Update on the Chinese Fixed Income Market

June 2014

Why is China loosening capital controls, freeing interest rates and internationalizing the RMB?

The 2008 crisis made China realize that being dependent on US$ for its trade finance was not in the country's long term interest

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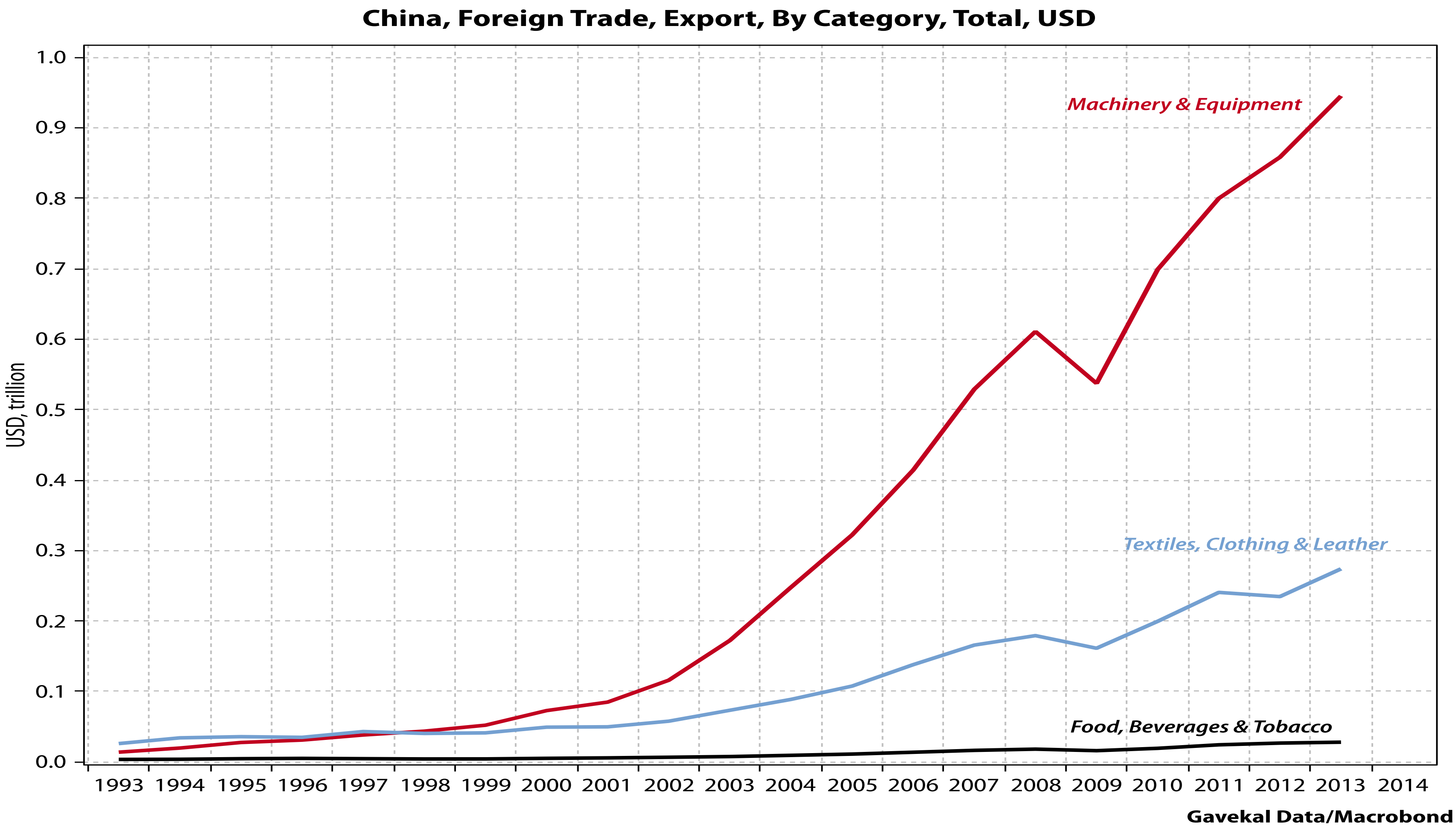
Combine that with a desire to move up the export value chain, and internationalization of RMB makes sense



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For internationalization of RMB to be successful, China needs a deep, liquid, financial centre that investors can trust– luckily, along amongst emerging markets, China has a liquid financial centre that people can trust: Hong Kong

China also needs for the RMB to strong enough that companies will want to keep working capital in the currency, and central banks reserves… This helps explain why the RMB remains one of the best performing currency of past three years, even as growth slowed

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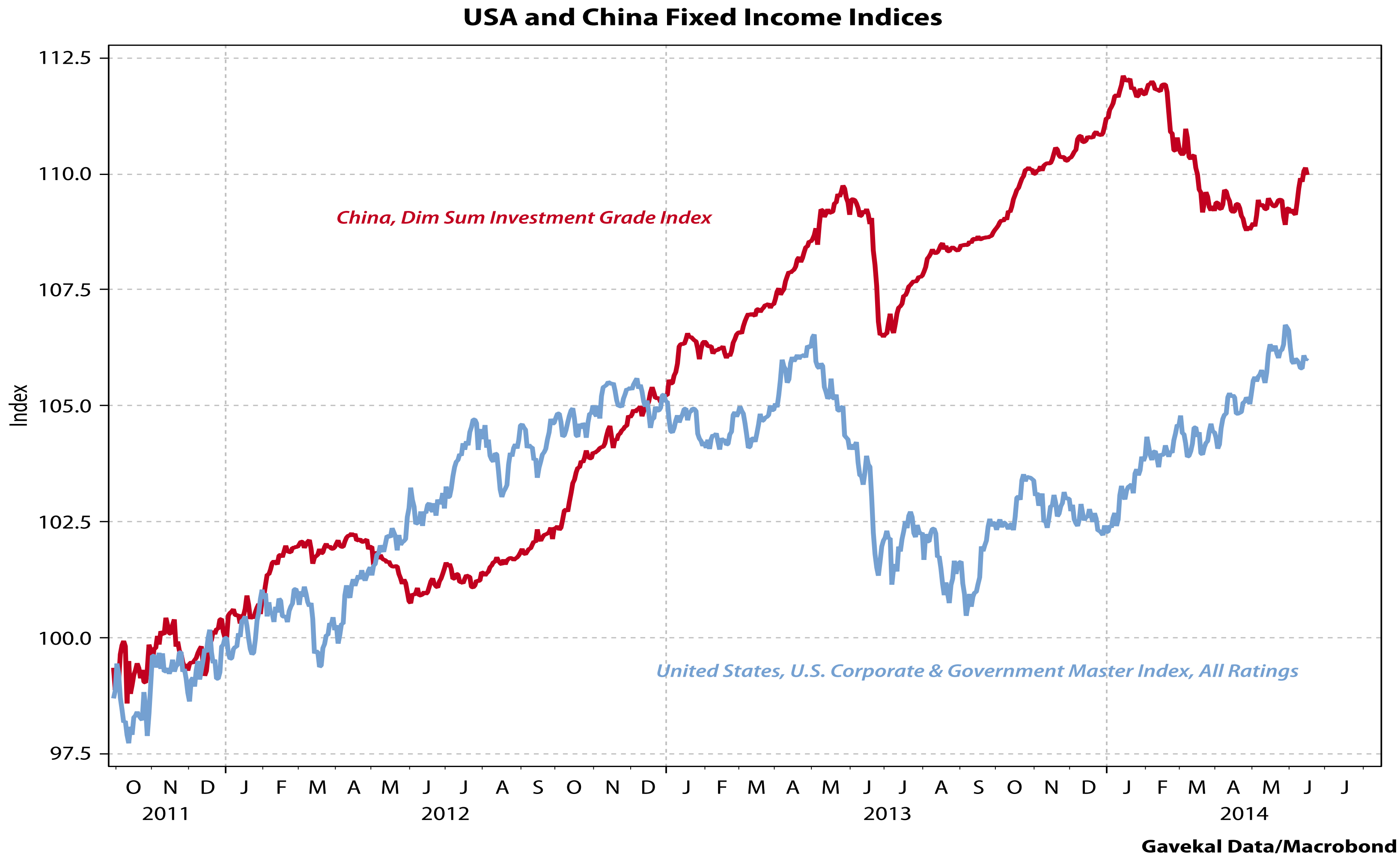
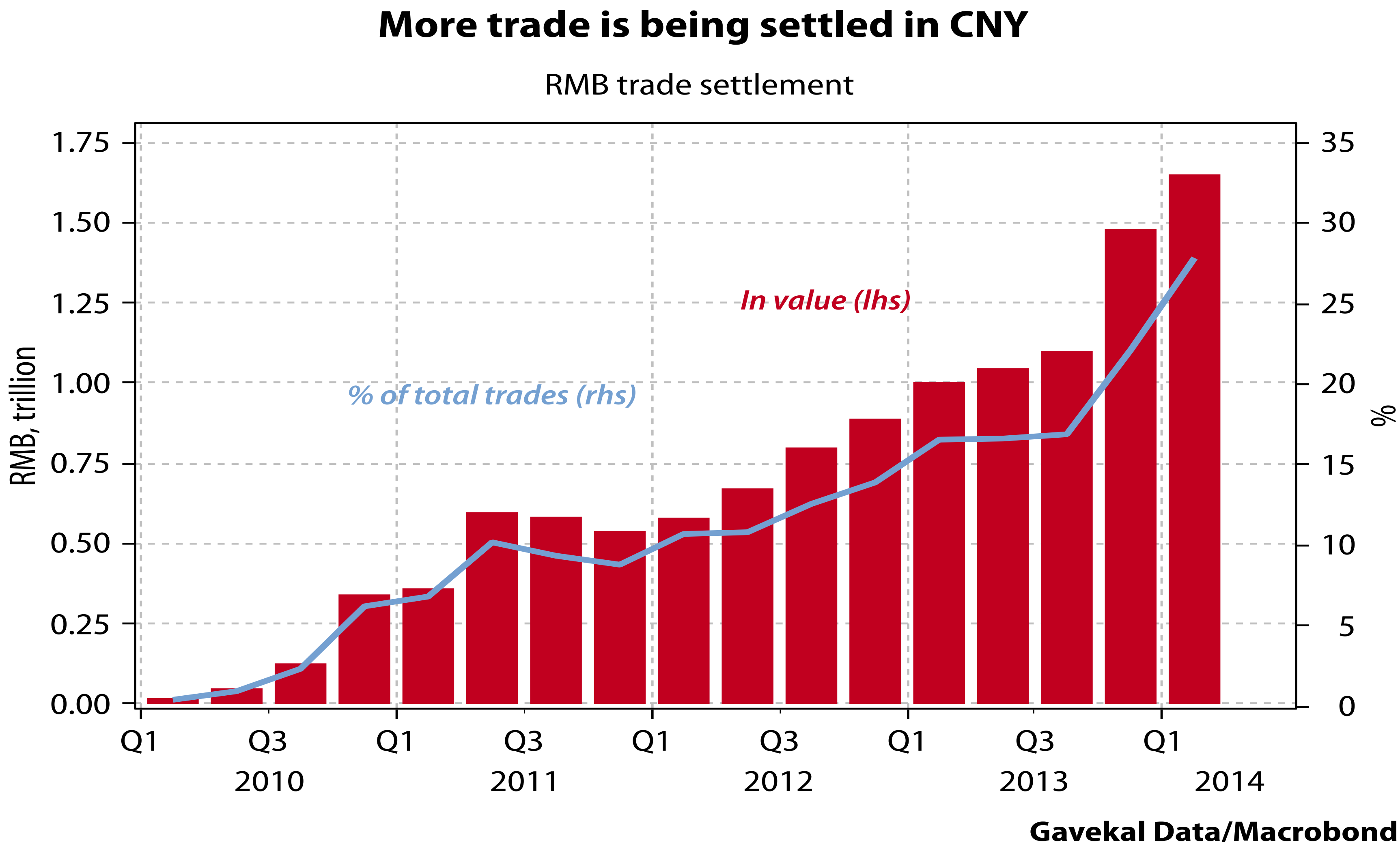
And finally, China needs a stable bond market

