August Monthly Strategy

Buy growth stocks with little policy risk

- **HK stock market suffered the worst selloff since Mar 2020.** The HSI / HSTECH slumped by 9.9% / 16.9% in Jul. The trigger was a series of regulatory tightening by the Chinese government on various industries. We believe investors would need more time to monitor and digest policy risks on internet companies, extending the sector's weakness.
- **Earnings revision: HSI up, HSTECH down.** We estimate that the HSI's 2021E / 2022E EPS would have been revised up by 5.1% / 3.3% YTD, after adjusting for HSI constituent changes. The earnings revision on HSTECH has been much worse, with adjusted 2021E / 2022E EPS revised down by 16.3% / 13.3% YTD.
- **Is valuation cheap enough?** The HSI does not look cheap in term of forward P/E when compared with historical data, with 2021E / 2022E P/E standing at 12.5x / 11.1x, one s.d. above 10-year average. The weighting of growth stocks in the HSI has increased from 20% in 2019 to 40%, thereby justifying a higher valuation than previous years. But with the headwinds and uncertainties surrounding growth stocks, current valuations do not look very cheap.
- **Technical Analysis: Downward breakouts in HK / China markets.** The HSI, HSTECH, MSCI China and SHCOMP have all breached key support levels following the selloff in Jul. Neither the HSI or the HSTECH has shown RSI reversals yet, and thus it is difficult to say they have bottomed out.
- **Wait for more policy clarity on growth stocks.** In Aug, we suggest staying on the side line to wait for more clarity on China's regulatory policies and internet stocks' interim results, when potential cut in guidance and more new investments could cause more pressure on stock prices.
- **Growth stocks with little policy risks.** We prefer growth stocks over cyclicals, and the key is to focus on those with little policy risk. We like NEV, new energy and hardware sectors, which are all supported by policies mentioned in the CPC Politburo meeting.
- **Selective cyclical stocks with policy support.** Infrastructure is one area which has more policy support. We expect some improvement in infrastructure spending in 2H 2021, given the potential speed-up of local government bond issuance. Machinery stocks have priced in many negatives after the recent correction, and we believe it is a good entry point into selective machinery names.

Selected sectors and stocks

Sector	Company
NEV	BYD (1211 HK, BUY), Li Auto (LI US)
New Energy	Suntien Green Energy (956 HK, BUY), Tian Lun Gas (1600 HK, BUY), S.C. New Energy (300724 CH, BUY), Zhejiang Jingsheng (300316 CH, BUY)
Hardware	BYDE (285 HK, BUY), Xiaomi (1810 HK, BUY)
Machinery	Weichai (2338 HK, BUY), Zoomlion (1157 HK, BUY).

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Market Data

Hang Seng Index	26,236
52-week High / Low	31,183/23,124
3-month avg. daily t/o	HK$161.9bn

Source: Bloomberg

Indices Performance

	HSI	HSCEI	HSTECH
1-month	-7.3%	-10.4%	-13.9%
3-month	-7.5%	-12.8%	-17.4%
6-month	-10.5%	-19.9%	-32.9%

Source: Bloomberg

12-month HSI Performance

Source: Bloomberg

Related Reports

1. Strategy Report – 2H Outlook: Growth stocks to regain momentum – 5 Jul 2021
2. Strategy Report – Short-term Value; Medium-term Growth – 1 Jun 2021
3. Strategy Report – Buy in May; HSI target raised – 3 May 2021
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Market stunned by China policy risks

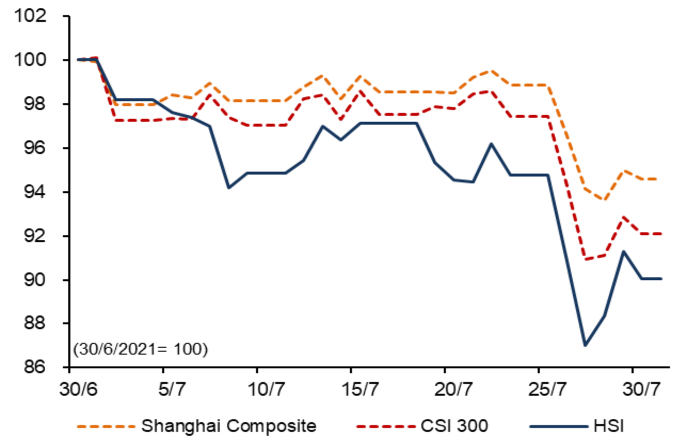
■ HSI had the worst selloff since Mar 2020

