NOMURA

China equity portfolio tracker

EQUITY STRATEGY

Apocalypse never now?

Remain defensive and selective still

Global Markets Research

9 July 2014

Favourable global liquidity lifting all assets

We attribute the recent resilience in the MSCI-China to A) stability and slightly improving China macro data, lack of adverse recent credit or liquidity events, and expectations that 1Q14 could be the lowest quarterly GDP for 2014, and B) the favourable global liquidity that has sent all asset classes upward, thus making the lagging China equities look more appealing from a yield and valuation perspective. That said, some investors have questioned whether the series of easing measures by Beijing could mean that things will be under control in China, or if things are so bad, authorities have had to ease.

Liquidity may not be as plenty as indicated by SHIBOR or loan growth

We believe several liquidity measures that investors pay attention to are painting too rosy of a picture: A) The robust loan growth y-y is in sharp contrast to tepid total social financing (TSF) growth since 2Q13, and indicates assets moving from off balance sheet to on balance sheet. B) The calm SHIBOR is a function of much-reduced y-y growth in interbank assets vs. surging supply of internet bank funding (e.g., money market funds). Indeed, access to funding among private sector businesses remain a challenge and interest costs remain stubbornly high. Based on historical issuance data, it appears to us that the trust repayment peak may last from 3Q14 to 1Q16. Also, 2014 is the peak year for LGFV repayment.

2H14 may see more market-driven defaults and bankruptcies than 1H14

While market-driven default and exit of idle capacity are necessary to break the vicious cycle of sending more good money after bad investments, so far there has been resistance at the execution level to allow default to occur due to concerns over messy fallout. But if funding for the relatively productive private sector remains difficult, things could change, in our view. This, combined with more reported cases of fraudulent bank borrowing in trade financing and more cases of corruption investigations in the banking sector, means that things could be stirred up more before the dust settles. While we hold a constructive medium-term view on China's structural reforms and its anti-corruption efforts, we find that few investors have real conviction in China's fundamentals at this point in time, and their portfolio exposure to China gets tweaked between neutral and underweight based on trends from the last three months plus the outlook for the next several months, which tends to be extrapolated off the last three months of data anyway.

Remain defensive and selective

Further to our note on 3 June, we remain defensive and selective. YTD, the average return of picks in our model portfolio was 3.3% vs. 2.2% on the MSCI-China, and cumulative returns of 59.6% on the model portfolio vs. 23.8% on the MSCI-China since 31 July 2012. In our model portfolio, we take profit in China Railway Group, Lenovo, and Sunny Optical, and trim Huaneng Renewable as it may miss consensus estimates for 1H14. We add AIA, Huadian Fuxing, Pacific Textile, and Shenzhou Int'l while keeping cash at 5.5%.

Anchor themes

We maintain our full-year forecast of 48 to 65 on the MSCI China. We are still some ways away from the lowest point in the MSCI China this year, which may be triggered by more credit defaults as we head into the peak maturity months.

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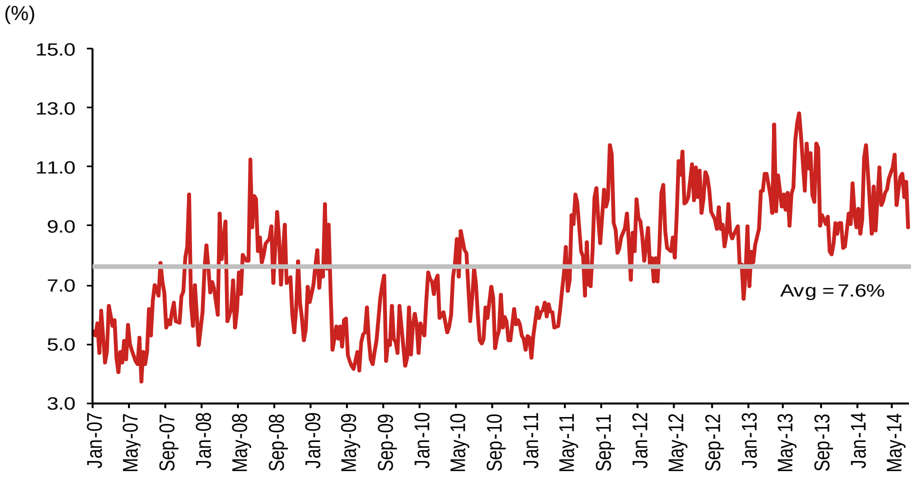
Apocalypse never now?

We maintain our full-year forecast of 48 to 65 on the MSCI China. We are still some ways away from the lowest point in the index this year, which is likely to be triggered by more credit defaults and bankruptcies as we head into 2H14, where repayment pressure on trusts and LGFVs is likely greater than in 1H14. We recommend being selective and defensive until it is time to turn more positive.

Not worth chasing

We find the weekly short selling ratio in Hong Kong to be a fairly good coincidental indicator of market sentiment. When the short ratio troughs, it has tended to be the peak in the MSCI-China, and when the short ratio peaked, it has tended to be the bottom in the MSCI-China. Recently, HK's short ratio has declined from a recent peak of 11.7% in the week of 7 Feb 2014 to 9.0% in the week of 27 June 2014.

Fig. 1: Hong Kong: Weekly short selling ratio



Source: CEIC, Nomura research

The question raised by many investors is, what is next? In our view, this is not the time to chase beta, but rather to selectively take some profit off the table, park money in steadier names, and wait for things to turn for worse before the dust settles.

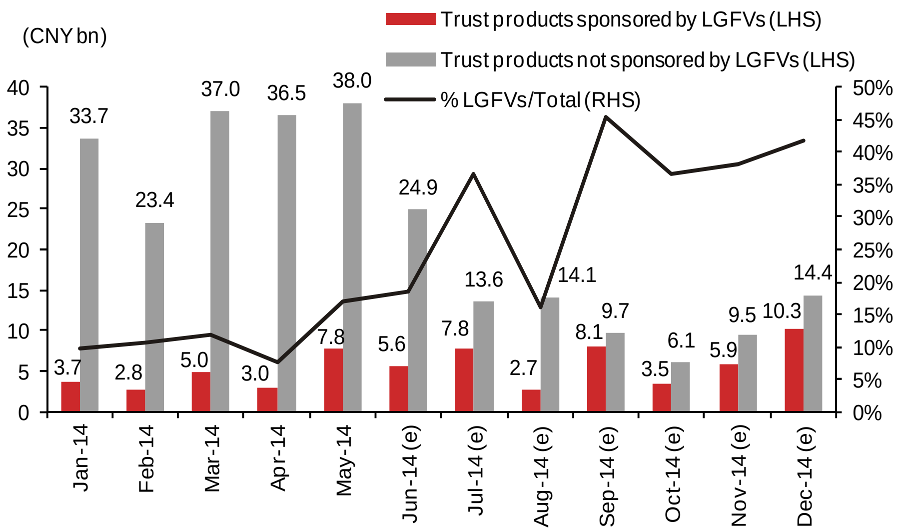
Likely greater repayment pressure in 2H14 vs. 1H14

Since early 2014, investors we have spoken with have regularly asked when the peak repayment seasons are for outstanding trusts and local government financing vehicles (LGFVs) in China. Unfortunately, data available to the public in this regard is not particularly good. The figure below is a typical chart we'd see when analysing trust maturity structure in China using the Wind database. Based on the following data, it is easy to conclude that perhaps we have passed the peak of upcoming trust maturity in 2014. But unfortunately, the size of the sample captured by Wind is rather limited.

For example, Wind's data capture ~80% of all collective-fund trusts post maturity, but it only captures 20-40% of all collective-fund trusts coming due in the future. Furthermore, according to the China Trustee Association, as of end-1Q14, collective-fund trusts only made up 25% of all trusts by assets under management. Of the total of CNY11.7tn in AUM as of end-1Q14, 70% was in single-fund trusts and 5% was in management trusts.

In all, the Wind data cover 20% of all trusts on a post-maturity basis, and approximately 5-10% of trusts on a forward-looking basis.

Fig. 2: Wind data capture 20% of all trusts issued on a post-maturity basis and 5-10% on a forward basis

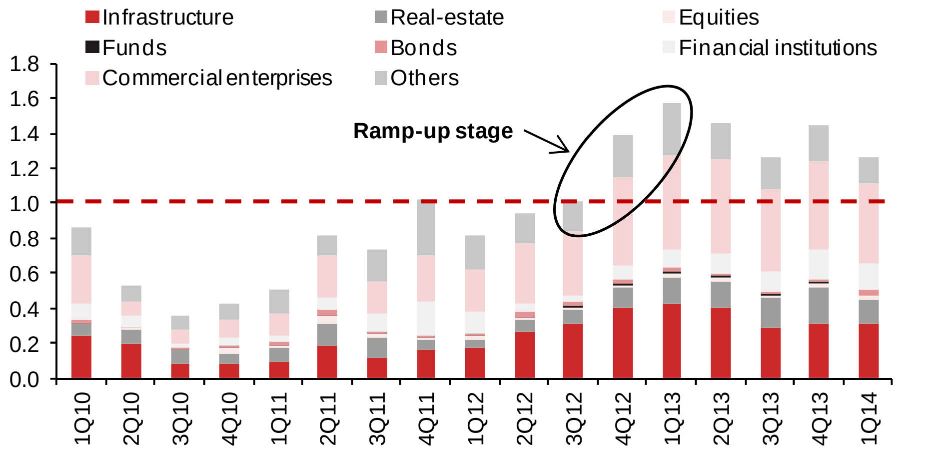


Source: Wind, Nomura research

Historical new issuance data paint a more challenging picture
In the next figure, we show quarterly new issuance of trust products from 1Q10 to 1Q14. We find that the dollar value of new trust issuance hiked in 4Q11 to CNY1tn, contracted in the following two quarters and then ramped up from 3Q12 to 1Q13 before moderating from 2Q13 to 1Q14 but stayed elevated at CNY1tn-plus per quarter.

- Based on data provided by Wind and Use-trust.com regarding collective-fund trusts, and input from Nomura's China banks team, we estimate that the average maturity of trust products is two years.
- Assuming the peak issuance from 3Q12 to 1Q14 needs to be paid back or refinanced within two years, we have just entered the extended peak repayment window from 3Q14 to 1Q16.
- Our China economics team estimates that CNY1tn and CNY0.9tn in trust products may come due in 3Q14 and 4Q14, respectively (Q&A: Risks in China's trust sector).

