6 Jan 2022

January Strategy Report

HK stocks to re-rate from distressed levels

After severely underperforming major markets around the globe in 2021, HK stock market is trading at distressed valuations. Its attractive valuation has not gone unnoticed, with Mainland investors returning via Southbound trading. China's growth-stabilising policies would serve as re-rating catalysts for H-shares, in our view. We prefer Internet and infrastructure-related sectors, and are cautious on Consumer Discretionary and New Energy.

- **HK stock market at distressed valuations.** HSI's P/B is now at 0.97x only, very close to troughs in previous crises over the past quarter of century. FY21E P/E of an adjusted HSI (excluding newly added high-growth constituents) is only 9.0x, the lowest in a decade. H-shares' discount to A-shares is also the widest in a decade.
- **Southbound net buying resumes.** Since Jul 2021, when HK stocks started being hit by Chinese regulatory risks, Southbound trading recorded net outflows until late-Nov, when Southbound trading resumed net buying for five weeks in a row. H-shares' decade-high discount to A-shares are apparently luring Mainland investors back to HK stock market. Data from the past decade shows that, when A-H premium was higher (esp. when >30%), H-shares would have a higher chance of outperforming A-shares in the subsequent 3-6 months.
- **China's policy turning supportive.** A key catalyst to drive re-rating of the HK stock market would be supportive policies from China. After a year of regulatory tightening on various sectors, the Chinese government is now placing more emphasis on stabilising growth. In Dec, the Central Economic Work Conference prioritised economic "stability", and the Q4 monetary policy meeting of the PBOC echoed the CEWC. We believe the government is signalling more pro-growth policies are on the horizon. RRR and interest rate cuts are possible in 1H 2022.
- **PMI rebounding bodes well for stocks.** Along with an increasing expectation of policy support, China's PMI has been rebounding for two months in a row, returning to the expansion territory. When the PMI returned to expansion, the HSI often staged a rebound.
- **Sector preference:** Internet sector may re-rate moderately, as its 5-year low P/E has priced in much of the policy headwind, and we expect fundamentals to improve in Q2 2022, while there could be a moderate re-rating in the shorter term. Among old-economy sectors, we prefer Construction Machinery & Materials on a speed up in infrastructure spending. On the other hand, we are cautious on Consumer Discretionary due to weaker consumer sentiment, and New Energy sector on potential profit-taking.

Daniel So, CFA
(852) 3900 0857
danielso@cmbi.com.hk

Market Data

Hang Seng Index	22,907
52-week High / Low	31,183/22,665
3-month avg. daily t/o	HK$126.2bn

Source: Bloomberg

Indices Performance

	HSI	HSCEI	HSTECH
1-month	-3.6%	-5.2%	-10.2%
3-month	-5.0%	-5.9%	-10.6%
6-month	-18.6%	-22.0%	-31.0%

Source: Bloomberg

12-month HSI Performance

Source: Bloomberg

Related Reports

1. 2022 Strategy Outlook – Crouching Tiger Ready to Leap – 16 Dec 2021
2. Strategy Report – Sector rotation opportunities – 3 Nov 2021
3. Strategy Report – China's stagflation fears overblown – 6 Oct 2021
4. Strategy Report – HSI nearing bottom; Buy policy-driven stocks – 3 Sep 2021
5. Strategy Report – Gauging a bottom of the HSI – 23 Aug 2021
6. Strategy Report – HSI constituent candidates in half-yearly review – 17 Aug 2021
7. Strategy Report – Buy growth stocks with little policy risk – 3 Aug 2021
8. Strategy Report – 2H Outlook: Growth stocks to regain momentum – 5 Jul 2021
9. Strategy Report – Short-term Value; Medium-term Growth – 1 Jun 2021

Contents

HK stock market at distressed valuations

Admittedly, HK stock market has been cheap for quite some time. After the Hang Seng Index dropped by 14% in 2021 (vs. S&P 500's 24% gain and Shanghai Composite's 5% gain), HK stocks have become even cheaper. Cheapness alone may not warrant buying, but HK stocks have fallen to a point where its P/E, P/B and relative valuation to A-shares are all at decade lows. We believe upside is much more than downside from here. Our target range for the HSI in 2022 is 22,500 – 28,400 (see 2022 Strategy Report).

