



INFINUM PARTNERS

China

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A member of the JD-Infinum Group

Index

I. Chinese stock market, what happened ?

- Chinese stocks initially ran up fast!
- Like any bubble, it eventually burst!

II. Meanwhile Chinese macro aggregates are weakening

- China's economy is slowing down further than expected.
- Chinese debt burden is inflating.

III. Can China be the catalyst for a world economic recession?

- It depends if it is a hard or soft landing, and how strongly property market recovers.
- Based on soft landing assumption China should not be such a catalyst.

II. Investment takeaway

- Despite a very volatile environment, China still represents a good long term value.

Chinese stock market, what happened?

Putting things into perspectives: Chinese stocks initially ran up fast!

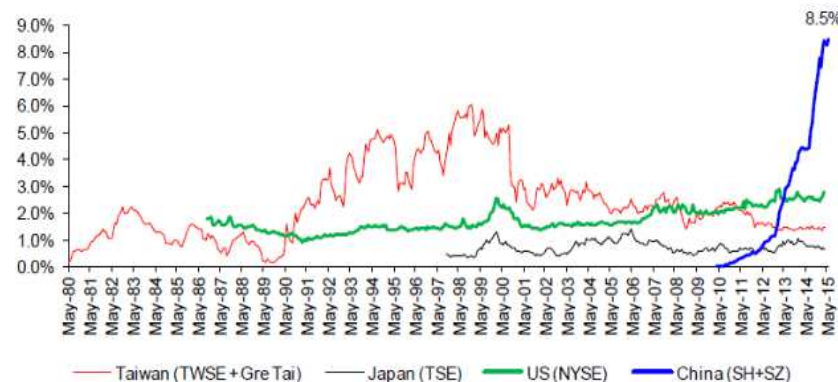
Shanghai Composite rallied by 125% in the 7 months to its peak on June 12th, 2015



But this rally embedded all the signs of a bubble:

- **Market driven by retail demand investors:** 85% of the market
- **Huge increase in margin loans:** 15% of transactions were led by margin debt, which accounted for up to 8.7% of est. free float (vs. 3.5% in most DM)
- **Expensive valuations:** Shanghai index (PE 18x) vs hist. avg. of 9x
- **Small stock market relative to GDP:** market cap. to GDP of 0.36x (vs. US 1.05x)
- **Low free float:** 30% (vs Japan 75%); Largely a state-owned market

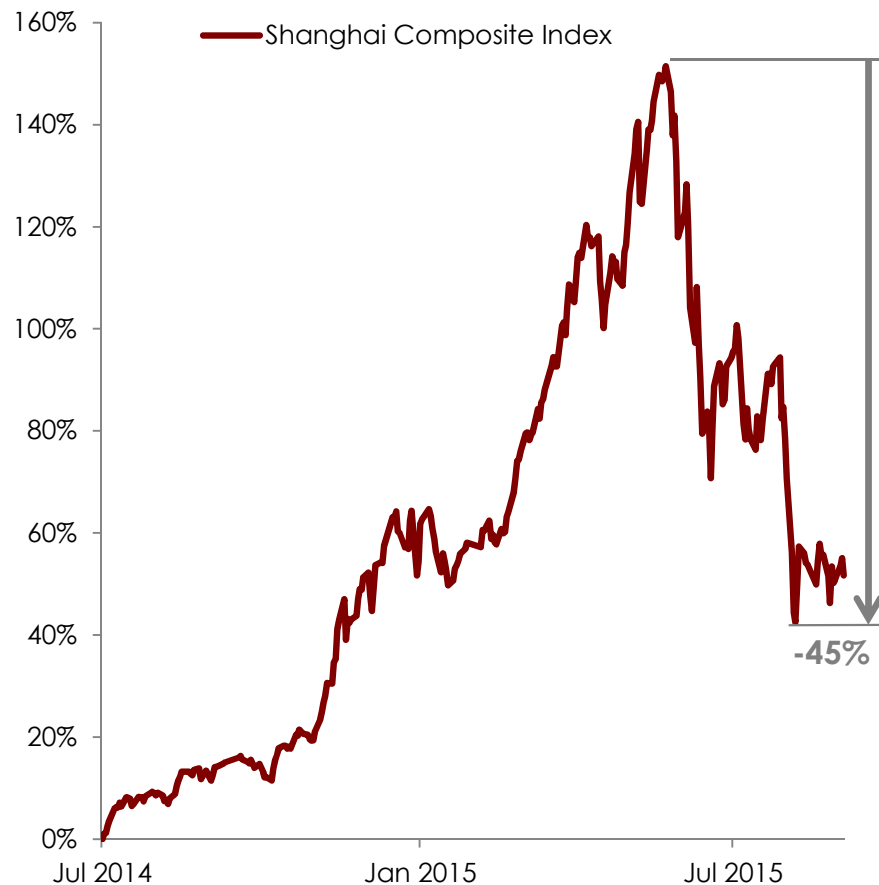
Stock margin debt as % of estimated free float



