

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

### China RMB appreciates against USD, reversing 2016 trends

China's RMB appreciated 3.2% against the USD and depreciated 2.2% against the official basket of currencies from January - July 2017, effectively reversing the 2016 trend.<sup>1,2</sup> As a result, analysts at Bank of America Merrill Lynch lifted their 3Q2017 currency forecast to 6.7 and year-end outlook to 6.9, evidencing a newly bullish view.

#### *Why the outperformance?*

The reversal is due to both China's unexpectedly buoyant economic performance and Trump-related uncertainty in the US. China's Gross Domestic Product has grown 6.9% thus far in 2017, erasing fears of a hard landing. Such growth has provided authorities a strong backdrop upon which to reform the financial system. The newly-established Financial Stability and Development Commission is anticipated to coordinate regulation across asset classes and accelerate the deleveraging process in both public and private sectors, measures expected to contribute to long-term RMB stability.

As the RMB was undertaking its steady upward climb, the USD dropped 8.8% between January and July, erasing the gains that manifested after Trump's election victory. Looking forward, market consensus expects the USD to remain weak in second half of the year. Not only are the Trump administration's reforms on medical care, taxation and infrastructure manifesting slower than expected, but the Federal Reserve is anticipated to start shrinking its balance sheet in September.

#### *So what?*

Ultimately, a weaker USD will help reduce the depreciation pressure on RMB, in turn easing pressure on policymakers and limiting the prospect of further capital controls.

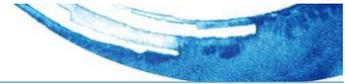
### China's old and new leaders meet for secretive summer retreat to finalize Politburo selections

China's current and retired leaders converged on the coastal resort town of Beidaihe for their secretive annual summer meeting. It is widely expected the top brass will finalize the selection of the Politburo—the top 25 decision makers-- during this year's "vacation" period.

#### *What are the stakes?*

Located 280 kilometers away from Beijing, Beidaihe has served as leaders' favored escape from the Beijing heat since 1953. Many historic policy decisions were made during the annual Beidaihe retreat, notably Mao's Great Leap Forward campaign.

This year's gathering is under particularly heavy public scrutiny ahead of the upcoming Party Congress and the recent ouster of Politburo member Sun Zhengcai. Due to retirement and Xi's widespread anti-graft campaign, over half of the Politburo's 25 seats are due to be filled. Thickening the plot, 5 of the 7 seats on the supreme Standing Committee are up for grabs, paving a path toward an aggressive power struggle. Filling these seats strategically is important; President Xi needs a strong and loyal team to navigate through China's stagnating economic growth and escalating geopolitical frictions.



## **China announces new rules governing local bond issuance, address major source of shadow banking**

China's Ministry of Finance announced a pilot revenue bond program for China's provinces. The policy change aims to attract private capital into public projects and increase transparency into operations of profligate local governments.

*What does the new policy achieve?*

Local government financing has long been a thorny issue for China's regulators. Deprived of reliable financing sources, local governments would fund budgets and infrastructure projects by establishing corporate vehicles (known as LGBVs) and borrowing from banks. Not only were the LGBV liabilities difficult to measure and regulate under this opaque structure, they were also interpreted as implicitly backstopped by China's central government.

Under the revenue bond pilot project, new debt streams are required to be secured by specified revenues such as income from tolls, airports and seaports. This is a departure from the current structure, which allows bonds to be repaid from general fiscal revenue.

*What's the implication?*

Onlookers are heartened by the policy change, which effectively forces local governments to borrow from capital markets rather than banks. Reliance on market mechanisms will have several impacts. First, it will make local government borrowing vehicles more visible, effectively encouraging governments to reduce their LGBV debt burden. Moreover, transferring LGBV funds to municipal bonds could help diversify risk away from the banking system and encourage more effective regulation of provincial borrowing.

## **President Xi shows off power, boats new weapons in major military parade**

President Xi presided over a military parade in China's Inner Mongolia province, an exercise intended to showcase the country's military power and Xi's absolute authority. The spectacle marked the 90<sup>th</sup> anniversary of People's Liberation Army and featured 600 types of weapons—from stealth jets to tanks to intercontinental ballistic missiles—more than half of which were on display for the first time.

*Xi's endgame*

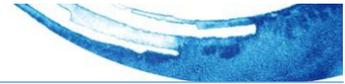
China's military parades are generally held in Beijing's Tiananmen Square and are structured as public events for hundreds of thousands of attendees. However, this year's parade at Zhurihe involved no bands or cheering bystanders, and all participants, Xi included, donned battle uniforms. As Zhurihe is the largest military exercise base in Asia, onlookers interpreted the event as a sign of both China and Xi's increasing aggression.

The event coincided with rising regional tensions such as North Korea's missile testing, the South China Sea land disputes, and the recent standoff with Indian troops. Construed as a show of political theater, onlookers believe Xi wanted to display not only China's might, but also his own. As this fall's Party Congress creeps closer, Xi has been gunning to cement his status and authority over all aspects of national power.

## **Signaling impactful policies, China's Outbound Direct Investment drops 43% YoY**

China's outbound direct investment (ODI) recorded RMB 331.1 billion in the first six months of the year, a 43% decline from the same period in 2016. Government officials attributed the drop to fewer "irrational"

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deals in property, culture, sporting and entertainment sectors and ensured that ODI in Belt and Road countries and overseas manufacturing industries were less impacted.

*Official explanation:*

A director at the National Development and Reform Commission argued that Chinese authorities were not overtly discouraging overseas investments made by local corporations. He instead explained the precipitous decline as a “fine tuning” of regulation rather than a reversal of Beijing’s policies or result of tighter capital controls.

*Real talk:*

Although officials praised the decline in ODI, local players are expressing concern. Anbang Insurance, one of China’s most aggressive overseas acquirers, was reportedly ordered to liquidate overseas assets and repatriate the proceeds back to China. As another example, Wanda recently expunged core domestic assets at fire sale prices in a move reportedly championed by central leadership. The company was also an aggressive bidder on overseas assets like AMC and Dick Clark productions. Fosun and HNA Group are also under pressure, facing increased scrutiny over acquisition funding sources. Following President Xi’s Financial Work Conference directive to severely mitigate financial risk, onlookers expect even tighter scrutiny for overseas deal makers in the coming months.

Notes:

1. RMB: Renminbi, the official currency of the People’s Republic of China
2. USD: US Dollar, the official currency of the United States