3 Sep 2021

CMB International Securities | Equity Research | Market Strategy

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Strategy Report

HSI nearing bottom; Buy policy-driven stocks

HK stock market underperformed again in Aug due to China's regulatory risks. We review 1H earnings, Fed's tapering plans, and potential catalysts for HK market to bottom out. We believe the downside risk in the HSI is diminishing, but upside is also limited until policy overhang is removed. Suggest gradually adding exposure to HK equities, focusing on policy-driven sectors while waiting for bottom-fishing opportunities on new-economy stocks.

- **China's regulations remain an overhang despite more policy support.** More than a month since the regulatory risks unfolded, there seems to be no signs that such risks have abated yet. Beijing is stepping up monetary and fiscal stimuli, which we believe would benefit respective sectors such as Infrastructure, but may not be enough to significantly improve the overall sentiment of stock markets.
- **China's PMI going down.** China's official Manufacturing PMI dropped for five consecutive months, and Caixin PMI even fell to below 50. A slowing economic growth does not bode well for corporate earnings, especially when regulatory crackdown is underway. Looking back at the bear market in 2015, China's PMI started rebounding in Mar 2016, which roughly coincided with the HSI's bottoming out.
- **Liquidity not returning to HK market yet.** Foreign investors tended to sell HK/China stocks since Beijing's regulatory crackdown began in Jul. Southbound trading recorded net selling for two straight months. PRC onshore mutual funds issuance remains moderate, which means fund managers do not have much new dry powder.
- **USD weakening bodes well for HK stocks.** The USD has often shown an inverse relationship with EM equities. After Fed Chair Powell's relatively dovish speech at Jackson Hole symposium, the USD breached its uptrend and is on course to retreat further.
- **HSI's adjusted forward P/E near troughs.** The HSI is trading at 12.4x 2021E P/E, above 10-year average 11.4x, but if we remove those growth stocks that were recently added into the HSI, the adjusted HSI's 2021E/2022E P/E would be only 9.6x/8.8x, close to 2 s.d. below 10-year average.
- **Technical analysis: wait for market panic and RSI divergence in the HSI.** The HSI should have good support at long-term uptrend since 2008 (around 24,000 now). A potential "triple divergence" with its RSI would be a good bottoming signal. If the HSI Volatility Index (VHSI) surges to around 28 again, that would reflect market panic and should be a good buying opportunity.
- **Strategy: Increase exposure while avoiding policy risks.** Investors have gradually become more prepared for further regulatory news, and thus further downside in the HSI should be diminishing. We suggest gradually increasing exposure in HK market, but reiterate our sector view in focusing on sectors with little policy risk, e.g. Machinery, New Energy, NEV & Hardware. At the same time, keep a close eye on bottom-fishing opportunity in new-economy sectors e.g. Internet & Healthcare for their long-term growth prospect.

Daniel So, CFA
(852) 3900 0857
danielso@cmbi.com.hk

Market Data

Hang Seng Index	26,090
52-week High / Low	31,183/23,124
3-month avg. daily t/o	HK$163.4bn

Source: Bloomberg

Indices Performance

	HSI	HSCEI	HSTECH
1-month	-0.6%	0.1%	0.1%
3-month	-10.9%	-14.7%	-17.4%
6-month	-10.3%	-17.8%	-26.5%

Source: Bloomberg

12-month HSI Performance

Source: Bloomberg

Related Reports

1. Strategy Report – Gauging a bottom of the HSI – 23 Aug 2021
2. Strategy Report – HSI constituent candidates in half-yearly review – 17 Aug 2021
3. Strategy Report – Buy growth stocks with little policy risk – 3 Aug 2021
4. Strategy Report – 2H Outlook: Growth stocks to regain momentum – 5 Jul 2021
5. Strategy Report – Short-term Value; Medium-term Growth – 1 Jun 2021
6. Strategy Report – Buy in May; HSI target raised – 3 May 2021
7. Strategy Report – Style shift to take a break – 1 Apr 2021
8. Strategy Report – Don't panic over rising bond yield – 3 Mar 2021
9. Strategy Report – HSI enhancement preview – 24 Feb 2021
10. Strategy Report – Follow the tide – 3 Feb 2021

Contents

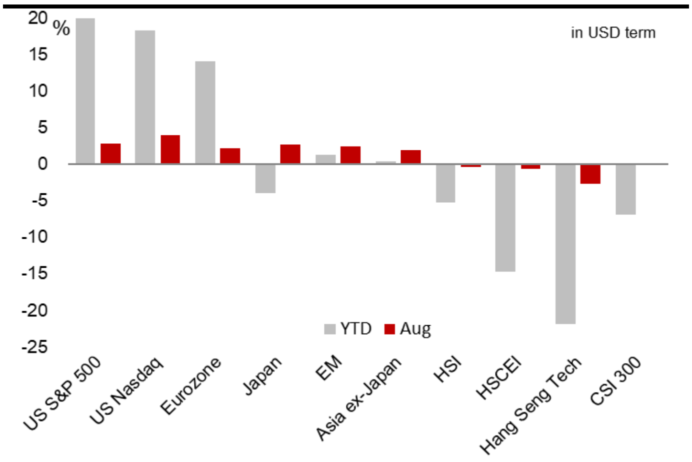
Recap of August

HK stocks underperformed again on regulatory risks

Hong Kong stock market had another weak month in Aug, as China's regulatory risks which unfolded in late-Jul continued to weigh on the market. The Hang Seng Index dropped 0.3% in Aug, following a 9.9% slump in Jul. The Hang Seng TECH Index fell another 2.6% in Aug, after a whopping 16.8% drop in Jul. These were in big contrast to the developed markets' gain, in particular the US S&P 500 and Nasdaq kept setting record highs (Fig. 1).

