19 February 2010

Equity Strategy
Global

HSBC Global Research

EI – Equity Insights

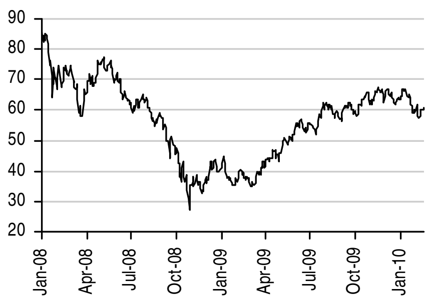
US gets bearish on China

- **The consensus among US fund managers has become deeply bearish on China**
- **In our view, this may present a good re-entry point into Chinese stocks, which look reasonable value again**
- **We worry more about India, where inflation is a bigger risk**

How quickly sentiment can change. When we were last in the US in November, virtually every investor we met was bullish on China on the grounds that this was the one country where long-term growth prospects were practically guaranteed. But, on our return trip last week, we found that the consensus had swung around completely. Almost without exception, fund managers are bearish on Chinese stocks. They believe that inflation is becoming a big threat, which will lead to sharp monetary tightening. They fret about long-term structural issues, such as a bubble in the property market and the chance of a rise in banks' non-performing loans (NPLs). And they are especially nervous about a rapid deterioration in US-Sino relations and what that might mean for the renminbi.

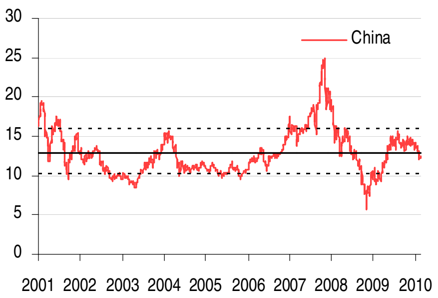
In our view, this could present an interesting buying opportunity. The MSCI China Index (Chart 1) fell by 14% from peak-to-trough before rebounding mildly last week. As a result, prospective PE has fallen to 12.5x (Chart 2), which looks attractive in the light of forecast 23% EPS growth this year and our assumption of long-term annual earnings growth of 12%. We forecast that CPI will average 2.6% this year which means that only moderate further monetary tightening is necessary. Bank stocks, which have corrected hard, look especially attractive. With their obsession on China, US fund managers seem to have forgotten India, where wholesale price inflation has reached 8.6% and where the central bank may raise rates ahead of the next monetary policy committee meeting in April (and where next week's budget will be a reminder of how big is the fiscal deficit).

1. MSCI China 2008-present



Source: HSBC, Bloomberg

2. 12-month forward PE, MSCI China



Source: HSBC, IBES, Datastream

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HSBC strategy recommendations

Global market calls (selected countries/regions shown, see The View section for a more comprehensive list)

Market	HSBC call current	HSBC call (last quarter)	Weight (%) MSCI AC World (%)	Weight (%) HSBC (%)	Diff (% pts)	Blue-chip index	current level	end-2010 level	change
US	Over	(Under)	41.9	45.0	3.1	S&P 500	1,100	1,300	18%
Pan-Europe	Under	(Over)	28.7	26.2	-2.5	FTSE Eurofirst 300	1,015	1,180	16%
Eurozone	Under	(Over)	13.7	10.6	-3.0	EUROSTOXX 50	2,762	3,350	21%
UK	Neutral	(Under)	8.8	8.8		FTSE 100	5,277	6,200	17%
Japan	Neutral	(Neutral)	8.4	8.4		TOPIX	905	1,000	11%
France	Under	(Neutral)	4.5	2.0	-2.5	CAC 40	3,725	4,300	15%
Germany	Over	(Over)	3.3	6.0	2.7	DAX 30	5,648	7,100	26%
China	Neutral	(Over)	2.3	2.3		MSCI China	61	75	24%
Brazil	Neutral	(Neutral)	2.2	2.2		Bovespa	67,284	80,000	19%
India	Under	(Under)	1.0	0.0	-1.0	SENSEX	16,429	18,000	10%
Russia	Over	(Over)	0.8	1.0	0.2	RTS	1,422	1,800	27%

