布局新时代

海通证券 HAITONG

New is better, less is more

——2Q18 Economy and Capital Market Outlook

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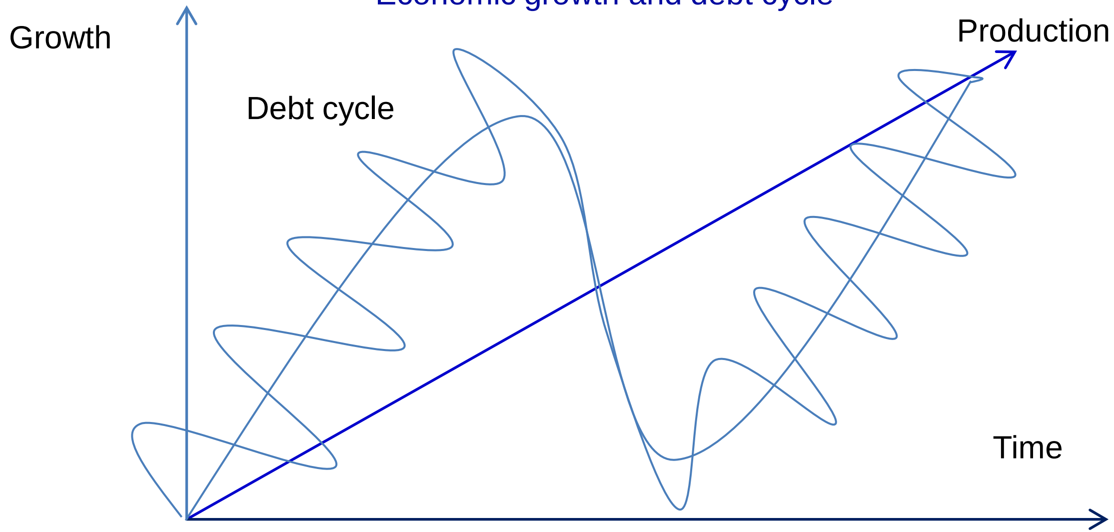
Outline

1. Economic growth and debt cycle
2. Debt reduction and supply-side reform
3. New is better, less is more

Economic growth and debt cycle

- Dalio described economic growth in his *Principles*: For the long term, production efficiency that determines economic growth. Productivity determines consumption capacity. Sometimes, people borrow money for consumption, and as a result, the economy will get better in the short term; but it will worsen if debts are being repaid, which means the debt cycle decides the movement of the economy.
- Dalio classified debt cycles into short cycles and long cycles. Short debt cycles are caused by individuals' borrowing activities, while long debt cycles are caused by borrowing activities of the economy as a whole. Nobody like the economy decline. After all borrowing tools are used, here will come a "lost decade".

Economic growth and debt cycle

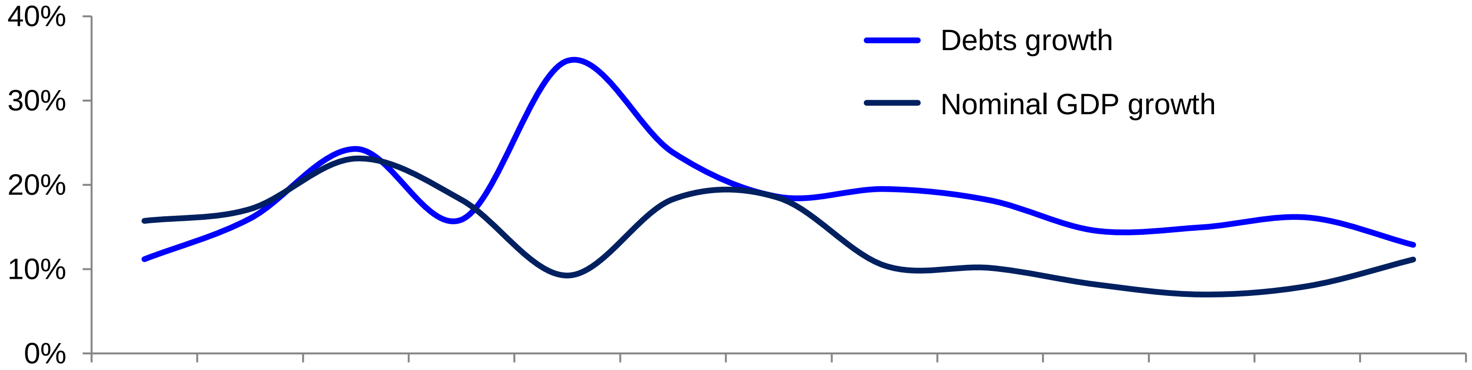


Source: WIND and Haitong Securities

Debts level in China – from normal to excessive

- Before the global financial crisis in 2008, the level of debts was normal in China. Although the average annual growth of debts reached as high as 17%, it did not exceed the nominal GDP growth of 18%.
- However since 2009, China witnessed excessive debts. Annually, China's nominal GDP growth rate was only 10%. The debts grew at a rate of 20%, which kept driving up the debt ratio of the entire society.

China's debts growth and nominal GDP growth

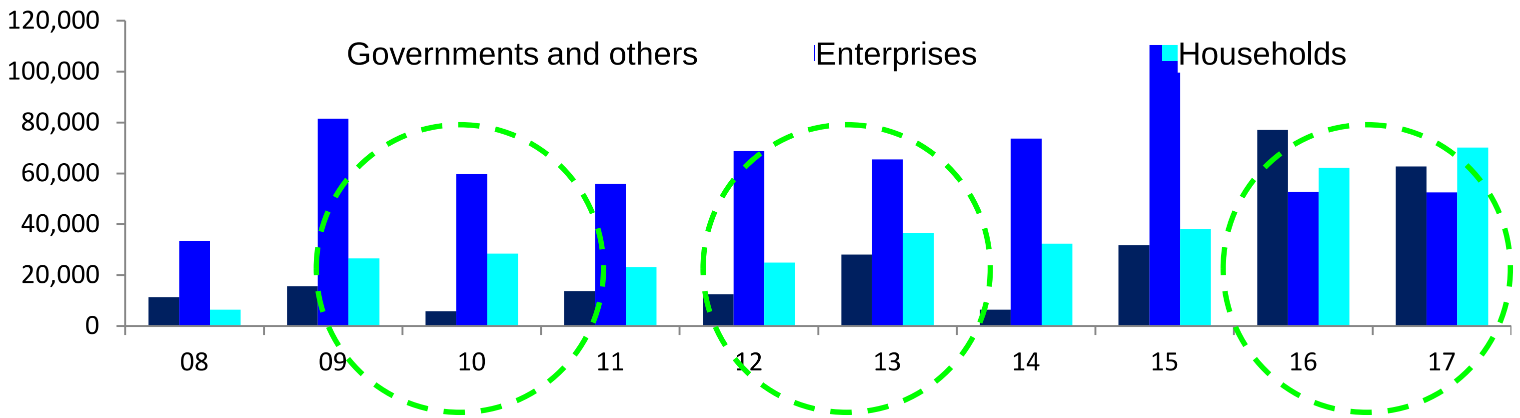


Source: Haitong Securities

Three rounds of increasing leverage over the past decade

- From the perspective of debts, the China's economy experienced ups and downs. The economy experienced three rounds of adding leverage after the financial crisis.
- First round – 2009/2010, corporate sector
- Second round – 2012/2013, government sector
- Third round – 2016/2017, individual household sector

Banks' incremental loans to various entities (RMB tn)

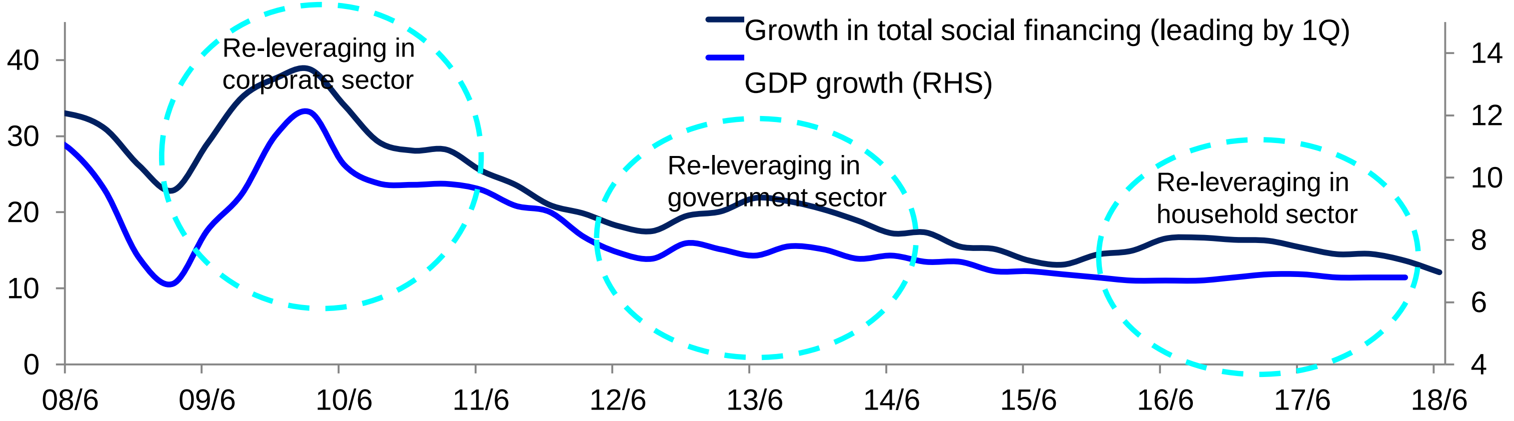


Source: WIND and Haitong Securities

Three rounds of short-term debt cycle

- Accordingly, China experienced three short debt cycles in the past decade.
- When the level of debts went up, we had a good time as the economy and inflation rebounded; the cyclical and large-cap stock price went up; the interest rate increased and the bond market declined
- When the level of debts went down, we had a tough time as the economy and inflation retreated; the cyclical and large-cap stock price went down; the interest rate decreased and the bond market rose.

Growth of government & social financing and GDP growth

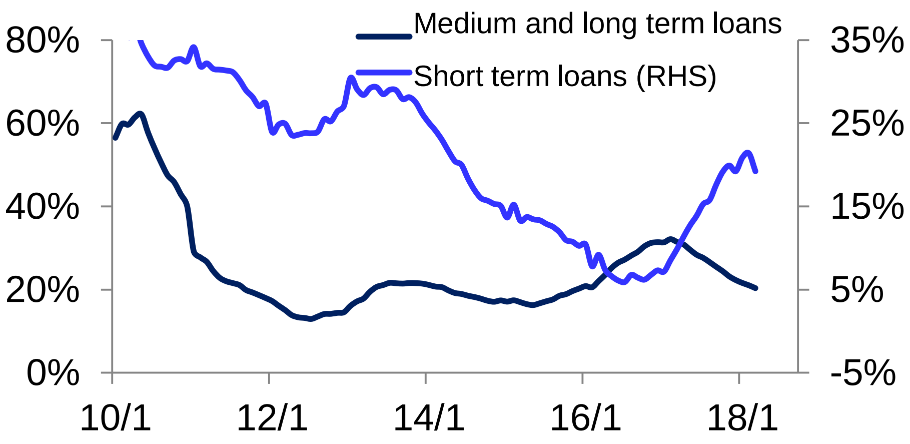


Source: WIND and Haitong Securities

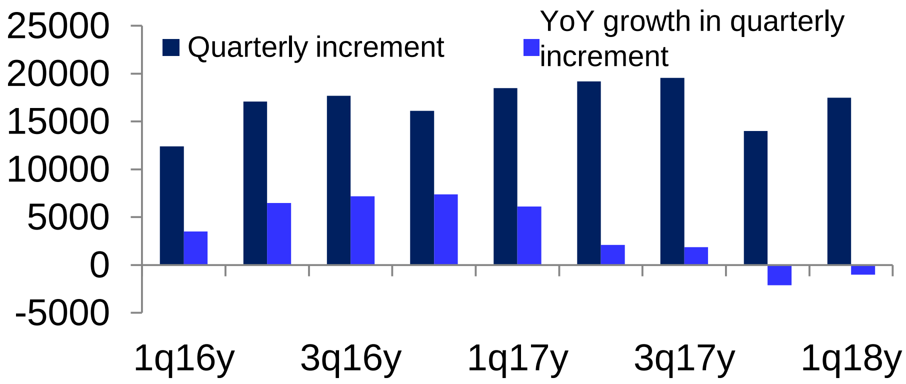
The growing trend of household debts is reversed

- Rising household debts resulted in economic rebound in 2016/2017. The cyclical stocks rose and the bond market declined.
- The decline of the stock market and the rise of the bond market in 2018 are mainly due to the end of this round of household borrowing.
- YoY growth of incremental household loans has been going down for two quarters since 4Q17, while the growth rate of short-term household loans dropped sharply in Mar 2018.

