

# Deal or No Deal? Trade War Scenario Analysis and Economic Outlook



Kevin Liu  
Executive Director



Brendan Ahern  
Chief Investment Officer





# Introduction to KraneShares

## About KraneShares

Krane Funds Advisors, LLC is the investment manager for KraneShares ETFs. Our suite of China focused ETFs provides investors with solutions to capture China's importance as an essential element of a well-designed investment portfolio. We strive to provide innovative, first to market strategies that have been developed based on our strong partnerships and our deep knowledge of investing. We help investors stay current on global market trends and aim to provide meaningful diversification. Krane Funds Advisors, LLC is majority owned by China International Capital Corporation (CICC).



## About the Speakers



Kevin Liu  
**Executive Director**

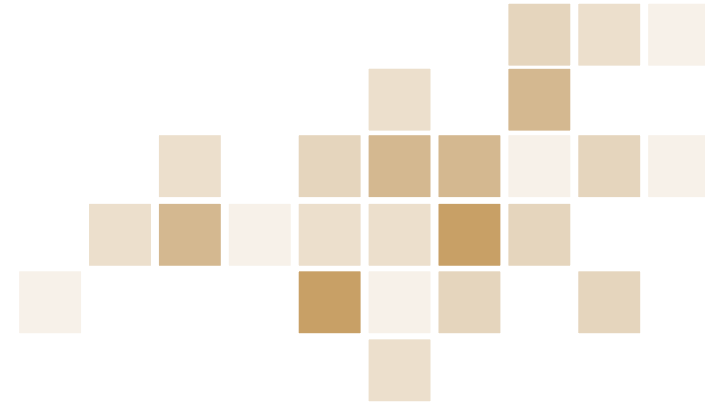
Kevin Liu joined China International Capital Corporation (CICC) in 2011 and holds the title of Executive Director as a Strategist in the Research Department. From a top-down strategy approach by incorporating macro (growth and policy) and micro variables (corporate earnings and valuations etc.), his main responsibility is to provide investors with investment strategies, as well as cross-market/asset/sector allocation recommendations. His focuses include Chinese equities as well as general global markets. Mr. Liu ranked the second in Portfolio Strategy of the 2017 II All-China and Mainland China Best Analysts Ranking. Prior to CICC, Mr. Liu worked as a Quantitative Strategist with UBS Hong Kong. He obtained his master degrees from both Cornell University and Tsinghua University.



Brendan Ahern  
**Chief Investment Officer**

Brendan Ahern joined KraneShares in June 2012 to head the firm's efforts in becoming the leading provider of China-focused exchange traded funds (ETFs) and Chinese investment education for US clients. Since early 2001, Brendan worked for one the largest global ETF providers where he was an original member of the business development team. His "from the ground up" experience at a global ETF provider allowed him to become intimately acquainted with all aspects of the business. His expertise spans product development, marketing, branding, business strategy, operations, portfolio management, trading, and client execution.

For questions during the presentation please email:  
[info@kraneshares.com](mailto:info@kraneshares.com)



# Navigating the Secular Trends in China

## - "3Cs": Challenge, Change and Chance

**Kevin LIU, CFA**

**Equity Strategist, Executive Director**

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SAC: S0080512030003

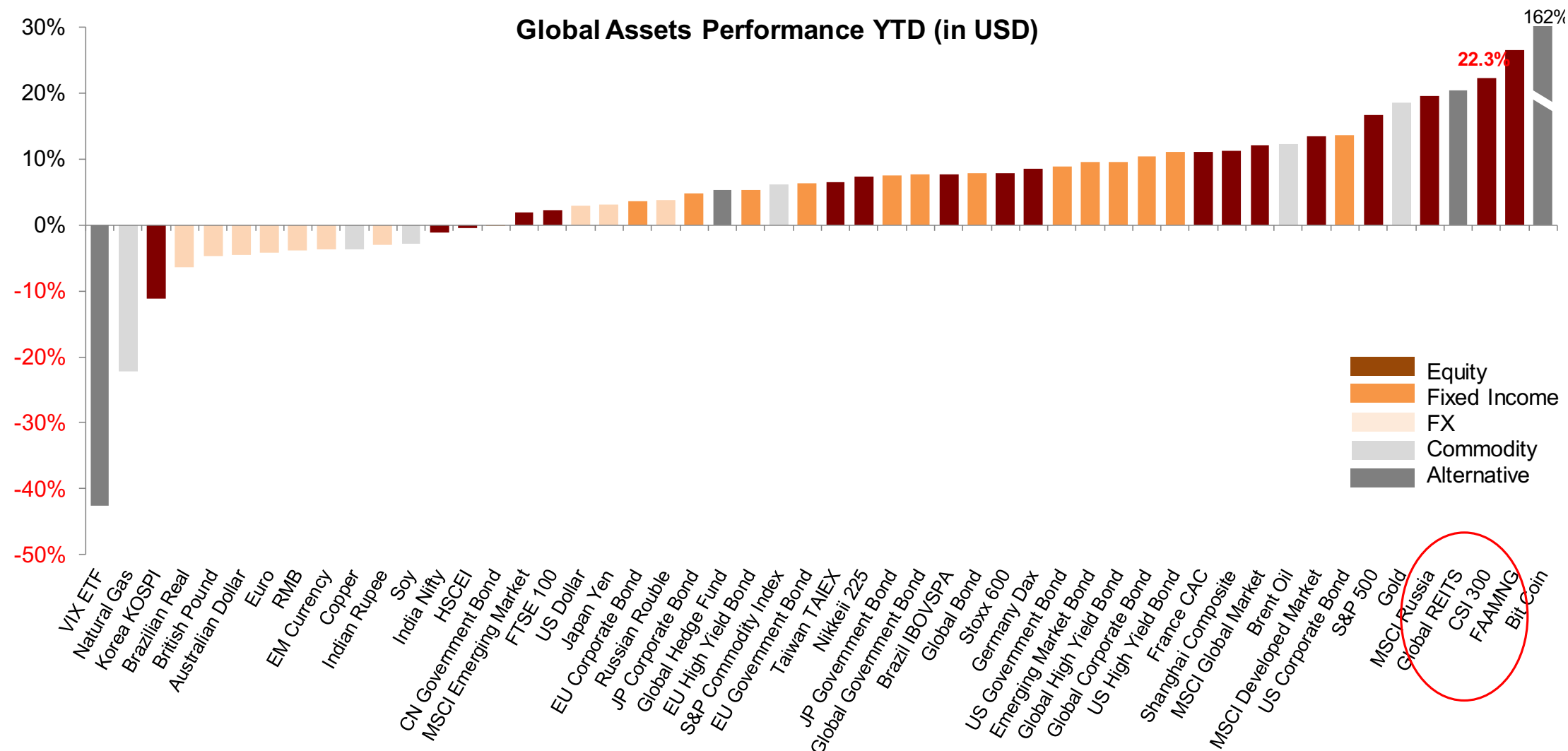
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**September 2019**

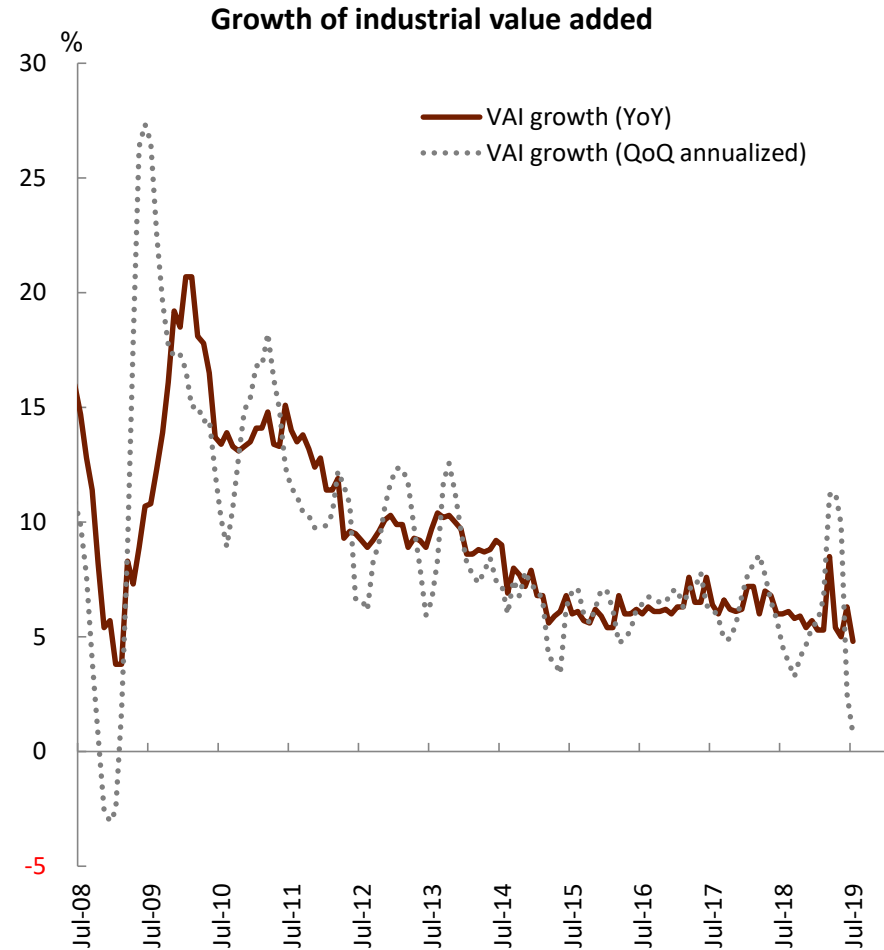
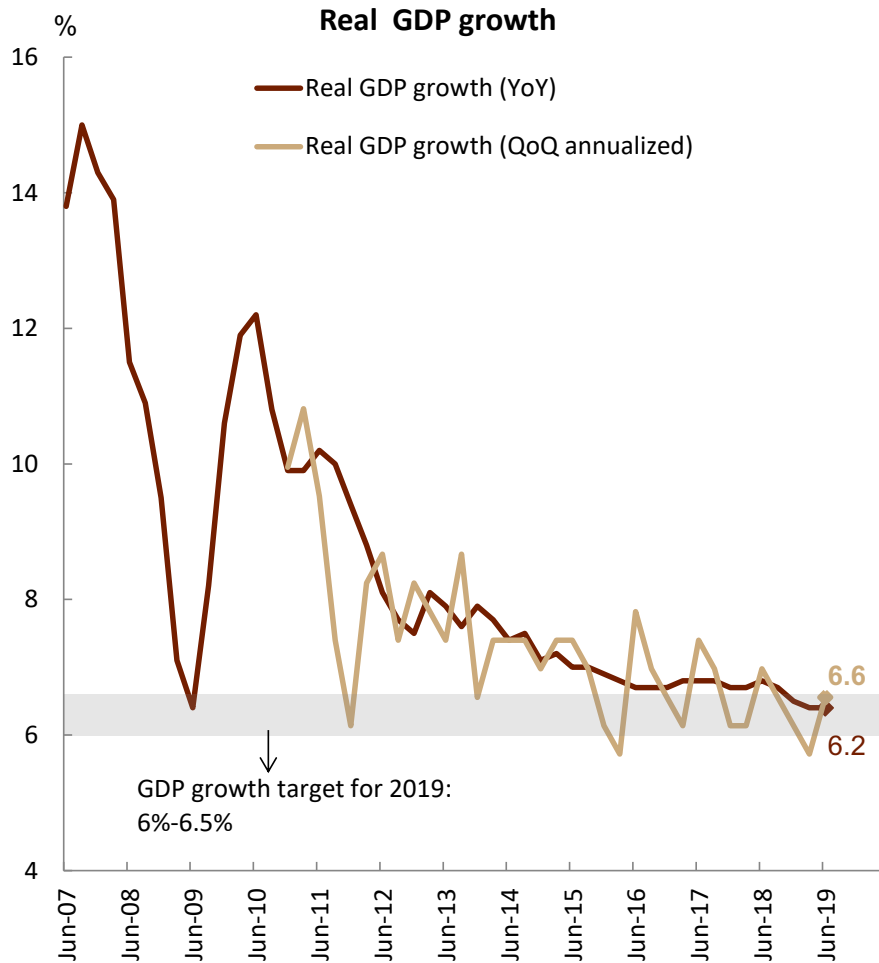
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## **Part I: Current market and macro condition**

# How China performed YTD? Still ranking the top globally

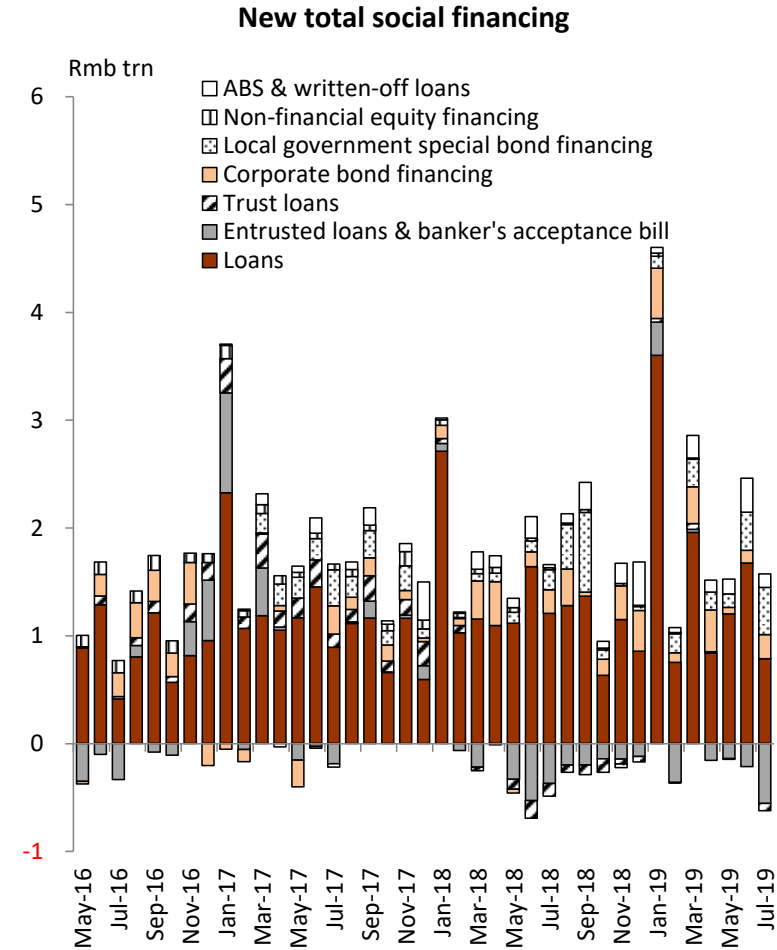
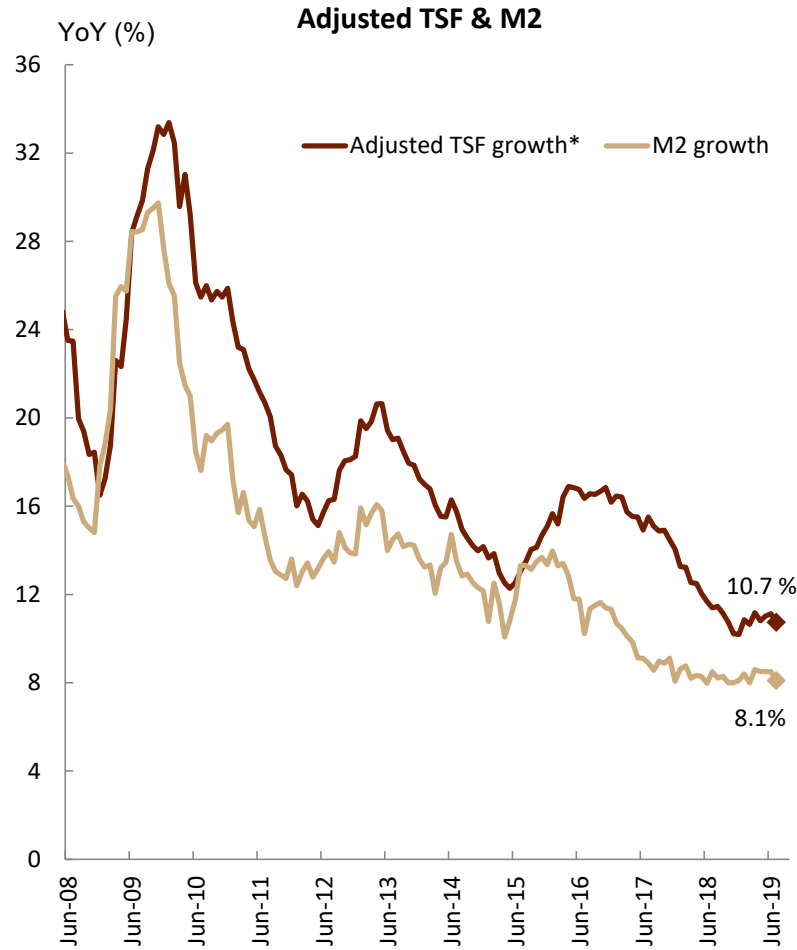


