China International
Fund Management

MARKET INSIGHTS

Voice of the Bund

2014 - February

2014: A Year of Reform

Client Portfolio Manager

Recent publication

- IPO reopens after a 14 month halt : Sprint before a marathon
  – 2014/02
- The End of the Blue?
  – 2013/12
- Reform 2.0
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Key Events Digest

Currently there are three major concerns that have tempered market sentiment: 1) the impact of reopening the IPO market on growth stocks and capital diversion; 2) rapidly expanding local debt increasing systemic risk; and 3) tight liquidity condition leading to high interbank interest rates slowing economic growth. Among these background noises, where are the silver linings?

The three concerns are actually interconnected. They reflect the temporary challenges faced by the economy as it transforms itself from investment-led to consumption-driven. The traditional economic growth model relied on policy driven investments--every dollar of GDP growth required five dollars of investment. Local governments had to rely to land sale to cover 80% of fiscal spending and only 40% of fiscal revenue. Banks have difficulties to meet demand for investment because of higher reserve ratio requirements and increasing funding costs due to interest rate liberalization. Consequently, instead of traditional bank lending channels, credit has flowed into the local debt and real estate market that provided higher yield, through the shadow banking system. Concerned with increasing leverage and accumulating potential risk, the central bank adopted a tighter monetary policy, driving money market and bond yields higher. This tightening contributed to the slowdown in the economy in Q42013. Additionally, the government reopened the IPO market after 14 months' halt, gradually shifting the listing power back to the hands of the investors. Money supply was further diverted in the stock market as investors eagerly anticipated the resumption of the IPO market.

Audit results of local government debt

	Jun 2013	2012	2011
Total Government Debt(Tn)	30.27	27.77	18.48**
Central Government Debt (Tn)	12.38	11.88	7.76**
Local Government Debt (Tn)	17.89	15.89	10.72
Debt/GDP	59%*	53%	39%**

*using GDP of 2012 as the denominator
** CIFM estimate

In our view, these challenges are inevitable phases of a transforming economy. Sporadic credit risk may surface. Periodical volatility in the money supply would cause temporary hiccups in the market. However, they will not lead to systemic risk; they are tempest in a teapot. These issues will not lead to systemic crises for a couple of reasons.

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First of all, China's financial system is dominated by banks instead of capital and derivative markets. China has the highest national savings rate in the world (over 50% of GDP as of 2012). The central government holds a large amount of assets and foreign reserves. China capital control policy prevents capital from leaving the country freely--unlike other emerging markets that suffered from massive outflow during previous financial crises. China is not dependent upon foreign capital for growth. Furthermore, China's local debt to GDP ratio is currently at 58%, below the international warning level of 60%.

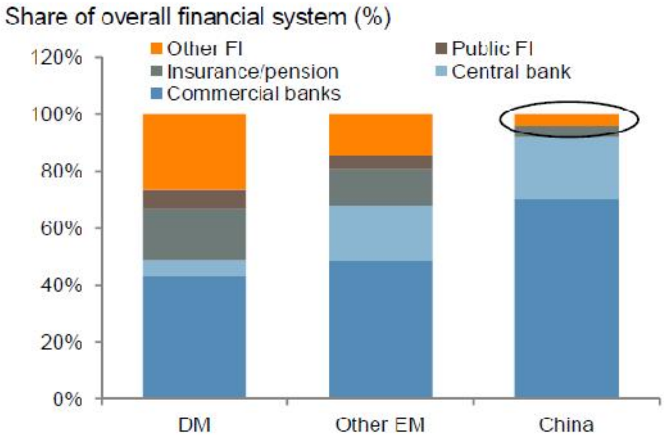
The local governments' total assets including land and state owned enterprises provide adequate defense against potential risk. Lastly, financial crises in 1998 and 2008 served as good lessons for the Chinese government—the central government will do everything in their power to prevent a massive crisis.

Secondly, by releasing the audit result of government debts, the government has shown its attitude towards and determination in acknowledging and tackling the problem. The National Development and Reform Commission (NDRC) gave endorsement to local government to issue new bonds to repay old debt as a way of rolling over their debt to avoid defaults. In addition, local governments are required to keep more detailed balance sheets. They are urged to strengthen their budget control, reduce leverage, and carry out SOE reforms. All these efforts are preparing the local governments for a more transparent and healthy budgeting system and the issuance of municipal bonds to let the market determine the risk premium.

