

# Dragon banishes bears

- Bear market trough now appears behind us; we believe we have had our 'Lehman's moment' for this cycle
- Some profit taking is inevitable but the bias should be upward
- We identify sectors and stocks vulnerable to profit-taking and candidates for new investment



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## ■ Summary

We are very encouraged by the strong rally in the first few weeks of 2012. As the Year of the (timid) Rabbit gives way to that of the (fiery) Dragon, we believe that the stage is set for a rewarding year for Chinese equities. We remain convinced that the October 2011 trough was the bear market low and reiterate our view that investors need to be fully weighted in the market. Against that positive backdrop, the HSCEI has moved into technically overbought territory and some profit-taking seems likely. We identify stocks that appear vulnerable in the near term.

So far, 2012 has been very rewarding for investors who kept faith with the China story. To Friday 3 February, the HSCEI had risen by 16.8% YTD and by 42.3% from its October 2011 low. We warned bearish investors in 4Q11 that Chinese equity valuations were so depressed, and sentiment so gloomy, that any good news was likely to trigger a substantial rally. That news came in the form of a growing perception that hard landing risks are receding as monetary easing has commenced and economic numbers have been stronger than expected. Additionally,

we have seen a steady trickle of news relating to the development of the institutional investor base in China, which would be supportive in the medium term. Finally, the flow of negative news from Europe (the most likely source of external shocks) has abated since the start of the year.

We are now of the view that we have had our 'Lehman's' moment (the event that signals the bear market low) for this cycle. Many had expected, and indeed still expect, this to be a Euro-crisis related incident. However, we believe that it came in summer 2011 in the form of the crescendo of cyclical (hard landing) and structural (LGFV crisis, property crash, bank NPL upsurge) pessimism that drove the market to its 4 October trough. The extent of international investor pessimism towards China was reflected in the underperformance of H shares relative to A shares from August to October 2011 (see the chart on this page). This helps to explain the outperformance of the H shares since the bear market low.

Looking forward, while we retain a very positive bias towards the market this year, some profit-taking seems inevitable since:

1. The base of China's economic recovery remains relatively narrow and could be derailed by external shocks. Economic news flow in the next few weeks is unlikely to be all positive.
2. Further monetary easing should be very gradual.

## China Strategy

3. The HSCEI looks overbought, having breached RSI 70. A level of 12,000 on the HSCEI also offers technical resistance.

At the stock level, we have screened our universe and considered:

- Current RSI overbought/sold levels
- YTD price changes
- Current level of new shorts
- Fundamentals (upside to our target prices)

We then identify near-term opportunities to take profits or to add to positions. Specific stock names follow below, in summary:

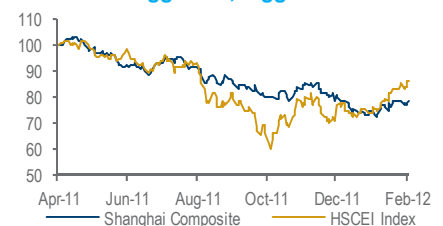
### Overbought:

**Banks** feature heavily here, along with the **Oil** stocks, several **Gaming** names and a range of **Machinery** and **Rail** names.

### Laggards:

**Utilities** inevitably feature strongly, together with **Coal**, **Cement**, **Autos** and **Power Equipment**.

### ■ H shares: bigger fall, bigger bounce



Source: Bloomberg; Note: Rebased to 100 on April 2011

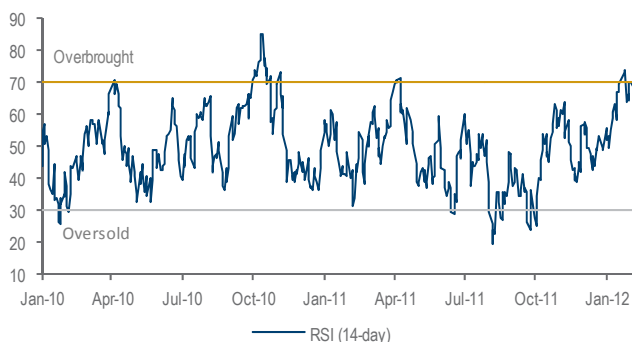
## Where to now?

*Upward bias likely to continue in 2012*

### Where to take profits, where to bargain hunt

As discussed on the front page, the Chinese market is at an interesting inflection point after the strong New Year rally. On the one hand, the H share index is looking somewhat overbought and vulnerable to profit-taking. At the end of January, the RSI overbought/oversold indicator moved above the 70 level, which signals an overbought situation.

