China Strategy

Mind the gap... as China rebalances growth

- **We stay cautious on MSCI China in the coming months**, despite possible technical rebound because: (1) We see downside earnings risk to MSCI China due to the economic deceleration on the back of the combined ripple effect of the crack-down on property sector and slowdown in banks' lending to local government-funded investment projects. (2) Policy risks, such as the resource tax, which may hurt the earnings of and de-rate the multiples of the energy and upstream resources companies. (3) Tight liquidity situation in China, as reflected in the recent rise in short-term interest rate in the repo market as well as inter-bank market. (4) Possible additional tightening measures in the property and FAI areas, such as raising share capital funds requirement for investment projects, and property tax on tier one cities on a pilot basis, etc. We recommend investors to wait for a better entry point until the above-listed concerns are addressed before buying China's secular growth sectors.
- **We firmly believe in China's bright medium-term growth prospects**: (1) China boasts of a strong balance sheet at the country, household, and consumer level. Total government debt is still below 50% of GDP, which is well below the ratios of many developed countries, whose government debt to GDP ratios typically hover above 60%. China's household debt burden is also well below that of developed economies—household debt/GDP ratio by end-09 was 24.4% in China versus 88.2% in US and 64.9% in Japan. (2) Favorable demographics—China's dependency ratio, a measure showing the degree of dependents (aged 0-14 and over the age of 65) to the total working population (aged 15-64), has declined from around 50% in early 1990s to below 40% towards late 2000s, and is not expected to rise until at least 2015 by our estimates. (3) We can still find some sectors with low penetration rates and solid secular growth. (4) A powerful central government with strong execution capability to carry on the necessary economic reforms.
- **Sector views**: We are bullish on: (1) consumer staples; (2) expressways with good dividend yields; (3) new economy plays such as high-tech manufacturing and strategic new industries, such as new materials, and new energy etc; (4) menswear with strong secular growth; (5) IPPs. We stay cautious on commodities, property, home appliances, and energy.

China
China Equity Strategy

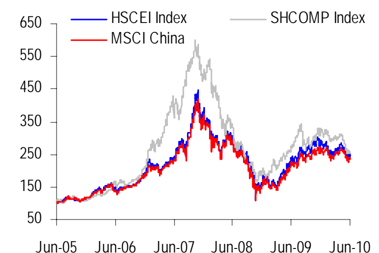
Frank Li[AC]
(852) 2800-8511
frank.m.li@jpmorgan.com

Peng Chen
(852) 2800-8507
peng.p.chen@jpmorgan.com

Lan Deng
(852) 2800-8520
lan.x.deng@jpmorgan.com

J.P. Morgan Securities (Asia Pacific) Limited

Relative index performance



Source: Bloomberg.

China top picks

	Rec	RIC ticker	Mkt cap (US$MM)	EPS Y/Y growth (%) 2010E	EPS Y/Y growth (%) 2011E	P/E (x) 2010E	P/E (x) 2011E	P/BV (x) 2010E	ROE (%) 2010E	Div. yld (%) 2010E
China Resources Power Holdings	N	0836.HK	9,423	24.7	26.9	12.3	9.7	1.8	15	2.6
Huaneng Power Int'l - H	N	0902.HK	9,683	35.0	1.7	10.9	10.7	1.0	10	2.1
China Mengniu Dairy Co. Ltd.	OW	2319.HK	5,251	15.2	34.1	26.5	19.7	3.6	15	0.8
Zhejiang Expressway	OW	0576.HK	4,047	13.6	12.2	13.6	12.1	1.9	14	4.9
Huabao International Holdings Limited	N	0336.HK	3,737	19.0	21.9	21.6	17.7	7.6	40	2.0

Source: Bloomberg and J. P. Morgan. Share prices and valuations as of 3 June 2010.

See page 44 for analyst certification and important disclosures, including non-US analyst disclosures.

J.P. Morgan does and seeks to do business with companies covered in its research reports. As a result, investors should be aware that the firm may have a conflict of interest that could affect the objectivity of this report. Investors should consider this report as only a single factor in making their investment decision.

Frank Li
(852) 2800-8511
frank.m.li@jpmorgan.com

Table of Contents

Table of Contents

Stay cautious in the coming months 5

(1) Potentially notable downward earnings revision risk for MSCI China 5

(2) Policy risks (resource tax reform) to hurt corporate earnings.......................19

(3) A relatively tight liquidity situation in China 20

4) Additional tightening measures focusing on the property and FAI areas......24

We firmly believe in China's bright medium-term growth prospects 27

(1) China boasts of a strong balance sheet at the country, corporate and consumer level 27

(2) China continues to benefit from its favorable demographic mix 28

(3) The secular growth potential in many sectors 30

(4) A powerful central government with strong execution capability to carry on necessary economic reforms..31

Sector views 32

OW: Consumer staples, expressways, new economy stocks, menswear, IPPs, and healthcare names 32

UW: Commodities (both upstream and downstream), property, home appliances, and energy...38

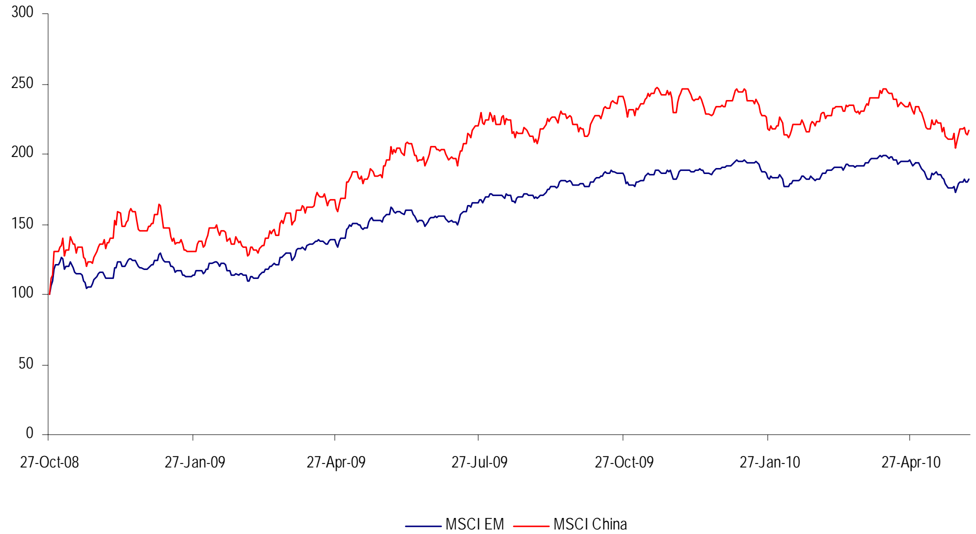
China model portfolio (CMP) adjustments 41

Cutting gaming, energy, upstream resources, and insurance 41

Increasing exposure to Zhaojin and China Railway Construction, and Sinopharm 42

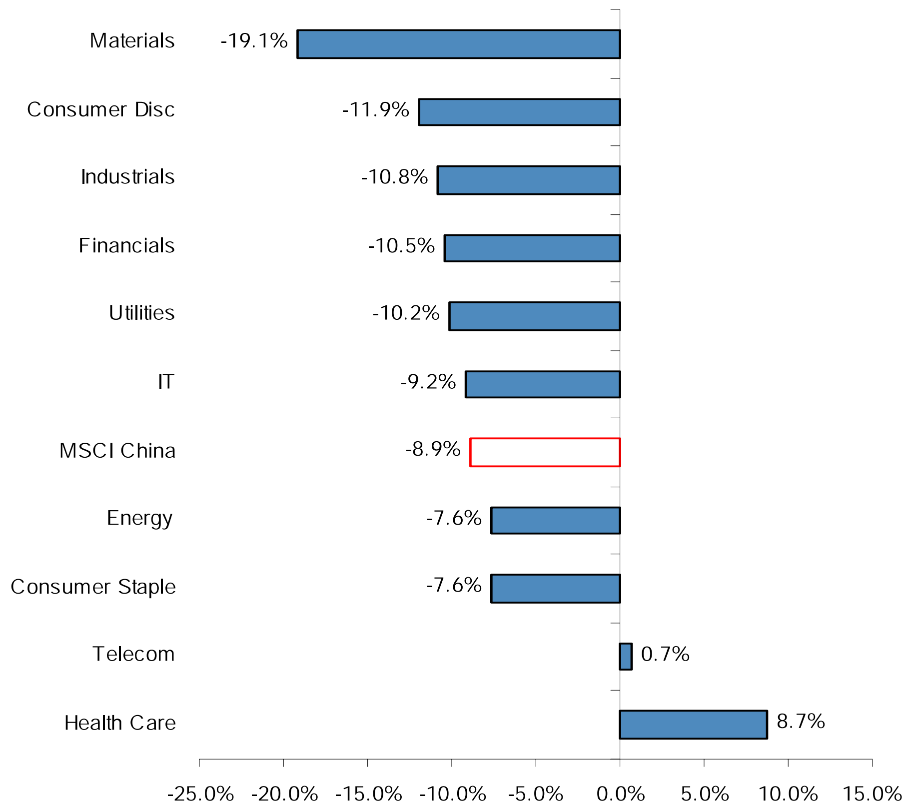
Frank Li
(852) 2800-8511
frank.m.li@jpmorgan.com

Figure 1: Price movements in basis points (as of June 3, 2010)



Source: Bloomberg.

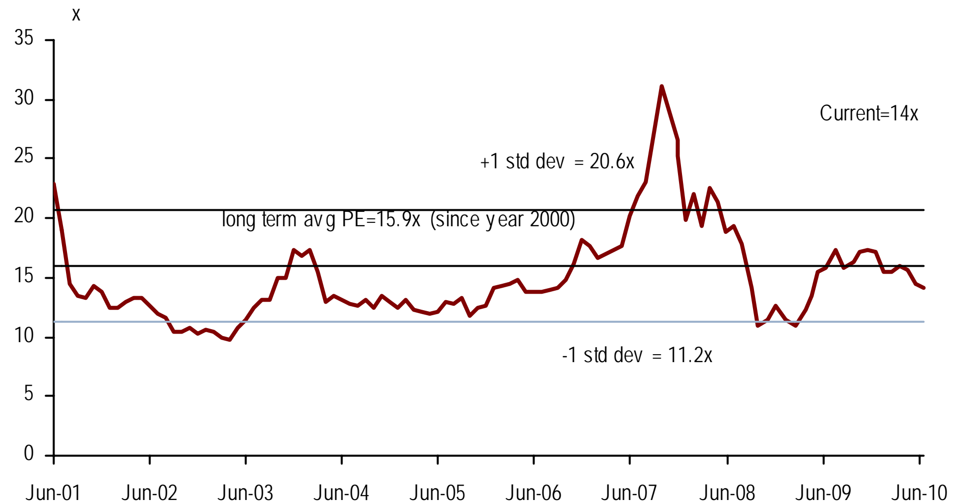
Figure 2: 2010 YTD MSCI-China price performance by sector



Source: Bloomberg. Updated as of June 3, 2010.

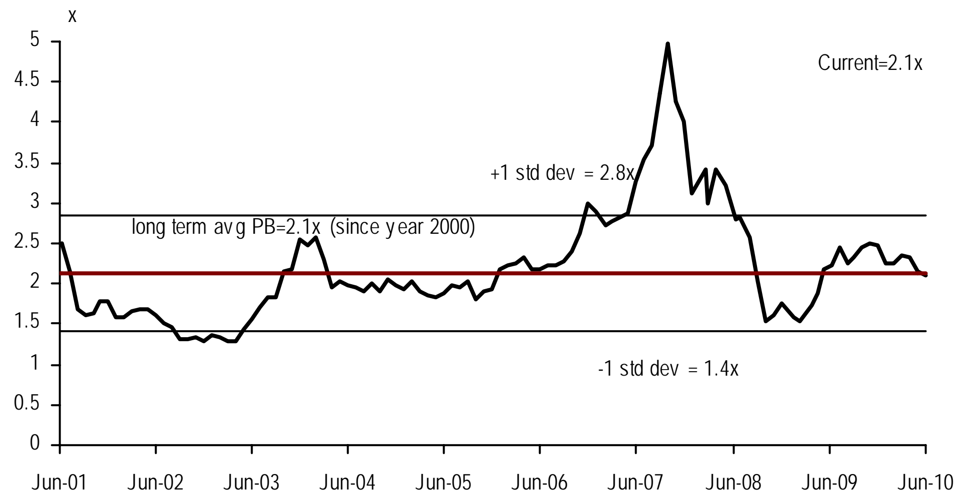
Frank Li
(852) 2800-8511
frank.m.li@jpmorgan.com

Figure 3: MSCI China trailing P/E ratio



Source: Bloomberg, J. P. Morgan.

Figure 4: MSCI China trailing P/B ratio



Source: Bloomberg, J. P. Morgan.

As of June 3, 2010, MSCI China is trading at FY10E 12.7x PER and 2.0x P/BV. Our Dec-10 MSCI-China target of 62 is based on its long-term average trailing P/BV of 2.1x (since 2000), which translates to 13.3x FY10E P/E vs. its long-term average trailing P/E of 15.9x (since 2000).

Frank Li
(852) 2800-8511
frank.m.li@jpmorgan.com

Stay cautious in the coming months

MSCI China declined 4.5% over the past month. The Financial sector was the best performer (-3.6% m/m), followed by Telecom (-4.8% m/m) and Utilities (-5.3% m/m), while Healthcare was the worst performer, down 13.4% m/m on heavy profit taking pressure.

Looking ahead, despite the expected possible technical rebound after the steep falls YTD, we remain cautious on MSCI China's performance in the coming months due to:

- Potentially notable downward earnings revision risk for MSCI China. As noted in our previous strategy reports, we maintain our view that MSCI China's earnings growth momentum should have peaked in 1Q10 due to economic deceleration on the back of the combined ripple effect of the crackdown on the property sector and slowdown in banks' lending to local government-funded investment projects.
- Policy risks, such as the resource tax, which may hurt earnings and de-rate the multiples of energy and upstream resources companies.
- A relatively tight liquidity situation in China, as shown in the recent money and bond market performance in China.
- Additional tightening measures focusing on the property and FAI areas, such as raising share capital funds requirement for investment projects, and the strict implementation of the Land Appreciation Tax, etc.

(1) Potentially notable downward earnings revision risk for MSCI China

As the corporate earnings trend in general follows the economic cycle, we could see notable downward revision in consensus earnings forecasts for MSCI China, in light of the possible economic growth deceleration due to the combined ripple effect of the crackdown on the property sector, and banks' slowdown in lending to local governments' investment projects amid NPL concerns.

Notably, we find that property related investments and local government funded infrastructural investment projects represent two major drivers of economic growth in China.

The crackdown on property market

The property sector has become an increasingly important economic growth engine as of 2005. The reported value of property FAI is equivalent to only around 12.8% of nominal GDP in 2009 (up from 9.3% in 2005). Adjusting for land sales, which should be deducted from the reported property FAI in GDP calculation, we estimate property investment accounts for around 10% of China's GDP in 2009.

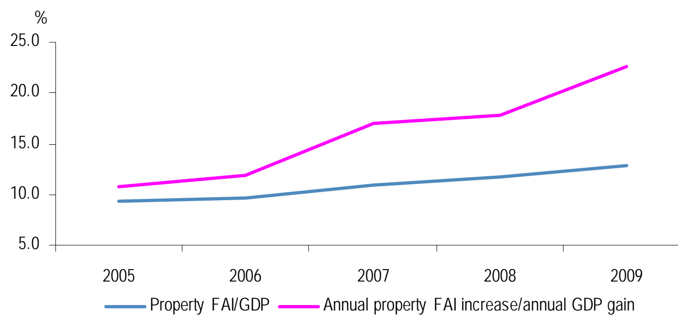
The property sector's contribution to economic growth has actually risen more sharply over the past five years, as shown by the fact that the ratio of the net increase in property FAI divided by the net increase in GDP has surged to 22.6% in FY09, from only 10.7% in FY05.

Table 1: China: Reported Property FAI Value vs. GDP

	Nominal GDP	Property FAI	Property FAI / GDP	Net increase in property FAI / net increase in GDP
	Rmb billion	Rmb billion	%	%
2005	18869.2	1752.7	9.3	10.7
2006	22165.1	2144.6	9.7	11.9
2007	26324.3	2854.3	10.8	17.1
2008	30067.0	3521.5	11.7	17.8
2009	33535.3	4306.4	12.8	22.6

Source: CEIC, J. P. Morgan estimates.

Figure 5: Property has become an increasingly important economic growth engine in China as of 2005



Source: CEIC, J. P. Morgan.

Table 2: China's FAI by sector (% share)

	Overall	Primary Industry	Mining	Manufacturing	Infrastructure	Property	Service	Other
2008	100%	1.5%	4.7%	31.3%	11.4%	23.8%	20.3%	7.1%
2009	100%	1.7%	4.2%	30.3%	13.0%	22.2%	21.7%	6.9%

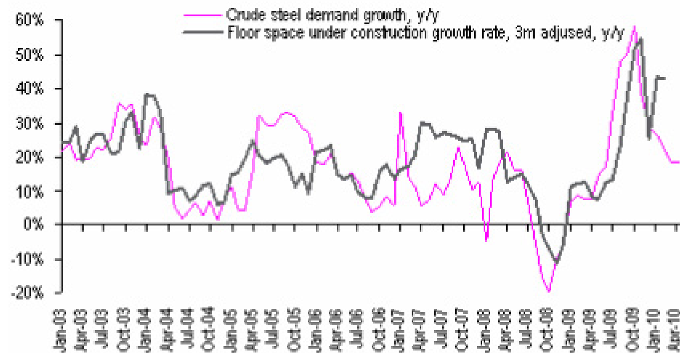
Source: CEIC, J. P. Morgan.