## Overall growth: largely stable despite high volatility for monthly path

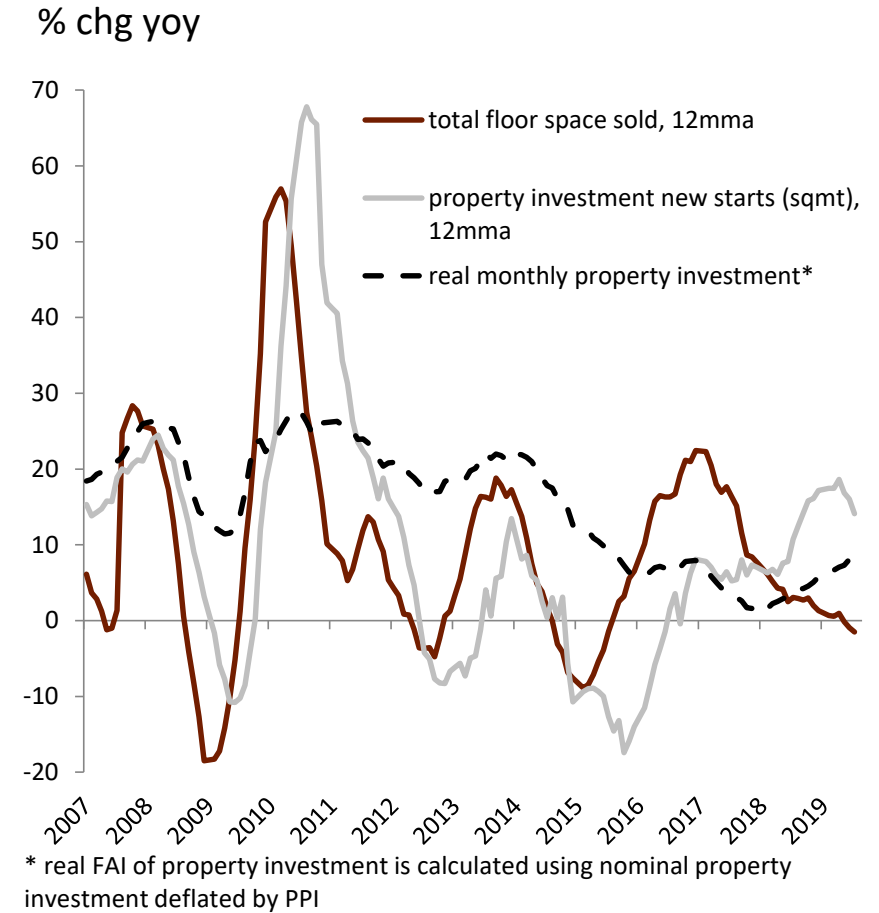
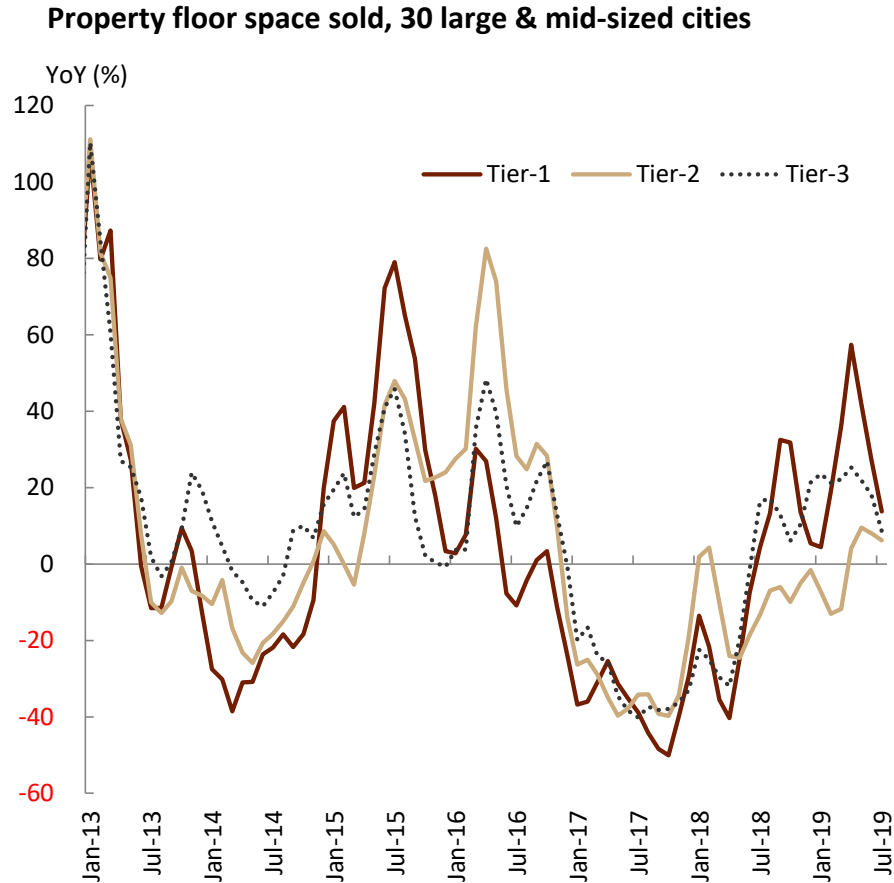




## Monetary: TSF picked up early this year, but moderated again since May after BSB takeover

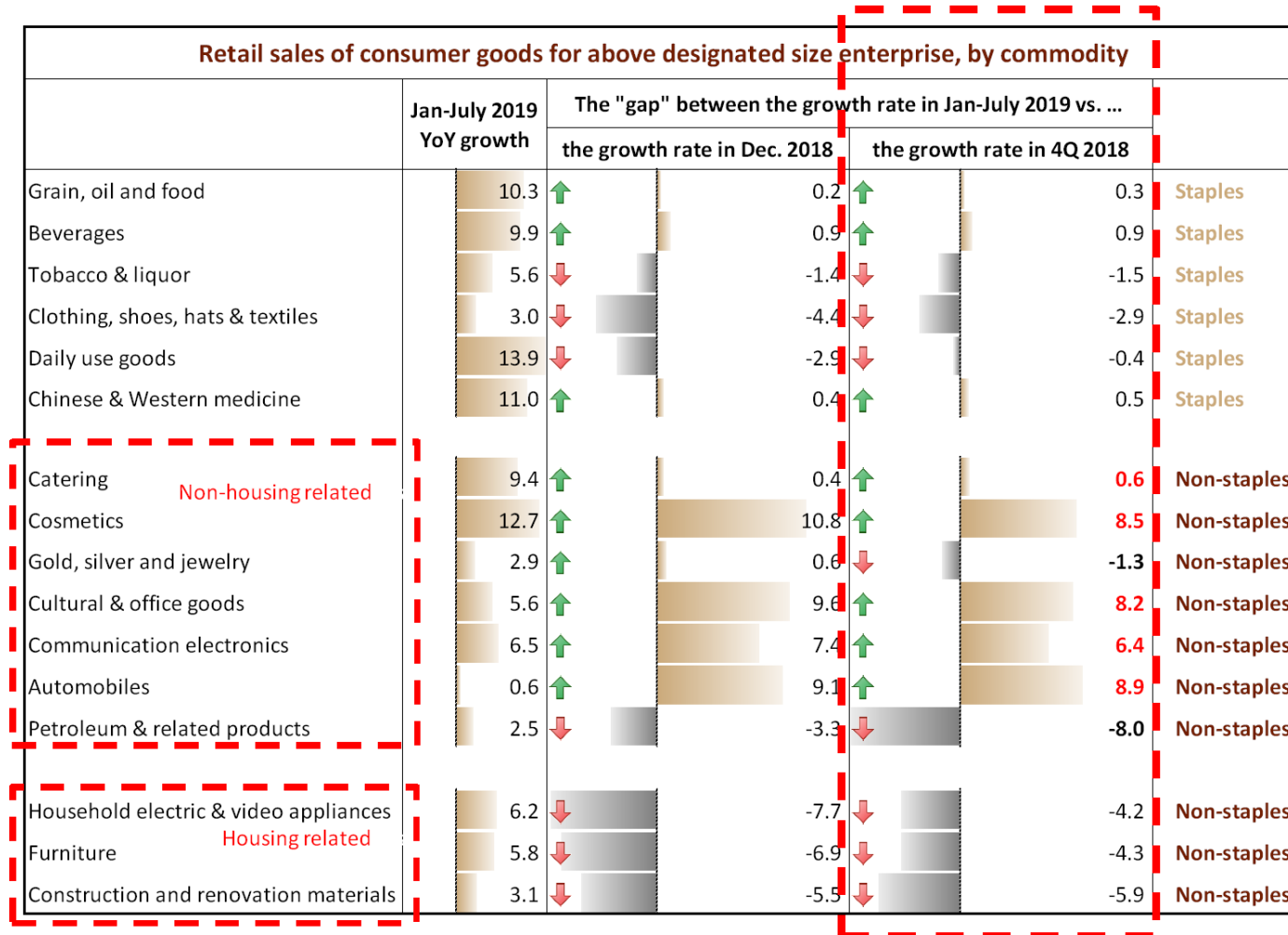


**Property:** more resilient than expected especially for tier-1 cities, but inv't growth may slow down in 2H

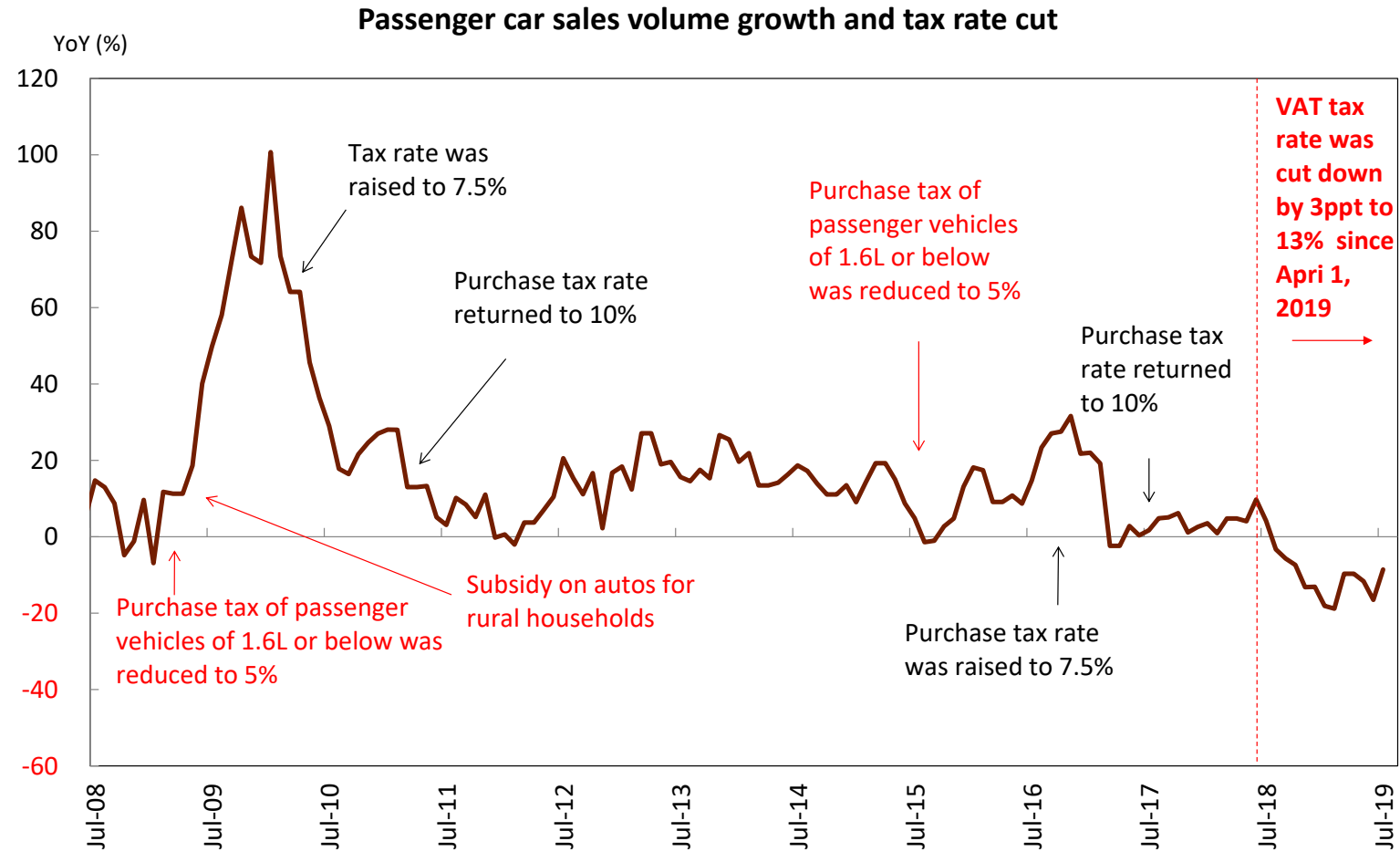


Note: \* Property floor space sold is 3-month moving average. Tier-1 cities (4): Beijing, Shanghai, Guangzhou, Shenzhen. Tier-2 cities (13): Tianjin, Hangzhou, Nanjing, Wuhan, Nanchang, Chengdu, Qingdao, Suzhou, Fuzhou, Xiamen, Changsha, Harbin, Changchun  
Source: CEIC, Wind Info, CICC Research

