Hong Kong/China 2011 Investment Outlook

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Bullish on China Plays

- **A volatile market in 2010.** Year to date, the Hang Seng Index and H share index have experienced high volatilities, mainly driven by global risk factors, US dollar carry trade, and China's money supply policies. On the fundamental side, corporate earnings beat the street forecast on the upside in the first three quarters in 2010, with a gradual and consistent profit forecast upgrade from analysts. We hold the view that going into 2011, China and Hong Kong's monetary and fiscal policy would be a major factor to influence market sentiment. Meanwhile, investors will refocus on the corporate earnings quality and sector fundamentals, as we expect 2011 earnings will rise back to the pre-financial crisis levels and enter into a new growth era.

- **2011: Normalization of interest rate is not a concern.** Complicated by the Fed's QE2 effect on global asset prices, especially in the emerging markets, we believe the Chinese government will continue to closely monitor the liquidity and money inflows in the property sector, commodity trading, and equity market and will apply measures to orchestrate an economic soft landing, including lower the new loan expansion pace, interest rate hikes, RRR hikes, and administrative price/production controls. However, we do not view that tightening policies will hinder overall growth in China and we believe the authority's pro-growth policy for the coming five years remain intact despite monetary policy normalization.

- **Major themes.** 1) Robust earnings growth: The key contributors of H shares' earnings growth in 2011 will be metals and mining sector, China banks and insurance sector, as well as railway and railway equipment sector. We believe the price performance of the above mentioned sectors will outshine the others on the back of strong earnings momentum. 2) 12th five-year plan: Under its investment theme, the market leaders in cement, gas utility companies, oilfield equipment makers, and high end machinery producers, are likely to benefit in the long term, in our view. 3) Interest rate upcycle: We project PBOC to raise benchmark interest rate by four times (100 bps) in the next 12 months, which will be positive for banks and insurance sector. Under our expectation of further PRC consumer inflation uptick toward 2Q11, the extension of negative real interest rate period would boost the retail sector performance.

- **Hang Seng Index and H share index target.** Our 2011 target for Hang Seng Index and for H share index are 27,000 and 16,500, respectively, representing about 17% and 29% upside from current index levels. We believe the upside potential for H shares is higher, as Hong Kong property shares are likely to be stagnant due to Hong Kong government's continuous intervention on speculative property transactions. Our target is based on FY11F PER for HSI and for HSCEI of 14.8x and 14.5x (five-year average PER), on the back of 15.6% and 16.1% index FY11 consensus EPS growth estimates. In our view, for both of the index to trade at above one standard deviation over the historical average, i.e. PER of 17x or more, that would be a case of speculative hot money inflows and liquidity overshoot, rather than fundamental support.

- **Strategy picks.** Based on our top down sector preference and our analysts' bottom up recommendations, we selected 12 stocks out of the 9 sectors which we have overweight ratings. Our strategy picks for 2011 include **ICBC (1398 HK)**, **CCB (939 HK)**, **Ping An Insurance (2318 HK), Dongfeng Motor (489 HK)**, **CNBM (3323 HK)**, **Anhui Conch (914 HK), Maoye International (848 HK), Anta (2020 HK)**, **TSC Offshore (206 HK), ENN Energy (2688 HK)**, **China High Precision (591 HK)**, **and Luk Fook (590 HK).**

2010 review: Equities volatile amid global economic uncertainties

After a strong rally in 2009, Hong Kong equities faced a few headwinds during 2010, including Mainland's stringent property control measures by central and local governments, EU sovereign debt woes, pre QE2 market enthusiasm but then post QE2 market jitters, and followed by Hong Kong government's extra stamp duty charge on property speculation. In 2010, the Hang Seng Index and H share index have had a wide trading range and high volatilities, mainly driven by global risk factors, US dollar carry trade (see Figure 1) and China's money supply policies (see Figure 2), in our view. On the fundamental side, corporate earnings beat the street forecast on the upside in the first three quarters in 2010, with a gradual and consistent corporate profit forecast upgrade from analysts quarter by quarter. However, unlike 2009, equities performance during 2010 has not been able to reflect further earnings improvement and fundamental recovery in most of the sectors.

