February Monthly Strategy

Impact of coronavirus

Coronavirus outbreak turns out to be the black swan which significantly drags down Hong Kong stock market. Looking back at the market performance during SARS in 2003, we believe HSI has yet to reach its bottom currently. We expect a weak trajectory in February and suggest investors to reduce sector directly hit by coronavirus and cyclical stocks. Wait till panic sell-off sets in to purchase quality stocks.

- **A black swan event after all good news are out.** In January the market first experienced a rise and followed by a slump. The first half of January was supported by the first stage of China-US trade deal, but the Wuhan coronavirus spread has encumbered HSI notably with an accumulated fall of 9.8% in seven trading days. The outbreak of Wuhan coronavirus is similar to SARS in 2013 yet with higher spreading rate but lower fatality rate so far.
- **Forecast based on SARS history.** On the time front, the market is likely to reach its trough in Mar or Apr. During the SARS outbreak Hong Kong stock market bottomed out a month before the epidemic started to stabilize. At this stage there is no consensus among medical professions on when the Wuhan coronavirus outbreak will reach its peak. A conservative estimate would be Apr, implying HSI could hit the bottom as soon as Mar, serving as an early indication of coronavirus containment. In terms of magnitude, HSI fell 18.7% in total during SARS but merely 9.8% since the outbreak of Wuhan coronavirus.
- **Market not enough panic.** A sinking market triggered by major bad news usually bottoms out amid panic. However, the market showed no significant increase in turnover nor panic sell-off in current. VHSI rose to above 23, yet still below the peaks in last two years which ranged from 26-30. This implies there is not enough panic in the market to signal an absolute bottom.
- **Investment strategy: Reduce sectors directly hit by coronavirus and cyclical stocks, avoid bottoming fish too early.** It is more reasonable to stay prudent at present and reduce stocks, especially sectors directly hit by coronavirus, such as airline, travel, hotel, gaming, retail, catering and movie, and cyclical stocks that are volatile, such as property, brokerage, basic metals and automobile. Meanwhile, investors may switch to defensive stocks like utilities. In the mid to long run, before the outbreak reaches its peak and when the market shows panic, it will be the opportunity to purchase good quality shares. Investors may then focus on sectors with high profit growth and visibility or sectors with policy support.
- **Sector implications:** In general, consumption, technology hardware and equipment, brokerage and automobile face hardest hit from coronavirus; healthcare, online games and videos, online education may benefit; banking, utilities and capital goods are more defensive choices.

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HSI	26,313
52w High/Low	30,280/24,897
Avg 3 mths t/o (HK$ bn)	86.1

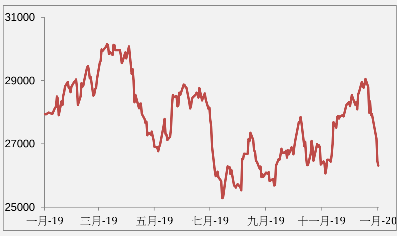
Source: Bloomberg

Performance of HSI and HSCEI

	HSI	HSCEI
1-mth	-7.5%	-9.0%
3-mth	-2.9%	-3.6%
6-mth	-2.3%	-1.0%

Source: Bloomberg

12-mth HSI Performance



Source: Bloomberg

Forecast based on SARS history

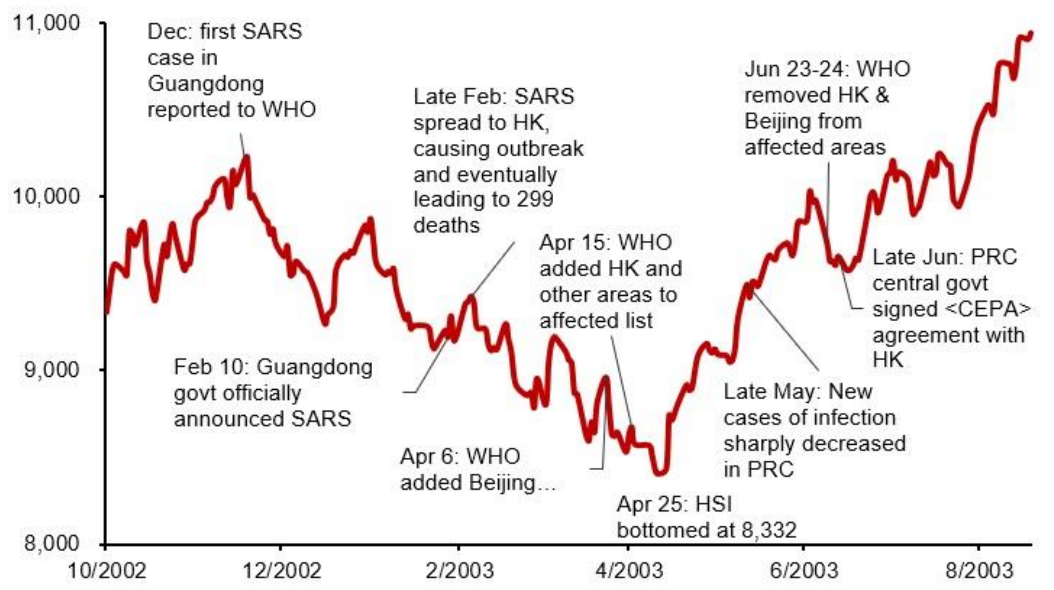
The market will not simply repeat itself, given the uncertainties of development speed and severity of the situation in relation to novel coronavirus infection, disease prevention policies and other factors (such as China-US relationship). Nevertheless, investors will undoubtedly refer to the past history in making decisions.

