2 Jul 2020

招银国际 CMB INTERNATIONAL
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Strategy – 2H Outlook

Growth stocks continue to outperform

Global stock markets had a rollercoaster 1H thanks to the pandemic and aggressive easing by central banks. Going into 2H, we examine liquidity and earnings outlook to see which direction the market will head to. We will also discuss potential impact from the U.S. presidential election. Our HSI target range for the 2H is 23,800-26,200 in our base case scenario.

- **How much further can liquidity-driven rally go?** Central banks' QE have helped stabilise stock markets during the pandemic. Now, the risk is the Fed may be taking a pause in QE, as its balance sheet shrank for the last wo weeks. We believe the Fed will offer some downside protection in stock market, but unlikely to give further impetus.
- **Can earnings recover at record pace?** The S&P 500's and the HSI's 2020E EPS have stabilised in recent weeks. Whether the worst is over in earnings downgrade remains to be seen, as the Q2 earnings season is coming. Consensus earnings will surpass pre-pandemic levels in 2021, which sounds very optimistic and will set a record pace of earnings recovery. The biggest risk to earnings remains the path of the COVID-19 pandemic.
- **How the U.S. election will affect stock markets?** This year's presidential election is arguably more influential on markets than ever, given that President Trump started the U.S.-China trade war during his first term. Trump is lagging behind Joe Biden in presidential election polls. Stocks tended to underperform when incumbent party lost, but Biden is widely seen as less pro-market as he vowed to raise corporate tax.
- **HSI target: 23,800-26,200 in base case**. We expect the HSI to trade between 9.4x-12.1x forward P/E in the 2H, within the P/E range of the past decade, based on blended forward 12-month EPS. In our base case scenario, we expect the HSI to be range-bound in 23,800-26,200. Upside potential would be capped by numerous risks, such as new waves of COVID-19 outbreak and U.S.-China tension.
- **Strategy: continue to prefer growth over value.** In our base- or worst-case scenarios (moderate to serious rebound in COVID-19 new cases in some of major countries), we continue to favour sectors that are less vulnerable to recession and lockdown measures. We also suggest positioning for 5G-driven recovery in technology sector, while diversifying risks via gold ETF or miners.

Selected sectors and stocks

Sector	Company
Internet	Alibaba (BABA / 9988 HK), Tencent (700 HK), FriendTimes (6820 HK), Tongcheng-Elong (780 HK)
Healthcare	Ascentage Pharma (6855 HK), PA Good Doctor (1833 HK)
Education	Hope Education (1765 HK), Wisdom Education (6068 HK)
Consumer staples	Mengniu Dairy (2319 HK), Want Want (151 HK), Yonghui (601933 CH), Sun Art (6808 HK)
Construction Machinery	Sinotruk (3808 HK), Jiangsu Hengli (601100 CH), SANY Heavy (600031 CH), Weichai Power (2338 HK / 000338 CH)
Technology	Xiaomi (1810 HK), Sunny Optical (2382 HK)
Gold	SPDR Gold ETF (2840 HK), Shandong Gold (1787 HK)

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Market Data

Hang Seng Index	24,427
52-week High / Low	29,175/21,139
3-month avg. daily t/o	HK$113.8bn

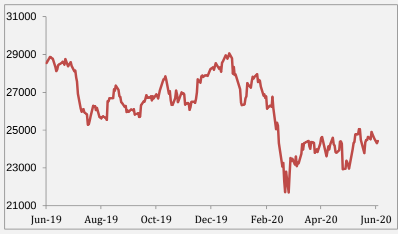
Source: Bloomberg

Indices Performance

	HSI	HSCEI
1-month	6.4%	2.1%
3-month	3.5%	1.7%
6-month	-13.3%	-12.6%

Source: Bloomberg

12-month HSI Performance



Source: Bloomberg

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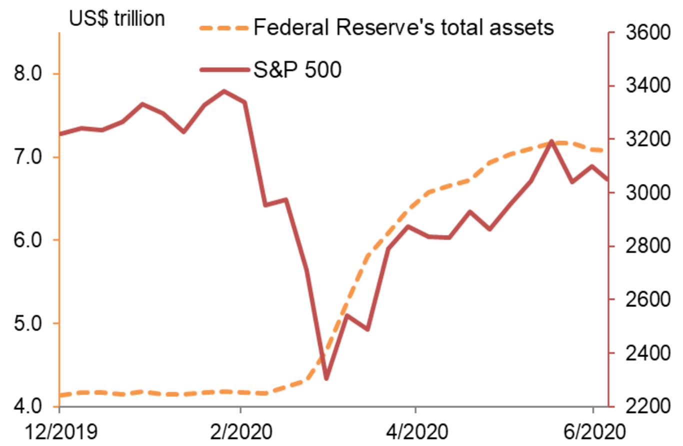
Liquidity-driven rally – how much further can it go?