Note: figures do not add because some countries excluded
Source: HSBC, Thomson Financial Datastream, MSCI

Global sector calls (benchmark: MSCI AC World index)

Sector	HSBC call current	HSBC call (previous quarter)	Weight (%) MSCI AC World (%)	Weight (%) HSBC (%)	Difference (% pts)	Industry preference
Energy	Under	(Neutral)	11.4	6.0	-5.4	Energy Equipment and Services
Materials	Neutral	(Neutral)	8.5	8.5		Construction Materials
Industrials	Neutral	(Over)	9.9	9.9		Machinery, Electrical Eq, Industrial Conglomerates
Consumer Discretionary	Over	(Neutral)	8.9	11.0	2.1	Retailing, Media
Consumer Staples	Neutral	(Under)	9.6	9.6		Food Producers
Health Care	Under	(Under)	9.0	5.0	-4.0	
Financials	Over	(Over)	21.1	28.0	6.9	Commercial Banks, Div Financial Services, Insurance
IT	Over	(Over)	12.2	15.5	3.3	
Telecom Services	Neutral	(Under)	5.0	5.0		Diversified Telecoms
Utilities	Under	(Under)	4.5	1.5	-3.0	
			100.0	100.0		

Source: HSBC, Thomson Financial Datastream

HSBC Global Super 10 – Model portfolio of 10 equally weighted stocks

Company	Code	Country/ region	Sector	Price (local)	HSBC Rating	Analyst	HSBC Target Price	Upside to Target (%)
AU Optronics	2409 TT	Taiwan	Electronic Equipment	36.3 (TWD)	OW(V)	Frank Su	57 (TWD)	57.0
Bank Of China Ltd	3988 HK	China	Commercial Banks	3.8 (HKD)	OW(V)	Todd Dunivant	5.6 (HKD)	47.0
Barclays	BARC LN	UK	Commercial Banks	2.9 (GBP)	OW(V)	Peter Toeman	4.5 (GBP)	53.2
Danone	BN FP	France	Food Products	42.1 (EUR)	OW	Cedric Besnard	50 (EUR)	18.8
Ericsson	ERICB SS	Sweden	Communications Eq.	71.9 (SEK)	OW(V)	Richard Dineen	87 (SEK)	21.0
Holcim Ltd	HOLN VX	Switzerland	Construction Materials	70.7 (CHF)	OW(V)	John Fraser-Andrews	120 (CHF)	69.7
Legal & General	LGEN LN	UK	Insurance	0.7 (GBP)	OW(V)	Kailesh Mistry	1.2 (GBP)	67.7
Pernod Ricard	RI FP	France	Beverages	56.6 (EUR)	OW(V)	Erwan Rambourg	68 (EUR)	20.1
Rosneft OAO	ROSN RU	Russia	Oil & Gas	7.7 (USD)	OW(V)	Anisa Redman	12 (USD)	56.5
Wal-Mart de Mexico	WALMEXV MM	Mexico	Food & Staples Retailing	60.1 (MXN)	OW	Francisco Chevez	71 (MXN)	18.1

Source: HSBC. Notes: (1) These companies represent a selection of those in sectors and markets that loosely reflect the strategy mentioned in this report and detailed in *Equity Insights Special*, 6 January 2010. (2) We choose only stocks on which HSBC's fundamental equity analysts do not hold negative views. For details, see *HSBC Super Tens*, a separate report published on 6 January 2010. Prices as at close, 17 February 2010.

What are they worried about?

The name most on the lips of many fund managers worrying about China is Jim Chanos, president of hedge fund Kynikos Associates. Chanos is famous for having made money from shorting stocks such as Enron and Tyco. Since late last year he has been talking about shorting Chinese stocks on the grounds that "China is Dubai times 1,000, if not a million." He argued on CNBC in November that "at some point all of [China's] (ill-advised) investment will come home to roost". There are four main worries that fund managers have.

