June Monthly Strategy

Short-term Value; Medium-term Growth

Stock markets are climbing a wall of worry in a supposedly weak season. In the short term, we believe Chinese value stocks to moderately outperform growth stocks, supported by strong CNY and earnings upgrade. Prefer financials. In the medium term, however, we expect growth stocks to regain momentum. Accumulate internet, software and technology.

- **Stocks climbing a wall of worry.** Global stock markets remained in uptrend in May, despite unfavourable economic data from the US. Markets climbing a wall of worry shows that investors are getting used to higher inflations and be assured that monetary easing will stay unchanged.
- **Sector divergence narrowing.** Value stocks outperformed growth stocks again in May. But sector rotations did not always happen pre-pandemic, and recently sector divergence has been somewhat narrowing. A more balanced approach on sector allocation, instead of frequently betting on sector rotation, would be increasingly preferable over time.
- **Strong CNY bodes well for HSCEI & value stocks.** CNY has appreciated to 3-year high, which is positive for earnings and valuations of Chinese stocks listed in HK. But HSCEI failed to follow CNY's strength in the past 2-3 months, and might catch up in near future.
- **PPI peaking out may weigh on commodity stocks in Q3.** China's PPI surged to 6.8% YoY in Apr, but we expect it to slow down in 2H21, by then Energy and Materials stocks will probably underperform given their higher correlation with PPI growth.
- **Earnings cut on growth stocks but valuation becoming attractive.** During Q1 result season, Internet and Consumer stocks suffered earnings cuts. Yet, after share price pullbacks, valuations have become more attractive, with growth sectors like Internet and Consumer Staples trading at forward P/E levels lower than historical average.
- **Short-term outlook: Value stocks maintain lead.** Expect Chinese value stocks to moderately outperform growth stocks in the next 1-2 months, as 1) strong CNY bodes well for asset-heavy sectors; 2) value stocks' Q2 earnings enjoy low-base effect, while internet giants still suffering earnings cut; 3) value stocks' relative momentum remains strong. **Prefer Chinese banking, insurance and brokerage sectors.**
- **Medium-term strategy: Accumulate Growth stocks.** Expect growth stocks to regain momentum and outperform in the 2H21, as 1) strong CNY might be unsustainable and thus can't keep lifting value stocks; 2) interest on growth stocks will re-emerge as low-base effect dissipates in 2H21; 3) monetary and fiscal policies will be expected to normalise too, and growth stocks are much less reliant on policies; 4) Relative Rotational Graph (RRG) forecasts potential rotation from cyclical to growth. **Accumulate Internet, Software & IT Services, Technology sectors**.

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Market Data

Hang Seng Index	29,152
52-week High / Low	31,183/23,124
3-month avg. daily t/o	HK$170.4bn

Source: Bloomberg

Indices Performance

	HSI	HSCEI	HSTECH
1-month	1.5%	0.6%	-2.5%
3-month	-1.0%	-14.9%	-12.8%
6-month	9.7%	2.2%	1.5%

Source: Bloomberg

12-month HSI Performance

Source: Bloomberg

Related Reports

1. Strategy Report – Buy in May; HSI target raised – 3 May 2021
2. Strategy Report – Style shift to take a break – 1 Apr 2021
3. Strategy Report – Don't panic over rising bond yield – 3 Mar 2021
4. Strategy Report – HSI enhancement preview – 24 Feb 2021
5. Strategy Report – Follow the tide – 3 Feb 2021
6. Strategy Report – Southbound inflows lift H-shares – 21 Jan 2021
7. Strategy Report – Keep faith in value stocks – 5 Jan 2021
8. 2021 Strategy Report –HSI targets 30,000 on post-pandemic recovery – 10 Dec 2020
9. Strategy Report – Start of the end of the pandemic? – 10 Nov 2020
10. Strategy after U.S. Election: Buy on dips in case of contested election – 5 Nov 2020

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Stocks remained in uptrend despite inflation worries

Investors did not "sell in May and go away". Instead, global major stock markets remained in uptrend in May, despite unfavourable economic data from the US, which include big miss in Apr's non-farm payrolls and higher-than-expected inflations in Apr (core CPI +3.0% vs. consensus +2.3%; core PCE +3.1% vs. consensus +2.9%).

