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China; no quick fix for the Beijing model

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The rapid deterioration in the Chinese economy is the culmination of long-standing structural issues which the authorities have failed to address, compounded by weakness in the developed economies. These problems have long been evident in the underlying dynamics of the corporate sector but not in the aggregate data, which is why most top down investors and economists have been taken by surprise. The situation is likely to continue to worsen from a bottom up perspective, as slowing growth combines with overcapacity, to drive a continuing rise in inventories of raw materials and finished goods.

We believe that the underlying cause of China's problems is the application of the soft budget constraint through which regional governments have provided subsidized factor inputs to selected enterprises, while Beijing controls key industries in order to serve its own strategic objectives. The resulting decline in productivity growth, which was obscured by a period of strong external demand and the post-Lehman stimulus, is now revealed in the rapid deterioration of profits and cash flow across many key industries. This is more reminiscent of post Soviet Russia in the years before the 1998 crisis, than the successful East Asian economies with which China is more usually compared.

The authorities in Beijing are trying to balance the conflicting objectives of maintaining reasonable rates of growth whilst transitioning to a more balanced and harmonious economy. It is not clear how they will attempt to reconcile these aims, but muddle through is the most likely option, in the hope that the external environment will improve, most likely through a pick-up in the US housing market. The most likely outcome is that estimates of sustainable GDP growth will continue to be revised down to levels, which feel close to stagnation by Chinese standards. Nevertheless, whilst the macro situation appears much more comfortable than post-Soviet Russia, there is a risk that without a concerted reform effort to impose more market discipline, falling confidence in the both the Chinese economy and financial assets will begin to feed on each other and lead eventually to a slow motion financial crisis.

The risk premium for Chinese equities is likely to remain high, given the likely continuing deterioration in the corporate sector and uncertainty over the direction of policy; investors should monitor the potential beneficiaries of industrial consolidation but it remains too early to buy yet. We would be especially wary of the banking sector, which will bear much of the burden in either a crisis or a restructuring scenario. Weakness in China should continue to drive global metals and eventually oil prices lower, which helps to underpin our long-held preference for DM over EM and within GEM for Mexico over Brazil and Turkey over Russia. We also anticipate increasing pressure within China for a RMB devaluation to act as a safety valve for the economy; this is likely to generate a high degree of friction with China's trading partners, which may then spread to broader foreign policy issues and could help to maintain the global equity risk premium at a relatively high level.

WEAKNESS IN CHINESE ECONOMY SYSMPTOMATIC OF A DEEPER STRUCTURAL MALAISE

Clear and rapid deterioration taking place across much of the Chinese economy.

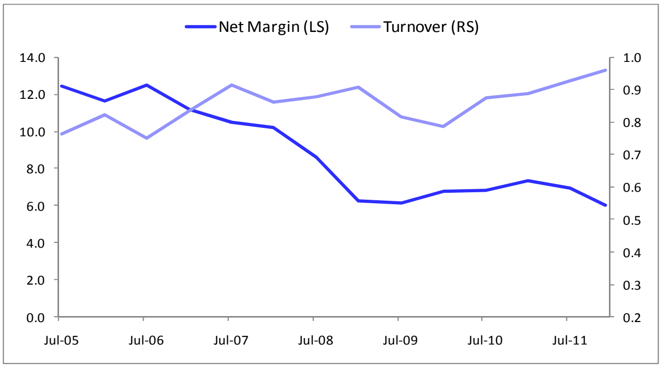
We have long believed that the key structural driver of long term returns in GEM equities is the relationship between the state and the corporate sector, which can also often be a lead indicator of economic problems before they are appear in the macro data. In May we wrote about the impact of the widespread overcapacity, which is evident across a broad range of Chinese industries, on potential returns for investors ('China's corporate sector; a messy transition' 15th May 2012). Since then the situation on the ground has deteriorated in much the way which we had anticipated, providing a steady stream of bad news, throughout much of the industrial sector through the results of listed companies and the more anecdotal evidence, in particular the rapid build up in inventories across a wide variety of industries. Most of the top down economic forecasting community have been taken by surprise and have had to adjust their GDP forecasts downwards, usually in small increments, implying a degree of precision which is largely spurious in the Chinese context.

We believe that the weakness of the Chinese economic is symptomatic of a deeper malaise in which large parts of the corporate sector bear a closer resemblance to post-Soviet Russia than the east Asian newly industrialising economies (NICs), Taiwan and South Korea, with which China is more usually compared. The authorities in Beijing are clearly aware of these structural issues, which is why they have been (rightly) reluctant to provide much in the way of stimulus this year. Nevertheless they will find it difficult to muddle through in the absence of an (unlikely) pick-up in growth in the major developed economies, so the economy and corporate sector are likely to continue to weaken in tandem, until one of two things happens; there is either a coherent reform programme to address the structural issues which have caused the potential growth rate to fall, or there will be a financial crisis of some kind.

Macro data gave little warnings of problems ahead

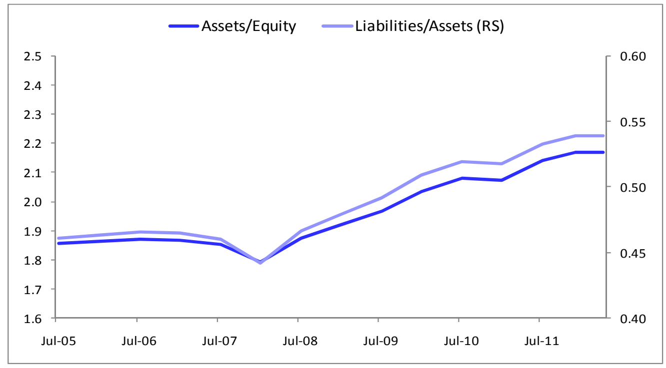
The aggregate data for either the Chinese economy or the listed corporate sector has given little warning of the problems, which are now becoming increasingly evident. Throughout the last ten to twelve years or so the conventional wisdom among most economists has been that the enterprise sector in China has continued to become more efficient and market oriented, following the SOE reforms which took place between 1998 and 2003. The official data shows a consistent increase in the share of the private sector in both investment and output, and has also indicated a positive change in profitability measures across the SOE sector, in particular ROE, while industrial value added (IVA) has also appeared relatively comfortable. The official measures of capacity utilisation have also given little cause for concern in most industries. The aggregate data for the listed corporate universe based on reported numbers, also appears perfectly respectable and has tended to reinforce the overwhelmingly positive view of most buy and sell side analysts alike until recently. Overall ROE has held up relatively well while the decline in capex to sales does tend to support the view that the listed corporate sector at least is becoming less focused on investment for its own sake. The only real worry is the steady deterioration in margins which has taken place since 2005 accompanied by a rise in financial leverage, though the later is not of sufficient size to cause any real alarm. (figures 1 through 4)

Figure 1: Rising asset turnover and falling margins



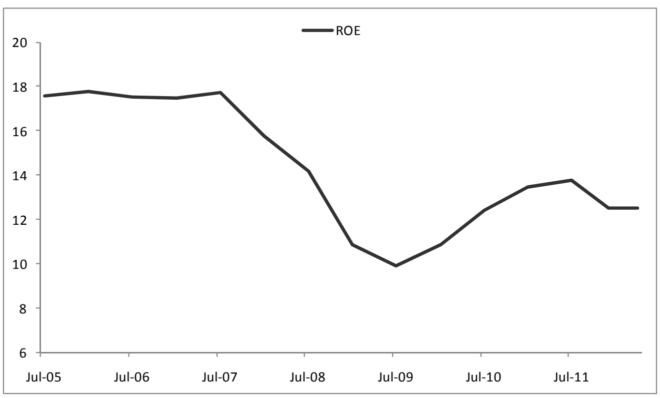
Source: Deutsche Bank. Bloomberg Finance LP

Figure 2: Financial leverage has risen post 2008



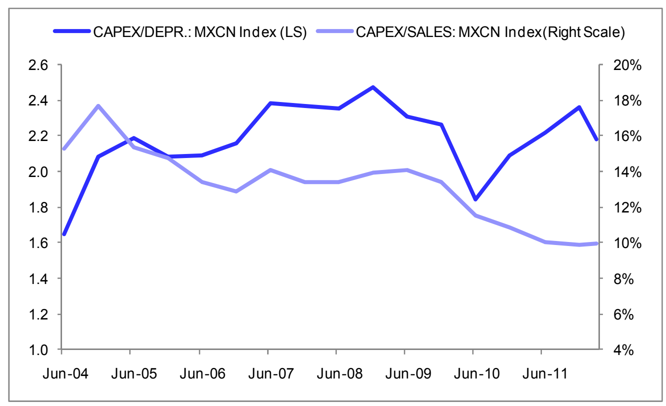
Source: Deutsche Bank, Bloomberg Finance LP

