INVESTMENT ACADEMY
BNPP IP CAMPUS

BNP PARIBAS
INVESTMENT PARTNERS | The asset manager for a changing world

For professional investors only and not for retail distribution

The 5 burning questions on China in 2016

Caroline Yu Maurer, Head of Greater China Equities Investment

20 January 2016

The 5 burning questions on China in 2016

1. At what stage is China in its economic 'rebalancing'?
2. What key policies are expected to drive the economy and markets in 2016?
3. Where can growth areas be found and how should investors position?
4. Where does the RMB go from here and are capital outflows a real concern?
5. What are the key risks which China faces in 2016?

Question 1:

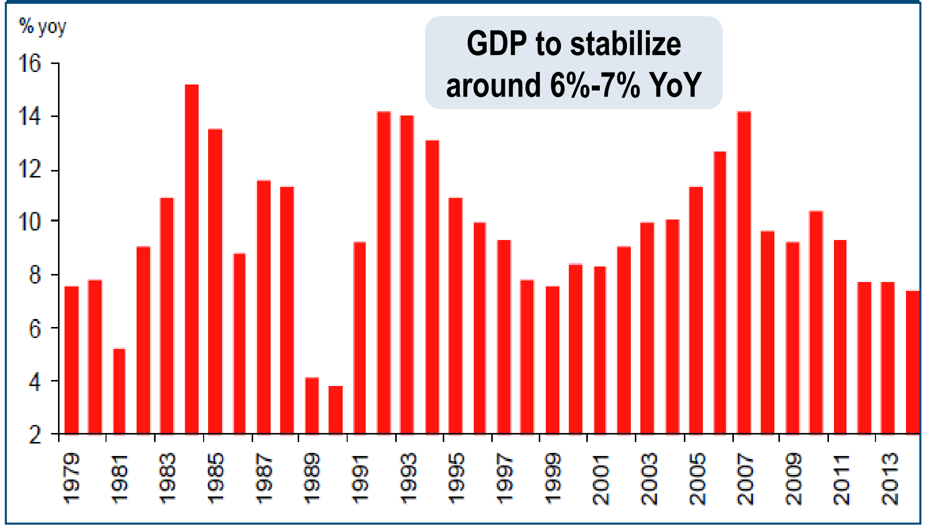
At what stage is China in its economic ‘rebalancing’?

BNP PARIBAS INVESTMENT PARTNERS | The asset manager for a changing world

China's structural rebalancing is progressing

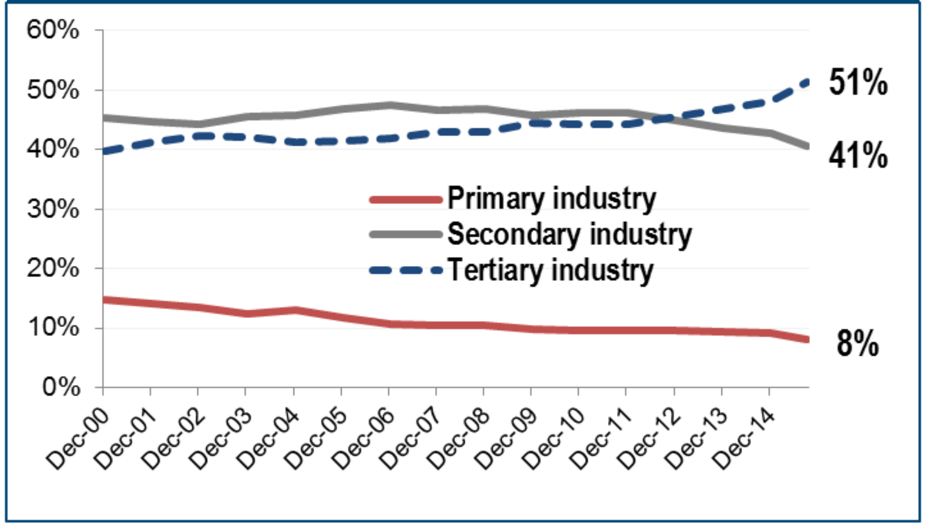
GDP deceleration expected to moderate during this transition period

China: Real GDP Growth (YoY %)



Source: CEIC, Macquarie research, August 2015

China: Nominal GDP Share by Industry



Source: Wind, Goldman Sachs research, December 2015

- GDP is expected to stabilize around the +6% to +7% level as the country undergoes rebalancing
- Beijing outlined a target minimum GDP growth rate of 6.5% from 2016-2020

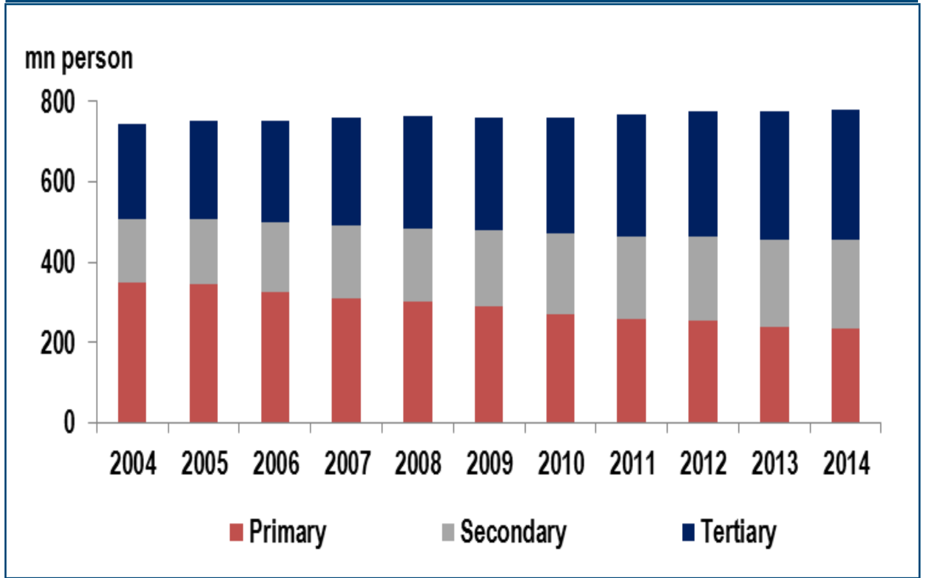
- Growth slowdown is a result of economic structural change
- Growth in the tertiary sector (50%+) has overtaken the primary and secondary industries

BNP PARIBAS INVESTMENT PARTNERS | The asset manager for a changing world

Employment and per capita income growth remain healthy

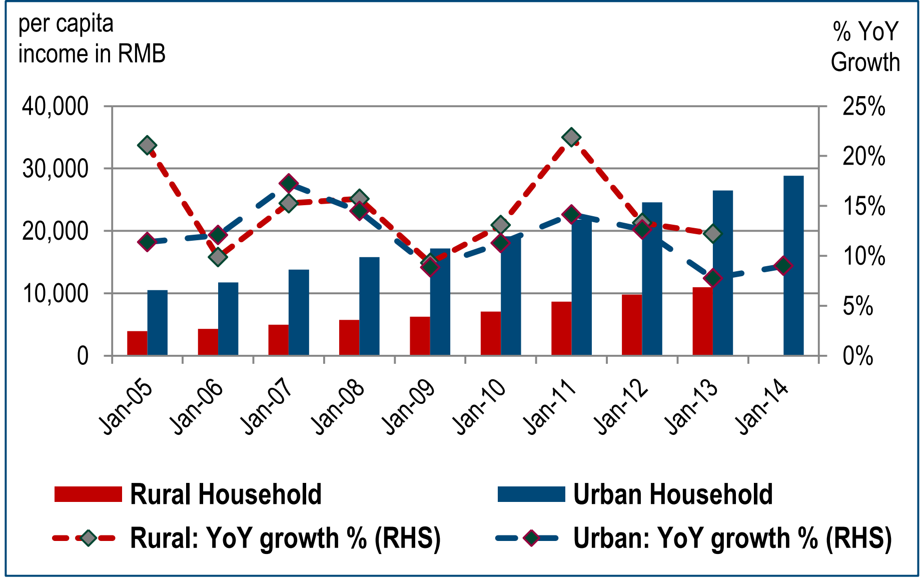
Shifting up the 'value-chain' secures future stable employment and wealth creation

