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China's Nuanced Policy Approach - Supporting Growth without Reviving Bubbles

China's economy has entered a slowdown phase, which in large part has been engineered by a year of credit tightening and government policies to cool the housing market. However, weak external demand has caused concern that the downside to growth may be bigger than expected, and that economic worries may take a toll on consumer confidence. Following a series of recent policy gatherings and ministry statements, the focus has clearly shifted towards a pro-growth bias after an extended tightening cycle when the government's main objective has been containing inflation, both in the price of every day items and in the housing market. The shift was marked in late-November by a 50bps reduction in the required reserve ratio for banks, but became more evident during last month's Central Economic Work Conference, when the government's policy statement gave priority to the goal of maintaining stable economic growth in 2012 (with economic restructuring and managing price expectations being the other major objectives). The stronger-than-expected growth in bank lending (RMB640.5 billion) and money supply (13.6% YoY M2 growth) in December further indicates the shift in monetary policy towards easing liquidity. At the close of this past weekend's National Financial Work Conference, Premier Wen Jiabao also emphasized that the nation's financial industry must improve the real economy's access to finance and guard against speculation and 'virtual bubbles'.

Emphasis on SME Support, Consumer Incentives and Targeted Investments

In comparison to China's post 2008-9 financial crisis response, we expect an increased prevalence of policies that aim to boost income growth and reduce the tax burden for both companies and individuals. Starting in mid-2011, the government introduced a rash of policies in support of the country's SME sector. SMEs account for ~80% of employment and ~60% of China's industrial output, but lost out during both the recent credit binge and subsequent tightening. We expect broader policy support for SMEs in 2012, as well as progress in longer-term financial reforms to redress this sector's structural disadvantage.

Recent domestic reports have also suggested that new incentives to boost consumer spending may be in the works. With consumer confidence softening, this appears likely – however consumption incentives cannot entirely supplant the government's traditional reliance on investments to shore up growth. The difference this time around is that incremental investments will likely be skewed towards areas of social welfare, environmental protection, in strategic industries of the future, and towards improving infrastructure in the less developed Central and Western regions of the country. With 2011 being a poor year for China's asset markets, there have been recent indications of support for China's ailing stock market – e.g. Premier Wen's recent pledge to boost stock market confidence during the 12th Five-year plan and Central Huijin's recent purchase of more bank shares. However, no reversal of property tightening measures appears imminent.

In terms of monetary adjustments, the PBoC's recent operations have been geared towards easing liquidity – the central bank in the last two weeks has broken from a four-week string of net fund-withdrawals through open market operations and recently stated that it is suspending all paper sales before the Chinese New Year to ensure sufficient liquidity (the suspension of its regular operation on Jan 6, resulted in a net fund injection of RMB51 billion). As noted by J.P. Morgan's China Economics team, a further RRR cut is most likely to occur in January, particularly as cash demands increase ahead of the holiday.

This report addresses several questions concerning how China's policy decisions are likely to impact the major pillars of the economy:

- *Since China has limited room for another massive stimulus program, what are the government's main policy levers?*
- *How will the government's continued real estate tightening and concern for the quality of FAI impact the pace of investment in 2012?*
- *With net exports expected to detract from growth in 2012, how is weaker demand both at home and abroad impacting the export and manufacturing sectors?*
- *Does the government's property tightening campaign bring a real risk of collapse in the housing market?*

Sector Implications

Inflation is now declining, monetary policy has begun to ease and stock multiples are currently inexpensive in historical comparison. However, as was the case during the 2008 global financial crisis, external risks have deteriorated sharply in recent months, with a worsening of the European outlook, a still-tentative recovery in the US and extreme volatility in financial markets. But unlike 2008-9, the government's response is likely to be far more nuanced, without the recurrence of a massive fiscal stimulus program that bolstered markets the last time around.

