How consumption will change China: Scale, structure and paths

Consumption will bring changes to both China and the world. As a large country with economies of scale, China can achieve domestic consumption and manufacturing upgrades without relying on overseas demand. At the latest politburo meeting on April 23, the authorities proposed to expand “domestic demand” again for the first time in three years. We believe “domestic demand” might have a different meaning this time around in that expanding domestic consumption is likely to represent the “new form of domestic demand”.

Over the next 30 years or so, China’s modernization will depend upon whether it can increase the proportion of consumption in its economy while ensuring that its manufacturing sector maintains a stable or slightly increasing global market share. In 2016, China’s manufacturing sector accounted for 34.8% of the G20 total, while private consumption achieved for merely 10%.

China’s consumption growth potential represents the resilience of its economic growth. Based on overseas experience, over the next 30 years on a constant price basis, consumer spending in China could grow 4-7 times. When inflationary factors are considered, nominal consumption growth could be as high as 18-32 times. Alternatively, RMB denominated nominal consumption growth might reach 52.5 times over the next 30 years should the annualized growth of 14.1% over the past 30 years be maintained.

In terms of the consumption structure, current private consumption in China is approximately at the same stage as the US in the 1930s, Japan in the 1950s and Korea in the 1980s. In the more developed eastern region, the proportion of consumer discretionary spending is close to 60%, similar to the level seen in Japan when it had a comparable per capita GDP. In 30 years’ time, this ratio might reach nearly 80%, while the proportion of consumer staples spending might have shrunk by half.

Consumption will bring various changes to China, the most important three aspects being that: 1) Only consumption upgrade can drive manufacturing upgrade, which in turn is a necessary condition for sustainable consumption upgrade; 2) China will transform from a major exporter into a major consumption-driven country in the world, and from a trade surplus country to a deficit one; 3) A deficit economy driven by consumption shall lend support to the regionalization and subsequent internationalization of the RMB.

If China maintains the kind of consumption growth seen over the past 10 years, it might become the world’s largest consumption-driven country in 20 years’ time. For China, consumption upgrade is the future. To capture relevant investment opportunities, we highlight keywords such as branding, standardization, cross-generational upgrade, new business models, and world-class companies.

Trade tensions or “trade cold wars” initiated by the US might have successfully suppressed the rise of the former Soviet Union, Germany and Japan; however, this might not work very well on China. Taking full advantage of the economies of scale in its consumption development, China should be able to resolve trade tensions, escape the middle-income trap, and become the world’s largest economy.

This is a translation of a report originally written in Chinese. Please contact us for more information of the original report.

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The logic of China’s economic growth in its “new era” will be changed fundamentally in that consumption, instead of exports or investment, will be the main driver of change for the country.

In fact, such a shift in growth drivers is already under way. Exports have supported China’s industrialization over the past four decades, while consumption will provide sustainable momentum for modernization for the country over the next 30 years. Only consumption upgrade can drive manufacturing upgrade, which in turn is a necessary condition for sustainable consumption upgrade. If successful, over the next 30 years, such a shift will turn China from the world’s major exporter into a major consumption-driven country, from a country recording a trade surplus to one with a deficit, and from an industrialized economy to a modernized one.

Sino-US trade tensions will help accelerate this shift of the Chinese economic focus towards consumption. Whatever their specific format, these trade tensions reflect the underlying competition between the world’s two major consumption-driven countries, namely today’s US vs. tomorrow’s China. As such, various measures through which for China to respond to trade tensions or even a “trade war” initiated by the US all come with a cost and represent anything but a “zero-sum game”. Only by encouraging domestic consumption can China put itself in a strategically favorable position, where it carries on with manufacturing upgrade and maintains moderate economic growth domestically, while externally mitigates attempts to “contain China’s rise” and even make breakthroughs with RMB internationalization.

I. China’s consumption growth potential

Thanks to economies of scale as a large country, China has to a large extent reached industrialization before its private sector becomes wealthy. Based on estimates by Maddison Program using purchasing power parities, China’s manufacturing sector currently accounts for 34.8% of the G20 total, 25.6pp higher than the percentage for Japan when the latter had a comparable per capita GDP (Figure 1). In comparison, China’s consumption sector appears relatively weak at less than 10% of the G20 total in 2016, or less than 30% of the size of its manufacturing sector.

