

China Banking Monitor

2H 2019

Nov 2019

Index

- 01 Macroeconomic environment
- 02 Performance of banking sector
- 03 Shadow banking activities

Main takeaways

- Credit growth slumped in October weighed by weak corporate demand coupled with seasonal effects, reflecting that the efforts to funnel credit to the real economy are showing little success.
- Bank assets growth picked up to 7.7% in the first three quarters supported by a higher loan growth rate.
- Asset quality deteriorated in the Q3 2019 as banks report a higher non-performing loan ratio. Asset quality diverged among big and smaller banks on a stricter standard of NPLs recognition.
- Banks' net profit growth and net interest margin (NIM) picked up as banks shift to relatively high-yield retail credit from interbank activities coupled with a lower wholesale funding cost.
- Capital adequacy ratio dropped on faster growth in risk-weighted assets. Small banks are still subject to capital shortfalls amid deteriorating asset quality and persistent regulations on shadow banking activities.
- Banks' liquidity remained adequate but is subject to challenges of credit events.
- Banks interconnectedness with the shadow banking system has further decreased.

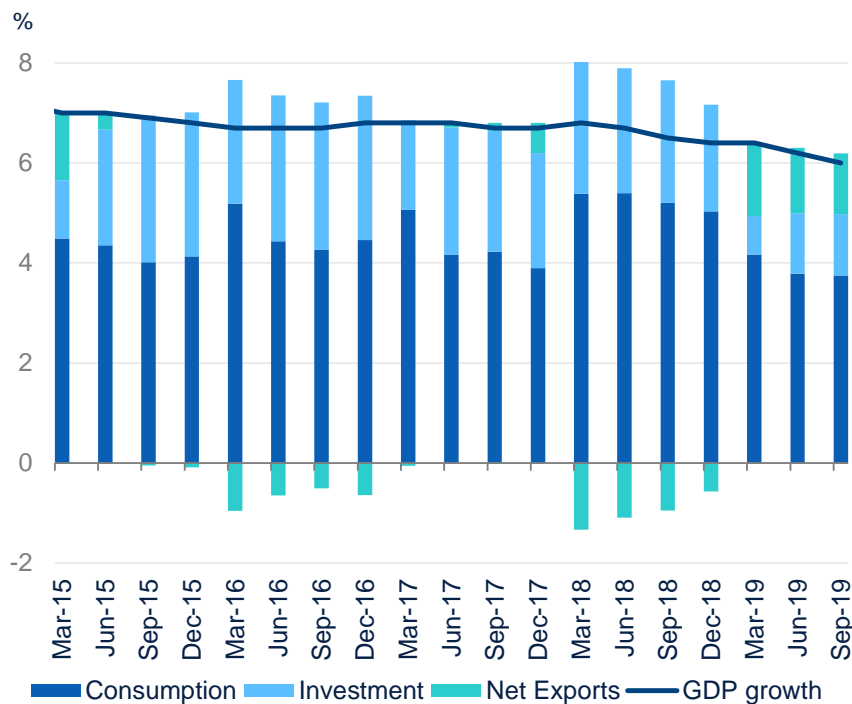
01

Macroeconomic environment

Credit growth remained weak
mainly supplied through banks'
balance sheet

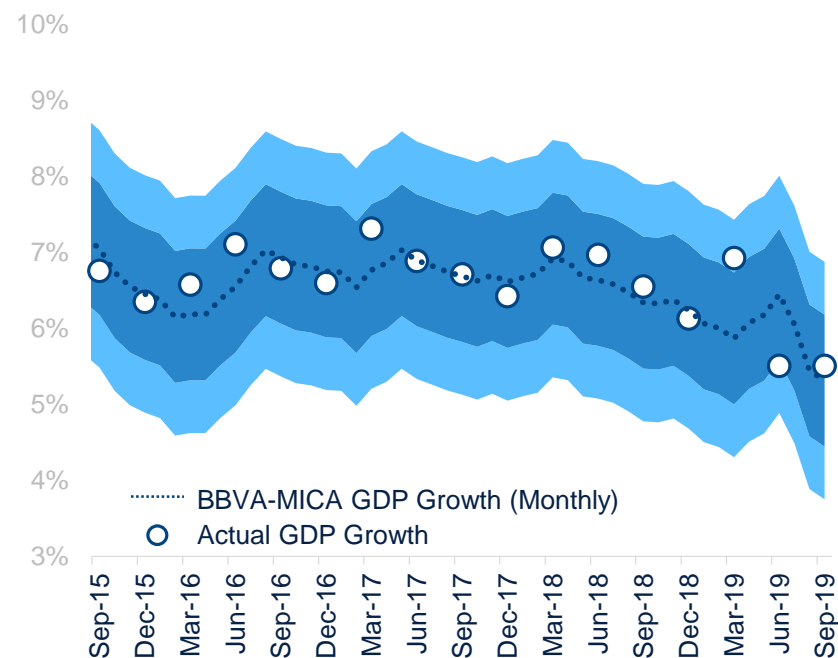
Deteriorating investment and external shocks continue putting downward pressure on the economic growth

GROWTH CONTINUED ITS DOWNWARD TREND IN Q3 2019 TO 6% FROM 6.2% IN Q2



Source: CEIC & BBVA Research

BBVA MICA MODEL FOR MONTHLY GDP FORECASTING (% YOY)

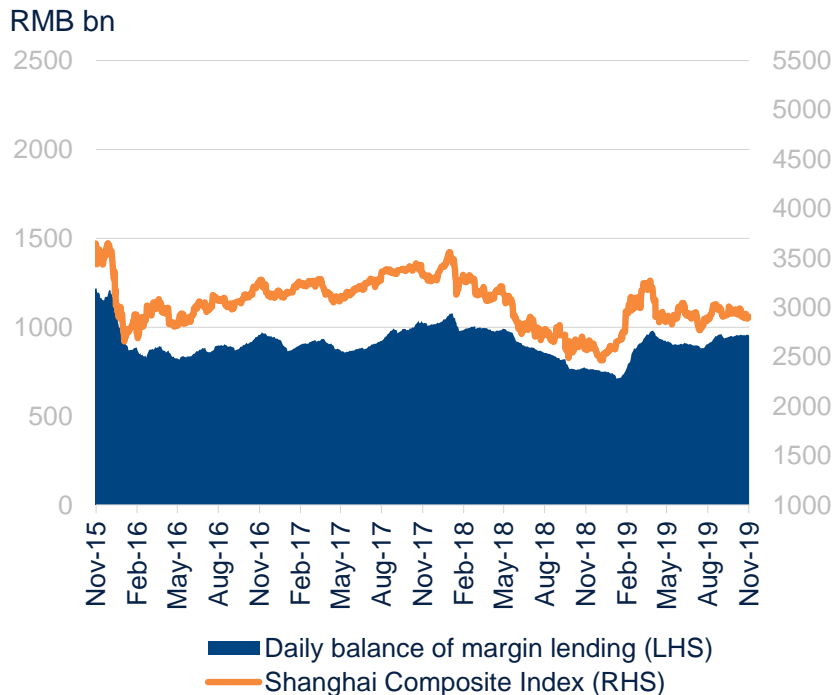


Source: CEIC, Haver & BBVA Research

The economic growth dropped to a three decades low of 6.0% in the third quarter weighed by a significant decline in fixed-asset investment and the instability from the trade tensions. Growth is expected to cool to 6% in the whole of 2019.

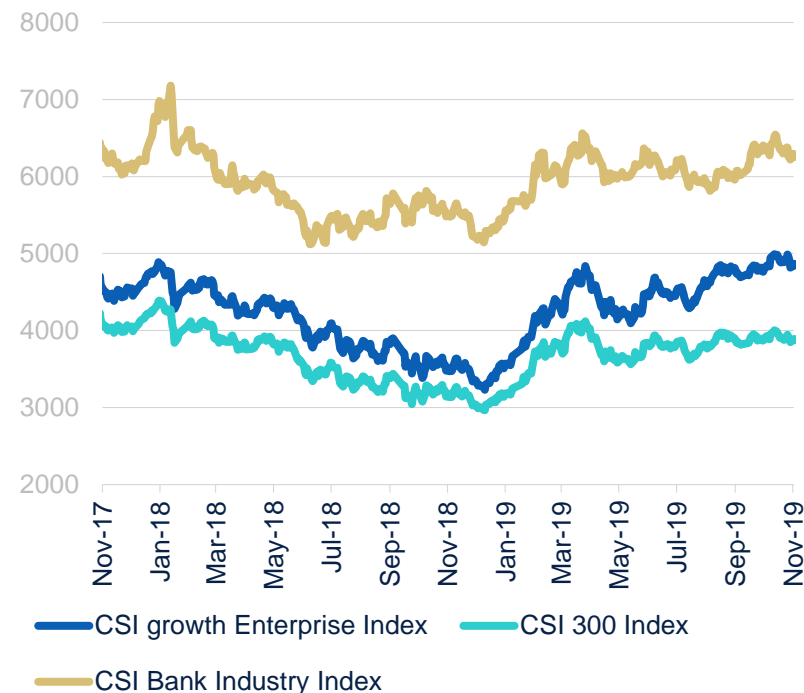
Uncertainty in trade talks weighed on stocks

SHANGHAI COMPOSITE INDEX



Source: Wind & BBVA Research

CSI 300 AND GROWTH ENTERPRISE INDEXES



Source: Wind & BBVA Research

Stock market was triggered a sell off weighed by the escalating trade tensions, potentially wiping out most of the market's year-to-date rallies. Margin lending to buy Chinese stocks is on the rise before slump

Prospect for a quick resolution to end the trade war has faded



U.S. accusation of China's backtracking

On 10th May, US government ratcheted up tariffs on \$200 bn of Chinese goods from 10% to 25%, and also signaled to impose duties on another \$300 bn of Chinese products so far unscathed.

Xi-Trump meeting in Osaka

On 29th June, Trump and Xi held a meeting at the sideline of G20 in Osaka, Japan. Both sides agreed to restart the bilateral negotiation.

US hiked the tariffs again, trade war escalated

On 15th Aug, the US announced a new round of tariffs, additional 5% on Chinese exports to penalize China's retaliation.

On 29th Aug, the US officially labelled China as a currency manipulator country.

China-US announced the Phase One deal

On 11th Oct, Trump announced "Phase One" of a long-awaited trade deal with China. US agreed to cancel its planned October 15 tariff hike in exchange for China resuming purchases of US agricultural goods.

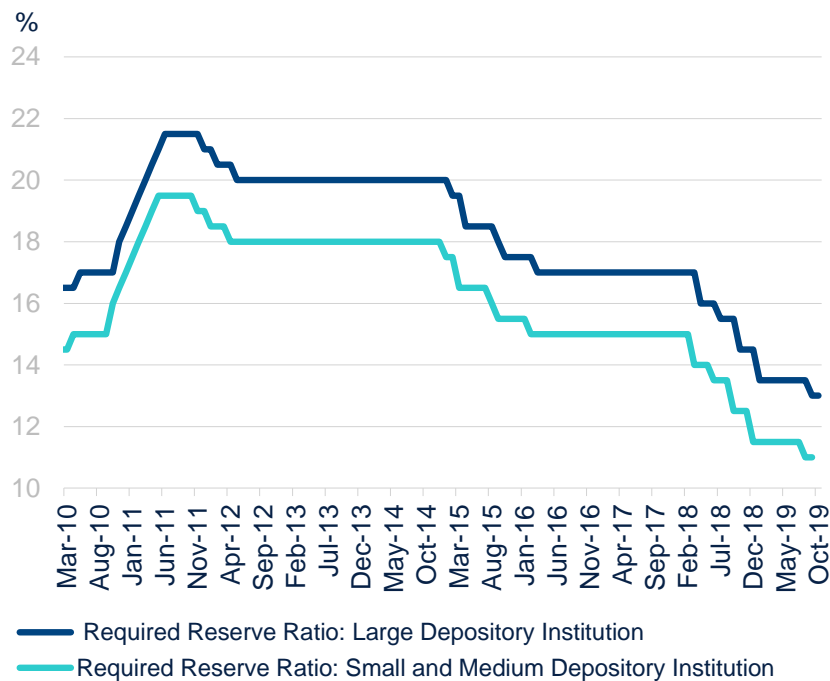
15th Dec will be the key date to see if a partial deal could be finalized.

Source: BBVA Research

We expect the final deal won't include substantive changes to China's state-driven economic model, and a tech war that US efforts to constrain China's technological rise will not stop.

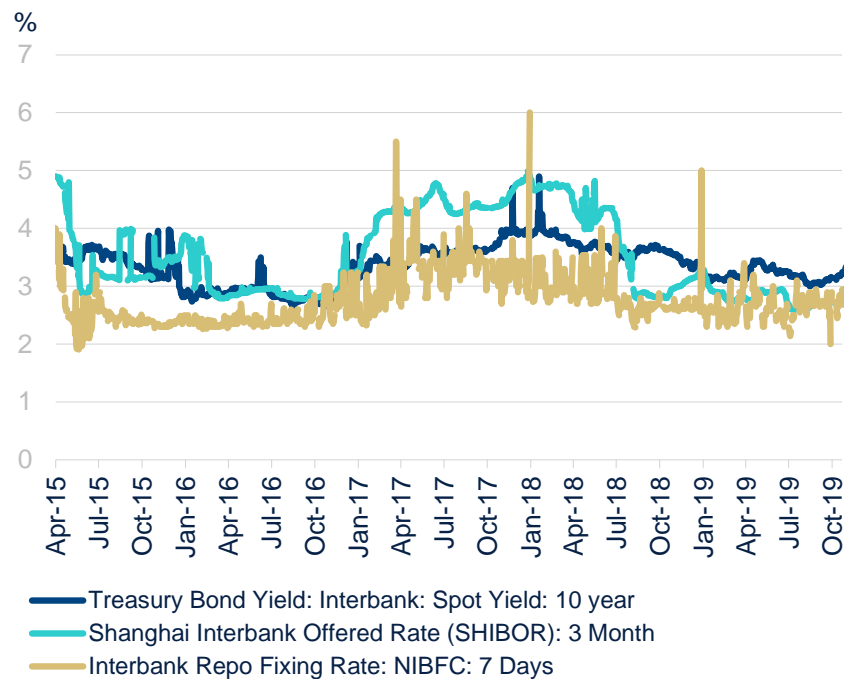
Supportive economic policies have been implemented to bolster the domestic economy

FURTHER EASING OF MONETARY POLICY IS EXPECTED...