Such a combination of data (weak jobs, high inflation) could have easily stoked stagflation concerns, but the fact that **stock markets are climbing a wall of worry** shows that investors are getting used to higher inflations, and at the same time buying into the belief that rising inflations are only "transitory" as the Fed suggested. Fed officials repeatedly reiterated monetary easing would stay unchanged also calmed investor concerns.

Figure 1: MSCI World stays on uptrend

Source: Bloomberg, CMBIS

Figure 2: S&P 500 stays on uptrend

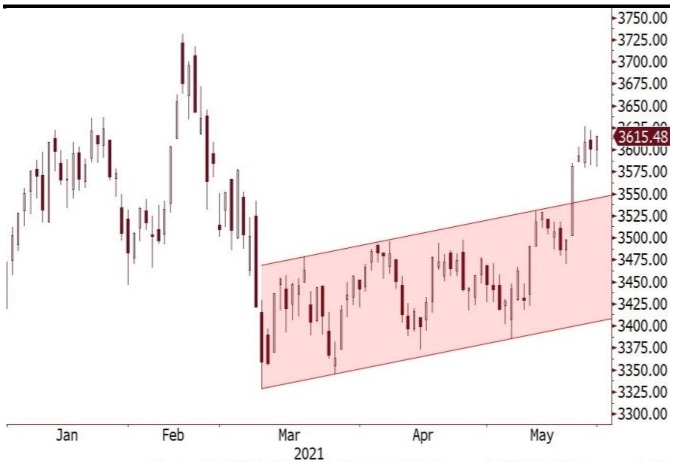
Source: Bloomberg, CMBIS

In China, the Shanghai Composite finally made an upward breakout after trading in a narrow range for two months. The Hang Seng Index managed to recover from a 3.5% loss in the first two weeks of May to record a 1.5% gain for the month.