![Figure 1: Major countries’ manufacturing sector as % of G20 total (%)](image1)

![Figure 2: Major countries’ private consumption as % of G20 total (%)](image2)

Sources: Maddison, World Bank, Conference Board, GF Securities
Industrialization has driven the rise of the Chinese economy over the past four decades. Using purchasing power parities, China’s GDP has outstripped the US, effectively shifting global economic landscape from one dominated by the US and Europe back to one dominated by China and India (Figure 3). On a global scale, consumption and investment pretty much grew at the same pace during 1978-2016 (Figure 4). Comparatively speaking, export-driven investment growth was the main engine of China’s rise. During this period, China’s export, investment and consumption growth was 29, 18.5 and 7.1 times the global pace of growth.

Various data point to the fact that China has underperformed in terms of consumption growth. While the country’s exports, investment and consumption as a proportion of the G20 total increased quickly from 1.6%, 2.2% and 1.4% in 1980 to 22.0%, 27.9% and 10.1% in 2016 (Figure 5), per capita consumer spending was equivalent to just 6.9% of the level in the US in 2016 (Figure 6).

In the cases of G20 countries, developed countries tend to have a high proportion of consumption relative to GDP, though countries with a high consumption-to-GDP ratio are not necessarily developed ones. In particular, China’s consumption-to-GDP ratio is the second lowest among G20 emerging markets, just next to Saudi Arabia (Figure 7). The
potential and scale of China’s consumption growth over the next three decades can be estimated using the two methods below.

1. Per capita consumer spending

China’s per capita spending as a proportion of per capita GDP is relatively low in the world. Based on 2010 World Bank data using a constant US dollar, China had per capita consumer spending of US$2,337, representing 36% of per capita GDP (Figure 7). There is a strong positive correlation between per capita GDP and per capita consumer spending in the 74 countries with a population over 10m (Figure 8). Putting China’s 2015 per capita GDP into the formula in Figure 8, we calculate that China’s per capita consumer spending is supposed to reach US$3,765 (2010 constant US dollar) to represent 58% of per capita GDP, which is 22pp higher than the actual figure.

![Figure 7: G20 per capita GDP and private consumption as % of GDP, 2015 (%)](image)

![Figure 8: Per capita GDP and private consumption, 2015 (US$)](image)

Sources: World Bank, GF Securities

2. Total consumption

Everything said, China still posted 11.2x consumption growth over the past 30 years on a low base, much faster than developed countries and other emerging economies (Figure 9). China’s current per capita GDP is equivalent to levels in the US in 1934, Japan in 1957, and Korea in 1987. Using a 2010 constant US dollar and referencing the path of development of three countries, China’s per capita is supposed to reach a range between US$20,466 (based on US growth path, partly affected by WWII) and US$34,332 (based on Japan’s growth path) in 30 years’ time.

![Figure 9: Per capita GDP and consumption path](image)

We can estimate China’s per capita consumption in 30 years using two methods.
Method I: correlation between per capita consumer spending and per capita GDP.
Putting the per capita GDP of Japan, Korea and the US into the formula in Figure 8 and using a 1.4bn population base, we arrive at total consumption of US$26.9tn, 21.3tn and 16.1tn for China in 30 years’ time, which would be equivalent to 7.2x, 5.7x and 4.3x the country’s actual total consumption in 2017.

Method II: per capita consumer spending vs. per capita GDP in corresponding years (Figure 10) Counting 30 years forward from the point when the three referenced countries had the same per capita GDP as today’s China, the consumption-to-GDP ratio for the US was 57% in 1964, 55% for Japan in 1987 and 49% for Korea in 2017. Applying a population base of 1.4bn, we calculate that China’s total consumption could reach US$26.3tn, 18.4tn and 16.3tn in 30 years to represent 7.0x, 4.9x and 4.3x of actual figures in 2017.

This means China’s consumption growth has strong potential ahead and is likely to become a key driver of moderate economic growth (4-6%). According to the analysis above, based on constant prices, China’s consumer spending is likely to grow 4-7x over the next three decades, with nominal growth likely to reach as high as 18-32x based on Rmb pricing. Alternatively, nominal consumption growth might reach 52.5x over the next 30 years if nominal growth over the past 30 years is maintained.

It can be expected that unless there are any major policy changes, China could only exceed the US in terms of consumption much later than it can in terms of GDP. As of now, China’s consumption has surpassed Japan but only represents 30% of US consumption.

