THE DRIVE YOU DEMAND

EMERGING MARKET TRENDS

Spring edition: China in transition

For Qualified Investors in Switzerland or Professional Investors or Eligible Counterparties as defined by the relevant laws

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The Spring edition of our publication Emerging Market Trends reviews opportunities and challenges created by China's economic transition and their impact on Chinese corporate bonds as well as international and domestic equity markets.

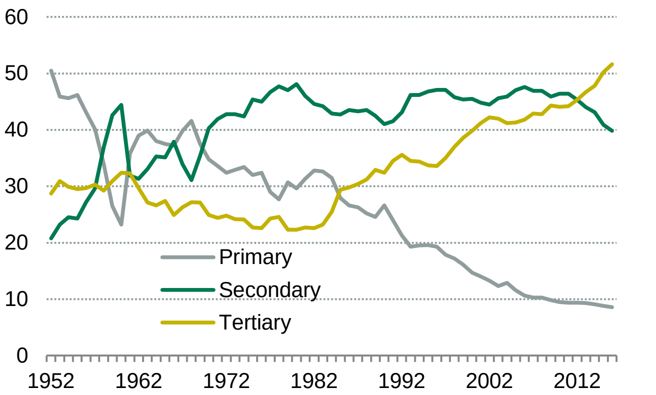
Key points

- *China's economic transition is well under way, as highlighted by the increasing share of domestic consumption and services in the overall economy.*
- *Few investors thus continue to fear a hard landing, but the size of the country's indebtedness may look worrisome.*
- *We expect the government to continue on the path of reforms and to rein in any risk of a banking crisis.*
- *This new economy creates many investment opportunities as well as some challenges in Chinese fixed income and equity markets.*

ON THE WAY TO A SUCCESSFUL TRANSITION

Over the last couple of years, the Chinese economy has been experiencing a profound, self-imposed, transition. Indeed, thanks to a series of measures implemented by the authorities, **domestic consumption is progressively becoming the main driver of China's economic growth**, and in 2016 for example, was responsible for over 4 percentage points of the 6.7% GDP growth. Domestic consumption has been compensating for the slowdown in manufacturing and exports, which has reduced the country's dependence on the global economy.

China GDP by industry



Source: Thomson Reuters Datastream

Moreover the success of consumption should lead to more investment in goods and services for consumers, diverting resources away from low value-added manufacturing sectors. Such a rebalancing should be helpful for social stability and have positive spill-overs on the global economy with Chinese imports boosting activity in other countries.

High frequency data is presenting a relatively optimistic picture. For most of 2015 and 2016 we witnessed consumption growth but declining industrial production. Starting from the second half of 2016, a number of industrial activity measures have also turned positive while consumption has remained strong. Since November 2016, imports have also returned to growth after many months of contraction signaling strong domestic demand.

Chinese authorities have clearly expressed that their aim is to continue to reform the economy. According to the statement accompanying the 13th five-year plan, China aims to double its 2010 GDP and per capita income of both urban and rural residents by 2020. This transition is welcome and, as we had already foreseen in our previous publications, it should help the country to avoid any "hard-landing", hence limiting any risk of contagion to global emerging markets (EM).

Investors' concerns have, however, turned towards what is now perceived as **China's main weakness: its high level of indebtedness** i.e. the legacy of the past investment-driven growth. While we acknowledge that this debt level is high, we believe that it remains well manageable, and that the risk of a systemic crisis is highly overestimated by some analysts.

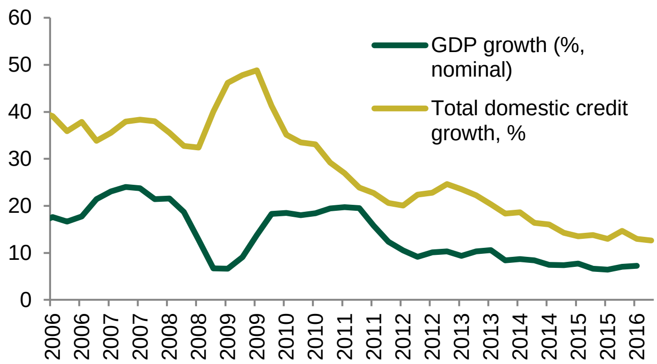
The debt load is heavy…

Emerging China's economy accumulated 146 pp of new debt (to GDP) since end 2008, with the total debt load of households, government and corporates at 246% of GDP at the end of 2016. A small portion of this fuelled household consumption and local government spending, while the bulk drove corporate investment in infrastructure, real estate, and manufacturing (and to a lesser degree, buying of foreign assets).

