



**ABCI China/Hong Kong Equity Research
2H14 Economic Outlook and Investment Strategy**

The Turning Point



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Definition of equity rating

Rating	Definition
Buy	Stock return \geq Market return rate
Hold	Market return - 6% \leq Stock return < Market return rate
Sell	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 2009-2013

Time horizon of share price target: 12-month

Definition of share price risk

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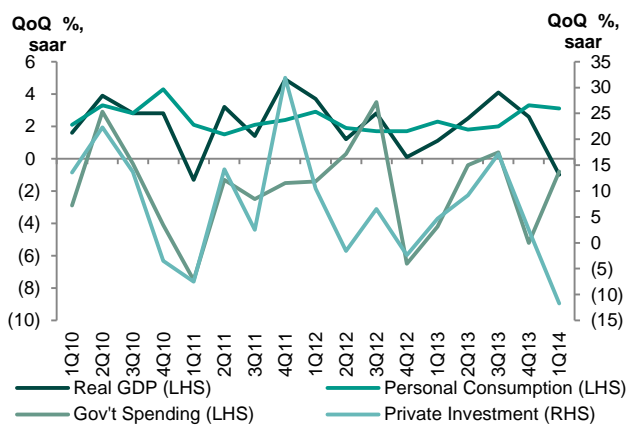


2H14 Global Economic Outlook

U.S.: Economic momentum continues

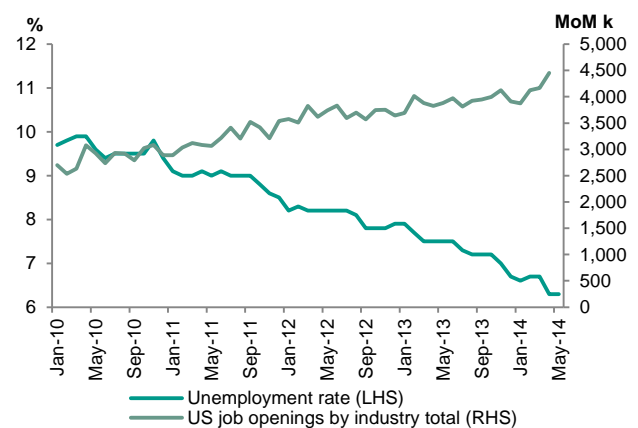
During 1H14, the U.S. economy is undoubtedly one of the best performers in the post-crisis economic recovery. Although its GDP decline of 1% QoQ in 1Q14 presents a negative surprise to the market, other economic data demonstrate a strong footing. The U.S. job market has been improving. Unemployment rate has been steadily decreasing; the number of job openings is standing at its seven-year high. Despite severe weather conditions in 1Q14, industrial production continued to rebound in May with a 4.27% YoY growth, and the ISM manufacturing PMI also climbed to 55.4% for the same month.

Exhibit 1: U.S. GDP growth in 1Q14 disappointed



Source(s): Bloomberg, ABCI Securities

Exhibit 2: U.S. job market continues to improve



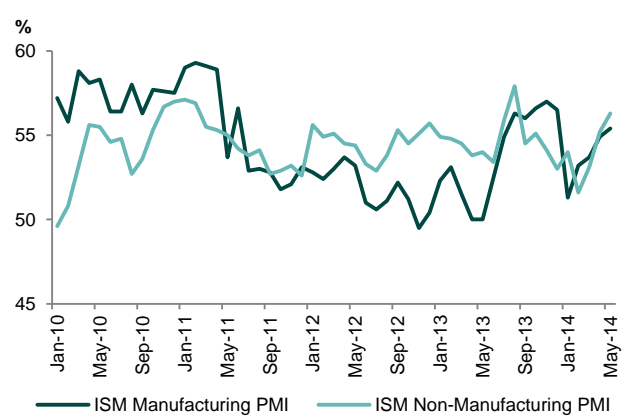
Source(s): Bloomberg, ABCI Securities

Exhibit 3: U.S. industrial production trended up in May



Source(s): Bloomberg, ABCI Securities

Exhibit 4: U.S. PMI climbed in May

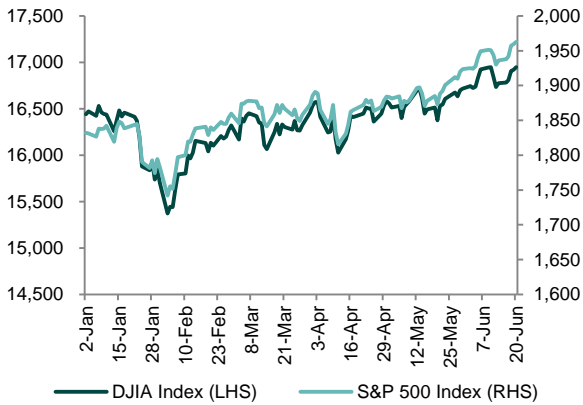


Source(s): Bloomberg, ABCI Securities

Buoyed by the positive economic momentum, the U.S. equity market soared to new highs in 1H14. As of June 20, 2014, the Dow Jones Industrial Average Index (DJIA) and S&P 500 Index stood at 16947.08 and 1962.87, equivalent to respective 2014 leading P/E of 15.14x and 16.61x. Meanwhile, the liquidity spread and default spread continued to narrow, indicating that systematic risk in the U.S. economy is declining.

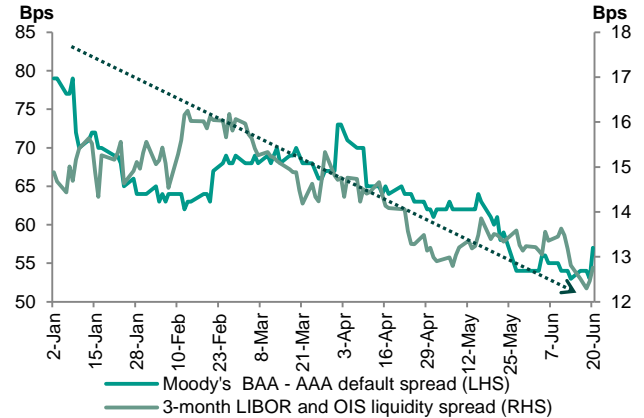


Exhibit 5: U.S. equity market edges to new highs in 2014



Source(s): Bloomberg, ABCI Securities

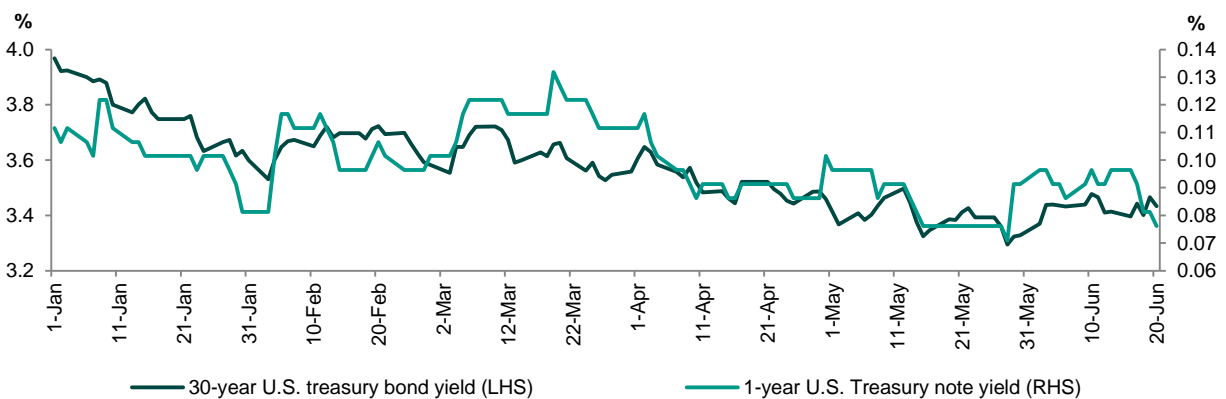
Exhibit 6: Spread measures indicate declining systematic risk in the U.S. in 2014



Source(s): Bloomberg, ABCI Securities

Despite the economic resilience demonstrated, QE tapering and the eventual interest rate hike remain significant concerns. Recent announcement of downsizing the asset-purchasing pace to US\$ 35 billion in July confirms the expectation that the recovery has strengthened the Fed's resolve to end the QE program by the end of this year. Yet, whether the Fed could smoothly step down from the QE program still hinges on its handling of the interest rate hike and asset reduction on its balance sheet. Even though the Fed has signaled that it will remain accommodative on the interest rate for a considerable period of time, we believe the interest rate will rise in mid-2015 or 2H15. We also maintain that the Fed would be committed to reinvestment of the asset holdings on its balance sheet to further stimulate growth. Economic data in the coming months will have great influences on the Fed's policy and market expectation of the Fed's exit trajectory.

Exhibit 7: Fed's accommodative policy stance led to lower yield and higher price of U.S. Treasury



Source(s): Bloomberg, ABCI Securities

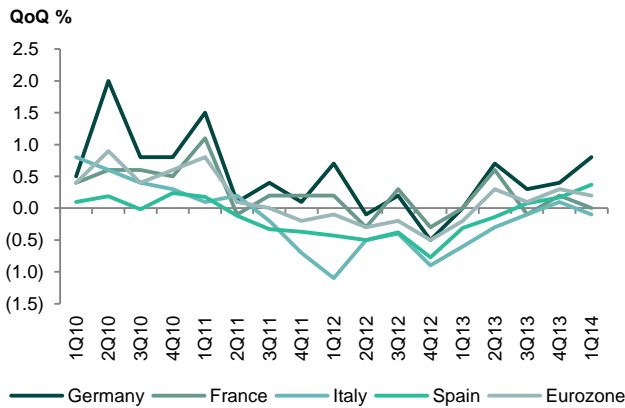
In our view, recovery of the U.S. economy is on track regardless of the setback in the 1Q14. Risk of another technical downturn diminishes, but there will be challenges ahead. Policy support from the government is necessary to sustain the current momentum. Fed's orderly exit from the QE and normalization of monetary policies are essential to the economic rebound in the rest of the year. Based on these concerns, we revise our U.S. 2014 GDP growth forecast downward to 2.2% YoY (from 2.7% previously).