Figure 3: HSI rebounded 5.2% from May-low

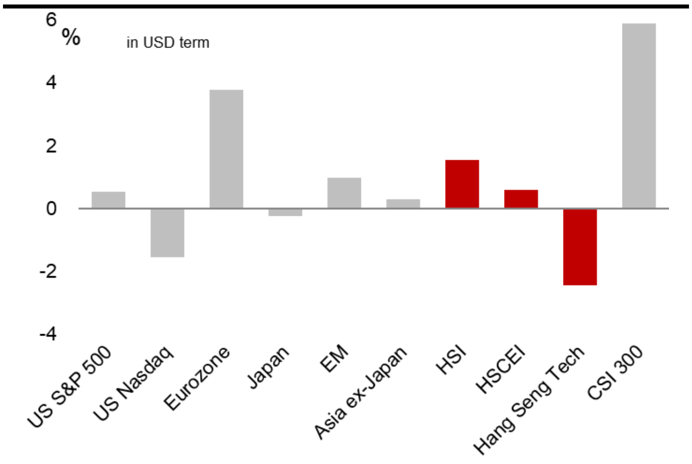
Source: Bloomberg, CMBIS

Figure 4: Shanghai Composite's upward breakout



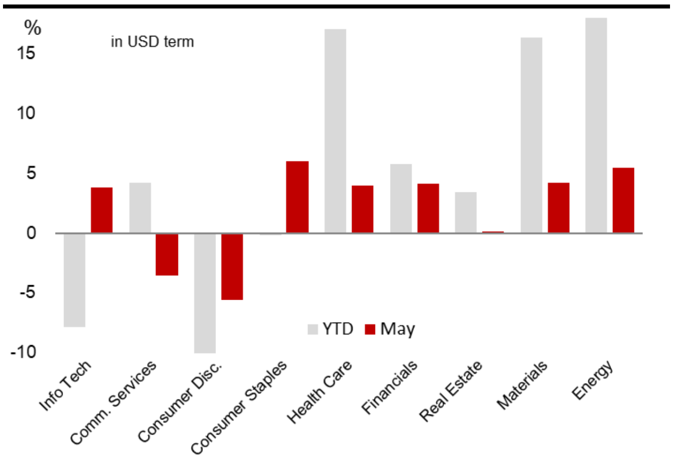
Source: Bloomberg, CMBIS

Figure 5: Global stock markets' return in May 2021



Source: Bloomberg, CMBIS

Figure 6: MSCI China sector returns in May & YTD



Source: Bloomberg, CMBIS

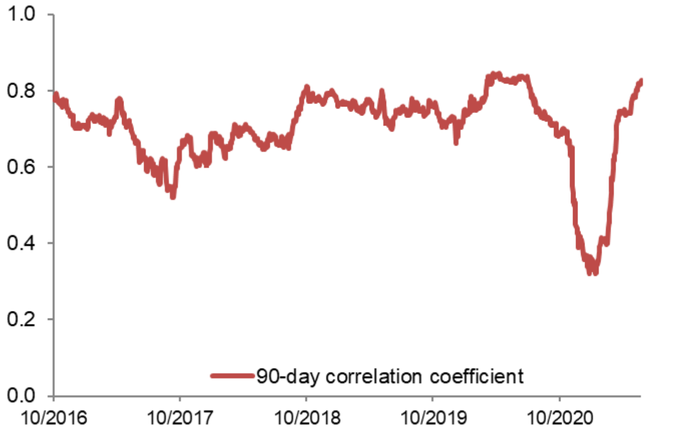
Sector divergence narrowing

In terms of sector/style performance, **value outperformed growth sectors again in May**, after some not-so-diverged performance in Apr. For instance, S&P 500 outperformed Nasdaq, and the HSI outperformed the Hang Seng TECH Index (Fig. 5). Under MSCI China, commodity and financial sectors outperformed growth sectors such as communication services (mainly internet) and consumer discretionary (Fig. 6).

Since the outbreak of COVID-19 in Q1 2020, sector/style rotation between value and growth has become a norm, but it has not always been like that. Pre-pandemic, performances of value and growth stocks have been much closer than in the past 15 months, with the correlation coefficient between the two ranging from 0.65-0.80 for the best part of the previous five years. During the COVID-19 pandemic, the number dropped to as low as 0.4, but recently **the correlation has been rebounding back to pre-pandemic levels for MSCI China**, while the correlation between S&P 500 Value with Growth is still low compared to pre-pandemic levels (Fig. 7 & 8).

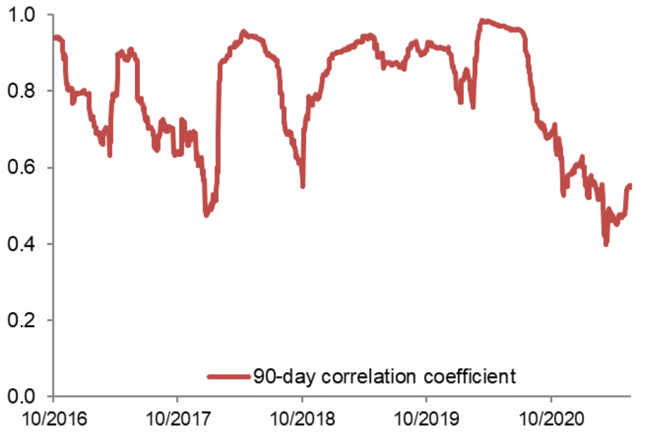
The implication from this almost-back-to-normal trend is that, as global economy gradually normalises in a post-pandemic world, dramatic sector rotation/style shift should not happen as often over the long term. **A more balanced approach on sector allocation, instead of frequently betting on sector rotation, would be increasingly preferable over time**.