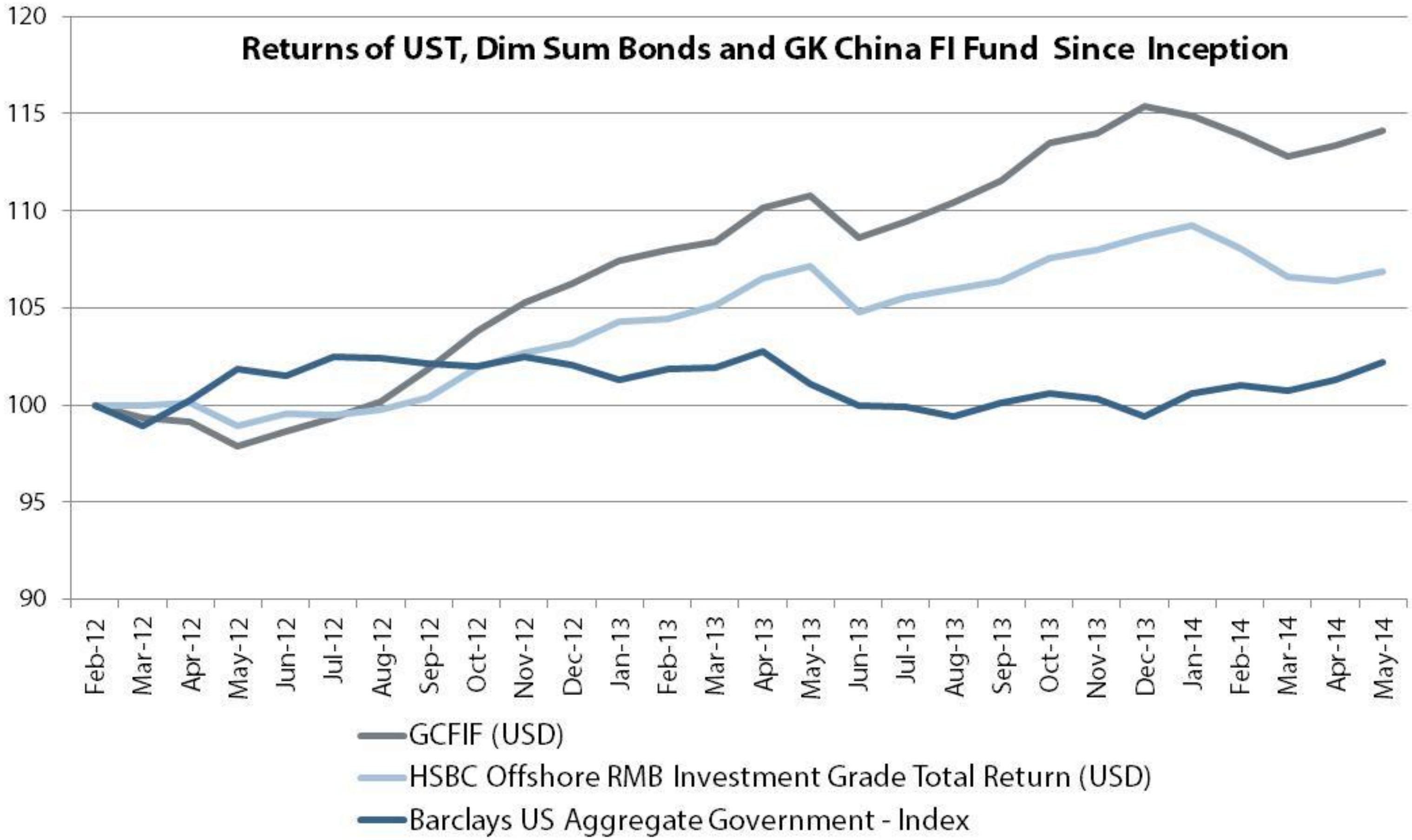


The proof is in the pudding: over past four years, more than quarter of China's trade has moved to being settled in RMB – that's a game changer!



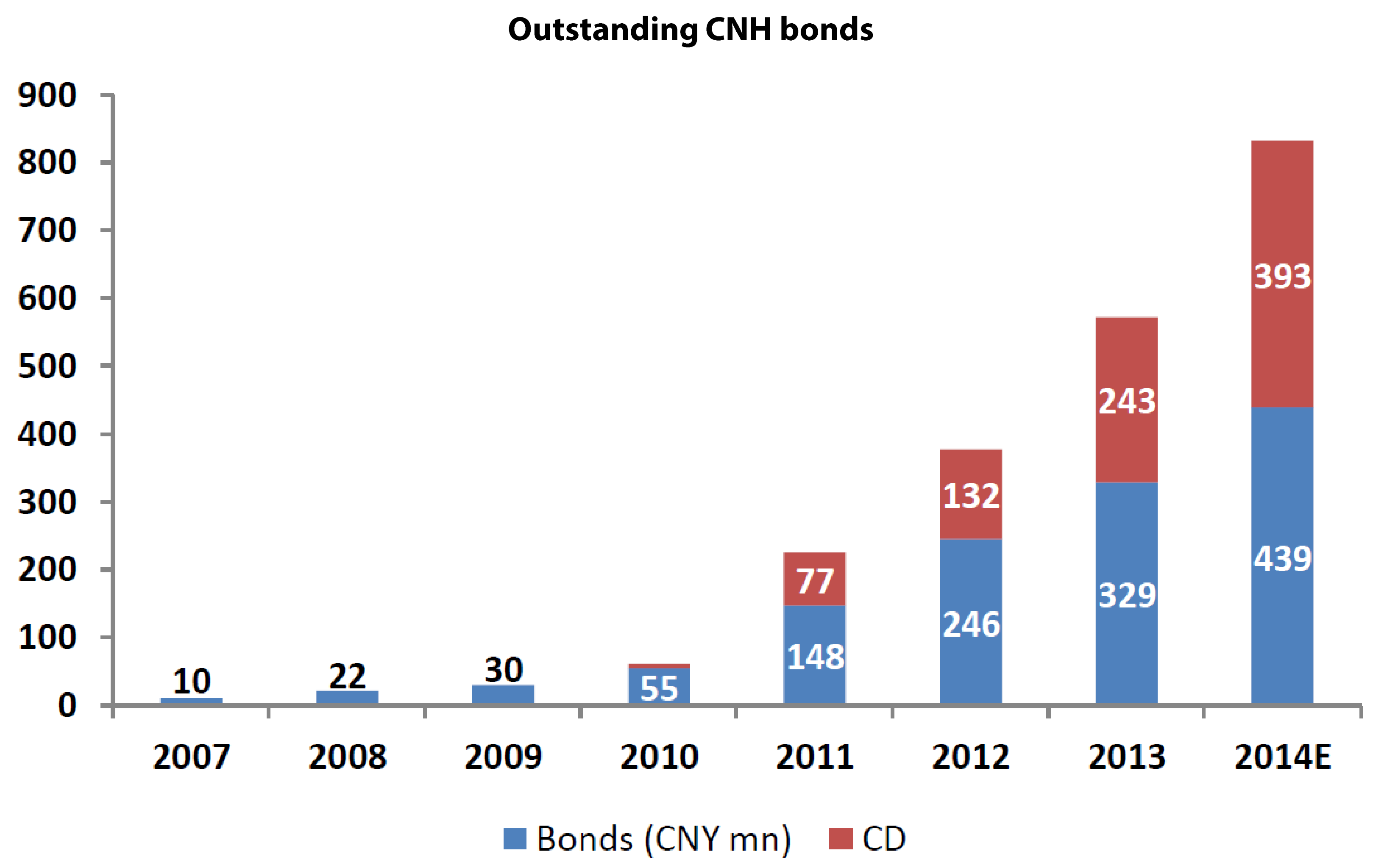
Why Chinese fixed income – the interest for investors and issuers

