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July 16, 2009

China Economics

Policy-driven Decoupling: Upgrade 2009-10 Outlook

What's new: China's 2Q09 GDP growth was 7.9% YoY, which we estimate implies 19% annualized QoQ growth.

Conclusion: A policy-driven economic decoupling between China and the rest of world is materializing, in our view. We upgrade our GDP growth forecasts to 9% for 2009 and 10% for 2010. The aggressive policy responses so far this year will likely continue to fuel rapid investment growth in the remainder of 2009. Also, we expect property investment to accelerate in 2010, partly offsetting the slowdown in infrastructure investment expected to materialize because of the high base in 2009. Private consumption will likely improve steadily through 2010, as consumer confidence and employment improve. We expect export expansion to resume in 2010 following a sharp contraction in 2009, which, together with recovery in profits, should help underpin private investment. Despite strong headline GDP growth, inflation pressures are unlikely to emerge until mid-2010, in our view. In terms of trajectory, we expect the GDP growth to peak in 1Q10 before starting to moderate thereafter.

Implications: The next 6-12 months will likely feature a mix of growth acceleration and low inflation against the backdrop of a relatively stable policy stance, a macroeconomic environment that is conducive to asset price reflation, in our view. However, we think that, as inflation pressures start to emerge by mid-year, concern about potential policy tightening will likely start to weigh on market sentiment. On the other hand, the bottom-line corporate earnings will likely improve in 2010, as autonomous organic growth gains traction over time.

Risks: We construct two alternative scenarios for 2010: the bear and bull cases to highlight the balance of risks. External demand will be the biggest swing factor between scenarios, in our view.

China: Economic Forecast Summary (YoY, %, unless otherwise stated)

	2007	2008	2009E	2010E
Nominal GDP	21.4	16.9	10.1	14.9
Real GDP	13.0	9.0	9.0	10.0
Consumption	10.5	8.3	8.5	9.8
Gross Capital Formation	12.3	9.9	15.1	12.2
Net exports, ppt*	2.6	0.8	-1.4	-0.1
Exports (US\$ terms)	25.6	17.3	-16.0	9.0
Imports (US\$ terms)	20.7	18.4	-13.0	10.0
Trade Balance, US\$ bn	262	297	216	225
% of GDP	7.8	6.9	4.4	4.0
CPI	4.8	5.9	-0.6	2.5

* percentage point contribution to real GDP growth

E = Morgan Stanley Research estimates

Source: National Bureau of Statistics, CEIC, Morgan Stanley Research

For important disclosures, refer to the Disclosures Section, located at the end of this report.

Policy-driven Decoupling: Upgrade 2009-10 Outlook

Another Stronger-than-expected GDP Report for 2Q09

The Chinese economy staged a stronger-than-expected rebound in 2Q09, with real growth reaching 7.9% YoY, up from the trough of 6.1% in 1Q09. On a seasonally-adjusted basis, we estimate the economy grew a strong 4.5% QoQ (+19% annualized), accelerating from 1.5% in 1Q09 and the trough of 0.4% in 4Q08. We attribute the better-than-expected economic performance to the maintenance of the growth-boosting policy stance, which made possible a much-accelerated realization of the real stimulative effect from the multi-trillion-Renminbi fiscal package and expansionary monetary and credit policy, which we originally expected to materialize only in 2H09. In particular, policy-driven monetary and credit expansion, which has been consistently surprising on the upside, has enabled the significant pick-up in domestic investment. The Rmb1.53trn new loans made in June sent money and loan growth to new record highs of 28.5% YoY (M2) and 34.4% YoY, respectively. Credit creation in 1H09 totaled Rmb7.37trn, three times the amount in the year-ago period, and exceeding the 2008 total (Rmb4.91trn) by 50%, helping to finance the 35.7% YoY growth in fixed asset investment (nationwide) in 2Q09, up from 28.8% in 1Q (33.5% in 1H).

- Much stronger-than-expected policy responses have successfully prevented a potentially sharper slowdown triggered by external shock and helped an early recovery in investment;
- The strong recovery in the property sector bodes well for further recovery in real estate investment in the remainder of this year and next year;
- Domestic consumption remains resilient as confidence holds up well;
- Policy stance will remain broadly supportive through 2010.

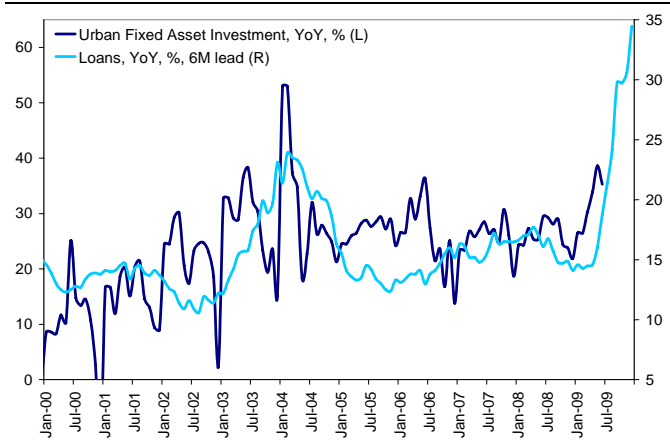
We raise our real GDP growth forecasts to 9% from 7% for 2009 and to 10% from 8% for 2010.

Domestic Strength Offsets External Weakness

Although the decline in exports continued into 2Q09 and turned out to be worse than our earlier expectation (see our report, *Trade Recovery Still Short of Expectations*, July 10, 2009), this had been adequately offset by the aggressive growth-supporting policies. Continued large-scale credit creation (see our report, *Acceleration of Monetary Expansion; Meaningful Tightening Unlikely*, July 15, 2009) continued to fuel domestic economic activity, starting from infrastructure investment.

