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Supply-side reform: initial taste of success

- Supply-side reform has succeeded in curbing excessive supply of coal, steel and cement, leading to rebound of energy and material prices as well as recovery in corresponding industries
- Hang Seng Composite Energy Index and Hang Seng Composite Materials Index have been outperforming the benchmark indices
- Easing deflationary pressure in China would reduce room for interest rate cuts in the near future.
- Recovery of profitability in manufacturing industry enhances debt repayment capability of manufacturers and quality of loan assets in the banking system

Hang Seng Composite Energy Index and Hang Seng Composite Materials Index outperformed the Hang Seng Index.

Hang Seng Composite Index (HSCI) was up 3.8% YTD. Meanwhile, HS Composite Energy Index (ENE Index) and HS Composite Materials Index (MAT Index) surged 18% YTD and 16% YTD. The rise in ENE Index was driven by the rallying coal-related stocks; meanwhile, rising prices of ferrous and non-ferrous stocks drove up the MAT Index. We believe the energy and material stocks were the beneficiaries of a supply-side reform that reduced supply and pushed up coal and material prices.

Sharp decline in coal output pushed up coal prices and profits in coal miners.

According to NBS, total coal output was down 10.5% YoY to 2.46bn tonnes for 9M16. In Sep 2016, coal output dropped 12.3% YoY to 0.28bn tonnes. Meanwhile, prices of 5500Kcal coal and 5000Kcal coal in Qinhuangdao port surged 55.4% YTD and 55.2% YTD to RMB 575/tonne and RMB 520/tonne. In summary, a 10% decline in coal output led to an over 50% increase in thermal coal price. Supply-side reform in the coal industry has reduced supply and driven up coal selling prices. In our view, the sharp increase in coal prices was the result of reduced supply instead of a strong demand. In 9M16, output of thermal power, cement, and crude steel grew by a tepid 0.8% YoY, 2.6% YoY and 0.4% YoY; FAI in the coal-mining industry fell 26.0% YoY. We expect coalminers to remain cautious on output expansion. Revenue of coal-mining industry was down 8.2% YoY in 9M16 but profit was up 65.1%YoY. In 3Q16, profit surged 181% QoQ, or 192% YoY. With constrained supply and limited competition, the business environment has turned more favorable to coalminers.

Demand outstripped supply in cement industry. Cement industry is another beneficiary of supply-side reform. According to NBS, cement production grew 2.6% YoY while total GFA of properties under construction grew 3.2% YoY in 9M16, illustrating that demand growth for cement was slightly higher than that of supply. As a result, cement prices increased. According to NBS's bi-weekly survey, prices of 325 type and 425 type cement rose by 21.7% YTD and 19.9% YTD in 9M16. So far in Oct, cement prices edged up further by 4.7%-5.7%. We believe the increase in cement prices in 3Q16 would



extend into 4Q16. Total revenue and profit of cement industry grew 4.5% YoY and 9.3% YoY in 9M16. In 3Q16, profit of cement industry grew 3.1% QoQ or 17.4%YoY.

Downstream demand boosted steel prices. In 9M16, automobile production grew 12.3% YoY whereas production of steel products edged up 2.3% YoY; in Sep 2016, automobile production rose 31.5% YoY while production of steel products grew slightly by 4.3% YoY. Total GFA of properties under construction rose 3.2%YoY in 9M16. Meanwhile, crude steel output grew 0.4%YoY. Demand for industrial steel and construction steel grew at a faster pace than that of output. Prices of ordinary medium steel plate and ordinary hot-rolled steel sheet surged 39.0% YTD and 43.2% YTD in 9M16. So far in Oct, prices of steel plate and hot-rolled steel sheet rose further by 3.9%-4.9% from late-Sep. These data highlight that supply-side reform has succeeded in constraining excessive supply of steel. Revenue of steel making industry was down 4.1% YoY in 9M16 but profit surged 272.4% YoY. It is apparent that profitability of the steel industry is recovering

Profitability in the manufacturing industry improved but manufacturers would remain prudent on fixed asset investment. Profit growth of the manufacturing industry accelerated from 12.1% YoY in 1H16 to 13.5% YoY in 9M16. The increase was higher than that of the industry revenue, which grew 4.2% YoY in 1H16 and 4.6% YoY in 9M16. In 3Q16, industry revenue and profit rose 4.9% YoY and 16.4% YoY. The higher growth in profit suggests the average profit margin of manufactures has been improving. Despite the positive development, manufacturers remain cautious on expanding production capacity. Fixed asset investment in the manufacturing industry expanded by 3.1%YoY in 9M16. For the private sector, FAI in the manufacturing industry grew 2.5% YoY in 9M16. In our view, continuous improvement of profitability in the manufacturing industry would enhance loan repayment capability of manufacturers and quality of loan assets in the banking system.

