



Q4 2015

Debating the state of.. ..China



BNY MELLON

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Can China step up its economic reforms while building healthy growth?

After three decades of economic growth averaging 10% a year¹, China experienced an economic correction in the second half of 2015 and now faces a range of challenges which are significantly affecting its expansion.

Against a backdrop of decelerating growth and increased stock market volatility, this giant Asian economy finds itself at a crossroads, with the Chinese government seeking to implement the next wave of its ambitious reform programme, while sustaining sufficient growth levels to maintain national employment, social cohesion and rising individual wealth.

Here, BNY Mellon Investment Management considers some of the most recent trends and factors influencing the Chinese economy and government strategy with accompanying comments and opinions from our range of investment boutiques.

¹ Why China's economy is slowing. The Economist. 11 March 2015.

Economics

The emergence of China as an economic superpower is one of the major global development stories of the past three decades. With a land mass covering approximately 9.6 million square km² and with a population of over 1.3 billion,³ China is a giant nation in every sense.

Ambitious economic reforms which started as far back as the late 1970s and continued steadily in the 80s and 90s ultimately led to the country joining the World Trade Organisation in 2001 – massively reducing trade barriers and spurring a new generation of Chinese economic development and growth.

According to the International Monetary Fund (IMF)⁴ until its recent economic slowdown China had grown at a rate of almost 10% a year since the start of economic liberalisation in 1978.

This has translated into higher living standards and raised many out of poverty, while steering the economy to be one of the world's key manufacturing centres. In the process, over 270m people have moved from rural villages to work in Chinese cities.⁵ Such is the scale of urbanisation that China's cities are already home to more than half the country's population.⁶

The Communist Party of China continues to dominate politics in the country – having been in power since 1949 – and the government of President Xi Jinping is said to be committed to ongoing economic and social reforms, attempting to balance traditional command-driven, state-owned structures with increasing private sector activity and ownership and an emphasis on innovation.

- October 2014 saw the IMF update its data on the world economy and for the first time ranked China's economy as the world's biggest in purchasing-power-parity terms – a measure which allows comparison of how much people can buy for their money in different countries.⁷
- IMF figures showed the Chinese economy was worth US\$17.6 trillion, compared to America's US\$17.4 trillion – the first time China has overtaken the US.⁸

China: Quick Facts

POPULATION:	1.36 billion
2014 ANNUAL GDP GROWTH:	7.0%
2014 INFLATION:	2%
MAIN INDUSTRIES:	Industry and construction, agriculture, services, energy, automotive production.

Sources: The Economist – The World in 2015. December 2014/BBC. 09 January 2015.

But the national economy has also faced a range of headwinds, including weakening growth, a slump in house prices, renewed stock market volatility a heavy reliance on investment and credit (seen by many commentators as unsustainable) and growing speculation about the possibility of a hard economic landing.

After years of rapid economic expansion in China, 2015 saw significant market turbulence and uncertainty. Against this backdrop, its government is now attempting to steer a new course. Dubbed the 'new normal' by Chinese policymakers this path is expected to be one of lower growth as the government attempts to rebalance from heavy investment and industrial production to a more service sector, consumer-led economy.

2 CNTA. China in brief. 24 April 2015.

3 China reaps benefits of urbanisation. FT. 05 April 2013.

4 IMF Country report No. 14. 25 July 2014.

5 China's migrant miracle grinds to a halt as rural labour supply runs dry. FT. 05 May 2015.

6 The Economist. Where China's future will happen. 19 April 2014.

7 America usurped: China becomes world's largest economy. Daily Mail. 09 October 14.

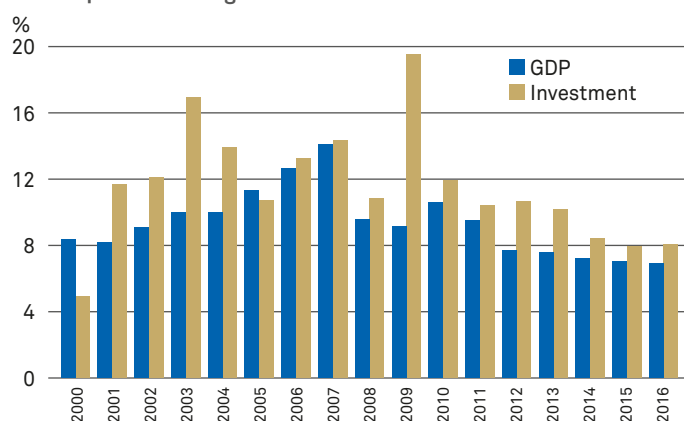
8 Daily Mail. America usurped: China becomes world's largest economy. 09 October 14.

Economic growth

In March 2015, the Chinese government set out what it hoped would prove a realistic annual growth target for 2015 of 7.0%.⁹ In light of renewed economic uncertainty and stock market volatility in the second half of 2015, the government did, however, suggest there might be a degree of flexibility with this target.¹⁰ The 7.0% level signals the slowest anticipated expansion in more than two decades and various agencies, including the IMF, forecast China's inflation adjusted GDP growth will continue on a gradually downward trajectory over the rest of the decade.

REAL GROWTH

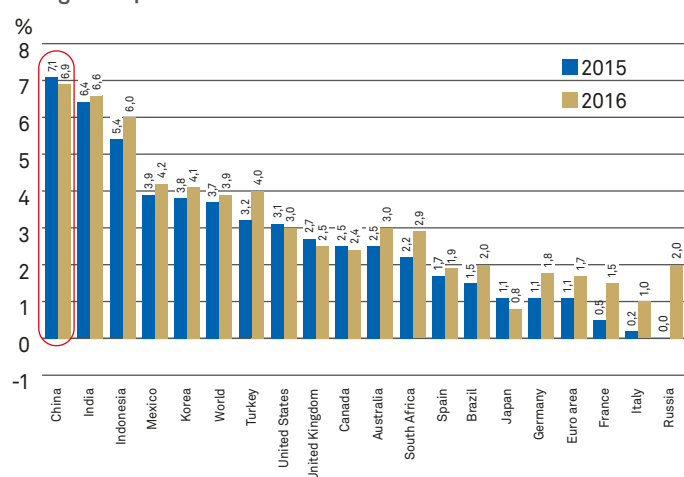
Annual per cent change



Source: FT. As at 31 December 2014/OECD. 2015 and 2016 = forecast.

GROWTH PROJECTIONS FOR 2015-16

GDP growth per cent



Sources: Preliminary November 2014 OECD Economic Outlook database. As at 31 December 2014.

China did report GDP growth of 7.0% per annum in the first half of 2015 – a dip from the 7.3% figure registered in the fourth quarter of last year and its economic growth also

dipped again to 6.9% in the third quarter of 2015. However, this level still places it among the fastest growing global economies.¹¹

- From a trading perspective, the total value of imports and exports in the first half of 2015 was Chinese yuan (CNY ¥)11,536.1bn, a year-on-year trade decrease of 6.9%, according to figures from the National Bureau of Statistics of China.
- These figures also show the total value of exports was CNY ¥6,572.2bn in the first six months of 2015, growing by 0.9% and for imports was CNY ¥4,959.4bn, down by 15.5%. The trade surplus was CNY ¥1,612.8bn.

In terms of future growth, much is said to depend on the implementation and success of further government reforms. These range from the introduction of a new nationwide property tax, to land and employment reforms and allowing Chinese provinces to issue bonds. The introduction of a deposit insurance scheme for banks to protect savers and potential part-privatisation of state-owned enterprises are also under discussion.¹²

“We think China will struggle a bit to meet its 7% growth rate this year. The sequential momentum of almost every single high frequency indicator has eased to a level consistent with a below 7% headline growth, and the one-off gains from financial services activity could be sharply curtailed following the equity market downturn.”

*Aninda Mitra, senior sovereign analyst, Standish**

Yuan or Renminbi?

