



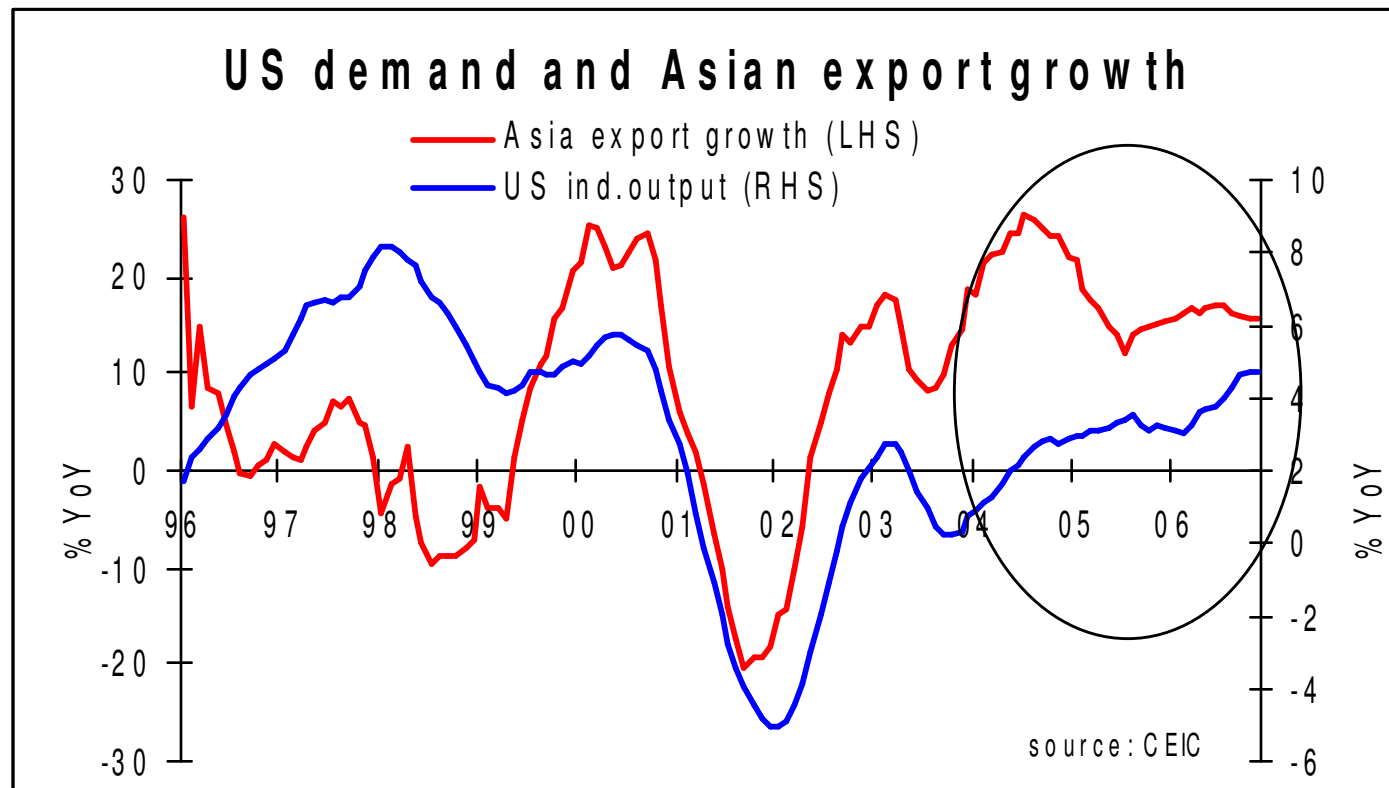
China/Asia Outlook: Improving Profits or Rising Risks?

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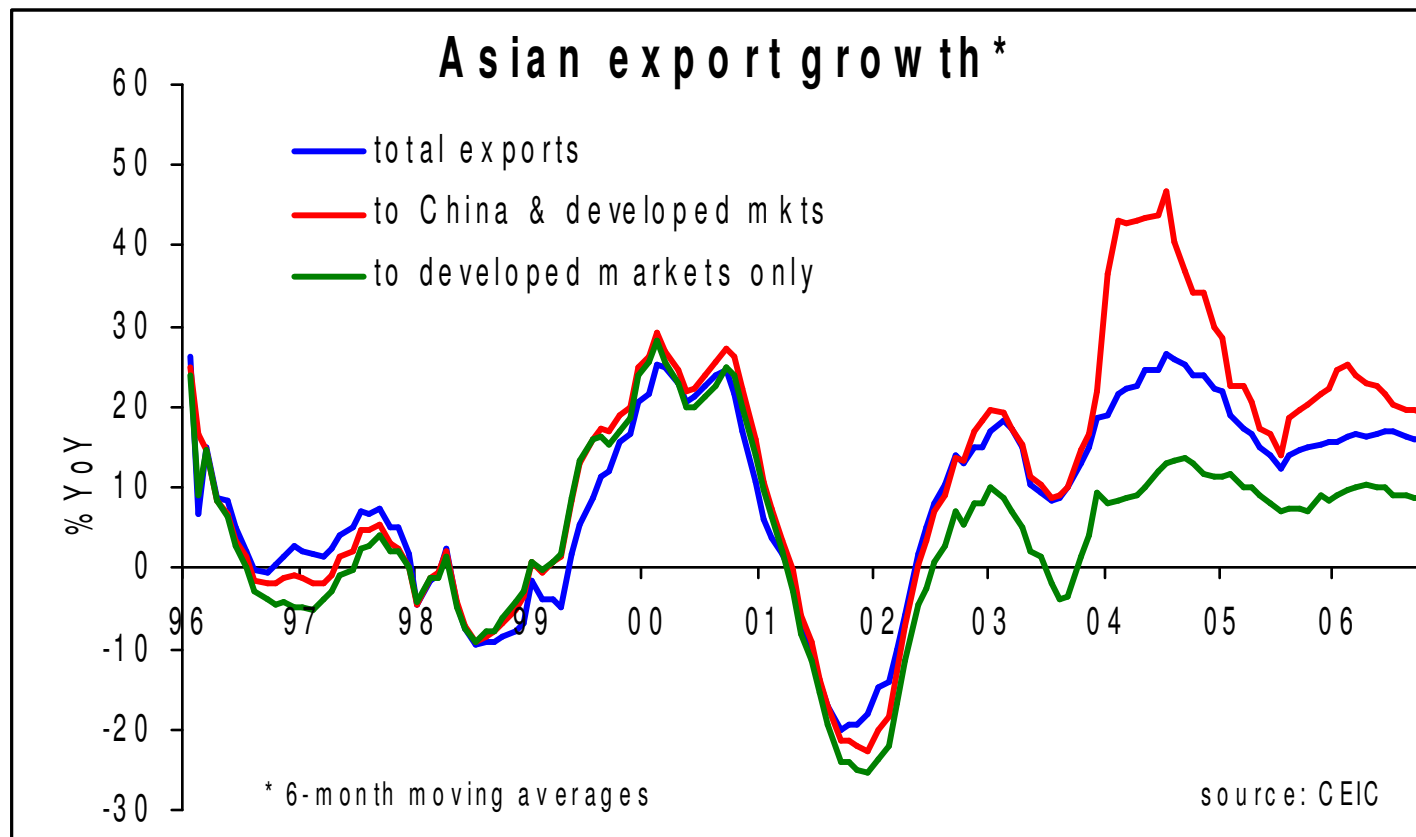
US Impact on Asia Declining

