## Bin Yuan Capital All China Strategy – Third Quarter 2016

### Market Review

Hong Kong Market had a strong performance in the third quarter led by large market cap stocks. Hang Seng Index advanced by 1.39% in September, extending a winning streak into the third month. The bullish run in the third quarter was mainly driven by the expectation of Shenzhen-Hong Kong stock connect, and China investors allocated money to Hong Kong to diversify RMB currency exposure. By contrast, China A-share market lagged behind with a reduction in both volatility and volume.

There are multiple signs that China economy is stabilizing. After the recovery of commodity price, industrial profits growth surged 20% in August after 11% increase in July, the highest since August 2013. The data was echoed by PPI which dropped by only 0.8% in August year on year, which was the slowest pace of decline since 2012. In addition, China railway cargo volume, an economic leading indicator, increased by 1% year on year in August. This was the first positive figure since 2013. House Price Index increased by 9.2% year on year in August following 7.9% year on year in July. It was the eleventh continuous month of gain and the fastest rise since January 2014.

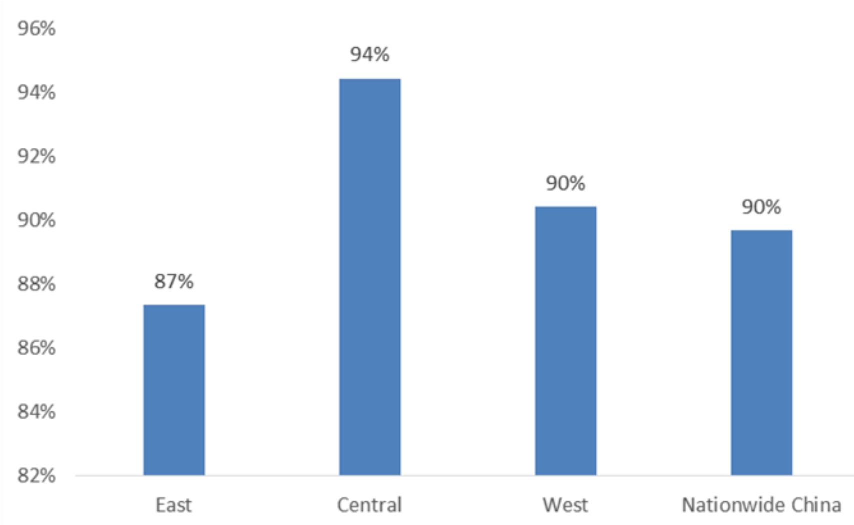
### China Outlook and Portfolio Positioning

Recent headlines on rapid property price rise and mortgage volume increase have brought concerns to the market. While the price sharp increase is alarming, when we break down the structure of the property market to analyze, the risk is not as severe as it appears due to lower outstanding mortgage base and higher home ownership ratio.

<u>The volume of property sales is incremental increase on a high home ownership base.</u>

Chinese households have a very high home ownership ratio with very low leverage. 90% of the households own the homes they live in (Chart 1). Almost 100% of the homes bought pre year 2000 were paid in cash.

Chart 1: 90% of households have self-owned properties




Source: Southwestern University Of Finance and Economics

The total stock of property in urban is around 14bn in terms of square meters. The property sales in the past five years were averaged 1bn square meters per year, which accounts for only 7% of total stock. The scale of incremental size is much smaller compared to this large base.

Tier 1 cities (Shanghai, Beijing, Shenzhen and Guangzhou) witnessed sharp property price hike and were most concerned. However, the incremental net increase of housing unit sold in Shanghai was 4% per annum in the past five years with 50% down payment on average.

