China cut banks' RRR

What's next? Which stocks will benefit?

The PBoC announced last Friday to cut banks' reserve requirement ratio by 0.5ppt and an additional 1ppt for qualified city commercial banks. The move is estimated to release RMB 900bn in liquidity to shore up the real economy. Following the State Council meeting on 4 Sep which articulated some supportive measure, we believe this RRR cut has largely been priced in. Banking, insurance, brokerage, construction machinery and education are among the sectors that would benefit from this RRR cut and further potential supportive measures.

- **HSI may face profit-taking.** While RRR cut would bode well for stock markets in theory, if the cut had already been priced in, there tend to be sell-the-fact pressure shortly after the announcements. Other important factors which may affect the stock markets: 1) China-US trade war, 2) RMB fluctuation, 3) HK social unrest, 4) any other supportive policies from Beijing.
- **China banks' NIM pressure alleviated.** This RRR cut would reduce banks' funding cost by approximate RMB 15bn p.a., alleviating banks' NIM pressure from potential decline in LPR. We estimate that every 50bps RRR cut would lift banks' FY20E earnings by 0.33-0.45%. We continue to prefer retail-oriented banks on more resilient NIM under interest liberalisation and less cyclicality to macro headwinds. Our sector top picks are PAB (000001 CH; BUY; TP: RMB 17.00) and CEB (6818 HK; BUY; TP: HK$4.60).
- **Insurers benefit from improving market sentiment.** We stay positive on the insurance sector mainly for three reasons: 1) sentiment recovery of the A-share market will contribute to investment gains, with notable YoY gain expected in 2H19 on low base; 2) NBV growth to recover in 2H19 for life insurers; 3) net investment return will not decline abruptly despite declining interest rates. Our sector top picks are China Life (2628 HK / 601628 CH; BUY; TP: HK$27.88 / RMB 37.52) and CPIC (2601 HK; BUY; TP: HK$37.12).
- **Brokerage sector boosted by better investor confidence.** Monetary easing usually helps restoring investor confidence, and therefore lifts brokers' performance in the short term. The sector's valuation is cheap, which is 0.79x FY19E P/B, 9% below historical average minus 1s.d. Our sector top picks are CITICS (6030 HK; BUY; TP: HK$18.7) and CICC (3908 HK; BUY; TP: HK$17.2).
- **Construction machinery sector to benefit from fiscal spending.** The State Council meeting confirmed measures to speed-up issuance of special-purpose bond, in an effort to spur effective investment. We believe the sector will continue to be the beneficiaries of the pro-investment approach by the government. This reaffirms our view that the upcycle will continue in 2020E. Zoomlion (1157 HK; BUY; TP: HK$6.95) remains our top pick.
- **Education sector – prefer higher education stocks.** The State Council meeting mentioned to stabilize employment by increasing student enrolment of vocational colleges by 1mn. We think these policies are positive for higher education and vocational training sectors. Our top pick is Hope Education (1765 HK; BUY; TP: HK$1.96).

Hang Seng Index	26,691
52w High/Low	30,280/24,541
Avg 3 mths t/o (HK$ bn)	78.1

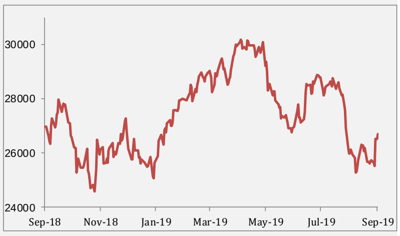
Source: Bloomberg

HSI & HSCEI Performance

	HSI	HSCEI
1-mth	2.9%	4.4%
3-mth	-1.0%	0.9%
6-mth	-5.4%	-6.5%

Source: Bloomberg

HSI 12-mth Performance



Source: Bloomberg

China Economy

Analyst: Wenjie DING, PhD (Tel: 3900 0856 / Email: dingwenjie@cmbi.com.hk)

RRR cut to free up RMB 900bn

The PBoC decided to cut banks' reserve requirement ratio last Friday, following the State Council meeting on 4 Sep. The RRR cut consists of i) broad RRR cut by 0.5ppt effective on 16 Sep 2019; and ii) targeted RRR cut by additional 1ppt for qualified city commercial banks, which will be carried out in two steps each by 0.5ppt on 15 Oct and 15 Nov, respectively.

