



China - *Understanding* the mythical dragon

A historical, cultural & socio-economic journey through the Middle Kingdom

Kelvin Tay,
Managing Director,
Regional Chief Investment Officer, APAC

November 2017

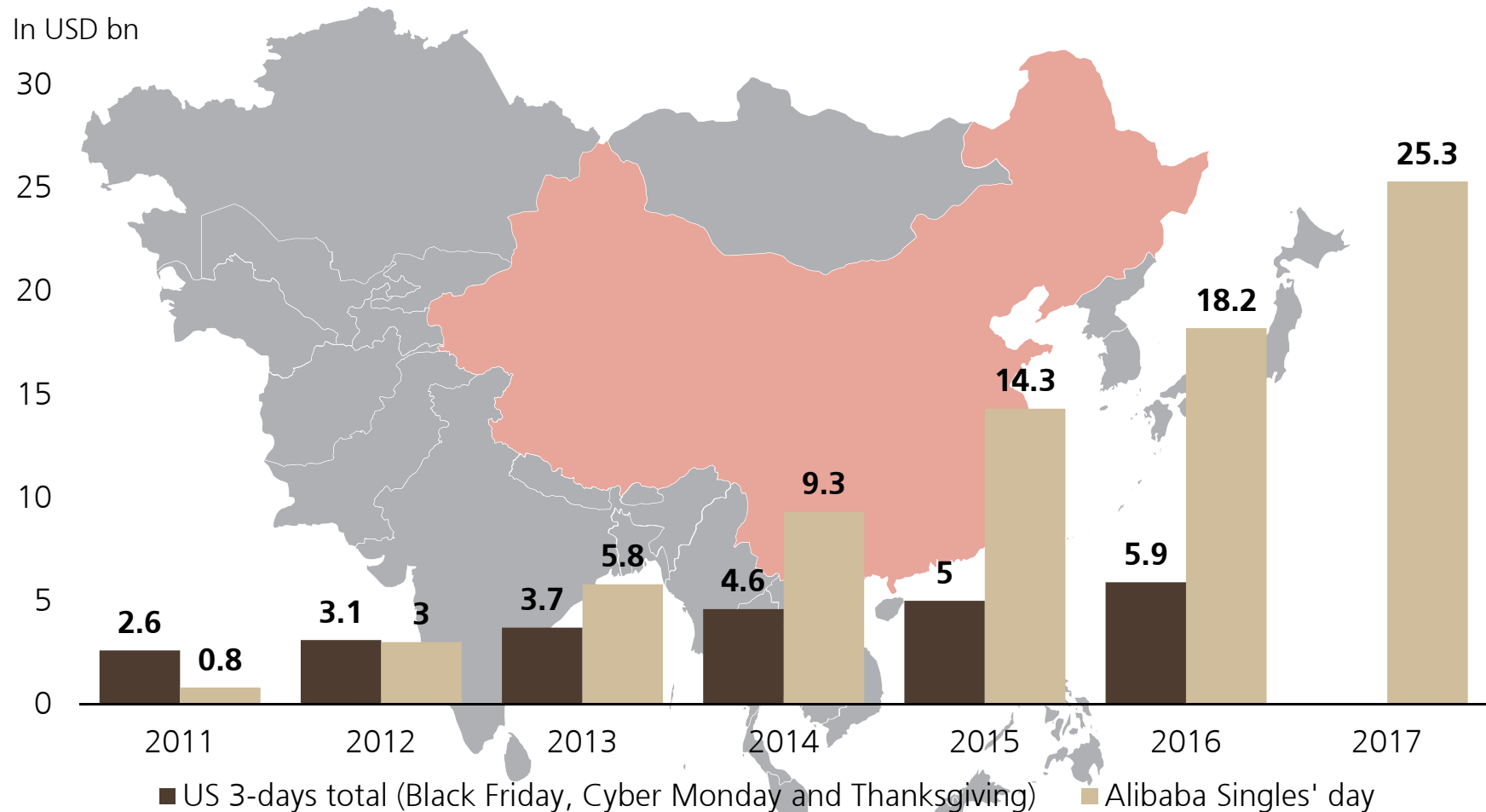


Investing in China

Alibaba's Singles' Day: Sales hit **new record high**

The gross merchandise value on Alibaba's Singles' Day exceeds the combined 3-day US spending by almost 3-4x

In USD bn



Alibaba's Singles' Day: By the numbers

Alibaba's infrastructure showcased reliability under large traffic

Payment: 1.48b payment

transactions, with the peak volume hitting **256k transactions per second**

Global reach: Covered **225 countries** & regions with **60k international brands** and merchants

Customer service: AI robots

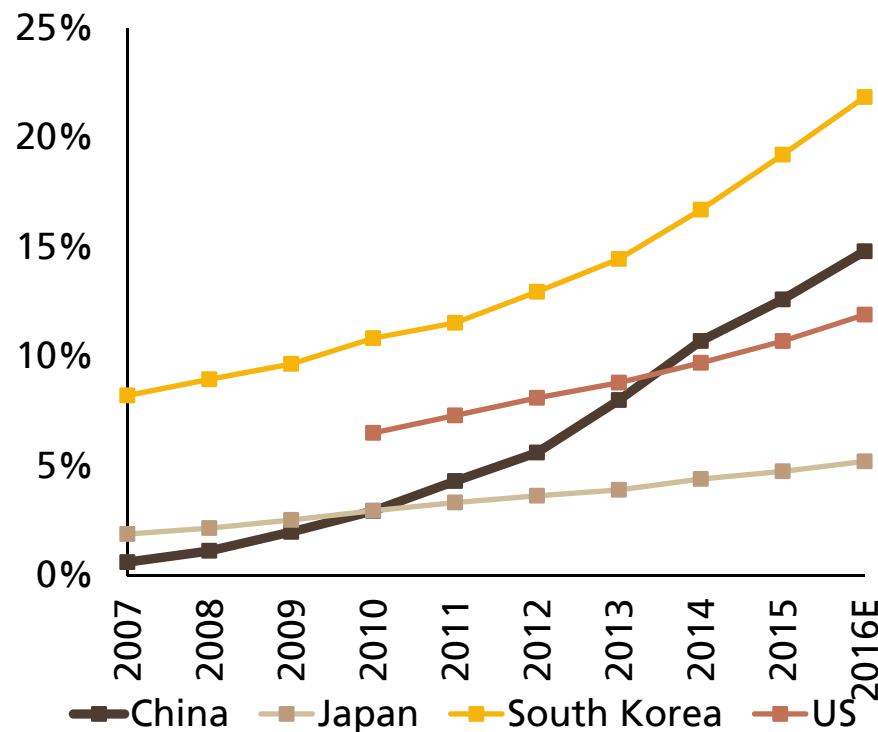
addressed 95% of customer queries during Singles' Day

Logistics: Couriers and robots expected to deliver an est. **1.5b parcels** over the next six days

Technology is part of everyday life

Chinese use online services for – gaming, social media and shopping

Online Shopping penetration (online shopping / overall retail sales of consumer goods)



Source: Bloomberg, US Census Bureau, METI, South Korea National Statistical Office, UBS estimates
For US, retail sales data is less Motor Vehicle & Parts Dealers, Gasoline Stations, Food Service & Drinking Places, and Online Travel



< 900

Mobile internet users



\$ 630 b

Online sales in China





\$ 21.7 b


Online gaming industry


China's reform program underpins its transition

Reforms are driving long-term sustainable growth and providing investment opportunities


Hukou
Enables rural migrants to register residential status in cities
Greater access to services and social welfare and increases disposable income


Demographics Policy
Scrapping one-child policy and allowing couples to have two children


Healthcare reforms
5-year plan aimed at providing effective and low cost health services


SOE reforms
Break up of industries controlled by state-owned enterprises (SOE) will boost private investment


Financial market liberalization
Various schemes to allow greater access to China's domestic market

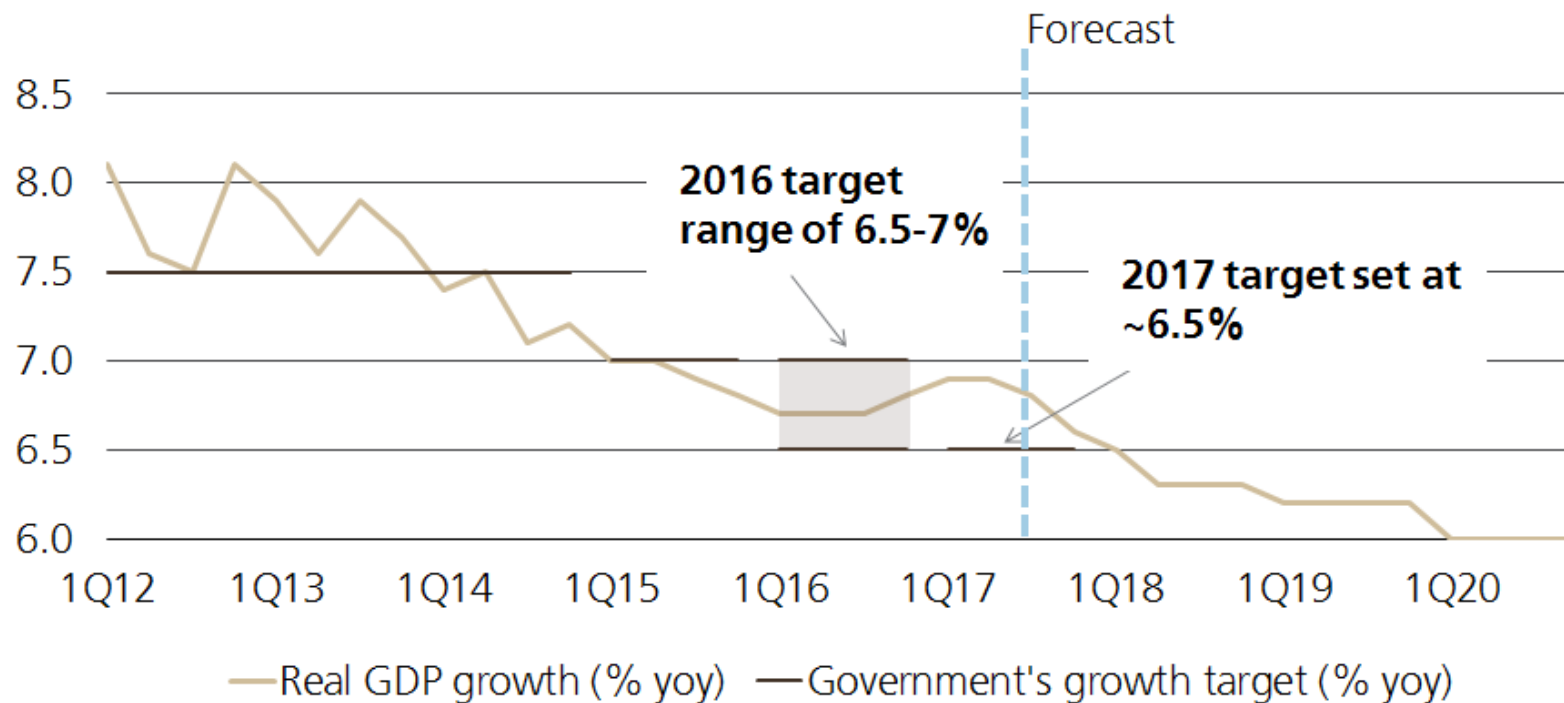
Direct beneficiaries

- ✓ Healthcare providers
- ✓ E-commerce platforms
- ✓ Internet platforms
- ✓ Online gaming
- ✓ Education providers

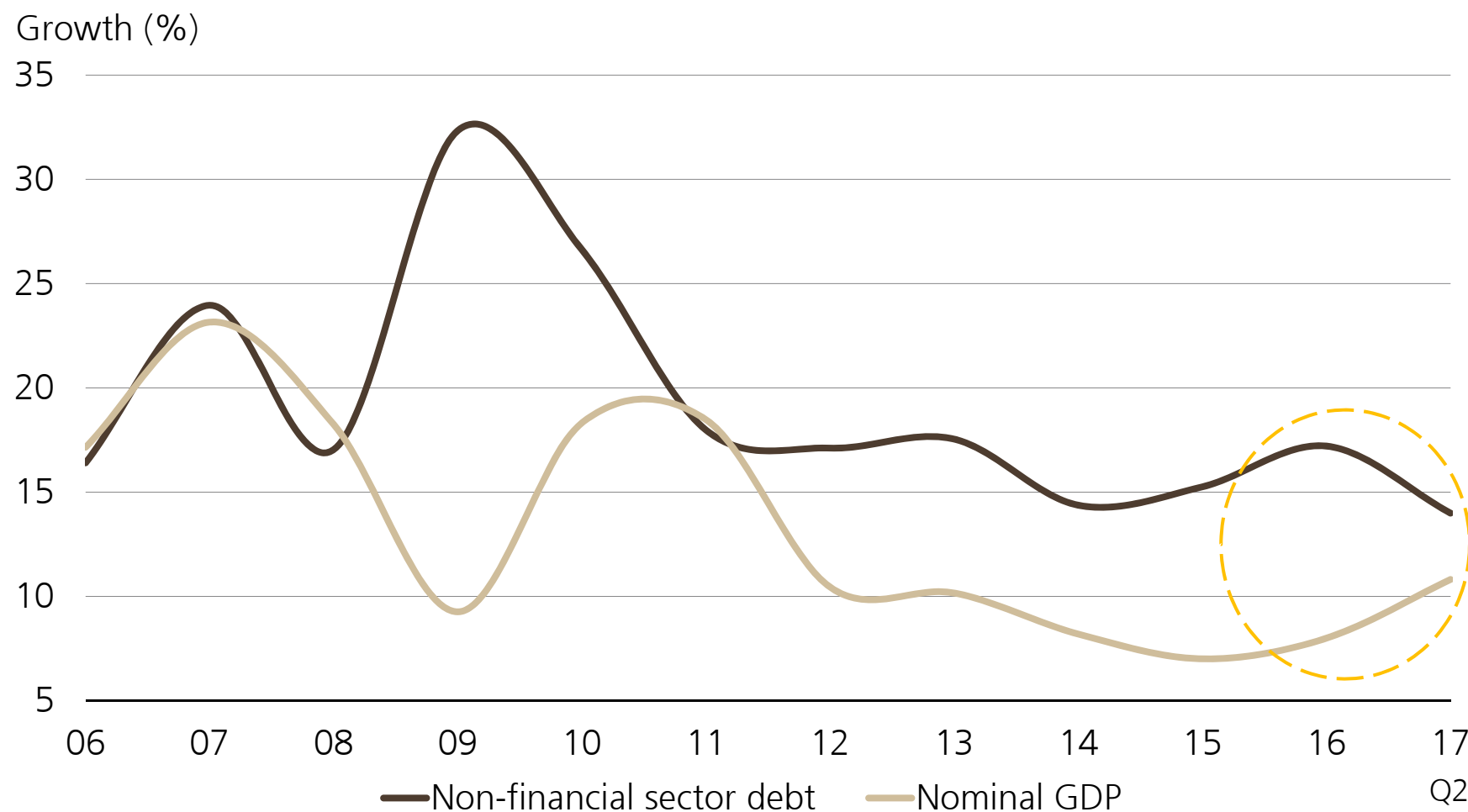
Stabilisation in China

China's real GDP growth and government's growth target, in %, yoy

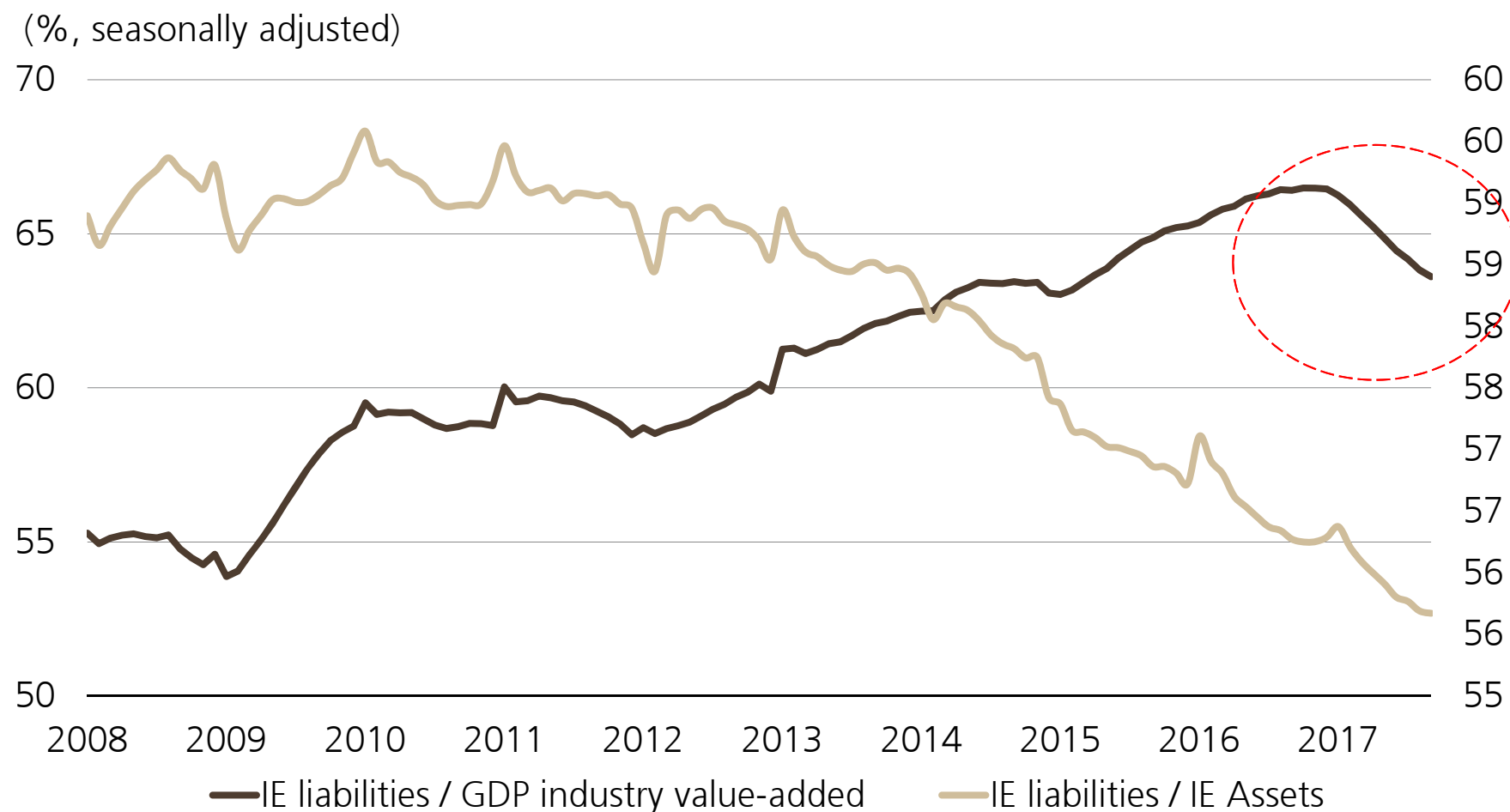
China's growth to moderate but remain above target – government likely to stick to a reasonable growth target of above 6% p.a. over the next three years



