

CHINA – STILL RESILIENT?

China's economy is the second largest economy in Asia, and the fourth biggest worldwide. The economy has seen tremendous economic growth over the past 30 years since the implementation of economic reforms. In 2007, China posted a strong double digit growth performance figure of 11.9%. The global recession that occurred in 2008 has started to slow down its growth momentum. However, we believe that China is able to withstand the global economic downturn, due largely to the government's ability to manage the economy by adjusting its fiscal and monetary policies. This investment perspective will provide our outlook on the economy, monetary policy and stockmarket performance.

ECONOMIC OUTLOOK

China's economy grew by 9% yoy in the third quarter of 2008, down from the 10.1% yoy growth in the second quarter. For the first nine months, it grew at an annualized rate of 9.9%, down from 11.9% in the same period in 2007. Forecasts by government and inter-governmental organisations (Exhibit 1) showed an expected slowdown in growth in 2009, with the World Bank forecasting a growth below 8%. The last time its growth fell below 8% was in 1999 when it experienced a major recession – it grew by 7.6% yoy then.

Exhibit 1: GDP Growth Forecasts for 2009F

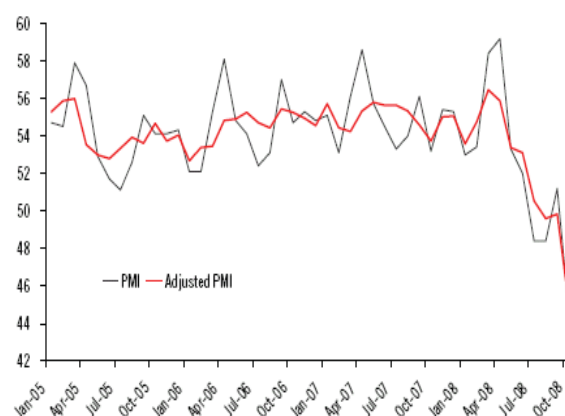
GDP Growth Forecast	2009F
Govt	8%
IMF	8.5%
World Bank	7.5%
OECD	8%

Source: Government, IMF, World Bank, OECD

Many indicators have pointed to a slowdown in its exports in the coming months. Despite growing 19.2% yoy in October, exports have slowed from the 21.5% yoy growth in September. PMI continues to be on a downward trend (Exhibit 2). It reached 38.8 in November, the lowest figure ever since the index started in 2005. Excluding the temporary rebound in September due to the Olympics, PMI has been declining since April this year. Similarly, Industrial Production has also been in decline. Exports orders index, one of the components of

PMI, indicated contraction during both October (41.4) and November (29), given the reduced demand from U.S., Japan and Europe.

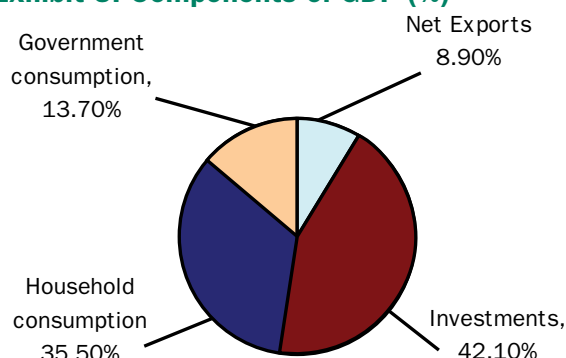
Exhibit 2: China Manufacturing PMI



Source: Citigroup

While exports have slowed down, the net impact may not be as high as net exports constitute only 8.9% of its GDP for FY 2007 (Exhibit 3). Thus, even if exports continue to slow but investment and household consumption can continue to enjoy robust growth, China's GDP growth will not be greatly affected.

