



- China's fifth plenum reinforced slower, sustainable and environmentally friendly growth with emphasis on social support structures.
- Financial restructuring continues with likely moves coming up on special drawing rights (SDR) inclusion and the incorporation of Chinese American Depositary Receipt (ADR) stocks into the MSCI emerging market indices as well as increased onshore bond issuance.
- Property companies are increasingly shifting debts back onshore and concentrating on tier one and tier two cities, creating tension over a bubble in both property and bonds, further encouraging authorities to step up the pace of financial reform.

Flows last week were largely rotational around the region and reflected some profit taking into month end. The balance of northbound and southbound trade through the Shanghai-Hong Kong Stock Connect was broadly sell A Share, buy H Share. Volumes were picking up, but nothing special.

The news out of **the fifth plenum the week before** was at a high level and broadly reinforced things that we already knew, but are nevertheless listing as **five key themes**:

- 1)** The growth target was expressed in terms of an intention to double GDP per capita and disposable income per capita between 2010 and 2020, which given the data we know so far equates to a modest slowing to an overall growth rate of around 6.5%. As we have noted on many occasions, the law of big numbers means that the growth rate is inevitably going to slow even as the amount of added economic activity rises— a 10% growth rate in 2010 added the same amount of output as a 5% growth rate would today.
- 2)** The notion remains of shifting the economy towards consumption and services. This is not new of course, but is important in interpreting the impact for the economy as well as investors. Services in China may not yet dominate GDP in the way they do in western economies, but they are already dominating the growth rate. In other words, most of the growth in GDP (Bernstein estimate as much as 80% of growth) is coming from the service sector. The fact that most of the available data is in traditional sectors risks misleading us about what is actually happening and where our opportunities lie – a frequent and relevant criticism of the Li Keqiang (the current Premier of the State Council of the People's Republic of China) indicators as well as highlighting a key issue for the authorities. It is much easier to command an economy from the centre by setting steel production targets or building infrastructure, how to do it in services? The answer of course is in allowing a greater role for market pricing, something announced at the

third plenum that much of the west has struggled to accept. **3)** As China develops it is moving up the value added curve with less of a focus on using more factors of production and more of a focus on the productivity of those factors. From 'using more stuff' to 'using stuff more productively'. This is reflected in the statements by the notion of 'made in China 2025' and has so far been visible in the greater use of machine tools and robotics as labour (a key factor of production) becomes more expensive in line with an ambition to double disposable income per capita. It also means the growth rate in raw material imports slows dramatically as the import (and particularly energy) intensity of GDP growth declines. Internet shopping may require a lot of electricity, but a lot less than an aluminium plant. There is also an emphasis here on the environment, particularly what Li Keqiang referred to in the past as the 'war on pollution'. **4)** The government is investing further in the social security net and in 'human capital'. This is important for education, healthcare and a basic pension, but extends more broadly through insurance and financial services. Plus of course, the building out of a basic health insurance and social security net will allow progress to another long term goal of reducing the extremely high savings ratio and thus support point 2), the drive for more consumption. **5)** The policy that probably attracted the most headlines is the end of the one child policy and its replacement with a two child policy. Studies suggest that urbanisation and increased disposable income per capita actually reduce birth rates, so in many senses one could argue that the reform is 'too late' but it didn't stop traders rushing out to buy companies specialising in milk or nappies.

**We continue to monitor the Chinese property sector**, as do our colleagues on the credit side as it is a key part of their investable universe. In particular we are monitoring the ongoing issuance of onshore debt to refinance the existing offshore dollar debt. While this may not be reflected immediately in the income line as most of the Chinese developers capitalise interest, it is nevertheless improving the overall economics as it reduces the cost of a key factor of production, capital. It is also reducing the currency mismatch, something that is actually systemically important at the aggregate level and finally it is helping meet the ongoing demand for yield from domestic investors. **At the time of the Shanghai market correction, I noted that this looked much more like the UK in October 1987 or 1998 than 2008 or even 1929** as the more hyperbolic commentators were suggesting and pointed out that the **response in previous times had been a flight to quality and in particular to property**. This looks to be happening, particularly in tier one and tier two cities, where prices are squeezing higher, not least as developers buy up land as they abandon the tier three and tier four cities with their huge inventory. The combination of rising property prices and rising debt issuance has naturally got the bubble watchers excited. We would not disagree that the excess capital that was in property, then in equities, is now going into bonds and by extension back into property. But that is how markets operate and a key reason behind the authorities attempts to broaden and deepen all the capital markets so that this diversification does not lead to serious mispricing.