The terms yuan (CNY) and renminbi are commonly used market names associated with the Chinese currency. While both are correct terms, each describes a different aspect of the currency. Renminbi is the official term for the Chinese currency – literally meaning “the people’s currency” – while yuan is the term for a unit of the renminbi.** This is similar to the use of the UK terms pound and sterling. As at May 2015 US\$1.0 was worth 6.2 Chinese yuan.†

**Source: BBC.
†Source: XE.com.

*BNY Mellon Investment Management EMEA Limited is the distributor of the capabilities of its investment managers in Europe, Middle East, Africa and Latin America. Investment managers are appointed by BNY Mellon Investment Management EMEA Limited or affiliated fund operating companies to undertake portfolio management services in respect of the products and services provided by BNY Mellon Investment Management EMEA Limited or the fund operating companies. These products and services are governed by bilateral contracts entered into by BNY Mellon Investment Management EMEA Limited and its clients or by the Prospectus and associated documents related to the funds.

9 China sets 2015 growth target at 7%. BBC. 05 March 2015.

10 *The Guardian*: China's growth target is flexible, says premier, 26 October 2015.

11 The 20 Fastest-Growing Economies This Year. Bloomberg Business. 25 February 2015.

12 China bank deposit insurance could tilt competitive landscape. CNBC. 01 April 2015.

Demographics and labour

While China remains classified as an emerging market, it faces a number of challenges some would consider to be more familiar to nations of the developed world. Among these is the potential threat posed by an increasingly ageing population which, coupled with low fertility rates, is leading to a dwindling working population.¹³ The severity of the threat saw the Chinese government announce the end of its controversial one-child policy in 2015 but this is expected to take time to deliver any major increase in birth rates.¹⁴

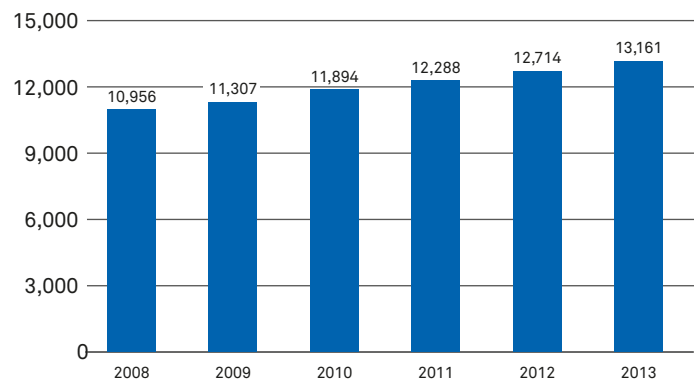
- Women represent 48.5% of China's total population of 1.37 billion and in 2011 the country ranked 34 out of 135 countries for female labour force participation, according to the World Economic Forum Global Gender Gap Report.
- 71.1% of women between the ages of 18-64 are employed; in urban areas, 60.8% are employed compared to 82.0% in rural areas.¹⁵

The Chinese retirement rate is similar, in some cases lower, than in the west – with men typically retiring at 60 and women often retiring at 55. This has potentially major impacts on the Chinese labour market as the country loses skilled, experienced workers at a steady rate.¹⁶ In this scenario, rising wages may pose a challenge to Chinese exporters.

As in the west, rising prosperity, improvements in nutrition and advances in healthcare mean life expectancy is improving for many Chinese people – with an average life expectancy of 76 years.¹⁷

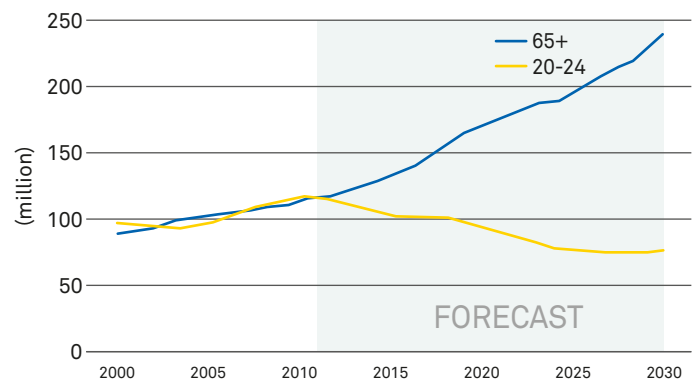
The benefits of a longer living population may be offset by rising pension and healthcare costs for an increasingly ageing population. The Chinese government, keenly aware of the potential threats ahead, believes its overarching economic reform programme can ultimately help address this.¹⁸

CHINA: POPULATION AGED 65 AND OVER (IN 10,000 PERSONS)



Source: National Bureau of Statistics of China as at 31 December 2013.

THE BURDEN OF AGEING
China's population by age group



Source: The Economist as at 05 May 2011.

"We find that demographics in China look quite unattractive compared to other countries (e.g. the Philippines). China's working age population is peaking in absolute terms and is poised to decline notably in the next few decades. At the same time we will see an aging population which will be a burden for the government."

Amy Leung, Asian Equity Team, Newton

¹³ Easing of China's one-child policy has not produced a baby-boom. The Guardian. 06 February 2015.

¹⁴ China to end one-child policy. BBC. 29 October 2015.

¹⁵ Catalyst.org: Women-labor-force-China. 04 February 2012.

¹⁶ Ageing population in China creates business opportunities. FT. 29 March 2015.

¹⁷ IBID.

¹⁸ China workers decline as demographic time bomb ticks. Mail Online. 20 January 2015.

Employment and industrial output

While globally competitive wage costs were considered an advantage to China throughout its rapid growth in the late 1990s and early 2000s, there are growing signs the picture is changing.

Rising wages and industrial disputes are becoming increasingly common features of the Chinese employment landscape. While investment and manufacturing in China remain an attractive proposition for many Chinese and multinational companies, the country no longer offers quite the low cost advantage it once did, though it still compares favourably with factory costs in many developed markets such as the US.¹⁹

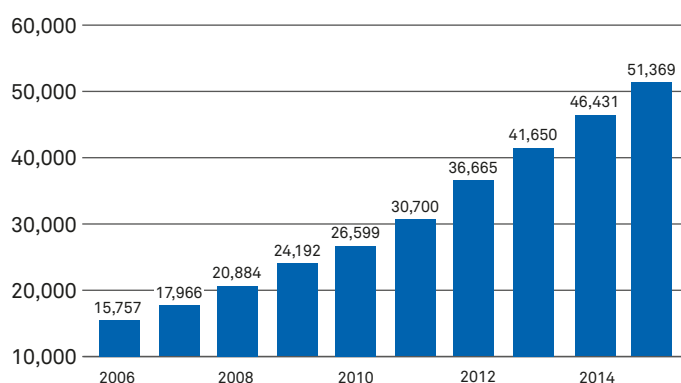
According to average yearly wages in manufacturing forecasts from global data website Trading Economics:

- Manufacturing wages are expected to increase from CNY ¥46k a year in January 2014 to CNY ¥56k by 2016.
- Manufacturing wages in China are projected to trend around CNY ¥78k, CNY ¥116k and CNY ¥174k in the years of 2020, 2030 and 2050 respectively.

“An area to keep an eye on is the labour market. Data is sketchy and not available with much frequency. But the anecdotal evidence is that rural to urban migration is slowing. What’s more, recent PMI (purchasing managers index) numbers show the employment/hiring sub-components have begun weakening. The authorities will remain acutely sensitive to hiring growth slowing sharply or redundancies rising rapidly.”

Aninda Mitra, Standish

CHINA AVERAGE YEARLY WAGES IN MANUFACTURING (CNY¥/YEAR)



Source: Trading Economics. 22 October 2015.

- Industrial production in China increased 5.70% in September 2015 over the same month in the previous year,²⁰ but factory production and fixed-asset investment in China were both weaker than expected in August, according to government figures²¹
- From an employment perspective, the Chinese government plays a key role in influencing the direction of minimum pay rates within the economy.
- In its latest five year plan to 2015, the government targeted an annual average rise in the minimum wage of 13%. In the manufacturing sector, hourly wages have risen by an average of 12% a year since 2001.²²

Urbanisation in China: Reforming the Hukou System

In March 2014 the Chinese government announced new plans to address problems arising from its rapid urbanisation, including a rise in pollution and social problems. As part of this process it aims to revise its *hukou* system.

Launched in the 1950s, the system is a form of household registration which officially records a person as a resident of a specific area. Traditionally it has been very hard to change a rural *hukou* registration to an urban one, depriving many migrants of equitable access to public services in the cities where they live.

Source: China: central government vision on hukou reform. UK Foreign and Commonwealth Office. 15 August 2014.

