

MARCH 2007 NEWSLETTER

— *What Caused the 9% One-Day Decline in Shanghai? When Will the Bull Come Back?*

SECTION I – CHINESE ECONOMY

Consumer

China's **Consumer Price Index (CPI)** increased 2.2% in January from a year ago, while increased 0.7% from last month. Rural CPI rose 2.6%, outpacing urban CPI's 2.0% pace. The price of food rose 5.0%, while non-foodstuff, consumable and services rose 0.7%, 2.6% and 0.7%, respectively. Although the 2.2% number looks high compared with 1~2% range in 2006, the year-over-year raw rate is misleading. After seasonal adjustment, January CPI only rose 0.01% from December. The food price blip is temporary, overall, we see CPI remain under control in the rest of 2007.

Industry

In January, the Industrial **Producers' Price Index (PPI)** for manufactured goods advanced from the same month last year increase of 3.3%, while raw materials, fuels and power increased 4.7%. PPI for means of production and for consumer goods continued to show different behavior. PPIs for means of production rose 3.8% over a year ago, of which prices for mining and quarrying industry, raw materials industry, machining industry rose 4.7%, 2.7% and 6.7%, respectively. On the other hand, PPI for means of consumer goods increased only 1.8% over the same month of the previous year, of which, food rose 4.8%, cloth and commodities surged 1.4% and 0.8%, while durable consumer goods dropped 1.3%.

The total amount of **import and export** in January was \$157 billion, or 30.5% higher than a year ago. Exports reached \$86.6 billion, up by 33%, and imports reached \$70.7 billion, up by 27.5%. January generated a trade surplus of \$15.9 billion. The annual growth rates over 30% looks alerting. However, considering the 2006 Chinese New Year

holiday was in January while the 2007 Chinese New Year was in February, the growth is reasonable.

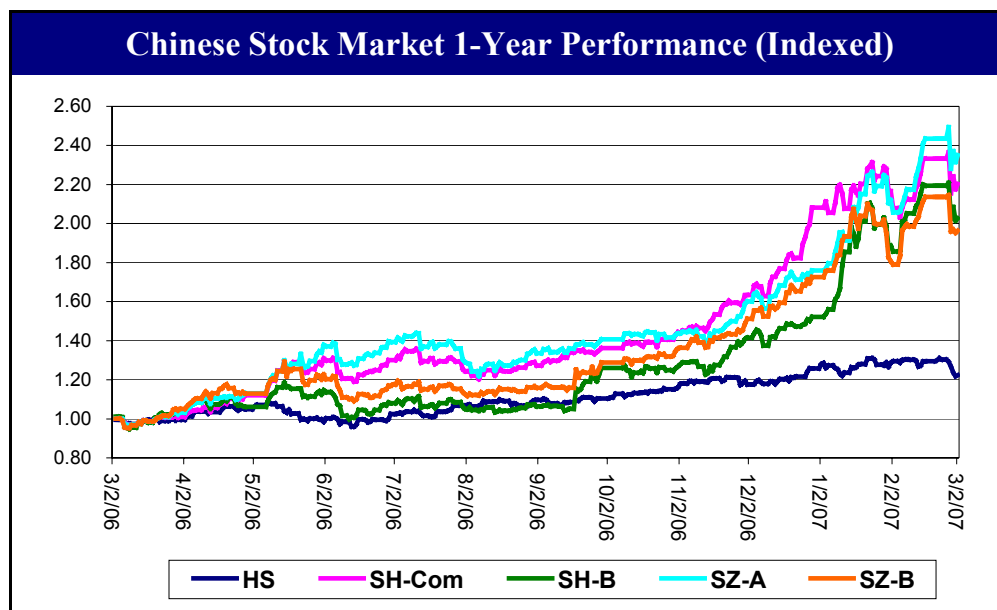
Money Supply

On the money supply front, at the end of January, M2 balance was RMB35.2trillion, representing an annual growth of 15.9%, which is 3.3 percentage points lower than the same month last year. M1 balance was RMB12.9 trillion, representing an annual growth of 20.2%, which is 2.7 percentage points higher than last month. M0 balance was RMB2.8 trillion which is lower by 4.6% from last January. In addition, total financial institution renminbi and foreign currency loans outstanding were RMB24.4 trillion with an annual growth rate of 15.4%, or 0.8 percentage points higher than last month. New renminbi loans issued in January was RMB23.1 billion. Money supply and loan growth is showing decelerated trend, which likely means the Chinese government's tightening policy is working and probably no further control measurement is necessary.

