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ABC INTERNATIONAL
ABCI SECURITIES COMPANY LIMITED

ABCI China/Hong Kong Equity Research
2H14 China Economic Outlook

The Turning Point

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Definition of equity rating

Rating	Definition
Buy	Stock return ≥ Market return rate
Hold	Market return – 6% ≤ 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 ≤180 day volatility/180 day benchmark index volatility
High	1.5 ≤ 180 day volatility/180 day benchmark index volatility < 2.6
Medium	1.0 ≤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 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 2H12, 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.

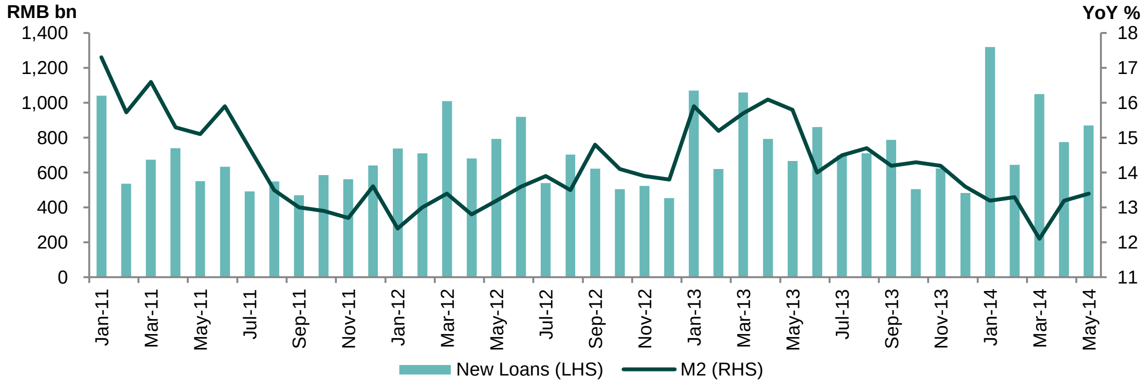
Monetary policy: Targeted monetary easing

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.

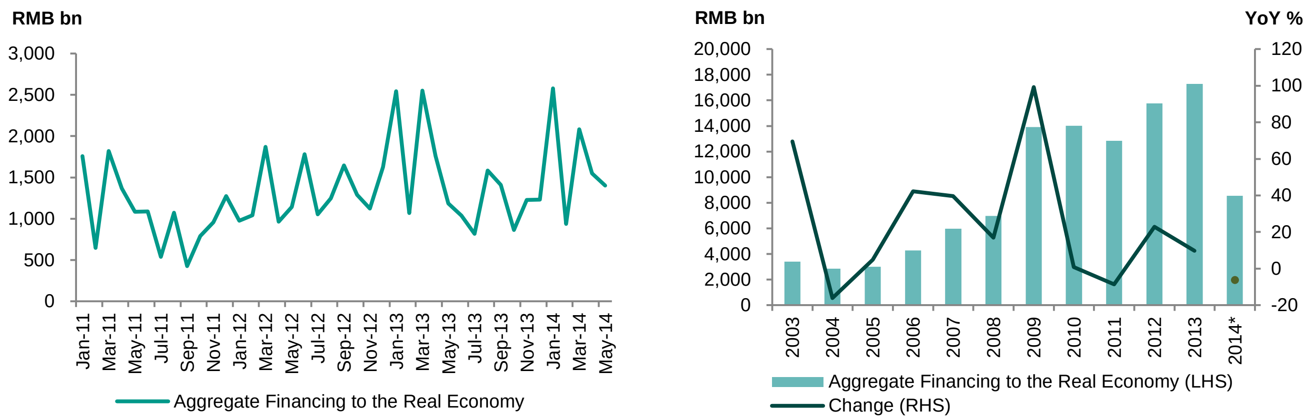
Liquidity management will continue to be a priority of monetary policy in 2H14. Considering the economic recovery in the U.S. and other developed markets, we believe international capital will continue flowing into China, exerting more pressure on PBOC to manage liquidity. Therefore, PBOC will continue 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

