China & Hong Kong Strategy

China’s economic recovery continues, “efficient and quality” growth ahead

Roy Chen, Macro Analyst 19 December 2012

CSI300: 2368.12 (+0.95% ytd); HSCEI: 11301.72 (+13.74% ytd); HSI: 22494.73 (+22.03% ytd)

- Head of Research China’s top picks are: China Merchants Bank (3968.HK) and Central China Real Estate (832.HK); Head of Research Hong Kong’s top picks are: Dah Sing Financial Holdings Ltd (440.HK) and HSBC (5.HK).

- We continue to overweight CSI300, HSCEI and HSI. PhillipETF recommends ChinaAMC CSI300 Index ETF (83188.HK) as a proxy for the A-share CSI300, H-Share Index ETF (2828.HK) as a proxy for the H-share HSCEI, and Tracker Fund of Hong Kong (2800.HK) as a proxy for HSI.

- PhillipCFD has long/short “H Shares Index HKD5 CFD” and long/short “FTSE China A50 Index USD1 CFD”

- Phillip Unit Trust Department recommends Aberdeen China Opportunities SGD and Fidelity China Focus A USD for China equity market investment.

- Marketweight CN bonds & Underweight HK bonds

China’s economic recovery continued in a moderate pace. Economic indicators such as industrial production and retail sales, for a third consecutive month, surprised to the upside. Government official manufacturing PMI continued to improve in November, reporting 50.6, compared to 50.2 for October while non-manufacturing PMI reported 55.6, compared to 55.5 in October; the rising PMIs indicated accelerating business activities in respective sectors. The 50.9 HSBC flash manufacturing PMI for December, beating the market expected 50.8 and the 50.5 final reading for November, adds signs that the expansion of industrial activities is likely to extend into December. The ytd FAI growth in November, remaining unchanged at 20.7% y-y in the first 10 months, trailed the market estimation of 20.9% y-y but still demonstrated a relatively fast expansion. Inflation picked up to 2.0% in November from the 33-month low of 1.7% in October, but trailed the market expected 2.1%. PPI reported a drop of a 2.2% y-y, compared to the 2.8% y-y drop in 1q12, reflecting stabilizing industrial activities. After two relatively well-performing y-y growth data in September and October, export growth fell back to 2.9% y-y, far below the market expected 9.0% y-y pace, attesting to what we maintained in earlier two China strategy reports (23 Nov and 22 Oct) that the nation’s economic reacceleration would more likely rely on domestic demand, especially when uncertainties persist in the prolonged Europe debt crisis and US fiscal cliff. 53 out of the 70 major cities registered a monthly increase in new apartment price in Nov, comparing to 35 in Oct. Given the improving economy and the “steadfast” efforts of the government in curbing property price, there is unlikely further monetary loosening in the near term. Beyond economic metrics, in this report we have devoted a session to summarize the points to be taken during the recently ended government central economic work conference. We maintain our forecast of 7.8% GDP growth and 2.2% inflation in 2012, and rollover our forecast for China’s economy into 2013, making a preliminary call of 8.0% y-y GDP growth with an inflation of 3.0%.

In Hong Kong, retail sales stayed weak in Oct and export to US and EU remained as a drag to the city’s economic growth. Property price surged to a new high, which may prompt further tightening policies from the government. As we expect the reacceleration of China’s economy to be a moderate one rather than in full speed, the positive spillover to Hong Kong in 2012 could be quite limited and but we expect more support lent in 2013. In regard to this, we maintain our forecast of 1.2% GDP growth with inflation of 3.9% in 2012, and make a preliminary call of 3.0% GDP growth and 4.0% inflation in 2013.

We maintain our Positive/Overweight (absolute/relative performance) on all 3 indices: the CSI300, the HSCEI, and the HSI on attractive valuations and signs of economic bottoming, noting that all the 3 indices have cleared some resistance levels and are likely to head higher. We marketweight China bond market and underweight Hong Kong bond market. We hold a positive outlook for CNY and negative outlook for HKD against peers in the long run.

