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Capital rationing at work in the Chinese economy

- Continued recovery of nominal industrial production growth implies improving profitability of manufacturing industry
- Growth and market shares of online retail sales keep expanding
- Private and public sectors are keen on investing in agricultural, husbandry & fishery, power utilities, water supply, electrical machinery, telecom equipment, road transportation, education & healthcare industries
- Capital rationing will slow M2 growth but we believe quality of growth will improve

Profitability of industrial enterprises rose on easing deflation of ex-factory price (PPI) and stabilizing real industrial output. Real industrial output has stabilized at ~6% for the past four months. Deflationary pressure of PPI has been easing since the start of 2016 ; decline in PPI contracted from -5.3% in Jan to -3.4% in Apr and -1.7% in July. The narrowing decline in PPI and stabilizing real industrial output have helped support nominal industrial output since Jan. Based on our calculation, nominal industrial output growth recovered from 2.21% YoY in 1Q16 to 3.44% YoY in 1H16 and 4.20% YoY in 7M16 (Exhibit 1). Accelerating revenue growth enhances profitability of industrial enterprises. According to NBS, profit margin of manufacturing enterprises rose to 5.71% in 1H16 from 5.50% in 1Q16 and 5.29% in 1H15; similarly, according to MOF, profit margin of non-financial SOEs increased to 5.27% in 1H16 from 4.35% in 1Q16. The higher profit margin will encourage manufacturing enterprises and non-financial SOE to increase output.

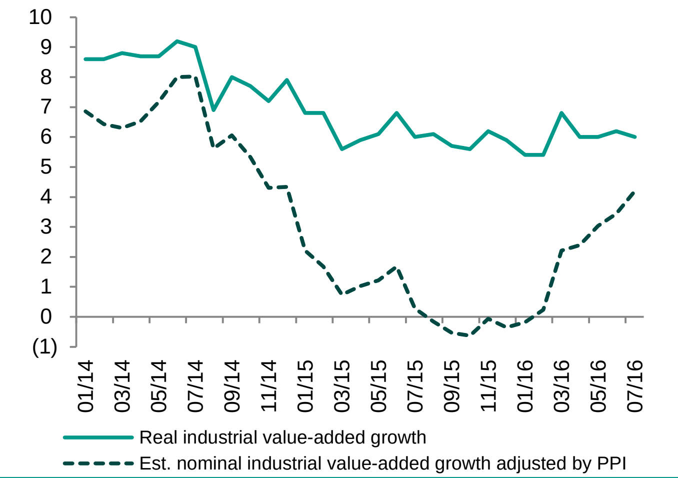
Two major trends: Online retailers continue to outperform; small retailers grow faster than the large ones. Total retail sales grew by 10.3% YoY in 7M16, of which offline retail sales expanded by 8.5% YoY and online retail sales increased by 27.5% YoY (Exhibit 3). Online retailers have contributed more to the growth of national retail sales than the offline ones. 7M16 online retail sales of physical consumer goods surged by 26.1% YoY and accounted for 11.6% of total retail sales of physical consumer goods (up from 10.6% in 1Q16); 7M16 online retail sales of non-physical consumer goods soared by 33.8%YoY. Small retailers are growing faster than the large ones. Retail sales values of small retailers of consumer goods and restaurant operation expanded by 2.7% YoY and 12.9% YoY; large retailers in the same categories grew by 7.6% YoY and 6.5% YoY. These trends are echoed by the latest results of listed retailers. Online e-commerce platform operators Alibaba (BABA US) and JD.com (JD US) recorded 49.6% and 44.4% YoY growth in 1H16 revenue, whereas hypermarket chain operator Sun Art retail (6808 HK) posted a meager 4.4% YoY revenue growth in 1H16. We believe this may indicate business environment of the large offline retailers could be worse than what is reflected by the NBS's statistics.

