WONDERFUL CHINA:
UNDERSTANDING INVESTMENT OPPORTUNITIES IN CHINESE EQUITIES

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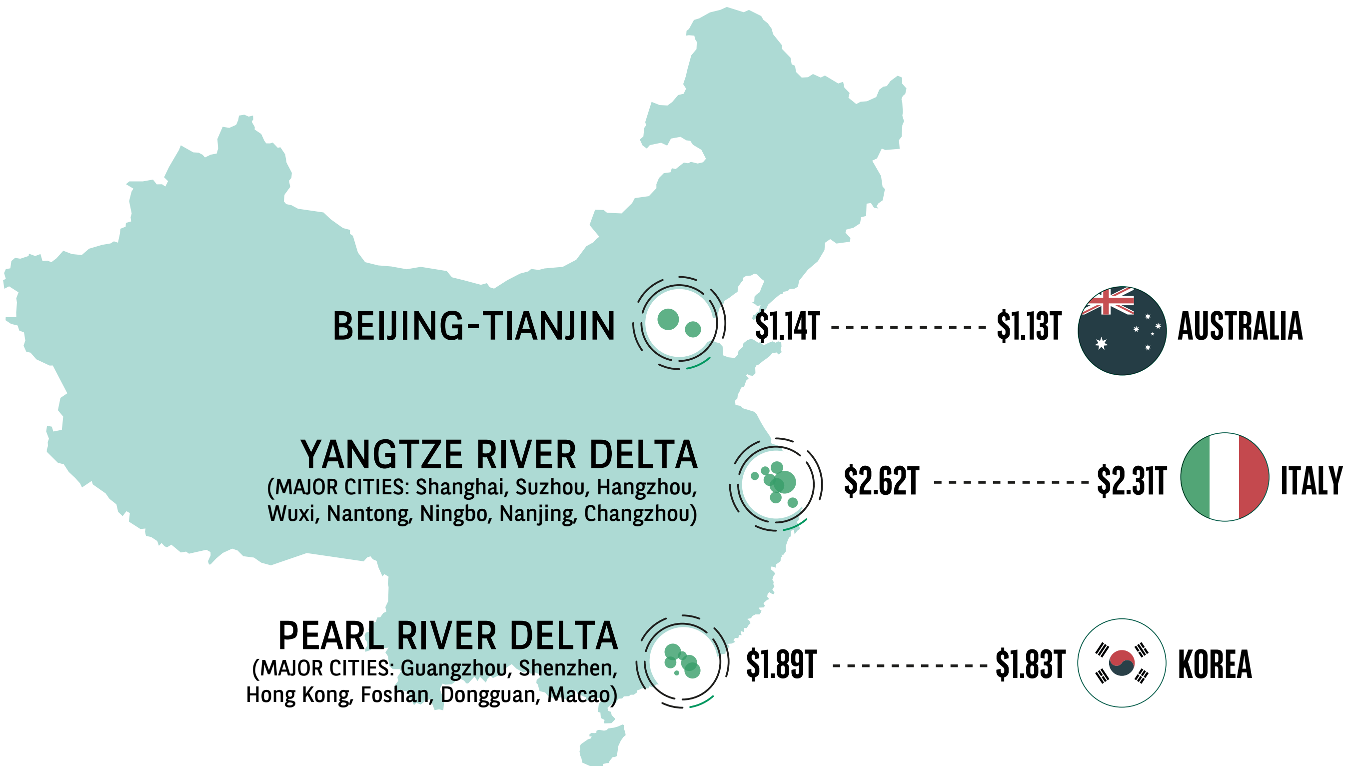
China's economic development is a unique success story. With 1.4 billion inhabitants and a Gross Domestic Product (GDP) growth of USD 12.8 trillion in 2017, China is today the world's second largest economy after the United States, and is increasingly playing an influential role in the global economy. This report looks at the key aspects of China's current and future growth, highlighting the sizable opportunities it offers to international investors.

DID YOU KNOW?

THE ECONOMIES OF CHINA'S MEGAREGIONS MATCH
THE SIZE OF SOME MAJOR NATIONAL ECONOMIES



Source: World Bank, Global Cities Initiative (Brookings + JP Morgan), Worldpopulationreview.com. Country Gross Domestic Product (GDP), Purchasing Power Parity (PPP) data from 2016, City GDP (PPP) data from 2015.

THE STRUCTURAL CASE FOR CHINA:

Towards more qualitative and sustainable growth

CHINA "NEW NORMAL" ECONOMY

After high-speed economic growth in the past three decades, the Chinese government has embraced slower economic growth, referring to it as the 'new normal', which not only aims at quantitative but also qualitative and sustainable growth.

China's GDP growth in 2017 was 6.9% (significantly higher than the government's initial target of 'around 6.5%' growth), led by continued strong public infrastructure investment, solid consumption growth and improving foreign demand. China's Q1 2018 GDP growth came in at 6.8% YoY. The annual growth target in the 13th Five-Year Plan (2016-2020) has been set at 6.5% (vs. 7.0% target in the 12th Five-Year Plan 2012-2017)).

The government's revised growth target reflects the **economic rebalancing and the increasing focus on the quality of growth, while still maintaining the objective of achieving a 'moderately prosperous society' by 2020**, though doubling GDP over the period from 2010 to 2020. The government aims at putting China's growth on a more sustainable path than before.

The government acknowledges the need for China to embrace a new growth model that relies less on fixed investment and exporting, and more on private consumption, services and innovation to drive economic growth. This implies as well structural reforms that China has to undergo to address challenges arising from the past high-speed growth. Building a balanced and efficient financial system is also key to support real economy. The new economy transformation centers on:

1. supply-side and mixed ownership reform,
2. investment to consumption growth model,
3. industrial upgrade "Made In China 2025",
4. new sectors (green, TMT, technology, healthcare),
5. "Chinese Inc. going global", Belt and Road Initiative (BRI).

Despite its transition to slower economic growth, China continues to be the largest contributor to world growth since the global financial crisis of 2008.

CHINA'S KEY FACTS:

2nd
LARGEST ECONOMY IN THE WORLD

6.9%
OF GDP GROWTH RATE IN 2017

1.38
BILLION INHABITANTS
(4x the US, 2x Europe population)

OVER 60% OF THE URBAN POPULATION WILL BECOME "MIDDLE-CLASS[1]"
by 2025.

N° 1
LARGEST E-COMMERCE MARKET
(online retail sales in mainland China exceed RMB 5.2 trillion in 2017[2]).

1. Middle Class is defined as urban households that earn US$9,000 - US$34,000 a year, according to the consulting firm McKinsey & Company.
2. National Bureau of Statistics of China

China is set to overtake the US economy by 2030 (Gross domestic product at market exchange rates)

2017	2018 estimates	2022 estimates	2032 estimates
UNITED STATES	UNITED STATES	UNITED STATES	CHINA
CHINA	CHINA	CHINA	UNITED STATES
JAPAN	JAPAN	JAPAN	INDIA
GERMANY	GERMANY	GERMANY	JAPAN
FRANCE	INDIA	INDIA	GERMANY
UNITED KINGDOM	FRANCE	UNITED KINGDOM	BRAZIL
INDIA	UNITED KINGDOM	FRANCE	UNITED KINGDOM
BRAZIL	BRAZIL	BRAZIL	SOUTH KOREA
ITALY	ITALY	ITALY	FRANCE
CANADA	CANADA	SOUTH KOREA	INDONESIA

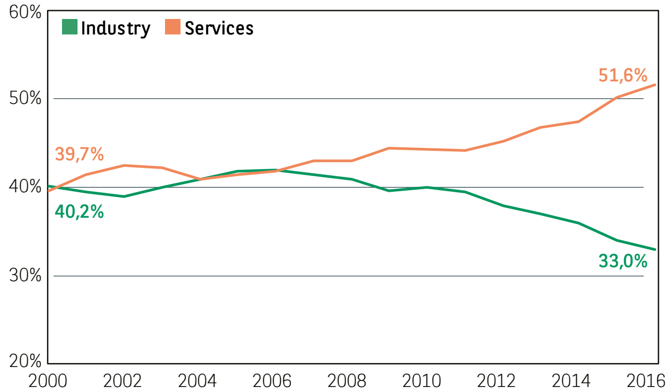
Source: Bloomberg, Centre for Economics and Business Research, as of 26 December 2017

CONSUMPTION: A CRUCIAL DRIVER OF CHINA'S ECONOMIC GROWTH

From a production perspective, the tertiary industry, accounting for 51.6% of total GDP (vs. 44% in 2011, as shown in the below chart), grew at an impressive rate of 8.0% YoY in 2017, suggesting that the new economic sectors were gaining traction. The contribution from the secondary sector also rose quarter on quarter but by less than the services sector. In 2017, the growth rate for the primary and secondary industry sectors posted 3.9% and 6.1%, respectively.

From an expenditure perspective, net exports dragged on GDP growth by 0.5 ppt in Q1 2018, continuing a trend of negative contribution to GDP growth since 2009. This underscores our argument that **China had switched from export-led to domestic-led growth since the Great Financial Crisis (GFC).** Within the domestic sector, total consumption contributed to more than three-quarters of GDP growth (vs. 45% in 2010), reflecting gradual expenditure-switching from investment-led growth.

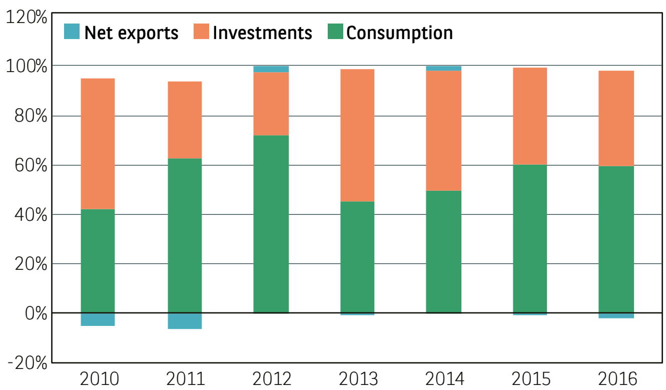
The services sector now represents more than half of China's GDP



Source: Wind, UBS, as of 16 January 2018.

Consumption leads China's economic growth

(China's GDP components by expenditure)



Source: Wind, UBS, as of 16 January 2018.

Slowing growth implies lower profits for enterprises and greater pressure to improve efficiency. **Against this backdrop, the rebalancing of the economy towards consumption is crucial.** Progress has been made, with growth slowing only gradually, helped by the fact that China's consumption is supported by stable income growth.

The growth of household disposable income continued to outpace GDP growth, boding well for consumption growth. This is largely because the wage share of GDP continues to go up, reversing the two-decade declining trend. Such a recovery is also in sharp contrast with the OECD countries where on average the wage share has been flat for several years.

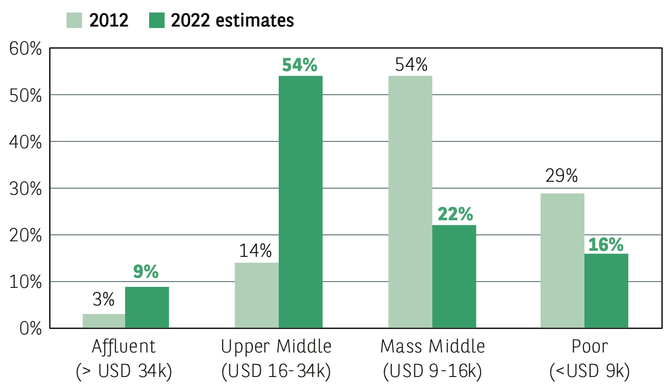
Overseas spending by China has increased in recent years as more people joined the ranks of the middle class.