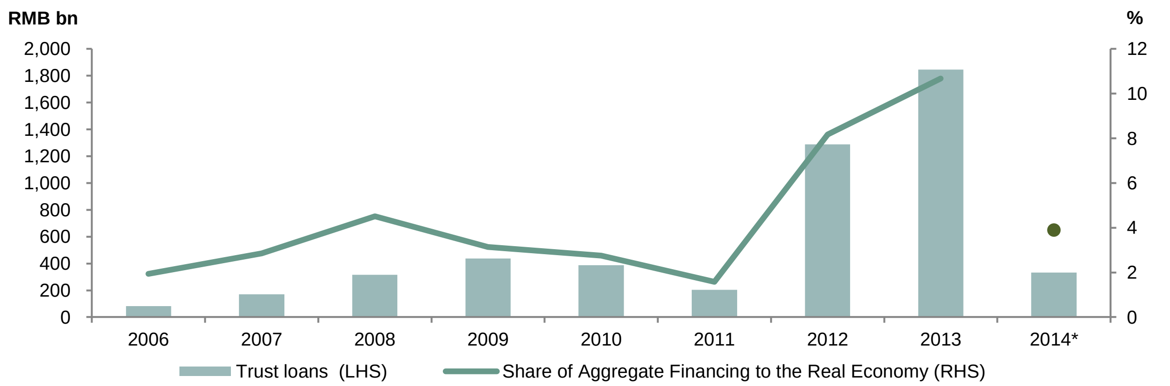
Exhibit 3: Aggregate financing to real economy (AFRE) turns stable in 2014



