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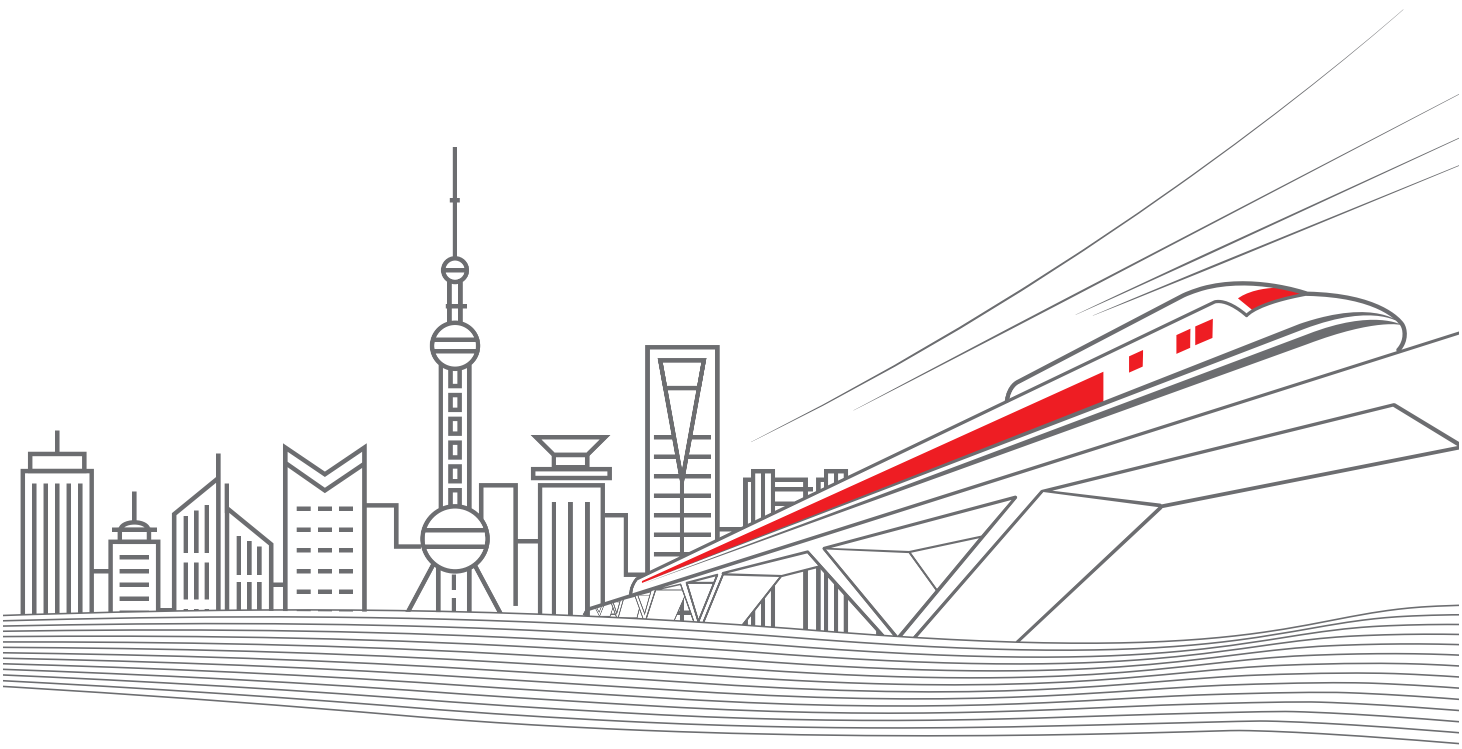
UBS Asset Management

The new China

A remarkable transformation



Manufacturing is traditionally a strong area for China. We will implement the 'Made in China 2025' strategy and redouble our efforts to upgrade China from a manufacturer of quantity to one of quality.

Li Keqiang, Premier of the People's Republic of China, 2015

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A remarkable transformation

China has experienced a rapid transformation and tremendous economic success since initiating reforms and opening-up domestic markets over the past several decades. To reach the next stage of economic development, China is forging a different growth path focusing on higher-end manufacturing, innovation, domestic demand and services. This report looks at the progress that China has made in transforming its economy and how structural reforms and financial liberalization are shaping the new China.

The only way is up

The fear of falling into the middle income trap has urged the Chinese leadership to steer the economy away from the low-cost manufacturing it had become famous for, towards high value-added manufacturing, consumption and services. In the 13th Five-Year Plan for 2016-2020, the Communist Party further laid out the government's core priorities and targets, which included promoting higher-end manufacturing, making China an innovative country, and encouraging the development of more advanced technologies.

While delivering the 2015 Annual Government Work Report at the annual parliamentary meeting in March 2015[1], Chinese Premier Li Keqiang said "Manufacturing is traditionally a strong area for China. We will implement the 'Made in China 2025' strategy; seek innovation-driven development; apply smart technologies; strengthen foundations; pursue green development; and redouble our efforts to upgrade China from a manufacturer of quantity to one of quality." China has pledged to cut the overcapacity in certain industries, support mergers and acquisitions as well as restructurings, and allow market forces to determine which businesses survive.

In May 2015, the Chinese leadership further unveiled the details of the 'Made in China 2025' strategy. The strategy aims to give its manufacturing sector a radical makeover and transform China into a leading high quality and value-added manufacturing powerhouse by 2049. The first of three 10-year action plans highlights ten key sectors at the heart of China's economic transition, including new information technology, robotics, biological medicine and medical devices. In addition, nine tasks have been identified as top priorities, for instance, enhancing manufacturing innovation, fostering Chinese brands, and encouraging service-oriented manufacturing.

The government has set out a clear-cut policy to reduce China's dependence on just manufacturing 'widgets' to increase the value of its production and exports. In 1993, the share of high value-added components within exports was 20%. But in 2015, this had more than doubled to 51% as shown in chart 1. On this note, Trump's election could cast a shadow on China's exports if President-elect Trump decides to impose tariffs on Chinese products or pull out of trade agreements.

