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Barings fixed income strategy

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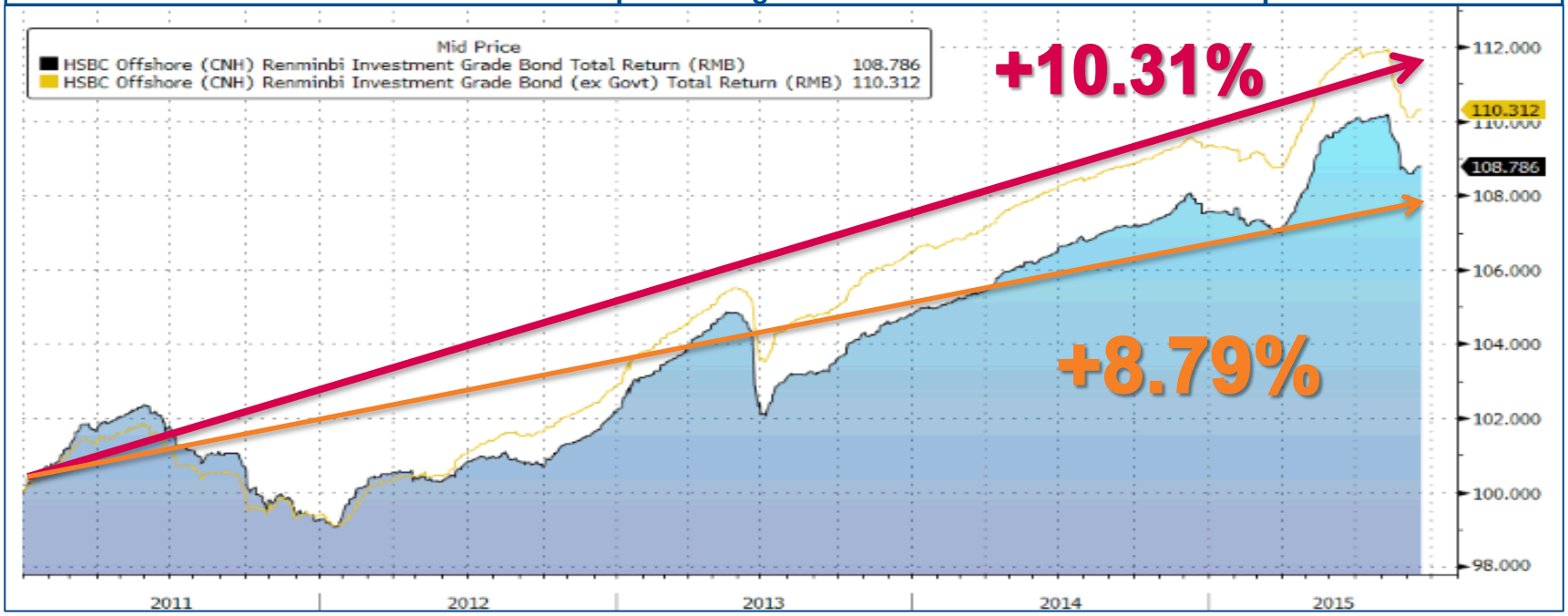
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RMB fixed income delivers stable performance

Offshore CNH IG credits outperforming overall CNH IG as fundamentals improve



- Credit markets are on a secular bull trend as evidenced by the four-year growth trend of the HSBC offshore RMB Investment Grade Index
- CNH Investment Grade (IG) credits have outperformed the overall market, returning around 8.8% since 2011 in CNH terms; excluding Government bonds, it has risen by 10.3%
- Current market yields for IG credits and overall IG bonds remain attractive at about 4.7% and 4.3% respectively

Source: Bloomberg , as at September 2015

Increased volatility partly "self induced"
Opportunities still outweigh threats

Recent event: Following volatility in the equity markets from June to August 2015, the PBoC announced a change in the RMB currency fixing regime. This resulted in a 1.86% one-day weakening of the CNY

The RMB movement was meaningful on a historical basis but it was less substantial on a comparative basis to other global currencies. The timing and magnitude of this change led to market anxiety, however this presents opportunities in the long run

Opportunities:
We believe that the RMB will still be managed tightly by the Chinese authority such that it will continue to hold its relative strength against other Asian currencies.

Asset price movements point to manageable fundamental impact and timely policy responses:

- The movements are manageable from a global perspective
- Liquidity indicators have not changed much
- Credit performance is still intact
- Policy response has been supportive and aggressive

