Euro Area Crisis and Its Impacts on EMs and China

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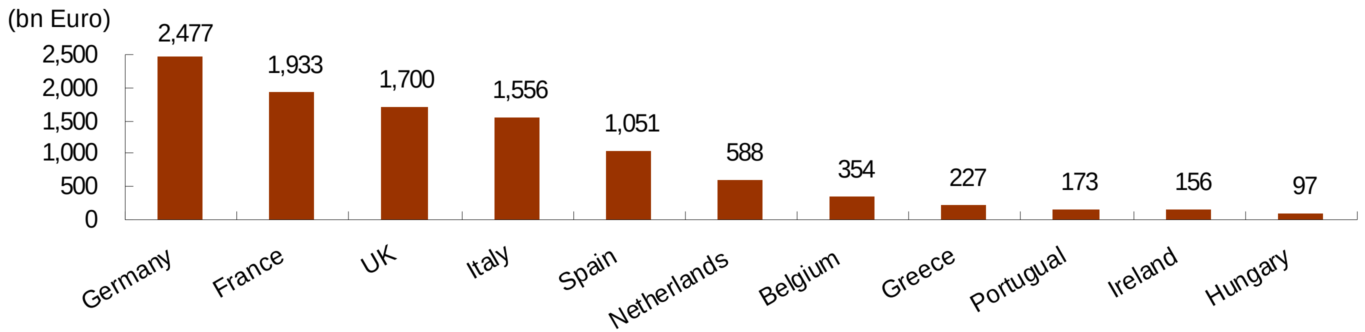
Review of Euro Debt Crisis: Differences in GDP sizes and growth rates

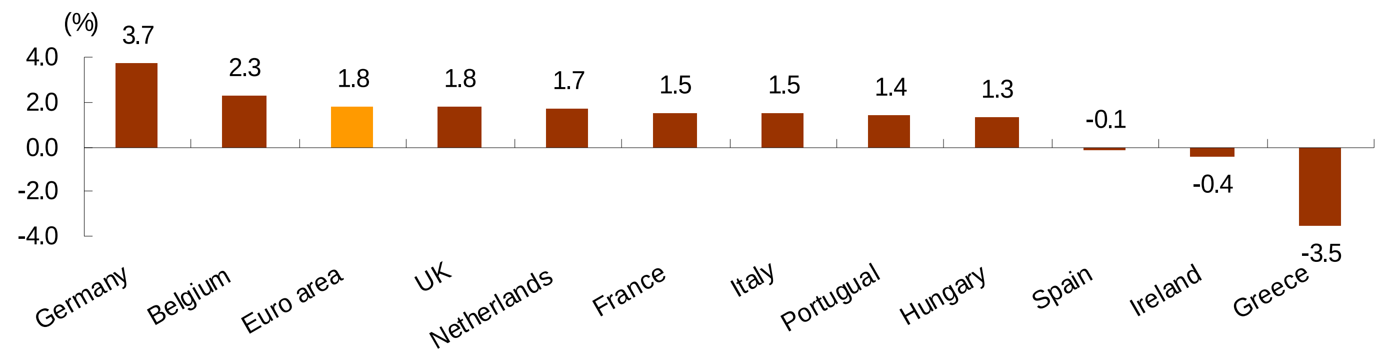
- Within Euro area, Germany is the largest economy which accounts for 27% of total Euro area GDP; France 21%, and Greece 2.5%.

- In 2010, the core Euro area countries led by Germany delivered strong economic growth, while the ones suffering sovereign debt crisis were in recession.

2010 Nominal GDP of major Euro area countries



2010 Real GDP YoY of major Euro area countries



Source: Bloomberg, CICC Research
Note: UK is member of EU but not of Euro area, same hereinafter.

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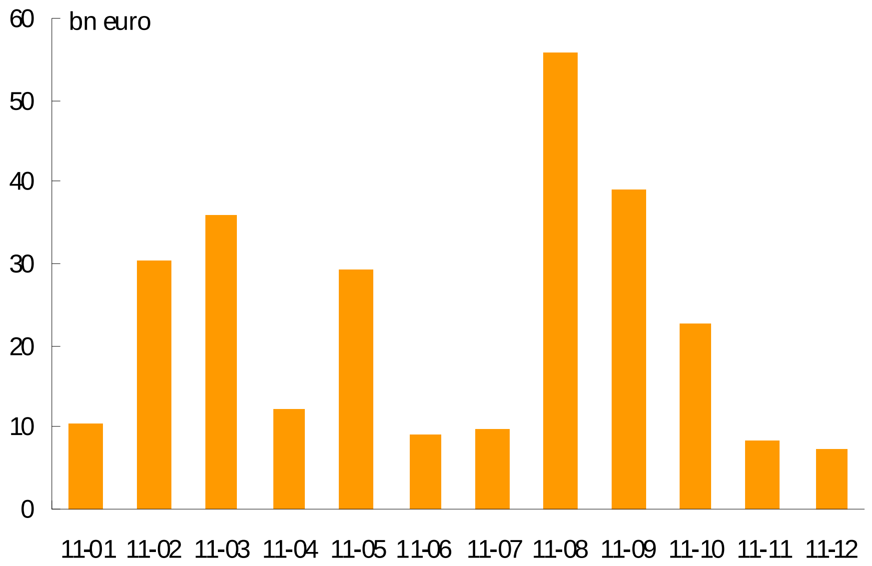
Outlook of Euro Debt Crisis: Complex Issues

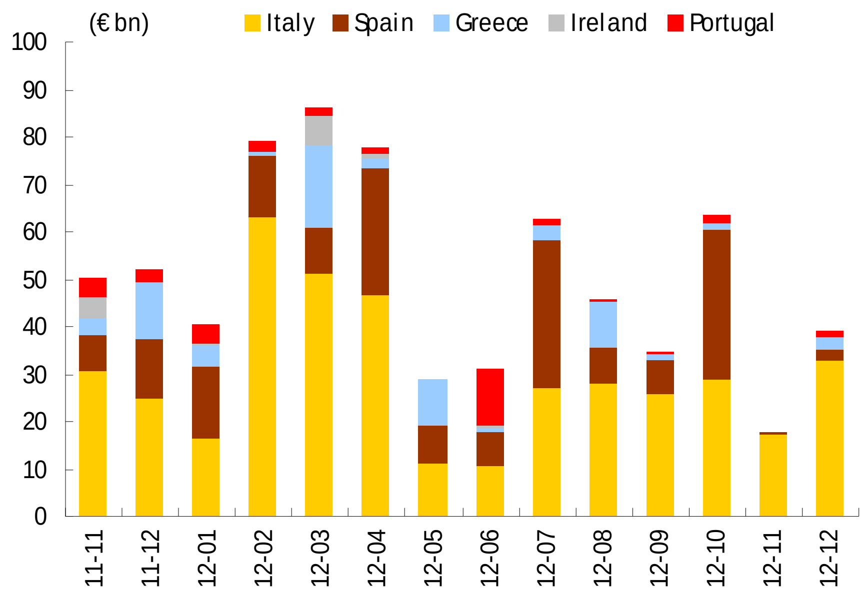
- Risk of Greece defaults
- Crisis is escalating and spreads to core countries such as Italy
- The Economic slowdown across Euro area may undermine the feasibility of solutions
- Will the huge risk exposure of European banking system cause systematic banking crisis?