Trough likely in Mar or Apr

The key factors to determine a trough lie on when coronavirus reaches its peak and substantial reduction in new cases. SARS broke out in Nov 2002 in mainland China and HSI first peaked at 10,247 in early-Dec and started witnessing a lurch since then, experiencing an accumulated fall of 10% by early-Jan in 2003. SARS was later spread to Hong Kong in Feb. HSI continued to plummet till it hit the trough at 8,332 in Apr. In May the new cases in mainland China substantially decreased (Fig 1). In other words, the Hong Kong stock market began to bottom out a month before the epidemic started to stabilize.

At this stage there is no consensus among medical professions on when the Wuhan coronavirus outbreak will reach its peak. On 28 Jan, Zhong Nanshan, the leader of the high-level expert group of the National Health and Medical Commission, predicted the epidemic will reach its peak within a week or 10 days, not with a large-scale increase after. On the other hand, the academics of School of Public Health of the University of Hong Kong predicted the number of cases in Wuhan could peak in Apr, while Chongqing and Beijing will also peak one to two weeks later. On a conservative side, assuming a higher probability for the predictions of the team from University of Hong Kong to happen, we estimate the market is likely to bottom out in Mar or Apr, serving as an early indication of coronavirus containment.

Figure 1: HSI timeline durings SARS



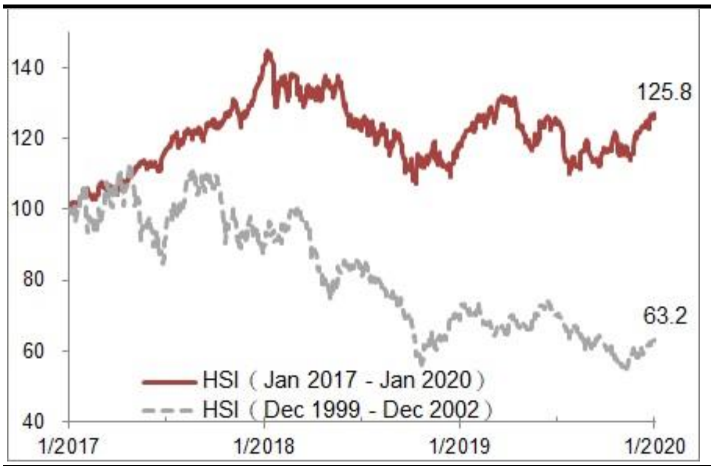
Source: CMBIS

Decline magnitude not great enough

The SARS trough appeared at 8,332 in end-Apr 2003. Compared with the accumulated 18.7% fall from 10,247 in Dec 2002 during SARS, the 9.8% drop of HSI since 20 Jan 2020 is far from notable.

One thing to note is that the Hong Kong stock market was already waning before the outbreak of SARS in end of 2002, as it was hardly hit by 1997 financial crisis, 2000 dot-com bubble and plunge of housing prices. Before SARS the HSI had already declined by over 40%. In contrast, prior to the outbreak of the novel coronavirus, HSI stood above 29,000, 26% higher than the level three years ago (Fig 2), only 12% lower than the historical high. The room for market correction is greater this time.

