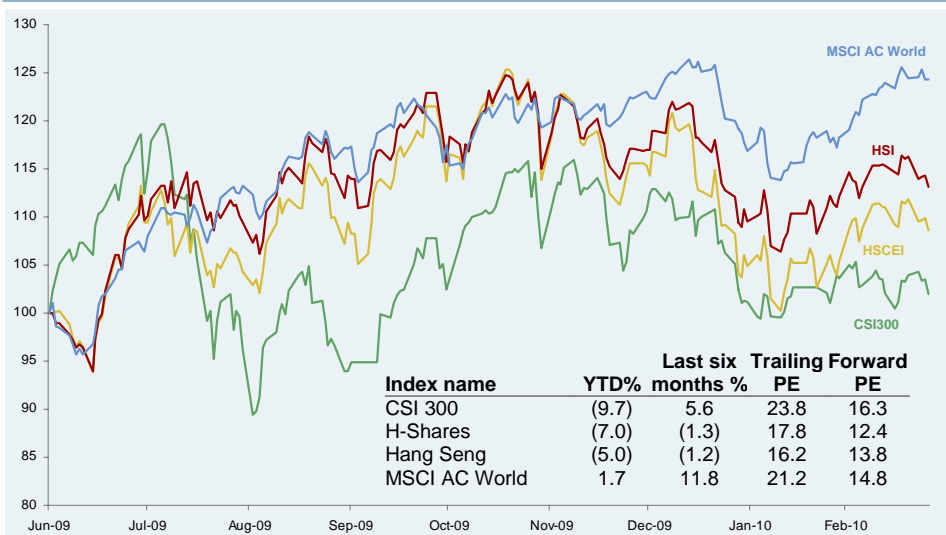


Jing Ulrich
Managing Director, Chairman,
China Equities, J.P. Morgan
+852 2800 8635
jing.i.ulrich@jpmorgan.com

Positive Momentum in Store for A shares

After racking up a 105% gain in the first seven months of 2009, during which 81% of China's new loans were extended, the domestic A-share market has conceded some ground and traded in a largely range-bound manner. So far this year, Chinese equities have underperformed most global markets, with the CSI 300 shedding 9.7% and the HSCEI declining 7.0%, against a 1.7% increase in the MSCI AC World (see Figure 1). The A-H Premium is currently near its historical low at 15.6%. According to data provider EPFR, China focused funds experienced net outflows in nine out of the first eleven weeks of 2010.

Figure 1: Relative performance of CSI 300, HSCEI, Hang Seng and MSCI World indices



Source: Bloomberg

Initially, the domestic stock market's pull-back coincided with gradual moderation in the pace of new lending, the maturity of discounted bills financing, and rising concern about stretched valuations and new share supply. Market sentiment this year has remained cautious after the PBoC twice raised banks' reserve requirements and policymakers introduced new measures to cool the property sector. With many investors now focused on the task of gauging the government's attitude toward stimulus removal, inflation and trade tensions, we find some reason to expect upward momentum in A shares in the medium term:

- **Impact of ample liquidity and negative real interest rates.** Policymakers have pledged relatively easy monetary policy goals: growth in the broad M2 measure of money supply is expected to moderate to 17% in 2010, from nearly 30% in 2009, while the year's loan target has been set at RMB 7.5 trillion. Although both of these increases are lower than last year's levels, elevated corporate and household deposit balances should be supportive of equity investments (see Figure 2). Moreover, February's CPI inflation of 2.7% pushed real Chinese 1-year deposit rates to -0.45%. With consumer

price inflation potentially rising to ~4% by 3Q10, real deposit rates are likely to remain negative in the absence of aggressive interest rate hikes. The threat of wealth erosion should encourage a higher allocation of funds toward equity markets.

Figure 2: Deposit growth (YoY%)

