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## China A-share strategy

# 2H2011 A-share Outlook: Appealing risk/reward

Equity Research

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### Rebound in the near-term, range-bound afterwards, watch for possible inflection points in inflation/policy

We believe the market will be range-bound after the short term bounce and return should be more pronounced as we see more signs of inflation peaking, growth stabilizing, or policy fine-tuning, possibly around mid-3Q or later. Further to our softening tone in the May 16 report (*Earnings concern, few catalysts*), we cut our year-end target for CSI300 to 3,400 from 4,000 mainly based on lower valuation assumption and lower earnings growth. The new target still implies a medium-term constructive view.

### High-teen growth in 2011E after cutting earnings forecasts amid margin pressure

Our updated top-down estimates based on refreshed growth/ inflation/ commodity prices forecasts indicate 17.4%/12.8% 2011E/2012E earnings growth for CSI300 index, 5.3ppt/3.9ppt lower than our previous forecasts, basically as a result of stable top-line growth but lower margins. We believe any potential earnings downgrade would not have significant impact on the market as the recent correction has already factored downside earnings risk to a large degree, although it may differentiate on a sector wise basis.

### Prefer consumption + low valuation cyclical

We upgrade food & beverage/health care from neutral to overweight, and upgrade oil& petrochemical from underweight to neutral, downgrade capital goods/shipping from neutral to underweight. Overall we like consumption with reasonable valuation (**food & beverage, health care, home appliances, and retailing**), low valuation and policy sensitive cyclicals (**property, coal, building materials**), and dislike utility, telecom and industrials. We are neutral on banks and insurance. We are much less bearish towards small-mid caps than before and suggest being selective in stock picking.

**Top Buy ideas for A-share market in 2H2011**

| Ticker | Name | Sector | Performance YTD (%) | Market cap (Rmb bn) | Price (Pricing currency) | P/E CY 2011 (X) | P/B CY 2011 (X) |
|---|---|---|---|---|---|---|---|
| 600048 CH | Poly Real Estate Group | Real Estate | 11.3 | 59.9 | 10.6 | 9.0 | 1.7 |
| 600376 CH | Beijing Capital Development Co. | Real Estate | -1.1 | 17.8 | 12.6 | 9.1 | 1.5 |
| 000937 CH | Jizhong Energy Resources | Energy | 28.5 | 55.9 | 25.5 | 17.4 | 4.1 |
| 601699 CH | Lu'an Environmental Energy Development | Energy | 10.6 | 65.4 | 66.0 | 15.9 | 4.4 |
| 600585 CH | Anhui Conch Cement (A) | Materials | 39.0 | 132.2 | 27.3 | 11.4 | 2.9 |
| 002024 CH | Suning Appliance Co. | Consumer Discretionary | -1.4 | 84.7 | 12.8 | 15.8 | 3.7 |
| 000527 CH | GD Midea Holding | Consumer Discretionary | 6.9 | 57.1 | 18.3 | 13.5 | 2.9 |
| 000858 CH | Wuliangye Yibin | Consumer Staples | 3.7 | 130.2 | 35.9 | 23.3 | 5.9 |
| 000869 CH | Yantai Changyu Pioneer Wine (A) | Consumer Staples | 1.0 | 48.5 | 97.9 | 27.0 | 9.8 |
| 600252 CH | Guangxi Wuzhou Zhongheng Group | Health Care | 1.4 | 18.1 | 18.1 | 18.5 | 8.7 |

*Source: CEIC, Wind, Gao Hua Securities Research, GS Global ECS Research.*

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*The prices in the body of this report are based on the market close of June 23, 2011 unless specified otherwise.*

The author would like to thank Chenjie Liu for his contribution to this report.

# 2H2011 key views: Appealing risk/reward

In this report we provide our 2H11 A-share market views and sector preferences based on the major developments since our update report on May 16 (*Earnings concerns, few catalysts*). We are relatively less bearish towards the A-share market after the recent correction and believe the risk/reward profile of the market is becoming appealing, though we should continue to see few positive catalysts in the near term. Key points in this report include:

**Macro: slower growth, and inflation, and probably less tightening**. Compared with what we saw in 1H2011, we should see growth continuing to slow down amid the persistent tightening since 4Q2010 before picking up some strength towards the end of 3Q/early 4Q. Inflation pressure may have already peaked in June and should turn gradually lower towards the end of the year, although the recent rally in pork prices brings some uncertainties. Policy tightening should maintain in the near term but could have some room to fine-tune when we see more signs of inflation peaking. The possible inflection point in inflation/policy stance is among the key factors we would monitor closely in 2H11.

**Earnings**: **slower earnings growth amid stable top-line growth but meaningfully lower margins, still high-teen growth in 2011E.**

- **Cut top-down earnings forecasts**: Further to potential earnings risk highlighted in our May 16 report (*Earnings concerns, few catalysts*), we update our top-down earnings forecast based on refreshed forecasts on GDP/inflation and commodity prices. Specifically our updated top-down earnings growth forecast for CSI300 is 17.4%/12.8% 2011E/2012E, down 5.3ppt/3.9ppt respectively from previous forecast, basically as a result of stable top-line growth but lower margins.
- **Earnings risks largely priced in, though it may differentiate on a sector wise basis**: The recent correction in A-share has factored in (to a large degree) potential earnings risk. On sector wise basis, we believe further downgrade earnings risk remain in capital goods, steel, chemical, construction and transportation sectors, etc, mainly due to slower-than-expected pace in social housing construction/infrastructure building amid tight local government liquidity.

- **Margin pressure: upstream/downstream hold better than mid-stream sectors**. So far this year we have seen some overall margin squeeze amid rising raw material costs, labor costs and financing costs, etc. Margins for the upstream sectors (e.g. mining and materials) and downstream sectors (e.g. consumer) hold relatively better than mid-stream sectors (capital goods and intermediate products manufacturing, etc) in the course of rising cost pressure, which is consistent with what we saw during the high inflation periods of 2004-2005/2007-2008. Overall we believe margins should bottom out in 2Q and be flat in 3Q and slightly improve towards the later end of this year, when there are more signs of inflation pressure abating.

**Liquidity & valuation: tighter liquidity, lower valuation.** Liquidity has been tighter than we expected at the year beginning due to:1) frequent policy changes to tighten the property market and manage inflation have led to lower risk-taking appetite, resulting in fund outflow from the equity market; 2) monetary tightening so far has boosted the yield for fixed income products, especially with those short-term tenors, diverting investable funds; 3) other non-conventional financial segments (like PE/VC funds etc) are also developing rapidly, attracting money inflow, etc. We believe that most of the factors behind the tight liquidity are cyclical rather than structural, and liquidity condition for A-share market should improve moderately when we see more signs that the cyclical concerns (inflation risks) abate or dissipate, but overall we still expect liquidity to be tighter than we saw in 2010. The tighter liquidity, together with the frequent policy changes seen so far, have resulted in a lower valuation for the A-share market and should continue to cap the market valuation over the near term. We thus lower our valuation assumption for CSI300 index from 14.2x 12-m forward P/E (as discussed in our April 7 report) to 13.0x.

**Updated year-end index target: Still implies mid-teen return potential for the rest of the year**.

- **Cut year-end index target for CSI300 to 3,400 from 4,000**. Further to our softening tone in our May 16 report, we lower our year-end index target for CSI300 to 3,400 from 4,000 (-15% cut) based on lower valuation (around -10ppt contribution) and lower earnings growth forecast (-5ppt contribution). The new index target implies a mid-teen return potential in the coming 6 months.

- **Possible index path: Range-bound trade after short-term rebound, and return should be more pronounced when we seeing more signs of inflation peaking, growth stabilizing or policy fine-tuning**. In our May 16 report we expected the time for market sentiment improving should be some time around mid of the year/early 3Q. While we still believe market sentiment will improve from now (as the A-share market was oversold on a series of unfavorable news flows and events since mid-April (potentially more tightening in later April, the drought in early May in Southern China, the pork prices rally since mid may, potentially more stringent CAR requirements on banks, etc)), the recent developments in inflation (the rise in pork prices) further blurs the inflation outlook and some external factors bring more complications (the recent global growth slowdown, especially for the US, and the debt crisis in the peripheral Europe countries). We think the market may be volatile and range-bound after the short-term rebound. We expect more pronounced return until we see more signs of inflation peaking, growth stabilizing, or policy fine-tuning. We expect the inflection point should be sometime around mid-3Q or later, when the market should have more information on whether the inflation have peaked, what the 2Q earnings and 2H growth look like, etc.

- **Introducing the 12-m index target**. We also introduce the 12-m index target (mid 2012) for CSI300 at 3,600, based on a 6% earnings accrual (in months 6-12) and a flat valuation assumption although we believe the visibility for the longer term market should be relatively low at this juncture.

**Sector preferences**. We upgrade food & beverage/health care to overweight (OW) from neutral, upgrade oil & petrochemical from underweight (UW) to neutral, and we downgrade capital goods/shipping to UW, and maintain other sector weightings. At the current index level we suggest a balanced sector allocation between capturing cyclical sectors' upside from a possible market rebound and buying stable growth at reasonable valuation. Specifically we like consumption with reasonable valuation (**food & beverage, healthcare, home appliance, retailing**) and low valuation and policy sensitive cyclical (**property, coal, building materials**), and believe the outlook for capital goods, utility and telecom, etc, are less favorable.

**Large/small mid caps: Much less bearish towards small-mid caps than before and suggest be selective**. Although there are still earnings and valuation related risks for the overall SME segments, we believe the risks are much lower compared with several months ago, and value is emerging for some of the small-mid cap names, especially those names that are consumption related. We suggest that investors be selective in stock picking in investing in A-share small-mid caps. We screen a basket of small-mid caps (market cap less than Rmb30bn but higher than Rmb10bn) among GS/GH covered universe for investors interested in having exposure to the growth stocks in China A-shares (Exhibit 68).

**Top-ten picks.** We have also refreshed our top 10 A-share picks to reflect our strategy preference and our analysts' fundamental views (Exhibit 2).

**Risks to our view**: Key risks to our view include that inflation may be stickier than we expect, and as a consequence, the space for policy fine tuning would be limited amid resilient inflation; or the growth may slow down more than we expect.

# 2H2011 macro backdrop: Slower growth, and inflation, and probably less tightening

In this section we discuss the macro environment in 2H11 and begin with outlining the more recent developments that underlie the continuous weakness in A-share market since our May 16 report.

### Several reasons underlie the A-share market's recent weakness

We explained the A-share correction since mid-April in our May 16 report, and we believe several recent developments may underlie the continuous weak A-share performance since then:

1) Although growth is slowing down, inflation remains sticky, and the recent pick-up in pork prices further blurs inflation outlook (growth in VAI/power consumption, auto sales, property sales, pork price vs. inflation) (Exhibits 3, 4, 5, and 6);
2) CBRC's drafting new regulatory requirements on banks weighed banks' performance down further;
3) The government's continued tightening measure. PBoC further tightened liquidity by another RRR hike in June (effective since June 20). Together with banks' acquiring liquidity towards the end of 2Q to satisfy the loan-deposit ratio requirements, the changes have put pressure the already tight market liquidity (Exhibits 8 and 10);
4) The global volatility induced by the sovereign risks in the peripheral Europe countries also added to the negative sentiment.

We are much less bearish towards the market after the recent correction in A-share market, although we think that the macro combination of slowing growth and high inflation remains challenging and we should see few positive catalysts in the near-term.

**Macro backdrop: Growth should slow down further before picking up in late 3Q, and yoy inflation may peak in June and trend lower in 3Q**

GS economists lowered their GDP forecast for China but raised CPI forecast in May. GS commodities team also raised forecasts for major commodity prices including crude oil and metals mainly due to supply constraints.

1) **Growth slows down before picking up in late 3Q/early 4Q**: According to our China economists' forecast, growth should slow down in 2Q induced by monetary and fiscal policy tightness and external softness, but will strengthen sometime in 3Q. The quarterly sequential annualized GDP forecasts are 8.0%, 9.0% and 9.3% for the 2Q/3Q/4Q 2011 respectively. GS economists also lowered their GDP forecast for 2012E from 9.5% to 9.2%. (Exhibit 11).

   We are now seeing more signs of growth slowing down:

   - The overall industrial production growth continues to slow down, as evidenced by headline growth in VAI and power consumption, and demand in some major sectors (like property and autos) continuing to soften amid volatility.

   - The export growth momentum weakening may continue into 3Q, according to our global leading indicator;

   - The FAI growth has been accelerating in nominal terms so far this year, underpinned by the strong manufacturing FAI, the resilient residential property FAI, and perhaps the high price inflation in 1H2011. However the infrastructure construction has already slowed down noticeably, and may slow down further amid the tight liquidity conditions felt by the local governments. We expect manufacturing FAI growth is more likely to be flat or slow down than to further accelerate given the tight credit conditions, and the property FAI growth should also moderate more noticeably as the property sales slowing down. The social housing construction will also be one of the major swing factors for FAI growth in 2H but so far the pace has been slower than expected (see, June 9, *Social housing: Navigating its way, with speed bumps*). While the government is strengthening support in this area, it should take time to see the effects as funding remains an important bottleneck (Exhibits 7 and 9).

2) **Inflation: May peak already in June**. GS commodity team raised their commodity price forecasts (Exhibit 13) in May and our economists also increased the inflation forecast (from average CPI 4.3% for 2011E to 4.7% 2011E). The updated inflation path still points to the CPI inflation in yoy term peaking in June and the average quarterly inflation for 3Q/4Q at 5.0% and 3.6% respectively. This implies that we would probably continue to see higher than 5% inflation before August, and it should gradually decline towards the end of the year. Inflation pressure should further abate in 2012E (average CPI 3% for 2012, Exhibit 12) according to GS economists.

   **The recent rally in pork prices poses a risk.** The recent pork prices rally has been one of the major drivers of the headline inflation, and historically China's CPI is highly correlated with pork prices, given its significant weighting in the CPI basket (4% by our estimate) and the strong correlation between pork prices and the prices of other meat products (Exhibit 14). The historical cycle of pork prices indicates that the current rally in pork prices may gradually come close to an end and enter into the down-leg of the price cycle (Exhibit 15), with the increasing supply of hogs towards the end of 3Q. That said, we agree that this remains one of the major risks to our inflation outlook in 2H.

3) **Policy outlook: Probably less tightening**. The threshold for policy easing is tougher this year but is likely to be met, in our view. Given the inflation outlook, our economists expect policy stance should remain tight in the near term, and they expect loan control to continue and there should be several more RRR hikes and one more IR hike before the IR hike cycle comes to its end. They expect it is possible to see some relaxation of investment restrictions later this year if CPI reading creates some breathing room in 3Q.

Overall under the baseline forecast, the macro combination of slower growth and high inflation may continue into the third quarter, which would not be a friendly environment for the equity markets, but we expect the situation to improve towards mid-3Q as we see more signs of inflation peaking, growth stabilizing or policy fine-tuning then.

**Exhibit 1: Updated CSI300 3-m/6-m/12-m targets and index path: Still a constructive med-term view**


*Source: Wind, Gao Hua Securities Research, GS Global ECS Research.*

**Exhibit 2: Top 10 Buy ideas for A-share 2H11 (from GS/GH covered universe)**

| Ticker | Name | Sector | Performance YTD (%) | Market cap (Rmb bn) | Price (Rmb) | P/E CY 2011 (X) | P/B CY 2011 (X) |
|---|---|---|---|---|---|---|---|
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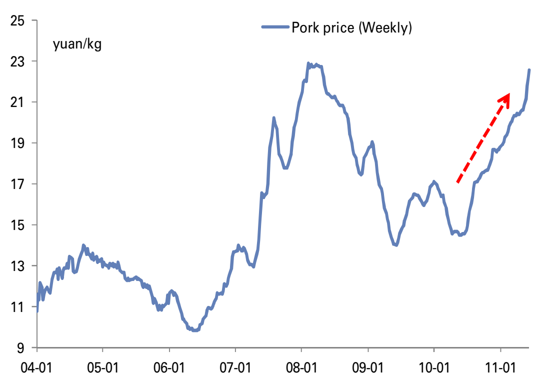
| 600252 CH | Guangxi Wuzhou Zhongheng Group | Health Care | 1.4 | 18.1 | 18.1 | 18.5 | 8.7 |

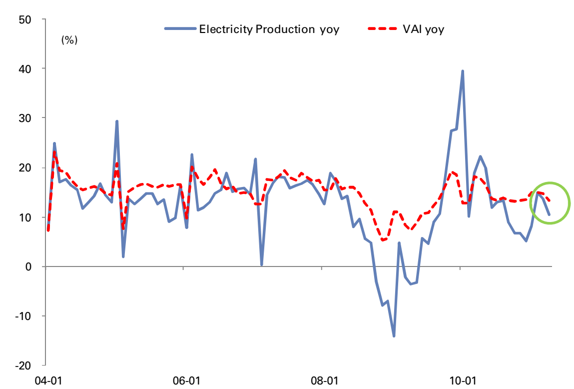
*Source: Wind, Gao Hua Securities Research, GS Global ECS Research.*

**Exhibit 3: Pork prices rose significantly, adding inflationary pressure**



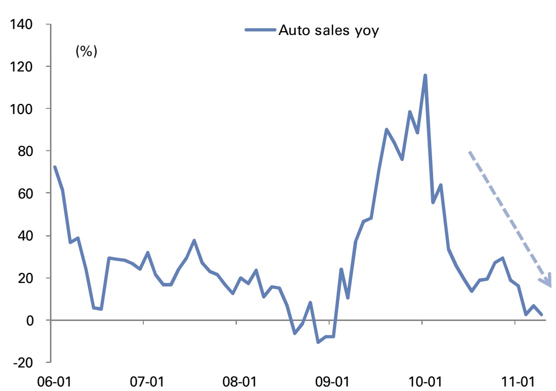

*Source: CEIC, Wind, Gao Hua Securities Research, GS Global ECS Research.*

**Exhibit 4: Growth slowing down: Weaker VAI and power production growth**



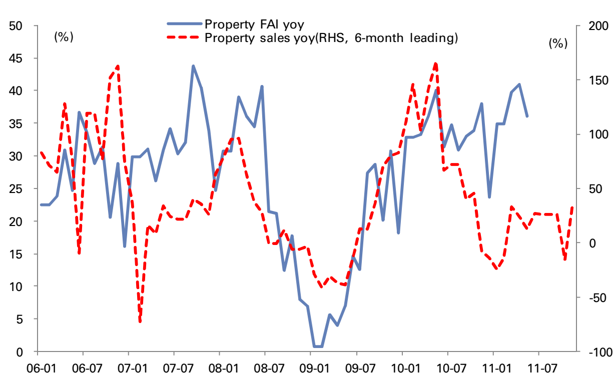

*Source: CEIC, Wind, Gao Hua Securities Research, GS Global ECS Research.*

Exhibit 5: **Growth in auto sales continues to decline**



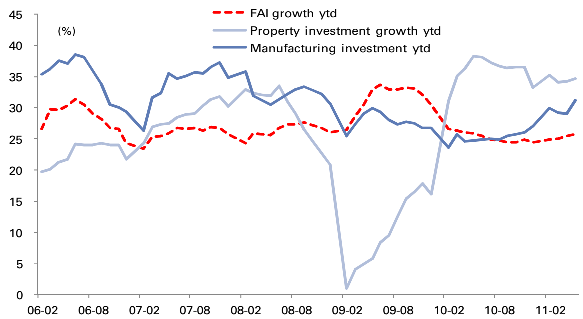

*Source: CEIC, Wind, Gao Hua Securities Research, GS Global ECS Research.*

**Exhibit 6: Property FAI may also begin to moderate due to weak sales**



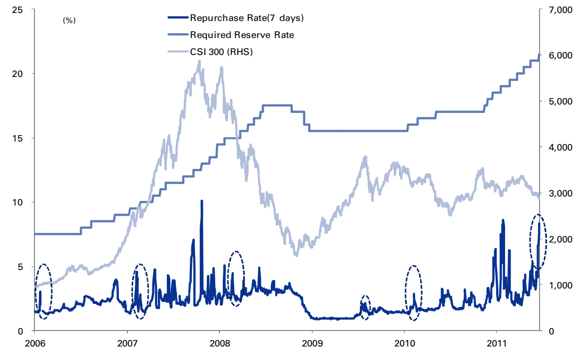

*Source: CEIC, Wind, Gao Hua Securities Research, GS Global ECS Research.*

**Exhibit 7: FAI growth has been supported by property and manufacturing FAI**



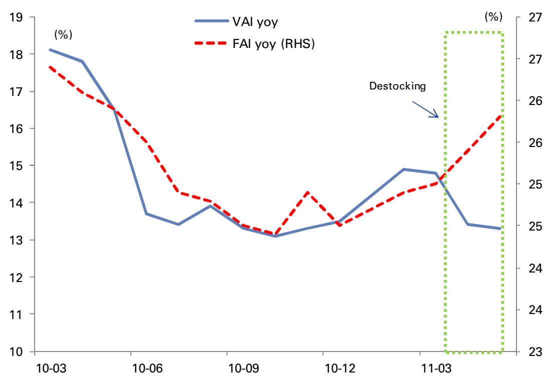

*Source: CEIC, Wind, Gao Hua Securities Research, GS Global ECS Research.*

**Exhibit 8: Repurchase rates, RRR hikes and CSI300**



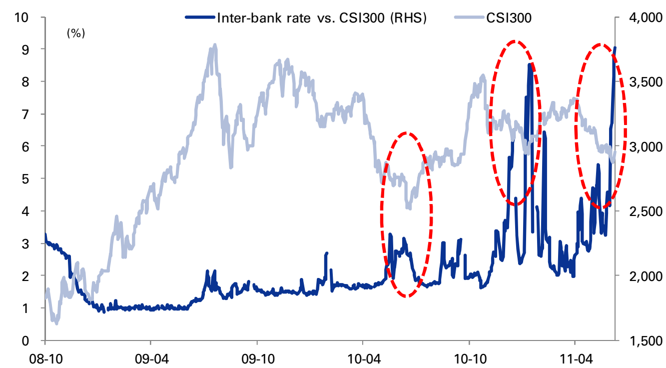

*Source: CEIC, Wind, Gao Hua Securities Research, GS Global ECS Research.*

Exhibit 9: **Destocking: Demand (FAI) keeps momentum while production(VAI) slows down**




