China Market Strategy
One-Belt-One-Road and A New World Order

“*It is not the voice that commands the story: it is the ear.*” – Marco Polo

**Summary:** Consensus is interpreting the One-Belt-One-Road initiative as an infrastructure investment opportunity. More than that, we believe the Yuan’s role in these investments through the AIIB, as well as the gradual decline of the recycle loop from China’s current account to the US treasury to found a new Yuan hegemony, have more significant implications. The recent Dollar weakness as the AIIB is signing up new member countries suggests market’s attention to the Yuan’s eventual rise. A softening Dollar is conducive to emerging markets and commodities.

Mutual funds may now be able to invest in HK via the HK-Connect scheme, instead of applying for QDII quota. And consensus believes that they will buy heavily immediately. But their heavy equity positions in the A-shares market make the immediate switch from Shanghai to Hong Kong less likely. Investors should continue to accumulate positions in Hong Kong on the cheap, as steep HK valuation discount compared with mainland augurs well for strong relative performance in HK.

A few years ago, I went on the first expedition to Kashgar, one of the most important posts on the Silk Road. It was still the early days when China first opened up its western frontier for closer economic ties with Central Asia. The Silk Road is a loosely defined concept, and is coined by a German scholar von Richthofen. The Silk Road prospered as the Romans discovered the luster of silk during their wars with the Parthians, and realized these mysterious materials were beyond the sophistication of these backward tribes. But as Zheng He explored the oceanic routes to the outside world in the Ming Dynasty to find safer and cheaper means of transportation, and the Islamic influence encroached on the Buddhist western China, the Silk Road slowly demised.

Now I have only pieces of memories left, among which the deepest impression is the clear skies and the pale dunes glowing beneath the light of the moon. The wind would sweep the shifting sands, rustling the travelers to their dreams. Everywhere we went the road was unpaved and dusty. And many were still dwelling in the relic of a city that had stood unchanged for thousands of years, with domestic animals kept in their houses. “How much infrastructure investment would be required to connect this backwater to the rest of the world?” I thought to myself during the trip. 800 billion USD – China is now planning. But it isn’t just about the infrastructure.

An emerging Yuan hegemony: As the Asian Infrastructure Investment Bank (AIIB) signs up more members, the Dollar is weakening. The AIIB initiative is an assault on the post Bretton-Woods system on two fronts: 1) the AIIB will raise some of the capital by selling yuan-denominated bonds to invest in infrastructure in the less developed areas of the world. Member countries of the organization will have the opportunity to become an offshore centre for the Yuan. It increases the Yuan’s prominence globally and sidesteps the Dollar. 2) China will gradually move away from its traditional ways of forex reserve management – from mostly buying US treasury bonds to investing some of its forex reserve in yuan in overseas infrastructure. This change will be accompanied by the opening of China’s capital account sometime this year. It is a significant change. As the petrodollar is dying, and the dollar recycle loop from China’s current account to US treasury bonds is about to slow, the situation for the Dollar and the US treasury appears delicate for now (Figure 1).
But the initiative is not without costs. For years, Russia, one of China’s close allies, has been trying to create a Eurasian economic union. With its financial might and various plans in the region, such as the Shanghai Competition Organization, the Silk Road Fund and now the AIIB, China appears to be taking over Russia’s lead in the region, and thus risks upsetting its ally from whom China imports much oil and gas. Russia’s hesitant bid to join the AIIB is a hint of such disenchantment. Further, many countries included in this scheme are torn up by regional conflicts and have low credit rating. The investments in these areas are not without risk – to say the very least. The dynamics with the US is also shifting, as China’s voting right in IMF, World Bank and the ADB lags substantially behind its economic growth and the existing world order begs for a change. While on the surface the AIIB is a triumph given the strong line-up of western countries, it remains to be seen how these countries’ responsibilities will be commensurate with their gains from the initiative.

