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Opening the Doors to China's Markets

In this report, we examine the growing opportunities for investors to gain exposure to China's markets, from key policy changes to its inclusion in equity and fixed income benchmarks.

China's economic engine accounts for roughly a fifth of global output, yet foreign investors own a mere fraction of the mainland markets' stocks and bonds due to years of restrictive government policies.

But access to China's domestic market is gradually expanding as the Chinese government slowly and decisively eases its grip on the flow of foreign money into domestic markets. This presents an important opportunity for investors. Looser restrictions have resulted in more foreign institutional investing and increased market liquidity. The progress has given global index providers more confidence to include mainland China stocks and government bonds in benchmarks. For funds tied to those benchmarks, China's Great Wall is looking less tall.

China is being deliberate in its approach to market liberalization in part to avoid dramatic swings in capital flows, which could add significant volatility to both financial markets and economic growth. The domestic equity markets, dominated by retail investors, have exhibited many periods of high volatility already. The presence of more foreign institutions with significant assets and long-term investing horizons would ideally lead to greater stability while diversifying the economy's sources of capital.

But the exit door needs to appear open as well in order for foreign investors to explore relatively untested pathways to mainland exchanges. Among the subjects of foreign bond investor scrutiny is the settlement process for trades and a general wariness of local credit ratings in China's bond market, as well as an uptick in defaults amid the country's ongoing deleveraging drive. In addition, frequent trading halts due to volatility have caused uneasiness for overseas equity investors. And now, with trade tensions escalating with the U.S., anxiety is rising.

Even if some investors choose to remain on the sidelines for now, change is underway. Those with global portfolios would do well to familiarize themselves with the Chinese market as it continues to push forward with opening access, and opportunities, to foreign investors.

The Background

The fundamental framework when thinking about investing in China is the staying power of its one-party system. Lacking frequent elections, policymakers tend to construct economic plans with a multi-decade time horizon. Monetary and fiscal policies focus on sustaining economic growth above roughly 6% per annum while steering a massive shift from an export-driven, industrial economy to one more focused on domestic consumption. But the system cannot remain closed if China's currency is to gain greater international status, which is what the government wants.

With domestic growth holding steady and infrastructure investments around the world showcasing China's power and reach, the timing is right for carefully unveiled policies and rules that allow more foreign money to flow in and out of China's markets.

China's roughly $12 trillion bond market is the third largest in the world and is expected to soon surpass Japan's bond market. China's government, quasi-sovereign, and corporate debt alone totals roughly $6.5 trillion, with commercial paper, municipal securities and various other instruments making up the balance. Foreign investors own only a small portion of China's debt assets.

China's equity market, with a market capitalization close to $6 trillion, is opening to foreigners at a more rapid pace. The Hong Kong Stock Exchange has been hosting Chinese listings as "H" shares quoted in Hong Kong dollars for a long time, and that's where many foreign investors have focused their attention thus far. Although Hong Kong listings tend to be the biggest Chinese companies, mainland "A" shares in Shanghai and Shenzhen offer a broader selection of stocks that more fully represent the diverse Chinese economy, including new technology businesses and startups.

China's Gradual Approach

One of the most important steps China took to expand foreign ownership of mainland companies was the Qualified Foreign Institutional Investor (QFII) program launched in 2002. It allowed certain international investors to trade yuan-denominated A-shares, with limits. In addition, in 2011, the Renminbi Qualified Foreign Institutional Investor (RQFII) program gave more foreign investors access to China's mainland market through offshore renminbi accounts. Notably, RQFII resulted in the creation of A-share and onshore bond funds, including ETFs, in the United States and elsewhere. Since then, the programs have expanded to allow additional types of foreign investors to access the market, with fewer restrictions and with incremental but significant changes.

Another program, Stock Connect, bridges trading between the Shanghai, Shenzhen, and Hong Kong stock exchanges. Trading is subject to daily quotas, but these limits have increased since first being introduced. A Shanghai-London stock connect program is also in the works, and the Bond Connect program begun in 2017 allows qualified foreign investors to buy Chinese bonds issued in the domestic market through Hong Kong.