In Jul, Hong Kong stock market suffered the worst selloff since Mar 2020 when COVID-19 became a pandemic. The Hang Seng Index (HSI) slumped by 9.9% in Jul, and the Hang Seng TECH Index (HSTECH) by 16.9%. On 27 Jul, the HSI reached as low as 24,749, down by 15.8% from the recent peak 29,395 barely a month ago (28 Jun).

The trigger was a series of regulatory tightening by the Chinese government on various industries, most notably the internet (anti-monopoly and cyber security) and education (after-school tuition) sectors, and US-listed companies with VIE structure.

Mainland China market had a less severe correction than HK, with the Shanghai Composite down 5.4%, and the CSI 300 down 7.9% in Jul (Fig. 1), as the two worst-hit sectors, internet and education, are predominantly listed in HK/US.

Figure 1: HSI underperformed A-shares in Jul 2021



Source: Bloomberg, CMBIS

■ Assessing policy risk

Investors have been caught off guard by the strict regulations on after-school tuition industry, and stocks in that sector slumped by as much as 70% in just a few days. Education stocks alone, however, would not cause any harm on the HSI, HSCEI and HSTECH. What dragged down benchmark indexes were fears of even more scrutiny on internet companies and potentially other industries, causing selloffs in many sectors.

Internet stocks have a much bigger influence on market indexes. While the anti-monopoly policies on the internet sector have been around since Q4 2020, and internet stocks' prices seemed to have digested much of the risk after significant corrections since peaking in Feb 2021. However, since early Jul, **a new round of policy risks on cyber security emerged**, starting from official investigations into **DiDi Global (DIDI US)**. As such, we believe **investors would need more time to monitor and digest relevant policy risks, extending the internet sector's weakness**.

Earnings & Valuation

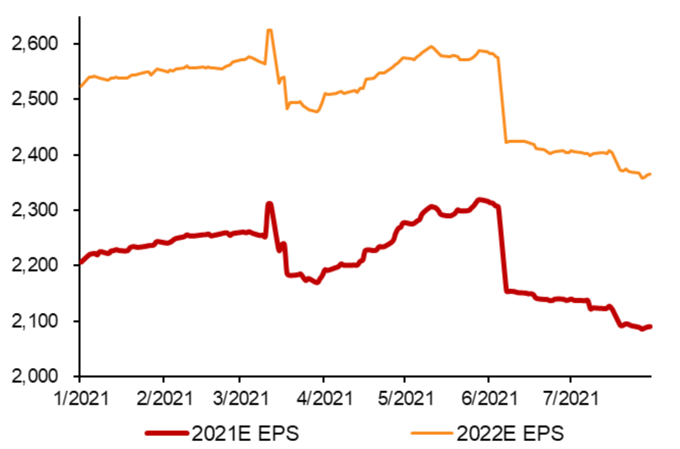
Earnings revision: HSI up, HSTECH down

On the face of it, the trend of earnings revision in Hong Kong market has not been pretty this year. The HSI's 2021E / 2022E EPS have been revised down by 5.3% / 6.3% YTD. But the cut in EPS estimates has largely been a result of HSI constituent changes, i.e. addition of high-P/E stocks into the HSI. We can see in Fig. 2. that the EPS dropped sharply in Mar and Jun, when the changes in HSI constituents came into effect.

Adjusting for constituent changes, the HSI's 2021E / 2022E EPS would have been revised UP by 5.1% / 3.3% YTD, by our estimates. The positive revision was thanks largely to cyclical stocks.