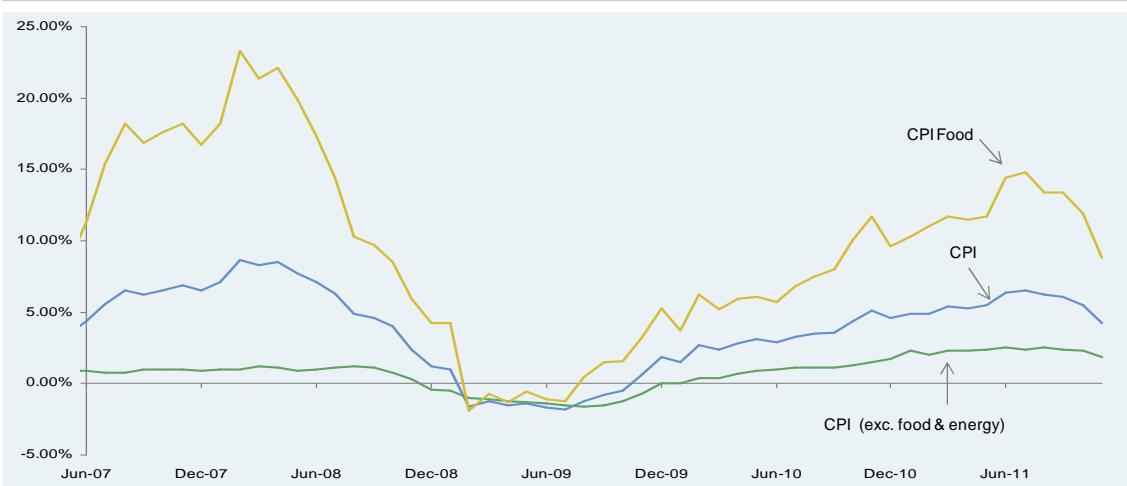
Premier Wen recently reiterated the need to tighten or loosen policies according to the circumstances of different industries. In effect, this points to policies that support restructuring, technological upgrades and credit restrictions for industries that suffer from excess capacity, high levels of pollution and energy intensity. Conversely, industries relating to consumption, social welfare, environmental protection, agriculture and strategic upgrading will benefit from priority access to credit, higher investments and preferential tax treatment. Given this context, we see more attractive investment opportunities in sectors such as internet, healthcare, as well as industries that stand to benefit from the targeted investment spending boost (e.g. water treatment operators and systems providers). We are cautious towards sectors with high exposure to housing policy – including property developers, materials and construction machinery. We are also cautious towards sectors where the build-up in capacity in recent years exceeds market demand, such as the mass-market segment of the automotive industry.

1. Since China has limited room for another massive stimulus program, what are the government's main policy levers?

At this juncture, the challenge for policymakers is to implement measures that boost domestic demand without setting back progress made in curbing inflation. With 24.7% year-over-year growth in tax revenue in the January-November period and a low fiscal deficit (at just ~2.5% of GDP in 2010), the central government has the financial capacity to launch another major fiscal spending package. However, it does not appear likely to do so unless conditions in the external environment deteriorate considerably. It is well recognized by national leaders that the previous round of credit expansion and stimulus spending resulted in a surge in inflation and property prices, a worrying local debt burden and ultimately set back the government's structural adjustment plans for the economy. Barring extreme developments in the external environment, the government's policy response is likely to rely on the following key pillars:

- **Adjustments to “prudent” bias in monetary policy.** The more benign outlook for inflation, as well as the appearance of a downtrend in property prices in major Chinese cities, has given policymakers greater leeway to allow for some monetary policy easing. Having already loosened credit restrictions for SMEs, on November 31, China cut RRR by 50 basis points to 21% for commercial banks and 19% for small and medium sized banks. This cut was not intended to relieve pressure in the property space, with central government officials making clear that they intend to maintain tight policy restrictions on the sector. Policy loosening is likely to be manifested in a larger lending quota, and multiple reductions in RRR over the course of the year, with the next cut likely to materialize sooner rather than later. J.P. Morgan China economist Haibin Zhu expects three RRR cuts in 1H12 and expects new loan creation to reach RMB8.2 trillion in 2012. This boost to money supply will offer some relief to businesses that have been coping with a credit shortage.

Figure 1: China CPI Inflation (YoY)



Source: CEIC

- **Income growth and tax adjustments to shore up domestic demand.** Although China is unlikely to embark on aggressive fiscal stimulus spending, as it did to counter the global slowdown in 2008-9, the government appears more inclined to support the economy by boosting wages and enacting tax reductions. There is considerable scope to support domestic demand by boosting income growth, and by reducing the tax burden for both companies and individuals. We saw signs of this in late-October, when the State Council approved a pilot program in Shanghai to replace business tax with the value-added tax (VAT) for the transportation sector and certain modern service industries. China's Minister of Finance has

said that upcoming tax measures will include lowering tariffs to encourage imports of energy, resources, high-tech equipment and key components. With export demand tapering off, the government has also said it is prepared to lessen the tax burden on exporters in order to soften the impact of the global slowdown.

Earlier in the year, revisions to the personal tax system raised the minimum threshold for personal income tax to RMB3,500, effectively eliminating the personal income tax for some 60 million people. Most retail professionals in China also anticipate a potential reduction in notoriously high consumption taxes and import duties on luxury goods, or the removal of certain categories of goods (such as cosmetics, tobacco and alcohol – no longer as “luxurious” at this stage of China’s development) altogether from the classification of goods subject to consumption tax. Such reforms would improve luxury brands’ margins (assuming that the tax savings would not be entirely passed along to the end consumer), as well as domestic retailers and distributors that stand to benefit from an increase in domestic luxury purchases.

