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WELCOME

On Track Insights – Webinar for index investors
July Edition

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22nd July 2020

Beyond the Great Wall

Economic outlook

Tilmann Kolb CFA
Emerging Markets Analyst
UBS Global Wealth Management CIO



Making its mark on the global economy and diversified portfolios

UBS House View on the Chinese Economy

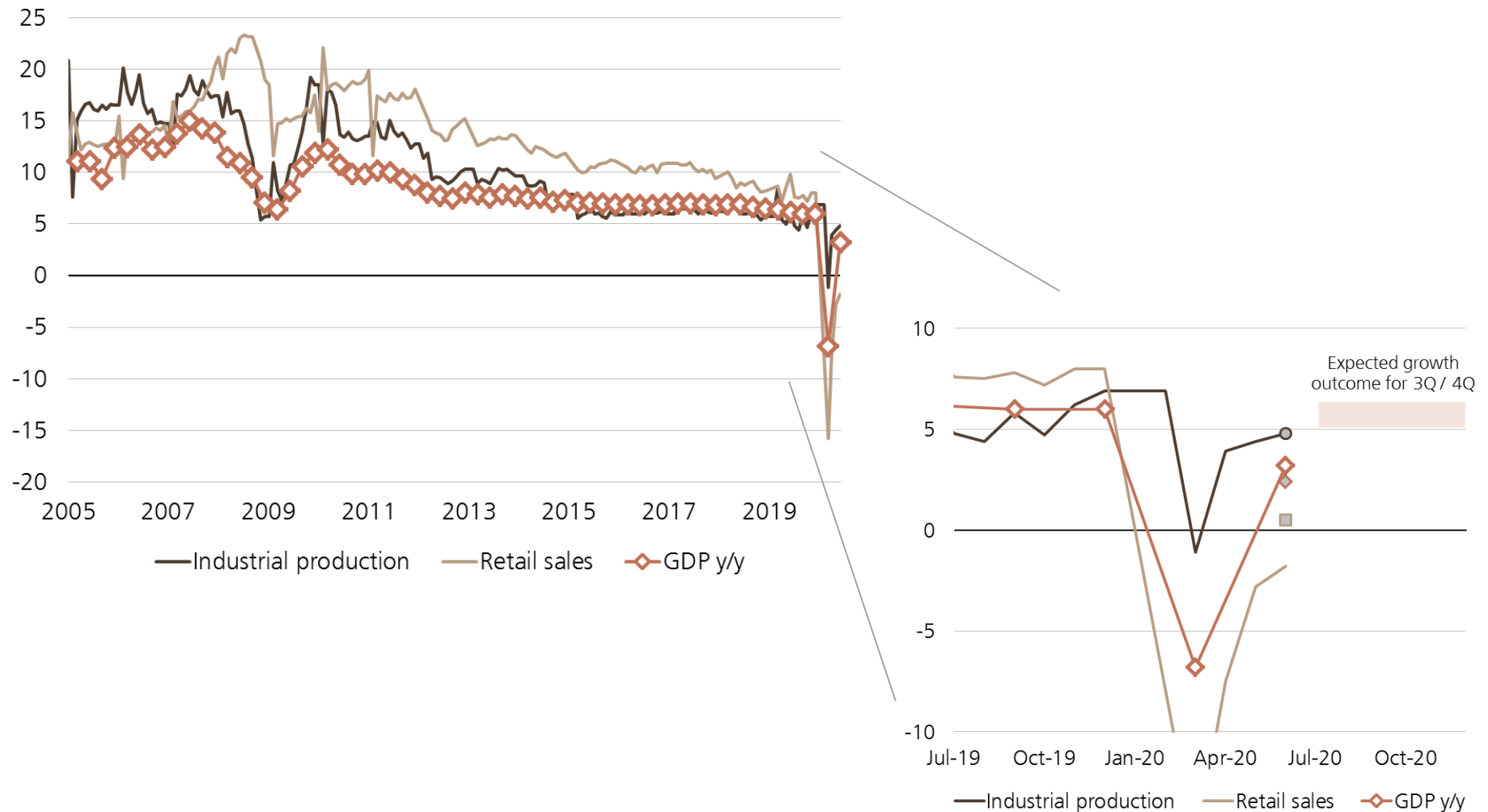
Tilman Kolb

EM Macro, FX & Rates



Rebound expected to bring growth back toward 5-6%

Chinese industrial production, retail sales and GDP growth (in %y/y)

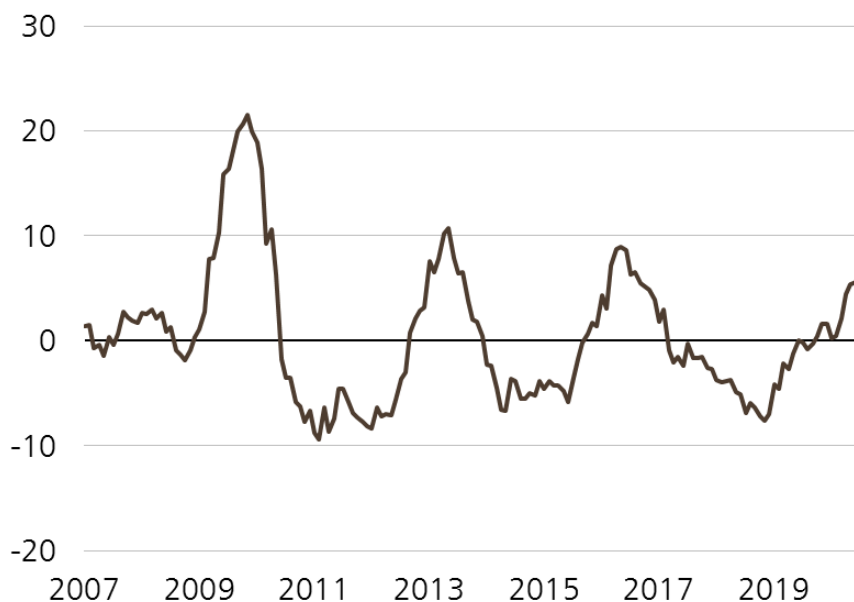


Fiscal and monetary policy supports recovery, in a more targeted manner than in past instances

