ROBECO

Responsible Investing
www.robeco.com

Outlook | February 2011

Chinese stock market update

Victoria Mio, fund manager of Robeco Chinese Equities, updates us on her views on the Chinese economy and the stock market in 2011.

China is a country of paradox

Based on the official estimate released recently, China grew by 10.1% in real terms in 2010, which takes the economy to almost USD 6 trillion, a size that positions it comfortably as the world second largest economy. Looking back, the size of China's economy was less than USD 1.5 trillion in 2001, smaller than France or the UK, but now it is more than two times bigger than the UK, and seven times bigger than the Netherlands. The GDP's consumption component is already over USD 2 trillion, closed to the size of France's GDP. What a difference ten years can make! However, in terms of GDP per capita, China is number 95 in the world with only USD 4,283, based on the IMF's 2010 estimate.

There are several different economies within the large borders of China, which is why we divide the cities into tiers, and the regions into east, central and west. This distinction has huge investment implications. In the tier 1-2 cities, China houses the most profitable stores worldwide for many famous brands, such as Apple, Louis Vuitton and Bentley. In the tier 3-6 cities and the rural areas, the market is dominated by many domestic brands, such as Haier, Daphne and Anta. Whereas growth in the eastern region is decelerating, it is gaining speed in the western and central regions.

Thus, China's sheer size, complexity, and breakneck growth make it really hard for anyone to get the true picture. But with an open mind, investors can discover excellent investment opportunities.

Macro-economic outlook for 2011

Macro data	Jan&Feb-10	Mar-10	Apr-10	May-10	Jun-10	Jul-10	Aug-10	Sep-10	Oct-10	Nov-10	Dec-10	2009	2010E	(consensus 2011E
GDP growth		11.9			10.3			9.6			9.8	9.1	10.0	9.4
PMI	53.9	55.1	55.7	53.9	52.1	51.2	51.7	53.8	54.7	55.2	53.9	52.9	53.0	52.5
Industrial Production	20.7	18.1	17.8	16.5	13.7	13.4	13.9	13.3	13.1	13.3	13.5	11.0	14.9	13.7
Fixed Asset Investment	26.6	26.4	26.1	25.9	25.5	24.9	24.8	24.5	24.4	24.9	24.5	30.5	23.8	22.2
Retail Sales	17.9	18.0	18.5	18.7	18.3	17.9	18.4	18.8	18.6	18.7	19.1	15.5	18.3	17.7
Export	31.3	24.0	30.5	48.5	43.9	38.1	34.4	25.1	22.9	34.9	17.9	(16.0)	28.9	15.4
Import	63.6	66.0	49.7	48.3	34.0	22.8	35.2	24.1	25.3	37.7	25.6	(11.2)	34.5	17.0
CPI	2.1	2.4	2.8	3.1	2.9	3.3	3.5	3.6	4.4	5.1	4.6	(0.7)	3.1	3.4
PPI	4.9	5.9	6.8	7.1	6.4	4.8	4.3	4.3	5.0	6.1	5.9	(5.4)	5.1	4.2
M1	35.0	29.9	31.3	29.9	24.6	22.9	21.9	20.9	22.1	22.1	21.2	32.4	23.0	18.0
M2	25.5	22.5	21.5	21.0	18.5	17.6	19.2	19.0	19.3	19.5	19.7	27.7	17.7	16.1
Loan growth %	27.2	21.8	22.0	21.0	18.2	18.4	18.6	18.5	19.3	19.8	19.9	31.7	19.0	15.2
New Loan (RMB bn)	2,090	510	774	639	603	533	545	596	588	564	481	9,594	7,800	7,000

Inflation risk is underestimated

Source: WIND

Despite moderate deceleration, the secular growth story remains intact

We monitor the above macro-economic data on a monthly basis. The January PMI of 52.9 confirmed the deceleration trend, which is likely to continue in the next few months due to the tightening measures. However, we think that the risk of a hard landing is low, unless inflation rises above 6%; at that level, draconian tightening is ensured. Our major forecasts for 2011 are as follows:

- 2011 GDP growth will remain robust; we forecast 9%-10% in GDP growth
- Consumption should remain as strong as in 2010 with 16%-18% growth in retail sales
- Investments should decelerate, but we still expect more than 20% growth in fixed asset investment, supported by 12th Five-Year Plan
- Trade will still be strong in 2011, but decelerating to 15% growth in exports, from 25%-30% in 2010.

