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

Bond Connect debuts July 3, Citibank takes step to include China in World Government Bond Index

The Mainland-Hong Kong Bond Connect scheme debuted on July 3rd, allowing international investors to trade Mainland interbank bonds via the Hong Kong Stock Exchange. A long-awaited milestone in China's capital market liberalization, the scheme saw approximately USD 1 billion in securities traded on debut day.[1]

Why is the Bond Connect program important?

Although China's bond market is the third largest in the world, international investors own less than 2% of the country's outstanding USD 9.3 trillion debt. This inequity pales with other emerging markets, which see 10% of debt owned by foreigners. Although Chinese entities contributed the majority of first day order flow, onlookers expect foreign participation to increase gradually given the attractive yield of Chinese government bonds and the Renminbi's stable outlook. Scheme orchestrators hope that the program will further stabilize China's currency by increasing the supply of yuan-denominated assets available to foreign investors. Heighted demand for China's currency will promote inflows, obviating the need for aggressive capital controls and offering a more effective market mechanism for pricing the RMB.[2]

The Bond Connect program also increases the prospect that index providers will include China government debt in dominant emerging markets fixed income indices. As a result of the scheme launch, Citibank announced they would include Chinese government bonds in their World Government Bond Index – Extended beginning July 2017.[3] As providers like JP Morgan and Bloomberg Barclays follow Citibank's lead, over USD 200 billion is expected to flow into the Mainland market in next two years. Deutsche Bank anticipates inflows over USD 600 billion in the first five years, and USD 1 trillion within the decade.

China's State Council takes major step to push forward commercial, tax-deferred 401k/IRA schemes

China's State Council released guidelines for a long-anticipated tax-deferred commercial pension scheme, paving the way for China to launch 401K & IRA programs. Under the guidelines, taxpayers will be allowed to deduct commercial pension premiums from taxable income and refrain from paying taxes until retirement.

Motivation for the scheme

Although China has made great strides in embracing market mechanisms in recent decades, the country's commercial pension system remains woefully underdeveloped. Chinese companies offer almost no tax-advantaged, commercial products and services, a problem considering the country's aging society and paltry returns on state-managed funds. To prepare for the future, citizens overwhelmingly store their savings in banks, which represent 85% of China's financial services industry. Chinese authorities consider the imbalance a system risk and are seeking corrective mechanisms.

To remedy this imbalance, the new tax incentives will encourage taxpayers to purchase commercial pension insurance. With the development of a commercial insurance network, Chinese citizens will feel secure to save less in banks and purchase more financial products, transferring personal wealth from the banking system to China's insurance and capital markets. Onlookers are heartened by the guidelines, which are anticipated to create new market opportunities for insurance and securities companies and reduce central pension obligations. According to Credit Suisse, the United States saw its annuity business grow 15.2% CAGR from 1975 to 1990 after launching deferred tax schemes.[4]

RBS sells position in Chinese securities joint venture

Royal Bank of Scotland (RBS) sold their stake of Hua Ying Securities to Guolian Securities for RMB 354 million. Originally a joint venture between RBS and Guolian, Hua Ying Securities will be fully owned by Guolian after the transaction. RBS originally bought the stake in 2011 for RMB 266.4 million, resulting in a profit of RMB 87.6 million.

Why did RBS sell their stake?

Onlookers assert that internal considerations motivated RBS to withdraw from the joint venture rather than a bearish turn on China. The Scottish lender is reportedly in the midst of a cost-cutting spree, offloading business lines and eliminating jobs in attempt to reverse nine straight years of losses. The restructuring bonanza began in 2008, when the British government took a majority stake in the bank during the global financial crisis. British leadership has since become impatient with the flailing lender. The UK Chancellor recently signaled that the government could suffer a multibillion pound loss from selling its 73% stake in RBS.

Will other foreign banks follow suit?

In contrast to the RBS move, a number of foreign banks have sought to increase their participation in China's onshore securities business. Although China has historically required foreign firms to partner with Mainland entities before entering the market, such restrictions are being gradually loosened. For example, HSBC recently became the first foreign bank permitted to establish a majority-owned joint venture in China. Moreover, Morgan Stanley and UBS are planning to boost stakes in their joint ventures, topping up ownership holdings from 33.3% and 25% to 49% of their respective ventures. Meanwhile, JP Morgan agreed to exit its minority-owned Chinese investment banking venture to form a new partnership where it can exert more influence.

