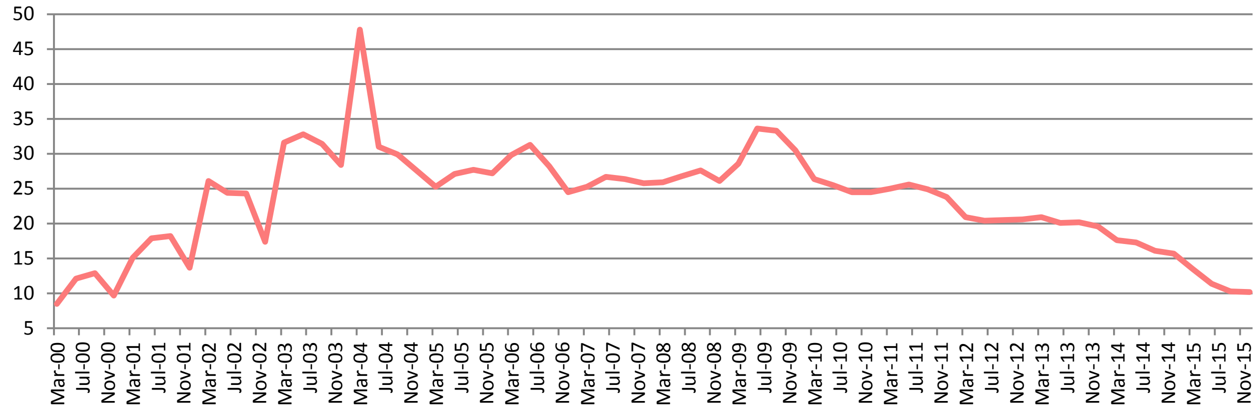
Our macro-research team in China just published their '*10 conjectures for 2016 China economy*'. The following are excerpts of the report together with some data charts we think relevant to the contents.

10 conjectures for 2016 China economy

No. 1: Keynesian economics helpless

Keynesian economics appear to be not working for China's economy. Specific to the property sector in China, developers were not adding investments in spite of solid sales in 2015, which reflects the changing demographics and high inventory, in our view. In the manufacturing sector, the post-crisis RMB4tn stimulus in 2008 has led to a vast overcapacity and worsening enterprises profits. 2016 is likely to see more drastic elimination in production capacity.

Figure 1: China fixed assets investment (excluding rural households) cumulative YoY



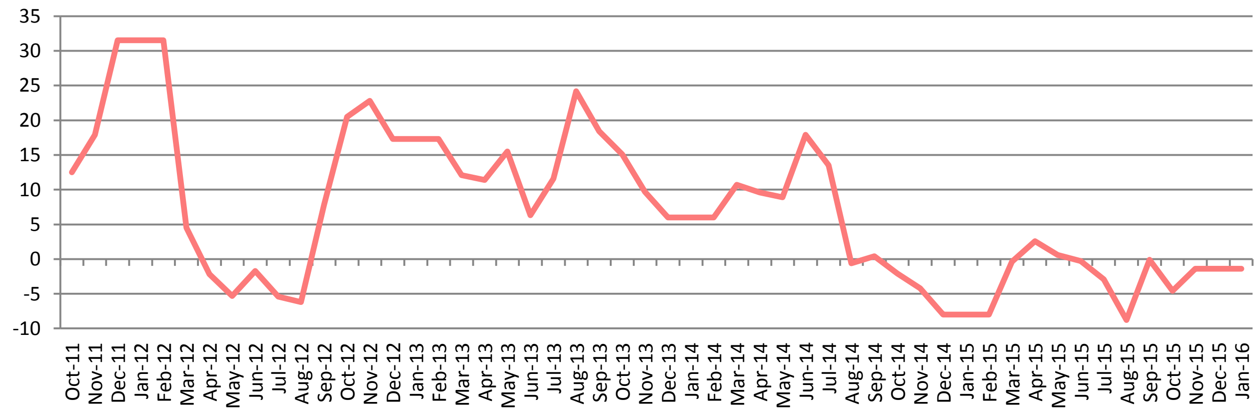
Source: Bloomberg, CSCI Research

No. 2: Production capacity reduction gathering strength

2015 saw deteriorating profitability in the traditional sectors including energy, industrials and materials. The number of loss-making companies rose 15% to a 33-month high in Dec 2015. China's industrial enterprises total profits recorded YoY declines for eight consecutive months.

