MARKET INSIGHTS ALERT

What is really happening in China? — A late-year revisit and local insights from our China trip

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SYNOPSIS

Since mid-June this year, the wild ride in the Chinese A-share stock market along with deteriorating economic and profit data have unnerved many global investors. Against this backdrop, the Chinese government's remarkably stable GDP growth reports of 7% for Q2 and 6.9% for Q3 have engendered increasing concern over the credibility of official figures. In an attempt to counter this slowdown, the government has rolled out a series of measures designed to stimulate demand. It has cut interest rates and reduced bank reserve requirements seven times this year, released funds for infrastructure investment, cut taxes on automobile sales and lowered the required down-payment for home mortgages. Historical precedent suggest that as China transitions to a "middle income" economy, the path of least resistance is downward. Based in part on observations from our recent visit to China, in this report, we posit that the key to understanding opportunities and risks in China is to:

1. **Appreciate the enormous sector and regional growth disparity between the Northern provinces (such as Liaoning, Jilin and Heilongjiang) that are heavily reliant on mining and manufacturing industries, and the wealthy coastal provinces (Zhejiang, Shanghai and Jiangsu) that are mostly driven by the flourishing service sectors.** The economic slowdown that China has experienced since 2012 is not simply a generalized cyclical decline, but is driven by an intense slowdown in the industrial sector, caused by the end of growth in housing construction and related demand for many industrial products. It would be a mistake to extrapolate the recessionary conditions in China's hardest-hit sectors and provinces to the economy as a whole. But it would be a mistake to gloss over the sharp economic slowdown now taking place in those affected industries and regions.

2. **Temper expectations for both growth and the progress or pace of structural reform, and evaluate investment opportunities based on the Chinese government's core constraints and stated objectives.** The core constraint is that while the Chinese government is not democratically elected, legitimacy with its increasingly disparate populace is enormously important. This need for legitimacy will lead to halting (i.e., one step forward …two steps back), contradictory and often confusing implementation of painful structural reforms. Economic opportunities will arise from the government's geopolitical goals of becoming the dominant trade end economic power (most evident in the "New Silk Road" of Chinese-built trade routes through Central and the Southeast Asia, linking China to Southeast Asia, the Middle East and Africa) and turning China into a global financial power. This will spur both financial liberalization and Renminbi internationalization. Reforms so far have turned the Renminbi into an important trading currency. The next step is to turn it into a reserve currency, for which the first milestone will be inclusion in the IMF's Special Drawing Rights basket.

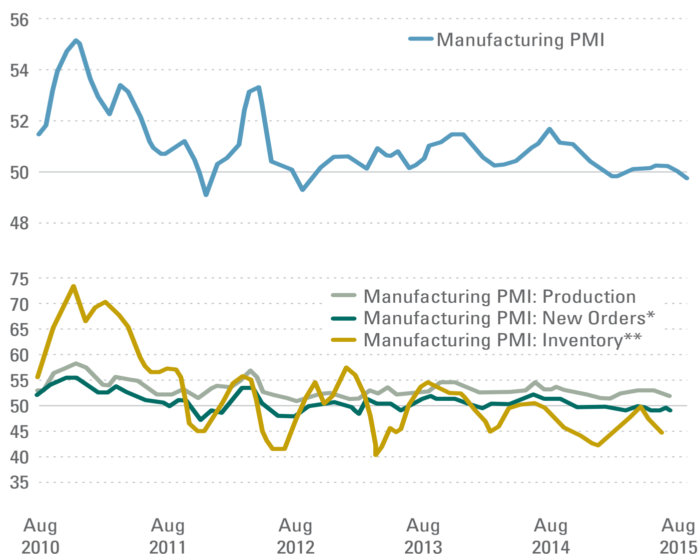
3. **Appreciate that as China shifts away from its investment/export model, and the anti-corruption drive enters its third year, the next big opportunities will be created by Renminbi internationalization, financial liberalization, and the consumer economy.** China's movement towards "middle-income" status will spur an "acceleration phenomenon," whereby demand for higher quality products and services is a function not of average income growth, but of the rate at which households cross key income thresholds. European and Japanese MNCs are best positioned to provide trendy, high-quality goods and services that local firms cannot. Furthermore, a weaker euro and yen would support demand by lowering the income threshold at which the goods become affordable. On the domestic China front, we repeat our recommendation to use down-drafts in Chinese equities to gain attractive entry points in "new-economy" sectors, such as Consumers, Health Care and TMT. Domestic Chinese markets have in part been viewed by the government as a policy tool to facilitate wealth transfers from household savings to rebalance the capital structure of State-Owned Enterprises (SOEs) towards more equity capital, as part of the overall objective of SOE reform.

This year's A-shares volatility has been a function of: (a) their market structure (over 90% of capital accounts owned by retail investors) which, like many Asian markets, is primarily driven by trade momentum, (b) valuations that were not supported by earnings , and (c) the government's inconsistent policy of first encouraging and then tamping down on stock margin lending. Perhaps learning from that experience, the government has been much more measured in its response to the subsequent crash in August. Importantly, as of September 30, regulated and unregulated margin balances had declined substantially. Much reduced forced selling and healthy cash balances at mutual and privately raised funds (estimated at RMB 1 trillion) is providing more stability (and a constructive backdrop for China A-shares).

