交銀國際 BOCOM International

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China Market Strategy

Value Striking Back

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- The strength in growth stocks relative to value stretched to an unprecedented high, before it began to unwind in late June 2020. It had gone almost unnoticed till the value rotation really started to gather momentum in late November 2020. The singular growth strength, established upon credit expansion, growth extrapolation and greed, and facilitated by the extremely low-cost internet brokers, can be best described as a "COVID Bubble" – both in the US and China. When we published our 2H20 outlook "**The Dragon Awaits**" last June, we first hinted at the emerging value rotation. In our 2021 outlook "**Value Strikes Back**", we recommended value, commodities and Bitcoin, with EM, China and HK as the long-term opportunities.

  Now, this bubble is threatened by rising bond yield and volatility, and is starting to deflate. Sticking to growth is really extrapolating linearly the growth during the pandemic. Thus, such thinking is a true lack of imagination, which is essential to long-term growth investing. And such thinking is downright pessimism, as it projects the pandemic growth pattern to continue forever.

- A global recovery is unfolding. The economic cycles of the US and China are more intertwined than ever, as Chinese exports have become an even more important input for the paused US. Upstream inflation in China in the coming months, as evidenced in the strength of commodities, will likely be reflected in rising US bond yields and bond volatility. Growth stocks are long-duration assets, and thus are sensitive to rising yields and volatility. Simply put, rising yields depress growthy multiples, while heightened volatility makes people more anxious to cash in on the phenomenal gains in growth stocks. Continue to rotate into value.

- Cyclicals and commodities' strength as a whole is in full swing. A vexing question is where to put money during the next phase of recovery. While cyclicals and commodities are definite terms, value is not. Given the circumstances, we can use valuation as a proxy for value. Or that "value investing" now is similar to "valuation investing". Both cyclical value and non-cyclical value are reverting their weakness, but still below long-term average. The opposite is true for cyclical growth and non-cyclical growth. There is still value to be gained in cyclical and non-cyclical value sectors, such as consumption, industrials, financials and telecoms.

- That said, geopolitical risks are rising. Harsh rhetoric was exchanged, and new sanctions were imposed. These risks will hamper the market. China's RRR is unlikely to move as a show of economic strength, while credit expansion is hindered by the property bubble. Historically, the RMB's weakness is concurrent with economic and geopolitical risks, as in 2008 and 2018. The change in valuation as measured by market cap to GDP suggests limited index gains. As such, we continue to believe that the opportunity lies more in value rotation, rather than overall absolute index level. Of course, don't confuse short-term fluctuations in bonds, stocks, and commodities with China's secular rise.

Value Striking Back

A Global Recovery

The recovery is here. Barring further COVID uncertainties, the recovery is likely to persist, and its strength to exceed expectations in the near term. By popular demand, we have been on an extensive book tour in the past few months to meet with our readers and fans, many of them with professional investment background. Our book “***Forecast: the Economy, Cycles and Market Bubbles***” has been re-printed 10 times within 4 months since its publication.

During our book tour, the Shanghai Composite had risen slightly above the upper bound of our forecast trading range of 2,900-3,600 laid out in our outlook report last November. When we published our 2H20 outlook “***The Dragon Awaits***” last June, we first hinted at the emerging value rotation. In our 2021 outlook “***Value Strikes Back***”, we recommended value, commodities and Bitcoin, with EM, China and HK as the long-term opportunities. Obviously, market participants want our forecasts for the market’s next move. It is the question most frequently asked during our tour, and the most challenging part of our job.

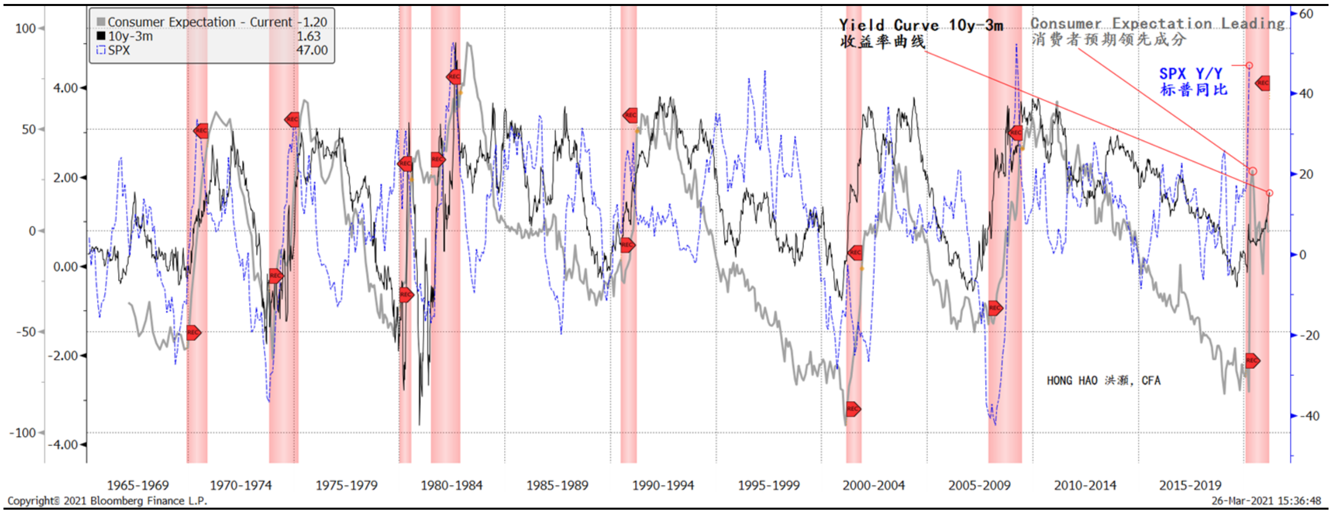
To see where China’s monetary cycle is, we compare the change in China’s RRR versus the spot price of rebar (**Figure 1**). These two variables are closely correlated. The change in RRR is plateauing, suggesting that the easing phase by cutting RRR is largely done. If the economy cools due to China’s self-imposed restraints on monetary easing and credit expansion, then RRR will be cut again. But that is not our base case. RRR is unlikely to move for some time, similar to the cycle from 2013 to 2014, as well as from 2017 to early 2018. At this stage, any cut in RRR will be seen as weakness in the economy, and will actually invite sell-off of cyclical assets.

