CEINEX

China Europe International Exchange

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CEINEX Quarterly – China Capital Markets Access

Editorial

Dear Ladies and Gentlemen,

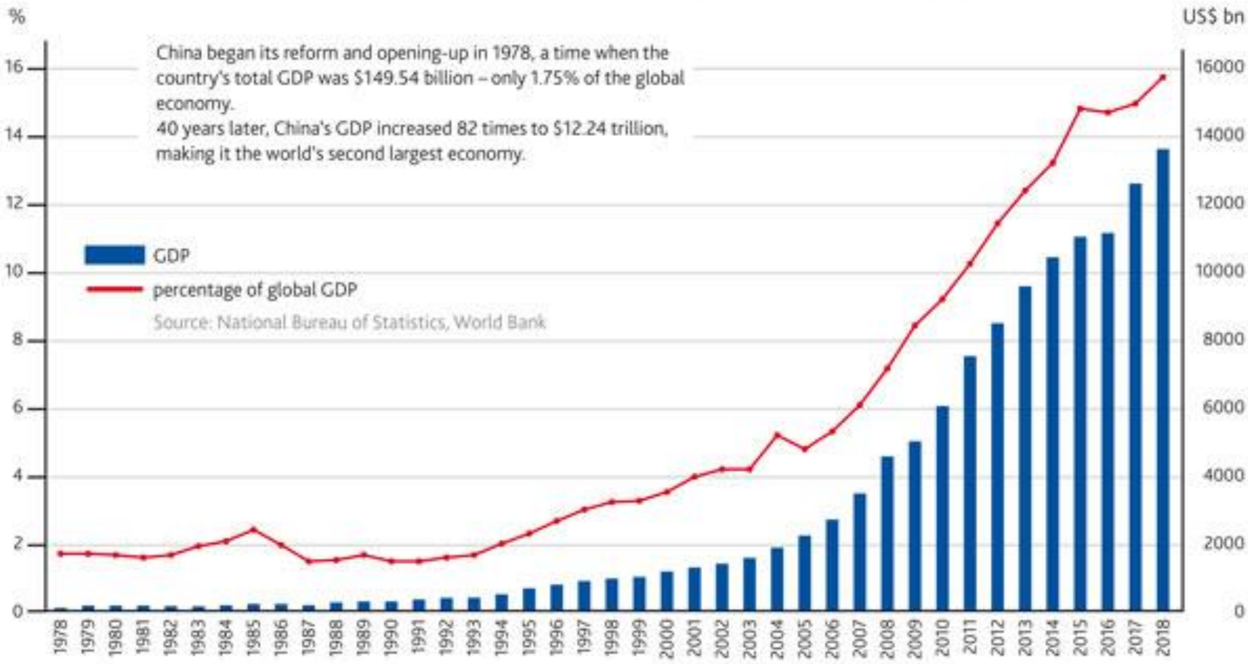
Welcome to the first issue of the revived CEINEX "China Capital Markets Access" newsletter. Hereby we are offering you a quarterly review and outlook on the proceedings at the Chinese capital markets and their interaction with global markets—from regulatory updates to investor issues, macro-economic outlooks to market schemes.

CEINEX, the China Europe International Exchange, is a neutral platform established to bridge the capital markets between China and Europe. With our globally unique position we are here to serve investors from both the Chinese and international markets to better understand and to give them easier access to the respective markets. Both, under local regulation and with international access.

Global financial markets are evermore interconnecting and China has become an important structural part of it, integrating more and more. 70 years after the founding of the People's Republic of China and 40 years into the ongoing reform of opening up, cooperation has never been as important as it is now.

Many of the success stories over the past decades were written by means of a carefully guided opening of the Chinese economy and financial markets. Each step received an eagerly interested response, especially from financial markets participants all over the world.

40 years after reform & opening-up – China's GDP 1978-2018



A most recent action taken by the Chinese financial markets authorities was abandoning the constraints for access to Chinese markets formerly imposed by means of QFII and RQFII. In this issue of our newsletter our guest authors from Hongkong-based asset manager CSOP will take a close look on the implications and impacts of this step. From our experience, we can tell that many investors are keen on extending exposure to China.