*Source: CEIC, Wind, Gao Hua Securities Research, GS Global ECS Research.*

**Exhibit 10: Tight short-term liquidity usually brings negative sentiment**

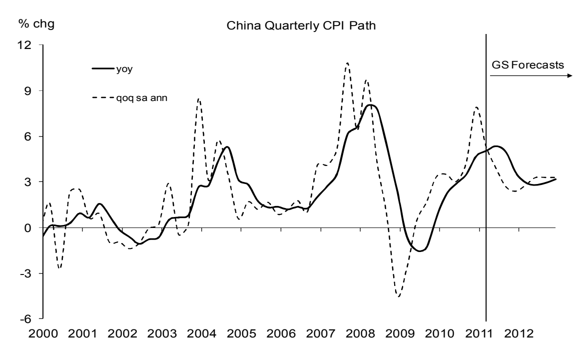



*Source: Bloomberg, Wind, Gao Hua Securities Research, GS Global ECS Research.*

Exhibit 11: **GS Global ECS team revised down GDP growth forecasts for China in May...**


*Source: Gao Hua Securities Research, GS Global ECS Research.*

**Exhibit 12: ...but raised CPI forecasts for China**



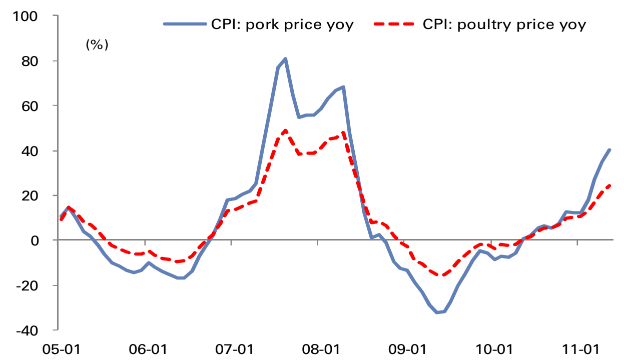

*Source: Gao Hua Securities Research, GS Global ECS Research.*

Exhibit 13: **GS Global commodities team raised commodity price forecasts**

| | units | Price Forecast 3m | 6m | 12m |
|---|---|---|---|---|
| Energy | | | | |
| WTI Crude Oil | $/bbl | 108 | 114.5 | 126.5 |
| Brent Crude Oil | $/bbl | 115 | 120 | 130 |
| Industrial Metals | | | | |
| LME Aluminum | $/mt | 2700 | 2750 | 2900 |
| LME Copper | $/mt | 9300 | 9600 | 11000 |
| Precious Metals | | | | |
| London Gold | $/troy oz | 1480 | 1565 | 1690 |
| London Silver | $/troy oz | 24.7 | 26.1 | 28.2 |

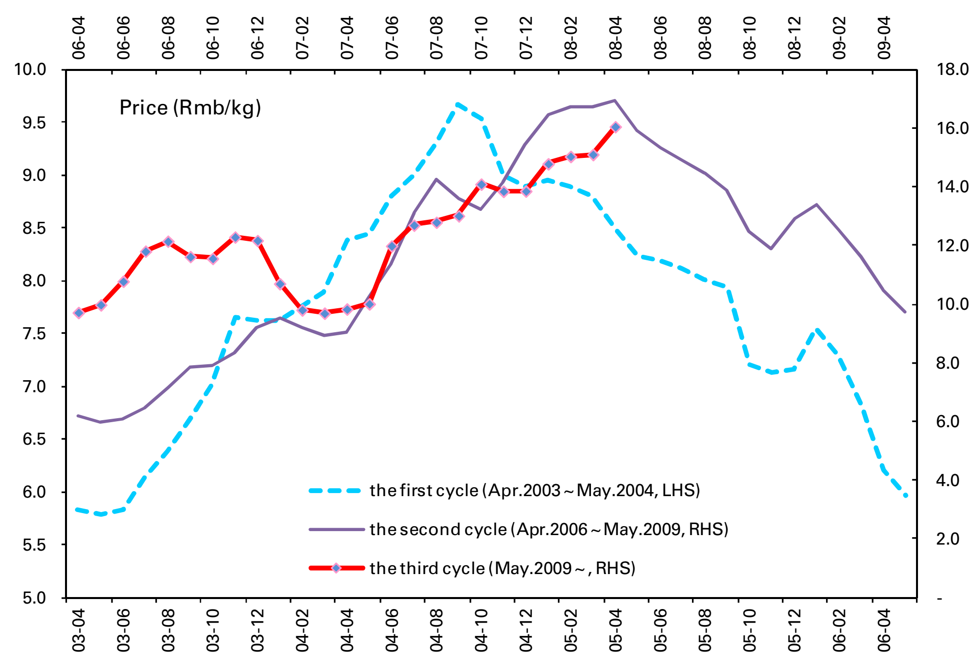
*Source: Gao Hua Securities Research, GS Global ECS Research estimates, Goldman Sachs Research estimates.*

**Exhibit 14: Trends of pork and other meat prices**




*Source: CEIC, Wind, Gao Hua Securities Research, GS Global ECS Research.*

**Exhibit 15: Current rally in pork prices should be temporary , and may enter into the down-leg of the price cycle**




*Source: CEIC, Wind, Gao Hua Securities Research, GS Global ECS Research.*

# Earnings and liquidity: Cutting earnings forecasts; tighter than expected liquidity

We discuss our views towards earnings trend and market liquidity in this section.

**Earnings: Lower top-down earnings forecast to 17.4%/12.8% 2011E/2012E from 22.7%/16.7% for CSI300 on lower margin and stable top-line growth**

We highlighted earnings risk in our May 16 report but maintained our earnings forecast at that time. In this section we revisit our earnings assumptions based our updated GDP/inflation and commodity prices forecast and revise down our top-down forecast to 17.4%/12.8% 2011E/2012E from 22.7%/16.7% previously (Exhibit 18), which is a reflection of stable top-line growth but lower margins amid rising raw materials and other input costs.

**Downside risk to top-line growth is relatively low**. We have discussed in our May 16 report that the downside risk to the top-line forecast is relatively low and we still maintain such our view, given that:

1) Although our economists revised down real GDP growth, they also revised up inflation forecast, as discussed above, and the joint results still point to a healthy nominal GDP growth of around 15%. Historically the top-line growth of the listed companies is highly correlated with the nominal GDP growth (Exhibit 19);

2) Q1 revenue growth for non-financial companies is above 30% (Exhibit 20), indicating the strong revenue growth momentum. Other monthly indicators (such as revenue growth of the above-scale industrial enterprises/ SoEs) suggest the revenue growth so far has been stable. The SoEs' revenue trend also shows that the revenue growth declined from the peak in early 2010 but has gradually stabilized at 20%+ recently.

**...but cost pressures could erode margins**. We believe the rising labor costs (Exhibit 23), raw material costs ytd, and the increasing financing costs as evidenced by the rising interest rates (Exhibit 24), should add to the cost pressures of listed companies and thus could erode margins. The Rmb appreciation ytd would also erode the profitability of those export-oriented sectors. According to our estimates based on the A-shares' Q1 earnings reports, the margin for non-financial companies has declined from 6.3% in 2010 (for all A-shares) to 6.1% in 1Q2011. The utilities, transportation and information technology sectors have declined the most while consumer staples and materials sectors saw some margin expansion (Exhibit 26).

**Margin erosion.** Our analysis based on the data for the industrial enterprises suggests the overall margin was still stable, 6.2% ytd May 2011, flat with Jan-Nov 2010. During historical periods of high inflation (like 2004-2005, 2007-2008, Exhibit 25), upstream sectors (energy and materials related sectors) and down-stream sectors (consumer goods related sectors, like food & beverage, garment manufacturing) were better positioned than the mid-stream sectors (intermediate products sectors including utilities, smelting and processing, and capital goods sectors). Details of sector classification are shown in Exhibit 16.

Going forward we believe margin trends depend on the trend of the input costs. Overall our current view is that margins may bottom at the second quarter and then be flat in 3Q and may gradually recover towards the end of the year with the cost pressure peaking around mid of the year/early 3Q, which is consistent with our economists' view that inflation pressure should peak and then abate in 3Q.

**Revise top-down earnings forecast based on stable top-line growth but lower margin**. We fine-tune our top-down earnings forecasts and our updated results are largely in-line with our analysis above. The results based on updated growth /inflation /commodity price forecasts suggest a relatively stable top-line growth for non-financial companies (23% vs. 23.5% previously) but the margin is meaningfully lower than we previously estimated for non-financial companies (declined to 6.4% in 2011E from 7.2% previously) . Overall the top-down results suggests 17.4% CSI300 index earnings growth for 2011E and 12.8% for 2012E, as compared with our bottom-up forecast of 21.9%/15.8% for 2011E/2012E.

**Earnings downgrade risk to Wind consensus earnings.** Currently Wind consensus suggests 24.5%/19.8% CSI300 earnings growth in 2011E/2012E, which are 2.6ppt/4.0ppt higher than GS/GH bottom-up forecast respectively, and 7.1ppt/7.0ppt higher than our top-down forecasts. The index consensus earnings have been moderately revised down by 0.1ppt since late April, led by construction, shipping, capital goods, auto & parts, etc (Exhibit 28). We believe there should be further downside risk to Wind consensus earnings compared with our top-down forecast, and property FAI related sectors, including capital goods, construction, steel and chemicals etc, should have greater earnings downside risk.

**We do not expect potential earnings downgrade to have much further negative impact on the market**, although sector wise it may differentiate, as,

1) The correction since mid-April in A-share stocks has priced in the earnings risks to a certain extent;

2) Consensus figures for the A-share market usually appear to lag in potential earnings downgrades, probably due to the survey time lag by the data vendor;

3) According to our discussions with the A-share institutional investors, they revised down earnings expectations much more quickly than what the Wind consensus has suggested.

While we believe there are some earnings downgrade risks to the current consensus earnings, we think **the risks should not be overestimated:**

1) **Destocking worries overdone**. Market worries that the impact of destocking on earnings has been overdone. We believe the destocking should be temporary and close out in 3Q.

   We track the destocking process by the ratio of the PMI sub-index of finished products inventory (and PMI raw materials inventory sub-index) over the PMI new order sub-index, which basically tracks the inventory trend while incorporating the impact of future demand (through new order index) on inventory. Basically we believe if inventory is high due to foreseeable high future demand (new order), then the high inventory should be healthy.

   As in Exhibits 29 and 30, the ratios normally illustrate some seasonality within a year, but for the latter half of 2008 the ratios rose significantly and deviated from the seasonal trend, implying rising inventories were not matched by demand, and consequently de-stocking pressures rose. The ratios again deviated from seasonal trends since February this year, which implies temporary de-stocking pressure but the ratio has come close to trend in June and we believe it should return to trend in 3Q as demand indicators (like FAI growth) suggest that the overall demand has remained relatively stable while production (VAI) already slowed down in 2Q, and the slowdown may continue into 3Q (Exhibit 9).

2) **Monthly earnings indicators point to moderating but still decent growth**. 1Q results indicate earnings momentum has been strong, while other indicators like the profit growth of SoEs (Exhibit 22), profit growth of above-scale industrial enterprises (Exhibit 21) and the growth in the enterprise income tax item the fiscal revenue report (Exhibit 31) point to moderating but still decent growth momentum;

### Valuation & liquidity: Lower valuation assumption due to higher inflation and tighter-than expected liquidity

We have discuss one of our key issues of liquidity later in this report and focus on the liquidity conditions ytd in the A-share market and the implications for valuation. The tighter liquidity conditions are something we did not expect at the beginning of the year and is a very important focus for the A-share market.

Our overall conclusion is that the liquidity conditions have been tighter due to frequent policy changes to manage inflation expectations and contain inflationary pressures, which have led to lower risk-taking appetite. The persistent monetary tightening has also boosted yield of the short/medium-term fixed income instruments, which attracted significant money inflows.

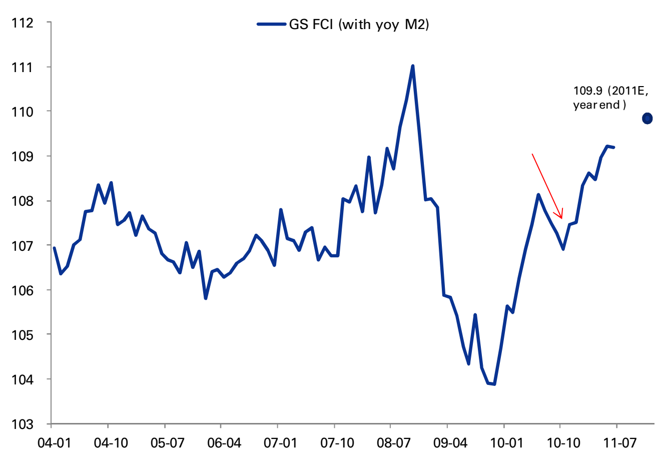
Consequently we lower our valuation target for CSI300 index from 14.2x 12-m P/E (as discussed in April 7 report) to 13.0x on the tighter-than-expected liquidity conditions in the A-share market, which is consistent with our regional team's assumption that higher inflation (oil prices) implies lower valuation (Exhibit 32). We believe the overall A-share market liquidity will remain tight over the near term before it could improve moderately.

Exhibit 16: **Classification of up/mid/down-stream sectors in our report**

| Upstream industries | Mid-stream industries | Downstream industries |
| --- | --- | --- |
| Coal Mining & Dressing | Processing of Petroleum, Coking & Nuclear Fuel | Agricultural & Sideline Food Processing |
| Petroleum & Natural Gas Extraction | Raw Chemical Materials & Chemical Products | Food Manufacturing |
| Ferrous Metals Mining & Dressing | Chemical Fiber Industry | Beverage Manufacturing |
| Non Ferrous Metals Mining & Dressing | Rubber Products | Tobacco Processing |
| Non Metal Minerals Mining & Dressing | Plastic Products | Textile Industry |
| Other Mining | Non Metal Minerals Products | Garment, Footwear & Headgear Manufacturing |
| | Smelting & Pressing of Ferrous Metals | Leather, Fur, Down & Related Products |
| | Smelting & Pressing of Non Ferrous Metals | Timber Processing, etc |
| | Metal Products | Furniture Manufacturing |
| | Universal Equipment Manufacturing | Paper Making & Paper Products |
| | Special Purpose Equipment | Printing & Record Medium Reproduction |
| | Transportation Equipment | Cultural, Educational & Sports Articles |
| | Electric Machinery & Equipment | Medical & Pharmaceutical Products |
| | Electronic & Communication Equipment | |
| | Instructment, Meters, Cultural & Office Machinery | |
| | Handicraft & Other Manufacturing | |
| | Waste Resources & Materials Recovery & Processing | |
| | Production & Supply of Electricity & Heat Power | |
| | Production & Supply of Gas | |
| | Production & Supply of Water | |

*Source: CEIC, Wind, Gao Hua Securities Research, GS Global ECS Research.*

**Exhibit 17: China's financial conditions loosened in the middle of last year**



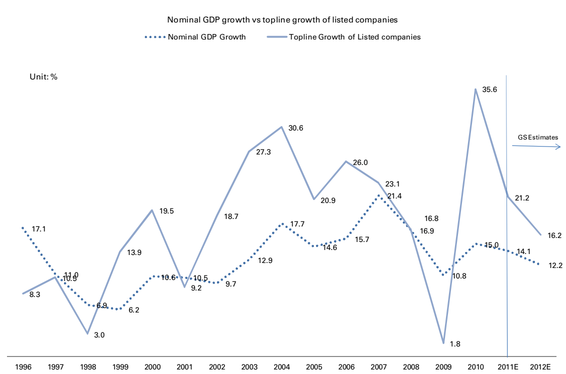

*Source: Gao Hua Securities Research, GS Global ECS Research.*

**Exhibit 18: Lower top-down earnings forecast to 17.4%/12.8% in 2011E/2012E from 22.7%/16.7% for CSI300 on lower margins and stable top-line growth**

| Assumption | CPI (%) | Crude oil average price (Brent,$/bbl) | Retail Sales (%) | Export (%) | FAI (%) |
|---|---|---|---|---|---|
| 2010A | 3.3 | 79.6 | 18.3 | 31.3 | 24.5 |
| 2011E | 4.7 | 113.5 | 18.0 | 18.0 | 22.0 |
| 2012E | 3.0 | 130.0 | 18.0 | 15.0 | 19.0 |
| ***Base Case*** | | | | | |
| Top-down Estimates | Non-Financial Revenue Growth (%) | Non-Financial Margin (%) | Total Earnings Growth (%) | | |
| 2010A | 28.6 | 6.9 | 32.5 | | |
| 2011E | 23.0 | 6.4 | 17.4 | | |
| 2012E | 15.0 | 6.3 | 12.8 | | |
| Bottom-up Estimates | | | | | |
| 2010A | 28.6 | 6.9 | 32.5 | | |
| 2011E | 19.3 | 6.3 | 21.9 | | |
| 2012E | 15.4 | 6.5 | 15.8 | | |
| ***Bear Case*** | | | | | |
| 2011E | 16.0 | 5.8 | 9.8 | | |
| 2012E | 12.0 | 5.6 | 7.6 | | |