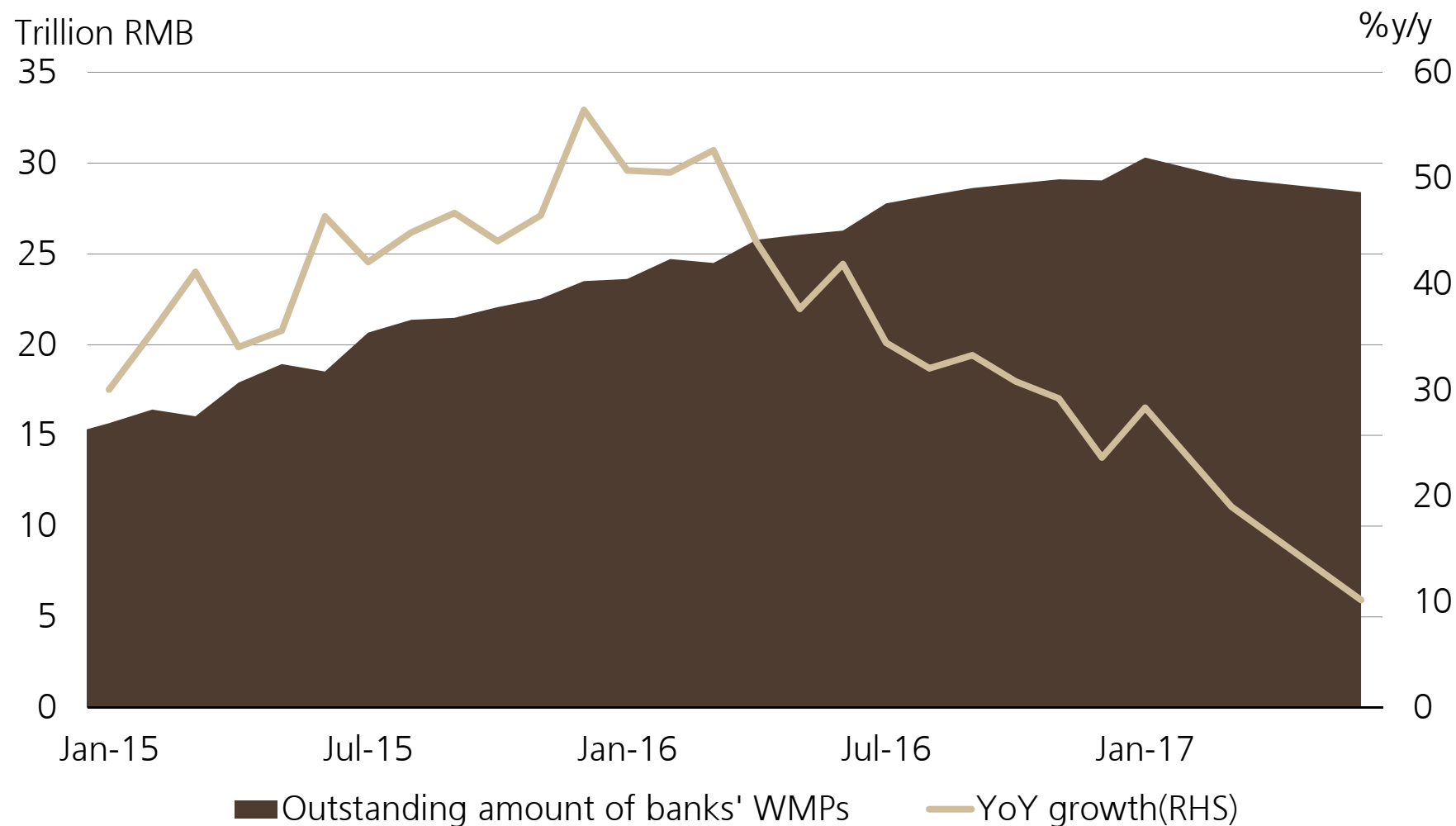
Narrowing gap between debt and GDP growth



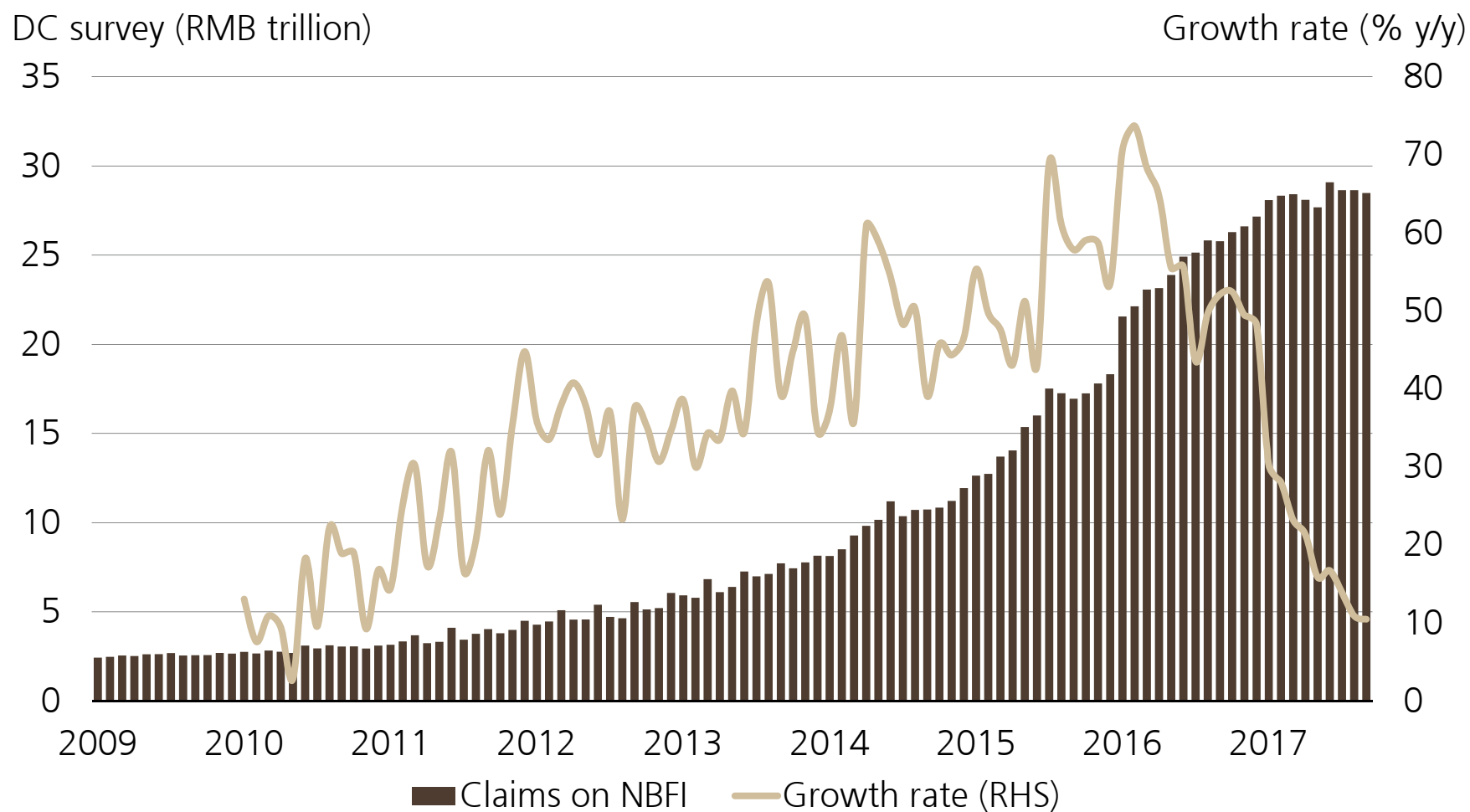
Deleveraging by industrial companies



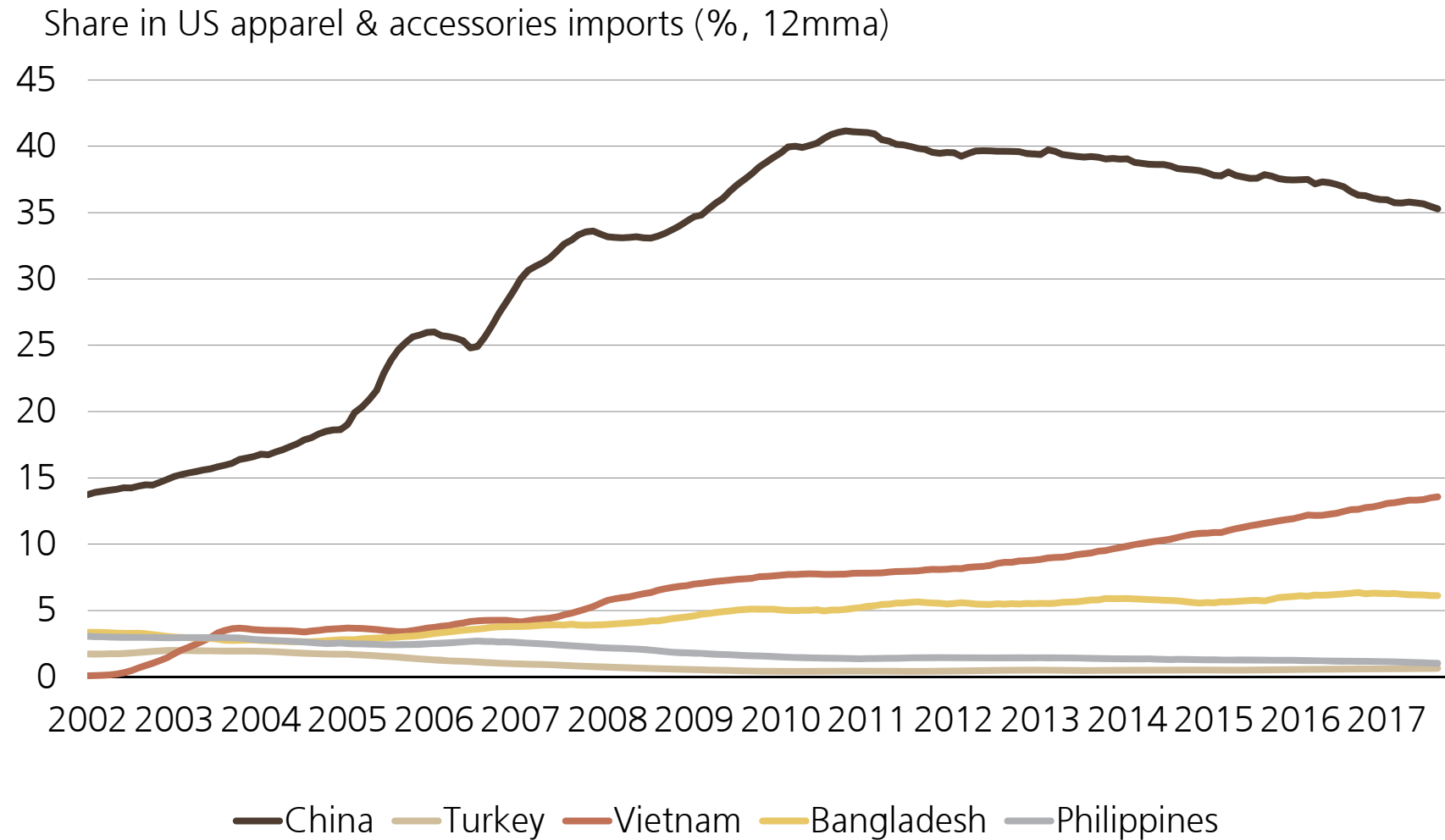
Banks' wealth management products stopped rising this year



Bank claims on non-bank financial institutions decelerated

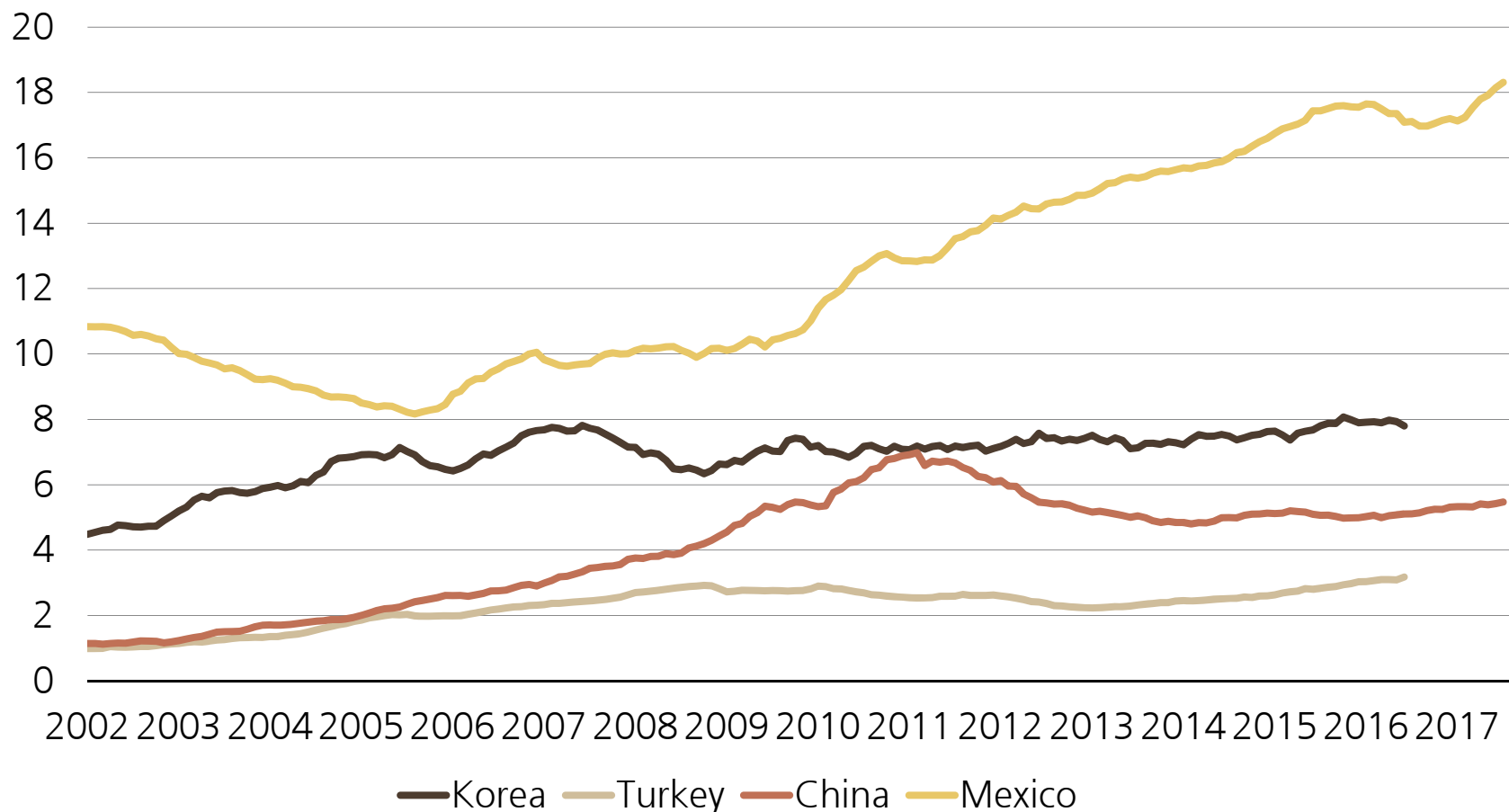


China losing market share in apparels



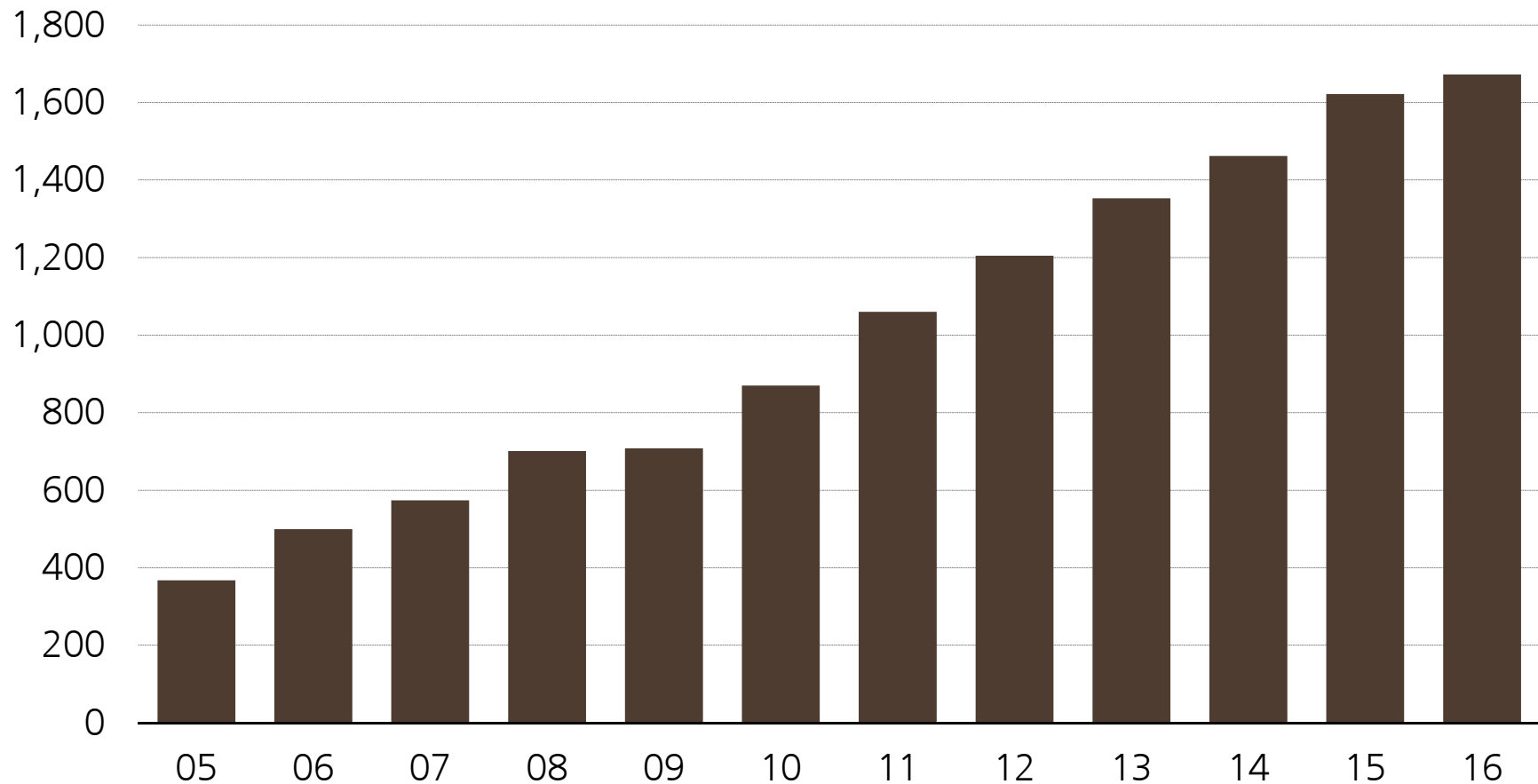
Also losing market share in transport equipment