Unlimited QE by major central banks

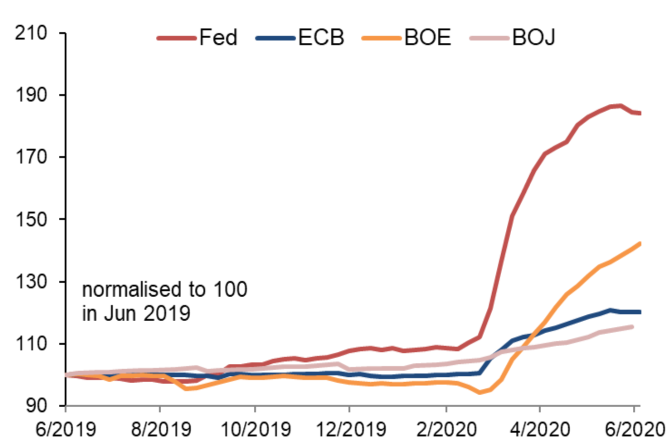
Soon after the COVID-19 triggered one of the sharpest sell-offs ever in global stocks markets in Mar 2020, major central banks around the globe offered monetary support in the form of massive asset purchases (Quantitative Easing), which have proven to be successful in stabilising the market (Fig. 1). In particular, The Federal Reserve, the European Central Bank and the Bank of England launched unlimited QE in Mar, and then the Bank of Japan followed suit in Apr (Fig. 2).

Figure 1: Fed's QE coincided with market rebound



Source: Bloomberg, CMBIS

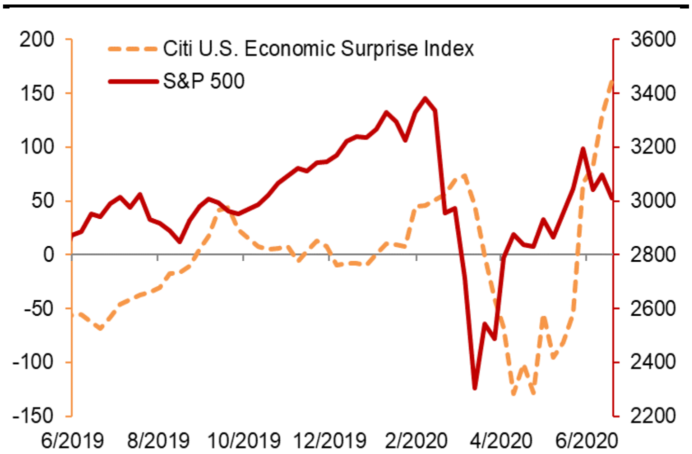
Figure 2: Central banks' balance sheets bulged



Source: Bloomberg, BOE, CMBIS

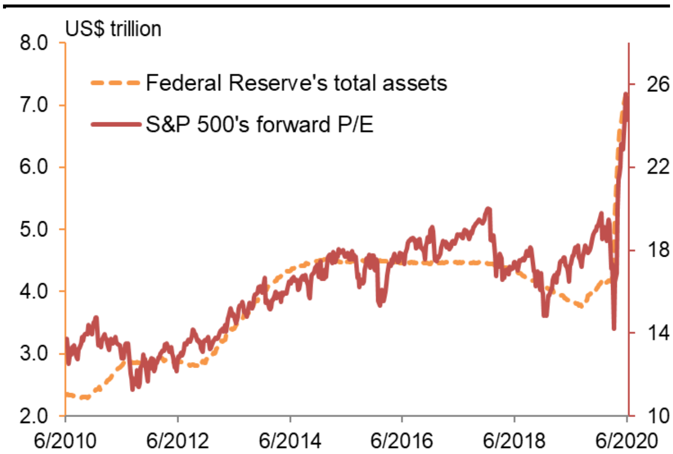
The Fed's announcement of unlimited QE on 23 Mar 2020 coincided with the S&P 500's bottoming out. Since then, the stock market benchmark rebounded by as much as 47%, despite economic data continued to surprise negatively (Fig. 3). Stock market kept rebounding for 10 weeks before economic data started to show positive surprise. This shows that the market rally since late-Mar has been primarily driven by liquidity, or money-printing to be more precise. In fact, **the Fed's QE has been a major factor in the U.S. stock market's valuation over the past decade** (Fig. 4).