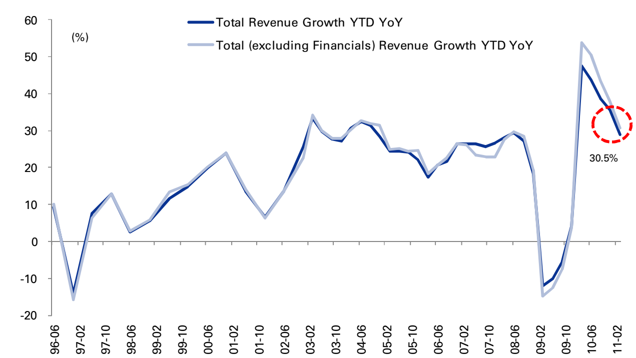
*Source: Wind, Gao Hua Securities Research, GS Global ECS Research.*

Exhibit 19: **A-share top-line growth correlates with nominal GDP growth**



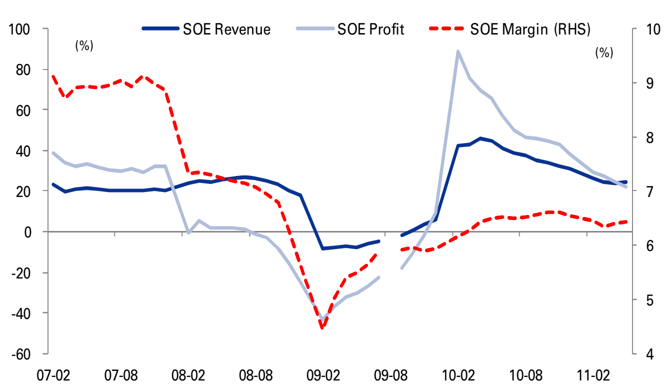

*Source: CEIC, Wind, Gao Hua Securities Research, GS Global ECS Research*

**Exhibit 20: Q1 revenue growth for non-financial companies is above 30%**



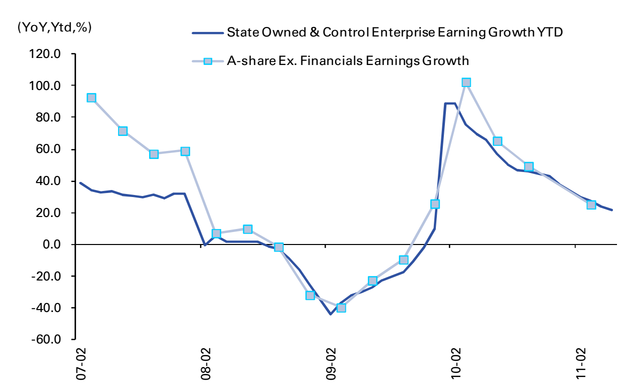

*Source: Wind, Gao Hua Securities Research, GS Global ECS Research*

Exhibit 21: **SOE Revenue, profit growth indicate moderating but still healthy growth momentum**



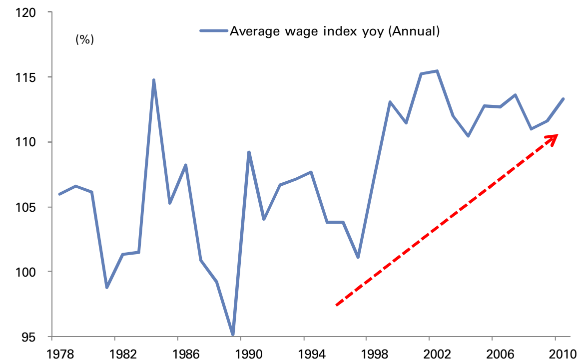

*Source: CEIC, Wind, Gao Hua Securities Research, GS Global ECS Research*

**Exhibit 22: SOE earnings growth vs. A-share (ex. Financials) earnings growth**



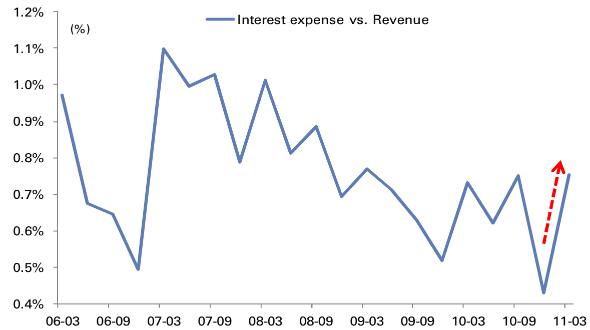

*Source: CEIC, Wind, Gao Hua Securities Research, GS Global ECS Research*

Exhibit 23: **Average wage index suggests rising labor cost pressures**



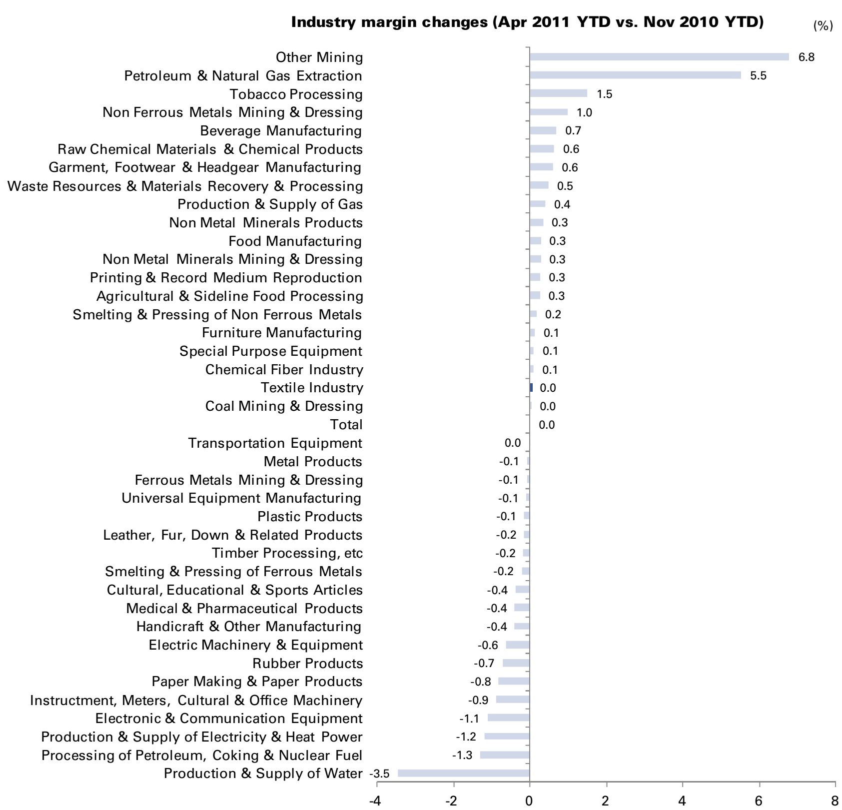

*Source: Wind, Gao Hua Securities Research, GS Global ECS Research.*

**Exhibit 24: A-share companies' interest expenses rose in 1Q2011**



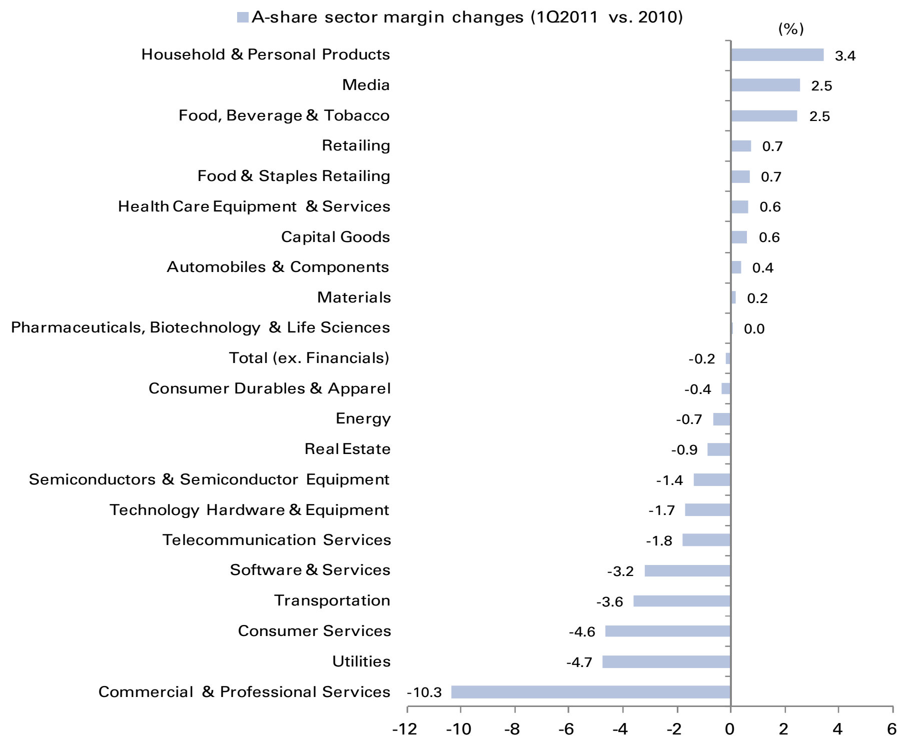

*Source: Wind, Gao Hua Securities Research, GS Global ECS Research.*

**Exhibit 25: Industrial enterprises: Margin changes by sector (Apr 2011 YTD vs. Nov 2010 YTD)**



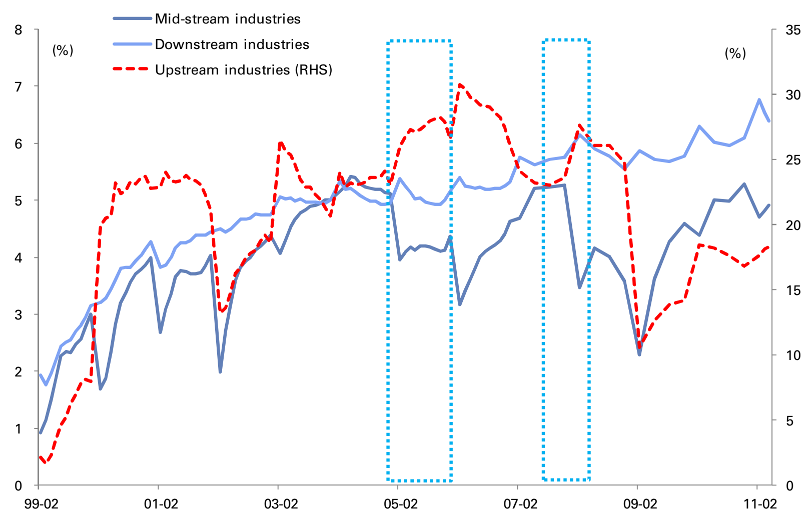

*Source: Wind, Gao Hua Securities Research, GS Global ECS Research.*

**Exhibit 26: A-share margin change by sector (for all A-shares 1Q 2011 vs. 2010)**



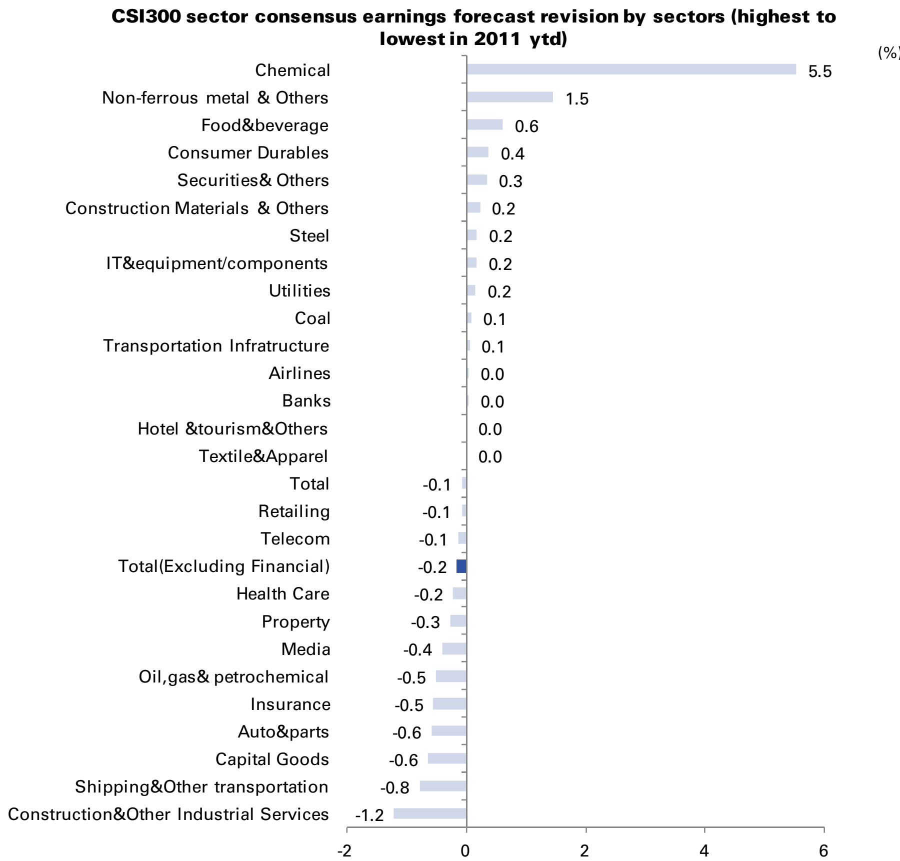

*Source: Wind, Gao Hua Securities Research, GS Global ECS Research*

**Exhibit 27: Up-stream and down-stream sector margins were better positioned those of mid-stream sectors amid historical periods of high inflation (2004-2005/2007-2008)**



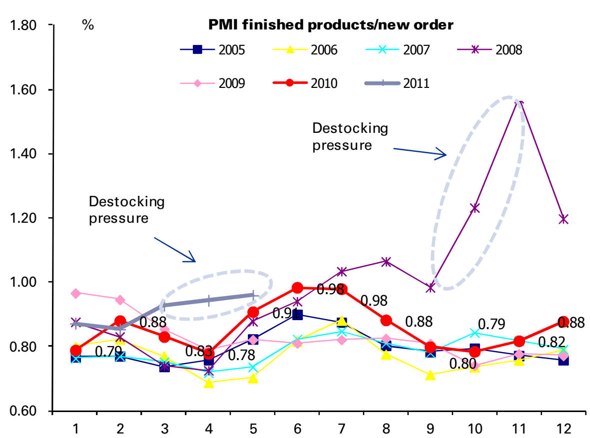

*Source: Wind, Gao Hua Securities Research, GS Global ECS Research.*

**Exhibit 28: CSI300 sector consensus earnings forecast revision by sectors (highest to lowest in 2011 ytd)**



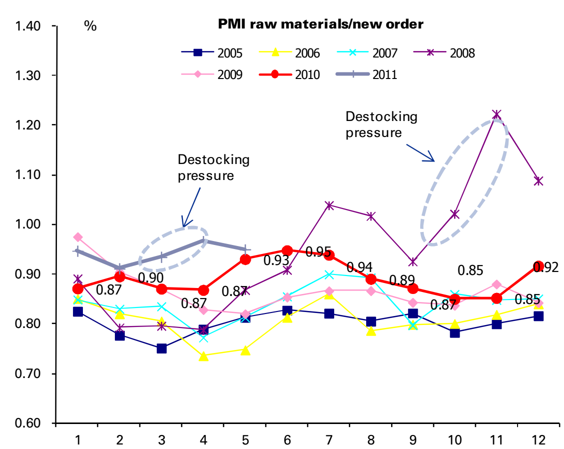

*Source: Wind, Gao Hua Securities Research, GS Global ECS Research.*

Exhibit 29: **The ratio of PMI finished product inventory sub-index over PMI new order index points to a de-stocking in manufacturing sectors which could end in 3Q**



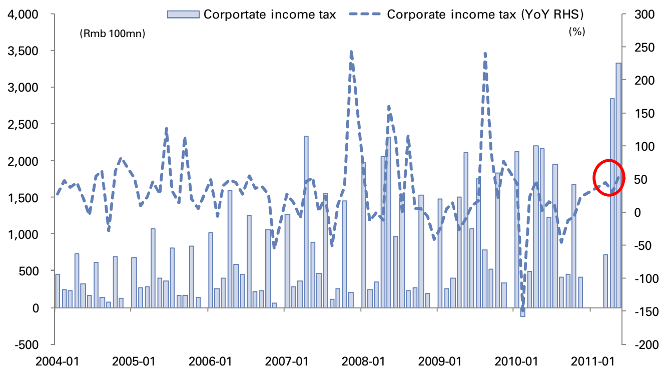

*Source: Wind, Gao Hua Securities Research, GS Global ECS Research.*

**Exhibit 30: The ratio of PMI raw material inventory sub-index over PMI new order index points to the de-stocking in manufacturing sectors may end in 3Q**



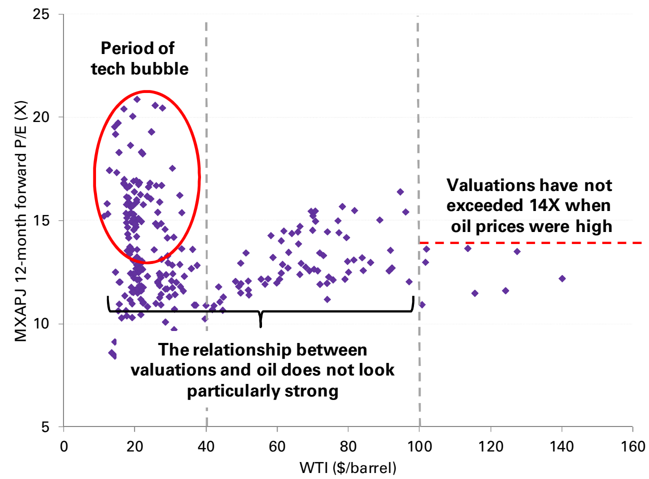

*Source: Wind, Gao Hua Securities Research, GS Global ECS Research*

Exhibit 31: **The robust growth in corporate income tax suggests underlying profit growth is still healthy**




*Source: Wind, Gao Hua Securities Research, GS Global ECS Research.*

**Exhibit 32: High oil prices could curb rises in market valuations**




*Source: Bloomberg, Gao Hua Securities Research, GS Global ECS Research.*

# Index path: Range-bound after the short-term bounce, watch for potential inflection point in inflation/policy

### Updated index target and paths for 2H11: Year-end target cut to 3,400 for CSI300 but still implies mid-teen return potential by year-end

**Our base case...** Under our updated base case scenario (Exhibit 33) we cut our year-end index target for CSI300 index to 3,400 from 4,000 (lowered by 15%) based on lower earnings growth forecast (contributing about a third to the cut) and lower valuation assumptions (contributing about two thirds to the cut). The new index target implies mid-teen return potential by the end of 2011E and an 8.5% annual return for CSI300 index in 2011E. The 8.5% return for 2011E is based on high-teen earnings growth and a further valuation contraction of around 10ppt vs. valuations by year-end 2010. We believe this is a reflection of the tighter liquidity conditions than what we factored into our assumptions for the A-share market in the 2011 outlook report (*Growth amid challenges*, Jan 17, 2011).

**Range-bound after the short-term bounce, and watch for potential inflection point in inflation/policy**. The new index target indicates our medium-term constructive view towards the A-share market. After the persistent correction since mid-April, the market valuation has declined to historical low level (12.4x 12-m P/E for CSI300), which indicates the market has already factored in a somber outlook. We believe the short-term market has been oversold and a rebound is likely. As there should be few positive catalysts after the rebound, we do not expect more meaningful returns until we sees more signs of inflation peaking, growth stabilizing or policy fine-tuning. We believe the timing for a potential inflection should be around mid-August.

