



農銀國際

ABC INTERNATIONAL

ABC SECURITIES COMPANY LIMITED

**ABCI China/Hong Kong Equity Research**  
**2014 Economic Outlook and**  
**Investment Strategy**

**Changes for the Better**

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**Definition of equity rating**

Rating	Definition
<b>Buy</b>	Stock return $\geq$ Market return rate
<b>Hold</b>	Market return - 6% $\leq$ Stock return < Market return rate
<b>Sell</b>	Stock return < Market return - 6%

Stock return is defined as the expected % change of share price plus gross dividend yield over the next 12 months

Market return: 5-year average market return rate from 2007-2011

Time horizon of share price target: 12-month

**Definition of share price risk**

Rating	Definition
<b>Very high</b>	$2.6 \leq$ 180 day volatility/180 day benchmark index volatility
<b>High</b>	$1.5 \leq$ 180 day volatility/180 day benchmark index volatility < 2.6
<b>Medium</b>	$1.0 \leq$ 180 day volatility/180 day benchmark index volatility < 1.5
<b>Low</b>	180 day volatility/180 day benchmark index volatility < 1.0

We measure share price risk by its volatility relative to volatility of benchmark index. Benchmark index: Hang Seng Index. Volatility is calculated from the standard deviation of day to day logarithmic historic price change. The 180-day price volatility equals the annualized standard deviation of the relative price change for the 180 most recent trading days closing price

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## 2014 Global Economic Outlook and Strategies: A Bird's Eye view

### 2014 Outlook in Brief

- Debt ceiling and fiscal budget issues will dictate the pace of recovery in the U.S. The Fed's QE tapering will have negative spill-over effects on the rest of the world. Our 2014 GDP growth forecast for the region is 2.7% YoY
- In Europe, political and fiscal fragmentations are dragging down economic growth and postponing the establishment of the banking union. Recovery will remain uneven, and our 2014 GDP growth forecast for Eurozone is 0.8% YoY
- In Japan, consumer spending will contribute materially to growth despite sales tax will rise in 2014. Our 2014 GDP growth forecast for the country is 1.6% YoY
- Emerging Asia will be adversely impacted by capital outflow when the Fed starts QE tapering; structural reform is called for
- China will continue to maintain an accommodative policy stance to facilitate economic rebalancing. Transformation into a consumption-led economy will be emphasized. Our 2014 GDP growth forecast for China is 7.6% YoY
- Driven by consumption and investment, Hong Kong economic growth is expected to improve in 2014. Our 2014 GDP growth forecast for the region is 3.4% YoY
- For 2014F, we expect HSI and HSCEI to post earnings growth of 8.1% and 8.8%. Year-end targets are set at 25,095 and 13,680, respectively

### Investment Highlights

Sector	Rating	Stock Picks
China Banks	Overweight	ICBC (1398 HK) / CCB (939 HK)
China Property	Overweight	CSC(1668 HK) / Franshion (817 HK) / Kaisa (1638 HK)/Greentown (3900 HK)
China Securities	Overweight	CGS (6881 HK)
Coal	Neutral	China Shenhua (1088 HK) / Yitai Coal (3948 HK)
Dairy	Overweight	Mengniu (2319 HK) / China Modern Dairy (1117 HK)
Internet & Media	Overweight	Tencent (700 HK)
Pharmaceutical	Overweight	Sinopharm (1099 HK) / Shanghai Pharm (2607 HK) /Sino Biopharm (1177 HK) / Sihuan Pharm (460 HK)
Renewable Energy	Overweight	Longyuan (916 HK) / HN Renew (958 HK) /BJCE (579 HK)
Special Machinery	Neutral	Lonking (3339 HK) / First Tractor (38 HK)
Transport Infrastructure Construction	Neutral	CRCC (1186 HK) / CRG (390 HK)

Source(s): ABCI Securities



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## Global economic outlook for 2014: Changes for the Better

- Resolution of the fiscal impasse will hold the key to improvement in the U.S. economy
- Positive trends in the Eurozone will turn more solid
- Consumer spending will contribute materially to growth in Japan despite the higher consumption tax
- China's top priority in 2014 will be on structural reforms to facilitate economic rebalancing and consumption

### Global economic recovery to gain momentum

The global economy is strengthening gradually although the recovery remains uneven. The global business cycle continues to evolve, with many developed economies steadily moving to a higher trajectory in terms of economic activity. The ongoing divergence between developed and emerging worlds is contributing to a marked variation in economic conditions across the global business cycle. It is also complicating the outlook for monetary policy as the U.S. Federal Reserve (Fed) delays QE tapering amid fiscal impasse and slower-than-expected economic recovery. In sum, supportive monetary policies, improving financial market conditions and gradual restoration of confidence are at the root of the recovery. We expect the global economic recovery to gain traction in 2014.

In 2013, economic recovery has been more impressive in Europe and Japan than that in the U.S., whose economy was hit by the temporary shutdown of the government in 4Q13. Entering 2014, economic instability, political deadlock and concerns over its fiscal health will remain in the world's largest economy. Resolution to the fiscal impasse will hold the key to the country's economic growth. In Europe, most Eurozone countries show signs of economic progress. Downside risks to the outlook have narrowed. Economic sentiment rebounded to the highest level in over two years, suggesting that positive trend in the Eurozone will turn more solid in 2014. However, adverse interactions between weakly capitalized banks, government finances, and the real economy remain a significant risk in Europe. Bolder measures to dissolve the financial and banking crises once and for all are needed to ensure a faster, stronger and more sustainable recovery. In Japan, the economy has swung back to growth on the back of monetary expansion. Economic activities continue to be driven by substantial increases in net exports, stronger-than-expected public infrastructure spending, and increases in household expenditure. We remain confident that consumer spending will contribute materially to growth given the lower borrowing costs, prospect of higher wages from more profitable businesses, and the household wealth effect arising from increasing land prices. The momentum in the household sector is expected to continue despite the increase in the consumption tax rate in 2014. For emerging Asian countries, most economies will continue to bear the brunt of capital outflows as a result of impending QE tapering, a cyclical slowdown in activity, and the increased market focus on structural challenges in the region. These economies have been growing at subpar rates affected by weak export demand from the advanced economies. While the outbreak of another Asian Financial Crisis is unlikely, the necessity of structural reforms remains intact among the emerging regions. Nonetheless, gradual and persistent growth acceleration in the advanced economies will translate into an upturn in global trade, giving a boost to the emerging countries and helping them to weather the storm of capital outflows.

For China, the year of 2013 has been a transitional one when the Chinese government changes hands with massive economic structural reforms. CPC's Third Plenum puts strong emphasis on enhancing reform efforts in key policy areas with the goal of sustaining healthy economic growth. With major GDP drivers strengthening, we believe the Chinese government will continue to maintain an accommodative policy stance to facilitate economic rebalancing in 2014. In Hong Kong, economic growth is expected to improve in 2014, with consumption and investment to be the major growth drivers.

**Exhibit 1: Global economic forecasts**

<b>YoY%</b>	<b>2011</b>	<b>2012</b>	<b>2013F</b>	<b>2014F</b>	<b>2015F</b>
US	1.8	2.8	1.6	2.7	3.0
Eurozone	1.5	(0.6)	(0.5)	0.8	1.4
Germany	3.4	0.9	0.6	1.5	2.0
France	2.0	0.0	0.2	1.1	1.5
Italy	0.4	(2.4)	(1.8)	0.5	0.7
Spain	0.1	(1.6)	(1.6)	0.1	0.2
Netherlands	0.9	(1.2)	(1.4)	0.4	1.0
Greece	(7.1)	(6.4)	(4.3)	0.3	1.1
Portugal	(1.3)	(3.2)	(2.0)	0.9	1.2
Ireland	2.2	0.2	0.7	1.8	2.4
UK	1.1	0.2	1.2	1.7	2.2
Japan	(0.6)	2.0	2.2	1.6	1.8
Mainland China	9.3	7.7	7.6	7.6	7.3
Hong Kong SAR	4.9	1.5	3.1	3.4	3.6
Singapore	5.2	1.3	3.3	3.5	3.8
South Korea	3.7	2.0	2.7	3.7	4.0
Russia	4.3	3.4	1.4	3.2	3.5
India	6.3	3.2	3.6	5.5	6.3
Brazil	2.2	0.9	2.6	2.6	3.6

Source(s): IMF, ABCI Securities estimates



## U.S. 2014 Outlook: Keeping the momentum forward

- The U.S. economic recovery will be on track in 2014 and grow 2.7% YoY based on our forecast
- Resolution to debt ceiling and fiscal budget conflicts will have direct impacts on the course of the economy
- Fed's tapering of the QE program will have negative spill-over effects on the rest of the world, especially the emerging markets

### The U.S. economic recovery exceeded expectations in 2013

In 2013, recovery of the U.S. economy has been accelerating with the fundamentals improving in varying degrees. The GDP growth in the first three quarters showed that recovery was on track. Unemployment rate and jobless claims continued to trend down, while the non-farm payroll increased gradually. The U.S. stock market performed better than the ones in other developed markets. Housing market continued to enjoy a strong rebound, driving up the household net worth and confidence in the economy. Meanwhile, inflationary pressure has been well contained, giving the authority ample headroom to maneuver policy. Although the political standoff over the budget deficit and debt ceiling temporarily dented growth in Oct, we expect the U.S. economy will continue to improve in the rest of 2013 with its GDP growing by 1.6% YoY in 2013F.

### Two major overhangs in 2014

We believe that the U.S. economy is recuperating and the pace of recovery will accelerate in 2014. The Fed's tapering of the QE program, and conflicts over the fiscal budget and debt ceiling, however, may present hurdles to positive development.

**Fed tapers, market jitters.** Speculation on the Fed's QE tapering will continue to cause disturbance in the global market. The U.S. 10-year government bond yield was pushed up and has not been able to return to the previous lower level ever since. The 3-month LIBOR-OIS liquidity spread and Moody's Baa-Aaa default spread also suggest that speculation of Fed's QE withdrawal has caused tremor in the market.

In our view, the current unemployment rate has not reached the target threshold that can substantiate the tapering action. Moreover, even though unemployment has been declining, the labor force participation rate is tilting towards the downtrend, rendering the use of unemployment as the only decision criterion to tapering unjustifiable. We believe that the Fed should take a more holistic assessment approach while the tapering may start as early as 1Q14.

Investors' concern will be on the interest rate increase. Back in 1994, the Fed's action to raise interest rate resulted in an across-the-board bond yield spike. The current situation is different from the episode in the 90's as: 1) transparency of the Fed's policy and the relevant communication have improved; 2) Optimism in the economy is higher in 1994 than in 2013; 3) the U.S. fiscal issues have become an important factor in considering the QE tapering. The issue will recur again in 1Q14 when the temporary solution expires. We believe the Fed will take a cautious approach in tightening in the near future. Bond yields are likely to rise when the QE tapering begins, but the Fed will maintain an accommodative monetary policy to avoid excessive surge in interest rates and the Fed Funds Rate will stay at the current level in 2014.

**Old problems die hard.** While the government shutdown was not unprecedented, the impact was the largest ever. According to the White House Budget Office, the 16-day government shutdown in Oct 2013 resulted in US\$ 2bn - 6bn in lost output. Compensation costs with benefits to furloughed federal employees amounted to US\$ 2.5bn, while revenue from suspended federal service and increased interest cost due to late payment also struck high. Concerns over the stability of the U.S. political system will further hamper its reputation domestically and internationally as the fiscal impasse recurs.

With the current extension of fiscal budget expiring on Jan 15 and the government's borrowing authority expiring on Feb 7 in 2014, crisis of another political impasse will arise. Central to the budget negotiation will be the different budget proposals



from the House Republicans and Senate Democrats. The former supports more spending cuts instead of tax increase to balance the budget, while the latter favors tax increase and moderate spending cuts without much emphasis on budget balance. Failure to reach an agreement on the fiscal issues will damage the creditability of the U.S. government and drive investors away from the U.S. debts. Nonetheless, we believe the FY14 fiscal budget would be approved. Taking a long-term perspective, we maintain that only through tax reform, entitlement reform, and fiscal consolidation will the U.S. government be able to manage its budget deficit.

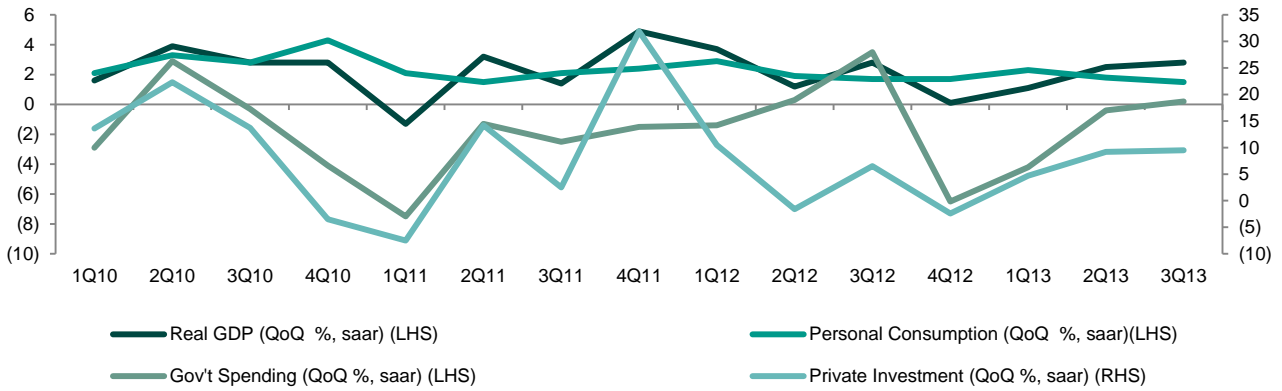
#### **Expect a mild recovery for 2014**

We expect that the Fed's QE tapering and the recurring fiscal impasse will be barriers to a speedy recovery in the U.S. Sustainability of the recovery momentum in U.S. is called into question as contradictory economic data adds to the confusion. Although certain economic indicators (PMI, industrial production, unemployment rate) show consistent improvement in the U.S. economy, others say the opposite. Unemployment rate has been improving, but the labor force participation rate is declining and other labor market indicators are not showing decisive advancement. Although business investments are accelerating, consumer confidence and consumer spending are trending down. While the economic output gap is narrowing, inflation remains flat. We believe structural changes in the U.S. economy are necessary to resolve the deep-rooted problems. As long as the monetary policies remain accommodative and recurrence of fiscal impasse can be minimized, the U.S. economy will continue to expand. We expect the U.S. GDP will grow 2.7% YoY in 2014F.



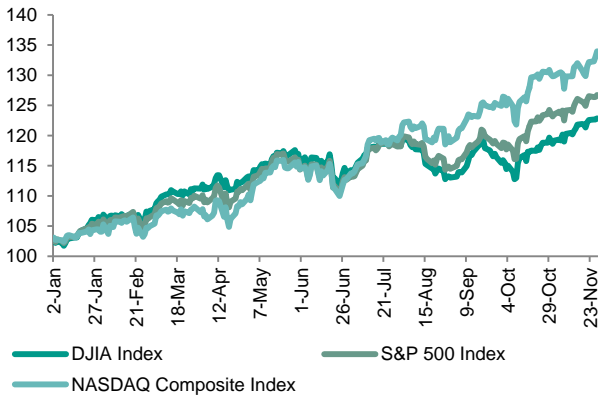


Exhibit 1: U.S. GDP growth



Source(s): Bloomberg, U.S. Bureau of Economic Analysis, ABCI Securities

Exhibit 2: U.S. equity indices in 2013



Note: For Exhibit 2, baseline = Jan 2, 2013  
Source(s): Bloomberg, ABCI Securities

Exhibit 3: DJIA Index and S&P 500 Index in 2013

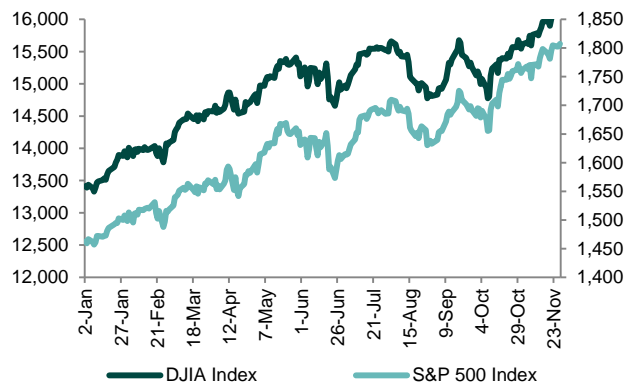
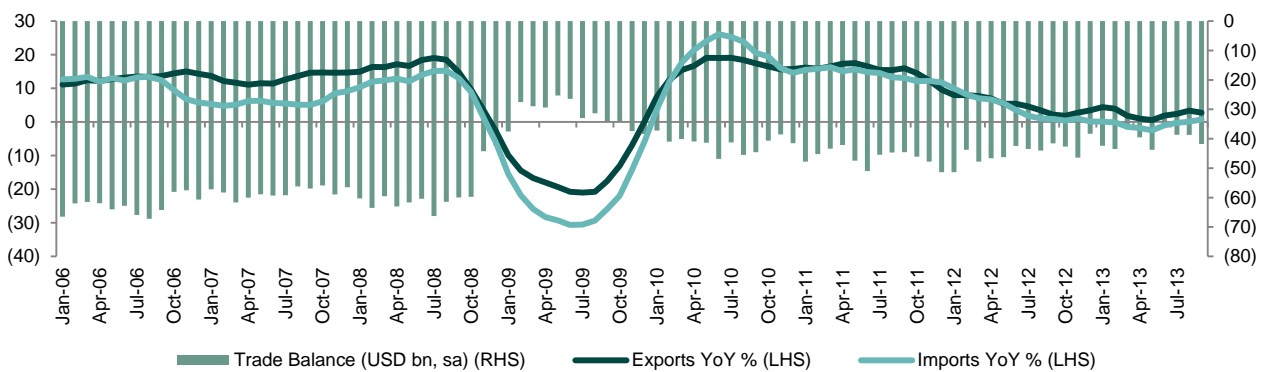


Exhibit 4: U.S. trade balance, 3MMA export and 3MMA import growth (L: YoY%, R:USD bn)



Source(s): Bloomberg, U.S. Census Bureau, ABCI Securities



Exhibit 5: Jobless claims is declining in the U.S.(k)

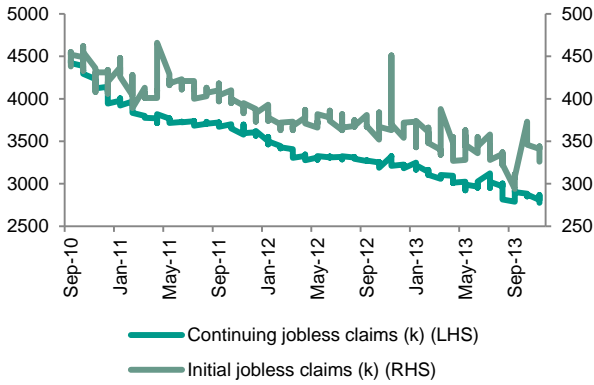
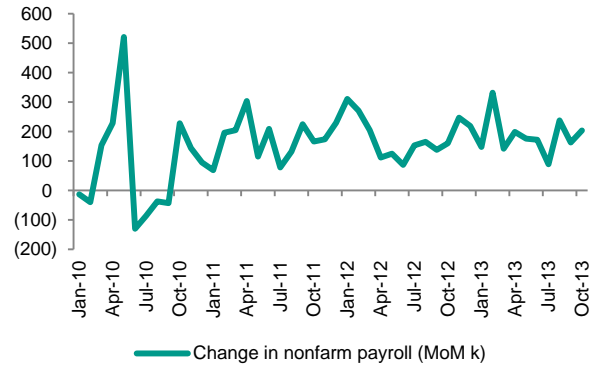
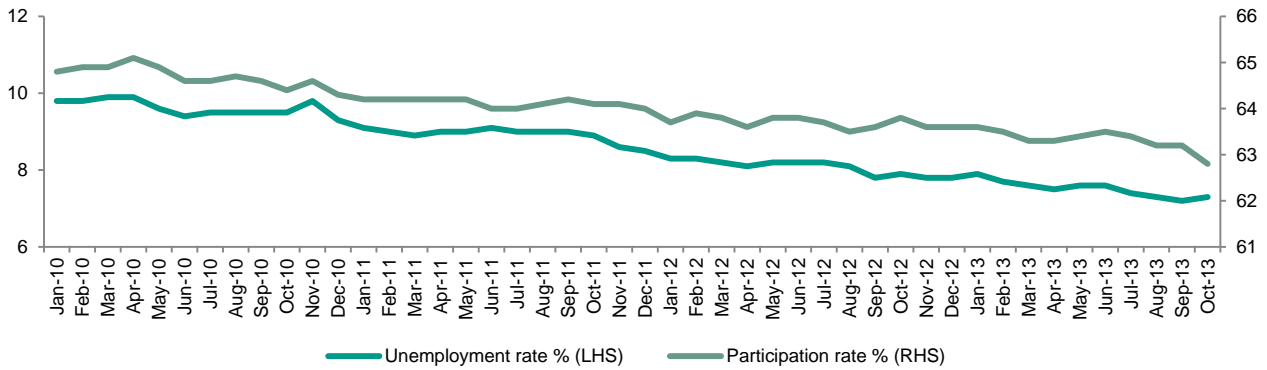


Exhibit 6: Changes in non-farm payroll in the U.S. (MoM k)



Source(s): Bloomberg, U.S. Department of Labor, Bureau of Labor Statistics, ABCI Securities

Exhibit 7: U.S. unemployment rate and participation rate (%)



Source(s): Bloomberg, U.S. Bureau of Labor Statistics, ABCI Securities

Exhibit 8: U.S. PMI (%)

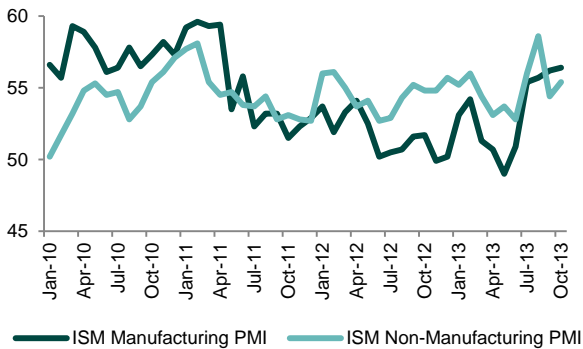
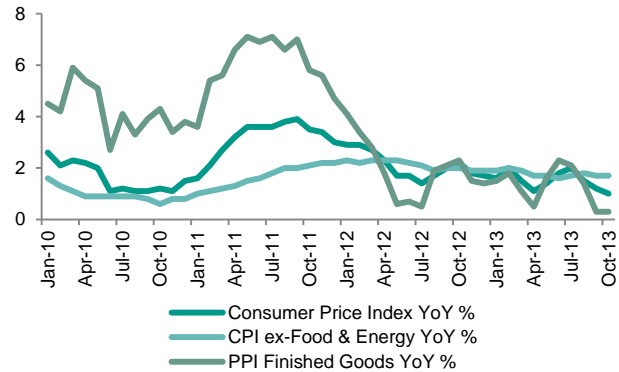


Exhibit 9: U.S. inflation rates – CPI&PPI (YoY%)



Source(s): Bloomberg, U.S. Institute for Supply Management, U.S. Bureau of Labor Statistics, ABCI Securities



Exhibit 10: U.S. new and existing home sales(L: k units, R:mn units)

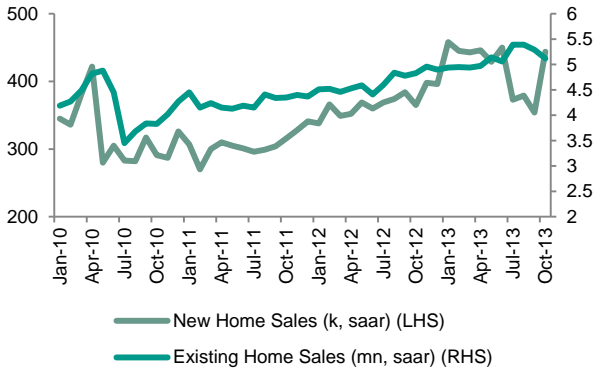
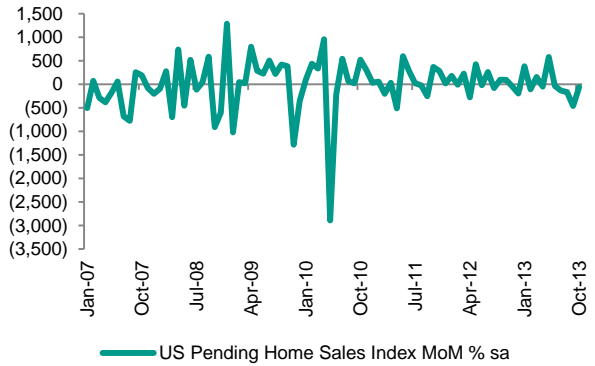


Exhibit 11: U.S pending home sales change (MoM %)



Source(s): Bloomberg, U.S. Census Bureau, National Association of Realtors, ABCI Securities

Exhibit 12: MBA mortgage application in the U.S. (WoW%)

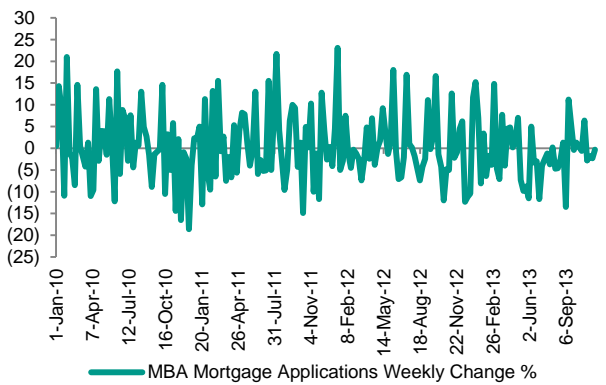
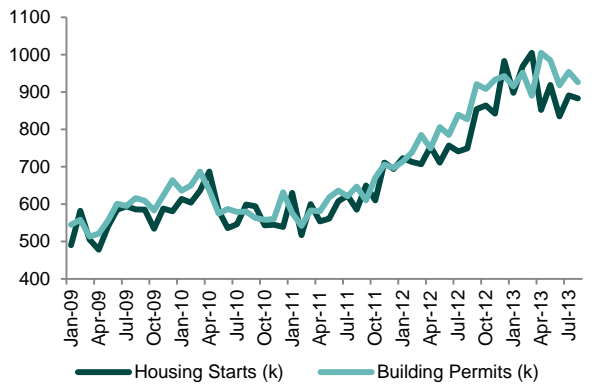


Exhibit 13: U.S. housing starts and building permits (k)

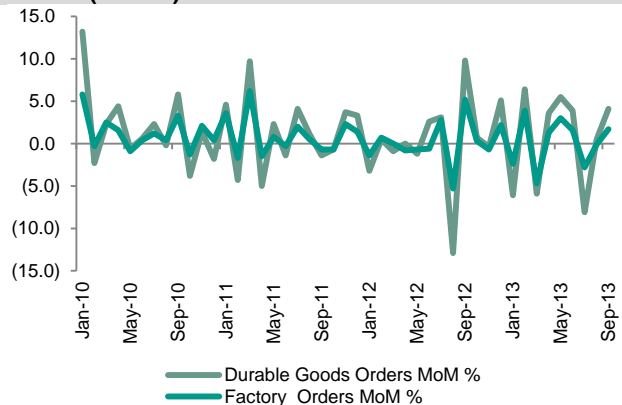


Source(s): Bloomberg, Mortgage Bankers Association, U.S. Census Bureau, ABCI Securities

Exhibit 14: U.S. industrial production (YoY%)



Exhibit 15: U.S. factory orders and durable goods orders (MoM%)



Source(s): Bloomberg, U.S. Census Bureau, Federal Reserve Bank, ABCI Securities



Exhibit 16: U.S. capacity utilization (%)

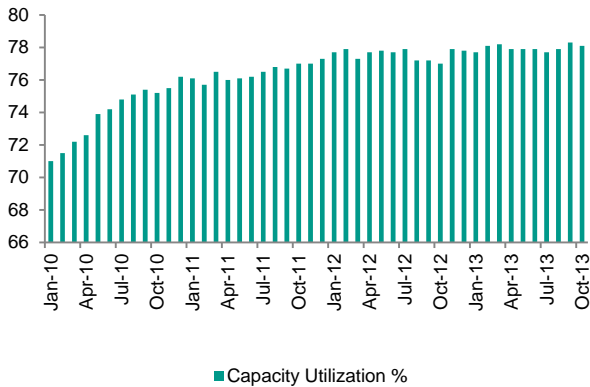
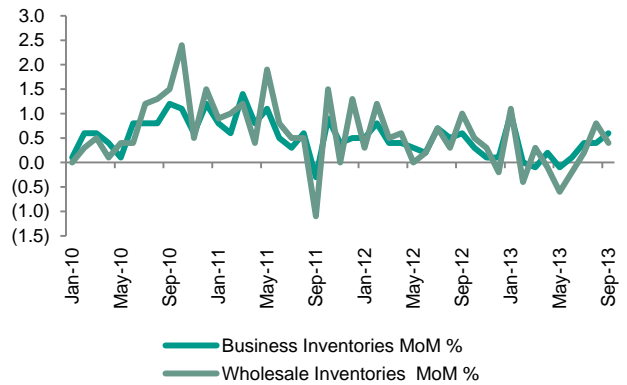


Exhibit 17: U.S. inventories change (MoM%)



Source(s): Bloomberg, U.S. Census Bureau, Federal Reserve Bank

Exhibit 18: U.S. personal income, household expenditure, and consumer confidence (L:MoM%)

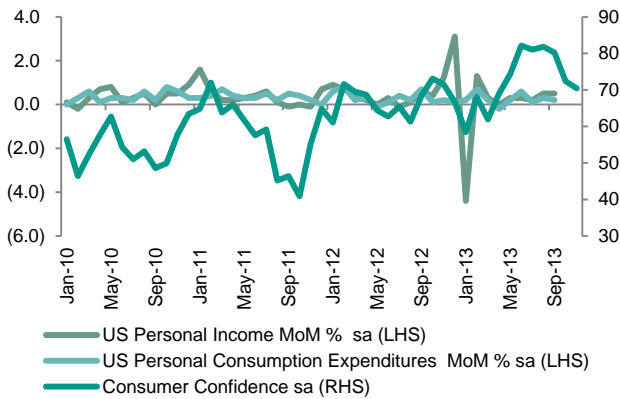
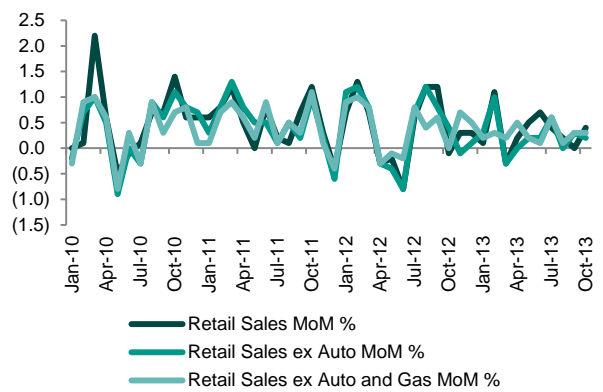
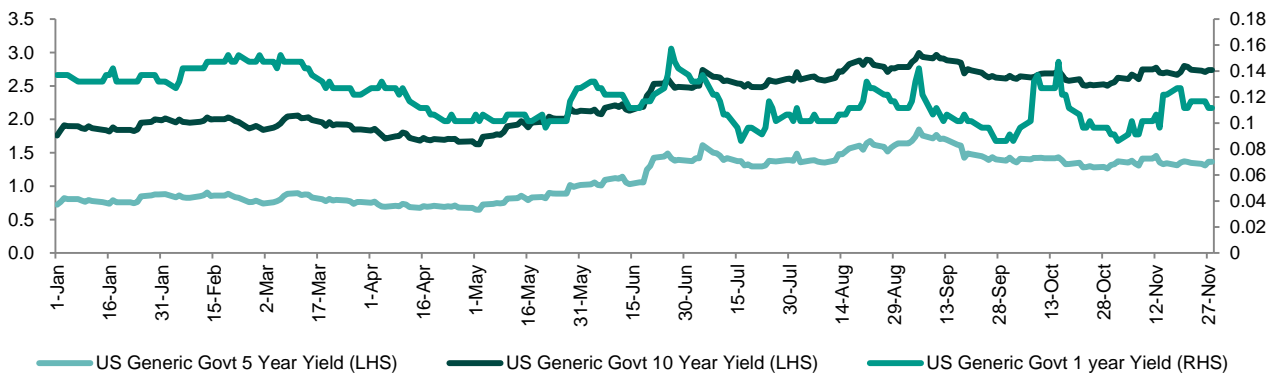


Exhibit 19: U.S. retail sales growth (MoM%)



Note: For Exhibit 18, Personal Income and Personal Consumption Expenditures are updated to Sep 2013  
Source(s): Bloomberg U.S. Conference Board, U.S. Bureau of Economic Analysis, U.S. Census Bureau, ABCI Securities

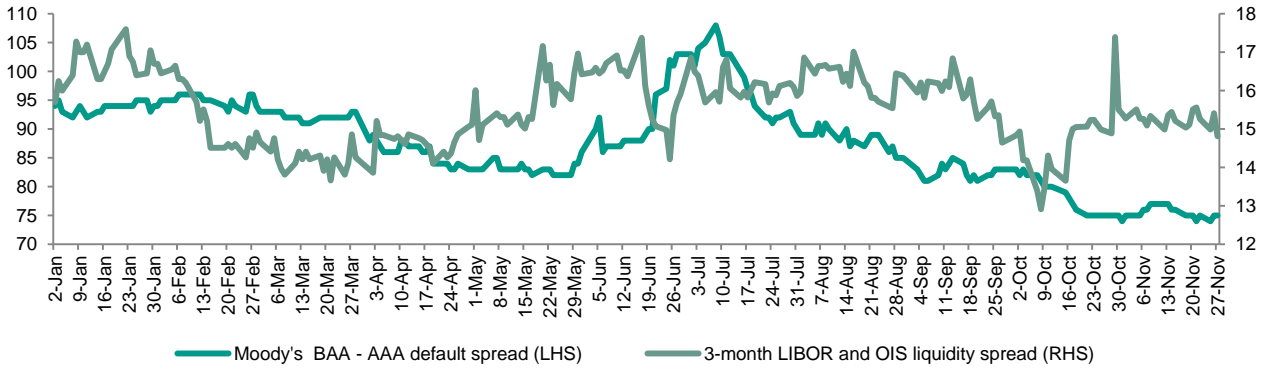
Exhibit 20: U.S government bond yields in 2013 (%)



Source(s): Bloomberg, ABCI Securities

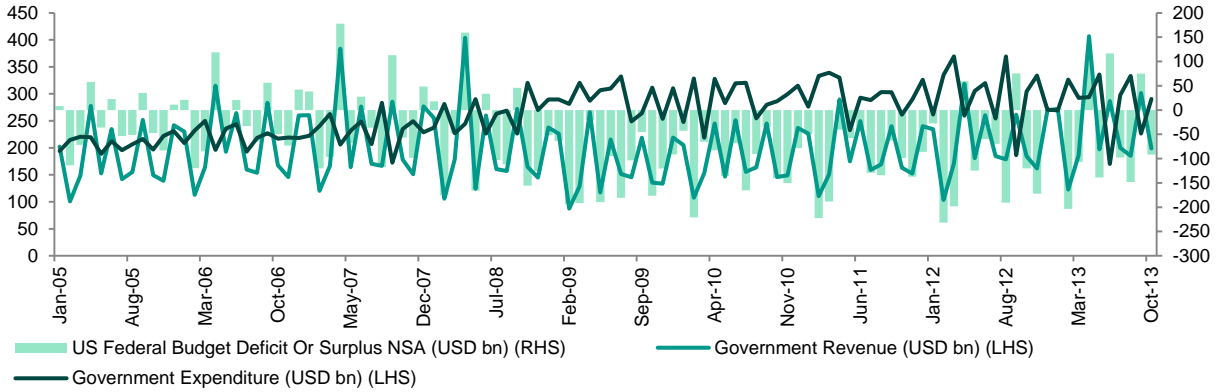


Exhibit 21: U.S Liquidity spread and default spread in 2013 (Bps)



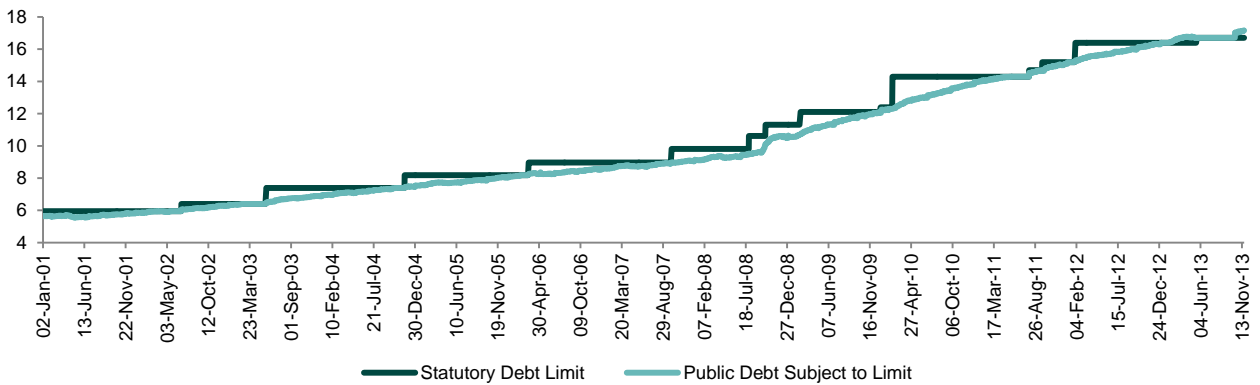
Source(s): Bloomberg, Moody's, ABCI Securities

Exhibit 22: U.S. fiscal condition (USD bn)



Source(s): Bloomberg, U.S. Treasury, ABCI Securities

Exhibit 23: U.S. government debt and the debt ceiling (USD tn)



Source(s): Bloomberg, U.S. Treasury, ABCI Securities

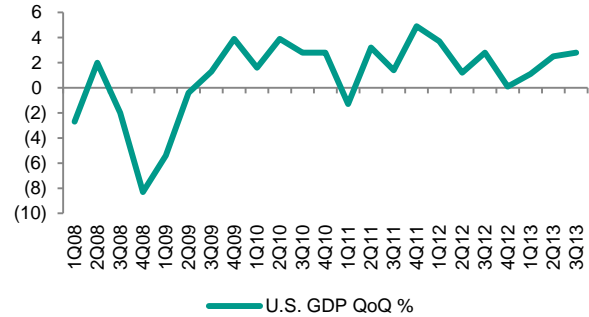


Exhibit 24: Key indicator comparison – 1994 & 2013

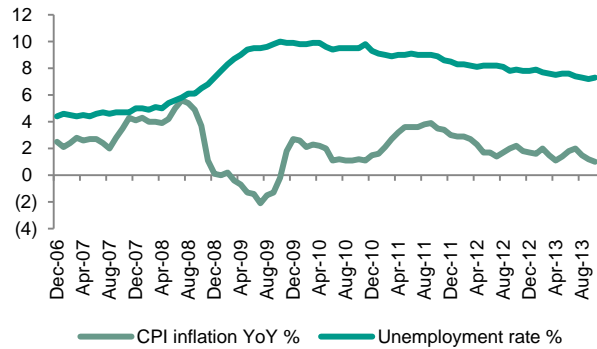
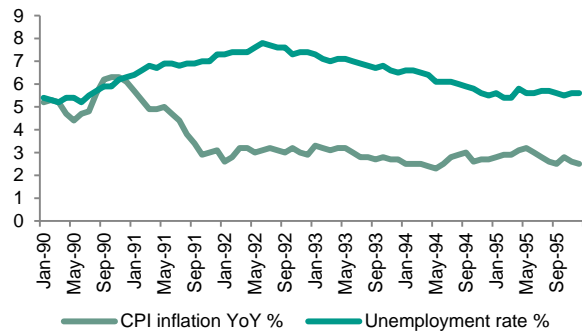
1994 (Left)

2013 (Right)

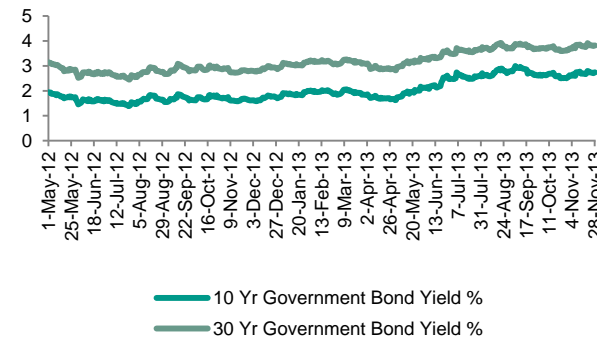
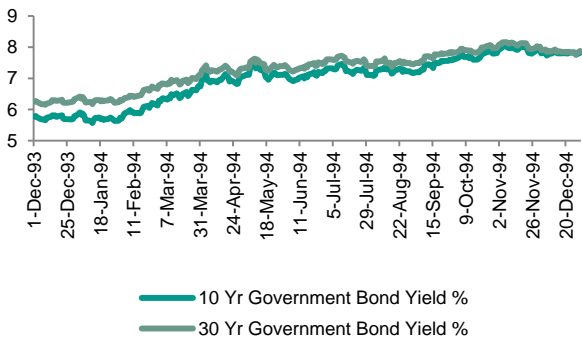
U.S. GDP



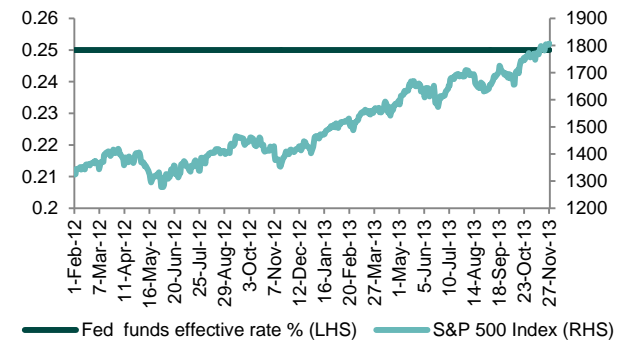
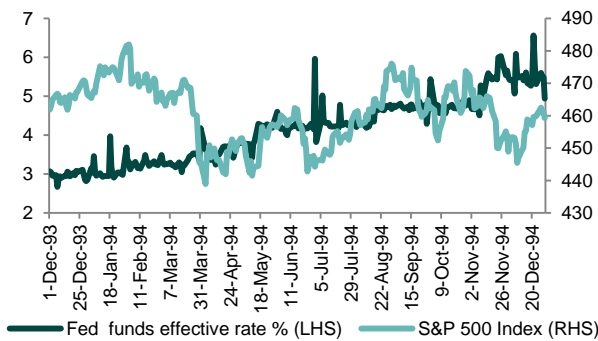
Fed's "Dual Mandate" – CPI and unemployment



Government bond yield



Fed fund rate and S&P 500 Index



Source(s): Bloomberg, U.S. Bureau of Economic Analysis, Federal Reserve Bank, U.S. Bureau of Labor Statistics, ABCI Securities



## Eurozone 2014 Outlook: Getting out of the woods

- We expect recovery in 2014 will be unsteady. Our 2014F GDP growth forecast for the region is 0.8% YoY
- Political and fiscal fragmentations are dragging down growth and postponing the establishment of the banking union. Additional efforts to integrate the Eurozone markets are necessary
- The uneven growth among member countries and recent ECB rate cut reflect a fragile recovery. External markets may not be able to compensate for the weak internal demand

### Recovery in the Eurozone was stalled in 3Q13, raising doubts on sustainability

After experiencing six quarters of economic downturn, the Eurozone finally showed signs of recovery in the 2Q13 with GDP expanding by 0.3% QoQ. More developed members, i.e. Germany, France, Italy, and Spain recorded varying degrees of improvement. Since Apr 2013, Eurozone's PMI indices have been improving, hinting to a ramp up of economic activities. Yet, the 3Q13 data disappointed the market with its tepid GDP growth of 0.1% QoQ. The downtrend in inflation and high unemployment also indicate the region's weakness. The road to Eurozone's recovery is unquestionably a rocky one with many fundamental issues awaiting resolution. We believe that the region will show a GDP decline of 0.5% YoY in 2013F.

