November Strategy Report

Sector rotation opportunities

This month we would witness the first step of withdrawing monetary easing by the US Fed, but that is well expected and should not cause much market fluctuation. While overhangs of China's property market weakness, power outage and regulatory crackdowns may cap the short-term upside of the HSI, cheap valuations should limit downside. Sector rotation is the key to generating alpha.

- **Fed tapering well guided; no taper tantrum.** We expect the US Fed to announce tapering by US$15 bn after the meeting on 3 Nov, eventually ending QE around mid-2022. But We believe the Fed will preserve some flexibility by NOT stating a pre-set tapering course for now. Since Chair Powell has given guidance on tapering well in advance, investors are now well prepared, and thus any "taper tantrum" is unlikely.
- **HSI's valuation undemanding; Property, Financials & Consumer Staples are particularly cheap**. HSI's P/B is now at 1.04x only, very close to previous troughs. We believe at this valuation a lot of negatives have been priced in. Before some of the overhangs are removed, valuation may stay in a relatively low range, but downside is also limited by the low P/B. We compared each sector's valuation to its own 5-year average to find out "deep value" sectors. Property, Financials and Consumer Staples are the most undervalued.
- **Sector rotation - more than style shift**. Style shift between growth and cyclical stocks have frequently occurred since the COVID-19 outbreak. We believe there will be more sector rotation in the short term, but that does not have to be limited to a style shift between growth and cyclicals, given COVID's impact has somewhat diminished. We suggest three rotation ideas: Upstream to Downstream, Fair value to Deep value, and Consumer Discretionary to Staples.
- **Prefer sectors: 1) New energy**: benefits from China's "carbon neutral" policy. Downstream power generators have more stable margins and earnings growth. Wind power has entered the strong winter season. Top pick is China Longyuan (916 HK). **2) NEV**: Chips shortage is easing since Oct. Entered peak season of production and sales. Top pick is BYD (1211 HK). **3) Internet**: Much of regulatory risk are priced in. Further downside in earnings and valuation is limited, and thus risk-reward is favourable. Top pick is Meituan (3690 HK). **4) F&B** (selective): Habitual consumption, premiumisation and effective cost pass-through help F&B players to a relatively stable margin. Focus on players with pricing power. Top picks are CR Beer (291 HK) and Mengniu (2319 HK). **5) China property** (selective): offers deep value. Major developers' sales stabilised MoM in Oct, and industry default risk is getting slimmer. Accumulate quality developers. Top picks are COLI (688 HK), CR Land (1109 HK) and Longfor (960 HK).
- **Potential catalyst:** 1) China's policy support after Plenary Session; 2) US lowers tariff on some Chinese goods; 3) Concerns on China's regulatory risks gradually easing; 4) China eases border control.

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Market Data

Hang Seng Index	25,100
52-week High / Low	31,183/23,681
3-month avg. daily t/o	HK$147.7bn

Source: Bloomberg

Indices Performance

	HSI	HSCEI	HSTECH
1-month	2.1%	1.6%	3.5%
3-month	-4.2%	-4.9%	-5.7%
6-month	-11.5%	-17.3%	-23.3%

Source: Bloomberg

12-month HSI Performance

Source: Bloomberg

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Fed tapering imminent

The Federal Open Market Committee of the US Federal Reserve is going to announce its interest rate decision on 3 Nov (02:00 on 4 Nov China time). They are very likely to announce a reduction in monthly asset purchase amount (i.e. tapering). Since the previous FOMC meeting on 20-21 Sep, the Fed has given strong hints about tapering.

QE to end around mid-2022

Firstly, that FOMC statement on 22 Sep stated, "*If progress (toward maximum employment and price stability goals) continues broadly as expected, the Committee judges that **a moderation in the pace of asset purchases may soon be warranted***."

