19 Aug 2020

Strategy Report

Tactical sector rotation to cyclicals

There are signs of value stocks starting to outperform growth stocks over the past two weeks. We see supporting fundamental factors behind this sector rotation, as well as short-term confirmation signals from relative momentum. We suggest tactically shifting to cyclical sectors including financials, property and machinery.

- **Rotation from growth to value underway.** Since the outbreak of COVID-19 in Q1, growth stocks led by tech have been outperforming value stocks significantly. Over the past two weeks, however, the tide is turning in both U.S. and HK markets. With the premium of U.S. growth stocks over value stocks at its highest in at least two decades, and U.S. tech stocks being the "most crowded" trade, there could easily be profit taking in growth stocks and at the same time catching up in value stocks given the right catalysts.
- **Fundamental catalysts for the rotation.** We see several catalysts supporting the rotation into value stocks: 1) upbeat economic data; 2) rising inflation expectations and bond yields bode well for financials; 3) positive news on COVID-19 and vaccines; 4) U.S.-China tension weighing on tech sector.
- **Momentum of sector rotation confirmed in the short term.** Relative Rotation Graph (RRG), a tool to gauge and forecast sectors' relative performance, confirms short-term rotation from tech to cyclicals in HK market. Compared to the short-lived rotation in early-Jun, we expect the current rotation into value should last longer.
- **Growth might still outperform in medium-to-long term.** In the medium term, however, such sector rotation has not yet been confirmed on RRG. We should not rule out the possibility of growth stocks keep outperforming value.
- **Tactical strategy: shift to selected cyclical stocks.** Expect value/cyclical stocks to outperform growth stocks in the next few weeks. While we still like the secular outlook of growth stocks, in particular internet giants, we suggest making a tactical shift to selected cyclical stocks. How long would this rotation last depends on upcoming economic data, COVID-19 trend and vaccine development progress, U.S-China tensions, China's monetary easing, among other factors.

Sectors and stocks for tactical rotation

Sector	Company
Insurance	CPIC (2601 HK), China Life (2628 HK), Ping An (2318 HK)
Banking	Ping An Bank (000001 CH), PSBC (1658 HK), CEB (6818 HK)
Brokerage	CITIC Sec (6030 HK), CSC (6066 HK), CICC (3908 HK)
Property	China Aoyuan (3883 HK), Country Garden (2007 HK), Vanke (2202 HK), Poly Development (600048 CH)
Construction Machinery	Sinotruk (3808 HK), Zhejiang Dingli (603338 CH), SANY Heavy (600031 CH)

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12-month HSI Performance

Source: Bloomberg

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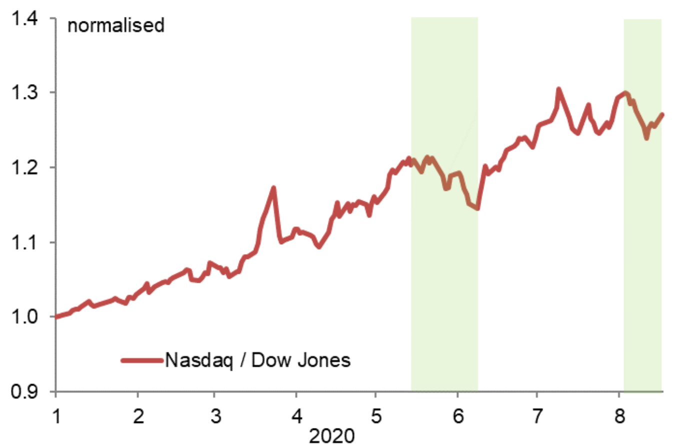
Sector rotation from growth to value underway

Since the outbreak of COVID-19 in Q1 2020, growth stocks, led by information technology, have been outperforming value or cyclical stocks significantly in major stocks markets around the globe. The main reason is that growth stocks are less affected by the pandemic and economic recession. **Over the past two weeks, however, beaten-down value stocks started to outperform growth stocks** in both U.S. (Fig. 1) and HK markets (Fig. 2 & 3). The last time such sector rotation happened was around early-Jun (shaded areas in Fig. 1 & 2).

