Deutsche Bank

8 March 2012

China Macro Strategy

Three upside risks

We raised our 2012 GDP growth forecast from 8.3% to 8.6% on three upside risks to market and our earlier expectations:

1) Exports likely to outperform expectations
We raised our 2012 export growth forecast to 13% from 8%. The upward revision reflects stronger-than-expected demand from G3, a rise in China's export orders, and improvement in the operating environment for export firms.

2) Small businesses are outperforming expectations
Small businesses, accounting for over 70% of the employment for more than 90% of the firms in the manufacturing sector, have witnessed significant improvement in their operating environment in the past months. Small business PMI rose sharply from 45 in June 2011 to 55.2 in February 2012, the highest reading since the index's inception. This improvement is supported by falling accounts receivables, lower raw materials inflation, increasing profit margin, and rising export orders.

3) The economy is more insulated from real estate risk than market perception
Our study shows that the economy is much more insulated from the weakness in the real estate industry than the market's perception. In the current cycle (from January 2010 to February 2012), the correlation between the manufacturing PMI and the real estate PMI was only 0.12, vs. a correlation of 0.81 during the period of July 2008-June 2009. We estimate that the fall in the leading indicator for residential construction (floor space started) by 55ppt in recent months will likely translate into only a 2ppt deceleration in total real gross capital formation for a limited period of time this year.

Market implications: We believe that these developments are positive for the overall economy, and will provide more solid support to EPS growth. Given the valuation (forward PE at 9.1x) is still very attractive and the reduced downside risk to growth, we continue to have a very positive outlook for China's equity markets. We expect another 15-20% upside to MSCI China for the remainder of this year, despite a rally of 11% year to date.

Among sectors, we prefer: 1) container shipping and ports, due to our upward revision in export forecasts; 2) banks, due to reduced credit risks from small business failures and economic hard landing; and 3) power, which should benefit from stronger commitment by the government to resource pricing reform this year.

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We have raised 2012 GDP growth forecast to 8.6%

We raised our GDP growth forecast for 2012 to 8.6% from 8.3% (8.3% is about the consensus estimate). Given that the market estimates China's GDP growth range from 7.9% to 8.7%, we have one of the highest estimates on the Street. The main source of our upward revision is the upgrade to our export growth forecast to 13% from 8%. The recent improvement in the operating environment for small businesses and our increased confidence that the downside risk posed by weak property activities to the broader economy will be limited also contributed to our conviction on the improving growth outlook.

We made several other changes to our annual economic forecasts: 1) we raised our nominal import growth forecast to 15% (from the previous 9%), reflecting the increase in import of raw materials and components for export production, and an increase in our global commodity inflation forecast; 2) we raised our CPI inflation forecast to 3.1% from the previous 2.8% largely on the back of stronger-than-expected food inflation in January and higher-than-expected oil prices; 3) we marginally raised our IP (on stronger exports) and retail sales forecasts (on slightly stronger inflation forecast); and 4) we lowered our RMB appreciation expectation for 2012 from the previous 3.5% as policy concerns on export competitiveness and US reactions appear to be stronger than we thought initially. Our updated macro forecasts are shown in Figure 1.

Figure 1: Summary of macroeconomic forecasts, yoy%

	2010	2011	2012F	2013F
Real GDP	10.3	9.2	8.6	8.6
CPI	3.3	5.4	3.1	3.5
Broad money (M2)	19.7	13.6	14.0	14.5
Bank credit	19.9	15.8	15.0	14.0
Budget surplus (%of GDP)	-1.7	-2.0	-1.5	-1.3
Fixed asset inv't	23.8	23.8	17.0	17.0
Retail sales	18.4	17.1	14.2	15.0
Industrial production (real)	15.7	13.9	12.3	12.0
Merch exports (USD)	31.3	20.3	13.0	14.0
Merch imports (USD)	38.7	24.9	15.0	16.0
1-year deposit rate	3.50	3.50	3.50	3.50
CNY/USD (eop)	6.59	6.30	6.14	5.93

Source: Deutsche Bank, CEIC

The reason that we did not raise our GDP growth forecast more than 0.3ppt is that part of the positive impact of higher export growth on GDP was offset by a similar increase in import growth. Note that we now forecast the export volume growth would be 10% in 2012, the same as last year. In 2011, half of the 20% rise in nominal export growth was due to an increase in unit value (reflecting currency appreciation and an increase in the unit cost of production).

As for quarterly profile of GDP growth forecast, we further raised our Q1 GDP growth forecast (qoq, saar) to 7.8% from 7% (Figure 2), largely reflecting the stronger-than-expected trade and small business performance and our increased confidence that the overall economy is better insulated from the real estate shock.

Figure 2: Quarterly real GDP growth forecasts, yoy and qoq (saar), in %

	yoy%	qoq%, saar
2011Q1	9.7%	8.7%
2011Q2	9.5%	9.1%
2011Q3	9.1%	9.5%
2011Q4	8.9%	8.2%
2012Q1F	8.6%	7.8%
2012Q2F	8.0%	8.5%
2012Q3F	8.7%	9.0%
2012Q4F	8.8%	8.5%

Source: Deutsche Bank, CEIC

Exports likely to outperform expectations

We raised our 2012 export growth forecast to 13% yoy, up from our previous forecast of 8% and market expectation of 10%. This reflects stronger-than-expected leading indicators from the US, Europe and Japan in recent weeks and improvement in the new export orders index in the recent Chinese PMI report. Arguments for this forecast change are:

1) Stronger global leading indicators. We constructed a composite G3 leading index for Chinese exports growth (Figure 3), using a weighted average of US manufacturing ISM, Euroland manufacturing PMI and Japan manufacturing PMI. Historically, this leading index had a correlation of 85% with Chinese yoy export growth, with a lead time of five months. The January-February average of this index rose to 51.2, up from 49.6 in Q4 of last year. A 1.6ppt rise in the G3 leading index is significant, and typically suggests an increase in G3 GDP growth by 0.7ppt.

