

UBS Investment Research

China Market Strategy

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

■ 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.

7 May 2007

www.ubs.com/investmentresearch**Henry Ho**Strategist
henry.ho@ubs.com
+852-2971 7537**Louis Shan**Analyst
louis.shan@ubs.com
+852-2971 7513This report has been prepared by UBS Securities
Asia Ltd

ANALYST CERTIFICATION AND REQUIRED DISCLOSURES BEGIN ON PAGE 5

UBS does and seeks to do business with companies covered in its research reports. As a result, investors should be aware that the firm may have a conflict of interest that could affect the objectivity of this report. Investors should consider this report as only a single factor in making their investment decision.

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.

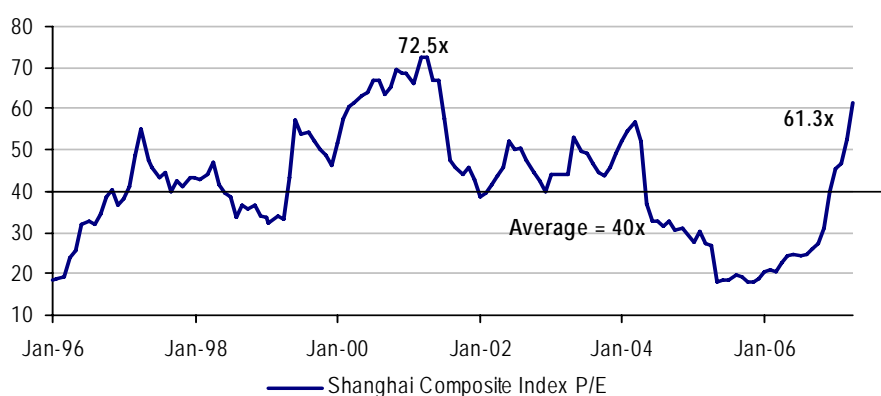
Forecasting the peak. While liquidity and sentiment are the engines and valuation is only a mileage signpost, lack of data leads us to resort to past peak valuation for this difficult task. Using the 2001 peak valuation in the Shanghai A-Composite index, our best estimate is a bubble peak at 4,600 on 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

Each research analyst primarily responsible for the content of this research report, in whole or in part, certifies that with respect to each security or issuer that the analyst covered in this report: (1) all of the views expressed accurately reflect his or her personal views about those securities or issuers; and (2) no part of his or her compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by that research analyst in the research report.

Required Disclosures

This report has been prepared by UBS Securities Asia Ltd, an affiliate of UBS AG (UBS).

For information on the ways in which UBS manages conflicts and maintains independence of its research product; historical performance information; and certain additional disclosures concerning UBS research recommendations, please visit www.ubs.com/disclosures.

UBS Investment Research: Global Equity Ratings Definitions and Allocations

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

Forecast Stock Return (FSR) is defined as expected percentage price appreciation plus gross dividend yield over the next 12 months.

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.

EXCEPTIONS AND SPECIAL CASES

US Closed-End Fund ratings and definitions are: Buy: Higher stability of principal and higher stability of dividends; Neutral: Potential loss of principal, stability of dividend; Reduce: High potential for loss of principal and dividend risk.

UK and European Investment Fund ratings and definitions are: Buy: Positive on factors such as structure, management, performance record, discount; Neutral: Neutral on factors such as structure, management, performance record, discount; Reduce: Negative on factors such as structure, management, performance record, discount.

Core Banding Exceptions (CBE): Exceptions to the standard +/-6% bands may be granted by the Investment Review Committee (IRC). Factors considered by the IRC include the stock's volatility and the credit spread of the respective company's debt. As a result, stocks deemed to be very high or low risk may be subject to higher or lower bands as they relate to the rating. When such exceptions apply, they will be identified in the Companies Mentioned or Company Disclosure table in the relevant research piece.

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

Global Disclaimer

This report has been prepared by UBS Securities Asia Ltd or an affiliate thereof ("UBS"). In certain countries UBS AG is referred to as UBS SA.

This report is for distribution only under such circumstances as may be permitted by applicable law. It has no regard to the specific investment objectives, financial situation or particular needs of any specific recipient and does not constitute a representation that any investment strategy is suitable or appropriate to a recipient's individual circumstances or otherwise constitute a personal recommendation. It is published solely for informational purposes, it does not constitute an advertisement and is not to be construed as a solicitation or an offer to buy or sell any securities or related financial instruments in any jurisdiction. No representation or warranty, either express or implied, is provided in relation to the accuracy, completeness or reliability of the information contained herein, except with respect to information concerning UBS AG, its subsidiaries and affiliates, nor is it intended to be a complete statement or summary of the securities, markets or developments referred to in the report. The report should not be regarded by recipients as a substitute for the exercise of their own judgement. Any opinions expressed in this report are subject to change without notice and may differ or be contrary to opinions expressed by other business areas or groups of UBS as a result of using different assumptions and criteria. Research will initiate, update and cease coverage solely at the discretion of UBS Investment Bank Research Management. The analysis contained herein is based on numerous assumptions. Different assumptions could result in materially different results. The analyst(s) responsible for the preparation of this report may interact with trading desk personnel, sales personnel and other constituencies for the purpose of gathering, synthesizing and interpreting market information. UBS is under no obligation to update or keep current the information contained herein. UBS relies on information barriers to control the flow of information contained in one or more areas within UBS, into other areas, units, groups or affiliates of UBS. The compensation of the analyst who prepared this report is determined exclusively by research management and senior management (not including investment banking). Analyst compensation is not based on investment banking revenues, however, compensation may relate to the revenues of UBS Investment Bank as a whole, of which investment banking, sales and trading are a part.

