ASIA CONNECT

Q4 2017

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ASSET MANAGEMENT

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CONTENT

ASIAN EQUITIES TAKE A BREATHER, CREATING A BUYING OPPORTUNITY

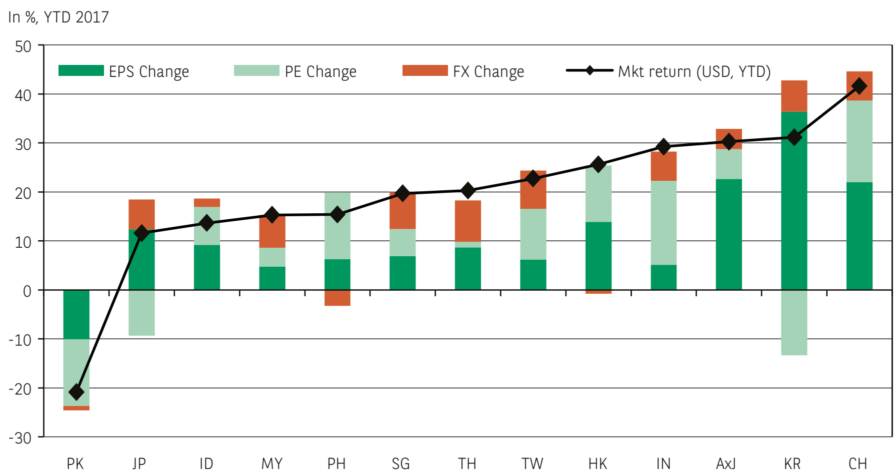
Asian equities performed well in the nine months to 30 September, returning more than 30% in US dollar terms. After such a strong performance, it is natural to assume some moderation towards the end of the year. The cushioning factor is that the H1 2017 gains were mainly driven by earnings revisions and currency appreciation, more so than higher valuations. Our Asia Pacific Equities team believes the acceleration of the earnings cycle over the next few years can support a continued strong performance. Consequently, we believe any pullback in Asian equities represents a buying opportunity for long-term investors.

Time for a breather

Asian equities have outperformed larger emerging and developed markets so far this year, with China offshore, South Korea and India as the top performers.

A combination of (1) earnings upgrades, (2) stronger regional currencies and (3) increases in price-to-earnings multiples from a low base was the main reason behind this regional rally. A number of key factors supporting this uptrend have remained in place: a weaker USD, China's better growth outlook and improving results from supply-side discipline in Chinese companies.

Earnings growth: the main driver of Asia's market performance (year-to-date)



Source: MSCI, Thomson Reuters DataStream, HSBC; data as of 14 September 2017

After this year's great rebound in Asian economic activities, we can expect momentum to taper off towards Q4 2017–early 2018, given the weaker commodity prices and the base effect of strong growth. The cycle of earnings upgrades in the two sectors (information technology and materials) that saw most of the increased forecasts appears to be softening.

Watch out for an attractive entry point

Despite the pullback by Asian equities, we remain bullish for the longer term, given our optimism that Asia will benefit from continued improving regional growth, stable macroeconomic conditions and undemanding valuations. We do not expect Asia to face any major crises any time soon.

1. **Improving economic activity** - While GDP growth is expected to remain relatively stable year-on-year, Asia continues to deliver higher growth relative to other regions. We continue to see structural opportunities in India and the ASEAN countries over the longer term given the working-population growth, the lower penetration of products and rising disposable income. Strong trade tailwinds and the renewed product launch cycle in the tech sector should continue to benefit the North Asian export markets of South Korea and Taiwan.

2. **Earnings recovery** – Asia is currently in the first year of an earnings recovery after six years of curbed profit growth. After strong earnings growth this year, we believe that it may soften in 2018, but remaining at a healthy double-digit level.

3. **Stability in China** - Increased rigour in risk mitigation ahead of top-leadership changes in Q4 are crucial for Beijing to preserve economic, social and political stability. Stability in China should allow for a stable year for Asian equity markets.

4. **Resilience against external shocks** – Most Asian currencies have appreciated against the USD this year. A stable oil price supports ASEAN equities, alleviating pressure on fiscal deficits. Across Asia, foreign exchange reserves remain healthy and provide sufficient liquidity, limiting the impact of action taken by leading central banks at a time when markets are concerned about another taper tantrum.

