

Asia Economics

How much will Asia slow down in a global downturn?

Asia Pacific

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The global economic growth outlook has clearly deteriorated. We believe the risk of a double dip recession in high-income countries has increased. But, so far, in China, India and other large emerging markets (EMs) both actual growth and the economic outlook have held up reasonably well.

In our view, EMs' resilience to weaker growth in the US and Europe is because their domestic growth drivers have remained intact, and macro fundamentals and balance sheets remain sound. We hold this view, but it seems equity markets have their doubts.

China's recent data points to a further slowdown, but not a drastic one. If growth is weak in high-income countries – especially Europe – but a steep global recession can be avoided, China's growth should be around 9% this year and 8% in 2012, in our opinion.

Meanwhile, inflation, which has been China's policy priority this year, should come down gradually. Lower growth, declining inflation and contained housing prices, over time, should provide room for policy easing. But rapid adjustments in China's policy stance are not likely.

The key domestic risks in China are the property sector, local government borrowing, and bank balance sheets. But these are unlikely to be large enough to cause systemic, macroeconomic stress.

India's growth should also hold up in such a global scenario, but it is more vulnerable macroeconomically. In the end, much of the macroeconomic robustness is fiscal in nature. China scores fairly well in this respect, India less so.

How will Asia fare in a global recession?

The impact on Asia of an outright recession in Europe and the US would be substantial. For China and most other emerging Asian economies, direct financial exposure is not the most important channel. However, some like South Korea and Indonesia may again be vulnerable to contagion via financial markets. But for most Asian countries, weaker exports are the most important channel.

To gauge the impact on Asian economies of a possible crisis in high-income countries channelled via the real economy, we focus on the impact via global trade and exports. Our worst-case scenario is based on what happened three years ago during the global financial crisis in terms of plunging global trade. We assume that the impact of a recession in high-income countries will reduce global trade by 15% in 2012, compared to the base scenario.

According to our estimates, Asian growth would be hit substantially by such a decline in global trade, especially in smaller economies that are open to trade. How much damage depends on how much stimulus governments provide. Our estimates suggest that China would need to provide stimulus measures with a growth impact of 1.8% of GDP to reach GDP growth of 7.5% in 2012, around one-third of the impact of the stimulus provided in 2009.

It is too early to say how a possible China stimulus package would look. However, the composition would likely be different from the previous package, with a larger pure fiscal component and less reliance on monetary stimulus.

A worsening global outlook, but large Asian EMs holding up so far

The global growth outlook has clearly deteriorated. Following disappointing news from the US, the key trigger now is eurozone turmoil. In this setting, forecasts for economic growth in the US and Europe have been revised downwards over the last three months. The base scenario of most forecasters – including the September consensus (see table below) and the IMF – includes weak growth in Europe and the US, but not a recession. With growth in most emerging markets and developing countries expected to slow but remain respectable, the IMF's WEO projects a slowdown in global trade – a key factor for Asia – to almost 6% in 2012, which is still reasonable. But with financial turmoil in the eurozone intensifying in recent weeks, several forecasters have slashed their global forecasts further.

The September consensus forecast for the global economy

GDP growth (y-y %) ¹	September			Change from June	
	2010	2011E	2012E	2011	2012
World	4.3	3.0	3.2	(0.2)	(0.4)
North America, o/w	3.0	1.7	2.1	(0.9)	(1.0)
US	3.0	1.6	2.1	(0.9)	(1.0)
Western Europe, o/w	1.9	1.6	1.2	(0.3)	(0.5)
Euro zone	1.7	1.7	1.0	(0.3)	(0.7)
Asia Pacific	7.0	4.6	5.4	0.2	(0.3)
China	10.4	9.1	8.6	(0.1)	0.1
India	8.5	7.5	8.0	(0.5)	(0.1)
Japan	4.0	(0.5)	2.4	0.2	(0.8)
Other	5.8	3.9	4.1	0.3	(0.5)
Eastern Europe	4.4	4.4	4.0	0.2	(0.3)
Latin America	6.3	4.4	4.1	0.0	(0.1)
Africa and ME	4.4	4.6	4.6	(0.4)	(0.2)

1) Weighted by market exchange rates

Source: Consensus Economics, MF Global estimates

The risk of a double dip recession in high-income countries has increased. All eyes are on Europe where severe sovereign debt problems in some countries threaten the eurozone and interact with banking sector problems. In a politically complicated environment, many steps are needed to tackle the eurozone's problems. MF Global's Chief Economist Jim O'Sullivan thinks that continued growth is still the most likely scenario in the US. But he is conscious of the risks. In the case of a "major event" in the eurozone, with financial and banking sector stress, weak economies and fiscal problems feeding on each other, it would be possible to see high-income economies shrinking substantially in 2012 and global trade plunging, as happened in 2009, when global trade fell 11% in volume terms.