[1] Source: http://english.gov.cn/archive/publications/2015/03/05/content_281475066179954.htm

Chart 1: China is not standing still and has been moving up the value curve

Share of high value add products as percentage of total exports, for key exporters

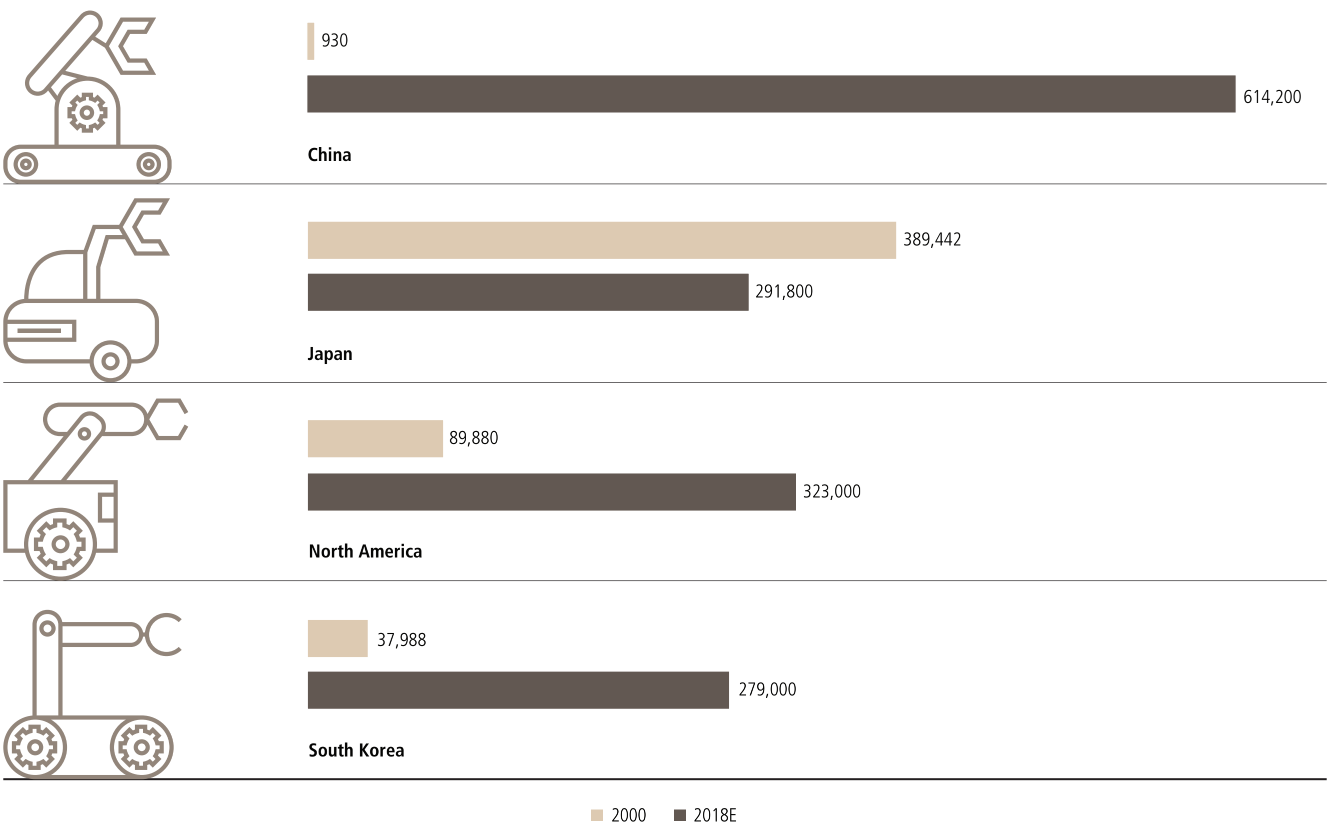
	1993	2013	2014	2015
Japan	77.5	64.4	64.6	65.2
Korea	46.6	61.2	61.5	NA
Taiwan*	56.7	56.6	57.8	60.9
Germany	51.1	56.4	56.8	57.7
China	20.4	51.1	49.6	50.7
France	43.3	47.6	47.6	50.0
Thailand	31.7	44.1	45.5	47.8
UK	49.8	37.2	44.9	46.7
Italy	40.2	41.8	42.8	43.8
Malaysia	50.1	41.1	42.0	45.4
US	54.0	41.0	41.4	43.1
Turkey	9.1	28.0	28.1	28.4
India	9.3	18.2	20.0	22.4
Brazil	22.2	19.3	15.8	17.5
Indonesia	6.6	12.4	13.0	NA

*1997/98
Source: Comtrade, Macquarie Asia Equity Strategy Research, UBS Asset Management, August 2016.

Factory automation is also set to gather momentum. China is expected to overtake Japan and the US in terms of the number of robots installed (chart 2). The robot density in China seems to be at a level similar to where Japan was in the 1970s and Korea around 1990. Factory automation will continue, in China and elsewhere in emerging markets. This trend can be partly explained by the challenging demographics China is facing. The wave of cheap labor moving from agricultural sector to manufacturing is coming to an end.

In addition, China's one-child policy means that we're seeing a decline in new labor supply and pronounced shift towards an older population. With a better educated population, there are also fewer workers willing to take lower-pay factory jobs. As a result, wages have increased significantly putting pressure on companies' costs, driving automation investments.

Chart 2: China expected to overtake Japan in terms of robots installed base (units)

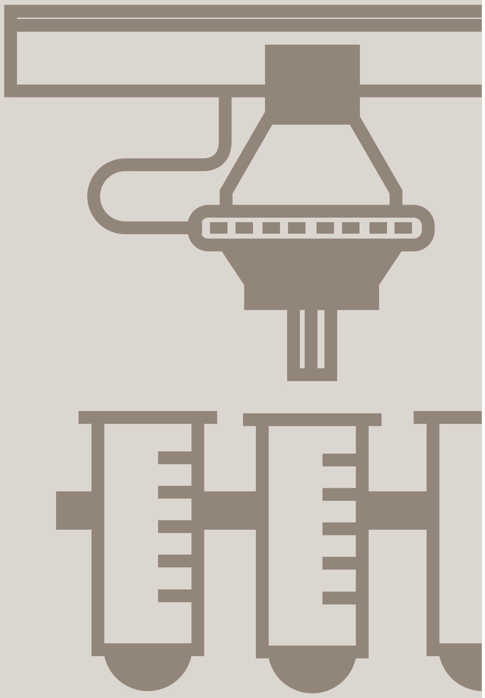


Source: International Federation of Robotics, Macquarie Research, UBS Asset Management, August 2016.

Pharmaceutical industry: from generics to innovative products

Innovation is high on the government's agenda in order to support China's next stage of economic development, with increasing number of pharmaceutical companies that research and develop new chemical agents and/or biologics for treatment of disease and illnesses. There is evidence of a biotech sector emerging, with increasing efforts made to create a world-class biotechnology industry.

