

Risky LGFV loans; family planning policy

Rmb2tr risky LGFV loans

According to China Securities Journal, CBRC has finalized nationwide LGFV loan statistics. Total LGFV loans stood at Rmb7.7tr as of June 2010, of which Rmb2tr is believed to be risky vs. a total banking sector capital base of Rmb2.5tr as of Aug 2010 and Rmb670bn total NPAT in 2009. Banks have raised Rmb695bn common equity in the first 8 months of the year. Some people may argue that a large part of the banks' re-financing activities is behind us; we are less optimistic. We suspect that it will be a multi year process given the size of the risky loans needed to be cleaned up ultimately. Given the sector's underperformance in recent quarters, some catch-up is happening. However, in the medium to long term, the banking sector remains one of our least favored sectors in China ([The new "untouchables"](#), 13 Aug).

More details: The statistics group placed the LGFV loans into three categories: Type-I (sufficient project cash flow for repayment), 24% of total; type-II (insufficient project cash flow, secondary repayment source needed) 50% of total; type-III (non-compliance loans or high default risk loans), 26% of total, or ~Rmb2tr. Source of the total LGFV loans: 30% from policy banks, 40% from large state owned commercial banks, 26% from joint stock banks and city banks.

One-child policy on the way out

According to Xinhua's Outlook Oriental Weekly, Mr. HE Yafu, a local demographics expert, said China will relax family planning policy in selected provinces (Heilongjiang, Jilin, Liaoning, Jiangsu and Zhejiang, low birth rate provinces) starting from 2011, and may expand the loosening nationwide by 2016. Under the new policy, any couple with either being a single child can have two children. Most young couples in China can qualify for this. China's current birth rate is only 1.22 and a rate of 2 is needed to keep the population size stable. Higher birth rate is good news for general consumption, especially staples like Hengan, Mengniu, and Want Want.

The existing policy is that both husband and wife have to be an only child to qualify for a 2nd child. So far there is no official confirmation or comment about the potential change in policy. But quite a few unnamed officials said that they have heard about the pilot test although they are not sure about its scope or timing.

Interestingly, Sept 25, 2010 was the 30th anniversary of China's one-child policy. Over the past few months, there has been frequent reference to a comment in the original announcement 30 years ago: "30 years from now, China's population problem will be alleviated, and we will be able to adopt a different policy then." Mr. TIAN Xueyuan, a core member of the team that developed the 1-child policy, said recently that the policy aimed to control the birth rate of only one generation, implying that it's time for a change now. More inside.

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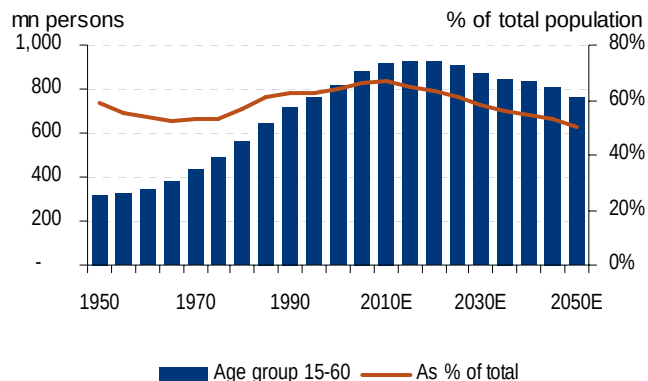


- Rmb2tr of LGFV loans are at risk.
- Banks' refinancing may not be over yet.
- Loosening family planning policy.