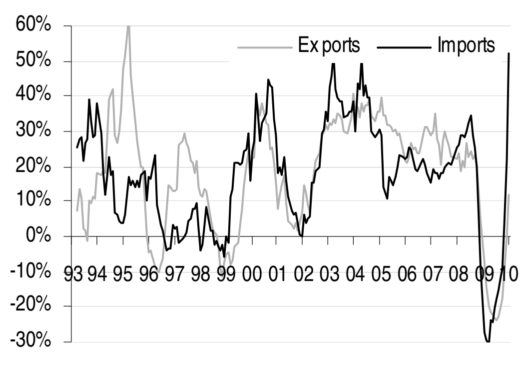
Overheating

With China having raised the reserve requirement ratio (RRR) twice since the start of the year, the most obvious concern is overheating in the economy and whether this will trigger inflation, which will necessitate drastic monetary tightening.

Certainly the most reliable economic data series (more reliable, at least, than GDP growth or the reported consumer price index) are pointing to a sharp acceleration in growth over the past few months. We have long argued that (1) imports, (2) money supply growth and (3) electricity production are as close to highly credible data as one can find in China. As shown in Charts 3-5, imports are growing 52% y-o-y on a three-month moving average basis (and 86% in January alone); M1 growth in January was 39% and M2 growth 26%; and electricity production rose by 44%.

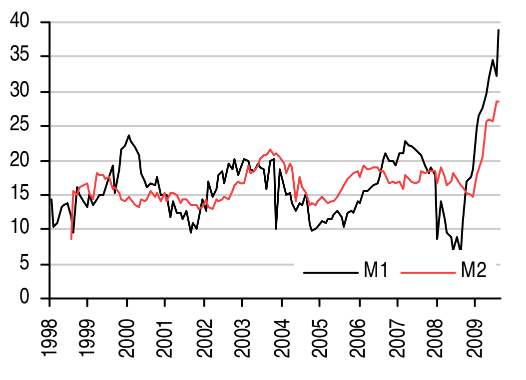
There is no doubt that Chinese growth has accelerated as a result of last year's stimulus and government pressure on banks to increase lending, but in many ways the recent data is misleading. For example, January was the low point for most economic data in 2009, and so the y-o-y change is flattered by the very easy prior-year comparison. Moreover, lunar new year in 2009 fell in January whereas this year it fell in February, which should also distort the numbers.

3. Chinese export and import growth (y-o-y, 3mma)



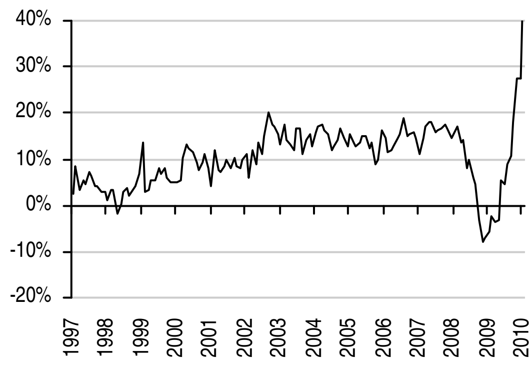
Source: CEIC

4. Chinese money supply growth (y-o-y)



Source: CEIC

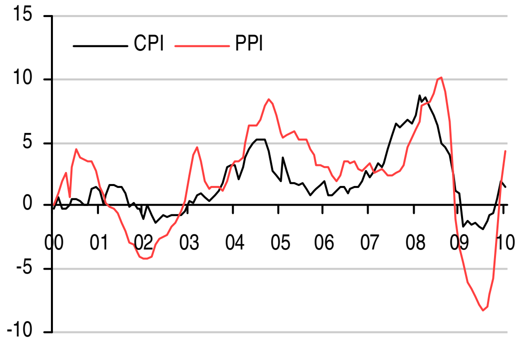
5. Chinese electricity production (y-o-y)



Source: CEIC (Jan and Feb combined to adjust for Chinese New Year effect)

Inflation (for the moment at least) remains fairly quiescent. The January CPI came in at 1.5% y-o-y, versus a consensus forecast of 2.1% (Chart 6). This clearly represents a pick-up from the negative numbers seen in mid-2009 but consumer price inflation remains well below the 5-8% level experienced in 2007-8.