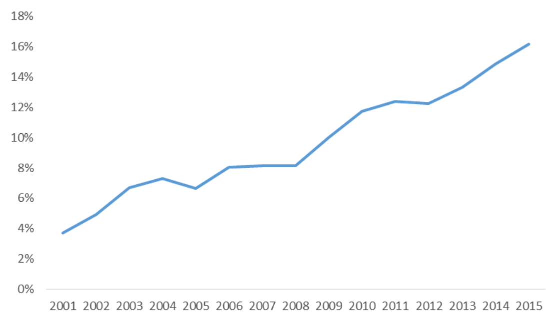
<u>The impact of mortgage to financial system is limited</u>

The mortgages issued before 2010 are less risky due to the low property price at the time. Most of the mortgages were issued after year 2010. Based on Bin Yuan estimate, there were 34 million families, which is 16% of the urban household, purchased houses with mortgages. The average mortgage balance per family is 260,000 RMB. With an income of above 100,000 RMB per annum per family in urban, this household debt level is not alarming enough yet.

The balance of mortgage as % of property value stands at 16% (Chart 2), and assume there is a 30% drop in property price which has a low possibility, the impact of mortgage default will not be significant.

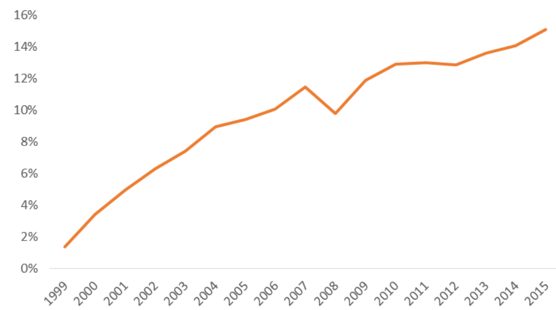
Chinese commercial banks have lower exposure to mortgage. The mortgage balance to total loan in China is 15% (Chart 3).

Chart 2: Mortgage balance / property value




Source: PBOC, Wind, Bin Yuan Capital

Chart 3: Mortgage balance / loan balance




Source: PBOC, Wind, Bin Yuan Capital

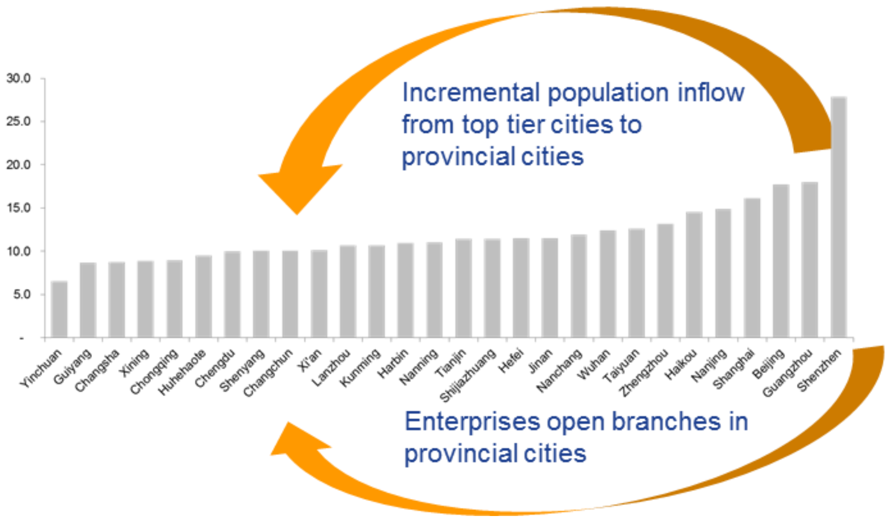
Although with small scale of mortgage, we believe that it is necessary for the government to control the sharp increase of property price to contain speculative buying which may cause short term problems.

The growth rate of mortgage will be moderated by the restrictive policy, and it will further relieve the concern of financial system risk.