- **Tech stocks seem expensive and crowded**

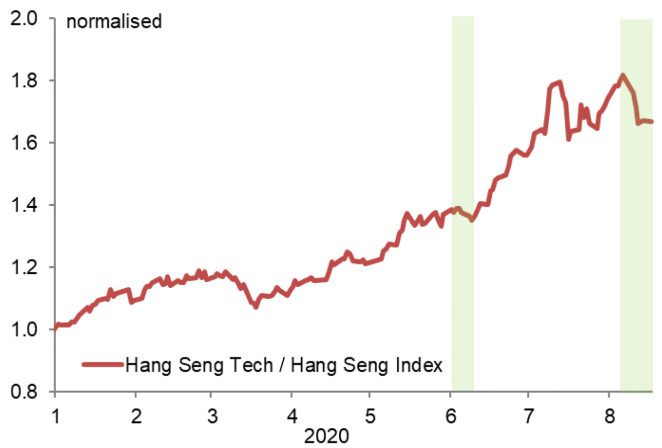
With the premium of U.S. growth stocks over value stocks at its highest in at least two decades (Fig. 4), and U.S. tech stocks being the “most crowded” trade in the market (according to BofA Merrill Lynch July Fund Manager Survey, 74% of fund managers interviewed thought so, though the number dropped to 59% in August’s survey), there could easily be profit taking in growth stocks and at the same time catching up in value stocks given the right catalysts.

Figure 1: Nasdaq’s performance relative to Dow



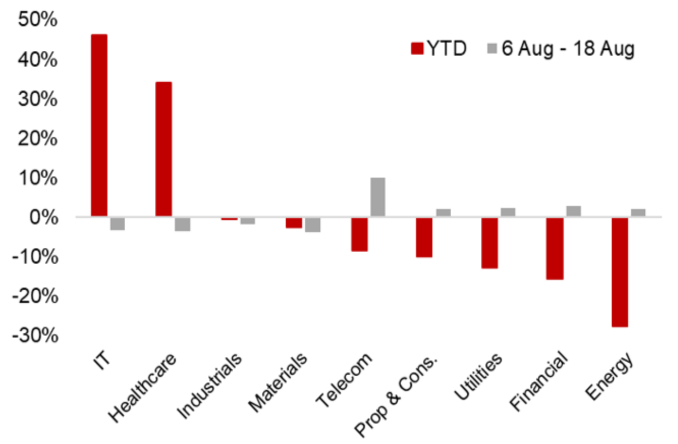
Source: Bloomberg, CMBIS

Figure 2: Hang Seng Tech’s relative performance



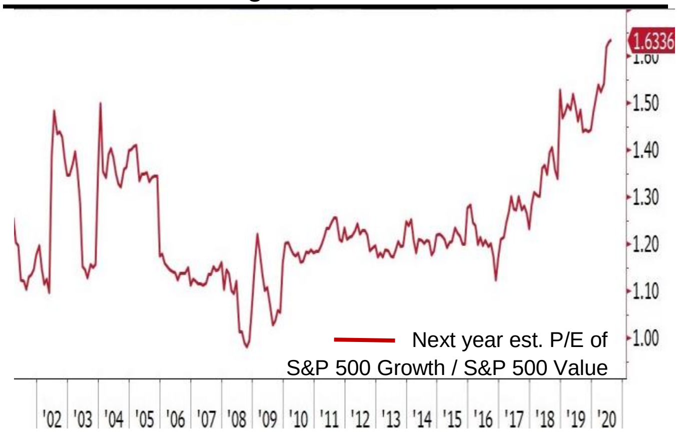
Source: Bloomberg, CMBIS

Figure 3: Hang Seng Composite industry indexes



Source: Bloomberg, CMBIS

Figure 4: S&P 500 Growth Index’s premium over Value Index is at highest in at least two decades



Source: Bloomberg, CMBIS

Fundamental catalysts

- **Upbeat economic data and rising yield**

Given that value stocks are more sensitive to economic recession/recovery, any positive surprise in economic data should boost their performance relative to growth stocks. This was the case when Dow Jones outperformed Nasdaq in late-May to early-Jun, coincident with the Citi U.S. Economic Surprise Index turning from negative to positive (Fig. 5), where a positive reading means data beat consensus. **Since early-Aug, there is a mild rebound in the U.S. Economic Surprise Index, supporting the case for rotation into value stocks.**

- **Rising inflation expectations and bond yields**

As recent economic data are better than expected, coupled with the ongoing QE by major central banks, **inflation expectations in the U.S. are swiftly rebounding** from the trough in Mar. U.S. Treasury yields usually move in tandem with expected inflation, but have been lagging behind in the past few months (Fig. 6). **If bond yields start catching up inflation expectations in near future, financials could lead value stocks higher**, as we will illustrate in Fig. 9 to Fig 11.