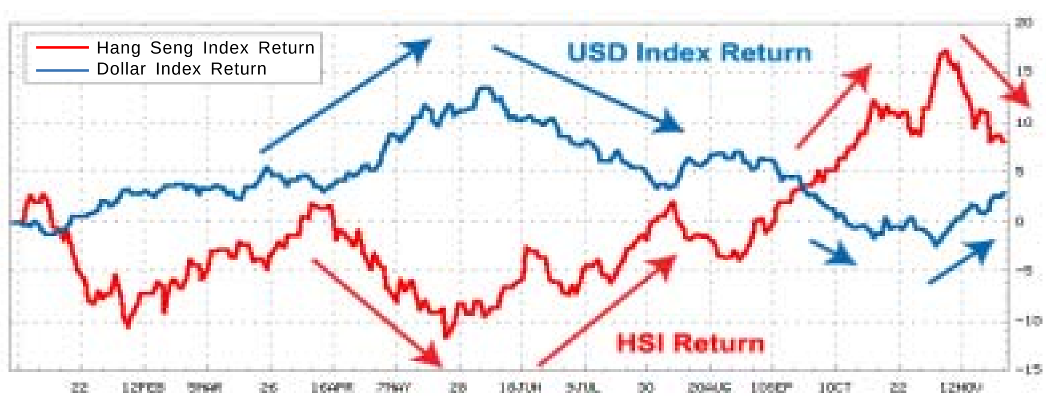
At the moment, we believe a tight monetary policy has taken place in both China and Hong Kong, and the stock market in the past few weeks zigzagged, trying to strike a balance between concerns of a tightened monetary policy environment in HK/China and the optimism of the potential of extra liquidity from Fed's QE2 plan. We hold the view that going into 2011, China and Hong Kong's monetary and fiscal policy would be a major factor to influence market sentiment. Meanwhile, investors will refocus on the corporate earnings quality and sector fundamental, as we expect 2011 earnings will rise back to the pre-financial crisis level. In our view, the authority's efforts to fight the hot money inflows and prevent asset price bubbles in emerging markets will be more effective this round in 2011, thanks to lessons from the past and improved flexibilities for central banks or governments to apply open market tools and to introduce and execute new administrative measures or new tax rules.

Table 1: **Hang Seng Index and sub-index performance up to Nov 30 2010:**

	Closing 30/11/10	Closing 29/10/10	*1-month % change*	Rank	Closing 31/12/09	*YTD % change*	Rank
HSU Index	42,425.4	42,228.1	*0.5*	2	37,585.2	*12.9*	1
HSC Index	12,721.9	12,623.5	*0.8*	1	11,452.9	*11.1*	2
HSP Index	29,937.8	31,072.6	*(3.7)*	5	28,147.4	*6.4*	3
HSI Index	**23,008.0**	**23,096.3**	***(0.4)***	**3**	**21,872.5**	***5.2***	**4**
HSF Index	34,207.2	34,433.1	*(0.7)*	4	34,170.8	*0.1*	5
H shares index	12,817.6	13,168.7	*(2.7)*		12,794.1	*0.2*	
Red chips index	4,110.0	4,205.1	*(2.3)*		4,059.9	*1.2*	

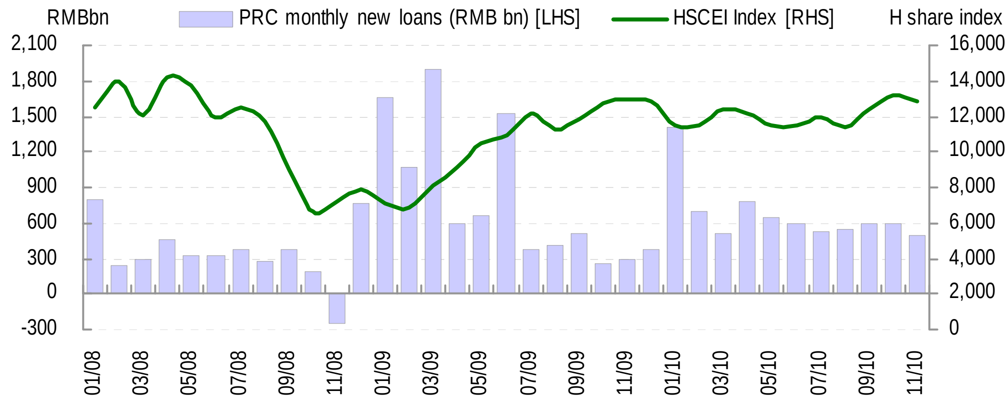
Source: Bloomberg

Figure 1: **Year to date US dollar return vs Hang Seng Index return (Rebased on 1 Jan 2010)**



