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Domestic Trade

Retail sales of consumer goods grow by 10.3% yoy in 1H16.

Growth in fixed asset investment decelerates to 9% yoy in 1H16.

Prices of production inputs continue to rise.

Household income shows high single-digit growth in 1H16.

Ministry of Commerce to carry out tasks to support the development of e-commerce.

Confidence among entrepreneurs in secondary industry improves for the first time in five quarters.

July PMI shows signs of contraction of the manufacturing sector.

Non-manufacturing sector expands at a relatively fast pace.

Foreign Trade

Both exports and imports fall at a slower pace in 2Q16.

Exports to Russia and to India show positive growth in 1H16.

Shanghai's exports contract by 9.0% yoy in January - May period.

FDI gains 1.6% yoy in 1H16.

Foreign exchange reserves post a smaller drop in 2Q16.

Chinese yuan depreciates against its trading partners by 5.5% in real terms in 1H16.

Brexit is set to adversely affect China's exports and Sino-EU trade relations.

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Executive Summary

Domestic Trade

Retail sales of consumer goods reached 15,613.8 billion yuan in 1H16, up nominally by 10.3% yoy. Online retail sales of goods, which accounted for 11.6% of total retail sales, surged by 26.6% yoy in the period.

Growth in fixed asset investment fell to 9% yoy in 1H16, mainly dragged down by a deceleration in growth in investment in the secondary industry.

Prices of production inputs have been rising. The purchaser price index of industrial products went up by 0.2% mom in June, posting month-on-month gains for four consecutive months.

Household income showed high single-digit growth in 1H16. The per capita disposable income of households in China increased nominally by 8.7% yoy to 11,886 yuan in 1H16. Rural household income grew faster than urban household income over the period.

Ministry of Commerce will carry out tasks to support the development of e-commerce. The tasks include fostering innovation in policies, institutions and services in thirteen cross-border e-commerce comprehensive pilot areas and promoting replicable practices nationwide, pushing forward negotiations on free trade agreements in areas of e-commerce, enhancing the development of e-commerce credit system, and formulating the 13th Five-Year Plan on e-commerce.

Confidence among Chinese entrepreneurs in the secondary industry improved for the first time in five quarters. China's Entrepreneur Confidence Index for the secondary industry rose by 0.6 pts from the previous quarter to 109.3 in 2Q16.

July PMI shows signs of contraction of the manufacturing sector. The PMI came in at 49.9 in July, falling below the critical 50-mark for the first time since March this year.

Non-manufacturing sector has expanded at a relatively fast pace in recent months. The NMI rose from 53.1 in May to 53.7 in June and 53.9 in July, the highest level since January this year.

Foreign Trade

Both exports and imports dropped at a slower pace in 2Q16. China's exports contracted by 4.6% yoy in 2Q16, after falling by 9.6% yoy in 1Q16. China's imports posted a single-digit drop of 6.8% yoy in 2Q16, compared to the 13.5% yoy fall in 1Q16

Exports to the US, the EU and Japan fell by 9.9% yoy, 4.4% yoy and 6.1% yoy respectively in 1H16. In contrast, exports to Russia and India managed to register positive growth of 10.0% yoy and 1.8% yoy respectively in the same period.

All top six provinces/ municipalities in terms of exports witnessed negative year-on-year growth in exports in the first five months of this year. Among these provinces, Shanghai saw the sharpest fall in exports (minus 9.0% yoy) in the January - May period.

FDI grew by 1.6% yoy to reach US\$ 69.4 billion in 1H16. The share of the service sector in the total FDI went up to 70.5%, while the share of the manufacturing sector fell to 28.1%, in 1H16.

Foreign exchange reserves posted a smaller drop in 2Q16. China's foreign exchange reserves fell by US\$ 7.4 billion in 2Q16, amounting to US\$ 3.21 trillion as at the end of 2Q16.

Chinese yuan depreciated against its trading partners by 5.5% in real terms in the first half of this year, according to the Bank for International Settlements.

Brexit is set to adversely affect China's export performance and Sino-EU trade relations. A more subdued EU economic outlook is expected to exacerbate the already-sluggish external demand for Chinese goods, as the EU is China's second largest export market. The Sino-EU trade relations may also be adversely affected as negotiations on a free trade agreement between China and the EU would become more difficult.

A Recent developments

1. China's real GDP growth stays stable in 2Q16

After registering 6.7% year-on-year (yoy) in 1Q16, China's real GDP growth stayed at the same level in 2Q16, according to the National Bureau of Statistics (see exhibit 1). Overall, in 1H16, China's nominal GDP amounted to 34.1 trillion yuan, up by 6.7% yoy in real terms.

The tertiary industry has continued to grow faster than the secondary industry. The value-added of the tertiary industry, which contributed 54.7% of China's nominal GDP in 1H16, gained 7.5% yoy in real terms in 1H16. Meanwhile, the value-added of the secondary industry, which contributed 39.4% of the country's nominal GDP, increased 6.1% yoy in real terms over the same period.

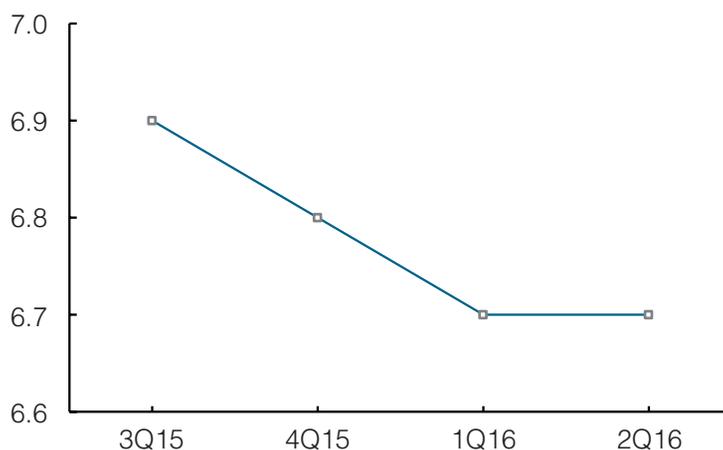
Compared to investment, consumption has played a more important role in boosting economic growth. In 1H16, the contribution by final consumption expenditure to GDP growth was 73.4%, while the contribution by gross capital formation was 37.0%.¹ Net exports made a negative contribution (minus 10.4%) to the GDP growth in the same period.

To keep stable economic growth, the Chinese government is likely to further boost the domestic demand in coming future. On the monetary front, the central bank will ensure abundant liquidity. On the fiscal front, the government will increase fiscal expenditure as well as infrastructure investment. All these efforts are set to maintain a stable macroeconomic environment that favours the implementation of reforms. It is noteworthy that one of the major policy focuses of the government is to push forward structural reforms, especially the 'supply-side reforms'; the five major tasks of 'supply-side reforms' include tackling the overcapacity problem, reducing housing inventories, de-leveraging, reducing costs on enterprises and shoring up weak areas.

We predict that, as the positive impact of the booming property market and the government's moves to lower taxes and fees unfolds, the real GDP will manage to grow by 6.7% yoy in 3Q16.

Exhibit 1 China's real GDP growth, 3Q15 to 2Q16

yoy growth (%)



FY15 6.9%

3Q15 6.9%

4Q15 6.8%

1Q16 6.7%

2Q16 6.7%

Source: National Bureau of Statistics, PRC

¹ http://www.stats.gov.cn/tjsj/sjjd/201607/t20160715_1377841.html

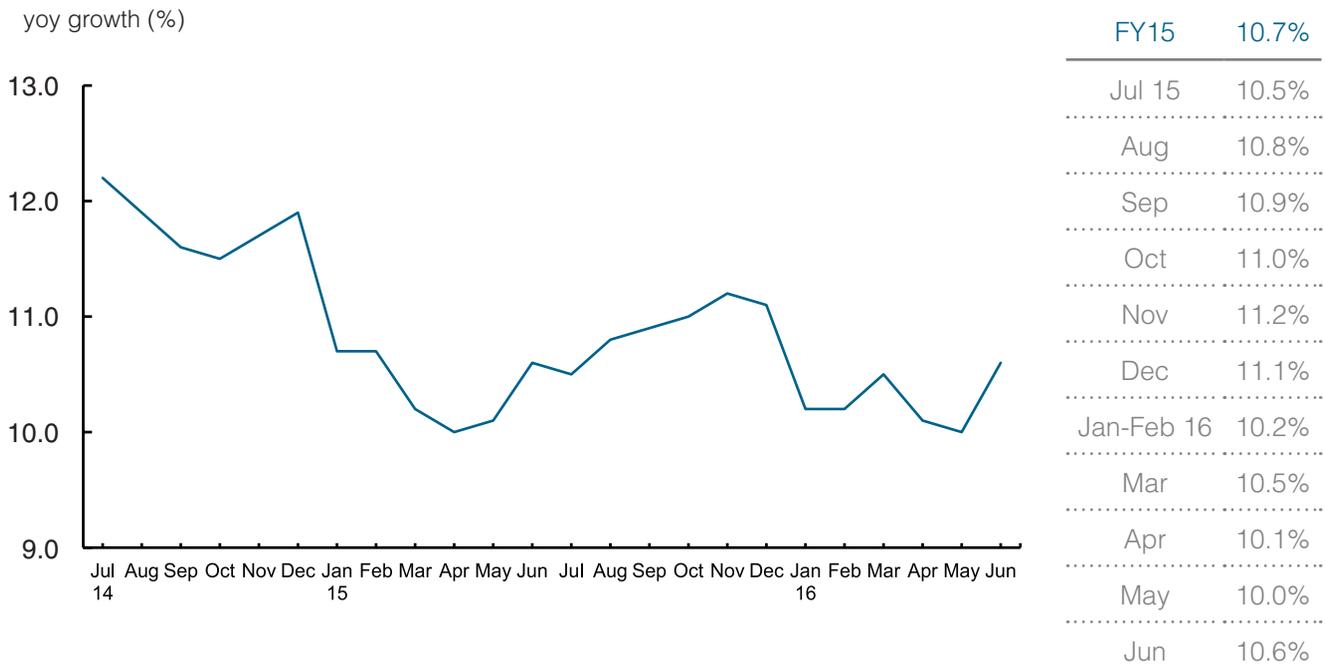
2. Retail sales growth rebounds in June

After dropping slightly from 10.1% yoy in April to 10.0% yoy in May, the growth in China's total retail sales of consumer goods rebounded to 10.6% in June, according to the National Bureau of Statistics. The month-on-month (mom) growth in seasonally-adjusted retail sales accelerated from 0.77% in May to a four-month high of 0.92% in June, indicating an improvement in consumption demand.

Overall, in 1H16, the total retail sales of consumer goods reached 15,613.8 billion yuan. The nominal growth rate was 10.3% yoy in 1H16, slightly lower than the 10.7% yoy growth seen in 2015 (see exhibits 2 and 3).