Eurozone: Still in doldrums for most

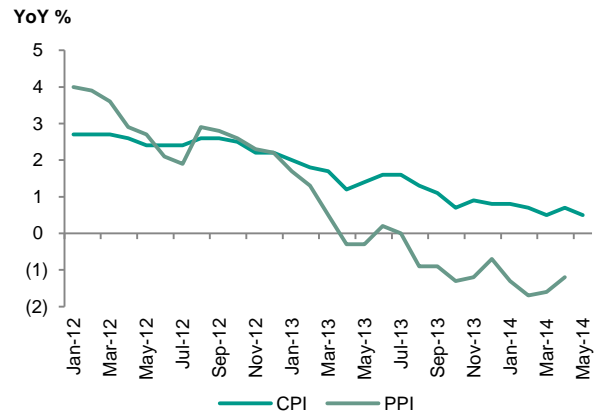
Recovery of the Eurozone economy in the 1H14 has been lagging behind other developed nations. Inflation measured in consumer price was 0.5% YoY in May, suggesting a persistently low inflation and the possibility of a widespread deflation in the region. Moreover, unemployment rate is still running high across the region. In addition, even though certain economic indicators generally have improved over the past 6 months, the member nations are recovering at different paces. So far, Germany has shown success in combating the economic recession, with its 1Q14 GDP growing at 0.8% QoQ and industrial production expanding by of 1.8% YoY in April; its European peers, such as France, Italy, and Spain, however, are still in the doldrums. Respective GDP growth for 1Q14 in these countries was 0% QoQ, -0.1% QoQ, and 0.37% QoQ.

Exhibit 1: GDP growth of Eurozone nations



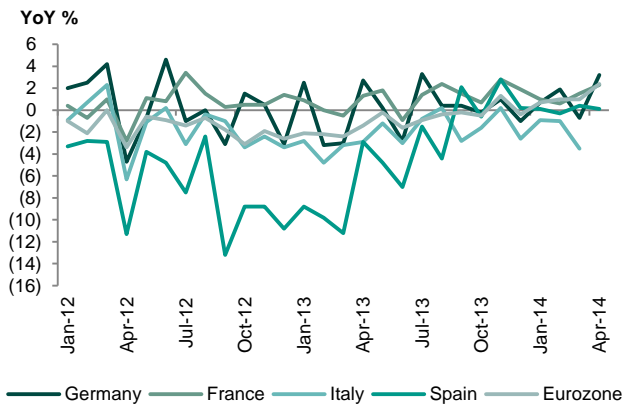
Source(s): Bloomberg, ABCI Securities

Exhibit 2: Eurozone CPI signals deflation risk



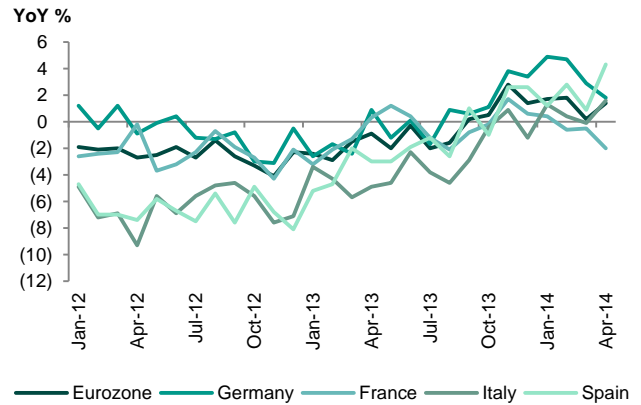
Source(s): Bloomberg, ABCI Securities

Exhibit 3: Retail sales growth of major Eurozone members



Source(s): Bloomberg, ABCI Securities

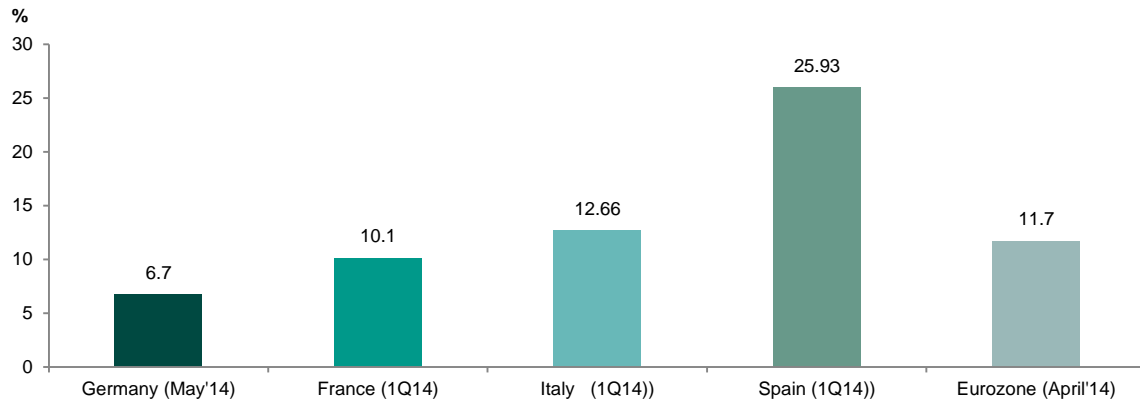
Exhibit 4: Industrial production growth of major Eurozone members



Source(s): Bloomberg, ABCI Securities



Exhibit 5: Unemployment rates of some Eurozone member states remain high



Source(s): Bloomberg, ABCI Securities

The European Central Bank (ECB) managed the dismal economic situation by employing a range of policy tools. The low inflation in May prompted adoption of new measures such as slashing refinancing rate and deposit rate to 0.15% and -0.1%. In addition, ECB will conduct the targeted long-term refinancing operations (TLTRO) to stimulate growth by requiring banks to provide cheap loans to small businesses and channel more liquidity to the struggling private sector. These unconventional moves indicate that ECB will continue to use necessary policy tools to support growth. We believe this strongly hinted to the possibility that ECB may conduct an asset-purchase program similar to the Fed's QE in the future if need be. Our only concern is that there could be major differences between the ECB's policy designs and subsequent implementations.

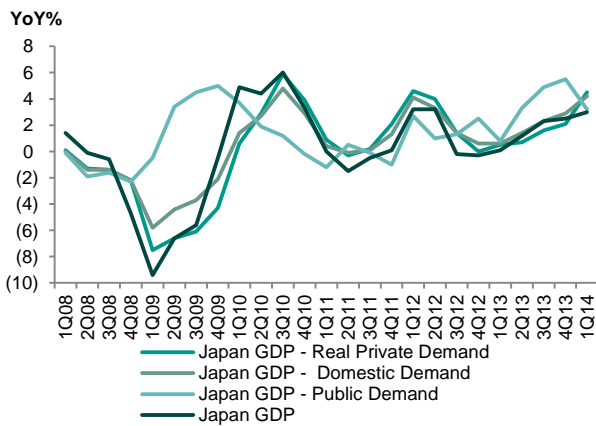
Growth in the Eurozone still faces challenges in 2H14. Even though we see continuous improvement, as reflected by the economic indicators, deflation risk still exists and recovery pace could be jeopardized by the uneven developments in the member states. While we believe ECB and other authorities in the Eurozone will still have to exert considerable efforts to revitalize the economy, the ECB's accommodative stance and improving global economy should be able to help Eurozone's economy regain poise. Therefore, we revise the GDP growth of Eurozone up from 0.8% YoY to 1.1% YoY for 2014.



Japan: Structural reform is the key to economic success

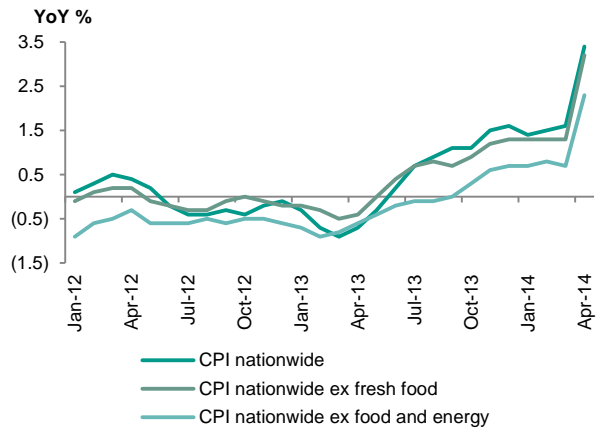
The Japanese economy has been expanding in 1H14, thanks to the monetary easing and fiscal stimulus (the first and second arrows of Abenomics). Japan's GDP expanded by 3% YoY in 1Q14. Industrial production, capital expenditure, and international trade are all growing in a healthy pace. Apparent success of raising inflation proves the effectiveness of the first two arrows of Abenomics, but consumers' frontloading behavior resulting from the consumption tax hike in April could have inflated the GDP growth, raising doubts on the sustainability of the growth observed. To be cautious, there seems to be signs of retraction in the economy. Household income growth could not keep up with the consumption tax hike and the rising inflation. Household spending and retail sales also dropped at an alarmingly fast pace in April, which we believe to be a direct result of the consumption tax hike. Therefore, rebalancing the fiscal restructuring and growth will largely depend on implementation of the "third arrow" of Abenomics – the structural reform.

