IP VIEWPOINT

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OPPORTUNITIES PRESENTED BY CHINA'S DELEVERAGING

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EXECUTIVE SUMMARY

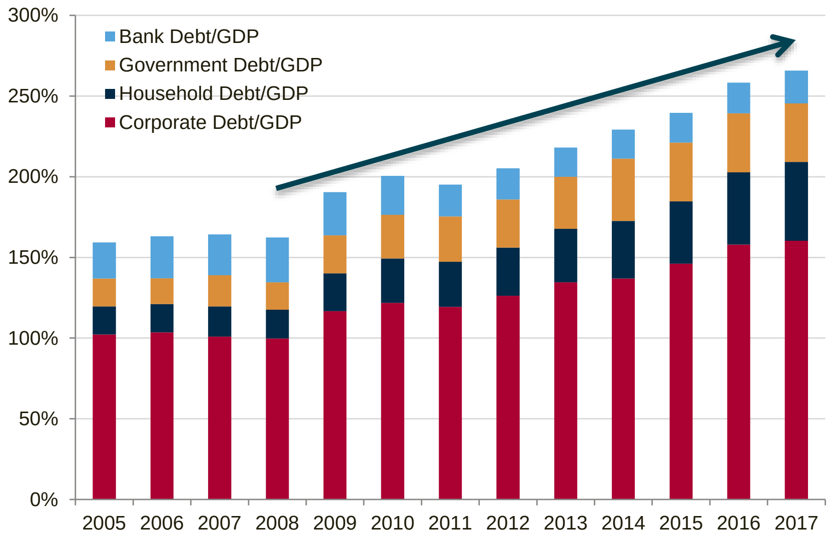
- Beginning late 2016, China's deleveraging policy has effectively stabilized the country's Debt/GDP ratio and released the most significant structural overhaul for its economy in several years.
- Going forward, China will have greater control over its Debt/GDP ratio, as the speed of overall credit expansion has converged to its nominal GDP growth, thanks largely to an increasing contribution from consumption versus investment.
- If managed well, China's Debt/GDP ratio is likely to decline further or at least stabilize at the current level over the medium term, which is likely to be positive for Chinese credits and equities.
- China's deleveraging policy resulted in credit tightening in the onshore shadow banking system in early 2018, but given more recent policy adjustments, overall credit growth is expected to stabilize from here.
- We see an attractive investment opportunity in selected offshore, USD-denominated, 3-year maturity, BB-rated Chinese high yield credits, which are less reliant on the shadow banking system for financing, and will benefit most from the recent policy adjustments, while offering an attractive yield of 7-8% in USD.

CHINA'S DEBT PROBLEM IS BEING RESOLVED

China's Debt Problem Is Concentrated in the Corporate Sector

Over the past few years, global investors have become increasingly concerned about China's debt levels. In the 10 years following the Global Financial Crisis, China's Total Debt/GDP ratio increased by almost 100%, from 162% in 2008 to 266% in 2017. The largest contributor to this increase was the corporate sector, where the Debt/GDP ratio increased from 100% in 2008 to 160% in 2017.