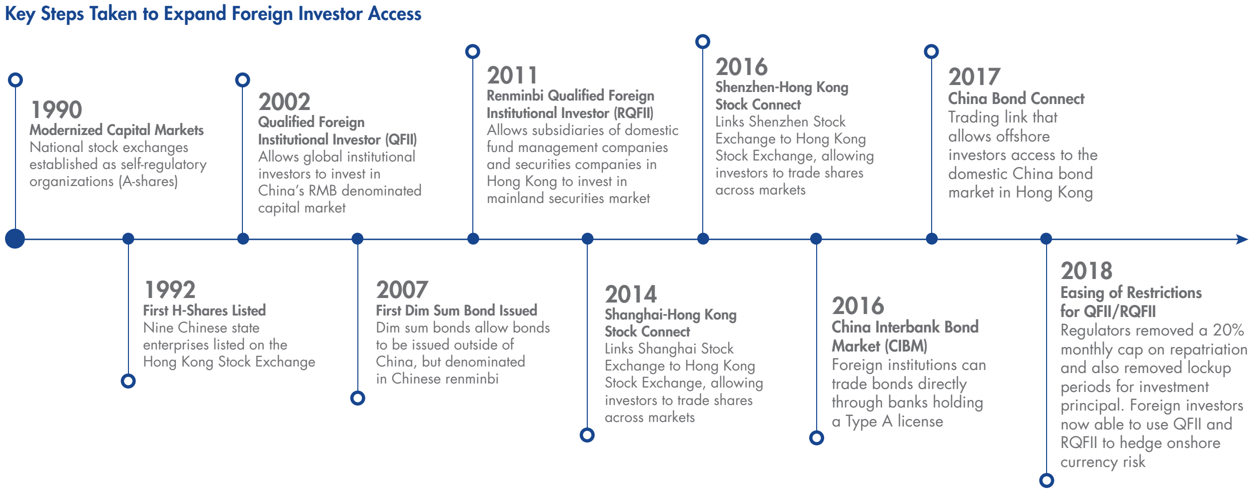
With all this in motion, and after years of review, MSCI has decided to add 234 China Large Cap A-shares to its indices in 2018 as part of a rolling addition of shares over time. A-shares alone will only account for a surprisingly small 0.8% of MSCI's broad emerging markets benchmark by year-end, because MSCI is including only 5% of the A-share market in this benchmarks as of September 2018. In September of 2018, MSCI also announced plans to increase the inclusion factor for Large Cap A-shares from 5% to 20% in two phases over the course of 2019. Securities trading on the ChiNext exchange will also become eligible for inclusion in 2019. Additionally, MSCI set the stage for Mid Cap A-shares to be included in its indices by May of 2020. Once the Mid-Cap A-shares have been added, a total of 434 A-shares will be in the flagship emerging markets index. In addition, other index providers have followed in MSCI's steps. This is an important opportunity for investors as billions of dollars flow into funds indexed, in part or in whole, to the Chinese market.

What's Next: Bond Index Inclusion

Investment in roads, ports, and other infrastructure over the past decade has coincided with a significant increase in onshore debt. The state backs much of it, but the government is allowing defaults to occur at an escalating rate. This is worrisome, especially if the size of the debt problem becomes bigger than market participants anticipated. But the trend of allowing failure can also be viewed positively: it is a sign that the government is allowing some bad loans to fail as they would in any open market. We expect that a shift towards market-based pricing that better reflects underlying investment risk will ultimately lead to more efficient allocation of capital.

Participation in China's interbank market for debt, an over-the-counter market dominated by China's large banks, is also expanding to include a more diverse group of participants, including foreign entities, following steps taken over the past several years. The China Interbank Bond Market (CIBM) allows bond trading for approved entities, including central banks, asset managers, pension

Key Steps Taken to Expand Foreign Investor Access



Source: VanEck.

funds, insurers, and other large investors. The People's Bank of China has also modified trading quotas and other restrictions to attract additional foreign investors.

