China Equity Strategy

Where are we now post the recent sell-off?

Equity Strategy

China

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Back to square one on tech

With the recent tech-led sell-off, major indices in China are now down 18% YTD (see Figure 23) and our gauge of AI-related tech hardware stocks is now up only 9% YTD. Our tracking of fast money position data such as crowding score and margin financing suggests net positions are back to beginning-of-the-year levels while HK equities' short interest is also the highest it has been with shorts in AI tech names also picking up recently. Meanwhile, earnings growth for tech hardware remains robust with earnings upgrades of 12-15% in the last three months across most AI tech names despite component shortages in China during the period. Meanwhile, valuations for the tech AI hardware names are now close to the historical trough and imply a major deceleration in EPS growth ahead. We believe the fundamental concerns for AI are overdone (see our regional team's report) and historically when valuations reached such levels, these names were on average up >50% over the following 12 months. We are wary that investor sentiment on AI is fragile, however we believe the risk reward is looking more attractive again and interest may come back towards the end of the year as investors rebuild their portfolios for the new year.

Valuations imply major deceleration in growth ahead

Historically there is a reasonably high correlation between tech stocks' share price performances vs forward earnings growth (see Figure 3). The last time the tech stocks traded at current levels (close to 2022/23), earnings growth was c.20%, implying a 50-60% growth deceleration in 2027 and c.20-30% downside to consensus estimates. Looking at the 2018 episode, the same AI tech stocks' PE valuations are now only 25% above the troughs reached then, a period that was affected by the trade war and Huawei sanctions, and no AI investments. It would seem that a reasonably weak future scenario for China hardware tech is being priced in. We note that after reaching the valuation trough in 2018 and in 2022, the AI tech names rallied over 50% on average in the following 12 months. As such, it would seem that the risk reward is increasingly skewed to the upside.

Flows and positioning show that fast money has significantly unwound

Our tracking of crowding data (which has a higher weighting towards hedge funds) suggests that hedge funds have significantly unwound their positions in AI tech hardware and their net positions are now back to the level at the beginning of the year. Margin financing balance on the A-share has also retreated below the level at the beginning of the year. Short interest in HK equities is close to a historical high and rising in some of the tech hardware names (see Figure 11). That said, our tracking of overseas long only funds suggests that they may not unwind positions to the same extent and positions remain higher vs history.

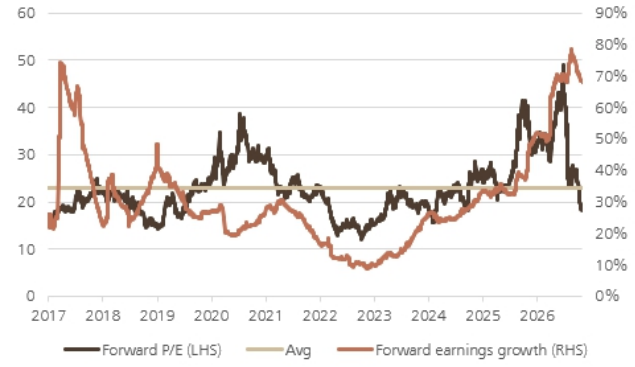
Overall market is better value though limited earnings upside near term

MSCI China 12-month fwd PE valuation has reached 9.5x, 1.2 std. dev. below historical average and at the 8th percentile vs history. That said, the relative earnings growth/ momentum for Chinese equities appears weaker in comparison to other markets (see Figure 24). Furthermore, the appreciation in RMB will continue to weigh on the exporters while higher input costs could continue to dampen domestic consumption. As such, we prefer a barbell strategy with AI tech hardware (NAURA Tech, CXMT and SMIC as preferred tech picks) and banks as our preferred picks.

This report has been prepared by UBS Securities Asia Limited. **ANALYST CERTIFICATION AND REQUIRED DISCLOSURES, INCLUDING INFORMATION ON THE QUANTITATIVE RESEARCH REVIEW PUBLISHED BY UBS, BEGIN ON PAGE 9.**