> "TODAY, CHINA ACCOUNTS FOR OVER **20%** OF GLOBAL OUTBOUND TOURISM WHICH IS TWICE AS MUCH AS THAT OF THE US."

Economic rebalancing underpinned stable growth in 1Q 2018 (which only slowed from 6.9% in 2017). Nevertheless, growth momentum in the new economy is still not expected to fully offset the growth headwinds in the coming quarters due to trade frictions with the US, weak domestic private investment, cooling of the property market, intensifying deleveraging and structural reform efforts, including environmental restriction.

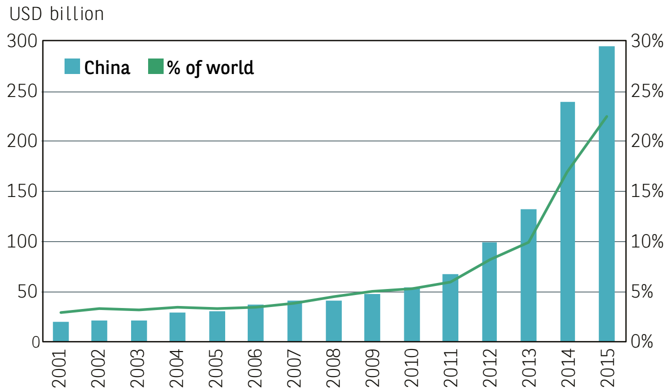
> "OWING TO THE RESILIENCE OF THE Q1 2018 GDP GROWTH, WE HAVE REVISED UP OUR GDP GROWTH FORECAST TO **6.5%** FOR **2018** FROM 6.2% PREVIOUSLY."

China's expanding middle class (2012 vs. 2022)



Note that data are annual income. Source: McKinsey Quarterly, 2013, BNPP AM, as of December 2017.

China now accounts for over 20% of global outbound tourism expenditure



Source: World Bank (based on World Tourism Organization, Yearbook of Tourism Statistics), HSBC, as of 10 January 2018.

CHINA'S BELT AND ROAD INITIATIVE (BRI)

70+ COUNTRIES ■ **4** CONTINENTS ■ **63%** OF WORLD'S POPULATION ■ **30%** OF GLOBAL GDP

BRI is a long-term project which will offer various investment opportunities for corporates. At the initial stage, the main focus is on infrastructure, logistics, energy, commodities, and environment. At a later stage, the focus will be on new industries and consumption markets such as technology, media, telecommunications, real estate, consumer goods brought by improved infrastructures.

Source: HSBC, Global Infrastructure Outlook, Asian Development Bank, BP Statistical Review, World Bank, as of February 2018

CHINA'S BELT AND ROAD INITIATIVE (BRI)

The Belt and Road Initiative (BRI) is an ambitious project conceived to promote economic co-operation among countries along the proposed Belt and Road routes. The BRI has been designed to enhance the orderly free flow of trade and the efficient allocation of resources.

The government's roadmap issued in March 2015 underlines the five priorities of the BRI: 1 achieve political cooperation, 2 infrastructure connectivity, 3 economic integration, 4 social and 5 cultural exchange across Asia, Europe, Middle-East and East Africa.
Over land routes, it includes the Silk Road Economic Belt, and for sea routes, the 21st Century Maritime Silk Road. A number of institutions will help fund the BRI, including the recently-created Asian Infrastructure Investment Bank.

Since October 2017, BRI has been incorporated into the Chinese constitution and embraces various strategic objectives:

✓ **Ease China economic transformation** by developing new markets for industries in overcapacity while encouraging innovation toward sustainability (Green Belt and Road).

✓ **Raise the share of RMB** in trade, overseas investment, financing by development banks, Chinese policy banks and commercial banks.

✓ **Reinforce China's role on the geopolitical stage** by promoting political cooperation and rallying countries around a common development project. ■

CHINA'S MACROECONOMIC outlook for investment

KEY TAKEAWAYS

Chinese President Xi Jinping has changed the government's policy objective function from maximising growth rates to improving growth quality, subject to the reform and debt-reduction constraints. Many players are expecting China's GDP growth to fall below 6% soon. Really?

What is revolutionary about Mr. Xi's approach is his forceful change of the political and economic incentives that had governed the country for over three decades. He has a much bigger agenda than what most analysts see as the power-grabbing move.

China's new economic model is based on strategic usage of markets under state guidance with very limited privatisation of state-owned assets. Key-man risk is the ultimate China risk that the world has to face in the future.

MEGA TRENDS OF CHINA: EVOLUTION OF CHINA'S GROWTH MODEL

BY CHI LO, SENIOR ECONOMIST GREATER CHINA

To ensure President Xi Jinping has enough time and power to make the necessary structural changes, the Communist party revised the constitution to remove the presidential term limit at the National People's Congress in March 2018. The move not only showed that Mr. Xi had the power to break with past conventions and change the constitution, but also that he dared to challenge and to alter the unwritten rules that have long guided the Party bureaucracy. For better or worse, he is moving China to a more centralised and top-down system.

Two crucial questions follow from these changes. First, as China's policy moves from maximising growth rates to improving growth quality, when will its growth rate fall below the 6% mark that Beijing has vowed to protect? Second, why does President Xi want to re-centralise power? Is this simply power-grabbing with self-interest to crown himself the emperor of modern China?

WILL GROWTH FALL BELOW 6% SOON?

Many players expect that China's growth rate would fall below 6%, or even 5%, in the next three to five years if not sooner because of various reasons, including capacity constraints due to economic distortions and Beijing's desire for slower growth in exchange for structure reforms. Indeed, at the 19th Communist Party Congress in October 2017, President Xi announced his vision of a "new era" in which China will achieve national supremacy by pursuing high-quality growth and de-emphasising high-speed growth.

In practice, the focus on high-quality growth will not end the pressure to deliver economic growth, nor does it mark a shift to a smaller role of the government/Party in the economy.

There is a Party goal of doubling China's per capita real GDP in 2020 from its 2010 level. This is a hard target for the President to deliver. This means that China will have to grow by an average of 6.3% a year between now and 2020 to hit that target.

Structurally, China's GDP growth may remain at around 6% for much longer than most players have expected. Firstly, China is going through a creative destruction process that will generate an inherent growth momentum. For example, China's tertiary sector, a proxy for the new economy, has grown bigger than the secondary sector, a proxy for the old economy, since 2013 **(Chart 1)**.

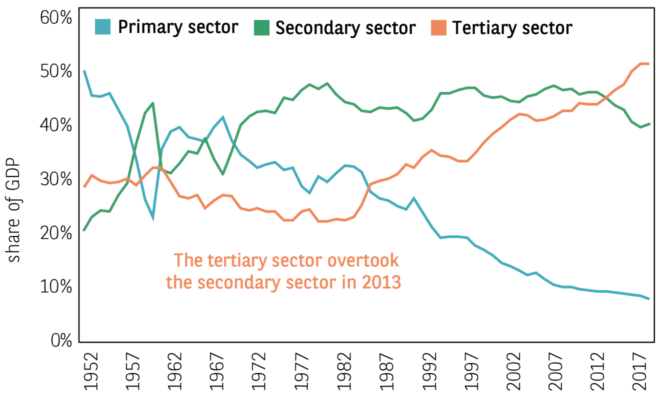
Secondly, there is a developing trend of industrial migration towards the inland provinces **(Chart 2)**, leading to reverse-migration of labour **(Chart 3)**[3], uncovering and employing cheaper and untapped resources, spreading job creation, income growth and consumption to the poor parts of the country. They are signs of economic rebalancing. The combination of the growth of the new economy and industrial migration will likely generate growth momentum to offset some of the growth drag from structural reforms, deleveraging efforts and even an ageing population in the medium-term.

IS IT SIMPLY POWER-GRABBING?

The media has mostly framed the discussion on Xi Jinping's scrapping of the presidential term limit as a power-grabbing move to make himself the life-time ruler of China. The move is a shock even to many Chinese because he is uprooting one of Deng Xiaoping's most important legacies of institutionalising leadership succession that was meant to end the political instability stemming from chronic power struggle in the Mao Zedong era. For the West, the term limit is a mechanism that constrains a system from moving towards dictatorship.

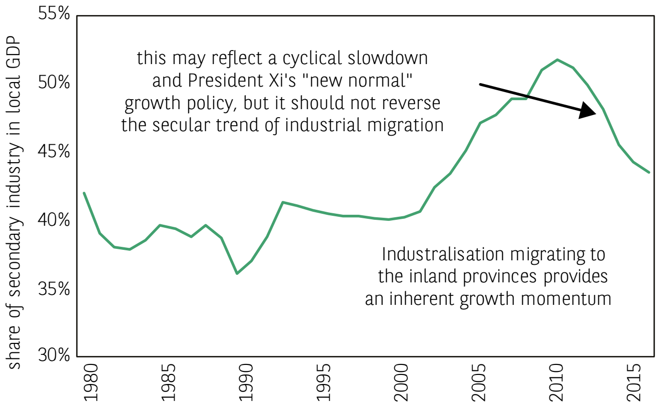
From Mr. Xi's perspective, the de-centralised power structure that evolved after Deng Xiaoping has become a set

Chart 1: China's creative destruction



Source: CEIC, BNPP AM (Asia), as of April 2018.

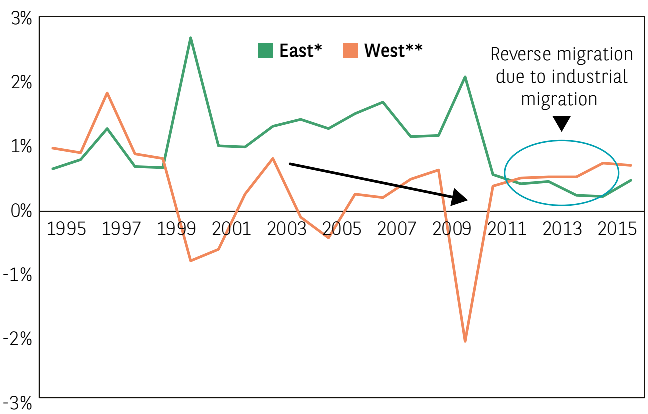
Chart 2: China's industrialisation migration inland*



* Represented by Gansu, Guizhou, Qinghai, Shaanxi, Guangxi, Sichuan, Yunan, Henan, Hubei, Hunan, Jiangxi

Source: CEIC, BNPP AM (Asia), as of April 2018.

Chart 3: Population growth



* Shanghai, Jiangsu, Zhejiang

** Sichuan, Guangxi, Yunnan

Source: CEIC, BNPP AM (Asia), as of April 2018.

3. See "Chi on China: Progress on China's Structural Rebalancing and Reverse Migration", 8 November 2017.

of outdated political conventions that need to be overturned so that he can deliver his "Chinese Dream" to make China a global power because de-centralisation has not worked as intended. For the two decades before him, Beijing delegated more autonomous power to the regional governments to encourage them to try out economic reforms. They were given powers to run major regional affairs, including land allocation, business development, infrastructure construction, local fiscal policy, law making and enforcement, and allowed to own state companies.

