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March Monthly Strategy

HSI may fall again on epidemic after short-term rebound

- **Coronavirus fears spreading across the globe.** Starting from late Feb the spread of coronavirus has been worsening as the number of new cases reported outside China exceeded that in China in the past consecutive days. It is expected the epidemic will drag global GDP growth to the lowest ever since 2008 financial crisis, meanwhile sell-off was already seen in US market.
- **Fed cut rate by 50 bps.** As US stocks tumbled, investors took shelter in US Treasury, driving yields lower. On 3 Mar, the Fed cut rate by 50 bps in an unscheduled meeting in light of the risks being posed by the coronavirus to economic activity. However, slashing interest rate once or twice would do little help in bolstering a sagging market.
- **Three indicators to watch when timing the bottom.** Ongoing virus outbreak outside China adds new risk to global economy and financial market. Hong Kong market can hardly stay aloof unaffected. We believe HSI is likely to extend its loss from the peak in mid-Jan and 25,989 in end-Feb is not yet the absolute bottom. HSI could be trending lower after the short-term rebound. By valuation, HSI has reached its trough at 9.3-9.6x forward P/E for a number of times in recent years. Revisiting 9.6x forward P/E implies a 6% potential downside in HSI from here. In other words, 24,800 could be the bottom. However, earnings forecasts are subject to uncertainties as possible disappointing results and management guidelines announced in Mar could lead to downward revision of forecasts.
- **Bottom estimated at 24,500-25,200.** A near-term rebound is likely as HSI hits 26,000 to form a "double bottom". But HSI has already broken the medium-term uptrend since Aug 2019, so the next support level for HSI should be 25,200. Besides, the forming of "head and shoulders" could drag HSI further to 24,500. HSCEI is also expected to stage a rebound with medium-term support at 9,750.
- **VIX signals a trough in short term.** A sell-off triggered by major bad news usually bottoms out amid panic. VHSI ranged from 26-30 when HSI hit the bottom in the past two years. On 28 Feb, VHSI rose to above 32, topping the previous panic range. It could signal a trough in the short term.
- **Investment strategy – buy in three phases.** In phase 1, investors may focus on **sectors with policy support** such as infrastructure, construction machinery, cement and 5G telco equipment. We recommend stocks less impacted by the epidemic with policy support.
- **Phase 2 – China consumer stocks less affected by epidemic.** When outbreak is fully contained in China, go for China consumer stocks which are less impacted by COVID-19, including property management, education, healthcare, dairy, gas, internet, as well as handset equipment names that benefit from work resumption. China consumer stocks is expected to show higher earnings visibility amid overseas outbreak.
- **Phase 3 – Sectors mostly hit by epidemic.** When the global epidemic is eventually contained, bottom-fish sectors with positive outlook in the long run, such as sports apparel, export, transportation, retail, and franchised restaurant. These sectors experience significant fall in stock price during

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HSI	26,292
52w High/Low	30,280/24,900
Avg 3 mths t/o (HK$ bn)	98.5

Source: Bloomberg

Performance of HSI and HSCEI

	HSI	HSCEI
1-mth	-0.1%	2.4%
3-mth	-0.6%	1.2%
6-mth	2.6%	3.8%

Source: Bloomberg

12-mth HSI Performance

Source: Bloomberg

outbreak and leave huge room for upward revision in earnings and valuation. Normally stock price hits the trough before all news are out. Investors may consider bargain hunting the abovementioned sectors when risk aversion begins to cool down. One of the reference indicators is gold price. If gold price slides back to the peak of previous trajectory and below US$ 1,550 with weakening momentum, it indicates a significant drop in risk aversion.

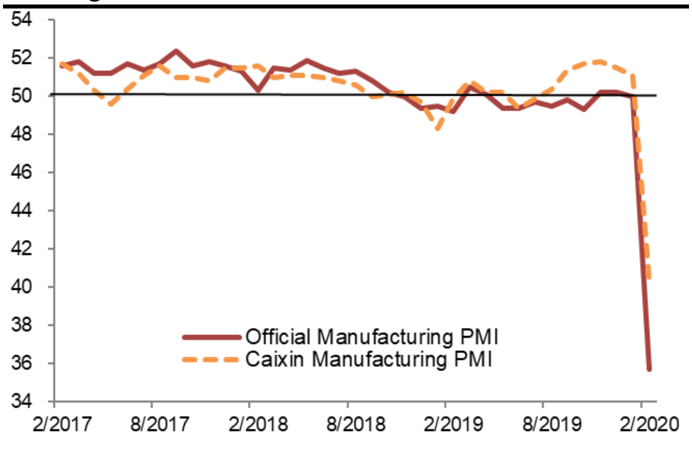
Coronavirus fears spreading across the globe