Exhibit 1: Japan's GDP growth



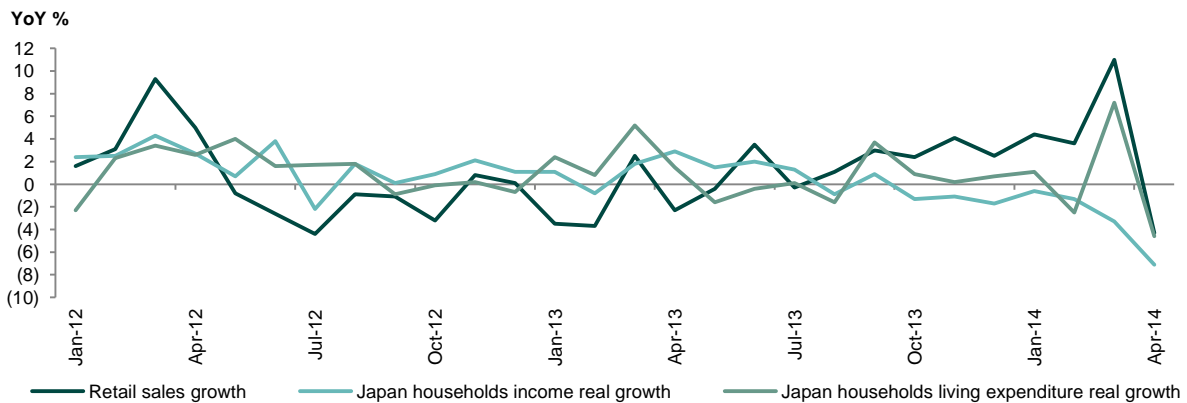
Source(s): Bloomberg, ABCI Securities

Exhibit 2: Japan's inflation moves higher



Source(s): Bloomberg, ABCI Securities

Exhibit 3: In Japan, consumption tax hike has taken its toll

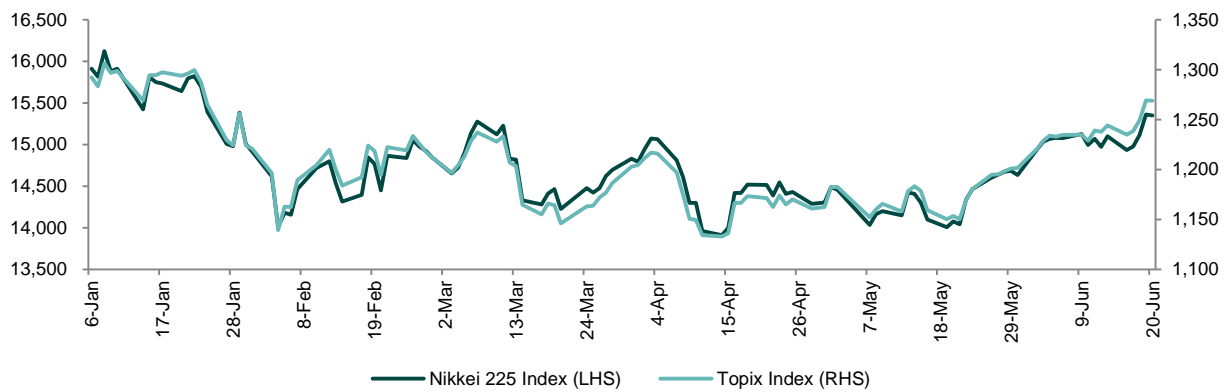


Source(s): Bloomberg, ABCI Securities



Structural reform will be the most critical part of the Abenomics. Due to the lack of a concise and detailed plan for the “third arrow” as promised by Abe, the Nikkei 225 Index and the TOPIX index dropped by 5.78% and 2.56% as of June 20, compared to their corresponding gains of 51% and 56% in 2013. On June 24, the government unveiled the long-overdue reform package, proposing initiatives such as opening special economic zones, reforming the labor market, lowering corporate tax rate, revising the investment style of the Government Pension Investment Fund, and tackling demographic issues – which are mostly in line with market expectations. We believe it would take some time before such measures could exert material impacts on the economy and Abe must bring forward complementary legislations to ensure fruition of the third arrow. In our view, it is also crucial for Abe to reach consensus with various interest groups to bring forward more bold changes, as we find certain part of the current reform package, such as the reform of the agriculture sector, failing to meet Abe’s previous promises.

Exhibit 4: Japan’s stock indices in 2014 reflect investors’ concern over the “Third Arrow”



Source(s): Bloomberg, ABCI Securities

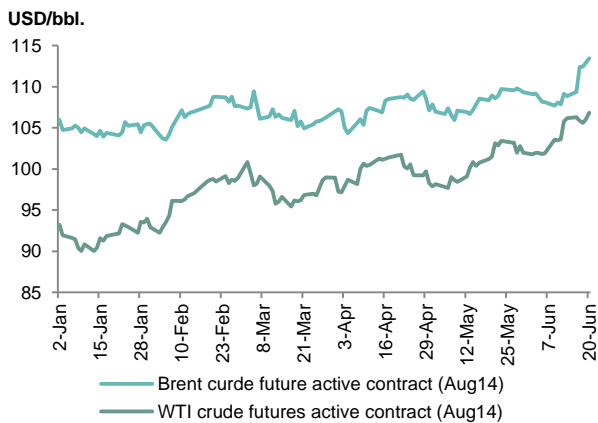
We believe the Abe administrations will soon explore specific details and legislations of the announced reform measures. More specifications regarding these reforms are likely to be released in the coming weeks. Whether a comprehensive reform package that complements the previous two arrows can be delivered remains to be seen. Our Japan 2014 GDP growth forecast is 1.7% YoY (from 1.6% YoY previously).



Emerging Market: Embracing the new reality

So far, 2014 has been a tough year for the emerging market as increasing geopolitical risks obscuring the political and economic prospects of the region. Even though the global market has calmed more or less on gradual recovery of the economy and supportive measures by the central banks, we believe uncertainty in the emerging market could potentially become a volatility trigger. While impacts of the Crimean crisis are largely contained, escalating conflict in Iraq is likely to weigh on the international market as the tension between the Iraqi military and the insurgents is mounting. In our view, the resulting disruption of oil production will bring more supply-side pressure to crude oil output and drive up crude oil prices. In fact, surge in oil and gold prices have already reflected such possibility and investors' flight-to-safety mentality. The global economic recovery will suffer if oil price spikes and market correction occurs across the board.

Exhibit 1: Tension in Iraq increase crude oil prices in 2014



Source(s): Bloomberg, ABCI Securities

Exhibit 2: Surging gold price in June this year reflect a flight-to-safety sentiment



Source(s): Bloomberg, ABCI Securities

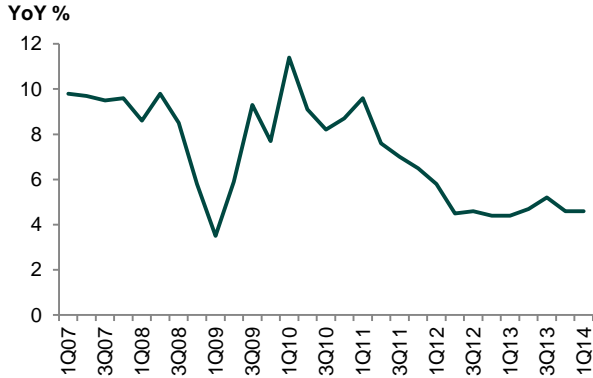
Concerns on Fed's QE withdrawal and subsequent interest rate hike in emerging market has been temporarily lifted as the U.S. signaled it will maintain interest rate at current level for a considerable period of time. While both the U.S. and the emerging market will also gain on such an accommodative policy stance, China's recent restructuring efforts are likely to weigh on the emerging market as a whole. We believe development of the emerging market will be more dependent upon the continuous improvement of external economic environment, resolution of regional issues, and their efforts to adjust their economic model to boost growth.

India

The election of Narendra Modi as India's new prime minister is the prelude to a new stage of the Indian economy. Modi has pledged to turn around India's economy by accelerating infrastructure investments, encouraging foreign investments, and enhancing the quality of life for the general public. Nonetheless, we believe the high fiscal deficit and inflation will present great obstacles for Modi to pursue his rather aggressive growth policy. If the government follows through its growth mandates without any structural adjustment, the resulting upward price pressure will lead to more monetary tightening from the RBI, and the government's fiscal burden will be elevated. Therefore, we expect that the government will push for economic initiatives and pursue structural adjustment at the same time. Increasing the short-term government fiscal flexibility, allowing more FDI inflow, and gradually reducing the current account deficit to make room for the private sector are some of the viable options to inspire healthy economic growth. All in all, we believe India will benefit from the Modi's commitment to economic growth in 2014. Therefore, we raise our 2014 GDP growth forecast for India from 5.5% YoY previously to 6.0% YoY.

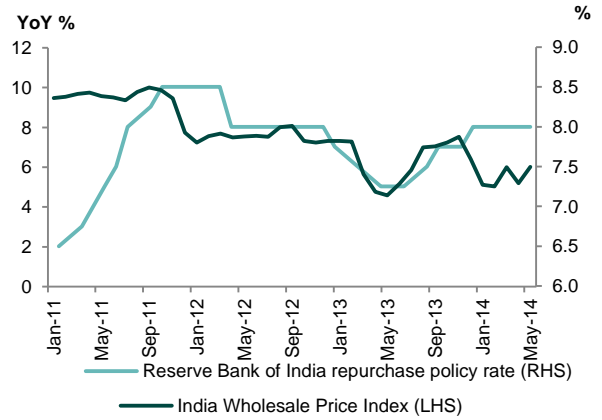


Exhibit 3: India GDP growth



Source(s): Bloomberg, ABCI Securities

Exhibit 4: High inflation in India

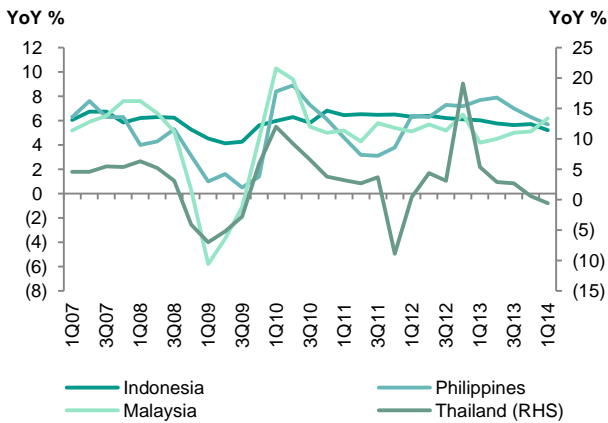


Source(s): Bloomberg, ABCI Securities

ASEAN

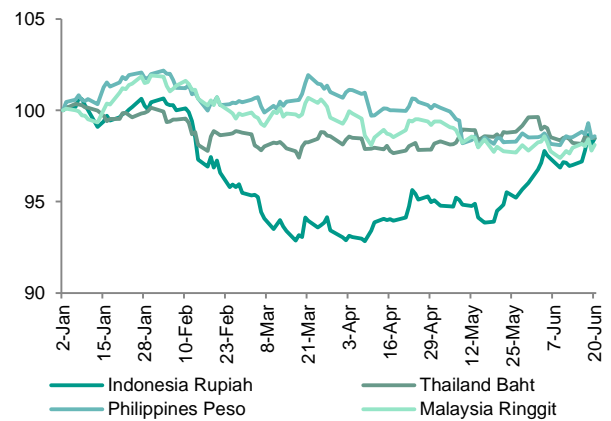
For the ASEAN members, expectation of the Fed's tapering caused another round of turbulence in the local equity and currency markets at the beginning of 2014. Setbacks in political stability occur as domestic and regional conflicts unfold. Thailand is suffering from political unrest on prolonged internal party disputes which led to the eventual takeover of the government by the military. Meanwhile, Indonesia's future is clouded by the presidential election in July. We expect growth in Southeast Asia will continue to be stymied by these negative spillovers in the short term. Also we maintain that leaders in these countries will need to prioritize structural reforms and cultivate new growth drivers to boost the economy.

