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Five China Issues

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Will the current slowdown and the ongoing effort to change the growth model from investment/export to domestic consumption lead to a hard landing, a sizeable decline in world trade, and global growth?

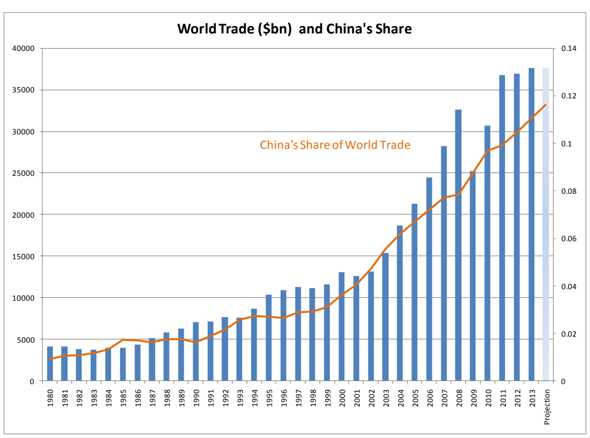
China Growth Statistics

China nominal GDP for 2014 will likely exceed $10 trillion, three times that of 2007. China has grown at 12.5% CAGR nominal and 10% CAGR real since 2000. 10% nominal growth in 2010 GDP was $500 billion; to generate the same amount in 2014 China needs to grow only 5%.

Source: IMF

China's share of total world GDP, less than 2% in 1990, has vaulted to 13% in 2014. China has been growing at 2x-3x world growth rate. Let's say China's 2015 nominal growth rate is half of 2014 and the world grows at the 3.9% pace of 2014, China's share of world GDP yet rises, to 13.5%.

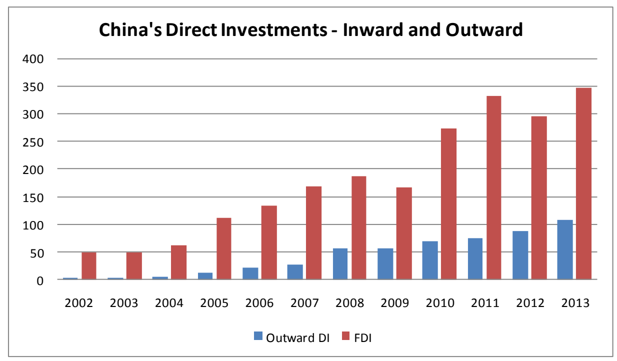
China's share of commodities demand ranges from 10% (oil) to 55% (iron ore), and many Asian economies and other commodity exporters would be wounded by a China slowdown. However, China commodity demand is strong, muting the impact of such dependencies.



Source: UNCTAD

Similarly for world trade: China's share has risen from 1% in 1980 to 11% in 2013. If we assume exports and imports grow at one-fourth the average of the last decade (i.e. 5%), China's portion of the world is steady at 11.6%.

China's outbound direct investment is rising as the government invests in resource-rich and developed countries in a continued aggressive outreach to new partners throughout the world.



Source: China Ministry of Commerce, World Bank

Many exporting countries, such as Taiwan and Korea, export components to China for processing and re-export. For these exports to grow, developed market demand is more vital than China demand.

New Growth Engine Needed

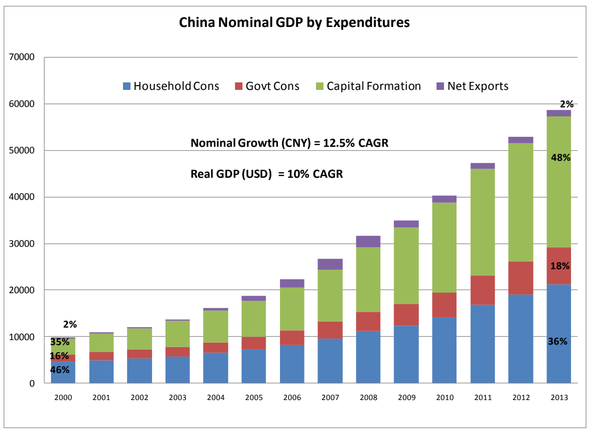
Growth in China has been fuelled by debt-financed investment (especially investment in property and construction), which has risen from 35% of GDP in 2000 to 48% in 2013, while consumption has declined from 46% to 36%. This is not sustainable – adding debt from projects which cannot pay back investors will worsen overcapacity and bring financial instability to the banking system and its local government backers.

What China needs is higher-quality growth with more consumption than investment, a more service-oriented innovation-driven economy, and less income inequality.

The China Economic Working Conference recently urged a lower economic growth rate through "forcefully proactive fiscal policy and appropriate adjustment in monetary tightness" signifying that China wants to stabilize growth while preserving fiscal expansion (infrastructure spending) under a backdrop of monetary easing, and with care to avoid downside risks.

From the chart below, construction and real estate account for 13% of China GDP (25% of fixed investments) and likely 30% of GDP including related industries: e.g. steel, cement, fixtures, furniture, metals, etc.

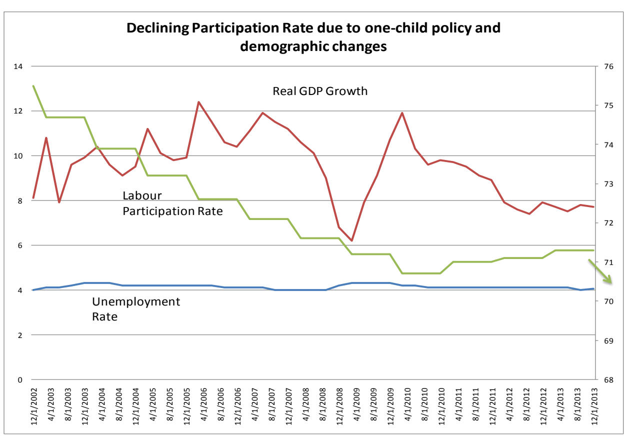
Real estate investment is facing headwinds: rising positive real interest rates and oversupply. We believe real estate investment will slow by half from 11% in 2014 to 5-6% in 2015. To ensure economic stability, the government will sustain infrastructure and social housing construction spending to avoid a hard landing.



Source: Bloomberg

The Labor Market and Social Stability

What is the level of growth that can maintain employment and social stability? China's labor market is more resilient than one would think.



Source: Bloomberg, World Bank

Demographics, the one-child policy, and economic structural change have made the labor market resilient to the slowdown.

A larger economy can generate as many new urban jobs. UBS has estimated that a 6.5% real GDP growth rate in 2015 could generate as many non-farming jobs in China as an 11% growth rate in 2008.

In cities, labor demand currently exceeds supply by 10% or more.

A labor-intensive service sector and SMEs are absorbing displaced labor from secondary industry.

Finally, the one-child policy implemented 30 years ago has lowered the labor participation rate, which has fallen five points from 2002 to 2010 and is likely to fall further.

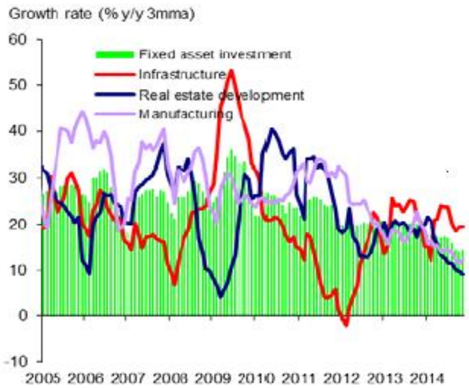
Population over 65 will rise to 14% in 2025, 20% in 2035, and more than 24% in 2050. Given the government's intention to create 10 million "new urban jobs" in 2015 and beyond, and the fact that they are aiming for a 7% or lower growth, we believe that 6-7% growth can provide labor market stability.