Easing deflationary pressure in China in 4Q16 will reduce room for interest rate cut in early 2017. Producer price index (PPI) for the industrial sector advanced 0.1%YoY in Sep, the first YoY gain since Jan 2012. In view of the rising coal and major material prices in recent weeks, PPI is likely to advance further in Oct. For late 2016 or early 2017, we believe deflationary pressure in the industrial sector would keep easing while cost-push inflationary pressure in the consumer goods sector would increase.



Exhibit 1: Hang Seng Composite Index and sub-index performance

Oct 26, 2016	Index level	YTD
HANG SENG COMPOSITE INDEX	3,136.08	3.79%
SUB-INDICES:		
INFORM TECH INDEX	8,021.18	28.36%
ENERGY INDEX	8,012.22	17.98%
MATERIALS INDEX	5,121.95	15.90%
PROP & CONSTR INDEX	3,125.51	8.01%
CONSUMER SERVICE INDEX	3,193.09	6.00%
TELECOM INDEX	1,838.21	1.79%
UTILITIES INDEX	6,924.35	0.30%
FINANCIAL INDEX	3,284.71	-1.59%
CONSUMER GOODS INDEX	4,115.47	-1.64%
INDUSTRIAL INDEX	1,140.10	-4.17%
CONGLOMERATE INDEX	2,587.76	-9.00%

Source(s): Bloomberg, ABCI Securities

Exhibit 2: Key financial indicators of industrial enterprises (9M16)

Products / Period	1-9/2016 Revenue (RMB 100mn)	Chg (%YoY)	1-9/2016 Profits (RMB 100mn)	Chg (%YoY)
Total	818,560.8	3.7	46,380.6	8.4
Of which: Mining and Quarrying	34,690.1	(8.5)	761.4	(62.1)
Manufacturing	738,333.3	4.6	41,743.8	13.5
Production and Distribution of Electricity, Gas and Water	45,537.4	0.2	3,875.4	(3.6)
Mining & quarrying:				
Mining and Washing of Coal	15,950.7	(8.2)	351.8	65.1
Manufacturing:				
Manufacture and Processing of Ferrous Metals	45,545.5	(4.1)	1,166.4	272.4
Processing of Petroleum, Coking, Processing of Nucleus Fuel	24,394.4	(4.9)	1,206.1	263.8
Manufacture of Non-Metallic Mineral Products	43,933.7	4.5	2,668.9	9.3

Source(s): NBS, ABCI Securities

Exhibit 3: Key financial indicators of industrial enterprises (3Q2016)

Products / Period	7-9/2016 Revenue (RMB 100mn)	Chg (%YoY)	7-9/2016 Profits (RMB 100mn)	Chg (%YoY)
Total	290,148.5	4.0	16,382.4	12.3
Of which: Mining and Quarrying	12,451.5	(6.6)	540.6	(21.2)
Manufacturing	261,614.7	4.9	14,543.4	16.4
Production and Distribution of Electricity, Gas and Water	16,082.3	0.2	1,298.4	(7.7)
Mining & quarrying:				
Mining and Washing of Coal	5,728.6	(3.2)	253.9	192.5
Manufacturing:				
Manufacture and Processing of Ferrous Metals	15,747.4	(0.0)	476.1	Note 1
Processing of Petroleum, Coking, Processing of Nucleus Fuel	8,448.0	(0.5)	368.1	665.3
Manufacture of Non-Metallic Mineral Products	16,178.6	4.1	1,009.4	17.4