- ◆ US demand growth affects Asian export growth (before 2004, correlation = 0.4)
- ◆ But its impact has been less pronounced recently (correlation = -0.5) => Asia is deriving demand from different sources

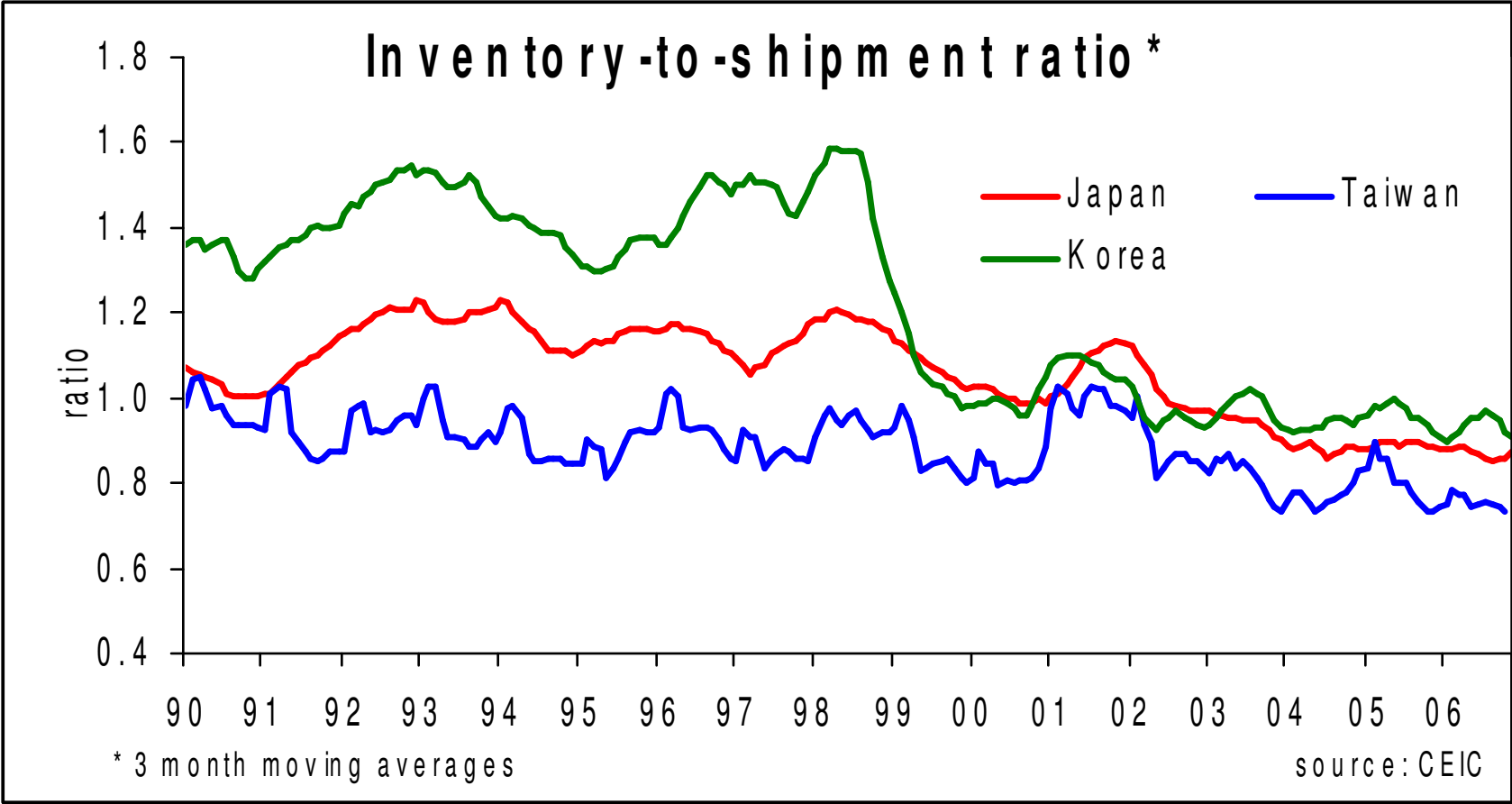


China's Trade Impact is Rising

- ◆ China is where the bulk of Asian exports have gone in recent years

