

China

November 2009

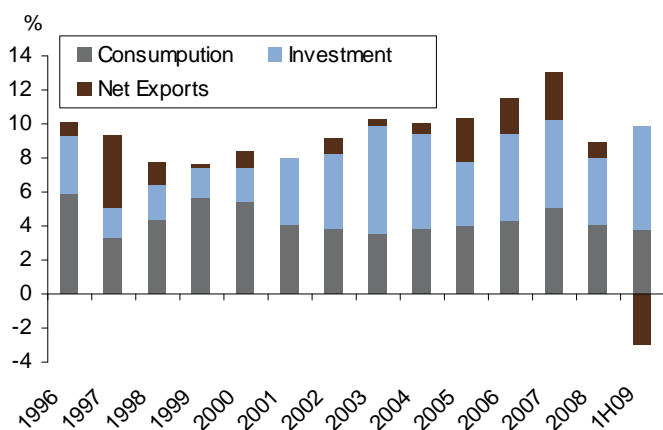
China – recovery remains well on track

- The release of China's Q3 GDP numbers, and a variety of other data points for October such as industrial production and retail sales numbers, have led to much heated debate in investment circles. In the one camp, there are those that believe that China's growth will continue to be underpinned by the government given its strong fiscal position, and in the other camp there are those that think China is a credit-driven bubble that will soon deflate.
- The aim of this paper is to highlight why we continue to remain positive on China over the long term, as well as aiming to answer some of the key questions that investors are asking about China including: How healthy are the Chinese banks? And how likely are we to see a property bubble?
- Finally, we will touch upon some of the other risks and challenges that China will face over the coming years.

What are the expectations for 2010?

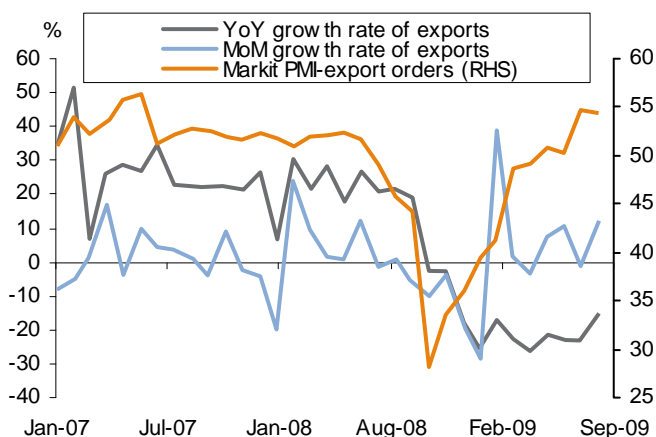
- The main driver of growth in 2009 has been the huge RMB 4 trillion (USD 580 billion) stimulus package that was announced last year. Looking into 2010 the impact of the package is expected to decline. We do not expect the government stimulus to decline in absolute terms; however, the rate of increase will be smaller than this year. Next year will see this rate of decline being somewhat offset by an increase in the contribution of GDP coming from exports. Whilst we are not expecting to see a strong recovery in exports as such, what is important is the percentage change and not the absolute level. Net exports subtracted some 4.0% from GDP growth this year, whereas next year net exports are expected to contribute 0.0 - 0.5% to GDP.

GDP growth by component



Source: CEIC, July 2009

China's export recovery is hesitant...



Source: CLSA 'Strong China lending & export numbers' 14.10.09.

- At the time of the announcement of the Q3 GDP numbers, the National Bureau of Statistics spokesperson said Beijing would continue to “insist on the proactive fiscal policies and moderately lenient monetary policies” and that “the overall situation of the national economy was good”. Thus signalling that the authorities are unlikely to introduce any major policy tightening in the near term.
- The State Council in recent discussions and statements has also announced that the government will manage inflation expectations whilst keeping economic growth relatively flat, thus monetary and credit growth may not be as expansionary as before.
- The government may well also look to address a number of areas of reform in 2010 that they have neglected over the past few years, such as the development of a pension system, adjusting utilities prices such as electricity, gas and water prices and potentially further opening up the services sector.