Figure 5: Value stocks tend to outperform on positive surprise in economic data

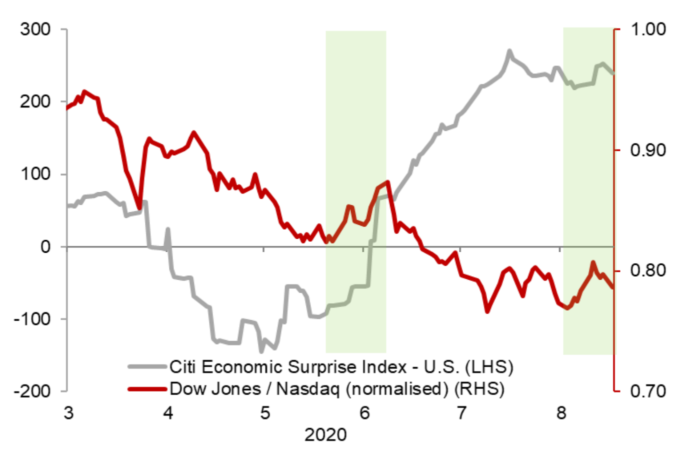


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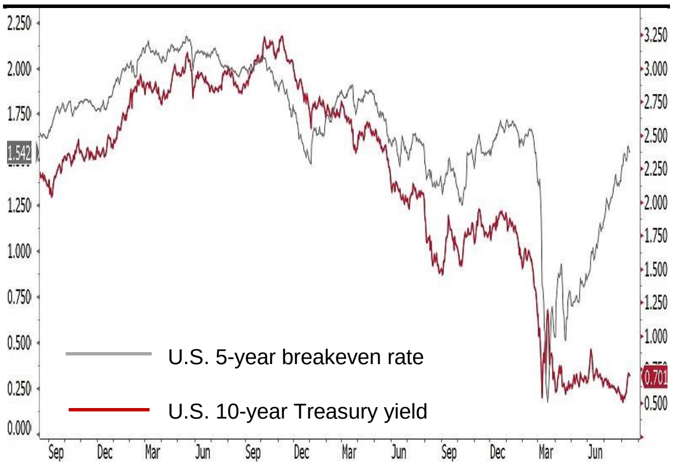
Figure 6: U.S. treasury yield lagging behind breakeven rates



Source: Bloomberg, CMBIS

Inflation readings in the U.S. are strongly rebounding since Jun, with both the headline CPI and core CPI beating consensus in Jun and Jul (Fig. 7 & 8).

Figure 7: U.S. CPI higher than consensus

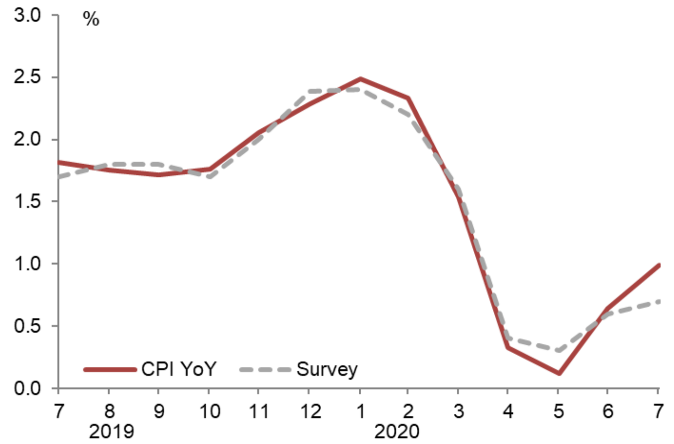


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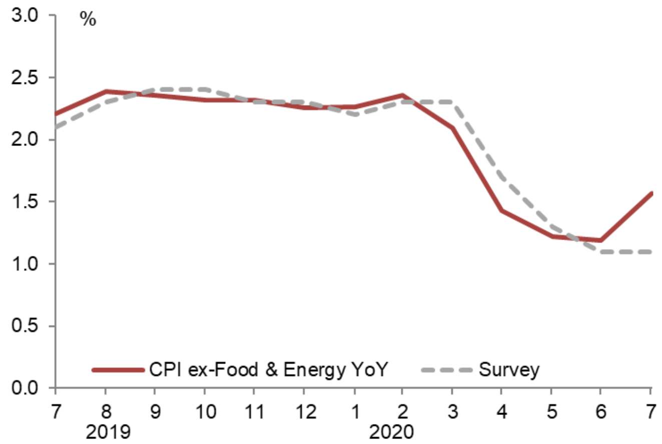
Figure 8: U.S. core CPI higher than consensus



