February Monthly Strategy

Follow the tide

Southbound net buying remained strong even on days of correction in HK stock market. While the valuation of the HSI is near decade-high, and market volatility would stay elevated, we believe the recent concerns over PBoC tightening is overdone, and expect HK market to maintain momentum in the short term.

- **Southbound buying helped HK market outperform.** HK stock market was among the best performing in the world YTD. In Jan 2021 alone, Southbound net buying is equivalent to 46% of the amount in the full year 2020. Policy is a main driving force behind the surge in Southbound trading, as Mainland annuities funds are now allowed to invest in HK stocks through Stock Connect.
- **China tightening not a major concern yet.** The HSI retreated sharply for four consecutively days by a total 6.2% during 26-29 Jan, due to fears over liquidity tightening by the PBoC. Considering that China's economy is showing some signs and risks of slowing down in Q1 2021, it is rather unlikely for policymakers to tighten monetary policy now. PBoC governor Yi Gang said last week the central bank would not exit supportive measures prematurely.
- **Reality check on valuation.** While approvals of HK-stock annuities funds and surge in newly issued mutual funds in the PRC certainly help raise Mainlanders' interest in HK stocks, the HSI is no longer cheap, trading at 13.1X of 2021E P/E, near decade-high. H-shares, however, still look attractive versus A-shares which are trading at 36% premium. Expect valuations of Hong Kong stocks to expand further moderately, with market turnover and volatility elevated, and corrections may occur more often.
- **Preferred sectors: Internet, Consumer, Financials.** In the short term, follow the tide, overweigh Internet sector which is sought-after by Mainland investors. With the "Two Sessions" of CPC (兩會) coming in early-Mar, policy-supportive sectors may outperform. We like Consumer, and suggest buying Solar glass sector on dip. In the medium term, we like financials (Insurance and Brokerage sectors) which are undervalued, lagging behind, and could enjoy re-rating on buoyant stock markets and higher bond yields.
- **Tactical idea: potential new Southbound stocks.** With Southbound inflows expected to remain strong in coming weeks, the half-yearly index review on the HSCI on 26 Feb 2021 warrants extra attention, as that will determine most of the changes in Southbound eligible stocks. We listed 20 stocks that may become Southbound-eligible.
- **Key risks:** 1) PRC policy to cool stock markets. If HK market shows signs of overheating or Mainland investors become too speculative, policymakers might cool the market by verbal warning or suspend approval of HK equity funds; 2) USD rebound. On chart, the USD is on the verge of a breakout of downtrend which may indicate further upside and exert pressure on EM stock.

Daniel So, CFA
(852) 3900 0857
danielso@cmbi.com.hk

Market Data

Hang Seng Index	29,249
52-week High / Low	30,191/21,139
3-month avg. daily t/o	HK$182.4bn

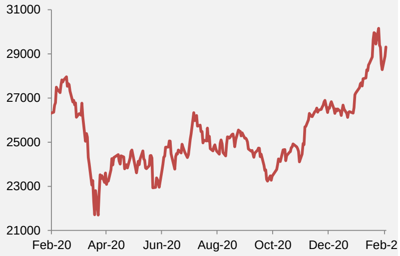
Source: Bloomberg

Indices Performance

	HSI	HSCEI
1-month	7.4%	8.1%
3-month	19.6%	16.8%
6-month	18.9%	15.6%

Source: Bloomberg

12-month HSI Performance



Source: Bloomberg

Related Reports

1. Strategy Report – Southbound inflows lift H-shares – 21 Jan 2021
2. Strategy Report – Keep faith in value stocks – 5 Jan 2021
3. 2021 Strategy Report –HSI targets 30,000 on post-pandemic recovery – 10 Dec 2020
4. Strategy Report – Start of the end of the pandemic? – 10 Nov 2020
5. Strategy after U.S. Election: Buy on dips in case of contested election – 5 Nov 2020
6. Strategy Report – Favour visibility amid uncertainties – 6 Oct 2020
7. Strategy Report – Dovish Fed and weak USD to lift HSI – 2 Sep 2020
8. Strategy Report – Tactical sector rotation to cyclicals – 19 Aug 2020
9. Strategy Report – Policy-driven stocks to beat range-bound HSI – 3 Aug 2020
10. 2H Outlook – Growth stocks continue to outperform – 2 Jul 2020

