

2015 China Market Outlook



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- An eventful 2014 laid the foundation for upward momentum in the Chinese economy and equity markets in 2015
- Reforms, monetary easing, and MSCI inclusion are the main drivers for Chinese equities
- Six investment themes to benefit from China market rally

The lingering impacts of 2014

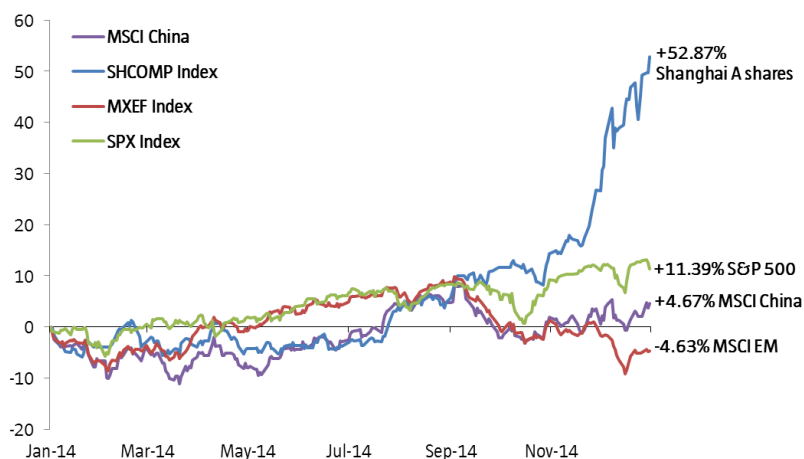
Spectacular rally in China A-share market in 2014

The Shanghai stock market closed 2014 with an impressive 53% gain for the year!

While margin finance for stock purchase added fuel to positive sentiment, we don't think that this bull-run in China's equity market was only a liquidity-driven bubble, but believe that it marked the beginning of a multi-year bull market in the Chinese A-share market. There are several positive forces that have made 2014 an inflection point:

- Historically low valuation.
- Implementation of China's comprehensive and productivity-enhancing reforms announced since 2013.
- The central bank cut interest rates and loosened monetary policies in 2H2014.
- The success of anti-corruption campaigns raised investor confidence on the current leadership and lowered risk premium for the market.
- Asset-allocation shift from property (61% of Chinese household wealth) to equity (only 10% of wealth) due to the end of the property bull market.

China A-share markets outperformed the US and Emerging Markets



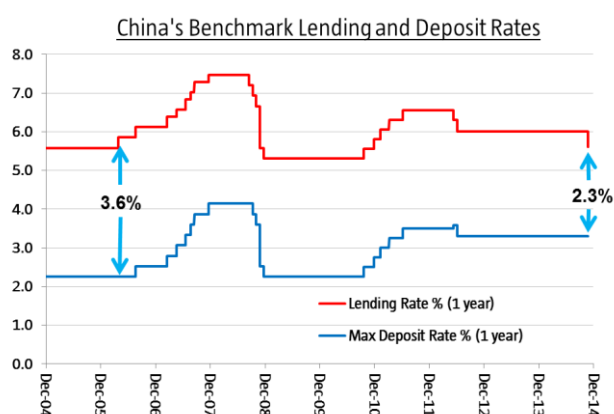
Source: Bloomberg, Robeco, as 31 Dec 2014.

The Chinese central bank kicked off the monetary easing cycle

In November 2014, the People's Bank of China (PBOC) cut interest rates. This is the first rate cut since July 2012, and came as quite a surprise, signaling the beginning of an easing cycle.

In December 2014, the PBOC has announced that the loan-to-deposit ratio will include the interbank deposit, and a temporary zero deposit reserve ratio will be applied to this interbank deposit. This implies a potential injection of RMB 5–6 trillion of new credit into the market, or a 160 bps RRR cut.

Policymakers are determined to lower funding costs for the real economy. We believe there may potentially be **further RRR cuts** and **interest rate cuts** if the Chinese economy continues to deteriorate going forward.