In addition, the property sector is closely linked with around 50 related upstream and downstream sectors, such as steel, cement, aluminum and home appliances, etc. Among others, the demand for steel, cement, and aluminum tends to chart a correlation with the property sector's floor space under construction while the demand for home appliances tends to lag property sales by six to nine months.

For instance, China's real estate sector is the largest consumer of steel products. By our estimates, the real estate sector consumes around 38% of the 560 million tons of steel produced in China last year.

Taking these into consideration, the property and its many related sectors' contribution to China's economic growth should not be underestimated, in our view.

Figure 6: China - Correlation between steel demand and floor space under construction



Source: CEIC, J.P. Morgan.

As such, considering the crucial role property and its related sectors play in driving China's economic growth in China since 2005, the government's ongoing crackdown on the sector may well exert a negative impact on economic growth.

Banks' slowdown in lending to local governments sponsored investment projects

The value of infrastructure investment is equivalent to around 7.5% of China's nominal GDP in FY09.

To counter against the global economic crisis, China resorted to infrastructure-related investment projects to jump-start the economy in late 2008. Infrastructure investment thus turned out to be a key driver in China's strong economic recovery in 2009, as indicated by the fact that the ratio of the net increase in infrastructure FAI divided by the net increase in GDP has surged to 24.0% in FY09, from only 7.5% one year earlier.

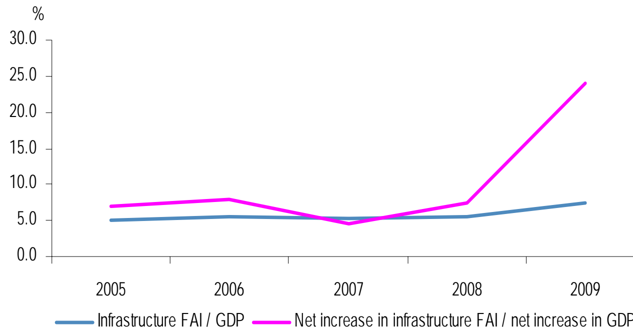
Table 3: China: Reported Infrastructure FAI Value vs. GDP

	Nominal GDP	Infrastructure FAI	Infrastructure FAI / GDP	Net increase in infrastructure FAI / net increase in GDP
	billion yuan	billion yuan	%	%
2005	18869.2	950.0	5.0	6.8
2006	22165.1	1213.7	5.5	8.0
2007	26324.3	1402.6	5.3	4.5
2008	30067.0	1684.6	5.6	7.5
2009	33535.3	2516.2	7.5	24.0

Source: CEIC, J. P. Morgan.

Frank Li
(852) 2800-8511
frank.m.li@jpmorgan.com

Figure 7: Infrastructure related investment turned out to be a key driver in China's strong growth recovery in 2009



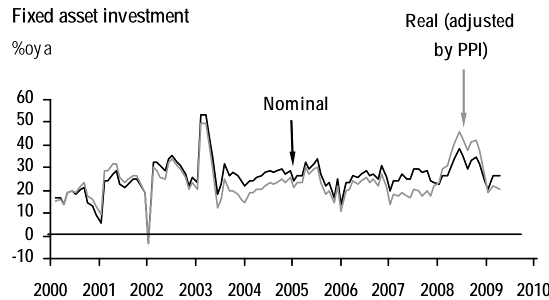
Source: CEIC, J. P. Morgan.

As most infrastructure projects involve a large amount of capital spending that may be beyond the private enterprises' financing capability, the majority of these projects are thus funded by the public sector. Among others, local government related entities undertake a lion's share (80% to 90%) of these projects, with the remainder by the central government.

A large portion of funding for the local government sponsored projects comes from commercial banks' new lending, through the channel of local government-sponsored funding vehicles (LGFV).

Given Chinese authorities' more stringent control over banks' loan expansion to LGFV, Chinese banks may be slowing down lending to local government-sponsored investment projects. Among others, the banks need time to reassess the risks related to these local government backed funding vehicles. Hence, we may see a moderation in FAI growth entering 2H this year, as less funding available for LGFV could well lead to a slowdown in the construction of new investment projects. This, in turn, could affect China's overall GDP growth in 2H10.

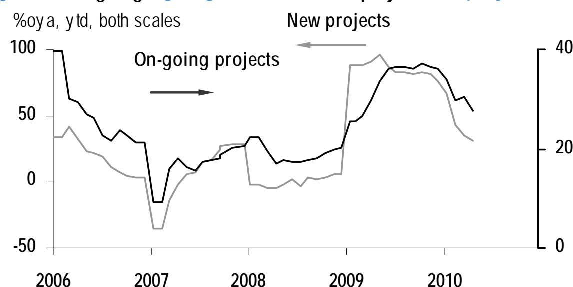
Figure 8: China: Fixed asset investment growth—both in nominal and real terms



Source: CEIC, J.P. Morgan economics.

Frank Li
(852) 2800-8511
frank.m.li@jpmorgan.com

Figure 9: China: Ongoing and new fixed investment projects



Source: CEIC, J.P. Morgan economics.

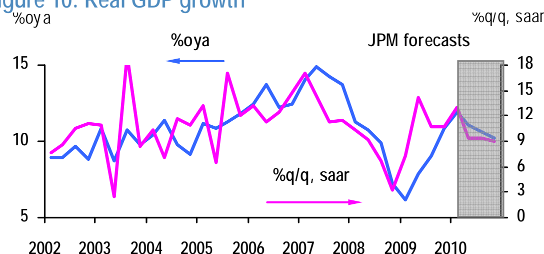
China's economic growth may slow-down from here

Bearing the above factors in mind, we maintain our view that China's GDP growth may have peaked in 1Q FY10, both on a sequential and a Y/Y basis.

Indeed, the latest macro indicators, including April's IP and May's manufacturing PMI, all indicate that the growth momentum in industrial activities seen in 1Q10 has started to eased as of 2Q10.

Meanwhile, the inventory component of May PMI rose 3.6 percentage point to 49.8%, with macro sensitive industries' (such as steel, aluminum, and cement etc) inventories experiencing a sharp rise. The expected inventory de-stocking of these macro sensitive industries is expected to hurt the related stocks' performance over the next two quarters.

Figure 10: Real GDP growth



Source: CEIC, J.P. Morgan estimates.

Table 4: China: real GDP growth

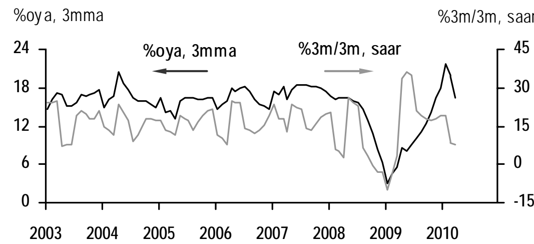
Percent change

	2009	2010E	1Q09	2Q09	3Q09	4Q09	1Q10	2Q10E	3Q10E	4Q10E
Headline GDP										
%oya	8.7	10.8	6.2	7.9	9.0	10.9	11.9	11.0	10.6	10.2
%q/q, saar			7.2	14.1	10.8	10.8	13.1	9.4	9.3	9.0

Source: CEIC, J.P. Morgan estimates.

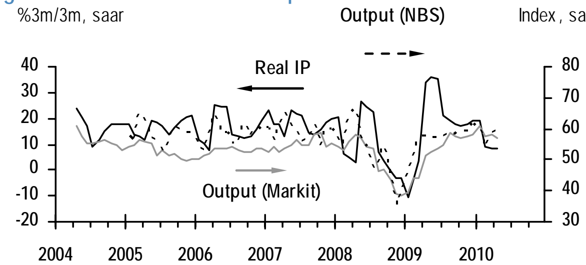
Frank Li
(852) 2800-8511
frank.m.li@jpmorgan.com

Figure 11: Real industrial production



Source: CEIC, J.P. Morgan economics.

Figure 12: China: IP and PMI output

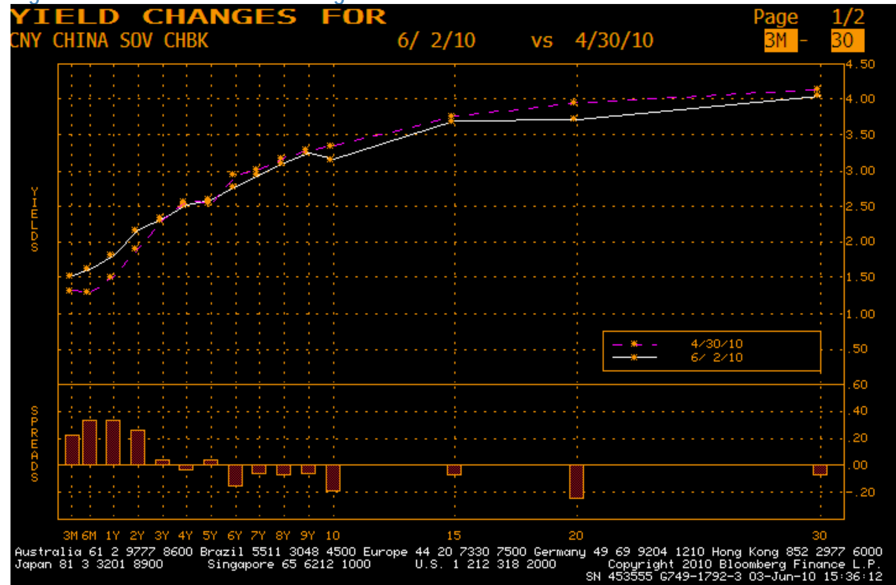


Source: CEIC, J.P. Morgan economics.

China's yield curve has started to flatten

Interestingly, the yield curve in China has started to flatten as bond traders move to factor in the risk of economic deceleration. The government bond curve has flattened with the short-end (3 month) up by 23bp and the long end (30 year) down by 8bp over the past month.

Figure 13: China: Yield curve change



Source: Bloomberg.

It remains to be seen whether the equity analysts may follow in the footsteps of bond traders to cut their FY10 and FY11 earnings forecasts in the coming months if China's economic slow-down continues.

We hold that the macro sensitive sectors, such as steel and aluminum, could slip into the red as early as 3Q10 due to the weakened demand as a result of the economic slow down.

We expect the heavy truck sector's earnings to peak in 2Q10. In fact, Weichai Power already guided for lower 2Q10 EPS on the release of its impressive 1Q10 results.

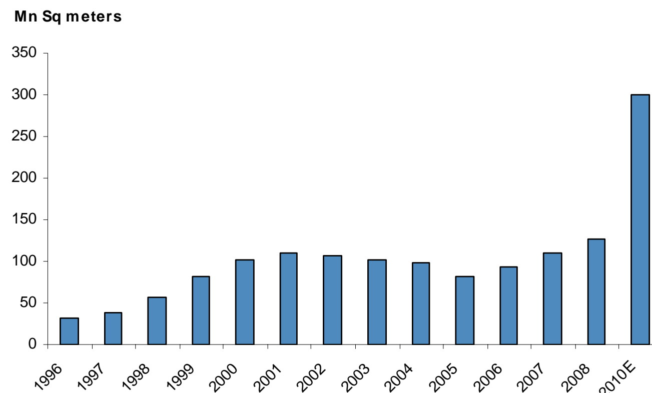
Economic housing and central government investment to cushion slowdown
Notwithstanding the above negative factors in economic deceleration, we have also noted two positive developments:

1. Speeding up of economic housing project, and
2. Re-acceleration of central government sponsored investment projects, which may help cushion the impact of an economic slowdown triggered by the crackdown on the property sector and banks' slowdown in lending to the local government's investment projects.

(a) Economic/affordable housing
As part of the plan to stabilize property prices, the authorities have stepped up its efforts to build economic housing (affordable) this year. In mid April, the State Council announced its plan to ensure the building of 3 million sets of affordable housing, as well as rehabilitation of 2.8 million units of run-down housing by 2010.

Assuming an average size of around 60 sqm per unit, this will result in over 300 million sqm of floor space under construction compared to an average of only 100 million sqm for the period of 2004-2008 (data of 2009 is not available).

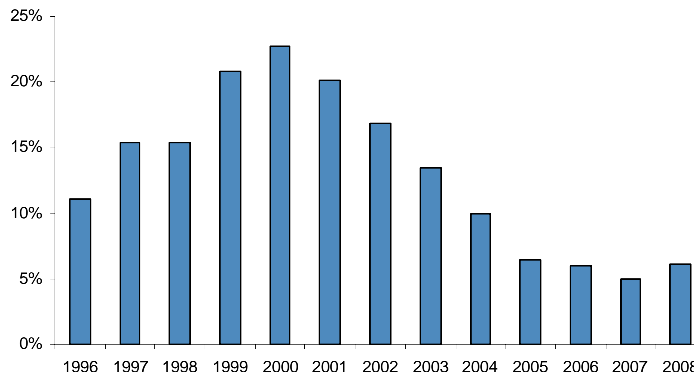
Figure 14: China: Annual space under construction for economic Housing



Source: CEIC, J.P. Morgan estimates.

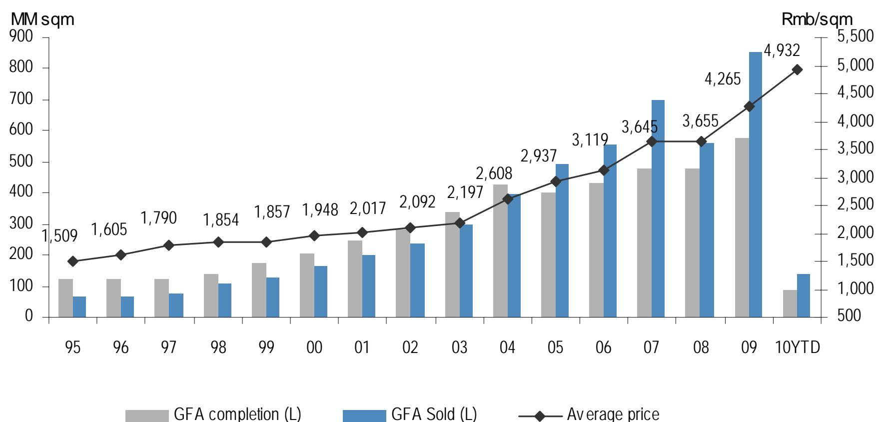
Frank Li
(852) 2800-8511
frank.m.li@jpmorgan.com

Figure 15: China: Economic housing as % of total residential sales (floor space)



Source: CEIC, J.P. Morgan property team.

Figure 16: China: Residential Commodity Building Floor Space completed vs sold and avg price



Source: CEIC, J.P. Morgan property team.

(b) Central government sponsored investment projects

Of the Rmb4 trillion economic stimulus program, the central government planned an investment of Rmb1.18 trillion. From 4Q08 to end-09, it has allocated Rmb580bn out of its committed Rmb1.18 trillion budget.

The Ministry of Finance noted in its work report in early this year that Rmb260bn of the central government's budgeted investment projects for FY09 have been carried forward to FY10, which we believe could be due to the central government's aim of smoothing the economic growth. An estimated Rmb200bn of the Rmb260bn investment projects are believed to fall under the RMb580bn allocated central government investment projects that are related to Rmb4 trillion economic stimulus program.

In other words, the remaining part of the central government sponsored investment projects related to the Rmb4 trillion economic stimulus program is around Rmb800bn, which, we believe, would be gradually activated to help cushion the impact of the slowdown in local government sponsored investment projects.

Frank Li
(852) 2800-8511
frank.m.li@jpmorgan.com

Table 5: China—Central government's spending out of the Rmb4 trillion stimulus package

	Rmb in billions
4Q08-2010 budget	1180
Total allocated through 3Q09	380
Economic housing	37.5
Rural infrastructure	104.3
Transportation infrastructure	87.1
Medical, healthcare, education and cultural	57.3
Ecological environment	39.6
Technology innovation and service industry	54.2
Total allocated by end FY09	580

Source: J.P. Morgan estimates.

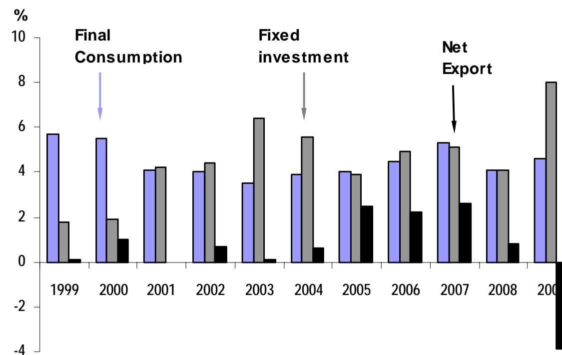
New economic growth drivers needed to replace old engines of property and investment

From a longer term perspective, we should see a trend of lower contribution to China's economic growth from the property sector and the government sponsored investment projects. This is because:

(a) Investment contributed to 8 percentage points (pt) of the 8.6pt in real GDP growth in 2009, compared to only 4.1pt out of 9pt in 2008. In contrast, the contribution to real GDP growth from consumption only managed to increase modestly—to 4.6pt in 2009 from 4.1pt in 2008.

Unless China proceeds with the economic rebalancing, i.e., shifting from an investment driven economy to a consumption driven economy, we could see problems of over-capacity in industries, etc.

Figure 17: China: Contribution to Real GPD growth by composition (%pt)



Source: CEIC and J. P. Morgan.

(b) As shown in the table and charts below, property prices in tier one cities have already risen to a rather high level.

