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Strategy Report

Gauging China's recovery and impact on HK stock market

COVID-19 has infected over one million people worldwide. Although in Mainland China newly confirmed cases have dropped significantly since late-Feb, the pandemic and global demand slowdown are hurting China's economy. We analyse the impact on economy, stock market and various industries, and discuss the potential directions stock markets may go and which sectors could outperform.

- **Supply side recovery – structural differences.** We believe work resumption rate in China approached 80% nationwide at the end of Mar 2020. However, production capacity resumption likely lagged behind, due to COVID-19 prevention measures applied in the workplace, and slack new orders both in domestic and international markets. Pace of recovery varies by industry, geography and firm size.
- **Demand stagnant to have longer-run impact.** COVID-19 has put consumers in hibernation. Some of the demand may be lost forever due to consumer habit shifts and shrinking wealth effect. Unemployment rate is likely to rise in the process of economy slowdown and possible market clearing.
- **Export hurt by global slowdown.** As downturn in manufacturing production has deepened outside of China. Export orders continued to decrease in China. We found that computer, telecom, electronic and electrical equipment sectors are among the most vulnerable to short-term global demand disturbance.
- **Expect broader policy support in larger scale.** Policy supports, including fiscal and monetary, so far have mainly focused on providing instant relief to fight against COVID-19. When the nation comes back to work again, we think policy boost will extend much more broadly and in a larger scale to prompt both supply and demand.
- **Risk-off sentiment abating.** While fundamentals of global economy and corporate earnings are still deteriorating, market sentiments have improved somewhat since mid-to-late-March. VIX and VHSI almost halved from peaks. U.S. T-bills returned to positive after sinking below zero for the first ever time. U.S. corporate bond yield spreads have narrowed modestly.
- **Chart: HSI may form a second leg.** The U.S. and HK stock markets often rebounded by 38.2% Fibonacci retracement after sell-offs, then formed a second leg before bottoming out. If this time the HSI follows such typical pattern, we can expect it to rebound to 24,200 in the short term, and then fall again to form a second leg to bottom out.
- **Accumulate for long term; prefer policy-supportive sectors.** The HSI is trading at valuations only seen during financial crises. This is a good opportunity to accumulate HK-listed equities for long-term investors. That said, the pandemic is not yet under control and thus global and HK/China stock markets would remain volatile in the weeks ahead. We prefer policy-supportive industries, such as construction machinery, cement and 5G telecom equipment.

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Market Data

Hang Seng Index	23,236
52-week High / Low	30,280/21,139
3-month avg. daily t/o	HK$120.5bn

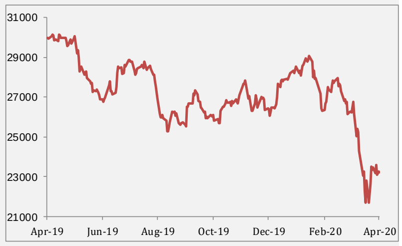
Source: Bloomberg

Indices Performance

	HSI	HSCEI
1-month	-11.6%	-9.5%
3-month	-18.3%	-15.7%
6-month	-11.0%	-7.1%

Source: Bloomberg

12-month HSI Performance



Source: Bloomberg

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China Economy – Recovery is shallower than V-shaped

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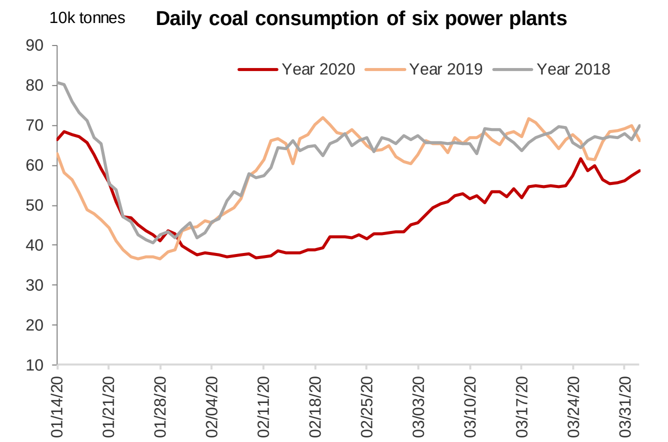
Supply side recovery – Structural differences

Overall work resumption rate may have approached 80%

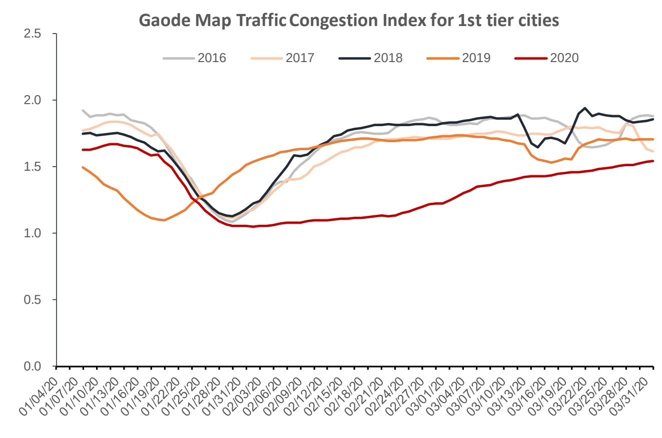
According to official data, work resumption rate (% of people coming back to work) reached over 96.6% for big and medium-sized firms in the PMI sample. Combining multiple high-frequency monitors, we believe work resumption rate could approach 80% nationwide at the end of Mar 2020. PMI data recorded marked improvement from Feb in terms of production and new orders growth. Daily coal consumption of six power plants reached ~85% of 2019 level. Inter-city traffic congestion index released by Gaode Map have also climbed to 80-90% of normal levels in first-tier cities.

