6 Oct 2021

CMB International Securities | Equity Research | Market Strategy

Strategy Report

China's stagflation fears overblown

Power outage is exerting more downward pressure on China's economy, but risk of stagflation is very low. As the economy slows further, expectations of pro-growth policies are rising, and the Politburo meeting at the end of this month will be closely watched. The HSI's P/E and P/B are near troughs, although we do not expect significant re-rating soon, we see opportunities in sectors that would benefit from policies.

- **GDP growth moderating, PPI high but CPI subdued**. Fears for stagflation are rising among investors, as major commodity prices are going up for longer than many have expected. In China, price pressures are mainly reflected in PPI while CPI is subdued. GDP growth is slowing down but a stagflation scenario is quite unlikely as growth in 2022 is expected to be ~5.5%, not so much lower than pre-COVID levels.

- **Policy watch: Politburo meeting at end of Oct.** China's policies have been a major negative factor in Q3, but there could potentially be some positive policy news in Q4. The Political Bureau of the CPC will hold a meeting at the end of Oct. Considering the recent downward pressure on the overall economy, there is possibility that the Politburo meeting would release pro-growth policy signals.

- **HSI outlook: P/B at crisis low; uptrends offer support.** The HSI's adjusted 2021E P/E (excluding new blue chips since 1H 2020) is below 10x. HSI's P/B is now at 1.01x only, very close to previous troughs. Technically, HSI has once again fallen to its long-term uptrends since 2008 (around 23,000-24,000 now), which should offer good support.

- **Prefer sectors:** 1) **Consumer sector** is less vulnerable to regulatory risks and power outage; 2) **New energy sector** would continue to benefit from "carbon neutral" policy in the long run and the power outage in the short run. Prefer selective wind power stocks which are still attractively valued; 3) **New energy vehicle sector** is also supported by China's policy. Chips shortage is going to ease, and both production and sales will be strong in Q4; 4) **China property and financial sectors**' short-term performance depends on how the Evergrande event unfolds. A potential re-rating catalyst is housing policy loosening which might be signalled by the Politburo meeting at the end of Oct. Once the worries on Evergrande and the property sector are alleviated, banks and insurers may stage a relief rally.

- **Avoid sectors sensitive to power outage**, including upstream materials, IPPs and downstream manufacturing sectors.

- **Other things to watch: US debt ceiling.** The US Department of the Treasury estimates that by 18 Oct, unless the Congress raises or suspends the debt limit, the Federal government will lack the cash to pay all its obligations, risking a default. Having the experiences in 2011 and 2013, investors would now probably be more confident that Congress will pass a last-minute deal to avoid defaults. As such, it is rather unlikely that the turbulent market in 2011 will repeat in the coming weeks.

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

Market Data

Hang Seng Index	24,104
52-week High / Low	31,183/23,681
3-month avg. daily t/o	HK$163.0bn

Source: Bloomberg

Indices Performance

	HSI	HSCEI	HSTECH
1-month	-7.9%	-9.1%	-12.1%
3-month	-14.1%	-17.1%	-22.1%
6-month	-16.7%	-24.1%	-30.5%

Source: Bloomberg

12-month HSI Performance

Source: Bloomberg

Related Reports

1. Strategy Report – HSI nearing bottom; Buy policy-driven stocks – 3 Sep 2021
2. Strategy Report – Gauging a bottom of the HSI – 23 Aug 2021
3. Strategy Report – HSI constituent candidates in half-yearly review – 17 Aug 2021
4. Strategy Report – Buy growth stocks with little policy risk – 3 Aug 2021
5. Strategy Report – 2H Outlook: Growth stocks to regain momentum – 5 Jul 2021
6. Strategy Report – Short-term Value; Medium-term Growth – 1 Jun 2021
7. Strategy Report – Buy in May; HSI target raised – 3 May 2021
8. Strategy Report – Style shift to take a break – 1 Apr 2021
9. Strategy Report – Don't panic over rising bond yield – 3 Mar 2021
10. Strategy Report – HSI enhancement preview – 24 Feb 2021