1. ON THE ROAD TO A STRUCTURAL TRANSITION: TWO ECONOMIES IN ONE CHINA

In the 3rd quarter, two news items released by China collectively triggered a mid-August downdraft first in Chinese and subsequently in global equity markets: the poor "Caixin PMI" and the devaluation of the CNY on August 11th. The Caixin/Markit PMI report fell to a 77-month low in late August, followed by similarly depressed official PMI data announced in early September. As shown in CHART 1, manufacturing PMI in August dropped to 49.7% from 50% in July, uniformly driven by weakened Inventories, New Orders, and Production. This, together with a surprise 4% RMB devaluation in early August, was interpreted by investors as a signal that China's economic growth is slowing more than the official data released by the government, leaving currency devaluation as the last resort to stem a growth meltdown.

CHART 1 Chinese Headline Manufacturing PMI and Its Three Components %



*"New Orders" is the average of new order and new export order indicies in manufacturing PMI

**"Inventory" is the average of finished goods inventory and raw material inventory indicies in manufacturing PMI.

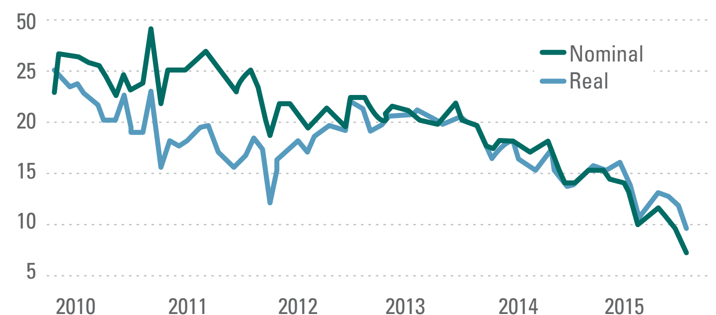
Source: CEIC, CICC Research

One of the most important things to understand about China's slowdown is how unevenly distributed it is. Effectively, there are **"two Chinas"** ("Transition to a Chinese Style 'New Normal': Less Is More", July 2015). Much of the current debate over the "true" rate of growth is based on extrapolating from one part of China to the whole. Bears look at depressed heavy-industry zones and assume everything is in recession. Bulls look at flourishing consumer markets and assume everything is fine. Neither view is correct. China is experiencing both a recession in industrial sectors, concentrated in certain Northern provinces, and a steadier growth in household consumption and services areas, concentrated in the Southern coastal provinces. This growth disparity is a natural consequence of the fundamental cause of the economic slowdown: overcapacity engendered by the investment and export intensive model that was exacerbated by ballooning credit-fueled investment in the post-2009 period.

In our research paper released in July ("Transition to a Chinese Style 'New Normal': Less Is More", July 2015), we posited that China is undergoing an economic transition from the old investment/export-dominated model to a consumption-driven "New Normal". Industry leadership in China is currently shifting from the "2nd" (capital-intensive) industry to the "3rd" (service-oriented) industry, accompanied by negative growth in some of the traditional industrial sectors. In that paper, in order to obtain a full appreciation of the "two Chinas" we suggested that investors focus on the service sectors' growth and consumption-related figures to assess China's economic transition, in conjunction with the traditional industrial-focused metrics, such as PMI, PPI, etc.

Recent economic data from China is consistent with this thesis. As of the writing of this paper, the government announced that China's GDP grew by 6.9% in the third quarter. As with the reported 7% growth for the second quarter, this figure, which exceeds most external estimates, warrants some skepticism. Industrial output in September slowed from 6.1% y/y to 5.7% and fixed investment rose only 10.3% during the first 9 months of this year. This divergence was most apparent in the monthly activity data for September, which provides a more timely reading of the economy's current momentum. Assuming that no revisions were made to the previous months' data, this implies that fixed investment growth fell from 9.2% y/y in August to 6.8% in September, the lowest figure since the current data series began in 2004 (see CHART 2).

CHART 2 China Fixed Asset Investment % Y/Y



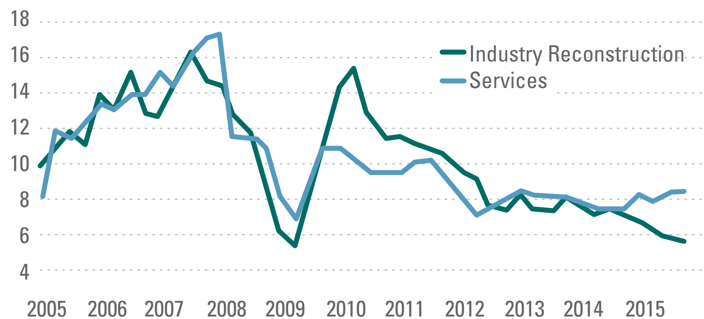
Source: CEIC, Thomson Datastream, Capital Economics

The weakness in fixed-asset investment this year is largely driven by the Real Estate, Construction and industrial sectors. Although property sales have recovered especially in Tier 1 cities, inventory levels are still high nationwide as developers are reluctant to buy land and start construction. Weak property

in turn leads to less investment in building materials and other upstream industrial sectors.

