Buy for a spring bounce

China Equity Strategy

- We recommend a trading buy of China equities, based on seasonality (NBS PMIs have typically been significantly higher in March and April than in the other 10 months over the past nine years) and all-time low valuations (12-month forward P/E of 8x). We expect a 15-20% market rebound (implied 10x of P/E) in the coming weeks, once growth stabilizes and the market's focus switches to structural reforms during the "two sessions" (NPC and CPPCC) in March.

- We recommend two stock screens for different risk appetites and investment horizons: (1) thematic/quality stocks—with the NPC and CPPCC conferences less than one month away, we expect the New China themes (healthcare, clean energy, environmental protection, e-commerce and Internet) to regain momentum after a 10% correction since the peak; and (2) severely corrected stocks (mainly Chinese banks), on the back of tough valuations, high dividend yields and high ROE. Please see Table 2 and Table 3. Our top picks are Ping An Insurance (OW), Sino Biopharm (OW), Longyuan Power (OW), Vipshop (OW) and Tencent (OW).

- The biggest risks to China equities in the next one to two months are repeated liquidity tensions and market volatility. There are no quick solutions, as the Chinese economy is highly leveraged and very sensitive to changes in liquidity supply and demand. In our view, the only way to lower interest rates (and thus ease liquidity) is to suppress demand through de-capacity or deleveraging. However, these measures pose the risks of a hard landing and widespread unemployment (which are politically unacceptable) and of system contagion/capital outflows.

China Strategy

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Asia Pacific Equity Strategy

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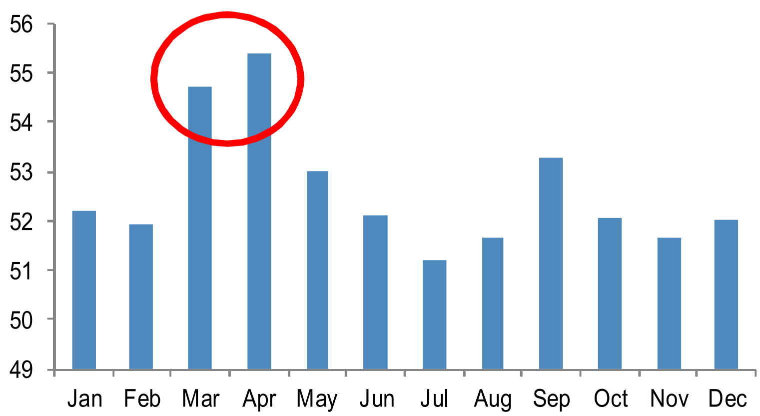
Table 1: J.P. Morgan top picks

	Code	P/E (x)	P/B (x)	ROE (%)
Ping An Ins.	2318	10.4	1.8	17.3
Sino Biopharm	1177	23.6	5.2	23.9
Longyuan Pwr	916	15.4	1.8	12.0
Vipshop	VIPS	47.8	42.5	61.8
Tencent	700	31.1	9.8	39.1

Source: Bloomberg, J.P. Morgan estimates.

Figure 1: China manufacturing PMI seasonality



Source: NBS. Data show monthly average between 2005 and 2013.

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Table 2: Thematic/quality stocks*

	Ticker	Rating	Analyst	Price 2/7/2014	Market cap (HK$ B)	3m ADT (HK$ M)	P/E (x) FY13E	P/E (x) FY14E	Div yield FY14E	P/B (x) FY14E	ROE (%) FY14E	JPM PT	Pot. up/ downside %
China Mengniu	2319 HK	OW	Ebru Sener	36.8	68	195	35.6	26.1	0.6	3.4	13.8	38.1	3.5
Wynn Macau	1128 HK	OW	Kenneth Fong	34.1	177	243	23.2	19.5	4.4	16.9	95.8	42.0	23.2
Sino Biopharm	1177 HK	OW	Sean Wu	6.4	32	99	28.5	23.6	1.5	5.2	23.9	6.6	3.1
China Pacific Insurance	2601 HK	OW	MW Kim	26.8	74	301	18.8	15.7	2.1	1.7	11.1	32.0	19.4
Ping An Insurance	2318 HK	OW	MW Kim	60.8	190	1179	13.2	10.4	1.1	1.8	17.3	84.0	38.2
China Oilfield Services	2883 HK	OW	Scott Darling	20.8	38	236	11.9	10.3	2.9	1.9	20.3	24.0	15.7
China Ptl. & Chm	386 HK	OW	Scott Darling	5.8	149	712	7.5	6.9	5.9	0.9	13.2	7.5	28.4
ENN Energy	2688 HK	OW	Boris Kan	50.8	55	168	23.4	19.0	1.3	3.6	20.4	51.0	0.5
Longyuan Power	916 HK	OW	Boris Kan	9.7	32	127	19.7	15.4	1.3	1.8	12.0	9.8	0.9
PetroChina	857 HK	OW	Scott Darling	7.6	159	687	9.8	8.8	5.1	0.9	10.7	11.0	45.7
COLI	688 HK	OW	Ryan Li	20.4	166	448	7.4	7.2	2.8	1.3	20.2	27.0	32.7
Shimao	813 HK	OW	Ryan Li	16.5	57	108	6.9	5.8	5.4	0.9	17.5	24.0	45.6
Tencent	700 HK	OW	Alex Yao	524.5	978	2233	48.7	31.1	0.2	9.8	39.1	580.0	10.6
Vipshop	VIPS US	OW	Alex Yao	103.5	45	698	106.5	47.8	0.0	42.5	61.8	88.0	-15.0
Anhui Conch Cement	914 HK	OW	Daniel Kang	30.8	40	389	15.0	11.3	1.8	2.1	19.6	35.0	13.6
China State Construction	3311 HK	OW	Leon Chik	13.6	53	59	19.4	13.6	2.2	2.9	23.2	19.0	39.7

Source: MSCI, Bloomberg, J.P. Morgan estimates. Share price in US$ for Vipshop. *For selection criteria, please refer to the China key trades section in *Tilting Toward New China*, Yu, et al., 23 January 2014.

Table 3: Severely corrected stocks*

	Ticker	Rating	Analyst	Price 2/7/2014	Market cap (HK$ B)	3m ADT (HK$ M)	P/E (x) FY13E	P/E (x) FY14E	Div yield FY14E	P/B (x) FY14E	ROE (%) FY14E	JPM PT	Pot. up/ downside %
China Minsheng	1988 HK	UW	Katherine Lei	7.6	44	418	4.1	3.8	5.2	0.7	19.9	7.5	-0.7
Chongqing Rural Bank	3618 HK	N	Katherine Lei	3.3	8	53	4.0	3.6	8.2	0.6	17.0	3.6	9.8
China Citic Bank	998 HK	UW	Katherine Lei	3.7	56	131	4.0	3.6	6.9	0.5	15.8	3.6	-3.5
China Merchants Bank	3968 HK	OW	Katherine Lei	13.6	63	371	4.8	4.8	6.2	0.9	19.7	16.4	20.4
Bank of Comm	3328 HK	UW	Katherine Lei	5.0	173	132	4.6	4.5	4.5	0.6	14.5	4.9	-1.0
Guangzhou R&F	2777 HK	OW	Ryan Li	10.2	10	60	4.6	4.3	8.7	0.8	19.0	14.5	41.6

Source: MSCI, Bloomberg, J.P. Morgan estimates. *Selection criteria are MSCI China constituents with a share price decline of >20% in the last 12 months, 2014E P/E <5x, 2014E P/B <1x and 2014E DY >4.5%.

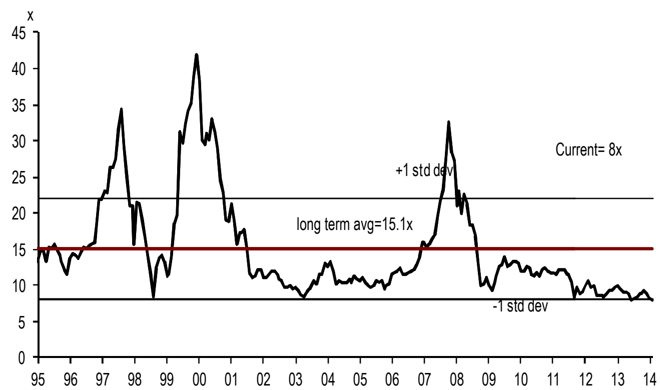
"Be greedy when others are fearful and fearful when others are greedy" – Warren Buffett

Why China is a trading buy now?