5. **Undemanding valuations** – Asian equities are trading at a discount versus the US and Europe. The MSCI AC Asia ex-Japan is at 14.1x P/E (FY 2018 Bloomberg estimates, as of 3 October 2017).

6. **Global investors remain underexposed to Asia ex-Japan** – Global mutual funds, totalling more than USD 1 trillion in assets under management, are about 520bp underweight, representing large inflows potential for Asian equities.

As bottom-up stock pickers, our team believes that competitive long-term returns are achieved by identifying high-quality companies that benefit from structural supply and demand drivers and holding them for the long term. It is a core belief that sound fundamentals drive stock prices over time. In our view, any near-term correction in Asian markets should be viewed as a buying opportunity given that the current policies aim to support the medium and longer-term outlook in Asia.

Despite the pullback by Asian equities, we remain bullish for the longer term, given our optimism that Asia will benefit from continued improving regional growth, stable macroeconomic conditions and undemanding valuations.

Questions?
Ask the contributor

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If Chinese bond markets eventually catch up with the levels of foreign ownership elsewhere, it would potentially translate into several USD trillion of inflows over the years.

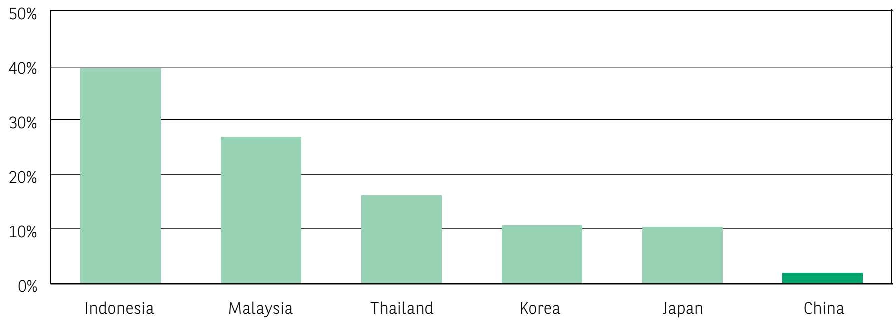
THE CENTRE OF EMERGING MARKET DEBT LOOKS SET TO MOVE EAST

Emerging market fixed income is no longer recognisable as the asset class it was 20 years ago. As it has evolved into the rich and diverse asset class it is today, its overall structure has all the while gradually shifted from loans to bonds. In this article, we look at the next major development that we anticipate will again redefine the asset class over the coming years. It can be summed up in one word: China.

China: the most under-owned bond market in the world

As the third-largest issuer of bonds globally behind only the US and Japan, it may seem surprising that China is currently the most under-owned bond market in the world. Foreign bond ownership in Indonesia currently stands at ±40% and in Malaysia it is ±25%. Yet in China, foreign ownership is very low, at ±2%. If Chinese bond markets eventually catch up with the levels of foreign ownership elsewhere, it would potentially translate into several USD trillion of inflows over the years.

Foreign holdings in local currency government bonds

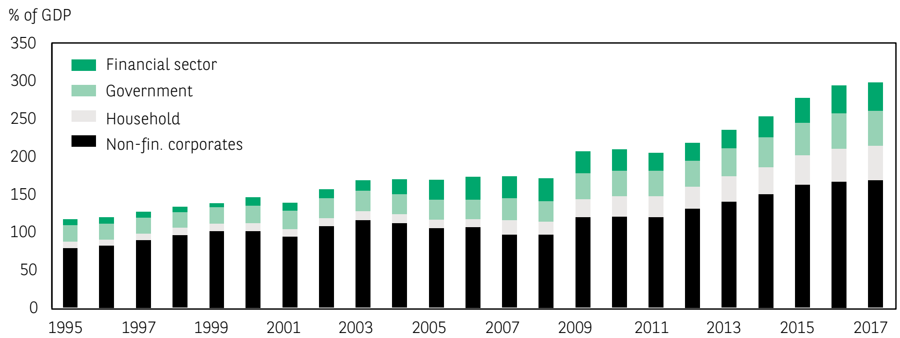


Source: BNPP AM, as at March 2017

Attracting significant amounts of new money is critical for China

A decade or so ago, as China had a low debt-to-GDP ratio and a fiscal deficit of around only 2%, there was no real incentive for the policymakers to let foreign investors in. However, recent developments and the current Chinese macroeconomic environment lead us to believe their position is now fundamentally different. From a macroeconomic perspective, it is clear that China is faced with a considerable challenge. Its debt-to-GDP ratio currently stands at ±280% and it has a high fiscal deficit-to-GDP ratio of ±9%, based on IMF data. In short, the country clearly has too much debt. Although this may not present any imminent danger, unless action is taken now to reduce the debt problem over the coming years, China will face significant fiscal risks. It is therefore critical for Chinese policymakers to ensure they are successful at attracting significant amounts of new (overseas) money.