The reforms aim to erode the distinction between urban and rural residents in China’s smaller cities and are expected to help migrant workers access services and social welfare.

The Chinese government is looking to provide up to 100 million people with urban *hukou* registration by 2020 in an effort to ease inequality between rural migrants to Chinese cities and existing residents who already hold urban *hukou* registration.

²⁰ China Industrial Production. Trading Economics. 25 September 2015.

²¹ *The Wall Street Journal*: China Data Add to Doubts About Beijing’s Ability to Meet Growth Target.

²² IBID.

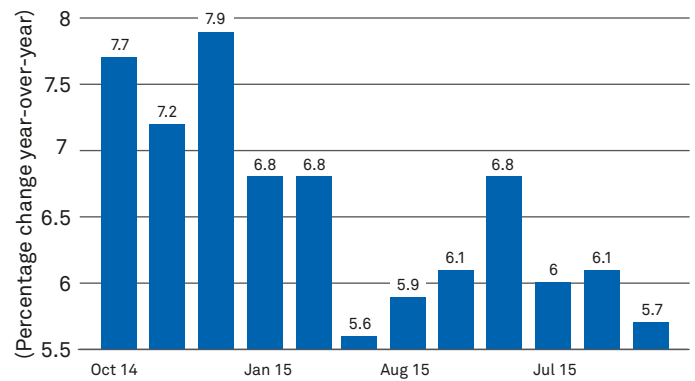
¹⁹ The Economist. A tightening grip. 14 March 2015.

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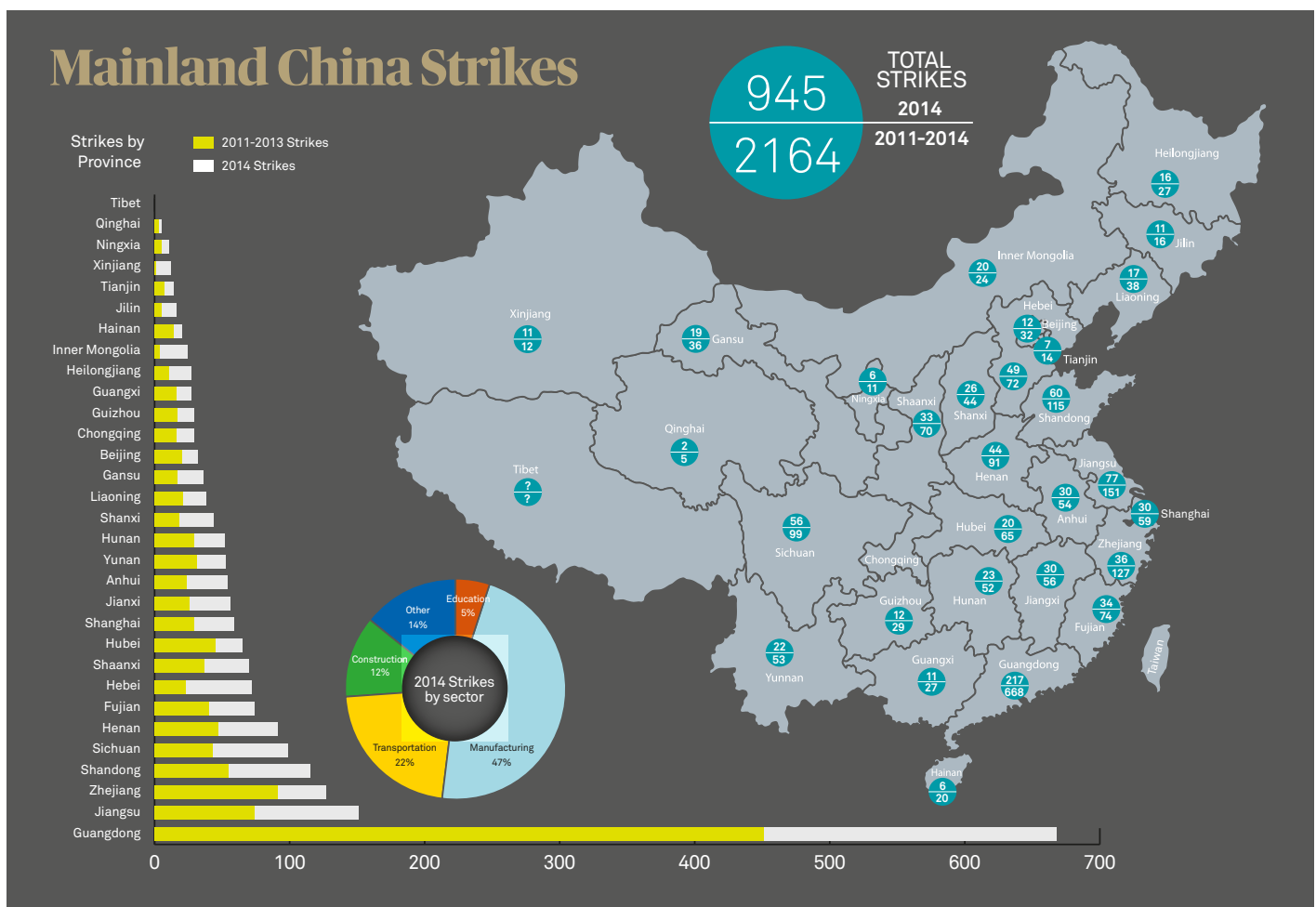
A shrinking domestic labour pool and increased wage pressures also appear to be fuelling rising industrial unrest. Hong Kong based NGO China Labor Bulletin claims the number of strikes doubled in the third quarter of 2014 compared to the same period a year earlier,²³ despite the fact that independent unions are outlawed in China. Some municipal authorities in manufacturing intensive regions, such as Guangdong appear to be taking the initiative on this front, introducing new regulations to codify workers' rights on collective bargaining in a bid to head off industrial strife.

- China is ultimately expected to move beyond manufacturing as its economy matures and evolves. To this end the Chinese government's reform programme – set out in 2013 – contains more than 300 measures designed to smooth this transition.²⁴
- Policies designed to speed up the growth of the service sector – now the largest sector in the Chinese economy have been set out. In addition, the government has been looking to attract a new wave of investment and technology, reforming financial markets to direct capital beyond heavy industry to more dynamic sectors such as retail, hotels and finance.²⁵

CHINA INDUSTRIAL PRODUCTION



Source: Trading Economics. 22 October 2015.



Source: China Economic Review. 10 November 2014.

23 Out brothers,out! The Economist. 31 January 2015.

24 Harnessing global capital to drive the next phase of China's growth. Goldman Sachs Global Markets Institute. 01 January 2015.

25 IBID.

Inflation

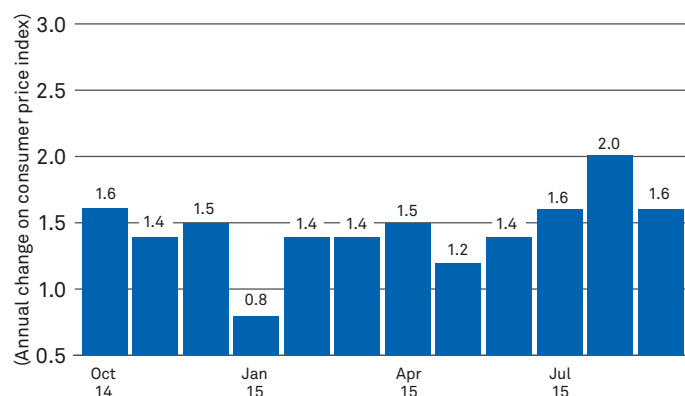
In September, the Chinese consumer price index (CPI) – the main gauge of inflation – went up by 1.6% on a year earlier, according to figures from the National Bureau of Statistics of China. This level is well below the Chinese government’s official 2015 inflation target of around 3%.²⁶ This has been most commonly attributed to a slump in global commodity prices, subdued demand and overcapacity in some sectors.²⁷

With fears of deflation preoccupying many global governments and prompting widespread money stimulus, China is not immune, with its own central bank intervening and cutting its domestic interest rates repeatedly in recent months in a bid to boost growth and stave off potential deflation.²⁸

Outside core inflation rates the picture appears even less positive.