At the central economic conference held in late 2014, the primary task of the government was to maintain stable growth for 2015. In contrast, the government set its work priority for 2016 as solving the overcapacity issue, thus we see an accelerating pace of the reduction in production capacity entering 2016.

Figure 2: China's industrial enterprises total profits YoY



Source: Bloomberg, CSCI Reseach

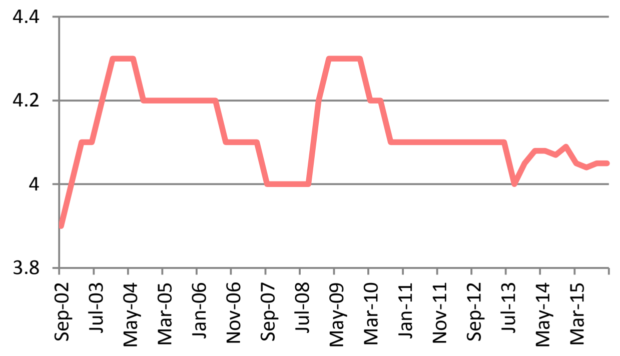
LIU Taisheng, Steven
(CE No.: AMO971)
stevenliu@csci.hk
(852) 3465 5652

TIAN Yang
(CE No.: BGL791)
tianyang@csci.hk
(852) 3465 5775

No. 3: unemployment rate faces upward pressure

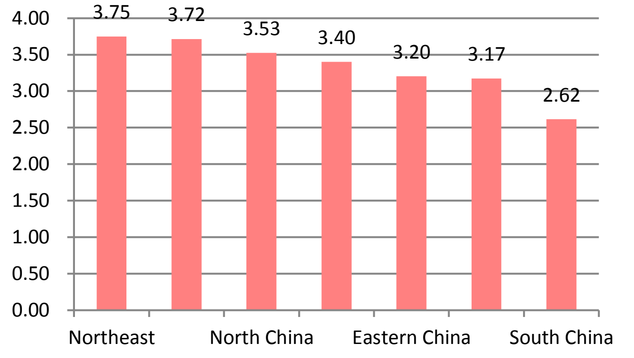
Amid the slowing economic growth and weak demand in China, 2016 is likely to see a sharp increase in enterprise restructuring and bankruptcy filings, which would be particularly the case in the resources, machinery and areas tasked with production capacity reduction. For example in northeast China, the average unemployment rates of capital cities stayed at 7% during 1H15, which was two percentage points higher than the national average and was likely a result of the region's high exposure to the aforementioned sectors. We can see a similar situation in certain capital cities in north China.

Figure 3: China's urban unemployment rates



Source: Bloomberg, CSCI Research

Figure 4: China's urban unemployment rates, 2014



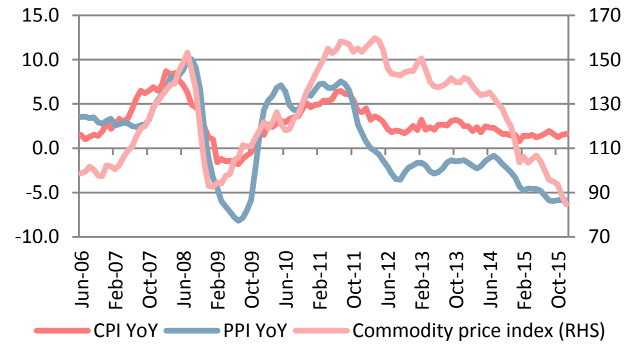
Source: Wind, CSCI Research

No. 4: deflation becomes prominent

Globally, low growth has become a norm for the world economy. Global commodities are generally in a glut status, amid slowing economic growth in China and past investments leading to upsurge in production capacity. In addition, a strengthening U.S. dollar will continue to weigh on commodity prices.

