August Monthly Strategy

Policy-driven stocks to beat range-bound HSI

HK & China equities' strong run in early Jul did not sustain, and may well consolidate further in the near term, but a weak USD should lend support to emerging markets and in particular China. U.S.-China tension will probably cap upside though, and the HSI may remain range bound. We favour sectors which benefit from fiscal & monetary policies as well as reforms.

- **Short term: Liquidity waning.** After a sudden spike in early Jul, HK & China stock markets retreated, with a few worrying signs, incl. turnover coming down, net outflows in northbound trades, and higher turnover on down days. These are not suggesting a prolonged down market though, as unlike in Apr-Jun 2015, this recent strong run did not show any bubbles or exuberance.
- **Medium term: Benefit from weak USD.** U.S. equities' valuation premium over emerging markets is at the widest at least since 2007. With the USD weakening, there could be some rotation from the U.S. to EM. China stands out from other major EM countries as far as COVID-19's impact and economic recovery are concerned. On the negative side, China has its own risks from the tension with the U.S.
- **HSI expected to be range bound in 23,800-26,200.** As liquidity has been waning in the short term, the HSI may test the uptrend support at ~24,000 before rebounding. Resistance would be at long-term downtrend at ~26,200. This in in line with our base-case forecast of target range 23,800-26,200 based on fundamentals.
- **Investment themes which ride on policies. 1) Infrastructure**: we expect China's infrastructure investments +12% in 2020 (v.s. -2.7% in 1H), boosted by strong growth in issuance of special purpose government bonds; **2) Consumer**: China's economic policy will centre on "internal circulation", supplemented by "external circulation", which means more focus will be placed on boosting domestic output and consumption; **3) Brokerage**: leading brokerage firms would benefit from China's capital market reforms, and catalysts in Aug include the listing of first batch ChiNext IPOs under registration-based system; **4) Gold**: QE and negative real interest rates are the two major driving forces behind the surge in gold price.

Selected sectors and stocks

Sector	Company
Construction machinery	Sinotruk (3808 HK), Weichai Power (2338 HK / 000338 CH), Jiangsu Hengli (601100 CH), SANY Heavy (600031 CH)
Consumer	Mengniu Dairy (2319 HK), GAC Group (2238 HK), Anta Sports (2020 HK)
Brokerage	CITIC Sec (6030 HK), CSC (6066 HK), CICC (3908 HK)
Internet	Alibaba (BABA / 9988 HK), FriendTimes (6820 HK), Tongcheng-Elong (780 HK)
Gold	SPDR Gold ETF (2840 HK), Shandong Gold (1787 HK)

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Market Data

Hang Seng Index	24,595
52-week High / Low	29,175/21,139
3-month avg. daily t/o	HK$135.6bn

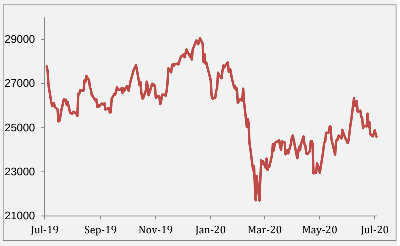
Source: Bloomberg

Indices Performance

	HSI	HSCEI
1-month	0.7%	2.9%
3-month	-0.2%	-0.0%
6-month	-6.4%	-2.0%

Source: Bloomberg

12-month HSI Performance



Source: Bloomberg

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Short term: Liquidity waning in HK/China markets