In order to provide more background on what is going on in the Chinese economy and financial markets we bring together experienced market participants and observers from some of the financial markets giants but also some fine-tuned niche-players in China and Hong Kong. We are very grateful that we can share the insights from these locally rooted but globally networked experts with you.

Our “Speaker’s Corner” for example shall provide your with a different perspective or some “food for thought”. In this first edition the question is raised, whether the current set-up of global benchmarks adequately reflects the size and success of the Chinese economy or if we need a new benchmark.

The history of opening Chinese capital markets for foreign investors has been a story of continuous learning as is our own at CEINEX. So, if you have any thoughts or comments on this newsletter please get in touch at communication@ceinex.com

Yours faithfully,
CEINEX Corporate Communications

Talking Point

Cancellation of investment quotas will attract more foreign capital

Research Team, CSOP

The State Administration of Foreign Exchange (SAFE), China’s currency regulator, has announced to scrap the investment quota limits under the Qualified Foreign Institutional Investors (QFII) scheme and the Renminbi Qualified Foreign Institutional Investor (RQFII). As the largest RQFII quota holder globally, CSOP welcomes the latest step of China opening up its financial market, and believes China’s effort to strengthen foreign investors’ confidence will consequently attract more capital inflow to the onshore market.

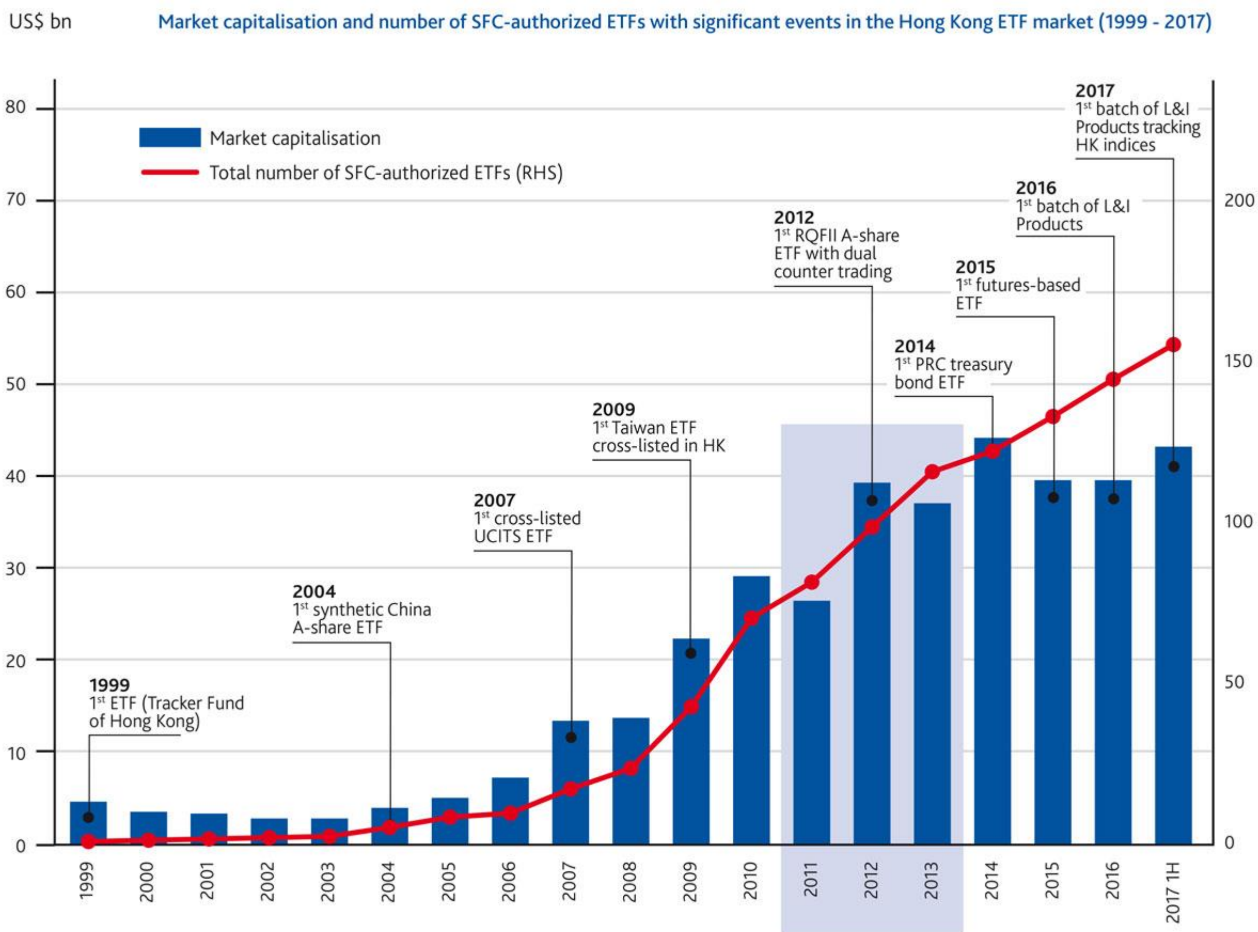
RQFII & QFII played crucial rule in China’s opening-up process

