21 Jan 2021

Strategy Report

Southbound inflows lift H-shares

The Hang Seng Index is approaching 30,000 with record-high market turnover. While valuation of the broad market is no longer cheap, we expect momentum to remain strong in coming weeks. In a more optimistic case, the HSI could rise to 32,100, i.e. 7% upside from here. We prefer certain cyclical stocks which have been laggards.

- **Southbound trading increasingly influential.** Southbound buying is a main driving force behind HK market's rally YTD. It now accounts for over 30% of daily total turnover in HK market. But note that sudden spikes in Southbound turnover often coincided with or preceded turning points in the HSI.
- **HSI valuation at decade high.** The HSI is trading at 13.5x 2021E P/E, right at decade-high valuation. No longer cheap even having considered the HSI has now included more growth stocks and deserves slightly higher multiples.
- **Momentum could remain strong in coming weeks.** The key reason behind aggressive Southbound buying is that HK stocks/H-shares were relatively cheap and lagged behind in 2020. After some catch-up by H-shares, A-H premium has now shrunk to 33%, which is still high versus historical average. Expect Southbound buying to remain strong in the short term.
- **HSI is extremely overbought, but may rise further.** The HSI has rarely been this overbought, with 14-day RSI at 86.3. But on previous similar occasion, the HSI on average rose 7% further and peaked 13 trading days later.
- **Cyclicals outperform during final rallies**. During late cycle rallies in Apr 2015 and Jan 2018, cyclical sectors such as financials, energy and property outperformed.
- **Strategy – Preferred lagging sectors/stocks**: 1) **Brokerage** sector which benefits from buoyant stock market, with sector P/B still below historical average; 2) **Insurance** sector which also benefits from strong stock market; 3) **China property** sector, which lagged behind due to overly concerned about loan cap & policy tightening; 4) **Laggards** within certain sectors, as there could be some intra-sector rotation into laggards.

Preferred sectors and stocks

Sector	Company
Brokerage	CITIC Sec (6030 HK), CSC (6066 HK), HTS (6837 HK), EB Sec (6178 HK)
Insurance	China Life (2628 HK)
China property	CR Land (1109 HK), Shimao (813 HK), KWG (1813 HK)
Healthcare	PA Good Doctor (1833 HK)

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Market Data

Hang Seng Index	29,962
52-week High / Low	29,993/21,139
3-month avg. daily t/o	HK$165.1bn

Source: Bloomberg

Indices Performance

	HSI	HSCEI
1-month	13.1%	14.0%
3-month	21.9%	19.6%
6-month	19.6%	16.1%

Source: Bloomberg

12-month HSI Performance

Source: Bloomberg

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Contents

The Hang Seng Index surged on 19 Jan to the highest since May 2019, with daily market turnover setting a record high HK$301.6bn. Turnover reached HK$300bn again on 20 Jan. After a strong start to the year, the HSI is one of the world's best-performing major equity indexes YTD (+10.0%).

The question is: **How long and how much can the market go further, and what stocks to buy now?**

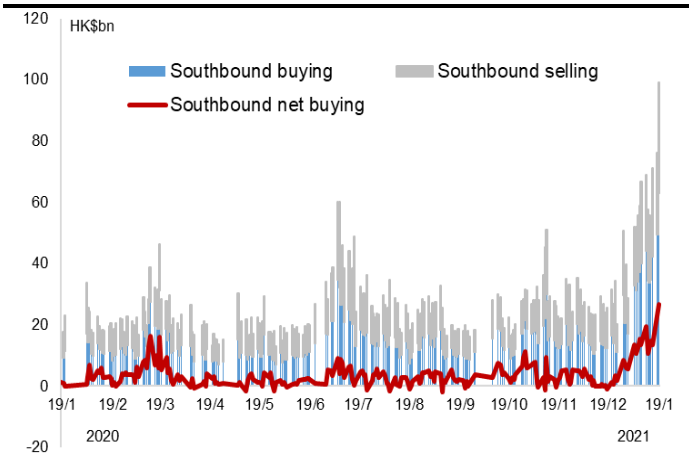
Southbound trading surged

Southbound trading's influence rising

Southbound buying through Stock Connect has been remarkably strong YTD, with its total turnover and net buying showing significant increases from previous years (Fig. 1). This has been **a main driving force behind HK market's rally** and outperformance vs. other major stock markets.

