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

Trump and Xi hold first phone call since November discussion, US concedes "One China" policy
Eliciting a global sigh of relief, Presidents Trump and Xi broke several months of silence with a long-overdue phone call last week. During the conversation, Trump agreed to honor the longstanding "One China" policy while the leaders proffered the necessary platitudes about working together to develop a mutually constructive relationship.

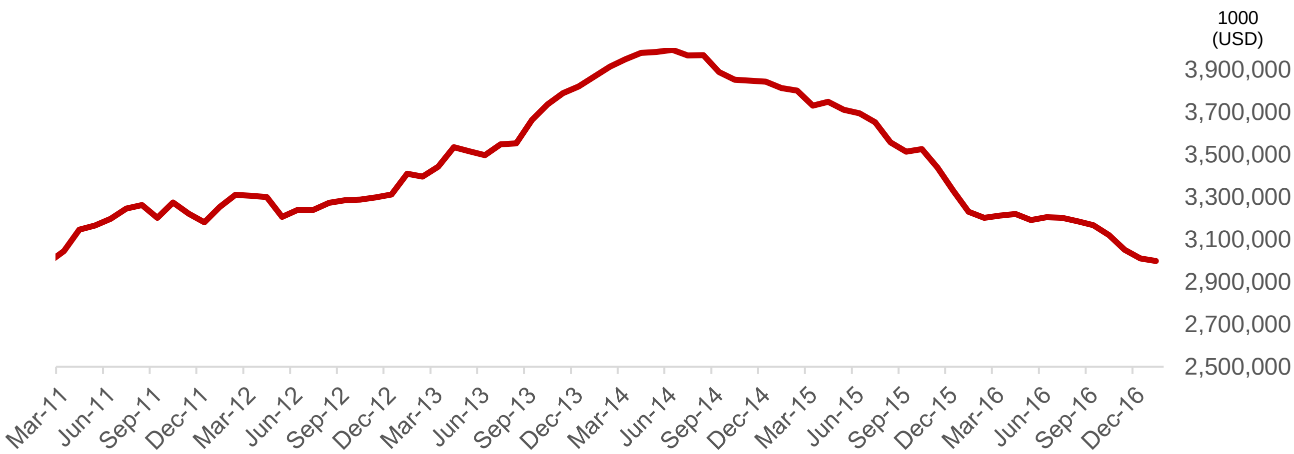
The phone call is widely interpreted as a victory for Beijing, which maintained composure in the hope that Trump would remove the non-negotiable item from the bargaining table. Analysts expect Beijing leaders will display more confidence in future dealings with 'paper tiger' Trump, though the United States' formal position on tariff agreements and currency manipulator designations remains uncertain.

The call represents a major reduction in tension between the world's largest economies. Despite conversing with other world leaders—including a controversial chat with Taiwan's President— Trump's Thursday phone call was the first formal conversation with Xi since a congratulatory call after his November election. In the absence of direct outreach, Beijing has spent the past several months cultivating goodwill through both official and informal channels. As one example, Ivanka Trump and her daughter were invited to a Chinese New Year celebration at the Chinese embassy in Washington. As another, Alibaba founder Jack Ma met with Trump as an unofficial emissary, promising to create 1 million jobs in the United States in the next 5 years.

Falling foreign reserves breach USD 3 trillion barrier, marking the seventh consecutive month of decline
China's foreign exchange reserves dropped below USD 3 trillion in January 2017, the first time the psychologically-important barrier has been breached since March 2011. Reserves declined USD 12.3 billion nominally, a .4% decrease MoM and the seventh consecutive monthly decline.[1] The decrease would have been more significant--closer to USD 37 billion-- if not for appreciation of the currencies which comprise China's FX reserves. Although nearly 2/3 of China's reserves are USD, the remaining currencies (EUR: 19.6%, GBP: 10.6%, and JPY: 3.1%) respectively appreciated 2.6%, 3.7%, and 1.9% against the USD in January, adding an estimated 'valuation effect' of USD 25 billion.[2]

China's State Administration of Foreign Exchange ascribed the higher demand for FX during Chinese New Year as the main driver for the decline in reserves. Administration officials also promised that capital outflows were slowing and assured that China has sufficient reserves. A weakening USD in 2017 has lent credence to their promises, serving to slow the Yuan's decline and offer the PBOC a reprieve from further dollar stockpile depletion.[3]