China: Total Debt-to-GDP



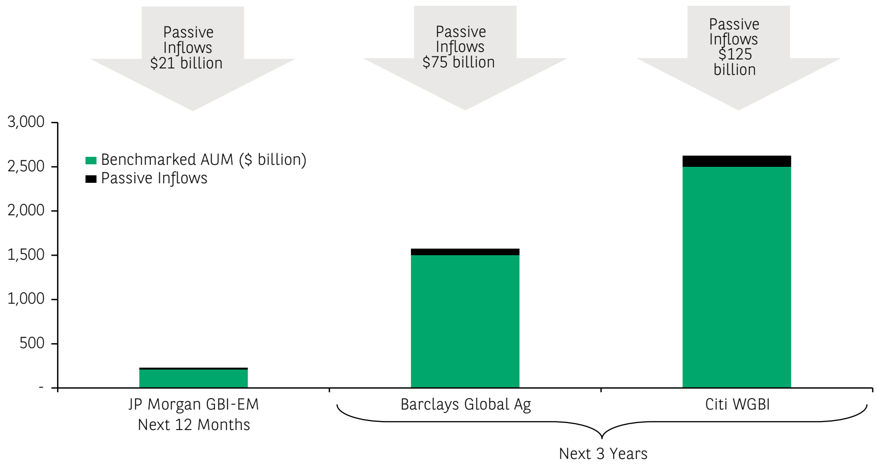
Source: IIF, as at July 2017

Inclusion of China in emerging market and global bond indices

We expect that, within the next six months to one year, it will be announced that China will be included in most emerging market and global bond indices. This would be a game-changer for emerging market investors.

Based on our own estimations, were China to be included in the JP Morgan GBI-EM Global Diversified index, the first of the major indices in which we would expect to see the inclusion, we anticipate it would generate passive flows of ±USD 20-25 billion into China. Our estimate is based on a likely index weight of 10%, investors likely staying somewhat structurally underweight, and some of them not immediately being in a position to access the market.

We believe that inclusion in the Bloomberg Barclays Global Aggregate index would take slightly longer – perhaps 12–18 months – but that this would eventually result in inflows of ±USD 75 billion. Furthermore, were China to be included in the Citi WGBI, which we see as feasible in the next three years, we estimate the resulting inflows to China would be at least USD 125 billion. Overall, China's index inclusion could, in our view, generate ±USD 200-250 billion of inflows into China.



Source: BNPP AM projection, as at 16 August 2017

These developments would result in the gradual shift of the centre of emerging market bond investment back towards the east of the region. This would not so much be the case with sovereign hard currency side, as very few Asian countries issue sovereign debt in external currencies. It is in the local currency bond market where we expect to see the impact. Historically, Asia has had a relatively low representation in the local currency fixed-income indices since China has not been included. But as and when China is included (at an assumed weight of 10%), Asia's weighting is likely to rise to over 30% of the benchmark and we thus expect the region to become a key driver of the asset class over the coming years.

We acknowledge that there remain issues to be resolved in terms of investing in the Chinese bond market. This is especially the case with corporate bonds, which we view as too expensive, and where the price discovery mechanism is still only at an embryonic stage and the default risk is generally underestimated by markets participants. However, we believe the future bond investment opportunities opening up in China are genuinely of the 'once in a lifetime' kind.

Questions?
Ask the contributor

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The trend of steady inflows from retail investors looks set to continue, as Indian investors remain underinvested in equities, which represent only 3.8% of households' total assets.

Questions?

Ask the contributor

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Investment Specialist
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DOMESTIC RETAIL INVESTORS: THE RISING FORCE IN THE INDIAN EQUITY MARKET

While ownership of foreign portfolio investors (FPI) in the Indian equity market touched a record high of 27.5% in Q2 2017, the main change over the last three years has been the growing proportion of domestic retail investors. In fact, since the general election of May 2014, Indian retail investors have poured no less than USD 51 billion into the Indian equity market. Is domestic retail investors' interest in the Indian equity market sustainable, or merely a passing fad?