Figure 3: Stock market ran ahead of real economy



Source: Bloomberg, CMBIS

Figure 4: Fed's assets correlated with S&P 500 P/E



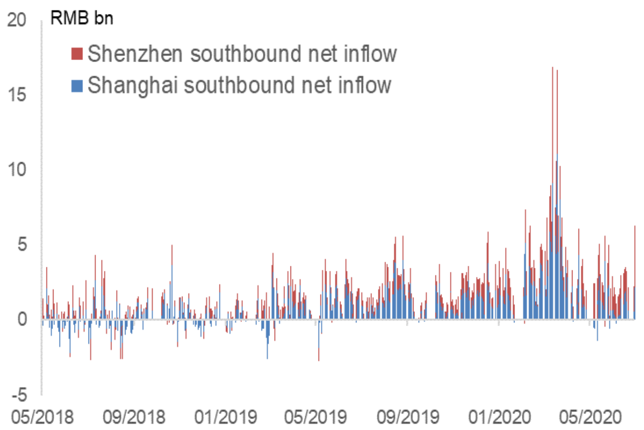
Source: Bloomberg, CMBIS

Now, **the risk is the Fed may be taking a pause in QE**, as its balance sheet shrank for the last wo weeks. We believe the Fed is ready to increase asset purchase again in case financial markets go under pressure again, but in the current state is unlikely to keep printing money aggressively. That is, **the Fed will offer some downside protection in stock market, but unlikely to give further impetus**.

Southbound inflows into HK surged

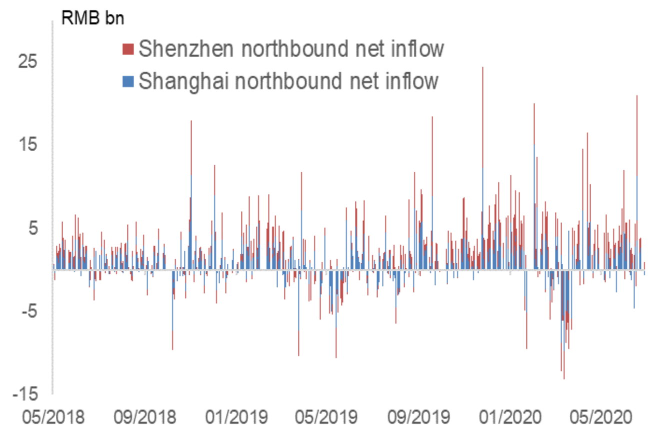
In Hong Kong stock market, capital from Mainland China through the Stock Connect programme also played a part in the market's rebound from the trough on 19 Mar. In Mar, when the Hang Seng Index slumped, southbound net inflows significantly increased (Fig. 5). Comparatively, northbound net inflows remained rather stable during the same period (Fig. 6), probably because Mainland stock markets dropped less in Mar, and thus a steep discount in H-shares presented bottom-fishing opportunities for Mainland investors.

Figure 5: Southbound inflows into HK market



Source: Bloomberg, CMBIS

Figure 6: Northbound inflows into SH/SZ markets



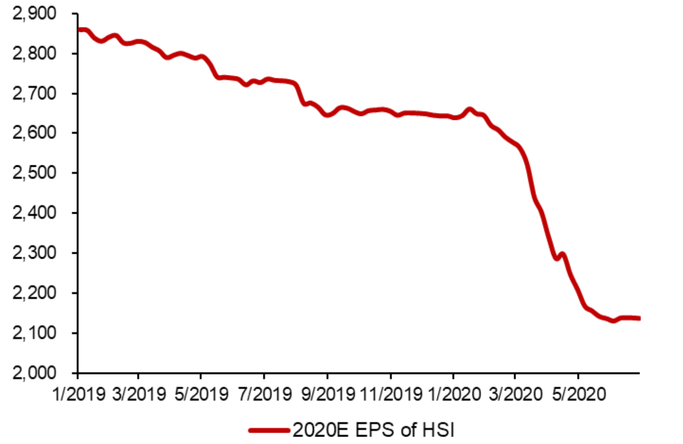
Source: Bloomberg, CMBIS

Earnings – can they recover at a record pace?

Earnings downgrade over?

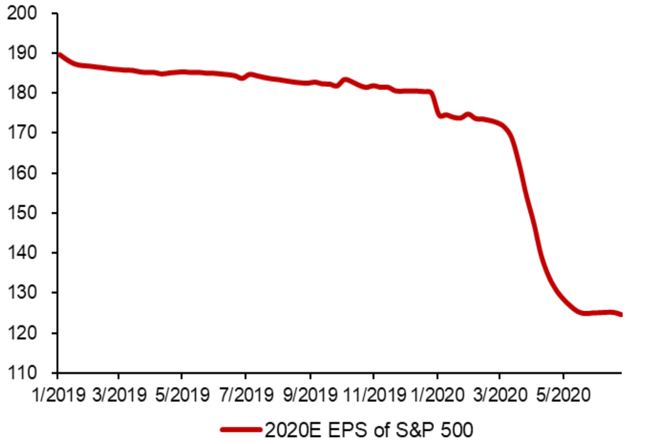
Downward revision in consensus earnings have lasted for months in the U.S. and HK stock markets, before taking a pause in Jun. **The S&P 500's and the HSI's 2020E EPS have stabilised in recent weeks** (Fig. 7 & 8). Whether the worst is over in earnings downgrade remains to be seen, as the Q2 earnings season will soon kick off in the U.S., which may trigger another round of earnings revision (upward or downward).