In 2008, the Chinese government instituted the 'Thousand Talent Plan' to entice Chinese-born scientists living overseas to return and develop the domestic biotech industry. It attracted more than 4,180 top-level scientists as of mid-2014[2]. At the same time, the number of job opportunities in global pharmaceutical companies was reduced to right-size their cost base for the pending patent cliff in early 2010s. As R&D divisions were restructured, the brain drain was reversed, which helped kick-start development of the pharmaceutical industry in their home countries[3]. Additionally, as global pharmaceutical companies restructure they also invested in emerging markets such as China. As the world's second largest market for medical drugs (after the US), it is currently underserved and the aging population makes China a sustainable long-term demand. There has also been government intervention in the pricing for generic drugs causing profit margins to shrink. With the cost of R&D also increasing, companies are turning to higher-value drugs for better returns, rather than low-value generic drug candidates. Indeed, for companies targeting overseas markets, high-quality and innovative products are needed to differentiate.



2 Zhou, Y. (December 17 2015). The Rapid Rise of a Research Nation. Nature Journal.
3 Hirschler, B. (June 26 2011). Drug R&D spending fell in 2010 and heading lower. Reuters.

The rise of the Chinese consumer

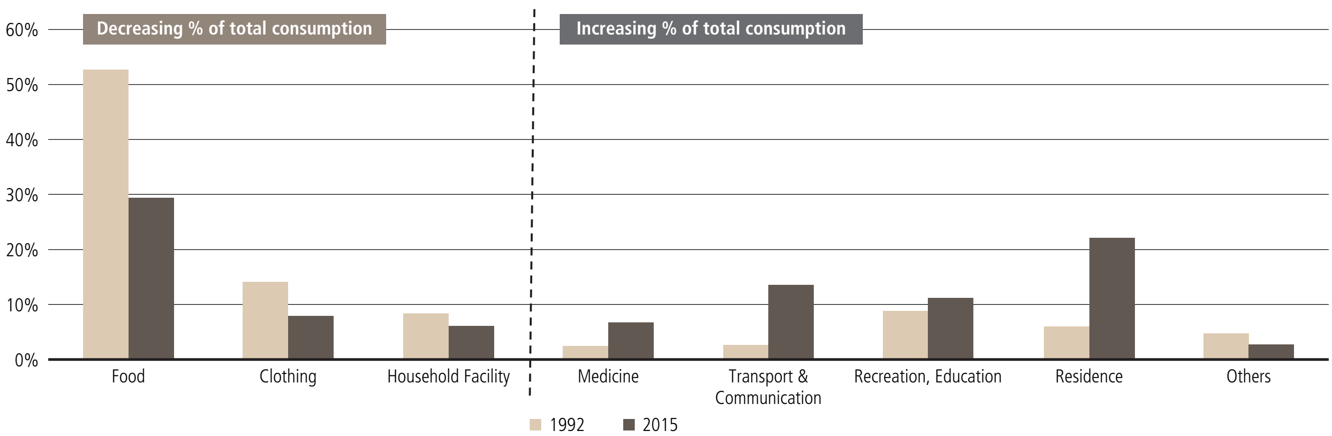
Rising income levels and higher purchasing power are creating an enormous new consumer class in China. Demographic shifts, i.e. the rise of a young, urban and tech-savvy consumer group plus an aging population, support not only a rise in consumption, but also changing consumption patterns.

In China, the percentage of middle income households is expected to rise to 51% of total households by 2020 (from 25% in 2010), according to UN figures. As income and standard of living rise, the needs and preferences of Chinese consumers have started to evolve. It is typical for consumers at first to spend a considerable share of their income on staples and then, on discretionary items. This trend – rising share of discretionary spending – is likely to continue with rising affluence, and will have a powerful effect on the global economy.

Rising share of wallet for discretionary spending
Chart 3 illustrates how spending patterns have changed in China over the 23-year period over 1992-2012. The Chinese consumer spends a significantly smaller share of his income on food than 25 years ago. On the other hand, residence has seen the largest increase given the increasing number of people moving to urban areas and rapid rise in property prices, in particular, in Tier-1 and Tier-2 cities.

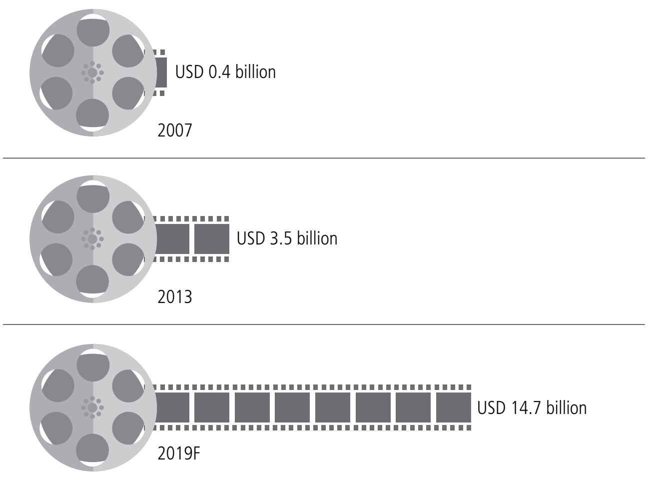
Chart 3: China consumption expenditure per capita

Sub category spend as % of total expenditure per capita



Source: NBS, CEIC, UBS Asset Management.

Chart 4: Strong growth in China movie box office



Source: Wind, Entgroup, UBS, as of March 16, 2016.

Rising income levels drive strong growth in leisure and entertainment spending, and a significant gap exists between emerging market and developed market economies. For instance, per capital spending on box office in the US is 10 times higher than in China. In terms of box office, China has seen rapid growth in recent years, from USD 0.9 billion in 2009 to USD 4.7 billion in 2014, implying 39% CAGR (Compound Annual Growth Rate). Given the lucrative size of this market, it is not surprising to see the likes of Wanda group partnering with Sony Pictures Entertainment in a number of upcoming releases. Alibaba pictures and Steven Spielberg's Amblin Partners recently announced plans to co-produce films for global and domestic audiences.

Trading up

Chinese consumer behavior has evolved rapidly and consumers have become increasingly sophisticated. Partly due to the various food safety scares in China, consumers are willing to pay a higher price for a majority of staple and discretionary items to improve their quality of life. Consumer behavior has also gradually shifted towards healthier products. Indeed, instant noodles have given way to fresh healthy food, driven by the ascent of China's middle class. Thanks to the rise of technology, mobile internet and e-commerce, freshly made food is delivered to the doorstep after a few taps on the mobile phone. It is hardly surprising that internet giants, such as, Alibaba, Tencent, and Baidu, are investing in food-delivery platforms.

