China – You Can't Ignore It

December 2011

China has been one of the most important economies on a global scale for a few years as its export machine helped drive down the prices of many goods in developed markets during the boom times between 2003 and 2008. However, China's influence on global markets has increased dramatically since the collapse of Lehman Brothers in September 2008. When China announced its massive stimulus package in November 2008 it marked the low point for emerging-market equities and helped to improve global sentiment over the next few months and end the liquidity crisis.

China: Huge Ambitions and Plans

You could argue that China's ability to affect sentiment and market direction is now on a par with the US, which has dominated global trends for many decades. Investors in all equity asset classes are feeling the China pull-effects: global equity managers are increasingly allocating some money directly to Chinese stocks or are at least looking for companies in other countries that are increasing their exposure to China. In addition to being the world's largest exporter, over the last couple of years China has become the world's biggest auto market and the second-largest economy. At some point in the next twenty or thirty years, China is likely to become the world's largest economy.

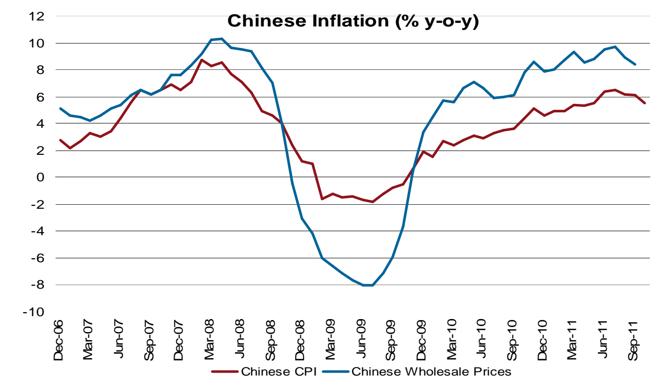
Source: Bloomberg, monthly data, December 2006 – October 2011

China's ambitions and future plans are huge. The country is now entering the next phase of its growth, which will rely more on domestic consumption and building technology than being the main exporter of low-tech manufacturing. It has a large pool of educated people to drive forward more value-added and high-tech industries: it has just launched an unmanned space vehicle (Shenzhou 8) that docked with the Tiangong-1lab, which was only launched in September; Commercial Aircraft Corp of China is attempting to challenge the duopoly of Boeing and Airbus in passenger planes and has already taken 100 orders for its 166-seat C919 plane that is expected to enter service in 2016; China only introduced high-speed rail services in 2007 and it already has the world's longest high-speed network at nearly 10,000 kilometres.

Other companies are looking to create global brands and challenge established developed-market leaders, such as Huawei in mobile handsets and Lenovo in laptops. Chinese car brands have yet to gain much traction outside of China but it will happen, especially now that Chinese companies have bought certain western businesses like Volvo, Saab and MG Rover, that will help accelerate its technological catch-up. Overall, what is happening in China is akin to Japan's development post the second-world war, although it is on a much larger scale and is happening at a much faster rate.

Inflation is Moving in a Positive Downward Direction

Rising inflation has been one of the key reasons behind the underperformance of emerging-market stocks over the past year. Investors were particularly worried about this trend in China. Consumer inflation in China peaked at 6.5% in July, well above the government's target of 4%.



Source: Bloomberg, monthly data, December 2006 – Sep/Oct 2011

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However, the level of inflation has been moderating since August, with a large fall to 5.5% in October and it could be nearer 4% by year-end or early 2012. The monthly rise in October was only 0.1%. A big factor in rising consumer prices has been food, particularly meat, which hit 33.6% (y-o-y) in July, but had fallen to 26.1% by October.

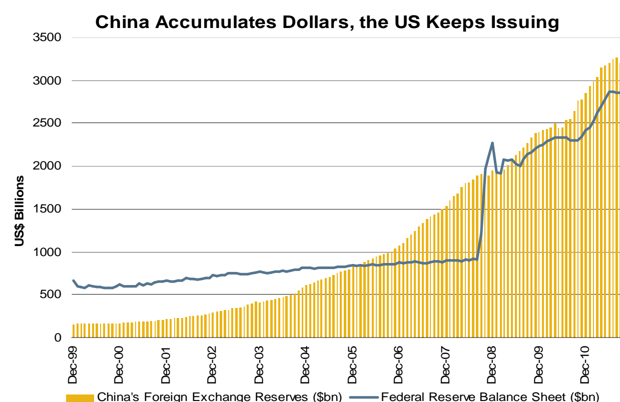
A Carefully Engineered Soft Landing

There has been talk of a hard landing in China, although we do not subscribe to this view. The authorities have done a good job of gradually slowing growth from bubble territory to a still-very-strong level. Third-quarter GDP came in at 9.1% (y-o-y), down from 9.5% and 9.7% in the previous two quarters.