The QFII policy was introduced already in 2002 for foreign institutional investors to directly invest in the Chinese Yuan (CNY) denominated Mainland China market, while the RQFII followed in 2011 allowing foreign investor to use CNH, “the offshore Yuan, to invest into equities and bonds in China. Thereby, RQFII and QFII scheme provided foreign investors a crucial access to China’s onshore market in the past decade. The scheme is also a key driver of Hong Kong’s ETF market. In 2012, the first batch of RQFII A-share physical ETFs were launched in Hong Kong and experienced explosive growth of assets under management.

Quotas no longer only access to onshore market

In the past decade, on the one hand, China has been opening up its capital market consistently by establishing and deepening Connect schemes with Hong Kong. For the equity market, the Shanghai Hong Kong Stock Connect scheme and Shenzhen Hong Kong Stock Connect scheme were set up in 2014 and 2015 respectively. For the fixed income market, the Bond Connect scheme was launched in 2017, allowing foreign investors to buy onshore bonds through Hong Kong. For the wealth management market, Mainland-Hong Kong Mutual Recognition of Funds scheme was kicked off in 2015, giving foreign investors’ an opportunity to allocate in certain specialized mainland funds, or the other way around.

On the other hand, China’s commitment and continuing effort to open the capital market has been well recognized by global investors in recent years, as index providers such as MSCI, FTSE Russell, Bloomberg Barclays, and JPMorgan Chase announced to include China equities or bonds in their global indices. The move has been facilitating huge capital inflows to the China onshore market despite short-term market volatility.



Currently, the RQFII/QFII scheme and the Stock Connect scheme are the two major access points for foreign capital investing in the mainland market. By the end of June 2019, foreign capital was holding CNY 1.65 trillion worth of A-Shares[1] or 3.73 percent of the total A-Share market capitalization. Foreign capital has become the second largest institutional investor group in mainland China, only next to domestic mutual funds.

Among the holdings of CNY 1.65 trillion 62.5 percent are invested via the Stock Connect scheme while 37.5 per cent are QFII/RQFII allocations. By August 2019, USD 111.4 billion worth of QFII quota was used, making up 37 percent of the total QFII investment quota limit[2].

As RQFII/QFII is no longer the single-log bridge to enter the Chinese market, the recent lift of the total investment quota is unlikely to bring significant impact into related RQFII products.

Opening up policy to further enhance foreign investment's participation and confidence in China's capital market

We believe that the lift of QFII/RQFII quota shows China's commitment to further continue to open up its capital market, and will bring long term impact to the onshore market in a positive way.

- In short term, the decision will increase foreign investors' confidence and interest in the Chinese market, attracting enhanced participation of various foreign investors such as hedge funds. It also provides foreign institutions with more flexibility to allocate in the mainland market.
- From a long term perspective, foreign institutions think highly of the stability and consistency of China's policy. The decision has sent a clear signal that China has a strong commitment to the opening-up policy which will not be shaken by short-term ups and downs in the market.

Foreign investors now hold no more than 4 percent of A-Shares, a small portion compared with other markets. As index providers continue to add A-Shares and Chinese bonds to their global indices, we believe more capital inflow will be seen and will likely benefit related ETFs.

[1][2]Source: Huatai Securities, as of June 2019 and August 2019 respectively.