Figure 7: Correlation between MSCI China Value & Growth is normalising



Source: Bloomberg, CMBIS

Figure 8: Correlation between S&P 500 Value & Growth is starting to normalise



Source: Bloomberg, CMBIS

Strong CNY bodes well for HSCEI & value stocks

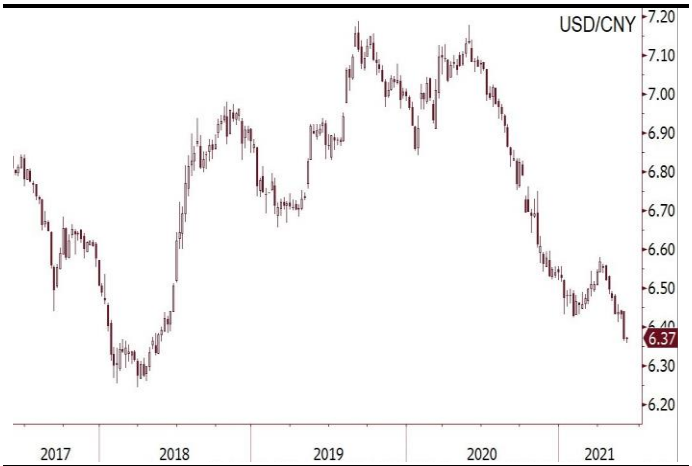
The CNY has appreciated 2.9% against the USD over the past two months, extending the strong run since mid-2020, and reaching a 3-year high (Fig. 9).

A strong CNY is typically positive for earnings and valuations of Chinese stocks listed in HK. For most of the time over the past five years, CNY and forward P/E of the HSCEI moved in the same direction. But in the past 2-3 months, HSCEI failed to follow CNY's strength and actually fell (Fig. 10).

If CNY stays strong (not necessarily appreciate further, just stay around current level), the **HSCEI may play some catch up, especially sectors which benefit the most from strong CNY such as paper and asset-heavy financial sectors**.

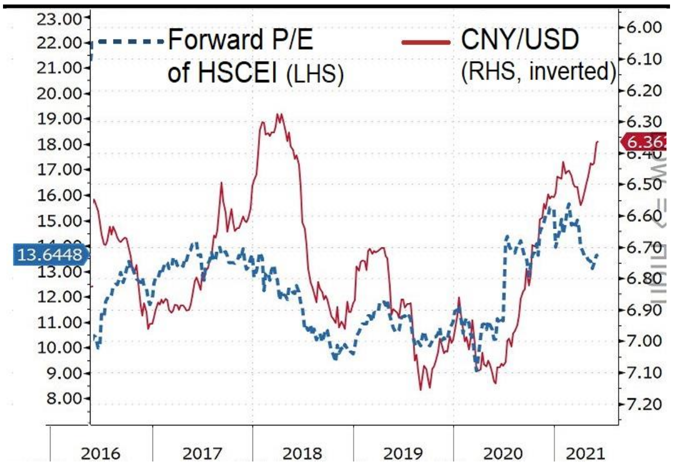
On the other hand, while Chinese property and airline sectors also benefit from strong CNY, they are probably overshadowed by risks of property market tightening and rebound in COVID-19 cases respectively.

Figure 9: CNY surged to 3-year high



Source: Bloomberg, CMBIS

Figure 10: CNY and HSCEI's P/E +vely correlated



Source: Bloomberg, CMBIS

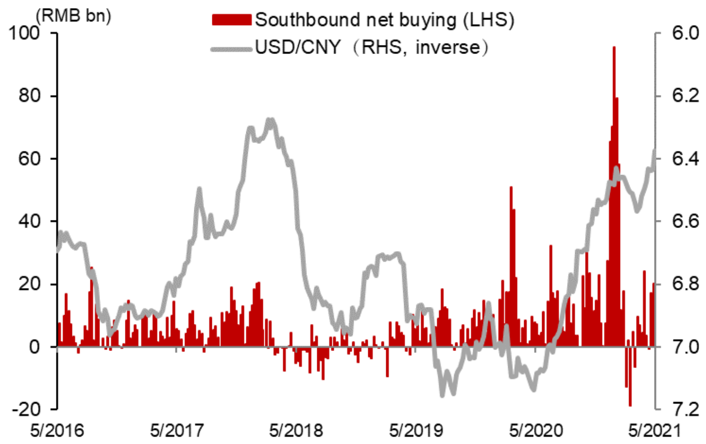
But Southbound buying may remain tepid

Theoretically, Mainland Chinese investors now have stronger buying power of offshore assets now that CNY has appreciated. Should investors therefore expect strong Southbound fund inflows via the Stock Connect?