### Political and fiscal fragmentations impede integration and growth in the Eurozone

Currently, the Eurozone member countries are facing the challenge of forming a monetary union without a solid underlying foundation of political and fiscal unions. In terms of political fragmentations, individual nations are having difficulties in overcoming the residual problems of the debt crisis due to the inability to adjust their monetary policies to the direction stipulated by the ECB. Also, they are unable to foster growth through exchange rate mechanism due to the single currency union. In some member countries (such as Italy) frustration over the austerity measures have been growing. On the other hand, fiscal fragmentations are reflected by the severe policy disagreements among member countries. The framework of fiscal union is also under heated debate as some member countries are reluctant to share the fiscal burden.

We expect that the Eurozone will continue to be challenged by the political and fiscal fragmentations in 2014. Many member countries will require further fiscal consolidation to strengthen their still fragile economies. The amount of fiscal transfer will be limited and will be directed to resolve region-wide problems.

### European Banking Union is crucial to market integration and sovereign health

The lack of consensus over the Single Resolution Mechanism and the Deposit Guarantee Scheme is still holding back the establishment of the European Banking Union. Diverging opinions persist over the resolution mechanism. Funding mechanism for bail-outs and treatments for Eurozone banks and non-eurozone banks remain the focus of attention. For the deposit guarantee scheme, the difficulty lies on resolving the differences among the member countries when merging such schemes across the member states.

The European Banking Union will be crucial to the recovery of the Eurozone. After the financial crisis, cross-border banking activities have been declining and are currently at its lowest since 1999. The financial market fragmentation has impeded the flow of liquidity, capital, and asset, hindering recovery of business activities. The establishment of the banking union will lower the market's apprehension of another financial crisis and reintegrate the national banking markets. Moreover, the European Banking Union will help banks reduce their sovereign debts. Therefore, sovereign health of the member countries and financial condition of the banking sector will not weigh on each other to orchestrate a vicious spiral should another crisis strike. After the stress test on banks' funding and capital is completed in 2014, leaders of the member states will be able to understand better the condition of the banking sector and structure a better framework for the Single Resolution Mechanism. We believe that progress will be made on the Single Resolution Mechanism in 2014. Consensus on the Deposit Guarantee Scheme, however, is unlikely to be reached.



### **Challenges remain, but a better economic prospect can be expected for 2014**

Growth fatigue in the Eurozone in 3Q13 revealed the foundation of the region's recovery is still wobbly. In addition, the high unemployment rates, anemic expansion in industrial activities and lackluster growth in retail sales reflected that domestic demand is still weak. Unresolved issues over the European Banking Union and the lack of fiscal unity mean that more decisive actions are called for. Even though the ECB recently announced that the main rate would be reduced to 0.25% from the previous 0.5% to counteract the mild inflation, we are concerned that the policy tools that ECB has at its disposal may not be sufficient to stimulate growth if the condition worsens.

We expect the aforementioned issues will remain in 2014. The austerity mandate will continue to post fiscal constrains to most member states. The prolonged disintegration in the banking market will result in a tight credit market. A fiscal union will only be struck only after many seesaw negotiations. Nonetheless, the downside risks in 2014 will be less than that in 2013. Sovereign credit risk is decreasing. So we believe the Eurozone will begin to shift its focus from austerity to structural reforms and the search for growth drivers. Progresses will be made on the Single Resolution Mechanism of the European Banking Union, and the ECB may deploy measures such as liquidity injection or even a QE program to elicit growth. The adjustment process may cap economic growth in the short term, yet recovery in the U.S. and Asian countries will help relieve some of the pains. Based on these factors, we project that Eurozone's GDP will expand by 0.8% YoY in 2014F.





Exhibit 1: Eurozone GDP growth (QoQ%)

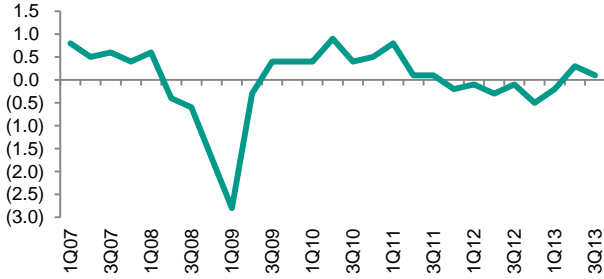
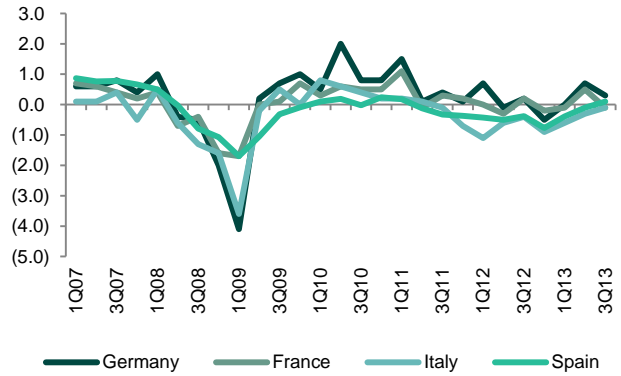


Exhibit 2: GDP growth of major Eurozone member states (QoQ%)



Source(s): Bloomberg, Eurostat, ABCI Securities

Exhibit 3: Eurozone current account balance (Euro bn)

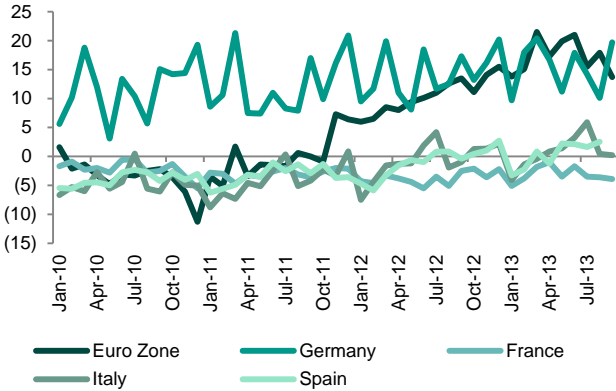
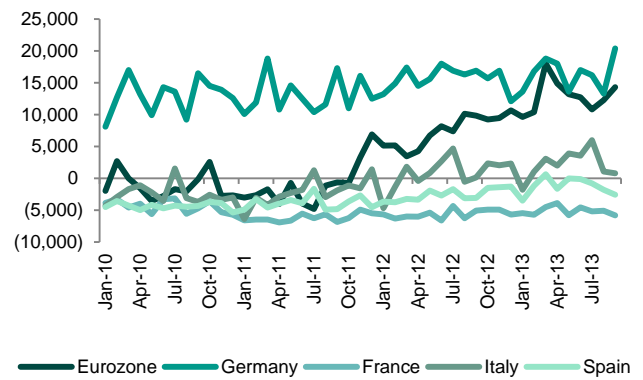


Exhibit 4: Eurozone trade balance (Euro mn)



Source(s): Bloomberg, European Central Bank, Eurostat, ABCI Securities

Exhibit 5: Eurozone PMI (%)

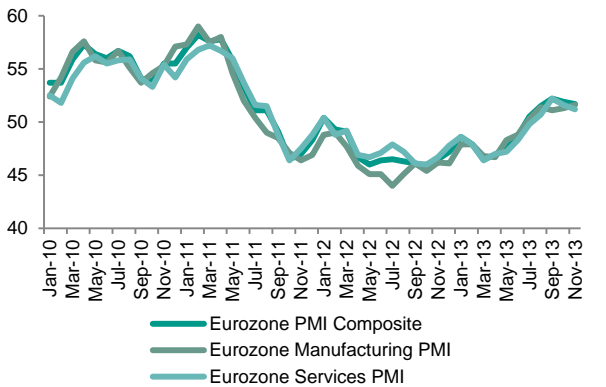
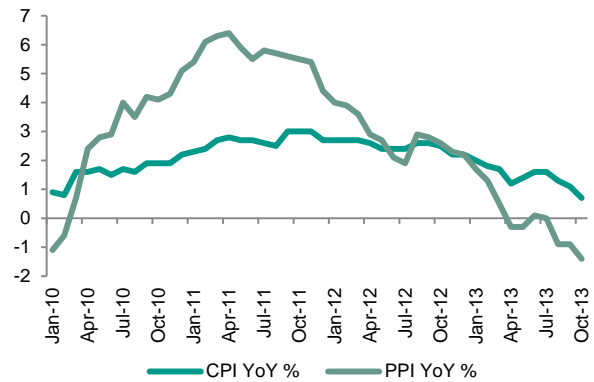


Exhibit 6: Eurozone CPI and PPI (YoY%)



Source(s): Bloomberg, Eurostat, ABCI Securities



Exhibit 7: CPI of major Eurozone member states (Harmonized YoY %)

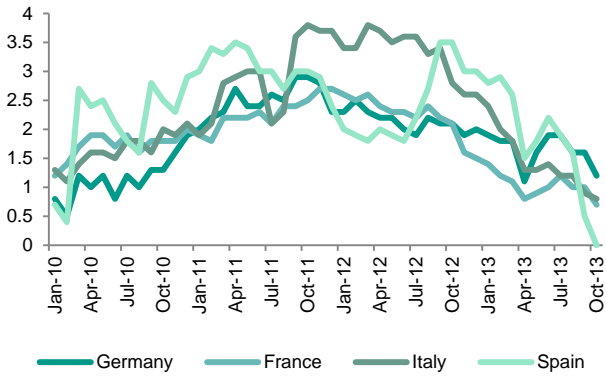
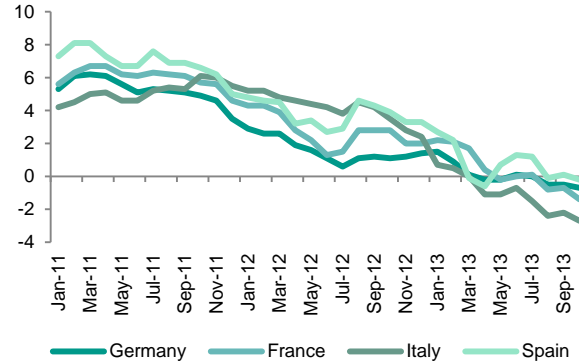
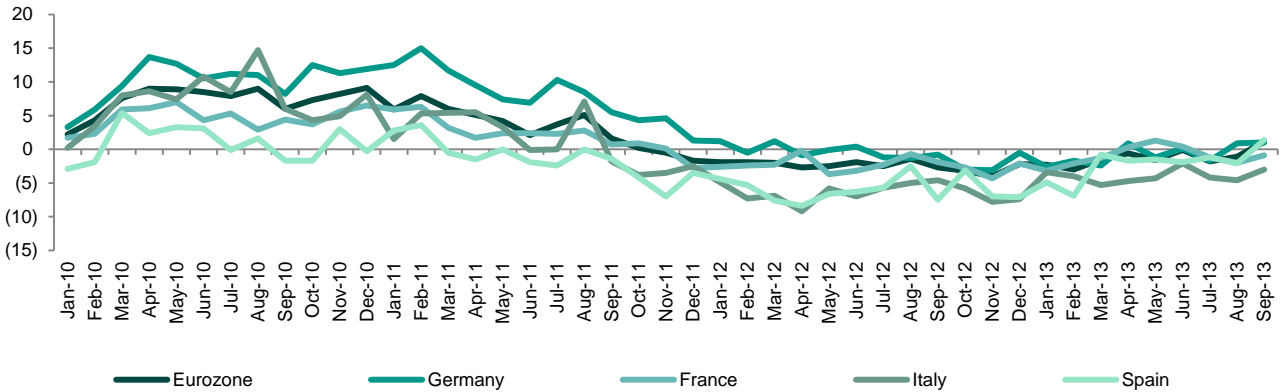


Exhibit 8: PPI of major Eurozone member states (YoY %)



Source(s): Bloomberg, ABCI Securities

Exhibit 9: Industrial production growth of major Eurozone member states (YoY %)



Source(s): Bloomberg, Eurostat, ABCI Securities

Exhibit 10: Eurozone unemployment rate (%)

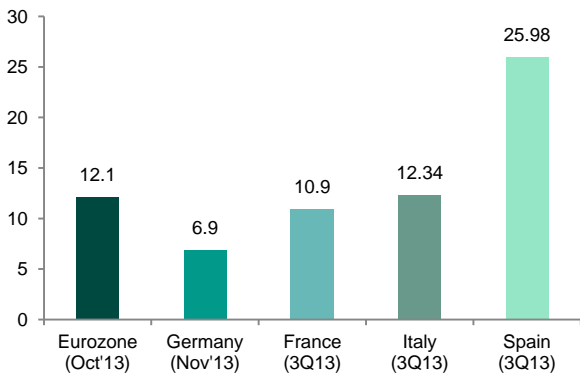
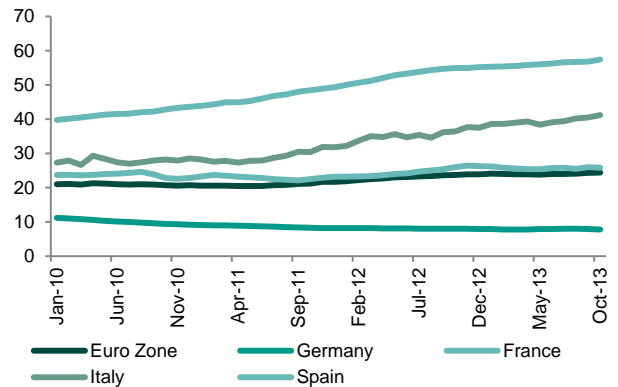


Exhibit 11: Eurozone unemployment rate – age 25 or under (%)



Source(s): Bloomberg, Eurostat, ABCI Securities



Exhibit 12: Eurozone retail sales growth (YoY %)

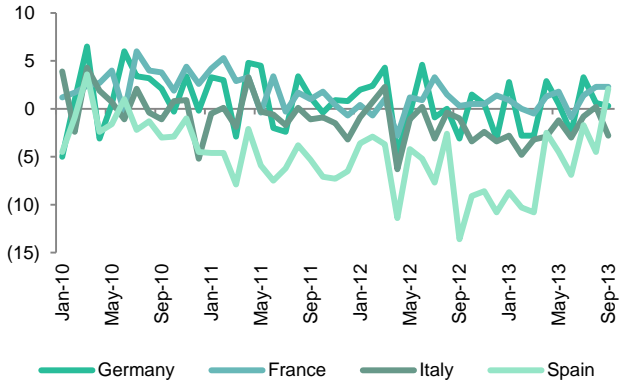
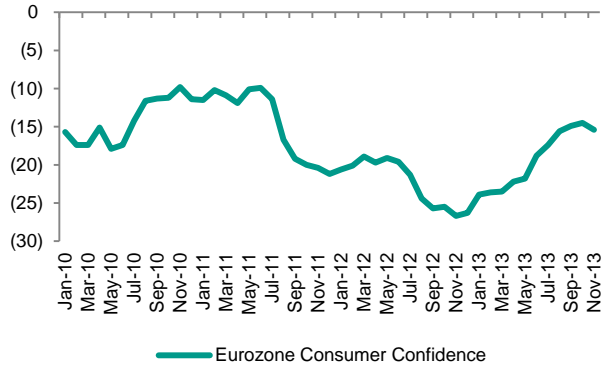
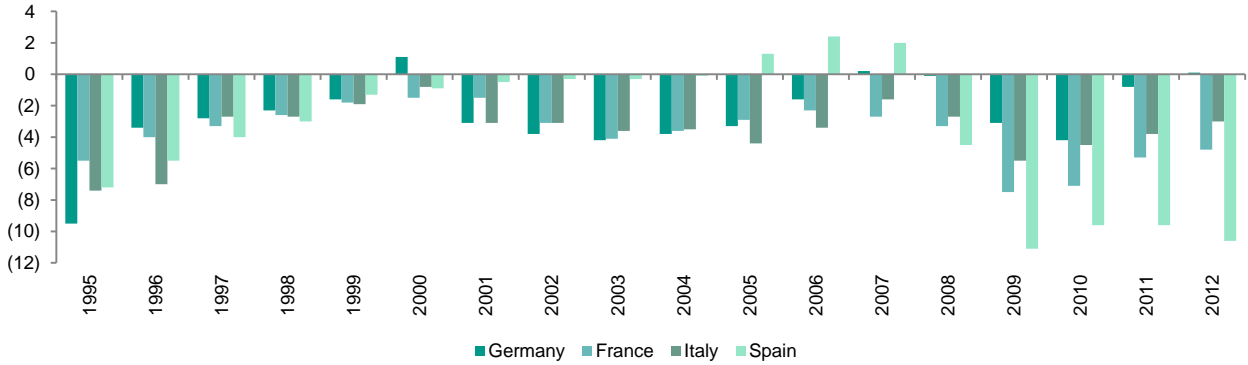


Exhibit 13: Eurozone consumer confidence



Source(s): Bloomberg, European Commission, ABCI Securities

Exhibit 14: Budget deficit (surplus)/GDP (%)



Source(s): Bloomberg, ABCI Securities

Exhibit 15: Eurozone government bond yield in 2013 (%)

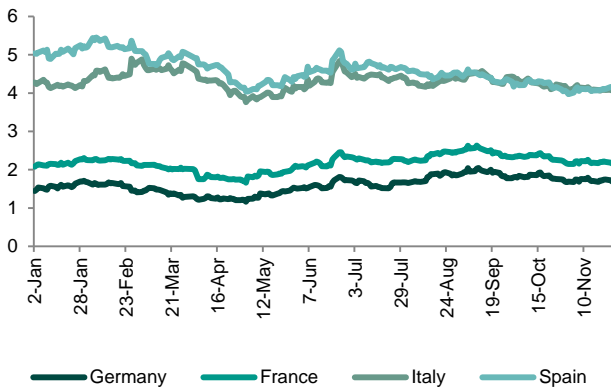
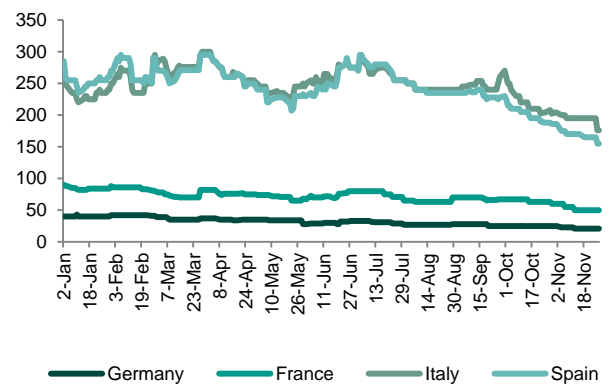


Exhibit 16: Eurozone 5-yr sovereign bond CDS in 2013 (bps)



Source(s): Bloomberg, ABCI Securities



## Japan 2014 Outlook: Balancing growth & restructuring

- Japan's economy will face uncertainty in 2014; our forecast for its GDP growth is 1.6% YoY
- Japan will need to tackle the extremely high government borrowings and begin fiscal consolidation
- The "Third Arrow" of Abecomices, i.e. structural reform, will be implemented to maintain the new administration's policy momentum

### **Abecomices steers Japan away from the economic abyss in 2013**

The new administration led by Prime Minister Shinzo Abe launched an ambitious stimulus program of quantitative and qualitative monetary easing to double the monetary base and drive CPI to 2% in two years. These new economic goals and the stimulus program were embraced by the market. The Nikkei 225 Index and Topix Index increased by more than 40% YTD by Nov, despite the global equity market was shaken by news of Fed's tapering. Japanese Yen, which has been staying at the ¥80/USD mark, started to depreciate in 2013 and breached the ¥100/USD level in Nov. Moreover, the Japanese government bond yields of different maturities also fell. The new initiatives have proved themselves effective so far. Japan's nationwide CPI trended up (Oct 2013: 1.1% YoY) and the national real GDP also improved on recovering domestic demand. Based on our forecast, GDP in Japan will grow by 2.2% YoY for 2013.

### **Jumping through hoops and loops – maintaining growth while navigating challenges of fiscal consolidation**

Prime Minister Shinzo Abe will be facing the challenge of raising the consumption tax from 5% to 8% early in 2014. When former prime minister Yoshihiko Noda attempted to increase consumption tax, the Japanese economy fell into a recession. Although the Asian financial crisis and the domestic credit bubbles in the banking sector also contributed to the downturn back then, the fear remains that a higher consumption tax will make consumers more reluctant to spend, as the weakening Yen is making imported fuel and food more expensive and the rising inflation is eroding the consumer's real wage.

The government debt is estimated to stand at more than 240 percent of the Japanese national GDP by end-2013. Years of stagnant growth has postponed the much-needed fiscal restructuring, putting the Japanese economy at risk of a government default. We believe that the Abe administration will pursue the tax increase on schedule to kick-start the fiscal consolidation in the country and establish the creditability of Abe's governance. We expect that once the Abe administration makes the first move on consumption tax, more constructive policies will be introduced to mend the fiscal condition.

The possibility of a recession induced by a raised consumption tax is small. Stimulus programs, if launched, will help mitigate the negative impacts of tax increase. The improving fundamentals of the Japanese economy point to a brighter near-term outlook. Moreover, while the Fed's withdrawal from the QE program expected in 2014 may create turbulence in the Asian financial market, we believe Japan will steer through the volatility steadily as long as the government maintains its loose monetary policies and stays on its course of reform.

### **Launching the "Third Arrow" of the Abecomices to sustain recovery**

The first two "arrows" of the Abecomices have been successful in stimulating Japan's economy. Potency of the fiscal stimulus and monetary easing, however, is starting to fade. GDP growth in 3Q13 was 1.9% QoQ, less than the 3.8% QoQ in 2Q13 and the 4.3% QoQ in 1Q13. The rising inflation, as measured by the nationwide CPI, has been partly driven by the increasing price of imported fuel and food. Domestic consumption is falling while export is suffering from the weakened trade partners such as China and Europe.

Structural reform, i.e. the "Third Arrow", of the Abecomices is essential to the policy success of the Abe administration. Conducting such reform will be a complicated task because of the multitude of issues and the conflict of interest involved. To achieve a long-term sustainable growth, the Abe administration will need to tackle issues such as salary, employment,



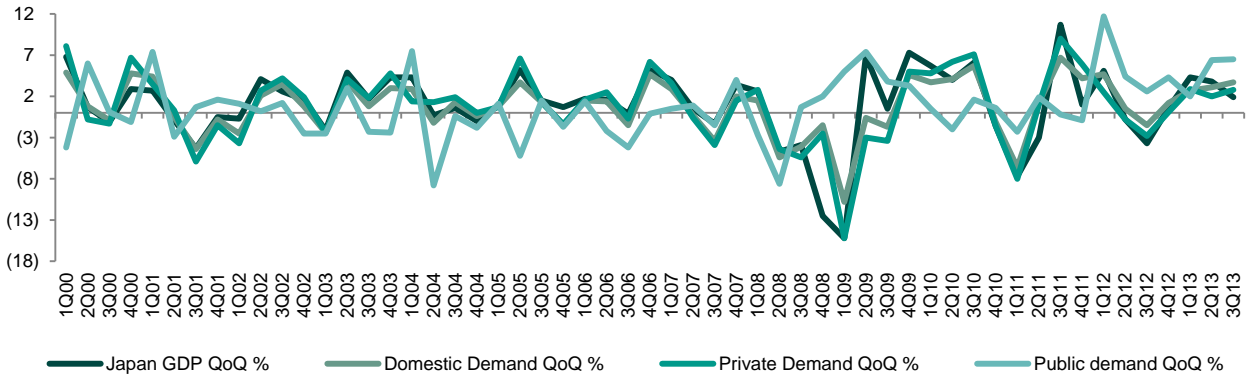
and population growth. Any radical structural reform will face strong resistance. Therefore, we expect that the restructuring will be implemented in a progressive manner starting from 2014.

**Growth in 2014 will be on track**

The higher consumption tax to be implemented in early 2014 and the fiscal stimulus program expected to be launched by the end of 2013 will exert downward pressure to growth. If the structural reform runs smoothly, we believe the pros will override the cons. In addition, the economic indicators also demonstrate the effectiveness of the government policies. Industrial productions and machine orders growth are trending up; retail sales and household income growth are bouncing back to the positive range; capital investment is also increasing, showing businesses are regaining confidence. By factoring in the positive signs of improving economic fundamentals as well as the potential negative impacts of future policy moves, we anticipate that Japan's GDP will grow by 1.6% YoY in 2014F.

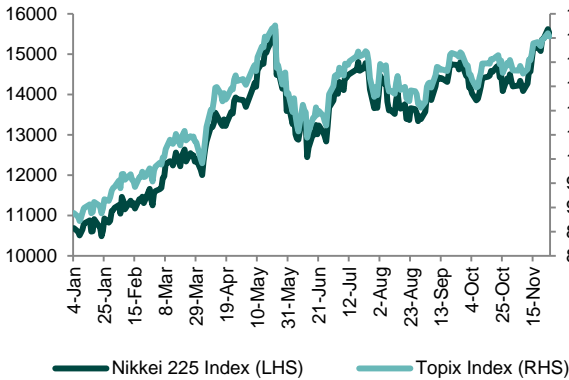


Exhibit 1: Japan GDP growth (QoQ %)



Source(s): Bloomberg, Japan Economic and Social Research Institute, ABCI Securities

Exhibit 2: Nikkei 255 Index and TOPIX Index edged up in 2013

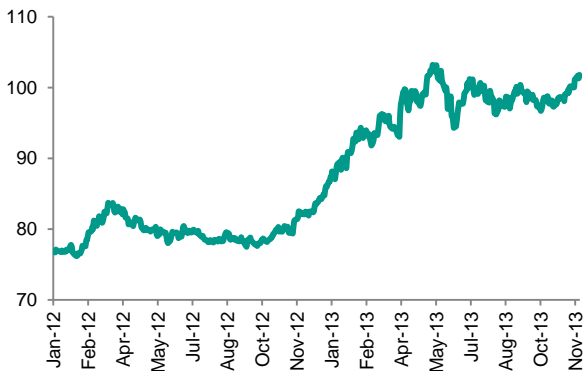


Source(s): Bloomberg, Bank of Japan, ABCI Securities

Exhibit 3: M2 growth in Japan



Exhibit 4: Japanese Yen depreciates against the U.S. dollar



Source(s): Bloomberg, Ministry of Internal Affairs and Communications, ABCI Securities

Exhibit 5: Inflation in Japan (YoY%)

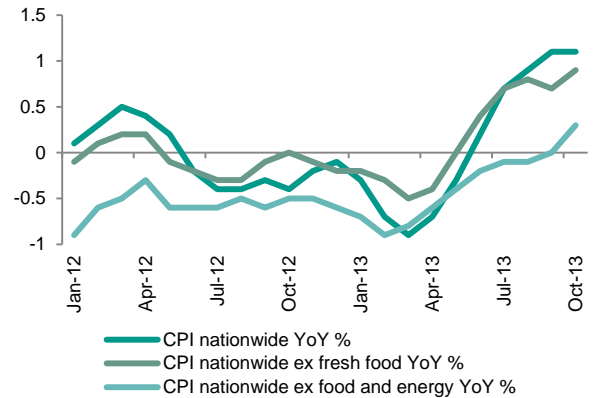




Exhibit 6: 3MMA exports and imports growth in Japan (YoY%)

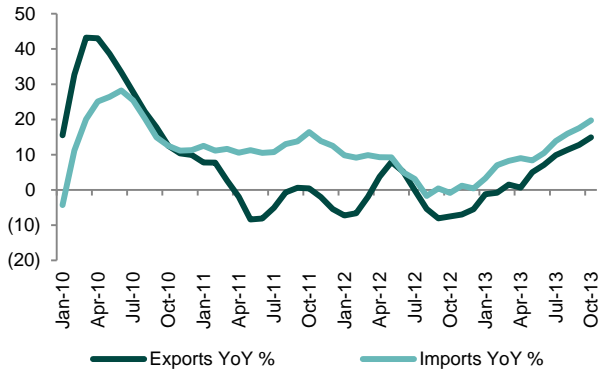
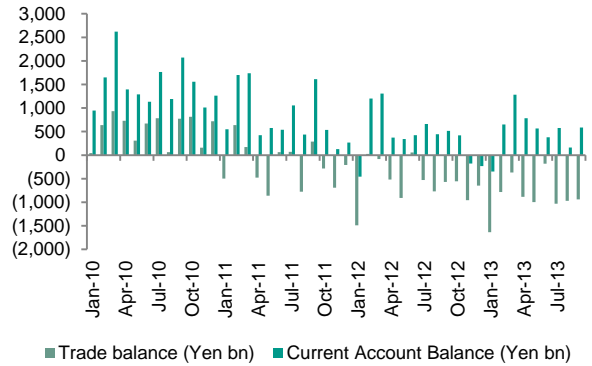


Exhibit 7: Trade balance and current account balance in Japan (Yen bn)



Source(s): Bloomberg, ABCI Securities calculation, Japan Ministry of Finance, ABCI Securities

Exhibit 8: Industrial activities in Japan (YoY%)

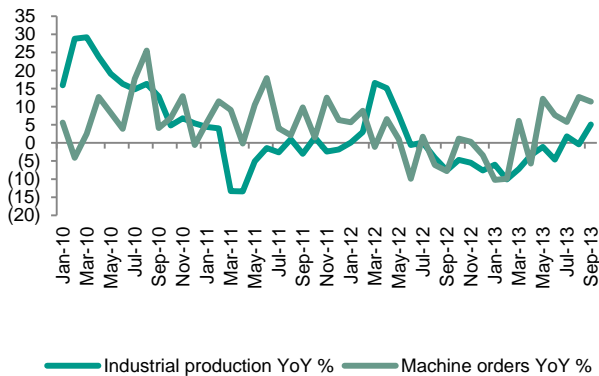
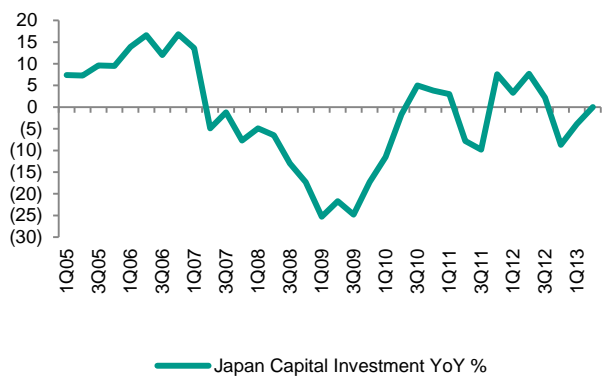


Exhibit 9: Capital investment in Japan (YoY%)



Source(s): Bloomberg, ABCI Securities

Exhibit 10: Retail sales and household income growth in Japan (YoY%)

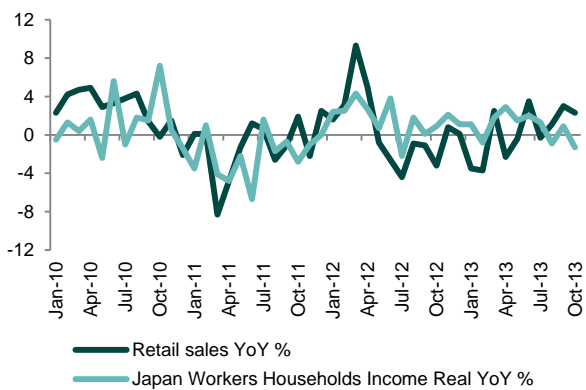
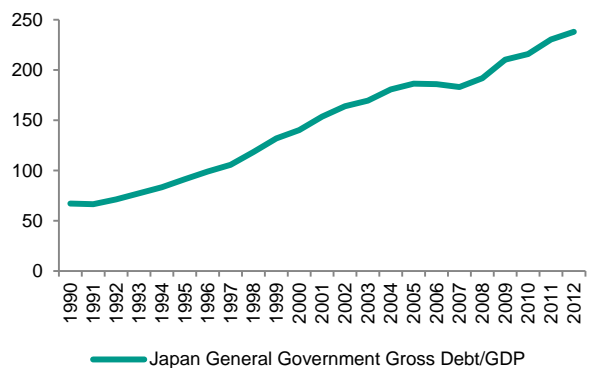


Exhibit 11: Government debt/GDP in Japan (%)



Source(s): Bloomberg, ABCI Securities



## Emerging Asia 2014 Outlook: Challenges Ahead

- Growth in emerging Asia has been weak in 2013, but its GDP would stabilize in 2014
- External shocks still remain in 2014, exerting negative impacts on the region's external trade, currencies, and equity markets
- Emerging Asian economies should pursue structural reforms to build up a better foundation for economic growth

### 2013 has been a trying year for emerging Asia

Economies in emerging Asia (defined as India, Indonesia, Malaysia, Philippines, and Thailand) have been suffering in 2013 on the tepid growth globally. The Eurozone only began to show signs of bottoming out in 2Q13 while recovery in the U.S. has proved to be a long-drawn one, weighing down exports in emerging Asia and widening the region's trade deficits. China is undergoing a restructuring process that reduces its appetite for commodity consumption from the APAC region. In addition, the prospect of the Fed's QE has led to huge outflows of funds and currency depreciation, triggering fear of another Asian Financial Crisis. Many long-standing issues in the region resurfaced as downward correction in the stock market takes place and currency devalues. Inflation, subsidy-led fiscal imbalance, and the lack of productivity improvement and infrastructure investment are some of the pressing issues.

### External shocks will be a threat to the region's growth

Entering 2014, we believe that the external environment will continue to pose threats to growth in emerging Asia. The Fed's QE tapering will conduct shocks to the equity and currency markets. The degree of impact will depend on the economic strength of the region. While a downward market correction seems inevitable, the situation will not escalate to a real crisis as these Asian economies are much stronger now than in 1997.

