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MORGAN STANLEY RESEARCH
ASIA/PACIFIC

Morgan Stanley Asia Limited+

Jerry Lou
Jerry.Lou@morganstanley.com
+852 2848 6511

Allen Gui
Allen.Gui@morganstanley.com

James Cao
James.Cao@morganstanley.com

Corey Ng, CFA
Corey.Ng@morganstanley.com

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China Strategy

2011 Outlook: A Year of Re-rating

Several bullish themes for Chinese equities in 2011:

1) Cheap valuation, humble relative performance in 2010, and mild consensus outlook.
2) Solid earnings growth outlook supported by expansive fiscal policies. Upside risk in large-caps.
3) Contained inflation risk with stable monetary policies and moderate tightening.
4) Strong currency, still ample global liquidity environment, good risk appetite.

Policy tone for 2011 – still pro-growth yet tackling inflation risk: The just concluded Politburo Working Meeting set the tone for 2011 fiscal policies as "appropriately accommodative" (same as 2010); monetary policies shifted to "stable and healthy" (from "appropriately accommodative" in 2010). This implies a balance between remaining pro-growth and curbing inflation risk.

We think mild inflation should favor stocks in 2011: This is contrary to the Street view, which we find overly concerned about inflation. Our economist, Qing Wang, forecasts inflation to peak by mid-2010 with a full-year reading at 4.5%. In this vision, stocks should rise with inflation stabilizing and peaking in 2011.

We favor high beta, deep value and cyclical plays: Our favored industries are banks, property, insurance, steel, cement and energy. We underweight consumer stocks including durables, staples, auto and tech.

Loan quota is the key domestic risk for 2011: An overly tight new loan quota would be a drag on economic growth and squeeze bank asset quality. A too-loose loan quota could fuel greater inflation and trigger aggressive tightening.

G3 growth is the key external risk: Surprisingly higher than expected growth in the G3 economies could drive oil, commodities and food prices even higher, followed by global inflation spillover. China would be forced into more aggressive tightening in that case.

Year-End 2011 Index Targets

		2011YE index target			Up-/Down-side		
Index	**Current**	**Base**	Bull	Bear	**Base**	Bull	Bear
MSCI China	67.6	94.5	111.5	73.2	39.8%	65%	8%
HSCEI	12,922	17,682	20,541	13,965	36.8%	59%	8%

Source: Morgan Stanley Research estimates

We Are Optimistic on the 2011 Outlook for Chinese Equities

Introducing Our Year-End 2011 Index Targets

We see several positive themes: Mild inflation, normalized liquidity, modest tightening, good growth, strong currency, cheap valuation, humble relative performance in 2010, and mild consensus outlook.

- We set our new year-end 2011 index targets for MSCI China at 94.5 (up 15.7% from 81.7 for year-end 2010) and for HSCEI at 17,682 (up 14.8% from 15,399 for year-end 2010). These targets imply 40% and 37% upside potential, respectively.
- We project YoY earnings growth of 14.9% for MSCI China and 16.4% for HSCEI in 2011.
- We also expect P/E multiple expansion of 20%, to 15.7x on average from current market levels of 13.1x.

We favor high-beta, cheaply valued and deep cyclical industries: These include banks, property, insurance, steel, cement and energy. We underweight all consumer sectors including durables, staples, auto and tech because we are not comfortable with their high valuation and high earnings expectations.

Loan quota is the key domestic risk and G3 growth is the key external risk: We are using our economist's forecast of Rmb 7 trillion new loans in 2011. If the actual quota turns out to be much less than this, we expect that stocks would fall due to over-tightening. If economies in the developed world surprise on the upside and recover quickly in 2011, oil and food prices would rise globally, forcing China to tighten aggressively. In that scenario, stocks would fall.

