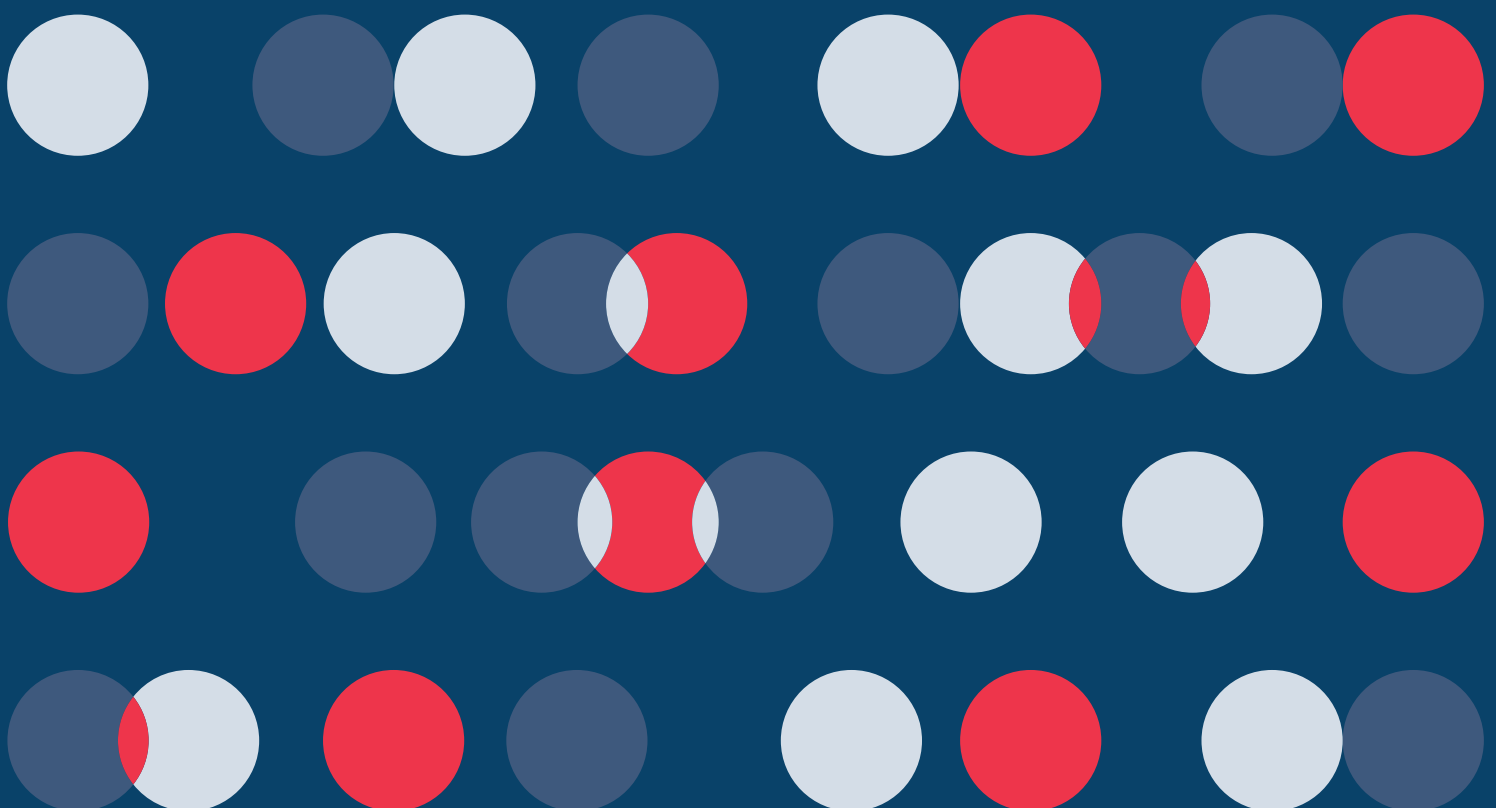


June 2018

RESEARCH REPORT

INVESTMENT OPPORTUNITIES IN
ASIAN GROWTH MARKETS AND
RELATED RISK MANAGEMENT



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SUMMARY

Asia has been the growth engine of the world. Excluding the advanced economy of Japan, the region comprises mostly of emerging or developing markets among which China is in lead. The Asia ex Japan (AxJ) economies have recorded higher growth rates than the developed economies in the past decade and are expected to continue this rapid upward trend. Conductive factors include the free trade initiatives in the region, China's spearheading effect and its Belt and Road Initiative, economic cooperation initiatives of the Association of South East Asian Nations (ASEAN), the domestic economic development plans and bilateral trade and economic cooperation agreements of the individual countries in the region, and the resultant deepening regional integration.

In the light of the potential offered by the Asian growth economies, **AxJ thematic investment** has become increasingly appealing to global investors. Specific benchmarks have been developed to track the investment performance in the AxJ capital markets. These include the MSCI AC Asia ex Japan Index and the FTSE Asia ex Japan Index. These market indices serve as benchmarks for passive investment tools such as exchange traded funds (ETFs), which have become increasingly popular in the world's capital market investment. For tapping the AxJ growth potential, ETFs on AxJ benchmarks would be suitable tools.

As with any kind of investment, AxJ investment would have potential downside risks. These include the current trend of interest rate hikes, US tax reforms and trade protectionism, and the vulnerability of the AxJ markets to uncertainties. For investors to manage risks in their AxJ investments, certain AxJ index futures are offered by the European exchanges — Eurex and ICE Futures Europe. No such kind of product is yet available on the Asian exchanges. The new product — **MSCI All Country Asia ex Japan Net Total Return Index Futures**, to be introduced by HKEX on 11 June 2018, will be the first product of this kind in the Asian time zone to serve the needs of global investors.

1. TAPPING THE ASIAN GROWTH POTENTIAL

Global investors, when looking for investment opportunities, generally go for emerging markets where there is high growth potential. Asia, excluding Japan which is a highly developed economy, is the economic region across the world that offers such attractive investment opportunities. As quoted, Asia ex-Japan had surpassed global emerging markets in the portfolios of UK public mutual funds¹. The Asia ex-Japan potential and the underlying contributing factors are discussed below.

1.1 Asian economies being the world's growth engine

In the past decade, emerging markets/economies (EMs), in particular the emerging Asian economies, have recorded much faster real growth rates in gross domestic products (GDP) than developed markets/economies (DMs). According to the International Monetary Fund (IMF), the 30 countries in *Emerging and Developing Asia* constituted 31.6% of the world's aggregate GDP (2017), lower than the 41.8% share by the *Advanced Economies* but comparable to the 31.0% share by the seven *Major Advanced Economies*² (see Table 1). Among the Emerging and Developing Asian Economies, China and India are the leading ones, which have a world GDP share of 17.7% and 7.2% respectively. During the past decade of 2007 to 2016, the seven Major Advanced Economies recorded an average of 0.74% of GDP real growth rate, much lower than the average of 4.89% recorded for the Emerging and Developing Asian Economies³. The corresponding average figures for the leading Asian emerging economies of China and India were 8.41% and 7.08% respectively.

