FIS GROUP

July 2015

MARKET INSIGHTS ALERT

Transition to a Chinese-Style "New Normal": Less Is More

TINA BYLES WILLIAMS
CIO & CEO

TRACY CAO
PRODUCT SPECIALIST
MANAGER RESEARCH

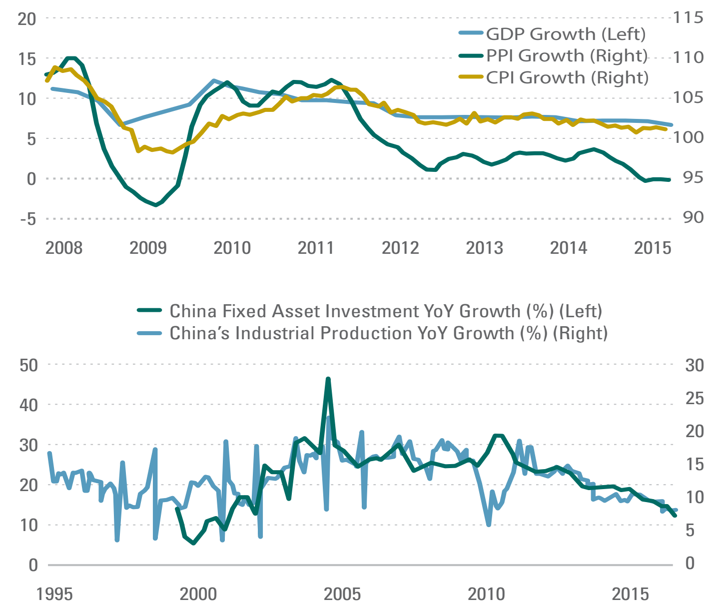
SYNOPSIS

In China, economic results of late have largely been disappointing, with traditional headline indicators highlighting sluggish growth and mounting deflation risk. Our view is that China is experiencing the economic transition to a so-called "New Normal", and the prevailing growth slowdown, gauged by traditional industrial-focused indicators, is both necessary and essential for the ongoing economic transformation. In this paper, we will discuss the key priorities of the reform agenda, along with the Chinese government's progress in implementing these reforms to date. In the last section, we will discuss the nascence of this round of the bull stock market and the recent massive correction, along with our short-term and long-term expectations. **The bottom line is that we are positive on China's economic reform and the government's efforts in supporting capital market reform. We also believe that there will be more upside in Chinese A-shares, but that the next leg will be characterized by extreme volatility.**

PART I: FUNDAMENTAL DECELERATION BASED ON TRADITIONAL GROWTH MEASURES

In China, economic results of late have largely been disappointing (see CHART 1). According to data from the National Bureau of Statistics of China, in May the Producer Prices Index (PPI) decelerated by 4.6%, after declining for 39 consecutive months. Consumer Price Index (CPI) dropped to 1.2%, registering the slowest pace since March 2010. GDP growth expectations were lowered to 7.0% from a 7.1% target at the beginning of the year, underscoring the prospect for further deterioration. On the industrial front, China endured a substantial slowdown in investments in housing, factories, and other fixed assets for the first 5 months of this year relative to the same period last year. Despite a recent snap-back in the property market, thanks to less restrictive government regulation, the Chinese housing market has largely lost steam, with both price and transaction volume pointing to a structural slowdown.

CHART 1 Macro Economic Climate of China



Source: National Bureau of Statistics of China

PART II: ROAD TO A "NEW NORMAL" – LESS IS MORE

The negative headlines, in our view, reflect both a cyclical slowdown (typical of EM economies whose rapid growth is supported by investment growth exceeding domestic consumption) and a fundamental economic rebalancing from an investment-focused and export-led economy to one more driven by domestic consumption. In this vein, the traditional, industrial-focused metrics that investors have primarily used to gauge China's economy are losing their relevance. In fact, we believe that the growth slowdown, indicated by those proxies, is both necessary and essential for this economic transition, which we have called "Less is More".

WHAT IS THE "NEW NORMAL" FOR CHINA?

Since 2013, the Chinese government has encouraged broad-based economic reform, by allowing for a short-term slowdown in order to achieve long-term sustainable growth, referred to as the "New Normal". The highlights summarized below, in our opinion, are key priorities in the government's reform agenda:

1. **Industry Leadership:** shifting from the "2nd Industry" to the "3rd Industry"
2. **Economic Structure:** shifting from Investment and Export to Domestic Consumption
3. **Property Market:** short-term improvement but downshifting over the long haul, driven by China's aging demographics
4. **Capital Structure:** replacing debt with equity; transforming government (including SOEs) leverage into private leverage

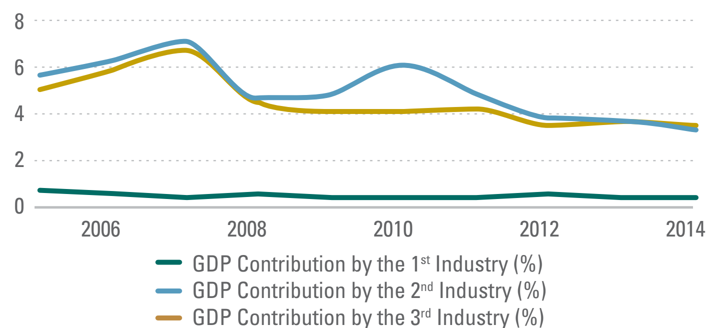
1. INDUSTRY LEADERSHIP: SHIFTING FROM THE "2ND INDUSTRY" TO THE "3RD INDUSTRY"

The strong growth of China's "2nd Industry", mainly comprised of the capital-intensive sectors such as Manufacturing, Mining, and Construction, was the key driver of its double-digit GDP growth rate prior to the government's RMB 4 trillion stimulation plan in 2009. This plan was initially aimed at girding against the global financial crisis. These actions pushed the "2nd industry's" growth to a record high of 15% in the 1st quarter 2010. The scale-chasing growth model generated tremendous overcapacity across various "2nd industries." Meanwhile, broad-based production costs, including labor, land, and environmental costs, rose to record highs, severely reducing China's competitiveness in the global market. The production overcapacity resulted in deflation. CPI thus declined from over 6% in September 2011 to 1.2% in May 2015. PPI began to decline in the 2nd quarter 2010, and has been in negative territory for the past 39 consecutive months as of May (see CHART 1 on previous page).

Meanwhile, the "3rd Industry", mainly composed of lightly-capitalized service sectors such as the IT, Financial, Consumer, and Health Care sectors, have been gathering force since Q1 2012 and became the leading driver of GDP growth in 2014 (see CHART 2). Additionally, according to the Ministry of Human Resources and Social Security of China (MOHRSS), the number of new jobs created per percentage of GDP contributed by the "3rd Industry" is twice that contributed by the "2nd Industry". Consequently, the labor market has remained tight against a gloomy macro environment (see CHART 3). In the first quarter of this year, the amount of new jobs added within urban areas was 32 million, in line with the same period last year. In addition, households' disposable income increased by 8.1% (adjusted for inflation) in the first quarter, significantly higher than the GDP growth rate of 7%.