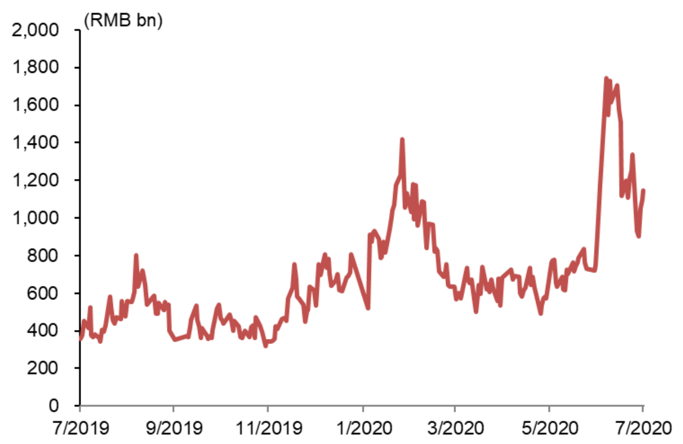
Profit taking after a sudden spike

After a sudden spike in prices and volume in Hong Kong and Mainland China stock markets in early Jul, major indexes have been retreating along with volume in the past few weeks.

As far as liquidity is concerned, there are several slightly worrying signs:

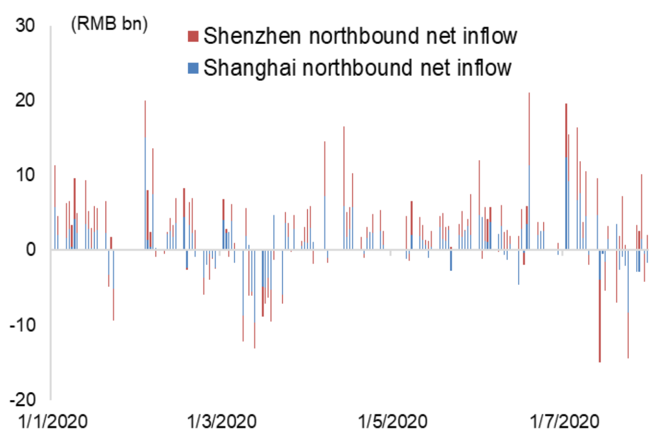
1. **A-shares' turnover retreated from early Jul** (Fig. 1), which signals momentum has been waning.
2. **Northbound trading recorded net outflows since mid-Jul** (Fig. 2), which suggests that offshore investors tended to take profit rather than chasing the rally.
3. **HK market turnover retreated from early Jul** (Fig. 3), **but tended to be higher when the Hang Seng Index had a down day** (Fig. 4), signalling that selling pressure has been stronger than upward momentum.