China's Total Debt/GDP ratio



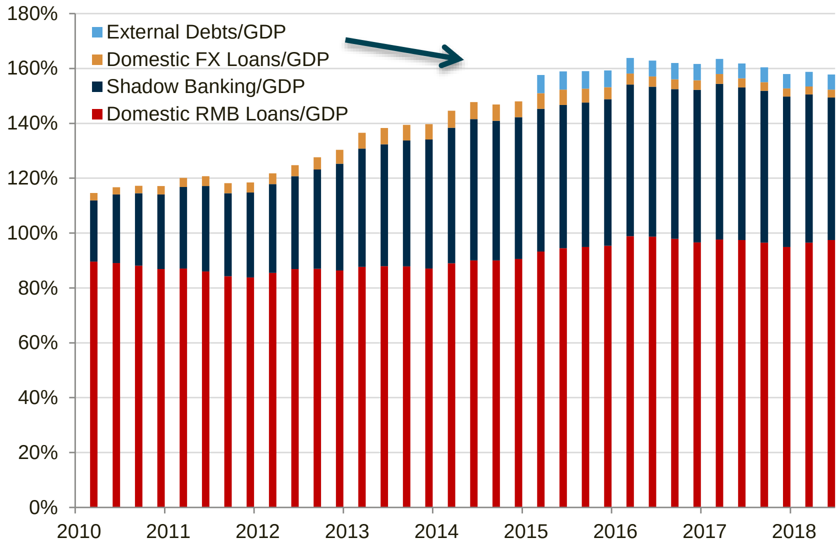
Source: Bloomberg, August 2018

The Deleveraging Policy Has Stabilized China's Debt/GDP Ratio

The high total Debt/GDP ratio has created a number of issues for China, including threatening the sustainability of GDP growth, reducing investment efficiency and potential environmental issues. Beginning in late 2016, Chinese policymakers announced a policy of deleveraging to encourage the corporate sector to reduce debt levels. Under this policy, industries with excess capacity have received less support from banks and the shadow banking system has become more tightly regulated, which together has resulted in better control over the speed of credit expansion.

As a result, China's corporate Debt/GDP ratio peaked in early 2017 and has begun to gradually decline.

Breakdown of China's Corporate Debt



Source: Bloomberg, Wind, August 2018
Quarterly data of Chinese corporates' external debts are only available since 2015

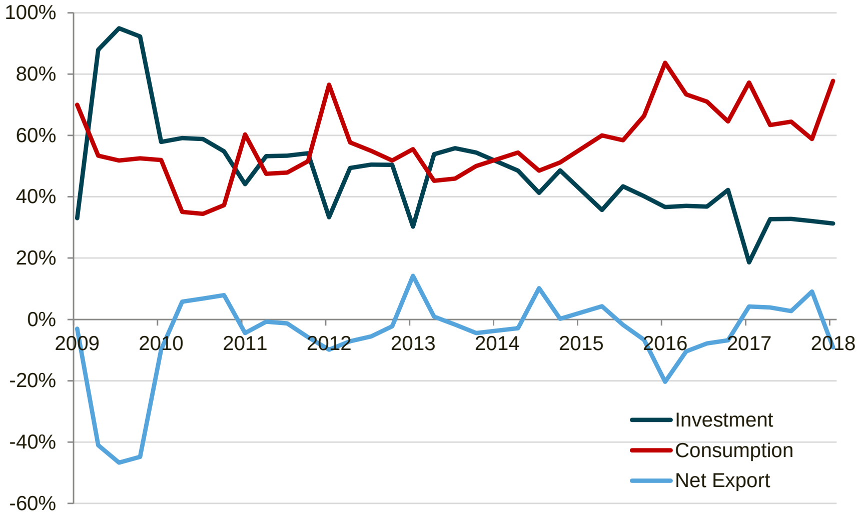
We Believe China's Debt Problem Is Now Under Control

Like any other rapidly growing economy, after a 30-year acceleration it is inevitable that China's GDP growth will slow as the base effect plays an increasingly significant role. Indeed, China's real GDP growth gradually decelerated from 10.6% in 2010 to 6.9% in 2017. At the same time, due to lower investment efficiency, the speed of China's overall credit expansion (as measured by China All-system Aggregate Financing plus Local Government Bonds) has surpassed that of nominal GDP growth, which has led to a rising Debt/GDP ratio. We believe the accumulation of debt has been major factor suppressing the valuation of China's financial assets since 2010.

After an 8-year slowdown, we believe China is approaching a turning point where credit expansion is converging to nominal GDP growth. A key reason for this convergence is that domestic consumption has been playing an increasingly dominant role in China's economy, and by nature consumption requires less credit support than investment.