The move is estimated to release RMB 900bn in liquidity to shore up the real economy, including RMB 800bn from broad RRR cut and RMB 100bn from targeted RRR cut to support SMEs and private companies in particular.

CMBI view and forecast

- **Next moves of monetary easing**

We expect the PBoC to cut MLF operating rate by 10-15bps on next operating dates, 9 Sep or 17 Sep, to reduce funding costs for corporates. Depending on TSF, M2 growth and economic conditions, there may be another targeted RRR cut by 0.5ppt by year end.

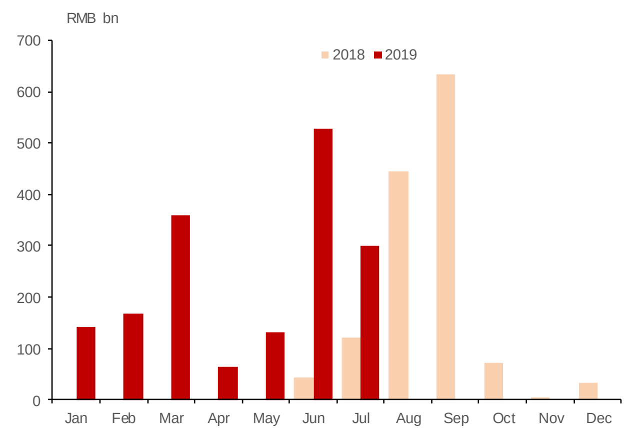
- **Other supportive measures**

The State Council meeting on 4 Sep articulated specific measures to stabilize economic growth. Key policies include:

1. Further monetary easing
    a. Take steps to lower financing cost for the real economy
    b. Use both broad and targeted RRR cut as monetary tools to support inclusive financing and financings for SMEs.
2. Fiscal expansion regarding local government special purpose bond
    a. Allocate in advance next year's local government special purpose bond to ensure financing for key projects.
    b. Enlarge the scope of use of local government special purpose bond.

These measures were more or less anticipated by us and the market. But being mentioned at high-level state council meetings implies that they will be executed soon and for sure.

Figure 1: New issuance of local gov. special bond



Source: Ministry of Finance, CMBIS

Regarding local government special-purpose bond, the pace of new issuance this year was much faster than last year's. New issuance in Jan-Jul totalled RMB 1.69tn, hitting 79% of annual target at RMB 2.15tn (new issuance in Aug was close to RMB 300mn according to our estimate). However, infrastructure FAI fell behind due to time lag of projects and unfavourable weather conditions. We expect in 4Q19, infrastructure FAI will stabilize and pick up steadily.

Hong Kong Stock Market Outlook

Analyst: Daniel SO, CFA (Tel: 3900 0857 / Email: danielso@cmbi.com.hk)

Profit-taking likely in the short run

While RRR cut and any other monetary easing would bode well for stock markets in theory, how the market reacts depends on what investors had expected and priced in.

Since 2015, there were 8 occasions of RRR cut (sometimes coupled with interest rate cut). In all but one occasions the Hang Seng Index (HSI) moved in different directions the day before the PBoC announcement and the week after (see Figure 2). It seems to suggest that if RRR cut had not been expected or priced in, it is indeed good news for HK/China markets. On the contrary, **if RRR cut had already been priced in, there tend to be sell-the-fact pressure shortly after the announcements**.

