September Monthly Strategy

Dovish Fed and weak USD to lift HSI

After moving sideways for two months, the HSI is more likely to go up in Sep, backed by a policy adjustment by the Fed, weak USD and strong CNY. The Fed's shift to average inflation target will probably make the yield curve steeper and the USD weaker. Financial and property stocks could benefit more from these factors.

- **Earnings season review: Financials overshadows internet.** Interim earnings have been disappointing in HK market, and the EPS estimates of the HSI have been revised down by 2.5%/1.4% for 2020/2021. Financial and property sectors have seen earnings cut post-result, while internet stocks reported upbeat results.
- **Fed's policy shift: average inflation target.** The FOMC announced on 27 Aug to update its policy goals. The most notable change is it would seek to achieve inflation that averages 2% over time. We believe that means inflation can stay moderately above 2% for several years before the Fed considers raising rates.
- **Market impact: Steeper yield curve, higher stock prices.** We expect the Fed's policy shift would make the U.S. long-term Treasury yield higher, yield curve steeper and stock prices higher, especially financial stocks which would enjoy a steeper yield curve.
- **Weak USD & Strong CNY.** The Fed's latest signal to keep interest rates on hold for years to come may extend the slide in USD. A weak USD usually bodes well for emerging market equities. The CNY strengthens against the USD, benefiting asset-heavy sectors like real estate and financials.
- **Technical Analysis: HSI next target 26,782.** YTD, the HSI has formed a triangle, and is on the verge of break out. Fundamental factors should make the break out more likely to be upwards than downwards. Once the HSI breaks 250-day MA at ~25,800, short-term target should be 26,782, the peak in early-Jul. Gold remains in uptrend after consolidation. Expect more upside in medium- to long-term as the Fed commits to low interest rates.
- **Strategy: Buy financials, property and internet giants.** The HSI is more likely to go up in Sep to break the narrow range. Financial and property stocks could benefit more from Fed policy shift, weak USD and strong CNY. Internet giants will probably play a part when the HSI rises further. Besides, we continue to like construction machinery stocks on increasing infrastructure spending by China.

Preferred sectors and stocks

Sector	Company
Insurance	China Life (2628 HK), CPIC (2601 HK)
Brokerage	CITIC Sec (6030 HK)
Property	China Aoyuan (3883 HK), A-Living (3319 HK)
Internet / Tech	Tencent (700 HK), FIT Hon Teng (6088 HK)
Construction Machinery	Zoomlion (1157 HK), Sinotruk (3808 HK)

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Market Data

Hang Seng Index	24,595
52-week High / Low	29,175/21,139
3-month avg. daily t/o	HK$141.7bn

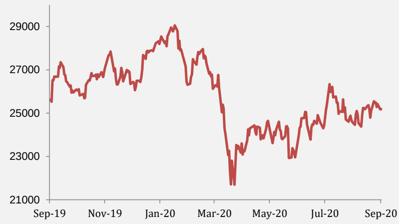
Source: Bloomberg

Indices Performance

	HSI	HSCEI
1-month	2.4%	-0.3%
3-month	6.1%	1.8%
6-month	-3.6%	-2.8%

Source: Bloomberg

12-month HSI Performance



Source: Bloomberg

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Contents

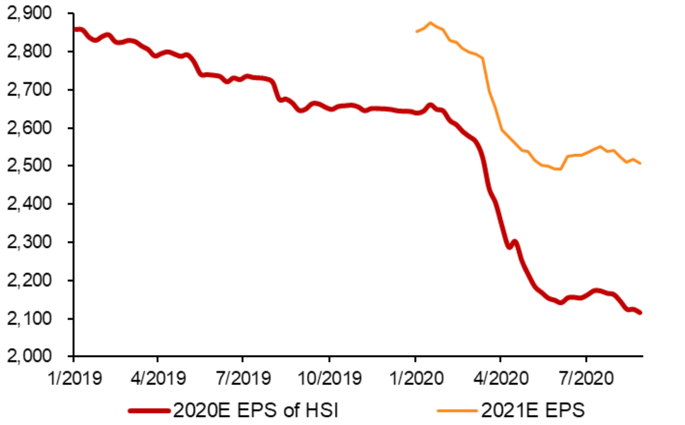
Earnings season review

Misses in Financials overshadows beats in Internet

The interim result season of the HK stock market has just come to an end. **Overall, earnings have been disappointing, and the EPS estimates of the HSI have been revised down by 2.5%/1.4% for 2020/2021.** This bucked the trend of earnings upgrade from early-Jun to mid-Jul (Fig. 1).