## Retail sales: non-housing related discretionary consumption also stayed resilient YTD



## Auto: sales remain sluggish but improved sequentially

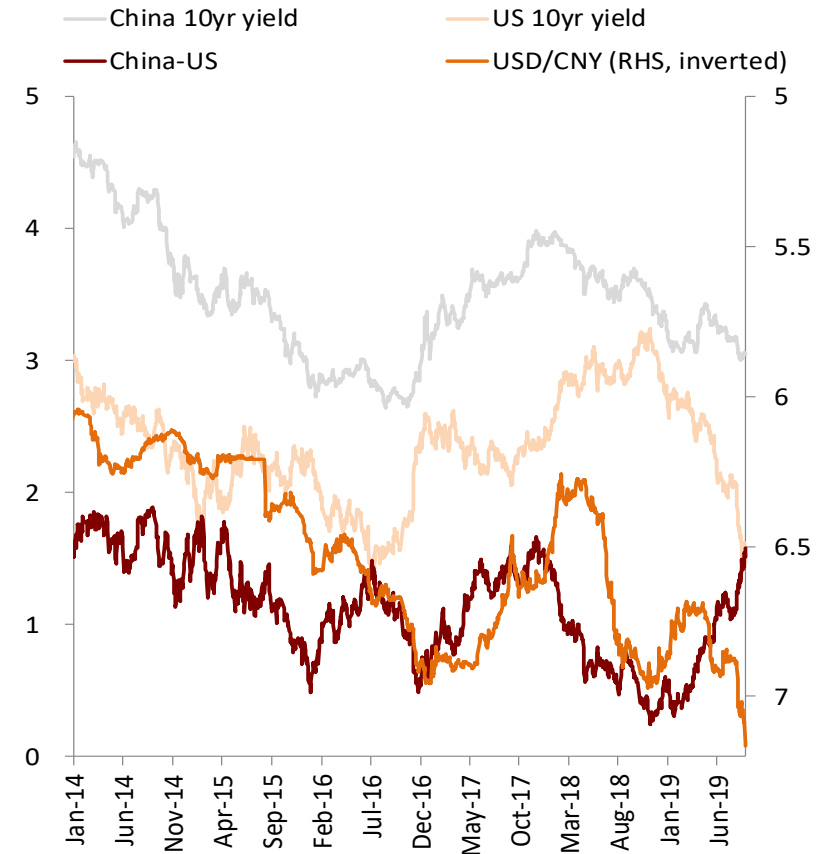


# Monetary: there is more room and necessity to bring down LPR, MLF, and risk-free rates in China

More yields are turning negative global wise, except US and China

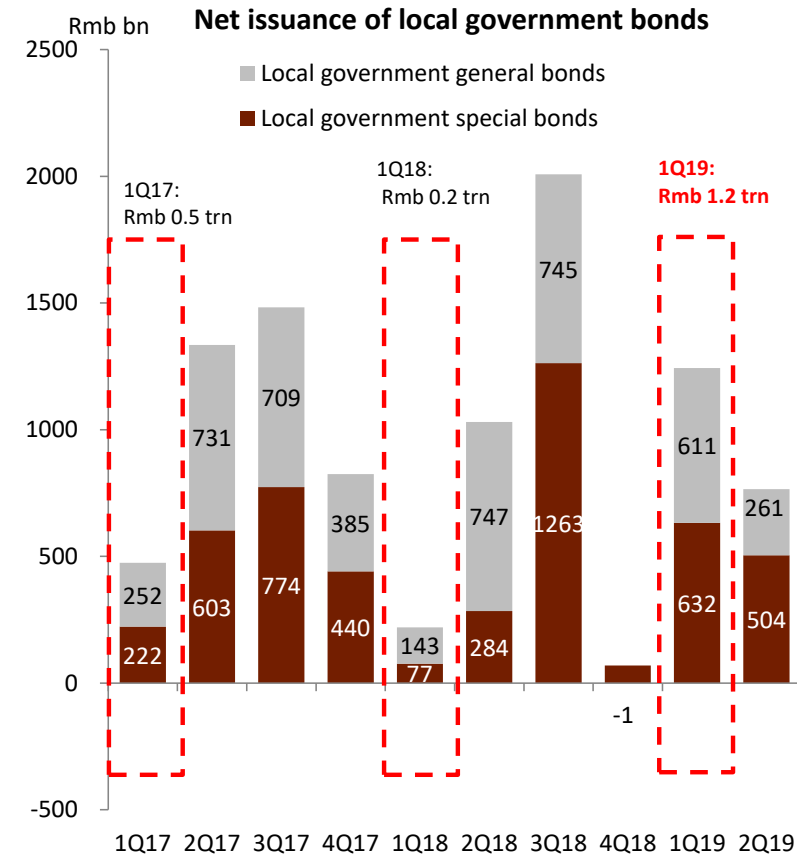
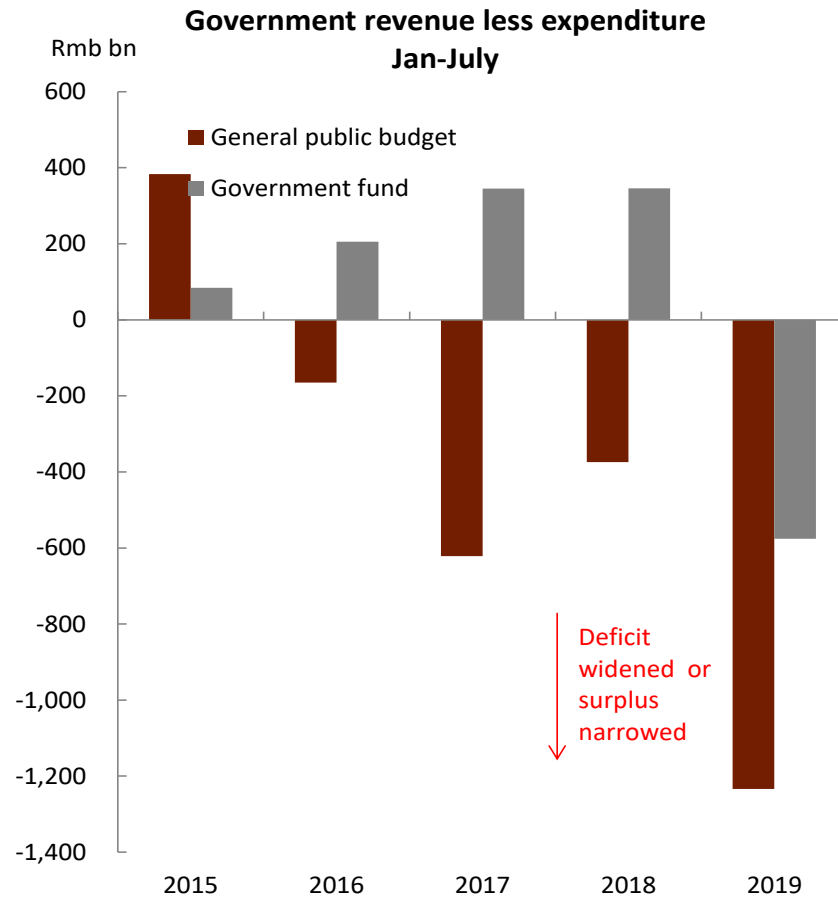
	1yr	2yr	3yr	4yr	5yr	6yr	7yr	8yr	9yr	10yr	15yr	20yr	30yr
Switzerland	-1.09	-1.10	-1.13	-1.12	-1.10	-1.07	-1.04	-1.03	-1.07	-0.99	-0.79	-0.70	-0.53
Japan	-0.25	-0.31	-0.31	-0.34	-0.35	-0.37	-0.39	-0.38	-0.34	-0.28	-0.09	0.06	0.15
Germany	-0.82	-0.89	-0.92	-0.93	-0.89	-0.89	-0.86	-0.82	-0.76	-0.69	-0.55	-0.41	-0.19
Netherlands		-0.86	-0.90	-0.87	-0.81	-0.75	-0.72	-0.65	-0.62	-0.56			-0.20
Denmark		-0.86	-0.89		-0.88	-0.83		-0.76		-0.65		-0.45	
Finland	-0.67	-0.77	-0.79	-0.77	-0.76	-0.66	-0.63	-0.55	-0.50	-0.43	-0.25		0.03
France	-0.74	-0.80	-0.84	-0.82	-0.75	-0.69	-0.63	-0.56	-0.49	-0.41	-0.10	0.00	0.43
Sweden		-0.64		-0.72	-0.70	-0.62	0.04	-0.53		-0.33	-0.16	0.11	
Austria	-0.65	-0.78	-0.78	-0.77	-0.71	-0.68	-0.60	-0.58	-0.52	-0.44	-0.19	-0.09	0.15
Belgium		-0.80	-0.81	-0.74	-0.65	-0.62	-0.55	-0.49	-0.43	-0.35	-0.07	0.15	0.53
Ireland	-0.55	-0.44	-0.65	-0.62	-0.54	-0.42	-0.34	0.57	-0.18	-0.09	0.22	0.42	0.75
Spain	-0.51	-0.56	-0.54	-0.42	-0.36	-0.24	-0.15	-0.08	-0.02	0.08	0.49		0.97
Italy	-0.17	-0.11	0.22	0.36	0.55	0.59	0.81	0.87	0.90	1.14	1.66	1.84	2.20
United States	1.73	1.51	1.43		1.38		1.43			1.47			1.93
China	2.59	2.71	2.80	2.76	2.92	3.19	3.09	3.12	3.15	3.05			3.67

China-US yield spread continues to widen

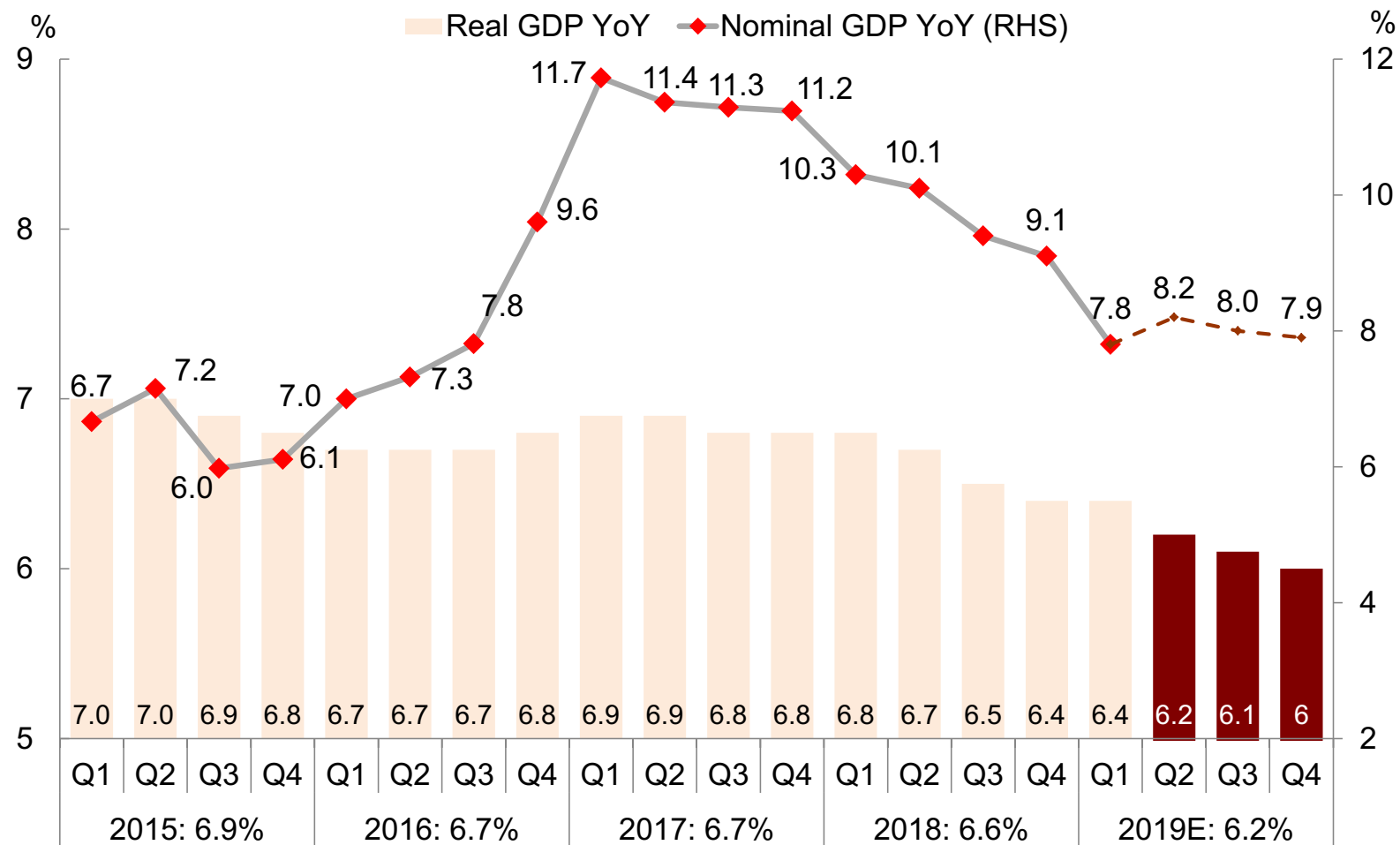




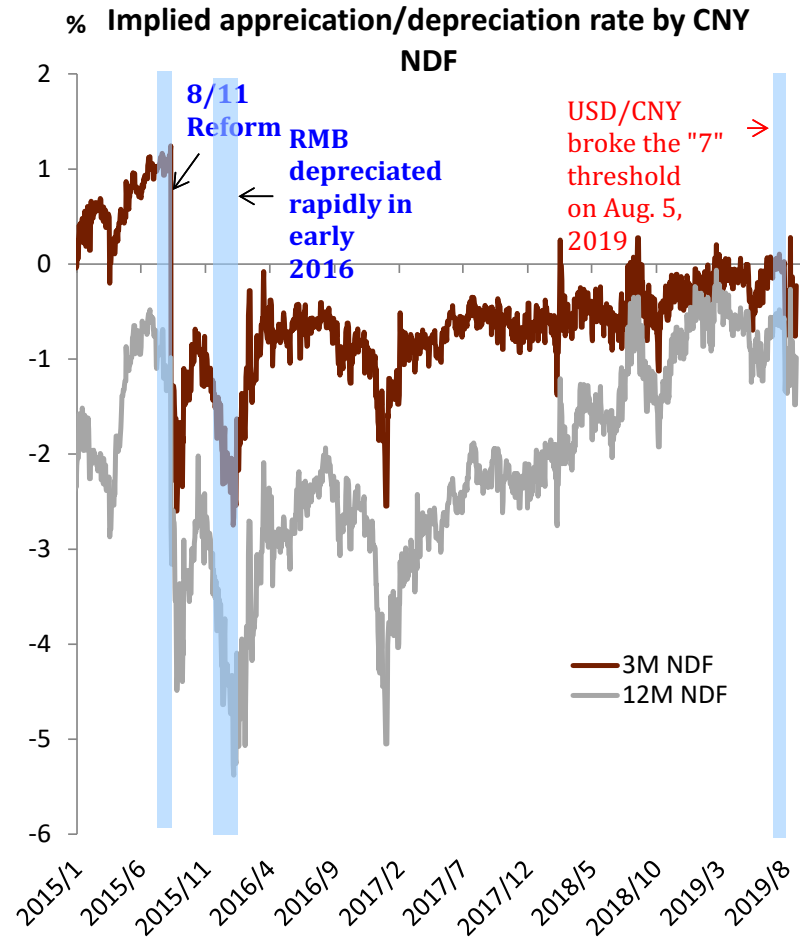
## Fiscal: deficit and local gov't bond issuance expanded to lend supports for moderate recovery in infrastructure inv't



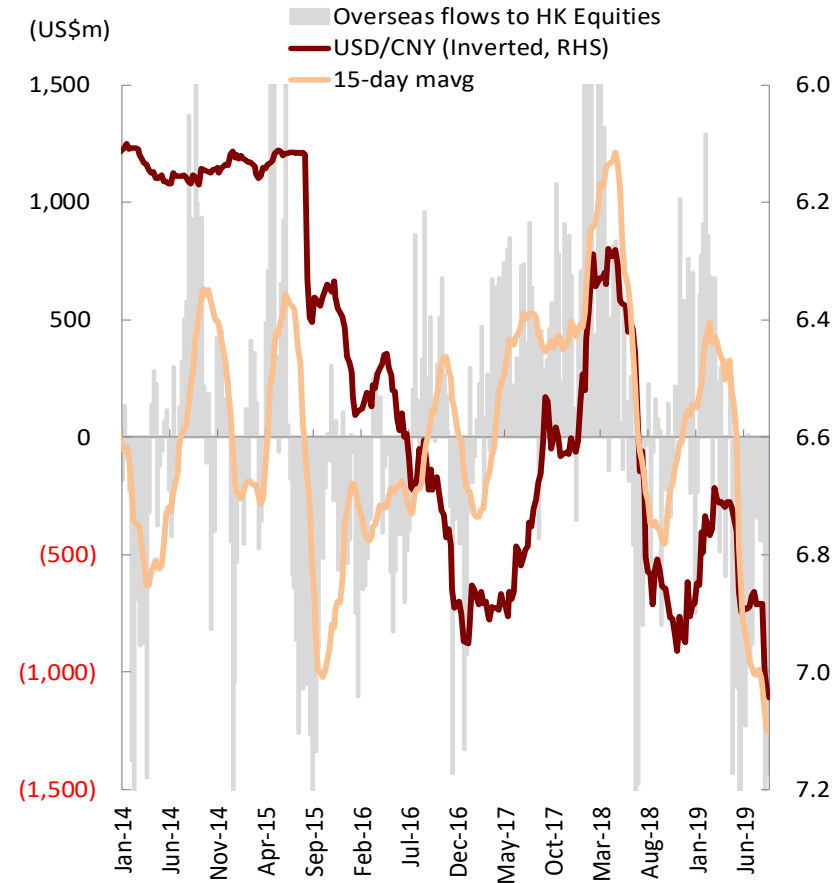
# Growth forecast: China's real GDP is expected to grow 6.2% YoY in 2019 and 6% YoY in 2020



