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Strategy Note

HK stock market more defensive than the U.S.

The Hang Seng Index's 0.9% gain yesterday might seem trivial by these days' standard, but the fact that it occurred right after the Dow plunged 13% in the worst day since 1987 spoke volumes. Amidst this global sell-off, we believe Hong Kong stock market is more defensive than the U.S. market, due to difference in COVID-19 risks, valuations and pressures to unwind positions.

- **Valuation of the HSI already priced in a financial crisis.** The HSI is trading at 9.3x 2020E P/E, the lowest since the global financial tsunami in 2008. P/B is 1.00x, even lower than the trough in 2008's financial tsunami, and only slightly higher than the trough in 1998's Asian financial crisis.
- **U.S. equities nowhere near distressed levels.** Even after the recent plunge, the S&P 500 is trading at 14.0x 2020E P/E and 2.6x P/B, both are much higher than the troughs in 2008. That suggests the HSI has less downside risks than S&P 500 if investors' worries on the pandemic and global recession persist.
- **Investors were much more bullish on U.S. equities than HK / China.** Fund managers were heavily overweight on U.S. equities only a month ago, and have been underweight on HK / China for some time. Now that Europe and the U.S. are facing more risks from the COVID-19, the U.S market have more selling pressure from investors who were overweight on them and need to unwind leveraged positions or forced-sell due to fund redemptions.
- **Corporate bond yield spread closely watched.** When the sell-off in equities will end depend a lot on whether the pandemic will lead to a financial crisis, and that in turn depends on how effectively governments' infection control measures are. Both the investment grade and high yield US corporate bonds' yield spread have surged to previous peaks in 2011 & 2016. Whether the spreads would go up much further reflects investors' perception of risks of a financial crisis.
- **Opportunities to accumulate H-shares for long-term value investors**. We prefer stocks which are less vulnerable to the pandemic and global recession risks, and / or benefit from China's fiscal stimuli. Construction machinery and 5G telecom equipment makers are key policy-beneficiaries. We also like internet giants.
- **Avoid stocks with heavy overseas exposure**, including those with significant overseas sales, strong connection with international companies or in global supply chain. We are also wary of devaluation / short-term profit taking on some best-performing sectors in 2019, e.g. property management and sportswear.

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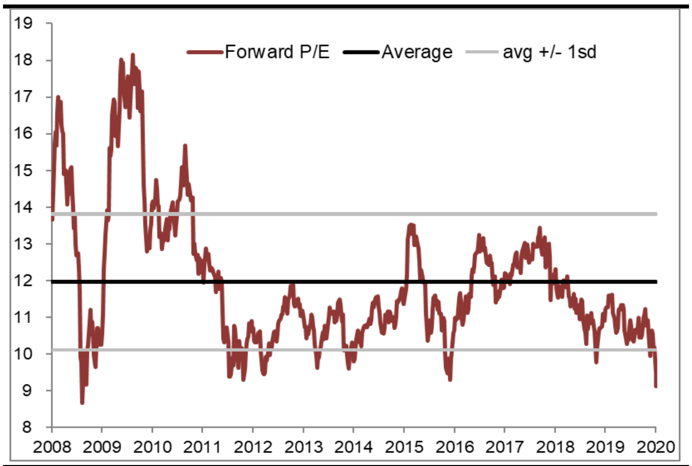
Valuation of the HSI already priced in a financial crisis

The Hang Seng Index is now trading at 9.3x 2020E P/E, the lowest since the global financial tsunami in 2008. We estimate that the EPS will be 2.6-4.6% below consensus due to the COVID-19 pandemic and plunge in oil prices, which would imply that the adjusted forward P/E is now around 9.5-9.7x. Still, this is comparable to troughs during crises.

Figure 1: P/E of HSI lowest since 2008 (weekly data)



Source: Bloomberg, CMBIS

Price-to-book (P/B) is another metric investor would look at during crises, since earnings estimates are subject to revisions of larger magnitude but book value is relatively stable. The P/B of the HSI is 1.00x, even lower than the trough in 2008's financial tsunami, and only slightly higher than the trough in 1998's Asian financial crisis.