■ HSI's P/B below 1

HSI's P/B is now at 0.97x only, very close to troughs in previous crises over the past quarter of century.

Figure 1: HSI's P/B near crisis troughs

Source: Bloomberg, CMBIS

■ Adjusted HSI's P/E below decade low

On the face of it, HSI's forward P/E is slightly higher than average of the past decade, not particularly attractive (Fig. 2). But note that he HSI has been adding more constituent stocks since 2H 2020. The number of constituents has increased from 50 to 64 currently, and most of the new constituents are high-growth, high-P/E stocks, thereby directly driving up the P/E of the HSI. This makes comparing P/E with historical data less meaningful.

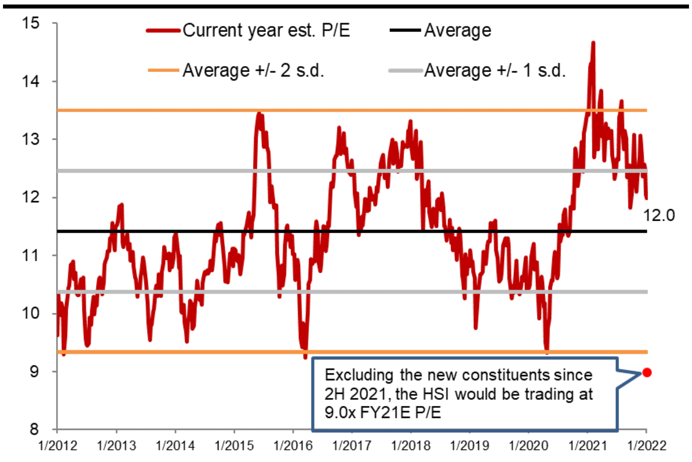
To make an apple-to-apple comparison, we adjust the HSI by excluding the 19 stocks which have been added to the HSI since Aug 2020, and the "original" HSI would be trading at only 9.0x FY21E P/E, the lowest over the past decade.

■ H-shares' discount to A-shares at decade high

The HSI not only underperformed the US, Europe and most of the emerging markets, but also A-shares. The A-H premium Index has climbed to 147 (Fig. 3), which means A-shares on average are trading at 47% premium over H-shares of A-H dual-listed stocks. Such a premium is at decade-high.

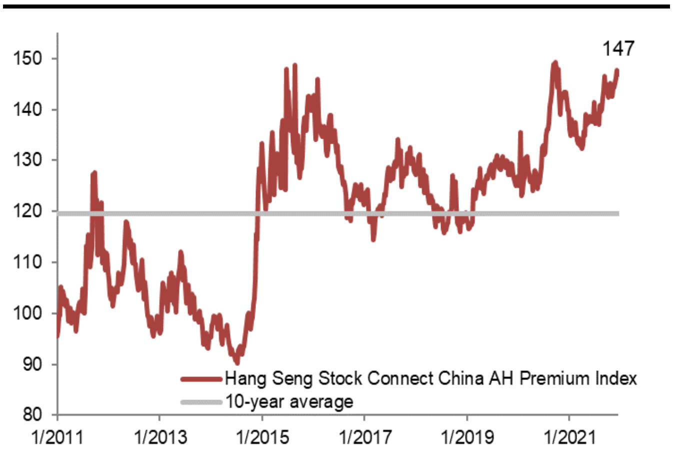
The last two times when A-H premium was that high, in Sep 2015 and Oct 2020, the premium contracted subsequently, exhibiting mean reversion to a certain extent. In other words, H-shares outperformed A-shares after A-H premium reached such a high level.