The central government had an explicit policy of encouraging regional competition to get rich as a reform motto. Hence, GDP growth became the predominant political objective with appointment and promotion of government officials being tied to local growth performance. This created an incentive scheme of "chasing growth at all cost". It also created powerful provincial officials, who acted like regional warlords, defying the central decrees. Indeed, Chinese bureaucrats have a long history of skillfully resisting orders from above and abusing power.

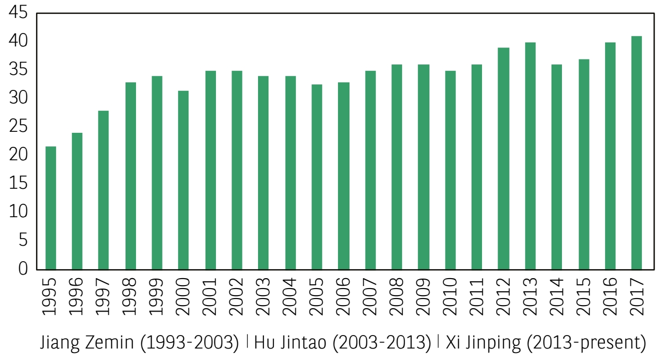
> The ancient Chinese proverb of **"THE MOUNTAINS ARE HIGH AND THE EMPEROR IS FAR AWAY"** has been manifested in modern day practice of **"WHENEVER THERE ARE DECREES FROM ABOVE THERE ARE COUNTER-MEASURES FROM BELOW"**.

XI JINPING'S FEAR

After five years of formulating growth and reform strategies, the leadership is poised to tackle the next phase of challenge: implementation. But the regional defiance has raised the risk of reform failure faced by Mr. Xi – in terms of failing to pull China out of the middle-income trap and risking political demise of the Party if the system's distortions are not resolved.

As power de-centralisation has backfired, the implementation risk has become a mounting concern. Using corruption as a proxy to implementation failure, China remained quite corrupt[10], according to the Transparency International Corruption Index (which ranges from 0 or highly corrupt to 100 or very clean) in the 20 years before Xi Jinping took office **(Chart 4)**. Its corruption index remained below 40 under both the Jiang Zemin and Hu Jintao administrations but rose to 41 in 2017, reflecting the initial success of Mr. Xi's anti-corruption campaign and structural reforms.

Chart 4: China remained quite corrupt in the 20 years before Xi Jinping took office

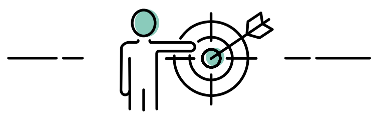


Source: Transparency International, BNPP AM (Asia), as of April 2018.

Mr. Xi believes that there is a link between leadership power and reform implementation. The need for greater leadership power, as reflected in the elimination of the presidential term limit, has become a key element of his implementation efforts. From the perspective of western democracies, scrapping the presidential term limit is a disappointing governance setback by China. But from Beijing's perspective, it may be the only option to tackle its daunting reform risk.

CHANGING THE INCENTIVE SCHEME

Hence, Mr. Xi is changing the incentive scheme of the system from single-mindedly maximising growth to multi-targeting different policy goals, including maintaining GDP growth, alleviating poverty, reducing financial risk and protecting the environment.



By replacing the old incentive, which was easy to pursue, with a complex set of priorities, which makes optimising all the policy goals simultaneously impossible, Mr. Xi is creating a political environment to ensure compliance by local officials. Since it will be so hard for local officials to know the best way to satisfy Beijing's multiple goals, they are more likely to just do what they are told rather than be creative.

So there is a big agenda behind Mr. Xi's motive to stay on as a patriarch leader. To realise his Chinese Dream, he needs

4. Evidence of rampant corruption abound. For example, see "The Dark Side of China's Rise", by Minxin Pei, Project Syndicate, October 20, 2009.

time and power to make changes. Eliminating the term limit makes it clear to the local officials that there are no alternative power centres for them to appeal to, and that waiting for Xi to pass from the scene is also not an option. To survive and thrive under this framework thus requires pledging loyalty to Xi.

Thus, Mr. Xi has created an increasingly high-pressure political environment to break local defiance and emphasise strict compliance of central decrees. His vision for the future is not to reduce state intervention, but to refine the role of the state in the economy. The new economic model will continue to be a strategic mix of markets and state guidance.

THE ULTIMATE CHINA RISK

Key-man risk – that the person making all policy decisions is increasingly insulated from criticism or feedback, leading to potential bad decisions and disastrous mistakes – is the primary China risk that the world is facing. There are secondary risks also. Mr. Xi's high-pressure political environment may ensure compliance, but the local knowledge and power of the regional officials may no longer serve as a checking force on potentially ill-considered central policies. The pressure on officials to deliver on multi policy targets may also worsen the old problem of data falsification and disrupt markets and even social stability.

These risks have remained manageable so far because Beijing has shown enough sensitivity to adjust policies when implementation gets off-track. A relatively closed capital account also helps minimise the risk of potential capital flight stemming from the loss of local confidence. But history has shown that few authoritarian regimes could maintain power and systemic stability through coercion alone. China's capital account is also opening wider as economic liberalisation progresses.

THE CHANGING DYNAMICS OF CHINA'S RISKS

BY CHI LO, SENIOR ECONOMIST GREATER CHINA

Concerns about China's risks have largely receded after a solid economic performance in 2017.

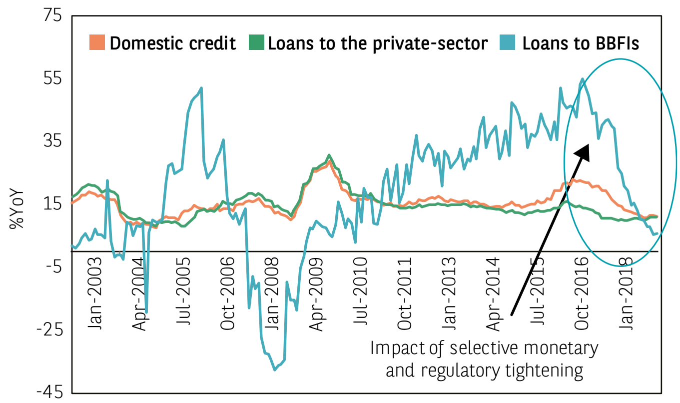
What about this year? Hidden behind an expected slowdown in real GDP growth this year are the same old set of risks stemming from potential policy missteps due to the push for debt-reduction, property bubble crackdown and enforcement of environmental standards, and from trade friction with the US. However, the dynamics of these risks have changed recently, affecting the probability of the outcomes in the coming year.

OVER-TIGHTENING RISK EBBS AND FLOWS

The risk of over-tightening of financial regulation leading to unintended consequences of credit events was increasing early in the year but has recently stabilised due to the PBoC's policy shift towards an easing bias in April. Beijing started its battle against financial risk in early 2017 by implementing selective tightening to force deleveraging in the wholesale funding market and non-bank financial institution (NBFI) sector. The impact was felt throughout the system with total credit growth declining **(Chart 1)** and corporate bond yield spread rising **(Chart 2)**.

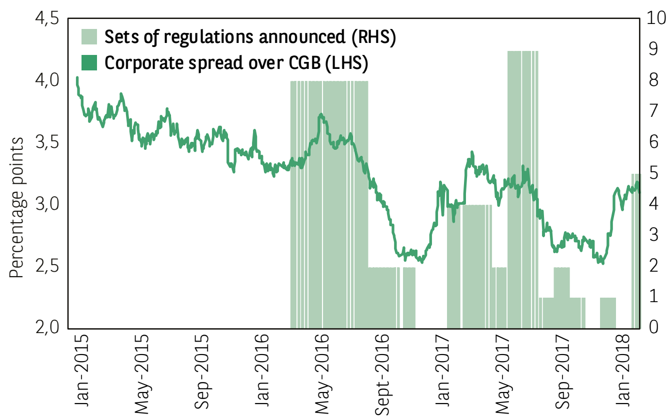
Nevertheless, the authorities still managed to wage that battle without causing collateral damage to the real economy. Real GDP grew by 6.9% YoY in 2017, above the government's target and market expectation of 6.5%. Controlling systemic risk remains a high policy priority in 2018. The renewal of tightening measures in October 2017, after a four-month pause, shows that Beijing was confident in speeding up its deleveraging efforts..

Chart 1: Selective deleveraging also slows total credit growth



Source: CEIC, BNPP AM (Asia), as of February 2018.

Chart 2: Corporate bond spread* and new regulations announced



* Five-year AA- corporate yield spread over CGB

Source: CEIC, UBS, BNPP AM (Asia), as of February 2018.

In addition to continuing cracking down on unconventional credit channels of shadow banks and NBFIs, the regulators are now stepping up scrutiny on conventional channels of credit, including trust loans and entrusted loans, which together account for about 13% of aggregate financing. They also want to reduce household leverage, which is predominately mortgage.

Mortgages account for about 18% of bank loans and bank loans account for 70% of aggregate financing. So mortgage lending is about 13% of aggregate financing. This means that Beijing's new deleveraging effort is expected to hit 26% (13% of trust and entrusted loans + 13% of mortgage loans) of aggregate financing this year. Adding it to the 16% share of the NBFI loans in domestic credit that are already being targeted for debt-reduction, we would expect 42% of aggregate financing to come under deleveraging pressure this year.

This would put a large liquidity squeeze on the system. The regulators will have to allow some offset to lessen the potential growth damage and systemic risk. In my view, this may come in the form of Beijing allowing more bond issuance by the corporate and provincial government sectors to keep aggregate financing growth sufficient to sustain 6%+ GDP growth. So expect an increase in bond supply to put upward pressure on the onshore yield spread further this year.

Furthermore, the deepening of deleveraging efforts will increase the number of defaults, leading to credit differentiation by investors and contributing to widening of credit spread in China. But the PBoC has also stepped up its effort to ensure no systemic risk will result. In April, it shifted to a policy easing bias and cut the bank reserve requirement ratio by 100 bps, releasing about RMB1.3 trn of liquidity into the system to contain the potential damages of deleveraging on GDP growth.

PROPERTY MARKET RISK IS DECREASING

Restrictive property market policies over the past few years have led to a slowdown in mortgage loan growth and property transactions **(Chart 3)**. Further cooling of the property market is expected for 2018. But with inventory declining gradually and demand from smaller cities reviving, the risk of a property market crash is decreasing.

Furthermore, Beijing has shown sensitivity towards the potential damages of its hawkish property policies on economic growth. Some non-Tier-1 cities have loosened their housing policies in recent months, which helps revive property sales in the central provinces and stabilise the volume contraction in the Tier-1 cities **(Chart 4)**. So the risk of a policy misstep crashing the property market is also decreasing.