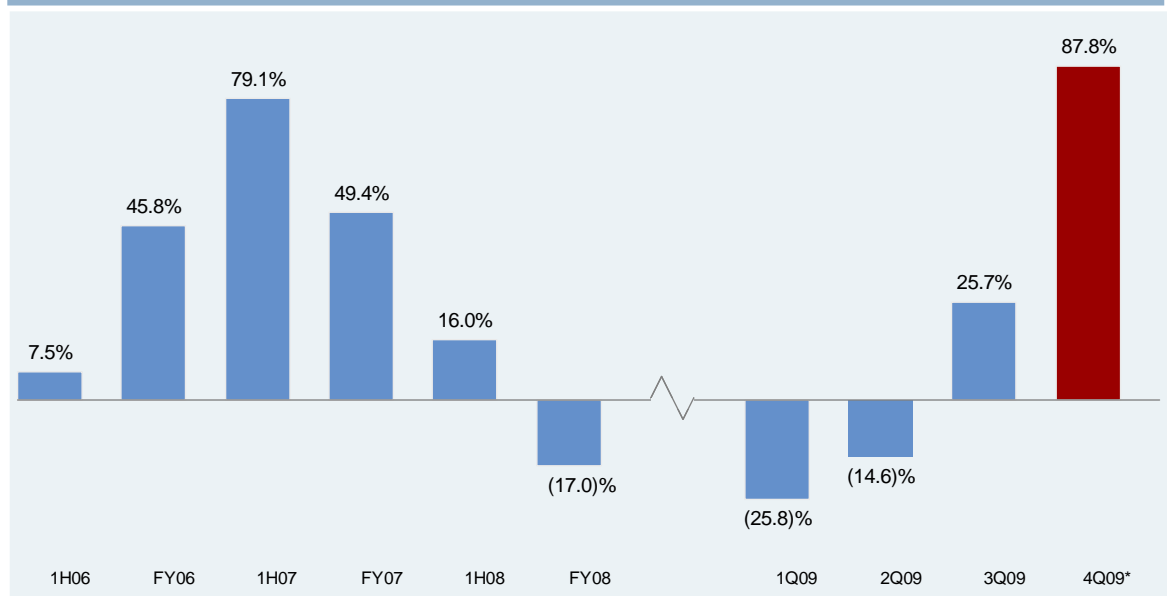


Source: PBoC, CEIC

- **Stock account openings and fund subscriptions trending higher.** There are early signs that investor interest in equity investment is improving. Although new stock trading account openings are well off record levels last year, new openings reached 352,201 in mid-March, rising for a third week since the Chinese New Year holiday, the most openings since mid December 2009. According to data from TX Consulting, 13 new mutual funds were launched in Jan-Feb 2010 compared to 8 funds in the same period a year ago. Subscriptions totaled RMB24.7 billion compared to RMB 15.5 billion last year. The CSRC is allowing fund management companies to launch more funds this year, so long as they avoid over-concentration in one category.
- **Limited domestic investment options.** Since policy tightening in the property market (especially for non-first-time homebuyers now required to make 40% down payments and up to 10% premium on mortgage rates) is limiting the potential for capital appreciation, investors are now more likely to gravitate toward equities rather than real estate investments.
- **RMB revaluation and stock index futures.** Renewed appreciation in the RMB and the introduction of new financial products will further attract capital inflows into Chinese equities. Amid heating Sino-US rhetoric over the currency issue, Chinese authorities have been taking a tough stance on RMB valuation. Currency markets have reacted negatively to the current climate, with the 12 month CNY/USD NDF rising from 6.63 to 6.68 over the last 2 weeks. Nevertheless, most observers expect the RMB to resume gradual long-term appreciation, allowing authorities to mitigate imported inflation and promote domestic consumption. The introduction of stock index futures, margin trading and short selling this year will be positive for the domestic market and should result in higher A-share trading volumes. Stock market officials have also placed ETF development high on the priority list for 2010 and aim to launch over 10 new ETFs during the year, twice as many as in 2009.

- Earnings and valuations will drive share market.** 4Q09 results of domestically listed companies thus far show earnings growth of 87.8% (against a weak base in 4Q08), with just over a third of companies reporting. Although 2010 earnings estimates have been adjusted downwards, companies in most sectors should continue to show healthy levels of earnings growth, supported by a strong domestic economy, pro-consumption policies and a recovery in exports. Consensus earnings growth estimates in 2010 and 2011 run at ~23% and ~19%, respectively, for the CSI300. Valuations, in terms of forward PE, have fallen to levels not seen since March 2009. The current forward PE for the CSI 300 is 16.3x compared to ~26x in August 2009. Similarly the forward PE for H-share companies is currently 12.4x, compared to ~16x in August 2009.

Figure 3: Earnings growth of listed A shares (YoY%)



Source: TX Consulting, Bloomberg * Includes 602 companies that reported up March 25

- Domestic investor feedback.** After speaking with several mainland fund managers we have found sentiment going into the second quarter leaning towards the positive. The feeling is that policy tightening has already been priced into the A-share market and while inflationary pressure may emerge, it could serve to speed up appreciation of the RMB. Interest is high in sectors connected to the government's push toward regional development, green tech, high-speed rail and the Shanghai World Expo. Concerns on the downside include global economic uncertainties, slowing FAI, and rising interest rates.

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