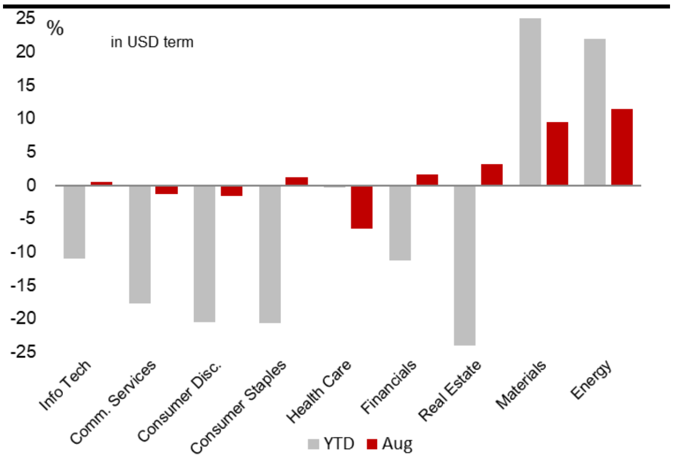
Sector performance in Aug clearly shows where the regulatory risks lie, with growth stocks such as Internet, Healthcare, and Consumer Discretionary underperforming old-economy stocks like Financials, Real Estate and Commodity (Fig. 2).

Figure 1: Global major stock indexes' performance



Source: Bloomberg, CMBIS

Figure 2: MSCI China's sector performance



Source: Bloomberg, CMBIS

1H Earnings Review

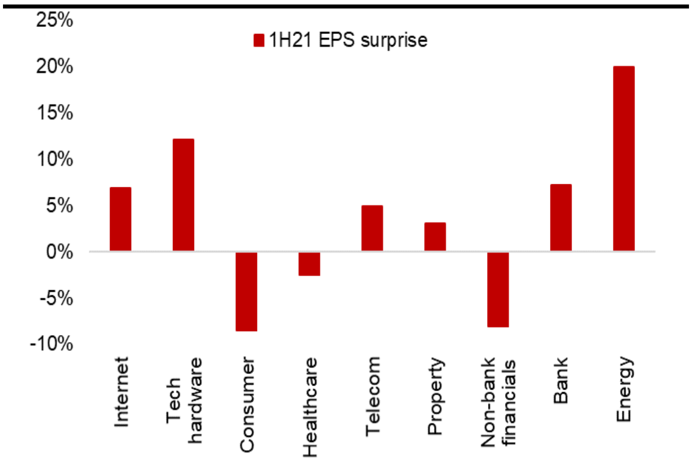
Earnings and revisons are mixed

1H 2021 result season in HK market has just been over. Overall speaking, earnings have been mixed/in line.

By sector, old-economy stocks delivered more positive surprises, with Energy, Bank and Property beating consensus. Technology stood out among new-economy stocks. Internet also beat, despite the ongoing regulatory crackdown, as consensus earnings have already been slashed over the past few months (Fig. 3).

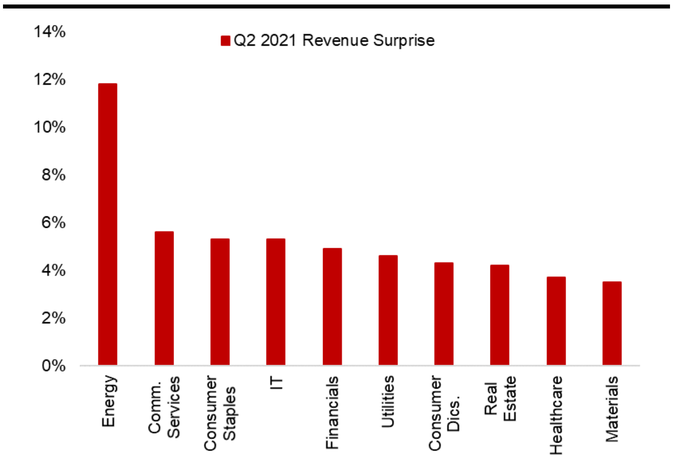
In the US stock market, Q2 2021 results beat across all sectors. Revenue beat in Energy was the most outstanding, and other sectors had 2.3%-5.6% beat in revenues (Fig. 4).