Chinese stock market, what happened?

Like any bubble, it eventually bursts!

The Shanghai Index collapsed by 45% from peak to trough



Triggered government interventions:

- Banned short-selling
- Introduction of circuit breaker on market volatility
- Set daily trading limits of 10% for the rise and fall of individual stocks
- Tighter control on broker's margin requirements
- Allowed pension funds to invest up to 30 % of their assets in equities

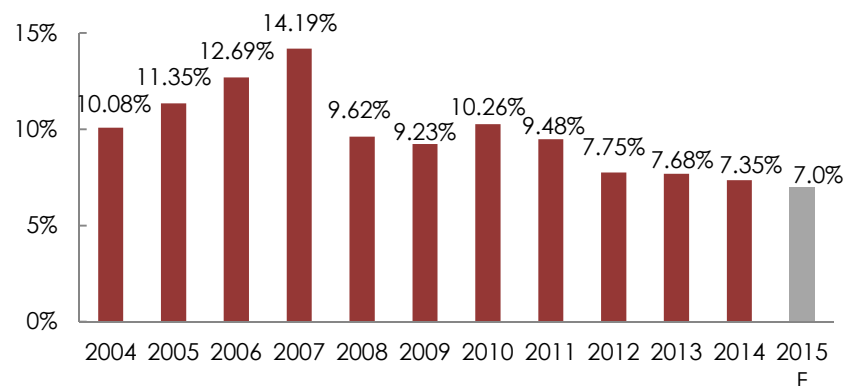
⇒ Market stabilizing:

- Hang Seng valuation back to 6.9x P/E, at 1 std. dev. below its 5-yr mean.
- Margin lending drop by half from 2 to 1 trn Yuan.

Meanwhile Chinese macro aggregates are weakening

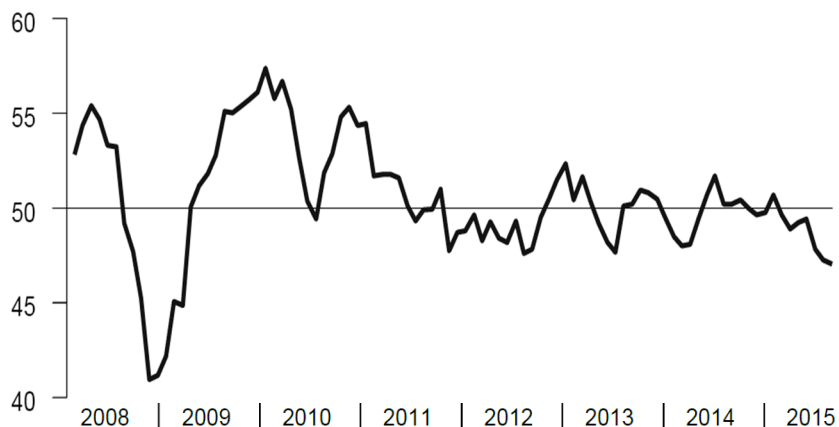
China's economy is slowing down further than expected.

