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China Update

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Growth outlook: Slowdown in 2H; whole year 6.7%

- Stimulus brought out in 2016 started to fade.
- Recent tightening pushed bond yields higher.
- Bank loan rate should also rise, albeit with some lag.
- Fiscal spending was front-loaded this year (21% in 1Q).
- Housing should cool down further in 2H. Home sales slowed; Home price started to fall in top cities.
- Hard commodity prices have peaked.
- Expect CPI inflation well contained (<2.0%). PPI peaked.

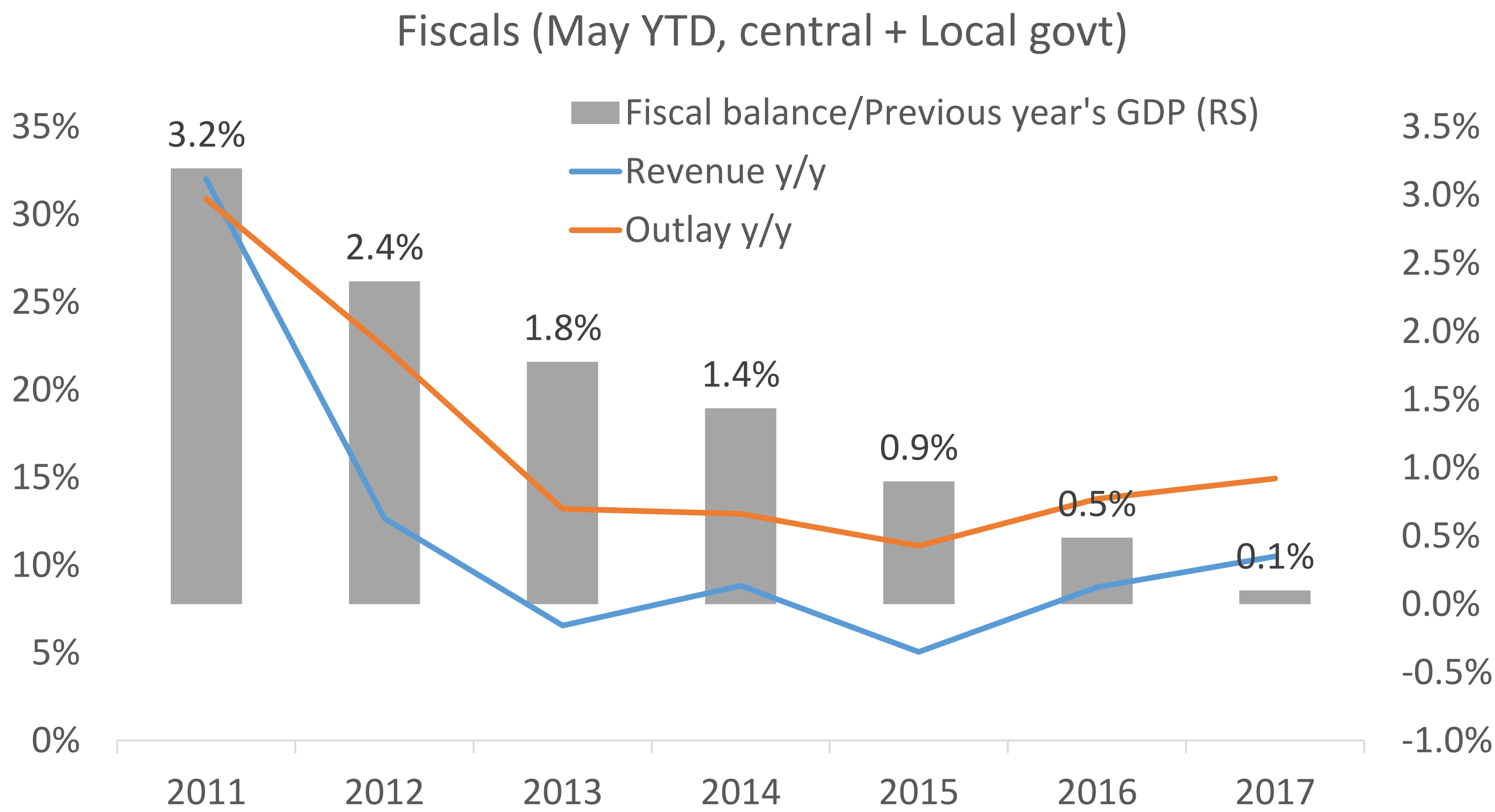
Deleveraging: The job handed from PBoC to CBRC

- “Contain the leverage; Contain the financial risk” the top priority.
- However these two goals are not entirely compatible.
- PBoC led the effort from August 2016~March 2017.
- CBRC took over since 2Q with much tighter regulations.
- PBoC might still have to raise money rates if Fed hikes aggressively.
- The chance of hiking benchmark rate is low due to the absence of inflation.
- M2/GDP will be flat or even decline in 2017. Debt/GDP is also likely to be capped, after years of rapid increases.
- The deleveraging process is risky.

