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June Monthly Strategy

Divergences & Opportunities

After global stock markets crashed in Mar and then recovered most of the losses, we observed several divergences in the market and economy: recession is deep but stock prices are strong, China's domestic demand is recovering but external headwinds remain, investors are buying while insiders are selling, etc.

- **Divergence 1: Wall Street & Main Street.** S&P 500 surged 42% in 50 days, due not to cheap valuation or upbeat economic data, but Fed's unlimited QE. We are wary of stretched valuations of stocks and the current market consensus of earnings which seemingly priced in an ideal recovery.
- **Divergence 2: COVID-19 in China & Overseas.** COVID-19 outbreak occurred in China earlier than in Europe and the U.S., and became under control in China much earlier than in the West. For China's economy, therefore, external demand is likely to stay weak due to the pandemic, while domestic demand is more resilient, especially with policy support.
- **Divergence 3: China's Domestic & External demand.** China's domestic demand is enjoying a better recovery than that of external demand, as illustrated by recent economic data. Manufacturing PMI dropped for two months in a row, while the non-manufacturing PMI rose further. Construction sector's sub-index rose for three consecutive months to 60.8, while new export orders sub-index dropped back to 35.3.
- **Divergence 4: Investors Buying & Insiders Selling.** U.S. public companies have sold a record value of shares in May (>US$60bn). In HK, there have been a mini wave of share placement in the past week, with at least six companies issuing new shares to raise a total of HK$20bn. This gives a signal to investors that their shares are not cheap and that management are cautious about business outlook.
- **Divergence 5: Growth & Value stocks.** Growth stocks such as internet significantly outperformed value stocks such as financial and energy YTD. Valuation gap between them widened to the biggest in at least a decade. However, as investors bet on economic recovery, sectors that were the hardest hit, i.e. cyclical value stocks, could well play catch-up in near future. Growth stocks that have outperformed much may face profit-taking.
- **Strategy: Switch to laggards in Consumer & Machinery.** 1) Buy on dips instead of chasing the rally; 2) OW domestic consumption sectors, UW external-driven ones; 3) Play catch-up in some laggards with sound fundamentals in domestic consumption sectors, plus a few value stocks.

Selected sectors and stocks

Sector	Company
Auto	GAC Group (2238 HK), Geely Auto (175 HK)
Consumer Discretionary	Anta (2020 HK), Pou Sheng (3813 HK), Samsonite (1910 HK)
Consumer Staples	Mengniu Dairy (2319 HK)
Construction Machinery	SANY Heavy (600031 CH), Weichai (2338 HK/000338 CH)
China Property	China Aoyuan (3883 HK)
Brokerage	CICC (3908 HK)

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Market Data

Hang Seng Index	24,366
52-week High / Low	29,175/21,139
3-month avg. daily t/o	HK$120.8bn

Source: Bloomberg

Indices Performance

	HSI	HSCEI
1-month	3.2%	3.8%
3-month	-7.1%	-5.3%
6-month	-6.5%	-2.8%

Source: Bloomberg

12-month HSI Performance

Source: Bloomberg

Related Reports

1. Strategy Report – "Two sessions" preview and what to buy – 18 May 2020
2. Strategy Report – A second wave of shocks – 4 May 2020
3. Strategy Report – Sell before May– 22 Apr 2020
4. Strategy Report – Gauging China's recovery and impact on HK stock market – 6 Apr 2020
5. Strategy Report – HK stock market more defensive than the U.S. – 18 Mar 2020
6. Strategy Report – Pandemic and opportunities in "bear market" – 16 Mar 2020
7. Strategy Report – Oil prices crash's impact on economy and stocks – 10 Mar 2020

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Divergence 1: Wall Street & Main Street