**Our credit team continue to prefer the higher quality, state-owned enterprise (SoE) backed property stocks** and from an equity point of view we would also be focussing on the higher end, cash flow positive companies. However, we would note the beneficial impact that such balance sheet restructuring could have on existing lenders as well as

the fee based parts of financial services. The reality is that China is now almost the size of Europe or the US as an economy, but has a financial service sector totally dominated by traditional banking. Changing this is the real background story of the new China growth model. One example, given at a conference I attended recently was the dilemma facing the Chinese healthcare sector, although it could have been any service based company, **how do you raise capital from a traditional bank when you have no collateral?** The 'modern' answer would probably be venture capital (VC) funding or crowd sourcing, but there is an obvious role for the traditional providers, **equity**. In fact one very important, but largely overlooked, benefit from the China stock bubble in Q2 was that it enabled a lot of small and mid-cap companies in the tech, med-tech and healthcare space to raise capital. In this sense there are echoes of the dotcom bubble, which widely written off as a huge misallocation of capital actually enabled the giants of Silicon Valley today to raise outside capital at a time when the traditional banking model was unable to.

Elsewhere this month we have **two index related events**. The first, which may come as early as this week would be the **inclusion of the Chinese yuan in the SDR basket of the International Monetary Fund (IMF)**. This is a long held aim of the Chinese authorities and as far as the IMF are concerned is a case of when rather than if. Everything that the Chinese authorities have been doing around the currency, from greater transparency on reserves to changing the way the currency band is set has been with SDR inclusion in mind. This is in contrast to the rather excitable commentary from the foreign exchange (FX) markets which has assumed it was all about 'stimulating the economy through depreciation'. The underlying notion is that SDR inclusion would require foreign currency reserve funds in particular to hold appropriate levels of renminbi (RMB) denominated assets. While this would not have to be an overnight change (even if it was announced this week, it would not be effective until October 2016), it would nevertheless provide an underlying bid for the yuan while simultaneously providing an underlying offer for other currencies, notably the dollar and euro. Longer term, this is all part of a greater de-dollarisation trend as the RMB becomes the dominant trading currency for Asia, much as, pre euro, the deutschemark (DM) became the trading currency for continental Europe.

The other index related event at the end of this month will be **the inclusion of the China N shares in the MSCI emerging markets index**. These are the Chinese companies with US ADR listings – Baidu, Alibaba, [JD.Com](http://JD.Com) etc. While this is not as dramatic as the issue of A share incorporation, and remember, that was the main motive force behind the leveraged bubble in Q2 this year, it is nevertheless meaningful. A locally traded exchange-traded fund (ETF) basket of N shares (Chimerica, 3161 HK) has done very well over the last month around +25% in Hong Kong dollars (HKD). It was helped by this trade, but also by the fact that most of the bigger ADR stocks are exposed to 'new China' and have reported very good numbers recently, or in the case of Baidu and Ctrip, the two largest weightings in the 'Chimerica' index, some earnings are enhancing M&A deals.

**Elsewhere in Asia, corporate activity is a reminder that companies buy shares, not just traders and investors** and when this is driving markets, we need to adjust our notions of fair value accordingly. In Australia for example, the energy and mining sector is going down the inevitable consolidation route as a market based solution to excess

supply and lack of pricing power. With bids for both Woodside and Santos still on the table, analysts expect more, with the Chinese majors such as Petro China and Sinopec on the bid side and a wide range of international energy companies potentially in their sights.

Meanwhile there was some fascinating news out of Korea this week when **Samsung, the largest stock in Korea and the biggest single stock capitalisation in the MSCI emerging index announced a \$10 billion share buyback**, and importantly, cancellation (previously the shares bought back have not been cancelled). More significantly they have declared that they plan to return between 30 and 50% of free cash flow to shareholders in the next three years, primarily through dividends. My new colleague here in Hong Kong Simon Weston, points out that currently Samsung Electronics pays out around 15% of its free cash flow as a dividend, implying a potential uplift to dividends from a yield of 1.5% to something between 3% and 4.5%.

The Samsung situation is tied up with the controlling family, but also reflects an underlying change in Asia, as corporate structures and governance become more westernised and thus easier to incorporate into western investors' portfolios. **M&A and other corporate activity have simply increased the misery for many macro hedge funds who have had to capitulate on their 'short equities' bet.** In fact Q4 to date, this has really been the pain trade as the consensus certainly on selling equities that seemed to be running across much of Wall Street in late September. Looking at an index of Macro Commodity Trading Advisor (CTA) returns, they are now negative over one year and year to date, as well as over five years. Over 10 years they show an annual return of effectively zero. The likely behaviour between now and year end is likely to go with what's working, which seems to be an ongoing equity squeeze.

Finally, on geopolitics, the endless rounds of travel – Xi, to the US, then the UK, Modi to the US, Merkel to India, then to China, the Trans-Pacific Partnership (TPP) talks, the upcoming G20 Summit in Turkey in two weeks' time and seemingly everybody to Paris next month are inducing a case of summit fatigue. It is therefore understandable then that **the one day summit on Sunday between China, Korea and Japan** would be overlooked, although it could well in my opinion be more economically significant than all of them. With claims that relations are 'fully restored' the shift of China's growth drivers from South East Asia and commodities to North Asia for services and high end manufacturing can proceed even faster. All part of China 'growth 2.0'.

Regards,

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All data sourced by AXA IM as at Monday 2<sup>nd</sup> November 2015.