- **Broader support for the SME Sector.** Starting in early-2010, China ratcheted up banks’ reserve ratio requirements to record levels in order to reign in excess liquidity in the market and over the course of 2011, the government has enforced a variety of restrictions on home purchases in an attempt to cool the housing market. The government’s credit controls and restrictive purchasing policy had the effect of squeezing property developers – who were indeed the intended targets. But there have also been undesirable consequences, such as the negative impact of tight credit on private companies (historically at a disadvantage in accessing bank loans), and particularly on small and medium sized enterprises. These consequences spurred a sharp increase in non-bank financing activities, which in turn have become a source of concern. During the past year, there has been a rise in unofficial lending by informal financial entities that are able to lend cash at much higher interest rates, as well as a rise in off-balance sheet lending under situations where banks have served as intermediaries to corporates, trust companies and other counterparties.

Among a host of recent measures (see Figure 2), China’s banking regulator has recently mandated that bank lending to small businesses must match or exceed the growth in overall lending, and has also directed banks to increase their tolerance for non-performing loans to smaller companies. We expect broader policy support for the SME sector in the New Year.

- **Targeted spending boost.** Although the government is reluctant to launch a stimulus effort of the magnitude experienced in 2008-9, the commitment towards “proactive” fiscal policy in 2012 leads us to expect a possible acceleration of existing spending plans – particularly in areas that improve quality of life for the general public, such as healthcare, education, as well as investments in modernizing the agricultural sector. The Vice Premier of Finance Wang Qishan has also commented that China will spend USD 1.7 trillion over the next five years on strategic sectors (such as alternative energy and biotechnology) to bolster growth. Higher investments may also be directed at modernizing infrastructure in China’s lesser-developed Western regions.
- **Supporting household consumption.** During the 2008-9 global financial crisis, direct measures to stimulate household consumption (such as the rural home appliance subsidy program and the reduction in taxes for passenger vehicles with engine sizes of 1.6L or smaller) constituted a key part of the government’s effort to shore up domestic demand. A recent China National Radio report, citing a spokesman for the Ministry of Commerce suggested that the government may soon announce measures to boost consumer spending.

In the latter months of 2011, worries about the economic environment seem to have started to weigh on consumer sentiment. The government's consumer confidence measure has drifted lower since mid-year, but retail sales growth has held fairly steady at around 17%. It is of some concern that sales growth in recent weeks appears to have declined across most categories of discretionary consumption.

Figure 2: Recent government measures in support of SMEs

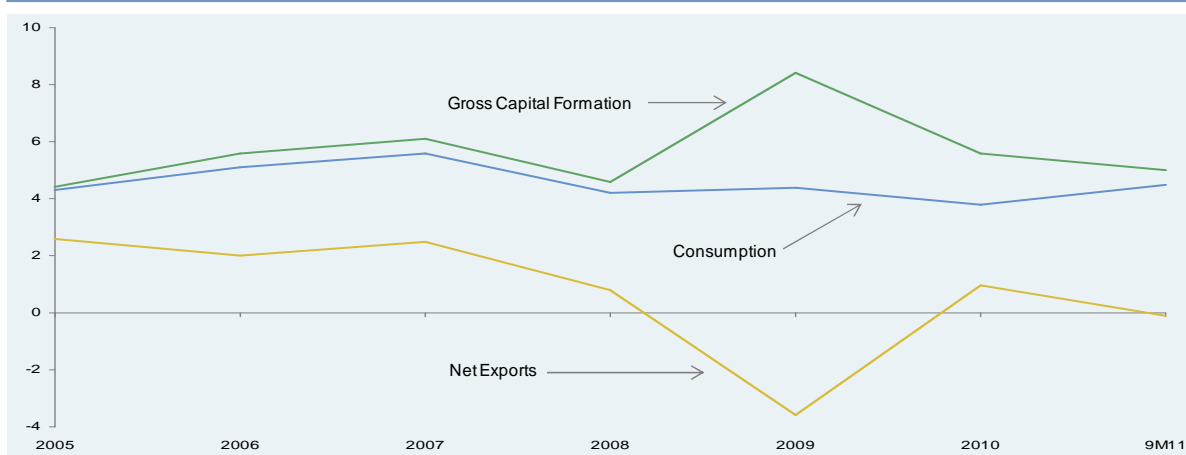
Date of Policy	Relevant Regulator	Details
Dec 31, 2011	MoF & MIIT	Government departments will allocate no less than 30% of government purchasing quota to small and medium-sized enterprise starting 2012. No less than 60% of the SME-allocated quota should be allocated to small and micro-sized enterprises.
Nov 14, 2011	MoF & NDRC	From Jan 1, 2012 – Dec 31, 2014, 22 types of administrative fees charged by 13 different government departments will be waived for small and micro-sized enterprises.
Oct 25, 2011	CBRC	Supplementary notice issued to encourage financial support for the country's small- and micro-sized enterprises. Banks should ensure that the growth of loans to small firms will not be slower than that of the average lending, and the growth should be higher than the level of the previous year.
Oct 17, 2011	MoF & State Administration of Taxation	Financial institutions can be exempted from stamp duties on loans made to small and micro-sized enterprise, from Nov. 1, 2011 to Oct 31, 2014.
Oct 12, 2011	State Council	<p>Financial measures:</p> <ul style="list-style-type: none"> - Increase credit support to small and micro-sized companies, especially those with credit lines less than RMB5 million. - The growth rate of bank lending to SMEs should be no less than that of overall lending growth. - New SME lending must be higher than in the same period of last year. - Continued implementation of a lower RRR to small financial institutions that satisfy the above requirements. - Tighter restrictions on the charges that banks levy on SMEs. - Broaden financing channels for SMEs by promoting reform and development of smaller financial institutions. - Encourage private lending on the basis of standard regulatory and risk control measures. <p>Fiscal measures:</p> <ul style="list-style-type: none"> - Higher threshold for VAT and business tax; halving of enterprise