Our GDP Outlook

We expect China GDP growth of 7% in 2015 and 5-7% in the next decade, with little chance of a hard landing or a boom/bust crisis in the near-term. The decline in China's torrid growth rates of the last decades will relieve pressures on local and global resources, thus ushering in a period of more balanced and sustainable growth. Given the move to more value-added production and the consequent productivity increase, China can comfortably afford a growth rate of 5-6%, which is what we expect. A growth rate in this range will indicate a serious intention to implement structural and market reforms for longer-term growth.

China has revised its 2013 nominal GDP upward by 3.4% after its third economic census to reflect better coverage of services. In fact, the tertiary service sector has grown from 40% of total in 2001 to 46.9% in 2013, the first time the services sector has exceeded the share of manufacturing (44%). The tertiary sector grew at 7.9% in the first three quarters of 2014, outperforming the 7.4% growth in the secondary sector.

This is a meaningful and deliberate rebalancing toward the household sector away from government and corporate sectors. As manufacturing continues to slow, services and other emerging industries will provide job growth and maintain job market resiliency.



Sources: CEIC, UBS

Property slowdown (from 40% growth in 2010 to about 10% currently) causes fixed investment to slow and poses the biggest risk to GDP downside.

However, the government will keep up infrastructure and social housing spending as manufacturing and real estate spending slow.

About Rebalancing Toward Consumption

The old consumption model was characterized by wealthy buyers purchasing gift cards for others (read: graft). This model needs a complete revamp: self-purchases must replace "gifts" in order to get a good read on and launch real consumption-driven growth.

Although the expansion of services and e-commerce is helpful (now 10% of retail sales from 0% four years ago), the real potential of a consumer economy lies ahead. Demographics, politics and culture are in favor, but the substantial gains will be in the next decade.

How bad is China's credit/debt problem – shadow banking, local government debt, corporate debt – and can China deal with a credit crisis?

The rapid ascent of shadow banking and local government debt via the Local Government Financing Vehicles (LGFVs) for infrastructure investment has caused widespread alarm. The market believes that there is an implicit guarantee by the central government of those activities that will lead to a rise in perceived financial risk and excessive growth.

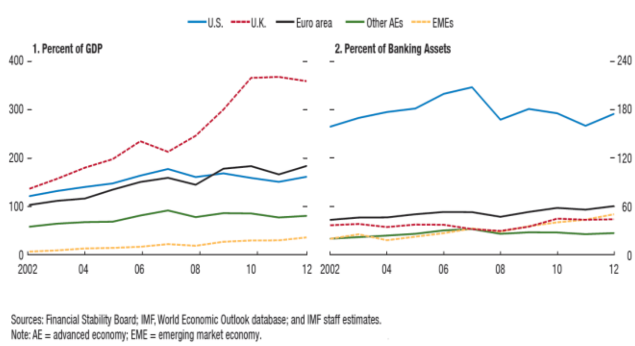
What is Shadow Banking?

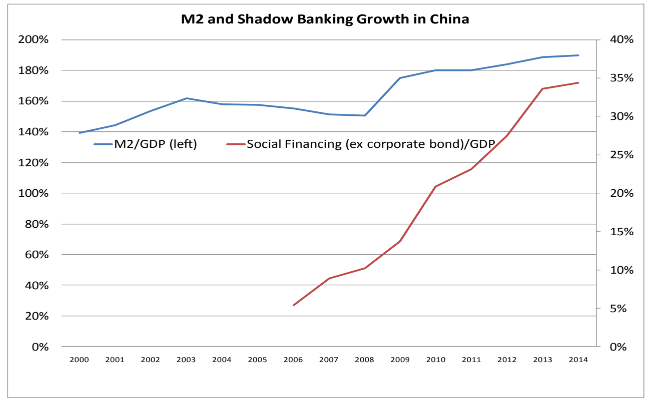
The Financial Stability Board (FSB) defines shadow banking as credit intermediation outside the conventional banking system, i.e. unregulated off-balance sheet financing. Today the shadow system is 25% of total financial intermediation. According to a 2014 study by the IMF, the U.S., U.K., and Euroland have the largest shadow banking systems (160 to 360% of GDP) with emerging economies far behind at around 30% of GDP.

*In China, shadow banking is **under 60% of GDP** (trust loans, entrusted loans, undiscounted bank acceptances, and corporate bonds). Off-balance sheet financing in China has surged and M2, while rising, fails to capture the true growth in financing activities.*

Shadow banking in China includes many activities and entities which are often double-counted. For example, trust funds and wealth management products (WMPs) are often added to gross measures of shadow banking even though they are the same credit chain (e.g. WMP invest in trust loans, bank bills, etc.)

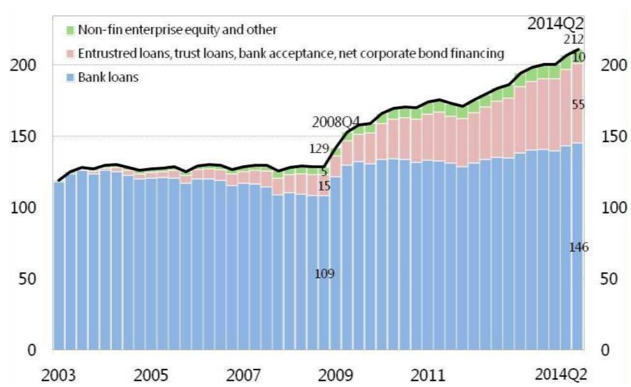
These are ways for banks to avoid regulations and controls such as the loan-deposit cap ratio, to retain bank deposits in the system while earning higher fees.





Source: Bloomberg

Since 2011, China has introduced a broader measure of credit called **Total Social Financing (TSF)**, which comprises bank loans, shadow funds, and equity, to include non-bank intermediation. Since the end of 2008, TSF rose alarmingly from 129% of GDP to 212% as of Q2 2014.



Sources: IMF, China National Bureau of Statistics

The chart above shows the asset side of the financial institutions – the total social financing, or simply the "uses of money". The growth in shadow banking, defined in China as trust loans, undiscounted bank acceptances, entrusted loans, plus corporate bonds, from 15% at 2008 to 55% of total by Q2 2014 is a dramatic change.

A broader definition might include underground peer-to-peer lending and finance and securities firms lending (e.g. bank-security cooperative business). Such a broader definition would highlight the larger magnitude of the longer term problem.

Viewed from the other side – the "sources of money" – the problem appears no less threatening and no less urgent, as the next table illustrates.

Shadow banking: liability side	Stock, year-end (RMB tn) 2011	2012	2013	Stock, year-end (% GDP) 2011	2012	2013
Total	23.4	29.5	36.9	45.3	56.7	64.8
Trust companies	4.8	7.5	10.9	9.3	14.4	19.2
Banks' Wealth Managemnt Products	4.9	7.1	10.0	9.5	13.7	17.6
Insurance Companies	5.5	6.9	7.7	10.7	13.2	13.5
Fund managers	2.2	2.8	2.9	4.2	5.4	6.4
Brokerage Firms	2.8	3.1	3.8	5.4	6.1	6.6
Others (VC, PE etc.)	3.2	2.1	1.6	6.2	4.1	2.8

Sources: CEIC, CVSOURCE, RBS

What Are the Risks of These Products?

