May Monthly Strategy

Buy in May; HSI target raised

Stocks are approaching a sweet spot, with 1) economy recovering without overheating, 2) reflation without hyperinflation, 3) monetary policies remain highly accommodative. We raise our HSI target range to 26,000-31,300, to reflect higher earnings, more visibility and less downside risk. Accumulate growth stocks in anticipation of outperformance in 2H21.

- **Economy recovering without overheating.** Economic data keep surprising positively in major economies since Q3 2020, while vaccination makes the recovery more visible. Earnings forecasts have been trending up. But despite the ongoing recovery, the economy is by no means overheating, with the US unemployment rate still elevated and China's GDP growth slowed down in Q1 on a 2-year CAGR basis.
- **Reflation without hyperinflation.** The Fed maintains that the rise in inflation is largely transitory, and the bond market seems to agree, with the breakeven rates having stabilised. In China, we expect PPI YoY growth may well exceed 5% in 2Q21 and then slow down in 2H21. We are having reflation rather than hyperinflation in the US and China. Reflation is actually positive for equities in terms of earnings and margins.
- **Monetary easing intact.** The Fed reiterated their aim to achieve inflation moderately above 2% for some time. Fed Chair Powell said in Apr that it was not the time to talk about tapering QE yet. We believe there will be no change in asset purchase and fed funds rate in 2021. In China, there are risks of policy tightening on the housing market, but broad-based monetary tightening or stock market-specific tightening measures are unlikely.
- **HSI target range raised to 26,000-31,300**, based on 10.8x-13.0x P/E of the average of 2021E and 2022E consensus earnings, because: 1) Consensus EPS for 2021E / 2022E has gone up by 2.4% / 1.3% since Dec 2020; 2) More visibility in recovery thanks to vaccination, and thus less downside risk; 3) More growth / new-economy stocks have been and will be more quickly added to the HSI, boosting earnings growth prospect and target P/E.
- **Strategy: Accumulate growth stocks.** We expect HK stock market's sentiment to gradually improve after digesting higher inflations and bond yields and risks of monetary tightening. Looking into 2H21, we expect growth stock to outperform cyclicals again. Accumulate internet giants on probes-induced weakness. We are positive on technology sector too.
- **Avoid upstream commodity stocks.** Commodity stocks are benefiting from economic recovery and rising energy and metal prices, but we believe stock prices may have fully priced in the positives. Supply bottlenecks will be resolved sooner or later. Another risk is China might take action to cap commodity prices to curb inflation.
- **Key risks:** 1) COVID-19 virus variants and / or rebound of new cases in major economies; 2) Inflations exceeding expectations; 3) Earlier-than-expected monetary tightening; 4) Geopolitical risks, e.g. Russia-Ukraine tension, which may lead to risk aversion and fear of oil price spike leading to high inflations.

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Market Data

Hang Seng Index	28,725
52-week High / Low	31,183/22,520
3-month avg. daily t/o	HK$195.0bn

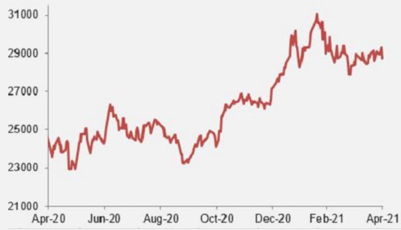
Source: Bloomberg

Indices Performance

	HSI	HSCEI
1-month	1.2%	-1.3%
3-month	1.6%	-3.4%
6-month	19.2%	10.9%

Source: Bloomberg

12-month HSI Performance



Source: Bloomberg

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Sweet spot for stocks

After a year of roller-coaster ride in the global economy and stock markets, we believe **stocks are approaching a sweet spot, i.e. 1) economy recovering without overheating, 2) reflation without hyperinflation, 3) monetary policies remain highly accommodative**.

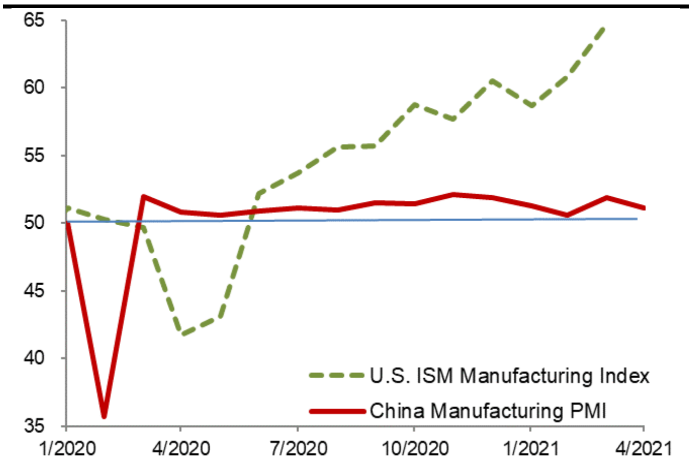
1. Recovery without overheating

Economic data keep surprising positively

Manufacturing PMIs of the world's two biggest economies, the US and China, have been in expansionary phase for 11 and 14 months in a row respectively (Fig. 1). The US ISM Manufacturing Index surged to 64.7 in Mar, the highest in 37 years, and the Non-Manufacturing Index even set record high.