Source: Bloomberg

Figure 2: **HSCEI index movement vs monthly new yuan loan**

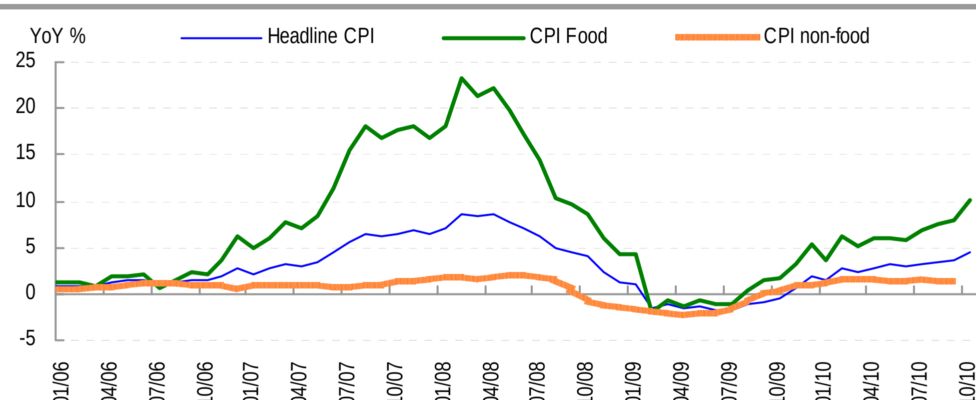


** 2010 November new loan is based on market forecast figure*
Source: CBRC, CEIC and Bloomberg

2011: Concerns on inflation will subside, market back to fundamentals

We do not think this round of monetary tightening will hinder China's growth. After the release of October CPI and new yuan loan data, Chinese authority used a more harsh tone to address the speculative activities in the agriculture and commodity markets and concerns on further inflation uptick. State Council laid out the measures to contain the hiking inflation pressure, including 1) ensuring enough supply of sugar, cotton, vegetables, and edible oil in the market, increase production output of diesel and coal; 2) providing subsidies to lower income people; 3) enabling local government to intervene and temporarily control the price of consumer staple products; and 4) scrutinizing the speculation and illegal trading activities in commodities. In our view, the purpose of the administrative measures focus on preventing the price of consumer staple goods from overheating and the hot money inflows to the consumer daily necessities in order to tame jittering consumers. We believe the move should be constructive and positive to the economic development and is able to reduce the risks of overheating and price bubbles. Complicated by the Fed's QE2 effect on global asset prices, especially on the emerging markets, we believe the Chinese government will continue to closely monitor the liquidity and money inflows in the property sector, commodity trading, and equity market and will apply measures to orchestrate an economic soft landing, including lower the new loan expansion pace, interest rate hikes, RRR hikes, and administrative price/production controls. However, we do not view that tightening policy will hinder overall growth in China and we believe the authority's pro-growth policy for the coming five years remain intact despite the normalization of monetary policy.