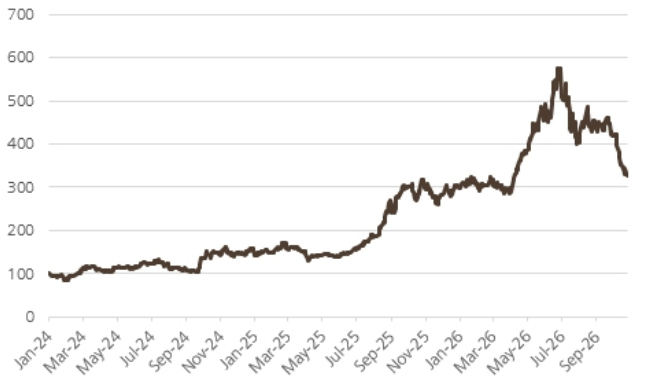
Share prices back to square one

Figure 1: China AI tech hardware forward P/E vs forward earnings growth



Source: FactSet, UBS

Figure 2: China AI tech hardware share prices now up only 9% YTD



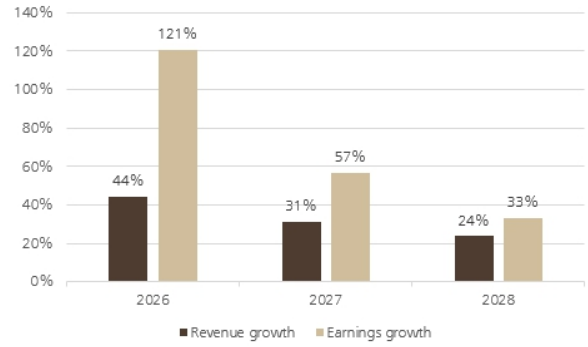
Source: FactSet, UBS

Figure 3: China AI tech hardware share prices imply major earnings growth deceleration ahead



Source: FactSet, UBS

Figure 4: China AI tech hardware consensus forecast for revenue and earnings growth



Source: FactSet, UBS

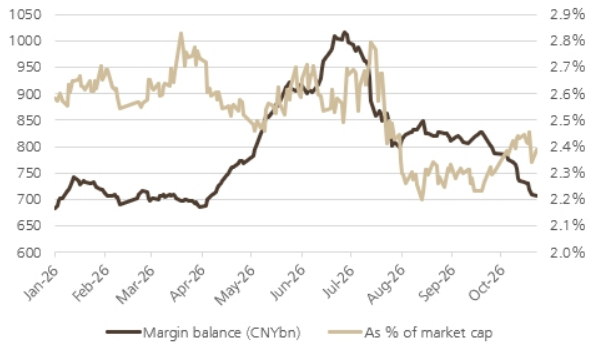
Fast money has significantly unwound

Figure 5: China AI tech hardware average crowding scores



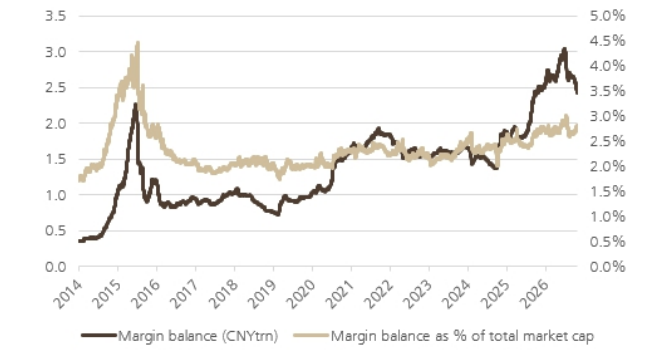
Source: UBS Quant Research

Figure 6: A share broader tech sectors' margin balance outstanding



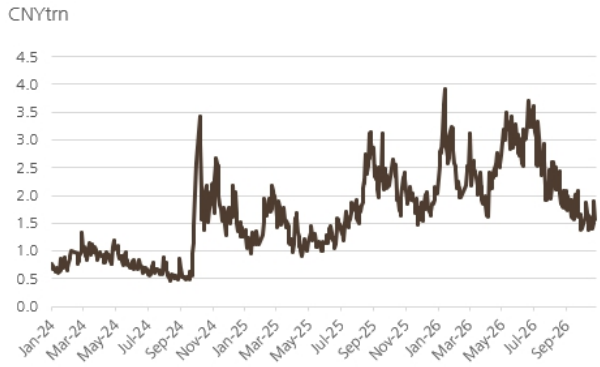
Source: Wind, UBS. Note: Electronics, computer and communication sectors are included.