RMB: Lacking flexibility

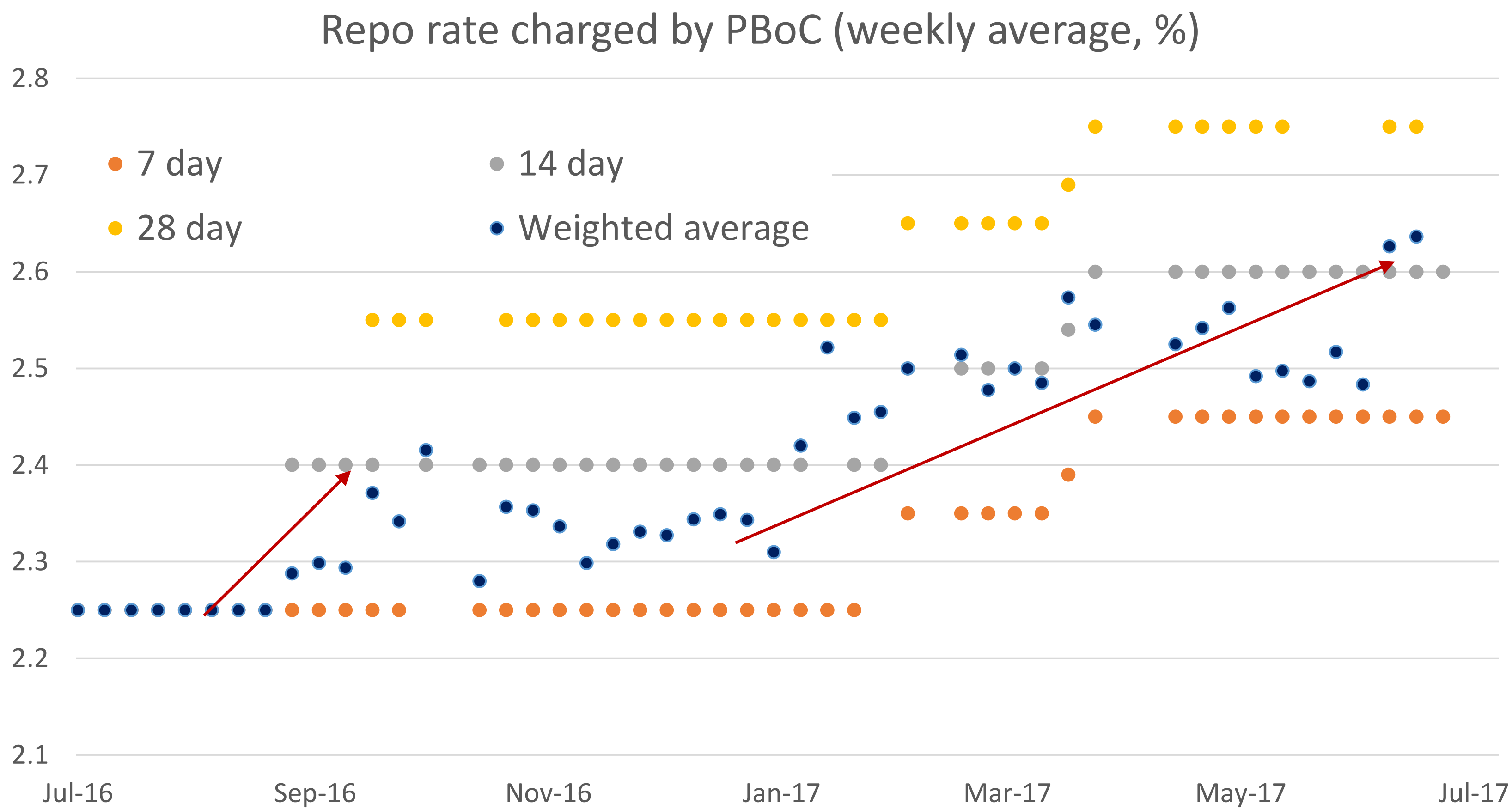
- RMB depreciation was not the best policy option—some help to exporters, yet huge trouble with outflows.
- The PBoC needs to break the vicious cycle of Outflow → Loss of FXR → Depreciation → Outflow.
- It tried direct FX intervention, capital control and now "counter-cyclical factor' in fixing. RMB expectation is the key to outflow.
- Squeezing HIBOR is the least costly way of intervention—help to lift onshore CNY, but not SHIBOR.
- Expect RMB to be managed to keep CFETS steady.
- Expect tight control over outflow and more opening for inflows.
- Good chance of SH-London Stock Connect in 2H.