This has led to an increase in non-performing loans (NPLs), which some independent analysis already suggests could have reached 5.5% for the banking sector end 20151. This compares to recent official NPL estimate of 1.7%.

While such numbers may appear worrying, **sharp NPL increases and a banking crisis are not in our baseline scenario**. Indeed, since late 2016, the Chinese authorities have been using official guidance and new rules to slow lending to the real estate related activity. Also domestic interest rates have been nudged up by PBOC rate hikes and tighter liquidity management (1y interbank rates at 3.88%, +60bps y/y). This is in line with measures implemented over the last couple years aiming to gradually manage GDP growth lower while trimming average loan growth (and debt accumulation) rates down.

Low returns from fast credit growth



Sources: Bloomberg Finance L.P., UBP – 07.02.2017

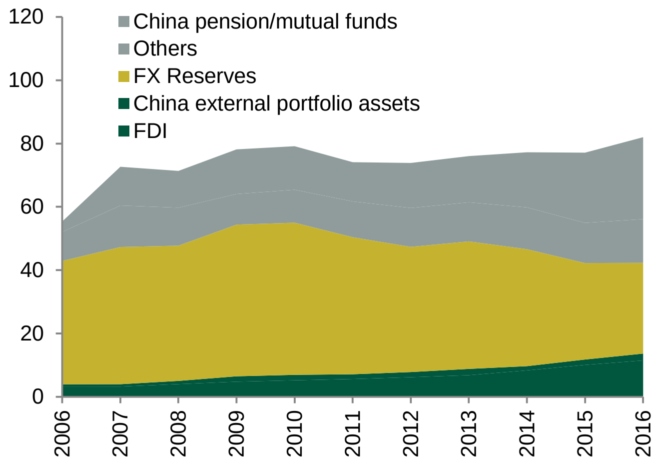
…But it is not too late to fix the problem

We see a number of **factors helping China's policymakers to stabilize debt** and head off a future banking crisis.

1. **Households are relatively unlevered with consumption driven by wages and dis-savings**. The consumption sector is large enough (half of the economy) and buoyant enough (8% nominal growth in 2016) to support GDP growth even as credit growth and investment activity by corporates slow down. Strong nominal GDP growth is a natural driver of de-leveraging and China is fortunate to have an important source of unlevered growth.

2. **The bulk of China's lenders and borrowers are state or quasi state-owned**. This means that the government can encourage debt rollovers and, the cleaning up of corporate balance sheets. The government can, for example, 1) force weak, heavily indebted corporates to close or merge with healthier ones; 2) finance debt clean up through different channels; or 3) facilitate deleveraging by encouraging large domestic asset managers to buy some of the debt from the banks.
The authorities have policy options to prevent or manage defaults. 44% of bank deposits are held by corporates and 17% by the government, meaning that policymakers have also a significant control over banks' funding base. These are useful levers that the government can pull on, even if so far it only did so moderately. We believe that the merger of two state-owned steel groups, Wisco and Baoshan Steel, as well as Beijing's encouraging local government to carry out restructuring plans for their indebted local steel companies (such as that for Bohai Steel Group, owned by the Tianjin city government) show that the authorities are willing to do more in that direction.

Assets/investors that can help deleveraging (%GDP)



Sources: Standard Chartered, UBP – 07.02.2017

3. **Funding rates both in CNY (domestic) and in USD (abroad) are low**. In the domestic market, yields on five-year bonds range from 3.1% for the government to 4.2% for low investment grade issuers (S&P and Moody's ratings). In the Eurobond market, the comparable yields are 3.1% – 3.7%. From a debt sustainability perspective, a critical metrics is the ratio of nominal GDP growth to the funding rate. Indeed, as long as this ratio is above 1, as is currently the case in China, the debt-to-GDP ratio will gradually come down – all other things being equal. As an illustration, assuming nominal GDP growth in China holds at the current 6.5% and somewhat all of the debt is rolled annually at 4%, debt-to-GDP ratio would fall from 246% to 240% after a year.

A good time to wean itself off debt

Now is a good opportunity for China to wean itself off leverage. Global growth and exports are strengthening which should support GDP growth in addition to strong household consumption. Both can help offset the growth drag from corporate deleveraging that should otherwise depress construction, the real estate sector and some manufacturing investment.

