

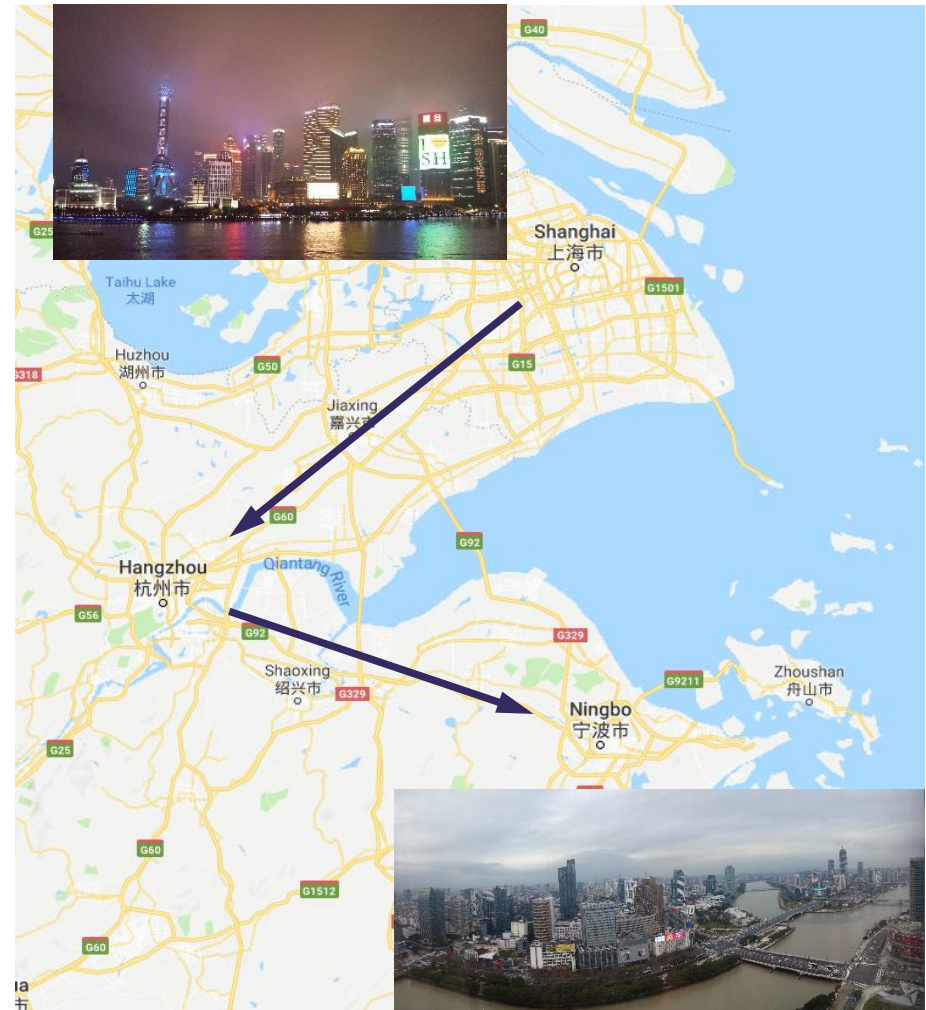


China Research Trip

January 2019

RESEARCH TRIP AGENDA

- UBS Greater China Conference and visited nine domestic companies covering:
 - Logistic and warehousing businesses including e-commerce supply chain fulfillment centres and express delivery parcel sorting facilities
 - Industrial and advanced robotics manufacturer
 - Excavator, roller, loader and forklift manufacturers
 - High precision machinery manufacturers for auto, electronics, white goods, healthcare industries
 - Plastic moulding machinery manufacturer
- Shanghai
 - Tier 1 city, population of circa 24-25 million
- Hangzhou
 - Tier 2 city, population of circa 6-7 million
- Ningbo
 - Tier 2 city, population of 7-8 million
 - Busiest port globally (by cargo tonnage)



Source: Google Maps

KEY THEMES

- Key insights
- Global outlook
- US-China trade tension
- Chinese government deleveraging drive
- Business, infrastructure and real estate investments
- Domestic consumption
- Policy response