China's online retail sales of goods rose strongly by 26.6% yoy to reach 1,814.3 billion yuan in 1H16. Consequently, the share of the online retail sales of goods in the total retail sales of consumer goods went up to 11.6% in 1H16 from 10.8% in 2015.

Exhibit 2 China's total retail sales, year-on-year nominal growth, July 2014 to June 2016



Source: National Bureau of Statistics, PRC

Exhibit 3 China's total retail sales, month-on-month nominal growth, January to June 2016

mom growth (%), seasonally adjusted

	Jan 16	Feb	Mar	Apr	May	Jun
Total retail sales	0.90	0.58	0.98	0.82	0.77	0.92

Source: National Bureau of Statistics, PRC

Part 1 : Domestic Trade

Rural retail sales have been growing faster than urban retail sales. In 1H16, rural retail sales expanded by 11.0% yoy to reach 2,188.9 billion yuan, while urban retail sales rose by 10.2% yoy to 13,424.9 billion yuan.

Growth in both sales of goods and catering services sales decelerated: the nominal growth in catering services sales moderated from 11.7% yoy in 2015 to 11.2% yoy in 1H16, while the nominal growth in sales of goods fell from 10.6% yoy in 2015 to 10.2% yoy in 1H16.

Retail sales of goods by enterprises above a designated size² rose 7.6% yoy to reach 6,685.7 billion yuan in 1H16. By product category, sales of both 'furniture' and 'building and decoration materials' posted rapid growth of 15.6% yoy, attributed to the strong sales of new homes in recent months. In contrast, sales of 'gold, silver and jewellery' fell by 1.5% yoy in 1H16, indicating the sluggish demand for jewellery from Chinese consumers. Exhibit 5 demonstrates the growth in China's retail sales by product among enterprises above a designated size.

Exhibit 4 China's total retail sales, 2015 to 1H16

Nominal growth, yoy (%)	FY15	1Q16	1H16
Total retail sales	10.7	10.3	10.3
Goods	10.6	10.2	10.2
Sales by enterprises above a designated size	7.9	8.0	7.6
Online sales	31.6	25.9	26.6
Catering services	11.7	11.3	11.2

Source: National Bureau of Statistics, PRC

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3. Consumer confidence index stays low

The consumer confidence index³ has stayed low in recent months, fluctuating within the narrow range of 99.8 and 101.0 throughout March to May. This indicates the relatively weak confidence among Chinese consumers (see exhibit 6).

4. Income of Chinese households shows high single-digit growth

Income of Chinese households showed high single-digit growth in 1H16. The per capita disposable income of households increased by 8.7% yoy in nominal terms (or 6.5% yoy real) to 11,886 yuan in 1H16. Specifically, rural household income grew faster than urban household income over the period. In 1H16, the per capita disposable income of rural households increased nominally by 8.9% yoy (or 6.7% yoy real) to reach 6,050 yuan; while the per capita disposable income of urban households rose by 8.0% yoy in nominal terms (or 5.8% yoy real) to reach 16,957 yuan.

² 'Enterprises above a designated size' refers to enterprises with annual sales of 5 million yuan or more and with an employee strength of 60 or more.

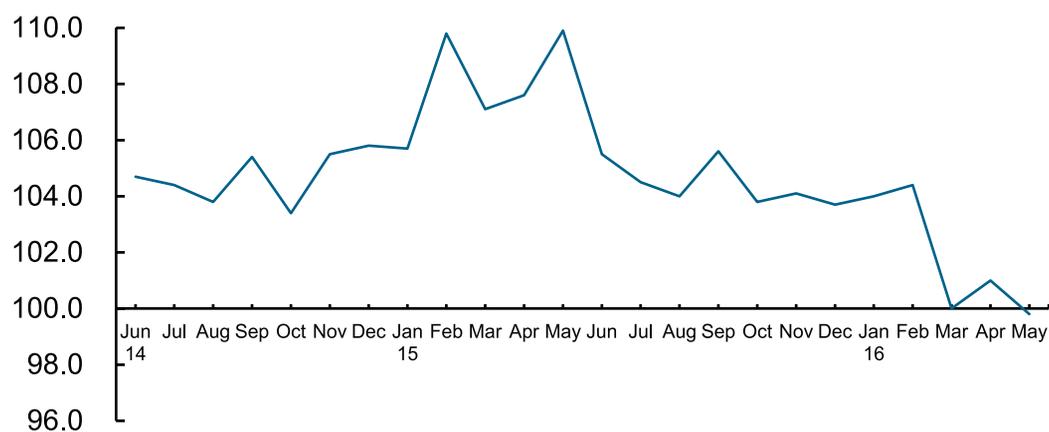
³ A reading above 100 indicates that consumers tend to be optimistic; a reading below 100 indicates that consumers tend to be pessimistic.

Exhibit 5 China's retail sales by enterprises above a designated size, by product, 2015 to 1H16

Nominal growth, yoy (%)	2015	1Q16	1H16
Grain, oil and food	15.1	12.7	12.3
Beverages	15.3	9.8	10.7
Tobacco and liquor	12.7	7.6	9.2
Clothing, shoes, hats and textiles	9.8	7.2	7.0
Cosmetics	8.8	10.6	8.9
Gold, silver and jewellery	7.3	-3.9	-1.5
Products for daily use	12.3	10.9	11.7
Sports and entertainment products	16.6	16.3	16.9
Home appliances and video equipment	11.4	7.2	7.3
Chinese and Western medicines	14.2	15.1	13.3
Stationery and office accessories	15.2	7.4	9.2
Furniture	16.1	16.2	15.6
Telecommunications equipment	29.3	18.9	14.9
Petroleum and related products	-6.6	0.4	-1.3
Automobiles	5.3	7.7	7.7
Building and decoration materials	18.7	15.2	15.6

Source: National Bureau of Statistics, PRC

Exhibit 6 China's consumer confidence index, June 2014 to May 2016



Source: National Bureau of Statistics, PRC

5. Consumer inflation eases further

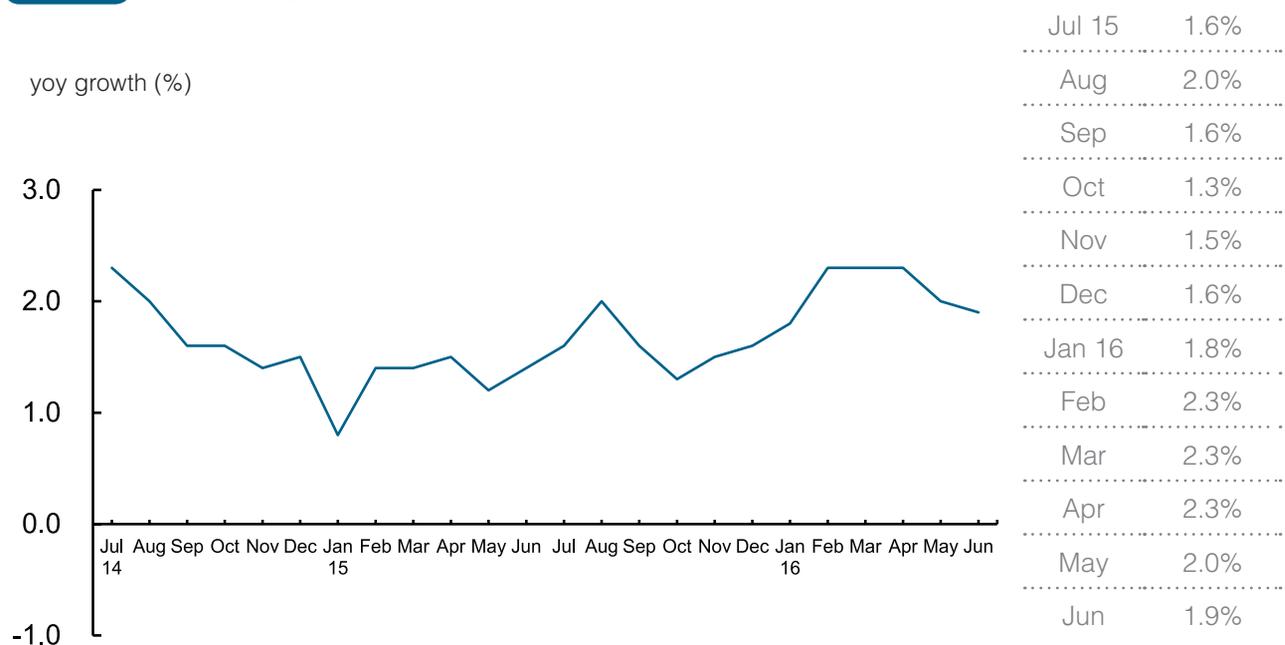
Having stayed at 2.3% for three consecutive months, the year-on-year growth rate of China's consumer price index (CPI)⁴ dropped to 2.0% in May and 1.9% in June. The downtrend of the CPI growth indicates that consumer inflation has been easing.

The moderation in CPI growth in recent months was largely due to the decline in the year-on-year growth in the food component in the CPI, which fell all the way from 7.6% in March to 4.6% in June. Meanwhile, the year-on-year growth in the non-food component in the CPI stayed at 1.1% in April and May, before edging up to 1.2% in June (see exhibits 7 and 8).

Looking ahead, we expect that the non-food inflation will stay around the current level in the near future, unless the domestic demand improves significantly; and we expect the growth in the food component in the CPI to rise in the coming months, as widespread flooding in central and southern China has driven up food prices lately. Overall, in our view, the CPI growth is likely to rebound in the coming months.

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Exhibit 7 China's CPI growth, July 2014 to June 2016



Source: National Bureau of Statistics, PRC

⁴ The CPI, compiled by the National Bureau of Statistics (NBS) of China, measures the price of a basket of goods and services purchased by a typical household. It is noteworthy that the NBS has changed the weights assigned to the various components in the CPI basket, effective from January 2016. The weight of the food component, for example, has been reduced by 3.2 ppt; the weight of the housing component has been increased by 2.2 ppt; and the weights of other components have been adjusted by around or less than 1 ppt. The impact of the re-weighting on the CPI growth was limited, according to the NBS.

Exhibit 8 China's CPI growth by commodity, January to June 2016⁵

yoY growth (%)	Jan 16	Feb	Mar	Apr	May	Jun
Food, tobacco and liquor	3.6	5.8	6.0	5.9	4.7	3.7
Clothing	1.9	1.6	1.5	1.5	1.5	1.4
Housing	1.4	1.3	1.3	1.4	1.6	1.6
Household goods and services	0.6	0.3	0.4	0.5	0.6	0.6
Transportation and communication	-1.6	-1.6	-2.6	-2.4	-2.6	-1.8
Education, culture and recreational activities	1.7	0.9	1.2	1.2	1.2	1.4
Medical and healthcare	2.9	2.8	3.1	3.2	3.5	3.8
Other goods and services	-0.4	0.4	1.7	1.7	2.2	2.6

Source: National Bureau of Statistics, PRC

The year-on-year growth in China's producer price index of industrial products (PPI)⁶ improved all the way from minus 5.9% in December to minus 2.6% in June (see exhibits 9 & 10).