China: Employment by Major Industry



Source: CEIC, HSBC research, 28 August 2015

China: China Per Capita Income Growth



Source: NBS, Goldman Sachs research, January 2016

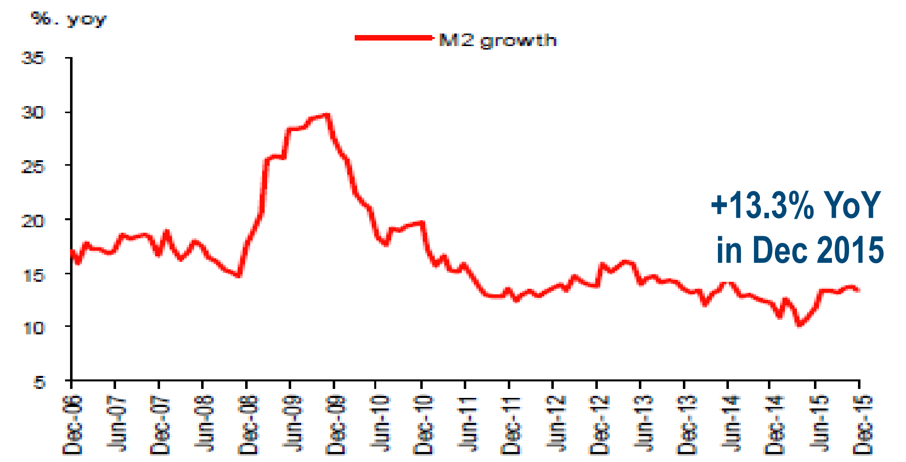
- Employment has held steady over the past decade despite slowing GDP growth
- Tertiary sector now employs more than 40% of workers in China
- Per capita income remains in expansion, with rural household income outpacing the urban cohort

BNP PARIBAS INVESTMENT PARTNERS | The asset manager for a changing world

Encouraging signs that the economy may be near bottoming

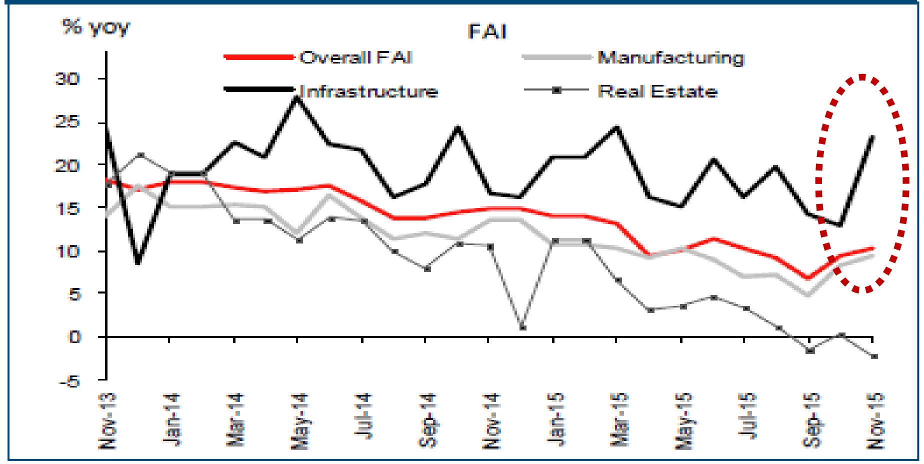
Pro-growth policy is helping consumption, investments, and the property sector

M2 Growth Rate is Picking Up



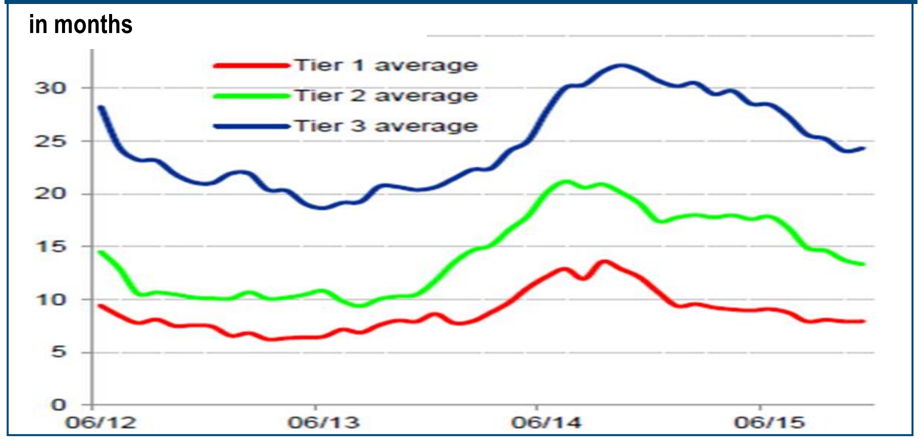
Source: CEIC, Macquarie research, January 2016

Fixed Asset Investment (FAI) Trending Up



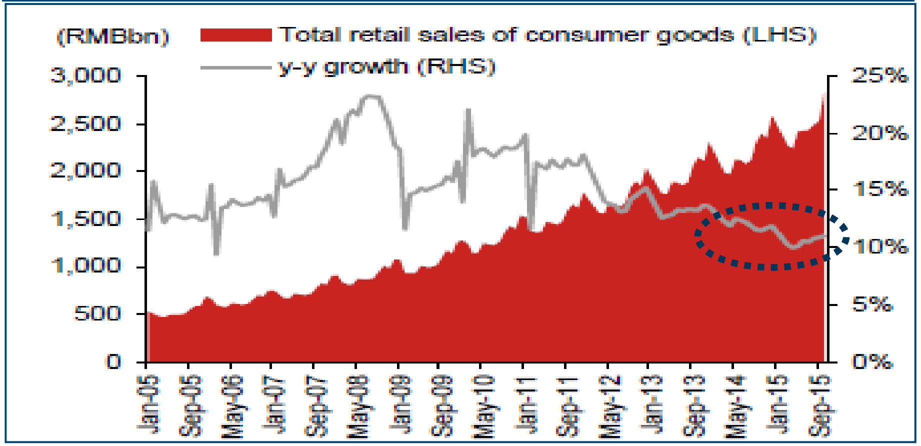
Source: CEIC, Macquarie research, November 2015

Property Inventory-to-Sales Level Improving



Source: CEIC, UBS research, 22 December 2015

Retail Sales Showing Signs of Stabilising



Source: NBS, Nomura research, January 2016

We believe a cyclical recovery is around the corner

Cyclical recovery driven by improved credit conditions and pro-growth policies

Expect a cyclical recovery driven by:

- Easing credit conditions from loosening monetary policy
- Increased pro-growth fiscal support
- Recovering property investment

We think the cycle is currently here

Uncertainties/complications in this cycle:

- Supply-side reform development
- RMB volatility

Policy bottom (Q4 2014)

Liquidity bottom (Q1 2015)

Credit bottom (Q2 2015)

Equity bottom (estimated 1Q16)

Economy bottom (estimated 2Q16)

Recovery (estimated H2 2016)

BNP PARIBAS INVESTMENT PARTNERS | The asset manager for a changing world

Question 2:

What key policies are expected to drive the economy and markets in 2016?

Recap: 2015 policy milestones

Focused on modernising the fiscal system and financial market deregulation

2015 reform highlights:

- Implemented local government debt-swap programme
- Implemented deposit insurance scheme
- Liberalised deposit interest rate
- Revamped the RMB fixing regime (removed the USD-peg)
- Extended the Free Trade Zones
- Opened up the domestic interbank market
- Opened up the onshore repo market to offshore RMB clearing banks
- Introduced mutual recognition of funds (MRF) programme
- Began preparation to expand Stock Connect (Shenzhen – Hong Kong link)

These reforms supported the IMF's decision to add the RMB in **the Special Drawing Rights basket (implement in October 2016)**
(one of five world currencies to hold a 'reserve currency' status)

Policy focus for next 5 years

Unlock new sources of growth >> stable employment >> political stability

Next 5 year strategy:

- Foster innovation and technology
- Upgrade the manufacturing base
- Promote domestic consumption
- Increase investment in public goods and services