Table 6: Beijing housing affordability analysis

	No of Person/Household	Annual Disposable Income Per Capita (Rmb)	Est household monthly disposable income (Rmb)	Price psm (Rmb)	Nominal Lending Rate (+5 Year) (%)	Mortgage rate (%)	Monthly Payment (Rmb)	Affordability index
	a	b	*c=a * b / 12 * grey income adj	d	e	f=e * 0.9	*g=PMT{f/12/100, terms, -(d * flat size * LTV ratio)}	h=g/c
1998	3.03	8,472	2,567	4,769	9.17	8.25	2,561	100%
1999	3.09	9,183	2,837	4,787	6.77	6.09	2,177	77%
2000	3.05	10,350	3,157	4,557	6.21	5.59	1,989	63%
2001	3.03	11,578	3,508	4,716	6.21	5.59	2,059	59%
2002	2.99	12,464	3,727	4,467	5.8	5.04	1,863	50%
2003	2.96	13,883	4,109	4,456	5.76	5.04	1,859	45%
2004	2.94	15,638	4,598	4,747	5.85	5.31	2,025	44%
2005	2.91	17,653	5,137	6,162	6.12	5.51	2,672	52%
2006	2.88	19,977	5,753	7,375	6.51	5.50	3,196	56%
2007	2.86	23,029	6,586	10,661	7.83	6.66	5,069	77%
2008	2.76	26,049	7,189	11,648	5.94	4.16	4,508	63%
2009	2.76	26,738	7,380	13,224	5.94	4.16	5,118	69%
2010E	2.76	29,037	8,014	17,912	5.94	5.05	7,478	93%

Source: CEIC, National Statistics Bureau, PBoC, J.P. Morgan estimates. * Affordability defined as the monthly mortgage payment as a percentage of the monthly disposable income ratio. * Assuming: (1) the grey income adjustment ratio=1.2x; (2) terms=240 month; (3) flat size=90sqm; (4) LTV=70%; and (5) FY10E property price assumption is based on the price at the end 1Q FY10.

Table 7: Shanghai housing affordability analysis

	No of Person/Household	Annual Disposable Income Per Capita (Rmb)	Est household monthly disposable income (Rmb)	Price psm (Rmb)	Nominal Lending Rate (+5 Year) (%)	Mortgage rate (%)	Monthly Payment (Rmb)	Affordability index
	a	b	*c=a * b / 12 * grey income adj	d	e	f=e * 0.9	*g=PMT{f/12/100, terms, -(d * flat size * LTV ratio)}	h=g/c
1998	3.09	8,773	2,711	3,026	9.17	8.25	1,625	60%
1999	3.08	10,932	3,367	3,102	6.77	6.09	1,411	42%
2000	3.04	11,718	3,562	3,943	6.21	5.59	1,721	48%
2001	3	12,883	3,865	4,625	6.21	5.59	2,019	52%
2002	2.9	13,250	3,842	4,886	5.8	5.04	2,038	53%
2003	2.98	14,867	4,431	6,111	5.76	5.04	2,549	58%
2004	3.03	16,684	5,055	7,683	5.85	5.31	3,278	65%
2005	3.01	18,644	5,612	6,698	6.12	5.51	2,905	52%
2006	3.01	20,664	6,220	7,039	6.51	5.50	3,050	49%
2007	3.01	23,623	7,110	8,253	7.83	6.66	3,924	55%
2008	2.97	26,675	7,922	8,182	5.94	4.16	3,167	40%
2009	2.97	28,838	8,565	12,364	5.94	4.16	4,785	56%
2010E	3	31,722	9,421	13,525	5.94	5.05	5,646	60%

Source: CEIC, National Statistics Bureau, PBoC, J.P. Morgan estimates. * Affordability defined as the monthly mortgage payment as a percentage of the monthly disposable income ratio. * Assuming: (1) the grey income adjustment ratio=1.2x; (2) terms=240 month; (3) flat size=90sqm; (4) LTV=70%; and (5) FY10E property price assumption is based on the price at the end 1Q, FY10.

Table 8: Guangzhou housing affordability analysis

	No of Person/House hold	Annual Disposable Income Per Capita (Rmb)	Est household monthly disposable income (Rmb)	Price psm (Rmb)	Nominal Lending Rate (+5 Year) (%)	Mortgag e rate (%)	Monthly Payment (Rmb)	Affordabilit y index
	a	b	*c=a * b / 12 * grey income adj	d	e	f=e * 0.9	*g=PMT{f/12/100, terms, -(d * flat size * LTV ratio)}	h=g/c
1998	3.31	11,464	3,795	5,039	9.17	8.25	2,705	71%
1999	3.2	12,326	3,944	4,663	6.77	6.09	2,120	54%
2000	3.16	13,622	4,304	4,598	6.21	5.59	2,007	47%
2001	3.12	14,416	4,498	4,049	6.21	5.59	1,768	39%
2002	3.15	13,361	4,209	4,109	5.8	5.04	1,714	41%
2003	3.07	14,765	4,533	3,474	5.76	5.04	1,449	32%
2004	3.08	16,882	5,200	4,618	5.85	5.31	1,970	38%
2005	3.11	18,288	5,688	5,114	6.12	5.51	2,218	39%
2006	3.12	19,850	6,193	6,727	6.51	5.50	2,915	47%
2007	3.14	22,469	7,055	7,993	7.83	6.66	3,801	54%
2008	3.12	25,317	7,899	8,502	5.94	4.16	3,290	42%
2009	3.12	27,610	8,614	8,988	5.94	4.16	3,479	40%
2010E	3	30,481	9,510	9,923	5.94	5.05	4,143	44%

Source: CEIC, National Statistics Bureau, PBoC, J.P. Morgan estimates. * Affordability defined as the monthly mortgage payment as a percentage of the monthly disposable income ratio. * Assuming: (1) the grey income adjustment ratio=1.2x; (2) terms=240 month; (3) flat size=90sqm; (4) LTV=70%; and (5) FY10E property price assumption is based on the price at the end 1Q, FY10.

Table 9: Shenzhen housing affordability analysis

	No of Person/House hold	Annual Disposable Income Per Capita (Rmb)	Est household monthly disposable income (Rmb)	Price psm (Rmb)	Nominal Lending Rate (+5 Year) (%)	Mortgag e rate (%)	Monthly Payment (Rmb)	Affordabilit y index
	a	b	*c=a * b / 12 * grey income adj	d	e	f=e * 0.9	*g=PMT{f/12/100, terms, -(d * flat size * LTV ratio)}	h=g/c
1998	3.33	20,245	6,742	5,609	9.17	8.25	3,012	45%
1999	3.29	20,548	6,760	5,400	6.77	6.09	2,456	36%
2000	3.31	21,577	7,142	5,595	6.21	5.59	2,442	34%
2001	3.33	22,673	7,550	5,812	6.21	5.59	2,537	34%
2002	3.22	24,939	8,030	5,829	5.8	5.04	2,432	30%
2003	3.19	23,885	7,619	5,790	5.76	5.04	2,415	32%
2004	3.24	25,875	8,383	5,869	5.85	5.31	2,504	30%
2005	3.2	28,665	9,173	7,921	6.12	5.51	3,435	37%
2006	3.21	32,015	10,277	9,875	6.51	5.50	4,279	42%
2007	3.22	33,593	10,817	13,370	7.83	6.66	6,357	59%
2008	3.25	26,729	8,687	12,823	5.94	4.16	4,963	57%
2009	3	29,245	9,504	14,389	5.94	4.16	5,569	59%
2010E	3	32,169	10,455	23,266	5.94	5.05	9,713	93%

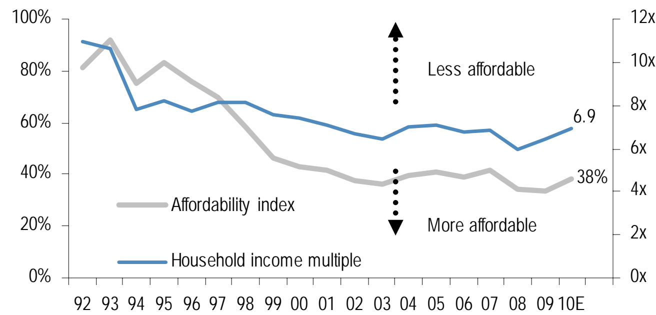
Source: CEIC, National Statistics Bureau, PBoC, J.P. Morgan estimates. * Affordability defined as the monthly mortgage payment as a percentage of the monthly disposable income ratio. * Assuming: (1) the grey income adjustment ratio=1.2x; (2) terms=240 month; (3) flat size=90sqm; (4) LTV=70%; and (5) FY10E property price assumption is based on the price at the end 1Q, FY10.

Table 10: China national housing affordability analysis

	No of Person/Household	Annual Disposable Income Per Capita (Rmb)	Est household monthly disposable income (Rmb)	Price psm (Rmb)	Nominal Lending Rate (+5 Year) (%)	Mortgage rate (%)	Monthly Payment (Rmb)	Affordability index
			*c=a * b / 12 * grey income				*g=PMT{f/12/100, terms, -(d * flat size * LTV	
	a	b	adj	d	e	f=e * 0.9	ratio)}	h=g/c
1998	3.16	5,425	1,714	1,853.56	9.2	8.3	996	58%
1999	3.14	5,854	1,838	1,857.02	6.8	6.1	846	46%
2000	3.13	6,280	1,966	1,948.43	6.2	5.6	851	43%
2001	3.10	6,860	2,126	2,016.75	6.2	5.6	880	41%
2002	3.04	7,703	2,342	2,091.72	5.8	5.04	873	37%
2003	3.01	8,472	2,550	2,197.35	5.8	5.04	917	36%
2004	2.98	9,422	2,808	2,607.97	5.8	5.31	1,113	40%
2005	2.96	10,493	3,106	2,936.96	6.1	5.51	1,274	41%
2006	2.95	11,759	3,469	3,119.25	6.5	5.50	1,352	39%
2007	2.91	13,786	4,012	3,645.18	7.3	6.24	1,677	42%
2008	2.91	15,781	4,592	3,654.56	7.6	5.31	1,560	34%
2009	2.89	17,175	4,963	4,264.50	5.9	4.16	1,651	33%
2010E	2.89	18,548.62	5,361	4,931.64	5.94	5.05	2,059	38%

Source: CEIC, National Statistics Bureau, PBoC, J.P. Morgan estimates. * Affordability defined as the monthly mortgage payment as a percentage of the monthly disposable income ratio. * Assuming: (1) the grey income adjustment ratio=1.2x; (2) terms=240 month; (3) flat size=90sqm; (4) LTV=70%; and (5) FY10E property price assumption is based on the price at the end 1Q, FY10.

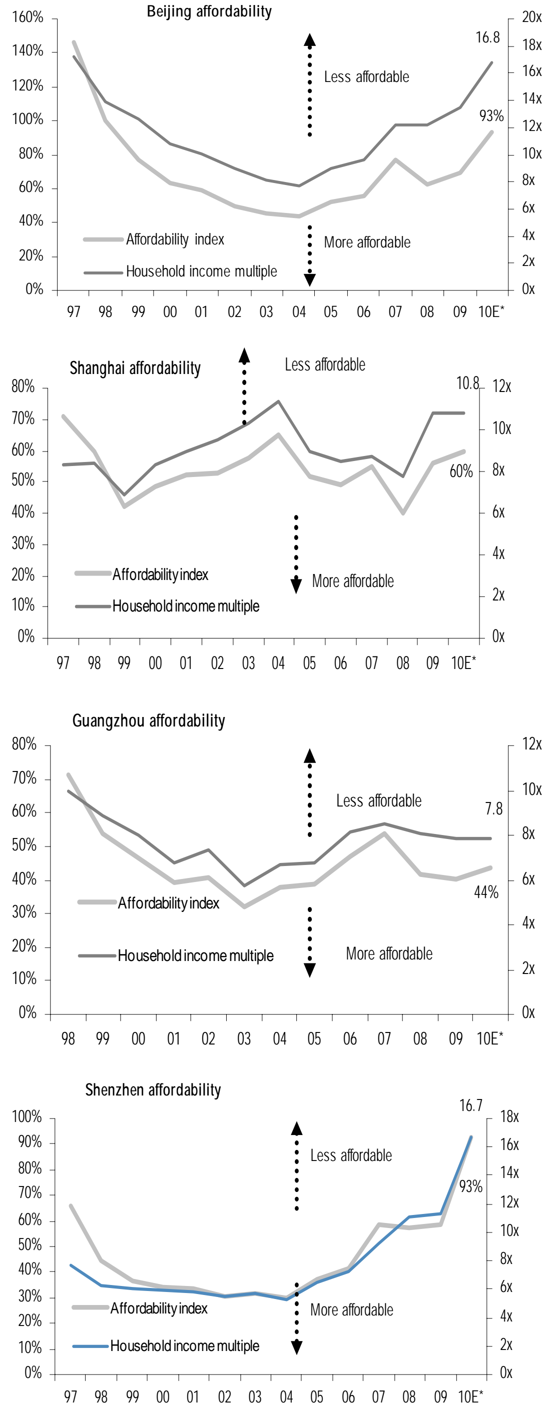
Figure 18: China: Housing affordability on the national level



Source: CEIC and J. P. Morgan property team. * Affordability defined as the monthly mortgage payment as a percentage of the monthly disposable income ratio * FY10E property price assumption is based on the price at the end 1Q, FY10.

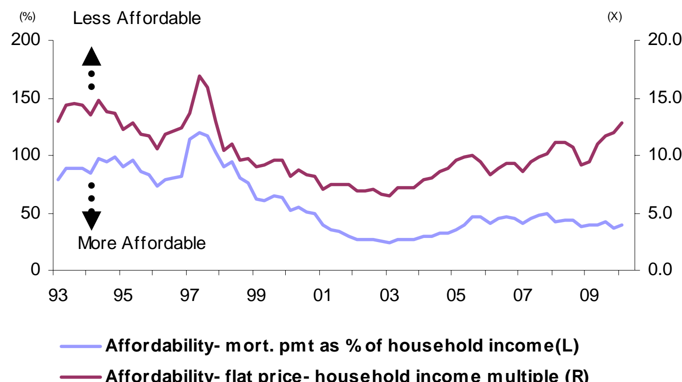
Frank Li
(852) 2800-8511
frank.m.li@jpmorgan.com

Figure 19: China: Housing affordability in tier one cities of Beijing, Shanghai, Shenzhen, and Guangzhou



Source: CEIC and J. P. Morgan property team. * Affordability defined as the monthly mortgage payment as a percentage of the monthly disposable income ratio. * FY10E property price assumption is based on the price at the end 1Q, FY10.

Figure 20: Hong Kong housing affordability analysis



Source: CEIC and J. P. Morgan property team. * Affordability defined as the monthly mortgage payment as a percentage of the monthly disposable income ratio * FY10E property price assumption is based on the price at the end 1Q , FY10.

If we assume China's FY10E property price be at the level of the end 1Q, FY10, we expect the monthly mortgage payment as a percentage of the monthly disposable income ratio in the tier one cities of Beijing, Shanghai, Guangzhou, and Shenzhen to rise to a high of 93%, 60%, 44%, and 93% respectively in FY10.

China started the housing reform in 1998, and the commodity housing market was not developed into a critical mass until 2004, which means that affordability ratio before 2003 may not be a meaningful comparison base.

China's national average monthly mortgage payment as a percentage of the monthly disposable income ratio averages at 38%, as helped by the relatively lower ratios in tier two and tier three cities. This is comparable to the ratio of 40% in HK expected for FY10.

In our view, this shows that the government cannot afford to loosen its tightening efforts on the rather high property market in tier one cities until prices come down by 20-30%. It could represent a risk to the general economy if the government does not take determined measures to tame the rather high property prices in tier one cities.

In other words, China needs to find new powerful growth engines to replace the property sector and the government sponsored infrastructural investment projects to drive China's long term growth. In our view, China has identified, among others, consumer, healthcare, and the so-called new economy sectors (hi-tech, 3G tele equipment, new energy, new materials etc) as the prospective new economic growth drivers. However, it may take time for these new drivers to be developed into powerful growth engines to replace the old powerhouses such as the property sector.

While we believe in the government's capability in engineering a perfect economic re-balancing, i.e., shifting from the property and investment driven growth mode to the consumption and service driven growth mode, the economic transition itself could create a lot of uncertainties in terms of timing and financial costs.

Frank Li
(852) 2800-8511
frank.m.li@jpmorgan.com

(2) Policy risks (resource tax reform) to hurt corporate earnings

Given the reduced concerns on CPI and rising funding needs from local governments to undertake economic housing and healthcare reform, we expect China to push forward with a series of pricing and tax reforms for industries like energy, upstream resources, water, gas and IPPs in the coming months.

Most of these necessary reforms that have been put on hold due to the financial crisis as of 2008, such as resource tax reform and resource price liberalization reform, if implemented, may translate into higher operating costs for many related companies.

Among others, we believe the first move may come from the resource tax reform, for the following two reasons:

- Falling commodity prices on deepening euro debt crisis could help arrest the consistent rise in China's PPI since Dec-09, which reduces the concern of the rising PPI being transmitted into the elevated CPI. This means FY10 may turn out to be a good time for China to launch the resource tax.
- China may want to boost tax revenue to help fund the increased spending on public welfare such as building a well covered healthcare system and boosting economic housing for low income residents. Since announcing the new "Healthcare Reform Implementation Plan" in Apr-09, China's different levels of governments had reportedly (*source: Economic Observer*) spent Rmb390.2 billion in the healthcare reform for the 10 months ending Feb-10, according to Economic Observer which quoted NDRC sources. Meanwhile, as noted above, China has announced to build 3 million sets of affordable housing for FY10.

On 20 May, 2010, China announced that the "new resource tax" will be applied to the production of oil, natural gas and coal in Xinjiang Autonomous Region.

Under the old resource tax regime, the tax was charged at a fixed rate based on production volume. The proposed new resource tax to be adopted in Xinjiang will instead be charged at 5% of sales revenue of oil and natural gas, and 2-5% of revenue of coal.

We believe the move in Xinjiang may be the precursor of a country-wide resource tax reform, which may be applied to all upstream resource products (oil, natural gas and coal, etc) across the whole country. Given that the government tends to favor gradualism policies, we expect China to gradually increase the resource tax rate to the target level of 5% of sales revenue for upstream resources companies within the next few years.