Contents

China's power outage brings further economic pressure

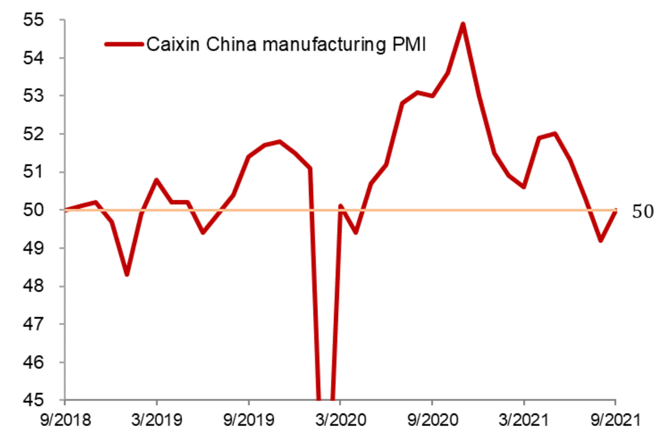
China's economy has been facing various headwinds in recent months, from mini-outbreaks of COVID in some areas, regulatory tightening on various industries since Jul, property market risks (Evergrande crisis), to more recently power outage in about 20 provinces.

All these have been exerting more downward pressure on an already slowing economy. China's official NBS Manufacturing PMI dropped for a sixth straight month in Sep to 49.6, under the expansion threshold 50 for the first time since Feb 2020 (Fig. 1). Although Caixin China Manufacturing PMI rebounded from 49.2 to 50.0 in Sep (Fig. 2), it has probably not reflected the power outage's impact yet as Caixin's survey was taken earlier than the NBS one.

Figure 1: Official China Manufacturing PMI

Source: Bloomberg, CMBIS

Figure 2: Caixin China Manufacturing PMI



Source: Bloomberg, CMBIS

Stagflation fears overblown

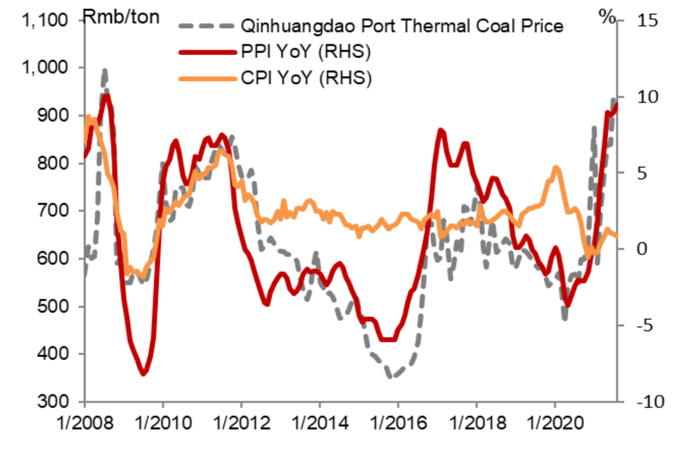
CPI subdued; GDP growth ~5.5% in 2022E

Fears for stagflation are rising among investors, as major commodity prices are going up for longer than many have expected, including the Fed officials who described high inflation as "transitory". Facing higher inflationary pressure, the Fed / ECB / BOE are contemplating exit strategy including tapering on asset purchases and interest rate hikes. At the same time, the momentum of the vaccination-driven economic recovery is somewhat dissipating.

In China, price pressures are mainly reflected in PPI, as it is much more correlated to commodity prices such as coal, while CPI inflation remains subdued (0.8% YoY in Aug) (Fig. 3). Pork and other food prices are more important drives of CPI in China.

China's GDP growth is slowing down (Fig. 4) as higher base kicks in, coupled with the aforementioned negative factors, but a stagflation scenario is quite unlikely. Our Chief Economist, Edward Ding, forecasts that China's GDP growth in 2022 would be around 5.5% (see Chief Economist's View [in Chinese only]). That would be only slightly lower than pre-pandemic growth rates (5.8%-5.9% in 2H 2019).