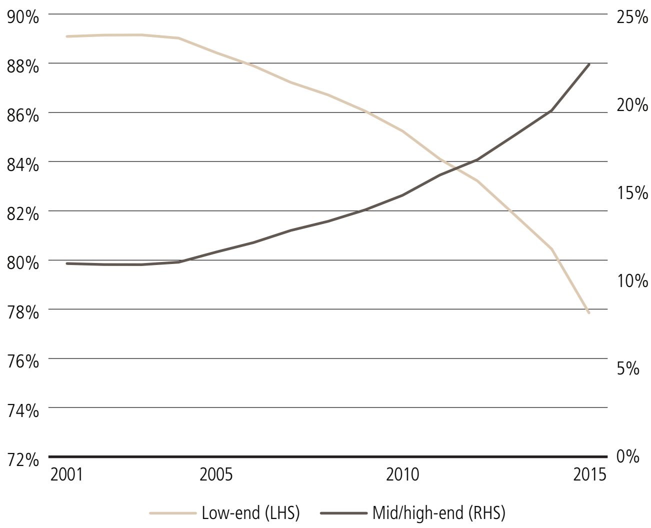
Chinese consumer behavior has evolved rapidly and consumers have become increasingly sophisticated.

The desire to trade up is also driven by the fact that many Chinese judge themselves and others by what goods they buy and consume. As such, driven by this desire to improve their lifestyle and social status, many Chinese are willing to upgrade and pay higher prices. For example, China's mid/high-end beer sales have doubled to 22% of total sales in 2015 from 11% in 2000 (chart 5).

At the top end of the market, China is also experiencing consumption shifts. With the recent government crackdown on luxury gifts, a flashy expensive watch has become more of a liability than an asset. But with wealth per adult expected to continue to grow strongly in the years to come, the demand for luxury goods should follow a similar trend. In this regard, discrete premium quality niche brands and nascent Chinese luxury brands are likely to be the winners at the expense of visibly ostentatious luxury goods.

Chart 5: China's beer sales mix to mid/high-end and low-end

Proportion of total beer sales



Source: Euromonitor, UBS Asset Management.

China's silver age

The silver age is catching up fast in China. In around 20 years, China's population over 65 years old will reach approximately 300 million[4], equal to the current population of the United States[5]. This is clearly an important emerging consumer segment. The elderly are often more vulnerable to diseases and will drive the demand for medical drugs. In addition, as wealth catches up and awareness around health issues increases, they will seek out more sophisticated healthcare services. And with medical insurance being made available to nearly 1.4 billion citizens, healthcare is expected to be a trillion dollar industry by 2020[5].

[4] Source: UN Population Division, World Population Prospects, the 2015 Revision.
[5] Source: China's healthcare provider market, Riding the waves of reform, Deloitte, 2015.

China took about five years to move from ~2% e-commerce penetration to ~14% e-commerce penetration, while the US took over 10 years to achieve that.

Tertiary industry: disruptive trends

As a result of China's economic rebalancing efforts, the tertiary industry is now the largest component of China's GDP, and continues to grow (chart 6). The tertiary industry surpassed the secondary industry in 2011 to make up the largest share of GDP. This trend is likely to continue with China's economic transformation towards a more service and consumption-driven economy.

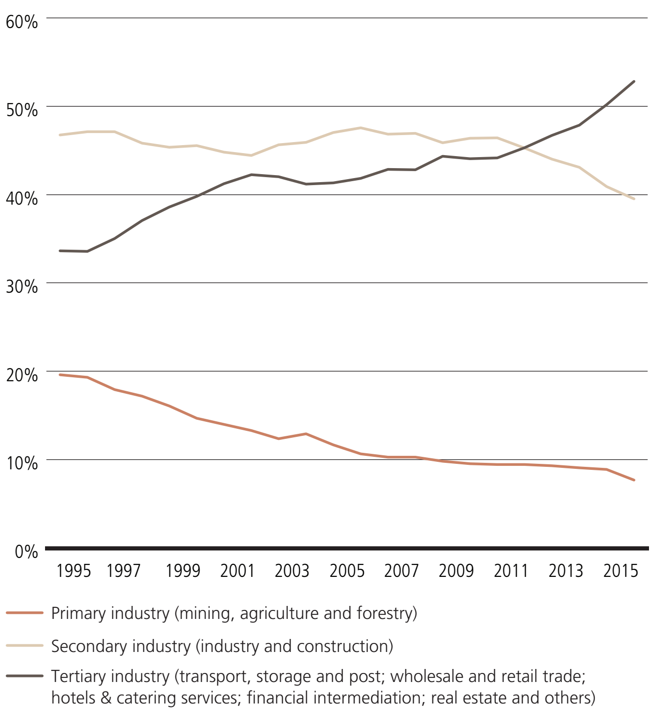
An online disruption: e-commerce

The internet will continue to disrupt many traditional retail industries and even create new business models unthinkable just five or ten years ago. Internet companies in China arguably started as followers, but more recently have been very innovative in extending the breadth of service offerings for domestic market needs, e.g. Alibaba. One may in fact argue that the less developed or weak traditional commerce infrastructure in many emerging markets (EM) countries lends itself naturally to a faster and higher growth potential for these internet companies. In many cases, incumbent companies are embracing new technologies that may disrupt their traditional service offerings as the latent cost of existing infrastructure is much lower compared to their developed market counterparts.

One of the most revolutionary changes in the retail trade is the rising share of online trade, which is disrupting the traditional distribution channels. Indeed, there has been a rise in e-commerce in China at the expense of traditional retailers like Lifestyle and Belle. Among emerging markets, China leads the pack with e-commerce penetration at ~13.5% of total retail sales in 2015, almost in-line with the US at 13.8% of comparable retail spend[6].

Chart 6: The tertiary industry is now the largest component of China's GDP and continue to grow

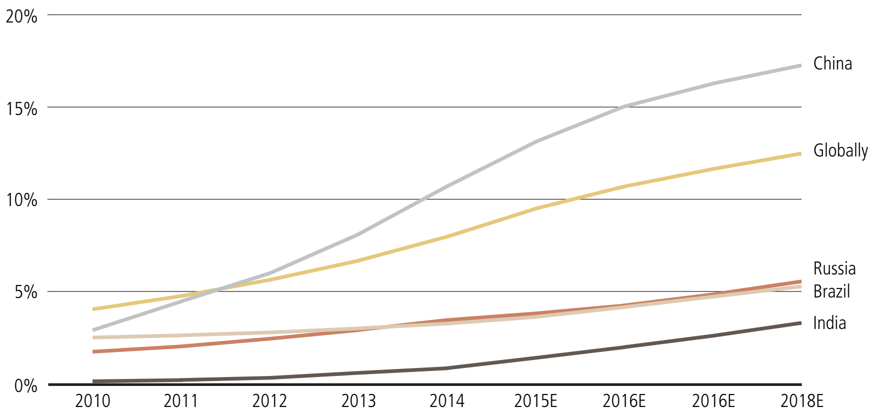
Share of China GDP



Source: BofA Merrill Lynch Global Research, NBS, CEIC, UBS Asset Management. Data as of 3Q16.