Figure 3: HSI 1H 2021 earnings surprise by sector



Source: Bloomberg, CMBIS

Figure 4: S&P 500 Q2 2021 revenue surprise

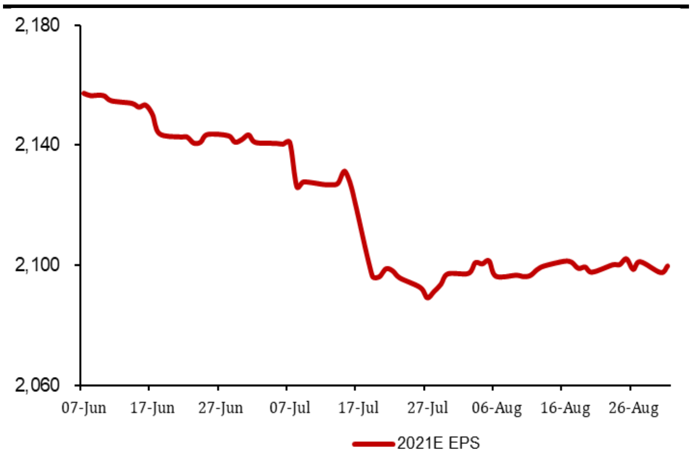


Source: Factset, CMBIS, as of 13 Aug 2021

■ Earnings revision: 2021E up, 2022E down

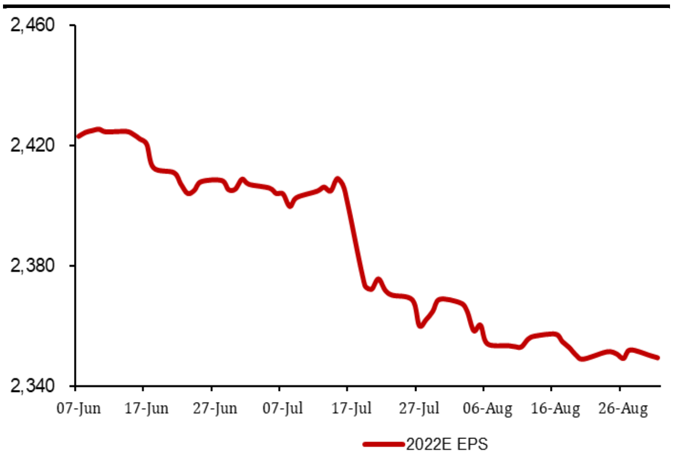
Consensus earnings revisions on the HSI and HSTECH are mixed too, with FY21E up and FY22E down (Fig. 5-8). The 2.9% downward revision in HSTECH earnings might reflect that investors believe regulatory risks have longer-term drag on earnings.

Figure 5: HSI 2021E EPS +0.1% in Aug



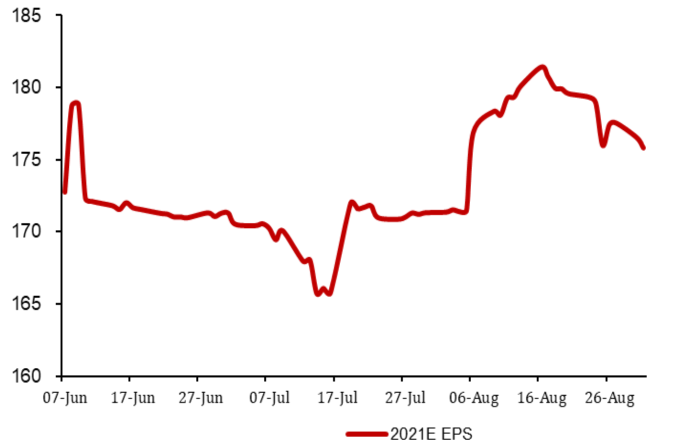
Source: Bloomberg, CMBIS

Figure 6: HSI 2022E EPS -0.8% in Aug



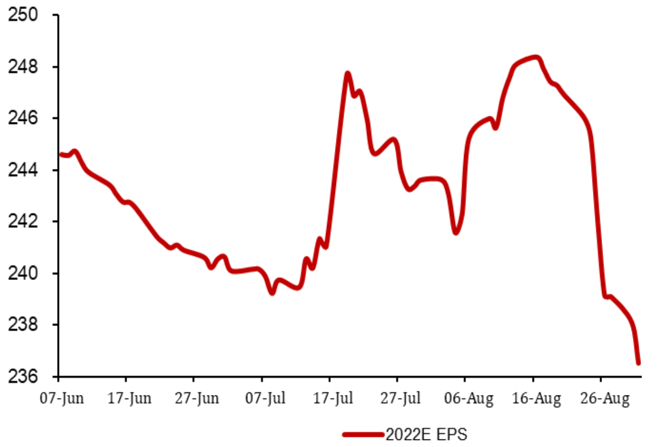
Source: Bloomberg, CMBIS

Figure 7: HSTECH 2021E EPS +2.6% in Aug



Source: Bloomberg, CMBIS

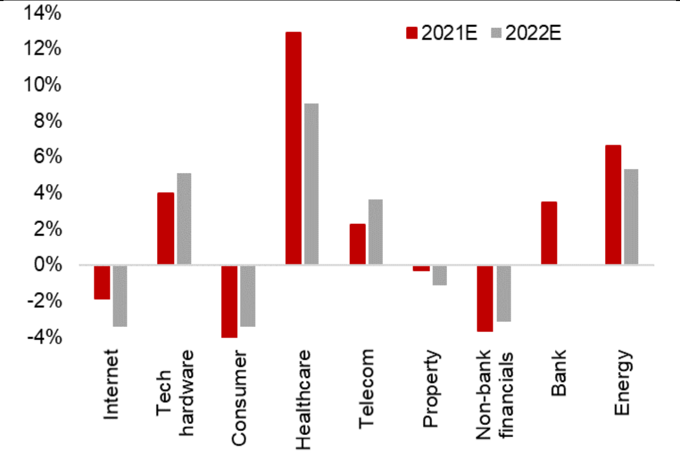
Figure 8: HSTECH 2022E EPS -2.9% in Aug



Source: Bloomberg, CMBIS

By sector, Energy, Healthcare, Hardware and Telecom enjoy upward revisions in consensus earnings, while Internet, Consumer and Non-bank Financials got earnings cut.

