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Index

- Editorial · CEINEX
- Talking Point · Phase One Trade Agreement: Long-term Benefits for China and the World Economy by Deutsche Bank
- Speakers' Corner · Understanding China's Future through Japan's Past by CSOP
- Policy Update · Cautious Liberalisation and Targeted Growth Impulses go Hand in Hand by ICBC
- Macro View · Coronavirus Epidemic Hits China by China Post Global
- Stock Markets · Calibrating China Investments by Ntree
- About CEINEX

Editorial

Dear Ladies and Gentlemen,

as a Chinese-German joint venture, we are particularly concerned by the Covid-19 pandemic. In China and beyond, it is primarily linked to human – not economic – fates. This makes it all the more important that governments and affected companies worldwide take decisive actions to protect citizens and employees. We too take our responsibility for our colleagues very seriously.

Obviously, the economic dimension of the pandemic is also considerable. We hear this from affected companies, read it in economic data and see it from the swings of capital markets. This second edition of our newsletter therefore takes a closer look at the consequences of Covid-19 for the Chinese economy and markets from a variety of perspectives. The unique view of Chinese experts on site is of great importance and adds valuable know-how to the research already at hand from Frankfurt or London.

It seems clear that the impact of the pandemic was underestimated at the beginning. Our globalized and (in normal mode) highly mobile society is more vulnerable than expected. At the same time, we are now better equipped than ever to deal with such challenges. In many areas, technologies can alleviate problems or create new business opportunities – initially born of necessity.

In the past, China in particular has proven to create new ideas for future progress, even from the most intense crises. Experts assume that the SARS epidemic in 2003, for example, has led to people getting used to shopping on the Internet and conducting important business digitally. This is how the foundations for the success of Chinese e-commerce giants like Alibaba were first laid.

Similar developments are also conceivable today. Further growth in online shopping and food delivery services, for example, could spur automated delivery by drones and give a boost to their manufacturers. Educational offerings could shift even more strongly into e-learning formats.

And teleworking could establish itself as a new standard – with corresponding consequences for people's mobility and consumer behaviour.

Such developments could also move the markets in the long term. In the short term, the focus is more on the simple question of whether they should position themselves for a sustained downturn or a rapid recovery. For this puzzle a new element has come into play with the recent oil price crash. While it put global stock markets into turmoil, the lower oil price should actually help the manufacturing companies from the »traditional industries«, such as automotive, mechanical engineering, chemistry, pharma, steel, etc., set off the drop in demand from China and globally through lower production costs.

Against this background, trading volumes on CEINEX have also risen significantly and reached a record high in early 2020. The size of the increase is also due to the current uncertainty on markets. However, the fundamental upward trend is rather the result of China's structurally increasing importance in the global economy and on capital markets. This trend is unchanged as well as irreversible and offers great opportunities for financial markets and the real economy alike.

We hope you are all staying safe and remain with all the best regards,

Yours
CEINEX Corporate Communications

Talking Point

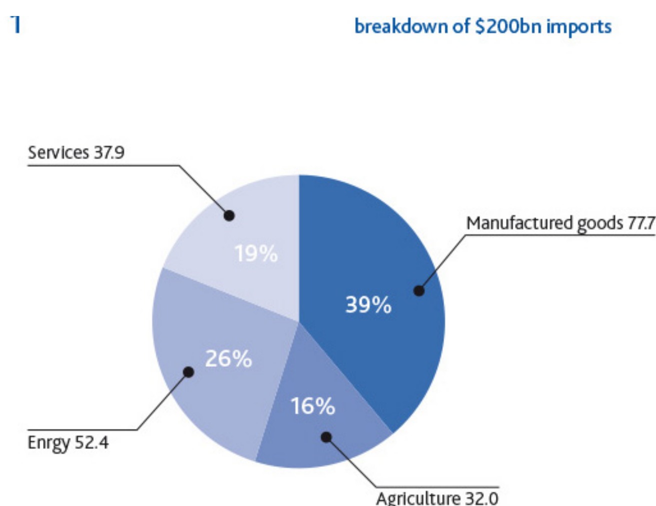
Phase One Trade Agreement: Long-term Benefits for China and the World Economy