**Compared with mid-2010**. It is meaningful to compare the current market situations with the market at the mid of last year. Under both cases, we saw tightening-concerns-induced market corrections which lasted for more than two months in the A-share market, and the market situation was also complicated by external factors (European debt crisis and a weak global growth outlook). The eventual loosening of policy (in terms of financial conditions and fiscal project spending, Exhibit 17) in China since early July last year drove the market into a V-shape rebound. At this juncture we believe a sharp V-shape rebound is less likely as we are facing much higher inflationary pressure than in the middle of last year, which may limit the room of potential policy loosening. Additionally after several rounds of property tightening, the financial conditions of the local government have become weaker than we saw in the middle of last year due to the sluggish land sales so far this year, which should also limit the ability of the local governments to boost growth (Exhibit 34).

**Bull case**. Under a bull case scenario in which we should have higher earnings growth and less inflationary pressure than as implied in our base scenario, we would expect a higher implied index target (3,800) towards the end of the year based on higher earnings growth and valuation expansion.

**Bear case**. Under a bear case scenario, however, in which we should see stickier inflation than as implied in the base case, we would see higher cost pressures and more tightening would be needed to manage inflation, resulting in greater risk of an economic hard landing. In this scenario we expect an implied index target of 2,700 by year end, which is 8.7% lower than the current index level.

## Introducing our 12-m index target, low visibility of longer term market outlook

**12-month target: 3,600 for CSI300**. We introduce our 12-m CSI300 target of 3,600 (mid-2012) based on a flat valuation with what we assume for 2011E (13x 12-m forward P/E) and around 6% earnings accrual for the 1H2012.

**Low visibility of longer term market outlook**. Longer term market outlook is relatively low at this juncture. We believe the low visibility of China's market is induced by a number of internal and external factors. While our global ECS team focuses on the intrinsic structural issues that underlie the weakening global growth outlook (like the deleveraging in the US, the European debt crisis, etc), we focus our discussion here on the domestic factors affecting China's market.

**Management of side-effects of the stimulus packages during and post-financial crisis periods still underway**. Domestically since late 2009, China has endeavored to manage two major side effects of the stimulus packages introduced to cope with the slowdown from the financial crisis (a combination of a very accommodative monetary policy and substantial fiscal expenditure), that is potential asset price inflation (mainly in the property market) and the consumer price inflation. The various counter measures taken have achieved some success in containing the further increase in property prices, albeit temporarily, and in curbing consumer price inflation so far. However, we believe it is still early to claim victory on this front. The recently reported liquidity problems of some China's local governments (like the Chaoyang district of Beijing) are further evidence that these measures themselves are bringing in some significant side-effects.

**Looking for medium-long term sustainable growth drivers for China**. Over a longer term, we believe the market should continue to balance the dilemma between "less tightening than more inflation" and "more tightening than less growth", which has been a key concern around the market since later 2009, and at the same time look for long-term sustainable growth drivers for China other than the property market (i.e., in effect the urbanization process). The widely-reported rise in China's labor cost is an indication of the bottleneck that there is a decreasing number of migrant workers who could transfer from rural regions to urban areas. This indicated that improvement in labor productivity is very important to maintain growth momentum, and the contribution to growth from labor input should slow down rather than speed further thus limiting the overall growth rate of China.

Deliberately maintaining a remarkable growth rate like what we saw in the years before 2007 for China through accommodative policies may either add inflationary pressure or cause growth instability, which should not be good for the market.

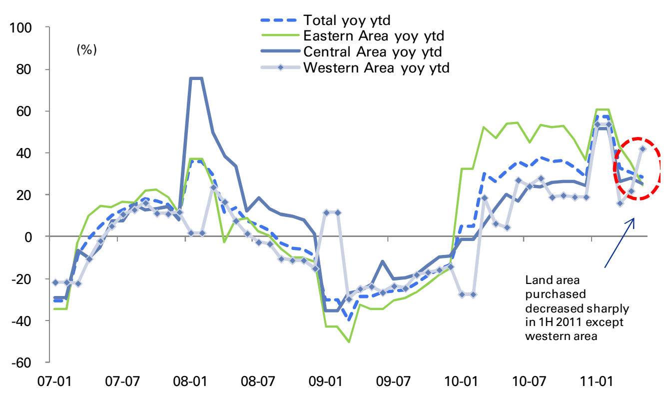
**Reform to sustain**. We need to see more concrete reform measures which are aimed at creating long term sustainable growth drivers for China (e.g. technology innovations and institutional reforms to improve labor productivity) to become more constructive on China's market in the longer term. We have seen very comprehensive schemes announced by China's government to speed the transition of the China economy development model in the past several years (the 12th 5-year plan is among them, see *12th Five Year Plan preview – equity investing do's and don'ts*, October 8, 2010); we now need to see the implementation and effectiveness of these measures.

**Exhibit 33: Lower valuation on tighter liquidity and higher oil price, lower valuation target**

| CSI300 Index | 2,957.6 | | | | | |
|---|---|---|---|---|---|---|
| Scenario | Earnings Growth | | 2010-2012 CAGR | 2011Year-end | | Implied Index Changes |
| | 2011E | 2012E | | Implied PE | Implied index target | (%) |
| Bull Case | 25.0% | 19.6% | 22.2% | 13.2 | 3800 | 28.5% |
| Base Case | 17.4% | 12.8% | 15.1% | 12.8 | 3400 | 15.0% |
| Bear Case | 9.8% | 7.6% | 8.7% | 10.7 | 2700 | -8.7% |

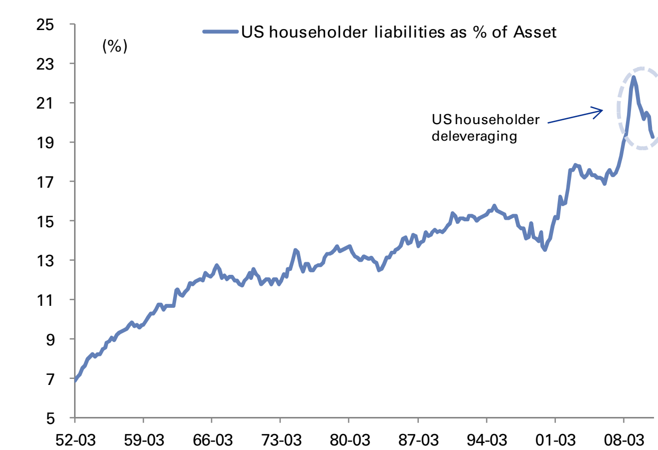
*Source: Wind, Gao Hua Securities Research, GS Global ECS Research.*

Exhibit 34: **Slower land area purchased ytd indicates land sales revenue by the local governments also decelerated**




*Source: CEIC, Wind, Gao Hua Securities Research, GS Global ECS Research*

**Exhibit 35: US households deleveraging is still underway, limiting consumption growth**




*Source: CEIC, Wind, Gao Hua Securities Research, GS Global ECS Research*

# Sector preference reshuffling: Prefer consumer and low valuation cyclicals

In this section, we review how our sector recommendations have turned out so far in 2Q11 and we rebalance our sector preference to reflect the risks/rewards at the current index level based on the major fundamental developments, sector valuations, and stock performance since our last update report entitled *Earnings concerns, few catalysts*, published on May 16.

Specifically, we upgrade food & beverage and healthcare to overweight, as a result of our positive change in tone towards these sectors in our May 16 report. We upgrade oil & petrochemical from underweight to neutral. We downgrade industrials (capital goods) and transportation (shipping & other transportation) to underweight, further to our downgrade of the two sectors from overweight to neutral in our 2Q outlook report entitled *Less tightening, more return* published on April 7, 2011. We maintain our weighting at neutral on banks and insurance.

Overall, at the current index level we recommend a balanced sector allocation between capturing cyclical sectors' upside from a possible market rebound and buying stable growth at reasonable valuations. Our top ideas include:

1) Buy consumer sectors with reasonable valuations, which include **home appliances, retail, food & beverage, and healthcare**.
2) Buy low valuation and policy sensitive cyclical, which include **property, coal, and building materials**.
3) Underweight **capital goods (construction machinery)** and **shipping**.

We refresh our top 10 ideas for A-share stocks based on our sector preferences and our sector analysts' views on sectors and individual stocks (Exhibit 2).

## Reviewing sector recommendations: What worked and what missed

The past quarter has been challenging for A-share investors as the CSI300 corrected by 9.7% between March 31 and June 21 and only the food & beverage sector achieved a positive return (Exhibit 36). Property, consumer durables (home appliances), coal, banks, and utilities were among the leading outperforming sectors, while media, airlines, capital goods, shipping, non-ferrous metals, and IT & electronic components, underperformed the most.

We upgraded property, home appliances to overweight for 2Q11, and maintained our positive stance on coal, building materials, and retail. We downgraded capital goods, shipping, insurance, and auto & parts to neutral. The relative performance of these sectors in 2Q11 has been largely in line with our view, although none of them achieved a positive return. We have been neutral on the banking sector but banks outperformed in 2Q11 due to their defensive nature during the economic downturn. We have been underweight utilities for 2Q11 while the sector outperformed the market due to tariff hike expectations during a power shortage in the second quarter of the year.

## Upgrade F&B/healthcare to overweight, upgrade oil & petro-chemical to neutral, and downgrade capital goods to underweight

Exhibit 39 illustrates the changes we have made to our sector recommendations in each sector. At the current index level we recommend a balanced sector allocation between capturing potential upside from cyclical sectors from a possible market rebound and buying stable growth stocks at a reasonable price. Specifically, we like low valuation cyclicals (property, coal, and building materials) and consumer (home appliances, retail, food & beverage, and healthcare), but are less enthusiastic about industrials, telecoms, and utilities.

### Upgrade food & beverage/healthcare to overweight

We have maintained our neutral sector stance on food & beverage/healthcare since the beginning of the year, as we believe the sectors' relatively high valuation could be vulnerable when liquidity in the market becomes tight. In our report entitled *Earnings concerns, few catalysts*, published on May 16, we mentioned that the outlook for these two sectors were improving as the sectors' valuations were declining towards more sustainable levels while the sectors' fundamentals remained stable.

We upgrade food & beverage/healthcare to overweight, although valuation risks may still exist during the current market of tight liquidity.

For food & beverage, we think the upgrade is justified by:

1) Strong earnings growth momentum and a potential earnings upgrade. 1Q11 earnings growth was strong at 40.3% (Exhibit 37), and we believe the momentum should continue into 2Q11. This, in our view, is a near-term catalyst, given that for some other sectors, earnings risks are likely to remain before the 2Q earnings are reported. For the full-year, WIND consensus forecasts 26.5% growth for the sector in 2011 and 28.2% in 2012, which, in our view, is a stable and decent growth rate, moreover, there could be a potential earnings upgrade if the growth momentum in 1Q continues into 2Q.

2) Valuation of the sector has declined to more attractive levels (Exhibit 38), although recent outperformance of the sector has led to some valuation expansion. Now the sector is valued at 23x 12-m fPE, close to the low end of its valuation range since mid-2009. The large cap food & beverage names, like the branded liquor names, still trade around 23x 12-m fPE, which is only slightly higher than its historical low levels.

For healthcare, we have become positive as:

1) From "policy negative" to "policy neutral" or even "policy supportive". We believe the policy environment for the healthcare sector is gradually changing from "negative" to "neutral" or even "supportive", as the price cut applied to the essential drug list/re-imbursement drug list policy is implemented and the local price tender is on trial in different provinces. The policy risks are largely known in the market and, as a consequence, the policy environment is becoming more supportive than it was just a few months ago.

2) Valuations are becoming more attractive. The sector valuation has declined to around 19x 12-m fPE, a relatively low level since mid-2009 (Exhibit 40). The valuation should look more attractive when the market begins to review 2012 valuations in 2H11. The 2010 and 1Q11 earnings growth were somewhat disappointing compared with the previous high earnings growth expectations. However, the earnings downgrade ytd for the sector has factored in the earnings risks to a certain extent (Exhibit 41).

3) The long-term outlook of the healthcare sector is intact and the sector's mid- to long-term growth prospects are underpinned by China's aging population, growing

healthcare expenditure – in line with rising income levels – and broader coverage of a social healthcare program.

We agree that our upgrade for the healthcare sector may be a little early as there should be a few near-term catalysts and there may be further disappointments from the 2Q earnings. However, our upgrade is based more on a gradual change in the policy environment and the long-term growth outlook for the sector as a whole rather than short-term earnings.

**Upgrade oil & petro-chemical from underweight to neutral**

We have been underweight the sector since the beginning of the year mainly due to our concern over the full cost pass-through given high inflation. Our upgrade of the sector is mainly based on valuation and to some recent positive developments within the sector.

1) Sector valuation is now at a historically low level, 10.8X 12-m fPE, which is even below that witnessed during the economic downturn.

2) High oil prices benefit upstream names. Our commodity team has become more bullish on oil prices (raised Brent crude to US$116/IUS$130/US$130 for 2011E-2013E on average) as we are at the beginning of a new phase where demand-rationing oil pricing will be needed to balance supply tightness, which should benefit upstream earnings. We understand that in A-shares we have few pure crude oil names, but overall PetroChina has meaningful exposure to the crude oil upstream business, and the offshore oil engineering and equipment names should also benefit from high oil prices. Aggregated they account for more than half of the sector weighting.

3) The consistent refined price adjustments ytd reiterate the government's commitment to the pricing mechanism, and also reduce our concerns over cost pass-through, especially when the overall inflation pressure should abate since 3Q. Other positive catalysts may include further refined product pricing reforms and natural-gas pricing reforms, as this has been highlighted as one of the important areas of reform by the government in the near future.

**Downgrade capital goods/shipping to underweight**

We downgraded capital goods from overweight to neutral in our 2Q outlook note published on April 17, 2011) and we think the reasons below help justify our further downgrade of the sector to underweight.

1) Earnings risks have not yet been fully reflected. Since early 2Q most of the construction machinery sales has turned weak (Exhibits 43, 44, and 45), probably due to the slowdown in infrastructure construction, slower-than-expected social housing building, and the implementation of tight credit control measures. Our machinery analyst Tian Lu feels that there should more than 10% earnings downside risk to the sector's consensus forecast and, for his own forecasts, which are already 10% below consensus, he feels there is also risk if 3Q sales remain weak. (Exhibit 42). The sector is priced at slightly below mid-cycle valuation, which may also imply further downside if sector fundamentals continue to weaken.

2) The tight liquidity condition of local governments not only means slower-than-expected social housing construction, but also slower infrastructure construction, which may put further pressure on machinery demand. Local governments started to become aware of liquidity constraints as a result of tight credit conditions and limited revenue generated by sluggish land sales so far this year. The media has reported (http://www.cs.com.cn/cqzk/201105/t20110518_2883208.html) that one district of Beijing experienced a severe liquidity problem and we believe this situation could be typical among China's local governments, which goes some way to explaining the slower-than-expected pace in social housing construction ytd. We believe this may also lead

to a further slowdown in the pace of infrastructure building, in which local government funds usually play an important role.

3) The recent weakening in global growth should pose risks to machinery exports, as the sector has meaningful exposure to overseas demand (more than 13%). Some stocks have even higher export exposure (more than 30%). Our machinery analyst has factored in about 30% yoy export growth for the machinery names under his coverage.

The sector has underperformed so far in 2Q11. We agree that the secular growth trend of China's capital goods sector remains intact. Long-term demand should still be supported by import substitution and labor-capital substitution given rising labor costs, but the cyclical factors we discussed above continue to justify our cautious stance on the sector.

Our further downgrade on shipping is more straightforward. Since our downgrade on the shipping sector ( see our note entitled *Less tightening, more return* published April 7, 2011), global growth momentum has weakened even further, which has put pressure on global trade volumes and earnings forecasts for the shipping names. The sector is valued at mid-cycle valuation in terms of P/B valuation (Exhibit 47).

**Maintain overweight property on the back of an improving policy environment**

We maintain our positive stance on China's property sector. The sector outperformed the market in 2Q11, although it posted negative returns. We are becoming increasingly confident after the price decline in 2Q that the sector should report absolute returns in 2H11.

1) Valuation is low vs. its historical valuation range. The sector is now valued at 9.7x12-m P/E, low compared with most other sectors and its own historical valuation range. The current price implies close to a 50% discount to NAV.

2) The policy environment for the sector is changing from negative to neutral, or even positive. We believe the property market is one of the few areas that the government could leverage to counter the possible macro over-adjustment, and alleviate the tight liquidity condition of the local governments at the same time.

We will discuss more about our perception of the potential property policy trend below in light of the current economic backdrop. We believe the policy outlook for the property sector is improving due to:

1) The existing mortgage lending tightening measures and house purchase restrictions are taking effect on house prices (see our recent note by our property team, *Early signs of price inflection, new policy risks low*, June 27, 2011).

2) The property market is one of the few areas that the government can leverage to counter more unfavorable macro changes, and to help reduce the tight liquidity conditions facing local governments.

   - Sluggish property sales ytd have led to the tight liquidity position that local governments currently find themselves in, and may have slowed activities that rely heavily on local government support, such as social housing and infrastructure construction. In Exhibit 56 we plot a simplified funds-flow chart for China, with a special focus on the role of the property market in China's economy, in which we illustrate that one of the main causes of the current liquidity problem facing local governments (as discussed by our banking team, *First Take: News on liquidity stress of land reserve loans,* June 22, 2011) is that demand in the property market has been tightened, resulting in fewer property sales and sluggish land sales ytd. The two "clouds" in the chart mean, (1) we are experiencing tightening over the households' housing demand and (2) as a consequence, local governments are facing liquidity constraints due to sluggish revenue generation from land sales ytd. We see significant inventory piling up in the property sector (Exhibit 51) and a need for liquidity among local governments.

- We believe the government can fine-tune the current tight property policy measures if unfavorable macro conditions materialize. The current macro conditions are not that extreme but we believe there is no need for harsher property tightening measures at present.
- Should the potential property policy fine-tuning help cushion the potential macro over-adjustments? Our answer is yes, given:
    1) The house purchase restrictions have room to be adjusted slightly to stimulate demand under extreme macro conditions.
    2) Quite intuitively, improved housing affordability can lead to better property demand, and the government should have the option to improve households' housing affordability should the economy run into an extreme macro situation. We note that the changes ytd in trading volumes yoy in the 40 cities we track (accounting for about 40% of nationwide trading volume in total) correlate positively with the housing affordability of households (as measured by the ratio of monthly mortgage payment as a percentage of household monthly disposable income) in these cities (Exhibit 53), which suggests better housing affordability can lead to improved housing demand.

We are not suggesting that the government will loosen its current property tightening measures but what we are saying is that with this option available to the government, we believe that the likelihood of a dramatic and undesirable slowdown in overall growth is low for China in 2H11. Given the more noticeable slowdown in domestic demand and recent weakening in global growth, we believe the need to adopt further harsher property market tightening measures becomes even less likely, if anything, in our view, the policy environment for China's property market is more likely to gradually improve, going forward.