Delivering steady absolute returns with low volatility and low correlation – a new asset class is being born in front of our eyes



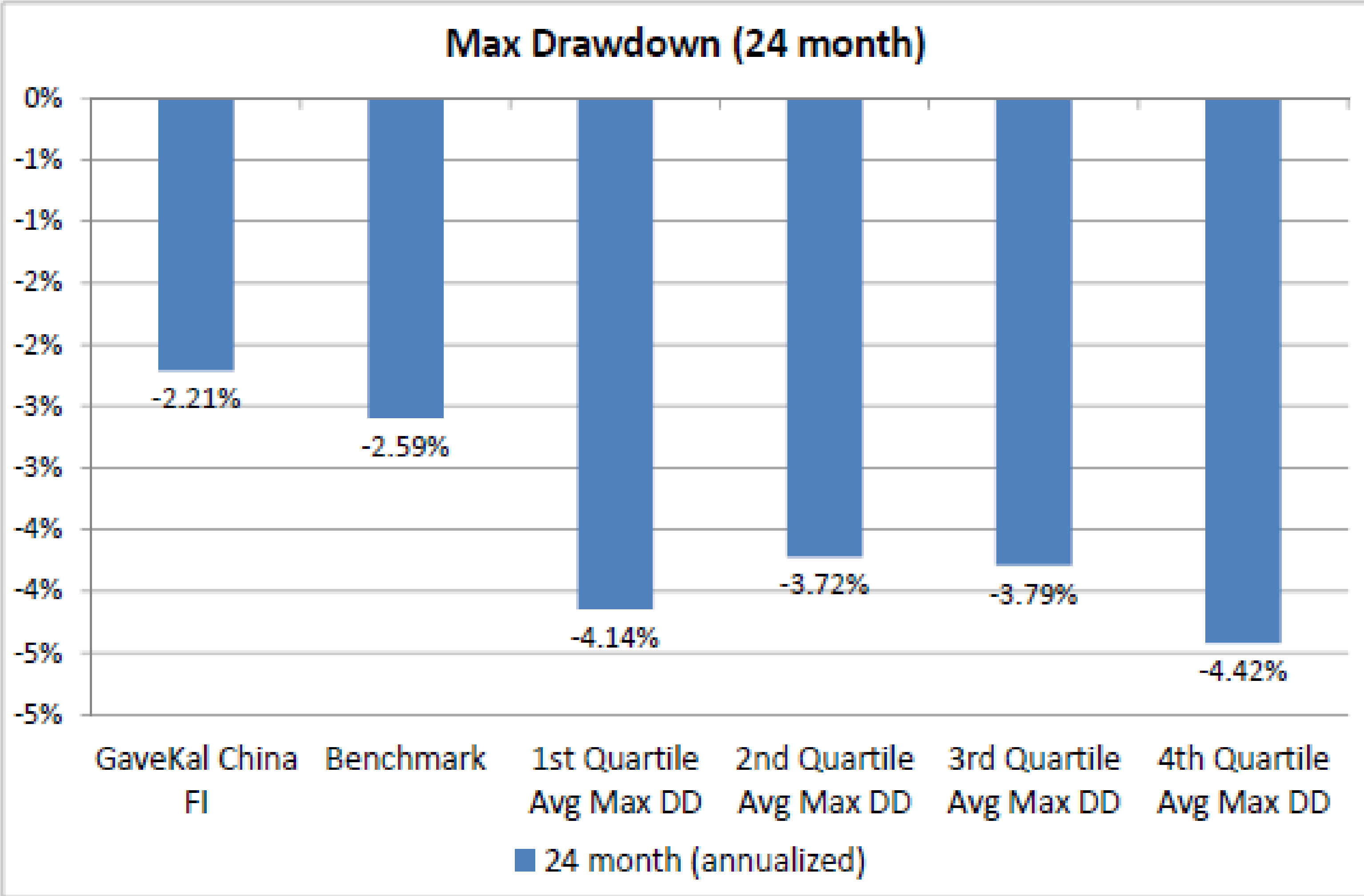
Source: GaveKal

Rapid growth of CNH bond market



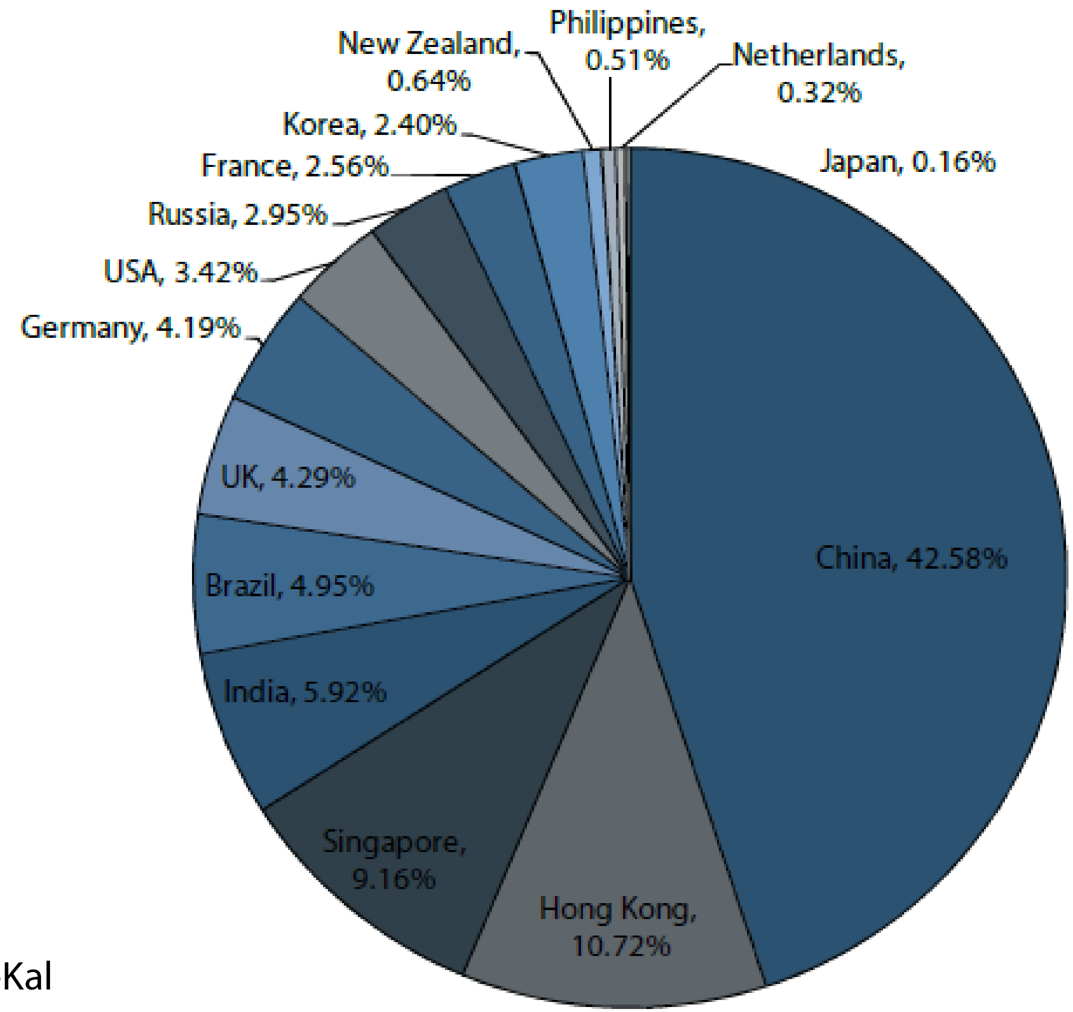
Source: Bloomberg

Controlled downside: even as bonds sold off aggressively in last summer's 'taper tantrum', dim sum bonds held their own