Exhibit 1

Policy Driven – From Loan Growth to Strong Investment

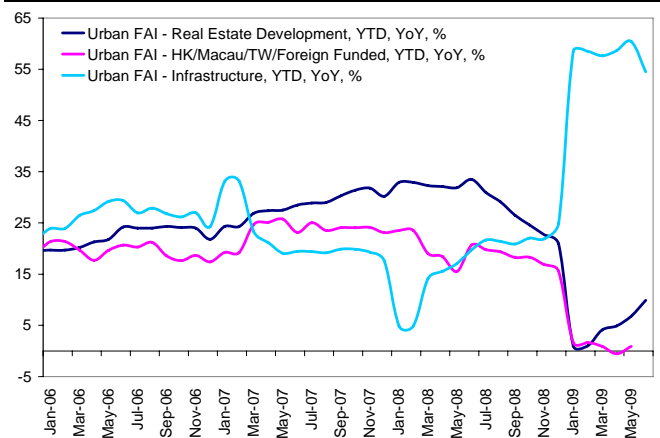


Source: National Bureau of Statistics, CEIC, Morgan Stanley Research

Taking stock of the achievements already realized in 1H09, and standing by our view that the Chinese economy will continue to stage a gradual and steady recovery in the remainder of the year, we are yet again raising our growth forecasts. Our latest upgrade is underpinned by the following four main arguments:

Exhibit 2

Urban FAI – Still Primarily Policy-led



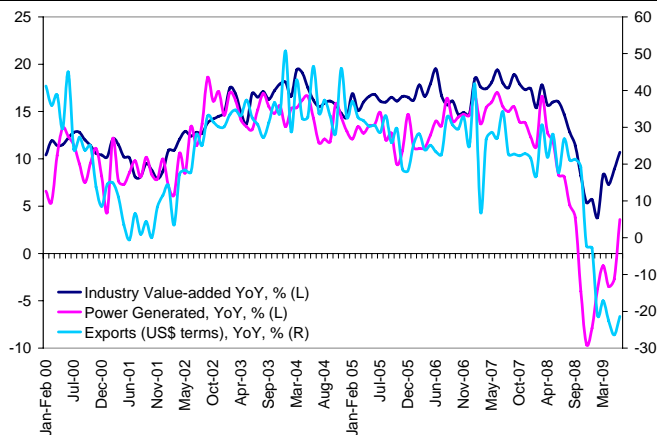
Source: National Bureau of Statistics, CEIC, Morgan Stanley Research

Urban fixed-asset investment growth remained strong in June, rising 35.3% YoY (+32.9% in Jan-May), bringing year-to-date (1H09) growth to 33.6%, although this was a tad slower than the 38.6% jump in May alone. In particular, the pick-up in real estate development investment (+18.1% YoY in June vs +12% in May, +9.9% in 1H09) remained encouraging

(although still weaker than the 20.9% expansion last year). Needless to say, policy-driven capex, as evidenced in infrastructure investment, remained the driver (Exhibit 2). Investment in the Western (+42.1% YoY in 1H vs +46.1% in 1Q) and Central (+38.1% vs +34.3%) regions continued to outpace that in the Eastern region (+26.7% vs +19.8%), also suggesting the policy-driven nature of the latest projects.

Domestic consumer demand growth, as evidenced by **retail sales**, also remained strong. June sales totaled Rmb994bn, up 15% YoY (vs our forecast of +15.2% and market forecasts of +15.3%). In real terms (deflated by retail price inflation, -2.3% YoY in June), sales growth powered ahead further, to 17.7% YoY in June, from 17.4% in May.

Exhibit 3
Industrial Production – Rebounding and Decoupling from Exports



Note: January and February data are combined every year to get rid of sharp fluctuations due to timing of the Lunar New Year.
Source: National Bureau of Statistics, CEIC, Morgan Stanley Research

The pick-up in domestic demand and restocking in the manufacturing sector have led **value-added industrial output** on a firmer recovery track. Output growth reached 10.7% YoY in June, beating our and market (both +9.5%) forecasts by a wide margin, up from 8.9% in May (+6.3% in Jan-May). Electricity generation also, finally, returned to positive growth in June, up 3.6% YoY, after remaining negative since October 2008 (except in February 2009 because of the Lunar New Year effect), suggesting a recovery in production in the power-intensive sectors, such as steel and other metals, which suffered relatively more severe contraction and destocking earlier on following speculative production and overstocking during the up-cycle. We attribute much of the strength in industrial production to domestic demand, and would like to highlight the apparent decoupling from the weakness in exports (Exhibit 3).

Consumer prices (CPI) remained in deflation in June, falling 1.7% YoY, slightly more negative than our and market forecasts (both at -1.3%), resulting in average consumer deflation of 1.1% YoY in 1H09. We believe the downside surprise mainly stems from the fall in food prices (-0.3% in 1H, which implies more than a 1% YoY drop in June). Indeed, we observe that CPI is still being dragged down on a sequential basis by food prices (-1.4% MoM in June by our estimate), although the non-food component is likely rebounding on the retail fuel price hikes.

In the upstream, **producer prices (PPI)** fell 7.8% YoY in June (-7.2% in May), while **raw materials purchasing prices (RMPPI)** fell 11.2% (-10.4% in May). The declines for both indices exceeded our (PPI -7.5%, RMPPI -11%) and market (PPI -7.4%) expectations. Nevertheless, we are confident that prices, both upstream and downstream, are riding out the bottom, in line with the pick-up in sentiment and activity. Sequential price drops are certainly alleviating, although YoY declines could persist – because of base effects – until late this year.

[Please refer to Exhibit 14 for detailed annual and quarterly economic data since 2007.]

A Policy-driven Decoupling

When a crisis of such a global scale hit, the initial negative effect of the shock was felt indiscriminately strongly by every economy that is deeply integrated into the global economy. The strength and speed of policy responses in the immediate aftermath of the crisis were, however, quite uneven among the countries, resulting in different patterns of post-crisis recovery.

The aggressive policy response ... distinguishes China from those countries that either suffer from a paralyzed financial system or are unable to launch strong pro-growth fiscal or monetary policy responses because of weak fiscal and/or external balance of payments positions.

China is a case in point. The aggressive policy response by Chinese authorities helped translate China's 'strong balance sheet' into a 'decent-looking income statement', which distinguishes China from those countries that either suffer from a paralyzed financial system or are unable to launch strong pro-growth fiscal or monetary policy responses because of

weak fiscal and/or external balance of payments positions. This makes China the first major economy to recover from the crisis with strong momentum, effecting a policy-induced economic decoupling between China and the rest of the world.

In our previous research, we highlighted a potential 'goldilocks recovery scenario', wherein the government's growth-supporting policies enable asset reflation, which underpins consumer and investor confidence and prevents the harsh adjustment in domestic consumption and private investment in 1H09 (see *China Economics: Mapping the Recovery in 2009-2010*, February 23, 2009). The shallower trough in the economic cycle is then followed by recovery in activity initially spearheaded by fiscal stimulus (3Q09), and then by a tepid recovery in external demand (4Q09 and 2010). Although the timing of these series of events is not exactly as we had envisaged, this ideal scenario appears to be playing out.