Manufacturing-based >> Consumption-led

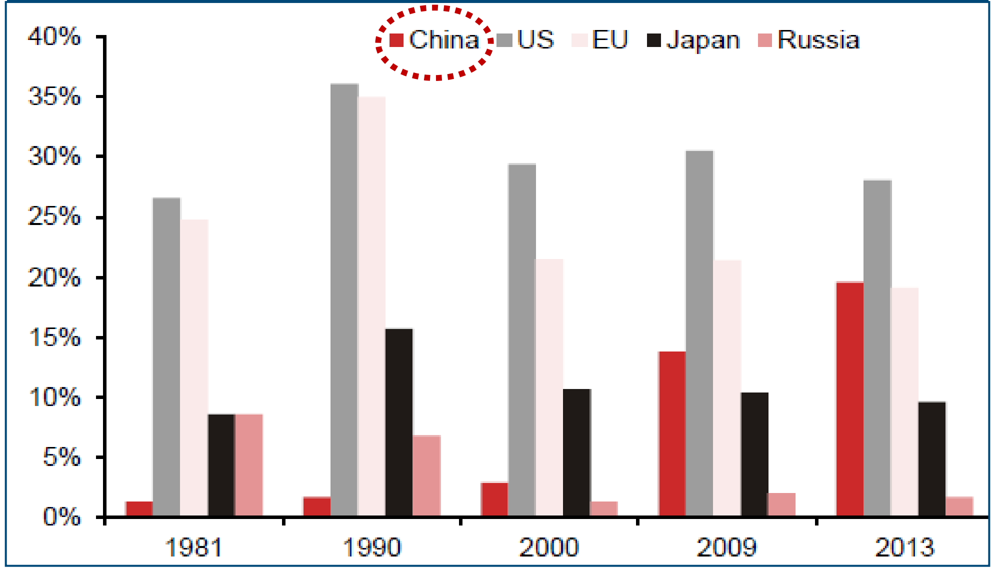
Externally reliant >> Internally reliant

BNP PARIBAS INVESTMENT PARTNERS | The asset manager for a changing world

Aiming to move up the value chain

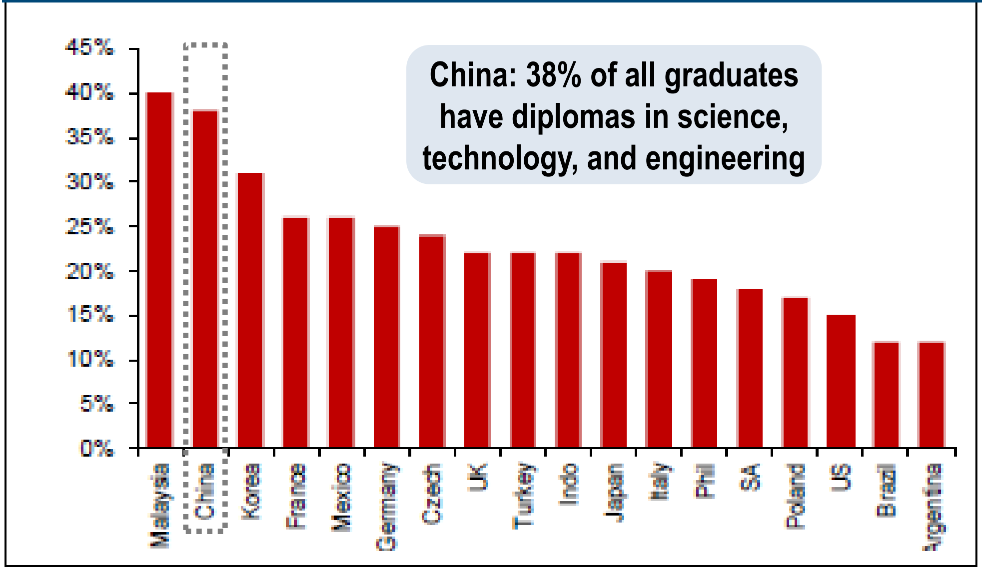
Accelerating investments in education and Research & Development spending

Changes in Share of Global R&D Spending



Source: Tsinghua University China Research Institute, UNESCO, Nomura research, January 2015

Graduates in science/tech/engineering (% of total)



Source: OECD, Macquarie research, 27 May 2015

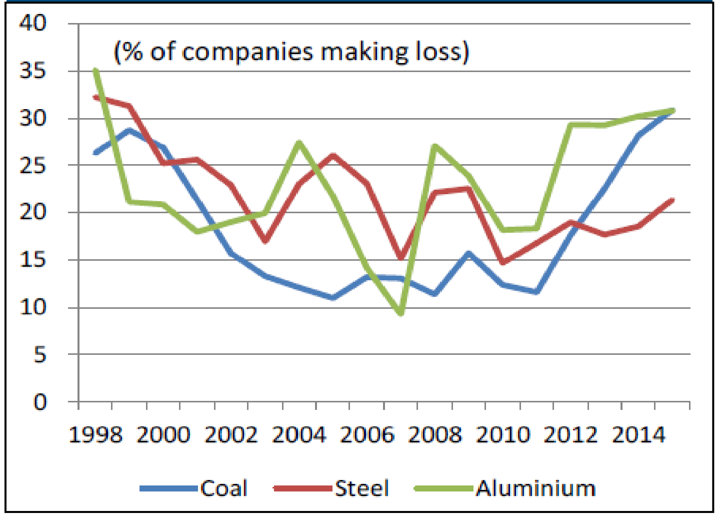
- China has accelerated Research & Development (R&D) spending
- 2013: **China's** R&D spending accounted for the second largest share (20%) of the **world's** total
- 2014: **China's** R&D spending totaled RMB1.3 trillion (+10% YoY growth and 2% of GDP)
- Around 38% (~2.4 million students per year) of university graduates hold degrees in science, technology, and engineering

BNP PARIBAS INVESTMENT PARTNERS | The asset manager for a changing world

Supply-side structural reform: a key focus in 2016

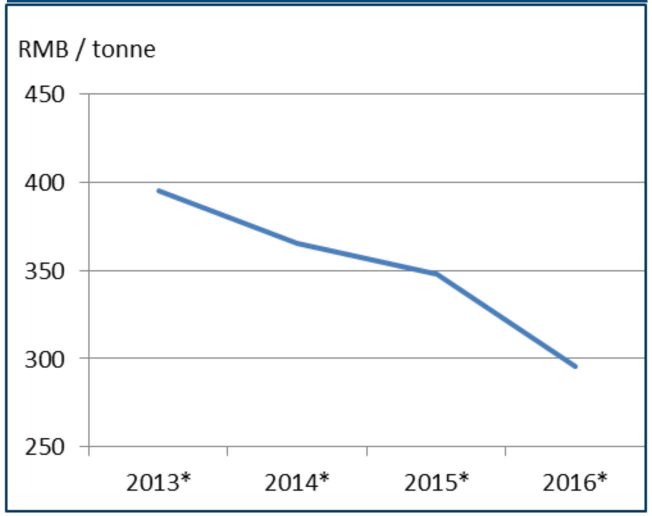
Taking energy-intensive 'zombie' companies in overcapacity industries off life-support

Loss-making companies on the rise



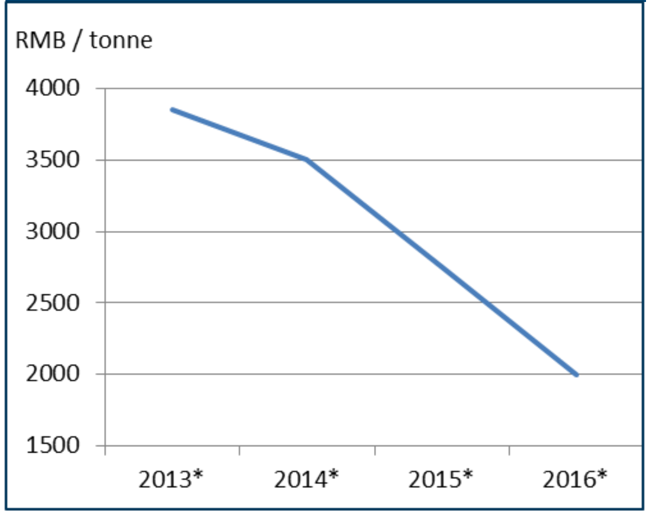
Source: CEIC, Credit Suisse research, December 2015

Cement price (RMB / tonne)



**Early-January prices. Source: WIND, Macquarie research, January 2016*

Steel price (RMB / tonne)