Some parts of shadow banking are useful and not so risky (assets for personal lending or down payment for mortgages).

Still, the jump from 2011 to 2013 was alarming. The risks are liquidity, default, legal, and regulatory.

WMPs sold by non-bank financial institutions invest in riskier assets, have asset-liability mismatch, and are not principle-guaranteed.

Trust companies are the most problematic area of shadow banking: of the RMB 11 trillion at the end of 2013 (and about RMB 13 trillion at the end of 2014), about half are equity-related and half are debt-financing, which bears default risks. Half of the trust businesses also lent to individuals as opposed to a pool of companies or projects (e.g. local government), without the WMP investors realizing that they were undertaking significant credit risk.

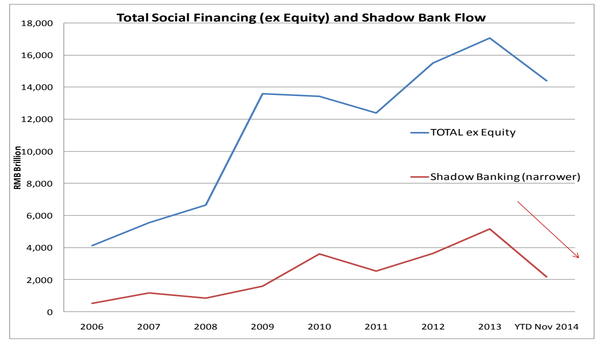
Currently, 70% of the WMPs are invested in fixed income products. With yield rallying over 150bp in the past two years and recent government regulation restricting investments into property trusts and the LGFVs, the banks must scramble for yield.

A May 2014 government Circular (No. 127) intended to curb interbank lending required a commercial bank to limit its interbank borrowing to less than a third of its liabilities. The same circular constrained lending to another financial firm to a maximum of 50% of its Tier 1 capital.

In early December the government changed the collateral requirements for repo, restricting it to bonds which are rated AAA and eliminating investments into LGFV-issued securities.

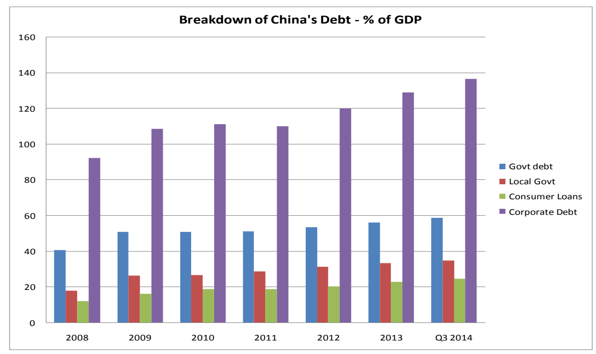
The PBOC repo operation is the main channel through which liquidity is injected into or withdrawn from the banks, which then use the repo market to provide liquidity to corporations.

As a direct result shadow banking flows have halved from 2013. December saw the outstanding amount of all trust products decline for the first time in the past 6 years.



Sources: Bloomberg, NBS

Corporate and Local Government Debt



Sources: NBS, NAO, JPM
(Local government debt is already included in Gov't Debt)

On first glance, the worrying debt component is the high and rising level of corporate debt, at almost 140% of GDP. Nonetheless, we believe there is no immediate danger: industry ROA is at 7.4%; profit margin is steady at 6%; current ratio at 1; and EBITDA/interest expense coverage is at 5.5x (at the end of 2013).

By contrast, default risk is much more real in local government debt. At 60% of GDP, the amount of government debt is not alarming. What is alarming is the dramatic increase in local government debt, which jumped from RMB 5.57 trillion at the end of 2008 to an estimated RMB 21 trillion as of Q3 2014. This occurred as a deliberate policy move to reach a certain GDP growth target, a goal set by the center and disseminated to local governments. Local governments are separated fiscal entities and can default (see above re: implicit guarantee). To meet their goals they issued LGFVs for infrastructure development since they were restricted from issuing bonds. These obligations usually have a 3-year term, with huge asset-liability duration mismatch, and doubtful revenue streams.

Government issuers may strive to roll them over but at some point these obligations are very likely to hit the central government balance sheet. The lack of hard budget constraints (local governments expand expenditures without dire consequences) encourages local governments to lever up irresponsibly.

In October 2014 the government came up with a new framework to deal with escalating local government debt:

- They delineated who could issue bonds and for what purposes, with debt repayment coming from the local budget, specified funds, or asset sales (e.g. via the stock market, de-levering the LGFVs).
- For infrastructure projects, public-private partnerships (PPP) will be used with the formation of SPVs that will be standalone entities.
- Local government debt will be separated from corporate debt, and the local debt levels and payment issues will be tied to local government's fiscal performance.

It is hoped that this new regime will focus local attention on fiscal imperfection and wean local bureaucrats away from bad past practice, particularly their obsessive focus on policy "headline growth" and unhealthy regional political competition.

We admire the initiative – and believe it can work -- but we believe change will come slowly to China's local cadres, as it comes slowly to politicians all over the world.

China's Risks Are Rising, But Manageable

China's financial risks are manageable as a result of the following factors:

(1) Low government debt and household debt: government debt, which already includes all the local government debt, is manageable at slightly less than 60% of GDP. Household debt is less than 25% of GDP.

(2) Supportive macro and regulatory environment:

  a) Lower interest rate and RRR trend to continue;

  b) government ownership of the big banks and heavy controls by the government to ensure that defaults are dealt with by protracted negotiations rather than a debt crisis trigger that would damage market confidence;

  c) captive deposits in the banks as capital account is still closed and the economy is heavily financed by banks;

  d) low loan-to-deposit ratio of 75%;

  e) high national savings rate of close to 50%, with total external debt at a mere 10% of GDP.

(3) Given state ownership, the government can sell down assets by IPO to de-lever the SOEs or LGFVs.

(4) Still-closed capital account means capital flight is unlikely to trigger any debt crisis.

Nevertheless, the slowdown of China's nominal growth from a high double-digit level as recently as 2011 to a current rate of about 8-9%, the rise of 1-year real lending rate to 7-8% in the past two years from 2000 to 2011 at 3% on average, the graying of the population, and the likely exit of the easy monetary policy by all the major central banks in about 4-5 years' time would give China a window to accelerate structural reforms in the next few years to put its financial risks under control.

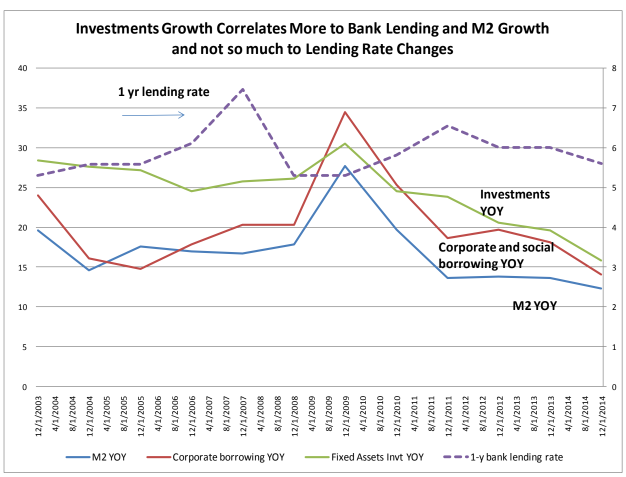
Do lower rates have a material impact on China growth, given the monetary tools China has at hand?