Currency volatility in China

Modest pressure from market anxiety

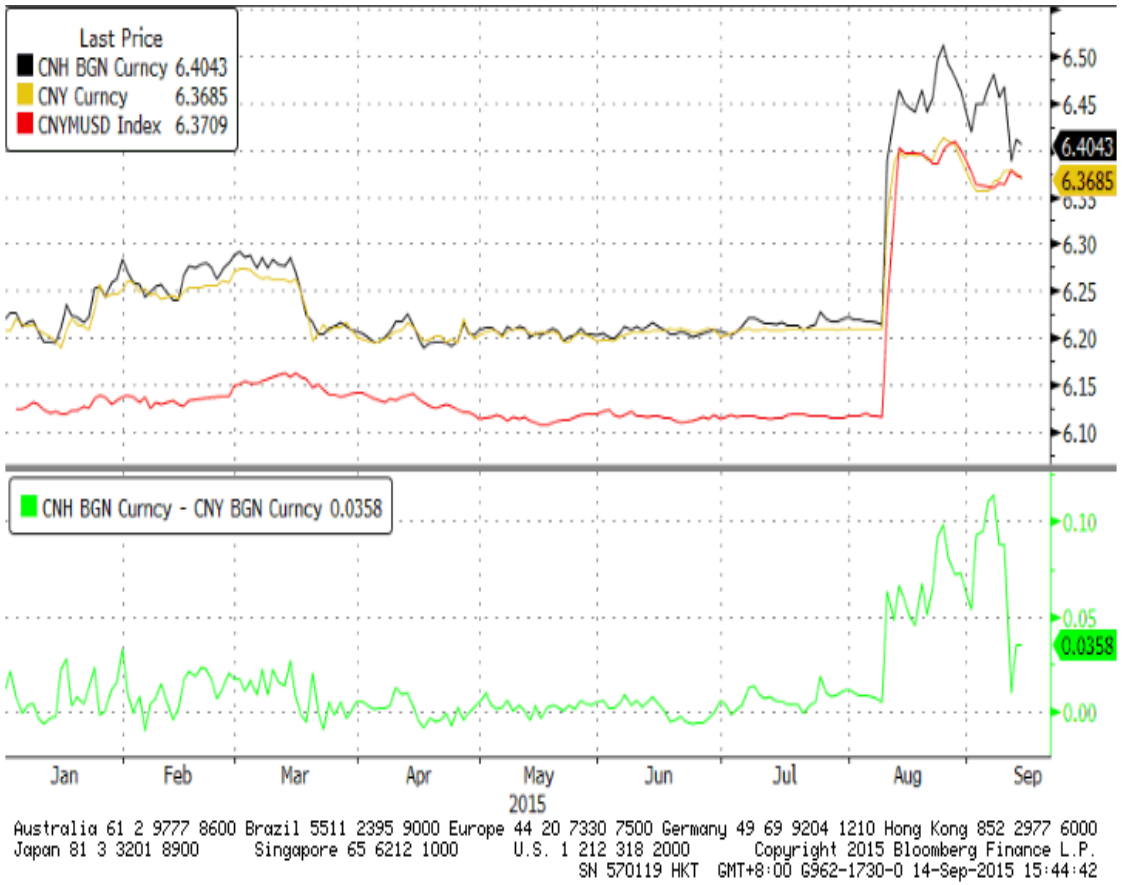
Following the currency movement in August, the RMB is now behaving more normally and has strengthened back to 6.40

The differential between onshore RMB (CNY) and offshore RMB (CNH) surged to a high record as the offshore currency became more volatile after 11 August.

It would be an ill-advised reform without merit. The Chinese authority has demonstrated its ability to contain market anxiety.

According to PBoC, the RMB fixing regime change was a one-time adjustment. The China Central Bank is keen to keep the RMB at a “stable and reasonable" level.

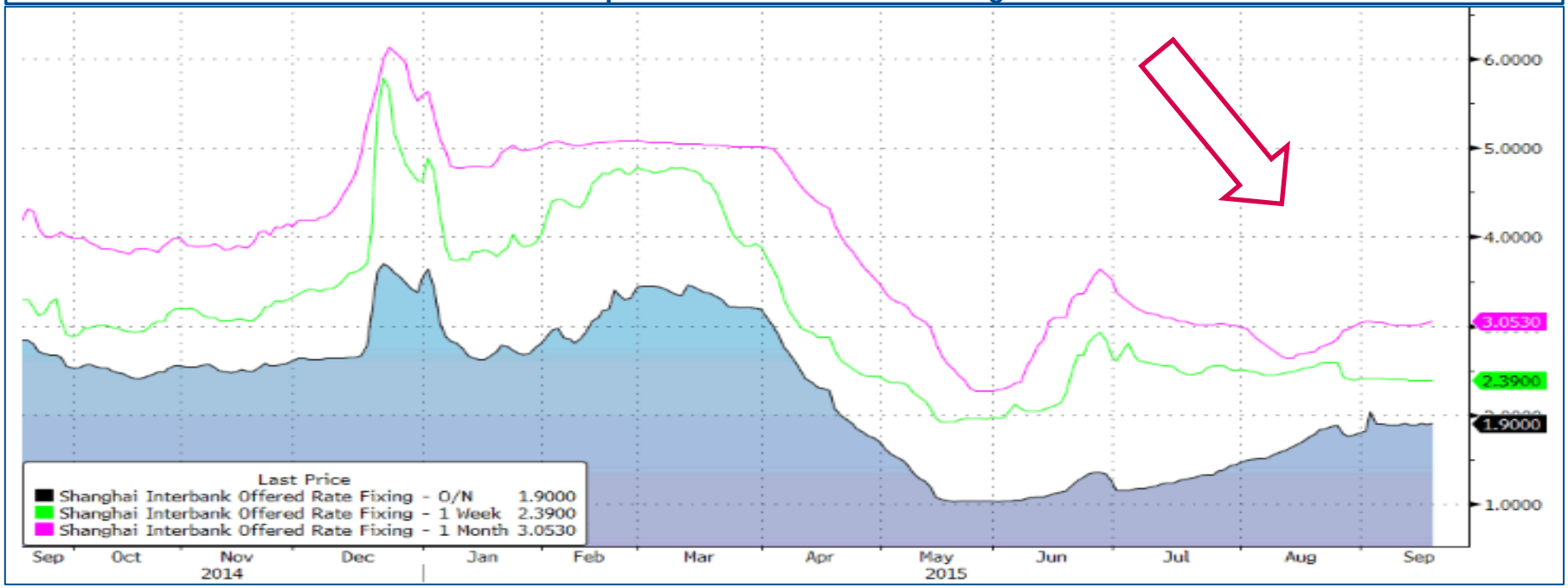
The IMF welcomes steps by the Chinese authority to promote flexibility of the RMB and allow its trading levels to be determined by the market forces.