Chinese credit impulse and indebtedness

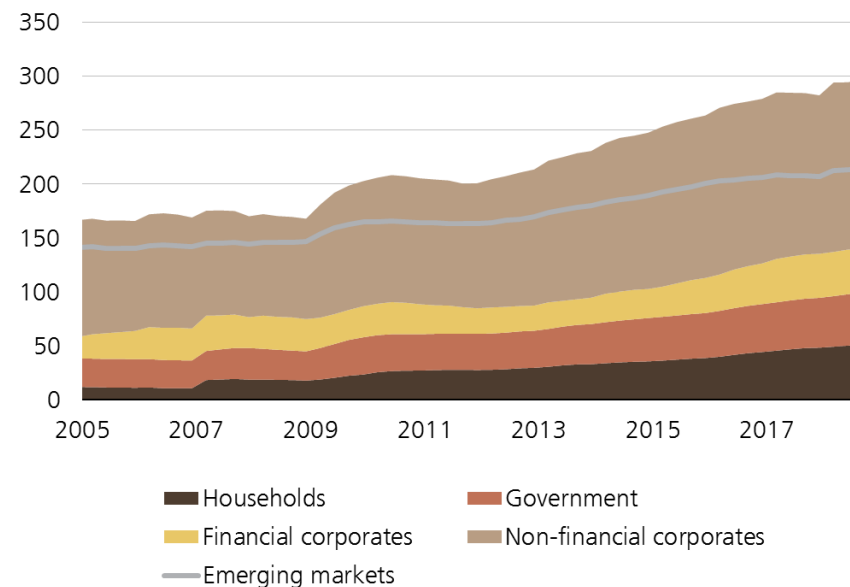
Sizable stimulus measures so far, more to come...

Credit impulse as % of GDP



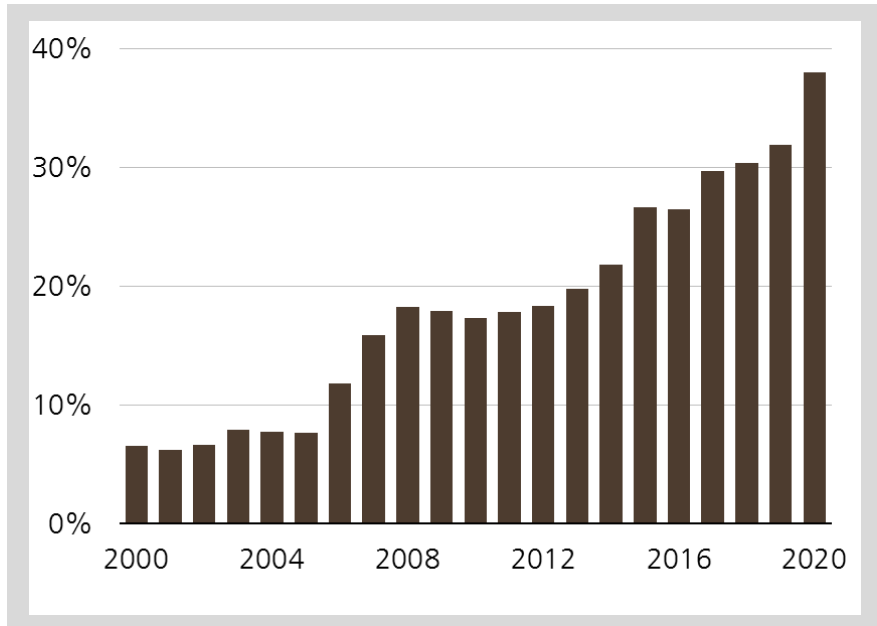
... but awareness has risen that stimulus should be targeted

Chinese debt per sector (in % of GDP), EM average



Chinese assets to make up increasing part of globally diversified portfolios

Weight of Chinese shares in MSCI Emerging Market Index, and Chinese government bonds in GBI-EM Global Diversified (in %)

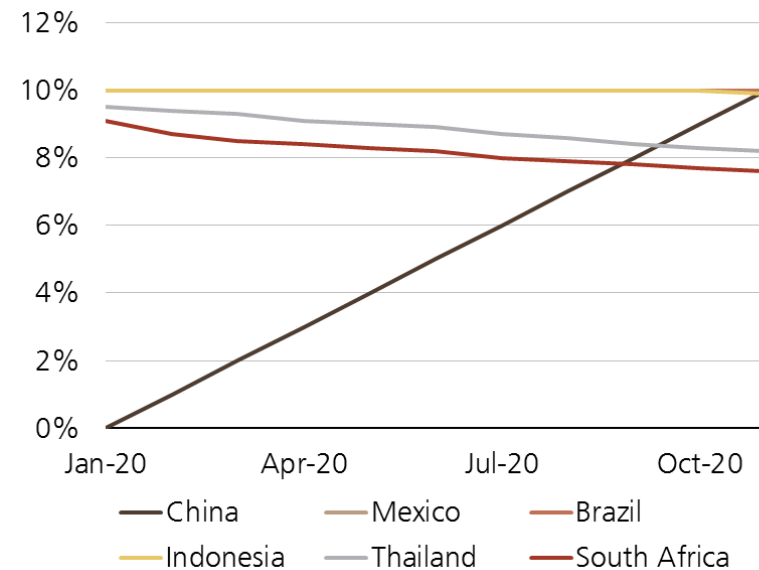


Emerging market equities are increasingly Asian, specifically Chinese

6 / 10 top 10 constituents are Chinese

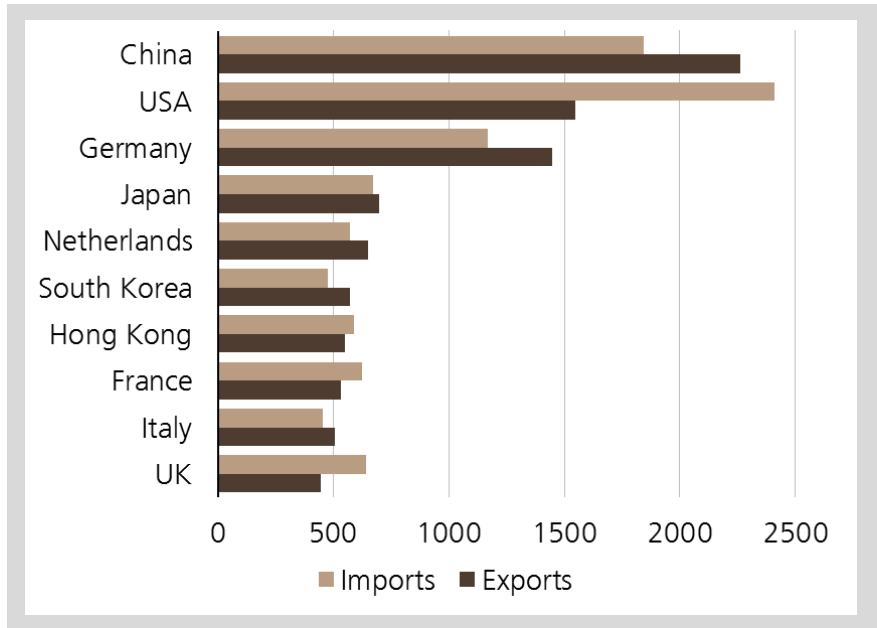
Chinese government bonds included into local currency EM bond benchmark from 2020