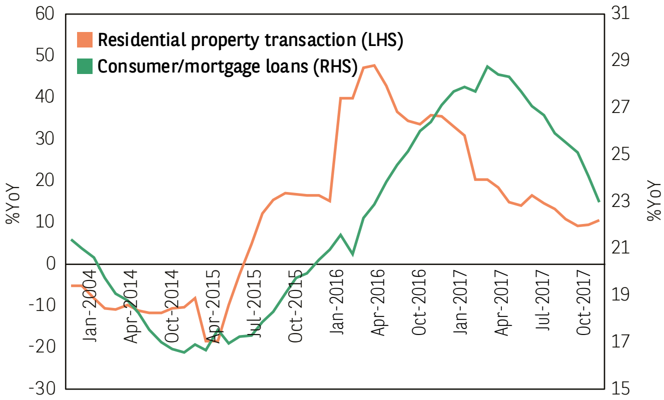
STRINGENT ENVIRONMENTAL STANDARDS RISK IS STABILISING

Beijing started enforcing stringent environmental standards by putting tight restrictions on the heavy and polluting industries, such as steel, cement, glass and coke, since 2017. The impact has been an improvement in air quality at the expense of a sharp decline in the heavy industrial output **(Chart 5)**. Even commodity imports have plunged **(Chart 6)**, reflecting the contraction in the heavy industries.

Yet the damage to overall GDP growth has been contained. This is partly because the air-pollution curbs are focused on north China but output in the south has increased to provide some offset, and partly because Beijing has scaled back the environmental crackdown, reflecting its awareness of the campaign's collateral damage on the people.

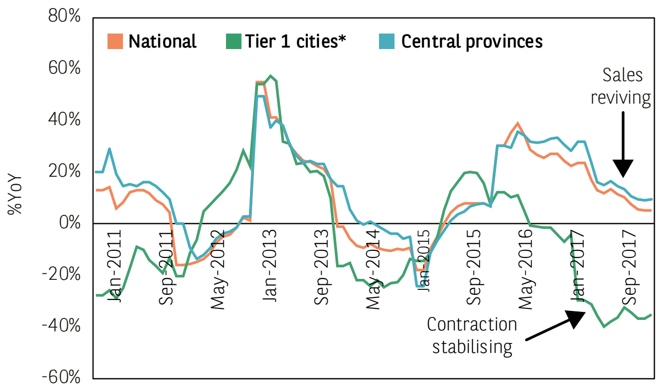
In fighting air pollution, the authorities moved to establish a coal-free zone around Beijing late last year by forcing households to switch from coal to electric or natural gas heating.

Chart 3: Housing market continues to cool



Source: CEIC, BNPP AM (Asia), as of February 2018.

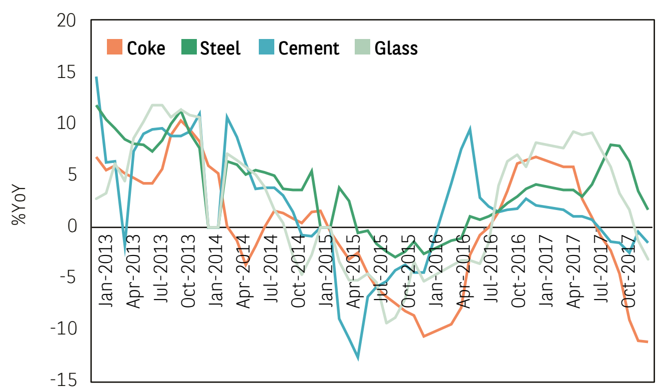
Chart 4: Residential property sales volume



*Beijing and Shanghai.

Source: CEIC, BNPP AM (Asia), as of February 2018.

Chart 5: Heavy industral output* dropping sharply on enforcement of environmental standards



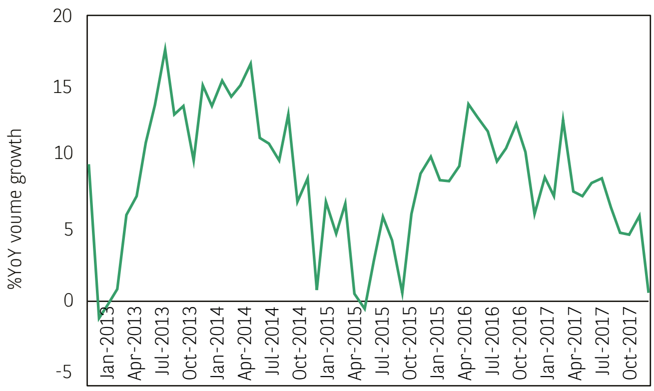
*Data series in 3-month moving averages

Source: CEIC, BNPP AM (Asia), as of February 2018.

But the local officials pushed ahead too hastily without sufficient electricity and natural gas supply to support the switch, leaving thousands of families, hospitals and schools without heating in the frigid winter. After a public outcry that caught national attention, the central authorities ordered a pause of the programme until sufficient facilities are installed. The switching from coal heating to electric or natural gas will continue but the completion deadline has been postponed to the end of 2019.

Policy sensitivity and cyclical recovery of some of the heavy industries suggest that the maximum stress of over-zealous enforcement of environment standards damaging growth may be behind us. The risk of a policy mistake in this regard is stabilising.

Chart 6: Commodity imports* plunge

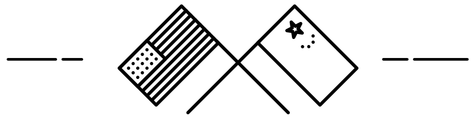


*Iron ore, copper ore, crude oil - series in 3mm

Source: CEIC, BNPP AM (Asia), as of February 2018.

SINO-US TRADE FRICTION RISK IS RISING

This is in fact a political risk that is outside of Beijing's control. But the persistent Sino-US trade surplus is an acute problem that US President Trump will use to harden his hawkish trade policy on China, partly to divert attention from the ongoing "Russia gate" investigation and partly to shore up support ahead of the mid-term elections later this year. So expect more trade frictions between the US and China as the year wears on.



Nonetheless, the macroeconomic effect of Sino-US trade friction on China is not too worrisome because there are vested interests in both countries to resist harsh trade sanctions. Market research also shows that even a permanent 10% fall in Chinese exports to the US would only cut about 0.3ppt from China's GDP growth a year, but this impact can easily be offset by Chinese domestic spending or exports to other destinations for example via the Belt and Road initiative. So the impact is likely to be more on individual sectors. While the odds for this risk to materialise are rising, it is not a big one for China.

Overall, the risks to China's outlook this year appear to be within manageable limits. A potential black swan may be the geopolitical risks which are scattered throughout Asia and surrounding China (the East China Sea, the South China Sea, the Korean Peninsula and the China-India-Pakistan borders). ■

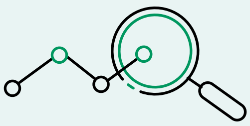
CHINA RISKS AT A GLANCE

RISK	STATUS	IMPACT
Regulatory over-tightening leading to credit events	Rising (no systemic risk)	42% of aggregate financing to come under pressure; corporate yield spread to rise on rising bond supply and worries about defaults
Property market crash	Decreasing	Property market continues to cool in 2018 with impact concenrtating on Tier-1 cities
Environmental regulations over-tightening	Stabilising	Heavy and polluting industries continue to face pressure to contract
Sino-US trade friction	Rising	Macro impact small; mainly sectoral damages
Geopolitical risk	Black swan	Damaging

CHINA: WORLD'S SECOND LARGEST EQUITY MARKET

The Shanghai and Shenzhen Stock Exchanges opened in December 1990 as part of Chairman Deng Xiaoping's 'Reform and Open Up' initiatives. At the opening, the markets were small, listing only eight names with a market capitalisation of about USD 500 million.

Today, no less than 3 348 companies are on these two Chinese exchanges, with a total market capitalisation of more than USD 8.2 trillion (as of February 2018). Although the Hong Kong Stock Exchange is governed differently than the Shanghai and Shenzhen stock exchanges, the three exchanges tend to be grouped in the 'Greater China' category, adding USD 3.5 trillion of market capitalisation. **The total market capitalisation of Greater China equity market exceeds USD 11.7 trillion, making it the second-largest market** after the United States.



Chinese equity markets are among the most active exchanges in the world, with a total trading value of over **USD 14.3 trillion** in 2017 as well as a total of **USD 180 billion** in equities raised over the same period.

HOW TO ACCESS

Chinese equity markets

Mainland China's two exchanges serve different functions:

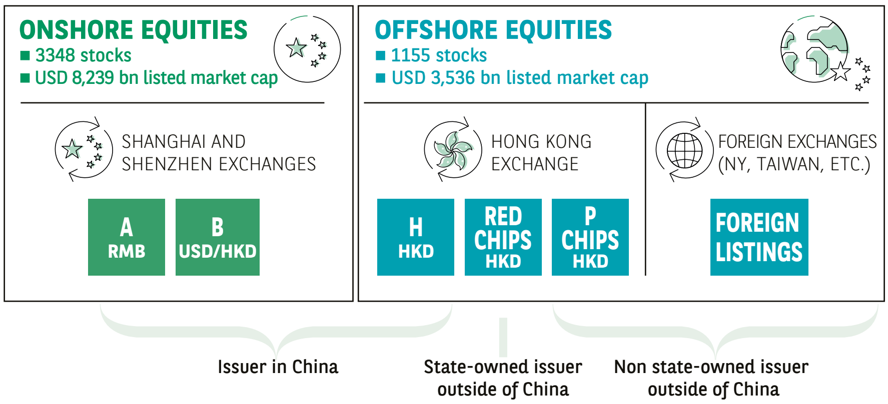
1 **The Shanghai Stock Exchange (SSE)** lists China's most prominent large cap companies – State Owned Enterprises (SOEs), banks and energy firms – sectors known as 'Old China'.

2 **The Shenzhen Stock Exchange (SZSE)** plays predominantly host to small and mid-cap private sector names. The ChiNext Market of fast-growing technology firms is also based in Shenzhen.

NAVIGATING SHARE CLASSES

Historically, Chinese regulators have restricted foreigners' access to Mainland equity markets. The gradual loosening of these controls resulted in the creation of multiple share classes which offer different privileges, depending on where the investor purchases the stock, where the listed company is incorporated, and the currency in which the stock is denominated. The chart below provides an overview of these differences.

CHINESE ALPHABET OF SHARE CLASSES



Source: BNP Paribas Asset Management, Wind, FactSet, Goldman Sachs Global Investment Research, as of 20 February 2018

While there is no restriction in investing in the Chinese offshore equities market (e.g. Hong Kong shares, US American Depositary Receipts (ADRs), Taiwan shares, Singapore shares), gaining access to the China A-shares market has historically not been as straightforward.

QFII & RQFII SCHEMES

Before the Stock Connect program began, foreign investors could only access the A-share market through the QFII (Qualified Foreign Institutional Investors) and RQFII (RMB Qualified Foreign Institutional Investors) schemes. These schemes have strict quota limitation as well as lock-up and repatriation restrictions, which is relatively not common in developed markets. A number of steps need to be completed before investing:

- Applications need to be submitted and approved for a license by the China Securities Regulatory Commission (CSRC).
- Once a license is granted, an application needs to be submitted for an investment quota.
- A trading account is set up.
- After an injection of capital, a local broker can be designated.

FACILITATING ACCESS THROUGH STOCK CONNECT

The mutual market access (MMA) schemes launched in recent years via Hong Kong, such as Stock Connect, Bond Connect and the Mutual Recognition of Funds schemes, give outside investors license- and quota-free access to Chinese assets, while also providing outbound investment channels for Chinese institutions and residents.