However, **we do not see a strong correlation between CNY rate and Southbound net buying** (Fig. 11). Divergence between the two were not rare, e.g. during Q4 2018-Q1 2019 CNY appreciated but Southbound buying stayed low, while during Q2 2019-Q2 2020 CNY depreciated but Southbound buying surged. The reason is that, in our view, Southbound trading are affected by multi-factors, and CNY rate is just one of them. Other factors include expected path of CNY rate, A-H shares' premium, monetary policies in China & US, etc.

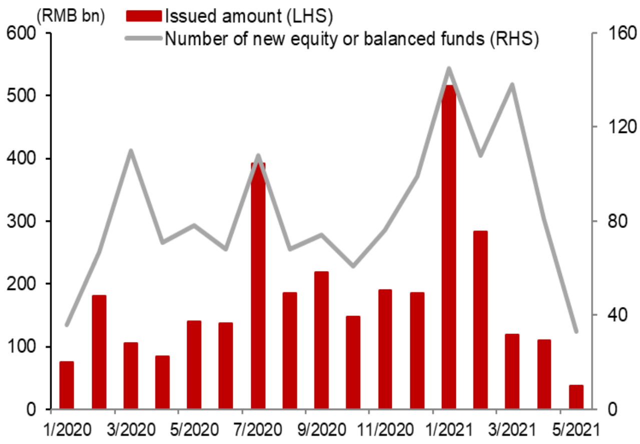
The dwindling amount of new issuance of onshore mutual funds does not bode well for Southbound inflows. The surge in fund issuance in Jan and Feb 2021 played a role in driving up Southbound buying and the HSI, but new issuance of equity and balanced funds have been falling for four months in a row. Issuance amount in May was less than 10% of that in Jan (Fig. 12).

Figure 11: CNY and Southbound net buying



Source: Bloomberg, CMBIS

Figure 12: Issuance of onshore mutual funds



Source: Wind, CMBIS

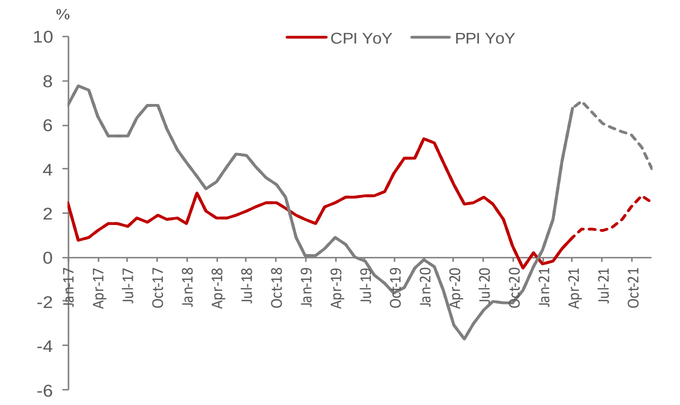
PPI peaking out may weigh on commodity stocks in Q3

China's PPI surged to 6.8% YoY in Apr. Energy and Materials have been two standout sectors YTD, thanks to strong runs in energy and base metals prices, which are closely linked to PPI. Unsurprisingly, Chinese energy and materials stocks have the highest correlation with China's PPI (Fig. 14).