The global economic outlook is still shadowed by uncertainties. While the Eurozone economy continues to make strides, it is still early in the recovery stage and sustainable improvement has yet to be demonstrated. Structural reform in China to transform the economy into a consumption-led one, and its willingness to tolerate slower growth for more sustainable economic expansion also means that its demand for commodity goods will continue to decrease. Indonesia, and Malaysia will be the ones suffering the most if global demand stays sluggish.

### Structural reform becomes a priority

Facing the eventual termination of low-cost liquidity, emerging Asia has started to prioritize structural reforms in their economies that were previously halted by political reasons and the global financial crisis in 2007. The main components of the structural reform include restoring fiscal balance, improving investment environment, accelerating infrastructure investments, and maintaining a healthy domestic credit growth.

**Restoring fiscal balance.** Many of the emerging Asian economies are facing the problems of subsidy-led fiscal imbalance. The subsidy programs, especially the ones applied to energy resources, have recently been adjusted. For example, Indonesia and Malaysia have terminated fuel subsidies by raising the administered fuel prices in June and Sep 2014. Similar changes to restore fiscal balance are expected to take place in other emerging Asia economies, which would help alleviate the negative impacts of tightened domestic liquidity that may occur as soon as the Fed reduces its asset purchase.

**Improving the investment environment.** Lower liquidity resulted from the Fed's normalized monetary policy will reduce yield-chasing behaviors. We believe the equity markets in emerging Asia are heading for major downward correction. To compensate for the reduced investment base, we believe more should be done to attract foreign capital through the FDI channel. It becomes necessary for the governments to improve investment environment via regulatory changes and encourage private investments.



**Accelerating infrastructure investment.** The lack of infrastructure investment that impedes productivity improvement also render the region less competitive compared to other developing economies in Asia, such as China. Recent developments show that the local authorities are attending to the issue. In India, where infrastructure investment has been lagging behind its GDP growth, infrastructure projects in transportation and power sectors have been increasing. Indonesia also announced a US\$ 35bn-infrastructure investment plan. We believe more progress will be made in 2014.

**Keeping checks and balances on domestic credit.** Rapid credit growth also has implications on the region's financial stability. For example, growth in household debts in Thailand and Malaysia has been higher than that of the household income, posing risks to the local banking system. High leverage in these developing economies can wreak havoc once the Fed tightens its monetary policy and raises interest rates. Therefore, reducing leverage should be one of the priorities of these high-gearing countries in the near term. Local governments will need to tighten borrowing on the supply side of credit and increase restrictions on lenders to prevent a credit bust.

#### Bracing for internal and external challenges in 2014

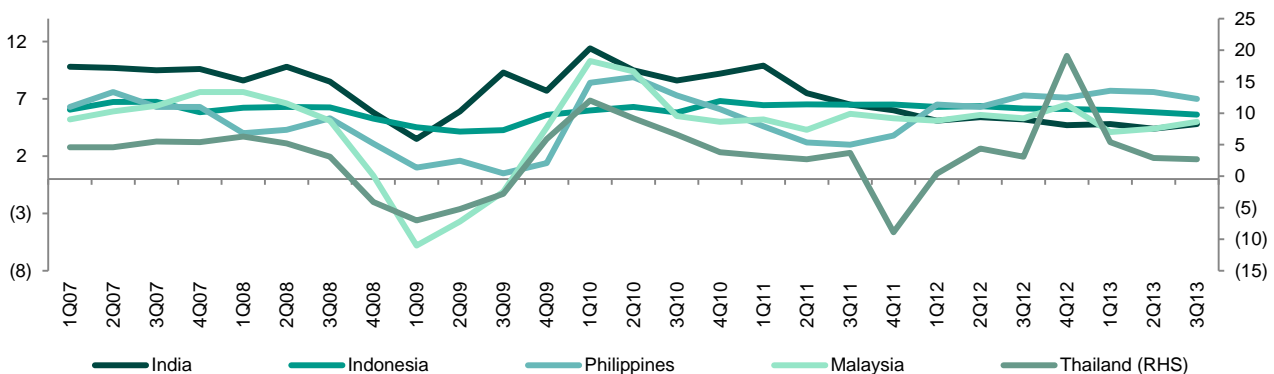
For the emerging Asian economies, the year of 2014 will be a challenging one. The Fed's tapering and budget talks in the U.S. will post downward, albeit temporary, pressure on the equity market, currency value, and external trade. Slower-than-expected recovery in the developed market may also weigh on economic growth. Domestically, the reduction of subsidy will drive up the local inflation rate and reduce domestic consumption. The rising inflation may cause these Asian countries, especially India and Indonesia, to maintain high benchmark interest rates. Domestic consumption, a major driving force of the region's growth, may decline as prices increase. In addition, external trade will continue to be a weak spot for the region's growth. The combination of weak external demand and low commodity price has been widening the region's current account deficit and pushing down the local currency value in 2013. We believe that the local authorities should seek for other growth drivers other than exports (such as infrastructure investments) to stimulate local demand. However, emerging Asia will achieve higher growth than other developed economies in 2014. Our 2014 forecasts for GDP growth in India, Indonesia, Thailand, and Malaysia are 5.5%, 4.6%, 3.8%, and 4.7% YoY.

**Exhibit 1: Annual GDP growth in emerging Asian economies**

YoY%	2010	2011	2012	2013F	2014F
India	10.1	6.3	3.2	3.6	5.5
Indonesia	6.2	6.5	6.2	4.3	4.6
Thailand	7.8	0.1	6.5	2.6	3.8
Malaysia	7.2	5.1	5.6	4.5	4.7
Philippines	7.6	3.6	6.8	6.7	6.1

Source(s): Bloomberg, ABCI Securities estimates

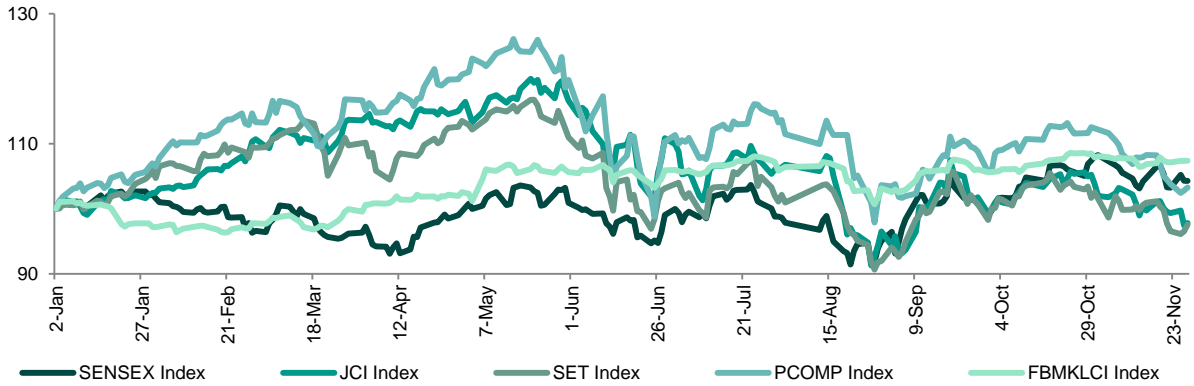
**Exhibit 2: GDP growth in emerging Asia (YoY %)**



Source(s): Bloomberg, ABCI Securities

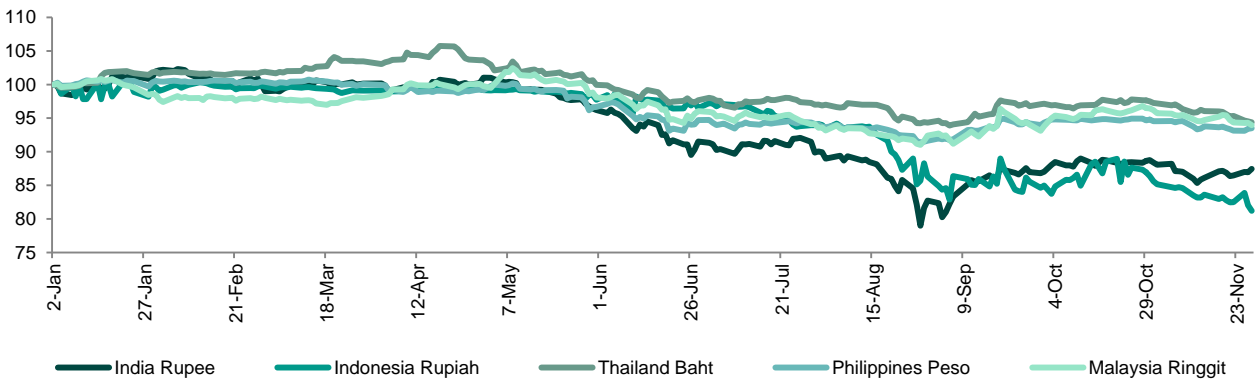


Exhibit 3: Emerging Asian stock indices



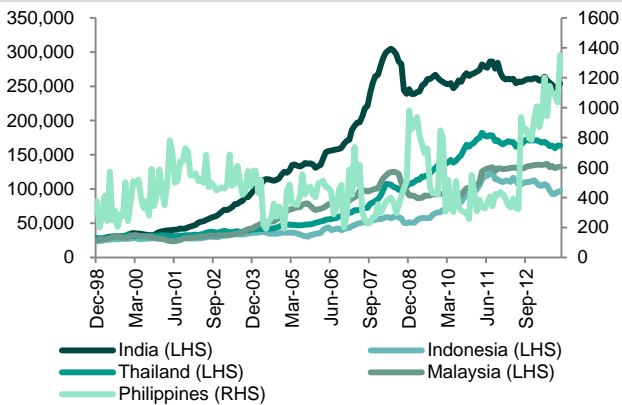
Note: Baseline = Jan 2, 2013  
Source(s): Bloomberg, ABCI Securities

Exhibit 4: Emerging Asian currencies



Note: Baseline = Jan 2, 2013; all currency values are against USD  
Source(s): Bloomberg, ABCI Securities

Exhibit 5: Forex reserve (USD mn)



Source(s): Bloomberg, ABCI Securities

Exhibit 6: Current account balance/GDP (%)

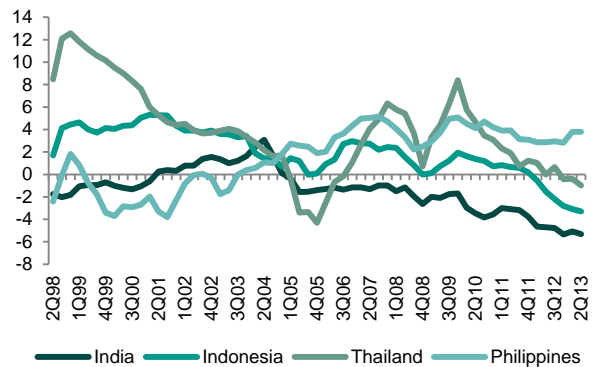




Exhibit 7: 3MMA export growth (YoY %)

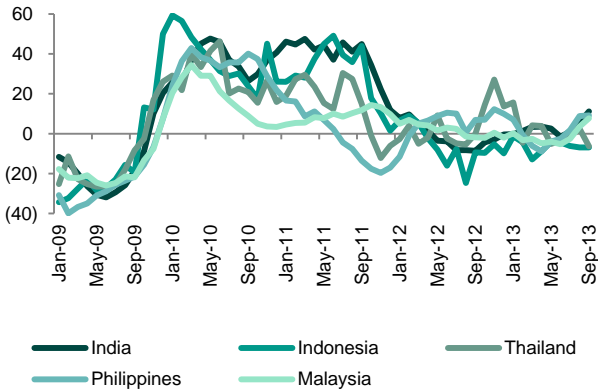
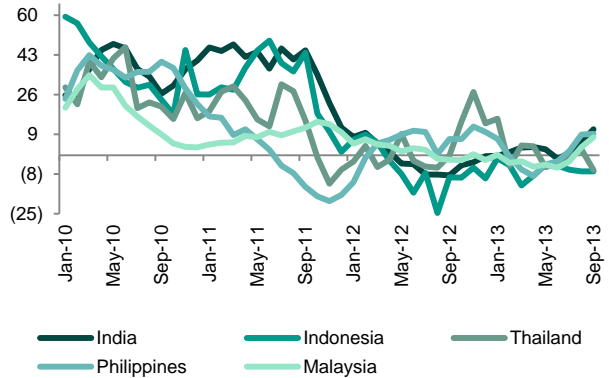


Exhibit 8: 3MMA import growth (YoY %)



Source(s): Bloomberg, ABCI Securities

Exhibit 9: Trade balance in 3Q13 (USD mn)

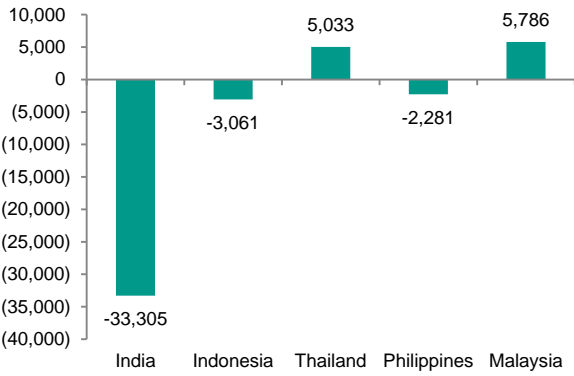
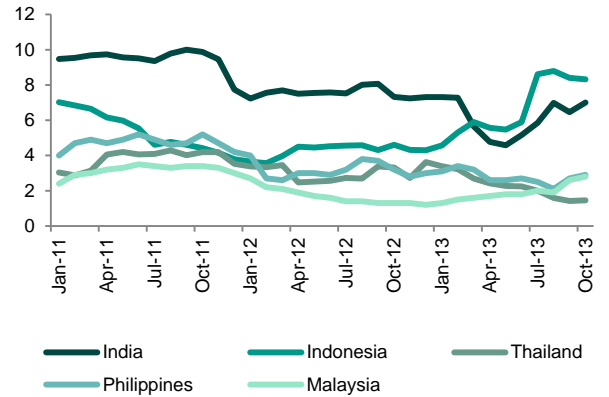


Exhibit 10: Inflation (YoY %)



Note: For Exhibit 9, India's inflation data is based on WPI; others are CPI-based  
Source(s): Bloomberg, ABCI Securities

Exhibit 11: Government deficit of India and Indonesia (%)

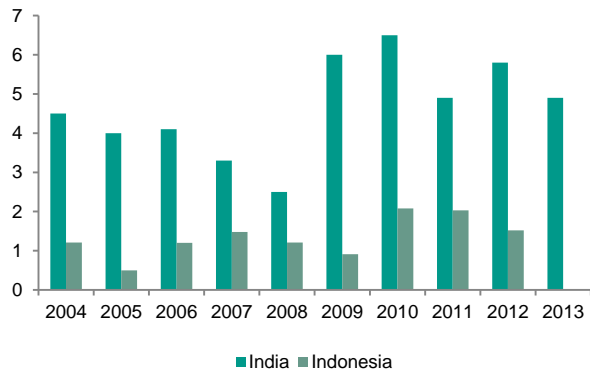
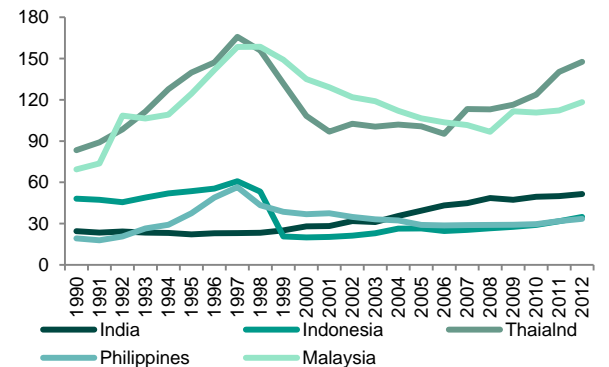


Exhibit 12: World Bank domestic private sector credit/GDP (%)



Note: India's fiscal year ends on Mar 31  
Source(s): Bloomberg, World Bank, ABCI Securities



## China 2014 Outlook: A new era of quality growth

- China will pursue mega reform as outlined in the Third Plenum to foster sustainable, high-quality, consumption-led growth
- Emphasis will be placed on sustainable economic growth. New growth drivers will be explored and developed. Our forecast for its GDP growth in 2014 is 7.6% YoY
- Consumption and investment will be the bright spots in Hong Kong. We expect its 2014F GDP will grow 3.4% YoY

### A new era of quality growth begins

Under the new leadership of President Xi Jinping, China calls for reforms to consolidate the nation's recovery from a slowdown and improve well-beings of the population through greater tolerance for slower, long-term economic growth. The Third Plenum of the 18<sup>th</sup> Party Congress marked the turning point of China. More comprehensive and deepened reforms will be carried out in the next decade to create a more balanced economy that is both socially and environmentally sustainable. Economic restructuring efforts that address the current structural imbalance and support growth become the key part of China's reforms that will have profound impacts on all aspects of the economy and society. The government targets to further liberalize the economy and pursue quality growth through financial liberalization, industry deregulation, land reforms, greater access to different industries for foreign investors, enhancing efficiency of SOE, strengthening social security system, deepening tax reform, stabilizing foreign trade growth, reducing overcapacity and creating new engines to drive consumption.

In 1H13, China's economy was on a bumpy road as economic activities lost momentum and GDP growth fell from 7.7% YoY in 1Q13 to 7.5% YoY in 2Q13. Entering 3Q13, GDP growth hit 7.8% YoY, pointing to a modest acceleration of domestic demand. We believe GDP has already troughed and the economy will exhibit solid growth underpinned by accelerated consumption and stabilized FAI despite moderating external demand.

In 2014, the major objective of the government will be striking a balance among sustaining economic growth, optimizing industry structure and managing inflation expectations while pursuing mega reform guided by the Third Plenum. Economic transformation should be the government's priority and macro-regulations is expected to be more on-target, flexible and effective. With major GDP drivers gaining momentum, we believe the Chinese government is likely to maintain its key policy objectives to facilitate economic rebalancing. After three decades of robust growth driven mainly by exports and investment, we expect China to restructure the economic mix to gear more towards consumption. We also believe the government will keep its accommodative policy stance. The PBOC will maintain a prudent monetary policy with timely fine-tuning, and we expect liquidity to be managed via reverse repo and standing lending facility (SLF). Fiscal policy will be proactive, targeting for more sustainable investments in infrastructure, new industries and service sectors. More emphasis will be placed on enhancing reform efforts in key policy areas and sustaining economic growth. The reform measures could boost domestic demand and efficiency while sustaining the economic growth to above 7.2%. We are optimistic on China's outlook in 2014 and forecast that GDP will grow 7.6% YoY.



Exhibit 1: China economic growth for 2013F and 2014F (YoY%)

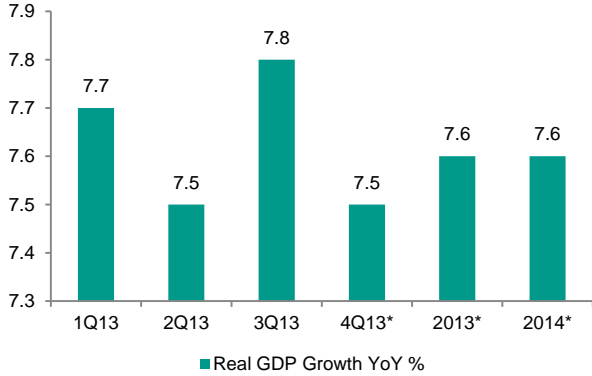
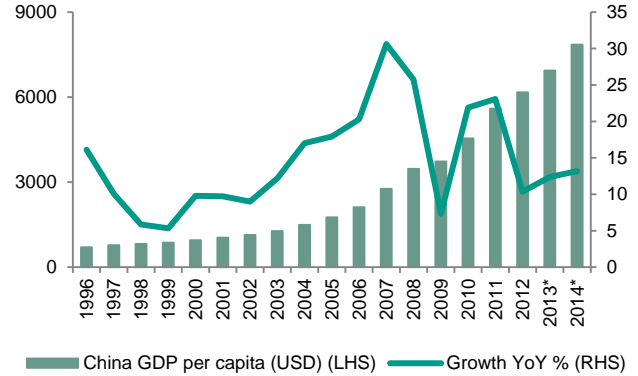


Exhibit 2: Wealth surges in China (L:USD, R:YoY%)



\*Forecast  
Source(s): Bloomberg, National Bureau of Statistics, ABCI Securities forecast

Exhibit 3: China Population (L:bn ppl, R:YoY%)

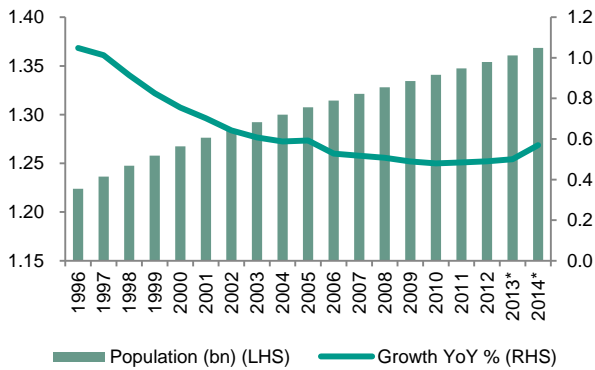
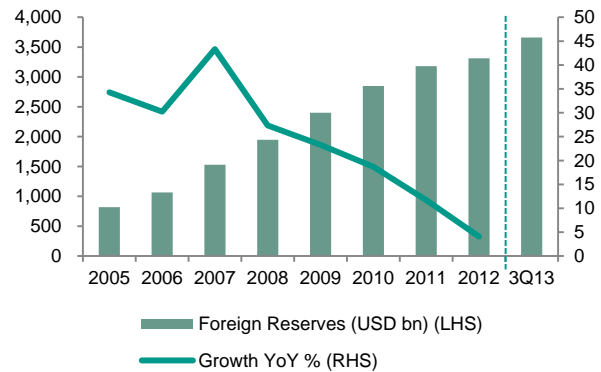
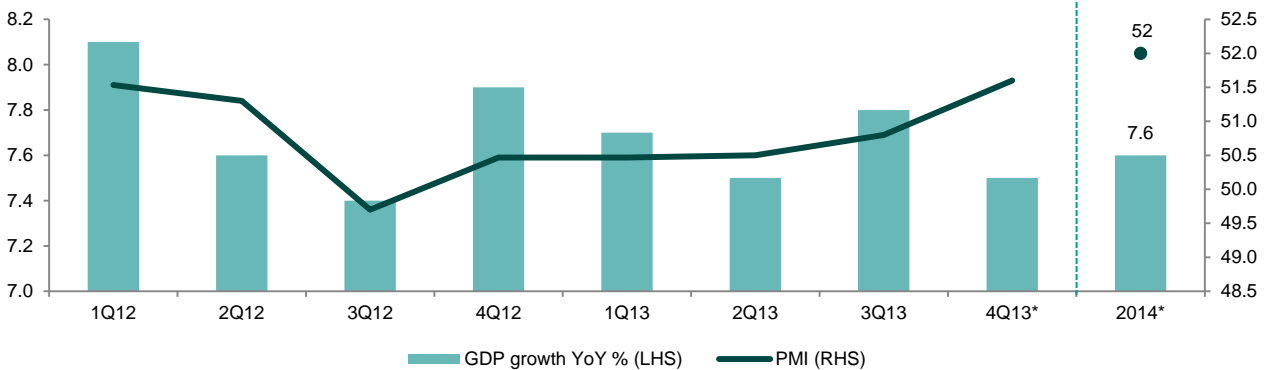


Exhibit 4: Foreign reserves reaches a record-high level in China (L:USD bn, R:YoY%)



\*Forecast  
Source(s): Bloomberg, National Bureau of Statistics, PBOC, ABCI Securities forecast

Exhibit 5: Surging PMI (GDP vs. PMI) – Quarterly data (L:YoY%, R:%)



\*Forecast  
Source(s): Bloomberg, National Bureau of Statistics, PBOC, ABCI Securities estimates

**Exhibit 6: Economic forecasts for China**

<b>YoY % (otherwise stated)</b>	<b>2011</b>	<b>2012</b>	<b>1Q13</b>	<b>2Q13</b>	<b>3Q13</b>	<b>2013F</b>	<b>2014F</b>
<b>Real GDP</b>	9.3	7.7	7.7	7.5	7.8	7.6	7.6
<b>FAI (YTD)</b>	23.8	20.6	20.9	20.1	20.2	20.3	20.5
<b>Retail Sales</b>	17.1	14.3	12.4	13.0	13.4	13.6	14.5
<b>Exports</b>	20.3	7.9	18.4	3.7	3.9	7.4	8.5
<b>Imports</b>	24.9	4.3	8.4	5.0	8.4	7.2	9.3
<b>Trade Surplus (US\$ bn)</b>	155.1	231.1	43.1	65.7	61.5	252.1	257.9
<b>CPI</b>	5.4	2.6	2.4	2.4	2.8	2.7	3.0
<b>PPI</b>	6.1	(1.7)	(1.7)	(2.7)	(1.7)	(1.7)	1.0
<b>M2</b>	13.6	13.8	15.7	14.0	14.2	14.0	14.0
<b>1-year deposit rate</b>	3.50	3.00	3.00	3.00	3.00	3.00	3.00
<b>1-year lending rate</b>	6.56	6.00	6.00	6.00	6.00	6.00	6.00
<b>Deposit RRR</b>	21.0	20.0	20.0	20.0	20.0	20.0	20.0
<b>Exchange Rate (USD/RMB)</b>	6.2950	6.2306	6.2102	6.1375	6.1209	6.0748	5.8925

Source(s): Bloomberg, National Bureau of Statistics, PBOC, ABCI Securities estimates

## China's policy outlook in 2014

In accordance with China's economic growth and structural adjustment objectives, we believe that the government will implement a policy characterized by prudent monetary accommodation and fiscal easing. The PBOC will remain largely neutral, adopting a supportive monetary stance to boost healthy growth and manage inflationary pressures. Meanwhile, CPC's Third Plenum has called for deeper reforms to raise the quality of economic growth in the coming decade. Both the central and local governments will offer more supportive policies to implement the much-needed reforms.

### 1. Monetary policy: A prudent approach in liquidity management

Effective liquidity control remains PBOC's top concern. Led by the United States, Japan and Eurozone, some developed economies have been loosening their monetary policies to boost growth. This has raised the risk of increased global capital inflow to China amid its economic recovery. By further opening up the renminbi market, China may face more liquidity inflow in 2014 and China's policymakers should remain vigilant to hiking inflationary risks. In our view, monetary policy in 2014 will remain accommodative. Accordingly, the PBOC's annual new bank loan growth target will be between RMB 9.5tr and RMB 9.8tr in 2014F compared to the 2013 target of RMB 9.0tr. Consequently, the target for M2 growth will be 14.0% YoY vs. 14.2% in 2013. The lower new loan growth reflects a neutral monetary stance in 2014, which should be able to support a GDP growth at 7.6% YoY in our view.

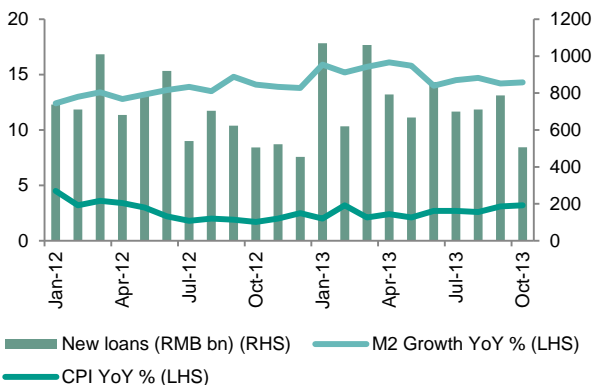
Liquidity management will continue to be a priority of monetary policy in 2014. Assuming the loose monetary stance among developed economies remains intact, we believe that international capital will continue to flow into China, which would exert greater pressure on the PBOC to manage liquidity. Continuous monitoring of market liquidity is necessary for China to control inflation preemptively. We estimate that the CPI will reach 2.7% YoY for 2013F and rise to 3.0% for 2014F. The PBOC is expected to accommodate the demand for capital while stabilizing price level through monetary tools including reverse repo and standing lending facility (SLF) instead of RRR cut or interest rate cut.

**Exhibit 7: PBOC may set a higher inflation target for 2014**

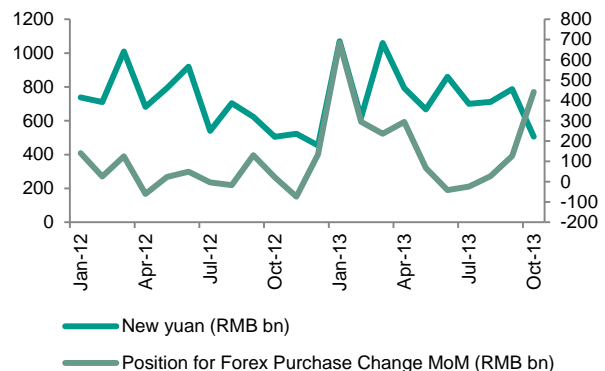
Year	Inflation target (%)	Actual inflation (%)	Over / Under the target	Monetary policy stance
2010	3.0	3.2	Over	Moderately loose
2011	4.0	5.5	Over	Tightening
2012	3.0	2.6	Over	Prudent liquidity Management
2013F	3.5	2.7	Under	Prudent liquidity Management
2014F	3.5	3.0	Under	Prudent liquidity Management

Source(s): State Council, National Bureau of Statistics, ABCI Securities estimates

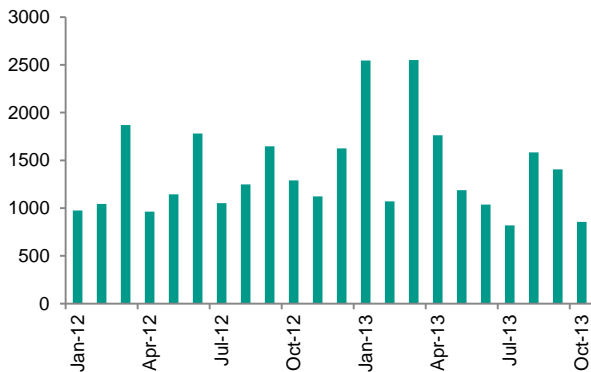
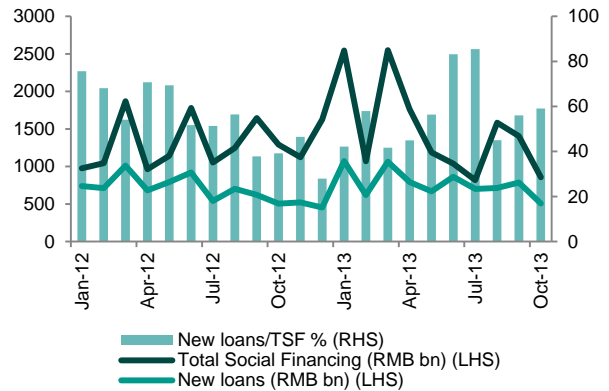
**Exhibit 8 : China's prudent monetary policy is expected to contain excess liquidity (L:YoY%, R:RMB bn)**



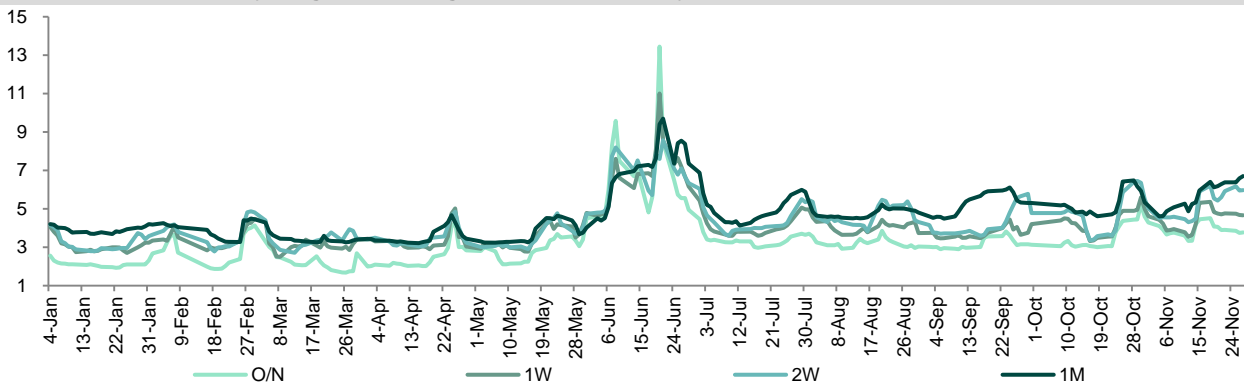
**Exhibit 9 : China's liquidity growth driven by banking lending and capital inflows (RMB bn)**



Source(s): Bloomberg, National Bureau of Statistics, PBOC, ABCI Securities

**Exhibit 10 : Total social financing turns stable in 2013 in China (RMB bn)**

**Exhibit 11: Share of new loans in total social financing is diminishing in China (L:RMB bn, R:%)**


Source(s): Bloomberg, PBOC, ABCI Securities

**Exhibit 12: SHIBOR stays high, reflecting a prudent monetary stance (%)**


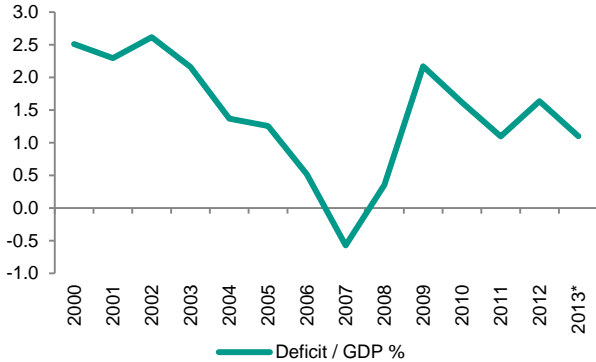
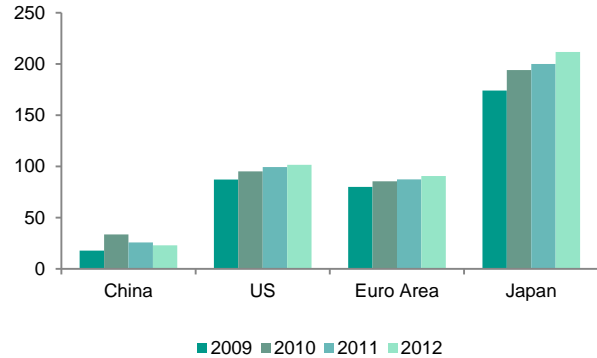
Note: Data in 2013

Source(s): shibor.org, ABCI Securities

## 2. Fiscal policy: A relatively expansionary approach

China will adopt an overall expansionary fiscal policy to facilitate the mega reform proposed in the Third Plenum. Such a move would be consistent with its objective of transforming the nation's economic structure over the medium term. The 383 plan involves a slew of reforms to open up the market, transform the government, and reform enterprises to boost innovation. A significant amount of fiscal resources will be needed to execute the reform package. Looking ahead, we expect more ambitious stimulus packages to emerge, including: (1) acceleration in approvals for infrastructure and construction projects for urbanization; (2) encouraging private capital to flow into large industrial sectors dominated by state firms and had high entry barriers; (3) tax reform to support the service sector, including enhancement of the experimental tax reform that entails conversion of a business tax to VAT and is currently trial testing in Shanghai and Beijing; (4) reforming the fiscal system, which includes the set-up of basic social security; (5) promoting innovation including green technology; (6) discontinuing the government's price intervention in the market; (7) opening up service sector.



**Exhibit 13: A healthy fiscal position to support reforms in China (%)**

**Exhibit 14: China's debt-to-GDP ratio has been significantly lower than that of the developed nations (%)**


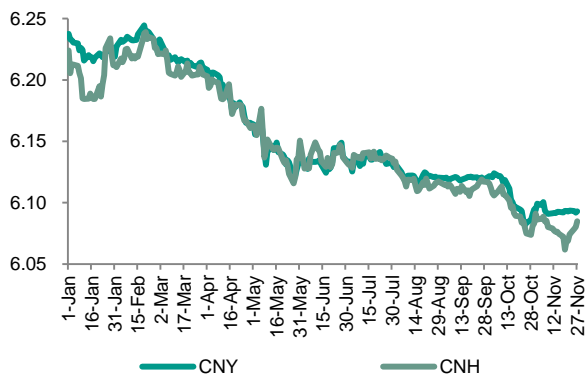
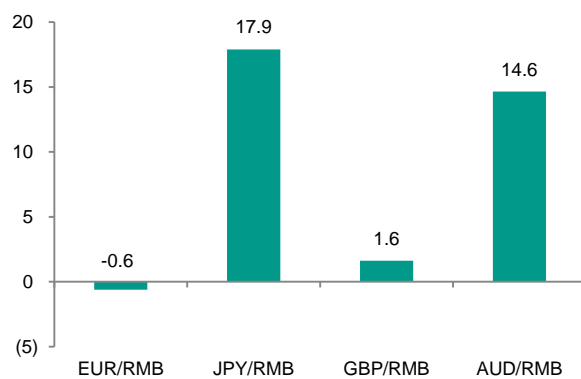
\* 1Q-3Q

Source(s): Bloomberg, IMF, ABCI Securities

### 3. Renminbi trend : Appreciation to pace up modestly

Accelerating renminbi internationalization will be considered as one of the most important financial reforms in 2014. The Third Plenum states that China will gear up renminbi internationalization, with the ultimate goal of making renminbi convertible in the next few years. The renminbi's emergence as a global reserve currency cannot begin until China establishes full currency convertibility by liberalizing strict controls on private capital outflows. With the financial reforms promoting further liberalization of capital account, more renminbi trade settlement, FDI and portfolio investment (QFII, RQFII, and QDII), global usage of renminbi will surge and its role as an international medium of exchange and unit of account will grow sharply in the time coming.

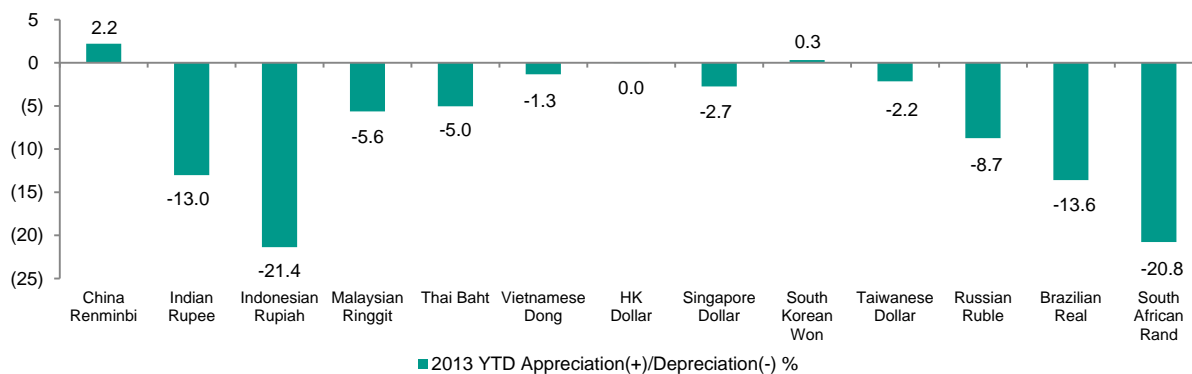
We remain positive on the outlook of renminbi in 2014. The weak U.S. dollar, enhanced convertibility of capital account, economic reforms for stable and sustainable growth and greater access to different industries by foreign investors will combine to increase the likelihood of further appreciation of renminbi in 2014, which we expect to rise 2.5% - 3.0% for 2014F.