Source: Haver & BBVA Research

INTEREST RATES ARE FALLING AS THE CENTRAL BANK EASES

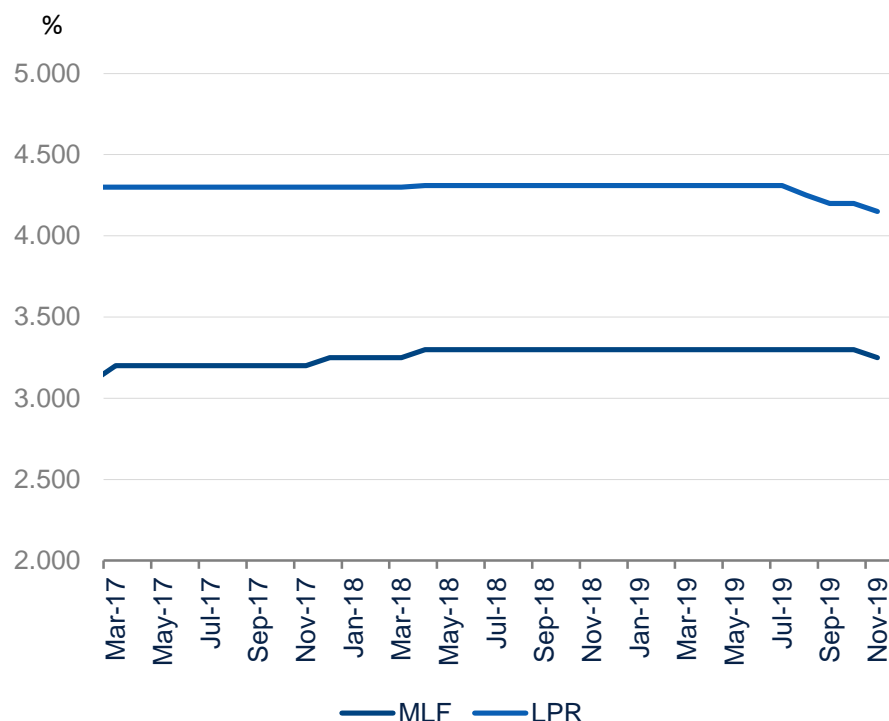


Source: CEIC & BBVA Research

The central bank has cut required reserve ratio 4 times in 2018, followed by another 2 cuts in January and September this year. To facilitate the bank credit channel into the real economy, authorities introduced the targeted medium-term lending facility (TMLF) to provide long-term funding for banks to support the small and medium sized enterprises (SMEs)

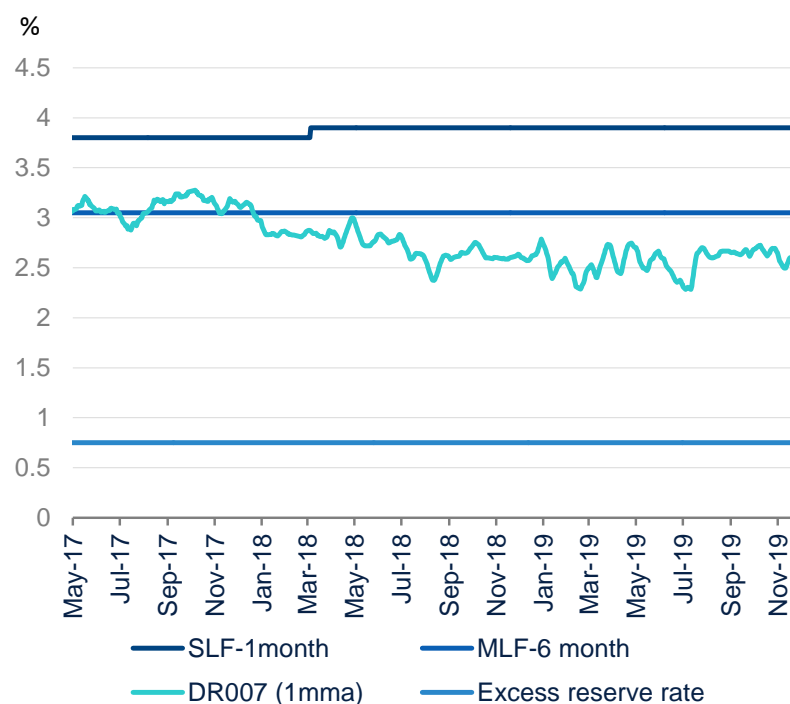
PBoC set the Loan Prime Rate (LPR) as the new target monetary rate

THE PBOC SET LPR AS THE NEW MONETARY TARGET RATE



Source: CEIC & BBVA Research

THE MOVE FURTHER IMPROVES THE NEW MONETARY CORRIDOR SYSTEM

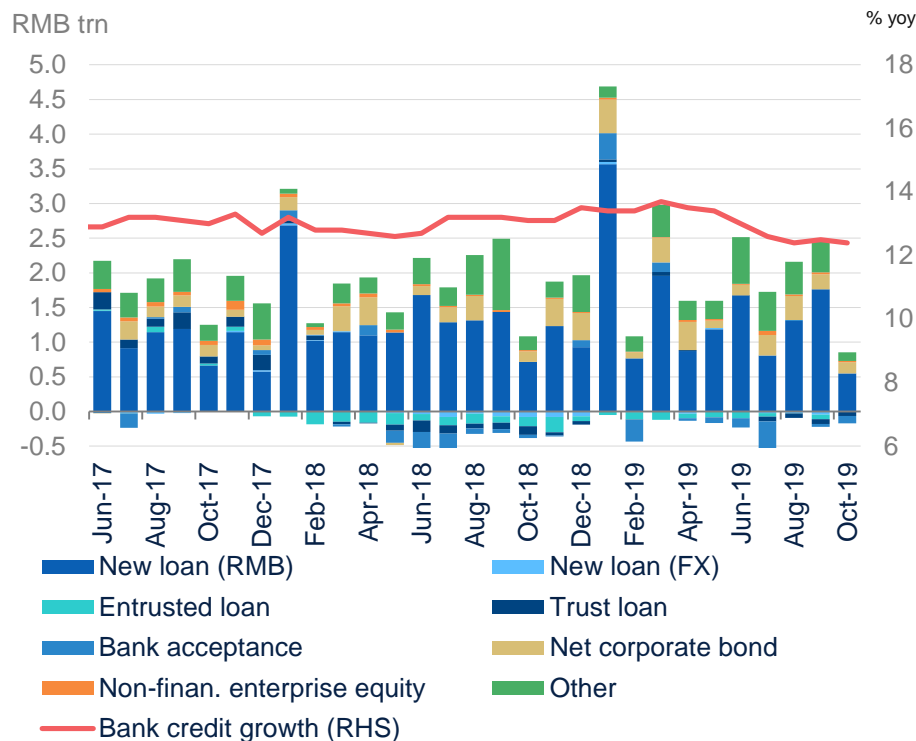


Source: Wind & BBVA Research

The PBoC set Loan Prime Rate (LPR) as the new monetary target rate to help transmit the money market rate to flow to the real economy, effectively cut interest rate. We expect the central bank to maintain its policy easing to support growth.

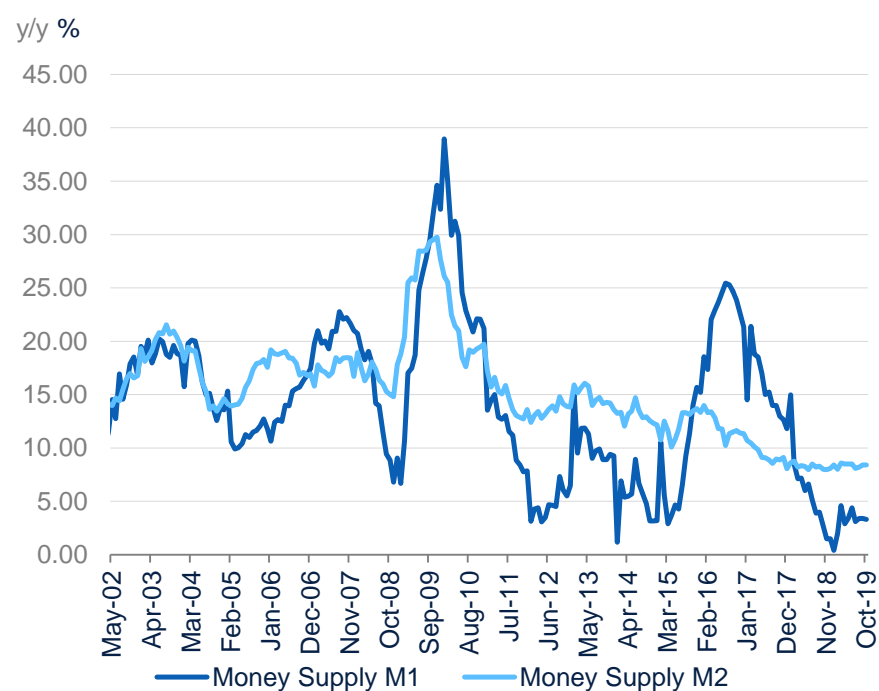
Credit growth slumped in October

NEW CREDIT SUPPLY IS MAINLY THROUGH BANKS' BALANCE SHEET



Source: CEIC & BBVA Research

BOTH M1 AND M2 WERE BOOSTED BY PRO-GROWTH MEASURES



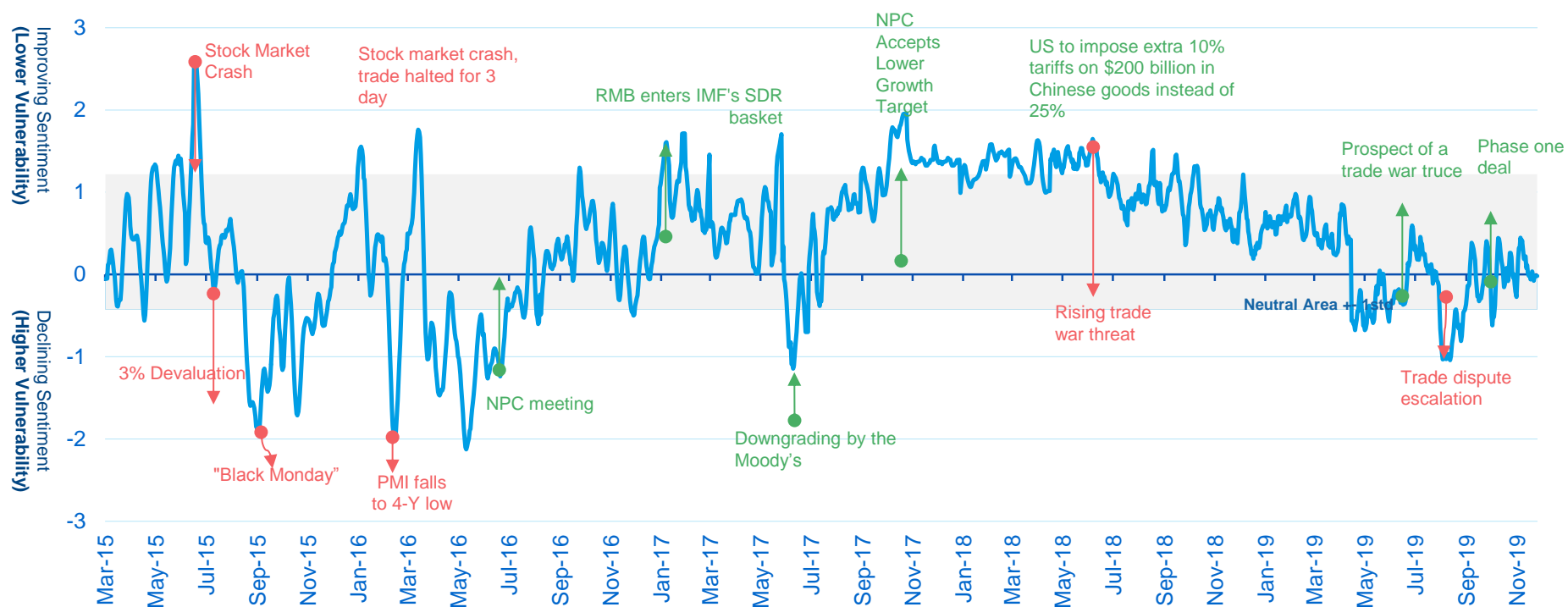
Source: Wind & BBVA Research

Growth of outstanding total social financing (TSF), a broad measure of credit in the economy, slumped in October weighed by weak corporate demand coupled with seasonal effects, reflecting that the effects to funnel credit to the real economy are showing little success.

Vulnerability sentiment index has shown a greater volatility to the downside amid the escalating trade war tensions

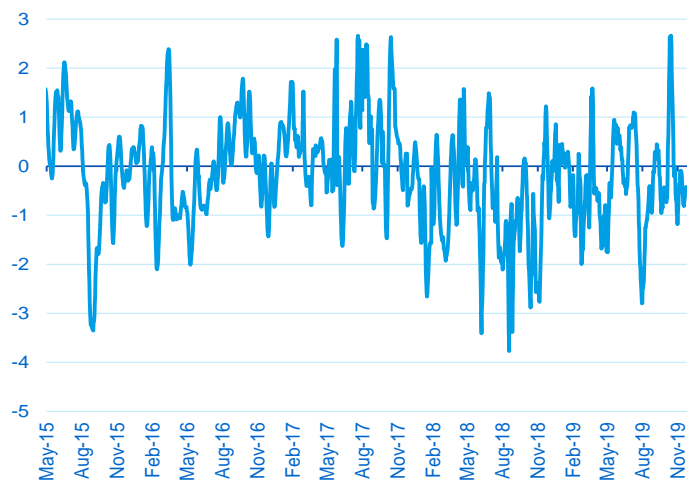
CHINESE VULNERABILITY SENTIMENT INDEX

(CVSI) (EVOLUTION OF THE "TONE" OF MAIN FOLLOWED THEMES ABOUT VULNERABILITY IN CHINA. LOWER VALUES INDICATE A DETERIORATION OF SENTIMENT AND HIGHER VULNERABILITY)