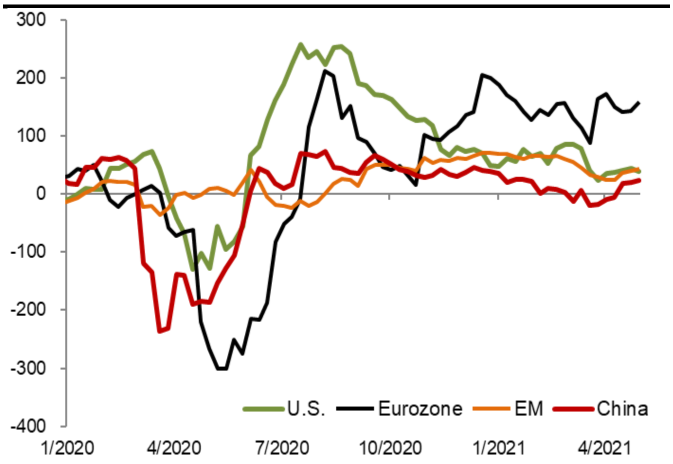
Not only economic recovery continues, data also keep delivering positive surprise, with Citi Economic Surprise Index of major economies remaining in positive territory since Q3 2020 (Fig. 2).

Figure 1: Manufacturing PMIs remain high



Source: Bloomberg, CMBIS

Figure 2: Economic Surprise Indices



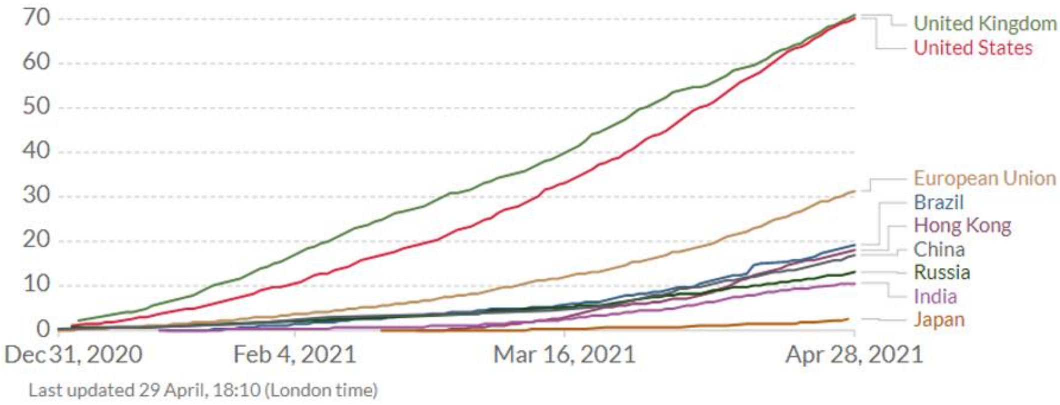
Source: Citigroup, Bloomberg, CMBIS
** Positive readings mean data are better than forecasts*

Vaccination makes recovery more visible

COVID-19 remains a real threat to the global economy, and the situation is severe in certain countries such as India, but the unprecedented vaccination around the world is bringing hope, confidence and more visibility to economic recovery.

As of 1 May, at least 1.13bn doses of coronavirus vaccines have been administered around the world, according to Financial Times. Advanced economies are ahead, with the UK, the US and the EU leading in terms of share of people received at least one dose (Fig. 4).