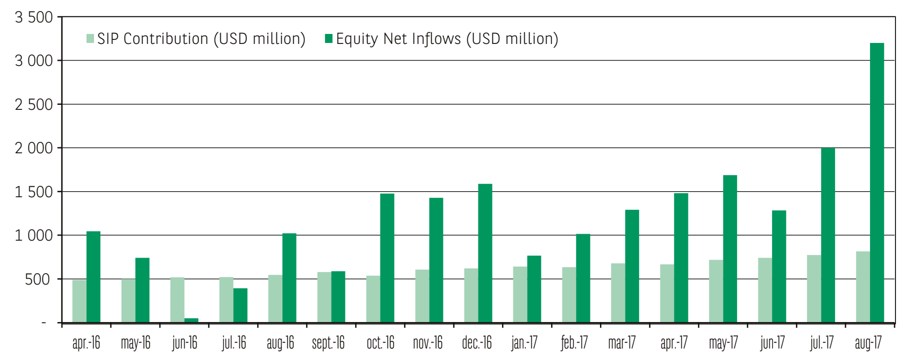
Positive real rates and higher confidence in the economy

Retail investors' appetite for equities can be explained by the consistently low inflation and positive real interest rates since 2014, which have encouraged a shift from over-reliance on physical assets such as property and gold to financial assets. Furthermore, India's improved macroeconomic stability and the government's ambitious reform programme have also fuelled greater confidence in the growth prospects for the Indian economy, leading to a renewed interest in the equity market. The trend has been further boosted by India's favourable demographics, with younger people showing they have a higher risk appetite.

Systematic Investment Plans (SIPs): when retail investment means stable flows

In some equity markets such as those in China, large-scale retail investment tends to engender high stock market turnover and volatile flows. However, in India the situation is completely different. Indeed, a key characteristic of domestic retail equity inflows has been the increasing popularity of SIPs, which enable retail investors to deposit on a regular basis a fixed amount in a mutual fund scheme, with a low minimum ticket size (starting from around USD 8). In fact, in the financial year ending in March 2017 (FY2017), SIPs collected no less than 72% of the total inflows into local mutual funds.

SIPs have been providing stable and growing support to the Indian equity market



Source: Association of Mutual Funds in India, as of end-August 2017

Thanks to their systematic nature, SIPs have supported the market even in 'risk-off' months, as in June 2016, when their contribution kept Indian equity inflows positive despite Brexit-related outflows from foreign investors.

Bright prospects ahead

The trend of steady inflows from retail investors looks set to continue, as Indian investors remain underinvested in equities, which represent only 3.8%[1] of households' total assets as of March 2017. The immense growth potential is well illustrated by the underpenetration of India's equity mutual funds, whose assets under management (AUM) stand at only 4% of India's GDP, far below the global average of 29%[2]. As the shift from physical to financial assets continues, AUM in domestic equity mutual funds could jump from USD 111 billion as of end of August 2017 to USD 1 trillion over the next ten years[3], providing sustained support to the equity market.

1 Source: CLSA, Bloomberg, RBI, ACE Equity, CMIE, SEBI, as of end-March 2017
2 Source: IIFA, AMFI, CLSA, as of April 2017
3 Source: Morgan Stanley estimates, taking into account market effect, as of September 2017

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[4]:

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

Here are some astonishing numbers[5] corroborating the fact that the common perception of China as a follower needs to change.

2018

CHINA'S R&D SPENDING

is expected to surpass that of the US and Japan

With 2.1% of its GDP, China has spent more on research and development (R&D) than the EU since 2014, while the pace of spending is accelerating at a much faster pace than in the US (2.8% of GDP). Also, China has become the clear leader in patent application, with over 1 million of applications in 2015 (vs. less than 400,000 in 2010), largely outstripping the US, Japan or Europe (all below 600,000 in 2015).

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 example of Alibaba is telling. With USD 5.9 trillion of transactions, Alipay users globally are as large 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[6].

2.8 mn

SCIENCE AND 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, 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. This represents a significant opportunity to invest in Chinese companies driving this trend.

Innovation is an imperative for China, as its labour force is no longer growing and the return on fixed asset investment is declining.

Questions?