China may further loosen its family planning policies

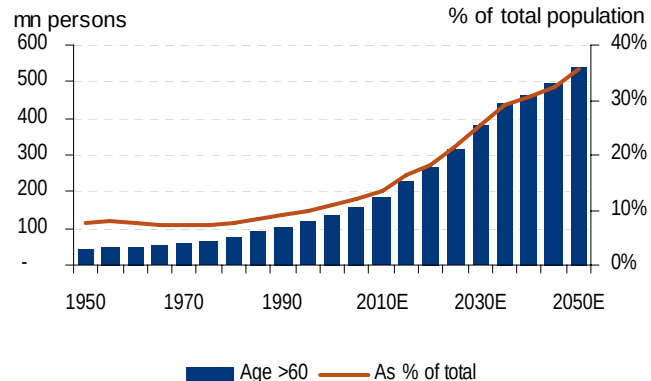
The call to loosen the policy has become louder in recent years, as local researchers worry about labor shortage and an aging population. Based on UN's data, the percentage of China's working age population vs. China's total population will peak in 2010 at 67% and decline to 50% by 2050. On the other hand, the percentage of seniors (age >60 years old) is expected to rise from 11.9% in 2005 to 35.7% by 2050. In general, a society is considered old if the percentage of seniors exceeds 10% (Chart 1 & 2).

Chart 1: Working age population 1950-2050



Source: United Nations, BofA Merrill Lynch research

Chart 2: Population of group age >60: 1950-2050



Source: United Nations, BofA Merrill Lynch research

The 5 provinces mentioned in the pilot test all have low birth rate, according to Mr. He, i.e. below the 1.22 national average based on data collected during the 2000 census.

If the change of policy is confirmed, the impact could be significant. According to an unnamed official from the Family Planning Committee in Liaoning province, a substantial portion of urban couples there meet the new criteria, and urban population accounts for 60% of the province's total.

The uncertainty lies in whether young couples are willing to have more children. For example, according to Shenyang Daily on Feb 5, 2010, Shenyang (the capital city of Liaoning), hospitals have seen fewer 2nd-child newborns from qualified couples in recent years. Zhejiang province has similar experience. Yuecheng, a downtown district of Shaoxin city, only saw 19 qualified couples registered to have a 2nd child between 2001 and 2007, according to Shaoxin Evening Post on Oct 2007. In Hunan province, which is not part of the reported five pilot test provinces, the local government tries so hard to encourage qualified urban couples to have a 2nd child that they have started to grant an Rmb10K/couple bonus, according to Hunan Daily on Jan 2010.

Today's key macro news

Monetary: Sept M2 +19.0% YoY, vs. +19.1% YoY in Aug. Sept new loans at Rmb595.5bn, vs. Rmb545.2bn in Aug. Sept FX reserve at USD2,648.3bn, vs. USD2,454.3bn in Aug. Outlook: 1) New loans: RMB400bn should be enough for running the Chinese economy at around 9.0% YoY in 4Q. We do not believe there will be a liquidity problem. 2) FX reserve: out of the total change, US\$158.0bn is explainable, leaving about US\$36bn "unexplained inflow" during 3Q, which is understandable due to rising RMB-USD appreciation expectations. 3) The RRR hike means the chance for rate hike before year-end is getting much smaller. –**Ting Lu/TJ Bond/Xiaojia Zhi.**

http://research1.ml.com/C/?q=jAYPJq30dVzltjEpqrEYA_&r=prodap

Foreign trade: Sept exports +25.1% YoY, vs. 34.4% in Aug; imports +24.1% YoY, vs. +35.2% in Aug; trade surplus at USD16.9bn, vs. USD20.0bn in Aug. Outlook: most of the decline should be ascribed to a rapid rise of base effects instead of the weakness of the global economy. We expect both export and import growth to drop to around 15% in 4Q10, and then to 10-15% in early 2011. –**Ting Lu/TJ Bond/Xiaojia Zhi.** http://research1.ml.com/C/?q=e8TuXizqZ-iltjEpqrEYA_&r=prodap

LGFV: Rmb2tr of LGFV loans are at risk

- By people close to the situation
- The nationwide scrutiny of LGFV loans has been completed. By Jun 2010, total balance was Rmb7.7tr, +0.1% from 2009 year end
- Classification: Type 1 loans have sufficient project cashflow to cover the repayment, 24% of total; type 2 needs secondary source for the repayment, 50% of total; type 3 are incompliant loans or have high default risk, 26% of total
- Lenders: 30% of loans are granted by policy banks, 40% from major SOE banks, 26% from joint stock banks & city banks.