Figure 3: ROE has held up relatively well



Source: Deutsche Bank, Bloomberg Finance LP

Figure 4: Falling capex rate suggests greater efficiency

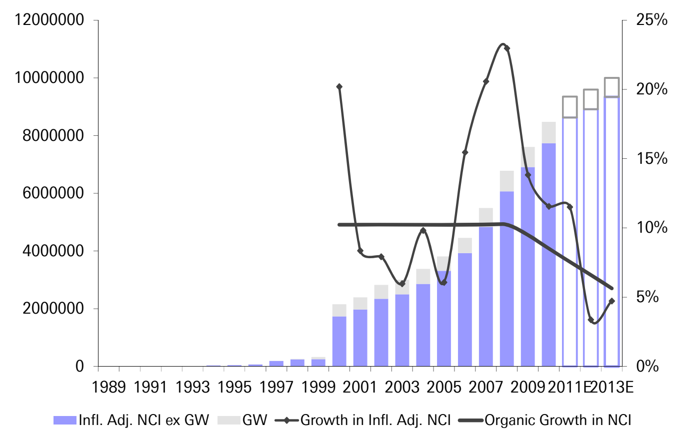


Source: Deutsche Bank, Bloomberg Finance LP

Structural trends have not supported optimistic view

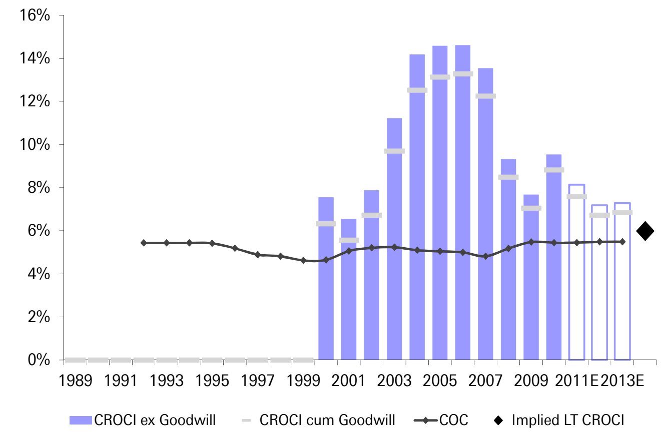
There were some indications that the underlying situation was not as positive as the macro data suggested, before the recent slowdown in the economy brought these issues to the surface. First, there were a number of third party studies of the underlying profitability of SOEs which questioned the extent to which the returns of the SOE sector really were as good as the official data suggested. Investigations by researchers at both the Unirule institute and the HKMA concluded that if due allowance for the below market costs of many factor inputs was taken into account, then the stated ROE for the SOE universe would be considerable lower and in some cases negative. The second piece of evidence, which we have cited since the start of 2011 in support of our more bearish view, has been the work of Deutsche own CROCI team, which suggests that the productivity of the Chinese enterprises under coverage has been declining steadily since 2006. We enclose the CROCI charts for the 44 non-financial companies under coverage which represent just under two-thirds of the MSCI China non-financial universe (Figures 5&6), but the clear conclusion is that the increases in profit have been achieved largely through an increase in the capital inputs, resulting in a sharp deterioration in cash ROE (CROCI). The decline is still significant, though not quite so pronounced when the data is broken out from a median as opposed to an aggregated basis, with a decline in CROCI of 3.1%. Given that the CROCI universe generally comprises some of the most market oriented and operationally efficient companies in China, we have long believed that this data has implications for the productivity of the broader economy and is another piece of evidence that the sustainable growth rate in China has been steadily falling over the past few years.

Figure 5: China ex-Financials Net Capital Invested



Source: Deutsche Bank

Figure 6: China ex-Financials CROCI



Source: Deutsche Bank

THE SOFT BUDGET CONSTRAINT HAS UNDERMINED CHINA'S PRODUCTIVITY GROWTH

Soft budget constraint is underlying reason for poor productivity

The late Hungarian economist Janos Kornai, devoted most of his career to the study of economies under Communist rule and introduced the concept of the 'soft budget constraint' to describe the position of enterprises during the transition from socialism to capitalism. The essence of the soft budget constraint is that enterprises are to some extent shielded from market discipline - whilst originally applied to command and transition economies, the concept is also relevant to supposedly market economies as has been illustrated by the aftermath of the global financial crisis. In China's case, the characteristics of the soft budget constraint take somewhat different forms according to the level of state control and competition, which Beijing has prescribed in each individual industry.

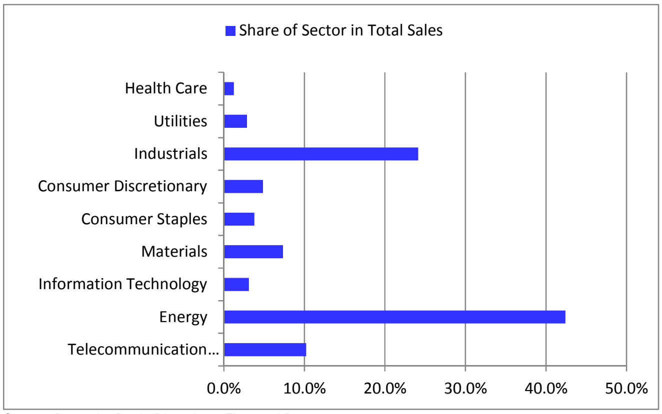
Strategic industries returns and investments controlled by Beijing

First, the so-called strategic industries, which are defined as those in which central government generally maintains at least a 50% ownership stake in each firm, comprising the following industries; defence, coal, air transport, power, telecoms, oil/petrochems and shipping. In theory Beijing has almost complete control over the entire investment and financial operations of almost all of these enterprises, although this has certainly not been the case in the coal and shipping industries where capex discipline has broken down. Nevertheless, the defining characteristic is that both investment and returns of these industries are made at the behest of the state and that strategic objectives will take place over commercial ones. This is likely to drag down both returns to investors and productivity rates in the broader economy in our view, through the potential misallocation of resources and overinvestment. The ongoing heavy investment programme into bulk chemicals is one example of Beijing's desire to obtain self-sufficiency in an industry where it’s difficult to identify any real comparative advantage. The use of the telecoms and power sector to develop indigenous technology and the expensive acquisition of natural resources at what might turn out to be close to the peak of the cycle by the raw material companies, are further examples of potentially value subtracting investments. Beijing also prevents many of these sectors, such as power and downstream oil & gas from earning a commercial return on investment, in order to enable the rest of the economy to benefit from lower prices.

'Pillar' industries with mixed ownership and control

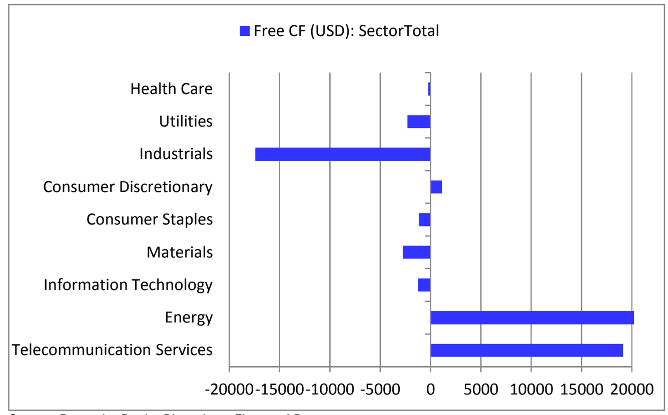
Second, the so-called 'pillar' industries, which are those in which Beijing has a strategic interest but where the parameters of control are not so tightly defined, namely steel, autos, construction, non-ferrous metals, machinery & equipment and IT/science and technology. The bulk of the listed industrial sector comprises these sectors in companies which are mainly state controlled, but which unlike the strategic industries have returns which are to some extent subject to competition. Most of the listed companies tend to be among the more efficient players in their respective sectors, but as we discuss later their returns are being dragged down by a large number of mainly unlisted competitors, which benefit from subsidized factor inputs. The result is a level of hitherto latent overcapacity, which is becoming increasingly obvious as the economy slows and is manifested in rapidly rising inventories and deteriorating cash flow. Figures 7&8 breaks down the MSCI China non-financial universe by sales and cash flow and reveals a sharp difference between the strategic sectors which are generally oligopolistic/monopolistic and the industrial sectors, which are more exposed to competitive pressures.

Figure 7: Distribution of sales of non-financial companies



Source: Deutsche Bank, Bloomberg Finance LP

Figure 8: Total free CF by sector



Source: Deutsche Bank, Bloomberg Finance LP

'True' private sector much smaller than suggested by official data

There has been a long running debate about the extent of the private sector in China. Whilst the official data suggests that the proportion of assets and investments controlled by the state has been falling steadily and is now under 50%, more qualitative assessments such as Derek Scissors and Yasheng Huang indicate that the 'true' private sector is much lower[1]. Our own analysis of the MSCI listed firms would appear to support this conclusion, as the state retains a high level of influence over much of the 20% or so of market capitalisation, which does not fall under its direct control. There are a number of prominent companies in the MSCI and the broader economy, which are purportedly private but whose relationship with the state is so symbiotic that it is difficult to discern any meaningful boundary between private and state. The omnipresence of the state is both a threat for private companies in terms of potential intervention and an opportunity to obtain direct subsidies as well as other more indirect forms of support. This dynamic is very evident in some of the more distressed sectors at present, such as construction machinery and shipbuilding, where it is very difficult to separate the private from the state owned enterprises. We would therefore be very sceptical of any official data concerning the size of the private sector and conclude that the very blurred boundaries reinforce the soft budget constraint and greatly increase the degree of moral hazard within the Chinese economy.

