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BOCOM International

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China Market Strategy

Outlook 2H20: The Dragon Awaits

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- **Value stocks set to outperform.** On 19 May 2020, the underperformance of value versus growth has plunged to the same level last seen at the peak of the internet bubble on 9 March 2000. This is a watershed moment for the NASDAQ. As for the S&P500 in March 2000, it also peaked. But it lingered around the top for another six months before initiating the historic plunge. Regarding whether the indices have peaked or not, we are more cautious than consensus, especially now that the optimism is running amok. Regardless, value stocks will outperform.

- **Market fallacy.** At ~25%, the disparity in earnings growth estimates between value and growth is roughly the same as in March 2000, with estimates being -23% for value and 2% for growth. At -23% and lagging growth by 25%, in ~3 years, value would disappear, and growth would take over the entire market – it simply cannot be true. In March 2000, growth estimate for value stocks was at ~15%, while for growth it was ~40%. At that rate, growth will rule the entire market in ~10 years. If March 2000 was a bubble, now we are confronted by an even bigger one.

  This observation holds true regardless of interest rate levels, as relative performance is a reflection of difference in growth estimates, while interest rate is the same for both value and growth. Interest rate turning negative would be a real disaster. With negative discount rate, opportunity cost in orthodox finance would become “opportunity return”. If so, one would have to be paid to own stocks, and stock price will turn negative. As such, negative rates cannot explain such lofty valuation. Falling interest rates did not arrest China’s bubble burst in June 2015. Nor did it save the Japanese and European economies.

- **Cyclicals offer value, but their strength can be misconstrued.** Value stocks now largely coincide with cyclical stocks. These are old and bruised names, such as industrials and financials. Their emerging outperformance may be misconstrued by traders as a signal of nascent economic recovery, and thus stretch the time before the S&P and the Dow will peak. The Dow may perform even stronger, as it is an equal-weighted index and thus can benefit more from optimism. After the internet bubble burst in March 2000, value stocks continued to outperform despite the ensuing recession.

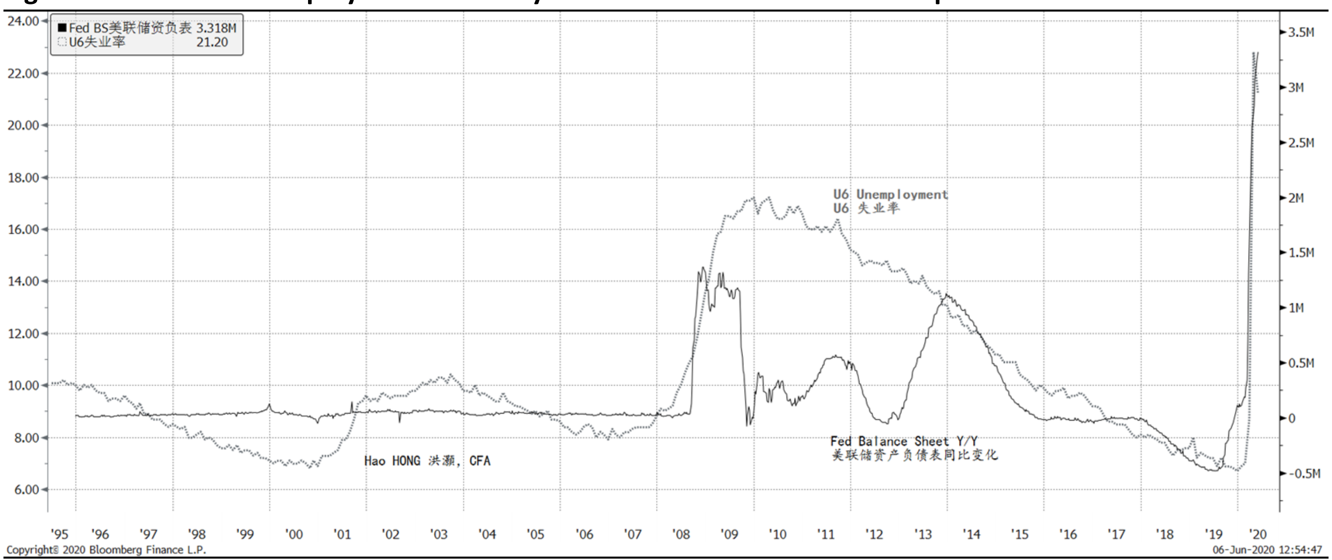
- **Shanghai and Hong Kong offer long-term value.** Shanghai’s relative performance to the S&P500 has reached a level auguring well for forward return. After March 2000, China indeed outperformed significantly relative to the US. Our trading range forecast for SHCOMP of 2,700 – 3,200 will continue to hold. During the epic plunge in March, the Hang Seng had also reached its lows in the current cycle, and these are unlikely to be breached. China and HK can be affected by the bursting US growth bubble. But for value investors, lower prices, if any, will be even better.