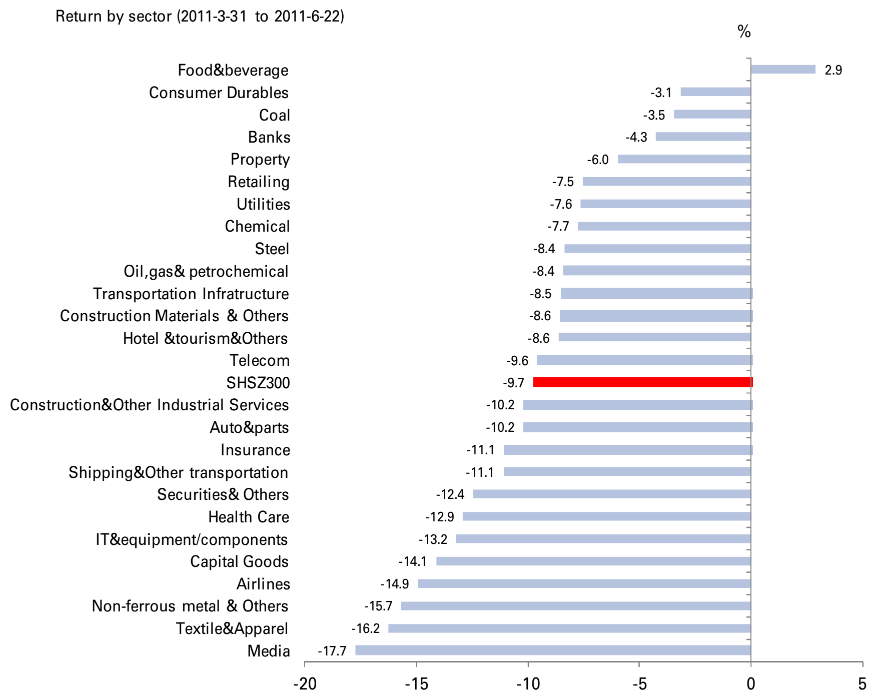
**Maintain overweight home appliances/coal/building materials, and other sector weightings**

We maintain our relatively positive sector stance on coal, building materials, and home appliances. We remain neutral stance on banks, and we maintain our underweight sector stance on utilities and telecoms.

Investors may ask why we are positive on property FAI-related sectors such as coal and building materials but cautious on machinery. We understand that these sectors are all highly related to FAI growth, but our divergent views towards these sectors are due to the differences in each sector's fundamentals.

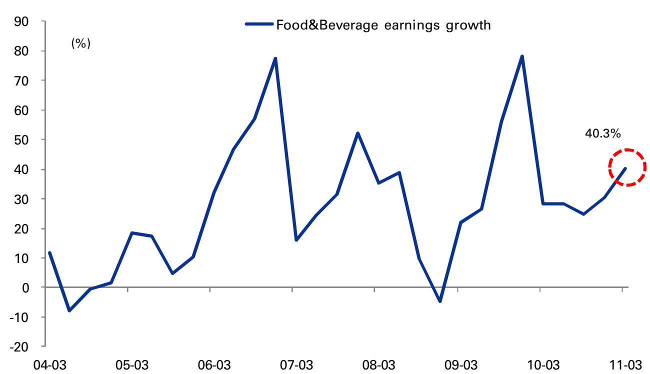
1) We believe machinery sales are more vulnerable to tighter credit conditions than sales in the coal/building materials sectors, as in recent years, machinery sales have become more reliant on credit. We believe the abrupt slowdown in machinery sales since 2Q is more a reflection of the cumulative effect of tighter credit than a slowdown in FAI-related activity, as overall FAI growth in China has been quite resilient ytd.
2) The growth in construction machinery sales over the past several years has led to a higher stock of construction machinery in China, which should result in slower future growth in machinery demand, as normally construction machinery has an economic life of at least 3-5 years. While in the coal/building materials sectors, we do not have such concerns. Exhibit 46 illustrates that the total stock of excavators almost doubled over the past two years (from around 500,000 units to almost 1mn units).

**Exhibit 36: CSI300 sector performance in 2Q11**



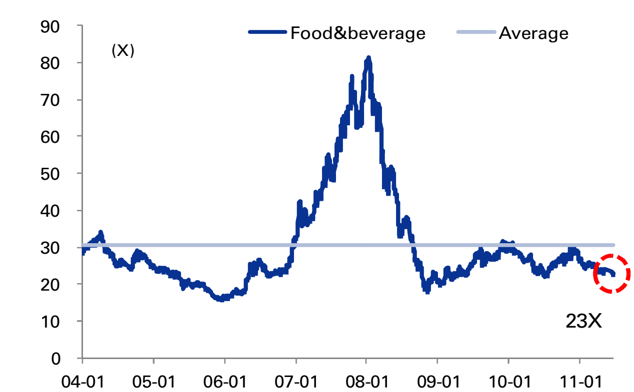

*Source: Wind, Gao Hua Securities Research, GS Global ECS Research.*

Exhibit 37: **Food & beverage sector 1Q11 earnings growth was strong at 40.3%**




*Source: Wind, Gao Hua Securities Research, GS Global ECS Research.*

**Exhibit 38: Food & beverage sector valuation fell to an attractive level**




*Source: Wind, Gao Hua Securities Research, GS Global ECS Research.*

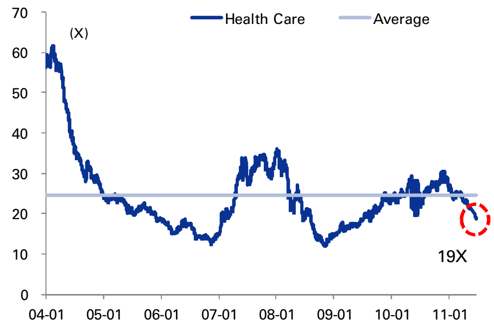
**Exhibit 39: Upgrade food & beverage/health care to overweight, upgrade oil & petro-chemical to neutral, downgrade capital goods to underweight**

| Sectors | Index Weighting | Previous rating | Suggested rating | PE(x) 2011E | PB(x) 2011E | Remarks |
|---|---|---|---|---|---|---|
| Coal | 6.7 | OW | OW | 13.4 | 2.7 | Coal demand should keep momentum and the sector is usually regarded as a proxy of crude oil. Although government intervention on price should be frequent if inflation pressure persists, the real effect on earnings should not be material as it's hard to fully implement price control. Valuation reasonable compared with growth. Supplyfor coke coal should be tighter than thermal coal but valuation already traded at premium over thermal coal. |
| Construction Materials & Others | 1.9 | OW | OW | 12.1 | 2.8 | Supply/demand is comfortably tight (partly due to the power shortage), which supports spot price; industry consolidation is an ongoing trend amid stricter environmental proctection/energy conservation policy implementations. Valuation is not high and within the reasonale range given the high earnings growth. Risks to the sector include that the social housing building plan may be slower than expected due to the tight budget of the local governments. |
| Non-ferrous metal & Others | 8.0 | OW | OW | 26.8 | 3.9 | Our commodity team is bullish on selective commodities ; Higher entry barrier and stricter enforcement of environmental protection should lead to industry consolidation, benefiting leading players;Usually regarded as inflation hedge plays in A share market and stock price usually goes along with spot price, although valuation is not supportive; |
| Property | 5.2 | OW | OW | 9.9 | 1.6 | The sector has underperformed the market for quite a while, currently valuation at historical low, factoring a very depressive scenario of the property sector. We believe risk reward balance for the sector is attrative as policy cloud has been largely cleared. Risks to the view include that the demand slows more than we expect amid the tight property tightenings we have never seen since China lauched residential property market reform. |
| Food&beverage | 6.1 | Neutral | OW | 26.5 | 6.5 | Earnings momentum so far has been strong, valuation is low compared with historical trading range and possibility of further price control measures is becoming low as inflation pressure allieviate gradully when the tightening begins to take effect. The branded liquor enjoys a favorable trend of consumer trading up, which underpins the earnings growth momentum. |
| Health Care | 4.3 | Neutral | OW | 22.5 | 3.5 | Time to OW the sector as 1) the valuation of the sector has come down to more sustainable levels, especially when market should begin look at the 2012E valuation towards the 2H of 2011; 2) policy risks have largely released and policy environment is becoming more supportive than depressive; 3) long term outlook of the sector intact amid China's aging population, growing health care expenditure with rising income level, and broader coverage of social health care program. |
| Retailing | 2.2 | OW | OW | 17.7 | 3.2 | Valuation gradually attractive and brand names continue to enjoy secular uptrend of trading up in China. Like more those local leading retailing names in the mid/western China. |
| Consumer Durables | 2.4 | OW | OW | 15.5 | 2.1 | Valuation in the reasonable range and demand for consumer durables correlation with propety sales less than expected; rural penetration improvement underpins the demand sustainability. Risks to the sector include more broad sales slowdown slowdown than we expect at the moment. |
| Textile&Apparel | 0.4 | OW | OW | 13.0 | | Brand names continue to enjoy secular uptrend of trading up in China, and valuation within reasonable range. Stable export growth is another earnings driver. |
| Airlines | 1.0 | Neutral | Neutral | 12.9 | 2.3 | Traffic volume growth should be strong but rising oil price may put earnings at risk; |
| Transportation Infratructure | 1.1 | Neutral | Neutral | 14.6 | 1.6 | Earnings growth stable but low , valuation reasonable, especially the after the outperformance year-to-date. |
| Auto&parts | 1.8 | Neutral | Neutral | 10.9 | 1.8 | Jpan earthquake-induced supply shock, policy headwind, rising oil prices should hurt demand and market sentiment towards the sector. Plays of alternative fuel autos and related parts/components should be a trading theme if oil price drifts even higher. |
| Hotel &tourism&Others | 0.7 | Neutral | Neutral | 19.4 | 2.2 | Valuation relatively high compared growth, brand names continue to enjoy secular uptrend of trading up in China. |
| Media | 0.3 | Neutral | Neutral | 26.4 | 2.2 | Growth low and high valuation although price performance may be supported by news flow of 3 net integration; |
| Banks | 18.5 | Neutral | Neutral | 7.2 | 1.4 | Fundamental of banks is still reasonaly good and return should be underpinned by earnings growth but a substantial rerating is less likely under current liquidty condition, especially amid frequent policy adjustments. Recent history indicates banks usually perform around earnings announcement. Risk to the sector include that banks' asset quality may begin to see some signs of deteriorating amid persistent monetary tightening. |
| Securities& Others | 4.4 | Neutral | Neutral | 16.1 | 2.0 | Valuation is not demanding, but growth quite depends on trading volume of A share market which is quite uncertain; lack of growth drivers other than this in the short/mid term unless policy on product innovation becomes more supportive; may have some trading opportunity if the market rebounds; |
| Insurance | 4.8 | Neutral | Neutral | 11.9 | 2.2 | Sector valuation not demanding but fundamental sees no signs of turning around yet. Should watch closely whether we may see some turning signs of the fundamental. May have some trading opportunities if the market rebounds. |
| IT&equipment/components | 2.3 | Neutral | Neutral | 24.0 | 2.3 | Subsectors with different fundamentals, some of the names benefit from strong growth in consumer electronics/touch screen mobile phone etc, but valuation is still generally high. |
| Oil,gas& petrochemical | 2.4 | UW | Neutral | 11.6 | 1.7 | Not attractive growth profile but so far the sector has underperformed the market for a while and valuation came back to historical low levels. Our commodity team is bullish on crude oil and we believe cost pass-through should be more likely when inflation pressure gradually peak towards the end of the year. More bullish on oil services/engineering plays. |
| Capital Goods | 11.5 | Neutral | UW | 17.8 | 3.2 | Earnings downside risk not fully released yet, amid the slowdown of property FAI, although favorable factors below still stay, 1)supportive government policy on machinery & equipment manufacturing; 2) Rising labor cost generate demands for capital goods as a substitution for labor, which is a mid-long term trend in China. |
| Construction&Other Industrial Services | 3.2 | Neutral | UW | 10.3 | 1.5 | Valuation is not expensive, but growth very sensitive to input cost rising as the margin of industry is generally low. May get more bullish if seeing some trend of margin improvement. |
| Shipping&Other transportation | 2.5 | Neutral | UW | 12.6 | 1.7 | Earnings is uncertainty given we have already seen a couple of leading signs of global slowdown, and may turn neutral or positive if we begin to see signs of strengthening global growth. |
| Chemical | 2.1 | UW | UW | 19.1 | 3.5 | Rising input cost should put earnings/growth at risk, valuation not attractive giving the highly cyclical feature, prefer resourse based names like potash; |
| Steel | 2.8 | UW | UW | 12.9 | 1.1 | Valuation reasonable but rising raw material price/competition stay as an industry concern, margin hard to improve. |
| Telecom | 1.0 | UW | UW | 54.9 | 1.4 | China Unicom is trying to gain market share and should be at advantage over the other two players, but earnings growth in the near/mid term should be sacrificed. Valuation is not attractive. Less bearish on telecom equipment and network optimization plays. |
| Utilities | 2.7 | UW | UW | 18.5 | 2.2 | Valuation is not attactive even if we factor in all the tariff rate hikes so far, and earnings growth of the sector quite depends on tariff policy and further resource price reform, which is quite uncertain at the moment. |
| OW Sectors | | 26.7 | 37.0 | | | |
| Neutral Sectors | | 62.5 | 37.4 | | | |
| UW Sectors | | 10.9 | 25.7 | | | |

OW=Overweight, UW=Underweight.

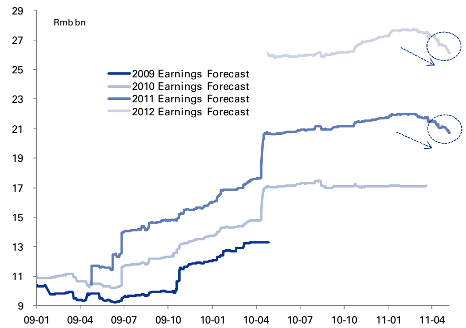
*Source: Wind, Gao Hua Securities Research estimates, GS Global ECS Research.*

Exhibit 40: **Healthcare sector valuations have become more reasonable**



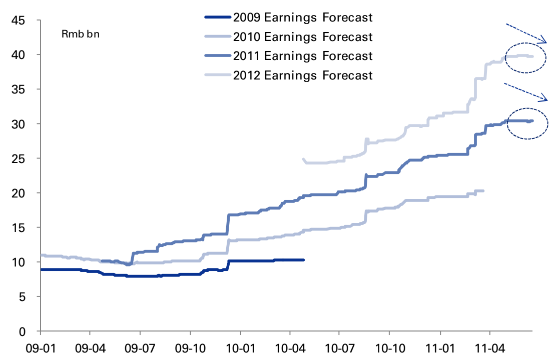

*Source: Wind, Gao Hua Securities Research, GS Global ECS Research.*

**Exhibit 41: Earnings forecasts for the healthcare sector have come down (based on Wind consensus)**



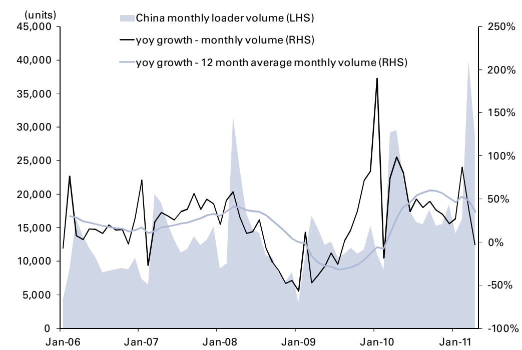

*Source: Wind, Gao Hua Securities Research, GS Global ECS Research.*

Exhibit 42: **Consensus earnings forecasts for the capital goods sector have been revised down**



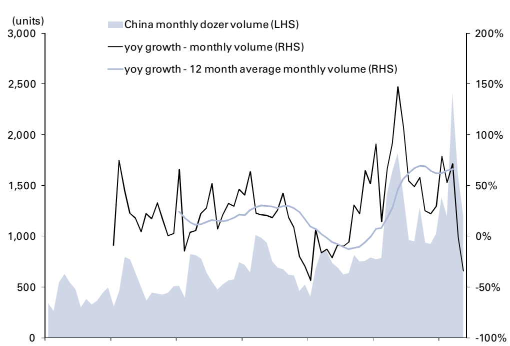

*Source: Wind, Gao Hua Securities Research, GS Global ECS Research.*

**Exhibit 43: Loader sales growth dropped significantly**



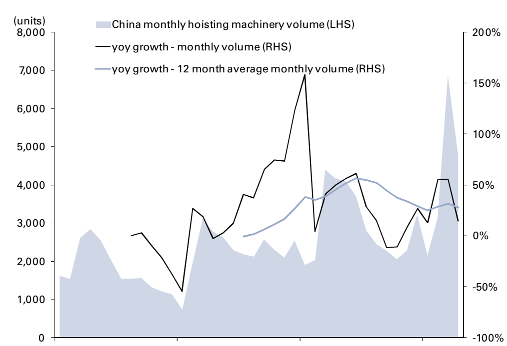

*Source: CEIC, Wind, Gao Hua Securities Research, GS Global ECS Research.*

Exhibit 44: **Dozer sales dropped sharply yoy**



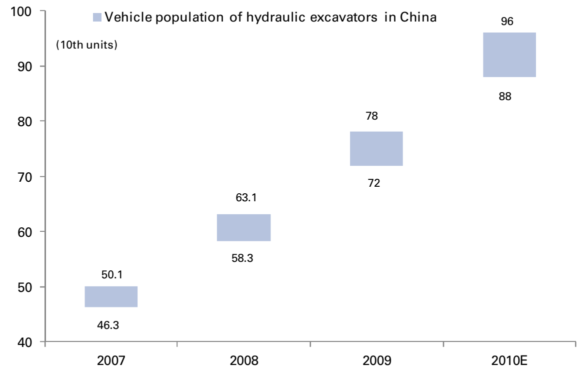

*Source: CEIC, Wind, Gao Hua Securities Research, GS Global ECS Research.*

**Exhibit 45: Hoisting machinery volume growth declined too**



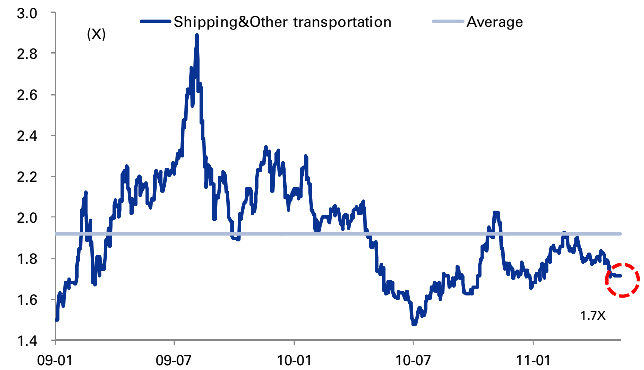

*Source: CEIC, Wind, Gao Hua Securities Research, GS Global ECS Research.*

Exhibit 46: **The total stock of excavators in China almost doubled over the past two years (estimated range of the stock)**



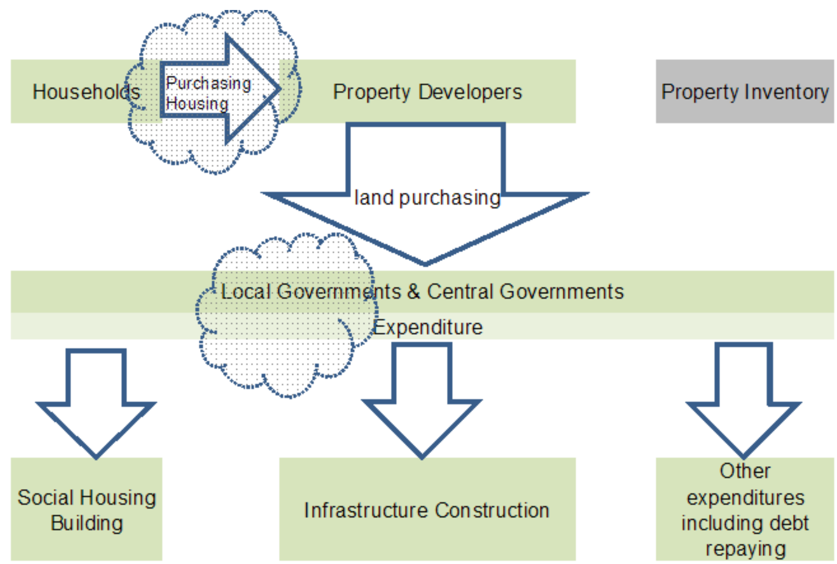

*Source: Wind, Gao Hua Securities Research estimates, GS Global ECS Research.*

**Exhibit 47: P/B for the shipping sector is at the mid-cycle level**



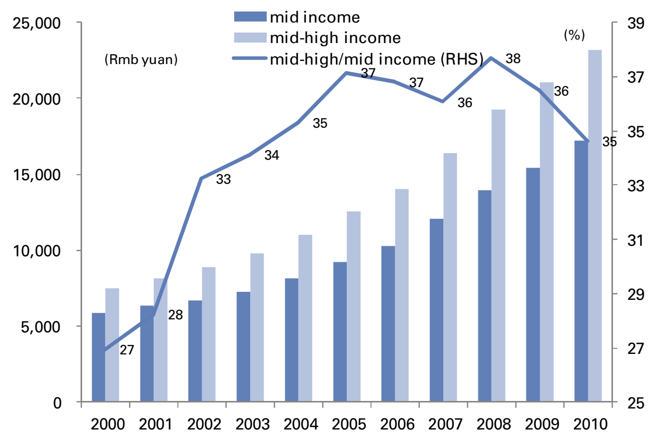

*Source: Wind, Gao Hua Securities Research, GS Global ECS Research.*

**Exhibit 48: A simplified funds-flow chart for China, with a special focus on the role of the property market within the economy**