by Dr. XIONG Yi, China Economist, Deutsche Bank Research

After almost two years of trade tensions and negotiations, the US and China have finally signed on the Phase One trade agreement. A key US demand is that China will increase imports from the US by at least USD 200bn in 2020 and 2021 compared to 2017 import levels. Whether these targets can be reached in the next two years will be crucial for the future of this agreement, and US-China trade relations in general.

Reaching the USD 200bn target might not be as difficult as it looks. China's imports are growing each year; by our forecast, China will import USD 5.2tr of goods and services in total in 2020 and 2021. To reach the target, USD 570bn of them would need to come from the US. The US's share in China's total imports would increase to 11% from 8.5% in 2017. This will take some efforts, but it doesn't require China to cut its aggregate imports from the rest of the world. In fact, China's imports from the rest of the world would still grow to USD 2.4tr in 2021 from USD 2tr in 2017. Furthermore, the purchase agreement's scope is broader than the regular definition of foreign trade. Notably, aircraft orders, rather than deliveries, are counted towards the goal. Financial and cloud services provided by US subsidiaries within China's borders are also included. Therefore, China's imports under standard trade metrics would not need to increase by 200bn.

The Phase One agreement is, however, much broader than a trade war truce and USD 200bn of purchases. It covers a broad range of topics from intellectual property (IP) protection to opening up China's market. Our broad assessment is successful implementation of this trade deal could bring sizable long-term benefits to China and world economy.



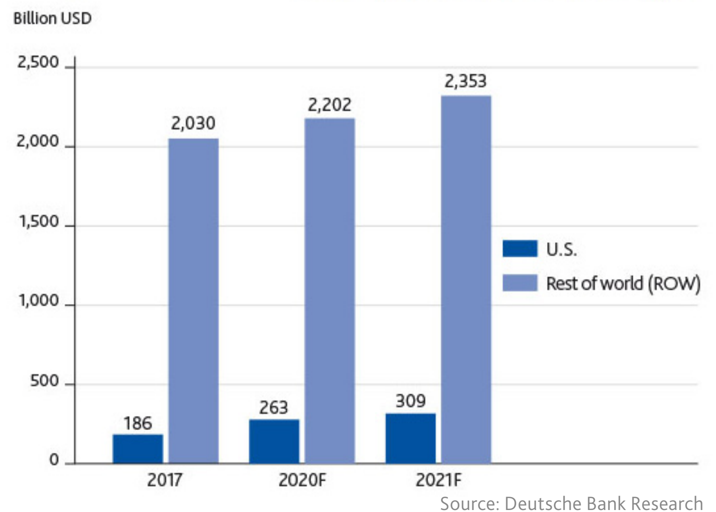
Source: Deutsche Bank Research

China agreed to enhance intellectual property protection by strengthening enforcement actions and increasing penalties on intellectual property infringements, shifting the burden of proof from plaintiffs to defendants, and making e-commerce platforms accountable for selling counterfeit products. It will open up the financial sector rapidly, and reduce or remove entry barriers for many agriculture products. It will also stick to a more flexible and transparent exchange rate regime. These are all necessary reforms to ensure China's continued economic growth in the coming years.

The Phase One deal is also good news for the world economy, which will benefit from a more open and fast growing China market. In particular, agriculture producers will likely

benefit from Chinas opening up its agriculture market. China's fight against counterfeits and piracy will likely reduce global trade of fake goods, and also speed up the penetration of world consumer brands to Chinese consumers in lower tier cities. Removing foreign ownership limits and better protecting IPs and trade secrets will likely benefit foreign companies in China and bring new market entrants.

