



J.P. Morgan's
Hands-On China Series

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HANDS-ON CHINA REPORT
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Finding Silver Linings Amid China's Tight Policy Environment

Since China officially adopted a “prudent” monetary policy stance in late-2010 and began to introduce measures to prevent real estate overheating, economic growth has clearly lost some momentum. While GDP growth slowed only a notch to 9.7% in 1Q11, from 9.8% the previous quarter, continuing declines in industrial production and PMI data, declining money supply growth, lower commodity imports, electricity shortages, as well as policy-driven declines in housing and auto sales have combined as factors to lead investors to give greater weight to a “hard landing” scenario over the coming quarters. Yet in some other respects, economic activity is still fairly strong when one considers the resilience of non-automotive retail sales, stable urban fixed asset investment rates and the upward trajectory of wage growth.

During our meetings in the US, we found investor sentiment by and large cautious. Premier Wen Jiabao's public declaration that China has controlled inflation is a major positive change which the markets have not discounted. A reduction in inflationary pressure in the third quarter will lessen the need for further monetary tightening measures, while increasing the likelihood that 12th Five-year plan government infrastructure investments will be green-lighted and funded more quickly (thereby partly offsetting the likely deceleration in real estate investment growth).

Chinese Leaders Sound a Note of Confidence on Inflation

Reinforcing market expectations that the current cycle of inflation has yet to peak, the NDRC acknowledged in a recent statement that June's CPI figure would show a further pick-up (from the 34-month high of 5.5% in May) and stay elevated for some months. However the economic planning agency noted that the momentum of price increases was under control – a sentiment reinforced by Premier Wen Jiabao's *Financial Times* editorial last Friday, in which he wrote that “the overall price level now is within a controllable range and is expected to drop steadily.” In a subsequent interview, Premier Wen said that efforts-to-date should allow inflation to be kept below 5%, although the full-year target of 4% would be difficult to meet. In response to concerns about food supplies in the aftermath of the worst drought in 50 years, the Premier noted that the country's grain supply is abundant, while yesterday a senior economist with the State Information Center projected that food inflation was likely to slow from October, in response to a likely bumper grain harvest and increasing pork output.

Silver Linings for Market Sentiment

Both A and H-share valuations are currently at the lowest level since the financial crisis, as investors price in a pessimistic outcome for the economy and exhibit caution about the corporate earnings outlook. As Figure 1 shows, the Shanghai Composite and HSCEI indices are currently priced at 15.4x and 11.3x trailing PE, respectively, or nearly one standard deviation below average levels of 24.4x and 15.0x since 2005. This is comparable to trough levels reached during periods of heightened market concern over the issue of non-tradable SOE shares (which accounted for as much as ~70% of market capitalization in 2005) and the impact of the global financial crisis.

Figure 1a: Trailing PE – A-shares (times)

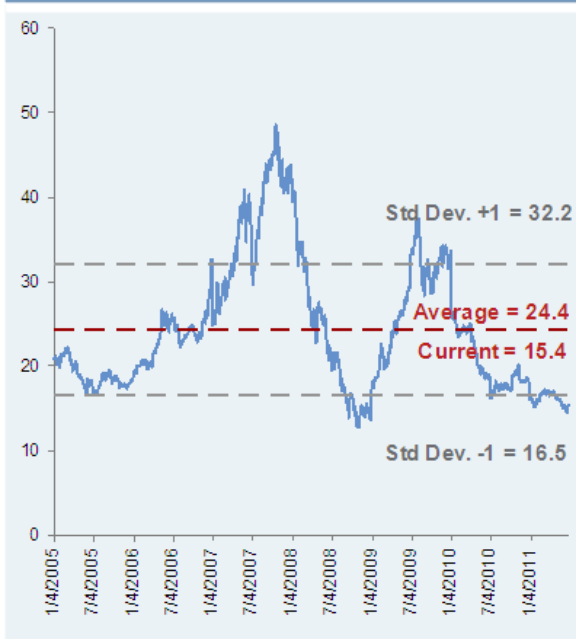
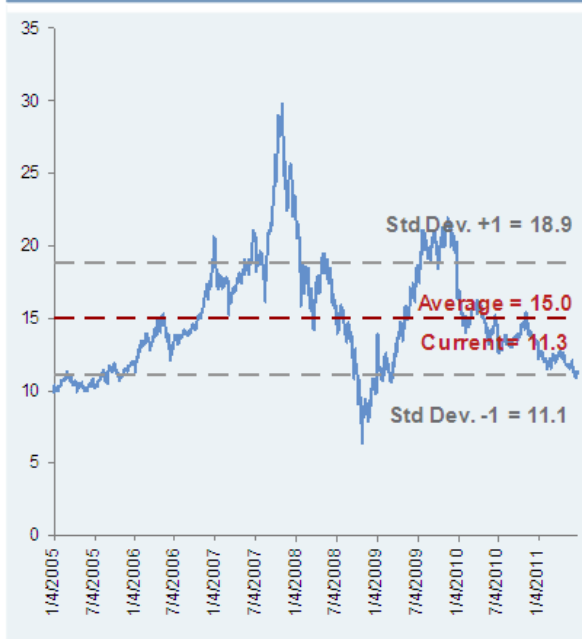