PPI inflation may not stay high for long though. Our economist forecasts that PPI YoY growth would slow down in 2H21 because economic rebound may decelerate marginally and commodity supply will gradually increase to catch up with demand (Fig. 13). **If PPI growth (along with major commodity prices) does slow down in 2H21 as we expect, Energy and Materials will probably underperform given their higher correlation with PPI growth.**

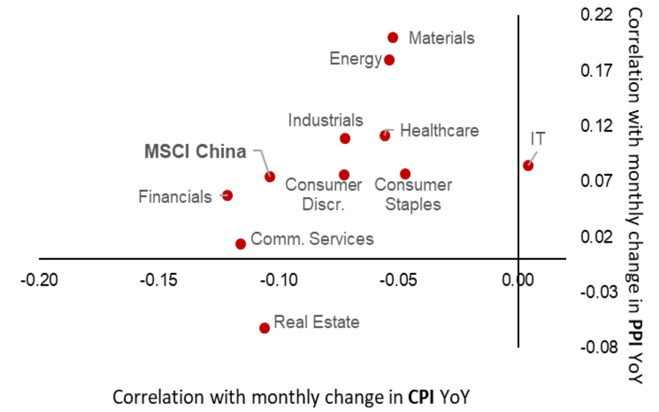
On the other end of the PPI-correlation spectrum, Real Estate is the only sector having a negative correlation with PPI change, and thus could outperform in 2H 2021.

Figure 13: CMBI forecasts of China's inflation



Source: NBS, Wind, CMBIS estimates

Figure 14: MSCI China sectors' correlation with China's CPI & PPI



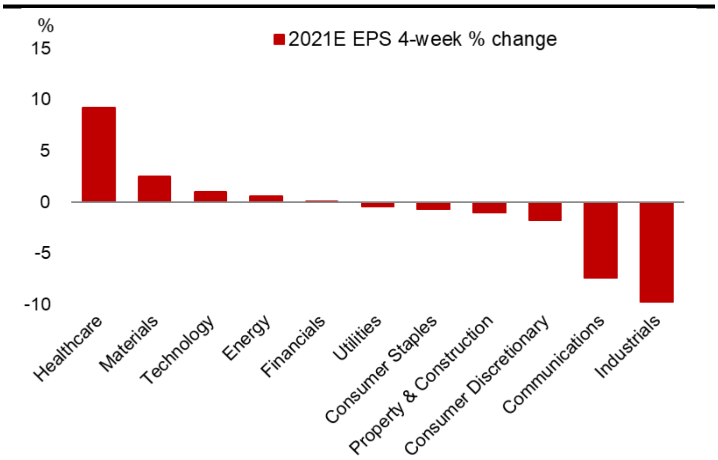
Source: Bloomberg, CMBIS

Earnings cut on growth stocks but valuation becoming attractive

During the Q1 result season in HK, Healthcare and Materials enjoy the best earning upward revision, while Communications (internet stocks), Industrials (probably due to rising material costs) and Consumer suffered earnings cuts (Fig. 15).

Yet, after some significant pullbacks in share prices of growth stocks over the past three months (e.g. Chinese internet giants dropped by 20-50% from peak), valuations have become more attractive, with growth sectors including Communications and Consumer Staples trading at forward P/E levels lower than historical average (Fig. 16).

Figure 15: EPS revision on HSCI sectors



Source: Bloomberg, CMBIS

Figure 16: HSCI sectors' P/E versus 5-yr average

HSCI sub sector	12-month blended forward P/E	No. of s.d. above/below 5-yr avg
Consumer Discretionary	23.0	+0.4
Healthcare	33.2	+0.1
Technology	26.4	0
Energy	12.2	0
Communications	19.2	-0.3
Property & Construction	13.2	-0.4
Utilities	10.6	-0.4
Materials	9.9	-0.4
Consumer Staples	23.1	-0.5
Industrials	15.9	-0.7
Financials	8.7	-0.8
HSCI	**17.4**	**-0.3**