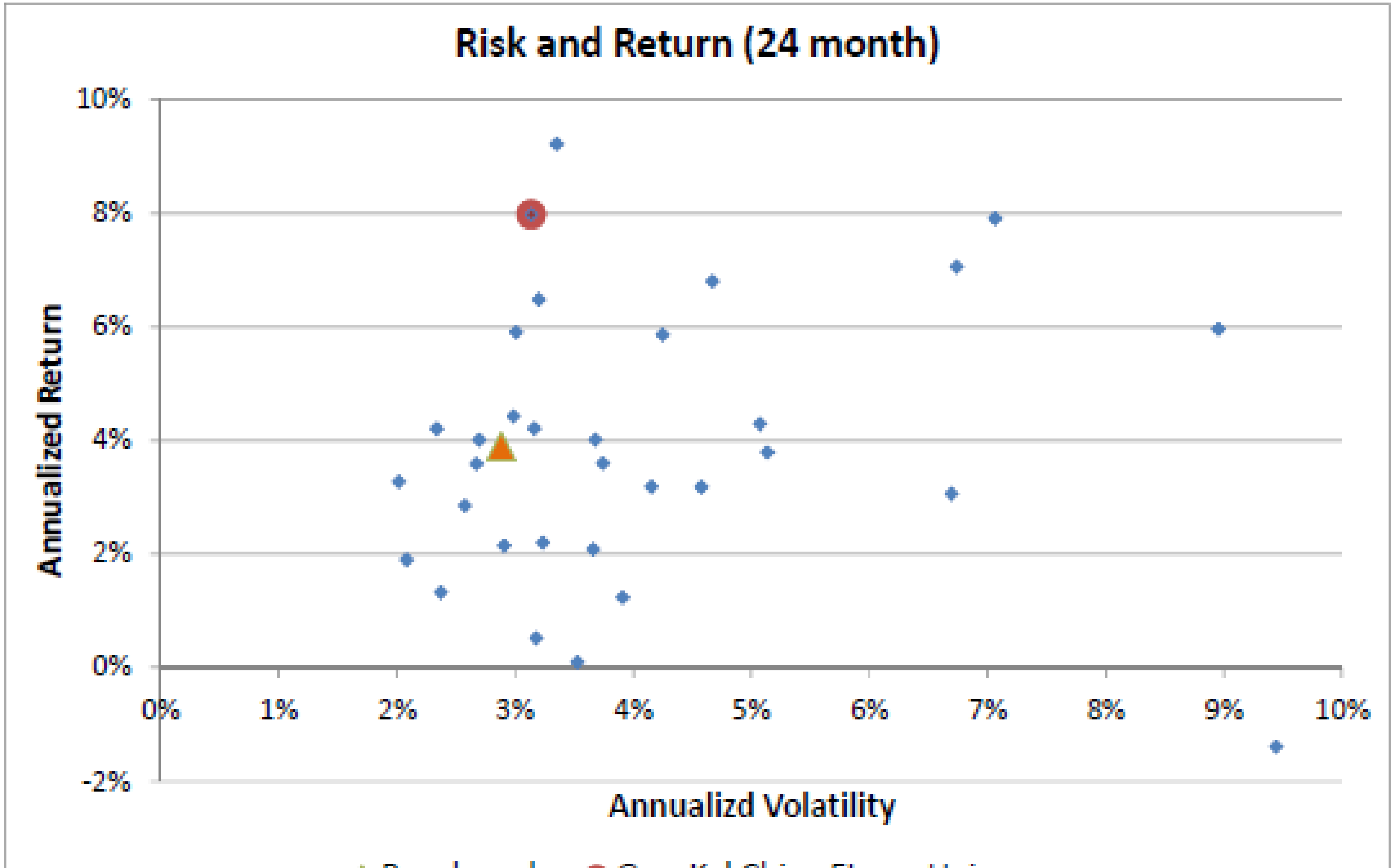
Source: GaveKal

As Chinese trade into RMB expands, so does the nationality of the issuer base. This makes for an increasingly diversified market – below, the regional breakdown of our holdings as of late May 2014:



Source: GaveKal

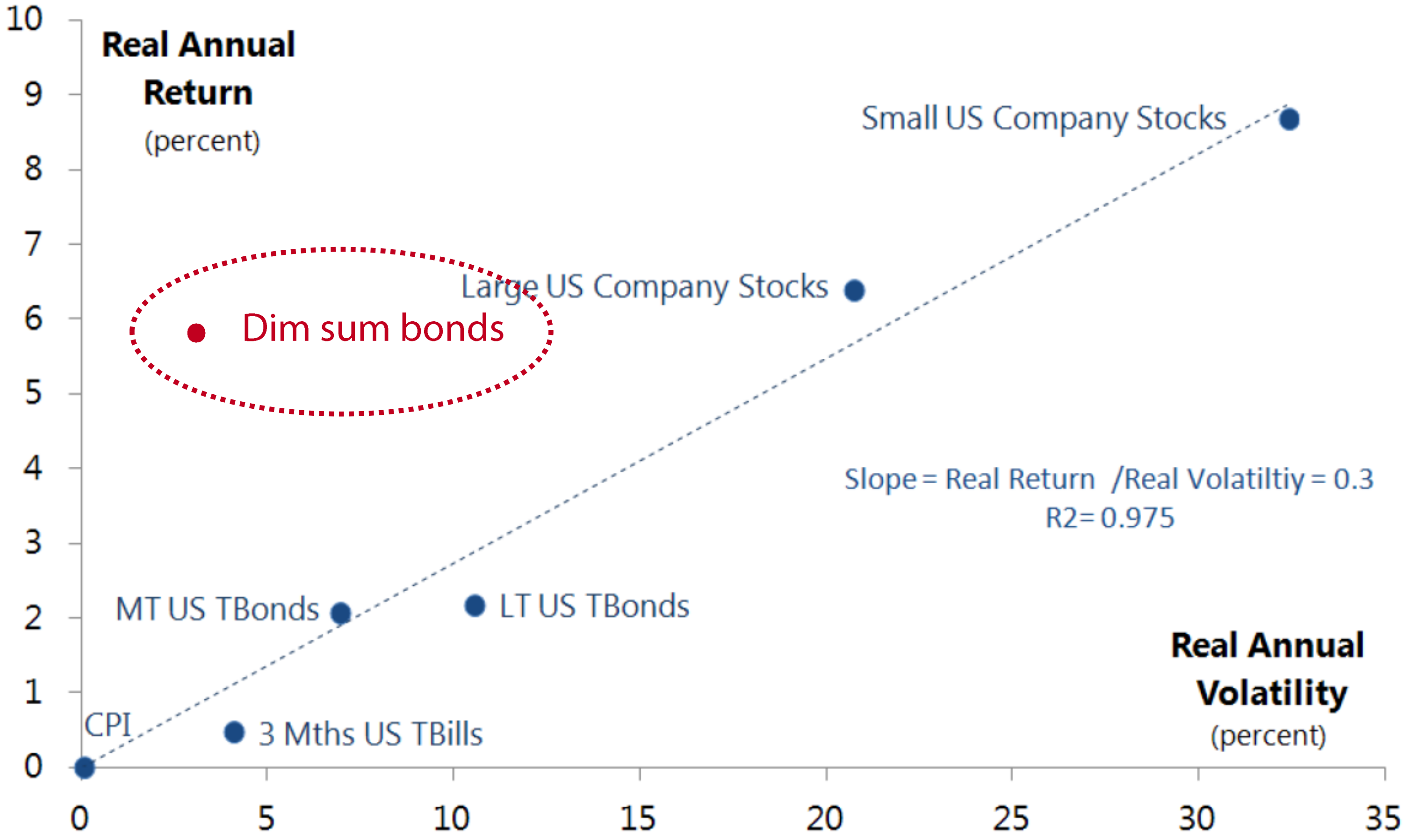
Very attractive risk/return profile: where else in the world can investors find 8% annualized returns with a 3% volatility?



Source: GaveKal

Getting value for risk – how long will this last?