Implementation of the trade deal will likely face some challenges in the short term owing to disruptions caused by the coronavirus outbreak, but we think this is unlikely to cause a complete breakdown. The main risk comes from outside the trade agreement, such as US restrictions on technology exports and sanctions on Chinese tech companies. Ongoing implementation of relevant US legislations, especially the yet-to-be released »emerging and foundational technologies« list, could potentially be a big negative shock.



Source: Deutsche Bank Research

Speakers' Corner

Understanding China's Future through Japan's Past

by CSOP

Commentators note the similarities between the successes and challenges China is currently experiencing and those seen by Japan from the 1980s. They point to rapid export led economic growth leading to deteriorating trade relations with the US, accusations of unfair business practices, a race for technological superiority and threats to US national security.

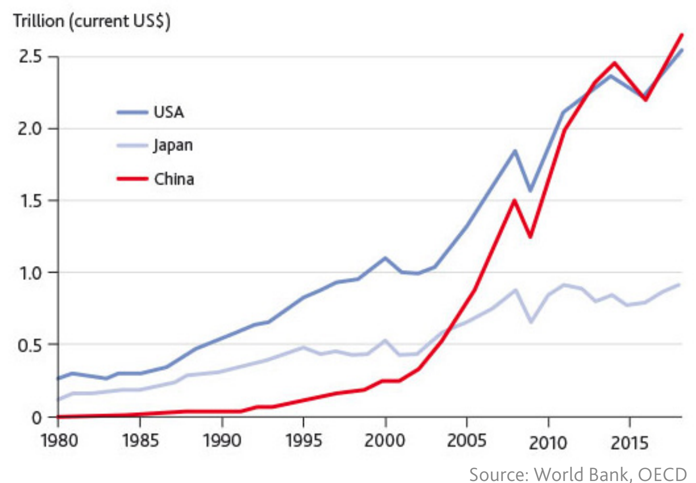
Looking at the two financial systems there are similarities such as high savings rates and closed financial systems and capital markets. Policies adopted in Japan designed to open up the financial system and foster domestic consumption led to a stock market and property bubbles in the 1980's. Will this also be China's future?

While much can be learned from studying Japan's experience and there are certainly many parallels, a number of major differences support the view that China's circumstances are in fact quite different, so there is little hard evidence China is destinated to follow the same path.

Japan's manufacturing strength leads to friction with US

By the 1980s Japan became the pre-eminent global manufacturer, with its high quality products and efficient kaizen processes in demand around the world. US industry feared Japanese imports would threaten their dominant positions in key motor, steel, and electronics industries even in their home markets.

Japan was seen by the US as an untrustworthy partner. Japan's trade surplus was partly due to its artificially weak currency putting US businesses at a disadvantage, while its



Source: World Bank, OECD

rapid advances in technology were believed to be through intellectual property theft. Japan's export success generated huge amounts of capital through trade surpluses to be invested overseas acquiring strategic assets and means of control. Meanwhile overseas investors were excluded from the closed Japanese financial system.

Similar to today's trade war, technological superiority was a key flashpoint. US protectionist interests came to the fore when it was revealed Japan's Toshiba had assisted the sale of stolen US defence technology to Russia. Penalties included the forced closure of US based factories and Toshiba's products being banned from the US. Relations with the US began to be normalised with the 1985 Plaza Accord agreement that mandated appreciation of the Japanese Yen and opening up of the financial system to foreign institutions.

Settlement and reforms laid foundations of today's Japan

Japan's drive to reduce its US export surplus was championed by the Maekawa Commission, which set out the new economic model refocusing the country's manufacturing output towards home markets. A key reform was to stimulate the domestic economy by increasing consumer demand and improving standards of living, enabled through policies including managed interest rates, increased credit availability and national infrastructure construction programs. The once closed financial system and capital markets were opened up to foreign competition and capital.

These policies were successful in re-setting relations with US and laid the foundations of domestic wealth, superior infrastructure and integration with global capital markets. However they also brought about the stock market and property bubbles which led to Japan's lost decade and low growth that continues even today.