Growth in medium and long term and short term household loans



Quarterly increment of household loans and YoY growth of the increment

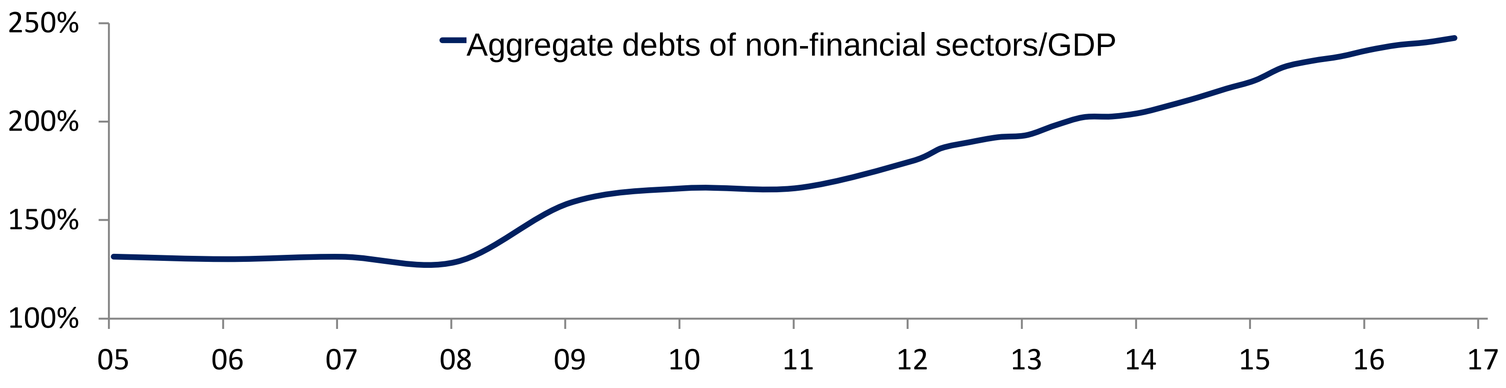


Source: WIND and Haitong Securities

Peak of the long-term debt cycle ?

- In the past whenever the level of debts went down, in response to the retreating economy and inflation, the government would increase money supply to stimulate debt raising activities.
- However, after three rounds of short-term debt cycle, China's all economic sectors – corporate, government, and household – have raised debt. China's debt reached a historical high (242% at the end of 2017, almost twice as high as that in 2008).
- Therefore, China faces similar challenge of the U.S. in 2008 and Japan in 1990s – the peak of a long-term debt cycle. As for the China macro outlook, we need to find ways out of the tremendous debts.

China's aggregate leverage ratio



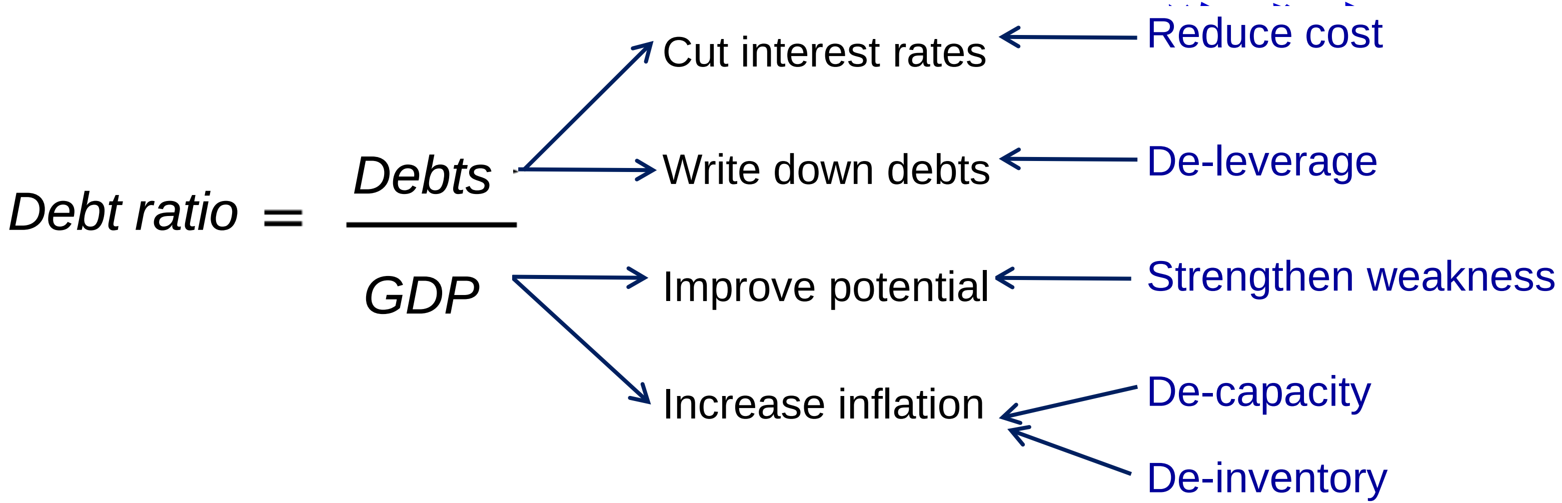
Source: WIND and Haitong Securities

Outline

Four ways of de-leverage

As for the outlook of China, we need to understand how to reduce China’s debt ratio. Theoretically, there are four ways to reduce the leverage ratio

1) cutting interest rates, which is to slow down the expansion of debts
2) writing down debts to reduce the total amount or expansion of debts
3) increasing inflation, which is to increase the nominal GDP
4) improving the potential for economic growth.



Source: WIND and Haitong Securities

Supply-side reform: attempts to reduce debts

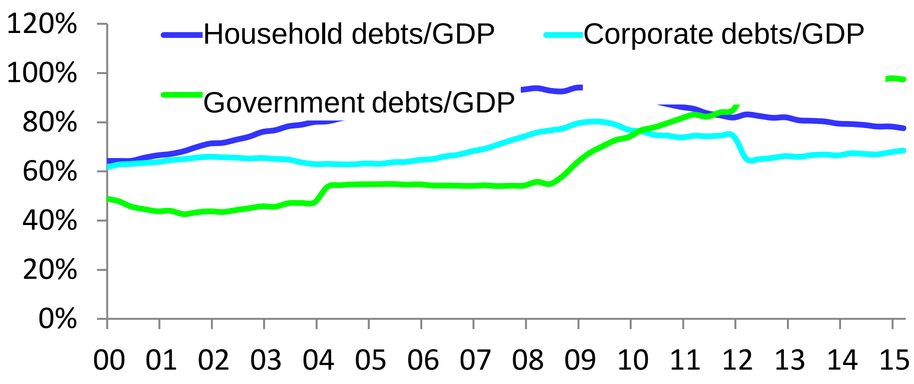
- Cost reduction in 2015: decreased interest rate, bull bond market and bull stock market
- De-capacity in 2016: surging commodity prices
- De-inventory in 2017: soaring housing markets in third and fourth-tier cities, robust home appliance sales
- 2018? De-leverage, strengthen weakness

- Against the backdrop of debt reduction, the supply-side reform came into being.
- Cost reduction was proposed first in 2015. Interest rates cut brought a short-term boom to both the stock and bond markets. In 2016 and 2017, inflation was the highlight of asset allocation. The rising inflation was a result of de-capacity and de-inventory initiated by the government. The stock price surges of Chinese alcohol, iron & steel and coal were attributable to the rising inflation, and the growth of banking and insurance stocks was due to the increasing interest rates upon the rising inflation.
- However, the debt ratio is still setting new highs in spite of the decline in interest rates and the rise of inflation. Because given lower interest rates and higher inflation, individuals and entities are more motivated to raise debt. Therefore, China has two ways to solve the debt issues:
  a) De-leverage – writing down debts by decelerating active borrowing
  b) Strengthen weakness – increasing real income (increasing nominal income by increasing inflation is inefficient)

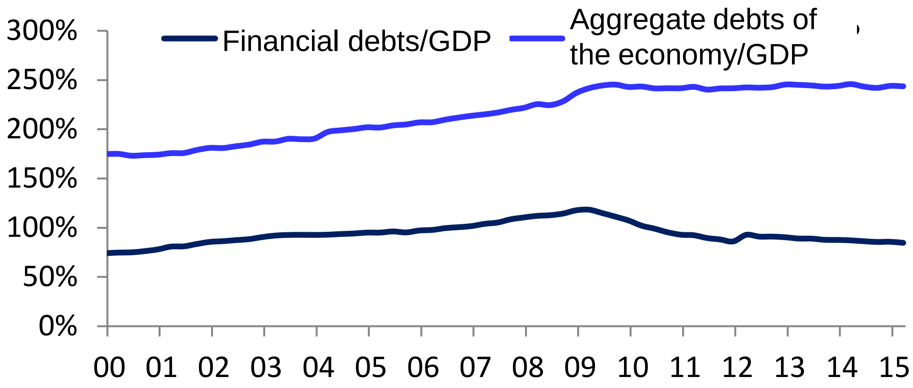
De-leverage in the U.S.: constrain the financial market

- Before the financial crisis in 2008, the U.S. faced the same problem as China currently has – debt had been growing faster than the economy for a long time, leading to continuous increase in debt ratio.
- The U.S. stabilized the debt ratio after 2008 mainly by contracting the financial market, which reduced the size of assets in banks. The decreasing monetary supply from the banks made it impossible for the residents and enterprises to rely excessively on debts for consumption and investment, the overall debt ratio was under control.

Debt ratios of various sectors in the U.S.



Debt ratios of financial sector and non-financial sector in the U.S.

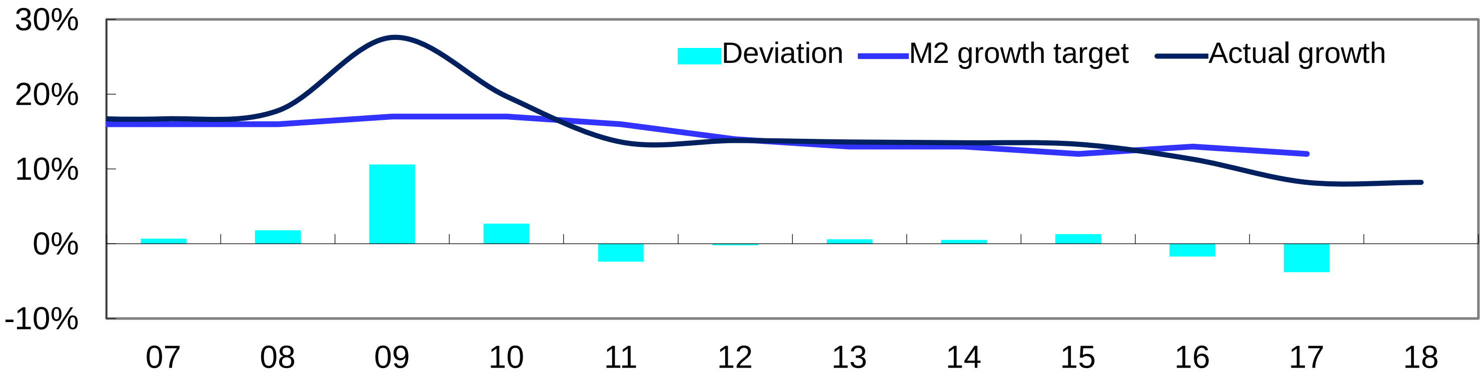


Source: WIND and Haitong Securities

National Congress in 2018: de-leverage and money supply contraction; low growth of money supply will be new normal

- According the government's statements in the past year, it has become a common understanding that China needs to slow down its growth of money supply first to lower its debt ratio.
- In 2018, the government proposed three tasks, among which preventing financial risks is of top priority. In 2018, the government for the first time didn't set any specific targets for money supply growth and financing growth.
- The governor of the PBOC – central bank explained that China's money supply was too much in the past and will be less in future. In the monetary policy report at the end of 2017, the PBOC expressly pointed out that the low money supply growth of around 8% might become new normal.