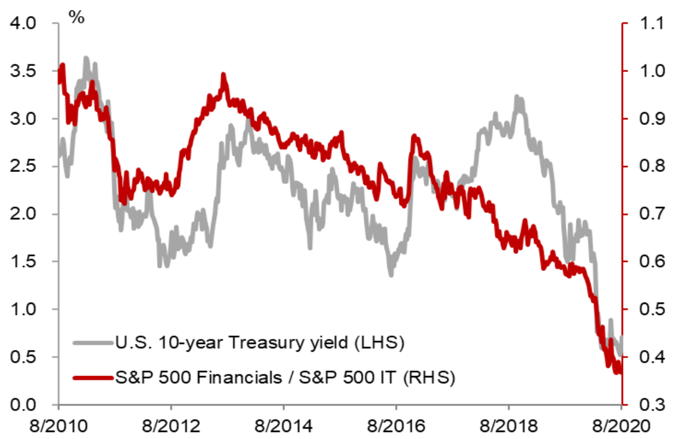
Source: Bloomberg, CMBIS

■ **Higher yields bode well for financials**

Financial stocks usually perform better when interest rates are rising, because 1) banks' NIM tend to widen; 2) insurers' investment returns in fixed income tend to rise; 3) rising rates reflect economic expansion, and financials are sensitive to the economy.

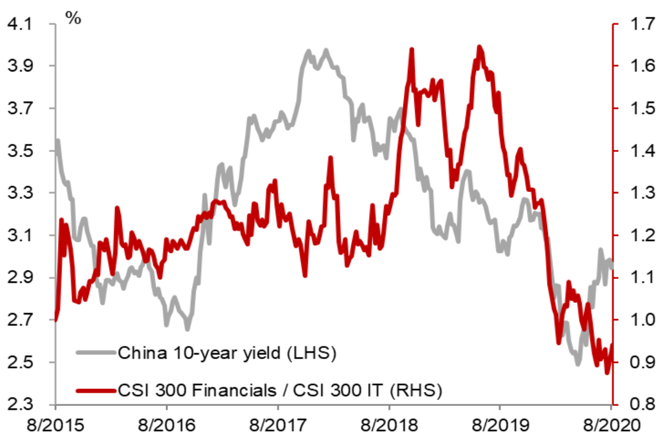
Over the past five to ten years, financial stocks' performance relative to tech did show positive correlation with bond yields in U.S., HK and mainland China markets.