Figure 3: China's PPI, CPI & coal price



Source: Bloomberg, CMBIS

Figure 4: China's GDP growth

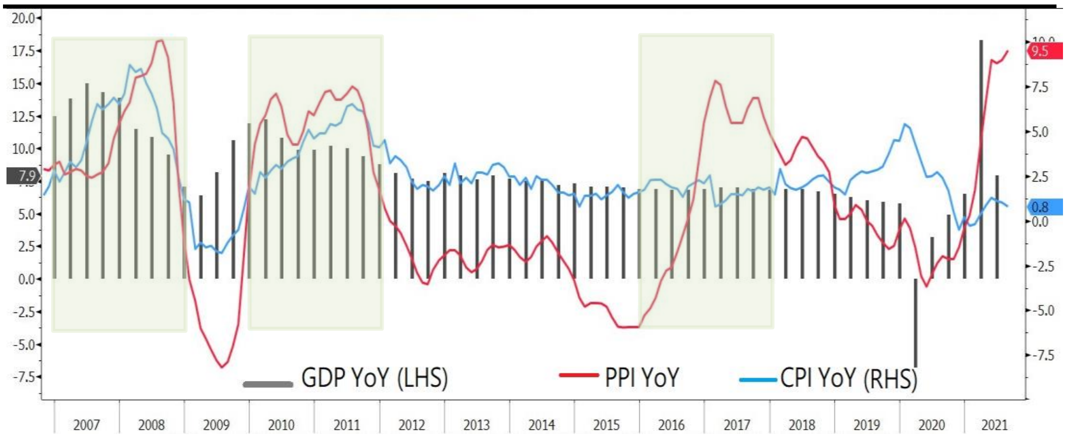
Source: Bloomberg, CMBIS

Comparable to 2016-2017

We reviewed several periods of PPI rising high and GDP slowing down (some traits of stagflation) and highlighted those periods in green boxes in Fig. 5 & 7 below:

- **2007-2008**: both PPI and CPI inflation were high, while GDP growth was slowing down. HSCEI fell along with GDP growth rate. China's high inflation and slowing GDP might have played a part in the stock market weakness, but the main culprit was US sub-prime crisis.
- **2010-2011**: both PPI and CPI inflation stayed high for a long while, with GDP growth moderating. HSCEI moved sideways. Oil price surging to >US$100 was the main reason of high inflation.
- **2016-2017**: PPI surged, while CPI stayed low. GDP growth was relatively stable at ~7%. HSCEI kept rising. Oil price moved sideways at ~US$50. China's coal price surged and drove up PPI.

Figure 5: China's GDP growth and CPI / PPI inflations



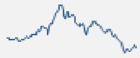
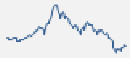
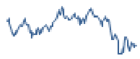
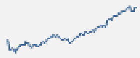
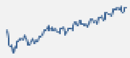
Source: Bloomberg, CMBIS

The current scenario is more similar to 2016-2017, when PPI surged due to rising coal price in China, but CPI stayed low, and monetary policy remained stable (rather than tightened to combat inflation as in 2007-2008 and 2010-2011).

During 2016-2017, China stocks actually rose steadily (Fig. 6), despite high PPI inflation. One of the reasons, in our view, was that PBOC's monetary policy remained stable in terms of benchmark lending rates and RRR for major banks. To put that into perspective, PBOC was tightening during the other two quasi-stagflation periods.

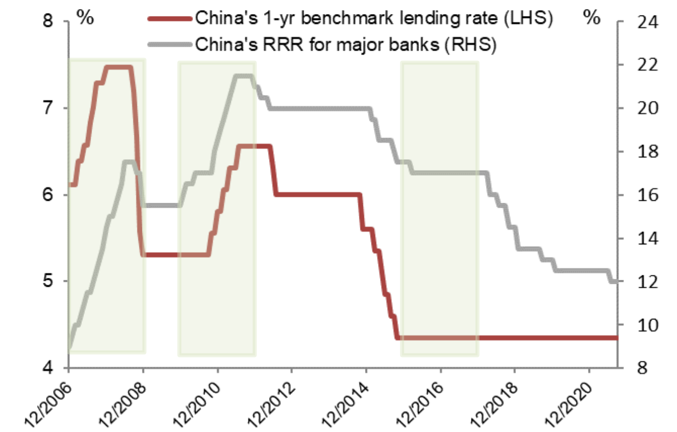
We are not saying China stocks will soon rise steadily as in 2016-2017, since downward pressure on the economy is now bigger than five years ago. But at least monetary policy has room for easing (e.g. another RRR cut), unlike the tightening cycles in 2007-2008 or 2010-2011.