Key Conclusion: The industry leadership in China is currently shifting from the "2nd" (capital-intensive) to the "3rd" (service-oriented) industry, which is leading to negative growth in some of the traditional indicators used to gauge Chinese economic growth, such as PMI, PPI, Power Generation, Railroad Transportation, etc. Our view is that the negative headlines related to these measures may actually be positive for long-term economic growth, as China is transitioning to a service-dominated, "New Normal" economy. At this transition phase, investors should focus more on the service sectors' growth and labor market improvement to evaluate the progress of China's economic reform, instead of the traditional industrial-related metrics.

CHART 2 GDP Contribution by the 1st, 2nd and 3rd Industry



Source: National Bureau of Statistics of China

CHART 3 Job Generation Versus GDP Growth

Source: BCA Research

2. ECONOMIC STRUCTURE: SHIFTING FROM INVESTMENT AND EXPORT TO DOMESTIC CONSUMPTION

Since 1980, low-cost export and scale-oriented investment were the main factors behind China's double-digit annual growth for almost two decades. Seven years after China joined the WTO in December 2001, the annual export growth rate surged to 25.5%, its peak level, in 2008. Since then, China's export has trended downward on a year-over-year basis, with an average annual growth rate of 9.8% until 2014, finishing at 6.1% for 2014. Meanwhile, consumption has gradually accelerated since 2010 and accounted for half of total GDP in 2014 (see CHART 4 on next page), which is still below the norm of 70% for developed countries. Given the strong growth prospect of the "3rd industry" as well as ongoing robustness in the labor market, consumption is expected to be an increasing driver of GDP growth.

Key Conclusion: Domestic consumption is gradually gaining GDP leadership at the expense of investment and exports. The consumption-driven economy should be categorized as a key feature for China's "New Normal". Boosting domestic consumption and propping up inflation remain the top priorities for the Chinese government in its economic reforms. Accordingly, investors should closely watch consumption-related figures, including CPI and inflation, to monitor China's transition progress.

3. PROPERTY MARKET: SHORT-TERM IMPROVEMENT BUT DOWNSHIFTING OVER THE LONG HAUL, DRIVEN BY CHINA'S AGING DEMOGRAPHICS

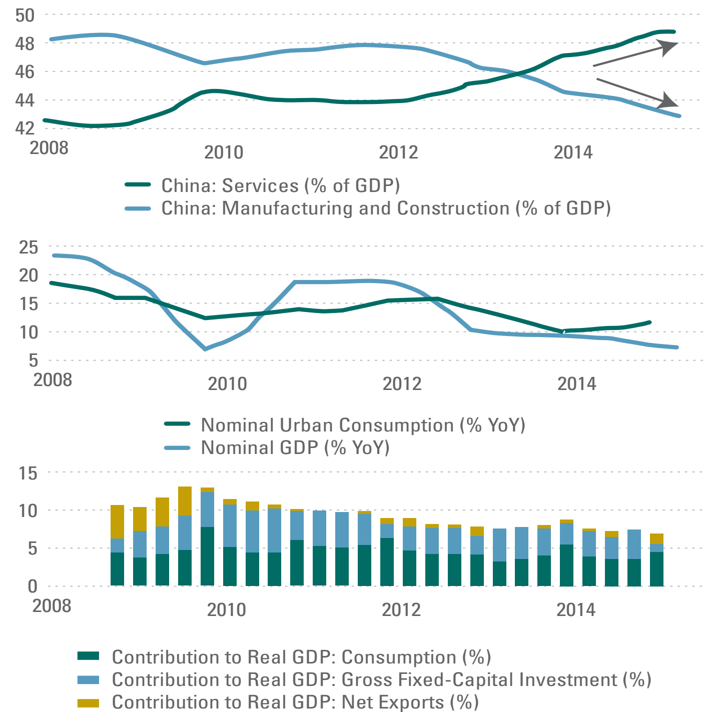
In our view, the aging demographic in China will be a secular headwind to the property market for a considerable period. Housing demand is normally driven by the working age population, and China is no different. According to research by China Index Academy and Haitong International Securities Group, in 2011, the age cohort between 23 and 44 has the highest level of housing demand. However this cohort as a percent of the total population began to shrink this year, as shown in CHART 5. Today, the Chinese population is dominated by those who were born between 1949 and 1969 (i.e. between the ages of 46 and 55), before the "One-Child" policy was adopted.

Another key factor that led to China's previous bull property market was the acceleration of urbanization. However, this trend has substantially decreased since 2010 (see CHART 5). Based on IMF research, Chinese urbanization growth will continue to shift downward, likely stabilizing by 2020. Taken all together, we are negative on the Chinese property market over the long haul, based on its aging demographics and slowing urbanization.

In the short-term, however, we are positive on the Chinese property market, because central government measures, designed to tamp down speculation over the past two years, are gradually being ameliorated. Alarmed by the fall-off in GDP growth and mounting signs of deflation, since last fall, the central government has gradually loosened housing restrictions. For example, mandatory down payment ratios for both homebuyers and non-resident investors have been cut and transaction taxes associated with property investment have also been lowered. In the meantime, aggressive cuts in benchmark interest rates, which closely correlate with mortgage interest rates, provided an additional tailwind for home sales. The weighted average of commercial mortgage rates and residential mortgage rates both dropped to historical lows, which is now even lower than the previous trough level at the end of December 2008.

As a result, home sales across the country improved notably in April, while YoY growth snapped back to positive territory for the first time since mid-2013 (see CHART 6 on next page). According to the "Top 100 City" housing index released by China Index Academy, the average housing price increased in 48 cities in May of this year, including Beijing, Shanghai, Guangzhou and Shenzhen, the first tier cities. Transactions in the top 30 cities advanced 15.5% in May 2015, and 34.9% from May last year. Meanwhile, total developers' unsold inventory sold has stopped contracting (see CHART 6 on next page). These encouraging results suggest that the property market is beginning to heal. At least in the short term, we expect the central government will continue to pursue less restrictive, or even moderately accommodative policies, in order to further drive up housing demand. It is worth noting that, compared to other countries, prevailing Chinese property regulations are still relatively restrictive. For example, the down payment ratio for 1st time homebuyers was cut from 30% to 20%, while the ratio for 2nd time home mortgages was lowered from 60% to 40%, both of which are still far more restrictive relative to other countries. On this front, the Chinese government maintains further capacity to stimulate housing demand and drive up its short-term growth, without fueling speculation risk.