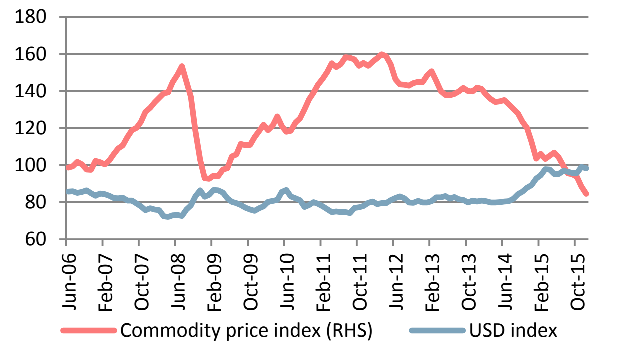
Domestically, there is an array of factors dragging on prices including weak investments and consumer demand, structural transformation, debt swap and rising NPL ratios. With falling production costs, there is still downside risk in food prices in our view. We expect China's CPI to fall to 1% in 2016.

Figure 5: China's CPI, PPI and commodity prices index



Source: Wind, CSCI Research

Figure 6: China's commodity prices and USD index

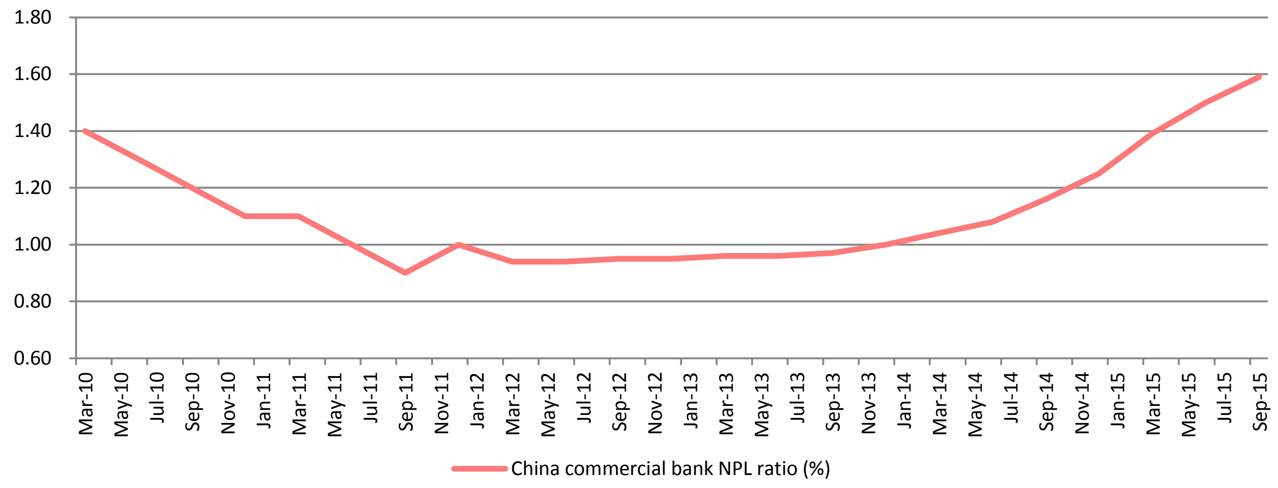


Source: Wind, CSCI Research

No. 5: Nonperforming loans issue looms

Entering 2016, nonperforming loans (NPL) will become an increasingly looming issue that we cannot avert. Since 2015, there has been an escalation of the NPL issue with many banks starting to suffer from problems of shrinking cash flows and declining profits. With the continuous cutback in production capacity, 2016 would see many 'zombie companies' defaulting, which would exacerbate the NPL issue, in our view. In addition, the property sector is one of the main culprits for a widening in banks' nonperforming loans, specifically with falling home prices in tier-2 and tier-3 cities leading to sharp reductions in property investment returns.