Both private and public sectors are increasingly selective in fixed assets investments (FAI). Private FAI growth slowed to 2.1% YoY in 7M16, 6ppt lower than the overall FAI or 19.7ppt lower than SOE's FAI. The market interpretation is that continued slowdown in FAI growth will suppress economic growth. We believe a slowing FAI signals that investors in both the private and public sectors are increasingly selective in investments by implementing capital rationing to increase investment return. This is especially true in the more profit-oriented private sector. Investors in the capital market may focus on industries drawing interests from both the private and public sectors (Exhibit 4) and remain cautious on industries that the private sector is divesting away from (Exhibits 5 & 7). Private and public sectors are bullish on the following industries: agricultural, husbandry & fishery, power utilities, water supply, electrical machinery, telecom equipment, road transportation, education and healthcare (Exhibit 4). Positive impacts of a highly selective FAI approach are apparent. Based on our calculation using the NBS data, the annualized asset turnover rate of large industrial enterprises improved from 1.02x in 1Q16 to 1.06x in 1H16; annualized ROA (i.e. realized profit/assets) also increased from 5.5% in 1Q16 to 6.0% in 1H16. Based on MOF's announcements and our calculation, the annualized asset turnover of state-owned non-financial enterprises (non-financial SOEs) rose from 0.325x in 1Q16 to 0.340x in 1H16; annualized ROA of non-financial SOEs increased from 1.41% in 1Q16 to 1.79% in 1H16. In general, financial resources are allocated to assets with higher efficiency (i.e. high asset turnover ratio) and enterprises are recording higher profitability (i.e. higher return rate of assets).

Oversupply of residential properties is easing, but oversupply of commercial properties is worrisome. Growth of investment in real estate slowed to 5.3% YoY in 7M16 from 6.1% YoY in 1H16, with investment in residential, office, and commercial properties calming in July. Property developers are avoiding the build-up of excessive supplies. Completed but unsold GFA of residential, office, and commercial properties at end-July is equivalent to 3.2 months, 9.4 months, and 16.8 months of average monthly sales volume, respectively; total GFA of residential, office and commercial properties under construction at end-July is equivalent to 35.0 months, 89.8 months, and 103.1 months of average monthly sales volume, respectively (Exhibit 8). Oversupply risk in commercial properties is high, and it is fair to expect that financial resources of office and commercial property developers will be tied up in unsold or under-constructing properties. Office and commercial property developer, Wharf (4 HK), said in its latest interim result briefing that the office & commercial property market in China is challenging.

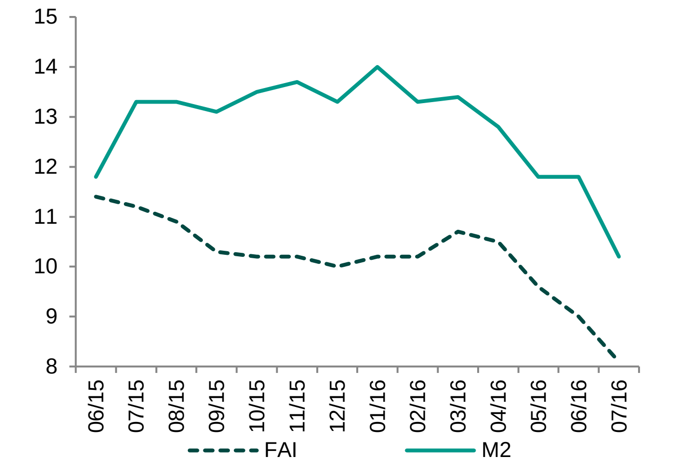
Slowing M2 growth in July- another sign of capital rationing. Declining growth in real and nominal M2 growth in July raises concern over diminishing economic momentum but we believe it is a reflection of capital rationing of FAI in China. Nominal M2 growth has been declining over the past four months from 13.4% YoY in Mar to 12.8% /11.8%/11.8%/10.2% YoY in Apr/May/June/July. Excluding the inflation factor, real M2 growth lowered from 10.85% YoY in Mar to 9.72% YoY in June and 8.25% YoY in July. Waning growth in real M2 in July may slash growth momentum in 3Q16. Nonetheless, we believe the economy is steering a course of higher profitability, rationality, and efficiency than before.