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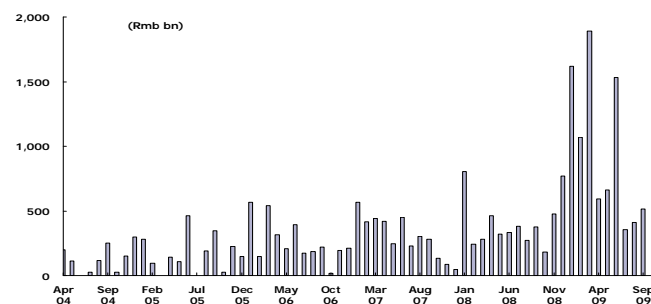
Is inflation going to be a concern going forward?

- Inflation has reached an inflection point and the trend has now turned up, but the pace of increase from here will likely be gradual. The Peoples Bank of China (PBoC) should not be concerned as long as the CPI (Consumer Price Index) remains below the 3-4% threshold. Negative headline inflation, plus a more normal rate of domestic credit expansion, together limit the risks of policy tightening in the near term. The first PBoC rate hike may not arrive before Q2 2010, though China's central bank may still find itself acting well ahead of the Fed.
- On an annual basis there was still deflation at the end of Q3 2009, with the headline CPI at -0.8% in September, down from -1.2% in August. Inflation, however, has turned positive on a monthly basis, up 0.4% mom in September following a 0.5% rise in August. Food prices were the main driver in the last bout of inflation in 2004-06. Currently, they are quite subdued, up 1.5% mom in September from 0.5% in August. With sustained expansionary monetary policy, inflation can be expected to trend slowly higher from here.

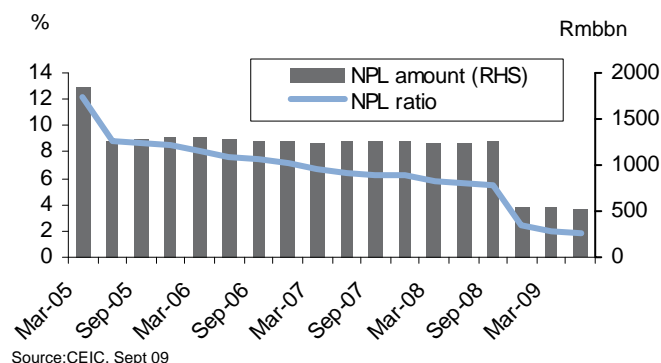
How healthy are the Chinese banks? How likely are we to see a pick up in non-performing loans?

- In addition to the fiscal stimulus package last year, the other important step that the government took was to remove the credit controls that it had put in place in 2007. By doing this the government gave a clear signal that China was not going to see a banking crisis or a credit crunch – and that the Chinese government effectively stood behind the banking system. This resulted in explosive loan growth – in the first six months of 2009 the banks lent RMB 7.37 trillion (USD 1.0 trillion) in new loans, which equates to 150% of the total amount lent in 2008. From July onwards the government reduced the amount of new bank credit each month as they turned off the bills discounting facility, which was seen as a relatively safe way to jump start credit early in the year. Bill discounting accounted for a quarter of total new lending. Even with the slowdown in bank lending, liquidity in the system remains strong – household savings grew 26% year on year in July to RMB 24.9 trillion (USD 3.6 trillion) and corporate savings increased 32% year on year to RMB 19.69 trillion (USD 2.9 trillion).

New bank credit no longer excessive...



