What You Should Know This Week: CSOP's Weekly China Wrap Up

S&P downgrades China's sovereign rating for the first time since 1999

China's Finance Ministry called S&P Global Ratings' downgrade of the country's sovereign rating "perplexing" and a "wrong decision" after the prominent US rating agency joined Moody's in turning more cautious on China's debt situation. The downgrade comes at a sensitive time, just a month ahead of the 19th National Congress, the most important political event for the Chinese government.

Current market and political context

The downgrade came unexpectedly to investors, at a time when local equity and currency markets have been outperforming and financial risk seemingly diminishing. This was the first time since 1999 that S&P has downgraded China's sovereign rating. Furthermore, at just a month away from the National Congress, in which China's political top echelon is determined, politicians are especially sensitive to any negative news that may impact their career. Both the Finance Ministry and the official Xinhua News Agency fought back fiercely post the downgrade.

What is the reason for S&P's decision?

The disagreement between the government and the rating agency lie in whether debt of state-owned enterprises (SOEs) and local government financial vehicles (LGFVs) should be considered as government debt. S&P have taken the conservative approach to include, with the assumption that the central government would bail out local governments and SOEs in case of failure. This assumption is shared by the market, unless the implicit guarantee endorsed by the central government proves to be false in the future. Indeed, the top authorities are fully aware of the potential risks of LGFVs, as President Xi has made the deleveraging and ensuring stability his top priority ahead of historical moment.

Tencent purchases a stake in a Chinese investment bank, for future fintech innovations

Tencent, the Chinese technology giant, agreed to purchase 207.5 million new H Shares issued by CICC at HKD 13.8 each, at an 11% discount to the Wednesday closing price. Once the deal is approved by the regulators, Tencent will hold around 4.95% stake in CICC. There is 36-month lock-up period for the stake, and under the cooperation agreement, the two firms will develop financial technology innovation in the wealth management business.

Who is CICC?

CICC is a leading Chinese investment bank, founded as a joint venture by Morgan Stanley and Construction Bank of China in 1995, although the US bank sold its stakes in the venture in 2010. The bank has some skeptics regarding its success in being mandated to write most of the Chinese state-owned enterprises initial public offerings (IPOs), suggesting deep connections with the top politicians in the country to be the key. Other have argued against this however, pointing to competitors quickly taking market share on the back of further opening of markets as well as reshuffling of top politicians.

What is the rationale for the partnership?

Chinese technology giants partnering with traditional financial institutions to general value-added financial services to clients has been a recent trend. JD.com, a Chinese e-commence platform, recently acquired 24% stake in brokerage First Capital Securities at USD 1.5 billion. Huatai Securities paid USD 780 million for the US financial consultancy firm AssetMark last year. The argument for partnership is clear; Internet companies own massive databases of individual consumer information but lack financial products to offer, while traditional financial institutions have the solution offering, but eager for better data and intelligence on retail clients. However, the apparent synergies have yet to produce solid results thus far, and it remains to be seen whether the cooperation can bring out the intended values.

Chinese parents are buying more real estate in the US

Chinese parents reportedly have spent USD 31.7 billion on American real estate so far this year, compared with USD 27.3 billion in 2016, according to the National Association of Realtors. In terms of unit number, that's 40,572 units this year, up from last year's 29,195.

What's bringing in the flow?

Property agents said open house sessions are often packed with Asian investors, many being Chinese buyers from mainland China, Macau and Hong Kong. There are currently almost 40,000 Chinese students studying in the US, and their parents are investing in US property markets in the hope that the returns would cover the cost of tuition fees. The idea is especially attractive for parents from top-tier mainland cities such as Beijing and Shanghai, where the property prices rallied more than ten times in the past decade, rendering the middle class financially comfortable to send their children to study abroad. Studio and one bedroom apartments in New York are the most popular, with the price tag ranging from one to two million. While similar apartments in Beijing or Shanghai are comparable in price, quality of apartments in the US is arguably higher.

Are any Chinese companies getting involved?

