Special Comment

2016 Outlook
The Chinese Economy and Debt Market

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Summary

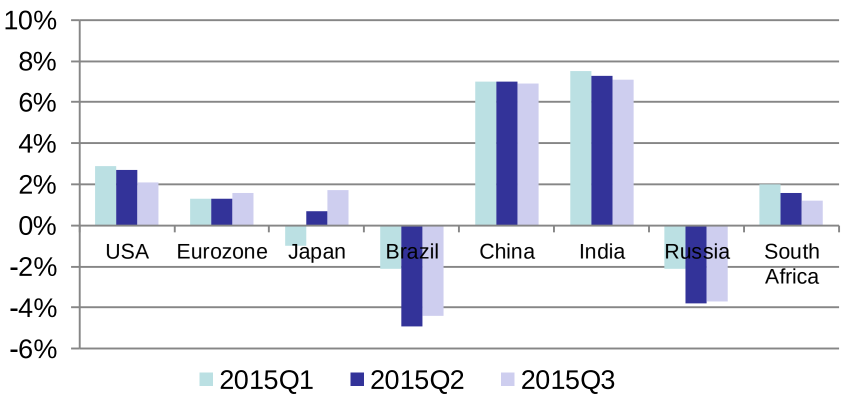
- The United States and certain number of developed economies recovered in 2015, whereas the emerging market economies slowed down due to decline in international trade and fluctuation in currency value.
- The Chinese economy will continue running down hill that the government is expected to launch stimulating policies to stabilize the economy. We forecast the GDP of China will decline to 6.3% in 2016.
- The government will further liberalize the onshore RMB debt market, allowing more foreign corporations and investors to enter the market.
- The prevailing easing policy of the central bank will attract more domestic and foreign issuers tapping the RMB onshore debt market.
- Although the current market conditions of the offshore RMB debt market are less favorable to issuers, yet we expect it will regain its attractiveness after RMB is included in the SDR in October 2016.

Global Economy

2015 at a Glance

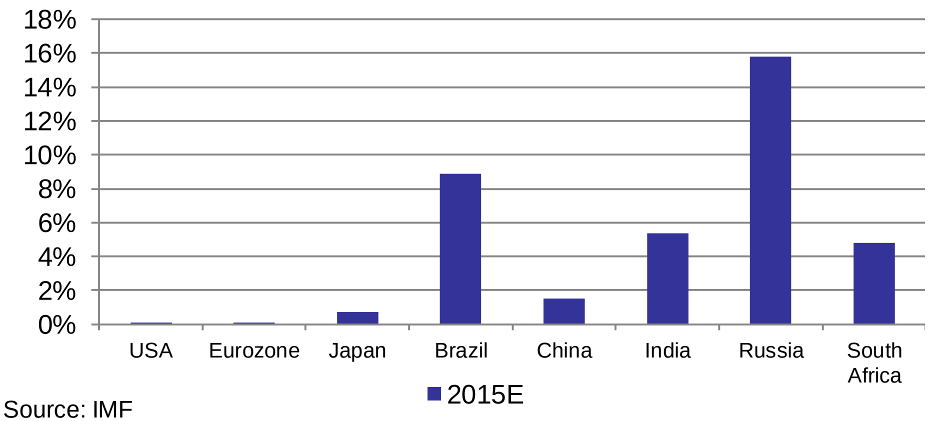
- Recovery in the major developed economies
  - US labor market improved remarkably, supporting the country's economic growth rate. The strong socio-economic figures provided the basis for the Federal Reserve to raise the key interest rate in December.
  - Although the Eurozone economy had improved slightly, yet the deflation risk was still there. The European Central Bank re-launched the quantitative easing policy to stimulate the economy.
  - The Japanese economy recovered gradually after the issuing of the qualitative and quantitative easing policy for a year.
- Emerging markets faced sharply fall in international trade and fluctuation in currency value.
  - India experienced the fastest economic growth, but slowing down in the second half of the year.
  - The Chinese economy slowed down steadily in its economic transformation period.
  - The political scandal, increasing inflation and budget deficit limited Brazil's economic growth.
  - Russia's economy further deteriorated due to sharp drop in oil price, currency devaluation and high inflation.