Outlook 2H20: The Dragon Awaits

Value investing is set to return; value stocks to outperform

Every day will be in the book of history in 2020. We would not recount the epic moves in global markets, and the unprecedented joint efforts by global central banks trying to arrest the rapidly-wilting economy. It has been on the front page on every single newspaper. The aftermath is that the Fed's balance sheet is surging to a historic high, together with US unemployment (**Figure 1**).

Figure 1: Worst US unemployment in history vs. fastest Fed balance sheet expansion on record

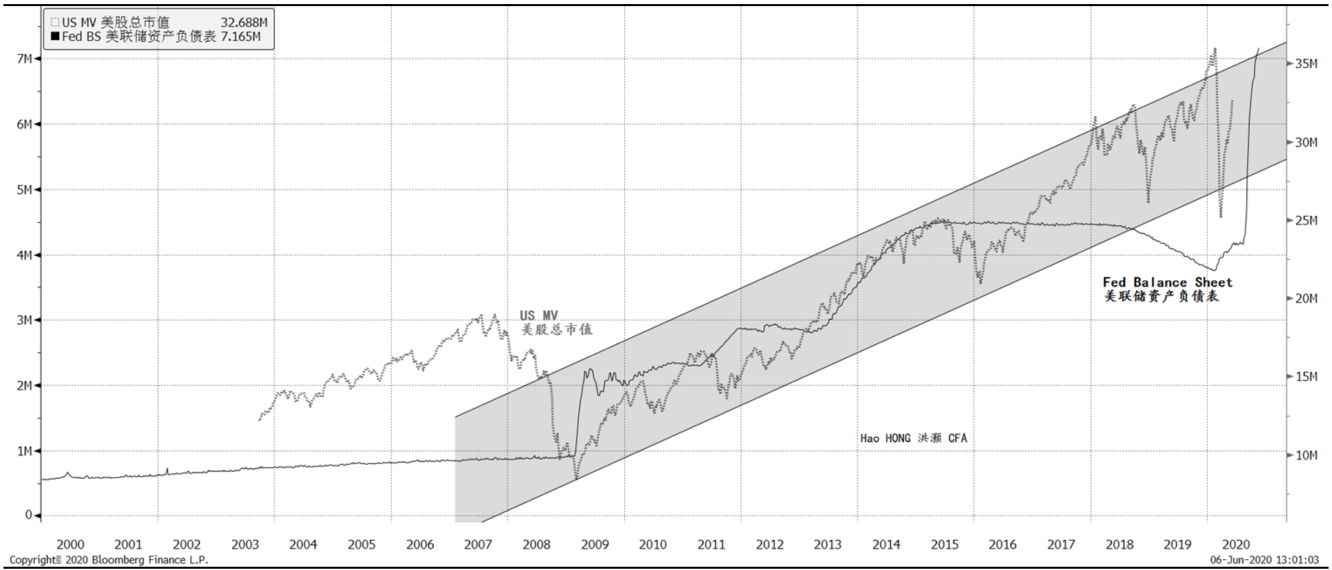


Source: Bloomberg, BOCOM Int'l estimates

There is a very consistent correlation between the size of the Fed's balance sheet and the US market capitalization (**Figure 2**). Such correlation has been in place since 2008, when the Fed initiated QE to rescue the economy from the worst recession since the 1929 Great Depression. By now, the belief that the Fed will backstop any economic failing is entrenched in the market.