#### ■ HSCEI has moved into overbought territory

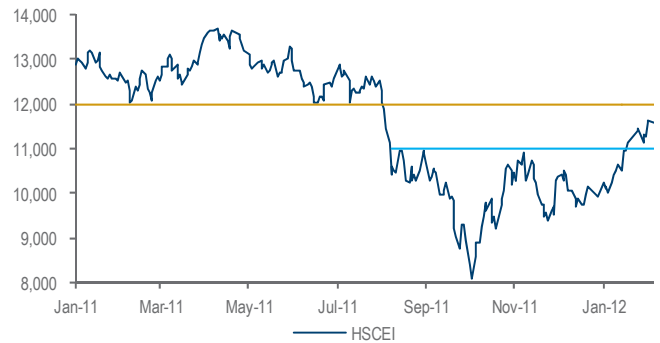


Source: Bloomberg

On the plus side, the market remained firmly overbought on this measure for the best part of a month in October 2010, rising almost 15% from the point at which it first went above 70, so this is not an infallible indicator of an imminent correction.

In addition, while it is encouraging that the index has broken up through the 11,000 level, which had been a barrier in both August and November last year, it is less than 4% away from what would appear to be a significant resistance level at 12,000.

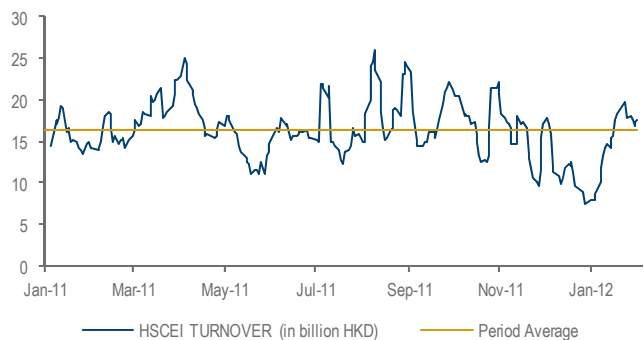
#### ■ HSCEI: resistance ahead at 12,000 level



Source: Bloomberg

Finally, while trading volumes have recovered from the depressed levels of 4Q11, they remain relatively anaemic, leaving some doubt about whether the market has the energy to punch up through that resistance level.

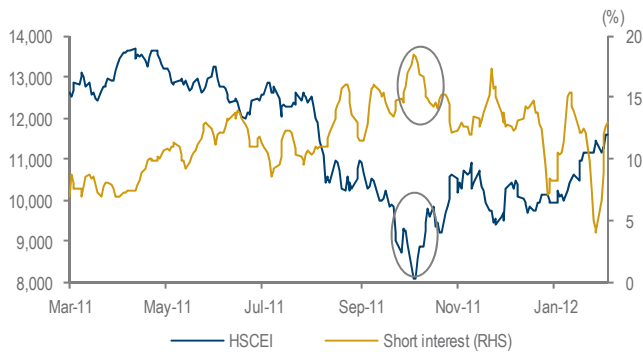
#### ■ Daily trading volumes remain close to recent average



Source: Bloomberg

On the other hand, it is always dangerous to underestimate the momentum of a rally when a market is coming off a period of extreme bearishness and ultra-low valuations, which is where the current upswing started in 4Q11. Moreover, the pattern of new shorting activity in the market seems to point to a change in market sentiment since the October trough.

■ **New short positions and the HSCEI**



Source: Bloomberg, Daiwa

The preceding chart shows the HSCEI and the five-day moving average of new short positions taken out. As we have pointed out previously, the October Index trough coincided with a new peak in short activity, implying potential upward momentum from short covering. We saw two bouts of apparent short covering in early and late January, which pushed new short positions to a 12-month low before the recent rebound. That should have been a signal of a looming correction, but the fact that the market pushed higher in the face of this appears to point to strong underlying support. Basically, the trend in new short positions appears to have reversed the uptrend that was in place for most of 2011, suggesting investors are wary of betting against a rising market.

Finally, while there will undoubtedly be trading opportunities as the year progresses, it is worth remembering that despite the strong recent rally, at 9.4x 12-month forward earnings, the MSCI China index is still very much at the low end of its long-term valuation range. In that sense, we would focus more on buying on dips than selling on rallies.

■ **MSCI China PER still at the low end of the long-term range**



Source: MSCI, IBES

## Sector and Stock Recommendations

### Sectors vulnerable to profit-taking

**Banks:** We stressed in our 2012 China Outlook report (3 January 2012) our view that investors needed to be fully weighted in the Banks Sector this year. We remain committed to this view, but would point out that there are five Chinese banks in our ‘Overbought’ list below. Given our fundamentally positive stance on the sector, we would regard this more as a signal to wait for a pull-back before continuing to build positions rather than a ‘sell’ signal. For those investors who do want to take some money off the table in the near term, however, **China Construction Bank (939 HK)** looks the most vulnerable at current levels.

