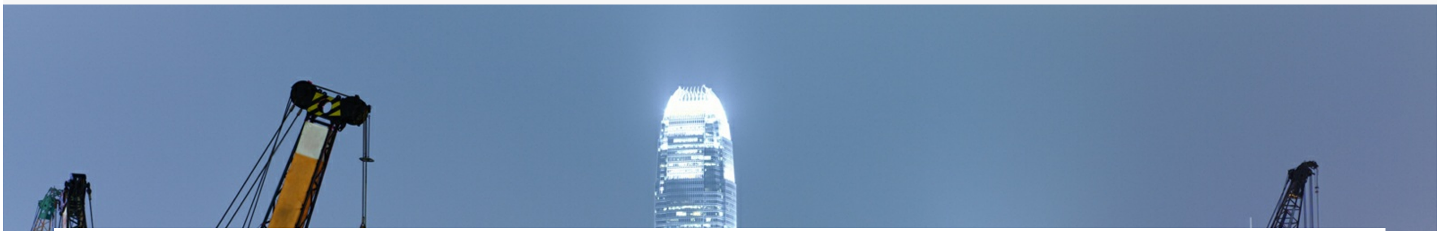
PICTET
Asset Management



EMERGING MARKETS

EMERGING MARKET MONITOR: CHINA GLOBAL TRADE

US-China trade war: why China's policies will keep growth on track.

October 2018

Patrick Zweifel, Chief Economist

More growth-supportive fiscal and monetary policies should lift China's GDP growth next year.

CHINA REACTS TO US TRADE TARIFFS

In the face of US trade tariffs, we expect China's fiscal and monetary policies to become more growth supportive, providing a lift to GDP growth by some 0.5 per cent next year. Yet, we think Beijing's stimulus is likely to take longer to work and be less impactful than in previous easing cycles.

Trade policy

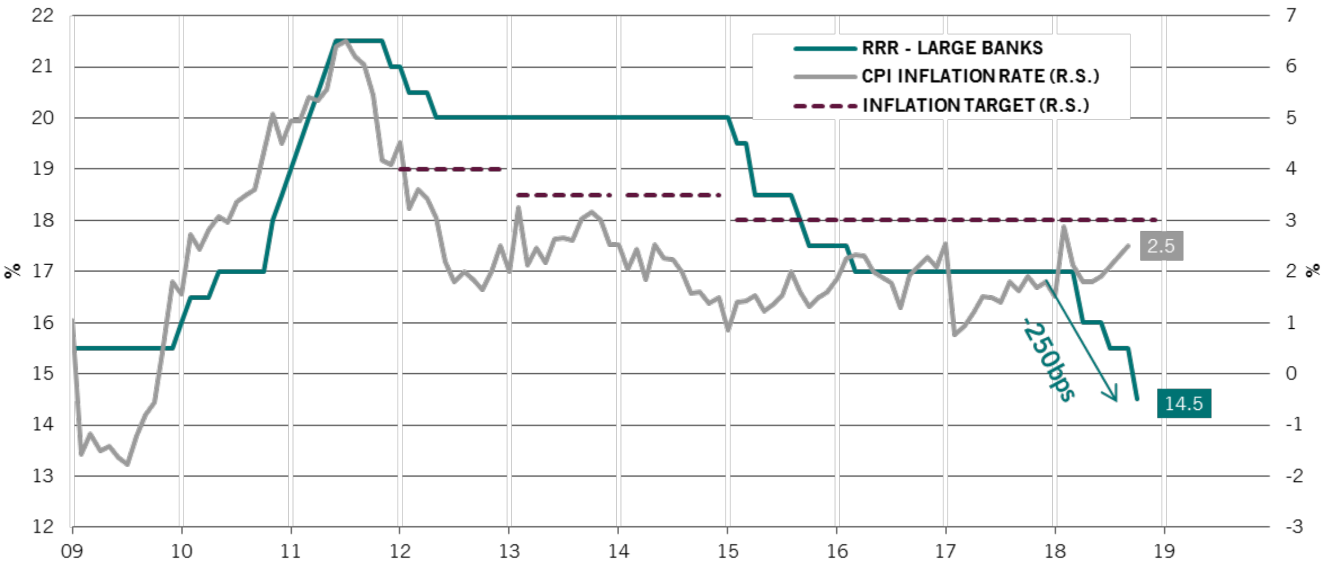
Whilst China has already hiked tariffs up to 25 per cent on USD 110 billion of US imported goods, it has cut the import duties it charges to Chinese importers / corporates / consumers and plans further moves. Including additional cuts on most favoured nation (MFN) tariffs due on 1 November, China will have reduced its average MFN tariff from 9.9 per cent to 7.5 per cent, easing the burden on those facing higher US tariffs by lowering duties charged on other countries' imports.