China – world power

How great are the similarities and do they mean China is fated to follow in Japan's footsteps ?

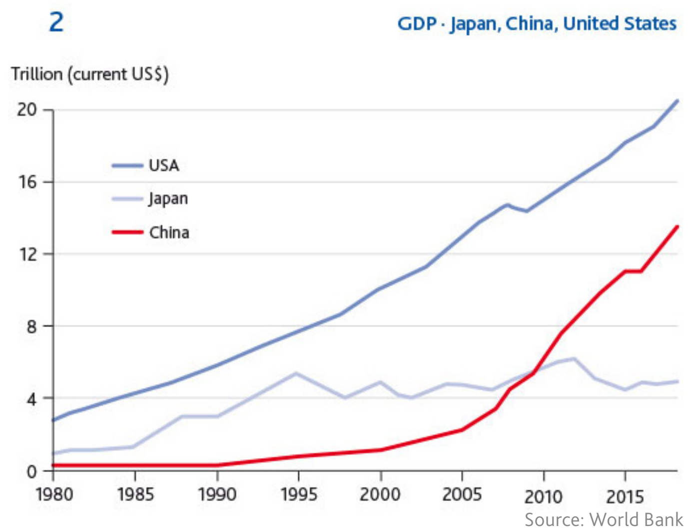
While China's present goals may be similar to those of 1980's Japan including rebalancing away from export reliance, stimulating domestic consumption and improving standards of living, there are a number of major differences. China's 1.4 billion population forms a significant share of the world population and provides massive economic potential, for example through further shifts from agricultural to urban living. At around two-thirds the size of the US, China is an important component of the global economy and significantly larger than its next competitor. Finally, China has proved itself independent of US influence in a way that post war Japan was not, and under the Communist Party of China there's continuity of political leadership mandated to pursue long term policies.

2020 Outlook

Relations with the US appear to be stabilising, however as trade conflict is a symptom of competition for global economic and technological leadership, it is likely the interests of China and the US will continue to diverge, so it should be expected for this friction to continue to contribute to China's already slowing economic growth. While trade war tension is expected to keep lingering and put pressure on China's economic growth, China's economy has already been shifting towards domestic consumption and services during the past decade. This is now the largest contributor to GDP growth. So this will somewhat offset the trade war pressure on exports.

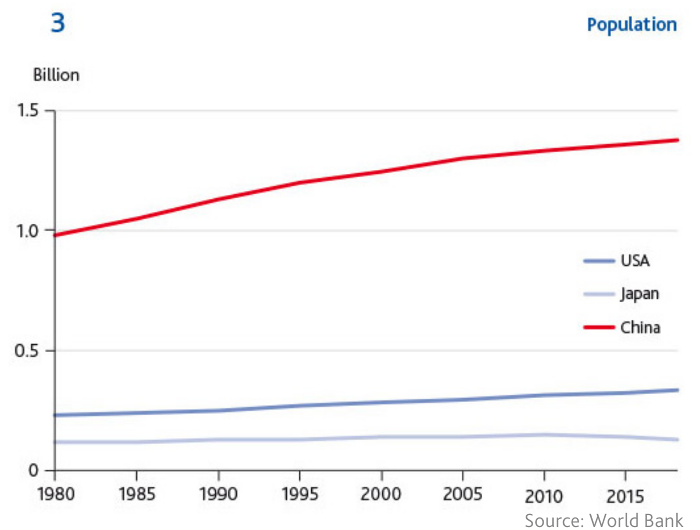
Inflation risks remain elevated due of food shortages, in particular pork products favoured by the rapidly growing middle class. However there are positive signs. China's politicians have shown themselves to be aware of the risks from a sharp deterioration in the economy and have demonstrated their willingness to act. Financial reforms continue to be introduced, most recently focused on improving the efficiency and flexibility of monetary policy mechanisms through the Loan Prime Rate (LPR). Further deregulation of the financial sector permitting foreign ownership to grow from the current estimated 1% will introduce new competitive pressures. As the urban middle class expands domestic consumption will continue to grow, accelerated by technological advances that increase access in remote regions to goods and services through e-commerce.

