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Regional Strategy - China

Risk Averse portfolios Marketweight; High Risk Portfolios Overweight

Research Team, 24 May 2012
Phillip Securities Research Pte Ltd

HKCEI: 9577 (-4%ytd)
FTSE China A50: 8173 (+9%ytd)

2011 Real GDP / Inflation: 9.2% / 4.1%
2012(f) Real GDP / Inflation: 8.0% / 3.5%

China's expansion has been slowing down since ~1q11 on all fronts: investment, consumption and export. But we now see nascent signs of a bottoming, though to be totally confident of such a conclusion remains elusive: FAI, retail sales, leading index and PMI suggest stabilizing or even reacceleration, but industrial value added was way below expectations, and exports are still slowing.

Housing will be an added drag to the economy, but the risk of an extreme and sudden deflation seem somewhat under control. Prices on a national scale are very over-valued, but we believe an uncontrolled bursting, while a clear and present danger, is not an instant conclusion. Firstly, uncontrolled burstings tend to be preceded by a state of denial, which the central government is clearly not in, as it "resolutely" maintains the current tight policy. Secondly, fast income growth constantly erodes the downside risk.

As a gradual deflation of the housing bubble is predicated on income growth, it is more likely that policy will remain "growth friendly" while at the same time keeping a tight reign on housing (ex-first time buyers). This could be a semi-permanent feature on the policy landscape for the foreseeable future. The policy landscape we forecast will likely be marked by a major fiscal response and liquidity loosening (2 more 50bp cuts), rather than policy rate cuts, as although house prices and inflation are coming off, authorities will not want to risk such hard fought gains while in the middle of a politburo transition (3q12). We expect China's real GDP growth to be 8.0% with inflation 3.5% for the whole year.

Our outlook for China equities is Overweight for High Risk Portfolios but Marketweight for all others. Essentially valuations are comparable (HKCEI) and below (FTSE A50) that of the Lehman crisis, which may well mean that one would be paid for the risks of slower growth, and the credit-housing overhang. Moreover balance of risks tilt to the upside, as we see a controlled housing deflation in an economic context where there are nascent signs of reacceleration, despite not firing on all cylinders, while policy leans toward growth in the context of low inflation, which may later allow scope for greater monetary loosening post politburo transition.

- ***PhillipETF recommends 2823.HK as a proxy for the FTSE China A50***
- ***PhillipCFD has the "H Shares Index HKD5 CFD" and the "FTSE China A50 Index USD1 CFD"***
- ***Head of Research China's top picks are: Zhaojin Mining (1818.HK) and China Singyes Solar (750.HK).***

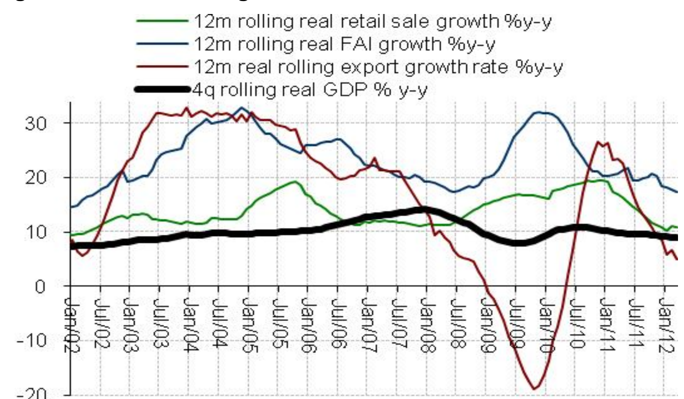
GROWTH OUTLOOK:

- China's GDP growth rate in 1q12 was only 8.1%, trailing the market estimate of 8.4%. To answer the question if the economic growth is bottoming, we investigated the 3 main drivers of China's GDP growth, industrial value added, and some leading indicators like leading index and PMI. Our conclusion is: **Although retail sales, fixed asset investment (FAI), leading index, and PMI showed signs of stabilization or even moderate re-acceleration, the latest industrial value added and export indicated significant downside risk. So at current stage, although we see nascent signs of a bottoming, it is not an instant conclusion.** Details of each metric are provided below.

2 out of 3 Drivers could be bottoming:

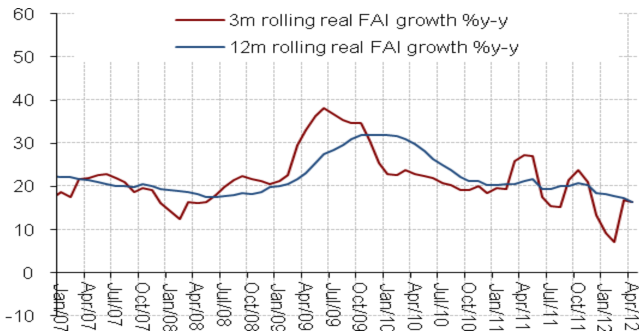
- Slowdown since 1q11 can be seen in all its 3 main drivers: Investment (using real FAI as proxy), Consumption (using real retail sales as proxy) and Export, as shown in Fig.1. After adjusted for inflation, the size of FAI is around 60% of real GDP, retail sales size grew towards to 40% of real GDP, and export takes up around 25% of GDP. Despite its relatively smaller size, the effect of export as a growth driver is, if not more, at least as significant as the other two.