China's M2 growth target and its actual growth

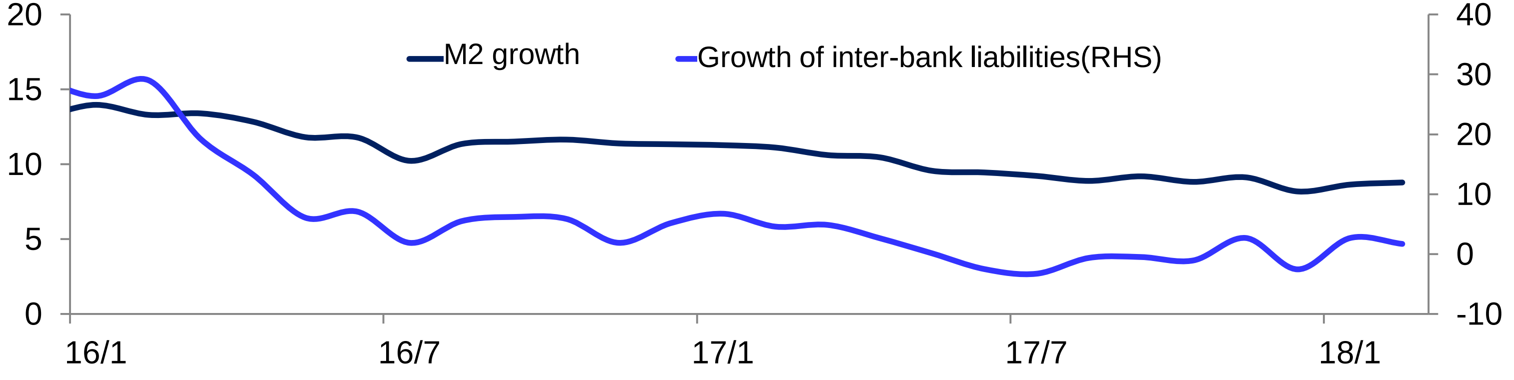


Source: WIND and Haitong Securities

Financial de-leverage in 2017: growth of money supply dropped sharply

- Financial regulation has been strengthened since 2017. Money creation from inter-bank business was contracted, driving down M2 growth from above 11% to around 8%.
- However, as M2 mainly includes types of deposits, its growth slowdown pointed to tightening liquidity among financial institutions. Deposits do not impact the economy directly. Therefore de-leverage mainly happened in the financial market and had little influence on the economy as a whole in 2017.

Growth of M2 and inter-bank liabilities

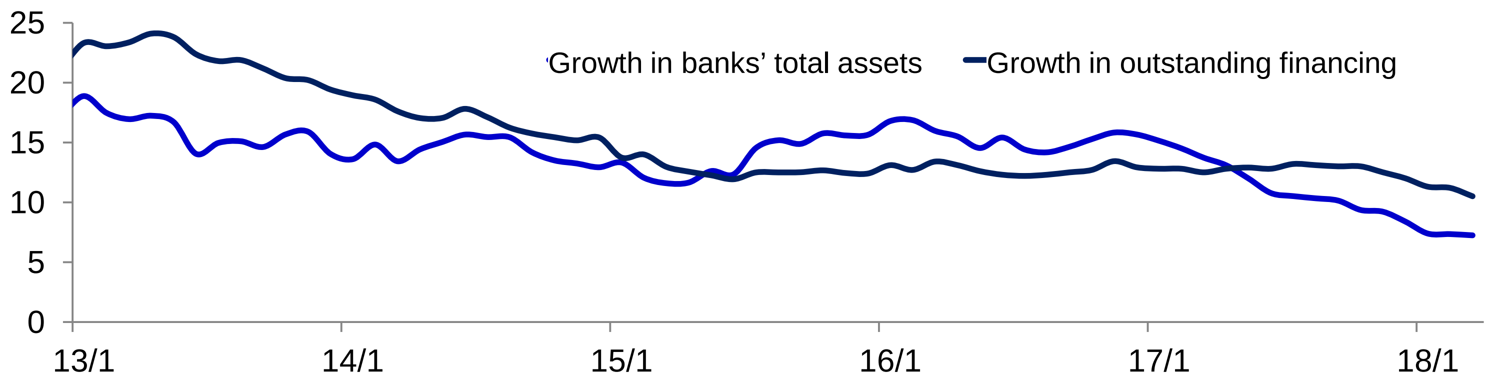


Source: WIND and Haitong Securities

Economic de-leveraging in 2018: financing growth will decelerate

- Debts are results of financing activities, and the total amount of debts is approximately equivalent to total social financing. If China is determined to decelerate raising debt activities, the growth of social financing will slow down in 2018. Growth of financing amount is an leading indicator in the industrials-oriented economy which relies on debts for development.
- The growth of financing amount dropped from the 13% in 2017 to the 10.5% in Mar 2018. According to the ratio of 1:1 of financing growth to GDP growth, the nominal GDP growth may fall from 11% to around 8% in 2018.

Growth in banks' total assets and total amount of outstanding financings

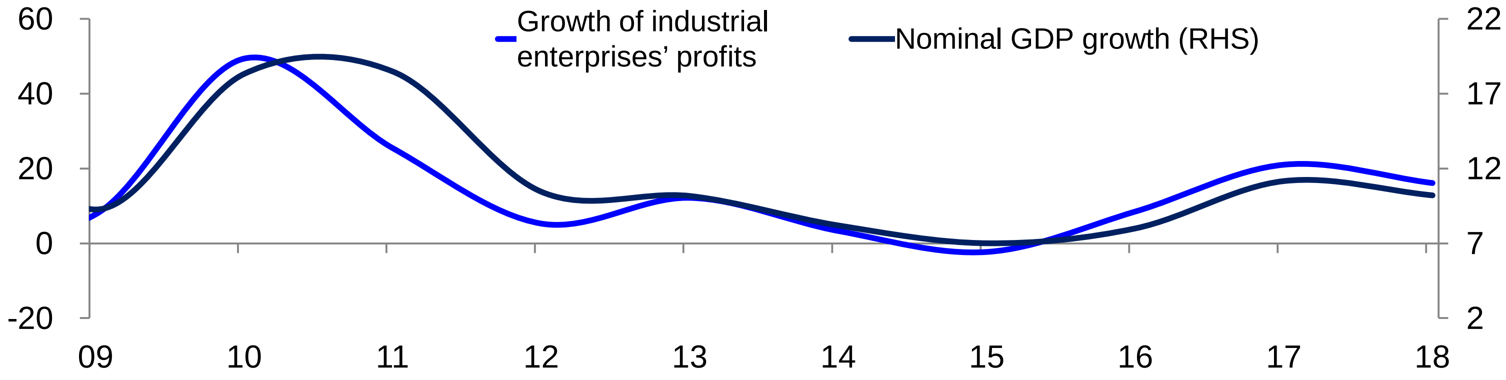


Source: WIND and Haitong Securities

Nominal GDP growth slows, industrials profit under pressure

- Nominal GDP growth is the most important indicator of China's industrials profit. If nominal GDP growth falls to 8%, growth of industrials profit will retreat to 0 according to China’s history.
- In 1Q18, though real GDP growth stabilized at 6.8%, nominal GDP growth fell to 10.2% because of falling prices. Accordingly, the growth in industrial enterprises' profits declined from the 21% in 2017 to 16.1%.

Nominal GDP growth and growth of industrial enterprises' profits

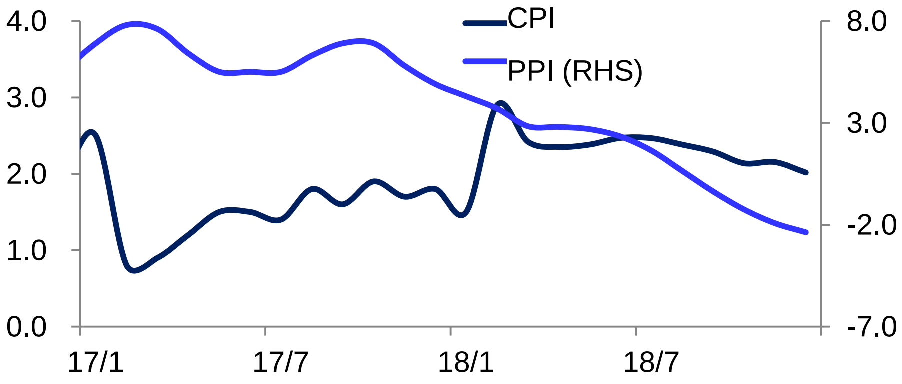


Source: WIND and Haitong Securities

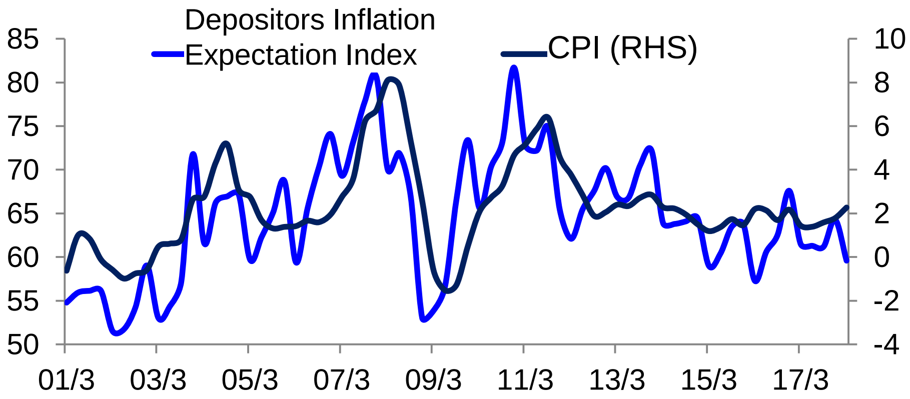
CPI has toped out, PPI shows a downtrend

- In the past two years, inflation expectation rose significantly, which was reflected in the large increase of PPI growth. Since 2018, CPI growth has stayed low, while PPI growth has showed a downtrend, which means the inflation pressure is easing gradually. The Depositors Inflation Expectation Index of the PBOC set a two-year low in 1Q18, pointing to declining inflation expectation.
- Both the drop of monetary financing and the falling nominal GDP indicate that the inflation expectation is declining.

CPI and PPI growth and forecast



CPI and Depositors Inflation Expectation Index



Source: WIND and Haitong Securities

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Strategic asset allocation for 2018

I. Innovation: Hong Kong stocks and A-shares

II. Slowing growth of financing: bond market and quasi-bond assets

III. Risk-aversion: gold

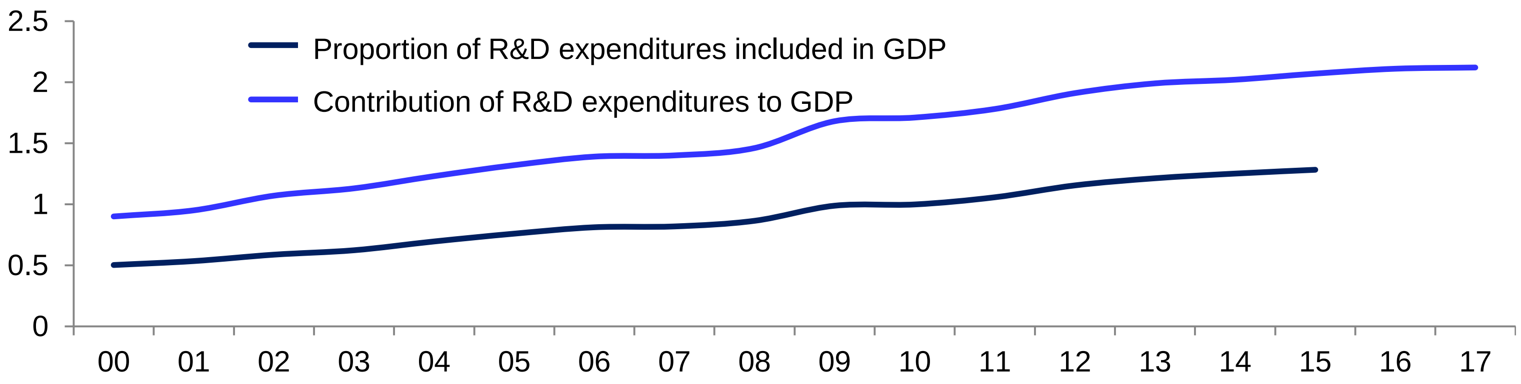
IV. Mild CPI growth: service and consumption sectors

V. Declining PPI growth: be cautious on domestic commodity and housing markets

R&D is included in GDP

- Why do we think innovation is the biggest opportunity for China in the future? From the macro perspective, the biggest change in China's economic growth calculation during the past few years was that China officially included R&D expenditures into GDP from 2016.
- According to the revised data, in 2015, China’s R&D expenditures were equivalent to 2.07% of its GDP and 60% of the expenditures was included in GDP, which means R&D expenditures contributed 1.3% of the GDP.