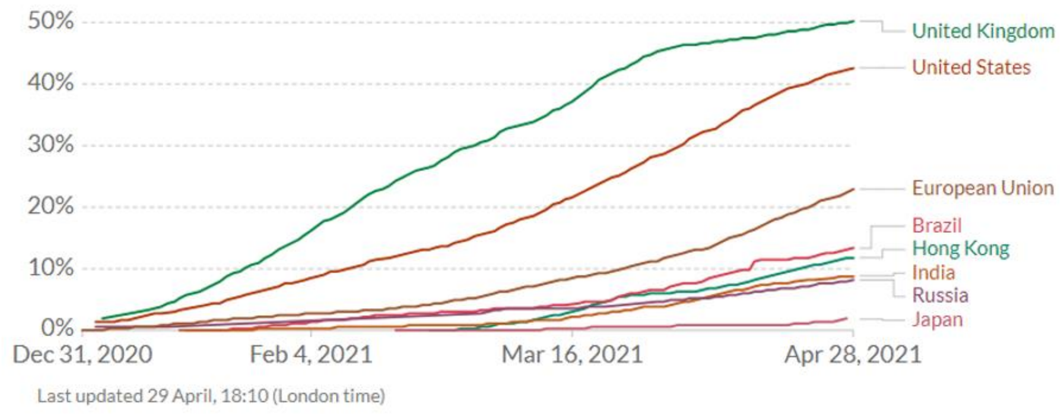
Figure 3: COVID-19 vaccine doses* administered per 100 people in key countries / regions



Source: Our World in Data, CMBIS

**Counted as a single dose; may not equal the total no. of people vaccinated (e.g. some receive multiple doses)*

Figure 4: Share of people received at least one dose of COVID-19 vaccine in key countries / regions



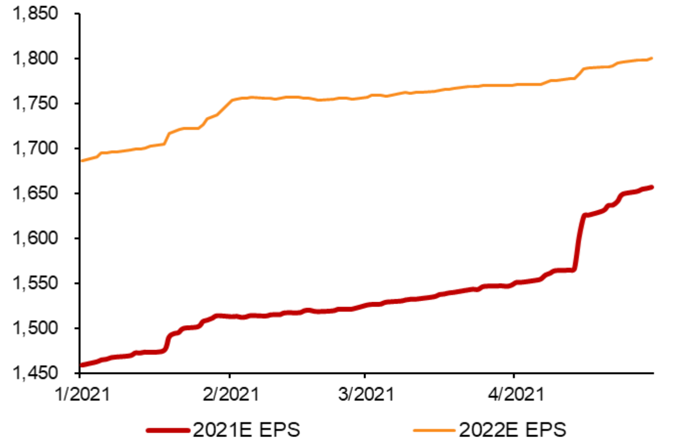
Source: Our World in Data, CMBIS

Earnings forecasts trending up

As the economy keeps recovering and beating forecasts, US corporate earnings consensus are being revised upwards (Fig. 5 & 6). 2021E EPS of Dow Jones Industrial Average have been revised up by 14% YTD, and that of NASDAQ by 9%, which shows that **cyclical stocks' consensus earnings have improved more than growth stocks**. In China, earnings revisions have been much smaller, but also better for value/cyclical stocks than growth stocks (+2% vs -1% YTD) (Fig. 7 & 8).

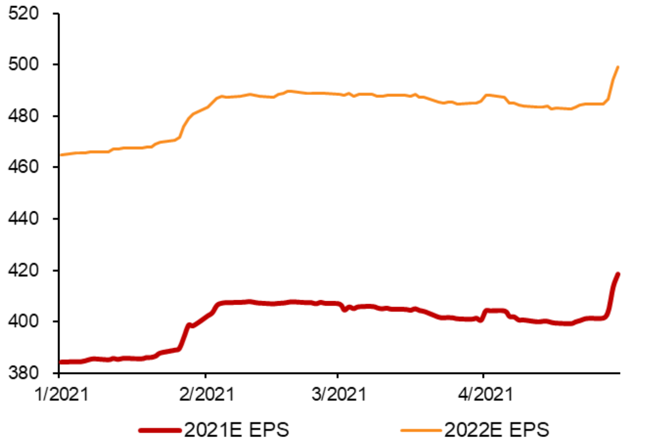
Perhaps unsurprisingly, **earnings forecasts tended to go up when PMI was higher** (esp. when >55). The boost to consensus earnings by high PMI readings is stronger for Dow Jones Industrial Average, which is composed of more cyclical stocks, than NASDAQ, which represents growth stocks (Fig. 9 & 10). China's earnings revisions (MSCI China) do show positive but lower correlation with China PMI.