**RMB:** this time is less of a shock; global easing also offers some cushion; but weaker RMB does weigh on global flows

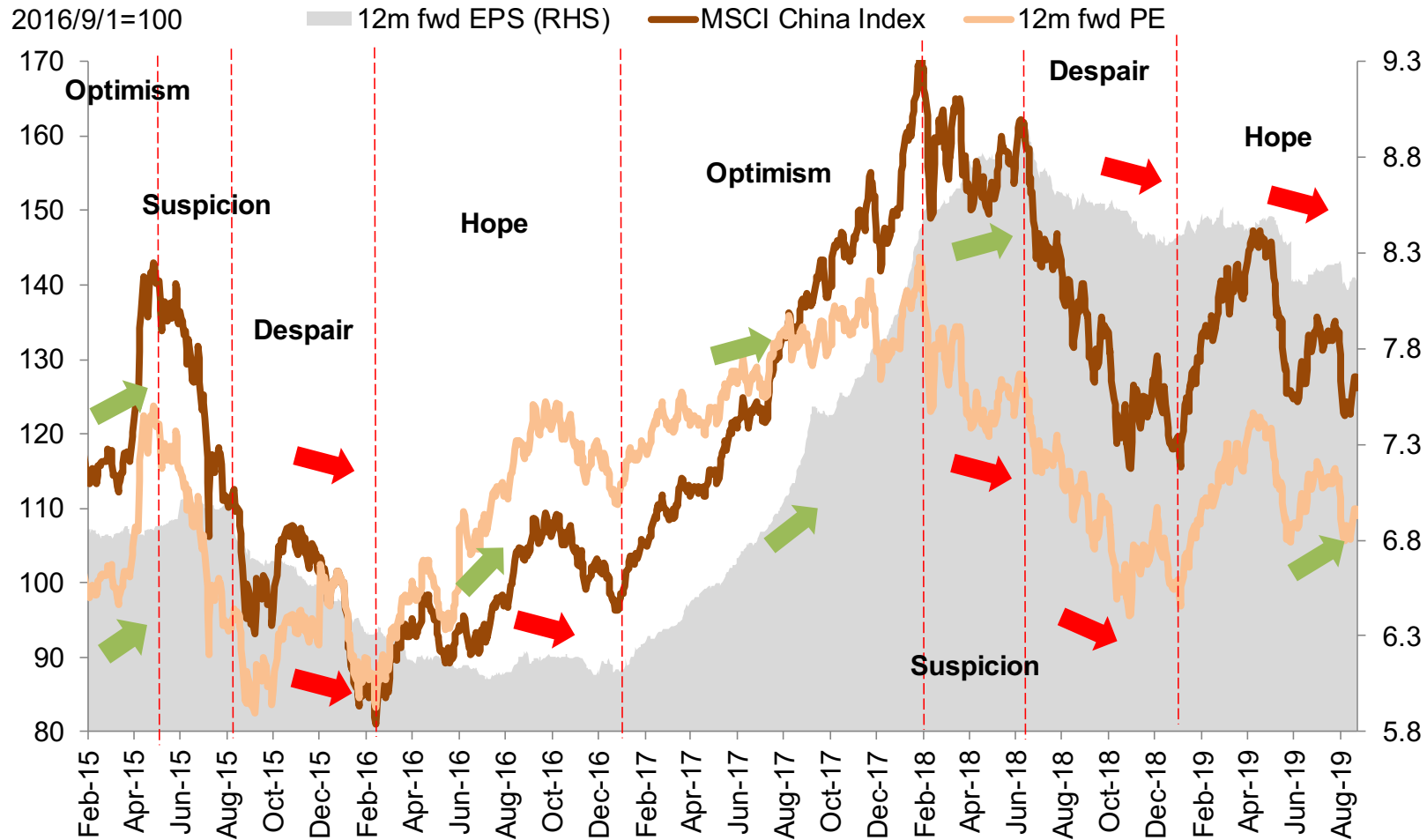


Overseas flows to HK is tightly correlated with RMB

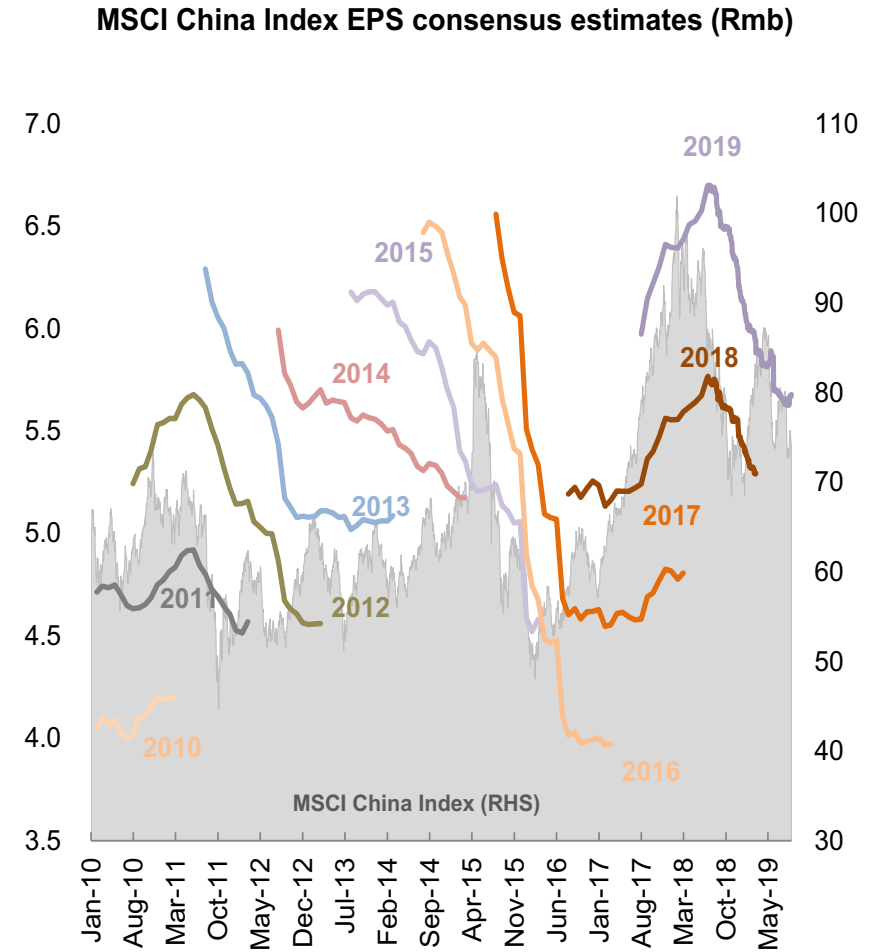
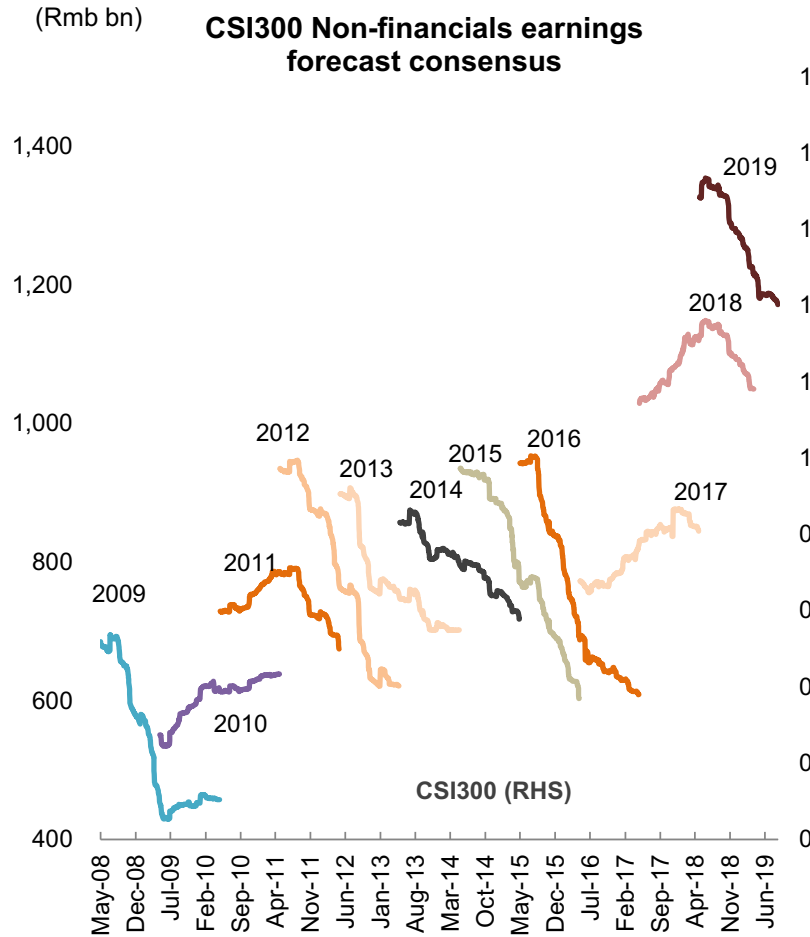


# Where the market stands now? The phase of “Hope”

Valuation rebounded first for the “hope” of future earnings recovery



# Market consensus: the consensus estimates are still in the downturn





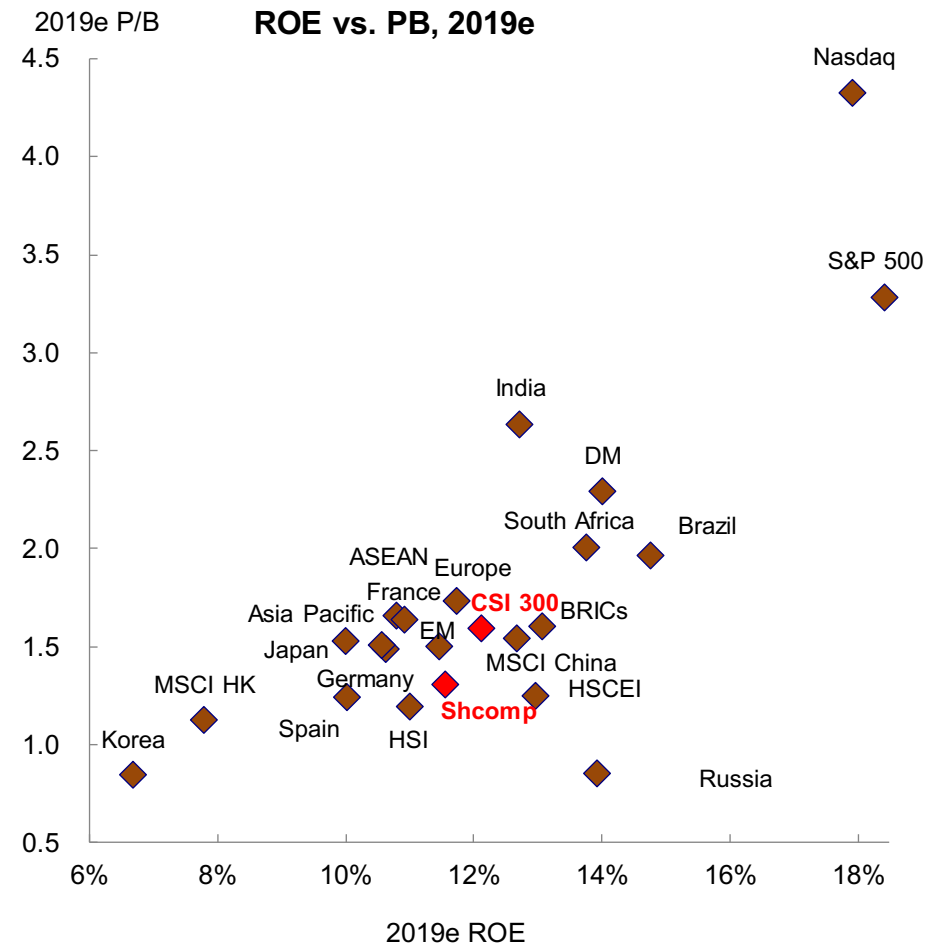
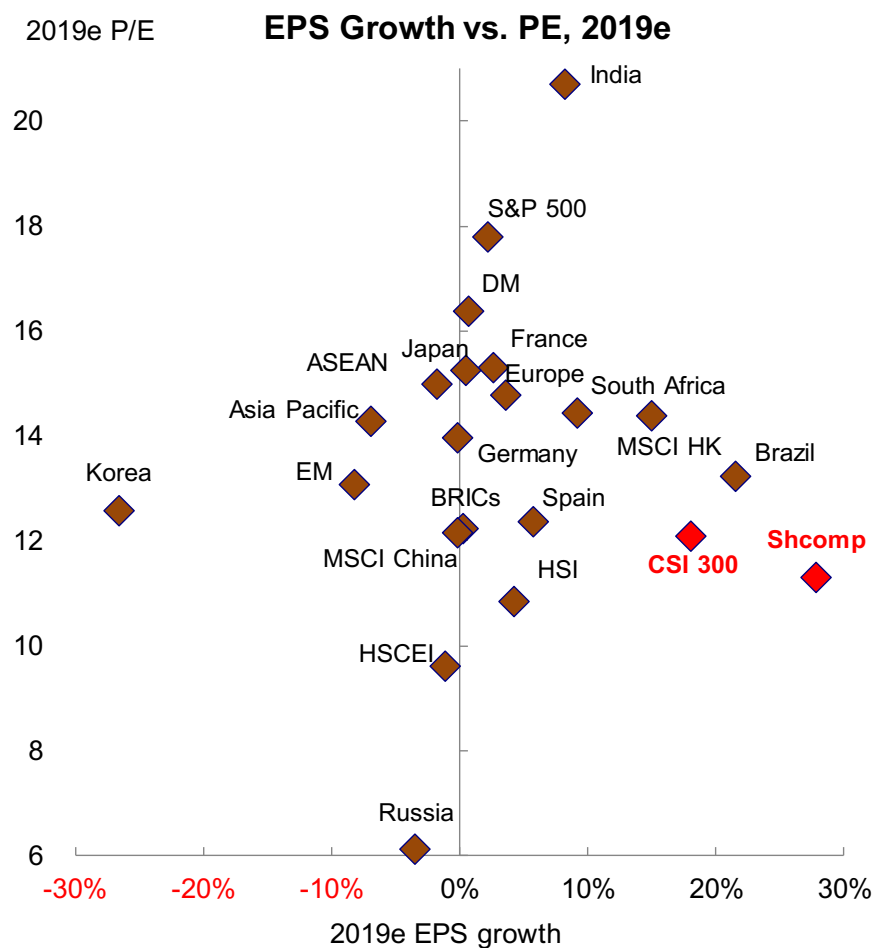
## Valuations: H-shares: close to the troughs repeatedly tested after the financial crisis



## Competitive advantage: equity looks more attractive vs. bond, 1 std. dev. above historical average



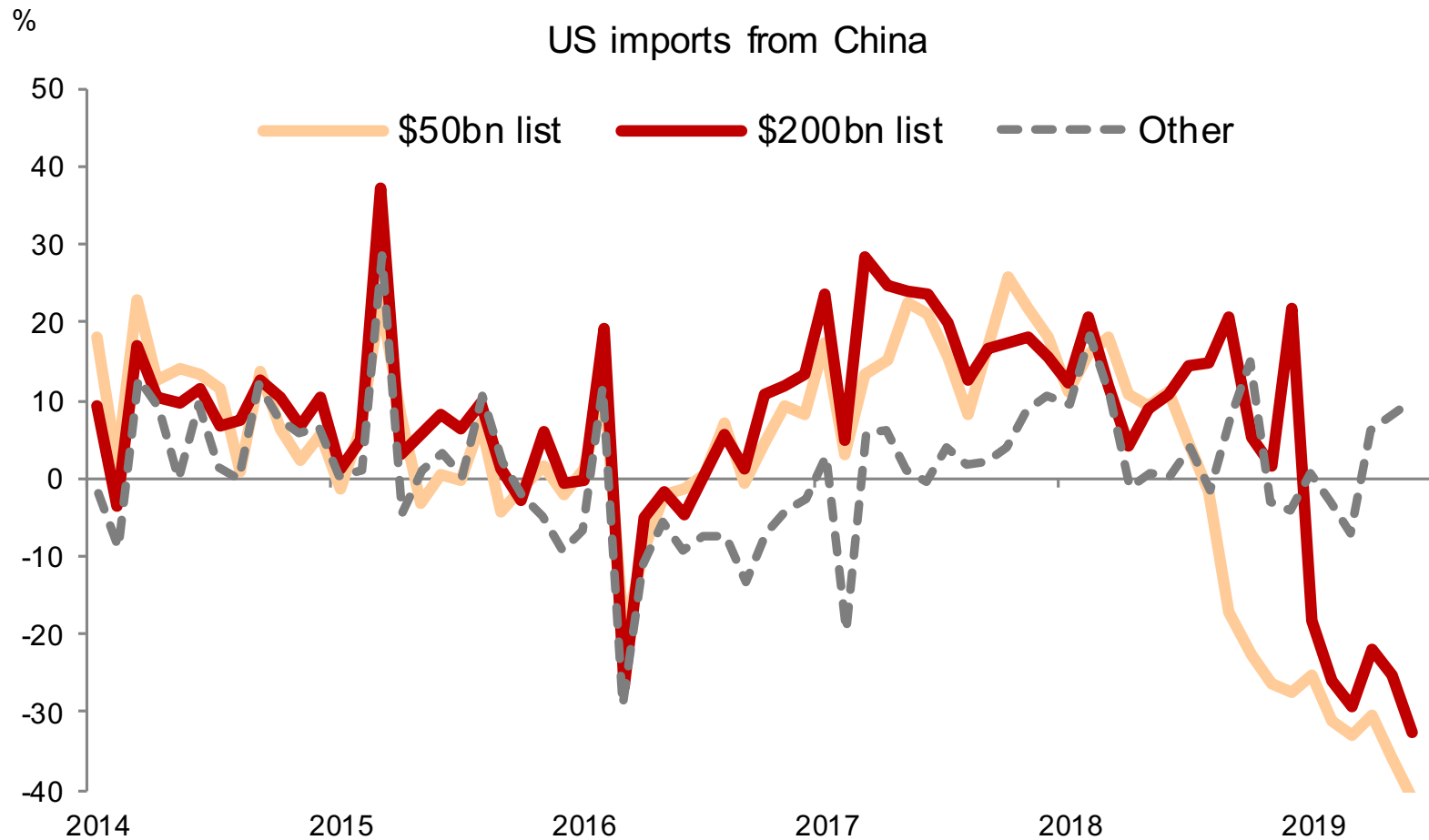
# Competitive advantage: better risk-reward global wise



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## Part II: Challenges and policy responses