Exhibit 5: GDP growth of 4 ASEAN countries



Source(s): Bloomberg, ABCI Securities

Exhibit 6: Year-to-date changes in currency value among ASEAN members



Note: Baseline = January 2, 2014; all currency values are against the U.S. dollar

Source(s): Bloomberg, ABCI Securities



Global economic forecasts

YoY (%)	2011	2012	2013	2014F	2015F
U.S	1.8	2.8	1.9	2.2	2.8
Eurozone	1.6	(0.7)	(0.5)	1.1	1.6
Germany	3.4	0.9	0.5	1.5	1.6
France	2.0	0.0	0.3	0.9	1.5
Italy	0.4	(2.4)	(1.9)	0.6	1.1
Spain	0.1	(1.6)	(1.2)	1.0	1.0
Netherlands	0.9	(1.2)	(0.8)	1.0	1.6
Greece	(7.1)	(7.0)	(3.9)	1.2	2.9
Portugal	(1.3)	(3.2)	(1.4)	1.3	1.5
Ireland	2.2	0.2	(0.3)	2.0	2.5
UK	1.1	0.3	1.8	2.7	2.5
Japan	(0.5)	1.4	1.5	1.7	1.5
Mainland China	9.3	7.7	7.7	7.6	7.3
Hong Kong SAR	4.8	1.5	2.9	3.0	3.5
Singapore	6.0	1.9	4.1	3.5	3.5
South Korea	3.7	2.0	2.8	3.6	4.0
Russia	4.3	3.4	1.3	1.0	2.0
India	6.6	4.7	4.4	6.0	6.4
Brazil	2.7	1.0	2.3	1.7	2.2

Source(s): IMF, ABCI Securities estimates



2H14 China Economic Outlook

The first half of 2014 was marked by global volatility and slowdown in economic activities in China, whose major indicators are showing unmistakable signs of softening. Although China's long-term growth prospect remains solid, there will be rocky times along the way of reforms. GDP growth in 1H14 will moderate as the economy is readjusting its expansion model. To reform the Chinese economy to one with more emphasis toward quality and efficiency, China will experience a structural slowdown, along with policy experimentation in areas including investment, international trade, land rights, and pricing mechanisms. The government will continue to implement ambitious reforms and mini-stimulus measures, including targeted RRR cuts and investment incentives for strategic sectors, to boost sentiment. Although growth in most indicators will moderate, the overall macroeconomic conditions will remain stable.

For 2H14, the acceleration in private consumption and investment, together with improvement in export growth, will promote more balanced growth in China's GDP; a macro turnaround is highly likely in our view. The declining trends observed in most economic indicators will decelerate, including those of external trade, investment, and industrial output. With more infrastructure spending and targeted liquidity easing supported by bold reform measures, the country is bound for a moderate recovery in 2H14. We believe the economy will bottom out in 1H14, expanding by 7.5% YoY in 1H14 – to be followed by resurgence in investor confidence and China's GDP will increase by 7.7% YoY in 2H14. Inflation is also expected to be mild at below 3% in 2H14 with the full-year figure estimated to be 2.6%. Major GDP contributors will strengthen in reasonable paces for 2H14. Accordingly, we reiterate our GDP growth forecast of 7.6% YoY for 2014F and 7.3% YoY for 2015F to take into account of the moderating economic recovery.

Exhibit 1: Economic Forecasts for China

(YoY %, or otherwise specified)	2012	2013	1Q14	2Q14F	2H14F	2014F	2015F
Real GDP	7.7	7.7	7.4	7.6	7.6	7.6	7.3
FAI(YTD YoY %)	20.6	19.6	17.6	17.5	17.5	17.5	17.5
Retail Sales	14.3	13.1	12.0	12.4	13.0	12.6	14.0
CPI	2.6	2.6	2.3	2.3	2.9	2.6	3.0
PPI	(1.7)	(1.9)	(2.0)	(1.5)	(0.2)	(1.0)	1.0
Exports	7.9	7.9	(3.4)	5.4	9.6	5.6	8.5
Imports	4.3	7.3	1.6	2.0	6.7	4.3	7.5
Trade Surplus (US\$ bn)	231.1	259.8	16.6	85.8	196.9	299.3	345.1
M2	13.8	13.6	12.1	13.4	13.3	13.3	13.5
Exchange Rate (US\$/RMB)	6.2306	6.0543	6.2171	6.2255	6.1000	6.1000	6.0000

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



2H14 China Policy Outlook

After 1Q14 GDP growth fell below the government's target to 7.4% YoY, China has launched a slew of min-stimulus measures, including targeted RRR cuts for rural financial institutions and qualified banks, accelerating railway investment, boosting overall investment and domestic consumption to stabilize the economy. China's macroeconomic policies will be tilted towards remodeling the economic structure and controlling risks. To achieve a GDP growth of 7.5% for 2014, policymakers have been enhancing support for small businesses and accelerating spending of budgeted funds to weather economic slowdown and restore growth momentum. As China is at the turning point of reversing the economic downtrend, we expect the government to scale up its policy support. Our analysis of the set of growth-prompting monetary and fiscal initiatives likely to be introduced in 2H14 is provided in the following paragraphs.

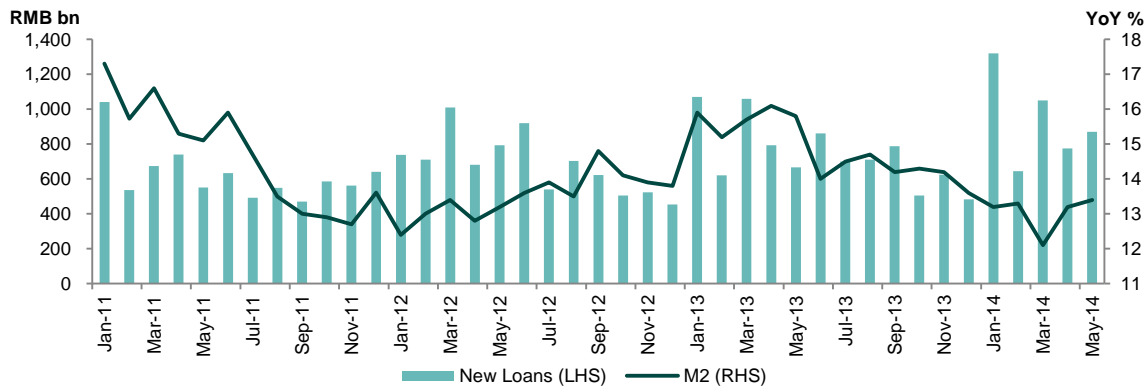
Monetary policy: Targeted monetary easing

In June, the People's Bank of China (PBOC) announced a 50 bps cut in the required reserve ratio (RRR) for two-thirds of city commercial banks, 80% of non-county level rural commercial banks, and 90% of non-county level rural cooperatives banks engaging mainly in lending to the agriculture sector and micro and small sized enterprises (MSEs). This is the second targeted RRR cut following the one in April. The cut will unlock an estimated RMB 60 billion for lending to diminish the risk of further slowdown in the world's second-largest economy. We believe the latest targeted RRR cut will gear up the lending momentum and lower the market risk premium, thus improving the market sentiment and stimulating economic activities.

China's challenge in 2H14 will be to maintain a healthy credit growth and accelerate economic restructuring while sustaining its GDP growth at above 7%. Following the targeted RRR cut for the agriculture sector and MSEs, we believe more targeted credit loosening will be rolled out to stabilize the economy. We may also see further widening of the floating range in deposit rates as interest rate liberalization deepens further. PBOC will keep the money supply and aggregate financing to the real economy (AFRE) growing at a reasonable pace while optimizing financing and credit structures.

Liquidity management will continue to be a priority of monetary policy in 2H14. Considering the economic recovery in the U.S. and other developed markets, we believe international capital will continue flowing into China, exerting more pressure on PBOC to manage liquidity. Therefore, PBOC will continue to accommodate capital demand and manage temporary liquidity fluctuations in the banking system on a discretionary basis via monetary tools, including repo, short-term liquidity operations (SLO), and the standing lending Facility (SLF).

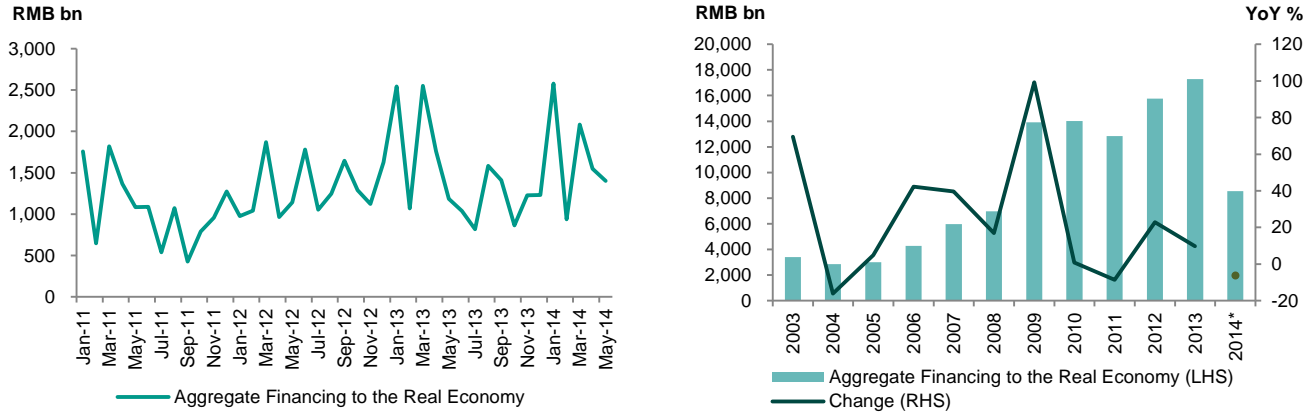
Exhibit 2: Stable growth of new loans and M2



Source(s): PBOC, ABCI Securities



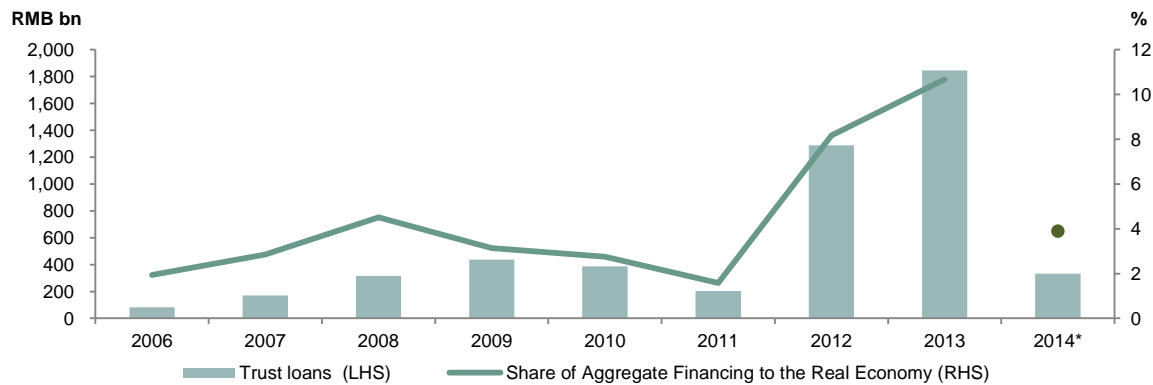
Exhibit 3: Aggregate financing to real economy (AFRE) turns stable in 2014