Figure 9: HSI stocks' post-result earnings revision



Source: Bloomberg, CMBIS

Fed: Tapering soon, Rate hike not so soon

- **Jerome Powell's speech at Jackson Hole**

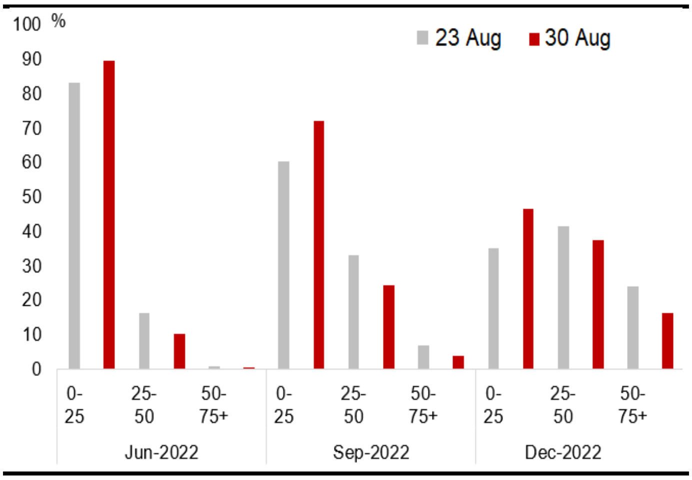
The Federal Reserve's Chair Jerome Powell gave a speech during the Jackson Hole economic policy symposium on 27 Aug. **Powell played down on the economy's progress towards the threshold of raising interest rates**: maximum employment and inflation on track to moderately exceed 2% for some time. While he admitted that *"the prospects are good for continued progress toward maximum employment"*, he stressed that *"the unemployment rate has declined to 5.4% but is still much too high"*, and *"**we have much ground to cover to reach maximum employment**, and time will tell whether we have reached 2% inflation on a sustainable basis."*

■ **Rate hike and inflation expectations moderating**

After the Jackson Hole symposium, **expected timeline of Fed funds rate hike is slightly pushed back**, according to the probabilities implied by Fed funds futures (Fig. 10). For instance, before Jackson Hole, the chance of Fed funds rate staying at the current level 0-25 bps after the Sep 2022 FOMC meeting was 60%, but now has risen to 72%.

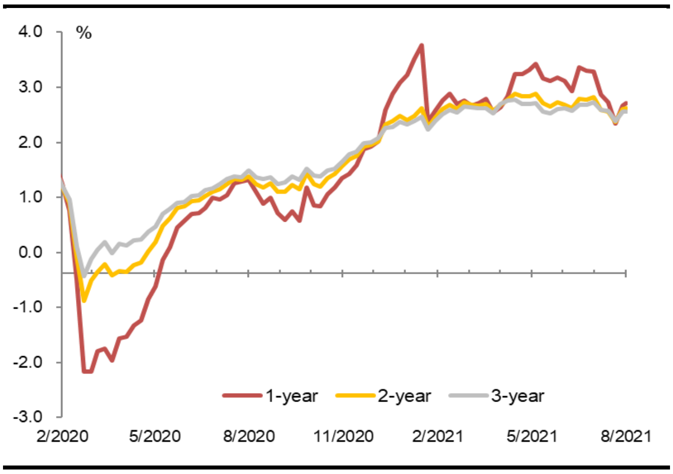
US inflation outlook has been moderating too, as indicated in the breakeven rates (Fig. 11). The expected CPI inflation one year from now fell from 3.4% in mid-Jul to 2.7%, which means the CPI inflation is expected to retreat from the current exceptionally high reading (5.4%) to a more "normal" level (Fig. 12). This is in line with what the Fed has repeatedly described high inflation as "transitory".

Figure 10: Implied probabilities of Fed funds rate



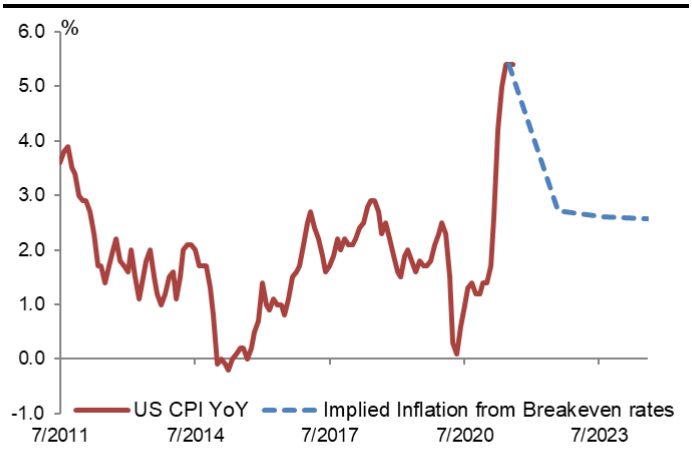
Source: CME Group, CMBIS

Figure 11: US breakeven rates



Source: Bloomberg, CMBIS

Figure 12: US CPI inflation expected to moderate



Source: Bloomberg, CMBIS

Catalyst for HK market to bottom out

In our previous [Strategy Report on 23 Aug](), we suggested several potential catalysts for the HSI to bottom out. We are now going to discuss the latest developments.