[6] Source: Credit Suisse Emerging Market Consumer Survey 2015.

Chart 7: e-Commerce as % of total retail sales



Source: MS Research, UBS Asset Management.

Shop till you drop

Chinese are the world's most fervent online shoppers. Single's Day in China falls on November 11 and is the world's biggest online shopping day of the year. In 2016, Chinese shoppers spent an estimated USD 17.8 billion on Single's Day[7], surpassing online sales for Thanksgiving, Black Friday and Cyber Monday. In 2015, they ordered USD 630 billion[8] worth of products, ranging from daily necessities, health products, sports equipment, furniture, flowers, to mooncakes. Behind the scenes of the thriving e-commerce industry, logistics represent an important backbone to support the e-commerce platforms. In China, despite the large e-commerce market, the logistics sector remains somewhat underdeveloped and lags behind developed economies. The sector also offers attractive long-term investment opportunities as discussed later in the real estate section.

Importantly, it took China about five years to move from ~2% e-commerce penetration to ~14% e-commerce penetration, while the US took over 10 years to achieve that. E-commerce in China (and EM) will continue to grow and even accelerate in the new normal.

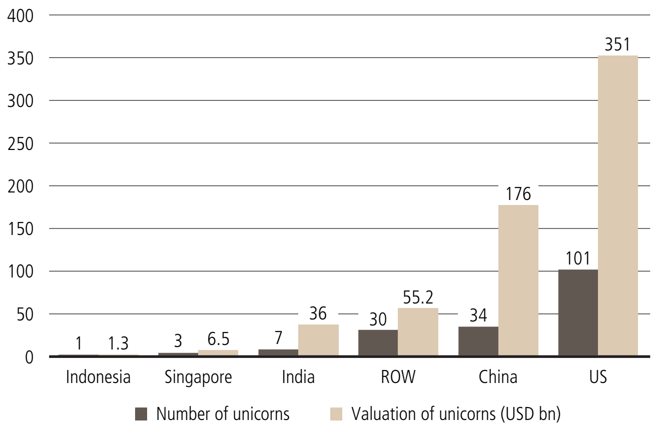
The FinTech revolution

FinTech, short for financial technology, may be defined as companies that use technology to make financial services more efficient. Software and the internet are at the core which means that the entire sector supply chain, from semiconductor to network infrastructure and IT services, will form part of the required building blocks. Likewise, virtual reality/augmented reality will change the way we work and live in the future. These innovations will continue to grow and create value in the new China. New exciting FinTech start-ups are popping up with innovative business solutions. In fact, China is already the leader of unicorns[9] in Asia (chart 8). From Shenzhen to Beijing, FinTech companies are spawning across China, and could soon start to rival Silicon Valley.

[7] Source: SCMP, Chinese spend USD 17.8 billion on Singles' Day as Alibaba reveals new global strategy, November 12, 2016.
[8] Source: Shenzhen International Holding, annual report 2015.
[9] Unicorns are defined as private start-up companies valued at USD 1 billion or more.

Chart 8: Wealth creation driven by technology

Values in USD billion



Note: Unicorns are defined as private start-up companies valued at USD 1 billion or more.
Source: CB Insights, UBS, September 2016.

Taking a closer look at the internet finance industry, China has seen a rapid development in this space over the last few years and is leading the pack in many ways. By the end of 2015, China had an estimated 500 million internet finance users[10], making it the number one globally, and the overall market size of China's internet finance was estimated between RMB 12-15 trillion[10]. The rise of internet finance in China is partly due to the supportive regulatory environment and high penetration of internet/e-commerce business. Ultimately, this is going to continue disrupting the traditional business models.

Within internet finance, third party payment is the largest and most developed segment. Internet giants and first movers such as Alibaba's Alipay and Tencent's Caifutong dominate the landscape. Wealth management, in particular, money market fund sales, represents the second largest segment in internet finance. The launch of Alibaba's Yu'e Bao in 2013, which allows Alipay customers to invest their balances in a money market fund, was a turning point for Chinese finance. Alibaba's Yu'e Bao, China's largest money market fund, is not only challenging the existing traditional financial landscape, but opening up a new wave of innovation in finance. This promising trend provides companies with cost benefits, and also revenue maximization opportunities.

Real estate: urbanization and income growth

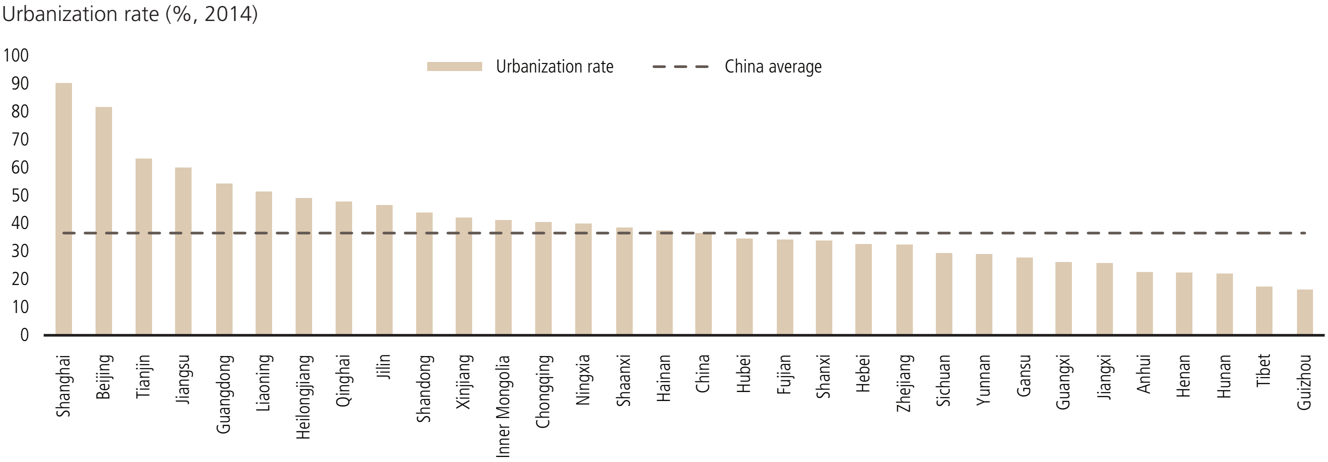
China property is differentiated from other mature markets with three core themes that drive property companies' investments in the mid-term as China's real estate market evolves:

Urbanization

According to the State Council, China's urbanization strategy would focus more on the development of big city clusters – each cluster with bigger cities (like Tier-2 and Tier-3 cities) linking with smaller cities and towns (like Tier-4 cities and institutionalized towns) via modern infrastructure (including transportation and information networks). The Central government is now actively looking for ways to develop new, big city clusters in the central, western, and northern part of China. Several provinces in the northern, northeast and Midwest are below the national average of urban development. With these, we now see strong development potential for Tier-2 and top Tier-3 cities, especially in central, western, and northern China, over the next 10 to 15 years.

