On the minds of investors

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Marcella Chow
Global Market Strategist

Chaoping Zhu
Global Market Strategist

What are the implications of China's removal of QFII and RQFII quotas?

On September 10, China's forex regulator, the State Administration of Foreign Exchange (SAFE), announced it will remove the investment quota limitations for Qualified Foreign Institutional Investors (QFII) and Renminbi Qualified Foreign Institutional Investors (RQFII), as well as country/region restrictions for RQFIIs. SAFE did not provide a clear timeline for the quota removal or RQFII relaxation and some of the foreign exchange related issues have yet to be clarified.

Recall that the QFII and RQFII programs were introduced back in 2002 and 2011 respectively, which allowed overseas institutional investors to participate in China's domestic bond and equity markets. International investors were initially limited by an aggregate quote of USD 150billion, which was raised to USD 300billion in January this year. The RQFII quota was RMB 1.99trillion as of August.

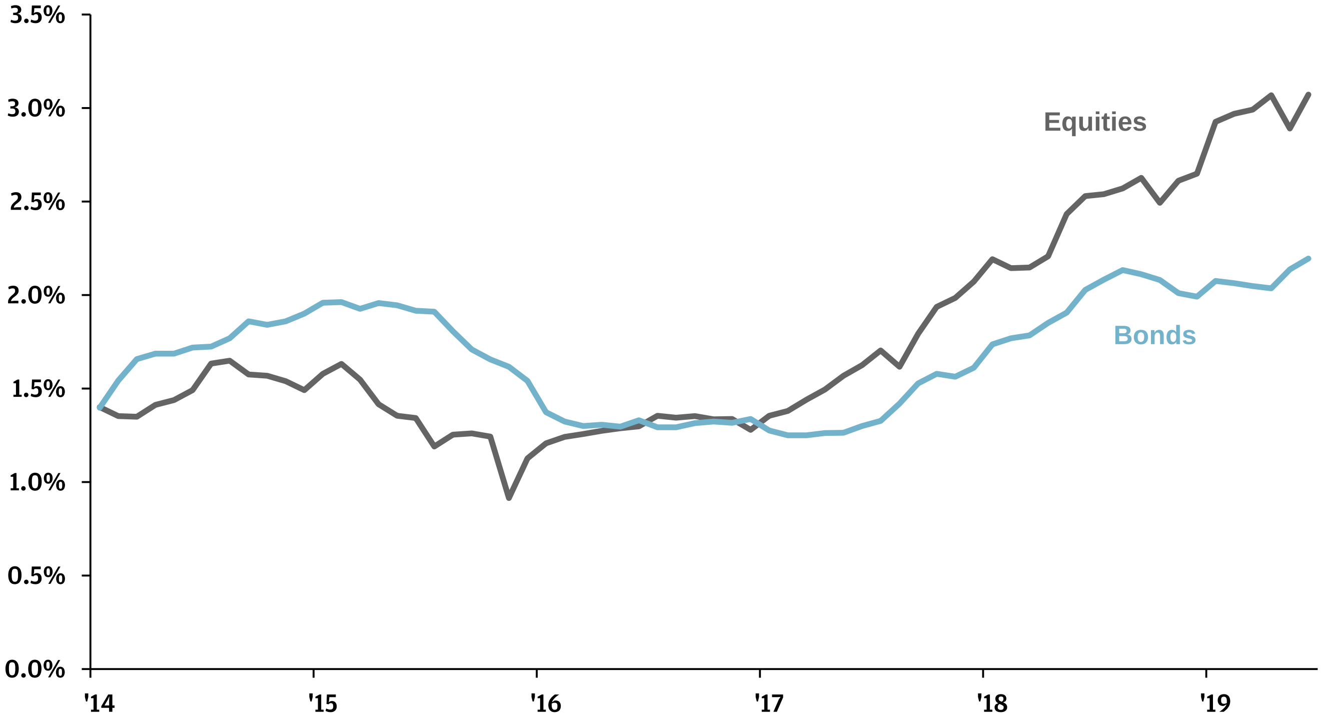
This announcement reflects the Chinese government's continuous efforts at boosting financial reform and opening-up of the capital market. Amid the economic downturn and sustained external uncertainties, it is increasingly essential for China to improve the efficiency of its domestic capital market by attracting long-term foreign investors. Moreover, this also helps China to manage its balance of payments and stabilize the Chinese renminbi. To curb hot money flows, foreign investors will still require QFII and RQFII licenses even as the quota is removed.

At the end of August 2019, there were 292 QFII-licensed institutions with an approved investment fund of USD 111.4billion (37% of the USD 300billion quota); while RQFII has been expanded from Hong Kong to 20 countries and regions with 222 RQFII-licensed institutions and an approved investment fund of RMB 693billion (35% of the RMB 1.99trillion quota). While the announcements are positive, the QFII/RQFII quota have not actually been fully utilized as most of the investors have been trading via Stock Connect, another cross-border investment channel. Unlike the QFII and RQFII systems, investors using the Stock Connect can buy stocks without requiring licenses granted by the currency or securities regulators. Hence, the impact of the recent announcements on the broader A-share market will likely be limited.

Foreign investors are a non-negligible component of the Chinese stock market. As of 2Q 2019, foreign investors' holding of A-share via all available channels reached RMB 1.65trillion, or 3.1% of total market cap and 7.5% of free floating market cap, almost equivalent to the proportion held by domestic mutual funds.

EXHIBIT 1: FOREIGN OWNERSHIP IN THE CHINESE FINANCIAL MARKET

SHARE OF FOREIGN HOLDINGS*



Sources: CEIC, People's Bank of China, J.P. Morgan Asset Management.
*For equities, data shows share of foreign holdings as a percentage of the total domestic equity market capitalization. For bonds, data shows share of foreign holdings of bonds as a percentage of the total outstanding bonds in the market.
Data reflect most recently available as of 11/09/19.

We expect to see further policies to facilitate foreign participation in Chinese market. The next step might be the lifting of the 30% ceiling for foreign holdings of a single company's A-share, which could attract more flows into quality stocks and further improve the efficiency of the market. A-share investment will probably become more institutionalized and value-oriented as a result of increasing long-term foreign investment.

Investment implications

The removal of the investment quotas is a continuation of the series of measures taken by Chinese regulators in the past years to simplify the investment process. This should further deepen the reforms in the Chinese capital market and facilitate the flexibility in onshore investment for foreign investors after the recent inclusion of A-shares and Chinese bond into major global equities and bond indices. Latest developments include 1) the second step of MSCI's enlarged inclusion of A-shares from 10% to 15% at the end of August; and 2) the upcoming second step of FTSE Russell's inclusion of A-shares from 5% to 15% as well as S&P A-share inclusion, which are both to be effective on September 23.

Even though the QFII/ RQFII changes may unlikely have a major impact on the broader market, coupled with recent monetary and fiscal stimulus efforts, attractive valuation and decent earnings growth, the decision should be supportive of sentiment towards A-shares.

As Chinese economic growth is still the highest among global major economies, its capital market continues to provide returns higher than that in developed economies. Chinese 10-year government bonds are now offering yields 130bps higher than 10-year U.S. Treasuries, and there are numerous structural opportunities to generate alpha within the A-share market. We prefer sector leaders which are more domestically-driven (domestic consumption and infrastructure activity) and have less exposure to the uncertainty of the trade talk outcome.

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