Figure 3: Global leading indicators (manufacturing ISM or PMI)

	US	Japan	Euroland	G3 index
2011Q1	59.7	46.4	57.5	57.4
2011Q2	55.8	50.7	52.0	54.6
Jul-11	51.4	52.1	50.4	51.2
Aug-11	52.5	51.9	49.0	51.1
Sep-11	52.5	49.3	48.5	50.5
Oct-11	51.8	50.6	47.1	49.9
Nov-11	52.2	49.1	46.4	49.6
Dec-11	53.1	50.2	46.9	50.3
Jan-12	54.1	50.7	48.8	51.6
Feb-12	52.4	50.5	49.0	50.8

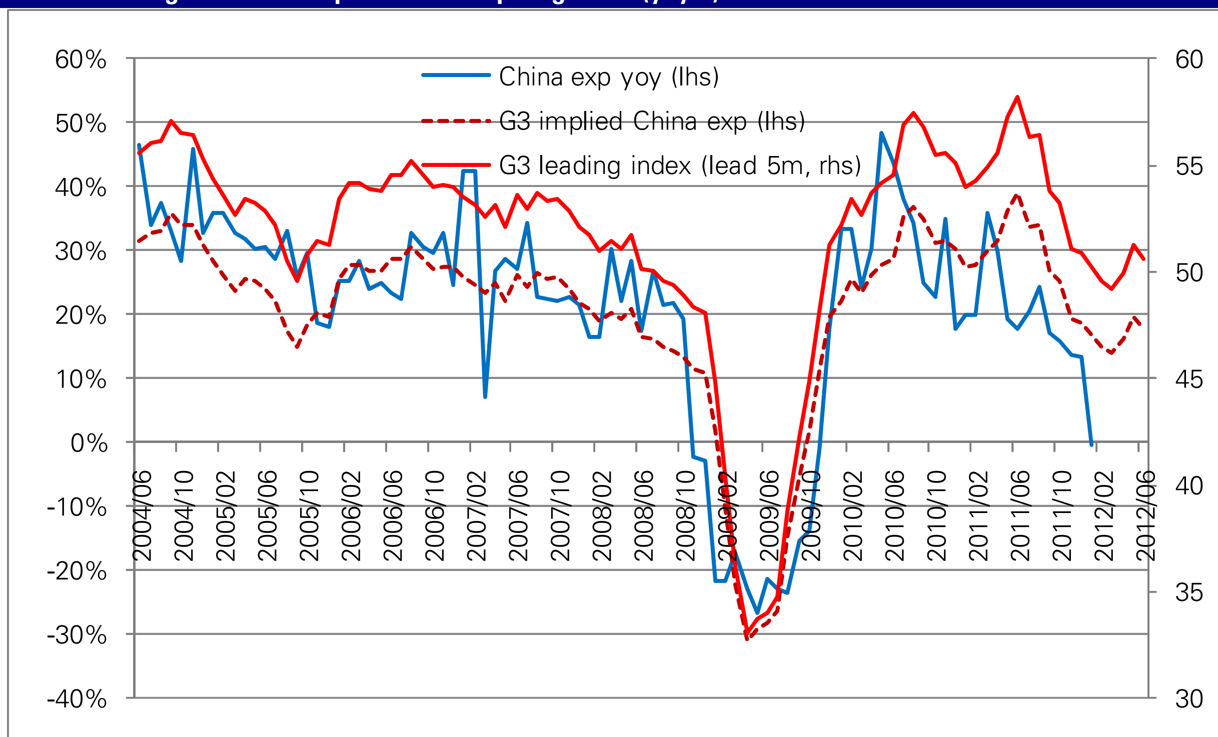
Source: Deutsche Bank

2) Stronger G3 leading index implies higher demand for Chinese exports. Our correlation analysis (between G3 leading index and Chinese export growth) suggests that a 1.5ppt rise in the G3 leading index tends to lift Chinese yoy

export growth by 5ppt. On the basis of our previous forecast of 8% export growth, it translates into export growth potential of 13%.

Based on a simple regression analysis, Figure 4 shows that the G3 leading index would in fact suggest that the Chinese export growth can reach 18% this year, i.e. up massively from January's -0.5% yoy. However, after taking into account the structural weakness (by roughly 5ppt below the potential export growth rate implied by the leading index since 2011 – as can be seen in Figure 4 – due to structural reasons such as rising labor costs and faster relocation of low-end export manufacturing to other countries), we believe that 13% is probably the best export growth forecast for 2012.

Figure 4: G3 leading index and implied China export growth (yoy%)



Source: Deutsche Bank, CEIC

3) **G3 GDP upgrade also supports our upward revision to Chinese export forecast.** Our economists have revised up US 2012 GDP forecast to 2.7% from 2.4% in February, and raised Japan's GDP forecast to 2.5% from 0.7%. The new and old quarterly GDP growth forecasts are listed in Figure 5.