Exhibit 3: Components of GDP (%)

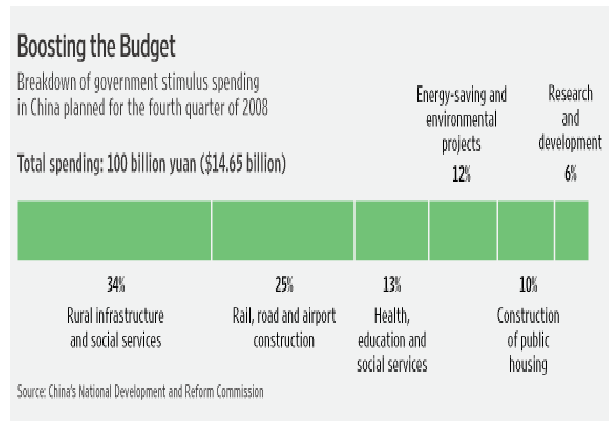


Source: Merrill Lynch

The announcement of 4 trillion yuan (US\$586 billion) fiscal stimulus plan, which is to be rolled out over two years, has also improved the general outlook for the economy. The government has allocated 100 billion yuan to be spent for the fourth quarter of 2008 (Exhibit 4). The 4 trillion yuan plan will focus on 10 key areas which include providing cheap housing for the lower income households and increasing subsidies for healthcare with the aim of boosting household

consumption. It has also allocated a significant portion for infrastructure investments which will create more jobs amid the current increasing unemployment rate environment in the country. (Exhibit 5)

Exhibit 4: Beijing provides outline of its stimulus plan for 4Q2008



Source: The Wall Street Journal

Exhibit 5: State Council Announced 4 trillion yuan Fiscal Stimulus package

10 Areas of Focus

1. Accelerating development of social security housing
2. Accelerating development of rural infrastructure
3. Accelerating development of transportation infrastructure
4. Strengthening healthcare, culture and education development
5. Strengthening ecological environmental construction, development of forest and support of projects saving energy and reducing pollution
6. Accelerating technological innovation and structural adjustments
7. Accelerating post-earthquake reconstruction
8. Raising income of rural and urban residents
9. Extending the VAT reform, encouraging technological transformation
10. Strengthening finance supports to economic growth

Source: Citigroup

The fiscal stimulus plan is also consistent with what the government has outlined in its 11th Five-year Plan. The objective of the plan is to rebalance the pattern of growth, making growth more domestic-demand led. Hence, growth is expected to shift from one of external-demand driven to that of more domestic-demand driven. This will be seen as positive in the light of current environment

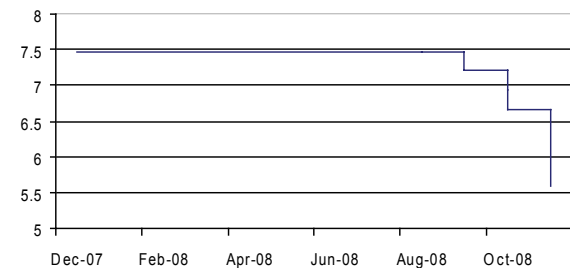
where its main trading partners have slumped into recession.

Thus, we still expect China's economic growth to be underpinned. Besides its huge foreign reserves of US\$1.9 trillion to support its fiscal expansion, China also has room to adjust its monetary policy.

INTEREST RATE OUTLOOK

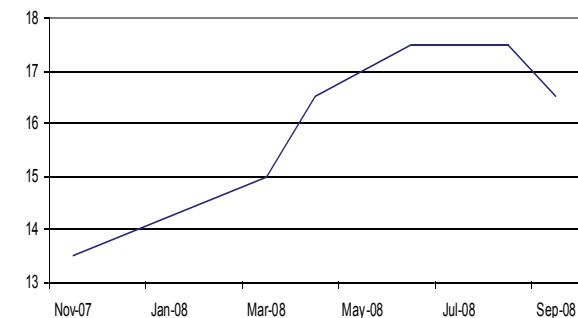
In a global concerted effort by central bankers around the world to cushion the adverse impact of the financial crisis, China has reduced its lending rates four times by a total of 189 bps to 5.58% (Exhibit 6). More cuts are expected as inflation is likely to ease in the months ahead given falling commodity and oil prices. In October, annual inflation eased to 4% from the 4.6% in September – the peak was 8.7% in Feb this year. Similarly, it has also cut its Reserve Requirement Ratio to 16.5% in October (Exhibit 7). The deposit rates have also been cut to encourage more people to invest and spend rather than leaving their monies in fixed deposits.