Table 1. Share of economies in world GDP by classification (2017)		
	No. of economies	Share of world GDP
Advanced Economies	39	41.8%
Major Advanced Economies	7	31.0%
United States*		15.5%
Euro Area	19	11.7%
Germany*		3.3%
France*		2.3%
Italy*		1.9%
Spain		1.4%
Japan*		4.4%
United Kingdom*		2.3%
Canada*		1.4%
Emerging Market and Developing Economies (EMDEs)	154	58.2%
<i>Emerging and Developing Asia</i>	30	31.6%
China		17.7%
India		7.2%

* Major Advanced Economies.

Note: The GDP shares are based on the purchasing-power-parity valuation of the economies' GDP.

Source: IMF World Economic Outlook, October 2017.

¹ See Tim Stewart, *Asia ex-Japan the new 'investment destination'*, Investor Daily (www.investordaily.com.au), 7 April 2017.

² Source: IMF World Economic Outlook, October 2017. The GDP shares are based on the purchasing-power-parity valuation of economies' GDP (the same applies to other quoted figures that follow). Countries are as classified by the IMF. The Major Advanced Economies are Canada, France, Germany, Italy, Japan, the United Kingdom (UK) and the United States (US).

³ The average figures are calculated based on the annual GDP real growth rates for each country obtained from the World Bank Databank database (last updated 22 December 2017) and in accordance with the IMF's country classification.

Undoubtedly, Asia has been the growth engine of the world and is expected to remain so in the coming years. According to the World Bank⁴, growth in advanced economies is expected to moderate slightly in 2018 to 2.2% (compared to an expected growth of 2.3% in 2017) and to an average of 1.8% in 2019-2020; while growth among *emerging market and developing economies* (EMDEs) is expected to accelerate, reaching 4.5% in 2018 (compared to an estimated 4.3% in 2017) and an average of 4.7% in 2019-2020. Among EMDEs, Asian economies are outperforming in particular. The growth rate for EMDE East Asia and Pacific region is projected to be 6.2% in 2018 and to achieve an average of 6.1% in 2019-2020, owing much to a structural slowdown in China. An even stronger growth is expected for EMDE South Asia region (covering India and Pakistan) — a projected growth of 6.9% in 2018 and 7.2% on average in 2019-2020. (See Table 2.)

Table 2. Real GDP growth rates ⁽¹⁾ of advanced economies and EMDEs				
(In percent, %)	2017 (Estimate)	2018 (Forecast)	2019 (Forecast)	2020 (Forecast)
World	3.0	3.1	3.0	2.9
Advanced economies⁽²⁾	2.3	2.2	1.9	1.7
US	2.3	2.5	2.2	2.0
Euro Area	2.4	2.1	1.7	1.5
Japan	1.7	1.3	0.8	0.5
EMDEs⁽²⁾	4.3	4.5	4.7	4.7
East Asia and Pacific	6.4	6.2	6.1	6.0
China	6.8	6.4	6.3	6.2
Indonesia	5.1	5.3	5.3	5.3
Malaysia	5.8	5.2	5.0	4.7
Philippines	6.7	6.7	6.7	6.5
Thailand	3.5	3.6	3.5	3.4
South Asia ⁽³⁾	6.5	6.9	7.2	7.2
India	6.7	7.3	7.5	7.5
Pakistan (factor cost)	5.3	5.5	5.8	6.0

⁽¹⁾ GDP at market prices, measured in constant 2010 US dollars.

⁽²⁾ Only selected regions and countries are shown.

⁽³⁾ Data refer to fiscal years for the countries for 2017/18 to 2020/21.

Source: *Global Economic Prospects — Broad-Based Upturn, but for Hong Kong?*, The World Bank, January 2018.

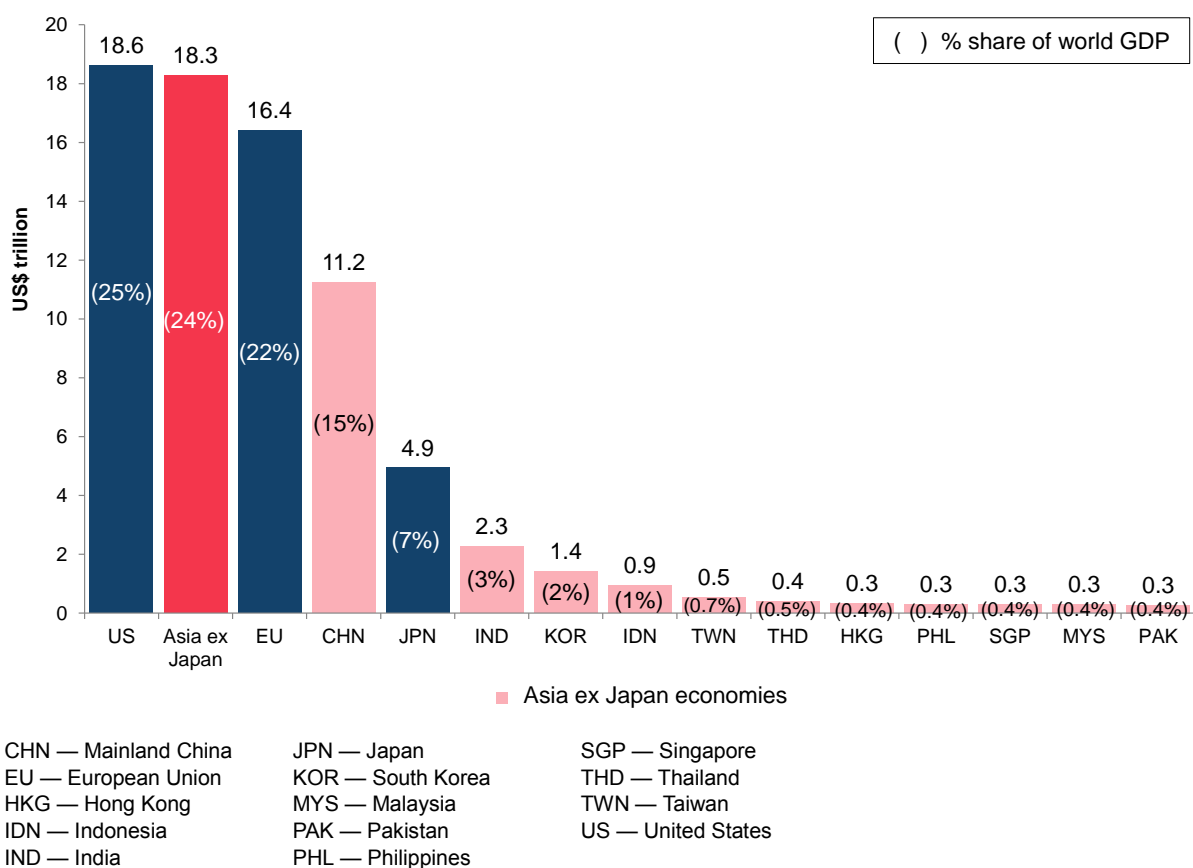
1.2 Asia ex Japan economies — An attractive investment theme

Most of the economies in the Asian region are emerging or developing markets excluding Japan, which is one of the Major Advanced Economies as defined by the IMF. Others include small but relatively more developed economies like Hong Kong and Singapore. These markets in aggregate constitute a significant weight in the world economy and most of them have their economic growth outperforming the major developed economies (see below).