Figure 5: DJIA's consensus EPS trending up



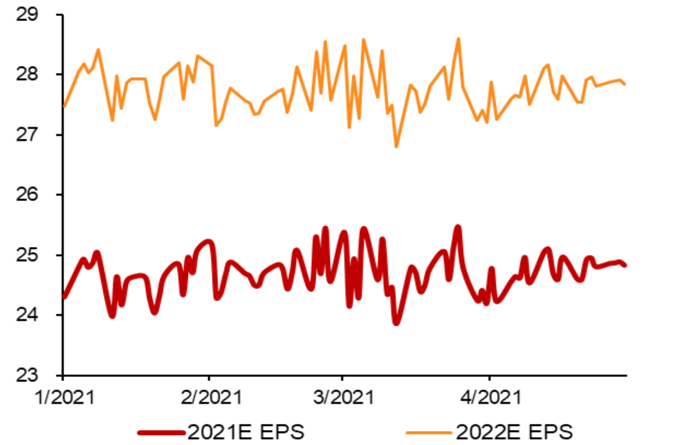
Source: Bloomberg, CMBIS

Figure 6: NASDAQ's consensus EPS trending up



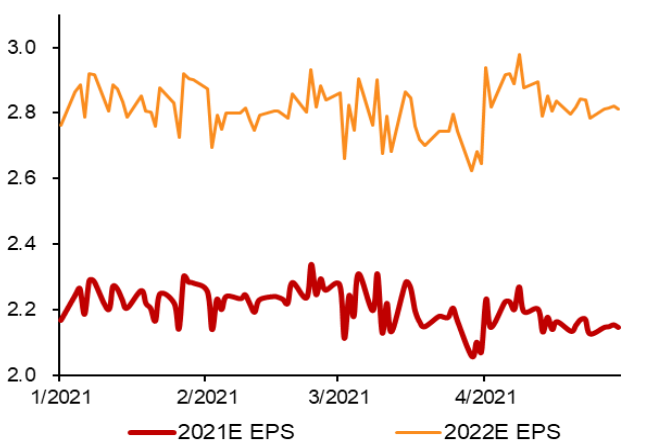
Source: Bloomberg, CMBIS

Figure 7: MSCI China Value's consensus EPS



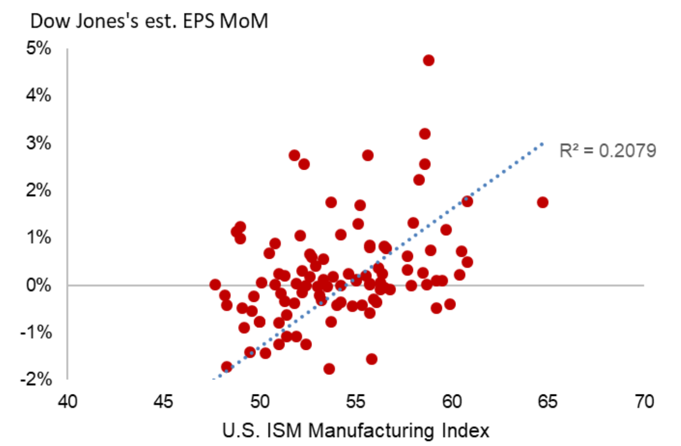
Source: Bloomberg, CMBIS

Figure 8: MSCI China Growth's consensus EPS



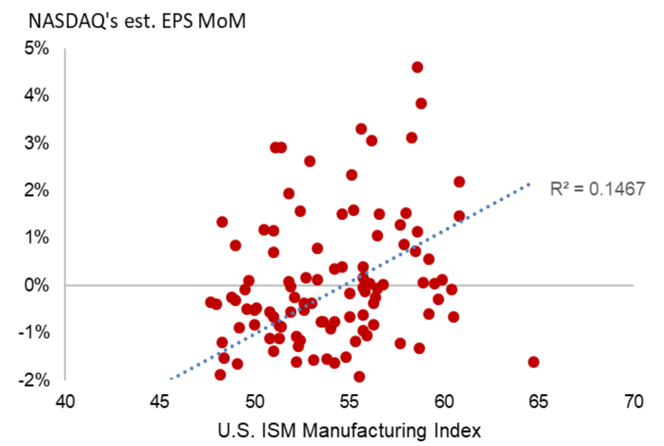
Source: Bloomberg, CMBIS

Figure 9: DJIA's EPS +ve correlation with PMI



Source: Bloomberg, CMBIS; data from 2011-2021

Figure 10: NASDAQ's EPS +ve correlation with PMI

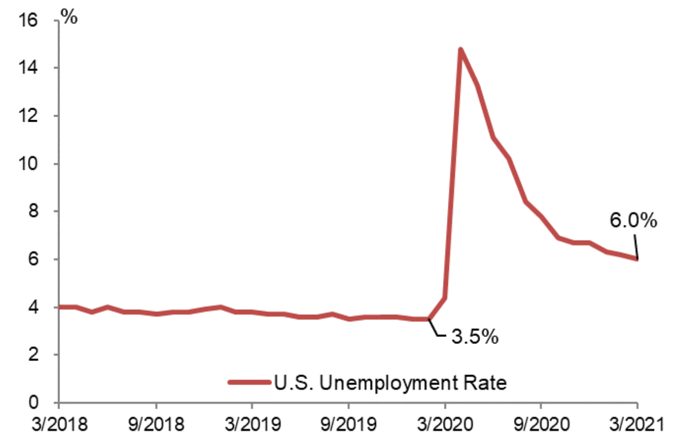


Source: Bloomberg, CMBIS; data from 2011-2021

Despite the ongoing recovery, the economy is by no means overheating. The US unemployment rate, in the Federal Reserve's words, "remained elevated at 6% in Mar, and this figure understates the shortfall in employment, particularly as participation in the labour market remains notably below pre-pandemic levels" (Fig. 11).