GDP growth falling below 7% (vs +10% in 2010)



Manufacturing activity has fallen in recent months

PMI (Reading below 50 indicate contraction)



- **Chinese trade data remains weak:** Export in August were 5.5% below y/y. (-8.35 in July) ; Imports slumped further to -13.8% y/y.
- **PMI contracting:** Caixin PMI fell to a 6-yr low, at 47.
- **Low Inflation:** CPI remain below 2%.

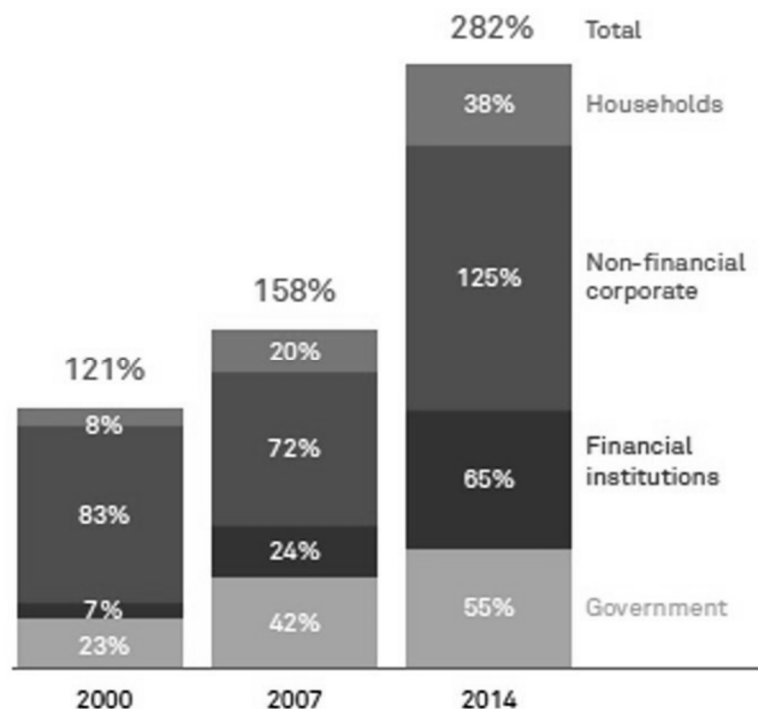
⇒ **Triggering further Government Interventions:**

- Currency Devaluation of about 4% in August
- Accommodative Monetary Policies: Reserve requirement cut by 50bps
- Inflating PBoC's balance sheet

Meanwhile Chinese macro aggregates are weakening

Chinese debt burden is inflating.

Debt level reached \$28trn or 282% of GDP

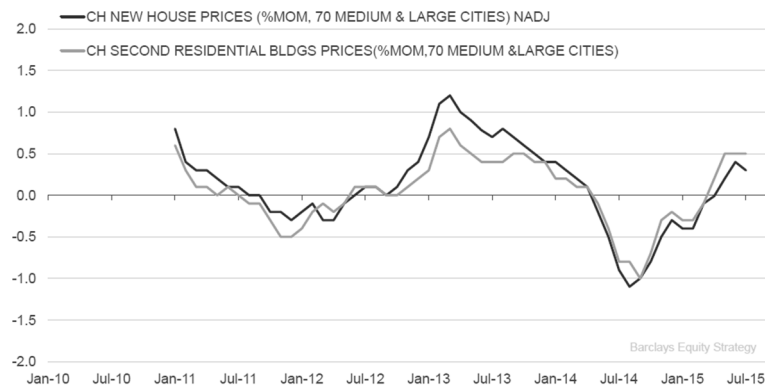


- **But government debt only 55% of GDP** and low households indebtedness level 38% of GDP (US 99%)
- **Debt burden concentrated around NBFCs:** 125% of GDP
- **Debt level should be manageable.** Essentially a domestic issue:
 - Low Foreign Debt: \$1.1bn
 - High currency reserve: \$3.65trn
 - PBoC strong Balance Sheet: Central Bank Debt is 27% of GDP
- **The key factor is the Real Estate sector:**
 - 45% of total debt is linked to Real Estate
 - ⇒ Inflating the property market