**Exhibit 15: RMB moves up by more than 2% on higher volatility in 2013 (USD/RMB)**

**Exhibit 16: YTD appreciation of RMB against other currencies (%)**


Source(s): Bloomberg, ABCI Securities



Exhibit 17: RMB performs better than currencies of other emerging markets (YTD appreciation/depreciation against U.S. dollar %)



Source(s): Bloomberg, ABCI Securities

## Economic themes for 2014

China's economic themes for 2014 rest on the scope of reforms under the new leadership. CPC's Third Plenum has put forward a reform agenda to establish a new economic model for the next decade. The essence of economic rebalancing is to decrease China's dependence on investment for growth and increases its reliance on more sustainable drivers including consumption, services and innovations. Structural reforms, as many believe, will become necessary for China to advance into a new stage of sustainable growth

### 1. CPC's Third Plenum – A recipe for market growth

Under Deng Xiaoping's leadership, the 11<sup>th</sup> Third Plenum in 1978 was a milestone in China's economic development. The 'open-up' policy that required seismic reforms propelled China's economy to grow at a CARG of 9.8% over 1978-2012. Under the new leadership of President Xi Jinping, the Third Plenum will pursue plans to develop a new economic model for sustainable growth. For the first time in history, the government leaders called for a more decisive role for the market forces. A new reform blueprint to push forward sustainable development in the coming decade was unveiled, and a deadline for progress in 2020 was set. We believe the latest Third Plenum has provided the country with a general reform roadmap and we expect more policy details to be disclosed in coming months.

#### Exhibit 18: New reform initiatives proposed in the latest Third Plenum

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#	Reform initiative
1	Allow market forces play a "decisive" role in the economy
2	Establish open and transparent market rules that allow the market to determine pricing
3	Establish a unified market for construction land in cities and the countryside
4	Enhance farmers' benefits in urbanization process; improve farmers' property rights; balance resource allocation between urban and rural residents
5	Reform fiscal system to better manage government budget
6	Establish more free trade zones; allow domestic and foreign investors to have more access to invest in China
7	Reform distribution system and social spending programs on medical care and social security
8	Accelerate environmental protection efforts

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Source(s): xinhuanet.com

#### Highlights of the Third Plenum

##### i) SOE sector to be further liberalized

The government is determined to transform the SOE sector by introducing more competition in SOE-dominated industries. Private capital will be allowed to invest in these industries and a mixed ownership economy will be encouraged. We believe that deemphasizing the SOEs' position will enable the market to utilize a wider range of capital resources for better growth, more job opportunities, and risk diversification in certain industries.

##### ii) Deepening financial reform

The document confirms that the government will continue to pursue reforms in interest rate liberalization, renminbi internationalization, and capital account convertibility. As part of the SOE sector reform, private capital is allowed to invest in banks and other financial institutions. We believe this will encourage more innovations in financial products and services, reducing the reliance on commercial bank lending as a financing channel. The financial reform is aiming to create a more sophisticated financial market sustainable for long-term development.

##### iii) Multiple measures to support urbanization

The document also includes details on the urbanization process, including reform on the Hukou system (i.e. household registration system). The new plan relaxes some of the restriction in the Hukou system among small and medium cities while maintaining a strict control over the population flow in mega cities. Farmers who stay in the rural areas will be granted more property rights and more flexible uses of their land. More resources will also be allocated to balance the development

in urban and rural areas. We believe these measures will facilitate urbanization by allowing the process to proceed in a more organized manner.

**iv) Improved fiscal management and taxation systems**

Spending responsibilities and revenue distribution will be divided among the central and local governments with a more transparent fiscal system and an enhanced taxation system. The new measures will help the central government share the increasing fiscal burdens of local authorities, establish a better system to monitor the local government debt level, and create a more business-friendly taxation system to encourage investment.

**v) Market forces to play a bigger role in price determination**

The government also specifies the role of market forces in price determination. The government will play a less dominant role in the pricing of major public goods or natural resources, such as water, electricity, oil, natural gas, and telecommunication. We believe that the pricing reform will be a stepping-stone for the gradual liberalization of these industries in which private capital will be introduced later on.

**vi) Environmental issues vs. economic growth**

Economic growth will no longer be the benchmark of assessment for the ecologically fragile regions. Management and monitoring systems will be established to protect natural resources, especially in areas where resources are overloaded. In addition, compensation for environmental damages will be channeled through the price and tax mechanisms. In our view, these new measures will help tackle the worsening environmental degradation in China and ensure the safety of various aspects livelihood.

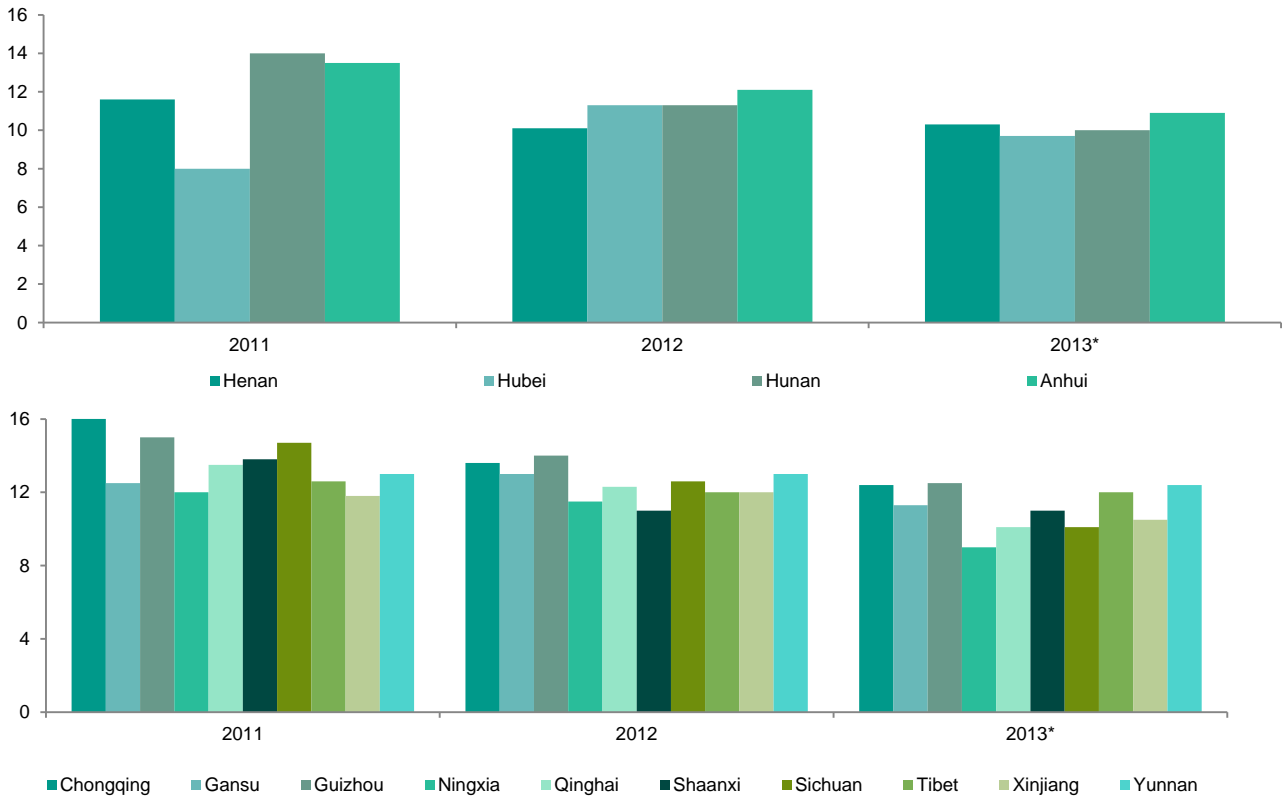
**2. Accelerating urbanization to create more opportunities**

**i) The shift to central and western provinces**

With urbanization becoming the key growth driver in coming decade, Chinese central and western provinces will substantially benefit from rising infrastructure/transportation investments, industry transfer from coastal provinces, and abundant labor supply, which in turn will boost property development, consumption upgrade and urbanization in these regions. With strong demand for infrastructure investment, we believe China's FAI growth will stabilize at above 20% YoY in 2014F on solid infrastructure and manufacturing investment growth and rising real estate investment. We see government spending on transportation and utility construction rebounding and expect greater investment in infrastructure construction as well as economic housing development.

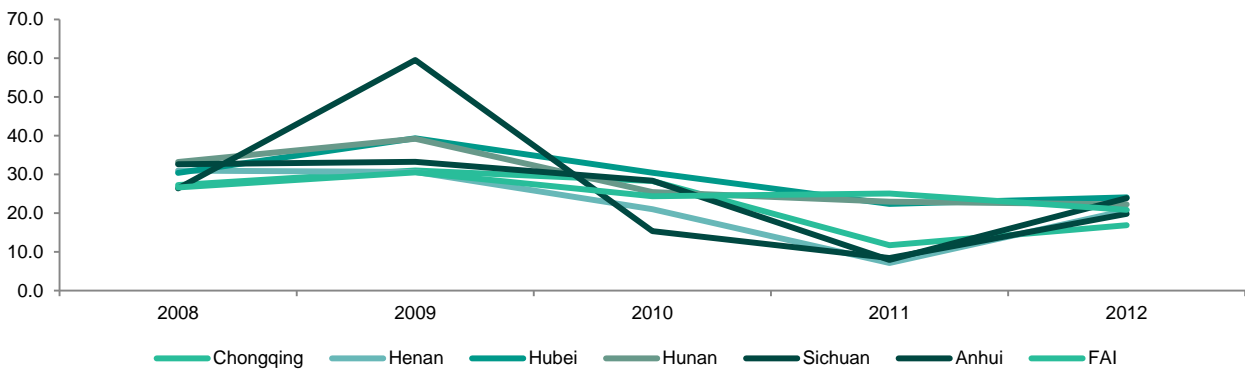
We have seen accelerating urbanization in central and western provinces since 2009, primarily aided by the government's tremendous investments in local infrastructure and transportation system, industry transfer from coastal provinces, and return of agricultural workers from coastal provinces.

We believe provinces in central and western China will attract industries and technologies relocated from coastal provinces, given the former's lower production costs and greater accessibility to resources. In addition, mass construction of high-speed railway and highway networks will significantly improve the logistics efficiency in these provinces, which will in turn accelerate industrialization and urbanization. For example, Anhui, Hunan, Jiangxi, Sichuan and Guangxi provinces could continue to act as the major destinations of industry transfer from the Yangtze River Delta (YRD) and Pearl River Delta (PRD) regions in the next three to five years.

**Exhibit 19: Faster GDP growth in China's central and western regions since 2009 (YoY%)**


\*1Q-3Q data  
 Source(s): Bloomberg, National Bureau of Statistics, ABCI Securities

Both opportunities and challenges are arising from urbanization in central and western provinces. Accelerating urbanization will provide a strong boost to infrastructure investment, property development and sustained consumption upgrades in these areas. According to the Ministry of Commerce, total retail sales nationwide grew by 13% YoY for 10M13. In 2014, we expect consumer discretionary products, including high-end home appliance products, fuel-economic automobiles, and mobile phones are likely to see strong growth in the central and western provinces.

**Exhibit 20: Strong FAI growth in China's central and western regions since 2009 (YoY%)**


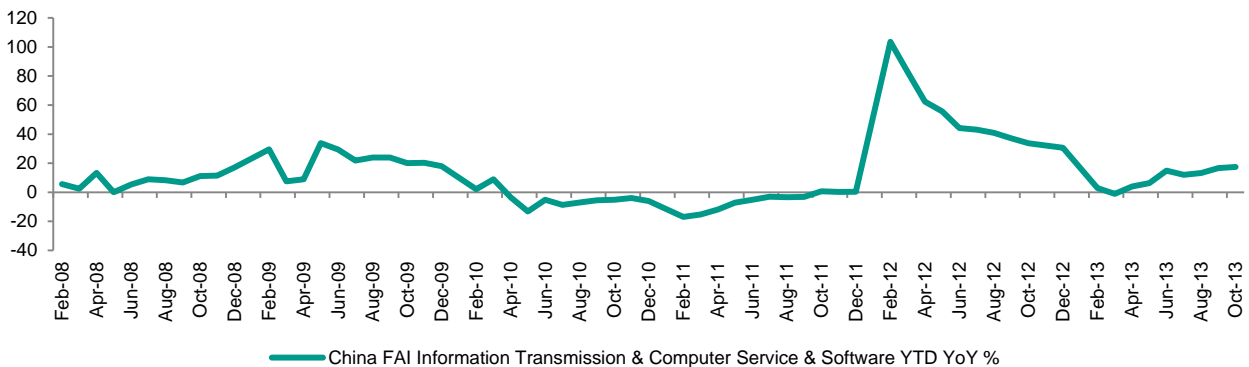
Source(s): National Bureau of Statistics, ABCI Securities

## ii) Broadband boost to sustain FAI growth and develop new industries

China's "Broadband China" initiative establishes a specific completion timeline and targeted broadband speed for urban and rural areas. 4G network licenses have already been issued on Dec 4, 2013. We believe that the infrastructure investment required in the process will boost the FAI investment. The nationwide enhancement of network infrastructure should serve the rapidly expanding population of digital consumers well and foster development of new industries outlined in the informatization goal under the 12th Five-Year Plan. Ultimately, the new initiative will help China complete the transition towards a consumption-led economy.

To extend the availability of internet and improve the connectivity of broadband network, upfront investments in transmission stations, pipelines, and optical fiber cables etc. are essential. Therefore, we believe that FAI will surge, benefiting upstream network equipment manufacturers and suppliers. Network capacity is the key to cultivate new industries in information technology such as cloud computing and mobile electronic devices. With the expansion and upgrade of the current cable and mobile networks, China is shoring up the foundation for a flurry of new industries to build upon. We expect development of these new industries will take flight once the IT infrastructure consolidates.

**Exhibit 21: Information-related FAI surges (YoY%)**

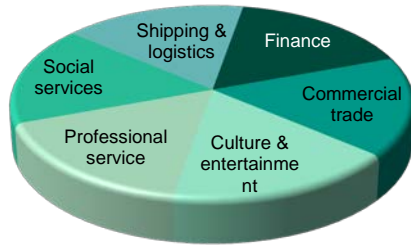


Source(s): Bloomberg, National Bureau of Statistics, ABCI Securities

### 3. More free-trade zones to be established

With the commencement of the China (Shanghai) Pilot Free-Trade Zone (SHFTZ), the market is clamoring for more reforms in China's financial sector. The financial reform will revolve around enhancing stability of the financial system and China's status in the international financial market. The government is likely to continue its pursuit of liberalization of exchange rate, internationalization of renminbi, and marketization of interest rate. Liberalization of the capital account will also be expedited to strengthen the financial system and integrate China into the global economy. The landmark plan for SHFTZ is the clearest sign that China's new leadership is determined to foster China's global competitiveness, set up a new platform for the nation's cooperation with other countries, and achieves sustainable growth in China's economy. As the Third Plenum highlighted greater access to investment by local and foreign investors through free trade zone, we expect more will be set up in the next five years.

Shanghai has officially announced its long-term development objective to become a global hub for finance, trade and shipping, with the local government actively promoting the development of service industries and advanced manufacturing industries. Given the constraints on land and human resources, Shanghai would need to escalate consolidation and transfer of its manufacturing sector, and fasten its economic ties in the YRD regions. In our view, the SHFTZ will generate tangible benefits to local and regional sectors of retail, transportation, tourist and construction, as well as creating magnificent opportunities for Shanghai to upgrade its service industries and improve the city's global image.

**Exhibit 22: Six key industries to be opened up in China**


Source(s): www.shftz.gov.cn, ABCI Securities

**Exhibit 23: CSRC's details on financial innovation**

- 1 Allow futures exchanges to set up international energy trading platform within the Zone, and introduce foreign investors to participate in futures trading
- 2 Allow individual or institutions to invest in or outside China
- 3 Allow the parent companies of domestic firms to issue renminbi-denominated bonds
- 4 Some securities and futures companies have applied for licenses in the Zone
- 5 Encourage overseas trading of derivatives

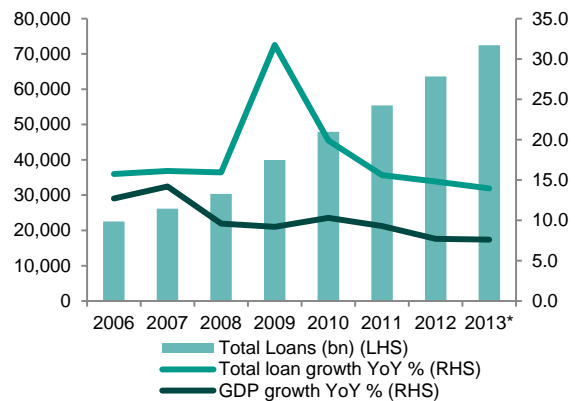
Source(s): www.shftz.gov.cn, ABCI Securities

**Exhibit 24: CBRC's details on financial innovation**

- 1 Allow domestic banks to operate within the Zone
- 2 Support non-bank financial institutions to offer services within the Zone
- 3 Encourage foreign banks to operate within the Zone
- 4 Support the experiments of private capital entering the banking industry
- 5 Encourage cross-border investment services
- 6 Support offshore business
- 7 Simplify the procedure for entry
- 8 Improve the supervision system

Source(s): www.shftz.gov.cn, ABCI Securities

**Exhibit 25: Resilient GDP growth in Shanghai (YoY%)**

**Exhibit 26: Credit growth has surpassed GDP growth in China since 2006 (RMB bn, R: YoY%)**


\*1Q – 3Q13

Source(s): National Bureau of Statistics, PBOC, ABCI Securities

#### 4. Credit normalization to tame inflationary pressure

In view of faster-than-expected credit growth since 2007, the PBOC has demonstrated a prudent stance on monetary policy to normalize. The likelihood of renminbi appreciation in 2014 will attract international capital inflows that may add to the rising domestic liquidity. Given the expectation of rising inflation and the mounting pressure to control liquidity, we expect the PBOC to assume an accommodative approach to manage liquidity. On the other hand, the Chinese government is determined to pursue sustainable economic growth and is likely to conduct more prudent monetary policies to manage inflationary pressure.

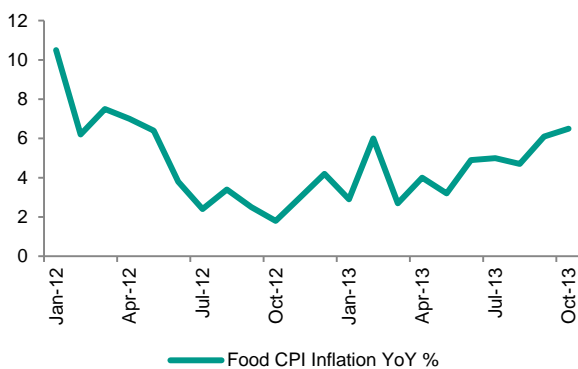
##### i) How high will the CPI be?

China's CPI has been rising over the past two months and reached 3.2% YoY in Oct with the YTD CPI inflation reaching 2.6%, which is still below the government's target of 3.5%. The mild CPI hike during the month was mainly resulted from the high-base effect and inflated prices of agricultural products push up by the extraordinary weather. As the base effect subsides and weather conditions improve, we believe that price rise of agricultural products would moderate in coming months, which in turn will keep inflation at 2.7% for 2013F.

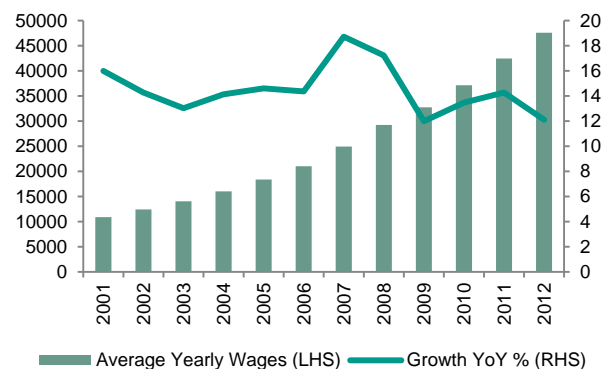
##### ii) Agricultural product prices are likely to stabilize

CPI's 3.2% rise in Oct was fueled by the inflation of food prices at 6.5% YoY, which included a ~30% YoY increase in vegetable prices. Key factors affecting agricultural product prices are production cost and cost inflation. While the reduced output caused by extraordinary weather has resulted in price fluctuations, we believe cost inflation is the key driver of sustaining price hikes of agricultural products over the medium term. Food prices rose 4.6% in 10M13, driven by inflation of pork, beef, grain and vegetables. We expect pork and beef prices to moderate at the start of 2014 on increasing supplies in the market. Vegetable price movements have demonstrated strong seasonality historically but as weather conditions improve in most southern provinces, we expect the price hikes to subside in coming months. In sum, we forecast that food prices will increase by 5.5% YoY in 2013F.

**Exhibit 27: China CPI trends up on soaring food prices (YoY%)**



**Exhibit 28: Rising wages in China's primary sector (L:RM, R:YoY%)**

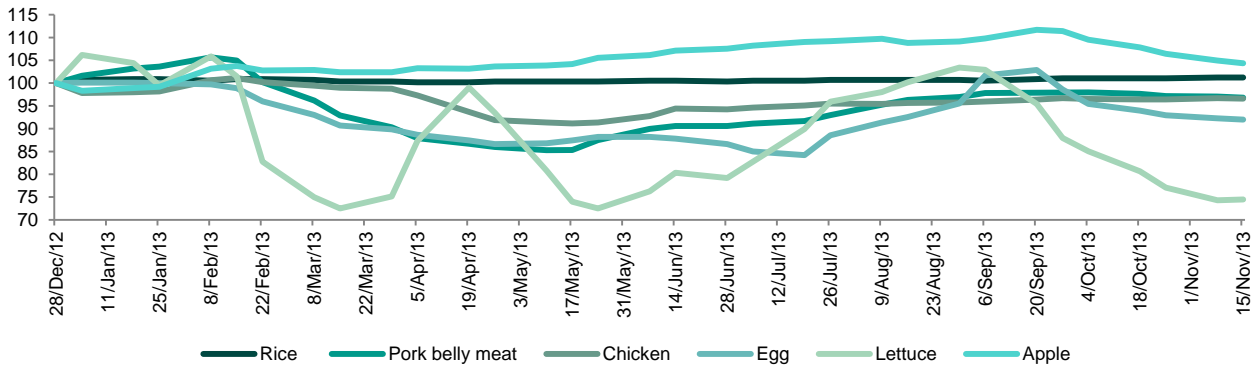


Source(s): Bloomberg, National Bureau of Statistics, ABCI Securities





Exhibit 29: China 50-cities average prices of selected agricultural produces in 2013

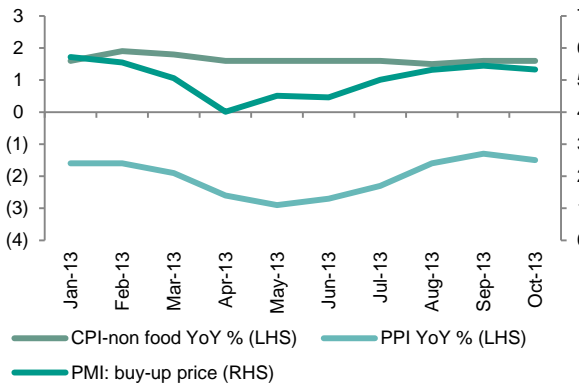


Note: Baseline = Dec 28, 2012  
Source(s): Bloomberg, National Bureau of Statistics, ABCI Securities

iii) Rebound in PPI will exert pressure on CPI

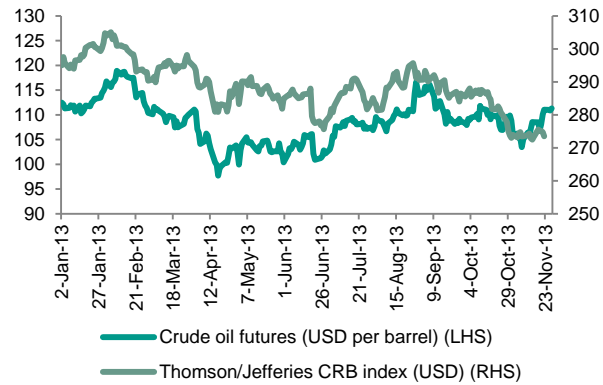
China's PPI has been declining since Mar2012 mainly because of price deflation in major international commodities and energy products. We see unrelenting pressure on the PPI as demonstrated by continuous rise in input price PMI since July 2013. As the developed markets recover, international commodity prices will continue to surge, which in turn will exert more upward pressure on China's industrial goods prices. We forecast the PPI will rise to 1% YoY for 2014F.

Exhibit 30: Higher production prices exert upward pressure on the CPI in China (L: YoY%)



Source(s): Bloomberg, National Bureau of Statistics, ABCI Securities

Exhibit 31: Rising international commodity prices in 2013 (L:USD/barrel, R: USD)



5. New strategic industries to support economic rebalancing

The year of 2014 marks the fourth year of China's 12<sup>th</sup> Five-Year Plan. Development of new strategic industries remains the cornerstones of the plan. We expect strong growth momentum within the new strategic industries, and supportive policies will be introduced to boost investment growth in new energy, environmental protection, energy saving automobiles, information technology, advanced equipment manufacturing, biotechnology, and the new material sectors. New measures to create new earnings platforms and stimulate downstream demand to increase asset turnover of supported industries will be introduced. New investment projects will continue to be initiated in 2014 to support growth in fixed asset investment.



### **Exhibit 32: New strategic industries in China**

Information technologies

Environmental protection

New energy

Energy-saving automobiles

Biotechnology

New materials

Advanced equipment manufacturing

Source(s): ABCI Securities

## **6. Service and information consumption: a new growth driver**

### **a) Service consumption**

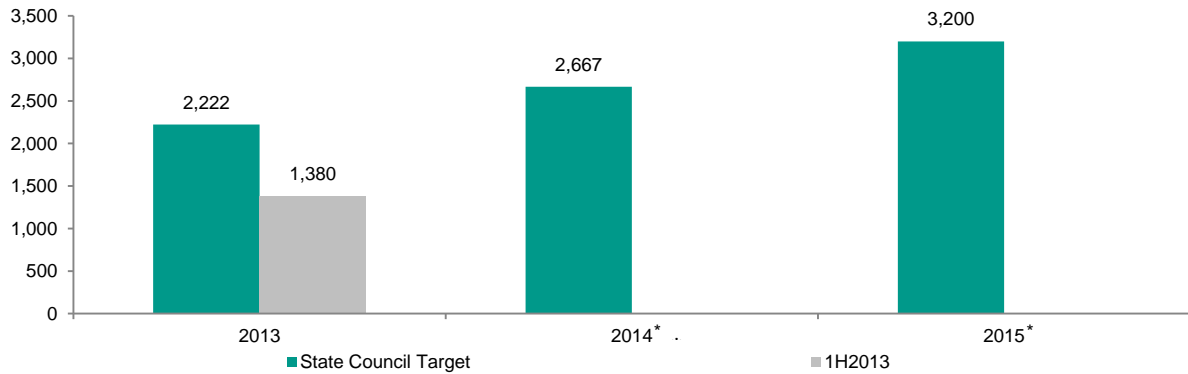
The Chinese government has been boosting domestic consumption to rebalance the economy. We believe that service consumption, primarily consumer spending on medical services, education, entertainment, tourism, household services and financial services, will be the main propellers of urban consumption growth. With the surge in residential disposable income and average household wealth, we have become increasingly convinced that China will be able to transit to a consumption-led economy in the next decade.

### **i) Information consumption to increase**

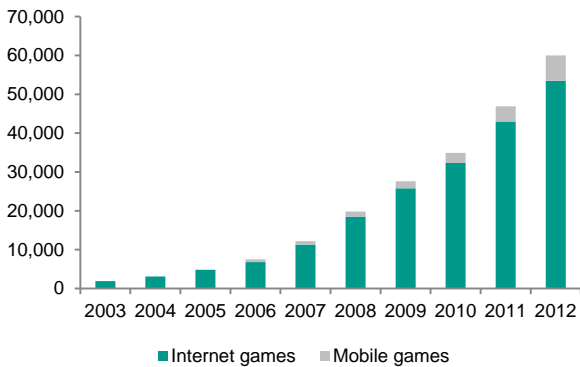
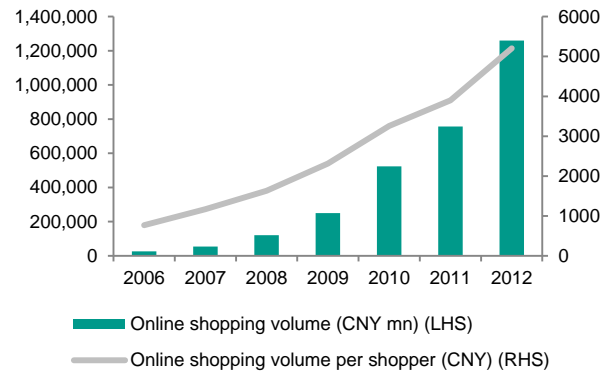
The information sector is considered by the government as a new growth driver. Information consumption can serve to invigorate domestic demand, sprout new growth for the economy, upgrade the service industry, and promote economic restructuring. In 1H13, consumption of information products and services jumped 20.7% YoY to RMB 2.07tr. The e-commerce sector's revenue hit almost RMB 5tn, up over 45% YoY. The government expects the sector to record at least a 20% growth over the next three years, making China one of the world's top consumers in information-related products including e-commerce, cloud computing, and fourth-generation telecom services. To promote information consumption, however, China would upgrade its broadband facilities and services and expedite internet innovation.

With China's economic growth slowing in the past two years, the government is targeting to make information consumption a new engine to boost domestic demand. The State Council has recently brought information consumption back to its priority list for 2H13 in a meeting on July 12. By We expect the government will ratchet up the integration of telecommunications, internet and broadcasting networks into one complete system covering the entire nation.

The consumer sector will see many opportunities. The "Broadband China" initiative will enable network operators to reach more consumers, including those in the remote areas. We believe that as more consumers shift to internet and mobile devices and upgrade to more advanced network, demand for high-capacity network will rise substantially. Network operators will also generate higher revenue from data services. This initiative to boost information consumption will benefit content and online service providers creating apps, games, and other services to China's ever-expanding digital consumers.

**Exhibit 33: Information consumption in China (RMB bn)**


\*State Council Target is calculated based on an assumed 20% YoY growth  
 Source(s): MIIT, PRC State Council, ABCI Securities

**Exhibit 34: Online gaming revenue in China (RMB bn)**

**Exhibit 35: Online shopping in China (RMB mn, R;RMB)**


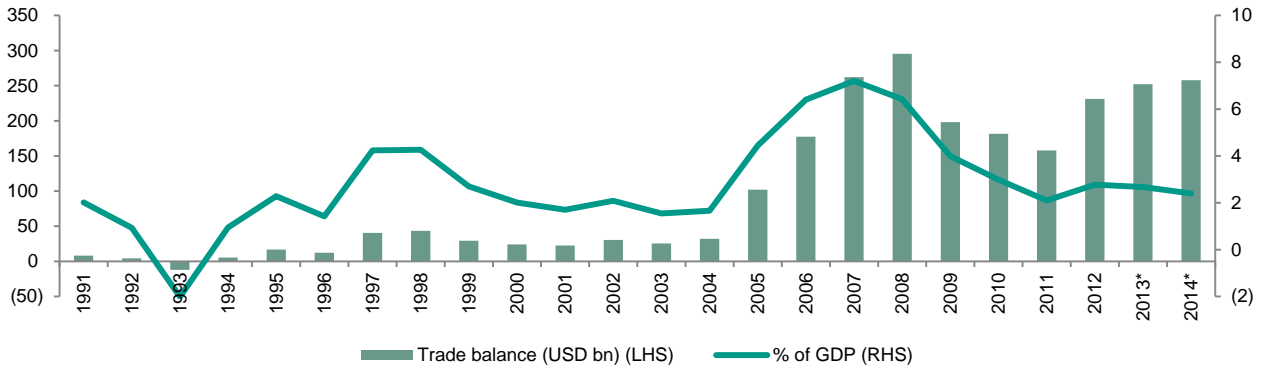
Source(s): China Internet Network Information Center, ABCI Securities

## 7. Transformation of external trade

Sectors associated with international trade have been the bread and butter of the Chinese economy as the country emerges as the second-largest economy in the world in terms of GDP. Low labor costs and loose environmental standards on factories are among the factors that attract overseas businesses and investors to China. However, this business landscape will change in the coming years. Exporters will face challenges including rising wages and land costs. In economic terms, China is losing its competitive advantage in low-value manufacturing products that can now be easily produced in other developing countries at lower costs. We believe this is the strongest headwind against exporters. Renminbi appreciation will be another overhang. As the U.S. dollar is expected to depreciate over time due to extensive monetary easing efforts by the Fed, products exported from elsewhere will become more expensive in U.S. dollar terms, adding more pressure on exporters.



Exhibit 36: Declining trade balance in China



\* ABCI estimates  
Source(s): Bloomberg, National Bureau of Statistics, ABCI Securities estimates

Trade reform on track – the shift to high-end value-added products

To stabilize export growth, we believe China will upgrade its industries by shifting to high-end, value-added manufacturing for higher selling prices. As consumption plays a bigger role in GDP growth, the Chinese economy will shift from goods consumption to service consumption. In terms of nominal GDP, we believe China's service sector growth will be faster than that of manufacturing given the currently low penetration of services and increasing government policy support for services.

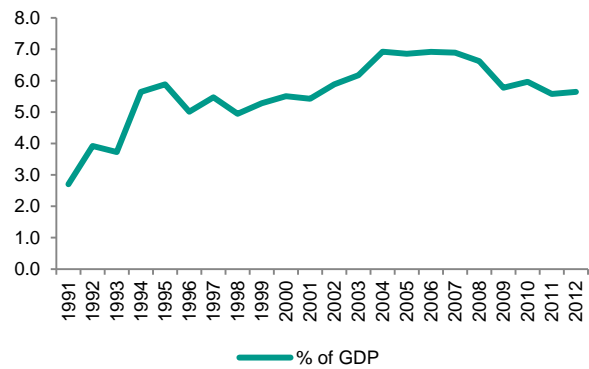
Service trade develops faster than expected

China's service trade amounted to US\$ 470.58bn in 2012, almost doubling that of 2007. China will accelerate the development of service trade to facilitate next-generation information technology, high-end equipment manufacturing, new material and alternative energy. With the substantial export and trade growth, it is only a matter of time before the transformation to service trade takes place.

Exhibit 37: Service trade is expanding rapidly in China (USD bn)



Exhibit 38: Contribution of Service trade to GDP in China (%)



Source(s): Bloomberg, Ministry of Commerce, ABCI Securities

### Sectors to benefit most from service trade expansion

Currently, about 45% of total service exports come from information-intensive sectors, including telecommunications, information services, financial services, and consultancy. Other major development areas include tourism, construction services, information technology, transport and logistics.

**Exhibit 39: 2012 Service trade balance by sector in China (USD bn)**

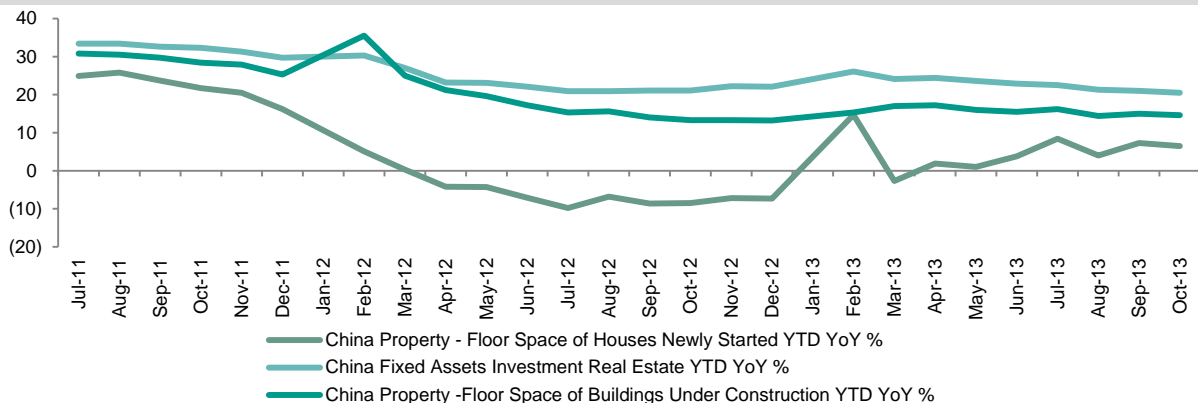


Source(s): Ministry of Commerce, ABCI Securities

### 8. Less policy risks in commercial property market compared to residential one

Although the government has increased tightening on the property sector since 2Q13, residential property prices in tier one city was up 18.2% YoY for 10M13. The government's measures to control rising prices in the domestic property market targets to promote affordable housing in the country for the poor, raising percentage of down payments for the first homebuyers and banning home loans for the third homebuyers. As housing prices continue to rise, we expect China will extend the property tax nationwide. Elevating policy risks may become the major overhang of the residential property market as cities including Shanghai, Beijing, Guangzhou, and Shenzhen have recently introduced more measures to calm the property market. Overall, the commercial property counters are more defensive than its residential counterparts, as the former has not been subjected to purchase restriction and the government sees rising commercial property price much less of a threat to stable economic growth.