Figure 1: Daily coal consumption – now close to 85% of last year's volume



Source: Wind, CMBIS

Figure 2: Intra-city traffic congestion now resumed to ~90% of 2019 level

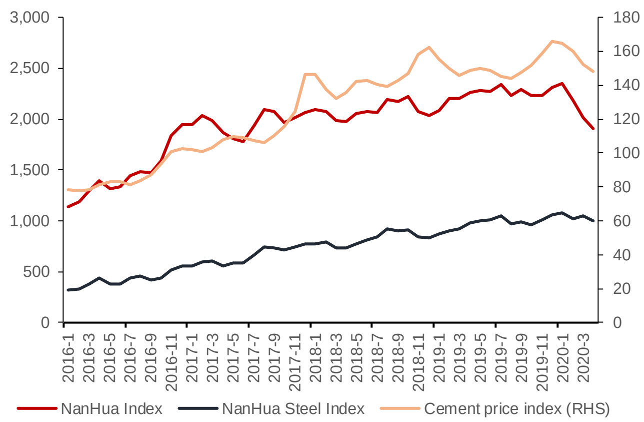


Source: Gaode Map, Wind, CMBIS
*Note: 7-day moving average data series is plotted.

…, however, production capacity resumption likely lagged

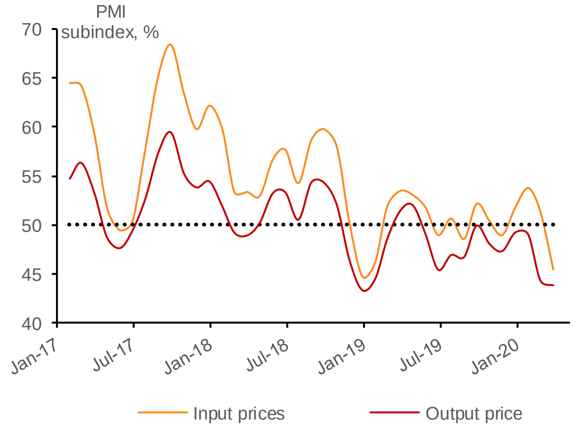
When it comes to production capacity resumption, however, extra discount should be applied primarily because of 1) COVID-19 prevention measures applied in the workplace; 2) slack new orders growth and demand stagnation both in domestic and international markets. For example, production resumption rate was 40% as of 11 Mar for major automobile producers while work resumption rate reached 90%, according to CAAM. Commodity prices continued to decline and PPI is likely to dive deeper in negative territory, all pointing to the fact that production status is far from being tight.

Figure 3: Declining commodity prices may suggest that production status has not been tight yet



Source: Wind, CMBIS

Figure 4: PMI price sub-index declined further in Mar, foreshadowing deepening PPI contraction



Source: Wind, CMBIS

Pace of recovery varies by industry, geography and firm size

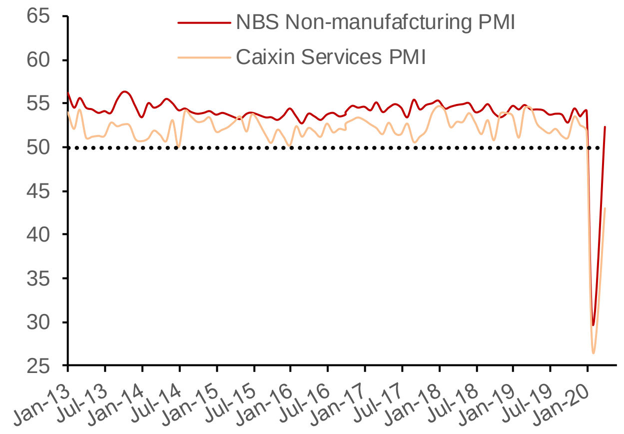
1) **Manufacturing exhibited more resilient recovery than the service sector**. The majority of non-manufacturing PMI sub-indices released by the NBS were still in contraction even though headline figure exceeded 50% in Mar. Moreover, Caixin services index read only 43% in Mar (vs. 26.5% in Feb), indicating that non-manufacturing companies especially SMEs the Caixin sample primarily comprised of, were still suffering.

2) We observed **sentiment recovery in policy-supportive industries**, such as auto, pharmaceutical, computers and telecommunications. In the non-manufacturing sector, logistics & delivery industry recovery was robust to lay a foundation for work resumption across the economy. Construction activities also picked up quickly since Mar (work resumption rate close to 90% except Hubei), which bodes well for infrastructure investment.

3) **Consumer-facing industries still suffered,** for example, hotels & restaurants, cultural & sports, residents' services, due to widespread social distancing and hibernating consumer behaviour.

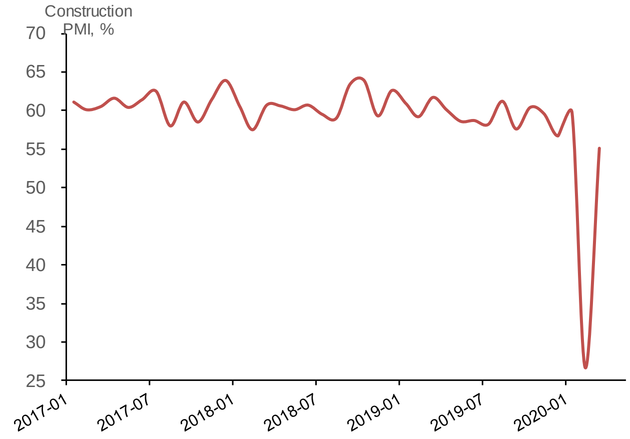
4) Larger firms witnessed speedier recovery than smaller ones, likely due to relatively ample resources, disease prevention and supply chain management capabilities, etc. Firms of vital importance in the supply chain recovered faster. For some industries, such as construction, companies in southern China enjoyed faster recovery.