Source: The PBOC, CEIC, Robeco

Shanghai-Hong Kong Stock Connect was successfully launched

The **Shanghai-Hong Kong** Stock Connect has been operating successfully since November 2014. Here is the progress so far:

- Approximately **4%** of Southbound and **25%** of Northbound aggregate quota has been used.
- **Southbound flows:** Interest could pick up significantly as domestic money managers obtain approvals to launch new products.
- **Northbound flows:** Retail investors and hedge funds have started making use of the Program, whereas most long-only funds have not been given approval to participate in the scheme due to European regulatory hurdles.
 - We expect the regulatory issues to be solved soon, as Luxembourg's Commission de Surveillance du Secteur Financier (CSSF) has introduced a 'fast-track' procedure for approving mutual funds sold to retail investors (UCITS).

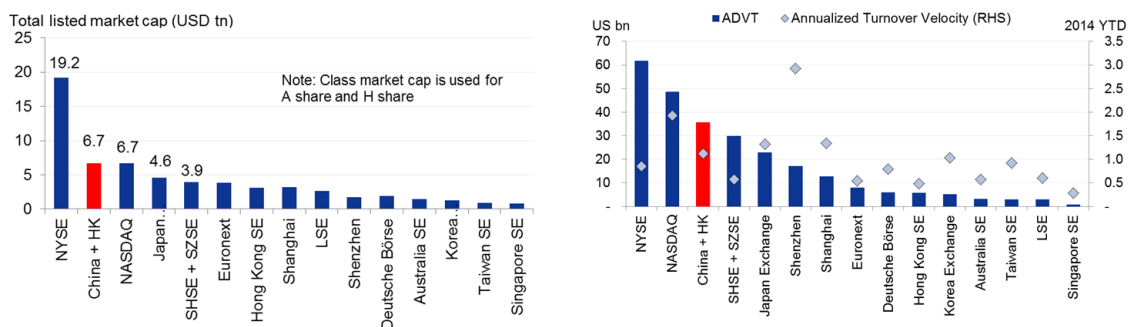
In January 2015, Li Keqiang stated that the **Shenzhen-Hong Kong** Stock Connect should be implemented next – this will have a positive impact on Shenzhen blue-chip stocks.

Shanghai-Hong Kong Stock Connect creates the world's second largest equity market

The combined A and HK market is simply too big to ignore:

- The 2nd largest equity market in the world by market cap (US USD 19 tn vs China USD 6.7 tn)
- The 3rd largest by turnover (US USD 61 bn vs China USD 36 bn)
- The 2nd largest by number of listed companies (US 6618 vs China 3681)

SH-HK Stock Connect allows Chinese financial markets to be an integral part of the global financial markets.



Source: WFE, Bloomberg, Goldman Sachs, as of Oct 2014

China government launched its new global strategy – the New Silk Road Project

In September 2013, President Xi Jinping launched a new international strategy named “One Belt One Road”, based on the history of the Silk Road by sea and by land.

In November 2014, President Xi Jinping actively promoted this to leaders at the APEC Summit, emphasizing common interests to achieve win-win development for China and related countries.

- Potential partners in **New Silk Road Economic Belt**: Russia, India, Mongolia, Kazakhstan, Pakistan, Iran, Qatar, UAE, Oman, etc.
- Potential partners in **21st Century Maritime Silk Road**: Indonesia, Singapore, Thailand, Philippines, Vietnam, Myanmar, Laos, Maldives, Saudi Arabia, Egypt, Sudan, Ethiopia, etc.

China has committed to contribute **USD 40 billion** to the **Silk Road Fund**, **USD 50 billion** to the **Asian Infrastructure Investment Bank** (USD 100 bn) and **USD 41 billion** to the **BRICKS Bank**.

The rationales for the New Silk Road Project include:

- Expanding external demand to absorb domestic excess capacity.
- Ensure stable and diversified access to natural resources via better interconnectivity.
- Increase trades with the New Silk Road countries.
- Diversify the investment of foreign reserves and promote RMB internationalization.