- Oversupply and a slump in demand for products has ushered in the longest ever period of factory gate deflation in China, with producer prices falling lower in September 2015 for a record 43rd consecutive month.²⁹
- While any rise in inflation above 3% would prompt concern, action to stem deflation looks more likely if headline inflation rates were to fall significantly. Chinese policymakers have acknowledged the need to keep a close watch on inflation data in the months ahead.³⁰

CHINA INFLATION RATE



Source: Trading Economics, 22 October 2015.

“Excessive capacity in many of the primary sectors in China has eroded pricing power. The country has seen the producer price index (PPI) in deflation for the past 30+ months and this has increased the challenge of reducing debt to GDP, as a large part of the leverage in China is on corporate balance sheets.”

Amy Leung, Newton

26 China inflation misses Beijing target. FT. 10 April 2015.

27 IBID.

28 Bloomberg: China Cuts Interest Rates as Policy Divergence With US Widens, 23 October 2015.

29 Reuters: China September inflation cooler than expected, producer prices extend slump, October 13, 2015.

30 IBID.

Property sector

Real estate has been a key driver of economic growth in China, with a vast range of construction projects supporting growing urbanisation and modernisation of the country. The global financial crisis of 2008 also prompted the Chinese government to spend billions on national infrastructure projects in a bid to sustain and build growth through difficult market conditions.

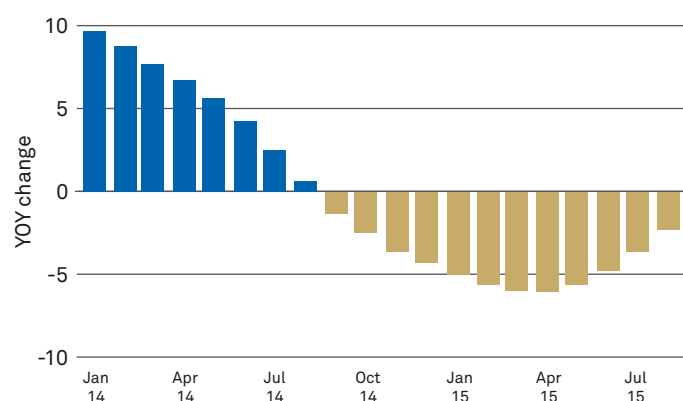
- Today, property and related sectors power nearly a fifth of the Chinese economy.³¹ Much of this has been funded by credit – triggering concerns about potential future debt crises.
- A downturn in the real estate market began in 2014 and continues to impact both the residential and commercial sectors. In the first four months of 2014 alone, newly started construction projects fell 22.1% compared with a year earlier.³²
- Despite the downturn, investment in the Chinese real estate development sector reach CNY ¥6.1 trillion in the first eight months of 2015 representing a year on year increase of 3.5%, according to the latest data released by China’s National Bureau of Statistics.

Recent IMF data suggests several Chinese regions are now oversupplied with property, fuelling fears of major overcapacity. So-called ghost towns and cities full of empty offices and residential buildings have become a visible sign of problems in the market.³³

Despite the recent decline, China has survived previous problems in its real estate sector and has a government willing to intervene. Consequently, the IMF is among global institutions which believe an orderly correction in the Chinese real estate market should be manageable.³⁴ Nevertheless, the IMF cautions: “the risk of a large drop in final (investor) demand has increased even if underlying, medium-term home ownership demand is sound.”

The Chinese property sector outlook remains mixed. The first 10 months of 2014 saw the value of residential sales fall by 10% compared to the same period in 2013³⁵ and the property downturn is expected to continue throughout 2015.³⁶

CHINA NEWLY BUILT HOUSE PRICES YOY CHANGE



Source: Trading Economics, 22 October 2015.

31 Coming down to Earth. The Economist. 18 April 2015.

32 Property sector slowdown adds to China fears. FT. 13 May 2014.

33 IMF Country report No. 14. 25 July 2014.

34 China property market set for demographic hit. FT. 05 December 2014.

35 Chinese cities see property prices fall. FT. 18 January 2015.

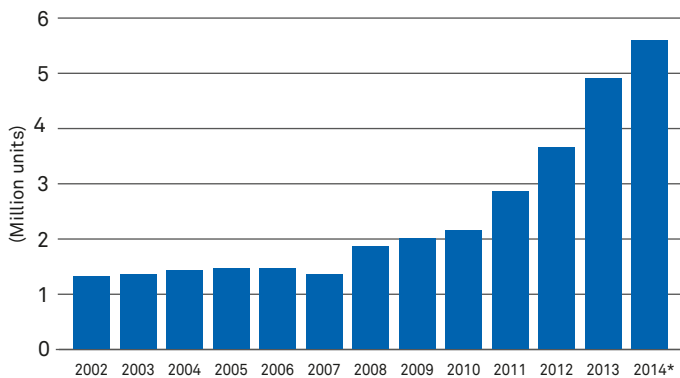
36 IMF Country report No. 14. 25 July 2014.

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“Until a wave of land privatisation in the early 2000s there had been no private property market in China and until then the market had not been able to determine the value of land. Following this change, prices soared from having no value at all to what we are seeing today.”

Amy Leung, Newton

CHINESE DEVELOPERS' INVENTORIES



*By end-August 2014.

Source: Coming down to Earth. The Economist. 15 April 2015.

Cementing Relations: China's Construction Boom

In global terms China's 2000s construction boom has seen unprecedented consumption of cement. While the US took a century to install 4.5 gigatons of cement from 1901-2000, China installed 6.5 gigatons in just three years from 2011-2013.

Source: Forbes statistics. 12 May 2014.

Consumer growth

Beyond its powerful industrial manufacturing capability, export base and large real estate sector, China also has a sizeable and growing consumer market. Recent economic slowdown in China is just one factor encouraging the government to hasten its shift from traditional dependence on exports and investments to a more service oriented, consumer-led economy.³⁶

There are some signs of optimism on this front. According to figures from the July National Bureau of Statistics of China report:

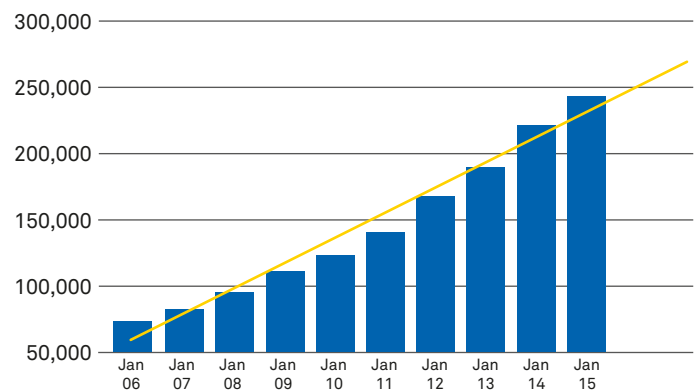
- The first half of 2015 saw total retail sales of consumer goods reach 14,157.7 billion yuan, a nominal year-on-year rise of 10.4%.
- Chinese consumers appear to be embracing online shopping. The first half of the year saw online retail sales reach 1,645.9 billion yuan, a year-on-year growth of 39.1%.

Growing prosperity in China and a rising middle class with genuine disposable income is spurring retail consumer growth. The 2014 annual integrated household survey by the National Bureau of Statistics of China found the national per capita disposable income was CNY ¥20,167, a nominal growth of 10.1% or a real increase of 8.0% after deducting price factors.³⁷

“We do see some good opportunities emerging in some of the more consumer and service-orientated parts of the Chinese economy.”

Rob Marshall-Lee, head of emerging market and Asian equities, Newton

CHINA CONSUMER SPENDING (CNY¥ HML)



Source: Trading Economics as at 22 October 2015.