Figure 5: Service sector recovery likely lagged manufacturing sector



Source: Wind, CMBIS

Figure 6: Construction activities resumed faster than average since Mar



Source: Wind, CMBIS

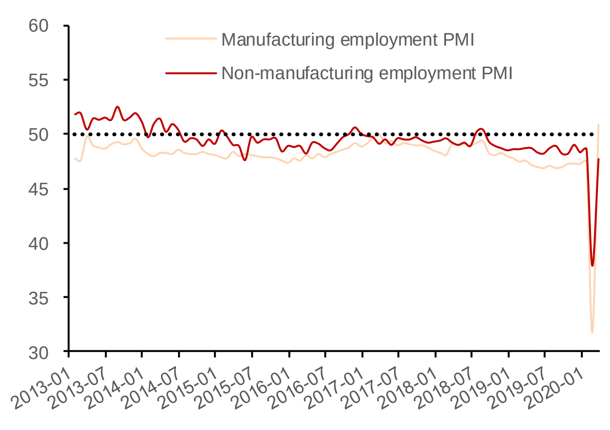
Demand stagnant is likely to have longer-run ramifications

In the short horizon, COVID-19 has put consumers in hibernation thereby sending consumer-facing industries and upstream producers into dismal. While some of the demand will definitely pick up, if not in a "revengeful" way, we suspect others may be lost forever due to 1) consumer habit shifts; and 2) shrinking wealth effect as wage growth decelerated and people are less willing to spend.

Slack employment conditions; service sector employment could be more worrisome

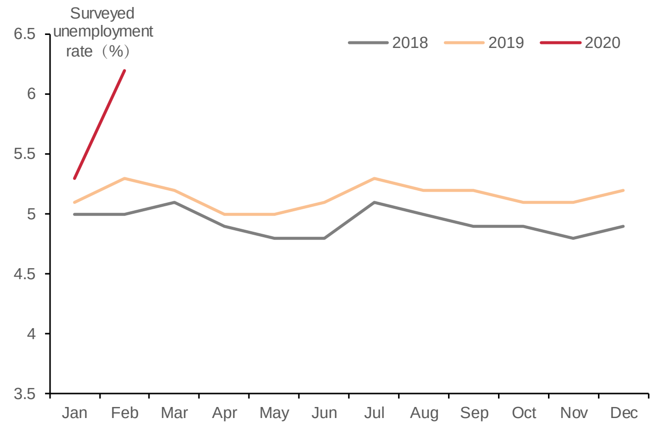
Unemployment rate is likely to rise in the process of economy slowdown and possible market clearing. One of the leading indicators that help us gauge labour market trends in China are the employment sub-index of PMI. After a free fall in Feb, manufacturing employment PMI climbed back above 50%, indicating improving conditions in Mar. However, non-manufacturing employment remained in contraction in Mar and below pre-coronavirus levels.

Figure 7: Non-manufacturing employment may face greater pressure



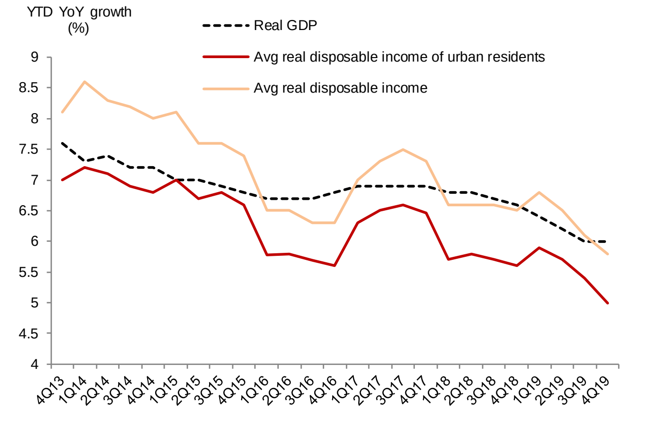
Source: NBS, Wind, CMBIS

Figure 8: Surveyed unemployment rate spiked to 6.4% at the end of Feb



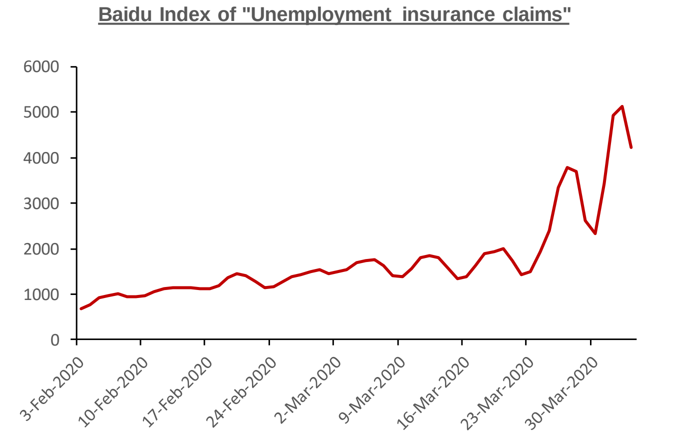
Source: NBS, Wind, CMBIS

Figure 9: Disposable income growth would plunge along with GDP growth



Source: NBS, Wind, CMBIS

Figure 10: Baidu index of "unemployment insurance claims" hiked since late Mar

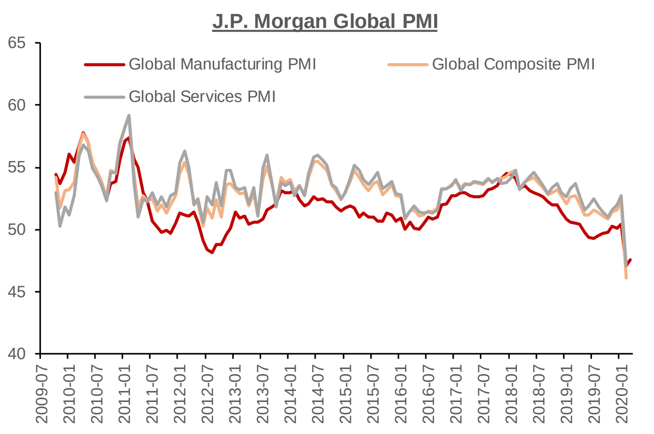


Source: Baidu, CMBIS

Export hurt by global slowdown

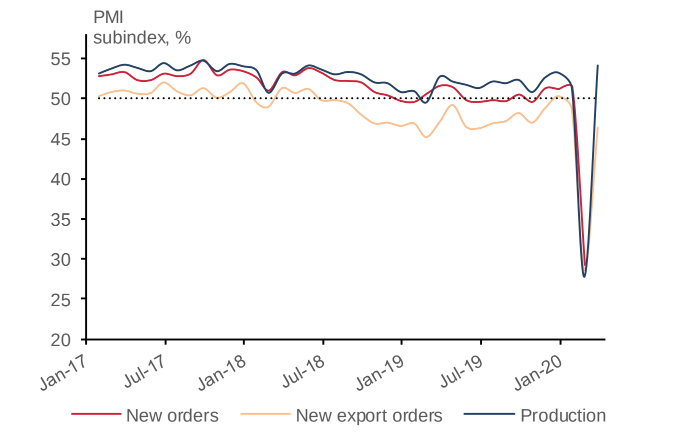
China is also likely to suffer collateral damage as the entire globe navigates through widespread economic slowdown. Downturn in manufacturing production has deepened outside of China. Export orders continued to decrease in China.