Value destroying overcapacity supported by regional governments

As Figures 9 &10 show, the listed industrial sector has failed to generate much in the way of cash flow for several years, despite very high rates of sales growth and a falling proportion of capex to sales. The reason is that the soft budget constraint has been enforced at a sub-national level by regional and local governments which provide their favoured enterprises with subsidized factor inputs (Figures 11-12), in particular the provision of low cost power, land and bank finance. According to the US China Economic & Security Review Commission analysis of SOEs in China published in 2011, local officials approve the vast majority of investments in China, in particular around 95% of fixed investment in manufacturing industry.

The regional government's natural inclination to invest heavily, which was compounded by the post-Lehman stimulus, has resulted in a level of overcapacity across many

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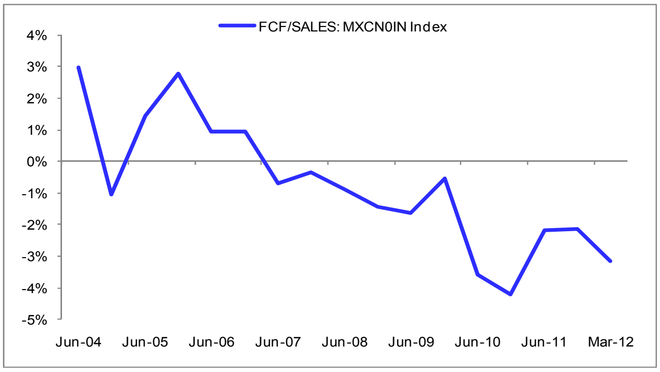
[1] State-owned enterprises in China, Testimony of Derek L Scissors, hearing before the US-China Economy & Security Commission, 11-March-2011
Huang, Yasheng, "Capitalism with Chinese Characteristics", Cambridge Univ. Press, 2008

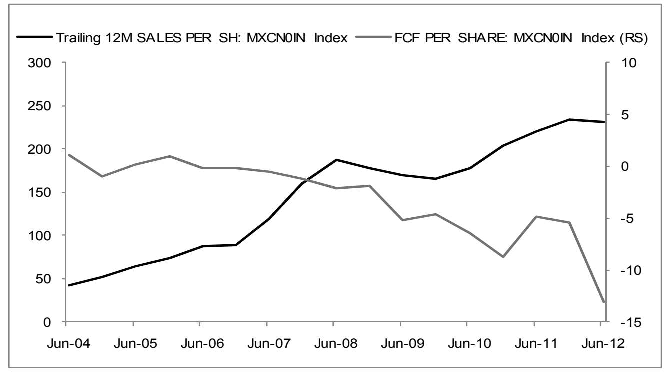
industries, which is becoming increasingly apparent in rising inventory levels as the economy slows down. This extent of this overcapacity had escaped the notice of much the macro-economic community, as it failed to show up in the aggregate data, but is now becoming more widely recognised, including by the IMF, who published the following chart in their most recent staff paper on China (Figure 13).

Figure 9: Negative FCF has become acute in industrials



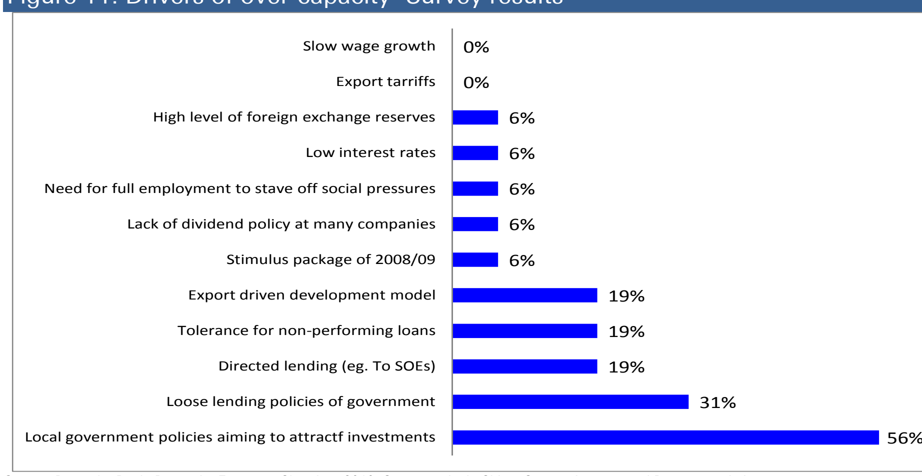
Source: Deutsche Bank, Bloomberg Finance LP, MSCI

Figure 10: ... despite very high sales growth



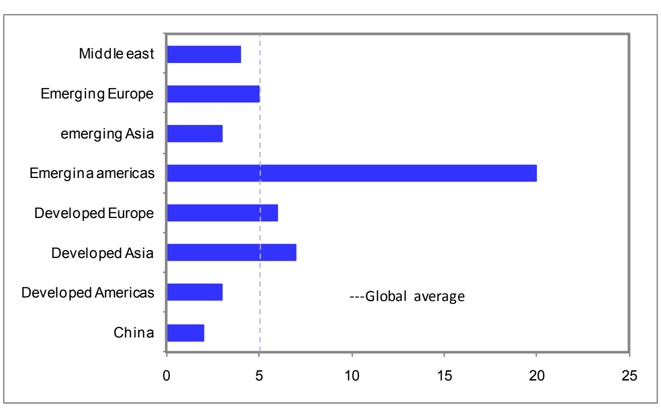
Source: Deutsche Bank, Bloomberg Finance LP

Figure 11: Drivers of over-capacity- Survey results



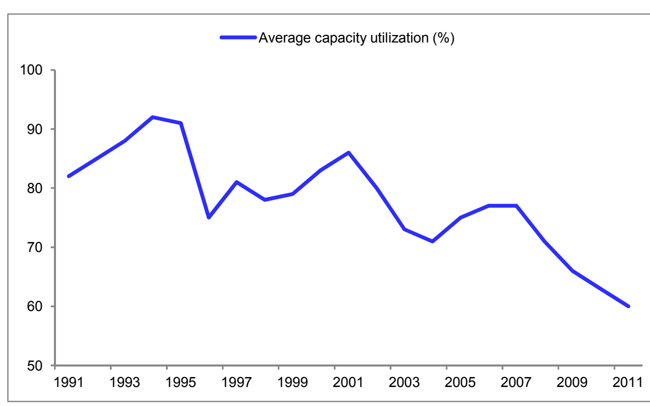
Source: Deutsche Bank, Report by European Chamber, 2010: Overcapacity in China; Causes, Impacts and Recommendations

Figure 12: Real cost of capital 2005-09



Source: Deutsche Bank, International Monetary Fund Country Report No.11/192, July 2011

Figure 13: Over capacity becoming more evident



Source: Deutsche Bank, International Monetary Fund Country Report No.12/195, July 2012

The soft budget constraint at enterprise level - Beijing is not in control

The majority of economists and investors have long laboured under the delusion that Beijing exerts almost complete control over China's economy. There is a widespread belief that the success of the Chinese economy in measured GDP terms over the past thirty years is as a direct result of government planning and the adaptation of a hybrid command/market economy. Indeed the most common response by investors when we have presented our bear case on China over the past eighteen months, is that 'the Chinese government wouldn't allow that to happen'. The limitations of the powers of the authorities in Beijing are however evident from their failure to follow through on their targets to consolidate industrial capacity in key industries, which were laid out in the past 10th and 11th five year plans. Beijing had (correctly) identified the ability of sub-national governments to supply low cost factor inputs to locally based enterprises as detrimental to the productivity of the national economy for two reasons. First, the resulting excess level of capacity drives down returns for the more efficient companies in the same sectors, including many companies which Beijing has in effect designated as national champions in industries such as aluminium, coal and steel. Second, some of the implied subsidy for locally based enterprises is at the expense of the 'enabling' sectors of the strategic industries such as power and downstream oil and more importantly at the expense of the state controlled banks, which have effectively been forced at the regional level to extend credit to locally based enterprises without a proper due diligence process.

CHINA SHARES SOME CHARACTERISTICS WITH POST-SOVIET RUSSIA

Soft budget constraint at regional level undermined reforms...

The presence of the soft budget constraints mean that there are certain elements of the Chinese economy today, which are much more reminiscent of the USSR and the post Soviet Russian economy, than the NICs of east Asia, at least as far as the corporate sector is concerned. On the face of it, the structure of the corporate sector in Russia in 1998 was very different to what exists in China today. Following the collapse of the USSR, the voucher privatisation from December 1992 to June 1994, which took 10,000 large and medium companies out of the state sector, generally resulted in concentrated private ownership, which it was thought would transform incentives and operational efficiency. The problem though is like China today, many of these nominally private enterprises were fundamentally unviable, but were kept alive by the use of their lobbying power and social importance to obtain resources at both a regional and national level. The regional dimension was critical in Russia where the 'hard state liberals' around Boris Yeltsin, struggled to curb the proportion of the country's economic resources which was taken up by value subtracting enterprises, due to opposition from vested interests mainly regional governors and the powerful enterprise lobby.