**Early-January prices. Source: WIND, Macquarie research, January 2016*

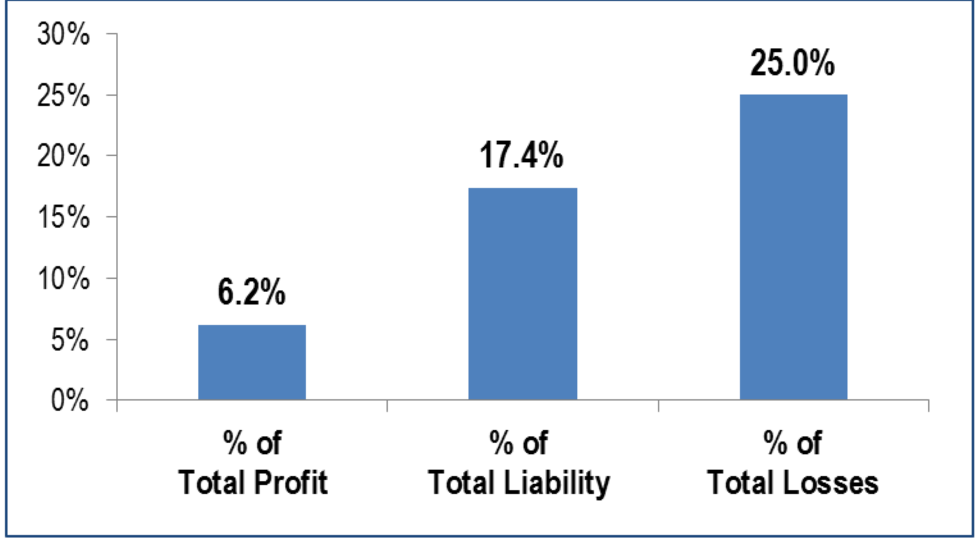
- Losses stemming from overcapacity industrial companies are rising
- Falling commodity and material prices coupled with weak domestic and global demand has put significant pressure on the industrials sector

BNP PARIBAS INVESTMENT PARTNERS | The asset manager for a changing world

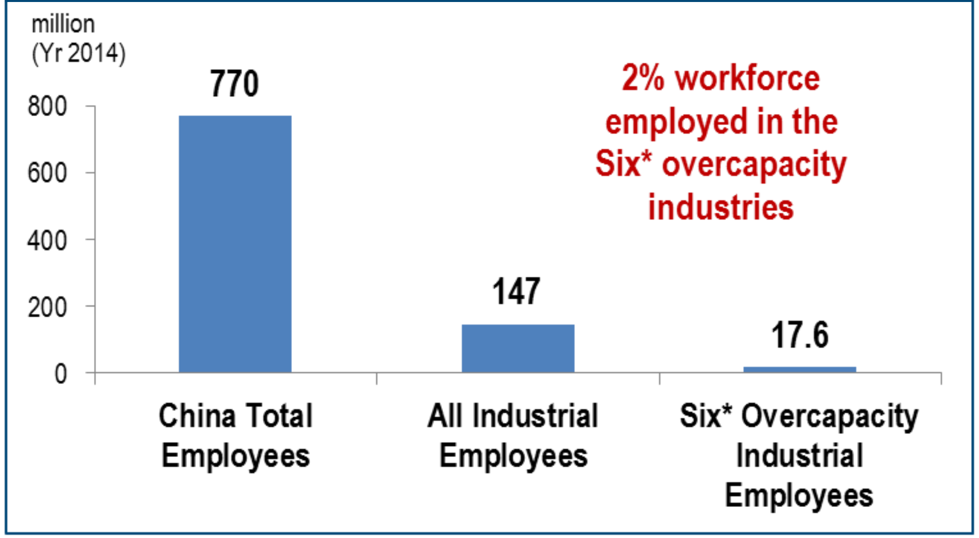
Supply-side structural reform: re-allocating resources

Consolidating overcapacity areas allows for redeployment of capital to growth areas

Six* Overcapacity Industries (as % of Total Industrial Sector)



Employment in Industrial Sector



- ► Overcapacity is mostly concentrated in six industries: steel, coal, aluminium, cement, shipbuilding, and flat glass
- ► Consolidating these areas will enable China to clean up the bad debt as well as the environment
- ► Restructuring the key six overcapacity areas should have limited impact to employment as these six industries account for only 2% of China's workforce

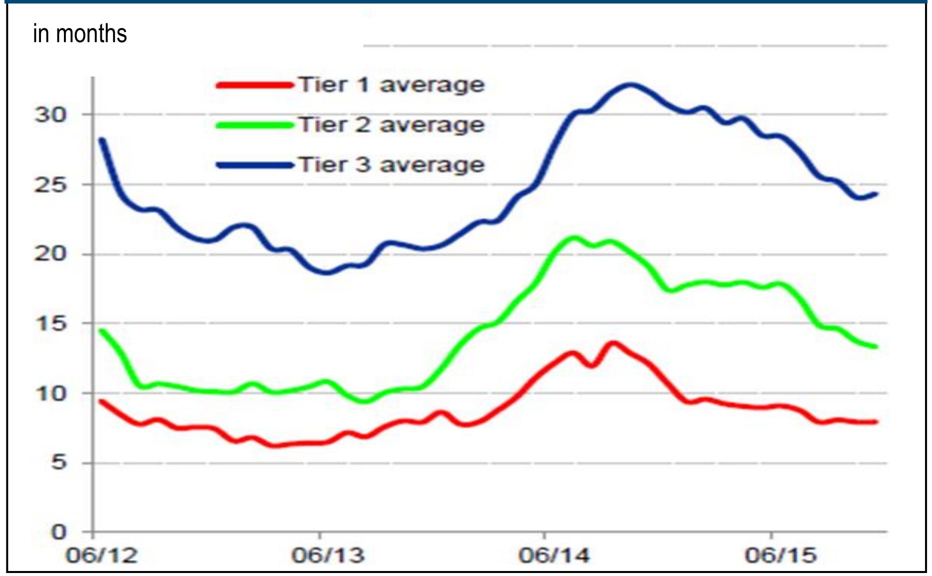
** Six overcapacity industries: steel, coal, aluminium, cement, shipbuilding, and flat glass.*
Source: CEIC, Credit Suisse research, December 2015

BNP PARIBAS INVESTMENT PARTNERS | The asset manager for a changing world

Demand-supportive policies: destocking property inventory

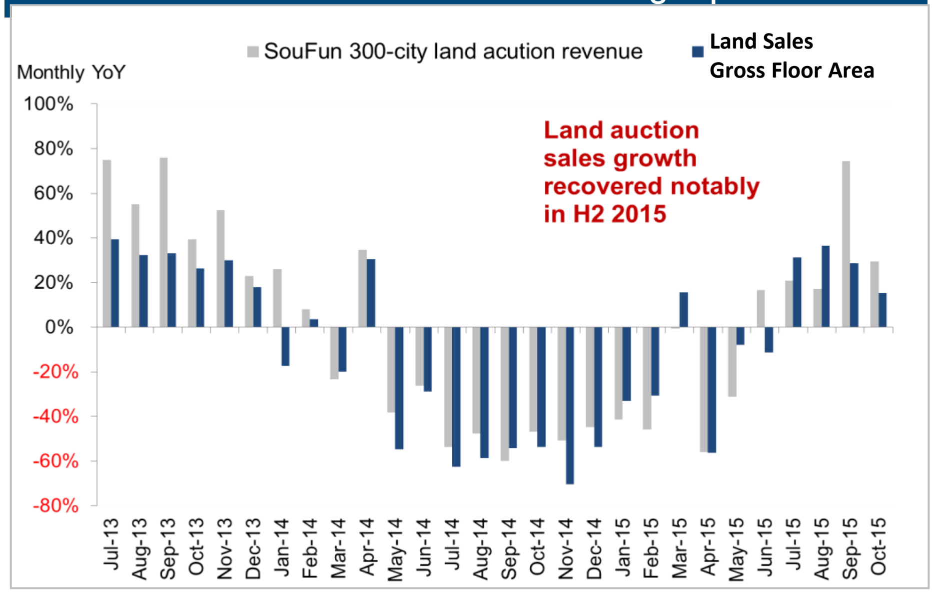
Increasing consensus within the government to further support the property sector

