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November 17, 2011

China A-Share Strategy

Rebalancing our Virtual Fund for the Upcoming Disinflation and Slower Growth

Investment conclusion: Inflation pressure has eased in China since July 2011. Our economics team believes the CPI inflation will trend lower towards year-end (*Yuande Zhu, China Economics: Disinflation on Track, Resilient Fundamentals Unscathed, 10 Nov. '11*). We think this will ease investors' main concern on over tightening or a China hard landing, which has been over-done, as we have argued. We rebalance our A-share virtual fund, cutting high-growth sectors and adding value stocks for the coming disinflation.

Disinflation and slower growth – high growth at risk:

There is no free lunch in the world economy: the cost of disinflation is growth. For some so-called high growth sectors, we think sell-side analysts are too bullish (Exhibit 2); therefore, we underweight high-growth stocks (most of which are FAI-related sectors) to avoid the risk of earnings cuts. Meanwhile we add value sectors, which have priced in mild growth with limited risk of earnings misses in an environment of disinflation, lower growth and investor sentiment recovery.

High dispersion of PE among sectors presents opportunity to overweight cheap names (Exhibits 15-25). PE has hit its historical low while the coefficient of dispersion has reached its highest level since 2000 (Exhibit 3). This signals some sectors' valuations are at depressed levels and should benefit from sentiment recovery.

A-share Virtual Fund revisions: 1) Cutting FAI related sectors – Construction & Engineering, Steel, Metals & Nonmetals and Construction Materials whose growth is high because of the Rmb4tn stimulation package and massive infrastructure projects. 2) Adding Utilities due to their 'Great Wall Effect' (*China A-Share Strategy: Increasing the 'Great Wall Effect' in our Portfolio, Apr. 7, 2011*). 3) Adding Banks and Transportation Infrastructure because of their cheap valuations.

Recent Reports

Title	Date
China and Hong Kong Quantitative Strategy: Launching Our A-share Virtual Fund James Cao / Jerry Lou	Nov 26, 2010
China A-Share Strategy: Rebalancing A-share Virtual Fund for the Volatile but Rewarding 2011 James Cao / Jerry Lou	Dec 8, 2010
China A-Share Strategy: Distance Breeds Beauty? An A-Share Play on US Recovery James Cao / Jerry Lou	Jan 27, 2011
China A-Share Strategy: Increasing the 'Great Wall Effect' in our Portfolio James Cao / Jerry Lou	Apr 7, 2011
China A-Share Strategy: Why Are We Bullish on A Shares? From Post-Crisis Mess to Mid-Cycle Confusion. James Cao / Allen Gui / Jerry Lou / Corey Ng, CFA	Apr 29, 2011
China A-Share Strategy: One-way Arbitrage in Mid-Cycle Confusion James Cao / Allen Gui / Jerry Lou / Corey Ng, CFA	May 18, 2011

Long-term Portfolio Sector Over/Under Weights

	CSI 300 Weight(%)	Portfolio Weight(%)	O/U weight(bps)
Energy	8.57	14.8	623
Insurance II	4.85	7.5	265
Materials	15.10	16.9	179
Consumer Discretionary	8.38	9.0	62
Real Estate	5.67	6.0	33
Industrials	19.42	19.4	-5
Telecommunication Services	0.95	0.0	-95
Utilities	2.13	1.0	-113
Consumer Staples	5.82	4.6	-126
Banks	18.33	17.0	-136
Information Technology	2.38	1.0	-138
Health Care	3.87	1.8	-206
Diversified Financials	4.58	1.1	-347
Grand Total	100	100	0

Source: Wind, Morgan Stanley Research

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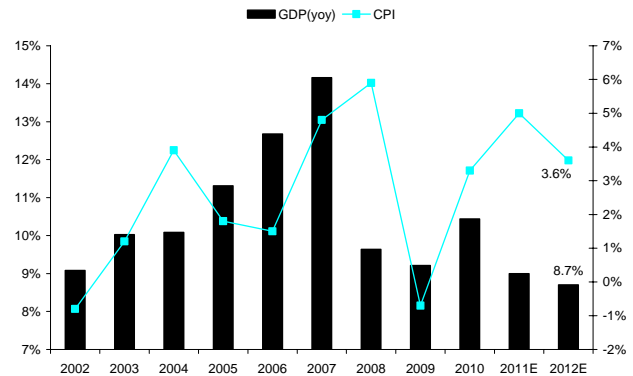
Investment Case

Disinflation and Sentiment Recovery: Inflation pressure has eased and funding markets have improved. Our economics team believes the CPI inflation will trend lower towards year-end (*Yuande Zhu, China Economics: Disinflation on Track, Resilient Fundamentals Unscathed, 10 Nov. 2011*). We think this will ease investors' main concern about over tightening or a China hard landing, which has been over-done, as we have argued in recent months.

Disinflation and slower growth: High growth sectors are at risk: There is no free lunch in the world economy; the cost of disinflation is 'Growth'. According to our economics team, GDP growth will slow to 9% and 8.7% in 2011 and 2012, respectively (Exhibit 1). However, compared to top-down forecasts, bottom-up consensus is still too bullish (Exhibit 2) – an 8%-9% GDP growth cannot afford 20-30% EPS growth in the A-share market. Sell-side analysts need to cut their numbers in the coming months, in our view. Therefore, we underweight high-growth names (most of which are FAI-related sectors) to avoid the risk of earnings cuts.

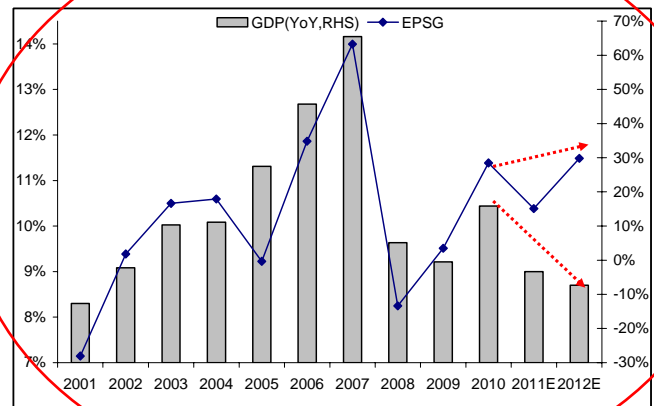
Fortunately, PE has hit its historical low in 10 years+ while the coefficient of dispersion has reached its highest level since 2000 (Exhibit 3). This signals some sectors' valuations are at depressed levels, and should benefit from a recovery in sentiment. PEs of Banks and Transportation Infrastructure are relatively lower than other sectors, which means these are pricing in mild EPS growth and the risk of an earnings miss is reduced relative to high growth names. Furthermore, according to global valuation comparisons (Exhibit 15-25), banks and transportation infrastructure are cheaper than their global peers.