So far growth seems to be holding up in China, India and other large EMs. Policymakers in China, India and other Asian countries have so far this year mainly focused on fighting inflation. During 2011, economic growth has started to moderate in China and, more significantly, in India. However, quarter-on-quarter GDP was still an estimated 8.6% in China in 2Q11 at an annualised rate. Moreover, recent downward revisions in growth projections for China and India have been modest compared to those for high-income countries. Economic forecasts are often flawed. However, we think that the September consensus table above makes an important point: growth in the large Asian EMs, especially China, is likely to remain fairly robust as growth slows in high-income countries.

Robustness in EMs versus weaker growth for the US and Europe reflects strengths.

Domestic EM growth drivers fueled by reform in recent decades – industrialisation, investment, productivity catch up – remain intact. Moreover, many EMs have reasonably sound macro fundamentals and balance sheets, especially China. Decoupling is impossible in today's globalised world. However, the improved macro performance and balance sheets of EMs – reflected in moderate inflation, sustainable government debt dynamics, and strong balance of payment and foreign reserves positions – makes them more resilient to shocks than in the past, thus keeping EM growth drivers going. We take this view even though equity markets seem to have their doubts. So far this year, EM equity markets have fallen more than developed markets (DMs). This is, in part, because growth does not always equal profits, and margins have been under pressure from cost increases.

Indicators of macro economic robustness (% GDP, unless otherwise indicated)

	— CPI inflation —		— Government debt —		— National saving —		— Current account —		— Official reserves —	
	1996	latest ¹	1996	2010	1996	2010	1996	2010	1996 (US\$bn)	2010 (US\$bn)
China	8.3	6.2	6.8	26.8 ²	41.3	53.5	0.9	5.2		3,197
India	8.9	8.4	64.4	64.1	24.1	34.2	(1.6)	(2.6)		312
NICs ³	4.3	2.3	...	42.4	33.3	33.4	(0.2)	6.9
Asean-5 ⁴	6.4	4.4	...	38.7	32.0	31.7	(4.9)	3.3

1) For the 2 groupings, this is the IMF WEO forecast for the 2011 year average.

2) This excludes about 30% of GDP of debt held by local governments and their platforms.

3) Hong Kong, South Korea, Singapore, Taiwan.

4) Indonesia, Malaysia, Philippines, Singapore, and Thailand.

Source: IMF WEO, September 2011

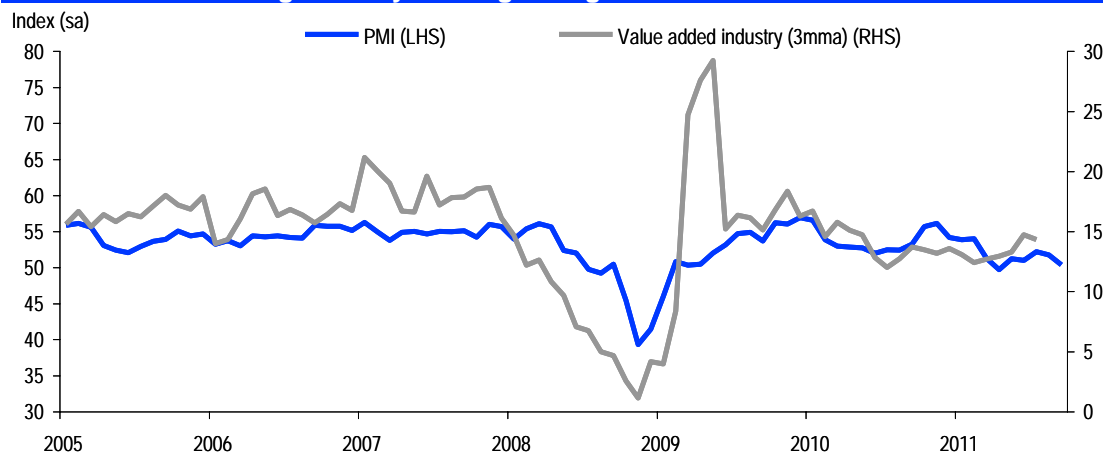
China's economy has also become less dependent on exports to the US and Europe.