Figure 7: China's commercial banks' NPL ratios

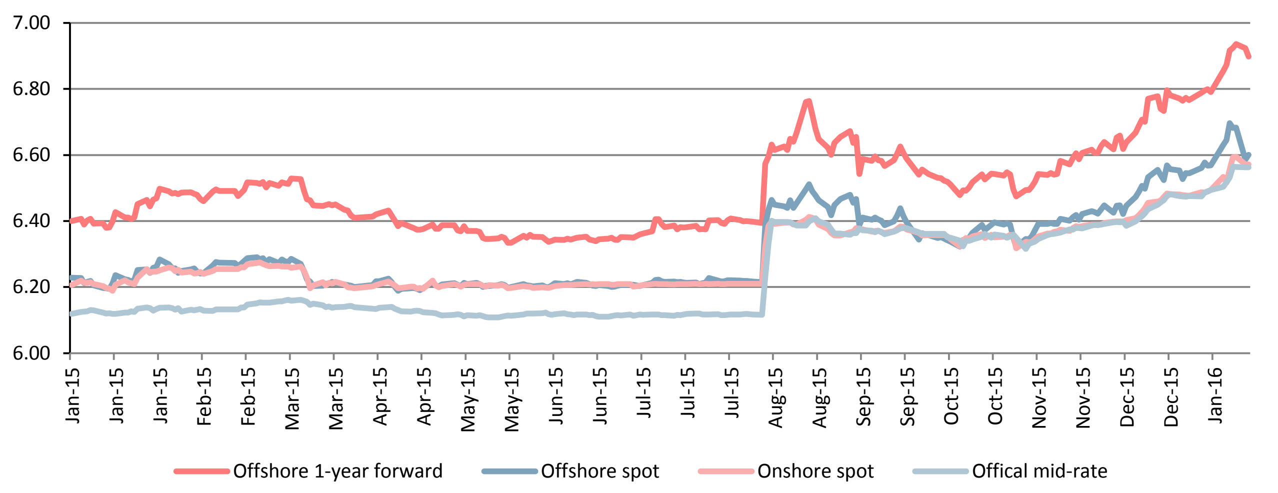


Source: Wind, CSCI Research

No. 6: RMB on gradual devaluation path

We expect the RMB to USD exchange rate to stay in the range of 6.6-6.8 during 2016, with the daily volatility enlarging to 3%. We are relative conservative compared with the street in projecting the rate of RMB's devaluation against the U.S. dollar, as we expect to see central bank invention in case of a deep RMB devaluation. Fundamentally, we do not see the basis for the RMB to further depreciate against the U.S. dollar in the long-term, taking into consideration the positive trade balance and still growing FDI. On the flip side, we believe near-term pressure of devaluation of the RMB against the U.S. dollar remains, given that the central bank would need to respect the market demand-supply relation during the course of the foreign exchange reform.

Figure 8: RMB exchange rates against the USD

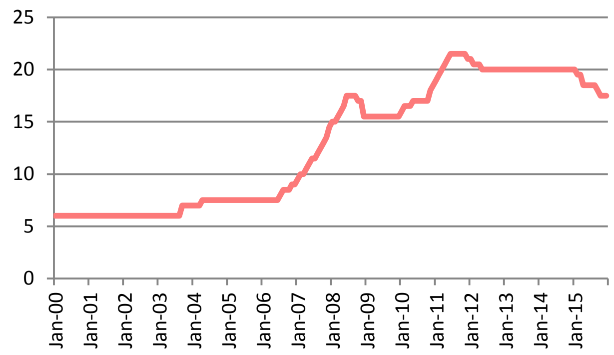


Source: Bloomberg, CSCI Research

No. 7: more reductions in interest rates and reserve ratio

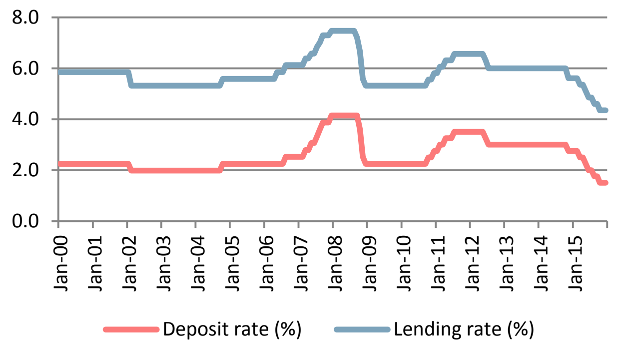
We expect the reserve requirement ratio (RRR) will be gradually lowered to 10% over the course of the coming few years, while 2016 is likely to see one to two more interest rates cuts. We have derived our projections of the RRR and interest rates trajectories based on the following developments: 1) as an integral part of the government's tasks in costs reduction, the central bank will aim to reduce financing costs going forward ; 2) increasing leverage, which is necessary to fend off a continuous economic downturn at a time when the economy's endogenous growth is weak and investment returns are dismissed; 3) 2016 and 2017 will see the peak in local debt swap, which also requires a low interest-rate environment; and 4) for the sake of independent monetary policies and stable economic growth, China's interest rates will remain on the downtrend regardless of whether or not the US Fed will hike interest rates in the near future, in our view.