1. China's policy support

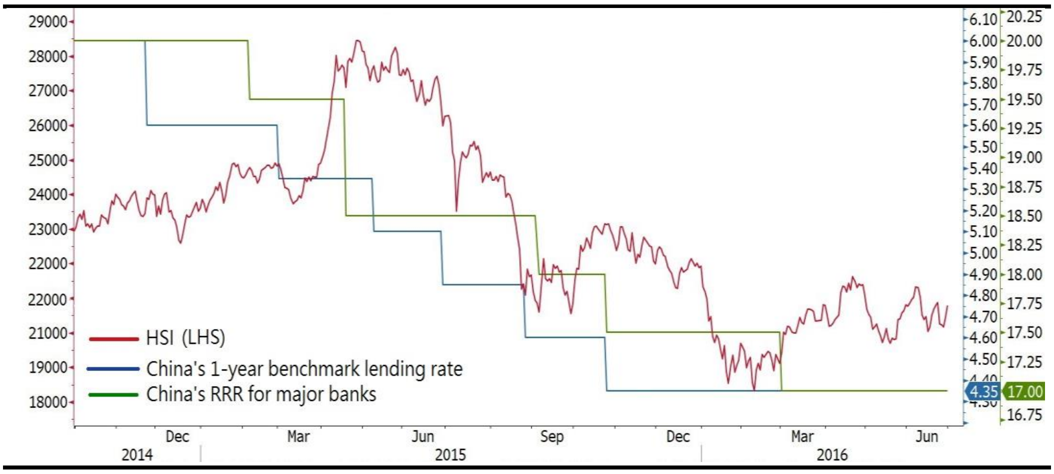
More than a month since the regulatory risks (on after-school tutoring, internet, monopolies, etc.) unfolded, there seems to be no signs that such risks have abated yet, with one latest policy to limit young online gamers to one hour a day on weekend and holiday evenings. That is, policy is still the biggest overhang rather than support for the HK stock market.

■ **Monetary easing not enough to offset regulatory risks**

Could additional monetary easing by the People's Bank of China (PBOC) suffice to lift the stock market? The PBOC did cut the RRR by 50 bps in Jul, and injected more liquidity through open-market operations in late-Aug. Furthermore, PBOC's meeting on 23 Aug confirmed that more easing is on the horizon. The central bank vowed to "strength credit support to the economy, especially SME", and "guide real lending rates downwards".

That said, we should note that during the bear market in 2015, the PBOC slashed 1-year benchmark lending rates by 165 bps, and the RRR by 300 ppts, but failed to stabilise the market until the HSI eventually troughed in Feb 2016 (Fig. 13).

Figure 13：PBOC's interest rate and RRR cuts could not stop stocks from falling in 2015



Source: Bloomberg, CMBIS

■ **Fiscal stimuli to step up**

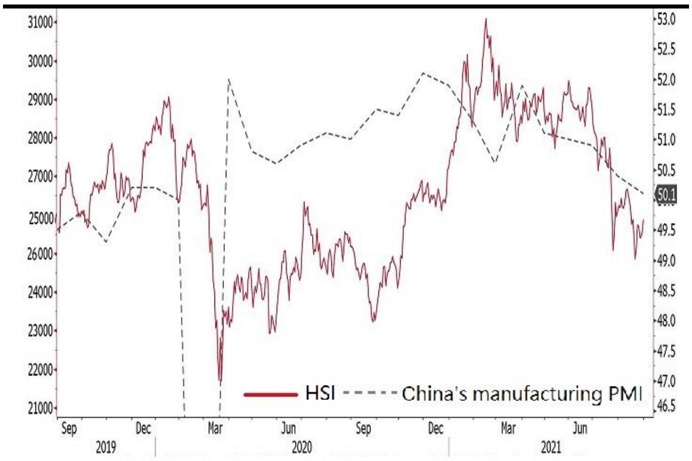
At a regular meeting on 1 Sep, **China's State Council pledged to launch additional measures to stabilise economic growth and employment, and increase support for SMEs**. It earmarked an additional RMB300bn in PBOC lending quota this year for local banks towards SMEs financing. It also vowed to make use of local government special bond (LGSB) to boost investment, strengthen its reserve of stimulus measures, and replenish some expiring supportive measures. We believe these measures are targeted rather than broad-based, and **would benefit respective sectors such as Infrastructure, Machinery, Materials, but may not be enough to significantly improve the overall sentiment of stock markets**.

2. China's PMI

China's official Manufacturing PMI dropped for five consecutive months, to 50.1 in Aug, narrowly missing consensus by 0.1 ppt (Fig. 14). The **Caixin China Manufacturing PMI even fell to 49.2**, from 50.3 in July, below the 50-mark that separates growth from contraction for the first time since Apr 2020 (Fig. 15). **A slowing economic growth does not bode well for industrial/corporate earnings** (Fig. 16), especially when regulatory crackdown is underway.

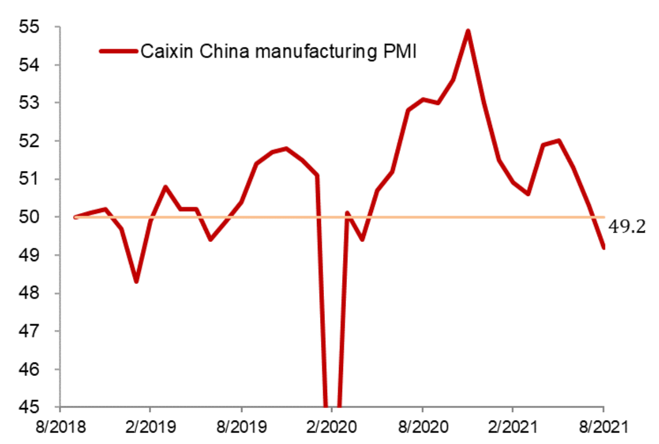
Looking back at the bear market in 2015, China's PMI started rebounding in Mar 2016, which roughly coincided with the HSI's bottoming out (Fig. 17).