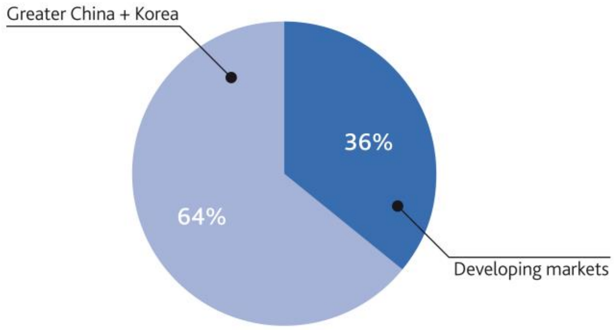
Speakers‘ Corner

China: An emerging market or a separate asset class?

Erwin Sanft, Senior Portfolio Manager, E Fund Management (HK)

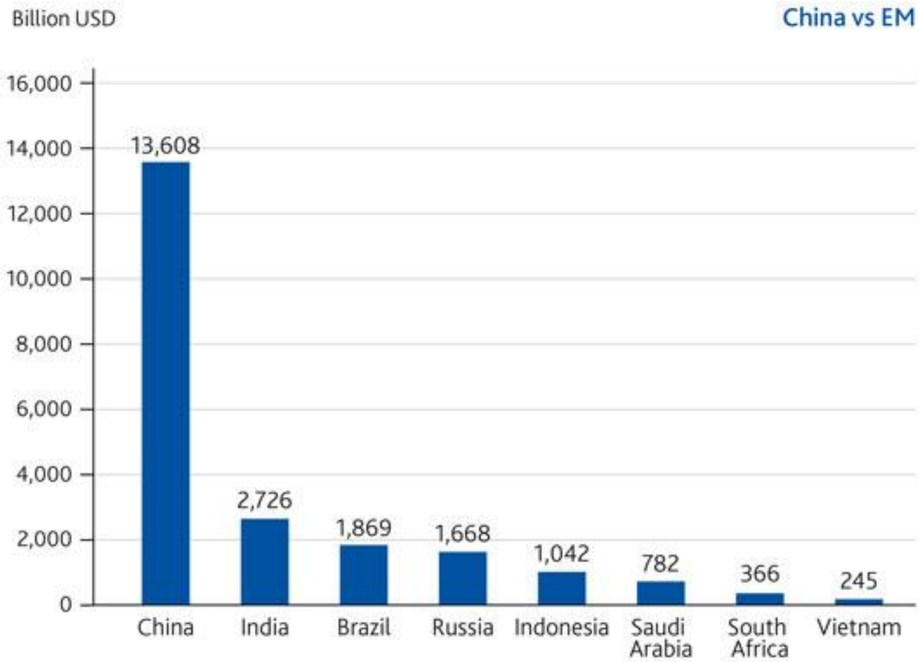
While China's rise to become one of the world's largest economies has been going on for decades, global equity index benchmarks have just begun reflecting the nation's impressive economic size. The respective index changes are now challenging the conventional wisdom of investing into emerging markets sparking a debate whether China should be considered a separate asset class. The index providers FTSE Russell and S&P Dow Jones have joined MSCI in adding China's domestic A-Shares to their global equity indices. This is helping propel foreign portfolio inflows into A-Shares to record highs as changes in the global equity indices are mirrored in many investors' portfolios, for example through their ETF investments. The weight of A-Shares in emerging market indices is surging as a result, rising from 1.8 percent to 5.4 percent in the MSCI Emerging Markets Index and catapulting from zero to 4.1 percent in the FTSE Russell Emerging Index, respectively to 6.2 percent in the S&P Emerging BMI.

MSCI Emerging Markets Index, upon full A-share inclusion



Looking ahead to when A-Shares are fully included, China will have outgrown the emerging markets investment category by far. At today's prices, developing economies outside of China will only stand for 36 percent of the MSCI Emerging Markets Index. This reflects the reality of China's economic size and the growing imbalances between countries within emerging markets indices. By size, China is better compared with the US and EU. China's largest coastal provinces are already developed economies. Korea, itself a developed economy, has only been kept in emerging market benchmarks as a counterweight to China. The demise of the "BRIC" (Brazil, Russia, India, China) investment category provides an example of how fast popular categories become outdated. Created by a Wall Street economist in 2001 to define large emerging markets as an asset class, the term had fallen out of use by 2012. Driven by the rise of China and the strength of Korea, we might soon see a new category.