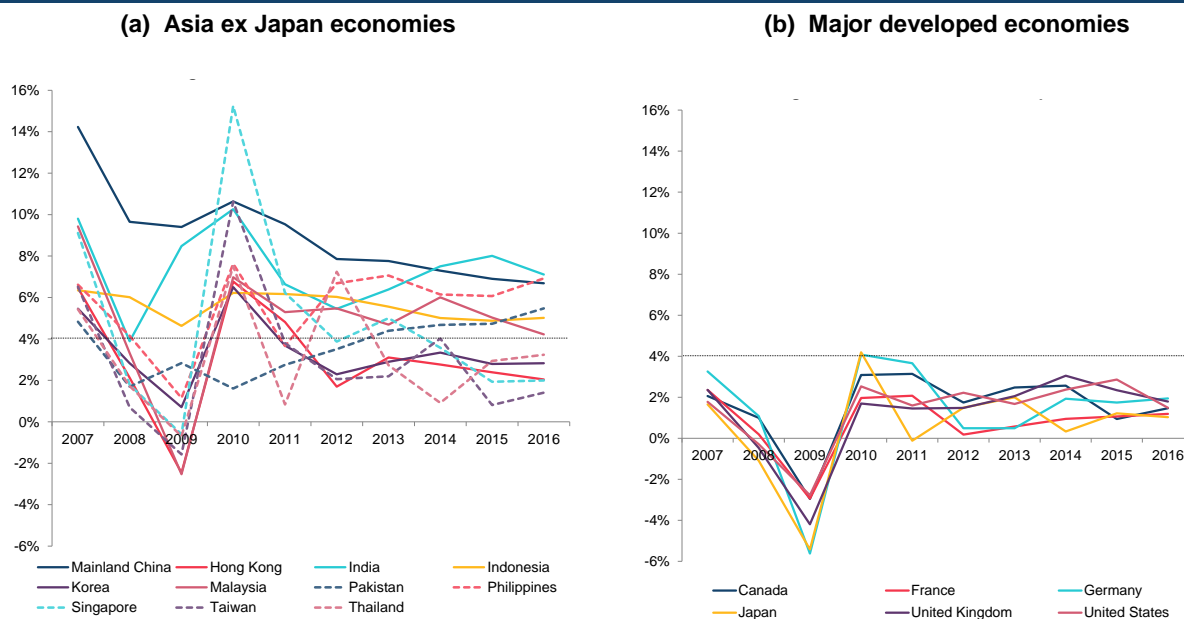
In 2016 nominal GDP terms⁵, China and ten other top Asia ex Japan economies together constitute 24% of the world's GDP, which is close to the share by the US (25%) and higher than that of the European Union (EU) (22%) (see Figure 1). Among these economies, Hong Kong, Singapore, South Korea and Taiwan are classified as Advanced Economies by the IMF; the other seven are EMDEs.

⁴ *Global Economic Prospects — Broad-Based Upturn, but for How Long?* The World Bank, January 2018.

⁵ Per IMF "World Economic Outlook Database".

Figure 1. Nominal GDP of Asia ex Japan economies vs major developed economies (2016)

Source: IMF World Economic Outlook Database, as quoted from Wikipedia.

Figure 2. Real GDP growth rates of Asia ex Japan economies vs major developed economies (2007 – 2017)

Source: Taiwan National Statistics website for Taiwan figures; World Bank Databank for others.

In the past decade, many of these Asia ex Japan (or AxJ) economies achieved more promising GDP growth rates than the developed economies (see Figure 2 above) and are expected to continue their relatively strong growth (see Section 1.1 above). The conducive factors are discussed below.

Free trade initiatives in the East vs protectionism in the West

In the western developed economies, trade protectionism and deglobalisation have become the prevailing sentiment, symbolised by the current US President's "America First" policy and the UK's exit from the EU (so-called Brexit). The US withdrew from the Trans-Pacific Partnership (TPP) in 2017 and the agreement between the remaining 11 signatories⁶ is not yet in force. Negotiations on the proposed Transatlantic Trade and Investment Partnership (TTIP) trade agreement between the EU and the US were halted following the 2016 US presidential election and not much progress has been seen. Nevertheless, developed economies are expected by the World Bank to achieve a moderate growth in the coming few years, led by a cyclical upturn in investment and further normalisation of monetary policy⁷. Yet, this forecast has not taken into account the recent initiatives by the US to impose punitive tariffs on certain imports from China and other countries, and the expected reciprocal actions by China and possibly by others⁸.

In contrast to the anti-globalisation moves in the developed economies, the AxJ economies are active in pursuing trade and investment partnerships between countries, providing driving forces to maintain their relative high growth momentum. Moreover, owing to their current state of relative underdevelopment, there is enormous potential for heavy investments in current and future infrastructure developments. This would bring about abundant investment and growth opportunities for enterprises and pave the way for more economic activities that support further growth.

China's Belt and Road Initiative

The *Belt and Road Initiative* (BRI), or the *One Belt One Road* (OBOR) initiative, was firstly raised by the Chinese President Xi Jinping in 2013. The initiative consists of the the Silk Road Economic Belt (SREB) and the 21st Century Maritime Silk Road (MSR). The SREB runs through Central Asia, West Asia, the Middle East to Europe, with extension to South Asia and Southeast Asia. The MSR runs through Southeast Asia, Oceania and North Africa. In a subsequent event in 2013, Chinese Premier Li Keqiang emphasised the need to build the MSR oriented toward the Association of South East Asian Nations (ASEAN)⁹. In March 2015, the Chinese Government issued the action plan on the BRI, stating that accelerating the building of OBOR can help promote the economic prosperity of the countries along OBOR and regional economic cooperation, strengthen exchanges and mutual learning between different civilisations, and promote world peace and development. According to the action plan, the BRI is aimed at promoting orderly and free flow of economic factors, highly efficient allocation of resources and deep integration of markets; encouraging the countries along OBOR to achieve economic policy coordination and carry out broader and more in-depth regional cooperation of higher standards; and jointly creating an open, inclusive and balanced regional economic cooperation architecture that benefits all.

The BRI is said to involve over 100 countries — over 60 along OBOR¹⁰ and many others participating through joining the Asian Infrastructure Investment Bank (AIIB)¹¹, developing

⁶ Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, Vietnam.

⁷ *Global Economic Prospects — Broad-Based Upturn, but for How Long?*, The World Bank, January 2018.

⁸ Market comments generally took the view that the US's anti-trade initiatives would hurt itself more than its counterpart, China. See, for example, *Trump-style tariffs against China would shoot US in the foot*, Financial Times, 6 April 2017.

⁹ ASEAN consists of the ten nations of Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Vietnam.

