China 2016 Outlook

Growing through a transition

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In the first week of January 2016, along with global markets, offshore Chinese equities were shaken by the developments in mainland China. The volatility was mainly explained by the new circuit breaking mechanism, where trading would be halted for the day after a +/-7% move in the CSI300 index. Two days during the first week of January (January 4 and 7), a -7% move triggered the circuit breaker. China's circuit breaker may in fact have added to market volatility as investors rushed to sell before the circuit breaker was triggered, especially since mainland bourses are driven by retail investors. At the end of the week, the circuit breaker suspension was, in our view, a prompt and appropriate decision. It is evident the Chinese government is still learning from experiences how to best build a less volatile and healthier stock market going forward.

In our view, China is rebalancing its economy to a 'new normal' level of long-term growth. Changing the framework of any economy, especially one the size of China, will take time and face many hurdles, leading to a ride that may be bumpy at times. That said, despite the volatility that may come from time to time, it is worth noting that there is essentially no change to the fundamentals of China's economy and markets. In particular, for this year and beyond, we believe the change in growth contributors, progress in structural reform, as well as MSCI index changes are important elements that we should continue to watch closely.

Change in growth contributors

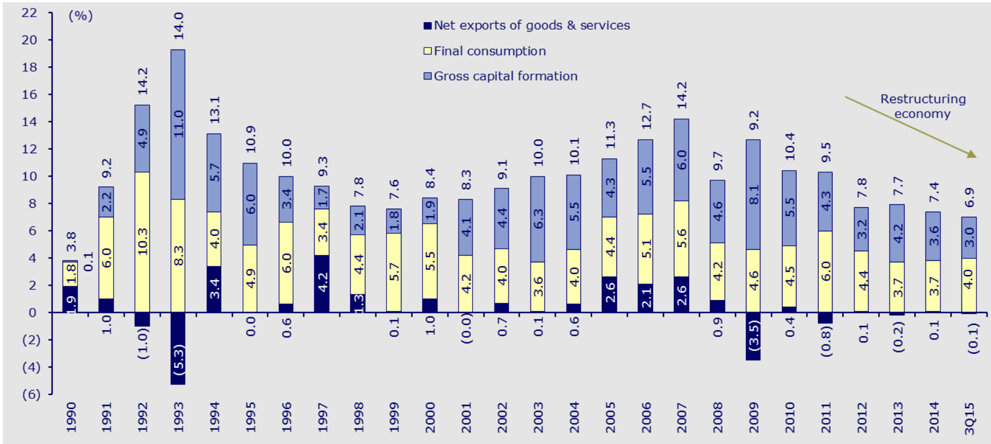
The contributors to China's economy, namely exports, investments and consumption, have certainly changed over the past decades. In particular, one key contributor to growth in China over the years has been investment. However, in recent years, investors have been increasingly concerned about the decline in investment spending in China, particularly the deterioration in the real estate sector. We are not as concerned about the slowdown, however, seeing it as a much needed inventory correction. Over the 5 year period to 2014, land sales in second and third tier cities increased by 245% and 223% respectively, compared to the 153% increase for Tier 1 cities during the same period. In the meantime, population outflows from second and third tier cities to major metropolitan areas in China resulted in cases of oversupply. We expect the consequential rise in property vacancies in second- and third-tier cities will likely take 2-3 years to be absorbed. Nevertheless, we do not believe there will be a collapse in property prices because household mortgage debt in China remains relatively low, at only 17% of GDP compared to 63% in the US[1].

Historically, exports were known to propel growth in China. However, their contribution has recently turned negative, due to slower global demand. Despite this, we believe weaker exports are not a major concern as long as the recoveries in Europe and the US continue. After all, they are China's largest export trade partners, making up around one third of China's total exports.

[1] Refers to 2014 figures. CEIC, CLSA Asia-Pacific Markets, August 2015

Looking into 2016, one of the 'bright spots' in China is likely to be the more stable and sustainable contribution from consumer demand. In the past, China was more dependent on cyclically geared export- and investment growth, which led to excess corporate spending and high indebtedness. We believe consumption in China will continue to be supported by increasing disposable incomes as more workers shift from lower wage earning manufacturing and agriculture related jobs to higher paying service oriented work. In fact, since 2012, tertiary industries have overtaken secondary industries to become the largest contributor to China GDP growth.

China- Contribution to GDP Growth



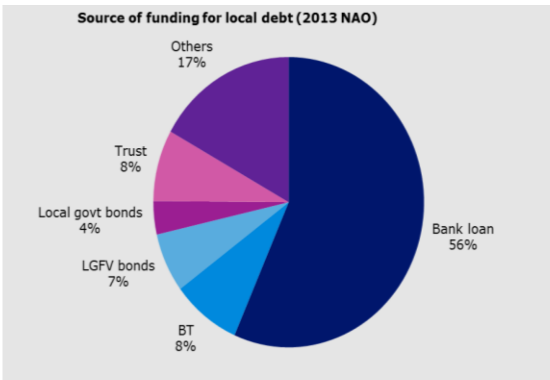
Source: CEIC, CLSA Asia-Pacific Markets, October 2015

Progress on structural reforms

In our view, China's structural reforms will boost growth more than most people expect. Many of the fiscal reform efforts have been aimed at reducing debt and improving productivity. To smooth the deleveraging process, the government introduced a debt-loan swap program whereby local governments are able to swap existing loans for government debt while at the same time they are no longer allowed to raise debt through financial vehicles.