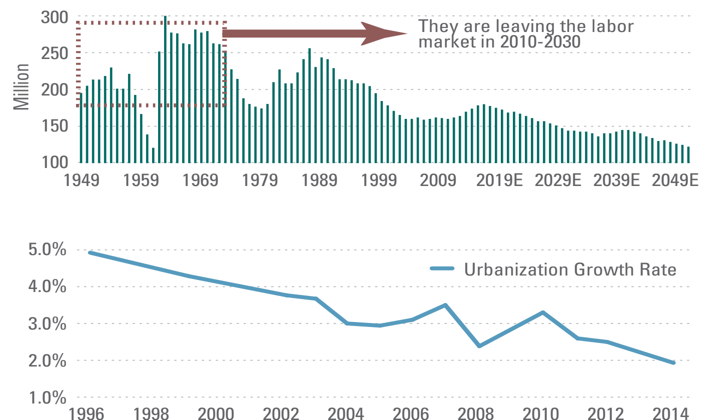
CHART 4 Consumption Is Gaining the GDP Leadership



Source: National Bureau of Statistics of China; MRB Research

CHART 5 Chinese Aging Demographics & Slowing Urbanization

Number of Population bom Each Year (in Million)



Source: National Bureau of Statistics of China

Key Conclusion: In the long term, aging demographics, along with the slowing urbanization pace, represent a secular headwind to the Chinese property market. However, in the short term, we expect the central government will continue to pursue less restrictive, or even moderately accommodative policies in order to stimulate the depressed housing market, which has already shown improvement in the past few months. At a minimum, with a significantly low ratio of the housing leverage, a major property crash is unlikely.

4. CAPITAL STRUCTURE: REPLACING DEBT WITH EQUITY; TRANSFORMING SOES' LEVERAGE INTO PRIVATE FIRMS' LEVERAGE

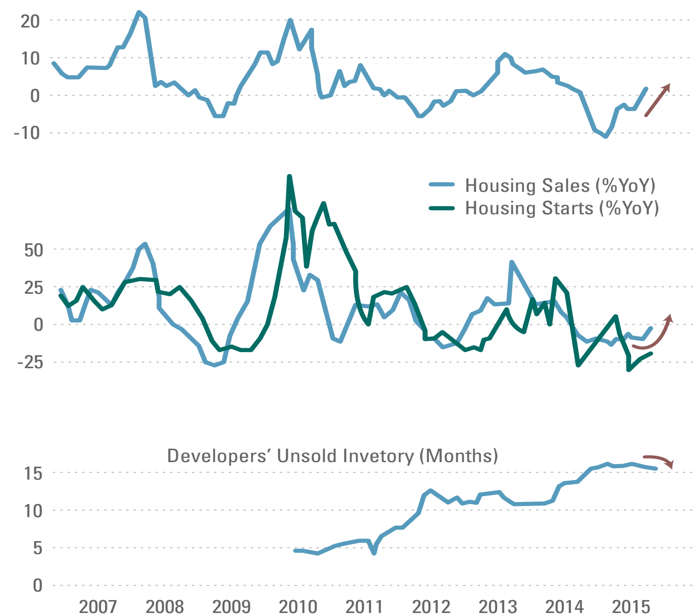
China's corporate debt ratio has skyrocketed in recent years, accounting for over 125% of GDP by the end of 2014, topping the United States as the highest corporate-leveraged country in the world (see CHART 7). However, of the total debt of RMB 80 trillion, over 80% is owned by State Owned Entities (SOEs) or government-backed organizations, whereas only 20% is associated with purely private enterprises. For years, large commercial banks were only willing to provide funding opportunities to the large SOEs. Consequently, the average interest rate on non-SOE private corporate debt surged to 20%, significantly squeezing capital access for private firms.

Additionally, equity financing in China has been historically low, at below 4% of total capital financing between 2001 and 2013, according to BlackRock research[1]. Greater use of equity financing will thus achieve the dual benefit of reducing corporate leverage as a whole and stimulating capital to flow into private firms.

Key Conclusions: The capital structure in Chinese corporations is unbalanced with extremely low equity capital versus debt capital. On the debt front, SOEs and government-related entities occupy the bulk of the corporate debt, squeezing out non-SOE private firms. To help alleviate the financial pressure faced by private enterprises and stimulate capital flow into more efficient sectors, the central government has implemented a series of conventional and targeted reforms (details discussed in Part III). In the interim, a strong stock market will facilitate greater diversification of corporations' financial structure.

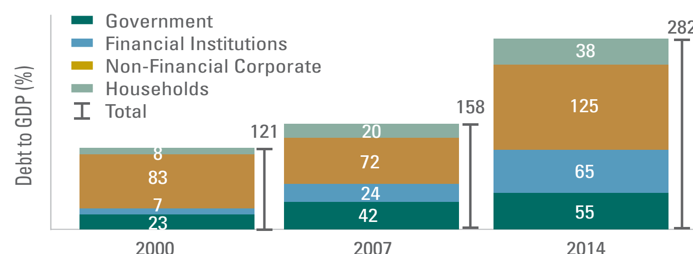
CHART 6 Property Market Is Bouncing Back

China: Home Price Index (%MoM, Annualized)



Source: MRB Research; National Bureau of Statistics of China

CHART 7 China Debt as a Share of GDP



Source: BlackRock Investment Institute and McKinsey Global Institute

PART III: CHINESE GOVERNMENT – THE ESSENTIAL DRIVER OF THE "NEW NORMAL"- BOUND TRAIN

2015 is expected to be a critical year for the Chinese government to step up the reform progress. Since late last year, facing persistent deflationary pressures, the government and central bank have collectively stepped up aggressive reform efforts, and achieved major breakthroughs in some key areas, which will be discussed in this section.

REFORM ACTION #1 – OVERHAUL OF LOCAL GOVERNMENT DEBTS

Local government spending accounts for one-third of Chinese GDP. Since local governments were not allowed to issue municipal debt, about one-fifth of the total debt was accumulated through Local Governments Financing Vehicles (LGFVs). A key near-term risk is that about 25% of the debt accumulated since 2009 matures in 2015. Furthermore, without an apparent legal evaluation system in place, banks added a premium to borrowing costs. As a result of the relatively short duration of those debts, typically around 2-3 years, local governments were forced to roll over their expiring debts at an even higher interest rate. Consequently, borrowing costs surged by around 20% by the end of 2014. Taken together, the imbalance between the long-duration, low-return of LGFVs and the short-duration, high-cost of the local government debts heightened financial risks both for local governments and financial institutions.

