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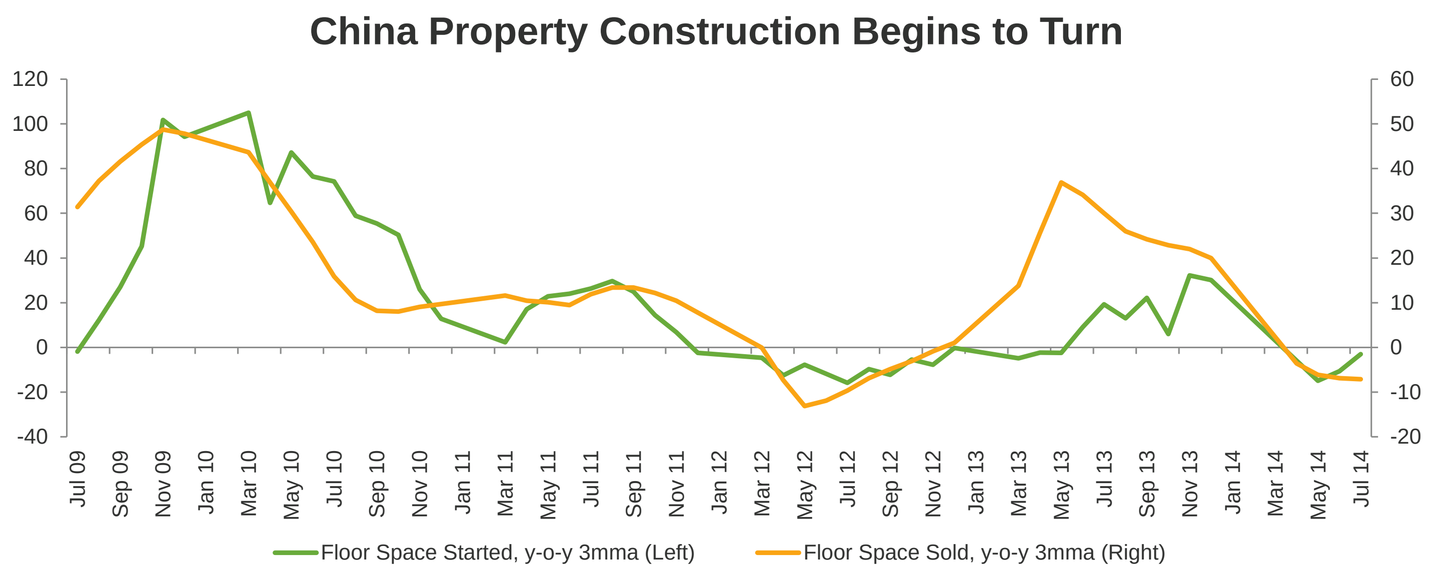
CHINA MACRO MONITOR
PROPERTY MARKET NEARING A TROUGH?

- **While some key economic indicators in China took a pause in July from their improving trend of recent months, we believe targeted policy stimulus will drive growth higher though the rest of the year and into 2015.**
- **The domestic equity market has shrugged off the recent batch of weak numbers and the MSCI China A Share index has rallied 10% in the past month.**
- **One of the factors weighing on economic performance recently is weakness in the property sector.**
- **According to IMF calculations, the real estate sector together with construction accounts for 15% of GDP, a quarter of fixed asset investment and 14% of urban employment. The health of the property sector is therefore important to the health of the overall economy.**
- **We believe that the property sector is going through an orderly correction and will near a trough in coming months as the effects of policy stimulus kicks in.**
- **We believe the government has the capacity and the policy conviction to stimulate the property market and the broader economy into 2015.**



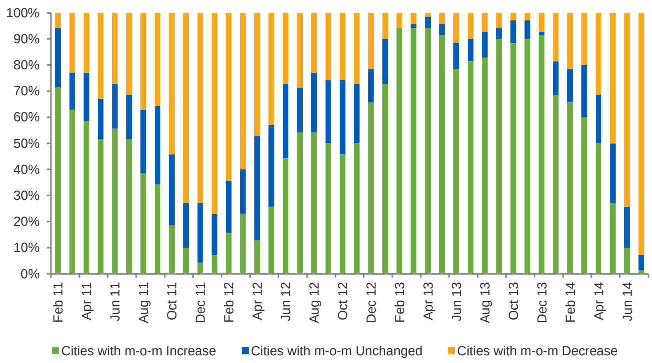
Source for all charts and tables in publication: ETF Securities and Bloomberg unless otherwise stated

ORDERLY PROPERTY MARKET CORRECTION

The Chinese property market is correcting. Price growth has moderated in year-on-year terms and on a month-on-month basis, more cities have reported declines than ever before. We believe the deterioration in July will prompt further policy stimulus that will lead to a turn in the property cycle. The government is determined to see economic growth measured in GDP terms hit 7.5% this year and is unlikely to let a downturn in the property market derail its plans.