Fig.1 slowdown in GDP growth drivers



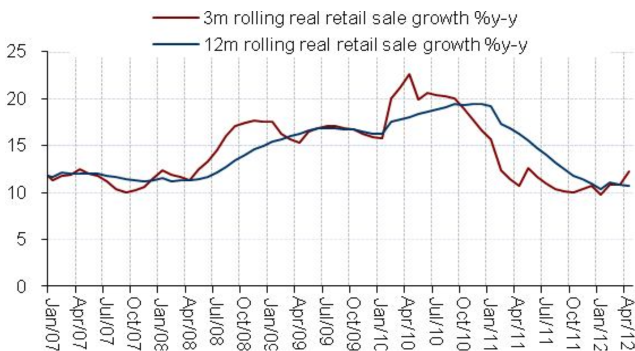
- **Fixed Asset Investment:** As shown in Fig.2, FAI growth rate rose significantly during 2009, peaked in early 2010 as a result of government stimulus plan, and then trended down thereafter as the effect of stimulus faded and the government turned to tightening fiscal and monetary policies to deflate the real estate bubble and curb inflation pressure. On the graph, 3m rolling FAI growth has already started picking up, which is an outcome of the government's policy loosening by cutting banking reserve requirement rate ratio and supported borrowing of small and medium sized companies.

Fig. 2 Real FAI Growth



- **Consumption:** We use inflation adjusted retail sales as a proxy. As shown in Fig.3, growth started to slow down since end 2010, slashed by half from around 20%y-y to 10%y-y. Despite the emphasis on domestic consumption, the slowdown has meant that the economic environment deteriorated and employment conditions worsened. Households saw declining wealth and therefore were more conservative in expenditure. From the graph, we see the 3m rolling growth has remained stable at round 10% since 3q2011. Now it is moving above the 12m rolling retail sale growth, which is a sign of improvement.

Fig.3 Real Retail Sales Growth



As consumption is highly dependent on household wealth, the trend of household income as a percentage of GDP was investigated in Fig.4a. The ratio of household income and disposable income over GDP was relatively stable around 47% and 41% respectively but has since started to rise again end 2011 as the government raised the taxation starting point, in an effort to relieve pressure on lower income household during the weak economic environment and also narrowing the wealth gap. Though the immediate effect on domestic consumption has been limited, it will boost already rapidly growing disposable incomes (Fig.4b), which is in the end the underlying confidence for consumption. Besides this, the government continues its pace of social security and social healthcare reforms. Some milestones have been achieved over the past few years, e.g. the expansion of experimental areas for new type rural social endowment assurance program, and also the openings of experimental cities for urban social endowment assurance program. 360 million residents participated and over 100 million of them have started receiving the basic pension from the government. These reforms would, in the long run, help promote consumption by unlocking wealth that was previously set aside for emergency needs.

Fig.4a Ratio of Household Income to GDP

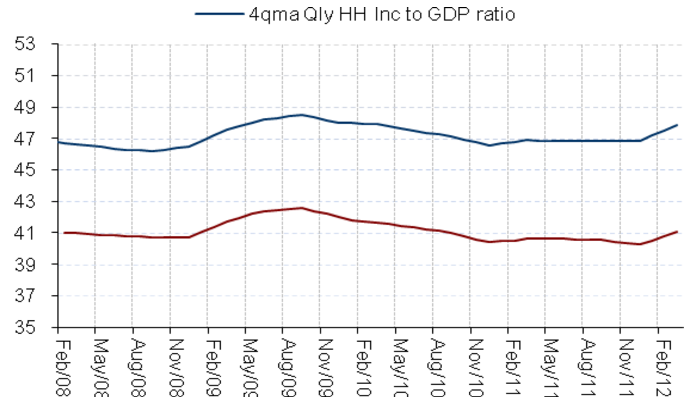
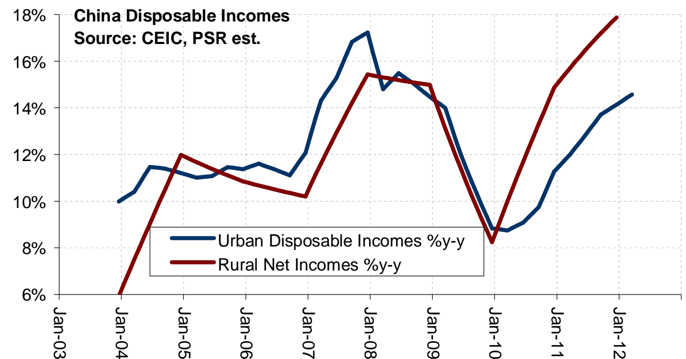
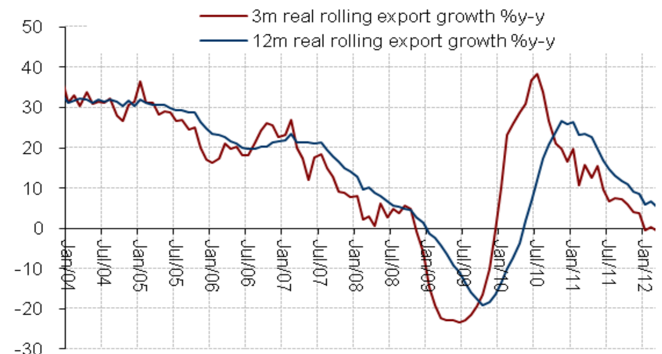


Fig.4b Strong disposable income growth



- **Exports:** Although the size of export as a percentage of GDP is much smaller than FAI and retail sales, it is at least as crucial as the other two drivers because of its much higher volatility, as can be seen from Fig.1. And since it relies on external demand, the government has no effective control over it. As shown in Fig.5, the 3m rolling export growth curve is currently trending down below the 12 rolling export growth curve.