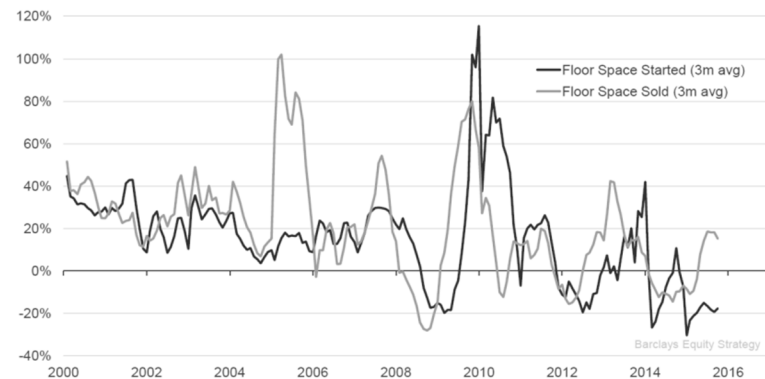
Can China be the catalyst for a world economic recession?

It depends if it is a hard or soft landing, and how strongly property market recovers.

Residential prices are increasing



Property sales pick-up shall leads to new construction.



No reason for a hard landing... yet:

- China is now the 2nd largest world economy (\$10.3trn of GDP)
- And it is still growing: forecasts 5-7% in 2015
- Although data are highly questionable: current growth perhaps closer to 2%
- With 5% growth, it would still be producing one Switzerland in a year.
- China produced three times more goods in 2013 than in 2007.

PBoC has still plenty of margin of manoeuvre for much accommodative monetary policy

Stock market crash should have moderate impact on GDP: Small stock market size relative to GDP: 0.36x

More importantly one sees early signs of property market recovery: residential prices appreciating and positive sales volumes growth

Can China be the catalyst for a world economic recession?

Based on soft landing assumption China should not be such a catalyst.

Index	China Sales Exposure
DAX (Germany)	10.2%
AEX (Netherlands)	8.8%
SMI (Switzerland)	7.5%
FTSE 100 (UK)	6.4%
STOXX Europe 600 (Europe)	5.8%
Eurostoxx 50 (Euro Area)	5.8%
CAC (France)	5.3%
OMX (Sweden)	4.9%
MIB (Italy)	3.6%
IBEX (Spain)	3.0%
OBX (Norway)	0.6%

China accounts for:

- 10% of US exports
- 7% of Europe exports

China weights moderately on corporate sales & earnings in developed market:

- For the Eurostoxx 600, China accounts for 5.8% of Sales
- Only 7% of the added value produced by developed economies, serves final demand in emerging countries.

However, China now contributes to at least 38% of global GDP growth. **The world economy would thus be more sensitive in the case of a much slower growth.**

Investment takeaway

Despite a very volatile environment, China still represents a good long term value.

- Reasonable valuation for blue chips: Hang Seng PE 6.9x
- A dominant economy although in a transition phase
- Still strong growth in absolute terms
- Strong PBoC margin of manoeuvre

⇒ **Take a very selective approach with buy & hold long term strategy:**

- Focus on high quality blue chips exposed to large growing middle class:

Beijing Enterprise Water (utility company providing waste water treatment)

Ping An Insurance (among China's largest insurance company)

Samsonite (world leader of travel accessories)

Dongfeng Motor Corp. (Chinese 2nd largest automotive manufacturer)

Alibaba (Chinese largest e-commerce operator)

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