Contents

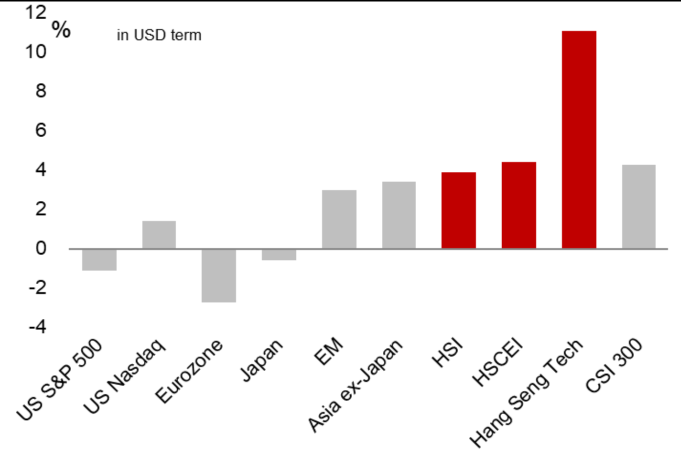
Southbound trading surged 3
China tightening not a major concern yet 3
Reality check on valuation 5
Preferred sectors: Internet, Consumer, Financials 6
New Southbound stocks 7
Key risks 8

Southbound trading surged

Hong Kong stock market has been the best performing among major markets world-wide YTD (Fig. 1), thanks to strong buying from Mainland investors through Stock Connect. In Jan 2021, Southbound net buying amounted to HK$311 bn, a 1,013% increase YoY (to be fair, there were only 14 Southbound trading days in Jan 2020 due to Chinese New Year). In year 2020, Southbound net buying totalled HK$672 bn. In other words, **in Jan 2021 alone, Southbound net buying is equivalent to 46% of the amount in the full year 2020** (Fig. 2). Such is the sheer jump in Southbound buying force.

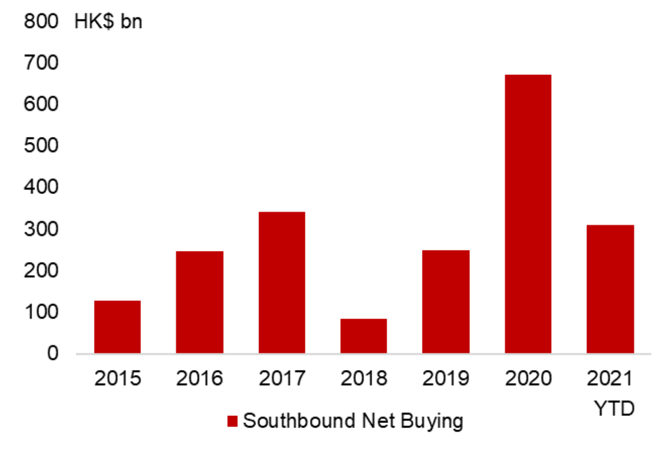
Policy is a main driving force behind the surge in Southbound trading. At the end of 2020, PRC government (Ministry of Human Resources and Social Security) revised rules to allow annuities funds, which form part of the country's retirement system, to invest in Hong Kong equities through Stock Connect effective from 1 Jan 2021. Before the change, annuities funds were only allowed to invest in onshore assets. Recently five HK equity annuities funds have been approved by regulators.