## External: trade frictions might still pose external demand shocks in the near term



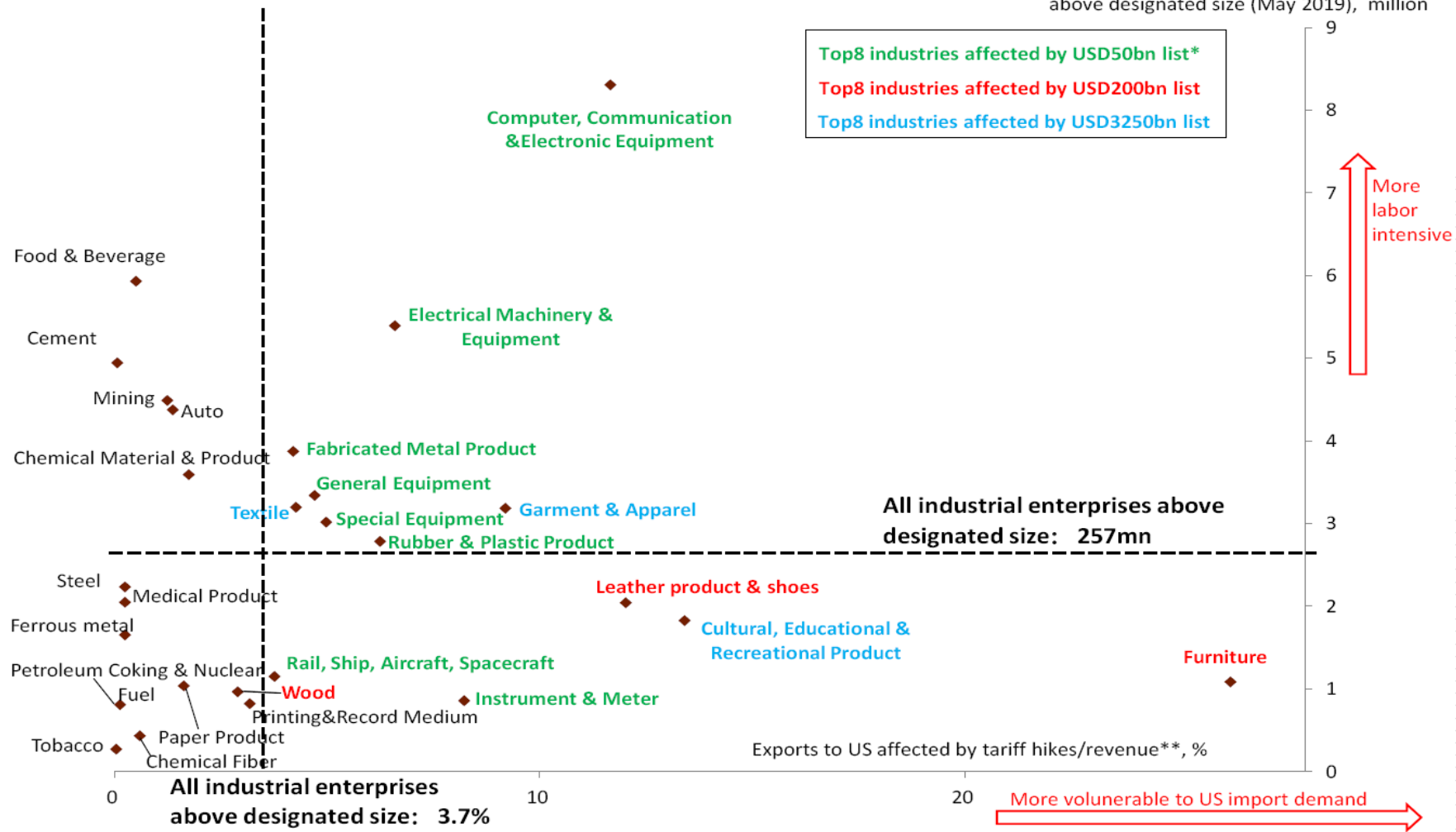
Source: USTR, Wind, CICC Research



# Sectors affected by tariffs more initially are mostly labor intensive

Assuming blanket tariff hike on Chinese exports to the US

No. of employees in industrial enterprise above designated size (May 2019), million

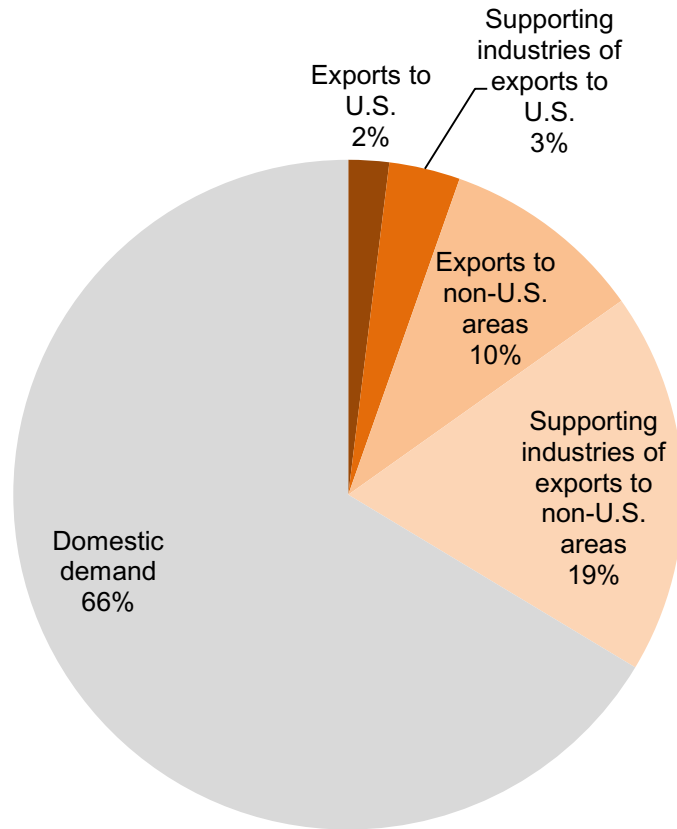


\*If a industry is included in top8 industries affected by tariff hikes of two or more lists, its label's color is the same as the legend of the earliest-published list.

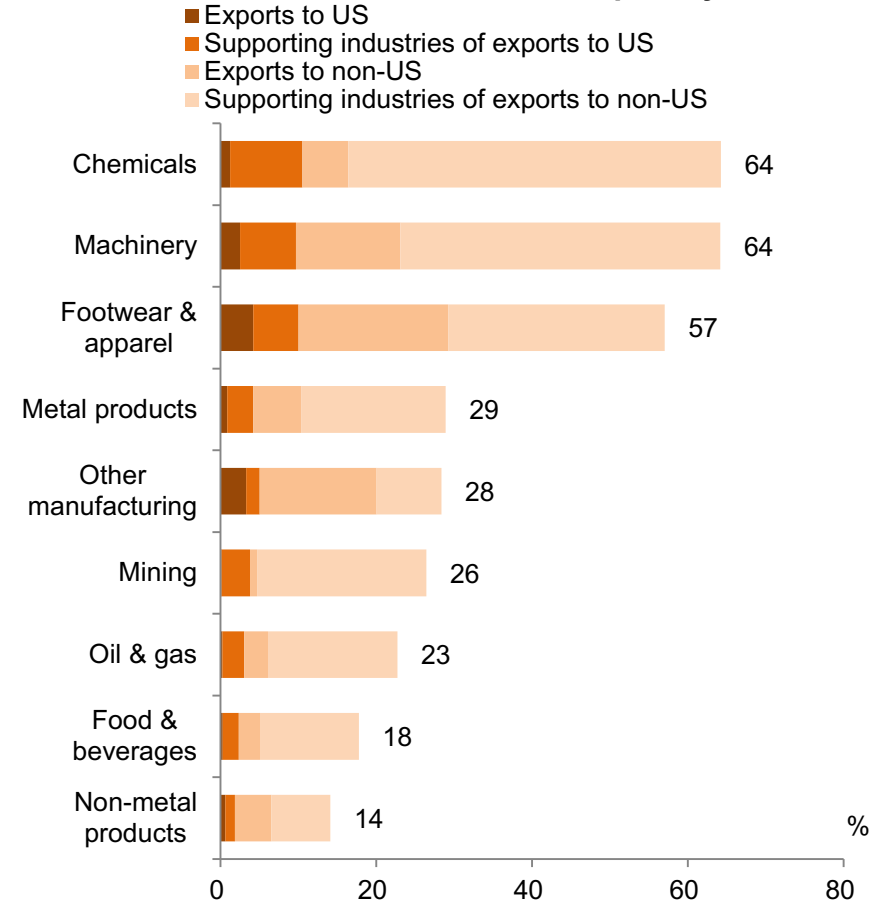
\*\*'Exports to US affected by tariff hikes/revenue' is a useful indicator to compare tariff hikes' impacts on different industries, but can not be used to estimate the impact from tariff hikes on a given industry because the indicator may underestimate the impact.

# Existing tariffs may drag down China 2019 nominal GDP by 0.4ppt in base case scenario

Breakdown of China's industrial output



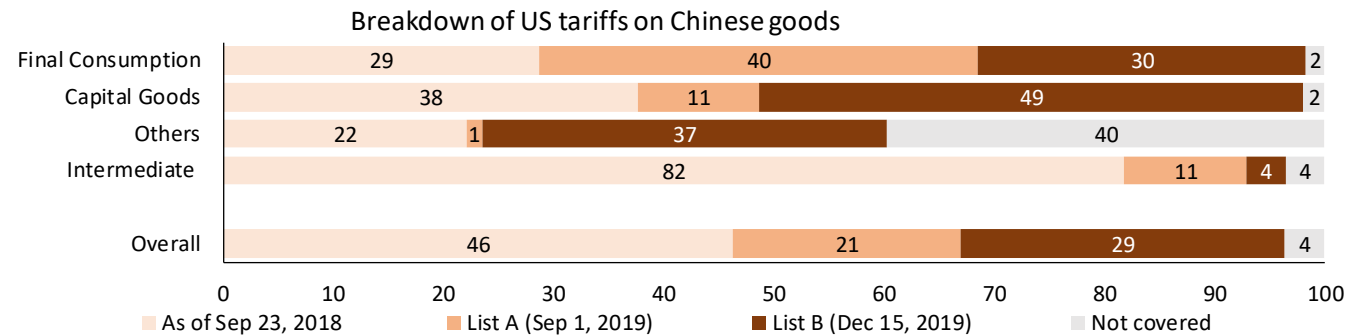
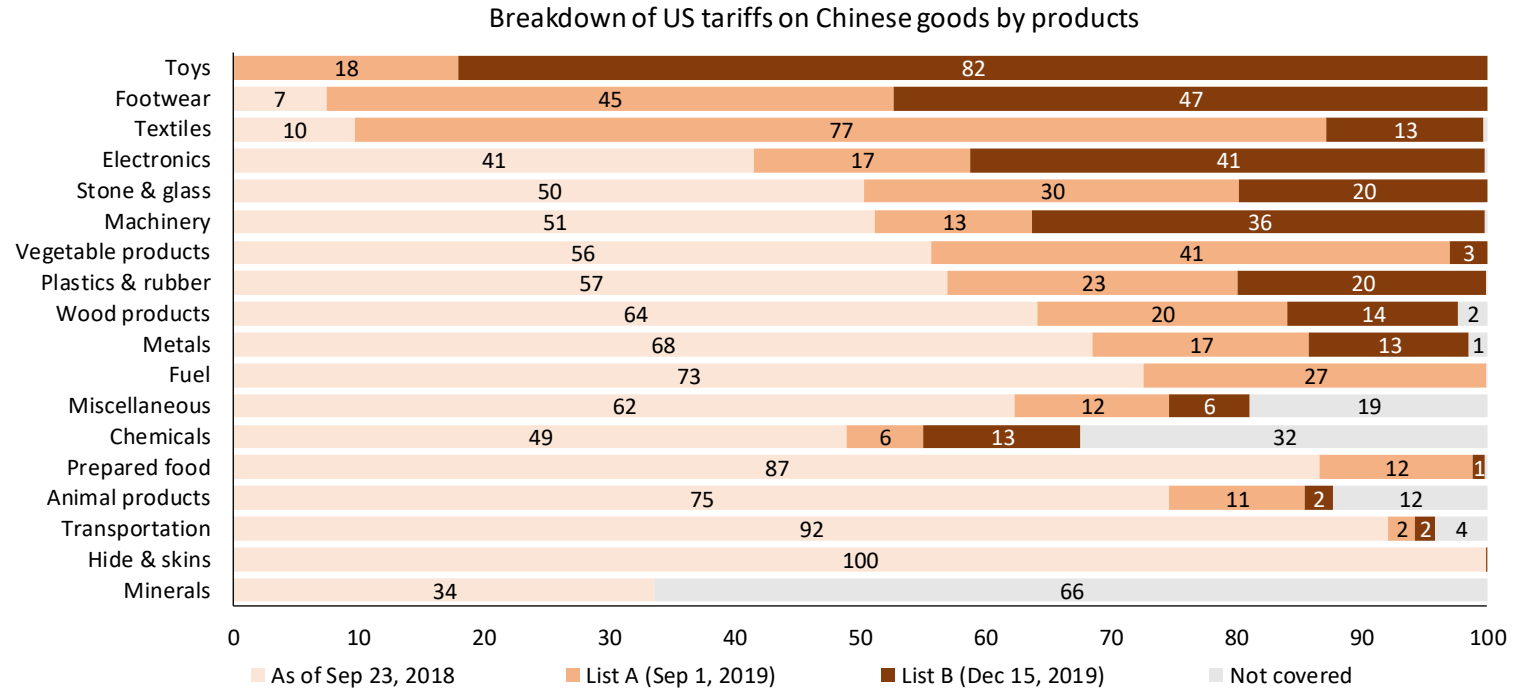
Breakdown of China's industrial output: by sector



## A-shares' earnings growth could thereby be 4.2ppt lower due to the tariffs in base case

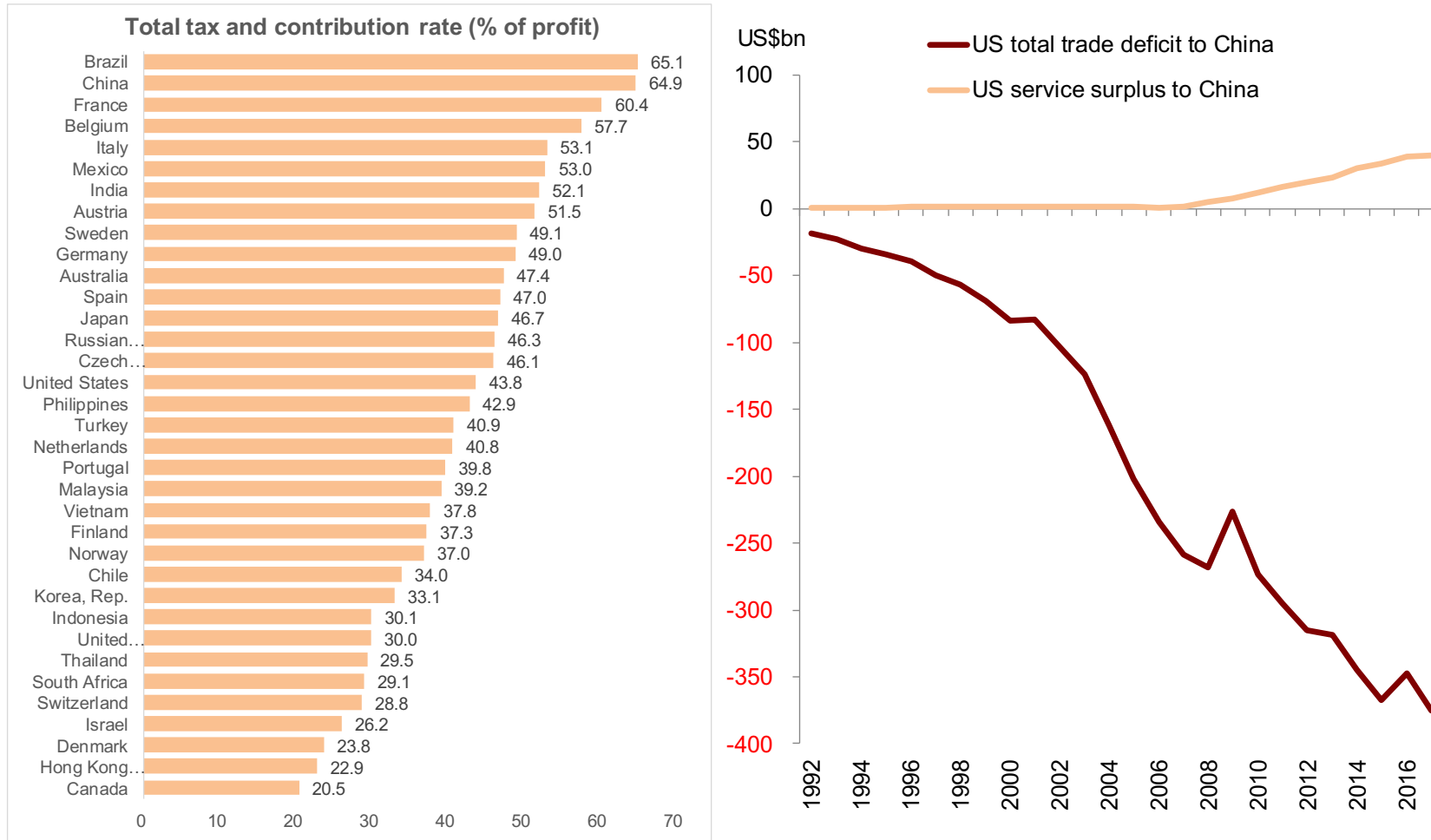
Scenario analysis on US-China trade friction	Impact on export growth	Impact on GDP growth	Impact on non financial listcos revenue growth	Impact on net margin of non financials listcos	Impact on earnings growth of non financial listcos over next 12 months
<b>A-share non financials</b>					
Bull	-2.2%	-0.2%	-0.5%	-0.1%	-2.3%
Base	-4.0%	-0.4%	-0.9%	-0.1%	-4.2%
Bear	-6.2%	-0.6%	-1.4%	-0.2%	-6.6%
<b>Offshore Chinese non financials</b>					
Bull	-2.2%	-0.2%	-0.5%	-0.1%	-2.8%
Base	-4.0%	-0.4%	-0.9%	-0.3%	-5.1%
Bear	-6.2%	-0.6%	-1.5%	-0.4%	-8.1%
Assumption 1: US\$50bn/US\$200bn/Remainders imports to tariff has elasticity of 2/1.5/1 respectively					
Assumption 2: A-share/offshore Chinese non-financials revenue to nominal GDP growth has elasticity of 2.31/2.44					
Assumption 3: A-share/offshore Chinese non-financials net margin to export growth has elasticity of 0.03/0.07					