*Jan - May

Source(s): PBOC, ABCI Securities

Exhibit 4: Share of trust loans is declining



* Jan - May

Source(s): PBOC, ABCI Securities

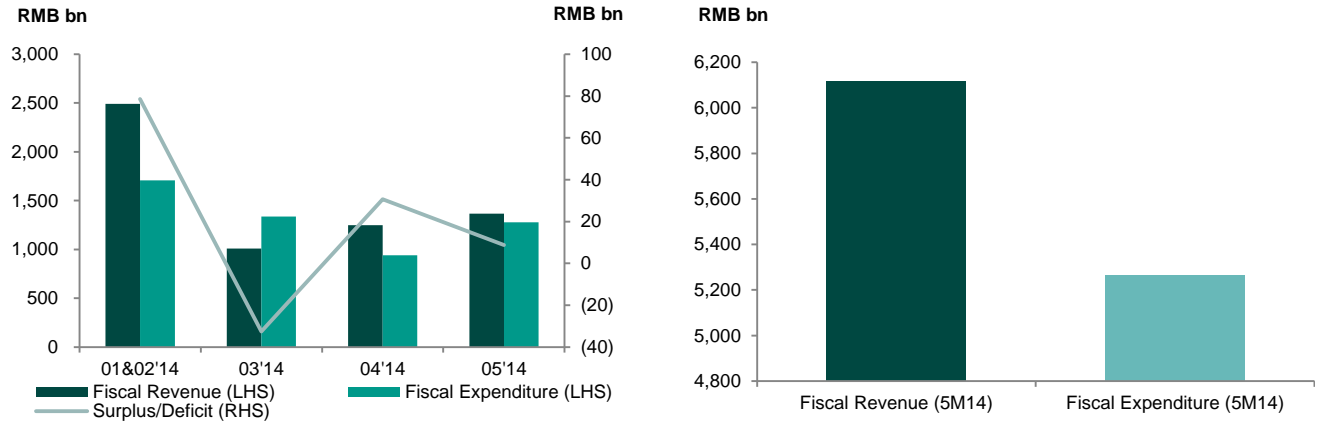
Fiscal policy: Aggressive approach to support economic reforms

Fiscal policy in 2H14 should serve the purpose of deepening reforms. Special attention will be given to transforming government functions and simplifying administrative approval procedures. The adoption of proactive fiscal policies is expected to prompt sustainable growth. For specific fiscal measures, the government will continue to adjust the structure of expenditures, invest in infrastructure, and improve tax structure by replacing turnover tax with value-added tax (VAT) across sectors. The key to current economic system reform is to reduce government intervention and let the market play a more decisive role. Moreover, the central government will support infrastructure investment in highways and high-speed railway construction, electricity grid upgrades, and resource development in the central and western provinces. It will also continue to monitor the construction of subsidized housing funded partially by the local governments. For 2H14, we expect further stimulus packages to be launched in a more aggressive manner. These packages will target to (1) accelerate approvals for infrastructure and construction projects, (2) increase issuance of local government bonds, (3) increase subsidies for energy-efficient consumer products, (4) direct more private capital to large , high-barrier industrial sectors that used to be dominated by state firms, (5) reform tax structure to support more service sectors,



(6) discontinue government's price intervention in consumer staples and certain products whose demands are rising, (7) and reform pricing in the energy sector.

Exhibit 5: A healthy fiscal position to weather economic slowdown

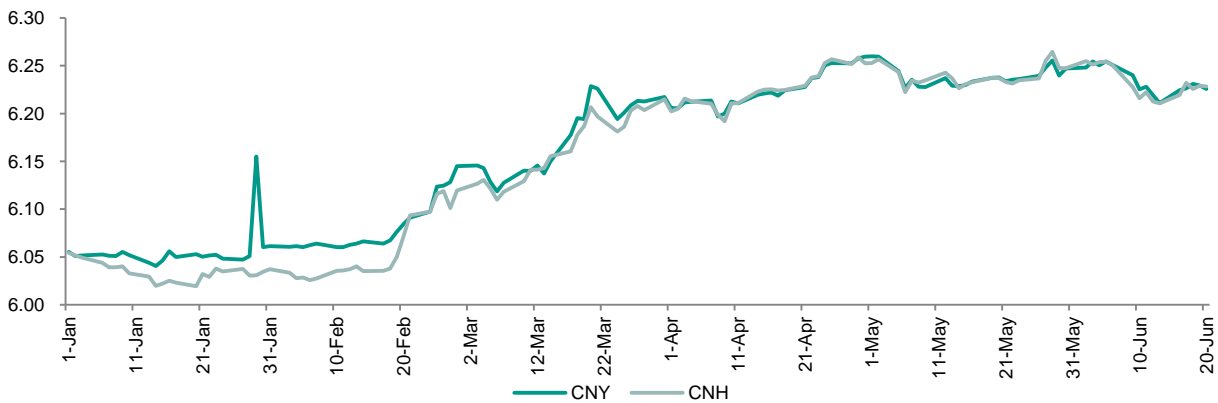


Source(s): Ministry of Finance, ABCI Securities

Renminbi trend: Expect greater volatility, but downward pressure is likely to halt

PBOC's moves to curb inflow of hot money and weaker-than-expected Chinese economic activities result in renminbi's depreciation in 1H14. Negative spillovers to renminbi were intensified when PBOC geared up forex liberalization to widen the trading band of renminbi against the U.S. dollar as problems loom in the financial sector. Modest depreciation and surging volatility resulted from PBOC's moves to slow the amount of carry trades, however, will allow the true value of renminbi to be reflected more by economic fundamentals and less by speculative trades. We expect the liberalization of exchange rate will allow market forces to play an increasingly bigger role in both the currency and capital markets. The economy will stabilize in the coming months, and renminbi will receive support from the growth in economic activities in 2H14. As a result, appreciation of the currency is anticipated, though the pace will be gradual in the medium and long term. For 2H14, we forecast that renminbi will rebound by 2.0% from its current level (RMB 6.2255 per USD) to RMB 6.1 per USD by end-2014.

Exhibit 6: Surging volatility of Renminbi after widening trading band in 2014



Source(s): Bloomberg, ABCI Securities



Economic themes for 2H14

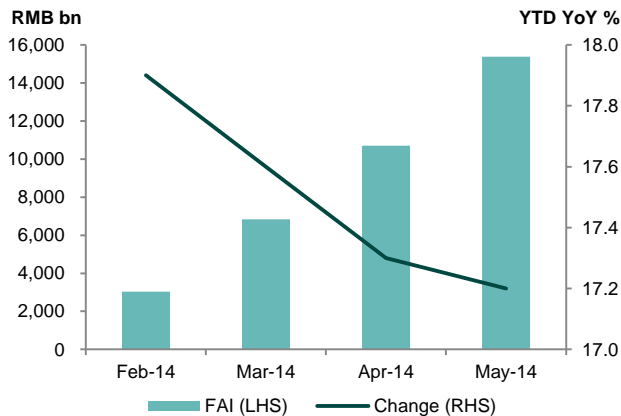
The Third Plenum and NPC have provided clear guidance for China's policymakers to implement reforms at a gradual pace. The reforms, while slowing output growth in the near term, is highly beneficial in the long run as China focuses on attaining sustainable and high-quality growth in coming decades. In a less accommodating macro context, we expect structural reforms and economic initiatives will help establish a new economic model in China.

1. FAI growth to be stabilized by surging infrastructure investment

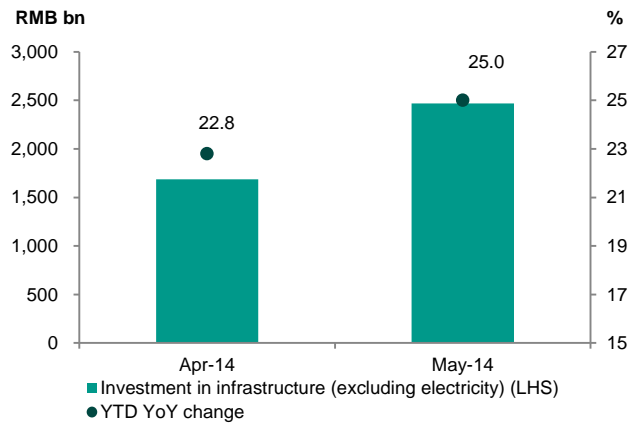
Deceleration in FAI growth has been a growing concern since 3Q13, but there are signs indicating that such growth is stabilizing as 5M14 FAI stood at 17.2% YoY, just slightly below April's figure of 17.3% YoY. We attribute the steady growth to the rebound of government-initiated infrastructure investments, which posted a 5M14 growth of 25% YoY, 2.2% higher than that of April.

As China Railway Corporation announced in April to increase the rail infrastructure investment budget for 2014 from RMB 630-650 billion to RMB 800 billion, local governments are urged to kick start the scheduled infrastructure projects. This should drive up infrastructure investment in 2H14, given that these projects will be able to secure funding successfully from the central government, local governments, and banks. To finance these infrastructure projects, we believe issuance of local municipal bonds and local infrastructure bonds will surge.