Figure 1b: Trailing PE – H-shares (times)

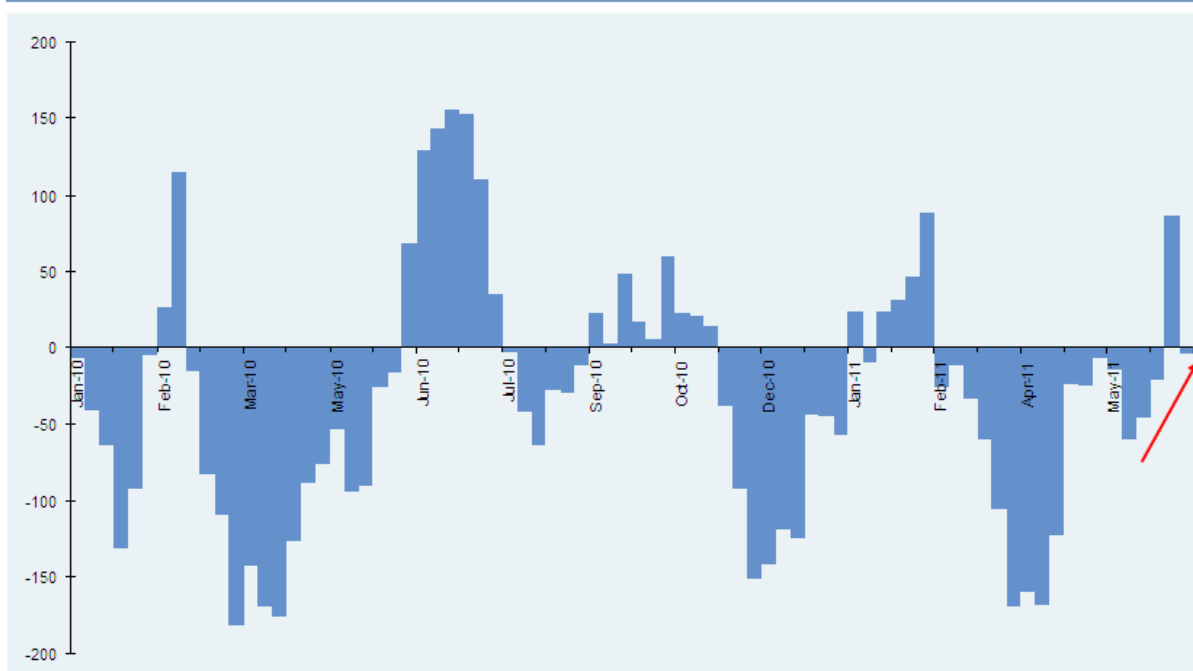


Source: Bloomberg

With investor sentiment now at very depressed levels, we see several potential developments on the horizon, which could counter the prevailing pessimism:

- **Improving liquidity conditions.** As domestic inflation moderates, the current tightening cycle could pause or end in the second half. The PBoC's actions to reduce market liquidity (including open market operations and RRR hikes) have recently slowed, with the net withdrawal level over the last 4 weeks slowing to RMB15.7 billion, compared to the prior 4-week level of RMB238.1 billion.