Liquidity, Inflation and Policies: Not a Vicious Spiral

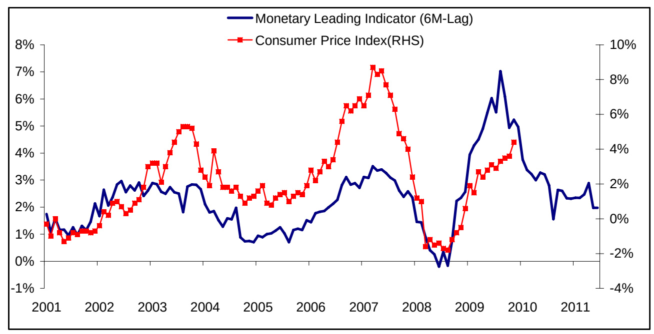
Liquidity, inflation and policies interact with each other, but we do not envision a vicious spiral that would derail growth, as China's money supply already decelerated in 2H2010.

Indeed, our Greater China economist, Qing Wang, forecasts a new loan quota of Rmb 7 trillion and 4.5% inflation in 2010, with CPI peaking by the middle of the year. This is a very mild inflation picture for 2011, with good growth.

We, the strategy team, also see the possibility that CPI could peak even sooner in 1Q2011. Our monetary leading indicator (constructed by M1 and M2 information) shows clear downward trend pressure on CPI in the coming months and for the full year 2011 – if we assume Rmb 7 trillion new loans to be allocated across the 12 months in 2011 in the same proportion as they have been in 2010.

Exhibit 1

Monetary Leading Indicator Implies Downward Trend of CPI in 2011: Assuming 7 Trillion New Loans



Source: CEIC, Morgan Stanley Research

Policy makers' change in tone has also confirmed this view: At the regular Working Meeting of the Politburo that just concluded, the tone for 2011 fiscal policies was "appropriately accommodative" (same as 2010); monetary policies shifted to "stable and healthy" (from appropriately accommodative in 2010). This implies a balance between remaining pro-growth and tackling inflation risk.

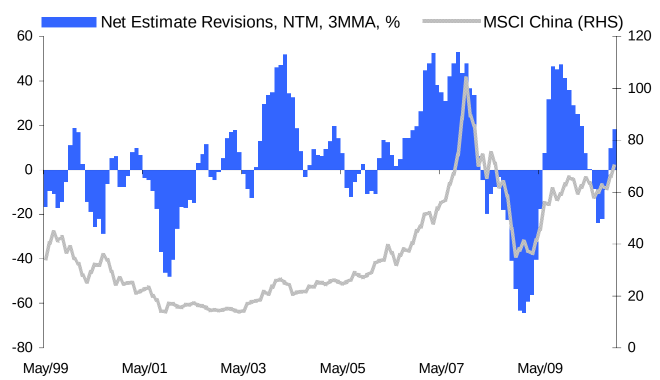
Finally, Rmb7 trillion in new loans is a very loose level of liquidity to fuel growth. Indeed, it represents 16% of GDP in 2011, which is still well above the 13% "normal" new loans to GDP ratio before the financial crisis (2005~2007 average). Clearly, this would not derail growth.

In conclusion, we can build a bull case on our economist's inflation and liquidity view in 2011, as CPI peaking by 2011 will be good news for equities. If CPI actually peaks earlier than that, as suggested by our monetary leading indicator, then it could trigger market re-rating in the next few months.

Growth Expectations: Moderate, with Upside Risk

In the past 10 years, MSCI China's EPS growth has averaged 15.5% YoY, compared to current consensus forecast of 14.9% for 2011. We think there are upside risks in consensus earnings forecasts, especially in the large-cap groups such as banks and energy.

Exhibit 2
MSCI China Earnings Estimate Revision Trend



Source: IBES, MSCI, Morgan Stanley Research

The market is pricing in little expansion in banks' net interest margin next year. However, we think this implies earnings upside for the industry, since we envisage interest rate normalization next year. Assuming average NIM rebounds to the 2007 level of 3% (our analysts now expect just 2.4%), the big five banks would net about Rmb125bn extra after-tax profit on top of the current estimate of 620 bn. That would dramatically lift their 2011 earnings growth from 18.7% to 42.7% on average.