Overview of China's Central Bank

Monetary targets and decisions in China are made by the State Council, China's cabinet, while the central bank (the People's Bank of China or the PBOC) implements the policy. The objectives of the PBOC are often multiple and at times contradictory, including: growth, inflation, exchange rate and financial stability, and structural adjustments. The central bank was only legally set up in 1995, and the capital markets are recent phenomena.

To implement policy imperatives China relies heavily on quantitative measures rather than interest rates. Chinese banks and corporates are primarily state-owned, and bank lending made up 62% of total financing (loans + bonds + equities) in 2014. In China, as a result, the price and quantitative measures **do not necessarily move in the same direction** (see chart later). Furthermore, the 2008/9 global financial crisis caused the government to use its banks to promote growth and rely heavily on the local government, which has strong ties to commercial banks, to step up infrastructure investments, using land sales and revenue as collateral for borrowing. The chart below shows the relationship between bank lending, fixed investment growth, and M2, with interest rates not changing much during the same period. In the past, monetary tools besides interest rates have been used to manage growth.

Lending rate changes are not affecting growth; rather bank lending growth and M2 growth (quantitative measures) affect investment growth.



Source: Bloomberg

How does monetary policy traditionally work in China?

After the State Council has set up its growth and inflation objectives for the next year, the PBOC will target the broad money (M2) growth, which in turn is indirectly influenced by the quantity of base money (M0).

The central bank controls the base money either through purchasing foreign exchange from the banks and injecting RMB or by directly on-lending to the banks. Since 2003, the fast accumulation of FX reserves has led the PBOC to sterilize the FX inflows by issuing central bank bills. When the bill rates rise above the US Treasuries (FX), the central bank has resorted to raising the Required Reserve Ratios (RRRs), reaching 20% by 2014. These reserve deposits of commercial banks earn below-market interest rates and are less costly than the issuance of central bank bills. The obvious drawback is that the high RRR reduces the banks' ability to lend and the bank margins, as RRR earns interest rates lower than the central bank bills and even the deposit rates. Therefore differentiated RRRs have been used since 2011, depending on the bank's capital adequacy ratios and actual loan growth.

The central bank can also influence the M2 growth through administrative controls on bank lending (amount of new lending, lending freeze, or lending quota, etc.). The advantage of using administrative controls is that the authority can more specifically control the over-lending situation, in particular sectors such as heavy industry, mining, and property without hurting the "good" sectors. (Reference: The China Monetary Policy Handbook by UBS)

More Recent Monetary Policy Operations

Beijing hesitates to cut interest rates for fear of sending an errant liquidity signal. Instead the PBOC has resorted to managing money market rates.

Short-term interbank rates are the true "free" market rates in China, visibly influenced by the demand and supply of funds (extracted from Bloomberg):

In 2007, the **3-month SHIBOR** (similar set-up to LIBOR) was introduced, which was later replaced by:

The **7-day repo** rate as the best short-term money-market rate (see following chart). The repo rate spiked when RRR was hiked or when large IPOs were issued.

SLO: Starting in 2013, the PBOC adopted SLOs, or repurchase agreements and reverse repos with maturities of fewer than seven days to manage the cash supply.

Investors should follow the 7-day repo rate for regulatory changes, FX flows, sentiment, PBOC liquidity management glitches, etc.

There is also an array of targeted facilities, each designed for this specific technical purpose:

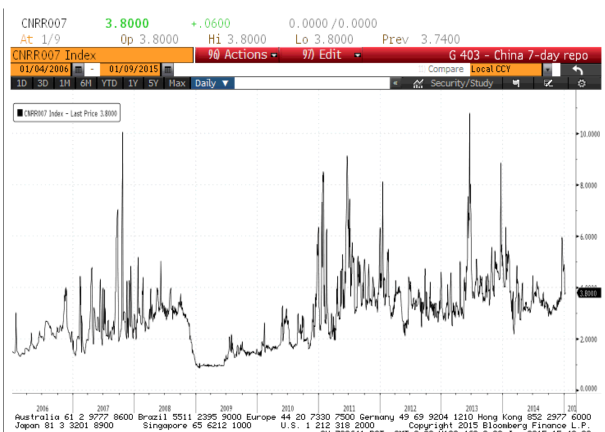
SLF (Standing Lending Facility): Similar to the discount window at the Fed or the marginal lending facility by the ECB, this offers 1- or 3-month liquidity support to banks and was mainly used in 2013.

PSL (Pledged Supplementary Lending): this provides long-term financing to banks for housing projects or shantytown development starting in 2014.

MLF (Medium-Term Lending Facility) was also an option for banks starting in 2014.

Targeted RRR cuts were offered to specific banks in April and June 2014 to boost rural and small businesses lending.

The targeted measures implemented to date have a similar impact as a 125bp broad-based RRR cut.



Source: Bloomberg

Currently, the 7-day repo rate is the best indicator of short-term interbank liquidity. Spikes represent either monetary tightness, regulatory changes, or PBOC liquidity management glitches.

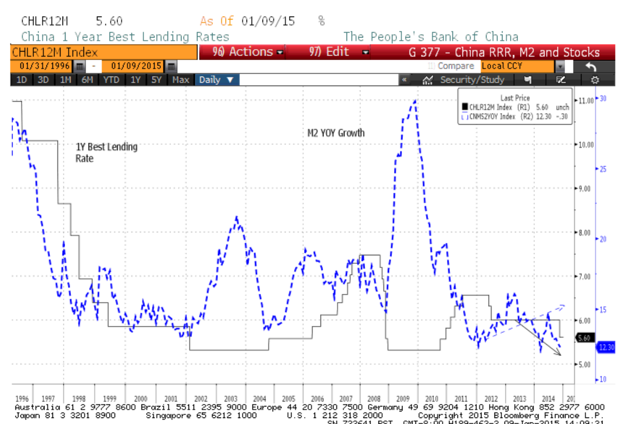
Why an Interest Rate Cut in November 2014?

The PBOC cut interest rates on November 21 for the first time since July 2012. They did it asymmetrically – lowering 1-year deposit rate by 25bp to 2.75% and 1-year lending rate by 40bp to 5.5%. More important, they **increased the maximum deposit rate** from 1.1x to 1.2x the benchmark – a good signal for further interest rate liberalization. Banks are universally offering deposits at the ceiling rate, which means if the deposit rates were liberalized interest rates would certainly rise, reducing bank margins.

If China mainly uses quantitative measures (monetary aggregates, credit quota), an interest rate cut can only be intended **to ease SOE interest burden**. The new monetary measures introduced recently were not as transparent as traditional measures and created unintended distortions. The economy was slowing down fast, with November industrial production growing at 7.2% yoy, approaching the level at the beginning of 2009. Auto sales and real imports have also been slowing down. Negative PPI since March 2012, low inflation of +1.4% yoy, and TSF growth deceleration completed a dismal context. Lowering the corporate interest burden thus required direct intervention in lending rates.