¹⁰ The report, *Industrial cooperation between countries along the Belt and Road* (《「一帶一路」沿線國家產業合作報告》), released by the China International Trade Institute in August 2015 identified 65 countries along OBOR that will be participating in the initiative.

¹¹ AIIB is a multilateral development bank headquartered in Beijing, which is promoted by China to be established to support the BRI, with a mission to improve social and economic outcomes in Asia and beyond. As at the end of 2017, AIIB had a total of 84 approved members from around the world.

transport infrastructure in collaboration with China, or through other forms of cooperation¹². A series of infrastructure projects, such as highways and railways, in OBOR countries have been initiated and underway. These are actively participated in by China both in financing and in the construction work. At the Belt and Road Forum for International Cooperation in May 2017, the Chinese President reaffirmed China's commitment to globalisation and free trade by promising a US\$124 billion investment into countries along OBOR.

Many of the developing countries along OBOR lack the financial capacity to develop the infrastructure themselves either by public or private means. Backed by China in the OBOR projects, these countries will benefit from the resultant enhanced infrastructural establishments, foreign investment and the trade and economic activities so stimulated. China itself has committed to further opening up its market with greater international cooperation.

The identified OBOR countries had a combined share of about one-third of the world's GDP and one-quarter of global trade in goods and services¹³. The BRI is expected to create abundant job and trade opportunities for people and enterprises in the region.

The ASEAN power

Apart from the Asian giants of China and India, the ASEAN has emerged as a burgeoning economic community — the ASEAN Economic Community (AEC) was established in 2015 with the aim of implementing economic integration initiatives to create a single market across ASEAN nations. Five of the 11 AxJ top economies identified above (see Figures 1 and 2) are ASEAN nations. ASEAN serves as a platform for inter-nation integration and cooperation both within Asia as well as between Asia and the rest of the world. As a result, there are ASEAN Plus Three (including China and Korea in AxJ)¹⁴ and ASEAN Plus Six (including India in AxJ as well)¹⁵ and the subsequent development of the Regional Comprehensive Economic Partnership (RCEP), a proposed free trade agreement involving the 16 countries of ASEAN Plus Six, in addition to the many free trade initiatives within ASEAN and with the world. Hong Kong, for example, has recently signed a Free Trade Agreement and a related Investment Agreement with ASEAN in November 2017, which will help boost bilateral trade and investment activities.

All ASEAN member states are also economies along OBOR. ASEAN's free trade initiatives and the BRI are expected to complement each other and together multiply the growth impetus in the Asian region. According to a recent report released by the ASEAN+3 Macroeconomic Research Office (AMRO)¹⁶, the ASEAN economies would benefit from BRI in respect of energy supply, infrastructure connectivity and regional integration. The report projected a total of US\$ 600-800 billion overseas investment to be made by China for BRI in the coming 5 years, which would also stimulate private investment in ASEAN countries.

¹² The report, *The Belt and Road Initiative: 65 Countries and Beyond*, Fung Business Intelligence Centre, May 2016, identified 48 such countries.

¹³ Source: *The Belt and Road Initiative: 65 Countries and Beyond*, Fung Business Intelligence Centre, May 2016; website of the Singapore Government (<https://www.iesingapore.gov.sg>).

¹⁴ Adding the People's Republic of China, Japan and South Korea.

¹⁵ Further adding Australia, New Zealand and India.

¹⁶ ASEAN+3 *Regional Economic Outlook 2018* released on 3 May 2018.

Economic initiatives in Asia ex Japan countries¹⁷

Asian developing countries have been actively pursuing infrastructural development to boost economic growth, now further promoted by the BRI. Six major economic corridors¹⁸ were proposed under the BRI, a number of which will run through the AxJ countries. Among the Southeast Asian countries, Malaysia, Singapore, the Philippines, Indonesia and Thailand are considered major cooperation partners with China. Below are some examples of the recent economic development initiatives of AxJ countries:

- **Malaysia** and China recently signed nine Memoranda of Understanding and agreements to be worth US\$7 billion. These include a number of investment projects in Malaysia, including construction, agriculture, stock exchange, infrastructure, and port and airport cooperation. It has targeted to roll out four major rail projects in 2018, estimated to cost a total of about US\$40 billion.
- **Malaysia and Singapore** signed an agreement in January 2018 to form a joint venture in the year to run the Rapid Transit System (RTS) Link from Johor Baru of Malaysia to Singapore.
- **Singapore** was the first Asian country to sign a comprehensive free trade agreement with China. The two countries are working on the China-Singapore (Chongqing) Connectivity Initiative and a Southern Trade Corridor to reduce the cost and enhance the flow of trade between Southeast Asia and Western China.
- **South Korea** outlined its “Eurasia Initiative” in 2013, calling for linking of energy and logistic infrastructure (such as rail networks, oil and gas pipelines, and electricity grids) across Europe and Asia. Commitment to this initiative was re-affirmed in 2016. Gradual elimination of trade barriers is also expected, leading to the establishment of a vast free trade zone. In addition, the Korean president Moon Jae-in, after taking office, proposed a “New Northern Policy” — building “nine bridges” and infrastructural projects with Russia, and a “New Southern Policy” that seek to deepen and broaden South Korea’s connections with the ASEAN economies in infrastructure, energy, tourism and other areas. Moon proposed to link these two policies with the BRI to promote diversified diplomatic strategies and expand foreign economic cooperation.
- **Indonesia** has planned several major infrastructure projects, including improving transport between cities and remote areas and new seaports. It is seeking investment for the projects.
- **Pakistan** signed US\$500 million worth of deals under BRI in addition to the US\$62 billion invested into the China-Pakistan Economic Corridor. In 2015, China announced its plan to invest US\$46 billion in infrastructure projects in Pakistan; the pledged investment amount had increased to US\$62 billion in early 2017. China will participate in the joint development of the power, transport, industry and service sectors in the country.
- **The Philippines** signed 13 bilateral cooperation agreements with China, with US\$24 billion funding and investment pledged by China. BRI-related projects include port network development.
- **Thailand** announced in June 2017 a US\$44 billion plan from 2017 to 2021 of infrastructural development, including the Eastern Economic Corridor project, and industry upgrade to link up with BRI, as part of its efforts to boost economic growth. The plan involves airport expansion, new railways and cities, port development and spurring modern industry.

¹⁷ Specific initiatives quoted are obtained from various media articles since the announcement of the BRI.

¹⁸ These are the China-Mongolia-Russia Economic Corridor, the New Eurasian Land Bridge (from Russia through China to Holland and Belgium), the China-Central Asia-West Asia Economic Corridor (linking China and the Arabian Peninsula), the China-Indochina Peninsula Economic Corridor (from China to Hanoi and Singapore), the China-Pakistan Economic Corridor and the Bangladesh-China-India-Myanmar Economic Corridor.

Hong Kong, being regarded as a developed market, is an open economy with advanced financial and transport infrastructure, and efficient port facilities, trade and logistics support, offering professional high-end services including financial, legal, management, mediation and arbitration. Hong Kong has become a member of the AIIB and is expected to play the role of a principal financial hub for BRI.