Exhibit 1
GDP is Slowing down amid CPI Disinflation



Note: E=Morgan Stanley estimates. Source: Company data, Morgan Stanley Research

Exhibit 2
Bottom up and Top down Forecasts Diverged; Some Sell-side Sector Analysts are still too bullish

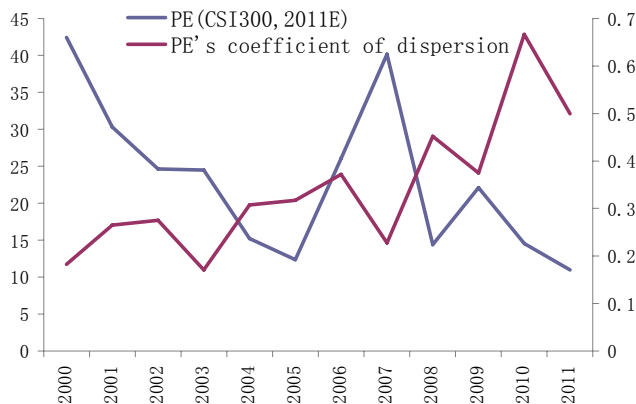


Source: WIND, Company data, Morgan Stanley Research; E = estimates

November 17, 2011
China A-Share Strategy

Exhibit 3

Historical Low PE and High Coefficient of Dispersion Signals Some Sectors are Under-valued



Note: PE's coefficient of dispersion = $\text{stdev}(\text{PE}) / \text{average}(\text{PE})$. Source: WIND, Company data, Morgan Stanley Research; E = estimates

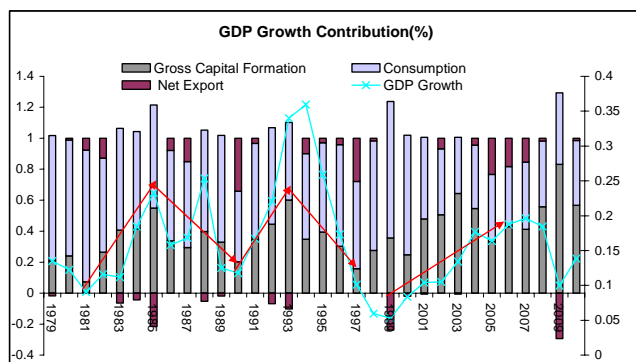
A-share Virtual Fund Revisions:

1) Cutting FAI Related Sectors

China's economic expansion has always been via fixed asset investment expansion since Chinese economic reforms thirty years ago. FAI is the direct driver of inflation; a declination of CPI usually means a fix asset investment slowdown. For this cycle, FAI has contributed 83% and 57% of GDP growth in 2009 and 2010, respectively, record high numbers since 1978. In other words, in large measure, FAI will afford the cost of the declination of CPI (or slowdown of GDP growth).

Exhibit 6

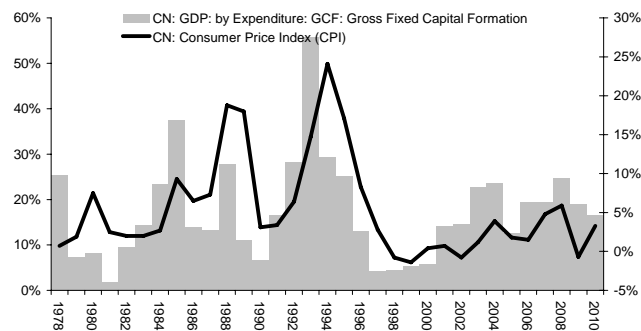
China Economy Expansion has always been via Fix Asset Investment Expansion since Chinese Economic Reforms Thirty Years Ago



Source: CEIC, Morgan Stanley Research

Exhibit 7

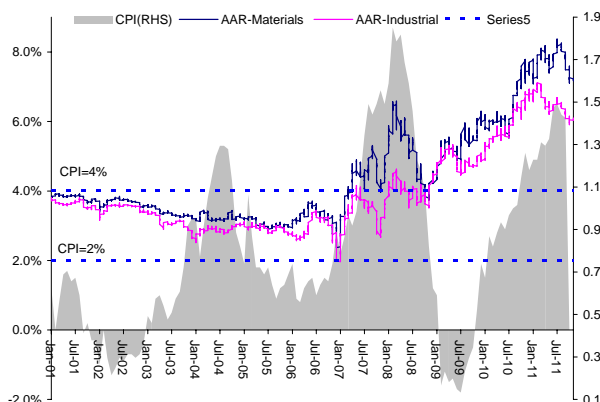
China Inflation is Positively Related with Fix Asset Investment Growth



Source: CEIC, Morgan Stanley Research

Exhibit 5

FAI Related Sectors Underperformed During the Declination of CPI



Note: AAR: Accumulative Abnormal Return index $t = \text{Accumulative Abnormal Return index } t - 1$ where: Accumulative Abnormal Return $t = \text{Return (Sector)} t - \text{return (CSI300)} t$. Accumulative Abnormal Return index 0 = 1.

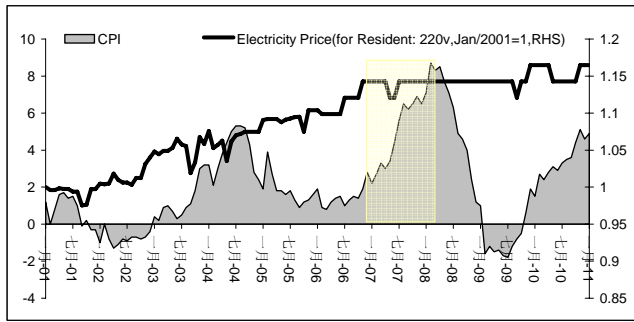
Source: WIND, Company data, Morgan Stanley Research

2 Adding Utilities Because of its Great Wall Effect (China A-Share Strategy: Increasing the 'Great Wall Effect' in our Portfolio, 4/7/2011).

A-share Utilities is an interesting asset class. In order to fight inflation, the government controls electricity prices. However, coal prices are not under government control, so utilities are hurt in times of rising inflation and are beneficiaries during the period of disinflation because there is more room for power price hiking and/or the upstream price pressure to ease. We had previously been overweight utilities in order to obtain

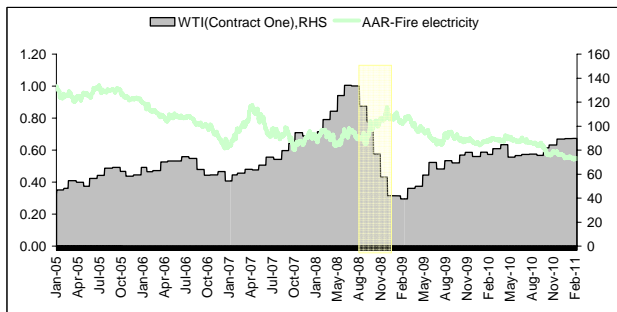
alpha and/or reduce total portfolio volatility after the peaking of CPI Inflation.

Exhibit 8
Gasoline and Electricity Prices is Controlled in China during the Period of Inflation



Source: WIND, Company data, Morgan Stanley Research

Exhibit 9
Gasoline and Electricity Outperformed during the Declination of CPI

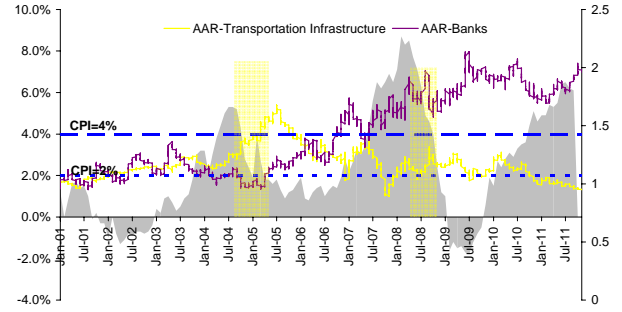


Note: AAR: Accumulative Abnormal Return index $t = \text{Accumulative Abnormal Return } t - \text{Accumulative Abnormal Return index } t - 1$ where:
Accumulative Abnormal Return $t = \text{Return (Sector)} t - \text{return (CSI300)} t$. Accumulative Abnormal Return index $0 = 1$.
Source: WIND, Company data, Morgan Stanley Research

3) Adding Banks and Transportation Infrastructure because of their cheap valuations

For two reasons, we are adding Banks and Transportation Infrastructure. Firstly, these two sectors' PE is relatively lower than other sectors, which means they are pricing in mild EPS growth expectations, maybe due to possible earnings cuts during the upcoming period of disinflation and slowdown of GDP. Secondly, according to global valuation comparisons (Exhibit 15-25), banks and transportation infrastructure are cheaper than their global peers.