Source: Bloomberg, quarterly data, Q1 2000 – Q3 2011

Massive Firepower to Change Policy

China has built up the world's largest pool of foreign reserves and in the process helped fund the spending plans in the US and other western economies.



Source: Bloomberg, monthly data, December 1999 – September 2011

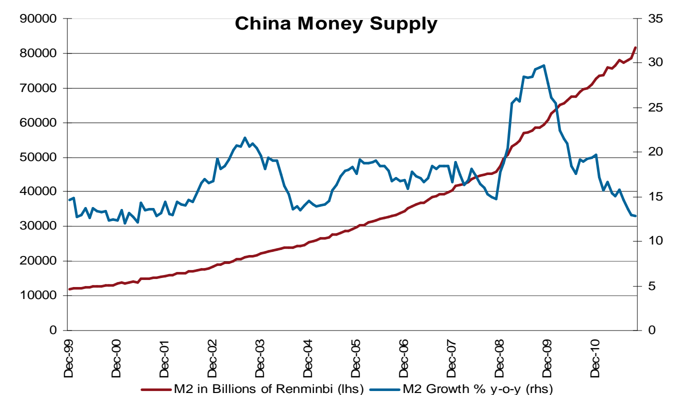
Global imbalances have substantially increased over recent years, with negotiations and accusations of currency manipulation becoming a hot topic, especially between the US and China. This has led to a gradual increase in the renminbi, although China has and will continue to adjust its currency at its own rate. The country can use this massive pool of money to help affect the transition towards a more balanced economy by promoting domestic consumption. It has already increased the provision of pensions and healthcare, which will encourage consumers to spend rather than hoard money.

Worries over Local-Government Debt

One of the main worries for investors over the past couple of years has been the build up of debt among local governments in China, which totals more than 25% of GDP. In particular, there are concerns over transparency and the off-balance-sheet nature of this borrowing. However, mid-November saw the first local-government bond issue in nearly 20 years, with Shanghai raising Rmb3.6bn in three- and five-year paper at yields of 3.1% and 3.3% respectively. Despite the low yields, much lower than many European governments have had to pay recently, the issues were more than three times oversubscribed. Guangdong and Zhejiang also have auctions planned in November. While this is an embryonic market, it is a positive step and should help to improve transparency and impose greater discipline on local governments.

Quantitative Tightening – May Turn to Easing

As the US and Europe have been loosening monetary policy by conventional and non-conventional means, China has been reining in credit growth to avoid bubbles in areas such as property. While overall money supply is still strong and helping to sustain 9% or more GDP growth, the authorities have increased banks' reserve ratios and enforced quotas on lending, thus slowing the rate of growth (see chart). With inflation now moving in the right direction and external demand slowing, Beijing is starting to look at easing policy in certain areas, with a more balanced focus on growth as well as price pressures. This could be directed at the small- and medium-sized enterprises that have been particularly hard hit by this policy stance over the past year or so.



Source: Bloomberg, monthly data, December 1999 – October 2011

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Chinese Equities Have Underperformed

Despite China's massive influence on economies and markets, Chinese equities have been through a prolonged period of underperformance since the early days of the credit crunch in 2008.

Equity Returns %	2008	2009	2010	2011 ytd*	31/12/07 – 31/10/11	31/12/09 – 31/10/11
Chinese H Shares	-51.1	62.1	-0.8	-17.2	-34.8	-17.8
Chinese A Shares	-65.4	80	14.3	-12.1	-53.1	-24.7
MSCI EM ($)	-54.5	74.5	16.4	-13.6	-20.1	0.6
MSCI EM EMEA ($)	-56.7	63.5	20.9	-15.7	-27.9	2
MSCI EM Latam ($)	-52.8	98.1	12.1	-15.2	-11.1	-5
MSCI EM Asia ($)	-54.1	70.3	16.6	-12.2	-20	2.4
MSCI World ($)	-42.1	27	9.6	-4.9	-23.4	4.2

Source: Bloomberg, *ytd as at 31 October 2011

We believe that Chinese equities now offer compelling value. Investors have been spooked over the past year by rising inflation. This now looks to be under control. The PE of Chinese equities is now low on an absolute and relative basis compared with other emerging countries and also developed markets. Looking at valuations on a price-to-book basis gives a similar picture. Factor in the world's highest GDP growth, the biggest reserves, a rapidly growing consumer economy and the ability of policymakers to act decisively and quickly, and Chinese equities look particularly appealing.