SECTION II – STOCK MARKETS

Chinese Stock Markets

During the four-week-period from February 5 to March 2, all major Chinese indices increased, except for Hang Seng. However, the real hot topic in the media and in the investment community is the 9% one-day decline on February 27.

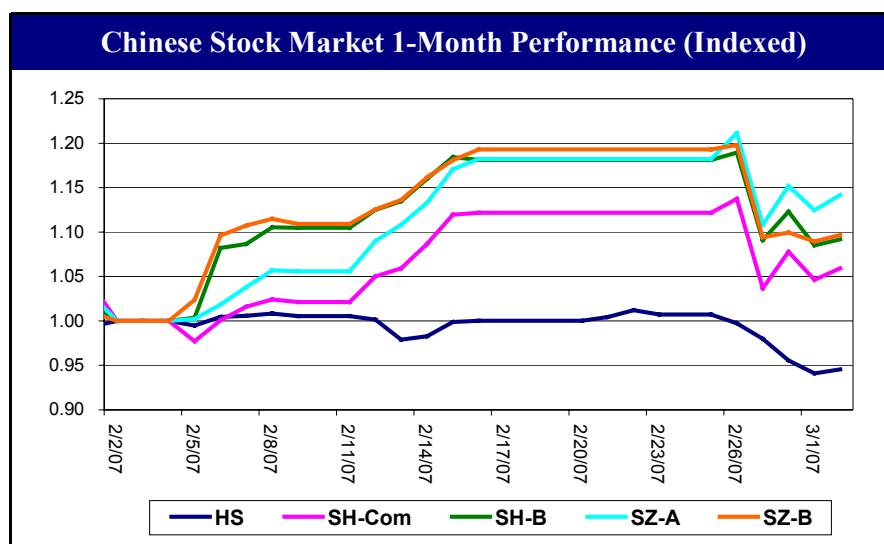


The following table shows the market performance of the five major indices.

Market data (02/05/07 - 03/02/07):

Index	Open	High	Low	Close	Change
Hang Seng	20,455.6	20,809.2	19,346.6	19,442.0	-4.96%
Shanghai Composite	2,612.5	3,040.6	2,612.5	2,831.5	8.38%
Shanghai B Share	159.4	188.9	159.4	173.4	8.78%
Shenzhen A Share	667.8	807.2	667.8	760.7	13.90%
Shenzhen B Share	460.2	538.5	460.2	493.0	7.12%

During the month, the Chinese stock markets experienced considerable volatility. Major indices rose 20% during the first 20 days, and then suddenly dived on February 27.



- *What Were The Major Drivers For The 9% One-Day Plunge?*

After a year-long bull market in China, the domestic stock market suddenly experienced a severe correction, which made the capital markets worldwide panic. What were the major drivers?

Rumor on Capital Gain Tax. The Chinese domestic stock investors has been exempt from capital gains tax, while China’s statutory capital gains tax is currently 20%. On February 27, rumors broke out that the government is going to levy capital gain tax, which obviously is a major negative factor.

Institutional Investors Cashed Out Profit. During the year-long bull market, most of the institutional investors and financial institutions have cumulated big capital gains. Somehow, they need to cash out. In addition, they need to create a big market correction,

so that they can fill their inventory to get ready for the next round of rally. The capital gain tax rumor gave them a great opportunity to do so.

Administration Gave Signal Of Tightening Liquidity On Stock Market. At the beginning of February, Xinhua InfoChina reported in our daily news that there are indications showing that the administrative departments have sent clear signals of tightening liquidity on China's domestic stock market, and predicted that the excess liquidity is expected to be prevented and the signal will ripple to stock market.

China Banking Regulatory Commission (CBRC) forbade embezzlement of credit funds on stock market; China Securities Regulatory Commission (CSRC) required securities companies to clear up unqualified stock accounts; Li Rongrong, director of the State-owned Assets Supervision and Administration Commission (SASAC) announced that the capital of state-owned enterprises entering the stock market would be put under supervision. In fact, CSRC has begun to send signals of tightening liquidity to the market since the end of 2006 including slowing down the issuing of new funds and speeding up the issuing of big cap stocks.

The benchmark composite index of Shanghai bourse rose over 200 percent from about 1,000 points in 2005 to almost 3,000 this year, fueled by the reform of China's capital market and the increase of the profits of China's listed companies, but liquidity also stoked up the market.

It is learned more measures of tightening liquidity will be unveiled, one of which is to set up an independent special department to manage part of the country's foreign exchange reserves. It will issue special RMB bonds to raise funds and purchase foreign exchange reserve from the central bank and then invest them on overseas market. Besides, the central bank will increase withdrawal of liquidity through central bank bill and required reserve ratio.