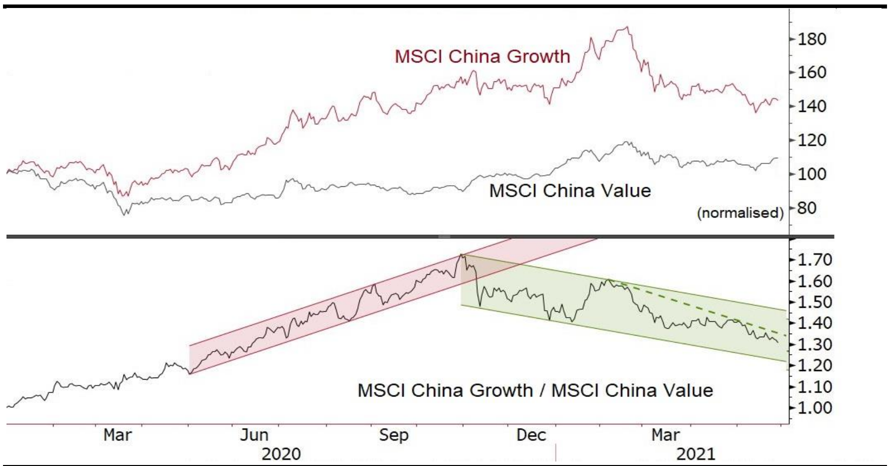
Source: Bloomberg, CMBIS

Short-term outlook: Value stocks maintain lead

We believe **Chinese value stocks may continue to moderately outperform growth stocks in the short term** (next 1-2 months). Prefer **Chinese banking, insurance and brokerage sectors.** Main drivers are:

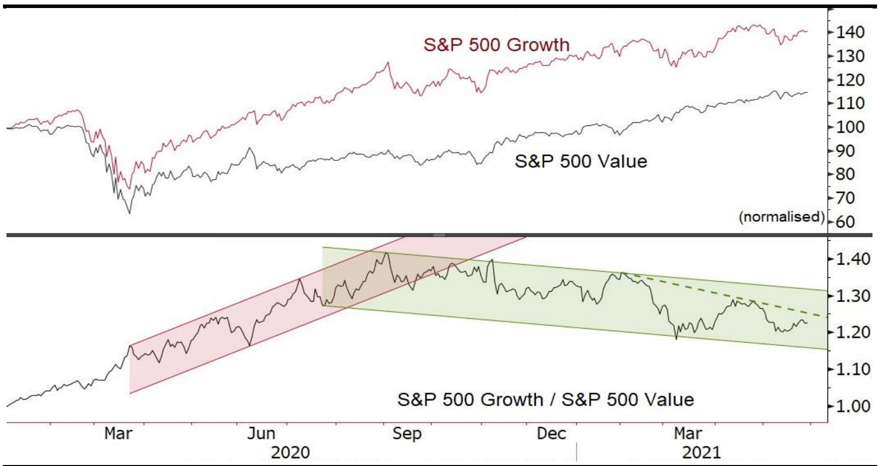
1) **Strong CNY against the USD bodes well for asset-heavy sectors** (mainly financials) and certain cyclical sectors (e.g. paper);
2) **Value stocks will enjoy exceptionally strong growth in Q2 YoY due to low base in 2020.** As the Q1 result season is just over, and investors turn their attention to Q2, such a low-base effect may give value stocks an edge. On the other hand, internet giants are still suffering earnings downgrade due to policy headwinds and increase in investments;
3) **Value stocks' momentum relative to growth stocks remains strong**, based on technical analysis (Fig. 17 & 18). Such momentum tends to continue until the ongoing trend is broken (in this case, an upward breakout of the downtrend in growth versus value).