Figure 11: JP Morgan Global PMI



Source: Wind, CMBIS

Figure 12: PMI export orders sub-index stayed below pre-coronavirus levels



Source: CMBIS estimates

Figure 13: JP Morgan Manufacturing PMI; new orders shrank more severely than production

	2019-01	2019-02	2019-03	2019-04	2019-05	2019-06	2019-07	2019-08	2019-09	2019-10	2019-11	2019-12	2020-01	2020-02	2020-03
Headline PMI	**50.80**	**50.60**	**50.50**	**50.40**	**49.80**	**49.40**	**49.30**	**49.50**	**49.70**	**49.80**	**50.30**	**50.10**	**50.40**	**47.10**	**47.60**
- Production	50.80	50.60	50.30	50.60	50.10	49.50	49.40	50.00	50.10	50.30	51.00	50.40	50.80	43.50	45.40
- New orders	50.10	50.00	49.90	50.10	49.50	49.00	49.20	49.00	49.40	50.00	50.40	50.30	50.80	45.20	43.80
- Input price	54.10	53.50	53.40	53.00	52.60	52.00	50.90	50.20	51.00	50.40	50.30	51.30	51.80	51.90	50.10
- Employment	51.10	51.10	51.00	50.60	49.90	49.80	49.20	49.60	49.50	49.20	50.10	49.60	49.80	47.20	47.50
- Output price	51.50	51.90	52.00	51.30	51.10	50.90	50.00	49.50	50.00	49.70	50.10	51.00	50.60	49.90	48.90

Source: Wind, CMBIS

What industries may be affected most in the short run?

We sorted manufacturing industries by export dependency, measured by the share of export in revenue in 2019. We find the following two industries may be among the most vulnerable to short-term demand disturbance in the global market - 1) computers, telecommunications and electronic equipment; 2) electrical machinery and equipment. These industries not only derive a larger proportion of revenue from export delivery, but also are significant in absolute value of export and production output.

Other industries are also prone to suffer from export declines due to higher export dependency, for example, a) cultural, educational, arts and sports goods, b) leather, furs, down and footwear, c) textile and clothing, d) general purpose equipment as well as special purpose equipment, e) rubber and plastic products, e) metal products, etc.

Figure 14: Manufacturing industries sorted by export dependency

(RMB bn, 2019 figures)	Export valu	Revenue	% Export / Revenue
Computers, Communication and Other Electronic Equipment	5,605.4	11,371.8	49.3%
Repairing of Metal ware, Machinery and Equipment	41.7	133.6	31.2%
Other Manufacturing	47.4	163.4	29.0%
Cultural, Educational, Arts and Sports Goods	364.9	1,278.4	28.5%
Leather, Furs, Down and Related Products and Footwear	310.3	1,167.3	26.6%
Manufacture of Furniture	169.2	711.7	23.8%
Textile and Clothing	358.2	1,601.0	22.4%
Railway, Ships, Aircrafts, Aerospace and Other Transportation Equipment	200.5	1,127.5	17.8%
Manufacture of Electrical Machinery and Equipment	1,143.9	6,543.8	17.5%
Instruments and Meters	119.5	724.3	16.5%
Rubber and Plastic Products	373.0	2,542.6	14.7%
General Purpose Machinery	547.8	3,826.5	14.3%
Textile	284.3	2,403.8	11.8%
Special Purpose Machinery	346.1	2,947.3	11.7%
Metal Products	354.6	3,432.3	10.3%
Printing, Reproduction of Recording Media	54.5	664.9	8.2%
Timbers, Wood, Bamboo, Rattan, Palm and Straw Products	53.2	848.5	6.3%
Chemical Fibers	53.0	857.1	6.2%
Medicines	141.6	2,390.9	5.9%
Raw Chemical Materials and Chemical Products	380.2	6,577.6	5.8%
Manufacture of Foods	109.8	1,907.4	5.8%
Processing of Food from Agricultural Products	230.6	4,681.0	4.9%
Automobiles	372.3	8,084.7	4.6%
Paper and Paper Products	60.3	1,337.0	4.5%
Processing of Petroleum, Coal, Other Fuel	166.9	4,837.8	3.4%
Manufacture of Non-metallic Mineral Products	179.5	5,382.6	3.3%
Smelting and Pressing of Ferrous Metals	179.6	7,072.5	2.5%
Smelting and Pressing of Non-ferrous Metals	116.9	5,630.0	2.1%
Manufacture of Liquor, Beverage and Refined Tea	22.9	1,530.3	1.5%
Discarded Resources and Waste Materials Recovery and Processing	2.0	457.7	0.4%
Manufacture of Tobacco	4.6	1,109.2	0.4%
Overall	**12,394.3**	**93,344.5**	**13.3%**

Source: Wind, CMBIS

Policy support

Fiscal policy has vowed for three measures: **1)** Raise deficit ratio. We expect official deficit ratio, to be announced during the NPC&CPPCC, to reach or even exceed 3.0%. **2)** Issue special treasury bond, possibly to target most-affected subjects and SMEs. **3)** Increase issuance of local government special bond (LGSB) and urge effective use of the proceeds to foster infrastructure investment.

Monetary policy – aims for lowering lending rate and maintaining liquidity at reasonable levels. Since the 27 Mar Politburo Meeting, the PBoC has 1) cut reverse repo interest rate by 20bp; 2) announced targeted RRR cut to support SMEs (expected to release RMB 400bn); 3) lowered interest rate on excess reserves; 4) increased relending & rediscount quota by RMB 1tn for medium- to small-sized banks so that the latter could better extend support to SMEs.