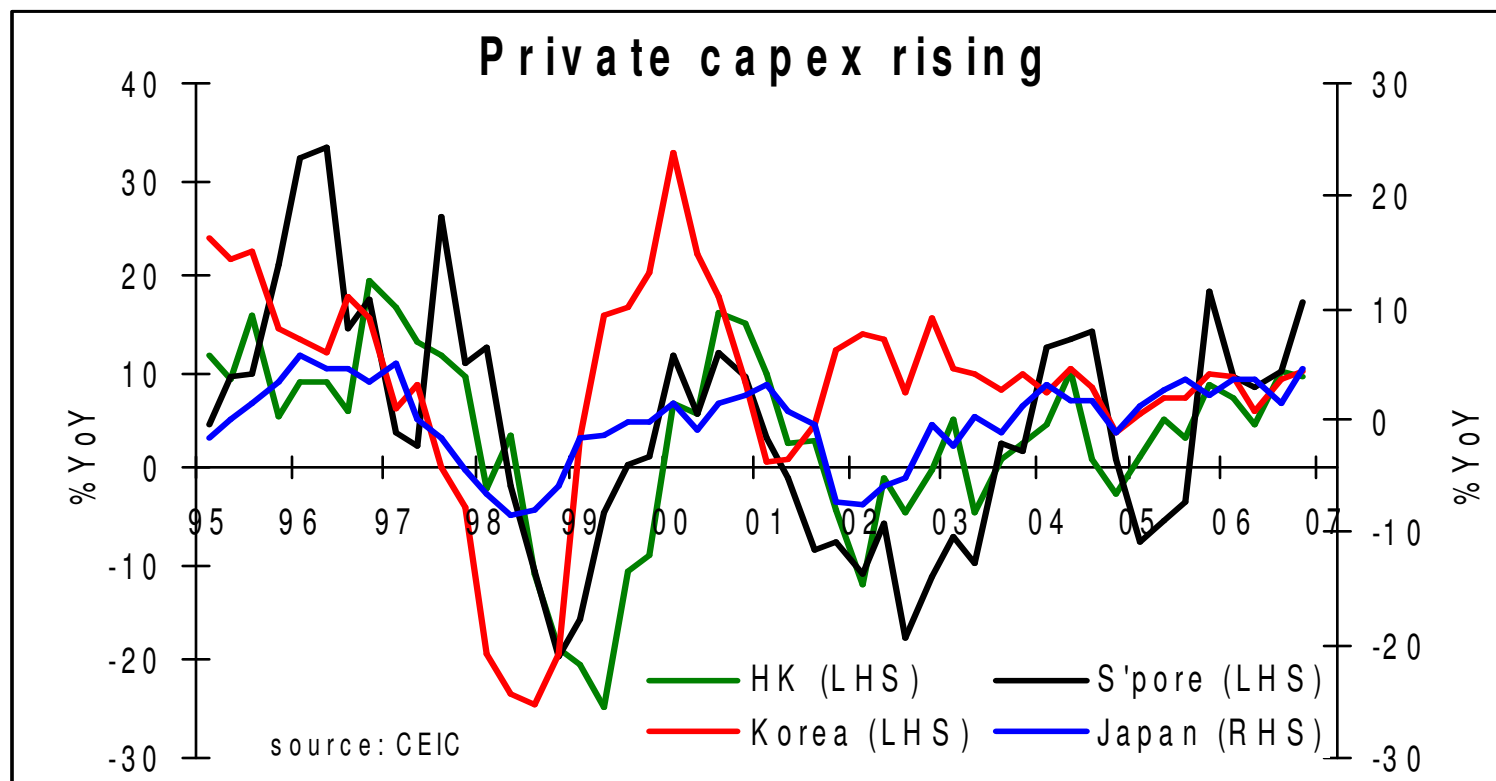


Leading Indicators Pointing to More Growth



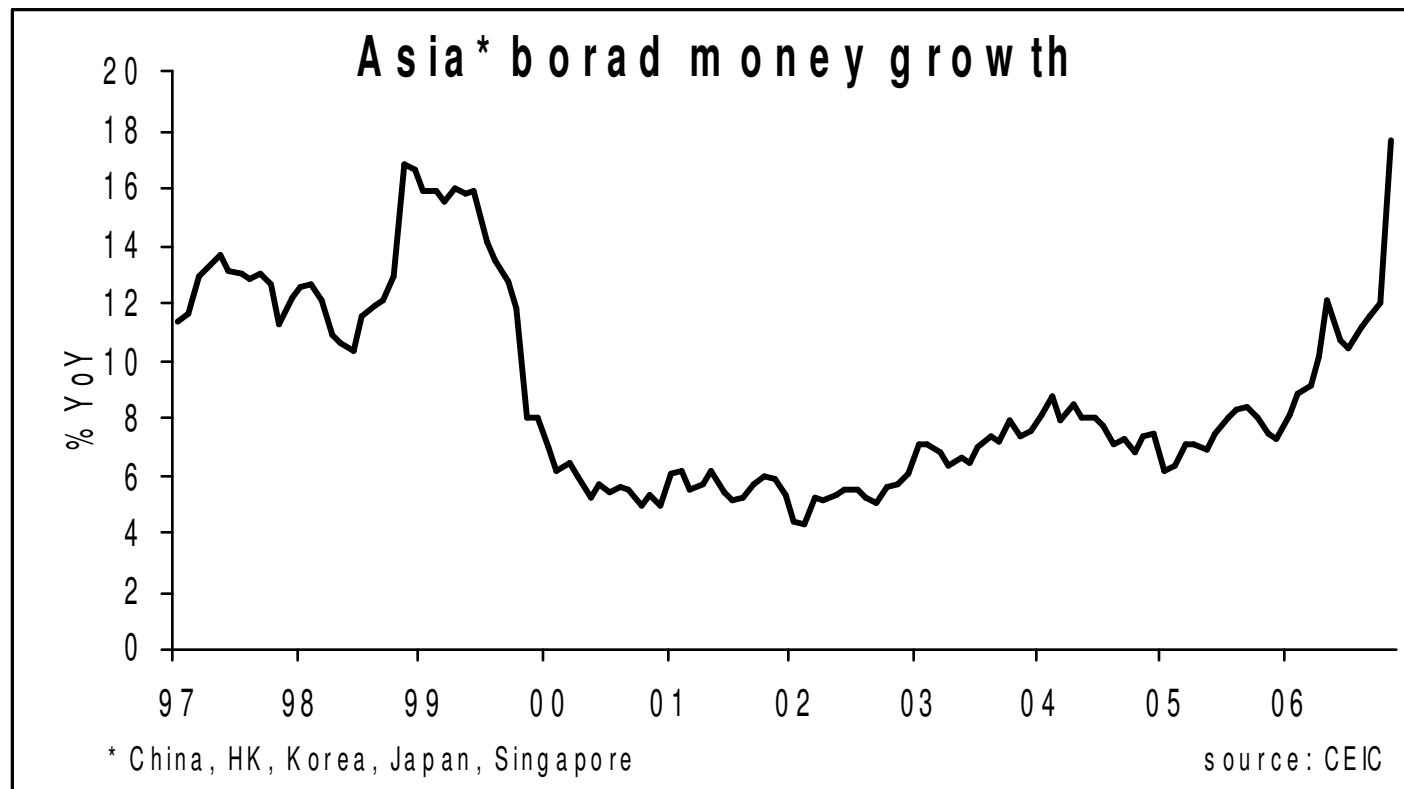
Capex Firming Up

- ◆ Buoyant profit growth boosting private investment
- ◆ Business investment to lead domestic demand growth, fuel consumption growth + wealth effect from asset markets