If the long discussed resources tax reform is to be rolled out to the entire country in the coming months as we expect, China's oil and upstream resource companies could be negatively affected by the downward earnings revision and multiple de-rating pressure.

(a) New resource tax impact on Chinese oil companies
Assuming 5% resource tax will be levied on sales revenue of onshore oil and gas products across the country starting July 1, 2010, we expect the EPS impact on PetroChina and Sinopec would be -6% and -4%, respectively.

That said, investors should not write off the full year impact. Our oil and gas analyst Brynjar Bustnes estimates that 2011 impact on a nation-wide change would be more meaningful on EPS for PetroChina (-12%) and Sinopec (-7%).

In contrast, we don't expect offshore/CNOOC to be affected by this change offshore China is subject to the so-called production sharing contracts (PSC), whereby a resource tax charged at 5% of revenue is already in place. Only in the event we see a higher onshore resource tax than 5%, do we expect it to possible affect CNOOC.

Table 11: PetroChina EPS down 12% in 2011E on new resource tax, Sinopec EPS down 7%

Impact of 5% resource tax	2010E	2011E	Impact of 5% resource tax	2010E	2011E
PetroChina	**Half year**	**Full year**	**Sinopec**	**Half year**	**Full year**
E&P operating profits	-7%	-14%	E&P operating profits	-9%	-18%
Total operating profits	-5%	-11%	Total operating profits	-3%	-6%
EPS	-6%	-12%	EPS	-4%	-7%

Source: J.P. Morgan Oil and Energy team.

(b) The new resource tax impact on coal companies
Assuming the new resource tax be levied at 5% of realized coal prices, the FY10E net profit impact on Shenhua, China Coal and Yanzhou Coal will be -8.7%, -15.7% and -14.0%, respectively.

Table 12: Impact of prospective resource tax on coal companies' earnings

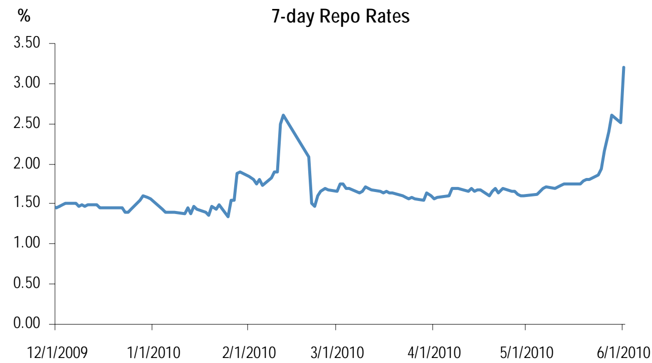
Million Rmb	Estimated resource tax uncer current regime	Estimated resource tax under scenario two	Implied negative earnings impact under scenario two
Shenhua	952	5,359	-8.7%
China Coal Energy	462	2,561	-15.7%
Yanzhou Coal	152	1,419	-14.0%

Note 1: Current resource tax on coal is levied on sales volume of each company at a rate of Rmb3-4 per ton; Note 2: Assuming the prospective resource tax is to be levied on the realized coal prices at a rate of 5%; Note 3: The FY10E earnings forecast of Shenhua, China Coal, and Yangzhou Coal is based on Bloomberg consensus forecast;
Source: J.P. Morgan estimates and Bloomberg.

(3) A relatively tight liquidity situation in China

(a) We find that overall liquidity condition in China may be rather tight, as reflected in the recent rise in short-term interest rate in the repo and inter-bank markets. As shown in the charts below, the 7-day Repo rate jumped to 3.20% on June 1st from 1.86% a week ago, while the Shanghai inter-bank rate surged to 3.20% on June 1st from 1.87% a week ago.

Figure 21: China: 7-day Repo Rates



Source: Bloomberg.

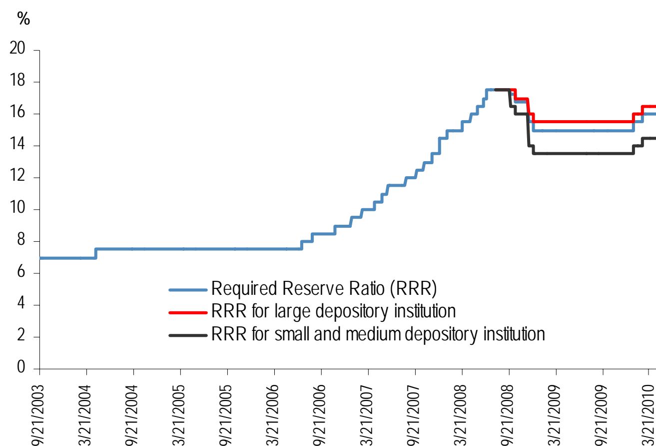
Figure 22: China: Shanghai Inter-bank Offered Rate (SHIBOR): 1 Week

Source: CEIC.

According to the *21 Century Reporter*, the lending rate in the underground money market in Wenzhou has shot up as of May 2010, with the annualized lending rate in the black market reportedly rising to a range of between 12% to 96%.

While some people may attribute the recent hike in 7-day Repo rate to Bank of China's convertible bond issue or possibility that a part of the "hot money" may be leaving China under the reduced Rmb appreciation expectations, we believe the reason could be due to the consecutive RRR hikes, which may have started to affect the domestic liquidity situation.

Figure 23: China: Required Reserve Ratio (RRR)



Source: CEIC.

(b) Chinese banks may be asked to reduce lending in May and June, compared to the average amount of loan lent during the first four months of the year, which may further hurt the domestic liquidity conditions for the near term.

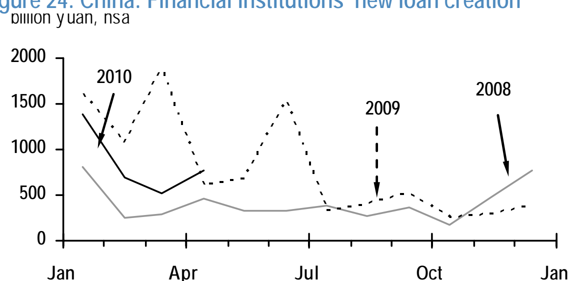
CBRC has asked banks to follow the quarterly loan creation quota, which is set with 30%, 30%, 20%, and 20% of the budgeted Rmb7.5 trillion new loans for FY10 in 1Q, 2Q, 3Q, and 4QFY10, respectively.

In reality, however, banks lent Rmb3.3748 trillion for the first four months of the year. This means only Rmb1.101 trillion would be available for lending in May and June, if the banks strictly comply with the quarterly loan quota.

This translates to an average monthly loan of just Rmb500 billion for May and June, much lower than the average of Rmb843.7 billion for January to April.

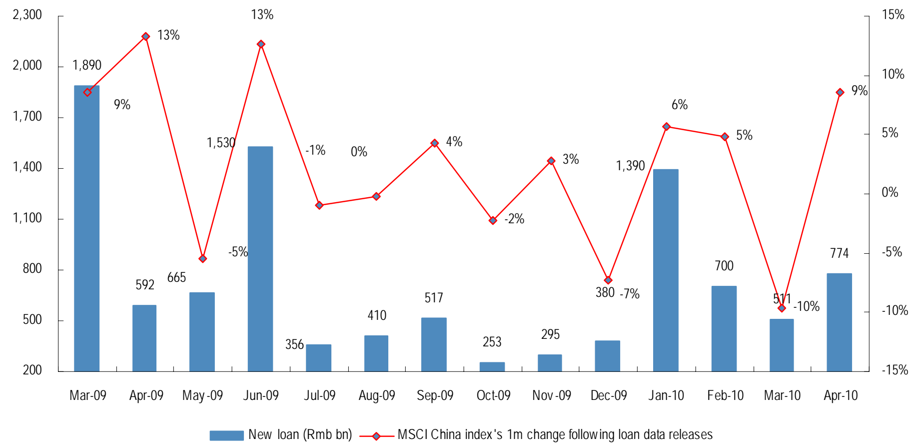
This, together with the real economy's possible weakened demand for loans amid the economic deceleration, means that China's new loan creation in May could record as low as Rmb500bn.

Figure 24: China: Financial institutions' new loan creation



Source: CEIC.

Figure 25: MSCI China's performance and the change in monthly new loan creation



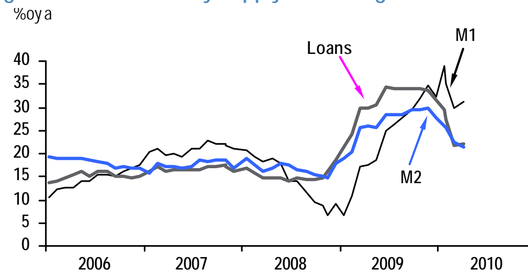
Source: CEIC, Bloomberg and J.P. Morgan. Please note that April loan data were announced on 11th May, so we use 3 week change instead of 1 month change after April loan data was released.

(c) If we look more broadly at the monetary supply growth in China, the overall situation also points to an increasingly tight liquidity condition in 2Q this year.

We find that China's M2 growth has dropped from its peak of 29.7% in November, FY09 to 21.5% in April FY10, which is still above the government's FY10E M2 growth target of 17%.

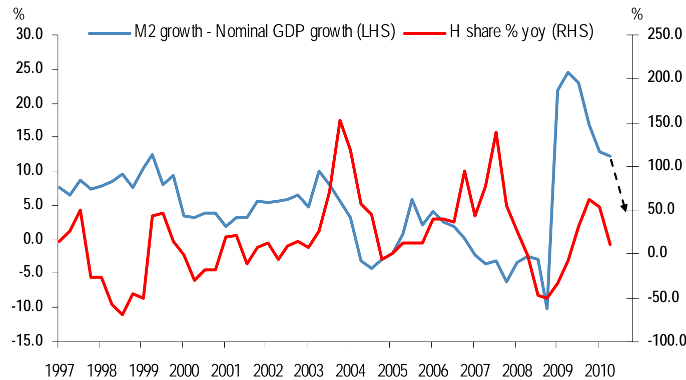
Up to now, the top authorities have steadfastly followed the policy of moderating China's money supply growth towards the above pre-set target.

Figure 26: China: Money supply and loan growth



Source: CEIC.

Figure 27: China—Correlation between the excess liquidity change and H-shares' performance



Source: CEIC, J.P. Morgan estimates.

4) Additional tightening measures focusing on the property and FAI areas

(a) With regard to the property market, we believe the Chinese government may put on hold some tightening measures, such as introducing the "property tax" in tier one cities, amid the deepening euro debt crisis and the resultant global financial market turmoil. That said, it is difficult for the government to loosen the tightening measures for the sector until the rather high property prices in tier one cities are brought under control because:

- Property prices in tier one cities have already risen to a rather high level. (*For more details, please refer to the text and charts on Page14-18*),
- High property prices that have become No.1 complaint target for Chinese people. In the previous National People's Congress (NPC), there are many motions filed by delegates representing different walks of society to tame the high property prices. As such, the high price has become a major social issue the government officials now pay great attention to.

In our view, the government may not loosen its clampdown on the property sector until prices in first-tier cities have declined by 20% to 30%. Should the property prices in tier one cities come down by 20-30%, we may see a notable pick up in genuine self-use property demand.

In fact, we find that the government continues to tighten the property sector even amid the deepening euro debt crisis. For instance, on May 26th, the State Taxation Bureau issued a notice on the Settlement of the Land Appreciation Tax, which asks for the strict collection of the land appreciation tax for the property developers.

Frank Li
(852) 2800-8511
frank.m.li@jpmorgan.com

Table 13: Tightening policy measures introduced in the property market since mid-April 2010

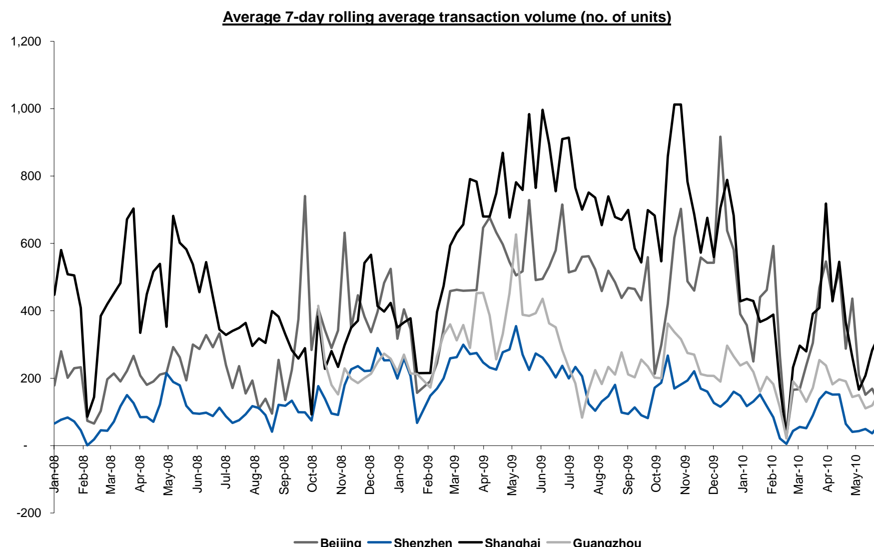
1	To implement differentiated loan policies; raising down payment requirement for 2nd home buyers to 50% from 40% and strictly implementing 1.1x PBoC rate for such buyers; for first time homebuyers acquiring 90m2 or above homes, down payment requirement set at 30% (up from minimum 20%). Also, if situation warrants, banks are to stop lending to buyers purchasing their 3rd home, as well as restricting non-resident home purchases in order to suppress speculative demand.
2	To increase land supply in cities where property prices have gone up too fast; to increase land supply for residential development, and to effectively reduce land hoarding activities. To evaluate different means for land sales in order to avoid excessive increase in land prices for residential development
3	To enhance the composition of land supply; to increase land supply for ordinary housing / affordable housing. 71% of 2010 planned land supply would be zoned for affordable housing; residential land supply is budgeted to be at 180,000hectares, +135% Y/Y; to increase the supply of small/medium sized ordinary housing
4	To ensure 3 million units of affordable housing to be built in 2010
5	To better regulate land acquisition activities of property developers, and to punish for land speculation; to better manage financing risks of property developers; for developers who are identified as involved in land hoarding activities, commercial banks would not be allowed to release new project financing loans to them; CSRC would also have to refrain from letting them do equity/debt financing in the capital market.
6	To strengthen market regulation on property transactions; local governments should ensure projects which have obtained pre-sale consents to be launched to the market as soon as possible; once the presale consent is released, developers would have to launch all units within a certain time frame; no major deviation from the original price list would be allowed
7	To improve property-related information dissemination; to increase the transparency of construction/land supply plans, to improve data availability regarding property transactions and price movements of different property types in different cities/districts
8	The Beijing government banned all families from buying more than one property, and ordered the firm implementation of central government policies that ban mortgages for purchases of a third or third-plus home.
9	The Hangzhou government announced an increase in deed tax to 1.5% from 1% for non-first time homebuyers who purchase apartments of less than 90 square meters.
10	Shenzhen will limit home purchases by foreigners and citizens of Hong Kong, Macau and Taiwan to one residence until the end of the year.
11	Soufun News reported on May 12th that Shanghai may start to impose property tax soon, based on the aggregate of total units held per households divided by household size. A fee of 0.6%-1.5% on appraised value would be charged on the area above certain minimum size per capita.
12	On May 26th, the State Taxation Bureau issued a notice on the Settlement of the Land Appreciation Tax for the property developers.
13	On May 31, NDRC announced that China will implement a gradual property tax reform, though no timetable was provided regarding the levy of the property tax

Source: Ministry of Finance, State council, J.P. Morgan.

So far, the above tightening measures have resulted in a sharp drop in transaction volume in the property market, with the transaction volume in tier one cities of Beijing and Shanghai down 50%M/M and 43%M/M, respectively, in May. Yet such measures have so far done little in bringing down the property prices. This, in turn, has made it difficult for the government to loosen its tightening measures for the property market.

Frank Li
(852) 2800-8511
frank.m.li@jpmorgan.com

Figure 28: China: Property transaction volume in tier one cities of Beijing, Shanghai, Shenzhen, and Guangzhou



Source: J.P. Morgan real-estate team.

(b) On the FAI front, in May 2009, China reduced capital requirement ratio for property projects from 35% to 20%, for coal sector from 35% to 30%, and for railway and highway sector from 35% to 25% in an effort to boost economic growth. To cool down the fixed asset investment growth, we believe China may increase the capital requirement ratio for these projects back to 35%.

Chinese banks normally do not allow companies to use loans from one bank (except from China State Development Bank, which is treated as a long-term stable funding source) to be used as share capital funds for investment projects when they apply to borrow money from other banks. During the lending spree last year, we believe such a requirement may not have been strictly followed. We believe banks may be asked to strictly follow the above rule again this year, which will make it difficult for investment projects with insufficient share capital funds to obtain bank credit.

Last but not least, given the government is now determined to push forward economic transition from an investment driven economy to consumption and service driven one, and China is yet to achieve 20% reduction target in energy consumption per unit of economic output from 2006 to 2010 (China's energy consumption per unit GDP has only dropped by 14% from 2006), the government has recently launched a series measures to crackdown on energy intensive and polluting industries.

Among others, China's State Council issued a notice requiring local governments to sign the so called "responsibility letter" to achieve the target of "cutting excess capacities in energy intensive and pollutive industries, such as steel, aluminum and cement, to achieve energy and emission reduction targets". Different government entities have started to come up with policies to crackdown on these industries. For instance, the CBRC (the banking regulatory commission) has issued a notice to banks to restrict lending to these industries. The Ministry of Land Resources noted that it would restrict land supply to these energy intensive and highly pollutive industries. The NDRC has apparently asked IPPs to remove the preferential power tariffs that used to be applied to these energy intensive industries.