Annual real returns vs. volatilities across US asset classes, 1926-2011



Sources: Ibbotson Associates, Bloomberg

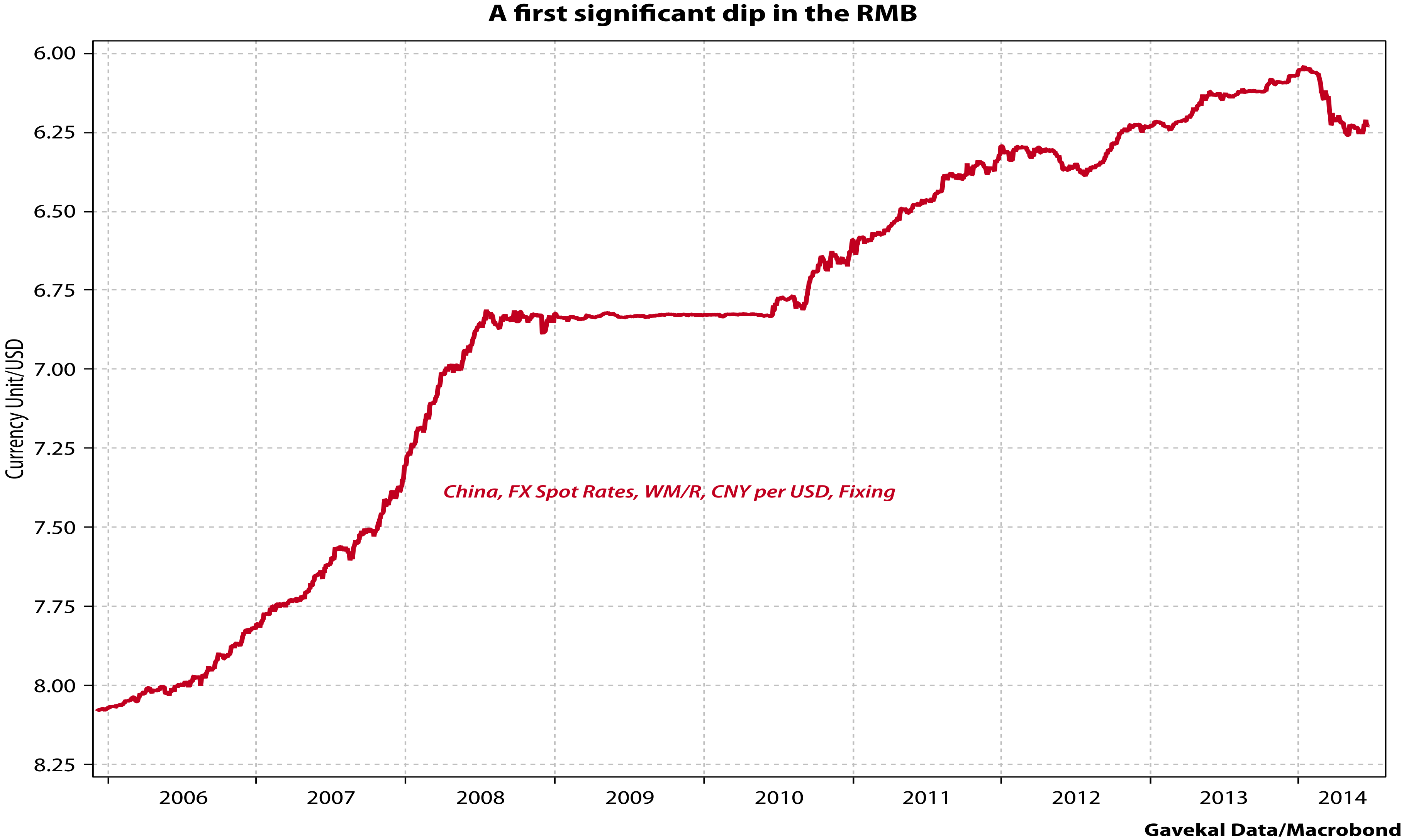
Financial markets are a global information system **on risks.** Over long-enough periods of time, asset classes typically return circa 30% real above their annual volatility.

But since the creation of the dim sum bond market, the risk reward has been much more attractive. Why? Because Beijing is keen to internationalize the RMB… And this is the price to pay!

As investors, should we look a gift horse in the mouth?

The RMB: does the recent dip mark a turn, or a buying opportunity?

For the first time since the RMB started to 'float' in 2005, the RMB is **down for the year:**



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Does the weakness mark the beginning of the end? Or the end of the beginning?

The fall in the RMB

- Direct consequence of years of capital misallocation
  - Sell all RMB denominated assets
- Government engineering a pullback to avoid excess speculation build-out
  - Buy RMB for year-end rally

China is slowing, but a crisis is unlikely

China's growth in 2014 will slow more than policymakers anticipated

It is almost a dead certainty that China will fail to hit the government' s 7.5% GDP target in 2014. By year-end the run rate of GDP growth will probably be below 7%, and in 2015 a further slowdown to 6-6.5% is possible.

The slowdown was prompted by a weak property market, which will lead to slower construction and heavy industry activity. Nationwide, we expect housing completions will fall about -5% in 2014, to 10 mn units, and then stabilize; prices in most cities could correct down by 5-10% but probably not more.

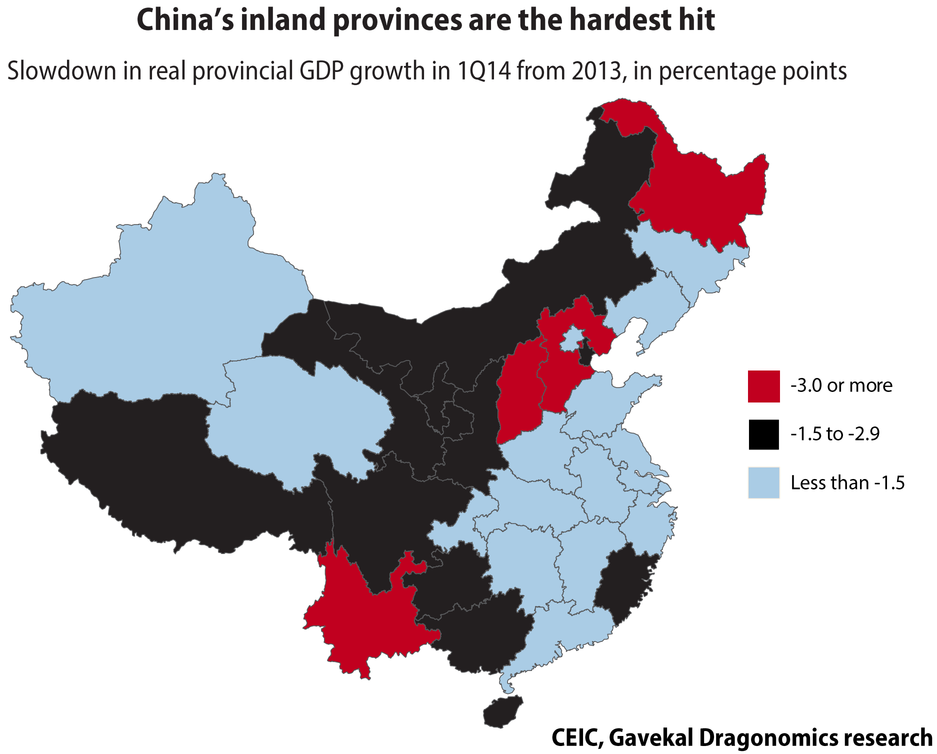
On the bright side, the government has already eased monetary policy and most cities are now free to end housing purchase restrictions. So a stabilization of credit and housing sales is likely in H2.

Moreover, the labor market remains very tight and exports are solid, so household consumption and the external sector should provide support for growth, making a big stimulus unnecessary.

There is little risk of a property collapse or financial crisis. Instead, the main question is how soon will we see gains from structural reform? And what is the impact of the anti-corruption drive?

Financial sector reform is proceeding smartly: a more flexible exchange rate since March is a prelude to liberalization of deposit interest rates within two years. Other reforms (fiscal, SOE and urbanization) are proceeding more slowly.

GDP growth continues to slow, especially inland



Since 2012, China's headline GDP growth has stayed in a relatively narrow range of 7.4% to 8.1% YoY. The slowdown in Q1 means growth is already back to the low end of this recent range.

But since momentum is deteriorating rather than accelerating, a further slowdown to a new recent low looks inevitable. The government may have wrongly assumed that growth would stabilize at 7% without policy intervention.

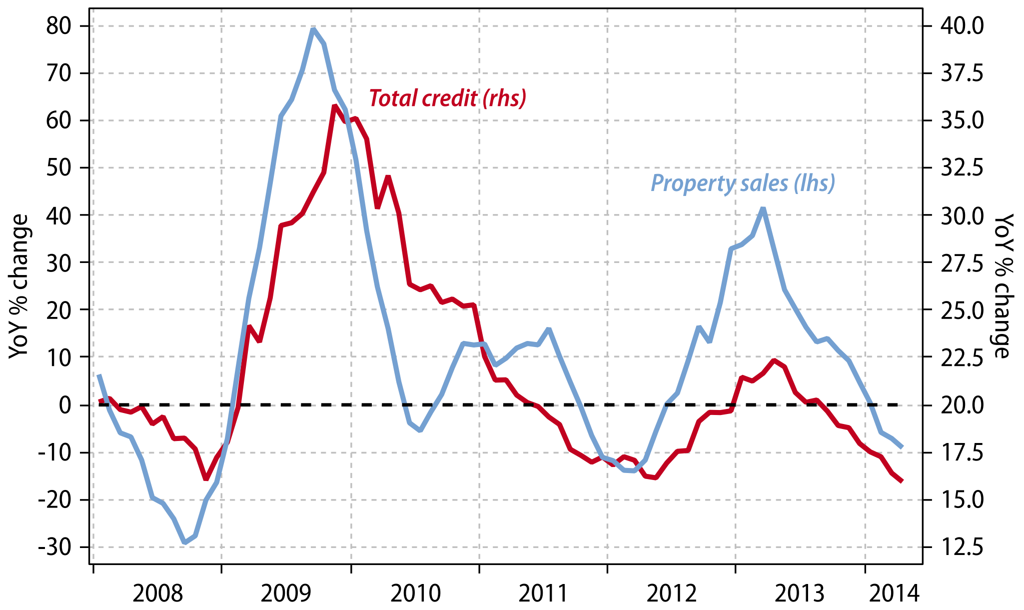
The slowdown in some parts of China—particularly inland provinces dependent on heavy industry and government infrastructure projects—is even more severe.