KEY INSIGHTS

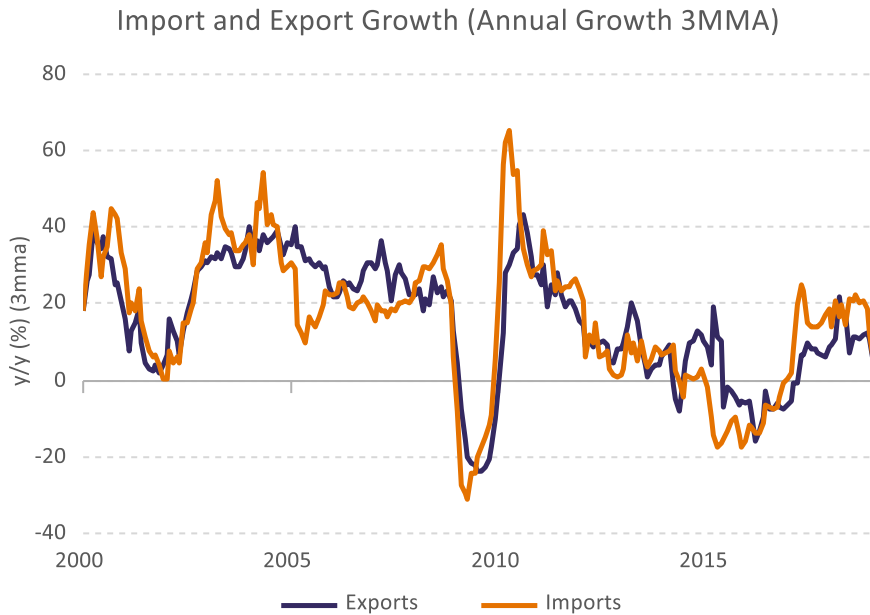
- Chinese growth is expected to slow structurally (due to demographics, size and economic transition) but economic growth has slowed further over the last 12 months due to government policy on deleveraging and trade uncertainty
 - Broad-based slowdown in domestic demand, but in particular, slowdown in the auto industry and property market. However, electric vehicle (EV) and online retail sales still growing strongly
- Clear evidence of trade uncertainty impacting on demand (both domestic and foreign) from company visits
 - Decline in new orders over 2018. Some orders cancellation. Logistics volume have slowed
 - Some firms have paused business decisions (potential for boost to growth if positive outcome from trade negotiation)
 - Firms are considering whether to shift production offshore/reduce workforce
 - Some have shifted focus to domestic market and emerging/frontier markets
 - Other firms are having difficulty with financing
- Although some stimulatory policies have been announced, consensus expectations from businesses are that growth/demand will continue to slow until:
 - Clarity is reached on US-China trade policy; and/or
 - Greater government stimulus measures are announced
- However, we continue to believe the probability of a major crash is low because the Chinese authorities have the capacity (monetary and fiscal policy) and willingness to support the economy

ASSESSMENT OF THE BROADER ECONOMY (BY FORMER CENTRAL BANKERS) AT THE UBS GREATER CHINA CONFERENCE (GCC)

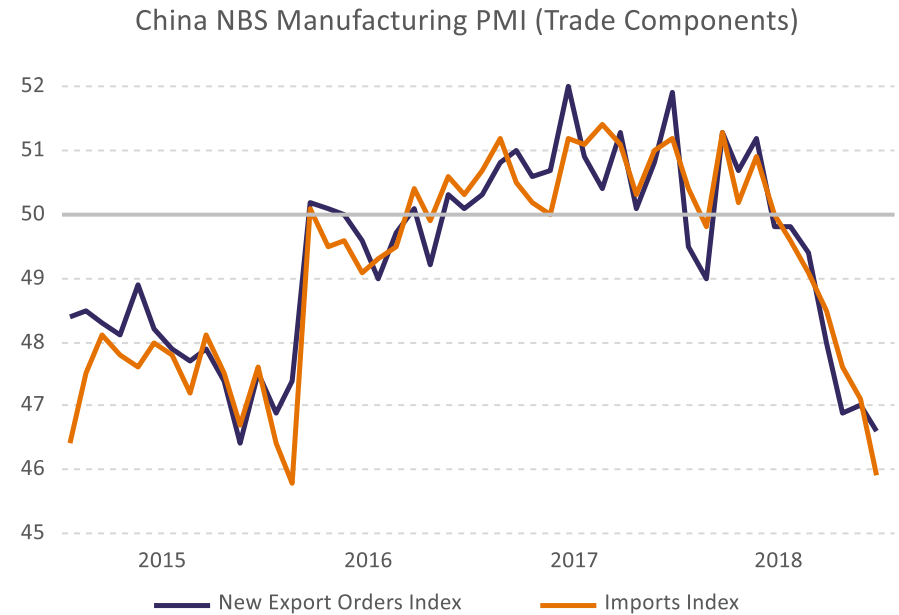
- US (Janet Yellen, former Chair of the Federal Reserve)
 - Economic growth likely to slow, but this is not unexpected
 - Fiscal boost fading
 - Trade risk impacting business sentiment and investment
 - However:
 - Labour market still strong
 - Inflationary pressure still benign
 - No clear economic imbalances
 - Expect this expansion to become the longest in history and sees similarities of current conditions with 2016
- China (Zhou Xiaochuan, former Governor of the People's Bank of China (PBOC))
 - Growth slowdown driven by:
 - Trade friction
 - Slower investment spending
 - Focus on **fiscal policy** rather than monetary policy which is consistent with focus on supply-side reform agenda but also means longer lag on economic impact
 - It is difficult to implement targeted monetary policy
 - Require ongoing Chinese urbanisation rate to justify further infrastructure investment