We firmly believe in China's bright medium-term growth prospects

Despite our cautious view on MSCI China's performance for the coming months, we disagree with doomsayers' view that China will crash. We firmly believe in China's bright medium-term growth prospects, given its strong balance sheet, favorable demographics, secular growth potential in many sectors, and strong central government. We recommend investors to wait for a better entry point until the above-listed concerns are addressed before buying secular growth sectors.

(1) China boasts of a strong balance sheet at the country, corporate and consumer level

We believe the possibility of a financial crisis to emerge from China is minimal given its solid balance strength at the country, household and consumer level. Unlike some developed countries, China has been cautious in leveraging up its balance sheet in the past decade. Most people/entities have maintained a relatively high level of savings, with a rather low level of gearing.

(a) On the sovereign front, China's balance sheet is very strong compared with major developed countries. As shown in the table below, China's total government debt is still below 50% of GDP (with the central government debt to GDP standing at around 20%, and implicit local government debt to GDP estimated to be no more than 30%) by end of 2009. This is still well below the ratios of many developed countries, whose government debt to GDP typically hover above 60%.

More importantly, China's debt is mostly domestically claimed—only 4.4% of government debt was held by foreign investors by end of 2009—which make it less vulnerable to international liquidity constraints.

China also maintains hefty current account surplus (6.3% of GDP for FY09), and manageable fiscal deficit (2.2% of GDP for FY09). In addition, China possesses the world's largest foreign exchange reserves, which, amounting to almost 50% of China's nominal GDP in FY09, provides a solid buffer against any potentially significant external liquidity shortage.

Table 14: China's balance sheet strength (at sovereign level) compared to developed countries

	China	US	UK	Germany	Japan
Government Debt/GDP (eop, 2009), %	< 50 *	86.5 *	68.1	73.2	202.7
% government debt held by foreign investors (eop, 2009), %	4.4	30.0	27.0	52.6	6.5
Fiscal Deficit/GDP (2009), %	2.2	10.3	11.5	3.3	11.3
Current account balance/GDP (2009), %	6.3	-2.9	-1.6	3.6	2.8
Official fx reserves/GDP (eop, 2009), %	49.2	N/A	2.6	1.80	20.19

Source: CEIC, J.P. Morgan economics. * Note: China's official public sector debt at about 20% of GDP, the implicit burden of local government debt no more than 30% of GDP; US's data only considers Federal debt rather than State and Local government debt

(b) Chinese consumers have been slow in building up their leverage due to both the conservative cultural tradition and a less developed consumer finance platform in China. As such, China's household debt burden is well below that of the developed economies—the household debt/GDP ratio by end-09 was 24.4% in China versus 88.2% in US and 64.9% in Japan.

Chinese consumers possess a relatively strong balance sheet (household deposits/debt coverage at 4.7x by end-09), which is due to households' over-savings over the last decade. We find that the saving ratios for Chinese urban and rural residents have been rising since 1995, despite the steady increase in households' disposable income, as reflected in the fact that residents' propensity to consume has been falling for the period.

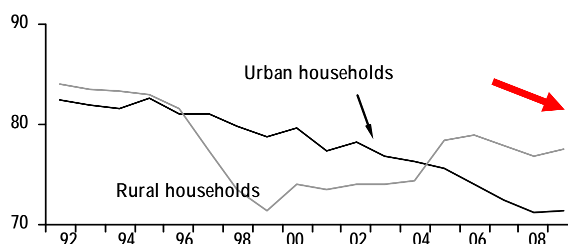
Hence, Chinese consumers' rich cash position should help China develop consumption as a key economic growth engine in the future.

Table 15: China's Household Debt/GDP ratio notably lower than US and Japan

	China	US	Japan
Household Debt/GDP (eop, 2009), %	24.4	88.2	64.9

Source: CEIC, J.P. Morgan economics.

Figure 29: China: Urban and Rural residents' propensity to consume has been declining



Source: CEIC and J. P. Morgan.

Table 16: China: Deposit and loans

	US $ bn equivalent	% of GDP
GDP (2009)	4909.5	
Total Deposit	8757	178.4
Household deposit	3877.2	79
Corporate deposit	4360.4	88.8
Total bank loans	5855.4	119.3
Corporate loans	4657.2	94.9
Consumer loans	1198.2	24.4
Official fx reserve	2416	49.2

Source: CEIC and J. P. Morgan Economics.

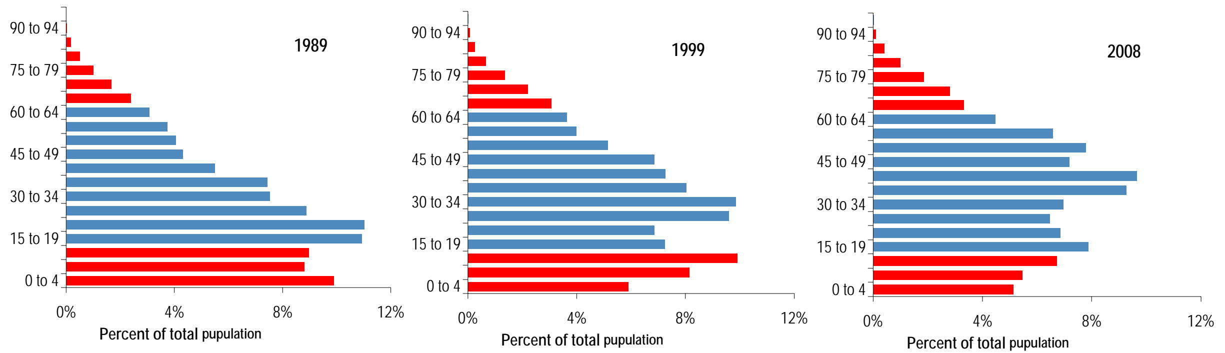
(2) China continues to benefit from its favorable demographic mix

China's favorable population mix, as reflected in an increasing portion of working age population within the total population, has been a significantly favorable factor in driving rapid economic growth during the last quarter century.

The dependency ratio, a measure showing the degree of dependents (aged 0-14 and over the age of 65) to the total working population (aged 15-64), has declined from around 50% in early 1990s to below 40% towards late 2000s.

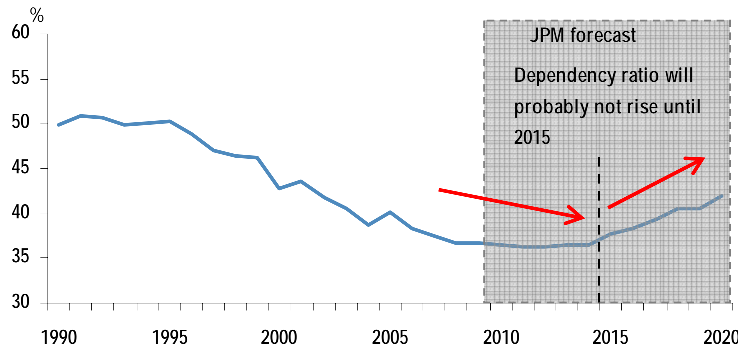
The so-called "demographic dividend" has hence enabled China to enjoy an abundant supply of labor, carry a comparatively light pension burden, and allocate more national wealth to boost economic growth over the past decade.

Figure 30: China: Population age structure in 1989, 1999, and 2008



Source: CEIC.

Figure 31: China's dependency ratio (number of individuals aged below 15 or above 64 divided by number of individuals aged 15 to 64) from 1990 to 2020E.

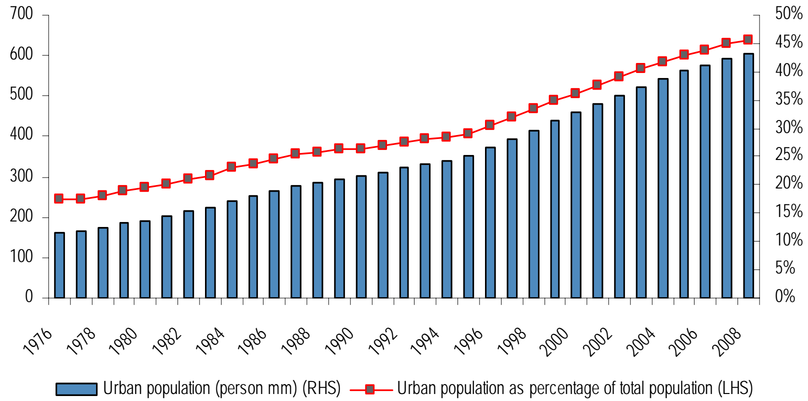


Source: CEIC and J. P. Morgan estimates.

Looking forward, we believe China's demographic dividend will continue to support economic growth. Based on our forecast, China's dependency ratio is not expected to rise until 2015 (figure above), which means the favorable demographics will remain in place for the next 5 years. This should continue to provide abundant labor supply and entail manageable pension burden for China in the foreseeable future.

The government has been dedicated since the 10th "Five-year Plan" to invest more resources in education and training to raise labor productivity, upgrade industrial base from labor-intensive processing business to high-tech manufacturing and strategic new industries, build a well-covered social safety network and speed up the urbanization process. These efforts, if maintained, could help China to transform its quantitative demographic dividend to a qualitative one, which will in turn cement a foundation for China's medium-term economic prosperity.

Figure 32: China's urbanization process



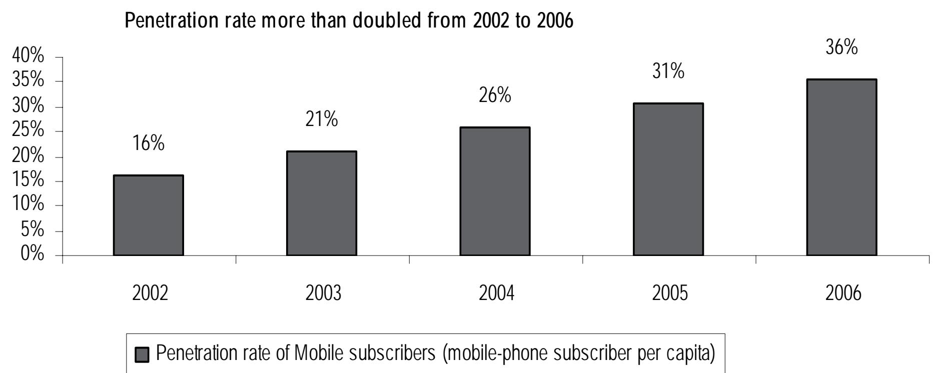
Source: CEIC and J. P. Morgan.

(3) The secular growth potential in many sectors

The past 20 years of economic wonder in China have shown us plenty examples of successful companies making a fortune in the sectors with low penetration rate and strong secular growth. We find that earnings and share prices of market leaders in the sectors of low penetration and strong secular growth booked significant gains.

For instance, a persuasive case is China Mobile (941 HK): The company saw its share price rise over 500% from HK$22 in early 2002 to above HK$120 as of mid-2007, when the mobile-phone penetration rate rose from a low level of 16% in 2002 to 36% by the end of 2006, surpassing the global average of 35.7% for the first time.

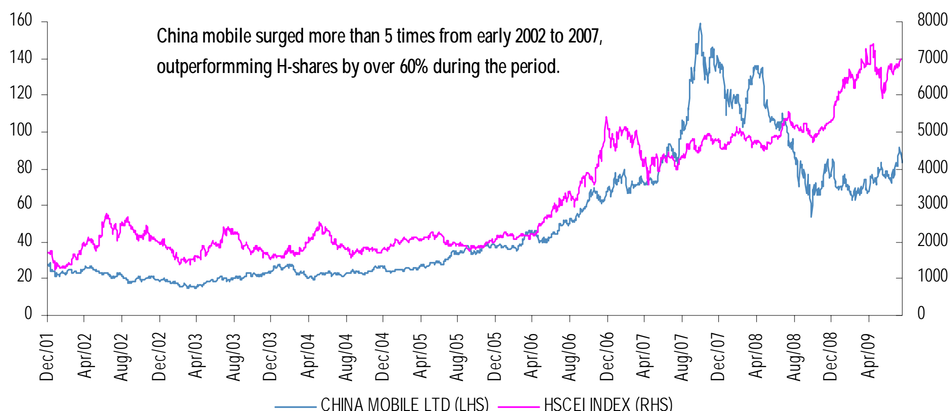
Figure 33: China Mobile Communication's Penetration Rate from 2001 to 2006



Source: CEIC, J.P. Morgan.

Frank Li
(852) 2800-8511
frank.m.li@jpmorgan.com

Figure 34: China Mobile and H - shares' performance in the past 10 years



Source: Bloomberg.

More importantly, at the current stage of economic development, we can still find a number of sectors with a low penetration rate and solid secular growth which may breed the next ten baggers. Most of these are consumer-related sectors, benefiting from China's transition from an investment- and export-driven economy to a consumption-driven economy. Among others, these may include: **internet, tissue and diaper, natural gas, healthcare, and consumer finance,** which all have a relatively low penetration rate compared with developed countries such as US.

Table 17: China—Sectors that still have low penetration rates

	China	US
Internet sector (Internet users per capita) (2008), %	22.4%	75.0%
Tissue sector (Tissue consumption per capita) (2008), KG	2.95	23+
Natural gas sector (% of population having access to natural gas) (2009), %	9.2%	60%+
Healthcare (Healthcare spending per capita) (2007), US$	108	7285
Consumer finance (Consumer loan outstanding per capita) (eop, 2009), US$	608	7934

Source: CEIC, World Health Organization, China National Household Paper Industry Association, J.P. Morgan.

Separately, we believe new economy related sectors, such as new materials, 3G equipment, bio-technology, information network, and new energy sectors, should also enjoy strong secular growth in the medium term, given the government's supportive measures to high-tech manufacturing and strategic new industries. In the medium run, the strong secular growth in the above-mentioned sectors with a low penetration rate and/or involved in new economy areas could prove to be a new dynamic engine driving China's sustained economic growth.

(4) A powerful central government with strong execution capability to carry on necessary economic reforms

The main advantage of a strong central government is that it ensures that national resources are distributed more efficiently and economic reforms completed. Experience shows that the Chinese government has successfully pushed with a series of tough economic reforms.

Given its past strong track record, we tend to believe in the government's capability in engineering a successful economic re-balancing, shifting its growth engine from fixed-asset investment to domestic consumption, and from labor-intensive processing industries, energy intensive and/or highly pollutive industries to high-tech manufacturing and strategic new industries.

Sector views

We are bullish on: (1) consumer staples after their recent correction, such as Mengniu Dairy, and Huabao; (2) expressways with good dividend yield support; (3) new economy plays, i.e., high-tech manufacturing and strategic new industries, such as new materials, 3G equipment, new energy etc; (4) menswear with strong secular growth; (5) IPPs; and (6) healthcare after last month's heavy correction. We take a slightly bullish stance on banks through our OW positions in medium-sized banks with relatively small exposure to the local government debt. We are also slightly OW on China's insurance sector on the sector's long term secular growth potential, but are concerned about their short-term investment returns amid a flattening yield curve, and the weak A-share market.

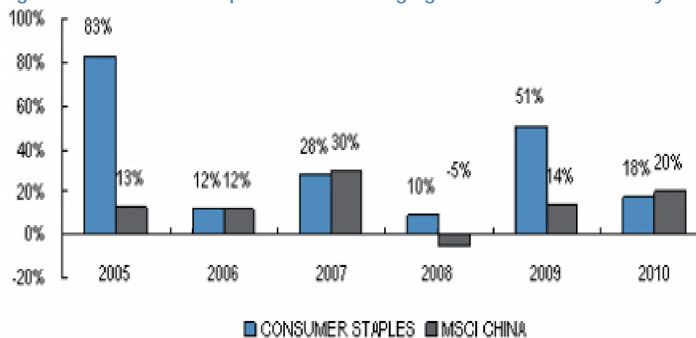
On the other hand, we stay cautious on commodities (both upstream and downstream), property, home appliances, and energy.

OW: Consumer staples, expressways, new economy stocks, menswear, IPPs, and healthcare names

A) Consumer staples after the recent correction

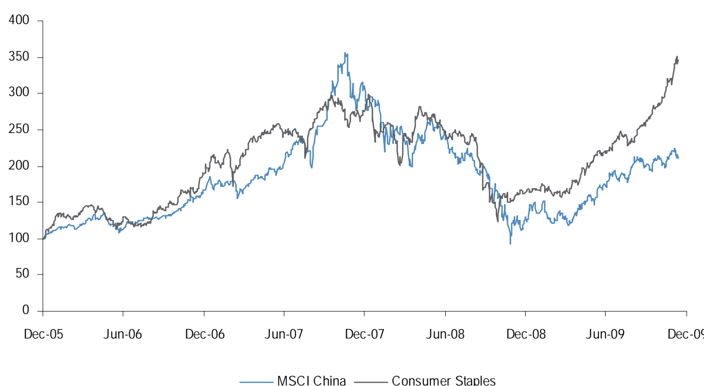
We recommend accumulating Mengniu Dairy and Huabao, after their recent correction. As shown in the figure below, historically, consumer staple companies have been able to post strong earnings growth, while at the same time highly defensive in nature, outperforming the overall market in several market downturns.

Figure 35: Consumer staple names' earnings growth over the last few years



Source: IBES and J.P. Morgan estimates.

Figure 36: Consumer staples outperformed MSCI China in market downturns (basis points = 30 Dec 2005)



Source: Bloomberg and J.P. Morgan.

China Mengniu Dairy

We are OW on China Mengniu (covered by Jasmine Bai). We are seeing a change in the competition dynamics in the dairy industry—more rational pricing strategy and less A&P spending among competitors. Focus is not on volume gains anymore. We are also seeing product mix improvement across the sector and at Mengniu as well. Finally, we believe less capex spending in liquid milk is an important driver. Raw milk price is not a big concern in the case of Mengniu. The company gets 70% of its raw milk from big ranches on long-term contracts, so its raw milk cost is less volatile than the industry average.