Inflation is the TOP concern for policymakers

The main sources of inflation in China have been food and vegetables, due to flooding and cold weather; non-food inflation has been mild throughout 2010. However, the economic recovery in the US is bad news for China, as commodities prices are pushed up by both excess liquidity and real demand recovery. Moreover, inside China, the excess liquidity used to go into property and stock markets, but the anemic performance of these markets has pushed excess liquidity to all kinds of raw materials and soft commodities. Inflation pressure will be therefore be much harder to control in 2011, which leads us to believe that the consensus inflation forecast is too optimistic.

Hot money inflows exacerbate the inflation problem, leading to aggressive tightening

The quantitative easing in the US spells liquidity problems throughout Asia. The central bank in China introduced the concept of "Hot money pool" – which is a series of tools to contain liquidity, including multiple RRR hikes (up to 20-23%), interest rate hikes (25bps per quarter), RMB appreciation (5%-6%% in the coming 12 months), and slower loan growth (from 19% in 2010 to 16% in 2011).

Our base-case assumption is that inflationary fears should start to fade in the second half of 2011, but until then, tightening risks will detract from growth momentum and hurt market sentiment. There is a real risk that inflation will exceed 6% YoY, that tightening will be much more aggressive than market expectations, and this will have global implications.

Consumer sentiment will be hurt by inflation but long-term fundamentals remain strong

Other bad news is that higher prices weaken the financial position and sentiment of average consumers in China. As a result, consumption stocks have been under strong selling pressure. Despite the short-term negatives, the longer-term fundamentals for consumption are strong. Supported by rising farm prices and higher factory wages, rural incomes rose by almost 15% last year. In urban areas, income growth looks robust too.

The major themes for China's 12th Five-Year Plan for 2011-2015

The 12th Five-Year Plan is still in its drafting phase, and will be finalized at the National People's Congress in March 2011. While it is a logical extension of the 11th Five-Year Plan, there are some major differences. In essence, growth will not be the single most important objective, but economic restructuring, improvement in the quality of life and social welfare will be just as critical.

The 12th Five-Year Plan emphasizes:

- Sustainability of growth and structural adjustments
- The raising of household income and redistribution of wealth
- The promotion of the development of seven strategic emerging industries: (1) alternative energy, (2) new materials, (3) high-tech equipment, (4) bio-tech, (5) new-energy vehicles, (6) environmental conservation, and (7) information technology. China will shift the emphasis to building its service and value-added manufacturing industries.

China also has a clear target to empower all citizens with middle class status and become a technology powerhouse by 2020.

Outlook for the Chinese equities markets in 2011

Ever since inflation exceeded 5% in November, policymakers have implemented a series of tightening measures, and the Chinese equities markets have started to react negatively. Given the current situation, we expect inflation to remain elevated in the first half of the year. This means that tightening will overshadow the Chinese equities markets, which will remain volatile with a downward bias. In the second half, we expect inflationary pressure to subside due to the high base and the effect of tightening. When this happens, we can turn more bullish on the market outlook again.

The Chinese equities markets are supported by their reasonable valuation. Domestic A shares are currently trading below their historical average (CSI 300 at 13.5x 11E P/E with 23% EPS growth), whereas offshore Chinese equities are trading at their historical average (MSCI China at 11.7x 11E P/E with 17% EPS growth). As for earnings, there will be downward revisions caused by the continued increase in commodity prices and labor costs.

Investment themes for 2011

Historically, industries that were promoted in the Five-Year Plan normally outperformed the market during the relevant period; therefore, we focus on investment themes that align with the 12th Five-Year Plan.

Theme 1: Income redistribution

As wages in the low income group have continued to increase, mid- to low-end consumer products and services industries will be the biggest winners in the stock market over the next few years. This also includes companies focusing on products for consumers in the tier 3-6 cities and the rural areas. We have gained exposure to this theme through several consumer stocks: **Haier Electronics**, a consumer electronics distributor in rural areas.