China would dominate without diversification thresholds



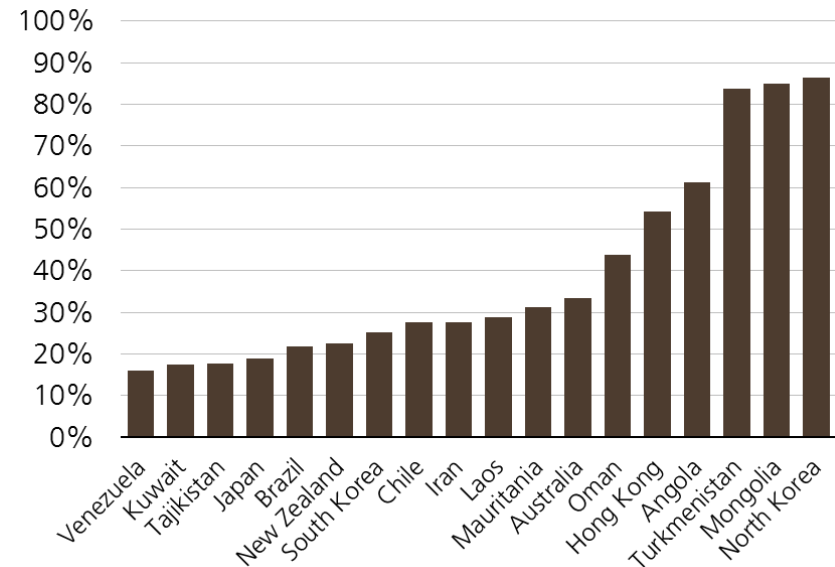
US-China tensions here to stay: Be prepared for a fight-talk-fight relationship

Merchandise imports and exports (in USDbn, as of 2017), share of merchandise exports to China (in % of total, as of 2017)



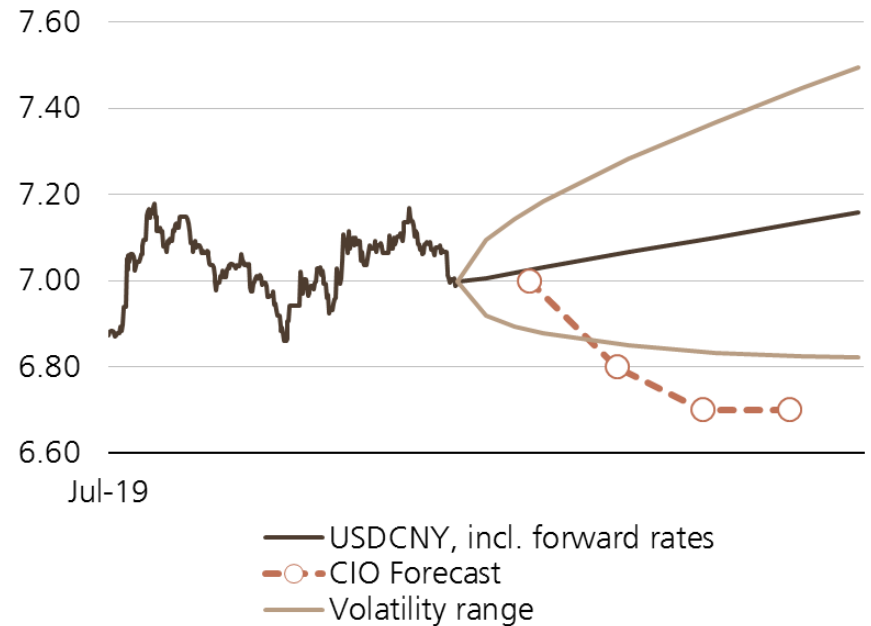
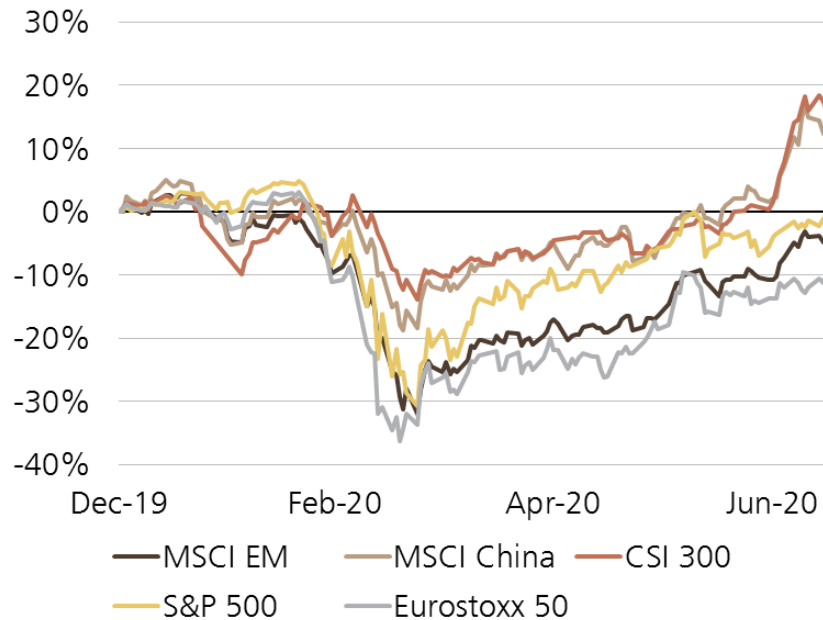
A large share of global trade runs through China...