70 City Residential Property Prices (y-o-y)

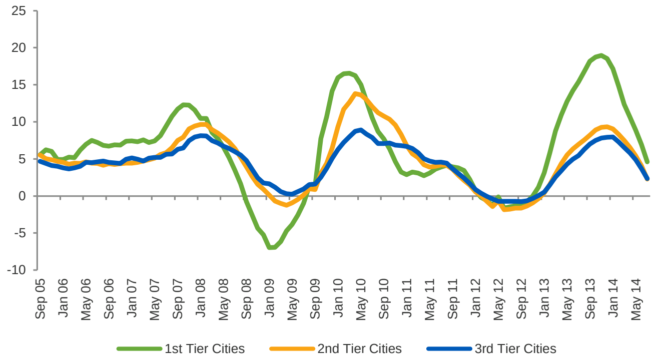
70 City Newly Built Residential Prices



Third tier cities suffering the most

The price moderation has been the most pronounced in third tier cities. Residential real estate inventories in third tier cities have increased the most. The oversupply is in part linked to local governments' reliance on land sales to finance spending (see China Macro Monitor July 2014). Land is more easily available to developers in these cities as governments are keen to monetise their assets. We believe that reform in local government financing will reduce this source of supply over time.

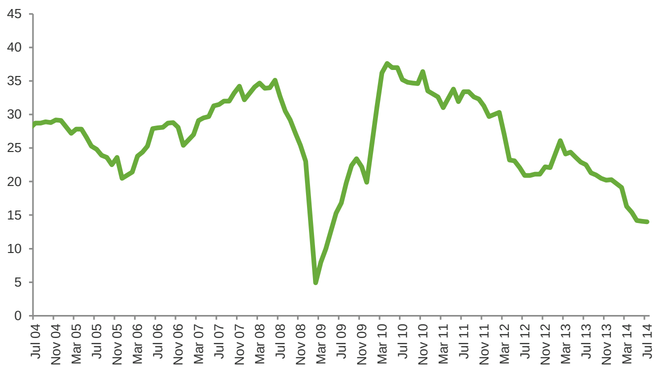
Newly Built Residential Property Prices (y-o-y)



Real estate investment has moderated, but shows signs of stabilisation

Real estate fixed asset investment accounts for about a quarter of total fixed asset investment. While its growth has been moderating, it has stabilised at a relatively high level of over 14% y-o-y over the past three months. According to IMF calculations, a 1% decline in real estate investment could shave off 0.1% of GDP growth in the first year[1]. China appears to be very far from seeing an actual decline in investment, but we would expect the government to be vigilant against any downturn that would threaten its growth targets. The IMF projects GDP growth of 7.4% this year, with real estate investment growth moderating to 5% y-o-y.

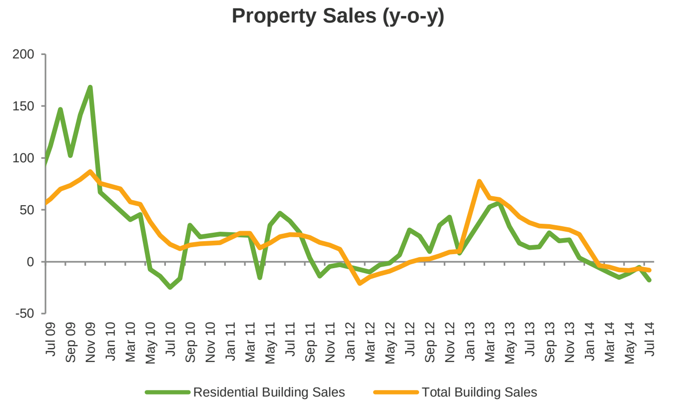
Real Estate Fixed Asset Investment (y-o-y)

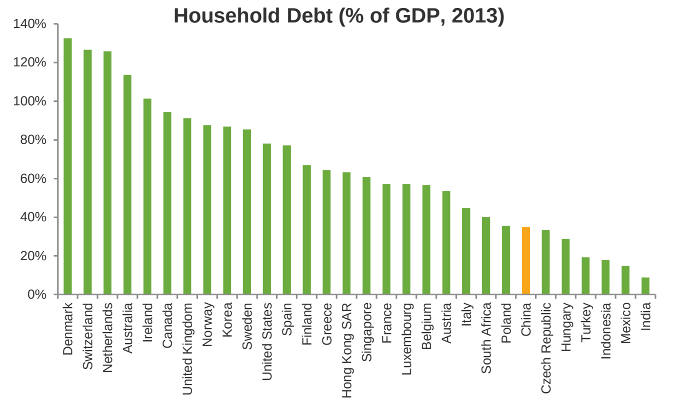


Property sales subdued while potential buyers wait on the side-lines

Potential buyers talking a 'wait-and-see' approach have been blamed for the decline in property sales. The pace of urban migration remains robust and pent-up demand to upgrade properties has certainly not fallen. With the threat of the malaise in the property market becoming self-fulfilling, we expect the government to offer further stimulus the break the cycle. Residential property sales had become less negative in June, but slipped further July alongside other measures of economic performance.