Share in US & EU imports of transport equipment (% , 12mma)



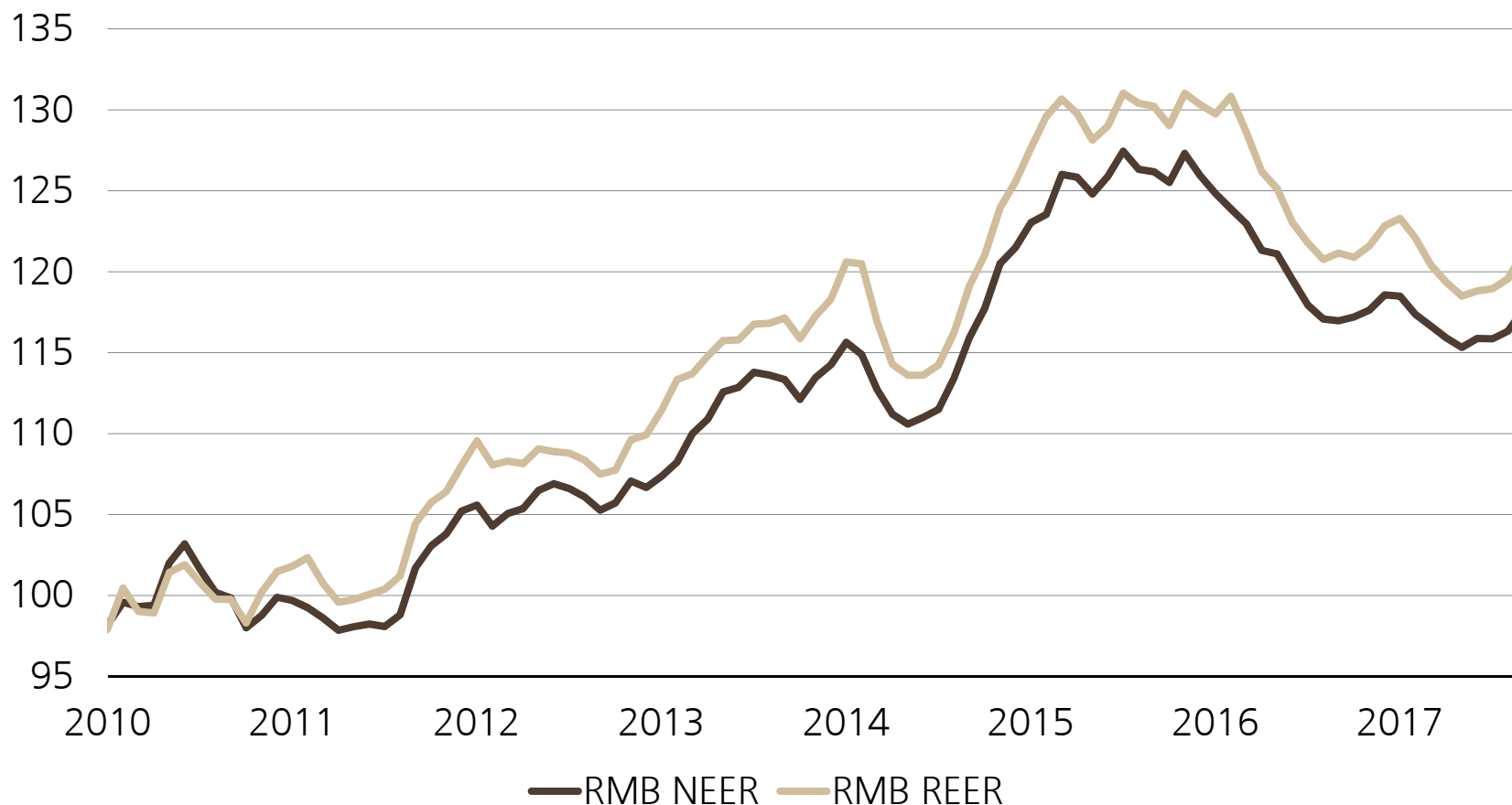
China's rapid wage growth

National average monthly minimum wage (RMB)



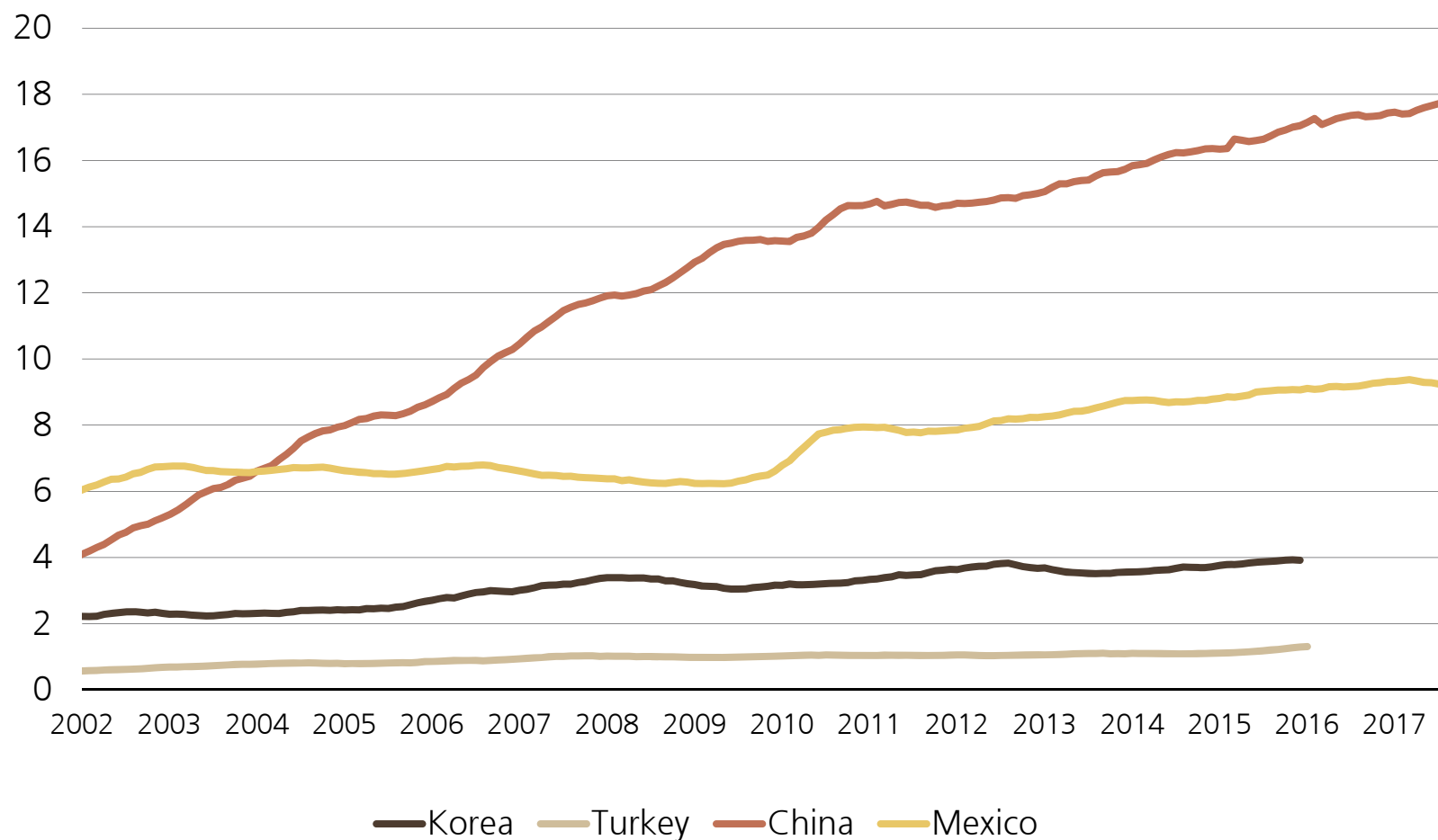
RMB's effective exchange rate stronger versus trading partners

BIS effective exchange rate (2010=100)



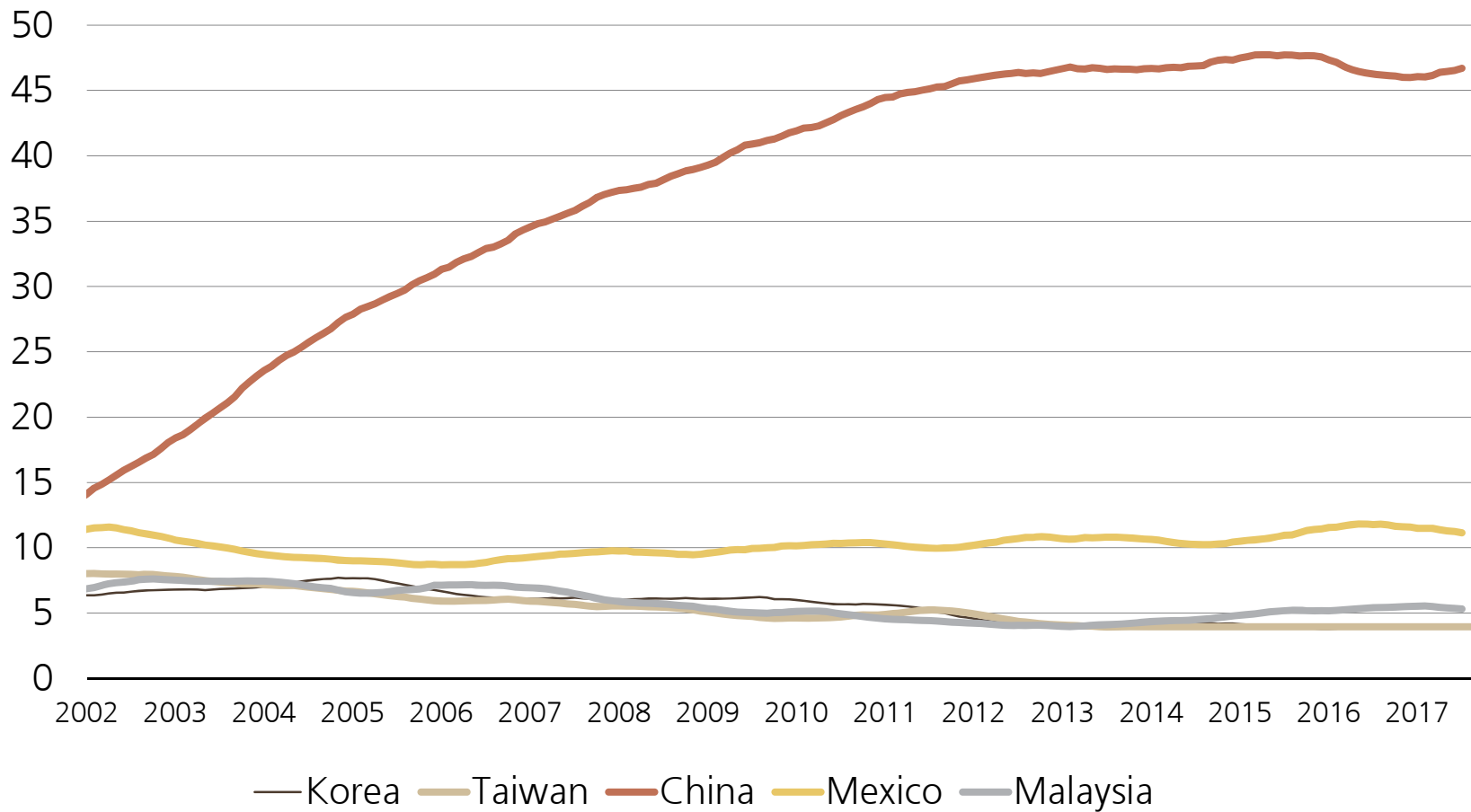
China gains market share in non-transport machinery

Share in US & EU imports of non-transport machinery (% , 12mma)



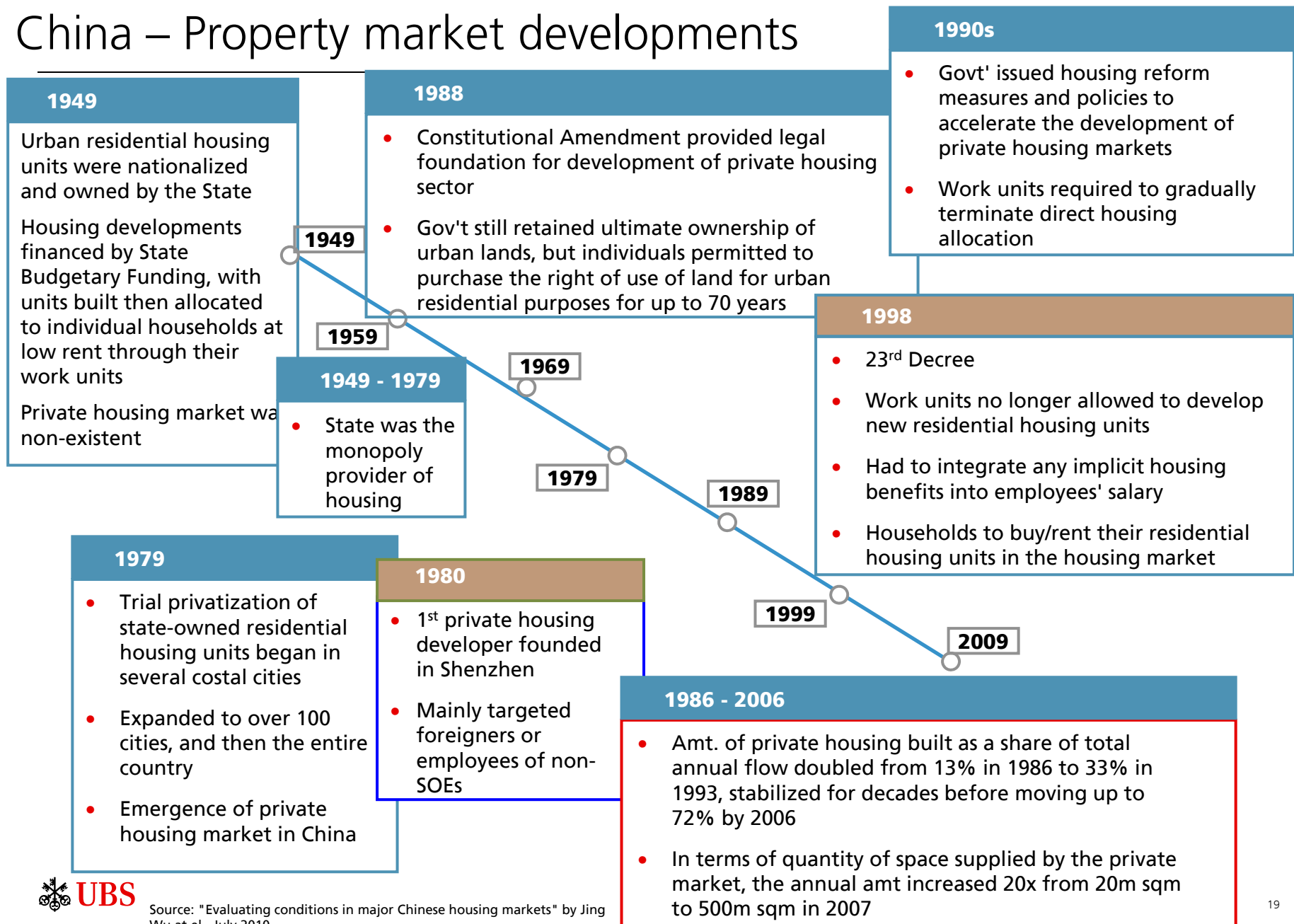
... And rising share in electronics

Share in US & EU imports of electronics (% , 12mma)