... making many economies dependent on China's health



Tactical views: A-shares still with upside potential, CNY to appreciate against the USD

Equity market performance (ytd, in %), USDCNY and CIO forecasts



- ❖ Monetary policy easing and rebounding property sales boosted Chinese shares in July
- ❖ Improving earnings from this to next year should underpin further gains
- ❖ Onshore equities should withstand US-China tensions better than offshore market

- ❖ CNY benefits from quick growth rebound, improving local assets' outlook
- ❖ Re-accelerating exports and reduced service sector deficit should support external balance
- ❖ CNY provides attractive carry vs developed markets, especially if volatility remains subdued

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Beyond the Great Wall

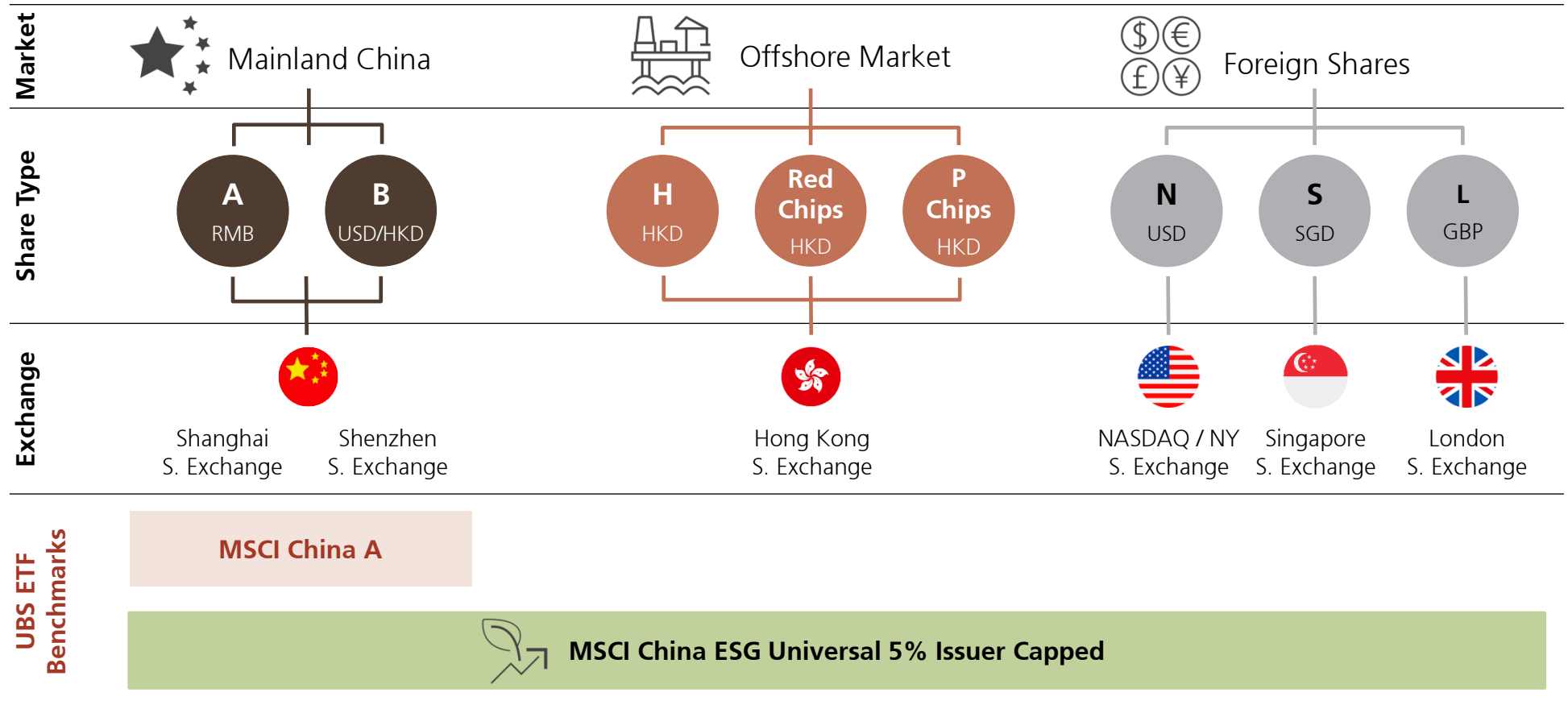
Our offering and how to trade Equity ETFs tracking MSCI China

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Equity market landscape



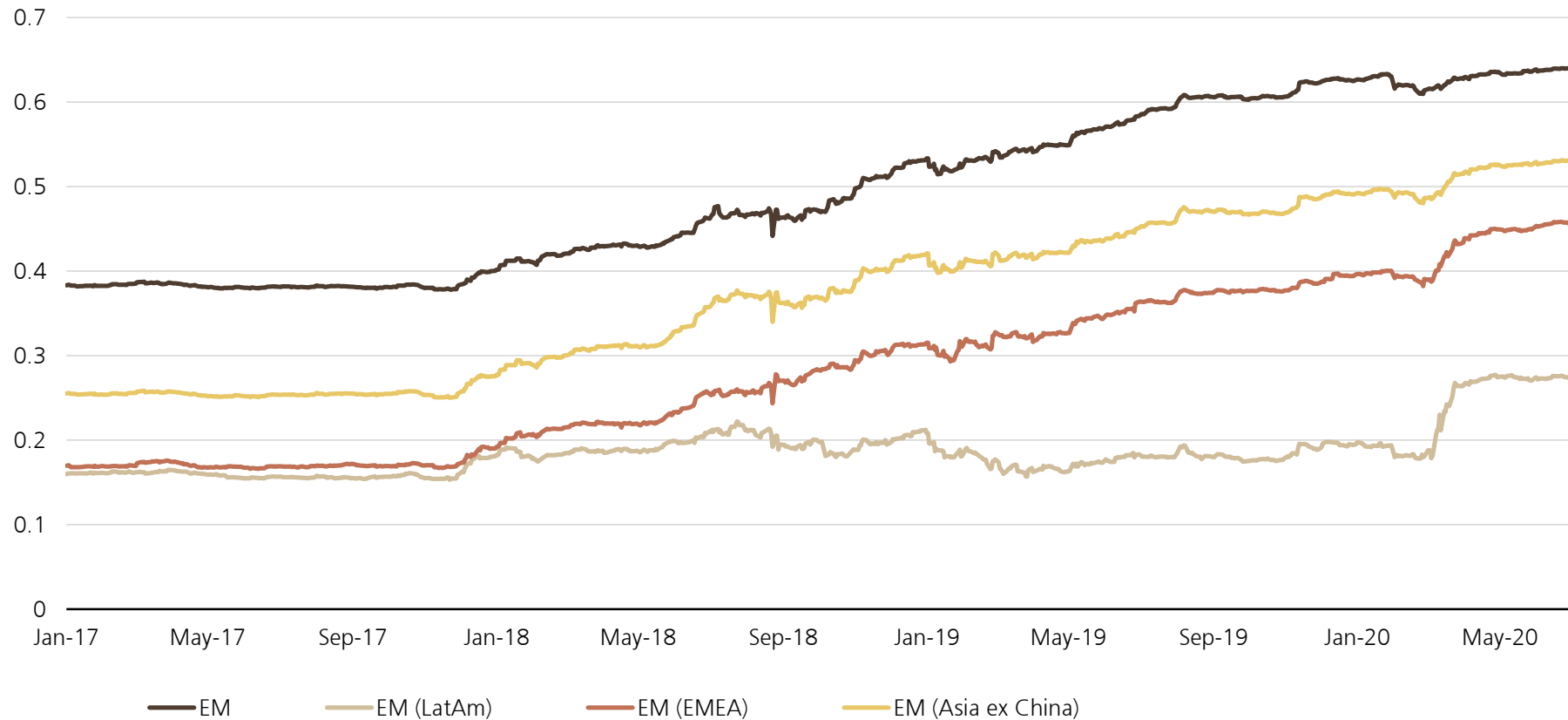
Sources: UBS. For illustrative purposes only.