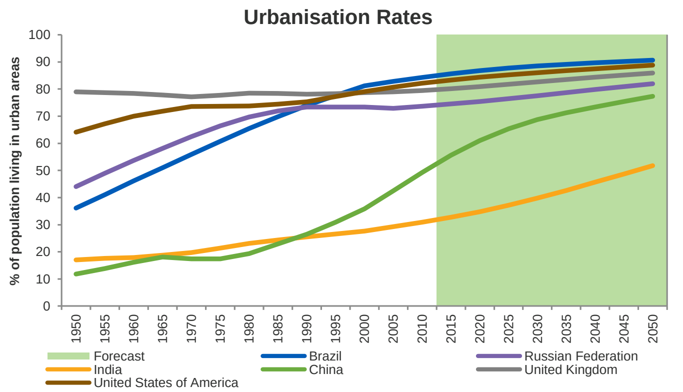
[1] See The Spillover Effects of a Downturn in China's Real Estate Investment, IMF Working Paper, 2012 by Ashvin Ahuja and Alla Myrvoda





Low household leverage and continued urbanisation bode well for medium term property demand

China is little over 50% urbanised, significantly less than other emerging markets such as Brazil and Russia and will continue to urbanise at a strong pace over the coming 20 years. According to the United Nation's projections, 310 million Chinese citizens (i.e. a population close to the size of the US today) will migrate from the countryside to cities over the next two decades. The Chinese government's ambitions are even grander – to move close to 400 million people to the cities. That speed and scale of migration is unprecedented in human history. Even though a number of cities appear to be over-supplied with property today, we believe that excess supply will soon be absorbed.



Source: United Nations, Department of Economic and Social Affairs, Population Division

Household indebtedness in China is also low by international standards. The orderly property market correction we foresee in China is unlikely to lead to a systemic problem for households because their financial leverage is relatively small.

We believe that such low level of indebtedness affords the government headroom to loosen house purchase restrictions (HPR) and lending criteria to stimulate the property market. As more Chinese people aspire to become homeowners, we are likely to see household leverage rise over time.

Policy relaxation will provide a tail-wind

In contrast to 2008 and 2011, when the People's Bank of China cut the reserve requirement ratio (RRR) to stimulate lending activity across the board, recent stimulus has largely been left to local governments and is therefore highly targeted[2].

For example, a number of cities have relaxed rules that previously prohibited households from owning more than one property (house purchase restrictions or HPRs). 37 out of 46 cities that had such restrictions have reportedly relaxed to some extent.

Some cities and provinces have announced tax subsidies to spur demand while others have been buying properties that have already been built to add to their pool of social housing.

The PBoC has also asked banks to speed up mortgage approvals and apply 'reasonable' pricing, which could quicken the pace of home sales. Anecdotal evidence from media reports point to banks following through on that request.

Changes to the loan-to-deposit ratio (LDR) made in July will also free up banks' capacity to lend. By reducing the categories of lending that need to be included in the loan component and increasing the number of items that can be included in the deposit component, banks will be able to avoid hitting their LDR limits so easily, allowing them to lend more to prospective home buyers.

To support real estate development, the central government has increased its social housing target to 7 million units of new starts (of which 4.7 million units will come from shanty town renovation). The central government is also leaning on local governments to see that red-tape does not slow the process of fiscal disbursement and planning approvals.

The central government could go further by relaxing Hukou policies, which currently apply laws asymmetrically to migrants from the country and native city dwellers. Easing of these laws, could allow the freer movement of people and encourage more migrants to purchase property.

Also the government could increase the maximum loan-to-value

[2] With the exception of targeted cuts to RRR for small and rural banks in June 2014

ratio and cut mortgage interest rates (either as part of an overall cut in rates or independently).

Developers display cautious optimism

The annual decline in floor space started has been narrowing in recent months, in a sign that property developers are becoming more optimistic about future demand. Developers need to plan ahead of the actual turn given the lag between starting development and the actual completion of properties to sell in the market. Nevertheless, if their optimism proves to be timely, we could see the property market trough soon.

Floor Space Started and Sold

CHINA A SHARE SENTIMENT MARKEDLY IMPROVES

Despite the string of weak data in July, including disappointing loan and money supply growth, equity markets rallied. The MSCI China A Share index gained 9.5% last month.

The China A Share market is also likely to benefit from the launch of the Shanghai-Hong Kong Connect, which expected in October 2014 (see Shanghai-Hong Kong Stock Connect: A Boost For China A Shares). The initiative will open up access to the Shanghai stock market for foreign investors trading through Hong Kong. Systems testing for the initiative will start at the end of this month. We believe that the manner in which the quotas are applied will drive net flows into the mainland. At the moment, dual-listed stocks are trading at approximately an 8% discount on the A shares market compared to the H share market. The introduction of the Shanghai-Hong Kong Connect should see that discount dissipate over time. Valuations of the China A share market indicate that it is cheap. Its prospective PE now stands at 10.2, 63% below its peak in 2007. It is not often that the stock market of one of the world's largest and fastest growing economies is trading at one of the world's lowest valuations. The imminent implementation of the Shanghai-Hong Kong Connect programme should help to speed the process of valuation normalisation.

