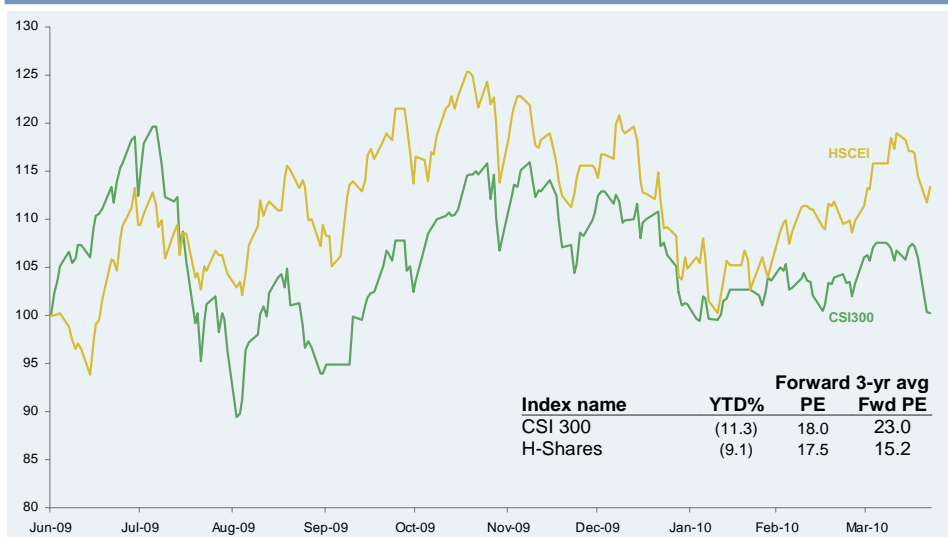


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Property Concerns Dampen Market Sentiment

China's A-share market has experienced a sharp correction in response to the announcement of several rounds of property tightening measures by the central government, beginning last Thursday. Over the last three trading sessions, the Shanghai Composite Index has declined 5.9% to 2980 while real estate constituents have shed 9.5%, reflecting concern about the impact of government efforts to deter speculation and prevent property and land prices from rising too fast.