Figure 1：Shanghai & Shenzhen stocks daily turnover



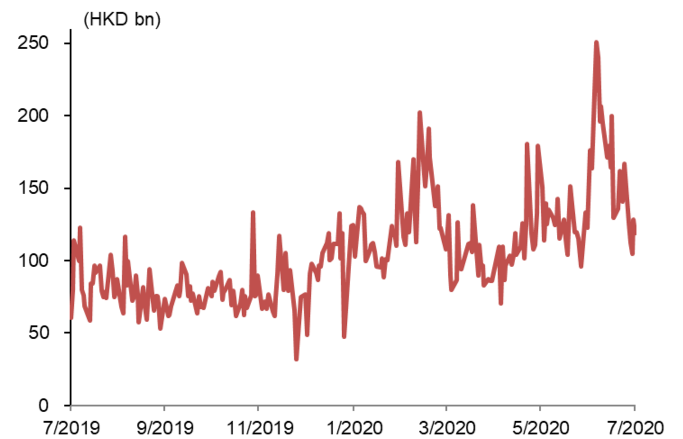
Source: Bloomberg, CMBIS

Figure 2：Northbound inflows into SH/SZ markets



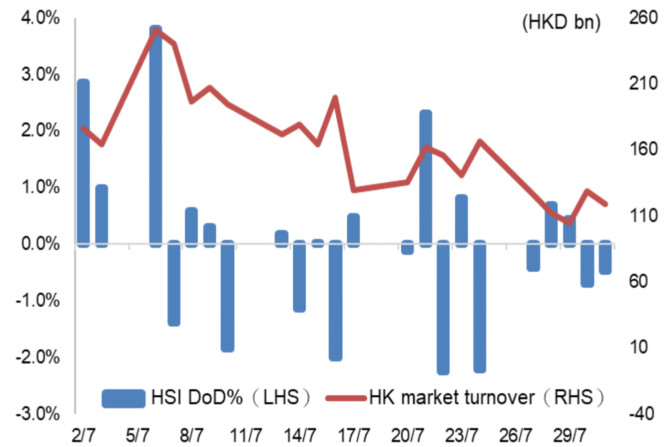
Source: Bloomberg, CMBIS

Figure 3：HK stock market daily turnover waned



Source: Bloomberg, CMBIS

Figure 4：HK market turnover higher on down days



Source: Bloomberg, CMBIS

Unlike 2015, no bubble burst this time

Having said that, **the above negative signs may merely reflect that the steep rise in early Jul were not sustainable**. They are not suggesting a prolonged down market going forward in similar fashion to the market crash in 2H 2015.

While the surge in early Jul 2020 drew comparison with that in Apr-Jun 2015, there are notable differences in terms of valuation and sentiment:

1. **No bubble.** During Apr-Jun 2015, the CSI 300 Index's forward P/E shot up to as high as 20x, while at the peak in early Jul 2020 was only at 16x (Fig. 5). Similarly, the Hang Seng Index peaked at 13.7x forward P/E during Apr-Jun 2015, but only at 12.1x in early-Jul 2020 (Fig. 6).

2. **No irrational exuberance or overleverage.** In A-shares market, turnover (Fig. 7) and margin trading outstanding balance (Fig. 8) were some way off the peak in Apr-Jun 2015. In fact, official media tried to cool down the market in early Jul before getting too hot to promote a sustainable "healthy bull market".

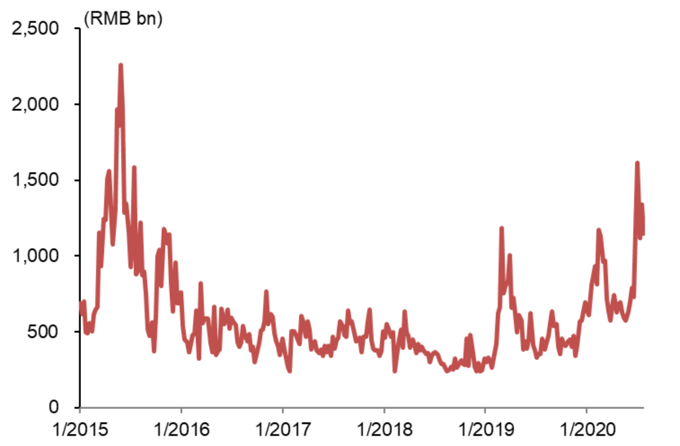
Figure 5: Forward P/E of CSI 300 Index

Source: Bloomberg, CMBIS

Figure 6: Forward P/E of Hang Seng Index

Source: Bloomberg, CMBIS

Figure 7: SH & SZ equities turnover (2015-2020)



Source: Bloomberg, CMBIS

Figure 8: SH & SZ total outstanding balance of margin transactions

Source: Bloomberg, CMBIS

Medium term: Emerging markets benefit from weak USD

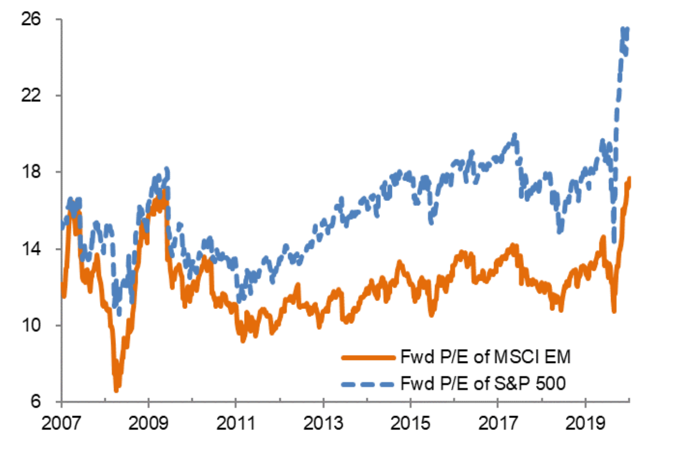
Rotation from U.S. to EM?

