

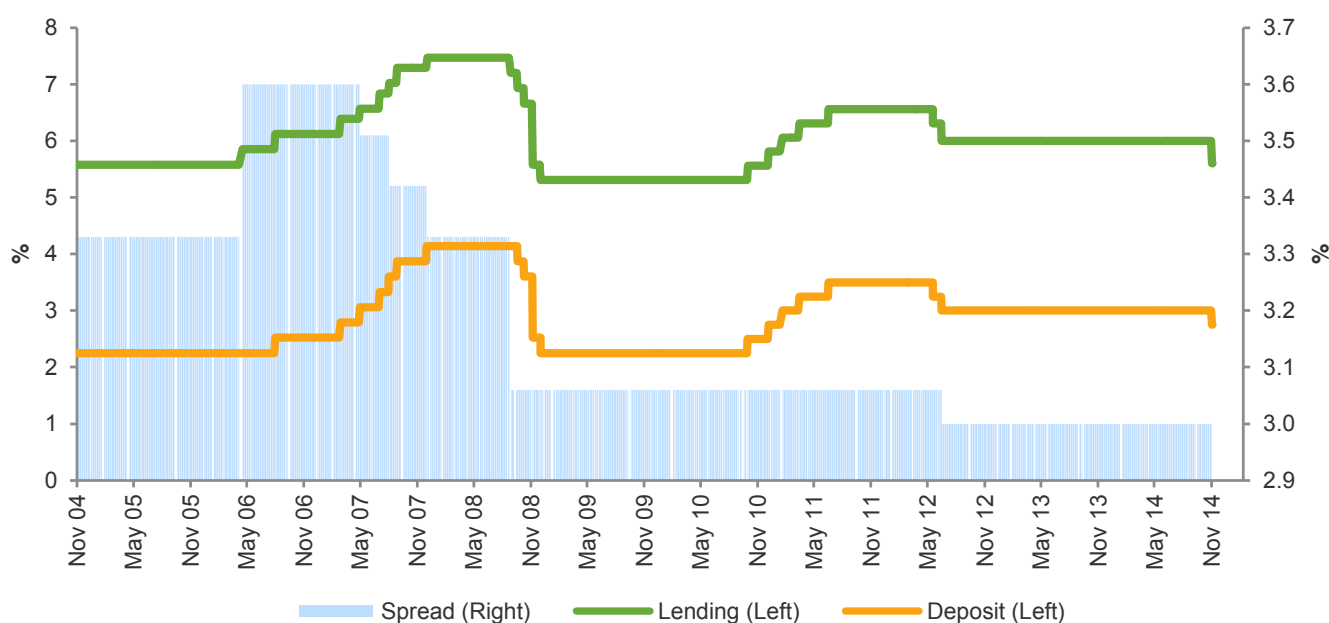
01 DECEMBER 2014

## CHINA MACRO MONITOR

### RATE CUTS DRIVE NEXT LEG OF EQUITY MARKET RALLY

- Last week the People's Bank of China (PBoC), the central bank, stepped up its fight against flagging growth and deflationary headwinds by cutting interest rates for the first time since 2012.
- The PBoC had been active this year in delivering very targeted policy easing and injecting liquidity into the banking system. However, last week's move marks the first broad-based monetary easing action in over two years. We believe there will be more to come.
- We believe the PBoC will cut the reserve requirement ratio (RRR) as well as cut interest rates further as it aims to generate sustainable demand in the economy and ward off rising deflationary risks.
- The PBoC also increased the flexibility of banks to set deposit rates, highlighting its commitment to increasing financial market liberalisation.
- The Hong Kong-Shanghai Stock Connect opened for business earlier this month. The daily quota was hit on the first day of trading, illustrating the strength of pent up demand for domestic Chinese equities.

#### PBoC Cuts Policy Interest Rates

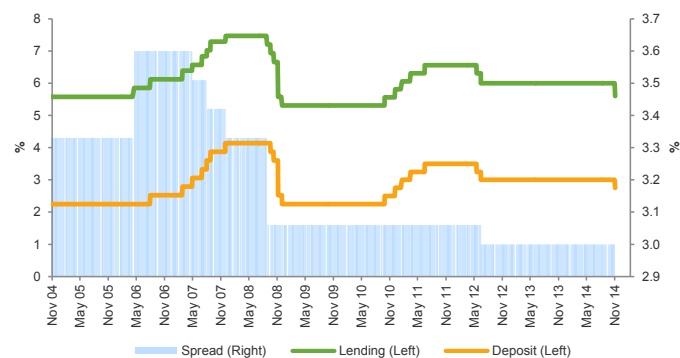


Source for all charts and tables in publication: ETF Securities and Bloomberg unless otherwise stated

## PBOC CUTS POLICY RATES AND ADVANCES ON RATE LIBERALISATION

We have long argued that weak economic data and the threat of deflationary pressures will expedite policy stimulus from both the Chinese government and central bank. The PBoC has been very active in recent months in delivering targeted policy easing and injecting liquidity into the banking system. Last week's moves however demonstrate that the central bank has stepped up its fight and marks the first time the PBoC has cut key policy rates since 2012. The PBoC cut the 1-year benchmark lending rate 40bps (to 5.6%) and cut the 1-year deposit rate by 25bps (to 2.75%).