...while blurred boundaries between state and private sector led to rent seeking

The resulting very blurred boundaries between the state and private sectors increased the incentives for rent seeking behaviour encouraging the privatisation of any gains and socialisation of any losses, preferably at the expense of resources which are controlled at the national level. The bias towards high levels of capital expenditure, which existed under the Communist system, was heightened by the opportunities to divert what we might euphemistically term as leakage into the pockets of controlling shareholders. The widely held view that present day China is much more disciplined is belied by the increasingly widespread evidence that Chinese politicians, officials and managers at state controlled companies, are using their public office for private gain. Two prominent recent cases include the investigation into procurement policies at the Ministry of Railways and the ouster of Bo Xilai. The subsequent concentration of wealth and power in the hands of relatively few families in China (Jonathan Fenby's book 'Tiger Head Snake Tails', [2]refers to suggestions that 3,000 families run China for their own benefit), is not dissimilar to Thomas Graham's description of the development of a 'clan' system in Russia in a seminal paper published in 1996.

Dysfunctional corporate sector underlying cause of financial crisis

The resulting build up of imbalances within the corporate sector, when companies extended credit to each other via barter or veksels or else simply did not pay their bills at all, created what was later termed Russia's 'virtual' economy. By the middle of 1997, 27 of the 82 regions across Russia were running deficits of 30% or more while overdue receivables through the corporate sector had climbed to 1288bn Ruble from 483bn in 1995. The result was that the local governments began to withhold increasing amounts of tax revenues from Moscow and used the local power utilities as a source of free credit, which in turn eventually undermined the finances of Gazprom. The consequent decline in tax revenues led directly to the financial crisis, which culminated in the GKO default and Rouble devaluation on 17th August 1998. In Russia in the absence of a banking sector which was willing and able to lend, Gazprom and the energy utilities played a supporting role for the manufacturing companies, just as the utilities,

[2] Tiger Head, Snake Tails, by Jonathn Fenby, Simon & Schuster, 2012

downstream oil companies and in particular the banks play a similar enabling role in China today. David Woodruff in his illuminating study of the non-payments crisis, 'Money Unmade'[3] cites the 'godfather' of Russian reform Yevgenny Yasin as having identified the top priority for reform as preventing firms from selling for less than their formal cost of production; this should also be Beijing's top priority, but like Russia, the barriers will be formidable.

Macro-economists generally behind the curve

Whilst the financial crisis in Russia now appears inevitable with the benefit of hindsight (don't they always), most of the macro-economists at the multilateral and private sector financial institutions were relatively sanguine about the outlook going into 1998. One of the UK's most prominent economists Professor Richard Layard at the LSE, co-authored 'The Coming Russian Economic Boom' in late 1996[4], while investors in Russian equities enjoyed huge gains between the middle of 1995 and the Autumn of 1997. The macro-economic data appeared reasonably good, with inflation and the fiscal deficit falling steadily, which implied that the economy was on the verge of stabilization. All of this was however undermined by the big increase in inter-enterprise arrears, which could only be understood by an examination of the relationship between the corporate sector and the state, at both a national and a local level. Martin Gilman was the IMF's chief representative in Russia in 1998 and in 2010 published a book about the crisis 'No Precedent, No Plan'.[5] This appears to confirm the impression that the IMF, along with most other commentators was overly reliant on accurate macro data which was not necessarily forthcoming, 'such facts did not readily appear in the data at the macro level', for example the foreign exchange exposure of Russian banks and the extent to which they were borrowing abroad at the start of 1998. Professor Gilman also concedes that the IMF underestimated both the influence of vested interests on policy making, 'in retrospect it is stunning just how naive most outside observers really were' and the impact of the broader social remit of the enterprise sector, 'it was not fully appreciated at the time that the economy was unprepared to accept the consequences of hard budget constraints in either the public or the private sector'.

[3] Money Unmade: Barter and the Fate of Russian Capitalism, by David Woodruff, Cornell University Press, 2000
[4] The Coming Russian Boom,by Richard Layard, Free Press, 1996
[5] No Precedent, No Plan, by Martin Gilman, MIT Press, 2010

THE RELATIONSHIP BETWEEN THE CORPORATE SECTOR AND THE UNDERLYING ECONOMY WILL DETERMINE HOW THE SITUATION IN CHINA PLAYS OUT

State's dominant role in resource allocation now detrimental to productivity led growth

The central role of the state to mobilize the resources necessary for strong growth in the early stages of industrialisation has been a common feature of all of the NICs. Those countries which have been successful in surmounting the so-called middle income transition, such as Korea and Taiwan however, have managed to shift the emphasis away from the state towards to the private sector in order to maintain high rates of productivity. Many Chinese economists, most notably perhaps Yasheng Huang at MIT, believe that China has been moving in the other direction, to the detriment of productivity; in 'Capitalism With Chinese Characteristics', he outlines how the way in which the liberalisation of entry into the private sector has been partially reversed over recent years. Deutsche Bank's senior Asian economist, Michael Spencer recently suggested that productivity gains in agriculture are largely played out and that further reforms to deepen land and property right are necessary to allow urbanisation to proceed further and restore rates of total factor productivity (TFP). The fall in the underlying level of productivity was obscured from 2002-07 by the impact of WTO entry and strong growth in the main developed economies on exports and then later by the unsustainable increase in bank lending during the post-Lehman stimulus. Both these analyses support the conclusions from our own analysis of the corporate sector, while the toxic aftermath of the post-Lehman stimulus indicates that the level of state control is clearly inappropriate for an economy with an annual GDP of around $8,000 in purchasing power parity terms.

Underlying fiscal situation in China not nearly as stable as it appears to be

The current fiscal balances and stock of government debt to GDP may appear relatively comfortable from a macro perspective, but the underlying situation is not nearly so stable. Christine Wong of the OECD estimates that following the 1994 tax reforms, which saw a redistribution of revenues towards Beijing, sub-national governments account for around 79% of total government expenditure but only 47% of total revenues. Moreover, one of the main effects of the SOE reforms of 1998-2003 was to transfer many of the responsibilities of the SOE sector for the 'iron rice bowl' provision of welfare services over to the regional and local governments, without any corresponding increase in formal funding mechanisms. In China some of the shortfall has been taken up by transfers from Beijing, but sub-national governments also rely on the fruits of local growth, such as user fees, property sales and tax income from locally based enterprises. After growth had begun to slow following the 2007 financial crisis, sub-national governments took advantage of the post-Lehman stimulus to utilise the banking sector as a source of funds for pet projects and enterprises. The result was a major increase in what was in effect deficit financing, some of which went through special purpose vehicles, the LGFVs which were established to circumvent the prohibition of direct borrowing by local authorities. As a consequence, inflationary pressures rose to levels, which began to threaten social stability and increased the overall ratio of debt to GDP by up to 40%, much of which in effect amounted to contingent liabilities for the national government.

Corporate capex based on unsustainable growth assumptions

The conclusion of falling levels of productivity growth accompanied by a dramatic increase in contingent fiscal liabilities, is that barring an unexpected pick-up in the major developed economies, the sustainable growth rate of the Chinese economy has fallen by a considerable amount over recent years. This has important implications for the corporate sector. The bias to overinvestment through the widespread application of the soft budget constraint, was compounded by the impact of the stimulus in disguising the structural deterioration in the economy's potential growth rate. Most corporates therefore engaged in 'extrapolative capex', that is based on a continuation of historical nominal growth rates in the mid to high teens. Whilst much of this investment was via retained earnings rather than borrowing, it was achieved on the back of an unsustainable rise in leverage for the overall economy from late 2008 through 2010 - the net effect was therefore similar to what it would have been had the companies been borrowing directly, namely a sharp cash crunch as the economy contracted as the stimulus was withdrawn. The most obvious effect has been a sharp increase in inventories and decline in pricing power. The first industries to be affected were the ones which had shown the most dramatic expansion in the stimulus, but the effect has rippled out to take in even those industries which had no obvious overcapacity eighteen months ago such as autos and cement. Many prominent listed companies such as Chalco, are now operating below their cash costs, while the level of distress must be much more acute among those enterprises, which have much lower levels of operational efficiency and have relied on support from local government.

Overcapacity causes rising inventory levels and cash shortages

There is mounting evidence that the weak economy and the result of overcapacity in the corporate sector are starting to feed off each other. There are growing symptoms of a cash crisis across a number of industries, both in the financial figures and in the more anecdotal evidence that is reported in the local press or on the newswires. Among the more obvious phenomena are the extension of payables and receivables, the extension of credit facilities some from 'supportive' local banks and the use of subsidies to patch up the gaps in revenues - the soft budget constraint is clearly alive and well. There also appears to be quite a high degree of leverage hidden off balance sheets, for example by establishing leasing companies in the construction machinery sector. In the same sector there are also well-sourced reports of multiple loans secured on single pieces of collateral. There has also been a dramatic increase in the spread of credit guarantee chains which entails obtaining bank loans with 3rd party guarantees and are supposedly popular among steel, solar and energy companies; apparently 600 or more companies have been dragged into a mini-credit crunch in Zhijiang. Caixin reports that the proposed restructuring of Zhongdan Inv & Credit Guarantee Co Ltd based in Beijing amounts to Rmb3bn and involves 22 banks & 294 enterprises. Patrick Chovanec of Tsinghua University in Beijing compares the situation with AIG, though the structural and anecdotal features of what appear to be pyramid financing schemes, remind me very much of the growth of *veksels* and barter payments in Russia in 1997.