Contribution of R&D expenditures to GDP

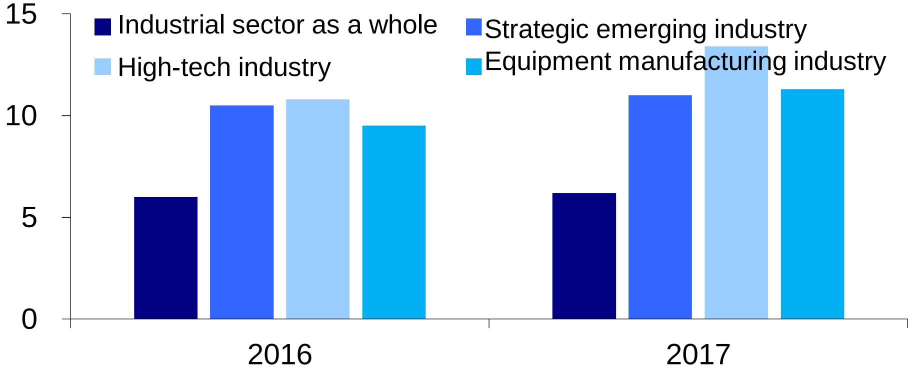


Source: WIND and Haitong Securities

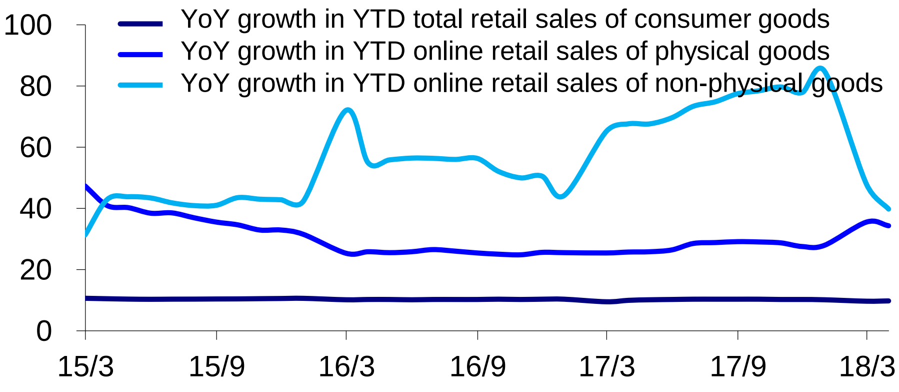
New economy is included in GDP

- Another change in 2016 in terms of statistics was that the new economy was also incorporated into GDP calculation. The NBSC has established new statistical system to reflect new industries, including high-tech industries, strategic emerging industries, high-tech service industry, Internet finance, technology incubators, crowd maker space and crowd-funding, etc.
- In terms of new industries, the strategic emerging industry, high-tech industry and equipment manufacturing industry all realized growth rate of over 10% in value-added output in 2016 and 2017, much higher than the average industrial growth rate of 6%. In terms of new business forms, the growth in online retail sales rose to 28% in 2017, much higher than the growth of about 10% in the total retail sales.

Growth in value added in the industrial sector and three emerging industries



Growth of total retail sales of consumer goods and online retail sales of physical goods and non-physical goods

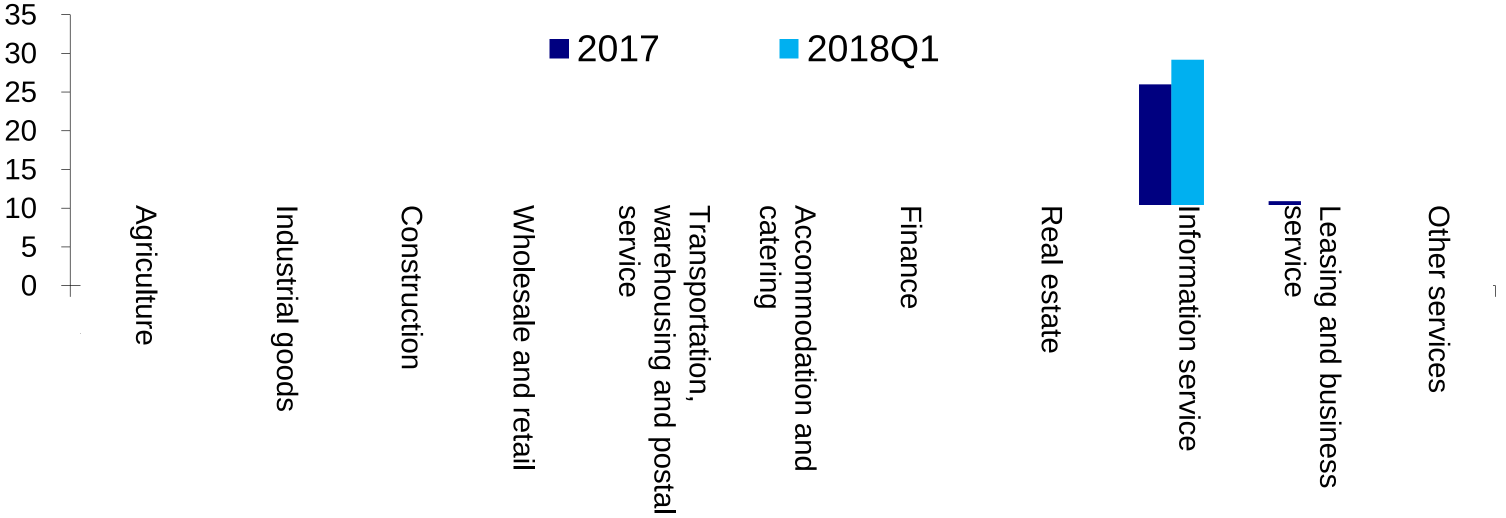


Source: WIND and Haitong Securities

The new economy grows fast

The information service industry, which represents the new economy, has been growing fast since 2017 and its growth rate reaches close to 30% at present.

The information service industry grows fast

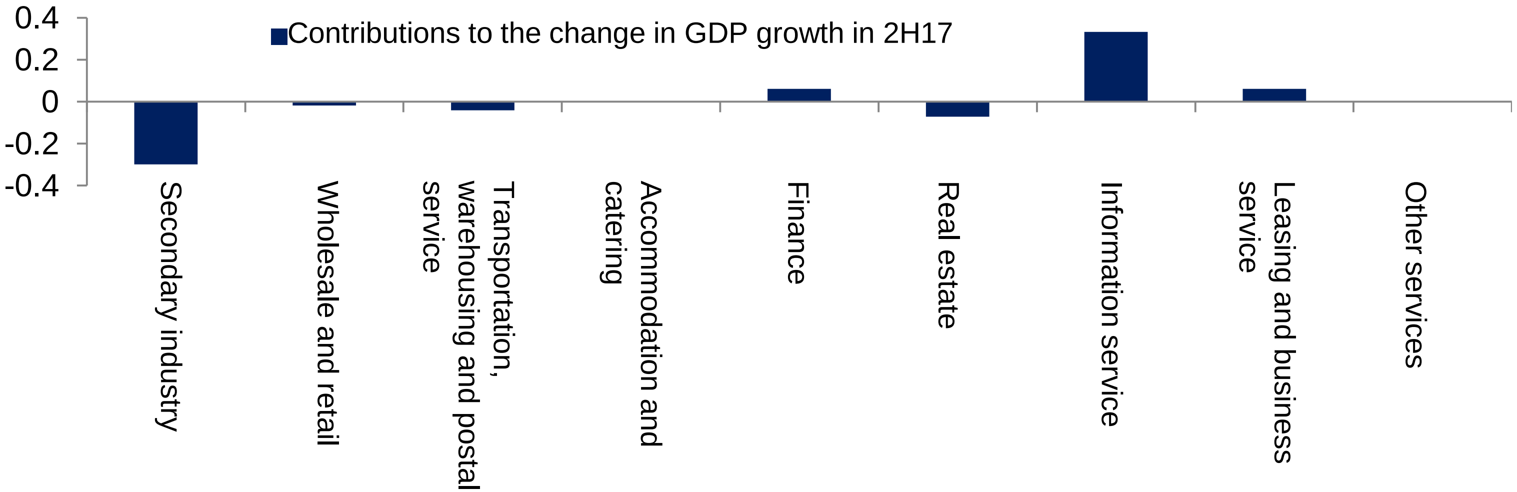


Source: WIND and Haitong Securities

Moderate economy growth: old economy slows, new economy rallies

- The moderate growth of economy since 2017 is contributed by the high growth of the new economy rather than the traditional industries such as real estate and industrials.
- In 2017, the information service industry grew by 25% and contributed 1% of GDP growth based on its weight of around 4% in GDP, fully making up for the decline in industrials.

Contributions to the change in GDP growth in 2H17

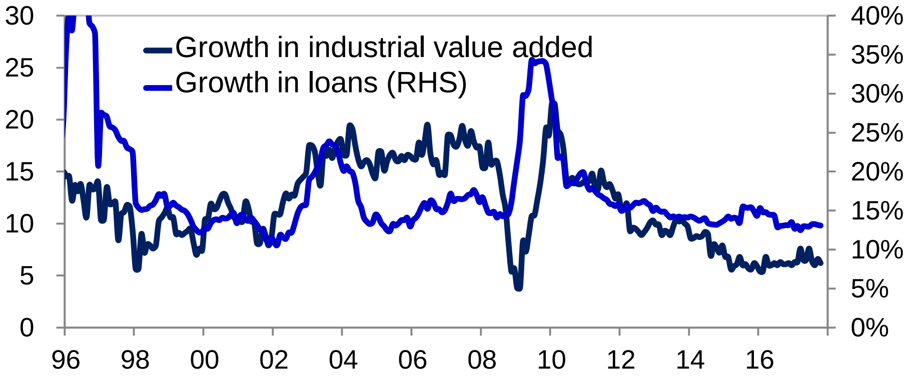


Source: WIND and Haitong Securities

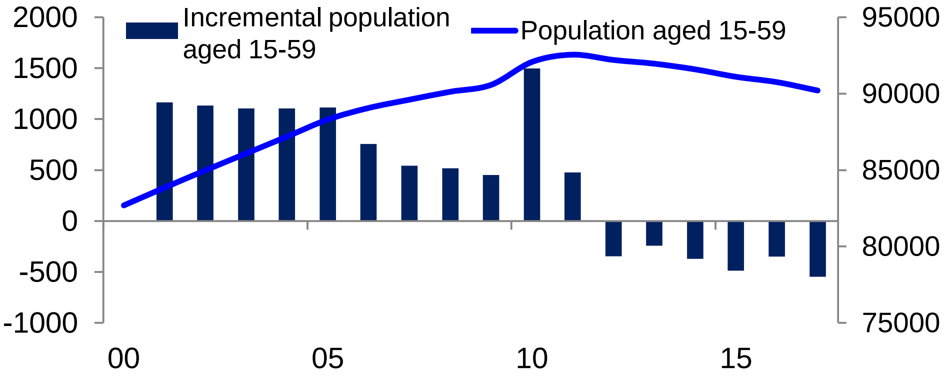
Industrialization relies on debt financing

- In the past, we were in the industrialization era. In this era, with the support of demographic dividend and urbanization, i.e. annual incremental young population of 10mn and rural population of 20mn migrating to urban areas each year, the residents' demand for material goods boomed. Therefore, the economy priority was to keep producing more and more houses, cars, furniture and home appliances. Debt financing from banks was the best tool.
- However, at present, the demographic dividend has disappeared as the young population is decreasing by more than 5mn each year. Urbanization is close to end. There is not so much incremental demand. If China still relies on debt financing, debts will pile up and bubbles will occur.