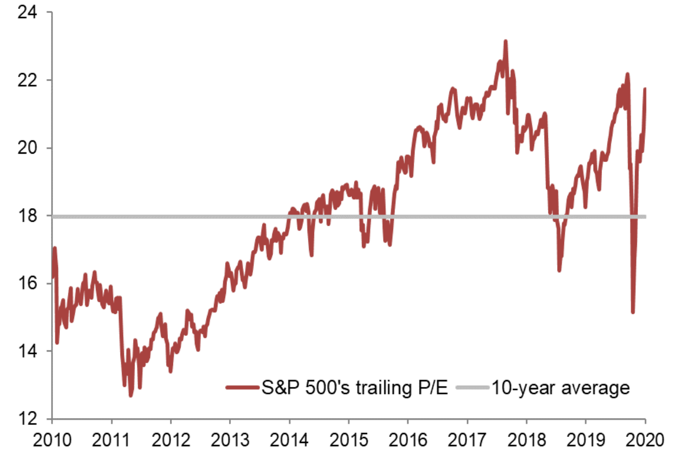
S&P 500 surged 42% in 50 days

The U.S. S&P 500 Index set a record high on 19 Feb 2020, before the COVID-19 pandemic triggered one of the steepest sell-offs in the index's history, by 35% in just over a month, and bottomed on 23 Mar 2020. It then staged a stunning rebound of 42% in just 50 days, intriguingly during the worst recession since the WWII.

Stock markets are forward-looking and typically bottom out before the real economy does. Any early signs of "green shoots" in the economy could push up stock prices from distressed levels. But what make this round of rally remarkable are:

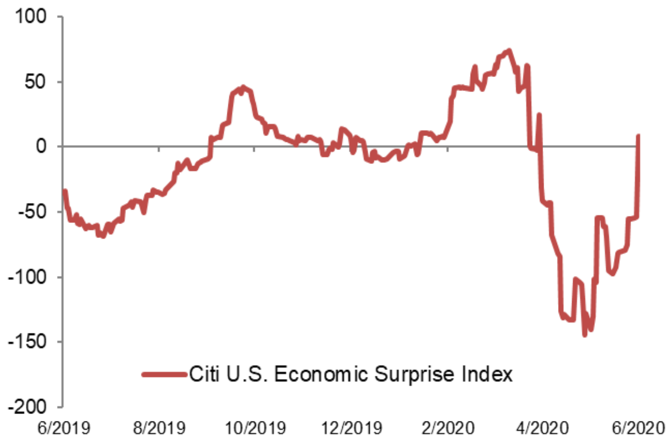
1) Even at its trough on 23 Mar, the trailing P/E of S&P 500 was 15x, lower than 10-year average's 18x, but nowhere near distressed levels (Fig. 1).
2) Economic data has not really been better than expected, until the ADP employment data announced on 3 Jun. The Citi U.S. Economic Surprise Index has stayed in deep negative territory since late-Mar until 3 Jun, indicating economic data have been worse-than-expected (Fig. 2).

Figure 1: U.S. equities not distressed even at trough



Source: Bloomberg, CMBIS

Figure 2: U.S. economic data in negative surprise



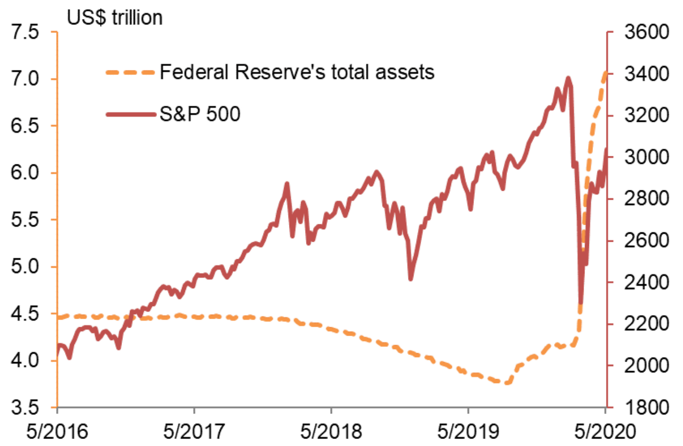
Source: Bloomberg, CMBIS

Fed behind the rally

What really drove the stock market up is central banks. The Federal Reserve on 23 Mar announced it would purchase an unlimited amount of Treasuries and mortgage-backed securities (unlimited QE) in order to support the financial market. It was exactly on that day the U.S. stock market bottomed out. Fed's balance sheet ballooned from US$4.2tn in early-Mar to US$7.1tn in late-May, a 70% increase (Fig. 3).