On a month-on-month basis, the PPI dropped by 0.2% in June, after rising for three consecutive months. The fall in the PPI in the month was mainly due to the price declines in the 'mining, manufacture and processing of ferrous metals' industry.

Looking ahead, we expect that the year-on-year growth rate of the PPI will further improve in the coming months, driven by the rise in prices of production inputs.

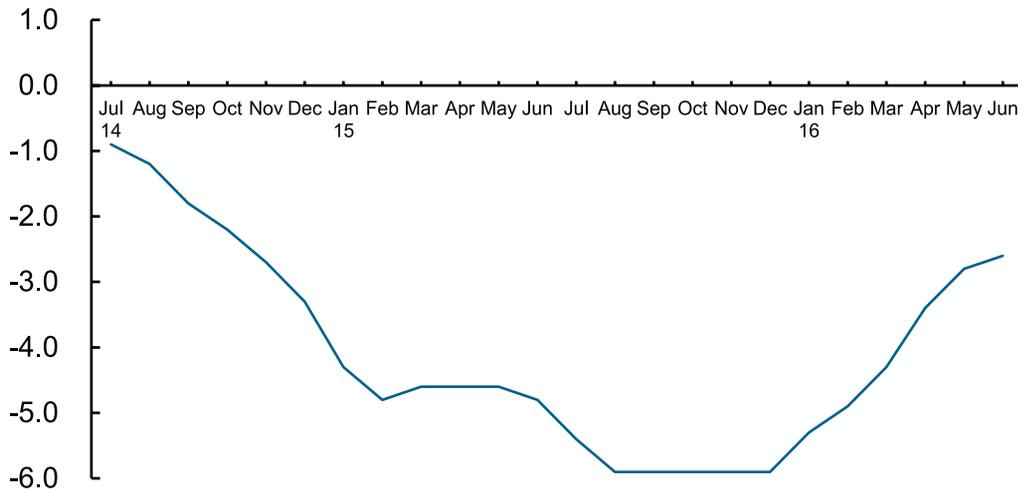
⁵ The NBS has re-categorized the categories in the CPI basket, effective from January 2016. For example, the old category of 'household goods and maintenance services' has been re-categorized into a new category called 'household goods and services' and the category of 'other goods and services'. The old category of 'recreational, educational products and services' has been re-categorized into a new category called 'education, culture and recreational activities' and the category of 'other goods and services'.

⁶ The PPI, compiled by the National Bureau of Statistics of China, measures the prices of industrial products when they are sold for the first time after production.

Part 1 : Domestic Trade

Exhibit 9 China's PPI growth, July 2014 to June 2016

yoy growth (%)



Jul 15	-5.4%
Aug	-5.9%
Sep	-5.9%
Oct	-5.9%
Nov	-5.9%
Dec	-5.9%
Jan 16	-5.3%
Feb	-4.9%
Mar	-4.3%
Apr	-3.4%
May	-2.8%
Jun	-2.6%

Source: National Bureau of Statistics, PRC

Exhibit 10 China's PPI growth by selected industry, January to June 2016

yoy growth (%)

	Jan 16	Feb	Mar	Apr	May	Jun
Textile industry	-2.9	-2.7	-2.5	-2.5	-2.6	-2.3
Apparel and accessories	0.5	0.3	0.3	0.5	0.5	0.6
Timber processing & wood, bamboo, cane, palm fiber and straw products	-0.7	-0.8	-0.8	-0.8	-0.5	-0.3

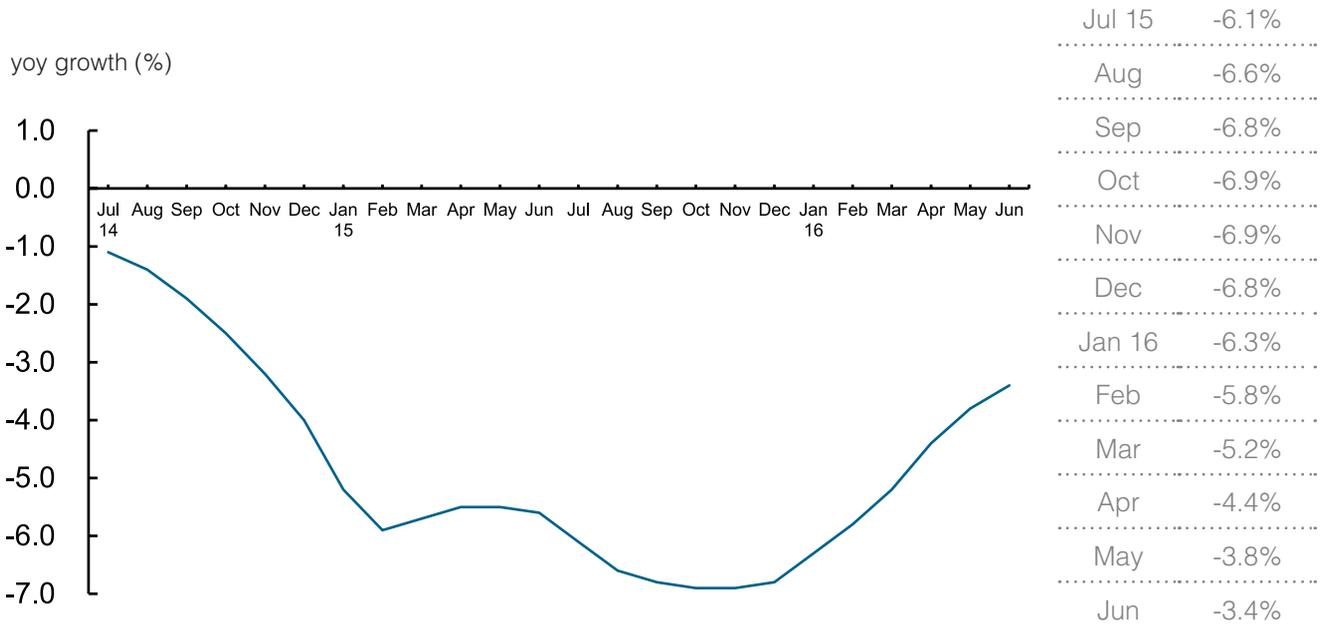
Source: National Bureau of Statistics, PRC

The year-on-year growth rate of China's purchaser price index of industrial products rose to a 19-month high of minus 3.4% in June (see exhibits 11 & 12).

On a month-on-month basis, the purchaser price index of industrial products went up by 0.2% in June, posting gains for four consecutive months. The rise in the purchaser price index in recent months can be attributed to the bottoming out of global commodity prices, in our view.

The input prices sub-index of China's manufacturing PMI, a leading indicator of upstream prices, has stayed above the critical 50-mark for six consecutive months from February to July, indicating that prices of production inputs have been bottoming out. Thus, we believe that the purchaser price index of industrial products will go up further in near future.

Exhibit 11 Growth in China's purchaser price index of industrial products, July 2014 to June 2016



Source: National Bureau of Statistics, PRC

Exhibit 12 China's purchaser price index of industrial products by selected commodity, January to June 2016

yoy growth (%)	Jan 16	Feb	Mar	Apr	May	Jun
Fuel and power	-10.7	-10.0	-10.4	-9.4	-8.3	-7.2
Non-ferrous metals	-10.4	-9.1	-7.2	-6.9	-7.0	-5.7
Raw materials for the chemical industry	-5.7	-5.1	-4.3	-3.9	-4.1	-4.2
Timber and paper pulp	-0.5	-0.6	-0.6	-0.8	-0.7	-0.8
Textile raw materials	-1.6	-1.5	-1.5	-1.4	-1.3	-1.2

Source: National Bureau of Statistics, PRC

6. Growth in industrial production improves

After standing at 6.0% yoy in April and May, the growth rate for China's industrial production (IP), measured by value-added of industrial output (VAIO), improved to 6.2% yoy in June (see exhibit 13).⁷ Overall, in 1H16, China's IP expanded by 6.0% yoy, slightly slower than the 6.1% yoy growth recorded in 2015.

In the coming months, industrial activities will be supported by the positive impact of the booming property market and the government's moves to lower taxes and fees. That being said, challenges facing Chinese manufacturers remain, including greater economic uncertainty caused by the 'Brexit' decision, increasing labour and environmental costs, intense competition in the international market, a rise in foreign trade protectionism and weaker luxury spending. Overall, we expect that the industrial production (VAIO) growth will stay stable at around 6.2% yoy in 3Q16.

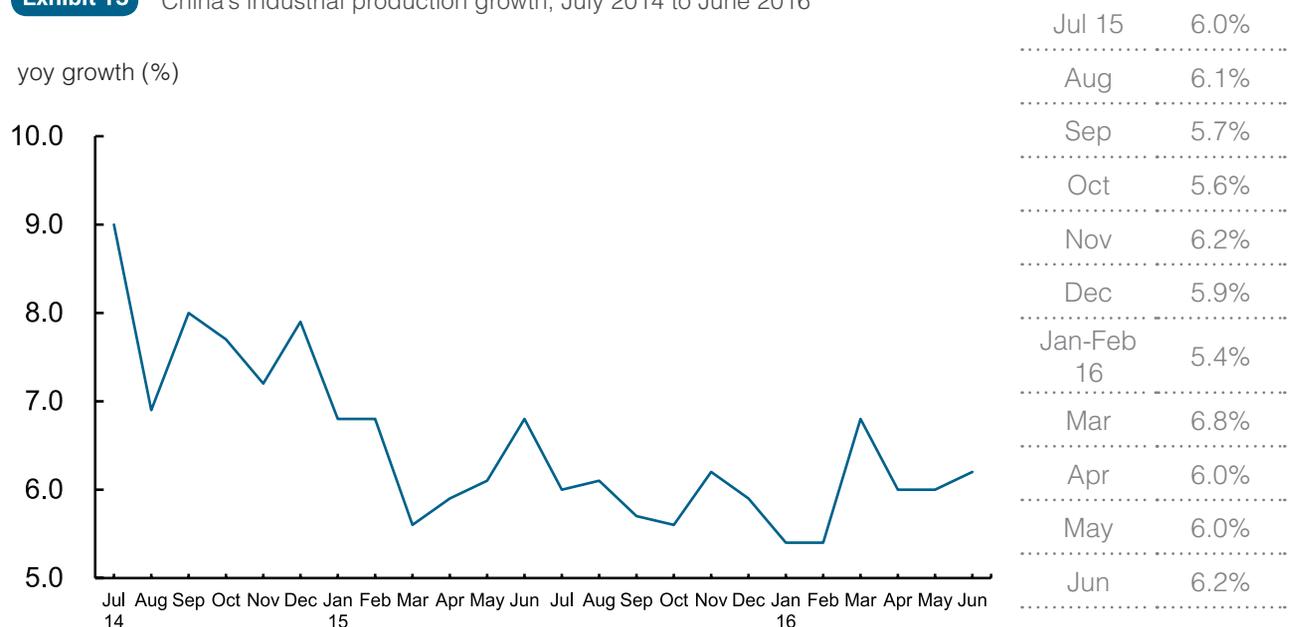
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7. Industrial profits show positive yoy growth in January to June

The growth in the total profits earned by large and medium industrial enterprises above a designated size⁸ picked up from 3.7% yoy in May to 5.1% yoy in June. Overall, in January to June 2016, China's industrial profits amounted to 2,999.8 billion yuan, up by 6.2% yoy (see exhibit 14).