Figure 2: Stock markets impact of RRR cut

Announcement date	Details	The day before		The week after	
		HSI	SHCOMP	HSI	SHCOMP
6-Sep-19	**Cut RRR by 0.5ppt and an additional 1ppt for qualifying institutions**	**0.7%**	**0.5%**	**?**	**?**
6-May-19	Cut RRR for small and medium-sized banks	0.5%	0.5%	-5.1%	-4.5%
4-Jan-19	Cut RRR by 1ppt	2.2%	2.1%	4.1%	1.5%
17-Apr-18	Cut RRR by 1ppt, and banks have to use the freed-up liquidity to pay back MLF loans	-0.8%	-1.4%	1.9%	2.0%
29-Feb-16	Cut RRR by 0.5ppt	-1.3%	-2.9%	5.5%	7.8%
23-Oct-15	Cut interest rates by 0.25ppt, cut RRR by 0.5ppt and an additional 0.5ppt for qualifying institutions	1.3%	1.3%	-2.2%	-0.9%
25-Aug-15	Cut interest rates by 0.25ppt, cut RRR by 0.5ppt	0.7%	-7.6%	-1.0%	6.8%
19-Apr-15	Cut RRR by 1ppt and an additional 1ppt for qualifying institutions	-0.3%	2.2%	1.5%	2.5%
4-Feb-15	Cut RRR by 0.5ppt and an additional 0.5ppt for qualifying institutions	0.5%	-1.0%	-1.5%	-0.5%
	Average	0.4%	-0.7%	0.4%	1.8%

Source: Bloomberg, CMBIS

This time around, the State Council meeting on 4 Sep stated explicitly to "use both broad and targeted RRR cut as monetary tools", and thus investors should have somewhat expected an imminent RRR cut. The HSI and Shanghai Composite (SHCOMP) rose 0.7% and 0.5% respectively on 6 Sep on which the RRR cut was announced after market close. If history is any guide, HK/China stock markets are likely to have profit-taking in the short run.

There are, of course, other important factors which may affect the stock markets: 1) China-US trade war, 2) RMB fluctuation, 3) HK social unrest, 4) potentially more supportive policies from Beijing. Trade war and social unrest would probably continue to pose significant uncertainties, while supportive policies would lend some support to stock markets, and there are growing expectations of such policies ahead of China's National

Day on 1 Oct. The bottom line is, **this RRR cut has largely been priced in in the broad markets. Focus should be on picking sectors and stocks which benefit most from the RRR cut**.

China Banking Sector (Outperform)

Analysts: Terry SUN, CFA (Tel: 3900 0836 / Email: terrysun@cmbi.com.hk)
Karen SUI (Tel: 3761 8775 / Email: suixiaomeng@cmbi.com.hk)

RRR cut is positive for China banks, as it offers extra funding for credit expansion or debt replacement. The PBoC indicated that the latest RRR cut would reduce banks' funding cost by approximate RMB 15bn per annum. Therefore, it should alleviate banks' NIM pressure from potential decline in LPR. Our analysis indicates that every 50bps RRR cut would lift banks' FY20E earnings by 0.33-0.45%, depending on whether banks will use funding released to repay MLF or to extend new loans. In general, smaller banks would benefit more, due to weaker deposit base and greater reliance on interbank borrowing.

Figure 3: Banks' earnings impact from 50bps RRR cut

Case 1 – RRR cut to replace MLF	
Interest rate of 1-year MLF	3.3%
Interest rate of required reserve at PBoC	1.6%
Increase in banks' net interest income	RMB 12.6bn
Impact on FY20E net profit	**0.33%**
Case 2 – RRR cut to extend new loans	
Average loan rate	5.7%
Interest rate of required reserve at PBoC	1.6%
Sector NPL ratio	1.8%
Increase in banks' net interest income	RMB 17.0bn
Impact on FY20E net profit	**0.45%**

Source: Wind, CMBIS

In particular, city commercial banks that operate within their respective province will enjoy 100bps extra RRR cut. This should help to ease their liquidity shortage and reduce the spillover risk for interbank counterparties and sector peers, especially after the incidents of Baoshang Bank and Bank of Jinzhou.