Figure 1: HK stocks outperformed in Jan 2021



Source: Bloomberg, CMBIS

Figure 2: Southbound buying surged in Jan 2021



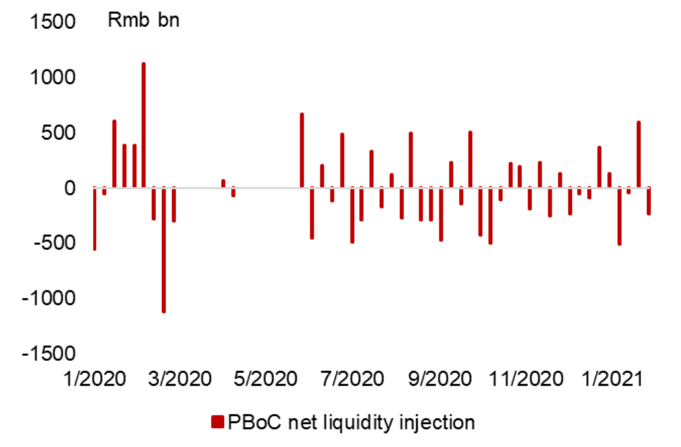
Source: Wind, CMBIS

China tightening not a major concern yet

After briefly breaking through the 30,000 level, the Hang Seng Index retreated sharply for four consecutively days by a total 6.2% during 26-29 Jan. In addition to the fact that the HSI was severely overbought, fears over liquidity tightening by the People's Bank of China (PBoC) was a major trigger of the correction.

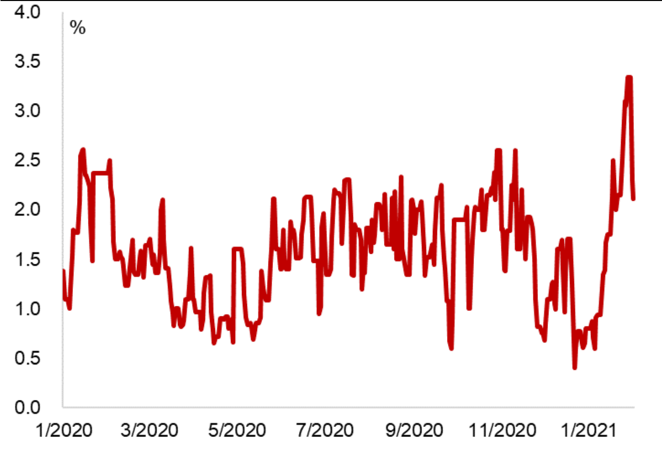
During 25-28 Jan, the PBoC drained RMB 568.5bn of liquidity through open market operations (Fig. 3). Interbank rates spiked throughout Jan, before coming down in the first two days of Feb. However, short-term liquidity draining is not uncommon even during the past 12 months when the economy was hit by COVID-19. It is premature to conclude that monetary policy is tightening based on only a few days of open market operations.

Figure 3: PBoC draining liquidity is not uncommon



Source: Bloomberg, CMBIS

Figure 4: China 1-day interbank repo rate

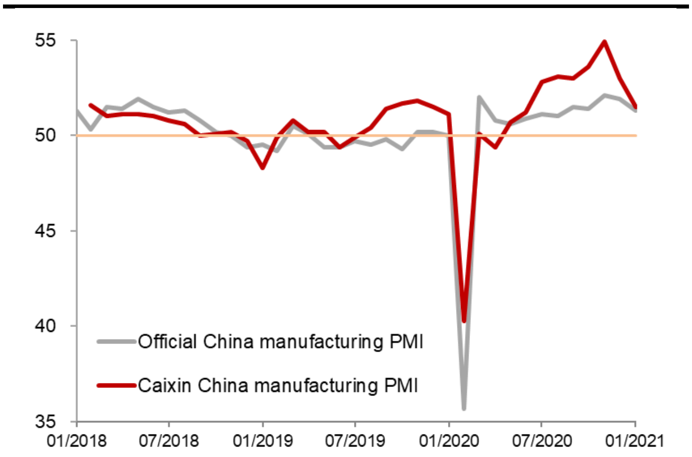


Source: Bloomberg, CMBIS

Considering that China's economy is showing some signs and risks of slowing down in Q1 2021, it is rather unlikely for policymakers to tighten monetary policy now. For instance, China manufacturing PMIs have trended down for two consecutive months (Fig. 5). COVID-19 new cases have been rebounding since the beginning of this year (Fig. 6), albeit mainly in a few provinces. Stricter virus prevention measures are likely to slow down economic growth in Q1 on a sequential basis.