[1] *Climbing China's Great Wall of Worry, BlackRock Research, June 2015*

Late last year, Chinese authorities announced the long-awaited approval to allow local governments to issue municipal bonds in the open market, and shut down the previous funding access through LGFVs, which the Chinese refer to as "close the back door and open the front door". Local governments are required to clarify the legal status of the outstanding debts from LGFVs by the beginning of 2015, which has been substantially completed. Those debt obligations with no clarified legal status will be excluded from government backing. According to the announcement, the yield of the newly issued muni bonds is capped at 1 - 1.3 times the 10-year government bond, which translates into 3.4 - 4.4%, considerably lower than the average interest rate of 8 - 10% charged to LGFVs.

Beginning this year, the central government also launched the "debt-swap" program, which is viewed as an enhancement of "open-the-front-door" policy. As an initial step, local governments are allowed to swap RMB 1 trillion debt, which will mature this year through LGFVs, with local muni bonds. The first batch of RMB 1 trillion equates to about 1/5 of the total debt due this year and 1/20 of the total outstanding local government debt. According to the rules, the initial batch of the debt swap with a RMB 1 trillion quota needs to be completed by the end of August, which implies that more swaps could be approved. In fact, the 2nd batch of the RMB1 trillion quota was announced in the recent central government's meeting in early June.

The benefits of the "debt swap" program are three-fold: (1) For local governments, it is an outright reduction of funding costs, roughly around 400-500 bps, translating into RMB 40-50 billion annually, according to BCA research[2]. With an improved risk profile, local governments will be qualified to borrow at a broadly lower expense, across their RMB 20 trillion total debt; (2) For commercial banks, the debt transformation from LGFVs to a government liability significantly lowers their debt risk and increases the "risk-weighted assets" on their balance sheet, potentially releasing more lending capital for higher profit margin; and (3) For private corporations, the debt swap will ease their access to credit.

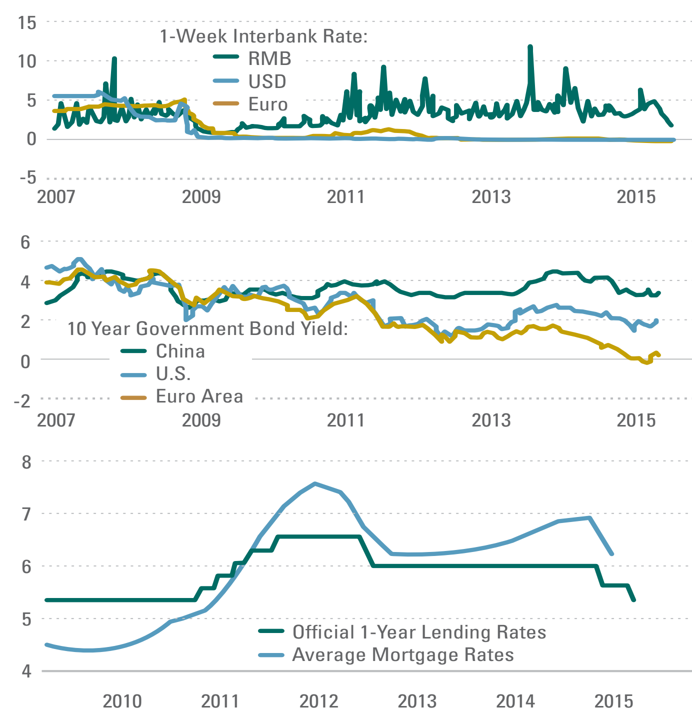
REFORM ACTION #2 – TARGETED EASING POLICIES THROUGH THE PLEDGED SUPPLEMENTARY LENDING (PSL) PROGRAM

Acknowledging local governments' intense pressure to borrow and the unbalanced return generated by various infrastructure projects, the PBoC launched the Pledged Supplementary Lending (PSL) program mid last year. In this targeted easing program, the central bank offered collateralized debt directly to the China Develop Bank (DCB), the largest non-commercial government bank, to fund specific industries and projects, with the goal of lowering their financing cost and optimizing their credit structure.

REFORM ACTION #3 – AGGRESSIVE MONETARY EASING – MULTIPLE CUTS IN RRR AND BENCHMARK INTEREST RATES

The PBoC has aggressively slashed both the banks' reserve requirement ratio (RRR) and benchmark interest rates multiple times since late last year, with the goal of increasing monetary liquidity, battling against deflation risk (partly due to a rising Renminbi - which represents a de facto tightening in monetary conditions), alleviating financing pressures and supporting the housing market. The PBoC's easing efforts have led to a sharp fall in interbank rates across the curve (see CHART 8). The one-week interbank repo rate slid by 200 bps since early February, which substantially reduces banks' funding costs, and potentially provides more liquidity for the overall economy. Given the prevailing still-high scale of both the one year benchmark interest rate (4.85%) and the required reserve ratio for banks (18.5%), the central bank still has substantial capacity to implement conventional accommodative monetary policy. In this vein, we expect another 2-3 interest rate cuts by the end of 2015, with the next one likely before end of August, leaving some time to cushion Chinese risk assets before the Fed begins to normalize rates.

CHART 8 Further Capacity For Monetary Easing



Source: BCA Research

Will the cut of interest rates penetrate to private non-SOE firms?

Some argue that looser monetary policies will fuel leverage risk in China. We have a different view. Indeed, the leverage ratio, measured by total debt (excluding the debt of financial sector) over GDP, surged from 72% in 2007 to 125% by the end of 2014. However, the escalation in the debt to GDP ratio not only reflects mounting debt, but also the deceleration of GDP growth, which fell from 9.7% in 2012 to 5.8% in the first quarter of this year.

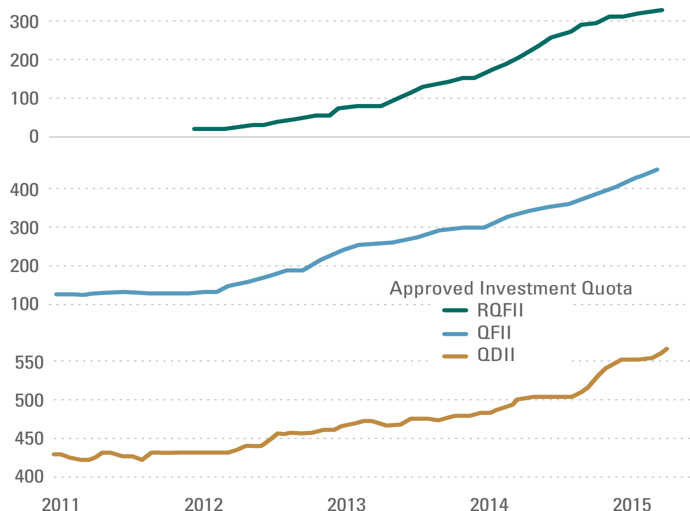
[2] *Speculation Versus Equity Re-Rating, BCA Research, April 2015*

The government therefore has to equally focus on reducing debt and encouraging growth in more efficient sectors of the economy where debt capital has been scarce. In fact, because of the legacy structure of the Chinese economy, interest rate policy will not achieve debt restructuring or reduction. For example, since late 2013, the central bank's tightening monetary policy had not been effective in reducing leverage. The reason is that the high-leverage entities in the economy, mainly composed of SOEs and governments-backed entities, are not sensitive to interest rate changes. On the other hand, private firms, with better efficiency and profitability, are the major beneficiaries of more accommodative interest rates. From this perspective, we believe that accommodative monetary policies will penetrate into the private sector and in turn benefit the general economy. At a minimum, moderate rates cuts will unlikely fuel leverage risk.