Industrial growth and loan growth



China's demographic dividend ended

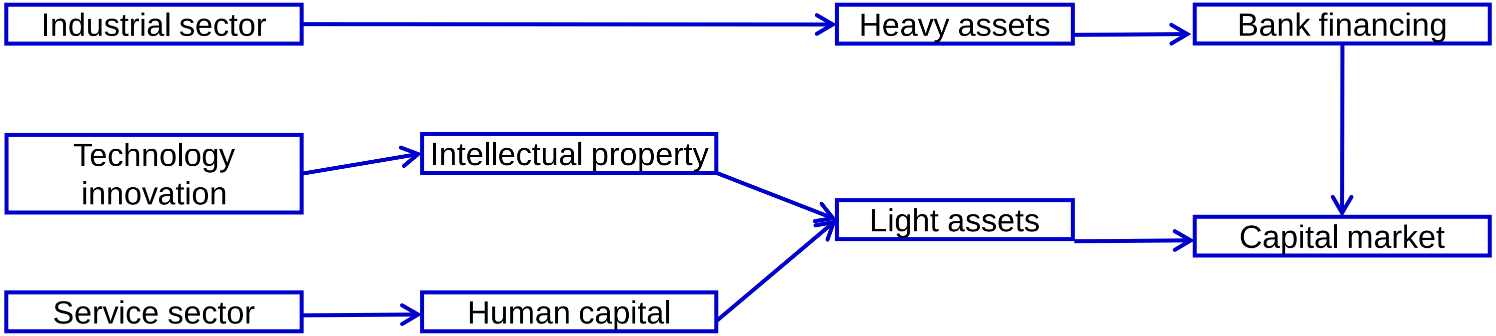


Source: WIND and Haitong Securities

Innovation relies on equity financing

- The foundation of innovation is intellectual property and human capital. In the industrialization era, simple replication was needed rather than professional knowledge. However, innovation is based on various types of professional knowledge and relies on scientists and engineers, which are human capital. The key to stimulate human capital is equity financing.
- Liu He (vice-premier of the State Council) wrote paper in 2001 to discuss the relationship between the new economy and capital market & venture capital. He thought that the new economy represented the future and was people-oriented. Human creativity and market were the driving forces. Venture capital was crucial for new economy expansion and must rely on the capital market for exit. Equity financing was the best mechanism to diversify risks and stimulate innovation.

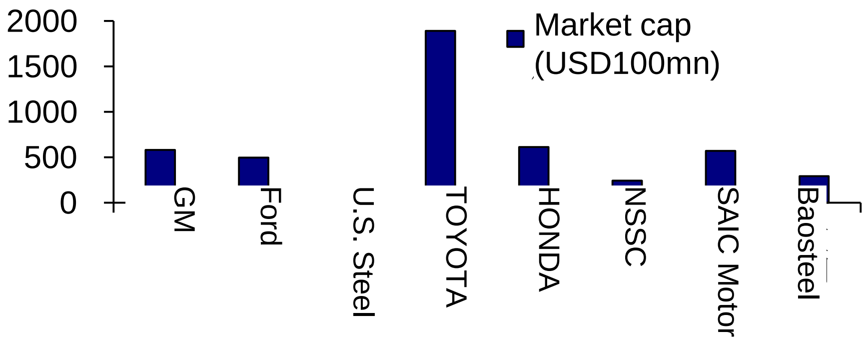
Financing restructuring brought by the shift of growth drivers



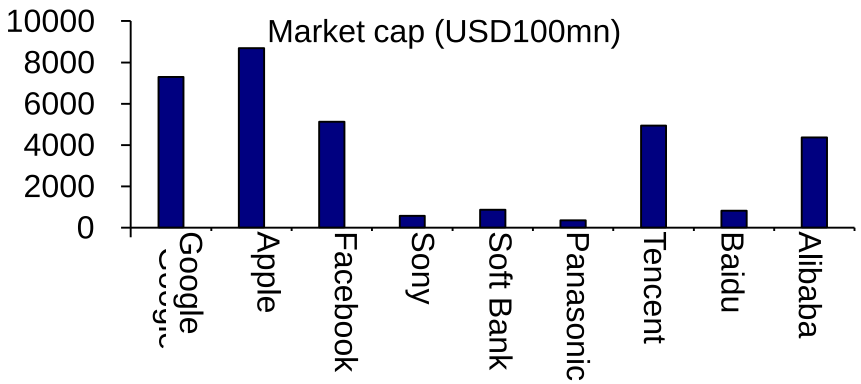
Equity financing cultivates innovative enterprises

- We have studied the success of the U.S. and the failure of Japan in economic transformation. We found that both of them were once caught in the trap of debt-driven development, but the U.S. successfully got out of the trap, while Japan fell deep in a bubble economy. Different financing structure is the key.
- In the U.S., after 2008, a lot of new enterprises grew up through PE and equity financing, including Google and Facebook. All of them were cultivated by equity financing. In Japan, the financing system was dominated by banks. The industrialization era cultivated traditional industrial leaders such as Toyota, but they all have fallen behind in the new economy era.
- China's current world-leading enterprises such Alibaba and Tencent were also cultivated by the capital market.

Market cap of companies from traditional industries



Market cap of high-tech companies



Source: WIND and Haitong Securities

How Facebook was created

- Almost all innovative companies in the U.S. are somehow related to equity investment funds such as PE/VC.
- For example, now Facebook has over USD500bn market cap. It had ten rounds of equity financing before IPO. With the support of equity investment funds, its market cap has risen from USD5mn after the first round of equity financing to USD50bn after the tenth round.

Pre-IPO investments from equity investment funds to Facebook

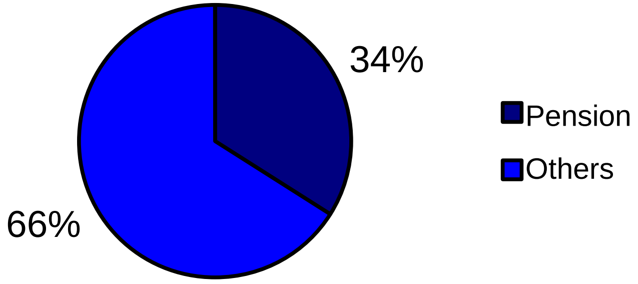
Series	Investor	Amount (USD)	Time	Valuation (USD)
A	PayPal founder Thiel	0.50mn	Sep 2004	5mn
B	Accel Partners	12.70mn	May 2005	127mn
C	Greylock Partners and other PE funds	27.50mn	Apr 2006	550mn
D	Microsoft	240mn	Oct 2007	15bn
E	Samwer Brother	15mn	Jan 2008	15bn
F	Li Ka-shing	120mn	Mar 2008	15bn
G	TriplePoint Capital	100mn	May 2008	15bn
H	DST from Russia	200mn	May 2009	10bn
I	Elevation Partners	210mn	Jun 2010	23bn
J	Goldman Sachs and DST	500mn	Jan 2011	50bn

Source: WIND and Haitong Securities

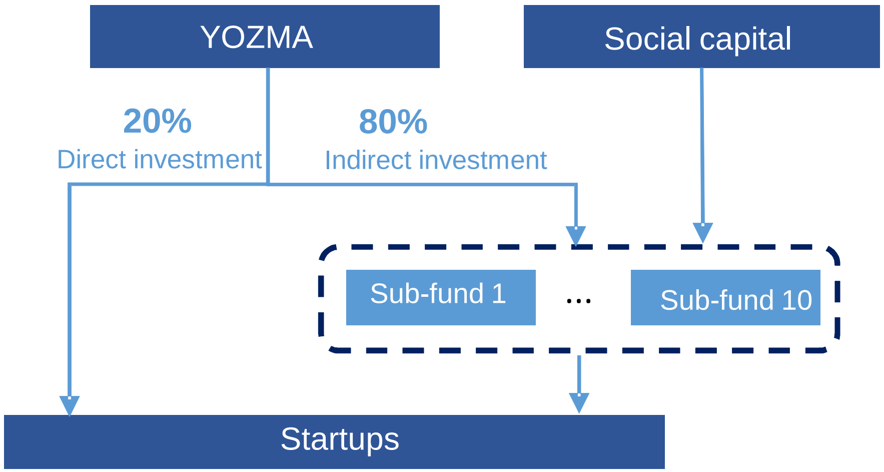
Source of capital: pension and government funds

- In 1979, the U.S. Department of Labor allowed pension plans to invest in emerging enterprises and venture capital companies, which provided long-term stable capital support for the U.S. equity investment funds. At present, 34% of the capital of the U.S. large-sized equity investment funds comes from pension – the biggest source of capital. In addition, government funds can also serve as a long-term stable capital source.
- The YOZMA program launched by the Israeli government successfully managed government capital to expand the value of the equity investment fund and enhance its innovation ability.

Sources of money of large sized equity investment funds in the U.S. in 2017



How YOZMA runs

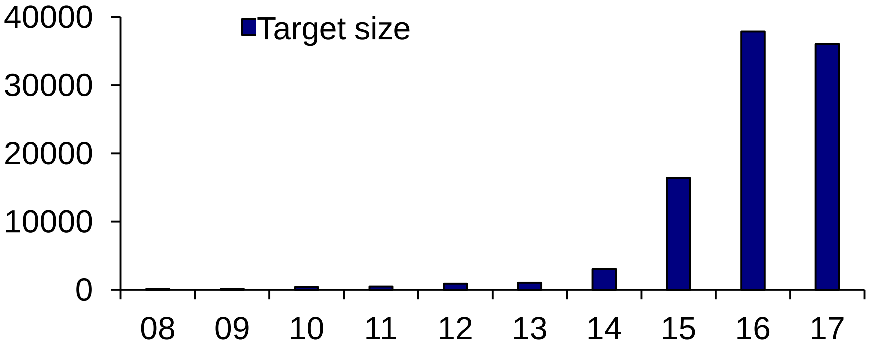


Source: WIND and Haitong Securities

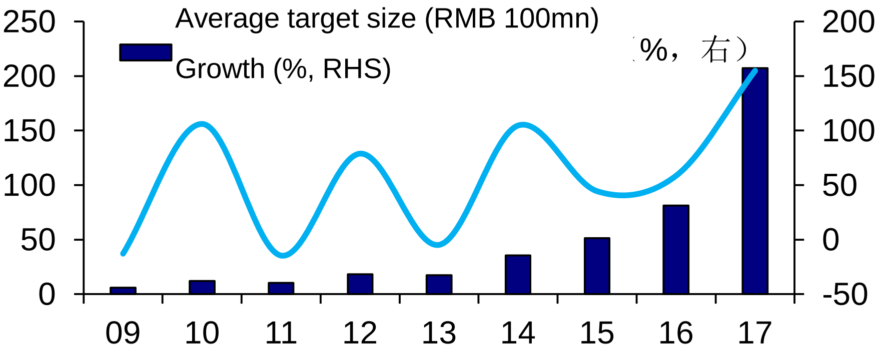
Industry investment funds are prospering

- Upon the establishment of the "big fund" (i.e. China Integrated Circuit Industry Investment Fund) in Sep 2014, China government's industry investment funds have been developing rapidly.
- The target AUM of the funds was only around RMB300bn in 2014, but surged beyond RMB1.6tn in 2015 and even exceeded RMB3.5tn in 2016-2017.
- From 2008 to 2014, the number of newly established funds rose from about 60 to 117, then soared to 444 in 2015 and kept increasing to over 500 in 2016. and AUM per fund also climbed from less than RMB2bn to over RMB20bn.