Figure 1: Change in RRR vs. rebar suggests recovery, but commodity strength appears plateauing

Source: Bloomberg, BOCOM Int'l estimates

In the US, the recovery is also underway. We measure the forward component of the US consumer expectation versus the US treasury yield curve, as well as the performance of S&P 500 index. These important and reliable leading economic indicators are simultaneously suggesting a strong recovery (**Figure 2**). Our European indicators are pointing in the same direction (not shown here). With COVID contained as our base case, a concurrent recovery in the world's largest economies is likely to go from strength to strength. These observations are consistent with our forecasts laid out in our outlook report "***Outlook 2021: Value Strikes Back***" (2020-11-20).

Figure 2: The US forward consumer expectation, yield curve and S&P500 are all showing recovery



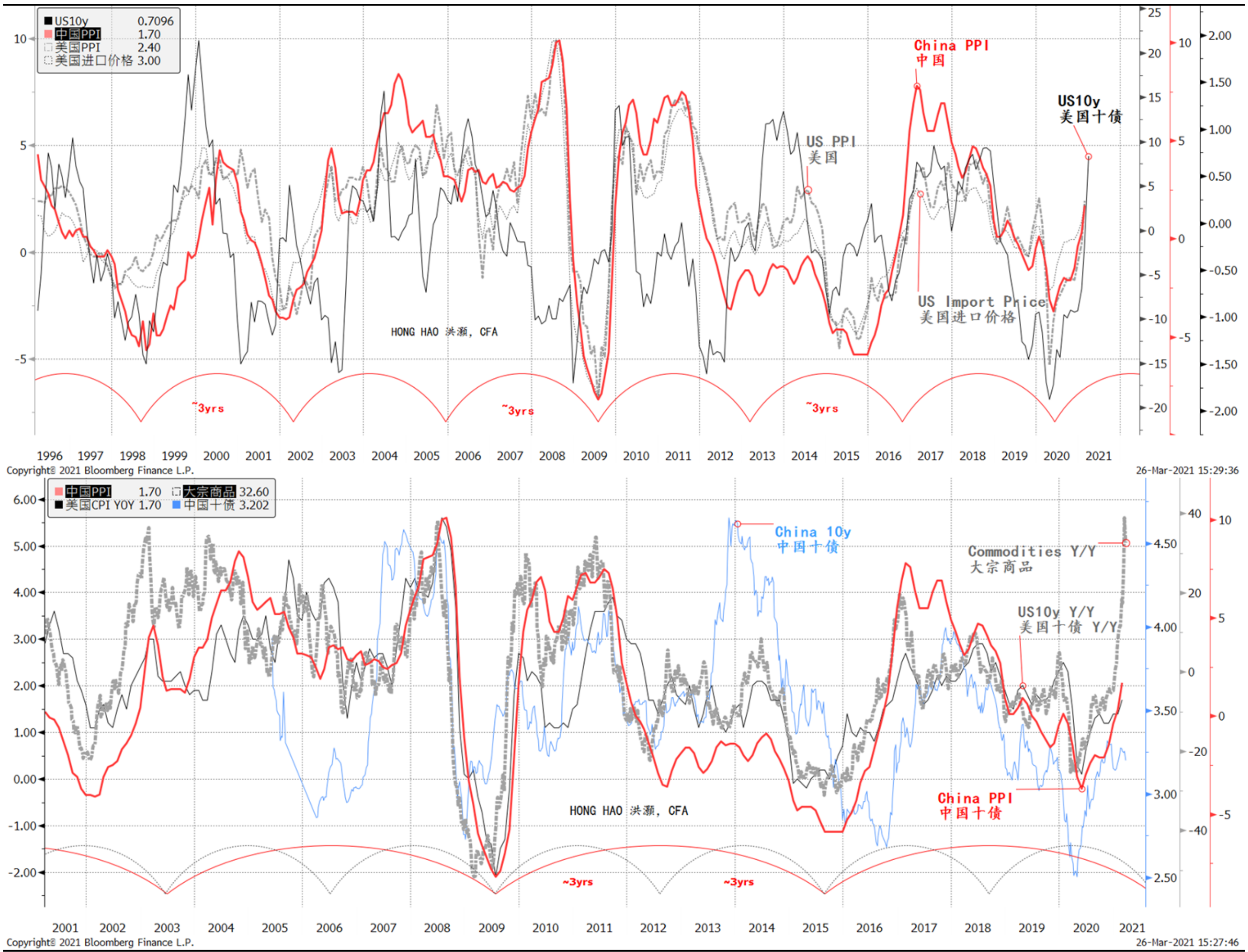
Source: Bloomberg, BOCOM Int'l estimates