		income tax until 2015; favorable import tax for qualifying enterprises. - Encourage financial institutions to strengthen services to SMEs by exempting them from contract stamp duty, and extending the reduction of operation tax for rural financial institutions until 2015. - Expand the size of special SME support funds.
Jun 07, 2011	CBRC	Loans of less than RMB5 million to small enterprises will be treated as retail lending and will not be subject to loan-to-deposit ratio supervision. Lower NPL ratios will be applied to loans to small businesses.

2. How will the government's continued real estate tightening and concern for the quality of FAI impact the pace of investment in 2012?

China's transition to a less investment-reliant model of growth has been long aimed for, but the transition has been slow. Increased government spending on infrastructure was a major component of the RMB4 trillion stimulus package during the 2008-9 global financial crisis. The contribution of gross capital formation to GDP growth has expanded from 43% to 49% in the 3-year period from 2008-2010 (see *Figure 3 below*). Considering that investments now account for 46.2% of China's GDP, investment growth in the primary housing market and in public infrastructure will be relied upon to underpin the economy. However, there is some cause for concern in this regard as there are now signs that new housing construction is slowing, with unsold housing inventory edging higher as a result of the government's strict implementation of property and credit tightening measures.

Figure 3: Contribution to China's GDP Growth (%)

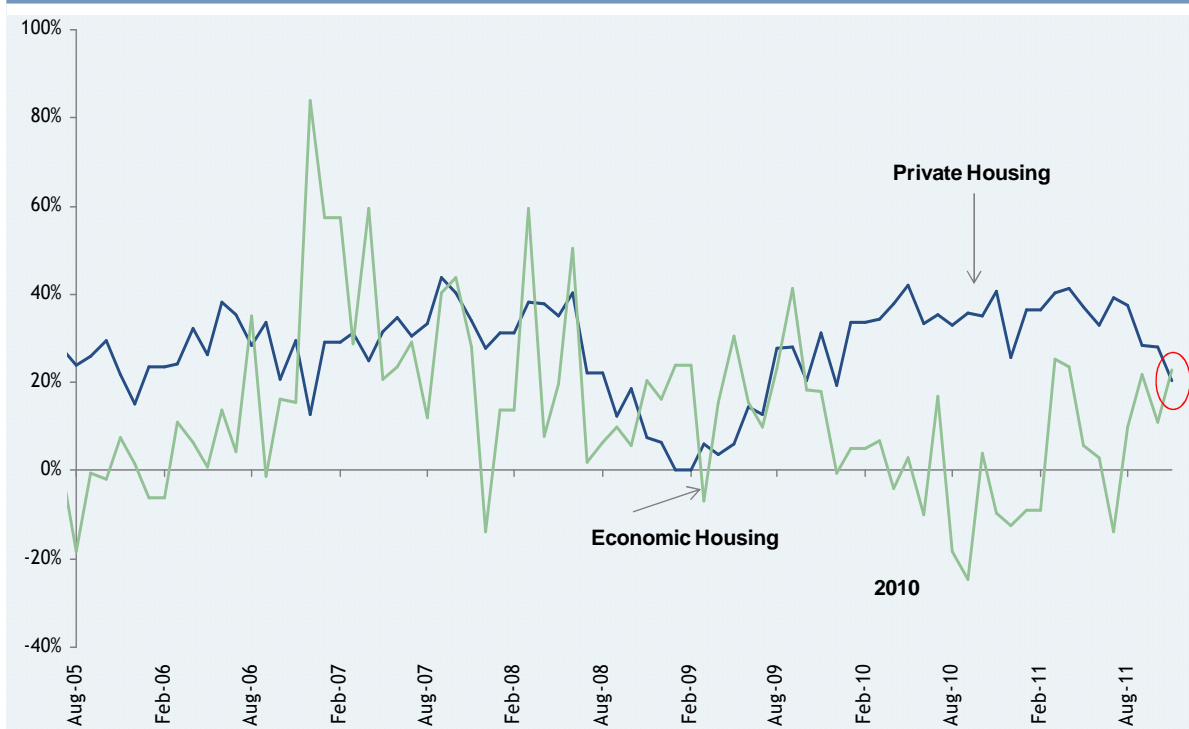


Source: CEIC

The affordable housing program should play an important role in offsetting some of the slowdown in construction within the private housing market. By the end of October, the Ministry of Housing and Urban-Rural Development (MOHURD) reported that construction had already begun on more than the government's targeted 10 million