

Defining Your China Strategy for Today's Market

China, the second largest economy in the world, has quickly become a major factor in the global markets. In VanEck's 2019 outlook on China, we noted that the People's Bank of China's "drip stimulus" would begin taking effect in Q1-Q2 of 2019, boosting Chinese assets and growth. So far, economic releases suggest that this is on schedule. During a recent webinar, we examined what's ahead for China and explored targeted strategies to help investors gain exposure to this developing market. We compiled a selection of questions that emerged from the webinar and answered them in the following Q&A.

Why is China considered an emerging market?

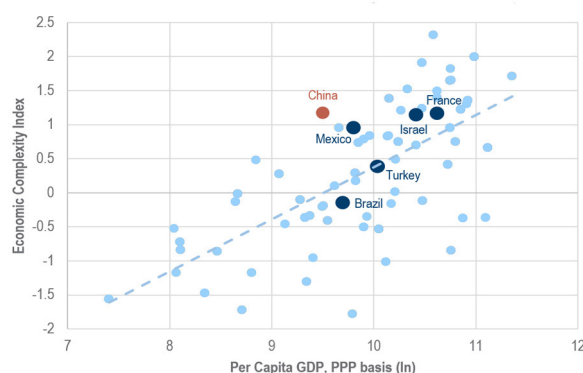
At VanEck we believe that the global emerging markets should not be viewed as homogenous, and investors should consider the significant diversity that exists when selecting investments and constructing portfolios. Classifying a country as emerging or developed is often an oversimplification, and China is perhaps one of the more difficult countries to categorize. Even among the countries commonly referred to as emerging markets, China stands alone in many ways. The country is highly developed in some regards, with a population that is highly educated and world-class infrastructure and technology in its booming cities. It is also undeniably developing in its rural areas, which remain poor and underdeveloped.

Overall, China has a low average income per capita, which places it firmly as "developing" by many observers' definition. However, its role as an economic powerhouse seems to belie this measure. China is now the most important driver of the global economy and, even with slower economic growth, is contributing more to global growth today than when its economy was growing at over 10% per year. Its share of global output now rivals that of the U.S., when adjusted for differing price levels.

Moreover, China's economic complexity, which is a measure of the productive capability, diversity, and sophistication of an economy, is far ahead of its emerging markets peers, and is similar to countries like Israel and France. Its transition to a knowledge-intensive economy based on higher value-added output is a reflection of its growth and economic potential.

That being said, most investors continue to consider China to be an emerging market, as evidenced by its presence in global emerging markets benchmarks, which generally consider

China Has a Diverse and Sophisticated Economy



Source: VanEck; Bloomberg LP. The Economic Complexity Index (ECI) is a holistic measure of the productive capabilities of large economic systems, usually cities, regions, or countries. In particular, the ECI looks to explain the knowledge accumulated in a population and that is expressed in the economic activities present in a city, country, or region. To achieve this goal, the ECI defines the knowledge available in a location as the average knowledge of the activities present in it, and the knowledge of an activity as the average knowledge of the places where that economic activity is conducted.

factors such as market access in addition to per capita income and others. Despite recent efforts to open up its onshore equity and fixed income markets to attract foreign capital, there are still issues that policymakers must address to develop its capital markets to a level on par with most developed countries.

We believe that the difficulty in assigning a label to China should not pose a roadblock for investors looking to construct portfolios aligned with their views on the opportunities presented by China's onshore markets. As China's presence in global benchmarks grows, it may warrant a strategic, standalone allocation within investors' portfolios that is separate from a broad emerging markets or international allocation.

How are China's current stimulus efforts different from previous measures?