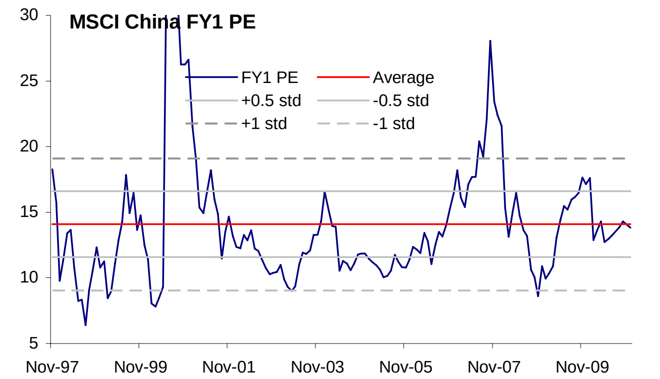
For the energy industry, every US$1 rise in oil prices would also add roughly 1% to the oil companies' combined earnings growth in 2011 – currently the oil price assumed by our analysts is US$95.

For other smaller industries such as capital goods, steel and cement, we believe the solid execution and delivery of social housing projects in 2011 (see Qing Wang's report *2011: A Year of Reflation*, Nov 22, 2010) could also prompt increased earnings estimates.

Valuation Attractive, Currency Should Support

MSCI China is trading at P/E multiples of 14.0x for 2010e and 12.2x for 2011e, based on consensus estimates. This is attractive compared to the historical average in the past decade of 13.8x FY1 PE. A 2011e P/E of 12.2x is also very close to half a standard deviation line below the long-term average – a historically strong support level. Also considering the humble performance of MSCI China in 2010 (up 4.3% year-to-date), we think that overall, the market's downside risk in 2011 should be very limited.

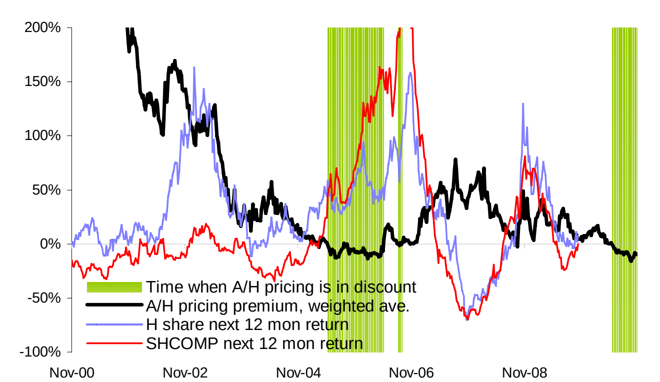
Exhibit 3
MSCI China Valuation Trend



Source: IBES, Morgan Stanley Research

The A-share market is trading at a discount to its H-share counterpart – which is very rare (only the third time in 10 years). This also suggests strong performance over the next 12 months in both the A-share and H-share markets.

Exhibit 4
A/H Premium vs. Market NTM Return



Source: Factset, Morgan Stanley Research

Our economist also believes that Rmb strengthening will continue in 2011 at an annualized rate of 6.5% (see Qing Wang's report *2011: A Year of Reflation*, November 22, 2010). Clearly this is not what the market is now pricing in (RMB 12-month NDF premium to spot rate is only 2.4% now). This implies strong re-rating potential in market valuation, given the close correlation between Rmb appreciation expectations and Chinese market valuation.

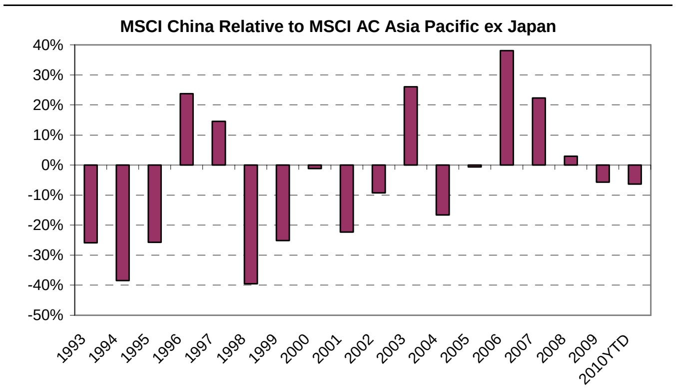
Exhibit 5
Rmb NDF Premium to Spot vs. Market Valuation

Source: Bloomberg, Morgan Stanley Research

From a relative performance perspective, we think it is also quite unlikely that MSCI China would underperform the regional market for a third consecutive year – unless fundamentals were exceptionally weak. Between 1993 and 1995, China underperformed AXJ for three consecutive years because the "Asian tigers" were booming amid an asset bubble, while China's domestic economy suffered a hard landing after severe inflation and the bursting of an asset bubble in Hainan Island property.