Figure 3: **Non-food CPI remained in the comfortable zone**

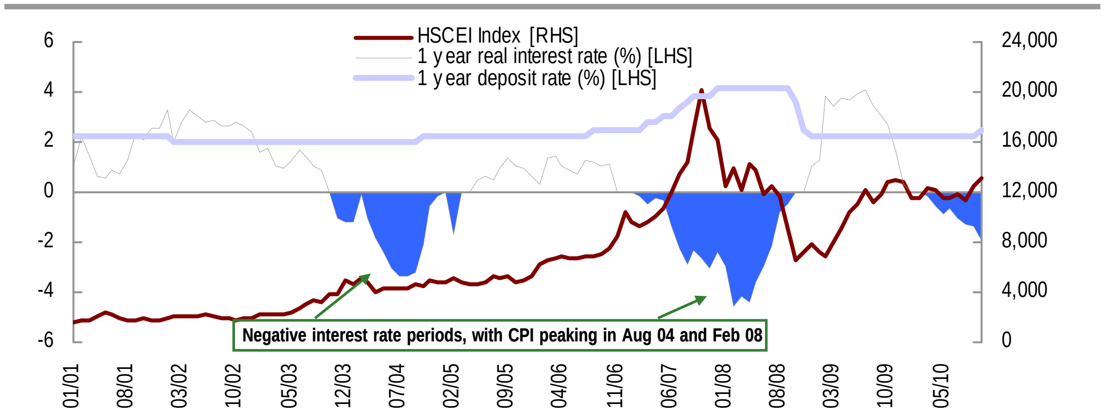


Source: CEIC

In the medium term, economic growth and earnings fundamental will support China equities. We forecast China GDP will expand 8.8% in 2011, slower from 10.0% growth in 2010, mainly due to the lower M2 growth, and lower new yuan loan amount (forecast at RMB6.5 to 7.0 trillion, down from RMB8.0 trillion in 2010). The major driver for GDP growth including Central government's railway projects and social housing construction, upward momentum in consumer spending (project retail sales to grow 17% yoy), as well as China's export growth to other Asian countries. At the same time, we expect the rising food price inflation would persist in 1Q to 2Q11, mainly due to the lagging effect on the abnormal high levels of money supply in the past two years. We project the food price hike will take overall CPI to its peak level of 5.5% around May to June 2011, but the inflation pressure would start to ease from 3Q11 when slower M2 growth begins to take effect. In 2H11, we expect inflation to come down to 3% level, and that would bring our full year CPI forecast to 4.0%.

In the short term, investors' sentiment will be affected by sharp rise in inflation and rate hike concerns and the phase out of loose monetary policy, but we view that in the medium term, equity market performance will be dependent upon stock valuations, the country's economic growth and corporate earnings performance. H shares are currently valuing at 13.3x/11.4x PER for 2010F and 2011F, much below its historical average estimated PER of 14.5x. We suggest investors to accumulate China plays amid the internal and external negative news and tightening uncertainties, The risks of economic hard-landing and stagnant corporate earnings in 2011 are slim, in our view, and we would like to point out that the initial stage of negative real interest rate environment (i.e. six months period before the CPI peaked in Aug 2004 and Feb 2008) has coincided with positive equity market performance in the latest two periods, as shown in Figure 4.

Figure 4: **HSCEI vs. PRC one-year real interest rate**



Source: PBOC, NBS and Core Pacific - Yamaichi

Table 2: **Economic growth and interest rate outlook in 2011**

China	Hong Kong
* In 2011, GDP growth will remain strong at 8.8%; inflation will rise to an annual average of 4.0%.	* HK GDP will grow 4.3% in 2011, driven by robust consumption (forecast retail sales to grow 12% yoy) and recovery in global trade.
* Retail sales growth to remain strong at 17%.	* CPI is forecast at to rise to 4.0% in 2011 on further weakness in US dollar.
* PBoC will raise RRR three times by a total of 150 bps during 2011, and will raise the one-year lending rate four times, by 25 bps each time, from 5.56% currently to 6.56% at end of 2011.	* Unemployment rate will continue to decline from 4.3% in 2010 to 4.0% in 2011.
* RMB will appreciate 3% to 4% against the USD.	* HK local prime rate would be unchanged compared with current level.

Source: Core Pacific – Yamaichi estimates

Major themes in 2011

China plays to deliver robust earnings. In 2011, we expect the Chinese corporate earnings to come back to the levels before the global financial crisis. Current market consensus earnings growth forecast of 16.1% is achievable, in our view, despite the inflation control pressure is likely to persist and financing cost will put margin pressure on high geared companies. The key contributors of H shares' earnings growth in 2011 will be metals and mining sector, China banks and insurance sector, as well as railway and railway equipment sector. We believe the price performance of the above mentioned sectors will outshine the others on the back of strong earnings momentum.

The 12th five-year plan. China will announce its full detailed five-year plan in March 2011. Chinese authority is expected to put great emphasis on improving the sustainability and the equitability of growth. It is clear that in the coming five years, it will turn to a more internally balanced economic structure, rather than pursuing economic growth rate itself. To achieve this target, the government is likely to focus on: 1) development of western region and rural areas in PRC, to close the income gap with residents in costal/urban areas; 2) investment in clean energy and environmental protection related sectors, while facilitating the consolidation of inefficient production capacities in steel, ferros metals, and cement sector, to reduce carbon output and pollution; 3) invest in social housing construction to speed up the urbanization rate and boost private consumptions; 4) reward technology innovations by supporting the domestic high-end equipment makers in railway industry, oil and gas exploration industry, and industrial sector; 5) speed up development of the service industry (i.e. banks, insurance, tourism, transportation and logistics industry) to increase job opportunities and raise the weighting of the service industry in GDP so that China can sustain its economic growth in the next decade. Under the five-year investment theme, we believe that the market leaders in cement, gas utility companies, oilfield equipment makers, and high end machinery producers, are likely to benefit in the medium term.