Exhibit 10
Banks and Transportation Infrastructure Outperformed during the Period of Disinflation



Note: AAR: Accumulative Abnormal Return index $t = \text{Accumulative Abnormal Return } t - \text{Accumulative Abnormal Return index } t - 1$ where:
Accumulative Abnormal Return $t = \text{Return (Sector)} t - \text{return (CSI300)} t$. Accumulative Abnormal Return index $0 = 1$.
Source: WIND, Company data, Morgan Stanley Research

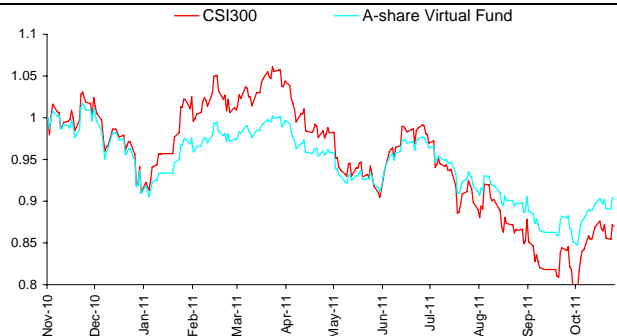
A-Share Virtual Funds Performance Summary:

Exhibit 2
A-share Virtual Funds Performance Summary

	3-Mth Perform.	YTD Perform.	Perform. Since Launched
Long Term Portfolio	-7.2%	-10.8%	-12.8%
Over-all Virtual Fund	-4.5%	-9.5%	-11.1%
CSI300	-7.8%	-14.9%	-15.4%

Source: Wind, Company data, Morgan Stanley Research

Exhibit 3
A-share Virtual Funds Performance



Source: Company data, Morgan Stanley Research

November 17, 2011
China A-Share Strategy

A-Share Virtual Funds Revisions Summary:

Exhibit 11

Overall Asset Allocation Changes

Name	Weight Change,%	Weight Before,%	Weight After,%
Reduction:			
Long Term Portfolio	0	80	80
Short Term Portfolio	0	0	0
Cash	0	20	20

Source: WIND, Morgan Stanley Research

Exhibit 12

Long-term Portfolio Revisions

Name	PE (2010E)	Wind Consensus (2011 Epsg)	Weight change, %
Reduction:			
Construction & Engineering III	18.48	38%	-4
Steel	25.7	43%	-3
Metals & Nonmetals	61.74	73%	-2
Construction Materials III	27.65	70%	-1.37
Addition:			
Utilities	34.04	14%	4
Banks	9.75	25%	3.37
Transportation Infrastructure	18.04	18%	3