Secondly, in the press conference after the same meeting, Fed Chair Jerome Powell said, "*participants generally view that, so long as the recovery remains on track, **a gradual tapering process that concludes around the middle of next year** is likely to be appropriate.*"

Thirdly, Chair Powell said in a virtual panel discussion on 22 Oct, "*I do think **it's time to taper** and I don't think it's time to raise rates*."

Summing up these clues, one can conclude that: It is time to taper (to be announced in the upcoming FOMC meeting), and the asset purchase will end around the middle of 2022, while the Fed funds rate will stay unchanged during tapering.

- **2014 tapering: US$10 bn in each meeting**

While a tapering decision is all but certain, the path is more uncertain.

Let's take the previous tapering in 2014 as a guide. Before the FOMC meeting in Dec 2013, the Fed has been purchasing US$45 bn of longer-term Treasury securities and US$40 bn of agency mortgage-backed securities per month, i.e. US$85 bn in total per month. Then the FOMC announced in the Dec 2013 meeting that, beginning in January, it would buy US$40 bn of longer-term Treasury securities and US$35 bn of agency MBS per month, i.e. US$75 bn in total per month, a US$10 bn tapering. Then, in each of the next six FOMC meetings, they tapered by US$10 bn, and finally in the Oct 2014 meeting decided to conclude the asset purchase programme. It took eight FOMC meetings or ten months in total to complete the tapering (Fig. 1).

Figure 1: Fed tapering in 2014

FOMC meeting	Taper by (US$ bn)	New monthly purchase (US$ bn)
Dec 2013	10	75
Jan 2014	10	65
Mar 2014	10	55
Apr 2014	10	45
Jun 2014	10	35
Jul 2014	10	25
Sep 2014	10	15
Oct 2014	15	0

Source: Federal Reserve, CMBIS

Figure 2: Possible Fed tapering in 2021-2022

FOMC meeting	Taper by (US$ bn)	New monthly purchase (US$ bn)
Nov 2021	15	105
Dec 2021	15	90
Jan 2022	15 in Feb	75
	15 in Mar	60
Mar 2022	15 in Apr	45
	15 in May	30
May 2022	15	15
Jun 2022	15	0

Source: Federal Reserve, CMBIS

2021-2022 tapering: US$15 bn monthly?

Now, the FOMC is purchasing US$80 bn of Treasury securities and US$40 bn agency MBS per month (US$120 bn in total). In the minutes of the Sep meeting, the FOMC discussed an "***illustrative tapering path***" which featured "***monthly reductions*** *in the pace of asset purchases, by $10 bn in Treasury securities and $5 bn in agency MBS*." Such a monthly reductions path would take only six FOMC meetings and eight months in total, slightly quicker than the 2014 tapering.

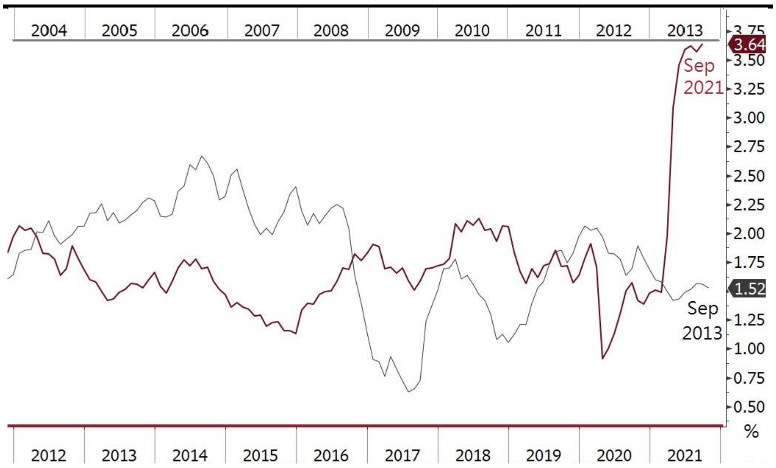
In the FOMC meeting this week, the tapering announcement might be: "*Beginning in December, the Committee will add to its holdings of Treasury securities at a pace of $70 bn per month rather than $80 bn per month, and agency mortgage-backed securities at a pace of $35 bn per month rather than $40 bn per month.*"