Figure 7: 2020E EPS of the Hang Seng Index



Source: Bloomberg, CMBIS

Figure 8: 2020E EPS of the S&P 500

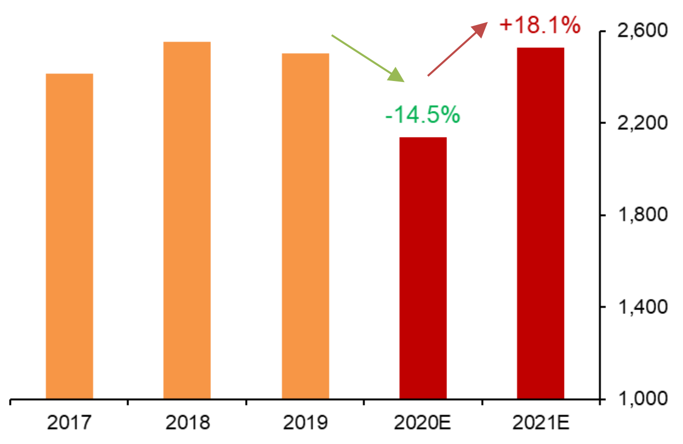


Source: Bloomberg, CMBIS

Consensus earnings will surpass pre-pandemic levels in 2021

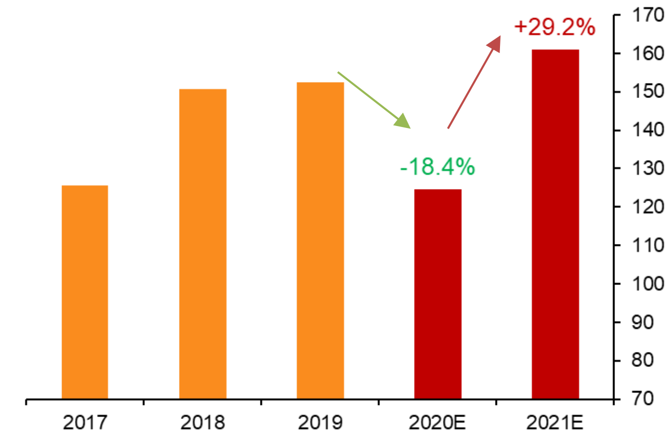
Some investors are starting to look beyond this unusual year 2020 where earnings are severely hit by COVID-19 pandemic. The consensus picture looks quite rosy in 2021, where earnings of the U.S. and HK markets are expected to surpass pre-pandemic, pre-recession levels, i.e. in 2019 (Fig. 9 & 10).