Diversification benefits

China A shares have displayed strong diversification benefits historically

3-year rolling returns correlation between MSCI China A and MSCI Regional benchmarks



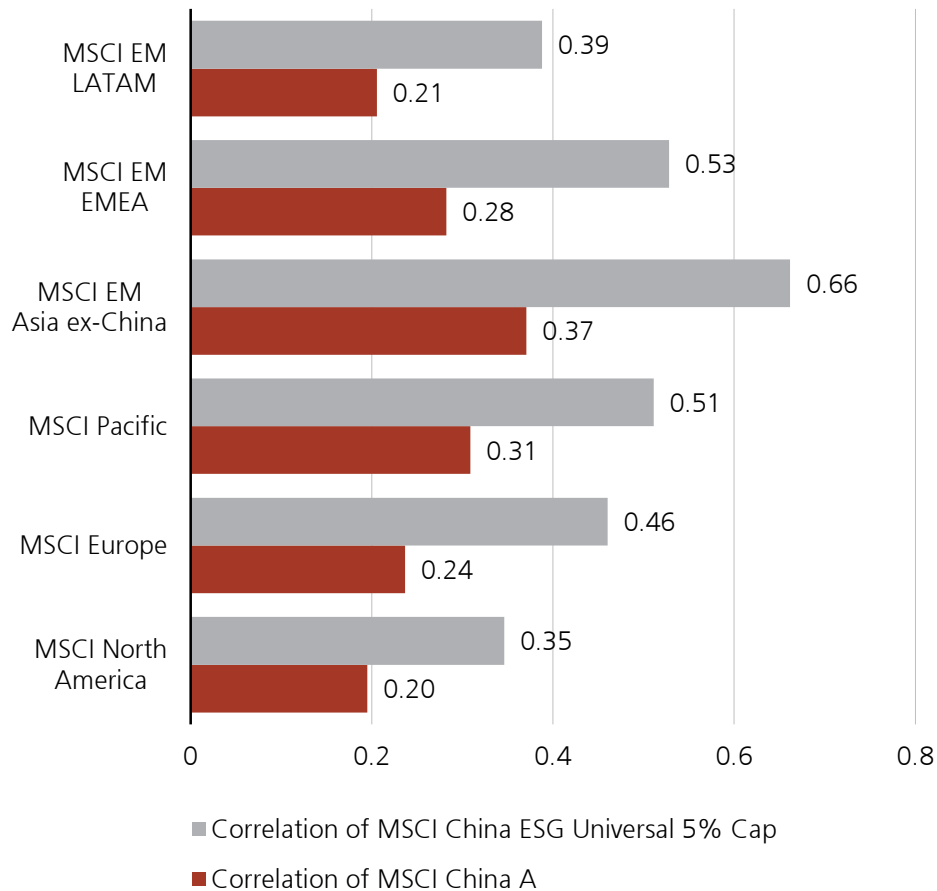
Source: UBS Asset Management, Bloomberg. All indices in USD Net Return version. Data from 31 December 2013 to 30 June 2020.



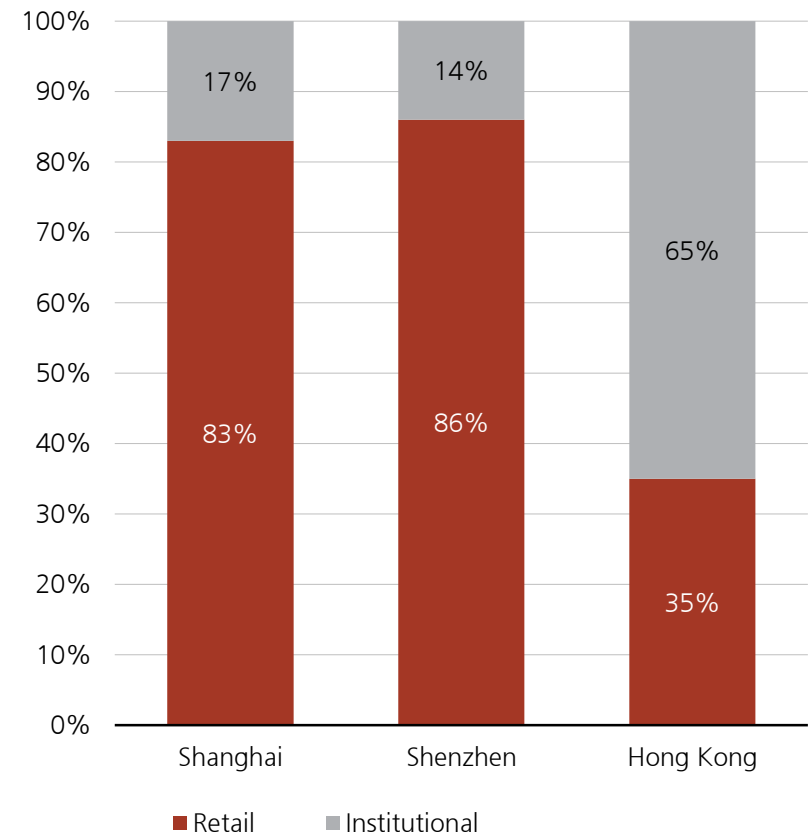
Diversification benefits

Lower correlations for China A shares as market mainly influenced by local retail investors

Correlations with Global MSCI Benchmarks



Investor base



Sources:

Left: UBS Asset Management, Bloomberg. All indices in USD Net Return version. Data from 31 December 2013 to 30 June 2020.

