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

Key trade and FX indicators outperform expectations in May

China's trade data outperformed analyst expectations in May, with exports up 8.7% YoY and imports following with a 14.8% YoY increase.[1] China's May foreign reserve (FX) figure also bested expectations, growing to $3.054 trillion from $3.030 trillion in April.

Deconstructing the trade data

After such a strong start to 2017—with economic growth touching 6.7%-- analysts expected to see China's trade data slow down gradually the rest of the year. Instead, construction and property-driven demand for commodities spurred import growth, even as iron ore prices fell to 8 month lows. Hearty demand in the US and EU helped bolster export figures, as did a rekindling of relations with Korea after THAAD missile defense-related boycotts earlier in the year.[2]

Although the $40.81 billion trade surplus fell below expectations of $46.32, the robust data nonetheless indicates the resilience of China's economy despite rising interest rates and the recent Moody's downgrade. Nonetheless, analysts continue to anticipate that trade will fall off slightly into the second half of the year as regulatory tightening and property cooling measures run their course.

FX data and RMB projections for 2017

The headline FX reserve number is slightly misleading, much of the rebound is due to the "valuation effect" from a strengthening RMB.[3] Of the $24 billion increase in reserves, analyst estimate that gains against a weaker USD were responsible for a $20 billion valuation effect.[4] Thus, when considering the trade surplus below the headline figures, UBS analysts took into account net $30 billion in non-FDI outflows and found a result nearly identical to April's.[5]

All told, it is likely that the PBOC will interpret the trade and reserve data as a sign that the economy is healthy enough to withstand continued deleveraging.[6] Such tightening, coupled with the PBOC's recent fixing mechanism adjustment, will likely help maintain China's stockpile of reserves and obviate the need for corrective monetary policy after the Fed's anticipated interest rate hike this week.

Stock Connect data indicates comparative popularity of southbound channel

The cumulative purchase of Hong Kong Stock Exchange-listed stocks (HKEx) through the Shanghai and Shenzhen-Hong Kong Stock Connect Schemes has reached RMB 450 billion since the program's launch in December 2014. The size of the southbound flow is almost double that of northbound transactions.

According to one local broker, Chinese investors represent 30% of participants in the Hong Kong market while Hong Kong buyers represented 21.89% of China's market in 2015 and a mere 13.1% in 2014. Moreover, 108 HKEx-listed stocks have more than 5% of shares held by Chinese investors purchasing through Stock Connect.

Why are Chinese buyers so keen on Hong Kong-listed names?

The performance difference between A-Share and H-Share markets is the first factor motivating Mainland investors' southbound purchasing spree. The Hang Seng Index returned 18.47% YTD as of June 8th, while the blue-chip Shanghai Composite Index delivered a paltry 1.5% during the same period.[7,8] Compounding matters, the ChiNext index—China's Shenzhen-listed, Nasdaq-esque tech index-- recorded a dismal 8.53% drop.

The second reason is expectation of RMB depreciation and demand for overseas asset allocation. The pickup in southbound trade began in August 2015, following the RMB's substantial depreciation against the USD. As HKD is pegged to the USD, HKD-denominated assets became comparatively attractive.[9] As evidence, the aggregate quota for southbound Shanghai-Hong Kong Stock Connect was almost exhausted in August 2016.[10] The subsequent abolishment of the aggregate quota in late 2016 further fueled inflows from the Mainland to Hong Kong.

Chinese firms now represent 9/10 biggest players in Hong Kong IPO market

According to Bloomberg, nine of the top ten IPO advisors and sponsors in Hong Kong are now Chinese companies, reversing historical trends that saw the domination of foreign firms.[11] China Construction Bank (CCB) and Haitong Securities are two of the biggest names in the growing market, which has seen around USD 5 billion of funds raised in IPOs so far this year.

What motivated the reversal?

Since China International Capital Corporation, China's first securities house, was established by China Construction Bank and Morgan Stanley in 1995, joint-venture brokerage agreements between international banks and local partners have played the dominant role in Hong Kong's IPO market. Bringing global experience and modernized accounting methods, these international organizations helped raise billions of dollars for companies seeking to raise funds—while training a pool of local talent in the process.

After the global financial crisis, however, overseas banks began shrinking Asia businesses while Chinese firms expanded aggressively, offering competitive packages to woo talent. What's more, the rise of deep-pocketed Chinese investors rendered Mainland connections more valuable. Previously, companies needed to hire international underwriters to explore overseas investors due to the lack of Chinese investors. However, it is now easy to obtain Chinese participants as cornerstone investors, obviating the need to conduct a far-reaching, global capital raise and limiting a former competitive advantage.