Among the sectors, profits of the manufacturing sector recorded double-digit growth of 12.1% yoy in the first half of 2016. In contrast, profits of the mining sector plunged by 83.6% yoy over the same period.

Exhibit 13 China's industrial production growth, July 2014 to June 2016



Source: National Bureau of Statistics, PRC

⁷ The National Bureau of Statistics has changed the method of compiling the value added for industry (industrial production, IP), effective January 2011. The statistical threshold for industrial enterprises has been raised to cover those with annual revenues of 20 million yuan or above, up from the previous threshold of 5 million yuan or above.

⁸ 'Industrial enterprises above a designated size' refers to industrial enterprises with annual sales of 20 million yuan or more.

Exhibit 14 China's industrial profits growth, December 2015 to June 2016

<i>yoy growth (%)</i>	Dec 15	Jan-Feb 16	Mar	Apr	May	Jun
Total profits made by industrial enterprises above a designated size	-4.7	4.8	11.1	4.2	3.7	5.1

Source: National Bureau of Statistics, PRC

8. Growth in fixed asset investment falls to single digit in 1H16

The growth in China's nominal fixed asset investment (FAI) (excluding rural households) decelerated to 9.0% yoy in 1H16 from 10.0% yoy in 2015, mainly dragged down by the fall in growth in FAI in the secondary industry.⁹ In 1H16, China's nominal FAI (excluding rural households) amounted to 25.8 trillion yuan (see exhibit 15).

Compared to 2015, the growth in real estate and infrastructure investment accelerated, while the growth in investment in the secondary industry decelerated in 1H16: the growth in FAI (excluding rural households) for

real estate development rose to 6.1% yoy in 1H16 from 1.0% yoy in 2015; the growth in FAI in infrastructure (excluding power infrastructure) came in at 20.9% in 1H16, up from 17.2% yoy in 2015; the growth in FAI (excluding rural households) in the secondary industry fell to 4.4% yoy in 1H16, down from the 8.0% yoy growth recorded in 2015.

Exhibit 15 China's FAI (excluding rural households) growth, January to June 2016

	Jan 16	Feb	Mar	Apr	May	Jun
FAI (excluding rural households) <i>(year-to-date, yoy growth %)</i>	NA	10.2	10.7	10.5	9.6	9.0
FAI (excluding rural households) <i>(mom growth %, seasonally adjusted)</i>	0.65	0.60	0.62	0.50	0.52	0.45

Source: National Bureau of Statistics, PRC

⁹ The National Bureau of Statistics has expanded coverage of the monthly statistics for FAI from the urban areas to rural enterprises and institutions, effective from 2011. Thus: 'FAI (excluding rural households)', the new indicator, has been released by the bureau as from March 2011 to replace 'urban FAI', the previous indicator. Also, a new statistical criterion has been adopted. The statistical threshold for the size of investment projects has been adjusted upwards from 500,000 yuan to 5 million yuan.

B Highlights

1. Ministry of Commerce to carry out several tasks to develop e-commerce

On 29 May, Wang Pingnan, the Assistant to the Minister of Commerce, delivered a speech at the China-Beijing E-commerce Conference. According to his speech, the Ministry of Commerce will focus on carrying out the following tasks in a bid to support the development of e-commerce: implementing measures to promote the development of Online-To-Offline (O2O) services, supporting the transformation and upgrade of brick-and-mortar businesses in retail, wholesale, logistics, household services and commercial services sectors, carrying out demonstration tasks in developing e-commerce in rural areas, fostering innovation in policies, institutions and services in thirteen cross-border e-commerce comprehensive pilot areas and promoting replicable practices nationwide, pushing forward negotiations on free trade agreements in areas of e-commerce, enhancing the development of e-commerce credit system, and formulating the 13th Five-Year Plan on e-commerce.¹⁰

2. Sales of housing-related items show strong growth

The sales of housing-related items showed strong growth in 1H16. For example, the retail sales of both 'furniture' and 'building and decoration materials' by enterprises above a designated size posted double-digit growth of 15.6% yoy, much higher than the overall growth of the total retail sales by enterprises above a designated size (i.e. 7.6% yoy) in 1H16.

Nevertheless, we expect the growth of the sales of 'furniture' and 'building and decoration materials' to moderate soon, as growth of the sales of residential buildings in terms of floor space has decelerated in recent months. The sales of residential buildings in terms of floor space posted a slower growth of 28.6%

yoy in 1H16, compared to the 38.8% yoy growth in the first four months of this year. The growth deceleration can be attributed to the introduction of the property tightening measures in some first-tier cities such as Shanghai and Shenzhen in recent months.

Looking ahead, it is likely that the government will launch measures to cool property markets in more cities. According to the statement made by the National Development and Reform Commission spokesperson Zhao Chenxin on 14 July, the government will take action to prevent a sharp rise in property prices in first-tier and some second-tier cities in 2H16. It is thus expected that property sales growth will slow further, which may in turn drag down the growth of sales of housing-related items.

3. RMB loans maintain stable growth

The credit conditions in China have remained accommodative in recent months. As at the end of June, the total outstanding RMB loans maintained relatively stable growth of 14.3% yoy. The growth rate for broad money supply (M2) came in at 11.8% yoy as at the end of June 2016 (*see exhibit 16*).

Looking ahead, in a bid to maintain stable economic growth, it is expected that the central bank will continue to ensure abundant liquidity through open market operations and lending facilities in coming future. Nevertheless, we do not expect to see aggressive monetary easing, as this may increase financial risks. It is noteworthy that the Chinese leaders vowed to prevent and resolve financial risks as well as contain asset bubble, according to the media report on the Politburo meeting presided by President Xi Jinping on 26 July.

Exhibit 16 Broad money supply (M2) and RMB loans, July 2015 to June 2016

As of	Broad money supply (M2)		Total outstanding RMB loans		Increase in RMB loans (trillion yuan)	
	Amount (trillion yuan)	yoy growth	Amount (trillion yuan)	yoy growth	FY15	1H16
End-Jul 15	135.3	13.3%	90.3	15.5%	11.72	
End-Aug	135.7	13.3%	91.1	15.4%		7.53
End-Sep	136.0	13.1%	92.1	15.4%	1.48	
End-Oct	136.1	13.5%	92.7	15.4%	0.81	
End-Nov	137.4	13.7%	93.4	14.9%	1.05	
End-Dec	139.2	13.3%	94.0	14.3%	0.51	
End-Jan 16	141.6	14.0%	96.5	15.3%	0.71	
End-Feb	142.5	13.3%	97.2	14.7%	0.60	
End-Mar	144.6	13.4%	98.6	14.7%	2.51	
End-Apr	144.5	12.8%	99.1	14.4%	0.73	
End-May	146.2	11.8%	100.1	14.4%	1.37	
End-Jun	149.1	11.8%	101.5	14.3%	0.56	
					0.99	
					1.38	

Source: People's Bank of China

4. Role of RMB loans as a source of financing strengthens

The increase in 'total social financing' (covering sources of financing such as RMB loans to the real sector, foreign currency loans to the real sector, trust loans, entrusted loans, bank acceptance bills, corporate bonds, equity issuance and other instruments) amounted to 9.8 trillion yuan in 1H16, larger than the increase seen in the same period of the previous year (i.e. 8.8 trillion yuan) (see exhibit 17).

The increase in 'total social financing' in 1H16 was largely due to the strong rise in RMB loans, entrusted loans and corporate bond financing.

In 1H16, RMB loans contributed 76.7% to the increase in 'total social financing', higher than the 73.1% share in 2015. These figures indicate that the role of RMB loans as a source of financing has been strengthening.

Exhibit 17 Increase in total social financing, 2015 to 1H16

	FY15		1H16	
	Amount (billion yuan)	Share (%)	Amount (billion yuan)	Share (%)
Total social financing	15,410	100.0	9,750	100.0
RMB loans to the real sector	11,269	73.1	7,480	76.7
Foreign currency loans to the real sector	-643	-4.2	-379	-3.9
Trust loans	43	0.3	279	2.9
Entrusted loans	1,591	10.3	1,050	10.8
Bank acceptance bills	-1,057	-6.9	-1,280	-13.1
Corporate bonds	2,825	18.3	1,730	17.7
Equity issuance	760	4.9	602	6.2

Source: People's Bank of China

C Outlook

1. Entrepreneur Confidence Index posts first gain in five quarters

China's Entrepreneur Confidence Index (ECI) for the secondary industry rose by 0.6 pts from the previous quarter to 109.3 in 2Q16, posting quarter-on-quarter gain for the first time in five quarters. The latest reading indicates the improvement in confidence among Chinese entrepreneurs in the industry (*see exhibit 18*).¹¹

The ECIs for the 'manufacturing', 'mining' and 'electricity, gas & water' sectors all recorded quarter-on-quarter increases in 2Q16. It is, however, noteworthy that the ECI for the 'mining' sector has stayed below the neutral-100 mark (*see exhibit 19*).

2. July PMI shows signs of contraction of China's manufacturing sector

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China's manufacturing Purchasing Managers' Index (PMI) fell from 50.1 in May to 50.0 in June, and edged down further to 49.9 in July. The index reading in July was below the critical 50-mark for the first time since March this year, showing signs of contraction of China's manufacturing sector (*see exhibit 20*).

The new orders index dropped all the way from the recent peak of 51.4 in March to 50.4 in July, indicating a moderation in growth in overall new orders.¹² Meanwhile, the new export orders index has dropped below 50 since June, indicating a contraction in new export orders.

Amid the moderation in demand growth, the output index fell from 52.5 in June to a five-month low of 52.1 in July, indicating that output growth has slowed.

The purchases of inputs index dropped from 51.2 in May to 50.5 in June and July, indicating a deceleration in the growth in purchasing activities.

Both the stocks of finished goods index and the stocks of major inputs index have remained below the critical 50-mark in the past few months, indicating that destocking activities have continued.