Right: UBS, HKEX, SSE and SZSE stock exchanges, data from June 2018.

Fixed Income market landscape



Government and Quasi-Government Bonds



Bond Type

Treasury Bonds

Policy Bank Financial Bonds

Local Government Bonds

Issuer

Ministry of Finance

Policy Banks:
 1. China Development Bank
 2. Agricultural Development Bank of China
 3. Export-Import Bank of China

Local Governments

Definition

Treasury bonds are issued by the Ministry of Finance and can be traded on the China Interbank Market. Maturities available between 3M to 50 years.

Policy Bank Bonds are issued by the three policy banks and have shorter maturities (1–10 years) than treasury bonds. It can also be traded on the China Interbank Market.

Local Governments can issue bonds subject to an annual ceiling set by the National People's Congress. Maturities ranging from 1 to 20 years.

UBS ETF Benchmark

J.P. Morgan China Government + Policy Bank 20% Capped 1–10 Year

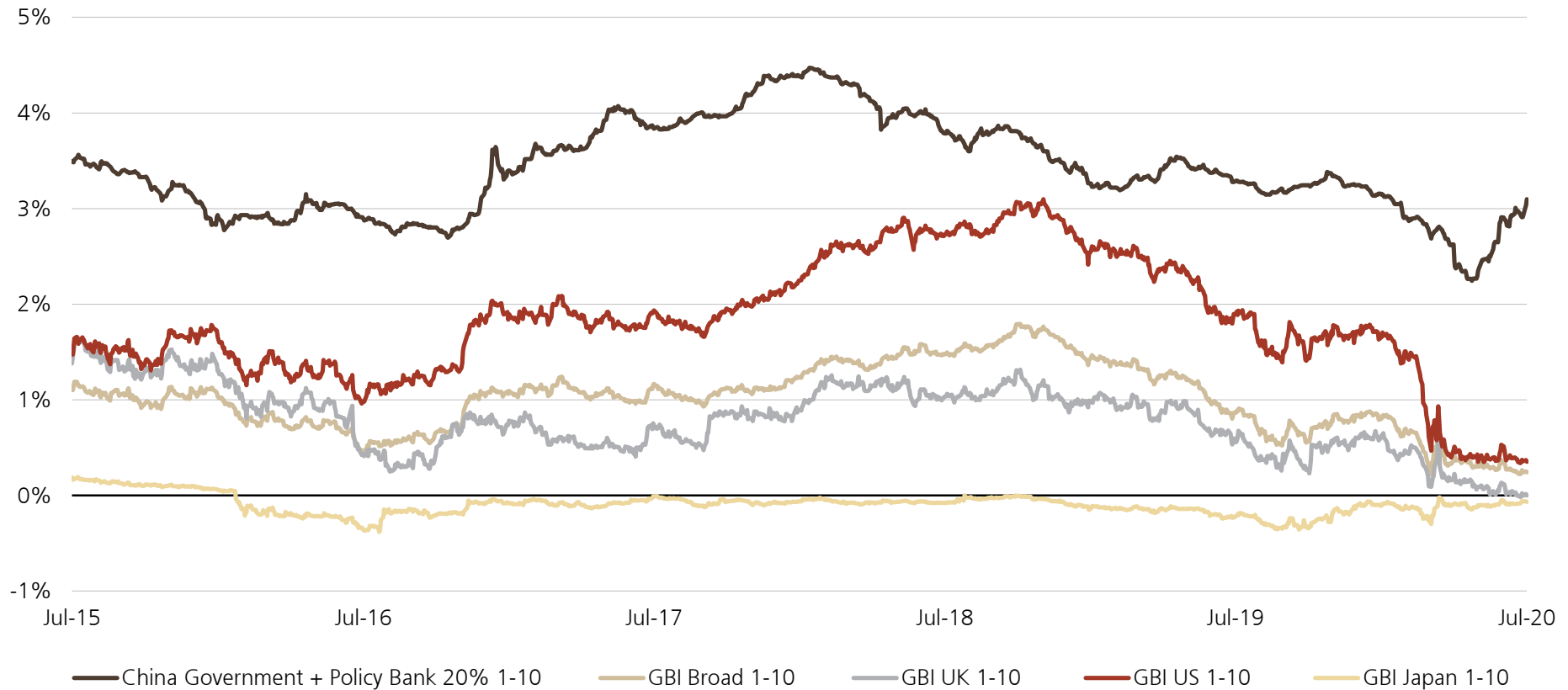
Source: UBS Asset Management. For illustrative purposes only.

Potential for higher returns



As share of global negative yielding debt increases, China offers attractive yields

