managing risks is necessary. It involves assessing the risks of an investment along three vectors: macro, sectoral, and company-specific risks. After evaluating the risks, investors can assign a China risk premium that can be incorporated into the overall assessment of an investment's merits. These risks must be carefully monitored for changes that would necessitate a reevaluation of the investment.

Develop an Understanding of the U.S.-China Relationship

It is unreasonable to expect that every investor will become an expert China observer, but an appreciation of the major dynamics of the relationship between the two countries is necessary. The issues outlined earlier in this paper are a starting point for this effort. At a high level, the relationship is shaped by China's growing challenge to the U.S. on the world stage, the imbalanced economic relationship between the two countries, and dissatisfaction in the U.S. with China's political and economic reforms.

Armed with a better understanding of the relationship, investors will be better prepared to assess how these issues may come to affect their portfolio. For example, concerns about China's growing challenge to the U.S. on the world stage are leading U.S. policymakers to take steps to restrict the growth of Chinese companies that are emerging as global competitors or are producing strategic technology. The imbalanced economic relationship between the two countries means that the U.S. is likely to continue using tariffs and other forms of economic pressure to gain greater access to the Chinese market. The widespread dissatisfaction with China's political and economic reforms makes it more likely that a hardline approach toward China will prevail in Washington and that companies closely linked to the Chinese government will be exposed to punitive actions from the U.S. government.

Understanding the history of the bilateral relationship will also help illuminate the current state of affairs. The relationship is likely to be interspersed with periods of relative calm; indeed, the waxing and waning of tensions has been the pattern of U.S.-China relations since the founding of the People's Republic of China, in 1949. The relationship is replete with periods of conflict and tension, including the Korean War, the Vietnam War, the Tiananmen Square massacre, the numerous Taiwan Straits crises, the Belgrade embassy bombing, the Hainan Island incident, Wang Lijun's defection, Chen Guangcheng's escape, and others. Knowledge of the many instances during which the relationship has been on the precipice of a breakdown provides much-needed context and perspective when evaluating current events.

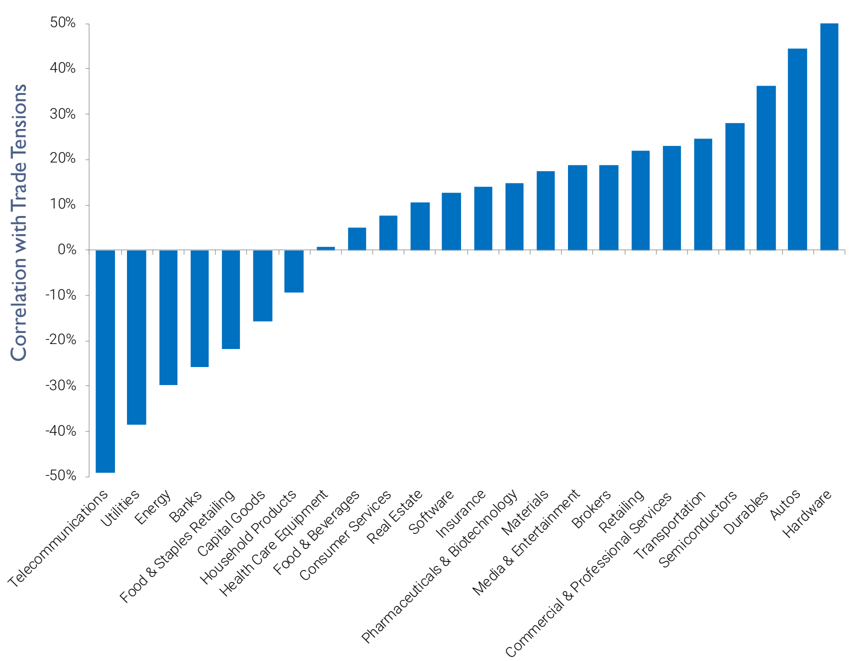
Many of the twists and turns in U.S.-China relations over the past few years have been surprising. That the two countries were headed toward greater conflict and the main fault lines along which that conflict would unfold were well known to people with an understanding of the relationship, however. Investors who venture into China without this knowledge may be blindsided by foreseeable risks.