[10] Source: McKinsey & Company, Disruption and Connection, Cracking the Myths of China Internet Finance Innovation, July 2016.

Chart 9: Urbanization rate (%) in key Chinese provinces



Source: NBS, CEIC, UBS Asset Management.

Taking five key clusters in China as an example, including Chengdu & Chongqing/Guangzhou, Shenzhen & Foshan/Shanghai, Nanjing & Hangzhou/Beijing, Tianjin and Hebei/ Greater Wuhan, we expect residential GFA (gross floor area) to hit 286msm (million square meters) by 2020 (a 4% CAGR).

Income growth

While high-income countries of today have been highly urbanized for several decades, upper-middle-income countries have experienced the fastest pace of urbanization only more recently since 1950. For high-income countries, a majority (57%) of the population already lived in urban areas in 1950 and urbanization is expected to rise from 80% today to 86% in 2050, according to United Nations, Department of Economic and Social Affairs, Population Division. By contrast, in today's upper-middle-income countries, only 20% of the population lived in urban areas in 1950, but these countries urbanized rapidly and 63% of the population now live in urban areas. This percentage is expected to rise to 79% urban by 2050, according to the United Nations. Countries such as China, where income growth rose rapidly in the past decades in the middle income and upper income segments, will experience both rapid urbanization and rapid growth of gross national income in the next 10 to 20 years.

Market consolidation

More interestingly, Chinese developers that are exposed to new urbanized clusters will benefit from higher growth due to further market consolidation.

By 2020 (estimated urbanization rate 60%), the top 10 property companies' market share could grow to 45% in top five metro areas and five regional hubs (17% are in other cities). We see the nationwide market share of the top 10 developers being around 35% by 2020. As such, the top 10 developers can grow their aggregated sales of RMB 1,069 billion in 2014 to RMB 2,619 billion in 2020E, implying around 16.1% CAGR.

Chart 10: Breakdown of China's administrative divisions

Provincial level	**Municipalities (4)**	**Provinces (22)**	**Autonomous Region (5)**
Prefecture level	Sub-Provincial cities (15)		
	Other Prefecture level cities (276)		
Country level	Country-level cities (2,852)		
Town level	Towns (more than 40,000)		
Village level	Villages (more than 700,000)		

Note: Republic of China (Taiwan) has been excluded from this chart.
Source: www.china.org.cn, August 2015; UBS Asset Management.

Real estate: an evolving landscape

China is not a single market and the sheer size and number of regions and cities mean that multi-tier and multi-speed property markets are inevitable. Much of the country's growth has been driven by local initiatives and developments over the years rather than by Beijing. There is an obvious heterogeneity amongst provinces, cities municipalities and counties, from the cultural aspects to the administrative features. Furthermore, despite China being a rather centrally commanded economy, the actual implementations of local policies and urban planning objectives are often not coordinated (even internally within a city) and may not necessary be fully aligned with the central government.

The long-term economic prospects of China remain positive. Undoubtedly, the economic cycles, capital cycles and occupier cycles in most Chinese property markets look to continue diverging in the near term.

In any lackluster market, there remain pockets of opportunities for the discerning. And this is especially so for China, where this rapid overbuilding phenomenon in the last decade has resulted in vast volumes of assets sitting across the nation, albeit on a very disparate quality spectrum. As much as there are scatterings of old and inferior grade buildings in the more developed Tier-1 cities, it is also not surprising to find institutional grade assets in most secondary Chinese markets.

As the services sector takes its place as a key driver of China's economy, property markets in cities with strong services sectors will be the initial beneficiaries, as higher wages, stronger employment and demand for commercial space boost overall real estate demand.

A side note on logistics demand in China

The logistics sector is an unobvious second-order manifestation of China's progress in rebalancing its economy. As an alternative proxy for the consumption theme in China, the demand for warehousing and cold storage facilities continues to intensify amid a structural shortage. In the area of industrial upgrading, China's state-level initiative to foster innovation and drive the 'Made in China 2025' goal will result in greater demand for high-quality industrial workshops catering to tenants engaged in advanced engineering and value-added manufacturing in new growth sectors (such as renewables, robotics, transport engineering and pharmaceuticals).

Robust wage growth and a rising middle class are supporting the growth of consumer markets across China. There is now greater emphasis on efficiency in retailers supply chains and third-party logistics operators, a trend which is driving demand for modern logistics developments and networks across the region.

Property consultants such as JLL point out that at almost 30 million square meters, China's quality grade logistics stock is at least five times smaller than that of the US. This means that there is still a structural under-provision of high quality logistics space in China, despite recent years of supply influx.

Chart 11: Quality grade logistic space

Square meters, millions

Source: JLL (China60 report), UBS Asset Management.

Reforms behind China's economic transformation

More than 30 years ago, China – under the leadership of Deng Xiaoping – launched an ambitious program of economic reform to stimulate growth and foreign investment. This has lifted millions out of poverty as the economy grew rapidly. More recently, at the third plenum in November 2013, the Communist Party unveiled a detailed blueprint to achieve its new growth strategy from an export and investment-led, to a domestic demand-led growth model. These reforms are behind China's economic transformation and provide a compelling case for investors to engage in the Chinese financial markets now.

Financial Market liberalization

Over the recent past, China has gradually introduced liberalization measures to give foreign investors' access to domestic equity and fixed income markets. These measures include the Qualified Foreign Institutional Investor (QFII) and Renminbi Qualified Foreign Institutional Investor (RQFII). The Shenzhen-Hong Kong (SZ-HK) Stock Connect was launched in December 2016, following in the footsteps of the Shanghai-Hong Kong (SH-HK) Stock Connect, which was implemented in November 2014 to enhance connectivity between the mainland and Hong Kong stock market.

Thanks to both Stock Connect programs, over 70% of the total market value of China A-share and about 85% of that in Hong Kong is open to offshore and onshore investors respectively. The Shenzhen stock market is host to many fast-growing companies engaged in the new economy sectors in China, unveiling new opportunities for international investors. The new link is a positive development for the Hong Kong stock market. Flows from domestic Chinese investors to Hong Kong listed stocks should increase on the back of the two Stock Connect programs and over time, it will represent a significant share of the total trading volume in Hong Kong. Greater access to the domestic China equity markets also increases the odds of A-share inclusion in the MSCI benchmark indices.

