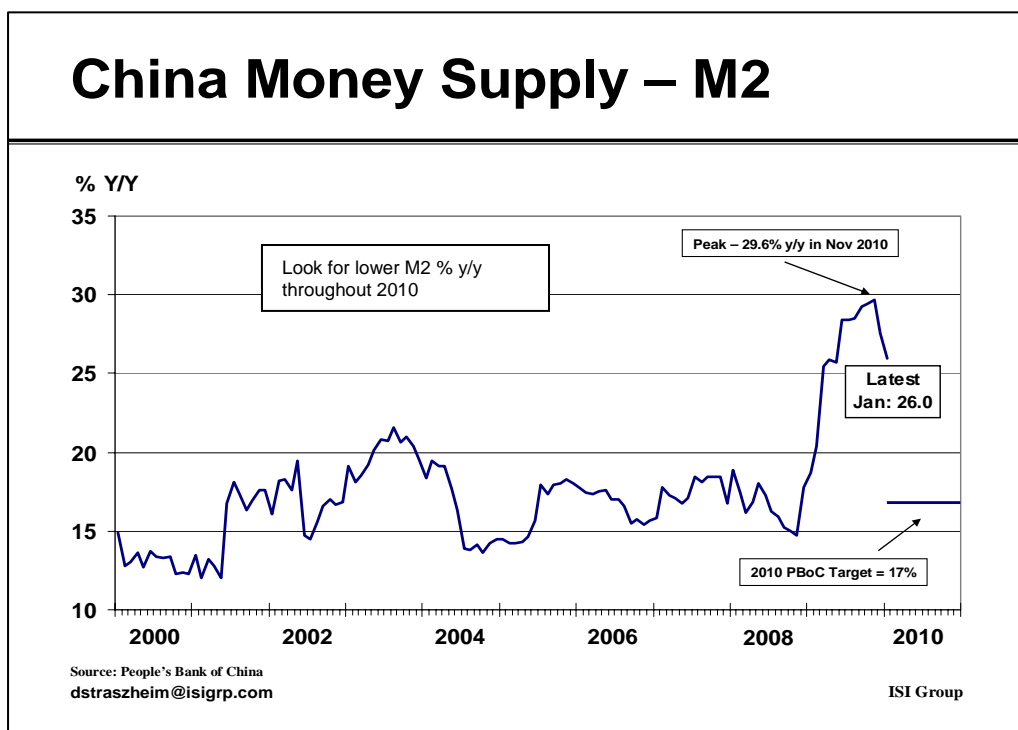


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China's Macro Goals and Monetary Targets

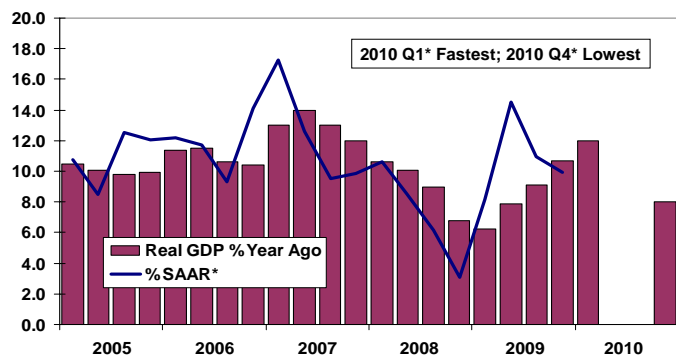


China is back in business with the Chinese New Year over. China's macro goals (GDP growth and inflation) compared to their M2 and bank loan targets are, we believe, inconsistent. Beijing must either tighten up their financial sector targets (painful), or sacrifice their macro GDP and inflation goals (backwards). We expect China to adopt more restrictive monetary targets by midyear. Watch for M2 growth to decline persistently as the year progresses. We expect the currency peg to begin to crawl again during 2010Q2, not a near-term revaluation as much speculation now believes. The recent sharp appreciation of the dollar has reduced Beijing's interest in a quick currency revaluation.

Slower Growth; Stopping Inflation's Rise

China's Real GDP Growth

Quarterly %SAAR* and %Year Ago

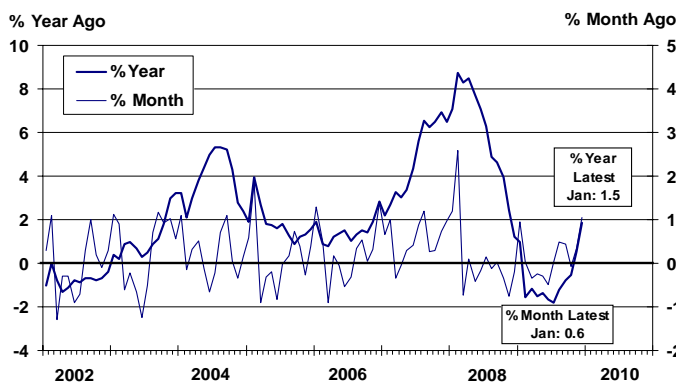


Source: IHS Global Insight, *ISI Estimates
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ISI Group

China Consumer Price Index

Monthly and Yearly Changes



Source: IHS Global Insight, ISI Calculations
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ISI Group

What Beijing is trying to do with policy is not mysterious.