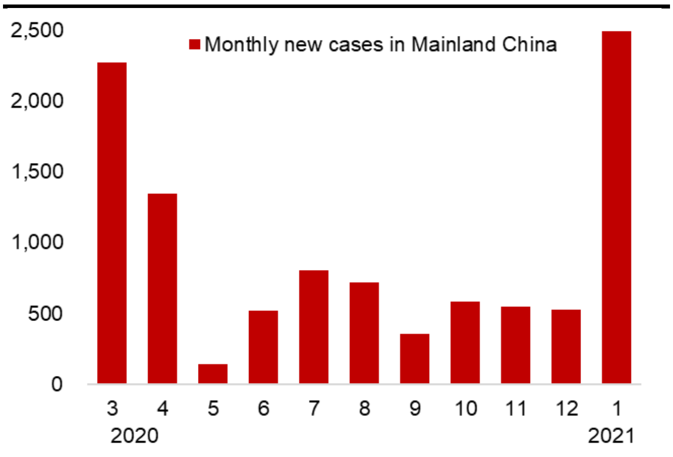
PBoC governor Yi Gang said on 26 Jan in the World Economic Forum in Davos that the central bank would ensure monetary policy is stable and consistent, and **would not exit supportive measures prematurely**.

Figure 5: China PMI dropped for two straight months



Source: Bloomberg, CMBIS

Figure 6: COVID-19 new confirmed cases rebound



Source: Bloomberg, CMBIS

Reality check on valuation

It is the same old story about Mainland money flowing to HK stock market. The widely cited rationales are:

1) H-shares are much cheaper than their A-shares counterparts;

2) "Scarcity" (稀缺性) in some HK stocks which are absent in A-shares market, most notably internet giants like **Tencent (700 HK)** and multinational companies such as **AIA (1299 HK)**;

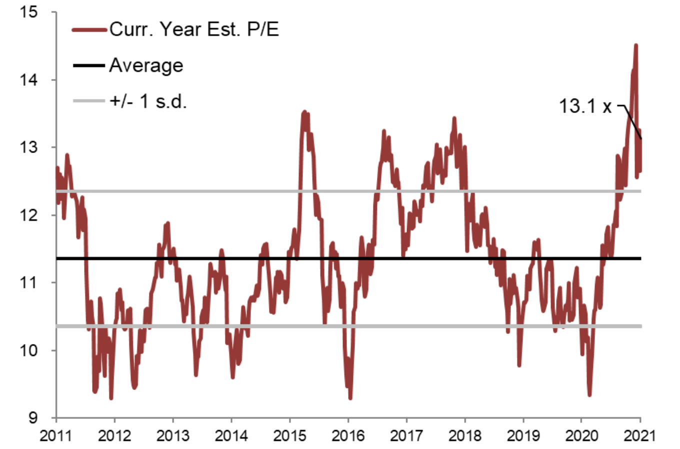
3) Expectation of new source of funds to invest in HK, e.g. "HK-stock Through Train" scheme in 2H 2007, and mutual funds to invest through Stock Connect in Q2 2015.

One should note that the first two of the abovementioned "reasons" to buy HK stocks have almost always been there, i.e. H-shares have for most of the time traded at discount to A-shares (average ~20% for the past ten years), and there is always "scarcity" in some HK stocks.

Rational investors should ask "why now?" Did investors overlook but now suddenly realise the discount and scarcity in HK stocks? Unlikely. While we acknowledge that approvals of HK-stock annuities funds and surge in newly issued mutual funds in the PRC certainly help raise Mainlanders' interest in HK stocks, valuation would be an important factor to judge how far can HK stocks go.