*Jan - May

Source(s): PBOC, ABCI Securities

Exhibit 4: Share of trust loans is declining



* Jan - May

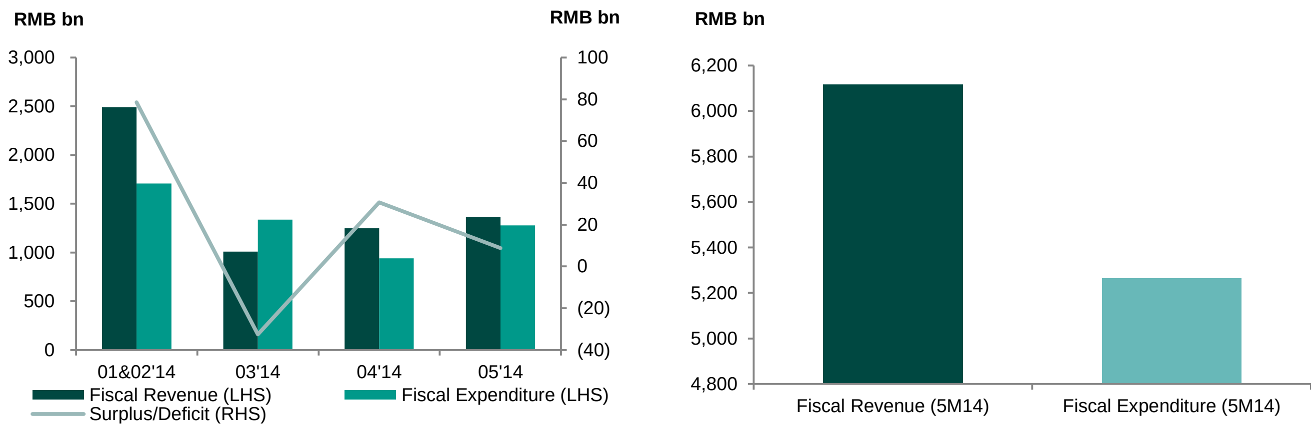
Source(s): PBOC, ABCI Securities

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

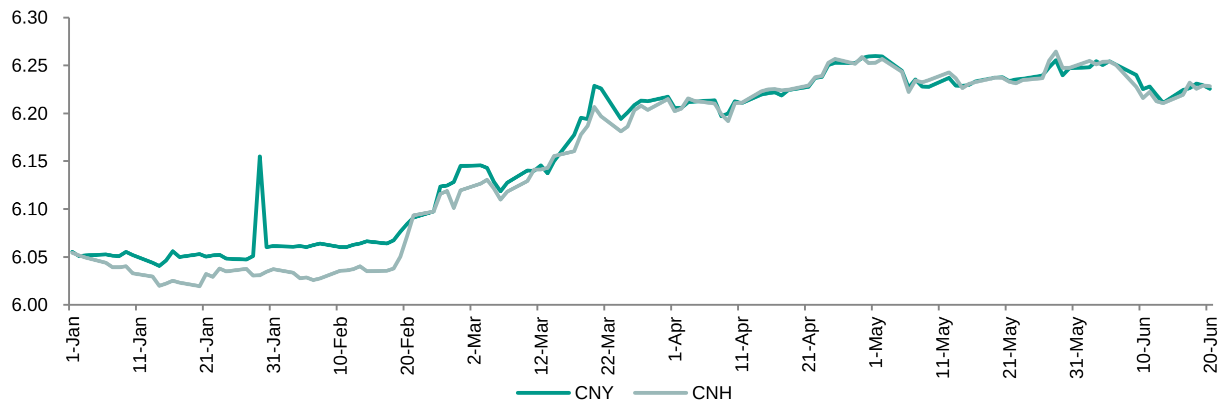


Source(s): Ministry of Finance. ABCI Securities

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

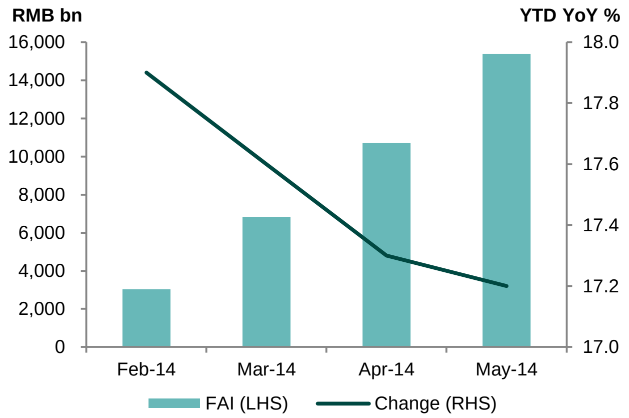
The Third Plenum and NPC have provided clear guidance for China's policymakers to implement reforms at a gradual pace. The reforms, while slowing output growth in the near term, is highly beneficial in the long run as China focuses on attaining sustainable and high-quality growth in coming decades. In 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

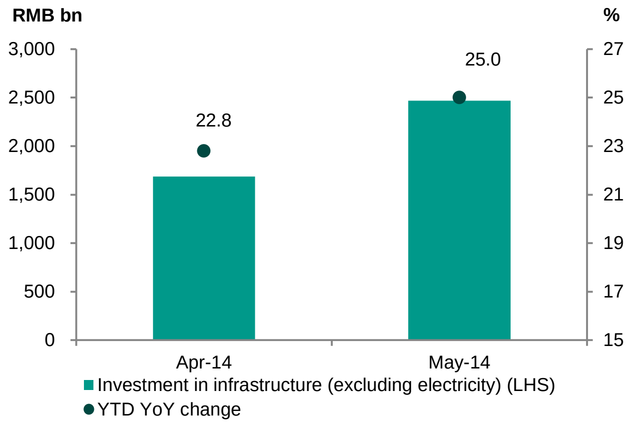
Deceleration in FAI growth has been a growing concern since 3Q13, but there are signs indicating that such growth is stabilizing as 5M14 FAI stood at 17.2% YoY, just slightly below April's figure of 17.3% YoY. We attribute the steadying growth to the rebound of government-initiated infrastructure investments,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