TRADE



Source: Thomson Reuters Datastream

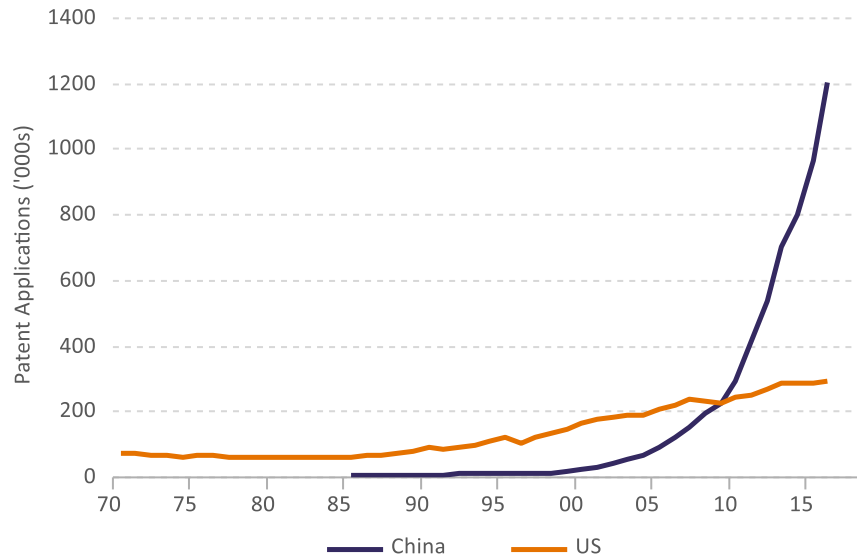


Source: Thomson Reuters Datastream

- Trade dispute is having a real impact on businesses and sentiment. Current US-China tension extends beyond trade (differences in political ideologies/culture etc).
 - Firms believe economic data will further weaken due to significant “front-loading” of orders in December 2018 quarter
- Likely to remain a long term issue even if trade dispute is resolved. There will be no returning to the “old system”. President Xi Jinping noted “participate in the reform of the global economic governance system” as a focus during his Annual Central Economic Work Conference in late December

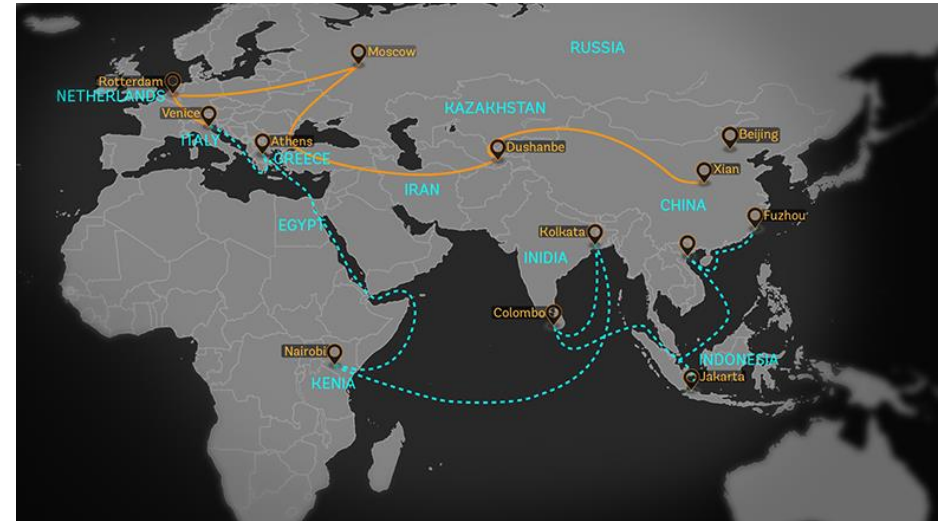
TRADE (CONT'D)

China and US Patent Applications



Source: Thomson Reuters Datastream

China's Belt and Road Initiative (BRI)