Figure 6: Stock market performance in quasi-stagflation periods

Year	PPI YoY	CPI YoY	GDP YoY	PBOC policy	MSCI China	HSCEI
2007 - 2008	Surging rapidly	Surged & then moderated	Cooling from 15% to 7%	Tightening		
2010 - 2011	Rising & stay high	Rising & stay high	Moderating from 12% to 9%	Tightening		
2016 - 2017	Surging from low base	Low & stable	Stable at ~7%	Stable		
2021	Surging from low base	Low & stable	Moderating to pre-COVID level ~6%	Stable		

Source: Bloomberg, CMBIS

Figure 7: China's interest rate & RRR



Source: Bloomberg, CMBIS

Policy watch: Politburo meeting & 6th Plenary Session

- **Politburo meeting to give pro-growth signals?**

China's policies (e.g. regulatory crackdowns) have been a major negative factor to the stock market in Q3. Expect investors to be keeping a close eye on policies in Q4 too. But there could potentially be some positive policy news. The Political Bureau of the CPC will hold a meeting at the end of Oct. Considering the recent downward pressure on the overall economy, there is possibility that the Politburo meeting would release pro-growth policy signals.

■ **CPC 6th Plenary Session in Nov**

The sixth plenary session (六中全会) of the 19th CPC Central Committee will be held in Beijing in Nov. The agenda unveiled on 31 Aug includes "comprehensively reviewing the major achievements made and the historical experience accumulated during the Party's 100 years of endeavour." Since "reviewing major achievements" will be on the agenda, the progress / achievements of the "three tough battles" of preventing major risks, targeted poverty alleviation and pollution control (坚决打好防范化解重大风险、精准脱贫、污染防治三大攻坚战) are likely to be reviewed too. Recent policies / events are related to these three tough battles, and have implications on relevant sectors in the stock market.

Firstly, **"preventing major risks" should include preventing systematic risks in the property and banking sectors**. While uncertainties still remain regarding the Evergrande crisis, "preventing major risks" should dictate that the government would intervene when necessary to avoid disorderly collapse of influential developers.

Secondly, **"targeted poverty alleviation" seems to be related to the "common prosperity"** (共同富裕) policy announced in recent months. There could be supportive measures on social welfare & redistribution for the lower-income class. **Mass market consumer stocks** may benefit from stronger spending power and higher demand in the long run.

Thirdly, **"pollution control" is in line with the Carbon neutral goal.** Given that the current power outage highlights the importance of renewable energy, **new energy sector** is expected to remain in the spotlight in the next two months.

HK stock market outlook

Valuation: P/B at crisis low

In our previous Strategy Report, we pointed out that the HSI's adjusted 2021E P/E (excluding new blue chips that were added into the HSI since 1H 2020) was below 10x, close to 2 s.d. below 10-year average.

Price-to-book ratio tells a similar story. HSI's P/B is now at 1.01x only, very close to previous troughs.

Figure 8: HSI's P/B at crisis low

Source: Bloomberg, CMBIS

Technical: Uptrend support and RSI divergence

The HSI has once again fallen to its long-term uptrends since 2008 **(around 23,000-24,000 now), which should offer good support**.

Figure 9: HSI monthly chart since 2008

Source: Bloomberg, CMBIS

A **"bullish divergence"** has been formed by the HSI and its RSI, **a bottoming signal**.