Probable rebound of China economy

Over 80,000 confirmed cases have been reported in China since the coronavirus outbreak in Jan. It pummeled China economy as consumption demand largely dropped and supply chain was disrupted due to strict precautionary measures imposed by the government. Manufacturing PMI in Feb slip to weakest reading on record. Official PMI fell to 35.7% while Caixin PMI declined to 40.3% (Fig 1), even lower than the level in 2008 financial tsunami.

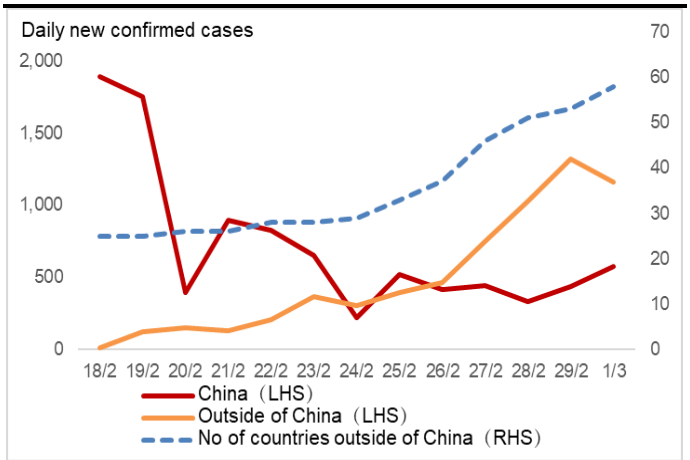
Dropping number of new cases in past few weeks shows that outbreak is slowing in China. Some forecast a v-shaped rebound of growth as production gradually resumes to normal levels since Feb. Local demand remains robust. Exports will face heightening pressures over the spread of coronavirus outside China. Please refer to our economist's report on PMI in Feb.

Figure 1: Manufacturing PMI in Feb slip to weakest reading on record



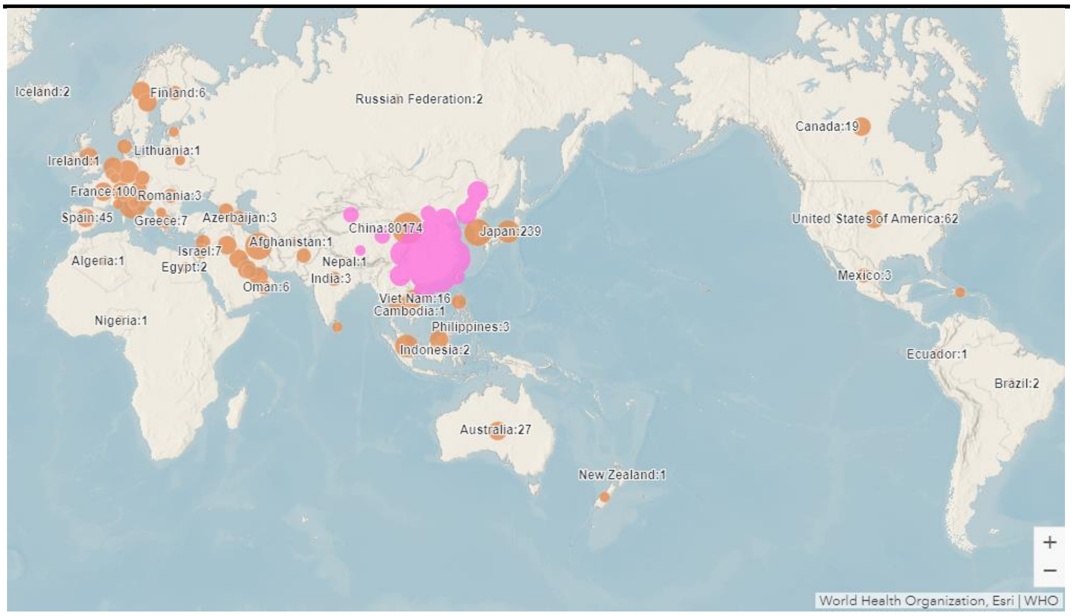
Source: National Bureau of Statistics of China, CMBIS