Main takeaways from the recent analyst meeting were: 1) Management expects sustainable sales growth rate to double GDP growth and 1Q10 met management expectations. 2) In 2009, sales volume was flat and revenue growth mostly from product mix improvement. 3) Deluxe brand recovered to 7% of sales; management expects 8% as full recovery. 4) Management does not have any plans for like-for-like product price increase at this point.

The stock is trading at a 22x FY10E diluted P/E (assuming all share options exercised and excluding option expenses). We believe higher-than-expected A&P in 2H09 was not a sign of competitive environment deterioration, as Yili, the biggest competitor, cut selling expenses in 2H. We stay OW on Mengniu. Key risks to our view are another surge in selling expenses and unexpected raw milk price movement.

Huabao

Our analyst Jasmine Bai found positive feedback from Huabao's biggest client, Hongta during her trip early this year. We believe Huabao's new business prospects are important to watch out for. These include: 1) reconstituted tobacco leaf (RTL). 2) upstream aromatic material; Huabao has two bases in Wuxi and Botswana; 3) F&B flavor: Huabao entered the business in 2007; we estimate EBIT contribution at 3% in the last six months. New business will be expanded organically and through acquisition, according to management. We expect more acquisitions to come.

We value the stock at 18x Mar-11E earnings to get a Dec-10 price target of HK$9.5. Risks include continued selling from management and limited interest in owning a defensive business. Potential re-rating catalyst is: The market has currently accorded a valuation discount to Huabao.

We believe the multiple expansion needs to be driven by: 1) a higher dividend payout; 2) more contribution from F&B flavor business; 3) potential future direct acquisitions; and 4) strong results as profits from new businesses begin to kick in.

B) Expressways with good dividend yield support

We like expressway stocks for their defensive growth feature, good dividend yields, and exposure to the rising number of cars in China.

Zhejiang Expressway (576 HK) (covered by Karen Li)

1. FCF estimated yield at low teens for coming years, a positive in light of rising interest rate cycle, and imminent policy tightening.
2. Since the opening of Shanghai WorldExpo from May, visitor numbers continued climbing, now at 500,000 per day, higher than the original estimate of 400,000 per day. As such, we believe there exists the scope of positive earnings surprises for ZJE benefiting from increased traffic to Shanghai.

3. The newly implemented weight-based tolls have brought 10% tariff hikes on ZJE's roads since its roll-out in mid-April (stripping off seasonality factors, and pro-rated on full year basis).
4. Against rising market volatility, ZJE beat the Index (HSCEI) by >10% since beginning of April.

Jiangsu Expressway (177 HK) (covered by Karen Li)

1. From a historical perspective, JSE's share performance has proven defensive, consistently outperforming the Index in all the past 4 bear markets since JSE's listing in late 1990s.
2. Current valuation still appears attractive for a "safety" stock like JSE, with a 6% dividend yield and 16% ROE (FY11E), particularly in light of rising market volatility. Total return is compelling, with a c30% return on a one-year horizon, inclusive of yield of 6%.
3. With the opening of Shanghai WorldExpo from May, there exists the scope of positive earnings surprises, in our view (the other key beneficiary is Zhejiang Exy). Our current projections are based on 7% traffic growth in FY10E for the S-N Exy.

C) New economy stocks

In order to achieve sustainable economic growth, China is actively looking for new growth engines. Among others, we believe the government will focus on following medium-term adjustments:

1. **Shifting from labor-intensive processing business to high-tech manufacturing and strategic new industries**. Premier Wen has stressed at the NPC meeting that China would proactively support the development of hi-tech industries such as new materials, 3G equipment, bio-technology and information network.
2. **Shifting from energy-intensive, highly-pollutive industries to new energy sectors** with energy efficiency and environment protection, as well as low carbon dioxide emissions. We believe companies in alternative energy and emission reduction-related industries would benefit from the supportive government policies.
3. **Shifting from manufacturing industries to service sectors**, especially in banking, insurance and healthcare sectors. In 2009, China’s primary, secondary and tertiary industries accounted for 10.6%, 46.8%, and 42.6% of China’s GDP, respectively. While secondary industries have played a major role in China’s urbanization in the past decade, going forward, we expect to see an accelerated growth in service industries. In fact, Premier Wen has noted at the NPC meeting that China should accelerate the growth in service industries such as finance, logistics, information, research and development, industrial design, energy efficiency and environmental protection to increase the weight of service industries in China’s overall GDP contribution.

Against this favorable backdrop, we believe new economy-related stocks may represent good investment opportunities, since they benefit from the government’s supportive policies for new economy-related sectors, and, at the same time, are largely immune from the on-going tightening policies.

Within this universe, our analysts like Baidu, and China High Speed Transmission.

Baidu

1. Our internet analyst Dick Wei expects a strong 2Q with revenue of US$236.8 million (or 32.1% growth Q/Q), above the consensus forecast of US$232.1 million. Our forecast is mainly based on strong organic traffic growth of Baidu. With improving monetization from Phoenix Nest, we expect ARPU to be key driver over the next few quarters.

2. Its medium-term positives are: strong organic traffic growth after Chinese New Year, improving Phoenix Nmst algorithm performance, and ecommerce growth in China. A large set of advertisers are to switch to Baidu in coming months after Google's exit from China, in our view.

China High Speed Transmission

1. Our industrial analyst Boris Kan holds the view that in order to fulfill future renewable targets, Chinese IPPs have to obtain more new wind capacities, regardless of whether these projects are generating profits in the near-term. Hence, concerns about a potential wind capacity slowdown due to grid connection problems might turn out to be overdone. Moreover, China's target to reduce CO2 emission by 40%-45% by 2020 might lead to higher-than-expected demand for wind capacities in the medium/long term.

2. Contrary to market concerns, the company delivered an improved margin in wind gearbox sales in 2H09. A key reason for this is that, unlike the wind turbine assembler market (>50 players, 15% average ASP cut over the past 12 months), the wind gearbox producer market does not suffer overcapacity problems (only three-four players) and hence has much better bargaining power. We expect ASP for new orders in 1Q10 to be strong and hence 2010 margins should hold firm.

3. Trading at 17x/14x 2010E/2011E P/E, CHSTE is trading at a significant discount to other China-listed wind plays (>21x 2011E P/E (consensus) for China Longyuan and Goldwind) but has a lower risk profile (no overcapacity/grid connection problems). The stock is also trading at a discount to most other China power equipment producers (15-17x 2011E P/E, consensus) but has better growth prospects as CHSTE has no exposure to the low-growth coal-fired power equipment market.

From a strategist's perspective, we share our analyst, i.e. Boris' positive arguments about China High Speed Transmission, even though we have some concern over the euro depreciation's impact on its export business.

D) Menswear

Within the consumer discretionary space, we continue to favor the menswear segment, which boasts of strong growth potential in the coming three to five years.

We believe the menswear segment, which is still not well developed in China in terms of menswear consumption per capita (US$291 p.a. in China, compared with US$1,175 p.a. in the US and US$1,489 p.a. in Europe), has significant room for growth, as Chinese men become more brand and fashion conscious, and start to spend more on purchasing branded menswear.

According to Euromonitor, menswear could record a 17.7% CAGR in its retail sales in China from 2006 to 2011, notably higher than the womenswear CAGR of 11.7%, childrens wear CAGR of 9.2%, and the overall apparel market's CAGR of 14.2%.

Table 18: Different apparel segments' CAGR of retail sales in China

CAGR (2006-2011)	
Total apparel market	14.2%
Menswear	17.7%
Womenswear	11.7%
Childrens wear	9.2%

Source: Euromonitor.

In light of the strong secular growth potential, we believe the menswear segment could represent a good investment opportunity in China. Among others, leading companies in China's menswear sector, such as Trinity with a strong brand name, as well as China Lilang and Bosideng which are moving into the menswear field, may all benefit from such a secular growth trend.

After a strong performance, the menswear sector may face profit-taking pressure. We recommend that investors accumulate the sector on possible weakness, arising from profit-taking pressure or from possible fund-raising activities.

E) IPPs

From a strategist's perspective, we like IPPs because of: (a) its cheap asset based valuations after the big underperformance, (b) the expected power tariff reform could translate into power tariff hikes; (c) coal price may have peaked, given the economic slowdown and that we are to see a lot of new coal capacities coming on stream by end FY10 and FY11.

China IPPs' earnings are most sensitive to power tariffs, followed by coal price movement and power utilization.

China Resources Power

Our utility analyst Boris Kan believes:

1. Proven track record in fuel cost control and robust power generation rebound: CRP has recorded over 40% generation growth in the first 4 months of 2010.
2. Visible coal strategy to mitigate coal price inflation risk in long term: CRP has formed a Shanxi JV to consolidate local coalmines, which are expected to produce 15mn ton in 2010, representing 25% of its consumption. CRP targets 40% coal self-sufficiency rate in long term.
3. CRP has the lowest gearing in the sector (112%% net gearing), and is trading at low valuation: 12x 10PE and 1.7x 10 PB.

Huaneng

Boris Kan's view on Huaneng is as follows:

1. Pure thermal power generator with high sensitivity to coal price change: Huaneng has no coalmine investment plan, and majority of its capacities are coal-fired. As a result, Huaneng should benefit most from any coal price drop.
2. Benefit from power demand rebound in China: Huaneng's power generation was up by 40% yoy in 1Q10.
3. Huaneng is trading at cheap valuation of 11x 10PE and 0.95x 10PB.

Table 19: China IPPs' earnings sensitivity to power tariffs, coal price hike and power utilization

	FY10E	FY11E
Huaneng		
Net income % from 1% coal cost hike	7.0	7.3
Net income % from 1% ASP	11.7	12.2
Net income % from 1% utilization	4.7	4.9
CRP		
Net income % from 1% coal cost hike	3.9	3.1
Net income % from 1% ASP	6.8	5.6
Net income % from 1% utilization	2.9	2.5

Source: Company, J.P. Morgan.

F) Healthcare

We move to a positive stance on the healthcare sector with a defensive growth feather because: (1) the sector's valuations have come to a more reasonable level after last month's correction, (2) the sector should benefit from China's on-going healthcare reform and (3) China's aging population.

G) Banks

We have a slight OW position in banks mainly through our OW positions in the medium sized banks i.e. China Merchants Bank, and Bank of Communications, that have largely completed fund raising capabilities, and boast of a low exposure to local government debt. For instance, China Merchant Bank's exposure to the local government debt records only 6.6% versus 14.4% for ICBC and 15% for CCB.

Table 20: LGFV loans as a percentage of the total loan book

	2010E	
	LGFV loans (RMB bn)	% of 10E loans
ICBC-H	936	14.4%
CCB-H	840	15.0%
BOC-H	552	9.5%
BoComm-H	181	8.4%
CMB-H	94	6.6%
Citic-H	195	15.3%
Minsheng-H	169	16.0%

Source: J.P. Morgan estimates

(H) Insurance

We also hold a small OW position on China's insurance sector in light of the sector's low penetration rate and strong secular growth potential and possible disappointing near term investment return outlook amid the economic slowdown. Our view is based on the following considerations:

(1) China insurance sector's long term secular growth potential

We continue to like the sector's long term secular growth potential in China. China is currently the third largest insurance market in Asia by premium size behind only Japan and South Korea but its growth potential is enormous. With its insurance penetration rate of 3% (defined as premiums/GDP) implying a barely penetrated market by Asian standards, Swiss Re has forecasted average annual premium growth of 14% per annum for the life sector and 12% per annum for the non-life sector for China for the next decade.

The tremendous growth potential is underpinned by an ageing population, a rising income level and, more importantly, a strong desire by the government to develop the sector to ensure social stability.

Frank Li
(852) 2800-8511
frank.m.li@jpmorgan.com

Table 21: Valuation summary for Chinese insurers

HKD	B'berg code	Share price (1-Jun-10)	2010 EPS	forward P/E	2010 BPS	forward P/B	2009 EV	trailing P/EV	2009 NBV	trailing NBM
China Life	2628 HK	33.55	1.47	22.9	9.86	3.4	11.48	2.9	0.71	31.0
Ping An	2318 HK	61.40	2.41	25.5	16.47	3.7	23.10	2.7	1.76	21.8
CPIC	2601 HK	29.75	1.25	23.8	11.00	2.7	13.01	2.3	0.66	25.3
CTIH	966 HK	25.20	0.79	32.1	7.15	3.5	n.a.	n.a.	n.a.	n.a.
PICC	2328 HK	6.91	0.27	25.2	2.60	2.7	n.a.	n.a.	n.a.	n.a.

Source: Company data.
Note: based on historical data and Bloomberg consensus forecast

(2) Possible disappointing investment returns
Chinese insurers reported a very strong improvement in net income for 2009 driven by strong investment performance in tandem with the recovery of the A-share market. Life insurers had reported new business value growth in excess of 30% driven by the success from business mix restructuring, while non-life insurers had seen a turnaround of their auto business due to reduced pricing competition. The uncertainties caused by the rushed implementation of a new accounting standard had weighed down on insurers' share prices since late 2009 but with most insurers reporting strong net income growth under the new standard, these concerns had dissipated.

That said, going forward, the market's focus could be shifting towards the sector's challenging outlook on investment returns in FY10.

We believe China insurance names' investment return could be hurt by: (a) flattening yield curve in China on economic deceleration concerns, and (b) A-share market which has been among some of the world's worst performing markets YTD amid concerns of monetary tightening, and economic deceleration due to the combined ripple effect of the property crack-down and the banks' slowdown in lending to the local governments' investment projects.

Table 22: Investment asset mix and performance reported by Chinese insurers

RMBmn/HKDmn	China Life 2008	China Life 2009	Ping An 2008	Ping An 2009	CPIC 2008	CPIC 2009	PICC 2008	PICC 2009	CTIH 2008	CTIH 2009
Invested assets	937,403	1,172,145	464,665	589,713	288,074	366,018	81,926	109,940	73,399	95,758
Invested asset mix:										
Bonds	61.4%	49.7%	61.7%	59.6%	57.2%	49.9%	55.1%	56.2%	70.3%	62.6%
Deposits	28.0%	32.5%	29.3%	28.1%	35.7%	32.8%	35.4%	29.1%	21.7%	21.4%
Equity	8.0%	15.3%	7.8%	10.8%	4.8%	12.3%	8.8%	14.0%	6.4%	14.8%
Others	2.6%	2.5%	1.2%	1.5%	2.3%	5.0%	0.7%	0.7%	1.6%	1.2%
Investment yield:										
Net investment yield	5.0%	3.7%	4.1%	3.9%	6.2%	4.0%	4.5%	3.0%	4.6%	3.7%
Total investment yield	3.5%	5.8%	-1.7%	6.4%	2.9%	6.3%	4.9%	4.8%	3.9%	5.3%

Source: Company data.

UW: Commodities (both upstream and downstream), property, home appliances, and energy

A) Commodities (both upstream and downstream) & Energy
We remain cautious on China commodities, both upstream and downstream in China, because:

1. China's economic deceleration should have a negative impact on its commodities demand. The demand of many of China's commodities tends to chart a close correlation with China's fixed asset investment growth. The crackdown on the

property sector and the slowdown in banks' lending to the local government's investment projects will bring about a moderation in fixed asset investment growth, which in turn, could hurt commodities demand.

2. We expect resource tax reform to be popularized across the country, which will negatively affect upstream commodity companies such as coal and oil. (Please refer to *"Heightened policies risks (such as the resource tax reform) to hurt the corporate earnings"* for more details.*).*
3. China's top decision makers have recently asked the local governments to sign the responsibility letter to achieve the target of "reducing energy and emission reduction", which could result in a series of closure of inefficient steel, aluminum, and cement capacities. This, in turn, could also reduce China's commodity demand.
4. In the short term, China's downstream material sector may face de-stocking problems due to the economic deceleration. This means that they may be forced to cut price despite the high raw material prices. Today Baosteel's price cut is the first example of such de-stocking triggered price reductions despite higher coking coal and iron ore costs.
5. In the short term, China's downstream material sector could also be hurt by the liquidity situation, as reflected in the recent rise in short-term interest rate in the repo market as well as the inter-bank market. The concern is that banks may move to reduce credit to these down stream material processing companies which are perceived to be of higher lending risks.

B) The property sector on additional policy tightening concerns

Despite the sharp correction, we remain cautious on China's property sector. From a strategy perspective, we believe it is too early to add positions in the property sector.

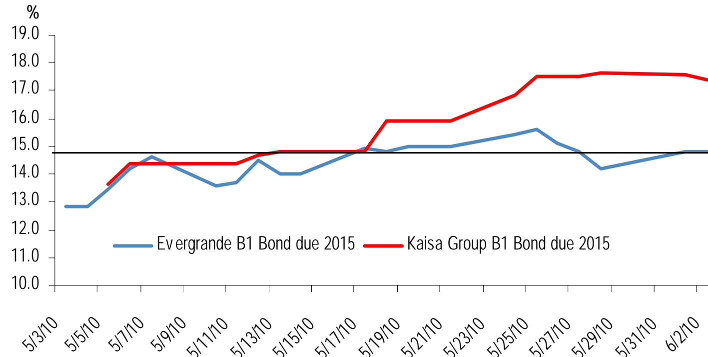
In the short term, it is difficult for the government to loosen its tightening on the property market, because: (1) property prices in tier one cities have already risen to a rather high level. *(For more details, please refer to the text and charts on Page 14-18)*, (2) High property prices that have become No.1 complaint target for Chinese. In the previous National People's Congress (NPC), there are many motions filed by delegates representing different walks of society to tame property prices. As such, the high price has become a major social issue government officials now pay great attention to.

We believe the sharp drop in the property sector's transaction volume (For May as a whole, sales volume averaged 1,650 units, down 51% M/M and 53% Y/Y, and was even 13% below May 2008 levels) will be followed by 15%-20% drop in property prices in coming months. Should property prices fail to decline by then, we may see harsher policies such as the property tax being adopted by the government to bring down prices.