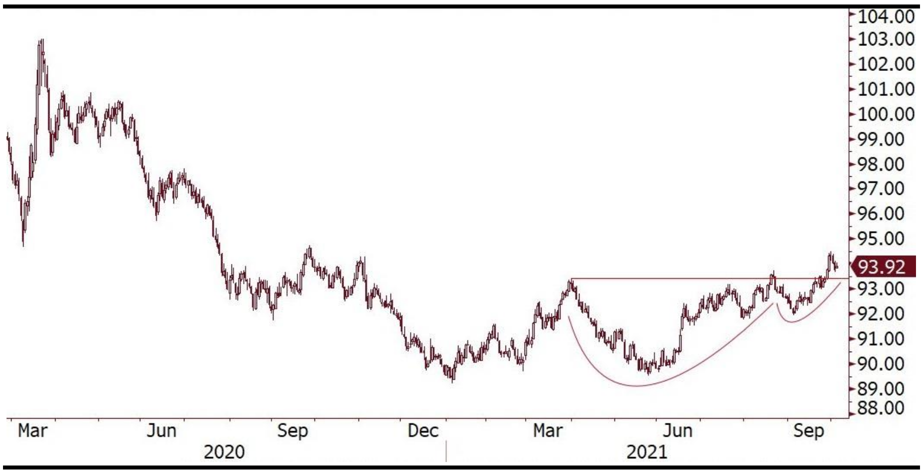
Figure 10: HSI has formed bullish divergence with RSI

Source: Bloomberg, CMBIS

- **But USD strength bodes ill for China stocks**

After the latest FOMC meeting ended on 21 Sep, the USD regained momentum, because the Fed's dot plot shows that the timing of their first rate hike since pandemic may move forward. On Fig. 11, the USD Index has just broken the neckline of its "cup and handle" bullish pattern, implying further upside is likely. A strong USD usually bodes ill for emerging markets including China.

Figure 11: USD Index's "cup-and-handle" breakout



Source: Bloomberg, CMBIS

Sector preference

Prefer Consumer, New Energy, NEV, Property & Financials

Consumer sector is, broadly speaking, not so vulnerable to regulatory risks and power outage. Under the "common prosperity" policy direction, mass market consumer goods may enjoy higher growth.

New energy sector would continue to benefit from "carbon neutral" policy in the long run and the power outage (highlighting the importance of alternative energy) in the short run. Note that some new energy stocks' valuations are not cheap anymore. Prefer selective wind power stocks which are still attractively valued: **Suntien (956 HK)** and **Datang Renewable (1798 HK).** After the strong runs in recent months, **accumulate on dips.**

New energy vehicle sector is also supported by China's policy. Our NEW analysts believe chips shortage is going to ease starting from Oct, and both production and sales will be strong in Q4. Top pick is **BYD (1211 HK)** (See our NEV Sector Report [in Chinese only]).

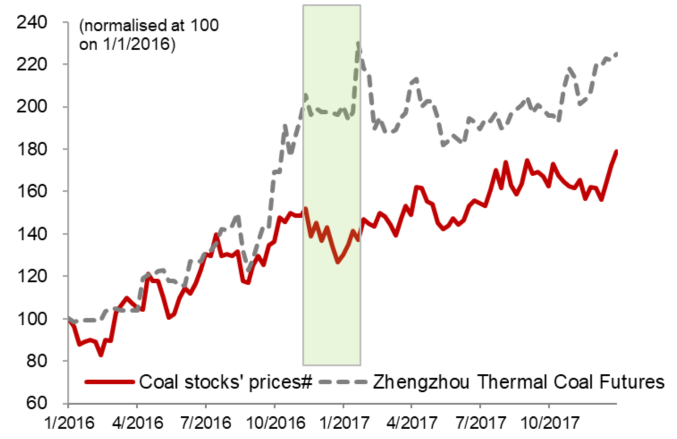
China property and financial sectors' short-term performance depends on how the Evergrande event unfolds. We believe the government is likely to intervene when necessary to prevent disorderly collapse of influential developers. Valuations of China property developers are very cheap. A potential re-rating catalyst is housing policy loosening which might be signalled by the Politburo meeting at the end of Oct. In the meantime, share prices would remain volatile. Prefer quality developer **CR Land (1109 HK)** (See our Property Sector Report). As for financial sector, Chinese banks and insurers are deemed to be affected by the housing market risks. Once the worries on Evergrande and the property sector have been alleviated, banks and insurers may stage a relief rally.