Figure 2: P/B of HSI at financial crisis levels

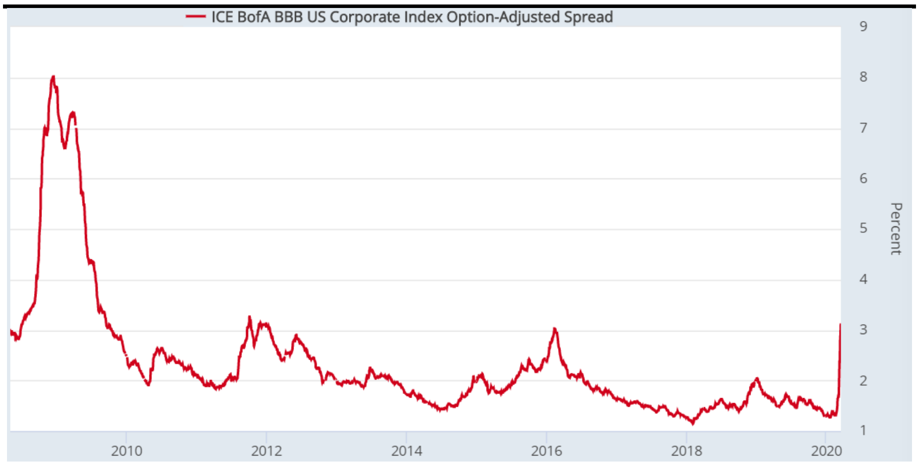
Source: Bloomberg, CMBIS

Corporate bond yield spread closely watched

When the sell-off in equities will end depends a lot on whether the pandemic will lead to a financial crisis (or investors fear so), and that in turn depends on how effectively governments implement infection control measures. Investors are worried that corporates hardest hit by the pandemic may go bankrupt and cause stress to the banking system.

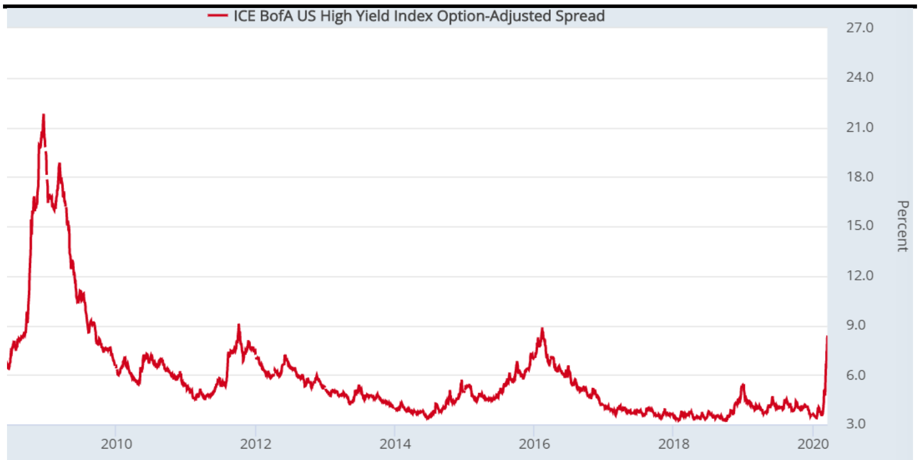
Both the investment grade (BBB) and high yield US corporate bonds' yield spread have surged to previous peaks in 2011 & 2016. If the spreads go up to way above those peaks, more sell-off in U.S. equities would be likely.

Figure 3: U.S. BBB Corporate spread



Source: ICE Data Indices, LLC, ICE BofA BBB US Corporate Index Option-Adjusted Spread, retrieved from FRED, Federal Reserve Bank of St. Louis, as of 16 Mar

Figure 4: U.S. High Yield spread



Source: ICE Data Indices, LLC, ICE BofA US High Yield Index Option-Adjusted Spread, retrieved from FRED, Federal Reserve Bank of St. Louis, as of 16 Mar

HSI has less downside risks than S&P 500

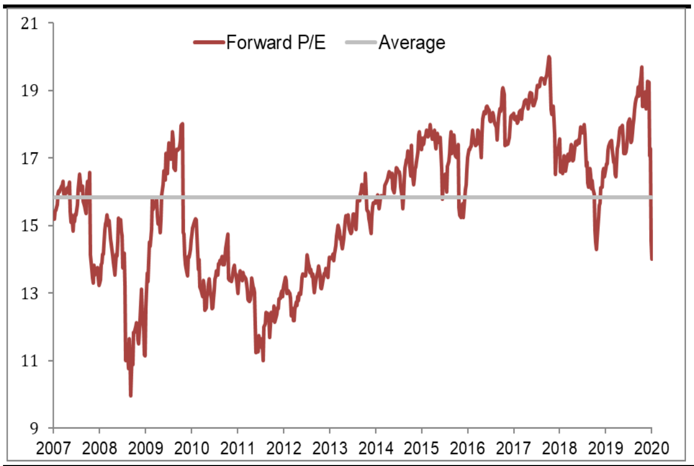
U.S. equities nowhere near distressed levels

While the HSI is at distressed valuations, the same cannot be said for the U.S. equity market, even after the recent plunge.