PBoC Cuts Policy Interest Rates

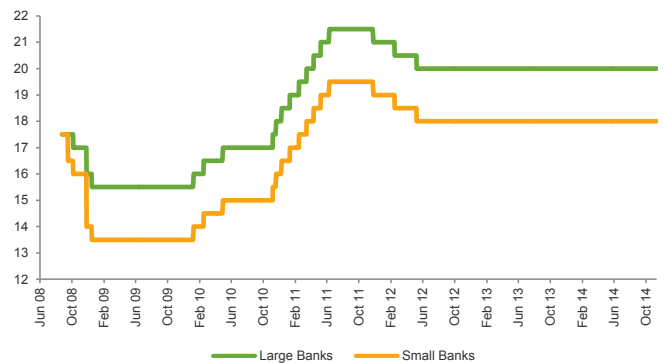


At the same time the PBoC raised the deposit rate ceiling (the limit on deposit interest rates, expressed as a multiple of the benchmark deposit rate) to 1.2 from 1.1 times previously. Deposit caps have been a constraint on the formal banking system and have led to the growth the shadow-banking system which does not face the same draconian constraints. The moves to widen the ceiling illustrate that policy easing and liberalisation can go hand-in-hand. While the net effect on deposit rates for this first rate cut could become muted if all banks utilise the new ceiling<sup>1</sup>, the moves highlight policymakers' commitment to supporting growth and liberalising financial markets.

We believe last week's rate cuts will be the first in a series of cuts that will be necessary to stimulate the economy. A further 50bps could be cut in H1 2015. In addition we believe that China will cut the reserve requirement ratio (RRR) i.e. the amount of deposits and notes that banks must hold as reserves at the central bank. Cutting the RRR expands the capacity of banks to lend into the real economy. Although the PBoC cut the RRR for select banks earlier this year, we believe that a broad-based cut is now required.

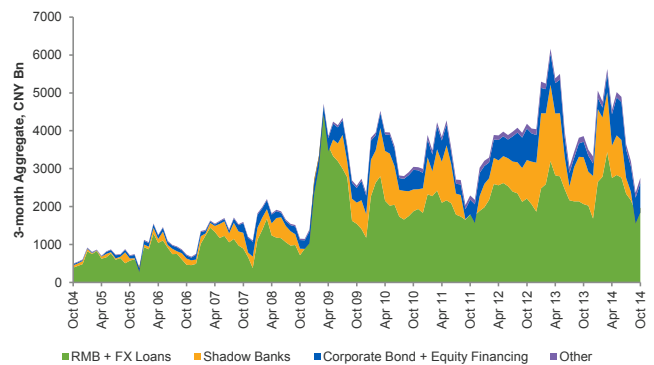
<sup>1</sup> If banks fully utilize the new deposit ceiling, the new deposit rate will be  $2.75\% \times 1.2 = 3.3\%$ , same as  $3.00\% \times 1.1 = 3.3\%$  under the old deposit rate and deposit ceiling.

China Bank Reserve Requirements Ratio



With shadow banks taking a back-seat, the onus is on the formal banking sector to provide financing into the economy. The banking sector therefore needs all the support it can get from the central bank.

Source of Finance: Shadow Banks Taking a Back-Seat

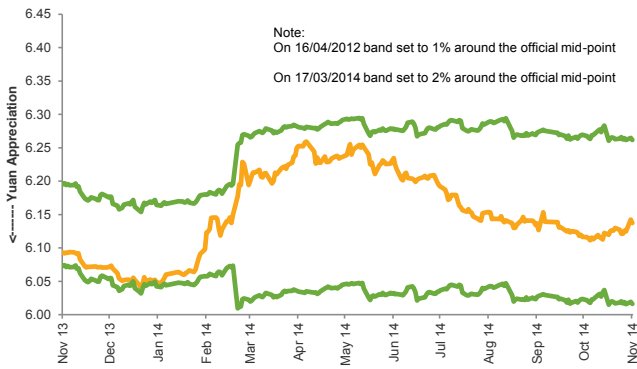


The PBoC took further steps to liberalise interest rates by abolishing the benchmark guidance for 5-year savings rates and consolidated the benchmark guidance for loans of 1-5 years maturity. These moves allow regulated banks to attract more deposits that would have gone to shadow banks and therefore should aid their ability to lend.