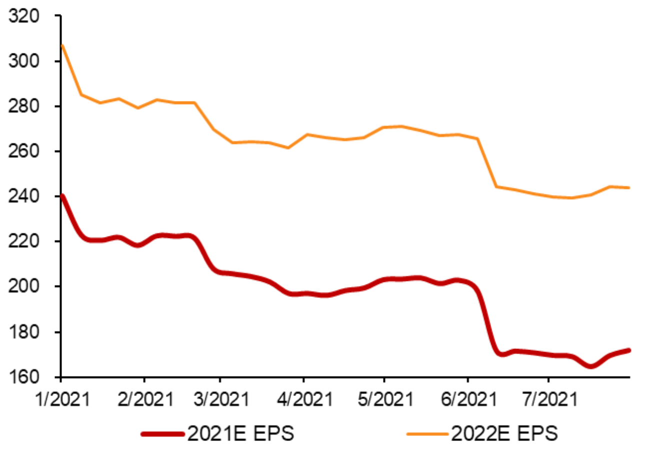
The earnings revision on HSTECH has been much worse. **Adjusting for constituent changes, the HSTECH's 2021E / 2022E EPS would have been revised DOWN by 16.3% / 13.3% YTD.**

Figure 2: HSI's EPS being revised down since Jun



Source: Bloomberg, CMBIS

Figure 3: HSTECH's EPS being revised down



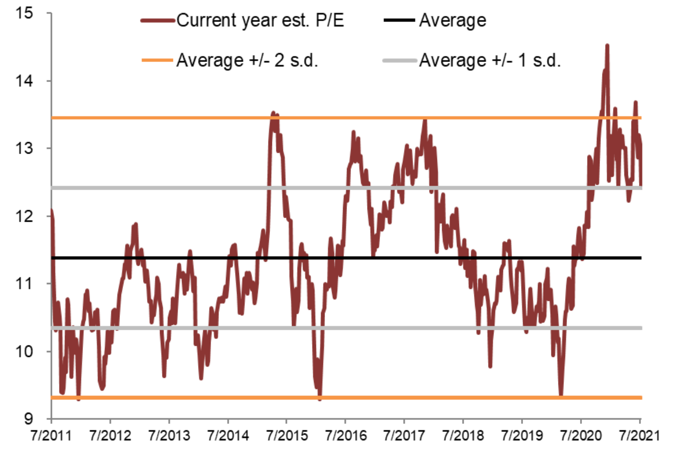
Source: Bloomberg, CMBIS

Has valuation hit rock bottom?

Even after the sharp correction in Jul, the HSI does not look cheap in term of forward P/E when compared with historical data, with 2021E / 2022E P/E standing at 12.5x / 11.1x, one s.d. above 10-year average (Fig. 4 & 5).

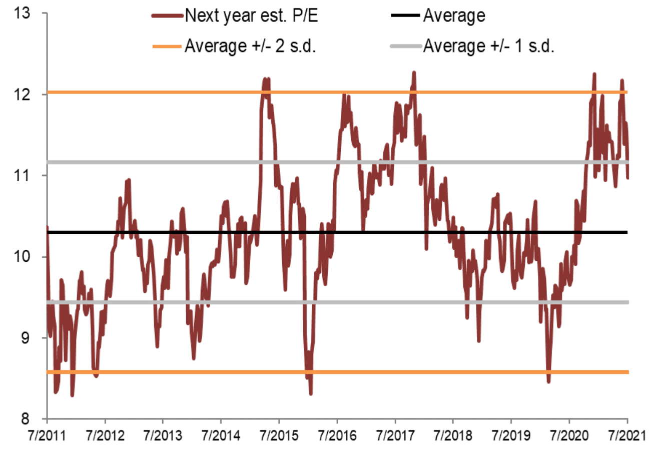
The elevated HSI P/E can partly be justified by the increasing weighting of growth stocks, which usually enjoy higher P/E than value / cyclical stocks. In 2021 YTD, the combined weighting of growth stocks in the HSI has increased from 39.9% to 45.9%. Compared to the end of 2019, the weighting has jumped by 20 ppts (Fig. 6). The changes in the HSCEI have been even more remarkable, with growth stocks' weighting increasing from 51.0% to 60.4% YTD, and by 30 ppts from the end of 2019 (Fig. 7).