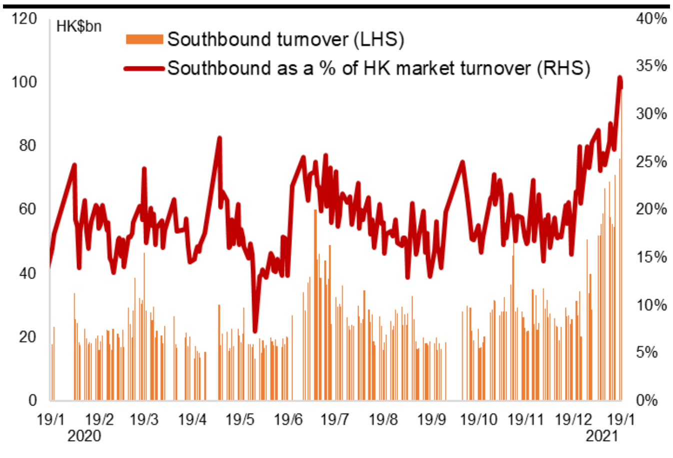
Southbound trading's influence on HK market is increasing along with the increase in turnover, with southbound trades account for over 30% of total turnover in HK market, up from 15-25% in the past year (Fig. 2).

Figure 1: Southbound turnover & net buying spiked



Source: Bloomberg, Wind, CMBIS

Figure 2: Southbound turnover as % of HK market



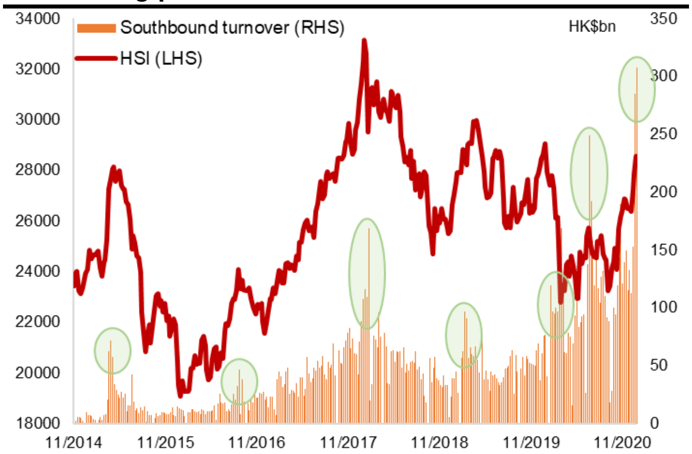
Source: Bloomberg, Wind, CMBIS

Is Southbound trading a leading indicator of HSI?

Is a jump in Southbound turnover a precursor to a rally in the Hang Seng Index? Not really. While sustained net buying via Southbound should bode well for the HSI, **sudden spikes in Southbound turnover often coincided with or preceded turning points in the stock index** (Fig. 3).

Big jumps in Southbound turnover did sometimes coincide with the HSI bottoming out, e.g. in Mar 2020, but they more often preceded market peaks. This is understandable as turnover spikes are usually to a certain extent a result of exuberance.

Figure 3: Southbound turnover spikes coincide with HSI turning point



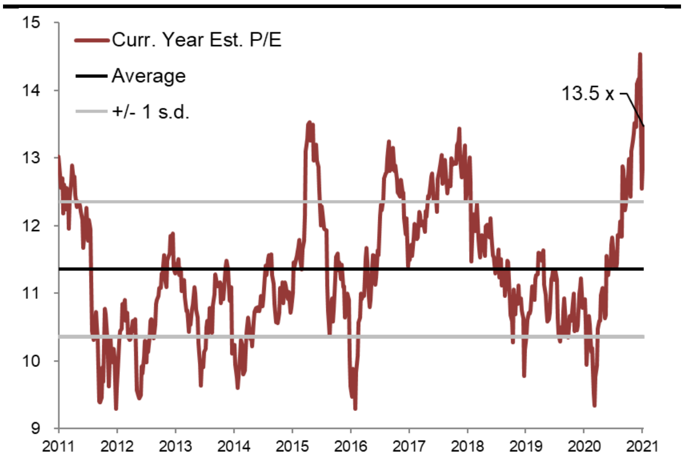
Source: Bloomberg, Wind, CMBIS

This is not to say we expect an imminent peak in the HSI. **While risks of pullback are on the rise, we are also aware of the risk of leaving the party too soon and missing out on the final rally.**

HSI valuation at decade high

The HSI is trading at 13.5x 2021E P/E at market close on 20 Jan, right at levels of current-year estimated P/E in the past decade. No longer cheap even having considered the HSI has now included more growth stocks and thus deserves slightly higher multiples.