Source: Bloomberg , as at September 2015

Short term rates: SHIBOR

Substantial improvement in onshore funding conditions

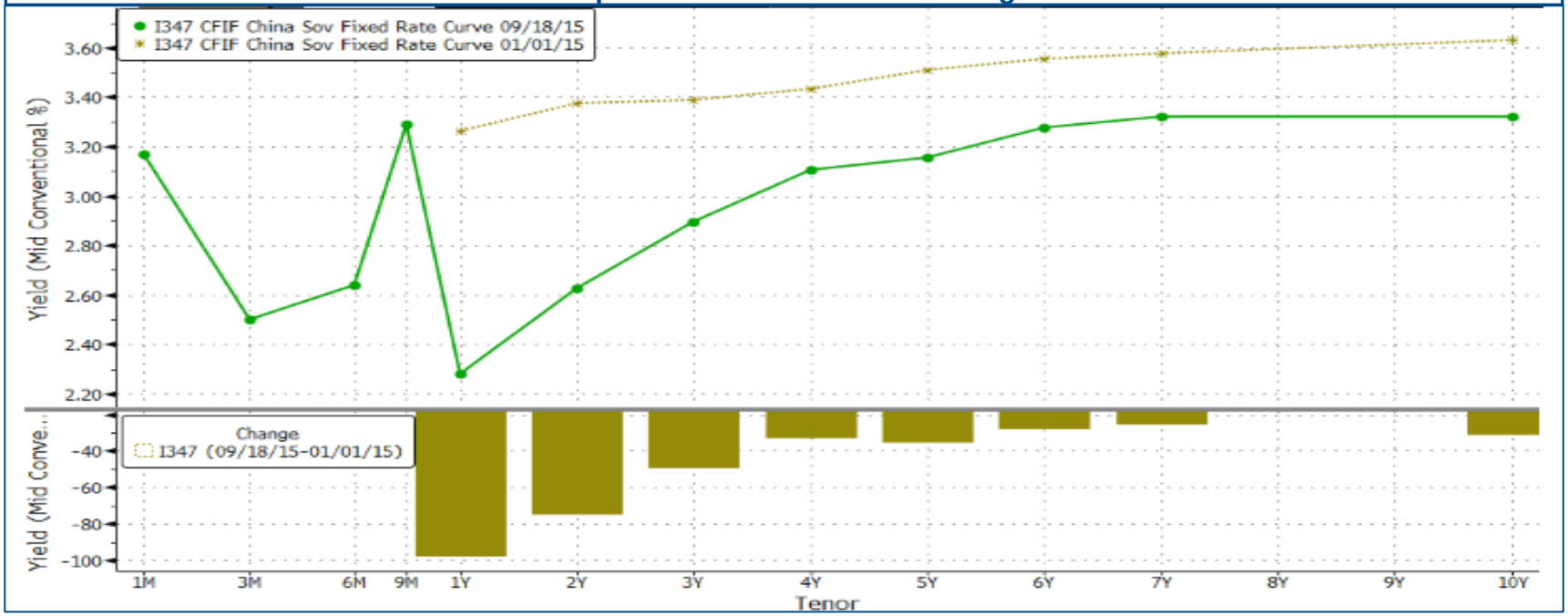


- Short term rates in China should continue to come down due to aggressive potential rate easing policy in the Mainland
- The SHIBOR has stabilised at new lows after the rate and RRR cuts
- This indicates improving liquidity conditions in the onshore Chinese markets despite volatility in the equity and currency markets

Source: Bloomberg , as at September 2015

Sovereign bond yields are declining

Substantial improvement in onshore funding conditions



- Chinese government bonds mirror recent monetary action
- Strong bull steepening of the curve as the PBoC has set out to cut benchmark rates
- Front end of the curve has rallied around 100bps year to date, implying that the market expects there may be further easing
- This is positive for credit markets and supports investment creation

Source: Bloomberg , as at September 2015

Monetary easing by the Chinese government

The PBoC has delivered a strong combination of RRR and rate cuts

- The PBoC has also utilised a variety of tools - OMO, SLF, MLF and PSL - to inject short-medium term liquidity. In 1Q it is estimated that the amount was RMB 490 billion
- In combination, the Chinese government has also implemented supportive measures for the economy, including relaxation of home purchase restrictions, measures to boost the water sector, continued SOE reforms, etc
- We expect this to boost interest rate-sensitive sectors, which are also one of the largest sectors in the credit universe, eg. financials and property
- Given the weak macro data, further policy support and monetary easing is expected

Historical changes in benchmark RRR, deposit and lending rates

	RRR Change (bp)	RRR for big banks (%)	Deposit rate change (bp)	Deposit rate (%)	Lending rate change (bp)	Lending rate (%)
23 Nov 2011	-50	21.5		3.50		6.56
30 Nov 2011	-50	21.0		3.50		6.56
18 Feb 2012	-50	20.5		3.50		6.56
12 May 2012	-50	20.0		3.50		6.56
07 Jun 2012		20.0	-25	3.25	-25	6.31
06 Jul 2012		20.0	-25	3.00	-31	6.00
24 Nov 2014		20.0	-25	2.75	-40	5.60
04 Feb 2015	-50	19.5		2.50		5.35
19 Apr 2015	-100	18.5		2.50		5.35
02 Mar 2015		18.5	-25	2.50	-25	5.35
11 May 2015		18.5	-25	2.25	-25	5.10
29 Jun 2015		18.5	-25	2.00	-25	4.85
25 Aug 2015		18.5	-25	1.75	-25	4.60
07 Sep 2015	-50	18.0		1.75		4.60

The bottom line is that the PBoC and NDRC will collaboratively push out monetary and fiscal measures to ensure the success of China's long term reforms

Source: Bloomberg, as at Sept 2015

Other forms of policy support still strong

Short term measures to stabilise equities

- To stabilise market confidence in a volatile stock market, there was government action across the board to support the market. For example:
  - CSDC announced that it would lower trading fees, reduce the number of IPOs and fund raising
  - Security firms were encouraged to set up a market stabilisation fund with 15% of their net assets for an aggregate of no less than RMB 120 billion and mutual funds (25) pledged to buy and hold for at least a year

Mid to long term policies intact, bodes well for offshore credits

- Municipal debt swap program to lower long term benchmark yields and extend maturities
- Continued liberalisation of accounts to bring convergence to on/ offshore rates
- Government agenda focused on lowering corporate funding costs
- **Fiscal stimulus:** The CDB and ADBC are to raise RMB 300 million through bonds, where the majority will be bought by China Postal Saving Banks and coupons subsidised by the central government. This is widely viewed as part of a multi-year RMB 1 trillion stimulus focused on boosting key infrastructure projects.