Ask the contributor

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4 Source: McKinsey Global Institute, as of October 2015
5 Source: OECD, UBS Research, as of 13 September 2017
6 Source: Bloomberg, as of October 2017

> Both the Dongbei default case and the newly tightened regulation on negotiable certificates of deposit issuance are evidence of China's structural reform progress on dealing with its debt and capital allocation problems.

CHINA'S PROGRESS ON DEALING WITH ITS DEBT RISK

SOEs: no longer sacred

Beijing has been using a partial-default strategy to tackle the country's debt problem by paying in full the principals of all failures, allowing only partial default on couple/interest payments. However, this policy of forbearance might have come to an end in August 2017 when Beijing allowed Dongbei Special Steel Group, a state-owned enterprise (SOE), to default on the principal of its debt. This was the first case of principal loss in a public bond default in the onshore market. In our view, the move should show itself to be structurally positive for China's fixed-income market in the long term, even though it may well augur the short-term pains of more defaults emerging.

The Dongbei bond default was a landmark case, with large investors holding more than RMB 500 000 (about USD 75 000) of debt at face value taking a 78% haircut on their principal if they opted for a cash settlement (creditors holding less than RMB 500 000 were still repaid in full). They could opt for a debt-equity swap at the rate of one yuan of debt for 0.175 yuan of unlisted equity. Most large bondholders, mainly securities houses and mutual funds, would likely take a cash settlement because most institutional investors are not allowed to hold unlisted securities in their portfolios.

We have long argued that China's excess capacity problem was due not only to debt build-up but more crucially to capital misallocation stemming from the implicit guarantee policy favouring the SOEs and their soft budget constraints. The low 22% recovery rate of the Dongbei bond default has likely set a benchmark for future haircuts for investors, and sent an important signal to the market that SOEs are no longer immune to default.

The whole debt resolution plan, which includes a debt-equity swap, paves the way for more zombie companies (including SOEs) to default or to restructure their debts so as to improve the credit pricing mechanism in China. It is likely to have the far-reaching effect of cutting excess capacity as zombie companies exit the system.

Beijing appears ready to be retreating further from its implicit guarantee policy. To handle more default cases, it has recently increased the number of bankruptcy courts to 90 from just five at the beginning of 2015[7]. This approach looks set to continue. Between January and July this year, the courts accepted more than 4 700 restructuring and liquidation cases, equivalent to 83% of all the 5 665 cases accepted in 2016. Sixty-four percent of those cases in 2016 were resolved, with 85% of the resolved cases resulting in liquidation.

Reining in shadow banking

In a separate move to rein in debt, the People's Bank of China (PBoC) in mid-August announced a plan to slow the growth of negotiable certificates of deposit (NCDs), to be effective from Q1 2018. The move is credit-positive especially for the onshore banks, as it will curb their reliance on wholesale funding.

Current regulations exclude NCDs from the calculation of a bank's compliance with the cap that limits its wholesale funding to one-third of its total liabilities. The new regulation will include short-term (one year or less) NCDs[8] in the calculation as part of the PBoC's macro prudent assessment (MPA) framework, which is a quarterly assessment by the central bank on the commercial banks' financial risks, including their excessive reliance on wholesale funding.

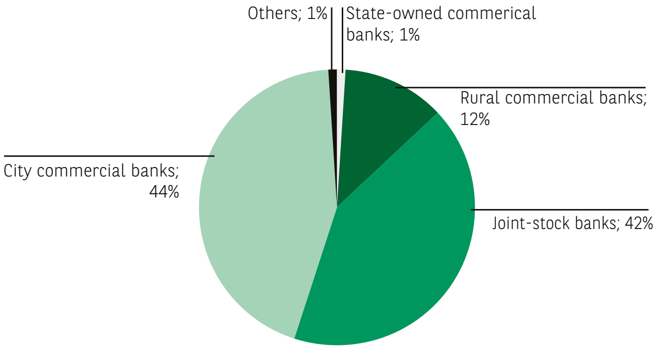
Crucially, the new regulation cuts multi-layer lending by barring a bank from issuing NCDs to fund the purchase of another bank's NCDs, thus reducing regulatory arbitrage and rent-seeking. The new regulation is indeed an extension of the 'surgical' regulatory tightening since March this year to force debt reduction in the onshore wholesale funding market. Small, regional (including city commercial and mid-sized joint-stock) banks will be the most affected since they are heavy users of wholesale funding (chart 1).