A recent roadshow for one of China's rural commercial banks demonstrates the new reality. Chinese brokerage houses managed the entirety of the targeted USD 1 billion transaction—poaching roles from global coordinator to sponsor to underwriter. As icing on the cake, all verbal and written communications during the roadshow were conducted in Mandarin.

Merger reportedly pending between China coal mining and processing giants

China's largest coal miner, Shenhua Group, and China's fourth largest coal-fired electricity generator, China Guodian, are reportedly in merger discussions. Trading of their Shanghai-listed stocks have been suspending pending a material information announcement.

Context of the merger

The move is a response to President Xi's efforts to cut industrial overcapacity and reduce production of energy generated by fossil fuels. To achieve that aim, China's State-owned Asset Supervision and Administration Commission (SASAC), one of the bodies responsible for carrying out the reform, issued a directive encouraging merging activity among SOEs in energy, heavy machinery, and steel sectors.[12]

Although significant, the merger differs from a previously reported plan that would have consolidated eight coal and nuclear power generators (Datang Power Generation, China Huadian, China Guodian, China Huaneng, State Power Investment Corp, China General Nuclear Power Group, China National Nuclear Corporation, and State Power Investment Corp) into three companies. Shenhua, with its enviable coal resources, would have been combined into one of the new companies.

Will merging bring benefit or harm to China's bloated energy sector?

The merger announcement indicates that the power industry heard Xi's call, though not all onlookers are thrilled with the strategy. Critics assert that consolidation of giant SOEs into fewer monopolies would disincentivize competition in an already-bloated industry. Other onlookers disagree. They argue that restructuring will enhance SOE operational efficiency across different business lines, citing Shenhua's significant power generation business and Guodian's coal production capabilities.

China and California sign agreement to jointly develop high tech solutions to global warming

California governor Jerry Brown and China's Minister of Science and Technology signed an agreement last week establishing the California-China Clean Technology Partnership, an initiative to develop and commercialize technologies that reduce greenhouse gas emissions. The announcement comes one week after President Trump formally removed the United States from the Paris Accord.

Context for the partnership

A longtime champion of progressive causes, California has historically spearheaded best practice environmental initiatives that are subsequently adopted by the rest of the US. Under President Xi, China has taken a similarly proactive role in climate change leadership. As the world's largest investor in renewable energy and biggest producer of solar power, China plans to devote more than USD 360 billion to clean energy by 2020.

Because of their shared goal of bolstering climate change abatement and shared view on Trump's Paris withdrawal—an action Brown publically deemed "insane"—Brown requested a meeting with Xi in Beijing to discuss mechanisms for cooperation. Xi agreed enthusiastically, mentioning during the meeting that local-level exchanges should become the new driver for strengthening bilateral relations.

Why does the meeting matter?

The move is the latest major protest action against Trump's decision to withdraw from the Paris Agreement. Last week, the top US diplomat in China resigned rather than deliver the news of Trump's decision to China's leadership. Tech titan Elon Musk similarly quit Trump's Advisory Council in protest.

The meeting also indicates that the sub-national level will play an increasingly dominant role in the fight against climate change. As one example, Michael Bloomberg announced formation of a coalition of mayors, governors, business leaders, and universities that will represent the US in climate change talks. Offering another, Daimler and Chinese joint venture partner BAIC Motor Corporation agreed to upgrade their Beijing factory to produce electric cars. China hopes to grow electric car sales from the present 1.8% of auto sales to 8% by 2018, according to official data.

Notes:

1. YoY: Year-on-year
2. THAAD: Terminal High Altitude Area Defense, a US anti-ballistic missile defense system
3. RMB: Renminbi, the official currency of China
4. USD: The official currency of the United States
5. FDI: Foreign Direct Investment
6. PBOC: People's Bank of China
7. YTD: Year-to-date
8. Hang Seng Index: An index of 50 constituent companies that tracks the performance of the Hong Kong Stock Exchange. *One cannot invest directly in an index.*
9. HKD: Hong Kong Dollar
10. ChiNext Index: A NASDAQ-style index of 464 fast-growing, high-tech companies listed on the Shenzhen Stock Exchange. *One cannot invest directly in an index.*
11. IPO: Initial Public Offering
12. SOE: State Owned Enterprise