

The China Markets are on fire! Why?

- Spectacular A-share performance – foundation for upward momentum in Chinese offshore H-shares
- Reforms, monetary easing, asset re-allocation and MSCI inclusion main drivers for Chinese equities
- Six investment themes to benefit from China market rally
- New Silk Road Initiatives to drive long term growth in Asia



Victoria Mio
CIO China
Fund Manager
Robeco Chinese Equities

The bull market in MSCI China has just begun

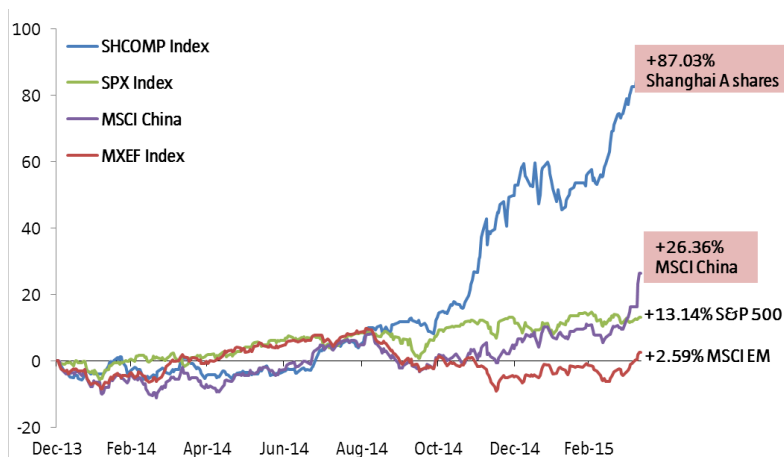
What are the reasons behind the spectacular rallies in Chinese equity markets?

As you can see from the chart below, the **Chinese domestic equity market** (represented by the Shanghai A share Index) has witnessed a spectacular 87% gain since December 2013.

The **Chinese offshore equity market in Hong Kong** (represented by the MSCI China Index, which includes China-domiciled, Hong Kong listed stocks, H-shares) started to soar in March 2015, with a gain of 26% since December 2013. **8 April was a historic day** – the daily trading volume on the Hong Kong Stock Exchange reached a new record high of **HKD 253 billion (USD 34 billion)**, with the market hitting a seven-year high.

As the rally happened over such a short period of time, we would not be surprised to see some near term market consolidation in both A- and H-shares. However, we believe the bullish case remains intact.

Chinese domestic market is pulling up the Chinese offshore market



Source: Bloomberg, Robeco, as 10 April 2014

China domestic equity market (A-shares)

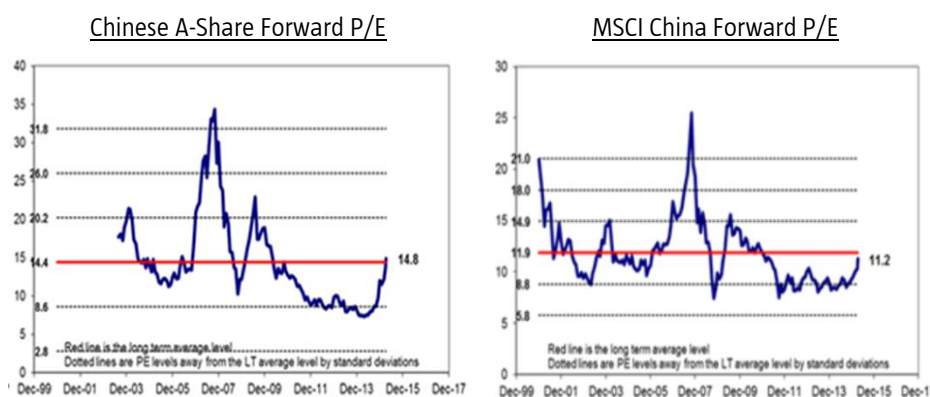
The bull market in the Chinese domestic market has been fueled by the following major factors:

- **Valuation:** It was at a historically low valuation in 2014 (please see chart below), and is now at historically average levels.
- **Reforms:** Implementation of comprehensive and productivity-enhancing reforms to combat weak economic fundamentals.
- **Liquidity:** The central bank has implemented two interest rate cuts and one RRR cut. The slower the growth, the more the government will ease.
- **Asset-allocation shift:** Government steps to encourage domestic investors to shift money from property and deposits to equities.
- **Shanghai-Hong Kong Stock Connect:** Sentiment lifted by the implementation of this scheme in November 2014, allowing global investors to invest in Chinese domestic A-shares listed in Shanghai.