Specifically, sustained and stronger-than-expected credit growth in recent months has continued to buoy sentiment and helped to deliver: (a) an accelerated rollout of public infrastructure projects (Exhibit 2); (b) more resilience in private consumption and private manufacturing sector capex despite weak exports; and (c) an increasingly convincing recovery in property investment. These positive developments, together with the steady asset price reflation, are serving to compensate for the prolonged weakness in external demand.

Growth Outlook Upgrade for 2009-2010

We upgrade our forecasts for GDP growth rate to 9% for 2009 and 10% for 2010 (Exhibit 4). The latest 2Q09 data confirmed that 1Q09 was the trough of the V-shaped trajectory we had envisioned, but the recovery track is proving to be even steeper than we had earlier expected.

The aggressive policy responses – as reflected in the rapid expansion of bank lending – so far this year will likely continue to fuel rapid investment growth in the remainder of 2009 (Exhibit 1). Moreover, we expect property investment to accelerate significantly in 2010, partly offsetting the slowdown in infrastructure investment expected to materialize because of the high base in 2009. Private consumption will likely continue to improve steadily through 2010, as consumer confidence and employment improve. We expect export expansion to resume in 2010 following a sharp contraction in 2009, which, together with recovery in profits, should help underpin non-property related private investment. Despite strong headline GDP growth, inflation pressures are unlikely to emerge until mid-2010, in our view. In terms of trajectory, we expect the GDP growth to peak in 1Q10 before starting to moderate thereafter.

Exhibit 4

GDP Growth Forecasts for 2009-10

	2007	2008	2009E	2010E		
				Base	Bull	Bear
Subjective Probability				70%	20%	10%
<u>Real Growth, YoY, %</u>						
GDP	13.0	9.0	9.0	10.0	12.0	8.0
Consumption	10.5	8.3	8.5	9.8	10.5	9.2
GFCF	12.3	9.3	15.1	12.2	12.8	11.9
Mining	13.4	13.0	10.0	12.0	12.0	12.0
Manufacturing	18.0	12.3	9.0	12.0	14.0	11.0
Real estate	15.0	11.0	10.0	15.0	15.0	15.0
Infrastructure	7.0	9.2	50.0	20.0	20.0	20.0
Other	6.5	4.0	2.0	5.0	5.0	5.0
<u>Contribution to Growth, percentage points</u>						
Consumption	5.3	4.1	4.2	4.8	5.1	4.5
GFCF	5.1	4.1	6.3	5.3	5.6	5.2
Mining	0.3	0.3	0.2	0.3	0.3	0.3
Manufacturing	2.3	1.6	1.1	1.5	1.8	1.4
Real estate	1.1	0.8	0.8	1.1	1.1	1.1
Infrastructure	0.6	0.7	4.0	1.6	1.6	1.6
Other	0.7	0.5	0.2	0.6	0.6	0.6
Net exports	2.6	0.8	-1.4	-0.1	1.3	-1.7
<u>CPI Inflation, %</u>	4.8	5.9	-0.6	2.5	3.5	1.5

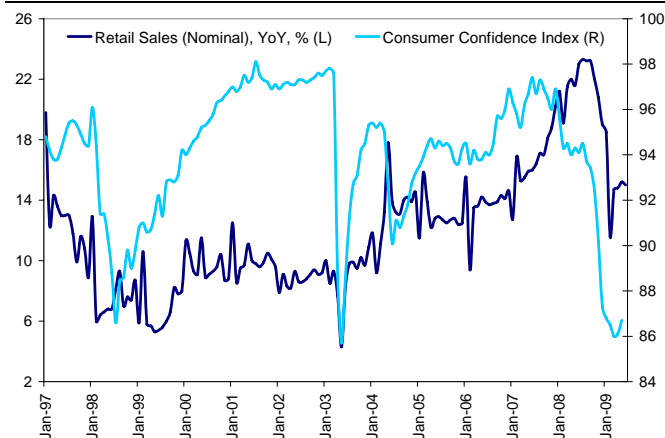
E = Morgan Stanley Research estimates. Source: CEIC, NBS, Morgan Stanley Research

...broadly stable employment since 1Q09, together with Chinese authorities' pledge to further strengthen the social security system and other social service reform...will underpin consumer confidence, preventing a sharp rise in precautionary savings...

Specifically, in our updated forecasts, we have revised consumption growth (in real terms) to 8.5% and 9.8% for this year and next, respectively, stronger than that in 2008 (+8.3%), though weaker in nominal terms because of lower inflation. Consumption has certainly demonstrated its resilience in 1Q09 with bottoming-out of retail sales and consumer confidence (Exhibit 5). Consumption-boosting measures introduced by the government appear to have worked well to make up for the shortfall in the near term. Moreover, broadly stable employment since 1Q09, together with Chinese authorities' pledge to further strengthen the social security system and other social service reform in the coming years, will underpin consumer confidence, preventing a sharp rise in precautionary savings despite a substantial economic downturn. Of particular note, housing-related consumption (e.g., furniture, decoration materials) will likely grow remarkably amid a strong recovery in the property sector.

Exhibit 5

Retail Sales and Consumer Confidence – The Worst is Over

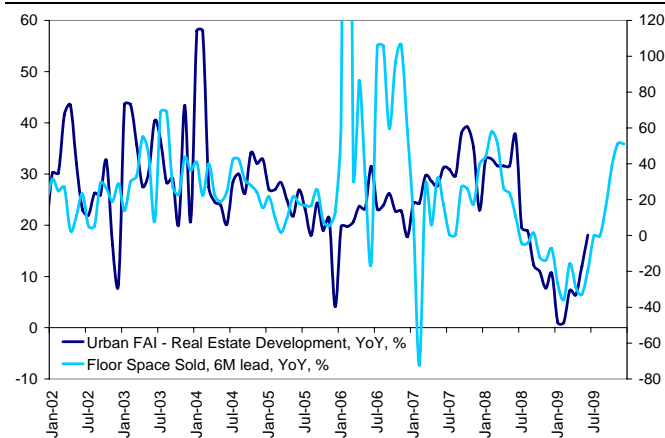


Source: National Bureau of Statistics, CEIC, Morgan Stanley Research

On the investment front, our last upgrade was primarily driven by an upward revision in real estate investment. This time round, it is the resilience in manufacturing sector investment despite weak exports, as well as real estate investment, that has prompted our revisions. We now expect 9% growth in manufacturing investment in 2009, versus 0% previously, and a further acceleration to 12% growth in 2010, as we expect profit growth to recover backed by improving exports (as discussed below).