We recommend a trading buy of China equities, based on seasonality and all-time low valuations. The NBS manufacturing PMI seasonality chart (Figure 1) shows that NBS PMIs have typically been significantly higher in March and April than in the other 10 months over the past nine years. In addition, Chinese equities are trading at their all-time low, with a 12-month forward P/E of 8x. We expect a 15-20% market rebound (implied 10x of P/E) in the coming weeks, once growth stabilizes due to seasonality and the market's focus switches to structural reforms during the "two sessions" (NPC and CPPCC) in March. After the March meetings, we expect the once-a-decade political power transition to end smoothly. Newly elected local government officers should start to implement or execute the economic adjustments under the strongly empowered leadership of President XiJing Ping and Premier Li Keqiang.

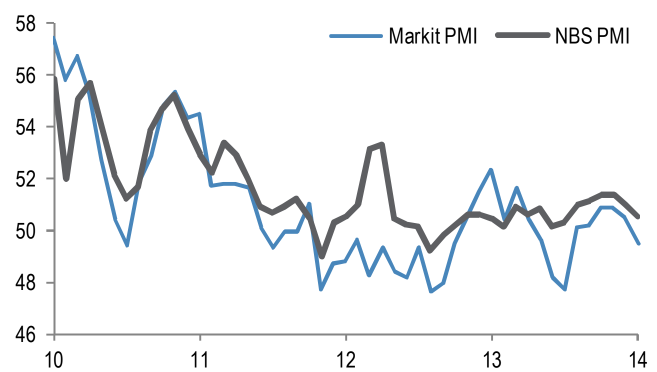
We recommend two stock lists for different risk appetites and investment horizons: (1) thematic/quality stocks (please see Table 2)—with the NPC and CPPCC conferences less than one month away, we expect the New China themes (healthcare, clean energy, environmental protection, e-commerce and Internet) to regain momentum; and (2) severely corrected stocks (mainly Chinese banks), on the back of tough valuations, high dividend yields and high ROE (please see Table 3). This is in line with our banking analyst's view (see *China Banks - Out of the frying pan, but not into the fire...YET*, Lei, et al., 9 February 2014).

Figure 2: MSCI China 12-month forward P/E



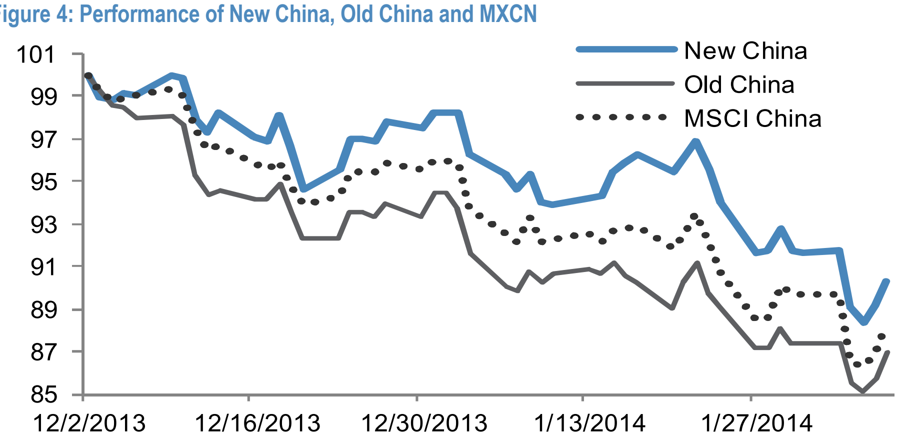
Source: MSCI, IBES, DataStream, J.P. Morgan.

Figure 3: China manufacturing PMI



Source: NBC, Markit, J.P. Morgan economics.

Figure 4: Performance of New China, Old China and MXCN



Source: DataStream, J.P. Morgan. New China includes healthcare, insurance, environmental protection and brokers. Old China includes banks, coals, materials, industrial machinery, construction equipment and power producers. Base = 100 as of 2 December 2013 (MXCN's peak in 2013).

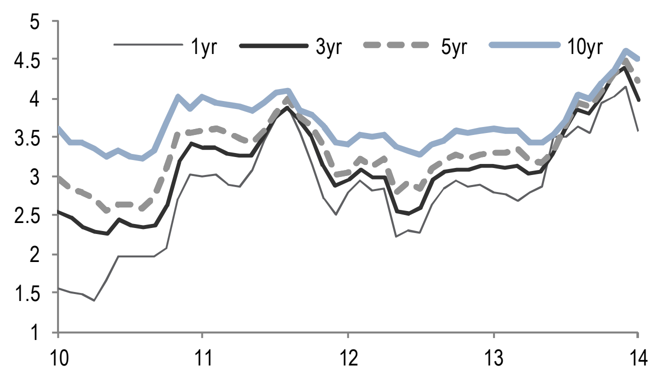
The biggest risks to China equities in the next one to two months are repeated liquidity tensions and market volatility. Domestic liquidity likely represents the biggest uncertainty to the broader economy and capital markets. With a 200% debt-to-GDP ratio and Rmb46.7tn in non-bank financing (for details, please see *To default or not to default: shadow banking in China*, Zhu, et al., 31 January 2014), China's economy is very sensitive to changes in the liquidity environment.

In order the cope with the repeated liquidity tension in the domestic financial system, what China needs is deleveraging, in our view. However, this is very challenging for the new government. So far, the Chinese economy appears to feature a bad mix of growth slowing and interest rates creeping up. A better macro scenario (growth slowing and interest rates coming down) can emerge only when deleveraging starts, in our view. However, given the political agenda to maintain a 7% growth floor, we expect the overall credit-to-GDP ratio to continue to rise. In particular, our China economist expects total social financing (TSF) growth to slow from 17.8% in 2013 to 16.2% in 2014, still much higher than nominal GDP growth. (For details, please read *Greater China Quarterly Issues - The path to rebalancing*, Zhu, et al., 24 January 2014).

To manage domestic liquidity, Chinese authorities face in a dilemma. On the supply side, they cannot do much. A fast-growing debt-to-GDP ratio and overcapacity are the curses of further easing of liquidity, even though inflation is under control. What the PBoC can do is be more innovative in terms of policy toolkits to control market volatility. On the demand side, liquidity demand comes mainly from incremental growth demand (real GDP growth still exceeds 7% per annum) and the need to refinance and roll over outstanding debts. In our view, the only way to lower China's interest rates is to suppress the demand for capital through either de-capacity or deleveraging. The problem is that broad-based de-capacity risks a hard landing and widespread unemployment, which are politically unacceptable. On the other hand, imminent deleveraging risks contagion in the financial system, potentially even causing capital outflows. The resolution of the recent near-default of China Credit Trust (CCT) products suggests that the Chinese government is vigilant about liquidity/contagion risks after the mid-2013 stress test.

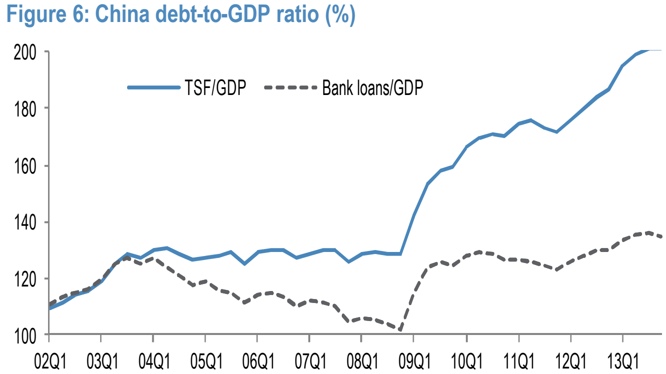
More importantly, we think even a moderate easing of liquidity may not able to lower interest rates at the long end of the yield curve. This is largely a consequence of duration readjustment among domestic industry players and tighter regulatory oversight. After the massive volatility in interbank markets in 2H13, Chinese banks have started to adjust/rematch the duration mixes of their assets and liabilities. However, a duration adjustment or re-matching for the overall economy is unlikely to be completed in a short period of time. As a result, the demand for long-duration money will stay strong, in our view, implying that long-end borrowing costs will stay high for a while. On the other hand, the PBoC is increasingly unwilling to keep short-term borrowing costs low. This could create incentives and arbitrage opportunities for local governments and shadow banking activities.

Figure 5: China bond yield creeping up



Source: CEIC.

Figure 6: China debt-to-GDP ratio (%)



Source: CEIC, J.P. Morgan.