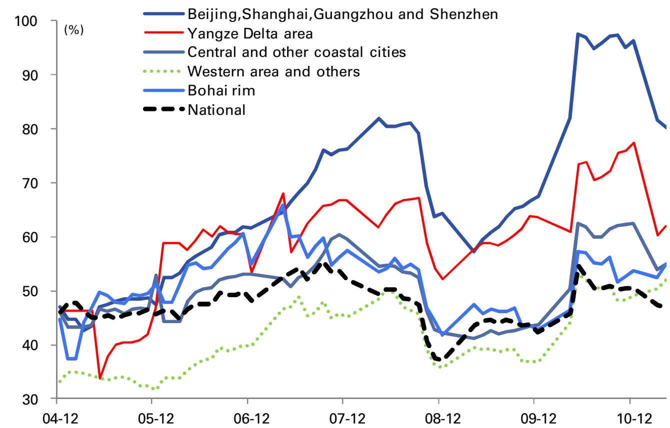

*Source: Gao Hua Securities Research, GS Global ECS Research.*

**Exhibit 49: Currently the average income of mid-high income families is 35% above that of mid-income families**



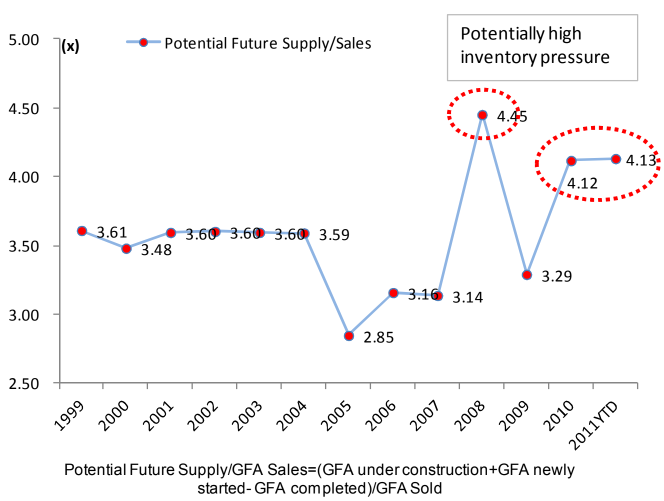

*Source: CEIC, Wind, Gao Hua Securities Research, GS Global ECS Research.*

**Exhibit 50: Our estimation indicates that at present overall housing affordability is slightly better than the worst situation during 2007-2008 (as measured by the ratio of monthly mortgage payment as a % of household monthly disposable income)**



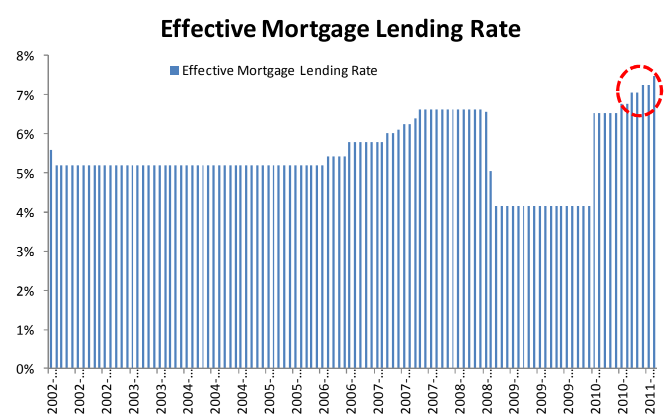

*Source: CEIC, Wind, Gao Hua Securities Research, GS Global ECS Research.*

**Exhibit 51: Property tightening led to inventory pressure in the property sector**



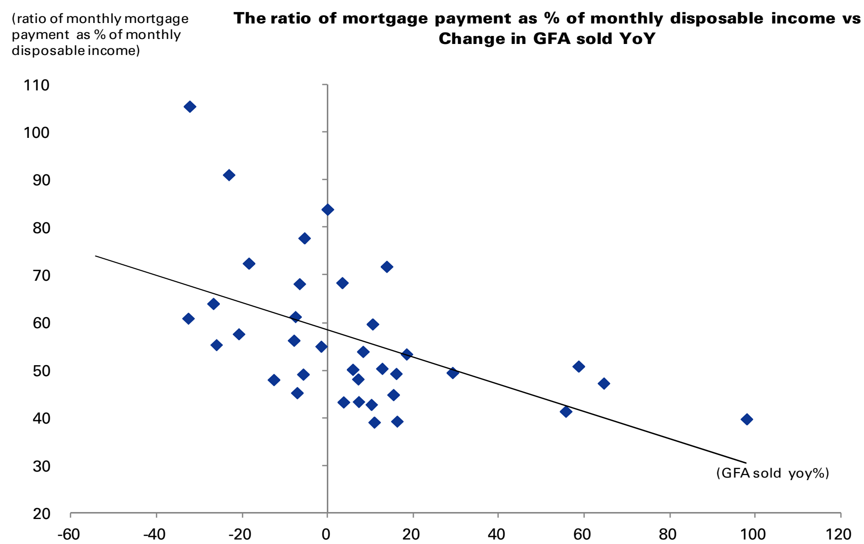

*Source: CEIC, Wind, Gao Hua Securities Research, GS Global ECS Research.*

**Exhibit 52: The current effective mortgage lending rate is higher than the peak level during 2007-2008**




*Source: CEIC, Wind, Gao Hua Securities Research, GS Global ECS Research.*

**Exhibit 53: Ytd, the changes in GFA sold yoy in 40 cities is highly correlated with housing affordability of the households in these cities**




*Source: Wind, Gao Hua Securities Research, GS Global ECS Research.*

# Key issue #1: Tighter-than-expected liquidity, results in lower valuations

Tight liquidity in the A-share market so far this year is one of the main areas of disappointment, in our view. In the following section we analyze the reasons for this tightness, provide an outlook on liquidity for the second-half of the year, and discuss what this implies for market valuations as a whole.

Overall, we believe the tight liquidity condition is the result of a low risk-taking appetite given frequent policy changes, higher yield on fixed-income instruments brought about by tighter monetary policies, and the diverting of funds as a result of the development of non-traditional financial segments in China such as PE funds and VC funds.

While some of the factors behind the tight liquidity are structural in nature, we view many of them as cyclical issues. As a consequence, we expect the liquidity position to improve once the cyclical concerns subside, which implies that the inflection point of the liquidity condition should be similar to the inflection point of major cyclical concerns, i.e., inflationary pressures.

The overall tight liquidity position ytd has caused valuations to contract continually in 2011, rather than a flat valuation or slight valuation expansion in 2011 vs. 2010, as we had assumed for 2011 at the beginning of the year, although we expect these policy concerns to cap a substantial potential re-rating. We believe there is room for market valuation expansion when inflation peaks. That said, we believe the liquidity condition may not reverse to a level that supports a substantial re-rating either, given a structurally expanding equity supply (as discussed in our 2011 outlook report) since 2007. Overall, we still expect around a 10 ppt valuation contraction for 2011E (12-m fPE to 13.0x) vs. 12-m fPE at the end of 2010 (14.4x, as discussed in our 2011 outlook report, *Growth amid Challenges*, January 17, 2011).

**We expected the liquidity condition in 2011 to stabilize or improve at the beginning of the year compared with 2010**. We expected the liquidity condition in 2011 to be supported by funds flow from retail investors seeking risky asset exposure amid high inflation. This underpinned our slight valuation expansion assumptions for 2011.

**However, this has proved to be one of the greatest disappointments so far**. The tighter-than-expected liquidity condition has led to further valuation contraction. Valuations have declined by around 14% ytd, from 14.4x 12-m fPE by the end of 2010, to 12.4x.

**Several developments, we believe, have caused the tighter-than-expected liquidity condition:** We believe there are several developments that have led to tight liquidity in the A-share market so far this year, namely:

1) **Frequent policy changes:** Have been used to tighten the property market and curtail inflation ytd. However, this tactic, in our view, has led to a low risk-taking appetite among investors and, as a result, we see continual funds outflow from equity markets through the redemption of funds (Exhibit 56), share reductions by company management teams (Exhibits 57 and 58) and/or major shareholders (block trades in the secondary markets, Exhibit 59).

2) **Persistent monetary tightening:** Perpetual RRR and IR hikes and credit controls, have led to higher yields for fixed-income financial instruments, which have attracted the attention of investors (especially when compared with the ytd return on equity and mutual funds). For example, the number of banking wealth management products and short-term products that have been issued by banks, have more than doubled so far this year yoy vs. 2010. We find some inverse relationship between the popularity of these types of products and equity market performance (Exhibit 63). The equity fund

raising activities through IPOs and SOEs, given the tight credit conditions, also exacerbated the situation.

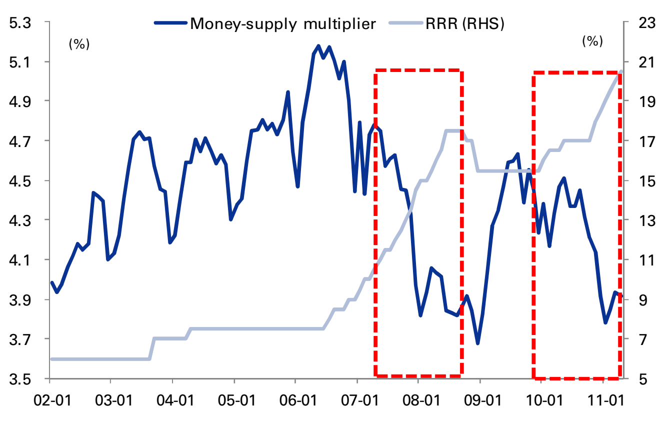
3) **Other non-traditional financial segments:** Non-traditional financial segments are also developing very fast, diverting funds flows, especially the funds from high-net-worth individuals. Such non-traditional financial segments include PE funds and VC funds. We do not have direct data on the funds raised by such funds, but through their investment activities over the past two years we do have some insight into how active they have been (Exhibit 55). Ironically, we see that China's lottery market has expanded very quickly, attracting significant monetary inflows ytd (Rmb83.7bn from January-May 2011, compared with around Rmb110bn net funds outflow for all mutual funds in 1Q11) (Exhibit 61).

**When is the inflection point?**

One of the most frequently asked questions regarding A-share market liquidity is "when will the liquidity condition improve". We believe most of the reasons mentioned above that are responsible for the tight liquidity ytd are cyclical rather than structural in nature. Therefore, we think the market liquidity condition should improve when the major cyclical concerns diminish or are removed entirely. That is, we expect the inflection point in market liquidity to largely coincide with the inflection point in inflationary pressure (sometime in mid-to-late 3Q11).

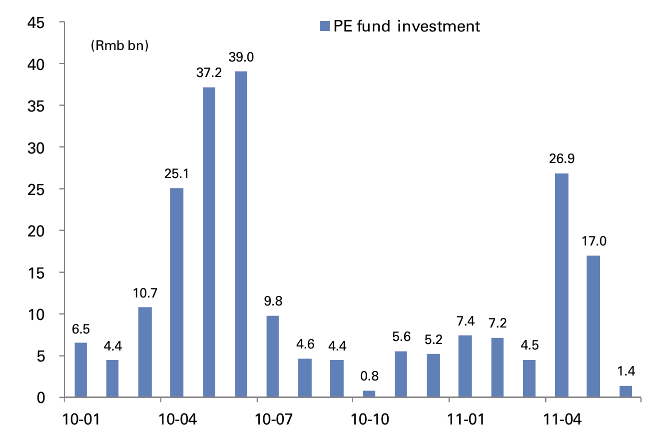
As a consequence, we believe there should be some room for valuations to expand when we see more signs that inflation is about to peak. That said, we do not expect the liquidity condition to reverse to a level that supports a substantial re-rating in the market, given the structurally increasing equity supply in A-shares, and still high inflation, which is supportive of a relatively high bond yield (especially for the short term ones). Overall, we still expect around 10 ppt valuation contraction in 2011 (12-m fPE to 13.0x) vs. 12-m fPE at the end of 2010 (14.4x, as discussed in our 2011 outlook report, *Growth amid Challenges*, January 17, 2011), as overall market liquidity for 2011 should be tighter than it was in 2010.

Exhibit 54: **RRR hikes depressed money-supply multiplier**



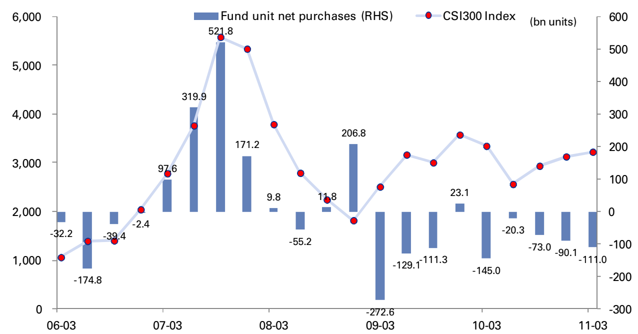

Source: Wind, Gao Hua Securities Research, GS Global ECS Research.

**Exhibit 55: Private equity fund investment is active**



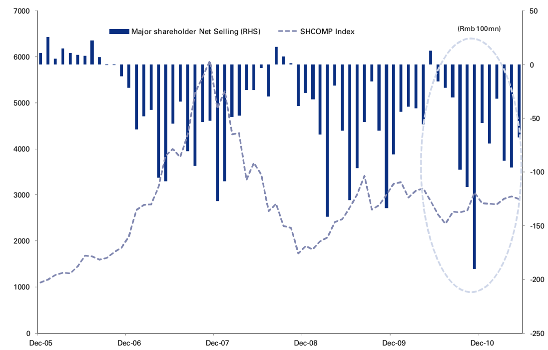

Source: Wind, Gao Hua Securities Research, GS Global ECS Research.

Exhibit 56: **Net change in total fund units was a decrease of 111bn units in 1Q11**



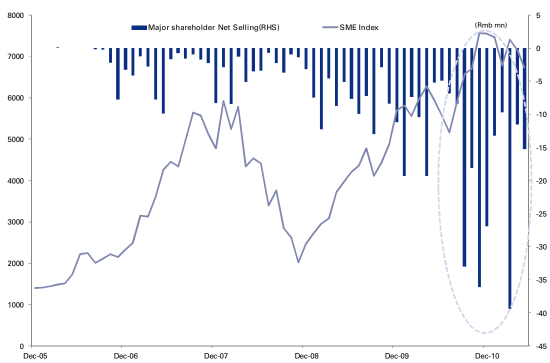

*Source: Wind, Gao Hua Securities Research, GS Global ECS Research.*

**Exhibit 57: Active share reductions by managements or major shareholders ytd (total)**



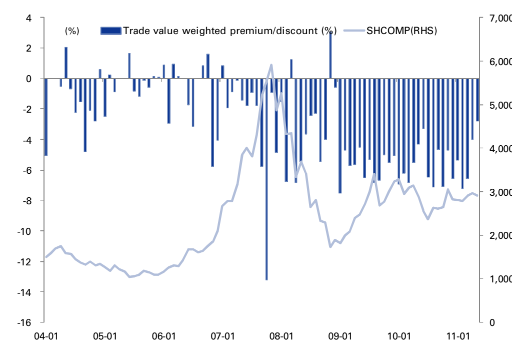

*Source: Wind, Gao Hua Securities Research, GS Global ECS Research.*

Exhibit 58: **Share reductions by management or major shareholders (SME&GEM) became more active from 4Q10**



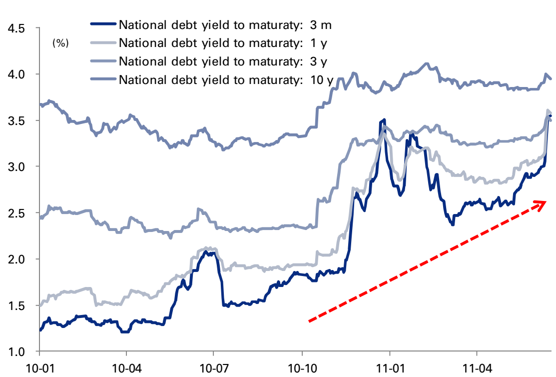

*Source: Wind, Gao Hua Securities Research, GS Global ECS Research.*

**Exhibit 59: Discounts on block trades in the secondary market have been deep over the past two years**



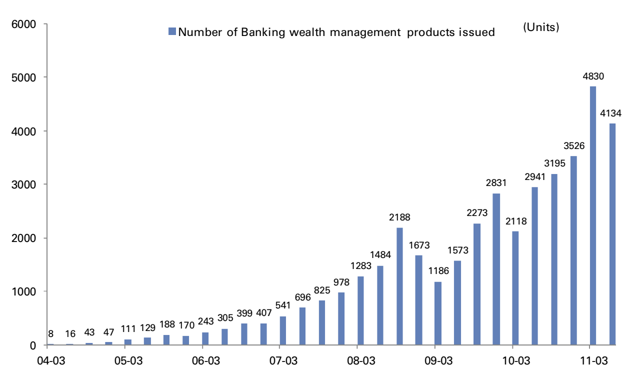

*Source: Wind, Gao Hua Securities Research, GS Global ECS Research.*

Exhibit 60: **Yield to maturity for short-term treasury rose sharply ytd**



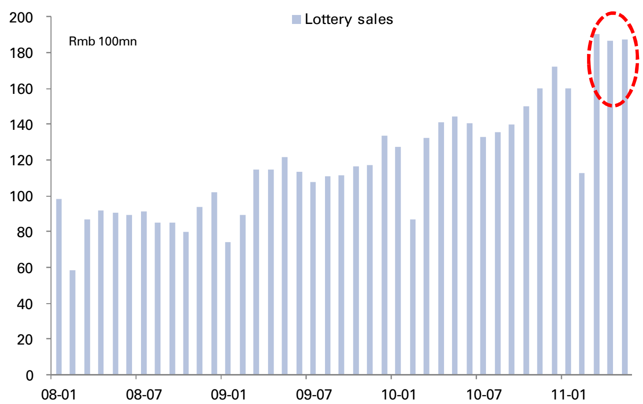

*Source: Wind, Gao Hua Securities Research, GS Global ECS Research.*

**Exhibit 61: Banking wealth management products increased sharply**



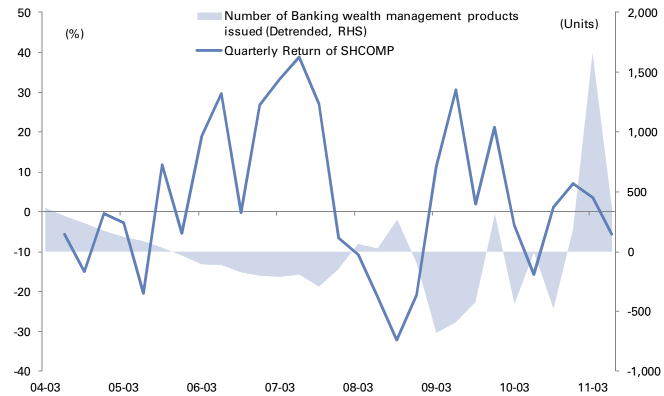

*Source: Wind, Gao Hua Securities Research, GS Global ECS Research.*

Exhibit 62: **China lottery market expanded very quickly during 1H11**




*Source: Wind, Gao Hua Securities Research, GS Global ECS Research.*

**Exhibit 63: No. of banking wealth management products (de-trended) vs. equity return: Inversely correlated**




*Source: Wind, Gao Hua Securities Research, GS Global ECS Research.*

# Key issue #2: Less bearish on small-mid caps than before; be selective

We are now much less bearish on small-mid cap A-share stocks and recommend investors be selective when choosing such stocks. We screen a basket of small-mid-cap stocks (market cap less than Rmb30bn but more than Rmb10bn) among the Goldman Sachs/Gao Hua covered universe for investors interested in gaining exposure to the growth stocks in China A-shares.