De facto liberalisation in financial sector adds to confusion

The price of China's soft budget constraint in the past has been paid by shareholders of the enabling companies, whose returns are subordinate to the needs of the state and by depositors in the Chinese banks who have received interest rates which are negative in real terms. The very direct relationship between low deposit rates and the industrial sector is best illustrated by the Rmb1.3trn of NPLs which resulted from the restructuring of SOEs at the end of the 1990s, which was put into AMCs controlled by the major state owned banks; the level of subsequent recoveries has been extremely low and in effect the level of both the NPLs and the retail deposits which fund the banks, have been left to erode in real terms as the economy has grown strongly. The academic Michael Pettis labels this a policy of financial repression, which he deems largely responsible for the very low levels of consumption relative to investment in China. Since late 2008 however, an increasing proportion of saving has been directed away from conventional bank deposits to wealth management products and trust companies. The authorities in Beijing have also raised the ceiling on deposits to attract more money. Some analysts have estimated that shadow banking, off balance sheet lending and trust companies are now the equivalent of up to one third of the official loan market. The problem lies in how to interpret this development. Some commentators see it as a *de facto* liberalisation which will increase the role of the market in determining the cost of capital, thereby pushing up productivity. We would be more inclined to see it as a potentially dangerous development given the growing evidence of a corporate cash crunch, which suggests that many of these structures are in effect pyramid schemes. The economist Joseph Stiglitz has highlighted the risks, which materialised in certain eastern European countries where the government was unable to intervene when a crisis developed in non-bank lending. Meanwhile, DB analyst Tracy Yu notes the increasing competition for deposits is starting to impact the formal banking sector, while the proportion of medium and long term loans is declining as a proportion of total loans.

Increasing lack of confidence in economy may lead to slow motion crisis...

We suggested that potential capital flight from China would develop as a theme for investors in our outlook piece for 2012 ('GEM to underperform again in 2012' 6th December). On the face of it this was a strange prediction since one of the (many) differences between post-Soviet Russia and China today is the fact that China has a closed capital account and a very high level of FX reserves, which is in direct contrast to Russia where the capital account was and remains, extremely open. Nevertheless China's capital account is somewhat porous and there is evidence that increasing numbers of wealthy Chinese, are trying to take money out of the country. The balance of payments figures have begun to deteriorate, while the PBoC has been selling dollars in order to maintain the value of RMB, a reversal of the usual pattern over the past few years. Viktor Shih's assertion that the top 1% of Chinese households by wealth have between $3trn and $5trn in disposable income highlights the potential risks to the capital while the Hurun Report suggests that almost 50% of wealthy Chinese would like to emigrate. The desire to take money out of China stems from three causes in our view. First, an inclination to diversify assets, which is natural enough and almost entirely innocuous. Second, an increasing level of insecurity among wealthy Chinese given widespread anger among the broader population about the perceived linkage between corruption and rising inequality - the PBoC has estimated that thousands of officials have disappeared abroad over recent years taking over $100bn with them. Finally and most disturbing for equity investors, is the implication that the level of returns on Chinese assets is likely to be much lower over the coming years, as the productive potential of the economy falls. The increasing perception that the weakening economy is likely to drive the RMB down over the coming months will also cause some of the 'hot' money inflows to begin to reverse, including money lent to Chinese companies by foreign banks.

... in the absence of a pick-up in external demand

Another similarity between Russia in 1998 and China today is that both countries are to some extent at the mercy of external events. If the Asian financial crisis in 1997 had not triggered a 50% drop in the oil price over a twenty month period, then the financial crisis would have been delayed at the very least and might not have taken place at all, since the main effect of the decline in oil was to suck liquidity out of the Russian economy. Similarly, the 2007 financial crisis and subsequent 'new normal' of low economic growth has driven a sharp decline in the contribution of exports to China's growth. The best hope for China is that the historically very high level of affordability of the US housing market translates into the start of a sustainable price recovery, though we think that this is unlikely until some sort of durable solution to the fiscal *impasse* is reached. In Europe there is absolutely no sign of a sustainable upturn in growth given the perceived need for fiscal austerity inside and outside of the eurozone.

WHAT POLICIES WILL BEIJING ADOPT GOING FORWARD?

Beijing appears to have realised that change is needed

The aftermath of the stimulus was clearly the key catalyst for the authorities in Beijing to realise that the existing extensive growth model was running out of steam. Their concerns are primarily economic, but are also about the extent to which the 'growth at all costs' policies have the potential to disturb social harmony and threaten the longevity of Communist rule in a country already notable for the sheer number of civil disturbances. There are three issues which particularly stand out;

- first, the potential for inflation especially in basic foodstuffs to impair the living standards of the poorest urban inhabitants. There is a widespread suspicion in China, which we in part share, that the real rate of inflation has been much higher than the published rates through most of the past three years. It is also quite clear that present disinflationary trends notwithstanding, the growing shortage of rural land and workers is a structural tailwind for food price inflation.
- second, increasing perceptions of rising inequality and corruption, which are most obviously manifested through the property market and the differences between the compensation paid to peasants when their land is seized and the subsequent market value for development.
- finally, the extent to which the extensive industrial growth patterns have occurred at the expense of the environment. The absence of any really effective legislation to protect the environment from the negative externalities of industrial activity represents a further soft budget constraint for much of the industrial sector.

Beijing is seizing back levers of control from sub-national governments

The actions of the authorities in Beijing this year, show that they are clearly well aware of the role of the sub-national governments in exacerbating the damaging imbalances within the Chinese economy and society. This underlies their continued determination to contain any stimulus and to persist with many of the restrictions on the property market. We would also see the ouster of Bo Xilai as part of this process, given that Chongqing was one of the biggest municipalities in terms of population and budget - in effect Beijing has handed out a warning to all the other local leaders that no-one is too powerful to withstand the power of central government. The ability of central government to face down even the most powerful regional leadership is very different to the weakness of the federal government in Moscow in 1998. There were many times when the 'hard state liberals' around President Yeltsin clashed with the regional leaders and until the arrival of Vladimir Putin at the head of government, the regions usually won. Even then, the most powerful regional leader of them all, the mayor of Moscow, Yuri Luzhkov was only ousted in 2010.

Mutually reinforcing weakness in local government finances and corporate profits

The centrally imposed measures to contain the property market combined with the downturn in the economy have had a very negative impact on local government finances over the course of 2012. The property market has been relatively resilient, but land sales which comprise up to 30% of the income of local governments, have been much weaker, since developers are sitting on an average of about nine years worth of land inventory, relative to a normalised level of around four to five years. Whilst here have been some big sales recently, most notably in Beijing, we think that most of the developers who wish to add to their land banks, will try to take advantage of any financially distressed weaker players by acquiring cut price land from them wherever possible. In addition provincial, regional and local governments also face a big deterioration in tax receipts from the downturn in corporate cash flows and profits. We should also bear in mind that local governments in aggregate have a level of indebtedness of anything up to Rmn10trn in the LGFVs, the special purpose vehicles which were set up to borrow money from the state controlled banks. Given the symbiotic relationship between the local governments and the industrial enterprise sector, the deterioration in the finances of both becomes mutually reinforcing and is the leading indicator for further weakness throughout the rest of the economy. It is also very unlikely that consumer spending will come to the rescue. Chinese workers in industry and parts of the service sector have enjoyed many years of wage growth in the mid to high teens, which appear unsustainable given the very visible squeeze on corporate margins.

Extent of stimulus measures unclear but probably limited

The central problem for Beijing is that any productivity reforms which are introduced will take a while to have an effect, while the dismantling of the key components of the soft budget constraint has an immediately negative impact. This unfortunate situation is a result of having embarked on changes too late and against a very negative external backdrop; the real opportunity to embark on reforms was 2002-07 when strong growth in the developed economies would have lubricated the impact of the changes. Some economists are still calling for a 2008 style stimulus, but we think this very undesirable and unlikely to happen. We think it most unlikely the Beijing is willing to underwrite the sort of grandiose expenditure plans which have recently been outlined by the governments of Changsha ($130bn), Chongqing ($236bn) and Tianjin (also $236bn). Still, some more limited measures are likely given the lack of alternative sources of growth. Whatever is decided though, will most likely be a relatively small percentage of the 2008-10 measures and insufficient to do much to prevent further declines in GDP growth forecasts.