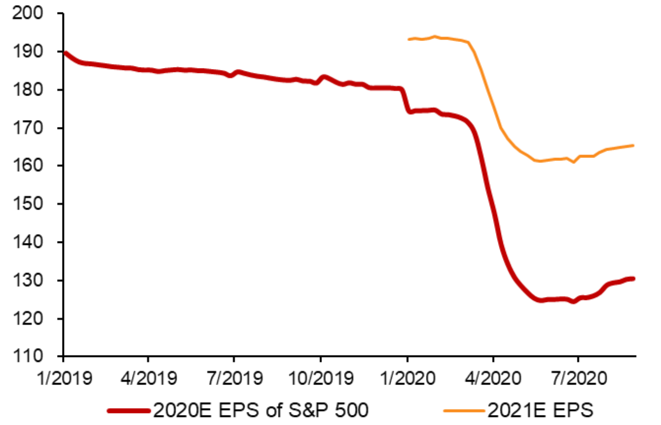
In comparison, U.S. stocks' EPS were being revised up since Jun and throughout the result season (Fig. 2). That partly explains why the S&P 500 keeps rising and setting record high.

Figure 1: Estimated EPS of the HSI



Source: Bloomberg, CMBIS

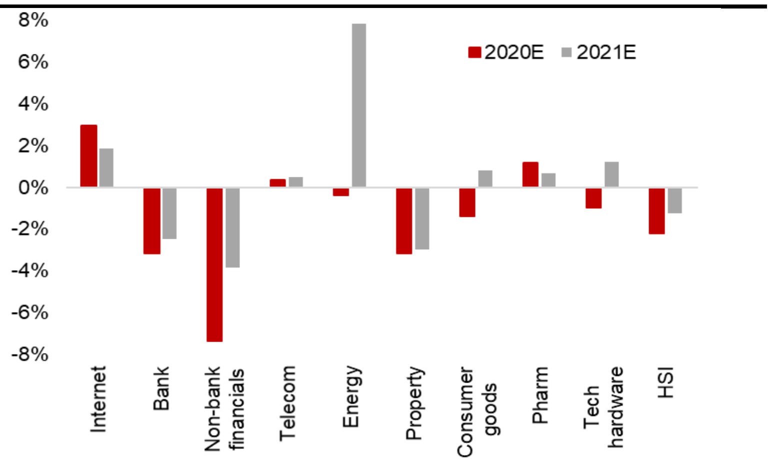
Figure 2: Estimated EPS of the S&P 500



Source: Bloomberg, CMBIS

To be fair, not all sectors reported disappointing results. We reviewed the changes in market consensus earnings of the 47 HSI constituent stocks which reported interim results for the six months ended 30 Jun (Fig. 3**). Internet stocks (e.g. Tencent (700 HK)) reported upbeat results**, followed by pharm and telecom. By contrast, **financial and property sectors have seen earnings cut** post-result, and having a combined ~50% weight in the HSI, they are the main drag on the index's earning forecast.

Figure 3: Changes in consensus EPS of HSI constituents in Aug



Source: Bloomberg, CMBIS

** include new HSI constituents which will be effective from 7 Sep, e.g. Alibaba (9988 HK) included in "Internet" sector*

Fed's policy shift

Average inflation target

The Federal Open Market Committee (FOMC) announced on 27 Aug to update its Statement on Longer-Run Goals and Monetary Policy Strategy. There are two key changes to its "dual mandate", i.e. goals of price stability and maximum employment:

- On maximum employment, the FOMC emphasises that maximum employment is a broad-based and inclusive goal and reports that its policy decision will be informed by its "**assessments of the *shortfalls* of employment from its maximum level**." The original document referred to "*deviations* from its maximum level."
- On price stability, the FOMC adjusted its strategy for achieving its longer-run inflation goal of 2% by noting that it "**seeks to achieve inflation that *averages* 2% over time**."