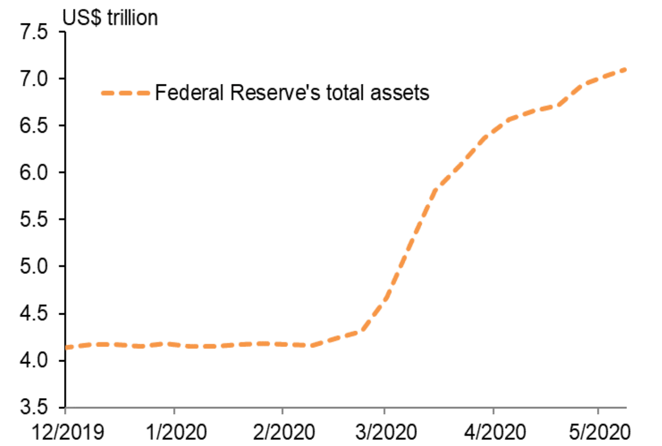
But the pace of QE has somewhat slowed down in recent weeks (Fig. 4). Look back on the period Jan 2018 - Aug 2019 when the Fed was shrinking its balance sheet, S&P 500's rally paused and largely moved sideways (Fig.3). Now that the economy is so fragile that in case the Fed's QE tapers further (buying less), the stock market may lose steam.

Figure 3: Fed's QE propelled U.S. equities



Source: Bloomberg, CMBIS

Figure 4: Fed is buying assets at a slower pace



Source: Bloomberg, CMBIS

Risk appetite returns…

The stock market is climbing a wall of worry, seemingly ignoring the pandemic (global confirmed cases surged from 335k to 6.3m during the stock market bounce), global recession, US-China tensions, and mass protests in the U.S. over the death of George Floyd.

In addition to unlimited QE by central banks, risk appetite has returned. Safe havens Japanese yen, USD, gold and U.S. 10-year Treasury retreated from recent peaks one by one over the past few weeks (Fig. 5-8).

Figure 5: Dollar Index (DXY) turned weak in late-May

Source: Bloomberg, CMBIS

Figure 6: Japanese yen turned weak in mid-May

Source: Bloomberg, CMBIS

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Figure 7: U.S. 10-year Treasury yield creeping up

Source: Bloomberg, CMBIS

Figure 8: Gold price retreated from 7-year high

Source: Bloomberg, CMBIS

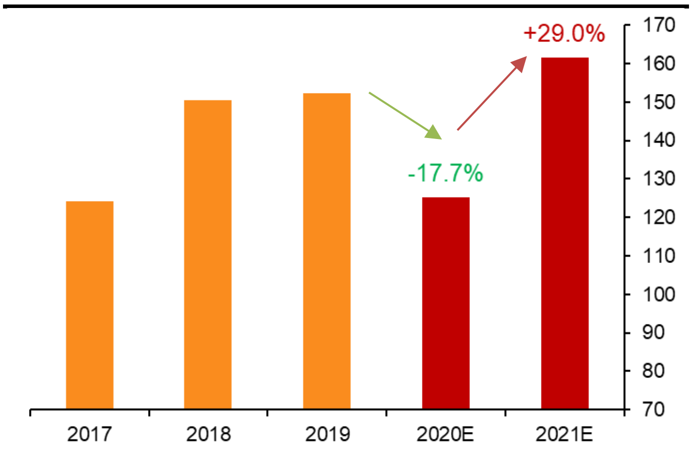
…but outlook is highly uncertain

Apparently, investors are looking forward to post-pandemic recovery in economy and corporate earnings, while ignoring short-term pains. The risk here is that, in the absence of vaccines, when the pandemic will be under control and thus global economy and corporate earnings will return to normal is highly uncertain.