China government and policy bank bonds yield vs major developed treasury markets



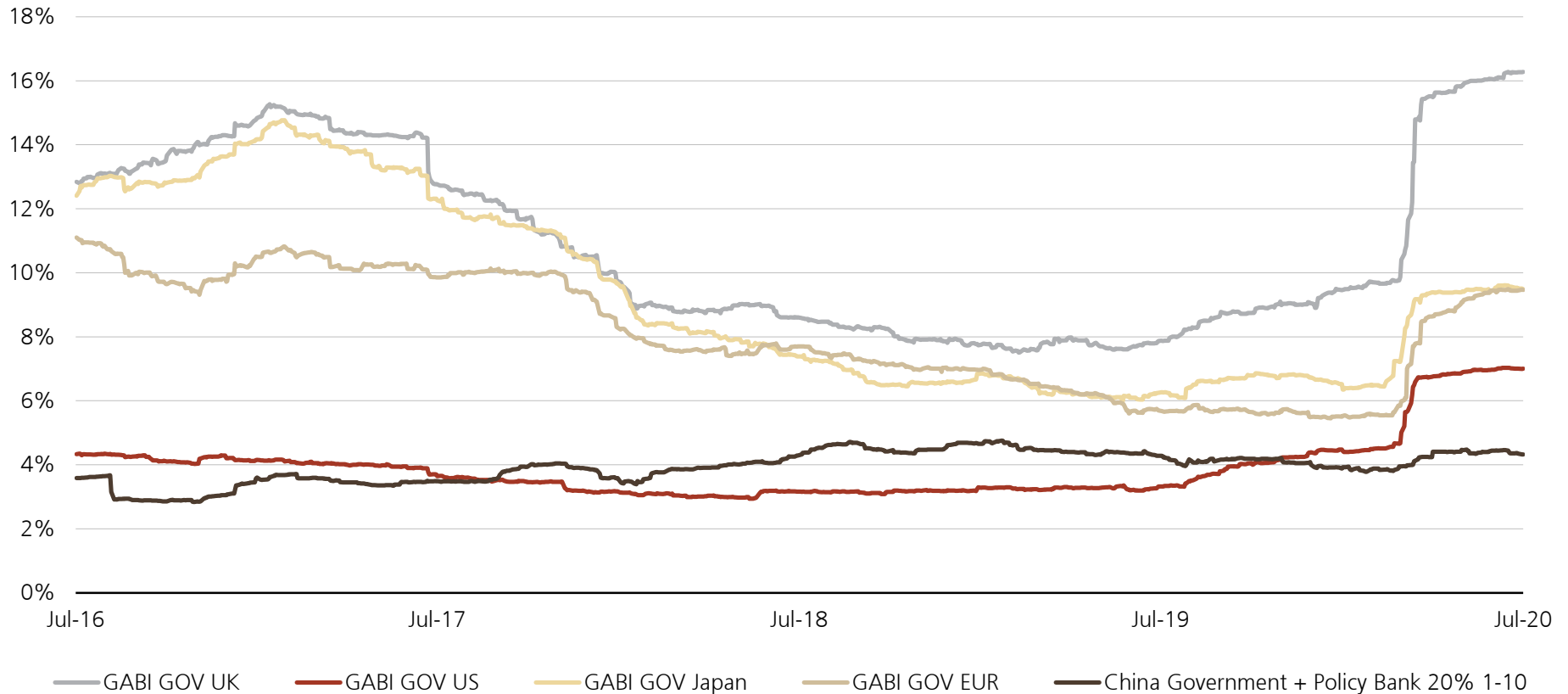
Source: J.P. Morgan Markets. All indices in total return versions. Data from 07 July 2015 to 07 July 2020.

China bonds as a safe haven?



Lower volatility compared to developed treasury markets, especially during stress periods

1-Year Annualized Daily Rolling Volatility



Source: J.P. Morgan Markets. All indices in USD total return versions. Data from 07 July 2015 to 07 July 2020.



How do you calculate an iNAV for an Equity ETF?

All underlying constituents are open.

- First step in sell-side ETF Trading is to compute an iNAV (intraday NAV) of an ETF, i.e. what do we think the ETF is worth right now.
- **iNAV is analogous to the fair value of a future.** Every sell-side participant will have their own iNAV depending on their pricing assumptions.
- Each counterpart will create a proxy model. I.e. build a pricing solution that takes each constituent or group of securities and extrapolates forward the last available price by a suitable proxy to calculate a synthetic spot (i.e. what is our best estimate of the share price now).

Lets price UBS ETF – MSCI Switzerland 20/35 UCITS ETF (SW2CHB SE)

- Assume all the constituents are open and have a live order book.
- A simple proxy model is then the sum product of the weights multiplied by the price of each constituent to calculate an iNAV.
- $$\text{iNAV} = \sum_{i=1}^n w_i S_{i,t}$$
- However, this is where the complexity begins. What is the “correct” price and are the weights according to the portfolio composition file (file published on daily basis by the ETF provider showing constituents of the ETF) valid?

Source: UBS Asset Management. For illustrative purposes only.



How do you calculate an iNAV for an Equity ETF?

All underlying constituents are closed but a liquid future exists.

Now lets price UBS S&P500 ETF (SPYUSY SE/SPYUSY.S)

- Assume the S&P500 is closed and it is the AM session for EMEA.
- Take the closing price of each SPX constituent and proxy forward by the performance of the SPX future to calculate an iNAV for the UBS S&P500 ETF, i.e. classic $y = mX + C$ for each constituent.
- In our simple example above X is the closing price for stock and m is the performance of the SPX future from the close of t-1 to t.
- $iNAV = \sum_{i=1}^n w_i m S_{i,t-1}$
- Proxy model is often called, more formally, a synthetic spot service.

Key challenge here is your assumption about the basis calculation, i.e. the difference between the future and implied spot:

- 1 **Funding** – What interest rate are you charged for long stock positions?
- 2 **Dividend forecasts** – How are you projecting forward a dividend curve? What proportionality model are you employing?
- 3 **Tax** – What tax rate do you assume on dividend distributions?
- 4 **Repo** – What rate do you receive for lending stocks?

Source: UBS Asset Management. For illustrative purposes only.



How do you calculate an iNAV for an Equity ETF?

All underlying constituents are closed and no perfect proxy exists.

Let's solve for pricing ETFs tracking MSCI China (41.38% of MSCI Emerging is MSCI China)

MSCI China is 12.34% US ADRs, 5.05% Mainland China and 23.93% H shares. Many of the H share names also have US ADRs so MSCI China is "easier" to price during US hours post 1430 with a synthetic spot, i.e. assume performance of a H share can be extrapolated well by the performance of its ADR.

0900–1000 CET

- HK open, ADR closed and China closed.
- Price off open stocks in HK for H share constituents and combination of HSCEI/A50 futures for non H share components.
- Hedge with combination of HSCEI, HSI, A50 futures and HSBC stock.

1000-1030 CET & 1115–1530

- HK closed and ADR closed.
- Price off HSCEI and A50 futures.
- Hedge with combination of HSCEI, HSI, A50 futures and HSBC stock.

1030–1115 CET

- Void period when HSI and HSCEI futures are closed.
- Pricing less aggressive as hedge availability is reduced.