Trump's trade policies are a risk to China (through the exports channel) but China's has leverage over the US through its $1tn holding of US treasuries and consumption of 10% of US exports. Moreover, if the US does impose some sort of tariffs on Chinese goods, its impact on Chinese GDP growth can be offset by CNY depreciation and from strengthening sales to other markets. China has already been increasing its global political footprint with its One Belt, One Road initiative that has strengthened investment, trade and political ties with other countries in Eurasia. An inward-focused US could reinforce this trend, which could end up yielding China a greater share of global trade and growth as well.

CHINESE CORPORATE BONDS

The debt of Chinese corporate issuers reached 170% of GDP at the end of 2016 putting the debt sustainability of borrowers and investment in Chinese corporate bonds into question.

Investors have started to price in this increase in credit risk at the end of 2016, as investors started to factor in higher default rates and tighter lending standards. Between the end of November 2016 and February 2017, credit spreads on Tier 1 and Tier 2[2] rated corporate issuers increased by 40bps and 60bps respectively. Onshore government bond yields rose from 2.7% to 3.1% in the same period due to the government ongoing tightening policy in an effort to curb lending, cool the property market and stem capital outflows. As a result, Chinese onshore yields rose sharply into year-end 2016: yields on China's Tier 1[3] corporates in CNY rose from 3.1% at the end of November to 4.4% at the beginning of February 2017. **Chinese onshore bond markets experienced their first default ever in 2014.**

[2] Companies rated AAA and AA by Chinese local rating agencies – These ratings are NOT equivalent to a AAA/AA rating assigned by leading US and European rating agencies.
[3] Companies rated AAA by Chinese local rating agencies – This rating is NOT equivalent to a AAA rating assigned by leading US and European rating agencies.

Prior to that, government bailouts or forced lending masked existing inefficiencies and created a false sense of security. But as the government decided to embark on more "orthodox" policies, with the aim of cleaning up the economy, defaults started to materialise. 2015 saw the number of defaults rise to 7 with a value of CNY18bn ($US 2.6bn) whilst 2016 saw 15 defaults with a notional value of RMB 53.9bn ($US 7.8bn), which, given the vast size of the Chinese onshore market, represents a default rate of only 0.4%.

While defaults have picked up in the onshore market, they have remained limited in the USD market, with 4 issuers defaulting in 2015 and 1 in 2016 (all these issuers were rated B- or below at the time of default). We expect the USD market to continue to experience low levels of default going forward due to its high quality bias (75% of Chinese issuance is investment grade), whilst the number of defaults may continue to rise in the onshore market as the economy transitions from an investment-led to a consumption-driven economy and the government continues its reform path and attempts to de-lever the system. This, we would argue, is positive for the soundness of the Chinese economy and financial markets. Defaults have become increasingly necessary as policy makers re-insert some much needed discipline in the mispriced bond markets. **This should lead to further repricing of corporate risk**. Indeed, moral hazard had so far been the primary issue in Chinese bond markets, as local investors were accustomed to low levels of default, government bailouts and par repayments keeping the risk premium investors demand at historical lows.

The **banking sector** is likely to be negatively impacted by rising non-performing loans (NPLs). **But, as previously mentioned, we believe that this rise** should remain **manageable**. First, NPLs remain fairly low today (even when accounting for the fact that official numbers may be underestimated). Second, Chinese banks are well capitalised and provisioning levels are sufficient. We expect the more aggressive banks with low asset quality to fare worse but the impact on the large, part-government owned banks should be muted.

In the dollar denominated Chinese corporate bond market, another factor behind tight credit spreads has been capital outflows and currency depreciation which have spurred onshore investors to invest in their own USD-denominated bonds. Given the recent development in the cross currency swap basis and the spike in onshore yields we foresee an increase in USD supply going forward. However, with further depreciation pressure on the CNY, the strong onshore demand for USD credit should remain unabated. This has pushed spreads tighter and should help support current valuations for the near term.

CHINESE EQUITIES WITHIN A GLOBAL EMERGING MARKET EQUITIES PORTFOLIO

Fiscal stimulus, property market, high leverage, supply side reforms and Trump policies are some of the issues that will impact Chinese equity performance in 2017. We see a cautiously optimistic picture with potential outcomes falling in a wide range, creating some uncertainty for investors. Given China's 26% current weight in standard EM benchmarks, we believe that managing the China risk in a Global Emerging Market (GEM) portfolio will be an ongoing challenge in 2017 and beyond.