Figure 2: Daily confirmed cases outside China exceeded that in China



Source: WHO, CMBIS

Figure 3: Outbreak spreading across the globe



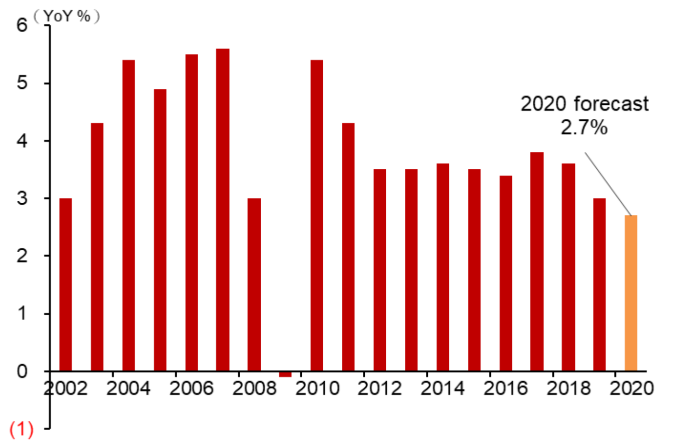
Source: WHO (as at 2 Mar, 18:00), CMBIS

Surging cases outside China

Starting from late Feb the coronavirus outbreak has been exacerbating with number of confirmed cases surging from 924 to 7,169 outside China during 19 Feb to 1 Mar. Daily confirmed cases far exceeded that in China, spreading to more countries from 25 to 58 during the period (Fig 2). The World Health Organization (WHO) raised its global risk assessment for COVID-19 to "very high" from "high" on 28 Feb. The Centers for Disease Control and Prevention (CDC) also reported that virus is likely to cause pandemic.

Impacted by epidemic uncertainties, our economist trimmed 2020 global growth estimates (report). Global economy is expected to grow by 2.7% in base case, the lowest since 2009 financial tsunami.

Figure 4: The world's real GDP growth is estimated to hit historical low since 2009



Source: IMP, CMBIS

Fed cut rate by 50 bps

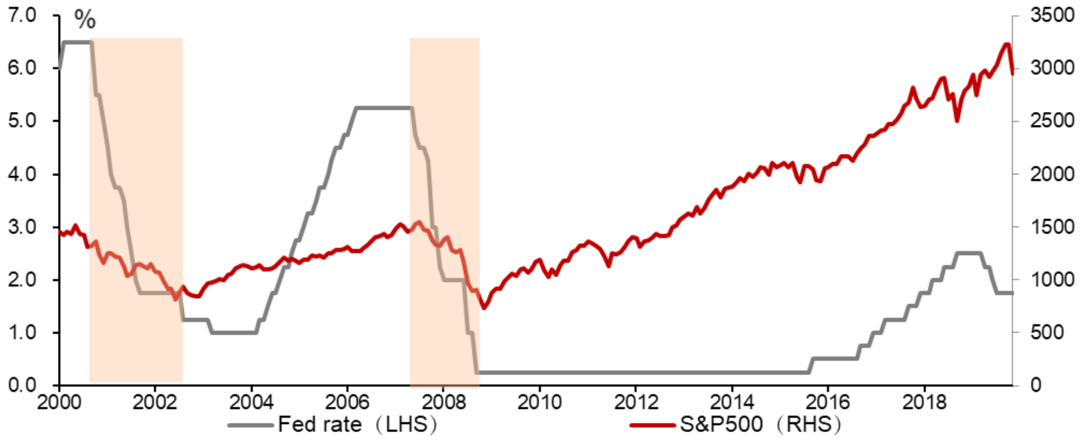
The three major US indexes plummeted over 10% within one week during 24-28 Feb mainly on fears of spreading coronavirus around the world. Investors fled global equities and other assets viewed as risky and took shelter in US Treasury. Both 30-year and 10-year Treasury yields hit historical lows, and the latter even fell through 1.0%. On 3 Mar, the Fed cut rate by 50 bps in an unscheduled meeting in light of the risks being posed by the coronavirus to economic activity.

Slashing rate once or twice would do little help in bolstering a sagging market

Loose monetary policy usually leads to price hike of risky assets, in particular when the rate cut magnitude is huge (0.5% estimated Fed cut in Mar vs 0.25% cut each time), thus fueling the stock market. However, a sharp rate cut could be triggered by major economic risk (i.e. dot-com bubble in 2000-2001, 9/11 attacks in 2011, subprime crisis and financial tsunami in 2007-2009). Rate cuts may not be effective enough in offsetting the negatives.