China offshore equity market in Hong Kong (H-shares)

The bull market in China offshore market has lagged but recently started to catch up:

- **Valuation:** It was at a historically low valuation in 2014 and has reached average levels now.
- **Lack of liquidity from China:** Capital controls have prevented the easy flow of liquidity from China to Hong Kong.
- **Outflows due to USD strength:** Hong Kong equity market has been dragged down by capital outflows from emerging markets as the US dollar strengthens.
- **Expansion of Shanghai-Hong Kong Stock Connect finally triggered the bull market:** In November 2014 when the Stock Connect Scheme was implemented, only individual investors with more than CNY 500,000 in liquid assets were allowed to participate. On 30 March 2015, the Chinese authorities allowed mainland mutual funds to invest in stocks Hong Kong-listed stocks through Stock Connect. This immediately triggered the rally in the Chinese offshore market.



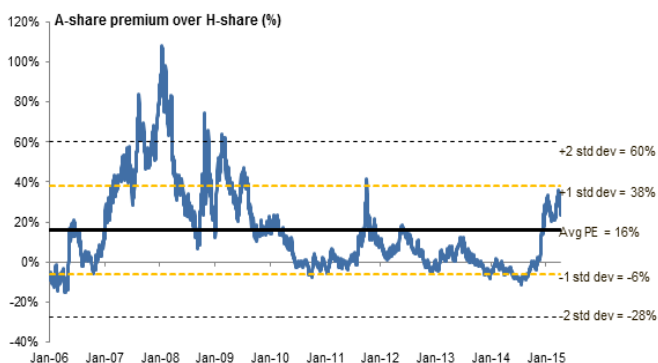
Source: IBES, Factset, MSCI, Morgan Stanley, Robeco, as of 10 April 2015.

The valuation gap between the Chinese domestic and offshore equity markets is closing

There are many dual listed companies with A-shares listed in China and H-shares in Hong Kong. These shares are not interchangeable, but do represent exactly the same claim on exactly the same company and so should have the same valuation.

However, on average, A-shares are currently trading at 23% premiums to their H-share counterparts (please see charts below). With the extension of the Shanghai-Hong Kong Stock Connect Scheme to include mutual funds, all Chinese investors can now exploit the arbitrage opportunities, and as a result the gap is narrowing.

Historical A-share / H-share premium trend



Source: Bloomberg, Robeco, as 10 April 2014

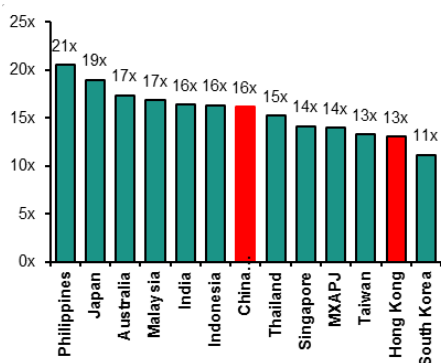
Will the bull market last?

We do not think that this bull run in China’s equity markets is just a liquidity-driven bubble, but believe that it marks the **beginning of a multi-year bull market** in the Chinese equity markets.

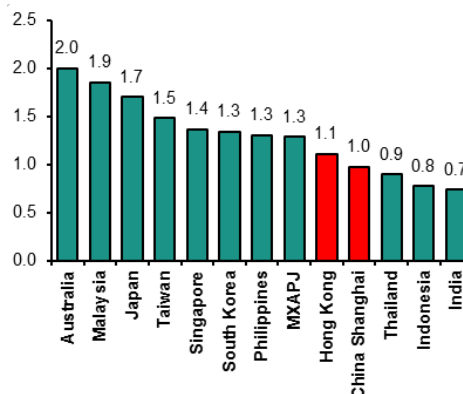
We remain positive on the Chinese equity markets, with a stronger preference for H-shares in the near term, due to A-H premium. However, given the speed of the rally, we would not be surprised to see near-term market consolidation.