Starting a year of cautious optimism

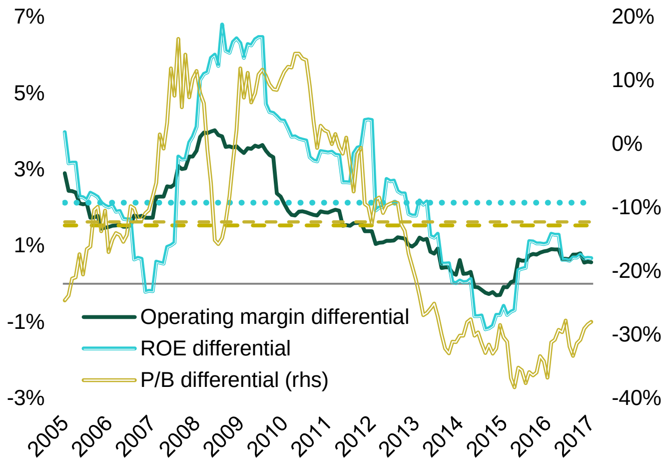
As we enter 2017, Chinese equities present a cautiously optimistic picture. We expect GDP growth of 6.5%, which is among the highest in the world. However, China is one of the three large economies in GEM where GDP growth is expected to decelerate in 2017 (others being Mexico and the Philippines).

One macro variable on which China does not rank well in a GEM context is its **currency valuation** based on real effective exchange rate. A combination of FED tapering expectations and Trump Presidency has led to a significant currency adjustment across EM particularly in countries like Mexico, South Africa and Turkey. Even though the Brazilian real and Russian rouble have strengthened in 2016, this was after a massive adjustment for both currencies in 2014 and 2015. Compared to all these currencies, the renminbi depreciation has been limited. This could make it harder for Chinese companies to compete with other EM in export markets and put pressure on their already low margins.

Consensus expects earnings per share for **MSCI China to grow by around 13% in 2017**. Even though this is in line with the GEM median, it is significantly lower than some of the peers like India (22%), Brazil (18%) and South Africa (21%). Furthermore, our earnings momentum score, which tracks the changes in earnings expectations, ranks China low among GEM countries.

Chinese equities are currently valued in line with with GEM, at 12x forward price-to-earnings (PE). However, it should be noted that historically China traded at about a 17% discount to GEM on forward PE and therefore it does not currently look attractive relative to its history.

EM bonds performance drivers – YTD



Source: Bloomberg Finance L.P., UBP – March 2017

China price-to-book of 1.72 is in line with the GEM average of 1.67. However, China's return on equity (ROE) has been deteriorating relative to other emerging markets since the second half of 2015. Although this stabilised in the second half of 2016, it is too soon to conclude that the relative deterioration has stopped. Unless Chinese ROEs start improving in 2017, investors may be unwilling to pay the current book value multiples.

There are some reasons to be optimistic on this front, though. After 54 months of deflation, PPI finally moved into positive territory in Q3 2016. Better pricing power, the recovery in commodity prices and the positive impact of supply side reform may indeed signal the end of margin contraction in the country. After reaching a peak of 18% in 2010, operating margins have been on a steady decline hitting a low of 13.5% in Q3 2016. Since then, operating margins have stabilized and slightly improved but it may be too soon to conclude that margin deterioration is over.

Critical factors to watch

Going forward, some of the factors we will be watching closely include fiscal stimulus, property market, leverage and bad debt, supply side reforms, the potential impact of Trump's policies and A-shares inclusion.

Fiscal stimulus is likely to play an important role to reach government's GDP growth target of 6.5% in 2017. Large weight of fixed asset investment (FAI) in GDP and measures to cool property investment means that FAI growth has to rely more on infrastructure investment. This is being confirmed by construction companies who are already seeing a number of new orders.

After more than a 20% price increase from trough to peak in 2015/16, we are seeing some stabilization in the **property market.** Sales volumes have dropped after the introduction of restrictions and year on year growth in new starts has slowed down to 4.9% at the end of 2016. This could lead to a small correction in property prices in 2017 which is likely to be limited since the stock of saleable inventory has come down and remains low.

We also monitor closely **the banking sector**. Already Chinese banks have some of the largest leverage ratios in GEM. Total assets to equity in MSCI China financials is 11.2x. This compares with a range of 6.3x (Indonesia) to 9.2x (Brazil) in the large EM countries we track. Just to put things into perspective, this figure is 8.1x for the MSCI US financials index.