Federal Reserve Chair Jerome Powell elaborated in his speech on 27 Aug:

- "**Employment can run at or above real-time estimates of its maximum level without causing concern**, unless accompanied by signs of unwanted increases in inflation or other risks that could impede the attainment of our goals."
- "Following periods when inflation has been running below 2%, appropriate monetary policy **will likely aim to achieve inflation moderately above 2% for some time**."

Implication on Fed policy

■ **Inflation can stay above 2% for several years**

Before the changes, one would expect the FOMC to consider raising interest rates when maximum employment is reached or inflation returns to/exceeds 2%. After the changes:

1) Employment running at or even above maximum level would be perfectly fine as long as that does not cause inflation concerns, and
2) Inflation rising to above 2% would not necessarily trigger rate hikes, and is actually welcomed as long as the long-term average inflation still runs at below 2%.

The U.S. Core Personal Consumption Expenditure (PCE) YoY, the Fed's preferred inflation gauge, languished below its 2% target ever since the financial crisis in 2008 (Fig. 4). While the Fed has not specified how to calculate the average inflation over time, we believe **inflation can stay moderately above 2% for several years to bring the average to its 2% target**, before the Fed considers raising rates.

As for the labour market, unemployment rate is still above 10% due to the COVID-19 pandemic (Fig. 5). While the number should drop rapidly once the pandemic is under control, it is very unlikely to return to "maximum employment" in foreseeable future, let alone to levels which would prompt the Fed to consider rate hikes under the new policy.

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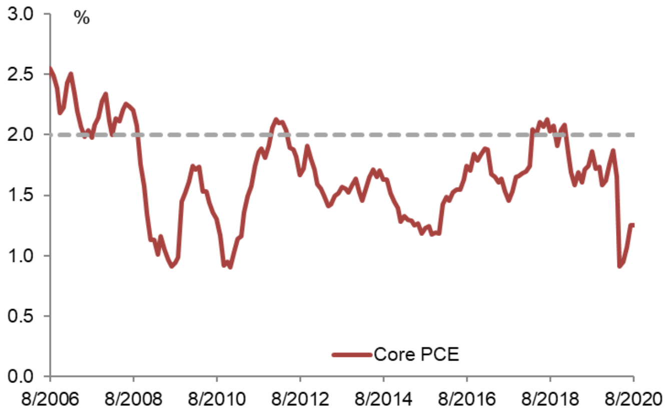
Figure 4: Fed's inflation gauge remained below 2%



Source: Bloomberg, CMBIS

Figure 5: Employment long way off "maximum"

Source: Bloomberg, CMBIS

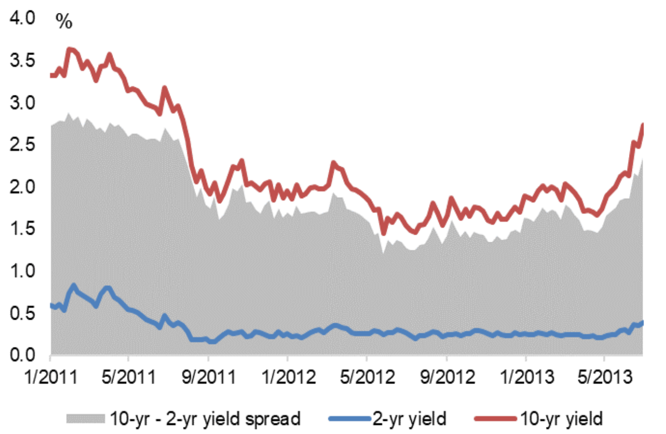
■ Yield curve may steepen - opposite to Operation Twist

As the Fed becomes more tolerant of inflation running above 2% and, in our view, in effect pledges to refrain from raising rates for years to come (at least beyond 2022), that should cause short-term yields to stay low while medium- and long-term yields should rise along with inflation expectations. That is, **the U.S. yield curve should steepen**.