Figure 2: Liquidity injections from open market operations and RRR hikes (4 week moving average, RMB billion)



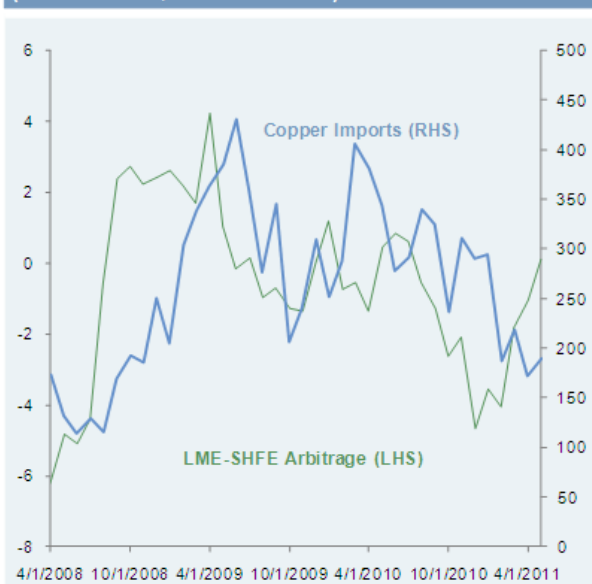
Source: CEIC

- **Oil price correction and reduced import tariffs.** While the motivation behind the IEA's decision to release strategic reserves of oil into the market has been debated, the effects are clear: oil prices have fallen and the market outlook otherwise has become more optimistic. In particular, copper has rallied some USD100 since. Another bright point from the standpoint of dampening inflationary pressure comes from the fact that import tariffs for 33 goods will be reduced from July 1, including a host of liquid fuels: aviation kerosene, light diesel oil, and fuel oil. While the impact of lower input costs will take some time to transmit to end-user prices, the reduction of taxes will serve to encourage imports and help prevent supply shortages.
- **Eventual rebound in commodity imports.** Taking copper as an example, since late-2008, LME spot copper prices have risen some 260% to this February's peak. In the latter part of this rally, China's monthly imports began to show a downward trajectory. Q2 import quantities were particularly underwhelming, given this is the season when demand usually peaks. At the same time, warehouse stocks at the Shanghai exchange experienced strong withdrawals, punctuated by a period of restocking in 4Q10 and 1Q11, when the LME-SHFE arbitrage window opened up.

SHFE copper stocks have been declining consistently over the last several weeks, and in May/June, aggregate stocks across the three major exchanges (SHFE, LME, COMEX) have retreated. The SHFE futures curve has shifted into deep backwardation, implying strong demand for Chinese copper. According to J.P.Morgan metals analyst Michael Jansen, the premium for bonded copper is high at over USD100, and bonded stocks are estimated to have near-halved in the second quarter from heavy destocking. This is in contrast to early April when there were reports of bonded metal being sold at a discount as financial arbitrageurs looked to offload units due to tighter lending criteria, according to Reuters.

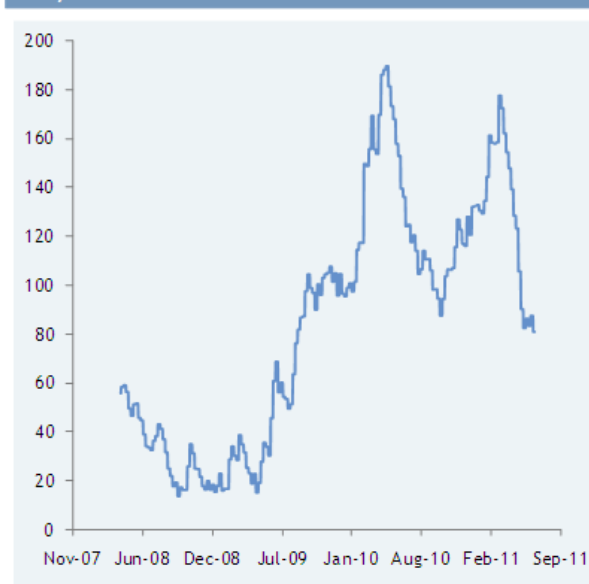
In effect, Chinese consumption has only shifted from imports to less visible domestic inventories. Scrap imports have remained resilient, rising over 20% YoY in May. This supports the idea that Chinese buyers have been looking for avenues to avoid purchasing copper on the international markets at a time when prices are still near recent highs and the level of external uncertainty is substantial. With the copper arbitrage opening between Shanghai and London, we expect Chinese buyers to reenter the international market in the near- to mid-term. However, in light of the combination of power and credit restrictions and seasonal weakness, it won't be until September when China will become a major buyer again, according to Michael Jansen.

Figure 3a: Monthly copper import and average arbitrage* (thousand tons, RMB thousands)



Source: Bloomberg

Figure 3b: SHFE exchange copper inventory (thousand tons)



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