2. INVESTMENT OPPORTUNITIES AND RISKS

Given the peculiar economic growth stage and pattern of the AxJ economies that differ from the western developed world, specific benchmarks have been developed for tracking the investment performance in the AxJ capital markets. These include indices compiled by the key global index providers of MSCI, FTSE Russell and S&P Dow Jones, e.g. the MSCI AC Asia ex Japan Index¹⁹, the FTSE Asia ex Japan RIC Capped Index²⁰ and the S&P Pan Asia Developed Markets Ex-Japan BMI²¹.

Taking the MSCI AC Asia ex Japan Index (MSCI AxJ Index) as an example, the index coverage spans across two DMs — Hong Kong and Singapore, and nine EMs — China, India, Indonesia, Korea, Malaysia, Pakistan, the Philippines, Taiwan and Thailand. As at the end of February 2018, the index had 646 constituents in which China had the highest country weight (35.32%), reflecting its economic dominance in the AxJ region²². In the past five-year period, the AxJ markets, represented by the MSCI AxJ Index, had underperformed the developed markets and the world market as a whole (represented respectively by the MSCI World Index²³ and the MSCI ACWI Index²⁴ (all country world index)). However, in the recent year of 2017, the AxJ markets had picked up much more strongly than the developed markets as the global economy continues to recover from the past decade of slowdown after the Global Financial Crisis. They have been the dominant contributor to the parallel growth in the EMs (represented by the MSCI Emerging Markets Index²⁵). (See Figure 3.)

¹⁹ Indices covering AxJ markets compiled by MSCI include also the MSCI AC Asia Pacific ex Japan Index, the MSCI Pacific ex Japan Index, and others.

²⁰ Indices covering AxJ markets compiled by FTSE Russell include also the FTSE Asia Pacific ex Japan Index, the FTSE Developed Asia Pacific ex Japan Index, FTSE World Asia Pacific ex Japan Index, and others.

²¹ Indices covering AxJ markets compiled by S&P Dow Jones include also the S&P Enhanced Value Pan Asia Ex-Japan LargeMidCap Index, the S&P Quality Pan Asia Ex-Japan LargeMidCap Index, and others.

²² The weights of other markets are: South Korea — 16.85%, Taiwan — 13.28%; Hong Kong — 11.32%; India — 9.53%; and others — 13.7%. Source: MSCI AxJ Index factsheet, 28 February 2018.

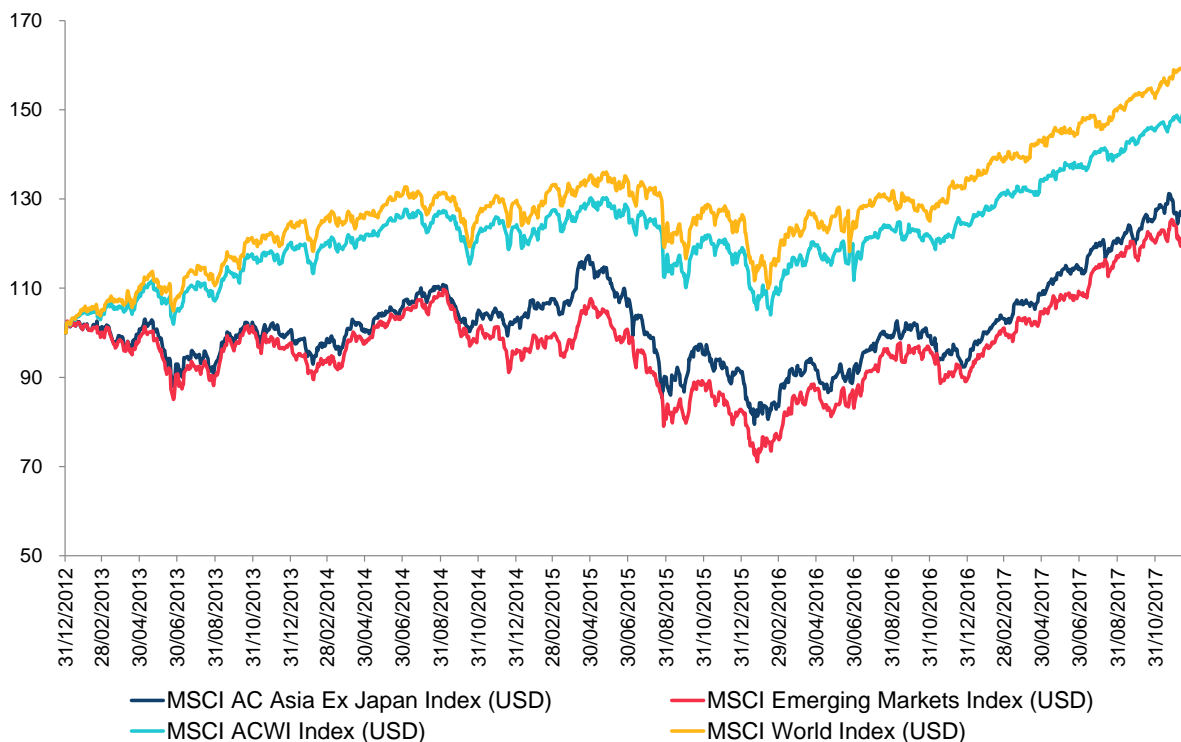
²³ The MSCI World Index captures large and mid-cap stocks across 23 DMs.

²⁴ The MSCI ACWI Index captures large and mid-cap stocks across 23 DMs and 24 EMs.

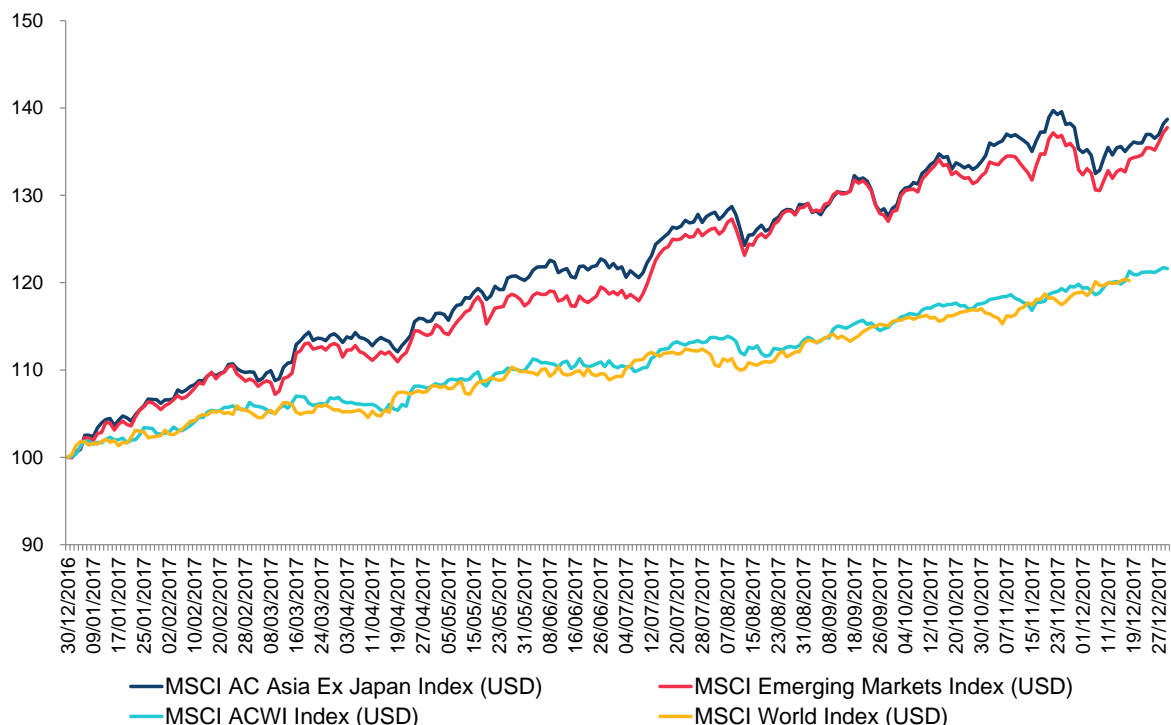
²⁵ The MSCI Emerging Markets Index captures large and mid-cap stocks across 24 DMs.