**Exhibit 40: Real estate investment growth in China remains strong despite of minor slowdown (YTD YoY%)**

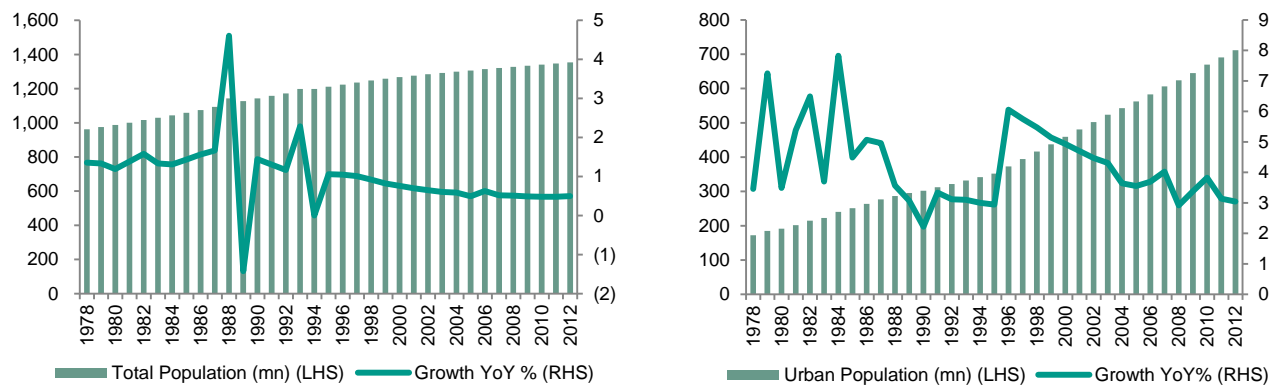


Source(s): Bloomberg, National Bureau of Statistics, ABCI Securities

## 9. Easing one-child policy to revitalize an aging nation

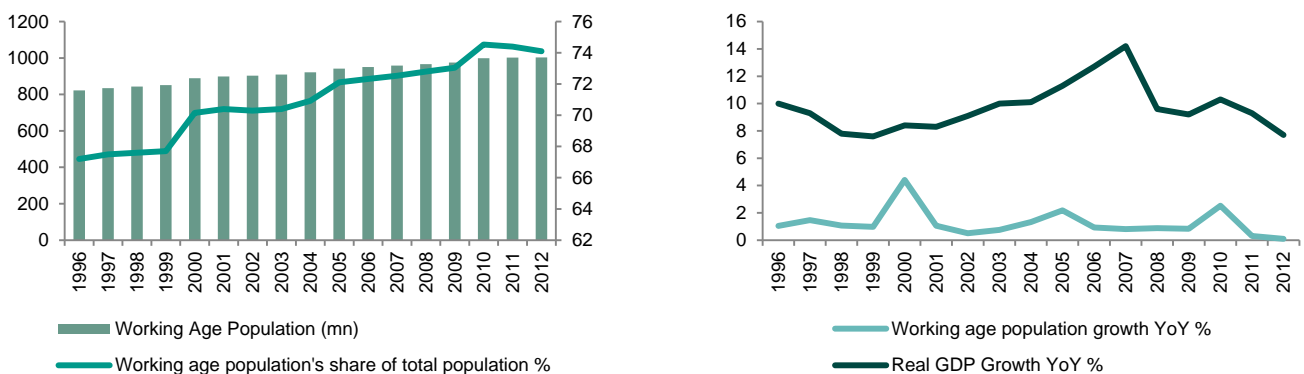
CPC's Third Plenum outlined a much-anticipated reform on population by relaxing the one-child policy. Families will be allowed to have a second child if one of the parents has no siblings - a change from the current policy where parents can only have a second child if both parents are the only children. The adjusted birth policy is a major step to promote the long-term balanced development of population in China. According to the official statistics, the share of the working-age population (aged between 15 and 64) started to decline in 2010 while the absolute size of the group shrank for the first time in 2012. This marks the end of the demographic dividend, a productive advantage brought about by a large labor force and a low dependency ratio. China has already begun to see the consequences of a shrinking labor force. A number of provinces, especially those along the coast, have experienced labor shortages. A smaller labor force may threaten economic growth as manufacturing jobs may move to developing countries like Myanmar, Vietnam, the Philippines, and Indonesia. In addition, China's population is aging quickly. It is estimated that China's elderly population will hit 360mn by 2030 from about 200mn in 2013. According to the United Nations, 8.5% of China's population is currently over 65, and the figure will rise to 23.9% by 2050. A change in the dependency ratio will pose a significant burden to the country in terms of healthcare expenses. The relaxation of one-child policy will help increase the working population after 2030 when the baby boomers enter the labor force, raising the annual economic growth to around 0.5% to 1%. In sum, the adjusted population policy will reverse the declining growth of working population and boost the economy in the medium and long term.

**Exhibit 41: China's population growth maintains at below 1% since the implementation of one-child policy**



Source(s): Bloomberg, National Bureau of Statistics, ABCI Securities

**Exhibit 42: China's working population growth is declining**



Source(s): Bloomberg, National Bureau of Statistics, ABCI Securities



### Hong Kong economic outlook for 2014

Strong rebound in the Hong Kong economy with continuous improvement in employment has spurred private consumption and investment during the first three quarters of 2013. Strong inflows of Mainland tourists and their increasing spending power amid renminbi appreciation will continue to lend support for Hong Kong's economic growth in 2013 and 2014. Domestic consumption has become the prime mover of the recovery. Expectedly, high inflation above 4% remains the key near-term challenge in 2014. In general, we forecast the Hong Kong economy will expand by to 3.1% YoY in 2013F and 3.4% in 2014F.

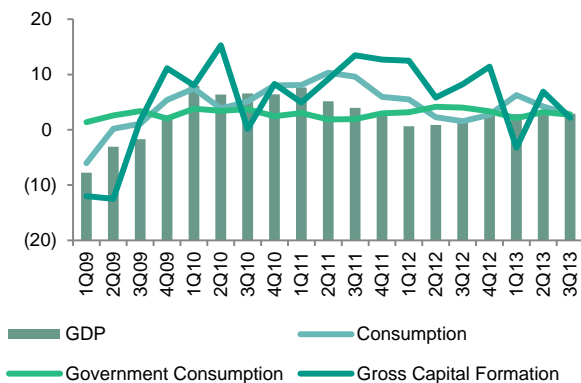
The Hong Kong economy for 9M13 grew 3.0% YoY, compared to 1.5% in 2012. The rebound was not solid as global economic environment remained uncertain. Entering into 4Q13, Hong Kong is able to enjoy more positive investor sentiment and liquidity flows from the developed economies on the back of a rebound in the Chinese economy, delay of QE's tapering, and recovery of Eurozone. Looking into 2014, we expect positive catalysts to include a recovery in retail sales and expansion of infrastructure investment. Economic fundamentals continue to improve, given that economies in Europe and continue to revive and declining exports to these countries start to turn around. Hong Kong's export sector is likely to experience a stable growth in 2014. Domestic demand drivers, namely consumption and investment, are likely to be the bright spots in 2014. Property tightening measures and high inflation remain to be the key overhangs in the region, however.

**Exhibit 43: Economic forecasts for Hong Kong in 2013F and 2014F**

(%)	2011	2012	2013F	2014F	2015F
Real GDP (YoY)	4.9	1.5	3.1	3.4	3.6
Consumption (YoY)	8.4	3.0	4.8	4.3	4.0
Investment (YoY)	10.2	9.4	3.3	4.5	3.8
Government consumption (YoY)	2.5	3.7	2.8	3.2	3.0
Exports (YoY)	3.9	1.9	6.6	6.9	7.9
Imports (YoY)	4.6	2.8	7.3	7.5	7.9
Unemployment rate	3.4	3.3	3.3	3.0	3.0
Inflation (YoY)	5.3	4.1	4.5	4.7	4.5

Source(s): Hong Kong Census and Statistics Department, ABCI Securities estimates

**Exhibit 44: Hong Kong's growth drivers (YoY%)**



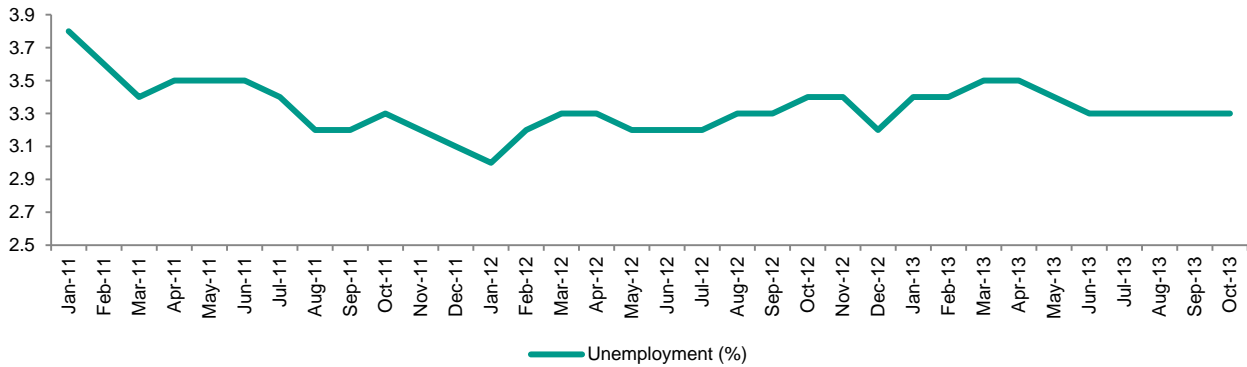
**Exhibit 45: Hong Kong's export and import (YoY%)**



Source(s): Hong Kong Census and Statistics Department, ABCI Securities



Exhibit 46: Hong Kong unemployment rate stays low (%)



Source(s): Hong Kong Census and Statistics Department, ABCI Securities

Thanks to the Mainland tourists, all is well with the retail sector

Underpinned by buoyant local consumers and tourists spending, private consumption expenditure in Hong Kong posted a remarkable growth of 4.4% YoY for 9M13, accounting for 65.4% of Hong Kong's GDP against 64.2% in 2012. Retail sales grew robustly at 11.9% on average for 9M13 against 7.2% in 2012, thanks to increasing number of Mainland visitors and the improved economic environment.

Mainland tourist consumption in Hong Kong has been picking up in the past few months. Retail sales grow alongside with tourist spending, especially after the launch of the Individual Visit Scheme (IVS) that facilitates visitors from Mainland China to visit Hong Kong in their individual capacity. Spending by Mainland China visitors is thus an important driving force underpinning the growth of retail sales in Hong Kong. Outbound Chinese tourists have constituted a powerful presence in HK tourist sector. Increasing income in China and renminbi appreciation will further attract Mainland tourists to Hong Kong, thus stimulating private consumption and supporting the economic growth.

Exhibit 47: Growth in private consumption expenditure remains resilient in HK (L: YoY%, R:%)

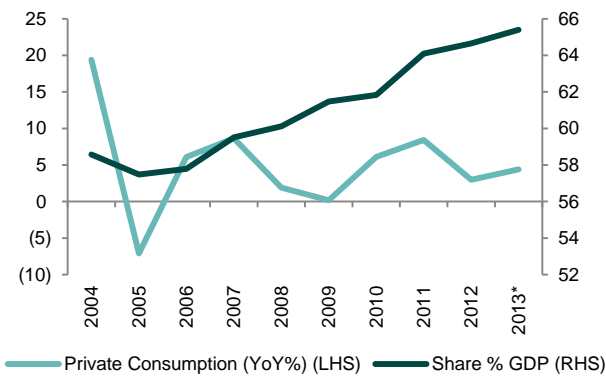
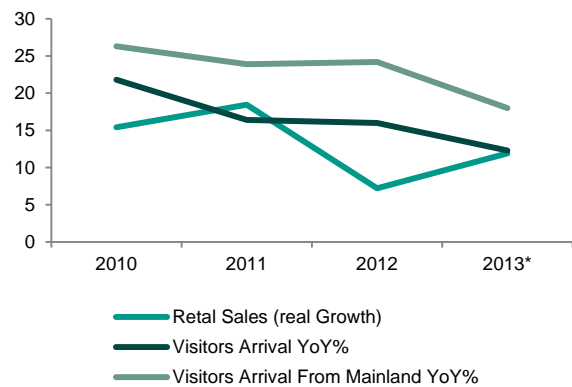


Exhibit 48: Despite slowing visitor arrivals, a rising per capita spending supports retail sales expansion in Hong Kong (%)



\*1Q-3Q13

Source(s): Hong Kong Census and Statistics Department, Hong Kong Tourism Board,





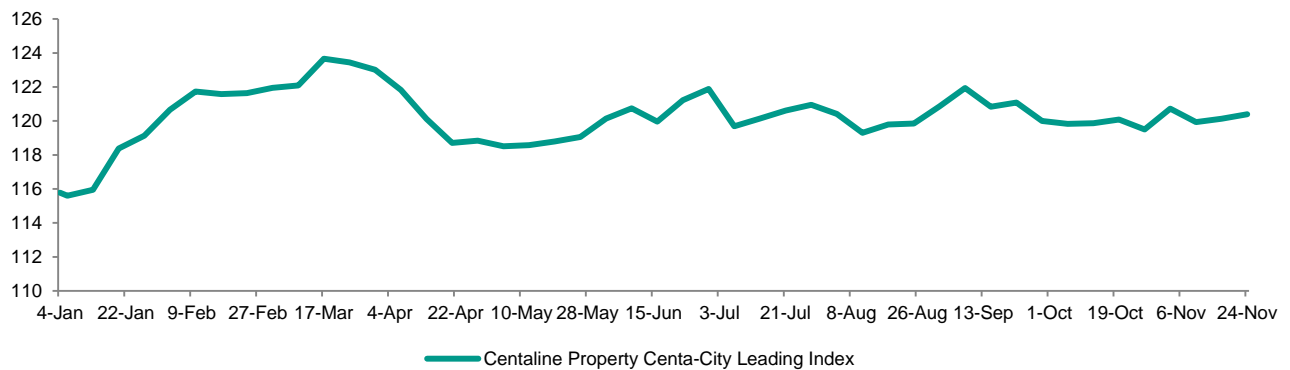
### Hong Kong Property market: Gathering gloom under tightening

Hong Kong's property market is a victim of the continuation of tightening policies. Sentiment in the residential market has weakened further on market uncertainty as reflected by lower transaction volume in 2H13. Residential price index has turned flat since Sep when buyers adopted a "wait-and-see" strategy.

Following the Hong Kong Monetary Authority's tightening of the risk-weighted assets requirement of newly offered mortgages, several leading banks raised home-loan rates and lowered the valuation of residential units. Potential buyers, facing more difficulty in financing and waiting for the release of new residential projects in the coming few years, shifted their focus towards the rental market. The residential and the commercial rental markets are expected to see growth on increasing demand for housing and robust retail sales.

With outlook for the Hong Kong property market deteriorating amid an increase in U.S. Treasury bond yields and the Hong Kong government's decision to bring forward the presale of units due for completion in 2015, property prices have started to decline mildly and the new projects released is priced close to or lower than the second-hand homes. It is a signal that a correction will happen. We expect property prices in the city to drop 5% to 10% by the end of next year as the government's market-cooling measures take effect.

**Exhibit 49: Property price in Hong Kong moderates in 2013**



Note: Baseline = July 1997  
Source(s): Bloomberg, Centaline, ABCI Securities

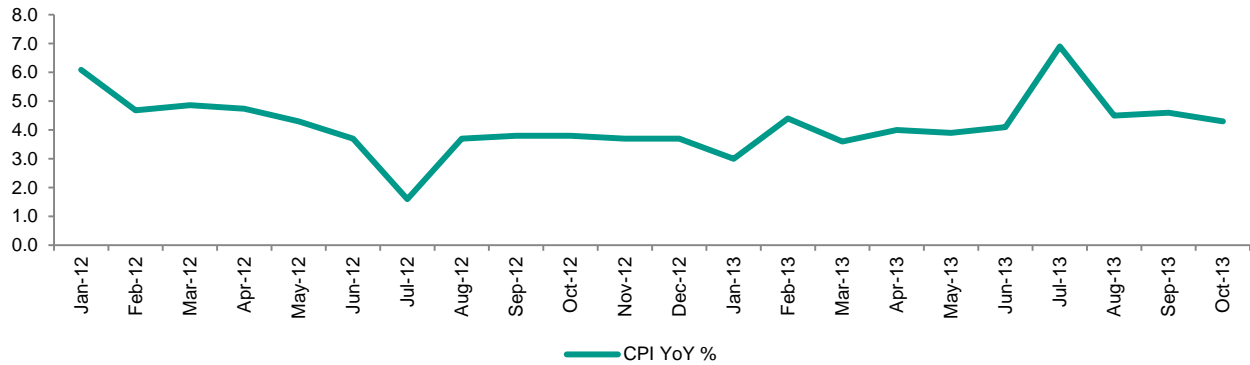
### Inflation - a near-term challenge

Hong Kong's inflation rose to 4.3% YoY for 9M13, with food costs rising 6.5% YoY in Sep. A combination of the low-interest-rate environment, surging imported food prices, the introduction of minimum wage, rent hikes, and strong retail sales are a perfect storm for spiraling inflation. The U.S. peg has muted proactive monetary policies to curb inflation, while measures for fighting inflation lack the teeth to slow rising prices. With that in mind, we look for inflation to rise to 4.5% in 2013F and 4.7% in 2014F.

High inflation will turn the real interest rate deeper into the negative territory, pushing Hong Kong's deposit base into the asset markets, especially the property market. Without the ability to change Hong Kong's monetary policy, the government will continue to impose tightening measures to cool the red-hot property market, although there is no guarantee that these measures will be effective.



Exhibit 50: Inflation in Hong Kong stays at above 4% (YoY%)



Source(s): Hong Kong Census and Statistics Department, ABCI Securities

HKD and USD are still good together

As renminbi internationalization accelerates, many question the justification of the current HKD-USD peg. In our opinion, concerns about a decoupling of Hong Kong's currency are premature. Proponents of de-pegging suggest that the currency peg no longer holds the function of stabilizing the value of the Hong Kong dollar against the world's currencies, as the Fed keeps expanding the scale of its balance sheet, which introduces a degree of volatility of the U.S. dollar against other currencies. Moreover, as Hong Kong's relationship with China is getting closer with rising use of renminbi in trade and investment, a peg to the renminbi seems to be more meaningful.

Nevertheless, we believe it is too early to consider the use of the renminbi as Hong Kong's anchor currency. First, renminbi is not yet freely convertible and the capital account of China is still not fully liberalized. We believe Hong Kong Monetary Authority will maintain HKD-USD peg in the short term. Al though renminbi is gaining more global recognition, it is still far from being a globally accepted currency. Once renminbi becomes a global currency with the full liberalization of capital account, the government should start to reconsider changing its currency peg system.

Exhibit 50: US Dollar index and inflation in Hong Kong (R:YoY%)

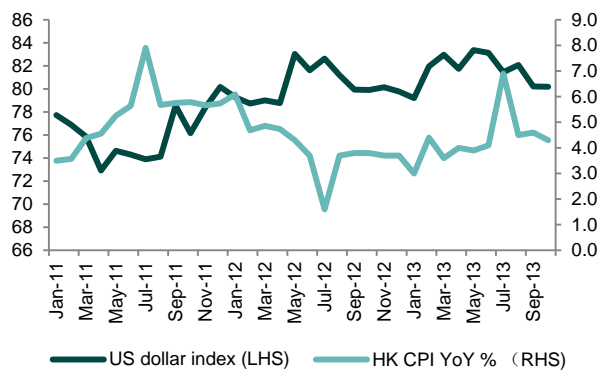
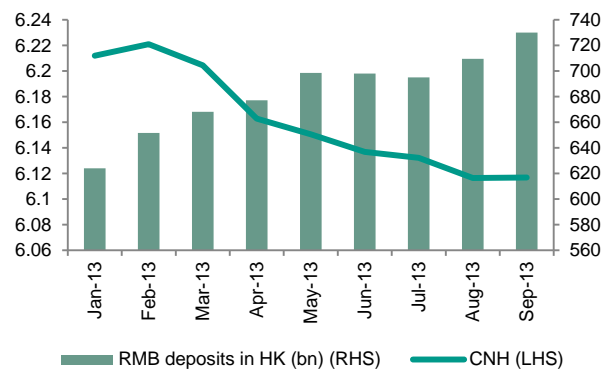


Exhibit 51: CNH and RMB deposits in Hong Kong (L: RMB bn, R:RMB)



Source(s): Bloomberg, HK Census and Statistics Department, HKMA, ABCI Securities

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## Investment Strategy for 2014

- We expect HSI and HSCEI to post earnings growth of 8.1% and 8.8% in 2014F. Year-end targets are set at 25,095 and 13,680, respectively
- We are positive on sectors such as e-commerce, consumer services, insurance, and distressed asset management. These sectors will benefit from the evolving commercial modes, growing income and social benefits in China
- Large SOE commercial banks will show slower profit growth in 2014 on deleveraging
- Weak earnings growth for fossil fuel energy stocks on overcapacity and lukewarm global sentiment
- Austerity measures in property market will continue to affect banks and developers in Hong Kong
- High earnings visibility in China property sector in 2014 despite policy risk

### Risk assessments

- Low systematic risks in late 2013 suggest less room for improvement in 2014
- Sovereign credit risk is falling in China but rising in some SE Asia & Latin America countries
- China factor will affect Hong Kong stock market more than the QE factor
- The rising treasury yields in the U.S., China and Hong Kong in 2013 signal outflow of liquidity from low-risk assets but will raise opportunity cost of investors holding high-risk assets in 2014
- Stock markets in China and Hong Kong underperform in 2013 but turnover rise sharply, signaling investors' growing optimism in corporate earnings outlook and bargain-hunting in the market
- High valuation risk in the U.S. and Japanese stock markets

### Relatively low systematic risks in major stock markets in 4Q13 suggest less room for improvement in 2014

At late Nov 2013, volatility indices of DJIA, S&P 500, Nasdaq 100, Stoxx 50, FTSE 100, DAX, CAC 40, Nikkei 225, and Hang Seng Index (HSI) were 6.1% - 41.2% below their three-year average, or 67.0% - 77.3% below their three-year high. Systematic risks of stock markets in the U.S., Europe, Japan and Hong Kong are low in 4Q13. Hence, further upside potential of these stock markets in 2014 would be driven by the reduction in non-systematic risks (i.e. reduction of business risks and improved earnings among listed companies). Downside risks of these stock markets would include the unexpected surge in systematic risks, such as sharp contraction in global liquidity driven by slower-than-expected credit expansion in major central banks; unexpected energy shortage resulting from geo-political conflicts, which in turn would lead to global inflation; sovereign credit risk, which could be triggered by the burst of asset price bubble in the APAC region and lead to net outflow of FDI.

**Exhibit 1: Volatility index indicates limited room for decline in market risks**

Underlying Index	Ticker of Volatility Index	11/26/2013 Volatility Index	3 yr avg of VI	Spot vs. avg	3 yr high	Spot vs. high	3 yr low	Spot vs. low
DJIA	VXD	11.83	17.14	(31.0%)	42.64	(72.3%)	8.12	45.7%
S&P500	VIX	12.81	18.86	(32.1%)	48.00	(73.3%)	11.05	15.9%
Nasdaq 100	VXN	13.60	19.95	(31.8%)	47.23	(71.2%)	11.34	19.9%
Stoxx 50	V2X	14.51	24.61	(41.0%)	59.80	(75.7%)	14.17	2.4%
FTSE 100	VFTSE	11.58	18.44	(37.2%)	47.07	(75.4%)	7.84	47.7%
DAX	VDAX	11.64	20.53	(43.3%)	47.30	(75.4%)	11.53	1.0%
CAC 40	VCAC	13.41	22.80	(41.2%)	59.10	(77.3%)	11.34	18.3%
Nikkei 225	VNKY	23.04	24.57	(6.1%)	69.88	(67.0%)	16.12	43.2%
<b>Hang Seng Index</b>	<b>VHSI</b>	<b>15.99</b>	<b>20.87</b>	<b>(23.4%)</b>	<b>58.61</b>	<b>(72.7%)</b>	<b>12.18</b>	<b>31.3%</b>

Source(s): Bloomberg, ABCI Securities



Rising credit risks in SE Asia and Latin America

The credit derivative market indicates that sovereign credit risks in the U.S., UK, major Eurozone countries, Japan, Australia, and New Zealand have been improving in 2013. Meanwhile, the sovereign credit risks in certain SE Asia regions and Latin America are emerging. Looking forward, possible net outflow of FDI in SE Asia and Latin America triggered by contraction in global liquidity sharper than expected will pose major market risks to these regions.

Credit risks in China are manageable

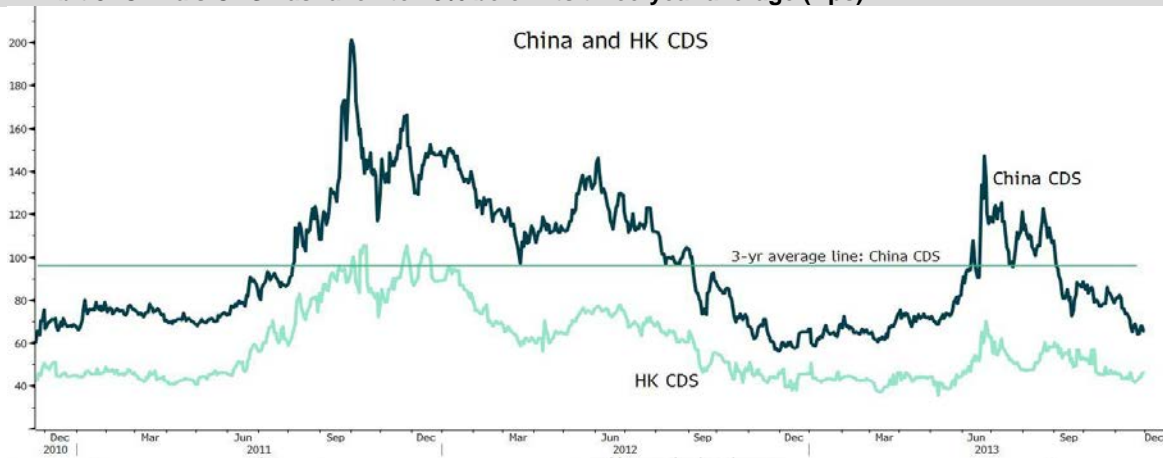
Credit quality of China's local-government financing vehicles (LGFVs) has been a major concern, as the amount of outstanding debts carried by the LGFV are unclear. According to the China Banking Regulatory Commission, the total outstanding loans due from LGFV in commercial banks were RMB 9,590bn by end-1Q13; the corresponding NPL ratio was 0.14%, representing 13.6% of total loans in the banking system by end-1Q13. Investigating the issue from a boarder perspective, we consider a LGFV entity as a state-owned enterprise (SOE) that is also owned by the local government. The total outstanding debt of a LGFV forms part of total liabilities of local government-owned SOEs. According to the monthly survey by the Ministry of Finance, total liabilities of local government-owned SOEs (excluding financial institutions) amounted to RMB 27,293.98bn by end-Oct 2013, representing 65.0% of total assets, or 50x of total profit for 10M13. In terms of financial leverage, local government-owned SOEs on average are similar to the central government-owned SOEs. However, repayment capability of local government-owned SOEs is weaker than the central government-owned SOEs due to weaker profitability in the former, which has led to concerns on the credit status of LGFVs. While we cannot negate the possibility that some SOEs are financially problematic, we believe they are of the minority. The latest statistics indicate that profitability of local SOEs is improving with narrowing profit decline. Growing profitability of these local SOEs will strengthen their debt repayment capability. The credit derivative market has already given its vote of confidence to China, as evidenced by the significant decline in China's five-year CDS since mid-2013 (refer to Exhibit 3).

Exhibit 2: Financial performance of non-financial state-owned enterprises (SOEs)

Table with 4 columns: As of Oct 31, 2013, Central government-owned SOE, Local government-owned SOE, Overall. Rows include Total assets, Total liabilities, Total profit, and various leverage ratios.

Source(s): Ministry of Finance, ABCI Securities

Exhibit 3: China's CDS has fallen to 29% below its three-year average (Bps)



Updated to Nov 26, 2013

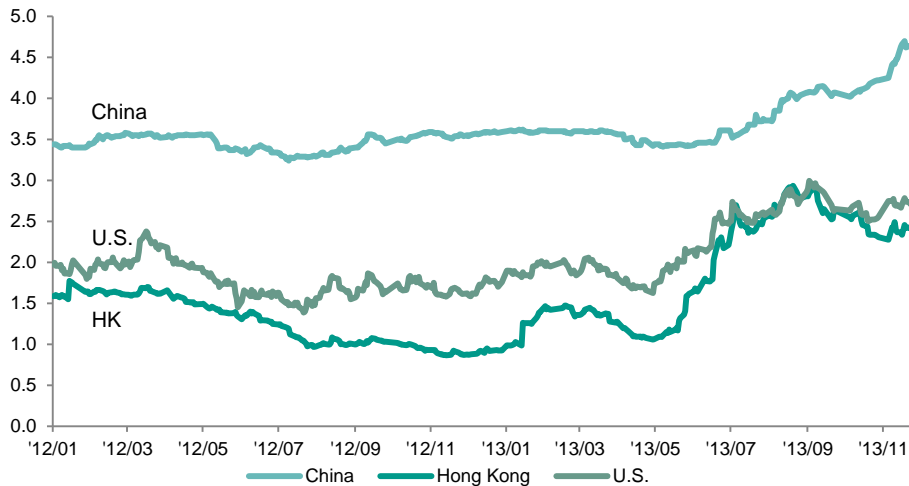
Source(s): Bloomberg, ABCI Securities



Surging treasury yields in China, Hong Kong and the U.S. raise opportunity costs of stock investors

The 10-year treasury yields in China, Hong Kong, and the U.S. climbed 105bp, 149bp, and 95bp, respectively, between end-2012 and Nov 26, 2013. Opportunity costs of yield investors in the stock markets are set to rise in 2014 if treasury yields continue to surge. To compensate for the potential loss, unsystematic risks of listed companies would have to decline (i.e. higher absolute earnings and dividends). Otherwise, stock prices could be subjected to downward correction.

Exhibit 4: 10-year treasury yields are trending up in China, Hong Kong, and the U.S. (%)



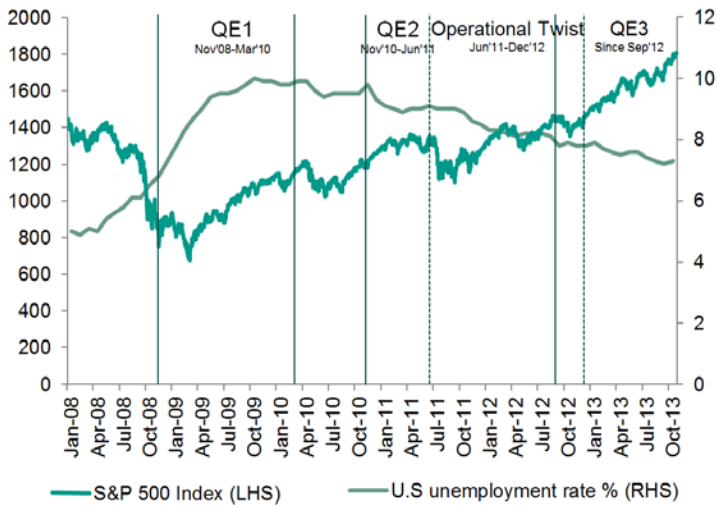
Updated to Nov 26, 2013  
Source(s): Bloomberg, ABCI Securities

Impact of QE tapering may be limited on Hong Kong and China stock markets

Continuous recovery in the U.S economy spurs concerns that the Fed may gradually taper off its QE3 program. In 2014-15, we believe the Fed would withdraw from QE in a cautious and gradual manner to avoid de-railing the U.S. recovery and sending shocks to the global economy. Between end-Sep 2012 (launch of QE3) and Nov 26, 2013, the HSI, HSCEI, and FTSE Xinhua A50 Index climbed 13.6%, 15.0% and 1.3% respectively. In contrast, S&P 500 in the U.S. and Stoxx 600 in Europe rallied by 25.1% and 20.0% during the same period. The substantial performance divergence suggests that other domestic or China-related factors were at work to eradicate much of the positive effects that the QE may have had on the Hong Kong stock market.



Exhibit 5: S&P 500, QE and unemployment rate (R:%)



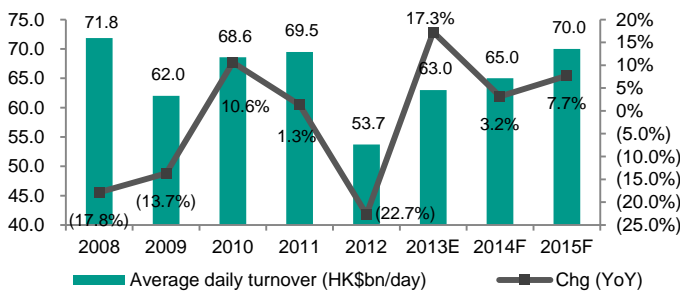
Updated to Nov 26, 2013  
Source(s): Bloomberg, US Census Bureau, Fed, ABCI Securities

Liquidity inflow to high-risk assets

As global systematic risk is reducing in 2013, yields of the Hong Kong treasury surge (i.e. liquidity outflow from the low-risk assets). The average daily turnover in the Hong Kong stock market has rebounded significantly in 2013 (i.e. liquidity inflow to high-risk assets). We expect average daily turnover in the Hong Kong stock market to continue to rise moderately in 2014-15 after a sharp rebound in 2013.

Although China's A-share market has underperformed in 2013, we estimate that its average daily market turnover would jump 53% YoY to RMB 197.3bn/day in 2013F, 15% higher than average daily turnover in 2011. The sharp increase in the A-share market turnover signals optimism in the stock markets are gathering and investors are accumulating stocks at bargain valuations.

Exhibit 6: Average daily turnover in Hong Kong mainboard (HK\$/day)



Source(s): HKEx, Bloomberg, ABCI Securities estimates

U.S. and Japanese stock markets: Rising valuation risk in 2014

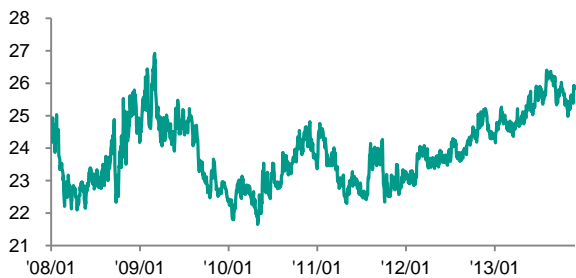
The valuation of MSCI HK is becoming more expensive in the APAC region after going up by nearly 7.67% YTD (up to Nov 26, 2013). Meanwhile, MSCI AP ex Japan and MSCI China were up 1.03% and 2.34% during the same period. Among major large-cap stocks listed in Hong Kong, non-China related stocks, such as those in Macau gaming and Hong Kong banking sectors, and international stocks in banking, insurance, and conglomerate sectors beat the market in 2013. In contrast, China's energy, insurance, banking and telecom stocks underperformed. China's IT & F&B stocks bucked the trend to outperform major China plays in 2013. These results are within expectation, given that cyclical stocks usually do



not thrive when economic risk is as high as that in 1H13. In contrast, China's IT and F&B stocks exhibit their defensiveness by delivering earnings growth despite uncertainty.

We see high valuation risk in the U.S. and Japanese stock markets. The DJIA (on Nov 26, 2013) has been trading at 1.75x FY14F PERG. Unless earnings of the U.S. stocks exceed market expectations significantly in 2014, the current valuation is unjustifiable. We also believe there is significant valuation risk in the Japanese stock market based on the weak profitability of companies and their high P/E and P/B valuations. Depreciation of the Japanese Yen may help support the export sector and reduce unemployment in the short term, but deepening trade deficit and the high government debt-to-GDP ratio of over 200% would constrain growth in the long term.

**Exhibit 7: Ratio of MSCI HK/MSCI AP ex Jap**



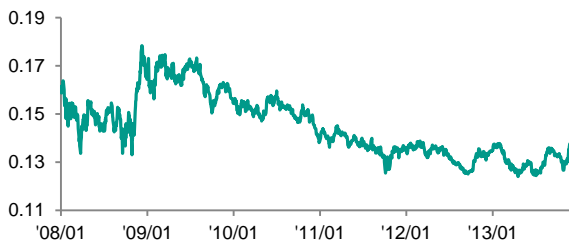
Source(s): Bloomberg, ABCI Securities

**Exhibit 8: Ratio of HSI/MSCI AP ex Jap**



Source(s): Bloomberg, ABCI Securities

**Exhibit 9: Ratio of MSCI China/MSCI AP ex Jap**



Source(s): Bloomberg, ABCI Securities

**Exhibit 10: Ratio of HSCEI/MSCI AP ex Jap**



Source(s): Bloomberg, ABCI Securities

**Exhibit 11: Performance of global major regional indices in 2013 (up to Nov 26, 2013)**

Major Index	11/26/2013	YTD	2013F P/E	2014F P/E	2014F P/E	2013F P/B	2014F P/B	2013F Yield	2014F Yield	2013F ROE	2014F ROE
MSCI WORLD	1,621.91	21.17%	15.78	14.23	1.30	2.02	1.88	2.49%	2.68%	12.8%	13.2%
MSCI AC ASIA PACIFIC	141.60	9.46%	13.93	12.44	1.04	1.46	1.36	2.59%	2.80%	10.5%	10.9%
MSCI AC ASIA PAC EX JAP	470.85	1.03%	13.12	11.62	0.90	1.60	1.47	3.09%	3.33%	12.2%	12.7%
MSCI EM	1,005.40	(4.72%)	11.65	10.36	0.83	1.49	1.36	2.77%	3.00%	12.8%	13.1%
MSCI EM ASIA	446.13	(0.28%)	11.97	10.42	0.70	1.55	1.40	2.45%	2.68%	12.9%	13.4%
MSCI CHINA	64.40	2.34%	9.99	9.11	0.95	1.46	1.31	3.27%	3.50%	14.7%	14.4%
MSCI HONG KONG	12,199.71	7.67%	16.53	14.87	1.33	1.32	1.25	2.77%	2.98%	8.0%	8.4%
DJIA	16,072.80	22.65%	15.18	14.05	1.75	2.87	2.63	2.15%	2.33%	18.9%	18.7%
S&P 500	1,802.75	26.40%	16.28	14.73	1.40	2.49	2.30	1.96%	2.14%	15.3%	15.6%
Stoxx 50	3,062.62	16.19%	14.02	12.50	1.03	1.39	1.32	3.69%	3.86%	9.9%	10.6%
Stoxx 600	322.24	15.22%	15.08	13.28	0.98	1.72	1.62	3.36%	3.62%	11.4%	12.2%
Nikkei 225	15,453.62	48.66%	19.75	17.48	1.35	1.66	1.55	1.52%	1.65%	8.4%	8.9%
CSI 300 Index	2,387.42	(5.37%)	10.49	8.91	0.50	1.49	1.32	2.49%	2.78%	14.2%	14.8%
Shanghai Composite	2,183.07	(3.79%)	9.61	8.50	0.65	1.31	1.17	3.19%	3.46%	13.6%	13.8%
FTSE CHINA A 50	7,372.98	(11.48%)	7.54	6.57	0.44	1.25	1.09	3.52%	3.89%	16.6%	16.6%
Hang Seng Index	23,681.28	4.52%	11.35	10.50	1.29	1.41	1.30	3.44%	3.68%	12.4%	12.4%
H-share Index	11,302.03	(1.17%)	8.33	7.65	0.87	1.24	1.11	3.83%	4.11%	14.9%	14.5%
Red Chip Index	4,612.40	1.79%	12.48	11.19	0.97	1.43	1.31	2.55%	2.73%	11.5%	11.7%
HS HONG KONG 35 Index	2,769.02	9.17%	15.89	14.32	1.30	1.34	1.27	2.95%	3.19%	8.4%	8.9%
HS High Dividend Yield Index	947.31	(2.72%)	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
HS Low Volatility Index	7,316.62	4.84%	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
HS High Beta Index	5,636.72	(4.72%)	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A

Source(s): Bloomberg, ABCI Securities estimates

### HSI: Single-digit growth in 2014

Owing to slowdown in earnings growth among the large-cap stocks in China's banking, telecom, and energy sectors, and Hong Kong 's property and banking sectors, we expect HSI and HSCEI to post earnings growth of 8.1% and 8.8% in 2014F. Despite the moderate earnings increase, capital return rate is expected to stabilize as more high ROAE stocks are incorporated into the indices. The ROAE of HSI would contract from 13.86% in 2012 to 12.83% in 2013F, and stabilize at 12.85% in 2014F. The ROAE of HSCEI would edge up from 15.77% in 2012 to 15.84% in 2013F but fall back to 15.31% in 2014F.