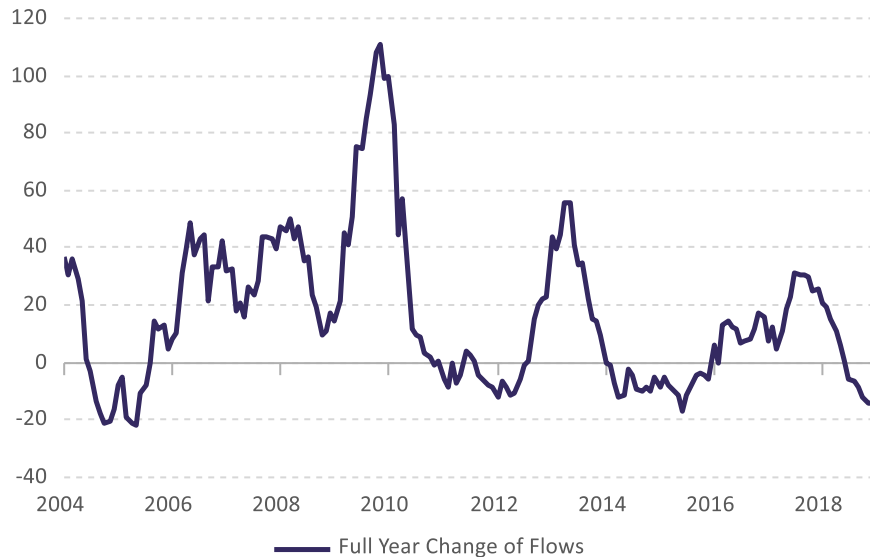


Source: World Bank

- Government is progressing on new patent, intellectual property and forced technology transfer laws
 - As part of the government's focus, China is already the global leader in innovation and technology in many industries
 - The new IP laws are likely to address US tensions but also to protect China's own IP as the economy moves up the value chain
- Outside of US-China tensions, China continues to progress on BRI. Trade between Europe and Asia is already the largest cross-regional flow in the world. BRI is expected to further boost this

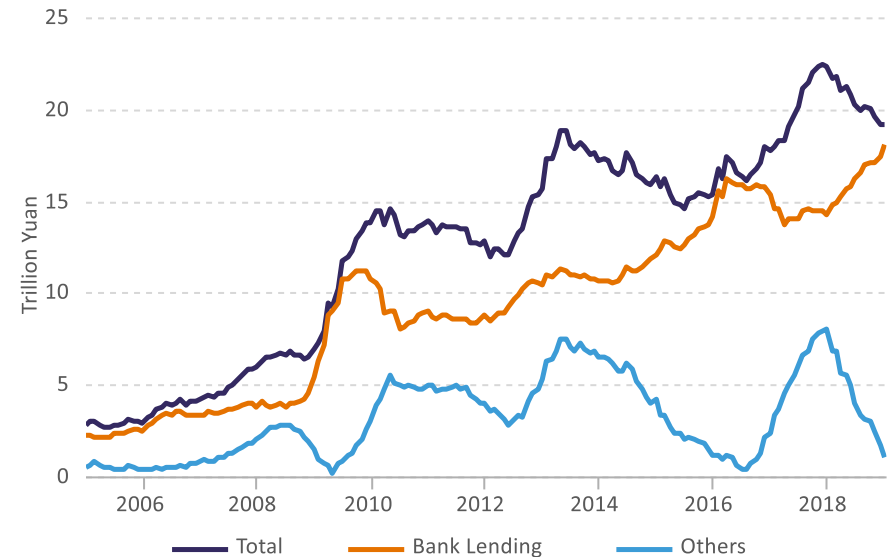
DELEVERAGING

China Total Social Financing (TSF)



Source: Thomson Reuters Datastream

Total Social Finance Components (12M Sum of Flows)

