June 30 , 2016

BREXIT on China
The aftermath of the UK's EU Referendum

Background
UK 52% to 48% vote to leave the EU marked a major set-back of globalization. It even hinted rising populism globally and could have huge impact on geo-political landscape both in the EU and across the Atlantic. Though less direct, BREXIT's implication on China could be complicated and for years to come, namely in the following three facets.

- China Macro
- RMB
- Domestic Capital Markets

China Marco
China being one of the biggest beneficiaries of globalization in the past few decades may be hurt in terms of export and investment once globalization were to be put in the reverse gear. Precedents from the EU financial crisis in 2011-2012 point to immediate negative impact on export and GDP growth as well as longer-term and more severe damages as the contagion spreads. (Exhibit 1)

Exhibit 1: China's export and GDP growth will be hurt by BREXIT

	Base Scenario	Risk Scenario	Spill Over Scenario
EU GDP Growth	-1%	-2%	
China's Export to EU	-5.50%	-11%	
China's Total Export	-1%	-2%	-5%
China GDP Growth	-0.20%	-0.40%	-1%

Source: CICC

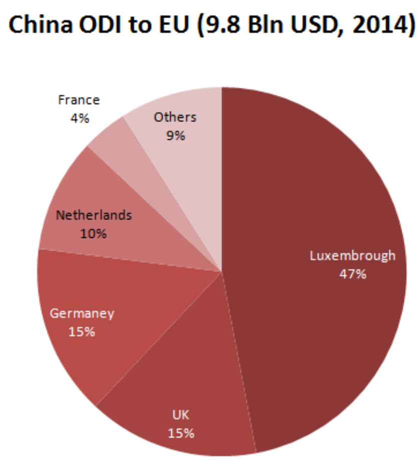
China has strong ties with EU and UK in trades and capital flows.

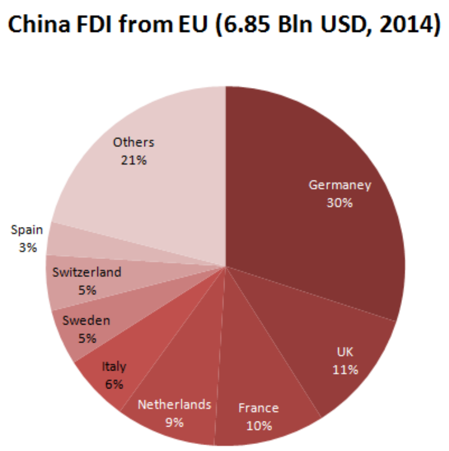
In 2014, China's outbound direct investment (ODI) in EU totaled 9.8 Billion USD (8% of China's total ODI), of which 1.5 Billion USD, or 1.5% of China's total ODI, went to UK.

On the inbound side, EU's 6.85 Billion FDI in China represented 5.7% of China's Total FDI, whereas UK represented 0.74 Billion USD, or 0.6% of total FDI. In 2015, China announced over 700 overseas M&As, of which 31 involved UK companies and 116 involved other EU countries. (Exhibit 2)

EU and UK are also strong footholds for the internationalization of RMB, with UK holding 80 Billion RQFII quota and the rest of EU holding a total of 260 Billion. Together they represent 1/3 of the total available RQFII quotas. With the breakup with EU, the UCITS scheme, under which many RQFII funds were raised and distributed in the Pan-Europe, may come under restructuring concerns.

Exhibit2: China's investment ties with EU and UK are strong



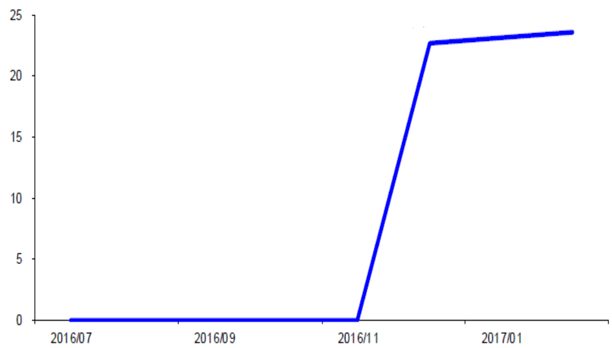


Source: CICC

RMB

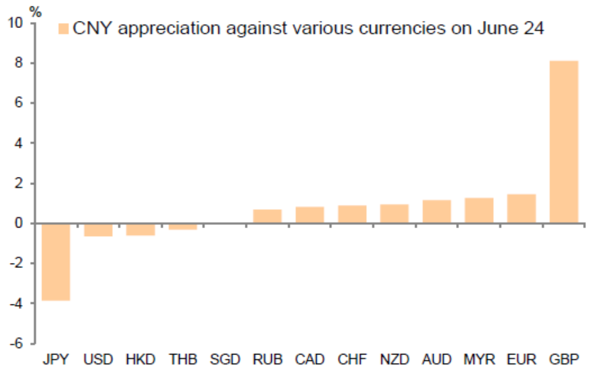
In longer term, the BREXIT result and the consequent British and EU economy deterioration could trigger another round of liquidity supply in Europe and even outside the continent, and the potential US Fed rate hike could also be delayed. (Exhibit 3) This could significantly ease the pressure of RMB depreciation in the longer term, making China less worried about imported inflation and therefore giving its central bank more room for monetary stimulation.