GDP Growth Rate of Major Economies



Source: IMF

Inflation Rate of Major Economies



Source: IMF

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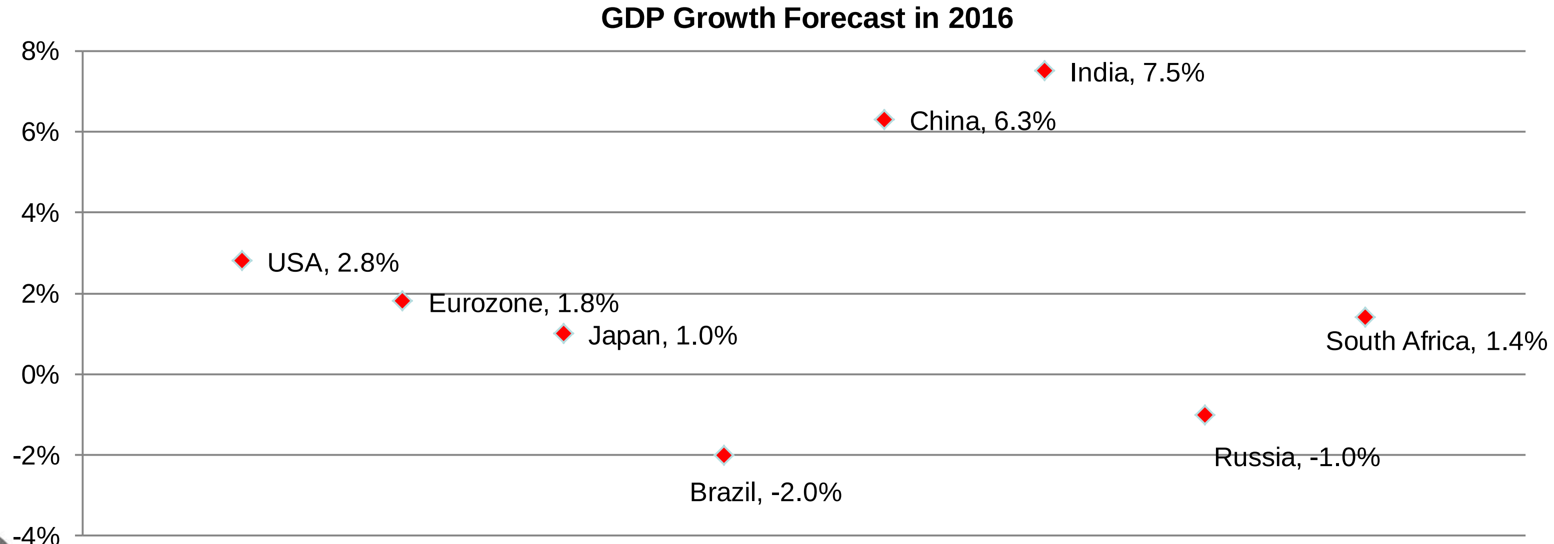
Global Economy

2016 Outlook

- The US would continue to recover and play a crucial role in the world economy. Further interest rate hike is expected.
- The respective economic growth rate of Japan and the Eurozone will remain low due to their budget deficit and the deflation.
- The deteriorated emerging market conditions will speed up the pace of their economic structural reform, and the results of their reform will determine the direction of their economic development.



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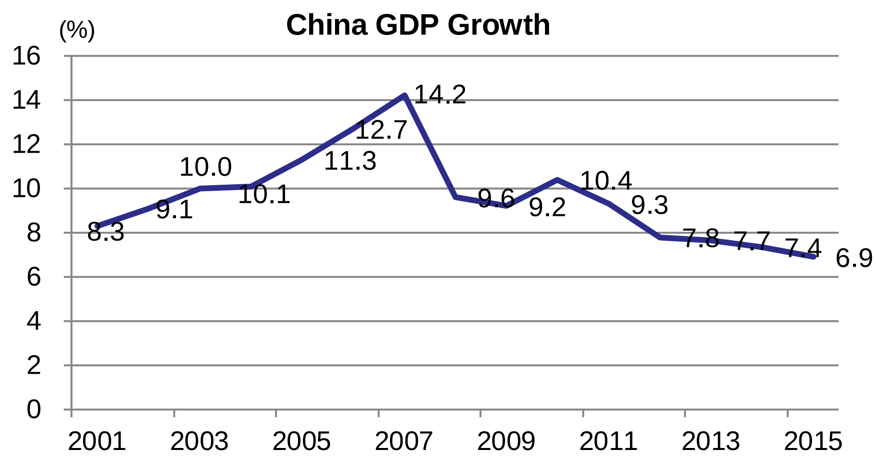
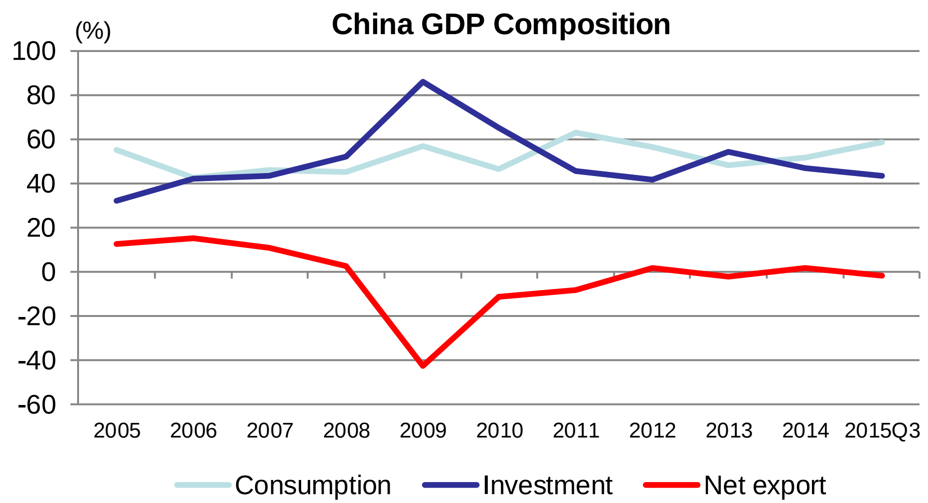
China's Economy

- The Chinese economy will slow down further. Deflation risk is high there. We expect the GDP growth rate of China will decline to 6.3% in 2016 from 6.9% in 2015.
  - *Fixed asset investment*: Investments in manufacturing and real estate industries will further drop and the overcapacity situation stays. The government will reform the economic structure to stimulate the economy.
  - *Consumption:* The key policy is to stimulate consumption.
  - *Net export:* In 2015, both imports and exports decreased sharply. We expect the devaluation of RMB will stimulate the Chinese export in 2016.