Monetary Policy Going Forward

As a UBS economist put it, the PBOC does not aim to loosen policy but to prevent monetary conditions from being too tight. As trade surplus and FX accumulation have eased, Beijing needs to counterbalance tighter financial conditions by injecting liquidity. Corporate cash flow needs to be improved as output prices fall and real interest rates rise. Today the price and the quantitative measures of monetary policy are moving in the same direction.



Source: Bloomberg

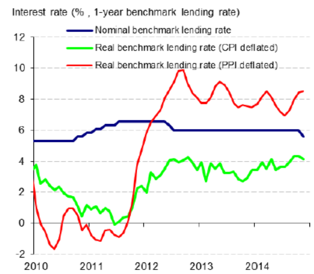
Monetary Policy Outlook

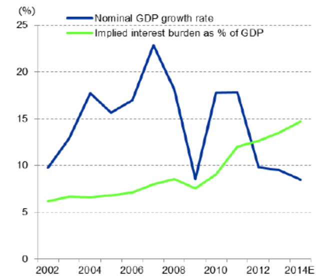
More liquidity injection is needed to buffer the effects of structural reforms: economic slowdown and traditional tightness of liquidity around year-end have led to a higher than expected release of fiscal spending of RMB 1.5 trillion. We predict the PBOC will continue to use a mix of traditional and non-traditional monetary tools in 2015 to accomplish these market effects:

Interest rates to be lowered by around 50bp and more RRR cuts.

Quantitative measures such as the SLF and MLF to aid growth.

Expanding the definition of deposits used to calculate the loan-to-deposit ratio (LDR) by including interbank deposits and securities. Today the RRR requirement for the newly added deposits is set at zero. LDR is effectively forced downward by 4-5%. This easing signal will encourage higher bank lending. Should the PBOC decide to include the newly added deposits in the RRR, then the PBOC would need to actually cut the RRR to prevent financial tightening.





Sources: UBS, CEIC

Note the rising real lending rate – no longer negative! Also *(right chart)* note the dangerously growing wedge between the interest burden and nominal GDP growth.

Are structural reforms for real?

In China's Third Plenary Session of the 18th CPC Central Committee in November 2013, the new leaders announced 60 reform tasks to be completed by 2020 in the following areas: Fiscal; Finance; Government Administration; SOE; Demographic Policy; Hukou (household registration, social security); Social Safety Net; Healthcare; Rural Land; Resource Prices; Services; Intellectual Property Rights Protection; and Environment and Infrastructure Investment.

China has been stalling its structural reforms efforts in the past ten years so these announcements were greeted with much fanfare and market commentary[1].

Several changes that were put forward do give us hope that China is serious about structural reforms:

Increasing Accountability: Establishing a leading team for "comprehensively deepening reform" and a State Security Committee to be headed by the top leader.

Market Mechanism: Highlighting that the market should play a decisive role in deciding asset allocation e.g. price reforms for water, oil, gas, electricity, etc. and open investment opportunities for foreigners in many industries.

Financial Reform: Reform of policy banks and financial institutions, allowing private capital to establish banks and financial institutions; a better IPO process; deposit insurance; a bond market and exchange rate system; and accelerating capital account convertibility.

Fiscal and Tax Reforms: Increasing the responsibility of local governments for their own expenditures (local government collects 50% of fiscal revenue but spends 85% of fiscal expenditure); extending the VAT reform; increasing the role of direct taxes; imposing environment protection; and increasing real estate taxes.

Public-Private Partnership and SOE Reforms: Encouraging private capital to participate in public-led investment projects and tightening property rights.

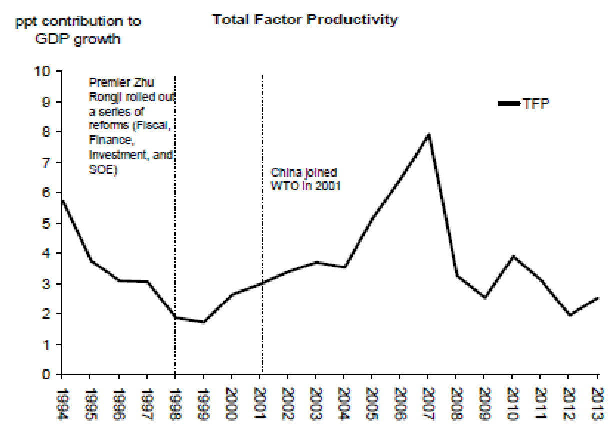
Establish a New Rural-Urban Relationship: Granting farmers more property rights, a market to transfer rural properties, a unified urban and rural land market, and faster household registration (Hukou reform).

How successful has implementation been in the past year and what should we expect?

I have ranked the reforms from the most progress to the least progress and assigned a score out of 10 in red for the progress so far – please refer to Appendix 1 for these rankings.

Will the reforms be implemented?

The reforms implemented by Premier Zhu Rong Ji during 1996 to 2001 – SOE reform, fiscal reform, financial reforms, current account convertibility, government administration streamlining, and WTO accession – have boosted the residual growth factor, TFP, by about 6% according to Morgan Stanley's study .



Sources: MS, CEIC

Previous reforms in 1996-2001 did raise TFP and GDP growth.

We conclude that if a majority of the contemplated reforms are implemented, growth in China can be maintained at 6-7% into the 2020's.

[1] One of the main obstacles to structural reforms in China is its unique system of a command economy with heavy localization of power in administration and economic resource control. The local government only accounts to the central government, not to the voters, while the center relies heavily on the local government for information, incentivizing it to cheat for its self-interests.

What is the outlook for the China A-share and H-share markets?

Growth Does Not Guarantee Returns; Cheap Valuation Does

At Manifold Partners we believe in systematic valuation, so *whatever* the growth potential of a security or market, we always ask: “what expectation is priced in already?”

Market historians and quants agree that growth alone may pay off in the short run in “greater fool” markets, but buying at the right entry price pays off over the long run *regardless* of short-term markets.

A revealing example of this time-tested concept is China. As soon as growth rates started to decline from the torrid double digits level of the previous decade, investors left in flock, some calling for a collapse of the “Chinese miracle”. The sell-off was so extensive that it accidentally priced in a hard landing: China was the cheapest market at the beginning of 2014. With a hard landing priced in, growth became irrelevant, and the domestic market had a staggering rally. A-shares printed a juicy 52% for 2014.

Despite the rally, based on our valuation, China remains one of the cheapest markets in the world, even assuming a decline in growth toward 6%. There are some concerns, mainly emanating from the financial system and the real estate market.

What investors overlook is that China is still a closed capital system, with many policy options to overcome financial, credit, or real estate crises. For example, bank deposits are an astounding 180% of GDP, reportedly funding 60% to 70% of loans; reserve ratios are at an amazing 19.5%. The Chinese authorities shrewdly used these reserves and captive deposits to re-capitalize the banking system in the late 1990s (see “Red Capitalism” by Carl Walter and Fraser Howie).

There are additional reasons that we continue to be positive about the A-share markets:

Government promotion continues.

Macro policy support.

Bank deposits shift into alternative products.

MSCI EM Index inclusion.

Margin financing encourages retail investors.