6. Chinese CPI and PPI (y-o-y, %)



Source: Bloomberg

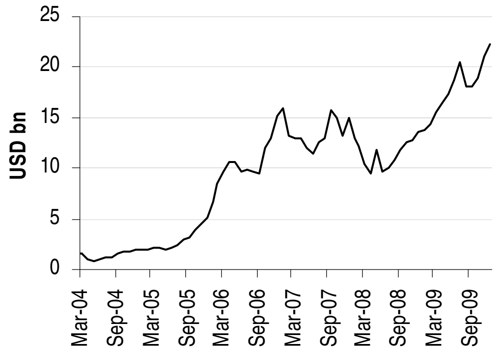
HSBC's Chief China Economist, Qu Hongbin, agrees that underlying inflation pressure is picking up and that the first interest rate hike could come as early as 2Q (see *China CPI and PPI (Jan): No reverse of accelerating trend*, 11 February). But he forecasts that CPI will peak at only 3.0% in 2Q and will average 2.6% this year and 2.5% in 2011. That is slightly more dovish than the consensus, which sees CPI this year growing 2.8% and 3.2% in 2011.

But clearly many fund managers were surprised that China moved to tighten policy so early this year (although it is worth remembering that two rises in the RRR does not represent any actual withdrawal of liquidity from the market since banks had – and still have – excess reserves with the central bank).

Our view has been for some months that China would tighten policy gradually during 2010, through a combination of rate rises, RRR hikes, currency appreciation – in combination with a sharp contraction in the fiscal stimulus used last year. We are, rather, surprised at the fund managers' surprise.

One of the problems, perhaps, is that a lot of new, less knowledgeable money flowed into Chinese equities during 2009, when China was seen as the only game in town. Neither the Hong Kong nor Shanghai Exchange publishes daily flow data but we can get some indication of foreign net buying from EPFR's data for global mutual funds (Chart 7). This shows that USD11.5bn flowed into Chinese stocks between September 2008 and the end of 2009.

7. Net buying of Chinese stocks by global mutual funds



Source: EPFR

What is interesting, though, is that there seems to have been some profit-taking in the late summer and autumn of last year. Our meetings with investors at that time suggest that many specialist Asia or China funds were already starting to worry about monetary tightening (this thesis is backed up by the under-performance of bank and property stocks). But these investors were replaced by large global macro funds that piled into China regardless.

Our sanguine view on over-heating and inflation is all very well, but isn't there a risk that the Chinese authorities over-react? We think that risk is small. It is worth remembering that the People's Bank of China is not an independent central bank; interest rate moves have to be approved by the State Council (although the PBoC can raise the RRR on its own volition). The State Council's predilection is always to be pro-growth unless there is a risk of inflation getting out of hand (as there was in 2008 or, more dramatically, in the early 1990s). And remember, too, that the government has many levers other than monetary policy to control inflation: it has, for example, much closer control of energy and food prices than in most countries.

For the moment, therefore, we see the risk of dramatic further tightening as low – although a gradual withdrawal of monetary accommodation is likely to continue throughout the year.

Structural problems

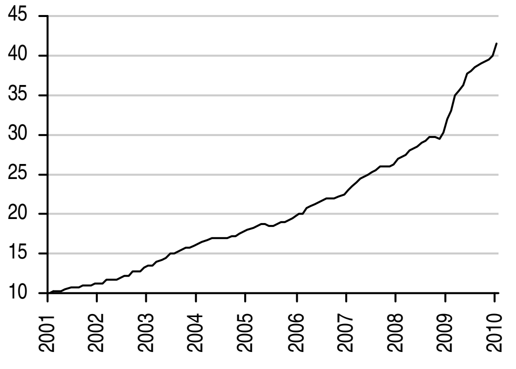
Less easy to answer are vague worries that the rapid fiscal and monetary stimulus of last year will produce side effects that will cause problems for years.