On 27<sup>th</sup> November, the PBoC refrained from selling repurchase agreements for the first time since July, loosening monetary policy further. It last suspended sales of repos, in the week of July 21 as initial public offerings boosted cash demand. This time the motivation seems more aligned with monetary stimuli. The sale of repos drain funds from the banking system. Indeed the PBoC could conduct reverse repos to increase liquidity in the banking system, a tool which we believe it will utilise in 2015.

The Renminbi depreciated modestly in November, helping to boost the competitiveness of Chinese exports. Exports were already been growing briskly during a period of Renminbi appreciation. The recent depreciation should act as a catalyst to extend that growth and is in line with the recent monetary easing efforts by the central bank.

### Yuan Depreciated in November



## HONG KONG-SHANGHAI STOCK CONNECT OPENS FOR BUSINESS

The Hong Kong-Shanghai Stock Connect programme, which allows foreigners access to the domestic equity market in China via Hong Kong, started on November 17<sup>th</sup>. This initiative marks the most substantial opening of the Chinese equity market in history. On the first day of trading, flows from Hong Kong to China hit the daily quota, in a sign of the strength of pent up demand for Chinese equity exposure. Coinciding with the opening of the Connect programme, capital gains tax on investments by foreigners has been waived for three years and the cap on HK dollar-yuan convertibility was lifted for Hong Kong residents in another significant sign of willingness to liberalise financial markets.

In June 2014, MSCI refrained from including China A-Shares into its MSCI Emerging markets Index due to concerns over difficulty in accessing the market. The Connect initiative should go a long way in alleviating these concerns. With approximately

US\$1.5tn benchmarked to MSCI China Emerging Markets Index, even a small allocation of 0.5% to the China A-Share market in the broader index could drive US\$7.5bn into the market on the back of index replication by investors. With equity markets becoming more optimistic on index inclusion, China A-Shares have staged a rally.

As a point of reference, the MSCI United Arab Emirates Net TR USD index rose over 90% between the time MSCI announced UAE stocks would enter its Emerging Market Index and actual inclusion (see shaded area of chart). While the Chinese and UAE markets are vastly different in size and composition and therefore limits comparability, we believe the increasing probability of index inclusion will bode well for China A-Shares.

### MSCI United Arab Emirates Net TR USD Index



The Hong Kong-Shanghai Connect programme does not open the Shenzhen market up to foreigners and for that reason many investors prefer investment products benchmarked to broad indices with exposure to all A-Shares such as the MSCI China A-Share Index.