## But further escalation could also hurt US by passing through higher cost and domestic inflation



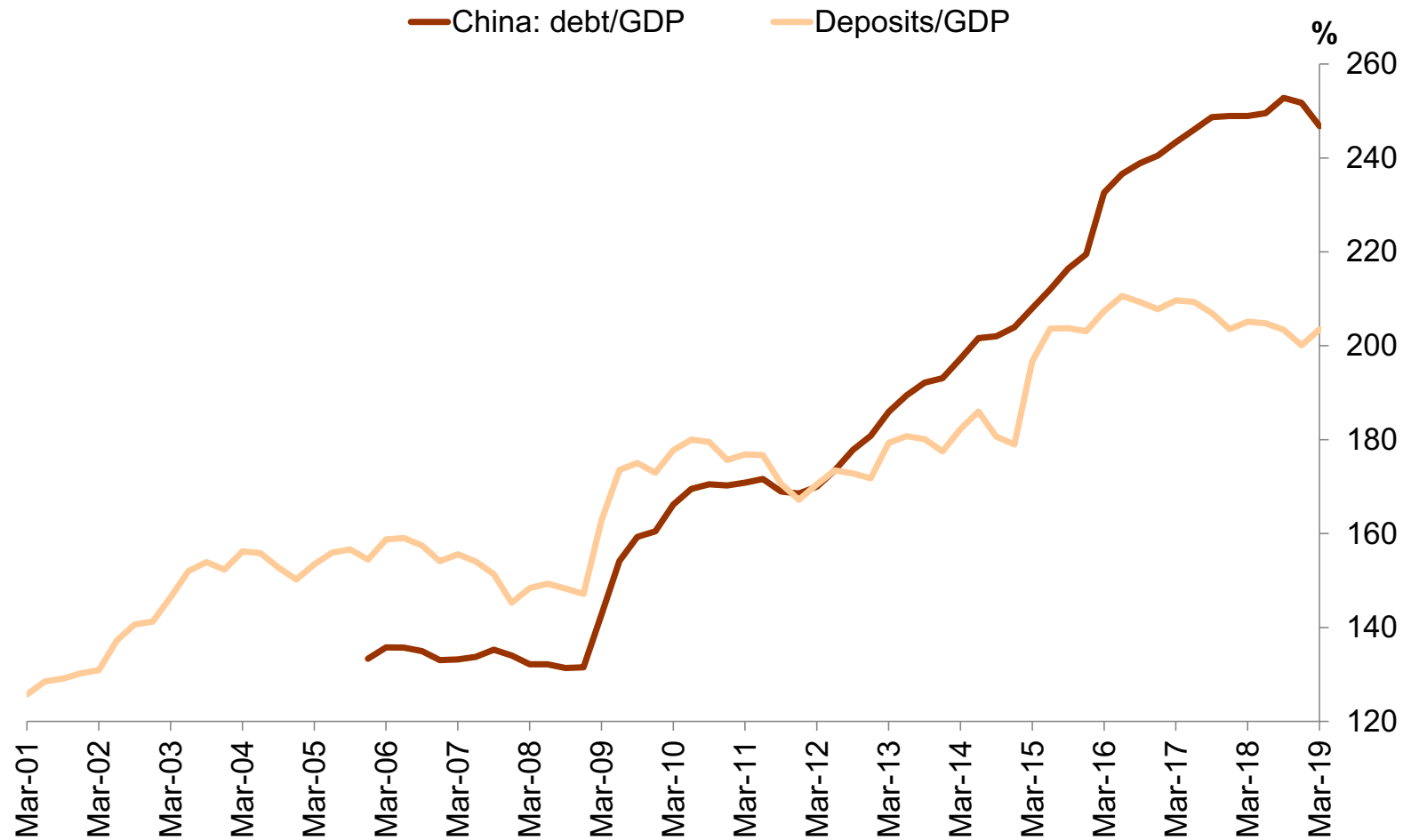
Source: USTR, PIIE, Wind, CICC Research

**Policy responses:** 1) boost domestic demands (e.g. VAT & fee cut, auto, infrastructure inv't); 2) to open service accounts

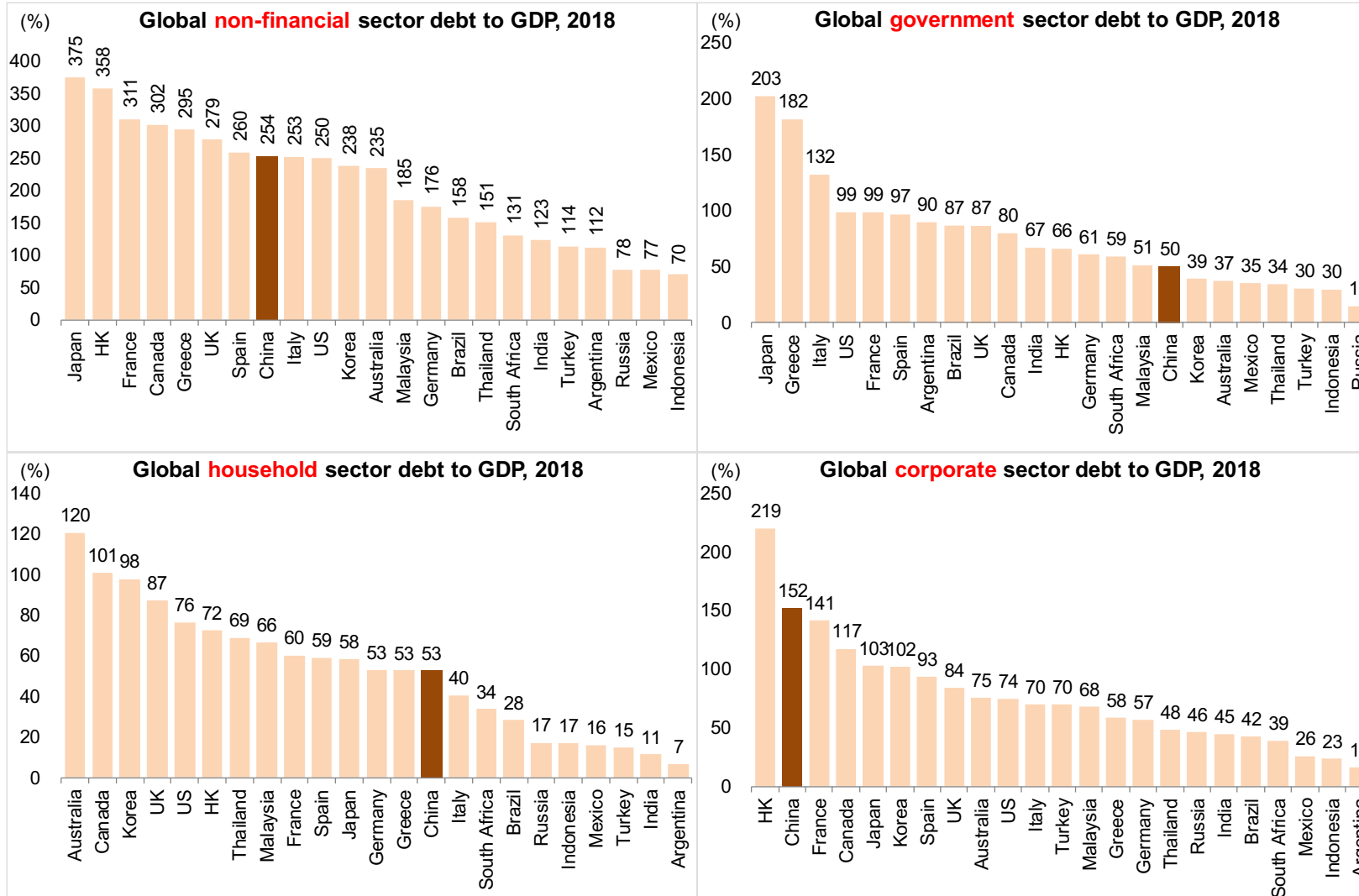




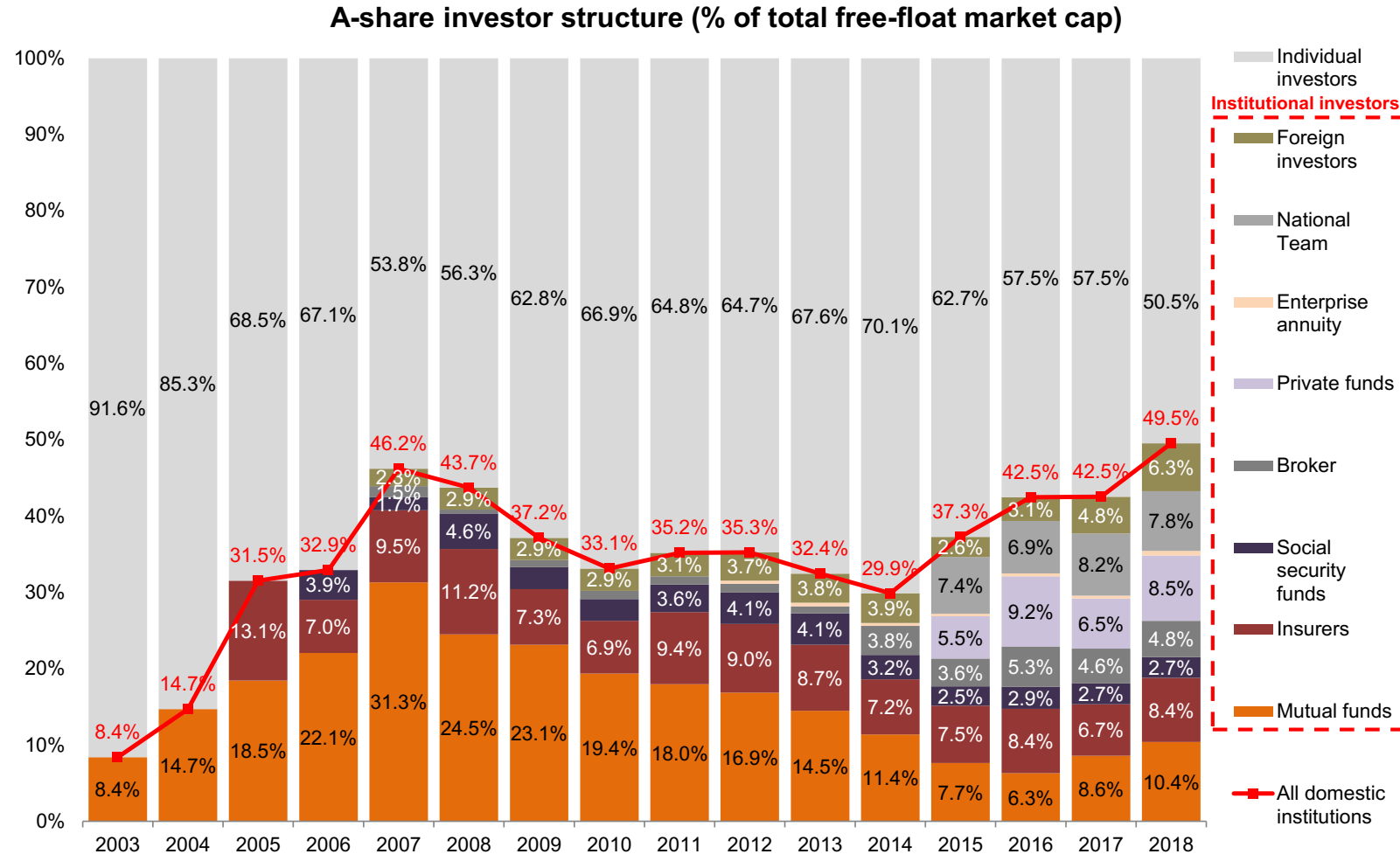
## Internal: the mystery of China's “high leverage”: high savings + the inefficient financial system



## By sector: more critical for corporate and LGFV; household & govt sectors are in net cash



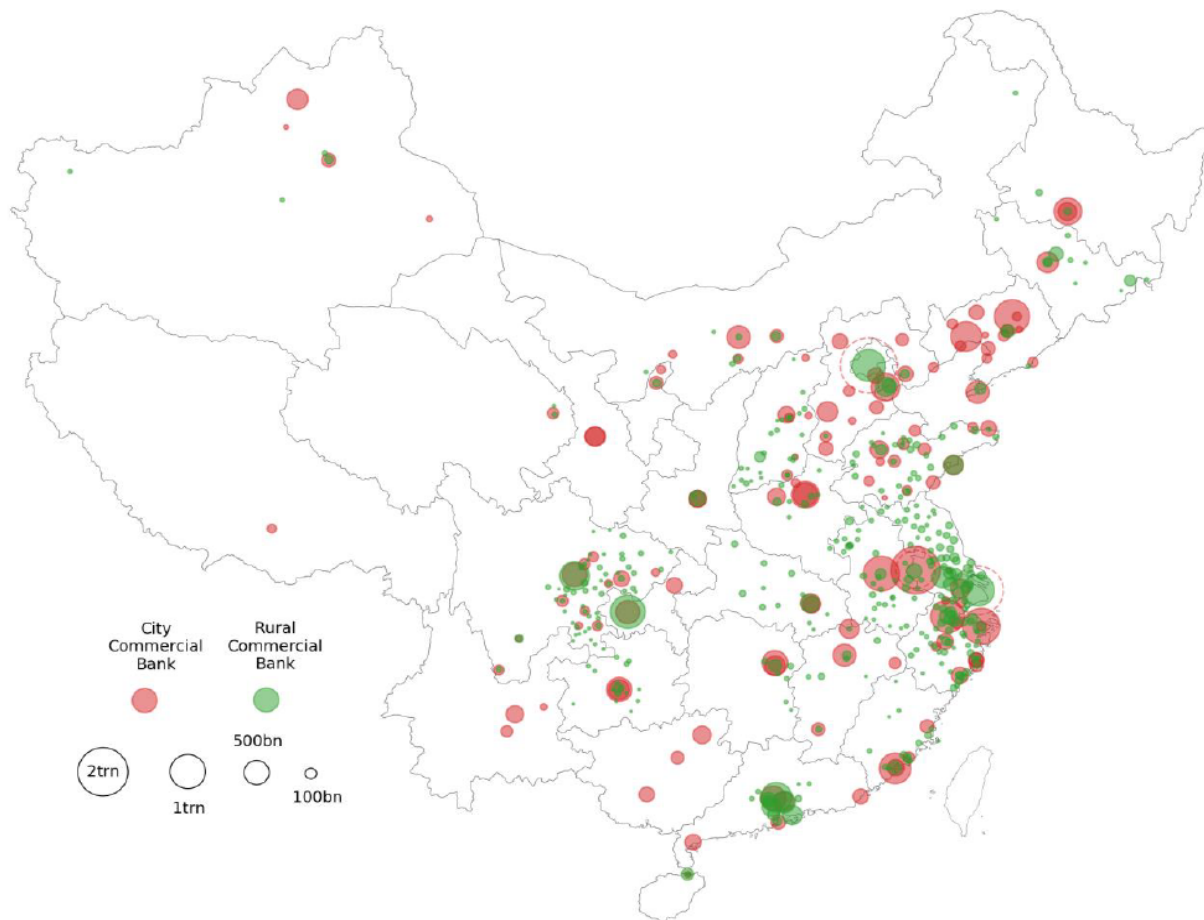
# Policy responses: promote long-term investors (institutional & foreign); share of retail investors could be below 50% now



Source: Wind, CICC Research

# But current small-bank deleveraging and tightening financial regulations could weigh on TSF growth

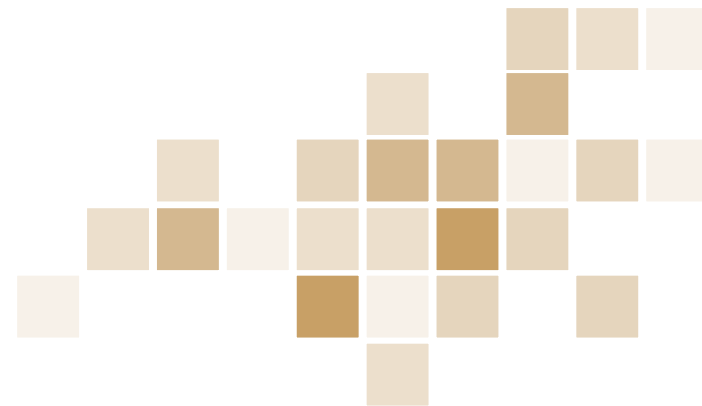
Total assets of City Commercial Banks & Rural Commercial Banks