Long term expectations are well-anchored

Why short term volatility will not derail long term development

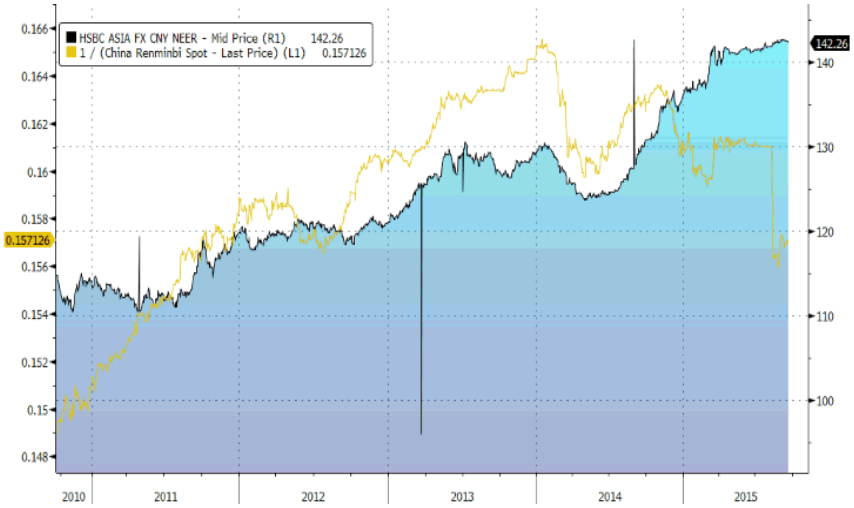
1) CNH offers relative stability

- Sharp devaluation is NOT our base case. To reiterate, this would be against trade incentives, reform agenda and internationalisation efforts
- China has proven its willingness and ability (~US$3.5t FX reserves) to support this agenda
- Fundamental demand for the RMB remains resilient as offshore deposits continue to growth and China continue to set up trade/ credit links with other countries
- There will continue to be support for the currency as key credit risks are contained and absolute yield differentials remain favorable relative to other developed or Asian countries
- This reaffirms the view of relative stability in the RMB

Disincentives for aggressive depreciation



CNY is still intact from a NEER perspective

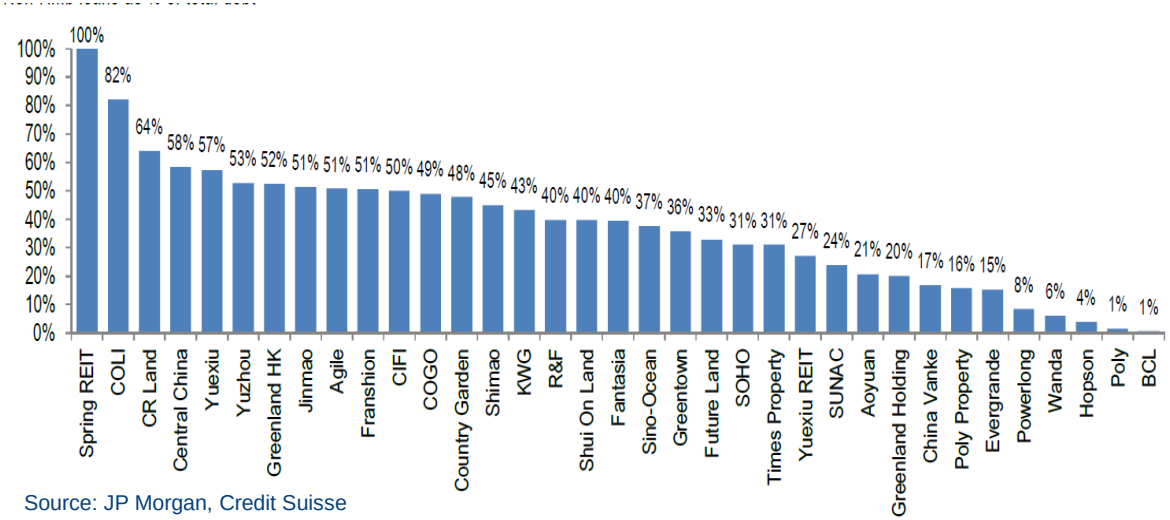


Source: Bloomberg, Barings

2) Manageable currency impact on corporates

- **Positive from a technical perspective.** This would limit further CNH bond supply and would be supportive for existing bond technicals
- **Mixed from a fundamental perspective.** However as most Chinese companies do not hedge their exposure, this would need to be selective on credits
  - This is especially true for companies with large USD debt exposure. For industrials, these may include names such as I.T., West China Cement, Parkson, MIE, West China, Car Inc, Geely, Anton and Hengdeli etc
  - For high yield property companies, they will likely be vulnerable given the traditional reliance on offshore debt. This is mitigated somewhat with the opening of the onshore bond market
  - However, we note that **despite the impact, this is likely to be contained**, given 1) the immediate impact is on interest payments, 2) transaction gain/ loss is a non-cash and non-recurring item, 3) net debt increase would just be around 5-8% , assuming a 5% RMB depreciation and the estimated net gearing rise at around 1-4 percentage points.

