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

Professional managers to invest RMB 360 billion of Chinese pension capital in equity market
Signaling an important step in China's pension reform process, professional managers have been tapped to invest RMB 360 billion of pension capital in domestic and foreign equity markets.[1] Whereas formerly pension money could only be invested in SOE banks and bonds, new rules permit up to 30% of total pension assets to be allocated to equity markets.[2] Seven provinces are contributing funds to a mandate heralded as a critical step in preventing pension fund shortages in a rapidly aging society.

Local media report that the new mandate will primarily be allocated to two strategies: value selection and index enhancement. Blue chip names like those in FTSE China A50 Index and sector leaders listed in the A-Share market are expected to benefit by the influx of new funds.[3] Although the initial RMB 360 billion represents less than 10 percent of the total value of the seven provinces' funds, onlookers believe that this initial mandate will inspire hundreds of billions of pension dollars into the A-Share market in the next several years.

Bullish Morgan Stanley report signals major reversal of China sentiment
Morgan Stanley published a series of "Turn More Bullish on China" notes last week, announcing the bank's optimistic outlook on China's economy and equity market for 2017 and beyond.

In contrast to analysis from competitors like Goldman Sachs, Morgan Stanley is more sanguine about China's ability to deal with the country's latent debt and reform issues. As for China's pernicious debt burden, Morgan Stanley views the country's default risk as low, pointing to the debt's domestic ownership. Much of the bank's optimism is contingent on China's rising middle class and contribution from the sectors most likely to benefit from wealthy Chinese customers. Analysts anticipate the service sector to be China's fastest-growing economic segment, responsible for an estimated 60% of GDP by 2030.[4]

The shift to a more balanced growth model will be predicated on effective SOE reform, which the bank believes will successfully improve efficiency and boost aggregate returns. MS economists argue that China will be able to continue eliminating a significant proportion of excess capacity within three to four years, improving ROE as a result. Considering such factors, Morgan Stanley asserts that MSCI China has outperformed both EM and the S&P 500 over the last 15 years by a considerable margin and will continue to do so in the coming years.[5]

China relaxes restrictions on stock index futures, signaling return to normalcy after 2015 crash
China abolished restrictions on trading stock index futures, unwinding rules imposed during the mid-2015 equity market meltdown. Blaming stock index futures for the 50% market drop, regulators imposed a series of tightening measures to slow the market downfall. As a result of such restrictions, index future turnover plummeted. Exemplifying the drop-off, futures turnover was a mere 8.7 billion on February 10, 2017, compared to RMB 3.1 trillion on June 25, 2015.

Signaling the policy reversal, trading fees will be reduced from 23 bps to 9.2 bps beginning February 17, 2017.[6] Margin requirements will also be lowered from 40% to 20%. In addition, rules governing speculative contracts will be loosened, doubling the allowable number of positions from 10 to 20. Moreover, there will be no limits on the number of contracts opened for hedging purposes.