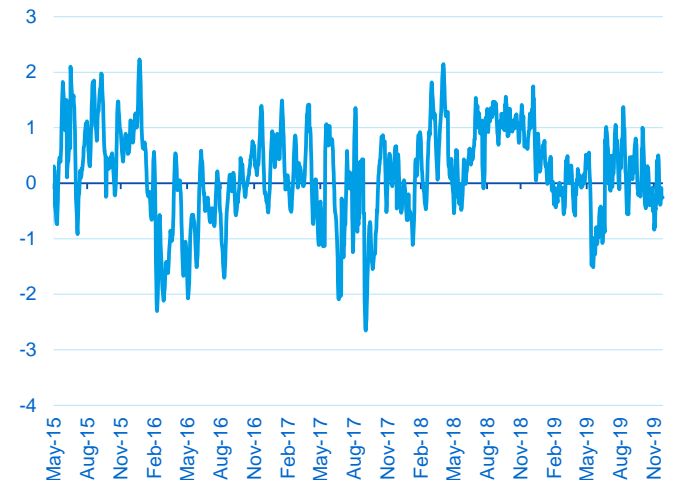


SOE and exchange rate sentiment index perform weakly

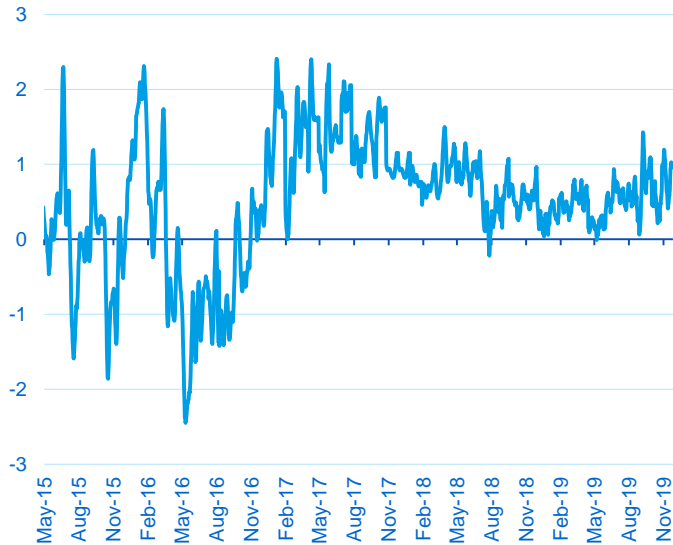
SOE VULNERABILITY INDEX



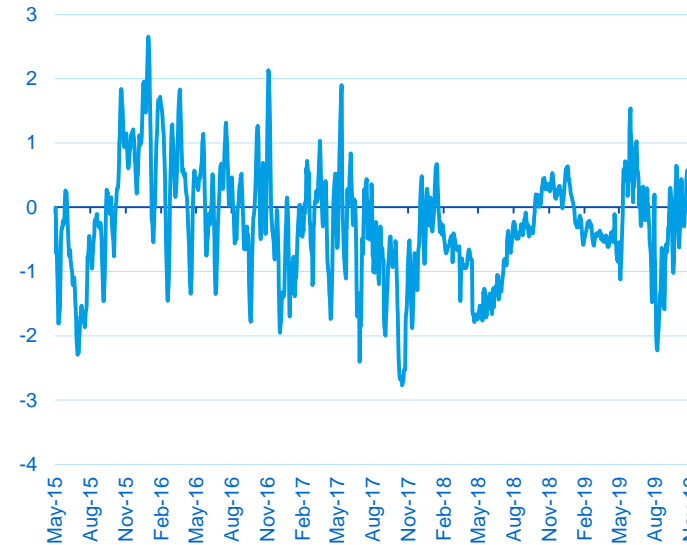
HOUSING BUBBLE VULNERABILITY INDEX



SHADOW BANKING VULNERABILITY INDEX



EXCHANGE RATE VULNERABILITY INDEX



02

Performance of banking Sector

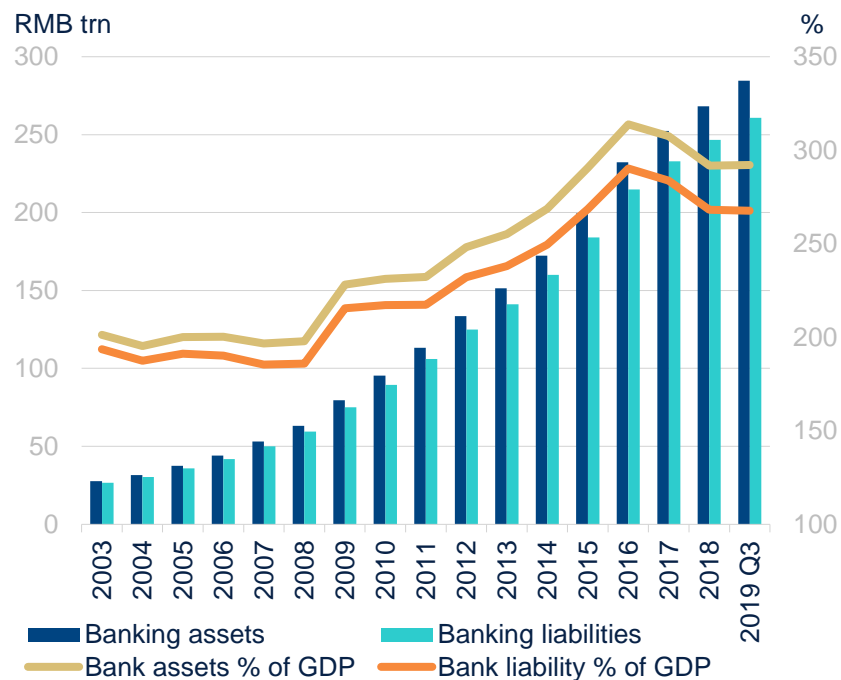
Banks are suffered from the pressure of raising capital as concerns over the health of the financial system grows.

A snapshot of financial fundamentals

	2017 Q3	2017 Q4	2018 Q1	2018 Q2	2018 Q3	2018 Q4	2019 Q1	2019 Q2	2019 Q3
Asset quality and credit risk									
Loans/total assets	47.6%	47.6%	48.8%	49.6%	50.4%	50.8%	51.5%	51.8%	52.7%
NPL ratio	1.74%	1.74%	1.75%	1.86%	1.87%	1.83%	1.80%	1.81%	1.86%
(NPL+special-mention loan) ratio	5.31%	5.23%	5.18%	5.14%	5.11%	4.93%	4.80%	4.74%	4.84%
Provisions/NPLs	180.4%	181.4%	191.3%	178.7%	180.7%	186.3%	192.2%	190.6%	187.6%
Profitability & efficiency									
NIM	2.07%	2.10%	2.08%	2.12%	2.15%	2.18%	2.17%	2.18%	2.19%
Cost to income ratio	28.6%	31.6%	27.3%	27.4%	28.0%	30.8%	26.7%	27.5%	28.6%
ROE	14.14%	13.94%	13.75%	13.55%	13.35%	13.15%	12.96%	12.79%	12.57%
ROA	1.03%	1.01%	1.01%	1.01%	1.00%	1.00%	0.99%	0.98%	0.97%
Solvency									
Tier 1 ratio	11.2%	11.4%	11.3%	11.2%	11.3%	11.6%	11.5%	11.4%	11.8%
Core Tier 1	10.7%	10.8%	10.7%	10.7%	10.8%	11.0%	11.0%	10.7%	10.9%
Leverage ratio	6.4%	6.5%	6.5%	6.5%	6.6%	6.7%	6.6%	6.6%	6.8%
NPLs/ Capital	10.4%	10.2%	10.3%	11.2%	11.1%	10.7%	10.6%	10.8%	10.9%
Liquidity and funding									
Deposits/Total assets	65.7%	65.0%	66.1%	66.5%	66.6%	66.2%	66.6%	66.5%	67.0%
Non-deposits funding (Central bank, bonds, NCDs, ...) / Total assets	38.1%	38.7%	37.9%	38.1%	38.0%	38.5%	37.4%	37.4%	37.3%
Loan to deposit ratio	70.0%	70.6%	71.2%	72.3%	73.6%	74.3%	72.2%	72.9%	74.4%
Current assets/ Current liabilities	49.2%	50.0%	51.4%	52.4%	52.9%	55.3%	56.8%	55.8%	57.0%
Liquidity coverage ratio	120.2%	123.3%	125.3%	131.3%	127.8%	138.0%	141.1%	140.2%	137.3%

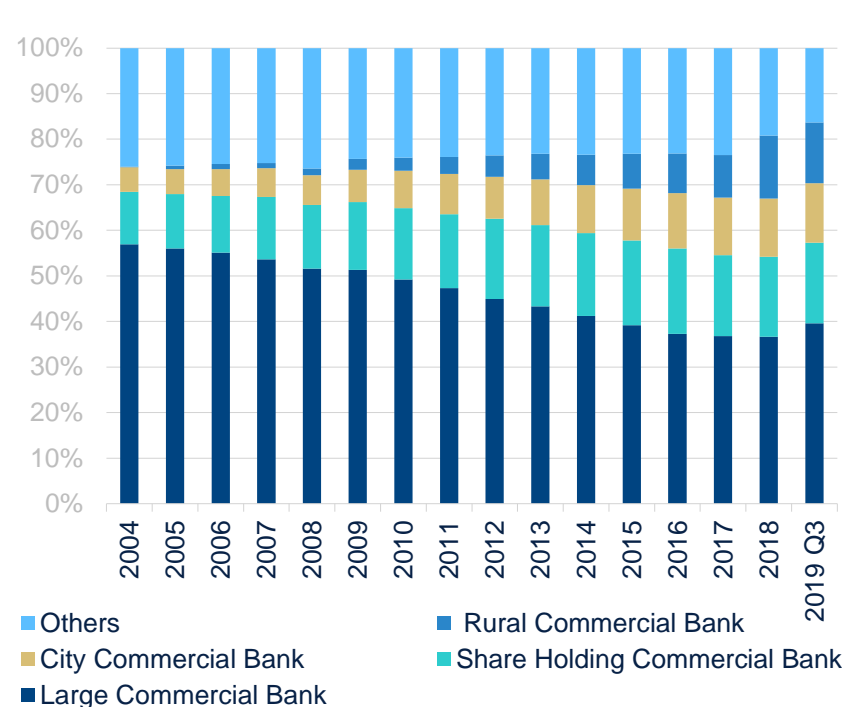
Bank assets growth moderated on government's efforts to curtail shadow banking and interbank activities

BANKING ASSETS HAS MODERATED ITS GROWTH RATE



Source: CBIRC & BBVA Research

LARGE AND SHAREHOLDING COMMERCIAL BANKS STILL DOMINATE

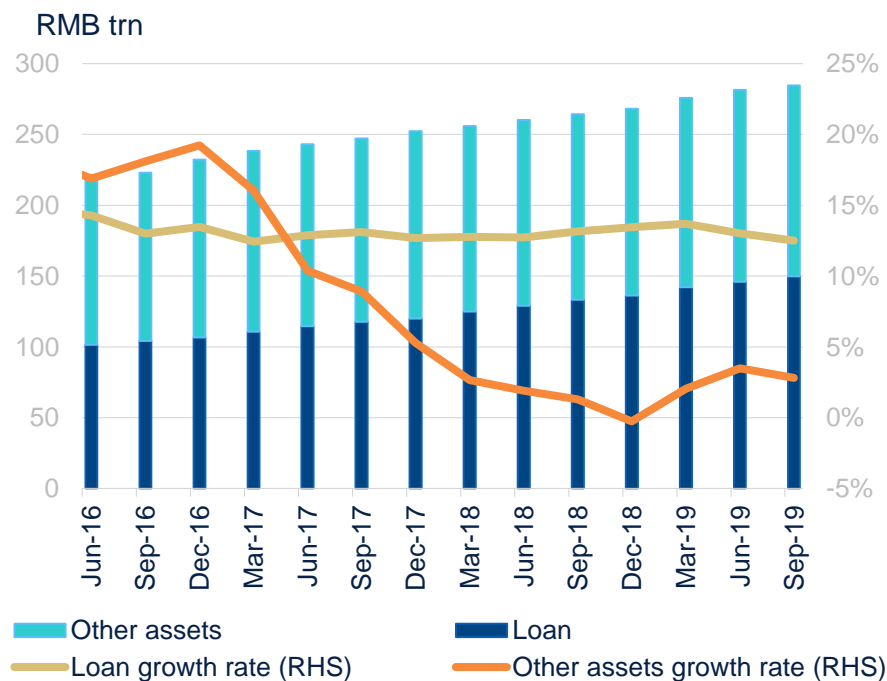


Source: CBRIC & BBVA Research

China's banking sector assets picked up to 7.7% yoy at the end of Q3 2019 from 6.3% at the end of 2018, with total assets reached RMB284.7tn. By category, the aggregated assets of large commercial banks accounted for 39.6% of the sector's total, representing a rise of 3% from the share at the end of 2018.

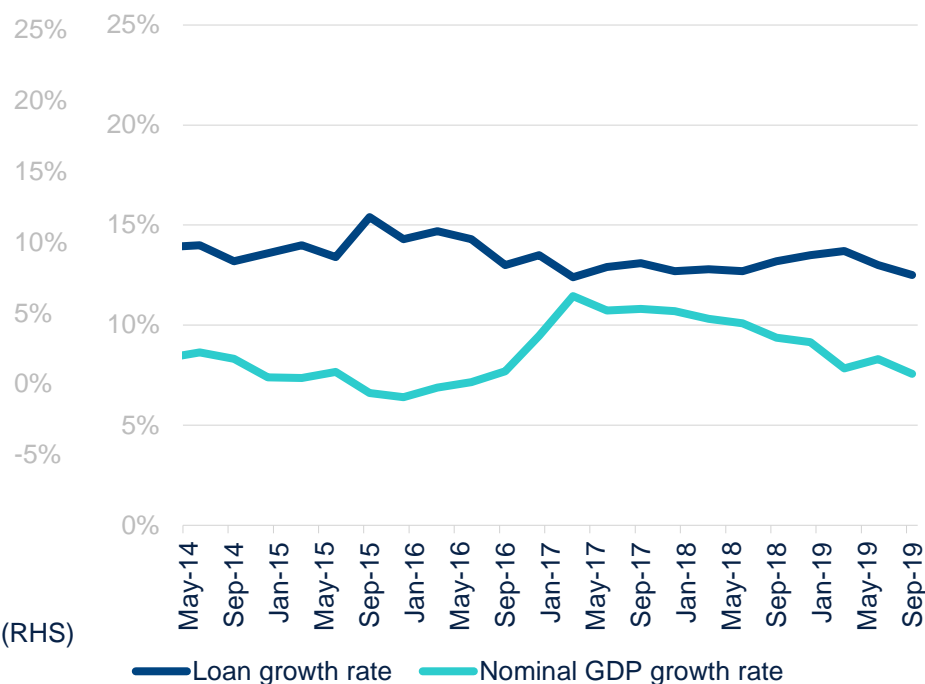
New credit are mainly supplied through banks' balance sheet

LOANS GREW FASTER THAN NON-LOAN ASSETS...



Source: CEIC & BBVA Research

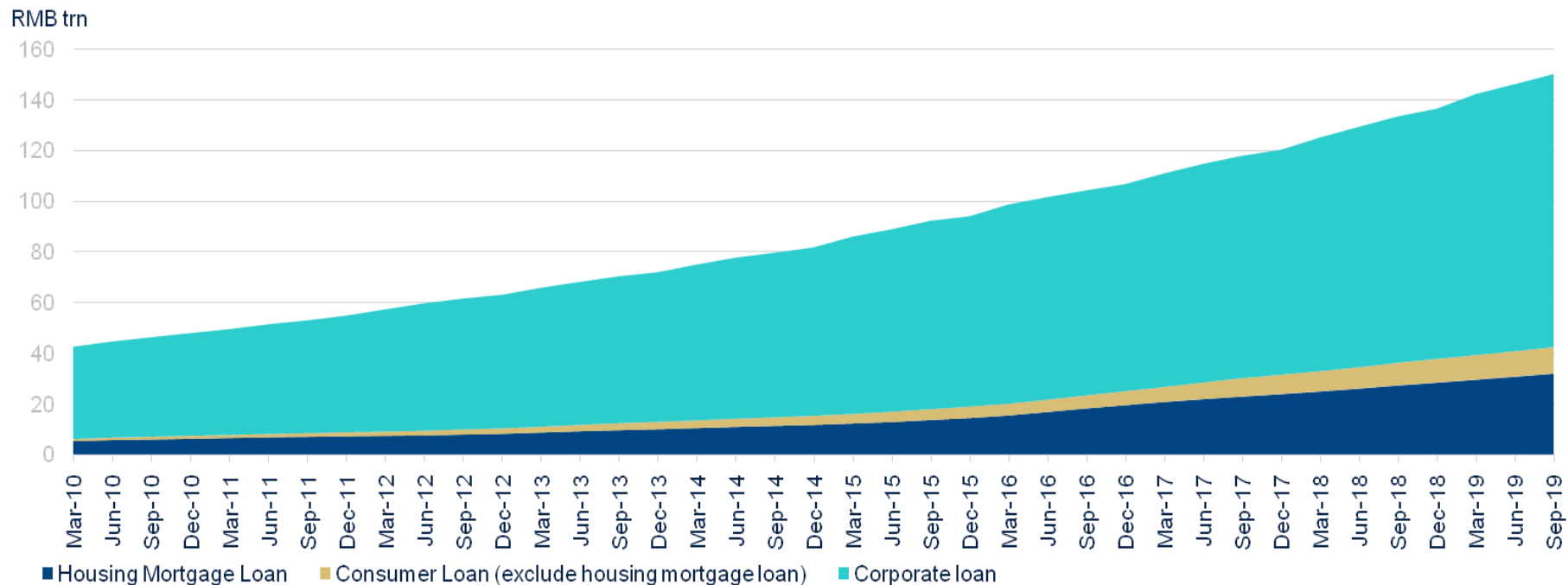
...AS WELL AS THE NOMINAL GDP



Source: CEIC & BBVA Research

Higher loan growth rate contribution to the asset growth amid authorities called for more lending to the small and medium sized companies (SMEs), the amount of loans to small and micro companies continued growing and increased by 17% qoq to RMB 647.1bn. Non-loan assets which are believed to be associated with shadow banking activities also increased.