Figure 4: HSI 2021E P/E



Source: Bloomberg, CMBIS

Figure 5: HSI 2022E P/E

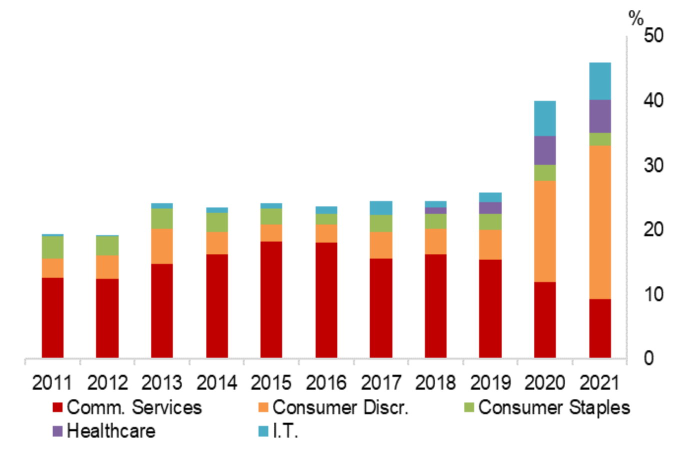


Source: Bloomberg, CMBIS

With more growth stocks contributing to higher earnings growth prospect to the HSI / HSCEI, we believe the indexes deserve higher valuations than pre-2020 period. Having said that, in the short term, investor concerns lie in policy risks on new-economy sectors, which may put some more downward pressure on their valuation.

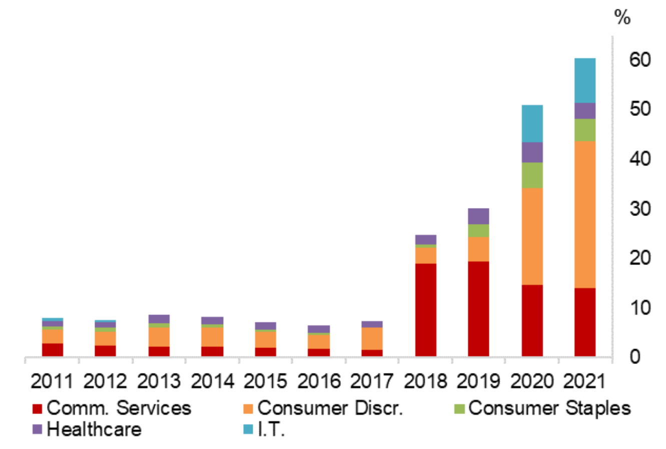
In short, **the HSI deserves a higher valuation compared to previous years, but with the headwinds and uncertainties surrounding growth stocks, current valuations do not look very cheap either**.

Figure 6: Growth stocks' weighting in HSI



Source: Bloomberg, CMBIS

Figure 7: Growth stocks' weighting in HSCEI



Source: Bloomberg, CMBIS

Technical Analysis: Downward breakouts

HSI breached supports

The HSI has breached some key support levels in Jul, including its 250-day MA, and the uptrend since Mar 2020 (Fig. 8). As the HSI is showing some technical rebound from oversold levels (RSI <30), it has not yet returned to the uptrend. Even if it does recover the uptrend, we expect resistance at a short-term downtrend near 27,000 and the 250-day MA.

Figure 8: HSI's short-term uptrend since Mar 2020 broken

Source: Bloomberg, CMBIS

The good news is that the **HSI is still above the long-term uptrend** since the Great Financial Crisis in 2008 (Fig. 9).

Figure 9: HSI's long-term uptrend since 2008 intact

Source: Bloomberg, CMBIS

However, neither the HSI or the HSTECH (Fig. 8 & 10) has shown RSI reversals yet, and thus it is difficult to say the indexes have bottomed out.