The PIIGS sovereign debt to repay in 2011



Source: Bloomberg, CICC Research

In 2012 PIIGS will still face refinancing pressure



Source: Bloomberg, CICC Research

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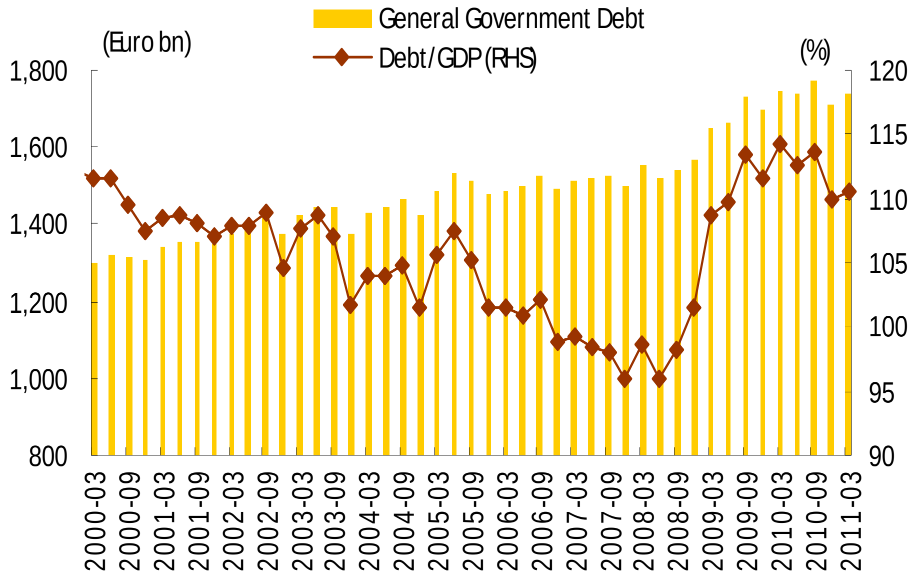
Will Italy become the next Greece?

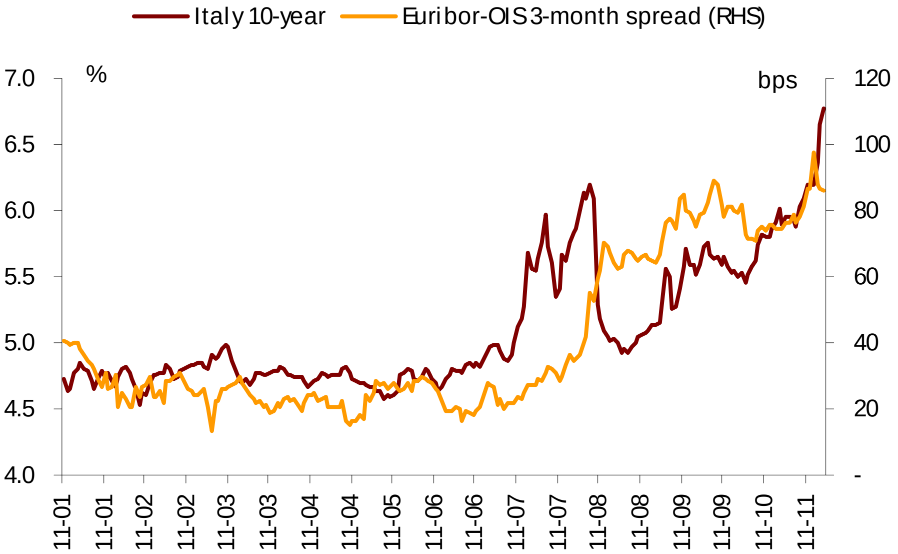
- The debt level of Italy is unsustainable and may face the risk of asset impairment as Greece did.
- The European banks holds Italian sovereign bond of total €170bn.
- What are the implications to these banks?

The debt structure of Italy is unsustainable



Source: Haver Analytics, CICC Research

The skyrocketing yield of Italian sovereign bond



Source: CICC Research

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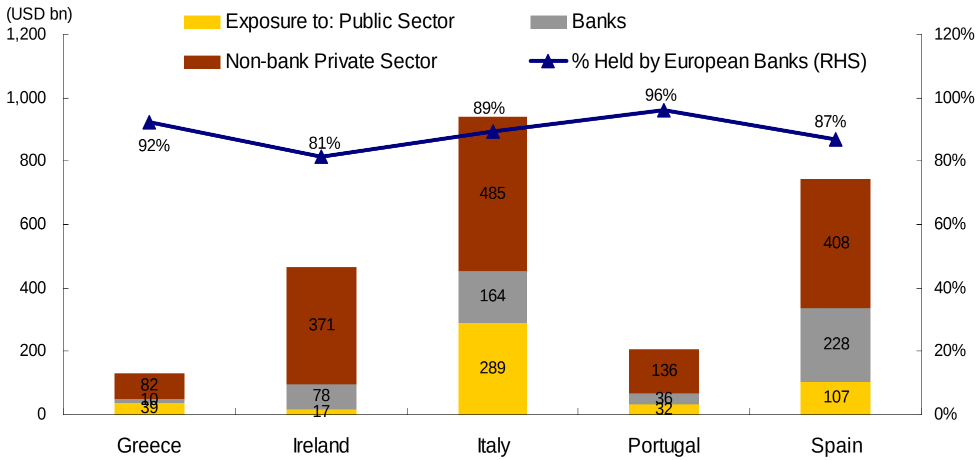
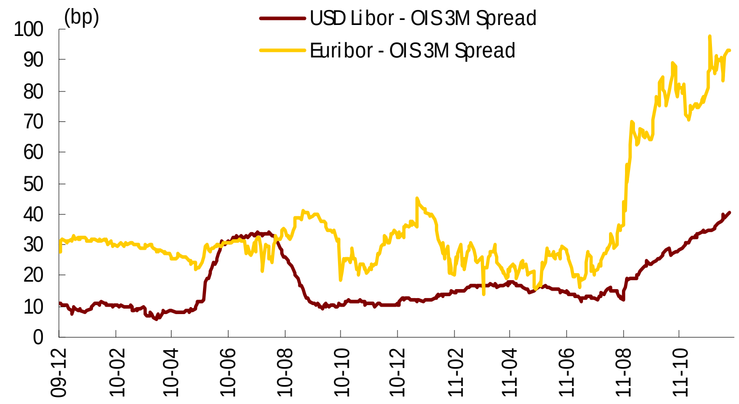
The Risk Exposures of European Banks