In short, we expect continued liquidity tensions and market volatility. Our economist believes that a default is likely in 2014 as growth momentum slows, and that it would help restore market discipline and mitigate the moral hazard problem in the long run. However, the challenge is to contain the near-term negative impact. (For details, please see *Possible contagion risks - shadow banking in China*, Zhu, et al., 31 January 2014).

In our view, the prospects for China's debt crisis are a match between reform and inflation. We think there are still at least five potential risks in the upcoming China debt cycle: (1) duration mismatch and the associated liquidity risks; (2) credit concentration risk in the form of land as a single collateral arrangement; (3) solvency problems in some government projects for which the rate of investment return is lower than the cost of funding, causing insufficient cash flow coverage; (4) the distortion of risk pricing caused by the underdeveloped market mechanism of debt defaults and corporate restructuring; and (5) rising interest rates due to financial reforms.

Table 4: Shadow banking in China

	Size (yuan in billions)	% of GDP	Memo: Size at end-2012	% of GDP
1. Trusts	10,130	18.3	7,471	14.4
2. WMP	9,920	17.9	7,100	13.7
Narrow definition (1+2)	*20,050*	36.3	*14,571*	28.0
3. Entrust loans	7,571	13.7	5,750	11.1
4. Bank acceptance	6,540	11.8	5,904	11.4
5. Security firms	2,779	5.0	1,350	2.6
6. Pawn shops	72	0.1	71	0.1
7. Guarantors	1,252	2.3	1,200	2.3
8. Small lenders	754	1.4	592	1.1
9. Finance company	4,140	7.5	3,442	6.6
10. Financial leasing	1,000	1.8	770	1.5
11.Underground lending	2,500	4.5	2,500	4.8
Broad definition (1 to 11)	*46,658*	*84.4*	*36,150*	*69.6*

Source: PBOC, CBRC, China Trust Association, media reports. As of September 2013.

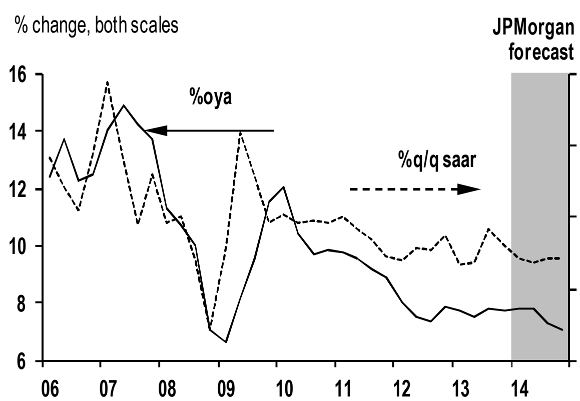
What is our 2014 market outlook?

In our view, China still has the capacity to maintain 7% growth for the next few years.

The easing in January NBS (50.5) and Markit (49.6) manufacturing PMIs reinforces the trend of softening growth momentum since 4Q13. Our China economist forecasts China GDP growth of 7.4% (vs. 7.7% in 2013), the highest growth in EM in 2014. We look for relatively stable consumption growth and a moderate improvement in exports. However, the good news will be more than offset by a slowdown in fixed investment attributable to lingering manufacturing overcapacity, tighter local government financing conditions and slowing in the housing market. We also expect inflation of 3-3.5% in 2014.

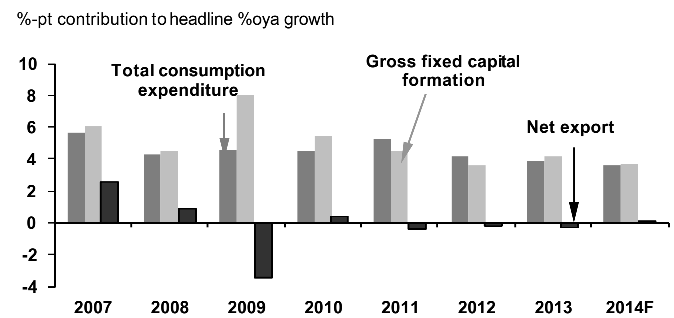
Meanwhile, we expect policy rates to be kept on hold throughout 2014, but credit growth (TSF) to slow from about 18% in 2013 to about 16% in 2014. The government reiterated its stance of proactive fiscal policy and prudent monetary policy in 2014. On the fiscal front, we expect the 2014 fiscal deficit to be around 1.9% of GDP (vs. an estimated 1.8% of GDP in 2013). But interbank rates may also continue to drift upward amid “credit tapering” (please see *China: tightened liquidity amid credit tapering*, Zhu, et al., 29 November 2013).

Figure 7: China real GDP growth



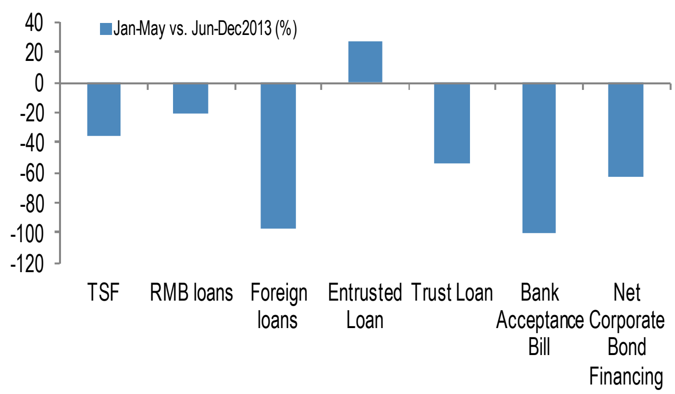
Source: NBS, J.P. Morgan economics.

Figure 8: Contribution to headline GDP growth



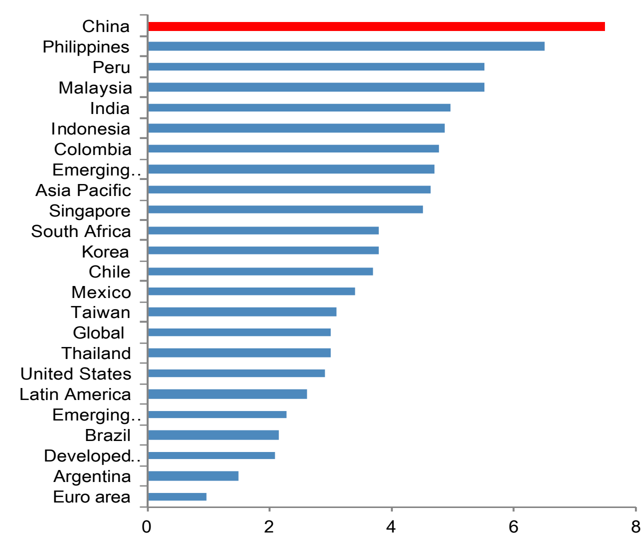
Source: CEIC, J.P. Morgan economics.

Figure 9: Tighter credit conditions since June 2013



Source: CEIC.

Figure 10: Highest growth in LatAm and EM in 2014



Source: J.P. Morgan estimates.

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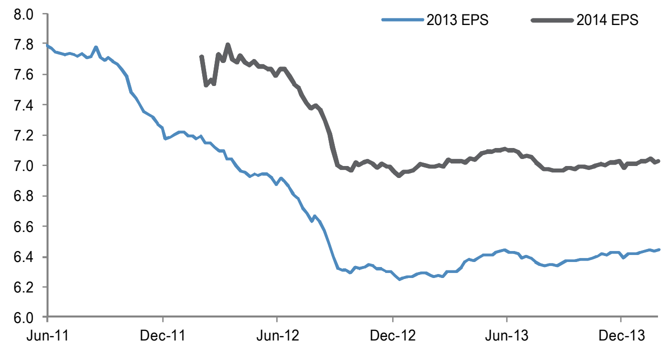
Our forecast is based on the assumption of a policy shift from stabilizing growth to structural reform. The Chinese government is committed to pushing ahead structural reforms. We are in the first year of a 10-year regime of new leadership. Nearly all the provincial governments have lowered their 2014 GDP growth targets, with an aggregated average of 9.1%, down 0.9% from 10% in 2013. (Link) We think this change in local governments' attitude reflects the centralized political power and reform leadership of President XiJing Ping and Premier Li Keqiang. Meanwhile, the strong rebound in GDP growth in 3Q13 and stable near-term economic outlook provide favorable conditions for structural reforms. We expect administrative reform, financial reform and fiscal reform to be the priorities in 2014.

