MARKET INSIGHTS

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# China: an update on the market and government policy

## Introduction

*After disappointing performance in 2010 and the first quarter of 2011, Chinese equities have only recently started to outperform regional markets. In this paper, we aim to investigate the reasons for the poor performance in 2010 and to analyse the implications of recent government policy announcements on the stock market. We believe that after the recent focus on developed markets, the investment case for Chinese equities looks appealing once again.*

## Explaining the poor performance of Chinese equities

Chinese equity markets ended 2010 as the worst performing market in a regional context, rising by only 2.3% in US dollar terms. This pales in comparison to the MSCI Asia ex Japan's 17% rise, and the 20% rise in other markets such as Korea, India, Hong Kong, Taiwan and Singapore. The poor performance continued into 2011, with the Chinese market only starting to register outperformance in March 2011 (**exhibit 1**).

Exhibit 1 – **Index: Absolute performance in US dollar (%) and valuations**

| 2 May 2011 US dollar price index | 1M | 3M | YTD | 12M | 2011 PE (x) |
|---|---|---|---|---|---|
| MSCI Australia | 5.7 | 10.4 | 9.9 | 18.1 | 14.0 |
| **MSCI China** | **-0.1** | **3.2** | **4.2** | **9.0** | **11.8** |
| MSCI Hong Kong | 1.8 | -2.1 | 1.5 | 22.5 | 15.3 |
| MSCI India | -2.2 | 7.2 | -7.3 | 3.8 | 15.0 |
| MSCI Indonesia | 5.3 | 20.1 | 11.2 | 25.1 | 15.0 |
| MSCI Japan | 4.6 | -6.4 | -3.9 | 1.7 | 14.6 |
| MSCI Korea | 7.8 | 13.1 | 16.2 | 34.1 | 11.2 |
| MSCI Malaysia | 0.8 | 3.0 | 5.3 | 23.8 | 15.1 |
| MSCI Philippines | 3.9 | 11.2 | 1.6 | 22.1 | 15.3 |
| MSCI Singapore | 4.5 | 2.7 | 4.1 | 19.0 | 14.3 |
| MSCI Taiwan | 5.8 | -1.1 | 2.1 | 22.5 | 13.8 |
| MSCI Thailand | 3.6 | 16.9 | 9.2 | 52.3 | 12.8 |
| MSCI AC Asia Pacific | 4.1 | 1.3 | 2.3 | 11.9 | 13.6 |
| MSCI AC Asia ex Japan | 3.1 | 5.0 | 5.0 | 19.4 | 13.1 |
| MSCI AC Asia Pacific ex Japan | 3.8 | 6.4 | 6.3 | 18.9 | 13.4 |

Source: MSCI, Factset, Thomson Financial Datastream, Credit Suisse

The reasons for China's poor performance in 2010 were relatively straightforward. Despite strong 9.8% year-on-year growth in 2010, foreign investors largely avoided Chinese equities given rising inflation, monetary tightening, policy headwinds and earnings downgrades.

Since reaching a trough in July 2009, inflation, as measured by the Consumer Price Index (CPI), has risen steadily and has hovered at around 5% for the past quarter, a level above the government's official 4% target. Food, which makes up a third of China's CPI basket, has seen inflation in the 10% range due to the effect of colder-than-expected weather on vegetable prices. Given that it has mainly been a supply-side disruption that has caused the spike in food inflation, we believe that the CPI will moderate from June 2011 onwards as the supply shock reverses and food prices fall.

Nevertheless, since the beginning of 2010, China's Required Reserve Ratio (RRR) for large banks was increased nine times by 4.5% to 20%. China's central bank has also hiked rates by four times since October 2010, taking the benchmark one-year lending and deposit rates to 6.31% and 3.25% respectively. Furthermore, authorities have introduced a raft of measures to cool the property market, such as tightening the lending conditions of mortgage loans and raising the minimum down-payment on a first house to 30%. Earnings in sectors that have been unable to pass on input price increases, such as the consumer staples sector, have also been downgraded, leading to falls in share prices.

As a result, rising inflation, the monetary and administrative response to inflation, and the impact of inflation on corporate earnings, have provided an element of uncertainty to the Chinese equity market and have led China to de-rate to a price-to-earnings multiple of 12x in the first quarter of 2011 – a discount to the rest of the region (see **exhibit 1**).

## An update on China's government policy

In early March, China held a National People's Congress (NPC) meeting where Premier Wen Jiaobao delivered the government's annual work plan along with details of the twelfth Five-Year Plan. The message from the NPC was consistent with prior government announcements.