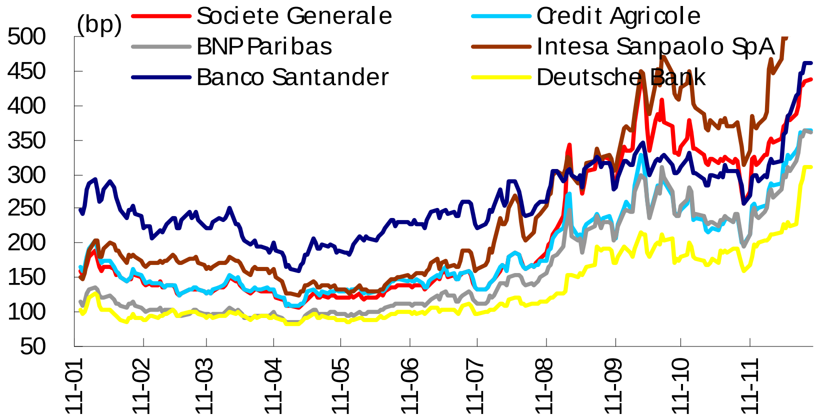
European banks hold huge risk exposure to PIIGS



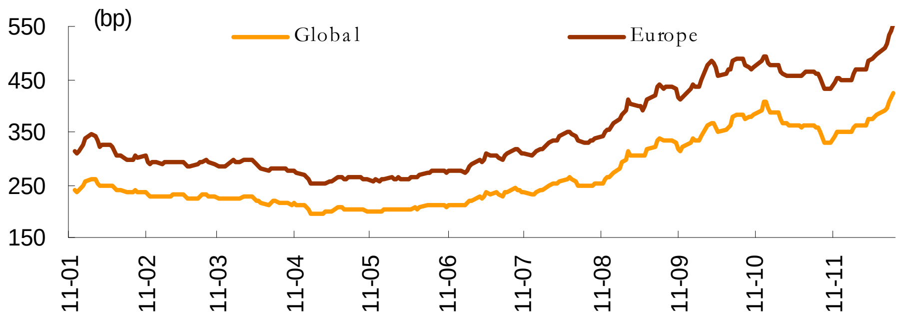
Euro Libor – OIS spread surges showing tight liquidity



CDS spreads of major European major banks shoot up



CDS spread for European banks stays high

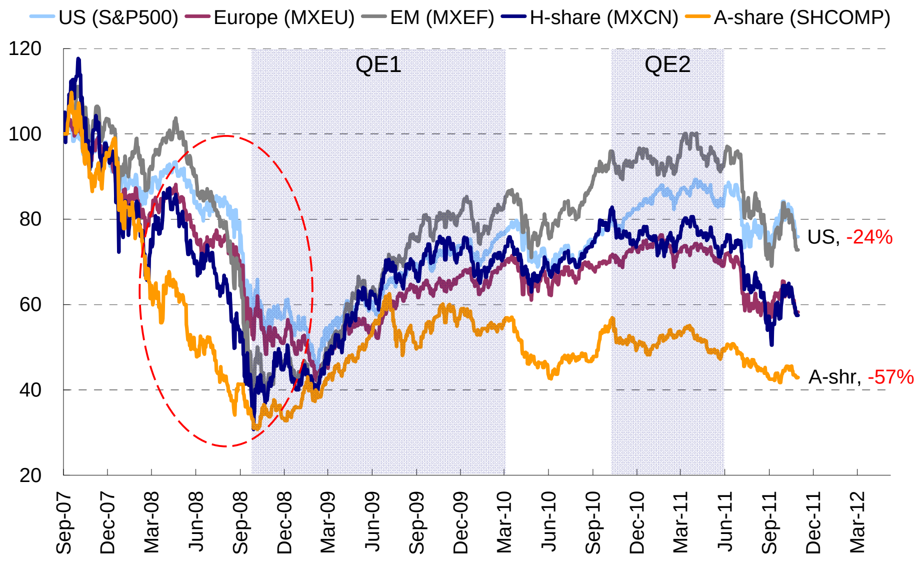


Source: BIS, Bloomberg, CICC Research

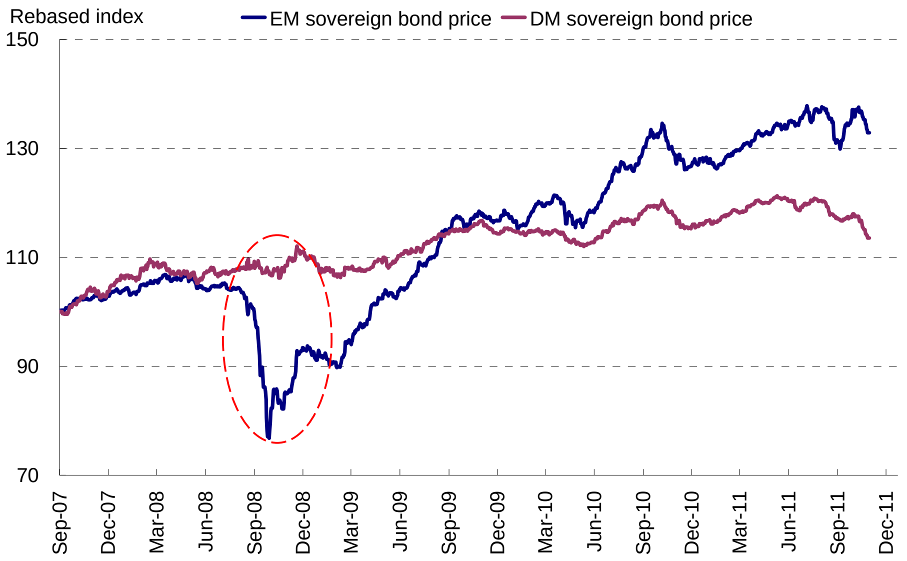
EM Equities and Bonds Were Hit Hard in 08/09 Crisis

- The 08/09 financial crisis hit EM equities and bond markets very badly, both asset classes underperformed DM counterparts by wide margin, particularly Chinese equities were among the worst performers, A-share index (SHCOMP) lost 57% since the peak in end-Sept. 2007
- EM sovereign bond gained preference over DMs in the past 2 years on the back of strong economic growth rebound and higher yields, however, investors are reminded on the sell-off during the 08/09 financial crisis