Figure 9: Yearly EPS of the Hang Seng Index



Source: Bloomberg, CMBIS

Figure 10: Yearly EPS of the S&P 500

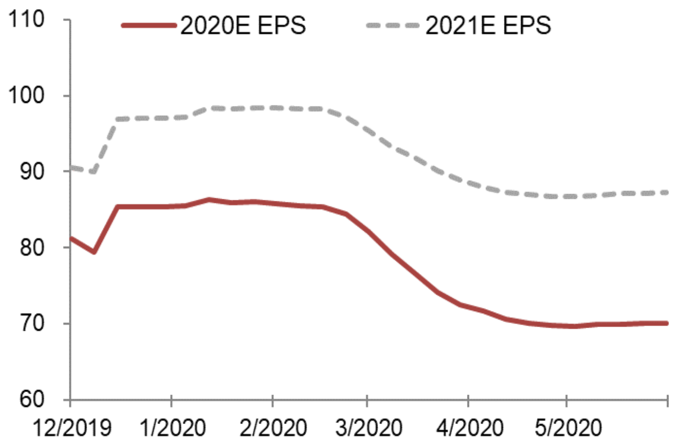


Source: Bloomberg, CMBIS

Outlook of value stocks still cautious

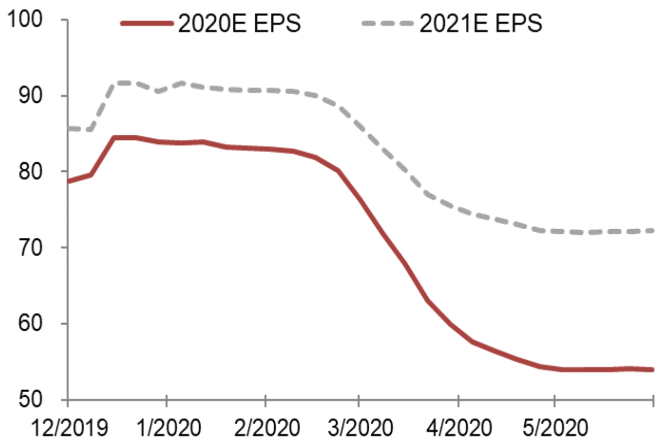
During this COVID-19 pandemic, value stocks (financials, real estate, energy) have significantly underperformed growth stocks (predominantly internet and healthcare sectors) due to their difference in vulnerability to pandemic and recession. Judging from consensus earnings forecast in the S&P 500 Growth and Value indexes, **investors are still more cautious on value stocks' earnings outlook in 2020 and 2021**. EPS estimates of Growth Index have stabilised, while those of Value Index are still being cut, albeit only by small margin (Fig. 11 & 12).

Figure 11: EPS estimates of S&P 500 Growth Index



Source: Bloomberg, CMBIS

Figure 12: EPS estimates of S&P 500 Value Index



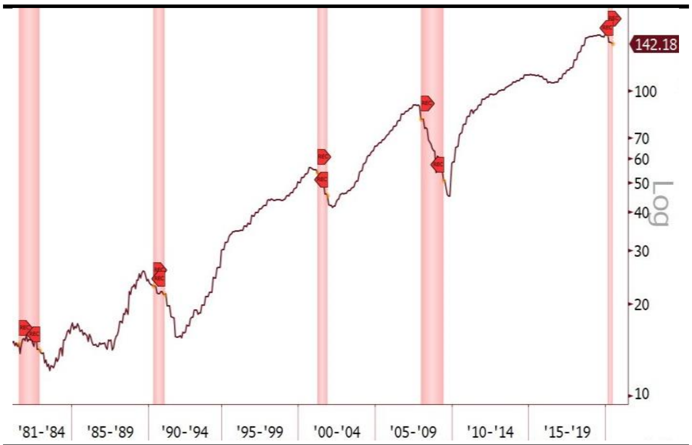
Source: Bloomberg, CMBIS

Earnings typically took two years to recover

Take a look at the four recessions in the U.S. over the past four decades. After the end of a recession, 12-month trailing EPS of the S&P 500 took 18-39 months to surpass the level right before the respective recession (Fig. 13 & 14).

Some may argue this recession in 2020 should end much sooner than a typical recession, and thus corporate earnings should take less time to return to pre-recession level. While there may be some truth in this argument, history suggests otherwise. In 2001, the recession lasted for only 8 months, but earnings took 28 months to regain lost ground. In any case, the expectation that earnings in 2021 will surpass that in 2019 (i.e. probably took less than 18 months to recover) sound very optimistic.

Figure 13: EPS of S&P 500 (recessions highlighted)



Source: Bloomberg, CMBIS

Figure 14: U.S. EPS took how long to recover

Economy Peak	Economy Trough	EPS reached pre-recession level	Months post-recession
Jul 1981	Nov 1982	Jun 1984	18
Jul 1990	Mar 1991	Jun 1994	39
Mar 2001	Nov 2001	Mar 2004	28
Dec 2007	Jun 2009	Sep 2011	27
Feb 2020	??	??	??
Average			28

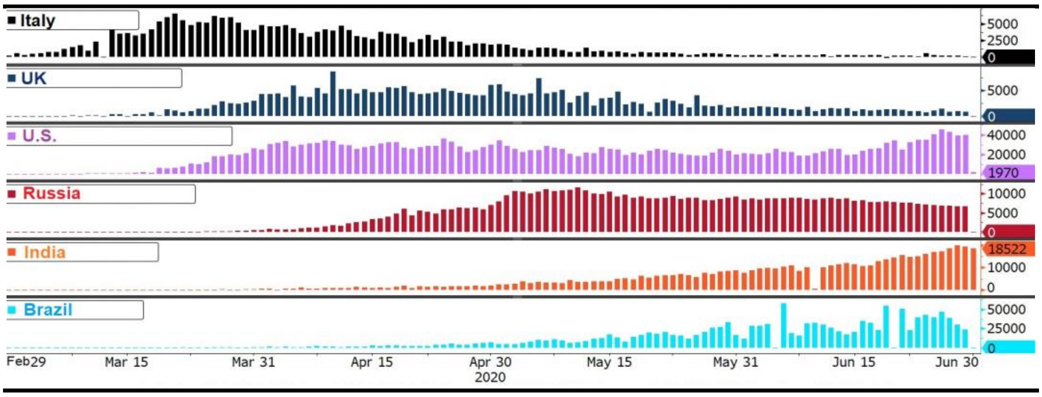
Source: Bloomberg, CMBIS

COVID-19 the biggest risk to earnings

This recession is caused by the COVID-19 pandemic, and will end only if the outbreak is under control in major economies. Therefore, the biggest uncertainty to the length of this recession, the shape of the subsequent economic recovery, and corporate earnings in 2020 & 2021, is the path of the virus outbreak.