Source: NBSC, CCXAP research



Source: NBSC, CCXAP research

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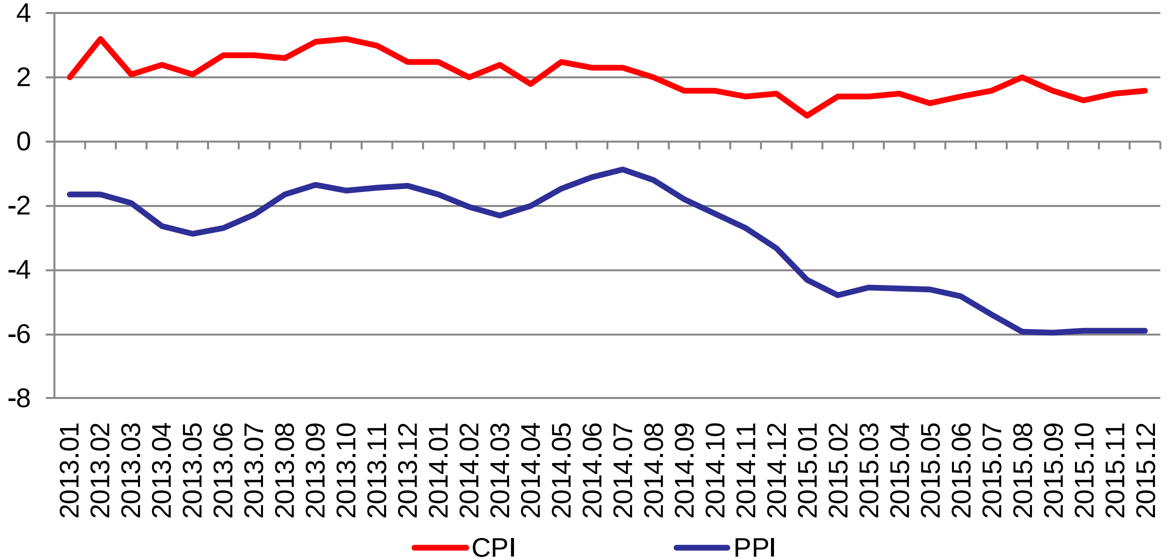
CPI and PPI

- Owing to the sharp drop in price of the commodities and the weakening domestic demand, China's CPI was weakened and PPI declined continuously. These indicators show that deflation risk is rising.
- Deflation could amplify debt burdens. In 2015 the PBOC established a set of stimulating policies. We expect an ease monetary policy will be launched in 2016 to contain the deflation risk.

China Under Deflation Pressure



Source: NBSC, CCXAP research

Monetary Policy

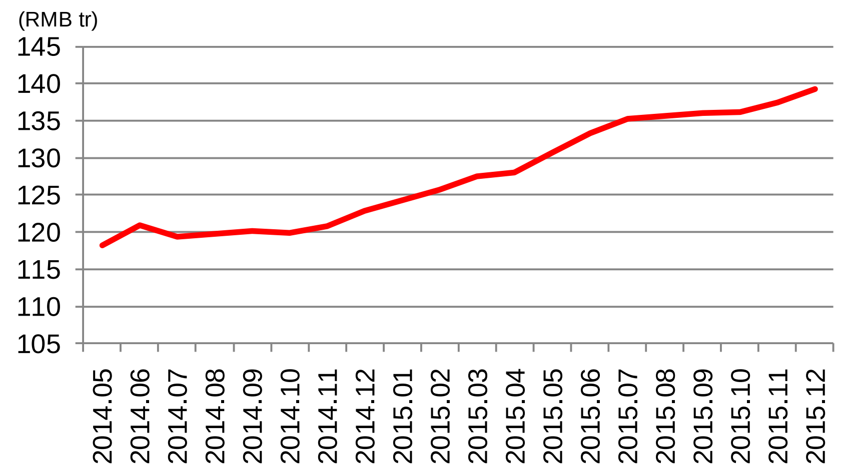
- The central bank of China will maintain its moderate loose monetary policy.
  - In the third quarter of 2015, the central bank lowered the interest rate and the lending and deposit benchmark rates 5 times to stimulate the economy, however, the effects were not obvious.
  - As the deflation pressure is increasing, we expect the central bank will further lower interest rate and bank reserve rate, say cut once in interest rate and five times in bank reserve rate.
  - Facing a more complicated economic environment, the central bank is expected to prefer using price based instruments rather than quantity based instruments to implement monetary policy.