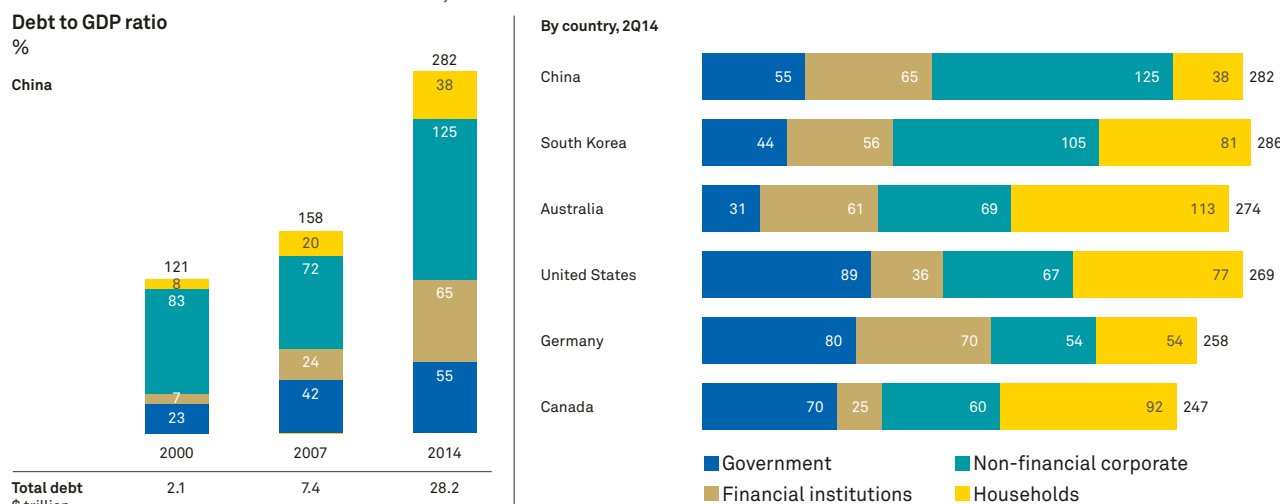
³⁶ China growth lowest since 2009 as property and manufacturing drag. FT. 15 April 2015.

³⁷ The National Bureau of the Statistics of China. China's Economy Realized a New Normal of Stable Growth in 2014. 20 January 2015.

Financial and policy making

At a macroeconomic level debt remains a concern for the Chinese government. Between 2008 and late 2014 total debt had risen to stand at levels of over 280% of GDP in mid-2014, according to research by McKinsey & Company – far higher than many other emerging markets.³⁸

CHINA'S DEBT REACHED 282% OF GDP IN 2014, HIGHER THAN DEBT LEVELS IN SOME ADVANCED ECONOMIES



Source: MGI Country Debt database; McKinsey Global institute analysis. Note: Numbers may not sum due to rounding. All by country dates as at Q2 2014.

- China's investment-driven leverage is almost entirely domestically financed³⁹ and household savings rates are high.⁴⁰
- China is currently using various measures to push its credit risk further into the future and its monetary policy continues to show an easing bias.⁴¹ Targeted easing was a major theme in 2014.⁴²
- The Chinese government has moved to provide greater protection to savers. In April 2015 it announced it would insure all bank deposit accounts up to CNY ¥500K (cUS\$80,700) from later in the year.⁴³

At a global level, slow but steady liberalisation of China's capital markets continues – with the government moving to revise the

regulation guidelines on exchange controls to encourage capital inflows, open up more securities markets including bond markets and freeing up access to cross-border investments⁴⁴

In addition:

- The Qualified Foreign Institutional Investor (QFII) and Qualified Domestic Institutional Investor (QDII) programmes have opened significant gateways for foreign investors, albeit through tightly supervised quotas.
- In March this year, the Chinese government announced its aim to make the renminbi more fully convertible for capital account transactions in 2015 in order to encourage foreign capital flows and other cross-border investments⁴⁵

The Asian Infrastructure Investment Bank

In order to boost regional infrastructure investment, China has sought to emulate existing international financial institutions such as the World Bank and Asian Development Bank by proposing its own regional development bank – the Asian Infrastructure Investment Bank (AIIB).

While the US government appears to view the project with some suspicion and has so far refused to join*, a range of emerging countries and developed nations including Britain,

France, Germany and Italy have expressed their desire to sign up to the project.

While the AIIB project has attracted political controversy from the start, its growing pool of financially strong and transparent members from developed economies looks positive for its financial future. The Bank's articles of agreement necessary for launch are expected to be in place by the end of 2015.

Sources: The Asian Infrastructure Investment Bank. 15 April, 2015/*Political Aspects of AIIB Establishment. Strategic Culture Foundation. 17 April 2015.

38 The Economist. Chinese debt: The great hole of China. 18 October 2014.

39 The Economist. 200% and counting. 16 July 2014.

40 The Economist. On cloud nine trillion. 29 March 2014.

41 Reuters. Chinese money rates tumble to 4-month lows on easing expectations. 03 April 2014.

42 Bloomberg. China central bank signals no broad monetary easing. 03 August 2014.

43 Reuters. China bank deposit insurance could tilt competitive landscape. 01 April 2015.

44 Deutsche Bank Research. China – RMB may become convertible in 2015. 07 April 2015.

45 IBID.

Interest rates and shadow banking

China's central bank, the People's Bank of China (PBC) has more financial assets and resources than any other financial institution in the world.⁴⁶ In October 2015 the PBC cut the benchmark one-year lending rate by 25 basis points to 4.35%, according to Tradingeconomics.com. In addition the PBC announced:

- The Chinese one year deposit rate would also be cut from 1.75% to 1.5% in October.⁴⁷
- Reserve requirements for all banks would be lowered by 50 basis points, with an extra 50 basis point reduction for some institutions.⁴⁸

The Chinese central bank is considered to have complete autonomy with regard to the use of monetary instruments, meaning among its many responsibilities it sets the interest rates for commercial banks. As such the bank has influence over the rates paid in the market for loans and mortgages as well as the interest paid on savings.⁴⁹

It is this that has led to what is called China's system of financial repression. According to a US academic economics report into the subject: "China has been experiencing financial repression for a long time. The main feature of this repression is a regulated interest rate system. This results in private firms' low likelihood of getting money from the official banking system and at the same time seeded the emergence of the shadow banks."⁵⁰

China's banks are predominantly state-owned, the largest lenders in the country and in 2013 were reportedly considered to be "hugely profitable", according to an August 2013 article (Too Big to Hail) in The Economist.

A decade ago, the conventional, state-owned Chinese banks accounted for virtually all lending in China – since 2010 this has changed. Today credit is available from a range of alternative financiers, such as trusts, leasing companies even money-market funds – known collectively as shadow banks.⁵¹ While some forms of 'shadow banking' are considered more salubrious than others, overall this industry accounted for almost a third of the rise in lending in 2013.⁵²

"Chinese banks have cut their dividend pay-out rates and are reporting a rising number of non-performing loans. We think this is the beginning of a trend and profitability for these companies will become harder. As such it remains an unappealing sector for us."

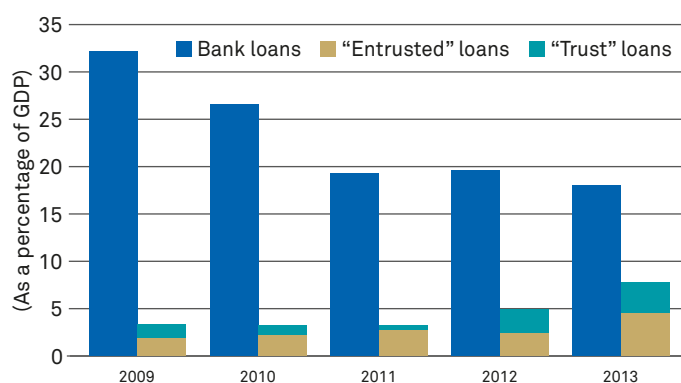
Caroline Keen, Newton

CHINA'S BIG FOUR BANKS
2012, \$bn (world rank)

	Tier-1 capital	Net interest income
Industrial and Commercial Bank of China (ICBC)	161 (1)	66 (1)
China Construction Bank (CCB)	138 (5)	56 (2)
Bank of China (BOC)	122 (9)	41 (8)
Agricultural Bank of China (ABC)	111 (10)	54 (3)

Source: The Economist, August 2013.

GROWTH OF DIFFERENT FORMS OF CREDIT IN CHINA



Source: OECD/The Economist, 10 May 2014.

"A slowdown in bank lending is beginning to turn around, following monetary easing by the authorities. This is offsetting the clampdown on shadow bank lending. However, there is growing anecdotal evidence of extensive rollovers and interest-capitalisation of unpaid loans. Credit risk and reported non-performing loans (NPLs) are on the rise. That said, the China Banking Regulatory Commission (CBRC) claims to have stress-tested loan portfolios rigorously and, as per their (unpublished) conclusions, remain comfortable with the results."