H-share China banks are trading at 0.66 FY19E P/B, 27% below their historical mean of 0.9x. Fundamentally, we continue to prefer retail-oriented banks on more resilient NIM under interest liberalisation and less cyclicality to macro headwinds. Our sector top picks are **PAB (000001 CH; BUY; TP: RMB 17.00)** and **CEB (6818 HK; BUY; TP: HK$4.60).** In addition, we see bargain hunting opportunity on valuation laggards, including ABC (1288 HK; BUY; TP: HK$4.50), BOC (3988 HK; BUY; TP: HK$4.30), CITICB (998 HK; BUY; TP: HK$5.40), and MSB (1988 HK; HOLD; TP: HK$5.90).

China Insurance Sector (Outperform)

Analysts: Wenjie DING, PhD (Tel: 3900 0856/ Email: dingwenjie@cmbi.com.hk)
Hanbo XU (Tel: 3761 8725/ Email: xuhanbo@cmbi.com.hk)

We stay positive on the insurance sector mainly for three reasons.

1) Sentiment recovery of the A-share stock market will contribute to equity investment gains for insurers, which has been one of the most volatile components of insurers' earnings. Recalling that in 4Q18 most insurers incurred significant loss in stock trading due to broad-based plunge of the A-share market, we believe stock trading return will post notable YoY gain in 2H19.

2) Underwriting performance of life insurers remained on track and we expect NBV growth to recover in 2H19 thanks to product upgrade and healthy development of individual agent channel.

3) Net investment return will not decline abruptly. Declining interest rate environment poses challenges for insurers because new money may be re-invested in bonds or other assets carrying lower returns. However, these negatives could be alleviated by i) a wider supply of fixed income assets insurers are allowed and encouraged to invest in; ii) active allocation and portfolio management of investment assets to capture opportunities among asset classes. For example, insurers could increase investment in equities and alternative assets when bond market outlook turns bleak.

Sector valuation is attractive at 0.52x FY19E P/EV. We prefer **China Life (2628 HK / 601628 CH; BUY; TP: HK$27.88 / RMB37.52)** and **CPIC (2601 HK; BUY; TP: HK$37.12)**.

China Brokerage Sector (Outperform)

Analysts: Karen SUI (Tel: 3761 8775 / Email: suixiaomeng@cmbi.com.hk)
Terry SUN, CFA (Tel: 3900 0836 / Email: terrysun@cmbi.com.hk)

Monetary easing (e.g. RRR cuts and/or interest rates cut) is usually good for restoring investor confidence, and therefore has a positive impact on brokers' performance in short-term. The sector's rally in the last few days was largely due to improved sentiment and low valuation. The sector now trades at 0.79x FY19E P/B, still 9% below historical average minus 1s.d.

Brokers with absolute low valuation, e.g. GFS (1776 HK; HOLD; TP: HK$9.8) and HTS (6837 HK; BUY; TP: HK$10.4) should benefit more in near-term. Yet in the medium-to-long run, we still prefer leaders with balanced revenue mix and strong franchise in investment banking and investment which could stand out in China's capital market reform, as favourable policies will likely skew towards them to foster domestic competitiveness amid deepened opening-up. We now have **CITICS (6030 HK; BUY; TP: HK$18.7)** and **CICC (3908 HK; BUY; TP: HK$17.2)** as our sector top picks.

China Construction Machinery Sector (Outperform)

Analyst: Wayne FUNG, CFA (Tel: 3900 0826 / Email: waynefung@cmbi.com.hk)

The executive meeting of the State Council confirmed the measures to encourage the speed-up of the issuance of special-purpose bond. The government will allocate, in advance, part of next year's special bonds quota and ensure that funds raised from the bonds be readily available at the start of next year, in an effort to spur effective investment for shoring up weak areas and expanding domestic demand.