- **China A-share market** will continue to be driven by:
 - a. Further interest rate and RRR cuts.
 - b. Retail investors’ asset reallocation.
 - c. A-share inclusion in MSCI indices.
 - d. Government support.
- **China H-share market** developments will be complicated by the interplay between domestic & global forces:
 - a. Global investors have yet to be convinced, but H-shares are relatively cheap compared to their regional peers (please see charts below).
 - b. ADR inclusion in MSCI China will increase the growth profile and quality of this China index tracked by global investors.
 - c. Shenzhen-Hong Kong Stock Connect to be implemented soon.
 - d. Earnings revisions are improving. (Please see 2015 guidance on next page).
- **Risks:** Economic fundamentals remain weak, funding costs are still high, structural overcapacity is a burden, and corporate debt default and non-performing loans (NPLs) are rising. Poor macro statistics in China and a rate hike by the US Federal Reserve might trigger a market decline.

2015 Forward P/E of Key Asian Markets



2016 Forward PEG Ratio of Key Asian Markets



Source: Bloomberg, Bernstein, as April 2014

The NPC has sent strong signals for reforms

In mid-March 2015, China held the ‘two sessions’ which refer to the National People’s Congress (NPC) and the Chinese People’s Political Consultative Conference (CPPCC). The Chinese stock markets reacted very positively and there were some important messages from the two sessions for investors to note.

1. **The ‘new normal’:** It had been widely anticipated that the Chinese government would lower its growth target, and it did, setting its 2015 GDP growth target at approximately 7%. This lower target allows the leaders to put more emphasis on reforms and restructuring the economy. China’s leaders are willing to tolerate lower growth in exchange for higher quality, and investors are glad to see this.
2. **The ‘New Silk Road’ or ‘One Belt One Road’ Initiatives:** Please refer to the next section.
3. **The ‘Internet +’ strategy:** In the two sessions, the Chinese leaders promoted their innovation and technology development strategy, including ‘Internet +’ – promoting the development of e-commerce and the introduction of the concept and use of internet to traditional industries.
4. **Environmental Protection:** The new ‘Environment Protection Law’ came into effect in January 2015. A recent online video has raised awareness on many environmental issues and enforcement problems. Chinese leaders used the two sessions to re-iterate its commitment to improve the environment.
5. **Financial Reforms:** Capital market open-up initiatives, launch of deposit insurance, potential offered by Shenzhen-Hong Kong Stock Connect after the successful implementation of the Shanghai-Hong Kong Stock Connect.
6. **Fiscal Reforms:** The Ministry of Finance (MoF) announced a CNY 1 trillion debt issuance quota to the local governments to replace maturing debt borrowed by local government funding vehicles (LGFVs). This is a major step towards resolving the LGFV issue. The scheme has significant benefits: 1) It transfers some LGFV loans to the official local government platform, lowering funding costs, and extending maturity. 2) It holds local governments responsible for debt repayment to avoid moral hazard. 3) It shifts some bank loan book items to the investment book, freeing up more space for other bank lending. 4) It reduces the imminent systemic default risk of LGFV loans.

The market is flying – but what about the fundamentals?

2014 results: Total earnings growth further decelerated.

Overall earnings saw a growth of **5.4% YoY in FY14**, in line with the market consensus of 4.2%. Broad-based deceleration continued, mostly from upstream sectors such as energy and commodities, etc.