Easy Regional Monetary Policy

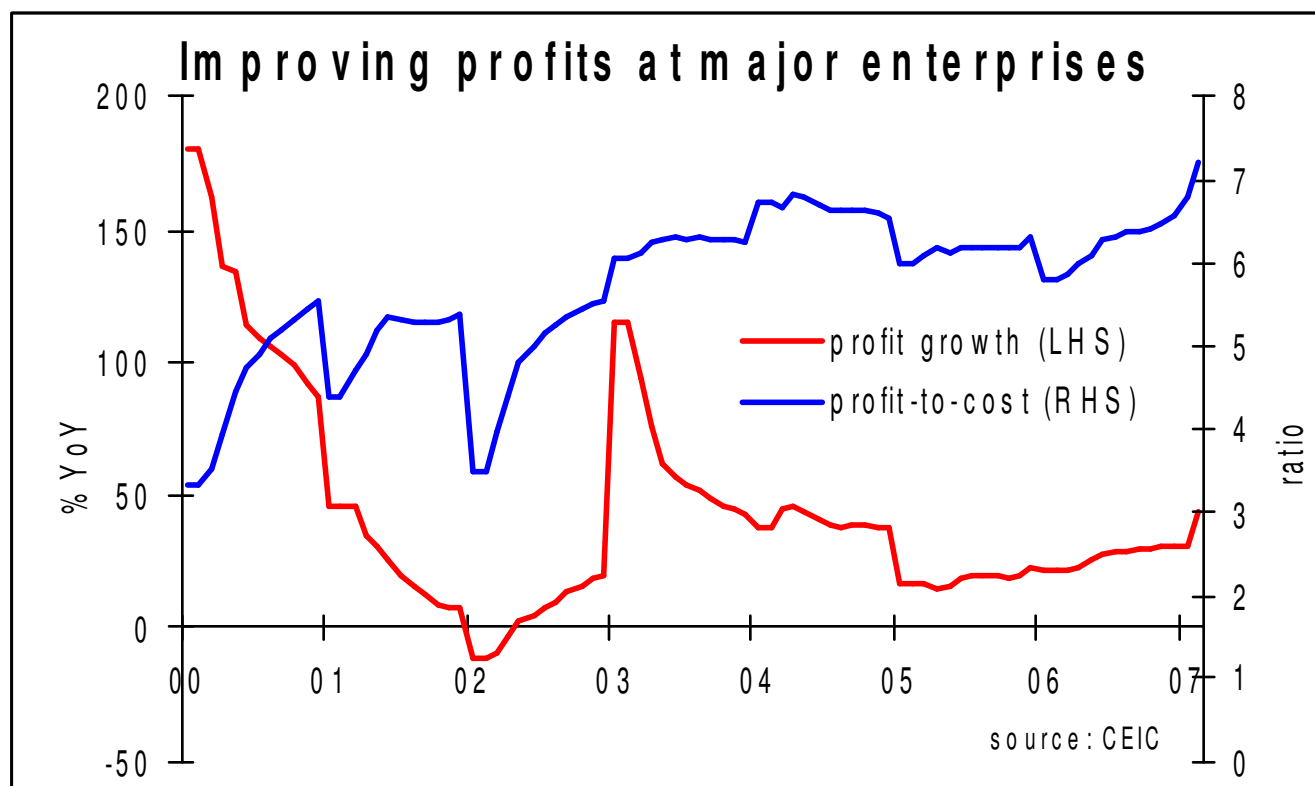
- ◆ Monetary expansion continues – prompted by forex intervention, lack of inflation and easing external demand



Regional Themes

- ◆ China and Japan are becoming more important in driving intra-regional trade
 - ◆ Over 1/3 of Chinese and Japanese imports from Asia are for local consumption
 - ◆ Asia is thus better able to weather a US shock than before
 - ◆ The lack of inflation => low policy risk to hurt liquidity
 - ◆ Japan has just climbed out of deflation
 - ◆ China and HK are stuck with very low inflation
 - ◆ Singapore is flirting with deflation
 - ◆ Pan-Asia inflation is low
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Chinese Corporate Profit Dynamics Positive



- ◆ Profit growth has stabilised
- ◆ Rising profit-to-cost ratio suggests improvement in cost base