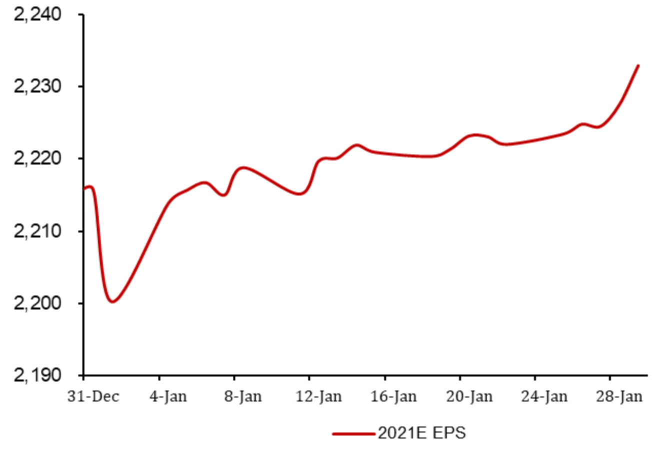
Broadly speaking, HK stocks are no longer cheap. The HSI is trading at 13.1X of 2021E P/E, near decade-high (Fig. 7). On a positive note, earnings estimates are moderately trending up YTD (+0.8% in Jan) (Fig. 8). If the upcoming earning season beats consensus, earnings estimates might be revised upwards, somewhat driving down forward P/E.

Figure 7: HSI valuation near decade-high



Source: Bloomberg, CMBIS

Figure 8: HSI est. earnings moderately trending up



Source: Bloomberg, CMBIS

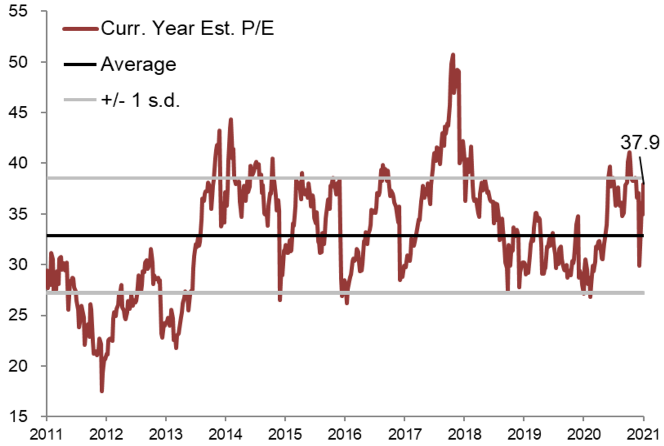
On a relative basis, **H-shares do still look attractive versus A-shares** which are trading at 36% premium (Fig. 9). But if H-shares continue to outperform and A-H premium edges back to historical average, such attractiveness should wane gradually.

If we single out the most sought-after, “scarcity” stocks in HK market, how is the valuation? Take **Tencent (700 HK)** as an example as it has the longest listing history among internet giants. It is trading at 37.9x 2021E P/E (Fig. 10), 1 s.d. above 10-year average. Not cheap but not yet frothy. In Q2 2015 when HK stocks were buoyed by optimism on Southbound buying, Tencent’s valuation peaked at similar levels. But with Southbound trading’s influence higher than in 2015 (indicated by Southbound trading as a % of market turnover), Tencent and other internet giants’ valuations could be pushed up further.

Figure 9: H-shares are still relatively attractive

Source: Bloomberg, CMBIS

Figure 10: Tencent’s fwd P/E 1 s.d. above average



Source: Bloomberg, CMBIS

In short, expect valuations of Hong Kong stocks to expand further moderately, with market turnover and volatility elevated. Corrections may occur more often, as investors may become more sensitive to negative news.

Preferred sectors: Internet, Consumer, Financials

In the short term, we suggest to follow the tide, overweighing Internet sector which is one of the most sought-after by Mainland investors.

With the “Two Sessions” of CPC (两会) coming in early-Mar, **policy-supportive sectors may outperform**. We like **Consumer sector**, which would also benefit from the ongoing economic recovery. We suggest buying **Solar glass sector** on dip, which is enjoying high profit margins due to tight supply, but stock price volatility is high.

In the medium term, we like financials (Insurance and Brokerage sectors) which are undervalued, lagging behind, generally trading at large discounts to their A-shares counterparts. Catalysts for re-rating include buoyant stock markets and bond yield creeping up.