Figure 9: U.S. financial stocks tend to outperform when bond yields rise



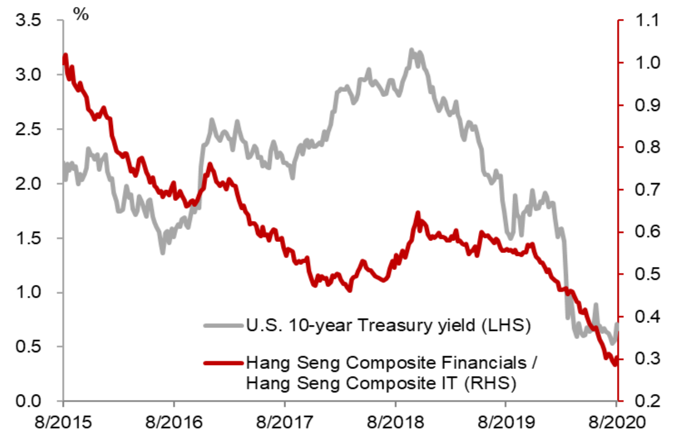
Source: Bloomberg, CMBIS

Figure 10: Chinese financial stocks tend to outperform when bond yields rise



Source: Bloomberg, CMBIS

Figure 11: HK financial stocks tend to outperform when bond yields rise

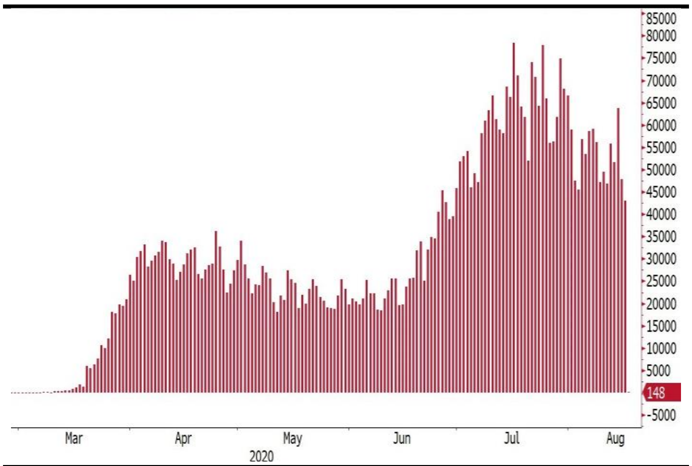


Source: Bloomberg, CMBIS

- **Positive news on COVID-19 and vaccines**

One of the reasons that the outperformance of value stocks in early-Jun did not last long was the rebound in COVID-19 cases in the U.S (Fig. 12). That second wave triggered worries about another dip in economic activities and reimplementation of lockdown measures, and therefore brought a premature end to value stocks' rally. Now, while the daily new cases in the U.S. are still uncomfortably high, at least the numbers are trending down.

Figure 12: U.S. daily new cases of COVID-19



Source: Bloomberg, CMBIS

Progress in vaccine development is another important driver for economic recovery and cyclical stocks. There have been several positive news on vaccines in the past two weeks:

- 11 Aug: Russia's President Putin announced approval of a coronavirus vaccine, Sputnik V, developed by the Gamaleya research institute, before phase 3 trials have even begun.
- 12 Aug: Pfizer and BioNTech published the preliminary, peer-reviewed data from BNT162 in the journal Nature.

- 13 Aug: CNBG (a subsidiary of Sinopharm Group) published the interim data of a phase 1/2 trial on an investigational inactivated whole-virus COVID-19 vaccine.

Our healthcare sector analyst expects that the first COVID-19 vaccine worldwide will be approved for commercial use by the end of 2020. Manufacturing of vaccines will be the next key issue, and we believe the capacity bottleneck will be gradually relieved through the course of 2021.

■ U.S.-China tension weighing on tech industry

The tension between U.S. and China continue to creep up, perhaps unsurprisingly, as investors have expected Trump's administration would play hard ball on China ahead of November's presidential election. On 8 Aug, U.S. President Donald Trump signed an executive order to stop U.S. firms from doing business with Chinese apps TikTok and WeChat. On 17 Aug, the U.S. Commerce Department announced fresh sanctions that restrict any foreign semiconductor company from selling chips developed or produced using U.S. software or technology to Huawei.

While heightened tension may bode ill for economic recovery and thus cyclical stocks, that the **recent disputes are primarily on tech industry may exert more pressure on tech stocks, prompting rotation out of this relatively expensive sector and into cheap cyclicals**.

Momentum of sector rotation

■ Relative Rotation Graph (RRG) confirms short-term rotation into cyclicals

Relative Rotation Graph (RRG) can be useful in gauging and forecasting sectors' relative momentum (**explanatory note* on the next page).

