China / Hong Kong Market Focus

China/HK Market Strategy

DBS Group Research . Equity 16 Mar 2022

Where is the market bottom?

- **Ukraine conflict and surging cases of Omicron in China caused indiscriminate sell offs in HK**
- **Historical market crashes with 30%+ drawdowns are financial in nature, and almost always on the back of a market bubble. This is not the case this time**
- **During major corrections, utilities outperform. Technology, industrial, property and materials do better during the rebound stage**
- **In view of reduced risk appetite, we revised down 12mth HSI target to 24,600**

Indiscriminate selloff as fear reigns. The Ukraine conflict fuelled inflation fears and crushed investors' risk appetite. Surging Omicron cases in China stoked the fear of a further slowdown in economic growth. The prospects of secondary sanctions on China and selloffs of US listed Chinese stocks drove the HSI down by as much as 4,487 points in 20 days, a bloodbath not seen since the GFC. The fear is strong as VIX and VHSI have hit highs not seen Mar 2020.

Lockdowns from Omicron in China dashes short term reopening hopes. The surging COVID cases in China due to the highly transmissible variant means more lockdowns are in the cards. Reduced economic activities will make it challenging for China to maintain its growth target. This will be reminiscent to 1H20 when supply chain disruption was rampant. The hope is that this time around, with 2 years of experience, actual disruption will likely be lower, contingencies in place and recovery post lockdowns should be smoother.

Revised down 12mth HSI to 24,600 to reflect low risk appetite. Given the severe correction, driven by multiple uncertainties, investors are likely to stay extremely cautious even during bottom fishing. We revised down our HSI target to 24,600 to reflect low risk appetite amid the market overhangs listed above. Referencing deep corrections from past sell offs, sectors such as utilities and staples are preferred, with secular growth stories like new economy and technology carrying the torch once stability is restored. We think policy uncertainties relating to new economy stocks are factored in, and recent sell offs attributed to this is more of a function of the risk averse state of the market, rather than the novelty of the policies. In our top picks, we continue to position ourselves recovering from the market bottom. We replace Alibaba with Meituan to remove the delisting risk, and Meituan can better take advantage of the continual strength in Southbound buying, while the secondary listed Alibaba cannot.

HSI: 18,415

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Recommendation & valuation

Company Name	Code	Closing price (HK$)	Tgt Price (HK$)	FY22F PBV (x)	FY22F PER (x)	FY22F yield (%)
AIA	1299 HK	72.55	127.0	1.6	13.9	2.2
Bank of China HK	2388 HK	27.40	32.0	0.9	9.7	5.2
China Longyuan Power	916 HK	14.62	21.0	1.4	13.2	1.5
China Merchants Bank	3968 HK	52.15	87.7	1.5	9.1	3.6
Country Garden Services	6098 HK	25.50	78.8	1.7	11.1	2.3
Link REIT	823 HK	62.70	83.3	0.8	n.a.	5.2
Longfor Properties	960 HK	28.30	54.6	1.0	5.7	7.9
Ping An Insurance	2318 HK	46.35	94.5	0.7	4.9	5.1
Meituan Dianping	3690 HK	106.00	342.0	6.5	-133	0.0
Tencent^^	700 HK	298.00	671.0	2.2	12.0	0.8

Market overhangs, risk, and rebound catalyst

Current overhangs
Geopolitical tensions and uncertainties (Ukraine)
Inflation, Shortage, Tapering and Interest rate expectations
China Property debt crisis and Contagion
Regulatory tightening and impacts
COVID resurgence – Omicron impact (China/HK)
Further risk factors
Intensified Ukraine conflict (NATO)
Faster than expected pace of FED rate hike due to inflation
Crippling wide scale lockdowns in China
Intensified conflict between US and China
Secondary sanctions on Chinese companies
Rebound catalyst
Resolution of Ukraine conflict, ceasefire (even temporary)
Relaxing COVID-19-zero policy in China
China property policy aimed to improve liquidity
Clearer signals of end of New economy companies crackdown
Slowing interest rate rise in response to market conflict

Source: Thomson Reuters, DBS Bank (Hong Kong) Limited ("DBS HK"), Bloomberg Finance L.P.