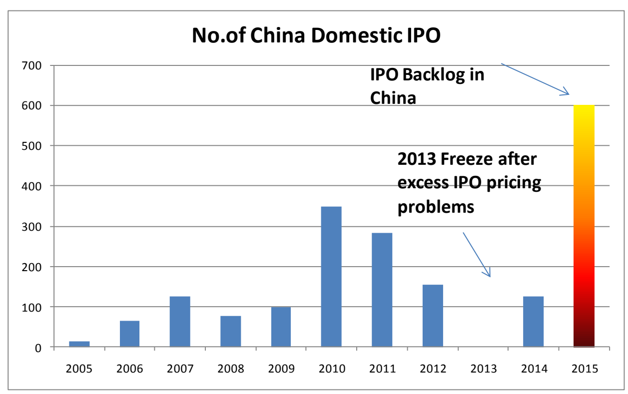
Anti-corruption investigations tapering off.

Government Policies and IPOs

Source: Bloomberg

It is no secret that the government is pursuing a fully functioning, transparent, and efficient stock market in order to force the SOEs to reform. They hope and predict that healthier SOEs will mean better economic growth.

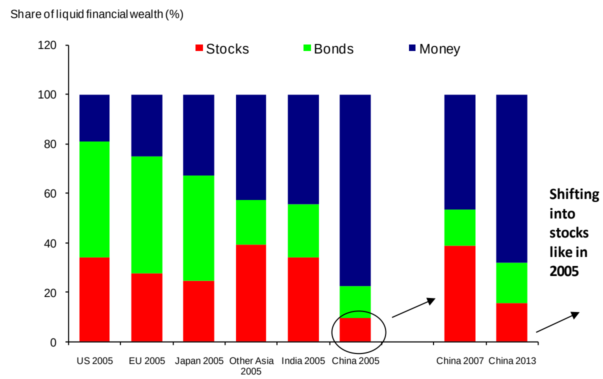
In the past, when the government has perceived inefficiencies or excesses in the stock market, Securities Regulators have micro-managed the pipeline for IPOs, usually to unfortunate effect. Most restrictions have now been removed and the current IPO pipeline is about 600, compared to barely 100 last year. This alone will be a major source of potential growth, since IPO activity increases liquidity regardless of IPO pricing.



Source: PwC, various news media

Shift in Portfolio Allocation

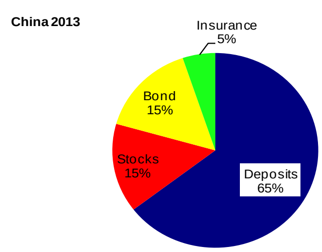
Over the past fifty years *every* developed market has undergone a transition from non-financial wealth to a robust share of wealth being stored in securities. In China, close to 70% of liquid wealth is still in the form of money or bank deposits. Prior to the stock market run in 2005, stocks were a mere 9% of total liquid financial wealth, rocketing to 35% after the bull market and settling lower thereafter. The following graph highlights the very small amount held in stocks by the Chinese compared to other selected markets.



Source: CEIC, UBS

Indeed, the market capitalization of Chinese stocks is currently at about USD 4.9 trillion compared to the Chinese household bank deposits of RMB 49 trillion or USD 8 trillion (RMB 113 trillion or USD 18 trillion counting all RMB deposits).

A mere 10% shift from bank deposits to stocks could raise market capitalization by close to 20%.



Source: UBS

Relative valuations among investment opportunities show the way to a sizeable inflow for local stocks. This will increase liquidity, transparency, and efficiency.

	Shanghai A	Shenzhen A	Residential Property	Bank Deposit	Govt Bond	Wealth Mgt Product
2005	-5.7%	-11.7%	23.4%	2.3%	25.2%	5.4%
2006	135.1%	97.5%	24.6%	2.3%	2.9%	4.6%
2007	97.4%	162.8%	44.2%	2.5%	-7.8%	5.0%
2008	-64.9%	-61.8%	-6.1%	4.1%	21.8%	10.2%
2009	82.4%	117.1%	41.5%	2.3%	-3.9%	8.1%
2010	-13.0%	7.4%	14.1%	2.3%	3.5%	7.5%
2011	-20.2%	-32.9%	8.0%	2.8%	8.6%	8.3%
2012	5.8%	1.7%	11.1%	3.5%	2.4%	9.2%
2013	-3.8%	20.0%	20.4%	3.0%	-3.1%	9.3%
2014	**58.0%**	**33.8%**	**-1.5%**	**3.0%**	**10.5%**	**7.3%**
2008-2013 (CAGR)	**-10.7%**	**-4.4%**	**11.9%**	**2.6%**	**3.9%**	**7.5%**

Source: Bloomberg, CEIC, Morgan Stanley

Lumen Global Value Compass

At our predecessor firm we developed a highly useful tool called the Lumen Global Value Compass. The Compass extracts from live data the market implied discount rate (or IRR), without resorting to forecasts, subjective predictions, assumptions, or theoretical models.

The result is an unbiased value metric that is directly comparable across the global investment universe.

This metric is not what is likely to occur, but what is priced in today. Once we know what is priced in, we use a scenario module to deconstruct implicit growth and profitability, evaluate their likelihood, and quantify the probable risk/return profiles.

For example, if we lower China implied earnings growth from 10% to 6% and the terminal growth rate from 8.8% to 7% for both the H and A markets, H-shares still look attractive to us with the hypothetical cost of equity (Ke) at 10.2%, while A-shares, with Ke at 8.6%, have become more expensive.

Implied Valuations – Actual vs. Scenarios

MARKET SCENARIO Reset All Initial Period 2 Years

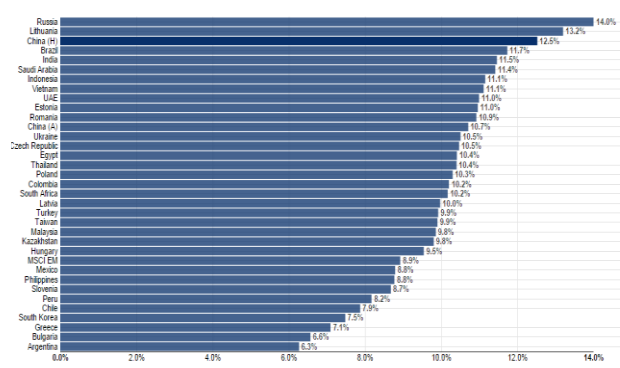
Market		Return on Equity	Implied Earnings Growth	Price-to-Book Value	Price-to-Earnings	Terminal GDP Growth (Nominal) Rate	Dividend Yield	Cost of Capital (Ke)
China (H)	ACTUAL	15.21%	10.34%	1.27	8.34	8.8%	3.84%	12.51%
	SCENARIO	10%	6.16%	1	10	7	3.84	10.19%
China (A)	ACTUAL	15.33%	10.69%	2.27	14.81	8.8%	2.04%	10.7%
	SCENARIO	9.71%	6.24%	1.7	17.5	7	2.04	8.55%

Sources: Bloomberg and Lumen Compass, as of 12/31/14

The Lumen Global Value Compass is research technology available from lumen@lumenadvisors.com.

Using the Lumen Compass, China (H) shares rank among the 3 cheapest markets in the EM universe as of the end of 2014. China (A) shares' valuation also ranks in the top one-third according to the Ke ranking chart below, despite the 52% rally in 2014.