Fund managers' main structural worries focus on the property market and on the risk that excessive bank lending last year will eventually come home to roost in the form of NPLs.

Certainly, the acceleration in bank lending last year was awesome. Banks made net RMB9.6trn of new loans, increasing their total outstanding loans by 32% (Chart 8). To put that in context, the growth in loans last year equalled 29% of GDP, with the ratio of total lending to GDP reaching 119% by the end of 2009.

But, here too, the numbers may be somewhat misleading. HSBC's China strategist, Steven Sun, calculates from the data for fixed asset investment financed by bank lending, that some RMB1trn of last year's new lending was not actually used but simply found its way back into banks' deposit accounts (and is likely to be mobilised gradually this year, offsetting some of the government-induced slowdown in new loan growth).

8. Total outstanding loans of Chinese banks (RMBtrn)



Source: Bloomberg

It is also worth remembering that a large proportion of last year's lending went to state-owned enterprises and, particularly, to the special purpose vehicles (SPVs) of local governments to finance infrastructure spending. Even if some of this lending does eventually become non-performing, this will take many years. If the loan was used on, for example, a rail line which eventually proves not able to pay its way and if the local government declines to bail out its SPV, a default is possible. But how long would this process take? We would imagine at least 5 and possibly as long as 7-10 years. A rise in NPLs will not be an issue for this year or next year.

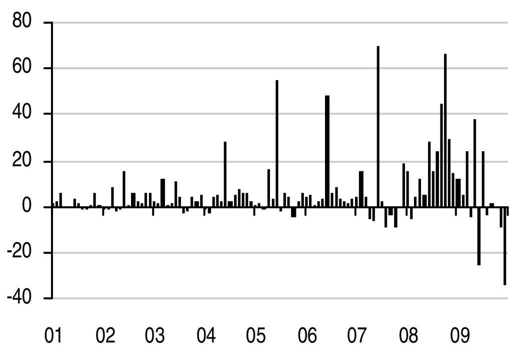
US-Sino relations

US fund managers have also become jittery about the sharp deterioration in US-Sino relations over the past few months and about what they perceive as a rise in China's assertiveness in diplomatic affairs.

This has been triggered by a series of events: tit-for-tat import tariffs, the failure of the Copenhagen climate talks, US arms sales to Taiwan, President Obama's rather uncomfortable state visit to Beijing in November and his meeting (planned for Thursday this week) with the Dalai Lama.

These vague worries were exacerbated by the release of data that showed China sold USD34bn of US Treasuries in December (the most ever in a single month), taking its net sales since last June to USD46bn and allowing it to slip behind Japan in terms of Treasury bond holdings (China owns USD755bn to Japan's USD769bn).

9. Chinese monthly net purchases of US Treasuries



Source: Bloomberg

It is true that these developments have a risk of escalating. Could China, for instance, place sanctions on Boeing and other US companies which are part of the arms-to-Taiwan deal? How would the US Congress react to that? How aggressively will China respond to the meeting with the Dalai Lama? Will the US move to declare China a currency manipulator in April and, if it does, how will China react? If US growth double-dips, will Congress press for further import restrictions or a tax to offset the perceived undervaluation of the RMB?

Our view, though, is that the relationship is too important for both sides to be allowed to deteriorate too far. Both China and the US have to worry about their domestic political constituencies; that is particularly the case in an election year in the US, but may be true in China too as the next generation of leaders manoeuvres ahead of the leadership change scheduled for 2012.