Figure 2：HSI 3-year trend before SARS and nCoV



Source: Bloomberg, CMBIS

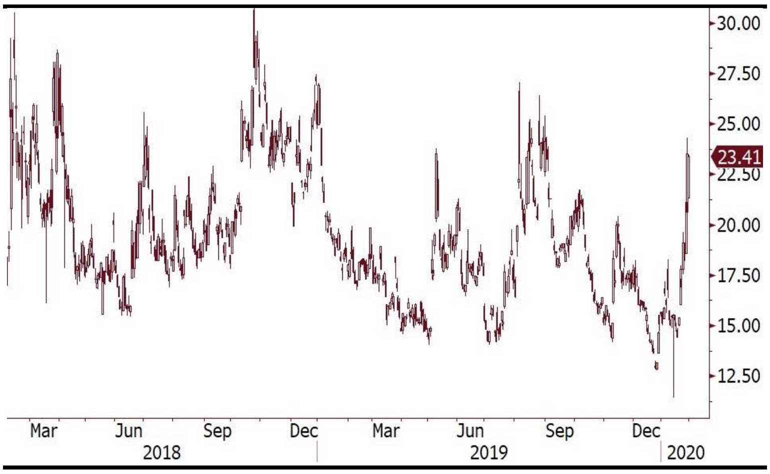
Investment Strategy

Market not enough panic

As cases of coronavirus continue to climb, the length and magnitude of correction is not significant enough, and there is not enough panic in the market, HSI is yet to achieve an absolute bottom.

A sinking market triggered by major bad news usually bottoms out amid panic. However, the market showed no significant increase in turnover nor panic sell-off in current. VHSI rose to above 23, yet still below the peak at range of 26-30 in last two years. This implies there is not enough panic in the market to achieve the hardest fall of all.

Figure 3: VHSI not yet at panic level



Source: Bloomberg

Reduce sectors directly hit by coronavirus and cyclical stocks

It is more reasonable to stay prudent at present and reduce stocks, especially sectors directly hit by coronavirus, such as airline, travel, hotel, gaming, retail, catering and movie, and cyclical stocks that are exposed to high volatility, such as property, brokerage, basic metals and automobile.

Meanwhile, investors may switch to defensive stocks like utilities, such as electricity, gas, and telecommunication.

In the mid to long run, before the outbreak reaches its peak while the market starts to show fears (likely to happen in Mar or Apr), it will be the opportunity to purchase good quality shares. Investors may by then focus on 1) sectors with high profit growth and visibility, including internet, technology, healthcare, education and property management; 2) sectors directly hit in the short term by epidemic but have sound long-term fundamentals, including sports apparel and dairy; and 3) sectors with fiscal policy support, such as construction machinery.

Sector Implications

In general, consumption, technology hardware and equipment, brokerage and automobile face hardest hit from coronavirus; healthcare, online games and videos, online education may benefit; banking, utilities and capital goods are more defensive choices.

- **Consumer staples**

The sector would be negatively affected by virus outbreak. The destocking of channel inventory would be affected because consumers are unwilling to go shopping. The impact on CNY dining and gift related categories such as white wines and dairy products could be greater. According to Mengniu, the operation of its Wuhan factory is still normal. On the other hand, manufacturers of instant noodles may benefit, including Nissin Foods (1475 HK), Tingyi (322 HK) and Uni-President China (220 HK).

- **Consumer discretionary**

The impact from virus outbreak is without doubt negative, because it would hurt the demand of: 1) social related consumption (e.g. catering, entertainment, shopping etc.), 2) outdoor activities (e.g. sports) and 3) tourism (e.g. domestic travelling, hotels, HK retail and even Macau gaming). On the other hand, demand may shift to online, hence may benefit E-commerce and food delivery platforms.

- **Technology**

Wuhan is a leading technology hub for Chinese tech companies, especially display and telco equipment supply chain. Wuhan-based listed companies are negatively impacted, including 1) Display: TCL (000100 CH) (50% of capacity), BOE (000725 CH), Tianma (000050 CH); 2) optical components: Fiberhome (600498 CH) (HQ), Accelink (002281 CH) (HQ), YOFC (6869 HK) (HQ); 3) Memory: XMC (NOR Flash), YMTC (NAND); 4) R&D center: Huawei (10k staff in Wuhan), Xiaomi (1810 HK) (Second HQ, 2k staff for AI in Wuhan). Technology supply chain are highly globalised and integrated. We expect lockdown of Wuhan will lead to negative impact to production lines and labour shortage after CNY. Regarding supply chain, we expect limited impact to Apple/Huawei plays given global diversified production location, while 5G telco equipment names will face short-term impact due to uncertainty of optical component disruption.