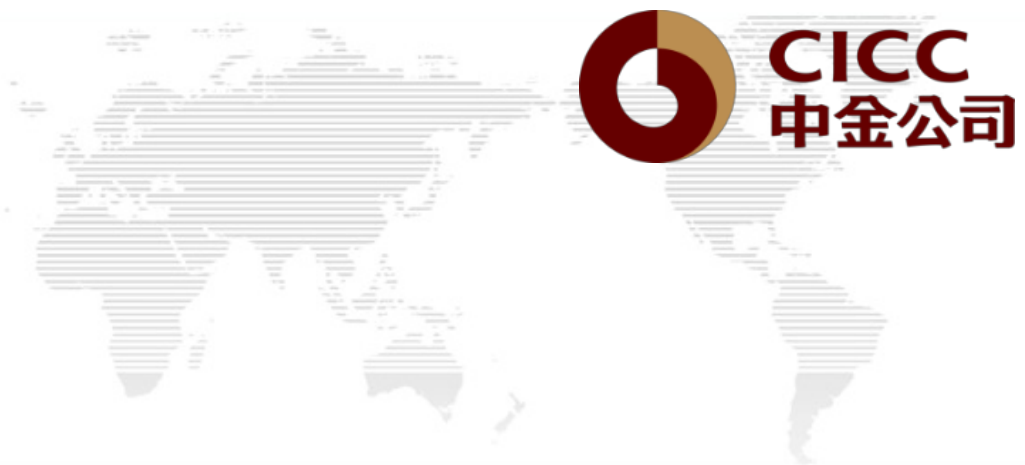
Total asset of top 30 city commercial banks & rural commercial banks



Source: CEIC, Wind, CICC Research

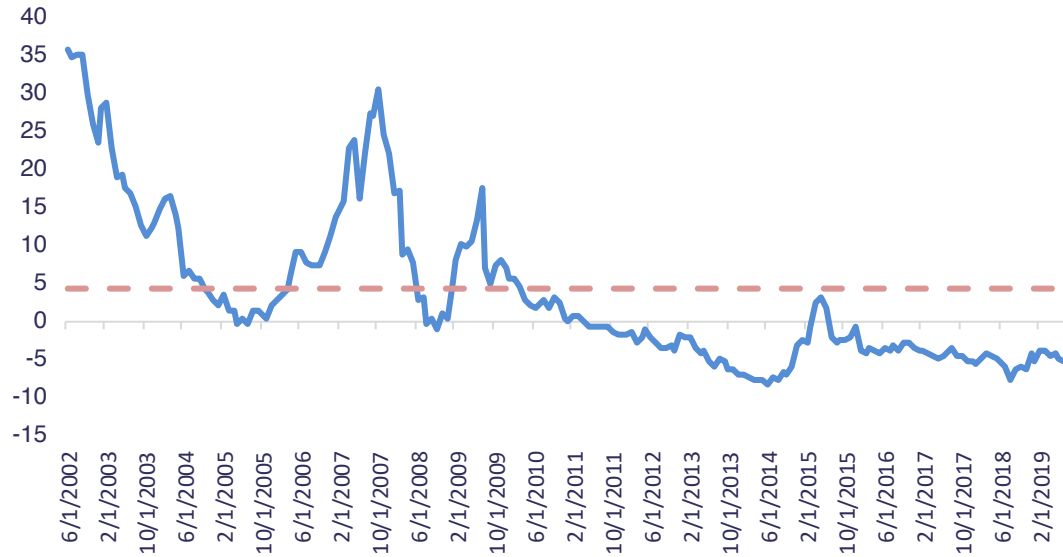


**Thank you!**

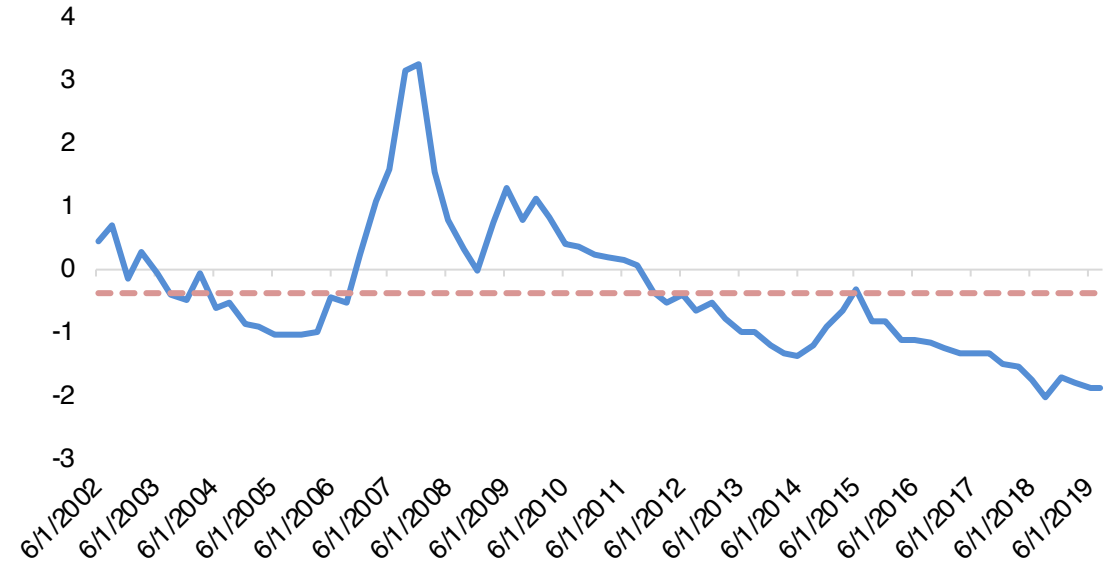


# Mainland Chinese equity market is selling at a multi-year low discount to US equities

Shanghai Composite Index P/E – S&P 500  
Index P/E<sup>1</sup>



Shanghai Composite Index P/B – S&P 500  
Index P/B<sup>2</sup>

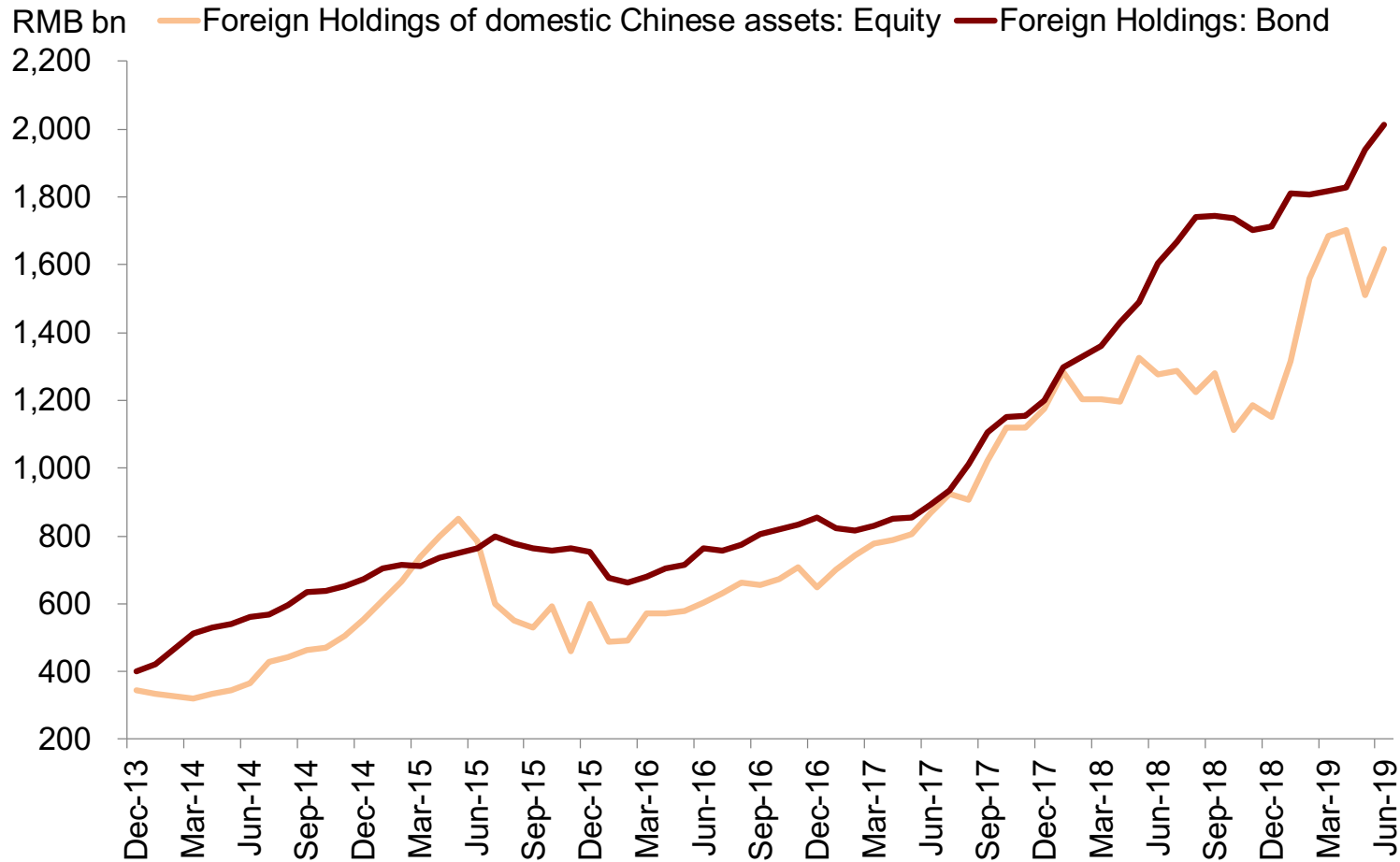


Source: Bloomberg as of 8/31/2019

<sup>1</sup>The price-earnings ratio (P/E Ratio) is the ratio for valuing a company that measures its current share price relative to its per-share earnings.

<sup>2</sup>The price to book ratio (P/B Ratio) is the ratio for valuing a company that measures its current share price relative to its per-share book value.

# There have been continuous foreign inflows via stock and bond connect into Chinese domestic assets



Source: Bloomberg, Wind, CICC Research

# The Index Matters

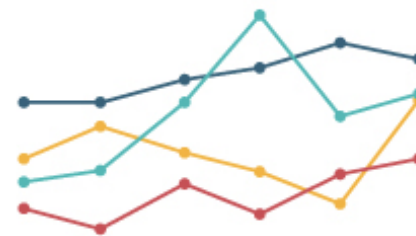
MSCI is a trusted index provider for the largest global investment managers



**>\$14.8 trillion**  
in equity assets are  
estimated to be  
benchmarked to  
MSCI indexes<sup>1</sup>



**99 of top 100**  
global investment  
managers are  
MSCI clients<sup>2</sup>



**1040+**  
ETFs are based on  
MSCI indexes, more than  
any other index provider<sup>3</sup>



**94%**  
of US pension fund  
assets invested in  
global equities are  
benchmarked to MSCI<sup>4</sup>

<sup>1</sup> As of June 30, 2018, as reported on September 30, 2018 by eVestment, Morningstar and Bloomberg, retrieved 6/30/2019.

<sup>2</sup> Based on latest P&I AUM data and MSCI clients as of March 2018, retrieved 6/30/2019.

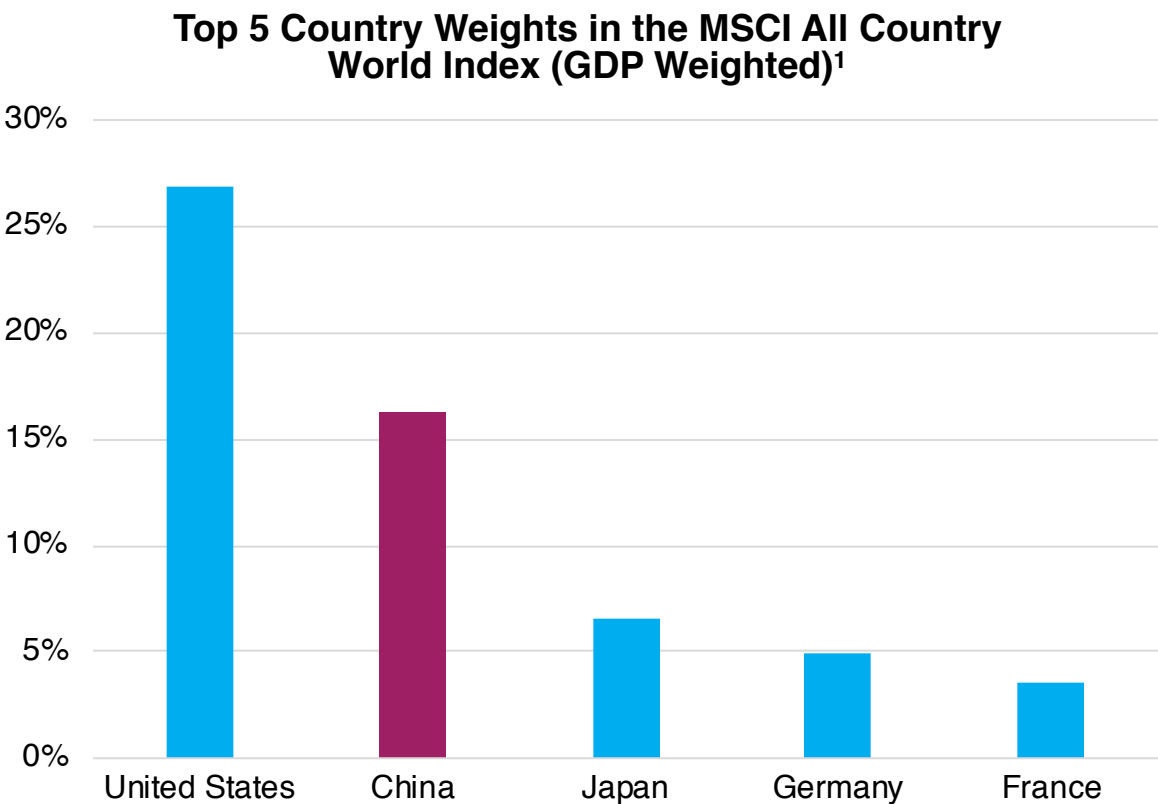
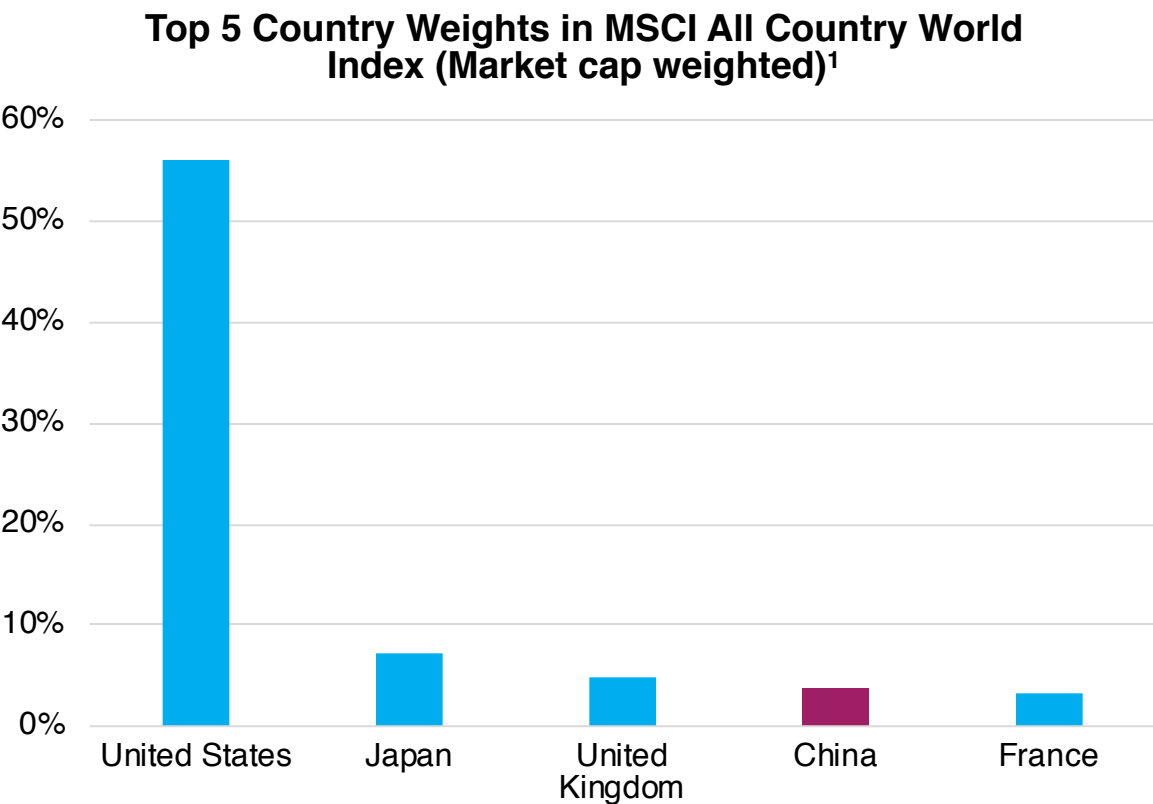
<sup>3</sup> As of September 2018, retrieved 6/30/2019; defined as each share class of an exchange traded fund, as identified by a separate Bloomberg ticker. Only primary listings, and not cross-listings, are counted.