This may be the opposite to what happened during "Operation Twist". Recall that the Fed implemented Operation Twist (OT) from Sep 2011 to Dec 2012. The plan was to purchase bonds with maturities of 6 to 30 years and to sell bonds with maturities less than 3 years, thereby putting downward pressure on long yields without expanding the Fed's balance sheet further. **During the OT period, the U.S. yield curve flattened,** with the 10-year and 2-year Treasury yield spread shrinking from 1.66% to as low as 1.17% (Fig. 6). This shows the Fed's policy did influence the yield curve. We expect the latest changes to the FOMC goals would again affect the yield curve, but in the opposite fashion making it steeper.

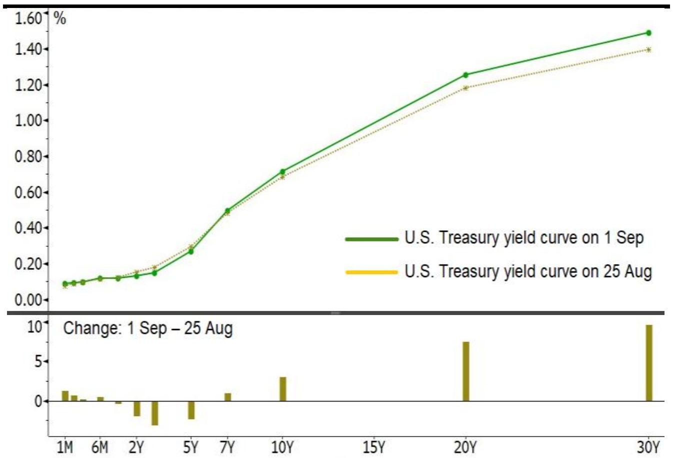
After the aforementioned changes in FOMC goals, the U.S. Treasury yield has already been steepening, with 1-year to 5-year yields going down, possibly pricing in no hike in Fed funds rate in the next few years, and 7-year to 30-year yields going up, reflecting higher long-term inflation outlook (Fig. 7).

Figure 6: U.S. yield spread during Operation Twist



Source: Bloomberg, CMBIS

Figure 7: U.S. yield curve steepens after Fed shift



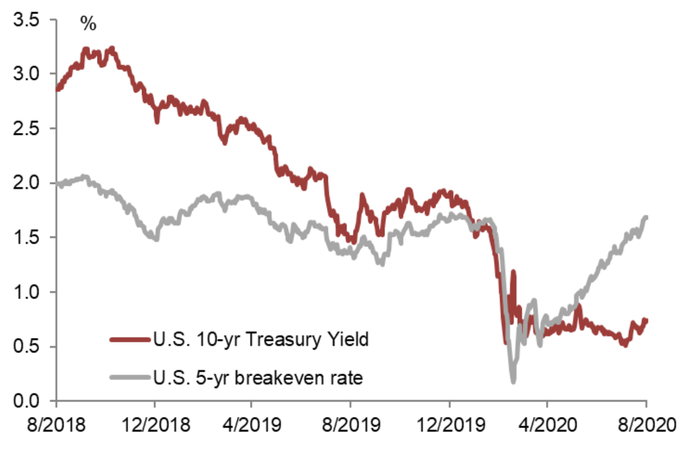
Source: Bloomberg, CMBIS

Implication on market

■ Higher long-term Treasury yield

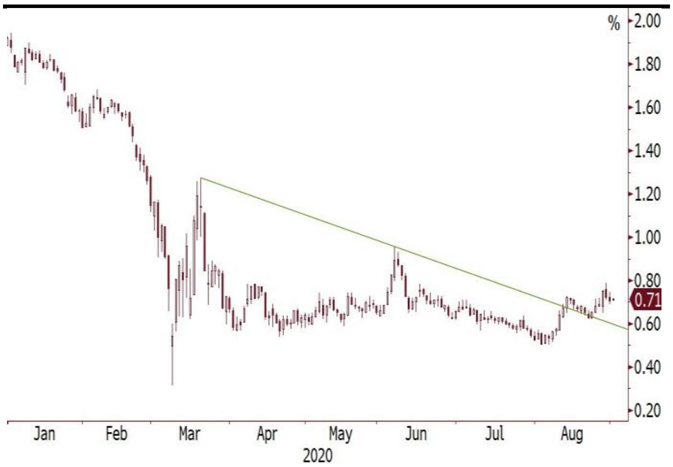
The U.S. breakeven rate, a gauge of inflation expectation, has been rebounding sharply since the Fed launched unlimited QE in Mar in response to the pandemic-induced market crash (Fig. 8). Treasury yield has been lagging behind, but creeping up over the past few weeks to break a downtrend (Fig. 9). As the Fed has signalled a shift in policy goals, long-term Treasury yield should rise further along with inflation expectations.