In February 2016, the People's Bank of China (PBoC) published a document which has done away with the requirements of approval and quota limit for qualified investors' entry to the Chinese Interbank Bond Market. This is an important step to open China's bond market, giving access to foreign central banks and similar institutions. Developing the bond market is also part of the transition from a bank-based financial system to a more market based one, signalizing China's commitment to further liberalize and reform its capital markets.

Chinese investment programs announced to further open its financial markets

2016

Shenzhen-Hong Kong Stock Connect

Allows mutual market access for investors on Shenzhen and Hong Kong stock markets. Daily trading quota.

2015

Mainland-Hong Kong Mutual Recognition of Funds

Allows Hong Kong domiciled funds to be sold to retail investors in China and vice versa, under certain regimes. Quota based in RMB.

2014

Shanghai-Hong Kong Stock Connect

Allows mutual market access for investors on Shanghai and Hong Kong stock markets. Daily trading quota.

2013

QDIE

Allows qualified domestic institutional investors in Shenzhen to raise funds from Chinese investors for offshore traditional and alternatives investment. Quota based in USD.

QDLP

Allows qualified foreign institutional investors in 6 cities, including Shanghai, to raise funds from domestic investors for offshore traditional and alternatives investment. Quota based in USD.

2011

RQDII

Allows qualified domestic institutional investors to access offshore markets in RMB.

RQFII

Allows qualified foreign institutional investor to access onshore securities and mutual funds. Quota based in RMB.

2006

QDII

Allows qualified domestic institutional investors to access offshore traditional investment. Quota based in USD.

2002

QFII

Allows qualified foreign institutional investors to access onshore capital market. Quota based in foreign currencies, primarily USD, EUR, JPY and GBP.

Source: UBS Asset Management. QFII (Qualified Foreign Institutional Investor), RQFII (Renminbi Qualified Foreign Institutional Investor), QDLP (Qualified Domestic Limited Partner), QDIE (Qualified Domestic Investment Enterprise), RQDII (Renminbi Qualified Domestic Institutional Investor), QDII (Qualified Domestic Institutional Investor).

Greater access to the domestic China equity markets increases the odds of A-share inclusion in the MSCI benchmark indices.

Renminbi internationalization

On October 1, 2016, the renminbi (RMB) was officially added to the International Monetary Fund (IMF) Special Drawing Rights (SDR) basket as the fifth currency. It joins the ranks of the US dollar, euro, yen and pound, as a reserve currency with 10.92% weight in the SDR basket. The IMF decision is a nod to China's progress in economic development and internationalization of its currency and financial markets. For Chinese policy makers, this milestone brings with it the international recognition that the government has coveted. While the SDR inclusion has limited impact in the near term, it will boost efforts towards financial reforms and capital account opening going forward. It creates legitimacy for the currency and signals that China is willing to adhere to international standards. China's financial apron strings are now tied to the rest of the world and it can no longer behave as a closed economy or financial market. Openness and transparency are the key requirements for institutional investors and it is part of the playing game as more sophisticated investors look to plough money in the middle kingdom. The suspension of a few stocks on the onshore exchange last June was a somber reminder of how a lack of transparency can hurt investors' sentiment. As China's financial market reforms gather further momentum, liquidity risk could become less of a sore spot for investors.

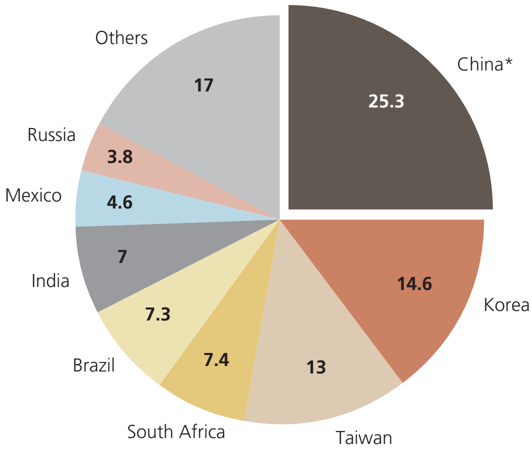
MSCI inclusion

In June 2016, MSCI – the global index provider – rejected for the third time the inclusion of A-shares in their index universe on concerns about market accessibility. The 20% monthly repatriation limit and local exchanges' pre-approval restrictions on launching A-shares financial products were cited as the outstanding hurdles. But MSCI acknowledged the notable progress made by the Chinese authorities to further improve market accessibility. The global index provider will reconsider inclusion in its 2017 annual market classification review, while not ruling out a potential off-cycle announcement. The launch of the Shenzhen-Hong Kong Stock Connect increases the odds of the A-shares inclusion in MSCI indices.

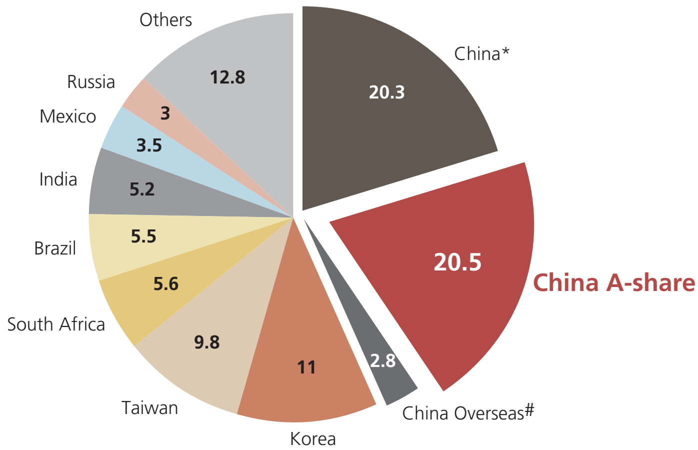
And in January 2015, MSCI announced that US-listed Chinese stocks would be more closely affiliated to its mainland roots. Fourteen Chinese American depository receipts (ADRs) would be folded into the MSCI China index as part of a wider plan to include foreign listed Chinese securities in US to the MSCI basket of global indices. This was done in over two phases: on November 30, 2015, half of the free float market capitalization of these Chinese ADRs was added to the MSCI China Index, and on May 31, 2016, the other half was included. With this, weightings of the IT and 'new economy' sectors increased, reflecting the macro-economic shift. China's economic transformation is indeed increasingly being reflected in equity benchmark indices.

Impact of potential inclusion of China A-shares into MSCI EM index

Current status
% of index weight in MSCI EM index



100%^ Potential full inclusion
% of index weight in MSCI EM index



Source: UBS Asset Management, MSCI (Consultation on China A-shares Index Inclusion Roadmap, June 2015).

* Includes H-share, B-share, Red chip, P chip

^ The percentage number refers to the Inclusion Factor applied to the free float-adjusted market capitalization of China A-share constituents in the pro forma MSCI China Index. China A-share securities are subject to a foreign ownership limit of 30%.