While some countries which were early sufferers of the virus outbreak, such as China & Italy, have not seen meaningful rebound in new cases for now, the U.S. is having a rebound in new cases, and new infections in Russia, India and Latin America remain elevated.

Figure 15: COVID-19 confirmed cases in major countries



Source: Bloomberg, CMBIS

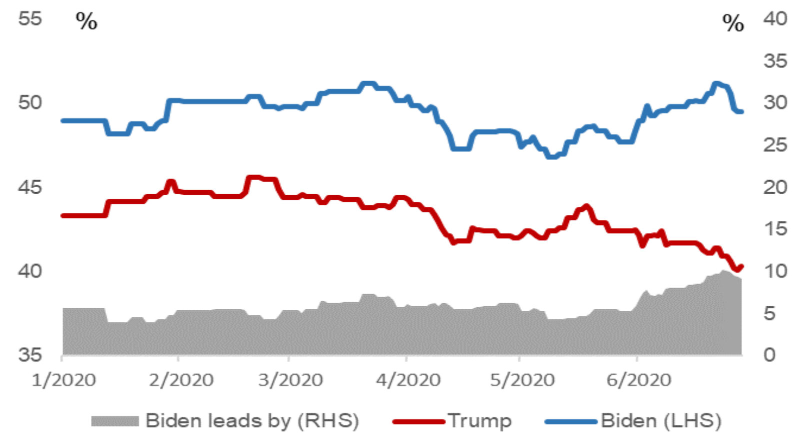
U.S. Election – what if Trump wins or loses?

Trump lagging behind Biden in polls

The U.S. presidential elections have always been influential on stock market performance, and this year's scheduled on 3 Nov 2020 is arguably more important than ever, given that President Trump started the U.S.-China trade war during his first term, and that ties between the two biggest economies have plummeted to their lowest point in decades. Whether Trump can win a second term may have profound influence on U.S.-China relations, among other issues.

If the election is held today, Trump will probably lose to Democratic candidate Joe Biden, according to various polls (Fig. 16). Trump's favourability declined since the COVID-19 outbreak in the U.S., and got further hit since the nationwide "Black Lives Matter" protests.

Figure 16: 2020 U.S. Presidential election polls



Source: RealClearPolitics, Bloomberg, CMBIS

Stocks tended to underperform when incumbent party lost

In case Trump failed in seeking a second term, how will the stock market fare? We reviewed the 18 presidential elections since the WWII (Fig. 17), and made several observations:

1. In 9 of those elections (50% chance), the candidate from the incumbent party lost.
2. In each of the three election years when a recession occurred, the incumbent party lost.
3. On average, when the incumbent party lost, the S&P 500 Index did more poorly both for the whole year and between Jul-Oct (four months leading to the elections in Nov).

Figure 17: Presidential election results and stock market returns

Year	Party elected	Incumbent party lost?	Recession in election year?	S&P 500 performance Full Year	1 Jul – 31 Oct
1948	Democrat			-0.7%	-1.4%
1952	Republican	✓		11.8%	-1.8%
1956	Republican			2.6%	-3.0%
1960	Democrat	✓	✓	-3.0%	-6.2%
1964	Democrat			13.0%	3.9%
1968	Republican	✓		7.7%	3.8%
1972	Republican			15.6%	4.1%
1976	Democrat	✓		19.1%	-1.3%
1980	Republican	✓	✓	25.8%	11.6%
1984	Republican			1.4%	8.4%
1988	Republican			12.4%	2.0%
1992	Democrat	✓		4.5%	2.6%
1996	Democrat			20.3%	5.2%
2000	Republican	✓		-10.1%	-1.7%
2004	Republican			9.0%	-0.9%
2008	Democrat	✓	✓	-38.5%	-24.3%
2012	Democrat			13.4%	3.7%
2016	Republican	✓		9.5%	1.3%
2020	??	??	✓	??	??
When incumbent party WON, on average:				9.7%	2.4%
When incumbent party LOST, on average:				3.0%	-1.8%

Source: CMBIS

Observation 2 does not bode well for Trump, as the U.S. officially entered a recession in Feb 2020.

On observation 3, it is difficult to say definitely whether a weak stock market (probably as a result of weak economy) led to the incumbent party's loss, or the incumbent party's loss led to stocks' underperformance (due to more political uncertainty). Probably both factors played some part.

The bottom line is, **if Trump remains out of favour as indicated by polls, the U.S. stock market is more likely to have a weak performance in the upcoming months**.