units of affordable housing, however it has been speculated that in some cases little more than basic foundations had been constructed. In December, MOHURD revealed that China will begin construction or renovation of at least 7 million units of affordable housing in 2012 – a number that is 30% lower than the 2011 target. Even so, we expect the scale of construction to remain large due to the ongoing completion of projects started this in 2011.

Private sector real estate investment may slow as policy tightening begins to weigh in, but even assuming a 10-15% decline in new housing starts by commercial developers in 2012, the ongoing construction of 10 million affordable housing units started in 2011, augmented by this year's 7 million slated starts, should provide some meaningful support for total real estate investment. Over 5 million units of affordable housing are due to be completed in 2012. J.P. Morgan's China economics team expects total real estate investment to register modest growth at about 10% in 2012, while overall FAI growth is expected to moderate to 18% YoY from an estimated 23% in 2011 (24.5% actual nominal FAI growth in Jan-Nov 2011).

Figure 4: Real Estate Investment Growth – Private Housing vs. Economic Housing



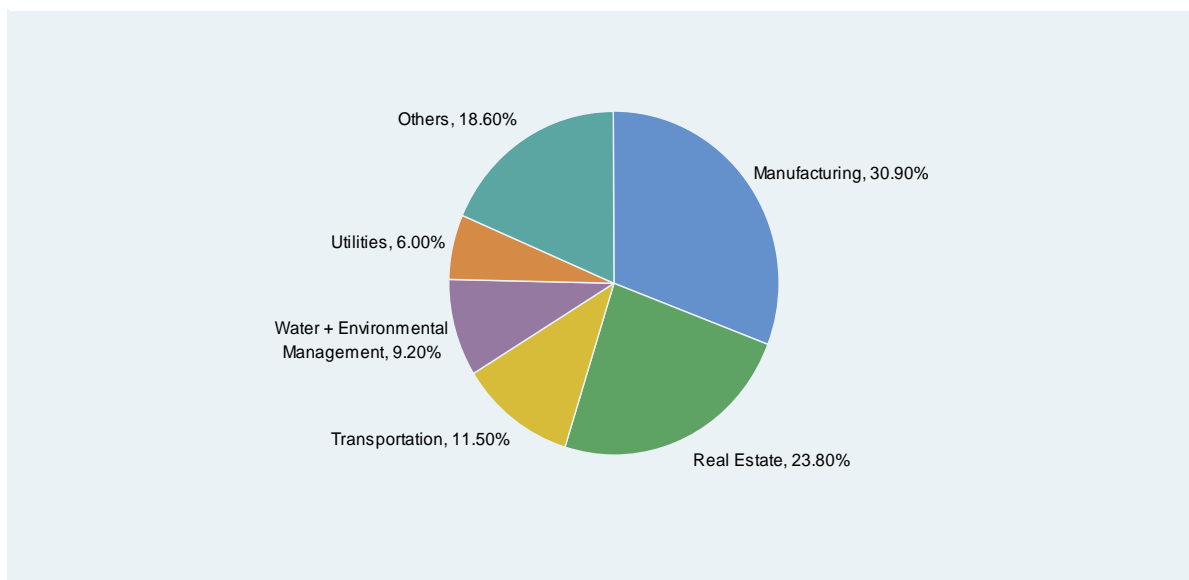
Adequate financing remains the key challenge to achieving consistent real estate investment growth. In both October and November, bank loans for real estate investment decreased on a year-over-year basis as a result of monetary tightening and stringent loan-deposit requirements imposed by the CBRC. The weak global economic outlook has also led to a slowdown in foreign direct investment in China's real estate projects. Under these circumstances, developers have needed to rely to a greater degree on financing projects through retained earnings, with the amount invested through self-raised funds growing 30.6% in Jan-Nov 2011, compared to the same period a year earlier.

Looking beyond real estate...