Today's relative fundamental outlook is exactly the opposite: China's economic strength and corporate fundamentals are probably the strongest in the region, yet it has underperformed the region continuously for two years. We think a third year of such mispricing is highly unlikely against this fundamental backdrop.

Exhibit 6
MSCI China Relative Performance to MSCI AC AXJ



Source: MSCI, Morgan Stanley Research

Index Targets: 37% and 40% Upside

We set our new index targets for MSCI China and HSCEI at 94.5 and 17682, implying 40% and 37% upside respectively, mainly driven by 2011 earnings growth of 14.9% and 16.4% from 2010, and PE multiple expansion of 20% from current market levels.

Assuming real GDP growth of 9% in 2011, our model indicates a forward earnings multiple of 14.58x, based on the historical relationship between growth and valuation. Assuming 6.5% Rmb appreciation in 2011, our model indicates 19x, based on the historical relationship between Rmb appreciation and valuation. We believe the achievable market forward PE should settle between these two. We thus use the median, 16.79x, as the target multiple for 2011.

Exhibit 7
Index Targets for Year-End 2011

		2011YE index target			Up-/Down-side		
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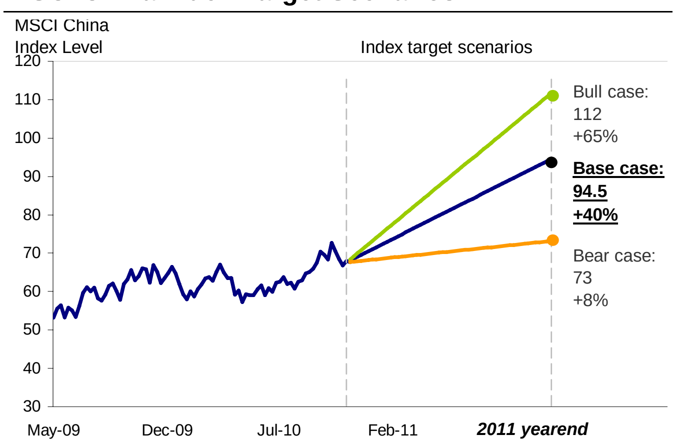
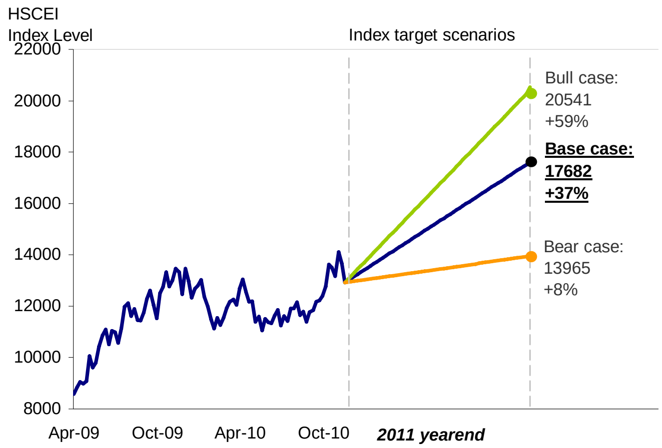
Source: Morgan Stanley Research estimates