Exhibit 1: Nominal and real industrial production growth (YoY %)



Source(s): NBS, ABCI Securities

Exhibit 2: FAI growth (YTD YoY %) and M2 growth (YoY %)



Source(s): NBS, PBOC, ABCI Securities

Exhibit 3: China's retail sales in 7M16

	7M2016 (RMB bn)	Chg (YoY %)	Prop (%)	1Q2016 (RMB bn)	Chg (YoY %)	Prop (%)
Total retail sales	**18,297**	**10.3**	**100.0**	**7,802**	**10.5**	**97.4**
Offline retail sales	16,173	8.5	88.4	6,777	5.8	86.9
Online retail sales of physical consumer goods	2,124	26.1	11.6%	824	25.9	10.6
Total online retail sales	**2,627**	**27.5**	**100.0**	**1,025**	**27.8**	**100.0**
Online retail sales of physical consumer goods	2,124	26.1	80.9	824	25.9	80.4
Online retail sales of non-physical consumer goods	503	33.8	19.1	201	36.2	19.6
Total retail sales						
Overall large retailers	8,292	7.5	45.3	3,462	8.0	44.4
Overall small retailers	10,005	12.7	54.7	4,340	12.3	55.6

Source(s): NBS, ABCI Securities

Exhibit 4: Industries favored by private and public sectors, as indicated by increased investments (7M16)

Industry	Private FAI (YoY %)	Non-private FAI (YoY %)	Overall FAI (YoY %)
Agriculture, Forestry, Animal Husbandry and Fishery	15.6	29.4	19.1
Production and Supply of Electric Power and Heat Power	35.4	16.4	22.8
Management on Water Resource	25.0	23.7	23.9
Manufacture of Electrical Machinery & Equipment	8.6	34.9	11.4
Manufacture of Telecommunications Equip, Computers and Other Electronic Equip	4.4	20.4	9.8
Road Transportation	7.1	14.9	13.7
Education	16.7	25.7	23.2
Health, Social Works	17.2	27.9	23.6

Source(s): NBS, ABCI Securities

Exhibit 5: Industries with reduced investments from private and public sectors (7M16)

Industry	Private FAI Chg (YoY %)	Non-private FAI Chg (YoY %)	Overall FAI Chg (YoY %)
Mining and Washing of Coal	-30.5	-40.2	-34.7
Extraction of Petroleum and Natural Gas	-20.7	-28.8	-28.1
Ore Mining, Processing of Non-Metallic Minerals	-3.3	-31.0	-4.9
Manufacture of Railways, Shipbuilding, Aerospace and Other Transportation Equipment	-7.0	-26.3	-12.8

Source(s): NBS, ABCI Securities

Exhibit 6: Industries favored by private sector but not the public sector, as indicated by reducing investments (7M16)

Industry	Private FAI Chg (%YoY)	Non-private FAI Chg (%YoY)	Overall FAI Chg (%YoY)
Manufacture of automobile	13.0	-7.8	7.7

Source(s): NBS, ABCI Securities

Exhibit 7: Industries favored by the public sector but not the private sector, as indictaed by reducing investment (7M16)

Industry	Private FAI Chg (%YoY)	Non-private FAI Chg (%YoY)	Overall FAI Chg (%YoY)
Ore Mining, Smelting and Pressing of Ferrous Metals	-37.4	14.7	-30.5
Ore Mining, Smelting and Pressing of Non-Ferrous Metal	-3.4	17.8	1.8
Manufacture of General Purpose Machinery	-2.2	9.7	-1.4
Manufacture of Special Purpose Machinery	-4.7	18.4	-2.7
Construction	-12.8	12.3	0.6
Railway Transportation	-30.4	11.4	9.5
Culture, Sports and Entertainment	-2.7	30.8	10.9
Public Management, Social Security and Social Organizations	-23.0	21.6	7.5

Source(s): NBS, ABCI Securities

Exhibit 8: Sales statistics of the China property market (new housing)

Jan-July 2016	**Residential**	**Office**	**Commercial**
Sales value (RMBmn)	4,927,300	262,200	458,000
Chg (YoY %)	*41.2*	*65.3*	*17.6*
Sales volume (mn sq.m.)	671.53	17.95	46.12
Chg (YoY %)	*26.7*	*41.3*	*15.5*
Implied ASP(RMB/sqm)	**7,337**	**14,607**	**9,931**
Chg (YoY %)	*11.4*	*17.0*	*1.8*
Unsold GFA for sale (mn sqm)	431.83	33.83	154.59
Chg (YoY %)	*0.3*	*9.8*	*23.3*
Unsold GFA/avg. monthly sales volume (months)	**3.2**	**9.4**	**16.8**
New construction starts in 7M2016 (mn sqm)	641.0	38.2	125.7
Chg (YoY %)	*13.1*	*15.8*	*4.1*
Total GFA under construction at end Jul 2016 (mn sqm)	4,701.4	322.5	950.8
Chg (YoY %)	*3.1*	*10.7*	*7.7*
Total GFA under construction/ monthly avg sales volume (months)	**35.0**	**89.8**	**103.1**