Fig.5 Export Growth



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To drill down further, growth to the two major trading partners, US and EU, each accounting for around 20% of China's total export, are shown in Fig.6 and Fig.7. We see that contraction of total export in 2009 was a synergy of declines in both these two partners. The growth of export to US has been stabilizing since 3q2011 and started trending up due to the recovery of US economy. Going forward though, we are of the opinion that US growth will be tepid this year with significant downside risks in 2013 (see Global Macro & Markets 12th Apr 12). As for EU, 3m rolling export growth shows no sign of stabilizing and future movement would highly depend on the ability of EU governments to solve the debt crisis. Our baseline scenario for the Euro zone is a recession this year and likely continuation in 2013 due to the new fiscal compact. But without further negative shock, we expect the export growth rate to EU would not drop to as low as the level in late 2009.

Fig.6 Growth of Real Export to US

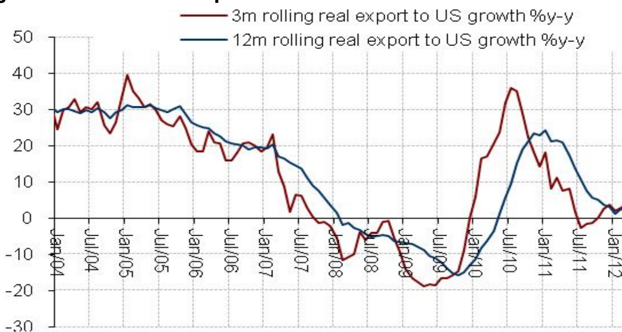
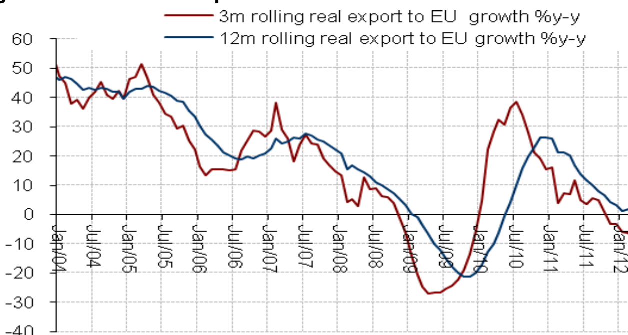
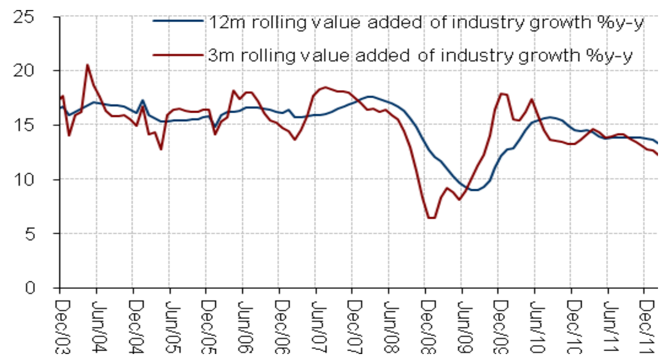


Fig.7 Growth of Real Export to EU



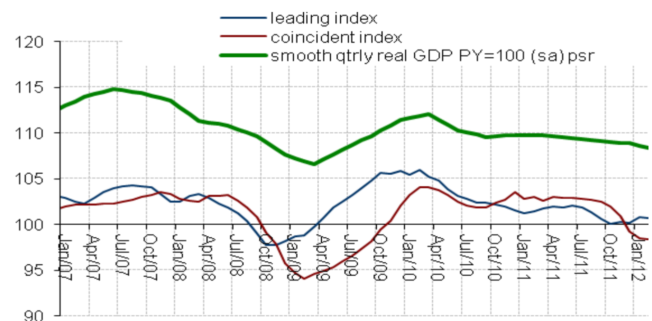
- **Value Added of Industry:** Even though FAI and retail sales signalled stabilizing, the latest statistic for growth of industrial value added is still trending down, in both 3m rolling and 12m rolling basis, as shown by Fig.8. This is partially explained by the higher correlation between industrial value added and export.

Fig.8 Growth of Industrial Value Added



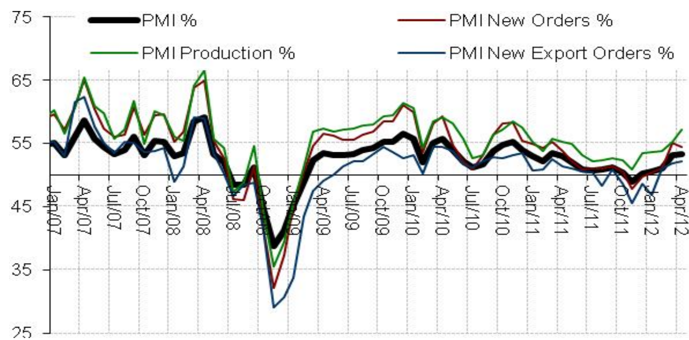
- **Leading and coincidence indices**, together with GDP growth are plotted in Fig.9. As can be seen from the graph, historically, coincident index was highly correlated with GDP growth in the long term, while the leading index indeed has some power in predicting GDP growth. Though GDP growth is still trending down, the coincident index has stabilized since start of 2012, while leading index showed signs of stabilization and slight improvement, suggesting that the nation's expansion might be bottoming.