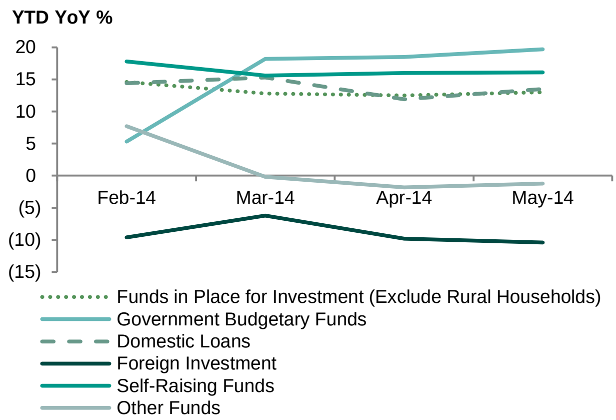


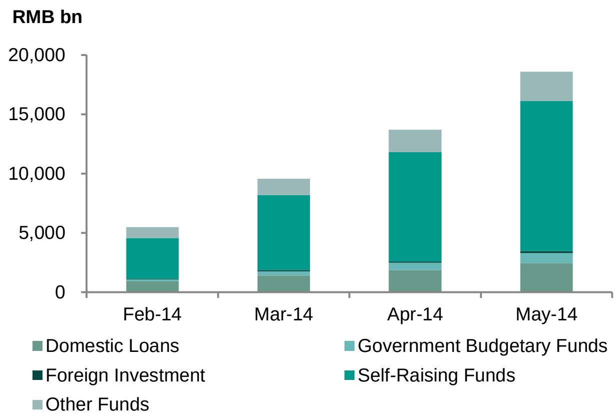
Source(s): NBS, ABCI Securities



Source(s): NBS, ABCI Securities

Exhibit 8: FAI funding growth turns stable





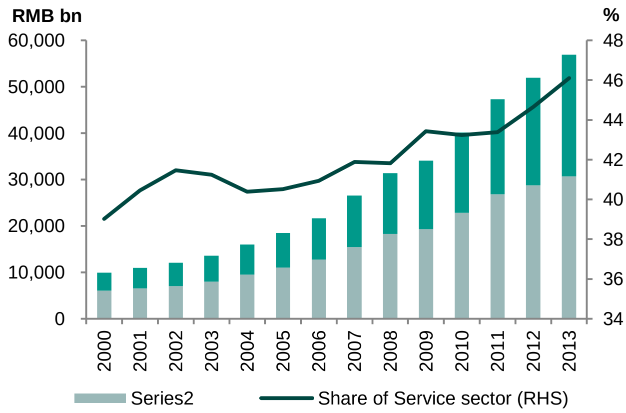
Source(s): NBS, ABCI Securities

Source(s): NBS, ABCI Securities

2. Deregulation of service sector to boost consumption

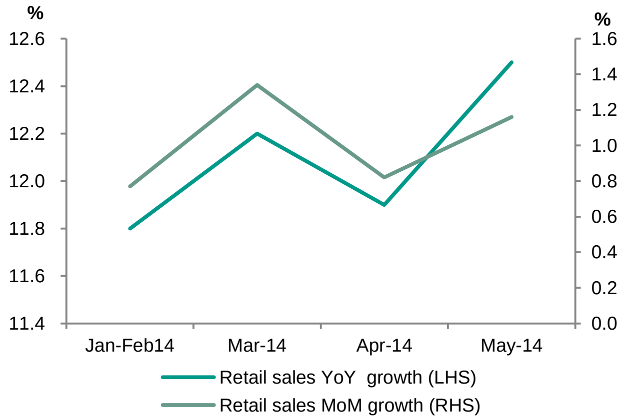
Services made up 46.1% of GDP in 2013, overtaking manufacturing – China's biggest employer in 2012. Recently, the official Purchasing Managers Index (PMI) for services rebounded to 55.5 in May from 54.8 in April – above the 50 level that divides expansion and contraction. The data show that China's services 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

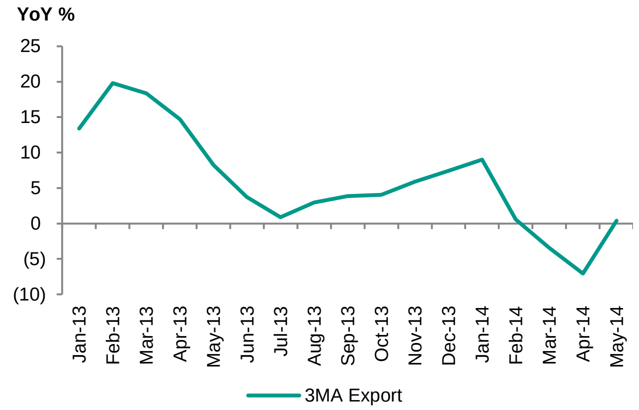


Source(s): NBS, ABCI Securities

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

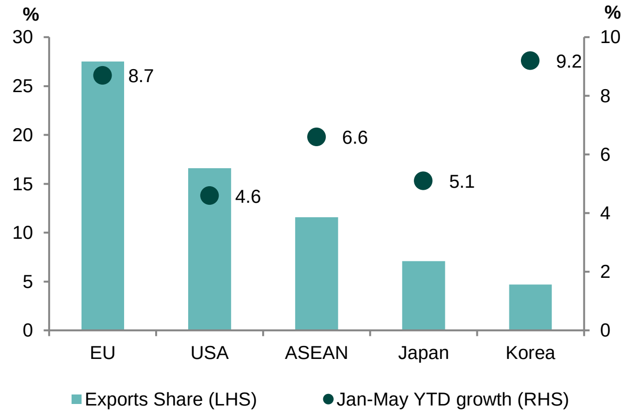
External trade, a pillar of China's economy, demonstrated anemic growth in 1Q14. Negative export growth in 1Q14 was not only a result of high base in a year earlier but also the sluggishness among the country's trading partners. Nevertheless, a turnaround in export has ensued in April and May, with China's 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