This arrangement is advantageous for both banks and the local governments. For the banks, the government bonds should reduce non-performing loans (NPLs) because the local government's debt has similar credit ratings to central government debt. Meanwhile, the local governments benefit from lower interest rates on government bonds compared to loans, as well as better cash flow positions because the bonds have longer durations relative to loans.

Nearly 60% of local debt financed by bank lending



	Debt due to mature*	Local bond swap quota	Implications
Volume (Rmb trn)	1.89	2	Likely to cover all the local debt due to mature in 2015
Maturity (year)	4	6.3	Ease the risk of duration mismatch between the local debt and assets of projects
Yield (% p.a.)	8	3.5	Reduce interest payment burden
Debtor	LGFVs	Local governments	A higher level of transparency in new borrowing with revised Budget Law

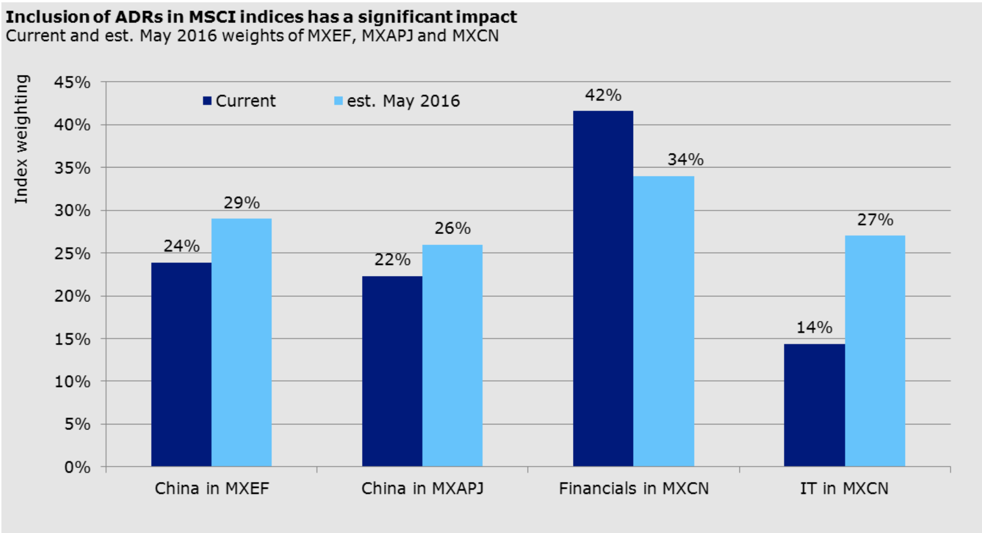
Source: National Audit Office (NAO), Morgan Stanley Research. August 2015
*(based on NAO)

Source: National Audit Office (NAO), Wind, Morgan Stanley Research. August 2015
Opinions are based on current market conditions and are subject to change without notice.

Another point to note is that investors tend to focus on government liabilities, but do not consider the 'assets' side of the balance sheet. The market capitalisation of SOE A-shares amounts to RMB 24.4 trillion versus provincial debt at around RMB 20 trillion.

MSCI changes are positive

The recent addition of 14 US listed Chinese ADRs[2] to MSCI indices not only better reflects the increasing importance of Chinese equities on a global scale, but also the changes taking place in China's economy. It includes more private enterprises, while reducing the weight in state-owned enterprises (SOEs). From a sector standpoint, after the full rebalancing in May 2016, the weight of the financials sector in the MSCI China index could fall from 42% to 34%, while IT exposure could climb from 14% to 27%. We believe this is a positive development for the index, as earnings growth in the banking sector is much slower than in the internet sector. From a regional standpoint, the inclusion of ADRs increases China's weighting in the MSCI Emerging Market (EM) and MSCI Asia Pacific ex Japan (APXJ) indices, with China's weight going from 24.0% at present to an estimated 29.0%[3] and from 22.0% to 26.0%, respectively.



Source: MSCI; Current data for MSCI Asia Pacific ex Japan and MSCI China Indices as of 11 Nov, 2015, current data for MSCI EM Index as of 30 Oct, 2015; est. May 2016 weights refers to the 100% inclusion in May 2016

Depending on the rate of progress in opening China's capital account, the MSCI may also decide to include mainland A-shares in global indices, possibly in the next 2 or 3 years. The implication of this change would be enormous. China's weight (offshore + A shares) in the MSCI Emerging Markets could rise to over 43% with full inclusion of A-shares based on MSCI estimates, in a report released in May 2015.

Conclusion

We believe 2016 will be a year where we see China's transition continue to unfold with a greater role for consumption, further reforms being carried out and MSCI index changes being made that better reflect the structural changes in China. Despite growth trending to a "new normal" level of slower growth, what is

[2] American Depository Receipts

[3] Source: MSCI; Current data for MSCI Asia Pacific ex Japan as of 30 Nov 2015, current data for MSCI EM Index as of 30 Nov 2015; May 2016 estimates from Goldman Sachs

important to remember is the fact that the absolute level of growth in China remains quite high. In the long-term, we believe China is heading in the right direction but managing growth and reform will be challenging. That is why, it is important for investors to continue to focus on bottom-up stock selection. We continue to prefer to find investment opportunities amongst private enterprise companies that are offering sustainable leadership and competitive advantages. As for SOEs, we remain selective.

Important Information