Interest Rate Adjustments

	1 March	11 May	28 June	26 August	24 October
one-year lending rate	2.5%	2.25%	2%	1.75%	1.5%
one-year deposit rate	5.35%	5.1%	4.85%	4.6%	4.35%

Source: PBOC

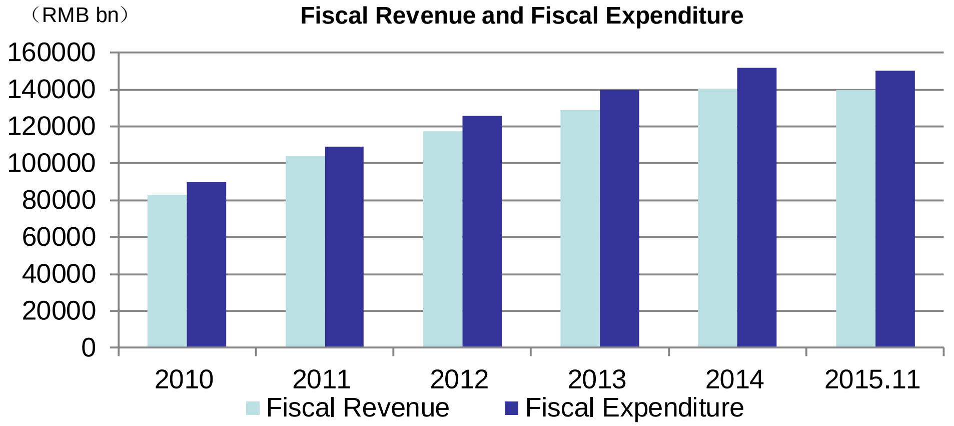
Money Supply



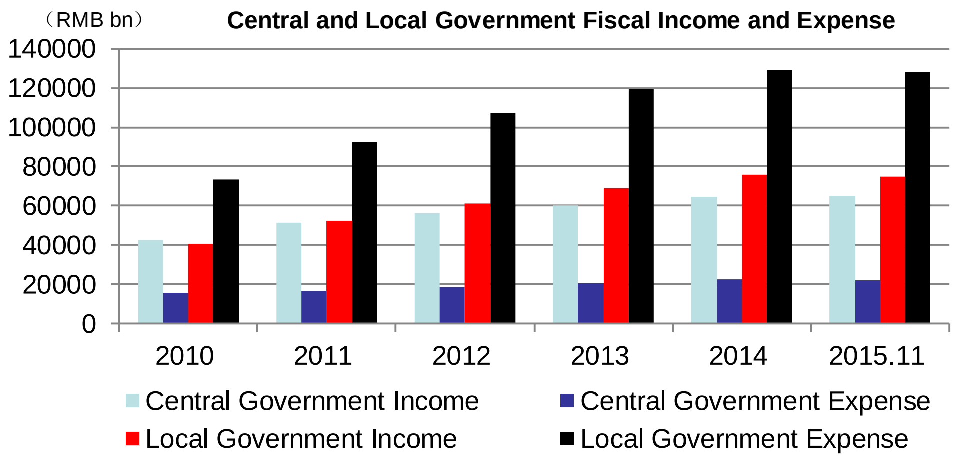
Source: PBOC

Fiscal Policy

- In 2015, the Chinese government adopted a proactive approach to establish its fiscal policies, allowing the increase in fiscal deficit rate and budget deficit of local governments.
- Debt swaps and PPP operating model can help lessen credit risk and financing pressure of local governments.
- In 2016, the government may increase its issue amount of treasury bonds and lower tax rates to provide rooms for companies to enhance their profitability. And enlargement of the debt swap scale would help avoid systematic risk and reduce the debt pressure on local governments.



Source: Ministry of Finance, CCXAP research



Source: Ministry of Finance, CCXAP research

13th Five-Year Plan

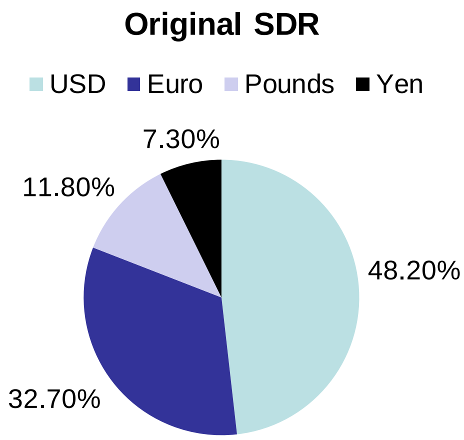
- 2016 is the first year of the "13th Five-Year Plan" approved at the 3rd Plenary Session of the 18th Central Committee. The Plan confirms the continuation of the economic reform and policies for the systematic breakthrough in tax, land and financial systems. The reform in state-owned enterprises and tax system and the further open up of financial markets to foreigners are the key notes of the reform.
  - However, the overcapacity situation in state-owned enterprises still exists that further reform in them will continue.
  - Corporate tax, consumption tax and resources tax have been carried out. Reform in environmental tax, real estate tax and individual income tax are complicated that need legal adjustment. The current separate tax system on the central government and local governments would change over time.
  - The Plan states that the government will build a standard platform for local governments to issue debt such that local governments' financing will become more transparent and the systematic risk can be mitigated.
  - The financial reform will increase the ratio of equity financing, allowing different layers of fund raising mechanism, two-way flow of funds including the opening up of the capital account, promoting RMB into SDR, uplift the investment limit, change in foreign reserve management and usage, etc.