Figure 5: DB's G3 GDP growth forecasts, new vs. old (qoq saar)

		US	Japan	Euroland	G3	US	Japan	Euroland	G3
2011	Q1	0.4	-6.8	3.1	0.2	0.4	-6.6	3.1	0.3
	Q2	1.3	-1.5	0.6	0.6	1.3	-2.0	0.6	0.5
	Q3	1.8	7.0	0.5	2.2	1.8	5.6	0.5	1.9
	Q4	3.0	-2.3	-1.3	0.4	3.0	-0.1	-1.2	0.8
2012	Q1F	**2.8**	**4.3**	-1.6	1.3	2.0	-0.4	-1.6	0.2
	Q2F	**2.9**	**3.8**	-1.2	1.5	2.7	0.7	-1.2	0.8
	Q3F	**3.2**	**2.3**	1.0	2.2	3.0	0.5	1.0	1.8
	Q4F	**3.3**	**1.6**	1.2	2.2	3.0	1.5	1.2	2.0

Source: Deutsche Bank

Based on these three forecasts, we calculated the weighted average G3 GDP forecasts. For 2012 as a whole, we raised G3 GDP growth by 0.6ppt. Historically, every 0.6ppt increase in G3 GDP tends to raise Chinese export growth by 4-5ppt.

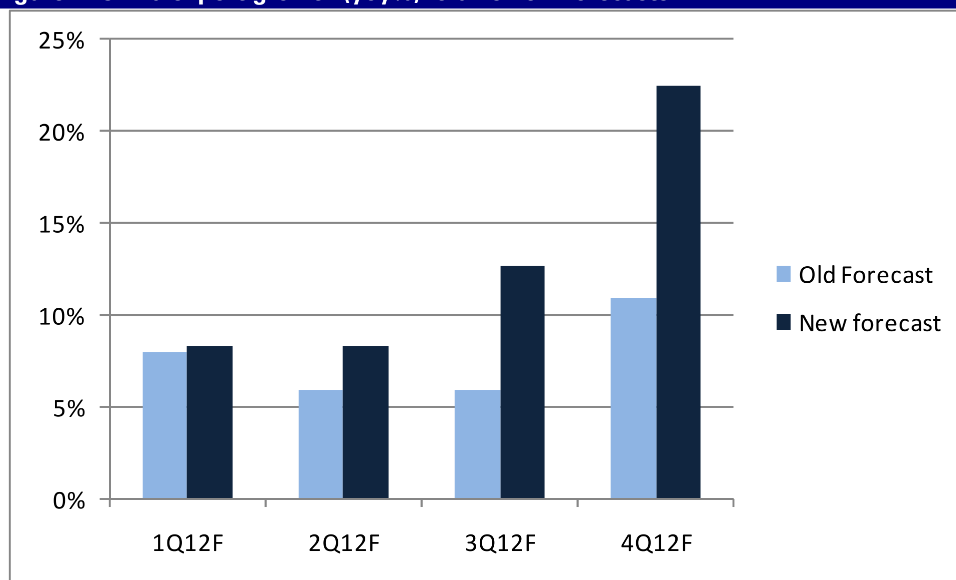
Based on the above analysis, and the latest quarterly profile of G3 GDP growth, we revised our China quarterly (yoy) export forecasts. Figure 6 shows both the revised and the old forecasts. It is important to note that the yoy export growth will likely accelerate by quarter – i.e. outperformance will likely be back-loaded – the Q3 and Q4 export growth rates are revised up by 7ppt and 12ppt, respectively. The larger upward revisions for later part of this year reflect the cumulative impact of upward revisions to qoq growth.

Figure 6: China export value growth forecasts (in USD terms), yoy %

	Old Forecast	New forecast
1Q12F	8%	8%
2Q12F	6%	8%
3Q12F	6%	13%
4Q12F	11%	23%
2012 annual	8%	13%

Source: Deutsche Bank

Figure 7: China export growth (yoy%): old vs new forecasts

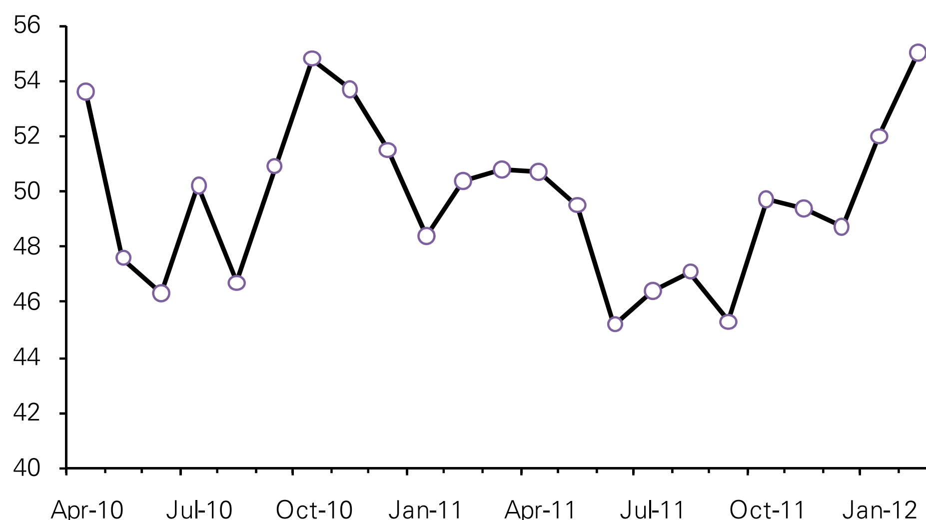


Source: Deutsche Bank

Small businesses are outperforming expectations

Small businesses (defined as small and micro firms in the manufacturing sector, with annual revenue below RMB20m), accounting for over 70% of the employment for more than 90% of firms in the manufacturing sector, have witnessed a significant improvement in their operating environment in the past months. The small business PMI rose sharply from 45 in June 2011 to 55.2 in February 2012, the highest reading since the index's inception two years ago. This improvement is consistent with anecdotal stories and suggests that financing constraints have eased, demand for labor is strong, and new export orders are healthier.