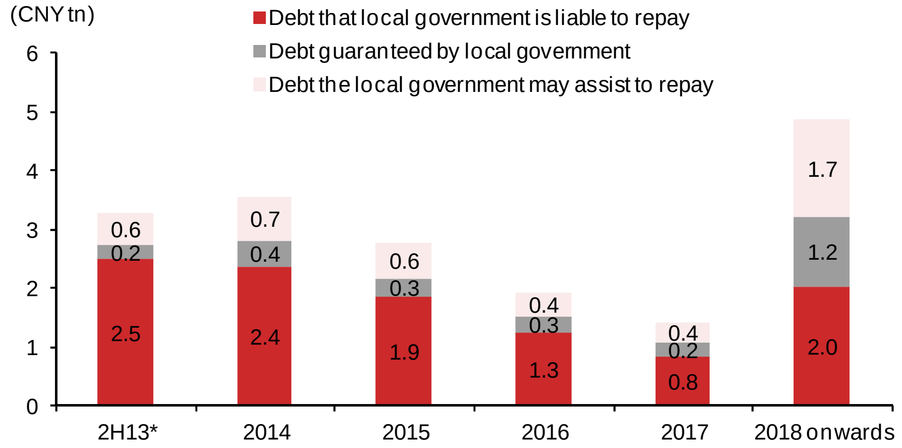
Fig. 3: Value of trust products newly issued per quarter
(CNY tn)



Source: China Trustee Association, Nomura research

On LGFVs, data provided by the National Audit Office show that 2014 is the peak year for repayment on an annual basis. Specifically, CNY2.4tn debt for which the local government is liable will mature in 2014, together with CNY0.4tn guaranteed by the local government and CNY0.6tn the local government may assist to repay. Our China economics team noted in the report (China: Revisiting the LGFV debt problem) that a majority of maturing debt in 2013 was likely rolled over. While we don't have a quarterly breakdown, our anecdotal checks indicate that repayment pressure will be greater in 2H14 than it was in 1H14.

Fig. 4: Repayment schedule for outstanding local government debt and LGFV debt
(as of end Jun 2013)



Source: National Audit Office, Wind data, Nomura research

* Data based on the National Audit Office's report on debt outstanding as of end June 2013, and therefore repayment schedule starts from 2H13.

WMPs: source of credit risks in trusts and LGFVs

While wealth management products (WMPs) are also deemed as a pillar of China's shadow banking system, they mainly act as the funding source of trust products and LGFVs. We believe that when it comes to shadow banking, the core credit risks reside with LGFVs and trusts.

So far, trusts have been "backstopped" by their parentcos

The consensus among the Chinese policy researchers that we've spoken with lately point to the need to have market-driven credit defaults on non-LGFV credits so as to channel money into the real economy. But thus far, there has been plenty of resistance on the execution level. Based on our checks, there have been strong incentives among the trust parentcos to avoid default on reputational risks, and the difficulty of applying remedies should there be messy fallouts.

For many trusts, our understanding is that they have sufficient equity capital for now to cover occasional cases of default and make their investors whole. Data from the China Trustee Association show that there was CNY9.06bn in reserves and CNY255.5bn in equity capital for the trust industry as of end-2013. Altogether, the CNY264.56bn is about 2.4% of the CNY10.91tn total AUM in the trust sector in China as of end-2013.

We also detail China's 68 trust companies and their parentcos. Among the total, 24 are essentially local government financing vehicles (LGFVs), 17 are held by central government-owned non-financial SOEs, five are held by local government-owned non-financial SOEs, 12 are funded by private investment and 10 are subsidiaries of financial institutions including banks, asset management firms and insurance companies.

The current distribution of ownership is the result of a few rounds of shuffles of the original holders of trust licenses, and their parentcos tend to have strong and recurring funding needs.

Fig. 5: Trust companies, parentcos, locations and classifications of parentcos

Trust company	Parentco	Owner's location	Owner's entity type
Bridge Trust	China Power Investment Financial	Beijing	Central SOE
China Foreign Economy and Trade Trust	Sinochem Group	Beijing	Central SOE
Great Wall Xinsheng Trust	China Great Wall Asset Management	Beijing	Central SOE
SDIC Trust	SDIC Capital Holding	Beijing	Central SOE
Huaneng Guicheng Trust	Huaneng Capital Service	Beijing	Central SOE
China Resources Szitic Trust	China Resources	Beijing	Central SOE
China Fortune International Trust	China Huadian	Beijing	Central SOE
Kunlun Trust	CNPC Assets Management	Beijing	Central SOE
Minmetals International Trust	Minmetals Capital Holdings Ltd	Beijing	Central SOE
Yingda International Trust	Yinda International Holding	Beijing	Central SOE
Zhonghai Trust	CNOOC	Beijing	Central SOE
Avic Trust	AVIC	Beijing	Central SOE
Cofco Trust	Cofco	Beijing	Central SOE
Zhongrong International Trust	Jingwei Textile Machinery	Beijing	Central SOE
China Railway Trust	China Railway Group Ltd	Beijing	Central SOE
Daye Trust	China Orient Asset Management	Beijing	Financial institution
Huarong International Trust	Huarong Asset Management	Beijing	Financial institution
CCB Trust	CCB	Beijing	Financial institution
China Jingu International Trust	China Cinda Asset Management	Beijing	Financial institution
China Credit Trust	PICC	Beijing	Financial institution
China Jiantou Trust	China Jianyin Investment	Beijing	Financial institution
Citic Trust	CITIC Group	Beijing	Financial institution
Beijing International Trust	Beijing State-owned Asset Management	Beijing	LGFV
Founder Bea Trust	Founder Group	Beijing	Local SOE
The National Trust Ltd	Fengyi Industrial Development	Beijing	Private investment
Sino-australian International Trust	Beijing Rongda Investment Limited Company	Beijing	Private investment
New Time Trust	New Time Yuan Jing (Beijing) Investment	Beijing	Private investment
China Minsheng Trust	China Ocean Wide Group	Beijing	Private investment
Hwabao Trust	Baosteel Group	Shanghai	Central SOE
Bank of Communications International Trust	BOCOM	Shanghai	Financial institution
LuJiaZui International Trust	Shanghai LuJiaZui Financial Development	Shanghai	LGFV
Shanghai International Trust	Shanghai International Group	Shanghai	LGFV
Anxin Trust	-	Shanghai	Private investment
Shanghai AJ Trust	Shanghai AJ	Shanghai	Private investment
Zhongtai Trust	-	Shanghai	Private investment
New China Trust	China New Industries Investment	Guangdong	Central SOE
Ping An Trust	Ping An Group	Guangdong	Financial institution
Dongguan Trust	Dongguan Finance Development	Guangdong	LGFV
Guangdong Finance Trust	Guangdong Finance Investment Holding	Guangdong	LGFV
Guolian Trust	Wuxi Guolian Development (Group)	Jiangsu	LGFV
Jiangsu International Trust	Jiangsu Guoxin Investment Group Ltd	Jiangsu	LGFV
Suzhou Trust	Suzhou International Development Group	Jiangsu	LGFV
Zijin Trust	Zijin Investment Group	Jiangsu	LGFV
Chang'an International Trust	Xi'an Investment Holding	Shaanxi	LGFV
Western Trust	Shaanxi Energy Group	Shaanxi	Local SOE
Shaanxi International Trust	-	Shaanxi	Private investment
Hangzhou Industrial & Commercial Trust	Hangzhou Investment Holding	Zhejiang	LGFV
Zheshang Jinhui Trust	Zhejiang International Business Group	Zhejiang	LGFV
Wanxiang Trust	China Wanxiang Holding	Zhejiang	Private investment
China Industrial International Trust Ltd	China Industrial Bank Holdings Ltd	Fujian	Financial institution
Xiamen International Trust	Xiamen Jincai Investment	Fujian	LGFV
Northern International Trust and Investment	Tianjin Teda Investment Holding	Tianjin	Local SOE
Tianjin Trust	Tianjin Hi-tech Holding	Tianjin	Local SOE
Anhui Guoyuan Trust	Anhui Guoyuan Holding (Group)	Anhui	LGFV
Chongqing International Trust	Chongqing International Trust Inv. Holding	Chongqing	Private investment
Gansu Trust	Gansu State-owned Asset Investment	Gansu	LGFV
Bohai Trust	HNA Capital Holding	Hainan	Local SOE
Zhongyuan Trust	Henan Investment Group	Henan	LGFV
Hunan Trust	Hunan Finance Investment Holding	Hunan	LGFV
Huachen Trust	Inner Mongolia State-owned Assets Supervision and Admin. Commission	Inner Mongolia	LGFV
Zhong Jiang International Trust	Department of Finance of Jiangxi Province	Jiangxi	LGFV
Jilin Province Trust	Department of Finance of Jilin Province	Jilin	LGFV
Huaxin Trust	Huaxin Huitong Group	Liaoning	Private investment
Shandong International Trust	Shandong Luxin Investment Holding	Shandong	LGFV
Shanxi Trust	Shanxi Guoxin Investment (Group)	Shanxi	LGFV
Sichuan Trust	Sino Hongda Group	Sichuan	Private investment
Tibet Trust	Department of Finance of Tibet	Tibet	LGFV
Yunnan International Trust	Department of Finance on Yunnan Province	Yunnan	LGFV

Source: Company data, Nomura research

According to statistics reported by Use-trust.com, trust assets grew by 78.8% on average in 2013. The National Trust, Wanxiang Trust, Great Wall Xinsheng Trust and Yunnan Trust grew by 599%, 489%, 457% and 189% respectively during 2013, leading the growth of the whole industry. Observation of the ranking of trusts' growth rates shows that trust companies of a smaller size tended to grow faster in 2013.

Fig. 6: Trust companies all over China categorised by their funding sources

Source: Company data, Mapsof.net, Nomura research

When to let market-driven default or asset liquidation occur?

As we know, the real economy businesses continue to face difficulties in accessing financing. The issue of rising financing cost for enterprises, especially SMEs, has been continually mentioned by Premier Li Keqiang in his recent speeches.

According to a financial sector contact we spoke to, recent targeted cuts in the RRR (April and June 2014) are aimed at channelling funding to banks that work closely with local communities and that are incentivised to help local enterprises in debt reorganisations. Specifically, in April 2014, PBOC announced a 200bp required reserve ratio (RRR) cut for rural commercial banks incorporated in counties and a 50bp RRR cut for rural cooperative banks incorporated in counties. On 10 June 2014, the PBOC announced a targeted 50bp RRR cut for banks engaged in proportionate lending to agricultural and small firms and not covered in the April RRR cut. There could be additional targeted easing in monetary policies in the coming months.

To us, stability appears to be the over-riding political objective for Beijing. Hence large-scale credit defaults or private-sector bankruptcies are ruled out. While not widely reported by the press, there are continuous efforts by financial institutions to rid their problematic assets, sometimes via direct write-offs. Furthermore, breaking the guarantee on principal is perhaps ultimately necessary to instil a sense of risk awareness so that investors don't send more money toward bad investments refinancing old borrowing with new borrowing, or to repay their loans, but to delay the final day of reckoning.