REFORM ACTION #4 – RMB INTERNATIONALIZATION

On the currency front, the RMB's liberalization has substantially progressed and policy makers have officially included the RMB convertibility into this year's top-priority short list. Achieving RMB convertibility is an important prerequisite for the RMB to be included in the Special Drawing Rights (SDR) basket this year. SDR entry will obviously give China greater influence in the international monetary system. Nearly 25% of China's trade was conducted in Chinese Yuan last year, up from 0.02% in 2009. In the meantime, the quotas for QDII, QFII, and RQFII have been lifted (see CHART 9). The "Through train" Shanghai-Hong Kong connection scheme initiated later last year, and the upcoming Shenzhen-Hong Kong scheme later this year, will further increase RMB convertibility.

CHART 9 Increasing Quota For Overseas Investments



Source: BCA Research

Up to this point, the PBoC has signed currency swap agreements with 28 central banks around the world. Notably, 30 countries' central banks agreed to include Chinese RMB into their foreign currency reserves. Given the goal of RMB convertibility and SDR entry this year, we do not foresee a RMB depreciation by the end of 2015, as value stability is a key characteristic of a convertible currency.

PART IV: VOLATILE, FRENZY, CRAZY A-SHARE MARKET – DRIVEN BY POLICY, LIQUIDITY AND IRRATIONALITY

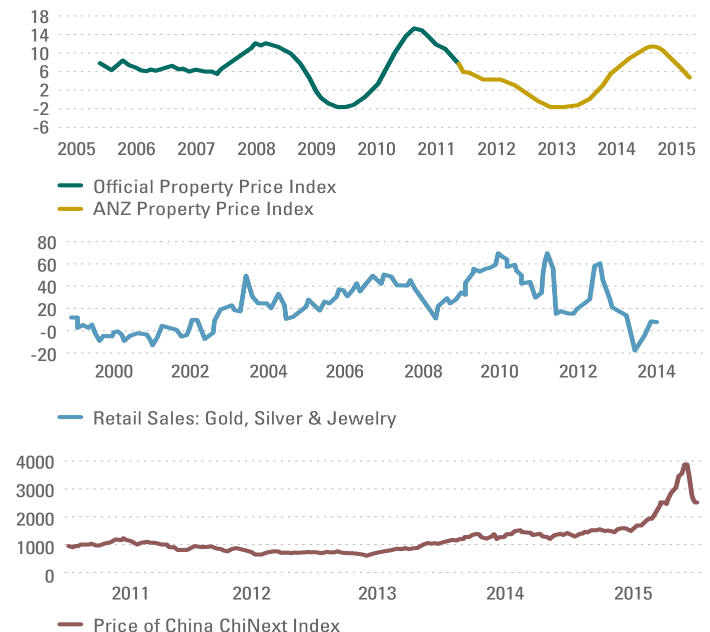
The Chinese stock market's implosion since June 20 (wherein as of this writing, the Shanghai and Shenzhen composites have declined 24% and 32% respectively) was the result of a stock bubble, fueled by government policy as well as increasing financial wealth among millions of newly minted middle class investors.

WHAT LED TO THIS A SHARE BULL MARKET?

1. **Investment assets transition from physical assets to equity stocks**

For the three decades after 1980, Chinese investors heavily invested in gold, silver and later on, the housing market. They barely touched the stock market, as a result of an under-developed financial market structure and households' lack of financial knowledge. As shown in Chart 10, commodity prices, along with property prices, appreciated dramatically since 2003, until the inflection point in Q3 2011 when overheated prices of physical assets began to trend lower. Following the meltdown of physical assets in Q4 2012, China's ChiNext composite, a NASDAQ-style index composed of innovative, fast-growing, and particularly high-tech firms listed on the Shenzhen Stock Exchange, began to pick up, registering the starting point of this round of the bull equity market (see CHART 10). The property market's continuing slowdown and the Chinese government's favorable policies supported the bull equity market. In short, our view is that it is the investment allocation transition from physical assets to the equity market that initially triggered this round of the bull equity market, with the inflection point occurring in the 3rd quarter of 2012.

CHART 10 Price Trend of Physical Assets Versus Stock Equity in China



Source: China Index Academy; BCA Research; Bloomberg

2. Government's support of the equity market

As discussed previously, the extremely high financial leverage of SOEs, and heightened borrowing costs faced by private corporations, are the two main challenges existing in today's Chinese reform roadmap. A prosperous stock market could help address both challenges. In this vein, the Chinese government is promoting capital to flow from Chinese residents' saving accounts to the corporations' balance sheet, optimizing the overall economic capital structure. In other words, reduce the corporations' leverage and increase the residents' leverage.