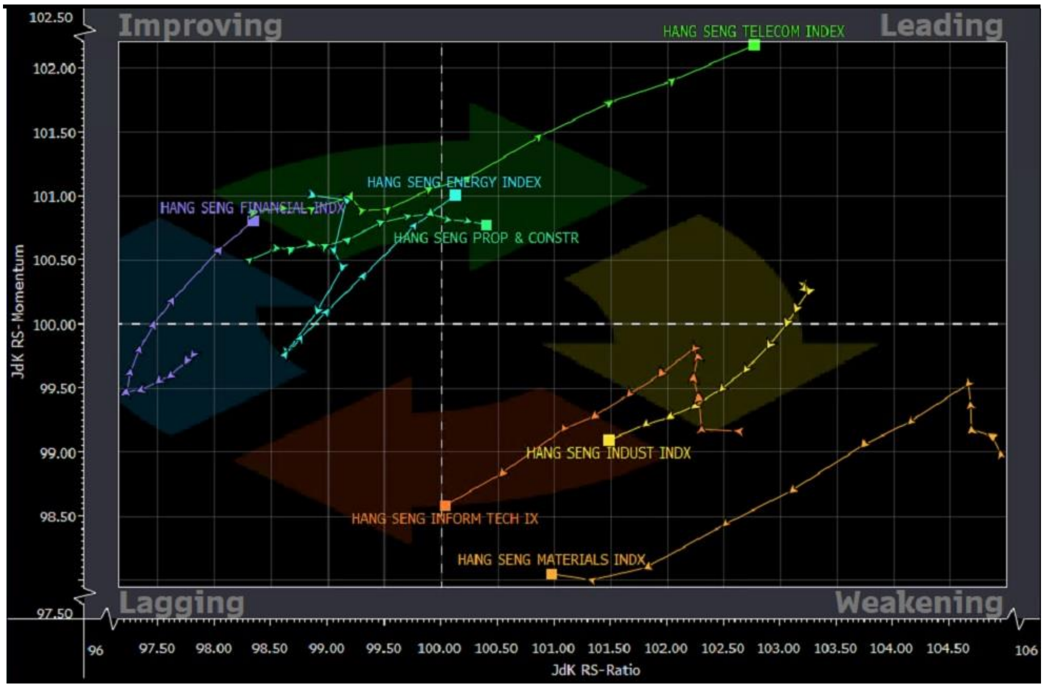
Fig. 13 shows that the Information Technology industry under Hang Seng Composite Index has been "weakening" over the past 12 days, and is on the brink of becoming a "lagging" sector. In contrast, **cyclical industries Energy and Properties & Construction have been "improving" and just become "leading" sectors, while Financials are still lagging but improving**.

Weekly chart (Fig. 14) shows a slightly different picture. While the momentum of the leading Information Technology industry is waning, it has not fallen into "weakening" yet. On the opposite, cyclical industries Energy, Properties & Construction and Financials are still lagging and not yet improving.

As far as HK market is concerned, the takeaways from daily and weekly charts are:

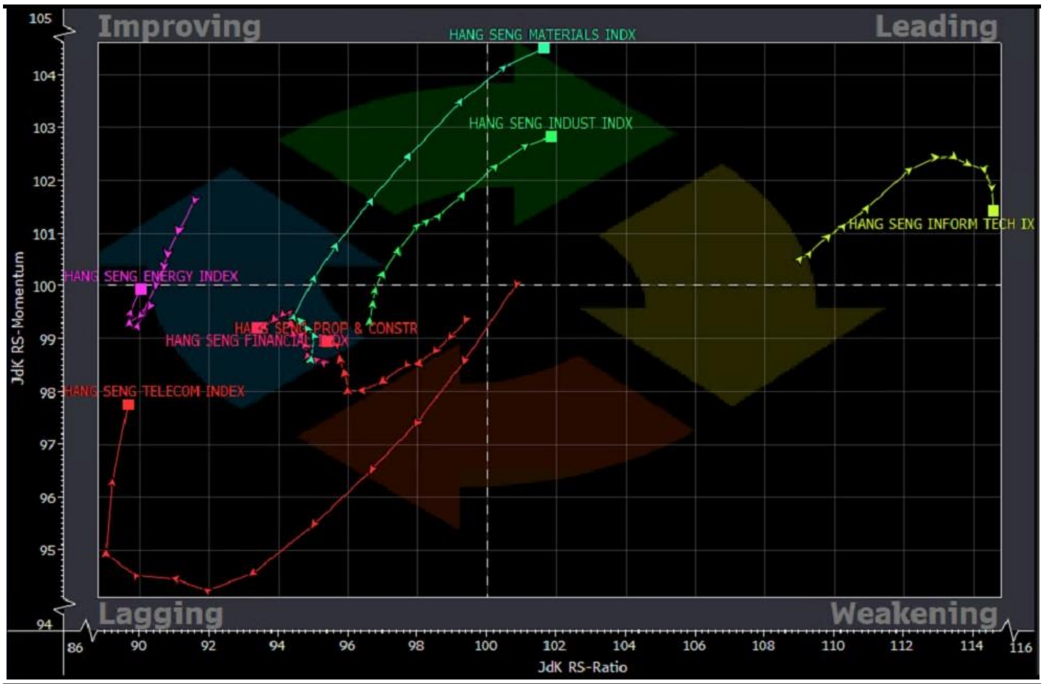
1) In the **short term**, there are clear signs of **sector rotation out of IT into cyclicals or value.**
2) In the **medium term**, however, **such sector rotation has not yet been confirmed.** We should not rule out the possibility of growth stocks keep outperforming value.