China A Shares are Trading at a Discount to H Shares

MACRO MONITOR

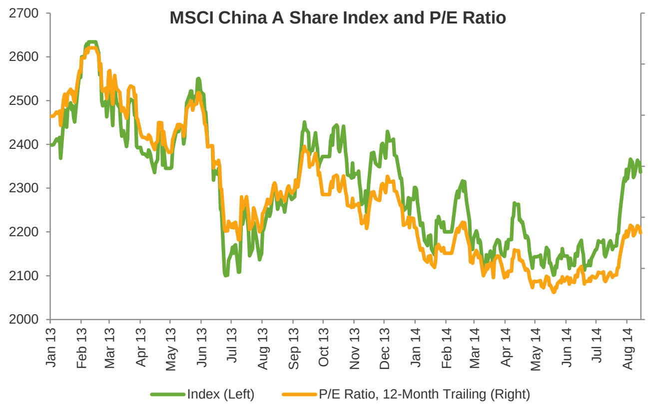
	Jul-13	Aug-13	Sep-13	Oct-13	Nov-13	Dec-13	Jan-14	Feb-14	Mar-14	Apr-14	May-14	Jun-14	Jul-14	
Growth Indicators														
GDP Growth (% y-o-y)			7.8			7.7			7.4			7.5		🟢
Keqiang Index*	8.4	11.0	10.0	9.7	8.4	8.5	7.0	-1.1	4.8	4.5	6.2	6.2	4.9	🟢
Industrial Production (% y-o-y)	9.7	10.4	10.2	10.3	10.0	9.7			8.8	8.7	8.8	9.2	9.0	🟢
Manufacturing PMI (Level)	50.3	51.0	51.1	51.4	51.4	51.0	50.5	50.2	50.3	50.4	50.8	51.0	51.7	🟢
Retail Sales (% y-o-y)	13.2	13.4	13.3	13.3	13.7	13.6			12.2	11.9	12.5	12.4	12.2	🟢
Fixed Asset Investment (ytd % y-o-y)	20.1	20.3	20.2	20.1	19.9	19.6		17.9	17.6	17.3	17.2	17.3	17.0	🔴
Trade, Reserves, Money and Inflation														
Trade Balance (US$ bn)	17.8	28.2	15.1	31.1	33.8	25.3	31.9	-22.8	7.8	18.5	35.9	31.6	47.3	🟢
Exports (% y-o-y)	5.1	7.1	-0.3	5.6	12.7	4.3	10.6	-18.1	-6.6	0.8	7.0	7.2	14.5	🟢
Imports (% y-o-y)	10.9	7.2	7.5	7.6	5.3	8.3	9.9	9.9	-11.4	0.8	-1.6	5.5	-1.6	🔴
Foreign Exchange Reserves (US$ tn)	3.5	3.6	3.7	3.7	3.8	3.8	3.9	3.9	3.9			4.0		🟢
M1 Money Supply (% y-o-y)	9.7	9.9	8.9	8.9	9.4	9.3	1.2	6.9	5.4	5.5	5.7	8.9	6.7	🟢
M2 Money Supply (% y-o-y)	14.5	14.7	14.2	14.3	14.2	13.6	13.2	13.3	12.1	13.2	13.4	14.7	13.5	🟢
CPI Inflation (% y-o-y)	2.7	2.6	3.1	3.2	3.0	2.5	2.5	2.0	2.4	1.8	2.5	2.3	2.3	🔴
CPI Non Food Inflation (% y-o-y)	1.6	1.5	1.6	1.6	1.6	1.7	1.9	1.6	1.5	1.6	1.7	1.7	1.6	🟡
PPI Inflation (% y-o-y)	-2.3	-1.6	-1.3	-1.5	-1.4	-1.4	-1.6	-2.0	-2.3	-2.0	-1.4	-1.1	-0.9	🟢
Interest and Exchange Rates														
Policy Interest Rate: Lending (%)	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	🟡
Policy Interest Rate: Deposit (%)	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	🟡
7d Repo Rate (%)	5.0	3.8	4.2	5.1	4.7	5.3	5.0	3.5	4.2	4.2	3.3	3.9	4.0	🟢
3m SHIBOR (%)	4.7	4.7	4.7	4.7	4.7	5.6	5.6	5.5	5.5	5.5	4.9	4.7	4.7	🟢
5yr Bond Yield (%)	3.6	3.9	3.9	4.1	4.3	4.5	4.2	4.0	4.1	4.0	3.9	3.8	4.0	🟢
Sovereign 5yr CDS Rate (bps)	127.0	110.7	86.5	79.7	65.5	79.8	98.2	89.7	92.3	88.9	73.2	77.0	79.7	🟢
CNY/USD	6.13	6.12	6.12	6.09	6.09	6.05	6.06	6.15	6.22	6.26	6.25	6.20	6.17	🟢
Effective Exchange Rate	114	114	113	112	112	114	116	115	113	111	111	111	112	🔴
Other Key Indicators														
Residential Building Sales (% y-o-y)	13.4	14.2	27.7	20.0	21.0	3.6			-10.7	-15.3	-11.3	-5.4	-17.8	🔴
Total Building Sales (% y-o-y)	37.8	34.4	33.9	32.3	30.7	26.3		-3.7	-5.2	-7.8	-8.5	-6.7	-8.2	🔴
70 City Residential Price (% y-o-y)	6.7	7.5	8.2	8.8	9.1	9.2	9.0	8.2	7.3	6.4	5.4	4.1	2.4	🔴
Aggregate Finance (CNY bn)	819	1584	1411	864	1227	1232	2600	937	2093	1526	1401	1968	273	🔴
MSCI China A Share Index	2150	2274	2372	2325	2402	2301	2200	2184	2144	2143	2145	2159	2343	🟢
MSCI World Index	9242	9012	9449	9770	9922	10053	9684	10297	10409	10564	10715	10817	10586	🟢