1530–1730 CET

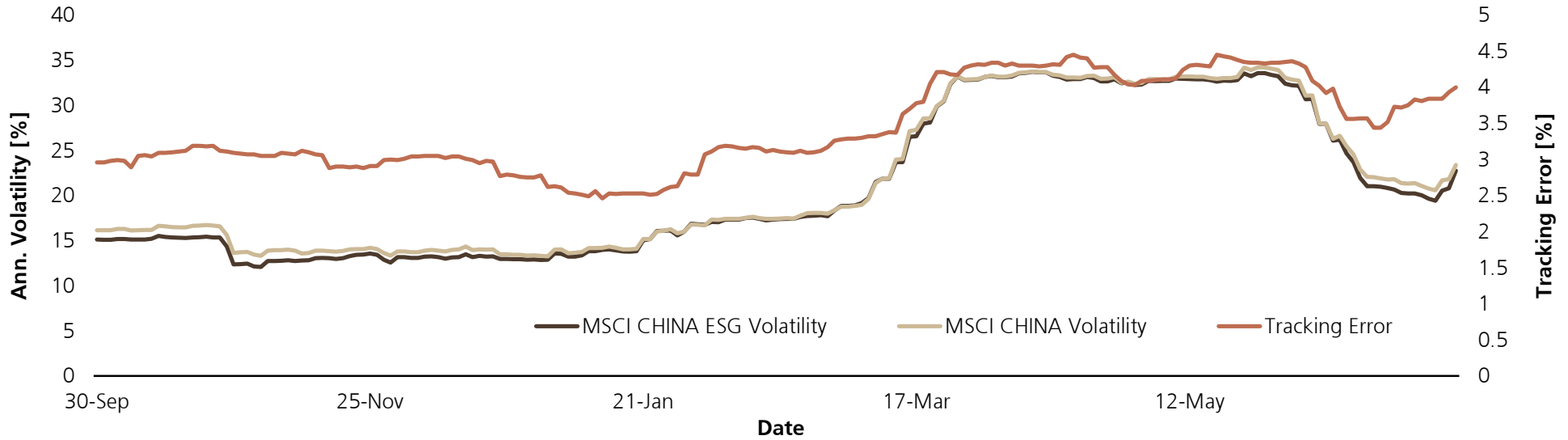
- Price off FXI, ADRs, HSCEI and A50 futures. Hedge with them too.
- Pricing is tighter in US session ironically given availability of ADRs to hedge.

Source: MSCI. Data as of 8 July 2020.

MSCI CHINA ESG vs MSCI CHINA



Sector Decomposition and Volatility Profile



Country	Communication Services	Consumer Discretionary	Consumer Staples	Energy	Financials	Health Care	Industrials	Information Technology	Materials	Real Estate	Utilities
MSCI CHINA ESG Weight	14.38%	25.46%	3.86%	1.97%	24.94%	7.28%	5.68%	7.40%	1.60%	4.65%	2.79%
MSCI CHINA Weight	21.89%	30.32%	1.97%	1.86%	12.81%	3.70%	3.36%	3.64%	0.95%	4.16%	1.64%
Difference	-7.51%	-4.86%	1.89%	0.11%	12.13%	3.58%	2.32%	3.76%	0.65%	0.49%	1.15%

There are significant sectoral differences and the tracking error between the two indices is very high.

Source: UBS Asset Management, Citigroup. Data as of 8 July 2020.



MSCI CHINA ESG vs MSCI CHINA

Impact Cost Comparison for USD10mm and Intraday Spread History

Name	Constituents #	Bid/Ask (full) bps	ADV %	EIC bps	Shortfall Risk bps	Total Cost bps
MSCI CHINA ESG	648	14.52	0.07	9.59	4.07	12.85
MSCI CHINA	711	11.94	0.05	7.82	3.11	10.30

Data for UBS MSCI CHINA ESG ETF	Spread 11:00-12:00	Spread 16:00-17:00	Difference
16.06.2020	0.77%	0.62%	-0.15%
17.06.2020	0.63%	0.93%	0.30%
18.06.2020	0.63%	0.63%	0.00%
19.06.2020	0.51%	0.42%	-0.09%
20.06.2020	0.74%	0.43%	-0.32%
21.06.2020	0.74%	0.43%	-0.32%
22.06.2020	0.64%	0.65%	0.01%
23.06.2020	0.64%	0.66%	0.02%
24.06.2020	0.64%	0.66%	0.02%
25.06.2020	0.64%	0.68%	0.04%
26.06.2020	0.64%	0.64%	0.00%
27.06.2020	0.62%	0.43%	-0.19%
28.06.2020	0.62%	0.43%	-0.19%
29.06.2020	0.65%	0.65%	0.01%
30.06.2020	0.66%	0.64%	-0.02%

- MSCI CHINA ESG is slightly more expensive due to a higher ADV for the constituent basket and wider spreads for the constituents.
- The wider bid ask spread for ETFs tracking MSCI CHINA ESG is driven by the sector difference between MSCI CHINA Market Cap and MSCI CHINA ESG.
- However, post US open the on exchange bid ask spreads for ETFs tracking MSCI CHINA ESG tighten substantially and as a market maker can better hedge any ETF orders with the US ADRs and US listed ETFs tracking China.

Source: UBS Asset Management, Bloomberg. Data as of 8 July 2020.

Risk information

UBS ETFs investing in equities

UBS Exchange Traded Funds invest in equities and may therefore be subject to high fluctuations in value. For this reason, an investment horizon of at least five years and corresponding risk tolerance and capacity are required. All investments are subject to market fluctuations. Every fund has specific risks, which can significantly increase under unusual market conditions. The fund's assets are passively managed. As a result, the net asset value of the fund's assets is directly dependent on the performance of the underlying equities. Losses that could be avoided via active management will not be offset.

UBS ETFs investing in Real Estate Funds

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UBS ETFs investing in Oil and Commodities

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UBS ETFs investing in HFR

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UBS ETFs investing in Fixed Income

This UBS Exchange Traded Fund invests in government bonds of a single country and may therefore be subject to fluctuations in value. For this reason, an investment horizon of at least five years and corresponding risk tolerance and capacity are required. All investments are subject to market fluctuations. Every fund has specific risks, which can significantly increase under unusual market conditions. As a result, the net asset value of the fund's assets is directly dependent on the performance of the underlying index. Losses that could be avoided via active management will not be offset.

UBS ETFs investing in Multi Asset Portfolios

The Fund is highly dynamic and may exhibit above-average potential growth and investment performance, depending on the economic environment. For this reason, an investment horizon of at least five years and corresponding risk tolerance and capacity are required. The Fund is exposed to the investment risk arising from the Reference Strategy underlying the Swaps. In the event that the swap counterparty defaults under the terms of the relevant swap, the Fund may suffer a loss. The Fund's assets are passively managed. As a result, the net asset value of the Fund's assets is materially dependent on the performance of the underlying investments. Losses that could be avoided via active management will not be offset. The Reference Strategy is a rules based Algorithm designed to target consistent returns but may not be effective in delivering such returns.

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