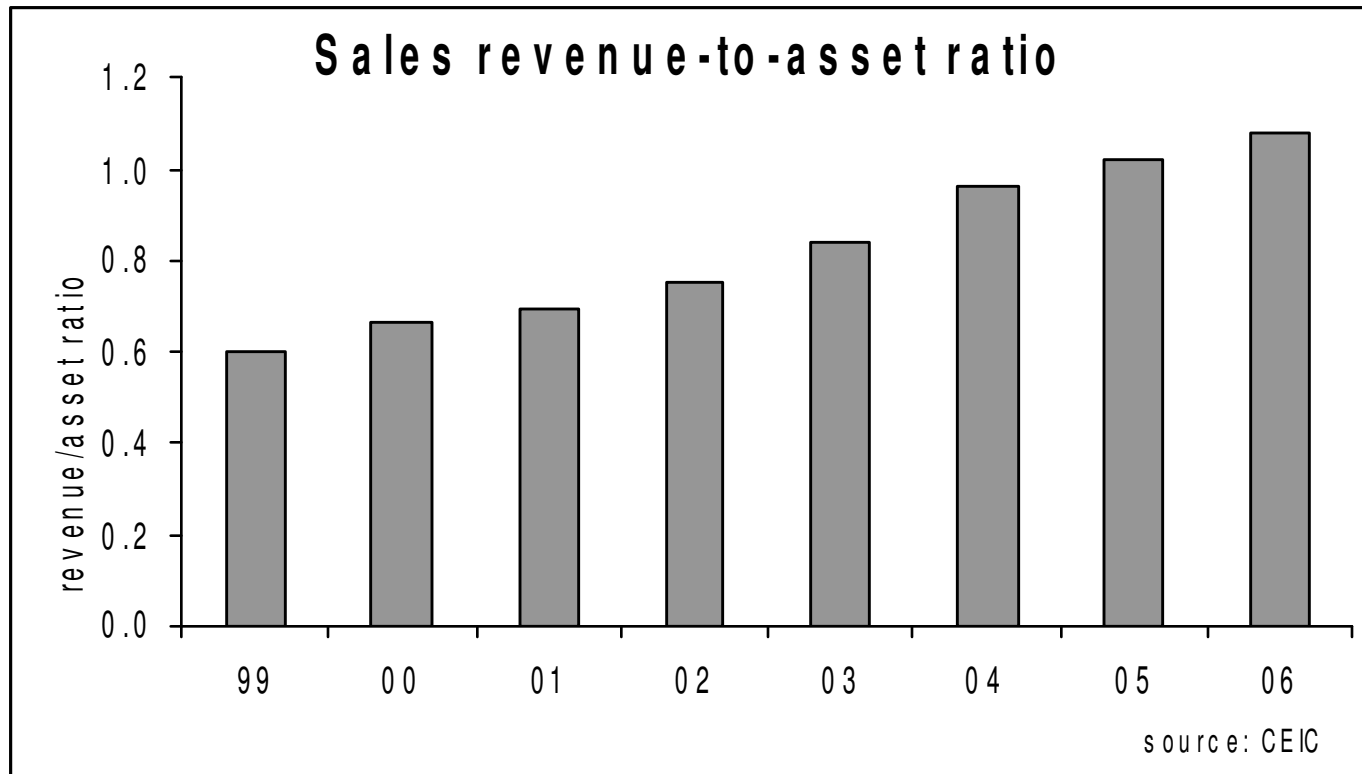
Concerns About Chinese Profit Growth

- ◆ Sharp rise in input prices
 - ◆ Excess capacity and rising competitive pressure
 - ◆ Inefficiency of the state firms
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Worsening Operating Environment vs Rising Profits

- ◆ Input prices and competition have risen, but so has profitability => higher efficiency driving profit growth
 - ◆ State sector has been restructured – privatisation, foreign participation, public listing
 - ◆ Technology improvement – massive relocation of the supply chain to China leading to industrial upgrading and skills and technology import
 - ◆ Capital deepening – more intensive use of inputs and technology
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Improving Efficiency



- ◆ Rising sales revenue-to-corporate asset ratio suggests improving efficiency

Risks to Chinese Profit Growth

- ◆ Reform of government-regulated prices
 - ◆ Input price distortions helped boost profits
 - ◆ Interest rates, land prices, wages and key commodity prices are held down artificially
 - ◆ Biggest risk = sharp decline in external demand
 - ◆ Leading to sharp drop in exports which will cut into demand and hurt the profit environment
 - ◆ Falling exports would also exacerbate the excess capacity problem in the Chinese corporate sector → profit squeeze
 - ◆ RMB appreciation
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China Growth Model Shifting After WTO

- ◆ Bulging trade surplus creates economic imbalances that make Beijing re-think growth model
 - ◆ To consumption-led from export- and investment-led
 - ◆ Structural and political trends are converging to boost consumption
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Structural Factors

- ◆ Steady income growth
 - ◆ Service sector now a/c for about half of GDP (<1/3 previously)
 - ◆ Accelerating urbanisation
 - ◆ At 40%, urbanisation is low
 - ◆ Beijing is experimenting to scrap the *hu-kuo* system
 - ◆ Growing middle class
 - ◆ Currently 4%, expect to grow by over 6-fold to 360 mn by 2010
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Policy Push

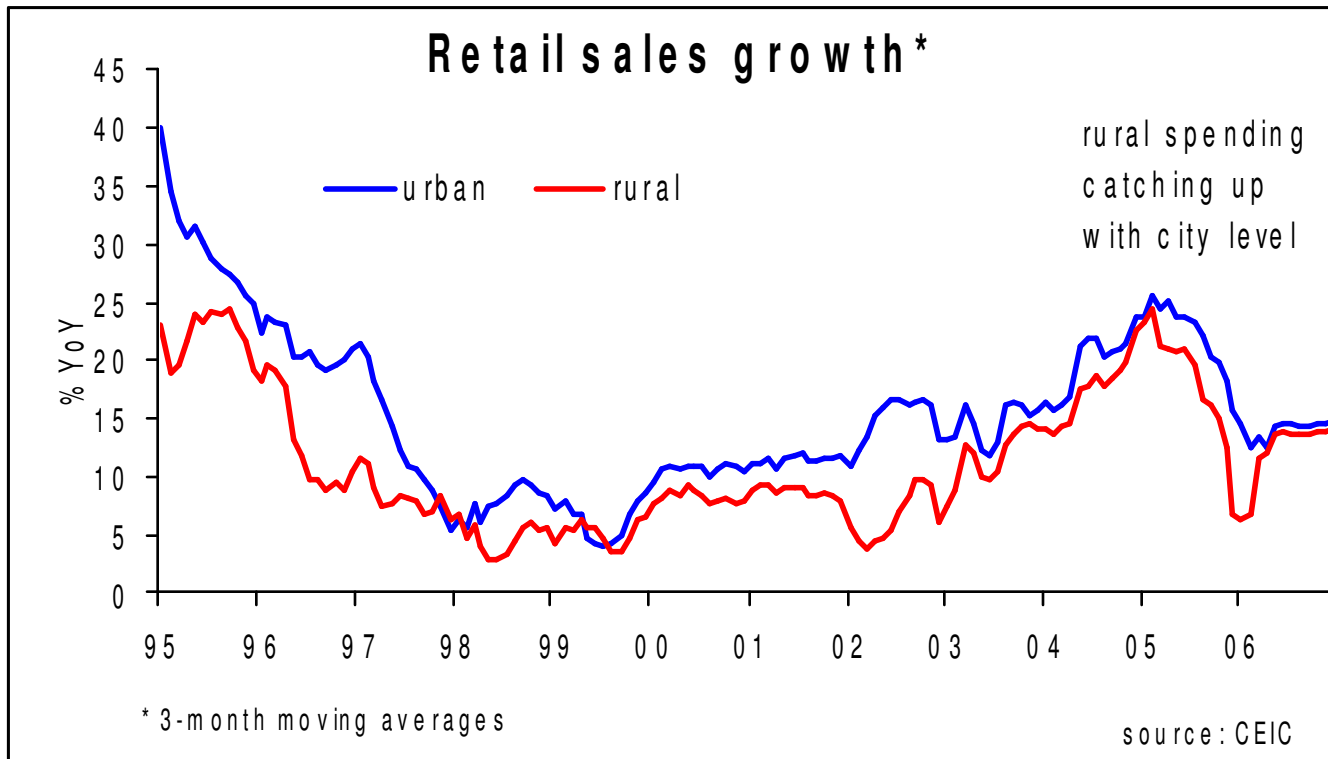
- ◆ Monetary policy less supportive for investment
 - ◆ RMB appreciation and end of export-tax rebates => switch to domestic market
 - ◆ The 11th Five-Year Plan – top priority to boost consumption
 - ◆ Scrapped agriculture taxes, lifted personal tax exemption
 - ◆ More fiscal spending on rural infrastructure
 - ◆ Experimenting with privatising lending in Shan-xi
 - ◆ Experimenting with scrapping the *hu-kuo* system
 - ◆ Financial liberalisation
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Household Budget Constraint Being Relaxed