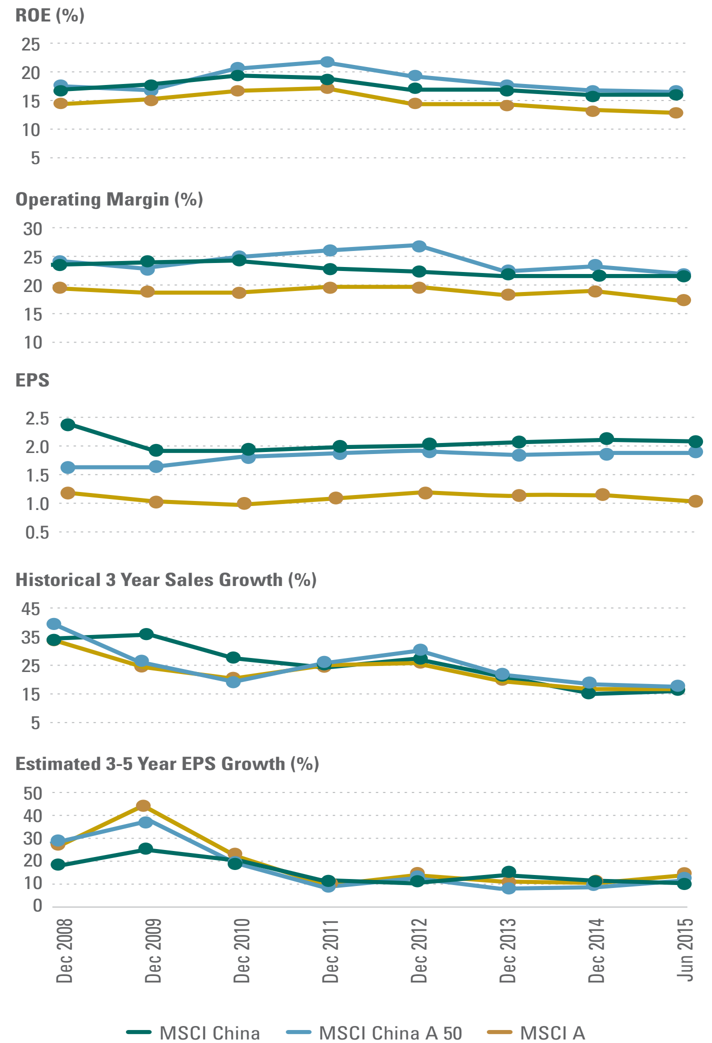
For this reason, the Chinese authorities have been promoting and protecting the bull market in A-shares via multiple official statements and various favorable policies since late last year. Chinese Premier, Li Keqiang, stated, "The equity market helps alleviate the high-leverage risk". The central bank governor, Zhou Xiaochuan, also stressed that "Capital inflow to the stock market is eventually positive to the underlying fundamentals". In fact, the most recent round of bull market frenzy came right after the Central Government Conference last July, which marked the central government's full-force implementation and engagement in economic reform. Besides, the government has been stepping up efforts to promote the equity market. The recent announcement of the multiple capital accounts policy, the finalization of the overhaul of the IPO registration process, and the launch of the Shanghai – Hong Kong connection program, all demonstrate the government's strong commitment to maintain the bull equity market.

DISCONNECTION BETWEEN THE STOCK MARKET AND CORPORATE FUNDAMENTALS

The meteoric rise in Chinese A-share prices since last year was clearly inconsistent with their underlying corporate fundamentals. As shown in CHART 11, the profitability of Chinese enterprises endured a gradual decline from its peak level in 2011/2012, dropping below the level at the beginning of the previous bear cycle in 2008 as measured by ROE, Operating Margin, and Earnings Growth of the MSCI China Index (which is comprised of investible large and mid-cap Chinese firms listed in HK exchange), the MSCI China A shares Index (large and mid-cap Chinese firms listed in mainland China), and the MSCI A 50 Index (50 largest firms in MSCI China A index). On the growth front, the deceleration appears to be more dramatic, which is highly correlated with the country's macro growth deceleration within the period (discussed in **Part I**). This disconnectedness, along with their limited availability for investment, were significant detractors for non-Chinese investment professionals.

However, China is a young, developing equity market, providing an investment option for millions of newly minted middle class retail investors. In this vein, the disconnectedness of prices from fundamentals was overwhelmed by the government policy that encouraged margin borrowing to purchase stocks and disappointing returns from their previous investment favorite, the property market.

CHART 11 Fundamentals Versus Stock Prices of Chinese Corporations



Source: Factset; FIS Group Research

THE RECENT CORRECTION IN THE CHINESE A-SHARE MARKET AND THE IMPACT OF GOVERNMENT POLICY

The initial spark for the recent massive price plunge was the PBoC's massive liquidity withdrawal from the banking system in mid-June, aimed at reining in the asymptotic rise in margin lending. Margin lending (i.e. investors buy stocks with borrowed money from brokers) rose fivefold over the past year in China. At its peak in mid-June, according to Macquarie's research, margin lending generated an 8.3% leverage ratio, based on floating volume in the A-share market. This compares with 2.5% in the U.S., 1.4% in Taiwan and 0.8% in Japan. Consequently, one week after the A-share's peak on June 12th, the PBoC suddenly reversed course by withdrawing 300 million yuan in short-term funds, aimed at curbing further growth of margin lending. However this move unexpectedly destroyed investors' confidence in the government, and subsequently the stock market fell 13% the following week. The drastic price decline triggered margin calls and forced selloffs by brokers, which accentuated the decline. By the end of June, A-share prices were slashed 29% from the peak on June 12th, wiping out one quarter of the market value.

In order to stem the rapid erosion of A-share prices, the government implemented several strong-handed policies that are summarized below:

1. 25 bp cut in both the RRR and the official lending rate;
2. 30% lower transaction costs in Shanghai and Shenzhen;
3. Relaxed margin trading rules (rollover contracts) and widened brokerage fundraising channels;
4. Measures to enhance liquidity. The PBoC provided liquidity support to the CSF, which in turn provided an RMB260b credit line to 21 brokers (who jointly invested RMB120b in blue chips and pledged to maintain long positions as long as the Shanghai index stays below 4,500). The CSF also invested RMB200b in five asset managers;
5. Measures that limited price declines and liquidity, including the suspension of IPOs; trading activity on 1,541 securities out of a total of 2,873 securities (i.e., over 50 percent of listed securities on the Shanghai and Shenzhen exchanges) as well as limits on short sales. Finally, the government restricted investors who own over 5% of listed company's outstanding shares from selling those shares over a 6 month period;
6. Central Huijin (subsidiary of China's SWF) to continue buying ETFs in the secondary market;
7. MoF issues public statements to support market stability; and
8. CBRC to support market stability by encouraging bank financing of companies that perform share buybacks, renegotiate WMPs and rollover share pledge financing.

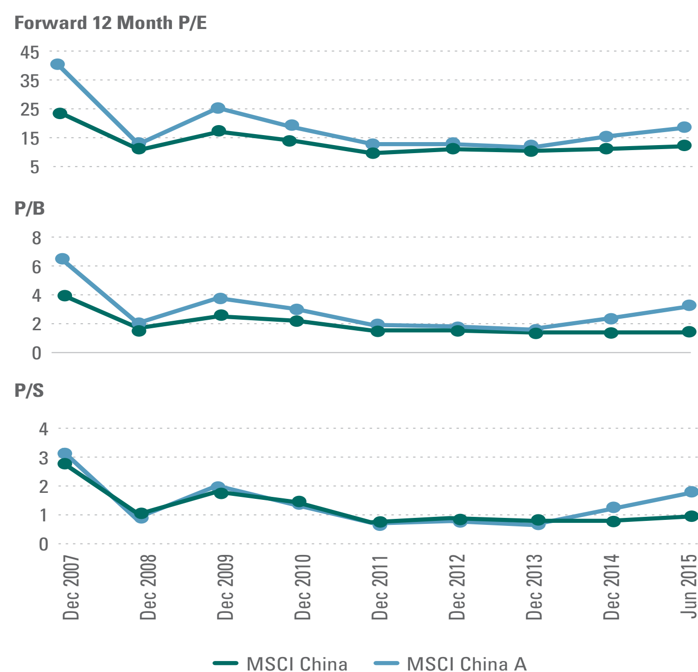
While these measures appear to have stemmed the free-fall in China A-share prices, they also confirm the degree to which A-share prices are, up to this point, policy driven as opposed to supported by underlying corporate fundamentals.