Exhibit 6

Real Estate Investment – More Upside Ahead



Source: National Bureau of Statistics, CEIC, Morgan Stanley Research

In line with our expectation, real estate investment has shown increasingly convincing signs of recovery as reflected in the remarkable rebound in property sales in recent months (Exhibit 6) (see *China Economics: Property Sector Recovery is For Real*, May 15, 2009). We believe this trend is sustainable,

pointing to considerable upside to real estate investment in the remainder of the year and next year. We therefore are again lifting our forecast for real estate investment to 10% in 2009 and 15% in 2010. On the other hand, we expect infrastructure investment to see explosive 50% growth this year but pass on its role as the key growth driver in 2010. We now expect overall fixed investment to grow 15.1% in 2009 and 12.2% 2010 in real terms. While policy-driven capex will likely prove to be the key growth driver this year (Exhibit 2), we expect steady revival in private investment to reduce the reliance on public investment for growth in 2010.

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Export Recovery Expected by 4Q09

Much attention has focused on the unprecedentedly sharp contraction in China's exports in the past several months. We had admitted, on several occasions, that the declines have far exceeded and sustained for longer than our expectations. Meanwhile, overall GDP growth and other economic indicators (output value for export delivery and trade data reported by Hong Kong) had shown far milder downturns than consistent with this export plunge, raising our skepticism yet again towards the reliability of the data.

We suspect that strong exports data in 2007 and 2008 (up to 3Q08) could have encompassed some hidden hot money inflows.

We suspect that strong exports data in 2007 and 2008 (up to 3Q08) could have encompassed some hidden hot money inflows. Driven by expectations of rapid Renminbi appreciation, exporters (domestic as well as foreign-invested producers) may have overstated their shipments to obtain more Renminbi. With the stalling of the Renminbi appreciation since 2H08 and intensified de-risking amid crisis, the cutback or discontinuation of this over-invoicing practice could have contributed to the exaggerated sharp declines in the export data. The YoY export numbers may be somewhat misleading – as they are being distorted downwards by the reduction in hot money inflows –

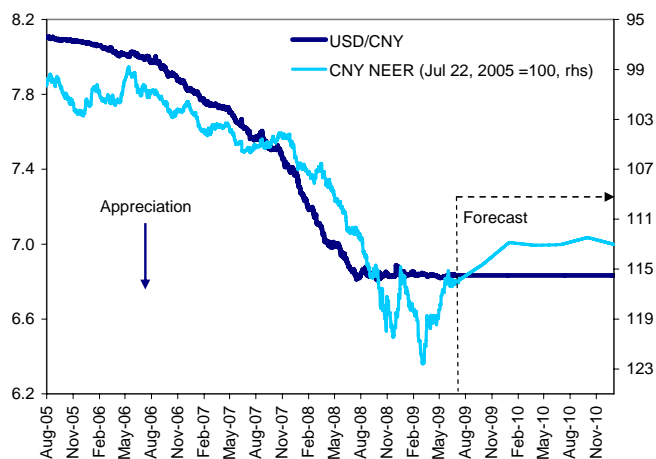
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and help solve the anomaly of the milder-than-expected effect of the export decline on the real economy in 1H09. It follows that we should not expect exports to return to pre-crisis levels any time soon, given the structural reduction in hot money inflows, and that weak YoY export numbers would sustain for up to one year. Nevertheless, it also means that as this one-off normalization wears out, exports can promptly resume positive growth.

Moreover, we believe that the current exchange rate policy, i.e. a quasi-hard-peg to the US\$ (see our report, *An Exit Strategy for the Renminbi?* June 9, 2009), combined with recent and expected US\$ weakness, helps Chinese exports reclaim external competitiveness (Exhibit 7), and strengthens our optimism towards export recovery. In fact, while the YoY export decline averaged 21.8% in 1H09, shipments have been showing sequential improvement in the past few months. We continue to forecast narrowing trade declines in 2H09, and expect export growth to return to close to zero by year-end, and average -16% in 2009, followed by a 9% rebound in 2010. We expect imports to contract by 13% in this year (-25.4% in 1H09) and increase by 10% in 2010. We expect the trade surplus to contract this year, for the first time since 2003, to just under US\$220bn, down from US\$297bn in 2008.

Exhibit 7

China Regaining Export Competitiveness



Note, forecasts are from Morgan Stanley Research. NEER = Nominal Effective Exchange Rate
Source: Bloomberg, Morgan Stanley Research

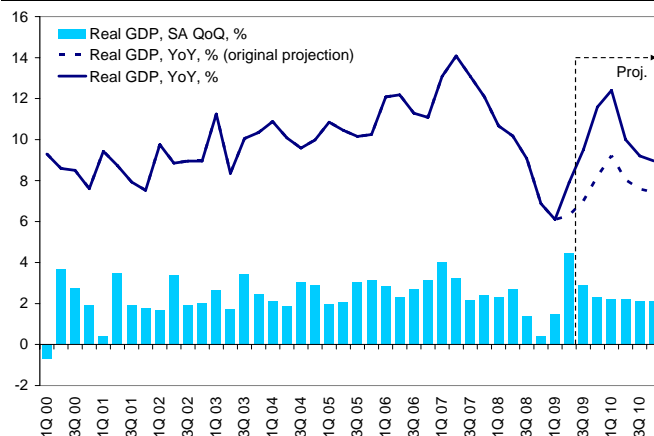
Quarterly Growth Profile

We have also updated the quarterly growth trajectory. The 2Q09 rebound (+4.5% QoQ) represents a strong bounce from the cyclical trough, so we do not expect this sequential growth rate to continue in the upcoming quarters, but return to a more sustainable 2.0-2.5% in the quarters ahead (Exhibit 8). Nevertheless, the YoY growth rate is set to accelerate further in

the next few quarters, surging to double-digit rates by 4Q09 and peak in 1Q10, before tapering off – on the base effect – toward a more sustainable high-single-digit level. The deceleration in growth rate over the course of 2010 would reflect acceleration in private consumption and investment (e.g., property investment) and recovery in exports being partly offset by a smaller dose of policy stimulus.

Exhibit 8

A More Buoyant Trajectory



Note, forecasts are from Morgan Stanley Research.
Source: National Bureau of Statistics, CEIC, Morgan Stanley Research

The Risks: Bull and Bear Cases

The key risk to this outlook lies in external demand. While strong policy responses could help achieve a meaningful decoupling between China and the rest of the world for several years, there is no absolute decoupling as long as China remains deeply integrated into global economy, in our view.

...there is no absolute decoupling as long as China remains deeply integrated into global economy...