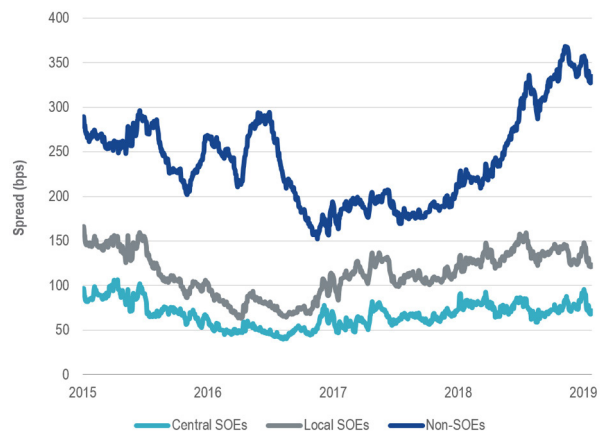
In the past, Chinese policymakers have employed a variety of stimulus measures that were often relatively large and consequential to maintain a high level of economic growth. A consequence of these measures has been high debt levels, as evidenced by various ratios such as total debt to gross domestic product (GDP) and private debt service coverage. Although not necessarily an immediate cause of concern, we believe this high level of debt could lead to problems down the road if interest rates go up.

Policymakers have introduced measures to address excess leverage, with a particular focus on the financing provided by the "shadow banking" sector, which generally refers to financial intermediaries that facilitate the creation of credit across the financial system but whose members are not subject to regulatory oversight. However, there have been unintended consequences as a result of this deleveraging drive. Unlike state-owned enterprises (SOEs), private companies have long relied on the shadow banking sector for financing, as banks have been more reluctant to lend to these higher risk companies. Removing this financing channel has resulted in a credit crunch in the private sector, resulting in a higher cost of financing since the deleveraging drive began. We believe, given the importance of the private sector in China's transition to a consumer led economy, this lack of credit could have significant repercussions on growth. Meanwhile, SOEs, which themselves generally exhibit high debt levels, have continued to access credit through the banking sector, at funding costs that have remained steady.

Certain stimulus measures that were once effective no longer appear to be having the same impact. This, too, may be a reflection of the evolving structure of the Chinese economy, from one led by investment and large SOEs, to one driven by consumption and the growing importance of a more dynamic private sector. For example, financial conditions have not eased despite multiple cuts to banks' required reserve ratio (RRR). Credit supply to the private sector has not increased, and funding costs have remained elevated.

The good news is that authorities appear to be aware of the issues that these imbalances have created, and are addressing the most pressing issues through a variety of mechanisms. Unlike previous stimulus efforts, policymakers