China: Property Inventory-to-Sales Level



Source: CEIC, UBS research, 22 December 2015

China: Land Sales Picking Up



Source: Wind, Deutsche Bank research, November 2015

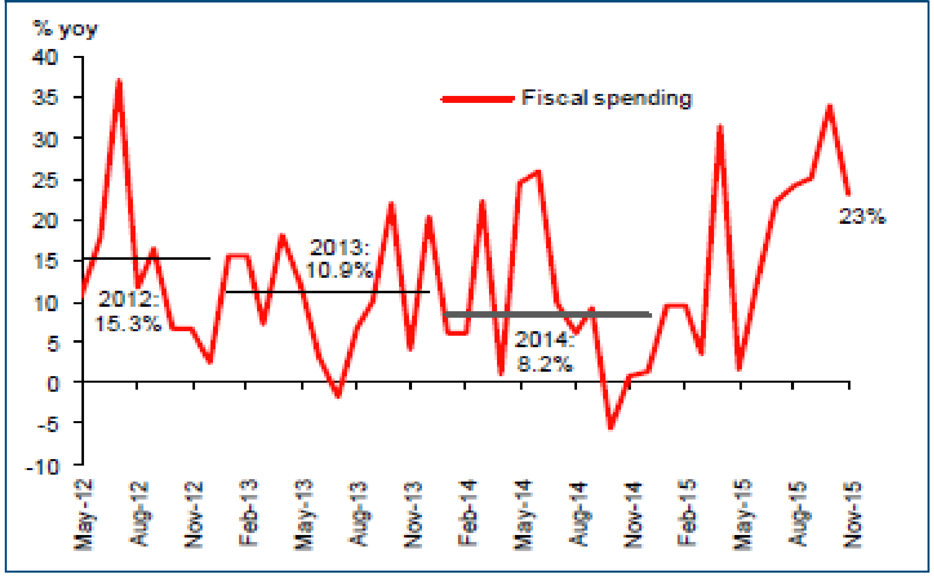
- Early signs of stabilisation in the property sector with sales volume, property prices, and land sales improving. This is helping with the inventory clearing
- Expected policies in 2016: 1) Hukou reform to encourage urbanisation; 2) housing subsidies for migrant workers; 3) convert commodity home inventory to social housing; and 4) further relax home purchase restrictions

BNP PARIBAS INVESTMENT PARTNERS | The asset manager for a changing world

Demand-supportive policies: fiscal and monetary stimulus

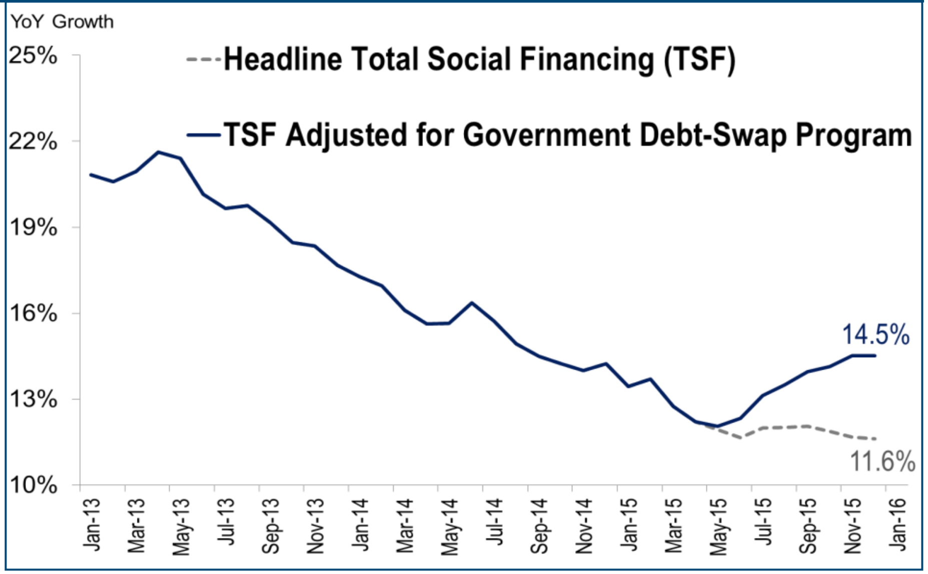
Pro-growth fiscal support and easing credit condition will help offset the slowdown

Fiscal Spending Ramped Up in 2015



Source: CEIC, Macquarie research, 18 January 2016

Total Social Financing (TSF)



Source: CEIC, Wind, Deutsche Bank research, December 2015

- An expansionary fiscal stance will likely be maintained in 2016
- Investments in domestic infrastructure projects (i.e. environmental-related, sewage, schools, and hospitals projects)
- Adjusted for the newly implemented local government debt-swap program, Total Social Financing (TSF) has been accelerating since May 2015

Demand-supportive policies: One belt one road (OBOR)

OBOR promotes the export of China's overcapacity **industries + raise political influence**

One Belt One Road (OBOR): Land and Sea Route

Source: HSBC research, July 2015

China's Contribution to OBOR

Financing Support

\+

Labour & Production Capacity

\+

Technology / Scale

What's in it for China?

Political influence
Export excess capacity

Question 3:

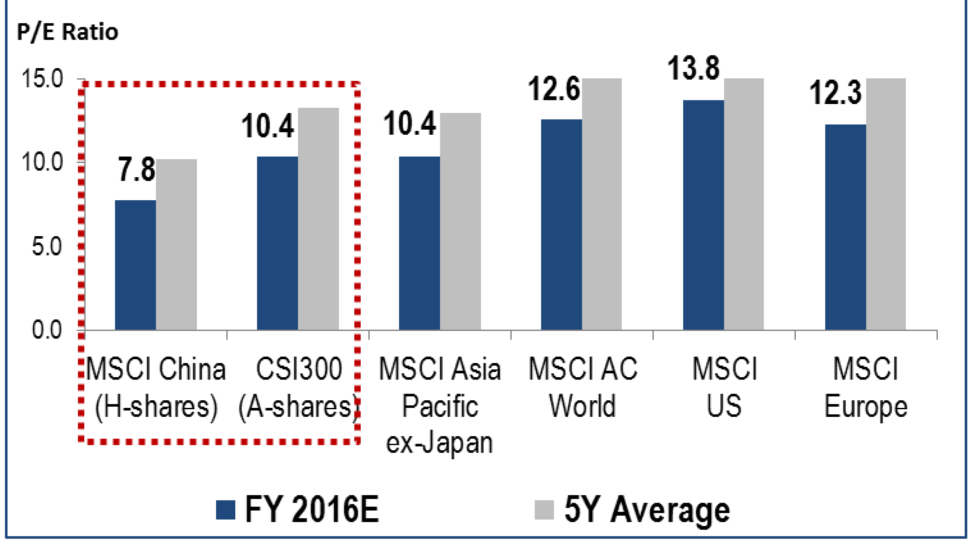
Where can growth areas be found and how should investors position?

BNP PARIBAS INVESTMENT PARTNERS | The asset manager for a changing world

H-share valuation is attractive vs key global indices

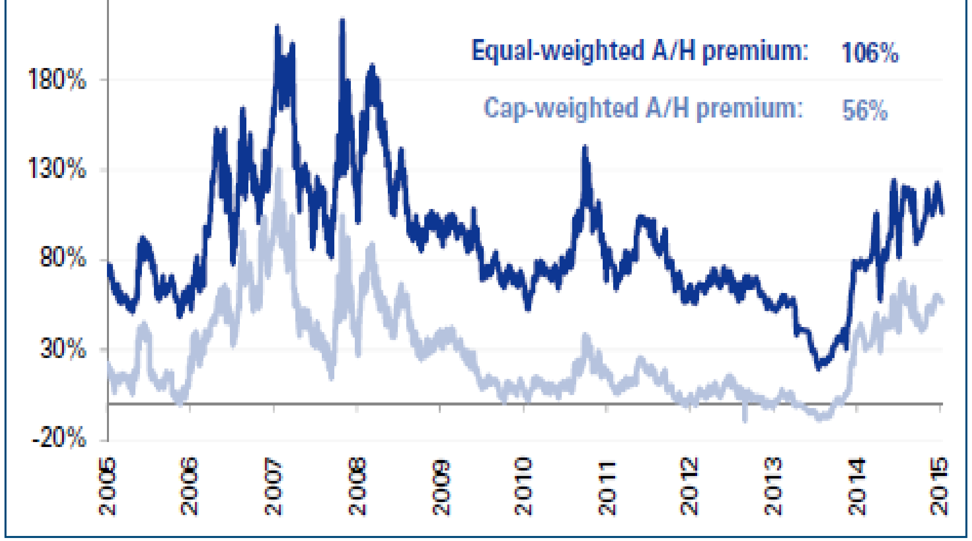
Value can now also be found in selected A-shares