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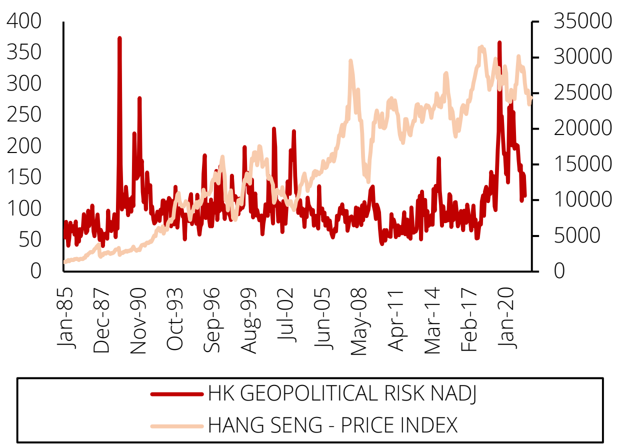
Geopolitical risk and impact on the HK market

HK geopolitical risk index spikes were financial crisis most of the time. Geopolitical Risk index ("GPR") is widely used and reflects the text search results of 11 international newspapers. The index captures the number of mentions of keywords such as military tensions, wars, terrorist threats, or incidents. Since 1985, spikes on the HK GPR index were mostly related to financial crisis, such as in 1998, 2000, 2008 and 2015. This underscores HK's financial hub status as well as its geographical location being far away from wars and terrorist attacks. On the non-financial risks, they are SARS in 2003 and the social unrest in 2019.

Events that led to major selloffs in the HK market. Looking at the past 40 years, there were major events that sent shockwaves to the HK stock market, and these were the financial crisis, geopolitical tensions, and pandemic. The financial crisis such as the Asian Financial Crisis (AFC) in 1997, Global Financial Crisis (GFC) in 2008 and Chinese stock market turbulence in 2015 saw the stock market plunging by 55.2%, 65.2% and 32.8% respectively, from the peak during those periods. it took around 300 days on average to reach a market bottom. These crises have more direct financial and economic impact to Hong Kong.

Geopolitical tensions such as Tiananmen Square protests had a significant but very short impact. The HSI dropped 33.4% in 10 days from the day when the State Council declared martial law. However, it took 109 days to recover to the previous level. Notably, the stock market dropped 21.7% on the day the event intensified.

HSI vs HK Geopolitical Risk Index



Source: Thomson Reuters

Stock market crashes in Hong Kong

Event	Beginning date	Hang Seng Index 1W return	1M return	Total return from start to bottom	Calendar days to Bottom	Recovery
Black Monday	Oct-87	-33.3%	-32.9%	-43.6%	49	938
Tiananmen Square protests	Jun-89	-15.2%	-15.1%	-21.7%	3	109
Asian financial crisis	Oct-97	-27.0%	-15.0%	-45.3%	294	447
Dot.com bubble	Apr-00	-4.8%	-7.8%	-15.0%	42	40
9/11	Sep-01	-10.7%	-1.4%	-14.2%	10	20
SARs	Feb-03	-2.6%	-2.3%	-10.5%	66	28
GFC	Oct-07	-7.0%	-9.5%	-65.2%	363	3385
Chinese stock market turbulence	Jun-15	-1.9%	-7.5%	-32.8%	245	535
COVID-19	Jan-20	-3.8%	-3.8%	-25.3%	66	301
Current	Feb-22	-1.9%	n.a.	-19.6%	20	n.a.
Avg.		-6.2%	-14.4%	-33.4%	121.8	825.6

Source: Thomson Reuters, DBS HK

Hong Kong market recorded the worst single day decline among global markets on Black Monday . The severity of the crash sparked fears of extended economic instability or even a reprise of the Great Depression. The market plunged 43.6% over 49 days and took almost 3 years to recover to the previous level. The Tiananmen Square protests had taken place in Jun 1989, adding pressure during its recovery.

2003 SARS had a relatively short drop and fast recovery. In Feb 2003, the first index patient was found in HK. The stock market dropped 9.1% in 66 days to reach a bottom as the pandemic started to be under control in late April. The market recovered in 28 days from the bottom after the pandemic.

COVID-19 pandemic took almost a year to recover. The recent pandemic shocked the global market in 2020, as the coronavirus had spread globally in a very short span of time. In contrast, the SARS outbreak in 2003 was short lived and ended within 6 months. COVID-19 has since mutated into different variants and continued to spread throughout the world. The COVID-19 pandemic was more damaging to the stock market and the total drawdown in HK was a drop of 25% in 66 days. The pandemic was global in nature and was more destructive due to countries implementing strict border closures and city lockdowns, causing disruption to the global supply chain. HSI took 360 days to recover to the pre-COVID-19 index level.