Source: WIND, Morgan Stanley Research

Exhibit 14

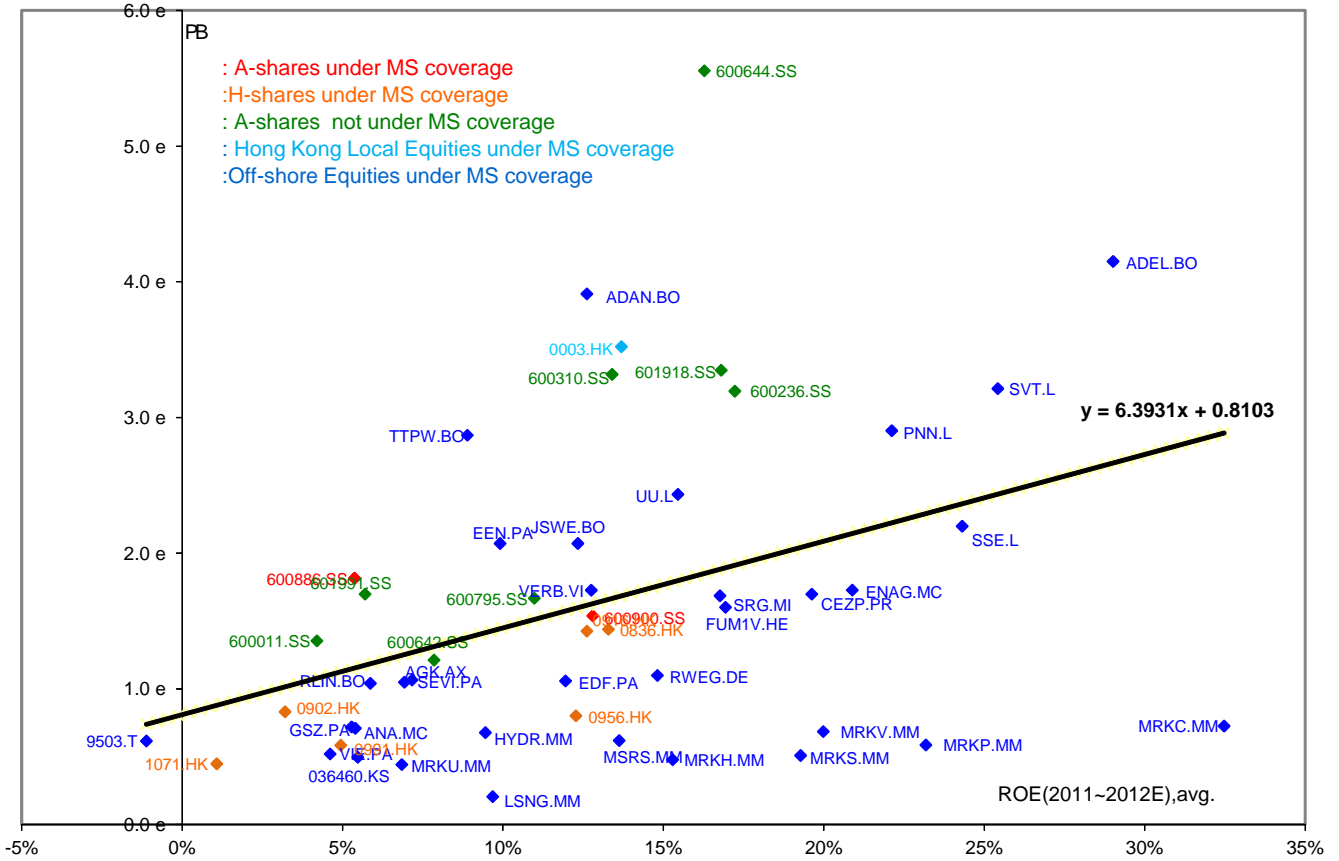
Long Term Portfolio

Wind Ticker	Sector Name	CSI 300	Portfolio	O/U weight(bps)	PE	EPSG	3-Mth	12-Mth
		Weight	Weight		(2010)	2011E	Perform(%)	Perform(%)
882001.WI Energy		8.37	14.80	643	13.68	10%	-0.95	-7.56
882200.WI Energy Equipment & Services		0.46	0.68	22	28.89	9%	6.91	-16.5
882402.WI Integrated Oil & Gas		1.33	3.58	225	11.65	6%	1.75	-11.14
882404.WI Oil & Gas Refining & Marketing		0	0.00	0	70.69	0%	-12.82	-6.18
882573.WI Oil & Gas Transportation		0	0.00	0	23.42	12%	-1.9	-15.75
882571.WI Coal & Consumable Fuels		6.58	10.54	396	17.45	18%	-6.53	2.38
882002.WI Materials		13.39	10.52	-287	31.47	46%	-13.91	-15.02
882202.WI Chemicals		2.02	2.45	43	39.09	74%	-9.73	-9.75
882203.WI Construction Materials III		1.57	0.00	-157	20.18	70%	-23.32	-6.68
882204.WI Containers & Packaging		0	0.13	13	28.41	18%	-11.87	-10.56
882413.WI Aluminum		1.25	1.50	25	58.66	32%	-15.62	-20.19
882414.WI Metals & Nonmetals		4.42	3.49	-93	51.03	72%	-13.69	-21.08
882415.WI Gold		1.85	1.30	-55	30.51	37%	-22.08	-22.72
882416.WI Precious Metals & Minerals		0	0.00	0	65.8	-7%	-11.81	-27.55
882417.WI Steel		2.28	0.16	-212	18.95	12%	-11.39	-14.89
882206.WI Paper & Forest Products		0	1.50	150	29.01	-21%	-8.72	-17.14
882003.WI Industrials		17.60	18.37	77	20.11	8%	-9.37	-18.11
882207.WI Aerospace & Defense III		0.76	0.00	-76	72.57	-2%	-14.98	-27.03
882208.WI Building Products III		0	0.00	0	37.52	43%	-15.02	-11.91
882209.WI Construction & Engineering III		2.83	1.00	-183	14.81	28%	-8.49	-15.09
882210.WI Electrical Equipment		2.56	1.00	-156	30.18	3%	-6.57	-23.81
882211.WI Industrial Conglomerates III		0.97	0.00	-97	26.15	10%	-7.91	-13.57
882212.WI Machinery		6.17	7.18	101	25.3	33%	-11.85	-12.54
882213.WI Trading Companies & Distributors III		0.51	0.00	-51	23.05	6%	-11.63	-14.71
882103.WI Commercial & Professional Services		0.12	0.00	-12	#N/A	#N/A	#N/A	#N/A
882215.WI Air Freight & Logistics III		0	0.00	0	27.43	12%	-8.64	-26.58
882216.WI Airlines III		0.89	1.50	61	8.85	8%	-16.02	-35.57
882217.WI Marine III		0.65	2.48	183	12.85	-144%	-7.11	-28.13
882218.WI Road & Rail		1.28	0.30	-98	14.25	1%	0.17	-10.05
882219.WI Transportation Infrastructure		0.86	4.91	405	14.46	2%	-7.54	-21.31
882004.WI Consumer Discretionary		8.10	9.00	90	22.82	27%	-8.22	-16.99
882105.WI Automobiles & Components		2.02	2.50	48	14.89	15%	-9.27	-21.82
882106.WI Consumer Durables & Apparel		2.94	2.50	-44	26.43	32%	-9.75	-10.63
882107.WI Consumer Services II		0.54	0.00	-54	29.16	29%	-4.36	-12.85
882108.WI Media II		0.42	0.00	-42	45.42	40%	11.26	-7.09
882109.WI Retailing		2.18	4.00	182	29.73	45%	-10.79	-22.68
882005.WI Consumer Staples		8.71	4.56	-415	46.29	35%	-7.46	-4.52
882110.WI Food & Staples Retailing II		0.84	0.56	-28	42.25	27%	-9.08	-24.39
882111.WI Food, Beverage & Tobacco		7.87	4.00	-387	45.93	37%	-7.32	-1.54
882112.WI Household & Personal Products		0	0.00	0	-3973.32	5%	-6.29	-12.35
882006.WI Health Care		4.15	1.81	-234	36.82	19%	-8.55	-20.76
882007.WI Financials		34.18	34.95	77	10.37	28%	-2.23	-11.92
882115.WI Banks		18.83	20.34	151	8.77	34%	0.15	-8.21
882116.WI Diversified Financials		6.07	1.11	-496	18.85	-10%	0.1	-15.88
882117.WI Insurance II		4.32	7.50	318	16.29	1%	0.16	-24.35
882118.WI Real Estate		4.96	6.00	104	17.03	16%	-13.31	-12.09
882008.WI Information Technology		2.44	1.00	-144	51.99	40%	-4.85	-17.73
882009.WI Telecommunication Services		1.12	0.00	-112	82.45	12%	10.02	0.07
882010.WI Utilities		1.91	5.00	309	25.25	-1%	-0.99	-13.79
000300.SH CSI300		100.00	100.00	—	13.05	22%	-7.76	-14.24

Source: Wind, Company data, Morgan Stanley Research

Exhibit 15

Global Valuation Comparisons: IPP



Source: WIND, Company data, Morgan Stanley Research

Exhibit 16

Global Valuation Comparisons: Machinery

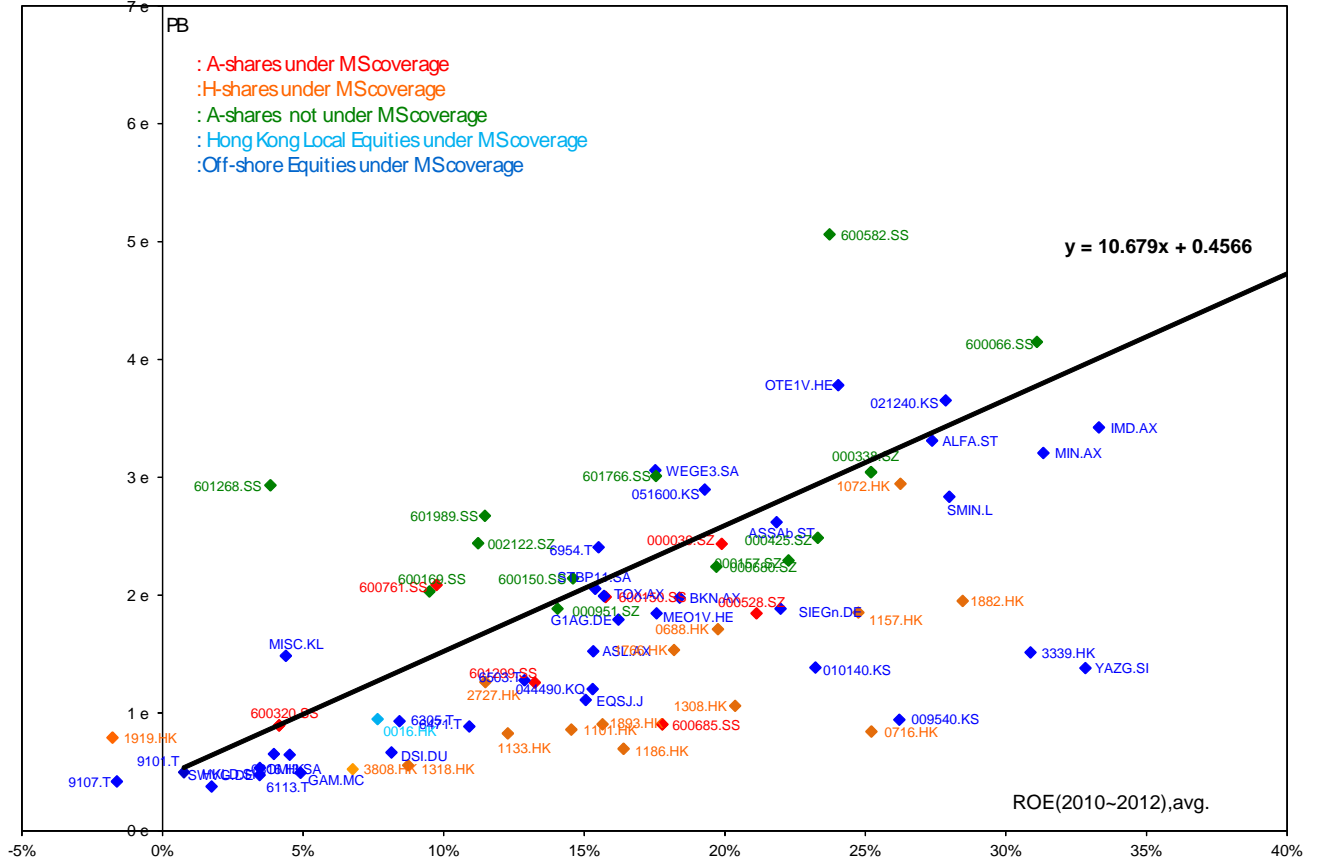
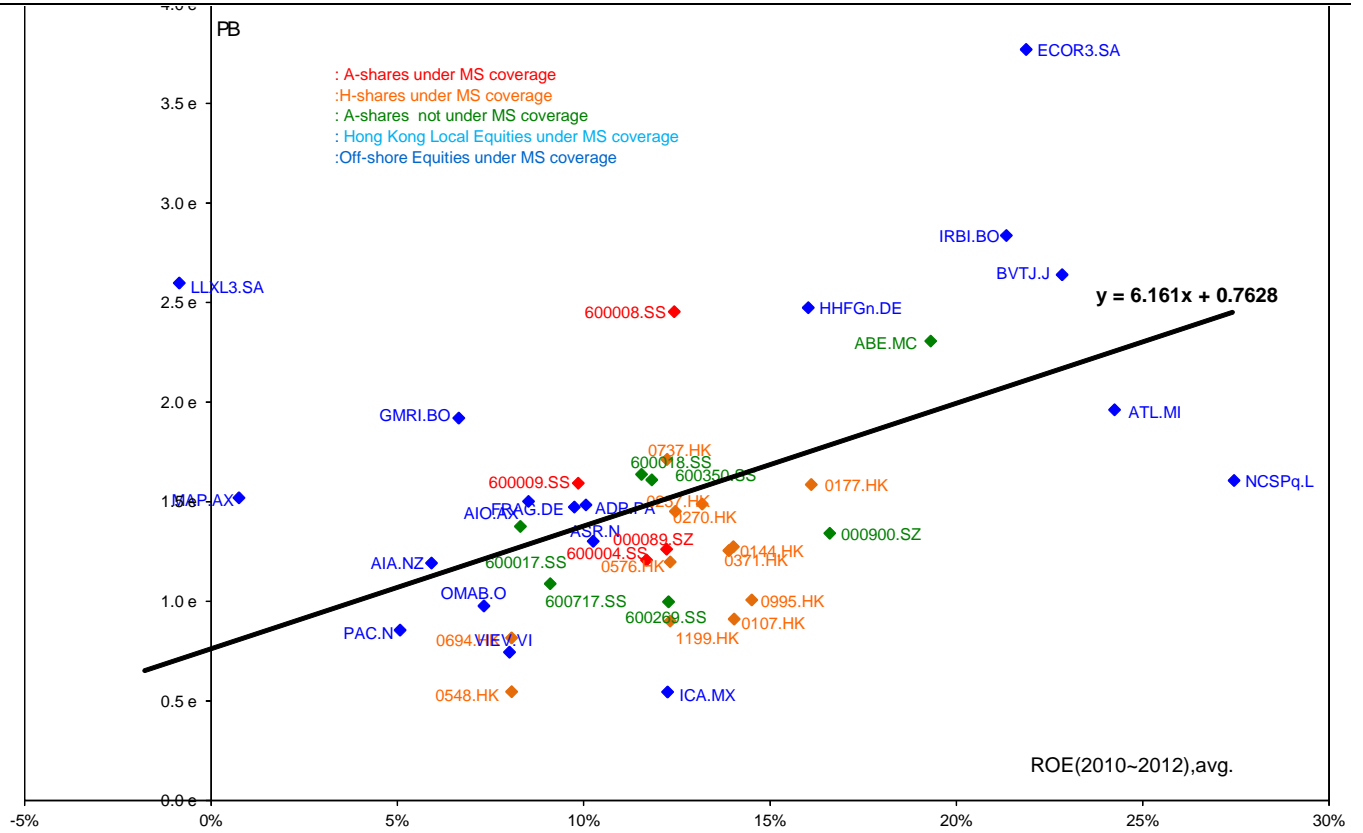