Deleveraging Has Raised Borrowing Costs for Non-SOEs



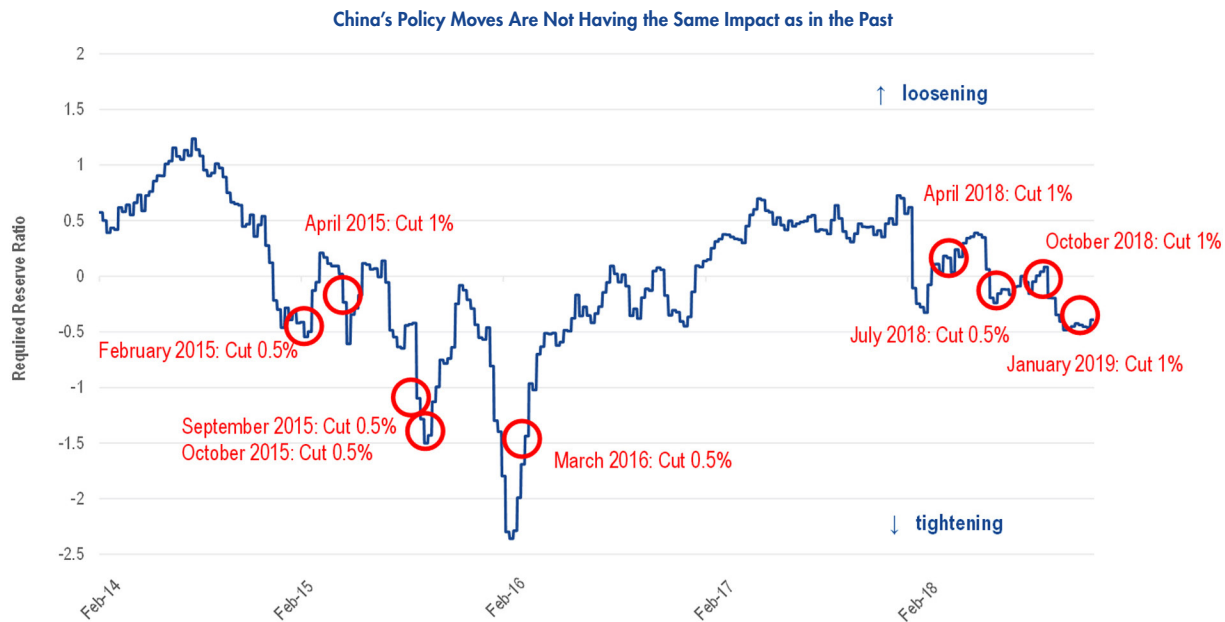
Source: VanEck; Bloomberg LP

China Lending: New Loans Up, Shadow Financing Down



Source: UBS

appear to be using a "drip" method rather than a "big bazooka." They have taken a multi-layered approach and appear to be willing to experiment with different initiatives. Recently, they announced bank lending targets and increased limits for loans to small companies, and a medium-term lending facility that links the provision of funding for banks to their supply of loans to small and medium enterprises. They have also introduced a central bank bill swap that is meant to improve the liquidity of bank's perpetual bonds and support additional issuance in order to replenish capital, with the aim of spurring lending to private companies.



Source: Bloomberg

In addition, the structure of recent stimulus measures has been different, particularly on the fiscal side. In the past, fiscal stimulus relied primarily on additional government spending. Recent measures center around tax cuts. This is a more orthodox approach, which may provide longer lasting impact and recognizes the growing role of consumption and services in China's economy today.

What is the outlook for China's currency?

One of the focal points of the ongoing trade talks between the U.S. and China revolves around China's currency, and more specifically, the notion that China has kept its currency at artificially low levels to maintain its competitiveness globally. The U.S. government has, in effect, accused China of manipulating its currency to gain a competitive advantage against other foreign countries in trade, and has sought a commitment to currency stability from China.

The stable yuan argument, in our view, is in stark contrast to fundamentals. For example, the yuan has already depreciated a lot relative to its regional peers and other reserve currencies over the past decade. Further, against the backdrop of China's evolution to a consumer-based economy, characterized by slower growth and a smaller current account surplus (with the prospect of a current account deficit in the future), there are many arguments

for a weaker currency. China's economy once relied on exporting of manufacturing, industrials, and materials and was taking in more money than it spent, leading to a currency reserve surplus. This is no longer the case.

In the last 10 years, China's economic growth has increasingly been driven by consumption as its economy matures. China's growth is now led by a growing middle class, and this middle class is spending money on goods and services. The result is that China is consuming more in relation to the amount it exports, shrinking its current account surplus as well as its foreign currency reserves.

Past Current Account Surpluses Have Disappeared



Source: Bloomberg

China's currency reserves fell dramatically in 2018, as the yuan came under strong selling pressure from slowing growth and escalating trade war tensions. Lower reserves directly affect China's ability to perform direct interventions in the currency markets, which is one of the primary tools that central banks use to manage their currency. Ultimately, a smaller currency reserves can hamper efforts by the Chinese government to stabilize the yuan.