The U.S. equity market, despite ongoing negative influence from COVID-19 (U.S. Q2 GDP contracted by 32.9% QoQ annualised), have staged a remarkable rebound since late Mar, boosted by an ultra-easing Fed and led by tech giants (Nasdaq surged to record high).

After the strong run, **valuation of U.S. equities looks rich, not only compared to its own historical levels, but also relative to other markets**. Its premium in terms of forward P/E over emerging markets is at the widest at least since 2007 (Fig. 9).

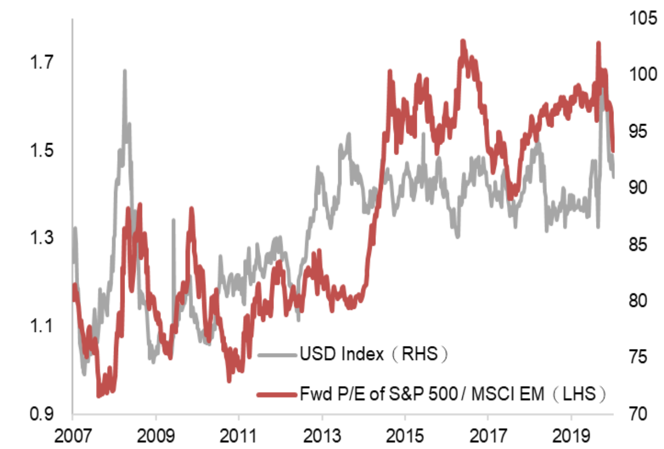
The USD has been in steep decline in recent weeks. Historically, **a weak dollar bodes well for emerging markets' currencies and equities.** When the dollar index declined, EM's valuation discount to the U.S. tended to narrow (Fig 10). With the wide valuation difference between U.S. and EM equities, and a weakened dollar, there could be some rotation from U.S. equities to EM.

Figure 9: Valuation gap between S&P 500 & MXEF



Source: Bloomberg, CMBIS

Figure 10: USD weakness bodes well for EM



Source: Bloomberg, CMBIS

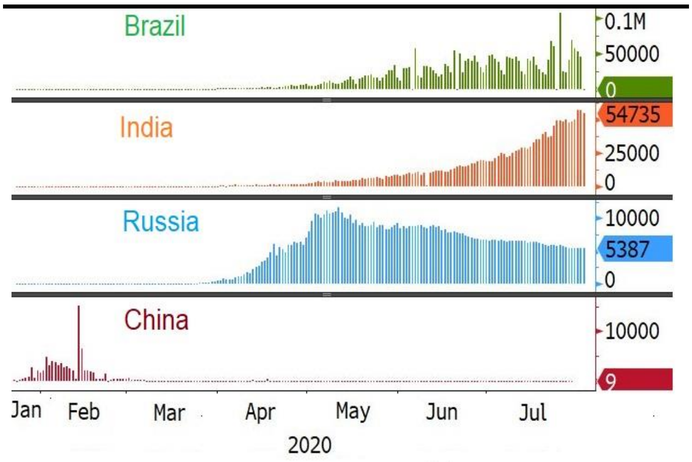
China stands out from major emerging markets

The COVID-19 pandemic has been hitting many countries hard, including many developing countries. Among major EM (BRIC countries), **COVID-19 has come under control in China relatively early**, thanks to stringent measures early on and "first-in-first-out". In contrast, the situations in Brazil and India are still quite serious or even worsening. In Russia, daily new cases are declining but still elevated (Fig. 11).