China Economic Metrics and Growth Outlook:

Fig.1 The growth of retail sales beats the market expectation for a third straight month, reporting 14.9% y-y in Nov, compared to the market expected 14.6% y-y growth and prior 14.5 % y-y for Oct. The continued improvement in retail sales indicated a better outlook for domestic consumption, which is also aligned with the government’s long term strategy of gradually reducing the growth reliance on investment and export.

Source: PSR, CEIC
Fig. 2 FAI grew by 20.7% y-y in the 11-month period ended in Nov, the same pace as it was in the 10-month period till Oct though the market was expecting a further pickup to 20.9%. On 3m rolling basis, the FAI continues to pick up moderately due to the effect of 1 trillion infrastructure projects announced in Sept. As can be seen from the chart, China used to maintain a FAI growth of near 25%, which we see unlikely to be regained as the nation’s economic infrastructure has become more mature. But still, the nation’s continued urbanization would lend support to investment growth and we do not expect a major slowdown in the foreseeable future.

Fig. 3 After two consecutive relatively well-performing export growth data in Sep (9.9% y-y) and Oct (11.6% y-y), growth of nominal export fell back to 2.9% y-y, the third below 3% reading in a 5 month period. As can be seen in the chart below, export growth on 3m rolling basis is hovering at a low level near 5%, which compares to an average of 20% y-y growth prior to the financial crisis. With a sluggish external demand due to the overhang Europe debt crisis, we do not expect a major pickup in the near term, though the major infrastructure spending in ASEAN countries would help stabilize the export. For the longer term, due to the growing labor cost, China made products would gradually lose attractiveness if the government fails to transform the manufacturing sector from low end labor intensive manufacturing towards high end technology intensive business.

Fig. 4 The official manufacturing PMI rose further to 50.8 in Nov, trailing the market expected 50.8, but beating the 50.2 reading in Oct. On the other hand, the 50.9 preliminary reading of December HSBC manufacturing PMI, beating the market forecasted 50.8 and November’s final reading of 50.5, adds signs that the re-acceleration in the nation’s manufacturing activities is likely to extend into December. The official non-manufacturing PMI reported 55.6 in Nov, slightly higher than the 55.5 reading in Oct, indicating a relatively healthy expansion in the nation’s non-manufacturing business.

Fig. 5 The growth of industrial value added continued to improve for a third straight month, reporting 10.1% y-y in Nov, beating the market expected 9.8% y-y and prior 9.6% y-y pace in Oct. This improvement in industrial activities adds to our conclusion that the nation’s economy is bottoming out.

Fig. 6 Property price reported accelerating growth in Nov, with 53 out of the 70 major cities seeing monthly increase in new apartment price, which compares to 35 in Oct. Over the year, 25 cities saw yearly growth in new apartment price, compared to only 12 in Oct. Following the two benchmark rate cuts in June and July, the market saw continued rebound in property transaction and in property price. The Nov data is likely to have reached the upper limit of government tolerance, therefore shut the window of monetary loosening. We expect the government to take actions to maintain a tame property price.
Fig.7 Inflation picked up to 2.0% on rising food price in Nov from the 33-month low 1.7% in Oct, but trailed the market expected 2.1% pace. PPI continue to stabilize, reporting a narrower y-y drop of 2.2% in Nov, after the 2.8% y-y drop in Oct, reflecting stabilizing production activities. With the nation’s economy re-accelerating but not running into full speed, the inflation would likely stay tame with mild pickups for the near future.

**Tone Set for China Macro Economic Policies - 2013:**

- During the central economic work conference held on 15 and 16 Dec, the government has set the tone of 2013 macro economic policy as “continue seeking growth given stabilization achieved”, which compares to the “stabilizing growth, containing inflation and adjusting structure” tone set for 2012 during the last central economic work conference. The meeting also established some guidelines:
  - 1. Discover and raise some new pipelines that have leveraging effects on consumption growth; and increase the contribution of effect of consumption growth to economic growth; make good use of investment as a key tool to achieve economic growth.
  - 2. Apply proactive fiscal policies in combinations with tax reform and structural tax reduction.
  - 3. Apply prudent monetary policies and enforce the flexibility; increase the size of social financing in a proper manner and maintain an appropriate growth of loans; keep RMB exchange rate relatively stable; practically lower the financing cost for real economy development.
  - 4. Continue the effort in curbing property market.
  - 5. Stay alert with risks in fiscal and financial systems, and safeguard the economy from systematic or regional financial crisis.