The share of overall exports to GDP has declined from a peak of 39% of GDP in 2006 to 29% in 2010. Also, while the US, Europe and Japan still account for about half of China's exports, they have only contributed one-third to export growth in the past three years, with two-thirds of export growth coming from emerging markets.

China is set to slow down but a hard landing remains unlikely

China's recent data points to a further slowdown but not a drastic one. Nominal fixed-asset investment growth slowed to a still-robust 23% YoY in August, supported by resilient property construction and capacity expansion in manufacturing. Consumption has been affected by inflation, but retail sales growth remained flat at a bit over 10% in real terms, in August. On the production side, industrial value-added growth eased to 13.5% YoY in August – still implying substantial sequential growth. The September PMI data, with a significant decline in the order component, suggests a further slowdown ahead. However, a PMI reading of around 50 does not mean there is no growth in China's manufacturing. It means that growth is below trend.

China's manufacturing industry is still growing



Source: CEIC, World Bank staff estimates

Looking ahead, with weak growth in high-income countries but no recession, China should be able to grow 8% next year. Export momentum is set to come down as a result of the weaker external outlook. This will have some knock-on effects on domestic consumption and investment. Also, urban consumption growth may remain subdued until inflation comes down more significantly in late 2011 or early 2012. Mainstream (market-based) property construction is likely to decelerate as property sector tightening effects sales and property developer financing. However, this should be partly offset by accelerated social housing construction in line with the recent State Council measures. The recent easing of housing prices gives the government room to ease some housing market measures if required.

Inflation, which has been China's policy priority this year, should come down gradually. Food price increases have been more persistent than expected this year; energy prices have also contributed to headline inflation. However, core inflation (stripping out food and energy) has remained moderate, as productivity growth and absorption in profit margins have offset most manufacturing cost pressures. We believe sequential month-on-month food price increases should be modest in the coming six months. With the prospect of slower global growth ahead and softer industrial raw material prices, we expect China's headline YoY inflation to come down, albeit gradually, to around 5% YoY in December, compared to 6.5% in July. Upside risk will mainly stem from food prices.

Lower growth, declining inflation and better contained housing prices should provide room for policy easing. We believe the pace and extent of policy easing will depend on the state of the global and domestic economy. On current trends, with the key variables evolving gradually, policymakers are likely to keep a wait-and-see attitude for a while. We expect GDP growth to ease to around 9% this year and 8% in 2012, with downside risks originating largely from abroad. For 2012, this is 0.6 percentage point lower than the September consensus.

MF Global's forecast for China in a global base-case scenario

(% change, unless otherwise indicated)	2008	2009	2010	2011F	2012F
The real economy					
Real GDP	9.6	9.1	10.3	9.0	8.0
Domestic demand ¹	9.6	13.8	9.8	8.9	8.6
Consumption ¹	8.5	8.5	8.0	7.4	7.8
Gross capital formation ¹	11.0	19.8	11.6	10.5	9.4
Contribution net exports (MFG, pp) ²	1.8	(4.8)	2.6	0.5	(0.3)
Exports (goods and services) ²	8.5	(10.4)	28.2	11.0	7.5
Imports (goods and services) ²	5.1	4.3	22.0	11.0	9.6
CPI (year average)	5.9	(0.7)	3.3	5.5	4.0
External account (US\$bn)					
Trade balance (BOP)	361	250	254	250	265
Current account balance	412	261	305	283	309
Current account balance (% GDP)	9.1	5.2	5.2	3.9	3.6
Foreign exchange reserves	1,946	2,399	2,850	3,310	3,699
Other					
Broad money growth (M2), e-o-p (%)	17.8	27.6	19.7

1) MF Global estimations using contribution to growth data from the NBS.

2) MF Global estimates based on trade data for goods from the Custom Administration.

Sources: CEIC, NBS, PBC, Ministry of Finance, and staff estimates

There are several domestic risks in China, but these are unlikely to be large enough to cause systemic, macroeconomic stress. The key risks are the property sector, local government borrowing and bank balance sheets. However, in our view, these risks are not large enough to overwhelm the financial system or macroeconomic stability.