Our estimate is that real GDP growth in 2010Q1 will be a too-hot 12% y/y, marking the high point of this post-meltdown recovery cycle.

We expect real GDP to slow to about 8-9% y/y by the last quarter of 2010.

And we see the CPI (at 1.5% y/y in January 2010), peaking near 6% at mid-year 2010, slowing to about 4.5% by year-end 2010.

This would represent a successful 'soft landing' setting China up for solid growth years again in 2011 and 2012.

But this implies a successful reduction of the massive emergency credit expansion of 2009. China's current 2010 targets (17% M2 Growth, and RMB7500 billion net new loans) are too expansive to be consistent with the desired slowdown in real GDP growth and inflation.

BEIJING HAS 3 CHOICES. How to align their macro goals and monetary targets?

Most likely, they will reduce their 2010 M2 target to 15% and bank loans guidelines to RMB 6500 billion by a quiet campaign – but without a lot of public fanfare.

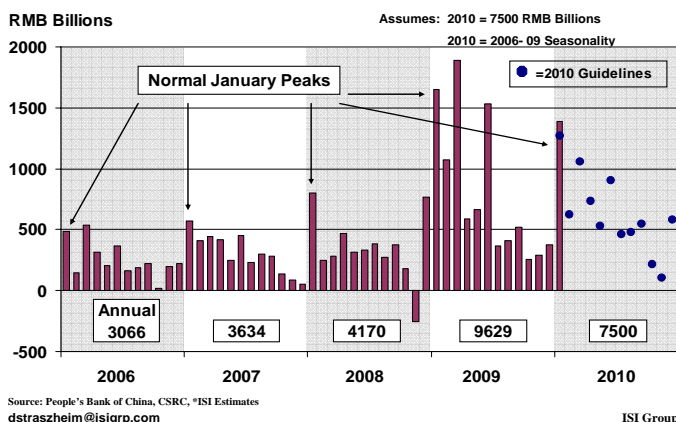
Second most likely, they would choose to announce explicitly that the targets are too loose, directly reducing the targets. However, this would involve admitting that the earlier targets were inappropriate, a difficult thing for Beijing officialdom to do.

And least likely, Beijing would stay with the M2 and new loan guidelines, sacrificing their GDP and inflation goals. This seems, simply, backwards.

Monetary Tightening Update

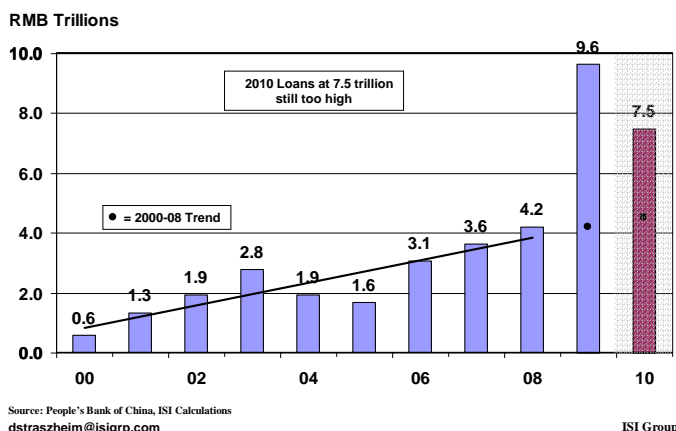
Net New Bank Loans

CBRC "Guidelines", Monthly Change, Net New Outstanding



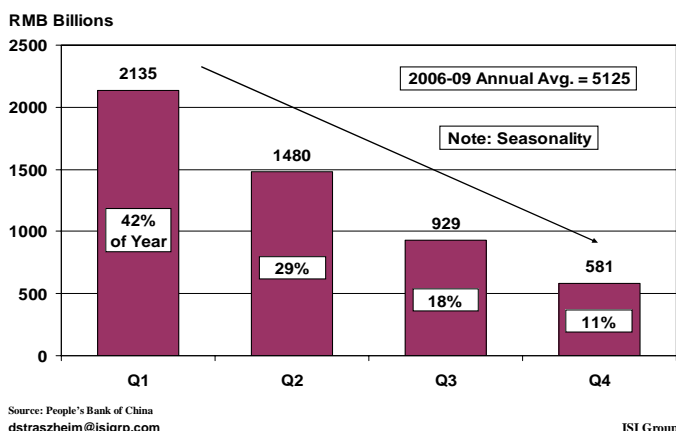
China Net New Bank Loans

Annual Change, 2000-09 History; 2010 per CBRC "Guidelines"