There is reason to maintain a somewhat positive outlook for investment in other major areas, particularly in non export-linked industries. As a reflection of the long-term progression of Chinese industry along the value chain, J.P. Morgan's Haibin Zhu has noted that investment associated with the upgrading of China's manufacturing sector (as indicated by FAI in machinery and electrical equipment) has grown at a strong pace in recent years, even during the 2008-09 global financial crisis. Meanwhile, as fiscal policy remains supportive of stable growth, infrastructure investment is unlikely to decelerate significantly. Following a sharp drop in railway investment since the fatal high-speed train

crash in Wenzhou, railway investment has again become a target for selective easing, following the conclusion of an extended safety assessment.

Figure 5: Allocation of China's Total Fixed Asset Investment in 2010



The Ministry of Railway recently announced a target of adding 6,336km in new operating railway mileage in 2012 (roughly triple the length added in 2011, and compared with 4,986km added in 2010), budgeting a RMB400 billion target for rail capex for civil works (excluding rolling stock); this figure falls below an estimated RMB469 billion in 2011, but may eventually climb higher when increased contributions by local government and the private sector are taken into account. Importantly, no change was made to the total railway investment target of RMB2.8 trillion for the 12th Five-year plan. On a visit to CSR Zhuzhou Electric Locomotive Co. Ltd. in Hunan in early-2012, Premier Wen Jiabao pledged the government's support for the sustained development of China's high-speed railways. J.P. Morgan's China infrastructure analyst Karen Li has pointed out that railway investment has been used as a counter-cyclical tool in China and believes the release of the final investigation report into the Wenzhou Train Crash is a positive for CSR (1766.HK) and Hollysys Automation (HOLI US), given the likely resumption of new rail orders – and since no fault was found with the two companies' trains and automation systems.

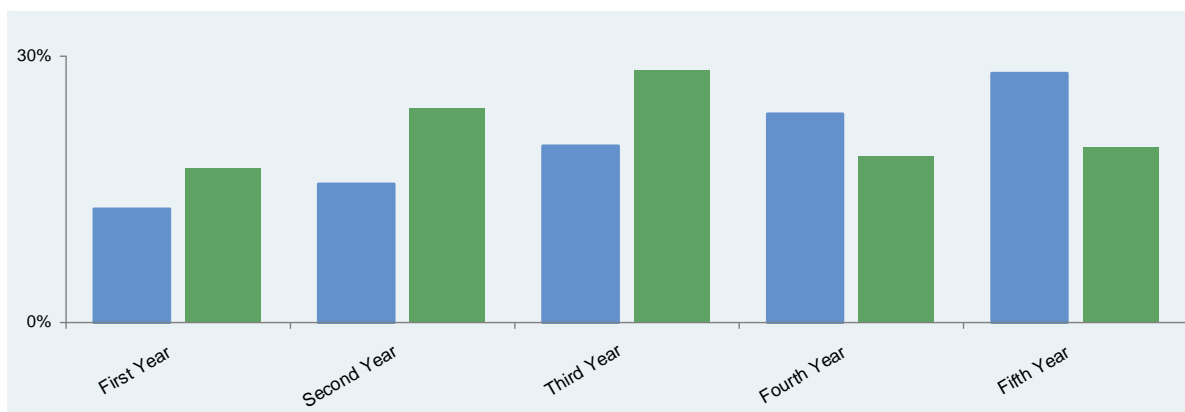
In other areas of transport, China's highway/toll-road network is due to expand from 74,000 km to 130,000km during the 12th FYP; investment in urban subway systems will amount to more than RMB1 trillion during the period, while the RMB513 billion in slated investment in airport facilities represents a fixed asset investment increase of 64% over the 11th FYP, according to Karen Li.

Investments in water conservation are expected to rise 200% to RMB1.8 trillion over the next five years - the 12th FYP targets reduction of water pollutants significantly from 2010 levels, requiring upgrades of existing sewage plants and establishing new capacity. Investments to alleviate water scarcity will also be crucial for important agricultural regions in Northern China. More projects are likely to start after the transition of China's leadership in 2H12, according to J.P. Morgan analyst Elaine Wu, who is overweight Beijing Enterprises Water (371.HK) and Guangdong Investment (270.HK), which stand to benefit as potential acquirers of water projects.

Looking forward, four major factors are supportive of fixed investment growth:

- 1) Based on the distribution of investment during China's 6th-11th Five-Year Plans, investment growth in the second year of the period was on average 6.7 percentage points higher than in the first year, since this is the point at which a larger number of major investment projects usually get underway (e.g. 2002, 2007).