We believe the construction machinery will continue to be the beneficiaries of the pro-investment approach taken by the government. This reaffirms our view that the upcycle will continue in 2020E. **Zoomlion (1157 HK; BUY; TP: HK$6.95)** remains our top pick in our universe, as we believe the replacement cycle, market share gain and the launch of new products will continue to serve as earnings drivers. We also like **Weichai Power (2338 HK; BUY; TP: HK$16.2)**, **SANY Heavy Industry (600031 CH; NR)** and **Jiangsu Hengli (601100 CH; NR)**.

China Education Sector (Outperform)

Analyst: Albert YIP, CFA (Tel: 3900 0838 / Email: albertyip@cmbi.com.hk)

The Executive Meeting of the State Council mentioned to stabilize employment by (1) proceeding the increase of student enrolment of vocational colleges by 1mn and the utilization of RMB100bn from Unemployment Insurance Fund to subsidize vocational training; and (2) studying further increase of the student enrolment of vocational colleges and technician schools and funding support for vocational training.

We think these policies are positive for higher education and vocational training sectors. Our top pick is **Hope Education (1765 HK; BUY; TP: HK$1.96)** (50%/5% student mix from higher vocational colleges/technician schools). **China East Education (667 HK; BUY; TP: HK$16.3)** and **New Higher Education (2001 HK; NR)** (52% student mix from higher vocational colleges) are also major beneficiaries.

China Property Sector (Market Perform)

Analysts: Samson MAN, CFA (Tel: 3900 0853 / Email: samsonman@cmbi.com.hk)
Chengyu HUANG (Tel: 3761 8773 / Email: huangchengyu@cmbi.com.hk)

Regarding the RRR cut announced last Friday, we don't believe there is huge impact on the property sector, or property developers. In recent months, we see the Chinese government continued to tighten financing channels for developers, such as bond issue, tightening construction loans etc. Therefore, reducing RRR does not imply that developers can benefit from any financing relaxation to access more funding. So we don't think developers will have re-rating in the near future due to the RRR reduction.

Disclosures & Disclaimers

Analyst Certification

The research analyst who is primary responsible for the content of this research report, in whole or in part, certifies that with respect to the securities or issuer that the analyst covered in this report: (1) all of the views expressed accurately reflect his or her personal views about the subject securities or issuer; and (2) no part of his or her compensation was, is, or will be, directly or indirectly, related to the specific views expressed by that analyst in this report.

Besides, the analyst confirms that neither the analyst nor his/her associates (as defined in the code of conduct issued by The Hong Kong Securities and Futures Commission) (1) have dealt in or traded in the stock(s) covered in this research report within 30 calendar days prior to the date of issue of this report; (2) will deal in or trade in the stock(s) covered in this research report 3 business days after the date of issue of this report; (3) serve as an officer of any of the Hong Kong listed companies covered in this report; and (4) have any financial interests in the Hong Kong listed companies covered in this report.

CMBIS Ratings

BUY	: Stock with potential return of over 15% over next 12 months
HOLD	: Stock with potential return of +15% to -10% over next 12 months
SELL	: Stock with potential loss of over 10% over next 12 months
NOT RATED	: Stock is not rated by CMBIS

OUTPERFORM	: Industry expected to outperform the relevant broad market benchmark over next 12 months
MARKET-PERFORM	: Industry expected to perform in-line with the relevant broad market benchmark over next 12 months
UNDERPERFORM	: Industry expected to underperform the relevant broad market benchmark over next 12 months

CMB International Securities Limited

Address: 45/F, Champion Tower, 3 Garden Road, Hong Kong, Tel: (852) 3900 0888   Fax: (852) 3900 0800