Stock Connect is a unique collaboration between the Hong Kong, Shanghai and Shenzhen Stock Exchanges, which offers international and Mainland Chinese investors to trade securities in each other's markets through the trading and clearing facilities of their home exchange. With the Stock Connect program, there is no lockup and no restriction on repatriation. Capital can be deployed quickly and access to the A-share market has never been easier. Investors can trade Chinese stocks from Hong Kong and the funding is possible through CNH (offshore renminbi) rather than CNY (onshore renminbi). Although there are some quotas in place that limit daily volumes, the daily cap on total quota is more than enough to accommodate most investors' needs. These programs are not static – each has been refined and expanded since launch. This approach is likely to continue as more participants join and as regulators streamline procedure and broaden the scope of the schemes. **This easier access has led to a significant increase in foreign investors' interest in the A-share market.**

Three main channels to access Chinese onshore equity markets

CHINA OFFSHORE EQUITIES

No restrictions for foreign investors

CHINA ONSHORE EQUITIES

	STOCK CONNECT	RQFII	QFII	
QUOTA SIZE	No quota limit	USD 218 bn	USD 150 bn	
ELIGIBLE INVESTOR	All investors	Only licensed investors based in selected eligible locations where the RQFII scheme is available	Only licensed investors that meet certain operation and AUM requirements	
QUOTA REQUIREMENT	No requirement	1 Quota linked to asset size or investment requirements. To be approved by SAFE; 2 Unused quota within a year will be cancelled	1 Quota linked to asset size or investment requirements.To be approved by SAFE 2 Unused quota within a year will be cancelled	
CAPITAL MOBILITY	1 No restriction 2 Daily investment quota of RMB 52 bn (USD 8 bn) for Northbound channel; RMB 42 billion (USD 6 bn) for Southbound channel	**Open-Ended Funds:** Repatriation: Daily Lock-up: None Remit Period: None Others: Quota required to be used within 1 year upon approval	**Open-Ended Funds:** Repatriation: Daily Lock-up: 3 months Remit Period: N/A Others: Monthly repatriation cannot exceed 20% of NAV of previous year	**Others:** Repatriation: Daily Lock-up: 1 year Remit Period: 6 months Others: Monthly repatriation cannot exceed 20% of NAV of previous year
ELIGIBLE INVESTMENT	1480+ stocks listed on Shanghai & Shenzhen	All securities listed on Shanghai & Shenzhen Stock Exchanges		
CURRENCY	CNH (Offshore RMB)	CNH (Offshore RMB)	CNY (Onshore RMB)	

Source: Stock Connect, MSCI & Citi Research, as of May 2018. QFII: Qualified Foreign Institutional Investor RQFII: RMB Qualified Foreign Institutional Investor.

TOWARDS FURTHER LIBERALISATION OF CHINESE ECONOMY AND FINANCIAL MARKETS

Chinese President Xi Jinping is making large promises about China's economic future, recently stating that China supports an open world economy and pledging further liberalisation of its market to foreign investors. Since the announcement of Stock Connect, the inclusion of the renminbi in the IMF's SDR[5] basket and MSCI's inclusion of A-shares, China has continued to accelerate the opening up of its financial sector, announcing that it will ease limits on foreign ownership of banks and securities firms. In our view, this is a milestone event that sends the signal that China's authorities are confident that the country's financial institutions are now strong enough to compete directly with foreign rivals.

ROADMAP OF CHINA'S CAPITAL MARKET DEVELOPMENT

Before 2004: No access (no foreign investors)

- **1990** Creation of Shanghai Stock Exchange and Shenzhen Stock Exchange
- **1992** Launch of B-share market
- **1998** First open-ended fund
- **2002** QFII launch
- **2003** QDII launch

2004-2014: Era of quotas (only qualified investors)

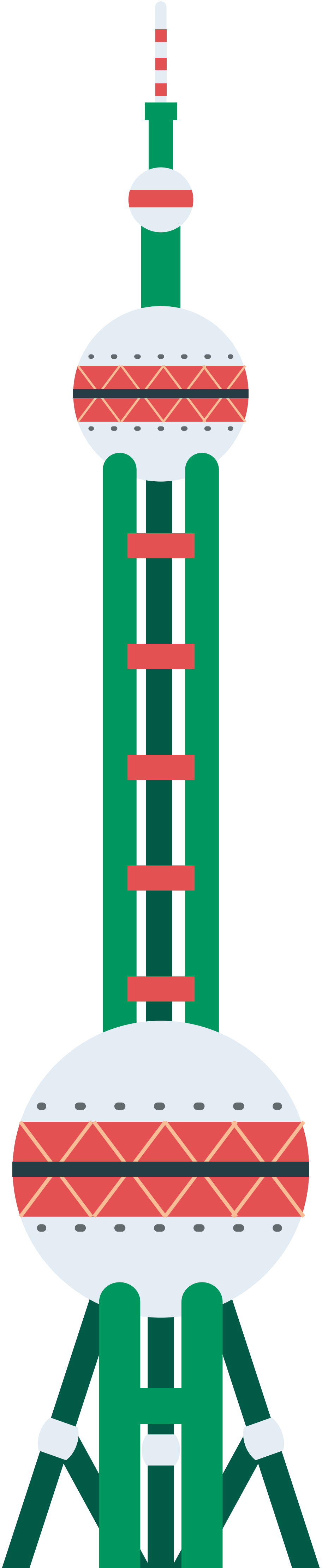
- **2009** Shenzhen Stock Exchange ChiNext market; margin trading and short
- **2010** Stock Index Futures
- **2011** RQFII launch
- **2013** First Tree Trade Zone in China

Since 2014: The Stock Connect Era (all investors)

- **2014** Launch of the Shanghai-Hong Kong Stock Connect
- **2015** Mutual fund recognition and market-oriented FX and
  - Mutual Fund Recognition Scheme
  - Revisions of RMB daily fixing mechanism to be more market-driven
- **2016** Launch of the Shenzhen-Hong Kong Stock Connect & RMB inclusion in the SDR basket
  - Shenzhen-Hong Kong Stock Connect
  - Renminbi inclusion in IMF's Special Drawing Right (SDR) basket: 10.9% weight in the SDR basket >> Milestone for renminbi recognition as a global reserve currency
- **2017** **Further opening up of China onshore market**
  - MSCI announces inclusion of China A-shares
  - Direct China Interbank Bond Market (CIBM) access
  - Bond Connect
  - Shenzhen-Hong Kong Gold Connect
  - Ease limits on foreign equity ownership of banks and securities firms

Global investors' participation is changing the structure of the A-share market significantly to make it more mature, more fundamentally-driven, which plays in favour of the long-term growth of the A-share market. As such, the Stock Connect program represents a key milestone in the globalisation of China's financial market. ■

5. IMF's SDR: International Monetary Fund's Special Drawing Right



THREE STRUCTURAL TRENDS DRIVING long-term investment opportunities in China

China's economy has developed as its industrial revolution and internet revolution occurred at the same time. The new wealth generated by the two revolutions offer exciting investment opportunities. We believe the following investment opportunities will continue over the next few years as the sectors benefitting from the following three structural trends are positioned for sustainable growth:

1 TECHNOLOGY INNOVATION:

The internet sector is highly synergistic and leverages infrastructure, user bases, unified language and culture, policy and talent. At over 700 million units, China has the largest population of mobile internet users in the world[6].

2 CONSUMPTION PREMIUMISATION:

Chinese consumers are transitioning from "having" to "having more" and "having better". As a result, companies with strong brand premiums, differentiated products and long-term competitive advantages tend to outperform the market.

3 INDUSTRY CONSOLIDATION:

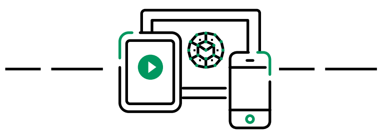
We observe a transition where companies' market positions are reinforcing and market leaders are gathering the cash flow and capabilities to further consolidate the market.

6. Source: China Internet Network Information Center (CNNIC), as of 8 January 2018.

TECHNOLOGY INNOVATION

CHINA: FROM AN INNOVATION "SPONGE" TO AN INNOVATION LEADER

China has emerged as a global driving force in innovation and its innovative capabilities are growing faster than is generally acknowledged. The country has evolved from an innovation 'sponge' – absorbing and adapting global technologies and knowledge – to an innovation leader. Innovation is an imperative for China, as its labour force is no longer growing and the return on fixed asset investment is declining. China is focusing on four areas of innovation[7]:



1. **Efficiency-driven:** broad manufacturing ecosystem (suppliers, labour, infrastructure)
2. **Customer-focused:** large domestic market for fast commercialisation
3. **Engineering-based:** government creates local demand, favours learning
4. **Science-based:** swiftly increasing, low-cost R&D capacity

2018

China R&D spending is expected to surpassthat of the US and Japan

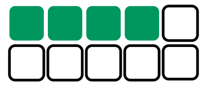
Here are some astonishing numbers[8] corroborating the fact that the common perception of China as a follower needs to change. With 2.1% of its GDP, China has spent more on research and development (R&D) than the European Union since 2014, while the pace of spending is accelerating at a much faster pace than in the US (2.8% of GDP)[9]. In 2017, China's total R&D spending rose 12% YoY to USD 280 billion, making China the second largest R&D spender in the world (in US dollars, in PPP terms). Over the last decade, the number of R&D personnel in China has increased by 11% a year to over 3.8 million in 2017, which is the world's largest pool of R&D personnel and three times the number in the US.

520 mn

Alipay users globally, 2.5x Paypal's active users

China has become an innovator that has helped to redefine many markets, particularly in the areas of social pastimes, entertainment and advertising. In particular, China has become a strong innovator in consumer electronics and construction equipment. The volume of mobile payments transactions in China skyrocketed again, reaching USD 12.8 trillion in 2017. Alipay is China's most popular mobile payment platform. With over USD 6 trillion of transactions, Alipay users globally are as many as 520 million, representing 2.5 times Paypal's active users in the world.

4 of top 10



Funded start-ups are from China

Although China initially grew to become a technology powerhouse by following the path of the US technology industry, it is now home to four of the world's ten largest internet and technology companies – Alibaba, Baidu, Tencent and Xiaomi. According to the MIT, iFlytek and Tencent were ranked among the top 10 Smartest Companies in 2017. China thus offers the potential for significant investment opportunities given that the market capitalisation of its largest internet companies exceeds USD 400 billion[10].

2.8 mn

Science & Engineering graduates per year; x5 levels of US graduates

Despite some current obstacles to innovation (e.g. slow regulatory processes and weak intellectual property protection), China has grown faster than expected. A rapid increase in China's base of engineering talent[11], and the continued strength of the government's investment commitment to make engineering-based companies effective innovators in the future should accelerate China's advances in innovation. China has become the leader in patent application, with over 1.3 million applications in 2017 (vs. less than 400,000 in 2010), largely outstripping the US, Japan or Europe (all below 600,000 in 2017)[12]. This represents a significant opportunity to invest in Chinese companies driving this trend.

7. Source: McKinsey Global Institute, as of October 2015
8. Source: OECD, UBS Research, as of 13 September 2017
9. Source: NSB's Science and Engineering Indicators 2018 report, as of 2017
10. Source: Bloomberg, MIT, as of May 2018
11. Source: UBS Research, as of 13 September 2017
12. Source: World Intellectual Property Indicators 2017, as of September 2017

CONSUMPTION PREMIUMISATION

FROM QUANTITY TO QUALITY

If you are looking for evidence that Chinese consumers are confident, look no further than the one-day online sales phenomenon known as Singles Day, which falls every year on November 11. Singles Day, which was initiated and hosted by China's ecommerce giant Alibaba, has transformed from being a day dedicated to lonely singles, to becoming the single largest e-shopping day globally. With an estimated USD 38.2 billion of total online sales (43.5% YoY surge in e-commerce sales), Singles Day' sales in 2017 easily were double those in the US over the five-day Thanksgiving weekend.