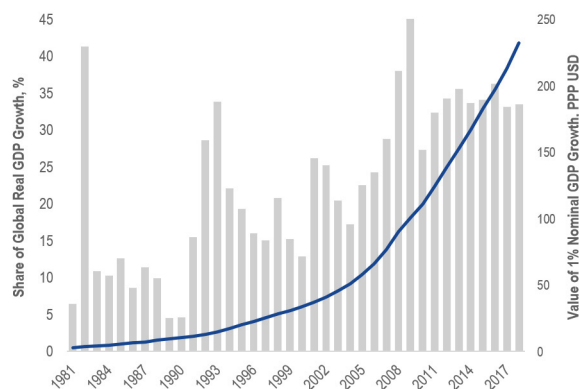
On top of these developments, China's GDP growth rate has also fallen as the economy has continued its development into an economic superpower. China's GDP growth was around 14% as recently as 2007, and has been steadily declining since (6-6.5% expected in 2019).¹

One way policymakers have addressed the shrinking current account surplus is by its gradual opening of its capital account to attract foreign investment. Ongoing reforms and new initiatives to promote access to its onshore markets have led to index providers' decisions to include Chinese onshore stocks and bonds in global benchmarks. We believe this may contribute to a strengthening in the capital account and offset the potential impact on the yuan from the shrinking current account. Further, although economic growth has slowed, it is still far ahead of its global peers. These factors may help to offset the fundamental factors that could place longer term pressure on the yuan. Policymakers are balancing the long-term dynamics associated with the maturation of the Chinese economy with increased openness to the global markets.

If China is successful in stimulating growth, what could be the impact on broader emerging markets and global growth?

Recent stimulus efforts appear to be having an impact on Chinese economic activity, with rebounds in manufacturing investment and new orders in recent months. Growth forecast revisions are no longer declining. In our view, this stabilization and rebound in economic activity has significant repercussions for global growth. Given China's contribution to global growth, it may likely be the main driver in a global cyclical recovery.

China Has Been a Major Contributor to Global Growth



Source: VanEck; Bloomberg

*Although not shown, China accounted for 100% of Global Real GDP in 2009.

On the other hand, the direct impact on other emerging markets is less clear, particularly given the changing nature of China's economy. For example, a consumer-led economic model driven by services may not have the same impact on commodity prices, which tend to be a driver of many emerging markets economies. If China's current account surplus continues to shrink, its role as lender to the world may likely change as it competes with other emerging markets for a share of global capital. This dynamic will only become more pronounced as China's onshore markets continue to open up to foreigners.

How can investors gain exposure to China's new economy and avoid SOEs?

SOEs are companies that have majority, or significant, ownership levels from the government or related organizations. These companies have reaped the rewards of having a close relationship with the government, which include favorable lending rates and other preferential treatment. Generally speaking, these firms are concentrated in traditional emerging markets sectors, including industrials, manufacturing, and finance.

The CSI 300 Index is the most widely-known onshore Chinese equity index, and comprises the largest, most liquid companies that are trading on the two major Chinese exchanges – Shanghai and Shenzhen. It's easy to consider the CSI 300 Index as the "blue chip" index of Chinese

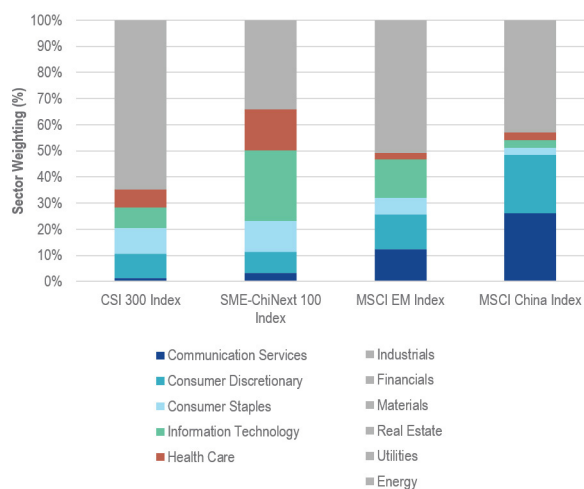
companies. These are the biggest companies in the market, and there is a large degree of SOE overlap in this index. According to some data, SOEs account for over 60% of the CSI 300 Index weighting, and around 80% of total revenues of companies in the index.²

For investors looking to capitalize on the evolution of the Chinese economy towards a consumer-based economy, there are other indices available that have a heavy weighting towards “new economy” sectors. “New economy” sectors are those which are primed to benefit the most from this shift, including consumer discretionary, consumer staples, health care, I.T., and finally healthcare. As China transitions towards a consumer based economy, small and medium enterprises (SMEs) have sprung up to cater to these new and growing segments of the economy. The defining characteristic of these sectors is that their growth and profitability is primarily driven by consumer spending and habits (as opposed to government-directed spending and investment).