## MACRO MONITOR

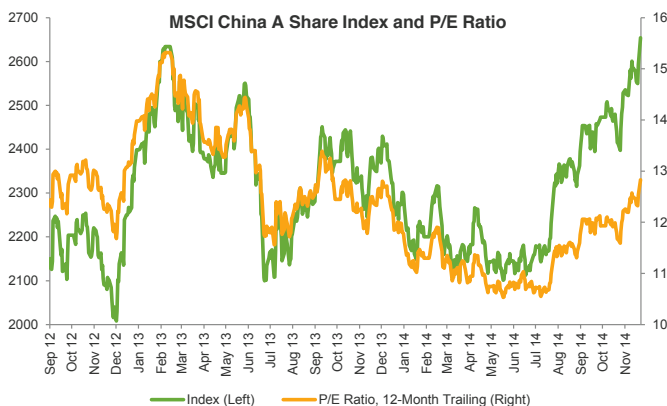
	Oct-13	Nov-13	Dec-13	Jan-14	Feb-14	Mar-14	Apr-14	May-14	Jun-14	Jul-14	Aug-14	Sep-14	Oct-14	
<b>Growth Indicators</b>														
GDP Growth (% y-o-y)			7.7			7.4			7.5			7.3		●
Keqiang Index*	9.7	8.4	8.5	7.0	-1.1	4.8	4.5	6.2	6.2	4.9	3.2	4.1	3.0	●
Industrial Production (% y-o-y)	10.3	10.0	9.7			8.8	8.7	8.8	9.2	9.0	6.9	8.0	7.7	●
Manufacturing PMI (Level)	51.4	51.4	51.0	50.5	50.2	50.3	50.4	50.8	51.0	51.7	51.1	51.1	50.8	●
Retail Sales (% y-o-y)	13.3	13.7	13.6			12.2	11.9	12.5	12.4	12.2	11.9	11.6	11.5	●
Fixed Asset Investment (ytd % y-o-y)	20.1	19.9	19.6		17.9	17.6	17.3	17.2	17.3	17.0	16.5	16.1	15.9	●
<b>Trade, Reserves, Money and Inflation</b>														
Trade Balance (US\$ bn)	31.1	33.8	25.3	31.9	-22.7	7.9	18.6	36.2	31.7	47.3	49.9	31.0	45.4	●
Exports (% y-o-y)	5.6	12.7	4.3	10.5	-18.1	-6.6	0.8	7.1	7.2	14.5	9.4	15.3	11.6	●
Imports (% y-o-y)	7.6	5.3	8.3	9.9	9.8	-11.5	0.7	-1.6	5.5	-1.6	-2.4	7.0	4.6	●
Foreign Exchange Reserves (US\$ tn)	3.7	3.8	3.8	3.9	3.9	3.9	4.0	4.0	4.0	4.0	4.0	3.9		●
M1 Money Supply (% y-o-y)	8.9	9.4	9.3	1.2	6.9	5.4	5.5	5.7	8.9	6.7	5.7	4.8	3.2	●
M2 Money Supply (% y-o-y)	14.3	14.2	13.6	13.2	13.3	12.1	13.2	13.5	14.7	13.5	12.8	12.9	12.6	●
CPI Inflation (% y-o-y)	3.2	3.0	2.5	2.5	2.0	2.4	1.8	2.5	2.3	2.3	2.0	1.6	1.6	●
CPI Non Food Inflation (% y-o-y)	1.6	1.6	1.7	1.9	1.6	1.5	1.6	1.7	1.7	1.6	1.5	1.3	1.2	●
PPI Inflation (% y-o-y)	-1.5	-1.4	-1.4	-1.6	-2.0	-2.3	-2.0	-1.4	-1.1	-0.9	-1.2	-1.8	-2.2	●
<b>Interest and Exchange Rates</b>														
Policy Interest Rate: Lending (%)	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	●
Policy Interest Rate: Deposit (%)	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	●
7d Repo Rate (%)	5.1	4.7	5.3	5.0	3.5	4.2	4.2	3.3	3.9	4.0	3.8	2.9	3.3	●
3m SHIBOR (%)	4.7	4.7	5.6	5.6	5.5	5.5	5.5	4.9	4.7	4.7	4.7	4.5	4.4	●
5yr Bond Yield (%)	4.1	4.3	4.5	4.2	4.0	4.1	4.0	3.9	3.8	4.0	4.0	3.9	3.6	●
Sovereign 5yr CDS Rate (bps)	79.7	65.5	79.8	98.2	89.7	92.3	88.9	73.2	77.0	79.7	70.2	88.8	79.0	●
CNY/USD	6.09	6.09	6.05	6.06	6.15	6.22	6.26	6.25	6.20	6.17	6.14	6.14	6.11	●
Effective Exchange Rate	6.1	6.1	6.1	6.0	6.1	6.2	6.3	6.2	6.2	6.2	6.1	6.2	6.1	●
<b>Other Key Indicators</b>														
Residential Building Sales (% y-o-y)	20.0	21.0	3.6			-10.7	-15.3	-11.3	-5.4	-17.8	-13.8	-10.3	-3.2	●
Total Building Sales (% y-o-y)	32.3	30.7	26.3		-3.7	-5.2	-7.8	-8.5	-6.7	-8.2	-8.9	-8.9	-7.9	●
70 City Residential Price (% y-o-y)	8.8	9.1	9.2	9.0	8.2	7.3	6.4	5.4	4.1	2.4	0.5	-1.1	-2.5	●
Aggregate Finance (CNY bn)	864	1227	1232	2600	937	2093	1526	1401	1967	274	958	1136	663	●
MSCI China A Share Index	2325	2402	2301	2200	2184	2144	2143	2145	2159	2343	2342	2473	2528	●
MSCI World Index	9770	9922	10053	9684	10297	10409	10564	10715	10817	10586	10739	10425	10444	●

\* The Keqiang index is the equal-weighted average of the year-on-year change in bank loans, rail freight volumes and electricity production

● Last 3 month trend improving  
● Last 3 month trend flat  
● Last 3 month trend worsening

## STOCK MARKET PERFORMANCE AND VALUATION

## MSCI China A Share Index



Performance	-1M	-12M	YTD	PE Ratio*
MSCI China A Index	10.0%	12.6%	15.3%	12.8
MSCI World Index	4.7%	8.0%	6.3%	17.9
S&P 500 Index	5.7%	15.5%	13.6%	18.3
Euro Stoxx 50 Index	4.4%	-2.8%	-5.6%	22.8
FTSE 100 Index	3.3%	-1.6%	-4.2%	19.2

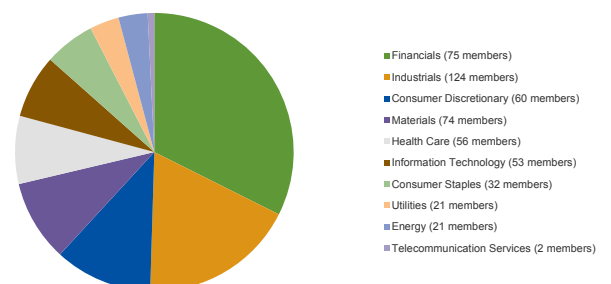
\* Based on current price and 12-month trailing earnings