Scenario I: Assuming 1) China follows Japan’s path and maintains the kind of growth experienced by Japan during 1957-1987; 2) China maintains a population of 1.4bn; 3) calculations are based on real values in US dollars, i.e. the current exchange rate; 4) the US maintains its pace of growth over the past ten years, China’s GDP will likely surpass the US around 2026. However, a relatively low proportion of private consumption in its economy means that China is unlikely to surpass the US to become the world’s largest consumption-driven country within the next 30 years (Figure 11).

Scenario II: If we replace assumption 1) above with that China maintains its pace of growth over the past ten years, while assumptions for the US remain unchanged, China’s GDP
is still likely to surpass the US around 2026, but it might take over the US around 2037 to become the world’s largest consumption-driven country (Figure 12).

Based on the discussion above, with appropriate policy measures, China needs to and could maintain relatively high consumption growth over the next 30 years. With manufacturing sector growth weakening, consumption will be the main driver of moderate economic growth. The size of China’s consumption might be somewhere between scenarios I and II. More importantly, consumption is by nature a slowly-changing variable, and its improvement requires early and prompt implementation of supportive measures such as accelerated urbanization, significant tax cuts, and substantial enhancement of retirement and healthcare protection.

II. Changes in the consumption structure

China’s consumption might have been underestimated, but it appears to be close to the levels for the US, Japan and Korea when they were at comparable per capita GDP levels based on data for some consumption subcategories. Overall, private consumption in China is approximately at the same stage as the US in the 1930s, Japan in the 1950s and Korea in the 1980s.
In the next 30 years following the abovementioned time periods, the proportion of food spending in the US, Japan and Korea would nearly contract by half, while per-1,000 resident motor vehicle ownership would increase two to three folds. Based on overseas experience, consumption subsector performance tends to diverge as per capita GDP continues to grow, with spending on consumer staples to be outpaced by discretionary. Due to a lack of data for the earlier days, we have looked at consumption structural changes in the US during 1976-2006 and in Japan during 1970-2000, and have reached a very similar conclusion (Figures 15, 16).

Based on a rough categorization where goods whose daily spending as a proportion of total consumer spending continues to decline are categorized as consumer staples, and those with a rising proportion are categorized as consumer discretionary, consumer staples mainly include food, tobacco, liquor & beverages, apparel & shoes, furniture, and home appliances, while consumer discretionary includes healthcare, education, entertainment & recreational products, transportation & telecom, water, electricity & fuel, and housing.

Figure 15 demonstrates changes in the proportion of consumer discretionary spending in Japan during the 30 years after 1970: the proportion of spending on housing, water & electricity, healthcare, education & entertainment, and transportation & telecom nearly doubled, and these are likely to be the fastest growing consumer subsectors for China over the next 30 years. Meanwhile, the proportion of spending on food, tobacco & liquor, apparel and daily necessities nearly shrunk by half during the period (Figure 18).
Based on China’s provincial data, consumption as a proportion of GDP has a U-shaped relationship with per capita GDP, first declining before picking up again as per capita GDP increases (Figure 19). At present, the consumption-to-GDP ratio in more developed regions such as Beijing, Shanghai and Zhejiang has picked up as per capita GDP rises. Food spending as a proportion of GDP has a strong negative correlation with per capita GDP, and is set to continue to go down going forward (Figure 20).

Based on provincial data for food spending as a proportion of total consumer spending and per-1,000 resident vehicle ownership, the more developed provinces of Jiangsu, Zhejiang and Guangdong are following the paths of Korea, Japan and the US (Figures 21, 22).
Over the past decade or so, consumer staples spending as a proportion of total consumer spending across various regions in China has declined, and at a faster pace especially since 2013 (Figure 23). In 2016, consumer staples accounted for 47.1% of total consumer spending in the northwestern region, 3.0pp and 5.5pp higher than the percentages in the central and eastern regions. During 2002-2016, spending on consumer staples grew by 2.6x, 3.1x, 3.1x and 3.3x in the eastern, central, western and northeastern regions, while spending on consumer discretionary grew by 4.8x, 4.7x, 4.4x and 5.5x (Figure 24).

The proportion of spending on consumer discretionary in the eastern, central and western regions is basically below the levels for Japan and Korea when their per capita GDP was at comparable levels (Figure 25). This proportion in the more developed eastern region has come closer to 60% since 2013 and to the level for Japan when it had a similar per capita GDP. This percentage is likely to reach nearly 80% in 30 years’ time, representing an upside of 20pp.