- **Brokerage**

We expect China brokers' share price to be negatively impacted due to fear-triggered selloff in short-term. The roll-out of reform measures are now less likely to be seen in 1Q20, while the industry's mid-term growth perspective remains intact as the market reform and opening-up will continue. The recent correction could provide a good entry point for market leaders with strong investment banking franchise, e.g. CITICS (6030 HK, BUY), CICC (3908 HK, BUY) and CSC (6066 HK, BUY).

- **Automobile**

Overall, we expect a downside pressure on auto sales volume in the short run as residents will reduce visits to 4S stores. Regionally, we believe Dongfeng Motor (489 HK) will be significantly affected as it is the single largest player in Hubei. However, the inventory replenishment together with production recovery will make the whole sales volume skyrocketed after the event settles down. We recommend investors to keep eye on strong local brands such as Geely (175 HK) as some residents will try to avoid public transportation and choose to purchase their first car.

- **Healthcare**

There are no drugs with clear efficacy for the virus. Pharma companies producing anti-virus or anti-biotic medicines may slightly benefit, including Livzon Pharma (1513 HK/ 000513

CH, NR), Yichang Hec Changjiang Pharm (1558 HK, HOLD), United Laboratories (3933 HK, NR). Yuyue Medical (002223 CH) will also benefit as a consumable medical devices manufacturer.

- **Internet**

We expect online entertainment sector (including Game and Live-streaming) to benefit, with more user time spent & MAU in spring festival than usual. Noted that DAU of <HoK> and <PUBG Mobile> hit record highs in CNY, suggesting eye-catching grossings of Tencent. On the other hand, we expect OTA and film segments to be negatively affected, for less transportation and CNY films delay. Stock call: Tencent (700 HK), benefiting from strong games.

- **Education**

K12 and higher education are formal education and the tuition fees are prepaid in advance. We expect the commencement of second semester could be delayed and summer holiday could be shortened for the completion of second semester tuition. Therefore, we think the impact on earnings is insignificant (more expenses for masks and sterilization products purchases), unless the virus outbreak lasts for very long time. For K12 after school tutoring, we think the winter break short-term courses could be replaced by online learning. However, the epidemic spread might negatively affect the registration of second semester courses. There could be shift from offline learning to online learning. K12 after school tutoring companies with high revenue mix from online learning businesses could do better than those with less. Koolearn (1797 HK, NR), a pure online K12 after school tutoring service provider, should benefit from increasing online education demand.

- **Banking**

On 26 Jan, CBIRC required banks to extend loan repayment deadline of mortgage and credit card overdraft for individual clients who temporarily loses income source. Banks should also increase credit support for certain sectors affected by Wuhan Pneumonia, including wholesale & retail, catering, transportation, tourism etc. SOE banks, especially BOC (3988 HK / 601988 CH), which have higher loan exposure to above-mentioned sectors, are more susceptible to “national service” policies. However, we believe the overall impact is limited given the China banks’ improving asset quality and undemanding valuation.

- **Property**

Many sales centers are close after outbreak. Furthermore, many people are not willing to go out. Therefore**,** recent property sales are adversely affected by the coronavirus. It is obvious that property sales in Jan and Feb this year will be disappointing and are expected to decline YoY. Of course, developers will adjust their launching plan to postpone the sales to 2Q or 2H. Therefore, the full year sales plan would not be affected so much. However, we may revise downward our full year contracted sales growth forecasts by high-teen to low teen because of the economic impact from coronavirus that will weaken Chinese purchasing power. For the earnings in 2020, there will not have great impact to developers as their earnings in 2020 are locked-in by the pre-sales done 1 or 2 years ago. We still forecast average earnings growth of developers to be 20% in 2020. Downside risk for 2020 earnings are limited.

- **Utilities & Renewables**

Wind operators’ fundamentals are still solid. Operations are less likely to be affected by the virus outbreak as well as extending holidays**.** Downside will be relatively limited due to low valuations. Gas sales from industrial and commercial usage will be affected due to delay resume production and less catering consumption in China, but impacts seem to be short-term. Gas distributors is trading at ~15x P/E, at long-term mean, indicating the sector may still facing panic sale and profit taking in risk off market. But given its defensive nature, we suggest to buy on dip.

- **Capital Goods**

We think the outbreak of Wuhan Pneumonia and the lockdown of major cities in Hubei will have relatively limited impact on the sector as a whole. Our latest check with some construction machinery makers suggested that component supplies are largely normal. While we might see some delays on certain construction projects in the near term, infrastructure spending should remain a measure to stabilize the economy after the epidemic is under control, which will boost the construction machinery demand. Key picks: Weichai Power (2338 HK), Zoomlion (1157 HK), SANY Int'l (631 HK).

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