Aninda Mitra, Standish

46 Global-rates.com.

47 Bloomberg: China Cuts Interest Rates as Policy Divergence With US Widens, 23 October, 2015.

48 Ibid.

49 Ibid.

50 economics.indiana.edu/home/conferences/2014-jordan-river-economics-conference/files/2014-05-02-05.pdf.

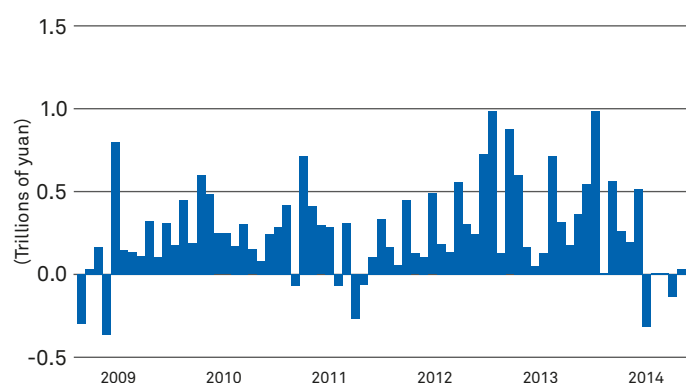
51 The Economist. Battling the Darkness. 10 May 2014.

52 Ibid.

A March 2015 Bloomberg report stated: “In China, savings deposit rates of 3%, lower than the target for inflation, combined with the inability of at least 90% of small businesses to get bank loans, have propelled the shadow-banking sector to an estimated US\$6 trillion.”

- The outstanding value of shadow-banking products stood at CNY ¥21.87 trillion at the end of November 2014, up 14.2% from the level a year earlier, according to estimates by Nomura Securities based on central-bank data. That growth is considered to be significantly slower than the 35.5% rise it registered for the whole of 2013 and the 33.1% gain in 2012.⁵³
- Beijing has since implemented regulations in an attempt to stave off growth in the shadow banking sector. At the start of 2015 the banking regulator further issued draft rules to restrict the use of company-to-company loans, China’s largest non-bank lending channel.⁵⁴ Growth in China’s shadow banking industry has since declined.

NET INCREASE IN SHADOW-BANKING NEW PRODUCT ISSUANCE

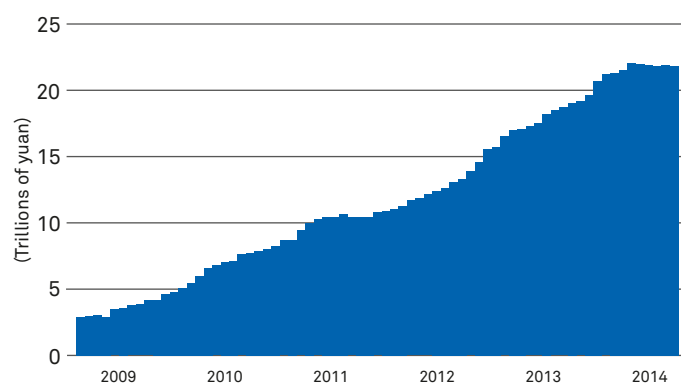


Source: The Wall Street Journal. December 2014.

“In some ways the Chinese government might have a favourable view on the shadow banking system as it pushes the state-owned banks to innovate. Very likely the government will encourage it to develop in the right way, to get around the problem of inefficiencies and complacency at the state-owned giants which have dominated the financial system in the past.”

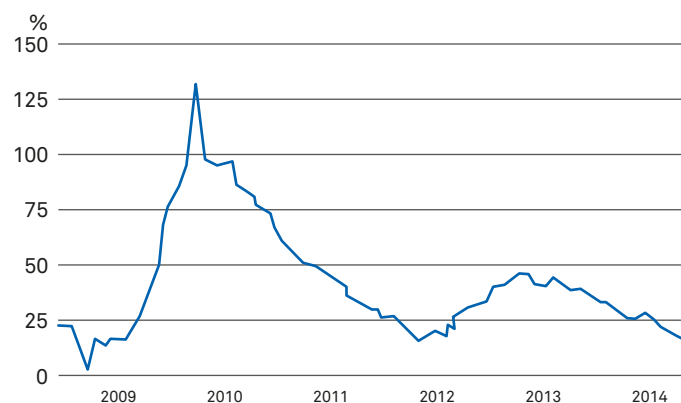
Amy Leung, Newton

OUTSTANDING VALUE OF SHADOW-BANKING PRODUCTS



Source: The Wall Street Journal. December 2014.

GROWTH IN OUTSTANDING VALUE OF SHADOW-BANKING PRODUCTS



Source: The Wall Street Journal. December 2014.

Chinese equity markets

Chinese equity markets enjoyed mixed fortunes in 2015, with the early half of the year producing strong returns, only to be followed by major market falls.

From a structural market perspective, Chinese companies can list and trade on both the mainland and Hong Kong stock exchanges. ‘A’ shares are available on the Shanghai and Shenzhen exchanges but are predominantly open to only domestic investors. Hong Kong listed H shares are mainly available to and accessed by non-Chinese investors.⁵⁵

53 The Wall Street Journal: China’s Shadow-Banking Boom is Over. 23 December 2014.

54 FT.com: China shadow bank regulation shows results. 02 February 2015.

55 Hong Kong Stock Exchange. Shanghai-Hong Kong Stock Connect FAQ. 26 March 2015.

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Foreign investors are also able to invest in companies in mainland China through a growing range of exchange traded funds (ETFs). Commonly used China equity indices include the Shanghai Stock Exchange Composite Index (SHCOMP Index) and the Hang Seng China Enterprise Index (HSCEI).⁵⁶ The SHCOMP is a capitalisation-weighted index, tracking the daily performance of all A and B-shares listed on the Shanghai Stock Exchange. The HSCEI index is a free-float, capitalisation-weighted index comprised of H-Shares listed on the Hong Kong Stock Exchange and included in the Hang Seng Mainland Composite Index.⁵⁷

In 2014, the Shanghai Stock Exchange (SSE) became the best performing major global stock market of the year, rising more than 50%. But while the upward trend continued in early 2015, the market hit difficulties in the second half of the year.⁵⁸

- Although the China Stock Market (SSE Composite) gained 21.27% in sterling terms in the first quarter of 2015, with the Hang Seng Mainland Composite index, returning 11.27% in sterling terms over the same period, the third quarter saw major stock market falls.
- At one point the Shanghai Composite Index, which includes China's biggest companies, fell 8.5%, to 3725.56⁵⁹ as concern grew about the Chinese economy.
- By early October, however, some signs of renewed confidence had returned, as Chinese share prices jumped to their highest level in some weeks amid hopes the stock market correction was nearing its close.⁶⁰

SHANGHAI STOCK EXCHANGE COMPOSITE INDEX 12 months to 22 October 2015



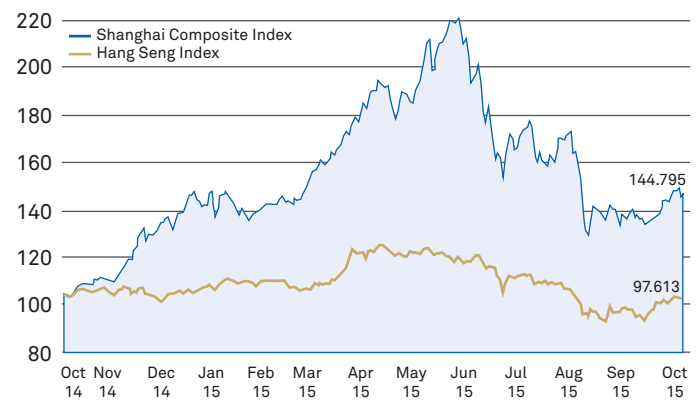
Source: Bloomberg, 22 October 2015.

"We think the government is allowing a bit of a stock market bubble to form in A-shares in an effort to boost sentiment and hope for a trickle-down effect in propping the economy in the face of a slowdown.