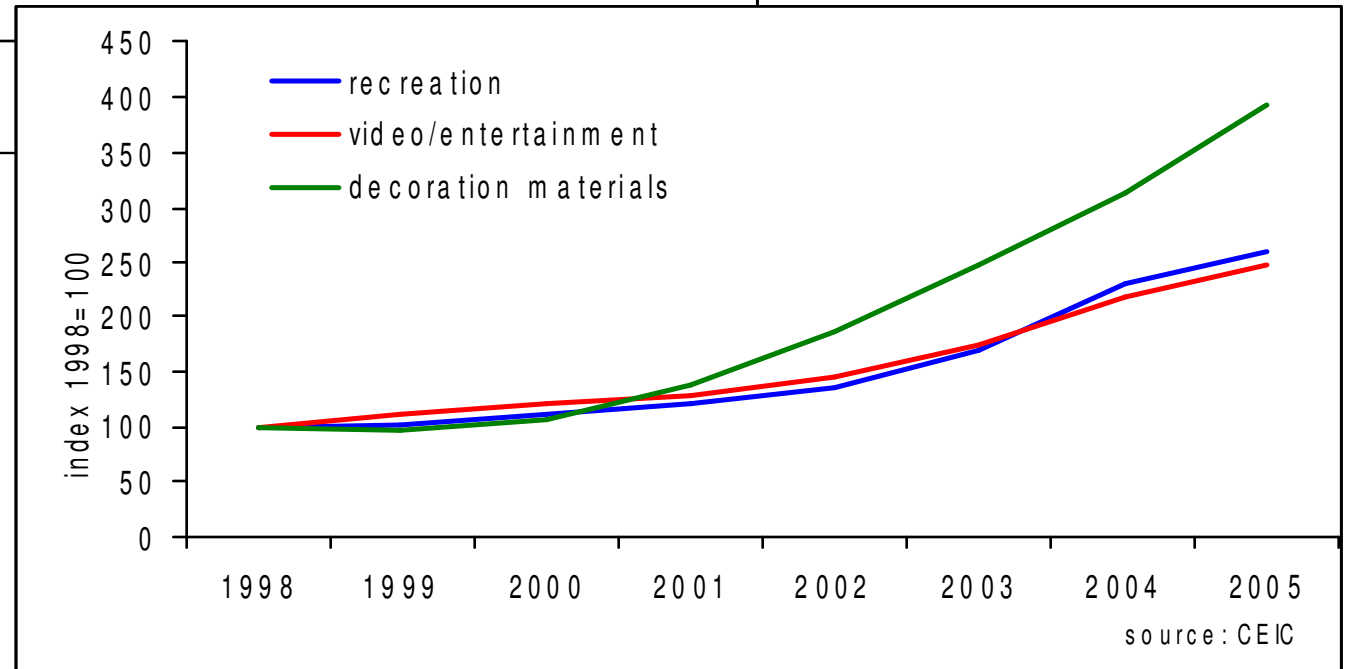
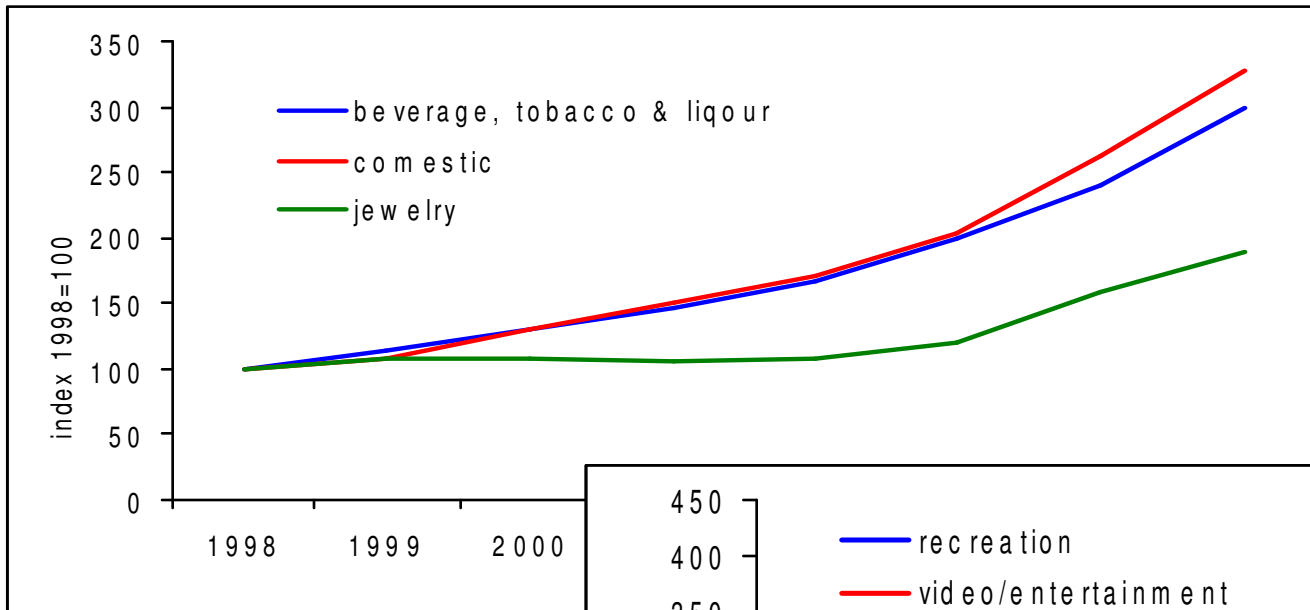
- ◆ The infant personal loan market suggests financial liberalisation will go a long way to unleash private spending

Rural Spending Catching Up



- ◆ Rural consumption has shown sign of catching up with urban spending
- ◆ Overall wage growth outlook positive due to tight labour market, higher reservation wage from the rural areas