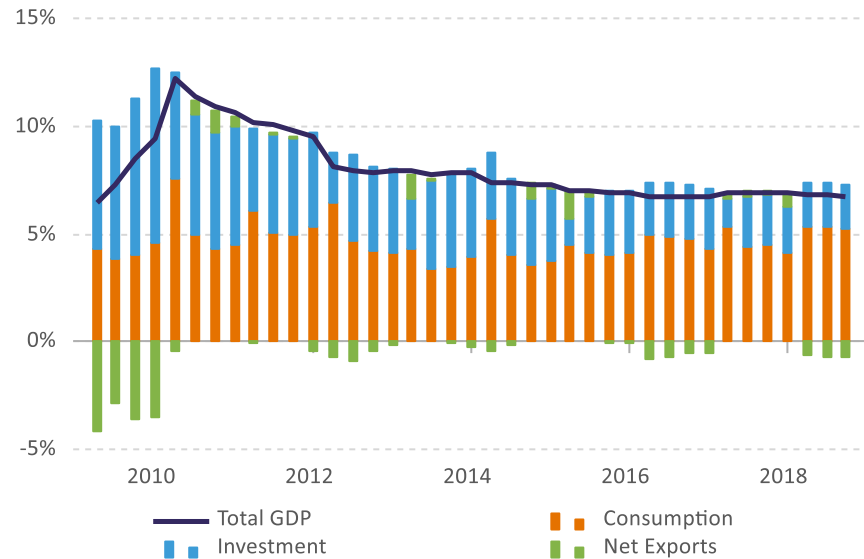


Source: Thomson Reuters Datastream

- Focus on reducing financial risk have curbed credit growth, particularly in the shadow banking sector but have had flow on effects for the rest of the economy
- There are several industries that have relied on financing via the shadow banking sector
 - Some consumers have relied on P2P financing for car purchases
 - Local governments have historically funded infrastructure projects partly using the shadow banking sector
 - Some firms mentioned that their customers were having difficulty getting financing

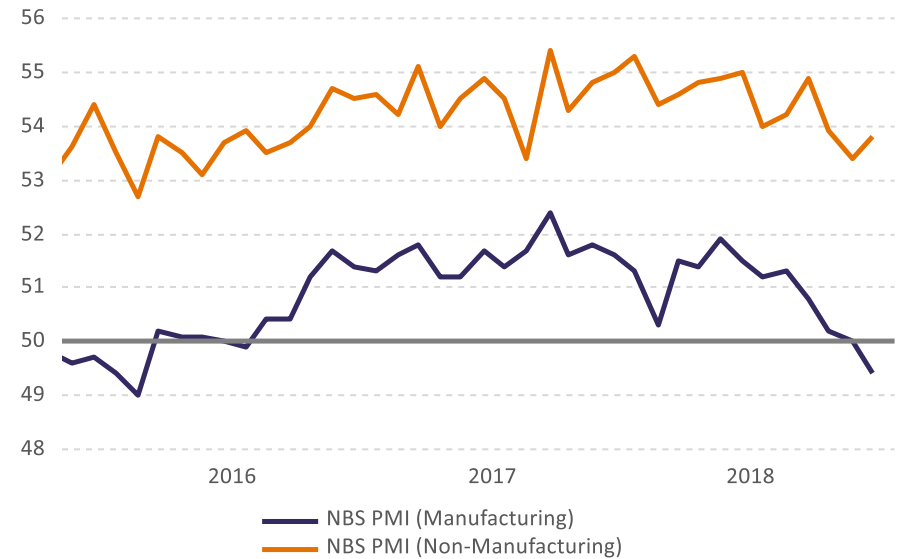
BROAD CHINESE ECONOMY

China Real GDP Contri. (By Components)



Source: Thomson Reuters Datastream

China PMI

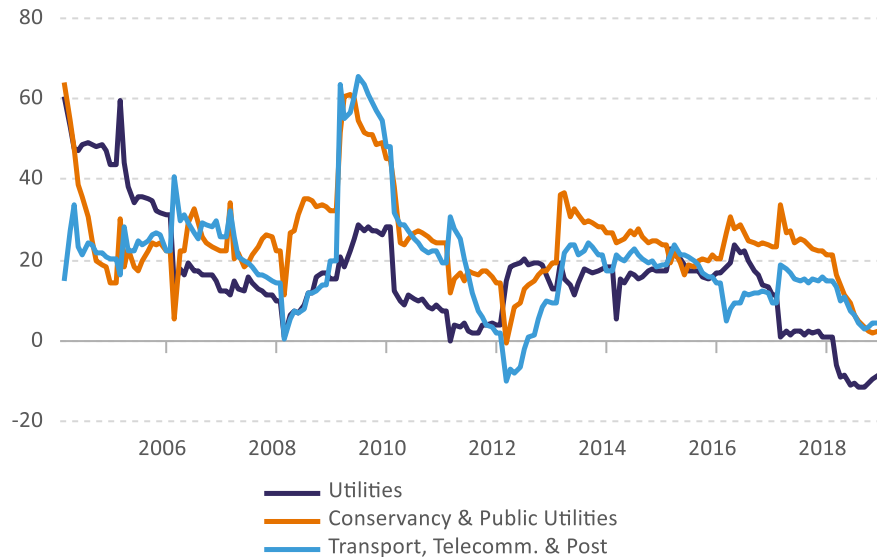


Source: Thomson Reuters Datastream

- Broad weakness in business sentiment
 - Firms recognise growth has slowed over the last year and are expecting it to slow further until clarity with trade policy and/or further government stimulatory measures are announced. However, no one is expecting a recession/crash
- Some expectations that growth will not likely accelerate until at least after the second quarter due to Chinese New Year holiday (5 February) and major government policies will need to be approved at the National People's Congress (NPC) in March