Expect more broad policy boost. Policy supports so far have mainly focused on providing instant relief to fight against COVID-19. When the nation comes back to work again, we think policy boost will extend much more broadly and in a larger scale to prompt both supply and demand.

Special support shall be extended to SMEs. Recovery of SMEs, particularly service sector SMEs has been weak and we don't expect "revengeful" consumption to happen soon to save them from bankruptcy. SMEs also employed a meaningful portion of working population. We think there has to be external forces, either by providing cheap and easy loans, tax and expense cuts, or urging residents to consume by distributing coupons.

Hong Kong Stock Market Outlook

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COVID-19 – One million people infected

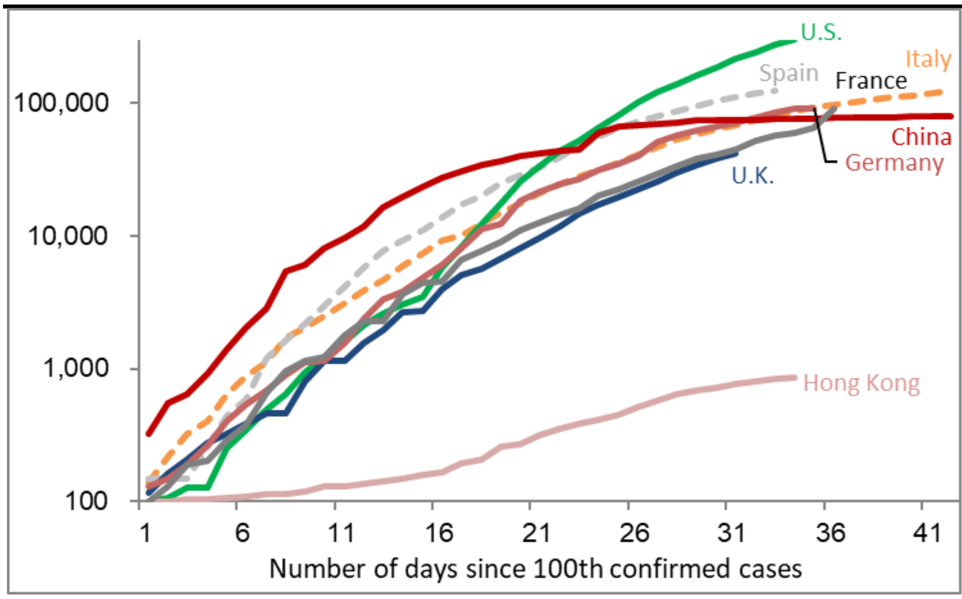
Reported COVID-19 cases around the world surpassed one million on 2 Apr.

The U.S. has become the country with the most cases, topping 300,000, as having adopted fast screening of suspected patients and strict quarantine measures may have pushed up the number.

In Europe, while Italy, Germany and Spain are showing signs of decline in newly confirmed cases (the head of Italy's national institute of health recently announced that the country "has reached a plateau" in its infection rate), the same cannot be said of France and the U.K. Overall speaking, Europe will probably take longer to battle the virus.

Extended period of lockdown measures and social distancing are going to put further pressure on the global economy.

Figure 15: COVID-19 confirmed cases in some countries



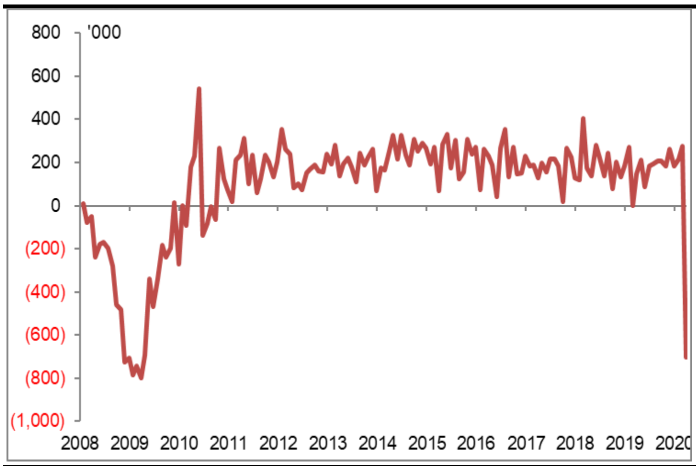
Source：Bloomberg, CMBIS

Risks of lower forecasts in economy and earnings

Economic data, in particular employment data, in the U.S. have been shockingly bad over the past two weeks. **Nonfarm payrolls in March fell by 701,000, close to the financial-tsunami-peak of -800,000 in March 2009**. The unemployment rate rose to 4.4% from 3.5%. What is worse is that the report has not yet captured the full damage from the virus because the Bureau of Labor Statistics used as its reference period the week ending 12 Mar, which came just as the U.S. began lockdown measures.

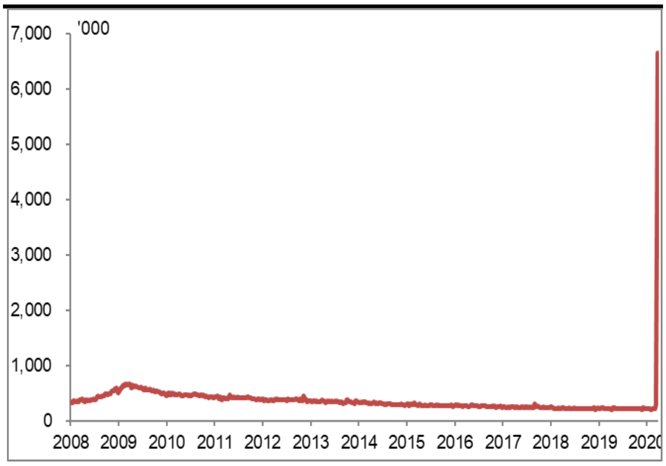
Initial jobless claims surged to record high for two consecutive weeks, and had 10 million in total in the past two weeks. This is showing a better picture of the pandemic's damage to the labour market.