\# Overseas listed China companies are/will be included in November 2015 to May 2016 as announced earlier this year.

Conclusion

China's leadership realized that the economy cannot continue to rely on external demand and investments in order to achieve sustainable growth. As a result, China is undergoing a significant transformation to rebalance its economy. This brings along challenges and opportunities. Along the way China has shown determination and ability to transform itself from an agricultural economy into the world's biggest manufacturer and trading nation, and now the second largest economy.

Over the recent years, a raft of new initiatives and reforms has been announced to further modernize its economy. In the coming years, further liberalization is likely. In May 2015, the 'Made in China 2025' strategy was unveiled with the aim to transform China into a leading high quality and value added manufacturing powerhouse by 2049. Further, the rise of internet giants, such as Alibaba and Tencent, is a reflection of how consumer behaviors have evolved and the way businesses operate has changed. This is the new China.

A changing China has offered investors significant opportunities in the past and the coming years will unlikely be different. For international investors, China is becoming more and more accessible and because of its sheer size alone, investors need to focus on China more than ever.

UBS Asset Management is your first call for China and is here to help you take advantage of emerging opportunities across asset classes.

China has shown determination and ability to transform itself from an agricultural economy into the world's biggest manufacturer and trading nation, and now the second largest economy.

UBS Asset Management, your first call for China

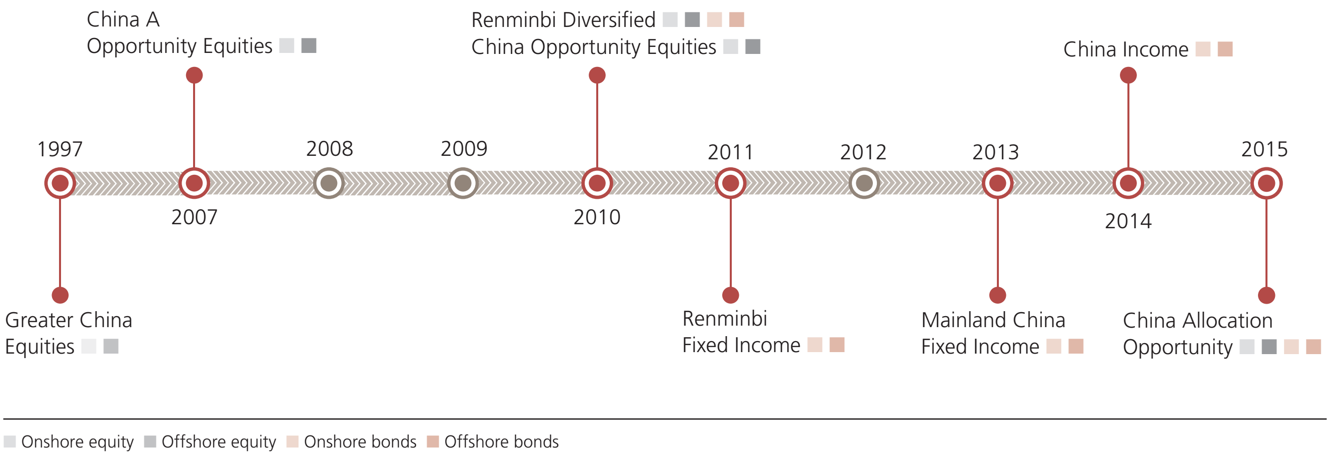
Having invested in China for nearly 20 years, UBS Asset Management has gained an in-depth knowledge of China and built an outstanding team of investment professionals. Our lead China portfolio managers for multi-asset, fixed income and equities have a wealth of investment experience.

We have a dedicated China team, supported by regional and global specialists. Our China research team covers the full breadth of the market from large to small caps. In addition, we benefit from our global network of analysts who share their research findings on our proprietary research database. Our research analyst network provides invaluable inputs on key variables and benefits from our global network of proprietary research databases.

The depth and breadth of our capabilities allow us to offer global and domestic investors a broad range of traditional China strategies and alternative solutions including real estate, private equity and hedge fund solutions. Investors can access China's onshore and offshore market through our wide spectrum of equity, fixed income and multi-asset class strategies with varying risk and return attributes to fit their specific needs and goals.

For offshore investors

UBS Asset Management has been offering equity, fixed income and multi-asset solutions since 1997



Source: UBS Asset Management

For onshore investors

Strategy	Description	Equity	Bonds
CSI 300 Financials	Passive index investment. Closely tracking the CSI 300 Financials and Property index.	✓	
CSI 300 Financials and Real Estate	Invests mainly in the target ETF fund.	✓	
RUIHE CSI 300 Multi-Class	Focuses on effectively tracking the CSI 300 Index.	✓	
Stable Income Bond	Focuses on having higher investment income than the benchmark.		✓
Core Bond	Provides investors with low volatility and stable returns.		✓
Corporate Bond	Based on the effective control of risk and steady long-term increase in value of the fund's assets.		✓
Mid/High Grade Bond	Focuses on the non-domestic credit bonds in mid and high grade.		✓
Enhanced Bond	Based on the effective control of risk; steady long-term increase in value of the fund's assets and maintaining liquidity.		✓
Healthcare Balanced	Invests in high quality companies from health care and related industries.	✓	✓
New Opportunity Balanced	Optimizes the allocation of different assets and portfolio selection in order to achieve a steady long-term increase in value of the fund's assets.	✓	✓
Ronghua Balanced	Pursues low risk and stable income. Focuses on bonds and invest steadily.	✓	✓
Stable Growth Balanced	Through the rational allocation of assets such as stocks and bonds, balance income and risk for a steady long-term increase in value of the fund's assets.	✓	✓
Jingqi Balanced	Balanced investment strategy and seize the investment opportunities of booming industries.	✓	✓
Select Strategy Balanced	Based on the effective control of risk and organic combination of various investment strategies. The objective is to increase steadily the value of the fund's asset in the long term.	✓	✓
Core Companies Balanced	Invests mainly in companies with core competitive advantage, good corporate governance structure and sustainable profitability.	✓	✓
Dynamic Innovation Balanced	Invests mainly in high quality companies that are innovative and share the excess return of business growth.	✓	✓
Key Selection Growth Balanced	Aims to achieve steady long-term increase in value of the fund's assets by investing in companies that have good prospects and rapid growth opportunities.	✓	✓

Source: UBS Asset Management, UBS SDIC.

Bibliography:

This piece includes extracts from "Riding a new wave, Emerging markets: The new normal", UBS Asset Management, Emerging Markets and Asian Equities Team headed by Geoffrey Wong, September 2016, and "Taking stock and looking ahead", White Paper: China real estate market, UBS Asset Management, Real Estate Research & Strategy, Shaowei Toh and David Roberts, February 2016.

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