Increasing Volatility in the Chinese Market: How can Asia’s Capital Markets cope with this?

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BNP Paribas Investment Partners
Topics for discussions:

1. **Economic Volatility**
   Hard landing vs New Normal

2. **Stock Market Volatility**
   ↓40.5% from peak vs ↑31.3% from 12 months ago*

3. **Currency Volatility**
   Competitive Devaluation vs Flexible Exchange Rate

* CSI 300 total return performance as of 15 Sep 2015 (Source: Bloomberg)
1. Economic Volatility

Hard landing vs New Normal
Welcome to the New Normal

- The World Bank assumes that China can achieve 7% growth from 2016-20 “assuming steady reforms and no major shock”. Trend growth steadily declining thereafter as technological catch-up slows down.

- Unchanged growth pattern leads to:
  - Economic risks
  - Social risks
  - Environment risks
  - External risks

- Long-term success is not guaranteed because of the “middle income trap”. Of 101 middle-income countries in 1960, only 13 became high income by 2008.

The GFC led to a rapid increase in Chinese loans

**United States - Loans and Leases in Bank Credit at All Commercial Banks**

Percentage change from year ago

- Jul-05 to Oct-08 (before crisis): Average 11.1%
- Dec-10 to Jul-15 (after crisis): Average 3.8%

**China - Total Loans of Financial Institutions**

Percentage change from year ago

- Jul-05 to Oct-08 (before crisis): Average 15.3%
- Dec-10 to Jul-15 (after crisis): Average 15.1%

Source: Federal Reserve Bank of St Louis, July 2015

China’s Economic Rebalancing towards Consumption and Services

**Gradual rebalancing from investment to consumption**

- Private consumption
- Investment

**China Composition of Gross Domestic Product (%)**

- Primary
- Secondary
- Tertiary

Source: CEIC, BNPP IP (Asia)

Innovation to drive productivity
Patent application by patent office and country of origin

Source: WIPO Statistics Database, Aug 2015
FDI flows into ASEAN has exceeded that into China

Source: CEIC, Nomura Strategy Research, SSI Vietnam, Apr 2014
New Silk Road (One-Belt One-Road)

- Helps unleash a regional infrastructure boom by connecting China with Asia, Africa and Europe by and by sea
- Extends the “go west” policy
- Facilitates RMB internationalisation along the way
- Helps China export its excess capacity

Source: Xinhua Finance Agency, Aug 2015
2. Stock Market Volatility

↓40.5% from peak or ↑31.3% from 12 months ago*

* CSI 300 total return performance as of 15 Sep 2015 (Source: Bloomberg)
Recent Decline was compounded by Margin Lending

Source: Bloomberg (Aug 2015)
Index Volatility belies a healthier development in earnings

Source: Bloomberg (Aug 2015)
China offers a broad range of companies

<table>
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<tr>
<th>% Weight</th>
<th>MSCI China A</th>
<th>MSCI China</th>
<th>MSCI Japan</th>
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<td>5.1</td>
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<td>6.1</td>
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</tbody>
</table>

Note: Grouped by GICS Industry Group and GICS Industry Sub-Group
Source: Factset, MSCI (Aug 2015)
China will make up 44% of MSCI EM Index after full inclusion

Current status
- China: 25%
- Others: 17%
- Russia: 4%
- Mexico: 9%
- India: 7%
- South Africa: 7%
- Brazil: 7%
- Korea: 15%
- Taiwan: 13%

Partial inclusion (5%*)
- China: 29%
- Others: 16%
- Russia: 4%
- Mexico: 4%
- India: 7%
- Brazil: 7%
- South Africa: 7%
- Korea: 14%
- Taiwan: 12%

Potential Additional Steps: Partial inclusion (>5%*)
- China A: 1%
- Others: 16%
- Russia: 4%
- Mexico: 4%
- India: 7%
- Brazil: 7%
- South Africa: 7%
- Korea: 14%
- Taiwan: 12%

Potential Full inclusion (100%*)
- China A: 21%
- Others: 20%
- Russia: 13%
- Mexico: 6%
- India: 5%
- Brazil: 6%
- South Africa: 6%
- Taiwan: 10%
- Korea: 9%
- China Oversea: 3%

Steps to be done
1. Further improvements in quota allocation mechanism and size of overall quota
2. Further relaxation on capital mobility and other market accessibility constraints

Steps to be done
1. Abolishment of the quota system
2. Full liberalisation of capital mobility restrictions
3. Alignment of international accessibility standards

Source: MSCI, BNPP IP, June 2015
*The percentage number refers to the Inclusion Factor applied to the free float-adjusted market capitalisation of China A-share constituents in the pro forma MSCI China Index.
China A-share securities are subject to a foreign ownership limit.
Asia ex-Japan’s valuation is already at relatively low levels

Source: MSCI, Aug 2015
3. Currency Volatility

Competitive Devaluation vs Flexible Exchange Rate
CNY is no longer undervalued

“...our assessment now is that the substantial real effective appreciation over the past year has brought the exchange rate to a level that is no longer undervalued...”

“... On the exchange rate system, we urge the authorities to make rapid progress toward greater exchange rate flexibility...”

Source:
IMF Staff Completes the 2015 Article IV Consultation Mission to China
Press Release No. 15/237
May 26, 2015

Source: Bloomberg, BIS (Aug 2015)
CNY does not have a history of competitive devaluation

Source: BNPPIP, Bloomberg, Aug 2015
Diverging real effective exchange rates in Asia

As of: 31/08/2015

<table>
<thead>
<tr>
<th>Country</th>
<th>Real Exchange Rate</th>
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<td>China</td>
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<tr>
<td>Philippines</td>
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<td>Singapore</td>
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<td>Thailand</td>
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<td>Japan</td>
<td>66.0</td>
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Source: Bloomberg, BIS (Aug 2015)
Recap:

1. **Economic Volatility**
   Hard landing vs New Normal

2. **Stock Market Volatility**
   ↓40.5% from peak vs ↑31.3% from 12 months ago*

3. **Currency Volatility**
   Competitive Devaluation vs Flexible Exchange Rate

* CSI 300 total return performance as of 15 Sep 2015 (Source: Bloomberg)
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