Target size of the government's industry investment funds (RMB 100mn)



Average target size of the government's industry investment funds and its growth

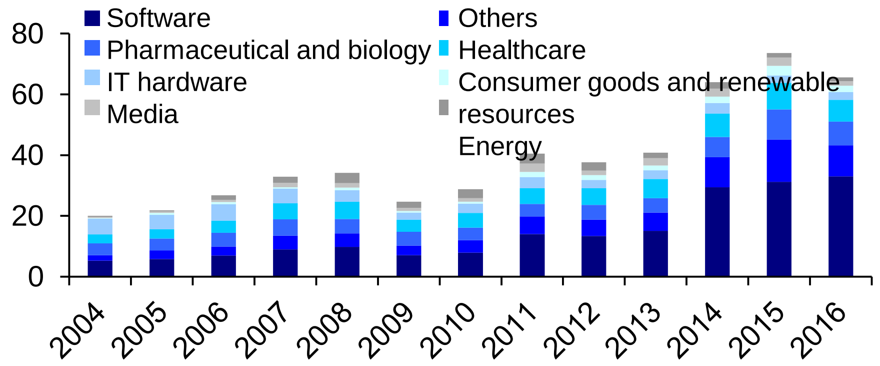


Source: WIND and Haitong Securities

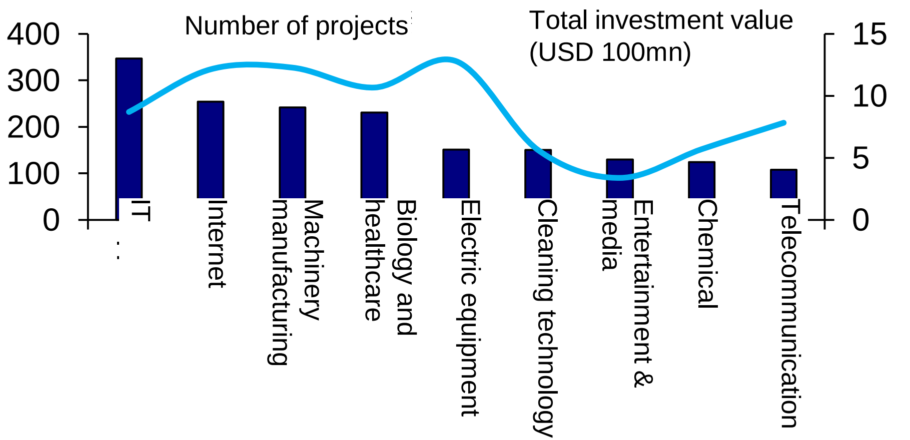
The funds mainly invest in emerging industries

- The US equity investment funds mainly invest in emerging industries. According to NVCA, in 2016, the IT industry ranked the top among the investment targets of the U.S. equity investment funds, followed by the biomedical industry. These two industries together accounted for 73% of the total investment, which shows the support of US equity investment funds for the emerging and high-tech industries.
- Chinese government's industry investment funds mainly invest in such industries as the new generation IT, high-end equipment, new materials, biology, energy conservation and environmental protection – the strategic emerging industries identified by the government.

Distribution of investments of U.S. equity investment funds by industry (USD bn)



Distribution of investments of Chinese government's industry investment fund by industry

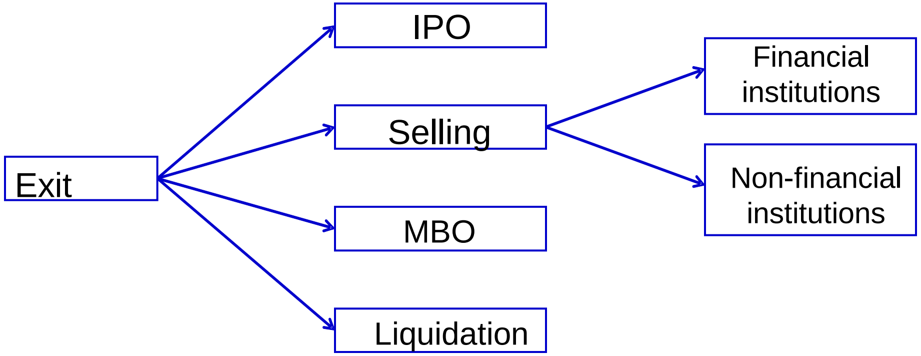


Source: WIND and Haitong Securities

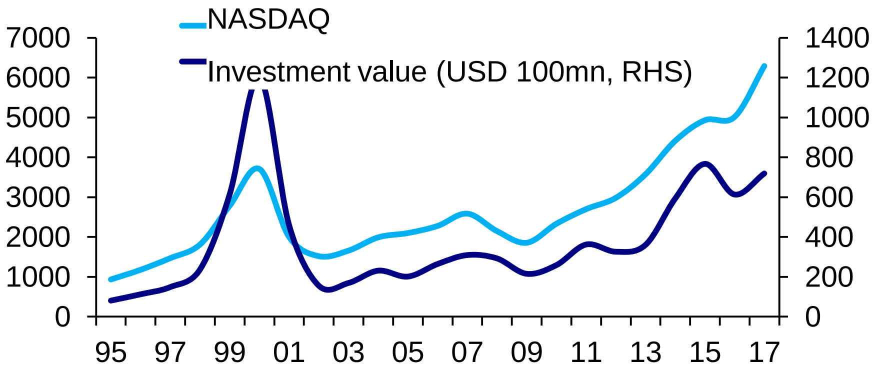
A developed capital market is indispensable

- Exit is the last step of equity investment funds. Generally, there are four ways to exit: IPO, equity sales and transfrer, MBO and liquidation for bankruptcy. Among them, IPO is the most attractive way for the long term, highly dependent on a developed capital market.
- In the U.S., the Nasdaq Index which reflects the performance of the "new economy" moves along with the investment amount of the U.S. equity investment funds, which points to the symbiosis between equity investment funds and innovative companies.

Exit of equity investment funds



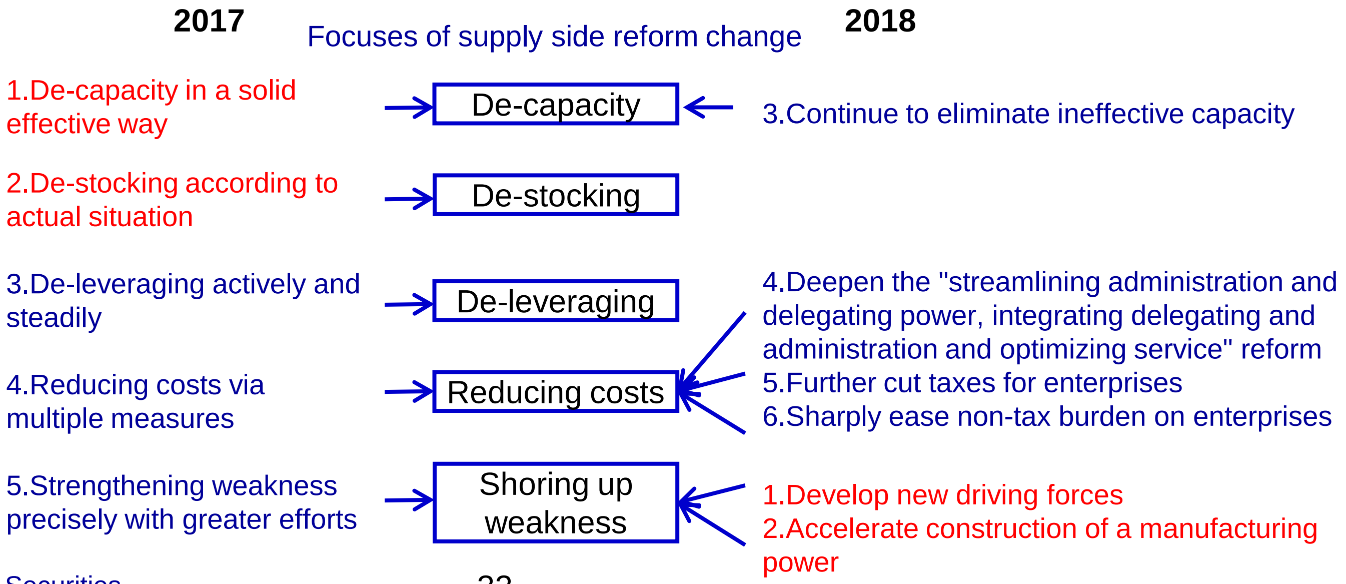
Investment value of U.S. equity investment funds and NASDAQ



Source: WIND and Haitong Securities

Strengthen weakness in 2018: develop new driving forces

- We find that the new leadership has an important feature - ruling by experts. The Vice-Premier Liu He and the PBOC's Governor Yi Gang both are economic experts. They will be carry out policies professionally rather than simply loose liquidity as before.
- In the Government Work Report released at the two sessions of NPC and CPPCC in Mar this year, "developing new driving forces" and "accelerating the set-up of manufacturing capacity" were specified as the primary goals of the supply-side structural reform in 2018. Meanwhile, the latest Politburo meeting clearly proposed to strengthen the development of core technologies and actively support the development of the enterprises with new technologies, new business forms and new products. These all signal that the focus of the supply-side reform has shifted to strengthening weakness and developing new economic driving forces.



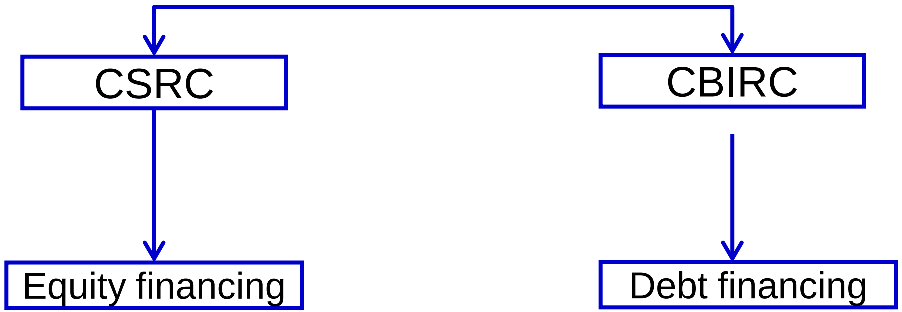
Source: WIND and Haitong Securities

Equal emphasis on equity and debt financing in the future

- We find a change from the government institutional reform at the two sessions of NPC and CPPCC, i.e. the CSRC is kept, but the CBRC and CIRC are merged into China Banking and Insurance Regulatory Commission.
- This will improves the position of equity financing, because the stock market under the supervision of the CSRC represents equity financing, and bank loans mainly represent debt financing. It foretells that equity financing and debt financing will be equally important in the future.

CSRC – China Securities Regulatory Committee
CBRC – China Banking Regulatory Committee
CIRC – China Insurance Regulatory Committee

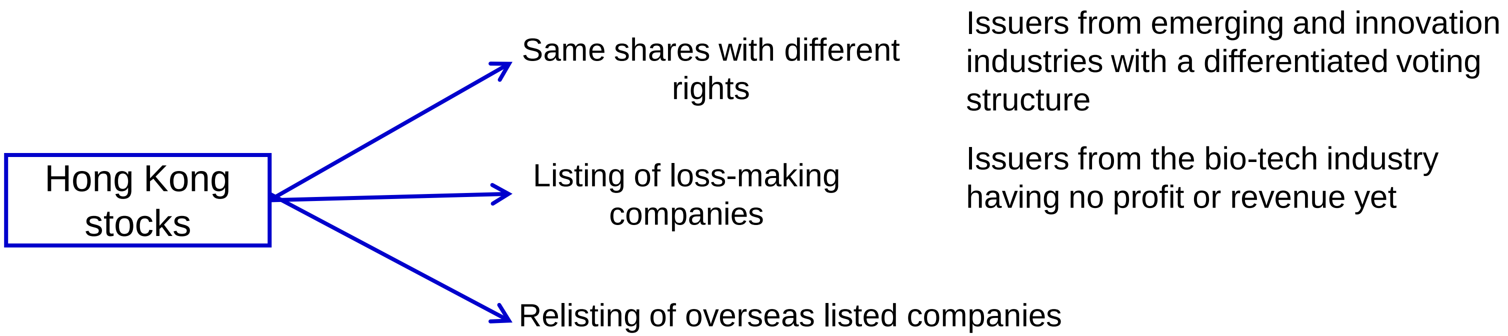
CSRC and CBIRC



The reform of HK stock market will boost innovative enterprises

- First, the Hong Kong stock market experienced significant change this year. The policies of “same shares with different rights” and “listing of loss-making enterprises” will be carried out.
- Innovation needs a lot of R&D expenditure and may not work in the short term. Therefore, it is necessary to allow loss-making companies to go public. Meanwhile, some companies need large amount of financing but do not want to lose control, so “same shares with different rights” should be allowed.
- If these new policies are implemented in Hong Kong, good enterprises such as the Alibaba and BeiGene will not need to list in the U.S..