Thirdly, the State Council recently called for tighter regulation on shadow banking system. This will help boost the transparency in the shadow banks and alleviate crowding out effect from sub standard credit products and off-balance-sheet lending on the credit market. Moreover, the risk-free rate is at its all time high in 9 years --without much room for growth. At this juncture, any loosening on the government's grip on liquidity will help boost investor confidence.

In conclusion, economic reform will improve the efficiency of capital. Funds will be diverted from projects with low returns to the capital markets, financing promising corporations to grow.

Chart: Share of Other FI and hence shadow banking still relatively small



Source: FSB, Emerging Advisors Group, JPM AM

2014 Market outlook

We expect the economy to stay on its “L” shaped trajectory and fluctuate within a narrow band in 2014. There is urgency to optimize the capital allocation between the public and private, traditional and emerging, industrial and service sectors in view of the labor cost hike, pollution, elevated property prices, and low yielding of investment. Therefore the investment contribution to GDP growth will decrease. The ongoing anti-corruption will improve government efficiency but will depress high-end consumption. It takes pain to transform and rooms are limited on the stock composite level.

However, the long term effect of reforms should not be overlooked or under-estimated. Since the third Plenary Session, financial system reforms have been pushed forward ahead of other reform agendas. Even though the road might be temporarily bumpy for the IPO market reform due to the imbalance between short term supply and demands, the change from approval based to registration based system will encourage entrepreneurship and creativity. The effect may be similar to the success brought by venture capital to the Silicon Valley and the first Industrial Revolution to Great Britain.

As expected, following the blueprint of the Third Plenary Session, Chinese economy is at the stage of further policy formulation and advancement. We are already seeing numerous government policies being introduced in an effort to push reforms forward. For instance, government has strengthened its effort to crack down corruption; plan to keep a detailed local governments’ balance sheets helps preparing for the budget reform; actions of Sales tax to VAT tax conversion are advancing, while property registration system setup is paving the way for the property tax policy; in regards to SOE reform, admittance of private owned banks and hospitals show meanings of “market oriented” mechanism will gradually replace government intervention; In order to prevent systemic risk, the government audited local government debts and introduced No. 107 Document to regulate shadow banks at the end of 2013, the government made two bold moves by setting-up the Reform Committee and the National Security Committee. All signs indicate that year 2014 will be the year of comprehensive reform. There is no doubt that the government is fully determined and committed to economic reform. However, uncertainties remain around sorting out the priority of each reform task and steps to push forward.

Economic reform implies reshuffling of different sectors. Traditional core sectors will shrink while emerging and growth sectors stand for benefits. Individual stocks could become winners during the transformation process as we have seen historically from economic transitions in the US and Japan. Outperformance by growth stocks was mainly driven by improved valuation in 2013. This year, stock performance will be determined by company fundamentals. In view of the macro-economy, our investment strategy in 2014 will focus on bottom-up stock selection in both the secondary and IPO markets.

Sectors we like in 2014 and why

Broad Consumer: benefiting from rising income and increasing demand for higher quality of living for individuals
Health care: benefiting from aging population and health care reform; short supply in health care services and medical devices also presents opportunities for private enterprises
Electronics: electronics supply chain is gradually moving to mainland China from Korea and Taiwan. Chinese consumer electronics manufacturers are entering the Apple ecosystem.
Oil and gas equipment and services: benefiting from China's heavy dependence on energy, increasing investment in shale gas as well as growing overseas market share.
Mobile Internet: benefiting from deeper penetration of smart phones and change of user behavior; the introduction and expansion of 4G network will promote growth in mobile games and video content.
Software: benefiting from smart city and domestication of information technology systems.

2013 CIFM Fund performance highlight

CIFM's 10 equity funds returned 27% on average in 2013. Of which 4 funds were ranked in the top 50 among 339 peers.
CIFM Balance Fund had a 1 year return of 32.4% and 2 year return of 47%, ranking No.1 out of 14 peers for both periods.
CIFM Emerging Power Equity Fund had a 1-year return of 47.2% and a 2-year return of 88%, ranking 12th and 2nd out of 339 and 292 peers.
CIFM Growth Series Equity Funds returned 40% on average in 2013. All of the funds were ranked top 50 out of 339 peers.
CIFM Trend and Thematic Series Equity funds returned 22% on average in 2013.

Source: Galaxy Securities Fund Research Centre (ranking of active investment management capability);
Data on performance of funds managed by CIFM as at 31 Dec. 2013, SA products as at 31 Dec. 2013.

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