Economic data (manufacturing PMI) in the BRIC countries reflect the difference in epidemic severity. **China's Caixin PMI bottomed out in Feb at 40.3, while the three peers' Markit PMIs bottomed out in Apr at much lower levels** 27.4-36.0. China's is also the first to return to expansion territory (Fig. 12).

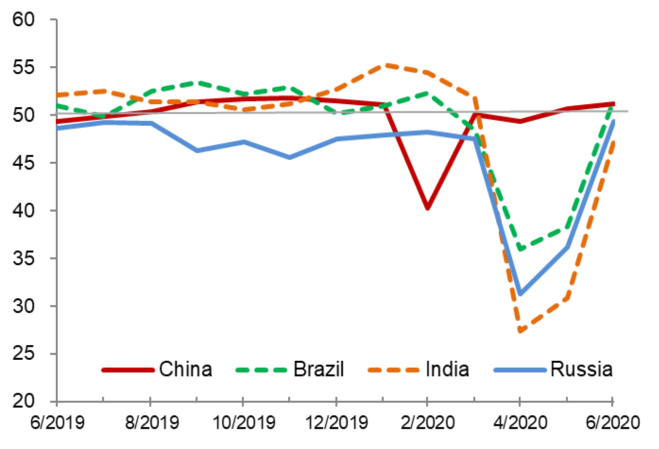
On the negative side, China has its own risks from the tension with the U.S. With the U.S. presidential election coming in three months, it is expected the tension would remain, if not elevate. **U.S.-China tension would probably cap the upside in HK & Mainland China stock markets.**

Figure 11: COVID-19 daily new cases in BRIC



Source: Bloomberg, CMBIS

Figure 12: Manufacturing PMI of BRIC countries



Source: Bloomberg, Markit, Caixin, CMBIS

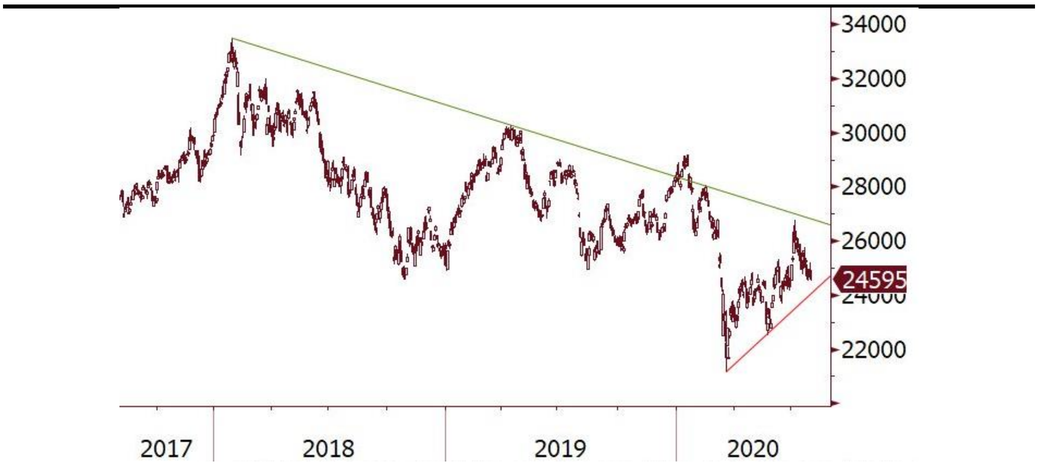
Technical analysis

HSI expected to be range-bound in 23,800-26,200

Since bottoming out at 21,139 on 19 Mar 2020, the HSI has been rebounding in an upward channel. As liquidity has been waning in the short term, chances are **the HSI may test the uptrend support at around 24,000 before rebounding**. Resistance would be at long-term downtrend at around 26,200 (Fig. 13).

This would be in line with our base-case forecast of target range 23,800-26,200 based on fundamentals. Please refer to our 2H outlook strategy report.