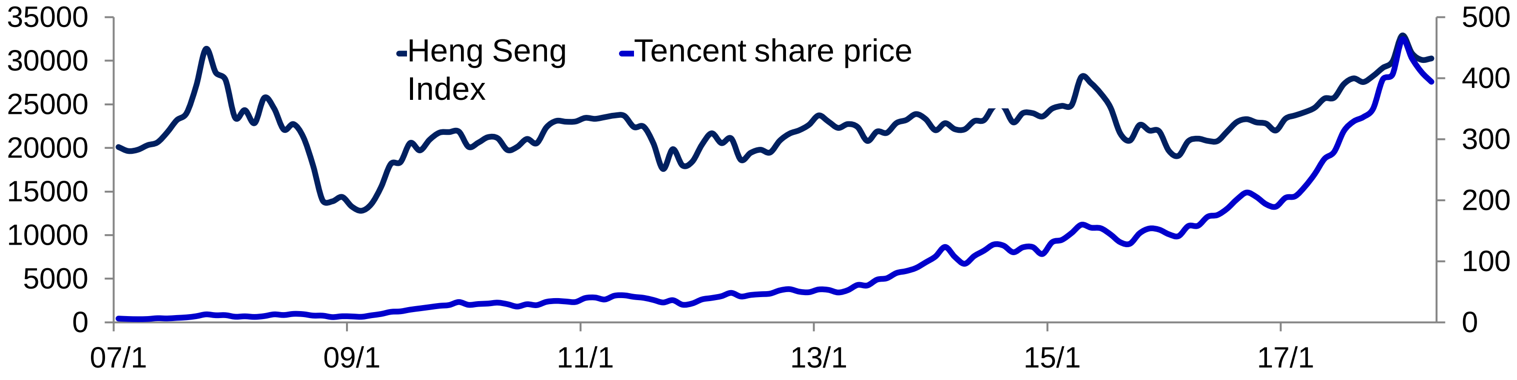
Big changes of HK Stock Market



HK stock market: from a cyclical market to a growth market

- We are optimistic about the Hong Kong market for the long term, because the Hong Kong market was no longer a cyclical market that represented the financial and real estate sectors, but would turn to a market headed by innovative leaders, including Tencent and a number of emerging leaders such as Xiaomi and Ant Financial.
- In the past, Heng Seng Index rallied to 30,000 points along with the growth of Tencent. Hong Kong stock market will be prosperous with more emerging enterprises in the long term

Heng Seng Index and Tencent share price

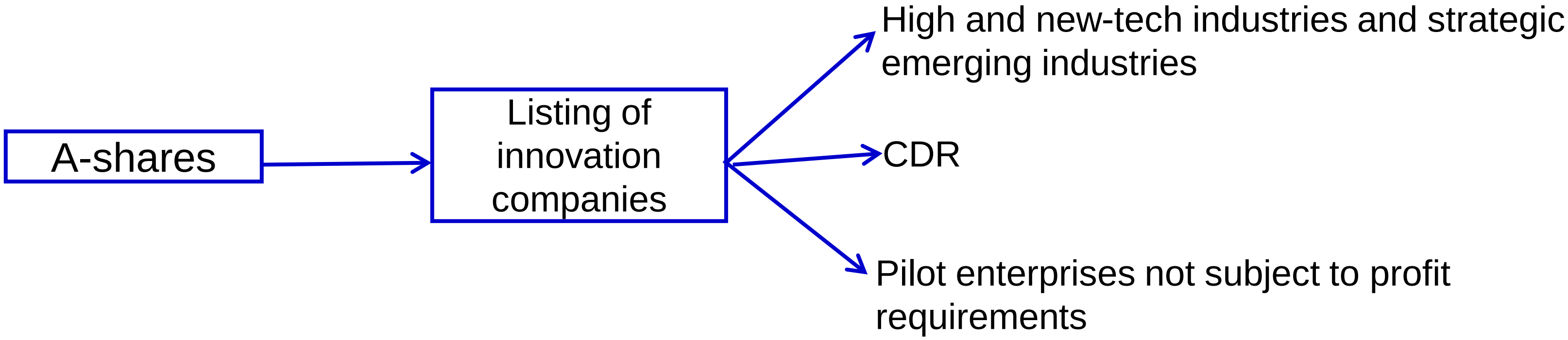


Source: WIND and Haitong Securities

A-share market reform stimulates innovation

- Similarly we have more confidence in A-share market. Hong Kong is an integral part of China, so the change in Hong Kong stock market is not independent but is a part of the reform and opening up of China's capital market. The A-share market also experienced drastic changes this year.
- At the end of Mar, the State Council forwarded the *Several Opinions on Pilot Issuance of Shares or Depositary Receipts in China by Innovative Enterprises* from the CSRC. Innovative enterprises are encouraged to issue securities in the domestic capital market. Innovative enterprises (with considerable size) from strategic emerging industries and strategic innovative industries – internet, big data, cloud computing, artificial intelligence, software, integrated circuits, high-end equipment manufacturing, biology and pharmaceutical – can issue shares or depositary receipts within China, not subject to any profit requirements.

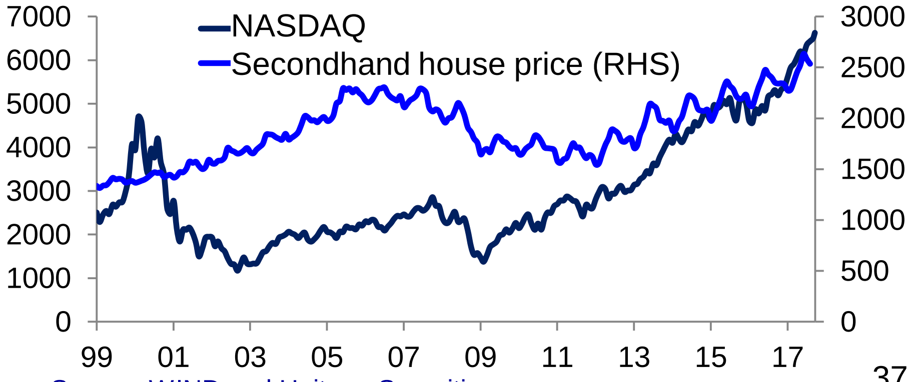
Institutional changes of A-shares



New era: the new is better

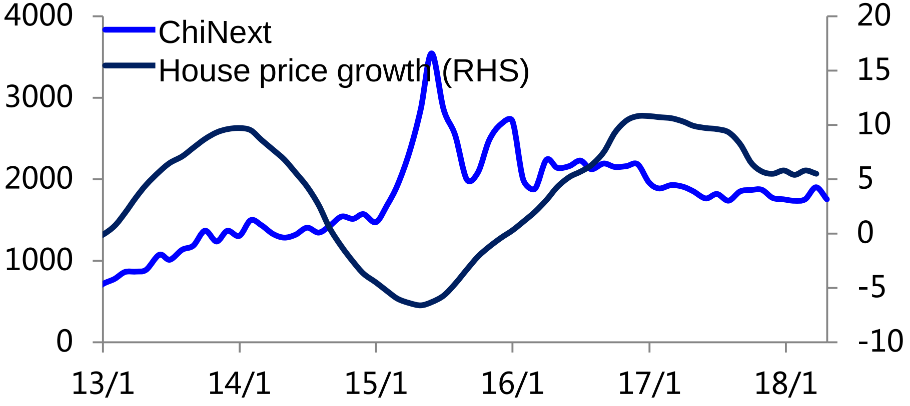
The development of the U.S. economy over the past 20 years is very similar to the current situation in China and can help us find the future direction. The dot-com bubble in the U.S. in 2001 was similar to China's ChiNext bubble in 2015, both of which were accompanied by the hope for economic transformation, but the first attempt failed in both countries. The two governments both loosened liquidity to deal with the situation and the people in both countries borrowed money to buy houses, which gave rise to a housing bubble; however, after the central banks tightened liquidity again, the bubbles burst. In the U.S., the wealth created during the 10 years after the bursting of the housing bubble was sourced from the Nasdaq leaders such as Google and Amazon. Therefore, according to what happened in the U.S., when China's housing bubble becomes a concern, we should fully allocate the assets to China's new economy. In the past, those assets were allocated to US stocks, while in the future, there will be opportunities in the HK stocks and A shares.

NASDAQ and secondhand house price in the U.S.



Source: WIND and Haitong Securities

ChiNext and China's house price growth



US: R&D creates value

For example, the famous Amazon has market cap as high as USD750bn. It kept making losses for 20 years before 2017 when it made net profits of USD3bn, pointing to PE of over 200X. Why can it has such high valuation? One important reason may be that it spent USD22.6bn on R&D in 2017. If Amazon gave up R&D entirely, its net profits could have reached USD25.6bn in 2017, corresponding to PE of 29X, lower than that of other major technology companies. This shows that in a mature market like the U.S., high value should be given to R&D. Amazon's R&D not only creates value for its shareholders but also directly creates GDP. In 2017, Amazon's R&D expenditures increased by USD6.5bn from a year ago. If this sum of additional R&D expenditures was directly included in GDP calculation, it was almost equivalent to 1% of the U.S.D760bn incremental GDP in the U.S. in 2017. This is just the contribution of Amazon.

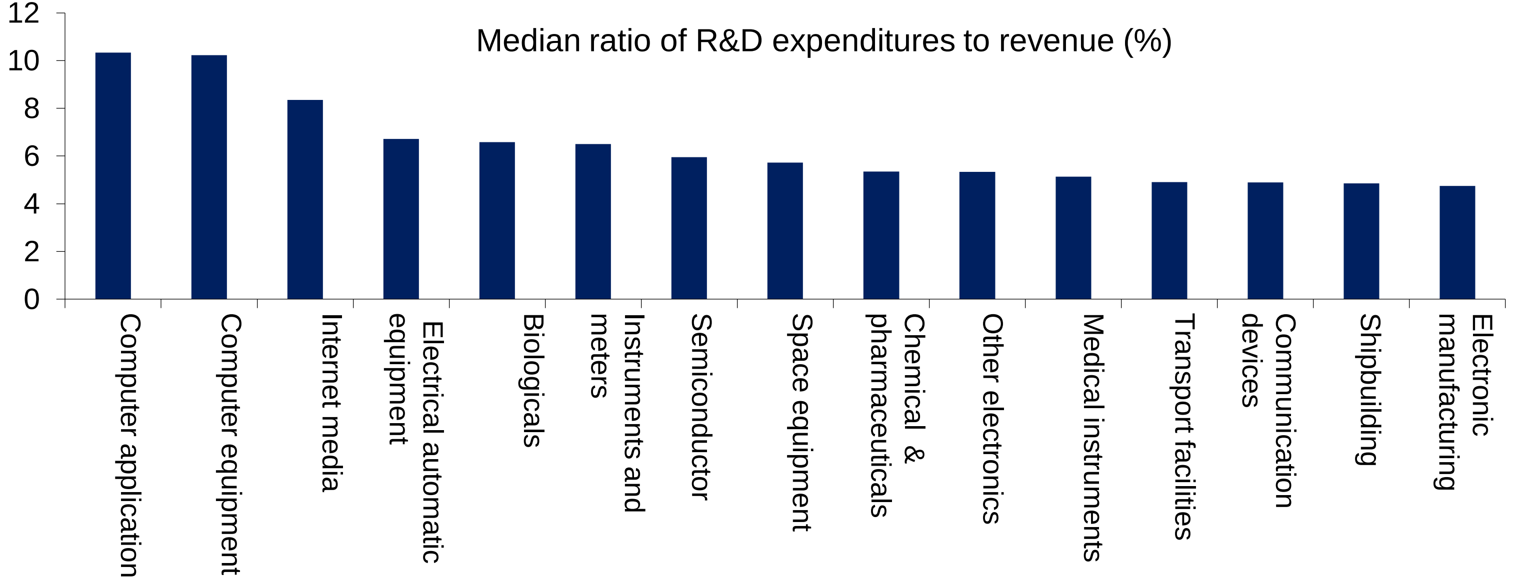
Amazon's profits, R&D and contribution to GDP

Market cap	Profits	PE	R&D expenditures	Profits before R&D	PE before R&D	Incremental R&D	Incremental R&D/incremental GDP
USD 750bn	USD 3bn	250	USD 22.6bn	USD 25.6bn	29	USD6.5bn	1%

Source: WIND and Haitong Securities

The sectors with a high R&D input/revenue ratio are best performers in A-share market

In the A-share market, growth stocks are the best performers this year, but many people satirize it as a bubble, because after the bursting of the ChiNetx bubble in 2015 and the rise of white-horse value stocks during the past two years, many people deem banking stocks and real estate stocks as good targets for value investing, while buying growth stocks is regarded as speculation. Is it true? We think this viewpoint is a big mistake and those investors are missing the major opportunities in China's economic transformation. The sectors such as innovative drugs, semiconductor and software, which have been rising this year, all have a high R&D input/revenue ratio.