The SME-ChiNext 100 Index has a high concentration in these sectors, with nearly 65% of the total weight of the index concentrated there. This index invests in the largest 100 names across the ChiNext and SME boards, both of which trade on the Shenzhen exchange. The ChiNext board was created to help drive innovation in emerging and high-tech sectors, with a goal of raising capital for smaller, non-SOE companies. Similarly, the SME Board was created to allow smaller and mid-sized companies access to capital to be able to grow their business. Both the SME and ChiNext boards have profitability requirements. This differs from other Chinese onshore exchanges, including the newly announced Science and Technology Board, which lack the profitability requirement of these two boards. Importantly, these smaller companies in consumer-based sectors have comparatively smaller degrees of SOE overlap when compared to indices with the largest Chinese companies.

Index providers also recognize the importance of these smaller, non-SOE companies in the future of China’s markets and economy. While the first rounds of index inclusion in 2018 were geared towards the largest, most liquid companies (i.e., SOEs), in 2019 MSCI specifically included ChiNext companies as being eligible for inclusion by the end of the year, in addition to mid-cap names.

Weighting Exposure to New Economy Sectors



Source: VanEck; FactSet. Data as of 3/31/2019

The onshore Chinese market is broad and deep, and represents a wide variety of companies and industries. The same factors that drove China’s growth for the last 20 years may not continue in the future. With China’s transition to a consumer-led growth economy, a new set of companies is primed to benefit. Fortunately for investors who are seeking to tailor their China exposure to benefit from these changes, there are many ways to access the opportunities in the onshore market, including ETFs that provide exposure to targeted segments of the economy.

Are there opportunities in the Chinese debt market, and are debt levels a potential concern?

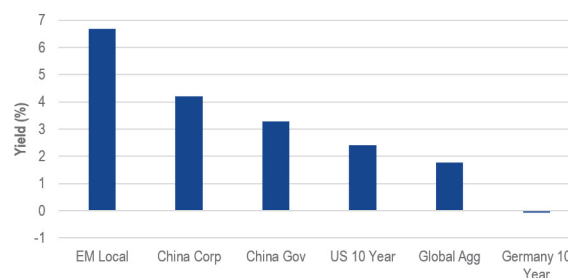
The recent addition of A-shares into emerging markets benchmarks has received a lot of attention lately, but equities are not the only onshore asset class benefitting from global index inclusion. Bloomberg Barclays recently added onshore China bonds to its flagship Bloomberg Barclays Global Aggregate Bond Index, and other index providers are expected to follow suit in the next few years. The expected result is that hundreds of billions of dollars of assets that track these broad benchmarks are expected to flow into the onshore bond markets. Foreign ownership of onshore bonds is low at less than 3%, and global fixed income investors who previously may have overlooked China’s vast onshore bond markets will no longer be able to ignore it.

China's bond market is significant. At over \$12 trillion, it is now the third largest bond market in the world, behind only the U.S. and Japan (which it is soon expected to surpass in size). The market is also extremely diverse, comprising bond issued not only by the central government but also local governments, policy banks, and corporations across a large variety of sectors. The market includes bonds across the maturity spectrum, as well as a large and active commercial paper securitization market. The onshore bond market is substantially larger than the "offshore" bond market, in which Chinese issuers issue bonds outside of mainland China. Historically, that has been a way for foreign investors to include China exposure in their bond portfolios, but as access to the onshore markets has become easier, this market has decreased in size and liquidity.