Small-mid caps (SME composite index) have fallen 18.7% ytd, underperforming the CSI300 index by 11.7ppt. This is a reversal of the trend which has lasted for 7 quarters since 3Q09 (Exhibit 64). During this period, the small-mid caps (SME composite index) outperformed large caps (CSI300 index) by 93 ppt.

We believe there are several reasons why the small-mid caps have underperformed so far this year:

1) **Equity supply through unlocking shares and IPOs:** This segment has experienced a more significant valuation contraction than the market as a whole. As discussed in the previous section, the level of liquidity in the A-share market ytd has been tighter than we had expected, which has led to a continual contraction in stock valuations for the whole market. We note that the de-rating has been even more significant in terms of small-mid cap stocks. We estimate there to be about Rmb800bn worth of shares to be unlocked in the SME&GEM markets in 2011, which accounts for almost 20% of the total market cap of the SME&GEM market. We have seen unlocked shares selling in the SME&GEM market (Exhibit 66) and continual IPO activity in this segment result in further valuation pressures (Exhibit 67). As a consequence, the 12-m fPE for the SME composite index, based on consensus earnings forecast, declined to around 20.7x, down 35% or about 32x from the beginning of the year. The valuation contraction in small-mid caps is much greater than we see in the CSI300 index (around 14% ytd).

2) **Earnings disappointments/concerns**: At the beginning of the year consensus earnings growth CAGR 2010-2012 for small-caps was high at 33.6%, as discussed in our report entitled *Growth amid challenges*, published on January 17, 2011. However, there were significant earnings disappointments in the 2010 earnings report for small-mid cap stocks, with consensus earnings forecasts having been downgraded by 2ppt since April (Exhibit 69) with further downward revisions expected.

3) **Corporate governance and balance sheet risks:** We highlight potential corporate governance risks in the SME&GEM markets as we believe quality control issues surrounding recently listed companies have not been strictly implemented due to the development of the market over the past year (the total number of companies in the GEM market increased from around 30 in late 2009 to 230 by June 2011). We have seen a couple of cases involving corporate governance issues in the market over the past few months, which increases the risk premium investors require if they are to invest in small-mid cap stocks.

   Tight credit control measures that have been imposed by the government this year have also added to the balance sheet risk of China's SMEs, in our view. SMEs usually feel the pressure of liquidity tightening the most, as mid-large cap stocks, especially large cap SoEs, usually have much better access to bank credit facilities than SMEs. This is especially true during the times when credit is tight, as discussed in various media reports (one of them, http://roll.sohu.com/20110629/n312009350.shtml ) that have highlighted the difficulties faced by SMEs in Zhejiang Province and Jiangsu Province in eastern China.

We are much less bearish on small-mid cap stocks for the following reasons:

1) The overall valuation of small-mid cap stocks has now declined to a more sustainable level. As discussed above, the 12-m fPE of the SME composite index based on consensus earnings is now 20.7x, which is its lowest level since May 2009. We believe there could be further downside to small-mid caps' valuations due to continual equity supply pressures although the segment should become increasingly appealing, especially when you consider the long-term growth outlook for some of the stocks, especially those in the food & beverage and healthcare sectors.

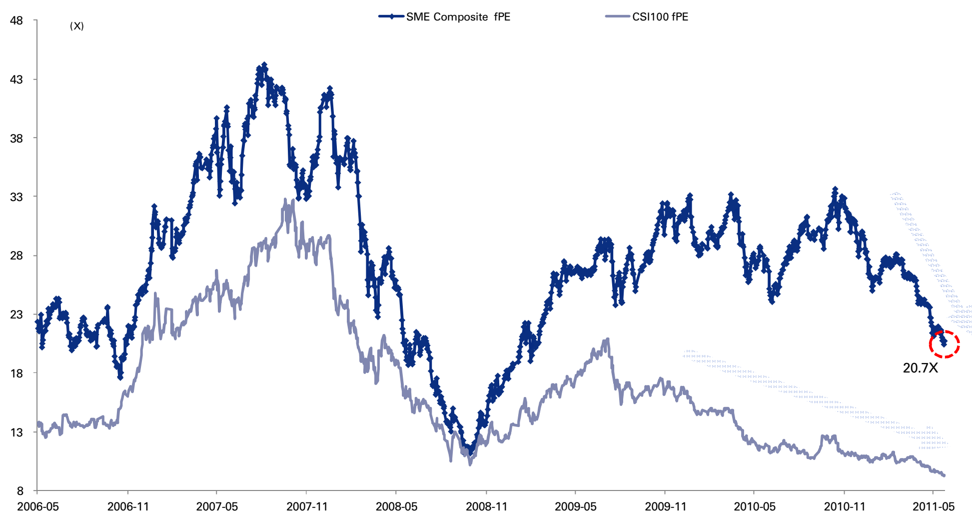
2) Although there may still be some earnings downside risks for small-mid caps, historically, the earnings volatility of small-mid caps is much less than that of large caps. Conversely, the growth rate for small-mid caps is much higher, probably due to their relatively high exposure to consumer-related sectors, as discussed in our 2011 outlook report (*Growth amid challenges*, January 17, 2011). We still expect high-teen percentage earnings growth for CSI300 index in 2011 and, as a result, believe the earnings growth for the SME composite should be above 20% in 2011.

We understand that small-mid caps differentiate themselves in terms of company fundamentals and quality and, as such, we recommend investors be selective when choosing such stocks, once the valuation of these small-mid cap stocks become less of a problem. We screen the Goldman Sachs/Gao Hua covered universe based on stock market cap (market cap of less than Rmb30bn but more than Rmb10bn have reasonably good liquidity), our analysts' ratings (generally Buy-rated stocks), and our current sector preferences. We have a basket of 13 stocks (Exhibit 68), of which most are consumer-related in nature.

**Exhibit 64: CSI100 vs. CSI500: The trend of small- and mid-cap outperformance reversed ytd**

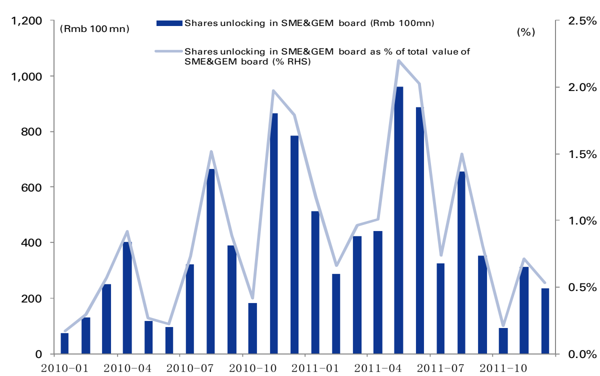

*Source: Wind, Gao Hua Securities Research, GS Global ECS Research.*

**Exhibit 65: SME 12-m forward P/E vs. CSI100 12-m forward P/E: Continuous de-rating**



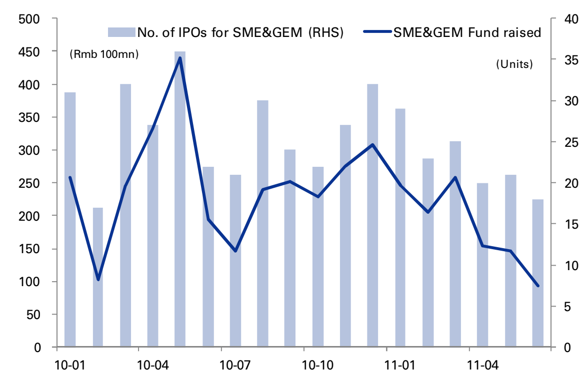

*Source: Wind, Gao Hua Securities Research, GS Global ECS Research.*

Exhibit 66: **Shares unlocking in SME&GEM boards**




*Source: Wind, Gao Hua Securities Research, GS Global ECS Research.*

**Exhibit 67: IPO fund raising in SME&GEM by the number of IPOs and the total funds raised**




*Source: Wind, Gao Hua Securities Research, GS Global ECS Research.*

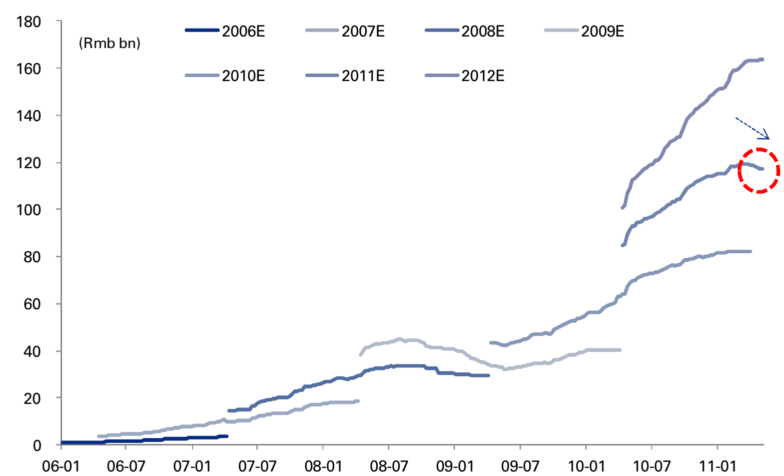
**Exhibit 68: A basket of small- and mid-cap stocks screened from GS/GH covered universe**

| Ticker | Name | Sector | Rating | Price (Rmb) | 6M/12M target Price (Pricing | Potential upside/downside to target | Market cap (Rmb bn) | P/E CY 2011 (X) | P/B CY 2011 (X) |
|---|---|---|---|---|---|---|---|---|---|
| 601888 CH | China International Travel Service Corp. | Consumer Discretionary | Buy* | 23.0 | 37.3 | 62.1% | 19.2 | 28.0 | 4.0 |
| 600859 CH | Beijing Wangfujing Department Store (Group) Co. | Consumer Discretionary | Buy | 38.5 | 44.0 | 14.2% | 15.0 | 22.8 | 4.2 |
| 600754 CH | Shanghai Jinjiang International Hotels | Consumer Discretionary | Buy | 17.1 | 25.3 | 48.0% | 10.0 | 25.4 | 2.2 |
| 000423 CH | Shandong Dong-E E-Jiao Co. | Health Care | Buy | 38.7 | 55.4 | 43.1% | 21.2 | 24.3 | 7.1 |
| 600252 CH | Guangxi Wuzhou Zhongheng Group | Health Care | Buy* | 17.9 | 50.7 | 183.2% | 18.1 | 18.5 | 8.7 |
| 000999 CH | China Resources Sanjiu Pharmaceutical | Health Care | Buy | 17.7 | 24.9 | 41.1% | 17.1 | 17.1 | 3.5 |
| 002223 CH | Jiangsu Yuyue Medical Equipment & Supply | Health Care | Buy | 23.5 | 30.4 | 29.1% | 9.5 | 37.2 | 9.4 |
| 600588 CH | UFIDA Software Co. | Information Technology | Buy | 19.9 | 26.0 | 30.9% | 16.3 | 31.9 | 5.7 |
| 300002 CH | Beijing Ultrapower Software | Information Technology | Buy | 27.8 | 46.9 | 68.8% | 10.3 | 24.2 | 3.6 |
| 000401 CH | Tangshan Jidong Cement Co | Materials | Neutral | 24.7 | 35.0 | 41.8% | 27.3 | 13.8 | 2.8 |
| 600383 CH | Gemdale Corp | Real Estate | Buy | 6.2 | 9.1 | 47.0% | 23.7 | 7.9 | 1.3 |
| 600376 CH | Beijing Capital Development Co. | Real Estate | Buy* | 12.4 | 18.5 | 48.4% | 17.8 | 9.1 | 1.5 |

*Denotes that this stock is on our Regional Conviction List. For important disclosures, please go to http://www.gs.com/research/hedge.html.

*Source: Wind, Gao Hua Securities Research estimates, GS Global ECS Research.*

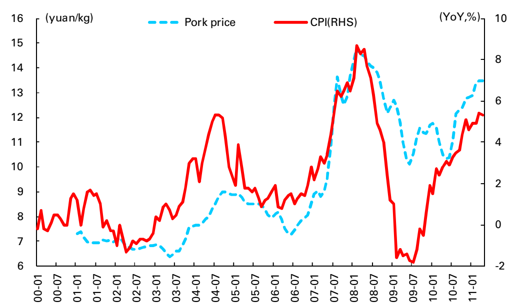
**Exhibit 69: Wind consensus earnings forecast for SME has been downgrade 1.8ppt since April**