Exhibit 17

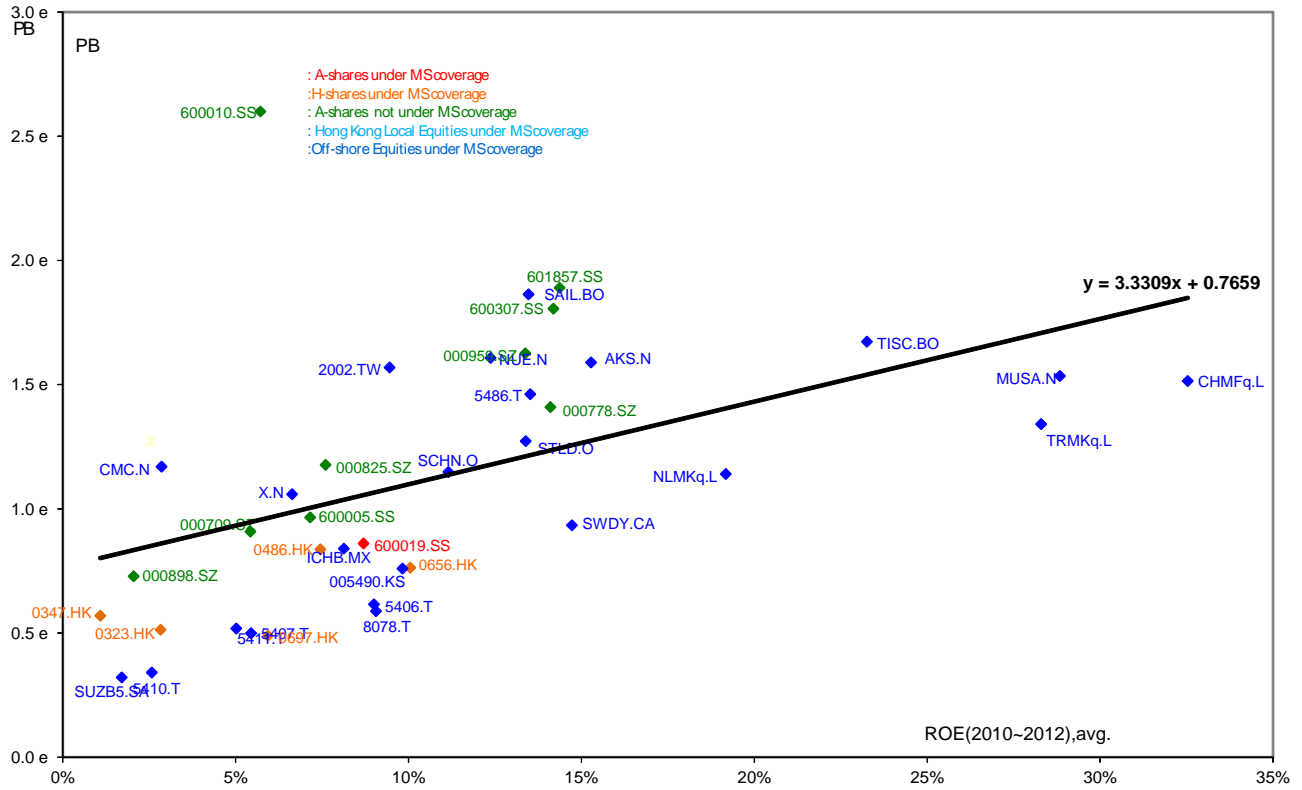
Global Valuation Comparisons: Transportation Infrastructure