Based on the assumptions above, we forecast HSI to trade in the range of 21,032 - 26,429 in 2014. with end-2014 target at 25,095 to imply a P/B range of 1.15-1.45x (year-end target: 1.38x), or a P/E range of 9.33x-11.72x (year-end target: 11.13x). For HSCEI, we forecast a trading range of 10,851 - 15,097 in 2014, with end-2014 target at 13,680 to imply a P/B range of 1.07-1.48x (year-end target: 1.34x), or a P/E range of 7.35-10.22x (year-end target: 9.26x).

#### Exhibit 12: Trading range projection for HSI in 2014F

Projected valuation range			Corresponding trading range		
P/B high	P/B low	End-2014F	Index high	Index low	<b>End-2014F</b>
1.45	1.15	1.40	26,464	20,988	<b>25,551</b>
P/E high	P/E low	End-2014F	Index high	Index low	<b>End-2014F</b>
11.70	9.00	11.00	26,387	20,297	<b>24,808</b>
Div. yield low	Div. yield high	End-2014F	Index high	Index low	<b>End-2014F</b>
3.30%	4.0%	3.50%	26,436	21,810	<b>24,925</b>
Average			26,429	21,032	<b>25,095</b>

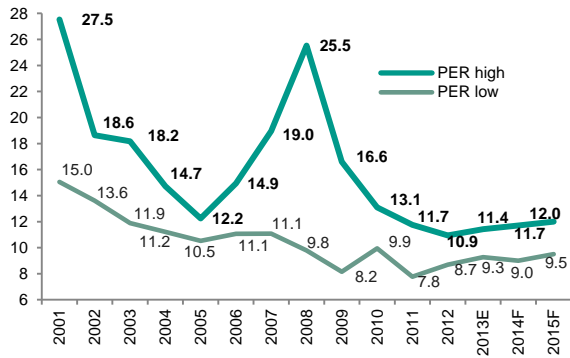
Source(s): ABCI Securities estimates

#### Exhibit 13: Trading range projection for HSCEI in 2014F

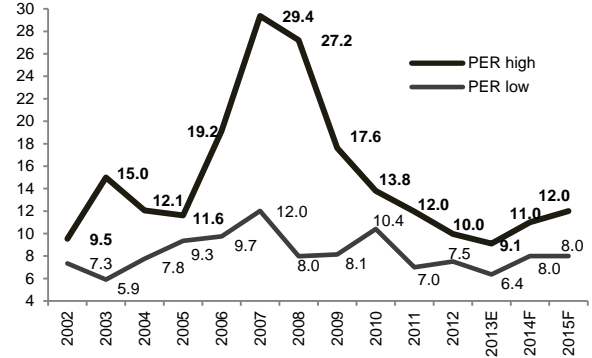
Projected valuation range			Corresponding trading range		
P/B high	P/B low	End-2014F	Index high	Index low	<b>End-2014F</b>
1.550	1.125	1.350	15,783	11,455	<b>13,747</b>
P/E high	P/E low	End-2014F	Index high	Index low	<b>End-2014F</b>
11.00	8.00	9.50	16,243	11,813	<b>14,028</b>
Div. yield low	Div. yield high	End-2014F	Index high	Index low	<b>End-2014F</b>
3.50%	5.00%	3.50%	13,264	9,285	<b>13,264</b>
Average			15,097	10,851	<b>13,680</b>

Source(s): ABCI Securities estimates

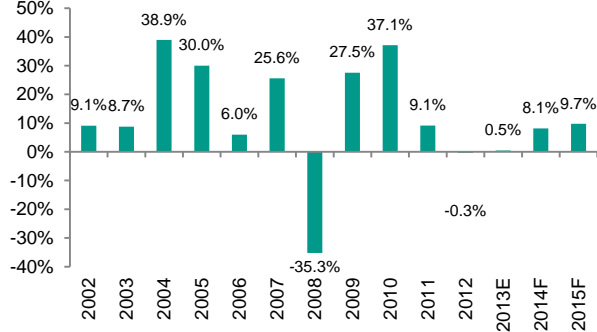


**Exhibit 14: P/E band of HSI (times)**


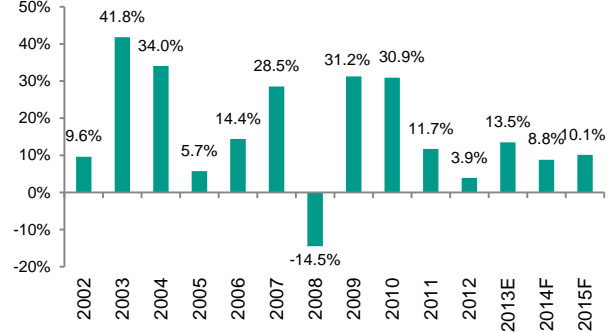
Source(s): Bloomberg, ABCI Securities estimates

**Exhibit 15: P/E range of H-share Index (times)**


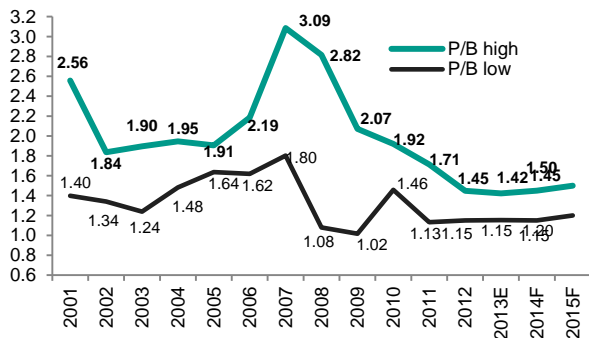
Source(s): Bloomberg, ABCI Securities estimates

**Exhibit 16: EPS growth of HSI (%)**


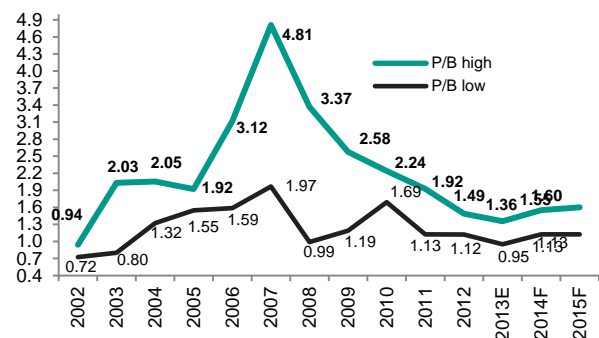
Source(s): Bloomberg, ABCI Securities estimates

**Exhibit 17: EPS growth of H-share Index (%)**


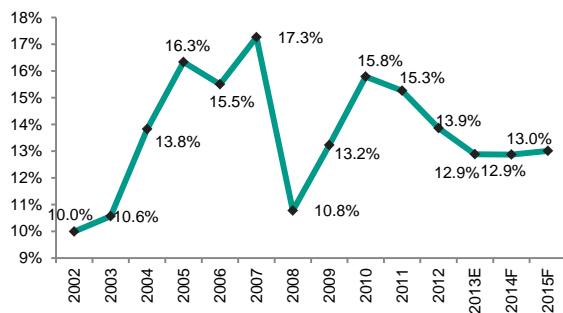
Source(s): Bloomberg, ABCI Securities estimates

**Exhibit 18: P/B band of HSI (times)**


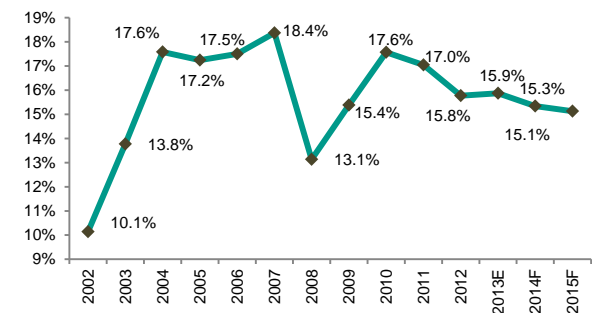
Source(s): Bloomberg, ABCI Securities estimates

**Exhibit 19: P/B band of H-share Index(times)**


Source(s): Bloomberg, ABCI Securities estimates

**Exhibit 20: ROAE of HSI (%)**


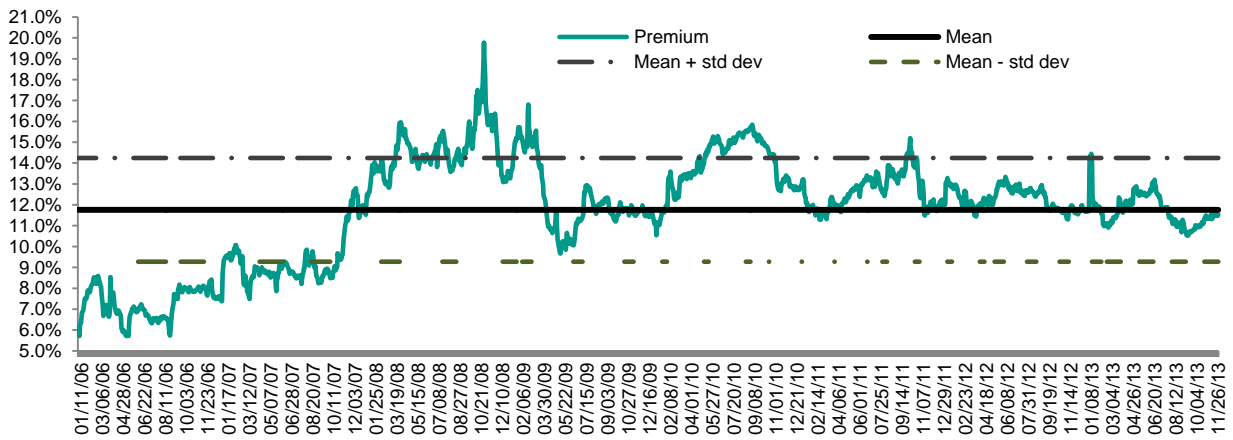
Source(s): Bloomberg, ABCI Securities estimates

**Exhibit 21: ROAE of H-share Index (%)**


Source(s): Bloomberg, ABCI Securities estimates

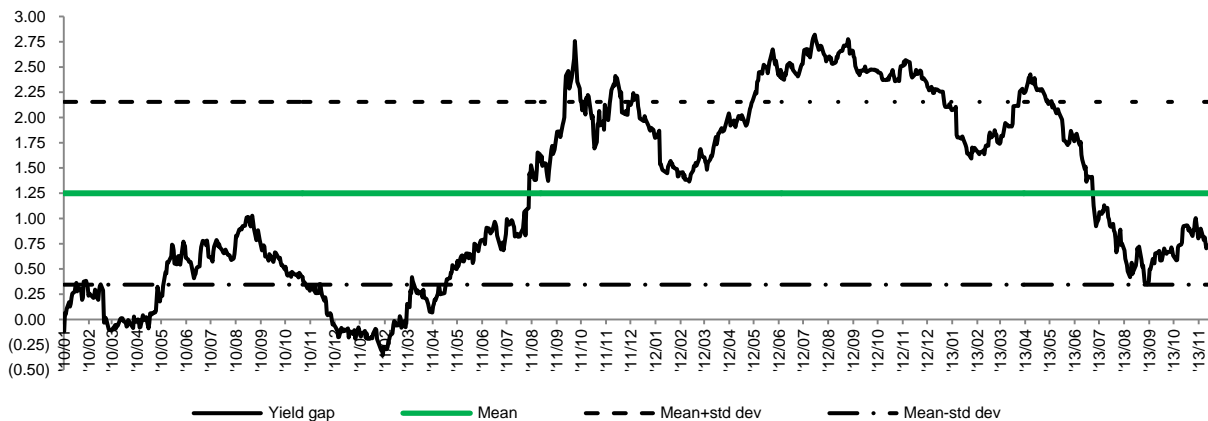


Exhibit 22: A positive sign to the market - Risk premium of Hong Kong stock market has been falling (%)



Updated to Nov 26, 2013  
Source(s): ABCI Securities, Bloomberg

Exhibit 23: Narrowing yield gap (HSI dividend yield minus Hong Kong gov't 10-yr treasury yield) raises opportunity cost of stockholding investors (%)



Updated to Nov 26, 2013  
Source(s): Bloomberg, ABCI Securities

Exhibit 24: Narrowing yield gap constrains rally of HSI



Updated to Nov 26, 2013  
Source(s): ABCI Securities, Bloomberg



Positive factors supporting HSI in 2014

- Profitability of local government-owned SOEs are likely to rise in FY14
- Uneven growth in various regions in China means that a regional approach in stock selection should be taken for the materials, energy, and banking sectors
- IT enhances economic efficiency and changes business channels, redefining competitive edges and nourishing the rapid growth in the e-commerce sector
- Demand for consumer services in gaming, entertainment, cultural and healthcare industries will continue to surge on the rapidly expanding middle class. Consumption will rise on positive wealth effect, income growth and improved social security net
- Increasing concerns on environmental pollution and policy demanding lower coal consumption per GDP bode well for clean energy sector
- Insurance stocks will show strong earnings recovery in 2013-15 due to expansion of investment channels and improvement in capital market
- Rising amounts of distressed assets in financial and non-financial sectors during the economic transformation cycle will lead to rising demand for asset management services

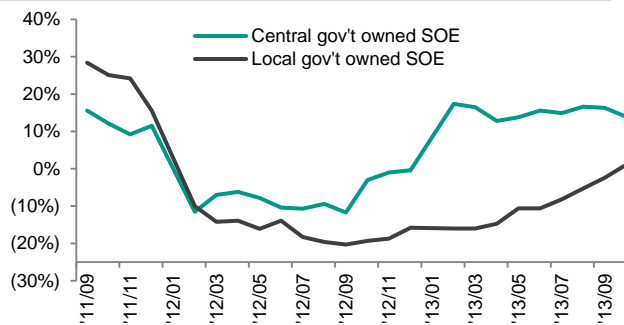
Negative factors enhancing downside risk of HSI in 2014

- Deleveraging of balance sheets among the large Chinese banks will result in slower earnings growth
- Earnings growth among the fossil fuel energy stocks are expected to decelerate due to (1) surpluses in coal output and capacity; (2) weakening energy demand driven by slowing global economic growth; (3) substitution effect of clean energy
- Austerity measures in Hong Kong property market will lead to higher earnings risk of the city's developers and local banks in 2014-15
- Despite strong earnings visibility in 2013-14, China property stocks will always be subjected to policy risk

Profitability of local SOEs to turn around in FY14

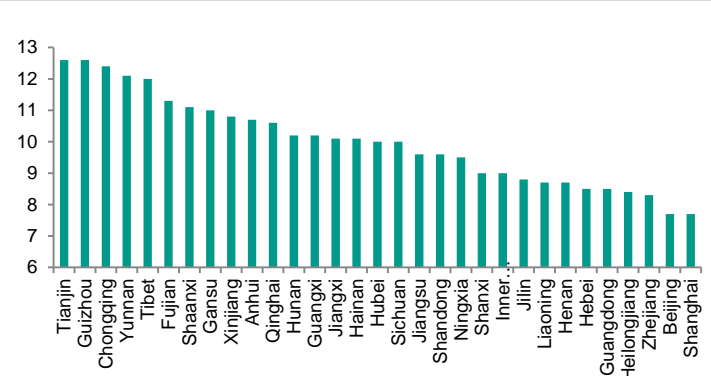
Regular survey by Ministry of Finance indicates profitability of SOEs kept improving (refer to Exhibit 25), driven by continuous revenue growth, better assets utilization and tightened control in operating costs. We believe the rising profitability would provide support to HSI and HSCEI in 2014. The expected increase in profitability among local SOEs would trigger an upward re-rating of the H-share sector and increase liquidity inflow. The plethora of IPOs of China-related companies in Hong Kong and the U.S. in 4Q13 signal the willingness of global investors to increase weighting on China plays.

Exhibit 25: Year-to-month changes in profit of non-financial SOE (YoY%)



Source(s): Ministry of Finance, ABCI Securities

Exhibit 26: Uneven GDP growth among China's regional economies in 9M13 (YoY%)



Source(s): NBSC, ABCI Securities

### **Uneven growth in various regions in China means that a regional approach in stock selection should be taken for the cyclical stocks**

Although economic growth in China is slowing, some of the regions in central and western China are able to achieve growth higher than the national average, as migrations of industries and workforce have accelerated urbanization and fixed assets investments. Uneven growth in regional economies will become a norm in coming years. Demand for construction materials, energy and financial services in the high-growth regions would surge. Regional cement producers, wind power producers, and city commercial banks would benefit more than their national peers whose nationwide operations would be affected by low economic growth in eastern China. We believe a regional approach in stock selection should be applied to identify outperformers in the future.

### **IT enhances economic efficiency and changes business channels, redefining competitive edges**

Traditional chain store operators position themselves as mid-stream players along the supply chain. E-commerce operators, however, are shortening the supply chain by eliminating the mid-stream players by acquiring one of the most valuable downstream assets – customer base. E-commerce is rapidly eroding the competitive edges of large players with high presence of physical stores. High physical presence in the consumer goods segment such as footwear, apparels, and daily-use articles represents a major cost burden or liability to large chain-store retailers, especially when the e-commerce operators are looting their market shares. E-commerce operators are not necessarily manufacturers. They adopt an asset-light business model, have large consumer networks, and utilize telecom and online payment technologies to provide various consumer services to end-users. We believe e-commerce would continue to expand in the next few years. Margins of traditional retail chain operators such as Belle (1880 HK), Daphne (210 HK), and China Resources (291 HK) would be squeezed. Tencent (700 HK), Alibaba, Baidu (BIDU US), and other niche players in e-commerce industry are redefining business edges in the supply chain of the real economy.

### **Demand for consumer services in gaming, entertainment, cultural, and healthcare industries will continue to surge on rapidly growing middle class via effects of positive wealth, income growth, and improved social security net**

China's tertiary industry dominated by the services industry grew by 8.4% YoY (vs. 8.1%YoY in 2012) in real terms for 9M13. The secondary industry dominated by manufacturing grew by 7.8% YoY (vs. 7.9% YoY in 2012) in real terms for the same period. The nominal GDP value of tertiary industry (RMB 17,597.5bn) exceeded the secondary industry (RMB17, 511.8bn) for 9M13. China's urban and rural household disposal income grew by 12.7% and 15.4% CAGRs over 2009-12. Continuous growth in household disposal income in urban and rural areas creates tremendous demand for consumer goods and services. We believe the consumer the sector of service sector would expand more rapidly than the consumer goods in coming years. Among the consumer goods counters, we are positive on the earnings prospect of Want Want (151 HK) and Hengan (1044 HK), and remain cautious on Belle (1880 HK) and China Resources (291 HK). For the service sector, we are bullish on the outlook of Galaxy (27 HK), Sands (1928 HK), Tencent (700 HK), and China Unicom (762 HK) but remain cautious on China Mobile (941) and Lenovo (992 HK).

### **Insurance stocks to show strong earnings recovery in 2013-15**

After the sector's disappointing performance in 2011-12, we expect insurance stocks to enter the cycle of strong earnings growth in 2013-15. Although price liberalization will raise the overall business risks of life insurers, liberalization of investment channels, diversification of investment assets, and the prospering bond market will enhance yields and reduce unexpected fluctuations in returns. Tightening liquidity in the Chinese banking system will drive up bond yields, and market value of bonds in portfolio (i.e. negative effect in the asset side of balance sheet) will decline although reserve liabilities will also be reduced (i.e. positive effect in the liabilities side of balance sheet). We believe the net effect of the rising bond yield is positive to insurers. EPS of China Life (2628 HK), Ping An (2318 HK) and AIA (1299 HK) jumped 67.6%, 28.4%, and 33.3% YoY, respectively, in 1H13, and we expect their EPS to grow at 19.5%, 15.2% and 12.5% CAGRs in FY13F-15F. The three insurance stocks have a joint weighting of ~10.5% in HSI. As earnings growth of large H-share banks is expected to slow in FY14F-15F, funds in the China's banking sector may be redirected to China's insurance sector. In fact, the Chinese insurance stocks have been performing better than their banking counterparts since end-June 2013.

**Exhibit 27: China insurance stocks**

Ticker	11/26/2013	Price (HK\$)	P/EBV (x)	Implied New contracts multiples (x)	1H13 New contracts growth (YoY)	P/B (x)	1H2013 ROAE (half yr)	30/6/2013 Life insurers Solvency margin	30/6/2013 P&C insurers Solvency margin
<b>Life insurers</b>									
2628	China Life	24.65	<b>1.51</b>	8.85	0.76%	<b>2.37</b>	7.17%	237.9%	N/A
1336	NCI	27.10	<b>1.09</b>	1.36	-4.82%	<b>1.76</b>	5.95%	174.2%	N/A
<b>Life &amp; P&amp;C insurers</b>									
2318	Ping An	71.95	<b>1.44</b>	8.08	14.16%	<b>2.59</b>	10.78%	176.1%	179.5%
2601	China Pacific	31.65	<b>1.61</b>	12.14	4.75%	<b>2.34</b>	5.68%	193.4%	156.9%
1339	PICC Group	3.93	<b>1.54</b>	9.60	8.56%	<b>1.84</b>	11.06%	182.6%	195.2%
2328	PICC P&C	12.54	-	-	-	<b>2.32</b>	14.76%	-	195.2%
966	Taiping	14.72	<b>0.93</b>	(0.83)	28.60%	<b>1.77</b>	3.70%	223.0%	173.0%

Source(s): Bloomberg, ABCI Securities

**Rising distressed assets in China's financial and non-financial sectors beckon for management**

Total NPL of commercial banks in China bottomed in 3Q11, increasing by RMB 155.8bn between end-3Q11 and end-3Q13. During the period, commercial banks have added RMB 513.7bn in loan loss provisions, which represented 3.3x of net addition of NPL. As banks are expecting NPL to climb further, NPL cover ratio of the commercial banks increased from 270.7% at end-3Q11 to 287.0% at end-3Q13. Total NPL of the commercial bank industry reached RMB 563.6bn at end-3Q13. As the NPL cover ratio was 287%, the credit loss was largely recognized. However, the non-performing assets, which are mostly zero-yield assets in the banks' balance sheets, are sinking cost. Holding these non-performing assets will raise both the administrative and opportunity costs for banks. In contrast, liquidating non-performing assets (via divestment or assets recovery) and redeploying funds to other positive-yield assets will help enhance shareholders' value. The increase in distressed assets in financial and non-financial sectors will expand the deal sources for the four largest distressed asset management companies in China. Distressed asset management companies with strong capital bases could provide support to commercial banks in terms of liquidating the latter's non-performing assets. This will create a positive feedback loop to the ecosystem in China's banking industry.

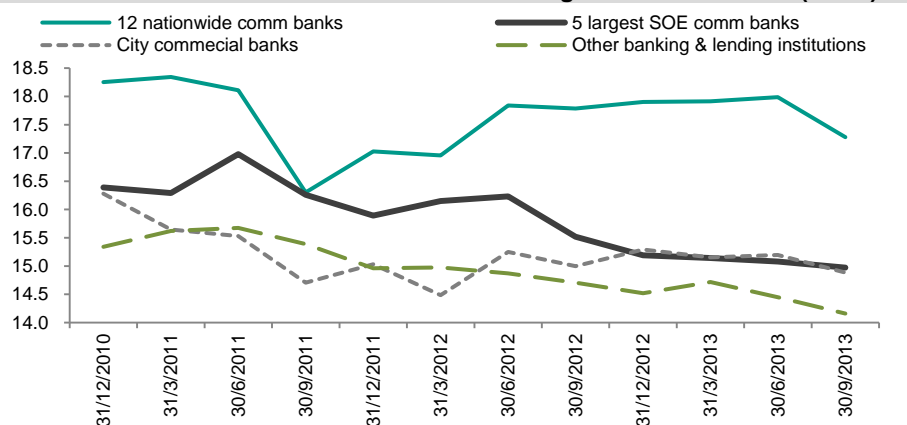
## Negative factors enhancing HSI's downside risks

### Slowdown in profit growth among the large H-share banks as deleveraging continues and competition intensifies

According to CBRC statistics, banking institutions are deleveraging their balance sheets and we expect this trend to continue in 2014-15. The total assets-to-net assets ratio of all banking institutions declined from 16.34x at end-2010 to 15.71x at end-2011, 15.41x at end-2012, and 15.07x at end-Sep 2013. In particular, the five largest state-owned commercial banks have been accelerating their deleveraging paces since 2012. Their total assets-to-net assets ratio declined from 16.39x at end-2010 to 15.89x at end-2011, 15.19x at end-2012, and 14.97x at end-Sep 2013. As net interest income accounted for ~78% of total operating income in the industry, the slowdown in asset growth will drag down growth in net interest income and total operating income. As the large banks, which are usually considered as systematically important banks, are relatively keen on deleveraging, their net interest growth has been severely impacted. For 9M13, net interest income growth of the five largest state-owned commercial banks averaged at 8.25% YoY, compared to the average growth of 11.32% YoY among the eight listed mid-cap commercial banks with nationwide presence. Worse yet, the net fee and commission income of large banks also grew slower than their smaller counterparts, as the latter have been strengthening the relevant businesses aggressively to reduce reliance on net interest income. For 1Q-3Q13, net fee and commission income of the five largest state-owned commercial banks grew 19.97% YoY on average, as compared to the 56.57% average increase among the eight listed mid-cap banks.

EPS of the five largest state-owned commercial banks (ICBC, CCB, ABC, BOC and BOCOM) grew 27.7%/ 19.2%/ 14.0%/ 12.4% YoY on average in FY10/FY11/FY12/1H13, respectively. The decelerating EPS growth would extend into 2014. Factoring in the negatives related to the deleveraging and the slowdown in net interest income growth among the big Chinese banks, the market expects EPS of the Big Four (ICBC, CCB, ABC, BOC) to grow at an average of 9.5%/6.9%YoY in FY13F/FY14F. H-share banks have a total weighting of ~16.5% in the HSI. The expected slowdown in their profit growth in 2014 would potentially become a drag to the benchmark index performance. Despite the expected slowdown in EPS growth, the Big Four are currently trading at 0.85x FY14F PEG (as of Nov 27, 2013). We believe the counters are undervalued and an upward revaluation is possible in the short term.

**Exhibit 28: Total assets-to-net assets ratio among the Chinese banks (times)**



Source(s): CBRC, ABCI Securities

### Surplus capacity in the coal sector, weakening energy demand, and increased use of clean energy will drain momentum of fossil fuel energy stocks

The supply and demand of fossil fuel energy resources in coming years will dictate their earnings outlook. In view of the surplus capacity in the global coal supply, the weak energy demand driven down by slowing global economic growth, and the increasing substitution effect from clean energy, we are cautious on the outlook of fossil fuel energy producers. Although geopolitical tension may cause fluctuations in fossil fuel energy prices from time to time, it is usually considered as a temporary supply-side factor. The heavy capex in shale gas, as well as exploration and development in coal bed gas in recent years will undoubtedly reduce the long-term demand for traditional forms of fossil fuel such as crude and coal. Most of new

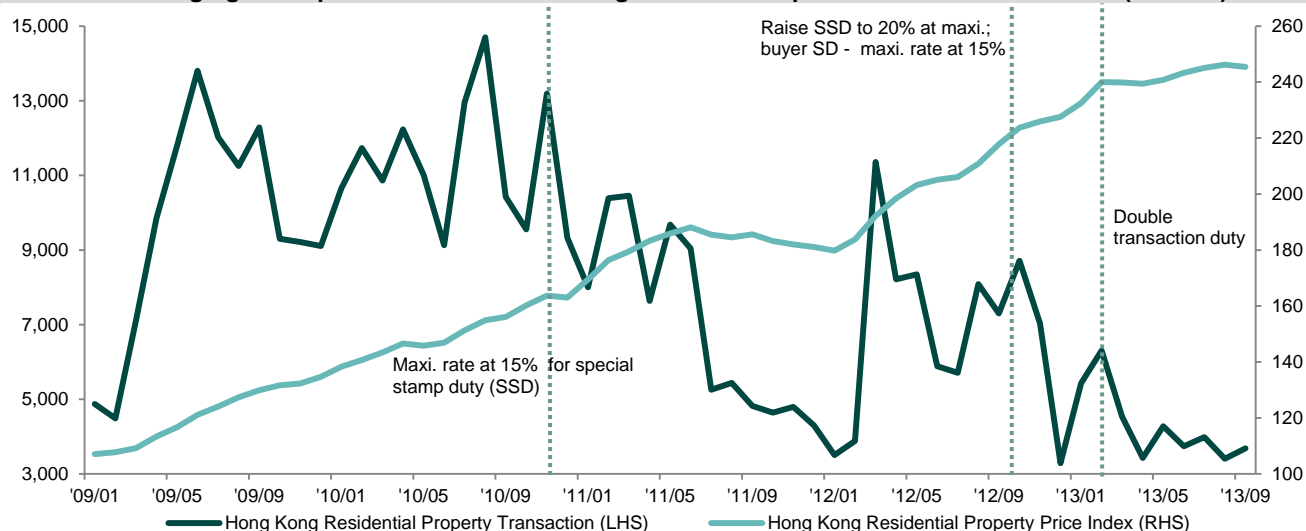
large-scale nuclear plants in China will commence operations starting from 2015. Demand for fossil fuel as energy sources to generate electricity will be depressed further in the long term. We expect to see single-digit earnings growth among crude producers such as PetroChina (857 HK), Sinopec (386 HK), and CNOOC (883 HK) in 2014. We also expect a flat to negative earnings growth among coal producers such as China Shenhua (1088 HK) and China Coal (1898 HK).

### Austerity measures in the Hong Kong property market will pump up earnings risk of developers and banks in 2014-15

Austerity measures that substantially raise the total transaction costs of home purchases to curb speculation in the Hong Kong property market have been effective in 2013 (refer to Exhibit 29). Although home prices on average have stayed firm in 2013, property transactions have declined significantly. New home sales value declined 43.18% YoY for 9M13, against the YoY growth of 0.06%/0.91%/8.79% in 2012/2011/2010. As transaction volume is shrinking rapidly, it is a matter of time before home prices adjust downwards. We believe the home-price bubble would deflate in 2014-15, with the pace of deflation accelerating in 2015 when the local interest rates follow the U.S. rates to go up. The sharp decline in new home sales in 2013 suggests increasing earnings risk of property developers in coming years (refer to Exhibit 30). We expect to see negative pre-exceptional earnings decline in Hong Kong Properties (16 HK), Henderson Land (12 HK), Cheung Kong (1 HK), Hang Lung (101 HK), New World (17 HK), Wharf (4 HK) and Sino Land (83 HK) in their current and next fiscal years.

Earnings risk of local banks is mounting as demand for property mortgage loans continues to shrink. Moreover, credit risk of Hong Kong banks in 2014-15 would surge when home-price bubble starts deflating. We expect to see mid-single digit to low-double digit EPS growth in Bank of East Asia (23 HK), BOC HK (2388 HK) and HSBC (5 HK). In particular, earnings of Hang Seng Bank (11 HK) would have a relatively high downside risk in the next two fiscal years.

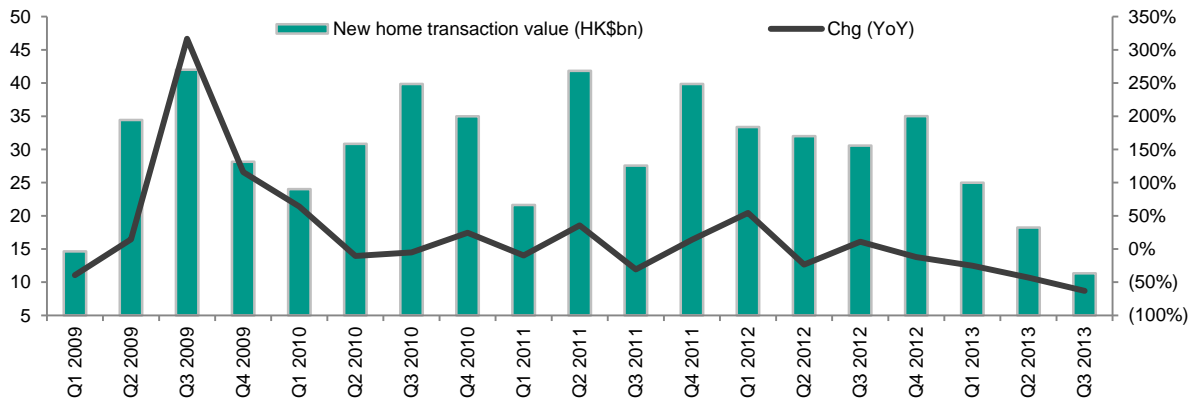
**Exhibit 29: Diverging home price and transaction- a signal that home price bubble is set to deflate (L:Units)**



Source(s): Bloomberg, Hong Kong Rating & Valuation Dept., Hong Kong Land Registry



Exhibit 30: Sharp decline in Hong Kong's new home sales leads to higher earnings risk among developers (HK\$ bn, R:YoY%)



Source(s): Hong Kong Land Registry, ABCI Securities

Policy risk will always be a threat to the China property sector despite strong earnings visibility in 2014

New home sales in China surged 22.3% YoY in GFA, or 32.6% YoY in value for 10M13 while the implied ASP of new homes climbed 8.4% YoY. Although sentiment in the residential property market is reviving, construction starts grew only by 5.2% YoY and GFA of residential property under construction rose 12.1% YoY during the same period. Moreover, land sales declined by 3.6%YoY in volume but surged 11.7% YoY in value. We expect average land cost of developers to rise and future supply of new homes in the private sector to remain tight in 2014. New supply from the public sector is unlikely to see substantial rise due to the financial constraints of local governments. The strong property sales in 2013 will strengthen the earnings visibility of China property developers in 2014. As ASP trends up this year, apprehension over new austerity moves on the fiscal (e.g. property tax, transaction tax) and monetary (e.g. lower loan-to-collateral ratio, higher lending rates, and quotas on mortgage loans) sides are mounting. Policy risk will continue to be an overhang for the China property sector in 2014-15. We believe a healthy balance sheet, a fast asset turnover rate, and a disciplined land replenishment approach would be the best armors for the developers to defend themselves against any threats arising from the ever-changing regulatory environment.

However, we remain cautious on the earnings outlook of the Chinese developers in 2015 because low new construction starts and volume of land sales in 2013 imply that presale in 2014 would be restricted. Also, the higher land cost in 2013 adds to the downside risk of profitability, as reported gross margin in 2015 may decline. While much of the impacts may only be realized in the reported earnings for 2015, we believe share prices of developers in 2014 would be pressured by the apprehension.





In general, we prefer China property developers over the Hong Kong ones. Among the China property developers, EPS of China Overseas Land (688 HK) and China Resources Land (1109 HK) are expected to grow at 17% and 22% CAGRs over 2013F-15F.

For further information on the Investment Strategy, please contact

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## Risks overdone; sector re-rating in 2014

-  Negative factors such as NIM squeeze, risk from shadow banks, and NPL are overdone
-  Deposit rate will not be fully liberalized any time soon, but ceiling may rise
-  Banks will continue to manage NPL
-  We prefer quality big banks. Our top picks include ICB and CCB

**Negative factors overdone.** Valuation of the China banks sector has been depressed by different negative factors such as NIM squeeze on interest rate liberalization, risks of a growing shadow bank system, local-government financing vehicles (LGFV), property-related loans, and rising NPL. However, we believe these negative factors are overdone and expect a sector re-rating to begin in 2014 on better-than-expected sector statistics and consistent improvement in banks' performance.

**NIM - More sustainable than the market believes.** Based on our 2014F economic growth forecast of 7.6% in, we expect new loans to be RMB 9.5-10tr in 2014F (2013F: RMB 9-9.5tr). We believe this loan growth would provide sufficient support to sustain pricing. According to the 3Q13 results, banks' NIM has stabilized after repricing from previous rate cuts in mid-2012 and continuous effort in optimizing balance sheet mix.

**Impacts of interest rate liberalization are limited.** Nevertheless, ongoing development in interest rate liberalization should still pose some impacts on banks' NIM, yet we expect the deposit rate ceiling will stay in place until the deposit insurance system is established. Our base case scenario expects deposit rate ceiling to rise once or twice in 2014, with the deposit insurance system to be fully established in 2015. Meanwhile, both interest rates and RRR should stay at current levels, and the PBOC would continue to use repo and reverse repo as primary tools to adjust system liquidity.

**Manage asset quality.** System asset quality remained sound in 3Q13 at 0.97%, although new NPL from coastal area in the manufacturing, wholesale and retail industries have been rising. We notice that banks have been increasing their efforts to write off and dispose NPL portfolio in recent quarters. These practices will be crucial for banks to maintain a quality balance sheet over the NPL cycle in 2014-15 and we believe the process will continue.

**Prefer strong big banks.** We continue to prefer quality big banks, such as ICBC and CCB, among the H-share bank universe for their diversified businesses and defensiveness against policy risk. The sector is currently trading at 0.72x-1.09x 14 P/B, or 1-1.5s.d below historical mean P/B.

**Risk factors:** 1) Competition from interest rate liberalization; 2) Collapse of shadow banking system; 3) Increased competition from non-bank FIs.