In the past 20 years, sharp Fed rate cuts only happened in 2001-2002 and 2007-2008 (Fig 5). During which the sharp cuts failed to stop the falling trend of the US market, not until one year after the first rate cut did the market reach its bottom. Despite less significant damage is expected this time as the market believes the epidemic will only last for a few months, it is the current major global risk which slashing rate once or two would do little help in combating.

Figure 5：S&P 500 Index and Fed Funds Rate



Source：Bloomberg, CMBIS

Three indicators to watch when timing the bottom

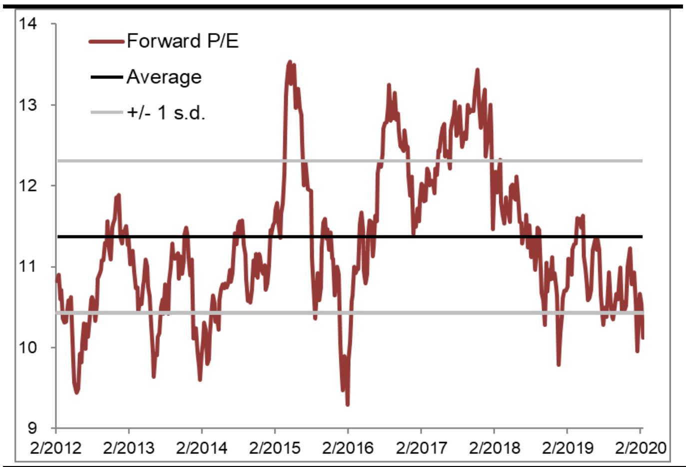
In spite of slowing outbreak and work resumption in China, as well as the policy support that helps stabilize A/H share markets, ongoing virus outbreak outside China adds new risk to global economy and financial market. Hong Kong market can hardly stay aloof unaffected. We believe HSI is likely to extend its loss from the peak in mid-Jan and 25,989 in end-Feb is not yet the absolute bottom. HSI could be trending lower after the short-term rebound. We try to time the bottom by taking reference from the following indicators.

i) Using P/E ratio to assess - 24,800 could be the bottom

In terms of valuation, HSI has reached its trough at 9.3-9.6x forward P/E for a number of times since 2012 (Fig 6). **The current 2020E forward P/E of HSI is 10.2x. Achieving 9.6x forward P/E at this stage implies a 6% decline from current point. In other words, 24,800 could be the bottom.**

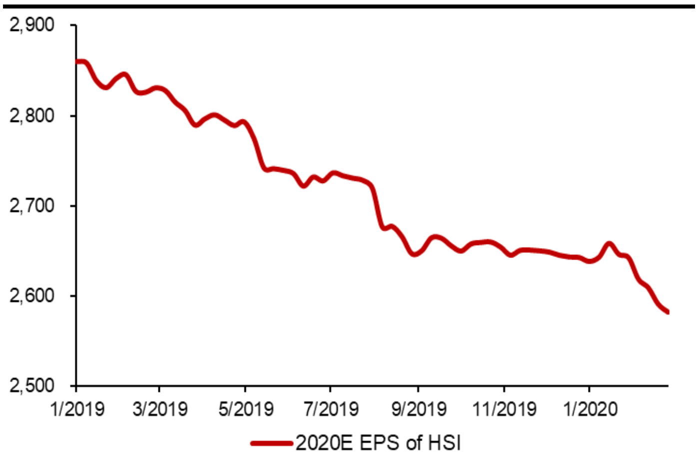
However, earnings forecasts are subject to uncertainties. Since the outbreak market has revised down HSI 2020E forward EPS by 2.9% (Fig 7). There could still be room for downward revision of earnings estimates in case of growing fears. Possible disappointing results and more conservative guidelines announced in Mar could also lead to further downward revision of forecasts.

Figure 6: HSI has reached its trough at 9.6x forward P/E for a number of times



Source: Bloomberg, CMBIS

Figure 7: Downward revision of earnings estimates after the outbreak



Source: Bloomberg, CMBIS

ii) Using charts to assess - 24,500-25,200 could be the bottom

HSI: A near-term rebound is likely to occur when HSI hits 26,000, forming a "double bottom". But HSI has already broken the mid-term support level it had been staying over since Aug 2019, so the next support level for HSI should be 25,200. Besides, the forming of "head and shoulders" could drag HSI further to 24,500 (Fig 8).