- Key tasks rendered during the meeting include:
  - 1. Enforce and improve the macro economic fine-tune; promote the quality, efficiency, and sustainability of economic growth; realize economic growth during the transition and optimization of economic development; Increase and induce domestic private investment, and increase public investment in long-term beneficial and welfare-enhancing public projects.
  - 2. Recognize the importance and further promote the capability of agriculture production; continue the favoring policies in agricultural activities and promote the profitability hence the initiative of agricultural production and operation; modernize agricultural business and promote safety of food products.
  - 3. Accelerate and deepen industrial reforms; focus on resolving over-capacity problems; promote technology edges and creativity in production to enhance competitiveness.
  - 4. Promote urbanization in a proactive manner and improve the quality of urbanization; Make urbanization compatible with regional economic arrangement and environmental constraints; integrate the ecological civilization into the process of urbanization; transform the rural residents to urban residents in an orderly manner.
  - 5. Enhance social welfare and social security plan; ensure the basic living standard of lower income households and subsidize students from low income families; stabilize and promote employment for university graduates; support business development of small and micro enterprises and promote the social conscience of large enterprises; enforce the social security system and improve pension system; Enforce the construction and regulation on economic housing.
  - 6. Deepen the reform of economic institution with a clear roadmap and timeline; increase market share in international market by enhancing the rights of foreign investors and protection of intellectual properties, and at the same time make wise and increasing utilization of foreign reserves for outward investments; make use of import to support adjustment in economic structure; increase multi-lateral cooperation and accelerate the strategic implementation of free trade regions.

**China Growth & Inflation Forecast:**

- Most of the economic data in the last 3 months suggest that the nation’s economy is consolidating strength and bottoming out. The question is more on whether the speed will be faster or slower than the market has expected. We expect the nation’s growth would not run into full speed in the foreseeable future as one of the 3 key growth drivers, export, remains subject to the sluggish external demand. The tame inflation allows scope for further monetary loosening; however the accelerating property price in Nov is likely to restrain the government from doing so. Therefore we expect the government to continue using reverse repo as a tool to accurately target the market liquidity for the near future. 2013 is perceived as a critical year being the opening year of the new leadership who is committed to foster a
more efficient and quality economic growth rather than simply of high speed. We believe the pursuit of efficiency and quality is beneficial for sustainability of a longer term growth. We maintain our 2012 growth forecast at 7.8% with inflation at 2.2%, and rollover our forecast for China’s economy into 2013, making a preliminary call of 8.0% y-y GDP growth with an inflation of 3.0%.

HK Economic Metrics and Growth Outlook:

Fig.8 Retail sales growth remained sluggish in Oct, with 3m rolling reading stayed near as low as 5%, pointing to a weak domestic consumption.

Source: PSR, CEIC

Fig.9 Household income continued to slowdown, to 5% in Sept from prior 6.7% reading in June. The slower household income growth might post a limit on consumption by local households. To help low income household through this hard time and as part of effort to work on the wealth gap, the government planned to raise the city’s minimum wage by 7.1% to 30 HKD per hour on 1 May 2013 from the current 28 HKD, which is estimated to affect 327,200 employees, or 10% the city’s workers. This policy could help stabilize consumption after implemented.

Source: PSR, CEIC

Fig.10 Total number of visitors continues to grow at a rate near 17% in Oct, mainly attributable to the above 26% growth of visitors from China, which would lead to increasing spending associated with the travels. However, visitors from the rest of the world has been contracting y-y on 3m rolling basis for the past few months, reflecting a growing reliance of Hong Kong’s economy on mainland China through not only export, but also domestic sales.

Source: PSR, CEIC

Fig.11 Growth of total export remained at around 3.8% for 3 month period ended in Oct; 3m rolling growth of export to China remain at near 11%; 3m rolling growth of export to US is hovering at a level near 0; 3m rolling growth of export to EU is still in a downward trend, reporting a 13.7% y-y contraction in Oct. Balancing the effect of austerity measures in EU and China’s moderate (rather than full speed) recovery, we hold a neutral outlook for Hong Kong export for the near future.