In terms of valuation, Chinese markets are at an all-time low. MSCI China is trading at an 8x forward P/E (J.P. Morgan analysts' forecast), which is one standard deviation below the long-term average. We believe this could be a good longer-term entry point. The Chinese A-share market is trading at an 8.7x forward P/E (consensus data), which is one standard deviation below the eight-year average and trending down.

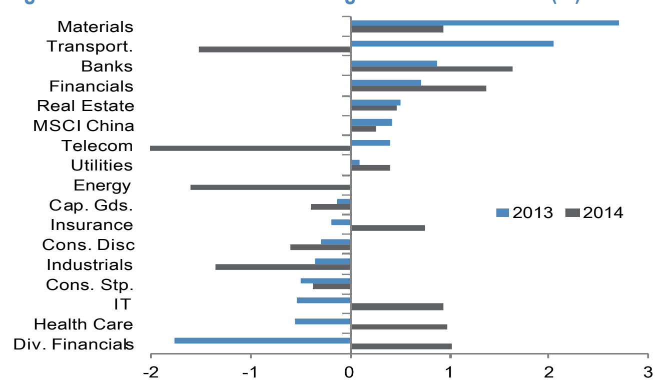
MSCI China's 2014 EPS growth forecast is 9.3%. Our 2014 GDP growth forecast of 7.4% assumes supportive policies. Policy priorities include information consumption (State Council target of US$0.5tn by 2015). The government also announced 4G licenses to promote the next generation of Internet infrastructure. Social welfare policies include shantytown redevelopment. It is policy support that makes us confident in earnings forecasts for e-commerce, Internet, mid- to low-end consumption, healthcare, insurance and clean energy. Our confidence in bank earnings forecasts is low due to asset quality concerns, NIM/ROE compression and regulatory risks in WMP and interbank business. Polluter and low-end industrials are likely to see margin pressure due to higher costs/taxes associated with tighter environmental standards. We are into Month 20 of PPI deflation. Capacity rationalization is necessary to address pricing power (i.e., commodity prices).

Figure 11: MSCI China earnings estimate revisions



Source: MSCI, IBES, DataStream.

Figure 12: MSCI China sector earnings estimate revisions (%)



Source: MSCI, IBES, DataStream, J.P. Morgan. Dates 31 December 2013 - 31 January 2014.

Table 5: Reform/growth initiatives and investment themes

To stabilize growth		To promote reform	
Information consumption	- Broadband China	Structural reform	- Information consumption
	- 4G industry		- Service industry
	- Tri-networks integration	Administrative reform	- Municipal construction
	- Mobile Internet		- Fewer government approvals
	- Culture and media	Financing system reform	- Railway construction
Public construction	- Pipe-network construction	Urbanization	- Municipal construction
	- Garbage disposal		- Land transfer
	- Smart grid	Ecological civilization construction	- Energy conservation and environmental protection
	- Public transportation	Social welfare	- Healthcare
Social welfare	- Shantytown renovation		- Food safety
	- Healthcare/insurance	Opening up	- Free trade zone
Public services	- Smart city		- Lower barriers to entry for foreign/private investments

Source: China State Council, Xinhua News Agency.

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Table 6: MSCI China valuation table

	EPS growth (%)			P/E (x)			Div yield (%)		
	CY13E	CY14E	CY15E	CY13E	CY14E	CY15E	CY13E	CY14E	CY15E
Cons. Disc	37	19	16	12.6	10.6	9.2	1.8	2.4	2.6
Cons. Staples	1	24	20	26.7	21.5	18.0	1.8	2.1	2.5
Energy	-6	11	-4	8.0	7.2	7.5	4.2	5.0	4.9
Financials	16	8	11	5.9	5.5	4.9	5.3	5.8	6.3
Banks	13	8	9	4.8	4.5	4.1	6.9	7.5	8.1
Insurance	57	30	16	15.5	11.9	10.3	1.6	2.0	2.0
Div. Financials	25	30	18	16.4	12.6	10.7	2.1	2.7	3.1
Real Estate	13	0	20	6.1	6.1	5.1	3.9	4.4	5.3
Health Care	19	15	12	23.3	20.2	18.0	1.4	1.6	1.8
Industrials	22	6	16	11.9	11.2	9.7	2.8	2.9	3.1
IT	48	44	30	33.8	23.4	18.1	0.6	0.6	0.8
Materials	34	12	22	10.4	9.3	7.6	2.1	2.2	2.5
Telecom	2	-7	0	10.0	10.7	10.7	4.2	4.3	4.3
Utilities	42	5	15	13.0	12.3	10.7	2.6	2.7	3.0
MSCI China	**11.8**	**9.3**	**10.0**	**8.9**	**8.2**	**7.4**	**3.6**	**4.0**	**4.3**

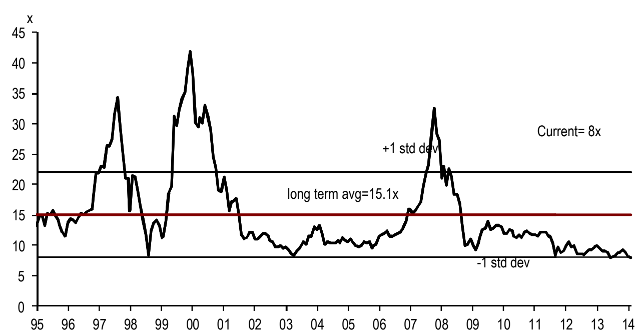
Source: MSCI, IBES, DataStream, Bloomberg, J.P. Morgan estimates. Priced as of 7 February 2014.

Table 7: MSCI China sector earnings revisions

	2013E EPS				2014E EPS			
	1m%	3m%	6m%	12m%	1m%	3m%	6m%	12m%
Materials	2.7	2.0	(4.6)	(23.7)	0.9	0.8	(5.9)	(23.5)
Transportation	2.0	3.2	(1.9)	(12.1)	(1.5)	(7.1)	(18.6)	(30.6)
Banks	0.9	1.4	4.4	13.8	1.6	2.4	3.7	11.4
Financials	0.7	1.3	4.2	10.2	1.4	2.2	3.6	9.0
Real Estate	0.5	0.8	3.4	6.2	0.5	0.8	2.6	6.9
MSCI China	0.4	0.5	1.5	2.6	0.3	0.3	0.4	0.5
Telecom	0.4	0.7	0.8	1.7	(2.4)	(2.5)	(3.0)	(7.6)
Utilities	0.1	(1.2)	4.9	18.4	0.4	(1.1)	(0.4)	10.6
Energy	0.0	0.3	(1.9)	(7.0)	(1.6)	(1.5)	(3.3)	(9.0)
Cap. Gds.	(0.1)	(0.6)	0.3	(7.0)	(0.4)	(0.3)	(1.9)	(9.9)
Insurance	(0.2)	1.8	6.4	0.5	0.8	2.8	5.2	5.6
Cons. Disc.	(0.3)	(1.5)	0.8	(2.7)	(0.6)	(0.1)	3.1	(0.4)
Industrials	(0.4)	0.9	0.3	(9.0)	(1.3)	(1.4)	(5.8)	(16.4)
Cons. Stp.	(0.5)	(1.8)	(7.3)	(13.5)	(0.4)	(2.4)	(7.4)	(13.1)
IT	(0.5)	10.6	5.7	5.8	0.9	9.3	10.7	9.9
Health Care	(0.6)	(1.5)	(2.6)	(9.6)	1.0	0.2	(1.3)	(7.1)
Div. Financials	(1.8)	(2.5)	(7.6)	(11.0)	1.0	1.2	(3.9)	(8.0)

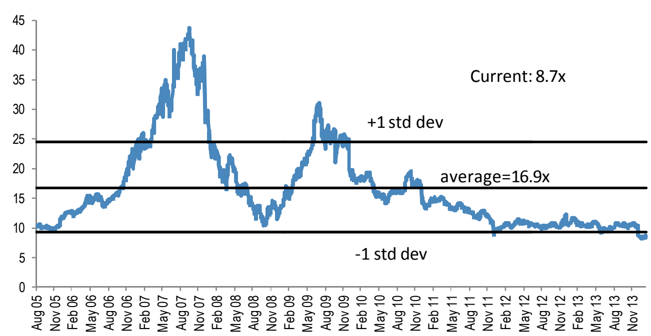
Source: MSCI, IBES, DataStream, J.P. Morgan. Data as of 31 January 2014.

Figure 13: MSCI China 12-month forward P/E (x)



Source: MSCI, IBES, DataStream, J.P. Morgan estimates.