Fig.9 Leading & Coincidence Index



- **PMI:** As shown by Fig.10, PMI bottomed at Nov 2011 and has been rising since then. The latest reading in April reported 53.3, marking a fifth straight monthly improvement. Sub-indices of production, new orders and new export orders all show improvement. April HSBC PMI, as a gauge of small and medium business PMI, also reported improvement to 49.3, compared to 48.3 in March, indicating slowing down in contraction. These figures indicate China's expansion is stabilizing, and do suggest re-acceleration,

Fig.10 PMI



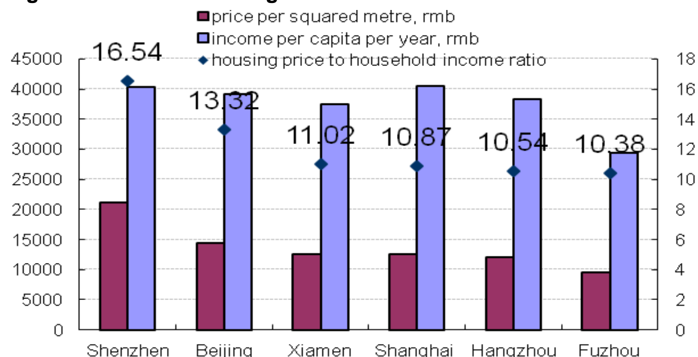
RISK IN REAL ESTATE MARKET:

We constantly hear news about China's sky high housing price in tier 1 and tier 2 cities, and investors are concerned that the bubble in real estate price will pop, putting the banking system into crisis.

- **Fast Growth of Housing Price:** The whole country's 2011 full year average nominal housing price reached twice as high as it was in 2004, accompanying the nation's high growth during these years. The housing price in tier 1 and tier 2 cities rose at a much faster pace than this. For example, over the seven years between Dec 2004 and Dec 2011, nominal housing price in Beijing rose around 3.9 times, Shanghai 2.7 times, Tianjin 3.14 times, Chongqing 3.45 times.

- **High Housing Price to Household Income Ratio:** Using NBS data, in Dec 2012, the average urban housing price to household income ratio of 35 major cities is calculated to be 7.6 (assuming 32 square metres for living floor space per capita), while the international rule of thumb is that 3 – 4x is regarded as affordable. On a city basis, we find that of the 35 cities, 6 had a ratio of more than 10, 18 had a ratio of 7 to 10, while 11 had a ratio of less than 7. Thus bubble-like pricing is a nationwide phenomenon. Fig.10 shows the six major cities which have an alarming housing price to household income ratio of over 10 in Dec 2011.

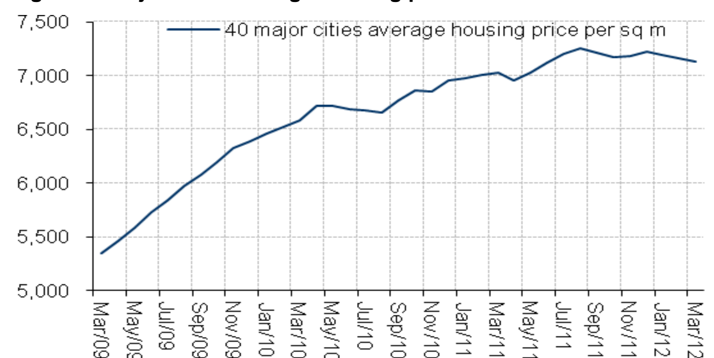
Fig.10 Cities with Housing Price to Household Income Ratio >10



- With the data just presented, it is clear that housing does pose a risk to the economy. However, here we would argue that although a cooling real estate market would heavily weigh on the whole economic growth and exert pressure upon banking system, an uncontrolled bursting while a clear and present danger, is not yet a foregone conclusion.

1. Firstly, the current drop in housing prices should be taken as a **deflation of the bubble led by the central government**, rather than a bubble popping from market forces. As a general rule, an uncontrolled bursting is the result of living in denial of a bubble, not something you constantly fret over as the Chinese government has been doing. In the last two years, the government has taken various measures to cool down the housing market, by tightening policies (e.g. imposing higher real estate tax) and curbing housing market speculations (e.g. requiring higher initial payment for 2nd house buyer in mortgage market). As can be seen from Fig.11, the growth of average nominal housing price of 40 major cities has been decelerating gradually and in 3q11 policy efforts finally paid off. From the graph, we can see that the current pace of deflation is quite moderate, the continuation of which should provided real estate developers and the banking system some scope to adapt. To mitigate the pace of downside, the central government has also been granting local governments some flexibility to fine tune the market by some local policies, such as discounts in mortgage rate for first home buyer or cash returns, in order to boost sales. These all provide some sort of cushion to prevent a fast drop. In such a way, the central government is trying to ensure that pressure is neither too heavy to miss its target GDP growth of 7.5% nor too light to fulfil its commitment to curb housing price.