Non-RMB loans as a % of total debt



Source: JP Morgan, Credit Suisse

	2014E net gearing	Assuming RMB depreciates by	
		5%	10%
COLI	25%	28%	32%
CR Land	54%	58%	62%
SOHO China	13%	15%	17%
COGO	34%	36%	39%
Kaisa	72%	76%	81%
Agile	98%	104%	111%
KWG	84%	88%	94%
Country Garden	84%	88%	93%
Franshion	47%	49%	51%
Shimao	69%	72%	76%
Glorious	69%	71%	73%
Greentown	70%	71%	72%
Sunac	86%	89%	92%
Guangzhou R&F	129%	131%	133%
Evergrande	81%	83%	84%
Sino Ocean Land	66%	67%	68%
China Vanke	21%	21%	21%
Poly Property	80%	80%	81%

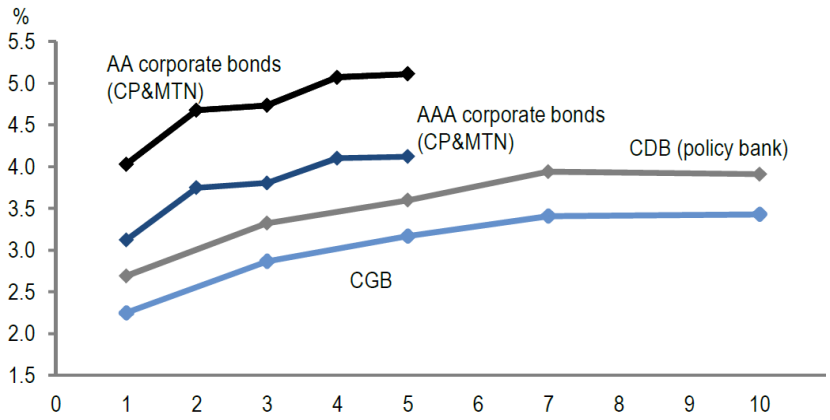
3) Credit fundamentals are improving

Opening up of domestic market is positive for credit metrics

- The onshore A share equity market has not been a vital avenue for fund raising given its previous track record of restrictions
- The wide issuance cost differential relative to offshore should encourage more onshore issuance and improve corporate balance sheets
- The gradual liberalisation of capital controls and onshore access as well as investment ability may bring on/offshore rates closer, which will also help drive offshore rates lower

Average YTM of onshore corporate bonds

Chart 1: Onshore Chinese bond yield curve



Coupons of issued domestic corporate bonds

	Tenor (Years)	Issue rate (%)	Onshore rating	Offshore issuer rating	Offshore bonds coupon
Shanghai Shimao	5	5.35%	AA	Ba2	6.625 -8.375%
China South City	3	7.00%	AA	Ba3	8.25 -13.5%
Guangzhou R&F	3	4.95%	AA+	Ba3	8.5 -10.875%
Times Property	5	6.75%	AA	B1	10.375 -12.625%
Jiangsu Future Land	5	8.90%	AA	Ba3	9.75 -10.25%
Longfor	5	4.60%	AAA	Ba1	6.75 -6.875%
Evergrande	4	5.30%	AAA	B1	8.75 -12%
Evergrande	7	6.98%	AAA	B1	8.75 -12%
Beijing Capital Land	5	4.58%	AA+	Ba2	6.875 -8.375%
Poly Real Estate	5	4.60%	AAA	Baa2	4.5 -5.25%
China Vanke	3	4.70%	AAA	Baa2	~4.5%

Source: Bloomberg, JP Morgan

Opportunities abound in a sidelined market

Attractive valuation with justified risk reward

Credits offer decent yield opportunities

Correlations between returns and volatility of stocks and HY credits are present…

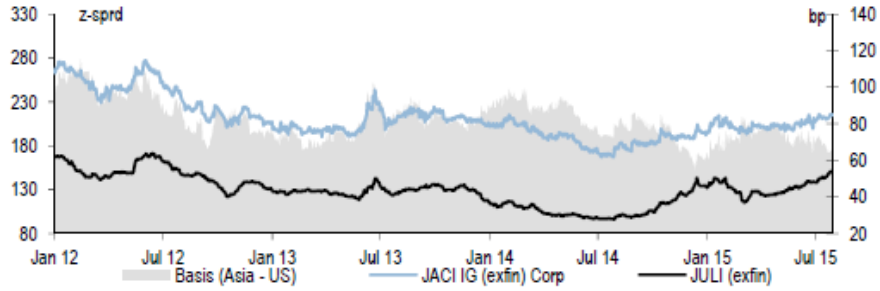
30-day volatility: HSBC CNH HK and the Hang Seng Index



- Given links in underlying fundamentals, high yield (HY) credit is statistically related to stock markets to a certain degree
- Relationship between HY spreads and stock prices is positively correlated
- This is consistent with volatility trends between the two asset markets
- Despite these trends, HY volatility still remains well below that of China stocks

…but opportunities emerging with the market stabilising and valuations reverting cheaper

Asia IG corps vs US IG corps (ex financials)



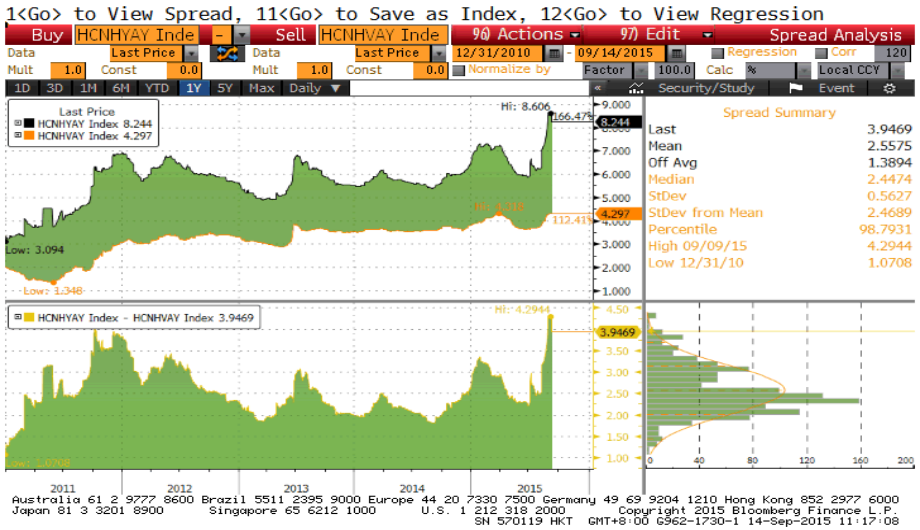
Index	z-sprd	Dur	YTM, %
JACI Corp IG	215	5.5	4.3
JULI exfin	151	7.6	4.2
Currenr Spreads	64		