Figure 8: Inflation expectation rebounding sharply



Source: Bloomberg, CMBIS

Figure 9: 10-year Treasury yield broke downtrend



Source: Bloomberg, CMBIS

■ Bodes well for equities, especially financials

Interest rates to stay near zero for a longer period is positive to risky assets including equities. By sector, cyclical sectors should be given a bigger boost as they are more sensitive to economic recovery propelled by monetary easing. **While financials typically do not thrive on low rates, this time could be different as the yield curve is expected to steepen, thereby lifting banks' NIM and insurers' investment yields**.

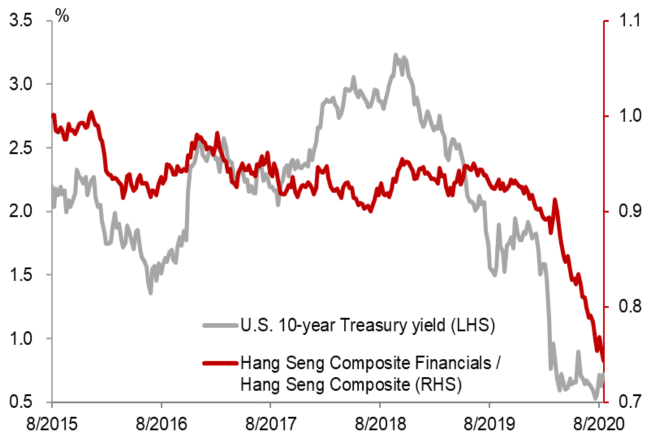
Fig.10, 11 & 13 show that financial stocks tend to outperform the broad market when bond yields rise. The correlation is stronger in the U.S. market than in mainland China and HK.

This is not to say financial sector will outperform as long as the yield curve steepens. Its long-term performance may be limited by a lack of growth, stringent regulations, structural changes, etc. But given that financials stocks have already significantly underperformed YTD, a steepening yield curve could be a re-rating catalyst in short- to medium- term.

Figure 10: U.S. financial stocks tend to outperform when bond yields rise

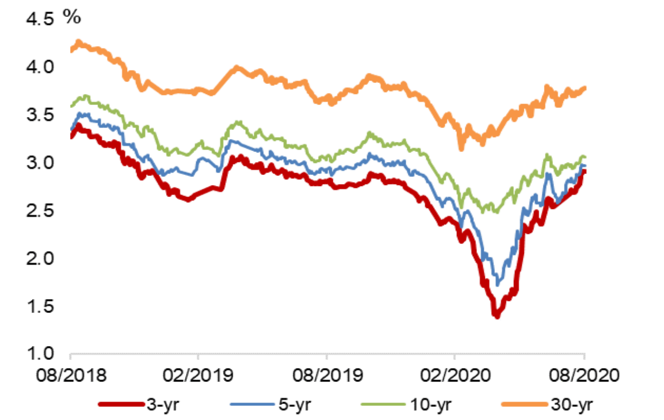
Source: Bloomberg, CMBIS

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



Source: Bloomberg, CMBIS

Figure 12: China's gov't bond yields rebounded



Source: Bloomberg, CMBIS

Figure 13: Chinese financial stocks tend to outperform when bond yields rise

Source: Bloomberg, CMBIS

Weak USD & Strong CNY

USD weakens on dovish Fed

The USD has been in a remarkable 10%-depreciation trend since Mar, coinciding with the Fed's announcement of unlimited QE and the stock market's bottoming out. As the Fed expands its balance sheet more aggressively than other major central banks, coupled with a waning risk aversion, the Dollar Index slides. The Fed's latest signal to keep interest rates on hold for years to come may extend the slide in dollar.