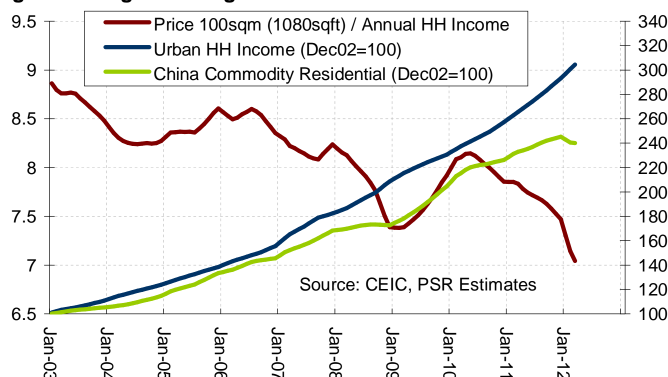
Fig.11 40 major cities average housing price



2. Secondly, while we agree that the current overall housing price is very high in terms of housing price to household income ratio, we should bear in mind that this is not a new story, as the nation's housing price has been historically so, as seen from Fig.12. Key thing to note as well is that the overall housing price to household income ratio is actually falling over the long term. The explanation is that, although

the house prices have been rising all the way until mid 2011, the nation's household income has been picking up even faster. Since 2003 urban household income has grown at an average rate of 12.6%y-y. On the unlikely assumption that prices do not fall from here, if this income growth rate can be sustained, it will take between 4-5 years for the ratio to drop to 4, the widely accepted upper limit of "affordable".

Fig.12 Average Housing Price to Household Income Ratio of All Cities

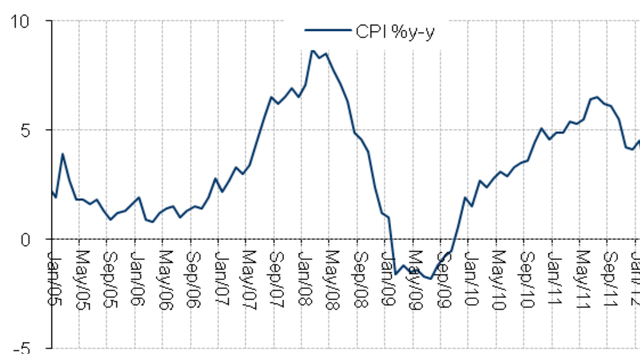


- Given the danger housing poses to the economy, and given the length of time it may take to bring price and income into affordability, it may well be the case that tight sector specific policies on housing may be a semi-permanent feature on the Chinese economic landscape for the next 4-5 years, predicated on rather high income growth. **Thus in terms of policy, it is quite likely going forward we will see more "growth friendly" policies in order to keep up the pace of income growth while at the same time keep a tight reign on housing ex first time buyers**.

INFLATION & MONETARY POLICY:

- Inflation pressures eased to 3.4%y-y in April, compared with 3.6% in March, as inflation has come off quite a bit (Fig.13). As growth signals have been poor, the central bank has been pursuing a loose policy with regards to liquidity measures: cutting reserve requirement ratio by 50bp moves 3 times since Dec11, central bank bill retirement and a series of reverse note repurchases. At the same time lending to small and medium size companies has been encouraged. **Over the year, we expect two or more reserve ratio cuts** but this is also dependent on whether the government is willing to take more aggressive loosening measure, i.e. benchmark interest rate cuts.

Fig 13. CPI



- **Interest rate cut possible, but a last resort:** One challenge the central bank faces is that, even though it allows commercial banks to lend out more by cutting reserve requirement ratio, domestic enterprises' willingess to borrow is quite weak as entrepreneurs see poor profit prospects. Moreover, the commercial banks also find it more difficult to find high quality borrowers as profitability of export enterprises and real estate developers deteriorates. Therefore, reserve requirement ratio cuts itself might not be effective enough to stimulate the economy growth. One option the central bank has is to lower the benchmark interest rate, which would give enterprises higher incentive to borrow by effectively reducing their borrowing cost. The drawback is that it would compromise the government's commitment to curbing house prices and inflation – both of which are political hot button issues. As the nation will undergo a politburo transition in 3q12, it is therefore very likely the government would maintain status quo (unless housing prices and CPI drop significantly).

FISCAL POLICY:

- If not an interest rate cut, and if liquidity measures are limited, what policy options are left? The answer is fiscal. We have a long held position that a major Fiscal response to guard the growth downside (Global Macro & Markets 12th April) is more likely than a major monetary response, and the following comments seem to suggest we are on the right track. Premier Wen stated last weekend that, "***We should continue to implement a proactive fiscal policy and a prudent monetary policy, while giving more priority to maintaining growth***," and that "***domestic demand should drive growth***", such that measures to support farmers, small and medium-sized enterprises would continue as well as increased social housing projects.