The securities described herein may not be eligible for sale in all jurisdictions or to certain categories of investors. Options, derivative products and futures are not suitable for all investors, and trading in these instruments is considered risky. Mortgage and asset-backed securities may involve a high degree of risk and may be highly volatile in response to fluctuations in interest rates and other market conditions. Past performance is not necessarily indicative of future results. Foreign currency rates of exchange may adversely affect the value, price or income of any security or related instrument mentioned in this report. For investment advice, trade execution or other enquiries, clients should contact their local sales representative. Neither UBS nor any of its affiliates, nor any of UBS' or any of its affiliates, directors, employees or agents accepts any liability for any loss or damage arising out of the use of all or any part of this report. Additional information will be made available upon request.

For financial instruments admitted to trading on an EU regulated market: UBS AG, its affiliates or subsidiaries (excluding UBS Securities LLC and/or UBS Capital Markets LP) acts as a market maker or liquidity provider (in accordance with the interpretation of these terms in the UK) in the financial instruments of the issuer save that where the activity of liquidity provider is carried out in accordance with the definition given to it by the laws and regulations of any other EU jurisdictions, such information is separately disclosed in this research report.

United Kingdom and the rest of Europe: Except as otherwise specified herein, this material is communicated by UBS Limited, a subsidiary of UBS AG, to persons who are market counterparties or intermediate customers (as detailed in the FSA Rules) and is only available to such persons. The information contained herein does not apply to, and should not be relied upon by, private customers. UBS Limited is authorised and regulated by the Financial Services Authority. France: Prepared by UBS Limited and distributed by UBS Limited and UBS Securities France SA. UBS Securities France S.A. is regulated by the Autorité des Marchés Financiers (AMF). Where an analyst of UBS Securities France S.A. has contributed to this report, the report is also deemed to have been prepared by UBS Securities France S.A. Germany: Prepared by UBS Limited and distributed by UBS Limited and UBS Deutschland AG. UBS Deutschland AG is regulated by the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin). Spain: Prepared by UBS Limited and distributed by UBS Limited and UBS Securities España SV, SA. UBS Securities España SV, SA is regulated by the Comisión Nacional del Mercado de Valores (CNMV). Turkey: Prepared by UBS Menkul Değerler AS on behalf of and distributed by UBS Limited. Russia: Prepared and distributed by the Moscow Representative Office of UBS Cyprus Moscow Limited. Switzerland: Distributed by UBS AG to persons who are institutional investors only. Italy: Prepared by UBS Limited and distributed by UBS Limited and UBS Italia Sim S.p.A.. UBS Italia Sim S.p.A. is regulated by the Bank of Italy and by the Commissione Nazionale per le Società e la Borsa (CONSOB). Where an analyst of UBS Italia Sim S.p.A. has contributed to this report, the report is also deemed to have been prepared by UBS Italia Sim S.p.A.. South Africa: UBS South Africa (Pty) Limited (Registration No. 1995/011140/07) is a member of the JSE Limited, the South African Futures Exchange and the Bond Exchange of South Africa. UBS South Africa (Pty) Limited is an authorised Financial Services Provider. Details of its postal and physical address and a list of its directors are available on request or may be accessed at <http://www.ubs.co.za>. United States: Distributed to US persons by either UBS Securities LLC or by UBS Financial Services Inc., subsidiaries of UBS AG; or by a group, subsidiary or affiliate of UBS AG that is not registered as a US broker-dealer (a "non-US affiliate"), to major US institutional investors only. UBS Securities LLC or UBS Financial Services Inc. accepts responsibility for the content of a report prepared by another non-US affiliate when distributed to US persons by UBS Securities LLC or UBS Financial Services Inc. All transactions by a US person in the securities mentioned in this report must be effected through UBS Securities LLC or UBS Financial Services Inc., and not through a non-US affiliate. Canada: Distributed by UBS Securities Canada Inc., a subsidiary of UBS AG and a member of the principal Canadian stock exchanges & CIPF. A statement of its financial condition and a list of its directors and senior officers will be provided upon request. Hong Kong: Distributed by UBS Securities Asia Limited. Singapore: Distributed by UBS Securities Pte. Ltd or UBS AG, Singapore Branch. Japan: Distributed by UBS Securities Japan Ltd to institutional investors only. Australia: Distributed by UBS AG (Holder of Australian Financial Services Licence No. 231087) and UBS Securities Australia Ltd (Holder of Australian Financial Services Licence No. 231098) only to "Wholesale" clients as defined by s761G of the Corporations Act 2001. New Zealand: Distributed by UBS New Zealand Ltd.

The disclosures contained in research reports produced by UBS Ltd shall be governed by and construed in accordance with English law.

© 2007 UBS. All rights reserved. This report may not be reproduced or redistributed, in whole or in part, without the written permission of UBS and UBS accepts no liability whatsoever for the actions of third parties in this respect.