Source: Bloomberg, monthly data, 31 October 2001 – 31 October 2011

Portfolio Positioning of Pioneer Funds - China Equity

Top 5 Overweights	Ptf Weight	Bmk Weight	Delta
Consumer Durables	5.06%	0.63%	4.43%
Food & Staples Retailing	2.59%	0.91%	1.68%
Consumer Services	1.04%	0.00%	1.04%
Banks	22.92%	22.12%	0.80%
Media	0.60%	0.00%	0.60%
Top 5 Underweights	**Ptf Weight**	**Bmk Weight**	**Delta**
Capital Goods	3.53%	4.84%	-1.31%
Utilities	0.72%	2.04%	-1.32%
Materials	4.65%	6.09%	-1.45%
Energy	17.42%	19.53%	-2.10%
Real Estate	2.83%	5.44%	-2.61%

Source: Pioneer Investments 31 October 2011. Benchmark is the MSCI 10/40 China Index

Overweight Sector Positions

Retailing

Retailing represents our largest sub-sector overweight. Global economic dynamics and China's necessary re-focus away from an export-driven growth model to a more domestic-driven consumption and services model should lead to be a very long-term trend of increased private consumption. This is supported by high levels of employment, strong nominal wage growth, and significant private savings. We hold a number of stocks that should benefit from this theme including:

- *Intime Department Store* is the leading department store operator in the Zhejiang province with a brand mix aimed at the mid/high end segment. Intime have a very impressive track record of generating strong same store sales growth and expanding the store network aggressively while containing costs. They effectively use operating leverage gains to fund expansion ensuring a reasonably stable margin and delivering strong revenue growth. Revenue growth over the last five years has averaged 35% to 40% and proved quite resilient even in difficult years. The valuation is very reasonable at 14 times 2012 consensus earnings, (8 times free cash flow) with the company expected to generate over 30% net profit growth next year.

- *Stella* is a footwear manufacturer, supplying many of the mid-end global brands such as Clarks, UGG, Guess, Merrell and Timberland. With strong research and development capability, short lead times and a focus on quality Stella has been able to gain market share very consistently. Stella is also developing its own high-end retail business within China, which should break even this year. With revenues growing at 50% per annum, we expect this to become a meaningful contributor to the bottom line in the coming years. With the company expanding original equipment manufacturing capacity at double-digit rates each year the growth should continue. Stella is very attractively valued, with a very strong balance sheet, is on 9 times 2012 consensus earnings and finally will pay a 6% dividend yield this year.

Banks

Although slightly underweight Financials in general - at a subsector level we are overweight banks. The Chinese Banking sector has been an area of hot debate of late since the government's liquidity-tightening measures have taken effect and system loan growth has been reduced to more sustainable levels. M2 growth in China (see chart on previous page) accelerated to almost 30% in 2009 when Chinese authorities put in place a stimulus package in

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order to sustain growth in the face of what was turning into a global recession. The necessary slowing of this credit growth has raised questions over the ability of local government infrastructure vehicles to fund their loans. This, combined with slowing overall economic growth and a deliberate policy targeted at lowering real estate prices, has weighed on the sector. We certainly agree that credit costs will be on the rise within the sector. However, we believe the increase will be modest relative to market expectations which appear extreme. With relatively protected net interest margins, low loan-to-deposit ratio's (70%), and high capital adequacy ratios and coverage ratios, we believe the sector is prepared for such a scenario, with the three largest banks trading at a little over book value and generating in excess of 20% Return on Equity.

- *ICBC* is one of the largest banks in China with a diversified branch network providing a source of funding at a competitive cost. ICBC has moderate exposure to Local Government Financing Vehicles (10% of assets), which are of particular concern to the market currently. It has a high level of loans to state owned enterprises which tend to be well capitalized and backed by the central government. ICBC has a good track record of controlling credit costs and has grown its balance sheet in quite a prudent way (15%) over the last seven or eight years. We would not view this growth as alarming when taken in the context of Chinas trend economic growth over the period. ICBC is set to deliver circa 23% return on equity this year. We would expect this to decline moderately next year as credit costs rise but at 1.3 times 2011 book we believe this is more than priced in.

Food and Staples Retailing
We are overweight Food and Staples Retailing. We see very interesting opportunities for both growth in organised retail penetration and consolidation within the sector as larger players leverage from scale purchasing, and an increase in national logistics and distribution networks. We have exposure to the sector through a number of companies including:

- *China Resources Enterprise* is one of the top players in China's evolving hypermarket space. It has a national footprint, has invested significantly in building its platform and should reap the benefits in the coming years as scale efficiencies kick in. CRE also own the top beer brand by volume. The company is currently targeting the premium end of that market and if successful will see good margin uplift. CRE trades on 1.8 times 2011 book, and around 8 times free cash flow. Despite looking a little expensive, we believe earnings to be depressed as losses in some geographies of the business are not offset against tax liabilities in other parts. We expect a significant uplift to earnings as some new projects become profitable. In addition, we believe the company is capable of generating double-digit earnings growth for many years to come.