Along with the rapid expansion of the country's middle class, we expect private consumption growth to remain strong, with a gradual shift towards discretionary and services/experience-related consumption, facilitated by a mushrooming e-commerce infrastructure.

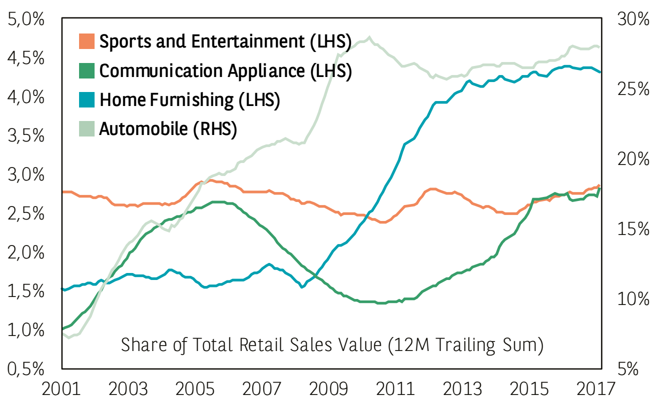
SHIFT IN CONSUMPTION PATTERNS

Faster income growth allows for a quicker steepening of the penetration curve in many categories, as well as a shift in consumption patterns that is occurring in three main ways:

1. From staples to discretionary
2. From mass to premium
3. From goods to services/experience-related purchases

Overall consumption growth has continued to outpace that of investment growth, indicating further progress on rebalancing China's economy.

The rising share of discretionary spending

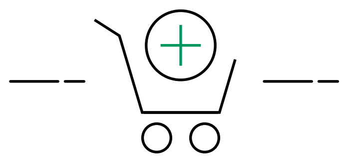


Source: CEIC, Morgan Stanley Research, as of 13 November 2017

E-COMMERCE: BETTER INFRASTRUCTURE, EASIER CREDIT

Several factors explain the impressive online sales in China:

- **Better infrastructure:** more internet access/smartphones, rapid expansion of e-payments and improving logistics network mean households have better access to e-commerce. Internet penetration in China rose from 34% in 2010 to 54% in June 2017.
- **Financial innovation:** consumer credit has become more easily available to younger consumers who tend to be more eager to borrow to spend.



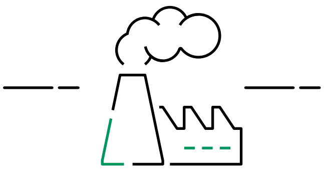
While growth has been impressive, China's total consumption is still one-third that of the US, meaning there is considerable further potential for spending on services and by rural consumers. Services accounted for 68% of US household consumption in 2016, but stand at only 49% in China, where rural populations' spending is lagging. Rural Chinese represent 43% of the total population, but only account for 22% of total household consumption, so **boosting both services and rural consumption is crucial**.

Our Greater China equities investment team expects private consumption growth in real terms to remain strong, while retail sales growth is likely to accelerate as CPI inflation gradually increases. The labour market remains relatively tight and household income growth should continue to improve. Consumption in China should become an increasingly important driver of aggregate growth, presenting significant opportunities to invest in the companies driving this trend.

INDUSTRY CONSOLIDATION

WAVE OF INDUSTRY CONSOLIDATION BOOSTING PROFITS IN CHINA

Industry consolidation in China has been occurring in recent years both inside and outside overcapacity sectors, as the country's structural economic rebalancing and government supply-side policies continue. During 2017, we have seen the share prices of numerous industry leaders perform significantly better than other stocks in the same industries in relative terms, contributing to the outperformance of large cap names. We believe this trend has longer to run and that winners across sectors should represent good investment opportunities.



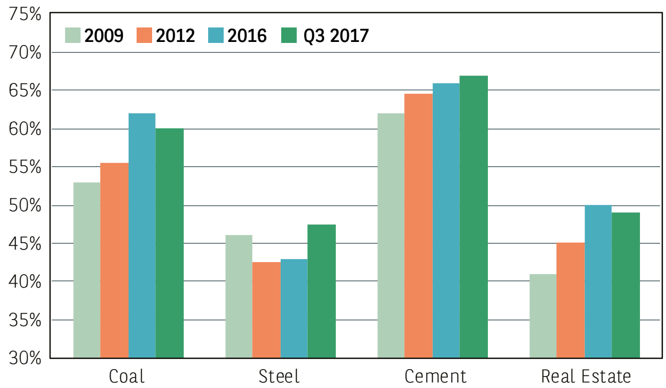
CONSOLIDATION IN OVERCAPACITY INDUSTRIES...

Consolidation is increasing at an accelerating pace across China's economy, particularly in the mining and materials sectors. One example in the overcapacity steel sector was *Baoshan Iron & Steel Co.'s* acquisition of *Wuhan Iron & Steel Co.* in 2016, to form the world's second-largest steelmaker after Europe's ArcelorMittal. In 2017, in the cement sector, China National Building Material (CNBM) merged with rival China National Materials *(Sinoma)* to form the world's largest cement maker and cement plant builder. The merged company aims at to be managing 100 plants in a number of countries involved in the Belt and Road Initiative in the next three to five years.

... BUT ALSO OUTSIDE OVERCAPACITY INDUSTRIES

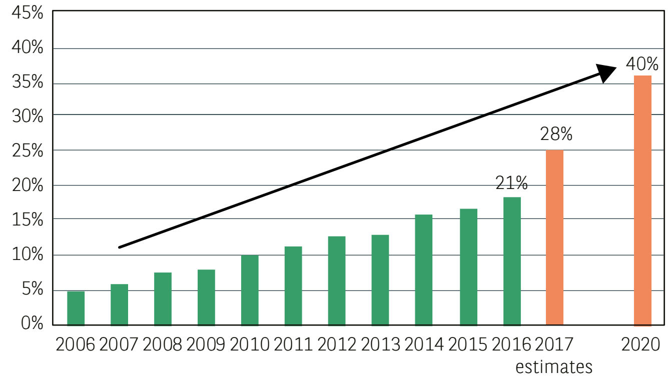
The wave of consolidation is now also washing far beyond China's overcapacity sectors into consumer and services industries. Examples include car dealers, paper producers, Chinese liquor companies, brewers, budget hotels, air conditioning manufacturers, e-commerce and insurance. For instance, China Lodging Group acquired the boutique operator Crystal Orange Hotel Holdings in 2017. A new wave of pharmaceutical industry mergers is also on the horizon.

The increasing consolidation in China's materials sectors (top 4 players' market share)



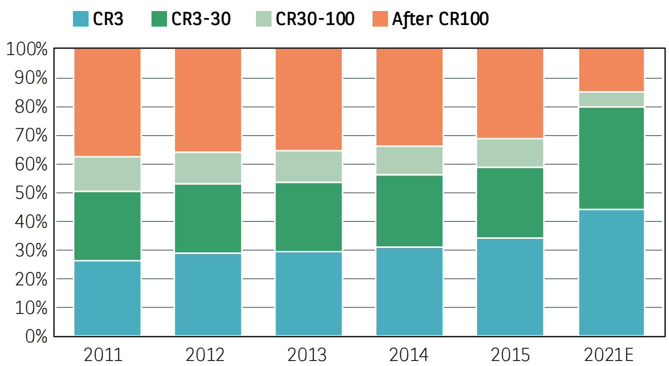
Source: based on revenue. Source: Wind, BNPP AM, as of 18 January 2018

Market share of top 10 property developers



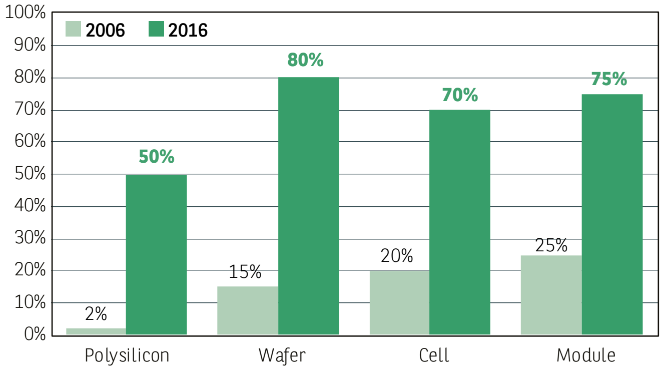
Source: Shangshi Consulting, Goldman Sachs Research, BNPP AM, as of 18 April 2017.

Concentration ratios (CR) for pharmaceuticals distributors



Source: MOFCOM, UBS estimates

Accelerating market share of Chinese manufacturers in the global solar value chain



Source: Company data, UBS, as of 18 January 2018

WHAT'S BEHIND THIS WAVE OF CONSOLIDATION?

Industry consolidation can help companies boost their earnings, regain their pricing power and reduce their debt-servicing burdens. Three principal reasons underpinned the current wave of consolidation:

1 **Government actions to rein in the risk from rising debt:** China's materials sectors (e.g. iron and steel) have been the areas most affected by debt and excess capacity. Merging larger state-owned enterprises and closing smaller, less efficient companies may help ease the increasing debt burden on a number of factories and mines. The Chinese government is making notable efforts to remove excess capacity in the coal and steel sectors through supply-side reforms initiatives. With fewer players and less production, consolidation should support the pricing power of the remaining players, which tend to be more efficient and have higher corporate profit margins.

2 **More stringent environmental protection rules:** Strengthening environmental protection measures have also caused closures / exits of a large number of firms in environmentally-sensitive industries.

3 **China's economic rebalancing, illustrated by three structural changes:**

- **Moving away from investment-led growth** has been one of the factors leading to overcapacity issues and consolidation in some industries. We have seen weaker construction-related demand in recent years.
- **Robust income growth, a fast-expanding middle class and consumption upgrades** are reinforcing strong demand for higher-quality branded products and services.
- **Technology advances** have made market leaders increasingly dominant in knowledge-intensive industries as China's innovation boom has geared up. Clear policy measures to encourage R&D and innovation as well as to promote advanced manufacturing, tend to favour industry leaders that have already acquired a large market share given their existing technological advantages.

This consolidation trend is in line with the government focus to move from quantity of growth to quality of growth. One side-effect of consolidation could be an ongoing slowing in fixed-asset investment, but that may prove a short-term setback on the road toward longer-term economic benefit.

THE IMPLICATIONS OF CHINA A-SHARES

Inclusion into MSCI Indices

After four years of consultations, MSCI announced in June 2017 the partial inclusion of China A-shares into its mainstream Emerging Markets and World indices. The symbolic importance of this development cannot be over-stated as it signals MSCI's inclusion of the world's second-largest equity market, with a total market capitalisation of approximately USD 8.3 trillion.

A partial inclusion factor of 2.5% will be applied initially in June 2018 and increased to 5% in September 2018. The 226 yuan-denominated stocks, or China A-shares, will represent an aggregate weight of 0.8% in the MSCI Emerging Markets Index at a 5% partial inclusion factor. All stocks to be included by MSCI will be large-capitalisation shares currently accessible to foreign investors through the Stock Connect schemes. This includes onshore China large-cap shares that have offshore share equivalents in the MSCI China index. The offshore CNH exchange rate will be used for index calculation instead of the CNY rate. In terms of sectors, after the inclusion, the financial sector will see its weighting increase the most in the MSCI China index, followed by industrials and consumer discretionary.