Figure 16: U.S. non-farm payrolls



Source: Bloomberg, CMBIS

Figure 17: U.S. weekly initial jobless claims



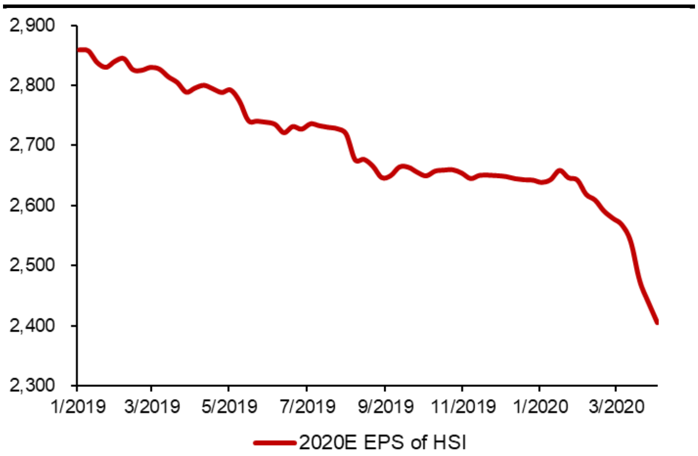
Source: Bloomberg, CMBIS

As we enter the Q1 result season in the U.S. stock market, attention will be on to what extent the dire economic situation has and will hurt corporate earnings. Guidance will be closed watched. Industries that are hardest hit by the pandemic such as transportation and consumer discretionary will probably give very conservative guidance, especially after shocking employment data.

In case American companies report poor-than-expected Q1 earnings and forward guidance, that will likely lead to lower earnings forecast in related HK/China companies too. **Chinese manufacturers with exposure in the U.S. or Europe may have some orders pushed back or cancelled**, and therefore have pressure in cashflows.

Consensus earnings forecast of the HSI are being revised downwards since mid-January when the coronavirus outbreak started in China. The cut has become more severe since mid-March when COVID-19 officially became a pandemic. **The HSI's 2020E EPS are now 9.6% below YTD peak**.

Figure 18: HSI's 2020E EPS down 9.6% from YTD peak



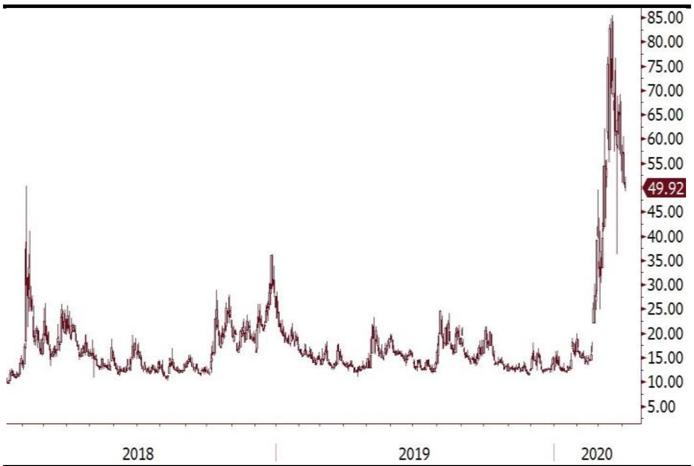
Source: Bloomberg, CMBIS

Risk indicators showing some calm for now

While fundamentals of global economy and corporate earnings are still deteriorating, **market sentiments have improved somewhat since mid-to-late-March**:

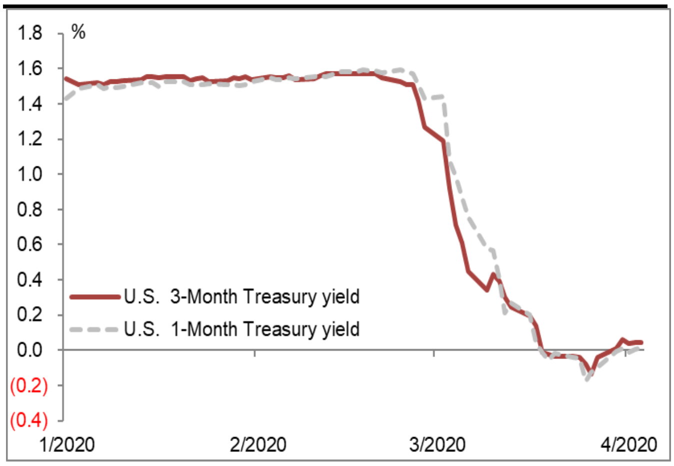
1. **The CBOE Volatility Index (VIX) has retreated** from 85, close to the peak in 2008, to 50, which is still abnormally high but at least shows that investors are now much less panic than 2-3 weeks ago.
2. **The U.S. Treasury bills (1-month & 3-month) have returned to positive** after briefly sinking into negative territory for the first time in history as investors sought safe haven.
3. **The investment grade (BBB) and high yield US corporate bonds' yield spreads have declined** for six days in a row from the peak in 23 Mar, before rebounding mildly in the first two days of April. Corporate yield spreads are closely monitored by investors, as the pandemic and stringent lockdown measures are putting some industries into serious existential threats. For now, worries of widespread defaults and consequently a banking crisis have calmed a bit.