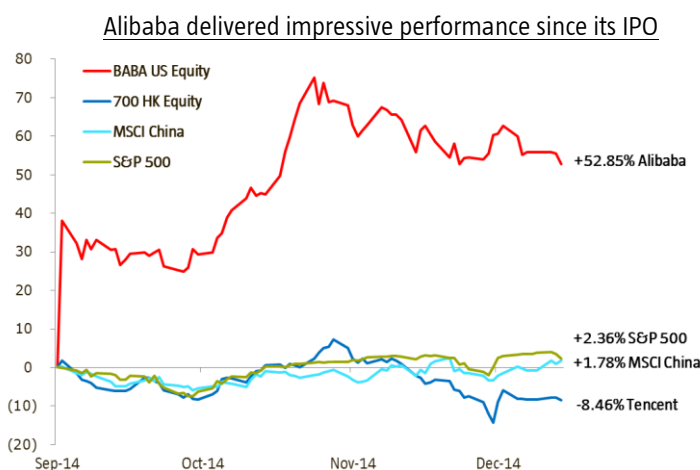


Source: Goldman Sachs as of Nov 2014

Alibaba claims title for largest global IPO ever

Overwhelming demand saw Alibaba Group’s IPO raise USD 25 billion, and the company can now say its record-breaking IPO was the biggest in the world. The stock surged 38% at its debut on 18 September 2014.

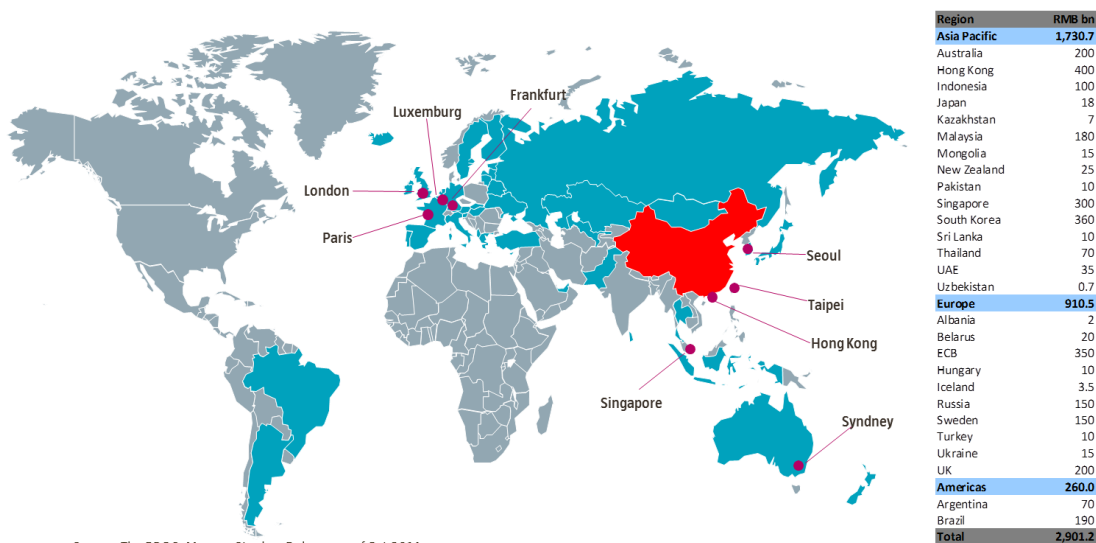
The Alibaba IPO introduced global investors to the digital revolution happening in China. In 2013, China accounted for 35% of the USD 890 billion in global e-commerce sales, with e-commerce sales equivalent to 3.3% of China’s GDP, the highest percentage globally. Industry analysts estimated that China’s e-commerce sales are likely to rise to a CAGR of 28% in the next three years, reaching USD 1 trillion, or 50% of the global market! “In the US, e-commerce is just online shopping. In China, it is a lifestyle,” said Jack Ma, founder of Alibaba Group.



Source: Bloomberg, Robeco, as 31 Dec 2014.

RMB Internationalization – covering half of the globe

In 2014, the Chinese currency RMB made significant progress towards internationalization. The PBOC has signed RMB bilateral currency-swap agreements with 26 central banks, totaling close to CNY 2.9 trillion (USD 475 bn) (blue highlight below). RMB bond issuance is available in nine offshore renminbi centers (red dot below). The RMB-denominated Dim Sum bond market grew significantly, defying a period of FX weakness and China growth concerns in 2014. We expect RMB to further penetrate into other markets.



Source: The PBOC, Morgan Stanley, Robeco, as of Oct 2014

The plunge in commodity prices benefits China, but we need to watch out for an EM crisis

From 2010 until mid-2014, world oil prices had been fairly stable, at around USD 110 a barrel. But since June 2014, oil prices have almost halved due to weak demand and OPEC's decision not to cut production.