Price/Earnings Ratio



Source: Bloomberg, BNPP IP, 18 January 2016

A/H-Share Premium/Discount



Source: Datastream, CICC research, 8 January 2015

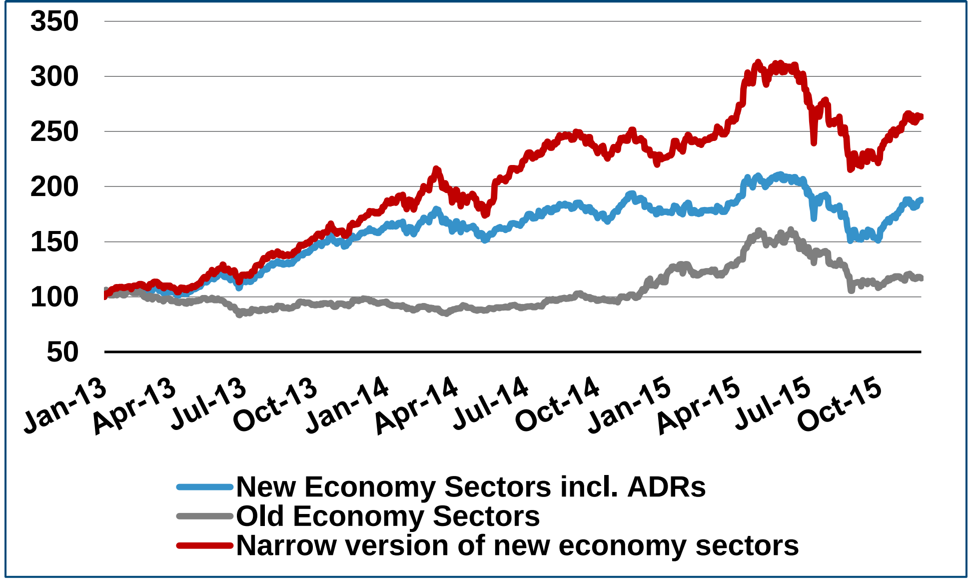
- ► Chinese equities are cheap on a historical basis and relative vs key global peers
- ► MSCI China index is valued at 7.8x P/E (consensus FY16 estimates), below its 5Y historic average; A-shares (CSI300 index) valuation is at 10.4x P/E

- ► The A/H-share valuation premium remains quite wide above 50% (cap-weighted)

'New Economy' is outperforming 'Old Economy' sectors

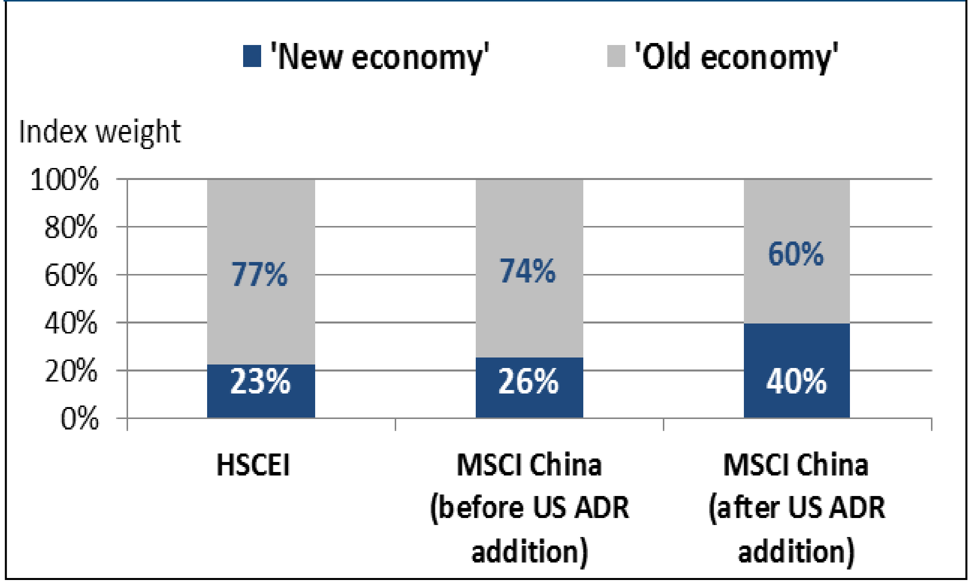
MSCI China index enhancement an improved proxy of China's future growth engine

Relative Performance of 'New' vs 'Old' Economy



Source: Bloomberg, UBS Securities, November 2015

MSCI China: Improved Proxy of 'New' Economy



Source: MSCI, Goldman Sachs research, November 2015

- **'New'** economy sectors include stocks with Technology and talent as their key growth drivers
- **'Narrow** version of new **economy'** sectors include technology, health care, alternative energy, and environmental equipment sectors

- Nov 2015: MSCI added 14 US-listed American Depository Receipts (ADRs) Chinese companies into the emerging market, regional, and country indices
- MSCI China index is an upgraded proxy of **China's** future growth engine (we suggest investors avoid passive funds linked to HSCEI index)

BNP PARIBAS INVESTMENT PARTNERS | The asset manager for a changing world

H1 2016 portfolio strategy

Focus on companies with sustainable earnings growth and positive cash flow

- ▶ Preferred sectors in H1 2016:
  - Selective consumer discretionary names (skewed towards automotive segment)
  - Selective financials (property and insurance)
  - Technology
  - Selective health care
  - Evaluating supply-side reform beneficiaries in deep-valued cyclicals/industrial areas (i.e. cement, steel)
- ▶ Least-preferred sectors in H1 2016:
  - Energy
  - Utilities
  - Banks
  - Selective consumer staples areas (underweight retailers and department stores)
  - Materials / mining

Question 4:

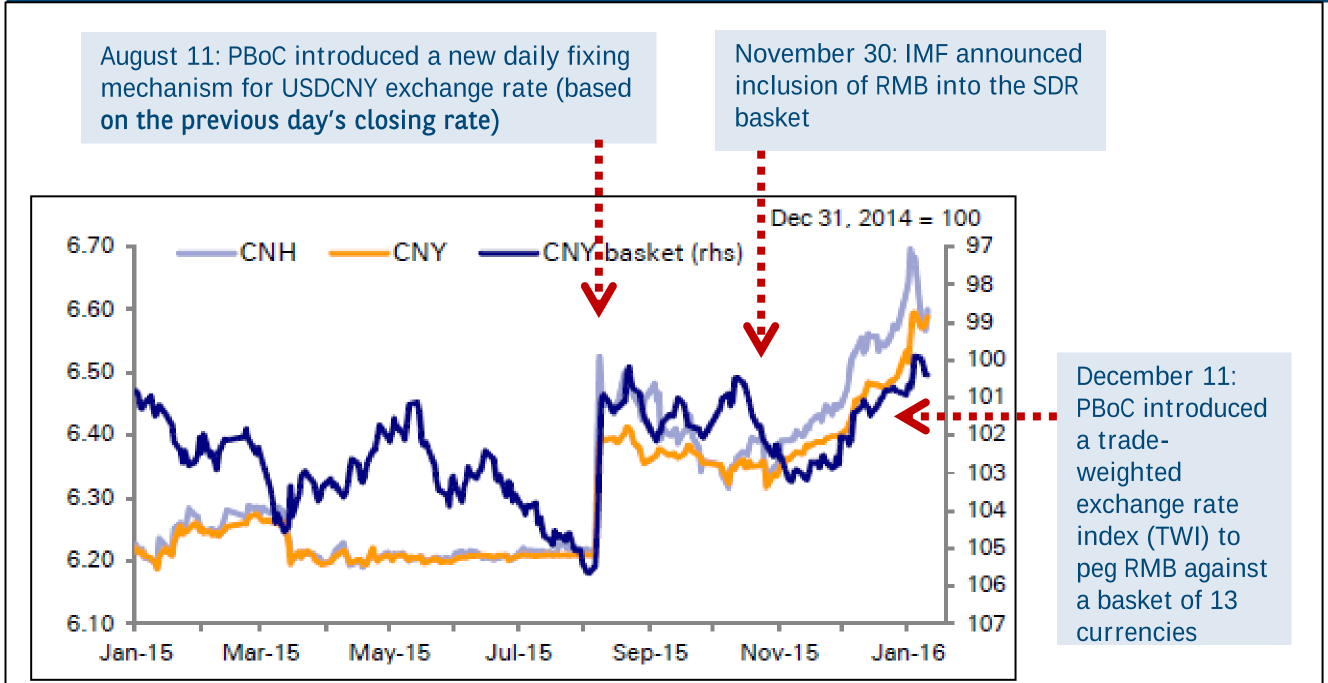
Where does the RMB go from here and are capital outflows a real concern?