Figure 14: China's PMI vs HSI (2019-2021)



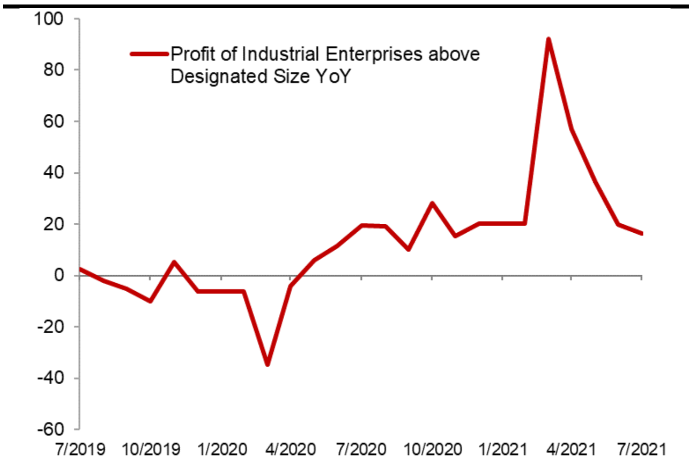
Source: Bloomberg, CMBIS

Figure 15: Caixin China Manufacturing PMI <50



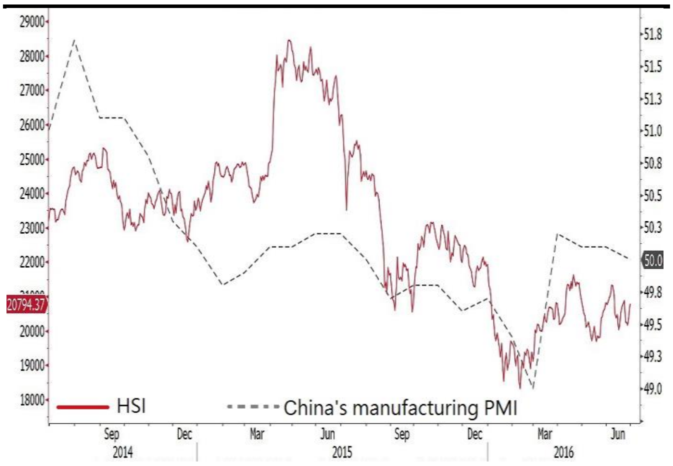
Source: Bloomberg, CMBIS

Figure 16: China's Industrial Profit growth slowing



Source: Bloomberg, CMBIS

Figure 17: China's PMI vs HSI (2014-2016)



Source: Bloomberg, CMBIS

3. Liquidity to HK market

Back in 2015-2016, optimism on extra liquidity into A-shares market (A-shares to be added to MSCI EM Index, and China's pension fund to buy stocks) was one of the catalysts for HK/China stocks to bottom out.

Now, since Beijing's regulatory crackdown began in Jul 2021, foreign investors tended to sell HK/China stocks, with "short China" becoming a common trade or even crowded trade.

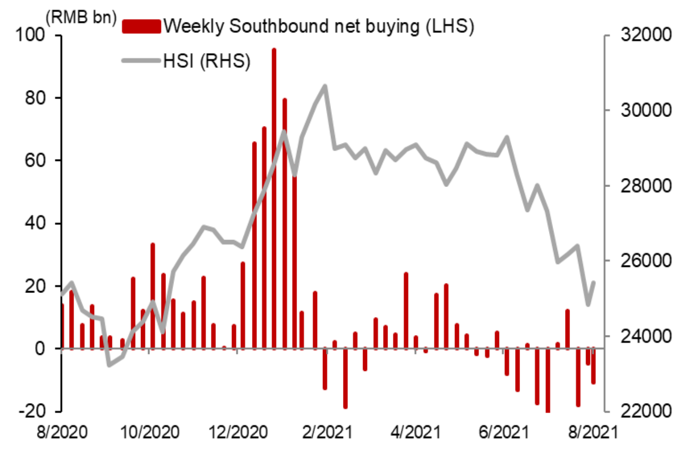
- **Southbound net selling for two straight months**

Mainland investors have not been bottom-fishing HK stocks either, indicated by the RMB20bn net selling via Stock Connect Southbound trading in Aug, the second consecutive month of outflows (Fig. 18). While one should note that Southbound fund flow may not be a leading indicator, **these numbers show Mainland investors are cautious on HK market**, and the key for their return is the removal of regulatory overhang, in our view.

- **PRC onshore mutual funds issuance remains moderate**

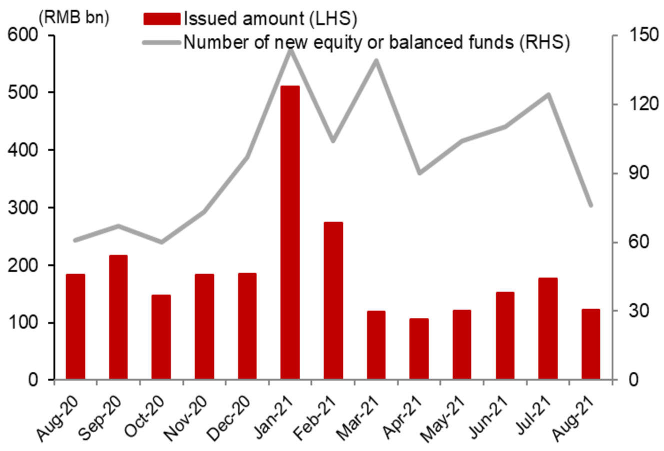
The sudden surge in mutual funds issuance in Mainland China during Jan-Feb 2021 helped fuel the short-lived bull run in HK market, especially new-economy stocks. But new issuance has sharply fallen since Mar, and remained at ordinary levels (Fig. 19). This means **fund managers do not have much new dry powder, and also reflects retail investors' interest in the stock market is rather low**.