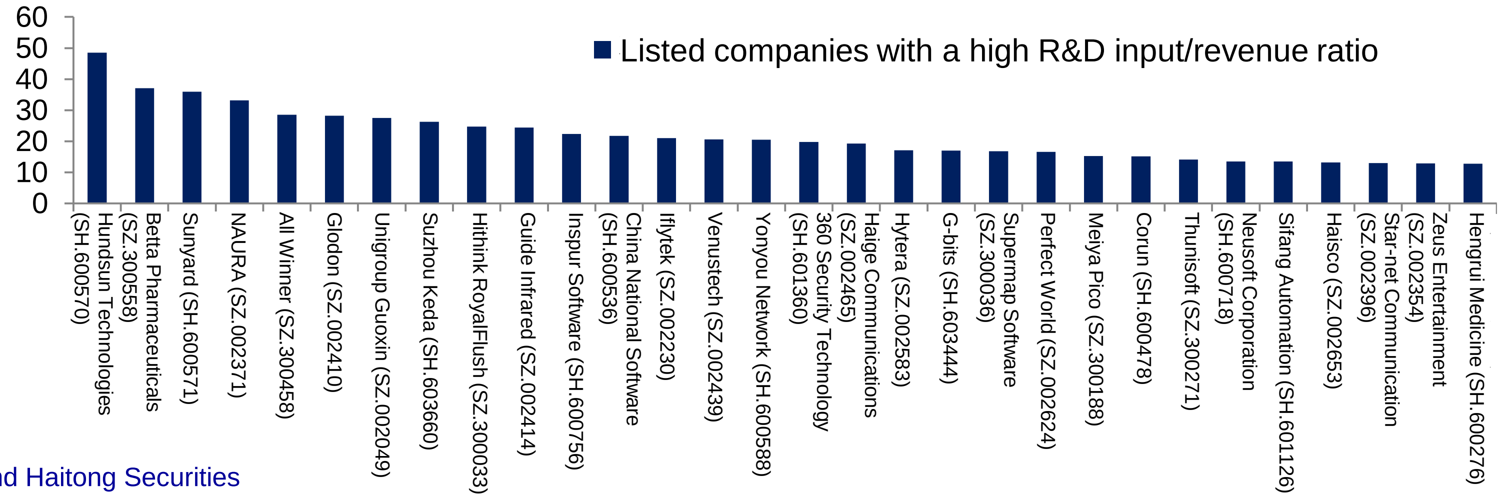


Source: WIND and Haitong Securities

The companies with a high R&D input/revenue ratio have the largest share price growth

Why does Hengrui Medicine (SH.600276) perform so well this year? Superficially, its PE reaches as high as 80X, because its net profits in 2017 were only RMB3.2bn, but its market cap is as high as RMB240bn. However, we can further find that its R&D expenditures were as high as RMB1.76bn in 2017, equivalent to 13% of its revenue. If Hengrui Medicine (SH.600276) didn't do R&D, its net profits could have reached RMB5bn and its PE would have declined to 50X. Another example is NAURA (SZ.002371). Its 2017E PE is 170X, because its net profits were only RMB130mn in 2017, but its market cap reaches as high as RMB22bn. However, its R&D expenditures were RMB740mn in 2017. If the R&D expenditures were added back to the net profits, its PE would be 25X. If the U.S. stock market can attach large value to R&D, why cannot we? Therefore, we can find that the companies that have a high R&D input/revenue ratio all have performed well this year in the A-share market.

Listed companies with a top R&D input/revenue ratio

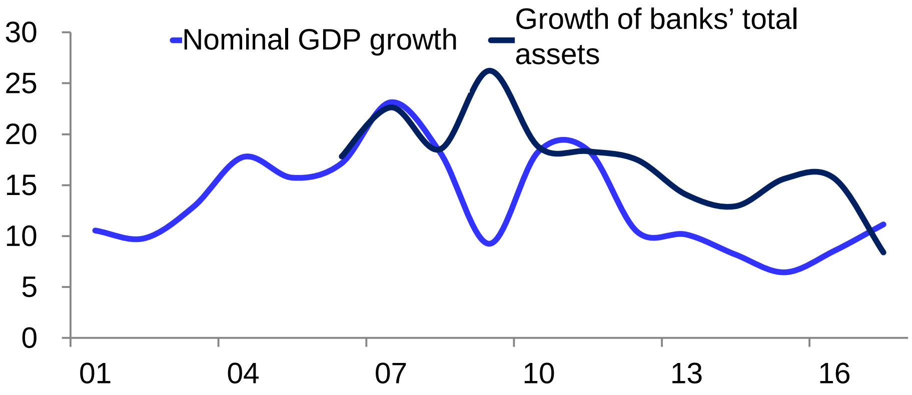


Source: WIND and Haitong Securities

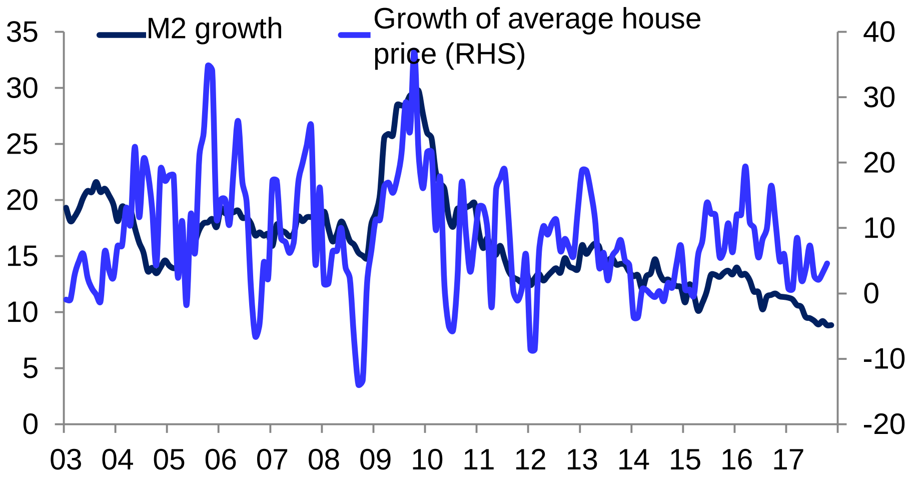
Money is no longer oversupplied, watch out for housing bubble

Conversely, if China can rely on equity investment, R&D and innovation to stabilize the economic growth in the future, it will not have to loosen liquidity as it did in the past, which in fact means that the housing bubble created by money oversupply will come to an end.

Growth of banks' total assets and nominal GDP growth (%)



M2 growth and growth of average house price (%)

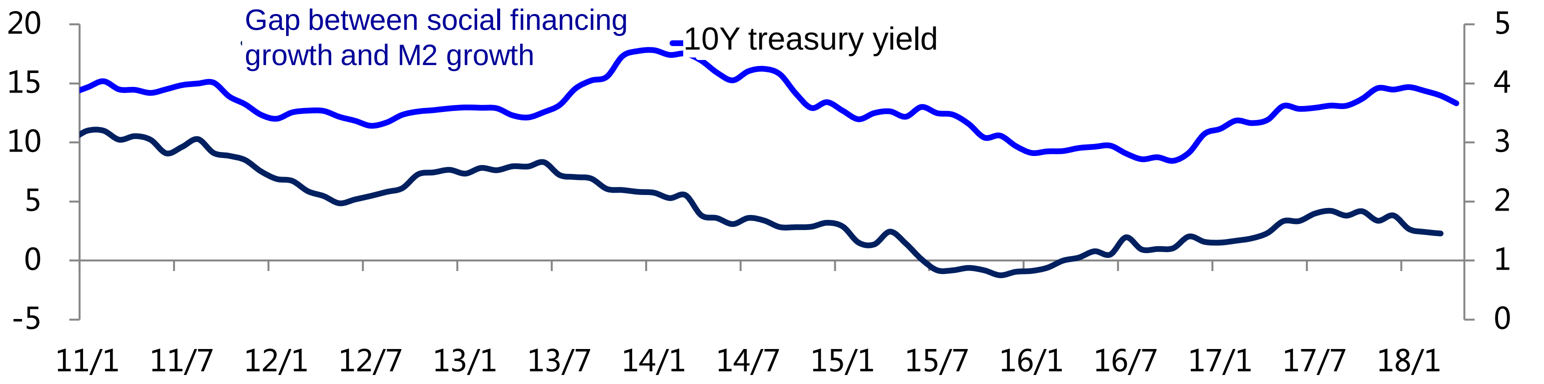


Source: WIND and Haitong Securities

Bond market: an inflection point of interest rate occurs

The PBOC has not loosened the monetary policy since 2017, but the bond market has risen beyond the expectation, which should be attributed to the changes in capital demand. We believe that the core driving force for the growth of the bond market comes from the decline in social financing. On one hand, the decline of financing has improved the supply-demand landscape of capital. On the other hand, social financing represents all capital used by the real economy and is actually a leading indicator of the economy and declining financing foretells a retreat in economic growth and inflation. We have been firmly convinced that the heavily indebted Chinese economy will definitely not go towards a high interest rate for the long term, because the two are incompatible. Therefore, a downward inflection point of interest rate will definitely occur on the course of de-leveraging, and now such an inflection point has already emerged. In 2018, we should pay high attention to the investment opportunities in bonds and quasi-bond assets.

10Y treasury yield and gap between social financing growth and M2 growth (%)

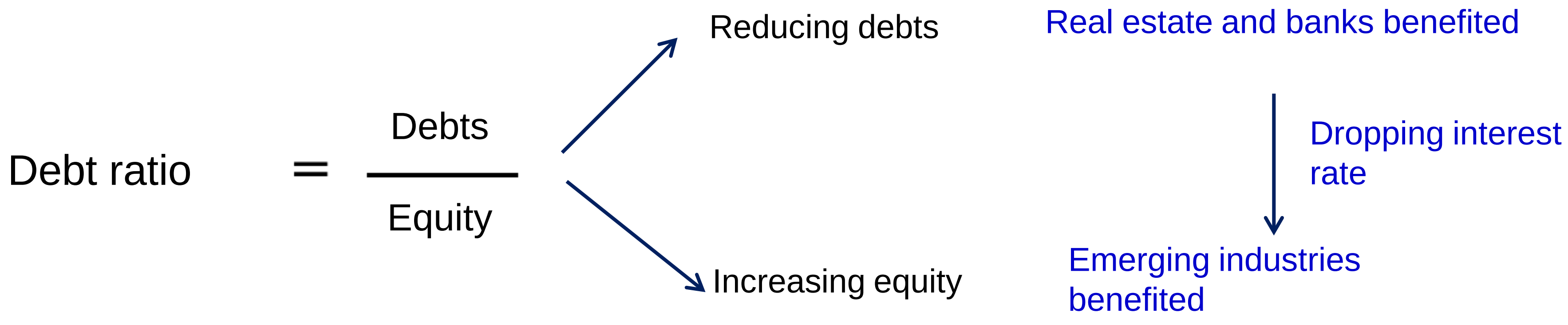


Source: WIND and Haitong Securities

Two big opportunities for the future: innovation and bond market

Therefore, as long as the government is determined to reduce leverage and shore up weakness, i.e. controlling shadow banking and money oversupply to curb the housing bubble and making the financial and real estate sectors serve the real economy on one hand, and developing the capital market with an institutional reform to promote the development of innovative enterprises on the other hand, the Chinese economy will be very promising, which should count on the real economy and innovative enterprises rather than the financial and real estate sectors. During this process, China can no longer rely on debt financing to stabilize growth, which means a downtrend in both financing demand and interest rates. This also means that innovation and the bond market will be the two promising asset classes in China over the long term.

Long-term influence of reducing debts



Source: WIND and Haitong Securities

Information Disclosure

Rating Definition

1. Benchmarks for investment ratings

Investment ratings are divided into company ratings and sector ratings

Using the market performance within six months after the release of this report as benchmark; using the difference between the gain/loss of the company’s stock price (or sector index) and the gain/loss of Haitong Composite Index concurrently within six months after the release of this report as benchmark

2. Rating standard of investment advice

Gain/loss of the company’s stock price (or sector index) relative to that of Haitong Composite Index concurrently within six months after the release of this report

Type	Rating	Definition
Company ratings	Buy	Return potential exceeds expected return of the market by over 15%
	Overweight	Return potential exceeds expected return of the market by 5% to 15%
	Neutral	With a markup less than 5%, better or worse than that of the market
	Underweight	Return potential is lower than expected return of the market by 5% to 15%
	Sell	Return potential is lower than expected return of the market by over 15%
Sector ratings	Overweight	Return potential exceeds expected return of the market by over 5%
	Neutral	With a markup less than 5%, better or worse than that of the market
	Underweight	Return potential is lower than expected return of the market by over 5%

Disclaimers