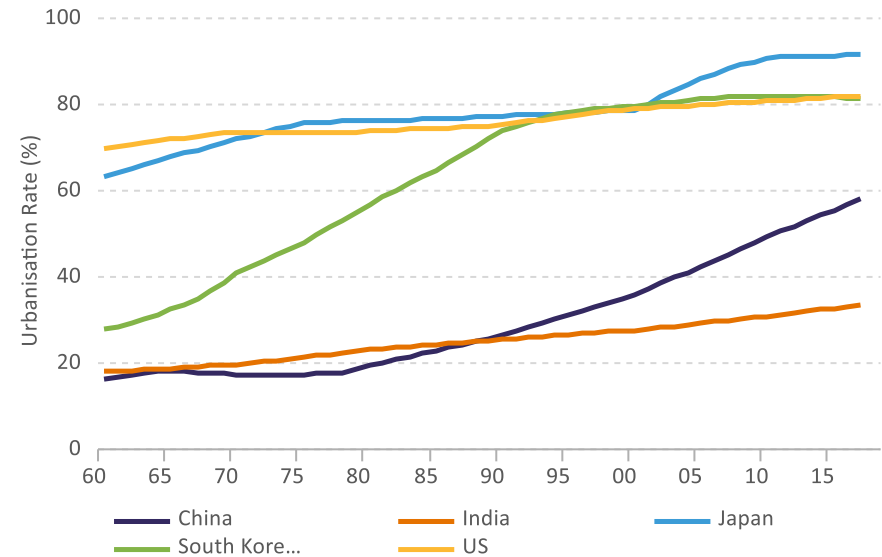
INFRASTRUCTURE INVESTMENT SPENDING

China Infrastructure Investment (Subsectors)



Source: Thomson Reuters Datastream

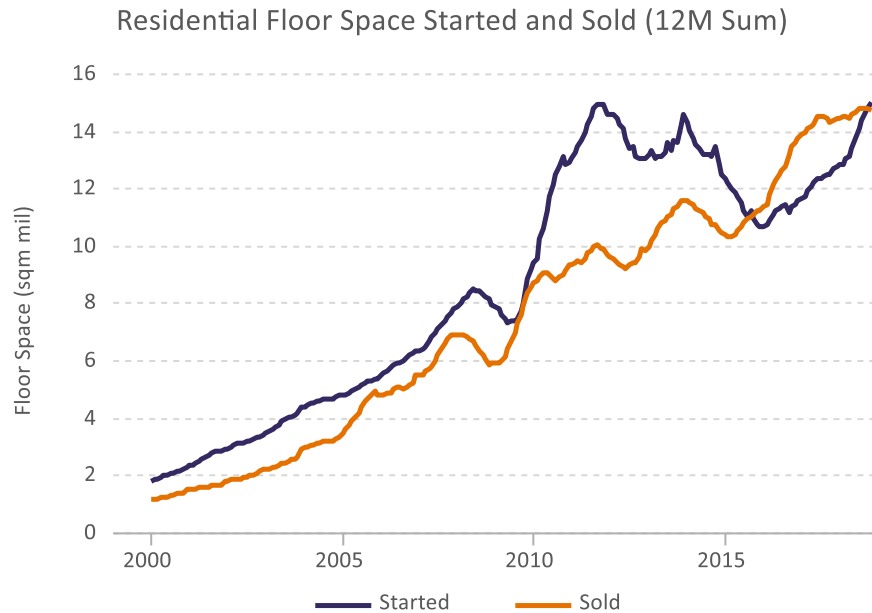
Urbanisation Rate of Key Countries



Source: Thomson Reuters Datastream

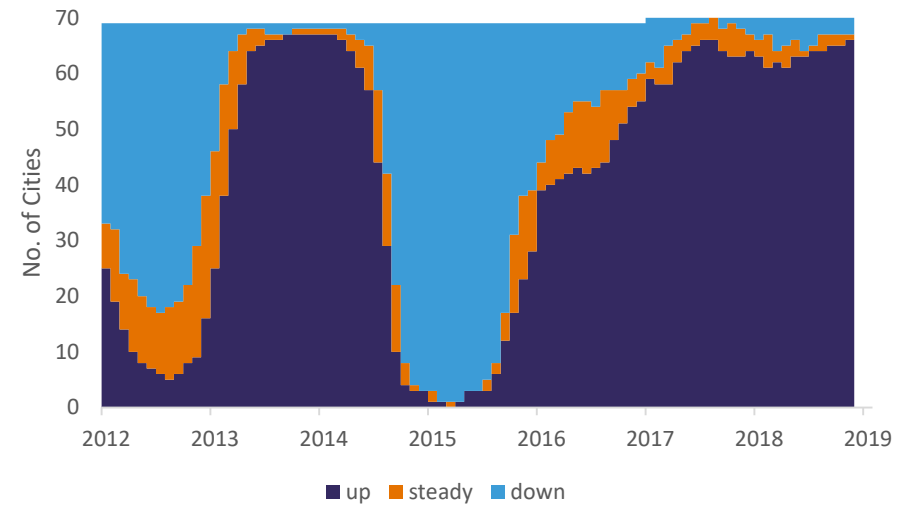
- Infrastructure investments have slowed as part of deleveraging drive as well as:
 - Higher scrutiny on PPP projects
 - Restriction on debt issuance from local government financing vehicles (LGFV)
 - However the government expedited the approval of their local government debt quota in December (usually approved in March at the NPC)
- Continuing urbanisation supporting further infrastructure investments but the rate of growth is slowing