Still, investors are right to be cautious. International credit rating agencies were only allowed to establish a presence for the first time in 2017, and independent bond ratings will take time to develop.

Interest in China's domestic bond market has surged this year after Bloomberg announced it would be the first index provider to add Chinese government bonds and policy bank bonds to its benchmark, the Bloomberg Barclays Global Aggregate Index. China debt will total roughly 5.5% of assets in that index once fully included, with inclusion over a 20-month period expected to begin in April 2019.

JP Morgan has been more cautious about including Chinese bonds in its indices. If Chinese government bonds do get added to its most widely followed emerging market local currency debt index, the J.P. Morgan GBI-EM Global Diversified Index, the indexer would ultimately cap China sovereign bonds at 10% of assets. However, China would comprise over 40% on an uncapped basis due to the market's massive size.

How to Access It

As Chinese assets gradually gain representation in broad global equity and fixed income benchmarks, exchange-traded funds (ETFs) that track these indices may offer one option for investors seeking to complete their global equity and bond exposures. Investors may also turn to ETFs for opportunities in China's vast onshore markets that may be underrepresented in these benchmarks. Although China is being added to global equity and bond indices, investors may not be getting exposure to the full opportunity set simply by tracking global benchmarks. This is true even for the MSCI Emerging Markets Index, where China is the largest country exposure.

Major stock indices that track China's domestic equity market include the CSI 300 Index, which includes the 300 largest, most liquid A-shares traded in Shanghai and Shenzhen. The VanEck Vectors ChinaAMC CSI 300 ETF (PEK) tracks the CSI 300 Index, which represents pure onshore Chinese equity and currency exposure, in contrast to the MSCI China Index, which includes offshore H-shares and other non-Renminbi securities. Other options include the SME-ChiNext 100 Index, representing the 100 largest and most liquid small- and mid-sized companies listed on two Shenzhen boards. The VanEck Vectors ChinaAMC SME-ChiNext ETF (CNXT) offers investors exposure to new-economy, entrepreneurial businesses that may not be included in the broad emerging markets benchmark, even after A-share inclusion.

On the fixed income front, the ChinaBond China High Quality Index tracks multi-sector onshore bonds. The VanEck Vectors ChinaAMC China Bond ETF (CBON) offers investors exposure to corporates and policy banks that are not currently found in global or emerging market bond indices. If and when J.P. Morgan decides to include China in its suite of investable local bond indices, investors may look to the VanEck Vectors J.P. Morgan EM Local Currency Bond ETF (EMLC), which tracks the J.P. Morgan GBI-EM Global Core Index. The index's coverage includes diversified local currency emerging market sovereign bonds, with Chinese government bonds expected to have a 10% weight if included.

The Risk and the Reward

Emerging markets faced pressure in 2018, and China specifically faces increased investor scrutiny as the government responds to U.S. tariffs on more than $200 billion in Chinese exports. Chinese currency and asset prices may remain under pressure, and selloffs can be abrupt and deep.

Foreign investors should mind volatility trends. The deleveraging of balance sheets is bound to affect the bond market, and retail investors in China have proven adept at day-trading.

Ultimately, however, the Chinese economic transition is in full swing. Abroad, the People's Republic is showing its financial muscle with its far-reaching Belt and Road investments. Domestically, it is focused on attracting the capital necessary to fund its economic goals, while redistributing a portion of the risk of those investments to foreign investors for decades to come. And as indices recognize China's size, financial reforms, and market stability, Chinese stocks and bonds are sure to play an increasingly important role in investor portfolios.

IMPORTANT DISCLOSURES

The Bloomberg Barclays Global Aggregate 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 J.P. Morgan GBI-EM Global Diversified Index tracks emerging markets local government bonds that are accessible by most foreign investors. The weighting scheme provides additional diversification by more evenly distributing weights among the countries in the index. Countries are capped at 10%.

The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. The MSCI Emerging Markets Index consists of the following 23 emerging market country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey, and United Arab Emirates.