Exhibit 8
MSCI China Index Target Scenarios



Source: Morgan Stanley Research

Exhibit 9
HSCEI Index Target Scenarios

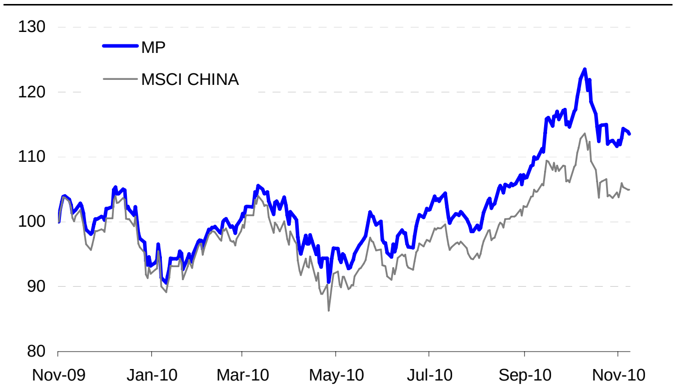


Source: Morgan Stanley Research

Asset Allocation Strategy: We Are Contrarians

Reviewing our 2010 asset allocation, we employed a low-beta strategy in 1H2010 and turned to a high-beta strategy since mid-2010.

Exhibit 10
China Model Portfolio Performance

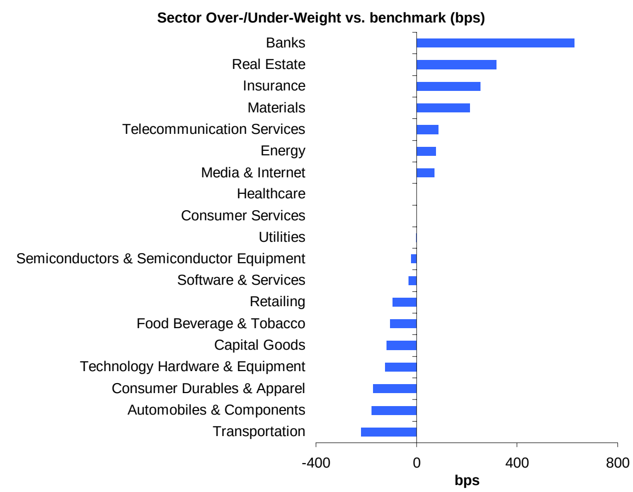


MP performance is measured by weighted average return of its constituents; initial MP price is indexed at 100 on 11/30/2009; portfolio is rebalanced immediately after changes; assuming no currency hedging, no trading costs, and no dividends. Note: past performance is no guarantee of future results. Source: Factset, Morgan Stanley Research

We are carrying forward our high-beta strategy into 2011: We have a great focus on value, as we believe deep value and highly cyclical sectors can beat the market significantly throughout the process of re-rating.

Our favored industries are banks, properties, insurance, steel, cement and energy. We underweight transportation, auto, durables, staples, and technology.