(Source: China Securities Journal)

Labor: China may allow more couples to have a 2nd child in selective provinces starting 2011

- By Mr. HE Yafu, a local expert on demographics, recently
- Pilot test will start in 2011 at Heilongjiang, Jilin, Liaoning, Jiangsu and Zhejiang, and will expand to nationwide by 2016. If one of the couple is the only child of his/her parents, the couple can have a 2nd child
- No official confirmation.

(Source: Outlook Oriental Weekly)

Sentiment: both Entrepreneurs' Confidence level and Corporate Prosperity Index went up slightly in Q3 2010

- By NBS on Wed
- Entrepreneurs' Confidence level: rose to 135.9, vs. Q2's 133.0. A rise across industry and region
- Corporate Prosperity Index : rose to 137.9, vs. Q2's 135.9.

(Source: Securities Times)

Food: NDRC said Sept prices rose slightly

- By NDRC recently
- Buy in price: wheat +0.3% MoM, rice +0.1% MoM, corn +0.3% MoM
- Retail prices also went up slightly.

(Source: Chinese Business News)

Food: Sept corn exports volume -36.3% MoM

- By China Customs on Wed
- Corn: Sept exports at 5,764tons, -36.3% MoM
- Rice: Sept exports at 32,500tons, +62.4% MoM (-20% YoY).

(Source: Shanghai Securities News)

Food: edible oil retail prices may go up by 10%

- By people close to the situation
- Several major makers plan to raise prices by 10% recently.

(Source: Chinese Business News)

A-share: No. of new accounts opened rise WoW for 4 weeks in a row

- The week of Sept 27-30 +3.6% WoW.

(Source: Securities Times)

Today's key sector/company news

Property - Shanghai: non-residential property market boomed in Q3

- By Jones Lang Lasalle and Hanyu, a local agent, recently
- Commercial: sales volume hit new high in Sept
- Office: Grade A's buildings rental +5.1% QoQ in Q3.

(Source: Chinese Business News)

Oil: Sept crude imports at new high

- By China Customs on Wed
- Sept imports: 23.3mn tons, +35.4% YoY, and +4.8% from the record high in Jun 2010.

(Source: Shanghai Securities News)

Coal: Qinghuangdao prices rose by 0.7% after staying flat for 4 months in a row

- By Qinghuangdao port
- Oct prices +Rmb5/ton.

(Source: Shanghai Securities News)

Steel & iron ore: Sept foreign trade picked up

- By China Customs on Wed
- Steel: Sept exports rose MoM slightly
- Iron ore: Sept imports +18% MoM, after a drop for 3 months in a row.

(Source: Chinese Business News)

Reports today

Investment Strategy: China: A Strategist's Diary - 13 Oct 2010 : Rural subsidy on cement; poor man's CPI - China - David Cui
http://research1.ml.com/C/?q=9nB3jql0f-blTljEpgrEYA__&r=prodap
 China Macro Watch : New loans below speculation; big rise in FX reserves - Asia | China - Ting Lu
http://research1.ml.com/C/?q=iAYPJg30dVzltljEpgrEYA__&r=prodap
 China Macro Watch : Sep trade growth fell on base effects - Asia | China - Ting Lu
http://research1.ml.com/C/?q=e8TuXizqZ-jltljEpgrEYA__&r=prodap
 PRC Power : Power tariff reform starts with progressive retail tariff hike - China - Angello Chan
http://research1.ml.com/C/?q=Xw7CulOVfITltljEpgrEYA__&r=prodap
 Building Materials : China to roll-out cement to rural; positive for the sector - China - Yongtao Shi, Colin Liang, Po Wei
http://research1.ml.com/C/?q=EK9Vxo2U-T3ltljEpgrEYA__&r=prodap
 1177 HK: Sino Biopharmaceutical : Positive updates from Hong Kong NDR - Buy - BUY - China - Shaojing Tong
http://research1.ml.com/C/?q=BfMKT7T5diPltIjEpgrEYA__&r=prodap
 EJ US: E-House China : Benefiting from the pick-up in volume - BUY - China - Matthew Chow
http://research1.ml.com/C/?q=ns!GhYHqghrltljEpgrEYA__&r=prodap
 Quant Strategy: Global Contenders & Defenders : Positioned for continued upturn - Global - Nigel Tupper
http://research1.ml.com/C/?q=bUIZG025fmPltIjEpgrEYA__&r=prodap