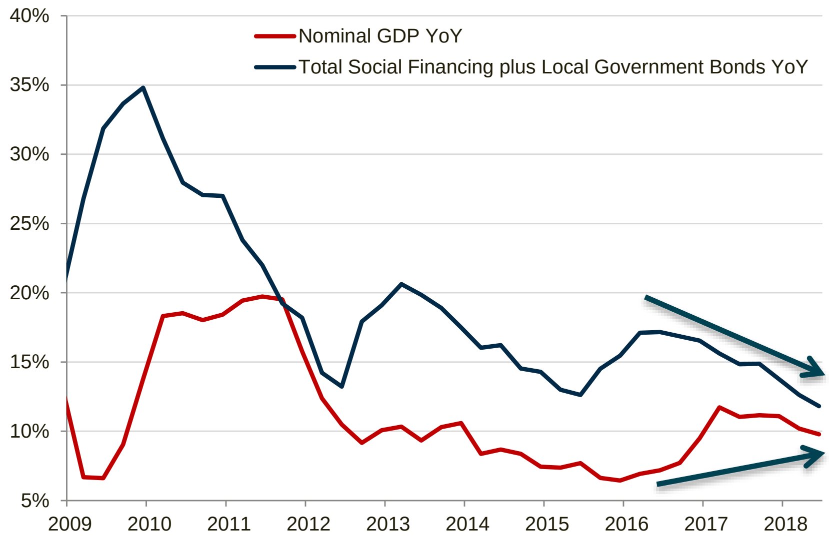
The major implication is that going forward, China will have greater control over its Debt/GDP ratio, as the growth rates of the numerator and denominator are converging. If managed well, the Debt/GDP ratio could further decline or at least stabilize at the current level over the medium term, which we believe will be positive for Chinese credits and equities.

Consumption Contributes More to China's GDP Growth



Source: Wind, August 2018

The Convergence of China's Nominal GDP and Credit Growth

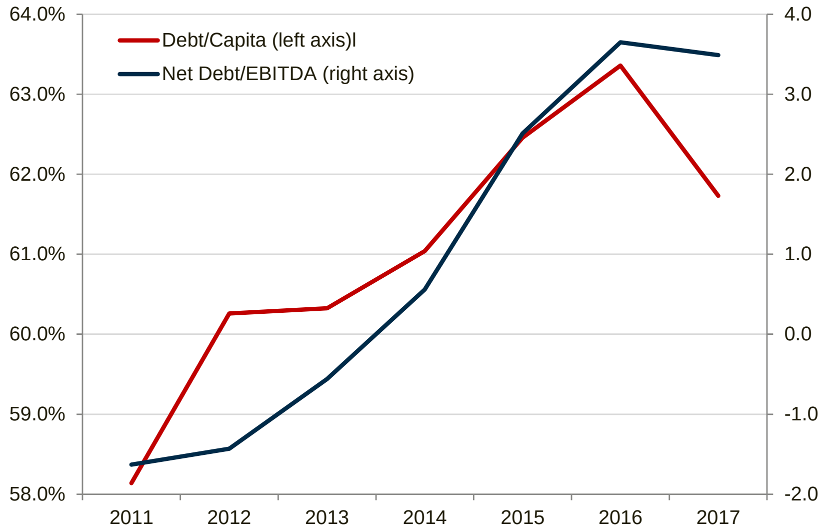


Source: Bloomberg, Wind, August 2018

Chinese Companies Have Been Deleveraging

Statistics on the Shanghai Stock Exchange Composite Index constituents indicate that listed Chinese companies have already entered into a deleveraging phase beginning at the end of 2016. In addition, the aggregate Debt/Capital ratio remains at a manageable level of 61.7%, implying no systematic risk.

Deleveraging of Chinese Listed Companies



Source: Bloomberg, Wind, August 2018
* Aggregate leverage ratios of the Shanghai Stock Exchange Composite Index

MOST OF THE IMPACT FROM DELEVERAGING IS NOW BEHIND US

Why There Was Credit Tightening Onshore in Early 2018

Beginning in 2018, Chinese companies, especially private companies, began feeling the lagging effect of the deleveraging policy, as the availability of credit from the onshore shadow banking system became much tighter.

At CNY 58.4 trillion in size (as of August 2018), China's non-bank credit system is almost half the size of the banking system (CNY 130.4 trillion as of August 2018). The non-bank credit system includes trust loans, entrust loans, undiscounted bankers' acceptance, corporate bonds, and non-financial enterprise equity.