Figure 13: Daily RRG of Hang Seng Composite Index on 18 Aug



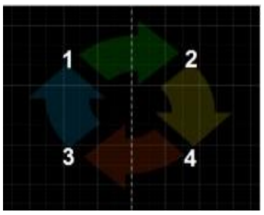
Source: Bloomberg, CMBIS

Figure 14: Weekly RRG of Hang Seng Composite Index on 18 Aug



Source: Bloomberg, CMBIS

**Explanatory note:*



1: Underperforming benchmark but momentum is UP

2: Outperforming benchmark and momentum is UP

3: Underperforming benchmark and momentum is DOWN

4: Outperforming benchmark but momentum is DOWN

Sectors tend to rotate clockwise on the graph

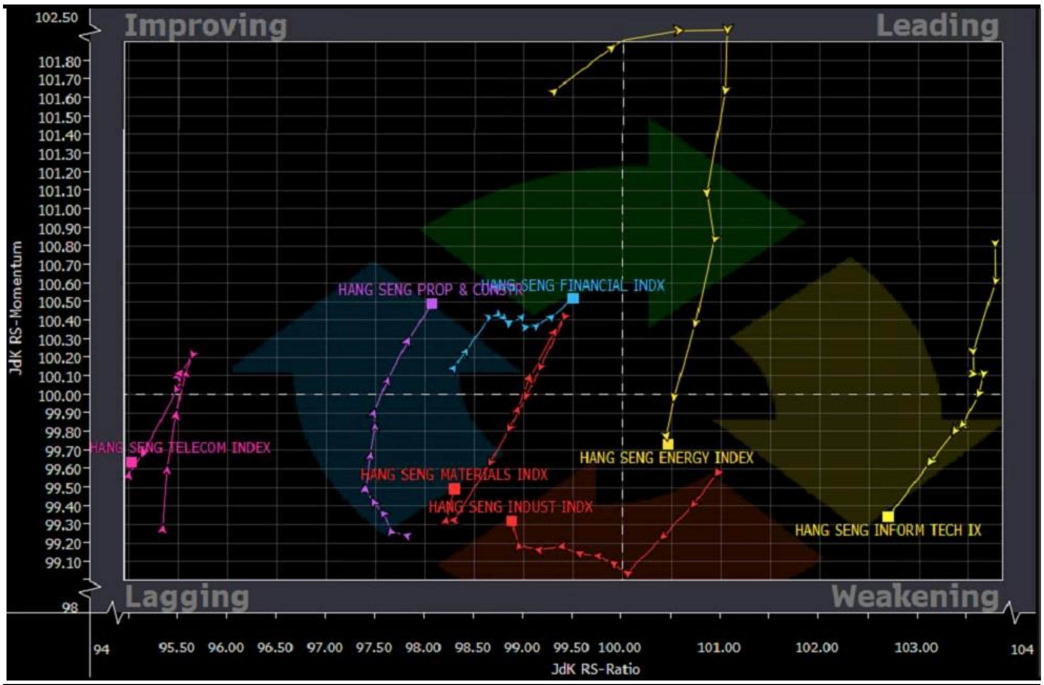
One may ask, **"How long will this sector rotation last for?"** Would it be as short-lived as the one in early-Jun? (three weeks in the U.S. and two weeks in HK)

To answer that question in the relative momentum perspective, we review the RRGs at the peak of that cyclicals' rally in Jun. There are two key differences compared to the ones on 18 Aug:

1) The daily RRG (Fig. 15) shows Information Technology was weakening in early-Jun, but was still by far the leading sector and a long way from becoming "lagging". Only two cyclical sectors were "improving", versus four on 18 Aug.
2) The weekly RRG (Fig. 16) shows Information Technology was still the clear leading sector, with all other sectors but energy in the weakest quadrant.