Figure 2: Adjusted HSI's P/E below decade low



Source: Bloomberg, CMBIS estimates

Figure 3: A-H premium* at decade high



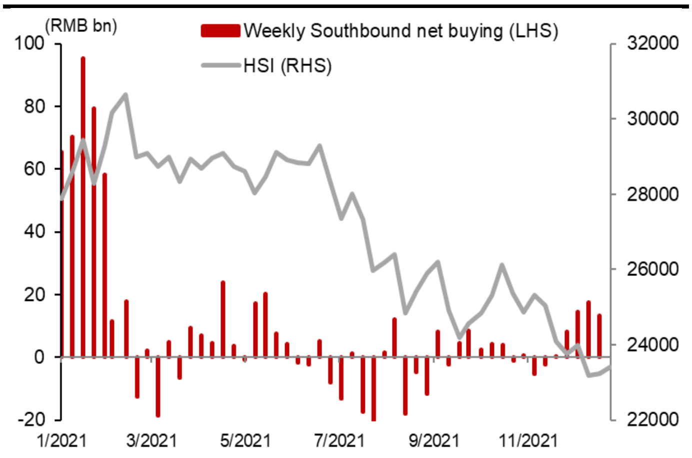
Source: Bloomberg, CMBIS
*Above 100 indicates A-shares trade at premium

Southbound net buying resumes

Since Jul 2021, when HK stocks started being hit by Chinese regulatory risks, Southbound trading recorded net outflows until late-Nov, when **Southbound trading resumed net buying for five weeks in a row** (Fig. 4).

Southbound flows may not always be "smart money", as they sometimes bought exuberantly near the peak, most notably in Jan-Feb 2021. Nonetheless, now that Southbound trading resumes net buying after five months of net selling during which the HSI slumped 5,000 points shows that **Mainland investors have rekindled interests in HK stocks**.

Figure 4: Southbound money bottom-fishing



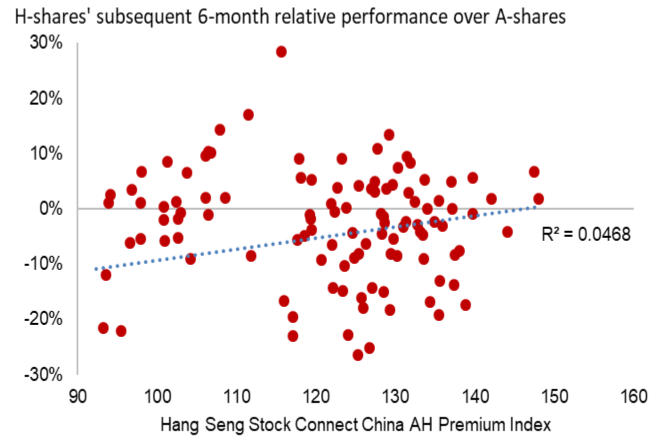
Source: WIND, Bloomberg, CMBIS

As we pointed out in the previous section, H-shares' decade-high discount to A-shares are apparently luring Mainland investors back to HK stock market. Data from the past decade shows that, when A-H premium was higher (esp. when >30%), H-shares would have a higher chance of outperforming A-shares in the subsequent 3-6 months (Fig. 5 & 6).

Figure 5: H-shares had a higher chance of outperforming A-shares after A-H premium >30%

Source: Bloomberg, CMBIS

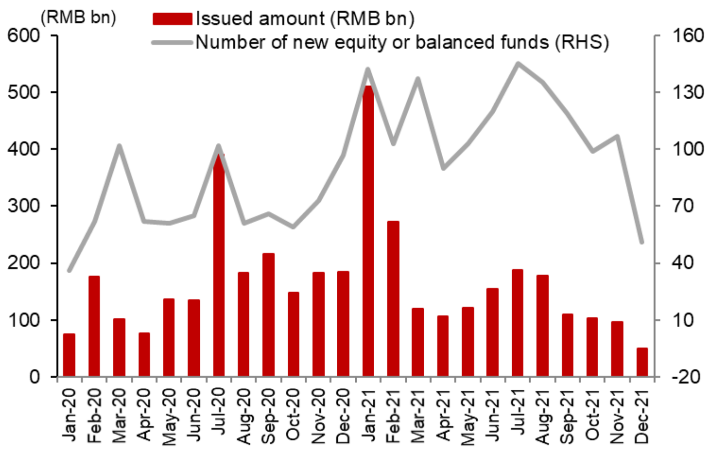
Figure 6: H-shares had a higher chance of beating A-shares when A-H premium was higher



Source: Bloomberg, CMBIS

Having said that, we are only expecting a moderate net buying through Southbound trading. Had onshore mutual funds' issuance been more active, we would have been more optimistic. But the fact is new issuance has been anaemic and declining throughout 2H 2021 (Fig. 7).