Estimated weighting of A-shares in MSCI indices post-implementation

INDEX	CURRENT A-SHARE WEIGHTING	A-SHARE WEIGHTING AT IF OF 2.5%	A-SHARE WEIGHTING AT IF OF 5%	A-SHARE WEIGHTING AT IF OF 100%
MSCI Emerging Markets	0.0%	0.4%	0.8%	16.2%
MSCI AC Asia Pacific ex-Japan	0.0%	0.5%	1.0%	16.1%
MSCI EM Asia	0.0%	0.6%	1.1%	18.5%
MSCI China	0.0%	1.3%	2.5%	34.1%
INDEX	**CURRENT MSCI CHINA WEIGHTING**	**MSCI CHINA WEIGHTING AT IF OF 2.5%**	**MSCI CHINA WEIGHTING AT IF OF 5%**	**MSCI CHINA WEIGHTING AT IF OF 100%**
MSCI Emerging Markets	32.0%	31.0%	31.3%	41.7%
MSCI AC Asia Pacific ex-Japan	37.2%	37.5%	37.8%	47.3%
MSCI EM Asia	43.9%	44.2%	44.5%	54.2%

Source: MSCI, BNP Paribas, data as of 16 March 2018. IF: Inclusion Factor.

The three previous hurdles to inclusion were: 1 Capital mobility/repatriation, 2 stock suspensions, and 3 local exchanges' approval to launch products. By aligning the request for inclusion with Stock Connect, some concerns of MSCI and investors were addressed:

- With the Stock Connect framework, investors can now access domestic Chinese stocks without being constrained by the quotas and repatriation restrictions imposed under the QFII/RQFII schemes.
- New trading suspension rules are introduced under Stock Connect. The proposal excludes securities that have been suspended for more than 50 days in the past 12 months from the eligible universe, limiting the number of stocks that are frequently suspended.
- Chinese exchanges have loosened their requirements to pre-approve index-linked investment vehicles.

Although the impact on fund flows will be minor over the short term, we believe that the long-term implications would be sizable. We expect the MSCI inclusion of A-shares to attract USD 22 billion of foreign inflows in the first year. However, USD 360-400 billion of inflows are expected over the next five to 10 years, according to our Greater China senior strategist, Chi Lo.

Currently, the MSCI Emerging Markets Index includes around USD 1.6 trillion of global assets, 15% of which are in passive funds. Compared to the USD 7.6 trillion A-share market, although the immediate inflow may not be meaningful, it is expected that full inclusion of Chinese A-shares will mean they will eventually constitute approximately 18% of the MSCI Emerging Markets index and bring total index exposure to China to over 40%.

Based on the Taiwan and South Korea equity inclusion precedents, it took South Korea six years and Taiwan nine years to gain full inclusion within the MSCI indices. Both South Korea and Taiwan started with much larger open capital account positions than China has today.

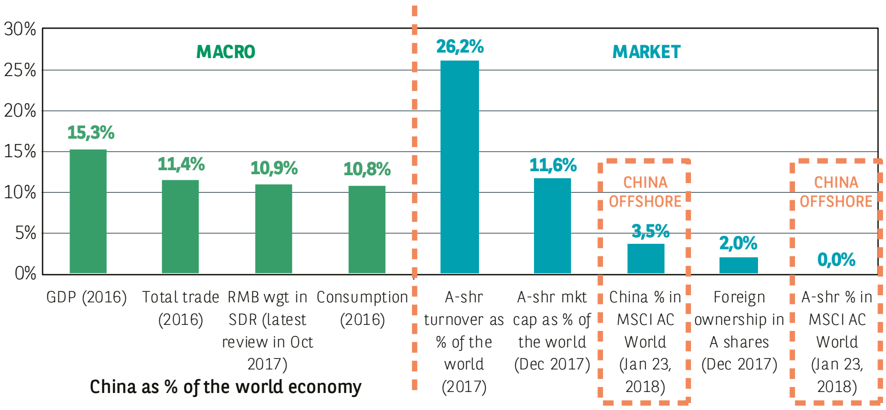
To secure full inclusion, China will need to open its capital account further and increase foreign ownership of stocks more significantly than is the case today. Notable hurdles include the trading quota system, trading suspensions, uneven international access standards and low quality corporate governance.

Although the MSCI inclusion of A-shares will initially be small in scale, we believe it will help improve global interest in China's A-share markets and encourage inflows into China. Our Greater China Equities investment team, managed by our Lead Portfolio Manager, Caroline Yu Maurer, believes inclusion in the MSCI indices marks a positive catalyst for Chinese equities and is of 'symbolic significance' to China as it is a signal of international recognition of China's market liberalisation. It should also help advance President Xi Jinping's ambitions to make the renminbi a global currency.

ENHANCING INVESTORS' PORTFOLIOS
with "All China" Equities

While numerous investors believe that Chinese equities are one of the most crucial investment opportunities in a generation, others are still waiting on the sidelines. Indeed, the high level of investment risk, low (but increasing) levels of transparency and a general unfamiliarity with local opportunities in China often make investors sceptical even as the growth opportunity passes them by. Although there are of course risks when investing in China, we believe that the opportunities for growth for Chinese companies (in Mainland China and globally) are broad-based and positive.

China equities appear under-represented given its strong economic contribution in a global context



Source: IMF, WFE, Wind, MSCI, FactSet, Goldman Sachs Global Investment Research, as of 20 February 2018.

FAVOURABLE MARKET FOR SKILLED MUTUAL FUND MANAGERS

It is our view that **the nuances of investing in Chinese companies are better understood by specialist managers devoting 100% of their time to the market**.

The clearest example of this is the significant role that China's ruling party plays in the market, which we expect to become more important as President Xi Jinping continues to consolidate his power base and push through his reform agenda. Understanding the politics of China is critical to understanding where to find opportunities (and risks) and a dedicated and well-resourced team can follow developments more closely. Looking through a narrower lens, there are examples of onshore Chinese companies within the consumer, healthcare and industrial sectors that are growing strongly and capitalising upon their competitive positioning within the China domestic market on a global scale. These investment opportunities are not always well known to fund managers with broader mandates.

Low correlation of Chinese equities relative to global equity markets

		Offshore China				Onshore China					Developed Markets				
	5-year correlaion	HSI	HSCEI	HSCCI	MXCN	SHCOMP	SZCOMP	SZSME	ChiNext	CSI300	SPX	DJI	Nasdaq	Nikkei225	Euro Stoxx 50
Offshore China	HSI	1.000	0.919	0.755	0.954	0.449	0.351	0.325	0.278	0.444	0.487	0.468	0.492	0.496	0.512
	HSCEI	0.919	1.000	0.745	0.951	0.577	0.412	0.373	0.310	0.576	0.440	0.425	0.428	0.442	0.468
	HSCCI	0.755	0.745	1000	0.805	0.524	0.525	0.503	0.445	0.498	0.373	0.353	0.408	0.333	0.354
	MXCN	0.954	0.951	0.805	1.000	0.532	0.413	0.382	0.324	0.528	0.472	0.449	0.487	0.459	0.484
Onshore China	SHCOMP	0.449	0.577	0.524	0.532	1.000	0.835	0.796	0.659	0.977	0.200	0.210	0.204	0.180	0.187
	SZCOMP	0.351	0.412	0.525	0.413	0.835	1.000	0.992	0.937	0.778	0.176	0.179	0.200	0.191	0.150
	SZSME	0.325	0.373	0.503	0.382	0.796	0.992	1.000	0.939	0.733	0.171	0.169	0.196	0.186	0.148
	ChiNext	0.278	0.310	0.445	0.324	0.659	0.937	0.939	1.000	0.592	0.166	0.163	0.196	0.191	0.147
	CSI300	0.444	0.576	0.498	0.528	0.977	0.778	0.733	0.592	1.000	0.180	0.192	0.190	0.158	0.171

Lowest correlation   Highest correlation

Source: Bloomberg, HSBC Qianhai Securities, as of December 2017

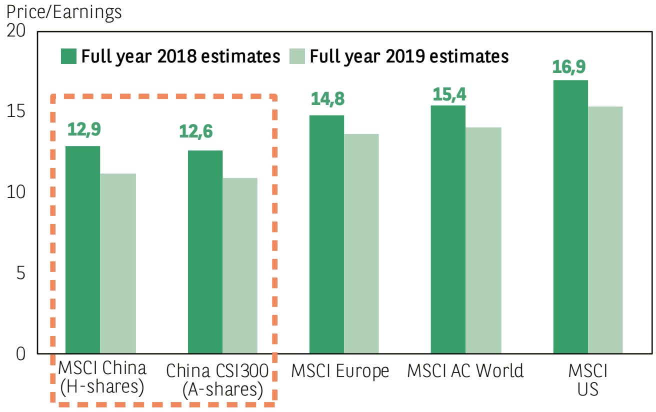
DIVERSIFICATION BENEFITS

International investors can benefit from consistently lower correlations in Chinese equity versus developed markets, which can lead to a greater diversification benefit. While exposure to Chinese equity can look challenging from a risk-return perspective, the diversification in the portfolio mitigates this to some extent, such that risk-adjusted returns may actually improve.

Investors who are exposed to the MSCI Emerging Markets Index may have some exposure to the Chinese economy. However, that exposure only represents some of China's publicly-listed companies, mostly those listed in Hong Kong (H-share) and the US (American Depositary Receipts or US ADRs) in its Emerging Market Index, while the onshore market (A-shares) will only be included from 2018. The A-share market has currently a low percentage of foreign investor holdings and a low correlation with other markets. MSCI's decision to include some China onshore companies in their indices was a significant milestone in the mainstream acceptance of Chinese equities in international investors' portfolios. A-shares could see stronger foreign fund inflows, lower volatility, higher institutional holdings, and diversified trading strategies.

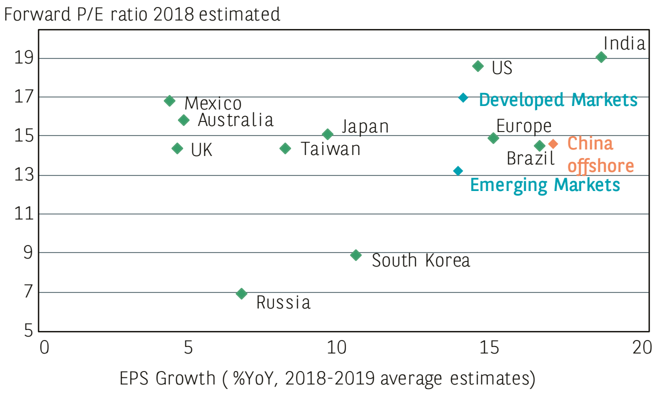
There remains a large discrepancy between China's share of the global economy and that of investors' equity allocations. We believe it to be inevitable that this margin will close as China continues to open up its capital markets to foreign investment.

Chinese equities markets: P/E ratio (vs. key markets globally)



Source: Bloomberg, Factset, Citi, 3 May 2018.