Hebei, the province surrounding Beijing that is home to much of the steel industry, saw GDP growth collapse to 4.2% in 1Q14 from 8.2% in 4Q13. Shanxi, China's primary coal producer, similarly saw its GDP growth fall to 5.5%. **Importantly, the inland provinces do not benefit much from a RMB devaluation.**

Economic cooling is led by a weaker property market

Housing sales and credit growth have cooled in tandem

Total credit and property sales volume, 5mcma



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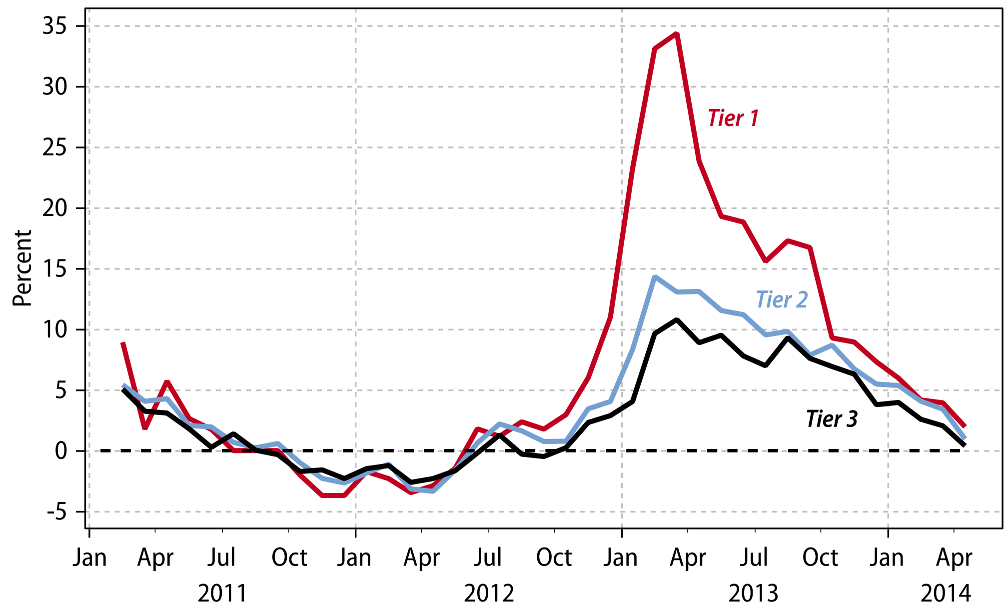
Housing price growth has slowed across all Chinese cities

Average annualized MoM change in 70 cities' price index for new housing, by city tier



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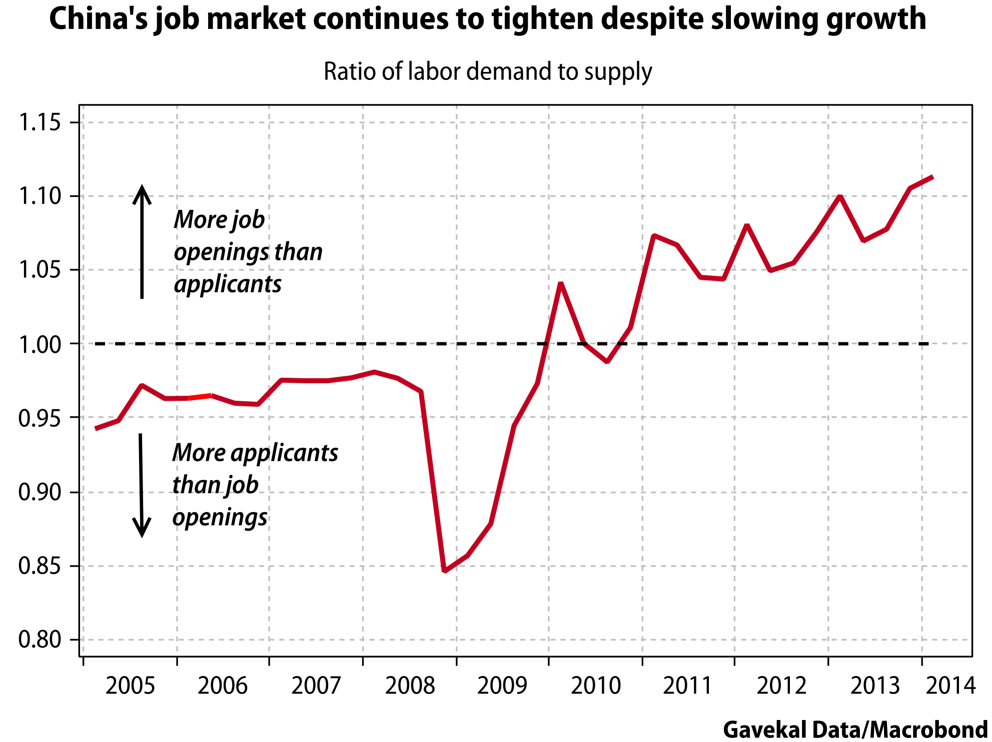
Property sales started slowing in 2013 after a surge early in the year, caused by front-loaded purchases on fears of a tax change. The slowdown continued later in the year as credit growth slowed, but sales have actually been weakest in larger cities—against the consensus view that small cities are more vulnerable because of larger supply.

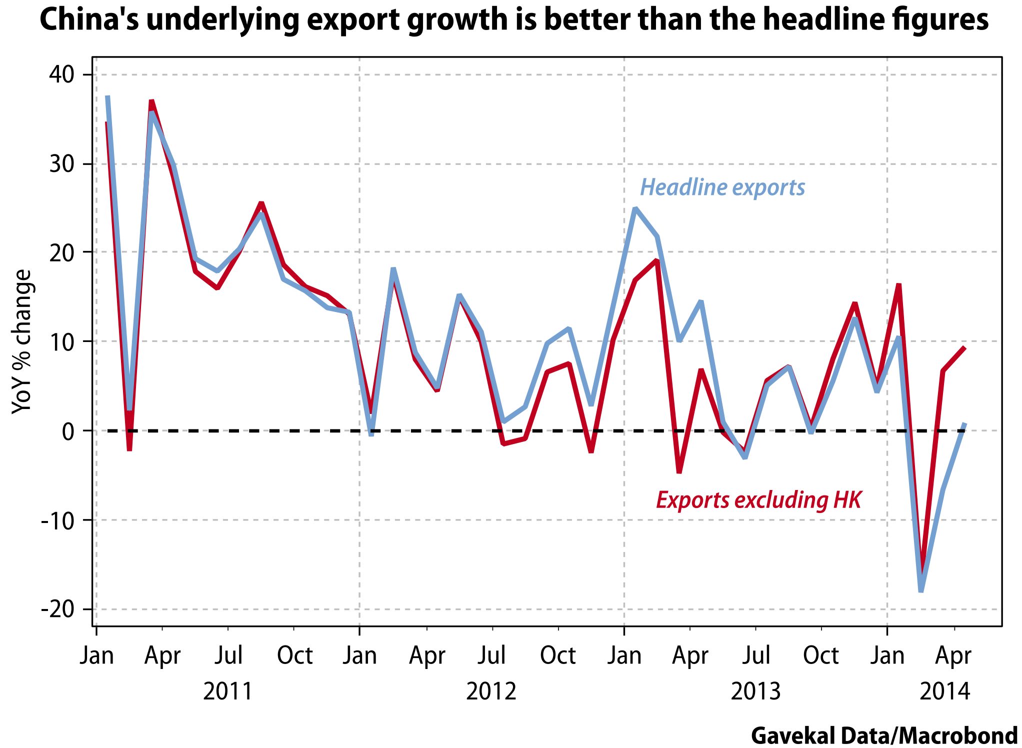
Sales growth slowed more sharply in March and April 2014 as price cuts sapped sentiment and led buyers to wait for a better opportunity.

As sales declined, property prices also cooled off. The price adjustment was much faster in the large Tier 1 cities (Beijing, Shanghai, Guangzhou, Shenzhen), as these cities saw the biggest price hikes in 2013 and affordability is much worse than in smaller cities.

Price cuts accelerated in early 2014 as the sales decline and tight credit led to cash flow problems for developers, and with sales momentum now weakening price indexes look to be heading into negative territory soon.

China doesn't need a devaluation: labor market is tight & exports are fine





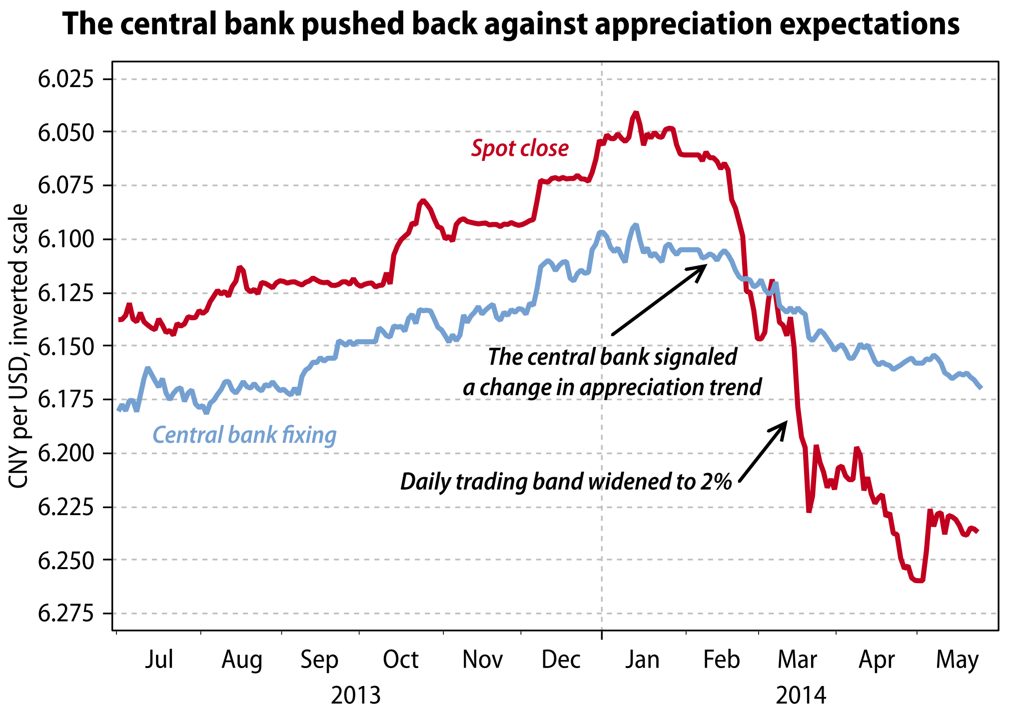
Despite slower GDP growth, the labor market is holding up well and wages continue to rise quite rapidly. This reflects structural constraints on the supply of labor from changing demographics and the slowing of rural migration.