Figure 7: China A share margin balance outstanding



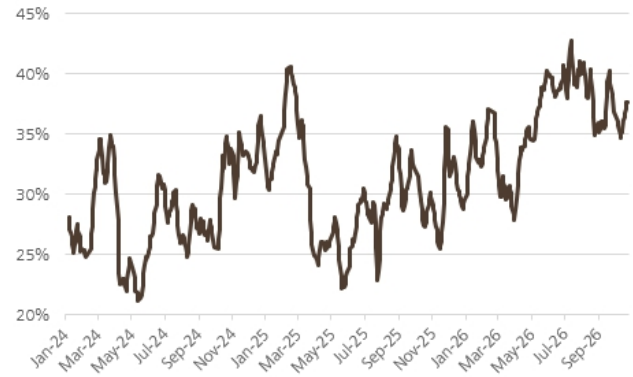
Source: Bloomberg, UBS

Figure 8: China A share market daily turnover (CNYtrn)



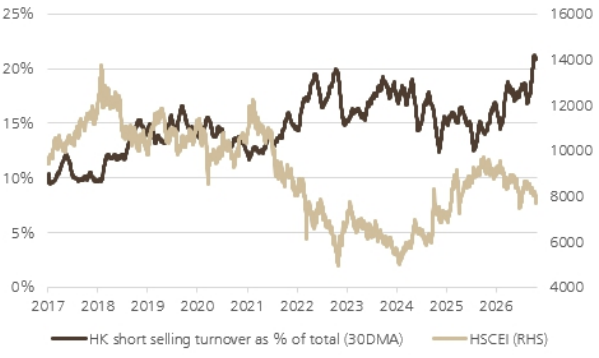
Source: Bloomberg, UBS

Figure 9: A share broader tech sectors' margin turnover as % of market total



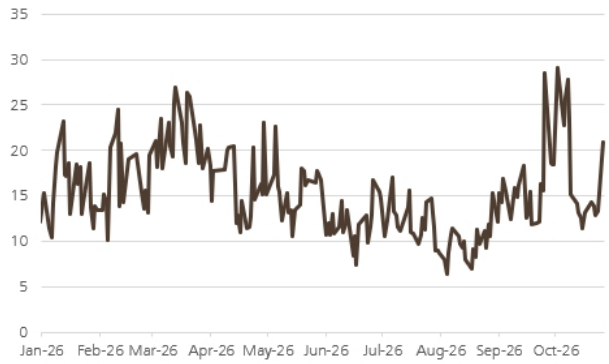
Source: FactSet, UBS. Note: Electronics, computer and communication sectors are included.

Figure 10: HK market short selling turnover as % of total turnover (30DMA) vs HSCEI



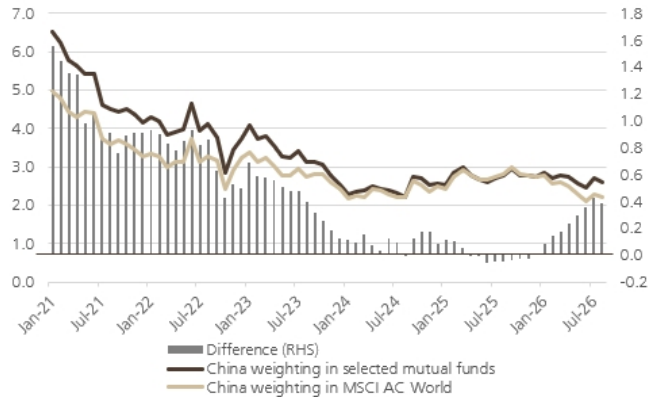
Source: Bloomberg, UBS

Figure 11: Average short selling turnover ratio of major AI stocks listed in HK



Source: Bloomberg, UBS. Note: Hua Hong, SMIC, Biren, Innolight, Lenovo, GigaDevice, Montage are included.

Figure 12: Mutual fund positioning in Chinese equity (% of equity portfolio)



Source: FactSet, UBS. Note: Data up to Aug 2026. A sample of c.900 funds reporting on monthly basis are included in this universe.

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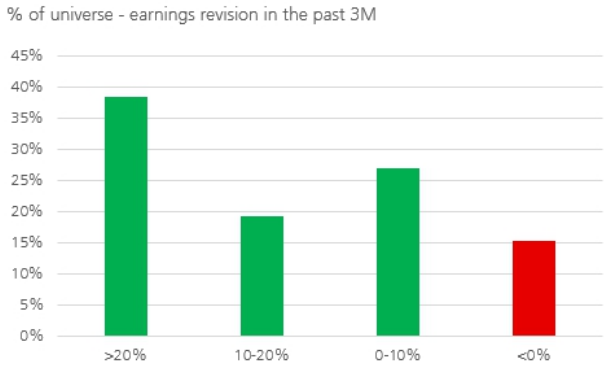
AI fundamentals have been sound