While the proportion of spending on consumer staples in China is set to come down, this does not entail that the growth upside to consumer staples spending is capped. Given a low base, simply the maintenance of current total retail sales growth of around 10%
means cumulative growth of 19.2x over the next 30 years. Based on the patterns across various provinces, spending on consumer staples is negatively correlated with the household savings rate, meaning that reducing the household savings rate could raise the proportion of consumer staples spending, partly due to the fact that some low-income regions have a relatively high proportion of precautionary savings (Figure 26).

III. What changes will consumption bring to China?

Given economies of scale for a large country and China’s current stage of economic development, consumption will bring changes to China as well as the entire world. It is unlikely for a large country to sustain its modernization process through exports and global consumption. On the contrary, the advantage of being a large country lies in the fact that it can achieve modernization without relying on overseas demand. Based on China’s current stage of economic development, consumption and consumption upgrade will be the core driver of high-quality economic growth.

Consumption will bring various changes to China, the most important three aspects being that: 1) Only consumption upgrade can drive manufacturing upgrade, which in turn is a necessary condition for sustainable consumption upgrade; 2) China will transform from a major exporter into a major consumption-driven country in the world, and from a country recording a trade surplus to one with a deficit; 3) A trade deficit driven by consumption will provide support for the regionalization and subsequent internationalization of the RMB.

1. Manufacturing upgrade driven by consumption upgrade

Since 2008, there has been a widening gap between China’s goods exports and manufacturing sector as a proportion of their respective G20 total (Figure 27). Accordingly, exports as a proportion of industrial and agricultural total production has continued to decline (Figure 28). This implies three options: 1) As global trade continues to recover, China will mitigate the pressure of overcapacity through increasing exports; 2) China will ensure reasonable demand growth through encouraging domestic consumption; 3) China will reduce its manufacturing sector growth and accordingly tolerate slower GDP growth. Among these three options, we find the encouragement of domestic consumption to be
more constructive – while economic growth will decelerate further, the resilience in consumption growth will help increase the resilience in overall economic growth.

Figure 27: Market shares of China’s goods exports and manufacturing sector among G20 countries (%)

![Graph of market shares of China’s goods exports and manufacturing sector among G20 countries (%).]

Sources: CEIC, Conference Board, GF Securities

Over the next 30 years or so, China’s strategy might be to increase the proportion of consumption in its economy while ensuring that its manufacturing sector maintains a stable or slightly increasing global market share. China is facing the mid/long-term challenge of ensuring that its GDP continues to rise as a proportion of the global total, while preventing the market share of its manufacturing sector among G20 countries from increasing significantly. Since the 1960s, the market share of the US manufacturing sector among G20 countries has shrunk by more than 50%. However, the proportion of the country’s GDP declined just slightly thanks to the strong support from domestic consumption (Figure 29). Based on nominal exchange rates, China has surpassed Japan to become the world’s second largest consumption-driven country. China’s global economic position will depend upon whether or not it can become a major consumption-driven country in the world after becoming a major exporter and manufacturer.

From this perspective, it can be said that the potential of China’s consumption upgrade determines the potential of its manufacturing upgrade.

Figure 29: US GDP and manufacturing sector as % of G20 total (%)

![Graph of US GDP and manufacturing sector as % of G20 total (%).]

Sources: CEIC, Conference Board, GF Securities
2. Consumption upgrade to reduce trade surplus

The process of China transitioning into a major consumption-driven country in the world is basically one of a declining trade surplus as: 1) declining exports following the relocation of low-end manufacturing industries typically happens along with consumption upgrade; 2) consumption upgrade tends to drive import growth. China is not far from becoming a country with a trade deficit, and a trade deficit is nothing to be fearful of. Based on overseas experience, the proportion of a country’s consumption in its GDP is typically negatively correlated with the proportion of trade surplus vs. its GDP.

Except for a few years in the 1980s, China has always been a country with a trade deficit. However, in recent years, its trade surplus has shown a declining trend, as the proportion it represents in the country’s GDP declined from the peak level of 6.5% to 3.5% in 2017 (Figure 35). Looking ahead, China may experience more monthly trade deficits, and the likelihood of China eventually turning into a country with an overall trade deficit will increase substantially.
3. Consumption to drive RMB internationalization

Several factors are behind the internationalization of a currency. In our view, consumption and a corresponding trade deficit are among the most critical factors. The degree of currency internationalization can be measured by several gauges; in terms of foreign exchange turnover, a country’s shares in global consumption and trade can basically explain its currency’s degree of internationalization (Figure 37). In comparison, due to regulatory restrictions, the RMB is much less internationalized than dictated by economic fundamentals. In other words, the potential of RMB internationalization is yet to fully play out.