China vs EM



Policy Update

China growth slows amid standoff with US in trade tensions

Research Team, China Post Global

On 6 September after market close the People's Bank of China (PBoC) announced a reserve requirement ratio (RRR) cut of 0.5 percent for all banks, and an additional 1 percent cut for provincial banks (those whose business is in local provinces only). The announcement states that the cut will release about Chinese Yuan (CNY) 900 billion reserves to commercial banks and reduce their funding costs by CNY 15 billion annually.

In line with its reform of the loan prime rate (LPR) in August, PBoC aims at streamlining the monetary policy transmission mechanism and reducing financing costs, especially for small and private firms who were squeezed severely by the recent economic slowdown as well as the crackdown on shadow banking. Now with the RRR cut in place, the last LPR quote on 20 September trended lower signalling that the task of lowering financing costs is successfully being achieved. Additionally, PBoC may charge a lower rate when extending Mortgage Liquidity Facilities (MLF) in October or November, further lowering LPR. The effectiveness of this, however, is doubtful as not only is there restricted supply caused by banks' reluctance to extend credit to the lacklustre sector, but there is also sluggish financing demand due to an increasingly bleak fixed asset investment outlook.

Another noticeable point is that recent RRR cuts are often accompanied by PBoC draining liquidity from the market. It de facto causes a structural shift, simultaneously reducing bank funding costs while also reducing the liquidity available to non-bank financial institutions. However, with current ample market liquidity, the draining should only have a marginal effect on financial markets. August financial data surprised to the upside, mainly due to the pace of crackdowns on shadow banking being slowed. Long-term corporate loans recovered

to a certain extent, and if this continues in the coming months, we believe that improved fixed asset investment in manufacturing may follow. This was reinforced by September financial data, where bank loans in CNY exceeded market expectation, and fixed asset investment was up 5.4 percent January to September. Household long-term loans have grown steadily, despite policy makers persistently tightening housing policy. Household loans, mostly mortgages, rose to CNY 755 billion in September, from CNY 654 billion in August.

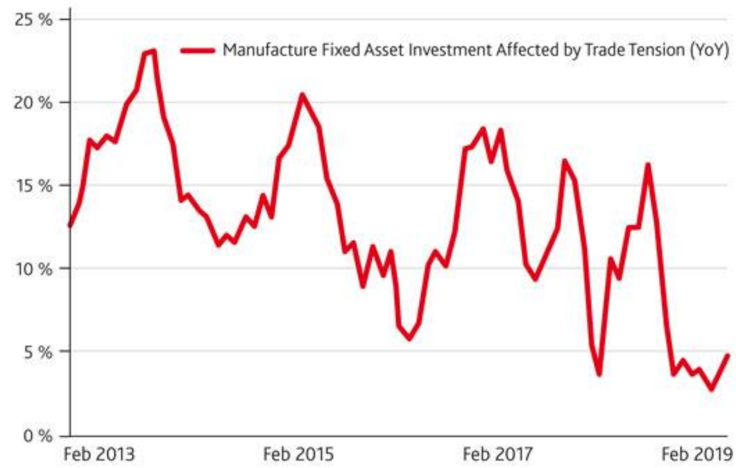
China growth slowdown continues

China growth continues to slow amid the US-China standoff and an ongoing global slowdown. The most acute pressure so far comes from subdued fixed asset investment, especially in the public infrastructure sector. Housing investment remains upbeat through the first half of 2019, though the market expects decreasing house sales to bring down housing investment from as early as the fourth quarter of 2019 onwards. Infrastructure investment may step in to reduce unemployment once housing investment falls, fortified by a large amount of local government bond issuance.