From a fundamental standpoint, we believe China's growing and dynamic economy provides several tailwinds for fixed income investors. The country's high savings rate and current accounts surplus, although declining, are positive for bond investors. As China's economy is increasingly driven by higher value-added output and consumption-led activity, the higher quality of economic growth may help to provide potential further support for both bond and currency returns. Similarly, although the deleveraging initiative over the past few years has been painful, particularly for investors in private companies, it may ultimately be positive for the overall credit market to the extent it results in a better pricing of risk and more efficient allocation of capital. Onshore bonds may therefore provide income-oriented exposure with a less volatile way to benefit from China's economic transition versus onshore equities.

Yields on 10-year Chinese government bonds have generally ranged from 3-4% since 2016, providing a significant pickup versus developed markets government yields with similar maturities. Although lower than many other emerging markets yields, investors should consider the relative credit, liquidity profile, and currency risks associated with CNY denominated bonds versus other emerging markets local currency bonds. Adding China government bonds to an emerging markets allocation may actually reduce overall risk given the currency's historical stability and the country's lower than average credit risk. A broader exposure that also includes policy banks bonds and corporate bonds has exhibited low correlation to other asset classes, including broad emerging markets local bonds, U.S. aggregate bonds, and U.S. equities.

Yield Comparison
as of 3/31/2019



Low Correlation to Global Fixed Income and U.S. Equities

	Chinese Onshore Bonds	Global Agg.	U.S. Agg.	EM Local Bonds	S&P 500
Chinese Onshore Bonds					
Global Bond Aggregate	0.27				
U.S. Bond Aggregate	0.11	0.75			
EM Local Bonds	0.28	0.50	0.28		
S&P 500	0.07	-0.20	-0.23	0.29	

Source: Factset. Data as of 3/31/2019. Chinese Onshore Bonds represented by the ChinaBond China High Quality Bond Index. Global Bond Aggregate represented by the Bloomberg Barclays Global Aggregate Bond Index. U.S. Bond Aggregate represented by the Bloomberg Barclays U.S. Aggregate Bond Index. EM Local Bonds represented by the J.P. Morgan GBI-EM Global Core Index.

What percentage of an investor's portfolio should be allocated to China?

Allocation size will vary depending on an investor's risk profile and investment goals. However, we believe that given China's role in the global economy and its increasing presence in global benchmarks, China has become too big to ignore. With onshore equities and bonds now being phased into global benchmarks, investors must consider how to size their China exposure. Its weight could, for example, match the market weight exposure of the global benchmark indices. A more active approach, on the other hand, would entail an underweight or overweight position to China relative to a benchmark, or tactically adding or removing exposure depending on a specific outlook.

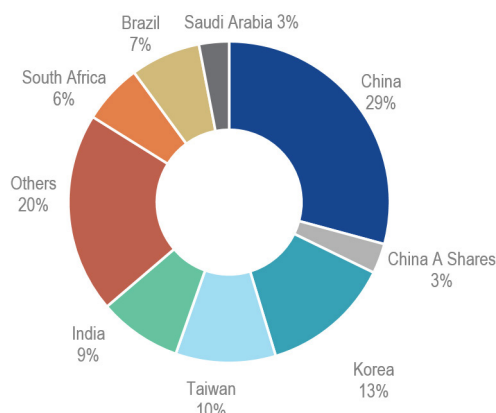
One way to frame the allocation question is to understand just how big China has become in relationship to the rest of the world's economy and markets. Currently, China's growth accounts for around one-third of global GDP growth. That figure is higher now when China's projected 2019 growth is 6-6.5% than it was when China was growing at 10%. Based on the size of the economy compared to the rest of the world, combined with the fact that onshore stocks and bonds have been excluded from global benchmarks up until recently, it's not a stretch to extrapolate that Chinese equities and bonds are significantly underweight in most investors' portfolios.