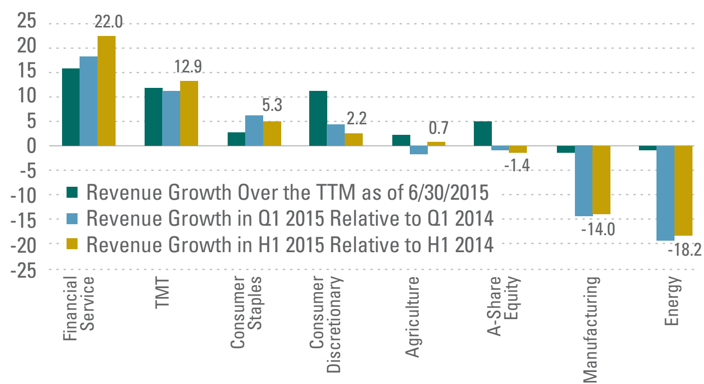
In stark contrast, the data on service sector was more upbeat. The service sector's growth accelerated to 8.6% YoY in Q3 from 8.5% in Q2, the fastest pace since 2011. Retail sales growth edged up from 10.8% y/y to 10.9% in nominal terms (although the more stable indicator of per-capita consumption spending slowed sharply). As a result of its ongoing robustness, the service sector's GDP contribution is now 10% larger than industrial sector (see CHART 3). As seen in CHART 4, several service industries, such as financial services, retail clothes, medical equipment and travel, were quite robust.

CHART 3 China GDP Growth by Sectors *% Y/Y*



Source: CEIC, Thomson Datastream, Capital Economics

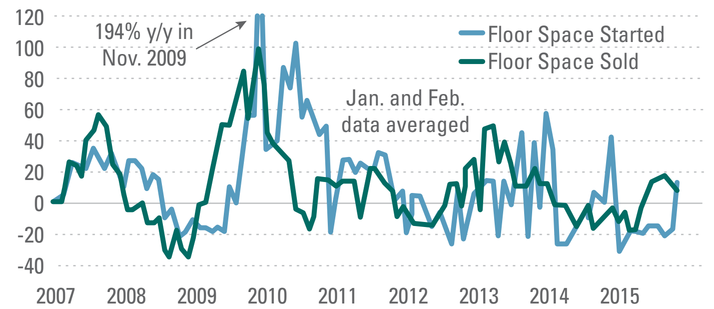
CHART 4 Revenue Growth of Various Sectors for Q1, H1 and TTM *%, As of 6/30/2015*



Source: WIND, GF Securities Research Center

Meanwhile, property sales growth remained buoyant and there are signs that developers are starting to respond to the pick-up in demand by stepping up construction activity. Floor space sold from January to July advanced by 6.1% relative the same period last year, 2.2% higher than the growth from January to June. Floor space sold has been falling at an over 20% annual rate, while home sales have been recovering – a combination that is beginning to reduce inventories in Tier one cities but has not yet to make a dent in smaller Tier three cities (see CHART 5).

CHART 5 Real Estate Activity *% Y/Y*

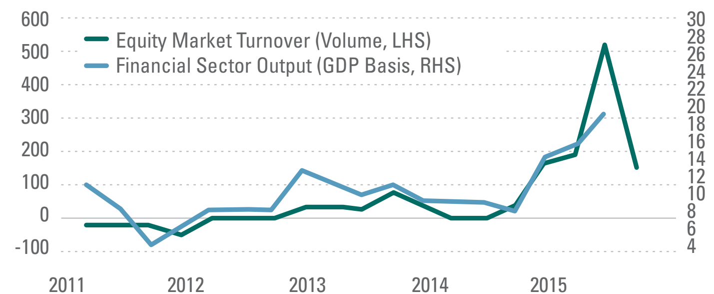


Source: CEIC, Thomson Datastream, Capital Economics

OUR OUTLOOK

For Q4, one potential threat to GDP growth is the impact of reduced stock turnover in the Financial sector, which is the largest contributor to the services sector growth. As shown in CHART 6, the Financial sector's output is highly correlated with stock turnover. However, since the June mini-crash in A-share equities, stock turnover declined by more than 60%. One of the concerns about the Q3 GDP data was that the Financial sector did not appear to be affected by the decline in stock turnover. We expect to see diminished output from the Financial sector in Q4, which in turn would be expected to significantly impact fourth quarter GDP. If, for example, the real growth in the Financial sector's value-added decelerates from 17% to 9%, which seems likely given shrinking turnover, that would cause service sector growth to drop below 7% and headline GDP growth to fall to 6%.