Figure 13: HSI may test uptrend at 24,000 and then remain range bound



Source: Bloomberg, CMBIS

Investment themes

With a range-bound HSI as our base-case forecast, sector and stocks picks will once again be the key. **While we continue to favour new-economy stocks over the medium term** given their higher earnings visibility amidst uncertainties in the COVID-19 pandemic and pathway of economic recovery, many of them are trading at rich valuations, and **investors have to be selective**.

We suggest to look at the following **sectors which should benefit from policies (fiscal spending, monetary easing, market reform)**. Stock picks are listed in Fig. 19.

1. Infrastructure – more government investments

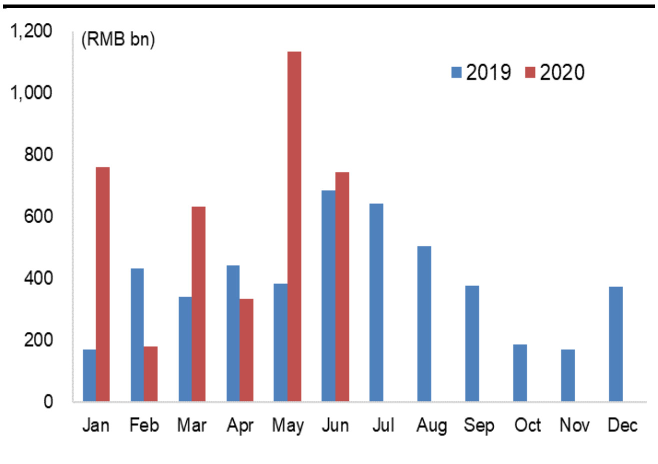
Infrastructure spending is counter-cyclical in nature. The worse the economy fares, the more urge for government spending in infrastructure as a stabilising tool. That is certainly the case this year after the coronavirus outbreak. In 1H 2020, China's infrastructure investments -2.7% YoY (Fig. 14), with Q2 markedly improved from Q1. **Our chief economist expects infrastructure investments to record 12% growth for the full year**, boosted in 2H by strong growth in issuance of special purpose government bonds, credit growth and overall policy support. In particular, government bond issuance in 2H is expected to reach RMB 4.57tn, a 104% YoY increase. Issuance in 1H increased by 54% YoY (Fig. 15). Please refer to our economic report (in Chinese).

Construction machinery and heavy-duty trucks manufacturers are best positioned to ride on the infrastructure investment boom. Monthly sales figures have been consistently encouraging which should lead to upside in earnings forecasts. Other catalysts include strict measures on emission control and market share gain for industry leaders. Please refer to our sector report.

Figure 14: China's infrastructure investment

Source: Bloomberg, CMBIS

Figure 15: China's government bond issuance



Source: PBoC, CMBIS

2. Consumer – "internal circulation"

With the coronavirus's impact being more serious in many countries than in China, coupled with ongoing U.S.-China tension, China's external-facing sectors such as exports and electronics are still exposed to higher risks than domestic consumption sectors. Our chief economist expects retail sales growth towards year end could return to similar levels to a year earlier (8.0% YoY growth in Nov-Dec 2019), a remarkable improvement from the 11.4% decrease in 1H (Fig. 16).

In a meeting of the Political Bureau of the CPC Central Committee on 30 Jul, the central government reaffirmed that China will form a new development pattern centred on **"internal circulation"**, which should also be better supplemented by the "external circulation" (加快形成以**国内大循环为主体**、国内国际双循环相互促进的新发展格局). It is generally interpreted as more policy focus would be placed on boosting local output and domestic consumption. **While more specific measures are needed to bring a positive impact on domestic consumption, consumers stocks may react positively in general**.

Figure 16: China's retail sales improving

Source: Bloomberg, CMBIS

3. Brokerage – capital market reform

Brokerage sector is highly sensitive to market sentiment and liquidity, and thus likely to consolidate further along with the broad market in the short term. However, we remain optimistic that leading brokerage firms with an edge in investment banking would benefit from China's capital market reforms. Upcoming catalysts in Aug and beyond would include: the listing of first batch ChiNext IPOs under registration-based system; more capital market reforms on corporate / enterprise bond issuance and SOE reforms. Please refer to our sector report.