CMB International Securities Limited ("CMBIS") is a wholly owned subsidiary of CMB International Capital Corporation Limited (a wholly owned subsidiary of China Merchants Bank)

Important Disclosures

There are risks involved in transacting in any securities. The information contained in this report may not be suitable for the purposes of all investors. CMBIS does not provide individually tailored investment advice. This report has been prepared without regard to the individual investment objectives, financial position or special requirements. Past performance has no indication of future performance, and actual events may differ materially from that which is contained in the report. The value of, and returns from, any investments are uncertain and are not guaranteed and may fluctuate as a result of their dependence on the performance of underlying assets or other variable market factors. CMBIS recommends that investors should independently evaluate particular investments and strategies, and encourages investors to consult with a professional financial advisor in order to make their own investment decisions.

This report or any information contained herein, have been prepared by the CMBIS, solely for the purpose of supplying information to the clients of CMBIS or its affiliate(s) to whom it is distributed. This report is not and should not be construed as an offer or solicitation to buy or sell any security or any interest in securities or enter into any transaction. Neither CMBIS nor any of its affiliates, shareholders, agents, consultants, directors, officers or employees shall be liable for any loss, damage or expense whatsoever, whether direct or consequential, incurred in relying on the information contained in this report. Anyone making use of the information contained in this report does so entirely at their own risk.

The information and contents contained in this report are based on the analyses and interpretations of information believed to be publicly available and reliable. CMBIS has exerted every effort in its capacity to ensure, but not to guarantee, their accuracy, completeness, timeliness or correctness. CMBIS provides the information, advices and forecasts on an "AS IS" basis. The information and contents are subject to change without notice. CMBIS may issue other publications having information and/ or conclusions different from this report. These publications reflect different assumption, point-of-view and analytical methods when compiling. CMBIS may make investment decisions or take proprietary positions that are inconsistent with the recommendations or views in this report.

CMBIS may have a position, make markets or act as principal or engage in transactions in securities of companies referred to in this report for itself and/or on behalf of its clients from time to time. Investors should assume that CMBIS does or seeks to have investment banking or other business relationships with the companies in this report. As a result, recipients should be aware that CMBIS may have a conflict of interest that could affect the objectivity of this report and CMBIS will not assume any responsibility in respect thereof. This report is for the use of intended recipients only and this publication, may not be reproduced, reprinted, sold, redistributed or published in whole or in part for any purpose without prior written consent of CMBIS.

Additional information on recommended securities is available upon request.

For recipients of this document in the United Kingdom

This report has been provided only to persons (I)falling within Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (as amended from time to time)("The Order") or (II) are persons falling within Article 49(2) (a) to (d) ("High Net Worth Companies, Unincorporated Associations, etc.,) of the Order, and may not be provided to any other person without the prior written consent of CMBIS.

This report is intended for distribution in the United States to "major US institutional investors", as defined in Rule 15a-6 under the US, Securities Exchange Act of 1934, and may not be furnished to any other person in the United States. Each major US, institutional investor that receives a copy of this research report by its acceptance hereof represents and agrees that it shall not distribute or provide this research report to any other person.

For recipients of this document in Singapore

This report is distributed in Singapore by CMBI (Singapore) Pte. Limited (CMBISG) (Company Regn. No. 201731928D), an Exempt Financial Adviser as defined in the Financial Advisers Act (Cap. 110) of Singapore and regulated by the Monetary Authority of Singapore. CMBISG may distribute reports produced by its respective foreign entities, affiliates or other foreign research houses pursuant to an arrangement under Regulation 32C of the Financial Advisers Regulations. Where the report is distributed in Singapore to a person who is not an Accredited Investor, Expert Investor or an Institutional Investor, as defined in the Securities and Futures Act (Cap. 289) of Singapore, CMBISG accepts legal responsibility for the contents of the report to such persons only to the extent required by law. Singapore recipients should contact CMBISG at +65 6350 4400 for matters arising from, or in connection with the report.