Exhibit 6: China cut its interest rates 4 times



Source: People's Bank of China

Exhibit 7: China cut its Reserve Requirement Ratio



Source: People's Bank of China

STOCKMARKET OUTLOOK

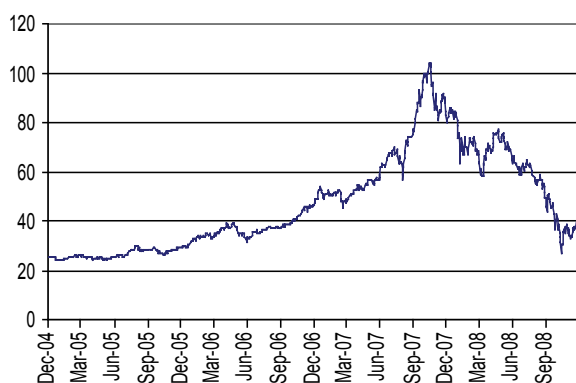
We have highlighted previously that the Chinese stock market was trading at high levels in 2007 which we thought was not sustainable. Further, due

to the global economic downturn and aggressive deleveraging by global investors, the Chinese stock market has fallen from its peak in October 2007 by 59% as of 11 December 2008. (Exhibit 8)

MSCI China¹ is currently trading at attractive valuation, with the expected 2008 P/E at about 11.3 times, which is lower than the long term average of 17.3 times. (Exhibit 9) Similarly, the expected 2008 P/B of 1.59 times is much lower than that in 2003, where P/B was at about 1.9 times and also much lower than the 5-year average of 2.6 times. (Exhibit 10).

According to Citigroup, the stock market usually bottoms after four or five interest rate cuts. Hence, with the latest cut in lending rates to 5.58% which was the fourth cut, the stockmarket may have reached its bottom. We are expecting an upside of 57.64% for MSCI China from its closing price on 11 December 2008. (Exhibit 11).

Exhibit 8: MSCI China Index



Source: MSCI

Exhibit 9: MSCI China's P/E



Source: Credit Suisse

Exhibit 10: MSCI China's P/B



Source: Credit Suisse

Exhibit 11: Upside for MSCI China

INDEX	11.12.08	PRICE-TO-BOOK(1)			PRICE-TO-EARNINGS(2)			AVERAGE [(1)+(2)]/2
		2008E	AVERAGE	UPSIDE	2008E	AVERAGE	UPSIDE	
MSCI CHINA	42.944	1.59	2.6	63.03%	11.36	17.3	52.25%	57.64%

RISKS

While we are optimistic on China's economic growth and the stockmarket outlook, we are mindful of the potential risks. Some of the risks to the forecasts are:

Corporate Failures

The slowdown in growth in the U.S and Europe has driven many exporters in China out of business. China's custom agency reported that half of China's toy exporters – about 3,600 companies in total – closed down in the first seven months of 2008. Reasons cited for the closures included slowing global demand and high operating costs due to government policies.

Furthermore, increased operating costs in China have also spurred more companies to relocate their factories to cheaper locations such as Vietnam, Cambodia, Bangladesh or Mexico. Japanese camera maker Olympus Corp has indicated plans to begin producing lower-end digital camera lenses, and lens and zoom units in Vietnam instead of in its Chinese factories in Shenzhen and Guangzhou².

The Business Climate Index – a key gauge of corporate performance – also shows a decline. It fell from 137.4 in the second quarter to 128.6 in the third quarter. The deteriorating corporate sentiment driven by global recession and higher operating costs suggests that more government support is required to reduce the risks of corporates facing refinancing problems and bankruptcies.