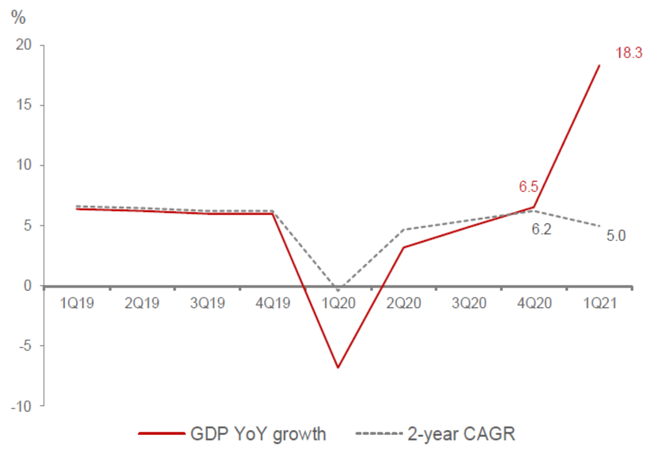
In China, GDP may have grown at record pace 18.3% YoY in Q1 2021, but that came off a low base, while 2-year CAGR was 5.0%, down from the 6.2% 2-year CAGR in Q4 2020 (Fig. 12).

Figure 11: US unemployment rate still elevated



Source: Bloomberg, CMBIS

Figure 12: China's GDP growth by quarter



Source: NBS, Wind, CMBIS estimates

2. Reflation without hyperinflation

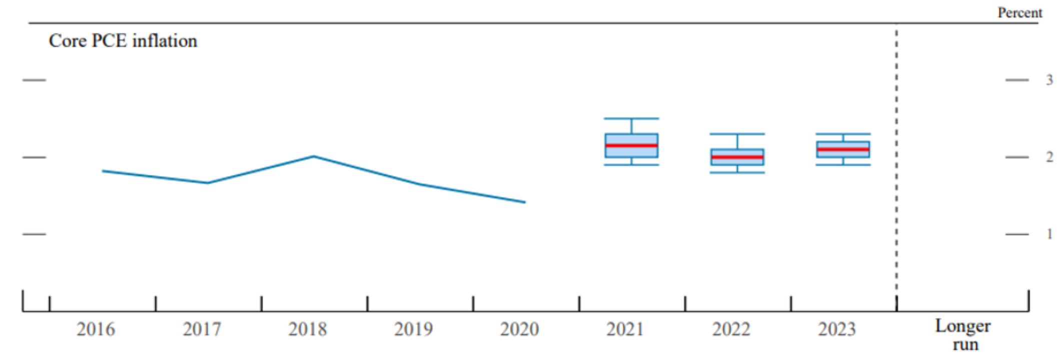
Rising inflation is "transitory"

A major concern for equity and bond investors is inflation, which might trigger monetary tightening by central banks. This worry, reflected in the surge in US Treasury yields during Jan-Feb 2021, caused a sharp correction in stock markets in Feb.

However, the Fed does not share this concern. While the Fed acknowledges that "in the near term PCE inflation is expected to move above 2%" on low base effect and as higher oil prices pass through to consumer energy prices, they maintain that **the rise in inflation is largely reflecting "transitory factors"** (e.g. supply bottlenecks).

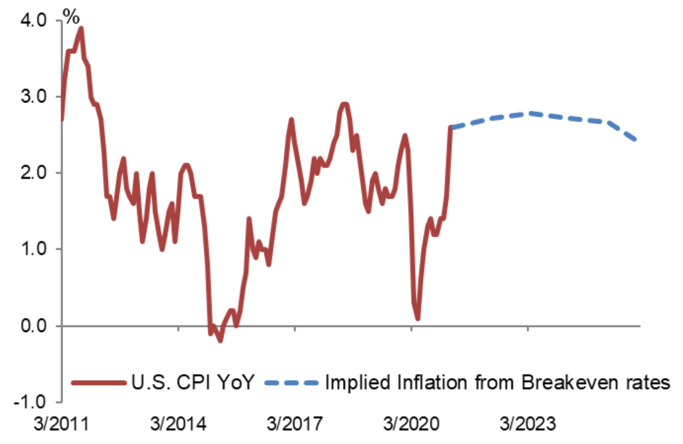
The Fed forecasts that core PCE inflation will be moderately above 2% during 2021-2023 (Fig. 11). The bond market seems to agree, with the breakeven rates (implied CPI inflation) anchored at around 2.7% during 2021-2023 (vs latest CPI reading 2.6%) (Fig. 14). The breakeven rates have, after a short-term spike in Feb, largely stabilised recently (Fig. 15).