We believe the FOMC will preserve some flexibility by NOT stating a pre-set tapering course at this point (monthly reductions mentioned above). The FOMC can wait until the Jan 2022 meeting to decide whether to go with a monthly reductions path, or follow the 2014 tapering path (tapering in each FOMC meeting). The latter would imply that the asset purchase programme would conclude in Sep 2022, which would still be in line with Powell's guidance of "*around the middle of next year.*"

The Fed maintained that high inflation is "transitory"

Some might argue that, with the current inflation much higher than in 2013-2014 (Fig. 3), the FOMC should taper at a much quicker pace than eight years ago or even raise interest rates soon. However, given that the Fed continues to view the current high inflation as short-lived (the FOMC statement in Sep 2021 stated "*Inflation is elevated, largely reflecting* ***transitory*** *factors*"), we believe the FOMC will taper prudently in order to avoid another "taper tantrum".

Figure 3: US core PCE YoY (now vs 2013)



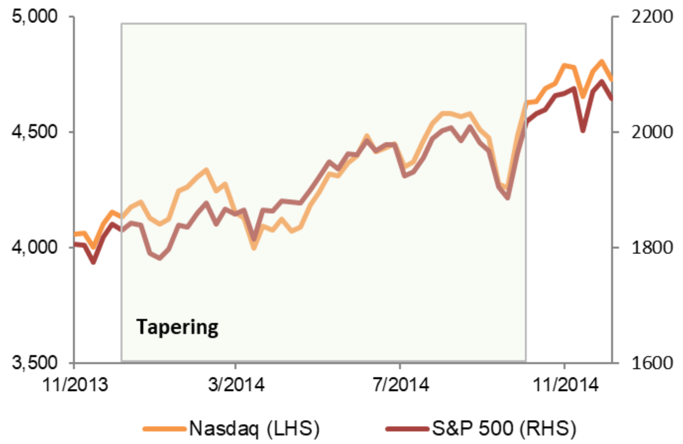
Source: Bloomberg, CMBIS

No taper tantrum

The Fed has learnt a lesson from the "taper tantrum" in mid-2013, when then Chair Ben Bernanke caught investors by surprise by mentioning tapering. This time, Chair Powell has given hints/guidance on tapering well in advance, and thus investors are now well prepared.

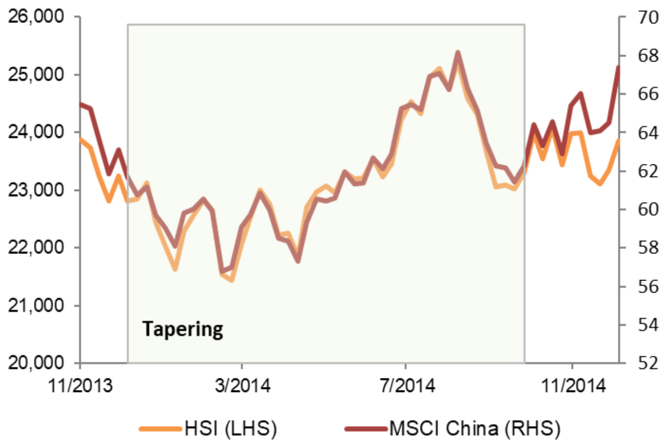
During the tapering period (Jan-Oct 2014), US stocks were little affected, with the S&P 500 and Nasdaq rising a further 9% and 11% respectively (Fig. 4). China stock markets were not as strong, but still managed to record gains during the tapering period, with the HSI and MSCI China rising 3% and 2% respectively (Fig. 5).