Fiscal impulse
Fiscal surplus in Jan-May decreasing

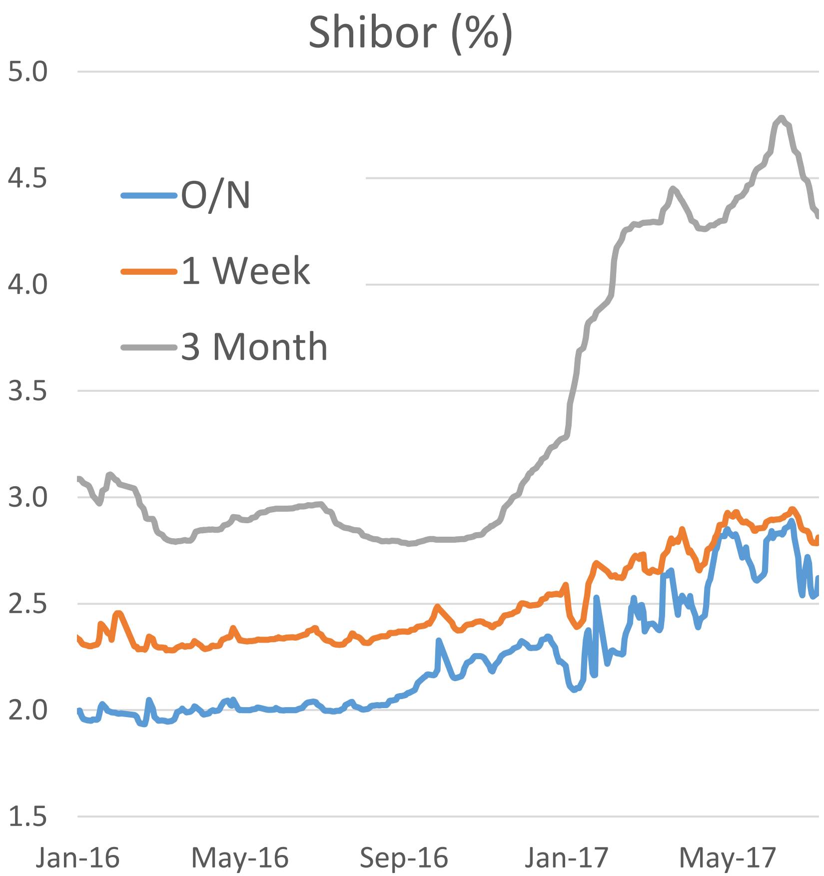


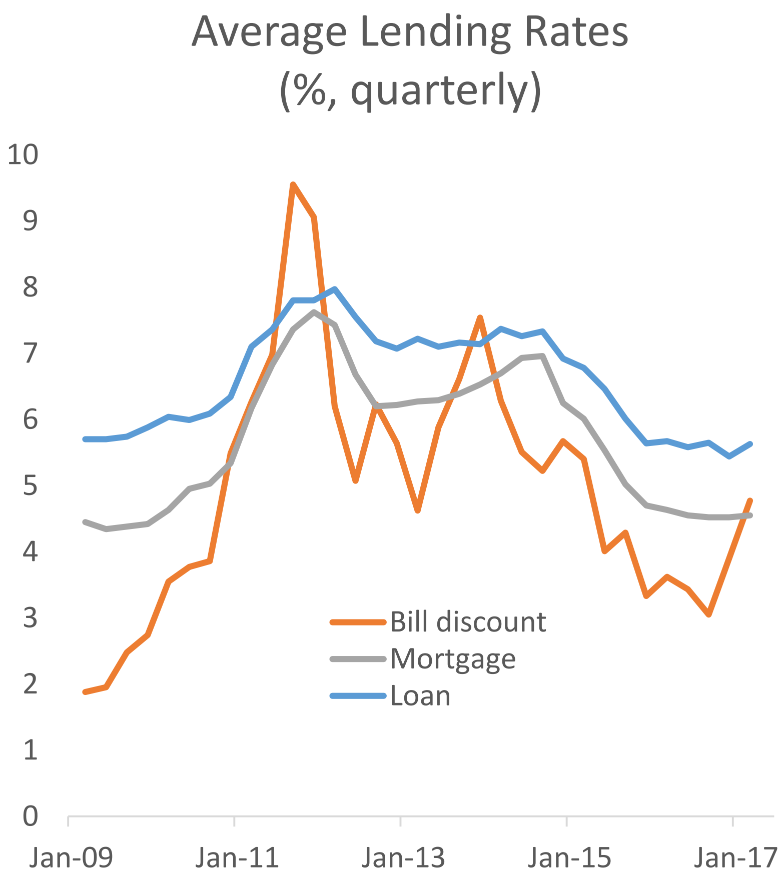
Monetary condition tightened

Fall 2016	Pushing up average rate without hiking repo rates
1Q2017	Hiked PBoC repo rate 3x, each 10 bp
2Q2017	Keeping OMO steady. Handing tightening over to CBRC



Rates
Both money and loan rates are higher





Recent tightening by CBRC

	On Balance Sheet				
Loan quality	Loans		Deposits		
	Deposit reserves		Owed to PBoC (MLF, etc.)		
Contain leverage	Investments (mainly bonds)		Bond issued		
	Loans			Borrowing	
Cap below 50% of Tier-1 capital	Deposits out	Interbank Assets	Interbank Liabilities	Deposits in	Can't be used as regular deposits
Collateral quality	Repo			Reverse Repo	
No re-packaging	Investments			CDs	Cap size. No more than 1/3 of total funding.
	Off Balance Sheet				
No buying other WMP	Investment, in house		WMPs Wealth management products		Back on B/S for MPA (macro-pru assessment)
Cap size and concentration	Investment, farmed out				