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



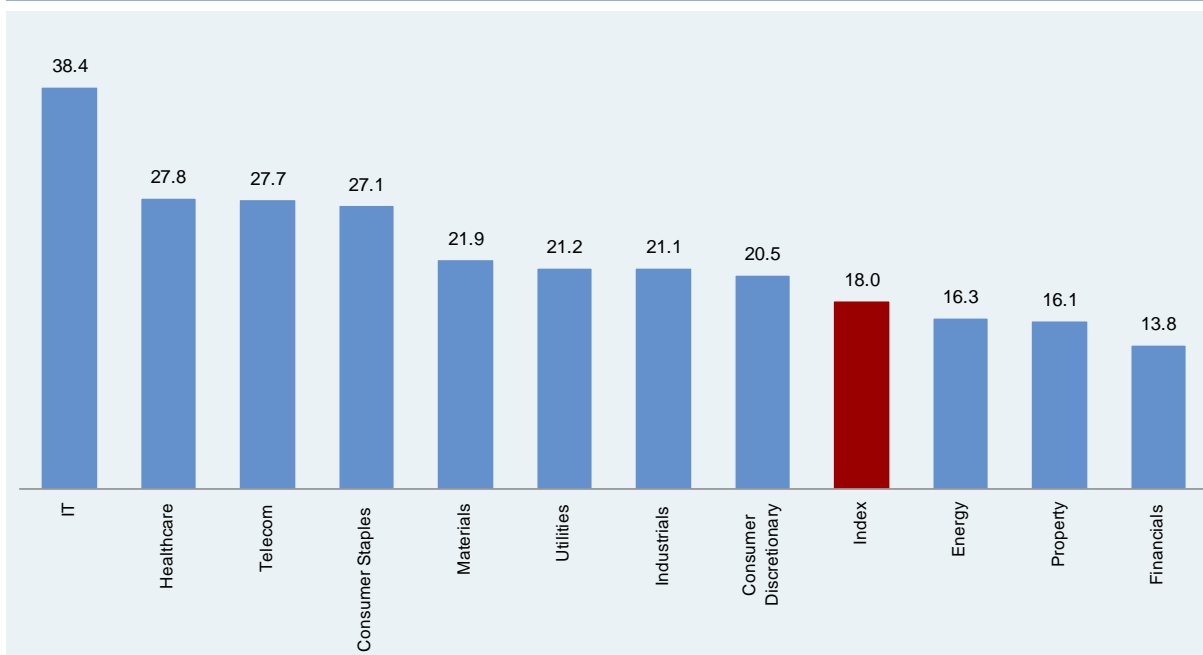
Source: Bloomberg

Since the debut of trading on April 16, futures contracts based on China's CSI 300 index have fallen 6.8%, compared to a 6.5% decline in the underlying index. While this may indicate slightly more bearish sentiment among a contingent of sophisticated investors, we do not believe the arrival of stock index futures had a major impact on the broader market correction, given stringent trading requirements that include a minimum deposit of RMB500,000 and the passing of futures trading examinations. According to the China Financial Futures Exchange, only 9,137 investor accounts had been opened to trade index futures as of last Thursday, compared with close to 180 million stock trading accounts.

- Domestic fund managers we spoke to characterize the recent property tightening measures as being more forceful and extensive than generally anticipated and believed they would add uncertainty to the economic outlook. Property, banking and FAI-related sectors (such as steel and cement) have suffered the sharpest deterioration in sentiment, while sectors with little direct exposure to property tightening (including healthcare, telecoms, IT

and consumer) are showing some degree of resilience. That said, some fund managers argued that valuations for new economy sectors - among the most favored in the current climate - are generally quite elevated and are valued at multiples similar to when the market was at its peak (see Figure 2).

Figure 2: Estimated Forward PE (CSI 300 sub-sector) *



Source: Bloomberg * Property sub-sector index is a part of the Shanghai Composite Index

Property Concerns at the Fore

Just days after the central government raised minimum down-payment levels and mortgage rates for second-home purchases, the State Council on Saturday adopted a still-stricter stance, targeting third-home lending, suspending mortgage financing for non-local homebuyers, and hinting at stricter implementation of existing policies. Among key developments in recent days:

- The State Council announced that banks could stop lending to buyers purchasing their third home in cities where property prices have risen too rapidly, or where supply is tight. While allowing banks considerable discretion, this policy provides a further deterrent against speculative home buying activity.
- Banks have been directed to suspend lending to homebuyers who cannot provide local income tax records or social insurance payments as proof of residency. If strictly implemented, this policy could create a substantial barrier for foreign and non-local property investors, particularly affecting demand for luxury properties in major cities.
- Local governments have the discretion to employ temporary measures to limit the volume of housing transactions. The central government indicated it will hold local officials responsible for stabilizing housing prices and implementing affordable housing programs.
- Local governments have been called upon to step up their land appreciation tax (LAT) collection efforts, which would increase land holding costs and potentially deter over-aggressive bidding at land auctions.

- Xinhua reported on Monday that property developers have been ordered to obtain official approval before accepting pre-payment for uncompleted homes.

Additionally, recent domestic media reports have suggested that China may soon start trials of a property transaction tax, while various commentators have suggested that recent developments indicate the central government is giving serious consideration to introducing a recurring holding tax (levied on the basis of property's value).

The recent slew of measures came shortly after the government revealed that home prices in 70 major cities climbed 11.7% from a year earlier in March, continuing the trend of excessively rapid price increases in the sector. The new measures preceded the Spring Housing Fair and May Day Holiday, when various real estate trade fairs are held around the country (in 2009, national average home prices rose 2.0% and 2.3% MoM in April and May respectively). Prospective buyers will now be more inclined to take a wait-and-see approach to see if home prices will correct. This suggests lower sales volumes in the next few months, although a large price correction is seen as unlikely.

In the current climate, investor sentiment toward the banking, property and building material sectors has turned significantly negative, while consumption, healthcare and new economy sectors are seen as potential beneficiaries of policy shifts. If the current round of property tightening succeeds in restraining price increases without triggering a collapse in transaction volumes, we believe the market should once again focus on the strong corporate profit growth of A-share companies, which are trading below their average valuations in recent years.

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