- Asian IG corporates on average offer similar yield at much lower interest rate risk compared to US IG corporates
- It also offers a spread premium of around 64bps against US IG corporates
- This represents a higher spread differential than the average historical spread of ~72bps since 2012

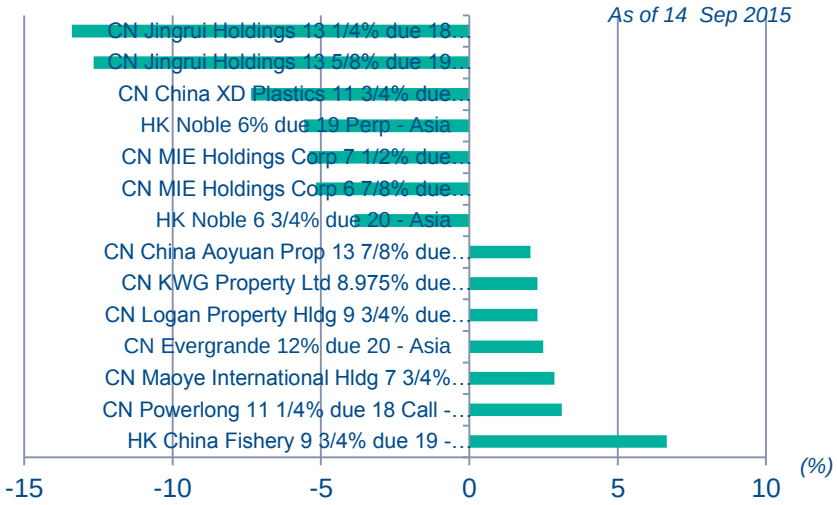
Source: Bloomberg, JP Morgan, Barclays, Bloomberg

Chinese IG and HY performance and valuations

IG versus HY returns (CNH Index)



Top and bottom performers of property bonds (MTD return) (USD)



Yields were driven by currency volatility

- Both HY and IG yields surged materially in August as the RMB fixing regime was changed
- The HY/ IG spread is now hovering at five-year highs
- The interim results of overall CNH issuers were reasonable but a positive bias for developers in the 2H
- See potential for volatility to remain heightened but spreads should tighten post-Fed decision and better corporate operational results

Source: Bloomberg, JP Morgan, Barings

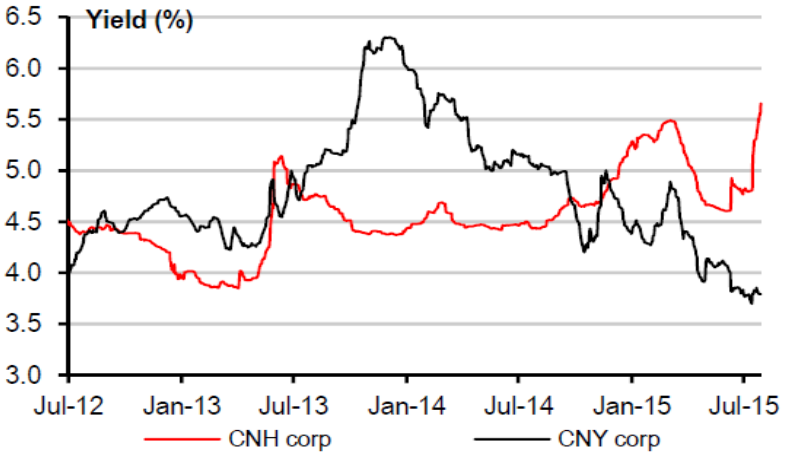
Opportunities emerging

Valuation have reached very attractive levels

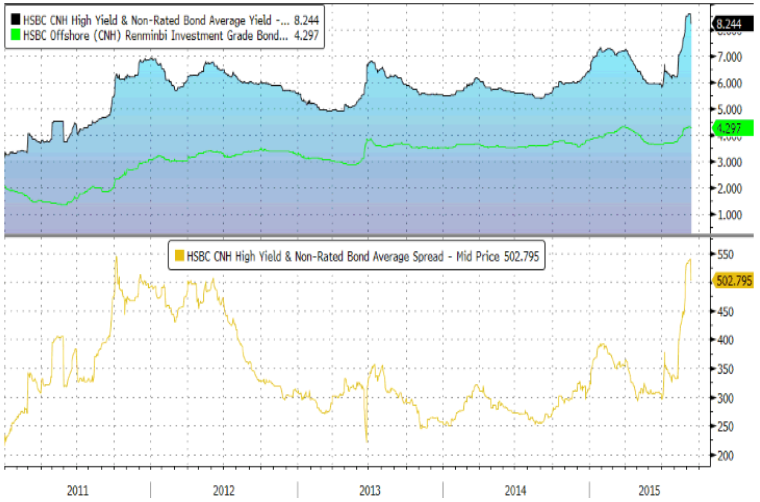
CNH valuations appearing very attractive