Corporate loans growth rate still lag behind individual loans

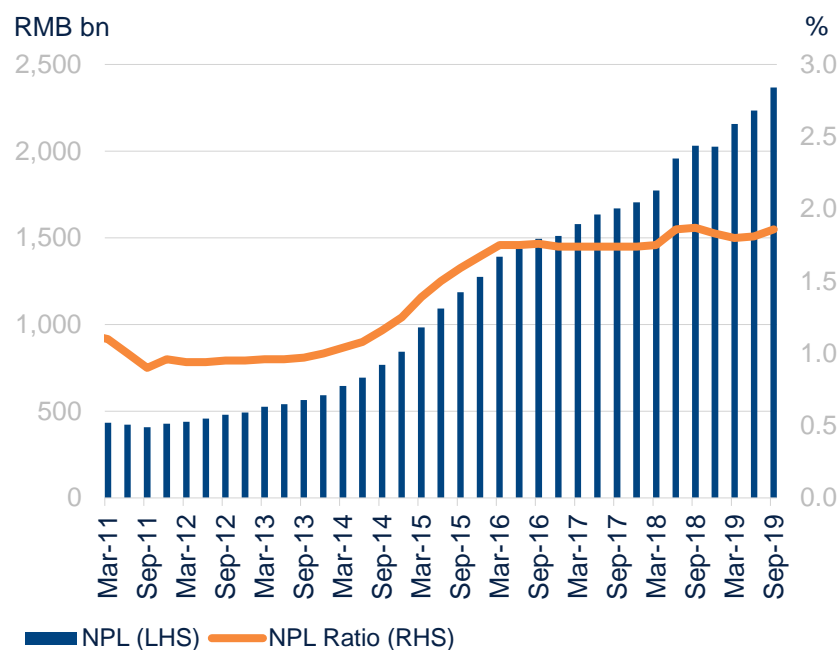


Source: CEIC & BBVA Research

Growth of loans to individuals continued to outpace that of corporate one, reflecting weaker demand for credit from companies as their confidence has been affected by the trade war although banks have stepped up lending to infrastructure projects and privately owned small and medium-sized enterprises.

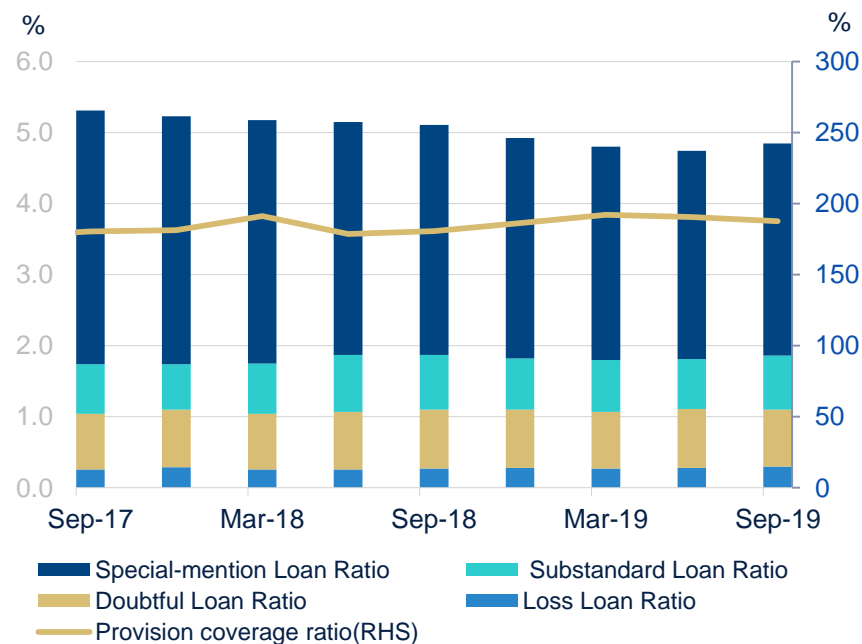
Asset quality deteriorated as an increase in bad loans...

NPLS RATIO WORSENEO ON AN INCREASE IN BAD LOANS



Source: CEIC & BBVA Research

...SPECIAL- MENTION LOAN RATIO DECREASED

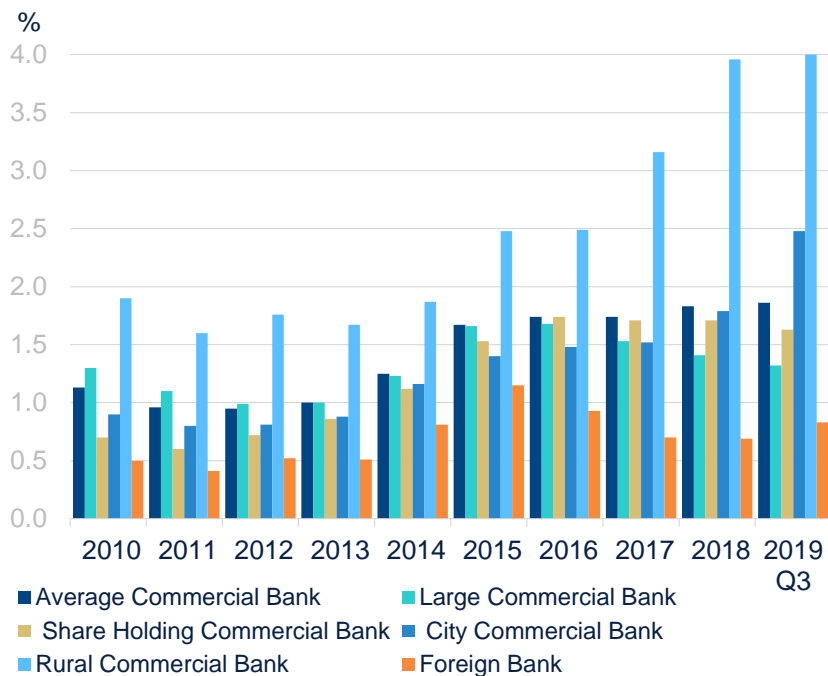


Source: CEIC & BBVA Research

Asset quality deteriorated in the Q3 2019 as banks report higher non-performing loan ratio, which edged up by a 3 bps compared with the level at the end of 2018. However, special-mention loan ratio declined to 2.99%, resulting banks overall NPL ratio dropped to 4.74% in Q3 2019 from 4.92% at the end of 2018 if added the special-mention loan ratio.

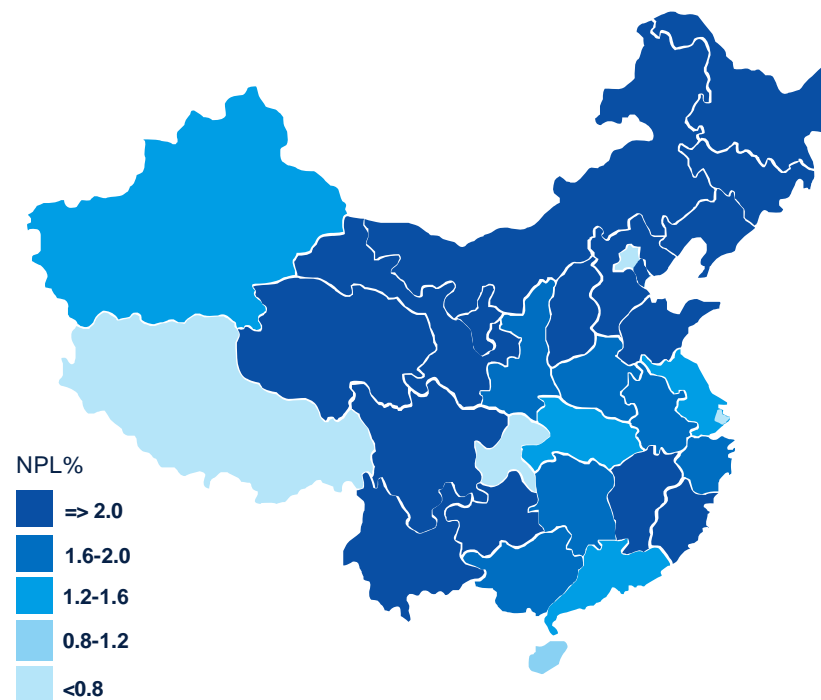
NPLs are rising for city and foreign banks

MARKED RISE IN RURAL COMMERCIAL BANK'S NPL RATIO



Source: CEIC & BBVA Research

NPL LANDSCAPE BY REGION

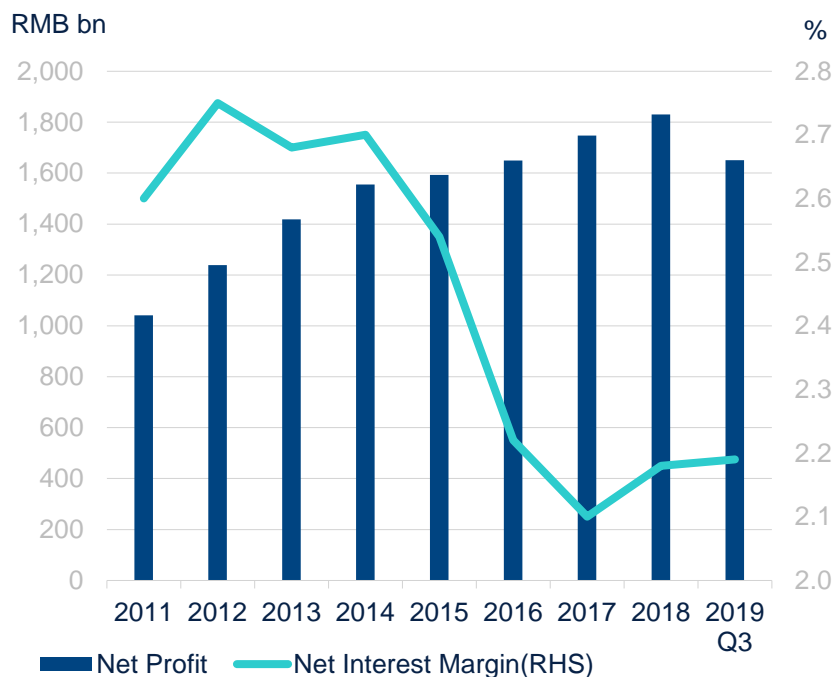


Source: CEIC & BBVA Research

Rural and city commercial banks suffered a higher NPL ratio increase as the regulators have enforced a stricter standard of NPL recognition policy since last year. Troubled banks are most numerous in north China.

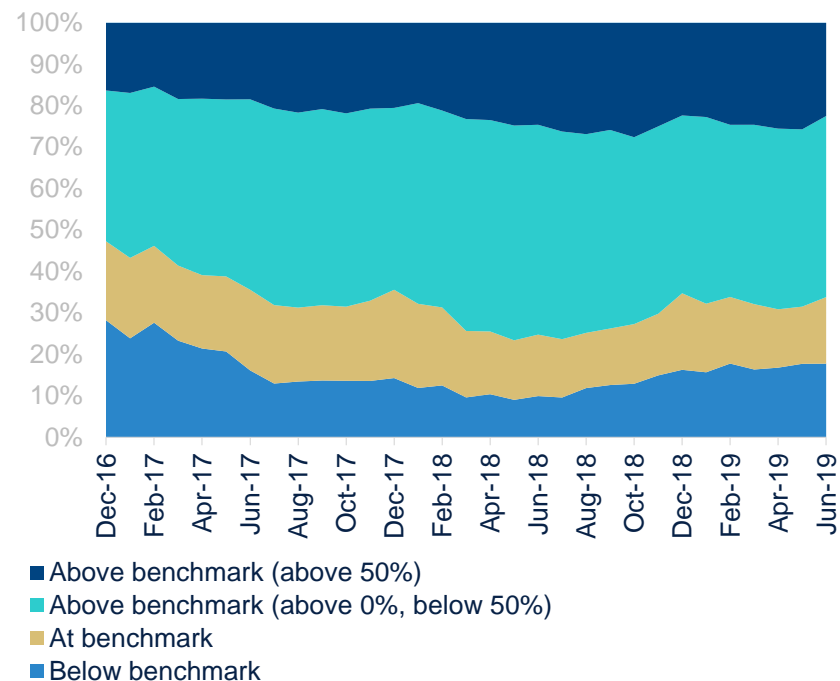
Banks' net profit managed to grow at a modest pace

NET INTEREST MARGIN (NIM) IMPROVED in 1H 2019



Source: CBRIC & BBVA Research

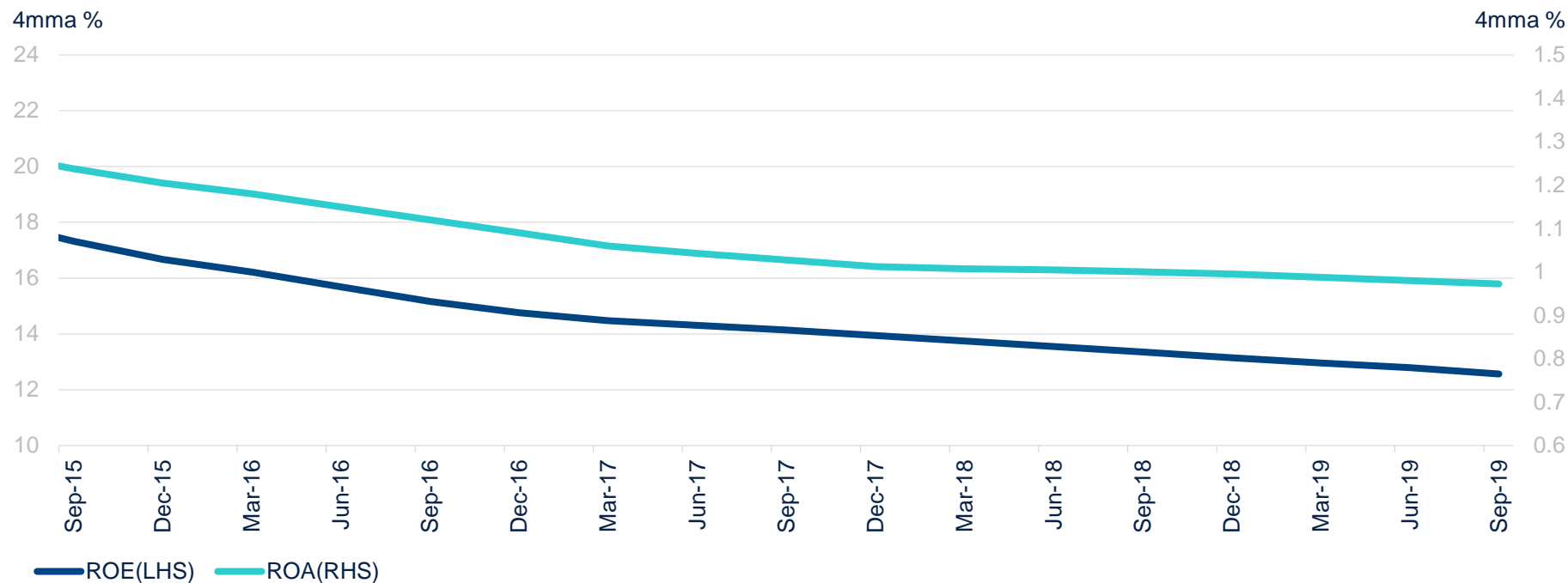
BANK'S LOAN PRICING CAPACITY DECLINED AMID THE MONETARY EASING



Source: CBRIC & BBVA Research

Both banks net profit growth rate and net interest margin (NIM) picked up at a modest pace as banks shift to relatively high-yield retail credit from interbank activities. Moreover, the overall debt cost of commercial banks generally declined amid an easing environment. While the challenges remain high for banks loan pricing as impairment cost remain high and deposit competition continues based on the new LPR.