Biden seen as less pro-market

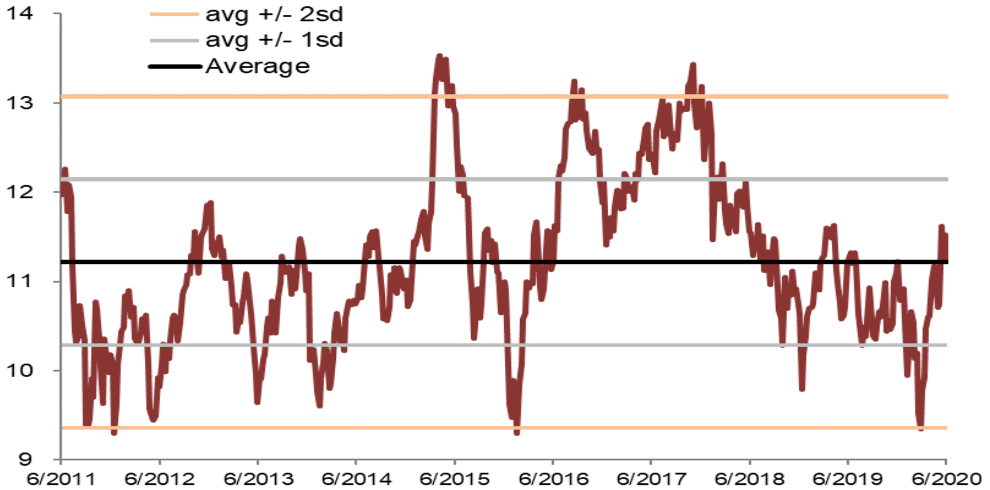
That is not to say a Biden victory would bring exuberance to the stock market. Market reaction may be mixed. On one hand, it is **widely believed Biden is less hostile to China**, and thus chances of U.S.-China tension escalating further may become lower than if Trump wins (but do not expect U.S.-China relations to improve drastically, as apparently it has become a bipartisan consensus to be tough on China).

On the other hand, **Biden is less business-friendly than Trump**. He vowed to "get rid of the bulk of Trump's US$2 trillion tax cut", and raise the corporate tax rate to 28%. The Trump tax cuts have shrunk corporate taxes to 21% from 35%. If Biden wins, the market may revise down U.S. corporate earnings forecasts from 2021E onwards.

HSI target in 2H – 23,800-26,200 in base case

The Hang Seng Index has been trading in a narrow range of forward P/E 9.4x-13.1x for the most part of the past decade (Fig. 18). In 1H 2020, the HSI again traded within this P/E range, except at the panic climax in mid-Mar when its forward P/E dropped to as low as 8.5x. **We expect in 2H the HSI will stay in this P/E range, with risks tilted towards the downside.** Upside potential would be capped by numerous risks, such as new waves of COVID-19 outbreak and U.S.-China tension.

Figure 18: HSI traded within 9.4x-13.1x forward P/E over the past decade



Source: Bloomberg, CMBIS

Fig. 19 summarises our HSI targets, P/E range and key assumptions.

Our HSI target is based on the consensus blended forward 12-month EPS, which we believe is more suitable than either 2020E EPS (exceptionally low due to the pandemic) or 2021E EPS (seems to have priced in an ideal scenario).

Figure 19: HSI targets in 2H 2020

	Best case	Base case	Worst case
Blended forward 12-month EPS (consensus)		**2,335**	
Target P/E	12.1x (average +1 s.d.)	**10.2x - 11.2x** (-1 s.d. to average)	9.4x (average -2 s.d.)
HSI Target	28,300	**23,800-26,200**	22,000
Key assumptions	1. COVID-19 under control in major countries; 2. vaccines development makes good progress; 3. economy reopens; 4. U.S.-China tension does not escalate	1. COVID-19 new cases rebound moderately in some major countries; 2. no vaccines can be successfully and applied any time soon; 3. economy reopens gradually with some social-distancing measures remain 4. U.S.-China tension slightly escalates	1. Major countries enter a second wave of COVID-19 infections 2. no vaccines can be successfully and applied any time soon; 3. Lockdown measures re-imposed 4. Surge in bankruptcies and bad loans due to pandemic 5. U.S.-China tension escalates

Source: Bloomberg, CMBIS

Strategy – continue to prefer growth stocks over value

Sector performance has been very diverged in 1H 2020, as old economy and cyclical stocks such as energy, airline, retail, real estate were hardest hit by the pandemic, while new economy ones like internet emerged relatively unscathed. Since we expect the HSI to be range-bound in 2H 2020, sector and stock picks would once again be vital.