Figure 19: VIX retreated from post-2008 peak



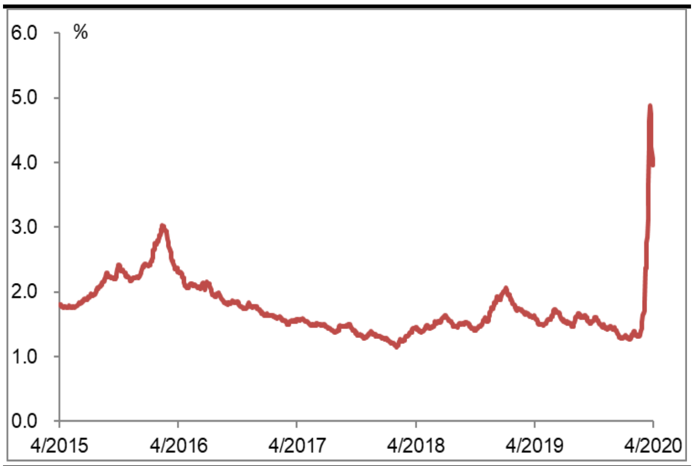
Source: Bloomberg, CMBIS

Figure 20: US T-bills' yield returned to positive



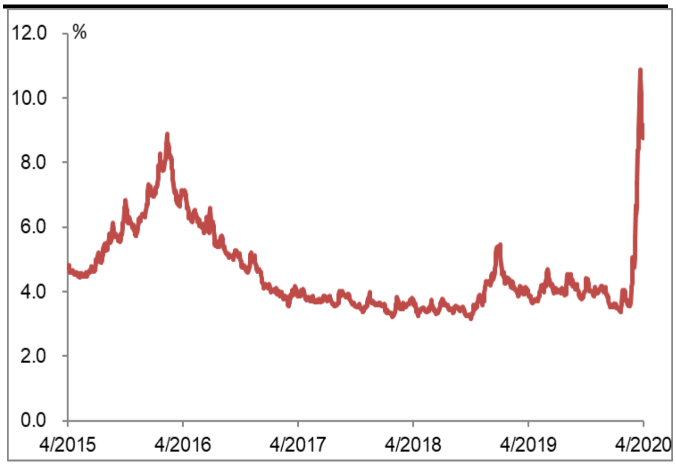
Source: Bloomberg, CMBIS

Figure 21: U.S. BBB Corporate spread



Source: CMBIS, Ice Data Indices, LLC, ICE BofA BBB US Corporate Index Option-Adjusted Spread, retrieved from FRED, Federal Reserve Bank of St. Louis, as of 2 Apr

Figure 22: U.S. Corporate High Yield spread



Source: CMBIS, Ice Data Indices, LLC, ICE BofA US High Yield Index Option-Adjusted Spread, retrieved from FRED, Federal Reserve Bank of St. Louis, as of 2 Apr

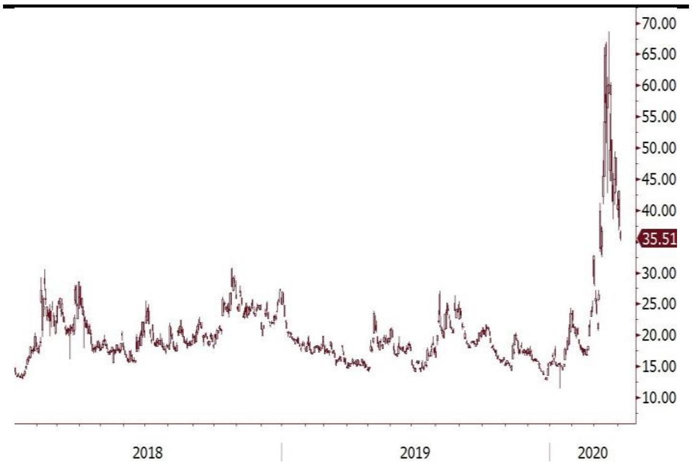
HK stock market at trough valautions

Sentiment in the Hong Kong market has also improved. Similar to the VIX, the Hang Seng Volatility Index (VHSI) retreated from historical high 68 to 36. With the HSI currently at crisis valuations, the improvement in sentiment should drive the valuation upward over the medium term.

The HSI dropped to as low as 8.5x 2020E P/E on 19 Mar, the lowest since the global financial tsunami in 2008, and is now trading at 9.7x after some rebound in share prices and further earnings cut.

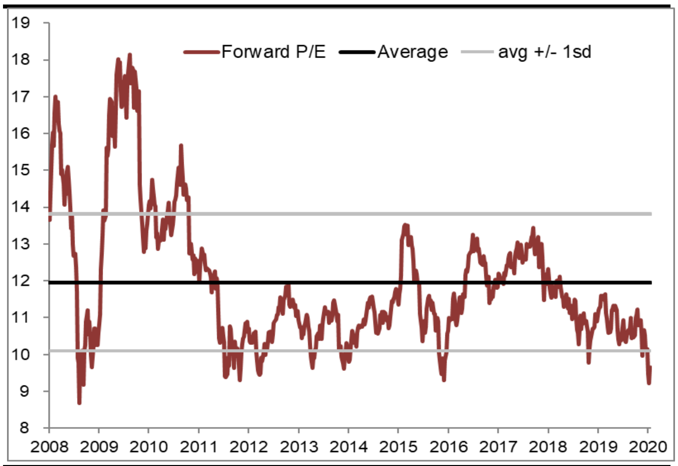
Price-to-book (P/B) of the HSI dropped to as low as 0.90x (now at 0.99x), even lower than the troughs in 2008's financial tsunami and 1998's Asian financial crisis.

Figure 23：VHSI retreated from historical peak



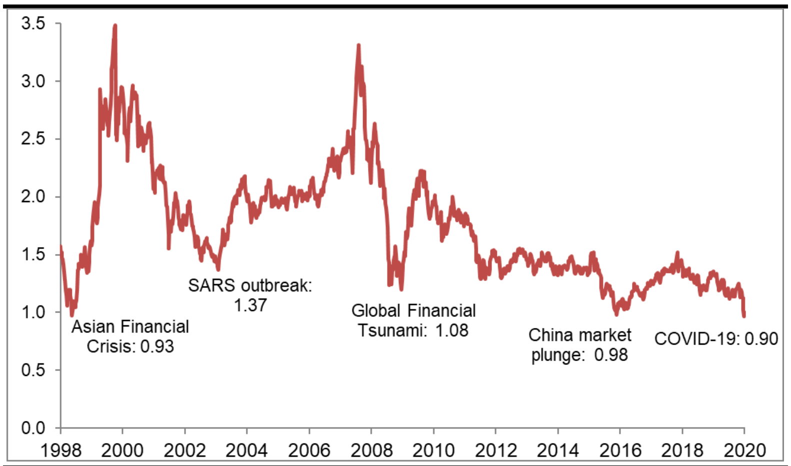
Source: Bloomberg, CMBIS

Figure 24：Forward P/E of HSI at 9.7x



Source: Bloomberg, CMBIS

Figure 25：P/B of HSI at financial crisis levels



Source: Bloomberg, CMBIS

Chart: HSI may form a second leg

While valuations suggest the HSI has probably reached a rock bottom, technical analysis shows that **the market may retest the recent bottom before staging a sustainable rally**.