## MSCI China index Top Five Stock Gainers and Decliners

Top 5 Gainers	Price (% m-o-m)	Weight (%)	Contribution (p x w)
Xiamen ITG Group Corp Ltd	83.9	0.19	0.16
Shanghai Lujiazui Finance & Trade Zone D	81.7	0.17	0.14
Everbright Securities Co Ltd	76.8	0.26	0.20
Gem-Year Industrial Co Ltd	73.4	0.13	0.09
Jinxi Axle Co Ltd	73.3	0.15	0.11

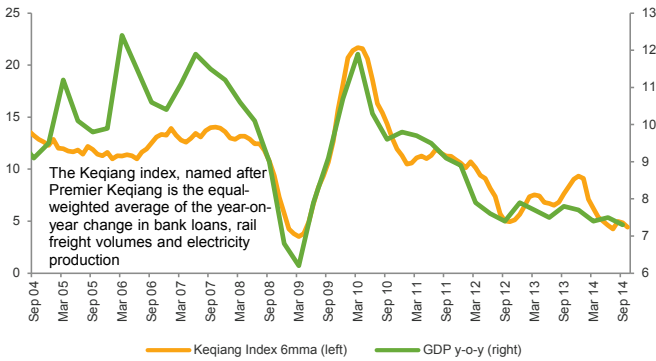
Bottom 5 Decliners	Price (% m-o-m)	Weight (%)	Contribution (p x w)
Da An Gene Co Ltd Sun Yat-Sen University	-18.4	0.11	-0.02
Guizhou Xinbang Pharmaceutical Co Ltd	-18.3	0.06	-0.01
Pengxin International Mining Co Ltd	-16.0	0.14	-0.02
Henan Shuanghui Investment & Development	-14.9	0.28	-0.04
Suzhou Dongshan Precision Manufacturing	-14.4	0.06	-0.01

## MSCI China A Share Sector Breakdown



## ECONOMIC GROWTH

China GDP Growth and Keqiang Index



- Q3 2014 GDP grew at a better-than-expected 7.3% y-o-y, although edging down from 7.5% y-o-y in Q2 2014.
- The “Keqiang index” index still points to weakening growth, with lower rail freight volumes compared to a year ago acting as the main drag. The weakness implied in the index is likely to be met with further policy easing.

China Industrial Production and Manufacturing PMI



- Industrial production growth in October edged down to 7.7% y-o-y from 8.0% in September.
- The official manufacturing purchasing manager’s index (PMI) also edged down to 50.8 in October from 51.1 in September.
- Preliminary HSBC/Markit manufacturing PMI for November pared the previous month’s gains and now sits at the 50.0 indicating no new improvement in conditions.

China Retail Sales



- China retail sales appear to have stabilised in the 11-13% range from the overheated levels of the 2009-10 government stimulus period. Retail sales growth in October dipped to 11.5% y-o-y from 11.6% in September.

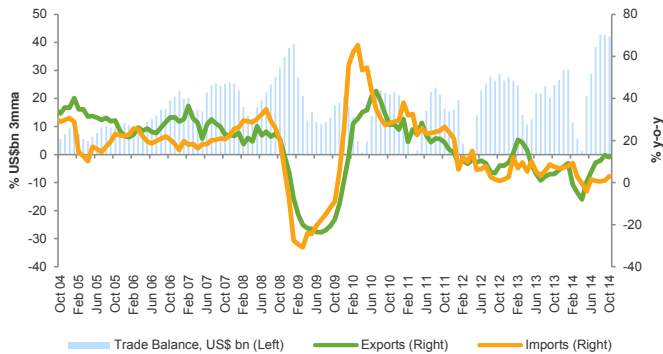
China Fixed Asset Investment



- Fixed asset investment grew by 15.9% ytd y-o-y% in October, down from 16.1% in September. With local governments able to borrow under their own name now, we expect fixed asset investment to increase. Many local governments were reluctant to spend on infrastructure projects earlier this year in fear of breaching the previous rules.

# TRADE, MONEY AND PRICES

## China Trade Trends



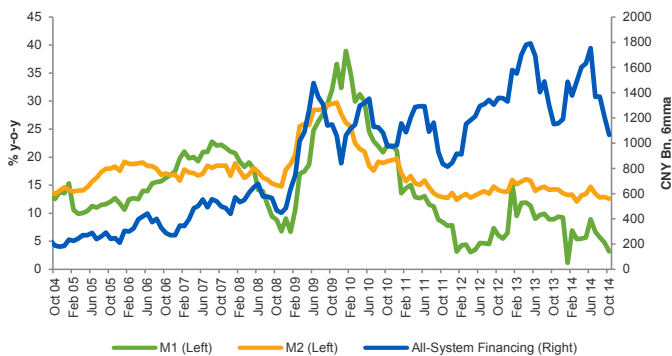
- Exports expanded strongly once again in October, rising 11.6% y-o-y, marking seven continuous months of export expansion.
- Imports rose for the second consecutive month, rising 4.6% y-o-y.
- The trade-surplus widened to US\$45.4bn in October as exports continued to outpace imports.