Figure 4: Forward P/E of HSI surged to decade high



Source: Bloomberg, CMBIS

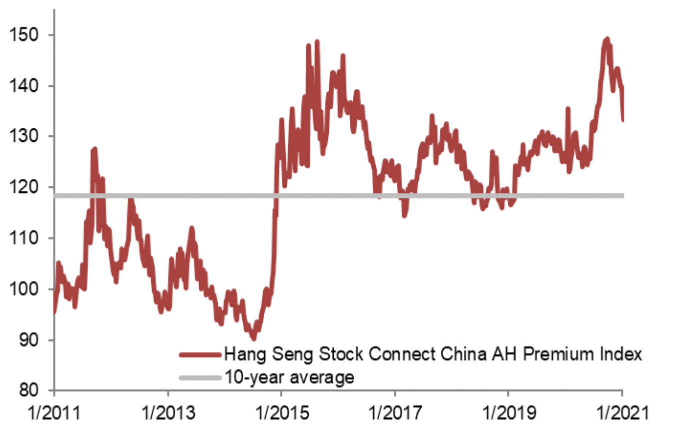
In a more optimistic case, if we look through the pandemic's impact and use the average of 2021E and 2022E earnings as valuation basis, and apply the decade-high P/E 13.5x, the HSI could rise to 32,100, i.e. 7% upside from here.

Momentum could remain strong in coming weeks

AH Premium's mean regression

We believe the key reason behind this round of aggressive Southbound buying is that HK stocks/H-shares were relatively cheap and lagged behind in 2020. Mainland investors saw the value in H-shares after they underperformed A-shares by ~30ppts in 2020, widening A-H premium to ~50% (indicated by the Hang Seng Stock Connect China AH Premium Index). After H-shares have played some catch-up, A-H premium has now shrunk to 33%, which is still high versus historical average. **Expect Southbound buying to remain strong in the short term.**

Figure 5: AH premium shrinking but still elevated



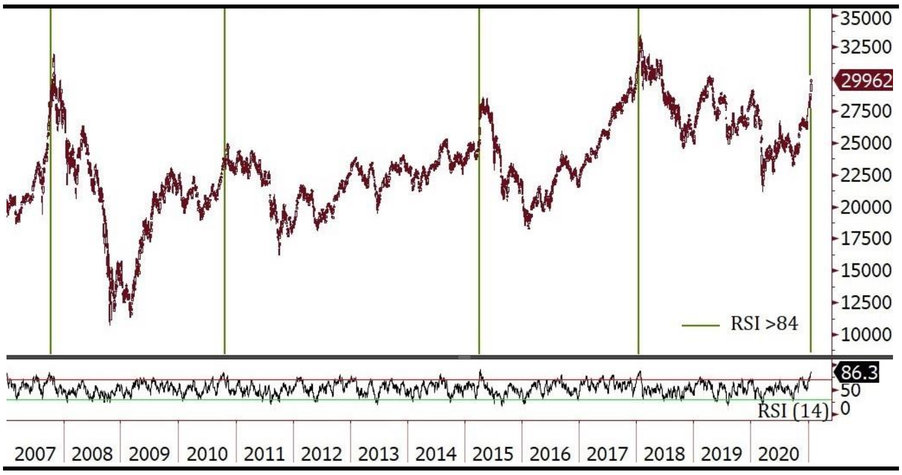
Source: Bloomberg, CMBIS

HSI is extremely overbought, but may rise further

Technically, **the HSI has rarely been this overbought, with 14-day RSI at 86.3** (Fig. 6). It is only the fifth time that RSI >84 since 2007. On the previous four occasions (2 Oct 2007, 14 Oct 2010, 9 Apr 2015, 19 Jan 2018), **the HSI on average rose 7% further and peaked 13 trading days later** (Fig. 7). But then a months-long correction (in fact, bear market) followed.

To be fair, in each of the previous four market peaks, there was a significant negative event as a trigger for correction (Fig. 7). It is difficult to foresee what negative factors will eventually bring an end to this current rally, but market tends to be more sensitive to bad news when valuations are stretched. We list some key risks on p.8.

Figure 6: HSI has been this overbought for just the 5th time since 2007



Source: Bloomberg, CMBIS

Figure 7: When HSI is extremely overbought

Date when 14-day RSI >84 (a)	Current-year est. P/E	Date when HSI peaked (b)	Trading days of final rally (b-a)	Magnitude of final rally	Trigger which ended the rally
2 Oct 2007	20.5	30 Oct 2007	19	13.3%	Beijing called off the "HK Stock Through Train Scheme"
14 Oct 2010	15.1	8 Nov 2010	17	4.8%	Eurozone debt crisis
9 Apr 2015	13.2	27 Apr 2015	12	6.1%	A-shares market meltdown
19 Jan 2018	12.7	29 Jan 2018	6	3.8%	U.S.-China trade war
19 Jan 2021	**13.3**	**???**	**???**	**???**	**???**

Source: Bloomberg, CMBIS

Which sectors outperformed during final rallies?