Source: WIND, Company data, Morgan Stanley Research

Exhibit 18

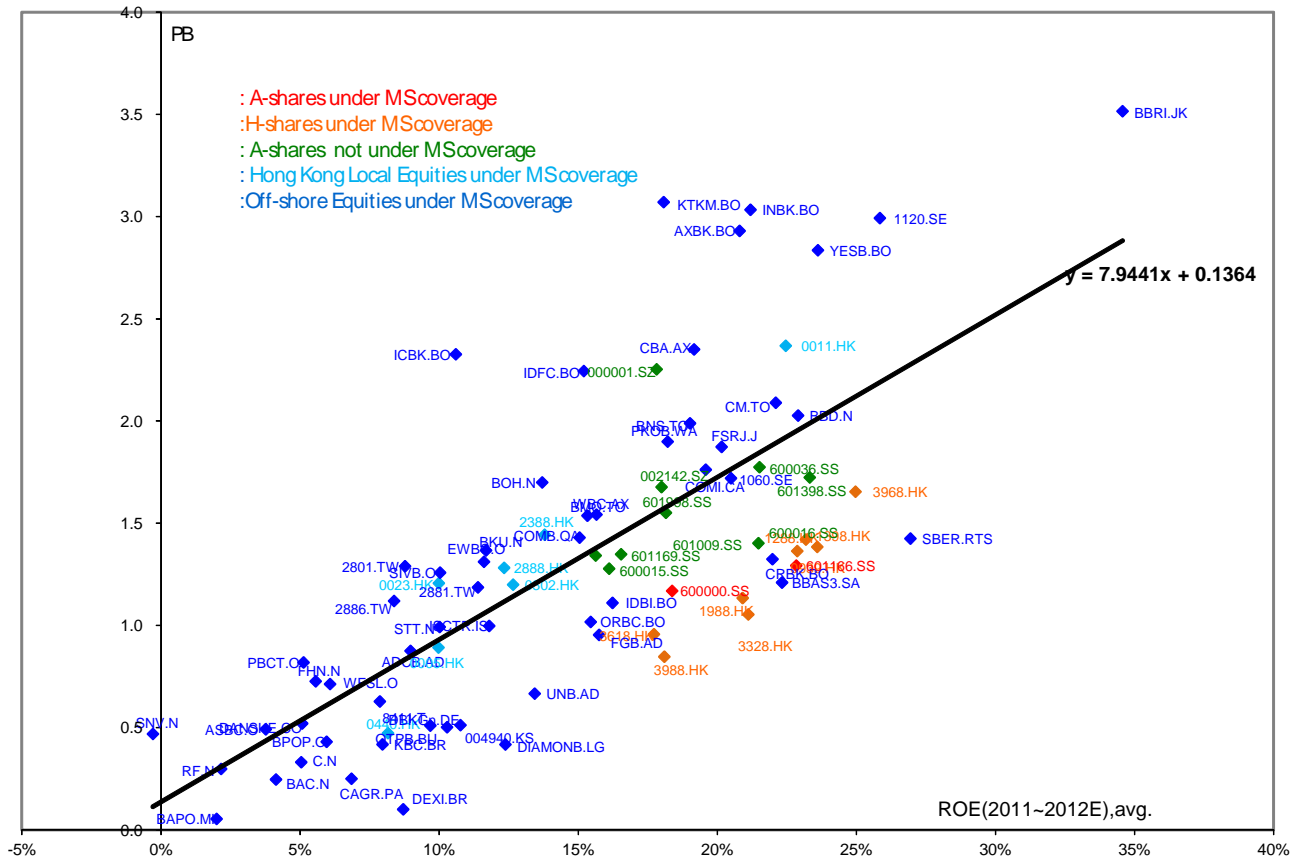
Global Valuation Comparisons: Steel



Source: WIND, Company data, Morgan Stanley Research

Exhibit 19

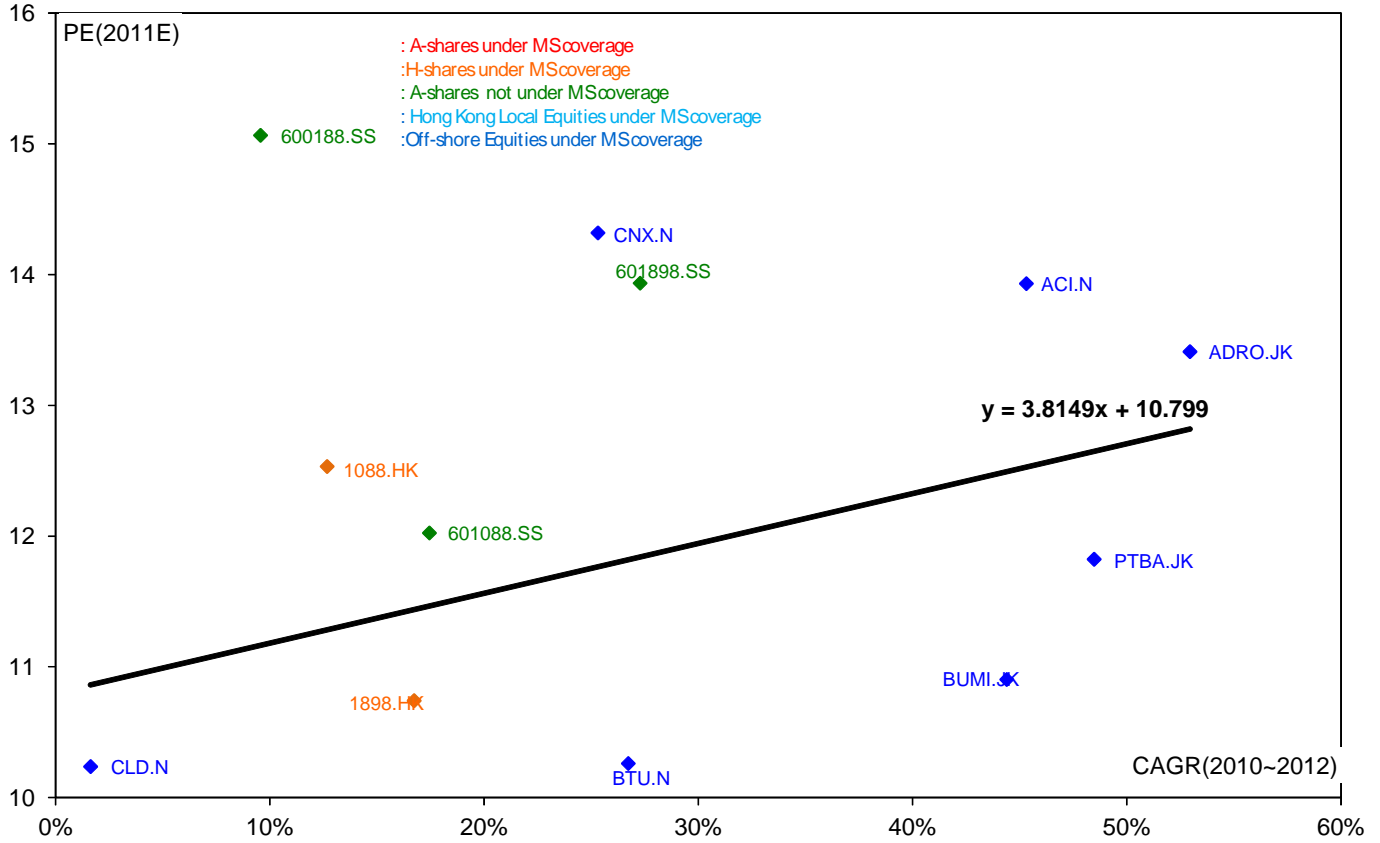
Global Valuation Comparisons: Banks



Source: WIND, Company data, Morgan Stanley Research

Exhibit 20