- » **The property sector.** The measures implemented to contain property prices have been blunt, but they have reduced the risk of a property bubble emerging or bursting. Sales and construction may slow down more, but the easing of prices means there is now some room to ease the policy stance if property construction weakens too much. More fundamentally, property market policy needs reform, including realigning incentives guiding local governments by reducing their reliance on land revenues. However, given the current urbanisation rate of around 47%, along with the current and envisaged pace of urbanisation, underlying demand for urban housing should remain strong in the coming decade.
- » **Local government investment platform (LGIP) debt.** During a bout of lending during 2008-10, LGIP debt increased to an estimated Rmb10.7tr (27% of 2010 GDP). A sizeable portion of that debt will need to be converted to longer-term maturity. Moreover, the coming years will likely see defaults of several LGIPs and complicated negotiations on burden sharing between banks and the government. However, a substantial part of LGIP debt will, over time, yield an economic return. Infrastructure development through LGIPs has been a long-standing element of China's development mode and has served the economy well. The bout of lending during 2008-10 was clearly unsustainable. However, given the central

government's sound fiscal position, the LGIP debt problem does not seem large enough to cause macroeconomic stress.

» **Bank balance sheets.** Banks' NPLs are likely to rise and provisioning for problem debt is set to be significant in the coming years, especially for LGIP debt (banks' exposure to property developers is modest, and mortgage debt is unlikely to be a systemic problem for the banks given the low loan-to-value ratios on mortgages). However, in most reasonable scenarios the banking system – especially the large, quantitatively significant banks – will be able to absorb this, helped by solid cash flows amid continued economic growth and guaranteed interest spreads. Mainstream stress testing, including by outsiders, suggests that the banking system is generally able to absorb substantial shocks. However, the 2008-10 lending bout has delayed financial sector reform by requiring the guaranteed spreads to exist for longer.

India could also grow 7-8% in this scenario, but is a bit more vulnerable

India, in principle, has the same EM growth drivers in place as China, but its macro fundamentals are less sound. MF Global's India economist Anjali Verma notes that domestic demand is facing some headwinds from the aggressive monetary tightening pursued by the Reserve Bank of India (RBI) to lower inflation. Anjali projects 7.5 % GDP growth in FY11-12 and 7.7 % in FY12-13, after 8.5 % in FY10-11. In the context of falling commodity prices and lower growth, inflation should ease in the coming six months. However, more so than China, India's inflation is in part a structural issue, boosted by supply constraints. With these supply constraints in place and the fiscal deficit on the rise again, the RBI's objective to bring down inflation requires large interest-rate increases. This dents economic growth and the investment that is needed to alleviate supply constraints. India's banking system is generally sound. However, its current account deficit makes it more dependent on capital inflows and, thus, more vulnerable to financial contagion.

Much of the macroeconomic robustness is fiscal in nature. Fiscal vulnerability is lower if: 1) government debt and deficits are low, 2) trend growth is high, 3) interest rates are low, 4) tax buoyancy (how much taxes rise when activity increases) is high, 5) the share of open-ended government spending (which is harder to cut than discretionary spending) is low, and 6) the proportion of debt held by foreign investors is low.

China scores well in this respect, but India less so. China's government debt is manageable, even assuming the government ends up absorbing half of the LGIP debt. The growth-interest differential is favorable and tax buoyancy is high. China's stimulus spending in recent years was largely used for frontloading infrastructure investment. This means less need for such spending in the future and makes cutting expenditure easier than open-ended spending. In a context of high national saving rates, the bulk of government debt is held by connected domestic institutions as opposed to foreign investors. This makes sell-offs less likely. In all, China's fiscal position gives it room for stimulus if needed. Most Asian countries, apart from Japan, do not have high government debt and retain fiscal leeway (Singapore's government has a high gross debt, but is considered fiscally sound because of its assets). India's fiscal outlook is less convincing: its government debt and deficit are relatively high, it has large infrastructure investment needs and a higher proportion of open-ended spending. This means the government has less fiscal leeway to respond to a downturn.

What about Asia in a global recession?