As a result, even if China misses the GDP growth target, the urban jobs creation target of 10 mn is almost certain to be met (13 mn new jobs were created in 2013). While wage growth may slow as the economy cools, consumption momentum seems solid.

Headline export growth slowed down quite dramatically in Q1, but much of this is a statistical artifact due to overstated exports to Hong Kong in 2013.

After excluding exports to Hong Kong, export growth looks better. The headline number will start to look improve more after May as the over-invoicing effect diminishes and US growth continues to strengthen.

Still, it is the end of the road for the one-way RMB bet



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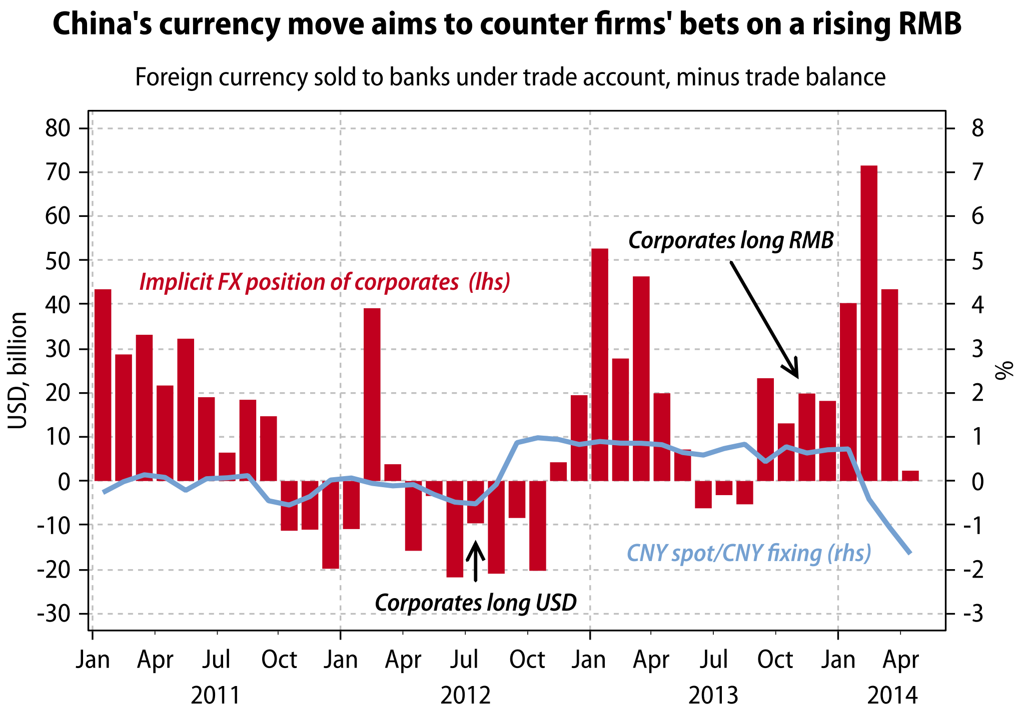

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The consistent appreciation of the RMB over the last few years entrenched expectations of its future rise. As a result, even though the current account surplus narrowed, capital inflows continued, pushing up FX reserves by more than $400 bn in 2013.

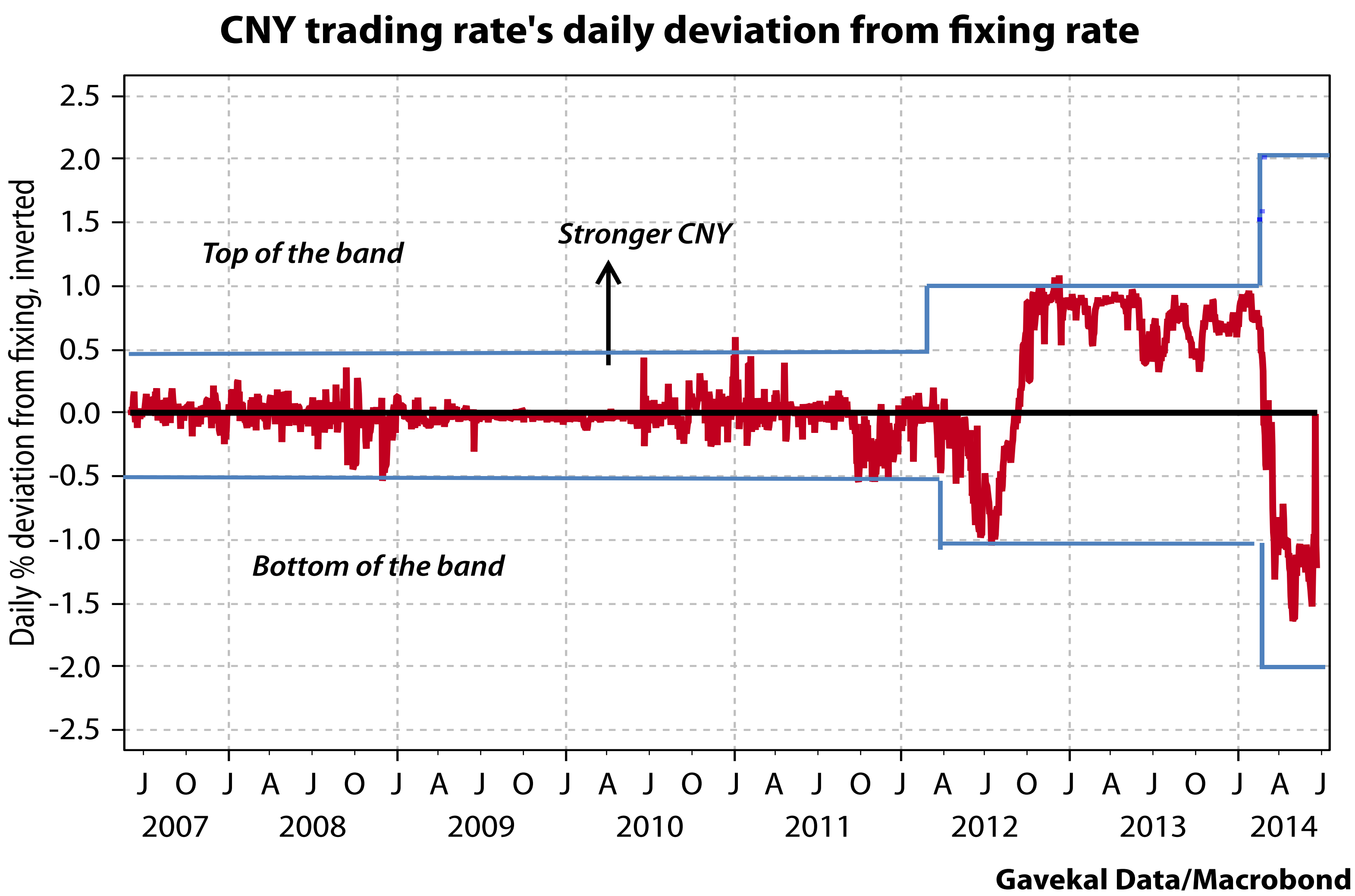
The central bank was increasingly uncomfortable with this pattern, and in February and March signaled a change in its stance through movements in the daily fixing and intervention in the spot market. It also widened the daily trading band as a signal of more market volatility to come.

While capital controls limit short-term portfolio investment in and out of China, significant capital flows occur through exporters' and importers' currency positioning. As of April, the central bank's moves appear to have caused companies to significantly scale back their implicit bets on a rising RMB, reducing capital flows from this channel.

This suggests that the central bank won't need to further devalue the currency to achieve its goals, but it also will not return to the steady appreciation of the past.