However, ROA and ROE continue its weak performance

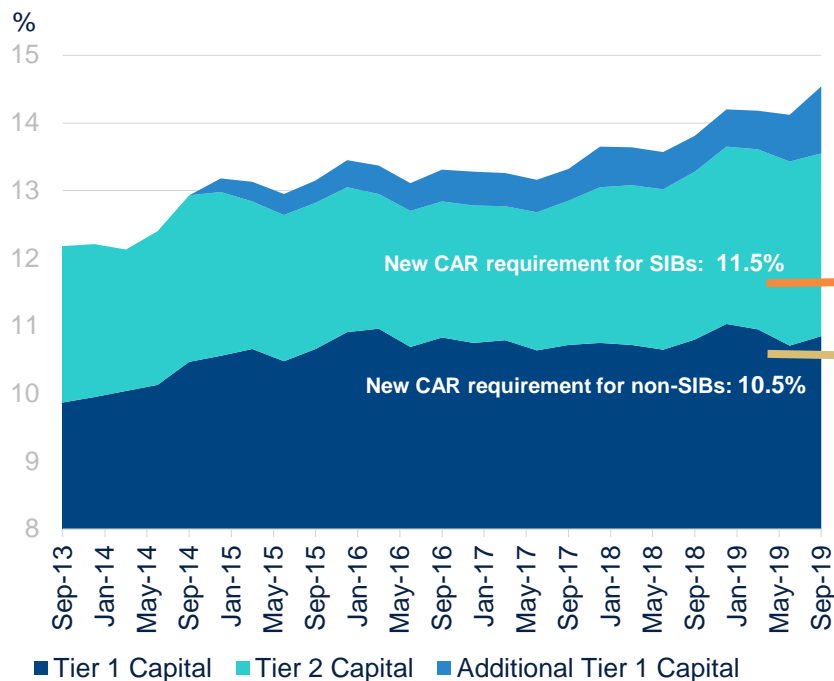


Source: CBRIC & BBVA Research

Although Net interest margin (NIM) maintained a small increase in Q3, both the return on equity (ROE) and return on assets (ROA) continue decreasing. It is related to the shrinkage of banks off-balance-sheet businesses (shadow banking), which used to contribute substantially to banks' profit growth with no change of balance sheet size.

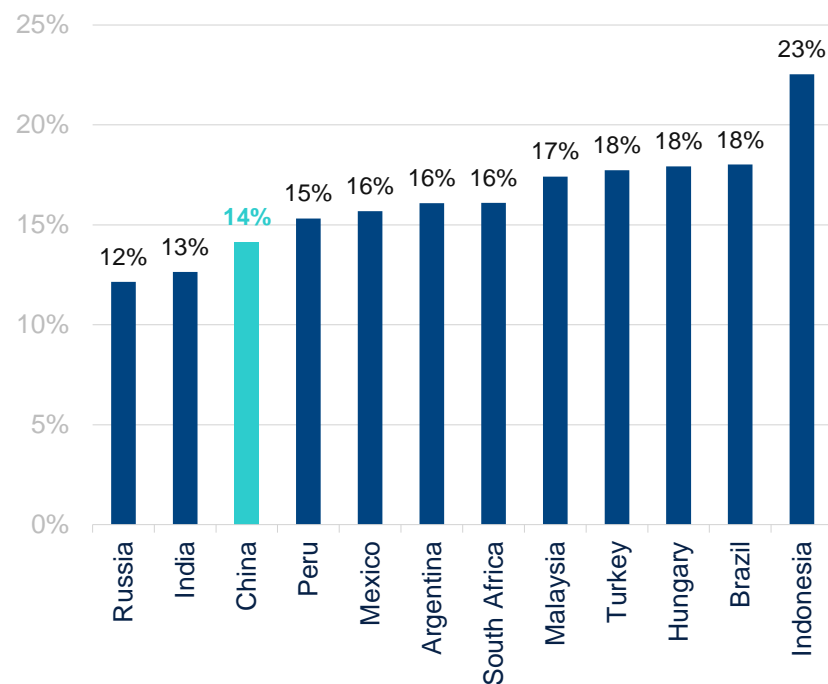
Capital buffers remained adequate

CAPITAL ADEQUACY RATIO INCREASED DUE TO THE ISSUANCE OF TIER 2 CAPITAL INSTRUMENT



Source: CBRIC & BBVA Research

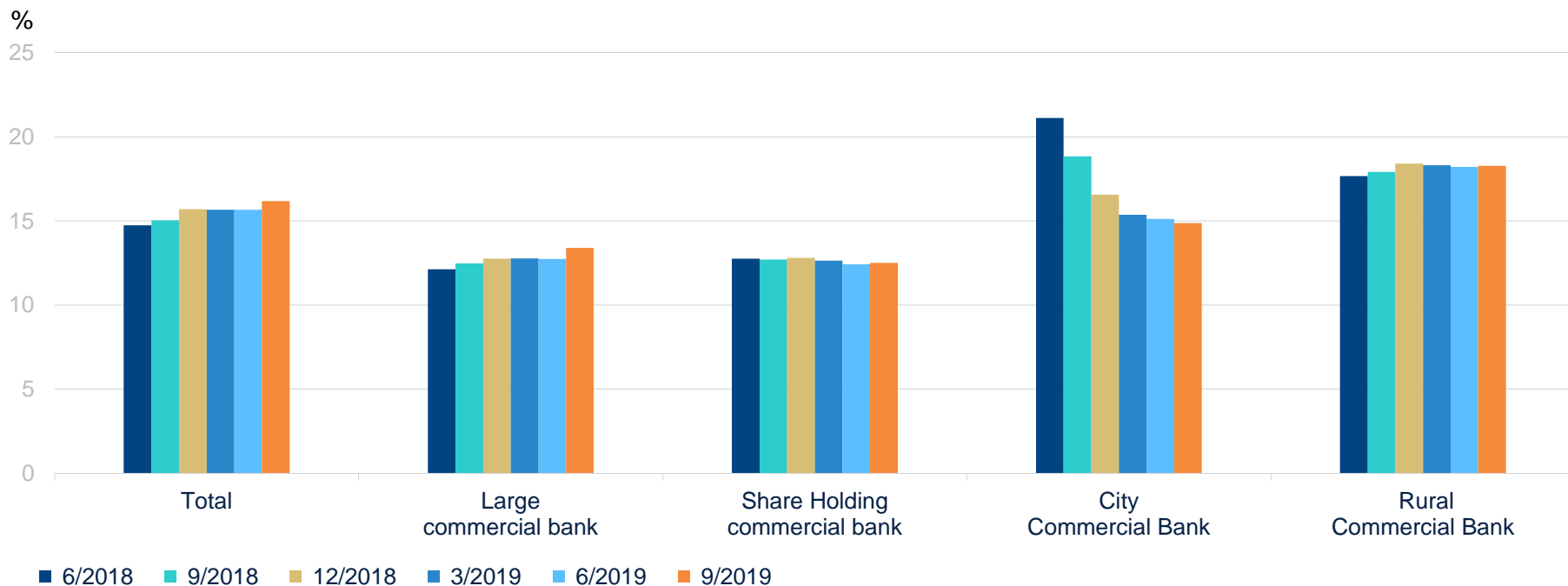
HOWEVER, CHINESE BANKS' CAR STILL LAG BEHIND THEIR MAJOR EMS PEERS



Source: CBRIC & BBVA Research

The capital adequacy ratio rose but the core tier 1 capital ratio dropped, as the fast growth of loans contributes to faster growth in risk-weighted assets. Banks are suffered from the pressure of raising capital as concerns over the health of the financial system grows.

A diverged capital buffer distribution among big and smaller banks

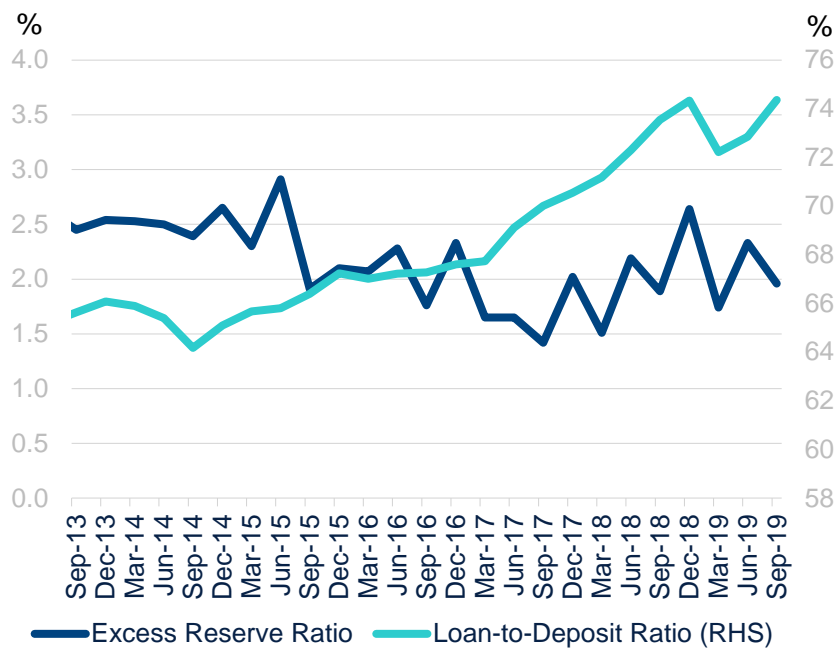


Source: CBRIC & BBVA Research

Although the total provision coverage ratio is rising for all banks except city commercial banks, provisions for possible loan losses are seldom matching the aggressive expansion in the overdue loan book for some small city and rural banks, pointing to a potential capital shortfall.

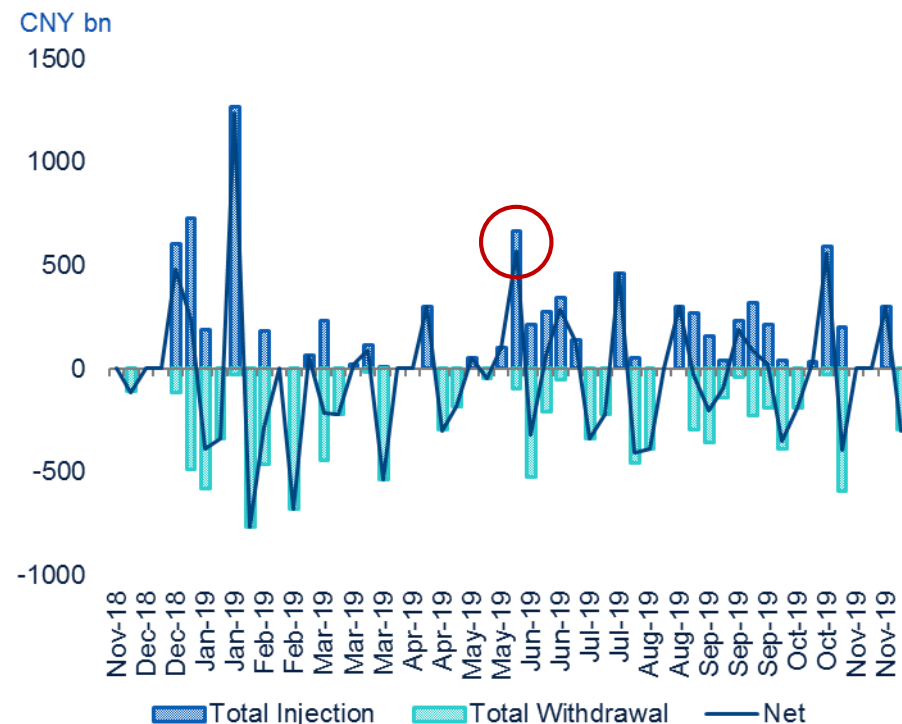
Banks' liquidity remained safe but is subject to challenges of credit event

RISING LOAN-TO-DEPOSIT RATIO INDICATES THAT BANKS BECOME THE DOMINANT CHANNEL FOR CREDIT EXPANSION



Source: CBRIC & BBVA Research

CHINA PBOC WEEKLY OPEN MARKET OPERATIONS AND ITS REACTION TO BAOSHANG BANK EVENT

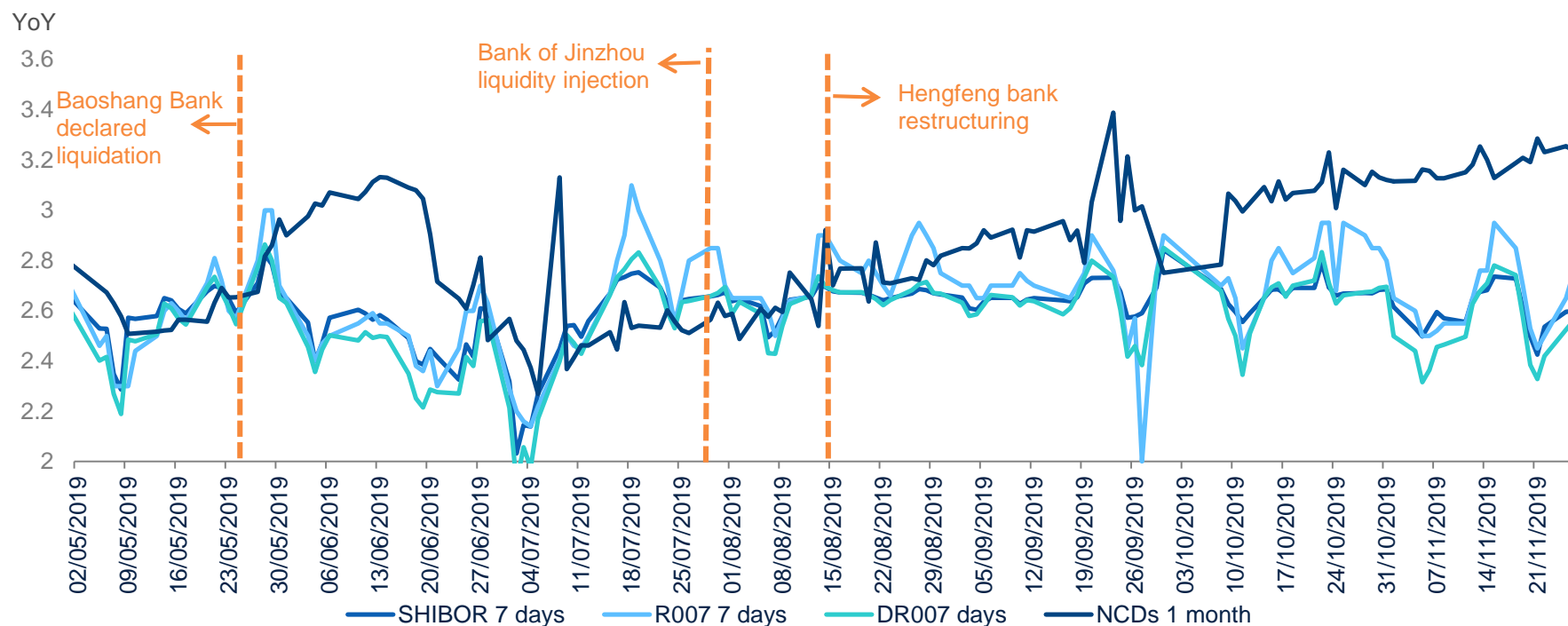


Source: Bloomberg & BBVA Research

The net liquidity injection the center bank injected has more than quadrupled to RMB 430 billion in the week immediately after the takeover of Baoshang Bank. PBoC has taken effort to inject liquidity recently to calm nerves in the interbank market and avoiding a liquidity crisis for troubled banks.