Hard budget constraints being applied selectively at best

There has been an increasing amount of talk from the central government about allowing industrial consolidation to take place, but we suspect that the hard budget constraint will be applied selectively at best. The prospects for unviable individual enterprises to survive the economic turmoil will depend on their lobbying clout with central and/or regional governments. Many small enterprises, which lack influence are being forced to close capacity once their product prices dip below their cash costs. Reports suggest though that it seems to be a case of business as usual for many of the larger enterprises. One recent example was the shipbuilder Rongsheng Heavy Industries which received Rmb670m in subsidies in the first half of 2012 compared with Rmb215.8m in net profit and reassured investors that it could rely on local Chinese banks for funding support. There are also similar reports concerning prominent companies in the solar industry, which like shipbuilding took advantage of the stimulus to expand very quickly. The current indications are that market forces may force some consolidation among smaller enterprises, which will be insufficient to put the economy on a firmer footing. Moreover, the increasing costs of providing financial support will add to the underlying level of bad debts in the banking sector, which is likely to bear much of the cost. Shareholders in the other 'enabling' sectors will have to pay; the authorities have made it perfectly clear over recent weeks, that further reform of downstream oil and utility pricing is unlikely to take place in the current economic environment.

The endgame is extremely unclear but continued deterioration is probable

There is no obvious endgame in sight for the time being. The Chinese authorities may be under the illusion that the provision of subsidies to key enterprises is akin to the Korean and Taiwanese governments' strategies of 'picking winners', which is widely believed to be one of the main factors behind the success of their respective economies. The problem is that at this point in time, the Chinese system requires a major overhaul to reduce the level of state involvement rather than a relatively minor adjustment. At this point, we can see four basic scenarios, which are by no means mutually exclusive:

1. **External growth** comes to the rescue to buy time for the authorities to implement the changes, which will restore very high rates of productivity growth. We do not think that this is very likely to come from Europe, but the situation in the US does look a little bit more hopeful, though not we suspect until after the election(s). The best prospect though lies in the possibility that oil prices will follow metals prices down, as the Chinese economy exhibits further weakness.

2. The authorities in Beijing really use their leverage over the regional governments and aggressively push through **market based reforms** by closing down a large amount of uneconomic capacity. The initial impact on GDP is negative, but the private sector rapidly gains confidence and begins to be the engine of economic growth. We suspect that this sort of programme would be both politically too difficult to carry out and also represents a step into the unknown in terms of the broader impact on the banks, which would be heavily exposed to potential NPLs from industrial enterprises. This sort of reform might be best lubricated by a currency devaluation, but it is difficult to envisage how this might happen given the likely degree of opposition from China's trading partners.

3. The Chinese authorities **panic** as the economy continues to weaken and rush through a 2008 style stimulus package. Given the amount of damage to the long term prospects for the economy which this move would do, together with the amount of political capital, which the current leadership has invested in not having a big stimulus so far, the only circumstances in which we can envisage this, are if there was a major shift of power within the Chinese political establishment.

4. **Muddle through**, which appears to be the case at present and which in our view is unlikely to change. This can basically work out in one of three ways. First, that the deterioration in the economy is not so pronounced, so that the authorities can hold on until external growth picks up and then implement a reform agenda. Second, if the level of internal financing for the 'zombie' enterprises can be maintained, mainly through continued financial repression, the result will be a continual decline in GDP rates to what will seem like stagnation levels by Chinese standards. There will still be a tailwind from ongoing urbanisation, but this will become progressively less powerful eventually leading to a Japan type scenario (but at much lower *per capita* GDP rates), or what the Russians called *zastoi* (stagnation) in the later Brezhnev years. Finally, that "muddle through" leads to a slow motion financial crisis, triggered by an increasing loss of confidence among businesses and households. Given the closed capital account and very low level of foreign financing, we find it very difficult to attach any sort on timescale to this scenario, but it is a rising possibility. Unlike Russia where much of the Rouble

government bond market (GKO) was held by foreign institutions, China's capital account is (theoretically) closed so there is relatively little external financing and around $3trn of foreign exchange reserves relative to Russia's pre-crisis level of $13bn. The main vulnerability though is through the banking system, via the relatively concentrated nature of deposits, as we discussed earlier and the ongoing deterioration in underlying asset quality. The obvious consequence would be that part of the deposit base would have to be written off, either directly or more likely by inflation which would be generated by a currency devaluation and/or by the central banks printing money. This is all purely speculative at this stage however since we still are a long way from any crisis scenario while potential policy options will be dictated by potential shifts in the balance of power within the Chinese political establishment, which are very hard to predict from the outside.

IMPLICATIONS FOR INVESTORS

We remain underweight in the Chinese equity market

We downgraded Chinese equities to underweight on February 29th, following the sharp rally in 'H' shares which took place over the first two months of 2012. Since then the MSCI China has underperformed the GEM average by 3%, while the domestic 'A' share market has fallen by around 6% so far this year. Most investors continue to overly focus on the prospects for a government led stimulus programme to boost equities in our view. We therefore anticipate that there is plenty of scope for further poor news flow concerning the Chinese corporate sector and broader economy to further dampen investor sentiment. There is also a widespread perception that the equity market is cheap, both by historical standards and when compared with its peers in and outside of the GEM benchmark. Both we and Ajay Kapur, have pointed out the excessive reliance on asset turnover, which is becoming increasingly apparent in negative cash flows for the industrial stocks as the economy slows. Much of the value argument also hinges on the banks, where we believe that potential NPLs are grossly understated in the likely event that the banking sector has to underwrite the costs of many of the problems in the broader economy.

We also struggle to find many obvious buy ideas in the non-financial sectors from a bottom up perspective and note the increasing level of concern among many DB stock analysts about the impact of overcapacity on the big industrial sectors such as steel, aluminium, coal, shipbuilding and solar. The strategic sectors, which are controlled by Beijing, such as oil and utilities are coming under increasing pressure to support the rest of the economy, while the high ratings of the consumer stocks are predicated on a continuation of wage growth in the mid to high teens, which is unsustainable in our view. Whilst we should note that foreign ownership of Chinese equities has risen this year, helped by bigger foreign quotas there has been about $6.9bn of net foreign buying of 'A' shares, most domestic investors remain very sceptical about their own market. Until the endgame becomes clearer we would therefore remain underweight in Chinese equities in a GEM context.

Volatility will continue around Chinese economy and financial assets

We think that Chinese financial assets are likely to remain very volatile and that China itself is likely to be a source of volatility for other global financial markets for three main reasons.

- First, the apparent cheapness of Chinese stocks suggests that any market rallies could be relatively sharp, which makes it an especially difficult market to short profitably. We have already seen this dynamic at work in the property sector, which has caught many short sellers by surprise over the course of this year, partly due to the news flow, which has generally been better than expected, but also to the big discounts to NAV, throughout the sector. The gap between the generally very low level of asset values and the sharp ongoing deterioration in cash flow is likely to make investors especially schizophrenic.
- Second, the lack of transparency around economic policymaking, which makes it very difficult for outside analysts to predict the direction of future policy. Winston Churchill famously referred to the conduct of Russian politics as 'two bulldogs fighting under a carpet' and much the same could be said about the situation in China today. Given the increasing importance of the Chinese economy, any potential changes in key policies are scrutinised very carefully, for example the relative caution of Beijing regarding stimulus measures has been a key driver in the weakness of metals prices this year.

- Finally, Chinese equities are to some extent a geared play on global growth given the structure of the economy and the importance of asset turnover in generating ROE for the listed stocks. If the outlook for the major developed economies improves again, then China will almost certainly outperform in any 'risk on' scenario, though we do not anticipate a durable bull market until there is a credible solution to the structural issues.

Tensions over currency and rising nationalism could raise global risk premium

Perceptions of the value of the RMB are slowly starting to shift - the IMF recently modified its view to slightly overvalued from very overvalued, following the roughly 8-9% appreciation in trade weighted terms, which has taken place over the past twelve months. There is plenty of room for sentiment towards the currency to deteriorate further along with the economy and a significant depreciation would provide both the authorities and the corporate sector with a little more breathing space. We should note that the dramatic recovery of the Russian economy in the wake of the 1998 crisis was aided greatly by the depreciation of the Rouble against the dollar from 5.8 in 1997 to 24.6 in 2000. Any attempt to lower the value of the RMB against the dollar would run the risk of inflaming tensions with the US and other countries within the EM universe such as Brazil, which are already attempting to contain the level of Chinese manufacturing imports. This issue does not appear to be on investors' radar screen yet judging by the mere 1% depreciation over the next twelve months implied by the NDF forwards market and by the lack of concern among investors due to China's $3trn worth of FX reserves.

We are also concerned about a the possibility of a further increase in tensions over the South China Sea as nationalist pressures increase within China in response to the economic slowdown, whether or not this is encouraged by the Chinese government. The effects of a more assertive Chinese foreign policy are have recently been visible in the breakdown of the ASEAN conference and the demonstrations which have been taking place against Japanese involvement in what most Chinese consider to be their territory.