GROWTH & INFLATION FORECAST:

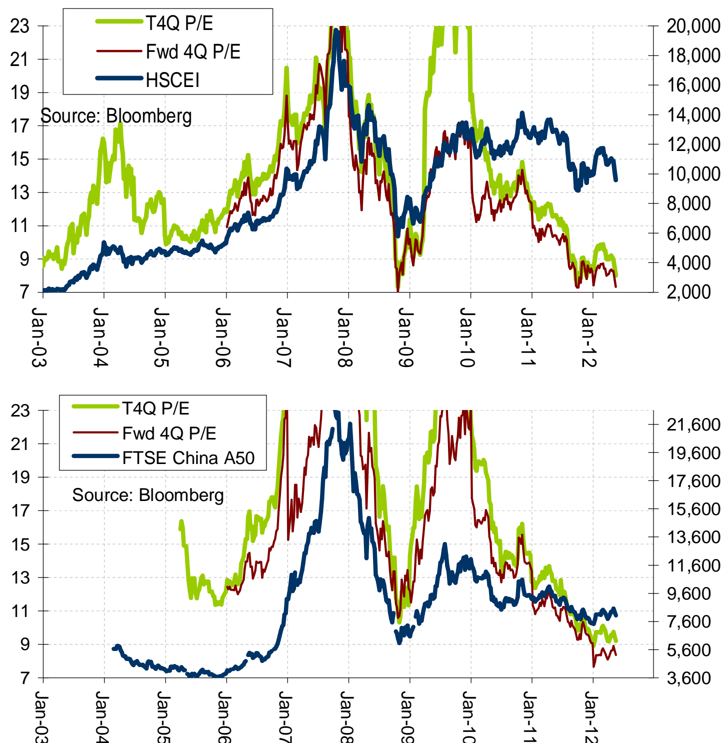
- To recap, FAI and consumption seem to be bottoming but industrial production, being tied to exports, is not. Housing will continue to weigh on growth but we doubt we will see an uncontrolled burst. Policy outlook will become increasingly growth friendly except for the real

estate sector. Further fiscal and liquidity measures are likely, but not for the benchmark rate, as even though softening inflation is presenting room to cut, there are political risks to cutting the benchmark rate too early. On balance, we would have been tempted to call for a bottoming of the economy cum 3q12, but global risks remain while domestic demand is barely out of the woods, and details of a fiscal boost are still more political rhetoric than concrete plans. **Overall, we expect 2012 GDP to achieve a growth rate of 8.0% and inflation 3.5%.**

EQUITY OUTLOOK:

- The H-share and A-share market both have been suffering since 4q10 and 3q09 respectively, since it became apparent that the 2009 credit binge has saddled the banks with unknown credit risk, and the economy with a real estate bubble overhang. After 2 years of relentless selling to valuations *below* the global financial crisis of 4q08 – HSCEI is at 8x T4Q p/e while the FTSE A50 is at 9.4x with forecast EPS growth at >9% for both – one has to therefore entertain the question of whether to enter China again. As current valuations are comparable to the Lehman crisis lows for the HKCEI and even lower for the FTSE A50, there is a likelihood that the credit risk and housing bubble overhang may have already been priced in. The payback may already be in the market. (see Fig.14)

Fig.14 Both H-share and A-share market are valuation lows comparable to the Lehman meltdown.



- Now, if the housing bubble does enter an uncontrolled deflation, there will be downside volatility, but the lows may have already been put in. On the other hand, balance of risks tilt to the upside, we see a controlled housing deflation in an economic context where there are nascent signs of reacceleration, despite not firing on all cylinders. In addition, policy leans toward growth in the context of low inflation, which may later on allow scope for greater monetary loosening post politburo transition. **So what we are saying is that, on a risk-reward basis, China is an Overweight. This is not an overweight that is recommended for risk averse portfolios though, for such we recommend being at Marketweight. Essentially, the risk is there, but at a discounted price, one may have already gotten paid for taking that risk.**

- **Unit Trust investors contact your FA on portfolio matters**

- **PhillipETF department recommends 2823.HK (traded on the HKSE), the "iShares FTSE China A50 Index Fund" as a proxy for the FTSE China A50. (See risks for ETFs: www.phillipetf.com > ETF education > Risks for ETFs).**

- **PhillipCFD has the "H Shares Index HKD5 CFD" and the "FTSE China A50 Index USD1 CFD". For levered short term trades, technical analysis is advised for entries and exits.**

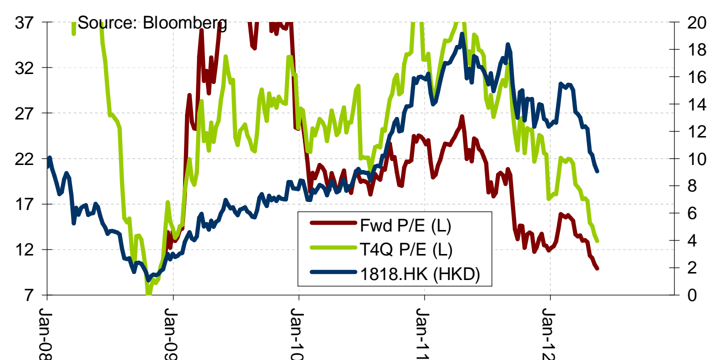
- **Head of Research China's top picks are: Zhaojin Mining (1818.HK) and China Singyes Solar (750.HK)**

  Zhaojin Mining (1818.HK):

  - HKD 8.94 (Buy), HKD 13.66 (12mth target price), Market Cap>US$3.6b.

  - Valuation: T4Q p/e 12.8x, Fwd 4Q p/e 9.8x is based on EPS growth of 31%y-y (Fig.15).