Major global military events/tensions. We have used the Geopolitical Risk Index to select the military action that had the most impact. They are Gulf War, 2003 Iraq invasion and North Korea -US tensions. However, we think these events had a lower impact relative to the financial crisis mentioned in the previous page. The military events all ended within 6 months. The Gulf War and North Korea-US missile tensions posted gains for the HSI from the beginning date to the end date of the wars, while the 2003 Iraq invasion led to a 4.8% drop. However, the 2003 Iraq invasion coincided with the SARS outbreak. The market saw a quick turnaround, taking only 57, 37 and 3 days respectively to reach the bottom.

Geopolitical tension has more impact on financial markets than the actual events. This is probably because threats tend to lower risk appetite as market uncertainties and downside concerns rises, leading to a flight to quality protracted recessionary effect as a result of a decline in stock prices. In contrast, the actual events are usually followed by a small but short-lived decline in the stock market. This could be due to the actual event tends to clarify if not, resolve uncertainty and prompt policy responses.

Implication from major market selloffs. The Hang Seng Index has dropped as much as 11.3% since the beginning of Russia's invasion into Ukraine. The impact, so far, is much less than the financial crises in the past 30 years. This is not a surprise given the nature of the crisis and the relatively minimal impact to HK/China. However, the index is still searching for a support, as the invasion has not progressed accordingly to Russia's expectations. Faster resolutions either way is usually positive to the market. That being said, current developments seem to preclude further escalation between NATO and Russia, and thus Nuclear escalation.

Are we at the end of the market sell off? In trying to answer this question, we look at i) the type of crisis ii) the extent and the duration of the drawdown iii) the initial state of the market, iv) the "fear" factor as well as v) likely outcome of the events in question.

The main overhang on the HK market is a military one in nature and the typical impact of the military conflict is relatively short. The total drawdowns also tend to be less severe than financial crisis. Most importantly, unlike the longer duration and more serious drops in 98, 00, 07, 15. The HK market is not coming off a strong bullish bubbly run, and in fact have underperformed significantly for a long stretch. Unlike the crises with more serious drawdowns, there is no significant bubble to prick. In the short term, the VSI and VHSI, both indicators of "fear" are showing that we are reaching sufficiently high levels (The outlier being COVID in 2020) that typically see some stabilisation.

We are cognizant that the nature of this conflict between Russia and The West being vastly more dangerous than recent conflicts. That being said, further escalation seems, in the form of NATO direct involvement, to be of low probability at the moment.

Rising omicron cases in China is a cause for concerns. Given the preparedness of China in dealing with outbreaks with strict lockdowns and a partially vaccinated population, supply chain disruption will happen but be more manageable. We are of the view that current levels should find support.

Of potential risks, the lesser known concern would be the potential use of sanction on China to pressure it in taking an active role in resolving the Ukraine crisis. We believe this is likely the largest risk that the market has yet to fully factor in.

Major military actions that impacted the HSI

Event	Beginning date	End date	1W return	1M return	Total return of the event	Bottom	Recovery
Gulf war	Aug-90	Feb-91	-9.5%	-10.2%	4.0%	57	143
2003 Iraq Invasion	Mar-03	May-03	-1.2%	-6.3%	-4.8%	37	28
North Korea-US tensions	Aug-17	Jun-18	-2.4%	-0.7%	11.7%	3	17