Figure 10: HSTECH has not returned to channel yet

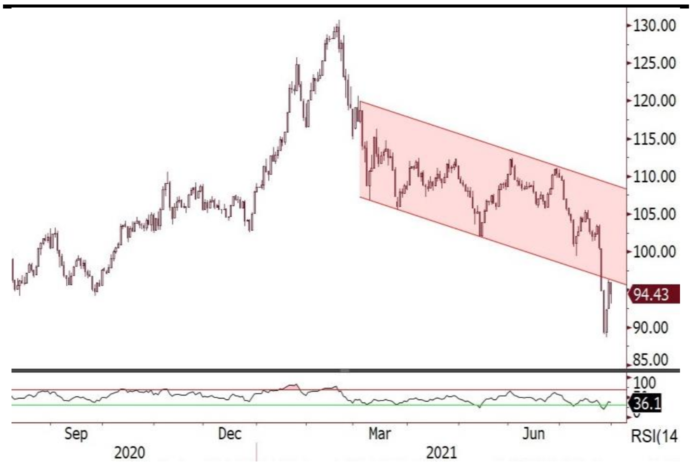
Source: Bloomberg, CMBIS

MSCI China and A-shares breached supports too

MSCI China Index, with a heavy weighting in technology stocks, have unsurprisingly breached key support levels too. The technical rebound over the past few days have failed to move back into the channel yet (Fig. 11).

Although A-shares have suffered a smaller decline than offshore shares, the Shanghai Composite breached a key support too, dropping below the bottom of a triangle, and have not recovered the support yet.

Figure 11: MSCI China not yet returned to channel



Source: Bloomberg, CMBIS

Figure 12: SHCOMP downward breakout of triangle

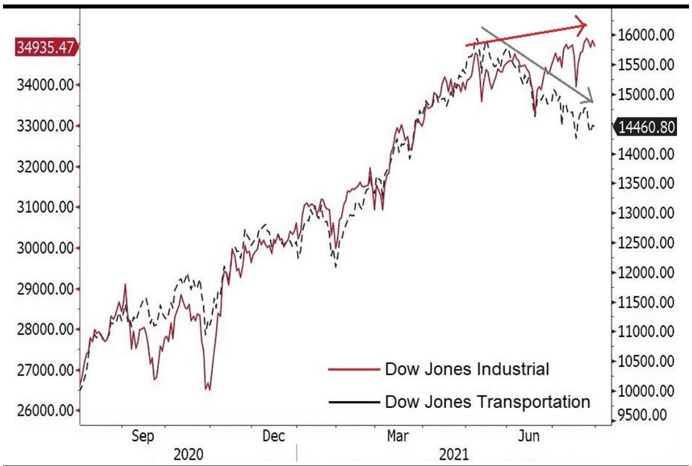
Source: Bloomberg, CMBIS

US stocks surged to record but shows "non-confirmation"

The US stock market has been outperforming HK/China for quite some time, and all three major US indexes keep setting record highs. However, as the Dow Jones Industrial Average surged to record, the Dow Jones Transportation Average failed to follow, and has been trending down over the past three months (Fig. 13). That is a classical "non-confirmation" according to the Dow Theory, a "warning sign" of a potential pullback (but not a "sell signal" by itself).

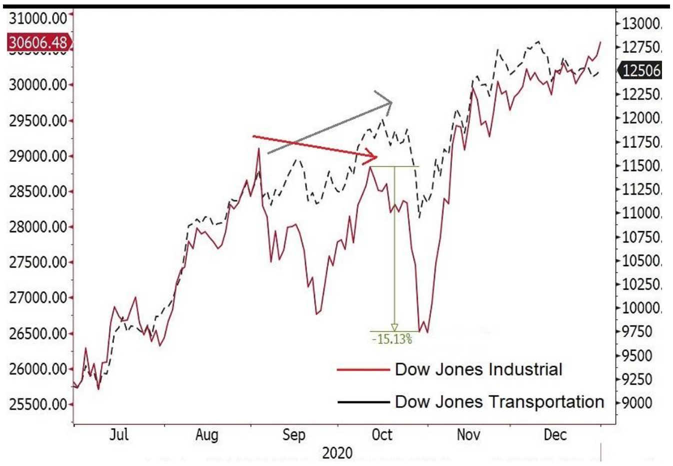
A recent example of such non-confirmation between Industrial and Transportation was during Sep-Oct 2020, ahead of the US Presidential Election. The market did subsequently pull back, with the Dow Jones Industrial Average having a 15% correction (Fig. 14).