Exhibit 11
China Model Portfolio: Industry Over-/Under-weight



Source: Morgan Stanley Research

Exhibit 12

China Model Portfolio

Name	MS Rating	MSCI China Weight	Portfolio Weight (%)	Overweight/ Underweight (bps)	Price Current (local curr)	2010E PE (x)	2010E EPS Gth.	2010E PB (x)	2010E Div. Yields	Market Cap. (US$m)	3-Mth Perform.	12-Mth Perform.
Banks		**21.73**	**28.0**	**627**								
Bank of China Limited	Equal-Weight	4.83	8.0	317	4.19	9.5 e	18% e	1.6 e	4.4% e	137,044	7.4%	(1.1%)
Bank of Communications	Overweight	1.01	4.0	299	8.17	9.6 e	19% e	1.8 e	3.8% e	59,226	(3.5%)	(6.7%)
China Construction Bank Corp.	++	6.26	8.0	174	7.06	10.8 e	23% e	2.3 e	3.8% e	204,397	10.6%	2.2%
Industrial and Commercial Bank of China	Overweight	6.70	8.0	130	5.97	10.7 e	24% e	2.2 e	3.8% e	256,941	4.2%	(8.4%)
Capital Goods		**3.18**	**2.0**	**-118**								
ZPMC B-Share	NA	0.00	2.0	200	0.62	29.2 e	26% e	1.0 e	NA	527	13.5%	(29.0%)
Consumer Durables & Apparel		**2.73**	**1.0**	**-173**								
China Dongxiang Group Co. Ltd	Overweight	0.18	1.0	82	3.45	10.3 e	9% e	2.0 e	5.8% e	2,519	(17.9%)	(40.8%)
Energy		**17.23**	**18.0**	**77**								
CNOOC	Overweight	6.06	9.0	294	18.36	13.6 e	74% e	3.4 e	2.6% e	104,807	35.6%	52.7%
PetroChina	Equal-Weight	3.91	4.5	59	10.10	13.2 e	16% e	1.7 e	3.4% e	238,183	16.2%	2.7%
China Petroleum & Chemical Corp.	Equal-Weight	2.13	2.0	-13	7.22	8.6 e	1% e	1.3 e	2.9% e	80,659	13.9%	10.6%
China Shenhua Energy	Overweight	1.98	2.5	52	31.30	14.3 e	17% e	2.7 e	2.4% e	80,217	3.6%	(18.8%)
Food Beverage & Tobacco		**4.05**	**3.0**	**-105**								
China Foods Limited	Underweight	0.00	2.0	200	5.27	29.6 e	13% e	2.5 e	1.0% e	1,895	(7.7%)	(27.6%)
Yantai Changyu B-share	Overweight	0.00	1.0	100	87.37	27.7 e	26% e	10.3 e	1.6% e	7,218	(0.9%)	33.4%
Insurance		**8.46**	**11.0**	**254**								
China Life Insurance	Overweight	4.62	8.0	338	33.30	23.0 e	11% e	3.6 e	1.3% e	121,276	8.6%	(18.8%)
Ping An Insurance Company	Overweight	2.92	3.0	8	91.50	33.9 e	22% e	5.1 e	0.9% e	86,597	30.2%	23.7%
Materials		**5.88**	**8.0**	**212**								
China National Building Material Company	Overweight	0.49	2.0	151	17.90	11.6 e	38% e	2.2 e	0.4% e	5,723	14.7%	3.8%
China Shanshui Cement Group	Overweight	0.20	2.0	180	6.43	14.7 e	49% e	2.6 e	1.7% e	2,333	31.2%	6.6%
Maanshan Iron & Steel	Overweight	0.14	2.0	186	4.35	22.1 e	230% e	1.0 e	1.1% e	4,316	(9.9%)	(19.4%)
Angang Steel Company Limited	Underweight	0.23	2.0	177	11.54	23.0 e	313% e	1.3 e	2.1% e	10,758	(11.4%)	(30.6%)
Real Estate		**5.81**	**9.0**	**319**								
Vanke B-Share	NA	0.25	2.0	175	10.64	14.3 e	33% e	2.3 e	NA	1,804	9.2%	5.4%
China Overseas Land & Inv.	Equal-Weight	1.16	2.0	84	15.26	15.9 e	20% e	2.6 e	1.6% e	16,071	(12.3%)	(17.2%)
China Resources Land	Equal-Weight	0.23	4.0	377	14.00	18.3 e	19% e	1.8 e	1.7% e	9,087	(12.6%)	(30.0%)
KWG Property Holding Limited	Overweight	0.16	1.0	84	6.40	13.2 e	62% e	1.3 e	1.9% e	2,139	5.4%	(5.0%)
Retailing		**1.96**	**1.0**	**-96**								
Parkson Retail Group Limited	Equal-Weight	0.31	1.0	69	12.68	31.5 e	14% e	7.3 e	0.0 e	4,586.5	(7.6%)	(6.2%)
Telecommunication Services		**11.13**	**12.0**	**87**								
China Mobile Limited	Equal-Weight	8.80	6.0	-280	78.95	11.7 e	2% e	2.4 e	3.7% e	208,424	(3.7%)	8.1%
China Telecom	Equal-Weight	1.02	3.0	198	3.96	16.2 e	13% e	1.2 e	2.1% e	41,296	(2.7%)	14.5%
China Unicom	Overweight	1.15	3.0	185	10.74	81.1 e	68% e	1.1 e	1.7% e	33,178	(7.3%)	6.3%
Transportation		**3.21**	**1.0**	**-221**								
Air China Limited	Equal-Weight	0.41	0.5	9	10.08	8.3 e	164% e	3.0 e	2.4% e	15,553	9.0%	59.7%
China Southern Airlines	Equal-Weight	0.19	0.5	NA	5.32	NM	NM	1.8 e	-	1,317.2	7.2	-2.5
Utilities		**2.00**	**2.0**	**0**								
China Everbright International Limited	Overweight	0.00	2.0	200	4.32	31.6 e	24% e	3.1 e	0.3% e	2,062	21.7%	11.6%
Media & Internet		**3.29**	**4.0**	**71**								
Netease.com	Overweight	0.00	1.0	100	39.77	16.2 e	13% e	3.6 e	0.0% e	5,192	5.9%	5.4%
Sohu.com Inc	Overweight	0.00	1.0	100	76.71	20.6 e	1% e	3.7 e	0.0% e	2,937	52.4%	44.2%
VisionChina Media	Overweight	0.00	1.0	100	3.65	NM	NM	1.3 e	0.0% e	267	(1.2%)	(66.6%)
Giant Interactive	Overweight	0.00	1.0	100	7.09	13.8 e	7% e	1.7 e	2.6% e	1,655	15.7%	0.0%
TOTAL			**100.0**			**17.6**						
MSCI China			x								8.2%	1.2%