There is considerable uncertainty about the outlook for 2010 for the global economy. As it stands now, our global economics team expects that both the US and Eurozone will start to show positive sequential growth by 4Q09 before embarking on a sustained albeit tepid recovery through 2010 (see *Global Forecast Snapshots: The Global Economy in One Place*, June 18, 2009). However, at the current juncture, it is still uncertain whether the G3 economies can successfully maintain such a strong recovery through 2010. Our US economists Richard Berner and David Greenlaw expect US GDP growth to be around 2.2% in 2010, but think it could swing between 1.2% under a bear case and 3.8% under a bull case. Similarly, our

European economist Elga Balsche expect Eurozone GDP growth to be around 0.5% in 2010, but thinks it could swing between -0.9% under a bear case and 2.2% under a bull case.

In this context, we also revise our two alternative scenarios – bear and bull cases – to highlight both downside and upside risks to the 2010 outlook under our new baseline scenario. We think the key risk to our new forecasts stems from the external demand outlook and its attendant effect on private investment in the manufacturing sector. The GDP growth rates under the bull and bear scenarios are 12% and 8%, respectively (Exhibit 4). We assign 70%, 20%, and 10% subjective probabilities to the base, bear, and bull cases, respectively.

Under the bull scenario, a faster and stronger recovery in the US and Eurozone economies implies that China's export growth turns positive sooner than expected and private investment in the manufacturing sector registers higher growth. Under the bear scenario, the economy will likely register a sharp double-dip after 1Q10. Persistently weak exports will offset the effect of policy stimulus and hurt sentiment again such that neither private investment in the manufacturing sector nor private consumption will pick up significantly.

Inflation Not a Concern in the Next 12 Months

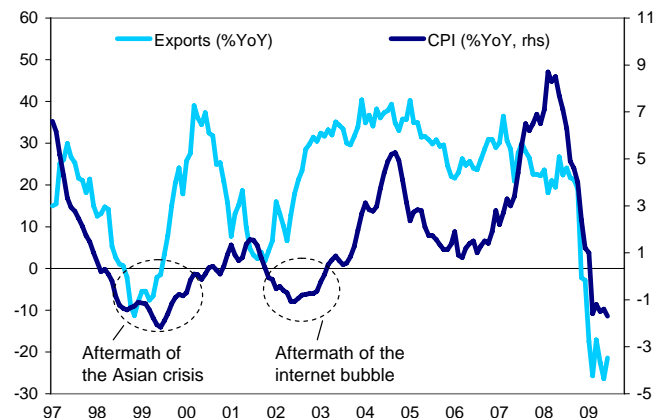
The rapid expansion of bank lending and money supply (M2) growth have caused considerable concern about the risk of inflation. However, we argue that these concerns are unwarranted at least in the next 12 months. When the economic system is subject to as large a negative external shock as the one China is experiencing now, the dominant contributing factor to headline CPI inflation is export growth instead of money growth, in our view. Here is why:

First, China's past experiences suggest that a sharp decline in export growth should have a strong disinflationary/deflationary effect on the economy. Export growth in this context can be treated as a proxy of the output gap in China: the lower the export growth rate, the larger the potential negative output gap and thus disinflationary/deflationary pressures. Note, however, that it is very difficult to estimate the output gap for China, an economy of which the structure evolves rapidly. China has suffered three episodes of deflation in the past 12 years: the first during the Asian financial crisis, the second in the aftermath of the NASDAQ stock bubble burst; and the third being the current one. All three episodes of deflation either coincided with, or occurred in the immediate aftermath of, a collapse in export growth. Although we do expect the decline in export growth to narrow substantially in the remainder of the year and exports to resume positive growth in 2010, we do not expect the recovery in export growth to be sufficiently vigorous

as to generate meaningful inflationary pressures (e.g., 3.0+% inflation) in the next 12 months (Exhibit 9).

Exhibit 9

Deflation Amid Negative External Shocks



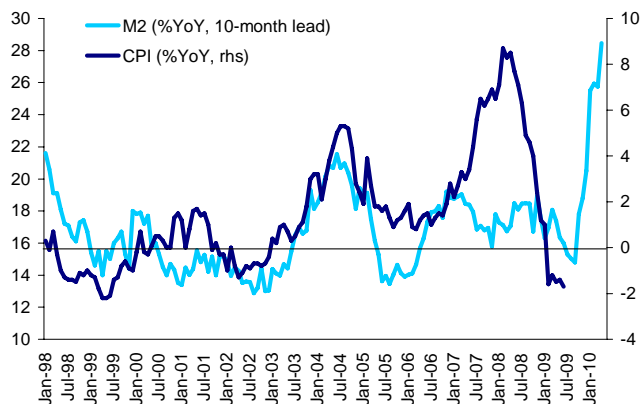
Source: National Bureau of Statistics, CEIC, Morgan Stanley Research

Export growth in this context can be treated as a proxy of the output gap in China: the lower the export growth rate, the larger the potential negative output gap and thus disinflationary/deflationary pressures

Second, the relationship between money and inflation tends to become quite unstable amid a serious economic downturn, because the velocity of money declines markedly. This makes gauging inflation risk simply based on money supply growth particularly tricky, especially when there is no robust and stable causal relationship between the two in the first place (Ex.10).

Exhibit 10

Unstable Relationship between Money and Inflation

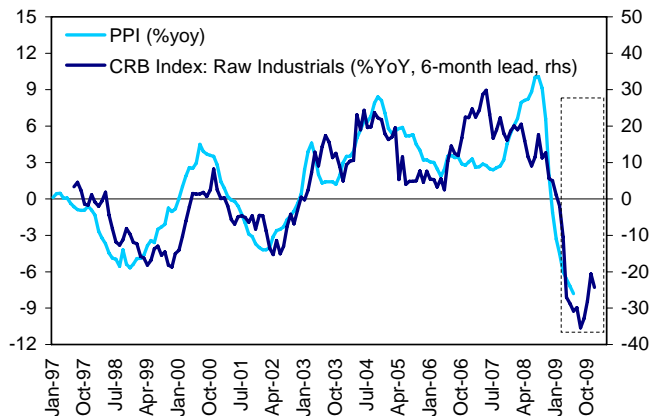


Source: Company data, Morgan Stanley Research

Third, from the supply side, the bursting of the international commodity price bubble caused prices of raw materials (e.g., crude oil, iron ore, metals) imported by China to decline sharply, representing a powerful positive terms of trade shock, as in part reflected in the sharp decline in PPI inflation (Ex.10 & 11).