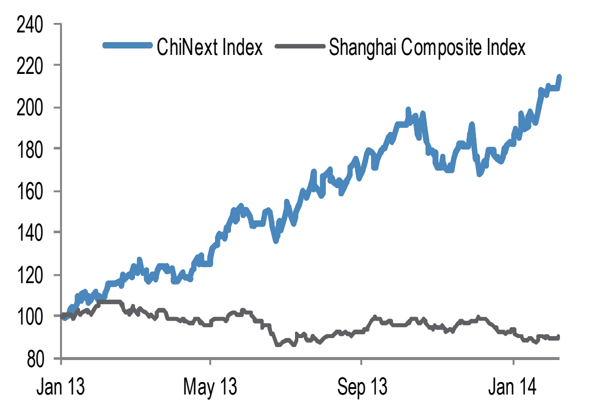
Figure 14: CSI 300 forward P/E (x)



Source: Bloomberg.

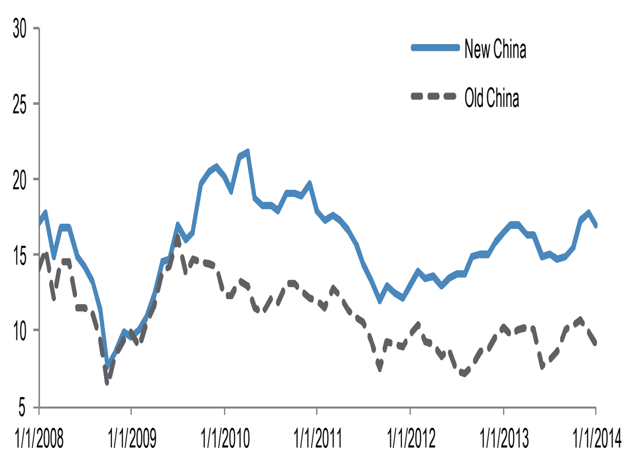
We continue to prefer New China over Old China. And after the recent correction, we think the valuation of New China is more reasonable than at the beginning of this year. We consider two criteria: (1) growth visibility and sustainability; and (2) valuation premium relative to the market. New China (healthcare, insurance, environmental protection, brokers) is trading at a 2014E average P/E of 17x, an 11% premium to the 10-year average. In contrast, Old China (banks, coals, materials, industrial machinery, construction equipment, power producers) is trading at a 2014E average P/E of 8.5x, a 21% discount to the 10-year average. New China continued to outperform Old China even after the run in 2H13. As an example, ChiNext has outperformed SHCOMP by 125% since 1 January 2013 (and by 21% YTD).

Figure 15: ChiNext and Shanghai Composite index performance



Source: Bloomberg. Based = 100 on 1 Jan 2013.

Figure 16: New China vs. Old China – 12-month forward P/E (x)



Source: IBES, DataStream, J.P. Morgan. Data based on simple average of IBES 12-month forward P/E.

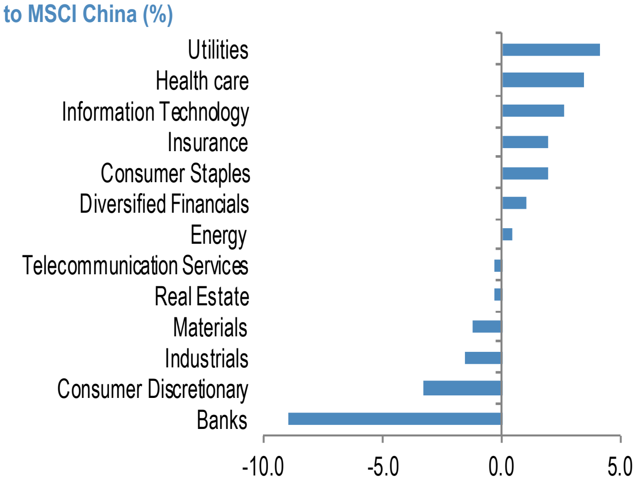
We most prefer sectors with endogenous growth drivers, such as e-commerce, Internet and mid- to-low-end consumption. Our next preference is for selected policy beneficiaries. Within this category, we prefer clean energy (gas and wind power) and healthcare to environmental protection. The latter's average P/E is at a 200% premium to overall China, with stretched balance sheets (e.g., BEW). We continue to suggest avoiding sectors at risk from reform and tighter liquidity and environmental standards, i.e., banks, industrials, materials and thermal coal.

Table 8: J.P. Morgan China model portfolio sector asset allocation

	MSCI weight	JPM weight	Deviation
Utilities	**3.8**	**8.0**	**4.2**
Healthcare	**1.6**	**5.0**	**3.4**
Information Technology	**11.9**	**14.5**	**2.6**
Insurance	**8.1**	**10.0**	**1.9**
Consumer Staples	**6.1**	**8.0**	**1.9**
Diversified Financials	**0.9**	**2.0**	**1.1**
Energy	13.6	14.0	0.4
Telecommunication Services	10.3	10.0	-0.3
Real Estate	5.8	5.5	-0.3
Materials	**3.2**	**2.0**	**-1.2**
Industrials	**6.5**	**5.0**	**-1.5**
Consumer Discretionary	**5.3**	**2.0**	**-3.3**
Banks	**23.0**	**14.0**	**-9.0**

Source: MSCI, J.P. Morgan.

Figure 17: Deviation of J.P. Morgan China model portfolio relative to MSCI China (%)



Source: J.P. Morgan calculations, MSCI, DataStream.

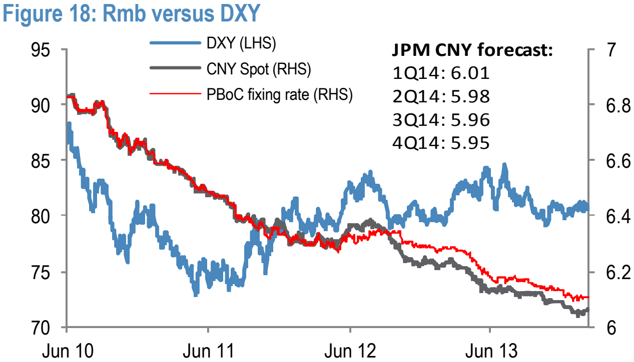
What are the risks to China markets?

The near-term concern is a repeat of events in the shadow banking/interbank market. The liquidity impact may be negative owing to domestic monetary tightening/credit tapering. The recent near-default of a trust product drew global attention. Although there is a plan to avoid another high-profile default, which might trigger a liquidity crunch, this event is a long-run negative, in our view (see *New developments in the potential default of China Credit Trust products*, Lei, et al., 23 January 2014).

The next risk is China's property bubble, which continued to inflate in 2013. Calls of "irrational exuberance" typically come too early (e.g., U.S. Fed Chairman Greenspan's came on 5 December 1996, 3-1/2 years before the end of the bull market). Current concerns about a bubble started in 2010. A cool-down of the land market, together with a slowdown in real estate market turnover, accompanied by a liquidity crunch, would cause a systemic debt crisis, in our view.

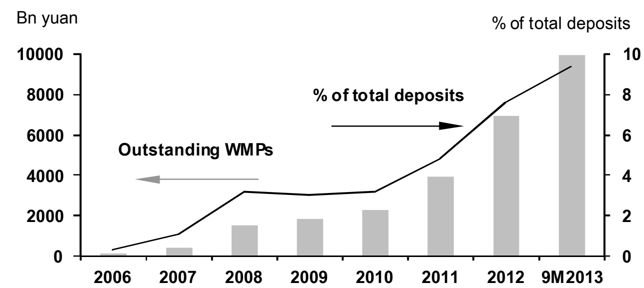
The last risk is the Rmb carry trade: local investors, corporates and high-net-worth individuals short U.S. dollars and long Rmb. Expectations of steady and consistent CNY appreciation have fostered carry trades both onshore (via USD funding) and offshore (via cross-border lending). The steady appreciation of the Renminbi yields the appearance of a low-risk trade, but Renminbi volatility could create a disorderly unwinding of this carry trade. Our Dec-14 forecast for CNY is 5.95. (For details, please see *Emerging markets FX*, Oganes, et al., 26 November 2013; *CNY: China liquidity crunch Q&A*, Gu, 27 January 2014; *No Easy Choices in China: Trying to Balance Leverage, Growth, and Stability*, Klaczek, et al., 27 January 2014).