During late cycle rallies, cyclical sectors such as financials, energy and property typically outperform.

We review the performance of HSI constituents during the rallies in 2015 and 2018, as back then Stock Connect were already in place and thus were more comparable to today. During the rally in Apr 2015, among the top 10 performing HSI constituents, seven were financials and two were energy (Fig. 8). During the rally in Jan 2018, among the top 10, three were financials, three were energy and two were real estate (Fig. 9).

Figure 8: Cyclicals led gain in the final rally in 2015

Top performing HSI constituents from 9-27 Apr 2015	Price return (%)
HKEX (388 HK)	24.6
Sinopec (386 HK)	15.8
CNOOC (883 HK)	12.4
HSBC (5 HK)	11.5
Ping An (2318 HK)	11.5
BOC (3988 HK)	11.4
BOC HK (2388 HK)	10.7
ICBC (1398 HK)	9.8
BoCom (3328 HK)	9.7
Techtronic (669 HK)	9.3
HSI	*5.5*

Source: Bloomberg, CMBIS

Figure 9: Cyclicals led gain in the final rally in 2018

Top performing HSI constituents from 19-29 Jan 2018	Price return (%)
PetroChina (857 HK)	11.7
CR Land (1109 HK)	10.6
BOC (3988 HK)	8.4
CCB (939 HK)	7.6
Sinopec (386 HK)	7.2
CITIC (267 HK)	6.6
BoCom (3328 HK)	6.3
Galaxy Ent (27 HK)	4.9
Henderson Land (12 HK)	4.6
CNOOC (883 HK)	4.5
HSI	*2.2*

Source: Bloomberg, CMBIS

Strategy: Preferred lagging sectors/stocks

At this stage, considering that the broad market is no longer cheap, we prefer quality names which are either still undervalued or lagging:

- **Brokerage sector**

Benefits from buoyant stock market. Valuation still undemanding, with FY21E P/B of stocks under our coverage averaging 0.97x, slightly lower than historical average 1.0x.

Stock picks: **CITIC Sec (6030 HK; BUY; TP:HK$24.6), CSC (6066 HK; BUY; TP:HK$15.3).**

Other interesting names include **HTS (6837 HK; BUY; TP:HK$10.2), Everbright Sec (6178 HK; NR)**, which have lower P/B and deep discount to their A-shares (A-H premium at 164% and 98% respectively).

- **Insurance sector**

Benefits from buoyant stock market.

Stock pick: **China Life (2628 HK; BUY; TP:HK$28.14)**, being the biggest laggard and its A-share premium (165%) among the widest among insurers.

- **China property sector**

Laggard due to overly concerned about loan cap & policy tightening.

Stock picks: **CR Land (1109 HK; BUY; TP:HK$44.79), Shimao (813 HK; BUY; TP:HK$44.94), KWG (1813 HK; BUY; TP:HK$17.87)**

(see our recent Property sector report)

■ **Laggards within certain sectors**

Intra-sector rotation into laggards could occur as leaders may have become expensive and overbought.

Stock pick: **PA Good Doctor (1833 HK; BUY; TP:HK$150)**.

Figure 10: Preferred sectors and stocks

Sector	Company	Ticker	Rating	Target Price (HK$)	AH Premium (%)
Brokerage	CITIC Sec	6030 HK	BUY	24.60	83
	CSC	6066 HK	BUY	15.3	287
	HTS	6837 HK	BUY	10.2	98
	EB Sec	6178 HK	NR	NA	164
Insurance	China Life	2628 HK	BUY	28.14	165
China Property	CR Land	1109 HK	BUY	44.79	NA
	Shimao	813 HK	BUY	44.94	NA
	KWG	1813 HK	BUY	17.87	NA
Healthcare	PA Good Doctor	1833 HK	BUY	150	NA

Source: Bloomberg, CMBIS

Key risks

1. **Mainland China: Signs of withdrawing monetary/fiscal stimuli, or official comments to cool stock market speculation.**

2. **Global: COVID-19 virus variant and vaccine efficacy.**

3. **U.S-China relations could remain tense.** U.S. President Joe Biden has just been inaugurated. Some investors have been expecting U.S.-China relations to become less tense in Biden's era. If Biden does not roll back some of the anti-China policies by Donald Trump soon, investors might become disappointed.

4. **USD rebound:** The USD Index 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.

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