**Gaming:** Another sector that leaves us with something of a dilemma, as our sector analyst, Gavin Ho, is positive and his two top picks – **Galaxy (27 HK)** and **Sands China (1928 HK)** – have outperformed significantly YTD. While they certainly have momentum at the moment, the magnitude of the gains and the fact that both are technically overbought suggests vulnerability to profit-taking in the near term.

**Oil:** The strong YTD performance of **Petrochina (857 HK)** and **Sinopec (386 HK)** perhaps reflects investors’ desire to rebuild positions in neglected large caps. However, both now look overbought and have downside to our target prices.

**Machinery / Rail:** These are two laggard sectors that have taken off in 2012. **China Railway Construction (1186 HK)** and **Zoomlion (1157 HK)** are amongst the best-performing stocks in the entire market YTD. **Longking (3339 HK)** and **China Railway Group (390 HK)** have lagged somewhat but still outperformed the market. We are lukewarm at best on these names and would certainly be more willing to take profits here.

### Laggards

On the flip side, it is interesting to note that while there is an element of predictability about some of the laggard sectors (eg, utilities, telcos, consumer staples), several cyclical sectors that might have been expected to participate in the rally have also trailed behind. These include Aviation, Steel, Coal and Cement. One reason for this may have been that there was no shortage of cheap, high-quality, blue-chip names (banks and insurance stocks, for example) for investors to choose from in 4Q11, so in that sense there was no need to go down the quality curve into deep cyclicals to

play the market upturn. While we would continue to be very wary of airlines and steel stocks, we are much more positive on cement and coal stocks and would focus our 'laggard hunting' attention there.

**Coal: Yanzhou Coal (1171 HK)** and our top sector pick, **China Shenhua (1088 HK)**, are both prominent on our laggards list, with 15-20% upside potential to our six-month target prices. We are positive on the sector for 2012 and the weak trend in 1Q12 coal prices offers an opportunity to get positioned in the key names.

**Cement: West China Cement (2233 HK), China National Building Materials (3323 HK)** and **China Resources Cement (1313 HK)** are all comfortably placed in the middle of the RSI range and have significant upside potential to our six-month target prices. Again, we are positive on the sector fundamentally in 2012.

**Power & Power Equipment:** In the Power sector, our top pick, **China Resources Power (836 HK)**, has underperformed its peers, we believe at least partly because of the company's relatively high coal self-sufficiency. With weak coal prices expected to reverse in 2Q12, we see this as a good time to add to positions. In the power equipment sector, we would stay with our top pick **Shanghai Electric (2727 HK)**.

**Autos: Dongfeng Motor (489 HK)** continues to look cheap relative to peers in an industry that we expect to perform well in 2012, while **Brilliance China (1114 HK)** also looks neglected.

■ **Overbought stocks which look vulnerable to profit-taking\*\***

Ticker	Name	Rating	Target price	Share price	Upside / downside to target price	YTD Share price change	RSI (14-day)	5DMA short interest minus YTD average*
45 HK	Hong Kong and Shanghai Hotels	3	10.58	10.64	-0.6	23.6	79.3	(2.4)
1186 HK	China Railway Construction	3	4.60	5.83	-21.1	36.2	79.2	5.3
3311 HK	China State Construction International	1	7.20	6.70	7.5	21.6	78.0	6.7
939 HK	China Construction Bank	2	6.25	6.39	-2.2	17.9	77.3	(1.6)
386 HK	Sinopec Corp	3	8.40	9.62	-12.7	17.7	77.0	3.6
1800 HK	China Communications Construction	1	7.50	7.59	-1.2	25.0	75.4	(1.0)
1928 HK	Sands China	1	26.25	28.25	-7.1	28.7	75.2	(4.0)
440 HK	Dah Sing Financial	2	29.00	28.05	3.4	20.6	74.1	3.2
658 HK	China High Speed Transmission	3	4.60	4.88	-5.7	43.5	74.1	1.1
2356 HK	Dah Sing Banking Group	2	8.00	8.22	-2.7	24.0	73.8	(2.1)
390 HK	China Railway Group	3	2.70	2.88	-6.2	18.5	73.4	1.5
1071 HK	Huadian Power International	3	1.46	1.81	-19.3	18.3	72.0	(3.2)
902 HK	Huaneng Power International	2	4.57	4.77	-4.2	15.5	71.8	4.0
27 HK	Galaxy Entertainment Group	1	19.54	18.08	8.1	27.0	71.2	4.6
3988 HK	Bank of China	3	2.95	3.39	-13.0	18.5	70.6	(0.7)
3328 HK	Bank of Communications	2	6.80	6.42	5.9	18.2	70.4	7.4
1157 HK	Zoomlion Heavy Industry	3	10.10	11.36	-11.1	35.9	70.2	5.4
998 HK	China Citic Bank	3	4.40	5.02	-12.4	14.9	68.6	1.3
2208 HK	Xinjiang Goldwind Science & Technology	2	4.50	5.02	-10.4	20.7	67.3	(2.0)
358 HK	Jiangxi Copper	2	18.50	20.80	-11.1	24.0	67.1	8.1
200 HK	Melco International Development	2	6.67	6.96	-4.2	20.6	66.9	6.3
3968 HK	China Merchants Bank	2	19.40	18.04	7.5	14.9	66.6	(4.2)
857 HK	PetroChina	3	10.20	11.48	-11.1	18.7	65.9	2.3
3339 HK	Lonking Holdings	4	2.51	3.27	-23.2	24.8	64.8	1.9
1766 HK	CSR Corp	3	5.60	5.48	2.2	23.4	63.4	(2.1)
960 HK	Longfor Properties	3	9.70	10.38	-6.6	18.2	62.6	7.8
2282 HK	MGM China Holdings	2	11.80	11.86	-0.5	16.7	62.4	(4.1)
1813 HK	KWG Property	4	2.30	3.41	-32.6	30.2	61.5	10.4
1898 HK	China Coal Energy	3	10.00	10.06	-0.6	20.0	61.0	0.7