Source: PSR, CEIC

Fig.12 Hong Kong is currently registering the worlds’ highest home price and the property price continued to rise even after the government introduced a series of tightening policies such as tightening mortgage requirement and imposing 15% tax on overseas buyers and company buyers. October property renewed record, reporting 29% higher than the 1997 peak where last housing price bubble burst. Fueled by the huge influx of China mainland buyers and the open-ended US QE3, the surge in home price is likely to continue and we expect more tightening measures by the government.

Source: PSR, CEIC
Fig.13 Hong Kong’s underlying inflation reported 3.8% in Oct, slightly slower than the 3.9% reading in Sept. There are two competing forces: mainland China’s relatively low inflation could help contain Hong Kong’s inflation in the near term; however, with the loose capital flow control, the city is more vulnerable to the inflation pressure introduced by QE3 in the long term.

Source: PSR, CEIC

**Hong Kong Growth & Inflation Forecast:**

- We maintain the forecast of 1.2% GDP growth and 3.9% inflation for 2012, and make a preliminary call of 3.0% GDP growth and 4.0% inflation for 2013 in consideration of the effects from rebounded China economy and open-ended QE from US.

**Asset Strategy**

- We maintain the overweight rating for all 3 indices on both short and long term perspectives. P/E ratios for HSCEI (9.5X), HSI (12X) and CSI300 (12X) are all residing near the lower end of their respective historical ranges, indicating cheap valuations and therefore attractive buys from a long term perspective. Following China’s economic bottoming out, HSI and HSCEI have trended up correspondingly since September, but it was not until recently that we observe a strong rally in CSI300 index (note that in our China Hong Kong report on 23 Nov we did have cautioned that there could be selloff purely due to sentiment if the 2180 supporting level was broken, but that the downside would be limited on valuation support, while the upside magnitude could be substantial). On the technical front, the index is experiencing an increasing transaction volume and an MACD bullish divergence in weekly charts has already been formed which makes the trade even more compelling. The resistance level near 2300 is already cleared and should turn into support if there is a pullback. The index is aiming at the new resistance level near 2500, therefore we continue to overweight. For HSI, fuelled by the fund inflow from FED QE and China’s economic recovery, the index has conquered resistance level near 21500, turning it into a new supporting level and is likely to continue to challenge 24000. As for HSCEI, the index has cleared resistance level near 11000 and the next stop is near 12000.

- We recommend the physically backed ETF, ChinaAMC CSI300 ETF (83188.HK) as a proxy for A-share CSI300 index. For HSCEI we recommend H-Share Index ETF (2828.HK) as a proxy. And we recommend 2800.HK as a proxy for HSI. CSI300 contains 300 major big cap Chinese companies listed in Shanghai and Shenzhen exchange and the CSI300 ETF is dominated in CNY. HSCEI contains all the Chinese enterprises listed in Hong Kong market and the corresponding 2828.HK ETF is dominated in HKD. HSI contains 49 largest companies listed in Hong Kong and the constituent companies also have significant business exposures in China. The corresponding index ETF 2800.HK is dominated in HKD. In the long run, we see 3 indices tracking each other well as the indices are all highly correlated with the well-being of China’s economy. Nevertheless there could be short term discrepancies in the 3 indices due to the different constituent companies and differences in market sentiments of buyers. The majority of CSI300 constituent stock buyers are mainland domiciled while HSCEI and HSI is open to international investors.

Fig.14 All 3 indices have PE ratios near their respective historical low at Lehman Meltdown, indicating attractive valuations.
Regional Strategy – China & Hong Kong
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- **Bond Market**: We observe a mild pickup in the yields of 2yr and 10yr government bonds as China’s bond market is gradually losing favour to stocks due to the nation’s economic recovery. However, considering the higher yields against peers, the relatively tame inflation and the positive long term outlook for CNY, we still like China bonds. The newly reported acceleration of property price in November may deter the yields from going lower but going forward the moderate economic recovery will still need support from a relatively weak borrowing cost environment. So in the balance we maintain our marketweight rating for China bond market.