Figure 7: Newly issued onshore equity / balanced funds



Source: WIND, CMBIS

China's policy turning supportive

A key catalyst to drive re-rating of the HK stock market, in our view, would be supportive policies from China. After a year of regulatory tightening on e-commerce, online gaming, education and property sectors, among others, the **Chinese government is now placing more emphasis on stabilising growth**.

- **Prioritising economic stability**

The Central Economic Work Conference (CEWC) held on 8-10 Dec 2021 **prioritised economic "stability" ("稳字当头")**, amidst various downward pressure on the economy, ranging from shrinking demand, supply crunch to weakening expectation ("面临需求收缩、供给冲击、预期转弱三重压力"). The meeting called for coordinated fiscal and monetary policies and combined cross-cyclical and **counter-cyclical policy adjustments** ("财政政策和货币政策要协调联动，跨周期和逆周期宏观调控政策要有机结合").

■ **Counter-cyclical pro-growth policy**

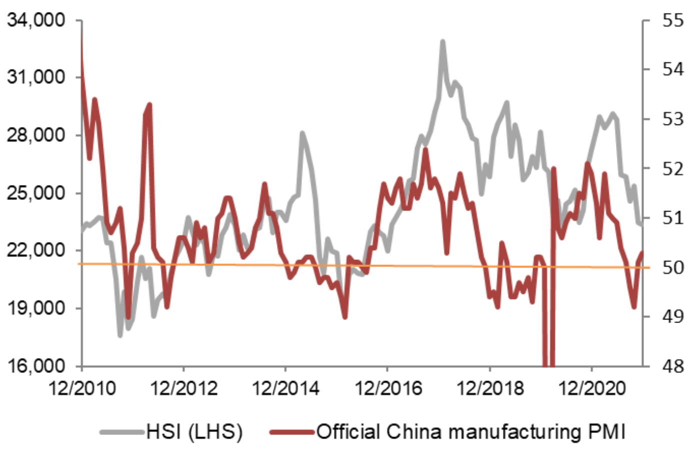
The Q4 Monetary Policy Committee meeting of the People's Bank of China (PBOC) held on 24 Dec 2021 echoed the CEWC, using some of the aforementioned wordings, including "combine cross-cyclical and counter-cyclical policy adjustments". Note that "counter-cyclical policy" was not mentioned in the Q3 Committee meeting or the PBOC's RRR cut announcement on 6 Dec 2021, but appeared in both the Q4 meeting and the CEWC. Counter-cyclical policy, compared with cross-cyclical policy, places more emphasis on short-term economic growth. Therefore, we believe the government is signalling **more pro-growth policies are on the horizon**.

As for the timing of launching pro-growth policies, Our Chief Economist, Edward Ding, pointed out that the PBOC might need to complete its major policy operations before the US Federal Reserve raise interest rates, and thus **RRR and interest rate cuts are possible in 1H 2022**.

PMI rebounding bodes well for stocks

Along with an increasing expectation of policy support, China's official manufacturing PMI has been rebounding for two months in a row, from 49.2 in Oct to 50.3 in Dec 2021, returning to the expansion territory. Fig. 10 shows that **when the PMI returned to expansion, the HSI often staged a rebound**.

Figure 8： HSI often rebounded when China PMI returned to expansion



Source: Bloomberg, CMBIS

Technical Analysis

■ **HSI holding above long-term uptrend**

The HSI fell to its lowest point in 2021 on 20 Dec, before rebounding modestly. At that trough, the HSI touched its long-term uptrend originating in 2008. In Mar 2020 during the COVID-driven market meltdown, the HSI touching that uptrend signalled the end of that bear market. This time around, **if the HSI can hold above that uptrend, it may again signal the end of this year-long bear market**.