Figure 4: US stocks continued to rise during taper



Source: Bloomberg, CMBIS

Figure 5: China stocks rose slightly during taper



Source: Bloomberg, CMBIS

Growth stocks outperformed Cyclicals in 2014 taper

Sector performance during the 2014 tapering (Fig. 6) might offer some clues to what to expect in the coming months. In China/HK markets, growth sectors IT, Communication Services (incl. internet giants Tencent and Baidu) and Healthcare strongly outperformed, while cyclical sectors Energy and Materials underperformed (oil price dropped 18% in that period).

Figure 6: Sector performance during taper (Jan-Oct 2014)

Market	Financials	Real Estate	Energy	Materials	Info Tech	Healthcare	Consumer Discretionary	Consumer Staples	Communication Services
China	-2.4%	NA	-4.8%	-6.7%	23.5%	18.0%	-1.7%	-15.8%	16.7%
HK	0.5%	1.0%	-7.5%	-1.6%	20.0%	24.3%	-13.1%	-0.7%	18.8%
US	9.0%	21.7%	-1.6%	4.4%	14.6%	21.3%	1.9%	8.6%	3.4%

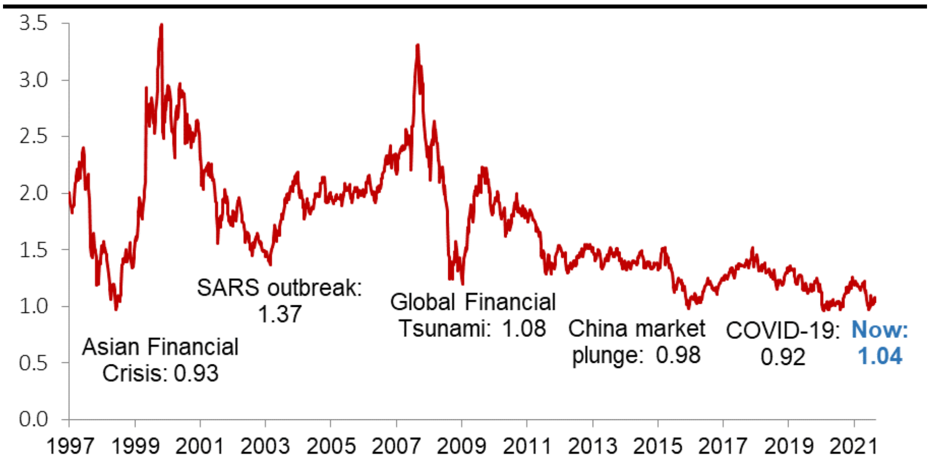
Source: Bloomberg, CMBIS; sector indexes under MSCI China, HSCI and S&P 500

HSI's valuation undemanding

P/B at crisis troughs, limiting downside

HSI's P/B is now at 1.04x only (Fig. 7), very close to previous troughs. We believe at this valuation a lot of negatives and risks, such as economic slowdown, the Fed tapering, China's regulatory risks and power outage, have been largely priced in. Before some of these overhangs are removed, the HSI's valuation may stay in a relatively low range, but downside is also limited by the low P/B, in our view. Re-rating is likely pending catalysts, which we will discuss on page 9.

Figure 7: HSI's P/B near crisis troughs



Source: Bloomberg, CMBIS

Deep value sectors: Property, Financials & Consumer Staples

While the broad market is waiting for catalysts, sector rotation is likely. We compared each sector's valuation to its own 5-year average to find out "deep value" sectors.

Property, Financials and Consumer Staples are the most undervalued compared to their own history (more undervalued than the HSCI in all the three metrics: forward P/E, P/B and dividend yield), followed by Healthcare and Communication Services.

On the other end of the spectrum, **Utilities, Energy, Consumer Discretionary and Technology (hardware) are relatively unattractive** (still cheaper than their respective 5-year average, but not as undervalued as the HSCI).