* The Keqiang index is the equal-weighted average of the year-on-year change in bank loans, rail freight volumes and electricity production

🟢 Last 3 month trend improving
🟡 Last 3 month trend flat
🔴 Last 3 month trend worsening

STOCK MARKET PERFORMANCE AND VALUATION

MSCI China A Share Index



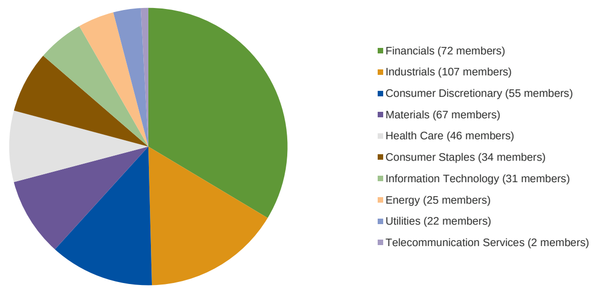
Performance	-1M	-12M	YTD	PE Ratio*
MSCI China A Index	9.7%	5.6%	3.3%	11.9
MSCI World Index	-2.0%	15.0%	5.6%	18.0
S&P 500 Index	-1.4%	19.6%	8.3%	17.7
Euro Stoxx 50 Index	-5.0%	8.5%	-2.8%	22.2
FTSE 100 Index	-3.1%	11.6%	2.4%	18.1

** Based on current price and 12-month trailing earnings*

MSCI China index Top Five Stock Gainers and Decliners

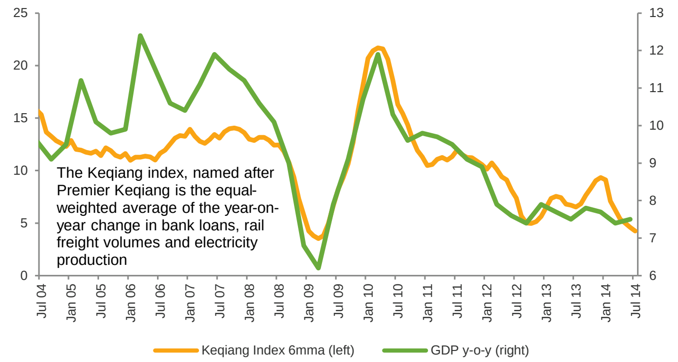
Top 5 Gainers	Price (% m-o-m)	Weight (%)	Contribution (p x w)
Shanghai Bailian Group Co Ltd	50.5	0.21	0.11
Shenzhen Agricultural Products Co Ltd	43.8	0.21	0.09
Financial Street Holdings Co Ltd	36.9	0.30	0.11
Gemdale Corp	29.2	0.69	0.20
Chongqing Changan Automobile Co Ltd	28.3	0.42	0.12

Bottom 5 Decliners	Price (% m-o-m)	Weight (%)	Contribution (p x w)
Yonyou Software Co Ltd	-28.6	0.14	-0.04
Shinva Medical Instrument Co Ltd	-27.7	0.17	-0.05
Changchun High & New Technology Industri	-25.8	0.18	-0.05
Yunnan Yuntianhua Co Ltd	-25.7	0.05	-0.01
Wuhan Guide Infrared Co Ltd	-24.4	0.06	-0.01