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

Source: Bloomberg, CMBIS

■ **RSI divergence bodes well for the HSI & MSCI China**

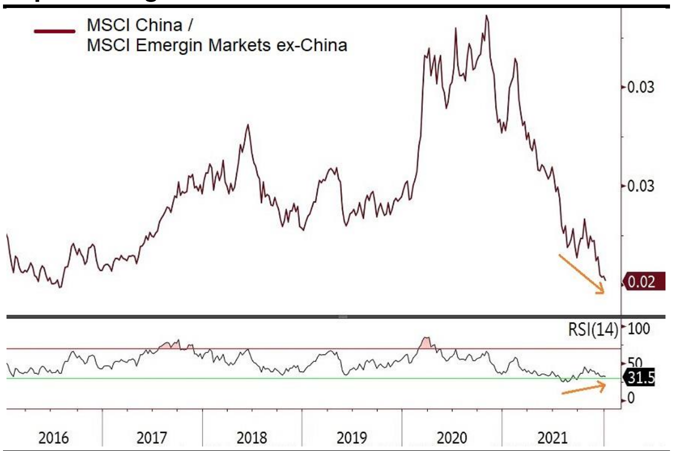
On the weekly chart, **the HSI is showing triple divergence with its RSI, which is a bottoming signal** (Fig. 10).

We also look at the relative performance of China market versus other emerging markets. Having significantly underperformed the rest of EM in 2021, the ratio of MSCI China over MSCI EM ex-China has fallen to the lowest since 2016, and is also showing triple divergence with its RSI (Fig. 11). This indicates **MSCI China may start outperforming the rest of EM** soon.

Figure 10: HSI showing RSI triple divergence on weekly chart

Source: Bloomberg, CMBIS

Figure 11: MSCI China vs MSCI EM ex-China - RSI triple divergence



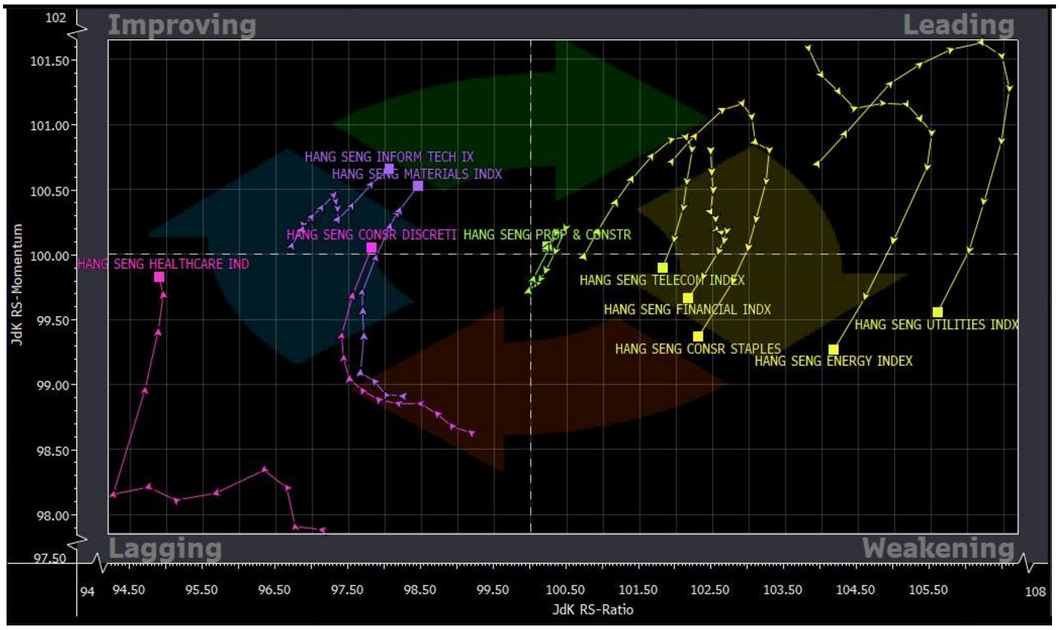
Source: Bloomberg, CMBIS

■ **RRG of HSCI favours Growth stocks over Value**

Daily Relative Rotation Graph (RRG) of the Hang Seng Composite Index is showing bipolar performances among sub-sectors. Five sectors have just sunk into the "Weakening" zone, including many old-economy sectors like Financials, Energy, Telecom and Utilities. On the other hand, new-economy or growth sectors including Info Tech, Healthcare and Consumer Discretionary have just entered or are approaching the "Improving" zone.

In short, based on the RRG, we expect Growth sectors led by Info Tech to outperform Value sectors in the next few weeks.