Fig.15 1818.HK trades very cheaply with 30%y-y EPS growth



  - Zhaojin Mining is China mainland's fourth largest mineral gold producer and the second largest mineral gold producer in the Hong Kong market. The company possesses a complete gold production procedure from gold mining, dressing to smelting,

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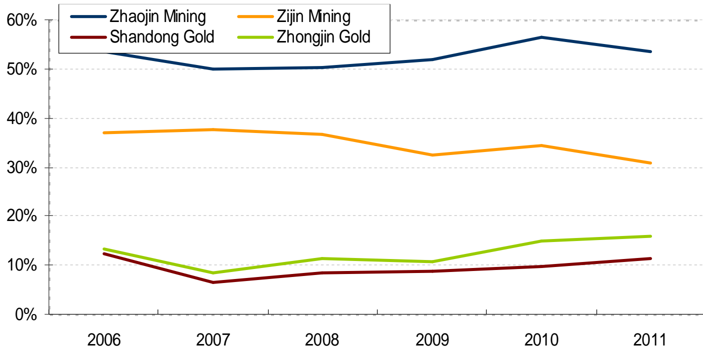
which enables it to have stronger gross margin than peers (Fig 16).

Fig.16 Higher gross margin of Zhaojin Mining



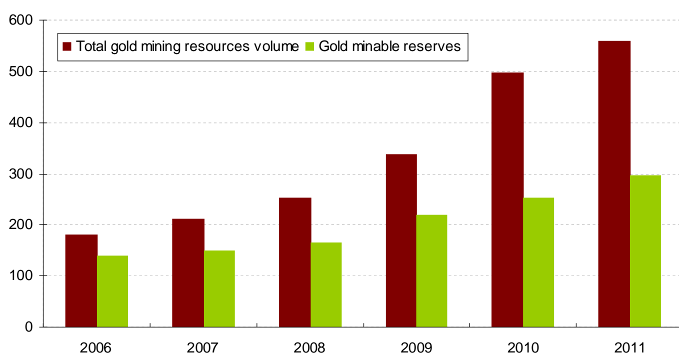
(Source: Company reports, Phillip Securities)

- Mineral gold production was 15.94 tons for 2011, expects 18.4 tons for 2012, +15.5%y-y (5yr CAGR is 13.7%).

- In 1Q12, the company's profit declined 3.5%y-y to RMB216m. However, it was mainly caused by its stockpiling 1.2 tons mineral gold, which could have been up to RMB400m worth of revenue. Furthermore, the management has declared it will sell the stocked gold if gold prices appreciate. At present, operations continue as management has guided, and the targeted 15.5%y-y output growth stands unchanged.

- As of the end of 2011, the company owns 558 tons of JORC gold resources, up 12.5%y-y, plus owning 297.06 tons of minable reserves, up 17.9% (Fig.17). It plans to continue applying an active capital expenditure program in 2012: purchase and exploration capital expenditure is budgeted to be RMB1 billion, planned yearly additional gold resources to be 130 tons. We maintain that as a company with gold as its main business, aggressive expansion of resources will help the company realize sustainable growth performance.

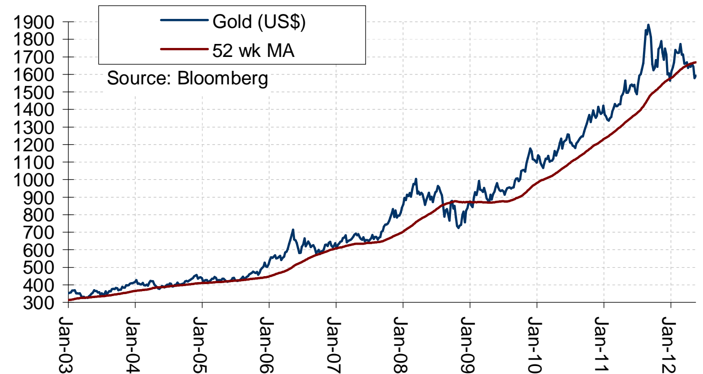
Fig.17 Rapidly expanded gold resource (tons)



(Source: Company reports, Phillip Securities)

- Recent share price weakness is mainly attributable to the decreased 1q12 performance and weakness in the price of gold. Although the price of gold is now below the 52 week MA (Fig.18), which is a bearish signal, our baseline view of the US economy (see Global Macro & Markets 12th Apr) is that it is actually not speeding up as commonly believed, it is slowing down, and in fact faces significant growth risks this year on falling real incomes and a peaked investment cycle – we expect QE3 to occur which will re-ignite gold.

Fig.18 Gold price trend



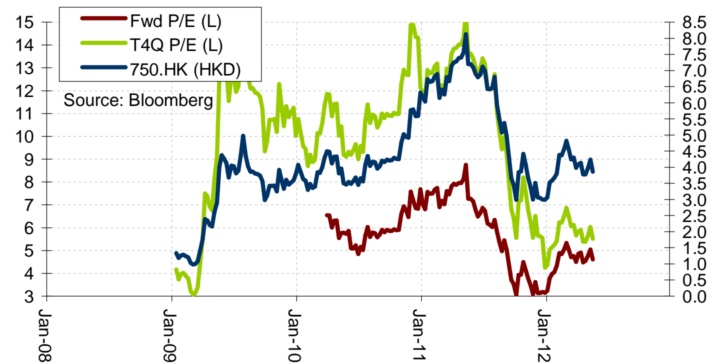
(Source: Bloomberg, Phillip Securities)

China Singyes Solar (750.HK)

- Current Price when estimation: HKD 3.95; Target Price in next 12 months: HKD 6.25.