Regulators announce 3% VAT tax on asset manager returns

China's Ministry of Finance and State Administration of Taxation jointly announced a 3% value added tax (VAT) on returns on assets under management starting on January 1, 2018. The tax represents a reduction from a previously-proposed 6% VAT tax and a further 6-month delay on implementation.

The 3% plan

The tax will target all financial institutions-- banks, trusts, mutual funds and subsidiaries, brokerage houses and subsidiaries, futures brokers and subsidiaries, private equity firms, insurance firms, and pensions. The taxable amount includes capital gains, interest and dividends from banks' wealth management products (WMPs), capital trusts, mutual funds, segregated accounts, private equity funds, and pension funds. Further details outlining specific tax treatment have yet to be disclosed, though authorities are expected to clarify the policy by the end of the year.

What is the effect?

China is one of the first countries in the world to have a VAT applied broadly to its financial services industry. Onlookers assume that increased costs of money management will be the policy change's main implication; financial institutions will likely pass part or all of the tax burden to clients by charging higher fees. In addition, the measure will accelerate China's deleveraging process. With steeper costs, some highly-leveraged strategies may lose attractiveness and be unwound, helping authorities fulfill their de-risking mandate.

China's box office ticket sales plummet

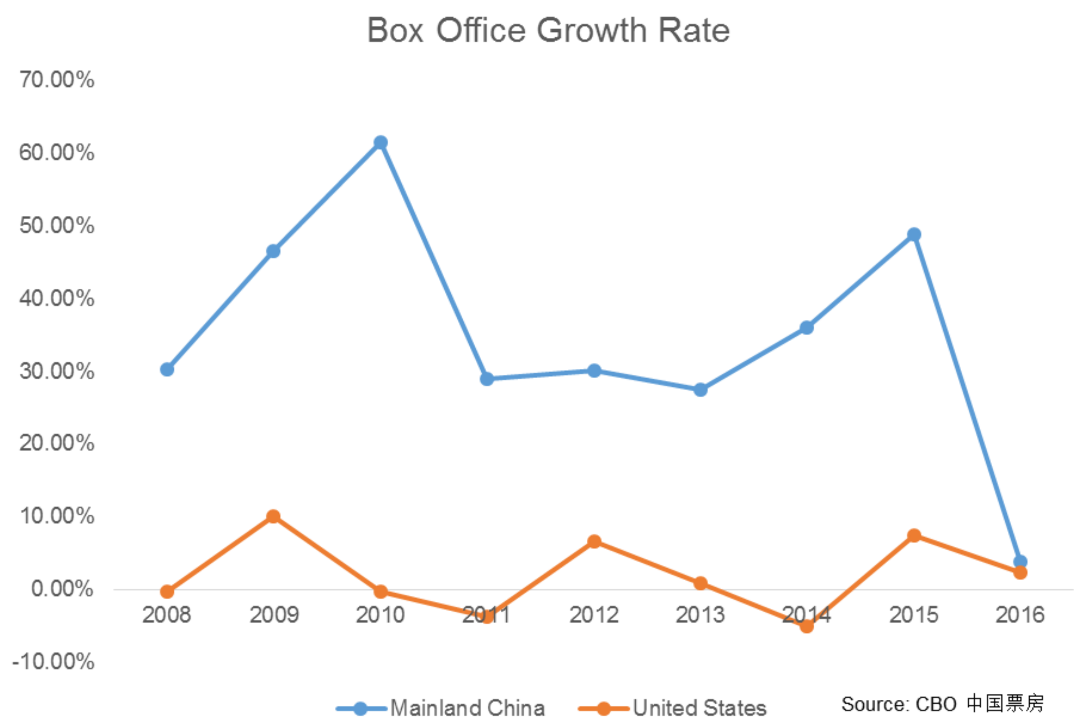
China's box office ticket sales dropped 3.73% to USD 6.72 billion in 2016, compared with an astonishing 48% increase in 2015. The fall represents the slowest rate in the past decade and reflects a marked departure from China's cinematic golden era of 2010-2015, which saw revenue for the movie industry expand threefold.