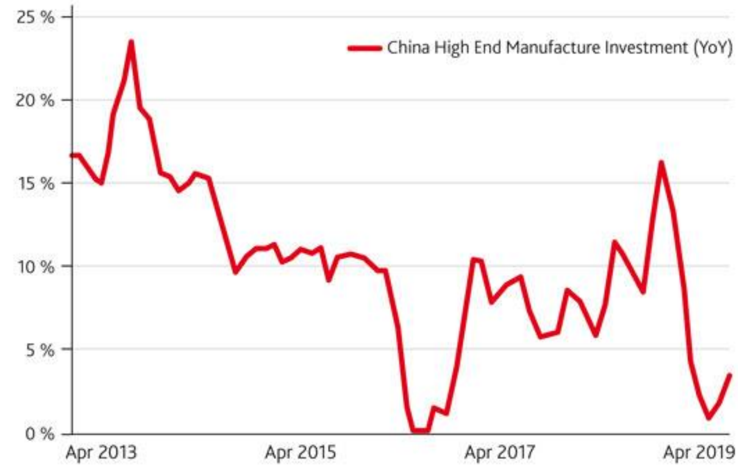
Manufacturing fixed asset investment, which is subject to drag from the slowing housing market and external shocks, is crucial to the economic outlook now. Reduced housing investment may bring down the currently buoyant level of investment in construction related subsectors from the fourth quarter of 2019, though the damage may be dampened by increased fiscal spending on infrastructure. Trade tension has also taken its toll on manufacturing fixed asset investment. The most affected sub-sectors, in our view making up about 14 percent of total manufacturing fixed asset investment, recorded the lowest year on year growth in more than seven years. The downturn may fade into 2020, mainly due to the base effect and improved financing conditions for manufacturers, though part of the supply chain is shifting out of China permanently.

The solution to the permanent supply chain shift is to boost investment in high end manufacturing sub-sectors, including machinery, equipment and medicine production. Fixed asset investment in

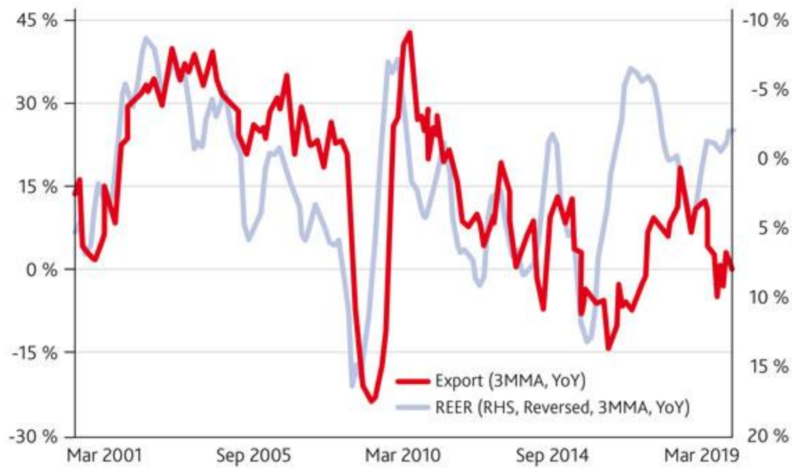
2 Trade Tension Affected Subsector Investment



3 High End Manufacturing Fixed Asset Investment



4 China Export vs REER

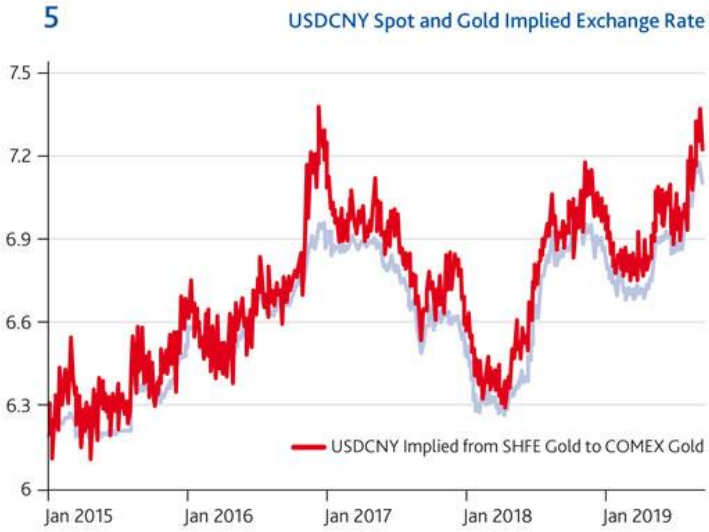


these sub-sectors, now around 40 percent of total manufacturing investment, has recovered from the previous trough. Policy tailwinds and more favourable financial conditions could help secure the outlook, though it still needs to be monitored how effective it could be at upholding manufacturing fixed asset investment and economic growth.

