

China in the Spotlight

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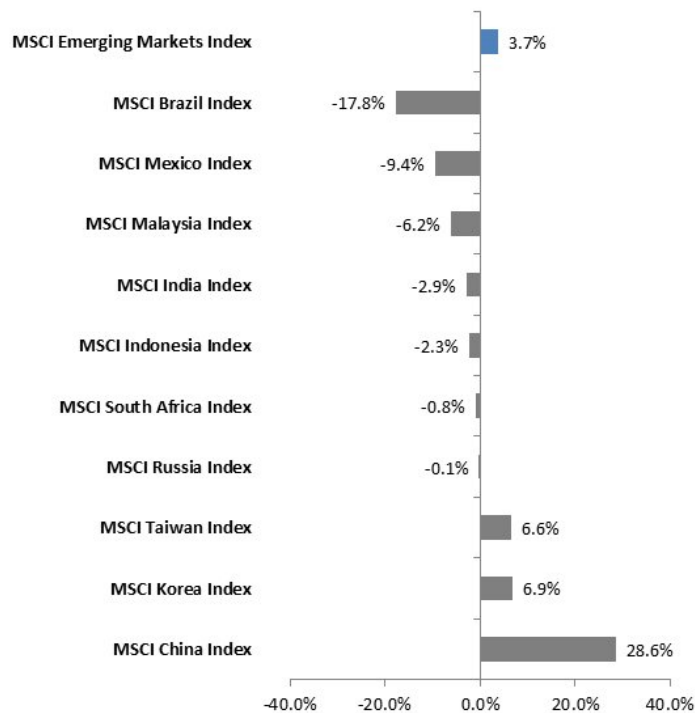
While 2014 was a challenging year for emerging markets, the story in 2015 has been substantially different so far. The MSCI Emerging Markets Index has returned around 9.0% year-to-date; this is in stark contrast with 2014, where performance retracted 2.2%. At a country level, both China and Russia have been primary contributors to this recovery. China's big moves commenced after the People's Bank of China (PBoC) embarked on its new policy-easing cycle in November of 2014; since then China has returned 28.6%.¹ Below we focus on measures China has undertaken to support its economy and its financial markets. Since November of 2014, PBOC has cut deposit and lending rates on three separate occasions and reduced its banks reserve ratio requirement (RRR) twice. We highlight its key policy decisions below:

1) **Cutting Deposit and Lending Rates:** The PBOC has been deploying a set of monetary easing tools to stabilize growth and mitigate disinflationary pressures. It has done so by adopting a more accommodative monetary policy stance. Consequently, over a span of six months, deposit rates have been cut by 25 basis points (bps) on each of the three occasions. Additionally, lending rates were cut from 6% to 5.1% over a similar time frame.

2) **Cutting RRR:** RRR cuts in China are an important tool for sustaining money growth, which subsequently lowers funding costs and helps promote credit growth. Many believe that without the RRR cuts—which are akin to liquidity injections—cutting deposit and lending rates alone would not lead to lower funding rates for the economy. The PBoC has cut RRR twice over the past four months, by 50 and 100 bps, respectively. Present-day RRR is 18.5%,² and Xiaojia Zhi, China economist at Bank of America Merrill Lynch, believes that more sustainable RRR over a four-to-five-year horizon is closer to 10%, so there may be more RRR cuts to come.