Meanwhile, trading stocks seems as simple as "don't fight the Fed" and "follow the trend". Market's excessive optimism is shown in the forward valuation of small caps relative to that of S&P 500. Since March, small caps' relative forward valuation has been surging, together with the soaring size of the Fed's balance sheet (**Figure 3**).

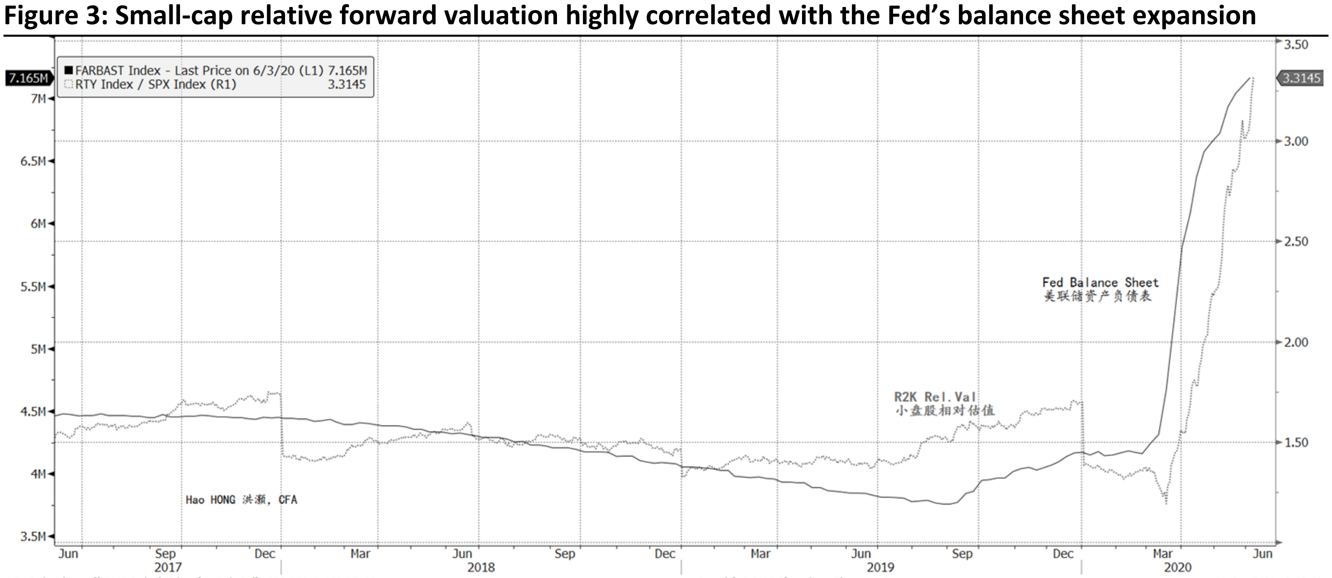
Figure 2: The Fed's balance sheet expansion drives market gains



Source: Bloomberg, BOCOM Int'l estimates

Small caps are less widely owned and not well understood, and thus do not command the same level of trading liquidity as large caps. And forward valuation, as calculated by the ratio of price to forward earnings estimate, is a measure of forward expectation. Small caps' surging relative forward valuation suggests that speculation in the market is rampant. After all, who would want to own illiquid small caps fraught with forward earnings risks, if not for significant potential capital gain as compensation?