Chinese property developers and investors such as Vanke and Anbang Group have been expanding their business in the US, increasing supply to meet the demand from China. In early 2016, Vanke reportedly purchased a USD 116 million vacant nursing home in Manhattan for conversion into 100 luxury condominiums. Anbang Group bought the landmark Waldorf Astoria Hotel at USD 1.95 billion in 2015 and now is converting the hotel into luxury condominiums.

China considers increasing foreign ownership of financial institutions

China's central bank is reportedly discussing with domestic regulators and key domestic institutions the possibility of allowing foreign investors to take majority stake in joint ventures with Chinese companies. The administration is also considering lifting the 25% ceiling on foreign ownership of Chinese banks. The news conveniently coincides with the Party Congress next month, as well as the expected visit by US President Trump.

What are the implications of the discussions?

The news was warmly received by the market as a sign of China further opening its financial border to foreign institutions. Currently, overseas financial institutions are restricted to minority shareholders in joint ventures with banks, securities firms, and insurance companies. Major American and European groups have been aggressively lobbying the Chinese government to grant more access to foreign players. In June of this year, HSBC became the first foreign bank allowed to own 51% of a securities joint venture in China.

Analysts view the need to attract and retain foreign capital as foreign direct investment in China as one of the key reasons behind the discussions to raise foreign stake in mainland banks, especially in the backdrop of US tightening cycle. Timing is also appropriate, with China better prepared to open up the financial services sector, with the currency more stable and shadow banking under control after a painful deleveraging process. Some senior management from domestic brokerage firms has also voiced their confidence in taking on a more competitive market.

Index definition:

1. 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

2. The CHINEXT index is China's Nasdaq-like barometer of high-tech stocks. Note that one cannot invest directly in an index

3. The MSCI China Index captures large and mid-cap representation across China H shares, B shares, Red chips, P chips and foreign listings (e.g. ADRs). With 150 constituents, the index covers about 85% of this China equity universe. Note that one cannot invest directly in an index

4. Bloomberg's Global Aggregate + China Index combine the Global Aggregate Index with the treasury and policy bank component of the China Aggregate Index. The EM (Emerging Market) Local Currency Government + China Index combine the EM Local Currency Government Index and treasury component of the China Aggregate Index. Note that one cannot invest directly in an index

5. Citibank's World Government Bond Index (WGBI) measures the performance of fixed-rate, local currency, investment grade sovereign bonds. The JPMorgan Emerging Market Bond Index (EMBI) is a set of three bond indices that track bonds in emerging markets. Note that one cannot invest directly in an index

6. 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

Institutions:

1. PBOC: People's Bank of China
2. SOE: State-owned enterprise
3. IMF: International Monetary Fund
4. CBRC: China Banking Regulatory Commission
5. CIRC: China Insurance Regulatory Commission
6. CSRC: China Securities Regulatory Commission
7. SAFE: State Administration for Foreign Exchange
8. ICBC: Industrial and Commercial Bank of China
9. EU: European Union
10. G20: An international forum for the governments and central bank governors from 20 major economies
11. UAE: United Arab Emirates
12. SSE: Shanghai Stock Exchange
13. LSE: London Stock Exchange
14. AIIB: Asian Infrastructure Investment Bank
15. WTO: World Trade Organization

Currencies:

1. RMB: Renminbi, the national currency of China
2. USD: US Dollar, the national currency of the United States

3. GBP: Pound Sterling/Great British Pound, the national currency of the United Kingdom
4. JPY: Japanese Yen, the national currency of Japan
5. EUR: Euro, the official currency of the Eurozone
6. HKD: Hong Kong Dollar, the national currency of Hong Kong
7. USDCNH: Abbreviation for the US offshore Dollar/RMB currency pair

Others:

1. IPO: Initial public offering
2. SPO: Secondary Public Offering
3. MoM: month over month
4. YoY: Year over year
5. GDP: Gross Domestic Product
6. EM: Emerging Market
7. Bps: Basis points
8. FX: Foreign Exchange
8. OTC: Over-the-counter
9. GDP: Gross domestic product
10. ETF: Exchange-traded fund
11. FATCA: Foreign Account Tax Compliance Act
12. TPP: Trans-Pacific Partnership
13. SDR: Special Drawing Right, an international reserve asset
14. OBOR: One Belt, One Road
15. RCEP: Regional Comprehensive Economic Partnership