The S&P 500 Index is trading at 14.0x 2020E P/E, much higher than the trough 9.9x in 2008.

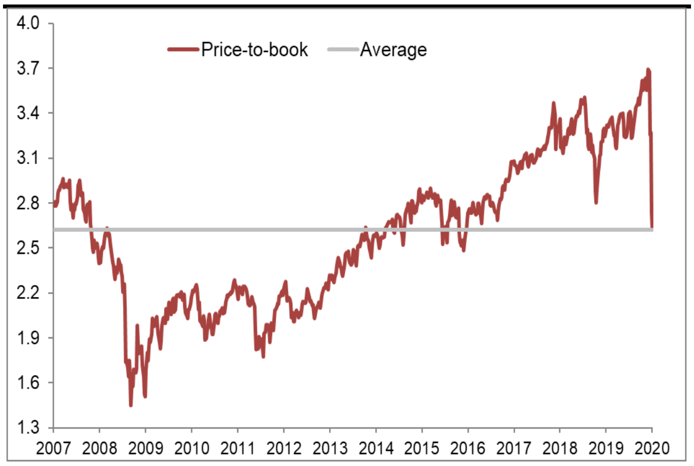
The P/B of the S&P 500 is 2.6x, much higher than the trough 1.5x in 2008.

Figure 5: Forward P/E of S&P 500



Source: Bloomberg, CMBIS, as of 16 Mar

Figure 6: P/B of S&P 500



Source: Bloomberg, CMBIS, as of 16 Mar

Investors were much more bullish on U.S. equities than HK / China

Fund managers / investors have been underweight on HK / China equities for some time, especially after the COVID-19 outbreak in China in Jan. In contrast, they were quite bullish on U.S. equities only a month ago. According to some survey, fund managers' overweight allocation to the U.S. equities in Feb rose to the highest in almost one-and-a-half year, and they cut their China GDP expectations to the lowest level in more than four years.

Now that Europe and the U.S. are facing more risks from the COVID-19, the U.S market have more selling pressure from investors who were overweight on them and need to unwind leveraged positions or forced-sell due to fund redemptions.

In case the pandemic turns out to be longer and worse than expected, U.S. equities should have more downside. **HK market won't be decoupled from any global sell-off, but should be more defensive considering its valuation**.

Chart: HSI at long-term uptrend

The HSI briefly touched the long-term uptrend since 2009 on 13 and 16 Mar. If this uptrend can hold in the coming weeks, that would signal the HSI has bottomed out at ~22,500.

The S&P 500 has also formed a long-term uptrend since 2009, but has slightly dipped below that on 16 Mar. It is more oversold than the HSI though, judging from the RSI, which suggests that a short-term technical rebound is likely, but may face more downward pressure in the medium term.

Figure 7: HSI at long-term uptrend

Source: Bloomberg, CMBIS

Figure 8: S&P 500 testing long-term uptrend

Source: Bloomberg, CMBIS, as of 16 Mar

Strategy: accumulate for long-term value investors

The COVID-19 pandemic poses significant risks to the global economy, and in the worst case might lead to waves of corporate default and even a banking crisis. But the HSI has priced in a financial crisis to a certain extent, and thus should have limited downside from here.

We suggest long-term investors to accumulate HK-listed stocks which are less vulnerable to the pandemic and global recession risks, and / or benefit from China's fiscal stimuli. Construction machinery and 5G telecom equipment makers are key policy-beneficiaries.

We also like internet giants because they suffer less than most industries from the pandemic and have bright growth prospect. Their high-beta nature would give them more upside in stock prices once investor sentiment improves.

On the other hand, avoid stocks with meaningful overseas sales, strong connection with international companies or in global supply chain, as they are more vulnerable to further outbreak of COVID-19 overseas and corresponding lockdown measures.

We are also wary of devaluation / profit taking on some best-performing sectors in 2019, e.g. property management and sportswear. Despite having promising long-term growth prospect, their relatively rich valuation may make them targets of redemption-induced selling by fund managers in the short term.

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