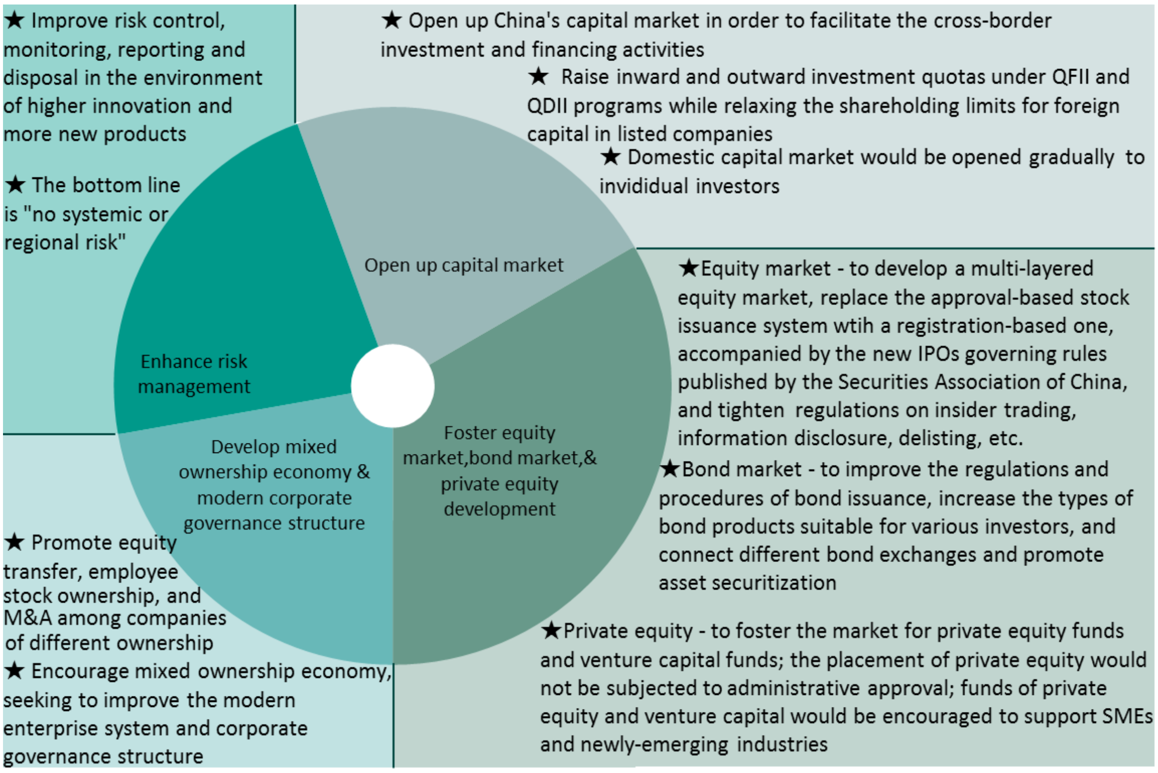
Trade reforms gearing towards increasing services trade will be the key element to sustain growth in the external trade sector. The latest emphasis on services trade is part of China's efforts to maintain its trade expansion amid a slowing domestic economy and flaccid external demands tarnishing exports 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

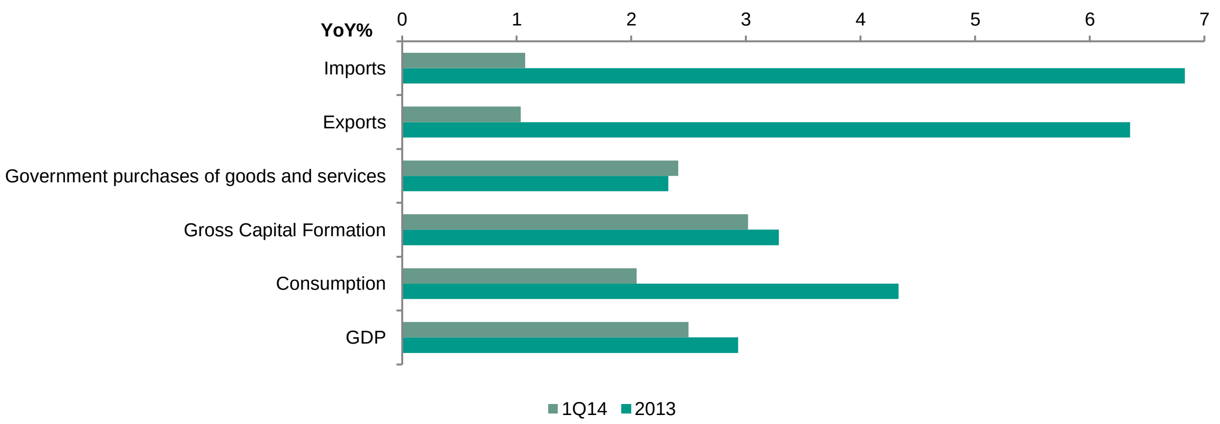
In 1Q14, Hong Kong's economy grew modestly at 2.5% YoY with unemployment rate remaining low at 3.1%. Price pressure was alleviated as inflation slowed to 4.0% YoY in 5M14. Private consumption expenditure grew by a meager 2.0% YoY in 1Q14, against 4.2% in 2013. Private consumption in Hong Kong, which 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**