Look at the market consensus of the S&P 500's earnings. EPS in 2020 is forecasted to be -17.7% YoY, and then +29.0% in 2021, which would be 6.1% higher than in 2019 (Fig. 9). For the Hang Seng Index, EPS in 2020 is forecasted to -15.5% YoY, and then +18.0% in 2021, which would be almost the same as in 2019 (Fig. 10).

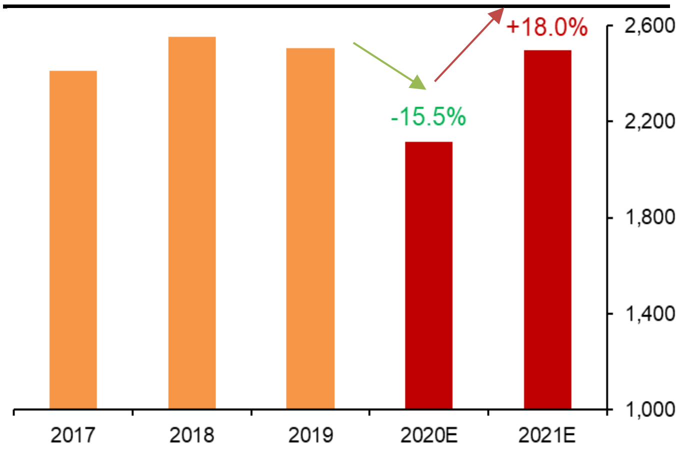
Such earnings forecasts seem to have priced in an ideal case, where pandemic is gradually under control, economy reopens without a second wave of outbreaks, unemployment rate swiftly goes down, vaccines successfully developed by year end, central banks keep zero interest rates and printing money, no significant escalation of US-China tension.

Figure 9: EPS of the S&P 500



Source: Bloomberg, CMBIS

Figure 10: EPS of the Hang Seng Index

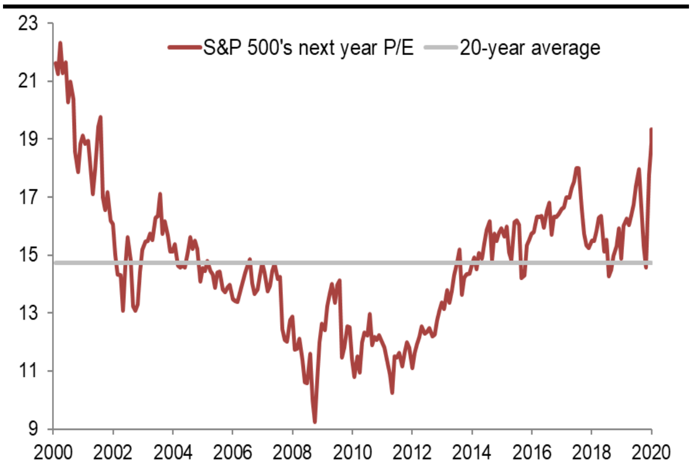


Source: Bloomberg, CMBIS

What if any of these factors turn out to be a negative surprise? The valuation of U.S. stocks is now quite stretched, and thus over the medium if the ideal case does not play out, valuation could easily be dragged to a fairer level. Even if we look beyond 2020 and take the market consensus of 2021E earnings forecast, **the S&P 500 is trading at 19.3x next-year P/E, highest in almost two decades** (Fig. 11).