Figure 8: China small business PMI (manufacturing sector)



Source: NBS and Confederation of Federation of Logistics.

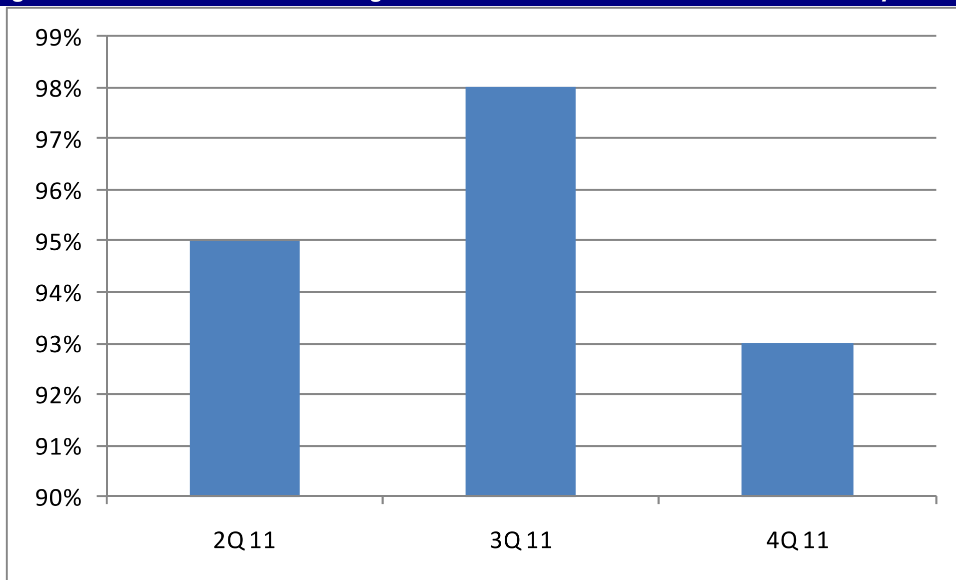
In Q3 last year, there was widespread media coverage about "runaway bosses" and private entrepreneurs committing suicide in places such as Wenzhou. This coincided with the very weak PMI reading of about 46. At that time, small businesses were indeed simultaneously suffering from several shocks: 1) very tight credit conditions, as evidenced by a surge in informal market lending rate to about 25% by June 2011 (vs. levels of 10-15% historically); 2) a strong increase in inflation (note that CPI inflation reached 6.5% yoy in July 2011), which exacerbated the upward pressure on labor costs; and 3) an increase of 23% yoy in raw materials price index in July 2011.

The operating environment for small businesses has indeed improved significantly since, as evidenced by the following:

1) The ratio of accounts receivables to sales has declined. As large companies (especially infrastructure companies) are better funded due to policy easing, they have begun to clear their arrears to suppliers including many small companies. This is particularly evident in the case of railway projects. Our railway analyst estimates that the railway sector owed about RMB150bn in arrears to suppliers at the end of Q3 last year. Most of these arrears have been cleared according to the latest estimate of our railway analyst. In addition, our banking analysts estimate that the LGFV loans of RMB300-400bn were rolled over by the end of last year (largely in Q4), again indirectly benefiting smaller suppliers and service providers.

Based on the CEIC data, the ratio of accounts receivables to monthly sales for non-state owned manufacturing companies declined to 93% in Q4 from the peak of 98% in Q3 last year. As most SMEs are non-state owned firms, this trend should confirm the improvement in the cash flow situation due to the clearance of payments arrears and the general improvement in liquidity.

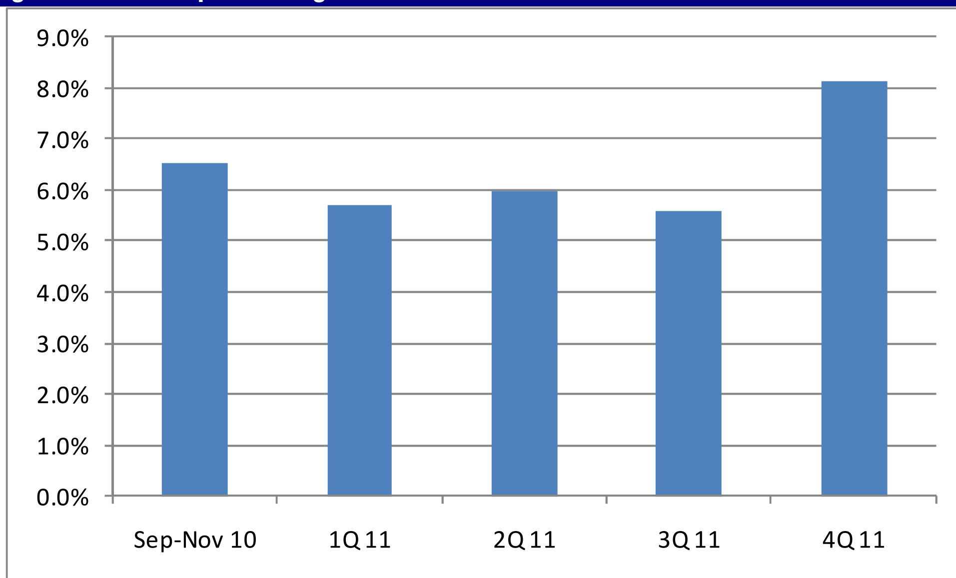
Figure 9: Non-state manufacturing firms: accounts receivables as % of monthly sales



Source: Calculated based on CEIC data.