EM equities were among the worst performers during the 08/09 financial crisis



EM sovereign bond was hit hard in the 08/09 financial crisis



Source: Bloomberg, CICC Research

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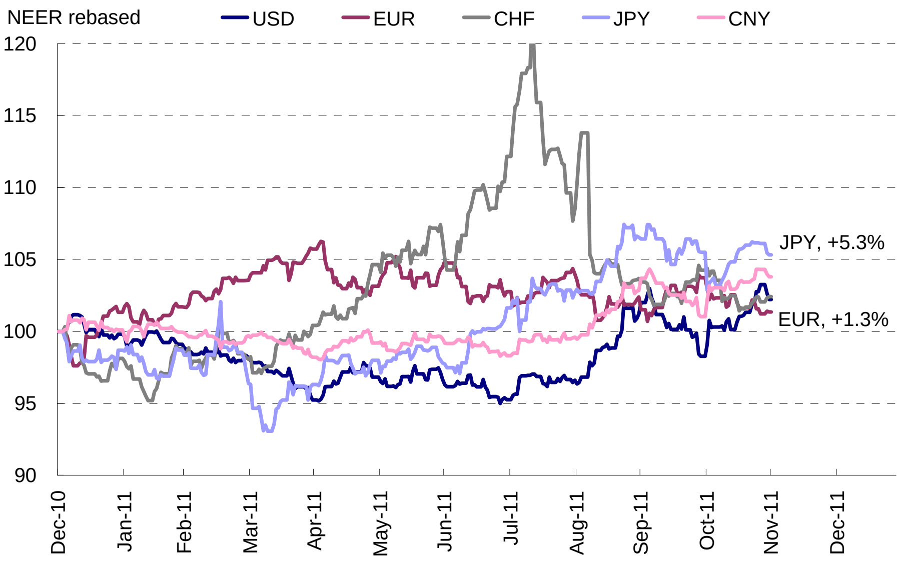
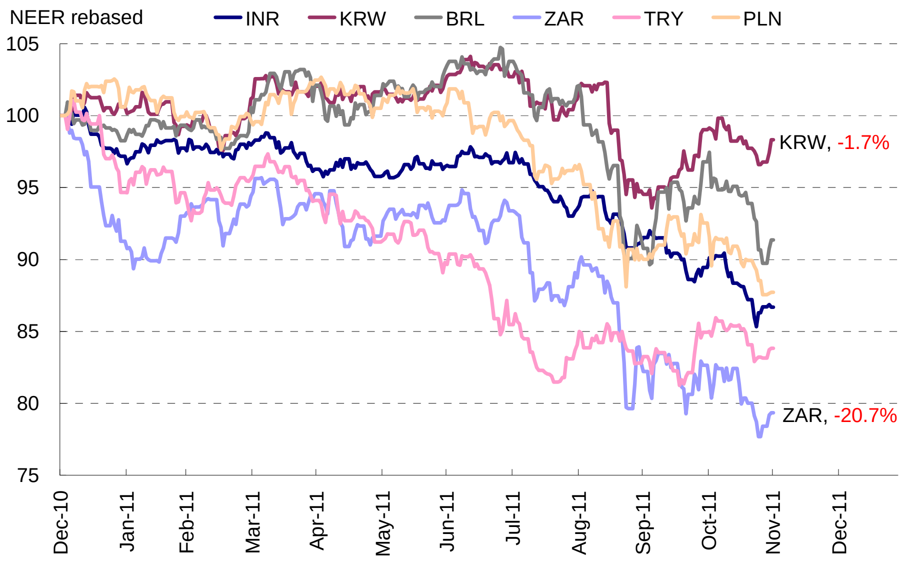
Visible EM Currencies Depreciation YTD 2011

- So far in 2011, major DM currencies all appreciated, JPY rose 5.3% and even EUR was 1.3% higher in terms of nominal effective exchange rate. RMB also appreciated in effective rate.
- On the other hand, EM currencies suffered visible depreciation, particularly South African Rand lost 20.7%, Turkish New Lira erased 16.2%, and India Rupee is 13.3% lower, Korea Won stood out with only 1.7% loss in its value

While DM currencies (except CHF) remain fairly stable …



EM currencies such as INR and BRL fell sharply in the past 3 months



Source: Bloomberg, CICC Research. ZAR = South African Rand; TRY = Turkish New Lira; PLN = Polish Zloty.

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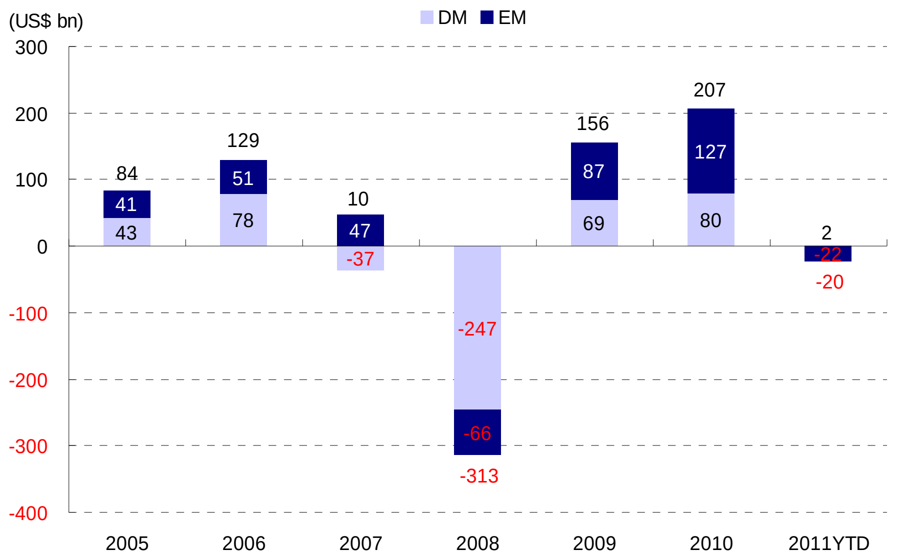
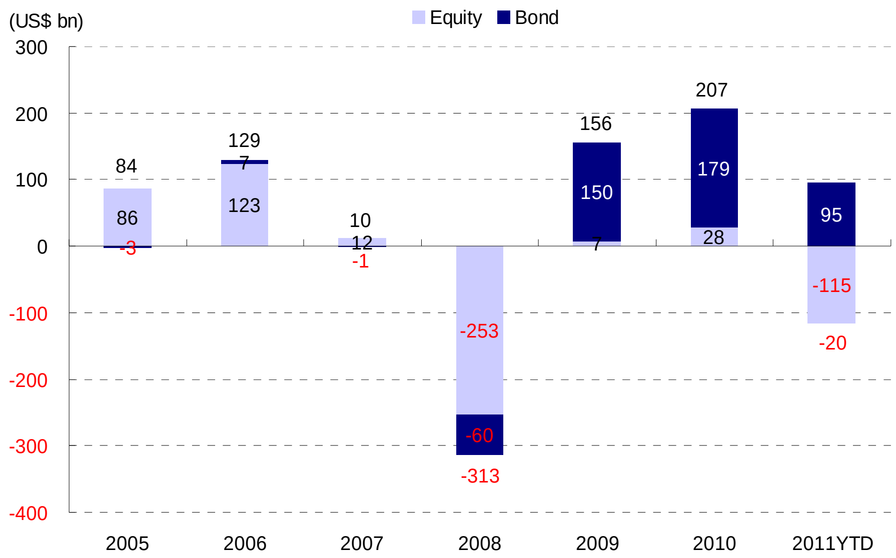
Moderate Global Capital Outflows from EM YTD

- In terms of global capital flows, 2008 was a very bad years for all markets and asset classes, outflows totaled US$313bn in the year
- So far in 2011, DM recorded marginal capital inflows, while US$22bn fled from EMs; from the perspective of asset class, equity saw big outflow of US$115bn, and bond had US$95bn inflows