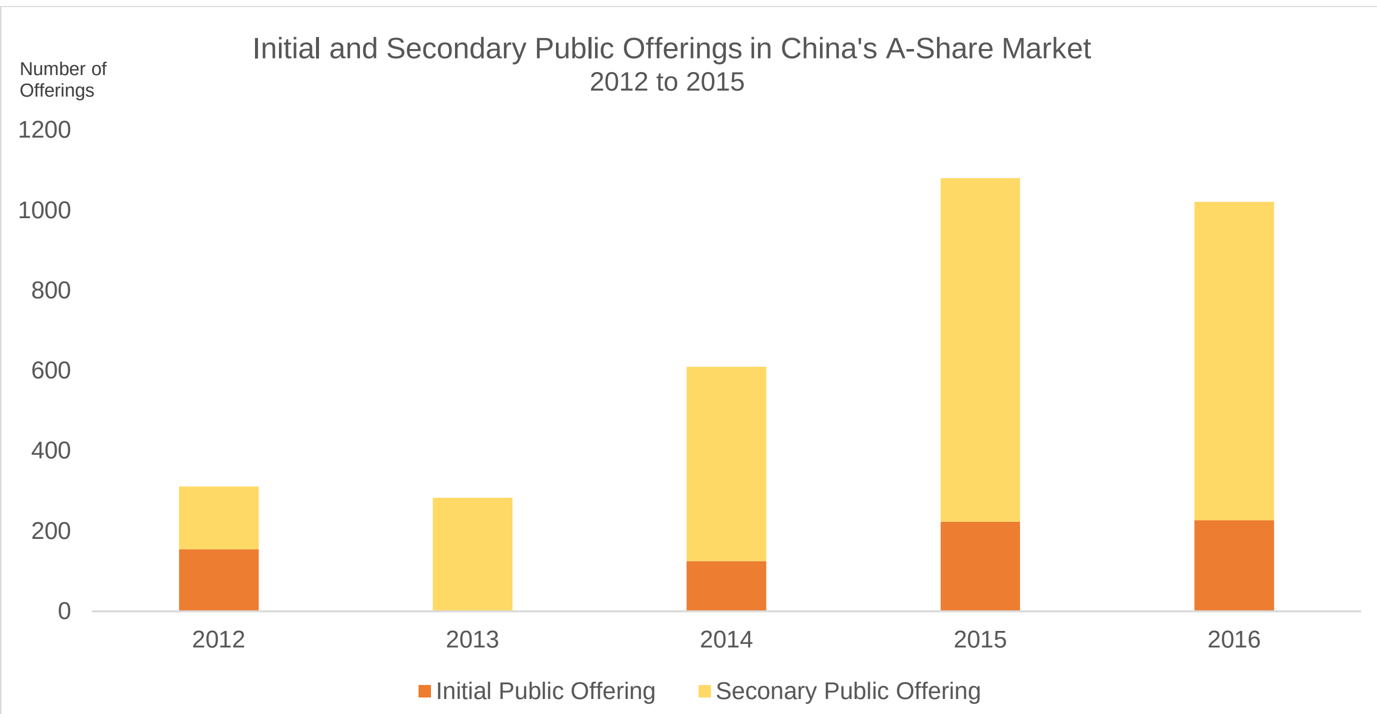
Local investors consider the regulatory changes an important indicator of policy maker confidence in market stability. The new rules are expected to encourage investors to return to the futures market, with the expected increase in turnover benefitting large institutional investors seeking more effective portfolio hedges.

CSRC to Limit IPOs and SPOs for A-Share Companies

China's Securities Regulatory Commission (CSRC) held a closed-door meeting with industry experts last week to review proposed rules on Initial and Secondary Public Offerings (IPO and SPO) by A-Share listed companies. The securities watchdog plans to limit the frequency with which A-Share companies can raise funds, a plan that aims to address deteriorating liquidity and poor A-Share market performance.