Figure 12: Daily Relative Rotation Graph (RRG) of the Hang Seng Composite Index



Source: Bloomberg, CMBIS

Sector preference

■ **Internet may re-rate moderately**

After a 1-year regulation cycle in the internet sector, we believe the market has factored in much of the policy headwinds, including anti-trust law, data security, minor protections, content supervision and social responsibility. While more detailed regulatory measures might continue to roll out, they should be within the framework announced earlier and well anticipated by the market. Further downside caused by regulation is limited, in our view.

We expect internet stocks' fundamentals to improve in Q2 2022 on gradual regulation easing and solid growth outlook with easy comparison base, and there could be a moderate re-rating in the shorter term, as the sector's FY22E P/E is slightly below 5-year historical trough.

Be selective about internet sub-sectors. Prefer games [**NetEase (NTES US / 9999 HK, BUY)**, **Tencent (700 HK, BUY)**] and consumer internet [**Meituan (3690 HK, BUY)**] over video streaming and ads. *(Internet sector is covered by analyst Sophie Huang)*

- **Construction Machinery & Materials to benefit from infrastructure spending**

Among old-economy sectors, we prefer Construction Machinery & Materials. Infrastructure spending in China was sluggish in 2021, dragged by a slowdown in local government special bond issuance. In 2022 however, with China's policy shifting to pro-growth, we expect infrastructure spending to speed up, supported by stronger new issuance of local government special bond. We believe that will offer strong support to the demand of construction machinery and heavy-duty trucks in early 2022. Demand for cement is expected to improve too.

(Construction Machinery / HDT sector is covered by analyst Wayne Fung)

- **Cautious on Consumer Discretionary & New Energy**

We are cautious on Consumer Discretionary sector, due to lingering impact from COVID mini-outbreaks and zero-COVID policy, economic slowdown, negative wealth effect from housing market, surging input costs caused by global inflation, and relatively rich valuation in the sector. Especially cautious on catering stocks.

(Consumer Discretionary sector is covered by analyst Walter Woo)

New Energy stocks may face short-term profit taking after strong gains in 2021. Long-term growth prospect is intact, supported by China's Carbon Peak and Carbon Neutrality policies. But recently some Chinese officials warned against too much haste in carbon reduction, calling for striking a balance between carbon reduction, economic stability and national energy consumption structure. Wait for better entry points into wind power operators.

Disclosures & Disclaimers

Analyst Certification

The research analyst who is primary responsible for the content of this research report, in whole or in part, certifies that with respect to the securities or issuer that the analyst covered in this report: (1) all of the views expressed accurately reflect his or her personal views about the subject securities or issuer; and (2) no part of his or her compensation was, is, or will be, directly or indirectly, related to the specific views expressed by that analyst in this report.
Besides, the analyst confirms that neither the analyst nor his/her associates (as defined in the code of conduct issued by The Hong Kong Securities and Futures Commission) (1) have dealt in or traded in the stock(s) covered in this research report within 30 calendar days prior to the date of issue of this report; (2) will deal in or trade in the stock(s) covered in this research report 3 business days after the date of issue of this report; (3) serve as an officer of any of the Hong Kong listed companies covered in this report; and (4) have any financial interests in the Hong Kong listed companies covered in this report.

CMBIS or its affiliate(s) have investment banking relationship with the issuers covered in this report in preceding 12 months.

CMBIS Ratings

BUY	: Stock with potential return of over 15% over next 12 months
HOLD	: Stock with potential return of +15% to -10% over next 12 months
SELL	: Stock with potential loss of over 10% over next 12 months
NOT RATED	: Stock is not rated by CMBIS
OUTPERFORM	: Industry expected to outperform the relevant broad market benchmark over next 12 months
MARKET-PERFORM	: Industry expected to perform in-line with the relevant broad market benchmark over next 12 months
UNDERPERFORM	: Industry expected to underperform the relevant broad market benchmark over next 12 months

CMB International Securities Limited

Address: 45/F, Champion Tower, 3 Garden Road, Hong Kong, Tel: (852) 3900 0888 Fax: (852) 3900 0800

CMB International Securities Limited ("CMBIS") is a wholly owned subsidiary of CMB International Capital Corporation Limited (a wholly owned subsidiary of China Merchants Bank)