## China Foreign Exchange Reserves



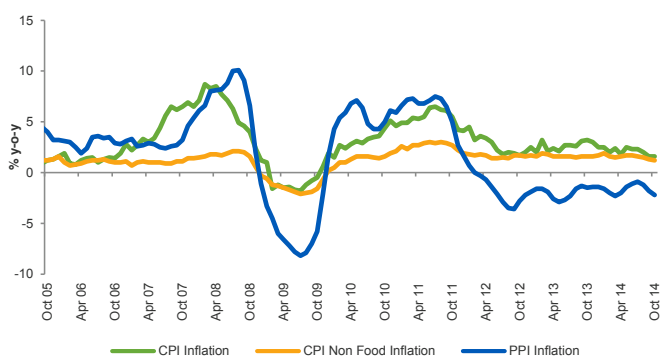
- In September 2014, China's foreign exchange reserves fell for the first time since July 2012.
- The steady appreciation of the renminbi has allowed reserve accumulation to fall, helping divert some of China's resources into more productive uses.
- Despite the lack of currency intervention in the past half year, China's reserves remain the highest in the world and more than three-times as high as Japan's (the country with the second largest reserves).

## China Money Supply



- M2 growth remained steady at 12.6% y-o-y in October compared to 12.9% y-o-y in September.
- All-system financing fell once again in October, largely held back by a contraction in shadow banking activity.

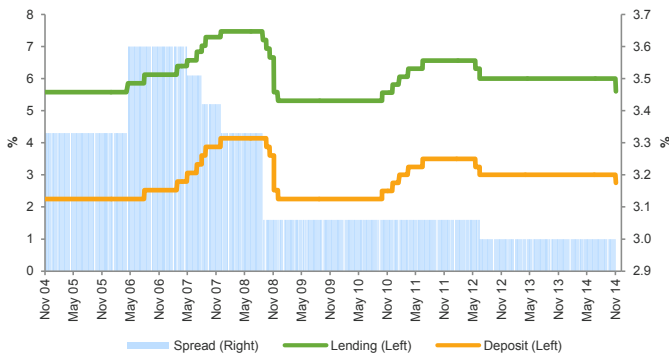
## China Inflation



- CPI inflation remained at 1.6% in October, the same as September, but markedly lower than a year ago, demonstrating the disinflationary pressures in the country at this stage.
- With inflation so low and far below the 3.5% target, the People's Bank of China has plenty of room for further policy stimulus.

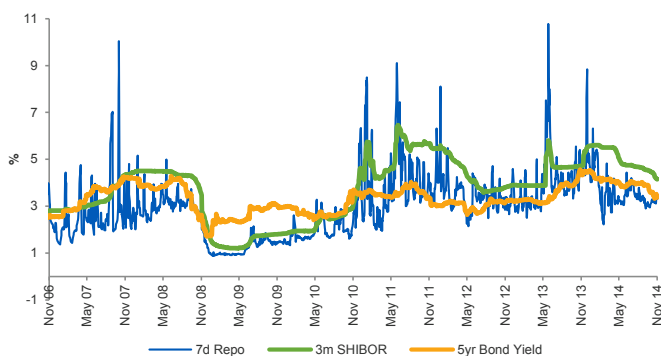
# INTEREST AND EXCHANGE RATES

### China Policy Interest Rates



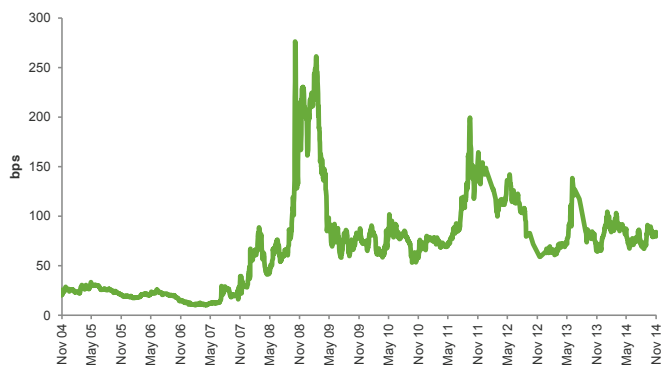
- Policy interest rates were cut for the first time in over two years in November as the PBoC stepped up its fight against flagging growth and deflationary headwinds.
- The cuts to the lending and deposit rates were asymmetric. The PBoC cut the 1-year benchmark lending rate 40bps (to 5.6%) and cut the 1-year deposit rate by 25bps (to 2.75%).
- We expect that this will be the first of several rate cuts to stimulate the economy.