Figure 3. Performance of the MSCI AxJ Index against the MSCI World Index, the MSCI Emerging Markets Index and the MSCI ACWI Index* (5-year period and 1-year period)

(a) 5-year period (2012 – 2017), rebased on 31 December 2012



(b) 1-year period (2017), rebased on 30 December 2016



* The MSCI World Index represents developed markets in the world while the MSCI ACWI Index represents developed markets plus emerging markets in the world.

Source: Thomson Reuters.

Being well aware of the return opportunities offered by the long-term secular growth in the AxJ region, institutional investors are seen to have a growing appetite for investment in AxJ markets²⁶. Apart from the improving global economies and international trade, fundamental factors supporting the strong growth in AxJ stock markets include the strong macro-economic conditions of China which is the spearhead economy in the region and which has set a target growth rate of about 6.5% for 2018²⁷, deepening regional integration and trade liberalisation, as well as the expected earnings growth of enterprises across different industries in the region along with the regional economic growth. Despite strong growth potential, the AxJ markets were traded at a price-earnings ratio (PE ratio) considerably lower than that of the overall world market²⁸, making the region more appealing as a “cheap-to-buy” option to investors.

Other driving factors include also specific market developments in respect of the trading of Chinese stocks. Currently, the stocks representing China in the MSCI AxJ Index are Chinese stocks listed in Hong Kong before the inclusion of China A shares in the MSCI Emerging Markets Index and the MSCI ACWI Index in June 2018²⁹ as announced by MSCI in June 2017. The inclusion of China A shares in the MSCI indices would stimulate more global investment in Chinese stocks (because of index-following passive investment strategies), which have already been promoted through the Stock Connect schemes between Shanghai and Hong Kong (the Shanghai Connect) and between Shenzhen and Hong Kong (the “Shenzhen Connect”). This would bring about greater buoyancy in AxJ market investment for which China is spearheading.

The Hong Kong market (including the listed H shares of Chinese enterprises), which has a major weighting in AxJ investment³⁰, could benefit from Hong Kong’s close economic ties with China and its connectivity with China’s financial market (manifested by the dual listing of many Chinese stocks and the Stock Connect schemes). The inclusion of China A shares in the MSCI indices is expected to have positive impact on the Hong Kong market as well. Apart from this, market liquidity in Chinese stocks will also be further activated by the pilot programme of H-share full circulation announced by the China Securities Regulatory Commission (CSRC) in December 2017, which allows the non-tradable shares of H-share companies held by Mainland shareholders to be converted into tradable H shares.

On the other side of the coin, there are risk factors accompanying AxJ market investment. These include potential impacts from the following:

- The interest rate hikes in the US, which would be contagious across the globe;
- The potential capital outflow from EMs resulted from a stronger US dollar;
- The US tax reforms including a Border Adjustment Tax and the increase in US tariffs on imports of selected commodities including steel and aluminium, uncertainties in Sino-US trade negotiations, and potential trade wars that might be induced;
- Geo-political conflicts within the region;
- The orderliness of the current economic transformation of China;

²⁶ See, for example, Tim Stewart, *Asia ex-Japan the new ‘investment destination’*, Investor Daily (www.investordaily.com.au), 7 April 2017, and “Why US protectionism will not quash opportunities in Asia ex Japan equities” by Anik Sen and Elizabeth Soon, (www.pinebridge.com), 10 March 2017.

²⁷ Source: The Chinese premier’s government work report delivered on 5 March 2018.

²⁸ As at the end of 2017, the PE ratio of the MSCI AxJ Index was 15.24, compared to 20.55 for the MSCI ACWI. Source: MSCI AxJ Index factsheet, 28 February 2018.

²⁹ The initial weighting of China A shares in the MSCI EM Index would be approximately 0.73% on a pro forma basis at a 5% partial Inclusion Factor (i.e. 5% of the market capitalisation of the eligible stocks in the Chinese market), according to the announcement.

³⁰ The combined weighting of Chinese stocks and local stocks listed in Hong Kong was 46.64% in the MSCI AxJ Index as at the end of February 2018.

- Political and policy uncertainties, and vulnerability of economies in the region to changes in market conditions.

3. ASIA EX JAPAN INVESTMENT TOOLS

To tap the potential offered by the AxJ growth markets, investors are looking for suitable tools to exploit the investment opportunities and to manage the related risks. Apart from the approach of active investment strategies to select individual markets and stocks, passive investment strategies through instruments such as **exchange-traded funds (ETFs)** have become more and more popular in the recent years — according to ETFGI³¹, US\$3.548 trillion was invested in the 6,630 ETFs or exchange-traded products (ETPs) listed globally at the end of 2016, with a net inflow of US\$389.34 billion in the year³²; the amount further reached a record-breaking US\$5.2 trillion in January 2018, marking also the 48th consecutive month of net inflows into ETFs or ETPs³³.

An ETF is a marketable security that tracks an index, a commodity, bonds, or a basket of assets. ETFs trade like common stocks on a stock exchange. Investment in an ETF replicates an investment in its underlying asset(s). For a stock index ETF, the underlying asset composition will be the same as the relative weightings of the constituents in the index. Therefore, ETFs based on AxJ market indices could be the ideal investment tools for passive investment strategies to tap the AxJ markets. In addition, there are also mutual funds specialising in AxJ thematic investment. With the growing focus on thematic investments, related **index futures and options** are also available for gaining market exposure or for hedging the investments.

The sub-sections below give a brief account of the ETFs and index derivatives for AxJ thematic investments.