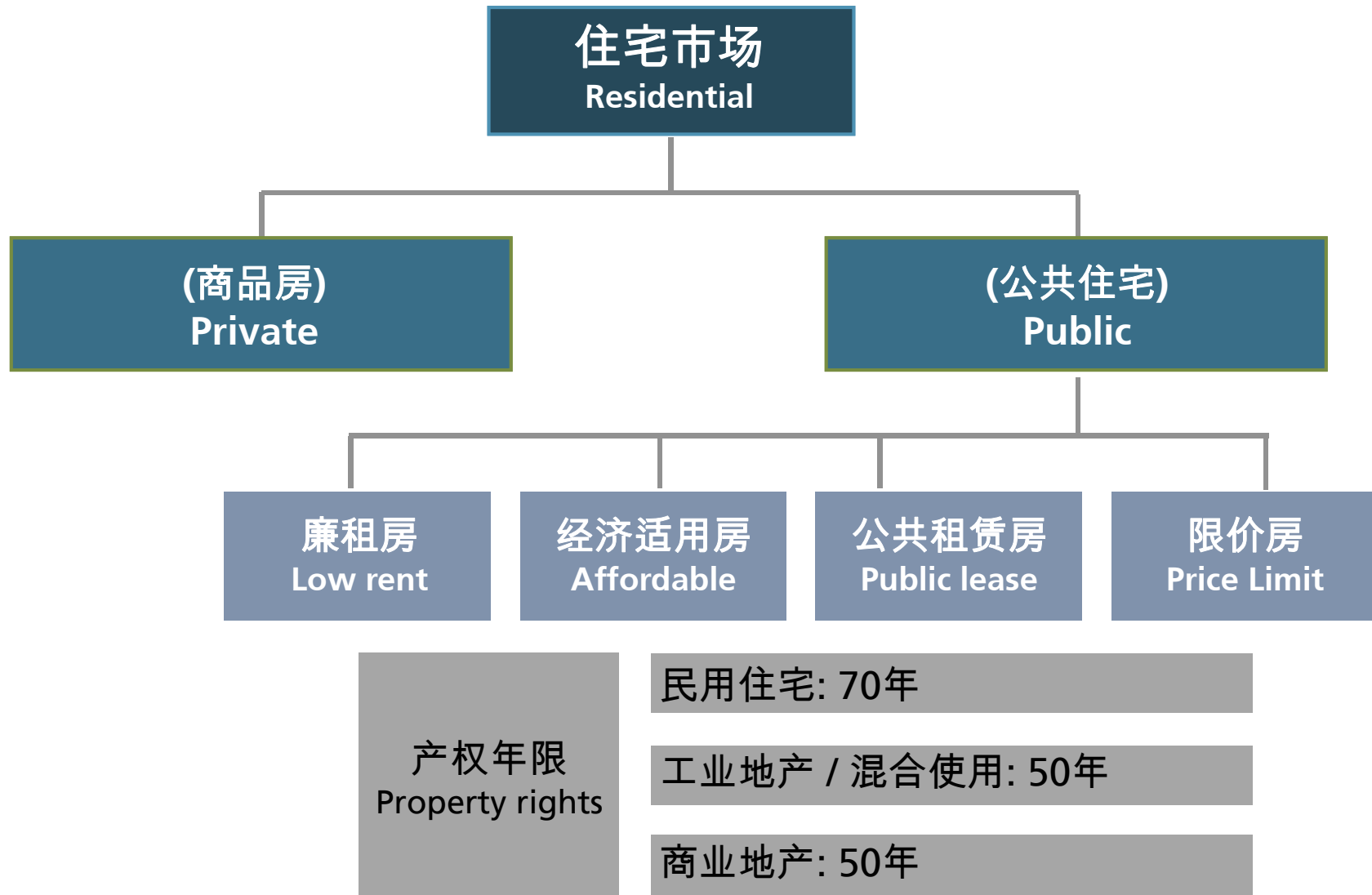


The Chinese property market

China – Property market developments

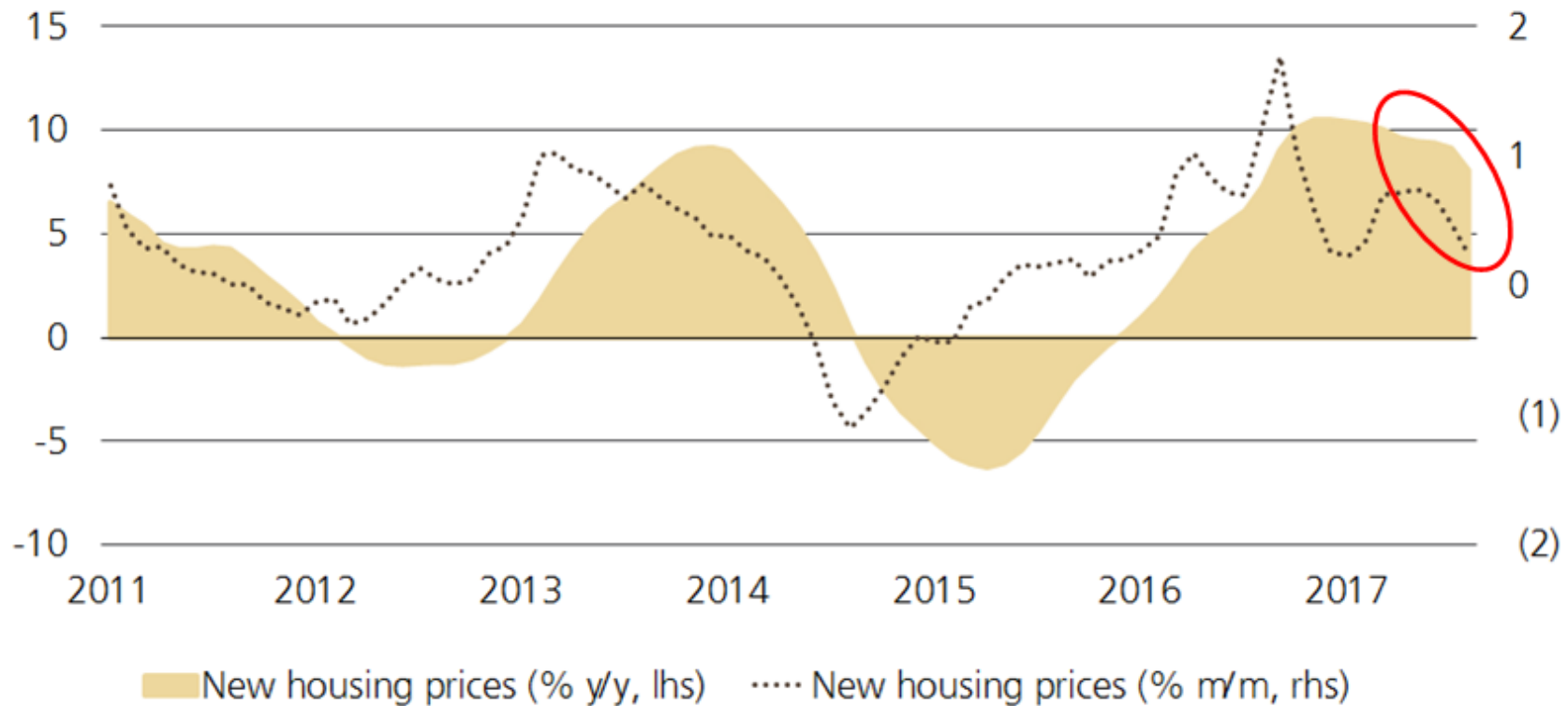


The China residential property market



China: Slowdown in the property market

New housing prices (% , year-on-year and month-on-month)



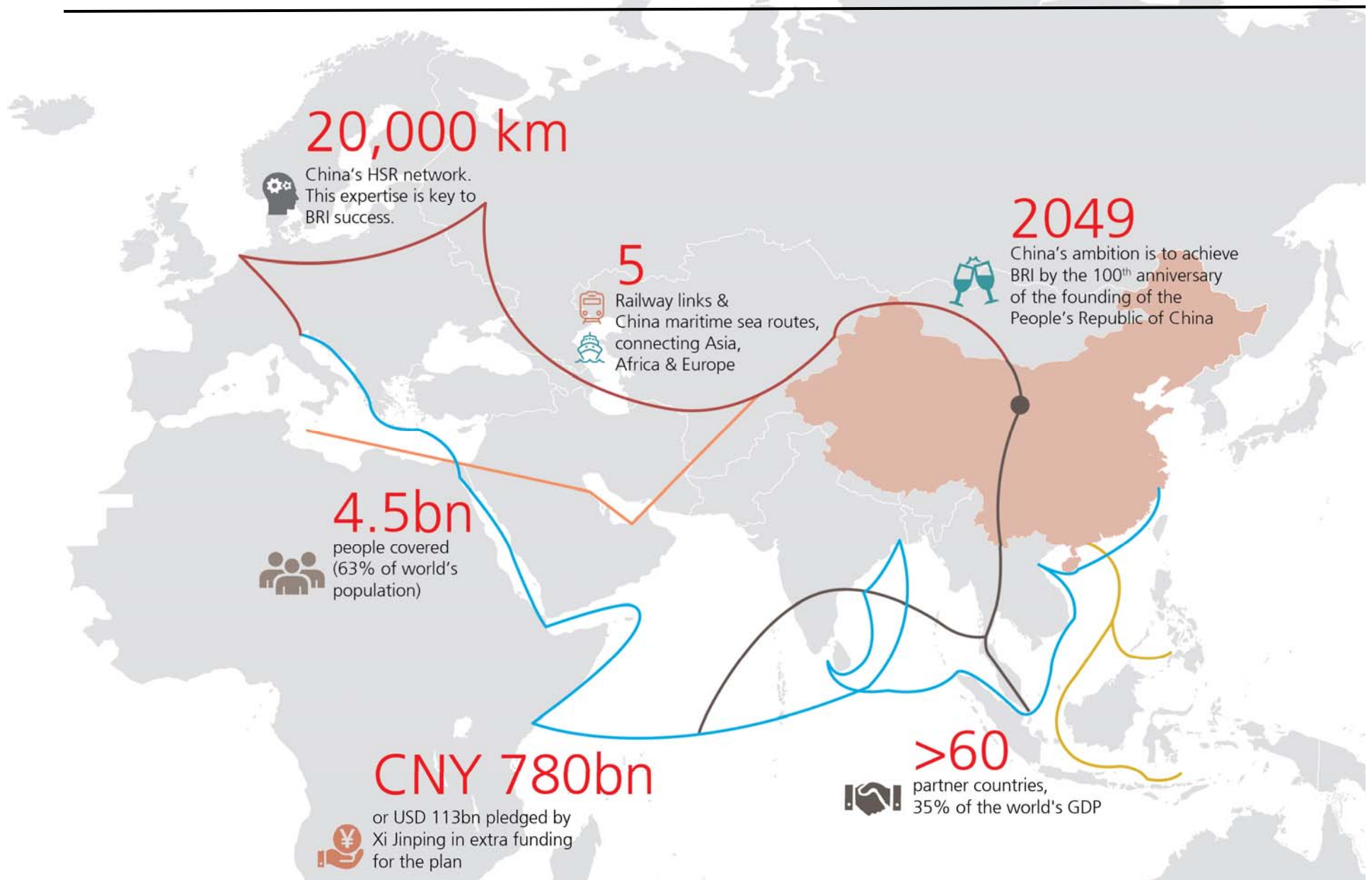
Belt Road Initiative

'The Belt and Road's potential scope for connectivity
is perhaps unmatched in human history'

*Ravi Menon,
Managing Director,
Monetary Authority of Singapore*



China's Belt Road Initiative

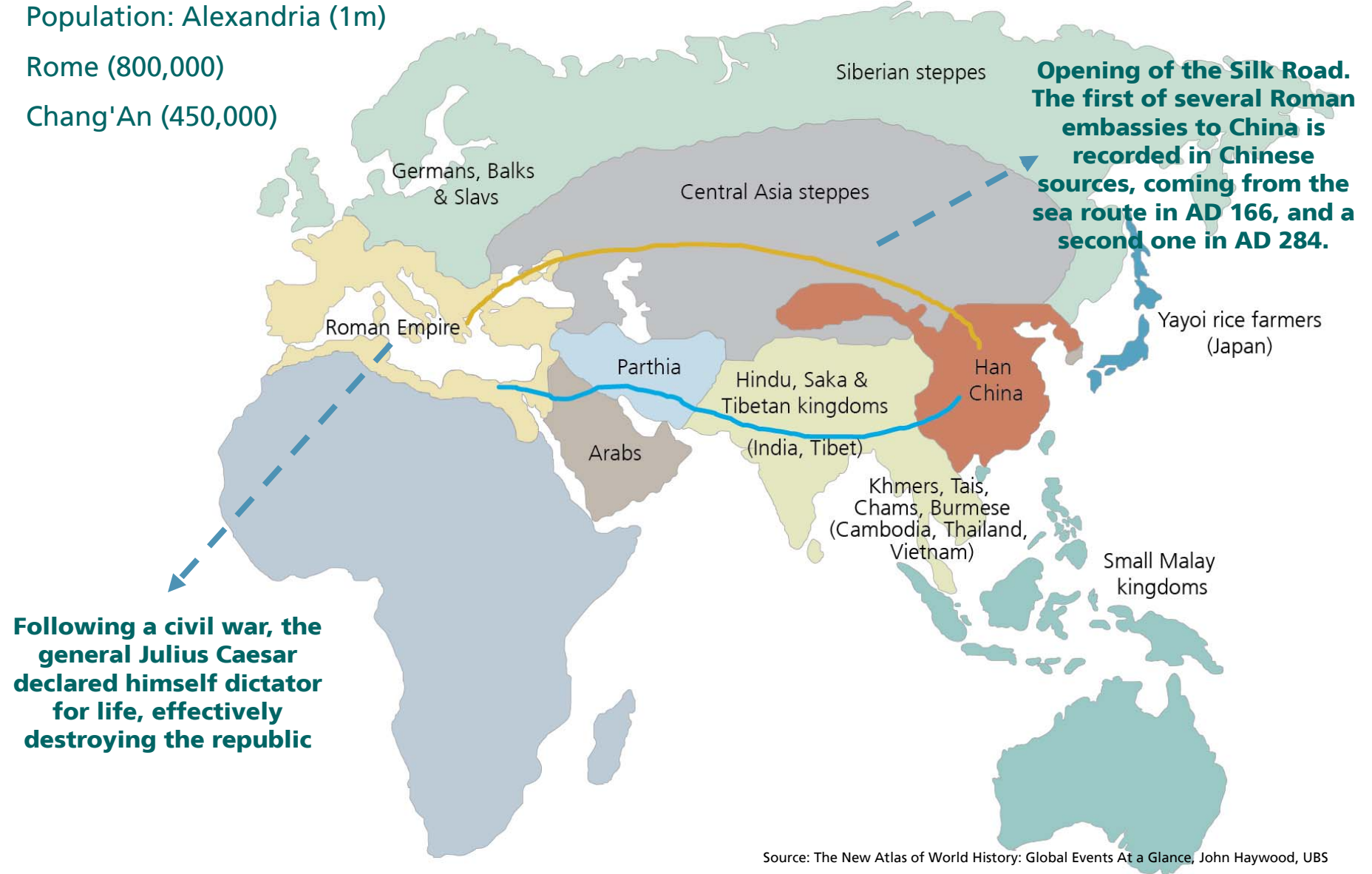


1 BC – Silk road during the Han & Roman empires

Population: Alexandria (1m)

Rome (800,000)

Chang'An (450,000)



Source: The New Atlas of World History: Global Events At a Glance, John Haywood, UBS

■ Via the Central Asian steppes ■ Via the Hindu, Saka kingdoms, through Parthia and Arabia

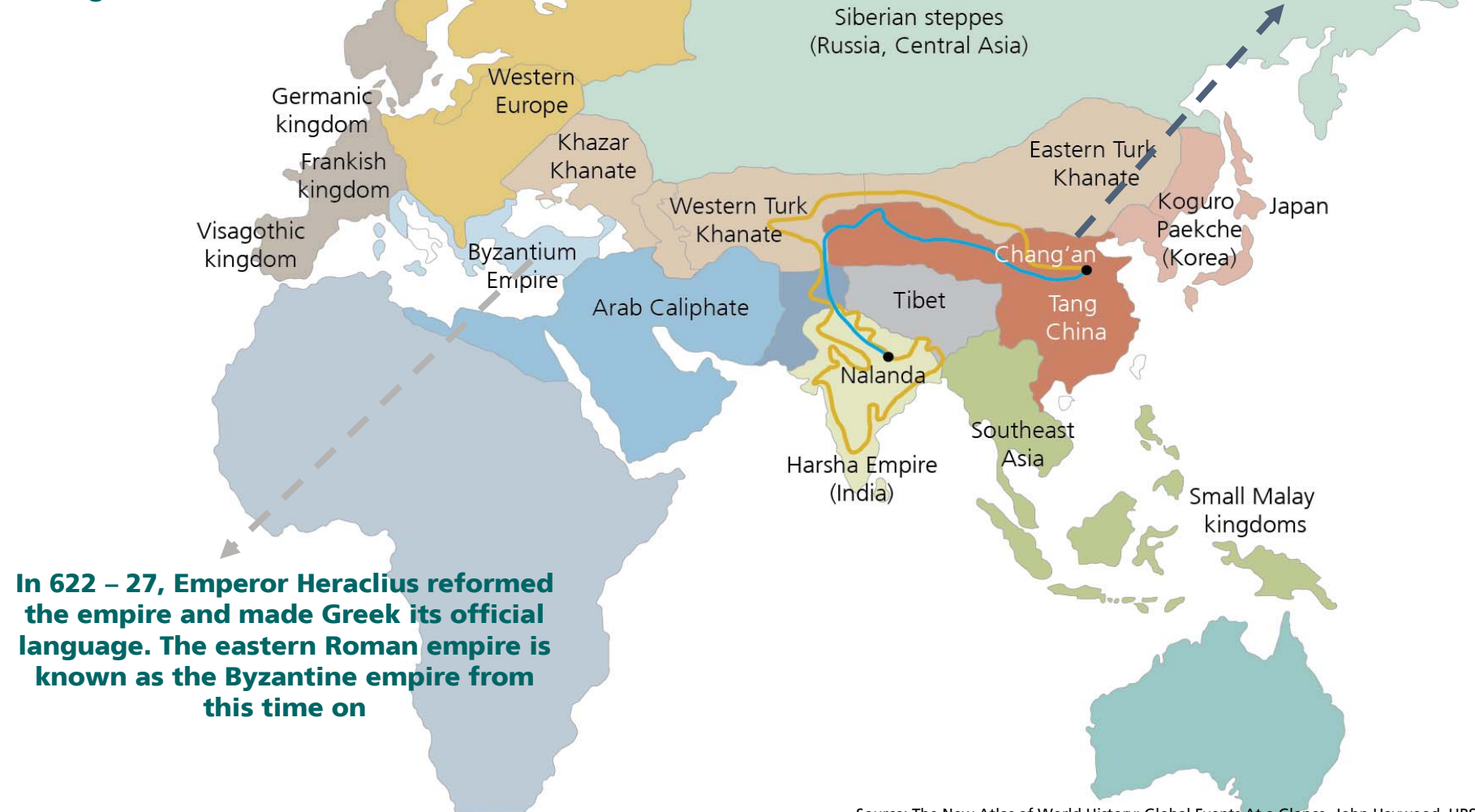
650 – Xuanzang's voyage to India

Population: Chang 'An (400,000)