Based on the combination of availability and valuation, trading at a huge premium to H-shares, the A-Shares market is not attractive to us right now. I don't see myself investing in the domestic market anytime soon. In my opinion the best, particularly high-yielding, companies are listed in Hong Kong."

Caroline Keen, Newton

SHANGHAI COMPOSITE INDEX V HANG SENG INDEX 12 months to 22 October 2015



Source: Bloomberg, 22 October 2015.

Supportive monetary policy from China's central bank, optimism on government reforms and ongoing efforts to open the Chinese market to foreign investors are among some of the key factors said to have driven the SSE upwards before its most recent bout of market volatility.⁶¹

Launched in 1990, the SSE had seen major changes in 2014 with the launch of Shanghai-Hong Kong Stock Connect. The so-called through train, the Connect scheme allows Hong Kong investors to buy Shanghai-listed securities and investors from the Chinese mainland to buy shares listed in Hong Kong.

The Hong Kong market's global accessibility means the move effectively opens up investment in most of the SSE's securities to investors across the globe.

In March 2015, SSE chairman Gui Minjie announced fresh plans to transform and modernise the exchange with the aim of improving the Shanghai-Hong Kong Stock Connect system and developing China's nascent options market via an exchange traded fund (ETF) option.⁶²

⁵⁶ Hong Kong Stock Exchange. Shanghai-Hong Kong Stock Connect FAQ. 26 March 2015.

⁵⁷ Bloomberg. 21 April 2014.

⁵⁸ BBC. Bull run in Chinese shares is just the 'beginning'. 13 January 2015.

⁵⁹ The Wall Street Journal: China Stocks Tumble 8.5%, Calling Into Question Beijing's Market-Rescue Effort, 28 July 2015.

⁶⁰ The Telegraph: Asian markets rally as China says stock market correction 'almost over', 12 October 2015.

⁶¹ BBC. Bull run in Chinese shares is just the 'beginning'. 13 January 2015.

⁶² Reuters/MailOnline. China stocks retreat as crackdown fears trump latest bank easing; rates, yuan also falls. 20 April 2015.

Chinese companies

Chinese e-commerce company Alibaba Group made news last year having completed what was called the world's largest initial public offering (IPO) in September 2014.⁶³ According to a Forbes' article that month, Alibaba raised US\$25bn, surpassing the 2010 offering from the Agricultural Bank of China, which raised US\$22.1bn when it debuted on the Hong Kong Stock Exchange.

Ahead of the Alibaba float, in May 2014 Forbes reported Chinese companies accounted for the top three spots (and half of the top 10) in its Forbes Global 2000 list of the world's largest, most powerful public companies, as measured by revenues, profits, assets and market value.

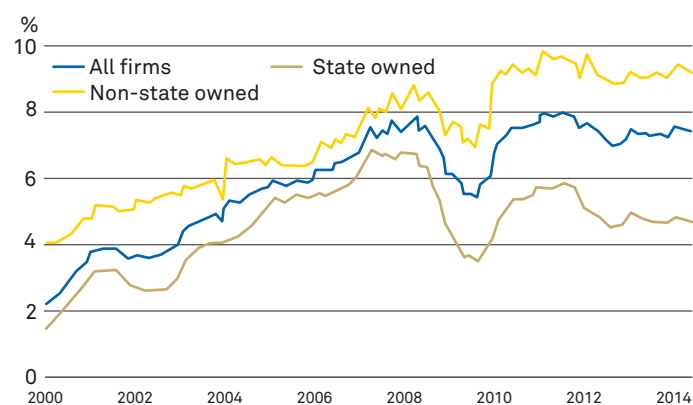
- State-controlled Chinese bank ICBC is number one on the Forbes' list with China Construction Bank in second place and Agricultural Bank of China ranked third.
- Also within Forbes' top 10 is the other member of the 'big four' Chinese banks, Bank of China, at number nine.
- Overall the US and Japan had the largest number of companies in the Global 2000 list in 2014 with China (mainland and Hong Kong) coming in third with 207.
- With an increase of 1,054%, mainland China added more companies to the Global 2000 list in 2014 than any other country in the world since 2003.

The presence of state-owned enterprises (SOEs) is one aspect of the Chinese equity market that has been increasingly criticised. China has about 100,000 SOEs at the national and local level, ranging from large companies such as PetroChina and China Mobile to smaller provincial-level firms. Many of these companies are considered to have serious internal problems, including mismanagement, inefficiency, and inaccurate accounting methods.⁶⁴

According to an article in the Wall Street Journal in March 2015, state companies are under pressure to hand the government 30% of their profits by 2020 – up from 15% or less now. The article reads: "Some of this is to be earmarked for costs related to a rapidly aging population. The new plan adds a goal of making the biggest state companies profitable enough to go public by 2025, according to the officials."

- Since the financial crisis, the productivity gap between state-owned and private companies has reportedly widened, with average return on assets for state entities at around 4.6% compared with 9.1% for private companies, according to estimates by GaveKal Dragonomics, a Beijing-based economic research house.⁶⁵
- State-owned Assets Supervision and Administration Commission (SASAC) controls 113 central SOEs, compared to 98,554 companies owned at the local level. But central SOEs control fully 53% of overall SOE assets totalling RMB95.7 trillion.⁶⁶

RETURN ON ASSETS OF CHINESE INDUSTRIAL FIRMS



Source: Gavekal Dragonomics & The Economist. 30 August 2014.

63 Forbes. Alibaba claims title for largest global IPO. 22 September 2014.

64 TheDiplomat.com. Xi's New Year's Resolution: Reform China's State-Owned Enterprises. 14 January 2015.

65 The FT. China announces plan for reform of state-owned enterprises. 15 July 2014.

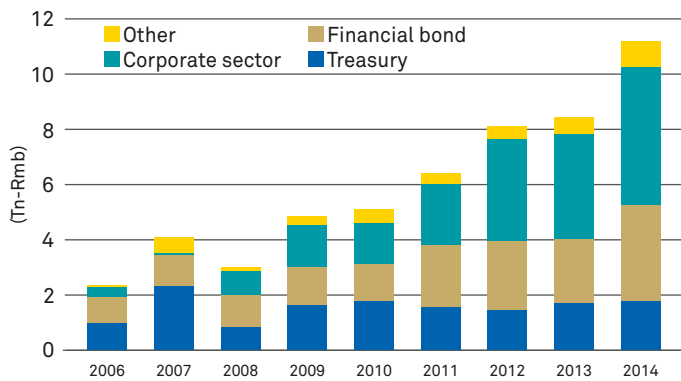
66 IBID.

Fixed income

From a fixed income perspective China has a well-developed US\$4 trillion bond market, rated as the third largest in the world by the Bank for International Settlements as of June 2014.⁶⁷ This has seen a recent boom, with net bond issuance reaching CNY ¥8.7 trillion, up from 67% in the same period a year earlier.⁶⁸ The Chinese fixed income market trades in government Treasury bonds, policy bank bonds, corporate bonds, medium term notes (MTNs), commercial bank bonds, government supporting and central bank bonds, asset-backed and mortgage-backed securities and a limited pool of other fixed income instruments.⁶⁹ Access by foreign investors has been introduced gradually via newly formed programmes.

Commenting on the potential strengths of the market in its November 2014 research paper: *A Changing Bond Landscape in China Index* provider S&P Dow Jones Indices says: "With the gradual opening of its capital markets and the size of its economy, China may present attractive investment opportunities to investors who are seeking to access its economic growth. In particular, China's onshore bond market contains attractive features in the form of higher yield, a stable currency and a low correlation to developed bond markets."

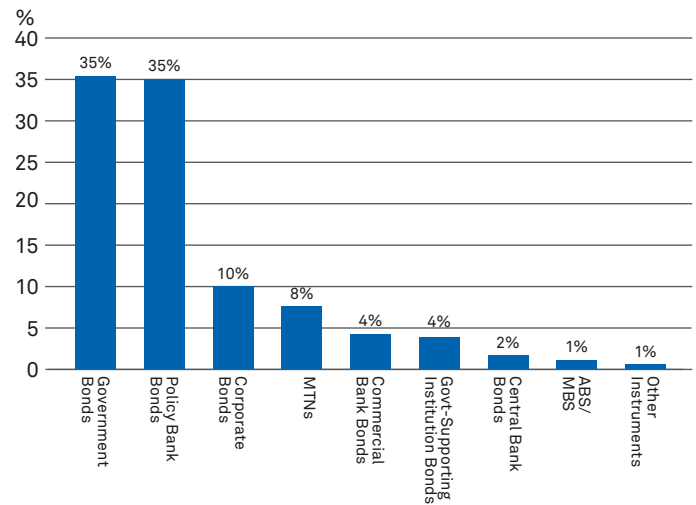
STRONG GROWTH IN THE CHINESE BOND MARKET Historical China bond issuance



Note: not including central bank bills.
Source: Wind, Goldman Sachs Global Investment Research. As at 31 March 2015.