The input prices index has remained above 50 in recent months, indicating that the prices of production inputs have been on an upward trend. The rise in input prices will in turn put upward pressure on manufacturing costs.

The business expectations index dropped markedly from 60.3 in April to 55.9 in May and 53.3 in June. The index rebounded to 55.3 in July, but was still at relatively low level. These index readings indicate that purchasing managers have become less optimistic about the near term outlook for their respective industries.

¹¹ China's Entrepreneur Confidence Index (ECI) ranges from 0 to 200. A reading above 100 indicates that entrepreneurs tend to be optimistic; a reading below 100 indicates that they tend to be pessimistic.

¹² The 'new orders index' covers both domestic and export orders. That is to say, the manufacturers are not asked to differentiate between domestic and export orders when filling in questionnaires.

Exhibit 18 China's Entrepreneur Confidence Index (Secondary Industry), 3Q14 to 2Q16

	3Q14	4Q14	1Q15	2Q15	3Q15	4Q15	1Q16	2Q16
Entrepreneur Confidence Index (Secondary Industry)	119.0	115.1	120.6	114.5	112.1	108.9	108.7	109.3

Source: National Bureau of Statistics, PRC

Exhibit 19 Entrepreneur Confidence Index by sector, 1Q16 and 2Q16

	1Q16	2Q16	Compared with the previous quarter
Secondary industry	108.7	109.3	Higher
Mining	68.6	75.6	Higher
Manufacturing	110.2	110.5	Higher
Electricity, gas & water	122.1	123.6	Higher

Source: National Bureau of Statistics, PRC

3. Non-manufacturing sector expands at a relatively fast pace

China's Business Activity Index, which is quoted as the Non-manufacturing Purchasing Managers' Index (NMI), rose from 53.1 in May to 53.7 in June, and further went up to 53.9 in July, the highest level since January this year. The July NMI indicates that the non-manufacturing sector has expanded at a relatively fast pace recently (*see exhibit 21*).

After rising from 49.2 in May to 50.8 in June, the new orders index fell to 49.9 in July, slightly below the critical 50-mark, indicating a slight contraction in new orders.

The sales prices index went down by 1.1 pts from the previous month to 49.5 in July, falling below the critical 50-mark. The index reading in July indicates that enterprises have started to reduce their service charges recently. Meanwhile, the input prices index has remained above 50 in the past few months, indicating a continuous increase in the costs of inputs.

The business expectation index rose from 57.8 in May to 58.6 in June and 59.5 in July, showing that the confidence among purchasing managers in the non-manufacturing sector has been improving.

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Exhibit 20 China's manufacturing PMI at a glance, July 2016

Index	Seasonally Adjusted Index	Index Compared with the Previous Month	Direction
PMI	49.9	Lower	Contracting
Output	52.1	Lower	Expanding
New orders	50.4	Lower	Expanding
New export orders	49.0	Lower	Contracting
Backlogs of orders	45.5	Higher	Contracting
Stocks of finished goods	46.8	Higher	Contracting
Purchases of inputs	50.5	Unchanged	Expanding
Imports	49.3	Higher	Contracting
Input prices	54.6	Higher	Rising
Stocks of major inputs	47.3	Higher	Contracting
Employment	48.2	Higher	Contracting
Suppliers' delivery time	50.5	Lower	Quickening
Business expectations	55.3	Higher	Optimistic

Source: China Federation of Logistics & Purchasing; National Bureau of Statistics, PRC

Exhibit 21 China's non-manufacturing purchasing managers' index (NMI) at a glance, July 2016

Index	Seasonally Adjusted Index	Index Compared with the Previous Month	Direction
Business activity	53.9	Higher	Expanding
New orders	49.9	Lower	Contracting
Input prices	51.4	Lower	Rising
Sales prices	49.5	Lower	Falling
Business expectations	59.5	Higher	Optimistic

Source: China Federation of Logistics & Purchasing; National Bureau of Statistics, PRC

A Recent developments

1. Both exports and imports drop at a slower pace in 2Q16

China's exports dropped at a slower pace in 2Q16, compared to 1Q16. The export growth improved from minus 9.6% yoy in 1Q16 to minus 4.6% yoy in 2Q16 (see exhibits 22, 23 and 24). Overall, in 1H16, China's exports amounted to US\$ 985.5 billion, down by 7.7% yoy.

It is noteworthy that China's exports to most of its major trading partners showed negative yoy growth in the first half of this year. Exports to the US and to the ASEAN fell by 9.9% yoy and 8.4% yoy respectively in 1H16, after gaining 3.4% yoy and 2.1% yoy respectively in 2015. China's exports to the EU, Japan and Brazil continued to post negative growth of minus 4.4% yoy, minus 6.1% yoy and minus 36.8% yoy respectively in

1H16, compared to the negative growth of minus 4.0% yoy, minus 9.2% yoy and minus 21.4% yoy respectively in 2015.

China's imports also fell at a slower pace, by 6.8% yoy, in 2Q16, compared to the 13.5% yoy drop in 1Q16. Overall, in 1H16, China's imports totalled US\$ 727.2 billion, down by 10.2% yoy.

China's trade surplus remained high at US\$ 143.7 billion in 2Q16, up from US\$ 125.7 billion in 1Q16. Such a massive trade surplus may encourage foreign politicians to advocate tough trade policies on Chinese products, which will pose a risk to China's exports.

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Exhibit 22 China's quarterly foreign trade data, 3Q15 to 2Q16

USD billion (yoy growth)

	Exports		Imports		Trade Balance
FY15	2,276.6	(-2.8%)	1,682.1	(-14.1%)	594.5
3Q15	597.5	(-5.9%)	433.9	(-14.4%)	163.6
4Q15	613.8	(-5.0%)	438.0	(-11.8%)	175.8
1Q16	463.9	(-9.6%)	338.2	(-13.5%)	125.7
2Q16	534.2	(-4.4%)	390.6	(-6.8%)	143.7

Source: China Customs

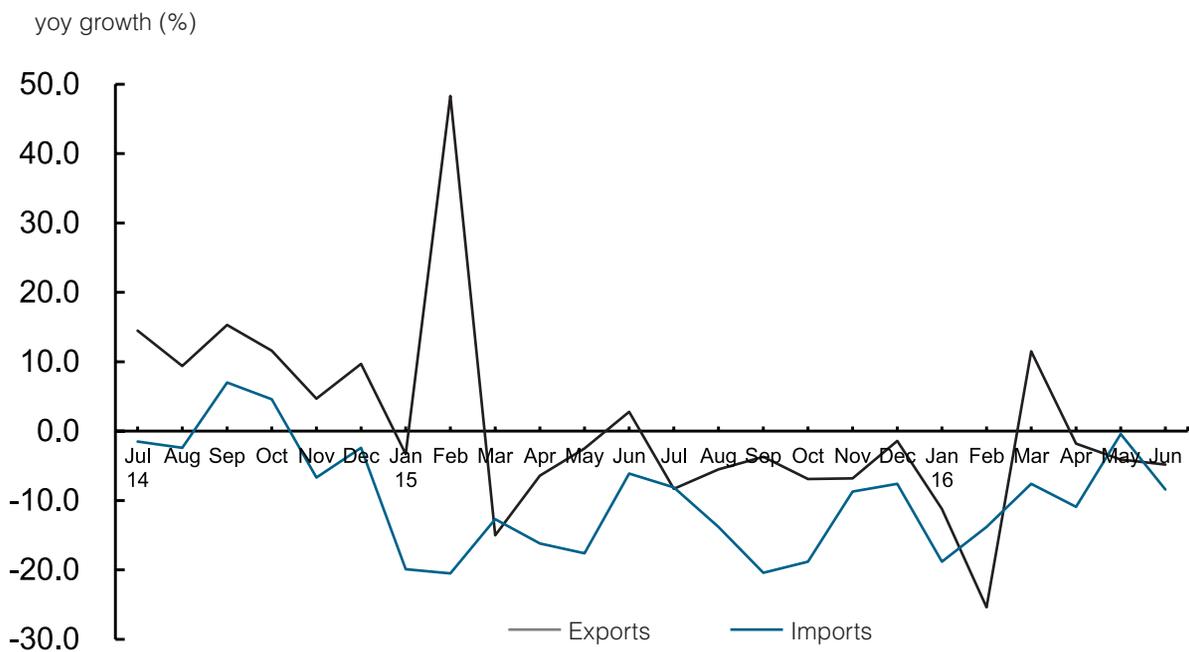
Exhibit 23 China's monthly foreign trade data, July 2015 to June 2016

USD billion (yoy growth)

	Exports		Imports		Trade Balance
July 2015	195.1	(-8.3%)	152.1	(-8.1%)	43.0
August	196.9	(-5.5%)	136.6	(-13.8%)	60.2
September	205.6	(-3.7%)	145.2	(-20.4%)	60.3
October	192.4	(-6.9%)	130.8	(-18.8%)	61.6
November	197.2	(-6.8%)	143.1	(-8.7%)	54.1
December	224.2	(-1.4%)	164.1	(-7.6%)	60.1
January 2016	177.5	(-11.2%)	114.2	(-18.8%)	63.3
February	126.1	(-25.4%)	93.6	(-13.8%)	32.6
March	160.8	(11.5%)	131.0	(-7.6%)	29.9
April	172.8	(-1.8%)	127.2	(-10.9%)	45.6
May	181.1	(-4.1%)	131.1	(-0.4%)	50.0
June	180.4	(-4.8%)	132.3	(-8.4%)	48.1

Source: China Customs

Exhibit 24 Growth rates of exports and imports, July 2014 to June 2016



Source: China Customs

Exhibit 25 Exports by category, 2015 and 1H16

<i>yoy growth (%) of export value, calculated in USD</i>	2015	1H16
Textile materials and products	-2.3	-1.6
Garments and clothing accessories	-6.4	-5.1
Footwear	-4.8	-11.3
Toys	10.8	8.9
Coal	-28.3	43.0
Crude oil	215.0	-63.9
Refined oil	-25.9	-7.2
Steel	-11.3	-18.0
Mechanical and electrical products	0.1	-8.0

Source: China Customs

Exhibit 26 Imports by category, 2015 and 1H16

<i>yoy growth (%) of import value, calculated in USD</i>	2015	1H16
Cereal and cereal flour	51.1	-29.4
Soybean	-13.6	-6.0
Iron ore	-38.3	-13.3
Crude oil	-41.1	-26.7
Refined oil	-39.0	-27.4
Steel	-20.0	-16.7
Textile yarns, fabric and textile products	-6.4	-16.2
Vehicles and vehicle chassis	-26.1	-10.3

Source: China Customs

2. Processing trade shrinks sharply in 2Q16

Both the processing trade¹³ exports and the general trade¹⁴ exports continued to post year-on-year drop in 2Q16. The processing trade exports contracted by 12.1% yoy in 2Q16. Comparatively, the general trade exports fell at a much slower pace, by 1.1% yoy, in 2Q16 (see exhibit 27).