*Source: Wind, Gao Hua Securities Research, GS Global ECS Research.*

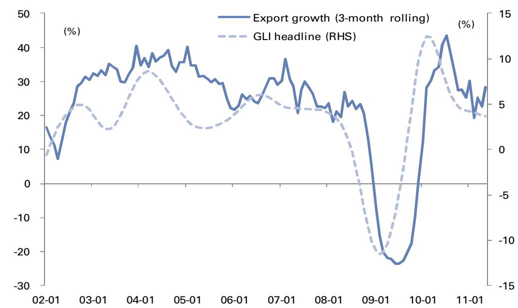
# Appendix: Key charts/updates

Exhibit 70: **China's CPI is highly correlated with pork prices**



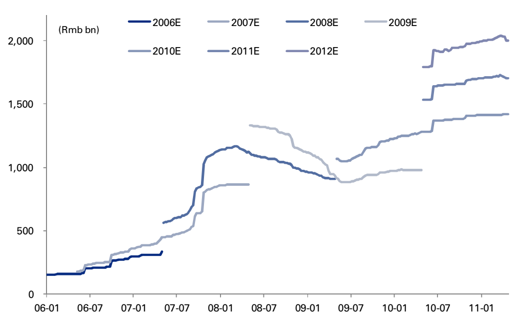

*Source: CEIC, Wind, Gao Hua Securities Research, GS Global ECS Research.*

**Exhibit 71: GLI implies exports may continue to weaken in 3Q11**



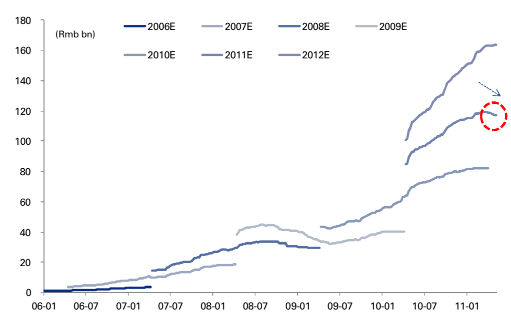

*Source: CEIC, Wind, Gao Hua Securities Research, GS Global ECS Research.*

Exhibit 72: **Wind consensus earnings forecasts for CSI300 index**



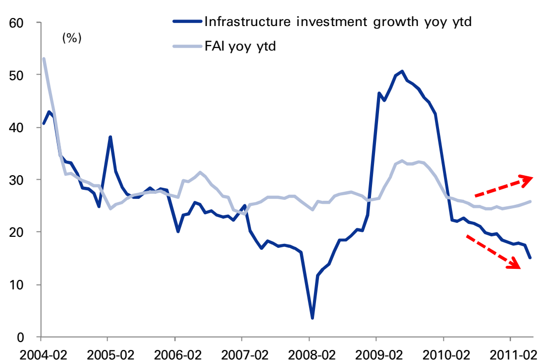

*Source: Wind, Gao Hua Securities Research, GS Global ECS Research.*

**Exhibit 73: Wind consensus earnings forecasts for SME composite index earnings**



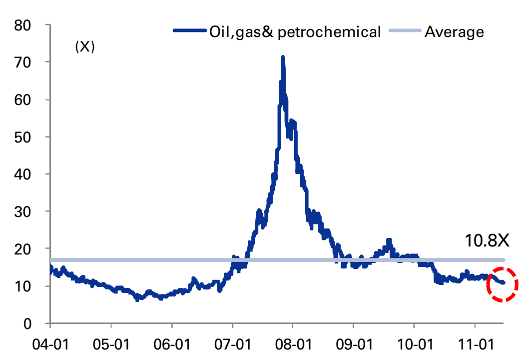

*Source: Wind, Gao Hua Securities Research, GS Global ECS Research.*

Exhibit 74: **Infrastructure investment slowed further in 1H11**



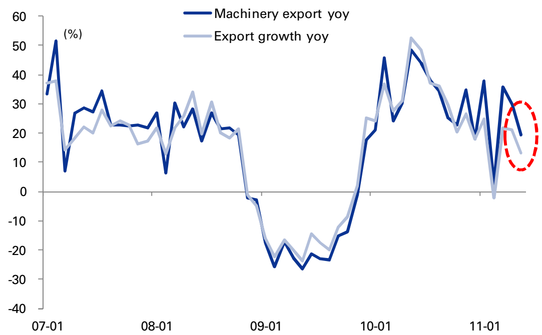

*Source: Wind, Gao Hua Securities Research, GS Global ECS Research.*

**Exhibit 75: Oil, gas & petrochemical sector valuation is even lower than during the economic downturn**



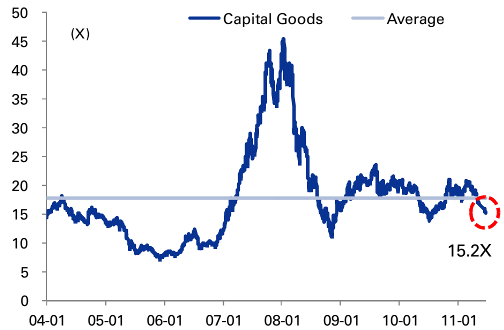

*Source: Wind, Gao Hua Securities Research, GS Global ECS Research.*

Exhibit 76: **Recent weakening in machinery exports**



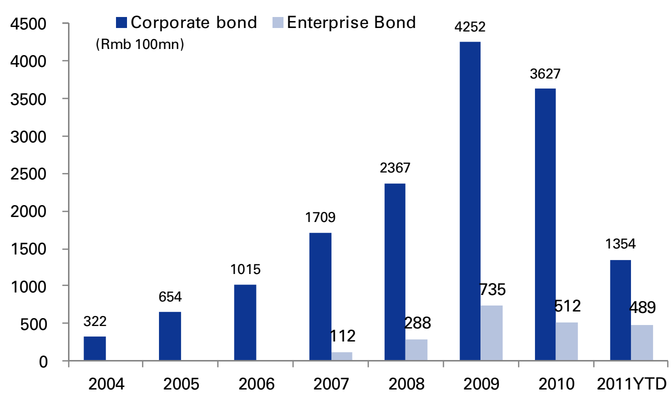

*Source: CEIC, Wind, Gao Hua Securities Research, GS Global ECS Research.*

**Exhibit 77: Valuation of the capital goods sector is slightly below the mid-cycle level**



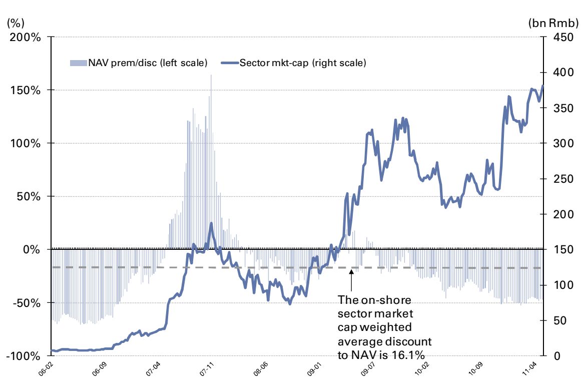

*Source: Wind, Gao Hua Securities Research, GS Global ECS Research.*

**Exhibit 78: Corporate and enterprise bond issuance from 2004 to 2011 ytd**



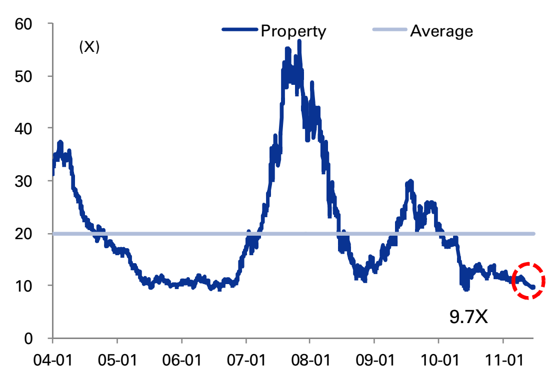

*Source: Wind, Gao Hua Securities Research, GS Global ECS Research.*

Exhibit 79: **The property sector now trades at a 50% discount to NAV**



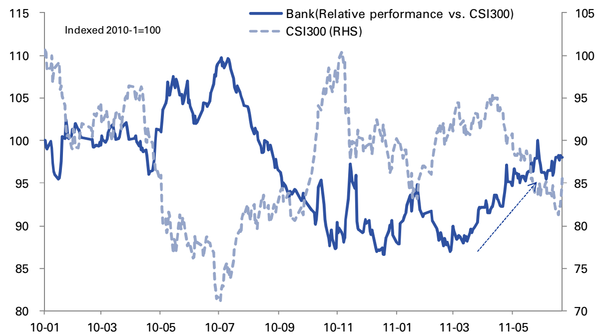

*Source: Wind, Gao Hua Securities Research, GS Global ECS Research.*

**Exhibit 80: The property sector is now traded at 9.7X 12-m forward P/E**



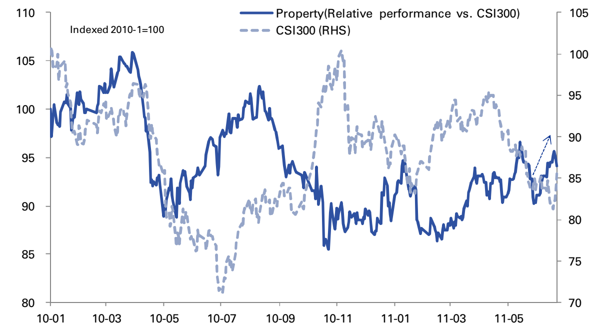

*Source: Wind, Gao Hua Securities Research, GS Global ECS Research.*

Exhibit 81: **Relative performance of banks; outperformed since 2Q11**



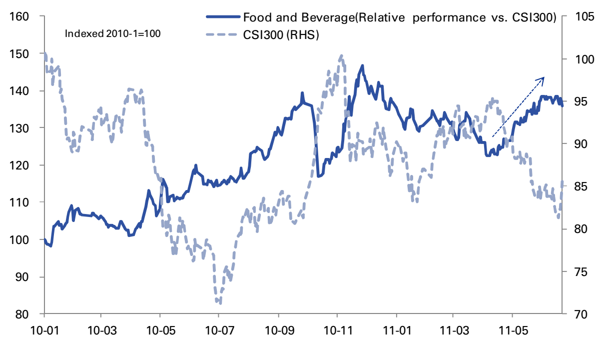

*Source: Wind, Gao Hua Securities Research, GS Global ECS Research.*

**Exhibit 82: Relative performance of property; outperformed recently**




*Source: Wind, Gao Hua Securities Research, GS Global ECS Research.*

Exhibit 83: **Relative performance of food & beverages; outperformed since 2Q11**

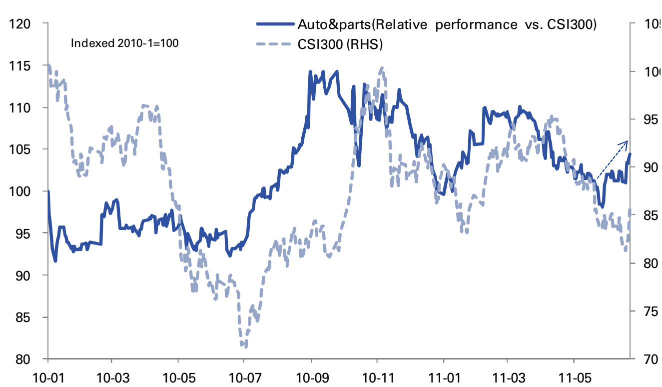



*Source: Wind, Gao Hua Securities Research, GS Global ECS Research.*

**Exhibit 84: Relative performance of retailing**

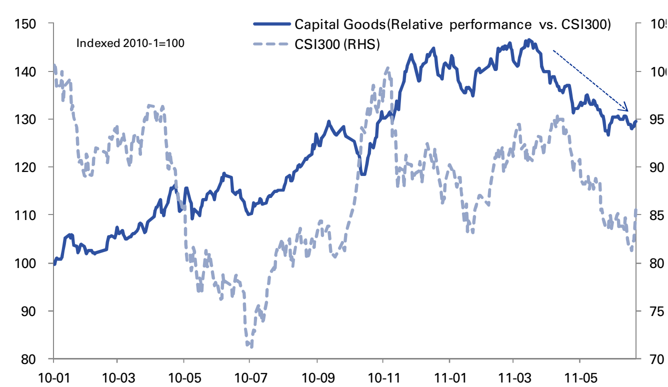

*Source: Wind, Gao Hua Securities Research, GS Global ECS Research.*

Exhibit 85: **Relative performance of autos; outperformed over the past few weeks**



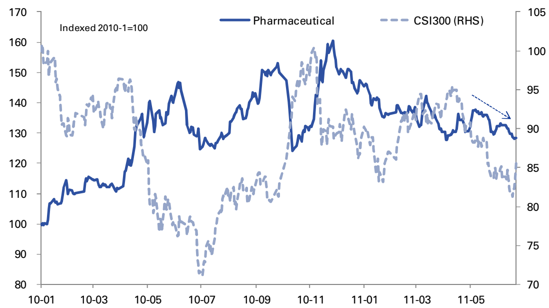

*Source: Wind, Gao Hua Securities Research, GS Global ECS Research.*

**Exhibit 86: Relative performance of capital goods; underperformed since 2Q11**



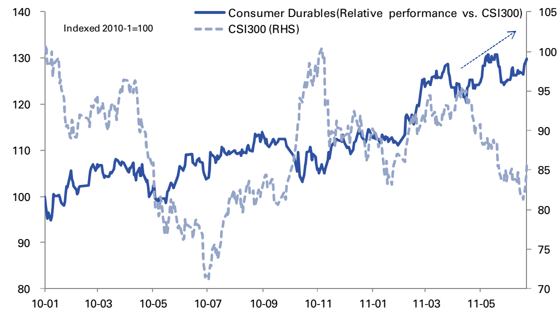

*Source: Wind, Gao Hua Securities Research, GS Global ECS Research.*

Exhibit 87: **Relative performance of pharmaceuticals; underperformed in 1H11**



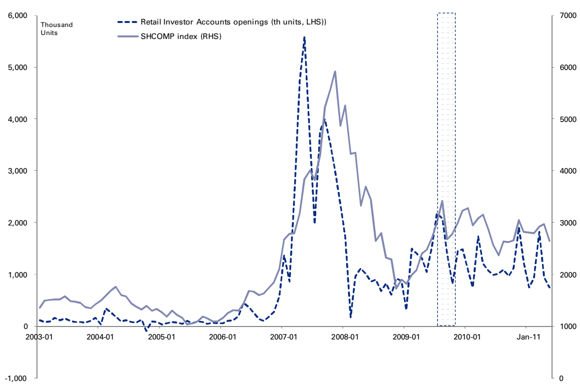

*Source: Wind, Gao Hua Securities Research, GS Global ECS Research.*

**Exhibit 88: Relative performance of consumer durables; outperformed in 1H11**



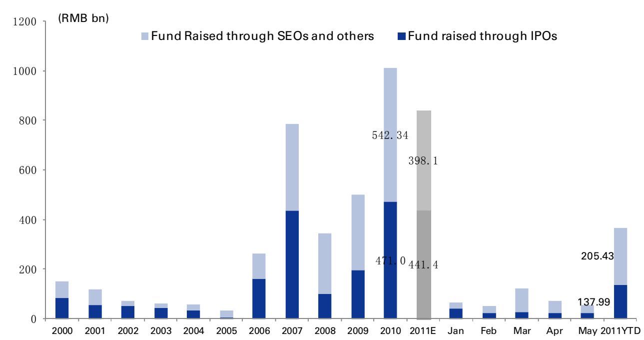

*Source: Wind, Gao Hua Securities Research, GS Global ECS Research.*

Exhibit 89: **Investor account openings vs. SHCOMP index**



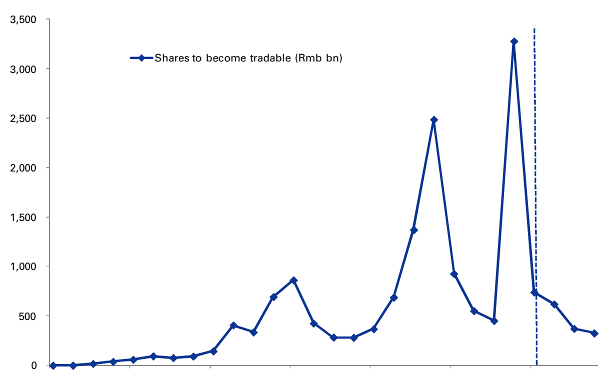

*Source: Wind, Gao Hua Securities Research, GS Global ECS Research.*

**Exhibit 90: Equity fund raising activities via IPOs and SEOs given tight credit controls exacerbated the situation**



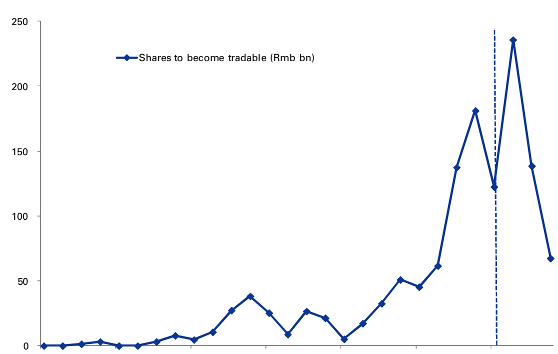

*Source: Wind, Gao Hua Securities Research estimates, GS Global ECS Research.*

Exhibit 91: **Shares to become tradable (overall A-share market)**



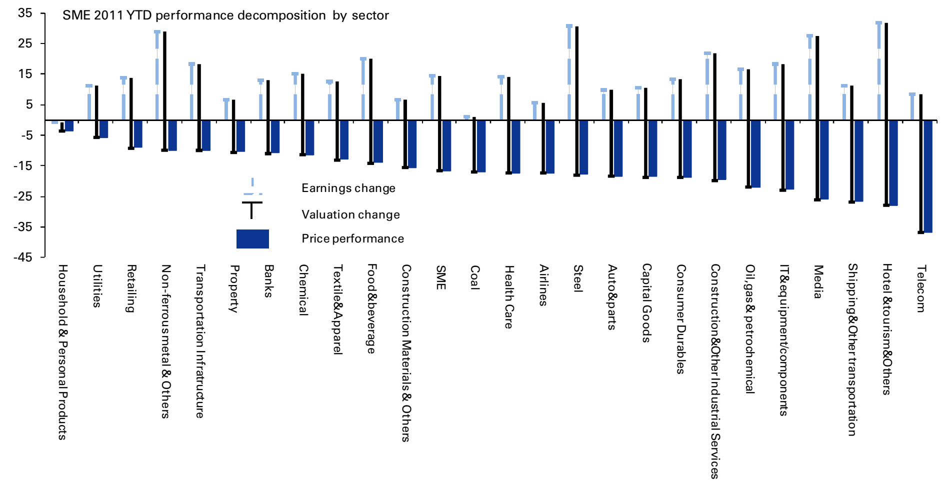

*Source: Wind, Gao Hua Securities Research, GS Global ECS Research.*

**Exhibit 92: Shares to become tradable (SME&GEM)**




*Source: Wind, Gao Hua Securities Research, GS Global ECS Research.*

**Exhibit 93: SME 2011 ytd performance decomposition**




*Source: Wind, Gao Hua Securities Research, GS Global ECS Research.*

**Exhibit 94: CSI300/CSI500/SME composite earnings growth/valuation comparison by sector, based on WIND consensus**

| Sectors | Earnings CAGR 2010-12E | | | 2011E PE | | | 2011 YTD Performance | | |
|---|---|---|---|---|---|---|---|---|---|
| | CSI300 | CSI500 | SME Comp | CSI300 | CSI500 | SME Comp | CSI300 | CSI500 | SME Comp |
| Oil,gas& petrochemical | 12.1 | 36.4 | 36.2 | 11.7 | 29.6 | 23.6 | -3.7 | 11.5 | -23.4 |
| Coal | 12.6 | 0.5 | 10.6 | 14.8 | 19.9 | 17.5 | 3.3 | 16.9 | -16.3 |
| Chemical | 38.8 | 63.5 | 37.3 | 23.0 | 27.3 | 25.1 | -5.4 | 7.8 | -14.4 |
| Construction Materials & Others | 41.7 | 34.6 | 36.3 | 16.5 | 17.1 | 24.2 | 13.7 | 6.7 | -14.8 |
| Non-ferrous metal & Others | 45.4 | 40.1 | 53.2 | 29.1 | 39.4 | 32.9 | -15.0 | 21.4 | -13.6 |
| Steel | 23.7 | 35.9 | 61.0 | 12.2 | 15.3 | 24.0 | 2.9 | -11.6 | -17.1 |
| Capital Goods | 26.5 | 29.5 | 33.3 | 18.2 | 23.4 | 26.2 | -8.9 | 8.0 | -22.2 |
| Construction&Other Industrial Services | 31.8 | 38.7 | 51.4 | 10.3 | 26.1 | 27.2 | -5.8 | 6.4 | -21.2 |
| Airlines | 2.4 | -15.6 | 21.1 | 10.7 | 33.9 | 28.8 | -29.6 | -6.3 | -21.6 |
| Shipping&Other transportation | 8.3 | 14.3 | 25.9 | 12.4 | 36.7 | 24.4 | -4.5 | -24.7 | -34.3 |
| Transportation Infratructure | 14.6 | 17.4 | 40.0 | 13.4 | 16.4 | 43.7 | -4.4 | -21.4 | -14.9 |
| Auto&parts | 12.9 | 32.2 | 28.0 | 10.5 | 20.8 | 21.9 | 4.5 | -4.8 | -17.9 |
| Consumer Durables | 23.2 | 33.0 | 34.7 | 15.9 | 29.6 | 25.8 | 8.4 | -1.8 | -20.9 |
| Textile&Apparel | 10.8 | 31.5 | 37.9 | 11.5 | 34.4 | 27.0 | -10.3 | 3.5 | -15.5 |
| Hotel &tourism&Others | 26.7 | 21.7 | 60.8 | 19.9 | 24.0 | 28.2 | -5.4 | -24.5 | -32.1 |
| Media | 65.3 | 7.7 | 42.4 | 28.6 | 32.4 | 32.5 | -19.0 | 3.0 | -27.9 |
| Retailing | 33.2 | 24.1 | 30.9 | 16.7 | 22.0 | 18.4 | -11.3 | -9.0 | -8.2 |
| Food&beverage | 25.8 | 60.6 | 43.6 | 25.7 | 33.2 | 30.4 | -1.0 | -1.4 | -14.7 |
| Household & Personal Products | - | 51.8 | 29.2 | - | 25.7 | 46.4 | - | -7.2 | -5.2 |
| Health Care | 21.3 | 39.0 | 34.3 | 19.0 | 27.6 | 27.0 | -19.7 | -0.2 | -20.8 |
| Banks | 18.7 | - | 27.0 | 7.7 | - | 11.1 | 2.1 | - | -13.9 |
| Securities& Others | 2.2 | 15.8 | - | 17.8 | 77.9 | - | -7.7 | -1.0 | - |
| Insurance | 18.7 | - | - | 14.1 | - | - | -15.6 | - | - |
| Property | 32.5 | 26.6 | 28.6 | 11.5 | 18.1 | 13.9 | -1.4 | -18.5 | -6.7 |
| IT&equipment/components | 17.7 | 43.6 | 46.8 | 23.5 | 33.0 | 29.9 | -15.4 | 6.3 | -26.0 |
| Telecom | 114.2 | - | 31.1 | 22.7 | - | 31.3 | -4.9 | - | -40.8 |
| Utilities | 11.3 | 31.5 | 31.5 | 16.5 | 38.9 | 30.7 | -6.0 | -6.5 | -7.6 |
| Overall | 22.4 | 30.1 | 33.3 | 11.5 | 25.1 | 25.5 | -7.0 | -12.1 | -18.7 |
| Overall Ex-Financial | 18.3 | 34.6 | 38.3 | 14.9 | 25.7 | 26.5 | -5.3 | 1.1 | -19.7 |

*Source: Wind, Gao Hua Securities Research estimates, GS Global ECS Research estimates.*

# Reg AC

We, Hanfeng Wang, Ph.D, CFA, Helen Zhu, Timothy Moe, CFA, Christopher Eoyang and Ben Bei, hereby certify that all of the views expressed in this report accurately reflect our personal views about the subject company or companies and its or their securities. We also certify that no part of our compensation was, is or will be, directly or indirectly, related to the specific recommendations or views expressed in this report.

# Investment Profile

The Goldman Sachs Investment Profile provides investment context for a security by comparing key attributes of that security to its peer group and market. The four key attributes depicted are: growth, returns, multiple and volatility. Growth, returns and multiple are indexed based on composites of several methodologies to determine the stocks percentile ranking within the region's coverage universe.

The precise calculation of each metric may vary depending on the fiscal year, industry and region but the standard approach is as follows:

**Growth** is a composite of next year's estimate over current year's estimate, e.g. EPS, EBITDA, Revenue. **Return** is a year one prospective aggregate of various return on capital measures, e.g. CROCI, ROACE, and ROE. **Multiple** is a composite of one-year forward valuation ratios, e.g. P/E, dividend yield, EV/FCF, EV/EBITDA, EV/DACF, Price/Book. **Volatility** is measured as trailing twelve-month volatility adjusted for dividends.

# Quantum

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# GS SUSTAIN

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# Disclosure Appendix

## Coverage group(s) of stocks by primary analyst(s)

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Goldman Sachs Investment Research global coverage universe

| | Rating Distribution | | | Investment Banking Relationships | | |
|---|---|---|---|---|---|---|
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