The key takeaways from the government's economic targets for 2011 include an inflation target of 4% (versus 4.9% as of the end of February 2011, and versus the prior target of 3%) and a real GDP growth rate of 8%, with a focus on improving the quality of growth and on economic structuring.

Stabilising prices was identified as the top priority of macroeconomic policy in 2011, with a target of 16% broad money (M2) supply growth in 2011. We continue to expect the government to increase interest rates and the RRR throughout 2011 in response to CPI over 4%, and to use necessary administrative policies to maintain stable prices, such as price caps on government-controlled products (eg energy, utilities). However, we believe that these measures have been well flagged by the government and are already priced into market expectations.

In terms of the composition of GDP and growth rates, the government has set a modest 2% budget deficit target to support private consumer expenditure growth in order to restructure the economy towards being increasingly domestic driven. The government has announced plans to increase spending on social welfare, education, healthcare, pension and, importantly, on social housing, to be funded by reducing spending on fixed asset investment.

Social housing, the provision of low-cost housing, is one of the key tenets of government policy that has been in focus over the past year and the NPC meeting provided more details on how the government aims to achieve its plan to make social housing available to 20% of urban households by 2015. Essentially, the central government is targeting the construction of ten million units of social housing in 2011 and 2012, and five to six million units per year in 2013, 2014 and 2015. To put the numbers in perspective, ten million units of social housing could account for a third of residential housing starts in 2011. Our Greater China team believe that the introduction of social housing will offset the expected slowdown in private residential construction and be a significant boost to companies involved in the construction sector (eg building materials, cement).

## The 12th five-year plan (FYP)

Given that 2011 is the first year of a new FYP, the NPC also provided more detail on the government's 12th FYP. In general, the main targets of the new plan include:

- Real GDP growth averaging at 7%, with a focus on enhancing the quality and efficiency of growth.
- A focus on economic restructuring, including support for the service sector and for strategic new industries (eg alternative energy, bio-medical, environment protection).
- A shift of the growth driver towards domestic demand, by aiming for real income growth of over GDP growth, and a target of 45 million jobs being created in the urban area.
- An increased importance on improving the welfare of citizens via 'inclusive growth;, which includes expansion of tax reform, pension coverage, an increase in minimum wages by over 13% annually and the construction of social housing.
- An increase in the share of non-fossil fuel energy from 8% to 11% via the construction of alternative energy capacity (eg wind, solar, nuclear, hydroelectric).

**Exhibit 2** provides some numerical data on targets of the previous FYP, the realised numbers and the targets for the new FYP.

Exhibit 2 – **Comparisons of the 11th and 12th FYPs**

| | 11th FYP target | 11th FYP Actual | 12th FYP target |
|---|---|---|---|
| Real GDP growth (%) | 7.5 | 10.5 | 7.0 |
| GDP (RMB trillion) | 26.0 | 40.0 | N/A |
| Urban income per capita (RMB '000) | 13.4 | 19.1 | 7% CAGR |
| Rural income per capita (RMB '000) | 4.2 | 5.9 | 7% CAGR |
| Population (bn) | 1.4 | 1.3 | <1.39 |
| Urbanisation ratio (%) | 47.0 | 46.7 | 51.5 |
| People employed in services sectors (%) | 35.1 | 34.9* | N/A |
| The service industry as % of value added (%) | 43.3 | 43.0 | 47.3 |
| Urban employment (%) | 5.0 | 4.1 | <5 |
| Energy consumption reduction per unit of GDP (%) | 20.0 | 19.1 | 16.0 |
| Comprehensive utilisation rate of industrial solid wastes (%) | 60.0 | 66.0 | N/A |
| R&D as % of GDP (%) | 2.0 | 1.7 | 2.2 |
| Social housing coverage (%) | N/A | <8 | 20.0 |

Source: CLSA Asia-Pacific Markets, Lianghui discussions, 12th Five-Year Plan draft

## Political change

In October 2010, Xi Jinping was appointed vice chairman of the Central Military Commission, a move that means he will almost certainly succeed the incumbent Hu Jintao as party secretary in late 2012 and as president in 2013. Howard Wang, head of J.P. Morgan Asset Management's Greater China team, does not believe that there will be any shift in government policy given the new leadership. He believes that the new generation of leaders have been carefully chosen to ensure a continuation of past policy and there is little in the political record of Xi Jinping to suggest that he intends to steer China in a different direction. In our view, the main tenets of the incumbent regime's economic views – strong growth, social harmony and inflation control, will be continued.