Identify Which Industries May Be More Exposed to U.S.-China Tensions

Some industries in China may be particularly exposed to risks, for two main reasons. The first is that some Chinese industries are more reliant than others on access to U.S. suppliers or customers. Whether through tariffs or market access restrictions, such as the Commerce Department's Entity List, U.S. policymakers can affect the economic interests of Chinese industries dependent on U.S. imports or exports. Reflecting these risks, these industries experience greater market volatility during periods of tension between the two countries. A recent study found that Chinese companies that are more reliant on exports or imports from the U.S. experienced greater price volatility during periods of both positive and negative news related to the trade war.[62]

Figure 9 shows the correlation between various industries within the MSCI China Index and a barometer of trade tensions. Industries with a positive correlation are those that perform worse when tensions increase. These industries – semiconductors, durables, apparel, auto parts, hardware – tend to be export-focused or reliant on U.S. imports. More domestically focused industries – telecom services, utilities, energy, banking – are less affected by developments in the trade war.

Figure 9. Correlation between Select Industries in China and Trade Tensions with the U.S.
As of 6/20/19



Source: Goldman Sachs, Seafarer.[63]

The second reason why an industry may be more exposed to U.S.-China tensions is that it has become linked to environmental, social, or human rights controversies. For example, the discussion in the U.S. of surveillance technology in China has grown increasingly negative over the past several years, particularly as it relates to how this technology strengthens the Chinese security state and allows it to persecute minority groups. Chinese companies involved in this sector have faced scrutiny from U.S. policymakers, the media, and activists. The level of criticism directed toward this industry continued to build until, eventually, many companies in the industry were placed on the Commerce Department's Entity List and largely shut out of the U.S. market. The punitive action appears to have been applied with little regard to the companies' level of involvement in these activities.

Analyzing risk is difficult because the sectors that are most at risk change over time. Predicting which industries will suddenly emerge as the focus of scrutiny is not always possible. Slower-moving controversies can be tracked, however. Investors should monitor the China-related controversies most frequently discussed by U.S. policymakers, journalists, and advocacy groups, to identify whether they are closely linked to specific industries in China and whether policy changes under discussion would have a significant negative impact on Chinese companies operating in that sector.

Evaluate Company-specific Risk Factors

Chinese companies may have characteristics that make them particularly vulnerable to shifts in the U.S.-China relationship. One such risk factor is ownership. State-owned enterprises are often viewed as a proxy for the Chinese government. As a result, the actions of these companies are more likely to come under scrutiny by U.S. policymakers than are actions by completely private companies. At the same time, SOEs have greater access to government assistance and resources, allowing them to better endure difficult conditions than their private sector peers.

Companies linked to social or environmental concerns also have elevated risk. A company that provides equipment and support to a Chinese government policy that has been condemned in the U.S., such as the detention of Muslim citizens in Xinjiang, is more likely to be targeted. The revenues derived from involvement in the policies may not account for a large share of their business, but their involvement is nonetheless sufficient to expose them to punitive actions by the U.S. government.

Chinese companies at the forefront of strategically important technology or an influential communications platform are more likely to face scrutiny. For example, Huawei has been the leader in China's efforts to export 5G technology to the rest of the world. The prospect of it occupying a critical role in the telecommunications infrastructure of countries around the world has made it a major target for U.S. policymakers. The rise of social media platform TikTok, which is owned by a Chinese company, as a major platform in the U.S., along with persistent allegations that it is censoring activity on its platform, has turned the company into a major target.[64]

Chinese companies at the forefront of strategically important technology or an influential communications platform are more likely to face scrutiny.

Companies that rely on access to U.S. capital markets or dollar-based financing are more exposed to shifts in the relationship than companies that do not. Chinese companies listed on stock exchanges in the U.S. are vulnerable to the threats of a forced delisting. Were they forced to delist, many of these companies would not be able to list on mainland exchanges, because of their use of the VIE structure. Some companies could list on the Hong Kong exchange, but the process of changing is likely to be disruptive for investors. Chinese companies that depend on significant U.S. dollar financing also face heightened risk, as this financing is often routed through the U.S. financial system. Were a company to be sanctioned by the U.S. Treasury, access to dollar-based financing would dry up.