Fig. 14 shows the Dollar Index is on the verge of breaking its 10-year uptrend support. The next support is at 88.2, the "double top" neckline. A weak USD usually bodes well for equities, especially emerging markets.

Strong CNY bodes well for financial and property stocks

As the USD weakens, it is no surprise that the Renminbi (CNY) strengthens against the USD. Fig. 15 shows that CNY is even stronger in terms of short-term momentum, with the USD/CNY dropping below the medium-term uptrend and “double top” neckline already. The next target of CNY could be 6.69, the low in early-2019.

Figure 14: USD weakens

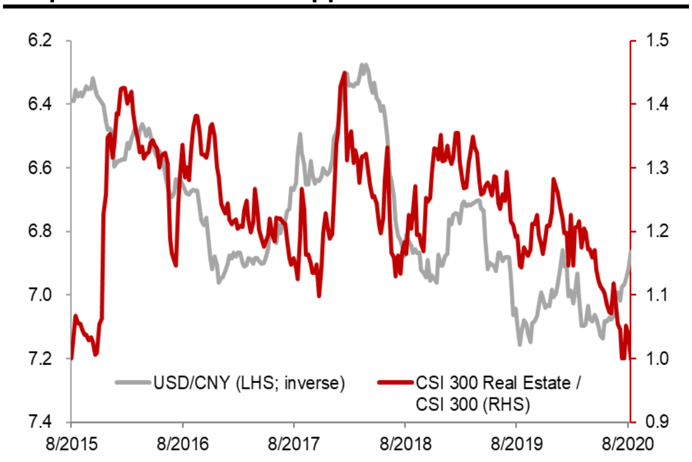
Source: Bloomberg, CMBIS

Figure 15: CNY strengthens

Source: Bloomberg, CMBIS

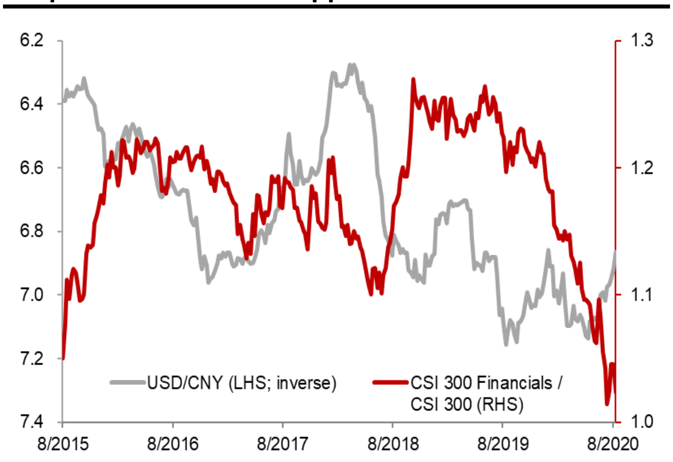
Asset-heavy sectors, i.e. real estate and financials, should benefit most from CNY appreciation**.** Real estate A-shares’ relative performance showed strong correlation with CNY (Fig. 16). Financial A-shares’ also showed positive correlation but to a lesser extent (Fig. 17).

Figure 16: Chinese property stocks tend to outperform when CNY appreciates



Source: Bloomberg, CMBIS

Figure 17: Chinese financial stocks tend to outperform when CNY appreciates



Source: Bloomberg, CMBIS

Technical Analysis

- **HSI next target at 26,782**

For the best part of Jul and Aug, the HSI whipsawed in a range of mere 2,000 points, stuck between 100-day MA and 250-day MA (Fig. 18). YTD, the HSI has formed a triangle, and is on the verge of break out.

Fundamental factors including Fed's pledge of zero interest rates for a longer term, a weak USD, a strong CNY, and ongoing moderate recovery in China's economy, should make the break out more likely to be upwards than downwards. Once the HSI breaks 250-day MA at ~25,800, short-term target should be 26,782, the peak in early- Jul.

Longer term, the HSI has formed another triangle (Fig. 19). Expect strong resistance at the top of the triangle at ~27,400 in the medium term.