Figure 13: DJ Industrial vs Transportation in 2021



Source: Bloomberg, CMBIS

Figure 14: DJ Industrial vs Transportation in 2020



Source: Bloomberg, CMBIS

Strategy: Avoid policy risks

Over the medium term (towards year end and beyond), we remain positive on growth stocks for their superior long-term growth prospects and undemanding valuations having underperforming value stocks for six months.

- **Is it time for bottom-fishing internet stocks?**

Not yet. **In Aug, we suggest staying on the side line to wait for more clarity on China's regulatory policies and internet stocks' interim results**, when potential cut in guidance and more new investments could cause more pressure on stock prices.

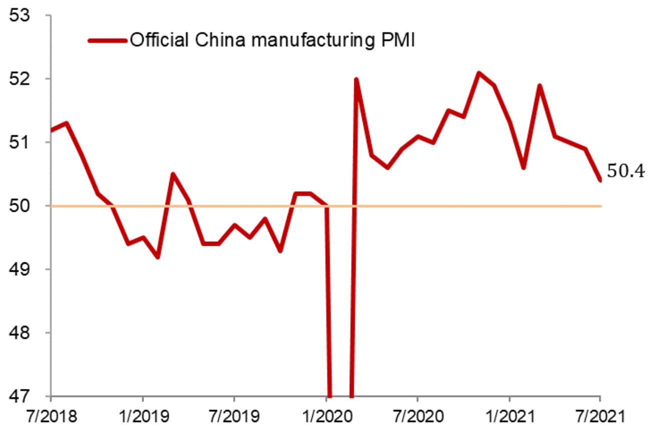
Cyclical stocks have their own risks

- **Should we shift to cyclical stocks as safe havens?**

No. We do not suggest chasing cyclical stocks as a shelter from regulatory risks, as they have their own risks (but we do have some selective BUYs on cyclical stocks on p.11):

1. Cyclical stocks may suffer from a slowdown in China's economy. China's Manufacturing PMIs (both official and Caixin ones) in Jul missed consensus, dropping to the lowest levels since Feb and Apr 2020 respectively (Fig. 15 & 16). Cyclical / Value stocks are usually more sensitive to and correlated to PMI than growth stocks are (Fig. 17 & 18). As PMIs are trending down and missing estimates, cyclical stocks should face more downward pressure.