Figure 18: Southbound net outflow in Aug



Source: Wind, CMBIS

Figure 19: PRC onshore mutual funds issuance



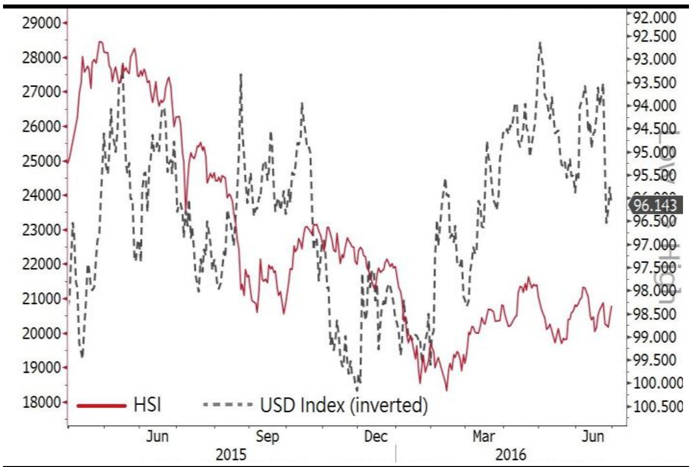
Source: Wind, CMBIS

4. USD weakens

The USD has often shown an inverse relationship with EM equities and currencies. The USD's turning weak in late-2015 and early-2016 lent a helping hand to the HSI's bottoming out (Fig. 20).

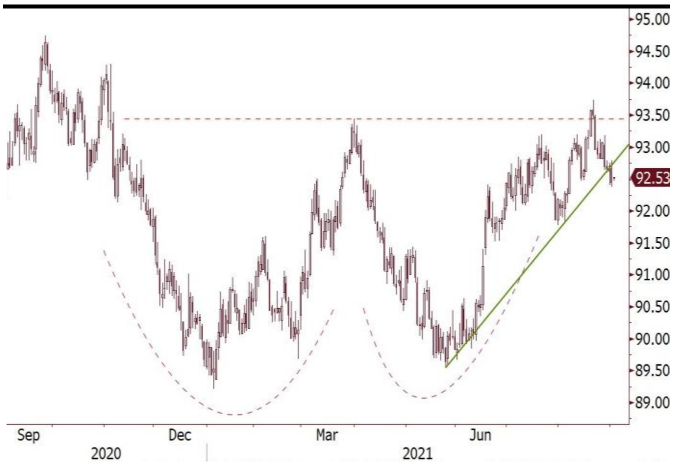
Following a 3-moth rally, the USD seemed to be breaking the neckline of "double bottom", a bullish pattern, in late-Jul, but that turned out to be a false breakout (Fig. 21). After Fed Chair Powell's relatively dovish speech at Jackson Hole symposium, **the USD breached its uptrend and is on course to retreat further. Positive for EM stocks**.

Figure 20: USD vs HSI (2015-2016)



Source: Bloomberg, CMBIS

Figure 21: USD breached uptrend?



Source: Bloomberg, CMBIS

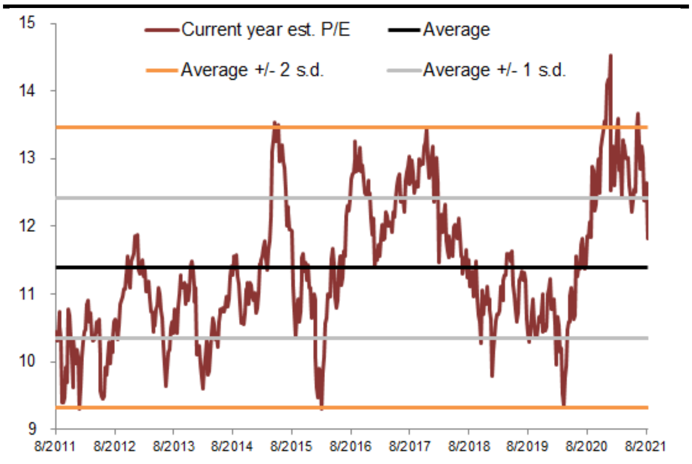
5. HSI's adjusted forward P/E below 10x

Cheap valuation is currently the most compelling argument for a bullish view on HK market.

The HSI is trading at 12.4x 2021E P/E, above 10-year average 11.4x, but if we remove the 12 stocks (of which 11 are growth stocks such as Alibaba, Meituan, Xiaomi) that were added into the HSI since 1H 2020, the **adjusted HSI's 2021E/2022E P/E would be only 9.6x/8.8x, close to 2 s.d. below 10-year average, and similar to the several troughs** as shown in Fig. 22.

As for new-economy blue chips that are excluded in the above calculations, **the room of further de-rating seem limited.** Take Alibaba (9988 HK), Meituan (3690 HK) and Xiaomi (1810 HK). Alibaba's P/E is at historical low, while Xiaomi's forward P/E and Meituan's P/S are below average (Fig. 23-25).