CHART 6 Financial Sector Output & Equity Turnover *% Y/Y*



LHS: Left-Hand Side | RHS: Right-Hand Side
Source: CEIC, Thomson Datastream, Capital Economics

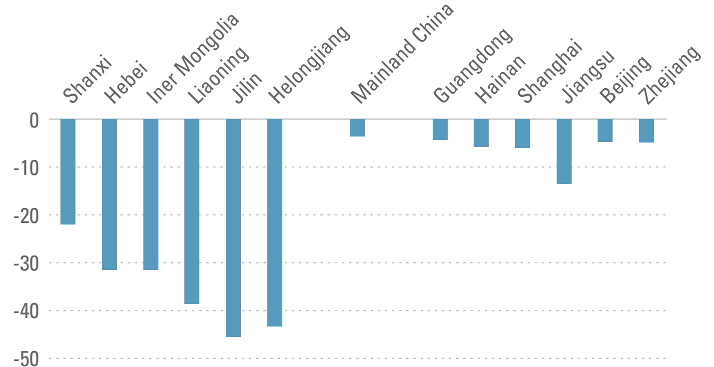
More importantly, while the Chinese economy may be transitioning to a consumption-driven "New Normal", the biggest challenge, in our opinion, is whether the consumption acceleration can weather the deceleration of the manufacturing slowdown, and eventually steer the overall economy into a sustainable growth mode.

The overall GDP growth rate, in this context, is less meaningful given the huge divergences among different sectors and regions. To illustrate, we contrast **six heavily industrialized provinces in Northern China** (Shanxi, Hebei, Inner Mongolia, Liaoning, Jilin and Heilongjiang) with **six primarily service-driven provinces** (Guangdong, Hainan, Shanghai, Fujian, Beijing and Tianjin). (see CHART 7). The "Northern six provinces", which comprised collectively about 17% of national GDP and are roughly the size of Russia's economy, are unarguably in recession and signs of economic distress, such as nonperforming loans—are increasing at a much faster speed than in the rest of the country. Even this is still likely understated given the heavy representation of SOE firms in Northern China, many of which enjoy local government subsidies and forbearance from banks. The six service-driven provinces, which comprise about 25% of China's GDP or roughly the size of Brazil, have more diversified economies and more competence in higher-end goods and services. The "Northern six provinces" are a smaller part of China's economy than the "Service Provinces Six" but their slowdown is much more severe than that of the "Service Provinces Six" (see CHART 8).

CHART 7 "Northern Six Provinces" vs. "Coastal Service Six Provinces"

Source: FIS Research

CHART 8 The Drop-off of Real GDP Growth in "Northern Six Provinces" vs. "Coastal Service Six Provinces"
%, From 2012-2014



Source: FIS Research

CREDIT GROWTH WILL NOT PROVIDE THE SAME FUEL AS THE BOOM YEARS

In the goldilocks years, bank assets exploded from about 190% in 2003 to about 300% of GDP in 2014 (see CHART 9). According to data from National Bureau of Statistics of China, between January 2008 and December 2011, credit grew 21.8% per year, whilst GDP grew 14.6%.[1] Credit growth, in essence, propelled GDP growth by 7.1%. This led to a buildup of excessive leverage, particularly for state owned entities. Total credit growth has fallen to around 12%, the slowest growth rate since 2006 but still above the growth of nominal GDP.

CHART 9 China Bank Assets *As % of GDP*

Source: FIS Research

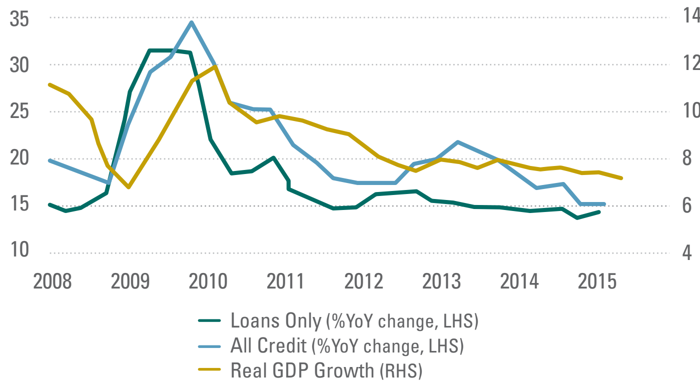
The government is trying to "thread the needle" between avoiding another credit run-up in light of already high levels of leverage while also trying to avoid another credit crunch, which precipitated the fallout in the Property and Construction sector in 2011.

[1] *National Bureau of Statistics on China*

Going forward, credit growth will clearly not provide the same fuel for GDP growth as it did in the earlier period.

Since 2011, regulatory restraint of shadow finance has been curbing credit growth substantially. As a result of base effects as well as continued reductions in lending rates, we expect to see a modest rebound in credit growth in the coming months (see CHART 10).