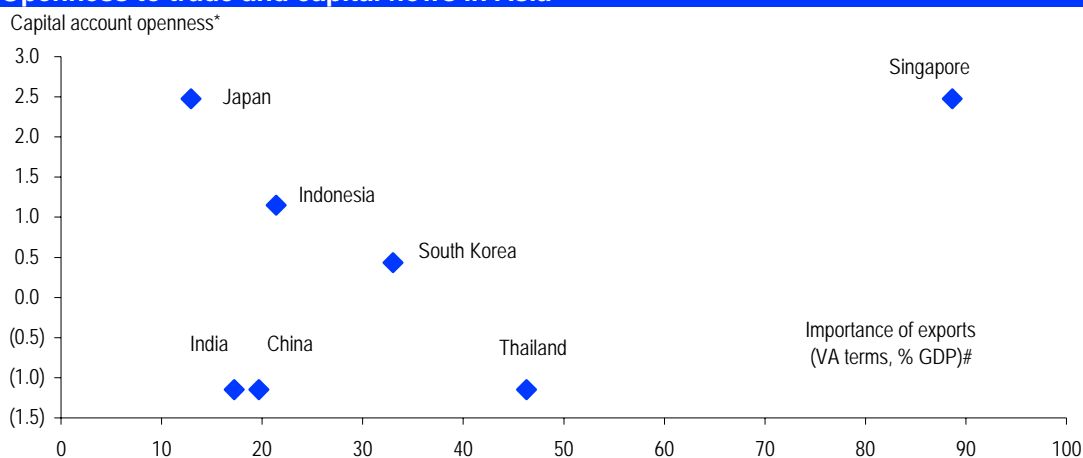
The impact on Asia of an outright recession in Europe and the US would be substantial. A crisis scenario for the global economy would combine financial upheaval (triggered by major stress in the eurozone, say Greece defaulting on debt) with an economic downturn, negative feedback between weak economies, fiscal problems, and banking stress. In such a scenario, it is possible to see high-income economies shrinking substantially in 2012 and global trade plunging, as in 2009 (global trade fell 11% in volume terms that year).

For China and most other emerging Asian economies, direct financial exposure is not the most important channel. The holding, by the Asian non-government financial sector, of sovereign debt of peripheral eurozone countries, along with shares in European banks constitute a low share of their assets. MF Global's Head of Asian Financial Equity Research Steven Chan comes to this conclusion for China's banks in a recently published report, although he finds that a rapid, large-scale write off on such holdings would affect short-term profitability in a major way. Of course, sovereign wealth funds (SWFs), such as those in China, hold substantial amounts of European government bonds (including those of stronger, core eurozone economies) and SWFs are likely to suffer significant losses on these holdings. However, unlike households or banks, SWFs do not spend much, so SWF asset write-offs are unlikely to lead to lower economic activity.

However, Asia's financially open economies would be vulnerable to contagion via financial markets. The table below shows a measure of the openness to capital flows of some Asian countries. In recent weeks, capital retreating from Asian countries with capital markets open to financial flows and/or significant holdings by foreigners of financial assets (including Indonesia and South Korea) has put downward pressure on currencies. This is in part a traditional response of financial markets to higher risk aversion. On top of that, some European and US banks have lowered their positions in emerging markets to shore up their own liquidity positions.

Japan, with its open capital markets and safe-haven currency, experiences inflows at times of high risk aversion. Singapore's financial markets are also very open. During the 2008-09 global financial crisis, Singapore felt some safe haven effects. But financial openness can potentially lead to outflow pressure; for instance, with European banks intensifying their retreat because of liquidity problems. China, with its controls on financial capital flows, is less vulnerable to a quick withdrawal of financial capital.

Openness to trade and capital flows in Asia



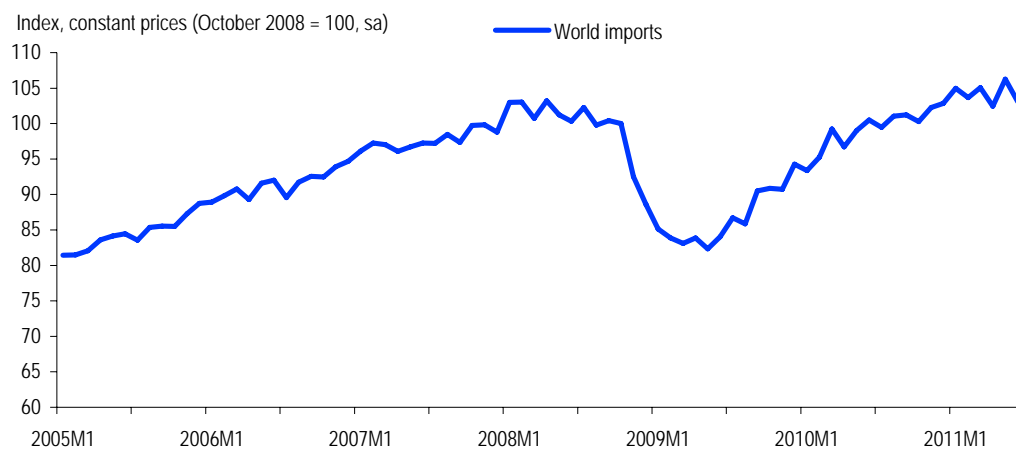
*Chinn and Ito measure.