Both the general trade imports and the processing trade imports continued to post negative year-on-year growth in 2Q16. The general trade imports fell by 3.6% yoy, while the processing trade imports plunged by 15.3% yoy in 2Q16. We believe that the sharp fall in processing

trade imports in 2Q16 suggests that the processing trade exports are likely to continue to show negative growth in the near future, as processing trade imports serve as a leading indicator of processing trade exports performance.

Correspondingly, the share of processing trade in China's total trade fell to 28.1% in 2Q16 from 29.5% in 1Q16. That being said, with a large surplus of US\$ 76.1 billion in 2Q16, processing trade still plays an important role in China's foreign trade.

¹³ 'Processing trade' refers to the business of importing all or part of the raw and auxiliary materials, parts and components, accessories and packaging materials from abroad, and re-exporting the finished products after processing or assembly by enterprises within the Chinese Mainland.

¹⁴ 'General trade' refers to China's import or export of goods by enterprises holding import-export rights. According to China's National Bureau of Statistics, the scope of general trade covers: Imports and exports using loans or aids; the import of materials by foreign invested enterprises (FIEs) for processing of goods for sale in the domestic market; the export of goods purchased by FIEs or manufactured by processing domestically-produced materials; the import of food and beverages by restaurants and hotels; the supply of domestically-produced fuels, materials, parts and components to foreign vessels or aircraft; the import of goods as payment in kind, in lieu of wages in labour service cooperation projects with foreign countries; and the export of equipment and materials by enterprises in China for their investment abroad.

Exhibit 27

China foreign trade (general and processing trades), 2015 to 2Q16

Item	yoy growth (%)			Share (%)		
	FY15	1Q16	2Q16	FY15	1Q16	2Q16
Exports	-2.8	-9.6	-4.4	100.0	100.0	100.0
Of which:						
General Trade	1.1	-7.2	-1.1	53.5	55.4	56.6
Processing Trade	-9.8	-16.0	-12.1	35.0	32.9	31.4
Imports	-14.1	-13.5	-6.8	100.0	100.0	100.0
Of which:						
General Trade	-16.8	-14.0	-3.6	54.9	56.5	57.8
Processing Trade	-14.8	-18.1	-15.3	26.6	24.8	23.5
Total of Imports and Exports	-8.0	-11.3	-5.3	100.0	100.0	100.0
Of which:						
General Trade	-7.5	-10.2	-2.2	54.1	55.9	57.1
Processing Trade	-11.6	-16.8	-13.2	31.4	29.5	28.1

Source: China Customs

3. Trade with most major trading partners shows negative year-on-year growth in 1H16

The EU was still China's largest trading partner, accounting for 15.2% of China's total foreign trade in 1H16. Sino-EU trade amounted to US\$ 260.3 billion in 1H16, down by 4.0% yoy. Specifically, China's exports to the EU fell by 4.4% yoy in 1H16, compared to the 4.0% yoy drop in 2015. Meanwhile, the growth of China's imports from the EU improved to minus 3.3% yoy in 1H16 from minus 14.5% yoy in 2015 (see exhibits 28 and 29).

The US continued to be China's second largest trading partner in 1H16, accounting for 13.8% of China's total foreign trade. Sino-US trade fell by 10.9% yoy in 1H16, after registering a weak growth of 0.6% yoy in 2015. China's export growth to the US turned negative, registering minus 9.9% yoy in 1H16, compared to the positive growth of 3.4% yoy in 2015. Meanwhile, China's

import growth from the US deteriorated to minus 13.5% yoy in 1H16 from minus 6.5% yoy in 2015.

The Association of South East Asian Nations (ASEAN), China's third largest trading partner, accounted for 12.2% of China's total foreign trade in 1H16. China's trade with ASEAN dropped by 8.1% yoy to US\$ 209.4 billion in 1H16. Of which, China's exports to ASEAN shrank by 8.4% yoy, and China's imports from ASEAN contracted by 7.7% yoy, in 1H16.

Sino-Japanese trade contracted by 5.1% yoy to US\$ 128.4 billion in 1H16. China's exports to Japan fell by 6.1% yoy, while China's imports from Japan slid 4.2% yoy in 1H16.

4. China's trade with Russia turns positive in 1H16

After falling by 28.6% yoy in 2015, China's trade with Russia gained 1.8% yoy in 1H16. The positive growth was mainly attributable to the impressive growth of China's exports to Russia, which recovered to a positive 10.0% yoy in 1H16 from minus 35.2% yoy in 2015. Meanwhile, the growth of China's imports from Russia improved to minus 5.4% yoy in 1H16 from minus 20.0% yoy in 2015 (see exhibits 28 and 29).

China's exports to India managed to record a positive growth of 1.8% yoy in 1H16. In contrast, China's imports from India dropped markedly by 16.2% yoy over the same period. Overall, the growth of Sino-Indian trade worsened to minus 1.9% yoy in 1H16 from 1.5% yoy in 2015.

Sino-Brazilian trade dropped by 9.3% yoy in 1H16. China's exports to Brazil plunged by 36.8% yoy in 1H16. China's import growth from Brazil turned positive, posting 12.1% yoy, in 1H16, compared to the negative growth of minus 14.5% yoy in 2015.

Together, these three BRIC members accounted for 5.4% of China's total exports and 5.9% of China's total imports in 1H16, up from 5.3% and 5.4%, respectively, in 2015.

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Exhibit 28 China's trading partners, 1H16

Country/ Region	Trade value (USD billion)	Share of total trade (%)	Export value (USD billion)	Import value (USD billion)	yoy growth (%)		
					Total trade	Exports	Imports
EU	260.3	15.2	160.3	100.0	-4.0	-4.4	-3.3
US	236.4	13.8	173.4	62.9	-10.9	-9.9	-13.5
ASEAN	209.4	12.2	123.3	86.2	-8.1	-8.4	-7.7
Japan	128.4	7.5	61.7	66.8	-5.1	-6.1	-4.2
Brazil	31.0	1.8	9.4	21.6	-9.3	-36.8	12.1
Russia	31.7	1.9	16.1	15.6	1.8	10.0	-5.4
India	33.5	2.0	27.8	5.8	-1.9	1.8	-16.2

Source: China Customs

Exhibit 29 China's trading partners, comparing growth rates for 2015 and 1H16

Country/Region	yoy growth (%)					
	Total Trade		Exports		Imports	
	2015	1H16	2015	1H16	2015	1H16
EU	-8.2	-4.0	-4.0	-4.4	-14.5	-3.3
US	0.6	-10.9	3.4	-9.9	-6.5	-13.5
ASEAN	-1.7	-8.1	2.1	-8.4	-6.6	-7.7
Japan	-10.8	-5.1	-9.2	-6.1	-12.2	-4.2
Brazil	-17.3	-9.3	-21.4	-36.8	-14.5	12.1
Russia	-28.6	1.8	-35.2	10.0	-20.0	-5.4
India	1.5	-1.9	7.4	1.8	-18.2	-16.2

Source: China Customs

5. All top six provinces/ municipalities in terms of exports witness negative year-on-year growth in exports in January to May

All top six provinces and municipalities in terms of value of exports – Guangdong, Jiangsu, Shanghai, Zhejiang, Shandong and Fujian – witnessed negative year-on-year growth in exports in the January to May period (see exhibit 30).¹⁵ Among these provinces, Shanghai saw the sharpest fall in exports, which went down by 9.0% yoy in January to May 2016.

It is noteworthy that several local governments in eastern China have ordered manufacturers in certain

industries such as textile, dyeing and petrochemical to cut or even suspend production ahead of the upcoming G20 Leaders Summit in Hangzhou on 4-5 September, in a bid to improve the air quality in Hangzhou. We therefore expect that exports from coastal provinces such as Shanghai, Jiangsu and Zhejiang will be adversely affected in 3Q16.

¹⁵ China's top six provinces and municipalities in terms of value of exports – Guangdong, Jiangsu, Shanghai, Zhejiang, Shandong and Fujian – jointly accounted for 79.1% of China's total exports in the January to May period.

Exhibit 30 Top six provinces and municipalities in terms of value of exports, January to May 2016

Provinces/ Municipalities	Value of exports (USD billion)	yoy growth (%)	Share of total exports (%)
Guangdong	252.2	-7.3	31.0
Jiangsu	130.4	-4.6	16.0
Zhejiang	106.8	-2.5	13.1
Shanghai	64.6	-9.0	7.9
Shandong	55.6	-6.1	6.8
Fujian	35.3	-5.1	4.3

Source: China Customs

6. FDI records positive year-on-year growth in three of the last four months

China's foreign direct investment (FDI) gained 4.5% yoy in June, recording positive year-on-year growth in three of the last four months. Overall, in 1H16, China's FDI amounted to US\$ 69.4 billion, up by 1.6% yoy (see exhibit 31).

Among the sectors, FDI in the service sector rose by 12.7% yoy to US\$ 48.9 billion in 1H16. The share of the service sector in China's total FDI reached 70.5% in 1H16, up from 61.1% in 2015. In contrast, FDI in the manufacturing sector fell by 6.4% yoy to US\$ 19.5 billion in 1H16, accounting for only 28.1% of China's total FDI. These figures suggest that foreign enterprises are less optimistic about the prospects in the manufacturing sector in China.

Among the regions, the eastern region remained the largest recipient of FDI in 1H16. FDI in the eastern region amounted to US\$ 60.6 billion in 1H16, up by 3.4% yoy; FDI in the central region fell by 34.7% yoy to US\$ 3.7 billion in 1H16; FDI in the western region grew by 23.9% yoy to reach US\$ 5.1 billion in 1H16.

The top ten countries/ regions in terms of FDI value jointly accounted for 94.6% (US\$ 65.7 billion) of China's total FDI in 1H16. Particularly noteworthy is that FDI from the EU rose strongly by 38.2% yoy to US\$ 5.6 billion in 1H16.

Exhibit 31 China's FDI, July 2015 to June 2016

	Amount (USD billion)	yoy growth
FY15	126.3	5.6%
1H16	69.4	1.6%
July 15	8.2	5.2%
August	8.7	20.9%
September	9.6	6.1%
October	8.8	3.2%
November	10.4	-0.4%
December	12.2	-8.0%
January 16	14.1	1.3%
February	8.4	-1.4%
March	12.9	4.0%
April	9.9	2.9%
May	8.9	-4.7%
June	15.2	4.5%

Source: Ministry of Commerce, PRC

7. China's foreign exchange reserves post a smaller drop in 2Q16

After falling by US\$ 117.8 billion in 1Q16, the foreign exchange reserves decreased by US\$ 7.4 billion in 2Q16, amounting to US\$ 3.21 trillion as at the end of 2Q16 (see exhibit 32). The figures indicate that China's foreign exchange reserves posted a smaller drop in 2Q16. We believe this can be attributed to the slowdown in hot money outflows. According to a statement made by a spokesperson of the State Administration of Foreign Exchange on 20 June, pressure for cross-border outflows of capital has gradually eased so far this year.¹⁶

Looking ahead, we predict that China's foreign exchange reserves will fall at a faster pace in coming months, as the recent depreciation of the Chinese yuan against the US dollar and the greater economic uncertainty caused by the 'Brexit' decision may quicken hot money outflows from China.