Figure 6: Distribution of FAI during the 6th-11th Five-year plans of China



- 2) The policy emphasis on developing new industries has expanded China's investment horizon. For instance, on December 20, the State Council announced RMB3.4 trillion in investments for environmental protection. An investment boom is also expected in China's cultural industries (e.g. media, arts, sports, publishing) for which the collective value-added output is slated to account for 5% of total GDP by 2016, compared to 2.8% in 2010.
- 3) China's Central and Western regions are catching up in terms of development by means of rapid investment growth. During the first eleven months of 2011, China's Central and Western regions recorded 28.9% and 29.2% year-over-year FAI growth, respectively, compared to 21.7% growth in China's Eastern regions. Lower labor costs, greater energy resources and better environmental capacity are factors that have been attracting investment to these regions.
- 4) Supportive measures towards SMEs and the pilot scheme of local government bond issuance will facilitate investment growth in the private sector, while supporting the capability of local governments to finance projects.

Without revealing targets (in 2011, the government aimed for 18% growth in FAI), the National Development and Reform Commission (NDRC) has indicated that the government will maintain an "appropriate" level of investment growth in 2012 to underpin the economy, ensure the completion of projects under construction and to start key projects under the 12th Five-year plan. In a statement in December, NDRC director Zhang Ping highlighted investments in affordable housing, education and water conservation in particular. Given a range of challenges in securing local financing for infrastructure projects in past several years, he also reiterated plans to promote private investment in railways, utilities as well as the financial and energy sectors.

The key downside risk for investment growth lies in the health of local finances. Financing difficulties have already been reflected in the slowdown of investments in public infrastructure, especially in city subways. With land sales revenue in 25 major Chinese cities down 11% YoY during Jan-Nov 2011, moderation in infrastructure spending was inevitable for localities that had inadequate fiscal support or alternative means of financing. Land sales typically account for ~40% of local government revenues.

Investors have been especially concerned about local government's ability to repay debt, as 17.2% of Local Government Financial Vehicle (LGFV) loans will mature in 2012. We are fairly optimistic about the central government's ability to resolve the LGFV debt issue. China's 4th Financial Work Conference, recently concluded in Beijing, with Premier Wen citing the management of gross local government debts as a key objective for the next five years. LGFV revenues and spending will be included in local government budgets, thus improving transparency. Moreover, the National Audit Office recently disclosed that of the RMB530.9 billion worth of local government debt in 2010 deemed to have been used inappropriately, RMB259.2 billion have been recouped.

To solve the problem at its root cause, China has begun to allow local governments to sell bonds independently to reduce their reliance on bank lending to LGFVs, and in the closing months of 2011 the first issuance of 3 and 5-year local government bonds occurred under a pilot program in four major localities. Local governments were previously banned from issuing bonds, and thus relied on their financing vehicles and trust companies to fund construction. It is hoped that this initiative may help in paying off maturing loans and easing concerns of default, at a time when local governments cannot rely on land sales revenue to the same degree as in the past.

3. With net exports expected to detract from growth in 2012, how is weaker demand both at home and abroad impacting the export and manufacturing sectors?

China's Ministry of Commerce has warned of a "severe" outlook for export growth in the first quarter of 2012, however at this juncture, the current global crisis appears likely to have a smaller impact on China than the previous crisis in 2008, due to the country's reduced reliance on foreign trade. That said, a host of recent economic figures have pointed to some weakness in business conditions. Readings from China's two manufacturing PMI surveys confirm that the external environment has put a drag on the manufacturing sector. In December, the NBS manufacturing PMI edged above the expansionary threshold to 50.3, however the improvement could perhaps be attributed to a pick up in activity in the run-up to the Chinese New Year holiday. The Markit PMI, which is skewed towards private sector companies, remained in contraction for the second consecutive month at 48.7, improving slightly from 47.7 in November. The export-related components for both surveys have been in contraction for two consecutive months.

Overseas economic problems aside, some of the recent slowdown in manufacturing may be attributed to conditions in domestic demand (arising especially from decelerating construction activity in the face of housing curbs and moderating infrastructure development). In November, the pace of industrial production growth moderated to 12.4% YoY, following 13.2% growth in October, while production growth for certain industries closely linked to construction – such as cement and steel – registered at 11.2% and -0.2% compared to 16.5% and 9.7% in October, respectively. According to the Ministry of Industry and Information Technology, the growth target for industrial output in 2012 has been set at about 11%, the same goal as that for 2011. Automobile output showed a year-over-year decline of 1.3% during the month, in line with the drop in sales growth to only 2.4% YoY in November (0.3% for passenger vehicles).