New Southbound stocks

As Southbound inflows are expected to remain strong in the coming weeks, stocks that are eligible for Southbound trading should generally perform better, and stocks that newly become eligible would probably attract fund inflows. There are currently 502 stocks eligible for Southbound trading.

With that in mind, the upcoming **half-yearly index review on the Hang Seng Composite Index (HSCI) on 26 Feb 2021** warrants extra attention, as that will determine most of the changes in Southbound eligible stocks. The HSCI constituent changes will be effective from 15 Mar 2021.

To recap, to be eligible for Southbound trading, a stock has to be:

1. **Constituent of the HSCI, with 12-month average market cap over HK$5 bn**, or
2. **H-shares of A-H dual listed companies**.

These **include pre-revenue biotech companies** that are eligible constituent stocks of the HSCI, or have corresponding A-shares listed on SSE or SZSE.

Companies with weighted voting right (WVR) structures must meet more stringent criteria to be included, such as listing history longer than 6 months and daily average market cap higher than HK$20 bn. Secondary-listed stocks are currently NOT included in Southbound trading, e.g. **Alibaba (9988 HK)**, **JD (9618 HK)**, **Netease (9999 HK)**.

Figure 11: Potential ADDITIONS into Southbound trading

Company	Ticker	Sector	Market Cap (HK$ mn)*
Evergrande Property Services	6666 HK	Property management	96,649
CR Mixc Lifestyle Services	1209 HK	Property management	82,056
Sunac Services	1516 HK	Property management	44,538
Shimao Services	873 HK	Property management	33,350
S-Enjoy Service	1755 HK	Property management	15,403
KWG Living	3913 HK	Property management	12,362
Jinke Services	9666 HK	Property management	8,002
Simcere Pharma	2096 HK	Healthcare	24,146
Everest Medicines - B	1952 HK	Healthcare	18,260
Ocumension - B	1477 HK	Healthcare	14,638
Antegene - B	6996 HK	Healthcare	11,118
CStone Pharma - B	2616 HK	Healthcare	10,478
RemeGen - B	9995 HK	Healthcare	9,362
JHBP - B	6998 HK	Healthcare	9,204
Henlius Biotech - B	2696 HK	Healthcare	7,405
Pop Mart	9992 HK	Consumer discretionary	114,048
Blue Moon	6993 HK	Consumer staples	87,701
HKTV	1137 HK	Consumer staples	6,890
Joy Spreader	6988 HK	Internet	7,767
Cathay Edu	1981 HK	Education	9,041

Source: Bloomberg, CMBIS *Month-end average from Jan-Dec 2020

Figure 12: Potential REMOVALS from Southbound trading

Company	Ticker	Sector	Market Cap (HK$ mn)*
Minsheng Edu	1569 HK	Education	4,734
China Aircraft Leasing	1848 HK	Leasing	4,729
Shineway Pharm	2877 HK	Healthcare	4,557
IMAX CHINA	1970 HK	Consumer discretionary	4,364
JNBY	3306 HK	Consumer discretionary	4,139
Kasen	496 HK	Industrial	1,784

Source: Bloomberg, CMBIS ∗month-end average from Jan-Dec 2020

This is not to say these Southbound candidate stocks (Fig. 11) are all fundamentally attractive, but short-term investors might consider them as tactical ideas and selectively buy before the HSCI review. Three of them are under our coverage and all have a BUY rating:

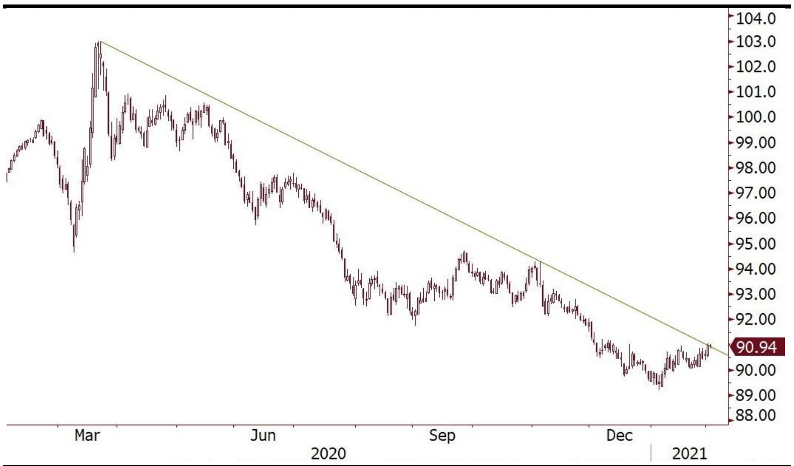
- **CR Mixc Lifestyle Services (1209 HK, BUY, TP: HK$52.16)**
- **S-Enjoy Service (1755 HK, BUY, TP: HK$29.52)**
- **Henlius Biotech-B (2696 HK, BUY, TP: $60.61)**

Key risks

1. **Policy to cool stock markets:** PRC policy helped drive up Southbound trading. But if Hong Kong market shows signs of overheating or Mainland investors become too speculative, policymakers might cool the market by verbal warning or suspend approval of HK equity funds. The China Securities Regulatory Commission (CSRC) did suspend approval of HK-focused funds back in Nov 2017, after the Hang Seng Index soared over 30% that year, although the CSRC did not state the reason.

2. **USD rebound:** The USD has been depreciating since Mar 2020, which helped boost fund flows into emerging markets. Any meaningful rebound in the USD may putting correction pressure on EM stocks. On chart, the USD Index has been rebounding recently, and a breakout of downtrend may indicate further upside.

Figure 13: Will USD Index buck downtrend?



Source: Bloomberg, CMBIS

Disclosures & Disclaimers

Analyst Certification

The research analyst who is primary responsible for the content of this research report, in whole or in part, certifies that with respect to the securities or issuer that the analyst covered in this report: (1) all of the views expressed accurately reflect his or her personal views about the subject securities or issuer; and (2) no part of his or her compensation was, is, or will be, directly or indirectly, related to the specific views expressed by that analyst in this report.

Besides, the analyst confirms that neither the analyst nor his/her associates (as defined in the code of conduct issued by The Hong Kong Securities and Futures Commission) (1) have dealt in or traded in the stock(s) covered in this research report within 30 calendar days prior to the date of issue of this report; (2) will deal in or trade in the stock(s) covered in this research report 3 business days after the date of issue of this report; (3) serve as an officer of any of the Hong Kong listed companies covered in this report; and (4) have any financial interests in the Hong Kong listed companies covered in this report.

Disclosure

CMBIS or its affiliate(s) have investment banking relationship with the issuers covered in this report in preceding 12 months.

CMBIS Ratings

BUY	: Stock with potential return of over 15% over next 12 months
HOLD	: Stock with potential return of +15% to -10% over next 12 months
SELL	: Stock with potential loss of over 10% over next 12 months
NOT RATED	: Stock is not rated by CMBIS
OUTPERFORM	: Industry expected to outperform the relevant broad market benchmark over next 12 months
MARKET-PERFORM	: Industry expected to perform in-line with the relevant broad market benchmark over next 12 months
UNDERPERFORM	: Industry expected to underperform the relevant broad market benchmark over next 12 months

CMB International Securities Limited

Address: 45/F, Champion Tower, 3 Garden Road, Hong Kong, Tel: (852) 3900 0888 Fax: (852) 3900 0800

CMB International Securities Limited ("CMBIS") is a wholly owned subsidiary of CMB International Capital Corporation Limited (a wholly owned subsidiary of China Merchants Bank)

Important Disclosures

There are risks involved in transacting in any securities. The information contained in this report may not be suitable for the purposes of all investors. CMBIS does not provide individually tailored investment advice. This report has been prepared without regard to the individual investment objectives, financial position or special requirements. Past performance has no indication of future performance, and actual events may differ materially from that which is contained in the report. The value of, and returns from, any investments are uncertain and are not guaranteed and may fluctuate as a result of their dependence on the performance of underlying assets or other variable market factors. CMBIS recommends that investors should independently evaluate particular investments and strategies, and encourages investors to consult with a professional financial advisor in order to make their own investment decisions.