Source: Thomson Reuters, DBS HK

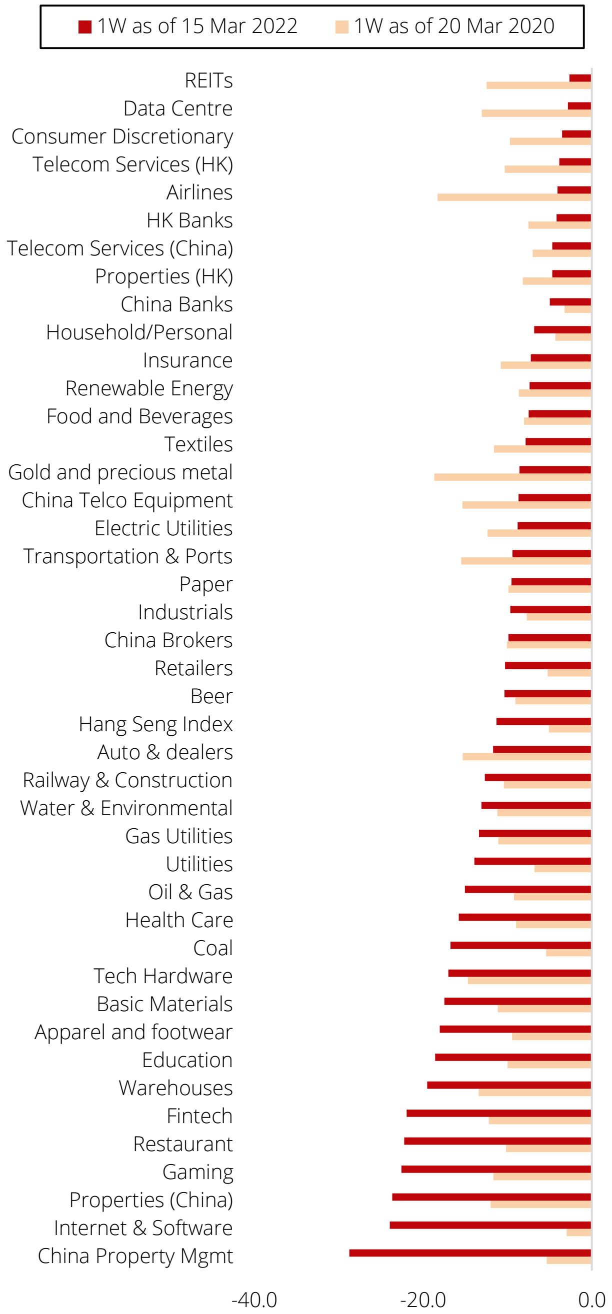
Comparison of recent sell-off and 2020 COVID-19 sell off

HSI dropped 11.3% in a week. In comparison with the sell-off in 2020 amid the beginning of global COVID-19 pandemic, HSI had a worse drop of 11.3% in just one week. This is due to the combination of uncertainties including Ukraine conflicts, ADRs delisting, rumors of Tencent's record high fine and resurgence of COVID-19 pandemic in China, HSI. In between the two period, the HK market had a Six-Flags-like roller coaster ride. China was the first to get out of COVID-19 but then new economy sector regulatory actions and property default risk after Evergrande contagion sent HK market to become the worst performing market in the globe.

Comparing sector performance during the market crashes of COVID-19 pandemic in China. The difference between the performance of the two period is the performance of internet and China property/ property management sectors, where they went from most defensive sectors from COVID-19 to the worst performed sectors in the past week. The recent sell off were not so consumer sector targeted comparing to 2020 sell off. Some underperformed sectors in 2020 such as airlines, REITs, consumer discretionary and data centre were more resilient to the recent sell off.

Concerns on lockdown to further reduce economic activities. We think the recent sell off might partly fuelled by the resurgence of COVID-19 in China. However, the fear has largely been digested comparing to 2020. The resilient of airlines proves that. The key concern here is whether China will strictly follow its lockdown procedures and zero-COVID-19 strategy and how long can it last until China follows the world and reopen. The surging COVID cases in China amidst lower vaccination rates amongst the elderly would mean more lockdowns. Reduced economic activities will make it challenging to maintain its growth target. This is similar to 1H20 when supply chain disruption was rampant. The hope is that this time, with 2 years of experience, actual disruption will likely be lower and recovery post lockdowns should be smoother

Comparing sector performance during the market crashes of COVID-19 pandemic in China



Source: Thomson Reuters, DBS HK

How should we position as we approach a market bottom?

Utilities industry index tend to outperform the HSI during stock market crash. Using the data on page 3, we have compared the Hang Seng Composite industry indices to calculate the performance from the first day of events to market bottom and then the recovery from the bottom to the previous pre-crisis level. The Utilities sector is an obvious "go-to" during a market sell down. The Utilities industry index outperformed the HSI by an average of 14.6% during previous stock market crashes in Hong Kong.

Prefer information technology, industrial goods, property, and materials ahead of a rebound stage. We have also looked at sectors during the rebound stage and the performance of the industry indices were complete opposite. During the recovery stage, information technology, industrial goods, property, and materials sectors outperformed the HSI at most of the observation points.