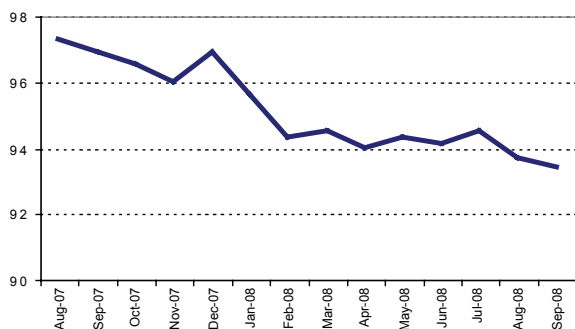
¹MSCI China includes H Shares, B Shares, Red Chip and P Chip

²The Wall Street Journal, "Chinese Laborers Face Grim Job Search", 10 November 2008

Dwindling Consumer Confidence

The second risk is that the proposed 4 trillion yuan stimulus package might not work as intended. Consumer confidence is an integral driving factor for the domestic consumption, equity market, as well as the housing sector. It has been on a downward trend since the beginning of 2008 (Exhibit 12). There is a concern that, even with aggressive fiscal and monetary expansionary policies, this will not translate into greater consumer spending.

Exhibit 12: China's Consumer Confidence Index



Source: National Bureau of Statistics of China

Government's control a double-edged sword

Thirdly, government control on the banks remains a concern for foreign investors. Indeed, this has helped the banks to avoid the problems experienced by U.S. and European banks in the last few months. However, if the government control is

too restrictive, foreign firms might not favour China as a place to invest, which could affect Foreign Direct Investment (FDI) negatively.

Rising Yuan

The appreciating yuan continues to be a major risk. As of 20 November, the yuan has appreciated 6% against the USD on the back of continued pressure from the U.S. to let the yuan appreciate. It is likely that the government will allow moderate appreciation of the yuan in 2009 for the following three reasons: (i) The emphasis by the government to boost private consumption and reduce dependence on exports, (ii) stabilising exports using tax rebates instead of currency, and (iii) continued pressure from US to strengthen the yuan.

FUNDS SELECTION

Our recommended funds for gaining exposure to the China's stock market are HSBC GIF Chinese Equity Fund and Fidelity China Focus Fund. The HSBC GIF Chinese Equity Fund is recommended for Cash/ CPF investments, while Fidelity China Focus Fund is for SRS investment.

The asset allocation/ geographical and sector breakdown of the recommended funds are illustrated in Exhibit 13, 14 and 15 respectively.

Exhibit 13: Comparative performance of funds invested in China

	Annualized Bid-to Bid price returns (SGD)				Annual Std Dev
	1 Mth	6 Mth	1 Yr	3 Yrs	
HSBC GIF Chinese Equity	13.20%	-28.82%	-52.67%	6.89%	33.85%
Fidelity China Focus Fund	12.60%	-27.41%	-47.30%	-	31.53%

Source: www.fundsupermart.com and Fund managers. Returns as at 11 December 2008.

* Fidelity China Focus does not have a 3 yrs return figure as its inception date was 5 March 2007.

Exhibit 14: Asset Allocation and Sector Breakdown of HSBC GIF Chinese Equity Fund

HSBC GIF Chinese Equity					
	HSBC GIF Chinese Equity			Sector Breakdown	
1	Hong Kong H Shares	63.9%	1	Financials	37.2%
2	Hong Kong Red Chips	28.8%	2	Telecommunications	16.4%
3	Hong Kong China Plays	2.5%	3	Oil & Gas	14.6%
4	New York N Shares	1.7%	4	Industrials	10.6%
5	Shenzhen B Shares	0.3%	5	Basic Materials	5.5%
6	Cash	3.7%	6	Technology	4.2%
			7	Consumer Goods	3.9%
			8	Cash	3.7%
			9	Utilities	2.9%
			10	Consumer Services	1.1%
	Total	100%		Total	100%

Source: Latest Fact Sheet of HSBC GIF Chinese Equity fund

Exhibit 15: Geographical and Sector Breakdown of Fidelity China Focus Fund

Fidelity China Focus Fund					
	Geographical Breakdown			Sector Breakdown	
1	China	91.3%	1	Financials	27.4%
2	Hong Kong	5.4%	2	Energy	20.7%
3	Cash	3.1%	3	Telecommunications Services	13.0%
4	Other	0.2%	4	Industrials	9.1%
			5	Consumer Discretionary	8.9%
			6	Information Technology	5.9%
			7	Consumer Staples	4.5%
			8	Materials	4.2%
			9	Other	3.2%
			10	Cash	3.1%
	Total	100%		Total	100%

Source: Latest Fact Sheet of Fidelity China Focus Fund