

## First Read

# China A-share Strategy

## Revisiting annual strategy: Minor bull market for large-caps; major bear market for small-caps

### Equity Strategy

China

#### Large-caps' minor bull still uncertain, small-caps' major bear increasingly clear

Since the interest rate cut on 22 November, the SSE 50 Index, CSI 300 Index, Shanghai Composite Index and CSI 500 Index have risen 38%/30%/25%/4%, respectively, while the SME and GEM indices have seen no gains. The SME and GEM indices have tumbled over the past five days and given back all the gains they made since the rate cut. The style rotation was so strong that investors who failed to change their investment mix in time may have suffered large losses in terms of net value.

#### We reiterate concern for small caps, watch CSI 500's margin trading sensitivity

1) As the money effect driven by the change in style is still spreading among individual investors, trend-following individual investors could quickly adjust their investment mix, thus accelerating the rotation in small/large-cap style. Some institutional investors may still be adjusting their style-investment mix. As of 30 September 2014, in the stock portfolios of publicly offered funds, financials (brokerage/insurance/banking) represented less than 4%, while the SME and GEM boards represented 55%. 2) The decline may lead to further declines. Some stocks, if they fall rapidly, may trigger a mandatory stop-loss for margin trading/securities lending. Specifically, when the margin trading/securities lending balance increased rapidly from Rmb400bn to Rmb700bn between July and October 2014, margin purchases were mainly small/mid-cap stocks, such as the constituents of the CSI 500 Index (GEM stocks/small SME stocks cannot be purchased on margin). If the CSI 500 Index continues to fall rapidly, it may trigger a mandatory stop-loss for the previous margin purchases. Therefore a fall may become a trigger for a further fall. In terms of sensitivity of margin trading/securities lending, the CSI 500 Index is more worthy of attention than the SME and GEM indices.

#### Small caps may face more downside risks for some time in future

3) Future stock supply pressure is always present. The draft for the IPO registration system reform may be released to the public in the next three months. Even if the implementation of the registration system is postponed to 2016 or later, investors will still be concerned about whether the 600+ companies queuing up in the pipeline will accelerate their listing on the market. And the 1300+ companies listed on the New Third Board are also watching the stock market's financing capacity. 4) The regulators' policy stance has clarified that "market cap management" is not "share price management". 5) The actual results of M&A since 2013 show that fewer than 40% of asset acquisitions have fulfilled their earnings commitments. More than 50% of asset injection M&A have not fulfilled earnings commitments, thus causing share price adjustments for many companies six months after M&A.

#### We reiterate bullish view on financials/real estate prior to Chinese New Year

We believe that if small-cap stocks continue to fall, their money effect, which has appeared since 2012, will gradually disappear, and investor sentiment will slump, which may lead to significant volatility in the market, and large-cap stocks may not be spared. Even this week's seasonal tight liquidity would be a reason for the adjustment of market volatility. However, we expect the monetary authorities to take appropriate measures to stabilise money market rates to meet the liquidity needs at end-2014. The expiry of wealth management products at end-2014 and the credit supply in early 2015 should provide funds for the stock market in the next two weeks. We therefore reaffirm our bullish view on the market before the Chinese New Year, and we favour the financial and real estate sectors.

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## Statement of Risk

We believe the medium-term downside risks to the A-share market include: 1) a slowdown in investment in new starts in the real estate sector leading to insufficient demand in the upstream of the sector; 2) since medium- to long-term money market interest rates are higher than the manufacturing EBIT margin, the manufacturing sector's willingness to invest remains weak; 3) a gradual QE exit, outflow of domestic funds, a long-lasting decline in new funds outstanding for foreign exchange and tight liquidity.

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Neutral	FSR is between -6% and 6% of the MRA.	42%	28%
Sell	FSR is > 6% below the MRA.	11%	21%
Short-Term Rating	Definition	Coverage <sup>3</sup>	IB Services <sup>4</sup>
Buy	Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.	less than 1%	less than 1%
Sell	Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.	less than 1%	less than 1%

Source: UBS. Rating allocations are as of 30 September 2014.

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Additional Prices: Baosteel Iron & Steel, Rmb7.15 (22 Dec 2014); Huaneng Power International - A, Rmb9.27 (22 Dec 2014); China Southern Airlines - A, Rmb5.53 (22 Dec 2014); Yantai Wanhua Polyurethanes, Rmb22.37 (22 Dec 2014); Inner Mongolia Yili Industrial, Rmb27.20 (22 Dec 2014); Great Wall Motor - A, Rmb39.57 (22 Dec 2014); Source: UBS. All prices as of local market close.

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