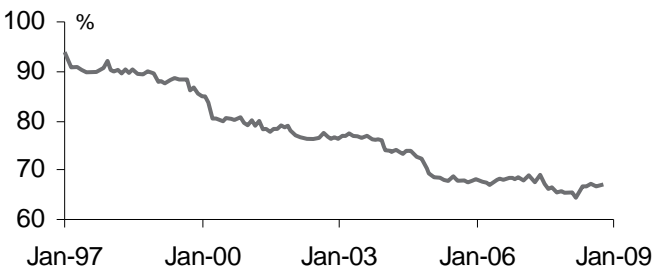
Declining NPL balance and ratio



- A common concern among investors is whether the massive loan growth in 2009 could potentially lead to future non-performing loans (NPLs). We do expect to see a very moderate increase in NPLs. The majority of the bank lending has gone to state connected entities, namely local government infrastructure projects and State Owned Enterprises (SOEs). In the first half of 2009, 42% of the loans went to infrastructure-related projects and thus default rates should be manageable.
- The CBRC (China Banking Regulatory Commission) has avoided the usual trap of relaxed supervision and provisioning during a period of expansion and their primary focus is in avoiding asset bubbles. The CBRC has been prompt in taking measures designed to manage the risks associated with the dramatic rise in H1 2009 lending. Over the past month, the CBRC raised provision coverage to 150% for the banks, pressed banks to raise capital and tightened up the definition of Tier 2 capital. China's banks are liquidity rich and have a strong capital base – the loan to deposit ratio is low at 70% and has been declining over the past ten years
- Post restructuring of the banking sector in early 2000 (the government took on the bad debts of the banks prior to the listing), the first test came in 2007-08 amid a booming stock market and property market. The PBoC and CBRC jointly issued regulations to protect the banks by tightening liquidity and strengthening credit controls – China's banks were resilient with a relatively stable amount of NPLs. There has been a significant improvement in terms of loan quality, with the NPL ratio now down to below 2%, and stability with the provision coverage ratio of major commercial banks rising to 118% by the end of 2008 and 150% by the end of this year. The regulator is guiding banks to shore up their balance sheets so that they reach 7-8% Tier 1 and 10% Total Capital Adequacy Ratios.

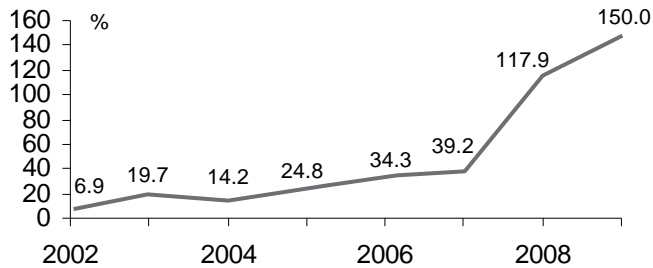
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Declining loan to deposit ratio



Source: CEIC, Jan 2009

Provision coverage must be 150% in 2009

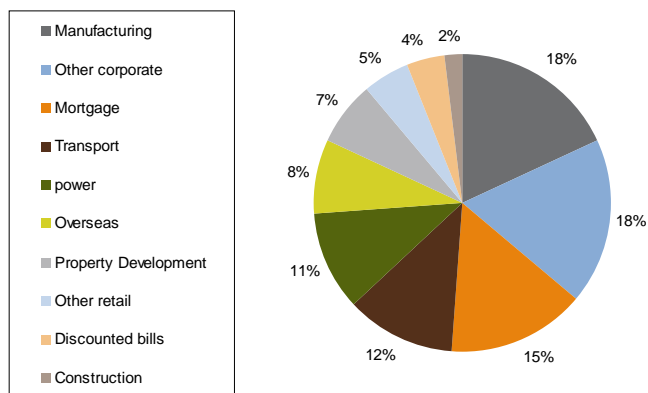


Source: CEIC, Jan 2009

What about the property market?