One Belt One Road Policy

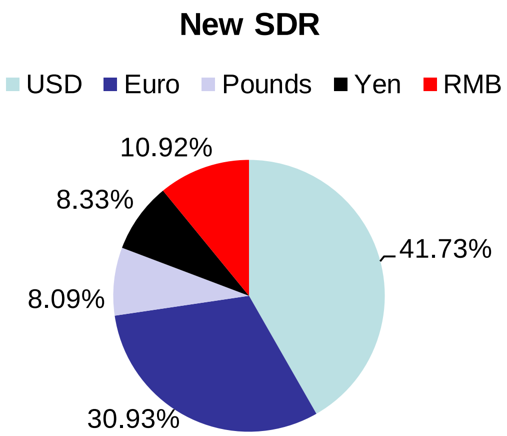
- In 2015, Chinese government further promoted the policy of “One Belt One Road” (the Silk Road Economic Belt and the 21st Century Maritime Silk Road).
- “One Belt One Road” is expected to positively influence the Chinese economy in the future.
  - China’s export focus would shift focus from commodity export to capital export. In 2014 the capital export amount reached US$2,530 billion, exceeding the amount of commodity export.
  - The Chinese investments and loans to the countries along the “One Belt One Road” would increase the use of RMB in the international markets.
  - More foreign companies would invest in the western areas of China, hence helping the rebalance of economy in the middle and western areas of China.
  - Business of metal, construction materials, shipping, electronic power and construction industries could be extended to the new markets. And some traditional industries could also transfer their excess capacities to other countries.

RMB's entry into SDR

- On 30 November 2015, IMF announced the admission of RMB to SDR effective 1 October 2016. RMB will share 10.92% of the SDR basket, more than that of Japanese yen and euro.
- RMB's entry into SDR is an important milestone of RMB's internationalization. RMB has become one of the most important reserve currencies in the world.
- RMB's entry into SDR helps China further liberalize and open up its financial markets. Although it will not trigger immediate free convertibility of RMB, investors around the world would begin consider putting RMB into their investment bundles.



Source: IMF



Source: IMF

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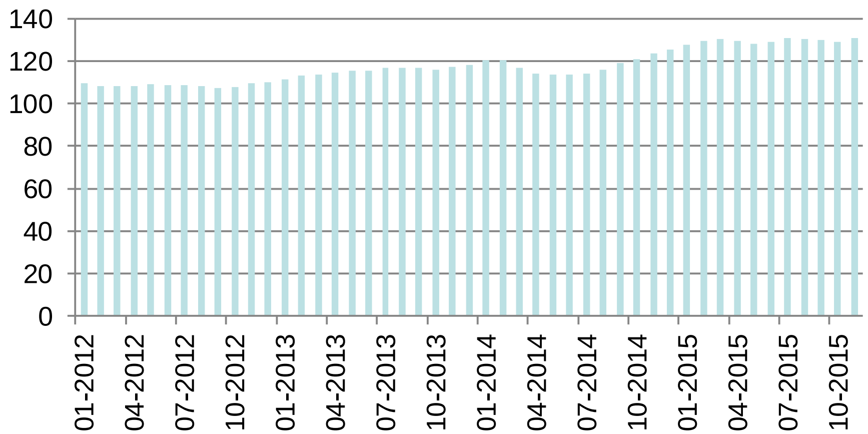
RMB Exchange Rate

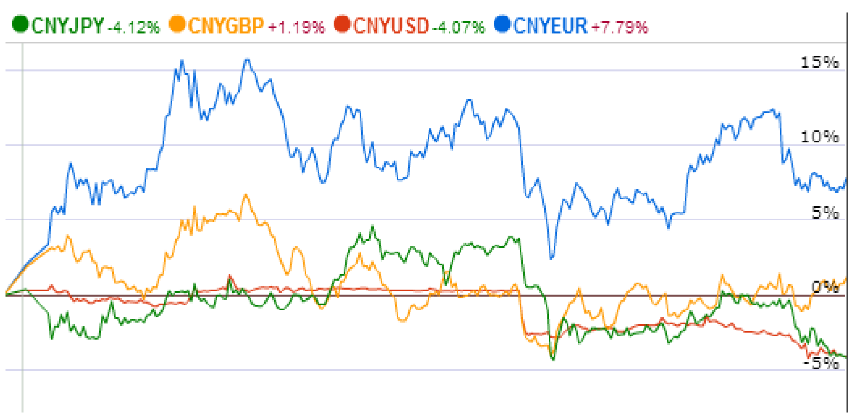
- In the course of its internationalization, RMB exchange rate has been fluctuating in a wider range.
- On December 17th, 2015, Federal Reserve of USA raised the key interest rate, while the central bank of China had cut the interest rates five times to stimulate the Chinese economy.
- On August 11th, 2015, the central bank of China adjusted the RMB exchange rate mechanism, triggering a sharp devaluation and outflow of RMB. We expect RMB will further devaluate in 2016 in a moderate pace.
- In the long term, improved mechanism of exchange rate and RMB's large use as a reserve currency will support RMB's internationalization.