## Chinese equities look attractive

After underperforming in 2010 and early in the first quarter of 2011, the MSCI China ended the first quarter as the second cheapest market in the region with a 2011 price-to-earnings ratio of 12x, versus the MSCI Asia Ex Japan average of 13x and versus India's 15.4x (**exhibit 1**).

After seeing earnings downgrades throughout 2010, the earnings of Chinese equities started to be upgraded in February and in March 2011 (**exhibit 3 and 4**). This was led firstly by the benchmark heavy energy sector given rising oil prices. More importantly, late in the first quarter of 2011, Chinese banks released their 2010 earnings and guided to strong earnings in 2011, both of which surpassed consensus analyst expectations. In particular, given the rising interest rate environment, Chinese banks' net-interest-margins started to expand, highlighting the pricing power of banks in a credit constrained environment. In 2010, the banking sector faced earnings downgrades given concerns over asset quality and non-performing loans, and was weighed down further by large capital raising across the sector. In hindsight, we believe that the regulators were prudent by proactively ensuring that the sector had high levels of capital adequacy and that banks' provisioning levels would be sufficient to absorb any potential bad loans.

Exhibit 3 – **China earnings per share (EPS) – 2011**

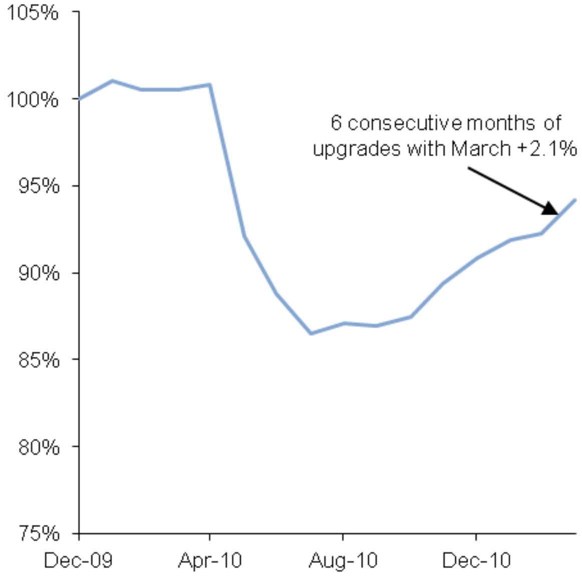
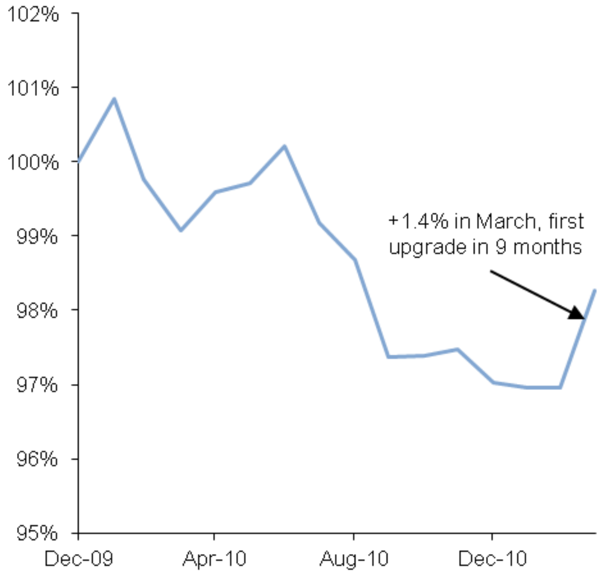



Exhibit 4 – **Chinese banks EPS – 2011**




Source: Credit Suisse

Higher oil prices due to the events of the Middle-East may cause inflation to remain above the government's official target in 2011. Nevertheless, we expect inflation to peak by the end of the second quarter, given the low base effect (the recent trough in inflation was in June 2010) and moderating food price pressure. Our Greater China team believe that monetary conditions are already very tight and unlikely to be significantly more restrictive going forward. Past experience has seen the Chinese equity markets trough several months before inflation actually peaks, and we believe that this cycle will be no different. In our opinion, inflation and the risk of further monetary tightening have been increasingly priced into the equity markets, as evidenced by the outperformance year-to-date of Chinese A-shares, the market most reflective of changes in investor sentiment. Furthermore, we believe that we have seen the peak in tightening policies and thus any corrections would present a good buying opportunity of Chinese equities given the attractive valuations relative to growth.