7 Source: "China bankruptcy cases surge as economy slows", Financial Times, 27 February 2017

8 Short-term NCDs accounted for 99% of all NCD issuance in 2016

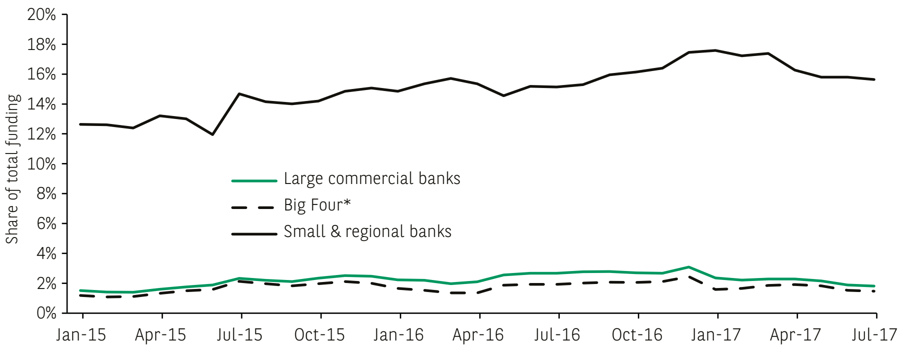
While structurally positive for the system, the new regulatory tightening may give rise to the risk of some localised financial failures due to the rapid expansion of small and regional banks, many of which have engaged in regulatory arbitrage through opaque and complex financial activities funded by wholesale funding. It is worth noting that interbank borrowing by small and regional banks has risen from 12% of their total funding sources in 2015 to almost 16% recently, compared to about 2% in the case of the large commercial banks and the Big Four (chart 2).

Chart 1: Types of NCD issuers (1H 2017)



Sources: Moody's, BNPP AM (Asia), as at July 2017

Chart 2: Source of funding from the interbank market



* Bank of China, Industrial and Commercial Bank of China, China Construction Bank, Agriculture Bank of China

Sources: CEIC, BNPP AM (Asia), as at August 2017

In conclusion, both the Dongbei default case and the newly tightened regulation on NCD issuance are evidence of China's structural reform progress on dealing with its debt and capital allocation problems. They should be credit-positive for China in the long term but come with the likely short-term cost of rising defaults and localised financial failures.

Questions?
Ask the contributor

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> While investors might still have concerns over China's financial sector's health and stability, we believe that the situation is improving as the gap between credit growth and nominal GDP growth has actually narrowed this year.

THREE LOWS, THREE HIGHS: UNCOVERING VALUE IN CHINA'S FINANCIAL SECTOR

Investors in the China A-shares market may currently have mixed feelings. On the one hand, they may be satisfied by the outstanding H1 2017 earnings results. On the other hand, they may still have concerns over China's economic slowdown or credit quality following the country's sovereign credit rating downgrade in September by credit rating agency Standard & Poor's. After the strong rally since the beginning of this year, stock valuations in a number of sectors are starting to look expensive. For that reason, we focus here on financials, an often-overlooked sector which we believe may offer good potential upside in the current market based on factors that we call the "Three Lows, Three Highs".

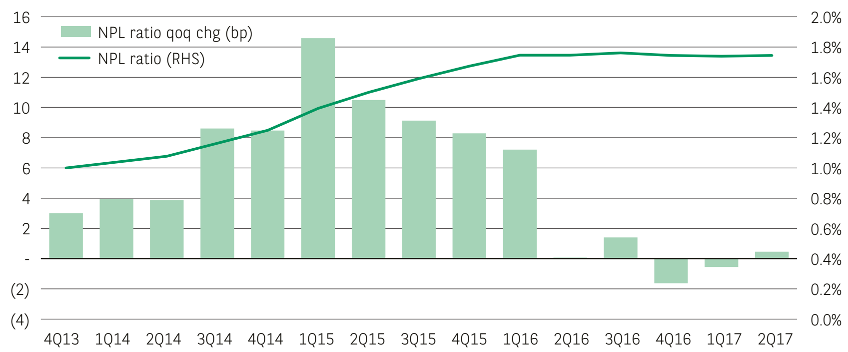
"Three Lows, Three Highs"

Low	1. Non-performing loans (NPL) ratio	2. Valuation	3. Underweight by foreign investors
High	1. Interest rate	2. Dividend pay-out ratio	3. Net interest margin

1. Lower NPL ratio

In the past four years, banks in China have recognised around USD 750 billion of non-performing loans (NPL), mostly coming from the private sector. Encouragingly, NPL ratios now seem to have peaked and even to have fallen to 1.74% as of the end of June 2017. This decline has been helped by financial improvements in China's overcapacity industries. In particular, we have seen profits recovering in the mining and materials sectors, which used to be debt-laden sectors and the main contributors to NPLs in recent years. We believe reforms in these industries are likely to help further stabilise the NPL ratio and hence ease market participants' concerns over banks' asset quality.