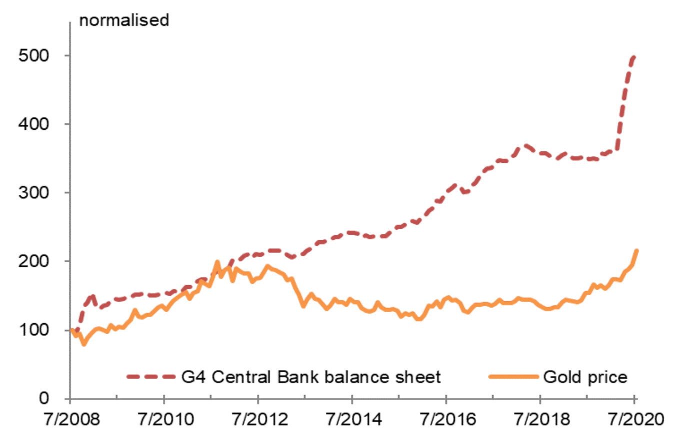
4. Gold – unlimited QEs & negative interest rates

Quantitative easing (aka money printing) and negative real interest rates have been the two major driving forces behind the surge in gold price.

G4 central banks' (U.S., Europe, UK, Japan) kept swelling since the global financial crisis in 2008 barring a short period from mid-2018 to 2019, before rising again in Mar 2020 in response to COVID-19 (Fig. 17).

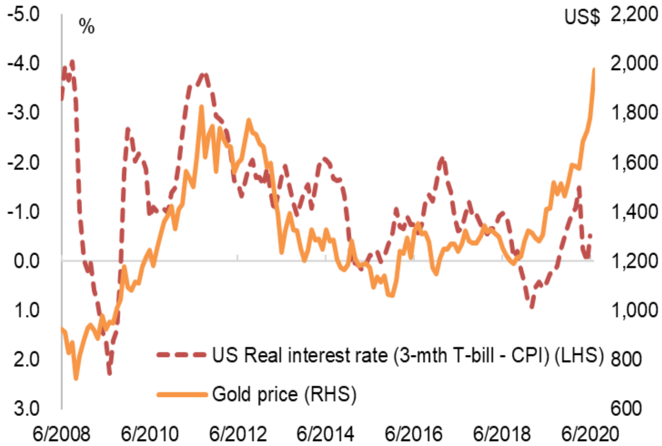
Real interest rates have an inverse correlation with gold price (Fig. 18). With the Fed expecting to keep interest rates on hold through 2022, real interest rates would probably stay negative with the magnitude increasing as aggressive monetary easing is reflationary.

Figure 17: Gold price vs central banks' balance sheet



Source: Bloomberg, CMBIS

Figure 18: Golds price vs U.S. real interest rate



Source: Bloomberg, CMBIS

Figure 19: Sector and stock picks

Sector	Company	Ticker	Rating
Construction Machinery	Sinotruk	3808 HK	BUY
	Weichai Power	2338 HK / 000338 CH	BUY
	Jiangsu Hengli	601100 CH	BUY
	SANY Heavy	600031 CH	BUY
Consumer	Mengniu Dairy	2319 HK	BUY
	GAC Group	2238 HK	BUY
	Anta Sports	2020 HK	BUY
Brokerage	CITIC Sec	6030 HK	BUY
	CSC	6066 HK	BUY
	CICC	3908 HK	BUY
Internet	Alibaba	BABA US / 9988 HK	BUY
	FriendTimes	6820 HK	BUY
	Tongcheng-Elong	780 HK	BUY
Gold	SPDR Gold ETF	2840 HK	NR
	Shandong Gold	1787 HK	NR

Source: CMBIS

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