Exhibit 7: Stabilizing FAI and surging infrastructure investment



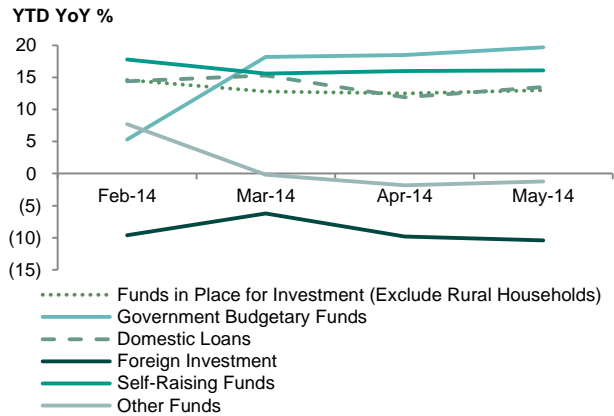
Source(s): NBS, ABCI Securities



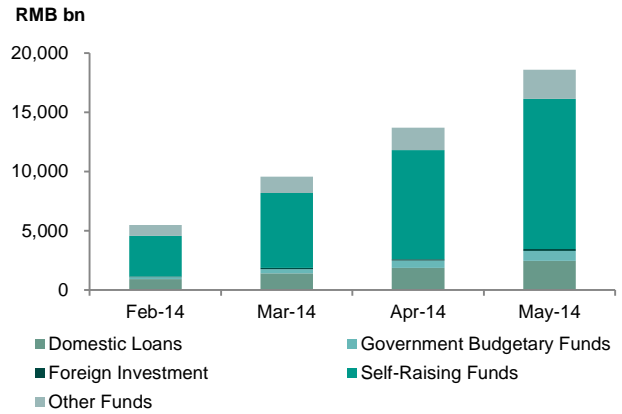
Source(s): NBS, ABCI Securities



Exhibit 8: FAI funding growth turns stable



Source(s): NBS, ABCI Securities

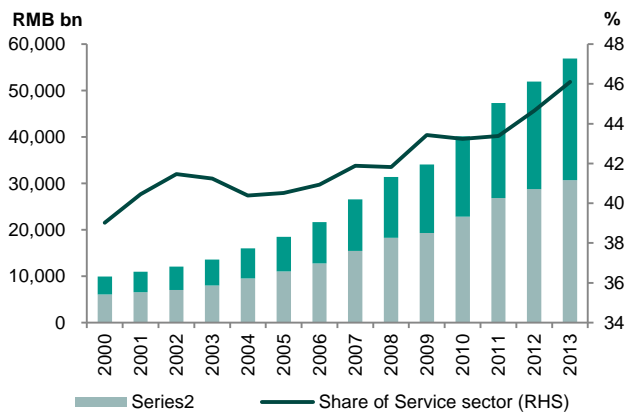


Source(s): NBS, ABCI Securities

2. Deregulation of service sector to boost consumption

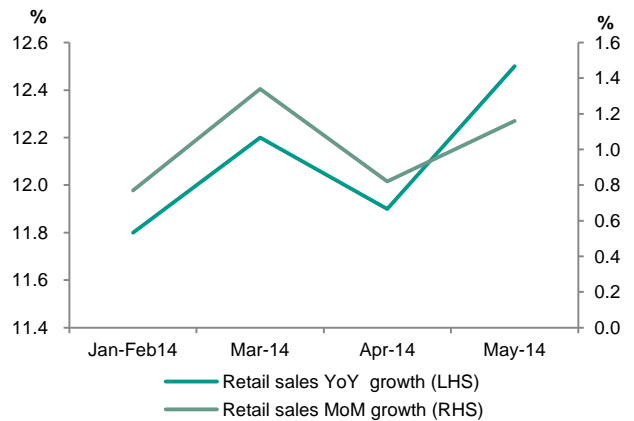
Services made up 46.1% of GDP in 2013, overtaking manufacturing – China's biggest employer in 2012. Recently, the official Purchasing Managers Index (PMI) for services rebounded to 55.5 in May from 54.8 in April – above the 50 level that divides expansion and contraction. The data show that China's services industry is still growing relatively swiftly. As the government intends to enhance the role of consumption and reduce the economy's dependence on exports and investments, services will continue to play a bigger role in driving China's economic growth in 2014. Deregulation of the services sector will be the key to sustainable economic growth; we foresee sectors such as healthcare, financials, and technology, media & telecommunications (TMT) will be open up further to non-SOE investors to increase efficiency of the services sector by competition.

Exhibit 9: Surging share of services in GDP



Source(s): NBS, ABCI Securities

Exhibits 10: Stabilizing trend of consumption



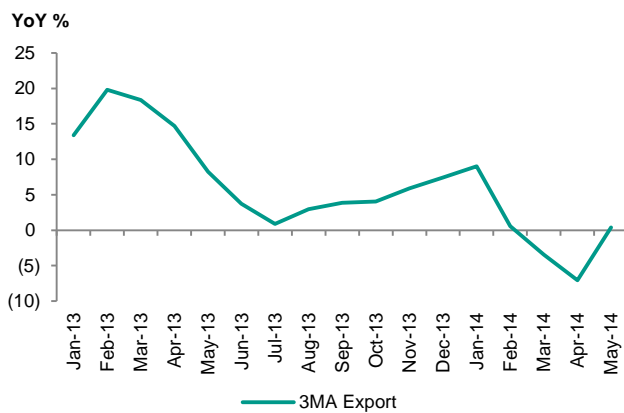
Source(s): NBS, ABCI Securities



3. External trade: The worst is over and services trade rises

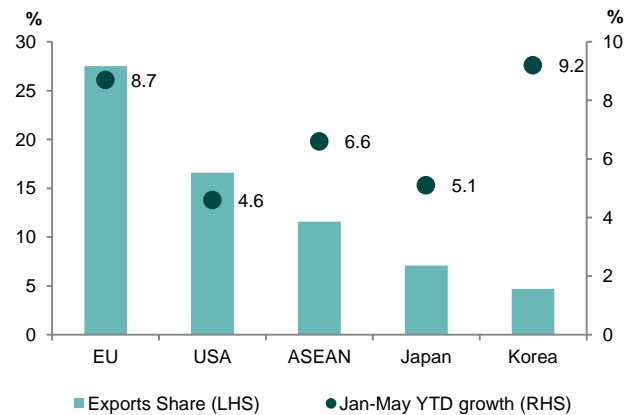
External trade, a pillar of China's economy, demonstrated anemic growth in 1Q14. Negative export growth in 1Q14 was not only a result of high base in a year earlier but also the sluggishness among the country's trading partners. Nevertheless, a turnaround in export has ensued in April and May, with China's exports to its major trading partners (the U.S., E.U., Japan, and ASEAN) surging during the period, signaling a recovery in foreign markets. With the high-base effect subsiding and external markets regaining strength, we believe China's export will be reinvigorated. Overall, we believe China's external trade will remain resilient with improvements to be seen in 2H14.

Exhibit 11: Exports show rebounding signs



Source(s): Bloomberg, ABCI Securities

Exhibit 12: Exports to major trading partners remain resilient



Source(s): Bloomberg, ABCI Securities

Trade reforms gearing towards increasing services trade will be the key element to sustain growth in the external trade sector. The latest emphasis on services trade is part of China's efforts to maintain its trade expansion amid a slowing domestic economy and flaccid external demands tarnishing exports of China-made products. Total services trade in 1Q14 grew 15.6% YoY to US\$ 138.8 billion, up 1.6% YoY and accounted for 12.8% of total trade and rose 1.6% YoY. Services exports and imports rose 14% and 16.6% YoY, indicating hastening developments in cross-border service trades. Since penetration of services is still low and government is shoring up its support for the services sector, services trade will undoubtedly become the growth engine of external trade.

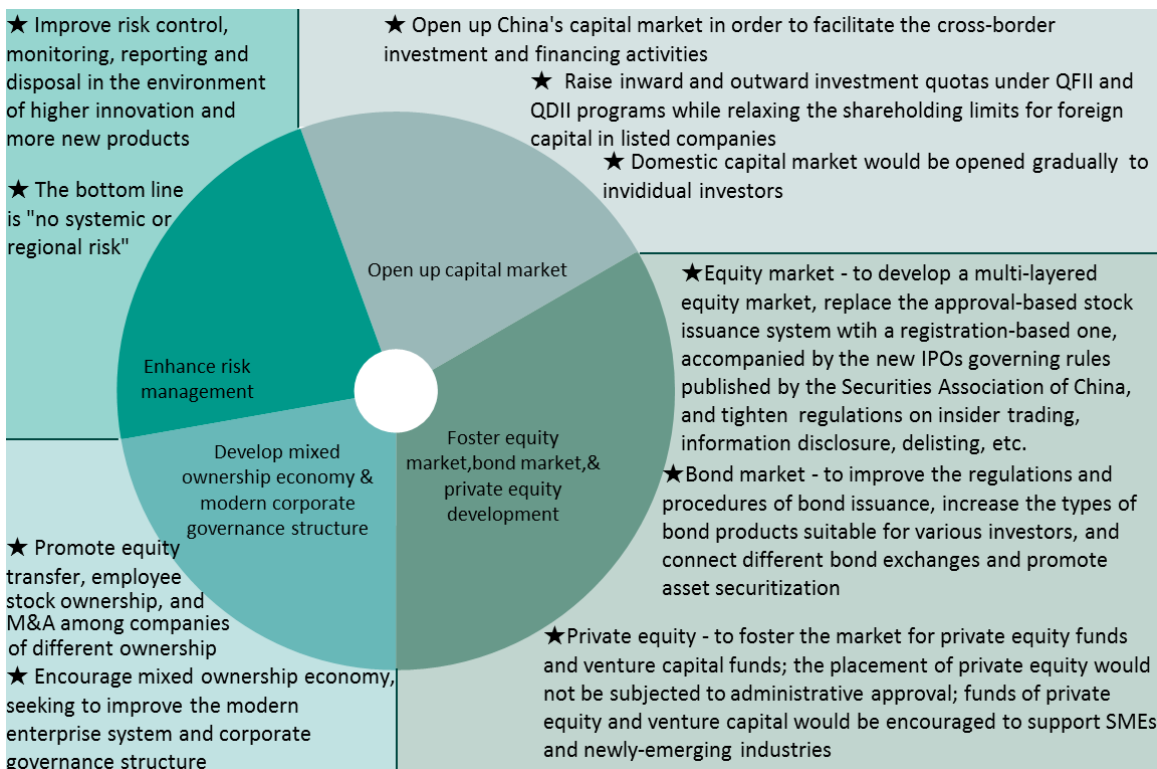


4. More liberalized financial system in sight

Major reforms in China's financial sector are set to step up in 2H14. In May, the State Council indicated it will deepen reforms of China's capital markets and unveiled the guiding principles of regulations for the coming years. The guidelines envisage the establishment of a multi-tier capital market with proper structure, functions and regulations, efficiency, and inclusiveness by 2020. To boost the healthy development of the capital market, the guidelines laid down nine targets, including those pertaining to government-market relations, innovations, and mixed ownership over the next few years, For equities, the approval-based stock issuance system will be replaced by one based on registration; the delisting regime will also be bettered. For bonds, the guidelines allow for the issuance of a wider and more diversified array of bonds to meet different investment needs while stepping up supervision of the bond market at the same time. Approval for private equity issuance will be loosened and capital raised through private equity will be encouraged to fund small enterprises. The futures market will be diversified by including the resource commodity futures. As such, monitoring of systemic risks will be paramount and authorities will toughen the punishments for breaches of laws and regulations.

We are of the view that China will relax its limits on foreign investment in listed companies, expand the quotas for capital flow, and develop commodity trading tools. The reforms will also include investment in banking sector by private sector, launch of deposit insurance, liberalization of deposit rate, development of asset securitization, issuance of local government bonds, liberalization of capital account, and development of market-driven exchange rate mechanism. With the gradual removal of barriers to participate in the financial sector, China will embark further on the road to financial liberalization and build up a healthier and more robust financial system in the long run.