Based on overseas experience, it is more likely for countries with a trade deficit to achieve currency internationalization. Major countries’ trade surplus as a proportion of GDP is negatively correlated with their share of total foreign exchange turnover. In other words, the larger trade surplus a country has, the less internationalized is its currency (Figure 38). If such experience is applicable to China, a large trade surplus is a constraint on RMB internationalization. To major countries and regions, China is their trade partner with the largest surplus, much larger than Europe, and the US is the largest trade-deficit country (Figure 39).
The internationalization of the domestic currency will help the expansion of outward direct investment (ODI), and thereby further promote the internationalization of the currency. Overseas experience indicates that the more internationalized a currency, the larger share of total ODI the country represents (Figure 40). The OBOR strategic plan is set to be an RMB-centric strategy. RMB internationalization is closely related to domestic reforms and consumption upgrade, but both are slowly-changing variables. Therefore, we think that the realization of the OBOR initiative will be a gradual long-term process.

Figure 39: Trade surplus/deficit for major regions, 2016 (US$ bn)  Figure 40: Shares of forex turnover and ODI (%)

Although China on the whole is a trade-surplus country, it has experienced regional trade deficits, which means RMB internationalization will likely start with the regionalization of the currency. Among G20 countries, China has a trade deficit with most developed countries (excluding Germany, Japan and Australia) and resource-rich emerging economies, and these goods dominated by Chinese demand are potentially subject to RMB pricing (Figure 41). China has a trade deficit with some of the OBOR countries (Figure 42), and the regionalization of the RMB may first start in these countries. Afterwards, the rise in China’s consumption power will gradually drive the RMB to become a major global currency. The internationalization of the currency will drive more RMB-denominated ODI; together with China’s consumption upgrade and import growth, this will fulfill important prerequisites for achieving the strategic goals of the OBOR initiative.

Figure 41: China’s trade surplus/deficit with G20 countries (2017, US$ bn)  Figure 42: China’s trade balance with OBOR countries (2017, US$ bn)

Sources: BIS, CEIC, GF Securities

Sources: CEIC, GF Securities
IV. A global consumption center

At the politburo meeting on April 23, "expanding domestic demand" was proposed again for the first time in three years, with an initiative to combine economic restructuring with domestic demand expansion. No doubt this is partly due to the latest uncertainties brought by China-US trade tensions; however, we believe “domestic demand” might have a different meaning this time around in that expanding domestic consumption is likely to represent the “new form of domestic demand”.

Promoting consumption is a good solution to China-US trade tensions. Firstly, China’s trade surplus will gradually decline along with consumption upgrade and manufacturing relocation – the most intense stage of China-US trade friction will be over soon. From this perspective, risks to the economy caused by China-US trade friction may be resolved. In addition, if trade friction has been deliberately employed to contain China’s rise, domestic consumption growth can offset risks tied to external factors. Consumption upgrade will still promote manufacturing innovation and upgrade in China, and will also mitigate political risks.

Trade tensions or “trade cold wars” initiated by the US might have successfully suppressed the rise of the former Soviet Union, Germany and Japan; however, this might not work very well on China. China still has sufficient room to escape the middle-income trap and become the world’s largest economy over the next ten years.

In 20 years’ time, China might become the world’s largest consumption-driven economy. For China, consumption upgrade is the future. To capture relevant investment opportunities, we highlight keywords such as branding, standardization, cross-generational upgrade, new business models, and world-class companies.

During 1996-2016, among the global top 500 companies, the number of Japanese companies dropped sharply from 141 to 52, while the number of Chinese companies surged from 2 to 110. The most important driver behind this was the rise of China’s large manufacturing sector. Currently, the vast majority of Chinese companies that have made it among the global top 500 are large SOEs, with a relatively small proportion of retail and consumer companies. According to statistics, in 2015, among the global top 100 retail and consumer companies, there were 39 US companies and just seven Chinese companies (Figure 44). Against the backdrop of consumption upgrade, coupled with China’s large domestic market, a number of domestic retail and consumer companies with growth potential are rising. To identify and take positions in these companies in advance will be crucial for value investors.
Figure 43: Number of companies among global top 500 by country

Figure 44: Global top 100 retail and consumption companies by country

Sources: PWC, GF Securities
Rating definitions

Benchmark: Hong Kong Hang Seng Index
Time horizon: 12 months

Company ratings

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<th>Rating</th>
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Sector ratings

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<td>Sector expected to underperform benchmark by more than 10%</td>
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