Currently, Chinese equities represent around 29% of broad emerging markets benchmarks in the form of H-shares, which are traded on the Hong Kong exchange. These are commonly known as "Chinese offshore stocks." Once A-shares (also known as "Chinese onshore stocks") are fully included, Chinese equities will represent nearly 40% of the broad emerging markets indices. Investors must consider whether that is a weight they are comfortable with in their emerging markets allocation. An alternative would be to view China as a standalone, strategic allocation at a weighting that aligns with an investor's views and risk/return preferences, complemented by other broad emerging markets or specific country and regional exposures.

There are several potential benefits to maintaining a weight to Chinese equities in most strategic allocations. Compared to other major asset classes, A-shares and onshore bonds have exhibited low correlations, providing potential diversification benefits within a broader portfolio. Chinese equities, in particular, are also showing relatively attractive

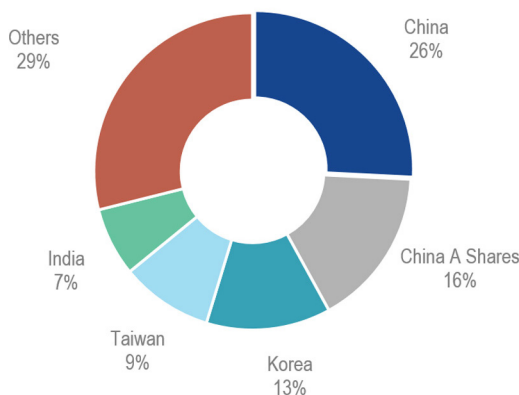
MSCI EM Index with 20% Inclusion Factor*

– China A Shares



MSCI EM Index with 100% Inclusion Factor*

– China A Shares



Source: MSCI

*Inclusion Factor (%) refers to the percentage of the eligible market cap of A-shares included in the benchmark index

valuation levels when compared to their historical P/E ratios. Even when accounting for Q1 2019's rally, Chinese equities still have some ways to go before they reach the overbought levels that were seen in 2015's equity bubble.

There are also risks in Chinese stocks which may not be present in other developed equity markets. To start, Chinese onshore equity ownership and behavior has historically skewed towards retail ownership. In the past, this has led to much more volatility than other markets with heavy institutional ownership. Evidence of this volatility, and resulting bubbles, can be seen as recently in 2015 and the dramatic selloff that occurred in early 2016. Investors should consider these risks when sizing their exposure.

DISCLOSURES

¹ Source: CNBC, <https://www.cnbc.com/2019/01/11/china-set-to-lower-gdp-growth-target-in-2019-policy-sources-say.html>

² Source: Matthews Asia, <https://matthewsasiasia.com/perspectives-on-asia/asia-insight/article-1275/default.fs>

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The CSI 300 Index is comprised of the 300 largest and most liquid stocks in the Chinese A-share market.

The SME-ChiNext 100 Index tracks the performance of the 100 largest and most liquid China A-share stocks listed and trading on the Small and Medium Enterprise (SME) Board and the ChiNext Board of the Shenzhen Stock Exchange.

The Bloomberg Barclays Global Aggregate Bond Index measures global investment grade debt from 24 local currency markets. It includes treasury, government-related, corporate, and securitized fixed-rate bonds from both developed and emerging markets issuers.

The ChinaBond China High Quality Bond Index comprises fixed-rate, Renminbi (RMB)-denominated bonds issued in the People's Republic of China by Chinese credit, governmental, and quasi-governmental (e.g., policy banks) issuers.

The Bloomberg Barclays US Aggregate Bond Index is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. This includes treasuries, government-related and corporate securities, mortgage-backed securities, asset-backed securities and collateralized mortgage-backed securities.

The J.P. Morgan GBI-EM Global Core Index tracks bonds issued by emerging markets governments and denominated in the local currency of the issuer. The weighting scheme provides additional diversification by more evenly distributing weights among the countries in the index. Countries are capped at 10% and floored at 3%.

The MSCI Emerging Markets Index captures large- and mid-cap representation across 24 Emerging Markets (EM) countries. The index covers approximately 85% of the free float-adjusted market capitalization in each country.

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