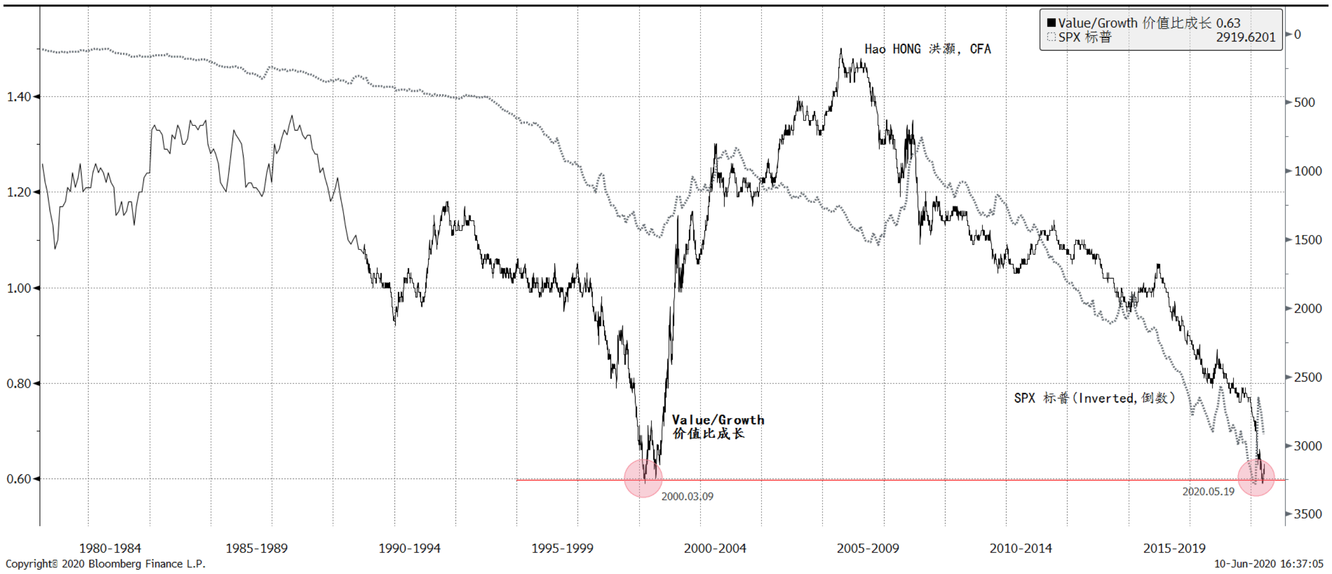
Figure 3: Small-cap relative forward valuation highly correlated with the Fed's balance sheet expansion



Source: Bloomberg, BOCOM Int'l estimates

Is the Fed omnipotent? Is there no consequence from reckless money printing? With the advent of MMT, many seem to be dismissive of the repercussions from the current liquidity deluge, casting away the legitimate concerns about hyperinflation and public finance in disarray. Of course, we may not be beset by these consequences immediately, as demand destruction in the near term dampens inflation pressure. But even so, what gives?

Figure 4: On 19 May, value underperformance vs. growth has turned to its peak last seen in March 2000



Source: Bloomberg, BOCOM Int'l estimates

We note that the relative performance of value stocks versus growth plunged to historic lows on 19 May 2020 – the same level as seen on 9 March 2000 when the NASDAQ bubble unraveled. It is also worth noting that value had outperformed growth since then till 2007. While the return of value stocks has been coveted for a few years, the relentless rise of the growth stocks led by the FANG-plus stocks has consistently defied the process of mean reversion. Now, growth stocks are once at a historic critical juncture reminiscent of the peak of the internet bubble in March 2000. Meanwhile, the price-to-sales ratio on the MSCI US also peaked before the plunge in March at the same level as March 2000 (**Figure 5**).

Yes, interest rates are low. As such, even though the underlying growth rate is falling, as long as interest rates fall faster than growth rate, stocks can sustain a very high level of valuation – according to the perpetual growth valuation model. Even if we use the two-stage or three-stage equity valuation model, interest rate falling faster than growth rate can still produce a very high terminal value, and thus a very high valuation multiple.