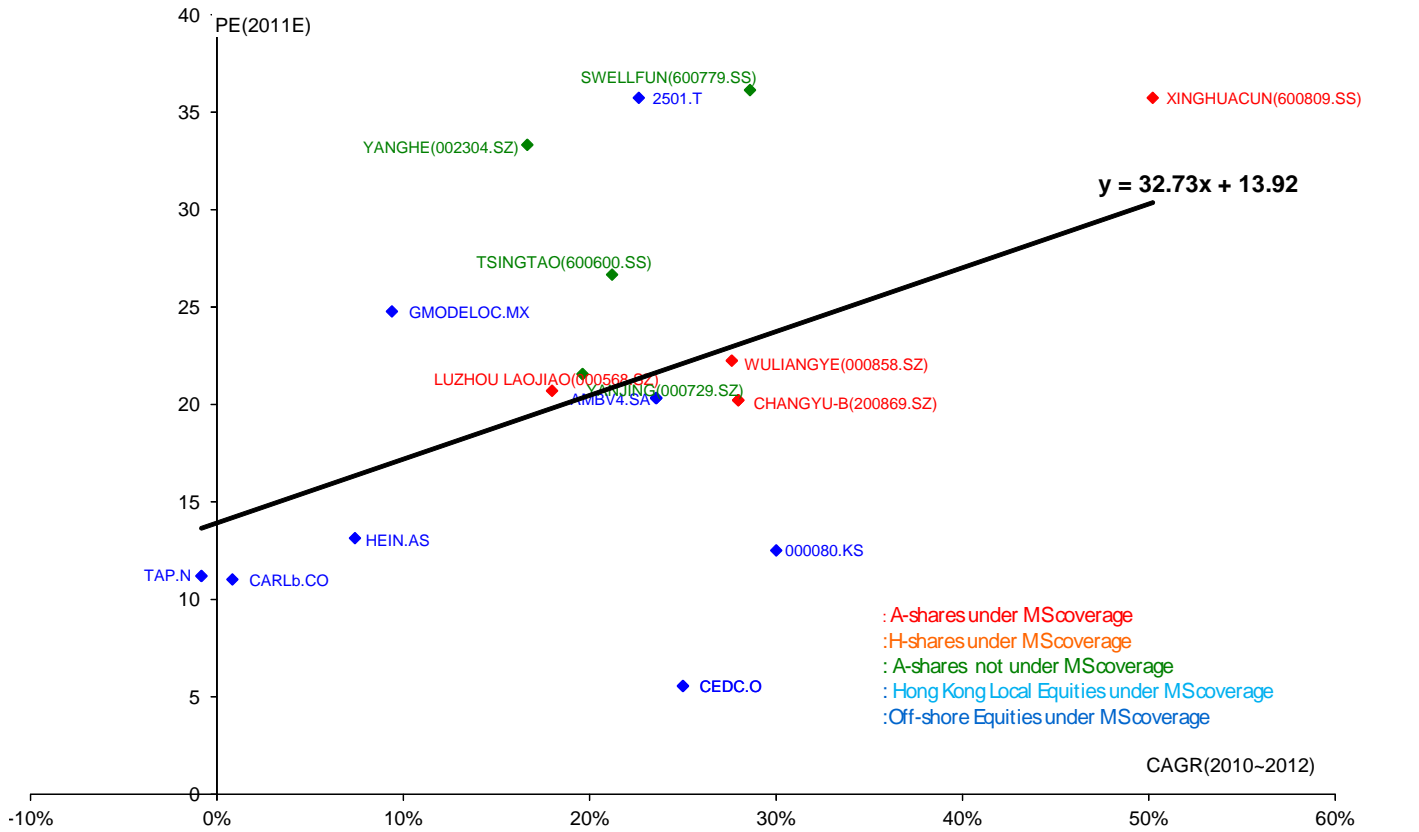
Global Valuation Comparisons: Coal



Source: WIND, Company data, Morgan Stanley Research

Exhibit 21

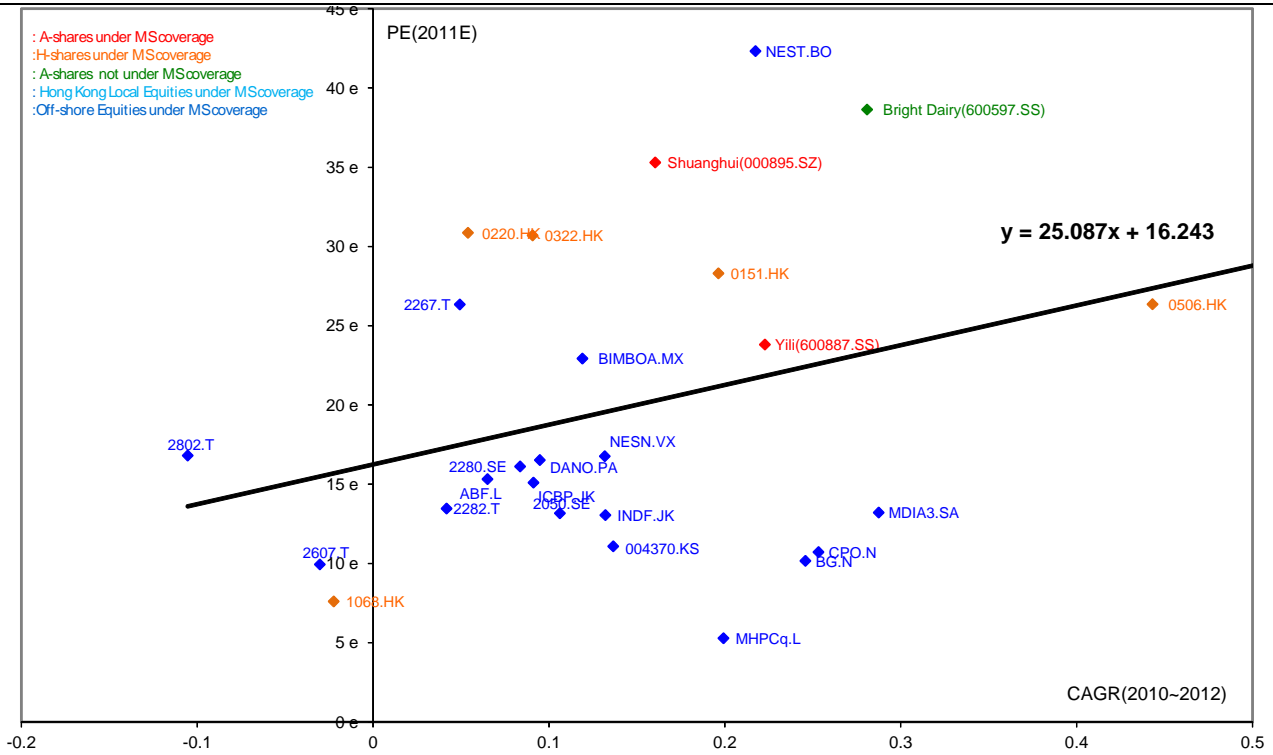
Global Valuation Comparisons: Beverages



Source: WIND, Company data, Morgan Stanley Research

Exhibit 22

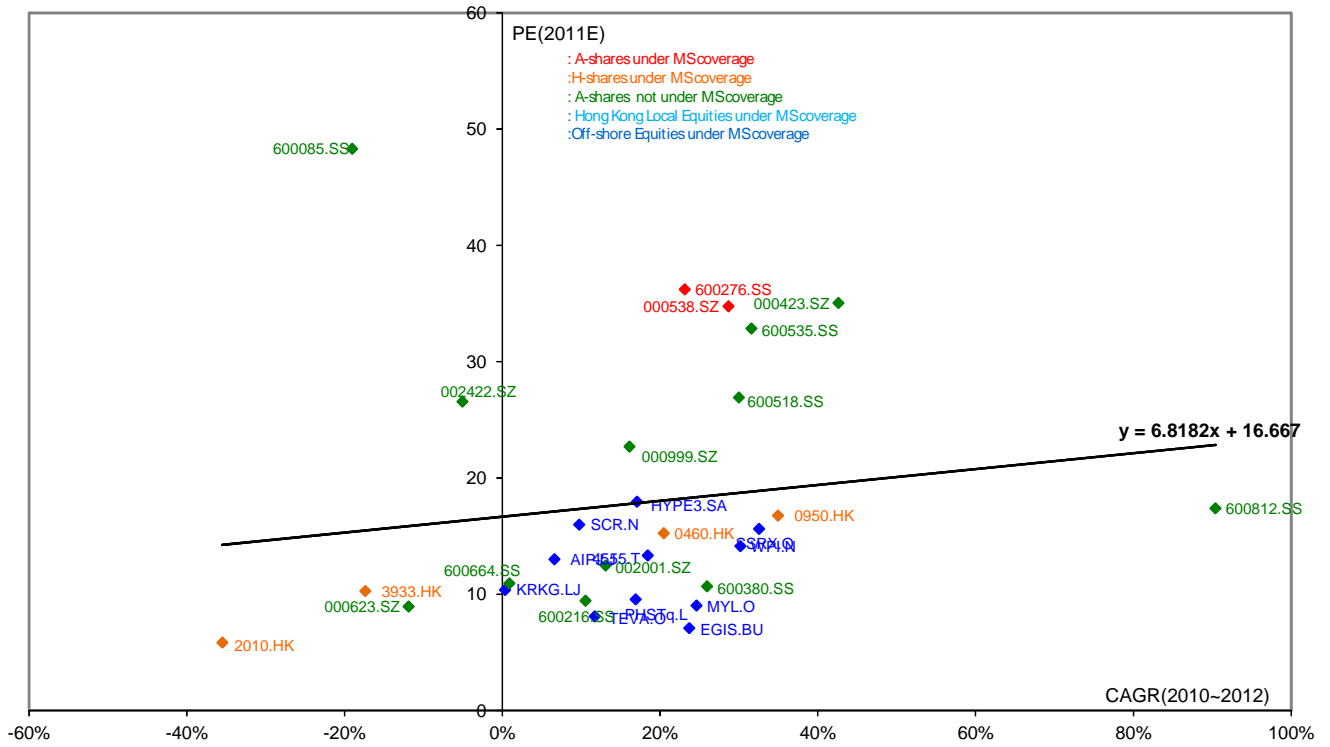
Global Valuation Comparisons: Food Products