China's FX Reserves Fall Below 3Bn



Source: Bloomberg, 1.31.2017

Solid import and export data leads to a USD 51.35 billion trade surplus for January

China's January import and export data outperformed analyst expectations, a promising start to an otherwise uncertain year. Improved external demand and increased commodity prices helped spur 7.9% YoY export growth and a stunning 16.7% YoY increase in imports, a USD 51.35 billion trade surplus that bested expectations of USD 47.90 billion.[4]

Bullish onlookers attributed the export growth to recovering PMIs in the US, Europe, Japan and South Korea. Bears, however, accredited the increase to a flurry of accelerated deals stemming from looming trade war concerns, as well as distortion and market closures from the Chinese New Year holiday. It bears consideration, however, that the holiday fell in February in 2016 and January in 2017, discrediting the seasonal distortion argument.

Contrary to the export situation, the rosy import data is mainly due to increased domestic demand for more expensive commodities. China's January import prices for iron ore, crude oil, and coal respectively rose 81.3%, 46.7% and 110% YoY. Demonstrating the extent of domestic demand, January's volumes of iron ore and crude oil reached the second and third-highest levels on record for China.

SOE reform expands to state and provincial levels

Following promises delivered at the Central Economic Work Conference in December 2016, several Chinese agencies have announced plans to reform China's State Owned Enterprises (SOEs).

On the national level, SOE regulator SASAC (State-owned Assets Supervision and Administration Commission) announced plans requiring more than 100 SOEs to complete corporatization reforms by the end of 2017. The enterprises will be required to establish boards and similar hallmarks of modern corporatism in preparation for the infusion of private capital, diversification of ownership, and strategic consolidation via merger and acquisition activity. The National Development and Reform Commission has designated six SOEs to serve as pilot endeavors, with China United Network Communication ("China Unicom") and China Eastern Air Holding ("Eastern Airline") among the four schemes that have already been approved.

On the local level, the government of Shandong Province announced a new reform package promoting mixed-ownership for state-owned enterprises (SOE). A province famous for its mining and power-generation companies, Shandong will allow SOEs to bring in private investors to lower the weighting of the state ownership, unless otherwise forbidden by the central government.

The eastern province's announcement follows similar rule changes implemented in Tianjin, Shanghai, and Guangdong, which have all launched initiatives to widen their respective SOE shareholder bases. For example, Shanghai has pledged that 5 to 10 SOEs will experiment with employee holding stock schemes in 2017. Tianjin too will pursue a similar experiment in mixed-ownership reform for at least 2 SOEs by year end.

Influx of Mainland money into H-Shares drives Hang Seng to year-highs

Hong Kong markets soared last week as H-Shares (Chinese stocks listed in Hong Kong) traded at year-highs. The Hang Seng China Enterprises Index delivered 7.77% YTD as February 10, 2017, one of the best performers among major world equity gauges.[5]

Onlookers attributed the outperformance to the influx of mainland money seeking non-RMB assets to diversify their holdings. Chinese stocks listed in Hong Kong are denominated in HKD, which is pegged to USD and considered a good hedge against possible RMB deprecation.[6] In addition, new capital account controls on the Mainland render the Shanghai-Hong Kong and Shenzhen-Hong Kong Stock Connect schemes among the few legal channels for Mainland investors to invest offshore. Mainland investors purchased net RMB 11.4 billion (USD 1.7 billion) in Hong Kong stocks through the two Connect schemes in February, taking this year's total inflow to RMB 34.1 billion (USD 4.95 billion).[7]

Source: Bloomberg, as of 2.10.2017. *Past performance doesn't guarantee future results*

Notes:

1. MoM: month over month
2. USD: US Dollar, the national currency of the United States
   GBP: Pound Sterling/Great British Pound, the national currency of the United Kingdom
   JPY: Japanese Yen, the national currency of Japan
   EUR: Euro, the official currency of the Eurozone
3. PBOC: People's Bank of China
4. YoY: year over year
5. The Hang Seng China Enterprises Index is a free-float capitalization-weighted index comprised of H-Shares listed on the Hong Kong Stock Exchange and included in the Hang Seng Mainland Composite Index. Note that one cannot invest directly in an index
6. HKD: Hong Kong Dollar, the national currency of Hong Kong
7. RMB: Renminbi, the national currency of China