RMB Effective Exchange Rate



Source: BIS

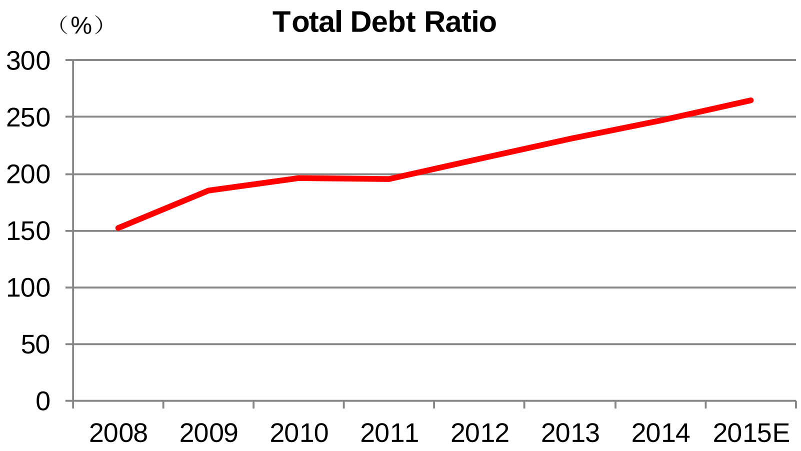
RMB Exchange Rate Against Major Currencies



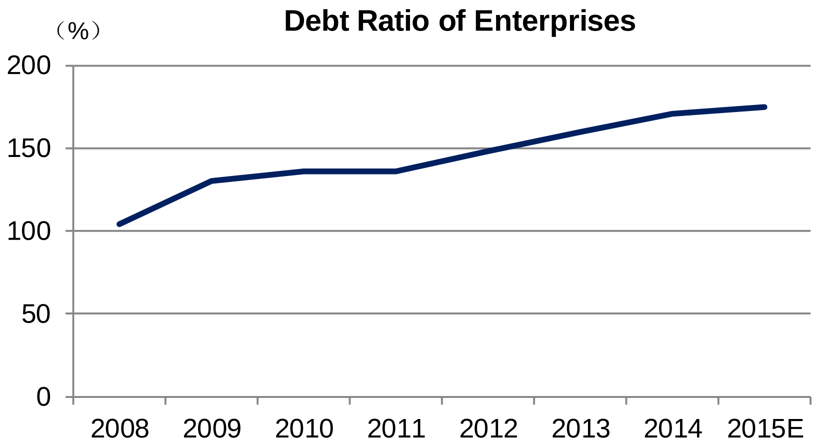
Source: State Administration of Foreign Exchange

China’s Debt Problem

- The debt amount of individual and government is relatively small, however, the debt amount of enterprises and companies has accumulated to an alarming level. Adding the amount of leveraging, the total debt amount is threatening China’s macro economy.
- After the global financial crisis in 2008, the stimulating policies launched by the government led to huge amount of debt-financed instruments. The debt ratio of companies went up rapidly, exceeding the international warning line of 90%.
- Solving the debt problem in the future requires supportive macro policies, financial market reforms and effective risk management tools.



Source: CCXAP

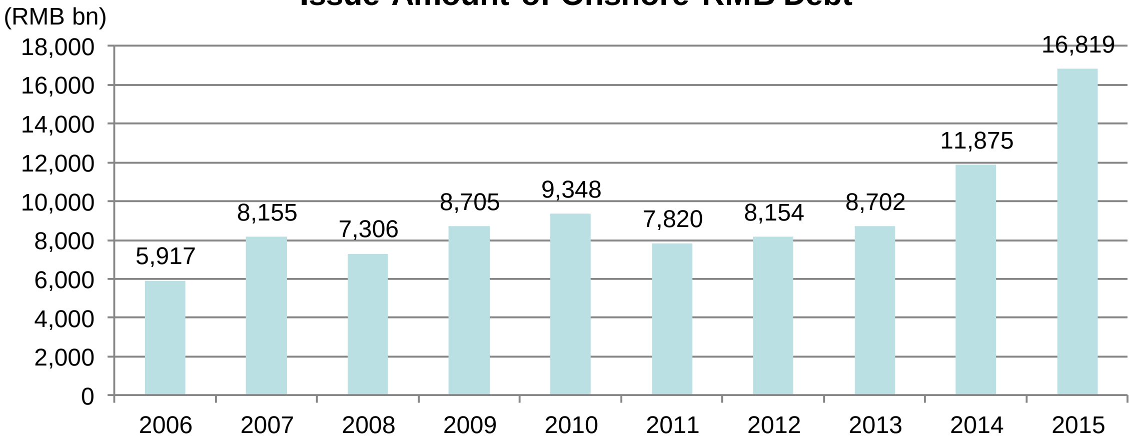


Source: CCXAP

RMB Bond Market – Onshore

- Onshore RMB bonds are traded in the interbank market and on the exchanges. 2015 was a record year of domestic debt issue with a total issued amount of RMB 16,819 billion.
- In 2015 the central bank further liberalized the debt market, allowing more foreign institutions to invest and issue debts in the market.
- Issuers of Panda Bond has extended to commercial banks and corporate. The issue amount (plus quota) exceeded RMB 20 billion since the liberalization of Panda Bond market in 2015.
- Establishment of the 10 year treasury bond futures provides a longer term hedging tool for investors and end-users.