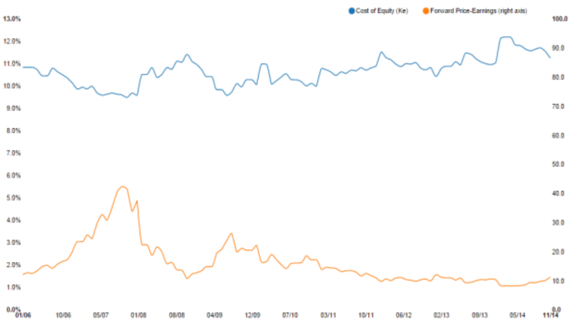
Ke (implied cost of equity) Ranking of Emerging Markets:
(The higher the Ke, the cheaper the market)



Source: Lumen Compass, as of 12/31/14

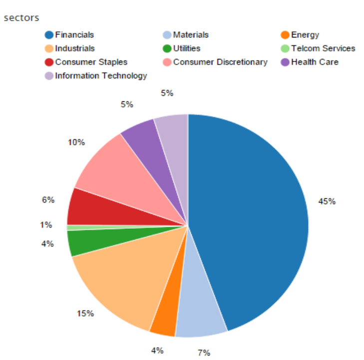
Despite the rapid ascent of the A-share market, we think talk of bubbles is misplaced. Valuation is more important than expectation! The Ke and forward PE are 10.7% and 14.8x as of the end of 2014, far below the peak in 2007 of 9.5% and 40x.

China (A) – Historical Valuation



Sources: Bloomberg and Lumen Compass, as of 12/31/14

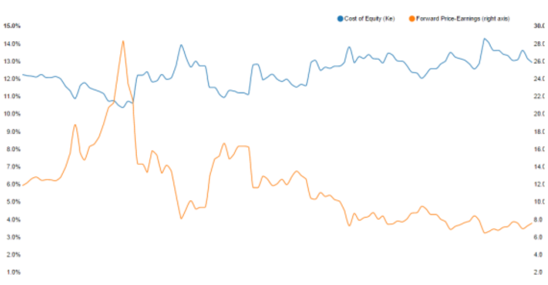
China (A) – Financials, Industrials, and Consumer Discretionary comprise 70% of the market, with Financials and Consumer Discretionary also being the cheapest sectors.



	Sector Weight
Financials	44.66%
Materials	7.04%
Energy	3.52%
Industrials	15.29%
Utilities	3.85%
Telecom Services	0.74%
Consumer Staples	5.51%
Consumer Discretionary	9.92%
Health Care	4.91%
Information Technology	4.57%
Other	0%

Source: Lumen Compass, as of 12/31/14

China (H) – Historical Valuation



Sources: Bloomberg and Lumen Compass, data as of 12/31/14

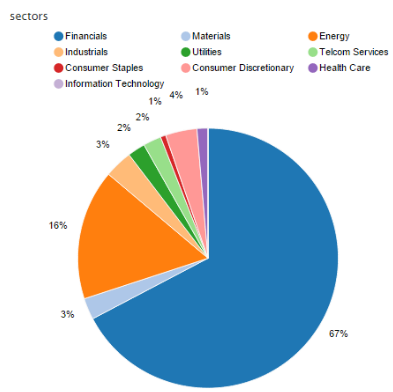
In China (H) shares, valuation is cheap on both an absolute and an historical basis, as shown in the chart above. H-shares are concentrated in financials (67%) and the energy sectors (16%), reflecting the dominance of the SOEs.

The same banks listed in the H-share markets are cheaper than those in the A-share markets, reflecting a consensus bearish view of foreign investors who can buy only H-shares. As shown in the table below, banks' Ke range from 12.7-16.6%; P/B at around 1x; forward PE at 5-6%; and ROE at around 16-20%. For example, in banks we believe that interest rate cuts and financial reforms focused on corporate governance will improve the balance sheet and the efficiency of banks and will slow NPL formation as corporate cash flow improves. Put another way: banks have priced in a lot of downside risk.

	MCap (M)	Ke	PE	PB	DY	g	ROE	ROA	Lev
BANK OF COMMUNICATIONS CO-H 3328 HK	588,236	**12.72%**	6.68	0.96	4.36%	10.14%	14.31%	1.06%	13.24
CHINA MINSHENG BANKING-H 1988 HK	439,001	**12.88%**	5.93	1.27	3.02%	17.66%	21.5%	1.44%	14.89
CHINA VANKE CO LTD-H 2202 HK	193,112	**13.76%**	9.7	2.21	3.14%	15.82%	22.76%	3.55%	6.23
CHINA CITIC BANK CORP LTD-H 998 HK	417,244	**13.97%**	5.74	0.95	4.91%	11.87%	16.53%	1.1%	14.75
CHINA MERCHANTS BANK-H 3968 HK	516,432	**14.26%**	6.87	1.39	4.09%	14.6%	20.3%	1.41%	14.41
BANK OF CHINA LTD-H 3988 HK	1,381,847	**15.11%**	5.94	0.99	5.83%	10.86%	16.61%	1.17%	13.99
IND & COMM BK OF CHINA-H 1398 HK	2,105,830	**16.27%**	5.85	1.14	5.91%	12.76%	19.5%	1.43%	13.43
CHINA CONSTRUCTION BANK-H 939 HK	1,638,288	**16.57%**	5.61	1.09	6.21%	12.61%	19.36%	1.46%	12.99
AGRICULTURAL BANK OF CHINA-H 1288 HK	1,479,957	**16.64%**	5.56	1.08	6.25%	12.67%	19.42%	1.24%	15.41

Sources: Lumen Compass and Bloomberg, as of 12/31/14

China (A) – Financials and Energy, two of the cheapest sectors, comprise close to 75% of the market.

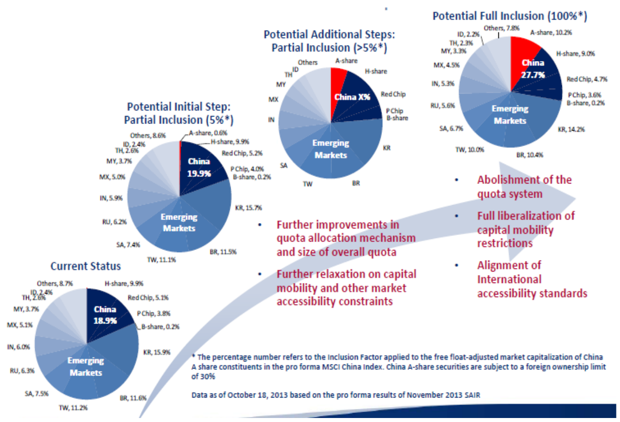


	Sector Weight
Financials	67.29%
Materials	2.66%
Energy	16.22%
Industrials	3.47%
Utilities	2.18%
Telecom Services	2.24%
Consumer Staples	0.66%
Consumer Discretionary	3.91%
Health Care	1.36%
Information Technology	0%
Other	0%

Source: Lumen Compass, as of 12/31/14

Another reason for optimism for the A-share market is related to the potential inclusion of the domestic shares in the MSCI EM Index, to be reviewed in April/May 2015.

MSCI China A-share Inclusion



Source: MSCI

Now that the HK-Shanghai Stock Connect has launched, A-share is likely to be included in the MSCI EM Index, taking the China component from 19% to 20% (with a partial inclusion of 5% of the free-float adjusted market cap of China A.) 100% inclusion would take the China component to nearly 30% of MSCI EM index.