Avoid sectors sensitive to power outage

We suggest **avoiding** sectors that are most sensitive to power outage, including **upstream materials, IPPs and downstream manufacturing sectors**:

- **Manufacturers** are suffering to varying extents in terms of production disruption and higher electricity costs (i.e. sales and margin pressures). High-power-consumption manufacturing industries (Cement, steel, aluminium, paper) with production bases in provinces identified as high-power consumption areas are the most vulnerable.
- **Coal-fired IPPs** are making more losses the more electricity they generate, taking the burden of high coal prices. In fact, the power outage has been partly attributed to IPPs' reluctance to operate at full capacity while making losses. Yet, the State-owned Assets Supervision and Administration Commission (SASAC / 国资委) has recently requested coal-fired plants to work on full capacity ("全力保障火電機組能發盡發"). The strong run in IPPs' share prices (+50%-100%) over the past two months, driven by re-rating on their renewable energy segments, make them more susceptible to pullbacks now.
- **Coal producers** may be the biggest winners from high-flying coal prices in terms of earnings, but stock market is forward looking. The big-three coal stocks have surged by 50%-210% YTD. Have that fully priced in the positives? Looking forward, coal price might be capped by increase in supply (both domestic production and foreign import).

Figure 12: Coal stocks peaked before coal price



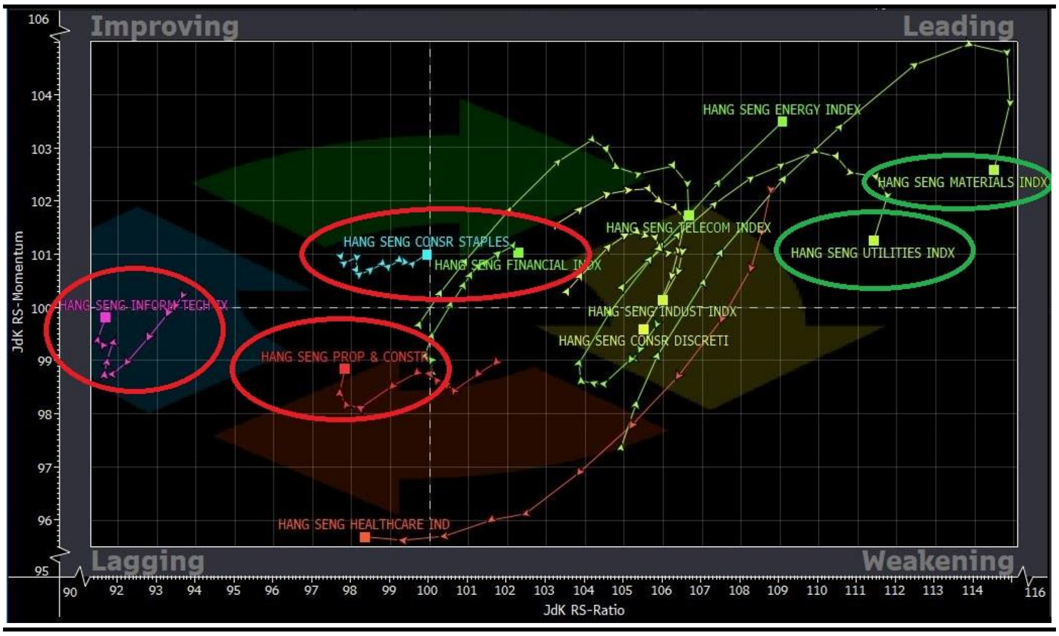
Source: Bloomberg, CMBIS
#Simple average of Shenhua, China Coal and Yanzhou Coal H-shares

■ Sector rotation

As shown in the weekly Relative Rotation Graph (RRG) of the HSCI (Fig. 13), the two strongest sectors recently have been **Materials and Utilities** (in green ovals), but both of them are heading south into "Weakening" zone soon. **Suggest to take profit**.