2 GDP · Japan, China, United States



Source: World Bank

3 Population



Source: World Bank

China has greatly improved on its transparency and decisive measures in containing the spread of the Covid-19 virus. The overall effective handling of the virus epidemic should allow China to recover and return to normalcy far quicker than analysts expect.

Policy Update

Cautious Liberalisation and targeted growth impulses go hand in hand

by ICBC

The United States and China signed an initial trade deal that will roll back some tariffs and boost Chinese purchases of U.S. products, defusing an 18-month row between the world's two largest economies but leaving a number of sore spots unresolved. President Donald Trump hailed the agreement as a win for the U.S. economy and his administration's trade policies. President Xi Jinping praised the deal as a sign the two countries could resolve their differences with dialogue. Trump, who has been touting the Phase 1 deal as a pillar of his 2020 re-election campaign, said he would agree to remove the remaining tariffs once the two sides had negotiated a »Phase 2« agreement.

China will boost purchases of U.S. goods and services by $200 billion over two years in exchange for the rolling back of some tariffs under an initial trade deal between the world's two largest economies. Chinese Vice Premier Liu He, who signed the trade deal with U.S. President Donald Trump, said the deal would not affect »third parties' interests«, apparently in reference to deals made with other suppliers of farm goods. Chinese companies will import U.S. agricultural goods according to consumers' needs, and supply and demand in the market.

As another result of the progress made in trade negotiations, China's exports rose for the first time in five months in December 2019 and by more than expected, signalling a modest recovery in demand. After a rough year, China's exports ended 2019 on an upbeat note, rising 7.6% in December from a year earlier. For all of 2019, its total exports proved remarkably resilient to trade tensions, rising 0.5%, though that was well off a near 10% gain in 2018, reflecting weaker U.S. sales.

PBOC implements pro-growth measures

Looking forward, China's central bank will use the loan prime rate (LPR) as a new benchmark for pricing existing floating-rate loans. Beijing has unveiled pro-growth measures this year, including tax cuts, infrastructure spending, reductions in the cash banks keep on reserve and lending rates to boost credit. Starting on Jan. 1, financial institutions were prohibited from signing floating-rate loan contracts based on the previous benchmark bank lending rate.

What's more, China's central bank extended fresh short- and medium-term loans but kept the borrowing cost unchanged to maintain adequate liquidity in a slowing economy and ease the Lunar New Year crunch. The People's Bank of China (PBOC) said the interest rate on one-year MLF loans remained at 3.25%, unchanged from the previous operations. It injected 300 billion yuan ($43.51 billion) via the liquidity tools.

Liberalisation of domestic market for financial services continues

China's banking and insurance regulator (CBIRC) has released new rules which make it easier for foreign lenders to enter the Chinese market. The measures cancel the total asset requirements for foreign banks to set up businesses in China and relax limitations on shareholders of joint venture lender. Foreign lenders will also be able to open both branches and wholly foreign-owned banks at the same time in China.

Macro View

Covid-19 Epidemic Hits China

by China Post Global

The outbreak of the Covid-19 epidemic has triggered a variety of consequences, effecting not only Chinese but global markets. As such it may delay or derail China's weak recovery from US-China trade tensions and deleveraging policies. Economic growth is certainly feeling the pain. Suppressed consumption has hit the service sector, property developers' sales have plummeted, manufacturers cannot fulfill orders. Above all, smaller enterprises face the greatest pressure as cash flow deteriorates.

We see three potential scenarios:

- An optimistic scenario, where containment measures are lifted before the end of march and fiscal policy supports smaller enterprises and infrastructure investment. The shock will largely be confined to Q1 and 2020 is likely to see growth around 5.5%.