DM recorded some marginal capital inflow YTD, while US$22bn flowed out from EMs



Bond funds had 3 years of continuous capital inflows, US$115bn flowed out from equities



Source: EPFR Global, CICC Research

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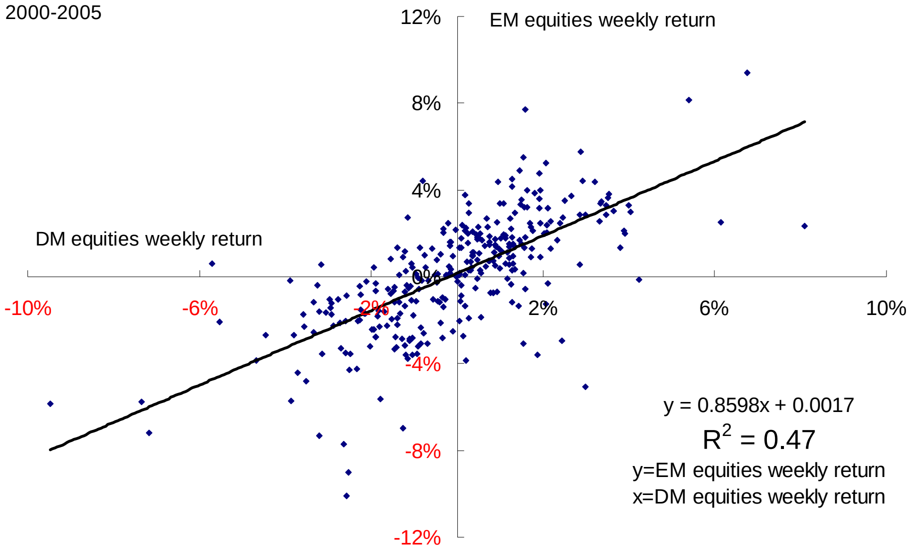
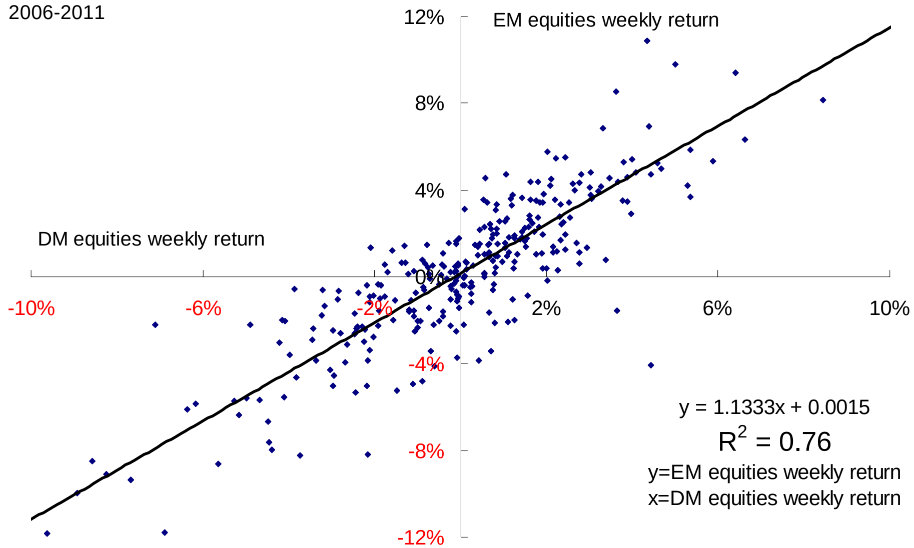
A More Synchronized Global Equity Markets

- Based on a regression of DM (MSCI World) and EM (MSCI EM) equity index, we found the R square for 2000-2005 was 0.47 and picked up notably to 0.76 for 2006-2011, indicating an increased correlation between the two major equity markets.
- What's more, the slope of the regression jumped to 1.13 in 2006-2011 from 0.86 in 2000-2005, i.e. EM equities tend to have bigger movements per the same DM equity returns.

47% of EM equity weekly return can be explained by DM equities



More portion of EM equity returns (76%) are influenced by DM equities

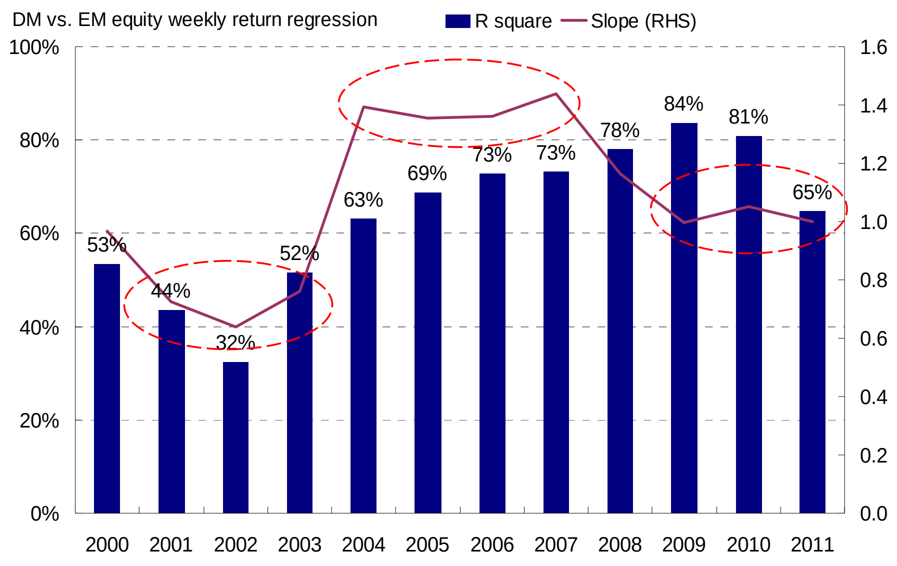


Source: Bloomberg, MSCI, CICC Research. DM = developed markets, EM = emerging markets.

