

Market Strategy

June 2010

MARKET OUTLOOK

Market turnover will remain thin in June

China is likely to slow the pace of renminbi revaluation and interest rate hikes amid the debt crisis in Europe. The recent falls in gasoline and diesel prices should reduce inflationary pressure in the second half of the year although inflation rate in May and June are expected to exceed 3%. We believe China will keep interest rate unchanged and the renminbi stable until the fourth quarter. The growth momentum of China's economy will inevitably weaken in the second half of the year given a slowdown in exports and property market. We reiterate our view that current valuation of the Hang Seng Index is attractive for long-term investors. However, we see no catalyst for a positive re-rating in near term. We believe the stock market turnover will remain thin in June while the benchmark index will trade range between 19,000 and 21,000.

Prefer local banks given high dividend yield

The approval by the State Council to gradually push ahead with property tax reform suggests that current tightening measures on the property market will not be relaxed despite growing uncertainty about global economic recovery. We think it is still not the right time to accumulate China property stocks even though their share prices have fully discounted expectation of some 20-30% drop in property prices over the next six to twelve 12 months. The fund raising exercises of China's commercial banks are likely to delay in order to facilitate a successful floatation of Agricultural Bank of China in July. We continue to maintain our neutral position on Chinese banks and property developers. Local banks such as Hang Seng Bank (11) and BOC Hong Kong (2388) look attractive for conservative investors given high dividend yield of 5%.

Overweight consumption stocks

We remain bullish on consumption, telecom, auto and coal stocks. Our top picks are China Unicom (762), Mengniu Dairy (2319), Belle (1880), Dongfeng Motor (489) and Yanzhou Coal (1171).

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MARKET REVIEW

European debt crisis changed the risk appetite of investors

Debt crisis in Europe and tightening measures in China weighed on global equity prices in May. Major stock markets in the U.S. and Europe, except for Germany, tumbled 6% to 8%. Japan's Nikkei 225 fell 12%. Most of the stock markets in Asia ex-Japan plunged 5% to 10%. Shanghai SE Composite Index, Hang Seng Index and HSCEI shrank 9.7%, 6.4% and 5.6% respectively. Mounting concerns over the European economy depressed commodity prices and the euro while the U.S. treasury prices rallied. Crude oil futures price sank 14.1% and the euro dropped 7.4% against the U.S. dollar during the month of May. Aluminium, copper and steel prices all declined. However, the rise in gold price to a record high and decline in U.S 10-year treasury yield demonstrated a change in the risk appetite of investors.

Heavy sell off in stocks with exposure to Europe

Esprit (330) and Foxconn (2038), down 19%-20%, were the worst performing constituents of the Hang Seng Index in May given its heavy exposure to Europe. HSBC (5), Hutchison (13) and Li & Fung (494) also declined 10%-12% for the same reason. Worries about a slowdown in China's export to Europe put pressure on port operators and shipping companies. China Cosco (1919), China Shipping Development (1138), China Merchants (144) and Cosco Pacific (1199) retreated 10%-15%. Non-ferrous metal stocks suffered from falling commodity prices. Chalco (2600) and Jiangxi Copper (358) lost 14% and 7% respectively. Weaker passenger car sales in China caused profit taking on auto stocks. Dongfeng Motor (489) and BYD Company (1211) tumbled 16% and 7% respectively. Hong Kong property stocks largely cut 6%-12% given disappointing land auction results and new stringent regulatory policies on property pre-sales.

Large Chinese banks and telecom stocks outperformed

Defensive stocks including Hong Kong utilities and Chinese telecom stocks outperformed the stock market in May. Large Chinese banks stayed firm thanks to attractive valuation. ICBC (1398) was flat whilst CCB (939) and BOC (3988) fell 2% and 5% respectively. Strong government commitment to enlarge production of affordable and welfare housing in China boosted cement stocks. Anhui Conch (914), the best performing constituent of the HSCEI, advanced 1% whilst CNBM (3323) was down 2%. China's tightening measures on the property market started taking effect. The number of property sales transactions in the main cities of China reduced by some 50% in May. Chinese property stocks showed mixed performance. China Resources Land (1109), Longfor Properties (960) and Poly HK Investment (119) advanced 2%-3% whilst Shimao Property (813), Agile Property (3383), Country Garden (2007), Guangzhou R&F (2777) and Sino-Ocean Land (3377) decreased 4%-9%. Oil, insurance, power, railway and Hong Kong banking sectors basically moved in line with the benchmark indexes.

Stock Performance Summary for May 2010

Sector	Stocks	% chg in share price in May 10	Reasons
	Hang Seng Index (19,765)	-6.4	Decline in A-share market plus debt crisis in Europe
	HSCEI (11,494)	-5.6	
Outperform			
HK Utilities	HK Electric (6), CLP Holdings (2)	+1	Defensive stocks
Large PRC banks	ICBC (1398), CCB (939), BOC (3988)	0 to -5	Cheap valuation
Telecom	China Mobile (941), China Unicom (762), China Telecom (728)	-1 to -5	Defensive stocks
Cement	Anhui Conch (914), CNBM (3323)	-2 to +1	Extra demand from production of affordable housing
China property	China Overseas Land (688), Shimao (813), China Resources Land (1109), Longfor (960), Country Garden (2007), Sino-Ocean Land (3377), Agile (3383), R&F (2777), Poly HK (119)	-9 to +3	Drastic property measures have been fully discounted in share price
In line/ Mixed			
HK banks	Hang Seng Bank (11), BOC Hong Kong (2388)	-3 to -7	High dividend yield
Power	Huaneng Power (902), Datang Power (991), China Resources Power (836)	-2 to -8	
Insurance	China Life (2628), Ping An Insurance (2318), PICC P&C (2328)	-4 to -8	Decline in A-share market may affect investment income
Oil	PetroChina (857), Sinopec (386), CNOOC (883)	-2 to -10	Falling crude oil price
Railway	China Railway (390), China Railway Const (1186)	-5 to -6	
Underperform			
HK property	Cheung Kong (1), SHK Properties (16), Henderson Land (12), Sino Land (83), New World Development (17), Wharf (4)	-6 to -12	New policies on property pre-sale and disappointing land auction results
Small PRC banks	Minsheng Bank (1988), CITIC Bank (998), Bank of Communications (3328)	-7 to -11	
Non-ferrous metal	Zijin Mining (2899), Jiangxi Copper (358), Chalco (2600), MCC (1618)	-7 to -14	
Auto	BYD Company (1211), Dongfeng Motor (489)	-7 to -16	Decline in China's auto sales in May
Coal	China Shenhua (1088), China Coal (1898), Yanzhou Coal (1171)	-8 to -19	
Shipping	China Cosco (1919), China Shipping Dev (1138)	-10 to -15	Anticipation of a slowdown in China's export
Port	China Merchants (144), Cosco Pacific (1199)	-11 to -12	
Europe exposure	HSBC (5), Esprit (330), Foxconn (2038), Li & Fung (494), Hutchison (13)	-10 to -20	European economic worries



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