2) Profit margin of non-state owned manufacturing firms has improved. While nationwide statistics on small company profits are not available, we can calculate the pre-tax profit margin of non-state-owned industrial firms based on the official data from the NBS. Note that that the majority of small companies are privately owned so we can use non-SOEs as a good proxy. Figure 10 shows that the pre-tax profit margin of non-SOEs rose to 8.1% in Q4 of last year, up visibly from the trough of 5.6% in Q3. Note that the Q4 margin is also significantly higher than 6.4% in September-November of 2010 (NBS changed its reporting period this year) or the historical Q4 average (where Q4 numbers were reported) of 6-7%. Therefore the improvement in Q4 2011 was not entirely due to seasonal factors.

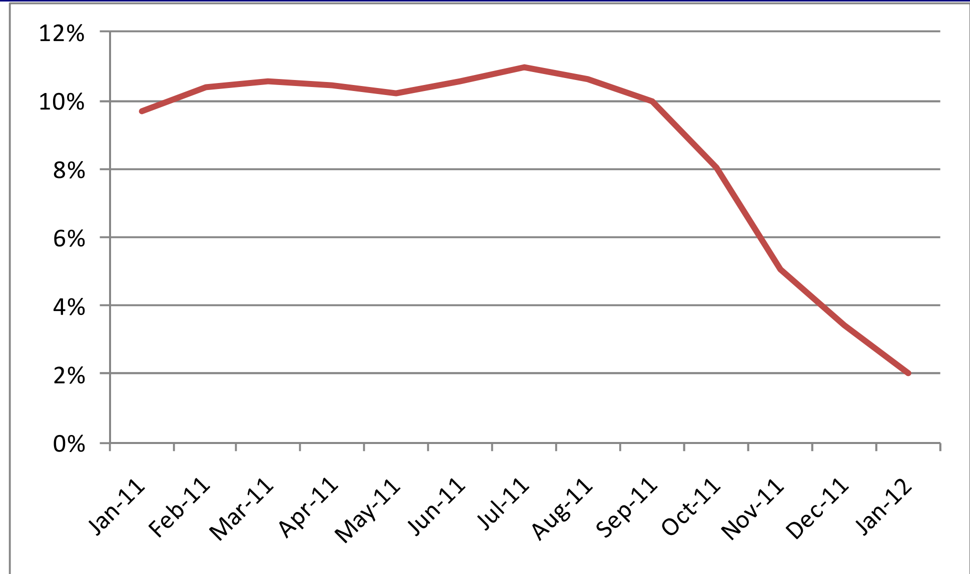
Figure 10: Pre-tax profit margin of non-state owned industrial firms



Source: Calculated using NBS data.

3) Raw material inflation has eased **significantly.** By the middle of 2011, the yoy inflation in raw material prices was 10–11%. It has declined steadily since and is currently only 2%, much lower than the historical average of 6–7% (Figure 11). Even if broad money supply growth is only about 13% yoy now, it is in fact an easier monetary condition (i.e. M2 growth minus inflation) for manufacturing firms relative to the time when raw material price inflation was 11% but M2 growth was 15%.

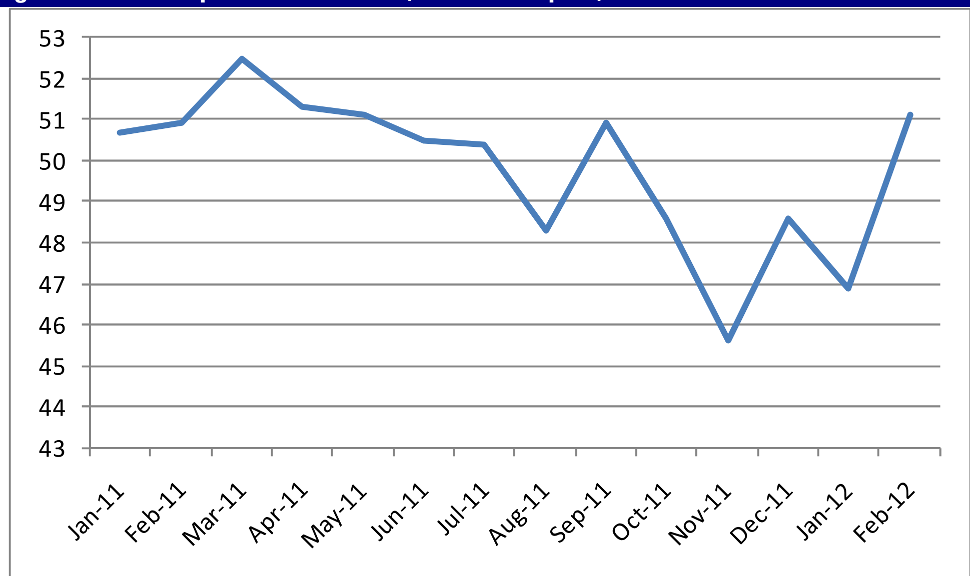
Figure 11: Raw material price inflation, yoy %



Source: CIEC.

4) **Export orders improved recently.** The new export orders index in the PMI report rose to 51 in February, up sharply from the worst reading of 45.6 in November. As a very high percentage of small companies are operating in export-related sectors, this improvement in export demand is positive for them.

Figure 12: New export orders index (from PMI report)



Source: NBS and Confederation of Logistics.