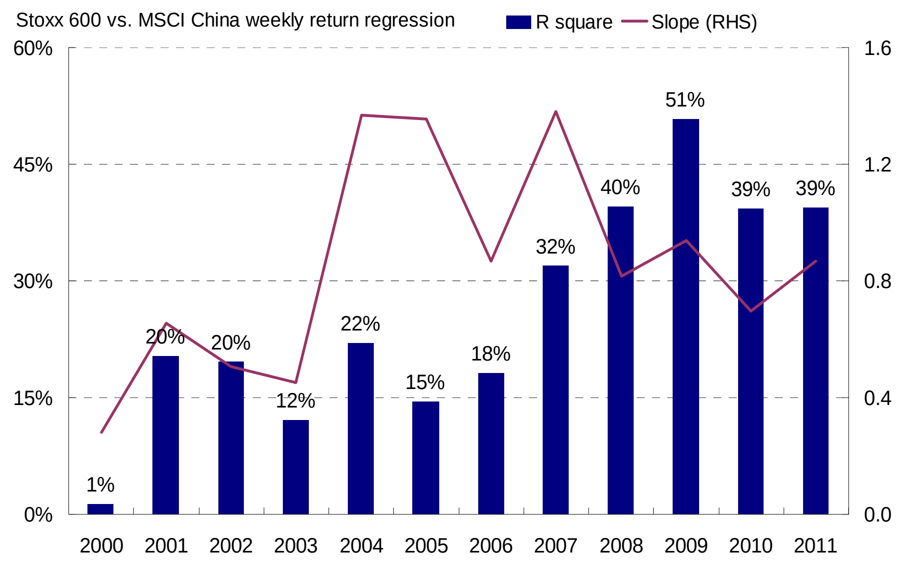
A More Synchronized Global Equity Markets

- Equity returns became more integrated, running the regression for each year's weekly returns of DM vs. EM, we found the R square kept rising from the 32% in 2002 to the highest of 84% in 2009 and the 65% so far in 2011, the slope also expanded and stayed firmly above 1.
- We run the same regression on Stoxx 600 vs. MSCI China and found a similar pattern, i.e. Europe equity returns have higher explaining power on H-share performance.

R square of the DM vs. EM regression rose from 32% in 2002 to 84% in 2009



Stoxx 600 index weekly return explain more percentage of H-share index

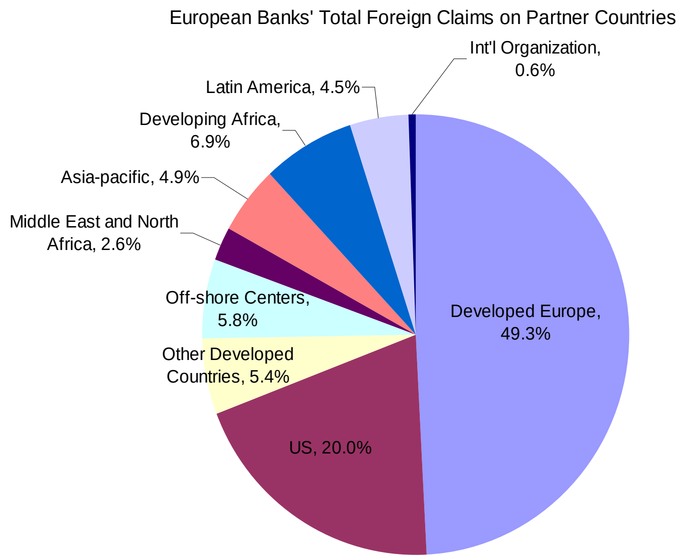


Source: Bloomberg, MSCI, CICC Research. DM = developed markets, EM = emerging markets.

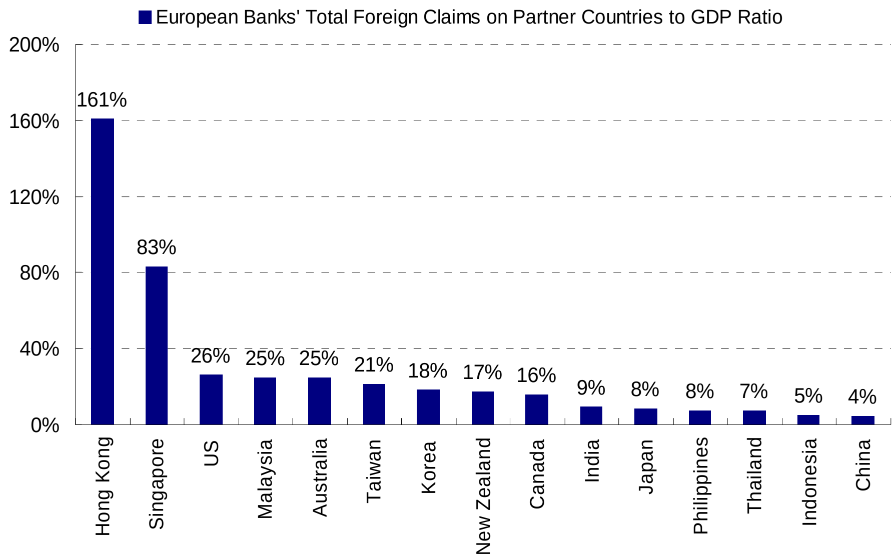
Who's Vulnerable in European Banking Crisis?

- According to BIS data, around 75% of European banks' foreign claims are in developed countries, only 5% in Asia-Pacific region.
- However, the total foreign claims of European banks is 161% of HK's GDP and 83% of Singapore's.

The majority of European banks' foreign claims are in developed markets



HK and Singapore look vulnerable in case of European banking crisis

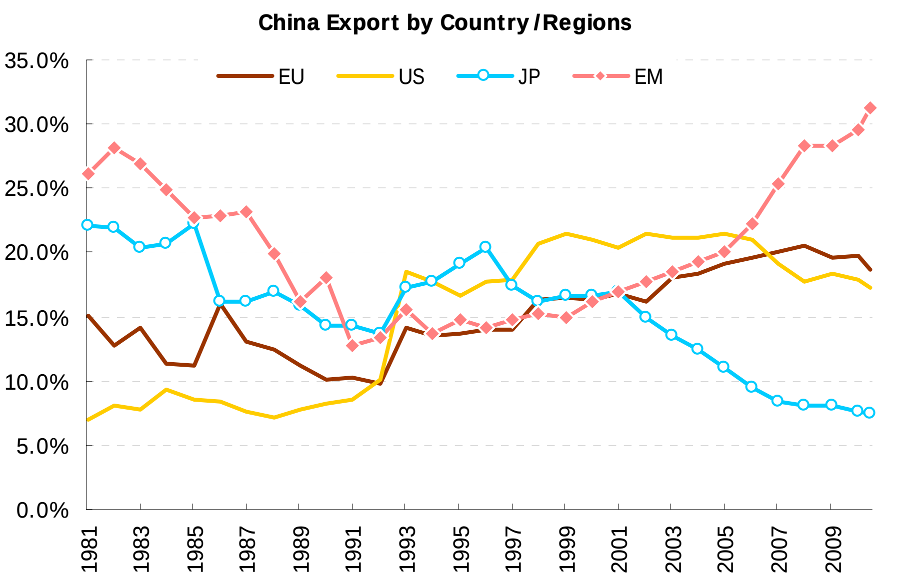


Source: BIS, CICC Research. European banks' foreign claims are as of 1H2011, GDP data is as of 2010.