Monetary policy

By cutting its reserve requirement ratio (RRR) by 250bps since April, China has sent a clear signal. Already, investment spending has accelerated in real estate and manufacturing in Q3. **We think there will be another 100bps RRR cut by March 2019.**

CUTTING THE RRR SIGNALLED EASING MONETARY POLICY

China Required Reserve Ratio (RRR) & CPI inflation rate



Source: Pictet Asset Management, CEIC, Datastream, October 2018

Fiscal policy

Also part of the arsenal is a more proactive fiscal policy in the form of tax reduction of RMB1.3 trillion for the whole year. This represents nearly 2 per cent of 2017 GDP, of which some RMB500 billion comes from a cut in individual income tax effective since 1 October.

More measures are expected in 2019, in particular fiscal support for infrastructure investments, cuts in VAT and corporate income tax.

A ROAD FULL OF OBSTACLES: CAPITAL OUTFLOWS, INFLATION & DELEVERAGING

China faces three major hurdles in extending fiscal & monetary stimulus:

1. China-US interest rate spread (10 year bond yield spread at a 7 year low at 40bps) & capital outflows risk

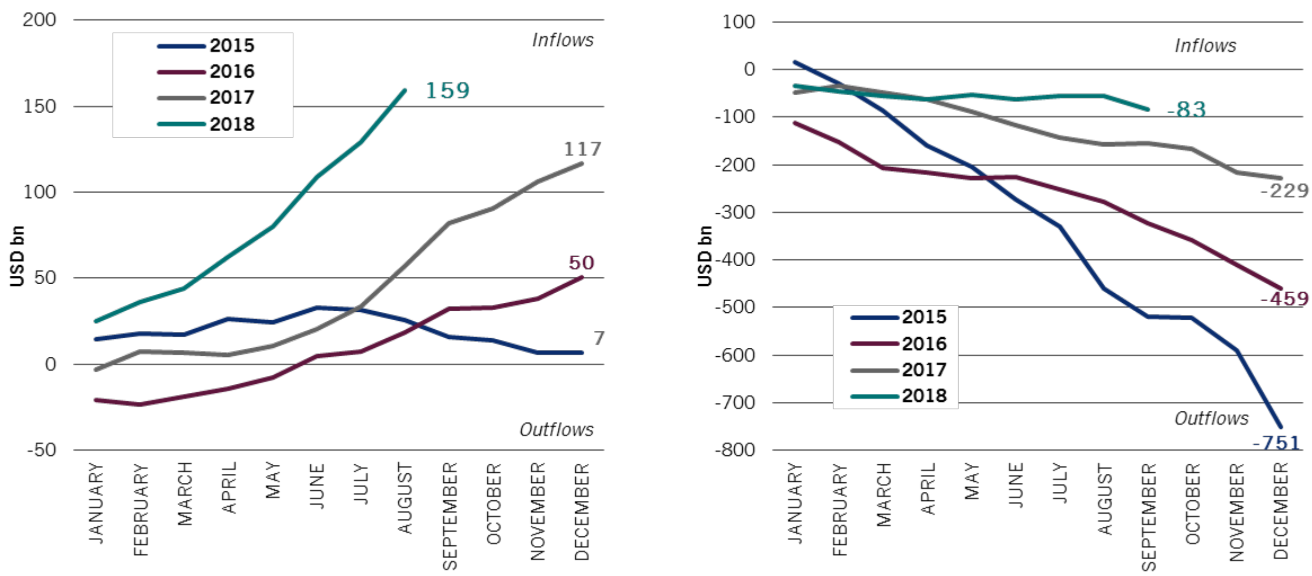
2. CPI inflation at a 7 month high

3. Deleveraging: total social financing at a record high

China has already tightened capital controls to deal with the first hurdle. On inflation, policymakers view the rise as temporary and below the 3% target, so not their prime concern. Finally on deleveraging, it should only resume when trade tensions fade as short-term growth has become the top priority.

CAPITAL OUTFLOWS HAVE REMAINED LOW DUE TO CAPITAL CONTROLS.