■ **Base/worst case: prefer Internet, Healthcare, Consumer Staples, Machinery**

In our base-case or worst-case scenarios (moderate to serious rebound in COVID-19 new cases in some of major countries), we continue to favour:

- Sectors that are less vulnerable to recession and lockdown measures, such as **internet, healthcare, education, consumer staples**. In particular, internet sector is expected to benefit from structural changes such as more digitalization.
- **Construction machinery** which benefits from China's policy support for infrastructure spending.
- We also suggest positioning for 5G-driven recovery in **technology** sector.
- Besides, **gold ETF or gold miners** can be a risk diversification asset, in an environment with zero interest rates, and in case of escalating U.S.-China tension and rising geopolitical risks.

Figure 20: Sectors and stocks we prefer in base case

Sector	Company	Ticker	Rating
Internet	Alibaba	BABA US / 9988 HK	BUY
	Tencent	700 HK	BUY
	FriendTimes	6820 HK	BUY
	Tongcheng-Elong	780 HK	BUY
Healthcare	Ascentage Pharma	6855 HK	BUY
	PA Good Doctor	1833 HK	BUY
Education	Hope Education	1765 HK	BUY
	Wisdom Education	6068 HK	BUY
Consumer staples	Mengniu Dairy	2319 HK	BUY
	Want Want	151 HK	BUY
	Yonghui	601933 CH	BUY
	Sun Art	6808 HK	BUY
Construction Machinery	Sinotruk	3808 HK	BUY
	Jiangsu Hengli	601100 CH	BUY
	SANY Heavy	600031 CH	BUY
	Weichai Power	2338 HK/000338 CH	BUY
Technology	Xiaomi	1810 HK	BUY
	Sunny Optical	2382 HK	BUY
Gold	SPDR Gold ETF	2840 HK	NR
	Shandong Gold	1787 HK	NR

Source: CMBIS

- **Best case: prefer Consumer Discretionary, Auto, Chi Property, Brokerage**

If things turned out to be closer to our **best-case scenario**, then we would expect significant upside in those beaten-down value stocks which will ride on economic recovery, such as consumer discretionary, auto, China's property, brokerage, insurance, and even airlines.

What would trigger a style shift from growth to value and cyclical stocks? The most important factor would be COVID-19 comes under control, ideally with successful development of vaccines. Sustained positive surprise in U.S. and China's economic data would bode well for value/cyclical stocks too.

Technical analysis

The U.S. and HK stock markets showed some signs of weakness in Jun, and in the short term (next few weeks) are more likely to consolidate.

HSI & HSCEI testing uptrends

For the large part of Q2 2020, both of the HSI and the HSCEI were largely range-bound, before showing signs of turning weak towards the end of Jun:

- **HSI** – Dropped below a short-term uptrend. Next support at medium-term uptrend at ~23,500. MACD line dropped below signal line, giving a "sell" signal (Fig. 21).
- **HSCEI** – Dropped below a medium-term uptrend. MACD line dropped below signal line, giving a "sell" signal (Fig. 22).

Figure 21: Hang Seng Index

Source: Bloomberg, CMBIS

Figure 22: Hang Seng China Enterprises Index

Source: Bloomberg, CMBIS

S&P 500 & Dow formed Island Reversal Top

The U.S. stock markets staged a remarkable rebound since bottoming out on 23 Mar 2020, despite ongoing virus outbreak. However, since mid-Jun, major indexes have turned weak. Both of the S&P 500 and Dow Jones formed a bearish “Island Reversal Top” pattern, and then dropped below a medium-term uptrend.

Figure 23: S&P 500 Index

Source: Bloomberg, CMBIS

Figure 24: Dow Jones Industrial Average

Source: Bloomberg, CMBIS

Risks & Catalysts

Downside risks

1. Poor economic data in major economies which add doubts on V-shaped recovery
2. A second wave of COVID-19 outbreaks in major economies
3. U.S.-China tension escalates, with concrete policies such as tariff hike and sanction.
4. Surge in bankruptcies if demand does not recover enough
5. Fed tapering & USD strength
6. Inflation shocks: cost-driven by supply-chain disruptions and trade wars, and demand-driven by unlimited QE & massive fiscal spending coupled with economic recovery.
7. Hard Brexit: The UK entered into an 11-month period of transition since officially leave the EU on 31 Jan 2020. The UK and EU are supposed to agree on a future trade arrangement to commence on 1 Jan 2021. But the progress has been stalled by the pandemic.

Positive catalysts

1. Strong economic data which suggest V-shaped recovery
2. Good progress in vaccines development
3. The U.S. and China begins talk on phase 2 trade deal
4. New economy stocks such as Alibaba (9988 HK), Meituan (3690 HK) and Xiaomi (1810 HK) may be included into the HSI as early as Sep 2020, adding to earnings growth potential to the benchmark index, and potentially drawing more investor interests in HK stock market.

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OUTPERFORM	: Industry expected to outperform the relevant broad market benchmark over next 12 months
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