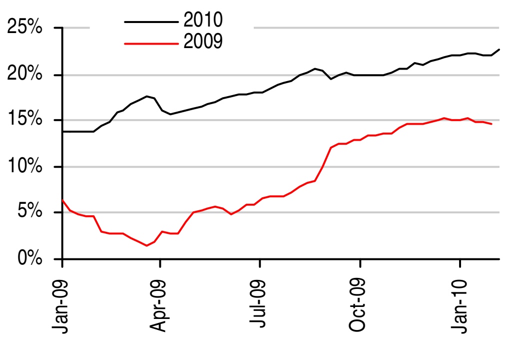
But China knows that, even as it tries to move towards a more domestic demand-driven economy, it cannot afford to upset its export partners too much. It is, after all, the world's largest exporter and policymakers in China worry that exports have not rebounded as fast as they hoped (exports rose only 21% y-o-y in January, despite the easy prior-year comparison).

We expect that there will be further fallings-out and threats, but nothing serious enough to upset equity markets too much.

Earnings growth

Perhaps the biggest real threat to China this year is one that only the most savvy fund managers mentioned: earnings growth. If inflation rears its ugly head any further, the Chinese authorities might be tempted to interfere with domestic prices (as they did in 2008) even if this is at the expense of the profitability of listed companies.

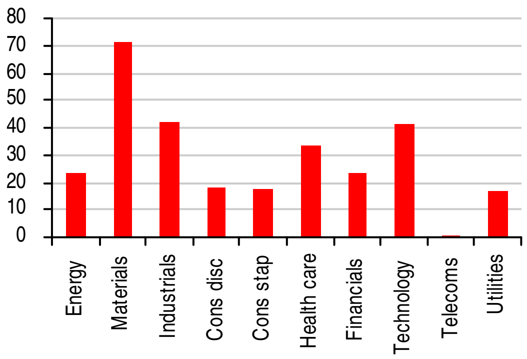
10. IBES forecast of EPS growth y-o-y, MSCI China



Source: HSBC, IBES, Bloomberg

That is particularly worrying since consensus earnings forecasts for this year are already fairly optimistic. IBES numbers show that analysts forecast 23% growth, on top of 15% last year (Chart 10). Every sector except telecoms is forecast to see robust growth. Some of the strongest earnings growth is forecast for sectors such as energy, materials and utilities (Chart 11) which might be most vulnerable if the government moves to control prices.

11. China sector forecast EPS growth, 2010 (% y-o-y)



Source: HSBC, IBES, Datastream

A buying opportunity?

As Steven Sun, our China strategist, argued in his report *Much to learn from 2004 tightening*, 28 January 2010, if HSBC's views are right and monetary tightening this year will be mild, we could be close to an excellent buying opportunity for Chinese stocks again.

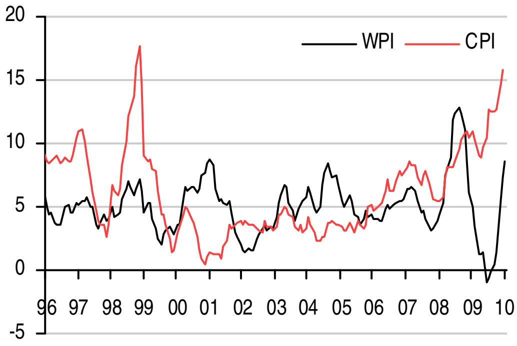
He argued that 2004 is a good comparison for the policy normalisation likely to take place this year. In 2004, MSCI China fell by 21% after the authorities first began tightening. But stocks bottomed only one month after the first tightening, rose slowly about 10% over the following few months and then, when inflation peaked after six months, really took off. That could be the pattern this time too. This would suggest that sectors such as banks and, selectively, real estate, which have been most aggressively sold off in the past two to three months, look especially interesting again. We remain overweight China in Asia Pacific (but are only neutral in our global portfolio).

What about India?

Indeed, we would argue that, in their excitement about China, investors have forgotten that it will hardly be the only emerging market that will have to tighten this year. Our economists expect all Asian central banks (except Hong Kong and Japan) to raise rates in 1H, and many other major emerging markets (including Brazil) will also need to tighten.