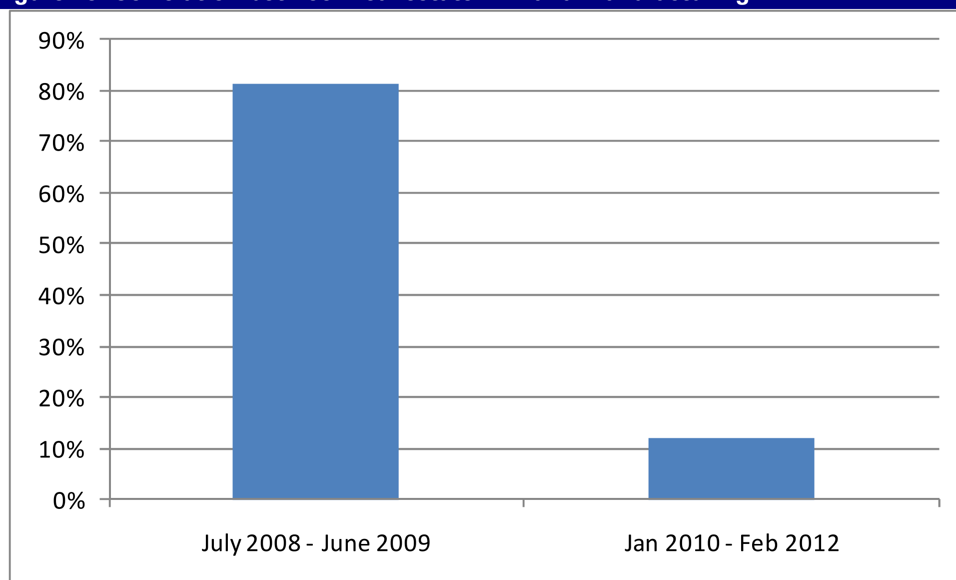
The economy is more insulated from the real estate risk than market perception

With export weakness and small business failures becoming much less of a concern, the only outstanding major risk to the economy is from the real estate industry. But even on the real estate industry, we believe that the downside risk it poses to the overall economy is significantly smaller than the perception of many investors.

Many investors are concerned that given the inter-relationship between the real estate sector and a large number of related industries such as raw materials, machinery, furniture, auto, and even luxury consumption (due to the negative wealth effect), weakness in property sales and investment would have a serious ripple effect on the overall economy. However, our study shows that the broader economy is in fact highly insulated from the weakness in the real estate industry. We found that in the current cycle (from January 2010 to February 2012), the correlation between the manufacturing PMI and the real estate PMI was only 0.12, vs. the correlation of 0.81 for the period of July 2008-June 2009 (Figure 13). This is because the high correlation between real estate and overall PMI during the 2008-09 crisis was mainly due to the resonance effect of other major contributors (especially inventory destocking and export decline) to the economic downturn during the Lehman crisis.

Fortunately, this time around, inventory and exports are performing much better and thus real estate per se is unlikely to lead to a hard landing of the economy. In fact, the PMI's raw materials inventory index remained largely stable during the past two quarters (at about 50 now, vs 39.5 in November 2008), while the new export orders index recovered to over 51 in February (compared with 29 in November 2008). Therefore, even though the most recent trough of real estate PMI (at 39 in January 2012) was as low as that in January 2009, the overall manufacturing sector is much more stable now than in 2008-09.

Figure 13: Correlation between real estate PMI and manufacturing PMI



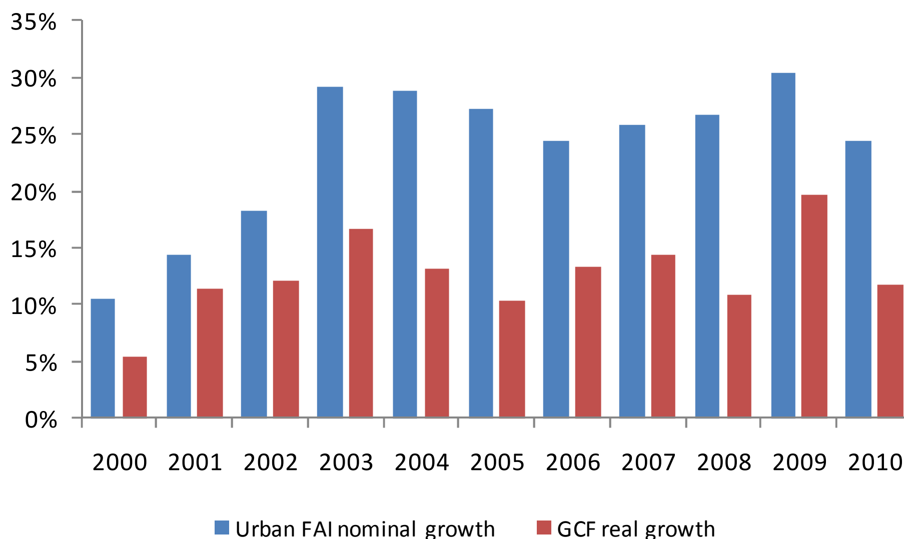
Source: Deutsche Bank calculation based on data from NBS and Confederation of Logistics.

A particular worry among investors is that a leading indicator for real estate construction – residential floor space started – has dropped sharply from a 30% yoy growth in August 2011 to 25% yoy in December 2011. Some view this as an indication of overall real estate investment growth slowing by 50-60ppt in the coming months, and believe it could be a serious blow to the economy given real estate FAI is about one-fourth of total FAI and investment is about half of the economy. A simple calculation based on these assumptions would result in an extremely bearish view -- GDP growth may slow by as much as 5ppt

This view grossly exaggerates the likely impact of real estate weakness on the economy. There are several problems with the assumptions used in the above calculation. **Firstly, residential floor space started is not a perfect predictor of total real estate FAI.** Based on the correlation analyses using data from 2000 to 2011, we note that the fall in the leading indicator for residential construction (floor space started) by 55ppt in recent months will likely translate into only 15-20ppt deceleration in nominal real estate FAI growth (rather than by 55ppt). This relative weak correlation is partly because the "residential floor space started" figures do not capture or do not fully reflect the changes in construction activities in commercial real estate, rural housing, and some residential projects built by work units (rather than be developers). And we know construction activities of these types remain strong.