China: net non-resident portfolio flows* (YTD cumulative flows) [left chart] / China net capital flows* (YTD cumulative flows) [right chart]



Left chart

Source: Pictet Asset Management, International Institute of Finance (IIF). *Net non-resident purchases of equity & debt. IIF portfolio flows tracker.

Right chart

Source: Pictet Asset Management, CEIC, Datastream. *Changes in FX reserves (net of currency valuation effect) adjusted for current account transactions & net direct investment flows.

So far, measures seem to be working and investors have remained on board. Although China's capital outflows rose in September, they are still low due to capital controls, representing only half the levels observed in 2017 (right chart). What's more, over the same period foreign inflows are three times larger last year (left chart).

Added to the expected inclusion of Chinese financial markets into broader market indices, this shows that investor confidence in China remains high.

THE VIEW FROM OUR EMERGING EQUITY TEAM

By Avo Ora, Head of Asia (ex-Japan) Equities

As outlined in the previous section, major policies by China to counter the impact of US tariffs are coming.

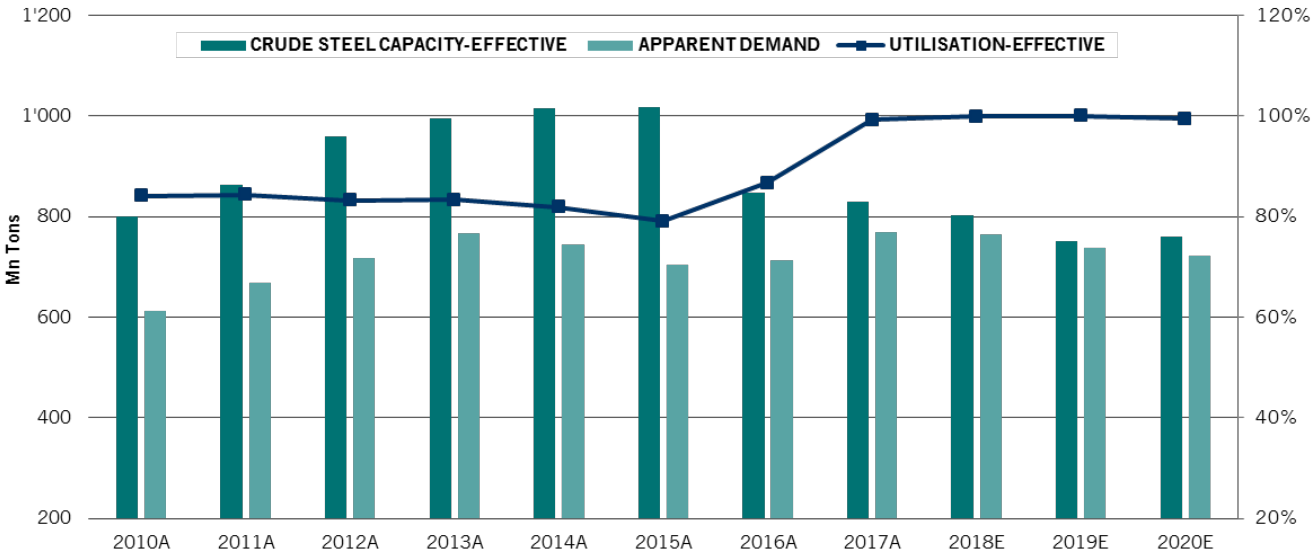
The Chinese government has been able to keep options open thanks to the offsetting weakness of the RMB vs. the dollar, but this will not last.

Among their most likely measures, monetary loosening and fiscal stimulus typically support fixed asset investments. This provides an additional leg to the investment thesis behind our holdings in construction-related firms – one being a cement manufacturer, the other a steel producer. These firms not only trade at attractive valuations, but their strong free cash flow generation is now supported by tighter supply conditions due to environmental restrictions put in place by Chinese authorities.

We think the supply side reforms are here to stay and additional stimulus should bring about an encouraging boost to construction activity.