BNP PARIBAS INVESTMENT PARTNERS | The asset manager for a changing world

A new RMB regime

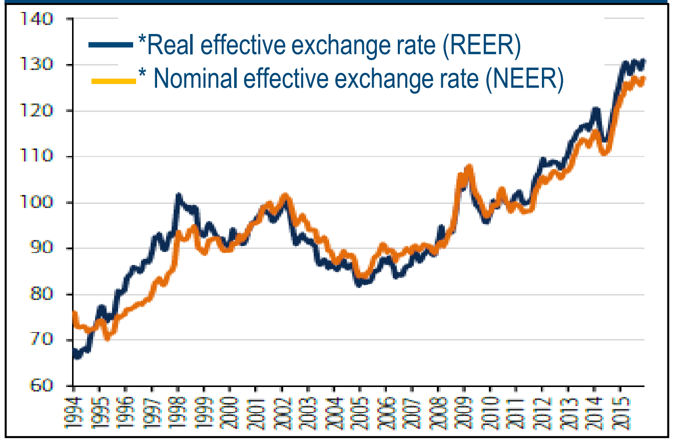
PBoC FX policy adjustment at the root of recent RMB volatility

China's Evolving RMB Policy



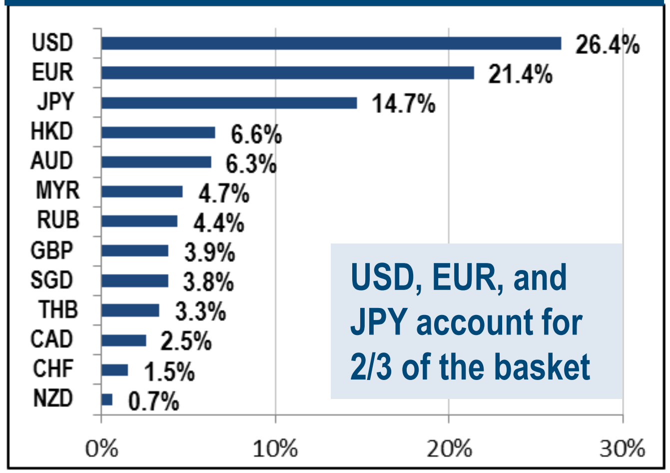
Source: Bloomberg, Deutsche Bannk research, 15 January 2016

RMB Appreciation (REER* & NEER*)



Source: CEIC, BofA Merrill Lynch research, January 2016

New RMB Trade-Weighted Index



Source: MSCI, Goldman Sachs research, November 2015

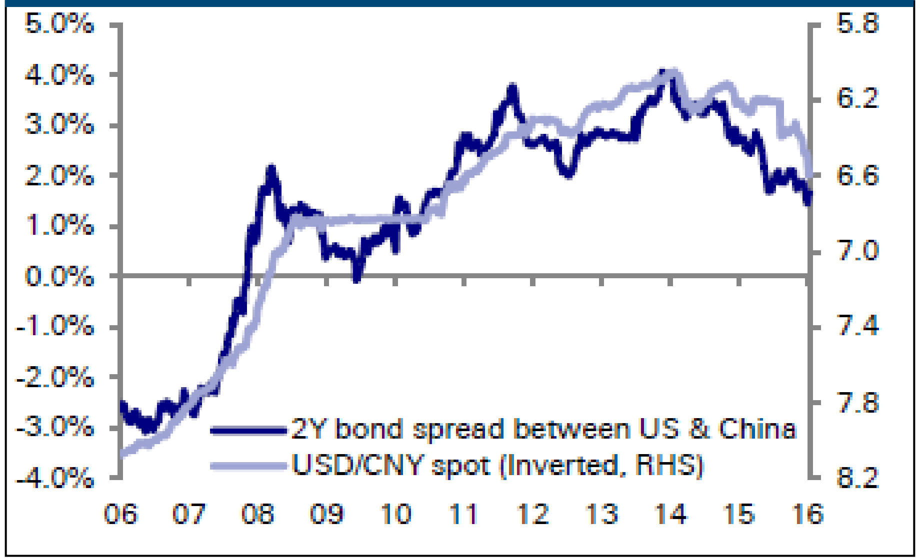
- PBoC maintains its intention to keep the trade-weighted RMB relatively stable
- FX policy more tolerant of depreciation after the IMF's decision to include the RMB into the Special Drawing Rights basket
- Increased volatility is a consequence of RMB liberalisation. Risk of the RMB overshooting to the downside has risen

BNP PARIBAS INVESTMENT PARTNERS | The asset manager for a changing world

What has been the extent of capital outflows?

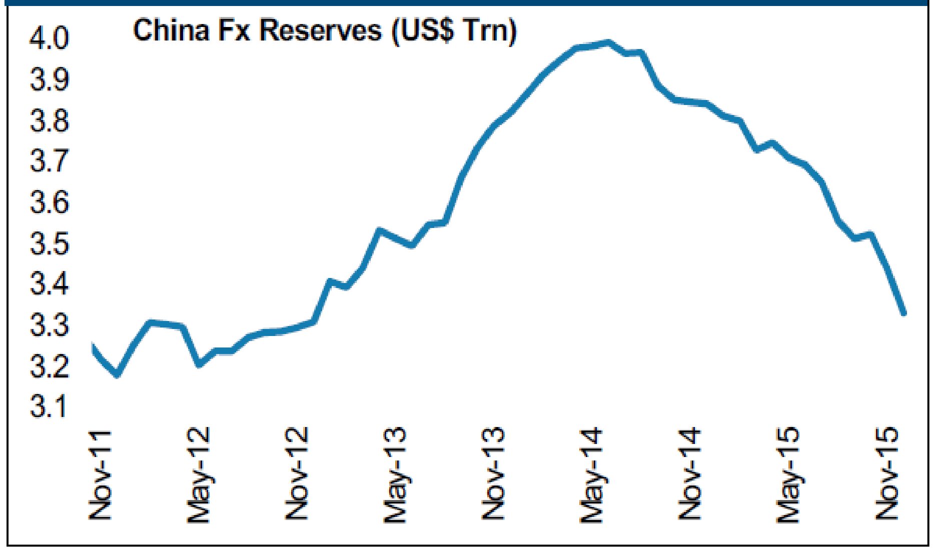
Capital outflows reflect economic weakness and uncertainty on RMB policy

Interest Rate and the RMB



Source: Bloomberg, Deutsche Bank research, January 2016

China FX Reserves (USD trillion)



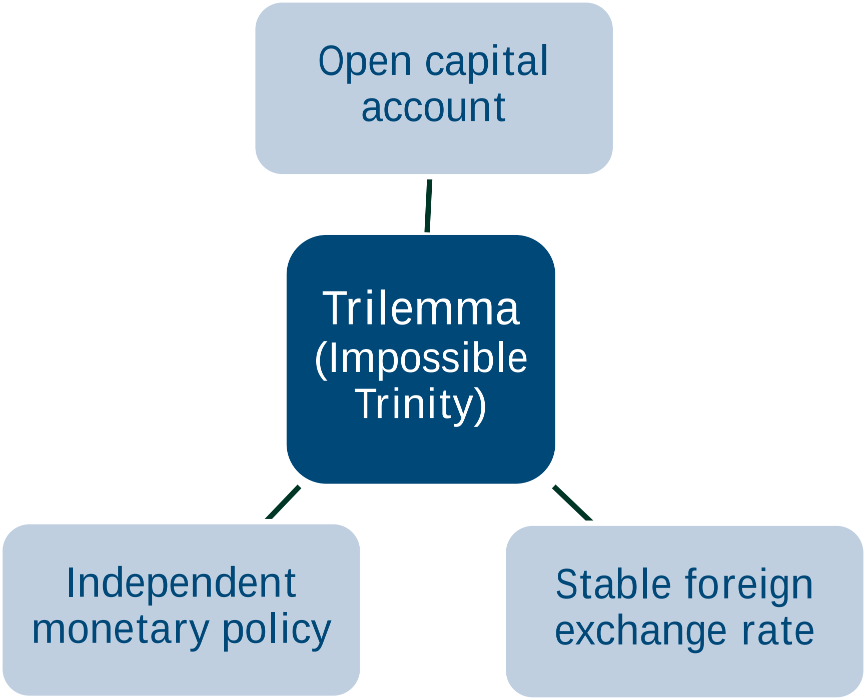
Source: Bloomberg, Morgan Stanley research, January 2016