CHART 10 Credit Growth Slowing from a High Base



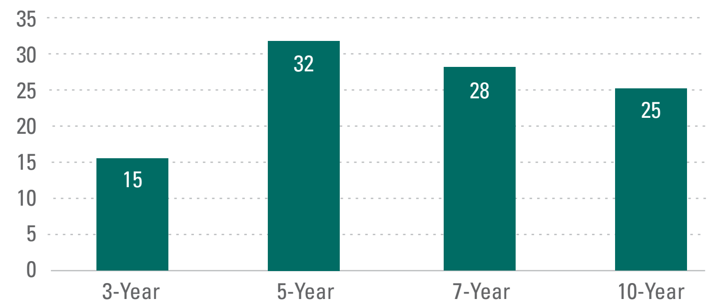
LHS: Left-Hand Side | RHS: Right-Hand Side
Source: FIS Research

2. THE GOVERNMENT'S EFFORTS AND PROGRESS IN PAVING THE ECONOMY REFORM

CLAMPING DOWN THE LOCAL GOVERNMENT DEBT MESS

We are encouraged by Beijing's progress in identifying the extent of local government indebtedness and restructuring their debt maturity through the debt swap program. For example, for the year 2015, RMB 16 trillion of local government debt obligations has been recognized. Thus far this year, RMB 3.2 trillion of muni bonds have been allocated to local governments for the "debt swap" program. As a result of the debt swap program, the average maturity of local government bonds issued this year is 6.5 years (see CHART 11) is much longer than that of the existing local government debt, which is about 2-3 years.[2] Taken together, the debt swap program has been effective in improving local governments' risk profile and significantly reducing their debt burdens.

CHART 11 Local Government Bond Issuance by Maturity
%, YTD

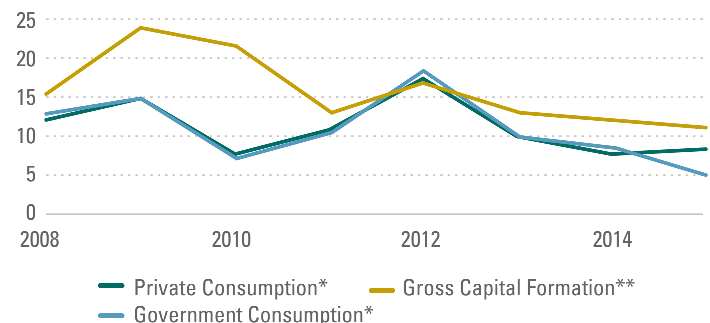


Source: Chinabond.com.cn, CEIC, Wind Info, CICC Research

BUT MORE POLICY SUPPORT IS NEEDED

China is among the few major global economies that can still use conventional policy tools to boost growth. However, on the fiscal front, government consumption has decelerated in recent years and underperformed all other major components of the economy (see CHART 12). Somewhat chastened by the excesses of the prior government's policies of aggressive fiscal stimulus through credit creation, the primary pillars of President Xi Jinping's economic plan reference such concepts as "deleveraging, structural reforms and no stimulus". The authorities have effectively cornered themselves into a binary choice between supply-side structural reforms and policy easing. The problem is that "two Chinas", like the European core and its periphery, need very different policy prescriptions.

CHART 12 The Fiscal Policy Thrust at the Central Government Level Has Been Muted by Retrenchment in the Troubled Industrial Northern Provinces



**Deflated by Consumer Price Inflation*
***Deflated by Producer Price Inflation*
Source: FIS Research

[2] *CICC: Local government debt swap watch, September 1, 2015*

While the Central government has ramped up fiscal expenditures this year, the depressed northern region probably needs a bigger increase in spending than the rest of the country. The sharp slowdown in economic activity in the Northern provinces has resulted in falling tax revenues, as the value-added tax and other corporate levies are the main source of government revenue. This decline in local fiscal income means the local government has fewer resources with which to cope with the downturn, either by supporting local companies or expanding social services. Additionally, the end of the housing boom and a declining population suggest it will be difficult for Northern China to quickly recover by transforming its growth model. As growth stays weak, local banks will have to recognize more non-performing loans in the next couple of years, threatening financial stability. Some regional banks will likely need to be recapitalized. More fiscal transfers from the central government will be necessary for these provinces to cope with higher unemployment and associated social problems.

Monetary policy has been muted by weak demand (particularly in the Property/Construction sector in response to high inventories). However, here again the government has been behind the curve by offsetting the deflationary impact of a strong RMB with incremental cuts in interest rates. As shown in CHART 13, Chinese banks' average lending rate is still 100 basis points higher than its level during the global financial crisis.

CHART 13 Monetary Policy Behind the Curve

Source: BCA Research

On October 23, 2015, the PBoC delivered another jolt of stimulus in the form of cuts to both benchmark interest rates and the required reserve ratio. The 12 month lending rate was lowered by 25bp to 4.35% and the equivalent deposit rate was cut by the same amount to 1.5%. The RRR has fallen by 50bp, taking it to 17.5% for major banks. This represents the seventh cut in the benchmark interest rate or reserve requirement (or both) this year at roughly two-month intervals. Consequently, we believe that it is highly likely that the benchmark rates and the RRR will both be cut once before the end of this year, with a further move in early in 2016.