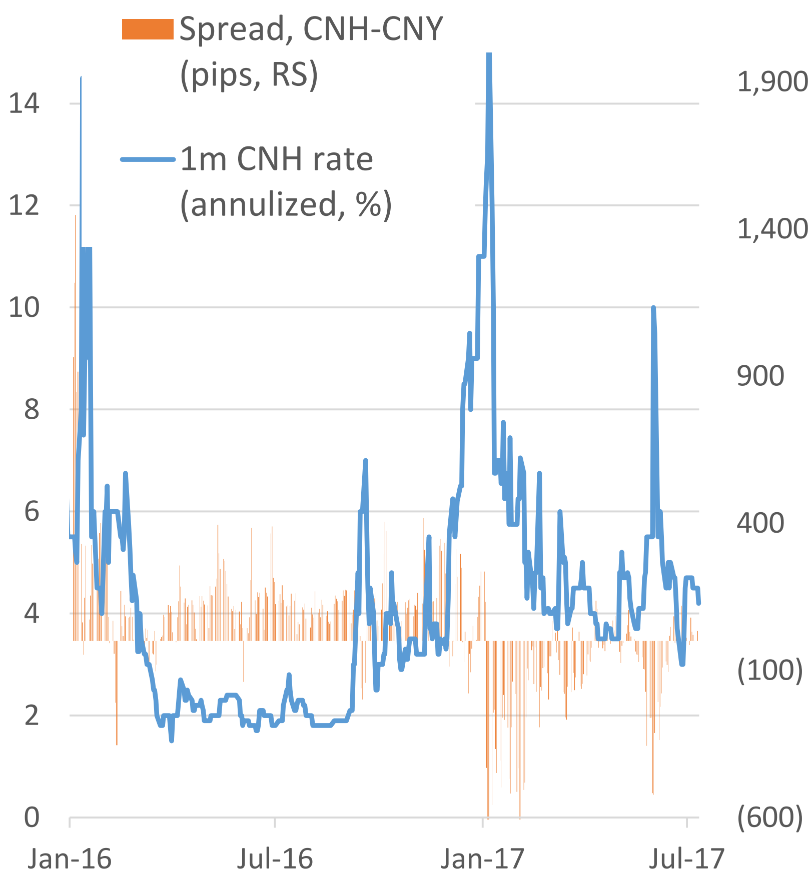
Recent tighter regulations by regulators

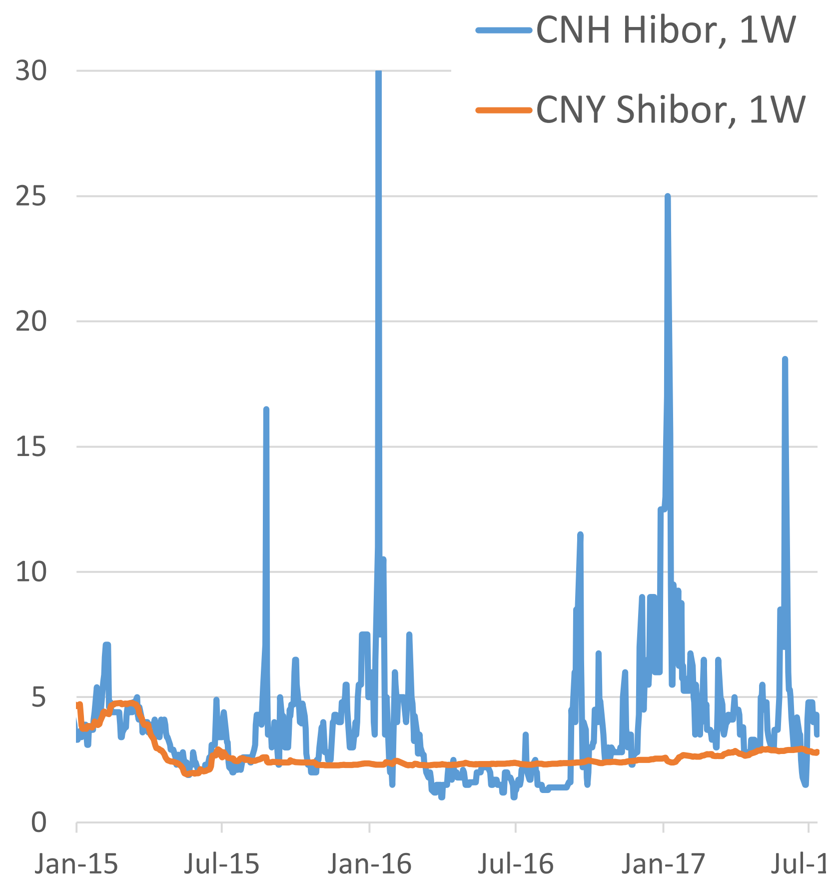
	CBRC		CSRC	CIRC
Managers	WMPs	Trusts	AMPs, hedge funds	AMPs
Cash pools	Banned		Banned	Banned
Re-packaging	Banned		Banned	Banned
Leverage	< 1.4x	Senior tranche < 1x Junior trance < 2x	Equity AMP < 1x Bond AMO < 3x	< 1x
Umbrella accounts	n/a	Banned	Banned	Banned
Investments ratio	Non-liquid assets < 35% of total WMP < 4% of bank assets	Cap, Funds from banks, trust loans	n/a	n/a
Advisory		Allowed	Tighter controls	Not allowed
Others	Invest in equity only through trusts		Higher loss provision More detailed filing	Ban structured products to NI

MPA is linked to PBoC funding, market entrance, and bank funding, broad credit growth, etc.