Constantinople (350,000)

Guangzhou (200,000)

Xuanzang embarked on a 17-yr journey to Nalanda, India to bring Buddhist scriptures to China



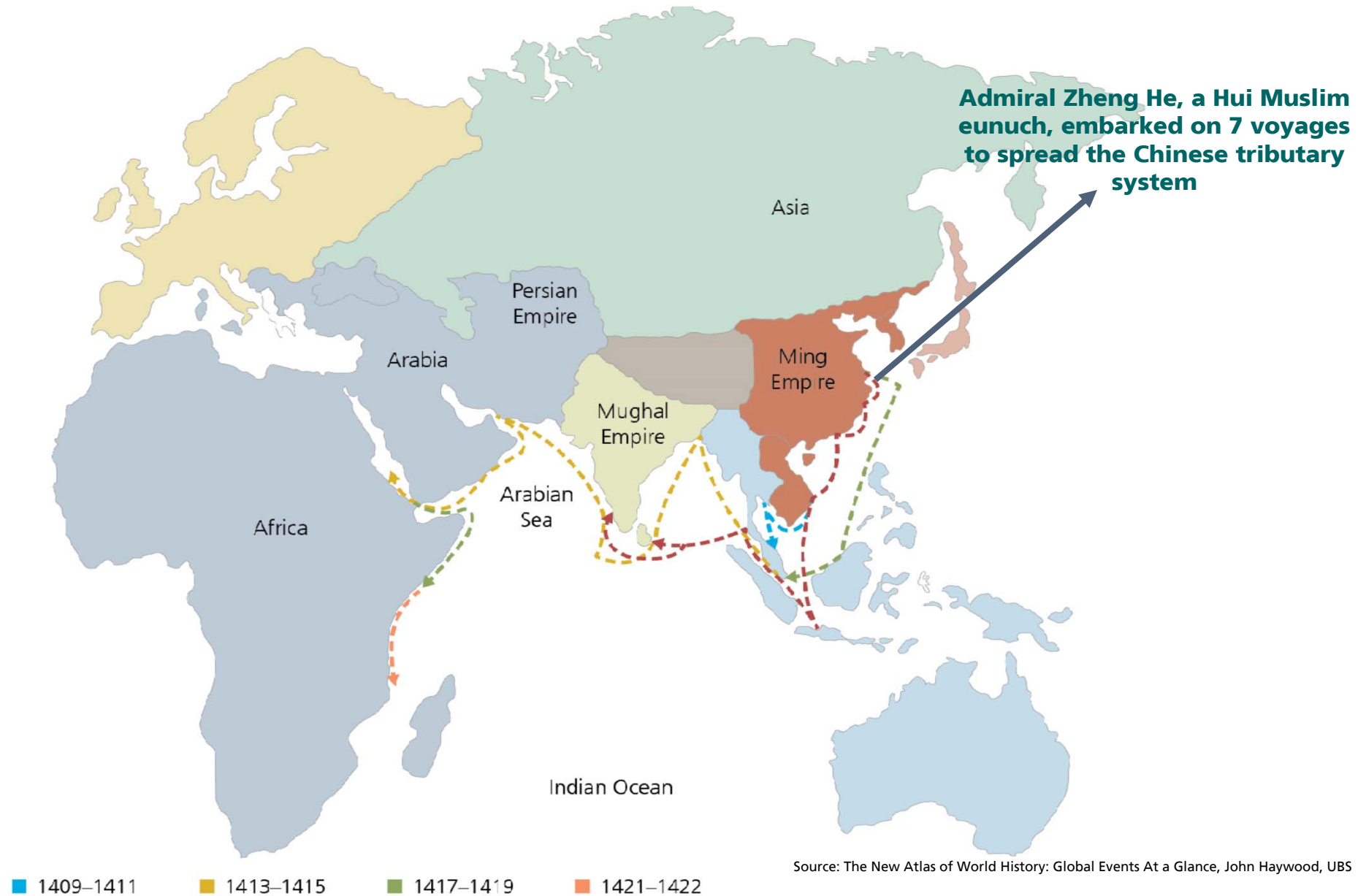
In 622 – 27, Emperor Heraclius reformed the empire and made Greek its official language. The eastern Roman empire is known as the Byzantine empire from this time on

■ Route to Nalanda

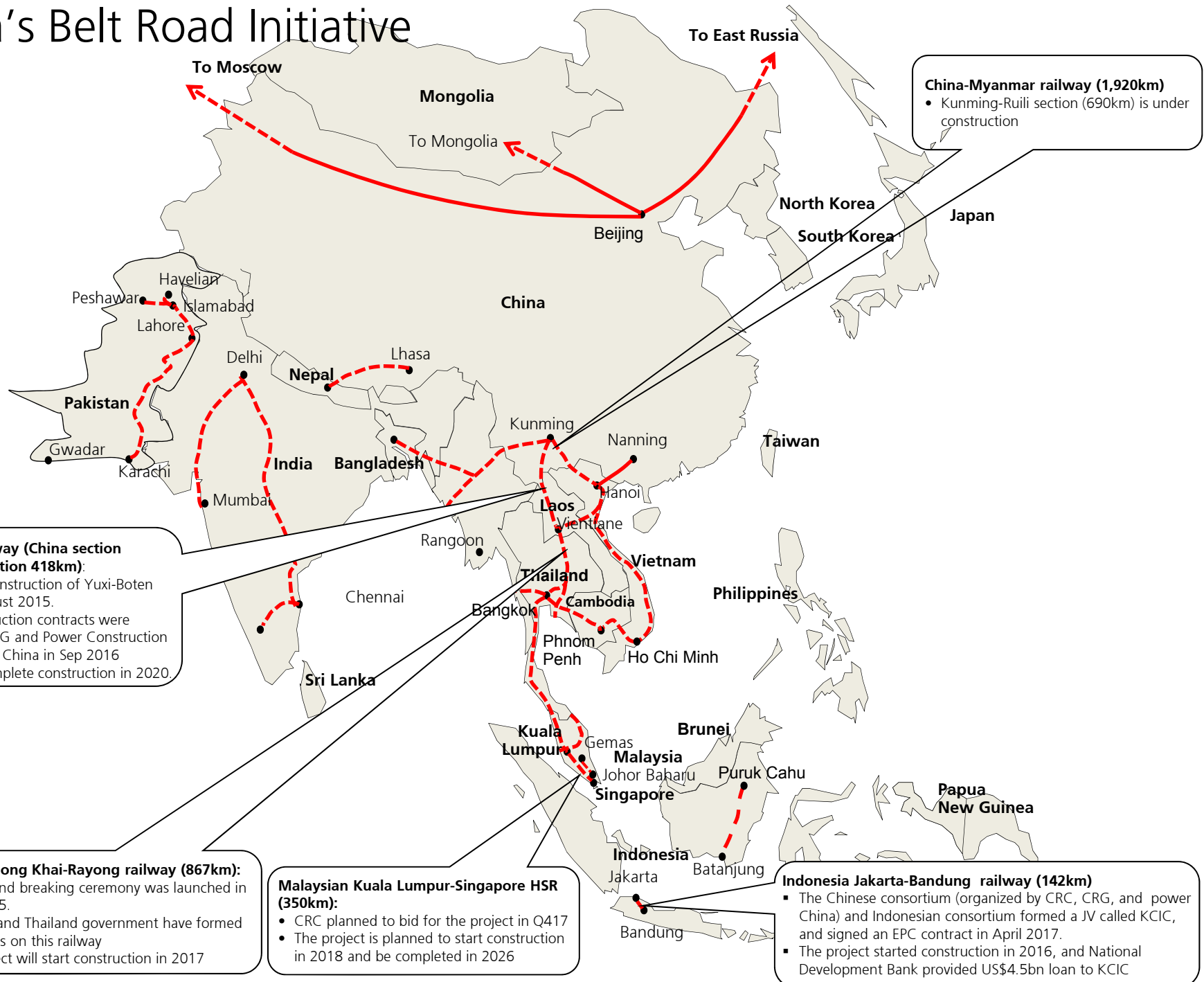
■ Route from Nalanda

Source: The New Atlas of World History: Global Events At a Glance, John Haywood, UBS

1405 – Zheng He's seven voyages



China's Belt Road Initiative



China's railway network – Chinese New Year in numbers

During Chinese New Year.....

1 billion people in transit

258 million train trips

62,000 flights per week, 1.1 million daily aircraft seats

2.65 million daily trips by public transportation vehicles



China's railway network

“ There seems little doubt, based on experience elsewhere and evidence collected in China, that most lines, except possibly isolated lines like Zhengzhou to Xian and Jiujiang to Nanchang, **are covering their immediate cash costs (rolling stock and infrastructure operations and maintenance costs).**

The next important financial hurdle for any railway is its ability to cover **its interest payments on debt**, and it is likely that **some of the better-performing services (with densities of 10-15 million passengers) are already doing that.** ”

**Taking the Pulse of China's Emerging Program
High-Speed Rail – The First Three Years**
World Bank Office, Beijing. Feb 2012

Belt Road Initiative: Route to Southeast Asia

To Laos & China



Vientiane

Nong Khai

Nakhon Ratchasima

Ayutthaya

Bangkok

Map Ta Phut

To Malaysia & Singapore



Sino-Thai railway

- 873 km in length; 4 phases
- 10 provinces
- GDP per capita ranges from THB28,700 (Rayong) to THB2,300 (Udon Thani)

Northeastern region

- 22m or 1/3 of population
- US\$2,000 GDP per capita, lowest in Thailand

Eastern Economic Corridor

- US\$44 billion
- Airport, sea port, railways, tourism & other infrastructure expansion
- Chachoengsao, Chon Buri & Rayong

Key beneficiaries of the Belt & Road Initiative?

- Both Chinese and BRI countries & corporates will benefit
- Contractors, capital equipment suppliers; building materials; property developers; operators of tolls, ports, rail; energy providers

Source: UBS

EM infrastructure: a USD5.5trn opportunity to 2025

- Emerging market infrastructure spending is forecast to rise from USD3trn to USD5.5trn by 2025
- EM's share of total global infrastructure spending will rise frto 2/3 from 1/2
- Infrastructure growth should outpace an average 5% GDP growth forecast for EM over the same period
- BRI investments still at infant stage; China currently has active investments in just 20 of these countries.

Understanding the *Middle Kingdom*

"If I were to be harsh about it, I'd say markets do not want to understand the Chinese market,"

Kelvin Tay, on CNBC (8 Jan 2016)

China - the chorus of dispirited prognosticators



Jim Walker
Economist, Asianomics

"When you have a period of rampant economic growth, as China has, there tends to be a pretty sharp correction at the end of that

9 August 2006, International Herald Tribune

"They are walking straight into the Japan problem [of the 1980s]"

20 October 2007, The Sydney Morning Herald

"Inflation expectations have begun to rise, and the government should do something significant. Otherwise, the stock and property bubbles will get bigger and eventually crash"

11 Sep 2007, New York Times

"China won't see GDP rise more than 4% in 2009, and the country's economy may not grow at all."

3 Feb 2009, TIME

China - the chorus of dispirited prognosticators

"China's structural imbalance is actually rather extreme by historical standards, and certainly more so than another global creditor, Japan, was in the 1980s"

22 Nov 2010, UBS Investment Research



George Magnus
Senior Economist, UBS



Nouriel Roubini

Professor, NYU

"China faces a "meaningful probability" of a hard economic landing and the euro zone is storing up problems for the future by not tackling the debt crisis head on"

13 June 2011, Reuters

How China could yet fail like Japan

14 June 2011, Financial Times



Martin Wolf
Journalist, FT

China - the chorus of dispirited prognosticators

“‘I was recently in Shanghai and I took their high-speed train to Hangzhou,’ referring to the new Maglev line that has cut traveling time between the two cities from four hours to less than one.

‘The brand new high-speed train is half-empty and the brand new station is three-quarters empty. Parallel to that train line, there is also a new highway that looked three-quarters empty. Next to the train station is also the new local airport of Shanghai and you can fly to Hangzhou,’ he said.

‘There is no rationale for a country at that level of economic development to have not just duplication but triplication of those infrastructure projects.’”

13 June 2011, Reuters



Nouriel Roubini

Professor, NYU ³⁶

China - the chorus of dispirited prognosticators

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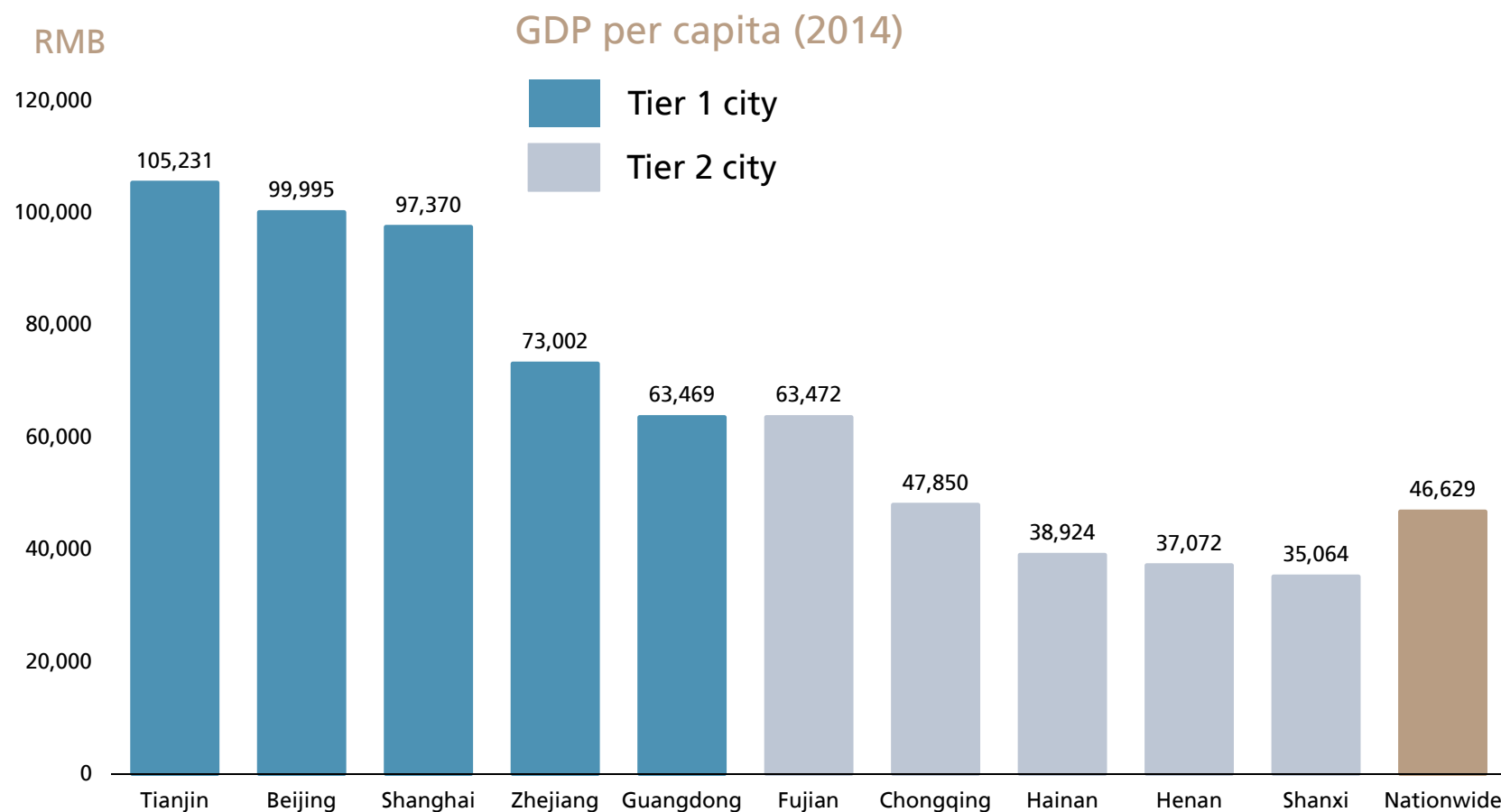


Nouriel Roubini

Professor, NYU ³⁷

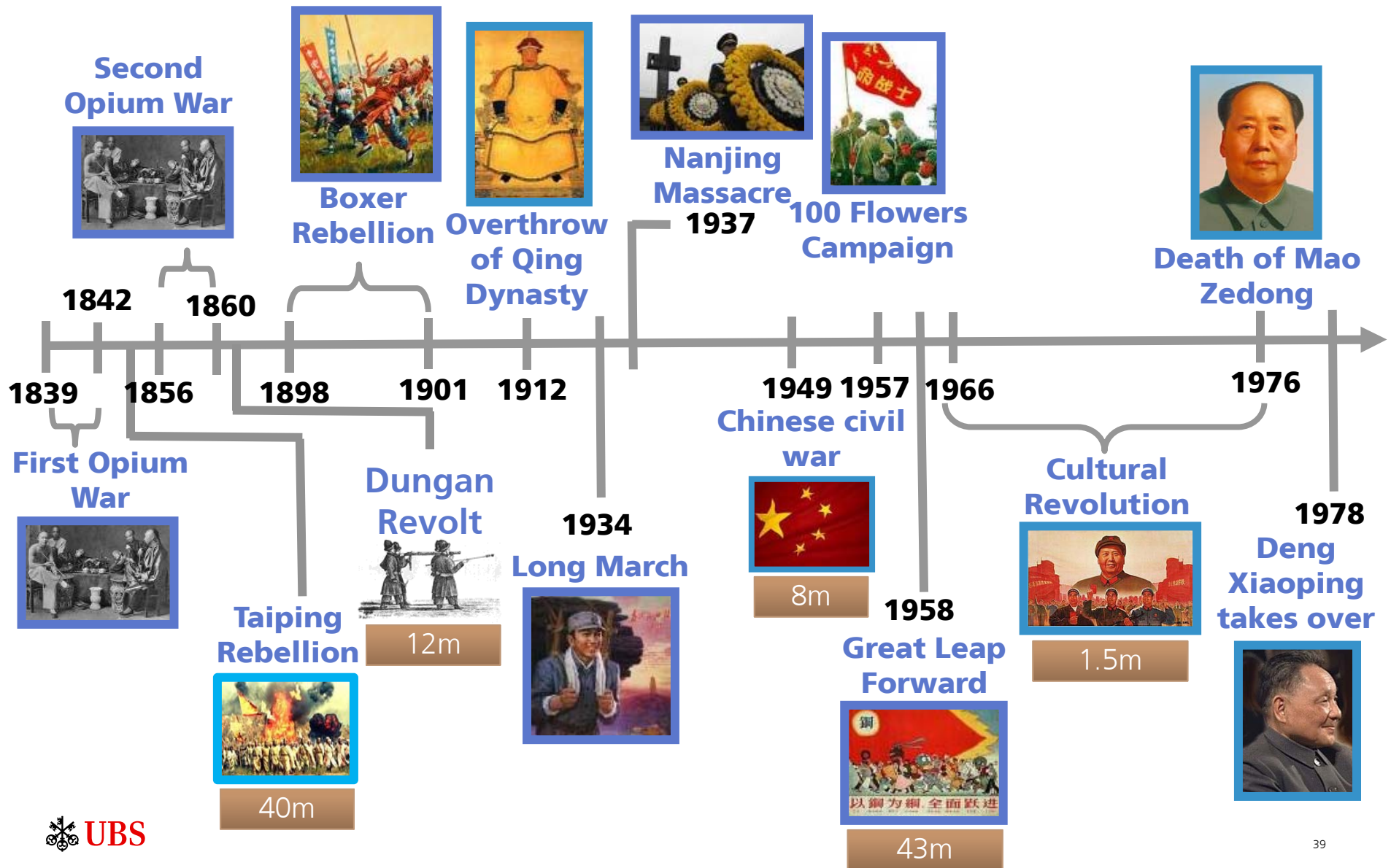
China is extremely diverse

Wide disparity in the income levels between the cities in China



Note: Charts and scenarios are for illustrative purposes only and historical performance is no guarantee of future performance
Source: CEIC, UBS WMR as of Feb, 2016

Modern history of China: social unrest?



