China Market Strategy

Where China shares are going? #2--A-shares bubble

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- **Danger of going into a bubble is high**

Liquidity and sentiment seem irrationally high, but does not appear to abate. At this stage, we believe the self-correcting mechanism of stock market is also not able to reverse the overpricing.

- **Government action to broaden the market**

We believe the measures of having more listings, QFII, QDII and financial futures are all the right cures. However, they may lag behind the fast-moving liquidity flow into the market.

- **What if the bubble continues?**

We believe conditions remain conducive to further run into a stock market bubble. Using past peak valuation as a guide, the Shanghai A-Share Composite Index could go higher before it reverts back to fundamental value.

- **Caution to investors**

We believe we are entering a phase of low predictability and high risk. While the index could still go higher, the eventual downturn could be damaging to investment performance. We re-iterate our A-share strategist's long-term valuation range of 2,200-2,900 on the Shanghai A-Share Composite index.

This report has been prepared by UBS Securities Asia Ltd

Going into a full-blown bubble

Traditional fundamental analysis suggests that share prices normally trade within a range around fair value. There are exceptional times of sustained over- or under- pricing. And at the extreme, there are the rare cases of bubbles, which typically reverse by crash. In this second report, we argue that **A-shares are at the beginning of a bubble, and could go even higher before the eventual reversal.**

Rationalizing irrationality

Let us review the market using our four-factor analysis:

(1) Growth and valuation have run their courses. These two drivers, namely, strong earnings growth (consensus +40% in 2007E, source: Wind.net) and PE re-rating, have driven the A-shares up. To support the current high market, these two factors must not only persist, but they must become even stronger. Otherwise expected return will only be dividends, which at 1.2% is very low indeed. We do not believe higher earnings growth or re-rating from these stretched levels could add significant upside from what the market has currently built in.

(2) Liquidity and sentiment have further to go. The other two drivers, namely, liquidity (the willingness to move liquidity into stocks) and sentiment (a belief that prices will rise simply because they have been rising), are still in strong momentum. While these two drivers do look rational, they have been very effective in driving this rally. Their current uptrend, if left unchecked, would push the market dangerously into a full bubble, in our view.

Bubble and a self-correcting market

A bubble goes through five typical stages: (1) a fundamental improvement, (2) smart money buys, (3) other investors follow, (4) price rises reinforce expectations of 'noise traders', and ending in (5) a price fall feeds on itself (*Is today's H-share index a bubble? #2: PE and re-rating*, 12 January 2007). Theoretically, the higher valuation gets, the more likely value investors are to sell. **Selling by value investors at high valuation could be triggered by a host of events. Its importance is that it could bring a significant price fall that could trigger a bubble crash.** This self-correcting mechanism does not appear to work at the moment. From recent discussions with overseas institutional investors, we believe many QFII investors have sold down their A-shares. This selling so far has not made a dent on the rally.

Nip it in the bud

History tells us that the bigger the stock bubble, the harder the crash. A possible check is government action. As Robert J. Shiller, a Yale University professor, pointed out, the head of the US Fed issued warnings in three US market peaks. The 1929 interest rate increase was announced as being directed against speculation. In 1965, Fed Chairman Martin warned of similarities with the 1920s and, in 1996, Chairman Greenspan talked about 'irrational exuberance'. What about action? Crack downs specific to the stock market by the government are rare. In February 1929, the US Fed raised the rediscount rate from 5% to 6%. Between May 1989 and August 1990, the Bank of Japan raised the discount rate from 2.5% to 6%.

Actions influencing trading

The following are approaches to dealing with bubbles: (A) **Interrupting or discouraging trading.** Examples are the “circuit breakers” and uptick rule for short sales in many exchanges, and China’s 10% daily price change limit. Talk of capital gains tax in China belongs to this “throw sand in the wheels” approach. (B) **Expanding or encouraging trading.** This is the opposite of interrupting or discouraging trade. By broadening the participants in the market and broadening the things traded, hopefully prices would stabilize. Examples are QFII, QDII, listing of H-shares and ‘Redchips’ in the A-market, the proposed financial futures, and potential sale of state-owned shares. The rapid expansion of the mutual fund industry also belongs to this “widen the road” approach to prevent accidents. (C) **China’s route.** *We believe the authorities in China are inclined towards the broadening approach.* However, the stabilizing effect of these measures is likely to lag behind the fast-and-furious drive by liquidity and sentiment.

Policy dilemma

The nature of speculative bubbles is complex; the available cases are few and their contexts are varied. China’s market is still in its development stage after the 2005 reform, and it is hard to predict the consequential resource misallocation of a bubble-and-crash. Policy makers would find it hard to design a set of ‘Goldilocks’ cooling measures that are not too hot and not too cold. There is also the question of, in a market-driven society, should the government protect people from the consequences of their own errors? As far as we know, the main action to date has been the investigation of illegal bank lending to stock trading activities in China.

The Chinese characteristics

Premier Wen announced macro tightening in March 2004 after the National People’s Congress, and took decisive administrative measures to cool down overheating industries. In recent years, the administration seems to have undergone a subtle change from charismatic leadership (Mao, Deng and Zhu) to that based on consensus building. In the case of property, there has been high-profile and concerted efforts to cool it. Regarding the stock market, there has been no official statement from top opinion leaders on a consensus for coordinated action. Moreover, an SCMP article suggests that there are vested interests in a buoyant market, such as the bank and insurance regulators. We believe many local governments and ministries would also want to see successful IPOs of SOEs. **While there may be isolated efforts to cool the bubble, we believe coordinated government measures are not imminent.**

Will the bubble end now?