Figure 15: China's official manufacturing PMI fell

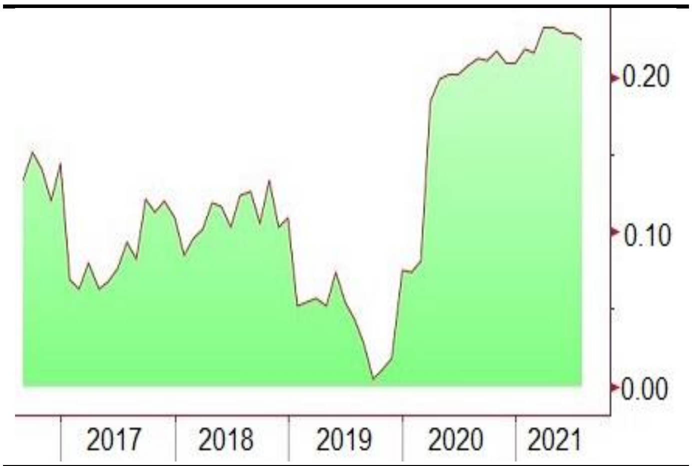


Source: Bloomberg, CMBIS

Figure 16: Caixin China manufacturing PMI fell

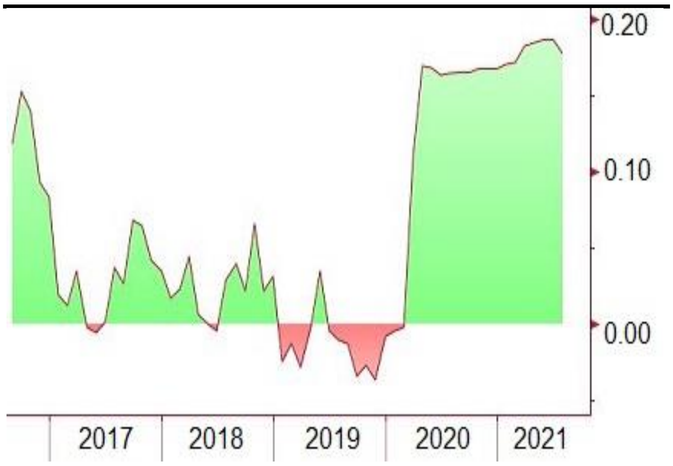
Source: Bloomberg, CMBIS

Figure 17: Correlation between China's official PMI & MSCI China Value Index



Source: Bloomberg, CMBIS

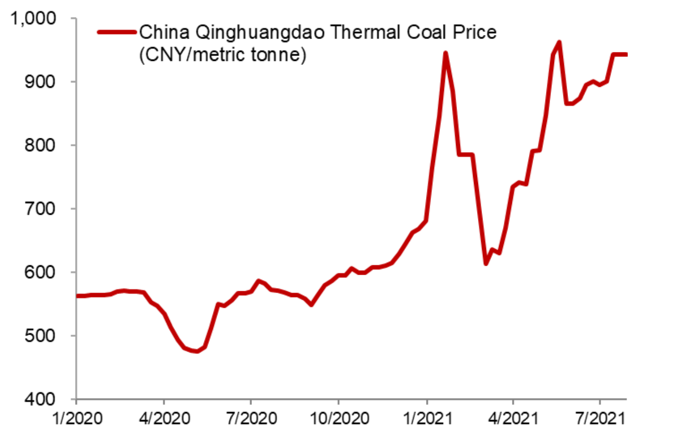
Figure 18: Correlation between China's official PMI & MSCI China Growth Index



Source: Bloomberg, CMBIS

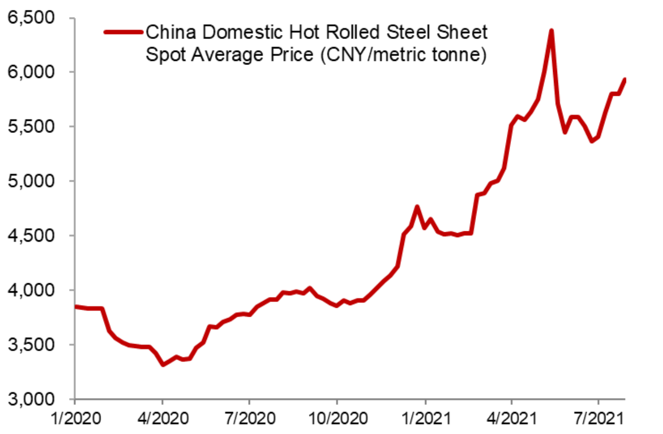
2. Policies to curb commodity prices. Beijing has vowed for a number of times since Apr 2021 to strengthen monitoring of raw materials market to alleviate businesses' cost pressure ("加强原材料等市场调节，缓解企业成本压力"). The Political Bureau of the CPC Central Committee's meeting chaired by President Xi on 30 Jul urged efforts to ensure supply and stable pricing of commodities ("做好大宗商品保供稳价工作"). The latest relevant policy was announced by the NDRC on 30 Jul to encourage qualified coal mines to expand production capacity. As prices of raw material such as coal and steel are still elevated after a short-term retreat (Fig. 19 & 20), there could be more policies from Beijing to stabilise prices, which means upstream players may face policy risks.