Note 1: It recorded loss of RMB6.34 bn in 3Q2015

Source(s): NBS, ABCI Securities

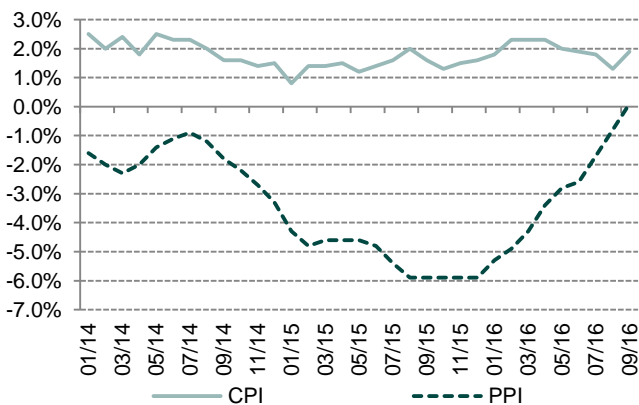


Exhibit 4: Market prices of important means of production in circulation

Products / Period	Mid-Oct '16	End Sep '16	End Sep '16	Mid-Oct '16
	vs End Sep '16	vs End Jun '16	vs End Dec'15	vs End Dec '15
I. Ferrous Metal				
Rebar	4.86%	10.06%	31.84%	38.25%
Wire	3.94%	8.45%	33.43%	38.69%
Ordinary Medium Plate	3.36%	9.56%	39.00%	43.67%
Ordinary Hot-Rolled Sheet	3.12%	10.51%	43.20%	47.66%
Seamless Steel Pipe	5.60%	15.39%	25.88%	32.93%
Angle Steel	1.47%	8.94%	26.92%	28.79%
II. Nonferrous Metals				
Electrolytic Copper	-0.08%	3.15%	4.11%	4.03%
Aluminium Ingot (A00)	2.40%	3.11%	20.23%	23.11%
Lead Ingot	6.45%	14.71%	11.04%	18.20%
Zinc Ingot	0.48%	14.14%	39.37%	40.04%
III. Chemical Product				
Sulfuric Acid (98%)	10.77%	-8.45%	-42.48%	-36.28%
Caustic Soda (Liquid Caustic Soda, 32%)	8.34%	23.23%	38.23%	49.75%
Methyl Alcohol (Superior Quality)	15.27%	7.32%	18.67%	36.79%
Pure Benzene (Petroleum Benzene, Industrial Grade)	2.58%	7.32%	21.40%	24.53%
Styrene (First Grade)	-0.96%	3.82%	16.44%	15.32%
Polyethylene (LLDPE, 7042)	3.49%	3.40%	4.50%	8.15%
Polypropylene (T30S)	4.26%	6.66%	19.10%	24.17%
Polyvinyl Chloride (SG5)	2.76%	26.92%	42.36%	46.29%
Butadiene Rubber (BR9000)	27.38%	30.79%	72.16%	119.31%
Polyester Filament (FDY150D/96F)	3.07%	4.23%	16.96%	20.56%
IV. Petroleum and Gas				
Liquefied Natural Gas	1.80%	3.45%	-14.43%	-12.89%
Liquefied Petroleum Gas	10.42%	5.33%	-15.14%	-6.30%
Gasoline (97#)	1.43%	0.15%	1.97%	3.43%
Gasoline (93#)	2.90%	2.28%	-3.65%	-0.86%
Diesel Oil	9.69%	3.76%	-4.66%	4.57%
Paraffin	0.82%	-3.09%	-6.25%	-5.48%
V. Coal				
Anthracite (No. 2, Washed, Medium Pieces)	4.18%	1.29%	-2.91%	1.15%
Ordinary Mixed Coal (4500 kilocalorie)	5.93%	35.97%	47.30%	56.03%
Shanxi Mixed Coal (5000 kilocalorie)	4.41%	37.53%	50.58%	57.21%
Shanxi Superior Mixed Coal (5500 kilocalorie)	2.11%	39.70%	51.03%	54.22%
Datong Mixed Coal	5.92%	35.43%	37.06%	45.18%
Coking Coal (1/3 Coking Coal)	11.73%	33.33%	55.34%	73.55%
Coke (Second-Class of Metallurgical Coke)	12.93%	56.83%	125.06%	154.16%
VI. Nonmetallic Building Materials				
Complex Portland Cement (P.C 32.5 in Bags)	5.73%	12.39%	21.73%	28.71%
Ordinary Portland Cement (P.C 42.5 in Bulk)	4.77%	12.83%	19.91%	25.63%
Float Flat Glass (4.8/5mm)	-2.47%	24.44%	28.04%	24.88%