Figure 13: Fed's inflation forecast in Mar 2021



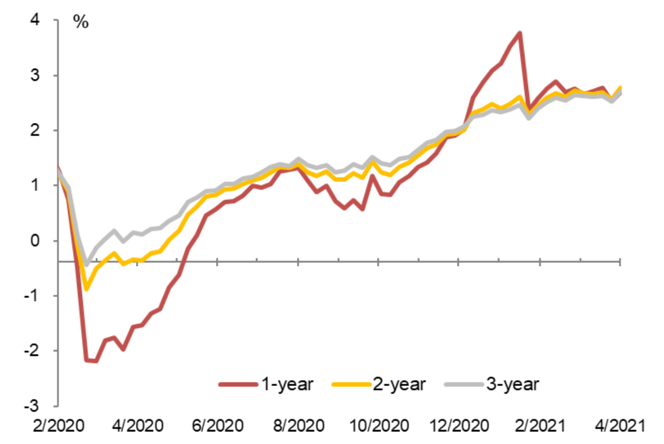
Source: Federal Reserve, CMBIS

Figure 14: Market's implied inflation



Source: Bloomberg, CMBIS

Figure 15: US breakeven rates stabilised



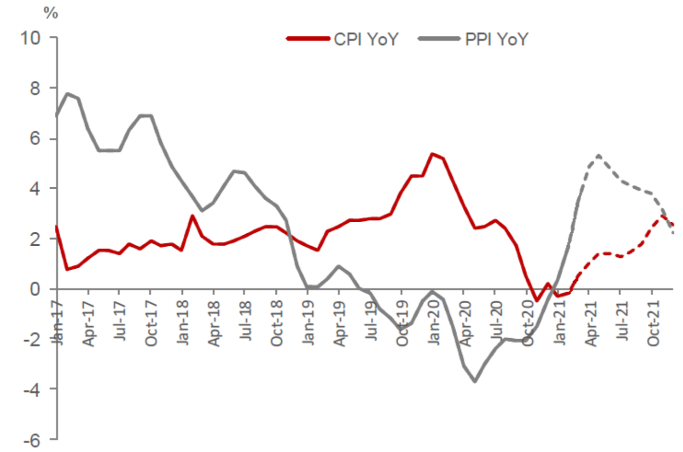
Source: Bloomberg, CMBIS

China's PPI to moderate

In China, our economist forecasts that PPI YoY growth may well exceed 5% in 2Q21 (4.4% YoY in Mar) on low base last year and continued post-pandemic recovery, and then slow down in 2H21 because economic rebound may decelerate marginally and commodity supply will gradually increase to catch up with demand. We forecast CPI/PPI to increase 1.4%/3.5% YoY, respectively, in 2021 (Fig. 16).

All in all, we are having reflation rather than hyperinflation in the US and China. **Reflation is actually positive for equities (esp. cyclicals) in terms of earnings and margins.** MSCI China's profit margin has been showing positive correlation of PPI growth, but is lagging behind recently, suggesting there is further upside in profit margins (Fig. 17).

Figure 16: CMBI forecasts of China's inflation



Source: NBS, Wind, CMBIS estimates

Figure 17: MSCI China's est. margin vs China PPI

Source: Bloomberg, CMBIS

3. Monetary easing intact

Expect no change in Fed easing in 2021

The Fed reiterated in Apr's meeting that they will aim to achieve inflation moderately above 2% for some time so that inflation averages 2% over time. They are not going to tighten (raise interest rates or taper asset purchase) anytime soon unless they see inflation moving materially above 2% in a persistent way (which they do not expect).

When the Fed does eventually tighten, they are going to taper asset purchase (QE) first before raising interest rates. They will let the public know about the discussion on tapering well before any actual decision, but Fed Chair Powell said in Apr that it was not the time to talk about it yet. **We believe there will be no change in asset purchase and interest rates in 2021**.

China's monetary policy relatively flexible

In the 2021 Government Work Report released on 5 Mar, China pledged to maintain "continuity, stability and sustainability" of fiscal, monetary and other policies. Overall stance on monetary policies is "flexible, precise and appropriate". While policy makers will avoid making U-turn on pledged monetary support, our economist thinks they are leaning against speculative asset price bubbles and financial risks.

