EASTFORT ASSET MANAGEMENT

Institutional access to the rapidly growing China fixed income market

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CONFIDENTIAL
For non-U.S. Investors

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EFAM Focus - National People's Congress (NPC)

Highlight of EFAM Views

China concluded the 2016 annual session of NPC meeting this week

- **Hard Landing is Remote -** given strict control of financial risk and structural reform by central government
- **Strong Government Support** – in key development areas, such as technology, innovation, public utilities, education, and environment, will continue to receive support in the forms of tax reduction, fee reduction, and investment fund, etc.
- **Monetary Easing Bias** - expect monetary policy to bias toward easing side but massive liquidity injection is unlikely
- **Structural and Supply Side Reform** – expected to be implemented in a "trial and error" manner. We expect overcapacity continue to deflate intermediate product prices and impose challenge on the profitability of companies in upstream industries in near term
- **Elevated Infrastructure Investment -** will remain elevated with enlarged budgets at central and local government level. We expect government will resort more actively to bond market to finance its lifted fiscal deficit

Premier Li Keqiang's Press Conference Highlight

With the GDP growth target in 2016 set between 6.5% and 7%, Premier Li acknowledged that the economy still faces persistent downward pressures amid sluggish external demand, in additional to potential problems that may arise in the transition process. Nonetheless, the Premier assured that the government still has sufficient policy options available to ensure economic growth within a reasonable range.

Key Topic and Agenda For 2016

1. Growth Target

The year 2020 is set as target year for realizing the "Centenary goal" of doubling GDP and per capita income from 2010 level. To this end, the 13th five year plan aims to target average annual growth at above 6.5% level from 2016 to 2020.

2. Macroeconomic Policy >>

The People's Bank of China (PBoC) governor Zhou Xiaochuan reiterated the need for flexible and adjustable monetary policy.

3. Reform and Structural Development >>

Supply side reform is among the top priorities in government projects. Premier Li emphasized that reform and development will be well balanced to avoid massive layoffs while cutting overcapacity

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In Depth: Macroeconomic Policy

The People's Bank of China (PBoC) governor Zhou Xiaochuan reiterated the need for flexible and adjustable monetary policy.

The governor emphasized that major stimulus is not needed to support the economy and that excessive monetary policy stimulus is not necessary to achieve the growth targets. Though the governor set the tone of monetary policy as “prudent with easing bias”, we do not expect massive liquidity injection especially given the Renminbi devaluation pressure and the build up of strict control against overleveraging. Both Zhou and PBoC deputy governor Yi Gang emphasized that China will not use exchange rate policy to boost exports. Yi Gang further stated that current capital outflow is benign and foreign currency liabilities of corporates have been reduced.

Corporate Debt

Premier Li addressed the fairly high corporate debt ratio by stating that:

“High debt ratio is no new problem in the country, as Chinese companies still raise capital mostly indirectly. But other market-based tools are still at disposal to help bring down corporate debt ratio.”

Relevant authorities will continue to develop the bond and equity market with the target of improving capital structure and reducing corporate debt burden. It is expected that the financial sector can facilitate overcapacity cut, deleverage while provide support to real economic growth in properly. The China Banking Regulatory Commission (CBRC) has asked joint-stock banks to assess the credit risks and potential asset losses for loans in sectors with overcapacity. Close monitoring and guidance will be imposed to control financial risk and prevent any illegal activities. Despite the recent volatility in the equity market, Shenzhen-Hong Kong Stock Connect is still projected to be launched this year.

Fiscal Target

Official fiscal deficit ratio target is set at 3% in 2016. We expect both central and local government to resort more actively to bond market for financing. Investment in infrastructure is expected to increase in order to accelerate urbanization and stabilize growth. In fact, apart from the core fiscal target, many other tools are available at the government’s disposal to take up “quasi” fiscal functions such as issuance of policy bank bond, special financing bond, and initiation of Public Private Partnership (PPP) projects, etc. The Ministry of Finance (MoF) has set up RMB180bn PPP fund to encourage private participation in the previous government dominated projects.

Market Transparency

Chinese government has also resolved to increase openness of its affairs and respond to public concerns by various means including the Internet and cloud computing.

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In Depth: Reform and Structural Development

Supply Side Reform

Supply side reform is among the top priorities in government projects. Key aspects include streamlining administration, delegating powers of the government and cutting corporate taxes.

Value added tax (VAT) reform – to be fully completed in 2016. China will promote market competition and encourage innovation to unleash the economy's potential.

Overcapacity and Employment Concern – Premier Li emphasized that reform and development will be well balanced to avoid massive layoffs while cutting overcapacity. RMB100bn fund has been set up to cover the layoffs mainly in coal and steel sectors. We expect that the structural reform to take on a rather slow pace in a "trial and error" manner. Overcapacity will continue to deflate intermediate products prices and impose challenge on the profitability of companies in upstream industries in near term. Service industry has been identified as the new drivers. Notwithstanding the slowdown in industrial growth, service industry has seen 8.1% growth in the first two months of 2016.

Banking Sector Reform

For the banking sector, Premier Li said that the capital adequacy ratio (13%) and provision coverage ratio (18%) are still above safe level. Nonetheless, the government will take coordinated measures to stabilize market and avoid systemic financial risk. Commercial banks are suggested to make use of the market to sell their bad assets. Three commercial banks have started the preparation for non-performing loan (NPL) securitized products offering under the trial program. The debt to equity swap program will also roll out to help bring down corporate debt ratio. Additionally, control of off-balance sheet items such as wealth management products (WMP) will be enhanced in areas of investable assets, limits, and counterparties.

Property Sector Reform

For the property sector, policy makers have identified the reduction of housing inventory as one of the top priorities for this year, and have in accordance announced measures such as reduced levies and lower deposits. Favorable measures will be rolled out to help migrant workers to buy homes, find jobs and settle down in cities. However, we expect to see differentiated policies in tier 1 and some tier 2 cities versus the rest. For example, loan to down payment will be restricted as it is one of the measures to prohibit speculation in order to stabilize house prices , particularly in the tier 1 cities.

Infrastructure Reform

On the Infrastructure front, investment needs in upgrading the industrial sector and accelerating urbanization, particularly in western area will remain substantial and serve as key demand generators. In addition, power transmission price reform will continue into 2016 and will involve 12 provincial level power generators.

In Depth: Reform and Structural Development (continued)

Corporate Sector Reform

For the corporates sector, the China government wants to give firms incentives via market liberalization to produce better products and improved services. The government will open the market in a more liberalized way to private capital, loosen restrictions on foreign enterprises, while encouraging innovation among all firms. As pointed out by Premier Li, there is still room for China to reduce the burden on enterprises by cutting their financing costs and social security burden. The Green Development imitative has been placed with heavy weight in the Five Year Plan. Environmental supervision reform will be completed in 2018 with key focus on law enforcement management of environmental watchdogs under the provincial level. Green bond market which houses the type of bonds issued to finance renewable energy and environment projects, will see substantial growth alongside with policy support.

Summary

China has made economic structuring its top priority for the next five years, and at the heart of that mission is tackling overcapacity and leverage issue. Fixing these problems will require consistent policy to avoid social and economic repercussions, and limit spillover of industry weakness to consumption. It has been acknowledged that China's economy will face transitional pressure in the near term. However, with the government's efforts in combining new and traditional growth drivers and prudent financial risk management, we believe China will be able to achieve a more sustainable, higher quality, and consumption-led growth model in the mid to long term.

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