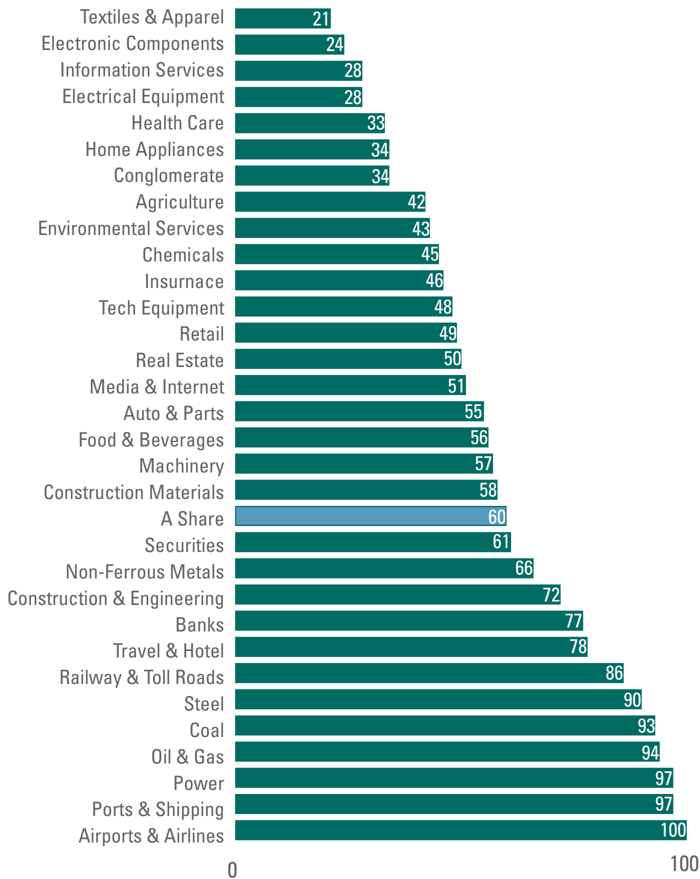
The latest announcement is consistent with the controlled easing cycle and evidences the important fact that China's policymakers, unlike many of their peers elsewhere, still have room for policy maneuver. Policy easing so far – both monetary and fiscal – does seem to be helping. Both credit growth and government spending is picking up and fears that the economy was rapidly decelerating seem to have receded. Admittedly, we're still waiting for clear evidence of an economic turnaround as September's activity data still does not show any great improvements. At this stage, we believe targeted fiscal policies, such as a reduction of the corporate tax rate and direct subsidy supports to growing industries, will be needed to supplement monetary policy to address China's corporate financing difficulty.

IMPLEMENTATION OF SOE REFORM PLANS CRITICAL TO A SUCCESSFUL TRANSFORMATION

State-owned enterprises (SOEs) reform is a focal point for effecting the economic reform. Based on the data from WIND, by the end of 2012 there were 981 SOEs (both central and local) across the 34 provinces in China. This represents over 40% of the total number of local corporations and 60% of their combined market cap. As shown in CHART 14 (on PAGE 7), SOEs dominate capital-intensive sectors, such as Transportations and Energy, and comprise a relatively small percentage of service-oriented sectors, such as Health Care and Consumers. For decades, the scale-chasing growth mode, with lucrative executive compensation, ballooning bureaucracies and inefficient corporate governance have led to mounting overcapacity, low profit margins and poor investment return. This is the primary driver of deteriorating fundamentals for the overall Chinese economy since 2010 (see CHART 15 on PAGE 7).

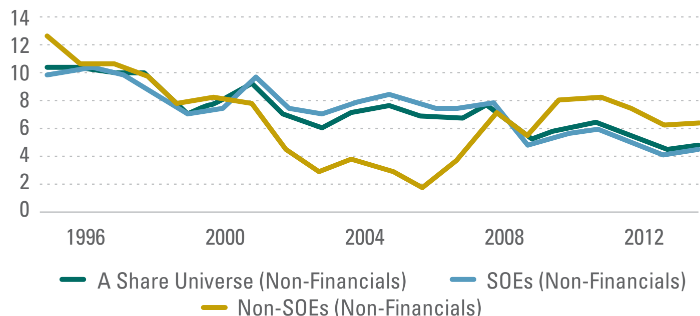
Since late 2013, SOE reform has been listed as one of the top three key reform priorities by the Party's top decision-making body Politburo. The four primary goals of SOE reform are (1) diversifying their capital structure to include more private equity capital; (2) consolidating firm assets via M&A and securitization; (3) changing the government's role from a "business manager" to a "capital allocator" by setting up state-owned investment firms, and (4) improving corporate governance, including aligning executive compensation with firm profitability and allocating shares to employees.

CHART 14 Each Sector's Portion of SOEs by Market Cap %



Source: WIND, CICC Research

CHART 15 Net Profit Margin of Listed Non-Financial SOEs and Private Businesses %



Source: CICC Research

According to CICC research, sectors with a heavy composition of SOEs and government control, such as Airlines, Telecom and Financials, are focusing on diversifying their capital structure and deregulation; capital-intensive sectors, such as Energy and Materials, are focusing on industry consolidation; and service sector SOEs, (a much small component of total SOEs), are focusing on improving incentives.

Six central SOEs have announced pilot reform plans, 16 provinces announced clear reform plan, and another 12 provinces provided specific targets which have not yet been announced. These plans estimate completion of the reform process between one year in rapidly-advancing regions, such as the south and east coast, to five years in the less-developed regions, including the northeast and southwest areas.