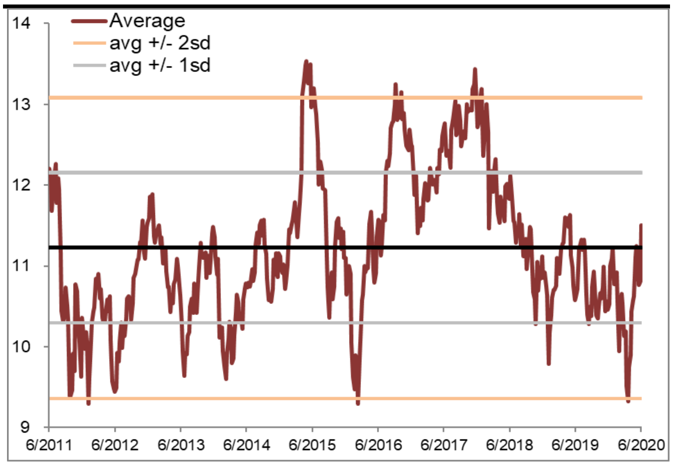
As for the **Hang Seng Index, current year's estimated P/E has rebounded to 11.5x**, slightly above 10-year average 11.2x. **Further upside in valuation should be limited** by 1) US-China tension and HK's political uncertainty; 2) financial stocks (accounting for 48% of the HSI) which have little positive catalysts, risks of rising NPLs due to corporate defaults under the pandemic, and higher vulnerability to HK's political uncertainty.

Figure 11: Next-year P/E of the S&P 500



Source: Bloomberg, CMBIS

Figure 12: 2020E P/E of the Hang Seng Index



Source: Bloomberg, CMBIS

Divergence 2: COVID-19 cases in China & Overseas

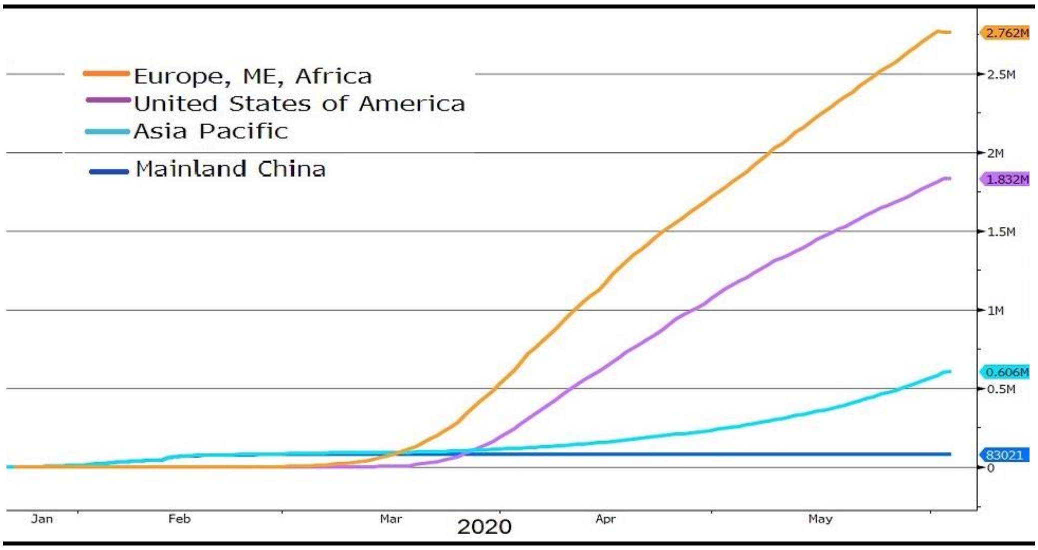
First in, first out

COVID-19 outbreak occurred in China (in Jan 2020) earlier than in Europe and the U.S. (in Mar)**.** In terms of cumulative number of confirmed cases, the outbreak was under control in China much earlier than in the West. Daily new cases have been declining in Europe and moving sideways in the U.S. since early-Apr, but in many developing countries such as India and Latin America are still on the rise (Fig. 13).