The non-bank credit system and the banking system in combination are referred to as Total Social Financing (or Aggregate Financing) and total CNY 188.8 trillion as of August 2018, representing basically the entire credit system for non-government entities.

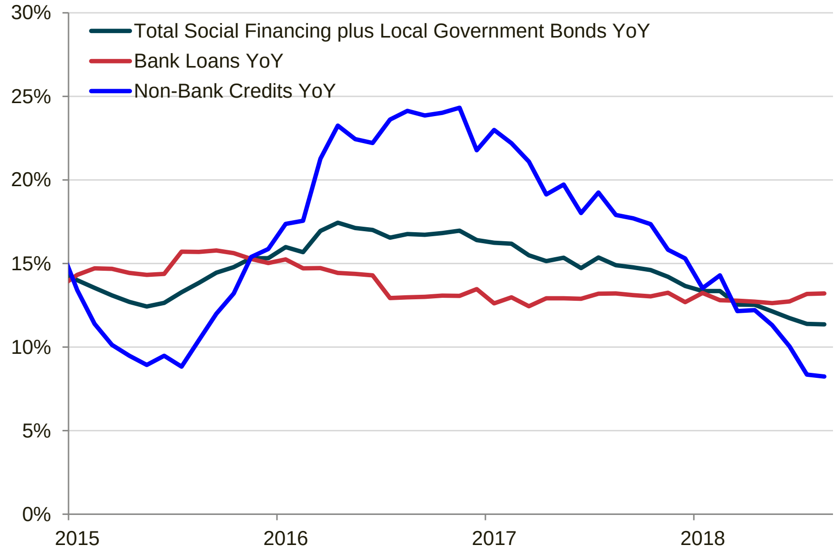
In addition, we believe local government bonds should be added to Total Social Financing to more comprehensively measure China's overall credit expansion.

Historically, state-owned enterprises (SOEs) and large private companies (typically investment grade / BB-rated or above) rely more on the banking system, while small-to-medium private enterprises (typically B-rated or below) rely more on the non-bank credit system.

In early 2018, China further tightened regulation on the shadow banking system, which is a major part of the non-bank credit system, under the deleveraging policy. This created a freeze on banks and trust companies issuing new products until after the announcement of a new high-level asset management rule by the regulator in April.

As a result, the YoY growth rate of the non-bank credit system declined to below that of bank loans, and led to a further slowdown in Total Social Financing growth. This meant that credit availability became much tighter than before, particularly for private companies.

China's Credit Expansion Slowed Further in 2018



Source: Bloomberg, Wind, August 2018

A Positive Monetary Policy Turning Point

In July 2018, Chinese policymakers began adjusting monetary policy from tightening towards a more neutral stance:

(1) On 18 July, reports surfaced that the PBOC will begin using the medium-term lending facility (MLF) to encourage Chinese banks to increase loan supply and to purchase high-yield bonds, which could stimulate loan growth and stabilize the onshore credit market;

(2) On 20 July, multiple regulators including the PBOC, CBRC and CSRC, published execution-level guidance for the new asset management rule announced in April, which should remove the uncertainty in issuing new wealth management products and stop the shadow banking system from shrinking further. Policy makers also expressed their desire to stabilize overall credit expansion by encouraging shadow banking activities to flow back to the more transparent banking system.

As a result, we expect that over the coming months the slowdown in the shadow banking system should gradually stabilize, while bank loan growth will continue to be strong to stabilize the overall growth of Total Social Financing.

We believe these developments are positive for Chinese credits, especially higher quality high yield credits which are less reliant on the shadow banking for financing and will benefit most from the recent policy changes. In addition, we view these credits as being oversold together with the broader Asian credit market since the beginning of this year.

The Sharp Correction in Asian High Yield

Source: Bloomberg, August 2018

INVESTMENT IMPLICATIONS

We believe that the peak in China's Debt/GDP ratio, together with the more dovish monetary policy stance from the PBOC, together are positive for Chinese credits, especially higher quality high yield credits. Between onshore and offshore markets, and when looking across the credit quality spectrum, our current preference is for select offshore USD denominated, 3-year maturity, BB-rated Chinese high yield credits, which offer attractive USD yields in the 7-8% range.