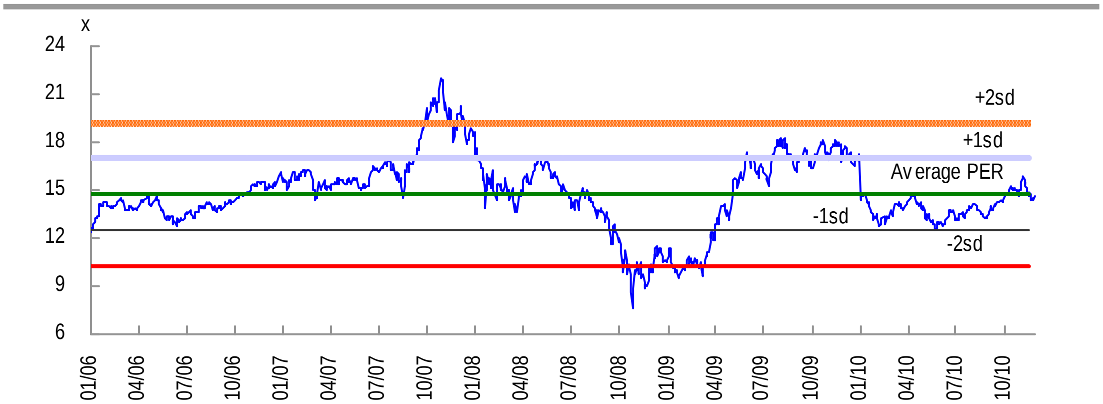
Interest rate upcycle. Fears of global central government's exit strategy and exit schedule have affected the sentiment and fund flows of equity markets in 2010. With further confirmation of Mainland China's stimulus exit (RRR hikes and banks' loan book control) and a series of policies on property sector tightening in 4Q10, we believe stock market has recognised the fact that most of policy stimulus China introduced after global financial crisis have come to an end. The worries about steeper and more frequent than expected interest rate hikes are overdone, in our view, as we think such actions, coupled with the speculation of RMB appreciation will attract more hot money inflows to China and will not be effective in wiping out the extra and speculative liquidity in the market. As mentioned earlier, we project PBOC to raise benchmark interest rate four times (25 bps each time) in the next 12 months. This interest rate normalization process will be positive for banks and insurance sector, although IPPs and property counters will suffer on higher gearing and higher finance costs. Under our expectation of further PRC consumer inflation uptick toward the 2Q11, the extension of negative real interest rate period would boost the retail sector performance. As such, we believe department stores, sportswear, and auto sector are likely to benefit from increase in consumer spending and lifestyle upgrades.

2011 index target and top-down strategy picks

In 4Q10, the Hang Seng Index has hit our yearly target of 25,000, which we set at the end of 2009. However, H shares index performance missed our expectation, dragged by the worse-than-expected return of China banks and China property stocks in 2010. Government's property sector tightening measures and mortgage loan control remained a big overhang since 2Q10, whereas China banks' fund raising plans and worries on their exposure to LGFV nonperforming loans dampened the market sentiment. Looking forward in 2011, we believe property sector would remain volatile and is likely to underperform the broad market, and we hold this view that Mainland property prices will face further corrections as the existing measures would remain and new measures such as property tax will be rolled out. On the other hand, we expect China banks to outperform after the negative catalysts to phase out, as 1) most of the banks have completed or announced the rights offering; and 2) we believe the concerns on nonperforming loans will be alleviated after the company management makes clear disclosures on LGFV loans.