### China Market Interest Rates



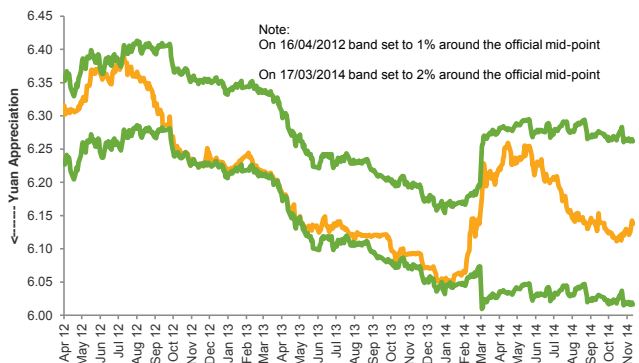
- 7-day repo rates rose to 3.5% by 24<sup>th</sup> November from 3.0% a month earlier.
- On November 27<sup>th</sup> the PBoC refrained from selling repurchase agreements for the first time since July. That should help reduce the repo rate and loosen monetary conditions.

### China Sovereign 5y CDS



- Sovereign credit default swap spreads spiked in response to China's first corporate bond default in March. Since then spreads have narrowed as the market realised that the failure to pay was not a symptom of widespread corporate malaise, but a decision by the government not to act as a backstop to every failing entity, in a conscious bid to introduce market discipline and risk awareness.
- CDS spreads fell in October and November as investors' perception of credit risks in the country improved amid the implementation of positive reforms to China's local government debt.

### China Exchange Rate

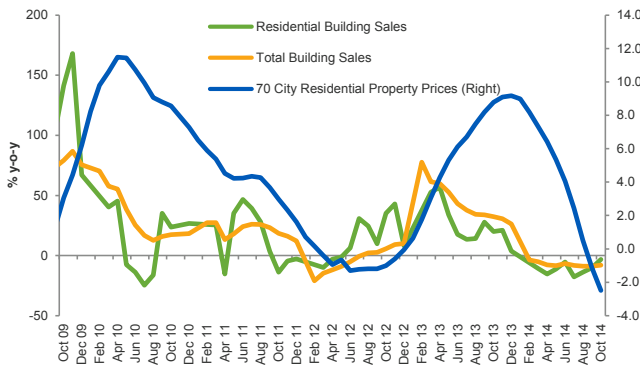


- The government widened the trading band and reminded investors that the currency can move in both directions in March 2014. However, from June, the currency has returned to its trend of appreciation.
- In recent weeks the renminbi has depreciated, in line with monetary easing.