Figure 8: HSI daily chart

Source: Bloomberg, CMBIS

HSCEI: “Double bottom” and “head and shoulders” are also formed in the chart. It is also expected to witness a rebound with mid-term support at 9,750 (Fig 9).

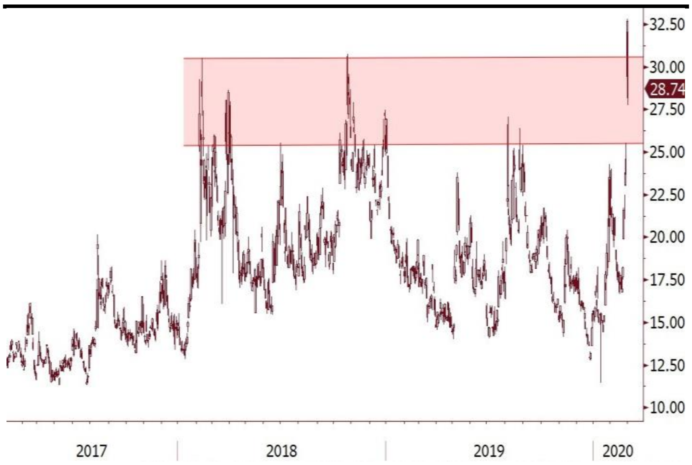
Figure 9: HSCEI daily chart

Source: Bloomberg, CMBIS

iii) VIX signals a trough in short term

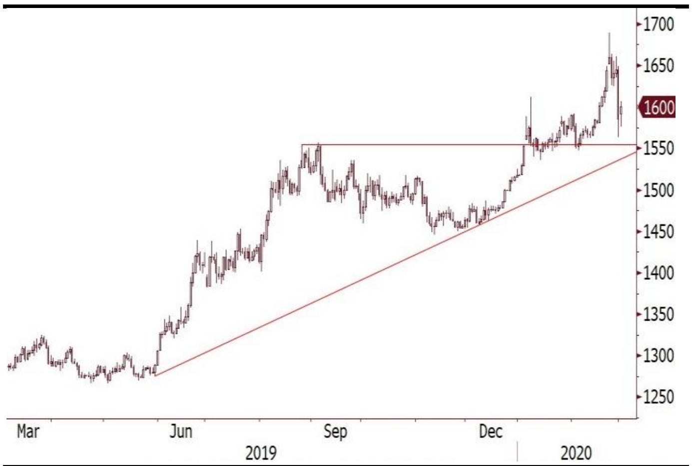
A sinking market triggered by major bad news usually bottoms out amid panic. HSI Volatility Index (VHSI) ranged from 26-30 when HSI hit the bottom in the past two years. On 28 Feb, VHSI rose to above 32 (Fig 10), a much higher level compared to the previous panic range. It could have signaled a trough in the short term.

Figure 10: VHSI rose to panic range last week



Source: Bloomberg, CMBIS

Figure 11: Gold price reflects risk aversion



Source: Bloomberg, CMBIS

Investment strategy – buy in three phases

1. **Phase 1 – Sectors with policy support.** Such as infrastructure, construction machinery, cement and 5G telco equipment. We recommend stocks less impacted by the epidemic with policy support.

2. **Phase 2 – China consumer stocks less affected by epidemic.** When outbreak is contained in China, go for China consumer stocks which are less impacted by COVID-19, including property management, education, healthcare, dairy, gas, internet, as well as handset equipment names that benefit from work resumption. China consumer stocks is expected to show higher earnings visibility amid overseas outbreak.

3. **Phase 3 – Sectors mostly hit by epidemic.** When the global epidemic is eventually contained, bottom-fish sectors with positive outlook in the long run, such as sports apparel, export, transportation, retail, and franchised restaurant. These sectors experience significant fall in stock price during outbreak and leave huge room for upward revision in earnings and valuation after then. Normally stock price hits the trough before all news are out. Investors may consider bargain hunting the abovementioned sectors when risk aversion begins to cool down. One of the reference indicators is gold price. If gold price slides back to the peak of previous trajectory and below US$ 1,550 with weakening momentum, it indicates a significant drop in risk aversion (Fig 11).

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