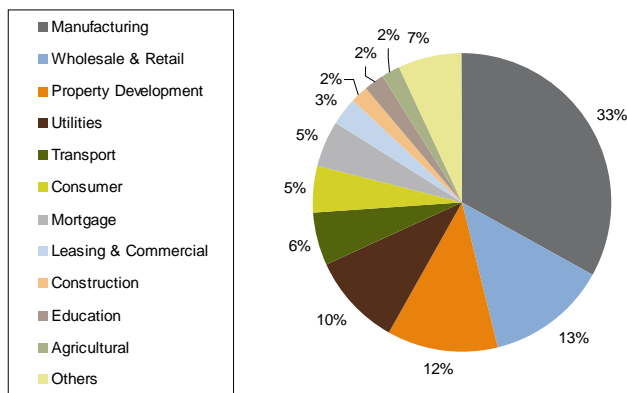
- Based upon the growth in property sales over the past year, up to 152% year on year, there could appear to be a bubble in the property market. However, this is not quite the case. In late 2007 the Chinese government, concerned about a rapid rise in house prices (along with a rally in equity markets as well), deliberately slowed down the property market. Beijing discouraged home buying and made it more difficult and expensive to buy property, and within a few weeks transactions ground to a halt and prices began to fall. The market remained weak until late 2008, when the government reversed this course by introducing a number of new measures such as cutting taxes, fees and mortgage rates in a bid to encourage home buying.
- Thus the extraordinary fast year on year growth in property sales is largely a result of two factors. Firstly a very low base effect, and secondly the sudden release of pent up demand for housing after a year of little or no transaction volume. Sales volumes rose by over 100% year on year in the first few months of this year. Had this carried on for the rest of the year this would have concerned us, but more recent data has indicated that transaction volumes have fallen off to a healthier more sustainable level. Property prices on a nationwide basis have just turned positive and affordability ratios still remain attractive in the majority of Chinese cities.
- The Chinese economy and banking system should be relatively well equipped to deal with a sharp correction in the housing market – given the low level of leverage in the market. In China, almost no mortgages are underwater, the majority of homeowners still live in the flat they received at nominal cost from the government a decade ago (the largest one-time transfer of wealth in history). We estimate that only a quarter of middle class homeowners are paying off a mortgage.
- Mortgage loans as a proportion of total bank loans for the industry have increased marginally from 9.5% in 2005 to 10.0% in 2008. The proportion of property loans and mortgages at the three listed big state-owned banks (BOC, CCB and ICBC) are 1-4% higher than the industry average, but remains extremely manageable. With a relatively new mortgage market, China has not developed credit derivatives or a mortgage securitisation market, which saved it from asymmetric risk issues and excessive leverage.

Loan breakdown of the three listed big SOE banks in FY08



Source: Company reports, CLSA, Dec 2008

NPLs breakdown of China commercial banks in FY08



Source: Company reports, CLSA, Dec 2008

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Is this a bubble forming?

- If we start with the definition of a bubble - “excessive valuation of assets fuelled by unsustainable leverage” then we believe that we are not currently seeing a bubble in either the property market or the equity markets. We put this question to Shumin Huang, the manager of the JF China Fund, as to whether a bubble is forming in the Chinese asset markets. She concluded that this was not the case, for the following reasons: (i) the stock market price-earnings ratio is below the long-term average; (ii) house prices nationally have only just turned positive, up 2.8% year on year in September (although a few cities are trailing behind); (iii) consumer borrowing is relatively restrained with less than half of homeowners taking out mortgages; and (iv) surging bank credit has been largely channelled towards infrastructure. She did comment that although a bubble is not forming now it is worth remaining vigilant in case the situation turns quickly.