Source: Bloomberg, Daiwa forecasts Share prices are as of 3 February 2012

Note: \*five-day moving average of new short interest; \*\* our picks are more tactical in nature and may be different from our ratings on these stocks, which are based on fundamentals with a six-month time horizon.

■ **Laggards with good upside potential\*\***

Ticker	Name	Rating	Target price	Share price	Upside / downside to target price	YTD Share price change	RSI (14-day)	5DMA short interest minus YTD average*
696 HK	TravelSky Technology	1	5.30	4.31	23.0	6.7	57.6	(4.0)
2688 HK	ENN Energy	1	34.00	24.50	38.8	-1.6	57.1	7.5
1171 HK	Yanzhou Coal Mining	1	22.60	18.62	21.4	12.3	55.8	2.8
951 HK	Chaowei Power	1	5.10	3.21	58.9	0.0	55.4	0.5
2233 HK	West China Cement	2	1.75	1.33	31.6	2.3	54.9	(2.2)
3323 HK	China National Building Material	1	12.90	9.54	35.2	8.2	54.8	9.7
753 HK	Air China	1	7.50	6.19	21.2	7.8	54.5	(5.9)
669 HK	Teclonic Industries	1	10.50	8.71	20.6	9.0	54.3	(11.2)
1313 HK	China Resources Cement Holdings	1	9.45	5.75	64.3	-0.7	54.0	5.6
392 HK	Beijing Enterprises	2	53.10	44.75	18.7	-4.0	53.4	(0.6)
489 HK	Dongfeng Motor Group	1	16.90	14.32	18.0	7.5	53.0	1.1
1088 HK	China Shenhua Energy	1	39.70	34.70	14.4	3.0	52.4	(1.8)
6 HK	Power Assets	2	68.00	55.90	21.6	-2.7	51.7	7.2
1114 HK	Brilliance China Automotive	1	10.00	8.38	19.3	0.0	51.6	3.4
694 HK	Beijing Capital International Airport	1	4.40	3.91	12.5	0.3	50.4	(0.4)
916 HK	China Longyuan Power	1	7.60	5.87	29.5	-3.3	48.3	(0.5)
836 HK	China Resources Power	1	18.00	14.72	22.3	-1.7	47.6	(6.5)
1899 HK	Xingda International	1	4.80	3.24	48.1	-7.4	47.0	(0.5)
2727 HK	Shanghai Electric Group	1	4.70	3.74	25.7	4.2	46.9	1.0
763 HK	ZTE	2	32.01	22.30	43.5	-8.4	45.6	(1.1)
1038 HK	Cheung Kong Infrastructure	2	55.80	43.25	29.0	-4.9	44.5	(3.1)
823 HK	The Link REIT	2	32.3	28.05	15.2	-1.9	44.3	(1.3)
410 HK	Soho China	3	6.00	5.10	17.6	-1.4	43.6	(11.3)

Source: Bloomberg, Daiwa forecasts Share prices are as of 3 February 2012

Note: \*five-day moving average of new short interest; \*\* our picks are more tactical in nature and may be different from our ratings on these stocks, which are based on fundamentals with a six-month time horizon.

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