Exports stall and CNY close to equilibrium level in the near term

The export sector is stalling after an outbreak of trade tension and fell 3.2 percent in September in US dollar terms. However, it remains far from the previous low in 2016 with help from real effective exchange rate (REER) depreciation. It is believed that exporters are trying to front run tariffs and so exports may see a sharp decline into 2020, the implication of which would mainly be slowed growth, and a depreciating currency. PBoC has acknowledged the pressure by loosening its tolerable trading band for the Yuan in US-Dollars in early August and, based on the currency's reaction that followed, it is safe to infer that capital outflow pressure is not acute.

The Yuan's depreciation expectation is contained at the moment, though PBoC monetary policy tilts slightly towards accommodative. One of the most prominent features of monetary policy from 2015 is that the regulator has curbed credit flowing into the asset market and thus curtailed capital outflow. With recent policy combinations and the balance of payments, continuous depreciation is not the base case scenario, and the current level should be close to equilibrium in the near term.



Macro View

China misses growth expectations

Jason Xi, Research Team, ICBC CS

China's foreign exchange reserves rose unexpectedly in August, even as the yuan posted its biggest monthly drop in 25 years amid escalating trade tensions with the United States.

The country's foreign exchange reserves - the world's largest - rose by USD 3.5 billion in August to USD 3.1072 trillion, central bank data showed. The increase in August was due to China maintaining a stable balance of international payments and generally stable economic growth, the foreign exchange regulator said in a statement after the data release.

China's exports unexpectedly fell in August as shipments to the United States slowed sharply, pointing to further weakness in the world's second-largest economy and underlining a pressing need for more stimulus as the Sino-U.S. trade war escalates. August exports fell 1 percent from a year earlier, the biggest fall since June, when it fell 1.3 percent, customs data showed. Market consensus expected a 2.0 percent rise in a Reuters poll after July's 3.3 percent gain. Among its major trade partners, China's August exports to the United States fell 16 percent year-on-year, slowing sharply from a decline of 6.5 percent in July. Imports from America slumped 22.4 percent.

The data also showed China's imports shrank for the fourth consecutive month since April. Imports dropped 5.6 percent on-year in August, slightly less than an expected 6.0 percent fall and unchanged from July's 5.6 percent decline. China reported a trade surplus of USD 34.84 billion last month, compared with a USD 45.06 billion surplus in July. Analysts had forecast a surplus of USD 43 billion for August. China's trade surplus with the United States stood at USD 26.95 billion in August, narrowing from July's USD 27.97 billion.

China's central bank said it was cutting the amount of cash that banks must hold as reserves for the third time this year, releasing CNY 900 billion (USD 126.35 billion) in liquidity to shore up the flagging economy.

The People's Bank of China (PBOC) said it would cut the reserve requirement ratio (RRR) by 50 basis points (bps) for all banks, with an additional 100 bps cut for qualified city commercial banks. The RRR for large banks will be lowered to 13.0 percent. China's economic growth has likely cooled further this quarter from a near 30-year low of 6.2 percent in April-June.

Stock Markets

Policy stimuli support Chinese stock markets

Dickson Chan, Strategy and Planning, BOCI

Despite in a range-bound pattern since the summer, year-to-date the Chinese A-Shares market has been one of the best performing stock markets globally. Factors such as expanded policy support, attractive valuation, more global index inclusion, and sustained ample liquidity have underlined the performance. In particular, big cap and blue-chip stocks have led the way, as demonstrated by the outperformance of the SSE50 index, which boasts some of the largest Chinese corporates from the financial services sector and construction companies. Since many of these large Chinese enterprises are considered world leading firms in their respective industries, they continue to enjoy the benefits of their broadening brand recognitions and expanding investor bases. China's Belt & Road Initiative also adds a new dimension of business opportunity for their global growth prospects.

Although both China and the world as a whole are currently facing an economic slowdown, many governments have already been pro-actively rolling out monetary and fiscal policies to stem the trend. China has also committed to boost its policy supports further, with the latest required reserve ratios (RRR) cut in mid-September as an example. We anticipate China to undertake further monetary easing. The Chinese government also continues to roll out additional fixed-asset stimulus measures, including an accelerated special bond issuance program by local governments for infrastructure works. We believe all those policy actions will continuously support the stocks of financial services and construction firms as they will also remain in the market focus for their defensive nature. We continue to view Chinese A-Share stocks presenting an attractive investment story on the basis of increasing participation from international investors seeking new investment opportunities and further risk diversification.

About CEINEX

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