The preparation work to link up the Shenzhen and the Hong Kong stock exchanges is likely to launch in 2015.

Summary

Despite persistent fears of hard landing, real estate and financial crises, and the China bashing amongst "sinologists", the market in China has actually behaved according to the simplest rule of finance: cheap valuations drive return.

The wide-ranging reform program launched in 2014 will solidify these gains and most likely achieve the main objective of the Government: a deep, transparent, and efficient capital market based on equity and not credit. This goal is crucial for a modern market and stable economy. There is no question that China is in a volatile phase, but the economic opportunity should be evaluated based on facts, not fiction.

Appendix 1: Reforms and Results

Reform Area	Implementations	Remarks
Market Mechanism and Administrative Reform	(1) Cutting or delegating to local governments about 400 administrative approval items. (2) Simplifying import management and administrative processes. (3) Simplifying approvals for corporate investments. (4) Progress in letting energy, agricultural, airline ticket prices adjust to market. (5) The Premier further pushed for the PPP model to encourage private capital into the government-led projects in power, railway, broadband, agriculture and social services.	**(7/10)** On track to let market play a bigger role – rising new enterprises registrations in 2014 and more tax cuts for small and micro enterprises.
Financial Reform	(1) Increased RMB daily trading band to +/- 2%. (2) Established Shanghai Free Trade Zone and fully liberalized FX deposit rates in FTZ. (3) Circular 127 to curb interbank lending and shadow banking. (4) CBRC approved 3 private-owned banks. (5) Established more offshore RMB centers and awarded more RMB QFIIs. (6) Launched HK-Shanghai Stock Connect.	**(6/10)** The government is taking small and gradual steps in all areas of financial reforms. Interest rate cap on deposit rates could be lifted by 2016 (CB target). Capital market development, especially in bond markets has accelerated. However, implicit guarantees beliefs in bond and shadow banking activities are still entrenched which means more NPLs to be dealt with over a longer time rather than a big crash.
SOE Reform	(1) SASAC has announced that 6 centrally administered SOEs will pilot reforms in: a) board of directors appointing executives and deciding compensation, b) capital investment company restructuring, c) mixed-ownership, d) to be supervised by Central Discipline Inspection Group. (2) Central government announced plans to cap SOE executives' salaries and expenditures. (3) Moving towards employees stock incentives in SOE banks.	**(5.5/10)** Lack of clear guidelines from the Central government on SOE reforms e.g. which industry falls under competitive sector vs. natural monopoly? Local-level SOE (about 2/3 of SOEs) reforms are progressing more rapidly in mixed ownership and assets listing than the centrally administered SOEs. Property-led slowdown and local government debt worries could speed up reforms.
Fiscal Reform	(1) Allowing 10 local governments to issue Municipal bonds for RMB 400 bn. The borrowings are strictly for investment projects, all to be approved by the State Council, and do not carry debt guarantees.	**(5/10)** There is still a lot more to do here, and **this is a key reform area** in order to rebalance wealth away from government

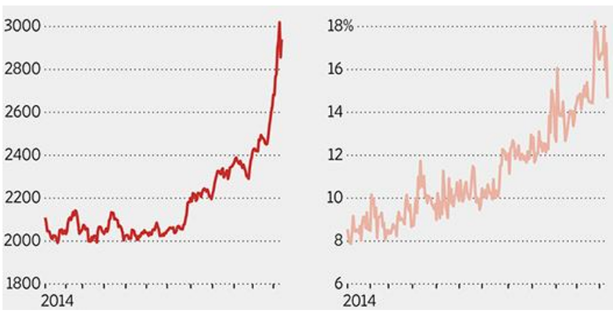
	(2) Changing the coal resource tax from quantity to price-based to better adapt to supply and demand changes. (3) Lowering taxes for small and micro enterprises. (4) Set up a framework to classify and regulate local government debt.	to household and corporates to improve consumption. Need to see real progress in 2015 for local government debt to be included in the budget management system to better match local government revenue and expenditures. Nationwide property tax implementation is not expected before 2017. Price adjustments in transport, energy and utilities can accelerate given disinflation.
Household Registration, Land Reform, and One-Child Policy	(1) Small and mid-size cities to remove residence restrictions. (2) Central government approved the "Guide on Rural Land Contract and Management Rights Transfer" and the "Pilot Reform Proposal to Develop Joint Stock Co-ops Among Farmers." (3) Relaxation of the "One Child Policy" carried out nationwide by mid-2014.	**(5/10)** Hukou and land reforms are linked. The more sensitive issues of equal social safety net for urban residents and non-residents are not addressed. Also 90% of rural hukou holders are unwilling to change it for a city hukou mainly due to farm land rights, pension, education, and medical benefits, according to a recent survey. Land reforms are likely the most complicated reform area – land rights clarification and transfer of management rights have to be undertaken before the implementation of nationwide land reform.

Sources: JPM, MS, RBS, various websites

Appendix 2: Anecdotes and Trivia

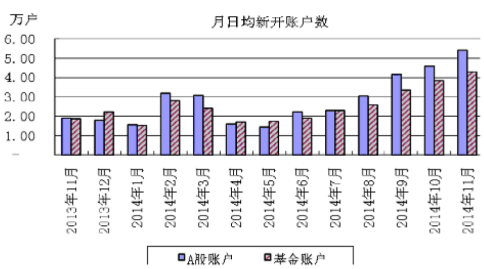
Liquidity Fuels A-share Rally

Margin financing from brokers reached RMB 1 trillion as of December 31, 2014 from almost nothing in 2010. With the CSRC easing the requirement for brokers' margin financing and stock market access in 2014, retail investors with assets as few as RMB 50,000 (USD 8,000) can margin. 95% of the margin financing is for "buys" as security lending is not yet well-developed – pushing the market up rapidly when times are good but adding to downside financial risks when the sentiment turns.



Source: Wind Info, WSJ; data from Jan 1- Dec 10, 2014

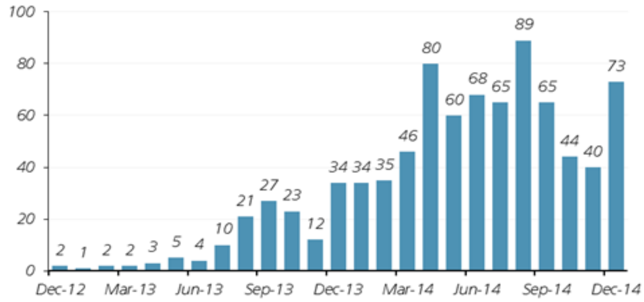
The number of new accounts is another sentiment indicator of the stock market. Currently the number of valid stock accounts stands at 142 million, a change of 9.5 million in 2014 and still a small number compared with a rise of 37 million in 2007. The following chart shows the new stock accounts opening in the Shanghai and Shenzhen Bourses (per day on average in increments of 10,000). In November 2014, the A-share account opening per day (blue bar) reached 55,000.



Source: CSDC, www.chinaclear.cn

Investigations Watch

The following chart shows the number of senior government officials being investigated by the Central Commission for Discipline Inspection. As the number of investigations goes down, the market sentiment improves. The government can also get tougher with the local government financing vehicles issues, pushing through more market reforms and getting on with the SOE reforms on both local and nationwide levels.



Source: http://www.ccdi.gov.cn/; UBS estimates, by date of public announcement

Disclosures

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