China enjoys strong EPS growth for low P/E
(vs. key markets globally)



Source: Bloomberg, Factset, Citi, 20 February 2018. EPS: Earnings Per Share. P/E ratio: Price-to-earnings ratio

ATTRACTIVE VALUATIONS

Chinese equity markets are also reasonably priced compared with their key peers in developed markets. In 2017, Chinese equity markets delivered returns of more than 15%, mainly driven by an improvement in corporate profitability and fundamentals. The MSCI China and MSCI China A indices were attractively valued at around 12.9x P/E and 13.6x P/E, respectively, thus representing a discount compared with MSCI US, MSCI Europe and MSCI World (as of 3 April 2018). **Not only does the Chinese equity market benefit from attractive valuations against developed markets, but it also enjoys strong Earnings Per Share (EPS) growth.**

RISKS AND OTHER CONSIDERATIONS

There are a number of risk factors related to investing in Chinese companies. Despite its manageable debt levels, China's debt reduction and state-reform programmes are directly addressing debt burden issues within the financial system. The Chinese government aims to create a unified regulatory framework to enable the more efficient allocation and accessibility of capital. The Chinese renminbi exhibited its resilience throughout 2017, appreciating by 5.2% against the US dollar. In addition, we have seen that liquidity in the market has remained adequate since 2016.

LOOKING AHEAD

The Chinese equity market is one of the most dynamic equity markets in the world. The opportunities today are too big to ignore, but China's market requires local expertise to navigate its waters successfully.

We expect China to provide an increasing number of global market leaders, which offers the opportunity for long-term investors to benefit from holding Chinese companies in enhancing the risk-return profiles of their portfolios.

GREEN CHINA:
Wait... Is China The Leader In Green Investments?

China is rapidly becoming one of the brightest stories in clean energy transformation. The Chinese government has introduced stricter regulations to protect the environment and direct significant investment into clean technology in a bid to reverse the damage caused by decades of energy-intensive growth. The government is implementing a comprehensive policy designed to achieve a sustainable, quality-focused economic growth model.

ENVIRONMENT ON THE GOVERNMENT AGENDA

The People's Bank of China (PBoC) estimates that **an annual investment of at least RMB 2 trillion (USD 300 billion) will be required to address environmental and climate change issues.** 85-90% of this investment will need to come from the private sector.

According to the environmental consultancy ENEA, China is set to invest USD 2.2 trillion across six sustainability-focused sectors by 2020, an amount close to India's GDP in 2017[13]. Renewable power, waste and water management, and measures to reduce air pollution will all receive sizeable investment. The sector likely to receive the largest investment is waste management, which should receive USD 831 billion.

A comprehensive policy being pursued by China's government

TOTAL: USD 2.2 trillion ▪ Investments to 2020

Source: ENEA Consulting analysis based on National Energy Administration, 2016 – IEA Energy Efficiency report, 2016 - International Trade Administration

By 2030, the Chinese government intends to[14]:

1. Reach peak CO_2 emissions,
2. increase the share of non-fossil energy to around 20%, and
3. reduce carbon intensity to 60%-65% below 2005 levels.

13. Source: ENEA Consulting analysis based on National Energy Administration, 2016; International Energy Agency (IEA) – Energy Efficiency Report, 2016; International Trade Administration – China's Environmental Technology report, 2017.

14. Source: China NDC (www4.unfccc.int).

CHINA: WORLD LEADER IN 'GREEN' INVESTMENT

In 2016, China became the world leader in green bonds, accounting for 35% of sustainable bonds issuance from almost zero in 2015[15]. China also represents about 30% and 27% of global investment in renewable energy and energy efficiency, respectively.

Green Finance Pilot Zones: Using the same gradual approach as Free Trade Zones, in June 2017 China implemented five green finance pilot zones as an incubator for green financing reform.

China's carbon trading market: In December 2017, China moved towards the launch of a nationwide carbon trading market by setting emissions quotas for companies in the power sector, after having launched seven carbon trading pilots system since 2013.

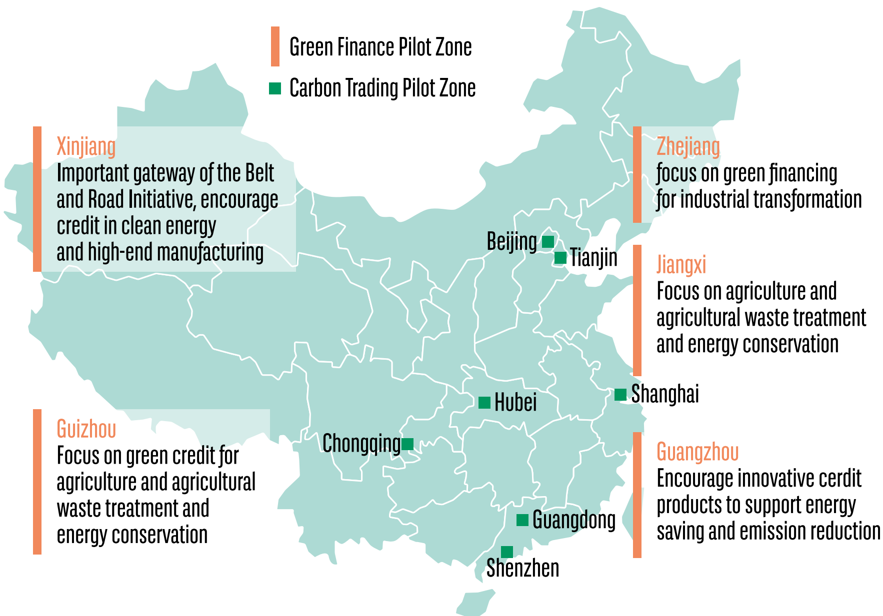
Green Belt and Road: The Chinese government has pushed businesses and institutions involved in the One Belt and One Road initiative to practise environmental protection in foreign countries, as illustrated in its guidelines on promoting 'Green Belt and Road'. Its involvement in the Asia-Pacific Economic Cooperation (APEC) green supply chain network and its initiative on environmental risk management for outbound investment also contribute to the 'green' push. Development banks such as the Asian Infrastructure Investment Bank (AIIB), New Development Bank (NDB) and Silk Road Fund also provide support for its global green finance strategy.

IN A NUTSHELL

DID YOU KNOW?

- China had about 99% of the 385 000 electric buses on the roads worldwide in 2017, representing no less than 17% of China's entire fleet.
- Given that standard buses consume 30 times more fuel than average-sized cars, electric buses are having a sizeable positive environmental impact.

China's carbon trading market



Source: China Daily, BNP Paribas Securities Services, as of February 2018.

China is promoting a national green financial system that provides incentives and easier financial access to green enterprises and limits activities in polluting, energy intensive industries. With the Chinese government's commitment at the 19th Communist Party Congress in 2017 to protect the environment, we believe that the country will continue to be a major player in green financing. ■

15. Source: China Green Bond Market 2016 report prepared jointly by the Climate Bonds Initiative and the China Central Depository & Clearing Company.

About
BNP PARIBAS ASSET MANAGEMENT

BNP Paribas Asset Management (BNPP AM) is the investment management arm of BNP Paribas, one of the world's major financial institutions. Managing and advising EUR 568 billion in assets as of 31 March 2018, BNPP AM offers a comprehensive range of active, passive and quantitative investment solutions covering a broad spectrum of asset classes and regions. With more than 700 investment professionals and around 600 client servicing specialists, BNPP AM serves individual, corporate and institutional investors in 70 countries around the world. Since 2002, BNPP AM has been a major player in sustainable and responsible investing.

BNPP AM's Greater China equity team is based 'on the ground' in Hong Kong and Shanghai and manages or advises on assets in excess of USD 1.0 billion (as of end of March 2018), for both local and international investors. The investment team is fully dedicated to Greater China equities research and their local presence and local background provides a strong edge in the interpretation of political, economic and social nuances in China. The investment team follows an active, high conviction, bottom-up investment approach, using a disciplined research process to identify sustainable growth companies over the long term. The team covers the 'All China' universe to fully capture the opportunity set and maximise return potential.

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HEAD OF GREATER CHINA EQUITIES,
LEAD PORTFOLIO MANAGER

Caroline has been leading the Greater China Equity strategy within BNPP AM since June 2015 and has been working within the financial services industry since 2003. Prior to joining BNPP AM, Caroline Yu Maurer was employed with Henderson Global Investors from January 2008 to February 2015. From 2008 to 2011, Caroline was the co-Manager of the Henderson Horizon China Fund. In January 2012, Caroline was assigned sole management responsibilities of the portfolio, and re-located to Henderson's Singapore office. While at Henderson, Caroline was also part of a three-person team managing the Henderson Asia ex-Japan Absolute Return Fund, with peak AUM of approximately USD 1 billion. She worked closely with the lead manager of the Henderson Asia ex-Japan Absolute Return Fund. Caroline holds a Master of Business Administration degree (majoring in Finance) from the London Business School. She has a Master of Science degree in Business System Analysis and Design from the City University in London. Caroline is a CFA® charterholder and a member of the United Kingdom Chartered Financial Analyst society. Caroline was born and raised in China. ■

- CHI LO -

SENIOR ECONOMIST GREATER CHINA

Chi is BNPP AM's Senior Economist for Greater China and is based in Hong Kong. Prior to joining BNPP AM, he was Head of Overseas Investment at Ping An of China Asset Management (HK) Ltd. Chi's other positions in Asia included Asia Research Head for the British private property fund Grosvenor, chief economist and strategist for Asia at Standard Chartered Bank and research director for Greater China at HSBC in Hong Kong. Before working in Asia, Chi was an economic advisor to the Canadian Treasury in Canada. His other experience includes international research firms in North America, regulatory bodies for securities trading in Toronto and London, and blue-chip international investment banks in North America, the UK and Asia. Chi is the author of 11 books on Chinese and Asian economic development and markets. His latest book is "Demystifying China's Mega Trends: The Driving Forces That Will Shake Up China and the World" (2017). Chi did his economics graduate work at the London School of Economics and Political Science (LSE) in England and the University of British Columbia (UBC) in Canada. ■

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INVESTMENT SPECIALIST,
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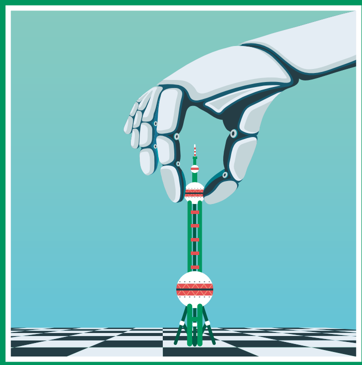
Jessica is the Greater China Equities team's investment specialist. In her current position, she works closely with the Greater China Equities and Asia Pacific Equities investment teams to market their capability to sales and clients globally. Prior to relocating to Hong Kong in 2014, Jessica first joined BNPP AM in Paris. She worked as a portfolio manager assistant in the Sustainable and Responsible Investment (SRI) equities investment team. There, she provided active support to the portfolio managers through in-depth portfolio analysis and the preparation of investment cases to aid decision-making. Prior to joining BNPP AM, Jessica held two different positions in BNP Paribas Wealth Management in Hong Kong. In 2012, she first worked within the Strategy and Business Development team. She then joined the Investment Funds Advisory team. Jessica holds a Master's degree in Management and a 'Diplôme des Grandes Écoles' with a major in Finance from the NEOMA Business School in France. ■



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