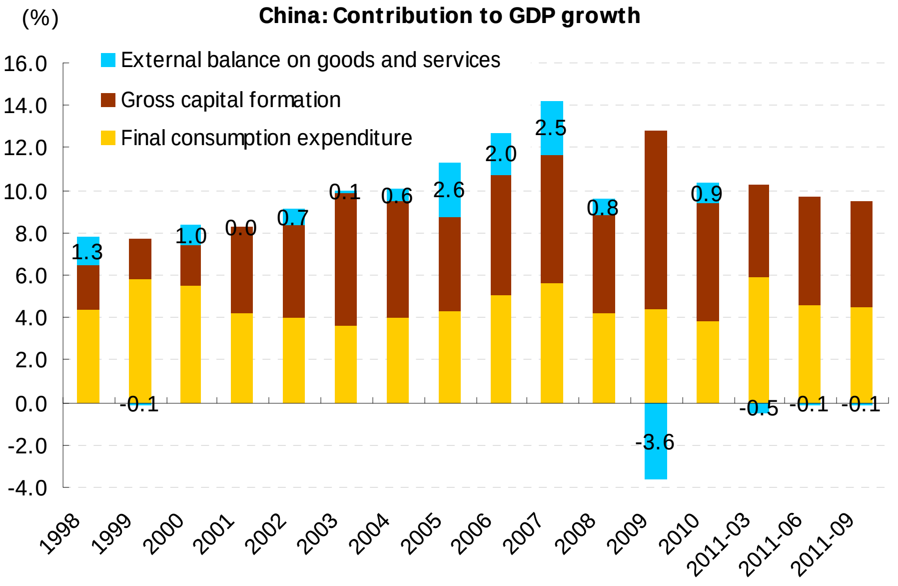
Impacts on China: Economy Growth

- Since 1992, China's exports to the EU had been growing steadily. After the crisis in 2008, China's portion of export to EU started to moderated. As of June 2011, exports to the EU accounted for 18.7% of China's total exports, exports to the PIIGS accounted for only 3.5%.
- China's exports to the emerging economies rise strongly from 2005, now over 30% of China's total exports.
- In the first three quarters of 2011, net exports contributed -0.1% to China's economic growth, CICC Macro Team expects the negative contribution of net exports will be expanded to -0.6% in 2012.

China export by country/region



Contribution to GDP growth



Source: IMF, Haver Analytics, Wind, CICC Research

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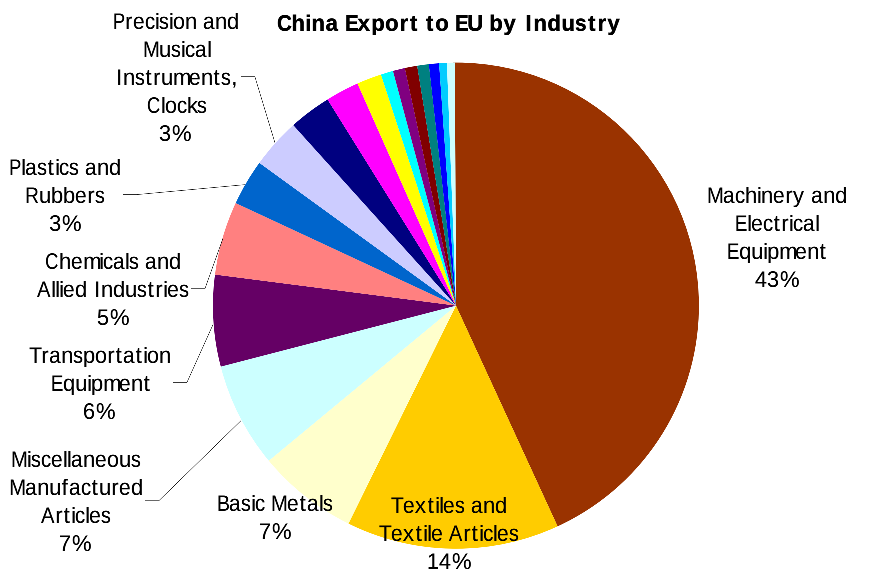
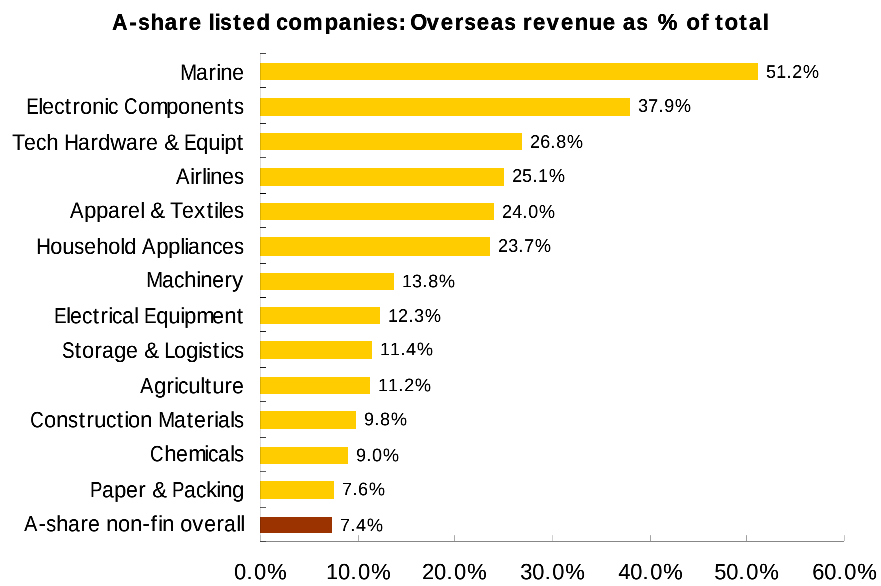
Impacts on China: Industries

- From the export structure to EU, machinery and electrical equipment, textiles and textile articles, basic metals accounts for larger proportions.
- An export decline has the greatest impact on the following two sections: 1) export services chain, the main industries include shipping, airlines, ports, containers, warehousing and logistics, 2) products and services exporters, including electronic components, technology hardware & equipment, apparel & textiles, home appliances, machinery, electrical equipment.

Export structure to EU (2011 Jan ~ Oct)	Industries with higher proportion of overseas revenue (A-share listed companies 2011 semi-annual report)