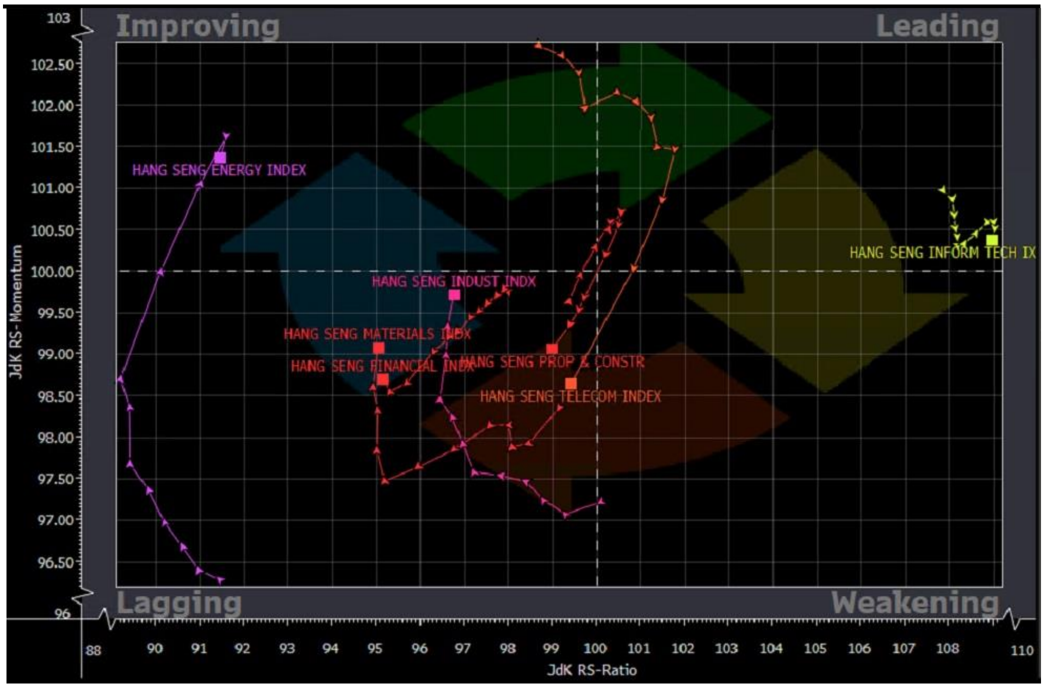
In short, the RRGs in early-Jun did not show clear signals of sector rotation from growth to value. **Now, the conviction of a sector rotation, at least in the short term, is higher.**

Figure 15: Daily RRG of Hang Seng Composite Index on 9 Jun



Source: Bloomberg, CMBIS

Figure 16: Weekly RRG of Hang Seng Composite Index on 9 Jun



Source: Bloomberg, CMBIS

Tactical strategy: shift to selected cyclical stocks

From the aforementioned fundamental and technical analysis, **we expect value/cyclical stocks to outperform growth stocks in the next few weeks.** How long would that last is highly uncertain though, depending on a number of key factors which we list below.

While we still like the secular outlook of growth stocks, in particular internet giants, we suggest making a tactical shift to certain cyclical sectors:

Figure 17: Sectors and stocks for tactical rotation

Sector	Company	Ticker	Rating	Target Price (Local Curr)
Insurance	CPIC	2601 HK	BUY	33.93
	China Life	2628 HK	BUY	24.95
	Ping An	2318 HK	BUY	96.06
Banking	Ping An Bank	000001 CH	BUY	19.80
	PSBC	1658 HK	BUY	6.30
	CEB	6818 HK	BUY	4.90
Brokerage	CITIC Sec	6030 HK	BUY	24.60
	CSC	6066 HK	BUY	15.30
	CICC	3908 HK	BUY	22.40
Property	China Aoyuan	3883 HK	BUY	15.48
	Country Garden	2007 HK	BUY	14.55
	Vanke	2202 HK	BUY	36.69
	Poly Development	600048 CH	BUY	22.16
Construction Machinery	Sinotruk	3808 HK	BUY	26.00
	Zhejiang Dingli	603338 CH	BUY	117.00
	SANY Heavy	600031 CH	BUY	24.70

Source: CMBIS

Key risks to our call

- **Catalysts**
  1. **Economic data** of China and the U.S. which beat consensus and point to a strong recovery should sustain the outperformance by value stocks.
  2. **Positive news on COVID-19**, e.g. significant drop in new confirmed cases in key countries, and further progress in vaccine development.
  3. **Further monetary easing by China**, as cyclical stocks react more to liquidity.
  4. **U.S.-China tech dispute**: the U.S. government further tightens bans and scrutiny on Chinese tech companies.

- **Risks:** The opposites of those catalysts.

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