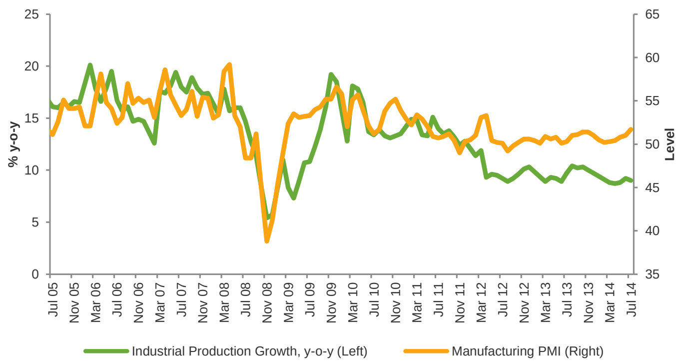
ECONOMIC GROWTH

China GDP Growth and Keqiang Index



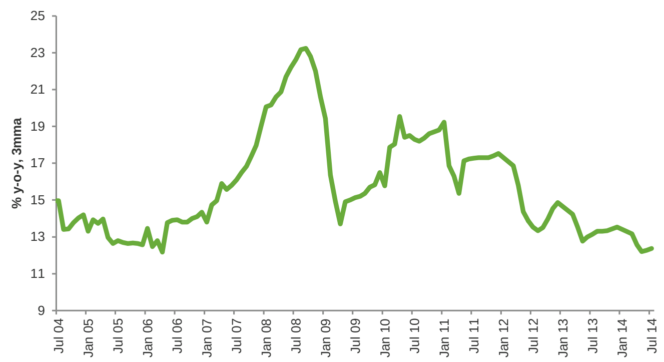
- Q2 2014 GDP grew at 7.5% y-o-y, beating consensus forecasts, and rebounding from 7.4% y-o-y growth in Q1 2014.
- The "Keqiang index" index moderated in July, but we expect the index to respond positively to the policy impetus in coming months.

China Industrial Production and Manufacturing PMI



- Industrial production maintained steady growth of 9% y-o-y in July.
- The official manufacturing purchasing manager's index (PMI) rose last month to 51.7, the highest since April 2012. That level of PMI is consistent with month-on-month annualised expansion of industrial production of between 8-12%, indicating healthy growth of the economy.
- Preliminary HSBC/Markit PMIs indicate further acceleration in July.

China Retail Sales



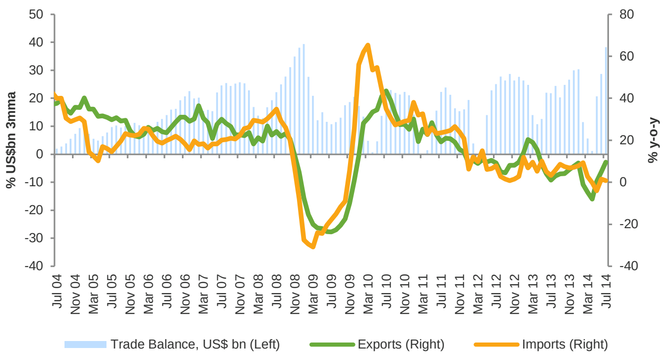
- China retail sales appear to have stabilised in the 12-13% range from the overheated levels of the 2009-10 government stimulus period. Over the past three months, retail sales have trended higher, indicating a possible trough.

China Fixed Asset Investment

- Fixed asset investment maintained steady growth of 17.0% ytd y-o-y. While the central government will remain vigilant in monitoring "unproductive" investments undertaken by local governments, the recent focus on GDP growth targets will likely see fixed asset investment start to turn.

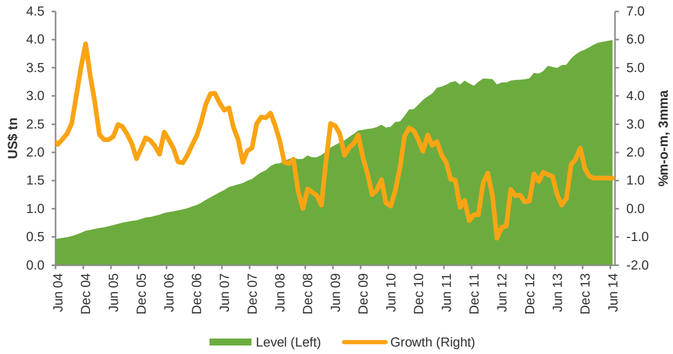
TRADE, MONEY AND PRICES

China Trade Trends



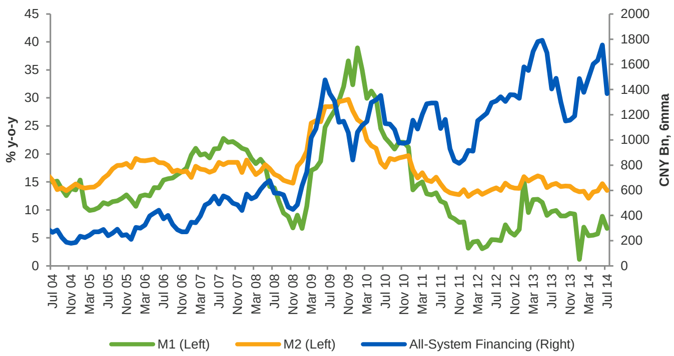
- Exports continued to expand in July, rising 14.5% y-o-y.
- Imports fell in July helping to widen the trade surplus by 50% in the month.
- The trade surplus remains high at over 85% of GDP, at US$47.3bn July.
- As China makes a structural shift toward more household consumption, domestically produced services are likely to gain at the cost of imports and the composition of exports is also likely to change.