There are risks of policy tightening on the housing market, but considering there are few signs of bubble in the stock market, **we believe broad-based monetary tightening or stock market-specific tightening measures are unlikely.**

HSI target raised to 31,300

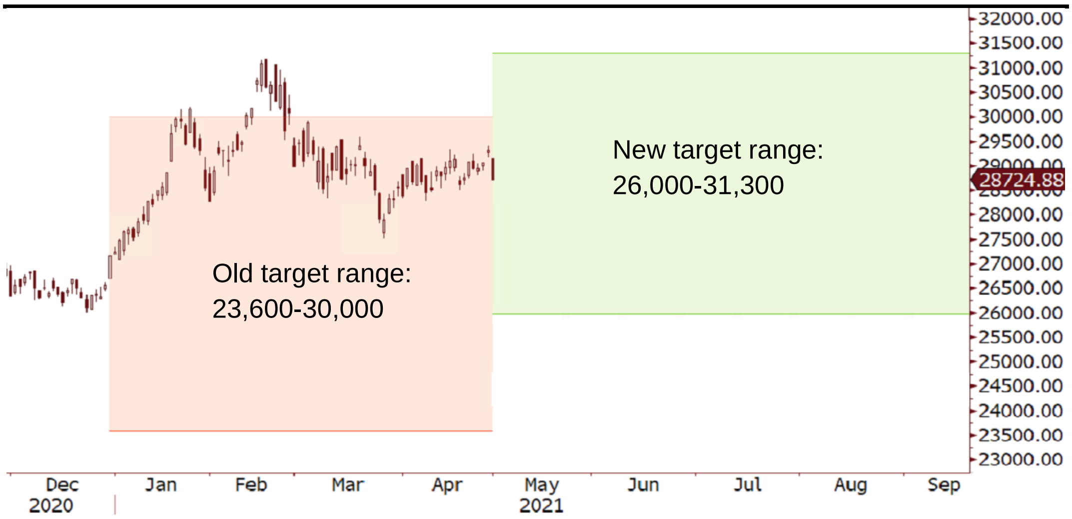
In our <2021 Strategy Report> published in Dec 2020, we set the target range for the HSI in 2021 as 23,600 – 30,000, based on 10.0x-12.7x P/E of the average of 2021E and 2022E consensus earnings. The HSI briefly exceeded the top-end 30,000 in Feb 2021 and then retreated and moved sideways.

We now raise our HSI target range to 26,000-31,300, based on 10.8x-13.0x P/E of the average of 2021E and 2022E consensus earnings, because:

1) **Consensus EPS for 2021E / 2022E has gone up by 2.4% / 1.3%**;
2) **More visibility of economic recovery thanks to large-scale vaccination**, and thus less downside risk and higher target P/E in the lower bound;
3) **More growth / new-economy stocks have been and will be more quickly added to the HSI** following the index enhancements announced in Mar 2021, thereby boosting earnings growth prospect and target P/E.

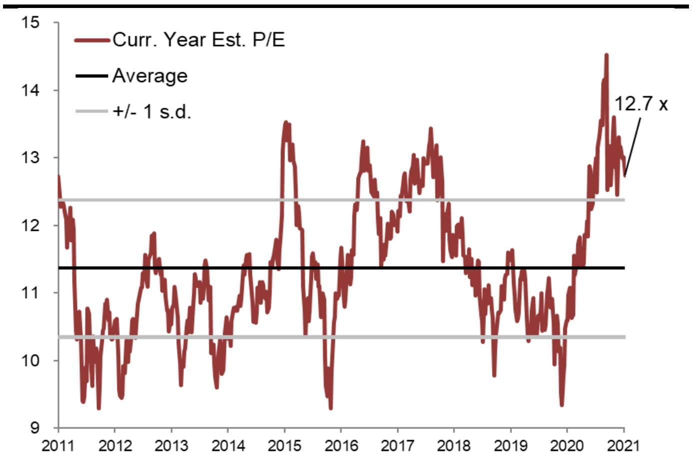
Our new target implies a 9.0% upside in the HSI.