Commenting on recent market performance and yield the report added: "With a relatively stable currency, Chinese bonds have offered attractive yields compared with those from developed markets. The 5-Year government bond yielded 3.96% as of the end of September 2014, compared with yields below 2% from US, German and Japanese government bonds."

CHINA'S BOND MARKET COMPOSITION



Source: www.chinabond.cn. Data as of September 2014. Charts and tables are provided for illustrative purposes.

At an infrastructural level, the SSE this year announced ambitious new plans to develop an exchange traded bond market, simplify issuance and listing procedures and expand the scale of asset securitisation in China. In a statement Gui Minjie pledged to "promote the building of a multi-layer bond market and improve the technological systems of the market."⁷⁰

"The Chinese central government bond curve has rallied in the last three months with lower policy and front-end rates and liquidity easing and supporting the mid-long end of the curve. Greater reliance on bond financing, relative to credit, will be underpinned by a broadening of the debt market and efforts to lower the structure of interest rates."

Aninda Mitra, Standish

67 Bank for International Settlements as of June 2014; Goldman Sachs Global Liquidity Management first half 2015. 10 March 2015.

68 *The Economist*: Deleveraging delayed, 23 October 2015.

69 Chinabond.com. 01 September 2014.

70 Gui Minjie: To transform SSE into a modern exchange. SSE/Shanghai Securities News. 09 March 2015.

What next?

While Chinese stock market performance started 2015 strongly, the market volatility seen in the third quarter of the year unnerved many investors. Against this backdrop, global investment opinion remains divided on whether the wider Chinese economy is heading for a hard or gentle landing as it embraces the “new normal”.⁷¹

Official third quarter figures released in October 2015 showed GDP growth on the previous year of 6.9% – the lowest level since 2009⁷² – and despite China’s economic resilience its problematic property market and rising bad debts are said to complicate the picture further.

Economic expectations vary. World Bank forecasts suggest growth will reach 7.1% this year – down from 7.4% in 2014 – but it points to the potential security offered by China’s large US\$3.9 trillion pool of foreign exchange reserves.⁷³

“The main challenge for the foreseeable future is that China is running up against the “impossible trinity” of simultaneously maintaining desirably low interest rates, a stable exchange rate and also controlling capital flows. For now the Chinese government seems willing to tolerate some loss of external competitiveness as well as foreign exchange (FX) reserves.”

Aninda Mitra, Standish

OECD macroeconomic indicators and projections suggest China’s annual growth will slow to 6.9% over 2015-19 as the country adjusts to changing demographics, a shift from investment to consumption-led growth and agricultural, environmental and educational challenges.

The Chinese government has shown its willingness to intervene in the market in a bid to stimulate growth. As just one example of this, April 2015 saw the government cut the level of cash commercial banks must hold with the Chinese central bank – the so-called reserve requirement ratio – by 1%.⁷⁴

While a return to the double figure growth of the early 2000s appears unlikely, much depends on the ability of the Chinese government to successfully implement its wide ranging reform programme.

“Although on the surface it looks like GDP growth is on track, as a long term investor we are mindful of the underlying risks in the economy – excessive leverage, shadow banking, the risk of a real estate bubble especially in the smaller tier 3 and 4 cities, capital outflows and a gradually shrinking FX reserve balance, amongst a number of other factors. We think the fundamentals of the economy have yet to be fully reflected in share prices.”

Amy Leung, Newton

71 The Guardian. China’s economy: hard landing or welcome rebalancing? 13 April 2015.

72 The Guardian: Chinese economic growth slows to 6.9% in third quarter despite stimulus, 19 October 2015.

73 The Guardian. China’s economy: hard landing or welcome rebalancing? 13 May 2015.

74 FT. China slashes cash reserve ratio as slowdown deepens. 20 April 2015.

Debating the state of... ..China

China: macroeconomic indicators and projections

	2008	2009	2010	2011	2012	2013	2014	2015	2016
	% change								
Real GDP	9.6	9.2	10.4	9.3	7.7	7.7	7.4	7.0	6.9
Exports of goods and services ¹	8.5	-10.1	27.6	9.0	5.3	8.6	5.4	5.5	6.0
Imports of goods and services ¹	4.0	4.5	20.6	10.2	6.3	10.7	7.1	7.5	5.9
GDP deflator	7.8	-0.6	6.6	7.8	4.8	2.2	0.8	0.9	1.3
Consumer price index	5.9	-0.7	3.2	5.5	2.6	2.6	2.1	1.8	2.0
Terms of trade	-5.5	8.8	-9.6	-3.4	2.8	1.3	2.7	2.6	0.2
	% of GDP								
Fiscal balance									
Overall ²	1.0	-0.5	0.1	0.5	0.0	-0.3	-0.5	-1.2	-1.5
Headline ³	-0.1	-2.8	-2.5	-1.8	-1.5	-2.0	-1.8	-2.3	
Current account balance	9.3	4.9	4.0	1.9	2.5	1.9	2.1	2.3	2.5
	Billion USD								
Foreign exchange reserves, end-year	1,946	2,399	2,847	3,181	3,312	3,821	3,843		
	% change								
Housing prices deflated by the CPI ⁴	6.5	1.5	9.8	4.2	-0.7	5.9	2.6		
Total employment	0.3	0.3	0.4	0.4	0.4	0.4	0.4		
Urban employment	3.7	3.8	4.1	3.5	3.3	3.1	2.8		
	Level								
Nationwide Gini coefficient for household disposable income	0.49	0.49	0.48	0.48	0.47	0.47	0.47		

Notes: 2015-16 figures are OECD forecasts.

1 OECD estimates.

2 The overall fiscal balance encompasses the balances of all four budget accounts (general account, government managed funds, social security funds and the state-owned management account).

3 The headline fiscal balance is the official balance defined as the difference between the three items: i) general budget revenue, ii) revenue from the central stabilisation fund, iii) sub-national budget adjustment on the revenue side and the three items, iv) general budget spending, v) replenishment of the central stabilisation fund and vi) repayment of principal on sub-national debt on the spending side. The 2015 figure is the official deficit target.

4 The housing prices are estimated using the property price index of 70 cities for 2008-10, then the simple average of the property price index of newly constructed residential housing of 70 cities for 2011-14.

Source: OECD. As at 31 March 2015. Forecasts and estimates based on the OECD Economic Outlook 96 and CEIC databases.

Commenting in a recent economic outlook⁷⁵ the OECD points to the need for greater social equality and better education, adding: "Rural and agricultural development could help promote urban-rural social equality. Continued improvements in education are required. Reforms are also needed to support the development of the services sector, which has the potential to help drive future growth."

For its part, while satisfied with the success of some existing reforms, the Chinese government appears pragmatic on the scale of the challenges ahead. According to a January 2015 dispatch from the National Bureau of Statistics of China:⁷⁶ "Generally speaking, China's economy has achieved stable

progress with improved quality under the new normal in 2014. However, we should also be aware that the domestic and international situations are still complicated and the economic development is facing with difficulties and challenges.

"In the next stage... we must keep the economic operation within proper range, prioritise the economic transformation and structural adjustment, focus on the reform and major breakthroughs, highlight the driving force of innovation, strengthen the fending off of risks, improve people's livelihood and security and promote a sound and sustainable economic growth and social harmony and stability," it concluded.


75 OECD Economic Outlook for South East Asia and China in 2015 - Strengthening Institutional Capacity 2015. 23 March 2015.

76 The National Bureau of the Statistics of China. China's Economy Realized a New Normal of Stable Growth in 2014. 20 January 2015.

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