Exhibit 13: Guidelines for the reform of China's capital market – 4 major focuses



Source(s): State Council, ABCI Securities



Hong Kong 2H14 Economic Outlook

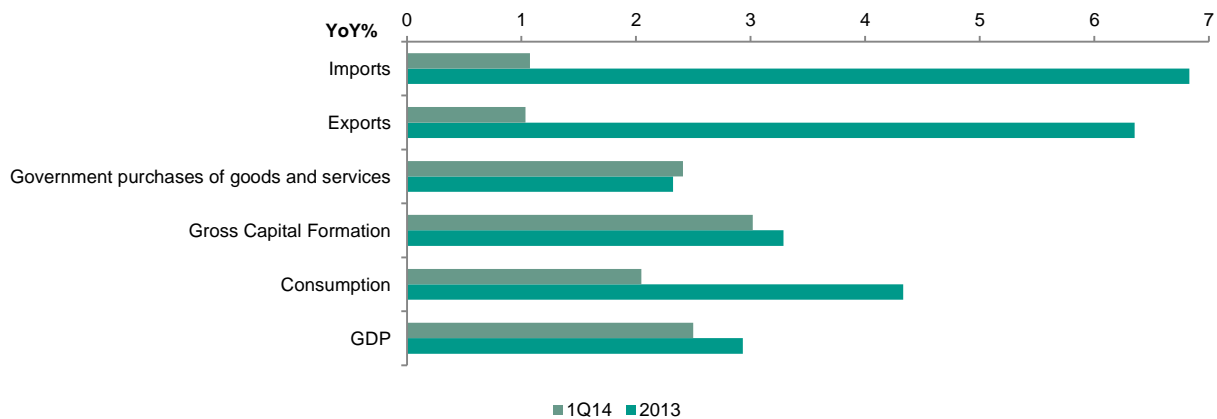
In 1Q14, Hong Kong's economy grew modestly at 2.5% YoY with unemployment rate remaining low at 3.1%. Price pressure was alleviated as inflation slowed to 4.0% YoY in 5M14. Private consumption expenditure grew by a meager 2.0% YoY in 1Q14, against 4.2% in 2013. Private consumption in Hong Kong, which is largely underpinned by the influx of tourists, especially those from mainland China, reduced its weight to GDP growth because of the economic slowdown in China and depreciation of renminbi. We expect Hong Kong's retail sales to show marginal growth in 2H14. Supported by infrastructure projects, investment remains strong at 3.0% in 1Q14, and we expect it to remain resilient in 2H14. In line with the unimpressive Chinese trade data and still-recovering global economy, Hong Kong's exports of goods and services edged up 1% in 1Q14. With the resumption of economic momentum in China and developed economies in 2H14, Hong Kong's external trade will see a hefty rebound in 2H14. On the property front, softness in both price and transaction volume reflects the impacts of tightening measures. Hong Kong's property market will continue to trend down for the rest of 2014 as the government policy expands market supply in the next few years to restore healthier market dynamics. Overall, we expect the economy will experience a more balanced growth in 2H14, and 2014 GDP growth will reach 3.0%.

Exhibit 1: Economic forecasts for Hong Kong in 2014

(YoY %, or otherwise specified)	2012	2013	1Q14	2014F
Real GDP	1.5	2.9	2.5	3
Consumption	4.1	4.2	2	2
Investment	6.8	3.3	3	3.1
Government expenditure	3.6	2.7	2.4	2.4
Exports	1.9	6.5	1	2
Imports	2.9	6.9	1.1	2.1
Unemployment rate (%)	3.3	3.4	3.1	3
CPI	4.1	4.4	4.1	3.8

Source(s): HK Census, ABCI Securities estimates

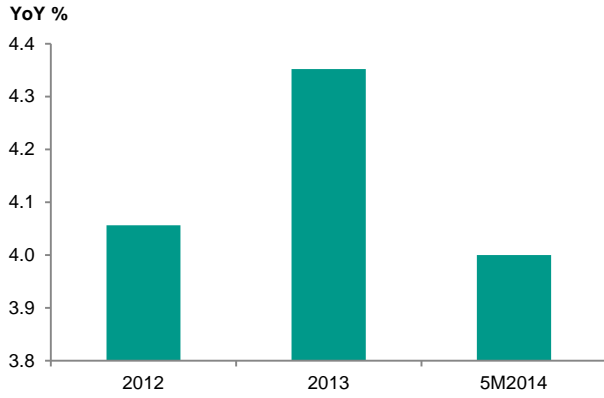
Exhibit 2 : Slowdown in Hong Kong's GDP growth



Source(s): HK Census, ABCI Securities

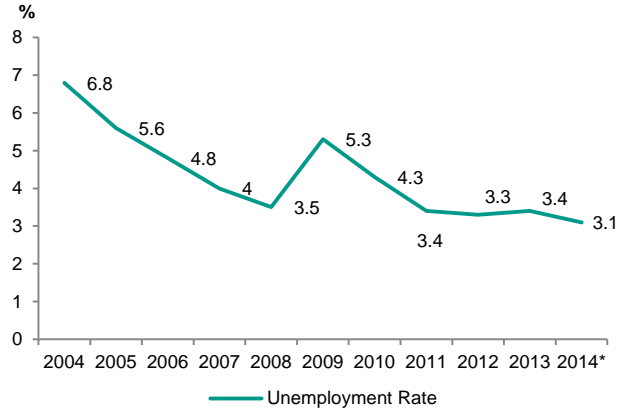


Exhibit 3: Inflation shows signs of cooling



Source(s): Bloomberg, HK Census, ABCI Securities

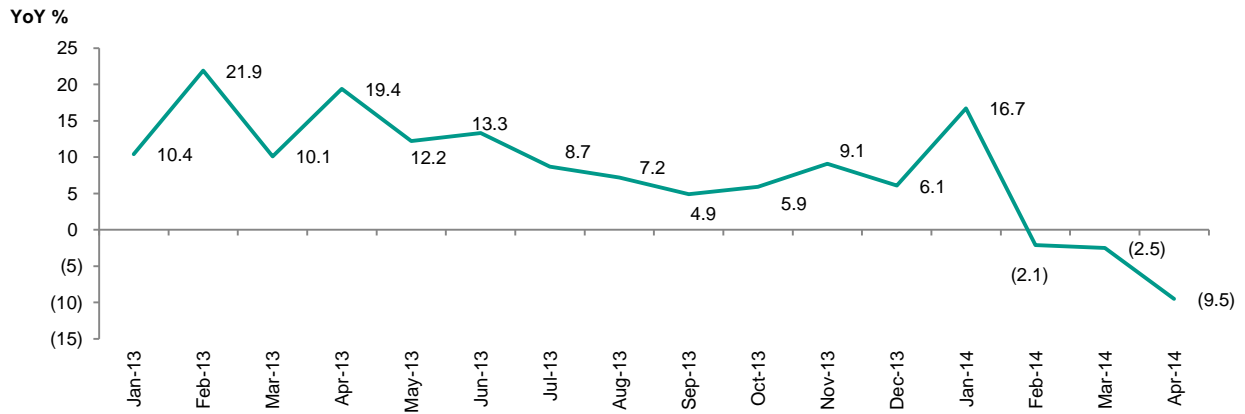
Exhibit 4: Unemployment hits full employment level



* Mar to May

Source(s): Bloomberg, HK Census, ABCI Securities

Exhibit 5: Weakening retail sales in Hong Kong



Source(s): HK Census, ABCI Securities



Investment strategy for 2H14

In 1H14, many investors are wary of investing in the Chinese market following a fallow 1Q14 marked by weak exports, retail sales, and FAI. In an effort to arrest these declines, China has launched targeted easing to support economic rebalancing. Against this backdrop, we believe fiscal stimulus and monetary accommodation will be deployed to spur growth in 2H14.

With China's economy bottoming out in 1Q14, optimism over an economic rebound in 2H14 has been growing. Investors may shift their investment interest to China for higher returns. Preferred stocks will be evaluated based on the forward valuation and growth potential, which in turn will be determined by earnings growth and industry environment under the structural reforms. The HSI and HSCEI are currently trading at consensus FY14 forward P/E of 10.8x and 7.6x; the consensus outlook has not reflected the recovery momentum of corporate earnings in 2014. Both indices' P/E ratios are below their respective 15-year average. This situation has been caused mainly by excessive market concerns (e.g. economic risks and corporate earnings risks), which led to a high risk premium for stock investments. In 2H14, these concerns will fade gradually as the economy reclaims impetus, and investors should take advantage of any dips in the market to accumulate equities in Hong Kong and China. For the rest of this year, should sentiment improve on rebounds in corporate earnings, we expect the trading range of the HSI and HSCEI to be at 21,656-24,255 (or 10.0-11.2x FY14F forward P/E) and 8,985-12,122 (or 6.3-8.5x FY14F forward P/E) respectively. We set their respective year-end targets at 23,822 (or 11.00x forward P/E) and 11,409 (or 8.00x forward P/E).

Investment themes in 2H14

1. Targeted easing for the agriculture sector and MSEs

The targeted RRR cut in June aims to encourage commercial banks and financial institutions to allocate more funds to the real economy in areas needing support. The release of credits to the agriculture sector and MSEs will strengthen the government's financial support for agricultural infrastructure construction and development of new types of agricultural business entities, as well as dedicate more support to MSEs. We believe the credit easing will benefit banks with higher exposure to agricultural lending and MSEs such as **CQRC (3618 HK)**, **BoCQ (1963 HK)**, **Huishang Bank (3698 HK)** and **Minsheng Bank (1988 HK)**; agricultural stocks such as **First tractor (38 HK)**, **National Agricultural Holdings (1236 HK)**, and **Sinofert (297 HK)**.

The RRR cut of 50 bps also applies to financial companies, financial leasing companies, and auto financing companies. China's intention to expand the role of consumer financing in the economy will support China's macroeconomic transition from an export-led economy to a more balanced model driven by domestic consumption. We believe the rate cut for financing companies will benefit such enterprises as **Far East Horizon Limited (3360 HK)** and **China Financial Services (605 HK)**. **Brilliance China (1114 HK)** will also benefit from the release of credits to auto financing.

2. Shanghai-HK mutual stock market access: Deregulation of cross-border investment

China unveiled the mutual market access program between Shanghai and Hong Kong stock exchanges on April 10, 2014. Such a move could accelerate China's opening of its capital market, facilitate the financial market reform in the country and boost utilization of offshore renminbi in Hong Kong. More importantly, it will introduce new investment opportunities for investors in both markets. Development of the offshore renminbi market in Hong Kong will be facilitated as Hong Kong investors will be able to invest in the mainland stock market. Accounts established under the new scheme and new services related to investing in China will spur demands for renminbi. We expect increases in innovative financial products and services denominated in renminbi, and strengthening of Hong Kong's position as the leading offshore renminbi center. We believe several stock categories will be boosted by the mutual market access: a) Stocks with large A-H share valuation discrepancies, such as **CITICB (998 HK)**, **MSB (1988 HK)**, **Great Wall Motor (2333 HK)**, **Sinopec Pechem (338 HK)**, and **CMOC (3993 HK)**, which allow investors to benefit from arbitrage trading; b) Stocks in ecommerce and gambling sectors and business conglomerates with international business exposure, such as **Tencent (700 HK)**, **Galaxy entertainment (27 HK)**, **Hutchison (13 HK)**, **AIA (1299 HK)**, **Prada (1913 HK)** and **Samsonite (1910 HK)**, which are previously inaccessible to the mainland stock investors; c) Brokerage firms, especially those with operations in Hong Kong and Shanghai, such as **CITICS (6030 HK)**, **China Galaxy Securities (6881 HK)**, **Guotai Junan Int'l (1788 HK)**, **Haitong International (665 HK)** and **Shenyin Wanguo (218 HK)**, will benefit as their businesses will be



driven up by the mutual market access.