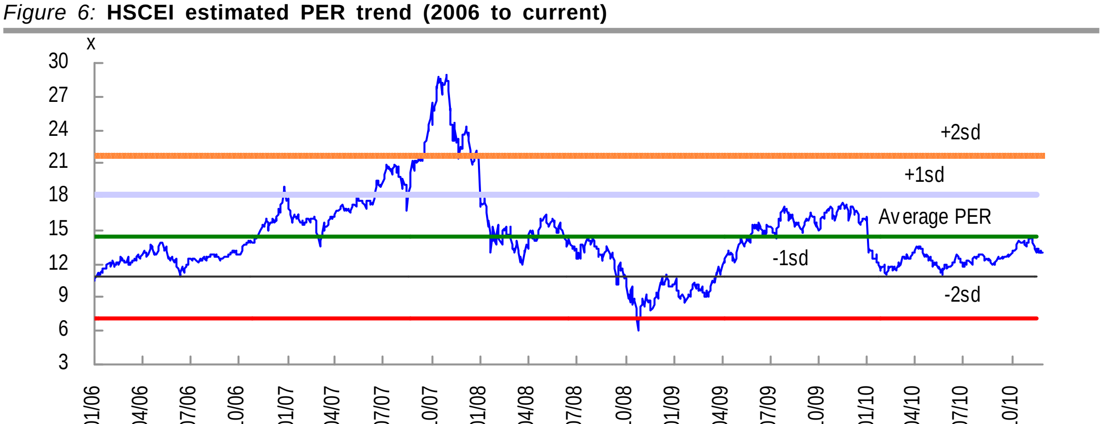
Our 2011 target for Hang Seng Index and for H share index are 27,000 and 16,500, respectively, representing 17% and 29% upside from current index levels. We believe the upside potential for H shares is higher, as Hong Kong property shares are likely to be stagnant due to Hong Kong government's continuous intervention on speculative property transactions. Our target is based on FY11F PER for HSI and for HSCEI of 14.8x and 14.5x (in line with the five-year average estimated PER), on the back of 15.6% and 16.1% index FY11 consensus EPS growth forecasts. In our view, for both of the index to trade at above one standard deviation over the historical average, i.e. PER of 17x or more, that would be the case of speculative hot money inflows and liquidity overshoot, rather than fundamental support. The major risk for reaching our target is: 1) faster-than-expected monetary tightening and interest rate hikes in PRC; 2) inflation risks and austerity measures; and 3) slower-than-expected recovery in global economy. In Table 4 and Table 5, we highlight our sector preference and top-down strategy picks for 2011.

Figure 5: **HSI estimated PER trend (2006 to current)**



Source: Bloomberg and Core Pacific - Yamaichi

Figure 6: **HSCEI estimated PER trend (2006 to current)**



Source: Bloomberg and Core Pacific - Yamaichi

Table 3: **Sector preference and top-down strategy picks**

Overweight	Sector theme	Strategy picks
China Banks	Expect expansion in NIM and fee income growth to drive profit growth and higher ROE, current valuations are at bottom level	ICBC (1398), CCB (939)
China Insurance	Wage increase will facilitate the penetration rate in insurance product, rate hike is positive for investmentn yield	Ping An (2318)
China Auto	Long term sales growth uptrend intact, margin improvement and expense control could partly offset new tax for foreign JV companies	Dongfeng (489)
China Cement	Cement industry consolidation will be one of the major tasks in PRC 12th FYP, expect cement price to trend up futher in 2011	CNBM (3323), Anhui Conch (914)
China Sportswear	Leading brands in 2nd tier cities will benefit from faster urbanization and wage increase the most	Anta (2020)
China Oilfield Equipment	High crude oil price will support further spending in oil&gas E&P activities and benefit the equipment makers	TSC (206)
China Gas Utilities	Direct beneficiary of the 12th FYP target to reduce pollution and increase natural gas supply and consumption	ENN Energy (2688)
China Highend Machinery	Local highend equipment and component makers will replace imports and continue to gain market share in China	China High Precision (591)
Hong Kong & China Retail	Strong consumer confidence, inflation hike and negative real interest rate will boost sales of luxury and brandy consumer products	Luk Fook (590), Maoye Intl (848)