Exhibit 32 Foreign exchange reserves by quarter, 3Q15 to 2Q16

USD billion	Accumulation	End of the quarter
FY15	-512.7	
3Q15	-179.7	3,514.1
4Q15	-183.8	3,330.4
1Q16	-117.8	3,212.6
2Q16	-7.4	3,205.2

Source: State Administration of Foreign Exchange, PRC

¹⁶ http://www.safe.gov.cn/wps/portal/!ut/p/c5/hY2xDolwAES_xS_oVWpbxIJW4uAaVRkIR0MIRFwMH6_EGf1bnx5d6Qhc8f46rv47Kcx3kINGt4yIMiMKpQh3cGIIkqgSgM7_yVhtlmcgByQzgWfYwVh8pXPLHvix_vLV6qw_eUEh_InBuE_T-5Nc6Fx_-a3_h-BIFUthpuJHHUKOvutUbGRxr1w!!/dl3/d3/L2dJQSEvUUt3QS9ZQnZ3LzZlSENEQ01LRzEwODRjQzBJSUpRRUpKSDeySTII/?WCM_GLOBAL_CONTEXT=/wps/wcm/connect/safe_web_store/safe_web/whxw/sjld/node_news_sjld_store/b6a225004d3346a98f1e8fe39639345e

B Highlights

1. Chinese yuan depreciates against the US dollar

The daily fixing rate (also known as the central parity rate) of the Chinese yuan against the US dollar has been on a depreciation trend since early May (see exhibit 33).¹⁷ Triggered by the Brexit vote result on 24 June, the pace of depreciation of the daily fixing rate quickened in late June. The daily fixing rate of the Chinese yuan against the US dollar depreciated from 6.5658 on 23 June to 6.6528 on 28 June. Afterwards, the daily fixing rate depreciated at a slower pace till 19 July, and has fluctuated at low levels since then.

The USD-CNY spot exchange rate has depreciated since late April. So far this year, the USD-CNY spot exchange rate has depreciated by 2.8% (as of 25 July).

The daily fixing rate of the Chinese yuan against the Euro has fluctuated at low levels in recent months (see exhibit 34). The daily fixing rate stayed between 7.3015 and 7.4765 throughout April to late July (as of 25 July). On 25 July, the daily fixing rate was 7.3273, implying that the Chinese yuan has depreciated by 3.2% against the Euro so far this year (as of 25 July).

According to the Bank for International Settlements, the real effective exchange rate (REER) of the yuan has been on a downward trend since February this year, falling to 123.14 in June, the lowest level since November 2014.¹⁸ Overall, in the first half of 2016, the Chinese yuan depreciated in real terms against its trading partners by 5.5% (see exhibit 35).

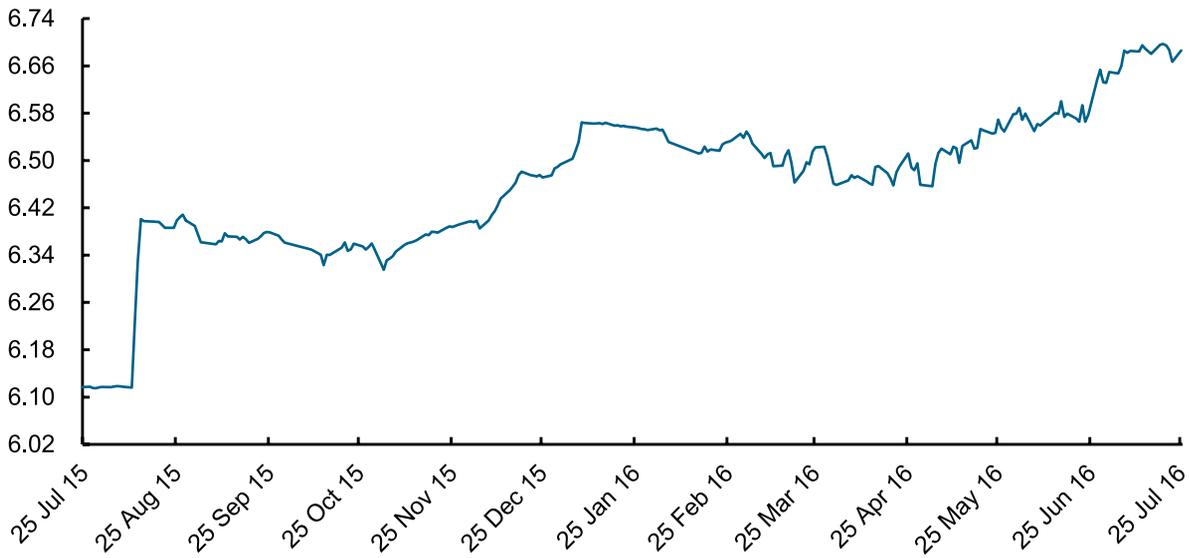
Looking ahead, we predict the exchange rate of the Chinese yuan against the US dollar to stay weak in coming months, as the 'Brexit' decision may quicken hot money outflows from China as investors turn to safe haven currencies. Nevertheless, we do not expect a sharp depreciation of the Chinese yuan against the US dollar, as this could trigger a financial turmoil, worsening the prospect of the Chinese economy.

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¹⁷ According to the PBOC, the daily fixing rate (also known as the central parity rate) of the Chinese yuan against the US dollar is directly formed by market makers based on the closing rate of the previous day, the supply-demand conditions in the market and the movements of major international currencies.

¹⁸ The Bank for International Settlements (BIS) calculates effective exchange rate (EER) indices for a total of 61 economies (including individual Eurozone countries and, separately, the Eurozone as an entity). Nominal EERs are calculated as geometric weighted averages of bilateral exchange rates. Real EERs are the same weighted averages of bilateral exchange rates adjusted by relative consumer prices. The weighting pattern is time-varying, and the most recent weights are based on trade in 2011-13.

Exhibit 33 USD-CNY daily fixing rate, July 2015 to July 2016



Source: State Administration of Foreign Exchange

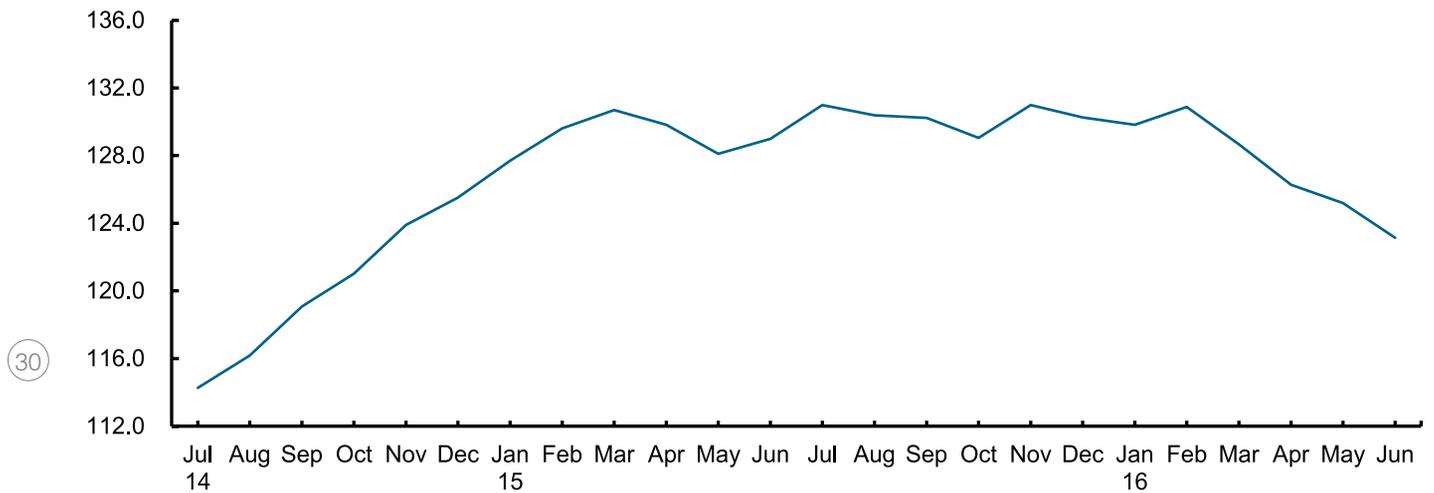
Exhibit 34 EUR-CNY daily fixing rate, July 2015 to July 2016



Source: State Administration of Foreign Exchange

Part 2 : Foreign Trade

Exhibit 35 Real effective exchange rate of the Chinese yuan, July 2014 to June 2016



Source: Bank for International Settlements

2. Brexit to adversely affect China's export performance and Sino-EU trade relations

On 23 June, the UK voted to leave the EU by 52% to 48%. The Brexit decision has caused high uncertainty over the UK's economic relationships with the EU and with the rest of the world after Brexit, thereby dealing a heavy blow to the UK economy in the short and medium term. Besides, this may hold back the already-very weak recovery of the EU, as the threat of an EU collapse will undermine government effectiveness and affect consumer and business sentiments.

Impacted by the Brexit decision, we believe that China's export performance will further deteriorate. China will be less impacted by a decline in trade with the UK as the UK only accounts for about 3% of China's exports. However, a more subdued EU economic outlook is expected to exacerbate the already-sluggish external demand for Chinese goods, as the EU is China's second largest export market. In 1H16, the EU accounted for 16.3% of China's total exports. Also noteworthy is that the Sino-EU trade relations could be adversely affected: The UK has been playing a constructive role in promoting and deepening China-EU ties, and has been a major advocate for a free trade agreement between China and the EU. Without the UK's involvement, it is anticipated that any future negotiations would become more difficult.

3. China and the US agree to accelerate negotiations of Bilateral Investment Treaty

There have been some positive signs for the negotiations of the China-US Bilateral Investment Treaty (BIT) recently. The eighth US-China Strategic and Economic Dialogue (S&ED), co-chaired by the Chinese Vice Premier Wang Yang, the State Councilor Yang Jiechi, the US Secretary of State John Kerry and the Treasury Secretary Jacob Lew, was held in Beijing on 6-7 June. During the meeting, China and the US agreed to accelerate the negotiations of the BIT. Afterwards, the two parties held the 26th round of the negotiations of the BIT in Beijing during 11-17 July.