Figure 13: China AI tech hardware forward earnings 3M revision trend



Source: FactSet, UBS

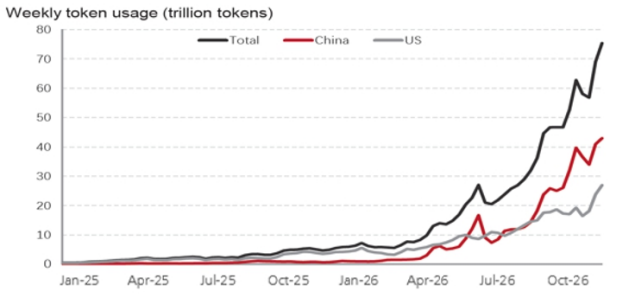
Figure 14: Most AI tech stocks are seeing earnings upgrades despite component shortage



Source: FactSet, UBS

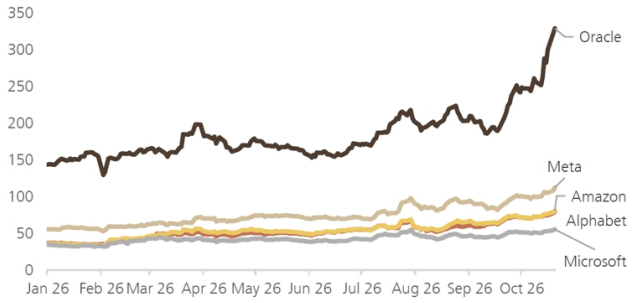
Global view on tech remains positive

Figure 15: Token usage growth



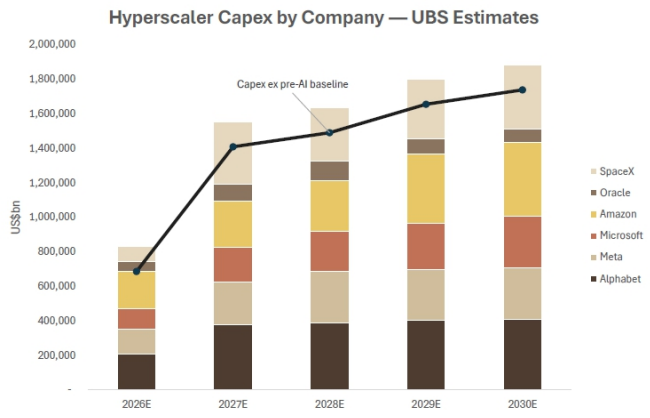
Source: Openrouter

Figure 16: Global hyperscalers' CDS generally well behaved



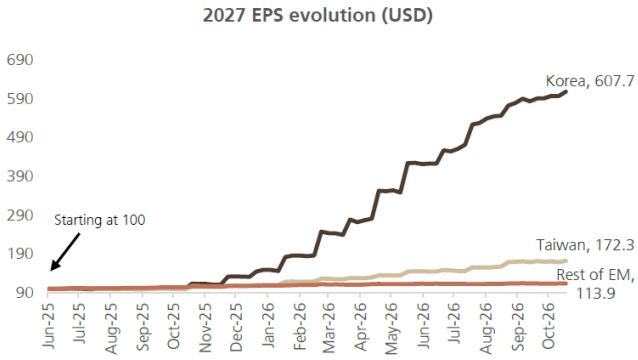
Source: Bloomberg, UBS

Figure 17: Hyperscaler capex outlook still robust



Source: UBS

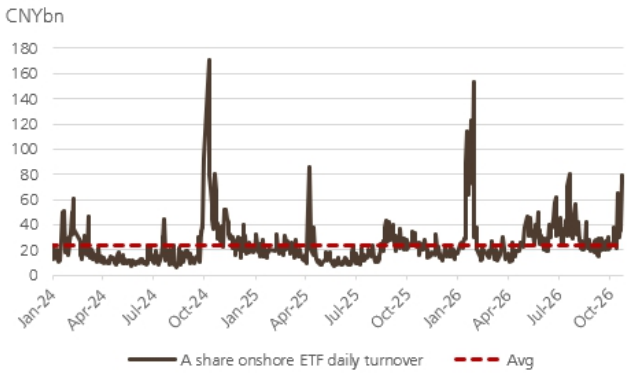
Figure 18: EPS in Korea and Taiwan still holding up



