In Case You Missed It: CSOP's Weekly China Wrap Up

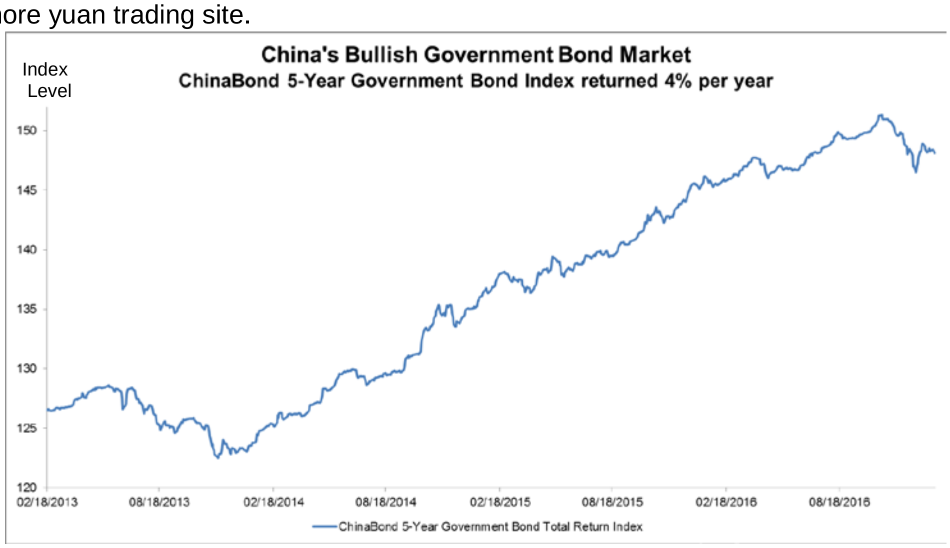
PBOC launches 'temporary facility' to ease liquidity crunch ahead of Chinese New Year holiday
The PBOC injected RMB 410 billion (USD 60 billion) last Wednesday, a 'temporary facility' to help ease a liquidity crunch ahead of the Chinese New Year holiday.[1, 2] Short-term funding costs reached a ten-year high ahead of the week-long holiday, which sees hundreds of millions of celebrants withdrawing cash to visit family and exchange the traditional money-laden red envelopes.

The injection is significant because it represents a new policy tool in the PBOC's arsenal, a subtle departure from favored mechanisms like reverse repurchases and 3-month Medium-term Lending Facilities. Citing the desire to balance seasonal liquidity demands while avoiding yuan depreciation, the bank is relying on the temporary facilities instead of more traditional Required Reserve Ratio (RRR) cuts to avoid sending easing signals. The bank maintains the 28 day facility is temporary, not a reversal of the stated "prudent and neutral" monetary policy goals for 2017.

Chinese Government Bond Futures to be launched on HKEx in 2017, USDCNH option eminent
Chinese government bond futures will be added to the Hong Kong Stock Exchange in 1H2017, the Exchange's Chairman announced last week, with a USDCNH option to be launched within the next year.[3] The instrument will give international investors more tools to participate in China's bond market, an expansion from the presently-available ETF tracking China's 5-year government bond index.

There is a strong need for new products. The 5-year China government bond future on Shanghai's China Financial Futures Exchange (CFFEx) is the most liquid bond future in China's capital market, as local investors rely on the security to hedge and speculate interest rate risk. Despite the demand from international investors, CFFEx had been historically hesitant to franchise the bond future to an offshore exchange due to concern over possible competition.

In addition to the bond future, HKEx is planning to launch a USDCNH option within the next year. Acknowledging growing demand for currency risk hedges for a volatile yuan, the Exchange will be the third international house to offer options on the currency pair. The Exchange's Chairman expects the current USDCNH futures market to synergistically complement the USDCNH options market, furthering the Exchange's ambition to serve as the preeminent offshore yuan trading site.



Bloomberg, as of January 20, 2017. *Past performance doesn't guarantee future results*

President Xi's pro-globalization Davos speech followed by new opening-up reforms in China
China delivered a strong signal of liberalization last week, a one-two punch that saw President Xi promoting globalization at Davos while China's State Council announced 20 measures to encourage overseas investment in China.

In his keynote speech to global political and business leaders, President Xi affirmed China's commitment to global trade and governance while railing against encroaching protectionist sentiments. While acknowledging the downsides of globalization, Xi articulated the importance of pushing forward and the impossibility of reversion to a mercantilist past. His attendance and comments evince China's concern about the impact of growing populist headwinds on China's export machine, and signal China's attempt to address the situation by consolidating leadership in the current global vacuum.