Exhibit 11

Low Commodity Prices Point to Low PPI Inflation



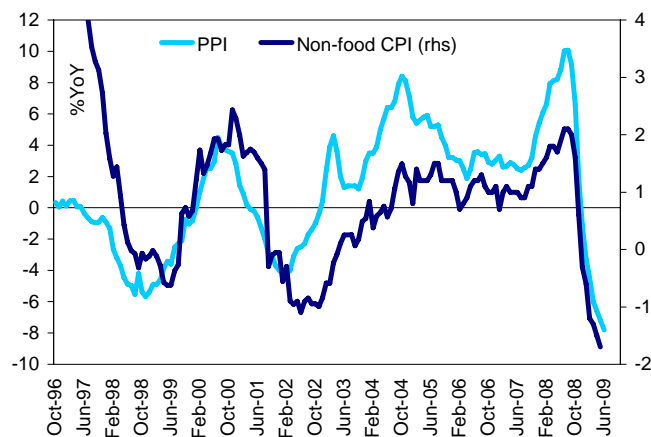
Source: CEIC, Morgan Stanley Research

Looking ahead, our global commodity research team believes that 'ultimately, commodities should perform strongly through this cycle,' although in the near term, 'fundamentals remain mixed with agriculture balances arguably most constructive, with energy and metals less so...' (see *The Commodity Call: Commodities Rally on Greenback & Green Shoots*, June 4, 2009). This suggests the upside to commodity prices will unlikely be large in the next few months, suggesting PPI inflation will unlikely rebound strongly any time soon from its recent low of -7.2%YoY in June (Exhibit 11). Furthermore, the

low PPI inflation will likely put downward pressures on ex-food CPI inflation (Exhibit 12).

Exhibit 12

Low PPI Inflation Points to Low Ex-food CPI Inflation



Source: CEIC, Morgan Stanley Research

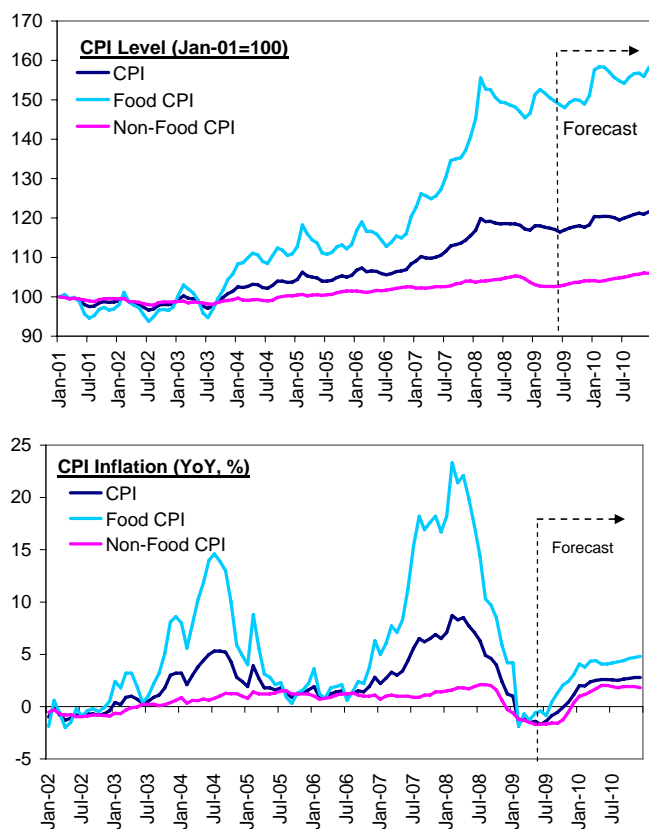
In this context, the inflation outlook through 2010 will likely again be largely shaped by changes in food prices, in our view. The relevant inflationary pressures could stem from two sources: a) the government's decision to hike the minimum purchase prices of grains by 15%, which will bring about grain price increases in 2010; and b) the classical 'hog cycle' that will likely lead to an increase in pork and other meat prices in 2010. In particular, regarding the latter, pork prices have been sliding sharply from the peak since 1Q08 and have fallen below the break-even level (i.e., 6-to-1 pork-to-grain price ratio) recently. Discouraged by the poor profit prospect, hog farmers have reportedly started to cut back breeding scale by slaughtering sows. According to our agricultural research team, the destocking of live hogs should extend to 4Q09 to complete supply adjustment, which could cause substantial pork price increases (e.g., mid teens) over the course of 2010.

...the inflation outlook through 2010 will likely again be largely shaped by changes in food prices...

We forecast CPI inflation at -0.6% in 2009 and 2.5% in 2010 (Exhibit 13). We expect the headline CPI inflation to remain negative through October 2009 and creep into positive territory from November 2009. Food price inflation will likely turn positive three months earlier than the headline inflation does, while we expect ex-food CPI inflation to remain in negative territory through 2009. Entering into 2010, while CPI inflation

will likely stay on a steady uptrend with food prices starting to edge up in part due to the base effect, we expect the overall headline CPI inflation to remain relatively low through 1H10 (i.e., below 2.5% YoY). We expect CPI inflation to climb slightly faster in 2H, as the recovery in export growth gains momentum, reaching 3% YoY in 4Q10. We forecast average food price and ex-food price inflation at 4.2% and 1.6%, respectively.

Exhibit 13
CPI Inflation Forecasts



Note, forecasts are from Morgan Stanley Research. Source: CEIC, Morgan Stanley Research

End of Profitless Growth

Latest data (through May) indicates that the decline in industrial profit growth narrowed substantially from about -30% YoY in Jan-Feb to -16% YoY in March-May. The improvement is particularly strong for downstream manufacturing sectors (from -40% YoY to -3.5% YoY) (see *China Economics: Green Shoots in Profits*, June 29, 2009).

The strong recovery and acceleration in the headline GDP growth in the remainder of the year and through 2010 will likely bring an end to the profitless growth in 2010. In particular, the favorable mix of potential growth drivers in 2010 bodes well for an eventual recovery in profit growth, in our view. Industrial

profits are a function of genuine strength of the economy instead of policy stimulus, as the latter may help produce decent top-line figures but not necessarily be able to deliver bottom-line earnings performance, in our view. In 2H09 and over the course of 2010, we expect the headline GDP growth to be increasingly driven by such autonomous demand as private consumption, property investment, and exports instead of public spending carried out under the stimulus plan.

... the favorable mix of potential growth drivers in 2010 bodes well for an eventual recovery in profit growth.

In addition to better overall economic conditions, the low cost pressures stemming from the still relatively low raw material prices will likely contribute to improved profits.

First, despite the sharp improvement in their terms of trade in late 2008 and 1H09, producers were unable to realize the potential gains back then, because activity such as production and sales dropped to very low levels at the height of the crisis.