Reasons for the slowdown

Three reasons are cited for the slowdown. First, a gradual decrease in China's economic growth translates to fewer dollars spent on entertainment. A lack of blockbusters in 2016 also contributed, as several big budget films produced by Chinese studios proved to be flops. In contrast, 2015 saw a number of unexpected successes, contributing to that year's outperformance. In addition, a crackdown on the practice of overstating ticket sales also cooled the market. Formerly, theaters and production companies would pass out free tickets in attempt to boost screening numbers to secure more money from profit-sharing agreements with US movie studios. However, China's National People's Congress outlawed this practice in November 2016, fining companies up to USD 74,000 for misreporting box office sales.

What's the implication?

The data came as a heavy blow to onlookers who predicted that China would overtake the US as the world's largest cinema market. Following the five-year boom in the Mainland cinema market, Hollywood cinemas had levied big bets that China's movie industry could continue expanding in spite of the country's slowing economic growth. The recent numbers are causing movie studios on both sides of the Pacific to reorient their strategies, putting the brakes on planned expansion and acquisition campaigns.



As of: July 6, 2017

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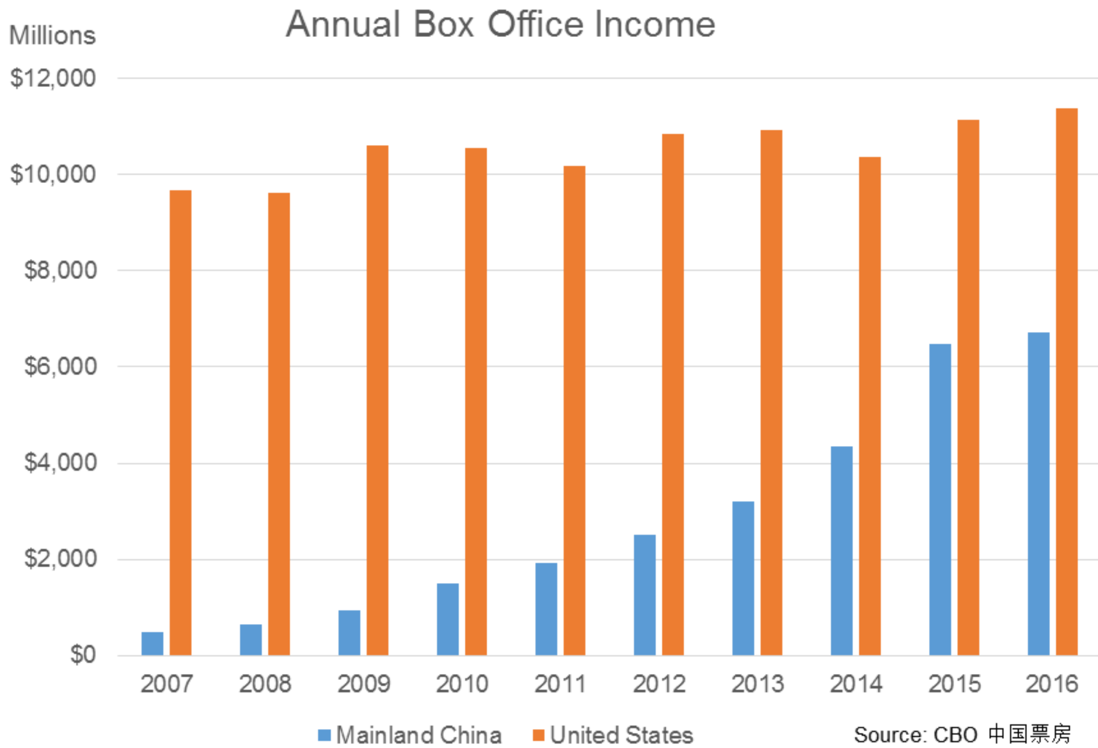

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Notes:

1. USD: US Dollar, the national currency of the United States
2. RMB: Renminbi, the national currency of China
3. World Government Bond Index: measures the performance of fixed-rate, local currency, investment grade sovereign bonds for over 20 countries, providing a broad benchmark for the global sovereign fixed income market. *One cannot invest directly in an index.*
4. CAGR: Compound annual growth rate (CAGR) is a business and investing specific term for the geometric progression ratio that provides a constant rate of return over the time period.