We look back on the sell-offs in the S&P 500 in 1987, 1998, 2008, and the HSI in 1998, 2008, 2011, 2015. In all those occasions, after the "first leg" down and subsequent rebound, the index fell by >10% from the rebound peak, sometimes forming a "double bottom" around the first leg's trough, other times breaching that trough. The HSI in 2011 is the only case where the "second leg" is significantly higher (almost 10%) than the first trough.

How far can the first round of rebound go before making the second leg down? Usually 38.2% Fibonacci retracement, as shown in the charts below.

If this time the HSI follows such typical pattern, we can expect it to rebound to 24,200 in the short term, and then fall again to form a second leg to bottom out.

Figure 26: S&P 500 in 1987

Source: Bloomberg, CMBIS

Figure 27: S&P 500 in 1998

Source: Bloomberg, CMBIS

Figure 28: S&P 500 in 2008

Source: Bloomberg, CMBIS

Figure 29: HSI in 1998

Source: Bloomberg, CMBIS

Figure 30: HSI in 2008

Source: Bloomberg, CMBIS

Figure 31: HSI in 2011

Source: Bloomberg, CMBIS

Figure 32: HSI in 2015

Source: Bloomberg, CMBIS

Figure 33: HSI in 2020

Source: Bloomberg, CMBIS

Investment strategy – Accumulate policy-supportive sectors

- **Broad market – Opportunity to accumulate for long-term**

Following the sell-off in the past three months, the HSI is trading at valuations only seen during financial crises. While there could be more earnings downgrade ahead, rendering the adjusted P/E ratio less cheap as it now seems, **P/B ratio below 1x suggests this is a good opportunity to accumulate HK-listed equities for long-term investors**.

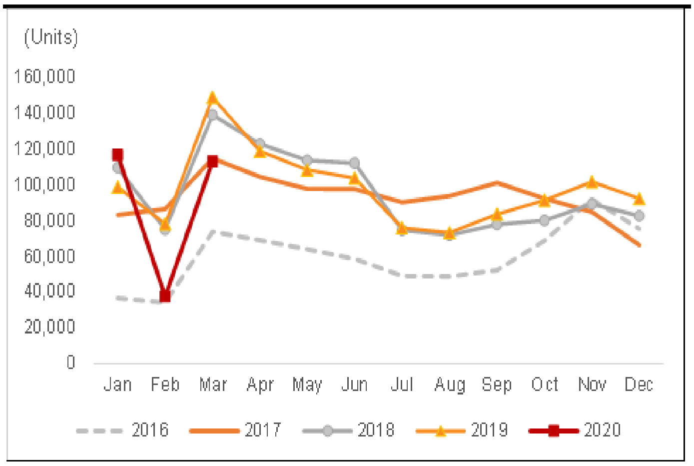
However, as the pandemic is not yet under control, and has already done severe damage to the global economy (shockingly bad employment data in the U.S., for instance), and would in turn undermine export and employment in China, **we believe global and HK/China stock markets would remain volatile in the weeks ahead**. Therefore, investors with shorter investment horizon and more focus on market timing may, instead of chasing the rally, wait for the HSI retest the recent trough at ~21,000 to buy more aggressively.

■ **Sector preference – Policy-supportive industries**

As our economist points out, China's export, service sector and consumer-facing industries are under more pressure. On the contrary, policy-supportive industries' sentiment is recovering better. They include infrastructure, telecommunications equipment and pharmaceutical.

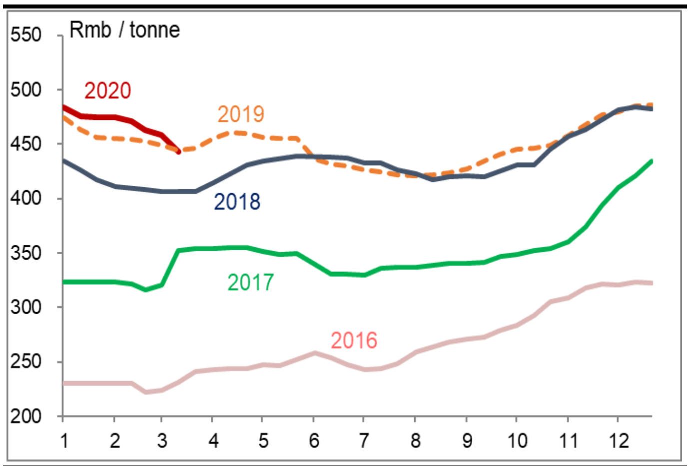
We continue to like infrastructure-related stocks. They are less impacted by the epidemic and oil prices' fluctuations, while benefit from China's fiscal stimuli. In particular, the latest data of heave-duty trucks (HDT) and cement sectors showed resilience. China's HDT sales in March rebounded threefold from February. Average cement prices in Q1 posted YoY growth in spite of the virus outbreak. **Construction machinery, cement and 5G telecom equipment stocks could outperform**.

Figure 34: China HDT sales in March +2x MoM



Source: Bloomberg, CMBIS

Figure 35: China's cement prices



Source: Bloomberg, CMBIS

Avoid consumer, export and OEM sectors, as they are the hardest hit by the pandemic and the resulting lockdown, social distancing and cancellation of orders. Things could get worse before they get better.

Downside risks

- Outbreak shows no signs of under control in Europe and the U.S.
- Surge in imported cases of COVID-19 in China and Hong Kong
- Lockdown and social distancing policies remain for an extended period
- Rebound in COVID-19 cases after relaxing lockdown measures
- Corporate defaults or bankruptcies which may trigger a surge in banks' NPLs
- Poor quarterly earnings and guidance by U.S. and Chinese companies

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