- CNH corporate yields are also at five-year highs and spreads near five-year highs
- For the first time, offshore corporate yields are almost 200bps higher than onshore corporate yields after the recent correction
- This appears unjustified given the improving funding environment for offshore issuers who are able to refinance at lower cost
- We believe this presents opportunities into unfairly penalised credits, e.g. decent interim results and FY15 outlook for quality developer names such as COGARD, SHIMAO, YLLGSP; while we also see tactical opportunities, e.g. GRNLGR'19, EVERRE'16, MOLAND
- Non-prop credits, such as SOE names also appear attractive, e.g. MEILAN, SANYPH, BJCAP

CNH corporate versus CNY corporate yields



CNH HY and IG yields/ spreads



Source: HSBC, Bloomberg

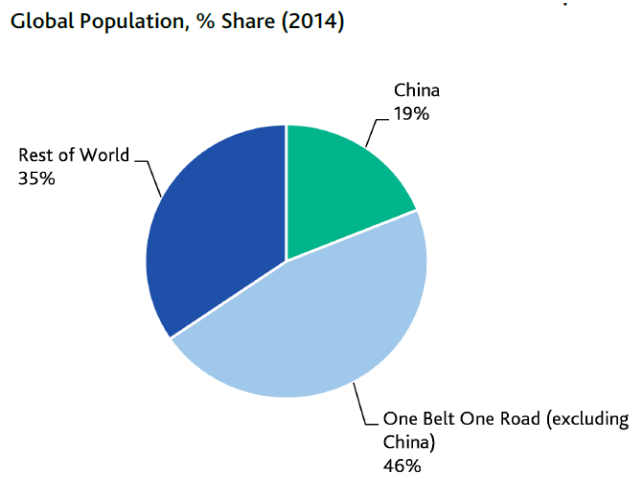
Mid to long term direction remains intact

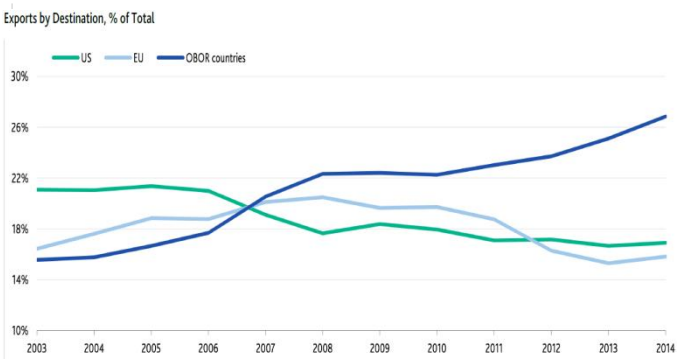
- Economic stability is on the top of minds of senior government officials in China
- Evidenced by strength in monetary and policy support – OBOR, rate/RRR cuts, debt swap program, etc
- Recent market trends in the credit markets also indicate confidence in IG corporate fundamentals
- The longer term agenda of reforms, economic liberalisation and streamlining of SOE functions are positive to the greater health of the overall economy and corporate resilience
- China's mid to long term development plans remain very much intact. This would include:
  - One Belt One Road
  - Shadow banking market reform
  - State-owned entity ("SOE") reform
  - Market liberalisation, e.g. removal of deposit and lending rate caps and floors
  - Social reform and urbanisation, e.g. Hukou system, one child policy

One Belt One Road ("OBOR")

Introduced by Premier Xi in 2013, this ambitious project encompasses building an economic framework and supporting infrastructure to bring closer regional connectivity and trade ties within the areas highlighted below.







Source: Moody's

Shadow banking market and LGFV reform

In 2013, China's National Audit Office conducted its most thorough regional and local government debt audit since 2011 as an effort by the central government to shine a light on the magnitude of the market and improve management of regional government fiscal finances. This also addresses Local Government Financing Vehicles ("LGFV"). The LG debt swap program was launched to alleviate risks in LGFVs.

A breakdown of total government debt

(RMB trn, % of total government debt, as of mid-2013)

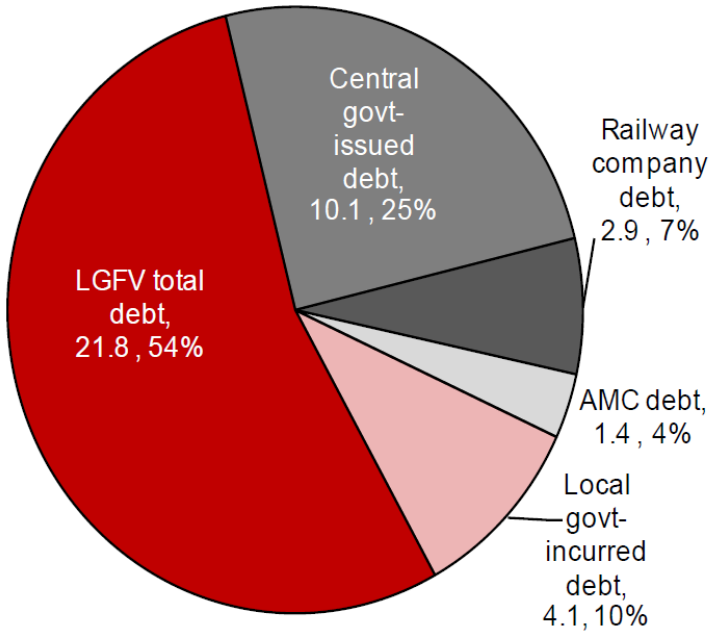
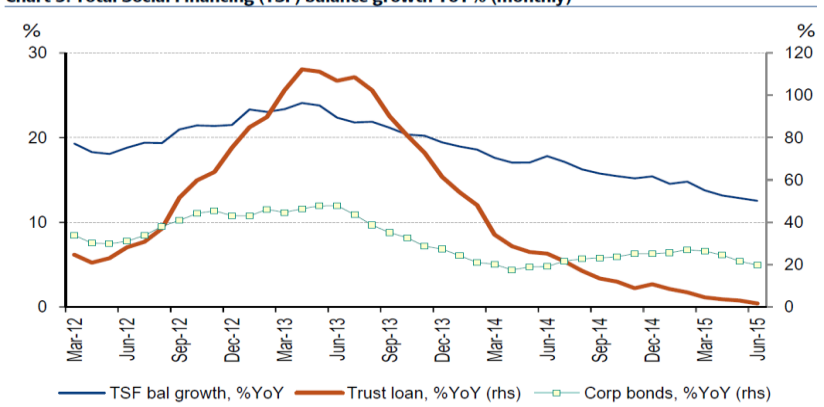