Here, new regulatory efforts are under way to offer guidance on separating liabilities between commercial banks and trust companies on jointly issued trust products. This may make it easier to execute potential credit defaults. On 10 April 2014, CBRC published the Directive on Issues Related to Adjustments of Equity Capital Calculation (Draft for Comments) 《关于调整信托公司净资本计算标准有关事项的通知（征求意见稿）》. This directive aims to separate trust's responsibility when acting as a conduit (or passive sales agent), or acting as a principal in performing all deal related due diligence. Although the directive only applies to new business generation, we think that the principles it defined will help dispute resolution in existing businesses.

Could coal/commodity be the next weak link?

As we speak, more boom-town shenanigans are being uncovered in the commodities trading area. For example, On 2 Jun 2014, Metal Bulletin, a news agency focusing on metals, reported the investigation of Qingdao Port commodity financing fraud related to iron ore, aluminium, and copper. One month later, on 3 Jul 2014, Reuters reported investigation of fraud related to petrochemical imports in Tianjin Port.

Indeed, we wonder if trusts backed by mining assets could be something to watch out for, particularly, for example, in the coal space.

- First, mining rights used as collateral for trusts are subject to appraisals that may face substantial write-off;
- Second, by end 2Q14, the Qinhuangdao 5500kc FOB steam coal spot price had dropped 23.9% from the mid-2012 level vs. a relatively modest decline of 7.4% from mid-2010 to mid-2012. While the 7.4% drop in coal price likely did not pose much threat on refinancing capacity of coal trusts two years ago, a 23.9% decline most likely is problematic.

We show in the figure below the 16 publicly disclosed coal-related trusts that face maturity in 2014. Assuming that the problematic enterprises involved in existing trust defaults in 1H14 remain problematic in 2H14, we note there could be seven more trust product defaults in 2H14, in addition to the nine in 1H14. Among the total of 16 cases, 14 are related to mining projects or companies in the mining business.

Fig. 7: Publicly disclosed coal mine trusts maturing in 2014

Due date	Scale (CNYmn)	Borrower	Trust	Underlying asset	Region
31-Jan-14	3000	Zhenfu Energy 振富能源	China Credit	Coal mine	Shanxi
7-Feb-14	289	Liansheng 联盛	Jilin	Coal mine	Shanxi
19-Feb-14	100	Liansheng 联盛	Jilin	Coal mine	Shanxi
21-Feb-14	500	Liansheng 联盛	Shanxi	Coal mine	Shanxi
6-Mar-14	N/A	Yuetai 粤泰	Pingan	Commercial enterprise (real estate, mining)	Guangdong
11-Mar-14	109	Liansheng 联盛	Jilin	Coal mine	Shanxi
31-Mar-14	196	Maijike 麦吉可	Citic	Real-estate	Chongqing
14-May-14	1500	Liansheng 联盛	Zhong Jiang Intl.	Coal mine	Shanxi
30-May-14	140	Nonggeshan 农戈山	China Credit	Lead zinc mine	Sichuan
25-Jul-14	1300	New North 新北方	China Credit	Coal mine	Shanxi
27-Jul-14	319	Hongsheng 宏盛	Huarong	Coal mine	Shanxi
7-Sep-14	400	Zhengda Investment 证大投资	CCB	Finance	N/A
10-Sep-14	N/A	Yuetai 粤泰	Jilin	Commercial enterprise (real estate, mining)	Guangdong
16-Nov-14	200	Liansheng 联盛	Chang An	Coal mine	Shanxi
20-Nov-14	600	Liansheng 联盛	China Jiantou	Coal mine	Shanxi
23-Dec-14	1140	Dewei Coal 德威煤业	China Resources	Coal mine	Shanxi

Source: Aastocks.com

As reported by China Business News (CBN) on 4 Jul 2014, the financial situation of New North started to deteriorate in 2Q13. Due to unfavourable local government policies and the slow approval process, the integration and reconstruction of five coal mines under New North have progressed very slowly, eventually leading to difficulties in their business operation. We note that trust products in trouble, including China Credit Trust's CNY3bn investment in Zhenfu Energy and Jilin Trust's CNY1bn investment in Liansheng, are criticized for being involved in the channel business. Critics quoted by

CBN say that the trust companies had low willingness to actively manage their investments when acting as channels, while the banks acting as principal were unwilling to take responsibility either. Therefore, some believe that the channel business model contributes to trust defaults as well.

What about property trusts?

According to the China Trustee Association, 28% of the total dollar value of China's trusts is invested in commercial enterprises, 25% in infrastructural projects, 10% in real estate and less than 40% in securities, financial institutions and others. Data from Wind, which track about 5-10% of all trusts on a forward-looking basis, suggest that about 60% of the infrastructure trust products due in 2014 are backed by LGFVs, while only 14% of the property trusts are backed by LGFVs.

Investors are aware that a sharp decline in real estate prices would have a ripple effect on China's economy: we may see a tightened bank loan market, which, in turn, causes shortfalls of capital needed by enterprises, triggering default on loans among private enterprises and private sector bankruptcies. Our checks with industry contacts suggest two things.

- First, only developers qualified as class 1 or class 2 developers can pass the background checks of most trust companies, and this universe consists of higher-quality developers than the sector average.
- Second, while listed developers have preferred access to funding for the most part, and those developers that are lightly leveraged should be able to cope with the current adjustment period in the physical property market, the problem child tends to be those mid-tier developers that have aggressively levered up in the past several years to make it to the IPO market. Some of the small developers may also see stress from tightened bank loans and high cost of financing from the private sector.

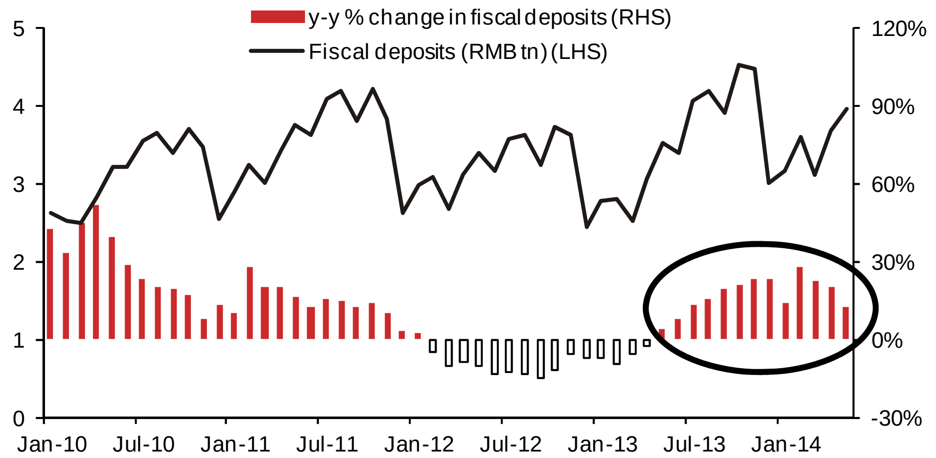
According to data published by the China Trustee Association, China's real estate trust assets grew by CNY146.2bn in 1Q14 vs. by CNY153.2bn in 1Q13 (-4.6% y-y) and CNY209.7bn in 4Q13 (-30.28% q-q). Data from use-trust.com show that CNY178bn in collective-fund real estate trust products are coming into maturity this year, including CNY36.8bn in 1Q14, CNY43.9bn in 2Q14, CNY44.5bn in 3Q14 and CNY52.8bn in 4Q14.

LGFVs should be relatively safe

We noted in our 3 June report (Be defensive and selective) that we think Beijing has put its foot down and is now holding local governments responsible for paying down their own debt with cash on hand or asset sales. Setting aside the recently reported Qilu Bank LGFV default, the first LGFV default we know of, we think that LGFV defaults overall are likely to be limited as they would carry reputational risk for the local governments as well as the central government ultimately.

In the following figure, we note y-y increases in the dollar value of fiscal deposits since 2H13. China's fiscal deposits experienced a similar growth to 2011 but China's economic growth rate since 2H13 has been much lower compared to three years ago.

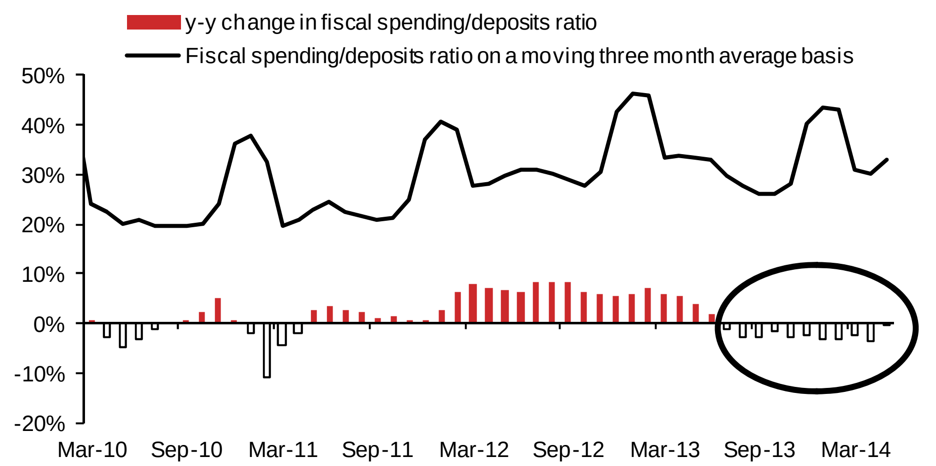
Fig. 8: Chinese governments growing fiscal deposit since 2H13



Source: PBOC, Nomura research

We also note the ratio of total fiscal spending to total fiscal deposits has declined since mid 2013. These two sets of data combined seem to indicate that the central and local governments are saving more and spending less.

Fig. 9: Chinese governments tightening their belts since 2H13



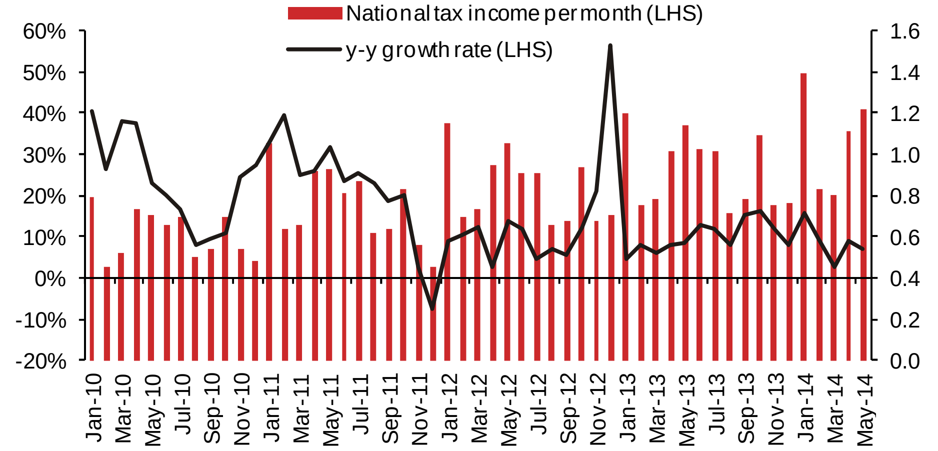
Source: PBOC, Wind, Nomura research

Note: PBOC only discloses aggregate Jan-Feb fiscal income and spending figures each year. We divide the two-month figures equally to extrapolate per-month data in Jan and Feb

Despite the various tax relief measures implemented in 1H14, national tax income per month has remained stable so far. Anecdotally, we have heard from local government officers and business people during our ground-check trips that tax bureaus around China have been combing through tax payers with a fine toothcomb and have intensified tax collection efforts.