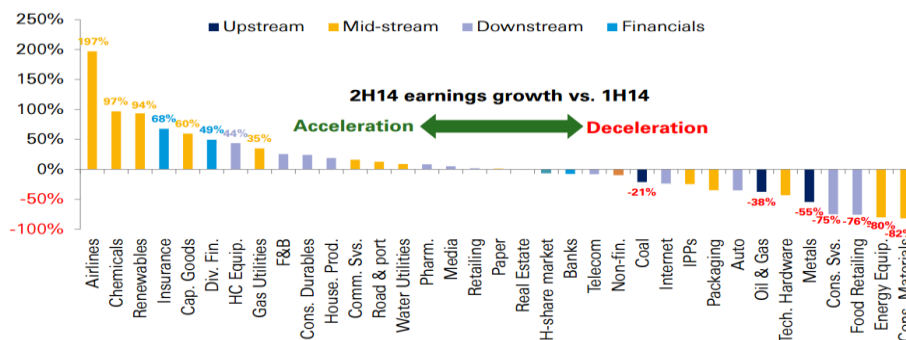
Excluding financials and energy, earnings grew 8.2% in 2H14, a mild rebound from 7.6% in 1H14, thanks to a visible margin expansion in mid-stream sectors.

2015 guidance: Total earnings growth is likely to improve.

The cyclical outlook is starting to improve amid intensifying policy loosening efforts and upward earnings revisions are likely to take place in 2H15. In addition, as companies are aggressively cutting costs as top-line growth pressure persists, there might be positive surprises in terms of margin expansion.

Sectors that have experienced the biggest upward earnings revisions for 2015 included Diversified Financials (+8%), Insurance (+6%) and Transportation (+4%). Sectors that have experienced the biggest downward revisions were Energy (-39%), Real Estate (-6%) and Information Technology (-3%).

Off-shore Chinese equities earnings growth, 2H14 vs 1H14



Source: Bloomberg Finance LP, Deutsche Bank Strategy Research

How can investors profit from this rally?

We continue to like ‘new economy’ themes such as health care, technology, and the environment. We have also added some ‘old economy’ themes such as financial reforms, state-owned enterprise (SOE) reforms and New Silk Road Initiatives. We also focus on sectors with accelerating earnings growth and reduce exposure to those sectors with deteriorating fundamentals.

Key Reform Areas	Expected Reform Measures	Overweight Sectors
1) SOE Reforms	Accelerate consolidation in industries with overcapacity Introduce management incentive plans and private capital	Selected SOE names
2) New Silk Road Initiatives	Build cross border infrastructure network on road & sea Export infrastructure construction capability	Construction, Railway Equip & Machinery
3) Financial Reforms	Rising long-end bond yield and investment liberalization Reopen the IPO market, and rising non-performing asset cycle	Insurance, brokers, banks
4) Healthcare Reforms	Expand access to health services to rural China Improve quality of care and deliver cost-effective care	Healthcare & services
5) Technology and Innovation	Government to support and stimulate consumption in: cultural, entertainment, internet, gaming, travel, IT services	Internet and hardware
6) Environmental Protection	85% of all the city waste water has to be treated Expand incineration capacity by 28% annually	Waste Water Mgt. Solid Waste Mgt.

What has divided the US and its allies?

What is ‘One Belt One Road’?

In September 2013, President Xi Jinping launched a new international strategy named ‘One Belt One Road’, based on the history of the Silk Road by sea and by land.

- The ‘One Belt’ refers to **New Silk Road Economic Belt** which will link China with Europe through Central and Western Asia.

- the 'One Road' refers to the **21st Century Maritime Silk Road** which represents a maritime route through the Strait of Malacca to India, the Middle East and East Africa.

Three financial institutions are to be established to fund the 'One Belt One Road' (OBOR) initiatives:

- **Silk Road Fund:** This was launched in February 2014 with a capital of USD 40 billion, solely funded by China, and is managed like China's sovereign wealth fund.
- **New Development Bank (NDB):** This is a BRICS development bank established in July 2014 by the BRICS countries. It was seeded with USD 50 billion initial capital.
- **Asian Infrastructure Investment Bank (AIIB):** This aspires to be a global development bank.
 - a. By October 2014, 22 Asian nations including China had signed an agreement to set up the AIIB with USD 100 billion in registered capital, including USD 50 billion contributed by China.
 - b. As of March 2015, 49 countries had applied to become prospective founding members of the AIIB.
 - c. The bank's membership will be finalized in April 2015. Its headquarters will be in Beijing.

What is the geopolitical significance?