With external demand weakening as a result of the Euro debt crisis, in November, China's export growth decelerated to the slowest pace since March at 13.8% year-over-year. Tellingly, export growth to the EU (China's largest export market, accounting for 18.9% of exports in Jan-Nov 2011) declined to just 5.0% YoY in November, compared to a pace of 18.1% in Q3 2011, while demand from Japan (China's third-largest export market, accounting for 8% of exports) has also dropped recently in line with the softening in Japanese industrial production. Consistent with recent data showing signs of improved growth, export growth to the US (which accounted for 17% of Chinese exports in Jan-Nov 2011) has shown greater resilience – however, this does not appear sufficient to offset the

deceleration in other major markets (see *Figure 7*). With China's imports growing 22.1% YoY (driven largely by commodity purchases) in November, the trade surplus narrowed to USD14.5 billion from USD17 billion a month earlier. A senior PBOC advisor has indicated that the FY2011 trade surplus is likely to narrow to just 1.6% of GDP, from 3.0% in 2010 and 3.9% in 2009. As China's trade surplus narrows, expectations for RMB appreciation are becoming more modest. J.P. Morgan's Economics team forecasts a USD-CNY exchange rate of 6.05:1 at end-2012.

Figure 7: Export Growth – EU, US, JPN, Rest of the world (YoY%)



4. Does the government's property tightening campaign bring a real risk of collapse in the housing market?

The property sector accounts for around one-eighth of China's GDP, but has deeper ramifications for the economy, given its relation to commodities demand, housing-related consumption, construction employment, as well as to the health of local government finances with respect to land sales. The government's measures have started to prove successful in containing property price increases. According to the National Bureau of Statistics, the average new home price in 70 cities showed a second consecutive month-on-month decline in November (-0.17% MoM, +2.3% YoY), while according to the real estate information provider *Soufun Holdings*, home prices in December declined for the fourth consecutive month, with prices sliding in 60 out of 100 cities tracked by the company, including China's 10 biggest cities. In November, primary market sales were skewed towards projects with prices marked down by a magnitude of 20%, while those offering more modest discounts of 5-10% attracted less attention. According to J.P. Morgan's China property analyst Lucia Kwong, transaction volumes might have bottomed out in late-2011 due to expectations of further RRR reductions, however seasonal patterns and a potential correction in land prices (considering that land sales in 130 key cities fell 13% YoY in 2011) suggest that a near-term revival is unlikely.

Under the government's tightening campaign, property transaction volumes last year declined by about 1/3 from the 2008-10 average. Although real estate investment growth has held up (residential FAI +32.8% YoY in Jan-Nov 11), there has been some deceleration since 3Q11, with growing unsold

inventory and a slower pace of new construction starts reflecting this. J.P. Morgan's China property team finds that on a nationwide basis, supply and demand was still broadly balanced until November 2011. However, in areas such as Beijing, Zhejiang, Jiangsu and Fujian provinces, oversupply is more pronounced. The pace of credit easing in 2012 will ultimately shape the health of the supply-demand balance. In December, it was reported in domestic media that following the RRR cut (and also in response to weaker demand for home mortgages), several banks in cities such as Beijing and Chengdu had lowered their first-home mortgage rates from 1.05-1.4x the central bank's benchmark lending rate to parity

Having performed several scenario analyses, our property team finds that without a recovery in demand, if there is no further credit and policy easing throughout 2012, housing markets in most cities will be over-supplied (taking <12 months of inventory to be normal), with prices in Tier 1-2 cities under pressure to decline by as much as 15-20%, while lower-tier cities will face less pressure. However, with further RRR cuts (as is currently expected) added liquidity may restore demand to close to 2010 levels. Given the current supply pipeline, supply and demand in three out of four 1st-tier cities (with the exception of Beijing) and most low-tier cities would return to balance more quickly under this scenario, but major second-tier cities such as Hangzhou would remain over-supplied. Taking this analysis into account, developers such as Agile (3383.HK), CC Land (1224.HK) and Guangzhou R&F (2777.HK) with a focus on Southern and Western China are better positioned in terms of geographic exposure.

Policymakers have welcomed the recent correction in housing prices, after waging an 18-month campaign to deflate the market. However, price drops of a large magnitude could lead to serious repercussions in the financial system and domestic economy, and thus we would expect the government to relax its controls before an extremely bearish scenario is reached. We are certainly not there yet – average prices have only dipped slightly on a sequential basis, and so the government has reaffirmed its commitment towards property tightening. J.P. Morgan expects house prices nationwide to fall 5-10% over the next 12-18 months, but a nationwide collapse is unlikely.

Fortunately, developer loans account for a small proportion of Chinese banks' loan books (~6.5%), while the risk of widespread mortgage defaults is low because down-payment levels are typically very high in China. Thus far real estate prices have fallen by 3-4% in some major cities over the past several months, but on a national basis, average prices have held fairly steady. It is important to keep in mind that the housing market boom and subsequent tightening has been much more benign in China's lower-tier markets. Beijing, Shanghai and Guangdong together account for only 20% of nationwide property sales, and only 16% of total real estate investment, according to analysis by our economics team. Major nationwide property developers are now in better financial health than they were during the 2008-9 downturn, and while the climate remains challenging, they are likely to gain better access to financing and drive further consolidation in the real estate sector.

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