Fig. 10: National tax income per month

CNY tn



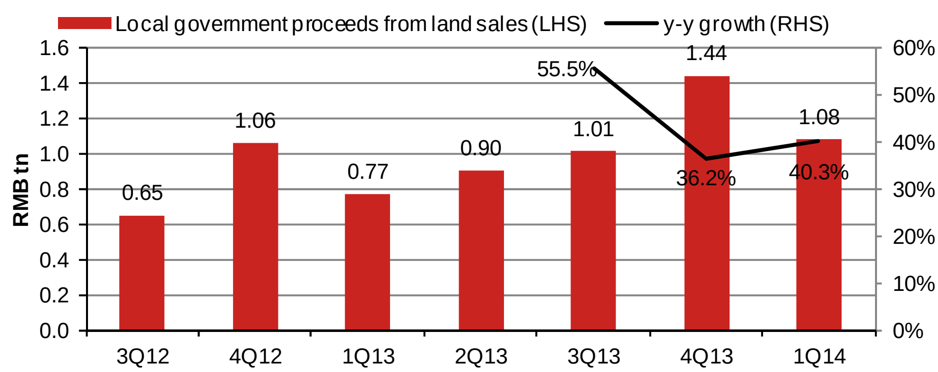
Source: Wind data, Nomura research

In February 2014, Premier Li requested for a thorough auditing survey on all public funds, state-owned assets and state-owned resources. He emphasized the importance of the survey again in the State Council executive meeting on 2 July 2014 and asked for a final audit result and rectification of inappropriate practices by end-October this year.

As of end April 2014, there were CNY3.7tn fiscal deposits in total including both central and local governments. "We have a lot of fiscal funds in stock in bank accounts of local and central governments and some of those have been idle for a very long period and should be utilised", said Premier Li, "we must wake those idle deposits up and utilise them in the most-needed way to promote economic development and improvement of people's living standards."

While the government has been cutting expenses and raising revenue, we see downside risk in weakening land sales. According to the latest report published by the China Real Estate Information System (CREIS), land sales fell in 2Q14 across 300 Chinese cities amid concerns on property market cooling off. If this trend continues, then local governments' capacity to pay down debt going forward may be limited. As a rule of thumb, we estimate that local governments may keep 30% of land proceeds for debt repayment. So, if total land sales can reach CNY2.4tn (-41.7% y-y) in 2014, CNY800bn can be used to refinance debt, representing a third of the CNY2.4tn LGFV debt due in 2014.

Fig. 11: Local government proceeds from land sales



Source: Wind data, Nomura research

Fig. 12: Land sales fell in 2Q14 amid concerns on property market cooling off

	Indicator	Land for sales (mn m^2)	Transaction area (mn m2)	Land sales proceeds (CNY bn)	Average price (CNY/m^2)	Price premium
1H14	Absolute amount	659	536	1241	1245	13%
	y-y growth rate	*-16%*	*-20%*	*0.1%*	*21%*	*-1%*
1Q14	Absolute amount	342	289	717	1330	13%
	y-y growth rate	*-3%*	*-11%*	*15%*	*25%*	*0.20%*
2Q14	Absolute amount	317	248	524	1136	12%
	y-y growth rate	*-26%*	*-29%*	*-15%*	*13%*	*-3%*

Source: CREIS

Moreover, it is reported by STCN, a financial news agency in China, that China's National Council for Social Security Fund issued the Temporary Measures on Social Security Fund's Loan Investment into Trust Products **《全国社会保障基金信托**贷款投资管理暂行办法》, effective from 16 June 2014. According to the report, a maximum of CNY500bn of social security funds can be invested into infrastructure trust products, amounting to 18% of the balance of infrastructure trust products due as of end-1Q14. This should also help alleviate the financing risks of LGFVs.

Over the next several years, more local governments will be allowed to issue their own debt with MOF's guideline on ending balance metrics by 2016. Such issuances will be used to fund new projects/spending, not to replace current debt. If and when the new Budget Law passes, local governments will be allowed to issue short-term debt also.

SHIBOR: too rosy of a picture on liquidity conditions?

Many investors have pointed to the relatively stable SHIBOR as a sign of liquidity aplenty in China. In our view, the current level of the SHIBOR likely overstates the liquidity conditions and is a function of moderating growth in interbank assets, outpaced by sharp supply growth of interbank funding, e.g., money market funds and wealth management products.

Interbank assets' moderating growth

Growth in China's inter-bank assets took off in 2011 and 2012, and eased slightly in 2013 upon tighter regulatory oversight. As of end-2013, inter-bank assets totaled CNY21.5tn (22.3% y-y) vs. CNY17.6tn (37.2% y-y) as of end-2012 and CNY12.8tn as of end-2011.

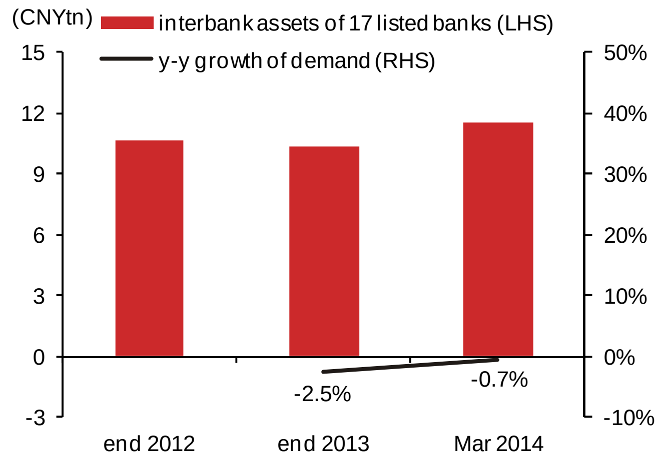
In Fig. 13 and Fig. 14, we use data on interbank assets of the 17 listed banks to model the growth rate of demand for interbank funds, and use data on MMFs and WMPs to model the growth rate of supply of interbank funds, given that we do not have sufficient data points for the whole industry. We find supply of interbank funds grew rapidly on a y-y basis while demand for interbank funds experienced a y-y decline.

At the individual bank level, the growth rate of interbank assets varies among different banks. We note that among the top-8 big players in the interbank market back in 1Q13, all but Bank of China (BOC) have reduced the size of their interbank assets. By contrast, among the bottom-9 players in the interbank market in 1Q13, all but China Everbright Bank (CEB) have increased the size of their interbank assets.

- Four-big banks – BOC (+42.4%) was the only one whose interbank assets grew from 1Q13 to 1Q14, while the other three experienced y-y declines in their interbank assets in the same period (ABC: -7.3%, ICBC: -20.3% and CCB: -1.7%).
- Commercial banks – Interbank assets decreased y-y in 1Q14 for CIB (-0.9%), Minsheng (-35.9%), SPDB (-16.9%) and CEB (-11.1%), but increased y-y for CMB (+33.4%), CITIC (+20.2%), Ping An (+1.6%) and Huaxia (+16.7%).
- City & rural commercial banks – CQRB (+24.7%), Bank of Ningbo (+18.7%) and Bank of Nanjing (+15.8%) all experienced y-y growth in their interbank assets in 1Q14.

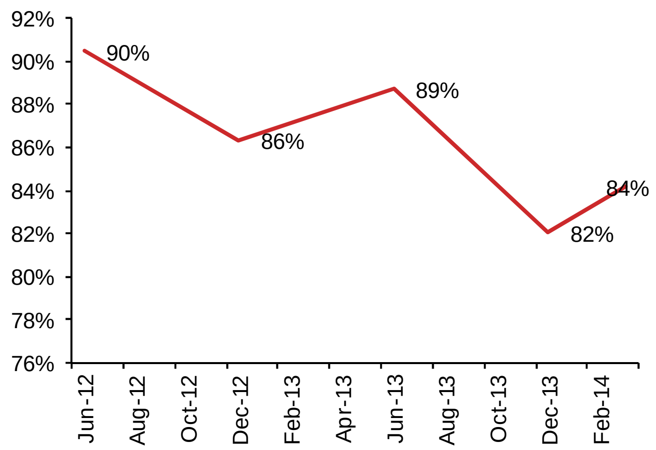
Below right, we show that as of June 2013 the asset/liability ratio on interbank assets held by 17 listed banks in China was 0.89. Amid strong regulatory pressure, this inched down to 0.82 as of end-2013 but rebounded slightly to 0.84 as of end March 2014.

Fig. 13: Demand for interbank funds moderating



Source: PBOC, Nomura research

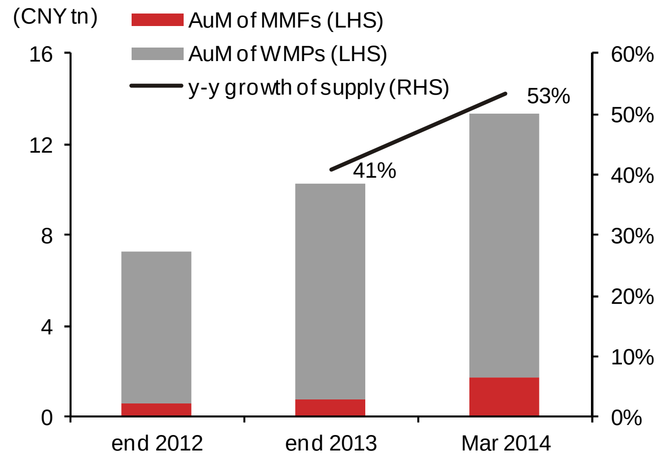
Fig. 14: Interbank asset & liability ratio of 17 listed banks



Source: Company data, Nomura research

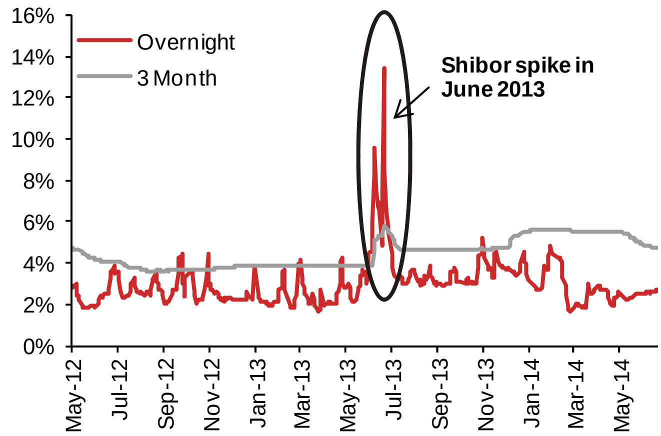
Fig. 15: Supply of interbank funds ramping up

CNY tn



Source: PBOC, CBRC, AMAC, 21st Century Business Herald, Nomura research

Fig. 16: Trajectory of SHIBOR rates



Source: CEIC, Nomura research

Supply to interbank liquidity on the rise: WMPs and MMFs

The total dollar amount of outstanding wealth management products (WMPs) continued its upward trend in 2013 and the first four months of 2014. As of end April 2014, there was CNY13tn in outstanding WMPs in China, as estimated by Mr Wang Yanxiu, Director of Innovation at CBRC, meaning that WMPs grew their assets by ~CNY5tn from end June 2013 to end April 2014. We estimate that ~20% of the WMP assets are directly invested in trust products and the remaining ~80% are invested in other financial products, including bonds and interbank deposits. Supposing 30% of WMP assets go to interbank deposits, incremental interbank liquidity from mid 2013 would be ~CNY1.5tn.