Key Issues for China in the next few years

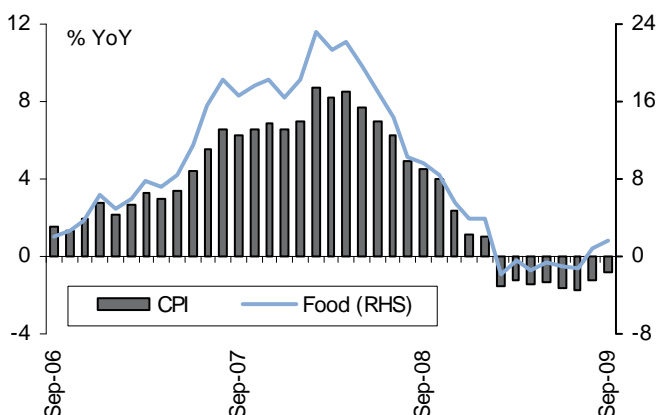
- A primary issue for China over the next few years will be to rebalance its economy away from investment (particularly public) towards one of consumption (particularly private). Premier Wen Jiabo’s comments back in 2007 still remain very relevant today: “The biggest problem in China’s economy is still the imbalances in the structure – that economic development is not stable, balanced or harmonious and sustainable.”
- Political considerations will increasingly become an issue especially in economic policy in the next few years. 2012 will see the transition of power to the fifth generation as the incumbent administration of President Hu Jintao and Premier Wen Jiabao draws to a close. The legacy of both the President and Premier and their influence in the next administration will be determined by the country’s economic performance over the next few years.

Risks

As with any article on China it is important to detail the risks as well as the opportunities that exist.

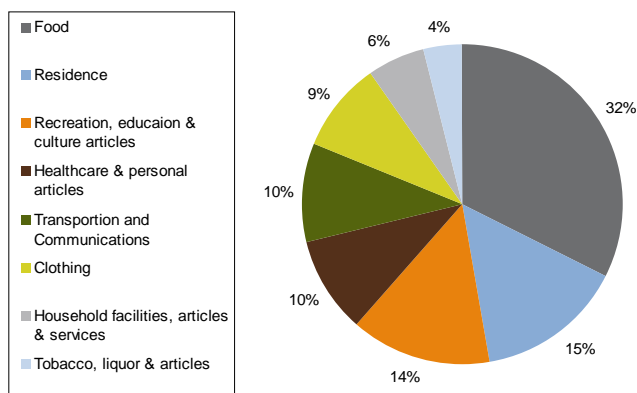
- Inflation - China will shift from a period of deflation to inflation over the next year, food being the key factor to watch out for. Food CPI inflation is currently low and down from the peak in February 2008 of 23%. With unemployment and excess capacity high, there is a very low probability of high inflation next year. CPI inflation should not rise above 4% in China next year, as domestic overcapacity will limit price increases for manufactured goods.

CPI and food price inflation both benign



Source: National Bureau of Statistics-China, Sept 2009

Consumer Price Index



Source: National Bureau of Statistics-China, Dec 2008

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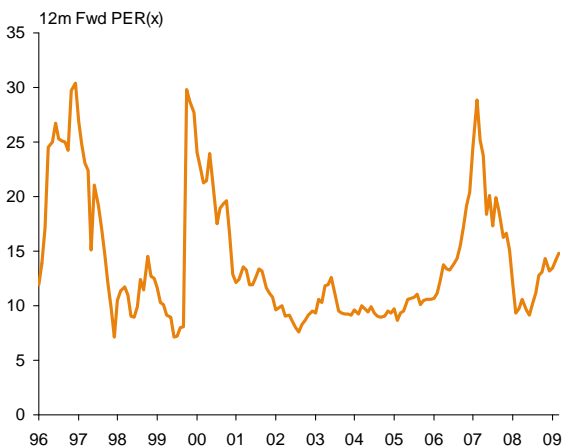
- **Currency** - we expect the RMB to remain flat versus the USD until mid-2010. The chances of a significant devaluation is very small – since any benefit to exporters would be outweighed by the damage with the existing US administration. The Chinese will merely resume the policy adopted in 2005, recognising that gradual appreciation of the RMB against the dollar is in China's self-interest. That policy was never abandoned, but implementation was suspended last year when the economy slowed and exports crashed. Beijing is, we believe, looking for an opportunity to resume implementation and by mid-2010 when GDP growth has stabilised at about 8-9% and exports are back in positive territory, there will be a return to gradual appreciation, on the order of 3-5% annually.
- **Protectionism** - the increase in the number of anti-dumping cases that the US had logged against China has concerned many that Washington wants to provoke a trade conflict with Beijing. The rise in cases being lodged is more of a domino effect, with one-dumping “win” leading other trade associations to file a case. Whilst these cases take up media space, the reality is that the individual cases are not that important. The latest anti dumping case of steel pipes accounts for about 1% of China's exports to the US, whilst the earlier tyre case accounts for 0.7% of exports. Beijing is fully aware that the tyre tariff was part of the Obama administration's efforts to win union support for its healthcare legislation. The risk is that a trickle of these small scale cases turns into a flood of cases, which ultimately does have an impact on bilateral trade.
- **Policy Risks** - the timing of the government's exit strategy will be vital, because if they wait too long to begin withdrawing the stimulus it could potentially lead to over-heating, while if they withdraw it too quickly it could lead to a relapse of sluggish growth. The other concern would be implementation of government policy. For example, it's possible that banks could fail to follow government guidance on loan growth or SOE's may refuse to slow their spending.