STEEL UTILISATION RATES RISE AFTER RESTRAINTS ON POLLUTING PRODUCERS

China's steel capacity, demand & utilisation



Source: Goldman Sachs, 15th October 2018

MARKET WATCH

EQUITIES	1 mth (%)	3mths (%)	YTD (%)	1 yr (%)	3 yrs ann. (%)	5 yrs ann. (%)	10 yrs ann. (%)
MSCI EM	-0.53	-1.09	-7.68	-0.81	12.36	3.61	5.40
MSCI EM Value	1.56	3.44	-4.28	2.27	11.55	2.04	4.53
MSCI EM growth	-2.61	-5.38	-10.94	-3.89	13.03	5.08	6.18
MSCI AC Asia ex Japan	-1.38	-1.57	-6.26	1.45	13.30	6.64	8.43
MSCI Brazil	7.00	6.07	-12.26	-14.01	20.53	-2.94	-0.91
MSCI China	-1.40	-7.51	-9.12	-2.20	13.69	7.85	8.26
MSCI India	-9.10	-2.25	-9.60	1.09	7.00	9.67	6.53
MSCI Russia	9.79	6.15	9.08	13.73	19.43	-0.04	0.82
MSCI EM Europe	6.71	2.24	-6.33	-1.46	10.34	-3.60	-1.14
MSCI World	0.56	4.98	5.43	11.24	13.54	9.28	8.56

BONDS	1 mth (%)	3mths (%)	YTD (%)	1 yr (%)	3 yrs ann. (%)	5 yrs ann. (%)	10 yrs ann. (%)
JPM EMBI Global Diversified	1.51	2.30	-3.04	-1.92	6.04	5.38	7.54
JPM GBI-EM Global Diversified	2.59	-1.83	-8.15	-7.40	5.17	-1.68	2.70
JPM ELMI+	1.09	-1.11	-4.48	-2.57	3.28	-1.10	0.39
JPM CEMBI Broad Diversified Composite	0.94	1.30	-1.60	-0.93	5.37	4.77	7.19
JPM Jade Broad Asia Diversified	-0.45	-0.61	-5.08	-2.22	3.91	1.82	-
Chinabond composite	-0.45	-2.31	-0.23	1.31	0.70	2.34	-
JPM GBI-EM Global Latin America	3.52	0.27	-5.43	-9.23	8.51	-1.28	3.48
JPM EMBI Global Diversified Europe	2.14	1.59	-2.22	-1.06	5.16	5.31	7.74
JPM Global All Mats	-1.12	-1.70	-2.62	-1.65	1.46	0.45	2.49

COMMODITIES	1 mth (%)	3mths (%)	YTD (%)	1 yr (%)	3 yrs ann. (%)	5 yrs ann. (%)	10 yrs ann. (%)
S&P GSCI TR	3.90	1.30	11.80	22.90	3.20	-10.00	-
S&P GSCI WTI TR	5.40	2.60	28.10	48.60	2.90	-15.40	-
S&P GSCI Brent Crude TR	7.40	5.30	29.50	55.30	12.20	-10.80	-
LBMA Gold pm	-1.30	-5.10	-8.00	-7.50	2.10	-2.20	-

CURRENCIES	1 mth (%)	3mths (%)	YTD (%)	1 yr (%)	3 yrs ann. (%)	5 yrs ann. (%)	10 yrs ann. (%)
USD/BRL	3.17	-3.66	-16.94	-20.79	-0.10	-11.03	-7.02
EUR/BRL	3.34	-3.16	-14.13	-19.38	-1.41	-8.27	-5.23
USD/RUB	2.80	-5.31	-13.43	-12.06	0.12	-13.47	-9.06
EUR/RUB	2.97	-4.81	-10.50	-10.50	-1.20	-10.78	-7.32
USD/INR	-2.16	-5.48	-11.95	-9.89	-3.25	-2.89	-4.25
EUR/INR	-1.99	-4.99	-8.97	-8.29	-4.53	0.13	-2.41
USD/CNY	-0.74	-3.71	-5.36	-3.46	-2.60	-2.31	-0.05
EUR/CNY	-0.57	-3.21	-2.15	-1.74	-3.89	0.73	1.87
USD/ZAR	3.53	-3.14	-12.52	-4.58	-0.77	-6.59	-5.22
EUR/ZAR	3.71	-2.64	-9.56	-2.89	-2.08	-3.69	-3.40

Top performer among the EM indices or currencies shown in this table, for the corresponding period.

Worst performer among the EM indices or currencies shown in this table, for the corresponding period.

Developed markets.

Source: Datastream, Bloomberg, data as at 30.09.2018 and in USD. Equity indices are quoted on a net dividend reinvested basis; bond and commodity indices are quoted on a total return basis. The currency rates evolution is treated as a performance calculation based on FX rates.