Figure 18：HSI yet to break 250-day MA resistance

Source: Bloomberg, CMBIS

Figure 19：HSI medium-term downtrend resistance ~27,400

Source: Bloomberg, CMBIS

Tech giants lead gains but market breadth narrowing

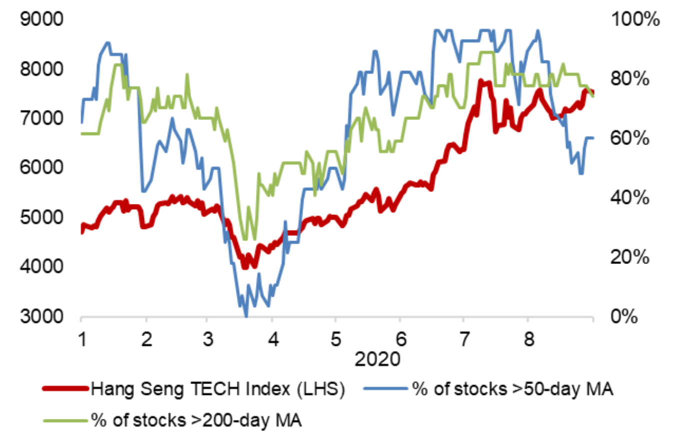
Tech stocks continue to grab the headlines in recent weeks, as the Nasdaq keeps setting record high, while in HK the "ATMX" (Alibaba, Tencent, Meituan, Xiaomi) all set record highs in Jul and Aug.

While the mega tech stocks in HK remained strong, the strength in the tech sector is not very broad-based, with some other tech stocks showing weakness. This can be seen in the market breadth of the Hang Seng TECH Index (Fig. 20). As the TECH Index is revisiting its record high in Jul, the percentage of constituent stocks above 50-day MA fell to below 60%. Not exactly a bearish signal yet, but it warrants caution on second-tier/mid-cap tech stocks. **Be selective. Pick only those with sound fundamentals and good interim results.**

Gold remains in uptrend after consolidation

Golds had a wild ride in Jul and Aug, spiking to record high and then retreated by 10%. It remains above this year's uptrend, and break out the short-term downtrend resistance (Fig. 21). Expect more upside in medium- to long-term as the Fed commits to low interest rates.

Figure 20: Market breadth of Hang Seng TECH



Source: Bloomberg, CMBIS

Figure 21: Gold price broke downtrend

Source: Bloomberg, CMBIS

Strategy: Buy financials, property and internet giants

We believe **the HSI is more likely to go up in Sep to break the recent narrow range, backed by a policy adjustment by the Fed, weak USD and strong CNY**. While these factors should benefit the broad market, **financial and property stocks could benefit more**. As "old-economy stocks", they have long underperformed growth stocks, and these positive factors may serve to be re-rating catalysts in the short term.

Internet giants, being the undisputed leaders in the rally since Mar, will probably play a part when the HSI rises further. But note that the internet/tech/biotech sector is starting to show mixed performance. Brace yourself for pullbacks in stocks with less solid fundamentals and rich valuations.

Besides, we continue to like construction machinery stocks, as they are still in solid upcycles, and would continue to benefit from increased infrastructure spending by China's government.

Figure 22: Preferred sectors and stocks

Sector	Company	Ticker	Rating	Target Price (HK$)
Insurance	China Life	2628 HK	BUY	28.14
	CPIC	2601 HK	BUY	33.22
Brokerage	CITIC Sec	6030 HK	BUY	24.60
Property	China Aoyuan	3883 HK	BUY	15.48
	A-Living	3319 HK	BUY	60.70
Internet / Tech	Tencent	700 HK	BUY	624
	FIT Hon Teng	6088 HK	BUY	4.10
Construction Machinery	Zoomlion	1157 HK	BUY	11.20
	Sinotruk	3808 HK	BUY	28.30

Source: CMBIS

Key risks

1. **U.S.-China relations: Tension might escalate ahead of November's Presidential Election. In particular,** the U.S. government might further tighten bans and scrutiny on Chinese tech companies.

2. **COVID-19:** New cases in Europe is on the rise again. If there are significant rise in new cases in China/HK/U.S., stocks markets in general and especially cyclical sectors would get hit.

3. **Rebound in USD:** Having depreciated steeply recently, the dollar might stage technical rebound anytime, especially if U.S. economic data beat or any Fed officials give not-so-dovish comments.

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