Chart 5: Total Social Financing (TSF) balance growth YoY% (monthly)



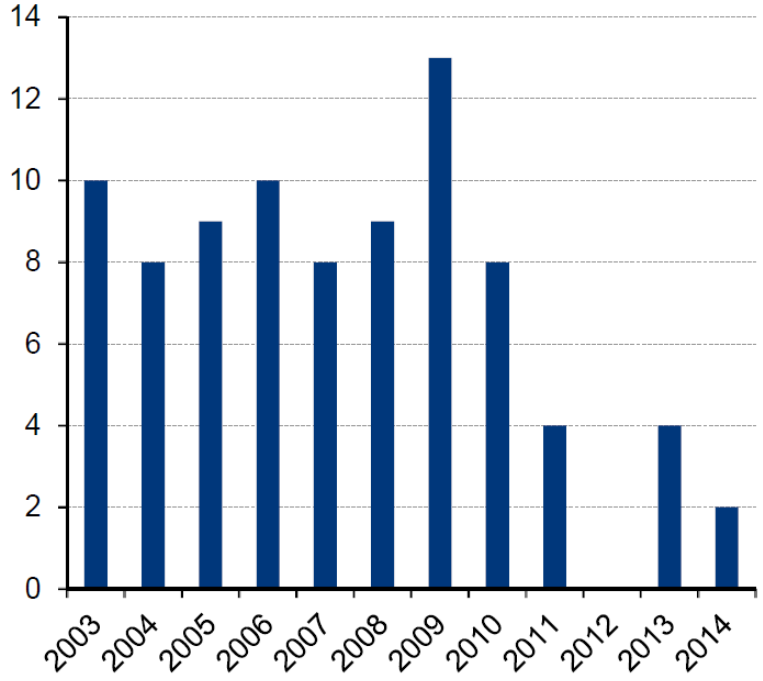
Debt swap quota approved in 2015 (RMB)	
Total	3.2 trillion
-March	1 trillion
-June	1 trillion
-August	1.2 trillion
Local gov't debt outstanding (end-2014)	22.6 trillion
-maturing in 2015	4.1 trillion

Source: Nomura, BofA Merrill Lynch

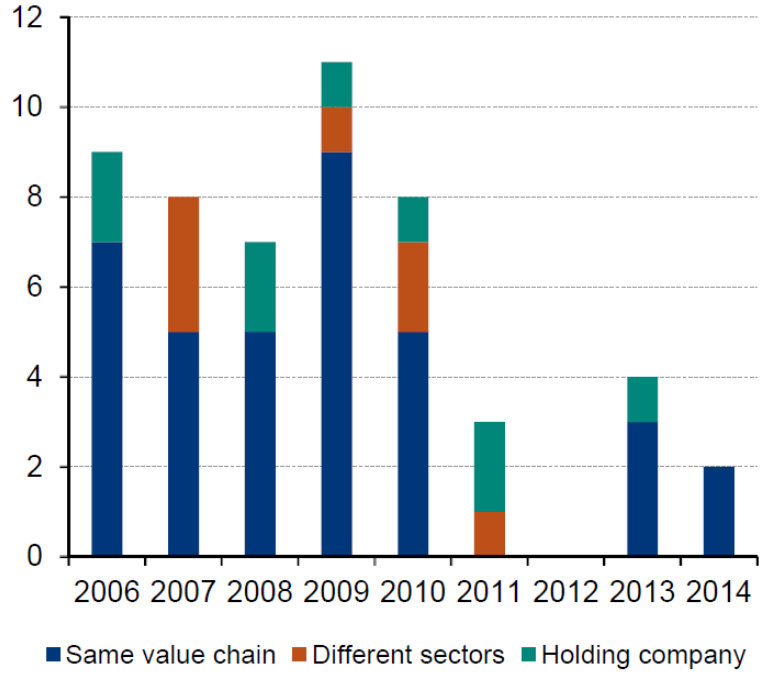
State-owned entity (“SOE”) reform

Widely anticipated, the State Council and CPCC jointly issued guidelines on deepening SOE reforms with an aim to achieve results by 2020. Key points include improving returns on SOE capital, deepening mixed ownership reforms through listing or private investors, deregulation of public goods, the SASAC to focus on managing capital rather than operations.

Number of central SOEs consolidated



Consolidations, by sector



Source:BofA Merrill Lynch

Implications of policy directions

Forthcoming policies from China are expected to keep demand afloat:

i) Anticipate more monetary easing in the Mainland, i.e. official rate and RRR easing, indirectly affecting Mainland fund flows into the Hong Kong monetary system

ii) OBOR could strengthen demand for large SOEs as well as industrial and real estate sectors

iii) More Chinese corporates are raising capital and obtaining equity financing in Hong Kong after revamp of shadow banking in the Mainland

iv) Sustained liquidity improvement as unconventional policy tools are utilised and certain investment channels open, e.g. Hong Kong Stock Exchange Mutual Connect with Shenzhen in 2H2015

v) Deregulation of deposit rate policy of Chinese banks will allow better market competition and facilitate growth

Overall: robust investment opportunities in China given unwavering support from the central government and improving framework of IG credits as markets further develop and become mature

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