Important Disclosures

There are risks involved in transacting in any securities. The information contained in this report may not be suitable for the purposes of all investors. CMBIS does not provide individually tailored investment advice. This report has been prepared without regard to the individual investment objectives, financial position or special requirements. Past performance has no indication of future performance, and actual events may differ materially from that which is contained in the report. The value of, and returns from, any investments are uncertain and are not guaranteed and may fluctuate as a result of their dependence on the performance of underlying assets or other variable market factors. CMBIS recommends that investors should independently evaluate particular investments and strategies, and encourages investors to consult with a professional financial advisor in order to make their own investment decisions.
This report or any information contained herein, have been prepared by the CMBIS, solely for the purpose of supplying information to the clients of CMBIS or its affiliate(s) to whom it is distributed. This report is not and should not be construed as an offer or solicitation to buy or sell any security or any interest in securities or enter into any transaction. Neither CMBIS nor any of its affiliates, shareholders, agents, consultants, directors, officers or employees shall be liable for any loss, damage or expense whatsoever, whether direct or consequential, incurred in relying on the information contained in this report. Anyone making use of the information contained in this report does so entirely at their own risk.
The information and contents contained in this report are based on the analyses and interpretations of information believed to be publicly available and reliable. CMBIS has exerted every effort in its capacity to ensure, but not to guarantee, their accuracy, completeness, timeliness or correctness. CMBIS provides the information, advices and forecasts on an "AS IS" basis. The information and contents are subject to change without notice. CMBIS may issue other publications having information and/ or conclusions different from this report. These publications reflect different assumption, point-of-view and analytical methods when compiling. CMBIS may make investment decisions or take proprietary positions that are inconsistent with the recommendations or views in this report.
CMBIS may have a position, make markets or act as principal or engage in transactions in securities of companies referred to in this report for itself and/or on behalf of its clients from time to time. Investors should assume that CMBIS does or seeks to have investment banking or other business relationships with the companies in this report. As a result, recipients should be aware that CMBIS may have a conflict of interest that could affect the objectivity of this report and CMBIS will not assume any responsibility in respect thereof. This report is for the use of intended recipients only and this publication, may not be reproduced, reprinted, sold, redistributed or published in whole or in part for any purpose without prior written consent of CMBIS.
Additional information on recommended securities is available upon request.

For recipients of this document in the United Kingdom
This report has been provided only to persons (I)falling within Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (as amended from time to time)("The Order") or (II) are persons falling within Article 49(2) (a) to (d) ("High Net Worth Companies, Unincorporated Associations, etc.,) of the Order, and may not be provided to any other person without the prior written consent of CMBIS.

For recipients of this document in the United States
CMBIS is not a registered broker-dealer in the United States. As a result, CMBIS is not subject to US rules regarding the preparation of research reports and the independence of research analysts. The research analyst who is primary responsible for the content of this research report is not registered or qualified as a research analyst with the Financial Industry Regulatory Authority ("FINRA"). The analyst is not subject to applicable restrictions under FINRA Rules intended to ensure that the analyst is not affected by potential conflicts of interest that could bear upon the reliability of the research report. This report is intended for distribution in the United States solely to "major US institutional investors", as defined in Rule 15a-6 under the US, Securities Exchange Act of 1934, as amended, and may not be furnished to any other person in the United States. Each major US institutional investor that receives a copy of this report by its acceptance hereof represents and agrees that it shall not distribute or provide this report to any other person. Any US recipient of this report wishing to effect any transaction to buy or sell securities based on the information provided in this report should do so only through a US-registered broker-dealer.

For recipients of this document in Singapore
This report is distributed in Singapore by CMBI (Singapore) Pte. Limited (CMBISG) (Company Regn. No. 201731928D), an Exempt Financial Adviser as defined in the Financial Advisers Act (Cap. 110) of Singapore and regulated by the Monetary Authority of Singapore. CMBISG may distribute reports produced by its respective foreign entities, affiliates or other foreign research houses pursuant to an arrangement under Regulation 32C of the Financial Advisers Regulations. Where the report is distributed in Singapore to a person who is not an Accredited Investor, Expert Investor or an Institutional Investor, as defined in the Securities and Futures Act (Cap. 289) of Singapore, CMBISG accepts legal responsibility for the contents of the report to such persons only to the extent required by law. Singapore recipients should contact CMBISG at +65 6350 4400 for matters arising from, or in connection with the report.