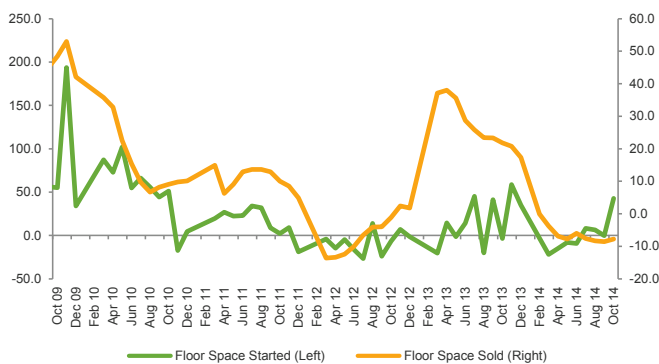


## PROPERTY AND FINANCE

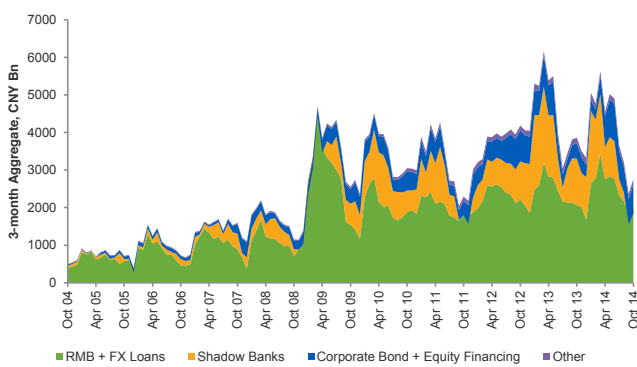
### China Property Market



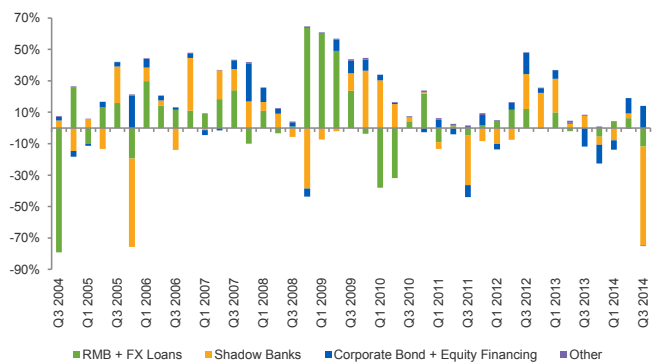
### China Floor Space Started and Sold



### China Sources of Finance



### China Contribution to Financing Growth



- While residential building sales continued to fall in October the pace of decline narrowed to -3.2% y-o-y in from -10.3% y-o-y in September.
- The average price of newly built houses across 70 cities fell by 2.5% y-o-y in October, marking the second consecutive month of y-o-y declines.
- While the government will likely maintain its policy of clamping down on real estate speculation, given the scale of urbanisation taking place in China it is unlikely that prices will decelerate substantially except in some of the more speculative projects and locations.
- Floor space started surged 43% y-o-y in October, in a sign of optimism by developers. Whether that optimism has come too early is difficult to tell, but judging by the continued decline in floor space sold (-7.8% y-o-y in October vs. -8.6% y-o-y in September), there is a danger that over-building could lead to more property market weakness.
- The shadow banking sector has played an important role in financial sector intermediation in China. While the bulk of RMB and FX loans offered by the formal state banking sector has almost exclusively been issued to state-owned-enterprises, the shadow banks have played a vital role in providing loans to commercial entities.
- Trusts, the largest part of shadow banking, are regulated by the China Banking Regulatory Commission (CBRC), the same entity that regulates banks. The CBRC now has the delicate task of clamping down on riskier types of financing, while allowing credit to continue to flow to "productive" areas of the economy.
- Undiscounted bankers' acceptances (a method of taking bank loans off-balance sheet) and trust loans continued to contract for the fourth month in a row in October, placing the onus of financial growth on traditional bank loans and capital markets.
- With the central government opening up the bond market to local governments, the reliance on local government financing vehicles, which fund themselves via the shadow banking sector, will continue decline.
- With trusts playing a vital role in capital market deepening (one of key goals of the government), close oversight as well as support from the government is expected.



## POLICY EASING

Date	Policy	Branch responsible
Mar-14	Currency trading band widened and Renminbi depreciated	People's Bank of China
Apr-14	CNY 800bn investment injection into railway infrastructure	China Railway Corporation
Apr-14	Increased social housing target to 7 million units of new starts (4.7 million units will come from shanty town redevelopment)	Central Government
Apr-14	Small businesses (with annual taxable income less than 100,000 yuan) will have tax halved from Jan 1 to end of 2016	Central Government
Apr-14	Reserve requirement ratio cut for rural banks	People's Bank of China
Jun-14	Cash injections to reduce short-term funding costs	People's Bank of China
Jun-14	CNY 100bn quota set for relending to agriculture and small businesses	People's Bank of China
Jun-14	Further reserve requirement ratio cut for small and rural banks	People's Bank of China
Jun-14	Exclude certain loans and widen deposit definition for loan-to-deposit ratios to free up capacity of banks to lend	People's Bank of China
Jun-14	Cut utility company taxes by CNY24bn	Central Government
Jun-14	Li Keqiang reminds local governments of their "inescapable responsibility" to help meet annual growth targets. Widely viewed as a prod to speed up spending and avoid procrastination by local governments who have been reluctant to spend for fear of getting caught up in the corruption probe	Central/Local Government
Sep-14	From October, small businesses (with annual revenue less than 30,000 yuan) will be exempted from VAT and business income tax, raising the threshold from 20,000 currently	Central Government
Sep-14	CNY 500bn of liquidity injected into five state-owned banks	People's Bank of China
Sept 14	14-day repo rate target cut from 3.7% to 3.5%	People's Bank of China
Sep-14	Mortgage rates and downpayment levels cut for some borrowers	People's Bank of China
Oct-14	State Council gives local governments the ability to borrow in their own right, while curbing borrowing via local government financing vehicles. While more a structural reform, it could help revive lending to sectors that were previously being crowded out.	Central/Local Government
Oct-14	14-day repo rate target cut from 3.5% to 3.4%	People's Bank of China
Oct-14	CNY200bn injected into 20 large national and regional banks	People's Bank of China
Apr - Oct 14	Selective housing policy stimulus. Relaxation of house purchase restrictions (e.g. limitations on number of properties people can own) saw some easing of rules	Local Governments
Nov-14	1-year benchmark lending rate cut by 40bps to 5.60%	People's Bank of China
Nov-14	1-year benchmark deposit rate cut by 25bps to 2.75%	People's Bank of China
Nov-14	Deposit ceiling widened from 1.1 times to 1.2 times the deposit rate	People's Bank of China
Nov-14	The number of lending and deposit benchmarks reduced, taking another step toward interest rate liberalisation	People's Bank of China
Nov-14	PBoC refrains from selling repos on 27 <sup>th</sup> November to avoid draining funds from the banking system	People's Bank of China

**IMPORTANT INFORMATION**

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**ETF SECURITIES (UK) LIMITED**  
3 Lombard Street  
London EC3V 9AA  
United Kingdom

**T** +44 (0)20 7448 4330  
**E** [info@etfsecurities.com](mailto:info@etfsecurities.com)  
**W** [etfsecurities.com](http://etfsecurities.com)