But the same argument can be applied to every episode of stock market bubble in history. Some believe that this time is different, as interest rates are at historic lows, and can even turn negative. Yet, if rates are at historic lows, then it means that rates have nowhere else to go except for turning negative. If rates were to go negative, it would even cause valuation multiples to collapse, using the same perpetual growth valuation model discussed above. This is because, in a world of negative interest rates, opportunity cost would become negative, and indeed would mean opportunity "return". As such, no one would want to buy risk assets. Instead, everyone would want to be paid to borrow, or equivalent to selling bonds at an infinite premium. In such a world, share price can turn negative, or one must be paid to own stocks. It is mind-boggling.

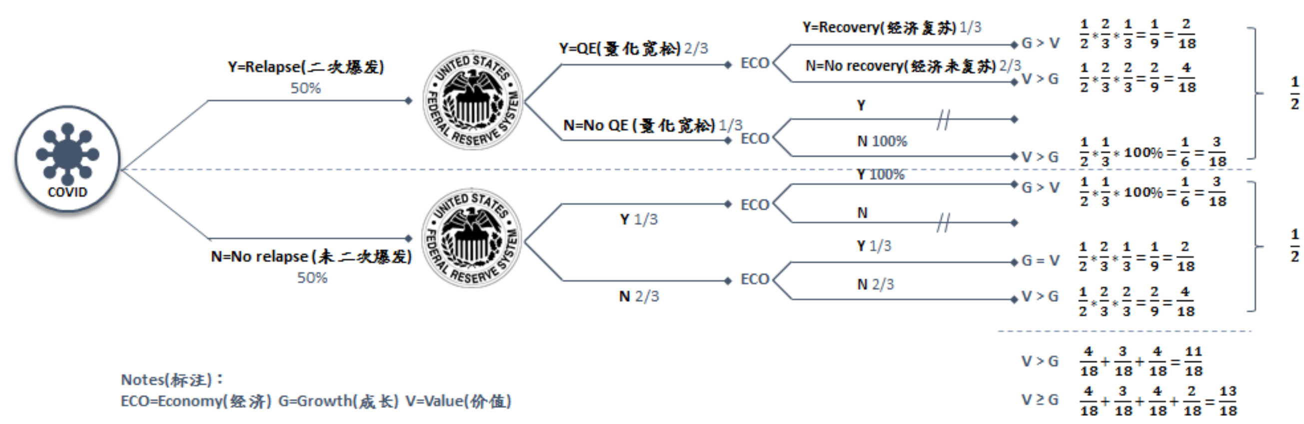
Figure 5: P/S of MSCI US has also peaked

Source: Bloomberg, BOCOM Int'l estimates

We can also step through how COVID-19, the Fed and the economy interrelate, and its effect on value versus growth investing (**Figure 6**). In Figure 6, we show various such scenarios. For instance, the top branch shows that the chance of a relapse of COVID-19 is 50/50, as not even the epidemiologists have reliable estimates; if there is a relapse, but the Fed prints more, then the chance of economic recovery is estimated to be 1/3.

After stepping through each branch, we can estimate the chance of value not underperforming growth to be 13/18, and the chance of value outperforming to be 11/18. That is, the chance for value investors faring better than growth investors is between ~2/3 and ~3/4. Intuitively, COVID-19 must have some impact on the economy. As long as the economy struggles, value is likely to outperform, especially given the historical precedence and its excessively cheap valuation.