On the other end of the RRG, **Property & Construction and IT** (in red ovals) have been among the weakest sectors in recent weeks, but both of them are pointing to northeast (i.e showing improvement) and **will probably move into "Improving" zone soon**.

Figure 13: Weekly RRG of HSCI



Source: Bloomberg, CMBIS

Other things to watch

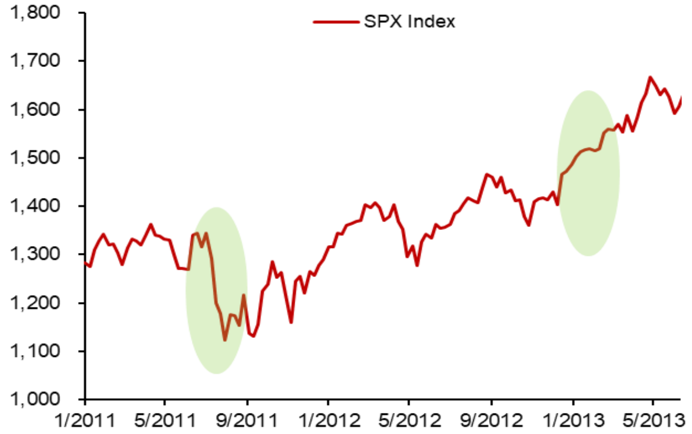
US debt ceiling

The US Department of the Treasury estimates that by 18 Oct, unless the Congress raises or suspends the debt limit, the Federal government will lack the cash to pay all its obligations, risking a default.

Investors may take reference from the last couple of debt ceiling crises in 2011 and 2013. On both occasions, a default has been avoided, as Congress passed a bill just in time to raise or suspend the US debt limits. But on 5 Aug 2011, Standard & Poor's lowered the credit rating of the US from AAA to AA+, triggering selloffs in stock markets. In 2013, with no downgrades from major credit rating agencies, and investors more confident that Congress would pass a bill to raise / suspend the debt limits, S&P 500 climbed during the uncertain period.

Having the experiences in 2011 and 2013, investors would now probably be more confident that Congress will pass a last-minute deal to avoid defaults. As such, it is rather unlikely that the turbulent market in 2011 will repeat in the coming weeks.

Figure 14: S&P 500 during US debt ceiling scares in 2011 and 2013

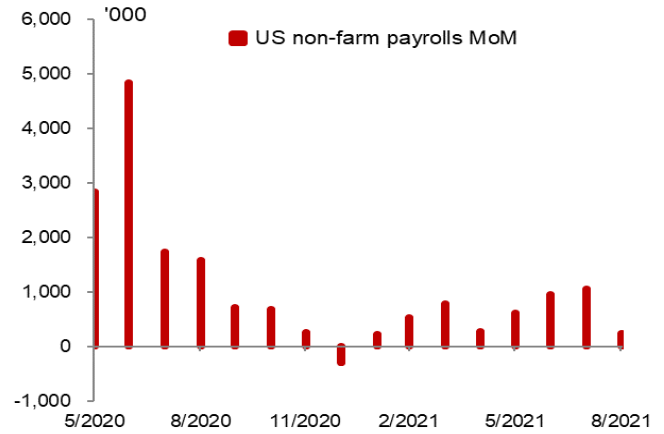


Source: Bloomberg, CMBIS

US job report

The FOMC will meet on 2-3 Nov, when they are expected to announce the start of QE tapering. Before that, the US non-farm payrolls to be announced on 8 Oct is arguably the most important economic data. US economy added 235K jobs in Aug 2021, the lowest in 7 months and well below forecasts of 733K. Consensus for the Sep figure is 488K. Even if the Sep figure misses again, it would be highly unlikely to derail the Fed's plan to announce tapering in the next FOMC meeting on 2-3 Nov.

Figure 15: US non-farm payrolls



Source: Bloomberg, CMBIS

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.