An update on China:
Reasons for the recent underperformance

May 2010

Market review

After the correction on global equity markets two years ago, Chinese equities staged a strong rebound late in 2008 in response to the Chinese government's large fiscal stimulus plan and to significant monetary easing. 2009 was a strong year overall for Chinese equities, with the H-share market rising by 62% and the A-share market rising by 92% in USD terms. H-share and A-share valuations recovered from an oversold level of 7x PE and 11x PE at the end of 2008 respectively to finish the year at 19x PE and 27x PE respectively. In addition, the market continued to be buoyed by strong earnings upgrades and foreign inflows throughout 2009.

The Chinese economy remains strong, with first-quarter 2010 GDP growth of 11.9% year-on-year (y/y). Meanwhile, inflation remains moderate, with the April CPI number coming in at 2.8% y/y. Domestic consumption has already started to contribute positively to growth, with retail sales rising by 18% annualised in March 2010. Importantly, the Chinese authorities have consistently maintained their pro-growth stance and their desire to enable "structural re-balancing" of the economy towards domestic consumption. Throughout 2009, measures were implemented to improve the social safety net and to increase spending in public housing and in medical care in order to lower China's high savings rate and increase consumption.

However Chinese H-shares, and in particular Chinese A-shares, have underperformed on a relative basis compared to other Asian and global markets for the past two quarters. From the beginning of 2010 until 12 May 2010, Chinese H-shares have fallen by 10% and A-shares have fallen by 20%, significantly underperforming the MSCI Asia Index (-3%) and the MSCI World Index (-1%). Despite strong domestic-led growth and muted inflation, Chinese equities have continued to underperform global peers. The reasons for this underperformance include concerns over a normalisation in excessively easy monetary policy, worries over increased equity issuance as Chinese banks seek to bolster their capital position, concerns over measures by government authorities to curb speculation in the property market, and poor sentiment in the domestic A-share market.

Reasons for China's recent underperformance

1. Normalisation of monetary policy

The first "catalyst" for the correction in Chinese equity markets was the slowdown in new loan creation from over USD 224 billion in June 2009 to USD 52 billion in July 2009. The drop in loan creation triggered market concerns about aggressive credit controls and the potential impact on investment/economic growth. Liquidity and policy support had been the key catalysts in driving the market upwards earlier 2009, and hence fears of a potential withdrawal of liquidity triggered a correction in the market. In addition to the drop in loan growth, China has raised its Required Reserve Ratio (RRR) by three times since the end of 2009.

CPI inflation is rising, but remains at a low level. April's CPI came in at 2.8%, below the central bank's 3% target. Our portfolio managers of the JPMorgan Funds - JF China Fund, Howard Wang and Shumin Huang, expect inflation to peak at above 3% in June, led by rising food/commodity prices, rising property prices, and due to the low base effect of last year. This is expected to lead to interest rates finally being increased, possibly in the second half of 2010.

However, we believe that muted global consumer demand and the effects of gradual policy tightening since the end of 2009 will keep inflation under control throughout the rest of 2010. Therefore, our base case is for a normalisation of both the RRR and interest rates, rather than an aggressive series of interest rate hikes. In our opinion the moves to normalise the RRR in order to withdraw excess liquidity from the financial system and to slowdown loan growth to sustainable levels, as well as the eventual rise in interest rates, should be seen as a mid-to-long term positive for the economy and for financial markets, particularly given that the Chinese government has been proactively trying to prevent the emergence of speculative bubbles in the property market and in the stock market.

2. Increased equity issuance

After extending USD 1.4 trillion in new loans in 2009, large listed Chinese banks announced early in 2010 that they would be raising equity to bolster their capital position. The lack of clarity in terms of the amount, the timing and the form of equity raising (i.e. via rights issue, convertible bonds, or issuance in the A or H-share market) has proved to be a significant overhang on the market, particularly early in 2010. It has been estimated that over USD 40 billion (source: CLSA estimates) of equity may be raised by Chinese banks in the second half of 2010. Equity issuance on the H-share market could be in the range of USD 16 billion if we exclude the participation of the government and strategic stakeholders.

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We view this as a prudent move on the part of the banks' managements to ensure that capital adequacy ratios remain strong and that the listed banks will therefore be able to take advantage of future growth opportunities and to be protected from a potential rise in bad debts. Although the increased supply would weigh on the equity market, we believe that the underperformance and relatively low valuations of Chinese banks has reflected a significant part of this risk. From the beginning of 2010 until 12 May 2010, Chinese banks have underperformed the MSCI China Index and the MSCI Asia ex Japan Index by over 5% and 10% respectively. Valuations, at 10x PE, also compare favourably with the Chinese and Asian average PE of 12.8x and 12.7x respectively. Banks in China are attractively valued with good growth prospects, strong provisioning levels of over 150%, and rising net-interest margins, which currently stand at over 2.5%. However, until the overhang of equity supply is removed, it is unlikely that the banks will show sustained outperformance. Furthermore, given that commercial banks account for around a fifth of the MSCI China 10/40 benchmark, it would be difficult for the Chinese equity market to rise strongly without a strong performance by the Chinese banking sector.