The adverse impact on economy was amplified by the troubles in banking sector

SOLVENCY RISK LOOMS LARGE AMONG SOME SMALL CITY AND RURAL COMMERCIAL BANKS

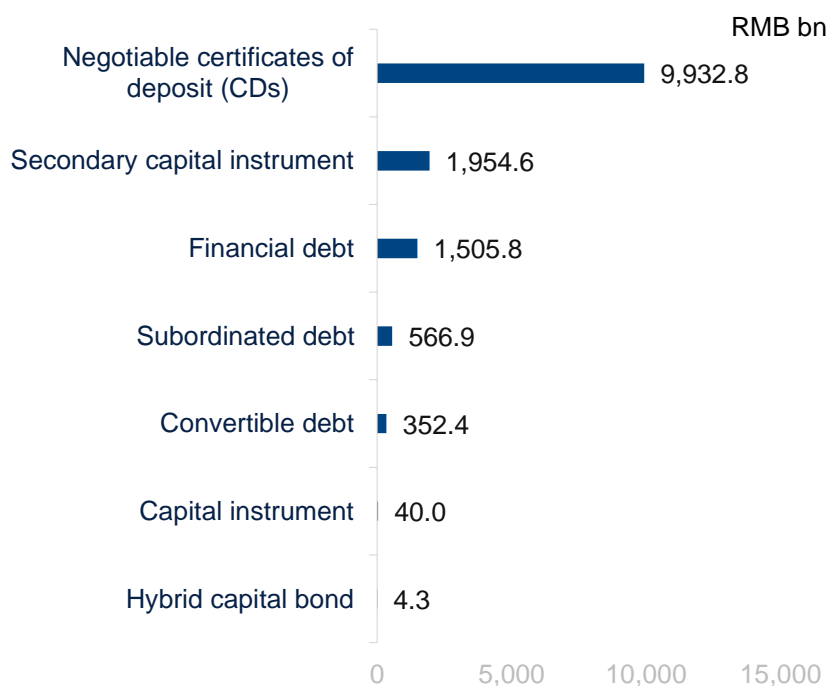


Source: Wind & BBVA Research

Markets saw another two banks-Bank of Jinzhou and Hengfeng Bank receive official assistance to continue operating after government rescue of Baoshang Bank, which is the first case of a direct state takeover of a lender in the past 20 years.

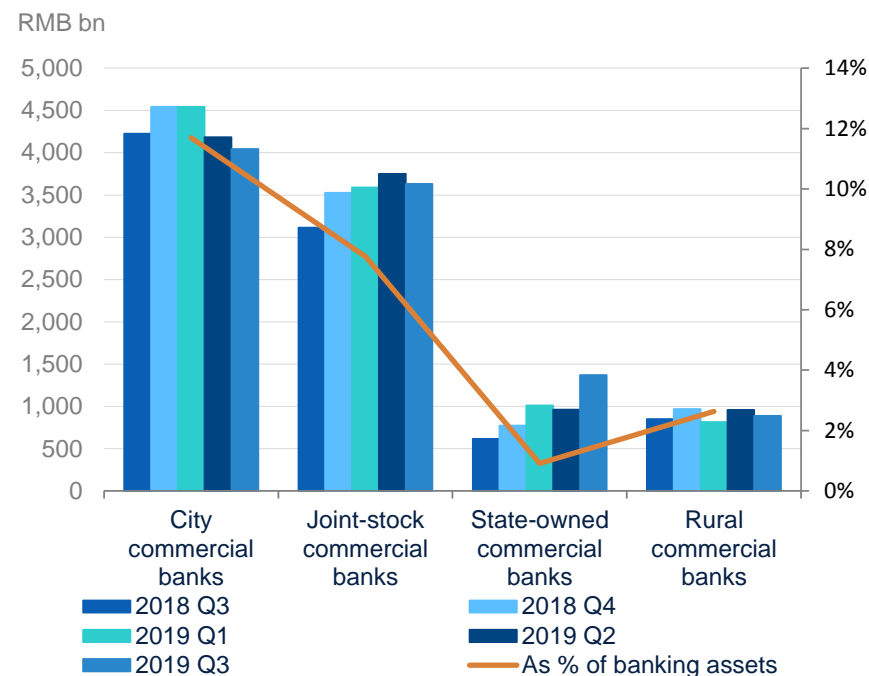
Small banks' reliance on negotiable certificates of deposits (NCDs) as funding sources has been damaged

COMMERCIAL BANKS ISSUED DEBT-INSTRUMENT



Source: Shanghai Clearing House & BBVA Research

BALANCE OF COMMERCIAL BANKS ISSUED NCDs BY BANKS TYPE

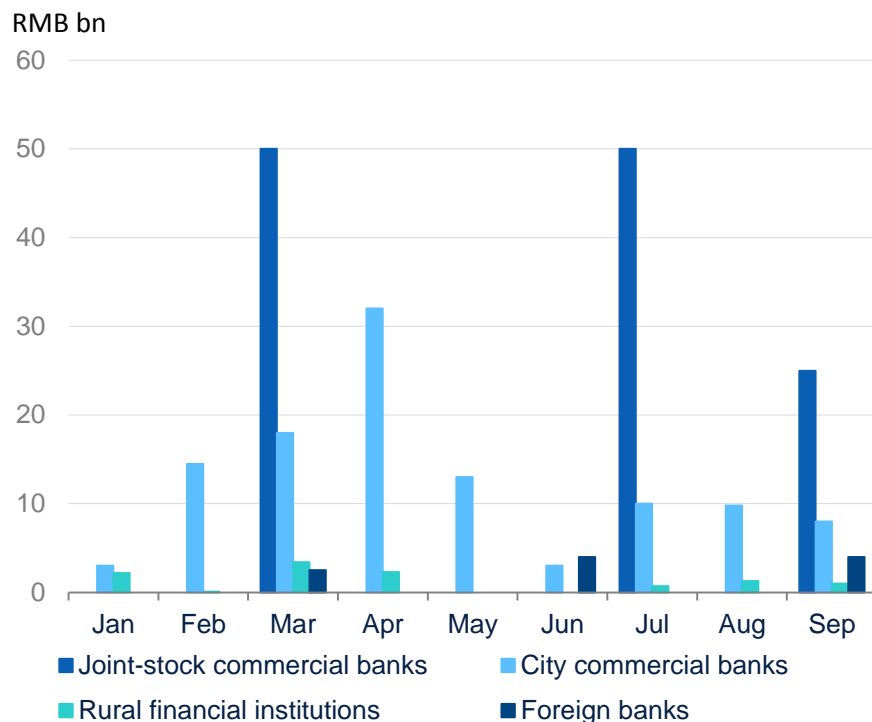


Source: Shanghai Clearing House & BBVA Research

Small banks are facing deteriorating funding conditions. It is reported that troubled banks have been able to secure only 20-40% of the funds they have sought to raise in the interbank market for negotiable certificates of deposit (NCDs), a vital source of funding for many smaller lenders.

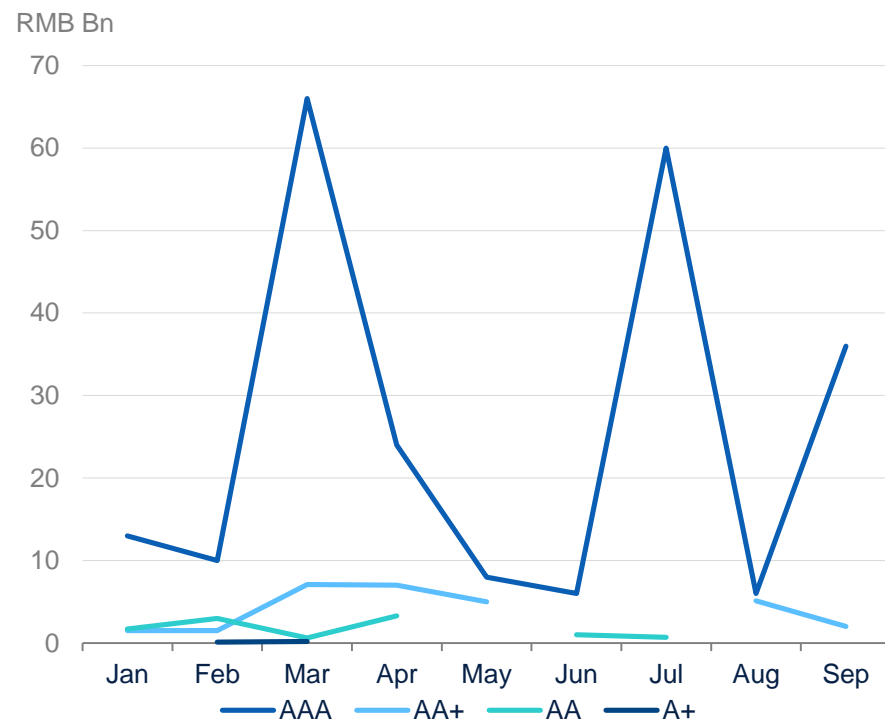
Small banks reliance on the bond market have also been curtailed

COMMERCIAL BANKS ISSUED BONDS BY BANK TYPE



Source: Wind & BBVA Research

COMMERCIAL BANKS ISSUED BONDS BY RATING



Source: Shanghai Clearing House & BBVA Research

After the credit events, the issuance of bonds in the primary market by city commercial banks and rural commercial banks were significantly reduced. These banks have significantly reduced issuing bonds as funding source and bonds issuance rating below AA+ have been diminished.

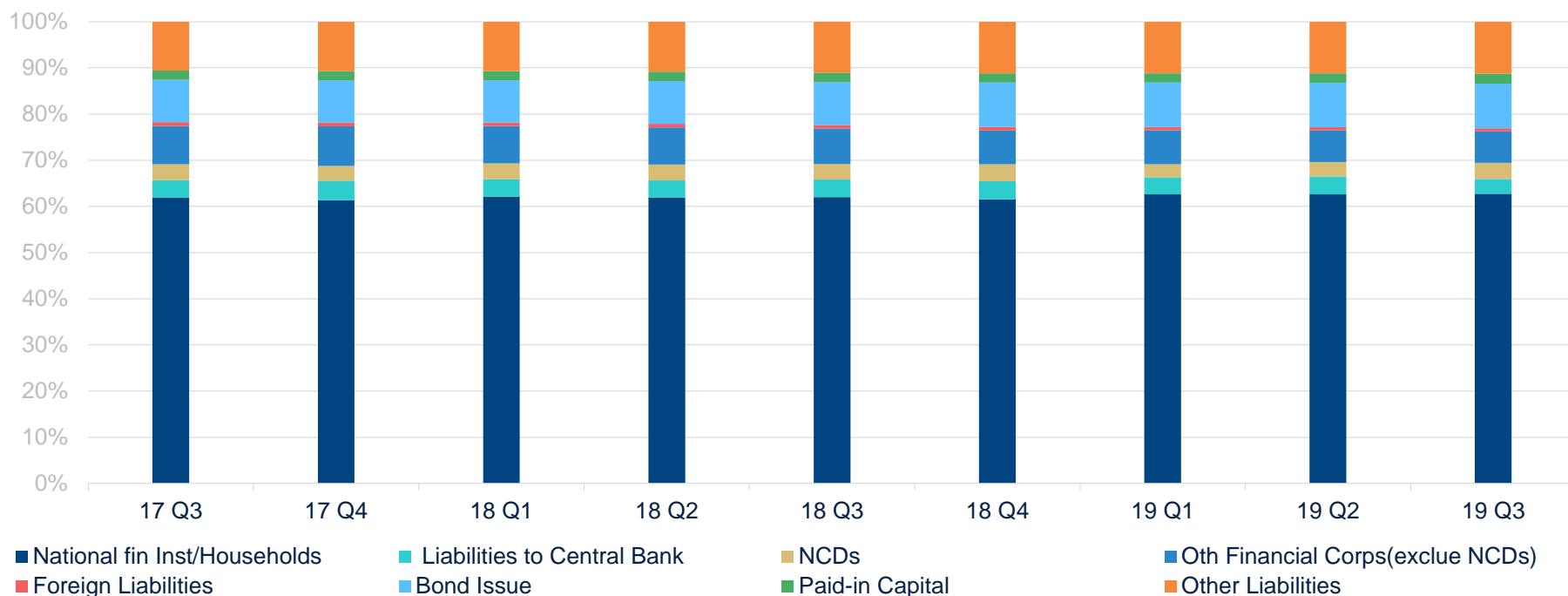
03

Shadow banking activities

Banks interconnectedness
with the shadow banking
system has further decreased

Banks' fund dependence of shadow banking system has further decreased

BREAKDOWN OF BANKS LIABILITIES

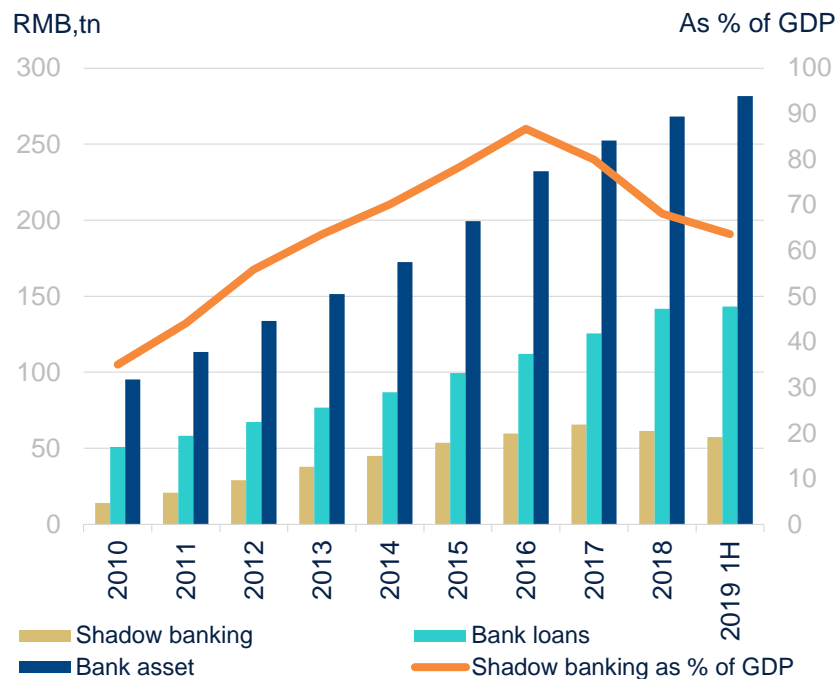


Source: Haver & BBVA Research

The mix of the banks' source of market funds also improved, with bonds and negotiable certificates of deposits rising to account for 4.1% of assets at 1H 2019 from 3.6% at the end of 2018, while the proportion of interbank and other shorter-term market funds dropped to 11.1% from 12.1% in the same period.