The domestic Chinese media is hyping on how great the opportunities are from infrastructure investments by citing the number of countries in the linkup and the sum of their GDP – without mentioning the associated costs. The fact is that China has been trading with these countries. Now new significant investments will be committed to these regions just to continue the trade. The growth in trade must compensate for the additional capital investment. For now, the Dollar’s strength is waning, both from the perceived weakening of its prominence and also from the overbought conditions that have prevailed for many months (Figure 1). A softening Dollar is conducive for commodity and emerging markets.

Subtle change in the PBoC’s tone suggests more easing; mutual funds unlikely to invest through HK-Connect for now: During the Boao Forum, we found subtle changes in the Ministry of Finance and the PBoC’s stance towards the local government debt swap program during their public communications. Mr. Lou, the Minister of Finance, suggested that the 3 trillion yuan originally set out might not be enough and was not the definite upper limit of the debt swap quota. And for the first time, Mr. Zhou, the governor of PBoC, was alluding to deflationary pressure and the fact that the economy was decelerating rapidly. He also for the first time hinted at the central bank’s participation in the debt swap program by not ruling out the possibility, despite that Mr. Lou precluded the PBoC’s participation previously. This is consistent with our conjecture in our last note ("Price-to-Whatever Ratio: A Bubble Scenario" 20150320). Our view is that as the PBoC expands the size of its balance sheet through unconventional measures such as SLO, SLF and MLF, it is conducive to the performance of risk assets - much similar to the Fed’s expansion of its balance sheet to US stocks. We would also expect interest rate and RRR cuts to offset the deflationary pressure.

Meanwhile, many cheer at the CSRC’s decision to allow mutual funds to invest in Hong Kong directly through the HK-Connect program, without applying for the QDII quota. We are less enthused. While this change is good news to HK, the fact that 90% of mainland’s mutual funds have equity positions of more than 70% makes it difficult for these funds to switch into HK immediately– unless they pare some of their A-shares holdings. As the news, liquidity and technical momentum continue to be supportive to the A-shares, it is difficult to imagine these funds will immediately switch following the rule change. That said, HK
is at a steep valuation discount relative to Shanghai. The discount is at a level that used to suggest strong relative performance in HK. Investors should continue to accumulate HK positions on the cheap.

Chart 2: HK valuation discount is at a level that used to suggest strong relative performance in HK going forward.

Source: Bloomberg, Bank of Communications (Int'l)
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### Company Rating
- **Buy**: Expect more than 20% upside in 12 months
- **LT Buy**: Expect more than 20% upside but longer than 12 months
- **Neutral**: Expect low volatility
- **Sell**: Expect more than 20% downside in 12 months

### Sector Rating
- **Outperform ("OP")**: Expect more than 10% upside in 12 months
- **Market perform ("MP")**: Expect low volatility
- **Underperform ("UP")**: Expect more than 10% downside in 12 months