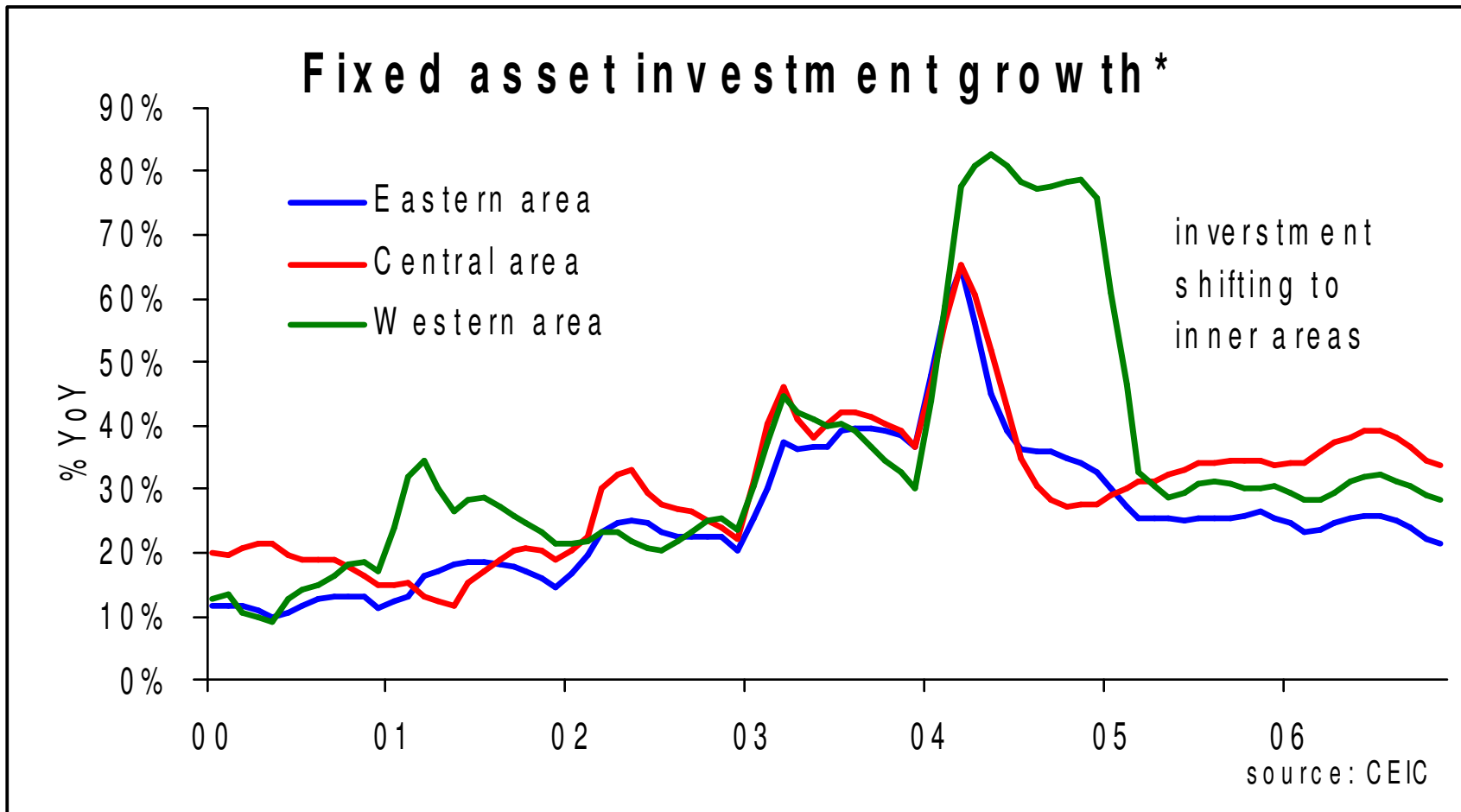
Discretionary Spending Rising



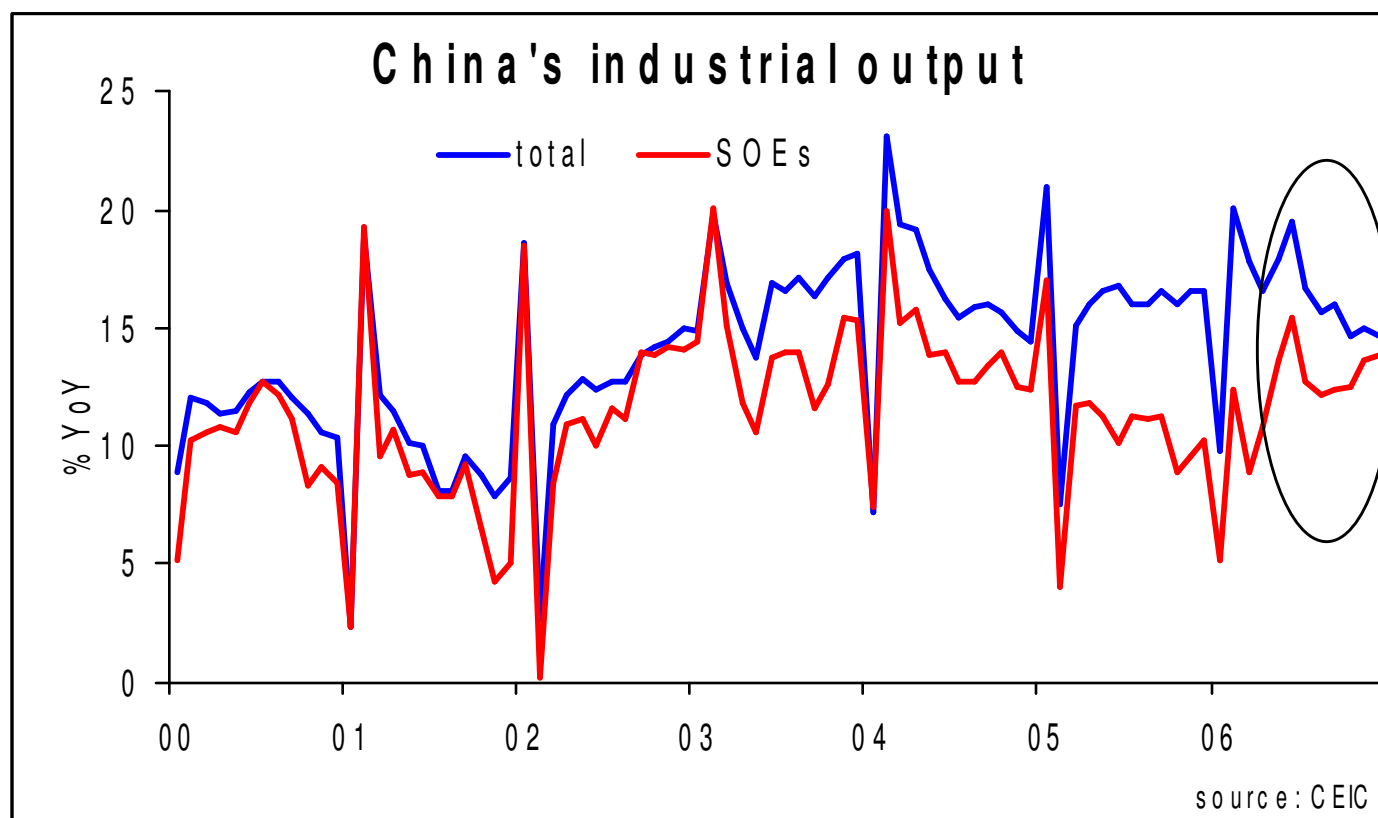
But Shifting Growth Model Won't Be Easy

- ◆ Lack of social welfare net makes precautionary demand for money high
 - ◆ Saving habit still dies hard
 - ◆ Investment growth won't slowdown sharply – only reshuffling of investment from coastal rich areas to inland poor areas
 - ◆ Cooling measures have hurt light industries and private firms more than SOEs
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Investment Growth Shifting to Inland Areas

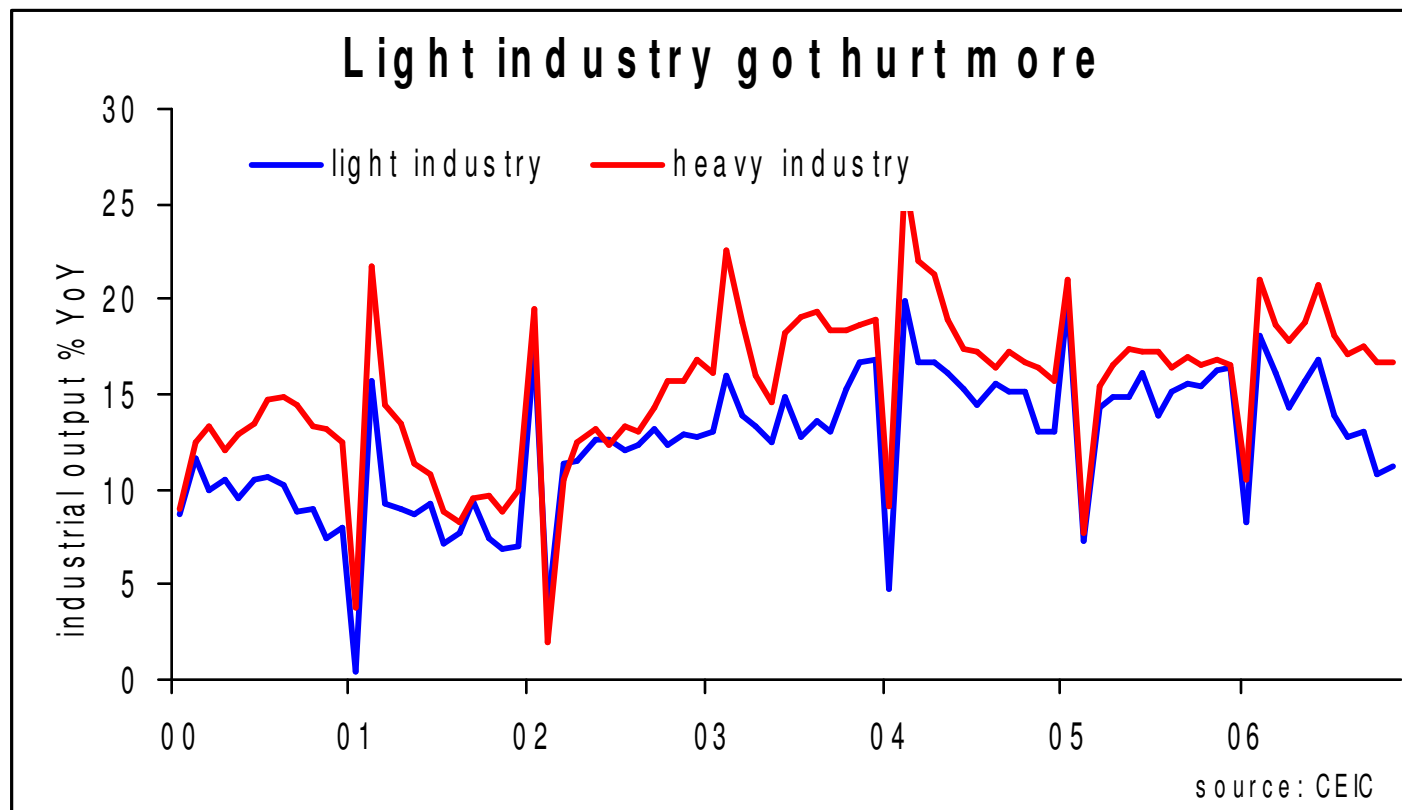


Austerity Measures Hurt Non-state Firms More