For us the biggest risk is India. Consumer price inflation is 17% for rural workers (and 14% in cities), close to the record high of the late 1990s. WPI, which the Reserve Bank of India watches more closely, has risen to 8.6% from below zero as recently as August. While much of the inflation is driven by food (after last year's bad monsoon), the surprising strength of economic growth (with IP, for example, up 17% y-o-y in December) suggests inflationary pressures must be increasing.

12. Indian WPI and CPI



Source: HSBC, Bloomberg (CPI is an average of the four published category CPIs)

Indian rates markets have reacted to this. Government 10-year bonds have risen to 7.9% from 7.2% in November and three-month CP rates have climbed to 6% from 3.9% over the same time. But so far the stock market has shrugged off the risk of tightening, even when the RBI raised the reserve requirement last month. We see much more risk in India than in China and remain underweight.

Disclosure appendix

Analyst Certification

The following analyst(s), economist(s), and/or strategist(s) who is(are) primarily responsible for this report, certifies(y) that the opinion(s) on the subject security(ies) or issuer(s) and/or any other views or forecasts expressed herein accurately reflect their personal view(s) and that no part of their compensation was, is or will be directly or indirectly related to the specific recommendation(s) or views contained in this research report: Garry Evans

Important disclosures

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HSBC believes that investors utilise various disciplines and investment horizons when making investment decisions, which depend largely on individual circumstances such as the investor's existing holdings, risk tolerance and other considerations. Given these differences, HSBC has two principal aims in its equity research: 1) to identify long-term investment opportunities based on particular themes or ideas that may affect the future earnings or cash flows of companies on a 12 month time horizon; and 2) from time to time to identify short-term investment opportunities that are derived from fundamental, quantitative, technical or event-driven techniques on a 0-3 month time horizon and which may differ from our long-term investment rating. HSBC has assigned ratings for its long-term investment opportunities as described below.

This report addresses only the long-term investment opportunities of the companies referred to in the report. As and when HSBC publishes a short-term trading idea the stocks to which these relate are identified on the website at www.hsbcnet.com/research. Details of these short-term investment opportunities can be found under the Reports section of this website.

HSBC believes an investor's decision to buy or sell a stock should depend on individual circumstances such as the investor's existing holdings and other considerations. Different securities firms use a variety of ratings terms as well as different rating systems to describe their recommendations. Investors should carefully read the definitions of the ratings used in each research report. In addition, because research reports contain more complete information concerning the analysts' views, investors should carefully read the entire research report and should not infer its contents from the rating. In any case, ratings should not be used or relied on in isolation as investment advice.

Rating definitions for long-term investment opportunities

Stock ratings

HSBC assigns ratings to its stocks in this sector on the following basis:

For each stock we set a required rate of return calculated from the risk free rate for that stock's domestic, or as appropriate, regional market and the relevant equity risk premium established by our strategy team. The price target for a stock represents the value the analyst expects the stock to reach over our performance horizon. The performance horizon is 12 months. For a stock to be classified as Overweight, the implied return must exceed the required return by at least 5 percentage points over the next 12 months (or 10 percentage points for a stock classified as Volatile*). For a stock to be classified as Underweight, the stock must be expected to underperform its required return by at least 5 percentage points over the next 12 months (or 10 percentage points for a stock classified as Volatile*). Stocks between these bands are classified as Neutral.

Our ratings are re-calibrated against these bands at the time of any 'material change' (initiation of coverage, change of volatility status or change in price target). Notwithstanding this, and although ratings are subject to ongoing management review, expected returns will be permitted to move outside the bands as a result of normal share price fluctuations without necessarily triggering a rating change.