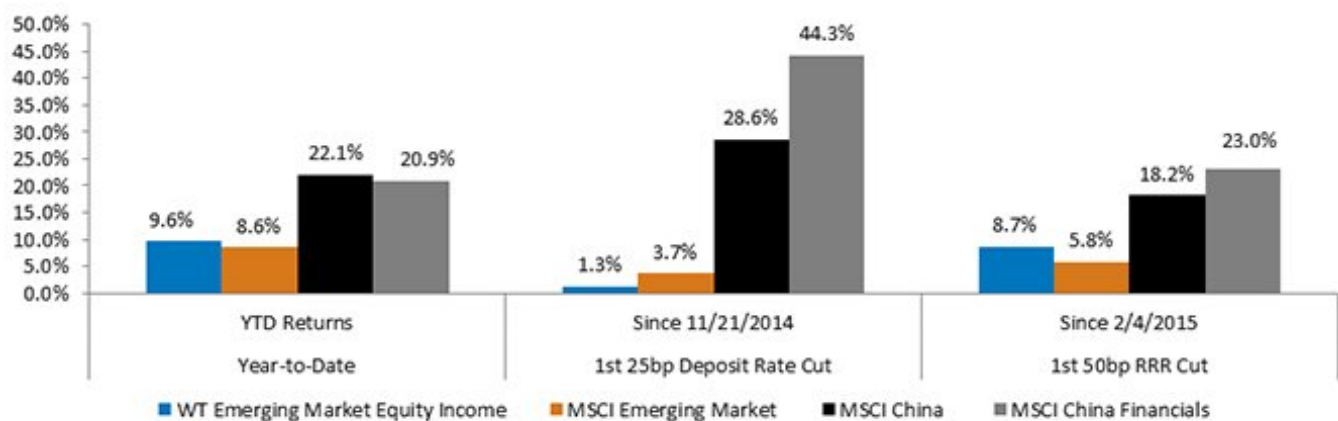
3) **Local Government Debt-for-Bond Swap:** The Finance Ministry recently allowed localities to sell up to 1 trillion yuan of government-guaranteed bonds to replace their existing debt—mostly in the form of short-term bank loans. To further incentivize banks to purchase these bonds, the PBOC now allows commercial banks to use these government bonds as collateral to take out low-interest-rate loans from the central bank. These funds will ultimately be directed in the form of loans to small and private businesses at an affordable rate, thus driving credit expansion. The PBOC hopes to be able to guide interest rates lower through this debt-swap tool.

Figure 1: China Driving the Emerging Market Bus since Initiating Easing Measures



Sources: WisdomTree, Bloomberg, with data from 11/21/14 to 5/21/15 on USD returns. Start date chosen because it was the first date that easing measures were announced by the PBOC. Top 10 countries by market cap in MSCI Emerging Markets Index. Past performance is not indicative of future results. You cannot invest directly in an index.

Figure 2: PBOC Policy Easing Buys Equities



Sources: WisdomTree, Bloomberg, with data from 11/21/14 to 5/21/15. Past performance is not indicative of future results. You cannot invest directly in an index.

China has been a standout performer in the EM universe: • **China Returned More than 7x That of the Broad EM Markets.** While the broader MSCI EM Index was 3.7% higher during the period of PBOC easing, MSCI China returned 28.6%. Due to the targeted nature of the PBOC's easing programs, returns on the financial sector were even greater, at 44.3% in a similar time frame. • **Valuations Still Attractive Despite Run-up in EM Equities.** WisdomTree's high dividend emerging market Index—the [WisdomTree Emerging](#)

[Markets Equity Income Index \(WTEMHY\)](#)—has a strict focus on stocks with relatively low valuations (high dividend yields) and has its largest country-level position in Chinese stocks. China represents over 22% of WTEMHY's exposure. • **While WTEMHY Appreciated 9.6% Year-to-Date, Valuations Remain Attractive.** In particular, WTEMHY has a 10.9x [price-to-earnings \(P/E\)](#) multiple and a dividend yield of 5.67%. For comparison purposes, the S&P 500 Index has a P/E ratio of 18.8x and a dividend yield of 1.96%. *Bottom line:* The broad EM region boasts relatively attractive P/E ratios and dividend yields when compared to the broad Europe, EAFE or U.S. markets. While we are in the early innings of PBoC's policy accommodation—and certainly early in the economic growth numbers showing any meaningful signs of strength—we are encouraged by the signs of stabilization in EM currencies as well as EM equities. There remains a large valuation case to be made for both the equity and currency asset classes in EM, which in itself is a rare occurrence in most other regions. 1Source: Bloomberg between 11/21/2014-5/21/2015. 2Source: Bloomberg, as of 5/21/15.

Important Risks Related to this Article

Investments in emerging, offshore or frontier markets are generally less liquid and less efficient than investments in developed markets and are subject to additional risks, such as risks of adverse governmental regulation and intervention or political developments.