Issue Amount of Onshore RMB Debt



Sources: Gildata, Chinabond

RMB Bond Market – Onshore

Credit Risk: Fundamentals

- The economic operating environment has been deteriorating and there is a large amount of excess capacities in the traditional industries. The situation will not change in 2016 that more companies will default, increasing the systematic risk.
- In the first 11 months of 2015, most chemical, non-ferrous metal, machinery and coal industries were downgraded by the local credit rating agencies. Companies in these industries have been poorly operated resulting in a worsened credit standing.
- Devaluation of RMB makes hard the conditions for those companies to pay interest and repay principal of foreign currency debts, hence hurting their credit quality. On the other side, companies exporting goods will find it more beneficial.

Rating Downgrades

Industry	Downgrades
Chemistry	15
Non-ferrous Metal	11
Machinery	11
Coal	9
Photovoltaic solar	7
Agriculture, forestry, animal husbandry and fishery	6
Electronic devices	5

Source: CCXI

RMB Bond Market – Onshore

Credit Risk: Credit Event

- The first debt default case out broke in early 2014 and since then debt defaults have become real events in the economic “New Normal". As the range of default issuers has widened, types of default debts have increased so are the remedial solutions for the defaulted debts.
- Apart from the defaults of the private placement issues of those small and medium size enterprises, there are also defaults in public offered medium-term notes, corporate bonds and super-short term commercial papers.
- The number of negative credit actions increased in 2015. The contagion effect of credit risk may spilt over to their relating companies, hence revealing the cross-default risk of the domestic debts.
- The “Supply Side Reform” may release more credit risk to the market. We forecast more credit events will occur in 2016.

RMB Bond Market – Onshore

Selective Cases of Credit Events in 2015

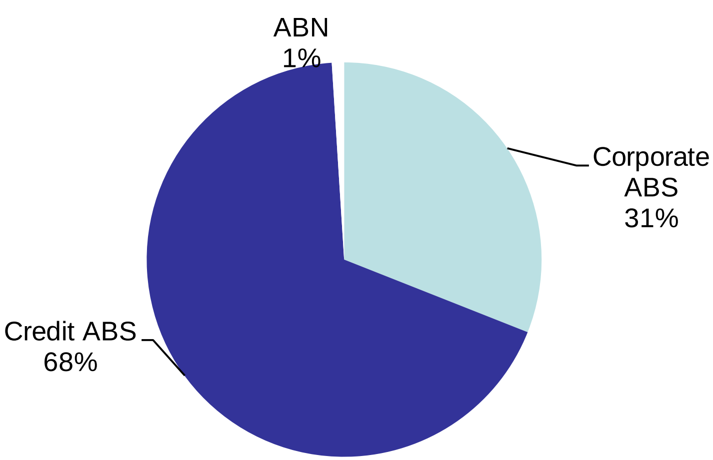
Issuer	Bond	Event	State Owned/Private
Jiangsu Feida Holding Group	12 Su Feida	Held a bondholder meeting and decreased the rate	Private
Tian Wei Corporation	11 Tian Wei MTN2	Uncertainty in interest payment, applied for bankruptcy	State-Owned
Cloud Live Technology Group	ST Xiange Bond	Zhong Xiang Company would pay for the bond and the interest	Private
Zhuhai Zhongfu Enterprise	12 Zhongfu 01	Lack of liquidity caused the default. Shareholders would provide guarantee	Private
Baoding Tianwei Group	10 Yingli MTN1	Already default	State-Owned
China National Erzhong Group	08 Erzhong Bond	The court has received the reorganization plan	State-Owned
Sinosteel	10 Zhonggang Bond	The buyback time has been extended	State-Owned
Shandong Shanshui Cement Group	15 Shanshui SCP001	Legal dispute	Private
Sichuan Shengda Industrial Company	12 Shengda Bond	Failed to repay the bond and the interest	Private

RMB Bond Market – Onshore

Securitization

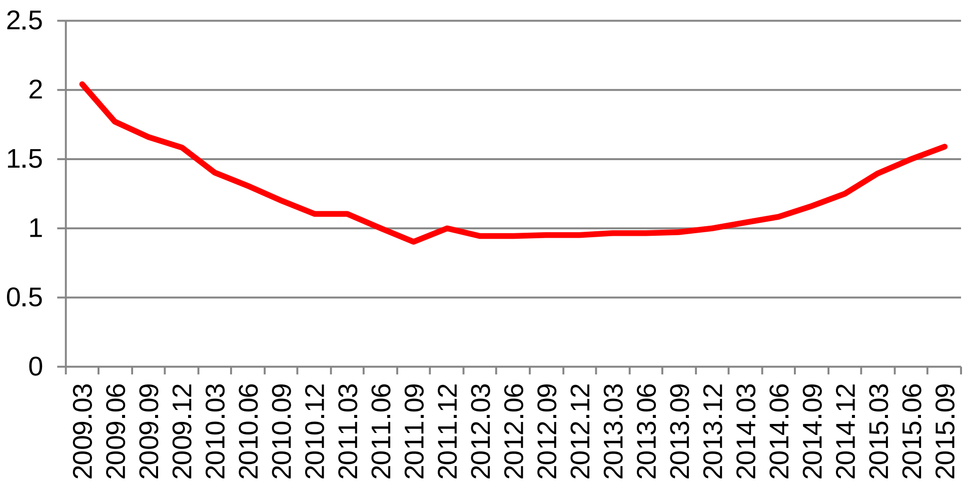
- The securitization market revived in 2015 where 1,386 securitized products were issued in a total amount of RMB593.039 billion or 79% more than that of 2014. It is noted that companies in the private sector have issued their first ever ABS, and internet financing products also connect with securitization.
- We expect that securitization will grow fast in 2016. And securitization of non-performing assets would be used to reduce the debt burden of the local governments.