Figure 18: Rmb versus DXY



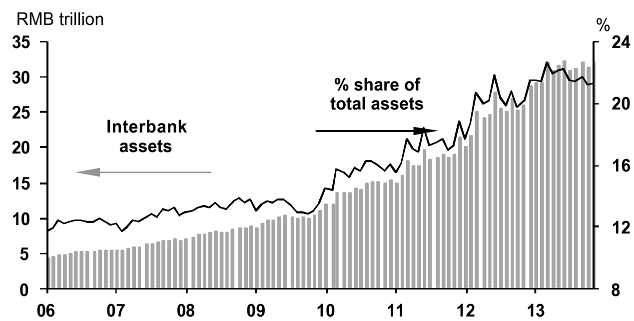
Source: Bloomberg.

Figure 19: Outstanding wealth management products



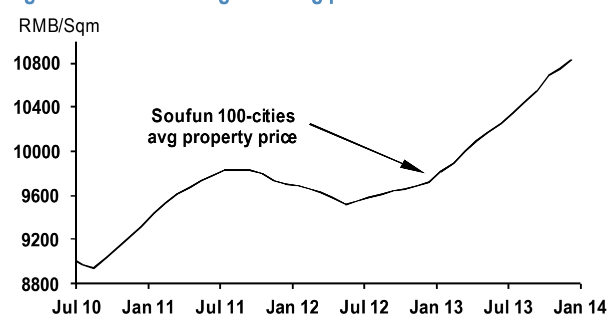
Source: CEIC, J.P. Morgan.

Figure 20: Interbank assets and percentage of total assets



Source: CEIC, J.P. Morgan.

Figure 21: China average housing price



Source: Soufun, J.P. Morgan economics.

When to buy China beta?

We expect alpha to continue to shine in 2014. There is a clear conflict of policy priorities between reform and a growth floor. Our base case is that the debt-to-GDP ratio will continue to expand in order to maintain growth. We expect small achievements on a few easier reforms, e.g., the one-child policy, administrative reform and financial deregulation. On the other hand, tighter liquidity and slower growth will likely suppress beta sector performance until government stimulus occurs. We expect trading opportunities in sectors like construction equipment, property and railway capex when growth drops near 7%. Looking ahead, we expect growth momentum to ease to 7.2% QoQ saar in 1Q14 and 6.8% QoQ saar in 2Q14.

In the past two years, when growth slowed, the Chinese government responded with mini-stimulus (Sep-12 and Jun-13). A decline in PMI below 50 has historically prompted policymakers to stimulate growth through mini-stimulus. Materials and industrials underperformed ahead of the stimulus and outperformed after it. There was a difference in sector leadership after September 2012 and June 2013 because the stimulus last year took the form of credit expansion, which was expected to feed through to the real economy. Thus, real estate and materials were the leaders. After the June 2013 low, IT, Macau gaming and consumer discretionary performed better than cyclicals and banks.

Table 9: Performance of MSCI China and sectors from 5 September 2012 low to 22 January 2013

Name	Abs	Rel
Div Financials	54.5	26.4
Real Estate	46.0	17.9
Materials	43.5	15.3
Macau Gaming	43.0	14.9
Banks	41.7	13.6
Cons Discretionary	40.2	12.0
Industrials	36.9	8.8
Insurance	31.4	3.2
MSCI China	**28.1**	
Utilities	23.6	(4.6)
Energy	22.4	(5.8)
IT	20.9	(7.2)
Cons Staples	7.3	(20.9)
T/Cm Svs	5.0	(23.1)
Health Care	5.0	(23.2)

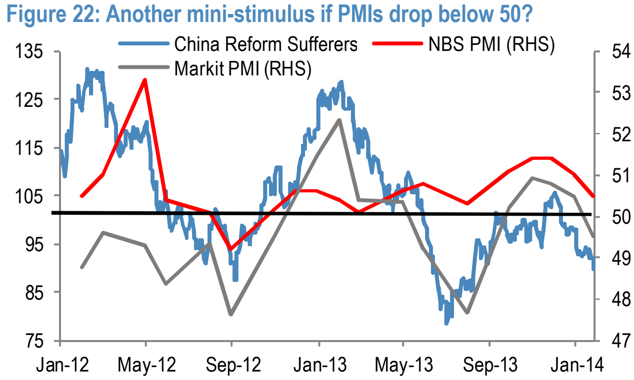
Source: MSCI, DataStream. Note: BIGAMEAC Index used for Macau gaming.

Table 10: Performance of MSCI China and sectors from 25 June 2013 low to 23 September 2013

Name	Abs	Rel
IT	40.3	18.2
Macau Gaming	34.0	11.9
Cons Discretionary	25.7	3.6
Real Estate	24.5	2.4
Div Financials	23.6	1.5
Banks	23.2	1.1
Materials	22.8	0.7
MSCI China	**22.1**	
Insurance	21.0	(1.1)
Industrials	20.4	(1.7)
Energy	19.6	(2.5)
Cons Staples	17.7	(4.4)
T/Cm Svs	16.9	(5.3)
Utilities	12.8	(9.3)
Health Care	3.2	(18.9)

Source: MSCI, DataStream. Note: BIGAMEAC Index used for Macau gaming.

Figure 22: Another mini-stimulus if PMIs drop below 50?



Source: Bloomberg, Markit, NBS.

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Why are EM Asia and China in a better position today than in 1998/99?

Markets entered 2014 with a sense of fear and panic, in our view. Investors have priced in global liquidity events, sharp EM currency devaluation (Argentine Peso) and credit risks. China's growth slowdown, the near-default of a Rmb3bn trust product, Fed tapering and EM contagion risks have dragged down the MSCI EM index 4.8% YTD vs. MSCI China 8.1%.

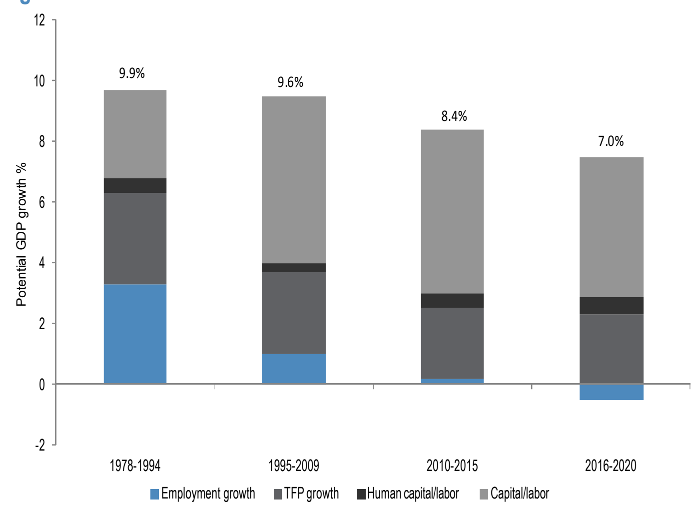
We believe the market correction based on a fear of contagion is overdone. This has been the worst start to the year for MSCI APxJ since 2010. But we believe the issues concerning the market are country-specific (e.g., Argentina) and see no reason why they should spread to EM Asia and China, where there are relatively strong regional/country fundamentals (please see Figure 24).

We think EM Asia is in a better position today than during the Asian financial crisis of 1998/99. Overall EM Asia is more immune to external debt/liquidity shocks today—equipped with lower external and short-term debt, flexible FX policies and high FX reserves. Together with strong economic growth and better corporate fundamentals, these factors provide a much more solid base for EM Asia to withstand hits from other markets.

We do not foresee an imminent crisis (or EM/global contagion) due to China's isolated financial system, government ownership of the major banks and their ability to "extend and pretend" by rolling over maturing loans, capitalizing interest and feigning better asset quality than is actually the case. The resolution of the CCT/ICBC trust product, with the assistance of the local government and CCT, is an example of avoiding outright default through intervention.

According to Caijing, CCT has announced that investors in the "troubled" trust product (Credit Equals Gold #1) will receive the principal investment in full, but that interest payments are not guaranteed. (Trust investors received interest of 10% p.a. in the first two years of the investment and only 2.8% in the third year). This development is in line with our expectations (please refer to our note *China banks: New developments in the potential default of China Credit Trust products,* Lei, et al., 23 January 2014). We believe this is positive in the near term, as a high-profile default might trigger a liquidity crunch, with WMP/trust buyers shying away from such products. However, we believe this is negative in the long run and do not expect it to be an isolated case. It reinforces the implicit guarantee on such products and thus increases system risks as credit risk is mis-priced.