- **China's** external debt accounts for only ~16% of GDP and 50%+ of gross FX reserves
- Outflows in recent months have been a result of the unwinding of the carry trade (differential rates vs US) and Chinese corporates paying down USD debt
- As of December 2015, the PBoC holds USD3.3 trillion in FX reserves, still well-above international FX reserve coverage standards

BNP PARIBAS INVESTMENT PARTNERS | The asset manager for a changing world

Is the impossible trinity (trilemma) possible for China?

Int'l finance **theory** says it's impossible **for any country to control all three factors**



Potential options to mitigate outflows:

- **Option 1:** Tighten capital controls
  - Impose stricter requirements to control market speculation on the RMB
  - Limit foreign direct investment outflows
  - Temporary tightening of quota on residents' FX purchases
- **Option 2:** Contain RMB depreciation
- **Option 3:** Maintain / raise interest rates

Over the medium term, the RMB direction will be more closely linked to the trade-weighted basket of currencies and China's overall economic **health**

Key data points to monitor

We expect the RMB movement will strongly influence market direction in 2016

- CNY-CNH spread
- Daily USD-CNY fixing and closing rate
- Monthly FX reserves / capital outflow data
- US interest rate hike expectations
- Trend in RMB trade-weighted exchange rate index (Bloomberg ticker CNYRINDX Index)

Question 5:

What are the key risks which China faces in 2016?

BNP PARIBAS INVESTMENT PARTNERS | The asset manager for a changing world

Key risks

Policy misstep poses the biggest risk for China, in our view

- Domestic risks:
  - Sharp RMB depreciation could trigger significant capital flight. Which may prompt Beijing to slow down (or reverse) financial deregulation and capital account opening
  - Policy missteps in implementing supply-side reform and corporate deleveraging which may assert excessive pressure on the economy

- External risks:
  - US economic recovery reverses
  - Significant swings in the energy price

- Upside risks:
  - US and European economic recovery stronger than expected
  - Accelerated improvement in China's real estate market

Appendix

2016 Key events to watch

- 2016: Maiden year of the 13th Five Year Plan
- 2016: 'National team' (government) exit from July buying binge
- 2016: A-share major shareholder selling ban expiration
- H1 2016E: Shenzhen – Hong Kong Stock Connect launch
- March: NPC & CPPCC Government Annual Session
- May: MSCI's China A-share inclusion decision
- May: MSCI China ADR inclusion (2nd batch)
- October: Sixth Plenum Meeting
- October: Official inclusion of RMB into IMF's Special Drawing Rights basket
- November: US Presidential election

BNP PARIBAS INVESTMENT PARTNERS | The asset manager for a changing world

Biography

Caroline Yu Maurer

Head of Greater China Equities Investment

12 years experience

- Joined BNP Paribas Investment Partners in July 2015
- Based in Hong Kong

Responsible for Greater China Equities Investment

Caroline Yu Maurer was appointed Head of Greater China Equities for BNP Paribas Investment Partners in July 2015. She is responsible for BNPP IP's Greater China equities investment capabilities and leads the portfolio management team of a number of the All China strategies.

Prior to joining BNPP IP, Caroline worked at Henderson Global Investors, starting in their London office and relocating to Singapore in her last three years. She was the Lead Portfolio Manager for the Henderson Horizon China Fund, which was awarded the 2015 Lipper Fund Award for Best Fund over 3 Years for Equity Greater China. The fund consistently ranked in 1st quartile* by Morningstar in each of the three years from 2012 to 2014. While at Henderson, Caroline was also part of a three-person team managing the Henderson Asia Pacific Absolute Return Fund.

In addition to her expertise in investment management, Caroline brings valuable experience and insight from jobs as a Financial Analyst with General Motors China and a Business Analyst/Project Manager at Prosys Solutions and Elementis PLC in London.

Caroline was born and raised in China. She holds a Master of Business Administration (majoring in Finance) from the London Business School. She has a Master of Science in Business System Analysis and Design from the City University in London and double degrees in Investment Economics and Economic Law at Jiangxi University of Finance and Economics in China. Caroline is a Chartered Financial Analyst and a member of the United Kingdom Chartered Financial Analyst society.

Source: BNPP IP Asia, January 2016

BNP PARIBAS INVESTMENT PARTNERS | The asset manager for a changing world

Disclaimers

This material is issued and has been prepared by BNP Paribas Investment Partners Asia Limited*, a member of BNP Paribas Investment Partners (BNPP IP)**. The content has not been reviewed by the Hong Kong Securities and Futures Commission.

This material is produced for information purposes only and does not constitute:
- an offer to buy nor a solicitation to sell, nor shall it form the basis of or be relied upon in connection with any contract or commitment whatsoever; or
- any investment advice.

Opinions included in this material constitute the judgment of BNP Paribas Investment Partners Asia Limited at the time specified and may be subject to change without notice. BNP Paribas Investment Partners Asia Limited is not obliged to update or alter the information or opinions contained within this material. Investors should consult their own legal and tax advisors in respect of legal, accounting, domicile and tax advice prior to investing in the Financial Instrument(s) in order to make an independent determination of the suitability and consequences of an investment therein, if permitted. Please note that different types of investments, if contained within this material, involve varying degrees of risk and there can be no assurance that any specific investment may either be suitable, appropriate or profitable for a client or prospective client's investment portfolio.

Simulated Results
Hypothetical or simulated performance results have inherent limitations. Unlike an actual performance record, simulated results do not represent actual trading. These simulations may not have taken into consideration all factors which might affect performance, hence the results may have under or over-compensated for such factors. No representation is being made that any portfolio will provide returns similar to those shown. The simulation presented is based upon assumptions which may include, but are not limited to expenses, market direction, volatility, transactions costs etc. Certain of the assumptions have been made for modeling purposes and actual results may vary materially. Changes in the assumptions may have a material impact on the simulated returns presented.
The back test (simulated) results contained in this document are hypothetical results and do not reflect actual investments. The trades during the back test were not actually executed – they are only simulations. These back test simulations cannot reflect all of the complexities of actual investing and there are many material factors that could have affected actual results. The performance results do not reflect the deduction of investment management fees, mutual fund fees, or any other fees and expenses. Also not included in the results are the reinvestment of dividends and all other earnings. Information, data, calculations and analysis contained in the back testing model has been compiled from sources deemed reliable, however, BNP Paribas Investment Partners cannot guarantee as to its accuracy, completeness and validity and cannot be held liable for any errors or omissions.

Investments involve risks. Given the economic and market risks, there can be no assurance that the Financial Instrument(s) will achieve its/their investment objectives. Returns may be affected by, amongst other things, investment strategies or objectives of the Financial Instrument(s) and material market and economic conditions, including interest rates, market terms and general market conditions. The different strategies applied to the Financial Instrument(s) may have a significant effect on the results portrayed in this material. Past performance is not a guide to future performance and the value of the investments in Financial Instrument(s) may go down as well as up. Investors may not get back the amount they originally invested.

The performance data, as applicable, reflected in this material, do not take into account the commissions, costs incurred on the issue and redemption and taxes.

* BNP Paribas Investment Partners Asia Limited, 30/F Three Exchange Square, 8 Connaught Place, Central, Hong Kong.
** "BNP Paribas Investment Partners" is the global brand name of the BNP Paribas group's asset management services. The individual asset management entities within BNP Paribas Investment Partners if specified herein, are specified for information only and do not necessarily carry on business in your jurisdiction. For further information, please contact your locally licensed Investment Partner.