- ◆ Total industrial output growth slowed to 14.7% early this year from 21% in Jan.06
- ◆ But SOE output growth sped up to 14% from 5%

Light Industries Also Suffered More



- ◆ The tightening policies have biased against the private and light-industry sectors

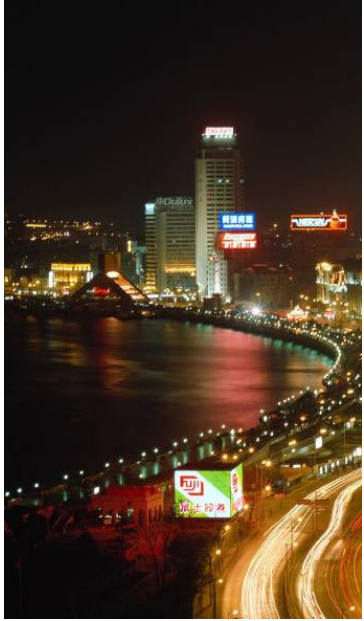
China Investment Themes

Longer-term (> 3 years):

- ◆ Urbanisation
- ◆ Consumption
- ◆ Resource-efficient industries and services
- ◆ Financial liberalisation

◆ Short-term (< 3years):

- ◆ SOEs
 - ◆ Heavy industries – metals, energy, commodity related
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