We caution against playing the property rebound, especially those with high gearing ratios. Entering May, FY10, many Chinese property developers' bond yields have started to shoot up to above 15%, boding ill for these names' stock performance.

Frank Li
(852) 2800-8511
frank.m.li@jpmorgan.com

Figure 37: China property developers (Evergrande and Kaisa Group) bond yields

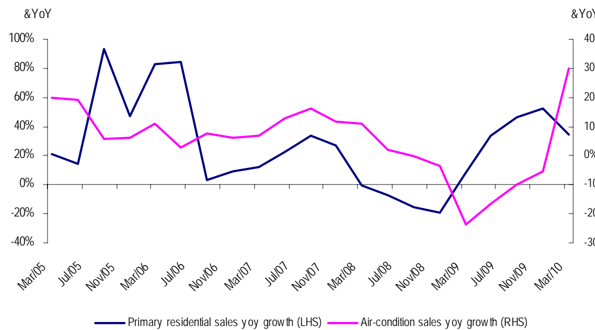


Source: Bloomberg.

C) Home appliance sector

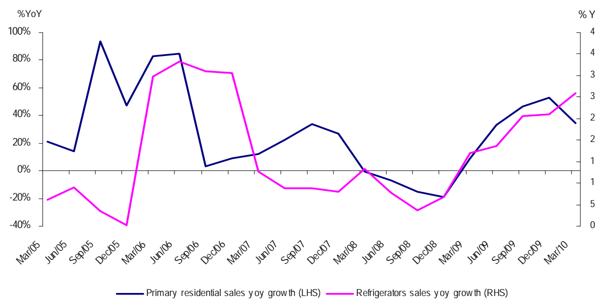
We stay cautious on home appliance stocks, given that (1) a number of foreign white goods players have recently launched a price war in China's color TV market; (2) the sale of home appliances may be negatively affected by the slowdown in China's property sales, even though there is a time lag of between six and nine months.

Figure 38: Primary residential sales tend to lead air-conditioner sales



Source: CEIC, J.P. Morgan.

Figure 39: Primary residential sales tend to lead refrigerator sales



Source: CEIC, J.P. Morgan.

Frank Li
(852) 2800-8511
frank.m.li@jpmorgan.com

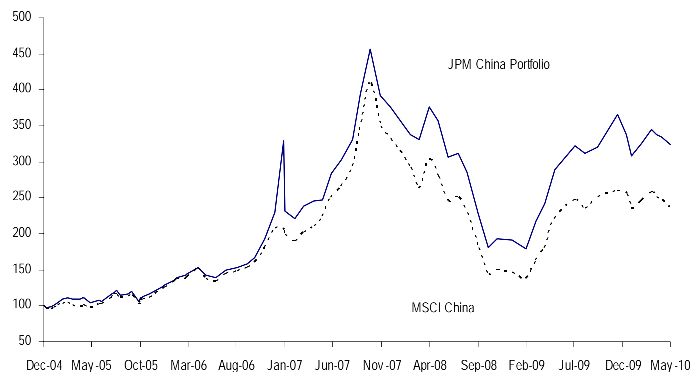
China model portfolio (CMP) adjustments

As of May 31, FY10, our model portfolio dropped 4.47% since January 1, 2010, versus an 8.12% decline in MSCI China during the same period. Since December 31, 2004, our model portfolio has outperformed MSCI China by 87.3%.

Year-to-date, our CMP's performance has been helped mostly by our big underweight position in the property sector, and the zero exposure to the downstream materials sector, but hurt the most by our overweight positions in banks, and underweight positions in the telecom service sector.

Over the past month, among others, our model portfolio has been helped by: (1) Baidu; (2) Huabao International; (3) China Shineway Pharmaceutical; and (4) Alibaba.com Ltd, which rose 6.3%, 6.1%, 4.9%, and 2.9%, respectively. On the other hand, detractors from performance included: (1) Yanzhou Coal Mining; (2) Sinopharm Group Co; (3) China Gas Holdings; and (4) Netease.com, which dropped 18.9%, 13.5%, 13.2%, and 13%, respectively.

Figure 40: Since 31 December 2004, our CMP has outperformed MSCI China by 87.3%



Source: Bloomberg and J.P. Morgan.

Over the past month, we have made the following adjustments to our China model portfolio:

Cutting gaming, energy, upstream resources, and insurance

First, we took profit in Tencent (-3.5%) after its strong relative out-performance, and on concern of "last standing man" risk as we have seen a series of results disappointment this year from China's internet companies with big gaming exposure such as Kingsoft, Shanda, Perfect World, and Netease, etc.

For instance, Shanda Games recently reported 1Q10 revenues of US$167.3Mn (down 14.4% QoQ and up 9.9% YoY) vs. our analyst Dick Wei's expectation of US$171.0Mn and consensus expectations of US$171.3Mn. Meanwhile it provided a 2Q10 guidance of down 3% to up 1% QoQ in revenues (implying US$162.4Mn-US$169.0Mn) vs. Dick Wei's forecast of US$178.3 and consensus expectations of US$175.2Mn.

Secondly, we cut our exposure in China's energy sector through cutting our weight in PetroChina from 4% to 1%.

Frank Li
(852) 2800-8511
frank.m.li@jpmorgan.com

Thirdly, we reduced positions in upstream resources, i.e. coal sector through cutting our positions in China Shenhua and China Coal from both 1% to 0.5%.

We cut weight in energy and upstream resources sector because of our belief that the new resource tax which is recently adopted in Xinjiang Autonomous Region on a pilot basis is most likely to be popularized across the country in the coming months. The onshore energy and upstream resources companies could be hurt by the potential earnings downgrade, and the de-rating pressure on the back of the resource tax, which is expected to be popularized across the country.

Lastly, we trimmed some exposure in China's insurance sector on investment return concerns on the back of the flattening yield curve through reducing our weight in Pingan Insurance by 2 percentage points to 2 %.

Increasing exposure to Zhaojin and China Railway Construction, and Sinopharm

With the proceeds, we mainly increase our weight in:

1. Shandong Zhaojin Mining with a weight of 3% on account its strong gold production growth,
2. We added China Railway Construction in our model portfolio with a weight of 3.5%. We like this stock due to (a) the valuations having come down to an attractive level; (b) room for margin improvement; (c) China's Railway capex could remain strong in the next three years.
3. We took advantage of the correction in Sinopharm's share price to add 2% weight in the stock from 0.5 % to 2.5%.

Frank Li
(852) 2800-8511
frank.m.li@jpmorgan.com

Table 23: J.P. Morgan Model Portfolio for China

	Ticker	Price	Rating	Change (%) 1m	Change (%) 12m	MSCI Weight	JPM Weight	Dev. (%)	PER 2010	PER 2011	DY 2010	ROE 2010
Consumer Discretionary	MXCN0CD INDEX	238.8		-13.0	31.4	4.6	4.0	-0.6	15.8	13.4	1.8	18.0
Belle International Holdings Ltd.	1880 HK	10.0	OW	-7.4	59.5	1.0	2.5	1.5	23.3	22.2	1.5	19.4
Trinity Limited	891 HK	5.0	N	-11.2	na	0	1.5	1.5	29.3	23.5	2.1	13.0
Consumer Staples	MXCN0CS INDEX	1181.4		-7.5	50.2	5.5	8.0	2.5	18.4	15.5	1.8	17.0
China Mengniu Dairy Co. Ltd.	2319 HK	23.4	OW	0.0	30.3	0.6	3.5	2.9	26.3	19.6	0.8	14.9
China Yurun Food Group	1068 HK	21.0	N	-10.8	69.9	0.6	1.5	0.9	17.2	15.7	1.7	22.4
Huabao International Holdings Limited	336 HK	9.1	N	0.4	35.1	0.3	2.0	1.7	21.1	17.3	0.0	39.7
Hengan International Group Ltd	1044 HK	55.1	N	-7.9	58.0	0.9	1.0	0.1	26.4	22.5	2.4	27.3
Energy	MXCN0EN INDEX	597.3		-10.1	6.6	17.3	10.0	-7.3	10.5	9.2	3.4	17.0
CNOOC	883 HK	12.1	N	-12.6	10.4	5.4	6.0	0.6	10.6	10.3	5.2	24.9
Sinopec Corp - H	386 HK	6.0	OW	-2.9	-0.5	2.3	1.0	-1.3	6.6	5.8	3.8	17.1
China Shenhua Energy	1088 HK	30.2	N	-9.7	12.5	2.4	0.5	-1.9	15.2	NM	2.3	18.9
Yanzhou Coal Mining - H	1171 HK	17.1	N	-18.4	58.6	0.8	1.0	0.2	14.1	NM	1.8	15.9
PetroChina	857 HK	8.3	UW	-7.1	-9.5	4.4	1.0	-3.4	10.1	9.7	4.4	15.0
China Coal Energy	1898 HK	10.1	OW	-14.4	2.4	0.9	0.5	-0.4	10.9	NM	2.8	15.2
Financials	MXCN0FN INDEX	458.6		-4.1	6.4	37.8	34.0	-3.8	11.9	10.0	3.2	16.8
China Life Insurance	2628 HK	33.4	na	-5.0	11.9	6.1	7.5	1.4	22.6	19.2	1.6	15.0
Agile Property Holdings Ltd	3383 HK	7.9	OW	-11.7	-24.8	0.3	1.0	0.7	8.8	6.6	3.4	18.6
Ping An Insurance 'H'	2318 HK	61.3	na	-7.3	7.4	1.9	2.0	0.1	25.6	20.1	1.0	14.5
ICBC - H	1398 HK	5.6	OW	-0.7	13.9	6.4	3.0	-3.4	10.1	8.2	4.4	22.1
China Merchants Bank - H	3968 HK	18.0	N	-5.7	15.3	1.8	3.5	1.7	13.7	10.8	1.4	21.4
China Construction Bank	939 HK	6.2	OW	-2.1	20.0	6.8	2.5	-4.3	9.4	8.0	4.6	21.6
Bank of China -H	3988 HK	3.8	OW	-5.2	8.9	5.4	8.0	2.6	7.7	6.1	5.5	19.6
Bank of Communications - H	3328 HK	8.1	OW	-8.2	8.2	1.2	4.0	2.8	9.0	7.5	3.6	20.6
China Citic Bank	998 HK	4.5	OW	-10.0	-4.6	0.6	1.5	0.9	6.8	5.4	3.2	20.3
China Overseas Land & Investment	688 HK	14.5	OW	-2.2	-9.7	1.5	1.0	-0.5	14.9	NM	1.2	18.1
Health care	MXCN0HC INDEX	146.9		-16.7	na	0.7	3.0	2.3	39.8	30.0	0.6	14.5
Sinopharm	1099 HK	28.5	UW	-20.1	na	0.4	2.5	2.1	41.5	30.0	0.6	12.0
China Shineway Pharmaceutical Group Limited	2877 HK	23.4	OW	2.4	233.4	0	0.5	0.5	20.9	16.8	1.4	27.0
Industrials	MXCN0IN INDEX	150.2		-10.4	-12.1	7.8	7.0	-0.8	14.0	11.7	2.2	10.6
China High Speed Transmission	658 HK	17.2	OW	-8.8	9.4	0.4	2.0	1.6	14.0	11.2	2.4	27.6
Jiangsu Expressway - H	177 HK	7.0	OW	-5.3	27.6	0.2	1.5	1.3	14.0	12.4	5.7	14.2
China Railway Construction Corporation Limited	1186 HK	9.0	OW	-5.0	-24.8	0.4	3.5	3.1	12.1	10.4	2.5	14.2
Information Technology	MXCN0IT INDEX	98.8		-10.8	58.1	6.1	9.0	2.9	27.9	19.6	0.7	15.8
ZTE Corp	763 HK	26.7	N	-6.0	39.0	0.2	1.5	1.3	13.1	10.5	1.7	17.5
Alibaba.com Limited	1688 HK	15.1	N	1.2	5.9	0.5	1.5	1.0	51.3	35.0	0.0	21.9
Baidu.com	BIDU US	73.2	OW	3.3	155.2	0	3.0	3.0	6.0	3.8	0.0	46.1
Netease	NTES US	30.4	OW	-11.7	-16.3	0	3.0	3.0	13.2	11.2	0.0	23.9
Materials	MXCN0MT INDEX	872.9		-10.9	-16.3	5.0	3.0	-2.0	12.2	9.8	2.3	13.4
Zhaojin mining	1818 HK	16.1	na	5.8	10.3	0	3.0	3.0	20.4	18.5	2.1	18.7
Telecommunication Services	MXCN0TC INDEX	114.6		-4.6	-8.6	13.3	14.0	0.7	12.1	11.5	3.6	15.2
China Mobile (HK)	941 HK	73.2	na	-4.6	-7.0	10.8	5.0	-5.8	10.9	10.6	4.0	20.9
China Telecom Corp	728 HK	3.5	na	-2.2	-8.9	1.2	1.5	0.3	15.9	13.1	2.4	6.8
China Unicom - H	762 HK	9.2	na	-5.5	-16.7	1.3	7.5	6.2	29.6	22.5	1.6	3.1
Utilities	MXCN0UT INDEX	343.4		-9.3	-21.5	2.0	8.0	6.0	13.7	11.5	2.6	10.8
China Resources Power Holdings	836 HK	15.4	N	-1.5	-10.7	0.6	3.0	2.4	12.1	9.5	2.6	15.1
China Gas Holdings Limited	384 HK	3.6	N	-19.1	93.6	0	1.5	1.5	25.4	NM	0.0	14.3
Huaneng Power Int'l - H	902 HK	4.2	N	-6.9	-22.6	0.3	1.5	1.2	10.9	10.7	2.2	9.8
Beijing Enterprises Holdings Limited	392 HK	47.1	OW	-4.9	42.7	0.6	2.0	1.4	17.2	15.1	1.8	7.7
MSCI Total	MXCN INDEX	58		-7	5	100	100	0	13	11	3	16

Source: Bloomberg and J.P. Morgan. Note: Updated as of June 2, 2010. Bloomberg data for NR companies.

Companies Recommended in This Report (all prices in this report as of market close on 04 June 2010)
China High Speed Transmission (0658.HK/HK$17.88/Overweight), Tencent (0700.HK/HK$150.90/Overweight), Zhejiang Expressway (0576.HK/HK$7.16/Overweight)

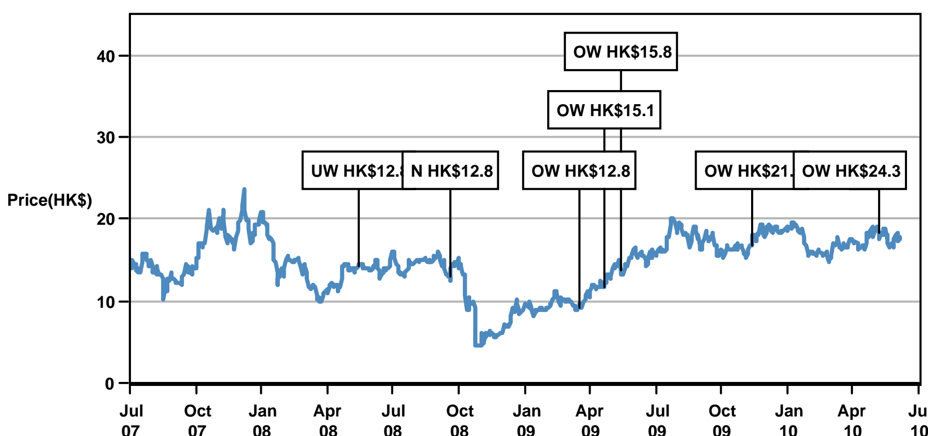
Analyst Certification:
The research analyst(s) denoted by an "AC" on the cover of this report certifies (or, where multiple research analysts are primarily responsible for this report, the research analyst denoted by an "AC" on the cover or within the document individually certifies, with respect to each security or issuer that the research analyst covers in this research) that: (1) all of the views expressed in this report accurately reflect his or her personal views about any and all of the subject securities or issuers; and (2) no part of any of the research analyst's compensation was, is, or will be directly or indirectly related to the specific recommendations or views expressed by the research analyst(s) in this report.

Important Disclosures

- **Analyst Position:** The following analysts (and/or their associates or household members) own a long position in the shares of Zhejiang Expressway: Adrian Mowat.
- **Client of the Firm:** Tencent is or was in the past 12 months a client of JPMSI.
- **MSCI:** The MSCI sourced information is the exclusive property of Morgan Stanley Capital International Inc. (MSCI). Without prior written permission of MSCI, this information and any other MSCI intellectual property may not be reproduced, redisseminated or used to create any financial products, including any indices. This information is provided on an 'as is' basis. The user assumes the entire risk of any use made of this information. MSCI, its affiliates and any third party involved in, or related to, computing or compiling the information hereby expressly disclaim all warranties of originality, accuracy, completeness, merchantability or fitness for a particular purpose with respect to any of this information. Without limiting any of the foregoing, in no event shall MSCI, any of its affiliates or any third party involved in, or related to, computing or compiling the information have any liability for any damages of any kind. MSCI, Morgan Stanley Capital International and the MSCI indexes are services marks of MSCI and its affiliates.