- Money market funds (MMF) have also taken off since mid 2013. Alibaba's Yuebao and the likes have attracted ~CNY1.5tn in new money from investors in the past 10 months, growing the total net asset value (NAV) of MMFs by five times from ~CNY0.3tn as of end June 2013 to ~CNY1.8tn as of end April 2014. The strong growth of MMFs outpaced the growth of interbank assets thus has injected additional liquidity into the interbank market.
- Take 1Q14, for example, NAV of MMF grew by 95% while interbank assets of the 17 listed banks grew by only 11%. As estimated by Mr Wang Qunhang, Director of Ji An Financial Information Center, ~50% of MMF assets are invested in interbank deposits, while the rest either remain as cash and cash equivalents or are invested in bonds with maturity of less than 397 days, central bank bills with maturity of less than one year and repo agreements.

This estimate may be conservative, in our opinion, considering that Yuebao's 92% investment in negotiated deposits, and Yuebao alone has a NAV of ~CNY7,000bn. Even based on the 50% investment ratio, MMFs added ~CNY0.8tn incremental liquidity into the interbank market in the 10 months from June 2013 to April 2014.

Rising demand for bank loans

The shift from off-balance-sheet financing back to on-balance-sheet financing which then become subject to lending quota, RRR and LDR requirements is also reflected in the decrease in entrusted loans and trust loans. For example, inflows of trust loans posted consecutive high double digits y-y declines from Aug 2013 to May 2014. Another form of popular off-balancing financing back then, undiscounted banker's acceptance, also posted consecutive y-y declines from June 2013 to May 2013. Another example, inflows of CNY loans expanded on a y-y basis from July 2013 to February 2014, only to drop slightly by low single digit in Mar and Apr 2014 before growing by 30% in May 2014.

This off-balance sheet to on-balance sheet shift and banks' more tempered enthusiasm over off-balance sheet product is the result of formalized supervision of such products by the CBRC and PBOC, since late 2012. The latest directives, the #127 Directive 《关于规范金融机构同业业务的通知》and the #140 Directive 《关于规范商业银行同业业务治理的通知》issued on 16 May 2014, continue to push in the same direction.

Fig. 17: Breakdown of TSF monthly flows

	TSF		CNY loans		Entrusted loans		Trust loans		Undiscounted bankers' acceptance		Others	
	CNY bn	y-y %	CNY bn	y-y %	CNY bn	y-y %	CNY bn	y-y %	CNY bn	y-y %	CNY bn	y-y %
13-Jun	1038	-41.70%	863	-6.20%	199	152.40%	121	22.20%	-262	-184.00%	116	-64.40%
13-Jul	819	-22.20%	700	29.50%	193	50.70%	115	200.10%	-178	-914.60%	-11	-103.70%
13-Aug	1584	27.00%	713	1.30%	294	180.90%	121	-2.40%	305	-460.40%	152	-57.00%
13-Sep	1412	-14.20%	787	26.40%	222	53.10%	113	-43.80%	-8	-103.70%	298	-29.00%
13-Oct	865	-33.00%	506	0.10%	183	94.90%	43	-70.10%	-35	-147.40%	167	-61.90%
13-Nov	1231	9.70%	625	19.60%	270	122.10%	101	-44.20%	6	-112.30%	229	-22.80%
13-Dec	1253	-23.00%	482	6.10%	273	31.20%	111	-57.20%	168	-36.30%	219	-41.50%
14-Jan	2598	2.10%	1319	23.00%	394	91.30%	106	-49.80%	490	-15.50%	288	-32.80%
14-Feb	937	-12.50%	645	4.00%	80	-44.00%	75	-59.10%	-142	-22.20%	280	1.00%
14-Mar	2093	-17.90%	1050	-1.20%	241	38.00%	107	-75.20%	225	-17.50%	470	-15.90%
14-Apr	1554	-11.90%	775	-2.20%	158	-18.20%	42	-78.50%	79	-64.50%	501	58.60%
14-May	1405	17.90%	871	30.10%	206	4.90%	12	-88.10%	-96	-15.90%	412	44.50%

Source: PBOC, Nomura research

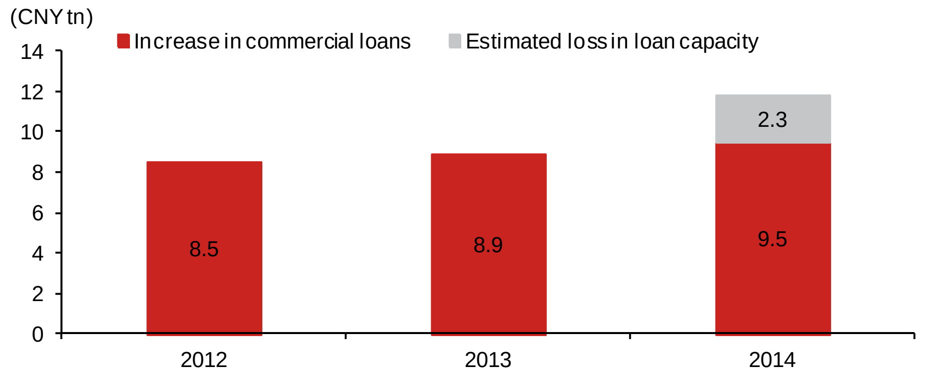
Moderating supply of bank deposits

While WMPs and MMFs altogether have contributed more than CNY2.3tn additional liquidity to the interbank market in the past year, their fast development has cost banks capacity to generate regular commercial loans.

Admittedly, interbank deposits may be circulated back to the on-balance-sheet system, but we expect a smaller money multiplier for interbank deposits to generate loans than that for regular deposits due to higher currency drain rate (currency drain happens when deposits are withdrawn from the banking system without being re-deposited into banks). This is because 1) not all interbank deposits will be invested into the real economy so that part of them will be kept within the interbank market, and 2) for the portion invested into the real economy, e.g. interbank deposits invested in trust products, we expect a more prolonged process for them to be re-deposited as regular deposits in banks.

In Fig. 18, we estimate on likely commercial loan generation capacity lost due to diversion of regular bank deposits to interbank deposits. Though these are back-of-the-envelope estimates and we are estimating theoretic capacity lost vs. efficient capacity lost (adjusted for individual bank's LDR and, etc.), we think that they can point us to the right direction. At the moment, the money multiplier is around 4 in China. Assuming that the money multiplier is 3 for interbank deposits, then CNY2.3tn of loan generation capacity is removed. To put this into context, China's full-year bank lending was 8.5trn in 2012 and Rmb8.9trn in 2013, and may reach Rmb9.5trn in 2014 per Nomura estimate.

Fig. 18: Estimated reduction in theoretical commercial loan generation capacity due to diversion of regular deposit to interbank deposit: CNY2.3trn



Source: PBOC, CBRC, AMAC, Nomura research

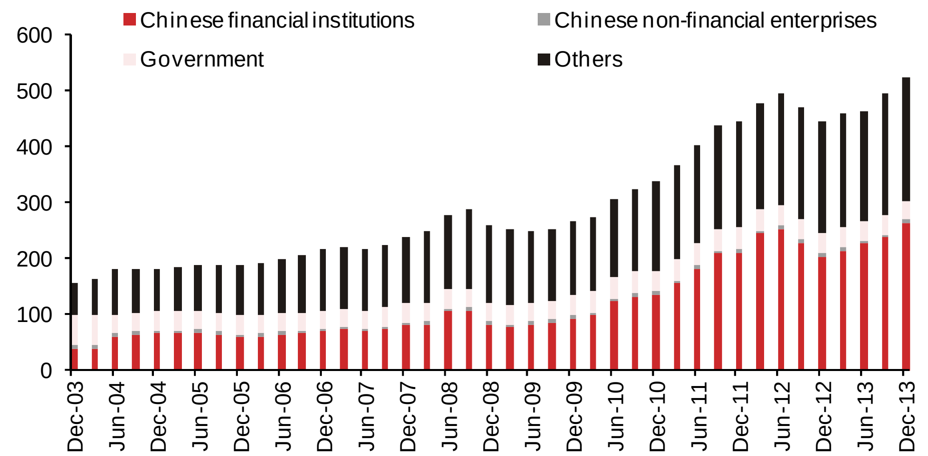
Rising FX and offshore CNY financing by Chinese entities

Chinese corporations have been actively seeking overseas financing in the past year in order to overcome funding constraints in mainland China. Various kinds of debt financing tools denominated in both CNY and foreign currencies including notes, interbank debentures, subordinate bonds and certificates of deposits (CD) have been actively employed.

- **Rising borrowing of FX debt by Chinese entities.** We see re-acceleration in FX debt balance since late 2012. Due to low costs of debt financing in the US and euro zone, USD/EUR-denominated bonds are becoming increasingly popular. According to Bloomberg data, as of 13 June 2013, there are USD232.5bn outstanding USD/EUR-denominated offshore debts issued by Chinese enterprises, among which USD60.6bn or 26% was issued YTD 2014 and USD75.3bn or 32% was issued in 2013.

Fig. 19: Outstanding balance of FX debt in China

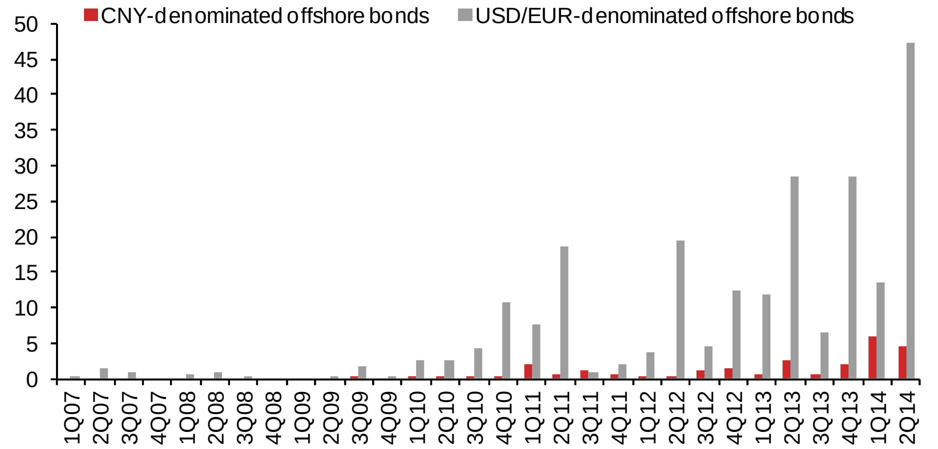
USD bn



Source: SAFE, Nomura research

- **Rising borrowing of offshore CNY.** In addition, there is USD24.1bn outstanding CNY-denominated offshore debt issued by Chinese corporations, among which USD10.4bn or 43% was issued YTD 2014 and USD5.9bn or 24% was issued in 2013.