## China Banks Sector

### OVERWEIGHT

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#### Key Data

Avg.14F P/E (x)	5.27
Avg.14F P/B (x)	0.89
Avg.14F Dividend Yield (%)	5.52

Source(s): Bloomberg, ABCI Securities estimates

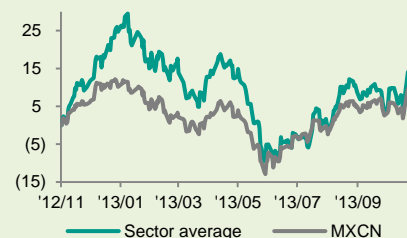
#### Sector performance (%)

	Absolute	Relative*
1-mth	9.06	3.01
3-mth	15.54	3.14
6-mth	(1.12)	(5.94)

\* Relative to Hang Seng Index

Source(s): Bloomberg, ABCI Securities

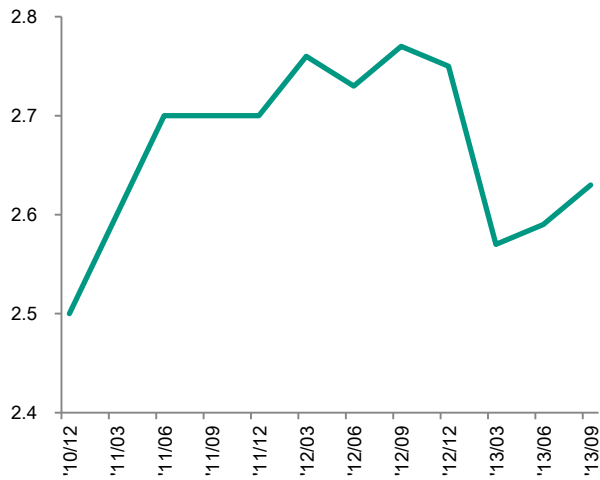
#### 1-Year Sector performance (%)



Source(s): Bloomberg, ABCI Securities

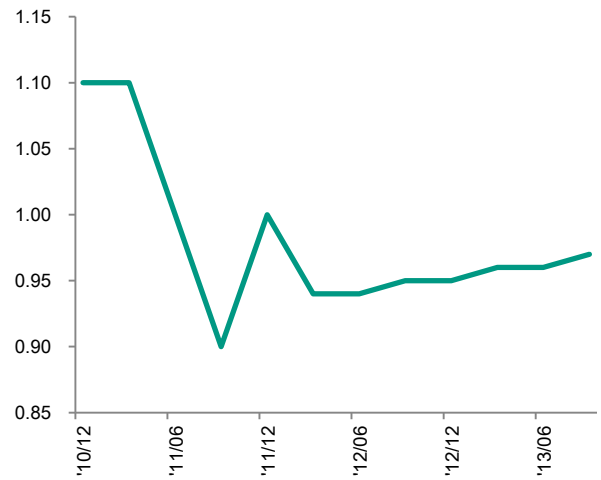


**Exhibit 1: System NIM trend (%)**



Source(s): CBRC, ABCI Securities

**Exhibit 2: System NPL trend (%)**



Source(s): CBRC, ABCI Securities

**Exhibit 3: System ROE trend (%)**



Source(s): CBRC, ABCI Securities

**Exhibit 4: System LDR trend (%)**



Source(s): CBRC, ABCI Securities

**Sector Valuation Summary (Data as of Nov 27, 2013)**

Company	Ticker	Rating	TP (HK\$)	Upside (%)	FY13F P/E(x)	FY14F P/E (x)	FY13F P/B (x)	FY14F P/B (x)	FY13F Yield (%)	FY14F Yield (%)
ICBC	1398 HK	BUY	7.36	32.6	6.02	5.61	1.20	1.05	5.72	6.13
CCB	939 HK	BUY	8.74	39.8	5.90	5.49	1.15	1.02	5.78	6.20
BOC	3988 HK	BUY	4.33	15.8	5.71	5.42	0.91	0.82	5.88	6.18
BoCom	3328 HK	BUY	7.12	24.0	5.53	5.25	0.80	0.72	4.75	5.03
CMB	3968 HK	BUY	20.60	24.5	6.31	5.98	1.24	1.09	4.42	4.73
MSB	1988 HK	BUY	14.02	53.6	4.97	4.51	1.07	0.90	4.31	4.76
CITICB	998 HK	HOLD	5.91	31.3	5.07	4.68	0.82	0.73	4.56	4.92

Source(s): Bloomberg, ABCI Securities estimates

## Looking ahead - More good than bad

- ✍ Expect 2014 to be a less rosy year due to rising policy risk and land costs
- ✍ Long-awaited property tax is likely to be implemented in 2014
- ✍ We forecast that residential ASP will remain flat; presale will grow 10%
- ✍ Prefer commercial developers and small residential plays with sufficient landbank

**2014: A less rosy year for China property sector.** 2013 has been a prosperous year for developers - national property price rose 8.4% YoY while developers' presales surged 33% YoY in 10M13. Entering 2014, we expect 1) reemergence of policy risks and 2) rising land cost to curb growth in the sector. Overall, we expect property price to be flat in 2014, while presales growth among developers will moderate from 35% in 2013 to 10% in 2014.

**Property tax to be the major policy risk.** We believe property tax is likely to be introduced nationwide. So far, such policy has only been implemented in Shanghai and Chongqing, with a mild tax rate at 0.6%-1.2% of the market value of specified residential properties (e.g. second home, villa or luxury apartment). However, if the long-rumored Hangzhou tax model (with a maximum tax rate at 8% of transaction value) is implemented nationwide in 2014, we believe that property price would be curbed effectively.

**Rising land cost to hurt margin.** Land market has been heating up during 2H13 with various cities registering record-high transaction prices. As developers' optimism has been boosted by strong presales in Sep/Oct, competition for land began to intensify. We expect rising land cost to hurt developers' gross margins in 2014.

**Long-term fundamental remains intact.** Despite the policy risk and heating land competition, we expect rising urbanization and relaxation of the one-child policy would drive property demand in the long run. Thus, we maintain our **Overweight** outlook for the sector.

**Prefer commercial plays subjected to lower policy risks.** We prefer commercial property players such as Franshion (817 HK) and China South City (1668 HK) for their defensiveness against tightening risks. For residential developers, we prefer small players with sizeable landbank to avoid high-cost land replenishment in an overheated market. Our preferred residential picks are Kaisa (1638 HK) and Greentown (3900 HK).

**Risk factors:** 1) Stronger-than-expected tightening by government; 2) intensifying land competition; 3) Aggressive price cut to clear inventories may hurt margin.

## China Real Estate

### OVERWEIGHT

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#### Key Data

Avg.14F P/E (x)	5.4
Avg.14F P/B (x)	0.9
Avg.14F Dividend Yield (%)	5.0

Source(s): Bloomberg, ABCI Securities estimates

#### Sector performance (%)

	Absolute	Relative*
1-mth	(2.1)	(6.4)
3-mth	(0.1)	(4.4)
6-mth	(1.1)	1.8

\* Relative to Hang Seng Index

Source(s): Bloomberg, ABCI Securities

#### 1-Year Sector performance (%)



Source(s): Bloomberg, ABCI Securities

### Commercial Picks

**China South City (1668 HK):** China South City (CSC)'s presale in 2Q14 (fiscal year ended in Mar) was up 234% YoY to HK\$ 3.57bn. CSC's business model is defensive against rising land cost as local governments are willing to provide land at low costs to developers of trade and logistic park. CSC is our top pick for the China property sector

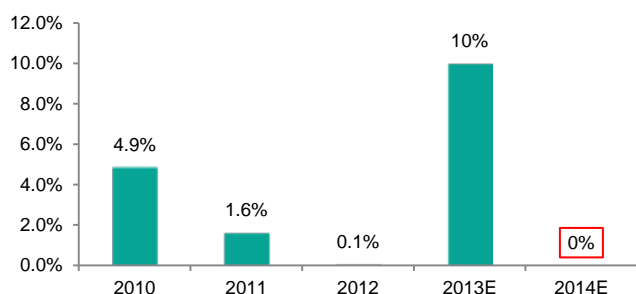
**Franshion (817 HK):** Franshion achieved RMB 6.1bn in sales for 10M13 from its primary land development project, Meixi Lake Phase 1. We believe its acquisition of the Meixi Lake Phase 2 will further boost its primary land business. The Group's exposure to investment properties would also render it more defensive against policy risk.

### Residential Picks

**Kaisa (1638 HK):** As at June 2013, Kaisa has a landbank of 24.8mn sqm, which is more than sufficient for next 5 years of development. Also its redevelopment pipeline allows an alternative way of land acquisition at low prices, enabling better gross margin no less than 35% compared to the sector average of 28%-30% only. Kaisa is our top pick for the China residential property sector.

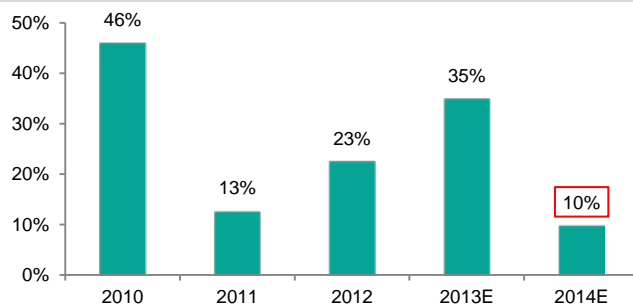
**Greentown (3900 HK):** We like Greentown for its improved balance sheet and quality brand name. By raising more low-cost offshore debt in 2013, Greentown's gross finance cost decreased 54%YoY to RMB 994mn in 1H13. In addition, its projects in Shanghai launched in Sep-Oct achieved impressive ASP (e.g. Francais Demeure: RMB 51k/sqm; Dynasty on the Bund: RMB 73k/sqm).

**Exhibit 1: Property price growth in China (YoY%)**



Source(s): NBS, ABCI Securities estimates

**Exhibit 2: Presales growth of major developers in China (YoY%)**



Source(s): Companies, ABCI Securities estimates

### Sector Valuation Summary (Data as of Nov 27, 2013)

Company	Ticker	Rating	TP (HK\$)	Upside (%)	FY13F P/E(x)	FY14F P/E (x)	FY13F P/B (x)	FY14F P/B (x)	FY13F Yield (%)	FY14F Yield (%)
<b>Commercial property</b>										
CSC*	1668 HK	BUY	3.00	47.8	6.1	3.5	0.7	0.6	4.9	7.4
Franshion	817 HK	BUY	3.30	32.0	8.1	6.4	0.9	0.8	4.0	4.8
<b>Residential property</b>										
Kaisa	1638 HK	BUY	3.10	29.7	4.3	3.0	0.6	0.5	0.0	0.0
Greentown	3900 HK	BUY	17.60	33.7	4.6	4.1	1.0	0.8	5.3	5.8
Sunac	1918 HK	BUY	6.30	21.9	4.5	3.1	1.0	0.8	2.2	3.3
COLI	688 HK	HOLD	25.00	6.6	9.3	8.1	1.8	1.6	2.2	2.5

\* CSC figures are based on Mar-end 2014 and 2015 estimates

Source(s): Bloomberg, ABCI Securities estimates

## Another good year for brokers

- ✍ 2013 YTD ADT of RMB 201bn is better than our base case scenario
- ✍ We forecast CSI300 to rise by 5%-10% in 2014E, while ADT would hit RMB170bn-190bn in our base case scenario
- ✍ Industry consolidation could be a catalyst for the sector
- ✍ CGS is our top pick based on sustainable ADT

**Higher-than-expected ADT in 2013.** Average daily turnover (ADT) has been stronger than our base-case scenario of RMB 145bn so far in 2013, reaching RMB 241bn in Oct 2013, and surged from RMB 129bn in 2012 to RMB 201bn in 10M13. We believe the turnover has been driven up the improved A-share equity performance in 2H13, delayed resumption of China primary market and fast growth in innovative products such as margin financing.

**Margin financing to propel revenue growth.** CSI300 is approaching to the 2,400 level by end-2013, and we expect it to grow by 5%-10% in 2014F to 2,500-2,600. Erring on the conservative side, we expect China ADT to be between RMB 170bn and RMB 190bn in 2014F in our base case scenario, considering the possibility that liquidity would be redirected to primary market from the secondary one when the CSRC officially restarts the IPO approval procedures. We believe the deal size in the IPO market would be relatively small at the beginning and therefore their impacts on ADT would be limited. Meanwhile, margin financing would continue to propel revenue growth. As of Aug 2013, total margin financing balance was RMB 248bn, up by over 200% compared to Dec 2012. This represented ~1% of total market cap compared to 0.3% in Dec 2012. We expect system margin financing balance to grow by 60%-100% in both 2014F and 2015F.

**Industry consolidation as catalyst.** According to media reports, CGS may merge with other brokerages under the common control with Huijin, which includes CIS, CICC, Shenyin Wanguo, Hongyuan and China Securities. Although we believe industry consolidation would be an effective way to grow in a low concentration industry, the timing and deal structure of the potential mergers are still highly uncertain at present. Yet continuous news flow should create positive catalyst for the sector and if merger occurs between brokerages with a common shareholder, the pricing is likely to favor the acquirer.

**BUY CGS on optimism over ADT.** We continue to prefer CGS over CITICS and HTS, given the strong momentum in China's ADT and the resumption of IPO approvals in China. CGS is currently trading at 14.2x FY14F P/E and breached our last TP of HK\$6.2. We maintain our **BUY** rating with TP under review.

**Risk factors:** 1) Sharp declines in capital market turnover; 2) Prolonged suspension of primary market; 3) Slowdown in China's economic growth.

## China Securities Sector

### OVERWEIGHT

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#### Key Data

Avg.14F P/E (x)	18.92
Avg.14F P/B (x)	1.59
Avg.14F Dividend Yield (%)	2.05

Source(s): Bloomberg, ABCI Securities estimates

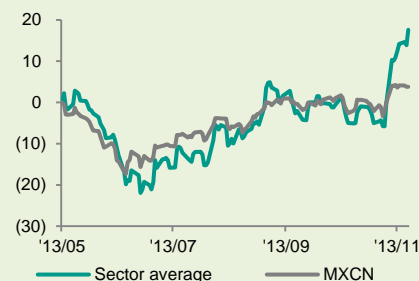
#### Sector performance (%)

	Absolute	Relative*
1-mth	23.91	17.05
3-mth	28.84	15.02
6-mth	14.35	8.78

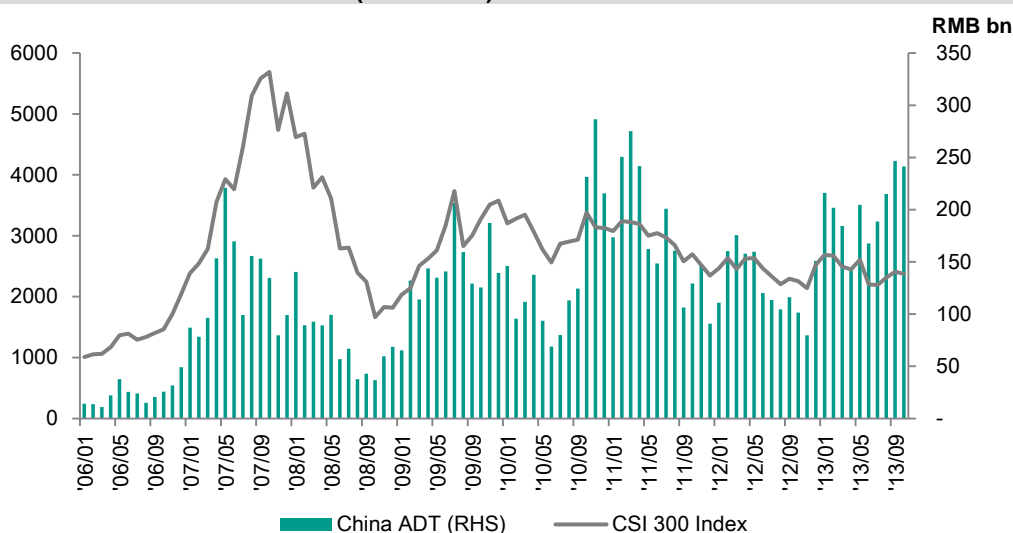
\* Relative to Hang Seng Index

Source(s): Bloomberg, ABCI Securities

#### Sector performance (since May 2013, %)



Source(s): Bloomberg, ABCI Securities

**Exhibit 1: CSI300 vs. China ADT (R: RMB bn)**


Source(s): Bloomberg, ABCI Securities

**Sector Valuation Summary (Data as of Nov 27, 2013)**

Company	Ticker	FY13F P/E(x)	FY14F P/E (x)	FY13F P/B (x)	FY14F P/B (x)	FY13F Yield (%)	FY14F Yield (%)
<b>China</b>							
CITICS - A	600030 CH	26.84	20.69	1.58	1.50	2.27	2.46
HTS - A	600837 CH	26.18	21.52	1.80	1.69	1.58	1.56
GF Securities	000776 CH	25.07	21.21	2.19	2.08	na	na
CM Securities	600999 CH	24.64	19.70	1.87	1.75	1.38	1.38
Huatai Securities	601688 CH	22.00	17.63	1.42	1.36	1.84	1.63
Everbright Securities	601788 CH	20.73	16.47	1.26	1.19	2.19	2.19
Founder Securities	601901 CH	31.60	24.73	2.42	2.28	N/A	N/A
Hongyuan Securities	000562 CH	20.86	18.85	2.04	1.90	N/A	N/A
Industrial Securities	601377 CH	34.18	28.19	2.05	1.94	2.14	2.45
Southwest Sec	600369 CH	42.49	36.94	2.14	2.06	2.93	2.93
Changjiang Sec	000783 CH	26.50	22.58	1.93	1.85	na	na
Guoyuan Securities	000728 CH	34.95	28.63	1.25	1.21	1.02	1.02
Sinolink Securities	600109 CH	65.52	49.55	3.50	3.32	na	na
Shanxi Securities	002500 CH	67.70	54.60	2.57	2.47	na	na
Northeast Securities	000686 CH	41.28	45.48	2.11	2.01	1.24	1.24
Pacific Securities	601099 CH	69.64	69.64	N/A	N/A	N/A	N/A
<b>Average</b>		<b>36.26</b>	<b>31.03</b>	<b>2.01</b>	<b>1.91</b>	<b>1.84</b>	<b>1.87</b>
<b>HK</b>							
CITICS - H	6030 HK	30.06	23.35	1.87	1.78	1.69	1.77
HTS - H	6837 HK	23.73	19.18	1.65	1.55	1.95	1.91
CGS - H*	6881 HK	18.80	14.23	1.59	1.45	2.28	2.47
(BUY, TP under review)							
<b>Average</b>		<b>24.20</b>	<b>18.92</b>	<b>1.70</b>	<b>1.59</b>	<b>1.97</b>	<b>2.05</b>

Source(s): Bloomberg, ABCI Securities estimates

\* ABCI Securities estimates

## Sector consolidation underway

- ✎ Maintain **NEUTRAL** for China's thermal coal sector on mild recovery in economy and downstream demand. With coal prices rebounding since mid-Oct, we believe the worst has been over
- ✎ Sector consolidation will deepen, favoring big players while eliminating the smaller ones.
- ✎ Pick China Shenhua for its leading position and high transportation capacity, and Yitai Coal for its competitive cost structure

**Coal prices have bottomed out.** China's thermal coal market bottomed out in mid-Oct, with Bohai-Rim Thermal Coal Prices rebounding by RMB 9/ton on Nov 13, 2013, up 4.53% MoM. The spot prices have rebounded for six weeks (up 8.7%) since Oct 9, 2013, indicating a gradual recovery.

**2014 Outlook clouded.** In 2014, coal miners would continue to be pressured by domestic oversupply and fierce competition from overseas suppliers. However, we believe downstream demand from thermal power, steel and cement sectors would lend support to coal prices. High levels of coal imports, however, would cap coal price and pose threats to inefficient players. In the long run, we believe thermal coal will remain the most important energy source in China and absolute demand will grow. However, sector restructuring will exert differential impacts on the profitability of market players.

**China Shenhua (1088 HK, BUY).** We like its leading position in the coal industry and high transportation capacity - an important fundamental to support business growth. Its P/B valuation is attractive based on its high ROE (~16% for FY13F-14F) and strong bargaining power. TP is set at HK\$ 29.9.

**Yitai Coal (3984 HK, BUY).** Yitai Coal's strength lies on its competitive unit cost (lowest among H-share peers) and high GP margin (39.19% in 9M13, the highest among H-share peers). Its present P/B valuation is attractive on expected ROE of 25%-26% for FY14F-16E. TP is set at HK\$16.29

**China Coal (1898 HK, HOLD).** The Group will benefit from sector restructuring and increased government support. Growing cost, however, is our biggest concern. Its mid-single digit ROE justifies the stock to trade at deep discount to book value. TP is set at HK\$ 4.11.

**Yanzhou Coal (1171 HK, SELL).** We believe its current valuation is overly optimistic, considering its less-qualified coalmines and reducing demand from downstream steel sector. The stock is overvalued even after we raised its TP to HK\$ 5.82

**Risk factors:** 1) Further declines in coal prices; 2) Supply-demand imbalance; 3) Business cycles of downstream industries; 4) Policy and regulation risks.

## Coal Sector

# NEUTRAL

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### Key Data

Avg.14F P/E (x)	5.27
Avg.14F P/B (x)	0.89
Avg.14F Dividend Yield (%)	5.52

Source(s): Bloomberg, ABCI Securities estimates

### Sector performance (%)

	Absolute	Relative*
1-mth	7.25	(4.78)
3-mth	6.03	(8.13)
6-mth	(3.07)	(9.10)

\* Relative to HSCEI

Source(s): Bloomberg, ABCI Securities

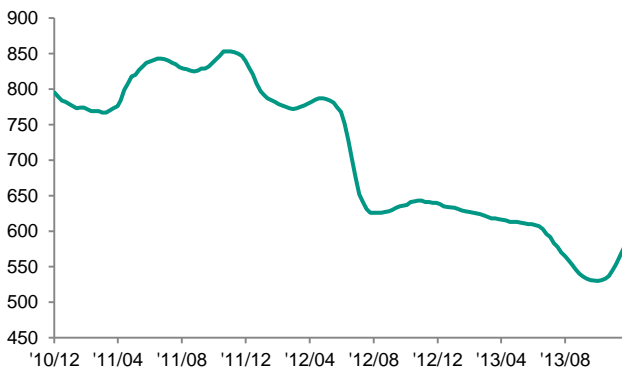
### 1-Year Sector performance (%)



Source(s): Bloomberg, ABCI Securities



Exhibit 1: The Bohai-Rim thermal coal prices are rebounding (RMB/ton)



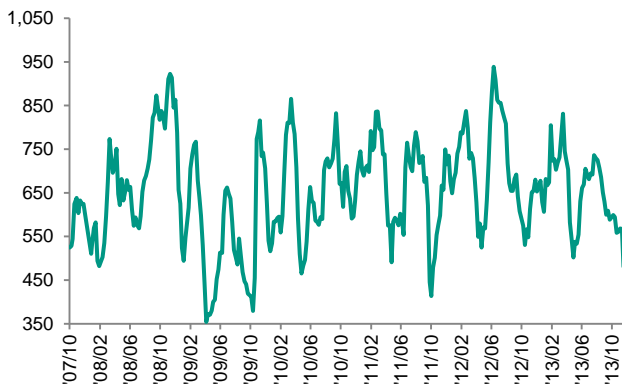
Source(s): WInd, ABCI Securities

Exhibit 2: Australia BJ thermal coal price Index shows a mild recovery (US\$/ton)



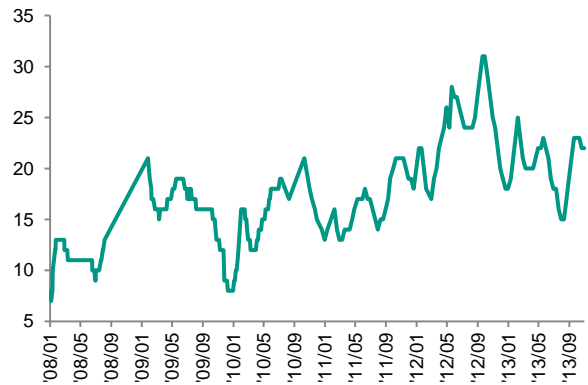
Source(s): Wind, ABCI Securities

Exhibit 3: Coal inventory at QHD port is declining (10k ton)



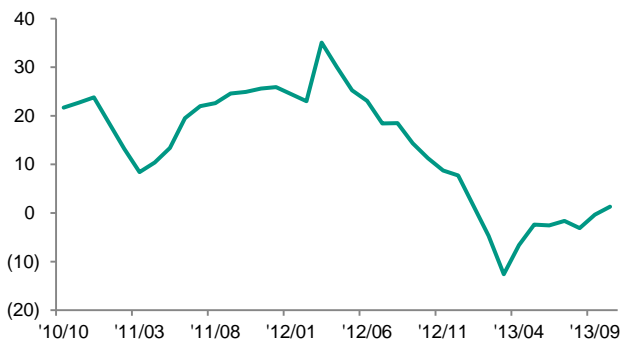
Source(s): WInd, ABCI Securities

Exhibit 4: Coal inventory days at major IPPs have been trending down since 2013 (days)



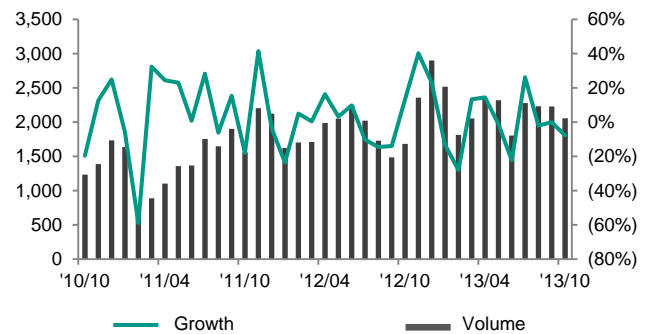
Source(s): Wind, ABCI Securities

Exhibit 5: YTM FAI growth in coal sector is rising (%)



Source(s): Wind, ABCI Securities

Exhibit 6: Import coal (10kt) and MoM growth (%)



Source(s): WInd, ABCI Securities

Sector Valuation Summary (Data as of Nov 27, 2013)

Company	Ticker	Rating	TP (HK\$)	Upside (%)	FY13F P/E(x)	FY14F P/E (x)	FY13F P/B (x)	FY14F P/B (x)	FY13F Yield (%)	FY14F Yield (%)
China Shenhua	1088 HK	BUY	29.90	14.12	8.58	7.64	1.30	1.14	4.55	5.11
China Coal	1898 HK	HOLD	4.11	(18.03)	9.52	8.58	0.54	0.52	2.99	3.31
Yanzhou Coal	1171 HK	SELL	5.82	(30.35)	15.39	8.33	0.61	0.58	2.01	3.72
Yitai Coal	3948 HK	BUY	16.29	12.37	8.05	6.03	1.64	1.39	3.71	4.95

Source(s): Bloomberg, ABCI Securities estimates



## Favor upstream & large downstream plays

-  Upstream players will gain from higher GP margin on rising raw milk ASP
-  Downstream players with higher exposure to premium products will be less affected by cost inflation; market leaders will benefit from industry consolidation
-  **BUY** Mengniu as gains from acquisitions in 2013 will be reflected in 2014
-  **BUY** CMD on rising raw milk prices and increased sales of UHT milk

**Upstream producers benefit from rising raw milk ASP.** Raw milk ASP has risen by 12% YoY in July-Oct 2013 compared to 5% in 1H13. The significant increase in raw milk ASP can be attributed to 1) smaller and unqualified farms exiting the market as major players demand high-quality raw milk; 2) rising beef prices drive some farmers to sell their cows to lock in short-term profit. We believe raw milk ASP would continue to increase in 2014-2015 as production cycle of dairy cow (from heifers to pregnancy and dairy cows when a calf is born) can be as long as two years. We estimate raw milk ASP to increase by 10%/5% YoY while feeding cost would increase by 5% YoY in 2014F/15F. Upstream raw milk producers would therefore benefit from higher GP margin in 2014/15. In longer term, we expect raw milk price to ease as the recently listed company, Huishan (6863 HK), and YST Dairy (1431 HK) would speed up expansion in the upstream after raising funds.

**Downstream producers to face cost pressure but large players will benefit from industry consolidation.** With supply shortage in raw milk, volume growth of liquid milk in the downstream will be constrained in the near term, as evidenced by the single-digit growth of 3%-4% YoY in liquid milk production in China in July/ Aug 2013. In addition, as milk is a staple food in China, milk prices are monitored by the government and cost inflation are only partially transferred to consumers. As the tight supply of raw milk will persist till end -2014, liquid milk producers will divert more resources to produce high-end products to help offset cost pressure. For infant formula milk (IFM) producers, sales volume growth is not subjected to constraints, as dry raw milk powder can be easily imported. Nonetheless, they also face inflated cost pressure. The sector consolidation will also favor large players while small players will be eliminated. Government plans to slash the number of domestic infant formula manufacturers (IFM) over the next five years to 50 from the current 200. By 2018, China expects the top 10 local companies to account for 80% of the domestic market, with the top three or five players having an annual sale of over RMB 5bn. Also, relaxation of one-child policy in China would be an upside catalyst for the dairy sector, especially the IFM.

**Favor market leaders; BUY Mengniu and CMD.** We prefer large dairy producers such as Mengniu (2319 HK, **BUY**) whose growth would be driven by point-of-sale expansion and elevated growth in star products. Benefits arising from its acquisition of Danone and Yashili in 2H13 will be reflected on its FY14 booking. Its stakes in upstream players China Modern Dairy and YST Dairy

## Dairy Sector

### OVERWEIGHT

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#### Key Data

Avg.14F P/E (x)	21.49
Avg.14F P/B (x)	4.19
Avg.14F Dividend Yield (%)	2.17

Source(s): Bloomberg, ABCI Securities estimates

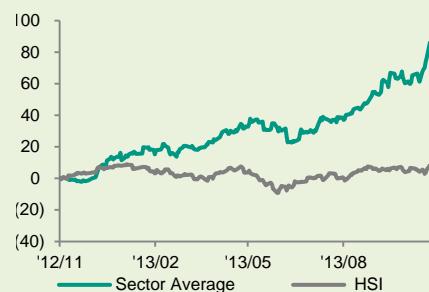
#### Sector performance (%)

	Absolute	Relative*
1-mth	15.99	12.14
3-mth	36.06	26.03
6-mth	37.90	32.13

\* Relative to Hang Seng Index

Source(s): Bloomberg, ABCI Securities

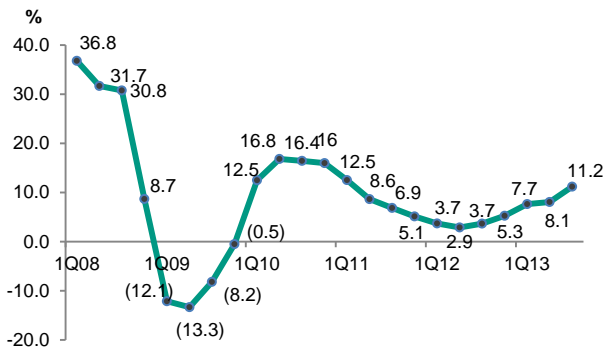
#### 1-Year Sector performance (%)



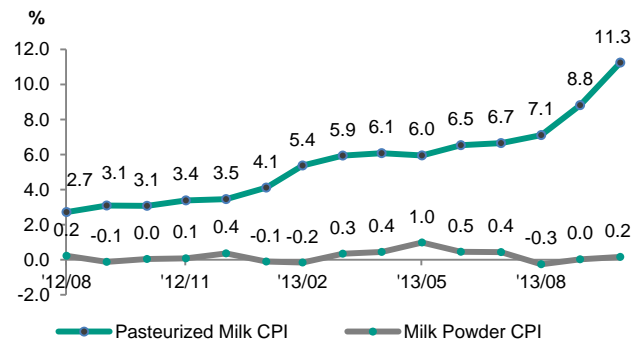
Source(s): Bloomberg, ABCI Securities

also help the Group secure premium raw milk to support volume growth. We also like China Modern Dairy (1117 HK, **BUY**) for its rising GP margin in FY14F/15F on rising raw milk ASP, and the 50% growth expected for its newly launched own-brand UHT products. We assign a **SELL** rating for Biostime (1112 HK) as we believe it is overpriced after rising by 159% between Jan and Nov 2013.

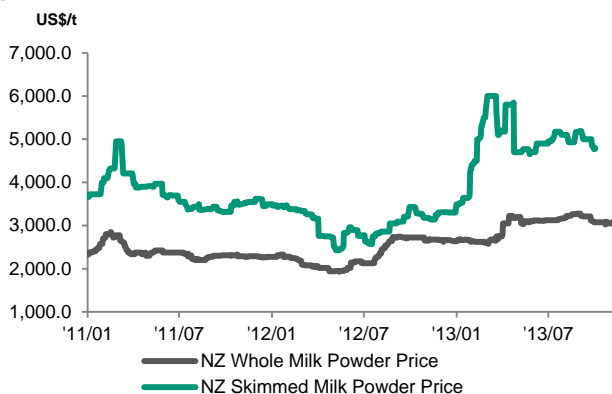
**Risk factors:** 1) Food safety risks; 2) Diseased cow; 3) Policy risks; 4) Intensifying market competition with foreign dairy producers; 5) Execution risks related to acquisitions; 6) Related party transaction.

**Exhibit 1: China's Milk PPI (YoY %)**


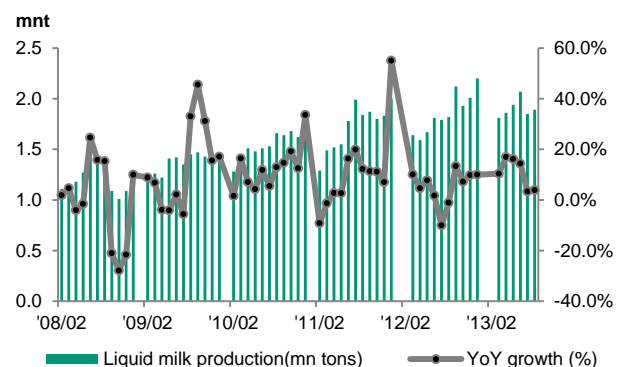
Source(s): Bloomberg, NBSC, ABCI Securities

**Exhibit 2: China's Pasteurized Milk/ Milk Powder CPI (YoY %)**


Source(s): Bloomberg, NBSC, ABCI Securities

**Exhibit 3: New Zealand Milk Powder Price (US\$/ton)**


Source(s): Bloomberg, ABCI Securities

**Exhibit 4: China's Liquid Milk Production and YoY growth (L:mn tons, R:YoY%)**


Source(s): Bloomberg, NBSC, ABCI Securities

**Sector Valuation Summary (Data as of Nov 27, 2013)**

Company	Ticker	Rating	Price (HK\$)	TP (HK\$)	Upside (%)	FY13F P/E(x)	FY14F P/E(x)	FY13F P/B(x)	FY14F P/B(x)	FY13F Yield(%)	FY14F Yield(%)
Mengniu	2319 HK	BUY	34.40	38.9	13.1	29.25	22.10	3.02	2.68	0.76	1.00
China Modern Dairy	1117 HK	BUY	4.11	4.73	15.1	23.02	17.15	2.55	2.23	0.36	0.48
Biostime	1112 HK	SELL	65.50	49.2	(24.9)	34.22	24.98	9.32	7.83	2.13	2.92
Yashili	1230 HK	UR	4.98	N/A	N/A	25.58	21.74	4.67	4.02	2.89	4.29
Huishan Dairy	6863 HK	N/A	2.91	N/A	N/A	N/A	N/A	2.38	N/A	N/A	N/A
YST Dairy	1431 HK	N/A	2.63	N/A	N/A	N/A	N/A	2.43	N/A	N/A	N/A
Yili	600887CH	N/A	39.36	N/A	N/A	29.09	24.68	5.21	5.14	N/A	0.90
Bright Dairy	600597CH	N/A	21.40	N/A	N/A	55.58	36.52	6.25	6.06	N/A	1.06
Beingmate	002570CH	N/A	32.11	N/A	N/A	26.00	21.25	4.03	4.45	3.99	1.31
Beijing Sanyuan	600429CH	N/A	8.42	N/A	N/A	N/A	N/A	4.34	N/A	N/A	N/A

Source(s): Bloomberg, ABCI Securities estimates

## Mobile Internet to drive growth in 2014

- ✎ Growing mobile internet (MI) usage will accelerate monetization and increase profit from VAS/Games/Online advertising/e-commerce
- ✎ China's broadband project, urbanization, rising income and liberalization of industries will boost development of China's internet service industry
- ✎ Pick Tencent for its huge user base and leading position in both PC & mobile internet markets. We expected its e-commerce segment to record high growth in the near future

**China's internet penetration is growing fast.** We expect China's MI users to grow rapidly. By 1H13, China's internet users reached 591 mn with an internet penetration of 44.1%, up 2 ppt from end-2012. MI uses have been growing fast, especially for instant messaging, gaming and e-commerce purposes. About 70% new MI users access internet through smartphone. In addition, popularity of the internet in rural areas has been growing quickly. For 1H13, rural users accounted for 54.4% of new internet users.

**Improving salary of low-income group would increase ARPU of internet services.** At present, most MI entertainment services users' ARPU is less than RMB 10/mth. Paying customers usually have lower education level, lower income and lower age. Population of higher education is less willing to pay for internet services. As the government is taking more measures to improve the income level of low-income group, the MI ARPU is likely to rise. In addition, as China's MI market transforms into an oligopoly dominated by a few major players from its currently fragmented state, companies with higher pricing power will achieve the strongest increases in ARPU.

**Factors to support growth in internet services.** While strict monitoring raises the entry barriers of China's internet industry, existing internet companies are encouraged to enter some previously restricted markets (such as the financial ones). In the long term, the Chinese internet service providers will be driven by:

- Promising development of 3G/4G/Wi-Fi services, declining smartphones prices, and innovative MI apps;
- China's plan to expand broadband and urbanization reform will increase internet penetration in rural areas, promoting development of an internet economy;
- China's growing per capita income;
- Development of online financial business and opening up industries to private enterprise will benefit dot-com companies.

**Positive sector outlook.** We expect MI to drive growth in the internet and media sector by expanding the internet user base and deepening overall internet penetration. Moreover, MI has the potential to generate higher internet demand than PC internet due to its convenience, increased penetration of mobile devices in China and growing use of mobile-based web functions (e.g. social networking). All these would drive revenue growth in the near future.

## Internet & Media Sector

### OVERWEIGHT

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#### Key Data

Avg.14F P/E (x)	31.72
Avg.14F PEG (x)	1.30

Source(s): Bloomberg, ABCI Securities estimates

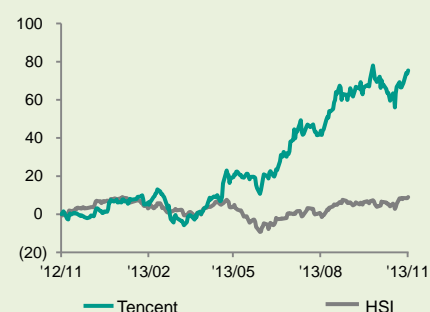
#### Company performance (%)

	Absolute	Relative*
1-mth	1.94	(2.44)
3-mth	23.92	13.32
6-mth	45.10	41.25

\* Relative to HSI

Source(s): Bloomberg, ABCI Securities

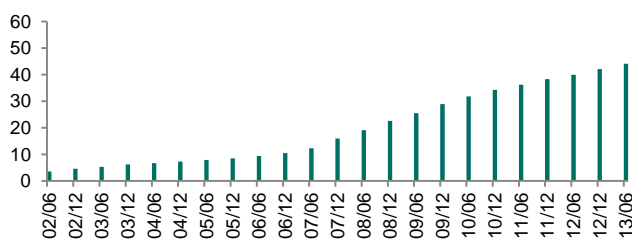
#### 1-Year Share price performance (%)



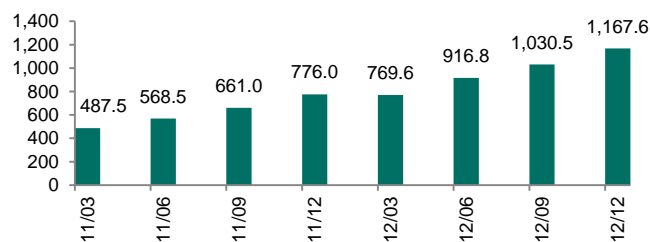
Source(s): Bloomberg, ABCI Securities

**Recommend Tencent (700 HK; BUY; TP: HK\$479.0).** We favor Tencent as it has the largest online community in China and dominant position in the country's internet market. With its huge user base in QQ/WeChat, Tencent is also becoming one of the top MI game distributors. We expect its e-commerce business to generate substantial profits in the next two years. Considering its high growth potential, its current valuation of 29.85x FY14F P/E, compared to the global average of 31.72x, is attractive. We estimate its net income to grow by more than 40% in the next 2 years.