As of the end of March 2010, our JF China fund had a neutral position on the banking sector, with an overweight in those banks with better asset quality at relative attractive valuations at the expense of those trading at a significant premium (CMB) or vulnerable to RMB appreciation (BOC). Our strategy regarding the banking sector has been to accumulate well-positioned stocks on weakness and to reduce positions on any outperformance.

3. Measures to curb speculation in the property market

Another significant regulatory concern weighing on the Chinese equity markets have been measures introduced by the Chinese government to dampen the residential property market. Nationwide property prices in the 70 large cities rose by 14% in the year ending March 2010 (source: UBS), with prices in cities such as Beijing, Shanghai and Shenzhen witnessing an even faster pace of price appreciation. Although the pace of price appreciation in tier-1 cities is worrying, we do not believe that there is a property bubble on a nationwide scale. Nationwide measures such as affordability, leverage and supply still look reasonable, especially taking into consideration China's continued urbanisation and double-digit growth in incomes.

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Since the end of December, the Chinese authorities have announced a series of measures to stabilise property prices and to prevent speculation in the property market. In general, the measures have focused on raising the instalment requirement for second-home purchases and raising the mortgage rates applied to these purchases. Local governments have also been asked to increase land supply for construction of mass market and low-end public housing. In addition, the urban coastal cities experiencing above-average property price rises, such as Beijing, have introduced further local regulations such as preventing banks from extending loans to third mortgages.

In a centrally-planned economy such as China's, these measures have already started to take effect. Our China team has seen major property developers cutting selling prices and delaying new launches and the construction of new projects. We have already seen transaction volumes start to decline, and we expect a further moderation of transactions and prices throughout the rest of the year. We believe that the stabilisation in prices and transaction volumes will allow the Chinese authorities to halt the introduction of further administrative measures to control the property market and this could therefore be the catalyst for a reversal in the current poor sentiment surrounding the property sector.

In terms of how we are positioned in property stocks, our JF China Fund was 2% overweight property stocks as of the end of March, but we trimmed the position given the rebound in the sector in early April. Within the sector, our strategy has been to switch our holdings in stocks that look relatively expensive, such as China Overseas Land, which is trading near its Net-asset-value (NAV), into other stocks in the sector, e.g. Glorious Property, which is trading at a discount of over 50% to NAV. We believe that the property stocks that are trading at attractive valuations relative to the rest of the property sector have already discounted a significant amount of policy risk for the year. Our strategy is to view any further significant correction as an entry point to accumulate stocks in this sector. On a structural basis, we believe that Chinese property stocks continue to provide investors with exposure to the ongoing trends of urbanisation, rising incomes and wealth creation in China.

4. Poor domestic sentiment

"Any easing of the current tightening stance by the government would be a welcome catalyst to boost retail participation"

The domestic equity market (A-shares) has been increasingly concerned that the measures to curtail bank lending and activity in the property market would negatively impact economic growth. The poor performance of the domestic market has led to concerns over the H-share market as well. A-shares still remain a very domestic-oriented market dominated by less sophisticated, short-term retail investors, resulting in higher volatility compared to the stocks listed in Hong Kong. "Sentiment" among retail investors is driven by the direction of government policy and consequently any easing of the current tightening stance by the government would be a welcome catalyst to boost retail participation.

Outlook and strategy

In conclusion, we believe that once the government and senior leaders start to ease their "tightening" tone, the market is likely to experience a relief rally. The latest property measures were introduced to stabilise housing prices, not to cause a sharp drop-off in construction activity or in overall growth. With the government increasingly concerned about global downside risks, we believe that property restrictions and monetary policy may be relaxed once it is clear that property prices have stabilised and/or global demand have started to weaken sharply.

Another potential policy catalyst to revive investor sentiment and interest in the Chinese equity market would be the long-awaited appreciation of the RMB. We expect a mild RMB appreciation for the rest of 2010 in the range of 3-5% when it will be in China's interest to do so, e.g. if inflation rises over 3%. RMB revaluation is a long-term trend, and is something that we have been expecting (at a gradual pace) over the past several years. Our funds would generally benefit from RMB appreciation given our large overweight in domestic-oriented stocks (property, consumer, insurance, selected banks) and our large underweight in exporters/manufacturing companies in China.

Although markets may range trade in the short term, we would view corrections as entry points on the back of our views that China's economic growth will remain strong in 2010, inflation remains under control, and the visibility of the earnings recovery at the corporate level remains high.

Valuations appear relatively attractive for longer-term investors, with our investment universe of Chinese stocks listed in Hong Kong trading at under 13X forward P/E on 25% 2010 expected earnings growth. Within a regional context, we retain our strategic preference for China and would look for further weakness to increase our weightings in the market. The core strategies of the JPMorgan Funds – JF China Fund remain unchanged, with an emphasis on domestic-oriented stocks, such as selected stocks in the retail, financials, property and infrastructure sectors.

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