Important Disclosures for Equity Research Compendium Reports: Important disclosures, including price charts for all companies under coverage for at least one year, are available through the search function on J.P. Morgan's website https://mm.jpmorgan.com/disclosures/company or by calling this U.S. toll-free number (1-800-477-0406)

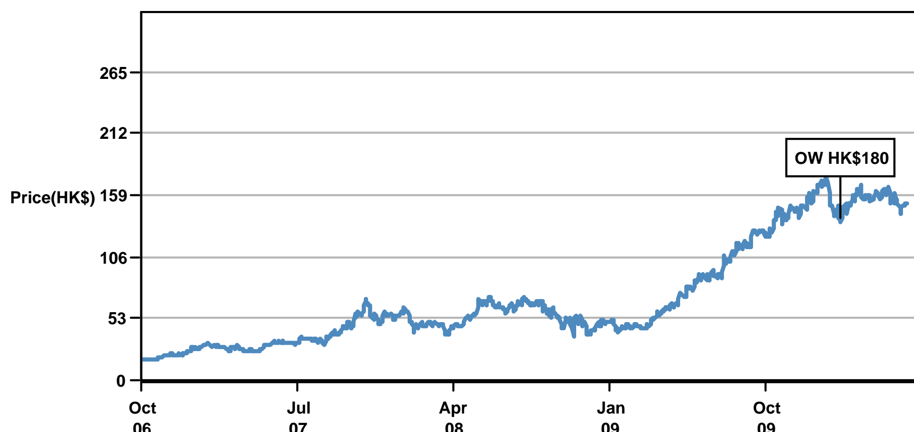
China High Speed Transmission (0658.HK) Price Chart



Date	Rating	Share Price (HK$)	Price Target (HK$)
15-May-08	UW	14.20	12.80
18-Sep-08	N	12.98	12.80
17-Mar-09	OW	9.27	12.80
20-Apr-09	OW	11.70	15.10
13-May-09	OW	13.70	15.80
11-Nov-09	OW	16.78	21.50
06-May-10	OW	18.42	24.30

Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends.
Initiated coverage May 15, 2008. This chart shows J.P. Morgan's continuing coverage of this stock; the current analyst may or may not have covered it over the entire period.
J.P. Morgan ratings: OW = Overweight, N = Neutral, UW = Underweight.

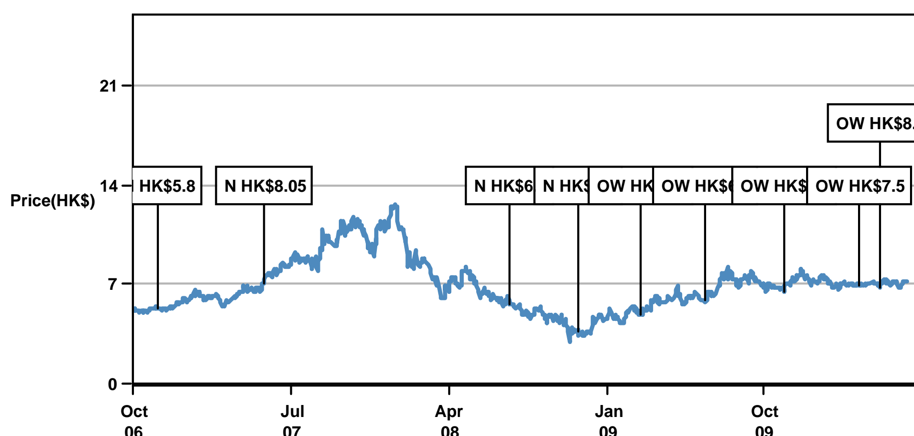
Tencent (0700.HK) Price Chart



Date	Rating	Share Price (HK$)	Price Target (HK$)
07-Feb-10	OW	138.40	180.00

Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends.
Initiated coverage Feb 07, 2010. This chart shows J.P. Morgan's continuing coverage of this stock; the current analyst may or may not have covered it over the entire period.
J.P. Morgan ratings: OW = Overweight, N = Neutral, UW = Underweight.

Zhejiang Expressway (0576.HK) Price Chart



Date	Rating	Share Price (HK$)	Price Target (HK$)
14-Nov-06	N	5.34	5.80
16-May-07	N	7.04	8.05
16-Jul-08	N	5.51	6.30
13-Nov-08	N	3.70	5.30
26-Feb-09	OW	4.89	6.20
21-Jun-09	OW	5.93	6.80
04-Nov-09	OW	6.51	7.60
15-Mar-10	OW	6.85	7.50
20-Apr-10	OW	6.83	8.10

Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends.
Break in coverage Oct 12, 2004 - May 02, 2005. This chart shows J.P. Morgan's continuing coverage of this stock; the current analyst may or may not have covered it over the entire period.
J.P. Morgan ratings: OW = Overweight, N = Neutral, UW = Underweight.

Explanation of Equity Research Ratings and Analyst(s) Coverage Universe:
J.P. Morgan uses the following rating system: **Overweight** [Over the next six to twelve months, we expect this stock will outperform the average total return of the stocks in the analyst's (or the analyst's team's) coverage universe.] **Neutral** [Over the next six to twelve months, we expect this stock will perform in line with the average total return of the stocks in the analyst's (or the analyst's team's) coverage universe.] **Underweight** [Over the next six to twelve months, we expect this stock will underperform the average total return of the stocks in the analyst's (or the analyst's team's) coverage universe.] J.P. Morgan Cazenove's UK Small/Mid-Cap dedicated research analysts use the same rating categories; however, each stock's expected total return is compared to the expected total return of the FTSE All Share Index, not to those analysts' coverage universe. A list of these analysts is available on request. The analyst or analyst's team's coverage universe is the sector and/or country shown on the cover of each publication. See below for the specific stocks in the certifying analyst(s) coverage universe.

Coverage Universe: **Frank Li:** Aluminum Corporation of China Limited (2600.HK), Angang Steel Company Limited - A (000898.SZ), Angang Steel Company Limited - H (0347.HK), Baoshan Iron & Steel - A (600019.SS), Brilliance China

Automotive (1114.HK), China Coal Energy (1898.HK), China Shenhua Energy (1088.HK), Denway Motors (0203.HK), DongFeng Motor Co., Ltd. (0489.HK), Great Wall Motor Company Limited (2333.HK), Maanshan Iron and Steel - A (600808.SS), Maanshan Iron and Steel - H (0323.HK), Minth Group (0425.HK), Qingling Motors Co (1122.HK), Sinotruk (3808.HK), Weichai Power (2338.HK), Yanzhou Coal Mining - A (600188.SS), Yanzhou Coal Mining - H (1171.HK), Zijin Mining Group Co Ltd (2899.HK)

J.P. Morgan Equity Research Ratings Distribution, as of March 31, 2010

	Overweight (buy)	Neutral (hold)	Underweight (sell)
JPM Global Equity Research Coverage	45%	42%	13%
IB clients*	48%	46%	32%
JPMSI Equity Research Coverage	42%	49%	10%
IB clients*	70%	58%	48%

*Percentage of investment banking clients in each rating category.
For purposes only of NASD/NYSE ratings distribution rules, our Overweight rating falls into a buy rating category; our Neutral rating falls into a hold rating category; and our Underweight rating falls into a sell rating category.

Valuation and Risks: Please see the most recent company-specific research report for an analysis of valuation methodology and risks on any securities recommended herein. Research is available at http://www.morganmarkets.com , or you can contact the analyst named on the front of this note or your J.P. Morgan representative.

Analysts' Compensation: The equity research analysts responsible for the preparation of this report receive compensation based upon various factors, including the quality and accuracy of research, client feedback, competitive factors, and overall firm revenues, which include revenues from, among other business units, Institutional Equities and Investment Banking.

Registration of non-US Analysts: Unless otherwise noted, the non-US analysts listed on the front of this report are employees of non-US affiliates of JPMSI, are not registered/qualified as research analysts under NASD/NYSE rules, may not be associated persons of JPMSI, and may not be subject to NASD Rule 2711 and NYSE Rule 472 restrictions on communications with covered companies, public appearances, and trading securities held by a research analyst account.

Other Disclosures

J.P. Morgan is the global brand name for J.P. Morgan Securities Inc. (JPMSI) and its non-US affiliates worldwide. J.P. Morgan Cazenove is a brand name for equity research produced by J.P. Morgan Securities Ltd.; J.P. Morgan Equities Limited; JPMorgan Chase Bank, N.A., Dubai Branch; and J.P. Morgan Bank International LLC.

Options related research: If the information contained herein regards options related research, such information is available only to persons who have received the proper option risk disclosure documents. For a copy of the Option Clearing Corporation's Characteristics and Risks of Standardized Options, please contact your J.P. Morgan Representative or visit the OCC's website at http://www.optionsclearing.com/publications/risks/riskstoc.pdf.

Legal Entities Disclosures
U.S.: JPMSI is a member of NYSE, FINRA and SIPC. J.P. Morgan Futures Inc. is a member of the NFA. JPMorgan Chase Bank, N.A. is a member of FDIC and is authorized and regulated in the UK by the Financial Services Authority. **U.K.:** J.P. Morgan Securities Ltd. (JPMSL) is a member of the London Stock Exchange and is authorised and regulated by the Financial Services Authority. Registered in England & Wales No. 2711006. Registered Office 125 London Wall, London EC2Y 5AJ. **South Africa:** J.P. Morgan Equities Limited is a member of the Johannesburg Securities Exchange and is regulated by the FSB. **Hong Kong:** J.P. Morgan Securities (Asia Pacific) Limited (CE number AAJ321) is regulated by the Hong Kong Monetary Authority and the Securities and Futures Commission in Hong Kong. **Korea:** J.P. Morgan Securities (Far East) Ltd, Seoul Branch, is regulated by the Korea Financial Supervisory Service. **Australia:** J.P. Morgan Australia Limited (ABN 52 002 888 011/AFS Licence No: 238188) is regulated by ASIC and J.P. Morgan Securities Australia Limited (ABN 61 003 245 234/AFS Licence No: 238066) is a Market Participant with the ASX and regulated by ASIC. **Taiwan:** J.P.Morgan Securities (Taiwan) Limited is a participant of the Taiwan Stock Exchange (company-type) and regulated by the Taiwan Securities and Futures Bureau. **India:** J.P. Morgan India Private Limited is a member of the National Stock Exchange of India Limited and Bombay Stock Exchange Limited and is regulated by the Securities and Exchange Board of India. **Thailand:** JPMorgan Securities (Thailand) Limited is a member of the Stock Exchange of Thailand and is regulated by the Ministry of Finance and the Securities and Exchange Commission. **Indonesia:** PT J.P. Morgan Securities Indonesia is a member of the Indonesia Stock Exchange and is regulated by the BAPEPAM LK. **Philippines:** J.P. Morgan Securities Philippines Inc. is a member of the Philippine Stock Exchange and is regulated by the Securities and Exchange Commission. **Brazil:** Banco J.P. Morgan S.A. is regulated by the Comissao de Valores Mobiliarios (CVM) and by the Central Bank of Brazil. **Mexico:** J.P. Morgan Casa de Bolsa, S.A. de C.V., J.P. Morgan Grupo Financiero is a member of the Mexican Stock Exchange and authorized to act as a broker dealer by the National Banking and Securities Exchange Commission.

Singapore: This material is issued and distributed in Singapore by J.P. Morgan Securities Singapore Private Limited (JPMSS) [MICA (P) 020/01/2010 and Co. Reg. No.: 199405335R] which is a member of the Singapore Exchange Securities Trading Limited and is regulated by the Monetary Authority of Singapore (MAS) and/or JPMorgan Chase Bank, N.A., Singapore branch (JPMCB Singapore) which is regulated by the MAS. **Malaysia:** This material is issued and distributed in Malaysia by JPMorgan Securities (Malaysia) Sdn Bhd (18146-X) which is a Participating Organization of Bursa Malaysia Berhad and a holder of Capital Markets Services License issued by the Securities Commission in Malaysia. **Pakistan:** J. P. Morgan Pakistan Broking (Pvt.) Ltd is a member of the Karachi Stock Exchange and regulated by the Securities and Exchange Commission of Pakistan. **Saudi Arabia:** J.P. Morgan Saudi Arabia Ltd. is authorised by the Capital Market Authority of the Kingdom of Saudi Arabia (CMA) to carry out dealing as an agent, arranging, advising and custody, with respect to securities business under licence number 35-07079 and its registered address is at 8th Floor, Al-Faisaliyah Tower, King Fahad Road, P.O. Box 51907, Riyadh 11553, Kingdom of Saudi Arabia. **Dubai:** JPMorgan Chase Bank, N.A., Dubai Branch is regulated by the Dubai Financial Services Authority (DFSA) and its registered address is Dubai International Financial Centre - Building 3, Level 7, PO Box 506551, Dubai, UAE.

Country and Region Specific Disclosures
U.K. and European Economic Area (EEA): Unless specified to the contrary, issued and approved for distribution in the U.K. and the EEA by JPMSL. Investment research issued by JPMSL has been prepared in accordance with JPMSL's policies for managing conflicts of interest arising as a result of publication and distribution of investment research. Many European regulators require that a firm to establish, implement and maintain such a policy. This report has been issued in the U.K. only to persons of a kind described in Article 19 (5), 38, 47 and 49 of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (all such persons being referred to as "relevant persons"). This document must not be acted on or relied on by persons who are not relevant persons. Any investment or investment activity to which this document relates is only available to relevant persons and will be engaged in only with relevant persons. In other EEA countries, the report has been issued to persons regarded as professional investors (or equivalent) in their home jurisdiction. **Australia:** This material is issued and distributed by JPMSAL in Australia to “wholesale clients” only. JPMSAL does not issue or distribute this material to “retail clients.” The recipient of this material must not distribute it to any third party or outside Australia without the prior written consent of JPMSAL. For the purposes of this paragraph the terms “wholesale client” and “retail client” have the meanings given to them in section 761G of the Corporations Act 2001. **Germany:** This material is distributed in Germany by J.P. Morgan Securities Ltd., Frankfurt Branch and J.P.Morgan Chase Bank, N.A., Frankfurt Branch which are regulated by the Bundesanstalt für Finanzdienstleistungsaufsicht. **Hong Kong:** The 1% ownership disclosure as of the previous month end satisfies the requirements under Paragraph 16.5(a) of the Hong Kong Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission. (For research published within the first ten days of the month, the disclosure may be based on the month end data from two months’ prior.) J.P. Morgan Broking (Hong Kong) Limited is the liquidity provider for derivative warrants issued by J.P. Morgan Structured Products B.V. and listed on the Stock Exchange of Hong Kong Limited. An updated list can be found on HKEx website: http://www.hkex.com.hk/prod/dw/Lp.htm. **Japan:** There is a risk that a loss may occur due to a change in the price of the shares in the case of share trading, and that a loss may occur due to the exchange rate in the case of foreign share trading. In the case of share trading, JPMorgan Securities Japan Co., Ltd., will be receiving a brokerage fee and consumption tax (shouhizei) calculated by multiplying the executed price by the commission rate which was individually agreed between JPMorgan Securities Japan Co., Ltd., and the customer in advance. Financial Instruments Firms: JPMorgan Securities Japan Co., Ltd., Kanto Local Finance Bureau (kinsho) No. 82 Participating Association / Japan Securities Dealers Association, The Financial Futures Association of Japan. **Korea:** This report may have been edited or contributed to from time to time by affiliates of J.P. Morgan Securities (Far East) Ltd, Seoul Branch. **Singapore:** JPMSS and/or its affiliates may have a holding in any of the securities discussed in this report; for securities where the holding is 1% or greater, the specific holding is disclosed in the Important Disclosures section above. **India:** For private circulation only, not for sale. **Pakistan:** For private circulation only, not for sale. **New Zealand:** This material is issued and distributed by JPMSAL in New Zealand only to persons whose principal business is the investment of money or who, in the course of and for the purposes of their business, habitually invest money. JPMSAL does not issue or distribute this material to members of "the public" as determined in accordance with section 3 of the Securities Act 1978. The recipient of this material must not distribute it to any third party or outside New Zealand without the prior written consent of JPMSAL. **Canada:** The information contained herein is not, and under no circumstances is to be construed as, a prospectus, an advertisement, a public offering, an offer to sell securities described herein, or solicitation of an offer to buy securities described herein, in Canada or any province or territory thereof. Any offer or sale of the securities described herein in Canada will be made only under an exemption from the requirements to file a prospectus with the relevant Canadian securities regulators and only by a dealer properly registered under applicable securities laws or, alternatively, pursuant to an exemption from the dealer registration requirement in the relevant province or territory of Canada in which such offer or sale is made. The information contained herein is under no circumstances to be construed as investment advice in any province or territory of Canada and is not tailored to the needs of the recipient. To the extent that the information contained herein references securities of an issuer incorporated, formed or created under the laws of Canada or a province or territory of Canada, any trades in such securities must be conducted through a dealer registered in Canada. No securities commission or similar regulatory authority in Canada has reviewed or in any way passed judgment upon these materials, the information contained herein or the merits of the securities described herein, and any representation to the contrary is an offence. **Dubai:** This report has been issued to persons regarded as professional clients as defined under the DFSA rules.

General: Additional information is available upon request. Information has been obtained from sources believed to be reliable but JPMorgan Chase & Co. or its affiliates and/or subsidiaries (collectively J.P. Morgan) do not warrant its completeness or accuracy except with respect to any disclosures relative to JPMSI and/or its affiliates and the analyst’s involvement with the issuer that is the subject of the research. All pricing is as of the close of market for the securities discussed, unless otherwise stated. Opinions and estimates constitute our judgment as of the date of this material and are subject to change without notice. Past performance is not indicative of future results. This material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. The opinions and recommendations herein do not take into account individual client circumstances, objectives, or needs and are not intended as recommendations of particular securities, financial instruments or strategies to particular clients. The recipient of this report must make its own independent decisions regarding any securities or financial instruments mentioned herein. JPMSI distributes in the U.S. research published by non-U.S. affiliates and accepts responsibility for its contents. Periodic

updates may be provided on companies/industries based on company specific developments or announcements, market conditions or any other publicly available information. Clients should contact analysts and execute transactions through a J.P. Morgan subsidiary or affiliate in their home jurisdiction unless governing law permits otherwise.

"Other Disclosures" last revised March 1, 2010.

Copyright 2010 JPMorgan Chase & Co. All rights reserved. This report or any portion hereof may not be reprinted, sold or redistributed without the written consent of J.P. Morgan.