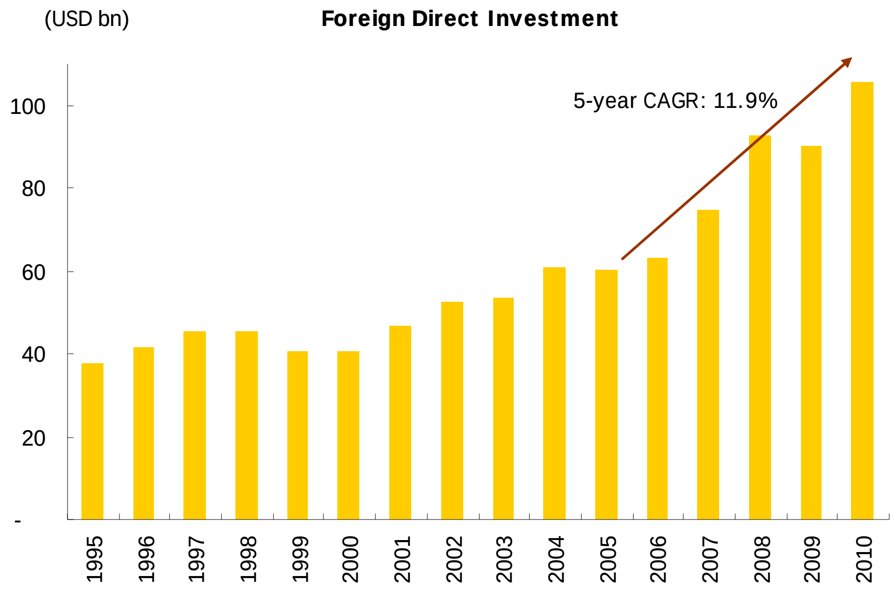


Source: IMF, Haver Analytics, Wind, CICC Research

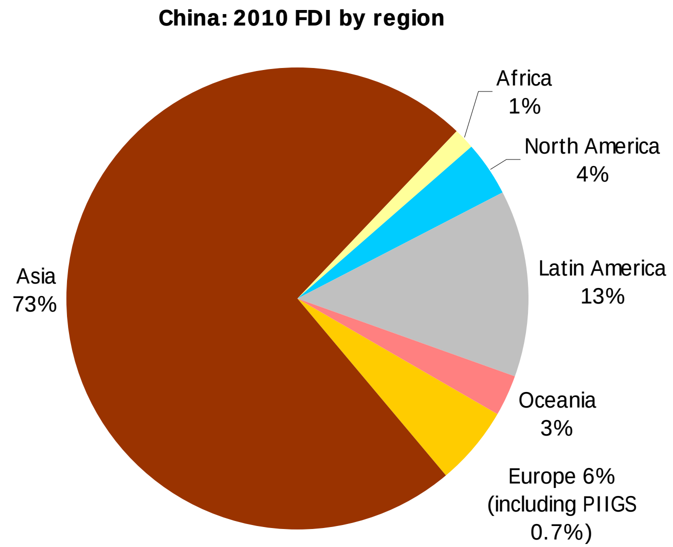
Impacts on China: FDI

- In the past five years, foreign direct investment increased rapidly, at CAGR of 11.9%, but most come from Asia.
- In 2010, only 5.6% of actual foreign direct investment came from Europe, and the proportion from PIIGS was no more than 0.7%.

FDI increased steadily



FDI by region

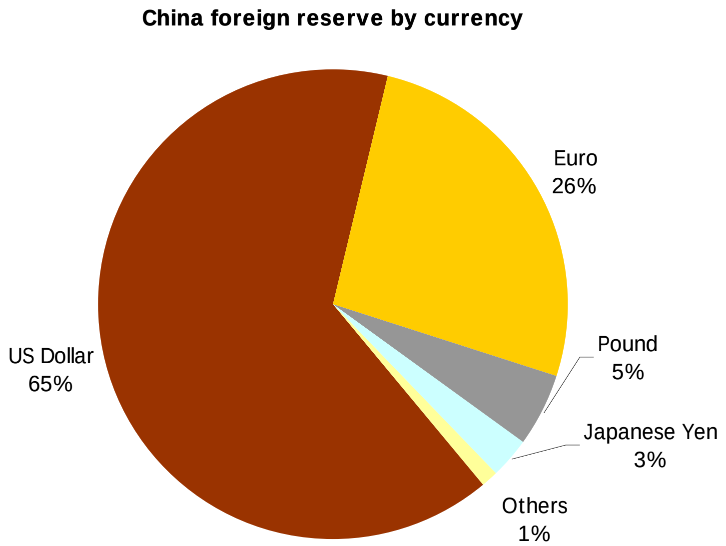


Source: IMF, Haver Analytics, Wind, CICC Research

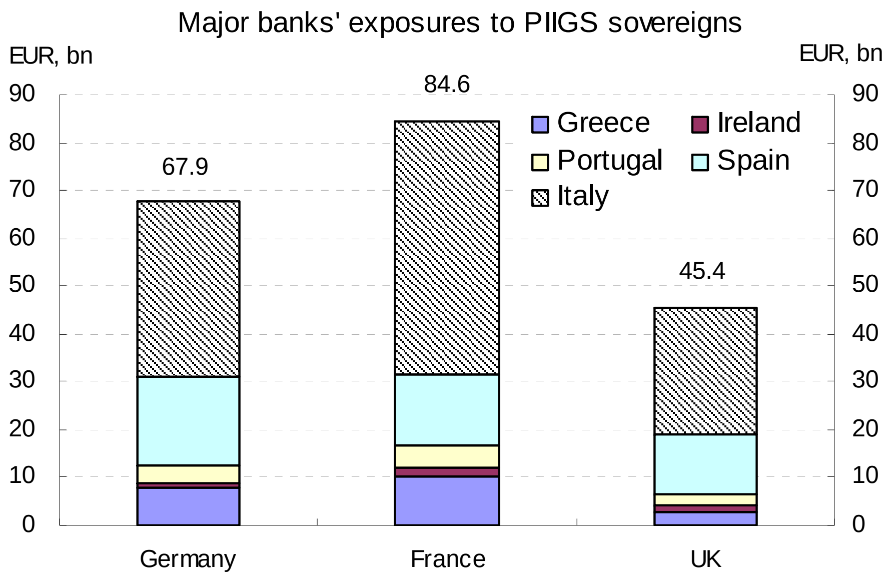
Impacts on China: Financials

- China has huge foreign reserves, most of them are in dollar assets, euro assets is relatively small.
- Major European banks have high exposures to PIIGS sovereigns, while China banks' exposures to PIIGS sovereigns are very small. According to Bank of China's third quarter report, as of Sep 2011, Bank of China Group hold the Italian government and various institutions bonds equal to Rmb454mn, the Group does not hold Portugal, Ireland, Greece, Spain governments and various institutions bonds.

China foreign reserve structure



Major European banks have high exposure to PIIGS sovereigns



Source: EBA, Wind, CICC Research

Summary

- **<u>The Euro debt crisis is complicated:</u>** The focus is on Italy; European banks hold large exposure to PIIGS sovereign bonds. Moreover, the crisis may spread to core countries including Germany.
- **<u>A more synchronized global equity markets:</u>** DM and EM equity markets become more integrated in the new century, particularly EM returns tend to have bigger movements. European equity returns explains 40% of H-share returns so far in 2011.
- **<u>Negative impacts capital flows and EM currencies:</u>** EM assets and currencies were hit hard in previous risk-off episodes, as investors fled to safe haven. Lately we have seen visible depreciation in ZAR, TRY, INR etc. Also HK and Singapore look vulnerable as European Banks' foreign claims account for a huge percentage of their GDP.
- **<u>Negative impacts on China's export:</u>** China's exports to EU declining and exports to PIIGS relatively small. The crisis may have potential impact on China's *export services chain* and *products & services exporters*.
- **<u>Limited impact on China's FDI and financial institutions:</u>** China's FDI increased rapidly but mostly from Asia and very limited from Europe and PIIGS. Unlike their major European peers, Chinese banks' exposure to PIIGS sovereigns is extremely small.

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