Secondly, the nominal change in FAI is typically much more violent than the real change in gross capital formation due to the volatility of land and raw materials prices and the double counting of items such as land transfers in FAI (Figure 14). Based on data from 2000, a 10ppt change in FAI growth implies only a 5.3ppt change in real gross capital formation. Applying this ratio (0.53) to the likely 15-20ppt deceleration in nominal real estate FAI growth, it means that the real gross capital formation (GCF) in the real estate sector may slow only by 8-11ppt. Given that the real estate GCF is about 25% of the overall GCF, it implies that weaker investment growth in the real estate sector may slow the overall real GCF growth by about 2ppt. Therefore, its impact on GDP growth would be around 1ppt, rather than by 5ppt.

Figure 14: Nominal FAI growth vs real gross capital formation growth



Source: Deutsche Bank

Thirdly, investments in the infrastructure and public housing sector may partly offset the real estate investment slowdown. Given the government's assurance for funding the ongoing infrastructure projects, the increase in local bond issuance quota (by 25% to RMB250bn this year from RMB200bn last year), rollover of some LGFV loans (already by RMB300-400bn by the end of last year, likely 7% increase in new lending (to RMB8tn this year from RMB7.5tn last year), we expect transport FAI growth to recover to 5–7% this year, up from last year's 1.8%. In addition, investment in public housing may rise 20–30% this year. Finally, the recent indication from the government to "ensure the supply of ordinary commodity housing" implies that the financing policies for some developers may be somewhat more relaxed later this year. These factors may, in our view, offset 3–4ppt of the real estate FAI deceleration.

Finally, the weakness indicated by the leading indicator is short-term in nature. It is quite likely that the property sales may recover later this year due to improved affordability and

policy incentives for first-time home buyers, and therefore, real estate FAI growth may recover from the middle of this year.

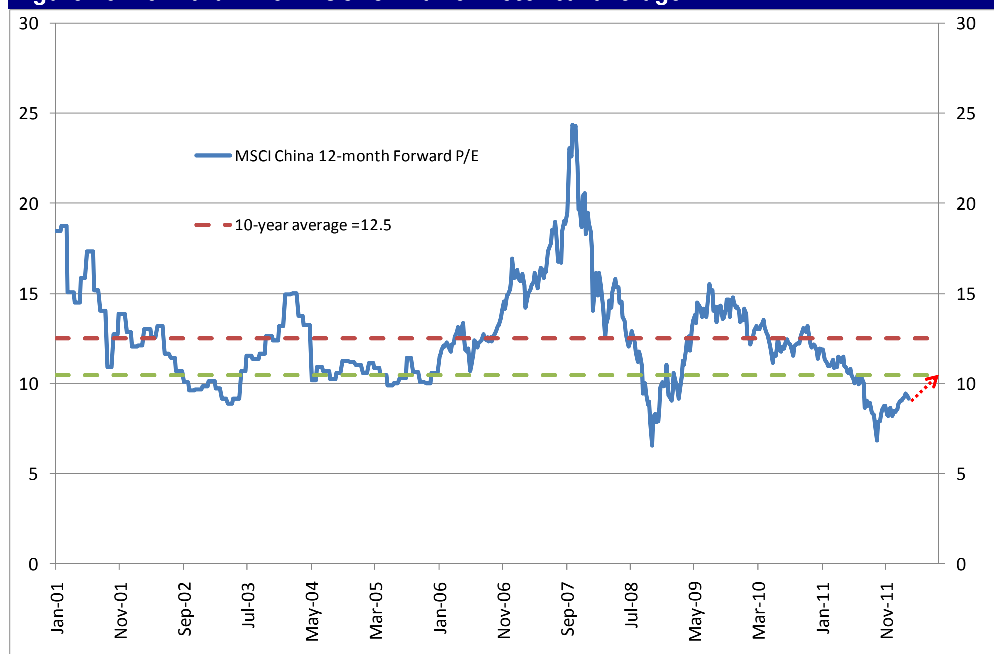
Our conclusion is that although the real estate FAI deceleration remains a risk to the economy in the short term, its magnitude is quite manageable and its full-year impact is partially offset by many other factors. Our annual GDP growth forecast of 8.6% is therefore quite achievable despite the drag from the real estate sector.

Market implications: We remain bullish on MSCI China for the rest of this year

We continue to have a bullish outlook for China's equity markets, and expect another 15–20% upside to the MSCI China index for the rest of this year. The market rallied in the first two months of this year -- with MSCI China up 17% in January-February, but experienced some technical corrections in the past week. We think the recent pullback (by about six percent since 1 March) is healthy, and should provide a better entry point for investors than just a few weeks ago.

Despite the ytd increase of 11% in the index, MSCI China is still trading at an attractive forward PE of 9.1x, compared with the average of 12.5x for the past ten years (Figure 15). Given our expectation of very healthy 8.5-9% GDP growth and 3-3.5% CPI inflation in 2H this year, we believe macro fundamentals should easily justify a further rerating of the forward PE to 10.5x by the end of this year. This valuation re-rating alone should imply 15% upside to MSCI China from its current level.

Figure 15: Forward PE of MSCI China vs. historical average



Source: Bloomberg, Deutsche Bank

In addition, we believe that the stronger-than-expected GDP growth (as discussed in the previous sections of this report) should provide more solid support to our EPS growth forecasts of 11% for this year and 13% for the next year. Expectation of continued +10% EPS growth by the end of this year should support further index upside than just multiple expansion.