Food scandals

"The milk was marketed as pure and wholesome, and it looked fine to the naked eye. How were the mothers to know they were poisoning their babies? They had paid good money for it on the open market.

It would take thousands of sick children before lawmakers did anything to stop it."

New York City, 1858

8,000 children died each year from "swill" milk and it took 50 years before New York City cleaned up its Food & Safety Act

*"Swindled: The Dark History of Food Fraud from
Poisoned Candy to Counterfeit Coffee"*
Bee Wilson

The 19th National Congress of the Communist Party of China

'China is much more important to the world right now than it was in past party congresses'

19th NCCPC: The Chinese power structure

2 TOP STORIES

COMMENTARY

Lining up a list of losses and leads

Party Congress sees President Xi taking stock of his long-term vision for China to become a modern socialist economy by 2035 and a great socialist economy by 2050

by Kelvin Tay

In three years, the Communist Party of China (CPC) will celebrate its centenary – the year by which the Chinese government promised to build China into a “moderately prosperous society”. Since its founding in 1921, the CPC has profoundly shaped the destiny of Chinese civilisation, and the Party Congress has been paramount in plotting the country’s course. The Third Plenum of the 13th Party Congress in 1978, for example, effectively consolidated Deng Xiaoping’s power, allowing the country to “reform and open up”.

China has since enjoyed unprecedented economic growth, catapulting the Chinese economy from obscurity into a major global power. Over the past 40 years, seven Party Congresses have ushered in three generations of leaders: Jiang Zemin, Hu Jintao and current president Xi Jinping.

The Party Congress is theoretically the highest body within the CPC. Despite being a one-party state, China still has political cycles, which turn every five years, and the Party Congress marks the critical turning point of this cycle.

Losing competitiveness

At the 19th Party Congress, Mr Xi delivered a long political report that reviewed his achievements since the previous Congress in 2012. In our view, nothing substantial has changed and his speech essentially followed the same policy guidelines on reforming the state-owned enterprises and the overcapacity on the supply side, private sector development, the role of the market and the social safety net.

Key tenets of his speech outlined his long-term vision for China to become a modern socialist economy by 2035 and a great socialist economy by 2050. Interestingly, Mr Xi did not state a specific GDP target, reflecting the current administration’s emphasis on quality growth, rather than the Hu Jintao administration’s “growth at all costs” policy.

However, its stated goal of doubling China’s 2010 GDP by 2020 implies a GDP growth rate of around 6.3 per cent per annum over the next three years, compared to the 6.8 per cent growth that the economy posted in the third quarter of 2017.

What was striking in his speech was the tacit acknowledgment that China is losing competitiveness in some of its key industries, such as apparel and toy manufacturing, hence the need for the country to move up



Delegates for the 19th National Congress at Beijing’s Great Hall of the People. Look out next for the annual Central Economic Work Conference in December, which will provide guidance for next year’s economic policies and growth targets. PHOTO: REUTERS

Ultimately, investors should care about the 19th Party Congress, not just because of the political changes per se, but what they mean for China’s economic and financial future.

the value chain and create new growth drivers if China were to avoid getting muddled in the middle-income trap like some of its Asian neighbours.

China has over the last decade or so lost ground in traditional, labour-intensive processing industries due to rising labour costs and the strength of its currency. From January 2008 to now, the RMB’s effective exchange rate has appreciated by around 30 per cent in both nominal terms and real terms.

While wage levels are still low compared to developed countries, the average manufacturing wage measured in USD has increased by 14 per cent per year over the past decade (UBS Investment Bank), or trebled since 2005. China’s wages are now on a par with, if not higher than, most developing countries.

But at the same time, there is strong evidence that it is moving up the value chain as it has been gaining market share in the elec-

tronics, machinery and equipment sectors. Increasingly, foreign companies are sourcing their inputs from China.

However, it is not enough to just focus on new growth drivers. Mr Xi also emphasised the importance of markets in resource allocation, such as increasing the role of direct financing and deepening of fiscal reforms. These measures should help lower the State-Owned Enterprise (SOE) gearing levels and improve return on equity, hence reiterating our preference for equity exposure to Chinese banks at the moment.

As confidence returns to the RMB, the Chinese government will increasingly allow more two-way fluctuations on the RMB.

Speaking on the sidelines of the 19th Party Congress, the deputy governor of the People’s Bank of China, Pan Gongsheng, said the central bank has exited routine market interventions, and the supply and demand for the RMB has become balanced as for the first time in 27 months, September recorded a

net purchase of foreign exchange as capital outflows taper off following the stronger-than-expected performance of the Chinese economy this year.

Shifting emphasis

Due to the lack of any major exchange rate policy announcement at the congress, we expect the CNY to remain stable. We have already seen USDCNY’s volatility falling back from levels close to 5 per cent.

A more important event to watch will be the annual Central Economic Work Conference in December, which will provide guidance for next year’s economic policies and the specific growth targets that will be detailed at the NPC in March 2018.

As the focus until then will be more on hard data releases from China and the US, as well as the policy direction from the Fed, we expect the news flow to be positive for the USD and negative for the CNY. Economic activity in China should moderate while activity in the US has room to bounce. The divergence in news flow could motivate capital outflows and test China’s efforts to tighten capital controls.

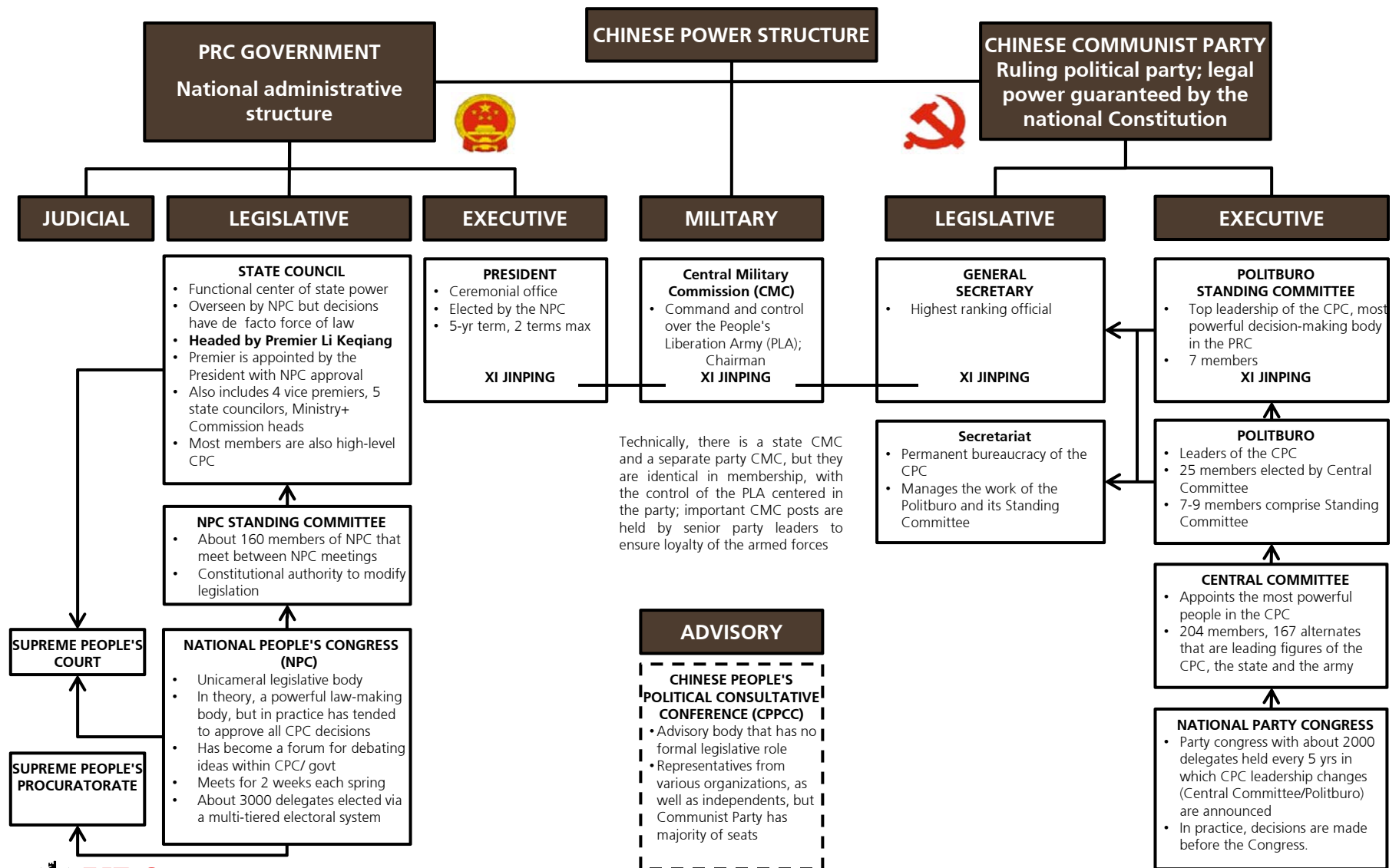
China is much more important to the world right now than it was in past party congresses. This is not just because of the ever-growing size and importance of its economy, but also due to the shift in policy emphasis in a bid to increase the country’s regional and global influence. For example, the Belt Road Initiative and associated institutions, such as the Asia Infrastructure Investment Bank, suggest the country’s greater interest in shaping the geopolitical environment.

This transition coincides with the US receding regional influence, as perhaps best evidenced by its withdrawal from the Trans-Pacific Partnership. Thus, foreign policymakers and investors have been paying far more attention to party congresses and the implications of China’s policy direction.

Ultimately, investors should care about the 19th Party Congress, not just because of the political changes per se, but what they mean for China’s economic and financial future. Assessing the full prospect of reforms will therefore require examining both the political changes at the Party Congress and the detailed policy announcements and implementations thereafter.

¹ The writer is managing director and regional chief investment officer, Asia Pacific at UBS AG.

19th NCCPC: The Chinese power structure



Charles Munger on China

" ***China*** has grown at a rate that for a country that big is unprecedented in the previous history of the world. So that's a huge development, and it's enormously important to the world. With that many people start getting ahead year after year at that kind of a percentage rate it affects the whole world. "



*Charles Munger,
Vice- chairman, Berkshire Hathaway
May 15, 2012 (interview with CNBC)*

Charles Munger on China & Singapore

China & Singapore

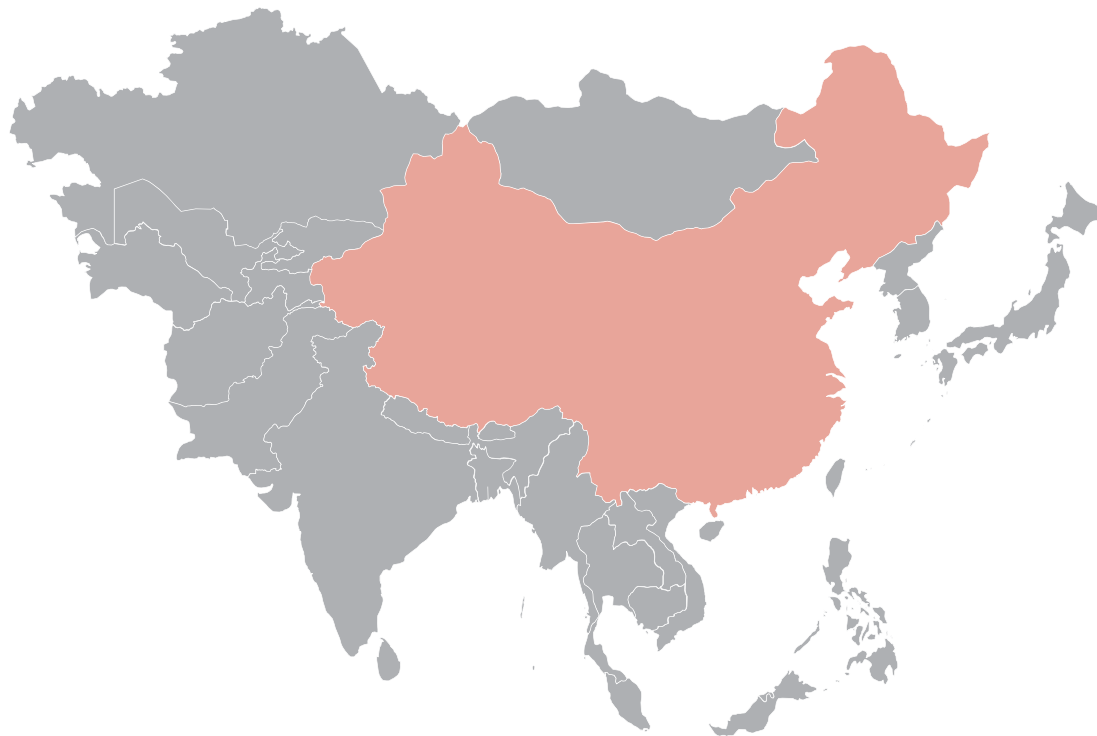
"I regard what happened in *Singapore* as the best example of successful governance in the history of the world. To take a handful of people in a malarial swamp and turn them into a meritocratic civilization as well as Singapore has is a huge achievement. I think *China* to some extent has copied *Singapore*. And I think they deserve some admiration."



*Charles Munger,
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Legitimacy of China's one-party system

- 80% of Chinese are satisfied with the direction of their country
- 80% of the 330,000 Chinese studying in the US say they will return home
- 47% of Europeans view China positively, compared to 49% for the US



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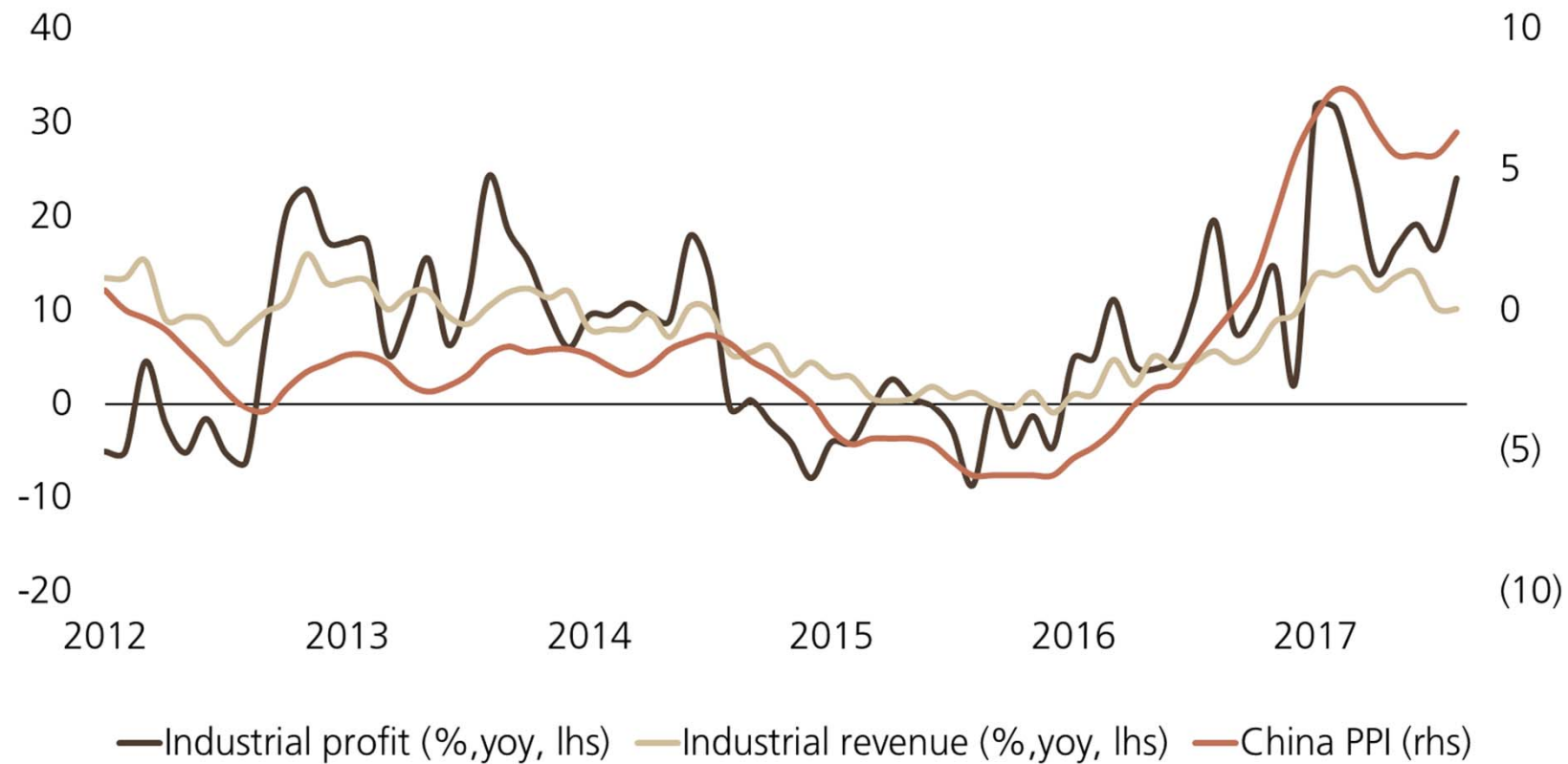
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Appendices