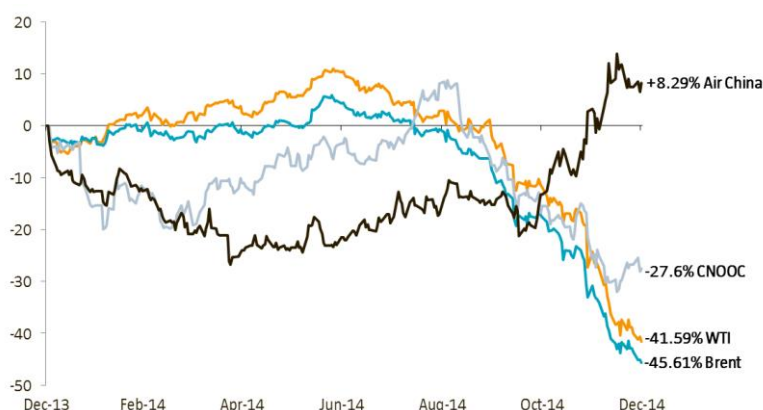
China is definitely a beneficiary. Analysts estimated that every USD 1 decline in the oil price shaves about USD 2.2 billion off the import bill, based on the latest import data.

Lower prices will of course be a drag on oil and gas companies, and their equipment and service suppliers. But many more sectors and stocks will benefit:

- Air and marine transport operators to benefit from less expensive fuel.
- Mid-stream manufacturers such as auto and machinery producers.
- Coal- and gas-based utilities to benefit from lower input costs or smoother fuel-cost pass-through to end users.

However, we need to be vigilant on a **potential emerging-market crisis**. If oil prices stay below USD 50 for over six months, we are likely to see a financial crisis in some vulnerable emerging-market countries, such as Russia, Venezuela, and Indonesia, thereby dragging down other emerging markets.

Winners and losers of crude-oil price decline



Source: Bloomberg, Robeco, as 31 Dec 2014

2015 – The year of Reforms & Re-rating

China macro data is likely to decelerate while reforms accelerate

Based on monthly macroeconomic data, we expect a continuous deceleration of growth in 2015. Our major economic forecasts for 2015 are as follows:

- **GDP growth** is likely to be 7.0% in 2015, with growth decelerating in 15H1, and then picking up slightly in 15H2.
- **Consumption** is likely to remain resilient, with 10% growth in retail sales.
- **Investments** are likely to decelerate further, but we still expect 14% growth in fixed-asset investment. Infrastructure FAI is likely to be the main driver, with property FAI remaining flat and manufacturing FAI flat to declining.
- **Exports** are likely to decelerate to around 5% growth.
- **Inflation** is likely to be under control, with CPI at 2.5%.

Offshore Chinese equities are likely to see re-rating and A shares will surge again

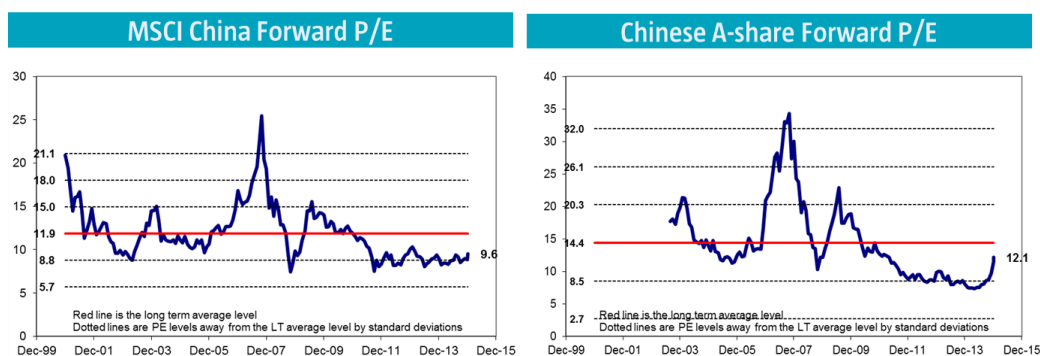
In 2014, offshore Chinese equities were dragged down by outflows in emerging markets. In 2015, we expect offshore Chinese equities to gradually catch up with A-share markets as valuation remain reasonable:

- MSCI China consensus estimates for EPS project growth of 8% in 2015, with forward P/E trading at 9.6x, below its historical average of 11.9x
- Chinese A-share market consensus estimates for EPS project growth of 11.5% in 2015, with forward P/E trading at 12.1x, below its historical average of 14.5x

Unfortunately, the bull market is unlikely to be linear, with the volatility seen in 2014 persisting. After gains of close to 53% in 2014, the A-share market may need some time to digest these gains in early 2015.