- ***When Will The Bull Market Come Back?***

We see the bull market have never gone away. The February 27 plunge was a temporary correction that every bull market has to experience now and then. We continue to be bullish on China for the rest of 2007.

Rumor Is Just A Rumor, Capital Gain Tax Is Unlikely. Implementing capital gain tax will be an abrupt policy shift which is contradictory to the government's fundamental policy of promoting domestic capital markets and indirect financing. In addition, the most concern of the Chinese government is social stability. A sudden implementation of capital gain tax will for sure bring turmoil to the investors – the middle- to upper-class Chinese – who are currently not a source of instability (as compared to rural residents).

Furthermore, technically it's difficult to implement capital gain tax, as it would require calculation of a tax basis to establish profit or loss, which will be close to infeasible to do in China.

Stock Market Is Expected to Continue to Roar. We continue to be bullish on China's domestic stock market in 2007, and we believe 2006 was just a start of this structural bullish market, considering

- China's economic growth will likely to remain at around 10%,
- Publicly-traded companies will probably post double-digit earnings growth,
- The sale of non-tradable shares reform has been successful, which provides favorable environment for growth,
- The "bubble" in the stock market has been pressed out, as average P/E ratio returned to 18X from 65X,
- Huge capital is flowing into stock market,
- And revaluation of assets in China will be reflected in stock prices.

Chinese Stocks in the U.S.

Our U.S.-China Opportunities Index decline significantly by 6.5% during the past four weeks, mainly driven by the sudden plunge of the Chinese stock markets. Sectors declined across the board, while at different magnitude. Technology / Internet sector, the most volatile sector, led the decline, posting a loss of 10.1%. While Mining and Metal Sector only lost 0.8%.



U.S. - China Opportunity Index 4-Week Summary: From 02/03/07 To 03/02/07

Index	Open	High	Low	Close	Change
U.S. - China Opportunity Index	9,606.9	10,106.9	8,940.0	8,985.8	-6.47%
Sub-Indices					
Technology Sector	142.8	145.2	128.5	128.5	-10.05%
Energy Sector	241.5	242.3	223.7	223.7	-7.34%
Communication Sector	168.8	183.0	158.2	161.0	-4.61%
Mining & Metals Sector	124.0	134.9	120.1	123.0	-0.80%
Airline Sector	117.1	135.6	112.7	114.4	-2.31%
Electric Utilities Sector	75.4	80.2	73.0	73.0	-3.12%

SECTION III – HOT TOPICS

- ***China Halts Handling Applications For Coal Prospecting Rights***

The Chinese government has halted handling new applications for coal prospecting rights to prevent investment in coal mining from overheating, according to the Ministry of Land and Resources.

The suspension will last from February 2 this year to the end of 2008, when no application for selling prospecting rights through competitive channels like bidding will be handled. However, major coal exploration projects approved by the State Council, as well as surveys of coal resources with the support of special geological funds from the central and provincial governments, can continue to set up new prospecting rights.

Sources with the ministry said the move aims to prevent an oversupply of coal in the country and keep coal production stable.

China's crude coal output reached 2.325 billion tons in 2006, up 8.1 percent year on year, according to the State Administration of Coal Mine Safety. China's crude coal production dropped to a low of 999 million tons in 2000, and then rebounded to 1.415 billion tons in 2002 and 1.997 billion tons in 2004. (InfoChina/Xinhua)

- ***China's Central Bank To Bolster Role Of Interest Rate Adjustments***

China's central bank said interest rate adjustments would play a greater role in monetary macro-control as it warned of increased inflationary pressure. "We'll make use of the interest rate tool and let the price lever play a bigger role in monetary policy," said the central bank in a quarterly monetary policy report released on February 9.

It said risks of price hikes have multiplied and inflationary pressures are building. China's consumer price index hit a 20-month high last November, reaching 1.9 percent,

and surged to 2.8 percent in December. A survey of depositors conducted by the central bank in the fourth quarter of 2006 showed citizens fear further price hikes. The bank attributed inflationary pressures to stronger demand from industries and consumers as well as higher costs for enterprises.

The last interest rate hike in August resulted from concerns about excessive investment and currency liquidity. But now the central bank is making the containment of inflation a key focus of its interest rate policies, said Shanghai-based Shenyin & Wanguo Securities Co. It predicted the bank is likely to increase interest rates this March or April. The Orient Securities Co. also anticipated interest rate rises but said one or two hikes will have a limited effect on the market. (InfoChina/Xinhua)

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