A last category of Chinese companies that are vulnerable are firms that rely on a regulatory exemption from U.S. restrictions. Most of these firms are the Hong Kong-based subsidiaries of Chinese firms. Companies operating in Hong Kong are generally not subject to the same export restrictions the U.S. applies to mainland Chinese firms. The U.S. Congress passed the Hong Kong Human Rights and Democracy Act of 2019 to require annual certification from the State Department that Hong Kong is still sufficiently independent to justify sperate treatment from the mainland. Companies relying on these exemptions face a persistent risk that their operating environment will change significantly.

One telling indicator of the risk facing a Chinese company is the extent to which it engages in lobbying in the U.S. Like their U.S. counterparts, Chinese companies facing a higher risk of adverse actions by policymakers tend to spend much more time and resources trying to sway opinion in Washington.[65]

Determine Whether a China Risk Premium Is Warranted

China risk premiums are based on judgments by investors of how the risks from U.S.-China tensions may affect an investment. Risks include the impact on a company's profitability, access to critical technology and components, the ability to expand overseas, and volatility in its share price. Also relevant are risks to investors from potential investment restrictions and reputational damage from being linked to a company whose practices are viewed as objectionable.

China risk premiums can vary significantly across investments. An investment in a company that is domestically focused, has few foreign suppliers, and is engaged in business activities viewed as routine is unlikely to have a significant China risk premium. A company that is engaged in practices deemed objectionable, highly reliant on U.S. technology and capital markets, and closely linked to the Chinese government may have a much higher China risk premium.

When the risks are known and their impact can be estimated, investors may decide to raise the hurdle rate for an investment – that is, require a higher rate of return relative to the return on a similar investment in other countries – in order to be compensated for this risk exposure. When the risks are less clear and their impact uncertain, investors may base their judgment on a subjective analysis of the risks facing a company and a range of projected outcomes.

Like other risk factors, a high China risk premium should not necessarily be determinative of whether investment is justified. It is an attempt to incorporate a specific type of risk into the overall assessment of an investment's merit.

Monitor for Events That May Change the Assessment of Risks

Once the review of risks has occurred and an investment is made, investors should carefully monitor events that could change their initial assessment. An aspect of an investment that was viewed as low risk may become higher risk as events change. For example, a company may be engaged in a line of business that was previously viewed as benign but is now a lightning rod for criticism. Investors that fail to monitor for such developments may not recognize the change until the risks of the investment have already increased significantly. Certain risks may become less salient over time, as a company takes actions that limit its vulnerability to shifts in the relationship. For example, Chinese companies listed in the U.S. can reduce the potential disruption that would occur from a forced delisting by pursuing a secondary listing in Hong Kong. Reducing its reliance on the U.S. can help make a Chinese company less sensitive to changes in the relationship between the two countries.

A significant challenge for investors in this process is to avoid becoming anchored in their initial analysis of an investment. It can be hard to acknowledge that a great company may have mortgaged its future by linking itself too closely to the Chinese state, thereby exposing itself to significant risks. It is important to be intellectually honest and recognize that the China-related risks of an investment will change over time as the U.S.-China relationship evolves.

Establish Guidelines for When to Exit or Increase Exposure

When analysis of events indicates that the risks of an investment have changed significantly, investors face the difficult decision of how to react. To the extent possible, they should try to establish clear guidelines about when a change in risks should prompt a review of a position. This review involves evaluating the current performance of the company, revisiting the original case for the investment, and determining whether the investment still has merits in light of the new risks.

After such a review, investors may determine that an investment is still attractive despite the risks. In these situations, it may make sense to subject an investment to heightened monitoring in order to validate the assessment of risks. In other cases, the accumulation of risks may be so grave that exiting the position immediately is warranted.

There may also be situations in which investors review the issue at hand and determine that the market has exaggerated the severity of risks or overstated the potential impact on a company. In these situations, a well-prepared investor might choose to increase his or her exposure to an investment, in order to benefit from the overreaction of the market. During periods of heightened U.S.-China tension, investors well-versed in the complexities of the relationship may find opportunities amid the turmoil.