However, the re-rating process for China's equity markets is likely still in its early stages. We continue to hold a positive view towards China's equity market for the following reasons:

- Reforms will reach their implementation stages in 2015 and visible reform dividends will likely be delivered in terms of better efficiency, growth, and corporate earnings.
- Consumer and service sectors will continue to be the drivers of the economy and will gradually represent a larger share.
- We saw signs of a stabilizing property market in December 2014, and this is likely to continue to improve, thereby alleviating some concerns towards the sectors.
- Deepening of capital-market reforms will have a direct positive impact on the markets.



Source: IBES, Factset, MSCI, Morgan Stanley, Robeco, as of 1 Jan 2015.

Anticipating the 13th Five Year Plan (2016–2020)

The NDRC announced in April that it had started formulating the **13th Five Year-Plan** (2016–2020). The **blueprint deliberation** is already well underway for **urbanization, healthcare, railways, education, transportation (railways, highways, and subways), etc.** Many rounds of deliberation are needed to work out the plans.

The **draft** plans will likely be debated in the fifth plenum of the 18th Central Committee of the Communist Party of China in October 2015. The **final** 13th Five Year-Plan is likely to be approved during the National People's Congress meeting in March 2016.

The announcement of some parts of the **draft** itself will have significant implications on the industries affected.

Fiscal reforms tried to resolve legacy problems in local government debt issues

Based on the State Council's budget reform plans in October 2014, a few key changes will be introduced in 2015:

- 1) Local governments are required to release their balance sheets;
- 2) Local financing vehicles will cease their business by end 2015;
- 3) All government income will be covered in the budget, including land sales revenue;

- 4) Local bond issuance could be used for new projects, as well as for rolling over old debts;
 5) If a bailout occurs, the local government officials would be held responsible for misconduct.

The implications of fiscal reforms include:

- The budget reforms may lead to a sharp slowdown in local government-dominated infrastructure investments.
- High-interest bank/trust loans may be swapped with cheaper provincial government bonds, thereby lowering the funding costs of local governments.
- The central government will likely leverage up (debt nationalization), whereas local government de-leveraging.
- PPPs (public-private partnership) will likely rise to become an important channel of infrastructure investment.

MSCI inclusion: making a better representation of Chinese corporates

The MSCI has proposed two important changes to the MSCI global indices: 1) the inclusion of China ADRs and 2) the inclusion of A-shares. The announcement is likely to be made in 1H2015.

If that happens, the new MSCI China Index will significantly improve the representativeness of the Chinese equity universe. Major implications are as follows:

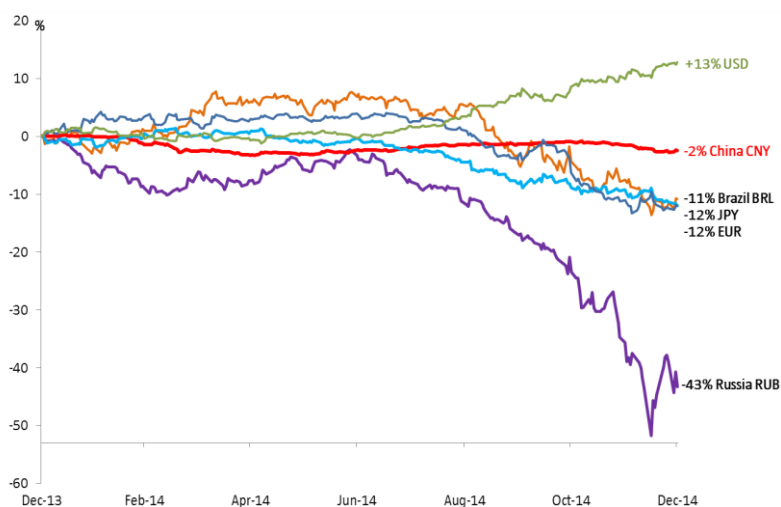
- Additions will benefit from fund inflows (namely, leading A-shares and China ADRs), while old constituents will see their weights down;
- The sector landscape will be largely different, with internet and discretionary taking up more weight, while financials, telecom and energy having smaller weights;
- Market behavior will change in the mid to long term, with more involvement of foreign investors and institutions to lower turnover velocity and index movement more correlated to global markets.