Figure 9: China's required deposit reserve ratio



Source: Bloomberg, CSCI Research

Figure 10: China's 1-year benchmark interest rates



Source: Bloomberg, CSCI Research

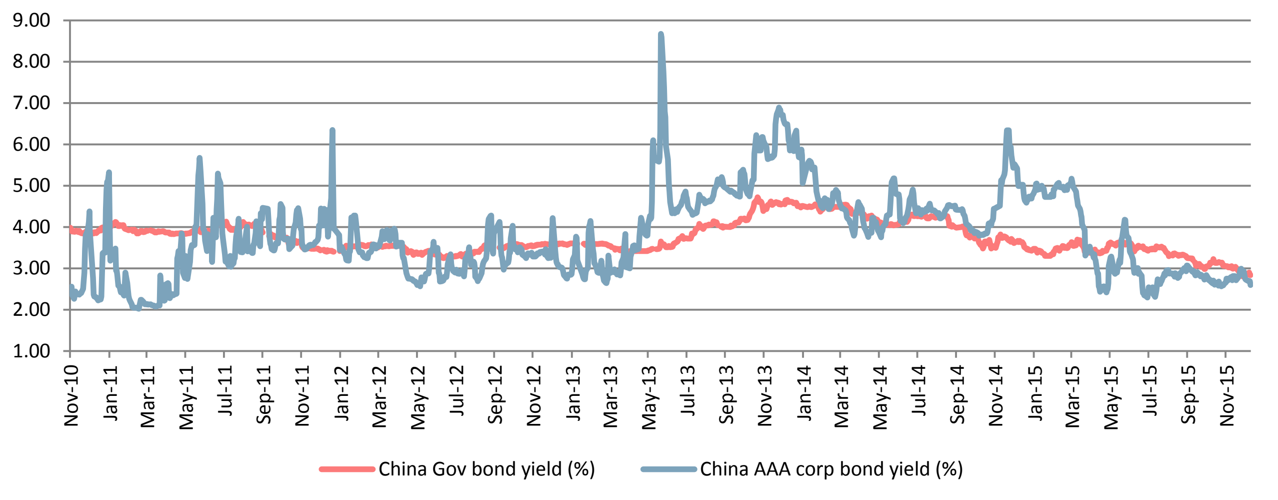
No. 8: an accommodative policy environment to continue

At the junction of the economic deceleration and structural reform in China, the real economy's marginal demand for money is diminishing. Based on publicly available data, over 50% of the debts raised for city infrastructure investments and industrial developments in 2015 were used to repay old debts. Though the central bank has continued to inject money into the commercial banking system, the money was not channelled to the real economy and but helped lower capital costs. We expect the recession-like monetary accommodation will last for a long time.

No. 9: In search of safe havens to continue

For 2016, we expect to see a new credit environment, likely a combination of asset crunch and bust of risk events. Meanwhile, it will be normal to see rising levels of banks' bad assets, broadening credit defaults and bust of high-risk credit like P2P in our view. Amid rising risk aversion, a search of capital in seeking safe havens will be channelled to interest-rate debts and highly-rated credit debts as well as cash-equivalent investments that are still in good value.