- Valuation: T4Q p/e 5.6x, Fwd 4Q p/e 4.7x is based on EPS growth of 19%y-y (Fig.19).

Fig.19 Singyes Solar trading cheaply with 19%y-y EPS growth



- China Singyes Solar Technology Holding Limited (Singyes Solar) is a company whose main business is PV projects construction, sale of related material and renewable energy goods.

- In the past 2 years, the company maintained good Revenue and EPS growth despite the industry in recession (Fig.20 and 21). The price of polysilicon has suffered decline in recent 2 years due to serious overcapacity in the upstream of the PV industry

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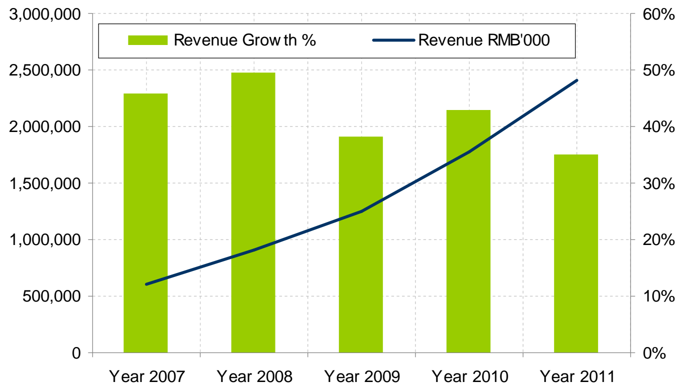
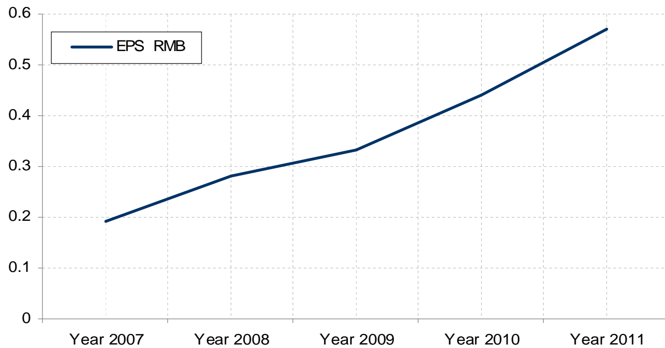
(Fig.22). But as a company in downstream, Singyes actually enjoyed the benefit of decreasing cost which has been helpful to net profit.

Fig.20 Revenue of Singyes Solar



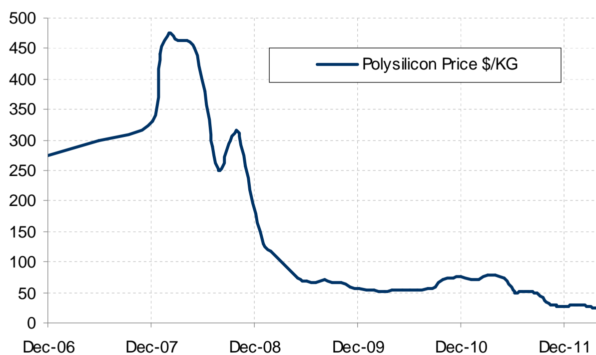
(Source: Company Report)

Fig.21 EPS of Singyes in Recent 5 Years



(Source: Company Report)

Fig.22 Polysilicon Price in Recent 6 Years

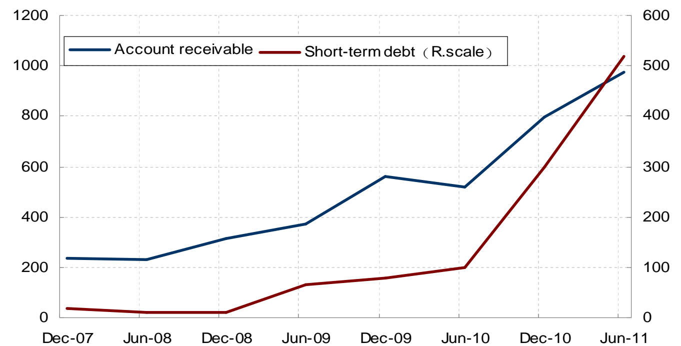


- Most Singyes projects are government related: government office buildings, large-scale railway stations and others. In the present economic environment, the government linked nature of projects are a growth insurance for the company. Furthermore, as discussed earlier, as we are expecting a Fiscal response from the Chinese government, there is likelihood of further government projects.

- The company has been expanding overseas and sub-branch business gradually. As the PV industry was trapped by the financial crisis in developed countries, we consider that the potential market of the overseas PV market has been transferred to the developing countries, so the new projects of Singyes Solar located in Nigeria are a good attempt. Besides, the company also uses the production facility to develop solar energy business; it could improve the operation revenue without additional risk.

- Risk: As accounts receivable has grown with the revenues of the company, it has had to increase its reliance on short-term debt for funding. We are monitoring the balance sheet situation if Singyes can improve its cash conversion cycle (Fig.23).

Fig.23 Receivable and Short-term Debt of Singyes in Recent 5 Years



(Source: Company Report)

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