OVER THE NEXT 6-12 MONTH WE EXPECT A CONTINUING BUT VOLATILE "BULL" – FAVORING H-SHARES OVER A-SHARES

1. Reasonably valued A-Shares, compared to their previous bull cycles

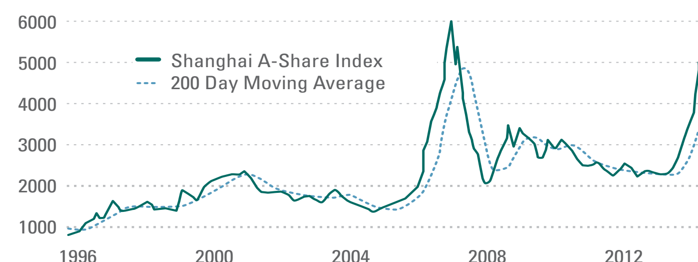
Chinese A-shares are no longer cheap even taking into account the recent correction. A-shares are currently trading at about 25% premium over the emerging market benchmark, and are roughly in line with the global universe. However, compared to both their historical norms and the previous bull cycles (see CHARTS 12 and 13), we believe there will be more upside in Chinese A-shares, and the recent selloff has provided a more attractive entry point.

CHART 12 Valuations of Chinese Corporations



Source: Factset; FIS Group Research

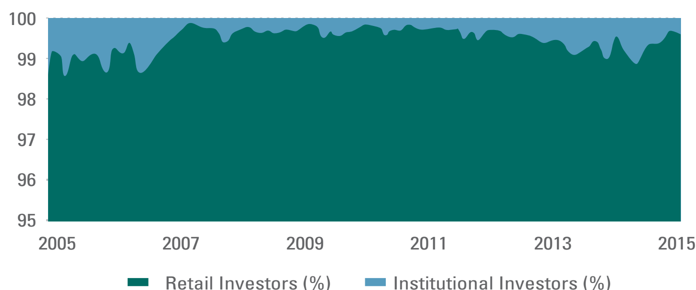
CHART 13 A-share Index Performance Over the Past Two Decades



Source: BCA Research

That said, the structure of the Chinese stock market will inherently lead to bouts of extreme volatility. Above 90% of the trading volume and 99% new accounts were initiated by local retail investors (see CHART 14), the majority of which have little to no experience with personal finance or stock investing and are largely trading on sentiment. In the first quarter of this year, the total transaction volume in the A-share market hit a record high of RMB 41.8 trillion, registering in the top 3 among global stock exchanges.

CHART 14 Chinese Stock Market Is Heavily Represented By Retail Investors



Source: WIND; CSRC

In the next 6-12 months, we expect A-shares to continue to grind higher, fueled by the tailwind of the government support and retail investors’ considerable wealth inflow. However, the upcoming journey will be accompanied by multiple setbacks.

2. **The potential benchmark money inflow (FTSE, MSCI and others)**

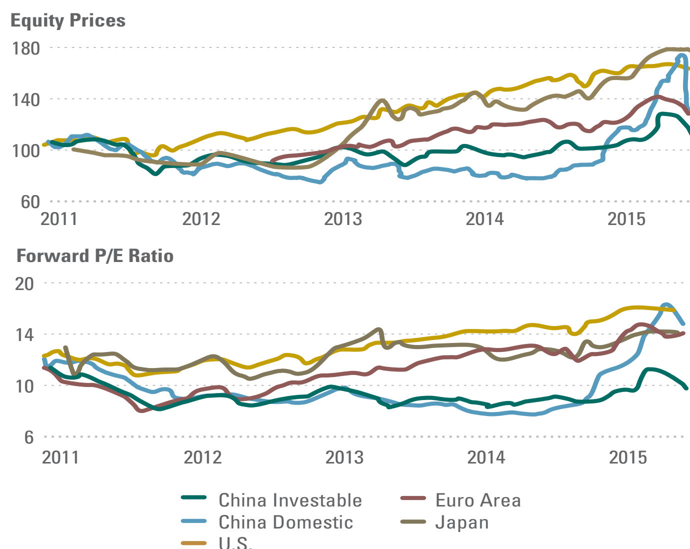
A-shares are currently being considered for inclusion in the major emerging markets index universe, which will increase the liquidity of the Chinese stock market. FTSE has already included A-shares in their emerging market indices, and there are about 1887 ETFs tracking the FTSE index, equating to $1.56 trillion in assets. The initial weight given to A-shares equities by FTSE is 5%, which could potentially translate into an $80 billion benchmark money inflow. With an expected 32% representation over the next few years, another $500 billion in passive money could potentially be China-bound. In early June, MSCI postponed the inclusion of A-share equity into their benchmark, stating that they need to see further liberalization of the Chinese capital markets. We believe that with the continuing liberalization efforts, being accepted by MSCI is likely to occur over the next three years, which could inject around $400 billion of funds into mainland China, as estimated by MSCI. For this reason, we are positive on A-share equities over the long term.

3. **Valuation gap between A-H shares**

Compared to the overheated A-share market, trading activity in the H-share market (i.e. the shares of companies incorporated in mainland China that are traded on the Hong Kong Stock Exchange), has been quite tepid. Historically, because H-shares trade more on fundamentals than sentiment, the valuation of H-shares has always lagged their A-shares counterparts, even though the underlying entities exactly mirror each other. Despite a recent hike, H-shares are still trading at 10 times forward earnings, registering a hefty bargain compared to 16 times in A-shares, 18 times in US, and 15 times in Japan (see CHART 15). After the recent correction, H-shares are trading at a 20% discount relative to the Emerging Market index, and roughly 50% discount compared to the A-shares counterparts.

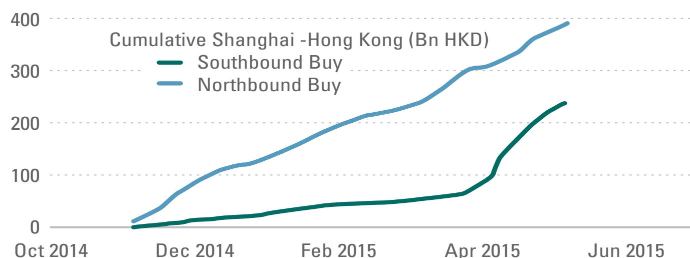
Since April this year, the H-shares market has gained more steam (see CHART 16), largely driven by the south-bound capital injection via the “through train” connection, as Chinese investors have expanded their speculation target from mainland to the adjacent H-shares market, expecting better return given the valuation dispersion. In the meantime, the Chinese government announced a series of favorable regulations aimed at facilitating cross-border capital flows. Starting on July 1st this year, mutual funds listed in mainland China can directly purchase H-shares stocks via the connection bridge, without going through the QDII procedure. The central government has also been preparing for the launch of the Shenzhen-Hong Kong connection scheme, which is expected to open late this year. Taken together, we believe all those policies will mainly benefit the cheaper H-shares in the coming months, speeding up the valuation convergence with their A-share counterparts.

