Blue Horseshoe

This is a sales note and not a research report

22 September 2010

Trading Strategy
Patrick Lee
patrick.lee@hk.daiwacm.com
(852) 2848 4041

Sales Trading
John Mar
john.mar@hk.daiwacm.com
(852) 2848 4949

Ricky Lo
ricky.lo@hk.daiwacm.com
(852) 2848 4982

May Tsang
may.tsang@hk.daiwacm.com
(852) 2848 4981

Highlights

- *Bull market top takes time to develop. Watch the small cap/big cap ratio for signs of weakness in market.*
- *Countries competing to devalue their currency mean asset plays continue to benefit. Silver/gold ratio has turned up indicating global economy is picking up.*
- *Trade: Long **China Bluechem** (3983 HK)*
- *Trade: Long **Melco International** (200 HK)*, recommended on Sept 17

Market Observations:

Bull market top is a process that takes time to develop.

Investor psychology doesn't change overnight.

"*Bull market tops tend to develop gradually over a long period of time. The reasons for this gradual process are easy to understand: It is the Law of Supply and Demand at work. Just as bull markets result from strong, persistent investor demand for stocks, bull market tops evolve when investors gradually stop buying. Some investors simply run out of new money to invest. Others begin to see individual stocks as being overvalued, and begin to hold back on new purchases. Whatever the reasons, the stock market cannot continue to advance without Demand exceeding Supply. The evolution of investor psychology from strong buying enthusiasm for stocks to passivity or complacency does not occur suddenly. Thus, bull market tops are commonly diffuse, possibly lulling most investors into inaction. Perhaps it is the slowness of the entire process that makes it difficult to recognize a bull market top.*" – Paul Desmond

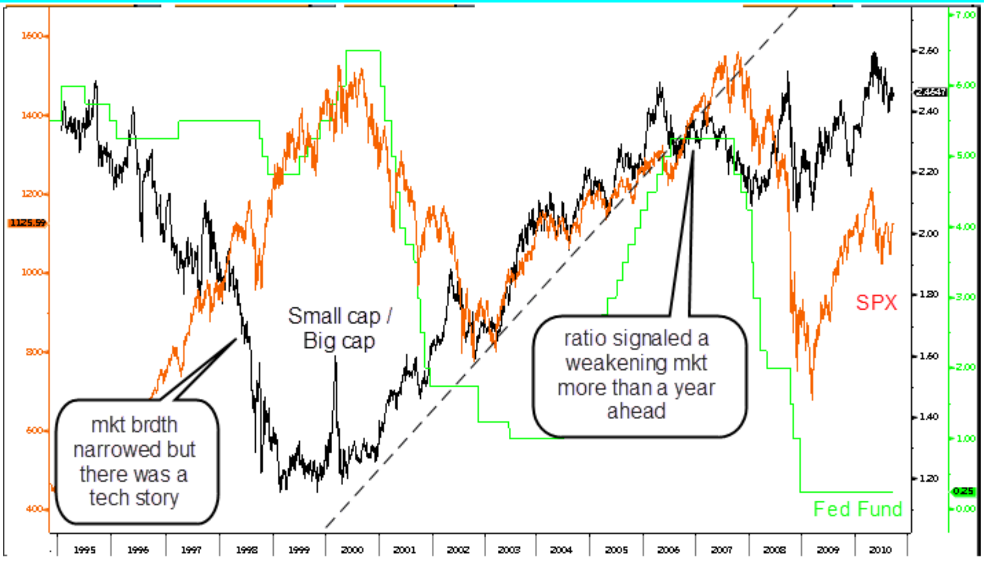
Small cap/big cap ratio is an indicator that warns of a weakening stock market.

Tight liquidity and a crisis are needed to push the market into bear territory.