Exhibit 3: Probability of US rate hike collapsed



Source: Haitong Securities

Exhibit 4: RMB performance on Jun 24th



Source: CICC

In the short term, the sharp devaluation of GBP and EUR boosted USD index by 3.5%. RMB, which is declared to be pegged to a basket of major currencies, had fared steady on June 24th, except for against USD and JPY. (Exhibit 4) The rise of the USD index gives the PBoC an excuse to slightly depreciate RMB against USD, as is evidenced by the offshore USD/RMB jump from 6.58 to 6.68 in two days.

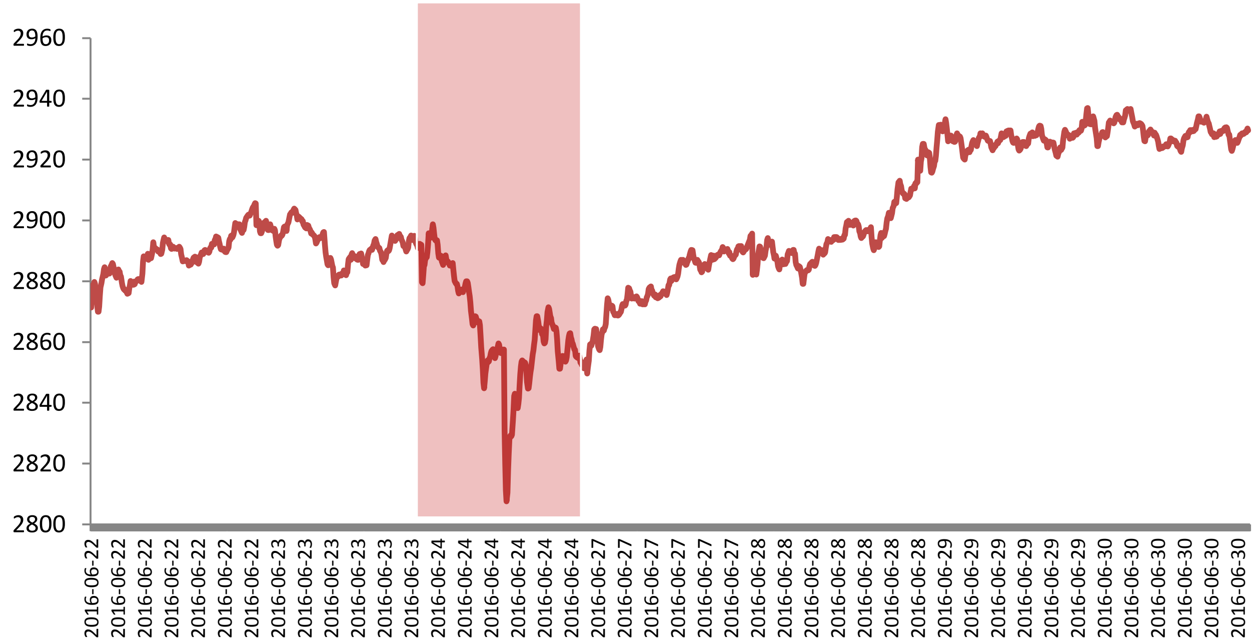
Domestic Capital Markets

BREXIT 's impact on China's domestic market is mixed coupled with a great level of uncertainty. The only certainty among all is the elevated risk aversion in the short term, which will boost the domestic bond market as investors take refuge.

Rising expectation for accommodative fiscal as well as monetary policies to weather expected external shocks is also benefiting the bond market at least in the short term. However, with the domestic yields already quite low and out of fear of putting additional pressure on the currency, the medium-term picture of the bond market is a bit vague at this moment.

On the equity side, domestic risk aversion sentiment went full-blown on the day of the BREXIT, yet it seemed to be short-lived. The Shanghai Composite index since then went on a four-day rising streak, reflecting the spooked domestic investors finding comfort in their home markets. (Exhibit 5)

Exhibit 5: SHCOMP Performance (Jun 22-30)



Source: Wind, ChinaAMC

The strategy we have been implementing so far this year has focused on value and consistency between valuation and earnings growth. With this philosophy, we believe that the downside risk is well managed even after the shock of BREXIT.

We will overweight stocks with steady performance and visible prospects in the future, such as Consumer Staples, and will keep performance of current portfolio holdings in close check, and will cut underperformed positions as we see fit.

We still see structural opportunities existing in the A-share market and will keep looking for investment opportunities in the emerging industries, including semiconductor and new-energy vehicles. In cases of a market correction, we will view it as an opportunity to pick up additional names whose valuations are in our comfort zone.

Disclaimer

Important Information

Contact Information

China Asset Management Co. Ltd.
8F, Tower 7, One Yuetan Street South, Xicheng District, Beijing 100045, China
IB@ChinaAMC.com
Tel: +86 10 8806 6688/ Fax: +86 10 8806 6330

Our Performance Your Trust