For China's economy, therefore, external demand is likely to stay weak due to the pandemic, while domestic demand is more resilient, especially with policy support. Recent economic data are confirming this:

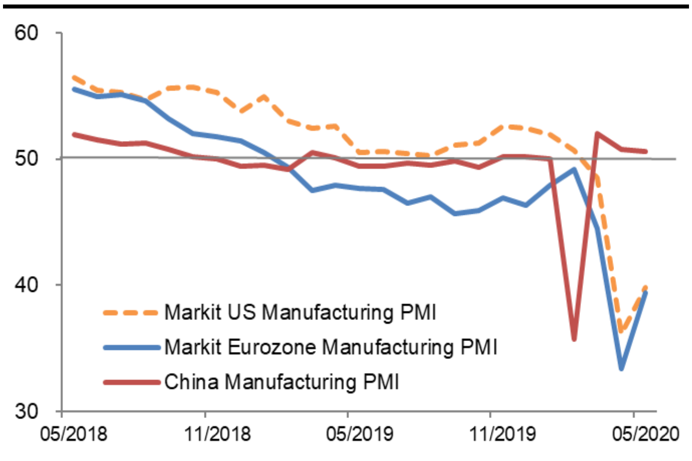
1. **China's manufacturing PMI bottomed out in Feb**, and then returned to expansion zone (>50) for three months in a row, while PMIs of Europe and the U.S. bottomed out only in Apr (Fig. 14).
2. **Korea's exports tumbled for the third straight month in May, by 23.7%**, only slightly improved from the 25.1% slump in Apr. While China's exports data in May have not yet been released, Korea's data suggested that global supply chain's disruption is not yet over. In fact, Korea's trade data has long been viewed as a bellwether for global trade (Fig. 15).

Figure 13: COVID-19 confirmed cases in major regions



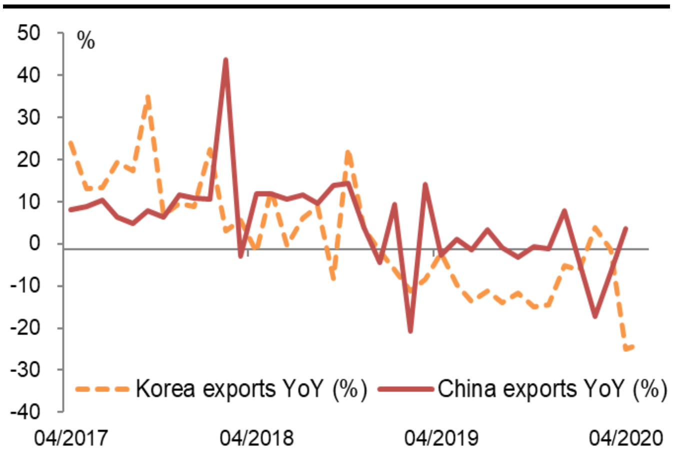
Source: Bloomberg, CMBIS

Figure 14: China's PMI bottomed out before the West



Source: Bloomberg, CMBIS

Figure 15: Korea's exports stayed weak



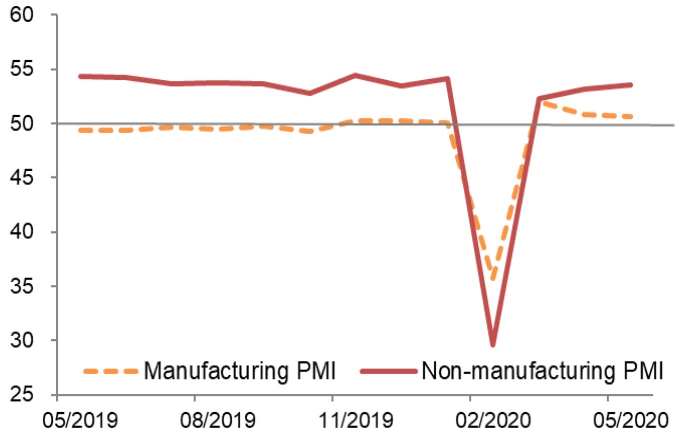
Source: Bloomberg, CMBIS

Divergence 3: China's Domestic & External demand

Due to that fact that China's economy bottomed out earlier than the West, unsurprisingly **China's domestic demand is enjoying a better recovery than that of external demand** (although some expected an even stronger recovery in domestic demand), as illustrated in recent data:

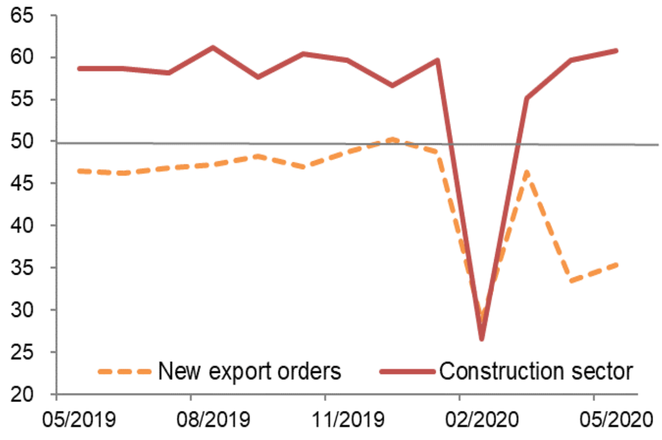
1. Both of China's manufacturing and non-manufacturing PMIs returned to above 50 in Mar, but then the manufacturing PMI dropped for two months in a row, while the **non-manufacturing PMI rose further in those two months** (Fig. 16).
2. Under the PMIs, **construction sector's sub-index rose for three consecutive months to 60.8**, while new export orders sub-index dropped back to 35.3 (Fig. 17).

Figure 16: China's manufacturing & non-manu. PMIs



Source: Bloomberg, CMBIS

Figure 17: China's construction & exports diverges



Source: Bloomberg, CMBIS

Divergence 4: Investors Buying & Insiders Selling

U.S. public companies have sold a record value of shares in May (more than US$60bn), the biggest monthly figure ever, according to Reuters. The number includes new shares placement and major shareholders reducing stakes.

In HK, there have been a mini wave of share placement in the past week, with at least six companies issuing new shares to raise a total of HK$20bn (Fig. 18).

Figure 18: Share placements recently in HK market

Date	Company	Funds raised (HK$ bn)
29 May	Geely Auto (175 HK)	6.45
3 Jun	Greentown Services (2869 HK)	2.69
3 Jun	Meidong Auto (1268 HK)	1.26
4 Jun	Vanke (2202 HK)	7.87
4 Jun	Minsheng Education (1569 HK)	0.24
4 Jun	Ever Sunshine Lifestyle Services (1995 HK)	1.56

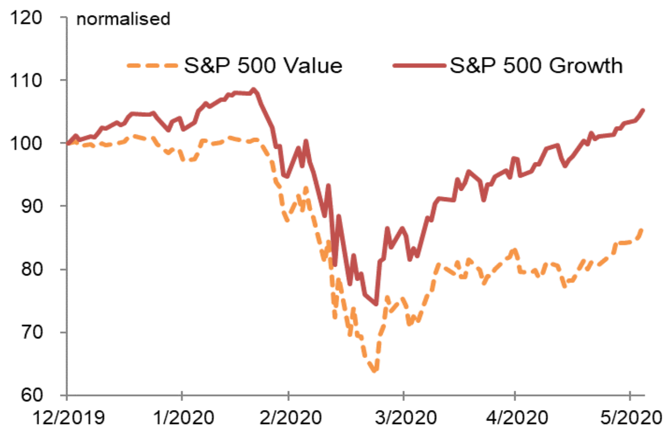
Source: Company announcements, CMBIS

With the economic outlook and business environment highly uncertain, it is understandable for companies to raise funds when the opportunity arises. Still, this gives a signal to investors that their shares are not cheap and that management are cautious about business outlook.