- A medium scenario, where the situation lingers into Q2 of 2020 with fiscal policy limited to support smaller enterprises. Annual growth may be dragged below 5% and a meaningful recovery may have to wait until 2021.

- Worst case is the outbreak translates into a protracted event with policy makers focusing on containment. Growth in 2020 may be well below 5% and could potentially trigger an international crisis.
  Given current information, the most likely outcome lies between the optimistic and medium scenarios, yet uncertainty remains significant.

Equity Market Outlook

Uncertainty has shifted the equity market from cautiously optimistic to neutral in the short-term as the epidemic dominates market sentiment and volatility rises, although the probability of a market collapse appears remote. In the medium-term if the expected scenario is realized, equity markets may shake off the shock by mid-2020 and deliver a satisfactory return for 2020 although a re-escalation of US-China trade disputes is a notable risk.

Healthcare and large caps are winners, while consumer services, real estate and construction related sectors face challenges. The shock most severely threatens smaller enterprises with limited reserves, particularly restaurants, hotels, and travel agencies. Weak real estate developers will suffer as housing sales plummet.

The Hang Seng Index may resume an optimistic trajectory by mid-2020 if the expected scenario is realized and the phase one trade deal is honored, although sentiment will remain fragile. Q3 in 2020 presents a risk event with the election of the Legislative Council of Hong Kong.

China Economic Outlook

The shock of the epidemic will likely paralyze the economy in Q1 2020. Once it passes, a friendlier environment is in prospect through policies supporting smaller enterprises and policies targeting poverty.

China Monetary Policy Outlook

People's Bank of China is lowering borrowing costs and holding back on policies that tighten financial regulation. Open Market Operations rates have been lowered, there's the prospect of further cuts in policy rates and reduction in the Loan Prime Rate, while for existing loans banks are advised to delay interest charges for certain areas and sectors. A lower funding cost does help the economy, but a slower pace of tightening regulation is most effective.

Source: China Post Global

China Bond Market Outlook

Accommodative monetary policy and the expected temporary nature of the virus shock imply a lower and steeper curve, however it is yet to be seen whether the current 2.8% 10-Year rate has fully priced in lower growth.

Credit spreads for higher rated issuers, e.g. state-owned enterprises (SOE) and local government financing vehicles (LGFV), may tighten, while lower rated issuers' credit spread could widen on deteriorating fundamentals and outlook.

Source: China Post Global

Stock Markets

Calibrating China Investments

by Ntree

Calibrating China investments is challenging

Calibrating investment in China is a herculean challenge for investors dealing with unfamiliar cultural and political systems, a rapidly evolving economy, multiple investment access points, and unforeseen events.

Risk management is critical in a highly complex and dynamic environment

Meaningful exposure to China's economy is a necessity for investors with a longer-term perspective, China is now the world's second largest economy representing approximately 16% of global output. Its expected growth rate prior to the impact of the current Covid-19 outbreak was 5.9%, far surpassing US growth for 2020 of 2.1% [1]. The effect of the Covid-19 epidemic is at present impossible to reliably estimate as the number of people affected and its geographic spread is rapidly changing.

A significant challenge for investors is obtaining broad exposure across China's diverse and rapidly evolving economy. In common with other developing Asian countries, combined economic and population growth is creating a climate supportive of a rapidly growing middle class. By 2030, China is expected to account for 22% of global middle-class spending, with the US only accounting for 7% [2].

Not only the Covid-19 epidemic but also the long running political conflict in Hong Kong re-enforce the importance of robust risk management. With no sign of reconciliation between the opposing sides, at the end of 2019 Hong Kong fell into its most severe recession since 2008, with the Hang Seng Index trading at a 40% discount to stocks in the MSCI World3. However, to date the role of Hong Kong's capital markets seems mainly unaffected by these widespread protests.

A-Shares grow in importance

The importance of China A-Share exposure has grown during 2019 as index providers such as MSCI have gradually increased China A-Share weightings within their popular global series, in particular Emerging Markets indices. Indices using market capitalisation based weighting methods have advantages including simplicity and transparency, however disadvantages include the dominance of large companies and high allocations to specific industry sectors – MSCI China A Index has more than a quarter allocated to financials.