Figure 18: HSI target range raised to 26,000-31,300



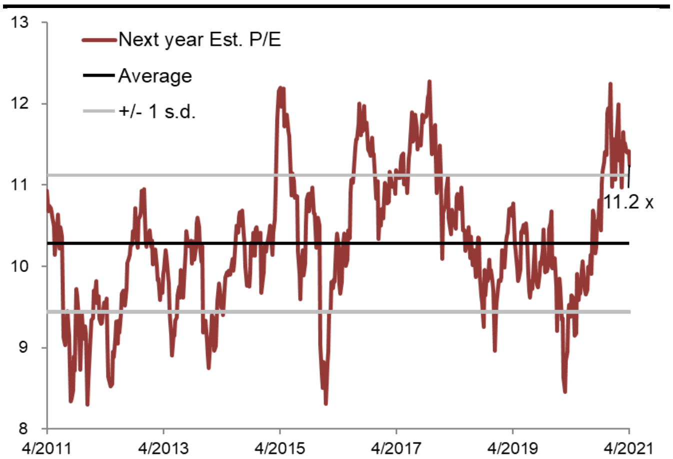
Source: Bloomberg, CMBIS

Figure 19: HSI current year estimated P/E



Source: Bloomberg, CMBIS

Figure 20: HSI next year estimated P/E

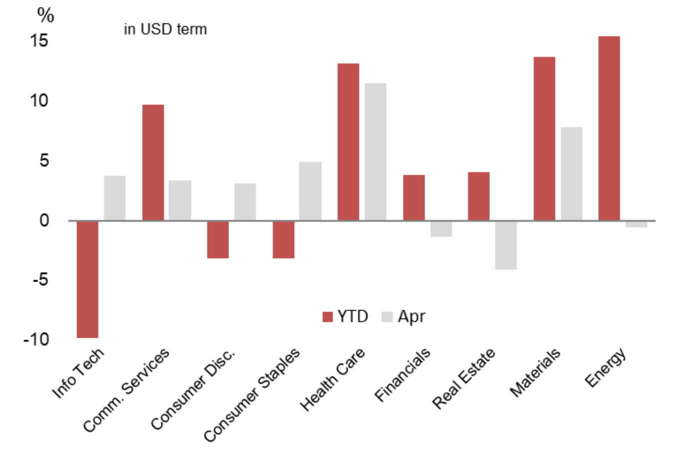


Source: Bloomberg, CMBIS

Strategy: Accumulate growth stocks

In <April Strategy Report>, we turned more neutral on both cyclical and growth stocks, expecting sector rotation to take a break. The sector performance of MSCI China in Apr did show much less contrast than in previous months (Fig. 21).

Figure 21: MSCI China's sector performance



Source: Bloomberg, CMBIS

We expect HK stock market's sentiment to gradually improve, as investors are getting used to moderately higher inflations and bond yields, and fears of monetary tightening by the Fed and the PBoC are being digested. In particular, the Fed has reiterated for several time to keep the current accommodative policies unchanged.

Growth stocks to lead again in 2H21

Looking ahead into the second half of 2021, low-base effect for economic growth and earnings will start to dissipate, and expectations of withdrawals of monetary easing will gradually build up (although we do not expect actual withdrawals by the Fed). Therefore, cyclical stocks which are enjoying strong earnings recovery fuelled by policy support may start to lose steam in 2H21, and investors will again prefer growth stocks which are much less reliant on monetary or fiscal stimuli.

Accumulate internet giants on probes-induced weakness

In May, there could be some more volatility in China internet stocks, as the likes of Tencent (700 HK), Alibaba (9988 HK), Meituan (3690 HK) will report quarterly results, and antitrust investigations by regulators could hit sentiment. **We believe any weakness in internet stocks brought about by antitrust probes should present good opportunities to accumulate**, as announcements of probe results/penalties could actually remove policy overhangs.

We are positive on technology sector (e.g. handset equipment) too. Shortage of chips may be affecting their production in the short term, but expect such shortage to ease in 2H21, when the sector would benefit from recovery in consumer demand and 5G rollout.

Avoid upstream commodity players

Commodity stocks are benefiting from economic recovery and rising energy and metal prices, but we believe stock prices in general may have fully priced in the positives. Chinese aluminium, steel, copper and coal producers have enjoyed 50%-70% surge in stock prices YTD. The rise in commodity prices is partly due to supply bottlenecks, which will be resolved by businesses sooner or later, although it is hard to predict the exact timing.

Another risk is that **China might take action to cap commodity prices to curb inflation**. Premier Li Keqiang stressed in Apr the need to strengthen market regulation of raw materials to ease cost pressures for companies.

Within the commodity sector, oil stocks are less risky than metals and coal stocks, as the former are lagging behind oil price and other commodity players.

Key risks

1) COVID-19 virus variants and / or rebound of new cases in major economies
2) Inflations exceeding expectations
3) Earlier-than-expected monetary tightening
4) Geopolitical risks, e.g. Russia-Ukraine tension, which may lead to risk aversion and fear of oil price spike leading to high inflations

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