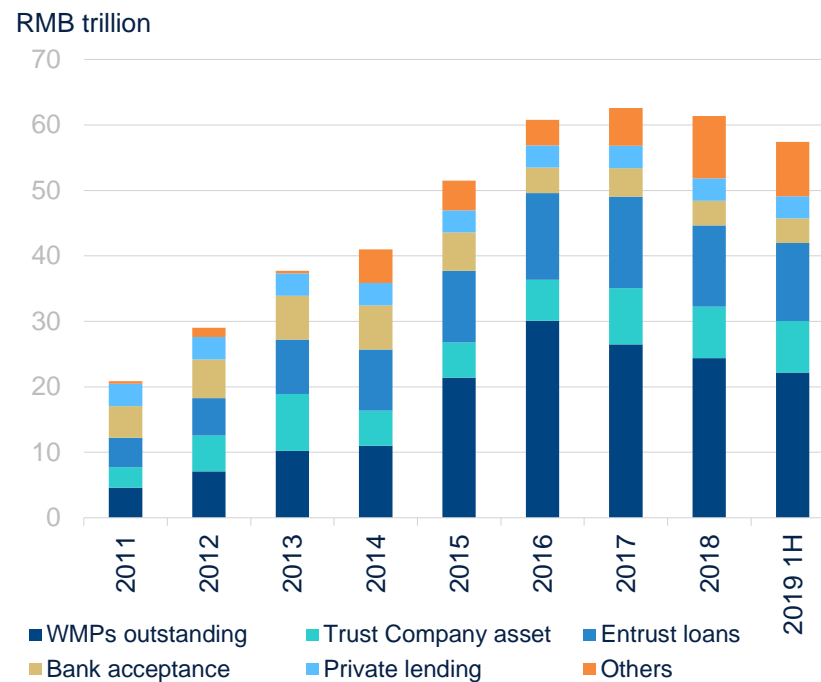
Financial deleveraging has seen good progress

SHADOW BANKING ASSETS AS % OF GDP DECLINED FURTHER AT THE END OF 2018



Source: CBIRC & BBVA Research

INTENSIFIED REGULATIONS HAVE A GROWING IMPACT ACROSS SHADOW BANKING SECTOR

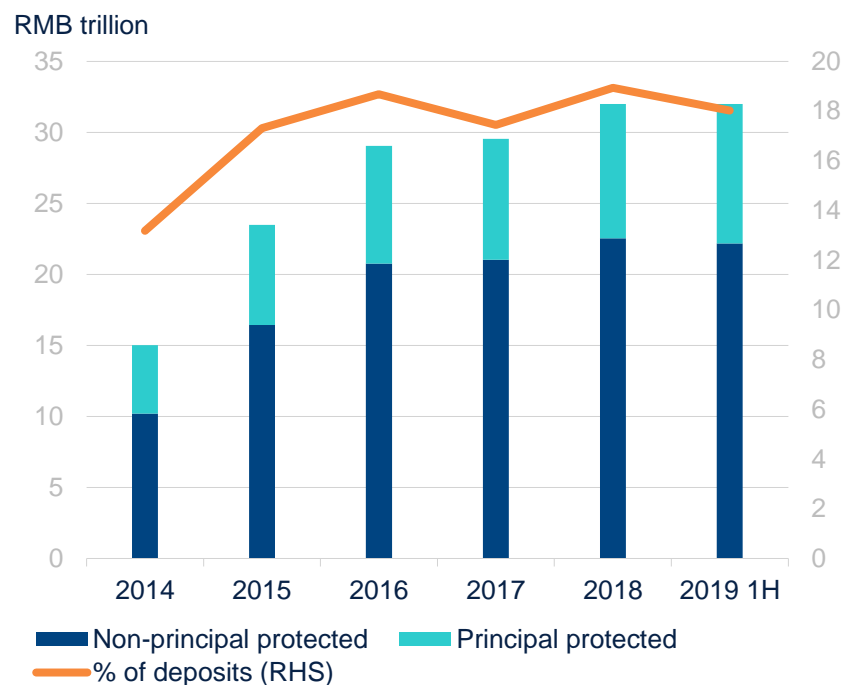


Source: CBIRC, China Banking Wealth Management Product Registration & Depository Center & BBVA Research

The broad shadow banking assets declined at RMB 57.4 trillion in 1H 2019. Major components of shadow banking including WMPs, trust loans, entrusted loan and bank acceptance all dipped to their slowest pace over the past eleven quarters.

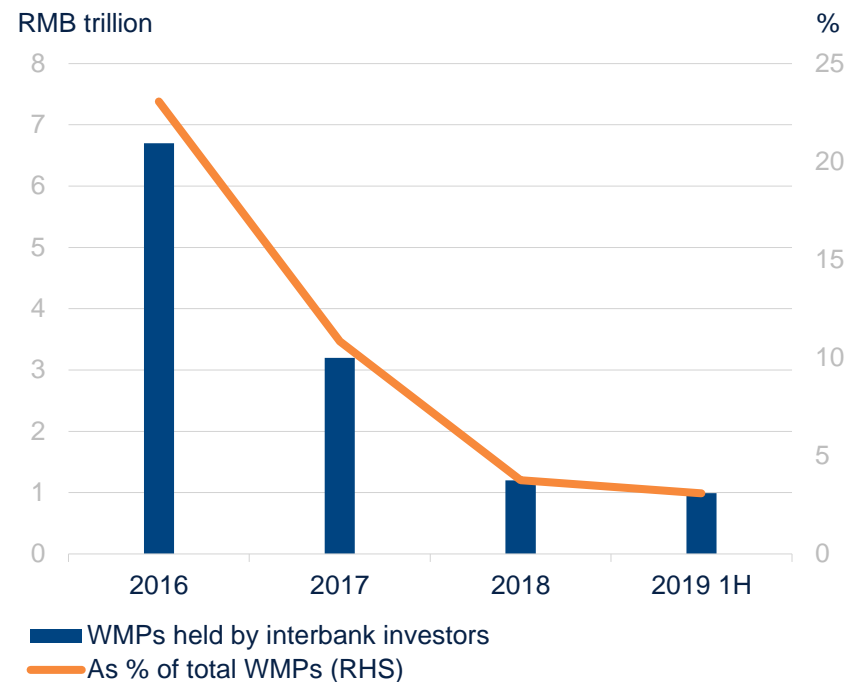
Coordinated regulatory actions help to curb WMPs growth

NON-PRINCIPAL PROTECTED WMPs OUTSTANDING MARGINALLY DECLINED



Source: Wind & BBVA Research

INTERBANK INVESTORS' EXPOSURE TO SHADOW BANKING HAS SHRUNK FURTHER

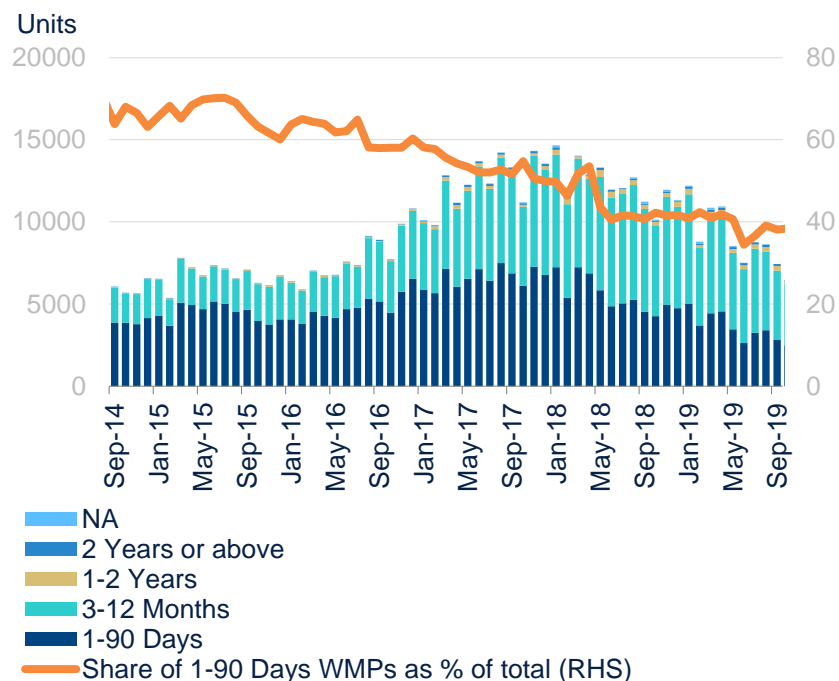


Source: Wind & BBVA Research

Non-principal protected WMPs distributed by banks have shrunk to RMB22.18 trillion at the end of 1H 2019. Both amount and percentage of WMPs held by interbank investors declined. We expect a marginal relaxation in the implementation of the asset management regulation this year as policy priorities are shifting away from combating leverage towards sustaining growth.

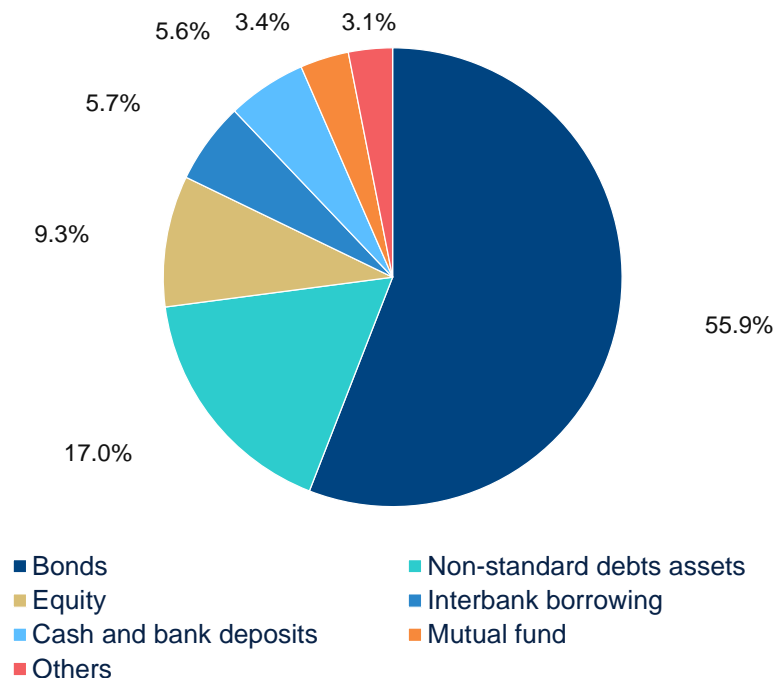
Maturity mismatch between WMPs and underlying assets has lessened

THE SHARE OF SHORT TERM WMPs REMAINED STABLE



Source: CEIC & BBVA Research

WMPs SHIFTED TO BOND-LINKED PRODUCTS

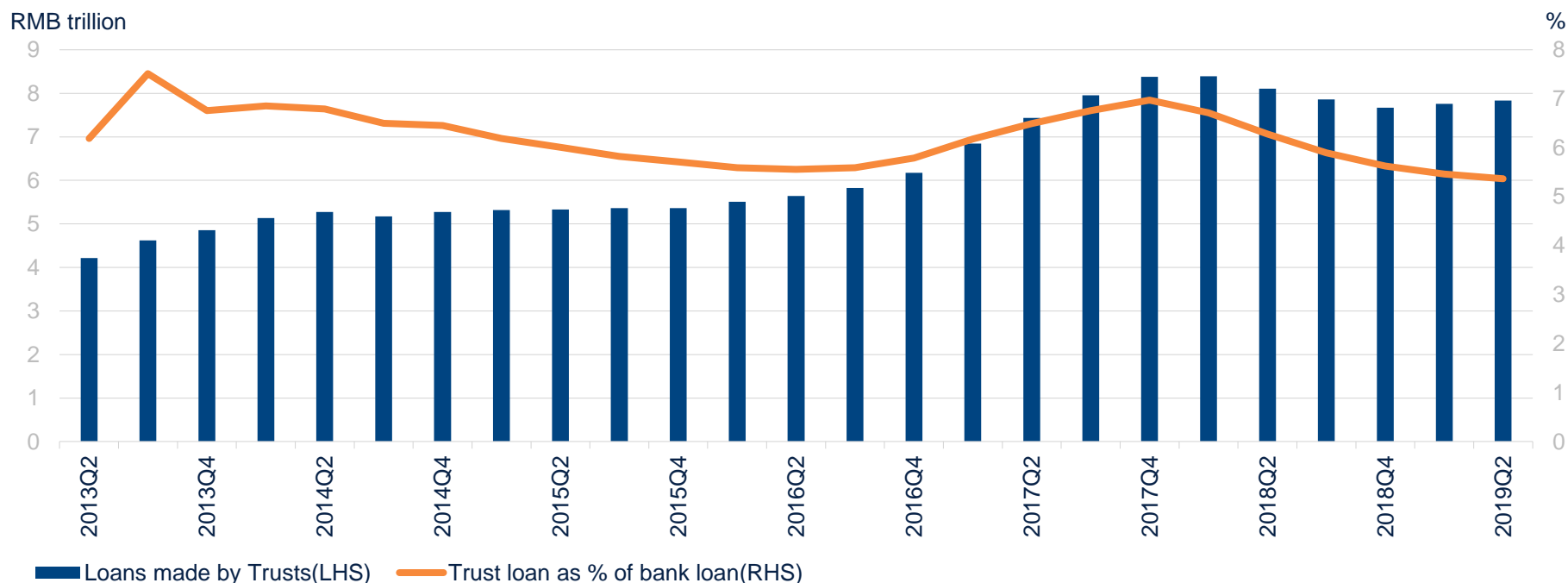


Source: CEIC, Haver & BBVA Research

WMPs with short maturities (below 3 months) are relatively steadily with their share around 40%, helping reduce liquidity risk from a maturity mismatch between WMPs and underlying assets. WMPs shifted to bond-linked products.