China Foreign Exchange Reserves



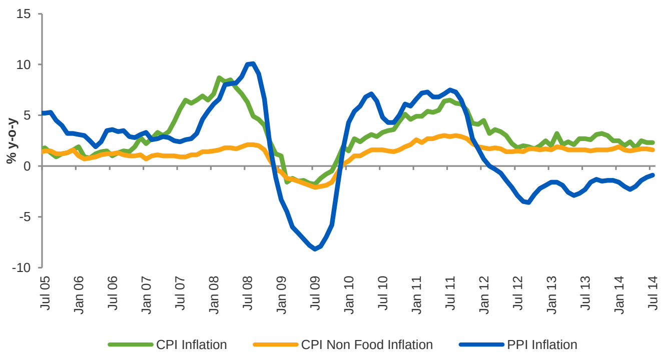
- China's foreign exchange reserves rose close to US$4 trillion in June, the highest in the world and more than three-times as high as Japan's (the country with the second largest reserves).

China Money Supply



- M2 growth moderated to 13.5% y-o-y in July from 14.7% in June as slower loan growth weighed on money supply.
- All-system financing took a set-back in July after three straight months of rising. Most of the decline came from the shadow banking sector and we are likely to see some compensating rise in bank lending and bond issuance in coming months as the government encourages a diversion to more transparent banks and capital markets. The latest reading is likely to be an aberration just like we saw in February, when loan growth re-accelerated in March.

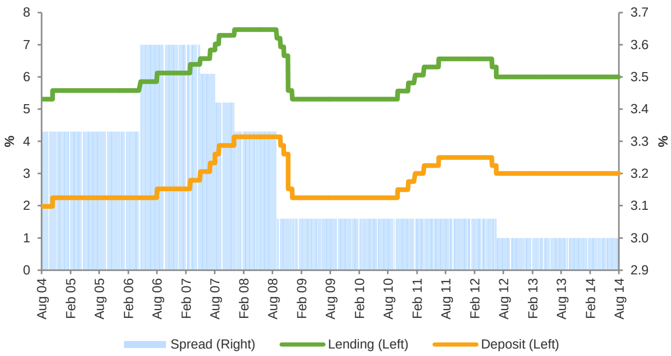
China Inflation



- With overall inflation staying at or below 2.5% over the past three months and non-food inflation remaining stable, the government has been in a position to offer a mini-stimulus programme without raising concerns of price increases.
- With the probability of an El Niño event subsiding the cost of food imports from India and Australia are less likely to rise sharply in the near future.

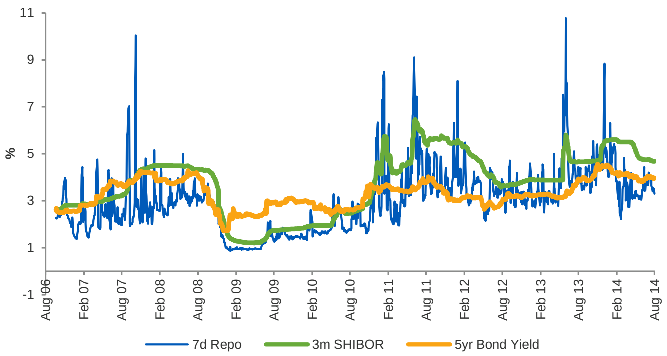
INTEREST AND EXCHANGE RATES

China Policy Interest Rates



- Policy interest rates have remained flat for the past two years, with the reserve rate ratio and quantitative targets still the preferred tool for monetary policy management.

China Market Interest Rates

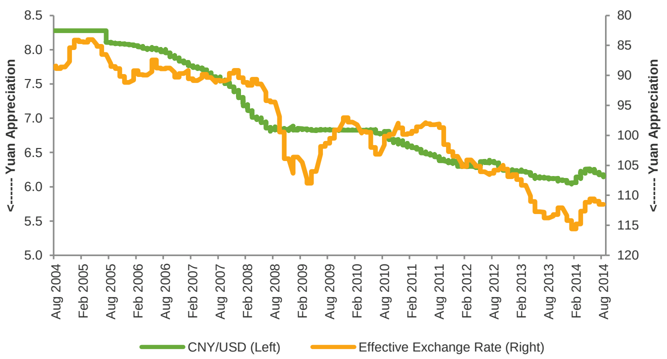


- The 7-day repo rates remain low though it picked up modestly over the past month. Repo rates spiked close to 8% in December 2013 when the government's clampdown on off-balance sheet lending led to financial retrenchment. Given the focus on meeting growth targets, we expect repo rates will remain accommodative for rest of this year.
- With the government leaning towards growth support measures, rates are likely to remain structurally low for some time.

China Sovereign 5y CDS

- After spiking in March in response to China's first corporate bond default, the sovereign credit default swap spread has narrowed as the market realised that the failure to pay was not a symptom of widespread corporate malaise, but a decision by the government not to act as a backstop to every failing entity, in a conscious bid to introduce market discipline and risk awareness.
- This decision indicates a strengthening of institutional quality and therefore should bode well for the credit strength of the nation, so long as the impact of risk re-pricing on the wider economy is contained.