According to the statement released by China's Ministry of Commerce on 17 July, both sides made positive progress on the negotiations over the remaining issues of the text and had in-depth discussions on the 'negative lists' of sectors that were exchanged in mid-June.¹⁹

China and the US started the negotiation of the BIT in 2008, with a goal to boost mutual investment. According to the media report in late May, the US Under Secretary of the Treasury for International Affairs Nathan Sheets reaffirmed the government's commitment to conclude the deal of the BIT before the end of Obama's presidency.²⁰

¹⁹ <http://english.mofcom.gov.cn/article/newsrelease/significantnews/201607/20160701362377.shtml>

²⁰ <http://www.reuters.com/article/us-usa-china-treasury-idUSKCN0YF2LK>

C Outlook

1. US economic growth is forecast to soften in 2016

The US real GDP advanced by an annual rate of 1.2% in 2Q16, an acceleration from the real annual growth of 0.8% in 1Q16 (see exhibit 36).

Some indicators show signs of improvement in the US manufacturing sector. For example, according to the Institute for Supply Management, the manufacturing Purchasing Managers' Index (PMI) rose all the way from 50.8 in April to a 16-month high of 53.2 in June. The PMI then moderated to 52.6 in July, but was still above the 12-month average of 50.4. Besides, industrial production gained 0.6% mom in June, recording positive month-on-month growth in two of the last three months (see exhibit 37). Meanwhile, the new orders for manufactured durable goods expanded by 2.0% mom and 3.2% mom in March and April respectively on a seasonally adjusted basis, before dropping by 2.3% mom in May.

The growth of the non-manufacturing sector has moderated slightly. The non-manufacturing index (NMI), compiled by the Institute for Supply Management, went down from its recent peak of 56.5 in June to 55.5 in July.

The US retail sales gained 0.6% mom in June, recording positive month-on-month growth for three consecutive

months. The Reuters/University of Michigan Index of consumer sentiment rebounded strongly from 89.0 in April to 94.7 in May, and then stayed high at 93.5 in June. The index readings in recent months indicate that the US consumers have been optimistic (see exhibit 38).

The pace of job creation decelerated in 2Q16. After increasing by 587,000 in 1Q16, the non-farm payroll employment rose at a slower pace, by 442,000, in 2Q16. The US unemployment rate rebounded from the recent low of 4.7% in May to 4.9% in June (see exhibit 39).

According to the latest projection by the International Monetary Fund (IMF), the US real GDP growth is forecast to be 2.2% this year, lower than the 2.6% yoy growth in 2015.²¹ Downside risks, in our view, come from the impact of the Brexit decision on the global financial market. The direct economic impact of the Brexit decision on the US should be limited. However, if Brexit triggers financial turmoil around the globe, business sentiments and consumer confidence in the US are likely to weaken, thereby worsening the outlook for the US economy.

Exhibit 36 US national accounts, 2014 to 2Q16

Annual growth (%)	2014	2015	3Q15	4Q15	1Q16	2Q16
Real GDP	2.4	2.6	2.0	0.9	0.8	1.2

Source: US Department of Commerce

Exhibit 37 US industrial sector, January to June 2016

mom growth (%), seasonally adjusted	Jan 16	Feb	Mar	Apr	May	Jun
Industrial production	0.5	-0.2	-1.0	0.5	-0.3	0.6
New orders for manufactured durable goods	3.7	-3.3	2.0	3.2	-2.3	-

Source: US Federal Reserve, US Department of Commerce

Exhibit 38 US consumer market, January to June 2016

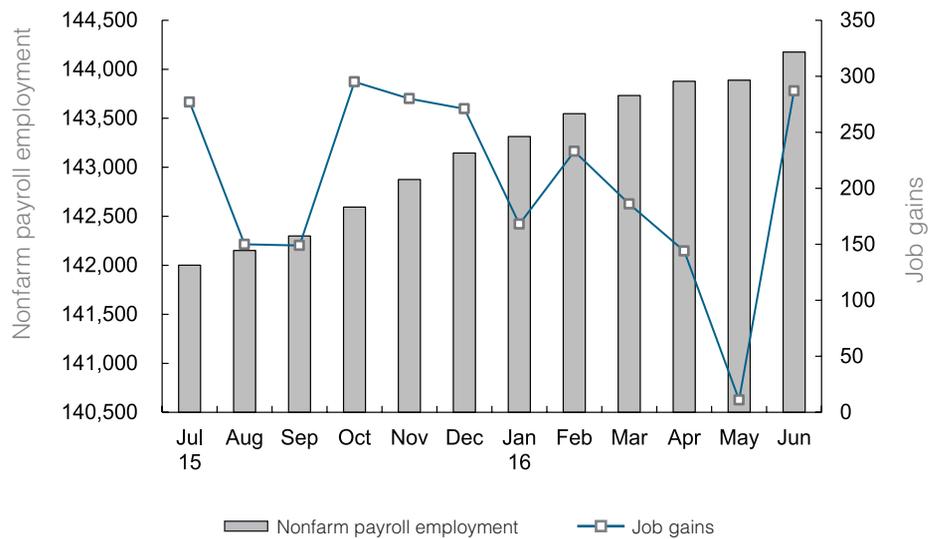
	Jan 16	Feb	Mar	Apr	May	Jun
Retail and food services sales (mom growth %, seasonally adjusted)	-0.5	0.3	-0.3	1.2	0.2	0.6
Reuters/University of Michigan index of consumer sentiment	92.0	91.7	91.0	89.0	94.7	93.5
CPI (yoy growth %)	1.4	1.0	0.9	1.1	1.0	1.0

Source: US Department of Commerce, Reuters/University of Michigan Surveys of Consumers, US Department of Labor

Exhibit 39 US employment

	Unemployment rate (%)
2014	6.2
2015	5.3
Jul 15	5.3
Aug	5.1
Sep	5.1
Oct	5.0
Nov	5.0
Dec	5.0
Jan 16	4.9
Feb	4.9
Mar	5.0
Apr	5.0
May	4.7
Jun	4.9

Nonfarm payroll employment, July 2015 to June 2016
In thousands, seasonally adjusted



Yearly figures: Annual average
Monthly figures: Seasonally adjusted

Source: US Department of Labor

2. Eurozone economic growth decelerates in 2Q16

The Eurozone economic growth decelerated in 2Q16.²² The real GDP growth in the Eurozone fell to 0.3% qoq in 2Q16 from 0.6% qoq in 1Q16 (see exhibit 40).

According to the global survey firm Markit Economics, the Eurozone services PMI dropped from 53.3 in May

to 52.8 in June, the lowest level since February last year, before rising slightly to 52.9 in July. In fact, the index has generally been on a downward trend since January this year, indicating a continuous moderation of the growth of the services sector in the Eurozone. Meanwhile, the Eurozone manufacturing PMI fell

²² Lithuania has become the 19th member of the Eurozone as from 1 January 2015. Other member countries include Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain.

Part 2 : Foreign Trade

from 52.8 in June to 52.0 in July, indicating that the manufacturing sector in the region has expanded at a slower pace lately.

On a seasonally adjusted basis, the retail trade volume in the Eurozone stayed stable in June, after gaining 0.2% mom and 0.4% mom in April and May respectively (see exhibit 41).

The good news is that the labour market conditions have improved. The seasonally-adjusted unemployment rate fell from 10.4% in February to 10.2% in March and April, and dropped further to 10.1% in May and June (see exhibit 42). Moreover, the Eurozone's economic sentiment indicator (ESI) rose slightly from 104.4 in

June to 104.6 in July in the wake of the Brexit vote decision (see exhibit 43).

Looking ahead, it is expected that the growth of the Eurozone economy will soften in the coming future. According to the latest projections by the IMF, the Eurozone's real GDP growth is forecast to fall from 1.7% in 2015 to 1.6% in 2016 and 1.4% in 2017.²³ That being said, the 'Brexit' decision has caused greater uncertainty over the global economy, in particular the Eurozone economy. The threat of an EU crisis could lead to financial market volatility, depreciation of the Euro and capital flight. This would in turn adversely affect consumer and business sentiments, hitting the economy in the region.

Exhibit 40 Eurozone's real GDP growth, 2014 to 2Q16

	2014	2015	3Q15	4Q15	1Q16	2Q16
Real GDP (<i>qoq growth %</i>)			0.3	0.4	0.6	0.3
Real GDP (<i>yoy growth %</i>)	0.9	1.7	1.6	1.7	1.7	1.6

* The figure in 2014 does not reflect Lithuania's membership of the Eurozone, which began on 1 January 2015.

Source: Eurostat

Exhibit 41 Eurozone consumer market, January to June 2016

	Jan 16	Feb	Mar	Apr	May	Jun
Volume of retail trade (<i>mom growth %, seasonally adjusted</i>)	0.2	0.3	-0.6	0.2	0.4	0.0
Annual inflation (%)	0.3	-0.2	0.0	-0.2	-0.1	0.1

Source: Eurostat

Exhibit 42 Eurozone labour market, January to June 2016

<i>seasonally adjusted</i>	Jan 16	Feb	Mar	Apr	May	Jun
Unemployment rate (%)	10.4	10.3	10.2	10.2	10.1	10.1

Source: Eurostat

Exhibit 43 Eurozone economic sentiment indicator, February to July 2016

<i>seasonally adjusted</i>	Feb 16	Mar	Apr	May	Jun	Jul
Economic sentiment indicator	103.9	103.0	104.0	104.6	104.4	104.6

Source: Eurostat

3. China's exports are expected to show single-digit decline in 3Q16

In its *World Economic Outlook Update* released on 19 July this year, the IMF announces its cuts on the growth forecasts for the world economy, as the Brexit vote decision has caused sizeable uncertainty for the global economy. The IMF's forecasts for the world economic growth is adjusted downward by 0.1 pts to 3.1%

in 2016 and 3.4% in 2017, compared to its previous predictions made in April this year (*see exhibit 44*). We therefore remain pessimistic over China's export outlook, and expect to see single-digit drop in China's exports in 3Q16.

Exhibit 44 Latest GDP growth forecasts by the IMF

<i>yoy growth (%)</i>	2015	2016 (Forecasts)	2017 (Forecasts)
World economy	3.1	3.1	3.4
Advanced economies	1.9	1.8	1.8
US	2.6	2.2	2.5
Eurozone	1.7	1.6	1.4
Japan	0.5	0.3	0.1
UK	2.2	1.7	1.3
Emerging market and developing economies	4.0	4.1	4.6
China	6.9	6.6	6.2
India *	7.6	7.4	7.4
Brazil	-3.8	-3.3	0.5
Russia	-3.7	-1.2	1.0

* Data and forecasts are presented on a fiscal year basis. India's fiscal year runs from 1 April to 31 March.

Source: IMF, World Economic Outlook Update, July 2016

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