Market Structure of Securitization



Source: Chinabond

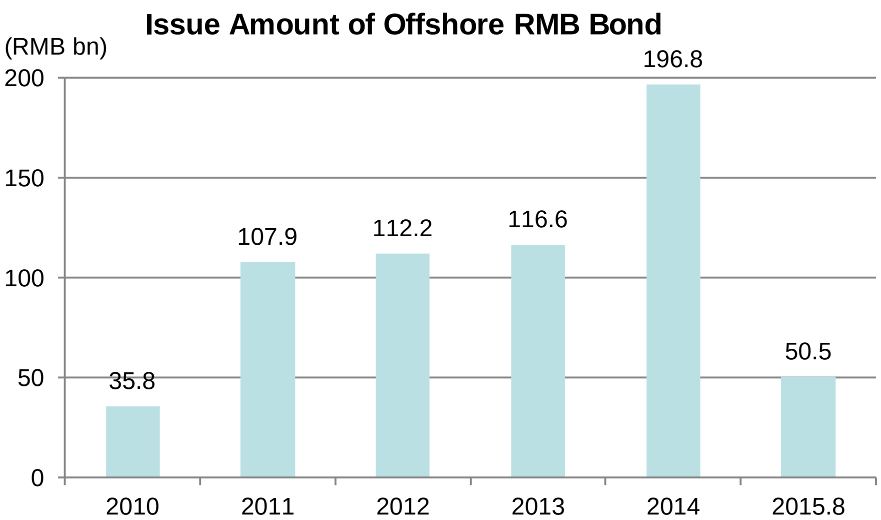
Non-performing Loans Ratio of Commercial Banks



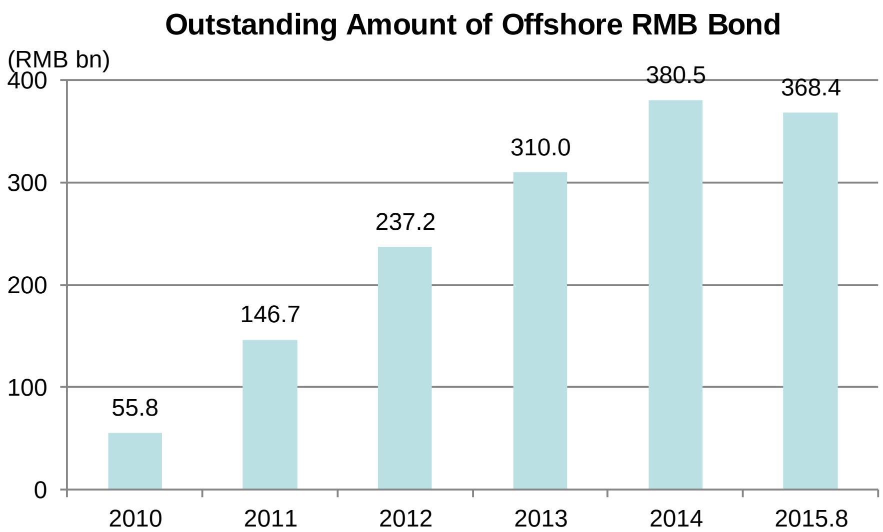
Source: CBRC

RMB Bond Market – Offshore

- Although internationalization of RMB and liberalization of capital account to a certain extend have promoted the offshore RMB debt market development quite fast over the past few years, yet the recent consecutive cut of interest rate by the central bank provides favorable market conditions for issuers switching their issuing action from the offshore market to the onshore market, hence slowing down the tempo of RMB internationalization.
- However, it is expected after the effective date on 1 October 2016 for the inclusion of RMB in SDR, RMB will be wider used in the international market and the RMB offshore debt market will regain steam.



Source: HKMA



Source: HKMA

Conclusion

- The Chinese economic growth will continue in its downward trend in 2016.
- Whether or not the Chinese economy can come out from the drought of the economic cycle will depend on effectiveness of the supply-side reform, results of the economic stimulating policies, restructuring of debts and performance of the innovative business.
- In the process of transforming economic structure, embedded credit risks in the excess capacity industries and traditional manufacturing industries will be released that debt default will become a phenomenon in the "Economic New Normal". Thus, the new policies will also set to prevent burst of systematic risk.

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