The structure of property value is imbalanced

The hike of property price in tier 1 cities was much faster than those lower tier cities in the past five years. As a result, the ratio of property price/disposable income varies across the cities (Chart 4). We believe only the highest competitive enterprises and talents will be remained in high tier cities, other less competitive ones have to seek lower cost alternatives. Provincial cities are well positioned to capture this trend. With increasing jobs offered there, incremental population will flow to provincial cities with less burden of property. This could be a potential positive move for a more balanced and healthy economy growth.

Chart 4: Property price / income ratio by cities




Source: CICC, Wind, Bin Yuan Capital

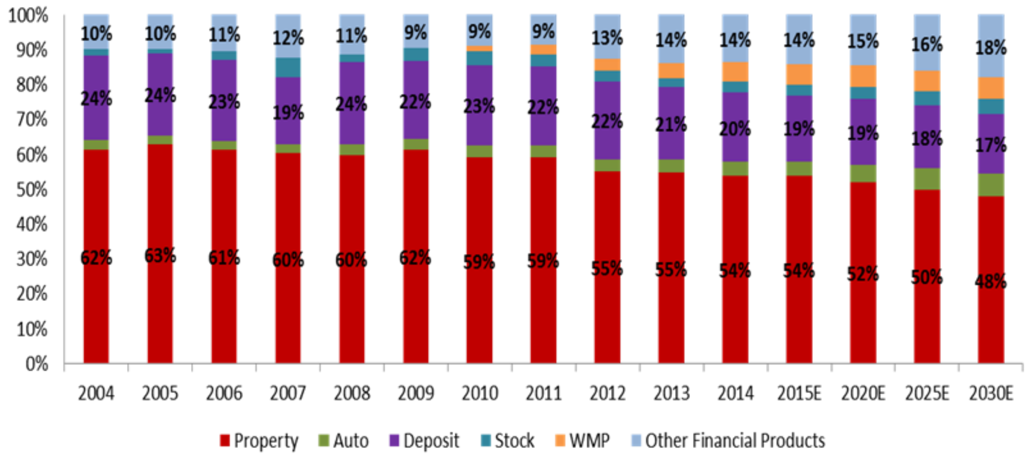
In summary, the sharp property price hike in tier 1 cities is not a nationwide phenomenon and recent property noise alone will have a limited impact on the overall financial system. The government control in further speculative property investment is necessary. In the long term, we expect a steady and healthy growth driven by urbanization and rising disposable income.

Stock market implications and portfolio positioning

Property exposure will be declining in the structure of both household assets and household consumption.

In the past 12 years, the property allocation in the household asset structure showed a decreasing trend from 62% in 2004 to 54% in 2014. The non-real estate asset has increased in the period with financial assets rising the fastest (Chart 5)

Chart 5: Household asset composition




Source: Wind, Bin Yuan Capital

Note： WMP refers to Wealth Management Products Issued By Banks

From asset allocation perspective, the restriction on speculative property purchase will be positive to stock market because people tend to shift incremental money from property market to financial assets.

From currency perspective, the flow of money to property space helped to keep the liquidity within China. The slow-down of the movement might put marginal pressure on RMB. We still hold the view that RMB will devalue, which is negative for firms that have US dollar debt and is positive to high end exporter. In the industrial sector, we will stay away from those with heavy USD debt and prefer global competitive manufacturing companies. We have increased exposure to those that will benefit from weaker Chinese currency.

From consumption perspective, the declining property burden will be positive for consumption upgrade. Interestingly, based on Bin Yuan data and grassroots diligences, we found that a group of people ‘Town Youth’ play increasingly significant role in service consumption. This group is defined as young people living in lower tier cities (as opposed to Metropolitan Youth in the high tier cities). This demographic is about 400 million youths. Due to the lower cost of living in these lesser tiered cities, ‘Town Youth’ will have relatively more disposable income to spend on upgraded consumption items. Data from The National Bureau of Statistics in China shows that 41.98% of expenditures went to upgraded consumption in Hebei Province, which is 4% higher than that of Beijing. Consumption/service is a major theme we position in the portfolio.

Sincerely,

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