- *Lianhua Supermarket* **is** a regional player in North East China. The investment case for this stock is one of restructuring as the parent merged retailing assets to improve scale and lift operating margins from very low levels. This year's operating margin should rise to almost 2.8% from just 2% in 2010 and losses in 2009. Lianhua trades at a very reasonable 2.4 times book and 10 times 2012 consensus earnings.

Consumer Durables/Consumer Services & Auto
Our overweight in this sector follows the same rational as our overweight in Retailing. We see good potential growth from penetration of white goods and also see significant opportunities in the auto market. Despite being the largest automobile market in the world penetration remains quite low.

- *Haier* is a white goods manufacturer and brand owner. The company operates one of the largest rural distribution networks outside of the first and second tier cities providing significant exposure to rural China where penetration is low. The recent acquisition of the Sanyo brand will help Haier improve branding and the recent joint venture with the UK's Home Retail (Argos & Homebase) looks like a promising growth engine for the future. Given double-digit operating profit growth this year and next and on just ten times 2012 earnings we think this represents good value.

- *Shenzhou* is a knitwear manufacturer, supplying brands such as Nike, Adidas and Uniqlo. The company is gaining share rapidly within the space, having achieved top-line growth of over 20% on average in the last five years. It provides technically difficult products to its customers and, as a consequence, is earning industry-beating margins. We believe this competitive advantage is sustainable, generating a Return on Equity of over 30%. The company trades on just 6 times earnings and pays a dividend of over 5%.

- *Great Wall Motor* is a domestic Chinese Auto brand which currently dominates the mid end SUV segment in China. Last year it launched a line of sedans which has met with much success. The company also sell pick-up trucks in Australia and Italy, and competes

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very favourably on a price/quality basis with the established international brands. Great Wall Motor has delivered some of the best industry revenue growth numbers within China - 50% in 2009 and 78% in 2010. This year it will do around 30% which is very impressive given the slower industry growth this year. The company has exercised very good cost control discipline and logistics channel management and has demonstrated excellent execution ability over the last number of years. We believe with the launch of new and successful models Great Wall Motor will continue to perform well. It currently trades on six times 2012 earnings and a price to book of 1.5 times, which we find very attractive.

Underweight Sector Positions

Real Estate

Central government policy towards the Real Estate sector is currently very negative; the central government is trying to avoid what would be an eventual problem of overvalued real estate and poor affordability for the middle classes. Over the last year it has introduced many austerity measures making it very difficult for individuals to buy investment properties, while Banks have been tightening supply of lending and only really extending it to first time buyers. Banks have stopped lending to property developers, thereby forcing the developers to cut prices in order to sell units and raise cash. This combined with constant speculation over a property tax has led for expectations of falling prices which in turn is leading to a drop in volume sales. Given the extremely leveraged nature of the property developers' business, they can be prone to collapse if the government's policy is in place for extended periods of time. Clearly the policy is there to achieve certain goals, so if these goals are met we could expect a change. However, we do not see this in the near future and despite what appears to be attractive valuations, we believe the risk of some insolvencies to be high.

Energy

We are underweight Energy as we believe that, in general, with slowing developed market growth energy prices should soften going forward. Clearly, any more unrest in the Middle East or another round of Quantitative Easing by the US Federal Reserve would result in a spike in energy prices but we remain comfortable with an underweight position.

Outlook

We believe that China has learned lessons from past policy mistakes, such as being too aggressive in tightening monetary policy in the downturn in 2008. With inflation cooling, the Chinese authorities are adjusting their focus to help promote growth as well as ensuring that prices remain under control. We now expect further initiatives in the coming months to increase credit growth, possibly through cuts to banks' reserve ratios. The government is also likely to continue addressing structural issues around local government debt, land ownership and taxation.

While European debt problems continue to drive market direction and sentiment, we would argue that risks are more than priced into markets, especially outside of Europe. After several years of underperformance and valuations at trough levels, now does not look like the right time to underweight or ignore China. There is a lot of money sitting in cash or low-yielding Bunds and Treasuries. As soon as the market mood improves and risk becomes "less unfashionable", Chinese equities could be in strong demand. Valuations will not stay this cheap for ever, so this could prove to be an opportune time to reallocate money into cheap assets with strong medium-term prospects.

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