3.1 AxJ thematic investment funds

The MSCI indices are known to be the most popular benchmarks underlying global ETFs. For AxJ thematic investment, as shown in Table 3, ETFs on the MSCI AxJ Index are found to have the highest value of assets under management (AUM) — about US\$7.3 billion compared to about US\$7.0 billion for ETFs on the MSCI Pacific ex Japan Index and an aggregate of about US\$3.2 billion for other identified ETFs on regional ex Japan benchmarks as of the end of February 2018. Apart from ETFs, over 100 mutual fund products were identified to have MSCI AxJ Index as the preferred benchmark, with an AUM of US\$118 billion as of June 2017.

Table 3. AUM of key products on MSCI AxJ Index compared to other regional ex Japan benchmarks (end-Feb 2018)	
Product	AUM (US\$m)
ETFs on MSCI AxJ Index	7,258
iShares MSCI All Country Asia ex Japan ETF	4,965
iShares Core MSCI AC Asia ex Japan Index ETF	897
db x-trackers MSCI AC Asia ex Japan TRN Index UCITS ETF	766
LYXOR MSCI Asia ex Japan UCITS ETF	525
UBS ETFs plc – MSCI Asia ex Japan SF UCITS ETF	105
Mutual funds on MSCI AxJ Index*	118,072

³¹ ETFGI LLP is a wholly independent research and consultancy firm providing services to leading global institutional and professional investors, the global ETF and ETP industry, its regulators and advisers (<http://etfgi.com>).

³² Source: "ETF industry grew faster than hedge funds in 2016 – ETFGI", International Adviser, 6 March 2017.

³³ Source: "ETFs, ETPs, pass \$5 trillion with record January net new assets", ThinkAdvisor, 9 February 2018.

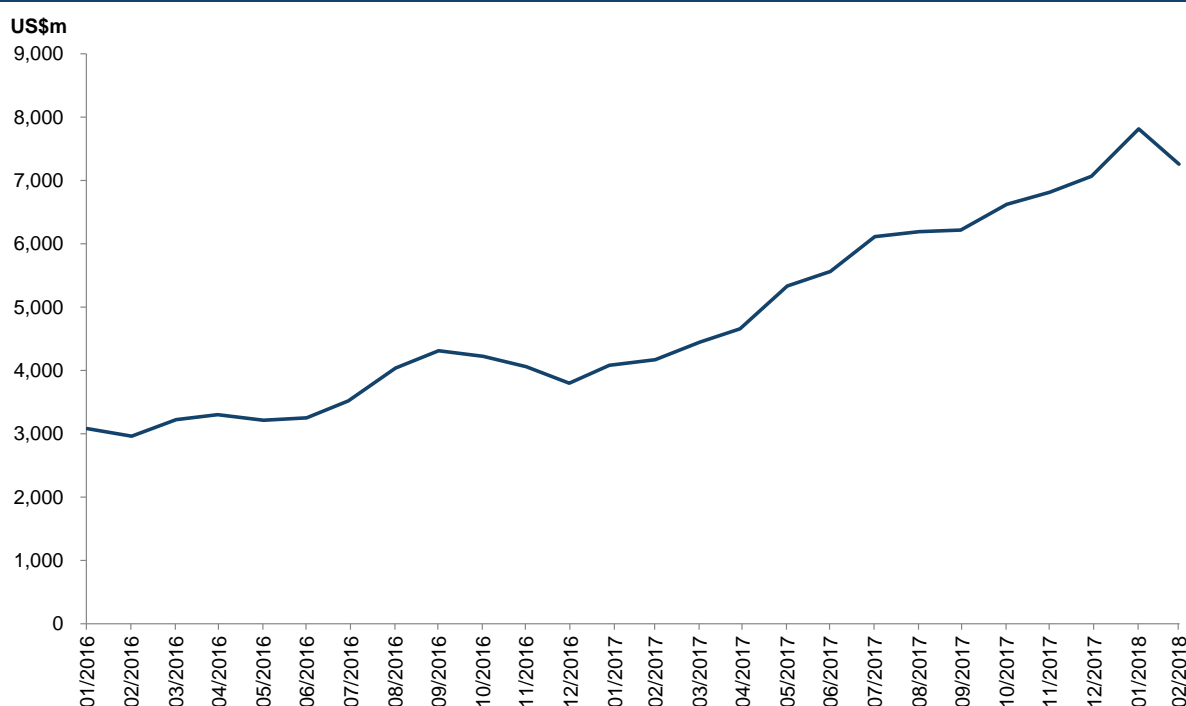
Table 3. AUM of key products on MSCI AxJ Index compared to other regional ex Japan benchmarks (end-Feb 2018)

Product	AUM (US\$m)
ETFs on other regional ex Japan benchmarks	10,233
MSCI Pacific ex Japan	6,992
MSCI AC Far East ex Japan	3,081
MSCI AC Asia Pacific ex Japan	16
FTSE Asia ex Japan	69
FTSE Asia Pacific ex Japan, Australia and NZ	52
FTSE RAFI Asia Pacific ex Japan	23

* AUM as of June 2017.

Source: Data on AUM of related individual ETFs searched on Bloomberg at best efforts; eVestment for AUM of mutual funds.

ETFs on MSCI AxJ Index are known to be listed in global markets including Hong Kong, Singapore, Germany, London and the US. The listing venues for other identified ETFs on regional ex Japan benchmarks also include exchanges in Italy, Mexico, Amsterdam and Switzerland. Driven by the growing popularity of ETFs listed across the globe and the increasing investor appetite for AxJ thematic investment, the AUM of the ETFs on MSCI AxJ Index recorded a strong growth of 135% in the two years' time from Jan 2016 to Feb 2018 (see Figure 4).

Figure 4. AUM of global ETFs on MSCI AxJ Index (Jan 2016 – Feb 2018)

Note: The chart shows the aggregate AUM of the five ETFs listed in Table 3.

Source: Bloomberg.

3.2 Related risk management tools

While over 20 AxJ thematic ETFs are listed and traded on exchanges worldwide, only a handful of risk management products — **regional ex-Japan index futures** — are offered by a couple of exchanges in Europe — Eurex and ICE Futures Europe. These products recorded a total trading volume of 624,757 contracts in 2017, representing a global average daily volume of about 2,540 contracts (see Table 4).

Table 4. Trading volume of regional ex-Japan index derivatives on global exchanges (2016 & 2017)			
Exchange	Product	Trading volume (no. of contracts)	
		2016	2017
Eurex	Futures on		
	MSCI AC Asia ex Japan Index (FMXJ)*	N/A	6,850
	MSCI AC Asia Pacific ex Japan Index	43,875	29,929
	MSCI Pacific ex Japan Index (FMPX)	4,580	35,395
ICE Futures Europe	Futures on		
	MSCI AC Asia Pacific Ex Japan Index	6,701	1,432
	MSCI AC Far East ex Japan Index	96	0
	MSCI All Countries Asia Ex Japan Index	275,561	166,770
	MSCI Pacific ex Japan Index Index	344,457	384,381
Total		675,270	624,757
Average daily volume[#]		2,756	2,540

* Product introduced in 2017.

[#] Based on the total number of trading days in the Hong Kong market.

Source: Futures Industry Association (FIA) volume report (December 2017).