NPL have now peaked and even started to decline



Sources: CBRC, UBS Research, as at July 2017

2. Low/attractive valuation

The Chinese onshore stock market has performed strongly so far this year, with the CSI 300 Index surging by 15.90% as of the end of September in CNY terms. As a result, the stock price of some leading companies has risen significantly, and their price-to-earnings (P/E) ratios are becoming too expensive (CSI 300 Index current PE: 16.4x). By contrast, the financial sector's current P/E ratio is relatively attractive, at around 6x to 10x, with the estimated 2018 P/E at only 5x to 8x. In fact, from a price-to-book value (P/B) perspective, most banking stocks remain below one, which is generally viewed as undervalued.

Historically, we can see that banks' stock prices and the Purchasing Managers Index (PMI) in China are highly correlated. We thus believe that investor perception of China's economic sustainability is driving the banking sector's stock value. Given the improving PMI trend, investor confidence in the financial sector could rise.

3. Low ownership by foreign investors

The financial sector, which is still largely under-owned by foreign investors, is expected to attract foreign investment inflows, especially after the MSCI inclusion of China A-shares. The financial sector accounts for the largest portion of the 222 A-share stocks being included in the MSCI indices, with a weight of 36%. Simply based on the upcoming 5% inclusion factor, inclusion in the indices is expected to attract around USD 2 billion of passive inflows to the A-shares market, according to Goldman Sachs Research.

1. High dividend pay-out ratio

Another reason why we find better value in the financial sector than in other sectors is due to its above-market average and stable dividend pay-out ratio, which currently ranges between 4% and 6% for most banks.

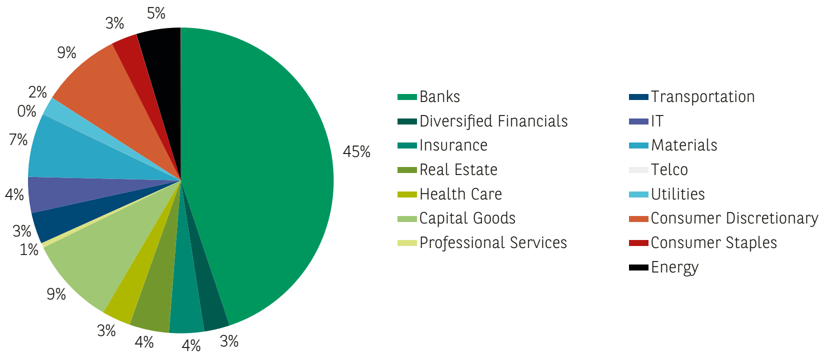
2. High interest rates

The ongoing tightening stance by the authorities is expected to keep interest rates high (current China Central Bank - 7 day interest rate: 3.45%), which should mean that banks and insurance companies can benefit from the high market rates for their assets investment. Additionally, higher rates also allow banks to increase their lending rates to clients, normally generating higher revenues.

3. High net interest margin

In terms of profitability, we expect to see the loan-to-deposits spread widen, which would improve banks' net interest margin (NIM) over the rest of this year, especially in the case of larger banks. In fact, in the A-shares market, 25 listed banks accounted for almost half of the earnings in the second quarter of the year, reflecting the improvement in the sector.

Financial sector accounted for more than half of the earnings in the China A-shares market in Q2 2017



Source: WIND, as at September 2017

What other people might ignore could be your opportunity

While investors might still have concerns over China's financial sector's health and stability, we believe that the situation is improving as the gap between credit growth and nominal GDP growth has actually narrowed this year. Fuelled by these "Three Lows, Three Highs" factors, we believe the sector may deserve greater attention from investors and could offer attractive return potential. Within the financial sector, we believe larger banks are better placed due to their solid deposit base, better liquidity management and lower reliance on interbank and wholesale funding. Asset quality should however be monitored closely for state-owned enterprise (SOE) banks, as by their nature they are more likely to have a higher exposure to SOE loans.

Questions?
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