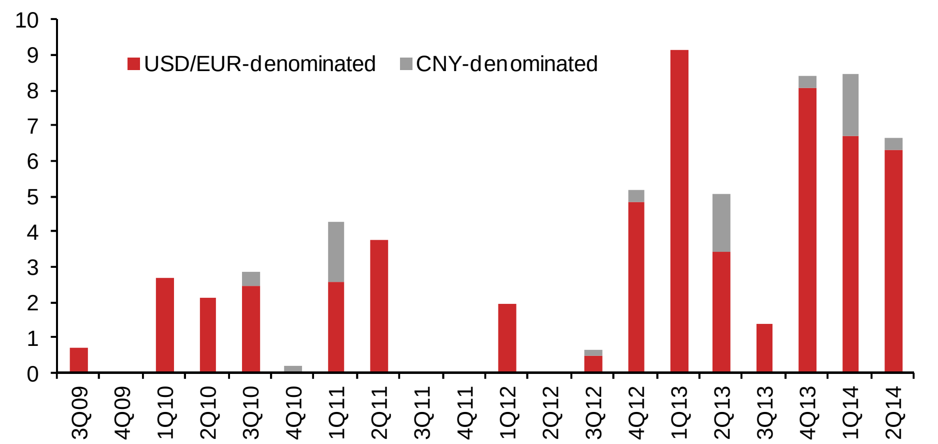
Fig. 20: Rising quarterly issuance of offshore CNY bonds since 2007
USD bn



Source: Bloomberg data, Nomura research

- **Chinese real estate developers** have been active in issuing bonds abroad in the past few years, finding it a cheap access to long-term capital. The group alone has issued USD56.9bn USD/EUR-denominated bonds since 2009, amounting to almost a quarter of the total value of USD/EUR-denominated bonds issued since 1997. As most of these bonds have a maturity of five years, we may see a peak of bonds maturing throughout 2018 and 2019. According to data provided by Bloomberg, a BBB-rated plain vanilla 5-year bond typically costs a coupon rate of ~4.5% and a not-rated plain vanilla 5-year bond typically costs a coupon rate of ~7.5%. Callable bonds are generally more expensive as we see a not-rated callable 5-year bond can cost a coupon rate of more than 11%. By contrast, total costs for real estate developers using trust financing may reach mid to high teens, if not higher based on our checks.

Fig. 21: Offshore bonds issued by Chinese real estate developers per quarter
USD bn



Source: Bloomberg data, Nomura research

- **Chinese banks** have been a rising force in using overseas financing since mid 2013. Facing increasing competition from money market funds and other investment products sold online, banks are eager to explore cheaper funding sources in addition to the traditional domestic savings whose growth rate is slowing down.

Buffering the downside

Premier Li Keqiang's overall tone: utilise the existing stock well…

Ever since June 2013, Premier Li Keqiang has talked about making good use of "existing stock" to support development of the real economy. Reflected in monetary policies, the emphasis over utilizing the existing stocks has meant a relatively cautious/prudent stance in terms of benchmark interest and total social financing (TSF) growth. For example, the benchmark interest rate stayed high despite moderating GDP growth.

Fig. 22: China's GDP growth vs. real interest rates (RI)

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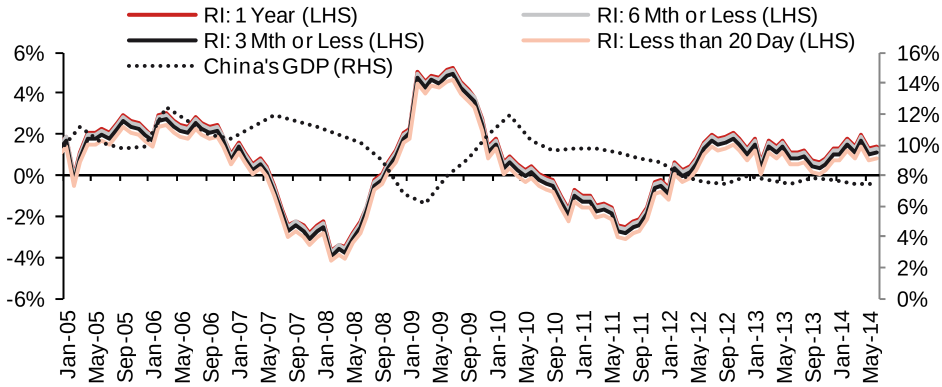
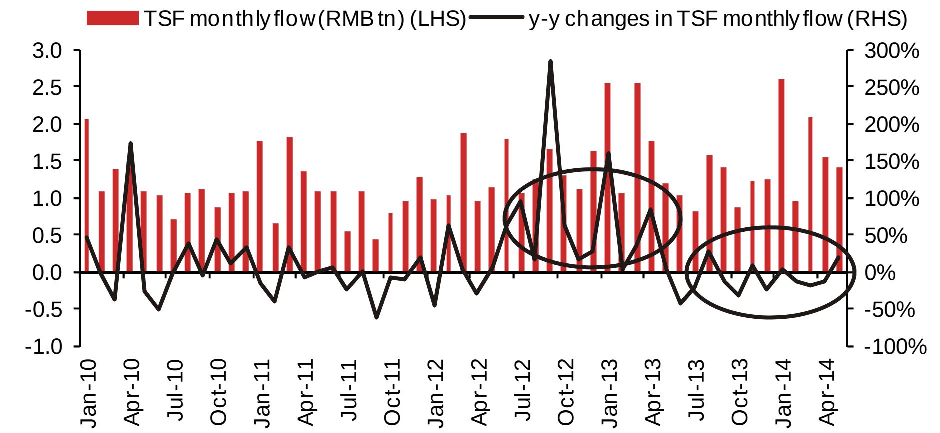


Source: Bloomberg data, Nomura research

On TSF, Y-Y monthly inflow growth rate surged in 3Q12 and stayed mostly positive through 1Q13 to accommodate a smooth hand-off of the central government to the new administration. But since 3Q13, the Y-Y TSF growth rate has declined and remained at a low level, fluctuating up and below 0%.

Fig. 23: TSF monthly flows



Source: PBOC, Nomura research

Monthly lending quota to allow precise liquidity management

The PBOC and CBRC this year have been setting monthly lending quotas for banks, instead of annual quotas. This, we believe, is aimed at managing system liquidity with precision, so as apply just the appropriate amount of fixes to ease liquidity constraints without courting inflationary pressure. We expect this monthly quota practice to stay in place for some time as financial stability is the over-riding priority.

Financial sector reforms pushed out

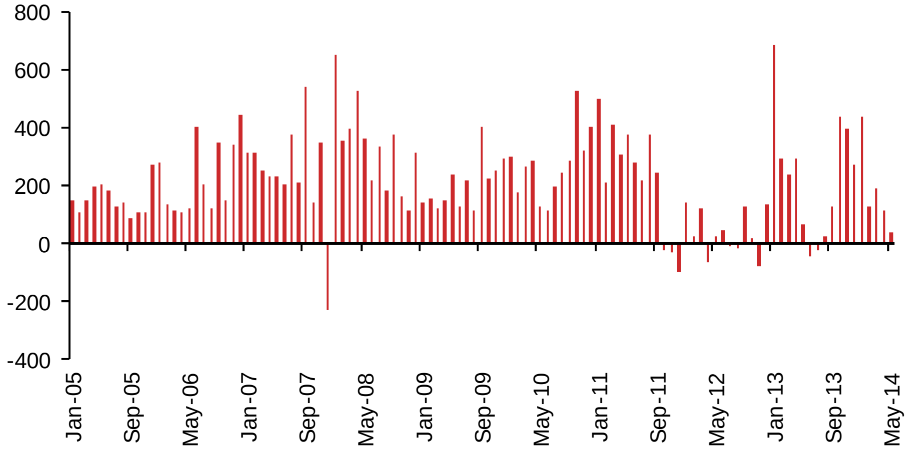
We understand that the deposit insurance is still possible for later in 2014. But given the over-riding priority of ensuring financial stability, the actual pace of implementation of deposit insurance and deposit interest rate liberalization could be pushed out further if needed. Indeed, some observers say that to accommodate the deposit insurance implementation alone may requires several hundred bps of reduction on the RRR simultaneously.

More targeted easing or across-the-board RRR cut likely

As of 31 Mar 2014, China has US$3.94tn in FX reserves. With moderating FX inflow in recent quarters, the PBOC has now gained more independence in its monetary policies. Assuming that relatively moderate FX inflows become the norm, there is more need for the PBOC to cut its RRR sometime in 2014. Our China economics team estimates that all the targeted RRR cuts may add to an equivalent 50bp cut in RRR for the whole banking sector (China: PBoC announces details of targeted RRR cut). Our China economics team forecasts a 50bp RRR cut in 3Q14 (China: Raising our 2014 GDP growth forecast to 7.5%).

Fig. 24: Change in funds outstanding for foreign exchange per month

CNY bn



Source: PBOC, Nomura research

Portfolio: stay selective and defensive

YTD, the average return of picks in our model portfolio was 3.3% vs. 2.2% on the MSCI-China. In our model portfolio, we take profit in China Railway Group, Lenovo, and Sunny Optical, and trim Huaneng Renewable. We add AIA, Huadian Fuxing, Pacific Textile, and Shenzhou Int'l while keeping cash level in the portfolio at 5.5%.

Equity model portfolio additions

AIA (1299 HK, Buy) (covered by David Chung, david.m.chung@nomura.com): We remain AIA is preferred stock within our life insurance coverage, given its strong solvency position, low leverage and the higher adjusted net worth in its EV. We expect continued strong momentum of VNB growth driven by both expanding margins and volume in its upcoming 1H14 results while there may be upside surprise in VNB growth likely coming from margin expansion.

Huadian Fuxin (816 HK, Buy) (covered by Joseph Lam, joseph.lam@nomura.com) We add Huadian Fuxin to our model portfolio due to 1) a diversified generation portfolio which reduces the impact of any wind speed volatility; 2) both the coal-fired and hydropower generation performing well YTD, with unit fuel cost drop by around 10% YTD; and 3) unit 1 of the Fuqing nuclear project will be commissioned in July/August, in line with previous guidance and can clear market concern of any project delay. Units 5 and 6 may receive government's approval soon, as China National Nuclear Power Co. recently performed preliminary preparatory work for the two units.