Figure 19: China's thermal coal price



Source: Bloomberg, CMBIS

Figure 20: China's hot rolled steel price

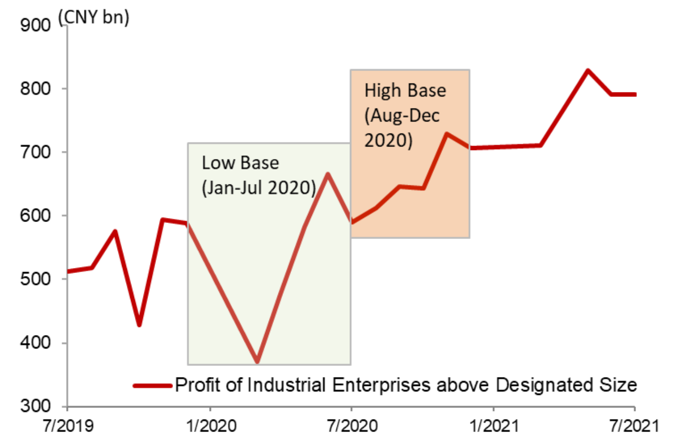


Source: Bloomberg, CMBIS

3. China property sector still facing concerns of tightening policies and liquidity. Please see our China Property sector report on 30 Jul.

4. Low-base effect on earnings is fading away in 2H. Take China's industrial profit as a proxy. Profits have been in recovery from the pandemic-low, but on a YoY basis, the low-base effect in 1H is over, and with a higher base in 2H (Fig. 21), expect YoY growth to slow down, especially for cyclical sectors.

Figure 21: China's industrial profit YoY growth set to slow down in 2H 2021 on higher base



Source: Bloomberg, CMBIS

Growth sector with little policy risks

In general, we prefer growth stocks over cyclicals, and the key is to focus on those growth stocks with little policy risk, or even better, supported by policies:

1. **New Energy Vehicles (NEV)** - The CPC Central Committee's meeting demanded efforts to tap domestic market potential and support quicker development of the new energy vehicles ("挖掘国内市场潜力， 支持新能源汽车加快发展"). **BYD (1211 HK, BUY)** is our sector top pick. We also like **Li Auto (LI US, BUY)**. Please see our NEV sector report on 2 Aug (Chinese version only).

2. **New Energy** - The CPC Central Committee's meeting called for the introduction of an action plan as soon as possible for achieving carbon peak before 2030 ("统筹有序做好碳达峰、碳中和工作，尽快出台 2030 年前碳达峰行动方案"). We like **Suntien Green Energy (956 HK, BUY)**, **Tian Lun Gas (1600 HK, BUY)**, **S.C. New Energy (300724 CH, BUY)**, **Zhejiang Jingsheng (300316 CH, BUY).**

3. **Hardware** – Among the tech sector, hardware names should have considerably less policy risks than internet/software giants, and thus are relatively defensive and may attract some fund inflows from sector rotation. The CPC Central Committee's meeting emphasised the importance of strengthening technological innovation and industrial chain resilience ("强化科技创新和产业链供应链韧性"). Sub-sectors include handsets, telecom equipment and semiconductors, such as **BYDE (285 HK, BUY)** and **Xiaomi (1810 HK, BUY)**. Although this sector has less policy risks from Beijing, investors should closely monitor risks from any US-China tension.

Selective cyclical stocks with policy support

Infrastructure is one area which has more policy support. The CPC Central Committee's meeting stated that construction on major projects in the 14th Five-Year Plan should be accelerated ("加快推进十四五规划重大工程项目建设"), and vowed to raise effectiveness of proactive fiscal policy, control the progress of on-budget investments and local government bonds issuance and generate tangible projects by end of this year and early next year ("积极的财政政策要提升政策效能，合理把握预算内投资和地方政府债券发行进度，推动今年底明年初形成实物工作量").

Machinery (selective) – We expect some improvement in infrastructure spending in 2H 2021, given the potential speed-up of local government bond issuance, although new demand for construction machineries will not be enough to cover the decline in replacement demand (in particular excavators and HDR). But the stock prices' correction over the past few months have priced in much of the negatives, in our view, and we like **Weichai (2338 HK, BUY)** and **Zoomlion (1157 HK, BUY)**.

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