Source: IBES, MSCI, Datastream, UBS

SOE fund purchases to provide some downside support

Figure 19: A share broad market ETF daily turnover



Source: FactSet, UBS

Figure 20: Cumulative net inflows into A share equity ETFs



Source: Wind, UBS

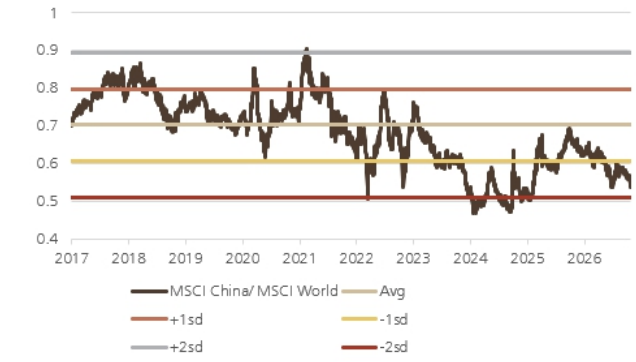
Overall market valuation and performance

Figure 21: MSCI China forward P/E



Source: FactSet, UBS

Figure 22: MSCI China/MSCI World relative forward P/E



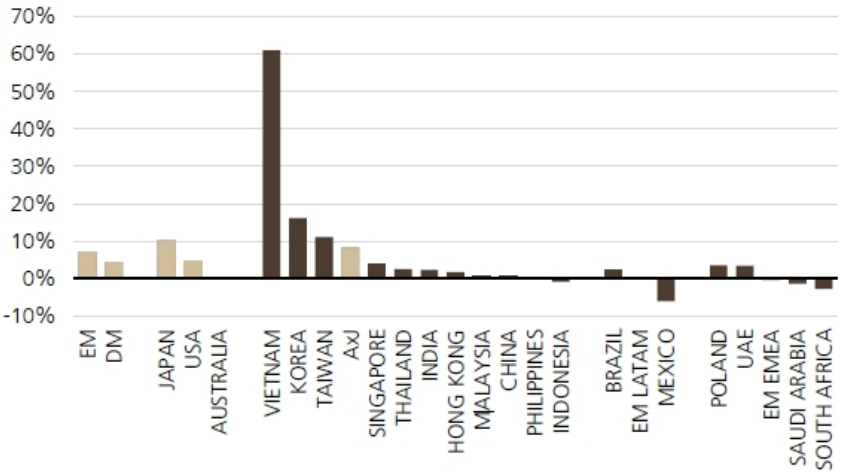
Source: FactSet, UBS

Figure 23: YTD major Chinese equity indices performance



Source: FactSet, UBS

Figure 24: 3M revision in FY27 consensus EPS



Source: IBES, MSCI, Datastream, UBS

Valuation Method and Risk Statement

For various stocks across the industries we cover in the Hong Kong and mainland China stock markets, we use a variety of valuation approaches, including DCF models, Gordon growth model analysis and relative valuation analysis using various multiples such as PE, EV/EBITDA and P/BV.

We think the risks facing China's equities include a hard landing for the property market, a capital exodus associated with currency depreciation and slow structural reform progress. In our view, any government policies that do not adequately address these risks could result in a shock to the market. For example, an excess of stimulus policies could pose a risk to the transition from an investment-driven to a consumption-driven economy and increase the debt of government and state-owned enterprises.

CXMT Corporation:
We use the PB valuation method to value CXMT. Downside risks include and are not limited to: 1) Price declines as new industry capacity is gradually released; 2) Progress in technology iteration and process migration is slower than we expected; 3) AI penetration is slower than expected, leading to a decline in storage capacity demand for servers and other facilities; 4) Geopolitical tensions have increased, with increased restrictions; 5) Intensified industry competition leading to loss of DRAM market share, etc.

SMIC:
Our price target for SMIC is based on a P/BV methodology. Downside risks include: 1) rapidly changing technology; 2) intensifying competition; 3) high capital investment; and 4) cyclical demand. Upside risks include: 1) a persistent trailing-edge foundry shortage; 2) milder-than-expected competition in legacy 12-inch foundries, particularly in China; 3) better-than-expected strength in China semiconductor localisation demand for MCU and analog semis; and 4) a loosening of restrictions exerted by US authorities.

NAURA Technology Group:
We value NAURA on PE methodology. We believe key downside risks include, but are not limited to: 1) geopolitical tension intensifying and restrictions being extended; 2) weaker-than-expected WFE demand in China; and 3) intensified competition leading to market share losses in the etching, deposition and cleaning businesses. We believe key upside risks include, but are not limited to: 1) geopolitical tension easing and restrictions being cancelled; 2) more aggressive than expected fab capex in China; 3); greater-than-expected market share gains in China; and 4) faster-than-expected technology breakthroughs in key processes, such as etching and deposition.