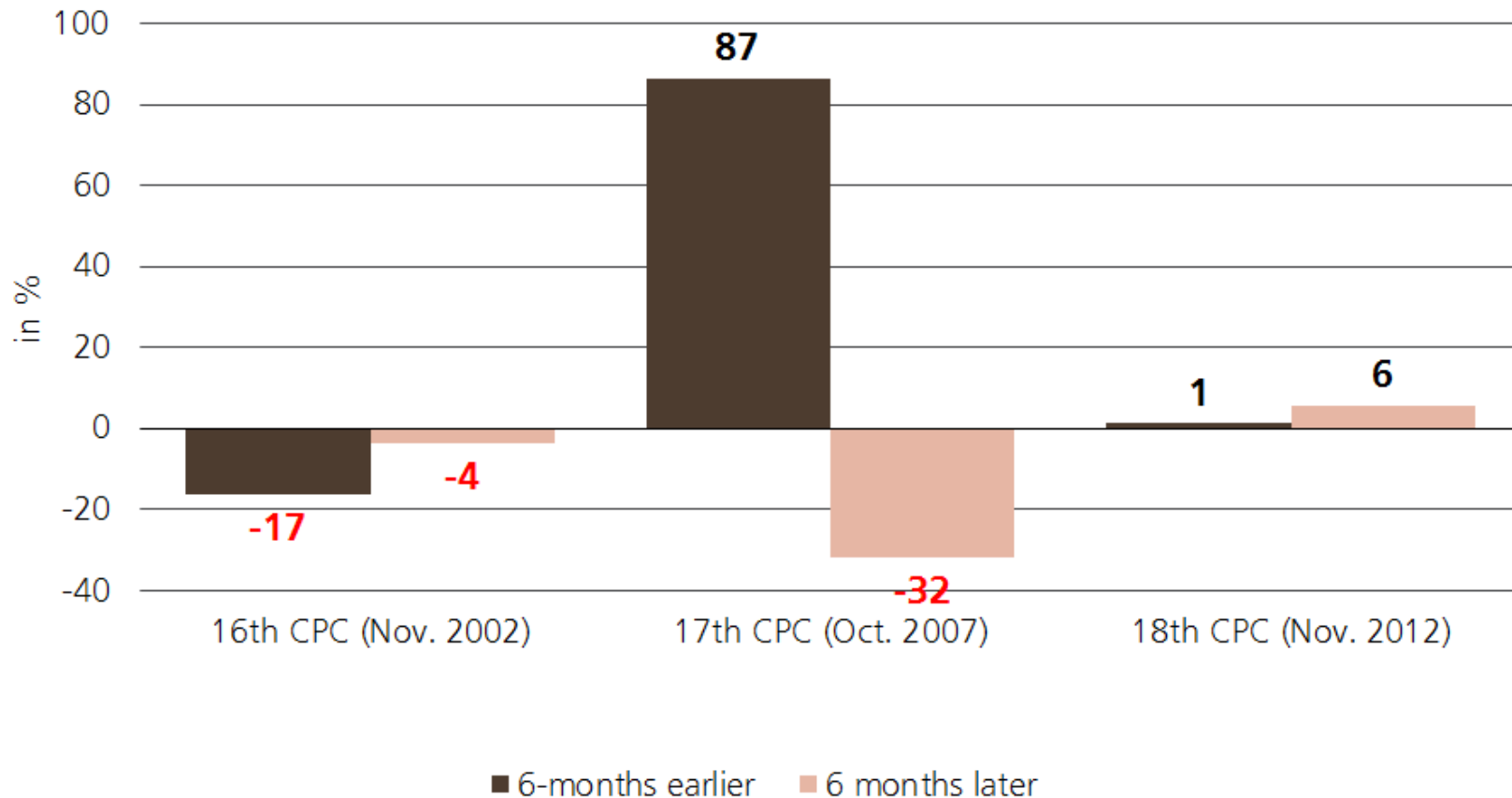
China: Better margin outlook should cushion deceleration

Profit and revenue (% yoy, lhs) of Chinese industrial companies versus PPI inflation (%yoy, rhs)



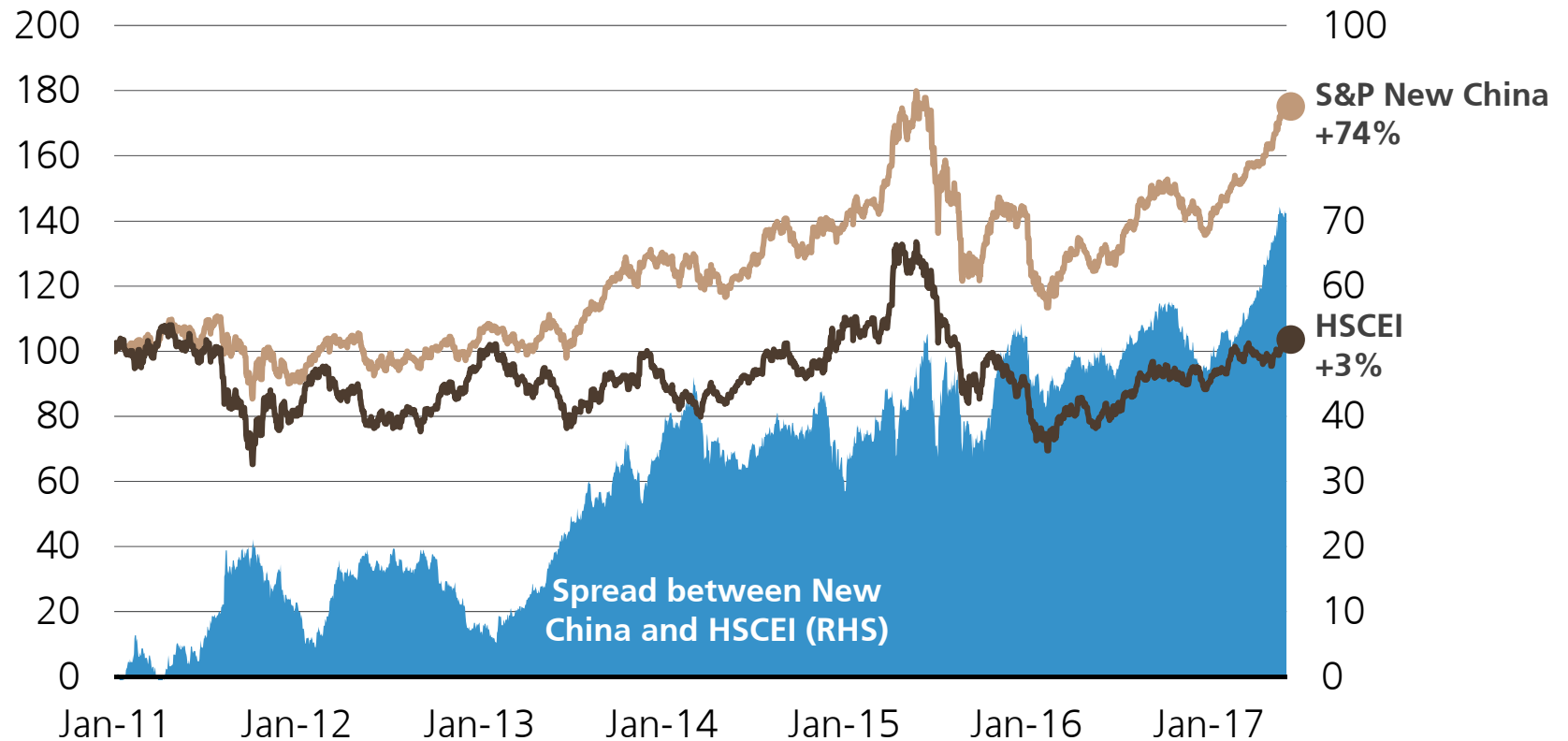
19th NCCP: The economy matters more than politics

MSCI China total return (USD), in %, six months before and six months after the China Party Congress (CPC)



China in transition creates clear winners & losers

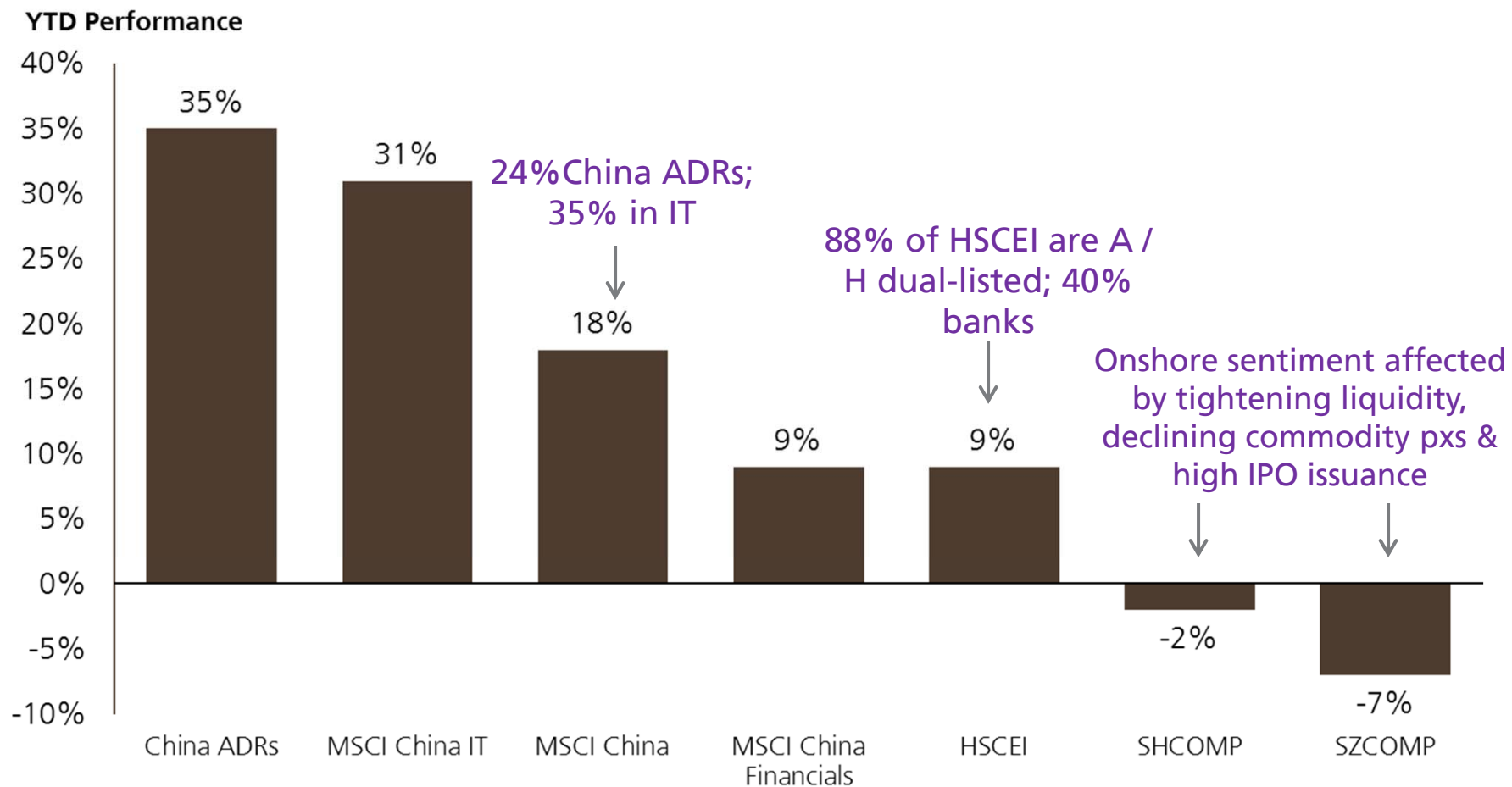
The New China Index outperformed HSCEI by more than 8% per annum since 2011



Source: Bloomberg, UBS, as of June 2017

Declining correlation in performance across indices

Wide dispersion in performance YTD (May 10, 2017)



Who benefits from BRI?

Company	ISIN	Country	Sector	M'Cap in USD mn	Currency	Price	OBOR exposure	UBS Rating
Contractors								
China Railway Construction Corp	CNE100000981	China	Construction	25,082	HKD	10.08	5%	Buy
China Railway Group	CNE00000722	China	Construction	29,244	HKD	6.40	5%	Buy
China Communications Construction Co	CNE000002F5	China	Construction	34,962	HKD	10.22	20%	Buy
Gamuda	MYL539800002	Malaysia	Construction	3,082	MYR	5.34	n.a.	Buy
Hyundai E&C Construction	KR700072003	Korea	Construction	3,885	KRW	39,600	n.a.	Buy
Siam Cement	TH0003010209	Thailand	Materials	18,109	THB	498.00	n.a.	Buy
Sino-Thai Engineering & Construction	TH0307010209	Thailand	Construction	1,202	THB	26.00	n.a.	Buy
Wijaya Karya	ID1000107600	Indonesia	Construction	1,274	IDR	1895.00	n.a.	n.a.
Energy								
Engro Corp	PK0102701015	Pakistan	Energy	104	PKR	34.00	n.a.	n.a.
Hub Power	PK0065001015	Pakistan	Energy	1,252	PKR	114.05	n.a.	n.a.
China National Petroleum Corporation	CNE1000003W8	China	Energy	217,548	HKD	5.02	n.a.	Buy
Huaneng Power	CNE100000624	China	Utilities	14,518	HKD	5.06	n.a.	Buy
China Power International	HK2380027329	Hong Kong	Utilities	2,477	HKD	2.61	n.a.	Buy
Property Developers								
Ayala Land	PHY048871004	Philippines	Property	12,328	PHP	42.75	25%	Buy
Country Garden Holdings	CNE100000569	China	Property	7,609	HKD	18.30	2%	Buy
Greenland Holdings	KYG458751049	Hong Kong	Property	980	HKD	2.72	n.a.	n.a.
R&F	CNE100000569	China	Property	7,609	HKD	18.30	5%	Buy
Other								
BOC (HK)	HK2388011192	Hong Kong	Financial	52,659	HKD	38.60	n.a.	Buy
Singapore Post	SG1N89910219	Singapore	Logistics	2,119	SGD	1.26	n.a.	Sell

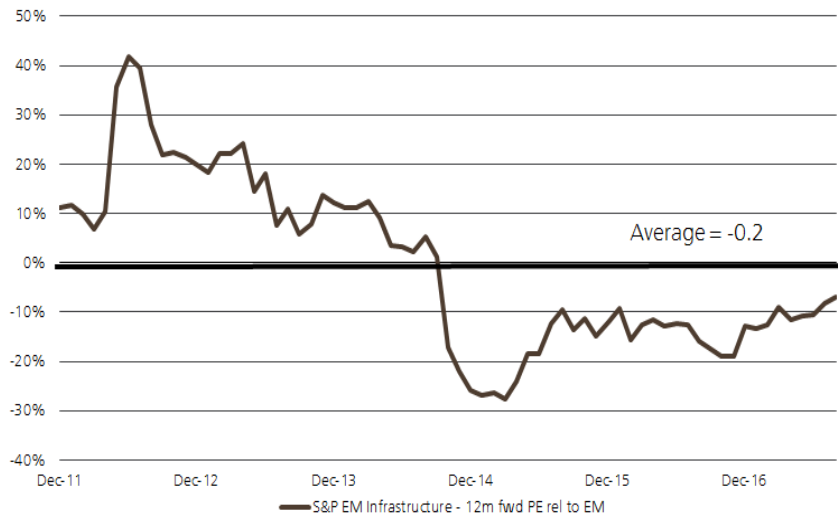
Source: UBS



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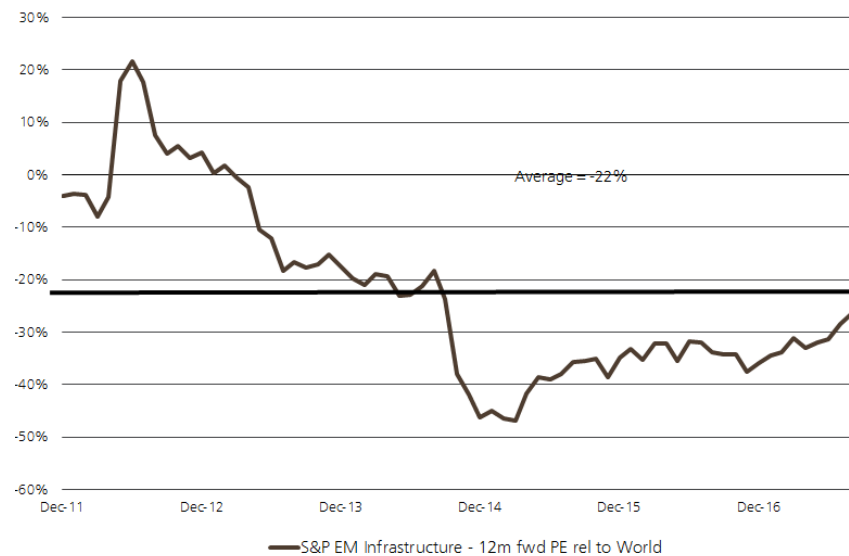
Attractive valuations not factoring in the BRI catalyst