During periods of heightened U.S.-China tension, investors well-versed in the complexities of the relationship may find opportunities amid the turmoil.

The Path Forward

Escalating political and economic tensions between the U.S. and China present challenges to many traditional methods of investment analysis and risk management. They also raise the larger and more fundamental question of whether the political and economic systems of the two countries are compatible over the long run. Few voices are supporting the notion that China and the U.S. can coexist peacefully. Some investors may even question whether investing in China is advisable under any circumstances, given the apparent trajectory of the U.S.-China relationship.

It is important to keep in mind that this relationship has been through many periods of heightened tension that have threatened a breakdown in relations. Each time, both sides recognized that they have much more to gain from cooperation than conflict and ultimately took steps to mend frayed relations.

Although the sources of friction between the two countries seem more numerous than ever before, so are the positive linkages. The flow of people, trade, and investment between China and the U.S. is unprecedented. Since China began its economic reforms, in the late 1970s, millions of businesspeople, investors, workers, and students have benefited from the interaction between the two countries. It will fall upon these people to push for a renewal of the relationship and the establishment of new long-term sources of cooperation. One basis of cooperation can be the sense of shared prosperity that arises when U.S. investors are able to access China's growing capital markets and benefit from the success of its companies.

In the meantime, investors will have to navigate the dilemma of a market that is too big to ignore but full of new and complicated risks. Faced with these uncertainties, the best approach is to try to understand the risks, make informed decisions based on that understanding, and be vigilant for developments that change the assessment of these risks.

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Glossary

Belt and Road Initiative: an international program to spur investment and trade links between China, central Asia, and Europe. The initiative was announced by China's President Xi Jinping in 2013. The official name for the initiative is the "Silk Road Economic Belt and the 21st Century Maritime Silk Road."

Bond Connect: a trading link that allows certain investors from Mainland China and overseas to trade in each other's bond markets through a special mechanism that was designed and implemented by the Hong Kong Stock Exchange. Currently, only Northbound trading is allowed, meaning that foreign investors are able to buy and sell Chinese bonds. Chinese investors are not yet able to trade Hong Kong and overseas bonds, known as Southbound trading.

Call Option: an agreement that gives the option buyer the right, but not the obligation, to buy an underlying asset – a stock, bond, commodity, or other instrument – at a specified price within a specific time period.

China Interbank Bond Market (CIBM): an OTC market outside the Shanghai and Shenzhen stock exchanges. The major instruments traded in the CIBM are Chinese government bonds, PBOC bills, Policy Bank bonds and others.

Chinese A-Shares: a class of securitized common stock in Chinese companies, traded exclusively on Chinese stock exchanges (i.e., Shanghai and Shenzhen), and denominated in renminbi, China's currency. Historically, A-shares were inaccessible to foreign investors, but more recently China has allowed foreign investors to purchase A-shares through the Qualified Foreign Institutional Investor (QFII) program and the Stock Connect programs.

Entity List: a U.S. Department of Commerce list of names of foreign persons – including businesses, research institutions, government and private organizations, individuals, and other types of legal persons – that are subject to specific license requirements for the export, reexport, and/or transfer (in-country) of specified items.

Foreign Direct Investment (FDI): investment in domestic businesses by foreign citizens.

Initial Public Offering (IPO): the process of offering shares of a private company to the public in a new stock issuance. Public share issuance allows a company to raise capital from public investors.

Market Capitalization: the value of a corporation as determined by the market price of its issued and outstanding common stock. It is calculated by multiplying the number of outstanding shares by the current market price of a share.

Office of Foreign Asset Control (OFAC): a U.S. Department of the Treasury office which administers and enforces economic and trade sanctions based on US foreign policy and national security goals against targeted foreign countries and regimes, terrorists, international narcotics traffickers, those engaged in activities related to the proliferation of weapons of mass destruction, and other threats to the national security, foreign policy or economy of the U.S.

People's Bank of China (PBOC): the central bank of the People's Republic of China, located in Beijing.

Put Option: a contract giving the owner the right, but not the obligation, to sell, or sell short, a specified amount of an underlying security at a pre-determined price within a specified time frame. The pre-determined price the put option buyer can sell at is called the strike price.