We think information technology stocks are seen as "growth" stocks when the market risk appetite improves. We think industrial and materials sectors are beneficiaries of an inflationary environment when government implied loosening monetary policy and QE. The property & construction sectors would usually also benefit from policies to boost the economy.

Defensive industries like telecommunication and utilities had significantly underperformed the benchmark index during all previous market rebound.

Hang Seng Comp. Industries Indices performance vs HSI - total drawdown to the bottom

	Performance vs HSI								
Event	CONGLOMERATES	ENERGY	FINANCIALS	MATERIALS	TELECOMMS	UTILITIES	INDUSTRIAL GOODS	INFO TECHNOLOGY	PROP & CONSTRUCT
Dot.com bubble	-1.9%	23.5%	19.0%	24.5%	-14.5%	32.0%	25.1%	-22.0%	-8.4%
US debt-ceiling crisis	-4.6%	18.3%	6.2%	-3.1%	-6.1%	24.2%	-12.1%	-3.4%	-4.3%
SARs	-4.0%	6.3%	5.0%	-4.3%	-7.8%	10.7%	-0.9%	-12.7%	-6.8%
GFC	-2.3%	-12.8%	1.7%	-22.9%	1.7%	23.2%	-13.0%	-9.8%	-7.5%
Bankruptcy of Lehman Brothers	-5.4%	-11.9%	-2.7%	-15.5%	14.4%	5.7%	-15.3%	-4.2%	0.8%
Chinese stock market turbulence	6.3%	-9.5%	-7.6%	-8.8%	11.8%	7.8%	-8.2%	10.6%	-1.7%
COVID-19	-10.3%	-13.8%	1.0%	-8.1%	4.3%	-1.0%	-6.2%	6.0%	-2.3%
avg.	-3.2%	0.0%	3.2%	-5.5%	0.6%	14.6%	-4.4%	-5.1%	-4.3%

Hang Seng Comp. Industries Indices performance vs HSI - Recovery from bottom

	Performance vs HSI								
Event	CONGLOMERATES	ENERGY	FINANCIALS	MATERIALS	TELECOMMS	UTILITIES	INDUSTRIAL GOODS	INFO TECHNOLOGY	PROP & CONSTRUCT
Dot.com bubble	-1.1%	-6.3%	-8.8%	-8.9%	11.8%	-19.0%	3.4%	-14.8%	5.0%
US debt-ceiling crisis	2.9%	53.0%	25.1%	132.2%	-38.4%	-14.6%	54.3%	6.3%	9.7%
SARs	1.5%	2.2%	-0.7%	7.7%	4.5%	-4.9%	5.1%	3.6%	0.7%
GFC	-3.7%	-62.9%	-31.5%	-1.4%	-150.2%	-70.8%	46.4%	1949.7%	65.5%
Bankruptcy of Lehman Brothers	19.0%	79.2%	-8.9%	162.3%	-30.6%	-30.5%	90.8%	64.6%	47.8%
Chinese stock market turbulence	-33.8%	-18.2%	3.9%	14.9%	-44.9%	-24.1%	0.2%	59.5%	16.4%
COVID-19	-20.0%	-12.4%	-3.9%	68.4%	-38.0%	-11.2%	66.4%	80.5%	-14.9%
avg.	-5.0%	4.9%	-3.5%	53.6%	-40.8%	-25.0%	38.1%	307.1%	18.6%

Source: Thomson Reuters, DBS HK

Revise down 12mth index target to 24,600

Expect earnings growth to drop 10% in 2022. We expect earnings to drop 10% in 2022 due to the (1) better than expected earnings in 2021 which would create a higher base. In our previous target, we expected 2021 earnings to recover c.80% of the pre-COVID-19 earnings in 2019. With more companies revealing their Q4 earnings results, the earnings per share for HSI slightly surpassed 2019 level. (2) The further inclusion of new HSI constituents led to earnings cut in March and will negatively contribute to the HSI overall earnings. (3) Overall slower expectation of China economic activities and growth led to more conservative earnings revision for the HSI constituents.

Risk averse environment amid war times. Due to the Russia-Ukraine war, the risk appetite remains low in HK. While the globe is standing with Ukraine with military aid, China's stance is relatively ambiguous. Will that lead to another round of secondary sanctions to China given, if any, their businesses related to Russia?