US rate hike is likely to throw emerging markets into turmoil

We expect the Fed will continue to be patient and gradual in their policy stance, with a first rate hike likely in September/October 2015. We think the Fed will only start hiking when the US economy's recovery is firmly established.

The end of QE by the Federal Reserve in the US has supported the USD strength against all global currencies, and caused significant outflows from emerging markets. The US raising interest rates will bring about another round of outflows from emerging markets, including HK and China.

RMB weakened against USD but strengthened against other currencies



Source: Bloomberg, Robeco, as 31 Dec 2014.

2015 investment themes in China

SOE Reforms Theme

The focus will be on efficiency improvements through various approaches, such as the introduction of private capital, cost-cutting measures, the promotion of asset-light strategies and focusing management efforts on profitability through incentive plans. There will be plenty of investment opportunities in SOEs that arise from the following reforms:

- SOEs have low profitability and high leverage. Reforming the SOEs and helping them to better manage their financial position is critical to China's deleveraging process.
- SOEs in overcapacity sectors may have asset disposals going forward to reduce the financial burden.
- Monopoly of SOEs in China's service sectors has led to insufficient supply in certain areas. Opening up the service sector to private capital investment will be important as the Chinese economy becomes more service and consumption driven.

New Silk Road Project Theme

The New Silk Road project will significantly promote the proportion of China's exports to related countries which account for 24% of China's exports and 26% of China's imports. In terms of investment, China's outbound investment was USD 100 billion in 2013, with 13% to the related countries. According to analyst estimates, China's total investment in New Silk Road countries is likely to reach USD 1.6 trillion in the next ten years.

As interconnectivity is a requisite and core focus of the New Silk Road project, China is expected to increase investment in transportation infrastructure, such as railways, express roads, ports, marine transport, pipelines, etc. The following sectors and companies are expected to benefit from this:

- Infrastructure construction & engineering companies
- High Speed Railway related companies
- Shipping & Port companies
- Equipment manufacturing companies
- Raw materials companies:

Financial Reforms Theme

The Central Leadership Group for Financial and Economic Affairs has been set up to take charge of the whole financial reform agenda. There will be plenty of investment opportunities in banks, insurance, brokers and property companies that arise from the following reforms:

- Banks may face earnings pressure given potential net interest margin (NIM) contraction, while the asset quality concern may ease slightly.
- The State Council published rules in October 2014 to manage local government debts. This helps to remove related asset quality risks in the banking system.
- Regulators tightened the examination of banks' interbank businesses, which has led to a deceleration of growth in non-standardized credit assets.
- Regulations on asset disposal were relaxed, with write-offs and disposals of non-performing loans by the banks picking up significantly as a result.
- Brokers and insurance companies may benefit from the acceleration of capital market development and liberalization.

Technology & Innovation Theme

The e-commerce mega-growth trend is still in its initial phase in China. It will contribute 30–40% of incremental retail sales annually, thereby becoming the key growth driver in China's USD 3 trillion consumer market. Chinese e-commerce companies will go through cycles due to changing consumption behavior, demographic shifts, channel change, and new technological advances.

The Internet is gradually being embraced by many different sectors, not only those that are consumer-focused, but also financial companies. Internet finance may see substantial progress in 2015 with the launch of WeBank Internet bank by Tencent. We continue to favor internet giants in search engines, e-commerce and online games, and selected e-commerce plays.

Including the existing themes, we are actively positioned in six investment themes in 2015:

Key Reform Areas	Expected Reform Measures	Overweight Sectors
1) SOE Reforms	Accelerate consolidation in industries with overcapacity Introduce management incentive plans and private capital	Selected SOE names
2) New Silk Road Projects	Build cross border infrastructure network on road & sea Export infrastructure construction capability	Construction, Railway Equip & Machinery
3) Financial Reforms	Rising long-end bond yield and investment liberalization Reopen the IPO market, and rising non-performing asset cycle	Insurance, brokers, banks
4) Healthcare Reforms	Expand access to health services to rural China Improve quality of care and deliver cost-effective care	Healthcare & services
5) Technology and Innovation	Government to support and stimulate consumption in: cultural, entertainment, internet, gaming, travel, IT services	Internet and hardware
6) Environmental Protection	85% of all the city waste water has to be treated Expand incineration capacity by 28% annually	Waste Water Mgt. Solid Waste Mgt.

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