Source: WIND, Company data, Morgan Stanley Research

Exhibit 23

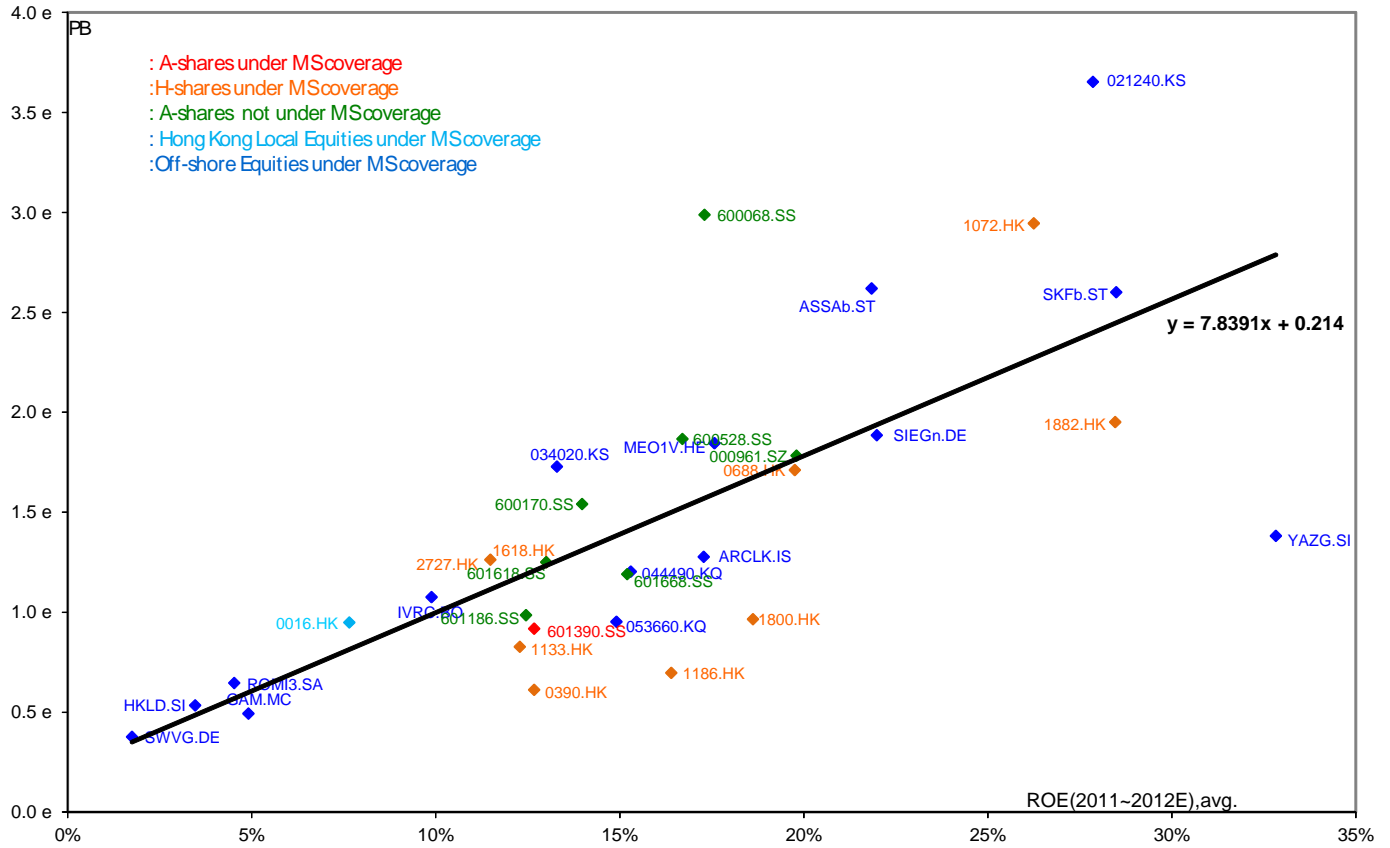
Global Valuation Comparisons: Pharmaceuticals



Source: WIND, Company data, Morgan Stanley Research

Exhibit 24

Global Valuation Comparisons: Construction Engineering



Source: WIND, Company data, Morgan Stanley Research

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(as of October 31, 2011)

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	Count	% of Total	Count	% of Total IBC	% of Rating Category
Overweight/Buy	1126	40%	449	44%	40%
Equal-weight/Hold	1176	42%	431	42%	37%
Not-Rated/Hold	108	4%	23	2%	21%
Underweight/Sell	418	15%	115	11%	28%
Total	2,828		1018		

Data include common stock and ADRs currently assigned ratings. An investor's decision to buy or sell a stock should depend on individual circumstances (such as the investor's existing holdings) and other considerations. Investment Banking Clients are companies from whom Morgan Stanley received investment banking compensation in the last 12 months.

Analyst Stock Ratings

Overweight (O or Over) - The stock's total return is expected to exceed the total return of the relevant country MSCI Index, on a risk-adjusted basis over the next 12-18 months.

Equal-weight (E or Equal) - The stock's total return is expected to be in line with the total return of the relevant country MSCI Index, on a risk-adjusted basis over the next 12-18 months.

Not-Rated (NR) - Currently the analyst does not have adequate conviction about the stock's total return relative to the relevant country MSCI Index on a risk-adjusted basis, over the next 12-18 months.

November 17, 2011
China A-Share Strategy

Underweight (U or Under) - The stock's total return is expected to be below the total return of the relevant country MSCI Index, on a risk-adjusted basis, over the next 12-18 months.

Unless otherwise specified, the time frame for price targets included in Morgan Stanley Research is 12 to 18 months.

Analyst Industry Views

Attractive (A): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be attractive vs. the relevant broad market benchmark, as indicated below.

In-Line (I): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be in line with the relevant broad market benchmark, as indicated below.

Cautious (C): The analyst views the performance of his or her industry coverage universe over the next 12-18 months with caution vs. the relevant broad market benchmark, as indicated below.

Benchmarks for each region are as follows: North America - S&P 500; Latin America - relevant MSCI country index or MSCI Latin America Index; Europe - MSCI Europe; Japan - TOPIX; Asia - relevant MSCI country index.

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November 17, 2011

China A-Share Strategy

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