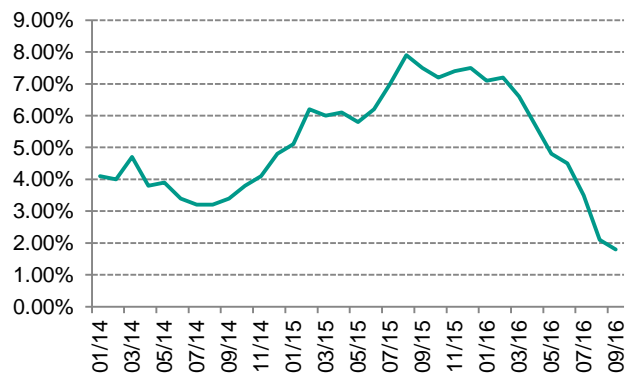
Source(s): NBS, ABCI Securities

Exhibit 5: China's CPI and PPI



Source(s): NBS, ABCI Securities

Exhibit 6: CPI minus PPI



Source(s): NBS, ABCI Securities



China Economic Indicators

	2015					2016								
	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep
Real GDP (YoY %)	---	6.9	---	---	6.8	---	---	6.7	---	---	6.7	---	---	6.7
Export Growth (YoY %)	(5.5)	(3.7)	(6.9)	(6.8)	(1.4)	(11.2)	(25.4)	11.5	(1.8)	(4.1)	(4.8)	(4.4)	(2.8)	(10.0)
Import Growth (YoY %)	(13.8)	(20.4)	(18.8)	(8.7)	(7.6)	(18.8)	(13.8)	(7.6)	(10.9)	(0.4)	(8.4)	(12.5)	1.5	(1.9)
Trade Balance (USD/bn)	60.2	60.3	61.6	54.1	60.9	63.3	32.6	29.9	45.56	49.98	48.11	52.31	52.05	41.99
Retail Sales Growth (YoY %)	10.8	10.9	11.0	11.2	11.1	10.2		10.5	10.1	10.0	10.6	10.2	10.6	10.7
Industrial Production (YoY %)	6.1	5.7	5.6	6.2	5.9	5.4		6.8	6.0	6.0	6.2	6.0	6.3	6.1
PMI - Manufacturing (%)	49.7	49.8	49.8	49.6	49.7	49.4	49.0	50.2	50.1	50.1	50.0	49.9	50.4	50.4
PMI - Non-manufacturing (%)	53.4	53.4	53.1	53.6	54.4	53.5	52.7	53.8	53.5	53.1	53.7	53.9	53.5	53.7
FAI (YTD) (YoY %)	10.9	10.3	10.2	10.2	10.0	10.2		10.7	10.5	9.6	9.0	8.1	8.1	8.2
CPI (YoY %)	2.0	1.6	1.3	1.5	1.6	1.8	2.3	2.3	2.3	2.0	1.9	1.8	1.3	1.9
PPI (YoY %)	(5.9)	(5.9)	(5.9)	(5.9)	(5.9)	(5.3)	(4.9)	(4.3)	(3.4)	(2.8)	(2.6)	(1.7)	(0.8)	0.1
M2 (YoY %)	13.3	13.1	13.5	13.7	13.3	14.0	13.3	13.4	12.8	11.8	11.8	10.2	11.4	11.5
New Lending (RMB/bn)	809.6	1,050	513.6	708.9	597.8	2,510	726.6	1,370	555.6	985.5	1,380	463.6	948.7	1,220
Aggregate Financing (RMB bn)	1,082	1,300	476.7	1,020	1,815.1	3,425.3	824.5	2,404.0	751.0	659.9	1,629.3	487.9	1,470.0	1,720