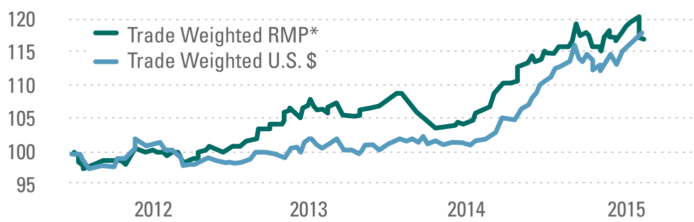
During our recent trip to China in September, local investors stated that, **thus far most of SOE reform has still remained in the planning phase**, and it may take several years to see substantial improvements in underlying SOE fundamentals. Some investors believe that the fundamentals of listed SOEs will improve significantly once their structures are streamlined and legacy issues are corrected. However, in the short term future, there remain notable obstacles and uncertainties. Cutting excess capacity means more layoffs, which could in turn generate social unease that would retard or stymie the government's SOE reform effort. In the meantime, we continue monitoring the implementation of such SOE reforms going forward, along with any change in their underlying corporate fundamentals.

RMB DEVALUATION AND INTERNATIONALIZATION

Between January 2007 and July 2015, the Chinese yuan appreciated 20% relative to US dollar, and 50% relative to a basket of major trading currencies, measured in real effective terms. For example, the RMB's value increased by 125% against the South African rand, 85% against the Mexican Peso, 80% against the Indian rupee, and 56% against the South Korean won. Since January 2014, the RMB has appreciated by 45% against Japanese Yen and 20% against Euro. Before the August 11 through 12 devaluations, the RMB and the U.S. Dollar were the only major currencies that were appreciating in trade-weighted terms over the past few years (see CHART 16 on PAGE 8). This, in effect, imported deflation from the rest of the world at the expense of their domestic economies.

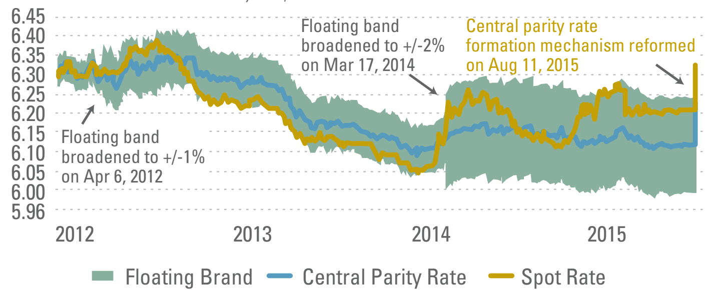
Many investors were caught off guard by the PBOC's August 11th decision to devalue the RMB by 3%, ostensibly to address the variance between the government's "fixing" rate and the market determined CNY. The move was important not because of the size of the depreciation but because the PBOC stopped setting the "fixing rate" at its discretion, instead linking it to the previous day's close. While it is difficult to believe that the RMB's impact on China's export growth was not a

CHART 16 The Substaintial Appreciation for RMB *Since 2012*



**Rebased to Jan 2012 = 100*
Source: J.P. Morgan Chase & Co.

CHART 17 The Movement of RMB's Fix, Spot and Floating Bank since 2012 *RMB/US$*



Source: CEIC, CICC Research

consideration, (particularly in light of divergent economic growth profiles and the prospect of a U.S. dollar supportive Fed hike), we believe that the primary motivation for the change was to show progress on market reforms and qualify the RMB for inclusion in the IMF's SDR basket. But the shift was poorly communicated, and caused panic in Asian and other markets as many investors believed China wanted a large devaluation to help boost its slowing economy.

Following this announcement, the intra-day floating band of the RMB spot rate widened significantly, similar to the doubling of the trading band in March 2014 (see CHART 17). Eventually, the more market-driven RMB will stabilize around its fundamental value.

The PBOC and top leaders including Xi Jinping have recently clearly stated they do not want further currency depreciation. Consequently, the PBOC spent US$115 billion in August intervening in the spot market to avert further depreciation, keeping the USD/CNY spot at around 6.36-6.40.

OUR OUTLOOK

After substantial appreciation over the past few years, the RMB is fairly valued. China's economic slowdown cannot sustain the RMB's peg to the greenback, especially in light of the Fed's upcoming interest rate normalization cycle. This is why we believe that once the worst of the pressure from capital outflows is past, the central bank will likely allow another 2-3% depreciation this year. Capital outflows this year remain small relative to the size of China's foreign reserves, and China has sufficient foreign exchange reserves to neutralize the capital outflow. From the peak record of $4 trillion reserve in 2014, China's foreign reserves dropped by roughly $430 billion as of end of September 2015, about 10% of the total reserve value. The remaining reserve amounts to approximately 26 months of imports and twice China's total external debts. That said, it is important to note that currency defense would require the PBOC to sell international reserves, which would actually further tighten domestic liquidity conditions and, ultimately, result in higher interest rates. In light of China's cyclical slowdown, such a policy outcome would hardly be desirable or optimal. This is why we believe that Beijing is likely to pair further relaxation of capital inflows with more stringent controls on capital outflows.