While investors' appetite for regional ex Japan investment is increasing and related ETFs are listed on the regional exchanges of Hong Kong and Singapore, there are currently no related risk management tools such as AxJ index futures or options listed on the regional exchanges. Seeing this gap to better serve investors trading in the Asian time zone³⁴, HKEX announced on 8 May 2018 the introduction of a new product — the **MSCI All Country (AC) Asia ex Japan Net Total Return Index Futures** (referred below to as the HKEX MSCI AxJ Index Futures). Regulatory approval has been obtained and the product will be launched in 11 June 2018.

3.3 HKEX MSCI AxJ Index Futures and related ETFs on HKEX

The underlying index of the HKEX MSCI AxJ Index Futures is the MSCI AC Asia ex Japan Net Total Return Index (USD). The product will be available for trading during the Day Session (08:30 – 16:30) as well as the After Hours Trading (AHT) Session (17:15 – 01:00 next day). The AHT trading hours will be further extended to 03:00 next day in an enhancement scheduled to be implemented in 2018. HKEX will operate a Liquidity Provider program to support the market liquidity of the new futures product. (See Appendix for the product's contract specifications.)

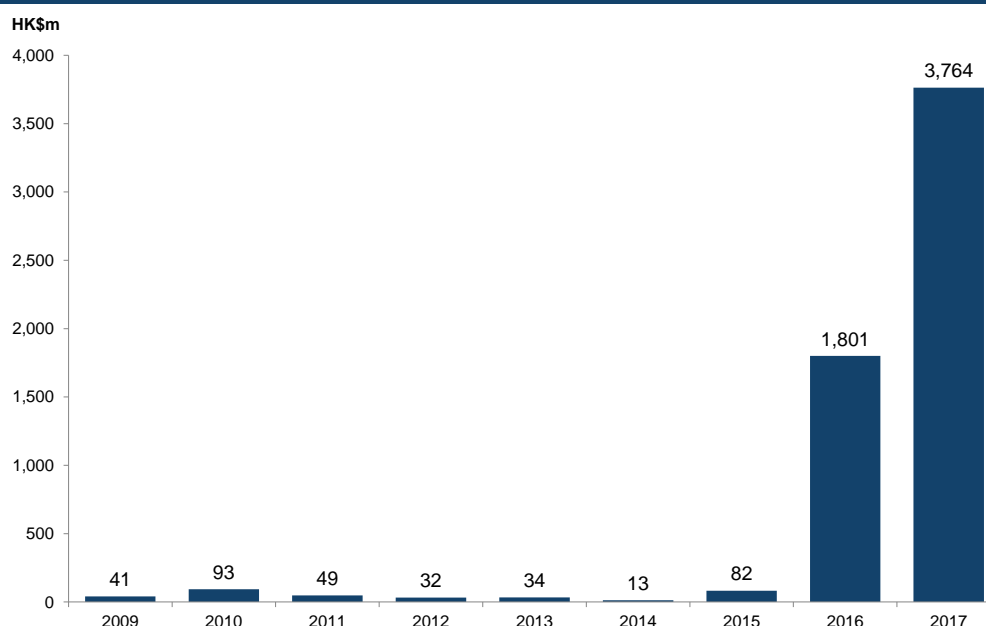
Currently, there are a number of AxJ ETFs listed on the HKEX securities market (see Table 5). Among them, the ETF recorded the highest trading value is the iShares Core MSCI AC Asia ex Japan Index ETF, which is traded in three currencies — HKD, USD and RMB. Figure 5 shows the ETF's annual turnover value since its listing date. The rapid year-on-year growth in the ETF's trading value in 2016 (20+ times) and in 2017 (109%) reflects the strong growing investor demand for AxJ products.

³⁴ The trading hours for the MSCI AxJ Index Futures on Eurex is 07:50 – 22:00 CET (Central European Time), which is 14:50 – 05:00 next day in Hong Kong. ICE Futures Europe offers longer trading hours for MSCI AxJ Index Futures from 01:00 – 21:00 London time, which is 09:00 – 05:00 next day in Hong Kong. In other words, Asian investors have very limited choices to hedge their AxJ investment through these futures products in the Asian time zone.

Table 5. Regional ex Japan ETFs listed on HKEX		
Stock code	ETF	Trading currency
3010	iShares Core MSCI AC Asia ex Japan Index ETF	HKD
9010	iShares Core MSCI AC Asia ex Japan Index ETF	USD
83010	iShares Core MSCI AC Asia ex Japan Index ETF	RMB
3085	Vanguard FTSE Asia ex Japan High Dividend Yield Index ETF	HKD
2805	Vanguard FTSE Asia ex Japan Index ETF	HKD
3043	db x-trackers MSCI Pacific ex Japan Index UCITS ETF	HKD

Source: HKEX.

Figure 5. Annual turnover of iShares MSCI AxJ Index ETF on HKEX (2009 – 2017)



Source: HKEX.

With the introduction of the HKEX MSCI AxJ Index Futures, investors in AxJ ETFs and other AxJ passive investment tools will be provided with a tool for their risk management.

4. CONCLUSION

Emerging Asian economies have been the growth engine of the world and are expected to remain so in the coming years. Conducive factors include the free trade initiatives in the region, China's spearheading effect and its Belt and Road Initiative, the ASEAN economic cooperation initiatives, the domestic economic development plans and bilateral economic agreements of the individual countries in the region, and the resultant deepening regional integration.

In the light of the potential offered by the Asian growth economies, AxJ thematic investment has become increasingly appealing to global investors. Alongside the growing popularity of passive investment, ETFs on AxJ benchmarks would be suitable tools to tap the AxJ growth potential. Facing possible downside risks coming from the current trend of interest rate hikes, US tax reforms and trade protectionism, and the vulnerability of the AxJ markets to uncertainties, investors would demand risk management tools for their AxJ investments. The new product, HKEX MSCI AxJ Index Futures, to be introduced by HKEX, will be the first product of this kind in the Asian time zone to serve the needs of global investors.

APPENDIX. CONTRACT SPECIFICATION OF MSCI AC ASIA EX JAPAN NET TOTAL RETURN INDEX FUTURES ON HKEX

Item	MSCI AC Asia ex Japan Net Total Return Index Futures
Underlying	MSCI All Country Asia ex Japan Net Total Return Index (USD)
Product code in trading system	MXJ
Trading Currency	US dollar (US\$)
Contract Multiplier	US\$100 per index point
Minimum Fluctuation	0.01 index point (or US\$1)
Contract Months	Nearest five calendar quarter months (quarter months are March, June, September and December)
Trading Hours (HK Time)	08:30 – 16:30 (Day Session); 17:15 – 01:00 (After-hours Trading Session)
Last Trading Day (LTD)	The third Friday of the Contract Month and if it is a HK public holiday, the LTD shall be the preceding HK business day
Trading Hours (HK Time) on LTD	08:30 – 16:30
Final Settlement Day	The second HK business day after the third Friday
Settlement method	Cash settlement
Final Settlement Price	Official closing value of the underlying index on the third Friday
Minimum Block Trade Volume	50 lots

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