Figure 23: China's GDP breakdown



Source: National Bureau of Statistics of China, World Bank.

Table 11: Why is Asia/China more immune now?

Why is EM Asia/China in better shape today	Why EM saw repeated crises in the 1990s
➢ Low external and short-term debt requirements	➢ High external debt
➢ Flexible exchange rates (arguably for China)	➢ Bad FX management, i.e., fixed exchange rate
➢ High FX reserves	➢ Low FX reserves
➢ Strongly capitalized banking system	➢ Weak financial systems that had little cushion against exogenous risks
➢ Better fiscal policy and subdued inflation	➢ Poor macroeconomic management and volatile growth
➢ Solid corporate fundamentals	

Source: J.P. Morgan.

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Figure 24: EM stress test: Overview of current account, fiscal and debt position, bond yields and FX for EMs

Country	CAD (% of GDP) 2013E	External Debt (% of GDP)	Fiscal Balance (% of GDP) 2013E	Public Sector Debt to GDP	Foreign Ownership of local Bond Markets (%)	Bond Yield	BY- 12M avg	BY-36M avg	EMBI-12M avg	EMBI-36MM avg	CEMBI-12M avg	CEMBI-36M avg	FX-12M avg (%)	FX-36M avg (%)	Local BY - EMBI BY
Turkey	-7.1	47	-1.1	38	30	10.2	2.2	1.6	72	50	-13	-8	-11	-16	4.1
South Africa	-5.9	34	-4.2	42	32	7.9	0.6	0.3	13	35	-3	10	-8	-20	2.8
Peru	-5.5	28	0.1	17	60	5.6	0.7	0.6	4	-7	-7	-21	-3	-4	0.6
Chile	-3.8	47	-1.0	12		2.2	-0.2	-0.4			-13	-8	-6	-7	-2.4
Indonesia	-3.7	30	-2.4	23	33	8.4	1.5	1.7	32	54	17	25	-14	-22	2.4
Brazil	-3.5	14	-3.4	59	9	13.2	1.3	2.0			-10	10	-9	-18	7.9
Colombia	-3.5	23	-1.2	41		6.8	0.7	0.0			-36	-55	-3	-5	2.1
India	-2.7	22	-4.8	52		8.8	0.7	0.6	21	23	-13	-49	-5	-14	3.7
Poland	-1.8	73	-4.5	48	37	4.3	0.3	-0.7	-17	-61	-64	-256	5	4	0.9
Mexico	-1.5	31	-2.4	36	37	6.5	0.8	0.4	-11	-10	-61	-108	-2	-2	1.4
Czech Rep.	-1.1	52	-2.9	46	13	2.5	0.4	-0.4			-20	-38	-1	-5	
Thailand	0.1	38	-3.6	46	9	3.9	0.1	0.3			-6	-65	-6	-6	3.9
Russia	1.8	35	-0.3	8		7.9	0.4	-0.1	3	-32	-39	-69	-3	-6	3.2
China	2.3	9	-2.1	32		4.6	0.8	0.9			-38	-171	2	4	0.2
Hungary	2.3	126	-3.0	79	38	5.6	-0.3	-1.5			-61	-64	4	0	0.2
Philippines	3.1	24	-2.0	52		3.8	0.0	-1.4	-20	-44	26	17	-4	-4	-0.7
Malaysia	3.3	19	-4.0	53	48	4.1	0.5	0.4	5	-5	-9	-9	-4	-5	0.6
Korea	5.8	36	0.9	35	16	3.6	0.3	-0.1			-27	-68	4	5	
Taiwan	10.7	40	-1.8	36		1.7	0.3	0.3			-26	-9	0	-1	

Source: Bloomberg, J.P. Morgan economics, 1 January 2014. Note: Fiscal balance for 2013E is highlighted in red if it is deteriorating vs. 2012 and highlighted in green if it is improving. Bond yield deviation is highlighted in red if yields rise > 10% and highlighted in green if yields fall. FX deviation is highlighted in red if depreciation>5% and green if appreciating. If foreigners own more than one-third of the local bond market, the cell is highlighted in red.

Table 12: MSCI emerging markets index performance (in USD)

	2013 %	2014 (1 Jan 14-7 Feb 14) %
Greece	46.2	9.5
Indonesia	(25.0)	6.0
Philippines	(4.3)	0.4
Thailand	(16.9)	(0.0)
Poland	(1.7)	(0.1)
Peru	(31.0)	(1.9)
Czech	(14.9)	(2.4)
Europe	20.1	(2.4)
USA	29.9	(2.7)
Developed market	24.1	(3.0)
Global	20.2	(3.3)
India	(6.0)	(4.2)
Taiwan	6.6	(4.7)
Malaysia	4.2	(5.0)
APxJ	0.4	(5.2)
EM Asia	(0.3)	(5.8)
Japan	24.9	(6.4)
Emerging market	(5.0)	(6.5)
Mexico	(2.0)	(7.0)
Hungary	(9.0)	(7.2)
Korea	3.1	(7.2)
Turkey	(28.1)	(7.5)
Russia	(2.6)	(7.9)
China	**0.4**	**(8.2)**
Latin America	(15.7)	(8.4)
Brazil	(18.7)	(8.7)
South Africa	(8.8)	(9.3)
Chile	(23.0)	(11.1)
Colombia	(23.7)	(11.8)

Source: MSCI, DataStream.

Lan Deng's role has been limited to assisting in gathering information for this report.

Companies Discussed in This Report (all prices in this report as of market close on 10 February 2014, unless otherwise indicated)
China Longyuan Power Group Corp. (0916.HK/HK$9.72/Overweight), Ping An Insurance Group - H (2318.HK/HK$60.55/Overweight), Sino Biopharmaceutical (1177.HK/HK$6.68/Overweight), Tencent (0700.HK/HK$533.50/Overweight), Vipshop (VIPS/$103.50[07 February 2014]/Overweight)

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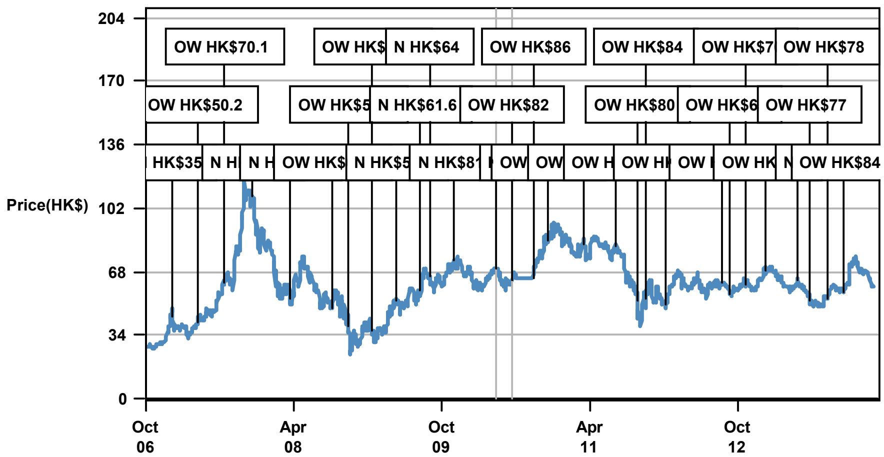
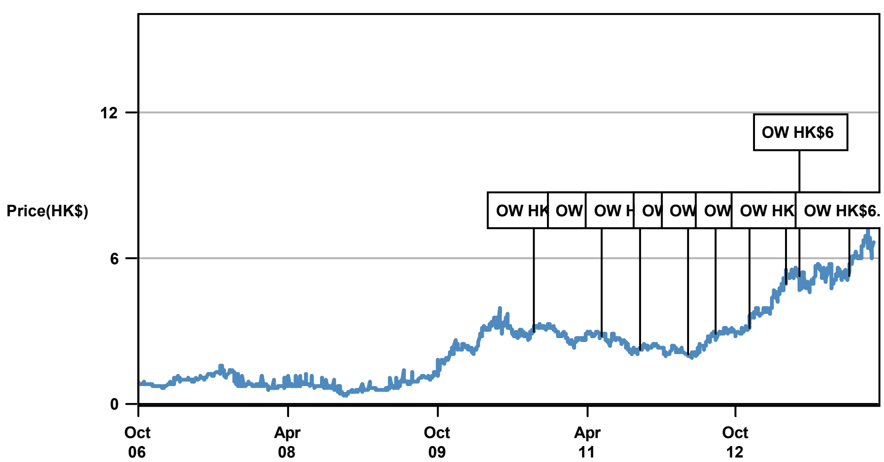
Ping An Insurance Group - H (2318.HK, 2318 HK) Price Chart



Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends.
Break in coverage Apr 14, 2010 - Jun 18, 2010.