Evolving situation in China underpins bearish view on GEM equities versus DM

China is by far the biggest constituent of the MSCI EMF and the one where there is potentially the biggest pipeline of equity supply, so it's difficult to be overly optimistic about the prospects on GEM, given our bearish view on the market. There are also two other ways in which China exerts a powerful influence on the asset class. The first is obvious, namely that a slowing economy will have powerful ripple effects on both neighbouring and commodity exporting economies. We first expressed a negative view on commodities through the China effect in May of last year, which has so far played out in the industrial metals markets, but not yet really in oil, though we think that this is only a matter of time. The second impact is less obvious and concerns the adoption of elements of the Beijing Model by governments across other emerging markets, largely as a response to the perceived success of China relative to the US over the past five years. The most pronounced change has been in Brazil, but Russia has also moved in a more statist direction while there are some worrying signs that government intervention is steadily pushing up the cost of doing business in South Africa. Our five most successful country calls within GEM has been as a result of the China factor, namely short China itself, long Mexico/short Brazil and long Turkey/short Russia, all of which appear somewhat stale and devoid of any real value rationale, but which should deliver further outperformance if the situation in China plays out as we expect. The outlook for the individual emerging markets ultimately depends however on the speed with which their governments and companies can adapt to the new environment, so that the next key driver for GEM equities will be restructuring rather than growth.

US best positioned in new ideological and economic environment

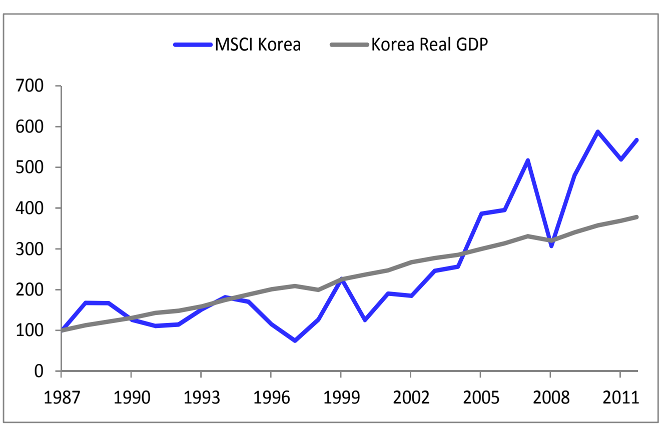
The US economy is the stand out beneficiary in relative terms of a protracted slowdown in the Chinese growth model. Whilst the years since the financial crisis first broke have been marked by an increasing level of state involvement in the economy, in particular the banking and housing sectors, the non-financial sector is well positioned to benefit from the relatively high degree of flexibility of the supply side of the economy. The US consumer will benefit disproportionately from any further decline in commodity prices and from the disinflationary impact of rising inventories in China, although we need to monitor the potential from China to become an exporter of inflation if industrial consolidation takes place on any scale. The US is also likely to benefit from any shift in the intellectual climate as it becomes clearer that the Beijing Model is running out of steam; asset allocators may not be necessarily aware of it, but they too are affected by the *zeitgeist*.

Longer term, is a financial crisis a necessary precursor to a bull market in China?

Many emerging economies and markets have adopted more market and investor friendly policies in the aftermath of financial crises. Conversely there have been occasions when the absence of any pressure has meant that government's can increase their own influence at the expense of investors, which usually turns out to the detriment of the long term health of the economy. Three prominent examples immediately spring to mind;

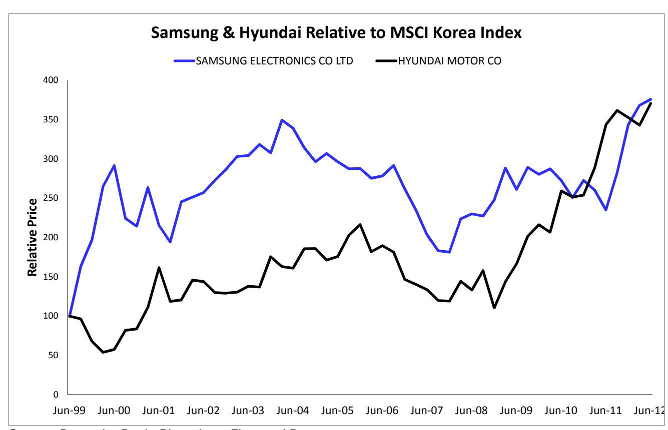
- **First Korea**, where the equity market barely appreciated in Dollar terms through the 1990s despite very strong GDP growth for most of that time. Following the 1997 crisis the *chaebol* became much more exposed to market forces so that 17 of the top 30 groups went out of business by 2000. This was the catalyst for much more commercial behaviour from the survivors and the emergence of a bull market, which was marked by the stunning success of Hyundai Motors and Samsung Electronics in international markets (Figure 15).

Figure 14: Korea GDP/ market



Source: Deutsche Bank, Bloomberg Finance LP

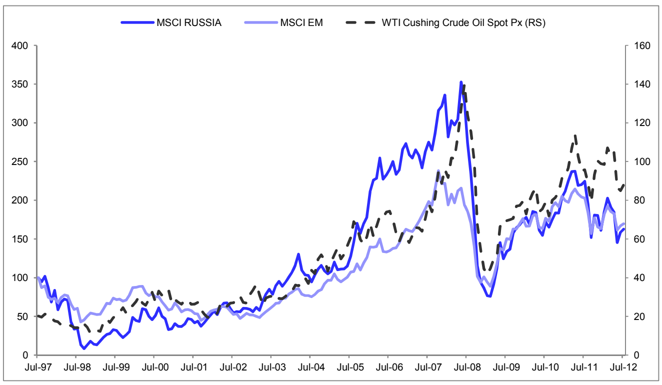
Figure 15: samsung & hyundai



Source: Deutsche Bank, Bloomberg Finance LP

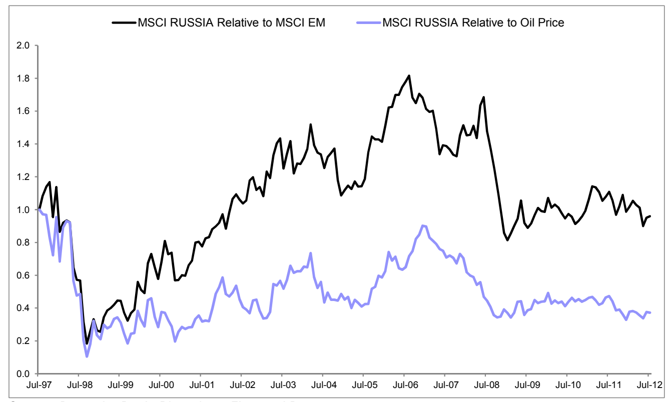
- **Second, Russia** where the main driver behind the massive rise in the market between early 1998 and late 2003 was the reforms enacted by the Putin administration in the aftermath of the financial crisis. The two most important and related changes were the imposition of political and budgetary discipline over the regional authorities and the major tax reforms, which strengthened the position of the federal government and restored confidence to the corporate sector. The post crisis settlement between the government and the oligarchs in which the private sector supposedly withdrew from political life in return for a more stable business environment, also introduced a much needed element of stability. Unfortunately, the arrest of Mikhail Khodorkovsky in October of 2003, was the catalyst for a further series of struggles over the control of key corporates, since when the equity market has underperformed a rising oil price and has advanced only about 50% relative to the 700% appreciation which took place between early 1999 and October 2003.

Figure 16: Russia index



Source: Deutsche Bank, Bloomberg Finance LP

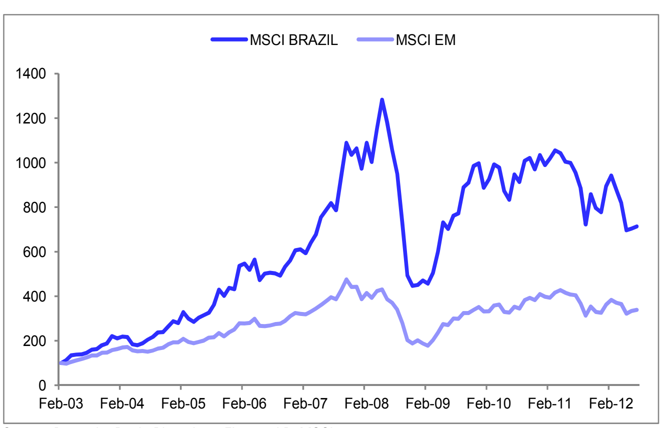
Figure 17: relative to em and relative to oil price



Source: Deutsche Bank, Bloomberg Finance LP

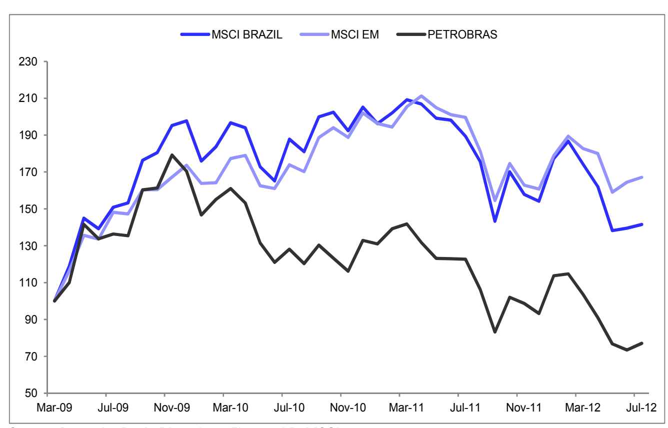
- **Third, Brazil,** where the governments of Cardoso and then Lula implemented highly market friendly policies, which along with rising commodity prices helped the market to be one of the very best performers in the world from 2002 to 2010. The market has however performed badly every since the Petrobras capital issue in early September 2010 when the government diluted minority investors in an oil for shares deal and which marked the catalyst for a series of policies designed to increase the role of the state in both the economy and large parts of the listed corporate sector.