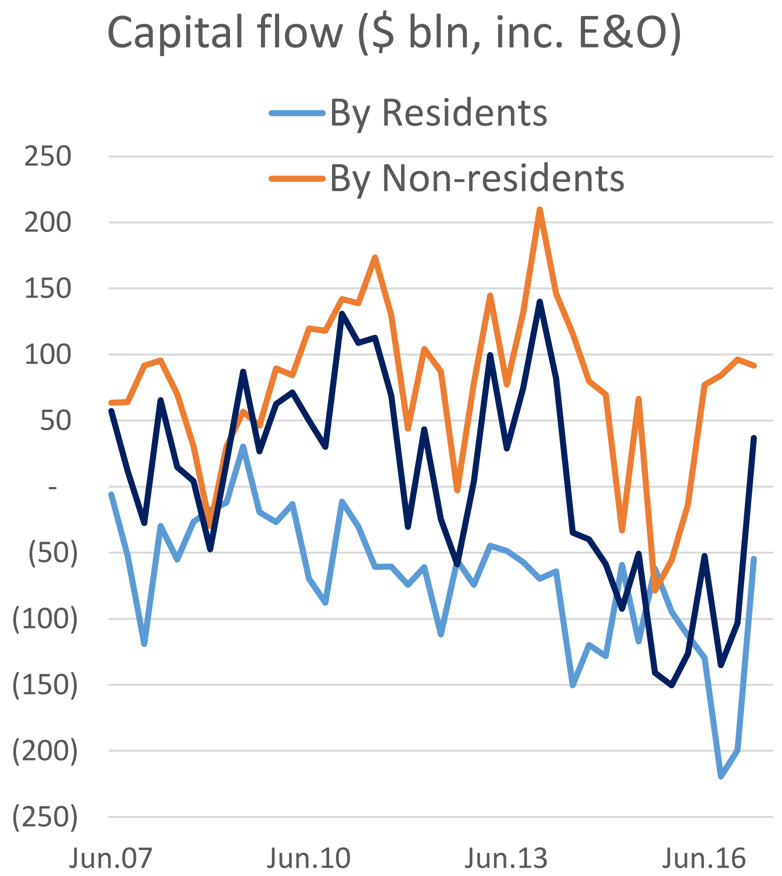
7 categories	16 parameters
Capital & Leverage	Capital adequacy ratio (80%) Leverage ratio (20%) TLAC (not yet used)
Assets & Liabilities	Broad credit (60%) Brokered loans (15%) Wholesale funding (25%)
Liquidity	Liquidity coverage ratio (40%) Net stable funding ratio (40%) Deposit reserves (20%)
Pricing	Interest rate pricing (100%)
Asset quality	NPL ratio (50%) Provision coverage ratio (50%)
Cross-border risks	The balance of risk-weighted cross-border assets (100%)
Credit policies	Credit policy assessments (40%) Credit policy implementation (30%) The use of PBoC funds (30%)

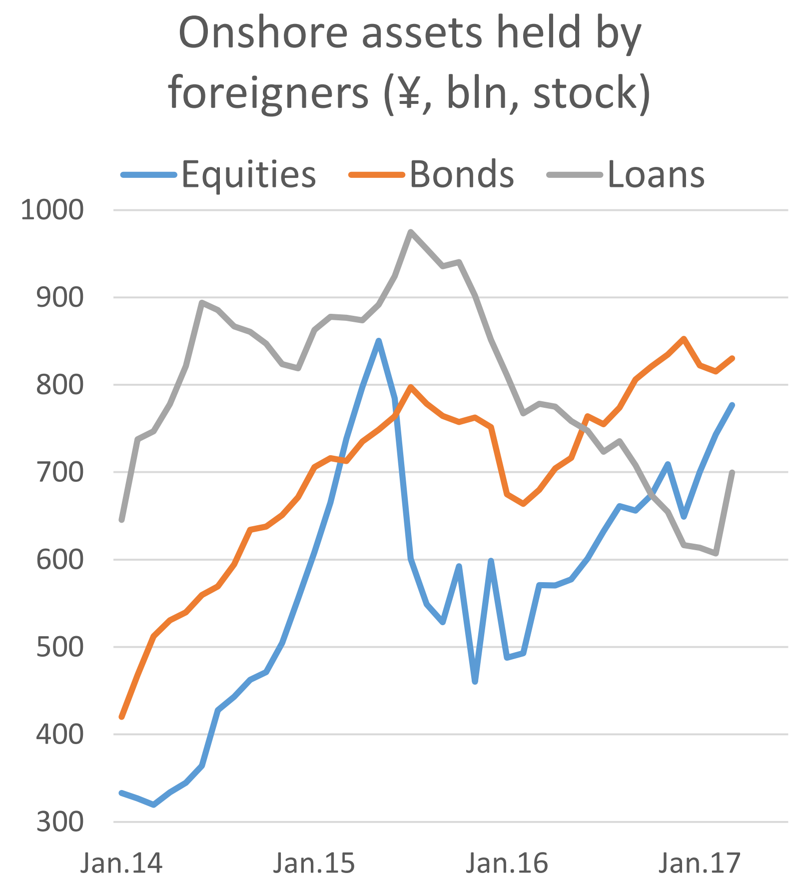
CNH can be pushed higher by squeezing HIBOR
Yet, no pass-through to onshore SHIBOR