Figure 8: HSCI sub sectors' valuation vs. 5-year average

HSCI sub sector	P/E (12-month blended fwd)	No. of s.d. above/below 5-yr avg	P/B	No. of s.d. above/below 5-yr avg	Div Yield (%)	No. of s.d. above/below 5-yr avg
Real Estate	9.4	-1.4	1.3	-1.3	6.1	1.8
Financials	7.2	-1.4	1.1	-1	5.3	1.2
Materials	8.1	-1.3	1.6	-0.2	4.4	0.5
Health Care	23.5	-1.2	4.3	-0.9	0.8	0.5
Consumer Staples	18.5	-1.0	4.4	-0.9	2.8	1.2
Industrials	13.8	-0.9	1.5	-0.6	3.6	0.5
Communication Services	15.9	-0.6	3.1	-0.9	2.2	1.4
Technology	23.9	-0.4	3.3	-0.2	1	-0.4
Consumer Discretionary	18.3	-0.3	3.5	-0.3	1.9	-0.3
Energy	11.1	0	1.4	-0.4	4.2	0.3
Utilities	11.5	0	1.6	-0.1	3.8	0.5
HSCI	**14.2**	**-0.9**	**2.5**	**-0.7**	**3.4**	**0.8**

Source: Bloomberg, CMBIS; based on Bloomberg Industry Classification Systems

Sector rotation - more than style shift

Sector rotation, or style shift, between Growth and Cyclical/Value stocks have frequently occurred since the COVID-19 outbreak in Q1 2020. When the pandemic hit the economy hard, cyclicals suffered while internet and healthcare gained. When the economy was recovering from lockdowns, cyclicals outperformed.

As the HK stock market is cheap but still facing overhangs, we believe sector rotation is more likely than an across-the-board directional trend in the short term. But that does not have to be limited to a style shift between growth and cyclical stocks again, given COVID's impact has somewhat diminished. We outline three ideas on sector rotation below.

Sector rotation ideas

- **Upstream to Downstream**

The surge in coal prices have been a major driving force behind China's record high PPI inflation (10.7% YoY in Sep), and a key cause of the power outage since late-Sep. The government recently tackled the problem with coal price curbs and supply push, and **thermal coal futures slumped by more than 50%** since hitting record in mid-Oct (Fig. 9).

Coal price has historically had a strong correlation with China's PPI inflation (Fig. 10). With the coal price peaked out, PPI inflation will probably ease in coming months. Changes in PPI has implications for corporate earnings and thus stock prices. If PPI inflation eases as we expect, sectors that are the most positively correlated with PPI inflation might suffer, while those with negative or low correlation with PPI might outperform (Fig. 11).

Out: Coal, Steel, Aluminium, Solar Glass, Shipping

In: New Energy Vehicle, Food & Beverage (F&B), Wind Power

- **Fair value to Deep value**

With not many significant catalysts on the horizon for the broad market for now, there could be rotation based on valuations, i.e. from richly/fairly valued sectors to cheap sectors, provided that those cheap sectors do not have further negative news (refer back to Fig. 8).

Out: Utilities, Energy, Catering, Retailers, Hardware

In: China Property (focus on quality names), F&B (those with pricing power)