<sup>4</sup> As of Dec 2016, according to Intersec LLC, retrieved 6/30/2019.



# The China A-Share market is too big to ignore

Even though China is the world’s second largest economy and stock market, China A-Shares are still underrepresented in global capital markets.



1. Data from MSCI as of 8/31/2019. See end of the presentation for index definitions

# MSCI's current Global Standard definition of China only represents a small portion of China's total market

The MSCI China Index was historically limited to Chinese companies listed on the Hong Kong Stock Exchange. Recently, MSCI expanded this definition to include US-listed Chinese companies. This definition represents only a small percentage of Chinese stocks.

## MSCI's Current Global Standard Definition of China

### MSCI China Index

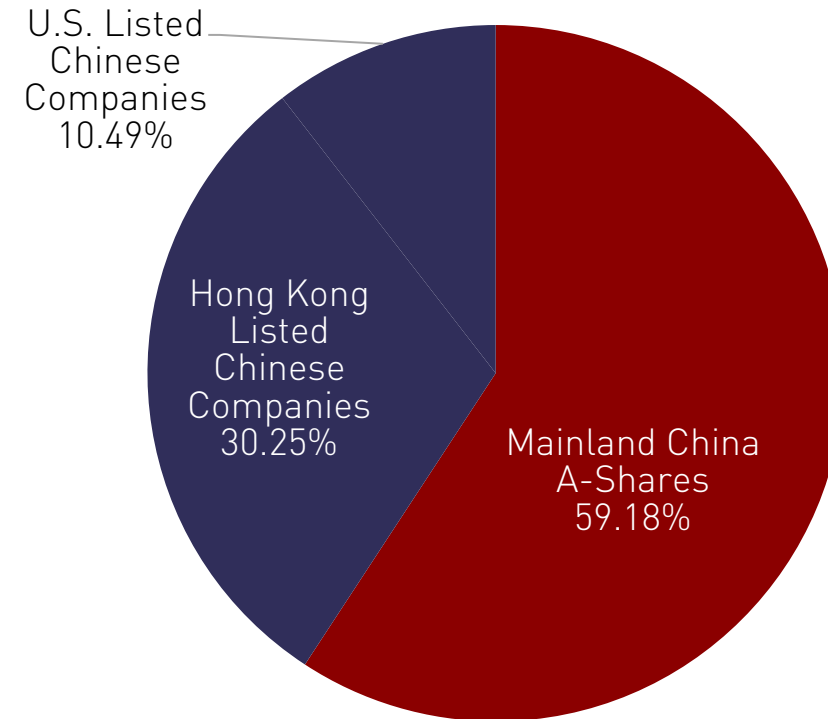
Hong Kong and US = 94.7%  
China A-Shares = 5.3%  
500 Stocks

## MSCI's Definition of Entire Mainland A-Share Market

### MSCI China A Onshore IMI Index

Shanghai and Shenzhen only  
2,411 Stocks

## CHINA A-SHARE CLASS BREAKDOWN OF MSCI ALL CHINA INVESTABLE MARKET INDEX (IMI)\*

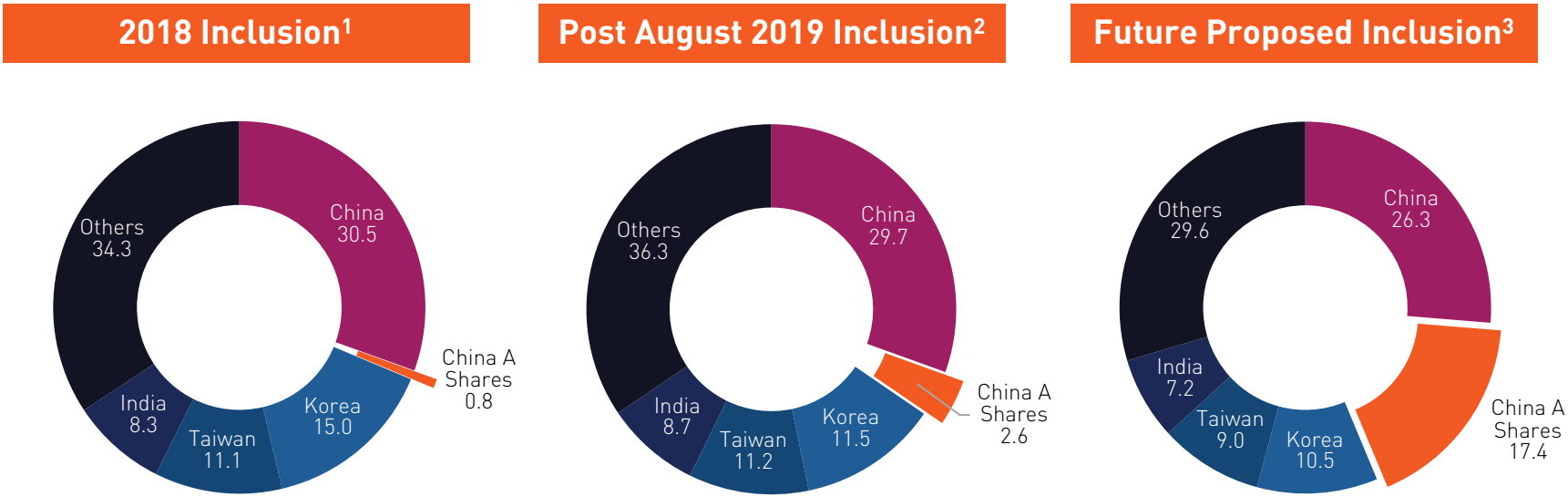


# On February 28, 2019, MSCI made a larger than expected China A-Share inclusion announcement. MSCI will increase the inclusion factor of China A-Shares in their Global Standard Indexes from 5% to 20% in 2019.

Currently, **\$1.8 trillion** track the MSCI EM Index. **Up to \$300b** are expected to be reallocated to China A-Shares after full inclusion.

- On September 3, 2018 MSCI completed the first 5% inclusion of China A-Shares within the MSCI Emerging Markets Index.
- Then, on February 28, 2019, MSCI announced they will increase the inclusion factor of China A-Shares from 5% to 20% in 2019.
- The full proposed inclusion weight is projected to reach 17.4% of the Emerging Markets Index.
- We believe multiple inclusions could provide a sustained catalyst for the outperformance of the Mainland market.

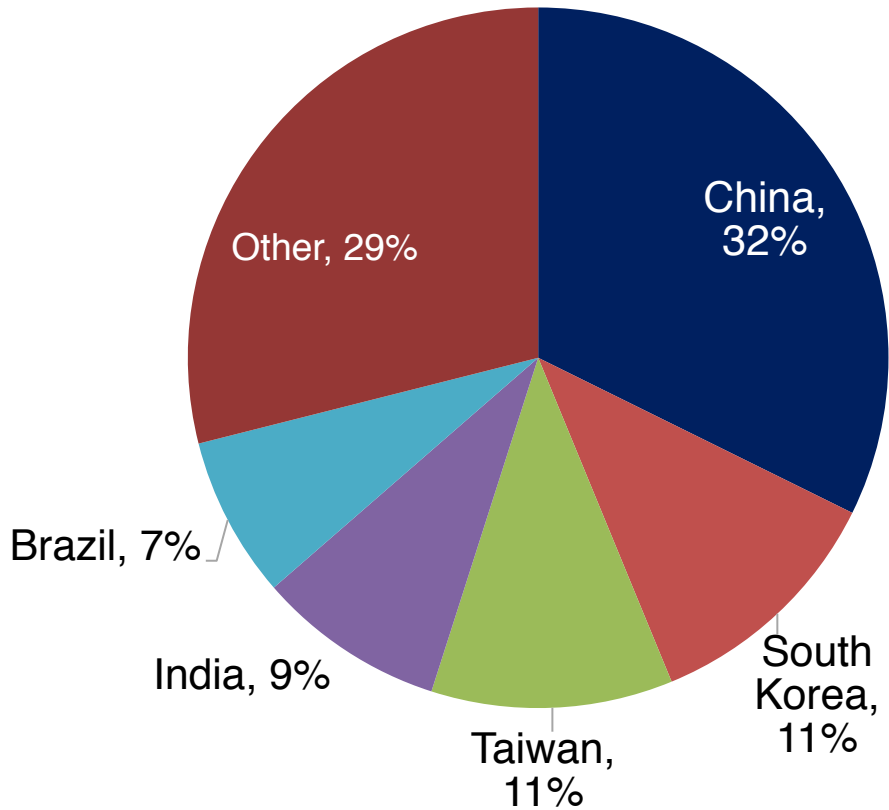
## Current and Country Weights within the MSCI Emerging Markets Index Potential



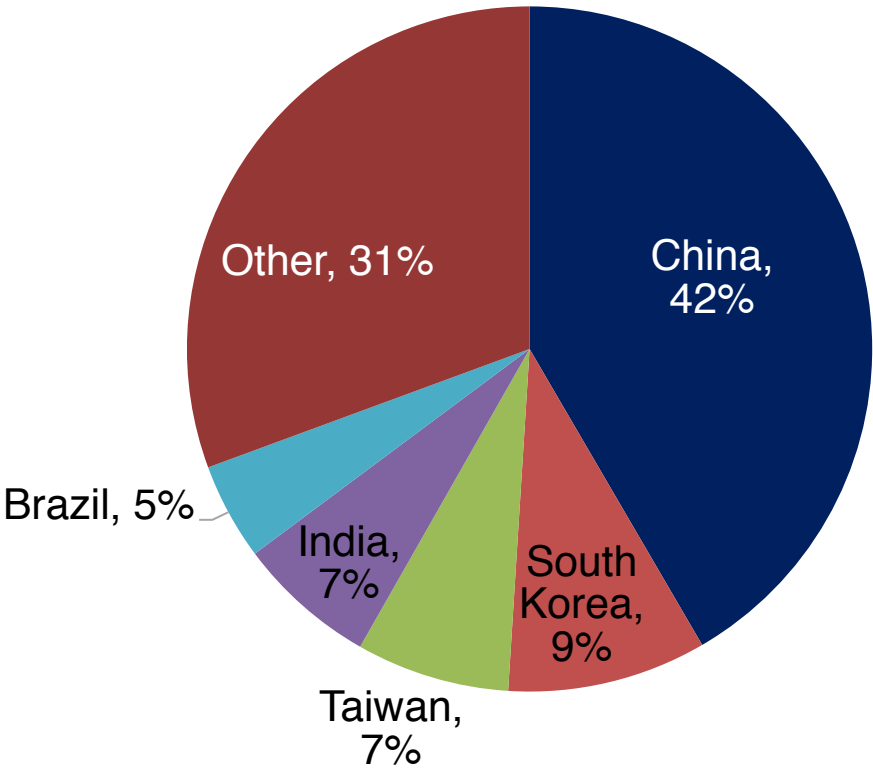
1. MSCI.com/China retrieved 6/30/2019  
 2. MSCI  
 3. MSCI, "China and the future of equity allocations", June 2019.

# China is the largest country in the MSCI Emerging Markets (EM) Index by weight and by number of securities

% of MSCI EM Index - by Weight



% of MSCI EM Index - by Number of Securities



## We believe that the MSCI China A Index has distinct advantages over the CSI 300 Index.

- The CSI 300 Index, originally built for domestic Chinese investors, consists of the 300 largest China A-Share stocks ranked by market capitalization.
- In comparison, the MSCI China A Index currently tracks 443 securities deemed most suitable for international investors by MSCI.
- The constituent count overlap of these indexes is 52%<sup>1</sup>.
- We believe gaining exposure to China A-Shares through an MSCI index provides international investors with several distinct advantages.

MSCI China A Index and CSI 300 Index Comparison <sup>2</sup>			
	MSCI China A Index	CSI 300 Index	MSCI Advantage
<b>Index Construction Methodology</b>	Based on MSCI's Global Investable Market Index (GIMI) methodology	Largest 300 China A-share companies ranked by full market capitalization	Consistent with MSCI EM and MSCI ACWI which enables building and monitoring portfolios in a cohesive manner
<b>Eligible Universe</b>	Only A-shares that can be traded through Stock Connect	Any A-share listed in Shanghai and Shenzhen Stock Exchanges	No QFII or RQFII quota restraints
<b>Foreign Ownership</b>	Takes into account Chinese regulator's foreign ownership limits of 30%	Does not consider foreign ownership limits, creating potential for tracking error	Tailored for foreign investors
<b>Size Segmentation</b>	Large Cap Size Segment targets 70%, Standard Size Segment targets 85%, and IMI Size Segment targets 99% of the coverage universe	Uses a fixed number of constituents methodology	Designed to dynamically reflect the growing China capital markets
<b>Index Review</b>	Semi-Annual and Quarterly Index Reviews	Semi-Annual Reviews	More timely reflection of the market

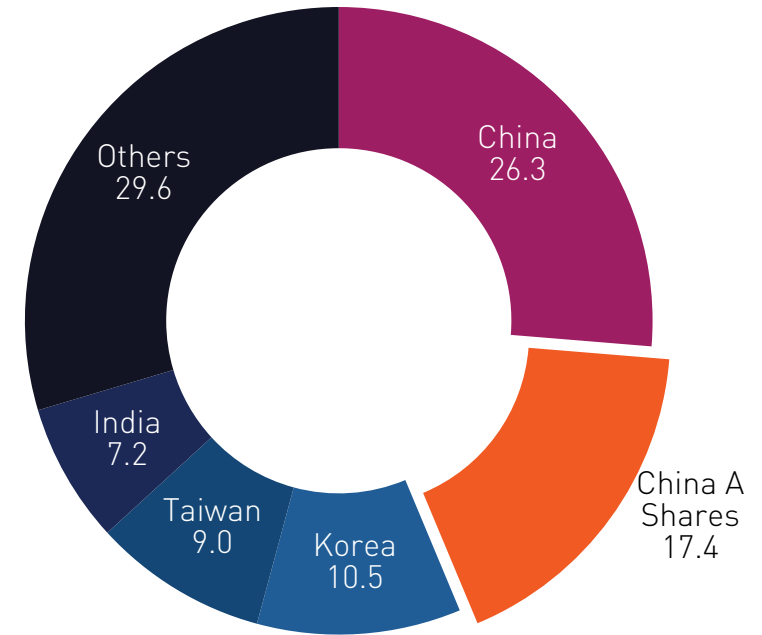
1. Data from Bloomberg as of 8/31/2019, calculated by KraneShares.

2. Data from MSCI as of 8/31/2019. See page end of presentation for index definitions.

## Conclusion:

- On June 1, 2018, MSCI commenced the multi-year process of including China A-Shares into their Global Standard Indexes.
- This rebalance has triggered what may be one of the largest asset transfers in recent history, causing hundreds of billions of dollars to be reallocated to China A-Share securities.
- We believe full inclusion could take up to five years, potentially providing a sustained catalyst for the performance of China's Mainland market.

## Potential Full Inclusion of China A-Shares Within the MSCI Emerging Markets Index



Source: MSCI, "China and the future of equity allocations", June 2019.

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## Index Definitions:

**MSCI China Index:** captures large and mid cap representation across China H shares, B shares, Red chips and P chips.

**MSCI All China Investable Market Index (IMI):** captures large, mid and small cap representation across all China securities that are listed in China and Hong Kong, the US and in Singapore. The index includes: A-Shares, H shares, B shares, Red chips and P chips as well as China securities that are listed on the NYSE Euronext (New York), NASDAQ, New York AMEX and Singapore exchanges.

**MSCI ACWI Index:** captures large and mid cap representation across 23 Developed Markets (DM) and 23 Emerging Markets (EM) countries.

**The MSCI ACWI GDP Weighted Index:** is based on the flagship MSCI ACWI Index, its parent index, and includes large and mid cap stocks across 23 Developed Markets (DM) and 24 Emerging Markets (EM) countries. The index uses a different weighting scheme than its cap weighted parent index, however. The weight of each country in the index is derived from its economic size (using GDP data) rather than the size of its equity market. Over time, GDP data tends to have more stability than equity market prices.

**The MSCI EAFE Index:** is an equity index which captures large and mid cap representation across Developed Markets countries around the world, excluding the US and Canada.

**S&P 500 Index:** is an American stock market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ

**The MSCI Emerging Markets Index:** captures large and mid cap representation across 23 Emerging Markets (EM) countries.

**The MSCI USA Index:** The MSCI USA Index is designed to measure the performance of the large and mid cap segments of the US market.

**The MSCI Frontier Markets (FM) Index:** captures large and mid cap representation across 29 Frontier Markets countries.

**The MSCI China A Index:** captures large and mid cap representation across China securities listed on the Shanghai and Shenzhen exchanges.

**The MSCI China A International Index:** is a free-float adjusted market capitalization weighted index that is designed to track the equity market performance of large-cap and mid-cap Chinese securities listed on the Shanghai and Shenzhen Stock Exchanges. The Index is based on the concept of the integrated MSCI China equity universe with mainland Chinese securities included.

**The MSCI United Arab Emirates (UAE) Index:** designed to measure the performance of the large and mid cap segments of the UAE market.

**CSI 300 Index:** consists of the 300 largest and most liquid A-share stocks. The Index aims to reflect the overall performance of China A-share market..