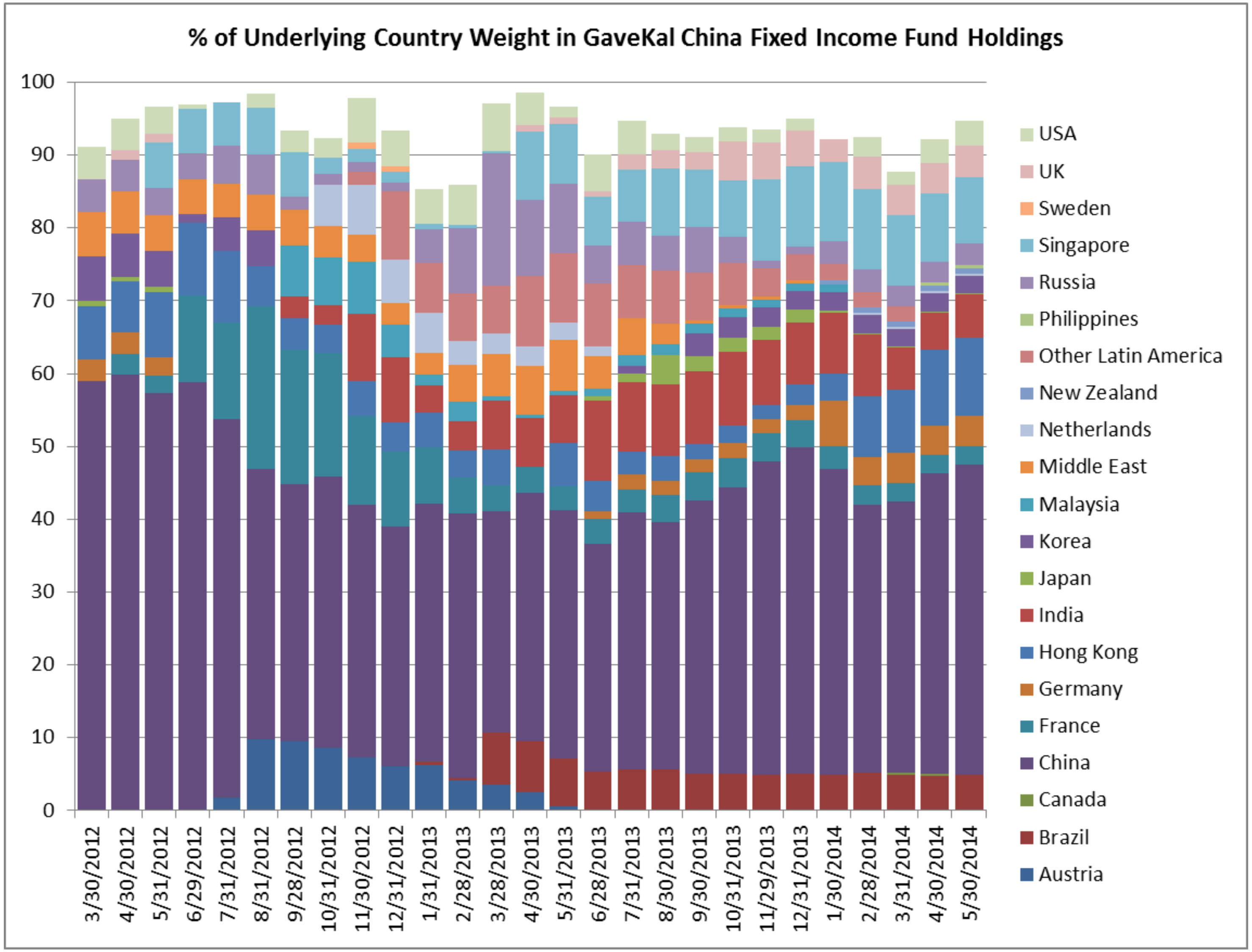
The end of the beginning

We now live in a world with greater RMB volatility – but the long term trend remains higher. So large dips are to be bought…



A market in rapid evolution

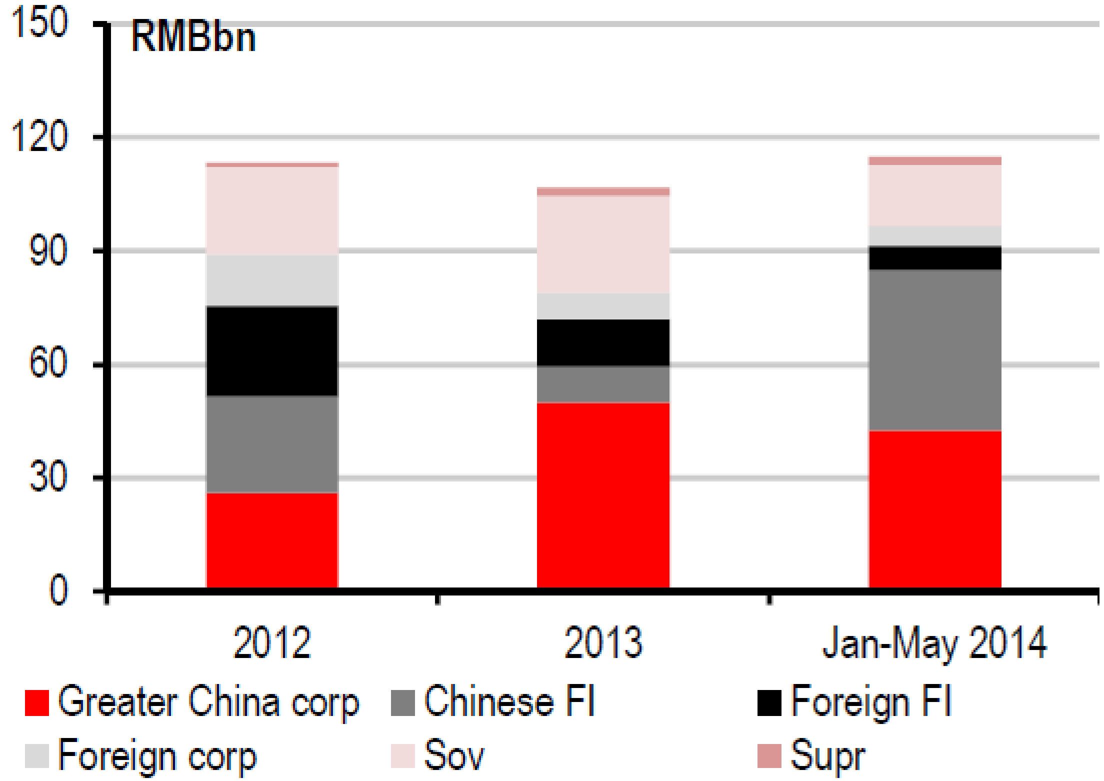
Increasing emerging market issuance is changing the market



Source: GaveKal

Growing corporate issuance

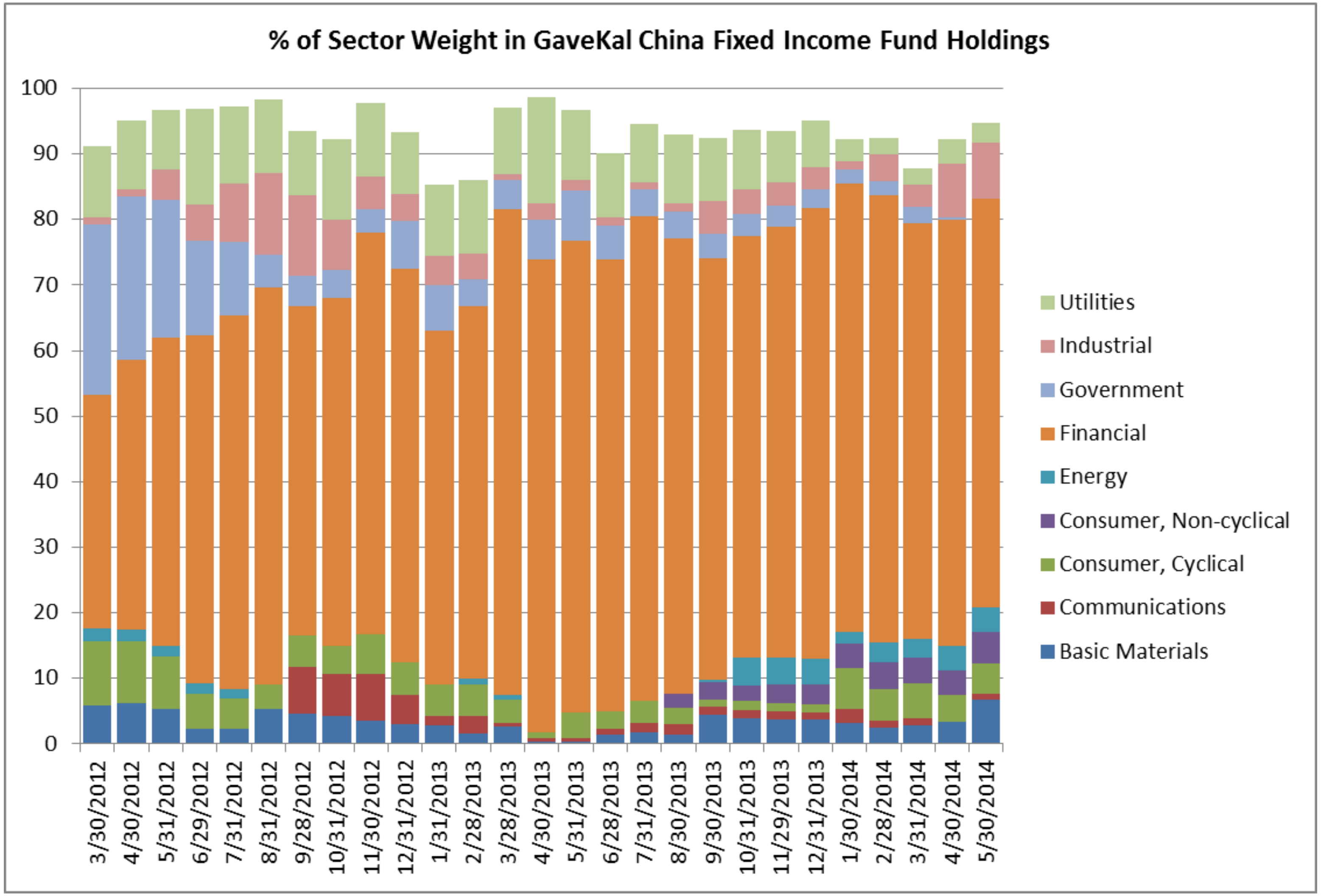
Primary issuance since 2012 (excluding bank CDs)



Source: HSBC

Source: GaveKal

Issuance remains skewed towards financials



Source: GaveKal

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