Second, as activity starts to pick up, the low cost benefits should show accordingly, especially for the producers who have seized the opportunity of very low international commodity prices to build up their inventory of raw materials.

Third, the recent developments in international commodities price markets have largely reflected normalization of the relative prices between commodities and manufactured goods – the structure of which had been compressed to unsustainable levels at the height of the crisis – instead of inflationary pressures due to broad-based recovery in global demand, in our view. Commodity price increases due to relative price normalization are consistent with the competitiveness of China's manufacturing sector and will thus unlikely have much negative implication for corporate profitability, in our view.

Fourth, the Morgan Stanley Commodity Research team does not believe the rise in demand due to an early economic recovery in China alone will be able to substantially drive up international commodity prices. This makes China a potential beneficiary from relatively low commodities prices for a considerable period of time until the economies of its competitors for the same fixed amount of supply of commodities recover.

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Policy Calls

As economic recovery gains traction, concerns about potential policy change that could derail the recovery are also on the rise. We, however, do not expect any meaningful policy change through 2009. Since the strong recovery has been largely policy-stimulus driven, it makes little sense to us for the authorities to make a major policy shift toward outright tightening in the absence of robust autonomous organic growth, especially when inflation does not pose a risk. Any meaningful policy tightening will be endogenous, i.e., contingent on sufficient evidence of sustainable, autonomous demand, in our view.

... it makes little sense to us for the authorities to make a major policy shift toward outright tightening in the absence of robust autonomous organic growth...

We therefore expect the *status quo* of the current accommodative policy stance to be maintained for the remainder of the year. We continue to expect further normalization in loan creation each month, which, however, should not be interpreted as policy tightening. In this context, total new loans could reach over Rmb9trn this year. We also expect the base lending and deposit rates to remain unchanged through 2009. Meanwhile, we do not expect additional fiscal policy stimulus of any meaningful size in the remainder of the year. We believe the current exchange rate arrangement – featuring a quasi-hard-peg of the Renminbi to the US dollar – will remain unchanged through 2009 and most probably through the next 12 months and even beyond.

If the outlook that we envisage for 2009 materializes, normalization of policy stance becomes a distinct possibility for 2010, in our view. The Central Economic Work Conference that traditionally takes place in late November and early December each year and sets the broad policy parameters for the coming year should be an occasion for such a policy shift. While some normalization of the policy stance in 2010 is entirely possible, we caution against interpreting these potential changes as outright tightening. By the end of 2009, export growth – despite perhaps having rebounded substantially from the lows – will likely remain slightly negative and the headline inflation will likely barely creep into positive territory. In this context, the Chinese authorities are unlikely to consider the Chinese economy to be completely out of the woods, and a major policy shift cannot be justified, despite potential double-digit GDP growth by 4Q09, in our view.

However, a more meaningful policy shift by mid-2010 is quite possible. By mid-2010, we expect the YoY export growth to have reached close to the high-single-digit level and the headline CPI inflation to have reached 2.5%YoY. The developments of these two key variables on the back of a peak GDP growth rate potentially at about 12% YoY in 1Q10 (as per our forecast), will make the authorities feel sufficiently comfortable with turning on the tightening bias in the policy stance for the remainder of the year, in our view.

Specifically, we expect the following: a) new bank lending to moderate considerably from the extraordinarily high levels so far this year such that the overall size of the loan book may increase 15-17% in 2010, down from nearly 30% in 2009; b) more proactive open market operations by the People's Bank of China in 1H10 likely to be aided by RRR hikes in 2H10 to help achieve the loan growth target; c) hikes of the base interest rates by 25-50bps in 2H10, signaling the beginning of a rate hike cycle that is broadly in sync with that of the US. Incidentally, our US economists, Richard Berner and David Greenlaw, expect that 'a hike in the (US Fed) target rate will not occur until mid-2010'. (See *US Economics: US Economic and Interest Rate Forecast: Does the Economy Need More Stimulus?* July 7, 2009); and d) the implementation of the second half of the Rmb4trn spending package will be unaffected.

We do not expect any major policy change vis-à-vis the property sector either. The strong recovery in this sector in general and recent property prices increase in particular have made many worry whether Chinese authorities will intervene in the property market heavy-handedly again, as they did in late 2007 and 1H08. Indeed, the memory is still fresh and many market participants have been traumatized. We, however, dismiss this concern. The property sector is the most important source of organic growth in China, and lessons from the past few years have made it clear that a stable policy environment is critical to healthy, sustainable development of the property sector in China. Looking ahead, we expect the authorities' current policy stance vis-à-vis the property sector to remain unchanged. In fact, we should view the policy change since October 2008 as policy normalization, rather than discretionary, counter-cyclical policy easing, which tends to be temporary.

We do not expect any major policy change vis-à-vis the property sector either.

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The authorities' current policy approach features two tracks: 1) encouraging market-based commercial housing by removing unduly austere policy measures that artificially depress its development; and 2) addressing the housing issue for low-income households by developing the low-cost, low-rent, affordable housing program financed by public funds. This is an effective and sustainable policy approach, as a viable affordable housing program is predicated on a buoyant commercial housing program, in our view. In view of the property sector's importance in supporting an economic recovery and sustainable growth, any concern that the policy shift might potentially hurt this sector is unwarranted, in our view.

That said, we think it justified if the government chooses to strictly enforce existing rules to prevent abuse by speculators. These moves will not change the broad trend of the property

sector – the fundamentals of which, as we have consistently argued, remain sound – and will instead contribute to a sustainable, healthy development in the long run, in our view (see *China Economics: Property Sector Recovery is For Real*, May 15, 2009; *China Economics: Can the Property Sector Be Counted on as the Engine of Growth?* September 2, 2008).

Investment Implications

The next 6-12 months will likely feature a mix of growth acceleration and low inflation against the backdrop of relatively stable policy stance, a macroeconomic environment that is conducive to asset price reflation, in our view. However, we think that as inflation pressures start to emerge by mid-year, concern about potential policy tightening will likely weigh on market sentiment. On the other hand, bottom-line corporate earnings will likely improve in 2010, as autonomous organic growth gains traction over time.