#Using estimates from Zhang Jun (for China) and WTO and IDE-Jetro (for the other countries).

Source: Chinn and Ito, WTO and IDE-Jetro ("Trade Patterns and Global Value Chains in East Asia"), Zhang Jun (presentation at IWEF, Beijing, September 22, 2011), and CEIC.

For most Asian countries, weaker exports would be the most important channel. Many Asian economies are relatively open to trade. As the global financial crisis showed, when recession in US and Europe is combined with major financial turmoil, global manufacturing and trade can be hit strongly, affecting Asia in a major way. At the end of 2008, global trade plunged, aggravated by the impact of higher counterparty risk on trade credit. Global trade fell 10.7 % in 2009, in volume terms (between October 2008 and May 2009, the decline was 18%). In our view, this was the most important channel transferring the financial crisis to Asia. Assuming that without the crisis, global trade would have expanded by, say, 4% in 2009, the impact on global trade growth was 15 percentage points. This is a reference point for our estimate of the likely impact this time.

Global trade is a key transmission channel



Source: Central planning bureau and MF Global estimates

To gauge the impact on Asian economies of a crisis in high-income countries channelled via the real economy, we look at global trade. We prefer this over looking at countries' specific exposure to other economies via their export structure. Experience during the global financial crisis showed how, with today's globalised production chains, the impact of a major trade shock spreads internationally, especially in Asia.

Our worst-case scenario is similar to three years ago in terms of the impact on global trade. There are reasons to think a recession in high-income countries should be less steep than three years ago. Economies are less stretched now in terms of how rapid growth has been and where output stands compared to capacity, especially in high-income countries. Financial markets are obviously less stretched now in terms of valuations. The private sector has been behaving more cautiously. That should make economies and markets less vulnerable. Also, having learned lessons from the impact of the Lehman failure, policymakers may be more reluctant to let financial institutions go under. On the other hand, there is much less policy space in Europe and the US now, both fiscally and monetarily. Therefore, we do a worst-case scenario with a shock as large as three years ago in terms of its impact on global trade.

What would be the impact of a crisis in high-income countries that reduces global trade by 15% in 2012, compared to the base scenario. The base is represented by the September consensus forecast (in the first table) and that of the IMF, which sees global trade growth of almost 6% in 2012. We assume exports would be hit one-for-one by lower global trade. We use the estimates of the importance of exports in several Asian economies shown

in the table above (exports in value added terms over GDP) to gauge the possible impact on GDP growth. Such a large export shock would trigger knock-on effects on consumption and investment, postponement of tightening measures and possible introduction of stimulus measures. We make the simplifying assumption that knock-on effects on consumption and investment are broadly offset by postponement of policy tightening and lower commodity prices.

Under these assumptions, Asian growth would be hit in a major way. The impact on China's GDP growth in 2012 would be 2.9 percentage points compared to the base scenario of the first table. It would be 2.6 percentage points for India and 5 percentage points for South Korea. Thus, without new, discretionary stimulus, the worst-case scenario for China would drag down 2012 GDP growth to 5.7%, much lower than in our own base scenario, even though our base scenario has 0.6 percentage point less growth than the September consensus.

How much Asian economies grow next year in case of a high-income recession depends on how much stimulus governments would provide. Most Asian countries still have macroeconomic policy space. But the policy response is likely to be smaller than years ago. In China, with the domestic economy (especially the property sector) in better shape than in 2008, less policy space, and perhaps more tolerance for lower growth among policymakers, a stimulus package would likely be significantly smaller. In our worst-case scenario, China would need stimulus measures with a growth impact of 1.8% of GDP to reach GDP growth of 7.5%. Taken into account "leakage" abroad via imports, the size of the stimulus in terms of spending would need to be larger than this. The required size would be about one-third of the stimulus provided in 2009, which lifted China's GDP growth to 9.1%, while the global economy, excluding China, shrunk by 2.8%.

The composition of China's stimulus would likely be different, with the pure fiscal component larger and less reliance on monetary stimulus. Taking into account what has already happened and China's objectives as enshrined in the 12th Five-Year Plan, fiscal stimulus would probably be less investment-oriented than the previous stimulus, and more consumption and household oriented. Within investment, there would likely be less emphasis on standard infrastructure spending and more on environment-related investment, facilitating industrial upgrading and moving up the value chain.

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