Figure 11: China 10-year government bond and AAA-rated corporate bond yield



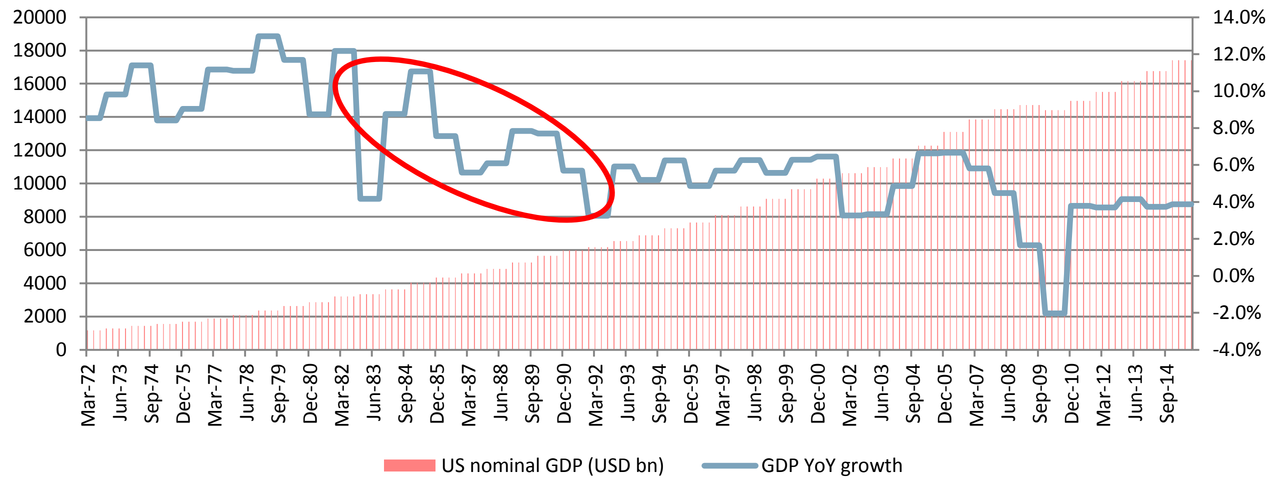
Source: Wind, CSCI Research

No. 10: supply-side reform to speed up

In the US, 'supply-side' reform was deployed by the then Ronald Reagan administration to revive the US economy in the 1980s. It was comprised of deregulation, tax cuts, restrained government spending and tightening money supply.

The demand-side management has become ineffective for the Chinese economy, which has been congested with a great amount of problems and contradictions featuring low credit efficiency, overcapacity, a large number of 'zombie companies', oversupplied infrastructure and long-term debt risks. In our view, the most important for the China economy is to speed up supply-side reforms, including reducing and foreclosing on loans to 'zombie companies', accelerating the inward and outward opening, promoting power delegation, encouraging and promoting innovations and strengthening intellectual property protection.

Figure 12: US nominal GDP



Source: Bloomberg, CSCI Research

Research

LIU Taisheng, Steven
TMT
(852) 3465 5652
stevenliu@csci.hk

SO Lai Shan, Jennifer
Consumer
(852) 3465 5781
jenniferso@csci.hk

CHAN Ka Yeung, Duncan
Commodity
(852) 3465 5654
chankayeung@csci.hk

TIAN Yang
Automotive
(852) 3465 5775
tianyang@csci.hk

SUN Lingxiao, Roger
Industrials
(852) 3465 5785
rogersun@csci.hk

XU Bo, Albert
Financials
(852) 3465 5789
albertxu@csci.hk

ZHU Kexin
Renewable energy
(852) 3465 5653
zhukexin@csci.hk

DUAN Xiaoxin, Joyce
Consumer
(852) 3465 5790
joyceduan@csci.hk

Institutional Sales & Trading

XIANG Xinrong, Ron
(852) 3465 5633
ronxiang@csci.hk

CAO Xiaogang, Glen
(852) 3465 5658
caoxiaogang@csci.hk

YUAN Zhefei, Annie
(852) 3465 5657
annieyuan@csci.hk

ZHANG Meng, Maurice
(852) 3465 5656
mauricezhang@csci.hk

HO Wen Hao, Jack
(852) 3465 5685
jackho@csci.hk

HO Hung Wei
(852) 3465 5687
hohungwei@csci.hk

LEE Ying Ju, Rose
(852) 3465 5707
roselee@csci.hk

AO Yiyu, Diana
(852) 3465 5708
dianaao@csci.hk

WANG Fei, Sophie
(852) 3465 5709
sophiewang@csci.hk

XIA Tian
(852) 3465 5670
xiatian@csci.hk

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China Securities (International) Research

18/F, Two Exchange Square, Central, Hong Kong

Tel: (852) 34655600 Fax: (852)21809495