A simple world map below shows the geographical significance of OBOR. In the west is Europe, one of the world's largest energy consumers and China's largest trading partner. In the middle are the energy producers, the Middle East and Central Asian countries. In the east are the energy consumers and exporting countries. Everyone has a common interest to protect the security of energy and goods that are transported mainly through sea lanes of the Middle East and South East Asia.

China expects that the annual trade volume between China and the OBOR countries to surpass **USD 2.5 trillion by 2025**.

One Belt One Road Initiative Geographic Reach



Source: Reuters

What is China's strategy?

At the APEC Summit in November 2014, President Xi Jinping actively promoted OBOR to world leaders, emphasizing common interests to achieve win-win development for China and related countries.

At the Boao Forum for Asia in March 2015, President Xi outlined the grand vision of a 'Community of Common Destiny', promoting regional economic integration.

In essence, China will use its financial capital to help fund regional infrastructure to promote trade and improve relations with ASEAN, Central Asia and European countries.

What is the total infrastructure required?

Asia's infrastructure sector offers tremendous growth potential. The Asian Development Bank estimates that Asia will need annual infrastructure spending of approximately **USD 730 billion** up to 2020, approximately one third for maintaining or replacing outdated facilities and two thirds to build new capacity.

Over the past 20 years, private investments in the infrastructure sector in Asia have averaged **USD 13 billion** per year, mostly in lower-risk countries. The Public Private Partnership (PPP) has been implemented to attract more private investments, but the overall number of PPP projects is still low.

There is a **massive funding gap** in infrastructure financing in Asia!

Why did the US resist?

In April 2015, Larry Summers, the former US Treasury Secretary and Harvard president commented, "This past month may be remembered as the moment the United States lost its role as the underwriter of the global economic system."

What Summers is referring to is the creation of the AIIB. It could pose a direct challenge to the World Bank, the IMF and the ADB – the traditional sources of international funding and organizations in which US economic interests have a strong voice and the power to veto.

Despite the US's opposition, major European economies like the UK, France, Germany, Switzerland and Luxembourg have applied to be the founding members of the AIIB.

Investment Implications:

We believe OBOR Project will have far-reaching and long lasting impact on Chinese and global economies over the coming years. The AIIB will play an important role in regional infrastructure financing. China will channel excess capacity, large foreign reserves and infrastructure development expertise to help emerging markets to build infrastructure and improve international trade. Sectors such as Energy and Transmission, Oil & Gas, Infrastructure, Machinery, Construction, Transportation (in particular railway) and Telecom will be the major beneficiaries.

Important Information

This document has been carefully prepared by Robeco Institutional Asset Management B.V. (Robeco).

It is intended to provide the reader with information on Robeco's specific capabilities, but does not constitute a recommendation to buy or sell certain securities or investment products.

Any investment is always subject to risk. Investment decisions should therefore only be based on the relevant prospectus and on thorough financial, fiscal and legal advice.

The information contained in this document is solely intended for professional investors under the Dutch Act on Financial Supervision (Wet financieel toezicht) or persons who are authorized to receive such information under any other applicable laws.

The content of this document is based upon sources of information believed to be reliable, but no warranty or declaration, either explicit or implicit, is given as to their accuracy or completeness.

This document is not intended for distribution to or use by any person or entity in any jurisdiction or country where such distribution or use would be contrary to local law or regulation.

Historical returns are provided for illustrative purposes only and do not necessarily reflect Robeco's expectations for the future. Past performances may not be representative for future results and actual returns may differ significantly from expectations expressed in this document. The value of your investments may fluctuate. Past results are no guarantee of future performance.

All copyrights, patents and other property in the information contained in this document are held by Robeco. No rights whatsoever are licensed or assigned or shall otherwise pass to persons accessing this information.

The information contained in this publication is not intended for users from other countries, such as US citizens and residents, where the offering of foreign financial services is not permitted, or where Robeco's services are not available.

Robeco Institutional Asset Management B.V. (trade register number: 24123167) has a license as manager of UCITS and AIFs from the Netherlands Authority for the Financial Markets in Amsterdam. The prospectus and the Key Investor Information Document for Robeco Chinese Equities, a sub fund of Robeco Capital Growth Funds SICAV, can all be obtained free of charge at www.robeco.com.