- **Consumer Discretionary to Staples**

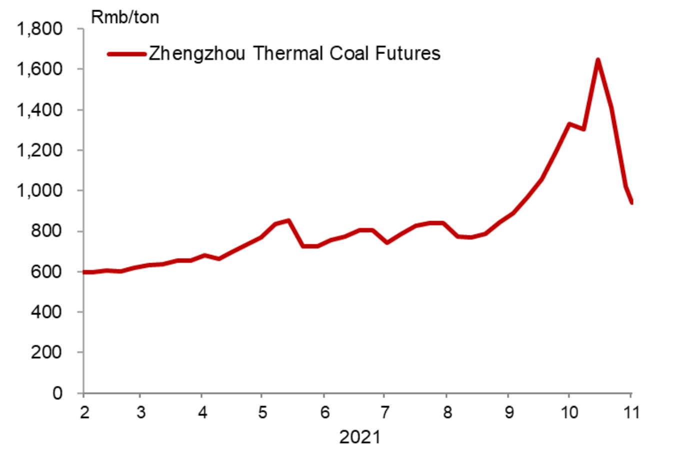
Negative wealth effect from the weakened property market, coupled with some mini COVID outbreaks, are likely to be hurting demand for and sentiment of discretionary spending, especially on big-ticket items. Consumer staples typically have a more stable demand. Besides, China's "common prosperity" (共同富裕) policy may benefit mass consumer goods at the expense of luxury goods, at least in terms of sentiment. Bear in mind that some consumer staples companies, like in many sectors, have been hit by a surge in input costs, and thus we should focus on those with strong pricing power.

Out: Luxury Goods, Electrical Appliances, Catering, Retailers

In: F&B (focus on those with strong pricing power)

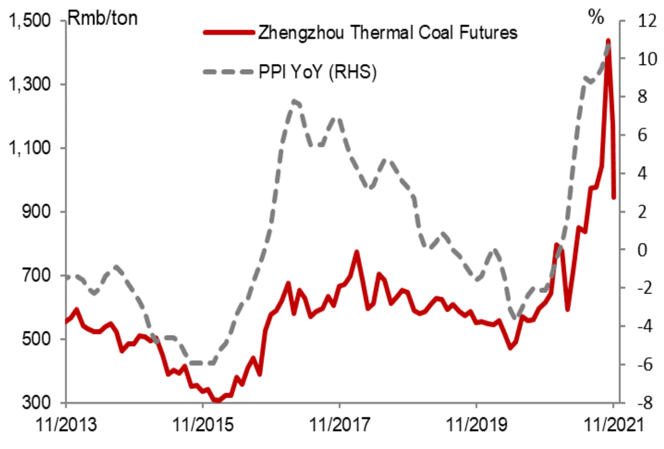
In addition, **we like Internet sector** which has been pricing in regulatory risks for one year already (beginning with anti-trust policy in Nov 2020) while long-term growth prospect is still promising.

Figure 9: Coal price halved on policy curbs



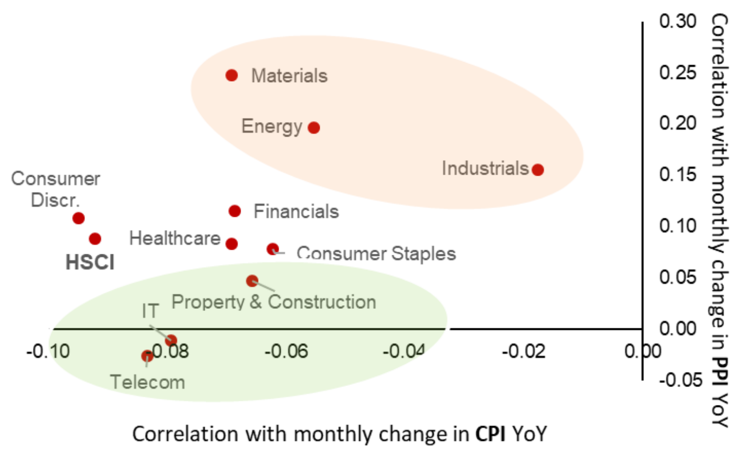
Source: Bloomberg, CMBIS

Figure 10: PPI inflation to ease with coal price



Source: Bloomberg, CMBIS

Figure 11: Materials & Energy stocks to suffer if PPI drops



Source: Bloomberg, CMBIS

Prefer New Energy, NEV, Internet; selective on F&B and Property

New energy sector: Expect to continue to benefit from China's "carbon neutral" policy in the long term and the power outage (highlighting the importance of alternative energy) in the short run. Upstream players such as solar glass will have more volatile earnings, and margin could peak as supply increases. Downstream power generators will have more stable margins and earnings growth. Wind power has entered the strong winter season. Expect wind power generation to accelerate. Top pick is **China Longyuan (916 HK)**. (See our latest report on Longyuan)