- **Currency Outlook**: We hold a positive outlook for CNY against major trading currencies in the long term as CNY is still moderately undervalued. For the near term, there are competing forces. On one hand, the recovery of China’s economy would likely induce fund inflow to China (i.e. CNY appreciation) to take advantage of China’s bottoming out. On the other hand, the government has an incentive to maintain a stable or weak CNY to bolster the nation’s faltering export growth. Therefore, we assign a neutral rating to CNY against major trading currencies in the near term. To sum up, we expect CNY exchange rate to remain relatively stable in the short term, but tilt upward in the long run. As for HKD, which is pegged to USD, the open-ended QE by FED would likely depreciate HKD against other major trading currencies.

- We assign an underweight rating to Hong Kong’s bond market as the yield is already so low and there is no much room to going down further.
STOCK PICKS:

- Head of Research China Mainland’s top picks are: China Merchants Bank (3968.HK) and Central China Real Estate (832.HK)

CMB (3968. HK)

Source: PSR, Bloomberg

- Established in 1987 in Shenzhen, China Merchants Bank ("CMB") is China’s first joint-stock commercial bank, and became listed in A+H Shares in 2002 and 2006 respectively. The Bank was short listed as a World-Class Chinese Brand and ranked No. 1 in the list of the world's top 50 banks with the largest market value by the British Financial Times. It also ranked No.60 among the world's Top 1,000 Banks by The Banker.

- According to CMB’s 3Q2012 result, its accumulate net profits reached RMB34.790 billion, rising 22.55% y-y and 49% q-q, translating to an EPS of RMB1.98, higher than our earlier expectation;

- The Group’s total assets increased sharply by 12.51% to RMB3.14 trillion compared with the end of 2011, equivalent to a BVPS of RMB8.85, 15.69% higher than that of 2011;

- We note there was some deterioration in CMB’s asset quality in terms of increasing amount and ratio of NPLs. As at the end of 3Q2012, the Group’s NPL ratio increased by 0.03 percentage points to 0.59% from the end of 2011, and the converge ratio dropped 22.76 percentage points to 377.37%;

- We concern about CMB’s financing plan. Currently, CMB had announced to delay the financing plan, and showed large capital pressure under the low CAR. By the end of Sep, Core CAR and CAR of CMB registered 8.47% and 11.56%, increasing by 0.25 and 0.03 percentage points respectively, residing at the bottom of the industry.

- Considering the better-than-expected profit growth, we increase 12-m TP of CMB slightly to HK$18.28, 11.18% higher than the latest closing price, equivalent to P/E6.9x and P/B1.4x in 2013 respectively. We recommend Accumulate rating.
Central China Real Estate Limited realized contract sales value of RMB9.3 billion during the first 11 months of 2012, 18% higher than a year ago and 3% higher than the earlier set contract sales goal of RMB9 billion for the whole year. The Company’s steady sales results from its good development-sale control rhythm, which also enhances good predictability of the Company’s operating cash flow. It also benefits from the sales diversification in terms of not only geographical layout but also property types.

In H1 2012 CCRE’s debt scale rose substantially from RMB4.4 billion at the end of last year to RMB6.8 billion; long-term debt increased considerably, which pushed the RMB2.7 billion senior notes to RMB3.3 billion. The rapid rise in debts and the RMB3.8 billion remaining cash indicated huge capital expenditure by the Company. Correspondingly, by the end of June 2012, the Company net debt ratio soared to 57.6% from 29.2% at the end of last year.

The early redemption of the RMB87 million bonds had a limited impact upon the Company capital structure, but the subsequent agreement with the principal bond investors had a major positive impact as it helped avoid further erosion of the Company capital.

According to the plan of Central China Real Estate, the Company is in an in-depth development stage into 18 county-level cities in Henan Province; tier-3 and tier-4 cities will gradually rise as a major component of the Company sales. We believe Central China Real Estate will continue to allocate resources into relatively developed county-level cities. Tier-3 and tier-4 cities in Henan are benefiting from urbanization. We predict the Company will channel about 1/3 capital into tier-3 and tier-4 cities in future, and build property products with clear positioning and attractive prices to boost future sales. We are cautiously optimistic about the property sale in county-level cities and expect an over 50% sales rate.