Qualified Foreign Institutional Investor (QFII): a program that permits certain licensed global institutional investors to participate in China's renminbi-based mainland capital markets, subject to a quota.

Renminbi (RMB): official currency of the People's Republic of China. The name literally means "people's currency." The yuan (¥) is the basic unit of the renminbi. It is also used to refer to the Chinese currency generally, especially in international contexts.

Shanghai-Hong Kong Stock Connect: a trading link launched in 2014 that allows offshore, non-domestic-Chinese investors and entities to invest in Chinese A-shares listed on the Shanghai Exchange. Investment via the Stock Connect occurs through a special mechanism that was designed and implemented by the Hong Kong Stock Exchange. The Stock Connect also allows Mainland China investors to purchase certain Hong Kong-listed stocks via accounts with the Shanghai Exchange.

Shenzhen-Hong Kong Stock Connect: a trading link launched in 2016 that allows offshore, non-domestic-Chinese investors and entities to invest in Chinese A-shares listed on the Shenzhen Exchange. Investment via the Stock Connect occurs through a special mechanism that was designed and implemented by the Hong Kong Stock Exchange. The Stock Connect also allows Mainland China investors to purchase certain Hong Kong-listed stocks via accounts with the Shenzhen Exchange.

Special Drawing Rights (SDR): an international reserve asset created by the International Monetary Fund in 1969 to supplement its member countries' official reserves. SDRs can be exchanged for freely usable currencies. As of October 1, 2016, the value of the SDR is based on a basket of five major currencies — the U.S. dollar, Euro, Chinese renminbi, Japanese yen, and pound sterling.

State-owned Enterprise (SOE): a legal entity that is created by the government in order to participate in commercial activities on the government's behalf. A state-owned enterprise can be either wholly or partially owned by a government.

Stock Connect: trading links that allow offshore, non-domestic-Chinese investors and entities to invest in Chinese A-shares listed on the Shanghai and Shenzhen Exchanges. Investment via the Stock Connect occurs through a special mechanism that was designed and implemented by the Hong Kong Stock Exchange. The Stock Connect also allows Mainland China investors to purchase certain Hong Kong-listed stocks via accounts with the Shanghai and Shenzhen Exchanges.

Strike Price: the set price at which a derivative contract can be bought or sold when it is exercised. Strike price is also known as the exercise price.

Variable Interest Entity (VIE): a legal structure created in order to facilitate investment by foreign companies into domestic companies in industries with foreign ownership restrictions. The variable interest entity (VIE) enters into a contractual relationship with a foreign-owned company, which gives the foreign company the right to the economic benefits of the domestic company and a degree of effective control without formal legal ownership.

MSCI All Country World Index (ACWI) Investable Market Index (IMI), Net Total Return USD is an all-capitalization index designed to represent the equity investment opportunity set in developed and emerging markets. Index code: M1WDIM. MSCI Emerging Markets Index is a free float-adjusted market capitalization index designed to measure equity market performance of emerging markets. Index code: MXEF. Bloomberg Barclays Global Aggregate Bond Index is an index of global investment grade debt securities from local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers. Index code LEGATRUU. J.P. Morgan Government Bond Index – Emerging Markets (Local Currency) is an index of local currency bonds issued by emerging market countries. Index code: GBI-EM. Cboe China ETF Volatility Index aggregates the weighted price of puts and calls over a range of strike prices for the iShares Trust FTSE China 25 Index, which tracks the performance of large-cap Chinese companies. Index code: VXFXI. VIX Index is the Chicago Board Options Exchange (Cboe) Volatility Index, or VIX, is a real-time market index representing the market's expectation for 30-day future volatility of the S&P 500 Index. iShares Trust FTSE China 25 Index tracks the investment results of an index composed of large-capitalization Chinese equities that trade on the Hong Kong Stock Exchange. Index code: FXI:US. MSCI China Index is a free float-adjusted equity index that tracks large and mid capitalization companies across China A-Shares, H-shares, B-shares, Red chips and P chips and foreign listings (e.g. ADRs). Index code: GDUETCF and MXCN. It is not possible to invest directly in an index.

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