With that being said, while we are cautiously optimistic to a potential market rebound in 2H, we revised down our 12-month Hang Seng Index target to 24,600 to reflect the risk averse environment, which implies 11.6x FY22F earnings, equivalent to its five-year average one-year forward PE. With same methodology, we revised down our 12-month HSCEI target to 8,160 to which implies 9.3x FY22F earnings, equivalent to its five-year average one-year forward PE

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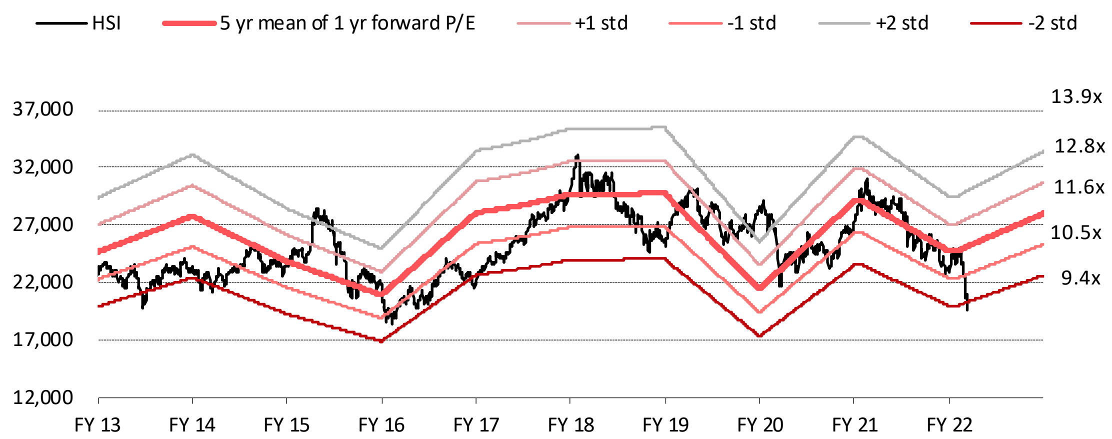
Hang Seng Index PE Band - 5 years mean of 1 year forward PE



Hang Seng Index PE Band - 5 years mean of 1 year trailing PB

Source: Bloomberg Finance LP

HK market strategist summary

Investment thesis:

Near the market bottom The Russia-Ukraine war has impacted risk appetite in the global market. Given that the conflict is unlikely to see a quick resolution, we expect risk averseness to prevail in the short term. That said, safe haven assets are reacting positively and chasing this momentum is unlikely to be rewarding. Moreover, with more Chinese listco included in HSI constituents, the ambiguous relationship between China and Russia become a geopolitical uncertainty to HSI. Our core view is that a recovering Hong Kong market has been delayed due to the Ukraine crisis, global inflation, interest rates and the epidemic, and financial tension between China and US.

HK market relatively less sensitive to interest rate concerns. The US annual inflation rate was 7% for the first time since 1982. Our economists see this set of inflation numbers as cementing a Fed hike in March. We expect a total of six hikes over the coming two years with risks on the upside if inflation proves to be persistent. The US is still reeling from this change in the narrative, but we think the HK market may be less affected, as HK's underperformance last year was due mostly to regulatory challenges and the property crisis.

Attractive valuation and hard to ignore unique secular growth giants. Given the diverging fortunes, the valuation gap between the HK and US markets has doubled. While we cautiously navigate through 2022 even though uncertainties remain, the attractive valuation of the HK market, from both a historical and relative standpoint, is hard to ignore. While fundamentals are sound, the lack of confidence could be resolved by more supportive government policies.

Valuation:

While we are cautiously optimistic to a potential market rebound in 2H, we revised down our 12-month Hang Seng Index target to 24,600 to reflect the lowered risk appetite, which implies 11.6x FY22F earnings, equivalent to its five-year average one-year forward PE. We revised down our 12-month HSCEI target to 8,160 to which implies 9.3x FY22F earnings, equivalent to its five-year average one-year forward PE

Sector preferences:

We are overweight on renewable energy due to supportive policy amid President Xi's pledges zero emissions.

We believe heavily regulated sectors and companies that have already been penalised are more likely to avoid further regulatory action and most importantly, these sectors such as China property, China property management, e-commerce, and internet, are trading at attractive valuations.