Date	Rating	Share Price (HK$)	Price Target (HK$)
05-Jan-07	N	43.65	35.00
12-Apr-07	OW	40.30	50.20
17-Jul-07	OW	62.00	70.10
25-Oct-07	N	108.50	91.10
17-Mar-08	N	53.20	73.50
15-Aug-08	OW	48.30	61.90
16-Oct-08	OW	38.30	54.20
16-Jan-09	OW	36.35	50.70
09-Apr-09	N	52.40	50.40
07-Jul-09	N	57.60	61.60
15-Aug-09	N	65.00	64.00
16-Nov-09	N	73.60	81.00
14-Apr-10	N	69.60	--
18-Jun-10	OW	62.70	82.00
02-Sep-10	OW	64.35	86.00
28-Oct-10	OW	84.15	105.00
07-Mar-11	OW	82.75	101.00
07-Jul-11	OW	81.95	97.00
23-Sep-11	OW	52.55	80.00
26-Oct-11	OW	53.50	84.00
09-Jan-12	OW	50.35	72.00
02-Aug-12	OW	61.85	68.00
02-Sep-12	OW	56.00	65.00
30-Oct-12	OW	61.20	70.00
09-Jan-13	OW	68.75	76.00
07-May-13	NR	63.30	--
22-Jun-13	OW	53.00	77.00
30-Aug-13	OW	53.20	78.00
27-Oct-13	OW	57.05	84.00

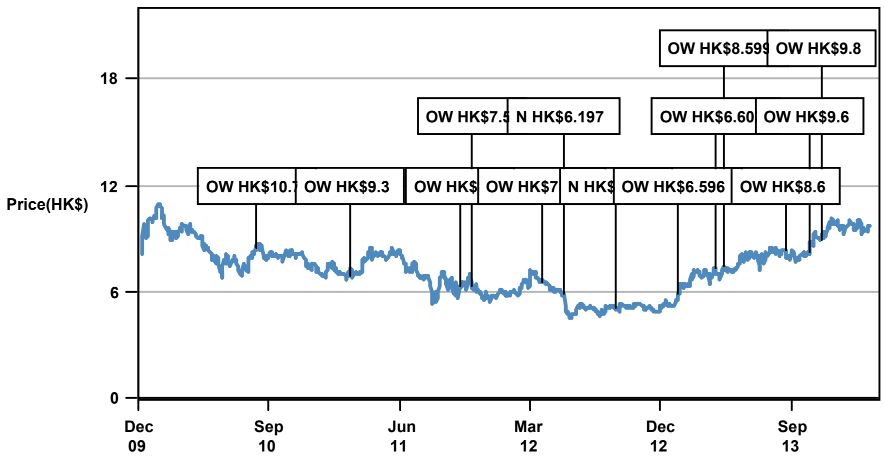
Sino Biopharmaceutical (1177.HK, 1177 HK) Price Chart



Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends.
Initiated coverage Sep 21, 2010.

Date	Rating	Share Price (HK$)	Price Target (HK$)
21-Sep-10	OW	2.97	4.00
23-May-11	OW	2.79	3.60
15-Oct-11	OW	2.21	3.50
02-Apr-12	OW	2.06	3.10
13-Jul-12	OW	2.87	3.60
15-Nov-12	OW	3.08	3.80
26-Mar-13	OW	4.91	5.50
16-May-13	OW	5.27	6.00
14-Nov-13	OW	5.29	6.60

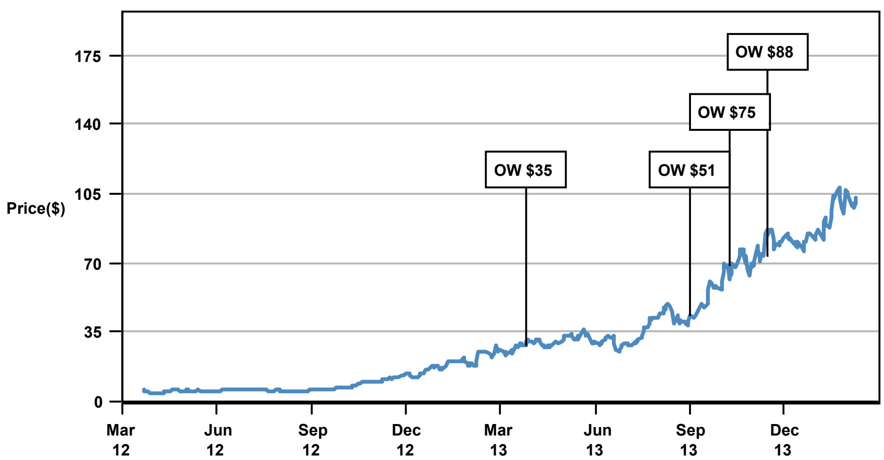
China Longyuan Power Group Corp. (0916.HK, 916 HK) Price Chart



Date	Rating	Share Price (HK$)	Price Target (HK$)
06-Aug-10	OW	8.48	10.70
18-Feb-11	OW	6.91	9.30
07-Oct-11	OW	6.34	8.20
02-Nov-11	OW	6.27	7.50
27-Mar-12	OW	6.57	7.72
13-May-12	N	5.84	6.20
28-Aug-12	N	5.06	5.50
06-Jan-13	OW	5.85	6.60
26-Mar-13	OW	7.30	6.60
11-Apr-13	OW	7.41	8.60
20-Aug-13	OW	8.32	8.60
09-Oct-13	OW	8.29	9.60
01-Nov-13	OW	8.91	9.80

Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends.
Initiated coverage Aug 06, 2010.

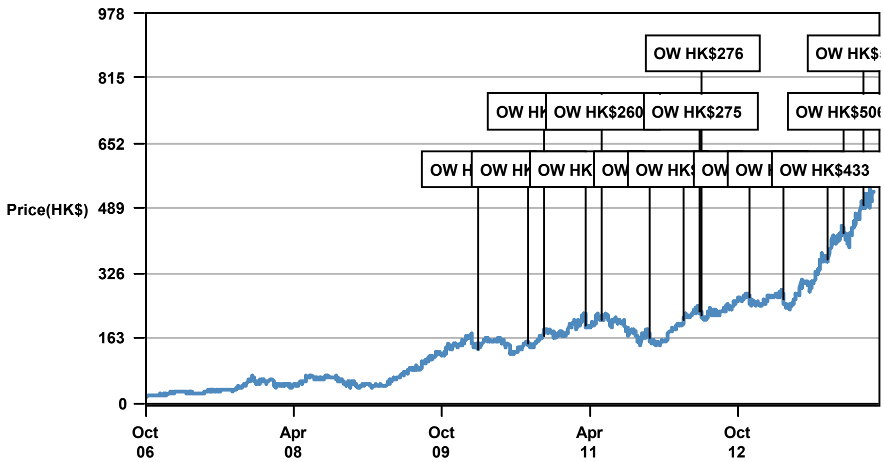
Vipshop (VIPS, VIPS US) Price Chart



Date	Rating	Share Price ($)	Price Target ($)
25-Mar-13	OW	28.57	35.00
30-Aug-13	OW	43.30	51.00
09-Oct-13	OW	68.22	75.00
13-Nov-13	OW	73.32	88.00

Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends.
Initiated coverage Mar 25, 2013.

Tencent (0700.HK, 700 HK) Price Chart



Date	Rating	Share Price (HK$)	Price Target (HK$)
07-Feb-10	OW	137.70	180.00
12-Aug-10	OW	148.70	175.00
10-Oct-10	OW	172.40	205.00
17-Mar-11	OW	193.20	240.00
12-May-11	OW	209.80	260.00
10-Nov-11	OW	164.90	230.00
15-Mar-12	OW	208.80	240.00
08-May-12	OW	231.20	275.00
17-May-12	OW	219.60	276.00
10-Nov-12	OW	267.00	306.00
21-Mar-13	OW	262.80	300.00
30-Aug-13	OW	363.60	433.00
27-Oct-13	OW	426.20	506.00
07-Jan-14	OW	495.60	580.00

Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends.
Initiated coverage Feb 07, 2010.

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IB clients*	57%	49%	36%
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IB clients*	75%	66%	59%

*Percentage of investment banking clients in each rating category.
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