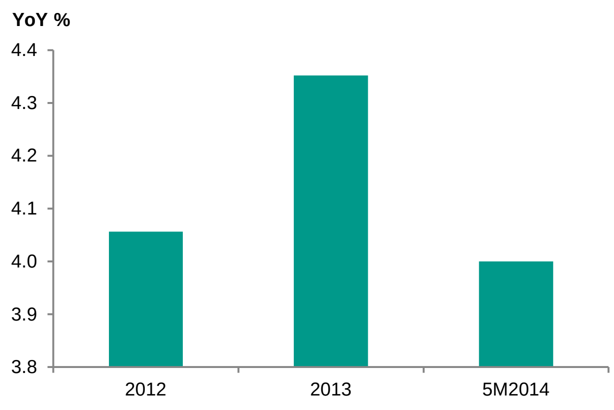
Source(s): HK Census, ABCI Securities estimates

Exhibit 2 : Slowdown in Hong Kong's GDP growth



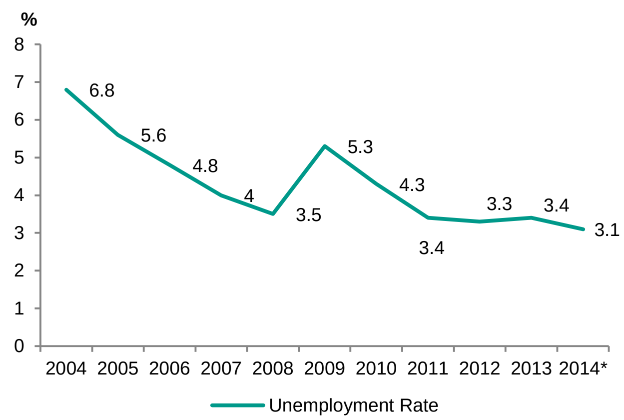
Source(s): HK Census, ABCI Securities

Exhibit 3: Inflation shows signs of cooling



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

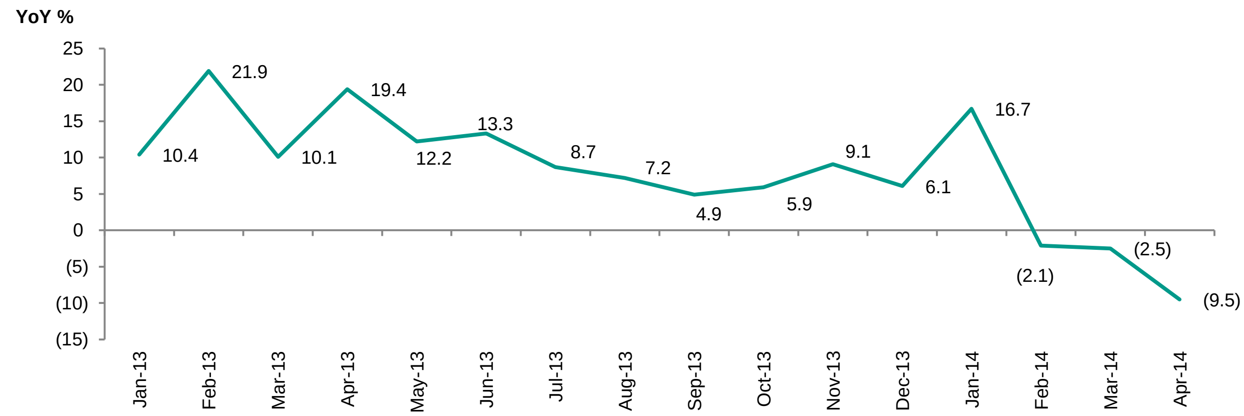
Exhibit 4: Unemployment hits full employment level



* Mar to May

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

Exhibit 5: Weakening retail sales in Hong Kong



Source(s): HK Census, ABCI Securities