



Equity Market Comment

1 February 2010

Summary

China – correction in a long term secular uptrend

The China market has corrected close to 10% since the beginning of the year, following market jitters on higher inflation and the announcement of measures by Beijing to cool down its domestic economy.

Notwithstanding investors' nervousness about more policy tightening measures to come, we view the measures taken by the Chinese government now as good for the market in the long term.

We view the current decline as a short term correction, rather than the end of the bull market which began in March 2009. There will be cyclical ups and downs, but the factors driving a secular stock market boom are still very much in place.





Government measures may be good for market in the long-term

The China market has corrected close to 10% since the beginning of the year, following market jitters on higher inflation and the announcement of measures by Beijing to cool down its domestic economy. The trigger for the correction started with the hike in the reserve ratio requirement by the People's Bank of China (PBOC) on 11th January 2010. This was followed shortly by a series of small increases in the yield of PBOC bills, further measures to cool speculative activity in the property, and calls for the banks to curb lending, following an explosion of new bank loans to RMB 1.45 trillion in the first 19 days of the year.

Notwithstanding investors' nervousness about more policy tightening measures to come, we view the measures taken by the Chinese government now as good for the market in the long term. We think that it is potentially better to take action now, and in small measures, instead of waiting for the situation to become over-heated. In that case, the government would then need to come down hard on the market.

After the rally in 2009, the China market (MSCI China) was trading modestly above its long term average of 12.8x one year forward price to earnings. The recent correction has made the market more attractive again. MSCI China is now trading below its long term mean valuation. It is comparable to the overall Asia ex Japan region and cheaper than the global average.

	12M forward PER
MSCI China	12.6
MSCI World	14.2
MSCI Far East ex Japan	12.4

Source: MSCI, IBES, Datastream, Morgan Stanley, 29 January 2010

We view the current decline as a short term correction, rather than the end of the bull market which began in March 2009. We highlight 2004 as a period for comparison during which the government came up with a series of tightening measures to reign in credit and capacity expansion, after pump-priming the economy in 2003 following the slowdown brought by the SARS epidemic. Following a sharp correction of nearly 30% lasting just over two months due to market jitters on tightening measures, the Chinese market resumed a long bull run till 2007.

We could see a similar pattern unfolding now. However, there are important differences to note between 2004 and now, and we believe China will not over-react on tightening.

Firstly, global growth is weaker now than compared to 2004. The US and Eurozone countries will likely see sub-par growth for quite some time post the financial crises and the Fed funds rate will likely stay low for an extended period. It will be difficult for China to raise interest rates significantly from here without drawing in hot money, thereby fuelling inflationary pressures.

Secondly, China's export growth engine has slowed down significantly unlike 2004 when export growth surged post China's entry into the World Trade Organisation (WTO). Beijing is keen to rebalance growth by boosting domestic consumption to drive its economy. Hence, policy will continue to be pro-growth in this direction.

View on China properties

Property prices outside tier one cities in China did not surge in recent years, and remain reasonably affordable. It should hold up well as growth spreads beyond Beijing, Shanghai, Guangzhou and Shenzhen. Measures are targeted to curb pockets of speculative activity. The government recognizes that property is still an important driver for the domestic economy will unlikely over-react. First-time home buyers still receive attractive incentives. The guidance on banks to hold back on loan activity should be viewed in the context of the lending spree since the beginning of the year. They are acting so as to smooth out overall loan growth throughout 2010. The government has set a target of RMB 7.5 trillion new banks loans for 2010, representing a decent 17% year-on-year growth in loans.

China critics often point to overcapacity as a major concern, given elevated fixed asset investment spending for many years. However, despite high levels of investment, China still needs a vast amount of all kinds of basic infrastructure from railways to underground train networks, airports, clean energy and water. Comparing China with the experience of South Korea, Taiwan or Japan during its fast growth era is misleading. China is geographically huge, its population vast and is starting from a low base in many areas. There are many inland second and third tier cities that the central government is targeting for further development outside the coastal cities and major urban areas.

Potential Opportunities in China

The consumer sector represents one of the most attractive opportunities in China. China's current per capita income is around the threshold level of US\$4,000-5,000 where consumer spending should really take off.

Government policies are now also tilted in favour of the consumer. In 2009, we have seen a range of subsidies and tax rebates for the purchase of small cars, white goods and first time home purchases. These have largely been extended this year and we can expect more subsidies in other areas such as travel. Despite having the largest mobile phone subscriber base and internet users in the world, the penetration rates are still lower than other emerging countries like Brazil. Even the number of TV sets and cars per 1000 people is lower than much of Asia too.

We view the stock market boom in China as still in the early stages. There will be cyclical ups and downs, but the factors driving a secular stock market boom are still very much in place.



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