We like both the port & toll roads and oil & gas sectors due to strong demand amid global economic recovery post pandemic and the inflationary environment. Oil & gas is also benefitting from supply challenges which has worsened due to the Russia-Ukraine war.

HK banks will stand to benefit from the upcoming Fed interest rate upcycle.

We like HK REITs taking a valuation perspective as the market is overacting to the Omicron outbreak in HK. The business performance of HK REITs mainly hinges on domestic consumption, which should remain resilient despite uncertainties from the Omicron variant. China banks will benefit from the improving sentiment from policy actions relating to the China property market.

Top picks:

Our picks are based on the top picks in our overweight sectors- AIA, BOCHK, CMB, CG Services, China Longyuan, Link REIT, Longfor, Ping An Insurance Meituan and Tencent.

Key risks to our view:

The biggest risk in the market is further escalation of the Ukraine Russian war. Any drag on regulatory developments will reduce investor interest in the HK market; further China Property contagion may lead to slower-than-expected economic growth; sporadic COVID-19 outbreaks in China; and continued chip shortage and transportation bottlenecks.

Sector performance

Overweight	Neutral	Underweight
• China banks • China insurers • China property • China property management • HK Banks • HK Landlords & REITs • Internet • Oil and gas • Ports and Toll Roads • Renewable energy	• Aviation • China automobile • China brokers • China telco equipment • China telecom carriers • China materials • Consumer discretionary • Environmental service • Food and beverages • Gas utilities • HK Developers • HK telecom • Restaurants and catering • Tech hardware • Textile	• China education • Gaming

Top picks

Company Name	Code	Closing price (HK$)	Tgt Price (HK$)	Upside (%)	Mkt Cap US$m	PE 22F (x)	PE 23F (x)	EPS 22F (HK$)	EPS 23F (HK$)	ROE 22F (%)	PBV 22F (X)	yield 22F (%)	Net Gear (%)	EPS CAGR 21-23 (%)
AIA	1299 HK	72.55	127.00	75.1	112,521	13.9	12.6	5.2	5.8	12.2	1.6	2.2	Cash	32.4
Bank of China HK	2388 HK	27.40	32.00	16.8	37,140	9.7	8.6	2.8	3.2	9.7	0.9	5.2	Cash	13.3
China Longyuan Power	916 HK	14.62	21.00	43.6	15,711	13.2	11.3	1.1	1.3	11.1	1.4	1.5	132.9	15.4
China Merchants Bank	3968 HK	52.15	87.70	68.2	168,617	9.1	8.0	5.7	6.6	17.8	1.5	3.6	Cash	15.3
Country Garden Services	6098 HK	25.50	78.82	209.1	11,004	11.1	8.6	2.3	3.0	16.1	1.7	2.3	Cash	34.1
Link REIT	823 HK	62.70	83.30	32.9	16,963	n.a.	n.a.	n.a.	n.a.	4.0	0.8	5.2	18.4	n.a.
Longfor Properties	960 HK	28.30	54.63	93.0	22,042	5.7	5.2	5.0	5.5	19.3	1.0	7.9	44.6	11.8
Ping An Insurance	2318 HK	46.35	94.50	103.9	108,627	4.9	4.2	9.4	11.0	15.7	0.7	5.1	Cash	16.7
Meituan Dianping	3690 HK	106.00	342.00	222.6	83,400	-132.9	27.2	-0.8	3.9	-4.9	6.5	0.0	Cash	n.a.
Tencent^^	700 HK	298.00	671.00	125.2	366,931	12.0	10.4	24.9	28.8	20.0	2.2	0.8	Cash	16.4

Source: Thomson Reuters, DBS HK

DBS HK recommendations are based on an Absolute Total Return* Rating system, defined as follows:
STRONG BUY (>20% total return over the next 3 months, with identifiable share price catalysts within this time frame)
BUY (>15% total return over the next 12 months for small caps, >10% for large caps)
HOLD (-10% to +15% total return over the next 12 months for small caps, -10% to +10% for large caps)
FULLY VALUED (negative total return, i.e., > -10% over the next 12 months)
SELL (negative total return of > -20% over the next 3 months, with identifiable share price catalysts within this time frame)

**Share price appreciation + dividends*

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Sources for all charts and tables are DBS HK unless otherwise specified.

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