Overnight markets

	Change	Change %
HSCEI index	322.5	2.5
HSCCI index	74	1.7
SHCOMP index	20	0.7
HSI index	336	1.5
RMB (against US\$)	0	-0.1
RMB (against EUR)	0.1	0.6
Dow Jones	75.7	0.7
NYSE Financial Index	25.7	0.5
DJ Euro Stoxx 50	64.8	2.3
US Govt 10y yield	0	-0.4
BDI	29	1.1
WTI Crude (US\$/bbl.)	1.3	1.6
Alum H.G. (US\$/MT)	-20	-0.8
Alum Alloy (US\$/MT)	-5	-0.2
Copper (US\$/MT)	17	0.2
Lead (US\$/MT)	59	2.5
Nickel (US\$/MT)	350	1.5
Tin (US\$/MT)	275	1
Zinc (US\$/MT)	40	1.7
Gold (US\$/oz)	21.8	1.6
Silver (US\$/oz)	0.7	2.9
Rice (CNY/MT)	5	0.2
Corn (CNY/MT)	-	-
Wheat (CNY/MT)	1	0

Source: Bloomberg, BofA Merrill Lynch research

14 October 2010

Table 1: Sector Performance and valuation of HK listed China stocks

10/14/2010	Performances							Sector Market cap (US\$ bn)	As % of China equities
	1D (%)	5D (%)	1M (%)	3M (%)	6M (%)	1Y (%)	YTD (%)		
Building materials	8.4	5.9	12.3	47.5	34.7	23.3	37.2	25.3	1.0%
Property	6.4	5.8	3.7	9.2	1.5	-2.6	-3.2	63.4	2.4%
Airlines	5.3	5.8	19.1	37.2	41.2	124.6	90.7	43.7	1.7%
Fertilizer	4.5	6.6	12.5	46.0	17.0	33.7	20.1	8.0	0.3%
Insurance	4.3	7.7	12.9	16.8	6.1	15.9	8.8	202.1	7.7%
Power Equipment	3.8	1.1	10.6	37.9	28.7	36.1	43.8	27.5	1.0%
Personal products	3.4	0.9	4.8	17.0	27.0	56.8	40.2	45.2	1.7%
Paper	2.8	-1.2	15.9	23.6	2.0	52.6	16.4	12.2	0.5%
Furnishing	2.6	1.7	9.5	14.6	-2.3	16.9	14.2	1.6	0.1%
Tourism	2.5	1.9	8.0	19.4	1.5	17.1	-6.6	4.7	0.2%
Banks	2.5	3.4	4.8	6.2	1.1	2.2	1.8	708.0	26.9%
HSCEI	2.5	4.1	9.6	14.1	3.6	4.1	4.0		
Auto Parts	2.3	5.0	15.5	59.1	39.5	79.5	38.3	4.8	0.2%