Source(s): NBS, ABCI Securities

China Economic Indicators

	2015							2016						
	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul
Real GDP (YoY %)	7.0	---	---	6.9	---	---	6.8	---	---	6.7	---	---	6.7	---
Export Growth (YoY %)	2.8	(8.3)	(5.5)	(3.7)	(6.9)	(6.8)	(1.4)	(11.2)	(25.4)	11.5	(1.8)	(4.1)	(4.8)	(4.4)
Import Growth (YoY %)	(6.1)	(8.1)	(13.8)	(20.4)	(18.8)	(8.7)	(7.6)	(18.8)	(13.8)	(7.6)	(10.9)	(0.4)	(8.4)	(12.5)
Trade Balance (USD/bn)	46.6	43.0	60.2	60.3	61.6	54.1	60.9	63.3	32.6	29.9	45.56	49.98	48.11	52.31
Retail Sales Growth (YoY %)	10.6	10.5	10.8	10.9	11.0	11.2	11.1	10.2		10.5	10.1	10.0	10.6	10.2
Industrial Production (YoY %)	6.8	6.0	6.1	5.7	5.6	6.2	5.9	5.4		6.8	6.0	6.0	6.2	6.0
PMI - Manufacturing (%)	50.2	50.0	49.7	49.8	49.8	49.6	49.7	49.4	49.0	50.2	50.1	50.1	50.0	49.9
PMI – Non-manufacturing (%)	53.8	53.9	53.4	53.4	53.1	53.6	54.4	53.5	52.7	53.8	53.5	53.1	53.7	53.9
FAI (YTD) (YoY %)	11.4	11.2	10.9	10.3	10.2	10.2	10.0	10.2		10.7	10.5	9.6	9.0	8.1
CPI (YoY %)	1.4	1.6	2.0	1.6	1.3	1.5	1.6	1.8	2.3	2.3	2.3	2.0	1.9	1.8
PPI (YoY %)	(4.8)	(5.4)	(5.9)	(5.9)	(5.9)	(5.9)	(5.9)	(5.3)	(4.9)	(4.3)	(3.4)	(2.8)	(2.6)	(1.7)
M2 (YoY %)	11.8	13.3	13.3	13.1	13.5	13.7	13.3	14.0	13.3	13.4	12.8	11.8	11.8	10.2
New Lending (RMB/bn)	1,280.6	1,480	809.6	1,050	513.6	708.9	597.8	2,510	726.6	1,370	555.6	985.5	1380	463.6
Aggregate Financing (RMB bn)	1,833	742	1,082	1,300	476.7	1,020	1,815.1	3,425.3	824.5	2,404.0	751.0	659.9	1,629.3	487.9

World Economic/Financial Indicators

Equity Indices

	Closing price	Chg. WTD (%)	P/E
U.S.			
DJIA	18,597.70	0.11	17.91
S&P 500	2,187.02	0.14	20.50
NASDAQ	5,240.15	0.14	32.36
MSCI US	2,083.16	0.11	21.15
Europe			
FTSE 100	6,856.21	(0.86)	56.91
DAX	10,522.51	(1.78)	23.91
CAC40	4,395.09	(2.34)	22.65
IBEX 35	8,458.00	(2.96)	21.00
FTSE MIB	16,341.41	(3.86)	36.93
Stoxx 600	340.61	(1.58)	29.15
MSCI UK	2,001.01	(0.73)	60.60
MSCI France	125.77	(1.38)	20.80
MSCI Germany	135.44	(1.01)	24.24
MSCI Italy	47.43	(1.80)	38.00
Asia			
NIKKEI 225	16,545.82	(2.21)	20.55
S&P/ASX 200	5,526.68	(0.08)	23.97
HSI	22,937.22	0.75	11.91
HSCEI	9,606.17	0.54	7.54
CSI300	3,365.02	2.15	14.68
SSE Composite	3,108.10	1.88	17.17
SZSE Component	10,872.71	3.27	31.98
MSCI China	62.31	1.70	12.40
MSCI Hong Kong	12,841.40	(0.63)	14.36
MSCI Japan	781.55	(2.22)	16.39