Figure 22: HSI's current year estimated P/E

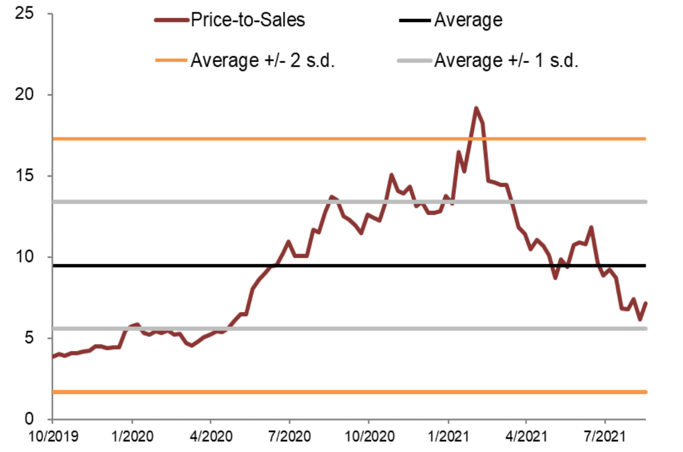


Source: Bloomberg, CMBIS

Figure 23: Alibaba's trailing P/E

Source: Bloomberg, CMBIS

Figure 24: Meituan's Price-to-Sales



Source: Bloomberg, CMBIS

Figure 25: Xiaomi's current year estimated P/E

Source: Bloomberg, CMBIS

Technical analysis

Wait for market panic and RSI divergence in the HSI

The HSI is not far away from its long-term uptrend since 2008, and considering its adjusted valuation is near previous troughs, we believe the **uptrend (around 24,000 now) should offer good support**.

Figure 26: HSI monthly chart since 2008

Source: Bloomberg, CMBIS

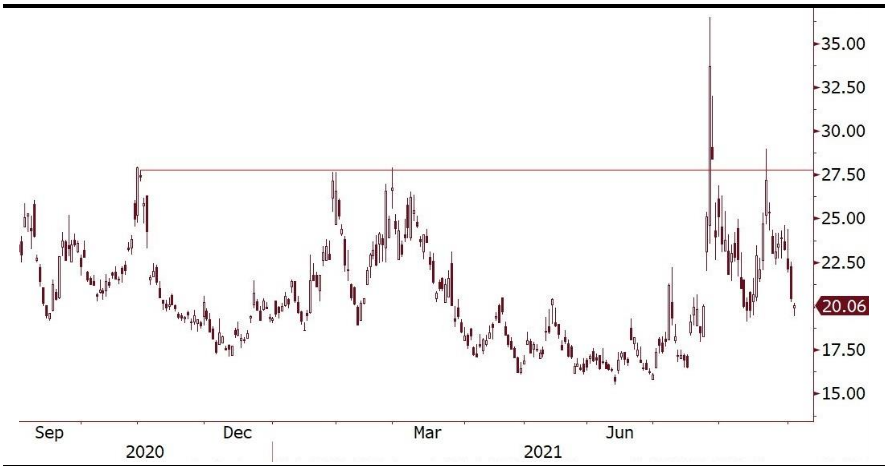
That said, regulatory overhang is likely to limit upside of any short-term rebound, and the HSI may retest recent lows in upcoming weeks. A potential **"triple divergence" with its RSI would be a good bottoming signal**, i.e. when the HSI breached its recent low 24,581 while its RSI holds above that corresponding low 29.8 (Fig. 27).

Figure 27: HSI could possibly form "triple divergence" with RSI

Source: Bloomberg, CMBIS

Another reference is market sentiment. **Markets typically trough when investors panic.** The HSI Volatility Index (VHSI), equivalent to the "fear index" VIX, reflects market panic when it surged to 28 or above. It has retreated to around 20. Should it surge to around 28 again in the coming weeks, that should be a good buying opportunity.

Figure 28: HSI Volatility Index (VHSI)



Source: Bloomberg, CMBIS

Strategy: Increase exposure while avoiding policy risks

Downside risks diminishing

After digesting news of regulatory crackdown for one-and-a-half months, we believe investors have become more prepared for further regulatory bad news, and thus further downside in the HSI should be diminishing.

To summarise the five potential catalysts discussed above, 1) cheap valuation and 2) weakening USD are supportive for the HSI, while 3) China's PMI (as a proxy of economic growth) and 4) liquidity are not yet, but could become supportive as soon as 5) policy overhangs are removed (which are not quite yet). Therefore, the key is still China's policy. **While China's monetary and fiscal policies are turning increasingly supportive, HK market would rebound strongly only when investors believe the worst of regulatory crackdown is behind us**.

Reiterate focus on policy-driven sectors

We suggest gradually increasing exposure in HK market, but reiterate our sector view in August, i.e. focusing on sectors with little policy risk or even benefitting from policies, such as **Machinery, New Energy, New Energy Vehicles** and **Hardware**.

Some of the stocks are **Zoomlion (1157 HK), SANY Heavy (600031 CH), Zhejiang Jingsheng (300316 CH), China Longyuan (916 HK), ENN Energy (2688 HK), BYD (1211 HK)** and **Xiaomi (1810 HK)**.

Wait for bottom-fishing opportunity in growth sectors

At the same time, suggest keeping a close eye on bottom-fishing opportunity in new-economy sectors such as **Internet** and **Healthcare** for their long-term structural growth prospect. Once the policy risks ease, these sectors should enjoy decent re-rating.

Some of the key names worth monitoring are **Tencent (700 HK), Meituan (3690 HK), CSPC Pharma (1093 HK)** and **Jinxin Fertility (1951 HK).**

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NOT RATED	: Stock is not rated by CMBIS
OUTPERFORM	: Industry expected to outperform the relevant broad market benchmark over next 12 months
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CMB International Securities Limited

Address: 45/F, Champion Tower, 3 Garden Road, Hong Kong, Tel: (852) 3900 0888 Fax: (852) 3900 0800

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