



Summary

**Near term headwinds for China equity markets
but global equity markets likely to continue to be supported**

The People's Bank of China (PBOC) yesterday raised the reserve requirement ratio (RRR) for Chinese banks by 0.5%. The new RRR will rise to 16% and takes effect from 18 January 2010. The PBOC also raised rates in the interbank market for the second time within a week. The market had been expecting some measure of monetary tightening in China this year albeit the move by the Chinese authorities has come earlier than anticipated.

Tightening was expected because China's economy has been rebounding strongly, with real GDP growth in the third quarter of 2009 up by 8.9% and inflation turning positive in November. The Chinese authorities have furthermore been voicing concern about asset prices, and measures to cool the property market had already been announced.

In our view, more hikes in the RRR are likely to follow in the coming months but the Chinese authorities are not likely to embark on any aggressive tightening of credit as the global economy is still weak and China needs domestic demand to stay strong. What we are seeing is possibly a normalisation of monetary policy, to return liquidity conditions back to pre-Lehman levels. New loan growth in 2009 was over 30% and it is likely that some of this leaked into the property and equity markets. Our view is that the Chinese authorities would like credit to continue expanding but at a more sustainable level, in line with nominal GDP growth. This would help keep speculative activity under control and also keep inflation pressures down. Broader liquidity conditions however remain accommodative and other policy measures to boost domestic demand will also continue to support economic growth in 2010.

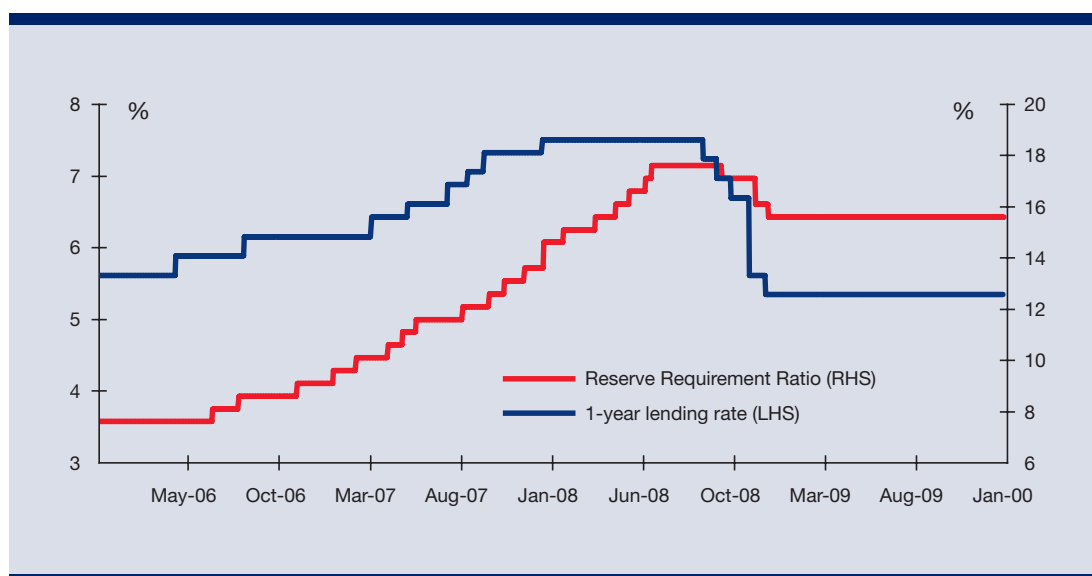
Monetary tightening typically creates headwinds for equity markets and China equity markets may struggle in the near term. However, as long as the economy continues to grow and earnings recover, the equity market is usually able to resume its upward trend. Although developments in China these days affect sentiment in global equity markets, we believe that the underlying conditions for global equity markets remain supportive i.e. the global economy continues to recover but the central banks in the developed economies, in particular the US Federal Reserve, have not signaled that they are in a hurry to raise interest rates.



Tightening unlikely to have impact on real economy

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China's Reserve Requirement Ratio and 1-year lending rate



Source: Bloomberg, 13 January 2009

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In our view, more hikes in the RRR are likely to follow in the coming months but the Chinese authorities are not likely to embark on any aggressive tightening of credit as the global economy is still weak and China needs domestic demand to stay strong. What we are seeing is possibly a normalisation of monetary policy, to return liquidity conditions back to pre-Lehman levels. In the wake of the Lehman crisis and the sharp plunge in the global economy, China lowered its RRR from 18% to 15.5%. The benchmark one-year lending rate was also cut from 7.47% to 5.31%. As China's banking system is functioning healthily, the loosening of monetary led to a massive surge in bank lending. New loan growth in 2009 was over 30% and it is likely that some of this leaked into the property and equity markets.