## Research Team

<table>
<thead>
<tr>
<th>Segment</th>
<th>Head of Research</th>
<th>Email</th>
<th>Phone</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Head of Research</strong></td>
<td>Raymond CHENG, CFA, CPA, CA</td>
<td>raymond.cheng</td>
<td>(852) 2977 9393</td>
</tr>
<tr>
<td><strong>Strategy</strong></td>
<td>Hao HONG, CFA</td>
<td>hao.hong</td>
<td>(852) 2977 9384</td>
</tr>
<tr>
<td><strong>Banks/Network Financials</strong></td>
<td>Qingli YANG</td>
<td>yangqingli</td>
<td>(852) 2977 9212</td>
</tr>
<tr>
<td></td>
<td>Shanshan LI, CFA</td>
<td>lishanshan</td>
<td>(86) 10 8800 9788 - 8058</td>
</tr>
<tr>
<td></td>
<td>LI WAN, CFA</td>
<td>Wanli</td>
<td>(86) 10 8800 9788 - 8051</td>
</tr>
<tr>
<td><strong>Consumer Discretionary</strong></td>
<td>Phoebe WONG</td>
<td>phoebe.wong</td>
<td>(852) 2977 9391</td>
</tr>
<tr>
<td></td>
<td>Anita CHU</td>
<td>anita.chu</td>
<td>(852) 2977 9205</td>
</tr>
<tr>
<td><strong>Consumer Staples</strong></td>
<td>Summer WANG</td>
<td>summer.wang</td>
<td>(852) 2977 9221</td>
</tr>
<tr>
<td></td>
<td>Shawn WU</td>
<td>shawn.wu</td>
<td>(852) 2977 9386</td>
</tr>
<tr>
<td><strong>Healthcare</strong></td>
<td>Milo LI</td>
<td>milo.li</td>
<td>(852) 2977 9387</td>
</tr>
<tr>
<td><strong>Insurance &amp; Brokerage</strong></td>
<td>Jerry LI</td>
<td>liwenbing</td>
<td>(852) 2977 9389</td>
</tr>
<tr>
<td></td>
<td>Jennifer ZHANG</td>
<td>yufan.zhang</td>
<td>(852) 2977 9250</td>
</tr>
<tr>
<td><strong>Internet</strong></td>
<td>Yuan MA, PhD</td>
<td>yuan.ma</td>
<td>(86) 10 8800 9788 - 8039</td>
</tr>
<tr>
<td></td>
<td>Connie GU, CPA</td>
<td>connie.gu</td>
<td>(86) 10 8800 9788 - 8045</td>
</tr>
<tr>
<td><strong>Metals &amp; Mining</strong></td>
<td>Jovi LI</td>
<td>jovi.li</td>
<td>(852) 2977 9243</td>
</tr>
<tr>
<td><strong>Economics</strong></td>
<td>Miao Xian LI</td>
<td>miao.xian</td>
<td>(86) 10 8800 9788 - 8043</td>
</tr>
<tr>
<td><strong>Oil &amp; Gas/ Gas Utilities</strong></td>
<td>Fei WU</td>
<td>fei.wu</td>
<td>(852) 2977 9392</td>
</tr>
<tr>
<td></td>
<td>Tony LIU</td>
<td>xutong.liu</td>
<td>(852) 2977 9390</td>
</tr>
<tr>
<td><strong>Property</strong></td>
<td>Alfred LAU, CFA, FRM</td>
<td>alfred.lau</td>
<td>(852) 2977 9235</td>
</tr>
<tr>
<td></td>
<td>Philip TSE, CFA, FRM</td>
<td>philip.tse</td>
<td>(852) 2977 9220</td>
</tr>
<tr>
<td></td>
<td>Luella GUO</td>
<td>luella.guo</td>
<td>(852) 2977 9211</td>
</tr>
<tr>
<td><strong>Renewable Energy</strong></td>
<td>Louis SUN</td>
<td>louis.sun</td>
<td>(86) 21 6065 3606</td>
</tr>
<tr>
<td><strong>Telecom &amp; Small/ Mid-Caps</strong></td>
<td>Zhiwu Li</td>
<td>zhiwu</td>
<td>(852) 2977 9209</td>
</tr>
<tr>
<td><strong>Technology</strong></td>
<td>Miles XIE</td>
<td>miles.xie</td>
<td>(852) 2977 9216</td>
</tr>
<tr>
<td><strong>Transportation &amp; Industrial</strong></td>
<td>Geoffrey CHENG, CFA</td>
<td>geoffrey.cheng</td>
<td>(852) 2977 9380</td>
</tr>
<tr>
<td></td>
<td>Fay ZHOU</td>
<td>fay.zhou</td>
<td>(852) 2977 9381</td>
</tr>
<tr>
<td><strong>Automobile</strong></td>
<td>Wei YAO</td>
<td>wei.yao</td>
<td>(86) 21 6065 3675</td>
</tr>
</tbody>
</table>
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