Divergence 5: Growth stocks & Value stocks

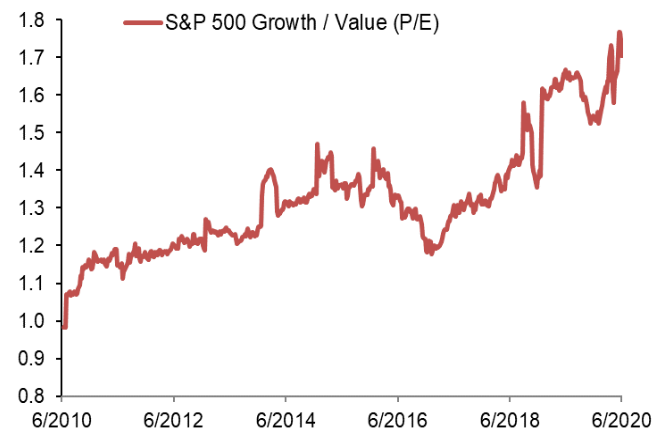
Stringent lockdown and social-distancing measures have been imposed in many countries during this pandemic. Consequently, many traditional industries suffered badly, while internet stocks in generally are less hurt or even benefit from citizens' "staying-at-home". Stock prices certainly reflect this difference. Growth stocks (where internet stocks belong to) significantly outperformed value stocks (financial, energy, etc) YTD (Fig. 19). Valuation gap between growth and value stocks widened to the biggest in at least a decade (Fig. 20), as a result of divergence in share price and deeper cut to value stocks' earnings.

Figure 19: S&P 500 Growth outperformed Value



Source: Bloomberg, CMBIS

Figure 20: Growth stocks' premium widened



Source: Bloomberg, CMBIS

However, as investors are becoming optimistic on economic recovery, sectors that were the hardest hit, i.e. **cyclical value stocks, could well play catch-up in near future**. **Growth stocks that have outperformed much may face profit-taking**.

In HK market, pandemic-hit sectors such as auto, retail, catering, travel may ride on economic recovery theme, while outperformers property management, online clinic, biopharma, office software stocks may face profit-taking.

Technical analysis

HSI formed a bearish "fan" pattern

Since bottoming out on 19 Mar, the HSI has formed a bearish "fan" pattern, which is essentially several uptrends originating from the trough. Every time when the HSI dropped below an uptrend, it failed to rebound back to above that uptrend. **Expect the HSI to test the fifth uptrend of this fan pattern, which is around 23,000.**

Figure 21: HSI may test the fifth uptrend at 23,000

Source: Bloomberg, CMBIS

With a longer-term perspective, the HSI still holds above the uptrend since 2008, after briefly breached it in Mar 2020.

Figure 22: HSI may test the fifth uptrend at 23,000

Source: Bloomberg, CMBIS

Strategy – Switch to laggards in Consumer & Machinery

From the above divergences in economy and stock market, we derived a strategy that:

1. **Buy on dips instead of chasing the rally**, as market consensus of earnings are quite optimistic and valuations are no longer cheap which allow little room for miss.
2. **Overweight domestic consumption sectors, underweight external-driven ones**, as recovery of domestic sectors in China are more solid and visible.
3. **Play catch-up in some laggards with sound fundamentals in domestic consumption sectors, plus a few selected cyclical value stocks**, as investors are turning to recovery-theme, and value stocks' discount to growth stocks are at record wide.

This table lists some stocks which fit into our strategy:

Figure 23: Sectors and stocks we prefer

Sector	Company	Ticker	Rating
Auto	GAC Group	2238 HK	BUY
	Geely Auto	175 HK	BUY
Consumer Discretionary	Anta Sports	2020 HK	BUY
	Pou Sheng	3813 HK	NR
	Samsonite	1910 HK	NR
Consumer Staples	Mengniu Dairy	2319 HK	BUY
Construction Machinery	SANY Heavy	600031 CH	BUY
	Weichai Power	2338 HK/000338 CH	BUY
China Property	China Aoyuan	3883 HK	BUY
Brokerage	CICC	3908 HK	BUY

Source: CMBIS

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