Minimum Variance assists risk management

Whilst building up an adequate China exposure has long been the main challenge for investors, risk management is now becoming more and more important as the formerly continuous upward trend now seems somewhat disrupted. As part of a diversified investment approach for risk management, investors can consider a strategy such as Minimum Variance, as it is designed to prioritise risk control objectives.

The strategy uses exchange share price data and is neutral to market capitalisation. By allowing a wider spread of industries facilitating superior diversification Minimum Variance portfolios tend to be less volatile than the overall market, an attractive characteristic in retail dominated markets.

1 Middle class consumption - top 10 countries, 2015, 2020, and 2030 (PPP, constant 2011 trillion US$ and global share)

Country	2015	Share (%)	Country	2020	Share (%)	Country	2030	Share (%)
U.S.	4.7	13	China	6.8	16	Cina	14.3	22
China	4.2	12	U.S.	4.7	11	India	10.7	17
Japan	2.1	6	India	3.7	9	U.S.	4.7	7
India	1.9	5	Japan	2.1	5	Indonesia	2.4	4
Russia	1.5	4	Russia	1.6	4	Japan	2.1	3
Germany	1.5	4	Germany	1.5	4	Russia	1.6	3
Brazil	1.2	3	Indonesia	1.3	3	Germany	1.5	2
U.K.	1.1	3	Brazil	1.2	3	Mexico	1.3	2
France	1.1	3	U.K.	1.2	3	Brazil	1.3	2
Italy	0.9	3	France	1.1	3	U.K.	1.2	2

Source: Brookings Institute

[1] International Monetary Fund, World Economic Outlook October 2019, 2020 Output Projections

[2] Global Economy and Development at Brookings, The Unprecedented Expansion of the Global Middle Class, an Update by Homi Kharas, February 2017

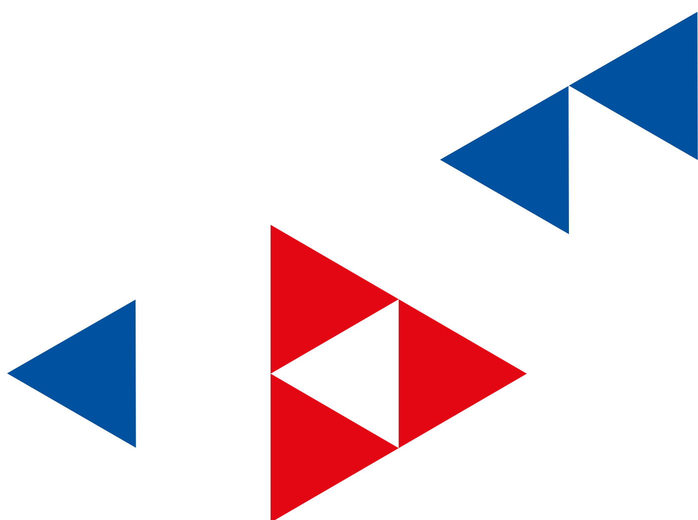
[3] FT, Hong Kong Stocks Cap Off Gloomy 2019 with December Rally, 31 December 2019

About CEINEX

China Europe International Exchange
China Europe International Exchange AG (CEINEX) is a joint venture established by Shanghai Stock Exchange (SSE), Deutsche Börse Group (DBAG), and China Financial Futures Exchange (CFFEX). It is the first dedicated trading venue for China- and RMB-related investment products outside of mainland China and considered a strategic project between China and Germany

Our vision
Establish a centralized marketplace for trading, risk management, and asset allocation for China-related or RMB-denominated exchange traded financial products in Europe.

Our mission
As a Sino-German strategic capital markets platform, CEINEX's mission is to support the real economic cooperation between China and Europe as well as promote RMB internationalization.



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