Media	2.2	7.2	17.8	27.1	12.1	25.5	6.5	54.4	2.1%
IT	2.1	1.2	6.9	10.1	-9.8	29.1	13.0	20.9	0.8%
Conglomerates	2.1	0.1	4.6	19.7	0.9	9.2	0.1	24.8	0.9%
Steel	2.0	5.0	5.7	38.4	0.1	-4.0	-14.4	17.6	0.7%
HSCCI	1.7	0.7	3.3	12.0	5.0	5.8	7.5		
Coal	1.7	4.4	18.3	28.3	2.9	18.4	-0.5	123.6	4.7%
Water	1.6	-1.9	4.9	12.3	-6.2	10.6	-6.3	5.0	0.2%
Machinery	1.5	2.9	11.9	39.9	22.8	68.7	34.9	26.4	1.0%
Shipping logistics	1.5	-1.4	8.0	18.1	4.2	12.9	7.7	1.4	0.1%
Non-food retail	1.5	2.7	2.5	11.2	18.3	36.4	17.5	23.1	0.9%
Auto	1.5	2.8	21.6	65.7	46.1	149.2	62.5	29.3	1.1%
Non-ferrous	1.4	5.6	21.2	41.4	9.4	12.1	12.4	45.0	1.7%
Construction	1.2	0.9	-0.4	1.0	2.4	-11.4	0.8	43.5	1.7%
Food & beverage	1.1	-0.6	2.8	13.8	12.9	36.9	11.2	62.9	2.4%
Food retailers	1.1	0.8	2.6	17.5	11.3	74.0	48.3	6.2	0.2%
Airports	1.1	-1.4	2.8	0.2	-12.8	-11.7	-18.1	2.8	0.1%
Oil	1.1	4.1	13.3	16.6	9.1	7.2	11.0	501.3	19.0%
Energy equipment/services	1.1	0.9	9.3	37.1	10.9	51.4	37.1	10.9	0.4%
Textile	0.7	0.1	2.9	25.3	-4.2	23.0	18.0	1.5	0.1%
Telecoms	0.6	-0.3	3.3	5.3	5.4	4.7	15.0	288.9	11.0%
Pharmaceutical	0.6	-3.6	-2.6	25.3	10.5	75.9	52.4	13.1	0.5%
Toll Roads, Railway	0.4	2.1	4.8	12.3	6.0	21.5	13.0	22.3	0.8%
Shipping	0.4	-1.7	5.8	12.9	-9.7	-6.6	-0.3	28.4	1.1%
Agriculture	0.3	1.3	1.6	-6.3	-10.1	6.9	-6.9	2.9	0.1%
Power	0.2	0.8	3.5	4.8	1.9	-9.2	3.2	40.8	1.6%
Ports	-0.1	-2.1	1.9	9.6	-5.2	1.4	9.3	16.1	0.6%
Telecom Equipment	-0.4	-1.2	8.3	14.5	-13.0	1.3	-6.4	43.6	1.7%
Gas	-0.4	0.9	2.7	16.5	-2.3	35.8	9.8	7.4	0.3%
Gold	-1.0	15.0	33.2	55.3	30.3	12.5	20.0	24.2	0.9%