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Exhibit 14

China Economic Scorecard

	2007	2008	4Q07	1Q 08	2Q 08	3Q 08	4Q08	1Q 09	2Q09
<u>NATIONAL ACCOUNTS</u>									
Nominal GDP (production-based), Rmb bn	25,731	30,067	8,288	6,348	7,125	7,330	9,265	6,575	7412
YoY, %	+21.4	+16.9	+23.0	+19.6	+20.0	+18.3	+11.8	+3.6	+4.0
US\$ bn	3,382	4,326	1,115	886	1,024	1,071	1,354	962	1,085
Private Consumption, YoY, %	+16.3	+15.8							
Government Consumption, YoY, %	+16.8	+15.7							
Fixed Capital Formation, YoY, %	+17.0	+19.7							
Net Exports, % of GDP	8.9	7.9							
Real GDP growth, YoY, %	+13.0	+9.0	+12.0	+10.6	10.1	+9.0	+6.8	+6.1	+7.9
Primary industry	+3.7	+5.5	+1.9*	+2.8	+4.2*	+6.5*	+8.5*	+3.5	+4.1*
Secondary industry	+14.7	+9.3	+14.4*	+11.5	+11.1*	+9.2*	+5.4*	+5.3	7.9*
Tertiary industry	+13.8	+9.5	+13.2*	+10.9	+10.5*	+10.1*	+6.5*	+7.4	+9.2*
Fixed asset investment, Rmb bn	13,724	17,229	4,571*	2,185	4,656*	4,784*	5,605*	2,813	6,319
YoY, %	+24.8	+25.5	+24.8*	+24.6	+27.1*	+28.1*	+22.6*	+28.8	+35.7
Urban Fixed asset investment, Rmb bn	11,741	14,817	3,917*	1,832	4,012*	4,144*	4,830*	2,356	5,454
YoY, %	+25.8	+26.1	+25.2*	+25.9	+26.8*	+28.8*	+23.5*	+28.6	+35.9
<u>INTERNATIONAL TRANSACTIONS</u>									
Exports, US\$ bn	1,218	1,429	340	306	361	408	355	246	276
YoY, %	+25.6	+17.2	+22.1	+21.3	+22.4	+23.1	+4.4	-19.7	-23.5
Imports, US\$ bn	959	1,133	264	265	303	325	240	183	241
YoY, %	+20.7	+18.5	+25.3	+28.6	+32.4	+25.9	-8.9	-30.8	-20.2
Trade surplus, US\$ bn	262	296	76	41	58	83	114	63	34.8
as % of GDP	7.8	6.9	7.0	4.8	5.9	8.0	7.9	6.5	3.2
Current account, US\$ bn	372	426	209 (2H07)	192 (1H08)		234 (2H08)			
As % of GDP	11.0	9.9	11.1 (2H07)	10.4 (1H08)		9.7 (2H08)			
Utilized FDI, US\$ bn	84	108	30	27	25	22	34	22	21
YoY, %	+15.0	+29.7	+1.0	+61.2	+31.5	+27.9	+11.8	-20.6	-15.0
Foreign exchange reserves, US\$ bn	1,528	1,946	1,528	1,682	1,809	1,906	1,946	1,954	2,132
<u>MONETARY</u>									
Money supply M0, Rmb bn	3,033	3,417	3,033	3,043	3,018	3,170	3,417	3,375	3,364
YoY, %	+12.0	+12.7	+12.0	+11.1	+12.3	+9.3	+12.7	+10.9	+11.5
Money supply M1, Rmb bn	15,252	16,622	15,252	15,087	15,482	15,570	16,622	17,654	19,317
YoY, %	+21.0	+9.1	+21.0	+18.3	+14.2	+9.4	+9.1	+17.0	+24.8
Money supply M2, Rmb bn	40,340	47,517	40,340	42,306	44,314	45,290	47,517	53,063	56,895
YoY, %	+16.7	+17.8	+16.7	+16.3	+17.4	+15.3	+17.8	+25.5	+28.5
Loan at all Financial Institutions, Rmb bn	26,169	30,347	26,169	27,500	28,620	29,650	30,347	34,956	37,745
YoY, %	+16.1	+18.8	+16.1	+14.8	+14.1	+14.5	+18.8	+29.8	+34.4
YoY/QoQ/MoM, Rmb bn	+3,634	+4,911	+272	+1,330	+1,120	+375	+1,431	+4,583	+2,789
Savings deposits, Rmb bn	17,253	21,789	17,253	18,755	19,440	20,469	21,789	24,307	24,938
YoY, %	+6.8	+26.3	+6.8	+8.8	+14.7	+21.1	+26.3	+29.6	+28.3
Total deposits, Rmb bn	38,937	46,620	38,937	41,569	43,899	45,494	46,620	52,262	56,629
YoY, %	+16.1	+19.7	+16.1	+17.3	+18.8	+18.8	+19.7	+25.7	+29.0
<u>FISCAL</u>									
Fiscal balance, Rmb bn	174	-111	-816	647	546	59	-1,363	183	
% of GDP	0.7	-0.4	-10.1	10.5	7.9	0.8	-14.7	2.8	
Revenue, YoY, %	+32.4	+19.5	+35.6	+35.5	+31.4	+10.5	-0.1	-8.3	
Expenditure, YoY, %	+22.6	+25.9	+19.0	+30.4	+25.8	+22.1	+26.5	+34.8	
<u>PRODUCTION / SALES</u>									
Value added industrial output, YoY, %	+18.5	+12.9	+17.5	+16.4	+15.9	+15.2	+6.4	+5.1	+9.0
Electricity Output, YoY, %	+14.9	+5.5	+13.3	+13.1	+11.0	+5.5	-7.2	-2.0	-0.9
Retail sales, Rmb bn	8,921	10,849	2,538	2,556	2,549	2,684	3,060	2,940	2,931
YoY, %	+16.8	+21.6	+19.0	+20.6	+22.2	+23.2	+20.6	+15.0	+15.0
<u>PRICES</u>									
Consumer price index, YoY, %	+4.8	+5.9	+6.6	+8.0	+7.8	+5.3	+2.5	-0.6	-1.5
Retail price index, YoY, %	+3.8	+5.9	+5.6	+7.4	+7.6	+5.9	+2.9	-0.8	-2.0
Producer price index, YoY, %	+3.1	+6.9	+4.4	+6.9	+8.3	+9.7	+2.5	-4.6	-7.2
Raw materials purchasing price index, YoY, %	+4.4	+10.5	+6.3	+9.8	+11.1	+14.9	+4.8	-7.1	-10.4
Corporate goods price index, YoY, %	+5.7	+5.7	+7.2	+9.3	+9.8	+8.2	+0.2	-5.6	

Subject to revision.

* Estimated from announced year-to-date figures.

^ Morgan Stanley Research estimates

Source: National Bureau of Statistics, People's Bank of China, Ministry of Commerce, CEIC, Morgan Stanley Research

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