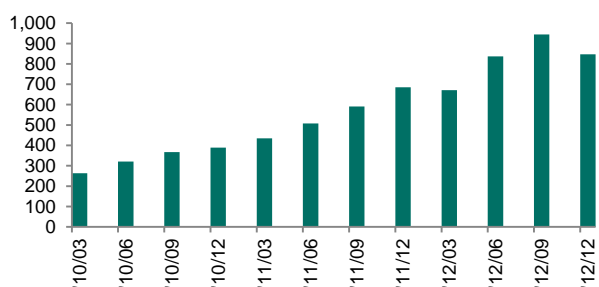
**Risk factors:** 1) Increased internet /e-commerce surveillance by government; 2) Intensified competition in mobile platform and e-commerce may lead to profit decline; 3) Slowdown in PC gaming.

**Exhibit 1: China's internet penetration rate trend (%)**


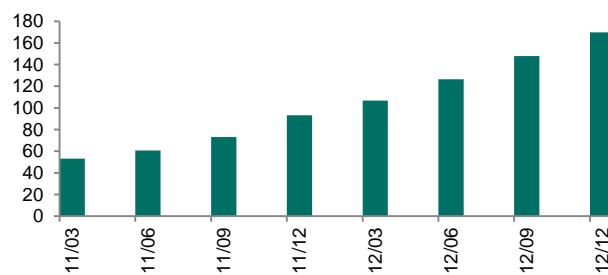
Source(s): Wind, ABCI Securities

**Exhibit 2: China's internet economy by quarter (RMB100 mn/Q)**


Source(s): Wind, ABCI Securities

**Exhibit 3: China's PC internet economy (RMB100 mn/Q)**


Source(s): Wind, ABCI Securities

**Exhibit 4: China's mobile internet economy (RMB100 mn/Q)**


Source(s): Wind, ABCI Securities

**Sector Valuation Summary (Data as of Nov 27, 2013)**

Company	Ticker	Price	Market Cap	FY13P/E(x)	FY14P/E (x)	FY13PEG (x)	FY14PEG (x)
Tencent-ABCI Est.	700 HK Equity	441.40	820,819	41.96	29.85	2.14	0.80
Tencent	700 HK Equity	441.40	820,819	38.70	30.36	1.45	1.14
Kingsoft	3888 HK Equity	18.72	22,094	26.74	21.28	1.06	0.84
Netdragon	0777 HK Equity	16.00	8,133	10.33	12.60	1.95	2.38
Forgame	0484 HK Equity	52.95	6,669	N/A	N/A	N/A	N/A
<b>CN Internet @ US, US\$</b>							
Sina	SINA US Equity	77.66	5,175	81.40	37.75	2.23	1.03
Sohu	SOHU US Equity	64.80	2,480	47.02	34.54	3.08	2.26
NetEase	NTES US Equity	70.53	9,217	12.44	11.03	0.94	0.83
BaiDu	BIDU US Equity	162.99	57,037	31.64	24.64	1.29	1.01
Qihoo 360	QIHU US Equity	82.15	10,086	63.10	39.36	1.38	0.86
Ctrip	CTRP US Equity	47.37	6,131	33.06	26.98	1.55	1.26
51job	JOBS US Equity	73.49	2,123	25.58	22.20	1.28	1.11
Perfect World	PWRD US Equity	18.41	897	12.96	10.43	1.16	0.93
YY Inc.	YY US Equity	50.00	2,760	36.02	25.38	0.78	0.55
<b>Global Internet, US\$</b>							
Google	GOOG US Equity	1063.11	355,172	24.13	20.34	1.45	1.22
Facebook	FB US Equity	46.49	115,846	56.22	41.66	1.88	1.40
Yahoo	YHOO US Equity	36.96	37,494	25.40	22.43	2.15	1.90
Amazon	Amazon.com US Equity	386.71	177,010	157.71	83.38	4.25	2.24
EBay	Ebay US Equity	49.30	63,824	18.27	15.69	1.25	1.07
American Online	AOL US Equity	44.70	3,508	22.18	19.25	1.56	1.35
LinkedIn	LNKD US Equity	223.13	26,643	139.20	100.46	2.65	1.91
GROUPON	GRPN US Equity	9.10	6,080	102.25	37.76	3.11	1.15
Yandex N.V.	YNDX US Equity	39.61	12,907	34.95	28.60	1.12	0.92

Source(s): Bloomberg, ABCI Securities estimates

## Booming demand for healthcare services

- ✍ Surging healthcare services demand will drive growth in the pharm supply chain in 2014-15
- ✍ Strong FAI growth 2012-13 in upstream pharm production implies keen competition and over-capacity risk in 2014-15
- ✍ Narrowing CPI-PPI difference in pharm industry suggests margin contraction in midstream distributors in 2014
- ✍ OTC retailers are losing market share to hospitals

**Beaming outlooks for 2014-15.** We are bullish on specialized drug/equipment makers and downstream healthcare services providers while being cautious on upstream producers and midstream distributors. Demand for healthcare services would be a major growth driver of the pharm supply chain on rising purchasing power of households (improved income and insurance protection), an expanding middle class population in China, and increasing patient visits.

**Prefer healthcare service providers.** The government is liberalizing the healthcare services sector. Reputable hospitals control cash flow of the whole pharm supply chain, have higher patient visit growth and stronger bargaining power than drug/pharma services suppliers. Fosun Pharm, which has penetrated into the healthcare services segment, would enjoy the first-mover advantage.

**Be selective on upstream manufacturing producers.** Value-added growth of the pharm industry declined to 13.7% YoY for 10M13 but the industry FAI surged 30.4% YoY for 10M13. Upstream players are aggressively expanding their output capacities, foreshadowing intensified competition and declined asset utilization in the sector. Specialized drug/equipment producers such as Sino Biopharm (1177 HK) and Fosun Pharm (2196 HK) would be less affected as their products in the fields of oncology, cardiovascular, nervous system, and anti-infection are more differentiated.

**Margin squeeze in mid-stream players.** Price regulatory control is squeezing margins of mid-stream distributors. The CPI-PPI gap of pharm industry is narrowing, indicating margin contraction in mid-stream players such as Sinopharm (1099 HK) and Shanghai Pharm (2607 HK) in 2014. Inorganic growth is expected to slow due to the high leverages among major distributors.

**OTC retailers are losing market share to hospitals.** YoY retail sales growth of downstream pharm retailers slowed to 16.7% for 10M13 from 23.0% in 2012. With increased price transparency and medical insurance coverage, patients prefer hospital pharmacies over the retail ones or drugstores for their drug purchases.

**Loose fiscal policy on public healthcare support sector growth.** Urbanization is driving demand for medical treatment and healthcare services (M&H). For 10M13, government expenditure on M&H grew 15%YoY, which was 5ppt higher than total government expenditure growth. M&H expenditure accounted for 5.3% /6.1% of total government expenditure in 2010/2013. We believe such fast growth in M&H expenditure would continue in 2014-15.

## Pharmaceutical Sector

### OVERWEIGHT

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#### Key Data

Avg.14F P/E (x)	18.2
Avg.14F P/B (x)	2.44
Avg.14F Dividend Yield (%)	1.85

Source(s): Bloomberg, ABCI Securities estimates

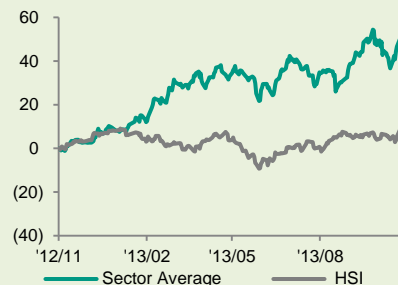
#### Sector performance (%)

	Absolute	Relative*
1-mth	(8.45)	(12.30)
3-mth	1.71	(8.32)
6-mth	1.19	(4.58)

\* Relative to Hang Seng Index

Source(s): Bloomberg, ABCI Securities

#### 1-Year Sector performance (%)



Source(s): Bloomberg, ABCI Securities

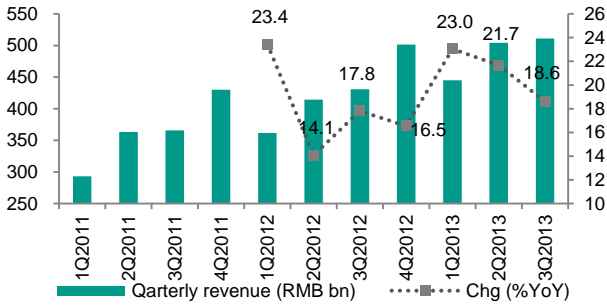
#### Jan-Sep 2013 Healthcare Services

Avg. outpatient fee	RMB/visit	(%YoY)
Class 3 hospitals	254.0	6.2
Class 2 hospitals	167.1	6.8
Avg. in-patient fee	RMB/patient	(%YoY)
Class 3 hospitals	11,687	3.0
Class 2 hospitals	5,013	2.3
Outpatient visits	million	(%YoY)
Class 3 hospitals	861.7	18.7
Class 2 hospitals	809.4	2.7
In-patient visits	million	(%YoY)
Class 3 hospitals	37.8	22.6
Class 2 hospitals	48.4	5.9
Patient visits	million	(%YoY)
Public hospitals	1,767	8.7
Private hospitals	197	15.8

Source(s): National Health & Family Planning Commission, the PRC. ABCI Securities

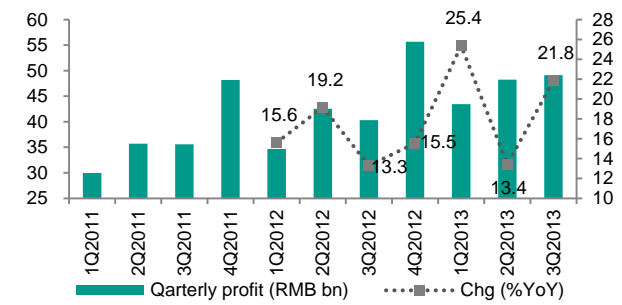


**Exhibit 1: Revenue of pharm manufacturing industry (RMB bn)**



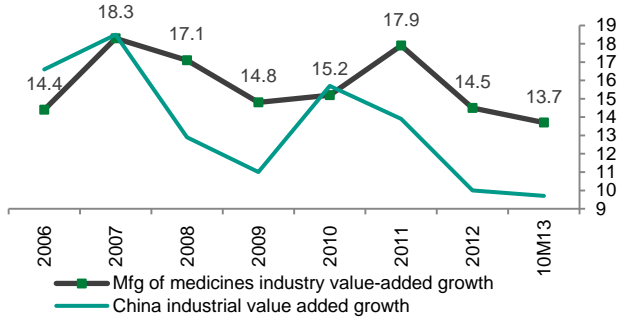
Source(s): NBSC, ABCI Securities

**Exhibit 2: Profit of pharm manufacturing industry (RMB bn)**



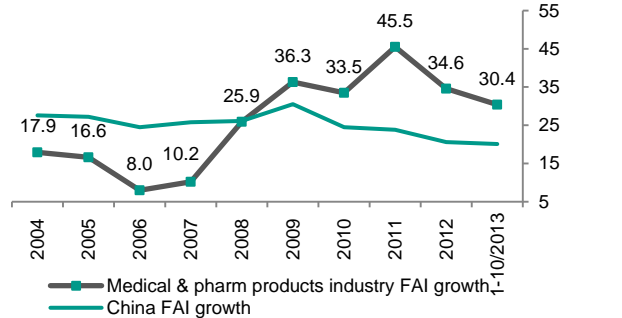
Source(s): NBSC, ABCI Securities

**Exhibit 3: Industrial value-added: Manufacturing of medicines industry (YoY%)**



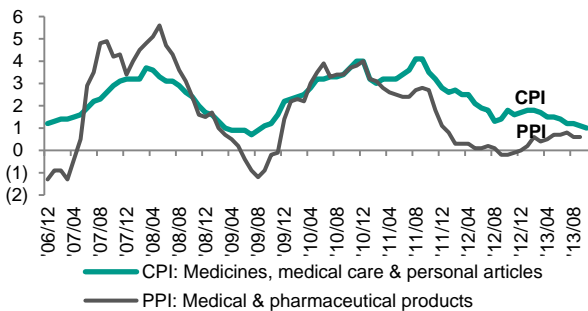
Source(s): NBSC, ABCI Securities

**Exhibit 4: FAI of medical & pharm products industry (YoY%)**



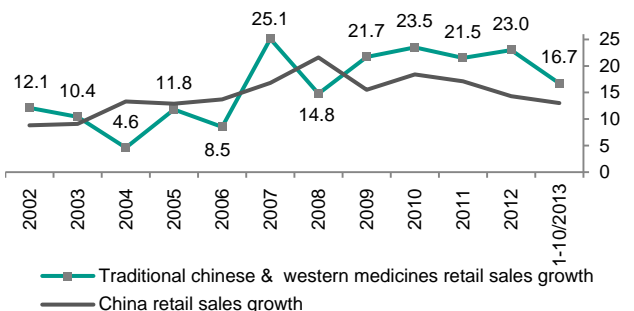
Source(s): NBSC, ABCI Securities

**Exhibit 5: PPI & CPI of pharm industry (YoY%)**



Source(s): NBSC, ABCI Securities

**Exhibit 6: Retail sales of Chinese & Western medicines (YoY%)**



Source(s): NBSC, ABCI Securities

**Sector Valuation Summary (Data as of Nov 27, 2013)**

Company	Ticker	Rating	Price (HK\$)	TP (HK\$)	Upside (%)	FY13F P/E(x)	FY14F P/E(x)	FY13F P/B(x)	FY14F P/B(x)	FY13F Yield(%)	FY14F Yield(%)
Sinopharm	1099	BUY	22.95	26.83	16.9	20.2	17.2	2.11	1.94	1.49	1.74
Fosun Pharm	2196	HOLD	19.44	19.11	(1.7)	19.1	20.5	2.30	2.14	1.57	1.46
Shanghai Pharm	2607	BUY	18.12	19.90	9.8	16.8	14.7	1.41	1.32	1.38	1.58
Sino Biopharm	1177	BUY	6.10	7.00	14.8	27.0	21.6	5.06	4.26	1.60	1.97
Sihuan Pharm	460	BUY	5.98	6.92	15.7	21.3	17.5	3.12	2.84	2.14	2.56
Microport	853	SELL	5.26	5.01	(4.8)	22.6	17.8	2.36	2.12	1.57	1.77

Source(s): Bloomberg, ABCI Securities estimates

## Wind power to prevail in 2014

- ✎ As China is pursuing development of renewable energy sources, we expect to see strong capacity growth in nuclear and wind power sectors
- ✎ Increase in subsidy by the government will improve liquidity and lower the financing costs of renewable energy developers, especially that of the wind power operators
- ✎ We favor Longyuan (916 HK) and HN Renew (958 HK) for their wide geographic dispersion of wind resources and higher operating efficiency

**Shifting to renewable energy.** Based on the 12<sup>th</sup> Five-Year Plan, the government is targeting to (1) raise the installed capacity of non-fossil fuel power from 20% in 2012 to 30% by 2015; (2) increase non-fossil fuel consumption from 8.6% in 2010 to 11.4%/15.0% by 2015/2020. We expect to see strong capacity growth in renewable energy sector, especially the nuclear and wind power sectors with relatively higher utilization hour. The government targets to raise installed capacity of nuclear/wind powers to 40 GW/100GW by 2015, representing a 5-year CAGR of 29.9%/26.4%, which is higher than the capacity growth of 7.8% in coal-fired power and 5.7% in hydropower.

**Increasing support for renewable energy sector.** In Sep 2013, NDRC announced to raise the renewable energy subsidy from RMB 0.008/kWh to RMB 0.015/kWh. The increased renewable energy subsidy will be financed by lowering the on-grid tariffs of coal-fired IPPs. We believe the increase in renewable energy subsidy would facilitate collection of overdue subsidy receivables and improve the financial conditions of the relevant energy developers starting from 2014. This is especially significant for the wind power operators with substantial amounts of outstanding subsidy receivables. In addition, we are expecting more supporting policies to be announced as NEA is currently finalizing renewable portfolio standards and setting requirements for renewable power consumption by province in 2015 and after. We believe the upcoming policy would include incentives to encourage grid companies to consume more renewable energies and hence would improve the utilization hour in the latter group.

**Positive sector outlook; BUY HN Renew, Longyuan and BJCE.** We are positive on the outlook for the wind power sector based on the increasing investment in grid construction and the expectation of more accommodative policies to be implemented. Our top picks include: Huaneng Renewables (958 HK, **BUY**) whose location advantage would generate higher unit returns via the improved utilization hour and increased on-grid tariff. We also like Longyuan (916HK, **BUY**) that has the highest utilization hour amongst peers. Its wide geographic dispersion of facilities can also ameliorate the impacts of uncontrollable factors in wind power generation. We believe Beijing Jingneng Clean Energy (579 HK, **BUY**) would be a major beneficiary under the government's plan to reduce air pollution in the city. We assign a **HOLD** rating for Datang Renewable (1798 HK) because of its highest gearing level and lowest profitability among peers.

## Renewable Energy Sector

### OVERWEIGHT

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#### Key Data

Avg.14F P/E (x)	13.57
Avg.14F P/B (x)	1.39
Avg.14F Dividend Yield (%)	1.65

Source(s): Bloomberg, ABCI Securities estimates

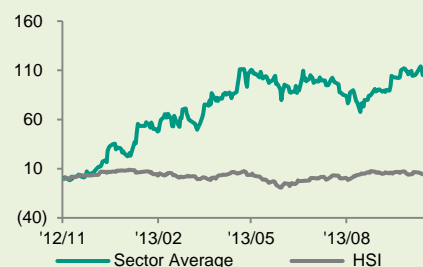
#### Sector performance (%)

	Absolute	Relative*
1-mth	7.35	3.50
3-mth	27.46	17.42
6-mth	8.82	3.05

\* Relative to Hang Seng Index

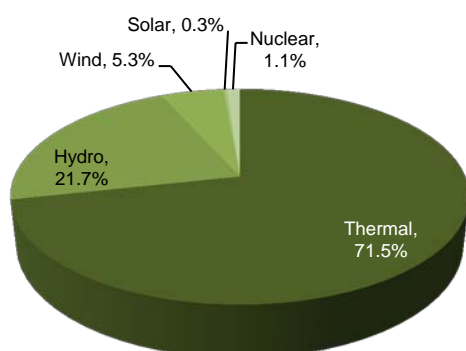
Source(s): Bloomberg, ABCI Securities

#### 1-Year Sector performance (%)

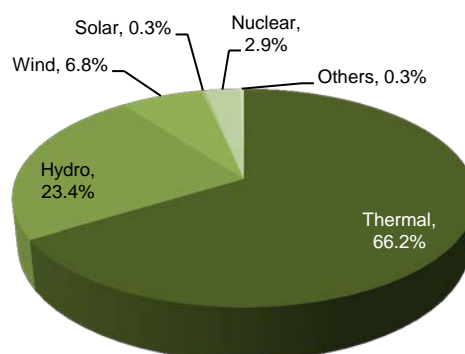


Source(s): Bloomberg, ABCI Securities

**Risk factors:** (1) High gearing of power players; (2) Natural resources risks; (3) Grid connection risks; (4) Policy risks; (5) Economic slowdown.

**Exhibit 1: Installed capacity breakdown by end-2012 (%)**


Source(s): NEA, ABCI Securities

**Exhibit 2: Installed capacity breakdown by end-2015F(%)**


Source(s): NEA, ABCI Securities

**Exhibit 3: Installed capacity growth of power plants in China (2010-20F)**

Type of Energy	2010	2011	2012	2015F	2020F	12-15F CAGR
Thermal	707	739	758	960	1170	8.2%
Hydro	198	212	249	290	420	5.2%
Wind	31	45	61	100	200	18.0%
Solar	1	2	3	21	50	85.7%
Nuclear	11	13	13	40	86	47.1%
Gas			38	56	80	13.5%
Others	27	44	23	79	9	51.0%
<b>Total</b>	<b>974</b>	<b>1,055</b>	<b>1,145</b>	<b>1,490</b>	<b>1,935</b>	<b>9.2%</b>

Source(s): www.gov.cn, CEC, ABCI Securities

**Exhibit 4: Net debt-to-equity ratios of major power operators in China (%)**

Company	Ticker	2008	2009	2010	2011	2012	1H13	5-yr Avg.
Huaneng Power	902 HK	243.1	244.2	212.0	265.8	237.5	212.5	240.5
Datang Power	991 HK	354.4	412.4	392.6	301.4	308.6	330.9	353.9
China Resources Power	836 HK	108.3	117.5	137.7	130.3	114.6	94.7	121.7
Huadian Int'	1071 HK	362.4	320.8	406.4	431.7	405.9	363.4	385.4
China Power	2380 HK	122.4	189.8	251.2	249.1	230.5	198.7	208.6
<b>Average</b>		<b>238.1</b>	<b>256.9</b>	<b>280.0</b>	<b>275.7</b>	<b>259.4</b>	<b>240.0</b>	<b>262.0</b>
Longyuan	916 HK	296.6	65.4	120.6	155.6	146.9	143.0	157.0
HN Renew	958 HK	227.6	305.4	273.1	152.1	195.5	185.0	230.7
DT Renew	1798 HK	190.2	270.8	195.1	264.3	313.6	310.3	246.8
BJCE	579 HK	160.0	214.0	162.3	106.1	174.3	161.2	163.3
<b>Average</b>		<b>218.6</b>	<b>213.9</b>	<b>187.8</b>	<b>169.5</b>	<b>207.6</b>	<b>199.9</b>	<b>199.5</b>

Source(s): Company reports, ABCI Securities





**Sector Valuation Summary (Data as of Nov 27, 2013)**

Company	Ticker	Rating	Price (HK\$)	TP (HK\$)	Upside (%)	FY13F P/E(x)	FY14F P/E (x)	FY13F P/B (x)	FY14F P/B (x)	FY13F Yield (%)	FY14F Yield (%)
Longyuan	916 HK	BUY	10.00	10.77	7.7	20.97	16.56	1.99	1.80	0.95	1.21
HN Renew	958 HK	BUY	3.34	3.63	8.7	18.40	13.80	1.67	1.52	1.20	1.59
DT Renew	1798HK	HOLD	1.47	1.50	2.0	19.88	11.74	0.72	0.68	1.26	2.13
BJCE	579 HK	BUY	3.65	3.90	6.8	13.46	12.16	1.63	1.54	1.49	1.65

Source(s): Bloomberg, ABCI Securities estimates



## Recovering in 2014

-  Demand for agricultural machinery is expected to rise in 2014-15 on agricultural reform and mechanization
-  Construction machinery industry is bottoming out, supported by peaking delivery schedule of construction industry in 2014-15
-  Recommend **BUY** on Lonking for its stringent credit sales control and reviving downstream construction activities
-  Recommend **BUY** on First Tractor for its leadership in China's agricultural tractor industry

### Agricultural machinery industry to benefit from agriculture reform.

Agricultural reform in China would be a catalyst for the agricultural machinery industry in 2014. After the Third Plenum in Nov 2013, we believe the government would roll out more policies to increase farmers' income and accelerate automation in farming. The government's ambitious urbanization goal also means that more facilitating policies (such as the reform of the household registration system) would be implemented to speed up the process. As the rural workforce is expected to decrease under urbanization, it becomes crucial for the Chinese government to ramp up the pace of modernization and industrialization in agriculture to ensure the national food security. Hence, we expect the government to increase subsidies in 2014 to finance farmer purchases of tractors and other equipment. Furthermore, PPI of farm crops in China was up 4.66% YoY, while the overall PPI and rural CPI was down 1.30% YoY and rose 3.30% YoY in 9M13, indicating farmers' revenue could be rising faster than production costs. We believe the improving income of farmers is conducive to increased procurement for farm machineries in 2014. In fact, the trend may have started in 2013 as the fixed-assets investment (FAI) on agricultural and fishery industry in 10M13 was up 29.3% YoY, outpacing the overall FAI in China that rose 20.1% YoY.

**Construction machinery to recover from trough.** Following the downturn in 2012-13, construction machinery industry is gradually bottoming out. We believe 2014 would bode well for the industry because:

- (1) Delivery of transport infrastructure construction projects will accelerate in 2014-15 to reach the 12<sup>th</sup> Five-Year Plan target;
- (2) On the property front, strong residential properties presales during 2012-13 (up 27.4% YoY in 10M13) also means that construction activities will increase in 2014 for delivery;
- (3) Production volume of cement rose 8.9% YoY in 9M13, up 2.2ppt from 6.7% YoY in 9M12. Production volume of cement manufacturing machinery also rebounded from an 8.6% YoY decline in 9M12 to an 8.0% YoY growth in 9M13;
- (4) Decline in FAI (including construction machinery procurement) within the construction industry narrowed in 3Q13.

All these suggest that downstream construction activities would be increasing in 2014 as project delivery peaks, supporting the demand for construction machinery. We believe a recovery in upstream construction machinery industry is currently underway and would turn more noticeable in 2014.

## Special Machinery Sector

# NEUTRAL

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### Key Data

Avg.14 P/E (x)	9.40
Avg.14 P/B (x)	0.87
Avg.14F Dividend Yield (%)	2.84

Source(s): Bloomberg, ABCI Securities estimates

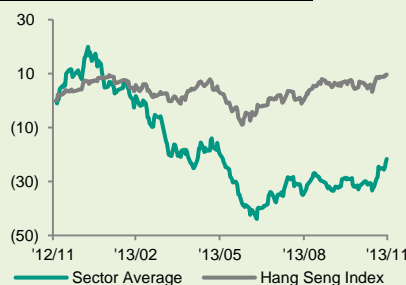
### Sector performance (%)

	Absolute	Relative*
1-mth	13.95	11.23
3-mth	14.16	7.52
6-mth	4.04	(5.32)

\* Relative to Hang Seng Index

Source(s): Bloomberg, ABCI Securities

### 1-Year Sector performance (%)



Source(s): Bloomberg, ABCI Securities

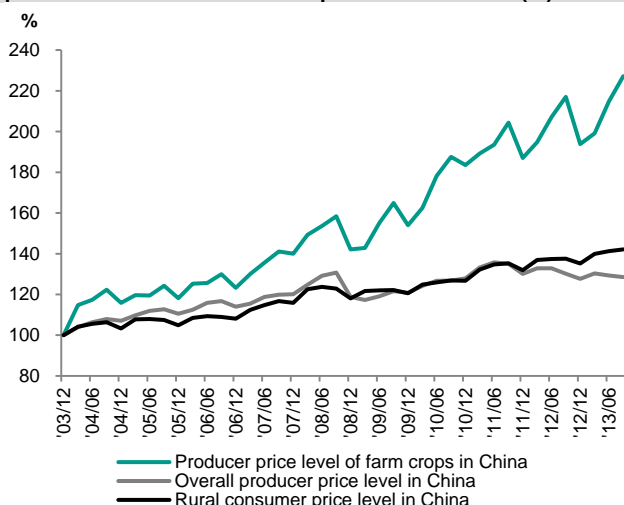
**Coal mining machinery orders topped by sluggish coal price.** Machinery purchases from coalmine operators have been weakening. The FAI in coal mining industry has been declining since 1Q13. According to NBS, the total FAI on coal mining industry was RMB 372.5bn in 9M13, down 0.3% YoY. Going forward, as recovery in China's coal price is expected to be mild at best and the challenging business environment is likely to persist in 2014, we expect the capex of coalminers to stay flat in 2H13-1H14. To conclude, a significant recovery is unlikely to occur in 1H14 for the coal mining machinery industry.

**Lonking (3339 HK, BUY).** We like Lonking for its better-than-peer credit sales control. The account receivables-to-revenue ratio of Lonking fell from 91.43% in 1H12 to 83.46% in 1H13, while major construction machinery makers surged from 96.33% to 134.28% during the same period. The group therefore has a relatively lower assets impairment risk. We expect the group's wheel loader sales would continue to improve in 2014 with the support of increasing downstream construction activities. Reiterate **BUY** with TP at HK\$ 2.01

**First Tractor (38 HK, BUY).** We expect policies reforming the transfer system of agricultural land, boosting farmers' income, and facilitating agricultural mechanization would be covered in the Central Committee's Document No. 1 to be released in Jan 2014. The subsidy for agricultural machinery is expected to increase to RMB 23bn in 2014 from RMB 21.7bn in 2013, benefiting tractor sales. As the largest tractor manufacturer in China with a domestic market share over 30% in 2012, we stay positive on the First Tractor's mid-to long-term prospect. Reiterate **BUY** with TP at HK\$ 7.68.

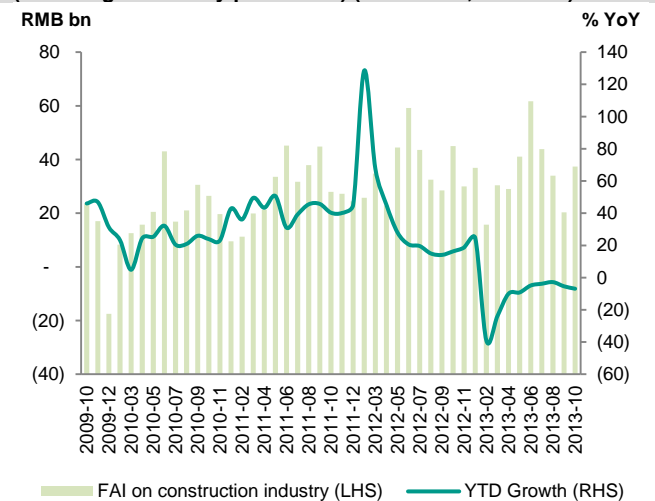
**Risk factors:** 1) Policy risk affecting sustainability of subsidy for agricultural machinery industry; 2) prolonged weakness in machinery industry, and sales growth suppressed by tightened credit sales; 3) coalminers lower capex on weak demand.

**Exhibit 1: Producer price level of farm crops vs. overall producer price level and rural consumer price level in China (%)**



\* Price level at end-2013 as 100  
Source(s): NBS, ABCI securities

**Exhibit 2: Fixed-assets investment in construction industry (including machinery purchases) (L: RMB bn, R: YoY%)**



Source(s): NBS, ABCI Securities

**Sector Valuation Summary (Data as of Nov 27, 2013)**

Company	Ticker	Rating	TP (HK\$)	Upside (%)	FY13F P/E(x)	FY14F P/E (x)	FY13F P/B (x)	FY14F P/B (x)	FY13F Yield (%)	FY14F Yield (%)
Zoomlion	1157 HK	HOLD	6.73	(9.52)	9.75	8.77	1.03	0.91	2.05	2.28
Lonking	3339 HK	BUY	2.01	25.36	11.29	8.92	0.81	0.74	2.21	2.80
First Tractor	38 HK	BUY	7.68	26.13	16.32	9.30	1.11	0.97	1.74	3.05
Sany Int'l	631 HK	HOLD	2.37	(9.42)	14.85	13.52	1.12	1.05	1.35	1.48
ZMJ	564 HK	HOLD	5.13	1.94	8.04	6.52	0.72	0.66	3.73	4.60

Source(s): Bloomberg, ABCI Securities estimates

## Urban Rail - Bright spot in 2014-15

- ✍ Urban rail will be the bright spot as we expect total FAI in infrastructure construction to grow at 35.95% CAGR over 2013-15F
- ✍ Completion of urban rail will accelerate in 2014-15 so as to reach the railway coverage target of 120,000 km (current: 98,000 km) set by the government
- ✍ Recommend **BUY** on CRCC and CRG. The former is a leader in transport construction industry with a sound financial status; the latter is a strong player in the urban rail segment with a 50% market share in 2012

**2013-15 Outlook.** Based on the construction pipeline of urban rail among the major cities in China, we estimate the total investment in the urban rail industry would remain strong in 2014-15. Urban rail investment (for infrastructure construction) would grow by 35.95%.

### Urban rail as growth driver of transport infrastructure construction.

Urban rail would become the growth driver of the transport infrastructure construction industry since waterway and highway constructions are expected to slow in coming years. Based on the existing construction pipeline, we estimate investment for infrastructure construction would increase further to RMB 259bn in 2015F, representing a growth of 35.95% CAGR over 2013F-15F. Based on the approved projects by NDRC and the cities' development plans, we estimate the investment in urban rail construction would soar to RMB 2,300bn during the 13<sup>th</sup> Five-Year Plan period (2016-20), up from the estimated RMB 804bn during the 12th Five-Year Plan period (2011-15). The room for growth is still ample for urban rail in China as urban rail coverage is still low compared to the developed regions. The average coverage ratio of urban rail (the length of the urban rail / urban area of the city) in China's major cities was 0.098km/km<sup>2</sup> in 2012, lower than Hong Kong (0.197km/km<sup>2</sup>), the U.S. (0.283km/km<sup>2</sup>) and Japan (0.157km/km<sup>2</sup>).

**Accelerated completion of railway in 2014-15.** With the establishment of China Railway Corporation (CRC), we expect completion of railway projects to accelerate in 2014-15 so as to reach the government railway coverage target of 120,000 km by 2015. In 2014/15, we expect 17,165 km of new tracks would be added and total investment in infrastructure construction would be RMB 1,232bn. Investment in railway infrastructure construction is expected to remain high -risk of a downturn similar to the one in 2011-1H12 is low.

**Tepid growth in highway and waterway construction.** The International Monetary Fund (IMF) revised down the global economic growth projection in Oct 2013 to 3.6% in 2014F, down by 0.2ppt compared to previous projection in July 2013. Amid an uncertain global economy, profitability and asset return of toll road and port operators would decrease. We expect the capex growth on highway and waterway construction to stay low in 2014/15.

## Transport Infrastructure Sector

# NEUTRAL

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### Key Data

Avg.14F P/E (x)	11.88
Avg.14F P/B (x)	1.47
Avg.14F Dividend Yield (%)	2.15

Source(s): Bloomberg, ABCI Securities estimates

### Sector performance (%)

	Absolute	Relative*
1-mth	6.35	3.64
3-mth	12.48	5.84
6-mth	19.73	10.38

\* Relative to Hang Seng Index

Source(s): Bloomberg, ABCI Securities

### 1-Year Sector performance (%)



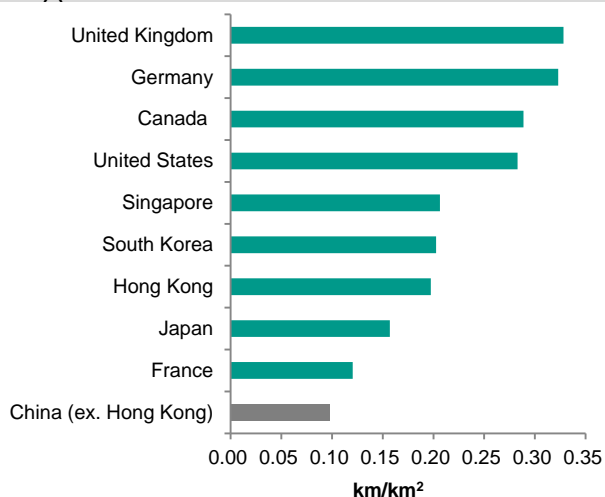
Source(s): Bloomberg, ABCI Securities

**CRCC - BUY.** We like CRCC for its low gearing and leading position in urban rail construction industry. Its low gearing would enable the Group to acquire capital at lower costs and undertake more urban rail projects. We estimate the revenue for its urban rail business to grow at 44.48% CAGR over FY13F-15F, while the Group's overall net income would grow at 17.03% CAGR over the same period. Reiterate **BUY**.

**CRG - BUY.** As the largest urban rail builder in China, the Group would benefit from urban rail expansion in China. We estimate its revenue in urban rail business would grow at 19.58% CAGR over FY13F-15F, while the Group's overall net income would grow at 12.02% CAGRs over the same period. Its high gearing, however, remains our primary concern as it could result in higher financial costs. Reiterate **BUY**.

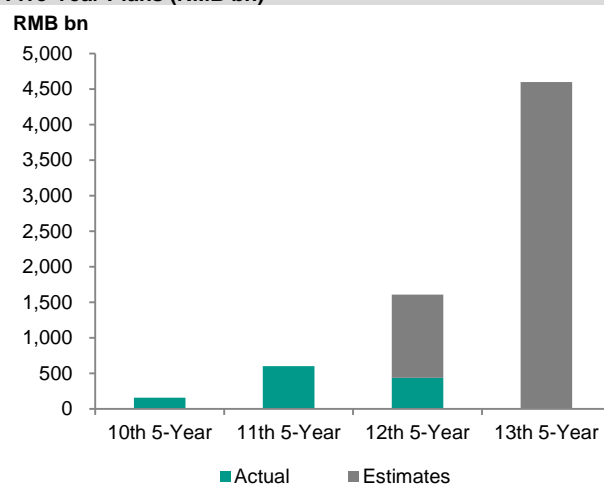
**Risk factors:** 1) Prudent monetary policy affects capital inflow and delay construction; 2) Heavy debt burden of CRC may limit growth in overall infrastructure investment and rolling stock purchases; 3) Loan tightening by creditors.

**Exhibit 1: Average urban rail coverage ratio in global regions (2012) (km/km<sup>2</sup>)**



\*Country data reflects coverage ratio in major cities (except Hong Kong)  
Source(s): Statistic Bureau of U.K./Germany/Canada/U.S./Singapore/South Korea/Hong Kong/Japan/France/China, ABCI Securities

**Exhibit 2: Urban rail investment targets based on China's Five-Year Plans (RMB bn)**



\*Urban rail investment includes investment in infrastructure construction and purchases of rolling stock, electrical & mechanical systems, and other components  
Source(s): MOHURD, ABCI Securities estimates

**Sector Valuation Summary (Data as of Nov 27, 2013)**

Company	Ticker	Rating	TP (HK\$)	Upside (%)	FY13F P/E(x)	FY14F P/E (x)	FY13F P/B (x)	FY14F P/B (x)	FY13F Yield (%)	FY14F Yield (%)
CRCC	1186 HK	BUY	10.22	19.93	8.60	7.32	1.07	0.95	1.74	2.05
CRG	390 HK	BUY	5.14	15.67	8.82	7.69	0.91	0.82	1.70	1.95
CCCC	1800 HK	BUY	7.67	22.15	6.46	6.02	0.87	0.79	3.87	4.15
CSR	1766 HK	HOLD	6.15	(12.46)	20.59	19.22	2.23	2.04	0.97	1.04
CSR Times Electric	3898 HK	HOLD	27.72	(3.01)	22.40	19.16	3.10	2.76	1.34	1.57

Source(s): Bloomberg, ABCI Securities estimates