Pacific Textile (1382 HK, Buy) (covered by George Hsu, george.hsu@nomura.com) We add Pacific Textile to our model portfolio as the company has a close relationship with Uniqlo as it has 50%+ sales exposure to the brand and our analyst believes Pacific Textiles' niche in inner wear products has helped it sustain a stable net profit margins at low-teens and a steady dividend payout ratio (50%+ since listing). We also think the 6%+ dividend yield and improved production efficiency should lend the support to the stock price.

Shenzhou Int'l (2313 HK, Buy) (covered by George Hsu, george.hsu@nomura.com) Shenzhou has a competitive edge in its integrated platform to offer innovative fabrics for key customers (Nike, Adidas, etc.), in our view. Therefore, it can tap into the growth opportunities of these brands' new products and defend high-teens net profit margins. The capacity expansion plan in Vietnam should give it another leg of growth once the whole project completes in 2016.

Equity model portfolio removals

China Railway Group (390 HK): We remove China Railway Group from our model portfolio as we prefer railway equipment manufacturers over railway infrastructure names. We maintain our exposure in the railway equipment space via CSR (1766 HK).

We swap **Huaneng Renewable (958 HK, Buy)** to Huadian Fuxin, mainly due to 1) risk of Huaneng Renewable missing 1H14 consensus estimates, given weak wind speed during 1H14 (except for May), and 2) potential dilution risk given the current high gearing level as well as strong capacity growth ahead.

Lenovo (992 HK): We expect Lenovo will continue to outperform global PC industry in 2014 driven by marketing share gain in consumer PC in EMEA and America and larger exposure to enterprise PC comparing with its peers. We expect Lenovo to close the acquisition of Motorola Mobility and IBM's server business on time. In short term, recent share price rally has largely priced in those upside already in our view.

Sunny Optical (2382 HK): We remain positive on the long-term growth outlook on Sunny Optical especially in smart car and handset lens. But in short term, we expect Sunny's margin to decline in 1H14 due to Sunny's aggressive marketing strategy in handset camera module business.

Fig. 25: Model portfolio from 3 June to 8 July 2014

Name	Ticker	Rating	Share price (08-Jul-14)	Market cap (US$m)	3mth avg daily T/O (US$m)	2014F PE (x)	2015F PE (x)	2014F PB (x)	2014F Dvd yield (%)	Performance from 3-Jun-14 to 8-Jul-14
Consumption										
Great Wall Motor	2333 HK	Buy	30.40	12,799	46.1	7.1	5.9	2.1	4.2	-4.6%
Energy										
Anton Oilfield	3337 HK	Buy	5.34	1,522	5.8	20.0	14.8	3.5	1.6	-6.2%
COSL	2883 HK	Buy	19.54	13,005	19.4	10.4	9.0	1.6	2.9	-1.3%
PetrChina	857 HK	Buy	9.80	223,264	84.9	10.5	10.5	1.2	4.3	4.9%
Industrials										
China Railway Group	390 HK	Buy	4.04	9,386	7.7	8.9	n/a	0.8	1.7	11.6%
CSR Corp	1766 HK	Buy	6.54	10,653	14.5	12.5	10.3	2.2	2.4	12.4%
Materials										
Lee & Man Paper	2314 HK	Buy	4.15	2,505	2.5	10.0	8.7	1.1	3.6	5.6%
Technology										
BYD Company	1211 HK	Buy	46.90	17,927	31.0	58.0	36.0	3.8	n/a	23.3%
Lenovo	992 HK	Neutral	10.76	14,450	46.4	17.3	14.4	5.1	2.3	8.7%
Sunny Optical	2382 HK	Buy	11.06	1,566	9.6	15.3	12.4	2.7	2.0	12.4%
ZTE Corp	763 HK	Buy	15.66	7,275	7.7	16.3	13.1	1.8	1.8	3.6%
Internet										
Baidu **	BIDU US	Buy	188.00	65,877	601.3	32.2	22.1	7.9	n/a	14.9%
Telecom										
China Mobile	941 HK	Buy	76.15	199,523	164.1	12.0	12.6	1.4	3.6	-1.0%
China Unicom	762 HK	Buy	12.30	37,837	52.7	18.5	16.8	1.0	2.0	5.3%
IPP & Gas										
China Resources Gas	1193 HK	Buy	24.45	7,016	8.1	18.6	15.0	3.4	1.1	0.2%
Datang International	991 HK	Buy	3.73	7,912	3.6	8.0	6.3	0.8	4.1	21.5%
Huaneng Power	902 HK	Buy	9.12	14,172	19.1	9.9	9.6	1.5	5.4	13.6%
Utilities										
Beijing Enterprise Water	371 HK	Buy	5.32	5,943	12.4	26.6	19.9	3.1	1.3	6.4%
Canadian Solar **	CSIQ US	Buy	29.73	1,595	94.6	7.3	4.8	2.0	n/a	18.5%
China Everbright International	257 HK	Buy	11.46	6,630	13.7	25.9	20.8	3.4	1.1	8.5%
Huaneng Renewable	958 HK	Buy	2.46	2,866	8.0	11.9	8.9	1.2	1.6	-5.0%
Cash - 5.5% of the portfolio										
Average return *										**6.9%**
MSCI China *										**4.5%**
Average return since initiation *										**59.6%**
MSCI China since 31-Jul-12 *										**23.8%**

Note: * Prices as of 7 July 2014. ** Share prices as of 7 July 2014 and share prices are in USD.

Prices as of 8 July 2014. Transaction costs not included in returns. Past performance should not and cannot be viewed as an indicator of future performance. Complete record upon request. For changes in the portfolio over time and calculation of returns, see http://www.nomura.com/research/GetPub.aspx?pid=335789. For the most recent changes in the portfolio, see our 3 June 2014 report: Be defensive and selective

Source: Bloomberg, Nomura estimates

Fig. 26: Model portfolio as of 9 July 2014

Name	Ticker	Rating	Share price (08-Jul-14)	Market cap (US$m)	3mth avg daily T/O (US$m)	2014F PE (x)	2015F PE (x)	2014F PB (x)	2014F Dvd yield (%)
Consumption									
Great Wall Motor	2333 HK	Buy	30.40	12,799	46.1	7.1	5.9	2.1	4.2
Pacific Textile	1382 HK	Buy	9.76	1,822	1.6	12.7	11.1	3.3	5.9
Shenzhou International	2313 HK	Buy	27.00	4,874	5.5	14.0	12.2	2.5	3.2
Energy									
Anton Oilfield	3337 HK	Buy	5.34	1,522	5.8	20.0	14.8	3.5	1.6
COSL	2883 HK	Buy	19.54	13,005	19.4	10.4	9.0	1.6	2.9
PetrChina	857 HK	Buy	9.80	223,264	84.9	10.5	10.5	1.2	4.3
Financials									
AIA Group	1299 HK	Buy	39.45	61,311	88.8	19.2	17.2	2.2	1.2
Industrials									
CSR Corp	1766 HK	Buy	6.54	10,653	14.5	12.5	10.3	2.2	2.4
Materials									
Lee & Man Paper	2314 HK	Buy	4.15	2,505	2.5	10.0	8.7	1.1	3.6
Technology									
BYD Company	1211 HK	Buy	46.90	17,927	31.0	58.0	36.0	3.8	n/a
ZTE Corp	763 HK	Buy	15.66	7,275	7.7	16.3	13.1	1.8	1.8
Internet									
Baidu *	BIDU US	Buy	188.00	65,877	601.3	32.2	22.1	7.9	n/a
Telecom									
China Mobile	941 HK	Buy	76.15	199,523	164.1	12.0	12.6	1.4	3.6
China Unicom	762 HK	Buy	12.30	37,837	52.7	18.5	16.8	1.0	2.0
IPP & Gas									
China Resources Gas	1193 HK	Buy	24.45	7,016	8.1	18.6	15.0	3.4	1.1
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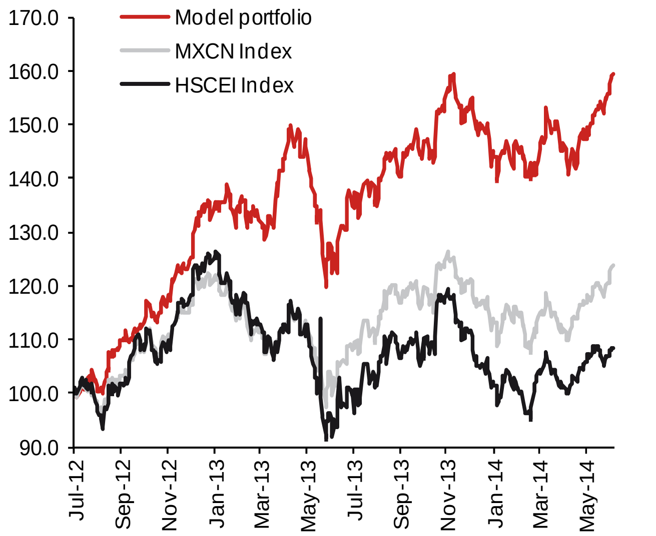
Utilities									
Beijing Enterprise Water	371 HK	Buy	5.32	5,943	12.4	26.6	19.9	3.1	1.3
Canadian Solar *	CSIQ US	Buy	29.73	1,595	94.6	7.3	4.8	2.0	n/a
China Everbright International	257 HK	Buy	11.46	6,630	13.7	25.9	20.8	3.4	1.1
Huadian Fuxin	816 HK	Buy	4.13	4,252	6.5	13.4	10.5	1.9	1.5
Cash - 5.5% of the portfolio									

Note: Share prices as of 8 July 2014. * Share price as of 7 July 2014.