New energy vehicle sector: Chips shortage has been easing since Oct, and both production and sales will be strong in Q4. Top pick is **BYD (1211 HK)**. (See our NEV Sector Report and latest report on BYD [in Chinese only])

Internet sector: Much of regulatory risk, from anti-trust, data security, protection of minors from online games to content supervision, have been priced in, in our view. While more detailed regulatory measures might be announced in coming months, that should be well anticipated by the market. We believe further downside in earnings estimates and valuation is limited, and thus risk-reward is favourable. Top pick is **Meituan (3690 HK).** (See our latest report on Meituan)

F&B sector (selective): Our Consumer Staples analyst argued that, while property tightening could result in contagious impact on consumption, margin pressure driven by supply shocks seems transitory. "A habitual consumption pattern, premiumisation and an effective cost pass-through are structural drivers that F&B players offer to buffer a relatively stable margins outlook amid a cost-inflation environment. Focus on players with high pricing power that would manifest into steadfast margins." Top picks are **CR Beer (291 HK)** and **Mengniu (2319 HK)**. (See our Initiation report on Consumer Staples)

China property sector (selective): Having been under pressure for some time, due to ongoing policy tightening and the Evergrande crisis, China property sector has become a deep value sector (Fig. 8). Our property analysts pointed out that major developers' sales stabilised MoM in Oct, and industry default risk is getting slimmer. Accumulate quality developers which can meet this year's sales target, have less off-balance or hidden debts and less construction costs pressure. Top picks include **COLI (688 HK)**, **CR Land (1109 HK)** and **Longfor (960 HK)**. (See our latest Property Sector Report)

Potential catalysts

1. China's policy support after Plenary Session

The sixth plenary session (六中全会) of the 19th CPC Central Committee will be held in Beijing during 8-11 Nov. **Investors may look for any shift in policy tones towards more pro-growth policies.**

More specifically, the progress / achievements of the "three tough battles" of preventing major risks, targeted poverty alleviation and pollution control (坚决打好防范化解重大风险、精准脱贫、污染防治三大攻坚战) may be reviewed and reiterated. If so, that could boost sentiment in property and banking sectors, mass consumer goods sector and new energy sector.

2. US lowers tariff on some Chinese goods

US Treasury Secretary Janet Yellen said in a Reuters interview on 1 Nov that, "*We want to see China meet their commitments they made under Phase 1 (of Trade Deal), but stabilising and* ***perhaps eventually lowering some tariffs*** *in a reciprocal way could be a desirable outcome*." She added that lower China tariffs might ease inflation in the US.

We believe it should come as little surprise that Yellen is open to tariff reduction, since she said in Jul that tariffs on Chinese goods were "tax on consumers" and had "hurt American consumers". Yet, **there is no concrete plan or timeline of tariff reduction**, and the US has to be convinced that China has met their trade deal commitments first.

3. Concerns on China's regulatory risks gradually easing

Regulation tightening on various sectors has been a major negative factor since Jul. There could well be more details on such regulations to be announced in coming months, and some industries which have not yet faced tightening might become the next target. However, **for major industries which have already been targeted, such as Internet and Property, the worst in terms of regulatory news are probably over**. Over time, if no more unexpected regulations on these major sectors come out, valuations could gradually re-rate upward.

4. China eases border control

China is one of the few countries with a strict "zero tolerance" approach in tackling COVID-19, while many western countries have adopted a "live with the virus" approach, easing border control, travel restrictions and social-distancing measures. **In case China eases any of these virus control measures**, sectors which are the most sensitive such as airlines, travel agencies, casinos, catering and retailers would be given a huge boost.

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