The rise in bad debt was mainly driven by property and mining sectors. The increase in bad debt was particularly striking in the real estate sector since it happened despite the strong property price rally. This concerns us for the period ahead where we expect a correction in property prices. We are slightly more comfortable with the mining sector since previously falling commodity prices have started to recover in 2016, a trend that could continue this year.

Overcapacity problems still persist particularly in steel, aluminium, coal, cement and glass. It is likely that the first two of this list will be in focus in 2017 as they are dominated by large state-owned enterprises (SOE). The **SOE reform** has been slow since its announcement in 2015. However, markets expect a pickup in 2017 as President Xi has increased the role of Party management in SOEs. If the reform progresses in line with expectations and the external environment does not deteriorate, 2017 could indeed mark the end of the deterioration in margins and ROE for Chinese SOEs.

The biggest unknown for 2017, in our view, is **the potential impact of President Trump's policies**. So far, the market has chosen to take a relatively relaxed view of Trump's election rhetoric on trade. Therefore, this is one area where we believe markets are vulnerable to downside risks. Steel and auto are two sectors in China where we would be cautious on risks of potential trade restrictions.

That said, while no country can be immune to the negative effects of a potential global trade war, China is probably one of the better positioned countries thanks to the existence of a large domestic market which could sustain growth. Furthermore, China could offset some of the potential losses by gaining more say in the design of international trade. For example, the withdrawal of the US from the Trans-Pacific Partnership could give the opportunity to China to further its trade influence in the region.

Another likely impact of Trump policies is the risk of rising rates in the US. This would limit any potential interest rate cuts in China and likely trigger further attempts to control capital outflows. Tighter monetary policy would be a source of pressure on growth, earnings and valuation multiples.

Clearly, there are significant uncertainties related to all of the points above. In the case of China such uncertainties should be particularly unsettling for investors, as **the country constitutes 26%** of standard market cap weighted GEM benchmarks. In the future, caution will be even more warranted as this number is likely to increase even further towards **40% after the potential inclusion of A-shares in international benchmarks**. MSCI should make an update on this issue later this year. Over the long term, it is likely to be more a question of "when" rather than "if". But we are yet to see what position MSCI will adopt following the recent restrictive measures introduced by the PBOC on the flow of capitals.

CHINA DOMESTIC EQUITY MARKETS: UNCOVERED OPPORTUNITIES

The China domestic equity market is volatile and full of uncertainty but never short of investment opportunities. After all, the current situation is the result of the raft of economic reforms meant to enhance the contribution from the tertiary industry.

As reforms continue to be implemented, we expect the Chinese economy to undergo a more balanced, inclusive and sustainable development.

Within those reforms, we see the emergence of a new economy. In this "**new China**", investment cases are emerging as key targets for long-term investors. Among others, compelling investment ideas are emerging from national defence, aerospace, new-energy automobile, medical services, information, intelligence concepts, and TMT. Basically those are the sectors highlighted in the 12th and 13th five-year plans. Even though some of these concepts are quite mature in Western countries, this is not the case in China yet.

Some of the companies in these sectors offer double-digit growth and have strong management teams. The performances this year are the reflection of a shift in investors' appetites from government-led sectors like banks to more nimble enterprises. Because most investors are gradually acknowledging the rise of privately-owned and managed businesses, those stocks are starting to rerate.

A or H-shares

H-shares have been the only access to China for most investors, but following the recent market liberalization efforts made by the Chinese authorities, the world's 2nd largest economy is now more easily accessible for foreign investors. The opening of the domestic market A-shares provides an opportunity for investors to broaden their exposure to the fastest growing segments within China (51 stocks in the MSCI China Index vs. 338 in the MSCI China A index for Consumer Discretionary, Consumer Staples, Health Care, Information Technology) via a subset of companies where one can find 'better' companies for cheaper than if one was selecting from only the H-share universe. In addition, it also gives investors the ability to better manage risks of the restructuring of the 'old economy' sectors (Industrials, Materials, Energy, Financials, etc.) with 480 potential names to choose from in these sectors in the A-share market compared to 97 in the H-share market.

Koon Chow
Emerging Market Fixed Income
koon.chow@ubp.com

Mathieu Nègre
Emerging Market Equities
mathieu.negre@ubp.com

Karine Jesiolowski
Emerging Market Fixed Income
karine.jesiolowski@ubp.ch

Cédric Le Berre
Chinese Equities
cedric.leberre@ubp.ch

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