Deutsche Bank

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China Macro Strategy

Is this "the" turning point?

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As we pointed out in our economic note today, economic numbers will likely get worse in the coming 2-3 months but policies may be only relaxed in Q4 this year (see our report *China: Will Macro Policies be Relaxed?*). How will the equity market react to this very mixed bag of signals?

A plausible scenario with multiple entry points
There are many scenarios for the remainder of this year, but one which we think is more plausible looks like the following:

1) The market rebound started from Friday last week on strong expectation that policy relaxation will likely continue in the very near term, reflecting market momentum, short covering and high cash positions of many investors. This short-term uptrend is to some extent self-fulfilling and does not require much support from improvement in macro fundamentals.

2) A pull-back is likely after this short-term rebound. This can be triggered by a few of the following likely events:
   - No confirmation from the government on policy relaxation within weeks;
   - Some government agencies publicly defy market speculations on specific policy relaxations or stimulus in areas such as property, fiscal spending and credit quota;
   - Economic data including PMI, industrial production, and power consumption may surprise on the downside; and
   - Data on non-viable projects under the local financing platforms may turn out to be a negative surprise, and the lack of a clear resolution strategy could undermine the government's ability to provide stimulus next year.

3) When the government has reported some worse economic numbers in Q3, which would raise the probability of Q4 policy relaxation to 70% (up from the current 50-60% in our view), the market could begin a more sustained recovery that we think could last six to nine months. Following that, the sequential (qoq) economic growth may show a consecutive recovery for 2-3 quarters (from Q4 this year to Q2 next year).

In sum, we think investors do not have to be overly concerned by the possibility of missing a huge rally starting from right now. There may well be other equally attractive entry points, on a risk-reward basis, in the remainder of this quarter. That is, even though the next entry point in the market is slightly higher than the current level, it may actually be a safer one.

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We expect 25% upside to MSCI China in the next 12-months

We assume that the MSCI China index will be trading at around 13x forward PE, the same as last ten years' average, by the middle of next year. Given our and consensus EPS growth estimates, both at around 17% for this and next year, we think the index should be at 77 in July 2011. This represents 25% upside to the current level of the MSCI China index.

This index outlook is relatively cautious compared with many other forecasts on the street, but we think it is justified for the following reasons.

First, we believe next year's GDP growth will be around 8.6% (vs. market consensus of 9.2%), lower than this year's 9.6% and significantly weaker than last ten years' average of 10.3%. The fundamental reason for this relatively weaker growth outlook compared with the past is that we think the three key drivers of growth in the past -- infrastructure spending, housing demand, and exports -- will all lose momentum going forward. This is because the ownership ratio of residential properties and the penetration of transport infrastructure are already very high, suggesting significantly weaker demand growth in the future. On exports, the weaker G3 outlook, rising wage inflation in China, and the appreciating RMB all suggest that export growth potential will be only half of that in the past decade.

Over the last ten years, when the economy was growing at 10.3% per annum, MSCI China traded at an average forward PE of 13x. If we are right that next year's economic growth is only 8.6%, it is hard to justify a PE multiple that is way above 13x.

Second, the stimulus package for 2011, if any, will have to be significantly less aggressive than that in 2009. We think the best the government can do it to allow M2 and loan growth to reach 18-19% next year (vs. around 30% in 2009), and the fiscal deficit/GDP ratio will unlikely exceed that in 2009. This is because the costs of over-expansion of macro policies in 2009 are just beginning to show up in NPLs and property bubbles, and this lesson will serve as a powerful reminder for policy makers not to react excessively to short-term signals of economic downside risks. The availability of commercially viable public projects for next year will also be much more limited than in late 2008, as most high quality projects have been started already under the previous RMB4tr program. Even in H2 of 2009, when the stimulus package delivered its maximum impact, the MSCI China index was merely trading at an average of 14 times.

Third, even if the government surprises the market with a stronger-than-expected policy package for 2011, it is unlikely to boost the equity market in the same way as in H1 of 2009. This is because the market has by now realized that the economy will eventually pay the bill for excessive policy stimulus in the forms of higher credit costs, inflation, asset bubbles, policy tightening, and higher economic and market volatility. Simply put, the growing market recognition that any sharp economic rebound due to short-term policy stimulus is not sustainable will likely keep market reactions relatively muted in the future.

Finally, we tested the plausibility of our market outlook of 25% index upside using a simple model. This model allows us to derive from our index target the implied probabilities of the "recession", "normal" and "high growth" scenarios of the economy and EPS growth. We define the valuation under "recession" as the PE seen in October 2008, "normal" as last ten years' average, and "high growth" as that in Q4 of 2007. The 25% index upside in the next 12 months is consistent with a 10% probability for "recession" in 2011, an 80% probability for "normal", and a 10% probability for "high growth".

Figure 1: MSCI China index upside and implied probabilities of three scenarios

MSCI China	21-Jul-10		
Current index level	61.55		
12M forward PE (x)	12.4		
EPS growth in FY11	17%		
Historical experience	12M forward PE	EPS growth in the following 12m	Implied 12M upside to current
Recession (Oct 2008)	8.4	5%	-29%
Normal (10Y average)	13.2	14%	21%
High growth (Q4 2007)	21.3	22%	110%
2010 scenarios	Likelihood	12M index target	
Recession - second dip (6-7% GDP growth	10%	44	
Normal - soft landing (8-9% GDP growth)	80%	75	
High growth - (12-14% GDP, as in 2007)	10%	129	
Central scenario (with probabilities given above)			
Index target			77
Index upside from current level			25%

Source: Deutsche Bank, Datastream, Bloomberg Finance LP

Appendix 1

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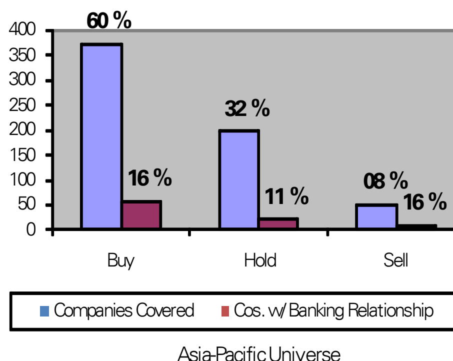

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