Figure 6: Value is likely to outperform growth

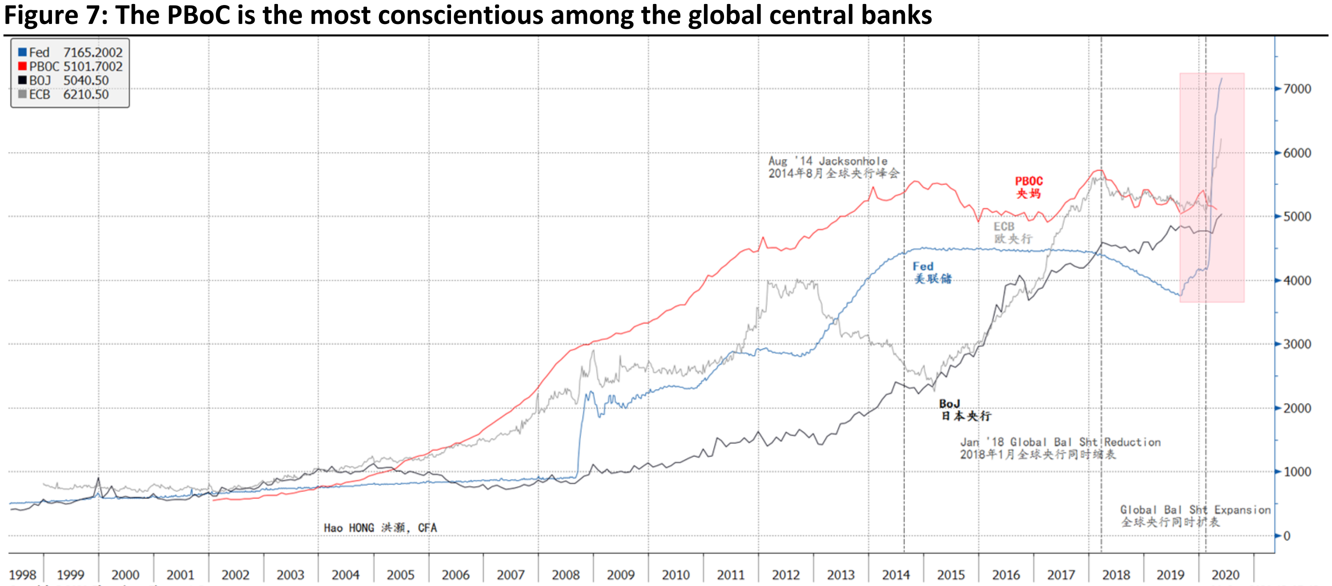


Source: BOCOM Int'l estimates

The Dragon awaits

While global central banks are expanding their balance sheet at an unparalleled velocity, the PBoC, one of the most important central banks, is conspicuously missing. If we look at the PBoC's balance sheet size now, it is higher year-on-year, but not higher since the beginning of 2020 (**Figure 7**). Since the COVID-19 outbreak, the PBoC has cut lending rate marginally, initiated targeted loans to SMEs and lent to certain small banks to replenish their capital base. Despite discussions regarding deficit monetization, these remain as sound bites rather than action. The PBoC is not buying bonds in the open market like its global peers, and as such is the most self-restrained. What is the PBoC waiting for?

Figure 7: The PBoC is the most conscientious among the global central banks



Source: Bloomberg, BOCOM Int'l estimates

Arguably, China is the first to recover from the COVID-19 outbreak that hit the Chinese economy during the low season of the Lunar New Year. Recently, high-frequency data suggest that the recovery is well underway, with capacity utilization of the manufacturing industries running at close to the normal level. The service industries, however, are recovering at a slower pace, due to lingering fear of the virus. China's financial markets withstood the storm very well. As such, there appears to be little need for dramatic central bank intervention in China's financial markets, while the PBoC is endeavoring to ease the liquidity conditions for the physical economy.

In our previous report titled "Guesstimating Unemployment in China" on 2020.03.30, we discussed how the performance of the Shanghai Composite is highly correlated with the change in China's MV/GDP ratio. What's more, the change in MV/GDP ratio has stuck in a very well defined range for the past decade – between +7% and -20%. In history, whenever the change in China's MV/GDP ratio reached 7%, the Shanghai Composite would run into resistance; whenever it fell to -20%, the Shanghai Composite would find support, and would even bottom out – except for the period during the 2015 stock market bubble (**Figure 8**).