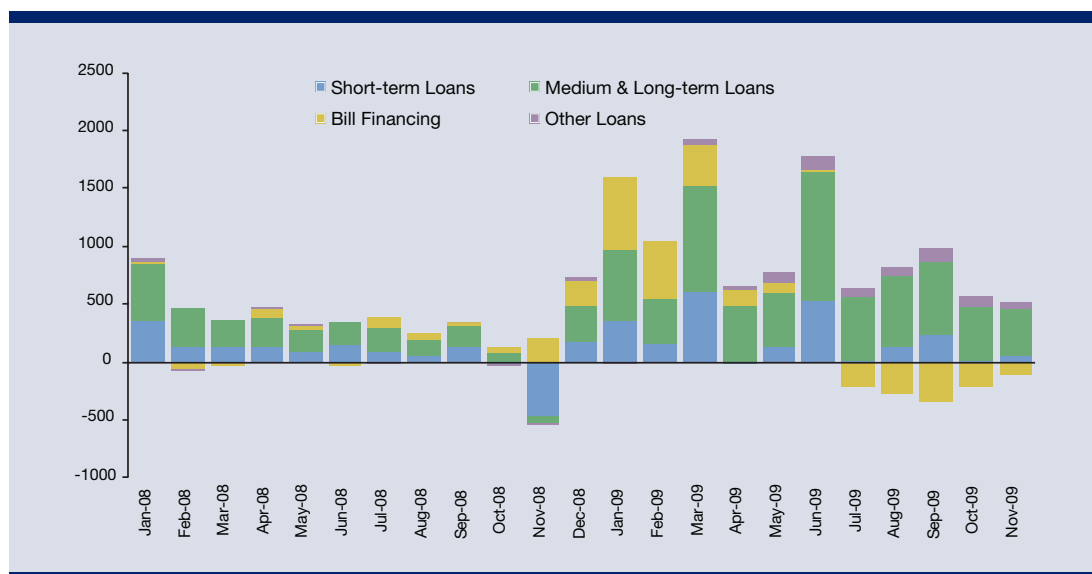
Equity Market Comment

13 January 2010

Adjusting the RRR has typically been the way credit growth is controlled in China, compared to the developed economies where the interest rates is the main tool of monetary policy. Raising the RRR means that Chinese banks have to place more deposits with the PBOC and there is therefore less money available for lending out. Our view is that the Chinese authorities would like credit to keep expanding but at a more sustainable level, in line with nominal GDP growth, i.e. something under 20%. This would help keep speculative activity under control and also keep inflation pressures down.

Although we are likely to see a moderation in loan growth in 2010, we believe broader liquidity conditions in China will continue to support the real economy. The larger Chinese banks have ample deposits and should be able to continue financing infrastructure projects and growth industries supported by the government. Over the recent months, the composition of new loans in China has already been shifting from short-term loans and bill financing towards medium and long terms loans, the latter two categories being more reflective of activity in the real economy.

Composition of China's new loans (RMB billion)



Source: JP Morgan, 12 January 2009

Another indicator that liquidity conditions remain accommodative in China is the strong rise in corporate deposits. In 2009, corporate deposits rose strongly, and the latest data show that they stand around RMB21 trillion, approximately 69% of China's 2008 GDP. Part of this rise reflects unused loans taken out in 2009 and part of it reflects the improving earnings in the corporate sector. Given these high cash balances, the corporate sector should not find itself constrained by credit.

We also believe that China will not be in hurry to raise interest rates and this means that borrowing costs will not be rising too quickly, all other things being equal. One reason for China to keep interest rates steady is the very low interest rate environment in the developed economies. Raising interest rates in China would attract inflows of hot capital and China would face a dilemma of either letting its exchange rate appreciate or seeing liquidity surge again.

China's growth in 2010 likely to be driven by household consumption

Although monetary conditions are likely to continue tightening over the course of 2010, China is still likely, in our view, to register strong GDP growth in 2010. The composition of growth will however likely shift. Growth in 2009 was driven primarily by fixed investments and in 2010, it is likely to be household consumption and to a lesser extent the export sector that drive the economy.

Household spending is likely to be strong in 2010 as the Chinese authorities have continued with their policies to boost consumer spending. The 2009 rural home appliance/electronics stimulus programme has been extended into 2010 and also expanded to cover more regions beyond the initial nine provinces. In 2009, this programme accounted for 20% of total sales in household appliances.

In the auto sector, there has been an increase in the subsidies for car owners who trade in old-for-new vehicles. The subsidies in the second half of last year were RMB3,000-6,000 and the maximum subsidy was recently tripled to RMB18,000.

The authorities have also recently approved plans by the Bank of China, Bank of Beijing and Bank of Chengdu to launch the country's first consumer finance companies. Going by draft proposals, these companies are likely to be able to extend consumer loans for travel, education and consumer durables, but not property or autos.

Still positive on global equity markets

Monetary tightening typically creates headwinds for equity markets and China equity markets may struggle in the near term. However, as long as the economy continues to grow and earnings recover, the equity market is usually able to resume its upward trend. The different sectors within China's equity markets are however likely to diverge in performance, with the banks and property sectors likely to underperform for a period of time.

Although developments in China these days affect sentiment in global equity markets, we believe that the underlying conditions for global equity markets remain supportive. First, purchasing managers indices continue to display upward momentum and the recovery in the global economy appears intact. Inflation pressure is however still muted because of the large amount of slack in the system and the central banks in the developed economies, in particular the US Federal Reserve, have not signaled that they are in a hurry to raise interest rates. The improving global economy (and the associated recovery in corporate earnings) plus extremely low interest rates will continue, in our view, to be the key driver of global equity markets.

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