Through layout stage and crucial stage in 2002-2012, Central China Real Estate has developed into a real estate enterprise of RMB10 billion sale size with major business exposure in middle region of China. Though the Company’s conservative development style might result in slightly slow growth, it helps to dodge many market risks. The share price has come close to our earlier target price of HK$2.55. We grant Central China Real Estate “accumulate” rating, with a 12-month target price HK$2.75, equivalent to 5-times of the expected PE for 2013.

Head of Research Hong Kong’s top picks are: Dah Sing Financial (440.HK) and HSBC (5.HK)

Dah Sing Financial Holdings Ltd (440.HK)

Dah Sing Financial Holdings Ltd (440) released interim results, which was better than we expected. Since we recommended it last year (3rd October), the share price has reached our target price, $25 within one month. Subsequently it reached $30 in the first quarter of this year, achieving a cumulative increase of nearly 40%. The share price performed beyond our expectation. Although the Group’s fundamentals are not as good as our first pick in banking group, BOC Hong Kong (2388), the valuation of Dah Sing Financial (440) is more attractive as current price does not fully reflect the Group’s reasonable value.

Furthermore, BOC Hong Kong (2388)’s price to book value is nearly doubled, limiting short-term increase potential. In addition, international banking sector is now troubled by the allegations of money laundering which exert downward pressure on the share prices. On the other hand, from the second quarter this year, market liquidity improved, and the pressures on interest costs and net interest margin compression are relieved. All these factors help improve the net interest margin of Hong Kong banking sector.
In the Hong Kong banking sector, valuations of the Dah Sing Banking group (2356.hk) and Dah Sing Financial (440.hk) are lower and more attractive compared to the peers, especially Dah Sing Financial (440) which had good performance in interim results. Pretax profit rose about 3%, the core business recorded overall increase, net interest income increased by 5.4% y-y to HK$1.16 billion (the same), net interest margin dropped 5 basis points to 1.47 percent, which was less than we expected.

Net fee and commission income recorded bright growth, reporting a significant increase of 19.1% y-y to $220 million.

Net trading income rose sharply to nearly doubled, reaching $355 million, mainly due to the increase in the fair value of financial assets and dividend income.

Overall, the Group’s core business grew and there is a slight upturning signal in the fundamental factors of the local banking industry. We expect that Hong Kong banking sector will have a better performance than the International Banking sector. Valuation of Dah Sing Financial is attractive. We believe that current price is undervalued. The potential increase in stock price will be considerable when the market finds its intrinsic value. Therefore, we assign a “buy” investment rating and 12-month target price of $33.

**HSBC (5.HK)**

As we expected, HSBC’s share price dropped technically after 3q12 results. Subsequently, the share price rose to HKD$80 with the news of disposal of Ping An Insurance (2318.HK). If client followed our recommendation in October, accumulate when the stock price returned to around HK$75, a considerable return would have been rewarded. We expect the stock price to retrace further after its downgrade by the rating agencies in the United States and dividend delivery in 3q12. Then there will be an excellent buying opportunity for medium to long term investment. We suggest that investors can buy HSBC for long-term investment when the stock price falls to HK$77 or below as we have seen high chance that the Group’s 2013 performance will show significant improvement.

The operation of HSBC has gradually improved; we raise the profit forecasts of the group for this year and next year, respectively to HK$8.0 per share and HK$9.34 per share, with earning growths of 11.7% and 16.75% y-y. Expected P/E are about 10.625X and 9.1X, forecasted P/B are 1.2X for 2012 and 1.124X for 2013. EPS is expected to reach HK$ 8 and HK$ 3.6 to be paid out as dividend; the dividend payout ratio can be maintained at 45%.

Our forecast is conservative, especially when the good cost control and the operating performance can be significantly improved in 2013 1H; we rose the target price to HK$ 85, maintaining “accumulate” investment rating. If the situation is as good as we expected, the target price can be achieved in 2013 1Q; To be more optimistic, the share price could achieve HK$100 in the first half of 2014.

The current P/B of HSBC is about 1.1 times, close to the the level of one standard deviation below five-year average. The Group’s cost-efficient ratio is slightly higher than its peers. However, with global business restructuring in progress and the expected improvement in global markets, we expect a double-digit growth in EPS in 2012 and 2013. Therefore, we maintain an “accumulate” investment rating, with target price raised to HK$ 85.

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**Fig. 24 HSBC**

Source: PSR, Bloomberg
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