Source: Core Pacific - Yamaichi

Table 4: **2011 strategy picks**

Company name	Bloomberg Code	Rating	Price (HK$) 30/11/10	PER (x) 2011F	PER (x) 2010F	Yield (%) 2010F	2011 target HK$
Anhui Conch	914 HK	BUY	33.00	16.5	20.4	0.9	44.00
Anta	2020 HK	BUY	14.48	17.0	20.8	2.9	18.84
CCB	939 HK	BUY	7.01	9.3	10.8	3.9	9.31
China High Precision	591 HK	BUY	5.50	11.0	14.6	1.2	7.20
CNBM	3323 HK	BUY	17.90	10.7	12.9	0.6	23.40
Dongfeng Motor	489 HK	BUY	14.78	9.1	10.0	1.3	19.20
ENN Energy	2688 HK	BUY	22.35	15.6	19.0	1.4	30.30
ICBC	1398 HK	BUY	6.04	9.5	11.2	4.0	8.07
Luk Fook	590 HK	BUY	26.30	15.2	18.5	2.2	34.50
Maoye International	848 HK	BUY	4.02	25.1	31.3	1.0	5.40
Ping An Insurance	2318 HK	BUY	89.60	26.0	33.2	0.6	117.00
TSC	206 HK	BUY	1.59	12.0	18.6	-	2.33

Source: Bloomberg market consensus forecast, Core Pacific - Yamaichi

Appendix 1: **Highlight of PRC economic indicators**

		2006	2007	2008	2009	10/09	11/09	12/09	01/10	02/10	03/10	04/10	05/10	06/10	07/10	08/10	09/10	10/10
Real GDP*	yoy, %	11.6	13.9	9.0	8.7			10.7			11.9			10.3			9.6	
Exports	yoy, %	27.2	25.7	17.2	(16.0)	(13.8)	(1.2)	17.7	21.0	45.7	24.3	30.5	48.5	43.9	38.1	34.4	25.1	22.9
Imports	yoy, %	20.0	20.8	18.5	(11.2)	(6.4)	26.7	55.9	85.5	44.7	66.0	49.7	48.3	34.1	22.7	35.2	24.1	25.3
Trade balance	US$bn	177.5	261.8	295.5	196.1	24.0	19.1	18.4	14.2	7.6	(7.2)	1.7	19.5	20.0	28.7	20.0	16.9	27.2
Actual FDI	US$bn	66.0	74.8	92.4	90.0	7.1	7.0	12.1	8.1	5.9	9.4	7.4	8.1	12.5	6.9	7.6	8.4	7.7
FAI (ytd)	yoy, %	16.6	16.7	26.1	30.5	33.1	32.1	30.5	na	26.6	26.4	26.1	25.9	25.5	24.9	24.8	24.5	24.4
New bank loans	RMBbn	3145.7	3633.6	4903.6	9576.7	253.0	294.8	379.8	1393.4	700.1	510.7	774.0	639.4	603.4	532.8	545.2	595.5	587.7
M0	yoy, %	12.7	14.0	12.7	11.8	14.1	15.0	11.8	(0.8)	22.0	15.8	15.8	15.2	15.7	15.5	16.0	13.8	16.6
M1	yoy, %	17.5	21.5	9.1	32.4	32.0	34.6	33.2	39.0	35.0	29.9	31.3	29.9	24.6	22.9	21.9	20.9	22.1
M2	yoy, %	17.0	18.5	17.8	27.7	29.5	29.6	28.4	26.0	25.5	22.5	21.5	21.0	18.5	17.6	19.2	19.0	19.3
CPI	yoy, %	1.5	4.8	5.9	(0.7)	(0.5)	0.6	1.9	1.5	2.7	2.4	2.8	3.1	2.9	3.3	3.5	3.6	4.4
PPI	yoy, %	6.0	4.4	10.5	(5.4)	(5.8)	(2.1)	1.7	4.3	5.4	5.9	6.8	7.1	6.4	4.8	4.3	4.3	5.0
Retail sales	yoy, %	13.7	16.8	21.6	15.5	16.2	15.8	17.5	14.0	22.1	18.0	18.5	18.7	18.3	17.9	18.4	18.8	18.6
Industrial Production	yoy, %	16.6	18.5	12.9	11.0	16.1	19.2	18.5	na	12.8	18.1	17.8	16.5	13.7	13.4	13.9	13.3	13.1
RMB exchange rate	/US$	7.812	7.304	6.823	6.827	6.828	6.827	6.827	6.827	6.826	6.826	6.825	6.828	6.781	6.775	6.807	6.688	6.671

** quarterly data*
Source: CEIC