Trust loans resume to grow in Q3 2019 amid a cooling economy

GROWTH IN TRUST COMPANY LOANS

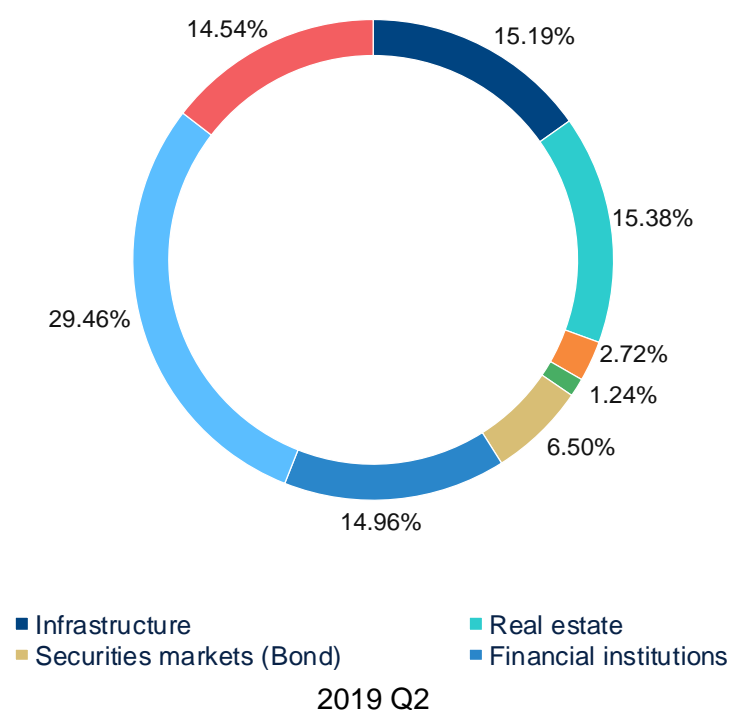


Source: China Trustee Association & BBVA Research

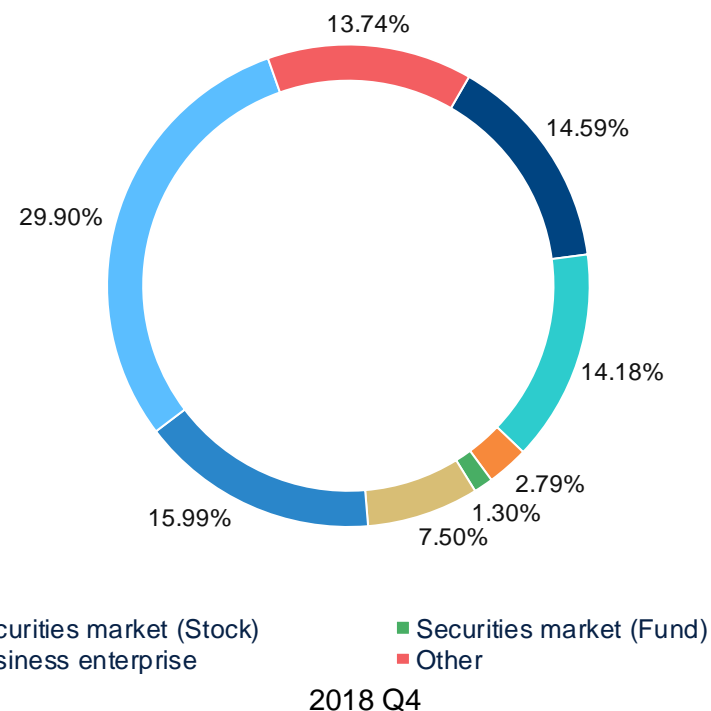
Growth of outstanding trusts loans continued its upward trend in Q3 2019 amid a cooling economy, which also reflected the recent relaxation of regulation. We expect this trend will continue in the rest of the year.

Trust assets continue to shift toward property sector and business enterprises

INFRASTRUCTURE AND REAL ESTATE SEEK TO TRUST ASSETS FOR FINANCING



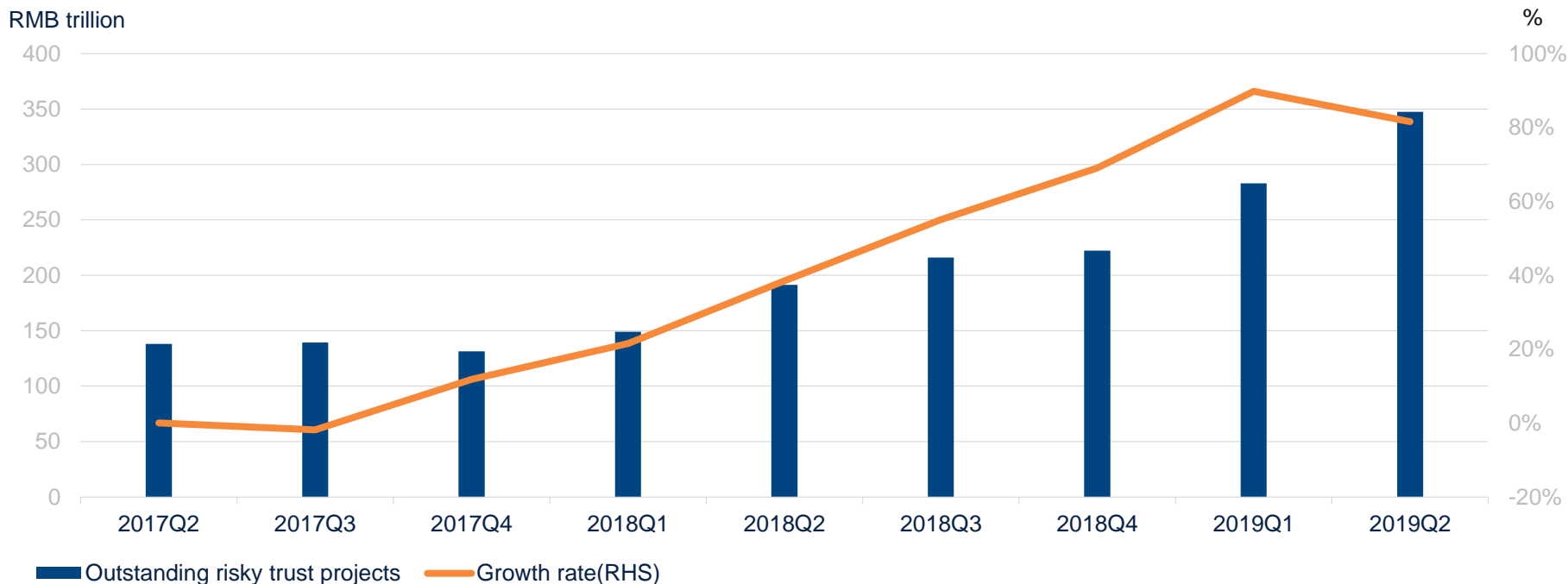
Source: China Trustee Association & BBVA Research



Source: China Trustee Association & BBVA Research

Many investors in infrastructure sectors and real estate seek financing through trust assets as they are facing refinancing risk amid the funding shortage. The latest tightening in funding might drive a fresh round of consolidation among property developers.

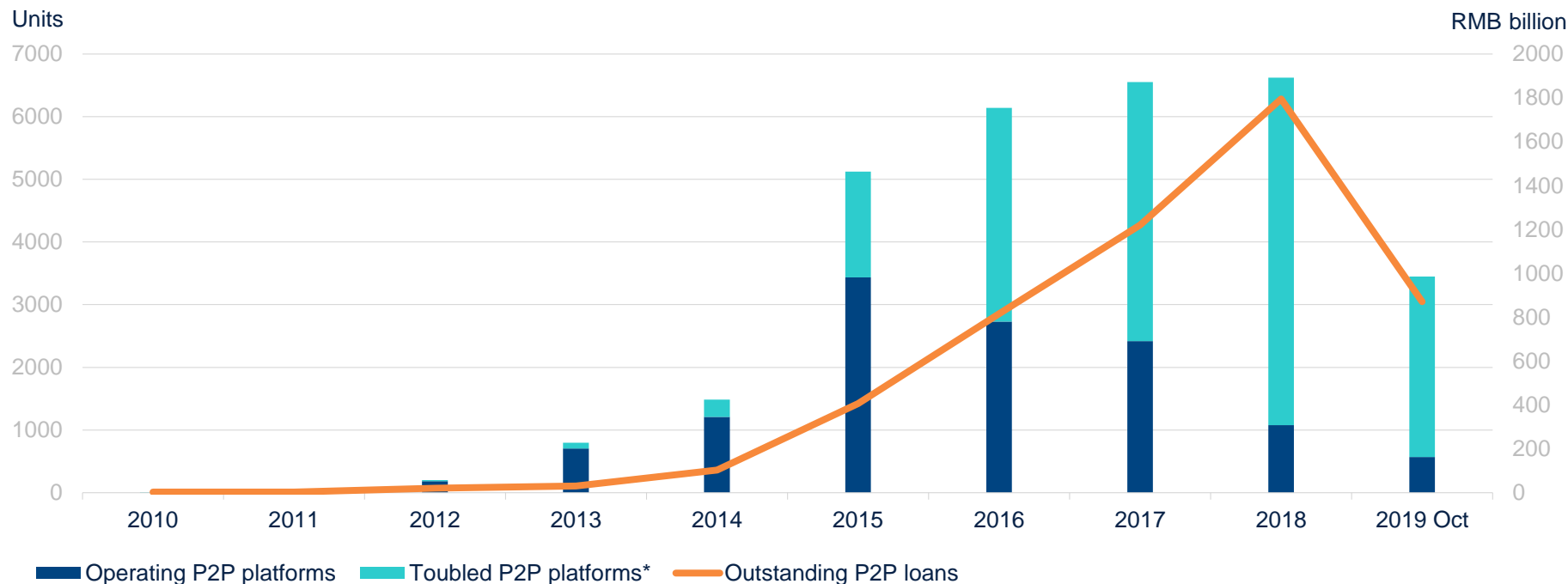
Trust asset quality deteriorated rapidly amid a cooling economy



Source: China Trustee Association & BBVA Research

Default risks are rising for trust projects at the end of 1H 2019 (RMB 347.4 billion), with the yoy growth amounting to 81.6% in the first half year. This will accelerate amid a cooling economy as most of its borrowers are highly leveraged. But the risks are still manageable given their small size (less than 1% of total trust assets).

P2P lending growth halved with declining number of operating platforms



Source: Wind & BBVA Research

P2P lending has attracted more stringent regulatory oversight for its high default rates due to weak risk management and fraud. However, the continuous increase in “troubled” P2P platforms has not posed as a significant systemic risk given the industry’s relatively smaller size (around 2% of broad shadow banking assets).

Regulatory measures to curb shadow banking activities

Date	Key Regulatory Developments
Mar-17	Combating market chaos, focusing on strict supervision of inter-bank arbitrage activities, e.g. interbank financing, interbank deposits and outsourcing
Apr-17	Improve the ability and level of the banking system to serve the real economy and avoid idling funds
Apr-17	Strengthen the requirements for risk prevention and risk control in the banking industry, clarify the key areas of risk supervision; limit the scale of inter-bank financing, and intergrate inter-bank businesses into liquidity regulation
Dec-17	Clearly define the bond holding business, the level of bond leverage, etc., implement unified supervision of the bond market business, and gradually de-leverag
Jan-18	Clarify the regulatory standards for large-scale risk exposure of commercial banks, further standardize interbank business, guide banks to focus on their main business
Jan-18	It is make clear that commercial banks, as trustees, may not participate in loan decisions, prohibit the use of funds raised from asset management products to issue entrusted loans, and restrict channels for non-standard investment in asset management products.
Apr-18	Fully standardize the asset management business of financial institutions: clarify the classification standards for asset management products; distinguish the on- and off-balance sheet, break the rigid redemption; control the leverage level; suppress multi-layer nested and non-standard business, etc.
Jun-18	PBOC and CSRC jointly publish rules to limit same-day withdrawal amount from one single MMF at RMB 10,000 per investor with a one-month transition period before full implementation. Only qualified commercial banks are allowed to provide advances for the instant redemption of withdrawals.
Jul-18	CBIRC releases new draft rules to strengthen supervision of commercial banks' WMP business. The draft rules allow product valuation on an amortized cost basis for qualified closed-end WMPs, and lower the minimum subscription amount for single publicly offered WMP to RMB 10,000 from previous RMB50,000. The transition period will last until the end of 2020, in line with the finalized regulation for banks' and NBFIs' asset management businesses released in April. PBOC issues asset management implementation guidelines. The regulator will adjust related MPS parameters and encourage banks to raise tier 2 capital to facilitate the transfer of qualified non-standard debt assets back to banks' balance sheets.

Regulatory measures to curb shadow banking activities

Date	Key Regulatory Developments
Aug-18	CBIRC issues a statement (Document 76) to ask banks and insurers to meet reasonable demand for financing from LGFVs and avoid disruption to ongoing infrastructure projects, as long as it will not increase local government debt. CBIRC issues a statement (Document 37) and clarifies that trust companies can carry out qualified channel business to support the real economy. The financial regulators announce 10 measures to address risks related to P2P lending platforms. The measures clarify the responsibilities of P2P platforms and their shareholders, stipulate the conditions for orderly liquidation of failed platforms, outline penalties for borrowers that escape their debt obligations and prohibit registration of new platforms.
Sep-18	CBIRC publishes the finalized regulation on commercial banks' WMP business after a two-month public consultation. The finalized regulations maintain a minimum 90-day tenor requirement for all closed-end WMPs as proposed in the draft rules, and also allow WMPs to indirectly invest in the stock market through mutual funds
Oct-18	CBIRC publishes the draft regulations on commercial banks' wealth management business unit for public comment. The regulations will split off wealth management units from the parent banks, and allow those units to sell publicly-offered wealth management products without a minimum subscription amount. Wealth management business unit allows a wider scope of products to be developed and to suit the needs of customers. A "fire-wall" will be developed between the bank and the wealth management unit. It will also facilitate to break implicit guarantees of banks' wealth management business.
Dec-18	CBIRC publishes the finalized regulations on commercial banks' wealth management business unit. The finalized regulation requires that wealth management business units cannot invest more than 20% of their own funds into wealth management products issued by the parent banks.
Jan-19	The Office of the Leading Group for the Special Campaign against Internet Financial Risks and the Office of the Leading Group for the Special Campaign against Peer-to-peer Lending Risks jointly release new guideline to facilitate an orderly liquidation of failed platforms in the P2P industry.
Feb-19	PBOC launches the first time issuance of central bank bills swap (CBS), which aims to support eligible banks' issuance of perpetual bonds.
Jun-19	The National Development and Reform Commission tightened trust loan for property developers, it stipulates that proceeds from offshore note issuances should be used to repay existing debt instead of investing in domestic property projects and replenishing working capital.
Jul-19	CBIRC and CSRC jointly issue the Guidelines on Commercial Banks' Issuance of Preferred Stock for Tier-1 Capital Replenishment (Revised) to relax capital replenishment rules for unlisted banks. The new guidance on banks' preferred shares removed a prerequisite for banks to publicly sell shares on the over-the-counter market before they can sell preferred shares to raise capital, which was an obstacle for some banks in the past.
Sep-19	MOF revised financial regulations for financial enterprises (Draft for Soliciting Opinions). The basis standard for the provision coverage ratio required by the regulatory authority is 150%. For banks whose provision coverage ratio exceeds the regulatory requirements by more than 2 times, it should be deemed as a tendency to hide profits, and the excess provision should be regarded as undistributed profit.

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This report has been produced by:

Chief Economist

Le Xia
le.xia@bbva.com

Olga Isabel Cerqueira De Gouveia
olga.gouveia@bbva.com

Betty Huang
betty.huang@bbva.com