Non-residents flows bottomed in 3Q2015
Resident flows hit bottom in 3Q2016

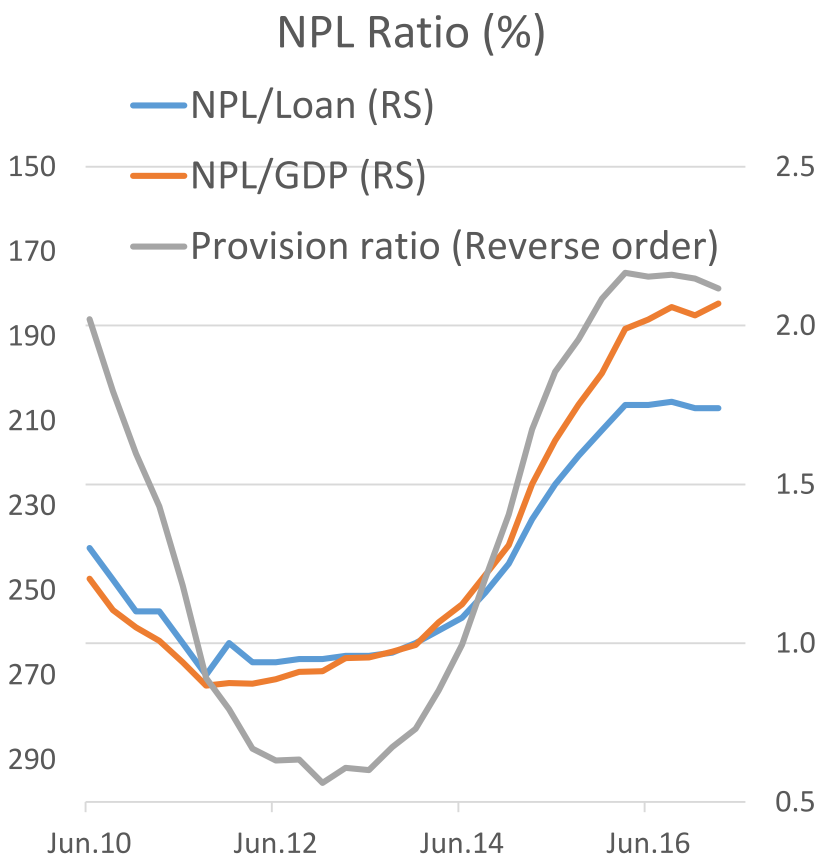


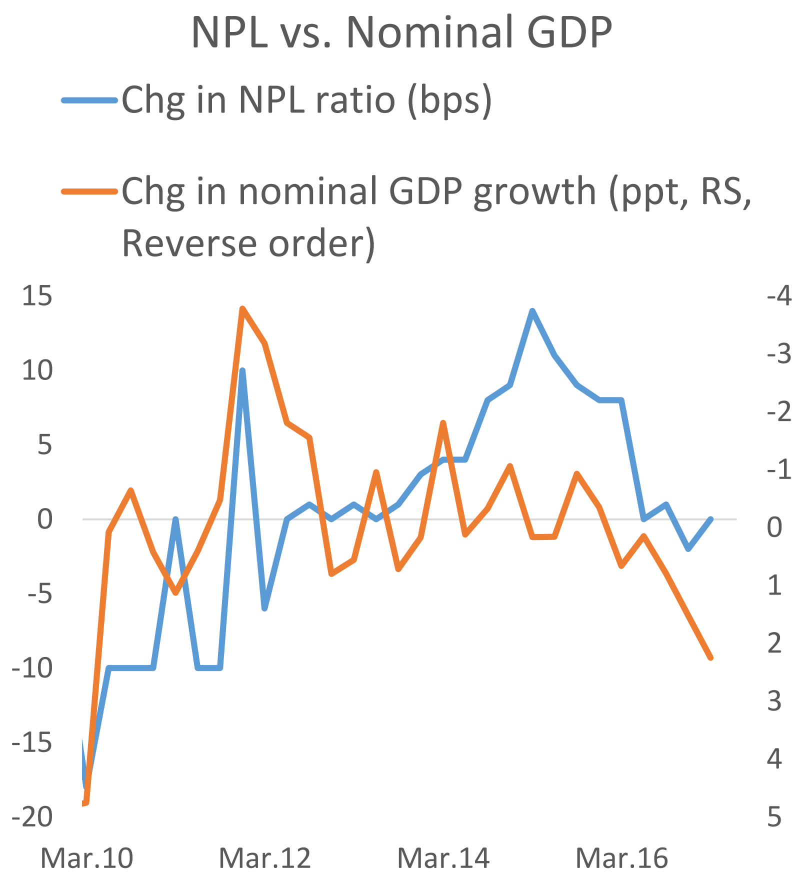


How banks will curb NPL

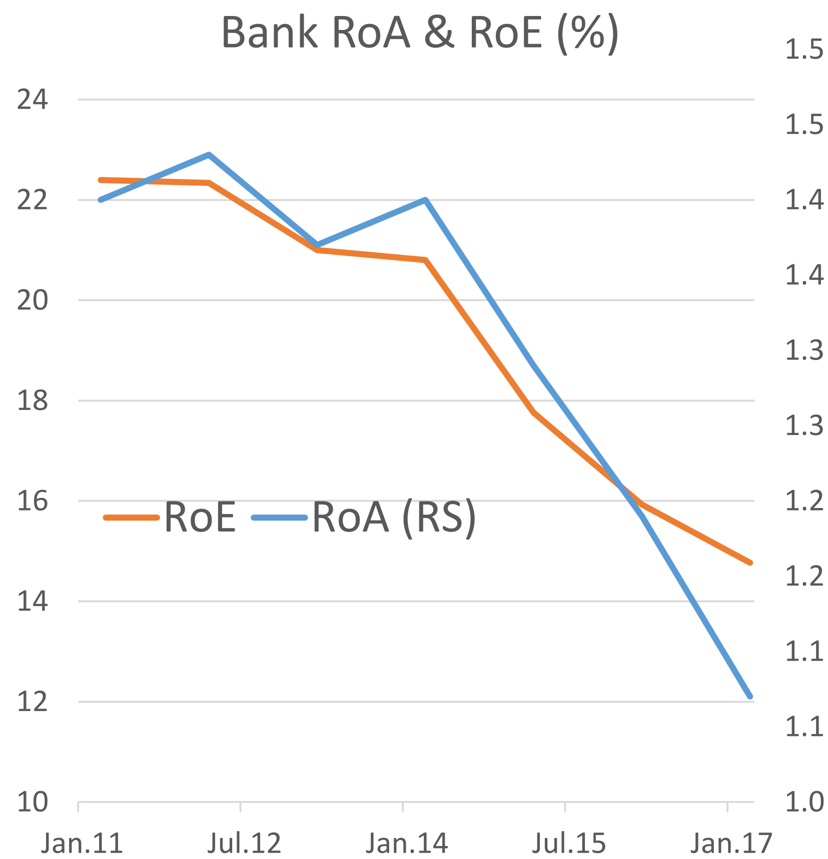
Methods	Objectives	Progress
Restructuring	Avoid defaults	Demand more collateral and/or sources of repayments
Loan-to-bond swap	Lower debt cost	Short-term and expensive LG loans swapped into longer term and less expensive LG bonds
Debt-to-equity swap	Avoid bankruptcy	Still in pilot stage. Needs to be on commercial term. Banks need to dispose shares
NPL sales	banks avoid total loss	Widely used. AMCs are better at recovery residual values
Securitization	Banks avoid total loss	Still in pilot stage. Need more participants.
Litigation	Banks recover some value	Widely used. Enforcement can be problematic.