This report or any information contained herein, have been prepared by the CMBIS, solely for the purpose of supplying information to the clients of CMBIS or its affiliate(s) to whom it is distributed. This report is not and should not be construed as an offer or solicitation to buy or sell any security or any interest in securities or enter into any transaction. Neither CMBIS nor any of its affiliates, shareholders, agents, consultants, directors, officers or employees shall be liable for any loss, damage or expense whatsoever, whether direct or consequential, incurred in relying on the information contained in this report. Anyone making use of the information contained in this report does so entirely at their own risk.

The information and contents contained in this report are based on the analyses and interpretations of information believed to be publicly available and reliable. CMBIS has exerted every effort in its capacity to ensure, but not to guarantee, their accuracy, completeness, timeliness or correctness. CMBIS provides the information, advices and forecasts on an "AS IS" basis. The information and contents are subject to change without notice. CMBIS may issue other publications having information and/ or conclusions different from this report. These publications reflect different assumption, point-of-view and analytical methods when compiling. CMBIS may make investment decisions or take proprietary positions that are inconsistent with the recommendations or views in this report.

CMBIS may have a position, make markets or act as principal or engage in transactions in securities of companies referred to in this report for itself and/or on behalf of its clients from time to time. Investors should assume that CMBIS does or seeks to have investment banking or other business relationships with the companies in this report. As a result, recipients should be aware that CMBIS may have a conflict of interest that could affect the objectivity of this report and CMBIS will not assume any responsibility in respect thereof. This report is for the use of intended recipients only and this publication, may not be reproduced, reprinted, sold, redistributed or published in whole or in part for any purpose without prior written consent of CMBIS.

Additional information on recommended securities is available upon request.

For recipients of this document in the United Kingdom

This report has been provided only to persons (I)falling within Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (as amended from time to time)("The Order") or (II) are persons falling within Article 49(2) (a) to (d) ("High Net Worth Companies, Unincorporated Associations, etc.,) of the Order, and may not be provided to any other person without the prior written consent of CMBIS.

For recipients of this document in the United States

CMBIS is not a registered broker-dealer in the United States. As a result, CMBIS is not subject to U.S. rules regarding the preparation of research reports and the independence of research analysts. The research analyst who is primary responsible for the content of this research report is not registered or qualified as a research analyst with the Financial Industry Regulatory Authority ("FINRA"). The analyst is not subject to applicable restrictions under FINRA Rules intended to ensure that the analyst is not affected by potential conflicts of interest that could bear upon the reliability of the research report. This report is intended for distribution in the United States solely to "major US institutional investors", as defined in Rule 15a-6 under the US, Securities Exchange Act of 1934, as amended, and may not be furnished to any other person in the United States. Each major US institutional investor that receives a copy of this report by its acceptance hereof represents and agrees that it shall not distribute or provide this report to any other person. Any U.S. recipient of this report wishing to effect any transaction to buy or sell securities based on the information provided in this report should do so only through a U.S.-registered broker-dealer.

For recipients of this document in Singapore

This report is distributed in Singapore by CMBI (Singapore) Pte. Limited (CMBISG) (Company Regn. No. 201731928D), an Exempt Financial Adviser as defined in the Financial Advisers Act (Cap. 110) of Singapore and regulated by the Monetary Authority of Singapore. CMBISG may distribute reports produced by its respective foreign entities, affiliates or other foreign research houses pursuant to an arrangement under Regulation 32C of the Financial Advisers Regulations. Where the report is distributed in Singapore to a person who is not an Accredited Investor, Expert Investor or an Institutional Investor, as defined in the Securities and Futures Act (Cap. 289) of Singapore, CMBISG accepts legal responsibility for the contents of the report to such persons only to the extent required by law. Singapore recipients should contact CMBISG at +65 6350 4400 for matters arising from, or in connection with the report.