Figure 8: Barring dramatic balance sheet expansion by the PBoC, the SHCOMP remains stuck in a range

Source: Bloomberg, BOCOM Int'l estimates

China's economy has been growing at roughly 7% on average since the 2008 global financial crisis. As GDP is a quarterly release, while the MV/GDP ratio is calculated based on daily share prices, the change in this ratio reaching above 7% would suggest that the market is rising much faster than the underlying economic growth. And, thus, the Shanghai Composite runs into resistance. But when the ratio change falls to or even below -20%, it would mean that the market has cheapened enough to reflect the underlying hardship in the economy, as in early 2016 after the bubble burst, and in late 2018 when the prospects of the trade war worsened.

As now, the change in the MV/GDP ratio remains elevated but not yet at its extreme. In our report "***Outlook 2020: Going the Distance***" published on 2019.11.11, we forecasted the trading range in the ensuing twelve months for the Shanghai Composite to be ~2,700 to 3,200. The actual trading range for the Shanghai Composite in the past seven months has been 2,646 to 3,127. That is, our trading range estimated last November holds, and should continue to hold in the second half till November. If the Shanghai Composite trades towards the lower end of this range, our investment should be more proactive, and vice versa.

Regarding long-term outlook for the Shanghai Composite, we have also discussed that the underperformance of the Composite versus the S&P500 has once again reached a historic extreme this February ("Strong Man of Asia: Markets at a Historic Pivot" on 2020.04.20). While this relative performance has most likely been driven by comparative valuation, the actual index levels of these two indices at the inception of the comparison period are about the same at ~1,000. Such a coincidence makes the comparison of relative performance between these indices very convenient. Such dramatic underperformance begs reversion to mean, as it had been in the past, most notably in 2005. As such, the Shanghai Composite is set to outperform the S&P500 in the long run. Long-term investors should take note.

Figure 9: The underperformance of SHCOMP vs. SPX at extreme; long-term investors should take note

Source: Bloomberg, BOCOM Int'l estimates

Meanwhile, the Hang Seng is also at a critical juncture.

Since early 2018, Hong Kong has endured numerous detrimental happenings derailing the market, including the trade war, drastic social events, and then COVID-19. During the global market rout in March, the Hang Seng plunged to 21,139 at its lowest, and has since found some support. Still, it is a significant fall from its January 2018 peak of 33,484.

We have written extensively about our theory of the 3.5-year short economic cycle, and how a few short cycles stack up to form a longer, intermediate cycle of seven to eleven years, and an even longer long cycle of 17.5 years and 35 years. The length of these intermediate to long cycles is multiples of the 3.5-year short cycle. In general, two to three 3.5-year short cycles form a 7 to 11 year intermediate cycle. Five 3.5-year short cycles form a 17.5-year intermediate cycle, and two 17.5-year intermediate cycles equal a 35-year long cycle ("The Colliding Cycles of the US and China" on 2018.09.03).

We have then discussed how these economic cycles are key to asset allocation. Simply put, the long-term moving average of market prices is a reflection of the economic cycles. The length of the moving average of market indices should correspond to the duration of the economic cycle. And we have proven that is indeed the case (*"A Definitive Guide to Forecasting China Market",* 2019.09.20). ***Please note that this is not technical analysis. Instead, this is an application of economic cycle theory to derive principles of asset allocation***.

Figure 10: The Hang Seng has arrived at its intermediate-cyclical bottom after the crash in March

Source: Bloomberg, BOCOM Int'l estimates

We found the 10.5-year and the 17.5-year long-term moving average of the Hang Seng are important support levels for the index (**Figure 10**). The length of these moving averages coincides with the duration of an intermediate economic cycle. We have discovered this trading principle in many major market indices, including the Shanghai Composite, the S&P 500 and the Dow. This cannot be a coincidence.

During the March rout, the Hang Seng fell to ~100 points from the 17.5-year long-term moving average, and now is trading around its 10.5-year moving average. As such, we believe that the lowest point in March is significant in the current cycle, and is unlikely to be breached again, even amid ongoing heightened uncertainties. Coupled with the Hang Seng's historical low valuation, we believe that long-term investors should also take a look at the Hang Seng. It will prove to be a good long-term investment.

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