On August 26th, we wrote that the downside for S&P500 is limited. Since then the market had gone up by more than 8.8%. While our view is that this bull market still has at least one more year to go, for investors who are concerned about when the run will end, one indicator to pay attention to is the ratio of small cap stocks relative to big cap stocks. In the previous bull market, the ratio peaked in April '06 and broke the trend line in July '06. The S&P500, however, continued to moved higher and did not peak until October '07. One thing to note with regard to the ratio is that it formed a divergence with regard to the S&P500 as the index went to all time high in late 2007. Thus, the divergence indicated that as the S&P500 was making a new high and was being propelled by big cap stocks, an increasing number of small cap stocks were weakening and were no longer tracking the index's strength, thereby signaling that trouble was ahead. Nonetheless, we would caution that this ratio should be viewed within the context of the macro environment. The S&P500 did not turn down in 2007 until the banking crisis started to tighten liquidity in the system. Furthermore, In the bull market of the 1990's, the ratio formed a divergence with the index for a number of years. As investors fell in love with the tech story, a number of big cap tech stocks kept pushing up the S&P500 even as smaller cap stocks were falling by the wayside. It was not until Microstrategy's accounting fraud shook investors' faith in the tech story that the bear market finally began in early 2000.

Small cap/big cap ratio can be a decent indicator to warn of an impending change in market trend. But should be viewed within a broader, macro context.

Exhibit 1: SPX, small cap/big cap ratio, Fed Fund rate



Source: Bloomberg, Daiwa Capital Markets Hong Kong Ltd.

Countries competing to devalue their currency to gain an advantage in trade means asset plays will keep getting bid up.

A notable move in the markets last week was the breakout of gold to a new high. While some look at the rise in gold as unsustainable, it is likely that the best days for gold and other precious metals are still ahead. Countries with weak economies such as US and Japan are devaluing their currency to gain an advantage in trade. It is clear that asset plays and precious metals will keep getting bid up as investors try to preserve their purchasing power. Thus it is likely that we will have a mania in gold and precious metal that could eventually rival the tech bubble of the late 90's.

Silver/Gold ratio has turned up, indicating that global economic activity has begun to pick up.

Yet, lost amidst the headline for gold, one precious metal that is quietly making a strong move is silver. The move in silver is noteworthy because unlike gold, it is also an industrial metal with application in different industries. As the below chart shows, in the last few weeks, silver has begun to outperform gold indicating that global economic activity has begun to pick up again. Throughout the last bull market, silver outperformed gold significantly. The ratio broke the trend line in August '07 indicating that the world economy was in trouble. Investors who paid attention to the message from silver would have locked in most of their gains in the last bull market.

Exhibit 2: Silver/Gold relative chart

Source: Bloomberg, Daiwa Capital Markets Hong Kong Ltd.

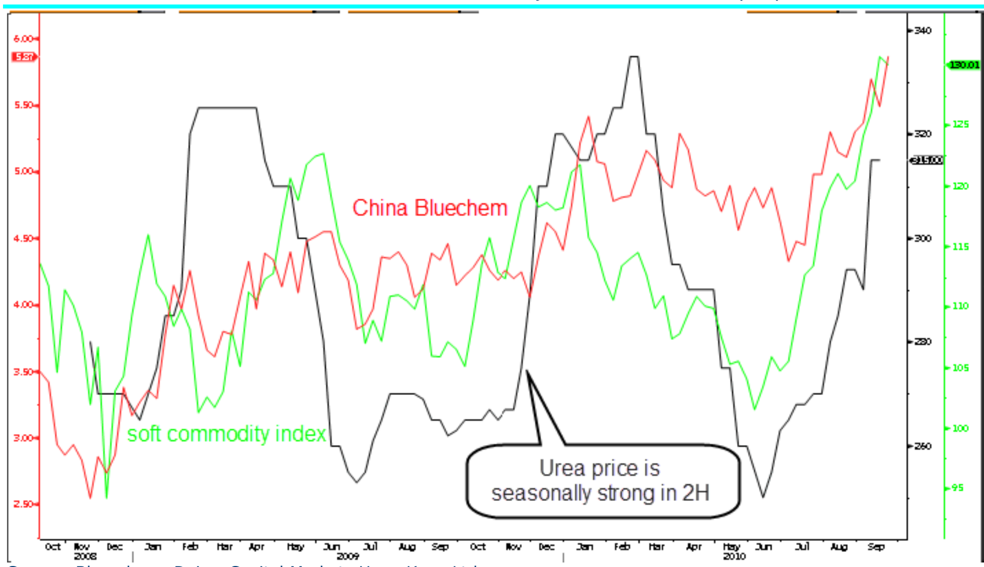
Trade:

26% increase in urea spot price.