3. A-SHARE MARKET VOLATILITY – AN OUTCOME OF INEFFICIENT FINANCIAL MARKET STRUCTURE

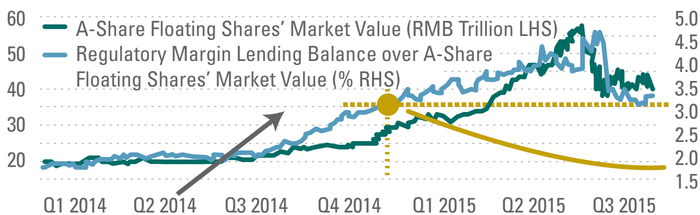
The Chinese equity markets have in part been viewed by the government as a policy tool to facilitate wealth transfers from household savings to rebalance the capital structure of mostly State-Owned Enterprises (SOEs) towards more equity capital, as part of the overall objective of SOE reform. As of September 30, the Shanghai Composite index was down 40% from its peak in June, a decline which was primarily driven by the unwinding of leverage. During the 9 months prior to the run-up, margin debt quadrupled to RMB 2.2 trillion. Unregulated margin lending was even higher as financing companies (the so-called grey loan companies) worked with brokers to allow retail investors to borrow even more.

The volatility in A-shares has been a function of: (a) their market structure (over 90% of capital accounts owned by retail investors) which, like many Asian markets is primarily driven by trade momentum; (b) valuations that were not supported by earnings , and (c) the government's policy of first encouraging and then tamping down on margin lending. Its measures after the June crash included increased monetary easing, forcing big shareholders to buy stocks, stopping IPOs, restricting transactions in the index futures market, launching investigations into short-selling, and direct buying of shares via the China Securities Finance Company. These measures achieved some temporary stability but attracted much public criticism. The new round of anti-corruption probes into brokerages has further dented investor confidence.

Encouragingly, after the subsequent market collapse in late August, the Chinese government's response has been more measured by targeting liquidity, rather than an index level. As estimated by local officials, the scale of regulated margin

balance has dropped off substantially from RMB 2.27 trillion in mid-June to RMB 0.96 trillion as of the end of September, which was below the level in the 4th quarter 2014. Additionally, unregulated margin balances have fallen significantly (see CHART 18). Much reduced forced selling combined with relatively high cash balances at mutual funds and private-raised funds (estimated to be RMB 1 trillion), is providing more stability (and could be constructive) for Chinese equities.

CHART 18 Mounting and Reversing of the Margin Lending Balance of A-Share Market



Source: CICC Research

OUR OUTLOOK

While the psychological impact of successive A-share mini-crashes on local Chinese investors is likely to be larger than the actual level of share ownership, it is important to remember that only 8% of the Chinese population and 8% of the total households' assets are invested in the stock markets. That said, the Chinese government needs to broaden the equity ownership and deepen the country's capital market by expediting financial market reform, including finalization of the IPO registration process and relaxation of trading restrictions that hamper market liquidity (including the current "stop-loss" rule and "T+1" future transaction rule). In the meantime, Beijing should continue pressing ahead with capital liberalization via increased QDII/QFII/RQFII quotas and the establishment of the "Hong Kong – Shenzhen" connection.

CONCLUSION

The Chinese government has been seeking to avoid a precipitous rebalancing from the traditional heavy industry/export model to a more service driven model through credit easing and targeted fiscal stimulus. Equity and capital market reform, market based resource allocation, currency internationalization and fixing corruption represent, in combination, important pathways to achieve this transition. For example, a robust stock market is critical for addressing the dual problems of an unbalanced capital structure which focuses too heavily on debt and unlocking the substantial savings of under-levered wealthy Chinese households, to provide equity financing for both the SOEs (that dominate the Shanghai market) and capital starved companies in the newer more productive companies (primarily listed in Shenzhen).

Understanding the growth disparity between the country's industrialized north and more service-oriented south is key to interpreting the government's policy actions and the pace of structural reform. The end of the housing boom and an aging population suggest that it will be difficult for northern China to quickly recover by transforming its growth model. Additionally, the huge increase in credit since 2009 has left China with a leverage ratio that is high by any standard and extremely high for a developing country. While we do not see a significant risk of a systemic financial crisis, there is a high likelihood of localized fiscal and financial problems in the more distressed parts of the country. But overall, increasing leverage is no longer a viable option for growth. More fiscal and monetary stimulus from the central government will be necessary for these provinces to cope with higher unemployment and associated social problems.

As China shifts away from its investment/export model, and the anti-corruption drive enters its third year, many traditional opportunities have dried up. The next big opportunities will be created by Renminbi internationalization, financial liberalization, and the consumer economy. Finally, China is in the grip of the "acceleration phenomenon." Demand for higher quality products and services is a function not of average income growth, but of the rate at which households cross key income thresholds. European and Japanese MNCs are best positioned to provide trendy, high-quality goods and services that local firms cannot. Furthermore, a weaker euro and yen would support demand by lowering the income threshold at which the goods become affordable. On the domestic China front, we repeat our recommendation to use down-drafts in Chinese equities to gain attractive entry points in "new-economy" sectors, such as Consumers, Health Care and TMT.

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