Source: Bloomberg, Nomura estimates

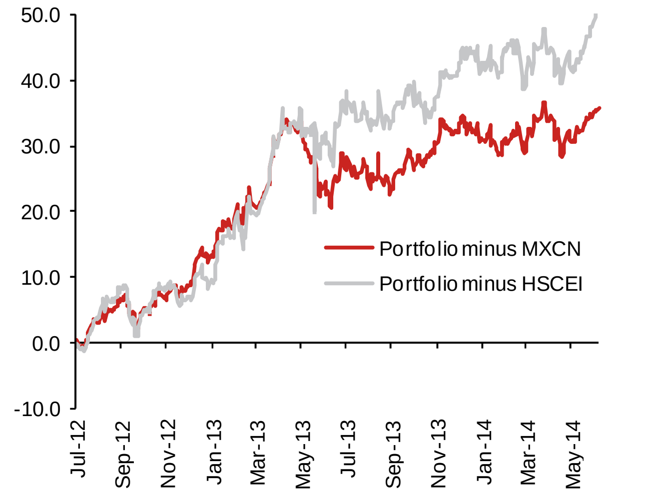
Model portfolio performance metrics in summary

Fig. 27: Total return since inception
(Rebased to 100)



Source: Bloomberg, Nomura research

Fig. 28: Cumulative performance: Portfolio minus MXCN and HSCEI
(Difference in percentage point)



Source: Bloomberg, Nomura research

Fig. 29: Tracking indicators
Tracking period from 1 August 2012 to 7 July 2014

	Total	Bull	Bear
Alpha	0.06	0.04	0.11
Beta	0.90	0.90	0.96
Mean Excess Return	20.45	-15.46	66.57
Information ratio	1.53	-1.10	5.44
Tracking Error	9.33	10.30	8.09

Source: Bloomberg, Nomura research

Fig. 30: Daily performance data

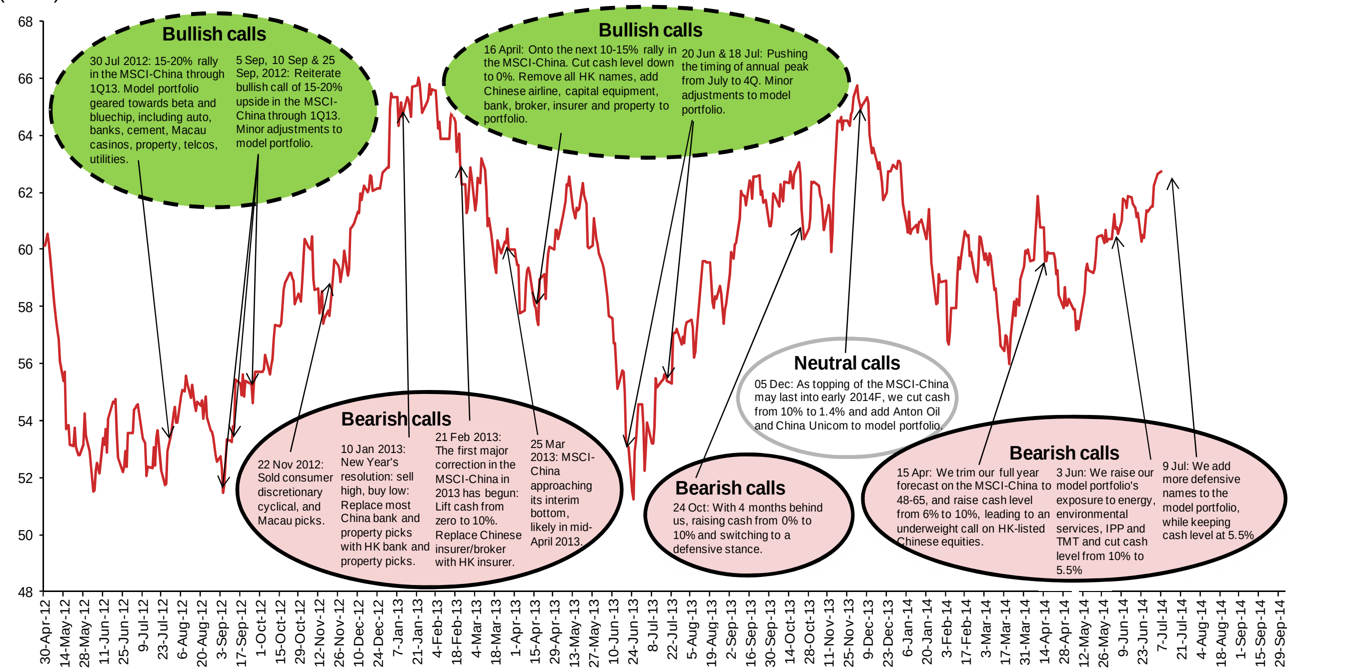
Performance: Daily	Portfolio	Benchmark
Total return 3Q13	9.9	12.2
Total return 4Q13	10.2	3.8
Total return in 2013	23.5	4.0
Total return 1Q14	-7.8	-6.0
Total return 2Q14	6.9	4.7
Total return YTD, 2014	3.3	2.2
Total return since initiation	59.6	23.8

Source: Bloomberg, Nomura research

Summary of our key calls

Fig. 31: Our published calls on the MSCI-China since initiation on 30 July 2012

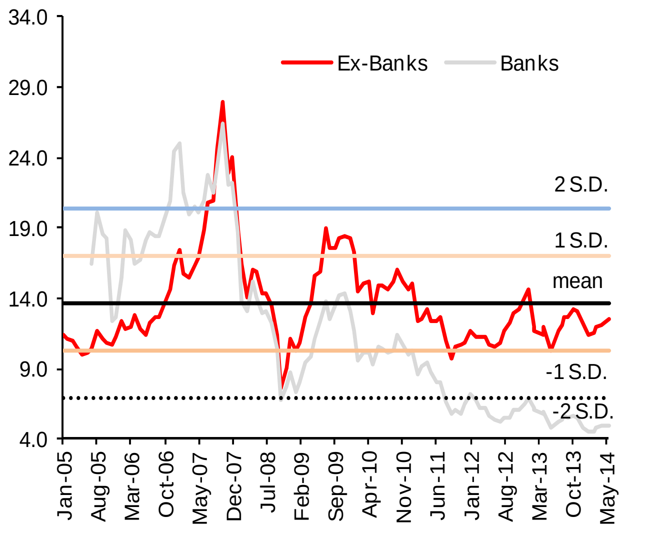
(Index)



Source: Datastream, Nomura research

Fig. 32: MSCI China: 1Yr forward P/E (x)

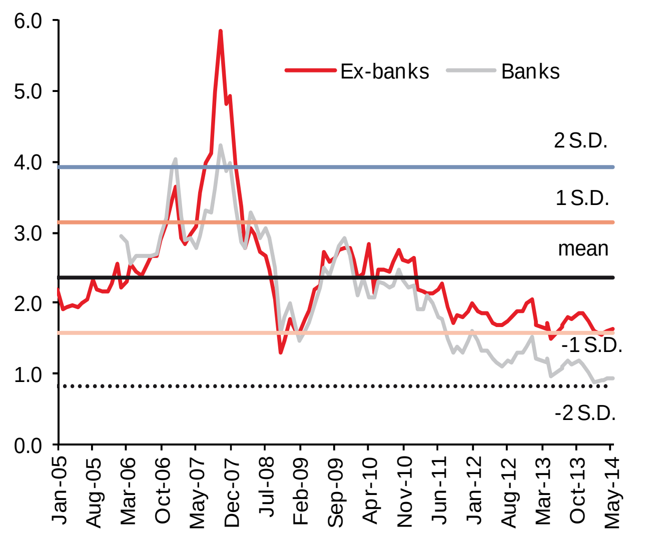
(x)



Source: I/B/E/S, Datastream, Nomura research

Fig. 33: MSCI China: Current P/B (x)

(x)



Source: I/B/E/S, Datastream, Nomura research

Fig. 34: MSCI China and its sub-sectors valuations for FY14F and FY15F

	Earnings growth		PER		Price to book		Dividend yield	
	FY14F (%)	FY15F (%)	FY14F (x)	FY15F (x)	FY14F (x)	FY15F (x)	FY14F (%)	FY15F (%)
MSCI China	**7.8**	**10.4**	**9.2**	**8.3**	**1.3**	**1.2**	**3.5**	**3.8**
Capital goods	2.8	13.7	10.0	8.8	1.0	0.9	2.6	2.9
Consumer								
- Automobiles	23.7	20.1	10.4	8.6	1.8	1.6	1.7	2.1
- Consumer durables & apparel	15.7	17.1	15.9	13.5	3.2	2.7	2.3	2.7
- Consumer staples	11.9	19.0	23.4	19.7	3.0	2.7	2.1	2.3
Energy	3.6	6.7	9.5	8.9	1.1	1.1	3.9	4.1
- Oil & Gas	3.5	6.6	9.5	8.9	1.1	1.0	3.9	4.2
Financial								
- Banks	6.7	7.3	4.9	4.6	0.9	0.8	6.6	7.1
- Diversified financials	19.3	20.8	12.3	10.2	1.1	1.0	2.6	3.1
- Insurance	22.5	16.7	13.1	11.2	1.7	1.5	1.8	2.1
- Real Estate	6.5	15.1	5.6	4.9	0.7	0.7	5.0	5.7
Health Care	19.3	18.4	20.2	17.1	2.5	2.2	1.4	1.6
Materials	22.7	16.6	9.9	8.5	1.0	0.9	2.5	2.7
- Construction materials	20.7	10.3	6.6	6.0	1.0	0.9	2.5	2.8
- Steel & Non-ferrous	95.5	54.1	24.1	15.6	0.9	0.8	2.1	2.0
Technology	41.3	26.3	28.8	22.8	6.1	5.0	0.6	0.8
Telecom	-11.0	0.3	12.2	12.1	1.3	1.2	3.5	3.5
Transport	-0.6	37.9	17.1	12.4	1.0	1.0	3.1	3.6
Utilities	17.7	12.6	13.7	12.2	1.9	1.7	2.4	2.7

Source: I/B/E/S, Datastream, Nomura research

Fig. 35: Nomura's subsector estimate vs. consensus for FY14F and FY15F

	Nomura estimate Earnings growth (%)		Market consensus Earnings growth (%)		Difference (ppt)	
	FY14F	FY15F	FY14F	FY15F	FY14F	FY15F
China	**4.4**	**8.8**	**7.8**	**10.4**	**-3.3**	**-1.6**
Capital goods	-0.2	16.9	2.8	13.7	-2.9	3.1
Consumer						
- Automobiles	18.8	18.8	23.7	20.1	-5.0	-1.3
- Consumer durables & apparel	15.9	12.5	15.7	17.1	0.2	-4.6
- Consumer staples	15.2	20.2	11.9	19.0	3.4	1.2
Energy						
- Oil & Gas	3.9	1.0	3.5	6.6	0.3	-5.6
Financial						
- Banks	5.0	5.4	6.7	7.3	-1.7	-1.9
- Diversified financials	21.4	25.1	19.3	20.8	2.1	4.3
- Insurance	18.1	15.6	22.5	16.7	-4.4	-1.1
- Real Estate	10.0	17.8	6.5	15.1	3.4	2.7
Health Care	n/a	n/a	19.3	18.4	n/a	n/a
Materials	-7.2	16.1	22.7	16.6	-29.9	-0.5
- Construction materials	7.7	7.0	20.7	10.3	-13.0	-3.3
- Steel & Non-ferrous	-35.4	33.0	95.5	54.1	-130.9	-21.1
Technology	39.9	24.8	41.3	26.3	-1.4	-1.5
Telecom	-12.6	-1.6	-11.0	0.3	-1.6	-1.9
Transport	n/a	n/a	-0.6	37.9	n/a	n/a
Utilities	6.4	14.0	17.7	12.6	-11.4	1.4

Source: I/B/E/S, Datastream, Bloomberg, Nomura estimates

Appendix A-1

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