Increase in Bank Loans Outstanding

Average 2006-09, by Quarter



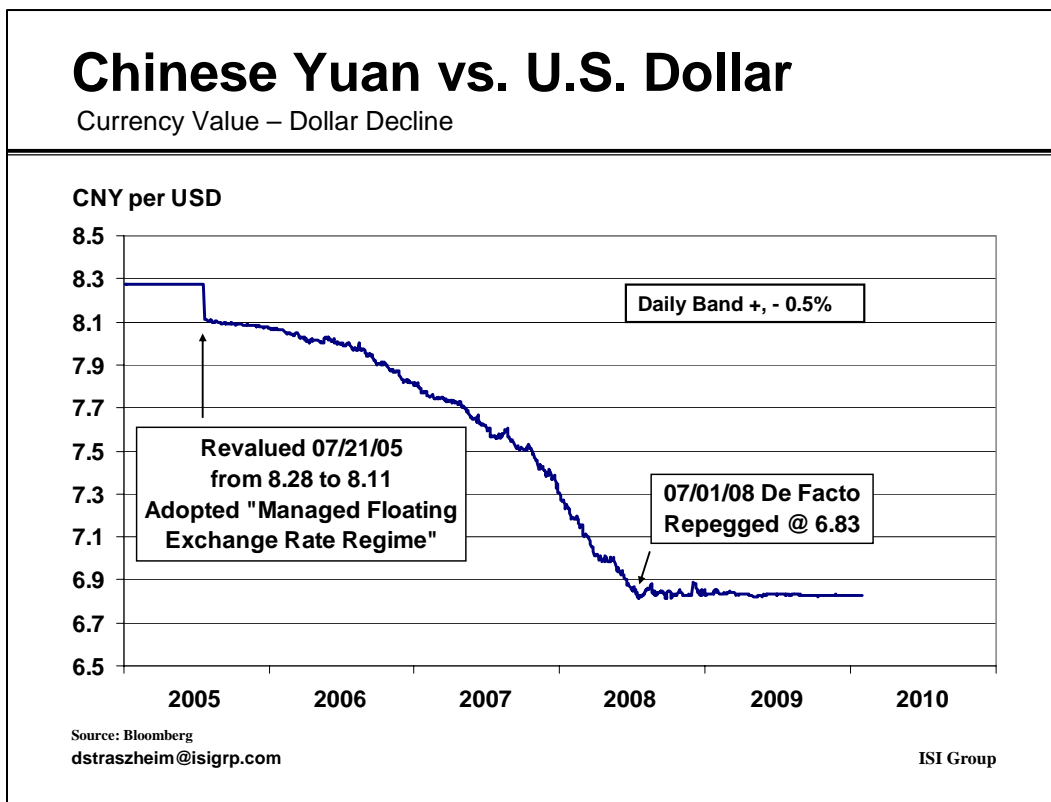
During the 2008-09 global economic meltdown, Beijing scuttled their recent practice of setting rather explicit bank-by-bank new loan quotas. Instead, the guidance was – ‘economic emergency – just make loans, and do what you can to hold up China’s very export-dependent economy.’

The result, *middle chart*, RMB9600 billion of net new loans were made, a level over 2x any prior year. China’s economy is now too hot, and Beijing has gone back to quotas (they call them ‘guidelines’ for 2010 of RMB7500 billion net new loans. While Beijing regards this as ‘tight,’ and it is 22% below 2009, we see it as still too high for Beijing to reach its macro growth and inflation goals.

Note the usual lending seasonality of recent years (*bottom chart*), more loans made in Q1, fewer in Q4. Assuming this seasonality were to pertain again in 2010, the RMB7500 billions would be distributed during the 12 months as shown (*top chart*). (*The dots represent each month’s net new loans consistent with past seasonality and the RMB 7500 total* .

January loans were RMB1390 billion, above the normal seasonal RMB 1260 billion. If the next few months also come in above the target, we will regard this as very bearish, raising the risk of a real GDP stronger 2010H1 and a weaker 2010H2.

Currency Appreciation? Not Quite Yet



We do not agree that ‘something is up’ in Beijing and that a quick revaluation of perhaps 5% in the Chinese RMB could happen any day now.

Beijing does not like discontinuities, and established the “managed floating exchange rate regime” (their terminology) in 2005. Their system, fully consistent with WTO rules, is more managed than floating. Beijing simply is more comfortable with the currency value being made in Beijing, not being made in the markets. We do not see this preference changing for many years.