Global Commodities

	Unit	Price	Chg. WTD (%)	Vol (5-Day avg.)
Energy				
NYMEX WTI	USD/bbl.	48.16	8.25	480,336
ICE Brent Oil	USD/bbl	50.72	7.98	294,099
NYMEX Natural Gas	USD/MMBtu	2.66	2.86	120,866
China Qinhuangdao Port Thermal Coal[2]	CNY/Metric Tonne	466.00	2.19	N/A
BasicMetals				
LME Aluminum Cash	USD/MT	1,670.00	1.64	29,395
LME Aluminum 3 -mth. Rolling Fwd.	USD/MT	1,683.00	1.69	36,533
CMX Copper Active	USD/lb.	4,799.00	1.01	16,303
LME Copper 3- mth Rolling Fwd.	USD/MT	4,809.00	1.01	28,462
Precious Metals				
CMX Gold	USD/T. oz	1,352.00	0.66	184,229
CMX Silver	USD/T. oz	19.56	(0.75)	68,596
NYMEX Platinum	USD/T. oz	1,120.10	(0.81)	13,267
Agricultural Products				
CBOT Corn	USD/bu	341.00	2.40	167,456
CBOT Wheat	USD/bu	442.75	0.63	63,008
NYB-ICE Sugar	USD/lb.	20.04	1.67	35,850
CBOT Soybeans	USD/bu.	1,003.25	2.19	105,110

Bond Yields & Key Rates

	Yield (%)	Chg. WTD (Bps)
US Fed Fund Rate	0.50	0.00
US Prime Rate	3.50	0.00
US Discount Window	1.00	0.00
US Treasury (1 Yr)	0.2745	1.59
US Treasury (5Yr)	1.1233	2.59
US Treasury (10 Yr)	1.5407	2.72
Japan 10-Yr Gov. Bond	(0.08)	2.40
China 10-Yr Gov. Bond	2.7150	4.00
ECB Rate (Refinancing)	0.00	0.00
1-Month LIBOR	0.5141	0.75
3 Month LIBOR	0.8113	(0.70)
O/N SHIBOR	2.0230	0.20
1-mth SHIBOR	2.6960	(0.90)
3-mth HIBOR	0.5659	0.21
Corporate Bonds (Moody's)		
Aaa	3.31	3.00
Baa	4.25	3.00

Note:
1. Data sources: Bloomberg, National Bureau of Statistics of China, ABCIS (updated on date of report)
2. The price is Coal 5500 kcal/kg FOB Spot Price

Currency

	Euro/USD	GBP/USD	AUD/USD	USD/JPY	USD/CHF	USD/CNY	USD/HKD	USD/CNY NDF 12-mth Spot pr.
Spot Rate	1.1321	1.3124	0.7619	100.10	0.9568	6.6525	7.7534	6.7990
Chg. WTD (%)	1.42	1.58	(0.43)	1.20	1.84	(0.25)	0.04	(0.22)

Disclosures

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Definition of equity rating

Rating	Definition
Buy	Stock return ≥ Market return rate
Hold	Market return – 6% ≤ Stock return < Market return rate
Sell	Stock return < Market return – 6%

Stock return is defined as the expected % change of share price plus gross dividend yield over the next 12 months
Market return: 5-year average market return rate from 2009-2013
Time horizon of share price target: 12-month

Definition of share price risk

Rating	Definition
Very high	2.6 ≤180 day volatility/180 day benchmark index volatility
High	1.5 ≤ 180 day volatility/180 day benchmark index volatility < 2.6
Medium	1.0 ≤180 day volatility/180 day benchmark index volatility < 1.5
Low	180 day volatility/180 day benchmark index volatility < 1.0

We measure share price risk by its volatility relative to volatility of benchmark index. Benchmark index: Hang Seng Index.
Volatility is calculated from the standard deviation of day to day logarithmic historic price change. The 180-day price volatility equals the annualized standard deviation of the relative price change for the 180 most recent trading days closing price.

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