PROPERTY MARKET



Source: Thomson Reuters Datastream

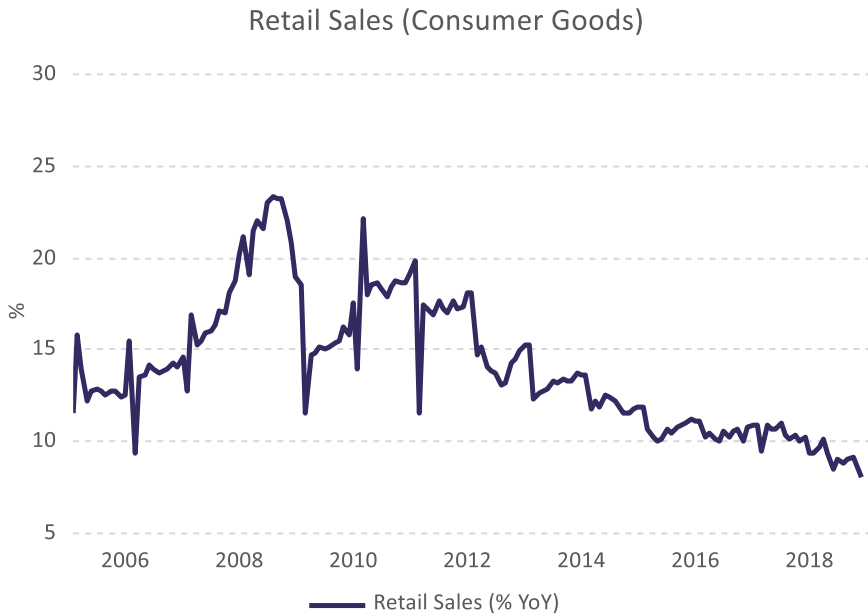
Annual House Price Changes of Individual Cities (Established Houses)



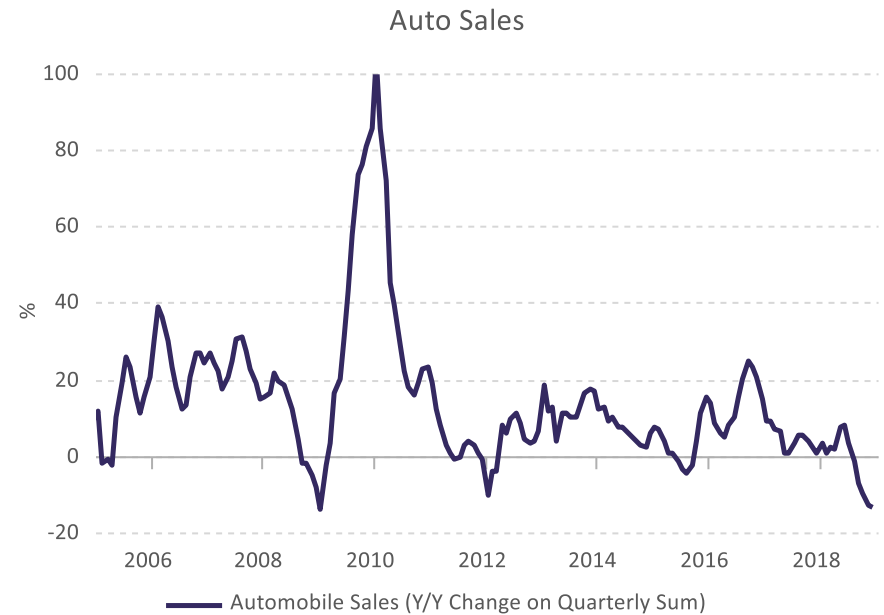
Source: Datastream, Frontier

- Expectation for property market slowdown
 - Consumer sentiment has weakened
 - Absorption of supply slowing and housing inventory picking up again
 - Government scaling back subsidy for shantytown redevelopments