*A stock will be classified as volatile if its historical volatility has exceeded 40%, if the stock has been listed for less than 12 months (unless it is in an industry or sector where volatility is low) or if the analyst expects significant volatility. However, stocks which we do not consider volatile may in fact also behave in such a way. Historical volatility is defined as the past month's average of the daily 365-day moving average volatilities. In order to avoid misleadingly frequent changes in rating, however, volatility has to move 2.5 percentage points past the 40% benchmark in either direction for a stock's status to change.

Prior to this, from 7 June 2005 HSBC applied a ratings structure which ranked the stocks according to their notional target price vs current market price and then categorised (approximately) the top 40% as Overweight, the next 40% as Neutral and the last 20% as Underweight. The performance horizon is 2 years. The notional target price was defined as the mid-point of the analysts' valuation for a stock.

From 15 November 2004 to 7 June 2005, HSBC carried no ratings and concentrated on long-term thematic reports which identified themes and trends in industries, but did not make a conclusion as to the investment action that potential investors should take.

Prior to 15 November 2004, HSBC's ratings system was based upon a two-stage recommendation structure: a combination of the analysts' view on the stock relative to its sector and the sector call relative to the market, together giving a view on the stock relative to the market. The sector call was the responsibility of the strategy team, set in co-operation with the analysts. For other companies, HSBC showed a recommendation relative to the market. The performance horizon was 6-12 months. The target price was the level the stock should have traded at if the market accepted the analysts' view of the stock.

Rating distribution for long-term investment opportunities

As of 18 February 2010, the distribution of all ratings published is as follows:

Overweight (Buy)	46%	(12% of these provided with Investment Banking Services)
Neutral (Hold)	38%	(12% of these provided with Investment Banking Services)
Underweight (Sell)	16%	(11% of these provided with Investment Banking Services)

Information regarding company share price performance and history of HSBC ratings and price targets in respect of its long-term investment opportunities for the companies the subject of this report,is available from www.hsbcnet.com/research.

HSBC & Analyst disclosures

Disclosure checklist

Company	Ticker	Recent price	Price Date	Disclosure
AU OPTRONICS	2409.TW	36.30	17-Feb-2010	1, 5, 7
BANK OF CHINA LTD	3988.HK	3.88	17-Feb-2010	5, 6, 7, 11
BARCLAYS BANK PLC (UK)	BARC.L	3.02	18-Feb-2010	2, 6, 7, 9, 11
DANONE (EX BSN)	DANO.PA	42.45	18-Feb-2010	1, 2, 5, 6, 7, 11
ERICSSON	ERICb.ST	73.15	18-Feb-2010	6, 7, 11
HOLCIM LTD	HOLN.VX	72.90	18-Feb-2010	1, 5, 6, 7
LEGAL & GENERAL GP	LGEN.L	0.76	18-Feb-2010	4, 6, 7, 11
PERNOD RICARD	PERP.PA	57.29	18-Feb-2010	1, 2, 5, 6, 7, 11

Source: HSBC

1 HSBC* has managed or co-managed a public offering of securities for this company within the past 12 months.
2 HSBC expects to receive or intends to seek compensation for investment banking services from this company in the next 3 months.
3 At the time of publication of this report, HSBC Securities (USA) Inc. is a Market Maker in securities issued by this company.
4 As of 31 January 2010 HSBC beneficially owned 1% or more of a class of common equity securities of this company.
5 As of 31 December 2009, this company was a client of HSBC or had during the preceding 12 month period been a client of and/or paid compensation to HSBC in respect of investment banking services.
6 As of 31 December 2009, this company was a client of HSBC or had during the preceding 12 month period been a client of and/or paid compensation to HSBC in respect of non-investment banking-securities related services.
7 As of 31 December 2009, this company was a client of HSBC or had during the preceding 12 month period been a client of and/or paid compensation to HSBC in respect of non-securities services.
8 A covering analyst/s has received compensation from this company in the past 12 months.
9 A covering analyst/s or a member of his/her household has a financial interest in the securities of this company, as detailed below.
10 A covering analyst/s or a member of his/her household is an officer, director or supervisory board member of this company, as detailed below.
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