Prices as of December 7, 2010. Past performance is no guarantee of future results. Results shown do not include transaction costs. E = Morgan Stanley estimates (except for ZPMC B-shares and Vanke B, for which we use consensus estimates as a Morgan Stanley estimate no longer provides coverage). ++Estimates, rating, and/or price target for this company have been removed from consideration in this report because, under applicable law and/or Morgan Stanley policy, Morgan Stanley may be precluded from issuing such information with respect to this company at this time.
Source: IBES, Morgan Stanley Research

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(as of November 30, 2010)

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Stock Rating Category	Coverage Universe Count	Coverage Universe % of Total	Investment Banking Clients (IBC) Count	IBC % of Total IBC	IBC % of Rating Category
Overweight/Buy	**1121**	**40%**	**417**	**44%**	**37%**
Equal-weight/Hold	**1175**	**42%**	**410**	**43%**	**35%**
Not-Rated/Hold	**119**	**4%**	**26**	**3%**	**22%**
Underweight/Sell	**392**	**14%**	**105**	**11%**	**27%**
Total	**2,807**		**958**		

Data include common stock and ADRs currently assigned ratings. 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. Investment Banking Clients are companies from whom Morgan Stanley received investment banking compensation in the last 12 months.

Analyst Stock Ratings

Overweight (O or Over) - The stock's total return is expected to exceed the total return of the relevant country MSCI Index, on a risk-adjusted basis over the next 12-18 months.
Equal-weight (E or Equal) - The stock's total return is expected to be in line with the total return of the relevant country MSCI Index, on a risk-adjusted basis over the next 12-18 months.
Not-Rated (NR) - Currently the analyst does not have adequate conviction about the stock's total return relative to the relevant country MSCI Index on a risk-adjusted basis, over the next 12-18 months.
Underweight (U or Under) - The stock's total return is expected to be below the total return of the relevant country MSCI Index, on a risk-adjusted basis, over the next 12-18 months.
Unless otherwise specified, the time frame for price targets included in Morgan Stanley Research is 12 to 18 months.

Analyst Industry Views

Attractive (A): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be attractive vs. the relevant broad market benchmark, as indicated below.
In-Line (I): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be in line with the relevant broad market benchmark, as indicated below.
Cautious (C): The analyst views the performance of his or her industry coverage universe over the next 12-18 months with caution vs. the relevant broad market benchmark, as indicated below.
Benchmarks for each region are as follows: North America - S&P 500; Latin America - relevant MSCI country index or MSCI Latin America Index; Europe - MSCI Europe; Japan - TOPIX; Asia - relevant MSCI country index.
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Morgan Stanley

The Americas
1585 Broadway
New York, NY 10036-8293
United States
Tel: +1 (1) 212 761 4000

Europe
20 Bank Street, Canary Wharf
London E14 4AD
United Kingdom
Tel: +44 (0) 20 7 425 8000

Japan
4-20-3 Ebisu, Shibuya-ku
Tokyo 150-6008
Japan
Tel: +81 (0) 3 5424 5000

Asia/Pacific
1 Austin Road West
Kowloon
Hong Kong
Tel: +852 2848 5200