Urea price typically peak in Q1.

Long **China Bluechem (3983 HK)**: We recommend going long China Bluechem. **Catalysts**: 1) China's urea spot price has increased by 26% since early June. Except for 2008, urea price in China had exhibited a strong seasonality with spot price bottoming in early summer and peaking in Q1. 2) Food inflation in China is picking up steam. China's August CPI for food increased by 7.5%. RBS China soft commodity index has broken above 20 months high. **Background:** 52% of China Bluechem's 1H10 revenue is from urea with the segment making up for 60% of gross profit. **Stop loss**: HK$5.26

Exhibit 3: China Bluechem, RBS China soft commodity index, China Urea spot price



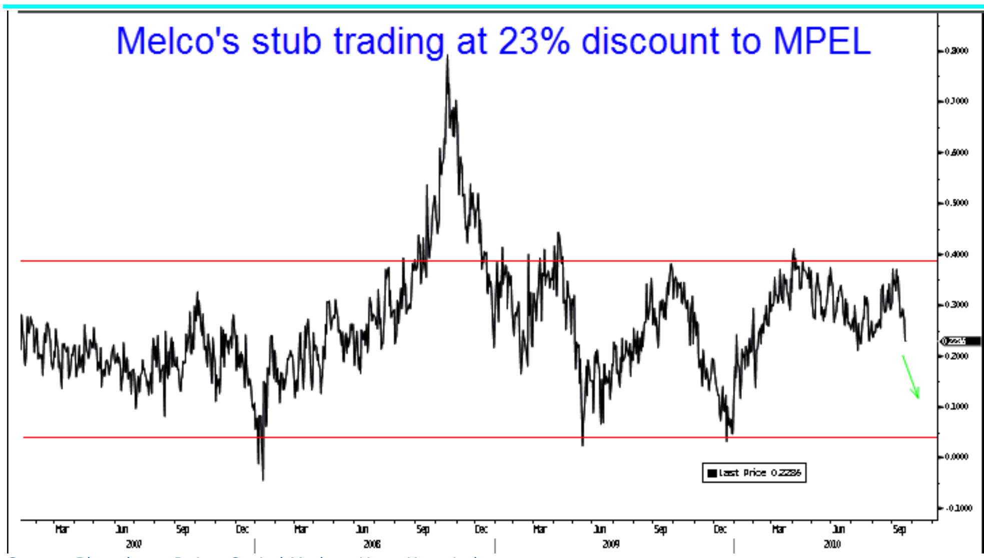
Source: Bloomberg, Daiwa Capital Markets Hong Kong Ltd.

House of Dancing Water a catalyst to build brand awareness.

Stub is trading at 23% discount.

Long **Melco International (200 HK),** *recommended on Sept 17*. We recommend going long Melco. **Catalysts**: 1) The new show House of Dancing Water at the City of Dreams should help Melco build brand awareness as it seeks to improve its position as a poor casino operator. 2) Melco International owns 33% of Melco Crown (MPEL US) which equates to HKD 6.75bn. Currently Melco Int'l is worth HKD 5.1bn. With buying interest in the gaming sector strong, we expect the stub discount to narrow. **Background:** In addition to Melco Crown, the company also owns interests Melco china Resorts (MCG CN), Enterntainment Gaming Asia (EGT US) and MelcoLot (8198 HK). **Stop loss**: HK$3.75

Exhibit 4: Melco International and Melco Crown stub discount



Source: Bloomberg, Daiwa Capital Markets Hong Kong Ltd.

Daiwa Sales Trading team

Beata Yeung	Benson Li	Erica Chan	Ross Pienaar	Steven Wong
beata.yeung@hk.daiwacm.com	benson.li@hk.daiwacm.com	erica.chan@hk.daiwacm.com	ross.pienaar@hk.daiwacm.com	steven.wong@hk.daiwacm.com
(852) 2848 4902	(852) 2848 4961	(852) 2848 4094	(852) 2848 4937	(852) 2848 4943