DOMESTIC CONSUMPTION



Source: Thomson Reuters Datastream



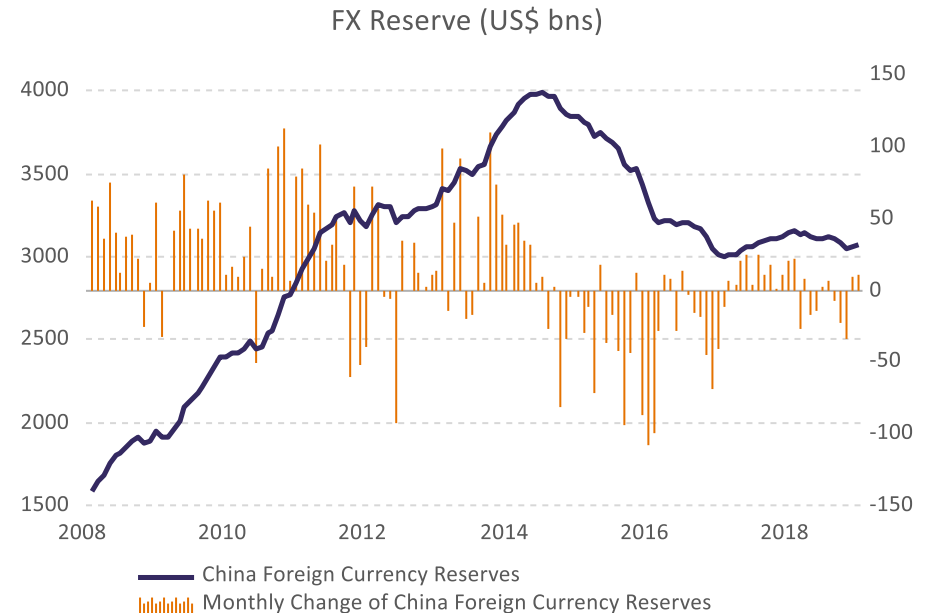
Source: Thomson Reuters Datastream

- Retail spending and auto sales have slowed due to broad economic slowdown from government deleveraging drive and US-China trade tension

POLICY RESPONSE



Source: Thomson Reuters Datastream



Source: Thomson Reuters Datastream

- Some further policy support announced
 - Cut to RRR by 100bps (January 2019)
 - Tax cuts (particularly for small and medium enterprises) (January 2019)
- Firms are expecting further government support although most also believe there will not be any “shock and awe” measures this time due to heightened concerns over financial risks
 - The lack of material measures have led to some policy confusion in the business sector

POLITICS

- As well as the US-China trade disputes, there remains many other political issues in play for China:
 - Removal of two term presidency limit from Communist party constitution (March 2018)
 - Detention of Interpol chief (September 2018)
 - Arrest of Huawei's CFO and detention of Canadians by China in response (December 2018)
 - Ongoing government corruption crackdown
 - Chinese "re-education camps" in Xinjiang (West China)
 - Meeting with North Korea's leader
 - South China sea dispute
 - Increasing tension of "re-uniting" Taiwan with China
 - Alleged "social credit score" system
 - Mass surveillance (installed around 170 million surveillance cameras with another 400 million expected by 2020)
- However, during the research trip it was notable that political issues were rarely raised, and it was generally only discussed by those based outside China
- We retain our advice to clients to consider the various forms of downside protection for inclusion in their portfolio to manage the heightened geopolitical risk environment

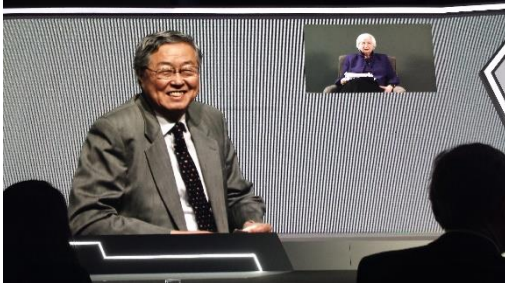
ON-THE-GROUND RESEARCH TRIP PHOTOS



Outside Haitian International's factory, a precision plastic moulding machinery manufacturer



Sorting centre of YTO Express, parcel delivery company (Taobao and Alibaba are main customers)



Former governors of US Fed (on VC) and PBOC at UBS GCC



Factory tour of Zhejiang Sanhua Intelligent Controls, air con/fridge/car parts manufacturer (Tesla is their largest customer)



Robot display at Siasun Robot, industrial robotics manufacturer



Factory noticeboard at Precision Tsugami, it reads: "If the quality of work is poor today, there will not be a job tomorrow"



Warehouse R&D centre of CJ Rokin Logistics



Precision Tsugami factory tour, high-precision computer controlled machinery manufacturer



Machinery parts manufactured from Precision Tsugami's machinery

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