



## Rate-cut, reform & re-rating in the Year of the Ram

Yuliang Chang, CFA

Strategist  
(+852) 2203 6195  
yuliang.chang@db.com

### "R.R.R." in Year of the Ram: Riding the upward sloping "W" in 2015

We expect **rate-cut and reform to drive a mild market re-rating** in the year of the Ram. We see **an upward sloping "W" as the potential road map**, with heightening volatility in near term and nice gains later. Specifically, **we see MSCI China to return 15%** thanks to 6% valuation expansion, 5% earnings rollover and 3% dividend yield. HSCEI may reach 13,500 by end-2015.

### Macro: Broad-based easing to "hold on to the bottom line"; watch CPI & RMB

We forecast lower-than-consensus GDP in 1H15, while **2H15 may see a minor pick-up thanks to rates and RRR cuts in 1-3Q15**. We think the policy regime remains largely unchanged as "hold on to the bottom line, but refrain from lifting high". We suggest **closely watching the developments in CPI (esp. pork prices) and RMB depreciation** to gauge how far the policy easing could go.

### Earnings: Non-financial earnings to recover at the expense of financials

**We see a decent recovery in non-financial earnings growth to 8% in 2015** (vs. 0% in 2014), thanks to profit margin expansion amid softening commodity prices and falling financial costs. However, **financials' earnings growth may slow to 3% in 2015** (vs. 8.5%), sending **overall H-share earnings growth to 5.5%** (vs. 4.4%). This trend may extend in 2016 and H-share earnings could grow at a similar 5.4%. We believe **cost cutting has its limit for Chinese corporate, top-line is still needed** for a more sustainable earnings recovery.

### Liquidity: When G2 diverges – the loosening PBoC vs. the tightening Fed

**H-share liquidity conditions may weaken** due to **1) further global capital outflows** alongside the tightening Fed and strengthening US dollar, and **2) the mounting northbound while lukewarm southbound flows** in the Shanghai Connect. **A-shares may continue to benefit from the loosening PBoC** and outperform H-shares, but in the near term, we would watch out for prudential measures given recent rapid leverage build-up, esp. via alternative channels.

### Valuations: 8-11x the fair range; market to enter the "optimism" phase

Modeling MSCI China with a three-stage DDM, **we estimate 8-11x 12-month forward P/E as the fair valuation range**. We expect the index to re-rate from the current 9.4x 12-month forward P/E to **10x by end-2015**, based on 3.5% RFR and 6.5% risk premium. Also, considering around 5% rollover in 12-month forward EPS, MSCI China may enter the "optimism" phase with the "double hit" of rising P/E and EPS boosting the index by 12% to 74 by end-2015.

### Themes: Cost savers, top-line growers, reform beneficiaries & MSCI inclusion

We suggest focus on C.T.R.M. in 2015: **1) Cost savers:** Mid-stream and highly-leveraged sectors; **2) Top-line growers:** Healthcare, environmental protection, TMT, and child/senior-related consumption; **3) Reform beneficiaries:** SOE reform, "Go Global", financial reform, fiscal/tax reform and land/Hukou reform; and **4) MSCI inclusion:** select TMT and consumer discretionary to receive fund inflows at the expense of financials, energy and telecom.

### Implementation: Overweight info. tech, industrials, utilities, and health care

We recommend **overweight** info. tech., industrials, utilities and health care; **underweight** telecom and energy; and **market-weight** financials, consumer discretionary, staples and materials. We introduce our **2015 China top-10 picks** and highlight five top-down thematic stock screens.

#### Sector preference

Overweight	Information Technology
	Industrials
	Utilities
Market-weight	Health Care
	Financials
	Consumer Discretionary
Underweight	Consumer Staples
	Materials
	Telecom
	Energy

Source: Deutsche Bank Strategy Research

#### 2015 China top-10 picks

Ticker	Company	Ticker	Company
2318 HK	Ping An	BIDU US	Baidu
688 HK	COLI	1093 HK	CSPC Pharm
6030 HK	Citic Securities	2380 HK	China Power Int'l
1186 HK	CRCC	371 HK	BEWG
2009 HK	BBMG	816 HK	Huadian Fuxin

Source: Deutsche Bank Strategy Research



## Table Of Contents

<b>Summary</b> .....	<b>3</b>
Key views in eight charts .....	3
10 Q&A about our 2015 outlook .....	5
<b>Macro</b> .....	<b>9</b>
Renewed broad-based easing in response to the renewed slowdown... ..	9
...but policy regime likely remains largely unchanged .....	13
This milder but longer easing cycle implies weaker recovery .....	16
How far could the policy easing go? .....	18
More and better implemented reforms to improve efficiency .....	22
<b>Earnings</b> .....	<b>23</b>
2014 earnings preview: A sluggish 4.4% with zero growth in non-financials ..	23
2015/16 top-down forecast: Slightly better on non-financial margin pickup....	26
<b>Liquidity</b> .....	<b>29</b>
Further EM-to-DM fund flow may cap H-share upside .....	29
Easing PBoC helps A-share outperformance; watch NT prudential measures ..	30
SH-HK Connect: The mounting northbound vs. the lukewarm southbound.....	33
<b>Valuations</b> .....	<b>37</b>
Financials trade at big discount, non-financials largely at par .....	37
8-11x the fair P/E range based on three-stage DDM .....	38
Our index return framework suggests 15% potential gains in 2015 .....	39
Conceiving 2015 roadmap: The upward sloping "W" .....	43
<b>Themes</b> .....	<b>45</b>
Cost savers: Mid-stream to see the most margin expansion .....	45
Top-line growers: What the burgeoning middle class wants? .....	57
Reform beneficiaries: Focus on SOEs, non-bank financials and "Go Global" ...	65
MSCI inclusion: Making a better representation of Chinese corporate .....	77
<b>Implementation</b> .....	<b>86</b>
Sector strategy: OW cost savers, top-line growers and reform beneficiaries...	86
Stock ideas: 2015 China top-10 picks and five thematic stock screens .....	89
<b>Appendix</b> .....	<b>95</b>
Key statistics for Chinese equity markets .....	95

**Note: All prices in this report are as of 31 December 2014 unless otherwise stated.**