Source: Bloomberg, Wind, IBES, BofA Merrill Lynch Global Research

Appendix - Latest market views and sector recommendations

We think the anticipated technical rebound in some of the short term oversold deep cyclical sectors such as cement, steel, non-ferrous, capital goods, and bulk Shipping is largely over. We suggest switching out of them now into more defensive sectors including consumer, agriculture, IPP and telco. In the medium term (6 months horizon), we expect the market to range bound trade because of FAI headwinds and policy uncertainties as a result of government's structural reform program. In general, we believe downside risk to H shares is more than that to A shares at the moment. Our medium term sector views, based on their fundamental outlooks, are detailed below.

Table 2: Our key sector views

Sector	Mid term (3m)	Comments	Key stocks
Capital Goods			
Machinery	UW	Inexpensive, but cautious given property tightening headwinds, and infrastructure stimulus exit concerns	Xiagong
Power Equipment	UW		
Telecom Equipment	EW	Not cheap, India uncertainties, high growth period over.	ZTE, Comba
Construction	UW	Infrastructure cycle coming to an end	CCCC, CRG, CRCC
Consumer Staples			
Food & beverage	OW	Demand outlook good, but valuation demanding, wait for better entry point	Tingyi, Uni-president, Mengniu, Tsingtao, Want Want, China Resource Ent
Food retailer	OW	Demand outlook good, but valuation demanding, wait for better entry point	Lianhua, Wumart
Personal product	OW	Demand outlook good, but valuation demanding, wait for better entry point	Hengan, Vinda
Consumer Discretionary			
Auto	EW	Mid term demand concerns due to property crack down.	Greatwall
Department store	OW	Mid term demand rosy due to income growth	Parkson, Golden Eagle, Intime
Home appliance retailer	EW	Mid term demand concerns due to property crack down	GOME
Sportswear	OW	Demand outlook good, valuation reasonable	Li Ning, Dongxiang, Anta
Shoe	OW	Demand outlook good, valuation reasonable	Belle, Daphne
Commodities			
Upstream oil	EW	Valuation attractive but uncertain oil price	CNOOC, COSL, PetroChina
Refiner	OW	Valuation attractive, defensive, beneficiary of RMB appreciation.	Sinopec, Shanghai Petrochem
Thermal coal	UW	Tightening, government price cap	Shenhua, China Coal, Yanzhou
Coking coal	UW	FAI growth slowing down	Hidili, Fushan
Steel	UW	Mid term cautious on demand outlook/capacity/environmental regulation	Angang, Maanshan, Shougang, Chongqing Iron & steel
Cement	UW	Property crack down and infrastructure slowing	Anhui Conch, CNBM, Sinoma
Non-ferrous	UW	property, infrastructure slowdown, US\$ strength	China Moly, Hunan Non-Ferrous
Fertilizer	OW	Valuation attractive	Bluechem, Sinofert
Gold	UW	Inflation concerns easing	Zijin, Zhaojin
Financials			
Banks	UW	Asset quality, fund raising, asymmetric rate hike risks	ICBC, BOC, BOCOMM, CMB, CMBC, Citic Bk
Insurance	OW	Robust premium growth, relatively defensive	China Life, Pingan, PICC, China Taiping, Pacific Ins
Property	UW	Policy headwinds	COLI, China Resources Land, Shimao, Country Garden, R&F, Agile, Hopson, Green Town, Forte, Evergrand
Healthcare			
Healthcare	OW	Outlook rosy, but valuation demanding, wait for better entry point	Weigao, Sinopharm, Shineway, Tongrentang, China Phar
Infrastructure			
Airports	EW	Valuation unattractive	Beijing, Meilan
Ports	EW	Europe uncertainty but business defensive	China Merchants, Cosco Pacific, Dalian, Tianjin, Xiamen
Toll Roads	OW	Defensive	Zhejiang, Jiangxi, Shenzhen
TMT			
Telecoms	OW	Valuation attractive, defensive	China Mobile, China Tel, Unicom

Table 2: Our key sector views

Sector	Mid term (3m)	Comments	Key stocks
Tech	UW	Uncertainties in global recovery outlook	Lenovo, SMIC
Media	OW	Valuation attractive, leverage on China's consumption growth	SINA, SOHU, Focus Media, Baidu
Gaming	OW	Defensive	Tencent, Shanda, Giant
Transportation			
Airlines	EW	Tight capacity, Rmb appreciation expectations. But valuation no longer cheap. High speed railway substitution is a concern.	Air China, China Southern, China Eastern
Bulk shipping	UW	FAI growth slowing down	China Cosco, China Shipping Dev
Container shipping	UW	Uncertainties in global recovery outlook	CSCL
Utilities			
IPPs	OW	Valuation attractive, tariff reform potential	Huaneng, Huadian, Datang, China Resources Pwr
Gas distributor	EW	Valuation demanding	Kunlun, HK China Gas, Xinao

Source: BofA Merrill Lynch Global Research

What the diary is about

This is a series of reports we aim to publish in the morning on most trading days, commenting on important local news, data points and highlighting our key research reports. The purpose is to put all the bits and pieces of information we get each day in perspective, i.e. how they fit into our framework of looking at the market. We hope reading our notes will help you to better identify key drivers of the market and develop your own hypothesis. We recognize that ours is but one of many potential ways of looking at the market, so any feedback will be gratefully received. There is an idiom in Chinese, Pao Zhuan Yin Yu (抛砖引玉), which loosely translates into something like we throw in a brick (definitely not at you) as a modest spur to induce you to come forward with valuable contributions, a jade article! There is another selfish reason for us: We hope the notes can serve as a record of our thought process as the market evolves, something quite useful in the future when we look back and try to find out why we get certain things right and/or wrong.

Link to Definitions

Macro

Click [here](#) for definitions of commonly used terms.

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster*
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

* Ratings dispersions may vary from time to time where BofAML Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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