Many commentators have cautioned the risk of near-term correction from government cooling, including Jon Anderson, UBS Chief Economist for Asia. As argued in the last paragraph, isolated cooling actions could only result in minor corrections, as demonstrated by the 9% one-day fall in February 2007. Instead, **we believe the probability of an extension of overpricing into a**

bubble has increased due to: (1) Our liquidity analysis in the first report in this series suggests ample of room for broad liquidity to continue its route into stocks, taking other Asian markets' experience as a guide. (2) As argued earlier, the self-correcting mechanism of the market has failed to function to trigger a trend reversal in this current bull phase. (3) Government crackdown action is likely to be isolated rather than coordinated in the near term.

High PE, forecasting the peak

Is PE high? The often-quoted high PE of 60 times is based on the Shanghai A-Composite index. Using the Shanghai-Shenzhen 300 index, which is more large-cap biased, the market PE on consensus 2007E EPS is below 30 times (Table 1). While this still looks expensive, it suggests that the market is not as overvalued as commonly believed. However, the SHSZ 300 suffers from a short history.

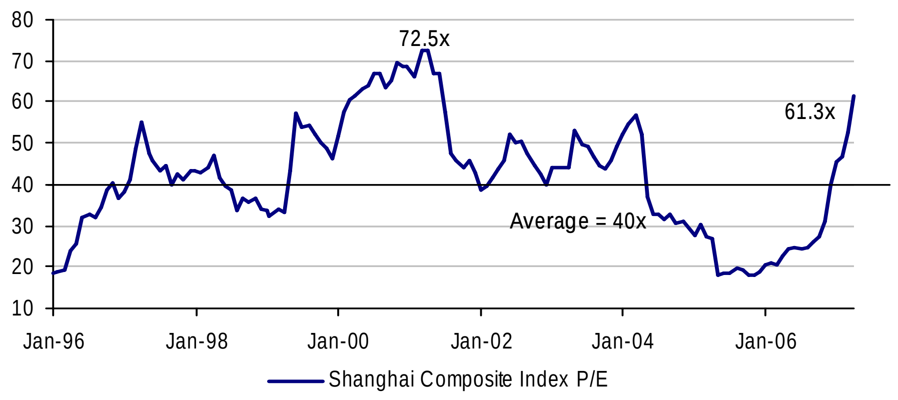
Forecasting the peak. While liquidity and sentiment are the engines and valuation is only a mileage signpost, lack of data leads us to resort to past peak valuation for this difficult task. Using the 2001 peak valuation in the Shanghai A-Composite index, our best estimate is a bubble peak at 4,600 on the Shanghai A-Composite index (Chart 1). This is equivalent to 72 times 2006 EPS and 42 times 2007 consensus EPS.

Table 1: Valuation parameters for SH/SZ 300 index

SHSZ300	2006	2007E	2008E
Net profit growth	37.1%	39.9%	25.9%
PE	38.49	27.40	21.77
PBV	4.84	4.04	3.46
Div.Yield	1.2%	NA	NA
ROE	12.6%	14.7%	15.9%

Source: Wind.net, UBS estimates

Chart 1: Shanghai Composite Index PE close to historic peak



Source: Wind.net, UBS

What should investors do?

Predicting bubble peak has inherently high risk due to: (1) low prediction confidence, (2) fluid and rapidly changing situation, and (3) costly wrong decision. While we are forecasting a further run-up to a bubble peak, we caution that potential gains can be fully wiped out or even exceeded by losses in a potential subsequent crash. **We recommend risk-averse A-share investors to put a strict limit to their exposure to A-shares in accordance with their respective portfolio's risk tolerance, despite potential near-term gains.** We will discuss alternative investments in the third issue of this series.

What can go wrong?

(1) A higher-than-expected interest rate rise in China of over 100 basis points over the next six months; (2) A warning statement by a public opinion leader and a set of coordinated market cooling measures; (3) A contraction in global liquidity for equities, or hike in perceived risk; (4) A sudden significant price fall in A-shares, in the magnitude of over 15% in a week.

■ Statement of Risk

In our view, risks include a hard landing, a sharp rise in the US dollar, weak corporate governance amidst a tightening scenario, worse-than-expected global growth, cross-straits tension, a property market correction, and a fragile domestic broking industry.

■ Analyst Certification

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UBS rating	Definition	UBS rating	Definition	Rating category	Coverage[1]	IB services[2]
Buy 1	FSR is > 6% above the MRA, higher degree of predictability	**Buy 2**	FSR is > 6% above the MRA, lower degree of predictability	**Buy**	47%	37%
Neutral 1	FSR is between -6% and 6% of the MRA, higher degree of predictability	**Neutral 2**	FSR is between -6% and 6% of the MRA, lower degree of predictability	**Hold/Neutral**	42%	36%
Reduce 1	FSR is > 6% below the MRA, higher degree of predictability	**Reduce 2**	FSR is > 6% below the MRA, lower degree of predictability	**Sell**	12%	28%

1: Percentage of companies under coverage globally within this rating category.

2: Percentage of companies within this rating category for which investment banking (IB) services were provided within the past 12 months.

Source: UBS. Ratings allocations are as of 31 March 2007.

KEY DEFINITIONS

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Market Return Assumption (MRA) is defined as the one-year local market interest rate plus 5% (a proxy for, and not a forecast of, the equity risk premium).
Predictability Level The predictability level indicates an analyst's conviction in the FSR. A predictability level of '1' means that the analyst's estimate of FSR is in the middle of a narrower, or smaller, range of possibilities. A predictability level of '2' means that the analyst's estimate of FSR is in the middle of a broader, or larger, range of possibilities.
Under Review (UR) Stocks may be flagged as UR by the analyst, indicating that the stock's price target and/or rating are subject to possible change in the near term, usually in response to an event that may affect the investment case or valuation.

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Unless otherwise indicated, please refer to the Valuation and Risk sections within the body of this report.

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