Although some observers found Xi's statements ironic considering China's history of subsidies and protectionist measures, concurrent announcements from China's State Council add legitimacy to the President's message. After Xi's speech, China's State Council published new rules reducing restrictions on foreign investment in the country. The reforms cover a range of industries, allowing foreign investors to enter fields such as transportation, industrial and automotive manufacturing, telecommunications, internet, and education— in some instances even receiving preferential policy support from local governments. In addition, a top Ministry of Commerce official promoted reforms that would cultivate a financial climate more hospitable to foreign companies. Under such reforms, foreign companies will be able to issue debt instruments to raise funds in China's capital markets or list on Mainland China's stock exchanges. Aside from general contours of the new policy items, the state agencies have yet to release details about or a timeline for implementation.

ChiNext plunges on concern over IPO acceleration in already-heated market[4]
The CHINEXT index—China's Nasdaq-like barometer of high-tech stocks—fell 6% on Monday due to concerns about an oversupply of shares from upcoming IPOs.[5] The market grew skittish after official news service Xinhua published an article supporting accelerating IPO approvals, which are already at a near-20 year high. Three IPOs are projected every day for the first half of January 2017, increasing from an average of one IPO per day in 2H2016.

The Xinhua commentary and subsequent reaction comes in the midst of ongoing IPO reform. Public offerings have been mostly restricted since mid-2015, after an IPO glut was blamed for the equity market crash. However, the past several months has witnessed an acceleration of IPO approvals, worrying onlookers that the potential oversupply of shares could again plunge the market downward or drain liquidity from more established companies.

While most market participants agree that a more transparent system of public offerings is necessary, debate exists over the shift from the current approval-based system to a registration-based listing procedure. Under the current approval-based procedure, companies need to obtain CSRC approval before getting listed. In this regime, companies wait several months or even years before obtaining listings; they are at the mercy of regulators who control the pace of IPOs to reduce market impact. In contrast, the proposed registration-based procedure allows companies to list after completing the necessary registration and disclosure procedures with one of the two local exchanges, rendering it far easier for companies to go public.

Small and mid-cap A-Share would be the most impacted by proposed reform. They would likely devalue from the average ChiNext PE valuation of 40x, falling closer to the 10x multiple found in FTSE China A50 Index companies.[6] Such reforms would benefit both investors by lowering share prices and the system as a whole, reducing administrative costs. Existing companies, however, would suffer from the drain on liquidity and addition of competition.

China reports uptick in 4Q2016 growth, but US-Sino relations bring uncertainty for 2017 prospects
China's National Bureau of Statistics reported 6.8% growth in 4Q2016, an expectation-beating uptick after three straight quarters of 6.7% growth. Although the pace of growth is the slowest in a quarter-century, it remains within Beijing's desired range needed to double per-capita income between 2010 and 2020.

Prospects for growth in 2017 are expected to slow further, with President Xi supporting a target around 6.5%. A number of factors weigh on future growth, including domestic items like supply-side reform, mounting debt, and currency outflows, and external issues like a hard Brexit and Trump-related unpredictability. Despite expectations for major structural reforms to address domestic issues, onlookers are divided on the timeline for these changes, uncertain whether they will occur before or after the November Party Congress. Equally as unclear is the timeline or substance of Trump's plan. Thus far, he has neither legislated tariff increases nor followed through with promises to label China a 'currency manipulator' on his first day in office. Nonetheless, analysts have been putting forth a range of growth and market scenarios for 2017. The most cited of these reports see the MSCI China Index largely unaffected by imposition of mutual 5% tariffs and failing over 25% should Trump impose 45% tariffs.[7] Although most analysts do not predict a full-scale trade war between the two countries, heightened tension is anticipated across the board.

Notes:

1. PBOC: People's Bank of China
2. RMB: Renminbi, the national currency of China
3. USDCNH: Abbreviation for the US Dollar/RMB currency pair
4. IPO: Initial public offering
5. The CHINEXT index is China's Nasdaq-like barometer of high-tech stocks. Note that one cannot invest directly in an index
6. The FTSE China A50 Index is the benchmark for investors to access the China domestic market through A Shares – securities of companies incorporated in mainland China and traded by Chinese and institutional investors under the Qualified Foreign Institutional Investor and Renminbi Qualified Foreign Institutional Investor (QFII & RQFII) regulation. Note that one cannot invest directly in an index
7. The MSCI China Index captures large and mid-cap representation across China H shares, B shares, Red chips, P chips and foreign listings (e.g. ADRs). With 150 constituents, the index covers about 85% of this China equity universe. Note that one cannot invest directly in an index