World Economic/Financial Indicators

Equity Indices				Global Commodities				Bond Yields & Key Rates			
	Closing price	Chg. WTD (%)	P/E	Unit	Price	Chg. WTD (%)	Volume (5-Day avg.)		Yield (%)	Chg. WTD (Bps)	
U.S.				Energy				US Fed Fund Rate			
DJIA	18,161.19	0.00	17.30	NYMEX WTI	USD/bbl.	48.67	(0.06)	589,950		0.50	0.00
S&P 500	2,126.41	0.00	19.94	ICE Brent Oil	USD/bbl	49.63	(0.16)	210,484	US Prime Rate	3.50	0.00
NASDAQ	5,190.10	0.00	30.64	NYMEX Natural Gas	USD/MMBtu	3.12	0.45	103,199	US Discount Window	1.00	0.00
MSCI US	2,025.89	0.00	20.51	China Qinhuangdao Port Thermal Coal ²	USD/Metric Tonne	672.00	4.67	N/A	US Treasury (1 Yr)	0.1622	0.50
Europe				Basic Metals				US Treasury (5Yr)			
FTSE 100	6,976.04	(0.29)	60.05	LME Aluminum Cash	USD/MT	1,718.75	0.00	10,938	US Treasury (10 Yr)	1.8397	(0.71)
DAX	10,662.32	(0.32)	19.89	LME Aluminum 3 -mth. Rolling Fwd.	USD/MT	1,719.00	0.00	48,779	Japan 10-Yr Gov. Bond	(0.05)	(0.60)
CAC40	4,526.25	(0.49)	23.02	CMX Copper Active	USD/lb.	4,835.00	0.00	9,110	China 10-Yr Gov. Bond	2.7440	3.20
IBEX 35	9,140.20	(0.66)	21.83	LME Copper 3- mth Rolling Fwd.	USD/MT	4,843.00	0.00	46,628	ECB Rate (Refinancing)	0.00	0.00
FTSE MIB	17,237.31	(0.50)	49.91	Precious Metals				1-Month LIBOR			
Stoxx 600	339.61	(0.35)	26.07	CMX Gold	USD/T. oz	1,274.10	(0.21)	161,398	3 Month LIBOR	0.8859	0.42
MSCI UK	2,034.87	0.00	63.78	CMX Silver	USD/T. oz	17.84	0.25	55,675	O/N SHIBOR	2.2530	(0.10)
MSCI France	129.39	0.00	21.32	NYMEX Platinum	USD/T. oz	982.00	0.06	15,106	1-mth SHIBOR	2.7453	0.26
MSCI Germany	136.21	0.00	20.41	Agricultural Products				3-mth HIBOR			
MSCI Italy	49.04	0.00	47.83	CBOT Corn	USD/bu	353.75	(0.35)	154,295	Corporate Bonds (Moody's)		
Asia				CBOT Wheat	USD/bu	410.75	0.55	64,682	Aaa	3.59	14.00
NIKKEI 225	17,425.02	(0.12)	22.04	NYB-ICE Sugar	USD/lb.	22.01	(0.68)	45,958	Baa	4.44	10.00
S&P/ASX 200	5,317.73	0.64	23.82	CBOT Soybeans	USD/bu.	1,013.00	0.10	146,652			
HSI	22,934.54	(0.09)	12.43								
HSCEI	9,559.39	0.46	8.18								
CSI300	3,336.28	(0.12)	14.93								
SSE Composite	3,100.49	(0.12)	17.59								
SZSE Composite	10,704.30	(0.06)	30.71								
MSCI China	62.13	0.00	13.86								
MSCI Hong Kong	13,077.52	0.00	15.06								
MSCI Japan	835.71	0.00	17.85								

Note:

1. Data sources: Bloomberg, National Bureau of Statistics of China, ABCIS (updated on date of report)
2. The price is Coal 5500 kcal/kg FOB Spot Price

Currency

	Euro/USD	GBP/USD	AUD/USD	USD/JPY	USD/CHF	USD/CNY	USD/HKD	USD/CNY NDF 12-mth Spot pr.
Spot Rate	1.0953	1.2184	0.7607	104.93	0.9888	6.7720	7.7550	6.9548
Chg. WTD (%)	(0.29)	(0.01)	0.11	(0.18)	(0.07)	0.10	0.00	0.03



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Definition of equity rating

Rating	Definition
Buy	Stock return \geq Market return rate
Hold	Market return - 6% \leq Stock return < Market return rate
Sell	Stock return < Market return - 6%

Stock return is defined as the expected % change of share price plus gross dividend yield over the next 12 months

Market return: 5-year average market return rate

Time horizon of share price target: 12-month

Definition of share price risk

Rating	Definition
Very high	$2.6 \leq$ 180 day volatility/180 day benchmark index volatility
High	$1.5 \leq$ 180 day volatility/180 day benchmark index volatility < 2.6
Medium	$1.0 \leq$ 180 day volatility/180 day benchmark index volatility < 1.5
Low	180 day volatility/180 day benchmark index volatility < 1.0

We measure share price risk by its volatility relative to volatility of benchmark index. Benchmark index: Hang Seng Index.

Volatility is calculated from the standard deviation of day to day logarithmic historic price change. The 180-day price volatility equals the annualized standard deviation of the relative price change for the 180 most recent trading days closing price.

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