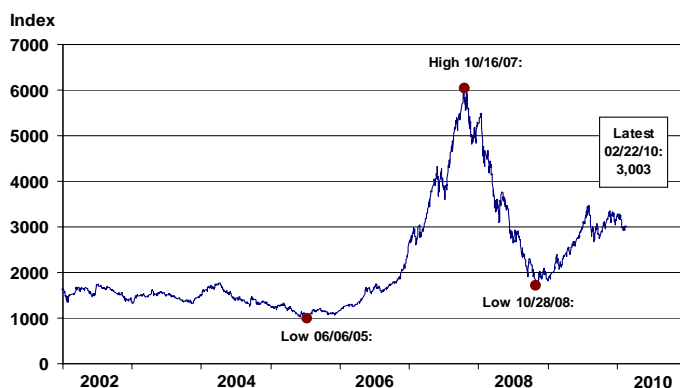
In mid-2008, aware of the gathering economic storm and fearing damage to her export markets, Beijing again re-pegged the currency to RMB6.83/US\$, and has left it there to this day. China has ridden the US\$ decline to great competitiveness gains in manufacturing for the last year.

Now, a RMB revaluation makes sense. It would reduce the cost of imports (helping the anti-inflation fight), and raise the cost of exports (helping slow the economy and export sector). But the recent rise in the US\$ (and accordingly, in the RMB) has started to accomplish some of these goals. The recent very sharp move in the US\$ has solidified Beijing’s desire to avoid currency volatility. Our view remains that Beijing will allow the currency to again resume an upward during 2010Q2.

Shanghai and China Equities

Shanghai Composite

Overall Equity Index

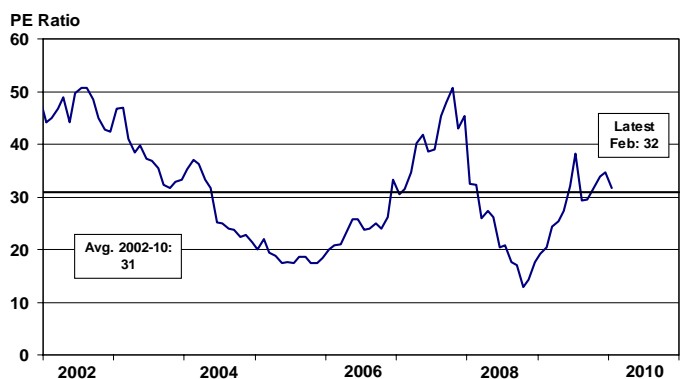


Source: Bloomberg
dstraszheim@isigrp.com

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Shanghai Composite Price/Earnings

PE Ratio

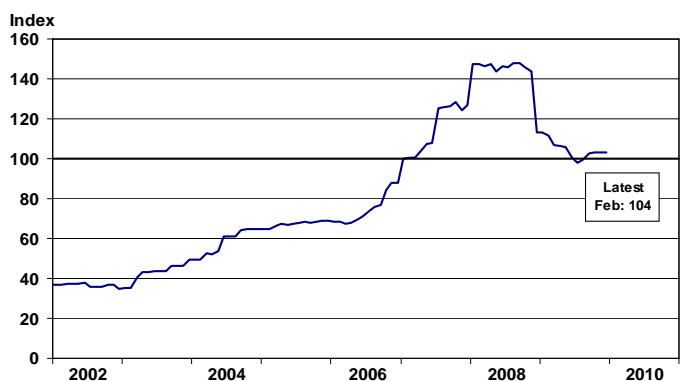


Source: Bloomberg
dstraszheim@isigrp.com

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Shanghai Composite EPS

Earnings per Share Index, Jan 2007 = 100



Source: Bloomberg
dstraszheim@isigrp.com

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The Shanghai equity market opened (down 0.5%) on February 22 after being closed for the Chinese New Year, Feb 15-19.

February 22 was the first opening since the Required Reserves Ratio (RRR) hike announced on Friday, February 12 – after the market close.

Remember, the Shanghai market is overwhelmingly composed of Chinese state-owned enterprises with minority stakes publicly traded. It has few companies in China that are privately owned (no state ownership).

While no systematic data are available, we believe that a considerable share of bank loans during 2009 were used to make speculative purchases of other companies stock (so-called cross holdings), a practice unlikely in 2010.

Some unwinding of these cross holdings would be another minus for 2010 Chinese equities.

Our view remains that Shanghai has considerable downside risk in the coming months as Beijing pursues its policy of sequential policy tightening.

Shanghai earnings are roughly equal to their January 2007 level. The rise in earnings during the 2007 and early 2008 boom, vanished during the global meltdown, and has not been rebuilt during the recent strength.