EM infra trading at 7% below historic discount to EM



Source: Thomson Reuters, S&P as of 3 September 2017

EM infra trading below long term 22% discount to world



Source: Thomson Reuters, S&P as of 3 September 2017



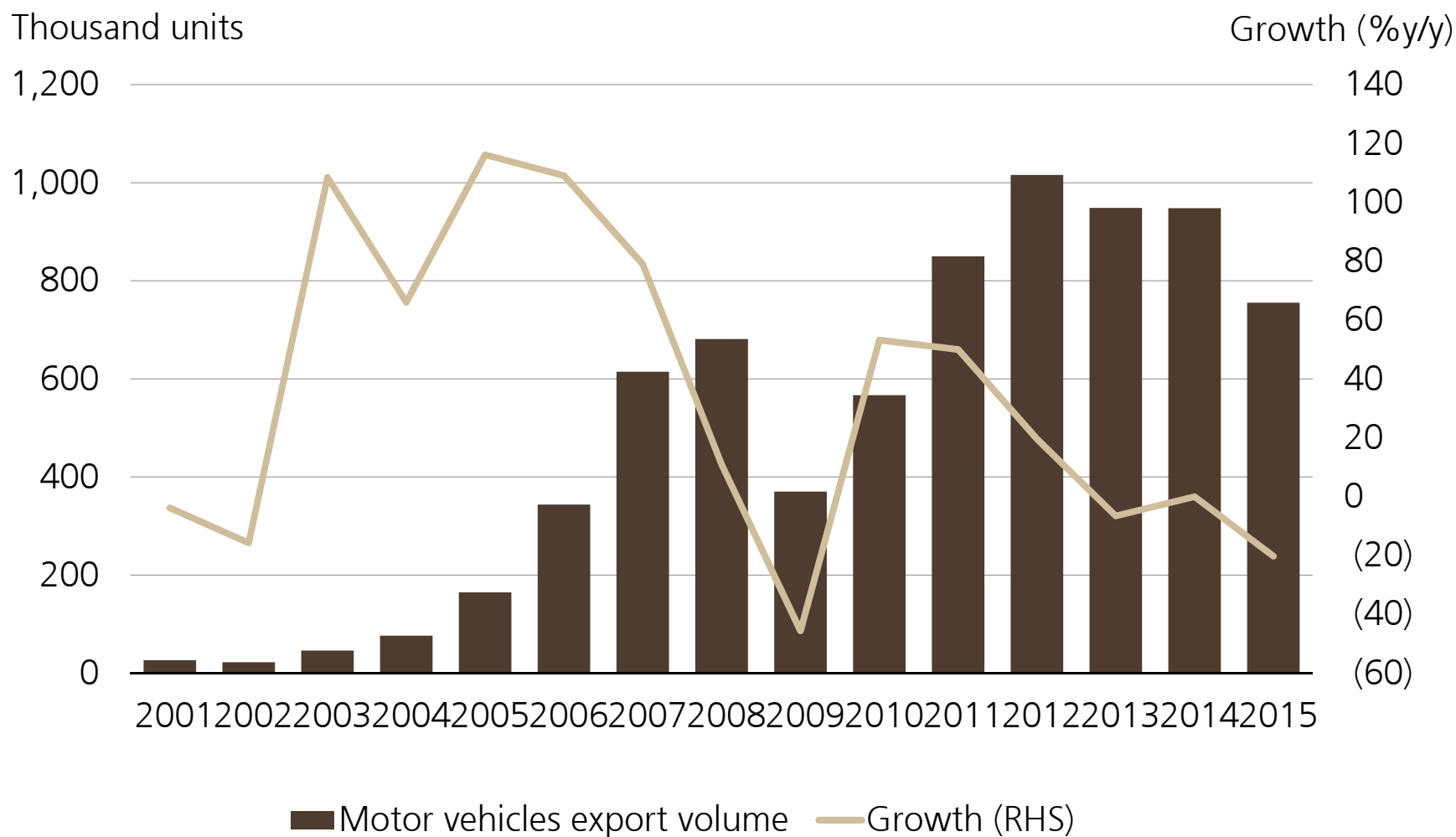
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How will China look like in 50 years?

Clash of civilizations?

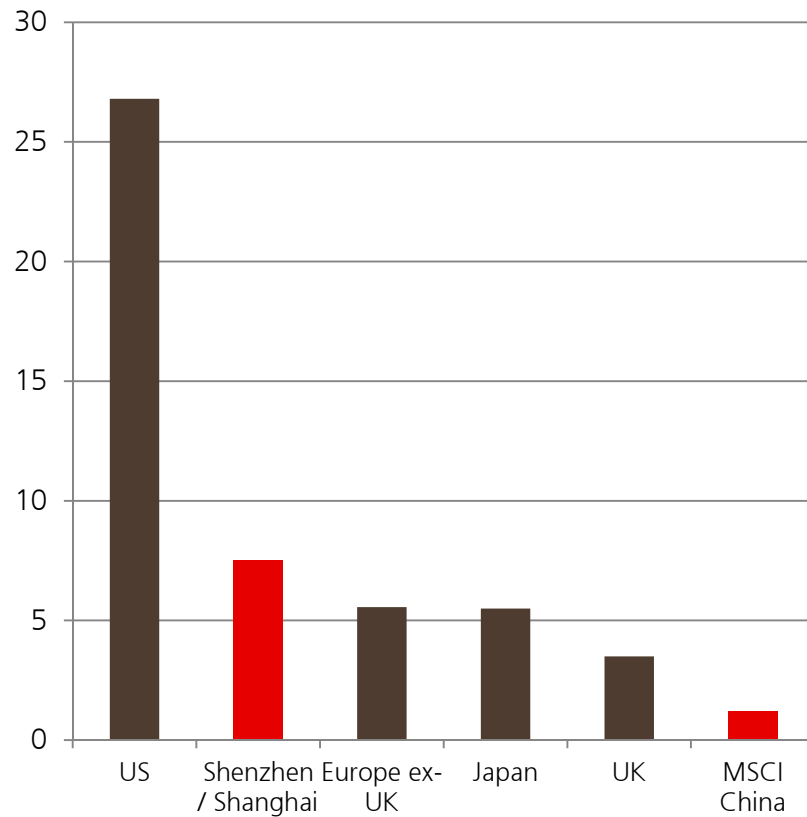
- As countries reach Western levels of development, do they become more like the West, less like the West or a combination of the two? In historical terms, we are very, very early in this debate
- Could we be witnessing the birth of multiple and competing modernities?
- Is the West imprisoned in its own assumptions of a modern, developed country?
- Western media can't see past the fact that China does not have a democratic system
- But China is the product of a history and culture which has little or nothing in common with that of the West
- The emergent Chinese model bears witness to a new kind of capitalism where the state is hyperactive and omnipresent in a range of different ways and forms

Exports of automobiles peaked in early 2010s

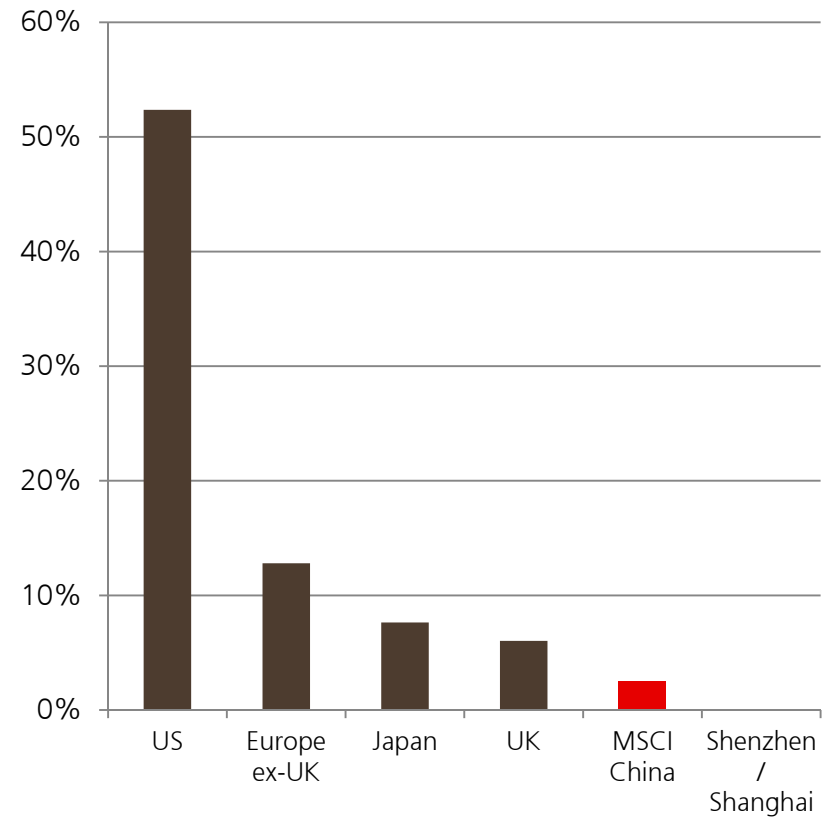


China is under represented in global capital markets

Equity market capitalisation (US\$ tn)



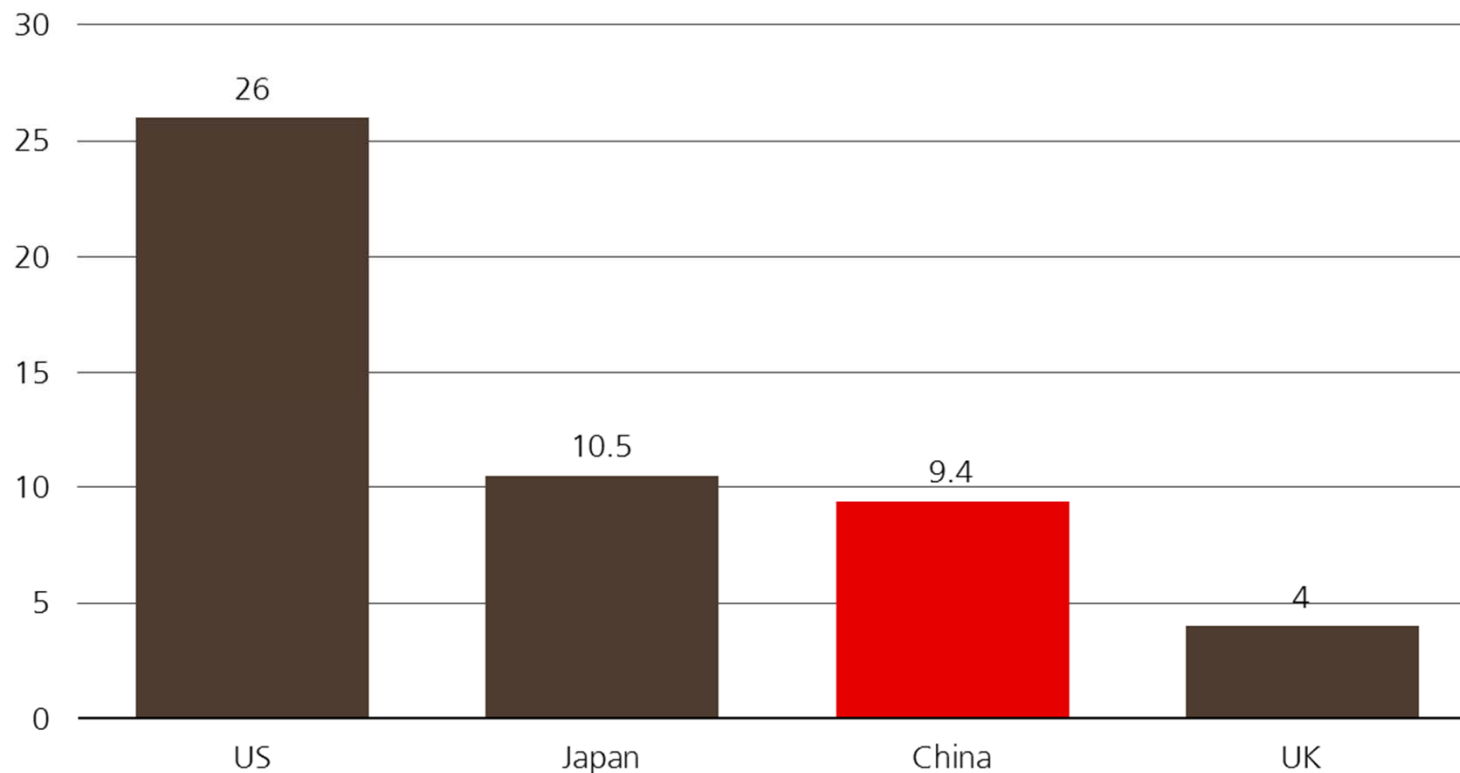
% of MSCI ACWI



China's capital markets

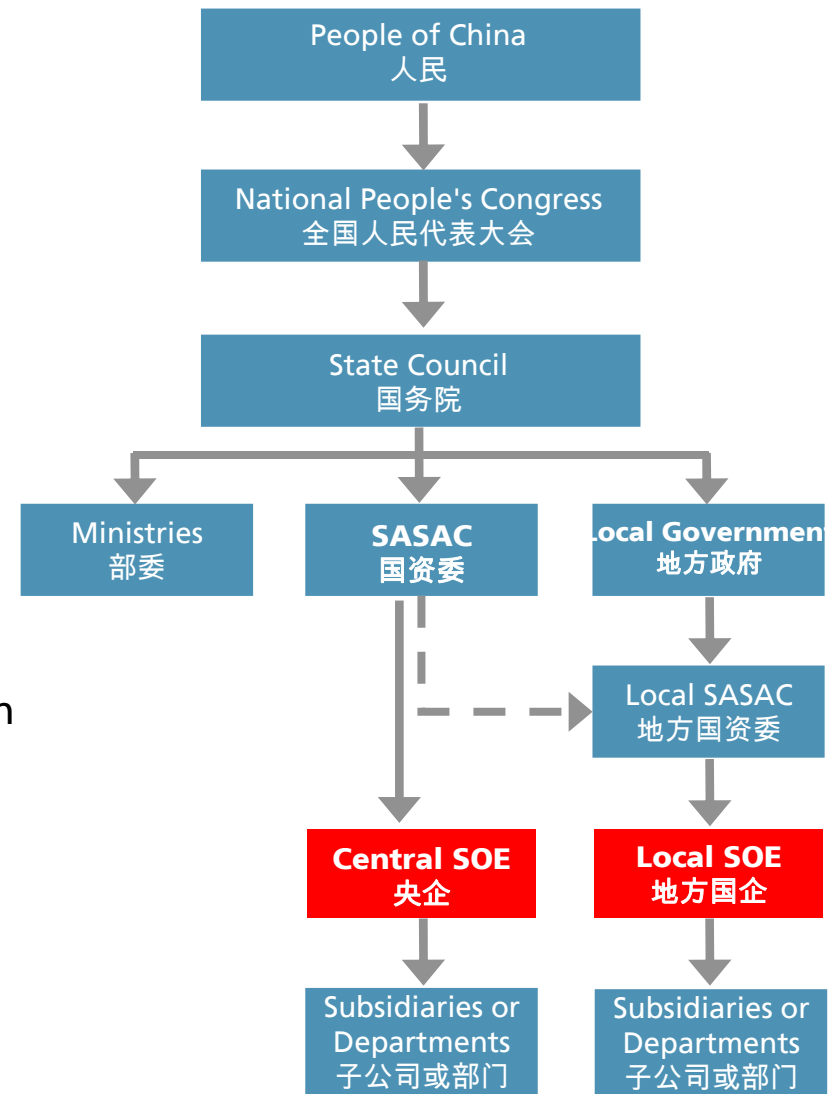
China has the world's 2nd biggest equity market and 3rd largest bonds market

Bonds market volume (US\$ tn)



Role of State-Owned Enterprises (SOEs)

- Prior to 1978, SOEs dominate the Chinese economy
1978年以前，国有企业主导中国经济
- Reform phase I (1978-1994)
改革第一阶段 (1978-1994)
- Reform phase II (1994-2003)
改革第二阶段 (1994-2003)
- **Reform phase III (since 2003)**
改革第三阶段 (2003年以来)
 - Formation of State-owned Assets Supervision & Administration Commission of the State Council (SASACs)
成立国务院国有资产监督管理委员会 (国资委)



No longer competitive - share of processing exports declined



BRI - Emerging Market Infrastructure ETF

SECTOR BREAKDOWN (%)

	Fund
Industrials	42.95
Utilities	38.08
Energy	17.93
Cash and/or Derivatives	1.03

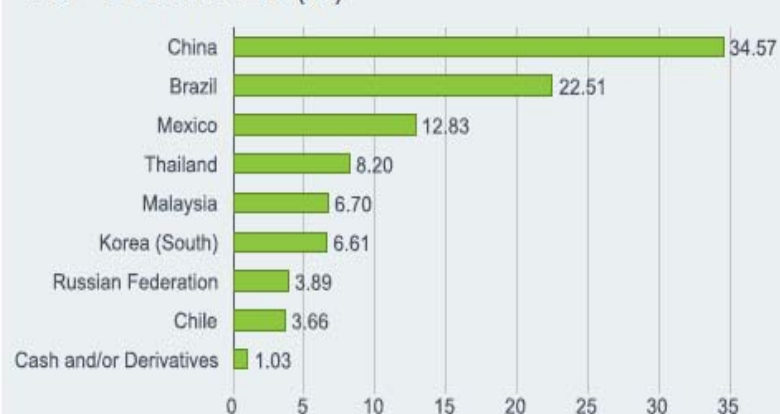
Allocations are subject to change. From 1 September 2016, GICS will increase from 10 to 11 sectors. Real Estate securities, previously classified with Financials, will be reported as a new sector – Real Estate.

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Exchange	Swiss Exchange	London Stock Exchange
Ticker	IEMI	IEMI
Bloomberg Ticker	IEMI SW	IEMI LN
RIC	IEMI.S	IEMI.L
SEDOL	B436VV0	B2NPL13
Valor	3801900	-
Trading Currency	USD	GBP

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TOP COUNTRIES (%)



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Source: UBS



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