Valuations

- The MSCI China Index is trading on a price-earnings ratio (PER) of 14x for 2010E based on consensus earnings-per-share (EPS) growth of 15% for 2009 and 21% for 2010E. This compares to the CSI 300 (Shanghai Composite Index – A share), which is trading on a PER of 20x for 2010E given consensus EPS growth of 20% for 2009 and 26% for 2010E. China has also recovered from the trough in terms of price-to-book value (PBV), as MSCI China reached a low of 1.4x at the end of February and is currently trading at 2.4x PBV. China remains an extremely attractive market and is not expensively valued considering that interest rates are at a multi-year low and government policy is restraining liquidity.

China's 12-mth forward PER

MSCI China Index Level



Source: CLSA Asia Pacific Markets, MSCI, Worldscope, Sept 2009

China's PBV

MSCI China Index Level



Source: CLSA Asia Pacific Markets, MSCI, Worldscope, Sept 2009

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How is the JF China Fund Positioned?

- Shumin Huang, the manager of the JF China Fund, commented that the strategy for the fund remains focused on domestic-driven growth plays. The fund has an overweight in the financials sector – which includes banks, property and insurance. In the banking sector Shumin points to the potential for rising Net Interest Margins (NIM) and fee income growth and lower credit costs next year. In the property sector the long-term trends of urbanisation and property upgrading remain structural drivers for the sector along with the stimulus measures that were announced. The fund is focused on those developers with strong management execution and solid balance sheets. We remain positive on the consumer discretionary sector, given the incentives that the government has made this year to boost spending but also the longer term strategic aim of raising the proportion of GDP coming from consumption. The fund has a large underweight in the telecom sector as industry restructuring has led to an aggressive competitive environment, thus generating lower returns for the sector.
- The portfolio continues to emphasise companies that have a sustainable earnings profile and balance sheet strength as well as strong franchise value.

	Portfolio Weight	Benchmark Weight	Sector Weightings (%)	Fund	Benchmark [^]
H Shares	54.67	59.52	Financials	43.48	40.34
Red Chip	18.45	25.30	Energy	17.30	16.92
China Others	17.52	13.84	Consumer Discretionary	7.65	4.39
HK Others	3.18	0.00	Materials	6.28	6.03
A Shares	3.09	0.00	Telecommunication Services	5.47	11.89
B Shares	0.48	1.34	Industrials	5.25	8.87
Taiwan	0.26	0.00	Information Technology	5.13	5.61
Singapore	0.24	0.00	Utilities	2.69	1.76
Cash	2.12	0.00	Consumer Staples	2.68	3.95
Overall Total	100.00	100.00	Managed Funds	1.34	0.00
			Health Care	0.62	0.24
			Cash	2.12	0.00
			Overall Total	100.00	100.00

JF share class of JPMorgan Funds

[^] MSCI China 10/40 Capped Net

Source: JFAM (As at 30/09/09)

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