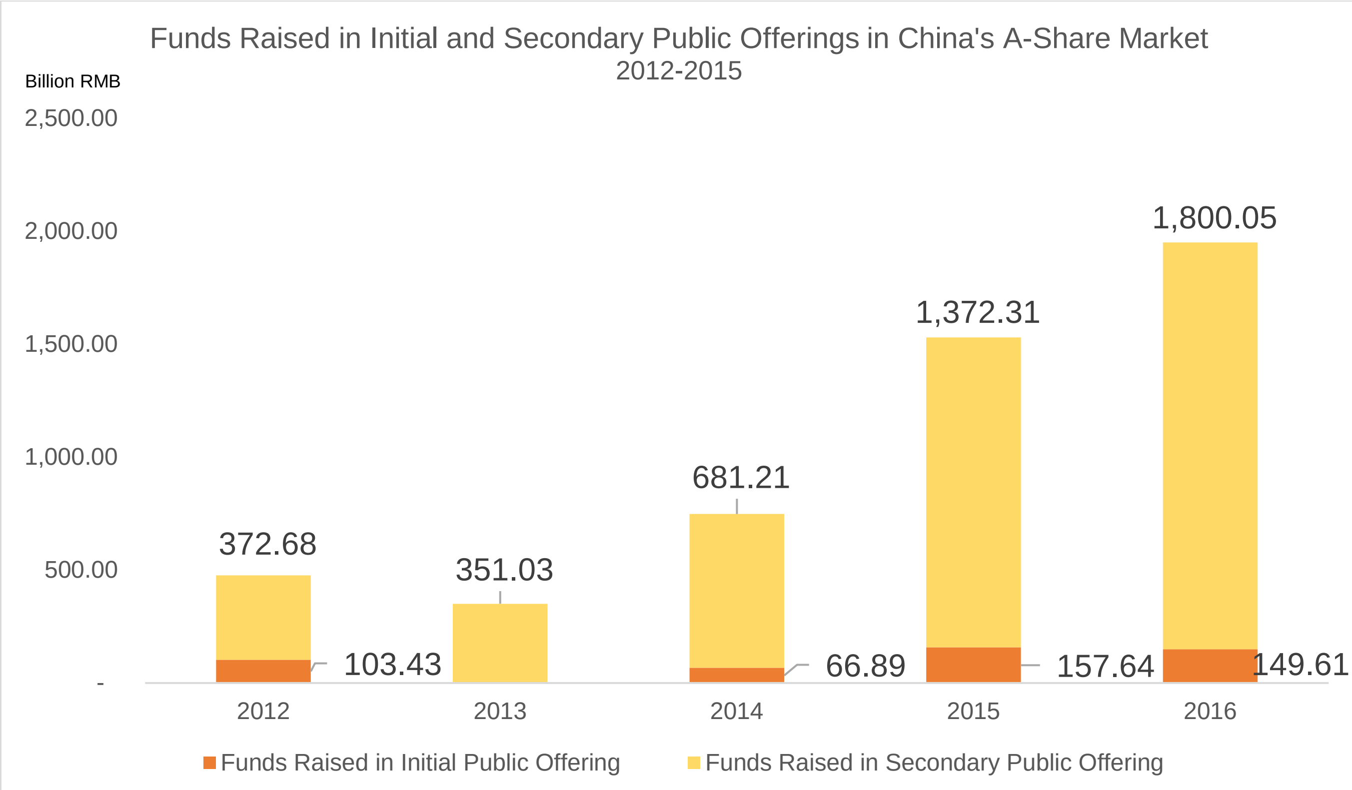
The proposed rules may forbid companies from pursuing SPOs within 12-18 months of previous funding-raising activities. In addition, the size of fund raising deals may also be limited in proportion to companies' market capitalizations. For example, a company with a RMB 10 billion market cap may be limited to raising RMB 1 billion per deal. As a workaround, CSRC may encourage companies to raise funds through issuance of preferred shares and convertible bonds (CB), helping to develop those relatively immature markets.

Local investors widely blame an overreliance on IPO and SPOs as the cause of deteriorating liquidity and poor A-Share market performance in recent years.[7] In 2016 alone, there were 227 A-Share IPOs and 794 private-placement SPOs, raising RMB 149 billion and RMB 1800 billion respectively, according to Wind. The number of SPOs is particularly concerning to regulators, who fear the tactic is being abused as a cheap source of funding to fuel acquisitions. Therefore, the proposed rules, if implemented, could calm acquisition sprees and lift market sentiment. Although the rules benefit small shareholders, they may hurt listed companies and investment banks, who will see reduced deal-flow and evaporation of a popular and cheap source of funding.



Source: Wind, as of 2.21.2017

The views expressed represent an assessment of market conditions at a specific point in time, are opinions only and should not be relied upon as investment advice regarding a particular investment or markets in general. Such information does not constitute a recommendation to buy or sell specific securities or investment vehicles.



Source: Wind, as of 2.21.2017

China's Environmental Ministry to intensify pollution reduction efforts with new rules
China's Ministry of Environmental Protection is reportedly in talks with local governments to reduce China's deteriorating air quality by imposing pollution limits.

The rules include reducing steel and aluminum manufacturing capacity, shuttering fertilizer plants, and banning coal in one of China's top ports, Tiajin. If implemented, the measures will significantly alter the supply-demand landscape and impact commodity prices. 28 cities in 4 heavily-polluted provinces—Hebei, Shandong, Shanxi, and Henan—will see their steel and fertilizer production capacity reduced by at least half and aluminum by 30%. Local investors anticipate further rallies in aluminum, steel, and coal, and reduced iron ore demand.

Coal in particular will be impacted with the new restrictions on Tianjin Port. It is the world's tenth largest port in terms of cargo-handling capacity as of 2016; one fifth of China's imported coal is handled there. Coal-related logistics will instead be diverted to Tangshan Port, which relies on environmentally-friendly railway to transport coal rather than Tianjin's polluting diesel trucks.

Notes:

1. RMB: Renminbi, the national currency of China
2. SOE: State owned enterprise
3. 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
4. GDP: Gross Domestic Product
5. EM: Emerging Market
6. Bps: Basis points
7. IPO: Initial Public Offering
   SPO: Secondary Public Offering