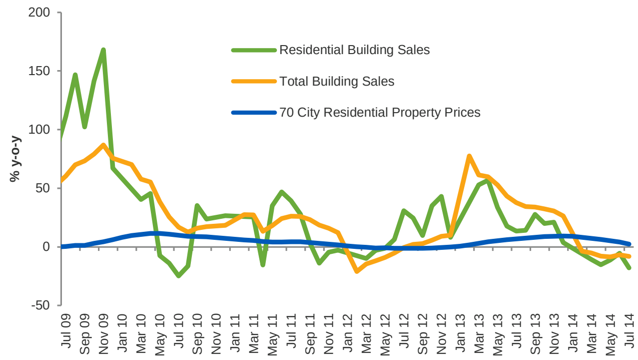
China Exchange Rate



- After widening the exchange rate band in March, the renminbi depreciated as the government wanted to show speculators that the currency can fall as well as rise in order to deter speculative flows.
- The rise in FX reserves in March indicates that central bank intervention was the most probable cause of the weakness.
- In the four months since then, the renminbi has appreciated but has not reached the same level prior to the correction.

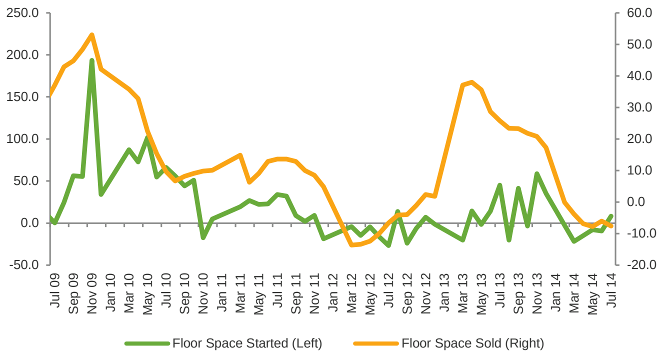
PROPERTY AND FINANCE

China Property Market



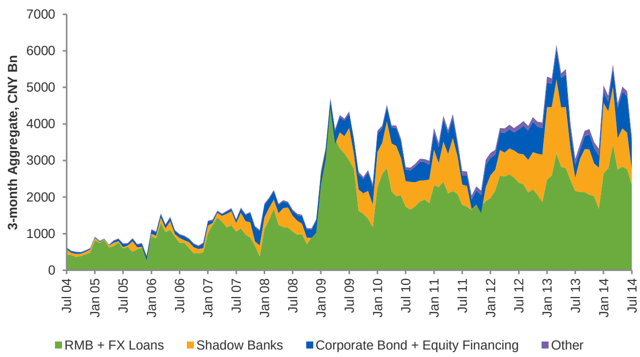
- Residential building sales fell in July after shows signs of stabilising in May and June.
- The average price of newly built houses across 70 cities rose 2.4% y-o-y in July, down from an average of 7.5% in the past year.
- While the government will likely maintain its policy of clamping down on real estate speculation, given the scale of urbanisation taking place in China it is unlikely that prices will decelerate substantially except in some of the more speculative projects and locations.

China Floor Space Started and Sold



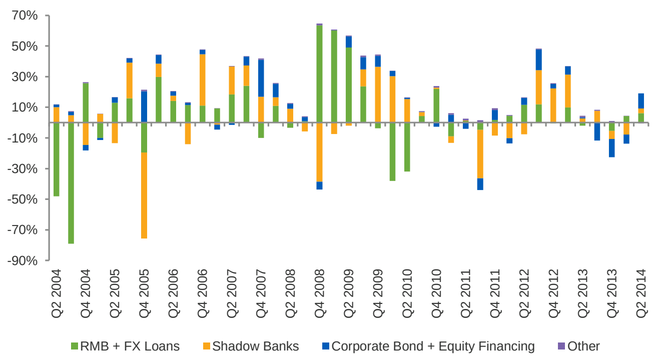
- Floor space sold has stabilised in recent months after falling sharply earlier in the year. Developers have become cautiously more optimistic and have started using the floor space they have bought to develop on.
- With space becoming scarcer, average property sizes are likely to fall in tier 1 and tier 2 cities, also acting to reduce the floor space metrics. Against this trend, the development of social housing should boost the figures in other cities.

China Sources of Finance



- The shadow banking sector has played an important role in financial sector intermediation in China. While the bulk of RMB and FX loans offered by the formal state banking sector has almost exclusively been issued to state-owned-enterprises, the shadow banks have played a vital role in providing loans to commercial entities.
- Trusts, the largest part of shadow banking, are regulated by the China Banking Regulatory Commission (CBRC), the same entity that regulates banks. The CBRC now has the delicate task of clamping down on riskier types of financing, while allowing credit to continue to flow to "productive" areas of the economy.
- The reduction in undiscounted bankers' acceptances (a method of taking bank loans off-balance sheet) led to most of the decline in shadow banking in July.

China Contribution to Financing Growth



- Subdued local government borrowing led to a contraction in trust financing in Q4 2013 and Q1 2014.That changed in Q2 2014, as the message from the central government to local governments to act immediately made an impact.
- Corporate bond and equity financing made the most substantial gains in Q2, in a sign that investor fears over the first corporate bond default in Q1 are largely over.
- With trusts playing a vital role in capital market deepening (one of key goals of the government), close oversight as well as support from the government is expected.

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