Figure 18: Brazil index performance



Source: Deutsche Bank, Bloomberg Finance LP, MSCI

Figure 19: Petrobras effect



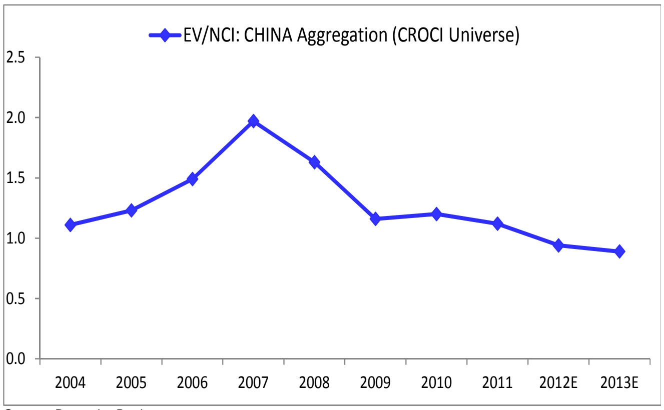
Source: Deutsche Bank, Bloomberg Finance LP, MSCI

Long term investors should return to Chinese equities when state imposes hard budget constraint

We very much hope that a Chinese financial crisis will not be necessary to stimulate deeper reforms, since there would be severely negative consequences for society as well as for investors. Nevertheless, we advise long term investors to remain wary of

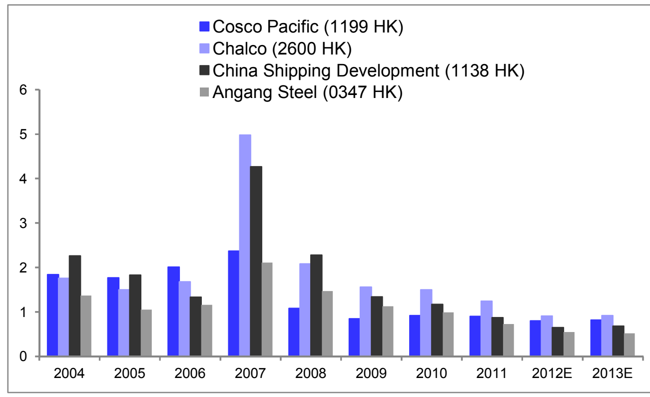
Chinese financial assets until there are clear signs that the state is taking a step back and allowing the emergence of 'true' private sector groups, much as happened in Korea in the wake of the financial crisis. Asset values in China are generally extremely cheap at present (Figure 20) precisely because the returns on those assets are so low, which could provide the fuel for the early stages of a bull market if the right policies fall into place. The key input would be a decision by Beijing to impose the hard budget constraint which would force unprofitable enterprises to close and force a consolidation across a number of industries. It is, in our view, however still too early to position in the potential beneficiaries of this process because these companies are heavily exposed to the further deterioration in the economy which we anticipate.

Figure 20: EV/NCI



Source: Deutsche Bank

Figure 21: EV/NCI; a sample of industrials



Source: Deutsche Bank

How we might be wrong?

1. Sustained recovery in property prices. We have been somewhat puzzled by the apparent resilience of the residential property market, which is reflected in the strength of the shares of the major listed developers, over the course of this year. This has also surprised the many bearish investors who have been shorting the sector, though not our China based property team led by Tony Tsang, who have been correctly (so far) bullish on the sector. There are a number of different explanations, which are not necessarily mutually exclusive. First it might simply be the case that we underestimate the pent up demand for property given the speed with which urbanisation is taking place and the poor quality of much of the existing housing stock. If this explanation is correct, then it bodes well for prospects through much of the rest of the economy. Second, it is possible that Chinese households are desperate to put their money into any investment, which is likely to hold its value, given their increasing lack of confidence in the stock market and bank deposits. Finally, some of the impression of strength might be illusory given that we do not really know the identity of many of the buyers - there have been many anecdotal reports of unidentified buyers taking big blocks of homes off the market at heavily discounted prices, many of which will be available for resale should prices recover. We favour the second and third explanations but are also concerned that if the economy does weaken much further then the authorities in Beijing might try to stimulate the sector in order to revive construction activity, notwithstanding the negative impact on social harmony, which we described earlier in the report.

2. We have overestimated the similarities with post-Soviet Russia. As we have outlined in the main body of the report, we are aware of the major differences in the macro-economic fundamentals between China and post-Soviet Russia, but believe that the situation at a corporate and regional level justifies making some comparison between the two situations. It is entirely possible that the structural macro trends in China are so strong, especially continued urbanisation, that they will overwhelm the micro issues, in particular the soft budget constraint, which we have highlighted. We may also be underestimating the leverage which Beijing is able to bring to bear on the regions to restore industrial and fiscal discipline, compared with the relative impotence of the 'hard state liberals' who surrounded President Yeltsin.

3. More encouraging signs on productivity. We have repeatedly cited the data from DB's CROCI coverage of China over the past twenty months, as well as the top down ICOR ratios, as evidence that the underlying rate of productivity in China is slowing to a point, which will have a pronounced detrimental impact on the overall economy. There is a counter argument that much of the state led investment, which took place from 2008 to 2010, simply has a long lead time in terms of returns, though we do not believe this. Clearly if we are too pessimistic about the overall rate of productivity growth, then the authorities will have far more scope for monetary easing and other measures to stimulate the economy, without having to worry too much about any inflationary side effects. This would then enable Chinese equities to decouple from global markets through the internal growth dynamic of the Chinese economy.

4. Potential fall in the oil price - We believe that increasing worries about the health of the global economy coupled with the transformation of the energy outlook for North America will cause oil prices to fall by a significant amount of the coming months. The US economy and market are likely to be the initial beneficiaries of this trend, but we would expect China to derive some benefit, as the move down in oil injects liquidity back into the economies of the developed world. Overall in this scenario, we would

expect GEM to underperform DM and China would most likely perform roughly in line with the GEM average, but with some prospect of absolute positive returns.

5. Quicker than expected expansion of private sector - . The ongoing *de facto* liberalisation of interest rates should divert resources away from state led investments to the 'true' private sector. We believe that this will play out over a relatively long time period, but if we see earlier evidence that the changes are having a demonstrable effect in unleashing the entrepreneurial vigour of China's private sector, then we will re-evaluate our view.

6. The authorities in Beijing manage to engineer a market rally - – Recent measures from the Chinese authorities leave little doubt that they would like to use the equity market as one way to stimulate the rest of the economy. Hence many of the so-called financial reforms, which have been mooted recently, are primarily aimed at enlarging the pool of domestic and foreign buyers for Chinese assets. We are sceptical about the potential benefits for three main reasons in addition to the fundamentally unappealing backdrop, which we have outlined in this report. First, any benefits are likely to go to the 'A' share market constituents, initially at least, which do not comprise part of the MSCI China benchmark. Second, the somewhat asymmetric nature of the measures to partially liberalise the capital account, which are primarily aimed at encouraging inflows, cannot disguise the increasing pressure from Chinese corporates and individuals to place money overseas. Finally, any significant inflow of liquidity in the market would soon come up against the huge pent up volume of equity issuance from Chinese companies.

7. China is an emerging market; expect the unexpected. Finally experience has taught us to be wary of being overly prescriptive about the way in which what we consider to be clear fundamental factors affect equity markets, especially emerging equity markets. Very few foreigners have participated in Egyptian equities this year, but the market has been by far and away the best performer despite the political and currency risk. The strength of the property sector within the Chinese market has surprised many of us as previously noted. The sheer number of moving parts and limited transparency when assessing China, should lead us to remain humble, flexible and pragmatic in order to be able to respond as the situation changes.

Appendix 1

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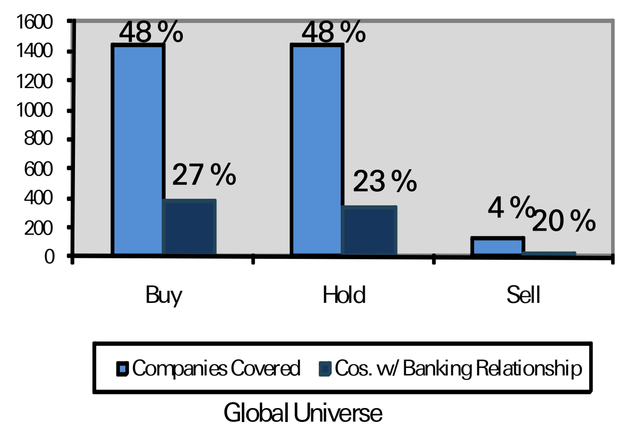
Equity rating key

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

1. Newly issued research recommendations and target prices always supersede previously published research.
2. Ratings definitions prior to 27 January, 2007 were:

   Buy: Expected total return (including dividends) of 10% or more over a 12-month period
   Hold: Expected total return (including dividends) between -10% and 10% over a 12-month period
   Sell: Expected total return (including dividends) of -10% or worse over a 12-month period

Equity rating dispersion and banking relationships



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