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

The MSCI China Index captures large and mid cap representation across China H shares, B shares, Red chips, P chips and foreign listings (e.g. ADRs). The index covers about 85% of this China equity universe.

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 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 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%.

All indices listed are unmanaged indices and do not reflect the payment of transaction costs, advisory fees or expenses that are associated with an investment in the fund. Certain indices may take into account withholding taxes. An index's performance is not illustrative of the fund's performance. Indices are not securities in which investments can be made.

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In addition, the Funds are also subject to liquidity and valuation risks, currency risk, non-diversification risk, and other risks associated with foreign and emerging markets investments. The Funds may gain exposure to the China A-Share market by directly investing in China A-Shares and investing in swaps that are linked to the performance of China A-Shares. An investment in the Funds involves a significant degree of risk, including, but not limited to, those associated with investments in Chinese securities, particularly A-Shares, risk of RQFII regime and the Fund's principal investment strategy, investing through Stock Connect, foreign securities, emerging market issuers, foreign currency, consumer discretionary sector, financial services sector, industrials sector, basic materials sector, information technology sector, swaps, futures, other funds, small – and medium-capitalization companies, cash transactions, equity securities, market, operational, index tracking, authorized participant concertation, no guarantee of active trading market, trading issues, passive management risk, fund shares trading, premium/discount risk and liquidity of fund shares, concentration risks and the Adviser's and Sub-adviser's ability to manage the Funds, which depends upon the availability of China A-Shares and the willingness of swap counterparties to engage in swaps linked to the performance of China A-shares all of which may adversely affect the Funds. The Funds may invest in swaps and derivatives which entail certain risks, including limited availability of swaps, counterparty risk, liquidity risk, risks of A-shares, tax risk (including short-term capital gains and/or ordinary income), and currency risk. Foreign and emerging markets investments are subject to risks, which include changes in economic and political conditions, foreign currency fluctuations, changes in foreign regulations, and changes in currency exchange rates and may negatively impact the Fund's returns, unstable governments, and limited trading capacity which may make these investments volatile in price or difficult to trade. The Funds may also invest in shares of other funds and absorb duplicate levels of fees with respect to these investments. Small- and medium-capitalization companies may be subject to elevated risks. The Fund's assets may be concentrated in a particular sector and may be subject to more risk than investments in a diverse group of sectors.

An investment in the VanEck Vectors® ChinaAMC China Bond ETF (CBON®) may be subject to risks which include, among others, investing in RMB bonds, RQFII regime and other Chinese bond market programs, Renminbi currency, Chinese banking industry, sovereign and quasi-sovereign bond, financial services, industrials, credit, interest rate, subordinated obligations, foreign securities, emerging market issuers, cash transactions, market, operational, sampling, index tracking, authorized participant concentration, no guarantee of active trading market, trading issues, passive management, fund shares trading, premium/discount and liquidity of fund shares, non-diversified and concentration risks, all of which may adversely affect the Fund. Investments in mainland China may be subject to local customs, duties and rights of ownership, which might change at any time should policy makers deem them in China's best interest.

CNXT, PEK and CBON Fund shares are not individually redeemable and will be issued and redeemed at their net asset value (NAV) only through certain authorized broker-dealers in large, specified blocks of shares called "creation units" and otherwise can be bought and sold only through exchange trading. Shares may trade at a premium or discount to their NAV in the secondary market. You will incur brokerage expenses when trading Fund shares in the secondary market. Past performance is no guarantee of future results.

Through the Renminbi Qualified Foreign Institutional Investor (RQFII) program or Qualified Foreign Institutional Investor (QFII) licenses, RMB Bonds are made available to certain foreign investors. The RQFII approves a specific aggregate dollar amount in which the RQFII or QFII can invest in RMB Bonds. The size of the Fund's direct investment in RMB Bonds will be limited by the size of the RQFII quota, and should this quota be depleted, there is no guarantee more will be granted.

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Van Eck Securities Corporation, Distributor
666 Third Avenue | New York, NY 10017
vaneck.com | 800.826.2333

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