Theme 2: Technology and innovation

Facing cost pressure from many fronts, such as wages and raw materials, companies need to find ways to cut costs and improve efficiency. Companies that provide IT services, hardware and software, will stand to benefit from strong demand. Prime examples include **Kingdee Intl Software Group**, a leading provider of enterprise management software in China; **CITIC Telecom**, a pioneer in VPN and Cloud Computing services in China and Hong Kong; and **Tencent**, the largest social networking services provider.

Theme 3: Alternative energy

Energy security will be one of the major targets of the twelfth Five-Year Plan. The government has released the development plan (outlined below) for public consultation. Clean energy as a proportion of total energy should go from 11.7% to 20% in the next five years; therefore, this space will be the major investment theme for the next few years. The fund has exposures in **Kunlun Energy**, **GCL-Poly Energy**, and **Harbin Power**.

	2009	2015E	CAGR	Companies
Gas	80.0 bM^3	260.0 bM^3	21%	Gas distributors: **Kunlun Energy, China Resources Gas**
Wind	17.6 GW	90.0 GW	31%	Wind power generator: **China Suntien Green Energy**
Nuclear	9.1 GW	30.0 GW	22%	Power equipment maker: **Harbin Power**
Solar	0.4 GW	5.0 GW	51%	Solar equipment maker: **GCL-Poly Energy, JA Solar**
Biomass	4.0 GW	13.0 GW	22%	
Hydro	196.3 GW	280.0 GW	6%	

Theme 4: Public housing construction

Social housing is clearly a key new focal point in the Chinese urbanization process. Social housing projects have two goals: 1) provide low-cost housing to low-income households, to reduce social and political pressure from rising property prices; and 2) offset negative impacts from the property austerity measures. The central government has earmarked RMB 60bn for these projects, approximately 15% of the investment needed for the 2010 target of 5.8 milion units. Another 4.8 million units are to be completed in 2011-12. We have exposure to this theme through cement producers operating in the western, central and northern part of China, such as **Anhui Conch Cement, China Resources Cement** and **BBMG Corp**.

Theme 5: RMB internationalization
Ever since we mentioned that RMB internationalization is a long-term objective of the RMB regime change in our July update, a number of exciting developments have let us have a glimpse of its significance. Moreover, from June to December 2010, the RMB appreciated by 3.5%, exceeding our expectation of 3% in 2010. The Chinese government will continue to let the RMB appreciate at a gradual pace and may achieve 5%-6% appreciation in 2011. The continued upward momentum and expectations will also accelerate the RMB internationalization process. Many RMB investment products will be developed, such as government and corporate bonds, mutual funds, ETFs and private equity funds.
Hong Kong has a de-facto monopoly, and the key beneficiaries are banks and Chinese brokers in Hong Kong. We have already gained exposure to this theme by investing in **Bank of China Hong Kong**, and **Guotai Junan International**.

Theme 6: Agricultural development
Demand: Agricultural product consumption growth continues to be driven by rising per capita disposable income and increasing meat consumption.
Supply: Desertification and illegal commercial conversion has led to a continued decline in arable land in the past 5 years. It is estimated, for example, that some 400 golf courses have opened during those years.
Policies: A key objective of the 12th Five-Year Plan is to reduce the disparity of urban and rural income, by boosting grain prices. This, in turn, is positive for chemical fertilizer demand as higher grain prices make fertilizers more affordable.
Top pick: While there are several agricultural stocks in the China market, they are plagued by corporate governance issues. The best way to play this theme in China is through fertilizer, and **China BlueChemical** is in our portfolio.

Theme 7: Connecting China with 8 horizontal and 8 vertical high-speed railroads
Based on the experience of Japan’s rail capex investment cycle (1955–98), a typical boom cycle lasts five years, and this reaffirms our view that a five-year capex boom cycle lies ahead for China’s railway equipment industry. The Ministry of Railways (MOR) had earmarked railway-related spending of RMB 1,500bn for the 11th Five Year Plan (2006–2010), and it has spent and built ahead of schedule. For the 12th Five Year Plan (2011-1015), it plans to spend RMB 2,000bn, connecting China with 8 horizontal and 8 vertical high-speed railroads. Moreover, this round of capex will be mainly in railway equipment, and the industry can experience more than 30%-50% growth for the next five years. We have gained exposure to the theme through **Zhuzhou CSR Times Electric, China CNR Corp** and **CSR Corp**.

Hong Kong, February 2011

Important information