Figure 17: Chinese value stocks remain strong versus growth stocks



Source: Bloomberg, CMBIS

Figure 18: US value stocks show similar patterns relative to growth



Source: Bloomberg, CMBIS

Medium-term strategy: Accumulate Growth stocks

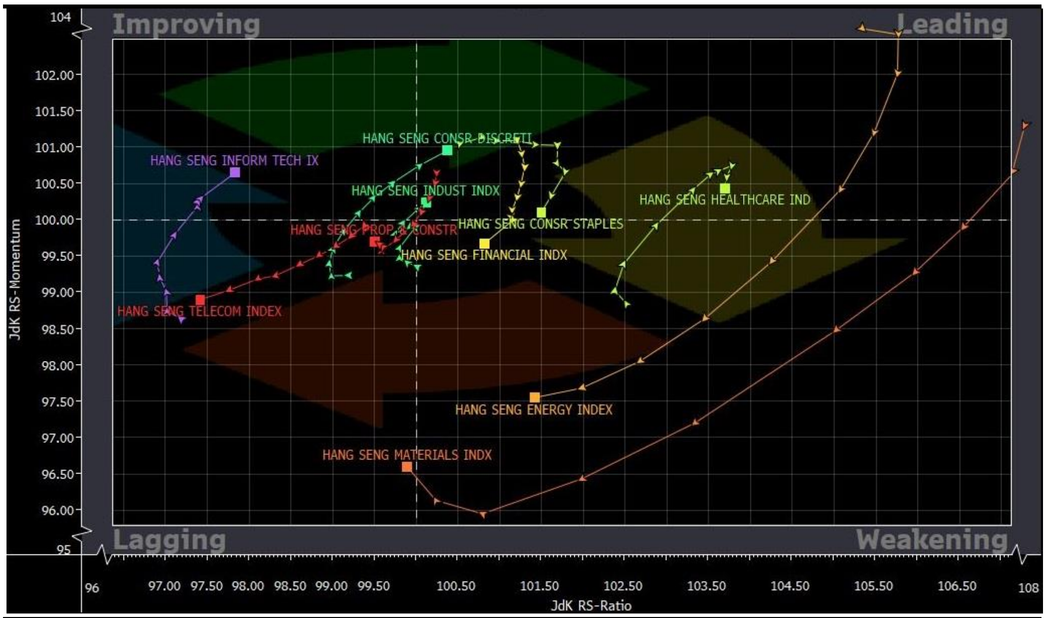
We expect **growth stocks to regain momentum and outperform value stocks in the medium term** (2H 2021). **Accumulate Internet, Software & IT Services, Technology sectors.** We also like Education (higher/vocational) sector as the biggest policy overhang has been removed. Factors that would propel growth stocks include:

1) **Strong CNY might be unsustainable,** and thus financials and some other value stocks might lose one of their driving forces. In response to the recent appreciation of CNY, PBoC officials stressed that exchange rate could fluctuate in both directions, and an official newspaper's editorial pointed out CNY might depreciate in the future due to factors such as Fed tightening, strong economic recovery in the US, pandemic under control globally, US asset bubbles bursting leading to risk off.
2) **Economic growth and earnings would start to normalise in 2H 2021** as the low-base effect dissipate. When investors look further ahead into 2H 2021, interest on growth sectors will probably re-emerge due to their superior growth prospect.
3) **Monetary and fiscal policies will normalise too**, at least such expectation would build up in 2H 2021. Growth stocks are much less reliant on monetary or fiscal stimuli.
4) **Relative Rotational Graph (RRG) forecasts potential rotation from cyclical to growth** within the coming weeks.
    a. In the Weekly RRG of HSCI sectors, Materials is already in "Weakening" zone, and may soon be followed by Energy and Financials, while IT may move into "Improving" zone over the next few weeks (Fig. 19).
    b. In the Daily RRG, Materials have moved quickly from "Leading" to "Lagging", and may soon be followed by Energy, while IT has already moved into "Improving" zone (Fig. 20).

Figure 19: Weekly RRG of Hang Seng Composite Index on 31 May

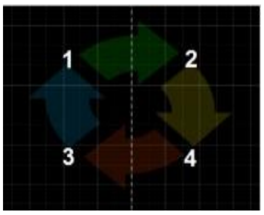
Source: Bloomberg, CMBIS

Figure 20: Daily RRG of Hang Seng Composite Index on 31 May



Source: Bloomberg, CMBIS

**Explanatory note:*



1: Underperforming benchmark but momentum is UP

2: Outperforming benchmark and momentum is UP

3: Underperforming benchmark and momentum is DOWN

4: Outperforming benchmark but momentum is DOWN

Sectors tend to rotate clockwise on the graph

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