On sectors, we see potential earnings upside from three factors:

1. The likely outperformance of exports this year may provide upside to container shipping, ports and export manufacturing industries.

2. The diminishing risk of small business failures (and default probability in the informal lending market) and the better-than-expected insulation of the economy to weakness in real estate sector will also allay market concern on banks' NPLs. Stronger GDP growth and the resulting upside to overall corporate earnings growth should also lower the asset quality risk to the banking system.

3. The determination of the government to implement resource pricing reform, as emphasized by the Premier at the NPC that the 4% CPI inflation target is to reserve room for the reform, bodes well for further improvement in margin outlook for the power sector.

Given the above reasons, we prefer container shipping, banks and power in our sector picks. We also added CNOOC to our top picks list as a hedge against potential upside surprises to global oil prices. Figure 16 presents the updated top Buys from China stocks covered by our analysts.

Figure 16: Our top Buys

Company	Ticker	Sector	Rating	6-Mar Price local	M. cap (US$m)	PE 2012E	PE 2013E	PB 2012E	EPS CAGR 11-13 E	PEG (11-13EPS /2012PE)
Baidu	BIDU.OQ	Software & Services	Buy	133.3	46,582	27.9	19.9	11.6	48%	0.59
China Shipping Container	2866.HK	Transportation	Buy	2.7	4,048	97.7	13.0	1.0	-4%	N.A.
China Construction Bank	0939.HK	Banks	Buy	6.2	200,629	6.9	6.3	1.4	10%	0.70
ICBC	1398.HK	Banks	Buy	5.3	236,473	6.7	6.1	1.3	9%	0.74
ZTE	0763.HK	TechHardware & Equipment	Buy	22.2	8,096	17.1	14.4	2.3	15%	1.16
Huaneng Power Intl	0902.HK	Utilities	Buy	4.8	7,423	9.3	9.0	0.9	86%	0.11
CNOOC	0883.HK	Energy	Buy	17.0	97,486	8.4	8.1	2.0	6%	1.47
China Resources Land	1109.HK	Real Estate	Buy	13.7	10,249	10.1	5.7	1.3	50%	0.20
Mindray Medical	MR.N	Health Care Equipment & Services	Buy	31.1	3,575	17.3	15.0	2.7	15%	1.19
Belle Int'L Holding	1880.HK	Retailing	Buy	13.0	14,113	16.9	14.0	4.0	21%	0.79
Ping An	2318.HK	Insurance	Buy	61.8	61,073	16.3	NA	2.7	32%	0.51
Dongfeng Motor	0489.HK	Automobiles & Components	Buy	13.9	15,471	7.6	6.7	1.7	13%	0.59
Average						20.2	10.7	2.7	25%	0.81
MSCI China						9.2	8.4	1.4	12%	0.77

Source: Deutsche Bank

As a final remark, we believe many investors' concerns on the Chinese government cutting its GDP growth target to 7.5% is overdone. Note that, historically, China's actual growth rates have almost always been higher than the official targets (for example, the targets were overshot by an average of 2ppt in the past decade). For this year, we believe China's official target is likely to be easily exceeded by 1ppt, i.e. actual growth would reach or even slightly exceed 8.5%. For all the reasons we stated for the past years, an 8.5% GDP growth rate is much healthier than 10% GDP growth, as the former would help reduce the risks of economic overheating, asset bubbles and NPLs. In other words, the likely outcome implied

by the conservative 7.5% GDP target should imply a more sustainable growth trajectory than before.

Appendix 1

Important Disclosures

Additional information available upon request

For disclosures pertaining to recommendations or estimates made on a security mentioned in this report, please see the most recently published company report or visit our global disclosure look-up page on our website at http://gm.db.com/ger/disclosure/DisclosureDirectory.eqsr.

Analyst Certification

The views expressed in this report accurately reflect the personal views of the undersigned lead analyst(s). In addition, the undersigned lead analyst(s) has not and will not receive any compensation for providing a specific recommendation or view in this report. Jun Ma

Equity rating key

Buy: Based on a current 12- month view of total share-holder return (TSR = percentage change in share price from current price to projected target price plus projected dividend yield) , we recommend that investors buy the stock.
Sell: Based on a current 12-month view of total share-holder return, we recommend that investors sell the stock
Hold: We take a neutral view on the stock 12-months out and, based on this time horizon, do not recommend either a Buy or Sell.
Notes:
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2. Ratings definitions prior to 27 January, 2007 were:

    Buy: Expected total return (including dividends) of 10% or more over a 12-month period
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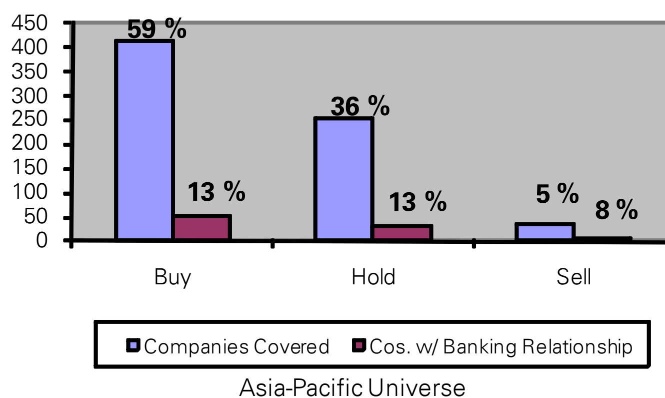
Equity rating dispersion and banking relationships



Asia-Pacific Universe

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