CHART 15 Valuation Gap Between A and H Shares



Source: BCA Research

CHART 16 Money Flow Via Shanghai - Hong Kong Connection



Source: BCA Research

OVER THE LONG HAUL, LOW ODDS OF A "BULL" MARKET CRASH

1. Major internal or global crisis unlikely to explode

Looking back over the past two decades, bull markets in China over the last two market cycles were disrupted by a combination of global crises and China's heavy reliance on global exports. The bull markets during the periods of 1999 - 2000 and 2006 - 2007 were driven by cyclical, export-oriented "2nd industries" that heavily rely on the global economic climate. In contrast, the main leaders in this round of the Chinese bull market are service-oriented, "3rd industries," including IT, Health Care, Leisure, and other service areas, that are domestically driven. Another major difference relative to the previous bull market cycles is the government's policy direction. Back then, the Chinese economy had achieved multi-year double-digit growth and policy makers were entering into a tightening cycle in order to control heightened inflation risk. In contrast this time, boosting growth through monetary accommodation is the central government's top priority.

On the global front, the US has been standing on a solid footing, as indicated by broad-based economic barometers. European equities are broadly benefiting from the EBC's accommodative policies, with Greece being a potential source of volatility, which we do not believe to be systemically important. Our sense is that the odds of a full-blown contagion will be low, even in the worst-case scenario of an eventual "Grexit". Finally, Japanese equity, the best performer year to date, has been substantially stimulated by the government's reform efforts and remarkable stimulation packages.

Putting it all together, the odds of either an internal hard landing or global crisis are extremely low. Supported by the central government's strong easing efforts, a bull market crash is less likely today.

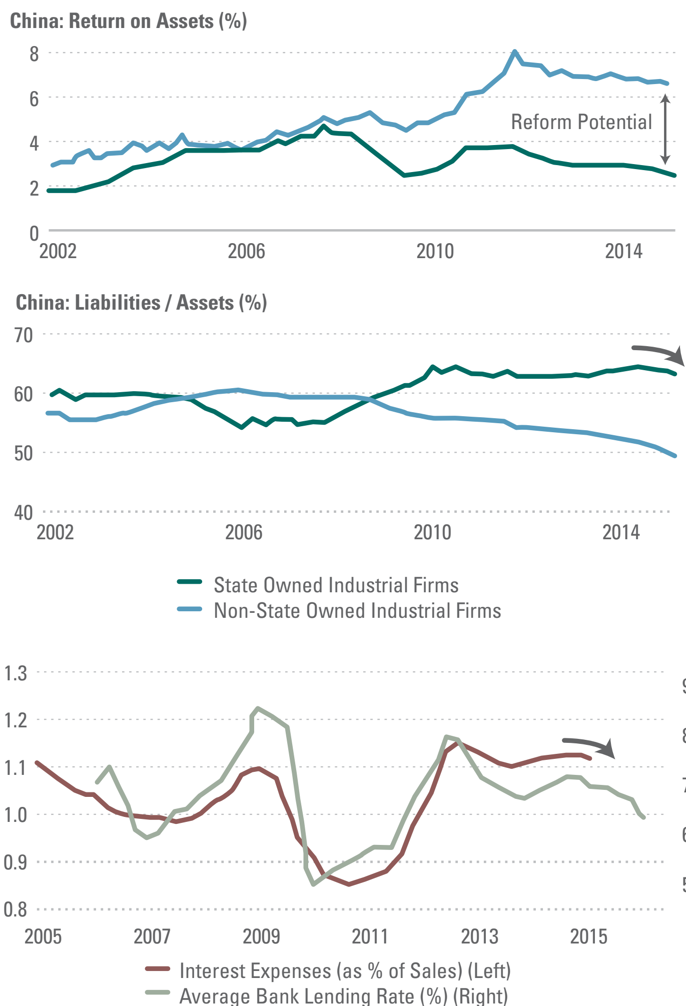
2. Government will continue to support the A-share market

Unlike other major countries, policy has a far more influential impact on the stock market in China. If the ongoing bull market collapses, the damage to broad Chinese households will likely be far greater than historical episodes, as the lifetime savings of millions of retail investors will be wiped out, which could further ignite social instability. Furthermore, a healthy stock market is central to the government's efforts to diversify the capital structure of both SOEs and non-SOEs.

3. Finally, we believe the government's reform will pan out and bear fruit

At the end of the day, economic fundamentals need to validate current stock price valuations beyond their liquidity-driven support. On this front, with improved funding support and lower interest expense, the more efficient private corporations will further improve profitability (see CHART 17), if our base case, that industry leadership will shift from the "2nd industry" to the "3rd industry," pans out. We suggest that investors closely watch more relevant macro data, including domestic consumption growth, "3rd industry" growth rate, and the unemployment rate, which in our view, provide better gauges of the effectiveness of China's reform. Eventually we believe these reform efforts will pay off, which will confirm investors' optimism.

CHART 17 More Room For Profitability Improvement



Source: BCA Research; National Bureau of Statistics of China

SUMMARY

We believe that while the next phase of the China A-share market will be volatile, it will continue to be propped up by supportive government policy, and increasingly fueled by domestic retail investors' wealth injections. We suggest investors who choose to participate in the remaining bull rally be more selective by focusing on high-quality, consumption-driven, growth-supported sectors, including Health Care, E-commerce, Leisure, and High-Tech companies. Blue-chip financial companies, which are very cheap but well-supported by the forthcoming RMB 120 billion stabilization fund, may also provide a tactical investment opportunity.

Important Disclosures:

This report is neither an offer to sell nor a solicitation to invest in any product offered by FIS Group, Inc. and should not be considered as investment advice. This report was prepared for clients and prospective clients of FIS Group and is intended to be used solely by such clients and prospects for educational and illustrative purposes. The information contained herein is proprietary to FIS Group and may not be duplicated or used for any purpose other than the educational purpose for which it has been provided. Any unauthorized use, duplication or disclosure of this report is strictly prohibited.

This report is based on information believed to be correct, but is subject to revision. Although the information provided herein has been obtained from sources which FIS Group believes to be reliable, FIS Group does not guarantee its accuracy, and such information may be incomplete or condensed. Additional information is available from FIS Group upon request.

All performance and other projections are historical and do not guarantee future performance. No assurance can be given that any particular investment objective or strategy will be achieved at a given time and actual investment results may vary over any given time.