3. Renminbi: Approaching a turning point

Market concerns rise as depreciation of renminbi in 2014 may result in exchange loss in Chinese companies. Renminbi fell by ~2.8% in 1H14 against U.S. dollar, reversing several years of consistent gains. The weakness has spread to certain corporate sectors, and elevates capital and operating costs while inflating the value of foreign-currency debts. Sectors with significant foreign-currency debts, high import costs or overseas expenses are particularly susceptible to fluctuations in exchange rate. Such companies include airlines, property developers, and consumer-goods companies. The Chinese airlines have as much as 80% of their net debt denominated in U.S. dollar to finance aircraft purchases and jet fuel for international flights. Chinese property developers are also vulnerable to the depreciation because foreign-currency loans and bonds account for up to 90% of their outstanding debts. As our economic team expect renminbi to rebound in 2H14, the Chinese airlines with high levels of U.S. debts, such as **Air China (753, HK)**, **China Eastern Airlines (670 HK)** and **China Southern Airlines (1055 HK)**, along with Chinese property developers with heavy exposure to USD denominated debts, such as **Agile property (3383 HK)** and **SOHO China (410 HK)**, will benefit from a strengthening renminbi.

4. Surging railway investment budget benefiting rail construction and equipment sector

Acceleration of rail construction is one the government's policy stimulus to strengthen infrastructure sector and support economic growth. The central government is encouraging more new rail project starts. The railway construction market will be open through reforms, and construction of rail facilities in less developed areas will be emphasized. We believe the increase in rail infrastructure investment budget for 2014 from RMB 630-650 billion to RMB 800 billion will deliver a major push to the infrastructure sector. Benefits of surging railway spending will also be conducted to the rail construction and equipment sectors, benefiting companies such as **CRG (390 HK)**, **CRCC (1186 HK)**, **CSR (1766)**, **CNR (6199 HK)** and **CCRT (1522 HK)**.

5. Environmental protection: Favoring non-fossil fuel energy consumption

Amid growing awareness of environmental pollution, China's current reliance on fossil fuel will be reduced by clean and renewable energy. As the reduction of national pollution becomes a priority task during NPC this year, China aims to increase the share of non-fossil fuels in its overall energy consumption. Based on the 12th 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 non-fossil fuels energy providers, especially those in the nuclear and wind power sectors that have a relatively high utilization hour. The government targets to raise installed capacity of nuclear/wind powers to 40 GW/100GW by 2015, representing 5-year CAGRs of 29.9%/26.4%. These capacity expansions are higher than the 7.8%/ 5.7% growth seen in coal-fired power and hydropower.

Based on the increasing investment in grid construction and the expectation of more accommodative policies, we are positive on the outlook for the wind power and nuclear power sectors. Our top picks for wind power sector include **Huaneng Renewables (958 HK)** and **Datang Renewable (1798 HK)**. For the nuclear sector, we favor power equipment producers such as **Shanghai Electric (2727 HK)** and **Harbin Electric (1133 HK)**. In addition, environmental protection will present more business opportunities for water and sewage treatment providers such as **Beijing Enterprise Water (371 HK)** and **China Everbright International (257 HK)**.



6. Financial reforms: Favoring large banks, brokerage and asset management companies

Reforming China's financial sector will be the top priority for China's new leadership. The guiding principles of regulations for the capital market in coming years unveiled by the State Council in May indicate China's strong motive to build a multi-tier capital market by 2020. Most financial sectors have been opened up for further competition; interest rate and exchange rate are moving toward the market-determined systems. For large banks, overall impacts of interest liberalization and opening of banking sector to private investors will be positive. So far, net interest margin (NIM) has not been severely eroded on the liberalization of lending; small and medium sized banks have been increasing their exposure to small and medium enterprises (SMEs), which are normally not the major customers targeted by large banks. For brokerage and asset management companies, financial reforms, including asset securitization and restructuring of A-share market, will create more business opportunities. These changes are essential in facilitating China's transformation from an export-driven economy to a consumption-oriented one. Overall, we expect China will accelerate financial reforms including the liberalization of interest rate, exchange rate, and capital account in 2H14.

Though it is possible that interest rate liberalization may slash net interest margin (NIM) in the Chinese banks, financial results in 1Q14 indicate such impacts were mild. We believe bigger banks are more capable to withstand the headwinds, as most have shown strong growth in fee income that helped offset contraction in NIM. With shares trading at below book value, the H-share Chinese banks are highly attractive by valuation. Our stock picks include **ICBC (1398 HK)**, **ABC (1288 HK)**, and **CCB (939 HK)**; we also prefer insurance companies such as **PICC Group (1339 HK)**, **Ping An (2318 HK)** and **China life (2628 HK)**, which will benefit from more diversified business opportunities brought by the reforms.

Renminbi internationalization will continue to be a major focus in 2H14. More actions will be taken by the government with the goal of achieving full convertibility of the currency. The need for a fully convertible renminbi is more pressing than ever as its global use as a trade settlement currency is rapidly increasing. China has also stepped up efforts to widen the scope of QDII scheme for overseas investment and allow more QFII capital to participate in China's capital markets. Given Hong Kong's well-equipped financial system and China's dedication to developing the region into a major offshore renminbi center, Hong Kong will take the center stage on the renminbi internationalization platform. Thus, we believe exciting growth opportunities will be available for Hong Kong's financial intermediaries such as **BOC Hong Kong (2388 HK)** and **Hang Seng Bank (11 HK)**.

To reap the benefits of mutual access of financial markets (Shanghai-Hong Kong) and renminbi internationalization, we recommend **HKEEx (388 HK)** who will be able to capture the benefits based on its broad range of investment products that will help absorb excess liquidity in China. Also, Chinese brokers in Hong Kong such as **Guotai Junan Int'l (1788 HK)** and **Shenyin Wanguo (218 HK)** will gain from the increasing business opportunities. Moreover, we maintain our positive stance on Chinese brokers and asset management companies including **China Galaxy Securities (6881 HK)**, **CITICS (6030 HK)**, and **Cinda (1359 HK)** as the ongoing capital market deregulation will be favorable to the industry; the fact that they are leveraged plays also mean that these counters will thrive more than the others upon recovery of the A-share market.

7. Mainland property sector to restore momentum in 2H14

China's residential property sector has performed poorly, retracting by 15% YoY in 1H14 as the industry was beset by tightened liquidity, price cut, and renminbi depreciation. Our property team is of the view that some of the aforementioned risks may have been overblown because property sales, especially those in the top-tier cities, are less dolorous than most would have expected (new home prices in first-tier cities were up 9.9% YoY in 5M14). After the correction in 1H14, valuation of the sector has turned attractive at 4.1x FY14E P/E with a FY14E yield of 7%. We believe most negatives have already been priced in for the sector and sentiment will improve in 2H14 after the housing prices have been corrected. Small developers focusing on top-tier cities and the ones with commercial or luxury property exposure will stand to benefit from the revived impetus. We favor **Aoyuan (3883 HK)**, a commercial loft apartment developer; **Sunac (1918 HK)**, a luxury home developer who has recently acquired shares in Greentown (3900 HK); and **Kaisa (1638 HK)**, a redevelopment specialist.



Investment themes	Stock Picks	Stock code
Targeted easing for the agriculture sector and MSEs	<u>Banks & Financial companies</u>	
	Chongqing Rural Commercial Bank (CQRC)	3618 HK
	Bank of Chongqing (BoCQ)	1963 HK
	Huishang Bank	3698 HK
	Minsheng Bank	1988 HK
	Far East Horizon Limited	3360 HK
	China Financial Services	605 HK
	Brilliance China	1114 HK
	<u>Agricultural companies</u>	
	First tractor	38 HK
	National Agricultural Holdings	1236 HK
Sinofert	297 HK	
Shanghai-HK mutual stock market access: Deregulation of cross-border investment	<u>Companies with large A-H valuation divergences</u>	
	CITICB	998 HK
	Minsheng Bank	1988 HK
	Great Wall Motor	2333 HK
	Shanghai Pechem	338 HK
	China Molybdenum (CMOC)	3993 HK
	<u>Stocks previously inaccessible to mainland stock investors</u>	
	Tencent	700 HK
	Galaxy Entertainment	27 HK
	Hutchison	13 HK
	AIA	1299 HK
	Prada	1913 HK
	Samsonite	1910 HK
	<u>Brokers</u>	
	CITICS	6030 HK
	China Galaxy Securities	6881 HK
	Guotai Junan Int'l	1788 HK
	Haitong International	665 HK
	Shenyin Wanguo	218 HK
Renminbi's weakness: Approaching a turning point, benefiting companies with high level of USD denominated debts	<u>Airlines</u>	
	Air China	753 HK
	China Eastern Airlines	670 HK
	China Southern Airlines	1055 HK
	<u>Real estate developers</u>	
	Agile property	3383 HK
SOHO China	410 HK	
Surging railway investment budget benefiting rail construction and equipment sector	<u>Railway builders</u>	
	China Railway (CRG)	390 HK
	China Railway Construction Corp. (CRCC)	1186 HK
	<u>Railway equipment providers</u>	
	CSR Corp.	1766 HK
	CNR Corp.	6199 HK
China City Railway Tech. (CCRT)	1522 HK	

**農銀國際**

ABC INTERNATIONAL

ABC SECURITIES COMPANY LIMITED

Investment themes	Stock Picks	Stock code
Environmental protection: Favoring non-fossil fuel energy consumption	<u>Clean energy providers</u>	
	Huaneng Renewables	958 HK
	Datang Renewable	1798 HK
	<u>Power equipment producers</u>	
	Shanghai Electric	2727 HK
	Harbin Electric	1133 HK
	<u>Water and sewage treatment providers</u>	
	Beijing Enterprise Water	371 HK
China Everbright International	257 HK	
Financial reforms: Favoring large banks, brokerage and asset management companies	<u>Banks</u>	
	ICBC	1398 HK
	ABC	1288 HK
	CCB	939 HK
	BOC Hong Kong	2388 HK
	Hang Seng Bank	11 HK
	<u>Stock Exchange</u>	
	HKEx	388 HK
	<u>Asset management companies & Brokers</u>	
	Guotai Junan Int'l	1788 HK
	Shenyin Wanguo	218 HK
	China Galaxy Securities	6881 HK
	CITICS	6030 HK
	Cinda	1359 HK
	<u>Insurance companies</u>	
PICC Group	1339 HK	
Ping An	2318 HK	
China life	2628 HK	
Mainland property sector to restore momentum in 2H14,	<u>Developers with top-tier cities exposure and are specialized in commercial or luxury properties</u>	
	Aoyuan	3883 HK
	Sunac	1918 HK
	Kaisa	1638 HK