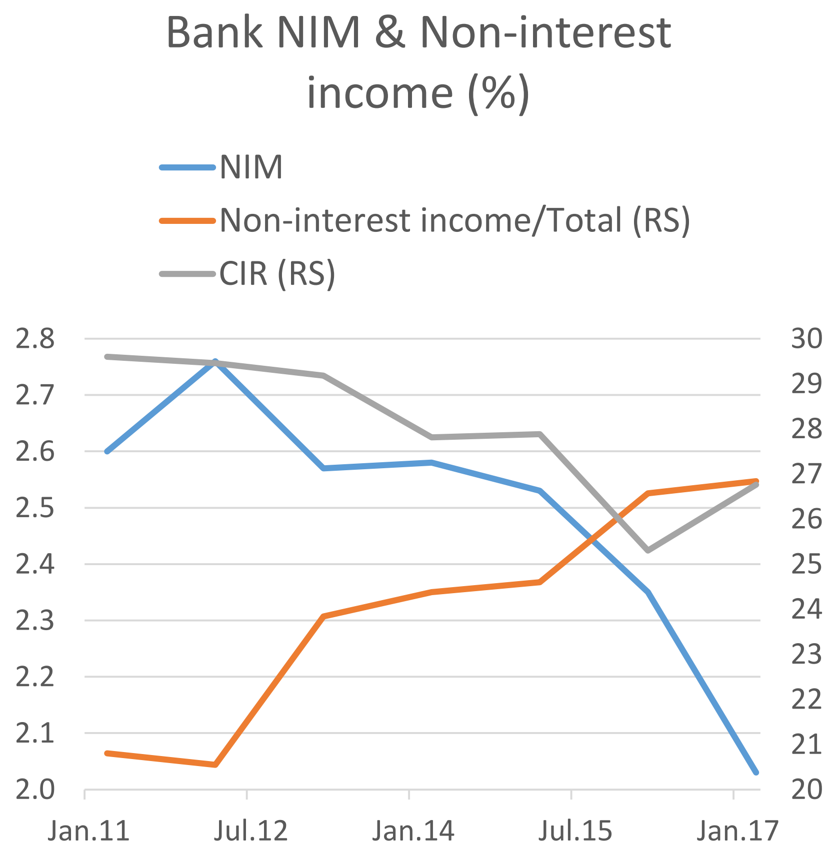
Bank NPL stabilized



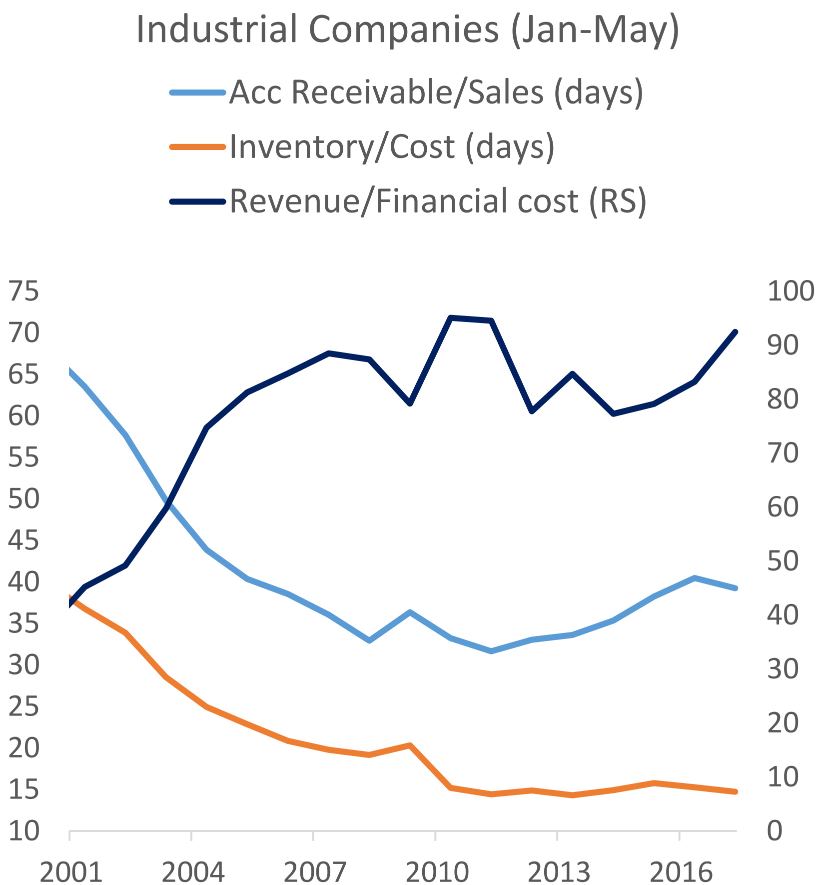


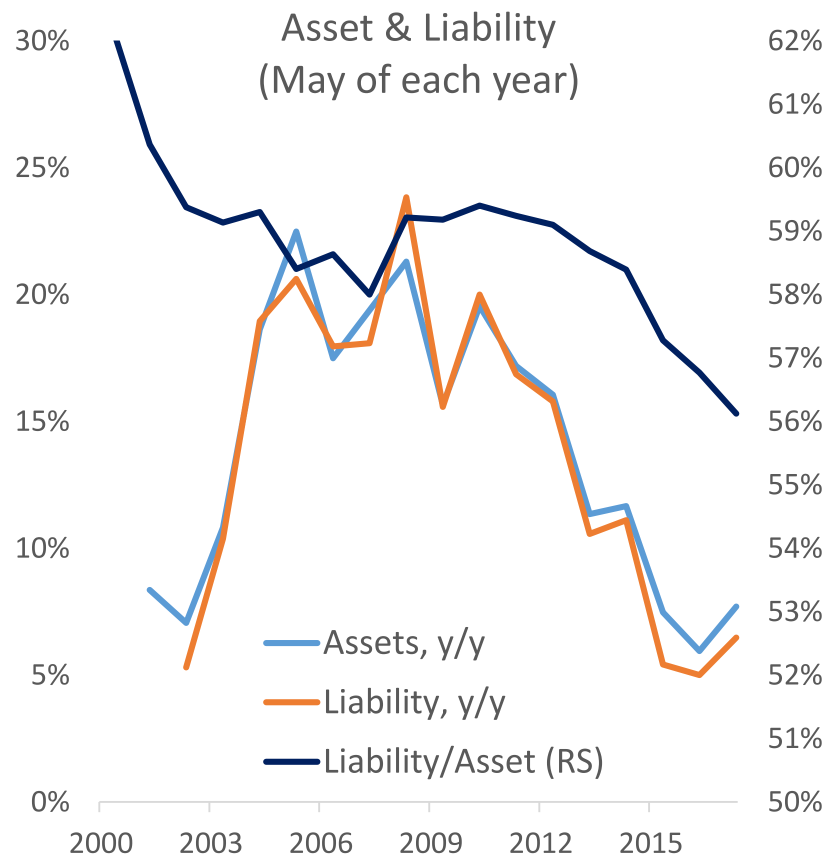
Narrower NIM, lower RoE & RoA, Higher non-interest income





Industrial Companies: Better interest coverage; Lower liability/Asset





2Q Growth: Flat PMIs; Better PBoC survey