The Interlocking Economies of the US and China

The US and Chinese economies are so interconnected that many of their economic variables are highly correlated. Indeed, in our eyes, there is really only one economic cycle to analyze. Back on September 3, 2018, we published a ground-breaking research paper "***The Colliding Cycles of the US and China***" on the economic cycles of the US and China, and how these cycles are intertwined to influence the market. We used quantitative methods to prove that the short economic cycles of around 3 years ripple through both economies, and how the Chinese cycle leads the US, and how these short cycles join into interim and secular cycles.

This relationship between the China and US cycles persists, and the key economic variables continue to be highly correlated. Indeed, we would argue that because Chinese exports have been an even more important input for the US economy, given the different management of the pandemic, the cycles between the two countries must now be even more intertwined. As such, China's inflation outlook, for instance, will continue to affect the US bond yields significantly. And the US bond yields, long been a global risk-free benchmark, will in turn exert its influence on the Chinese stock market. Indeed, we can see these interconnections in their full strength from the following charts (**Figure 3**).

Figure 3: The US and China's economic cycles highly intertwined; all key variables closely correlated



Source: Bloomberg, BOCOM Int'l estimates

Value Striking Back

To see where China's credit cycle is, we compare China's credit conditions with the relative performance of growth stocks versus value (**Figure 4**). We can see that credit expansion drives growth stocks' relative strength, and vice versa. We note that the strength in growth stocks started back in 2019, when China's economic cycle turned up from the nadir of the China-US trade war. But in 2020, the relative strength in growth stocks really stretched to an unprecedented height, with continuing credit expansion and the spread of COVID.

It is likely that the pandemic altered the market perception of growth stocks, many of which are internet platform companies. After all, these companies had shown earnings resilience when confronted by the rampage of COVID. The strong earnings fundamentals, the expanding credit conditions and the shifting expectations during the pandemic together were necessary conditions to germinate a "COVID bubble" in the growth stocks. The extremely low-cost internet brokers facilitate this process. But we would caution against extrapolating this growth during an unusual period.

Post COVID, the economy is recovering and no longer shrinking. In a growing economy, the relative strength of growth will wane. Or growth stocks are no longer taking market share from value stocks. And this is indeed the case now (**Figure 4**). Growth stocks will no doubt continue to grow – don't get us wrong, but the unreasonable growth expectations embedded in their valuation will likely subside – as they are now. And the COVID bubble is now deflating.

Figure 4: Credit expansion drives the relative strength of growth vs. value

Source: Bloomberg, BOCOM Int'l estimates

For the US, our quantitative analysis shows a similar "COVID bubble" – growth stocks' relative strength to value is well above historical levels, but now reverting, as the vaccination program proceeds (**Figure 5**).

We have shown in the above charts of the relationship between China's PPI cycle, commodity strength and the US 10-year yield. In the near term, China's PPI is likely to rise further, concurrent with the rise in the US 10-year yield. As such, the US bond volatility will likely increase in the coming months.

In **Figure 5**, we show that bond market volatility is inversely correlated with the relative strength of growth stocks. Growth stocks are essentially long-duration assets, as evidenced by their high valuation multiples. Intuitively, in a steady environment, it is much easier to extrapolate growth into a distant horizon. So, as bond market volatility rises, it will pressure the valuation of long-duration assets, such as growth stocks.

Figure 5: Rising bond market vol will pressure growth valuation, dragging down its relative strength further

Source: Bloomberg, BOCOM Int'l estimates

We can further show that China's cyclical sectors have outperformed, as the recovery unfolds (**Figure 6**). Indeed, the strength in the cyclical sectors may have surprised most. When we first forecasted the comeback of cyclicals in our 2021 outlook ("***Outlook 2021: Value Strikes Back***", 2020-11-20), most found it incredulous. But now that the cyclical strength has gradually become consensus, and cyclicals' strong performance seems to have reflected the economic recovery, what other market opportunities are there in the next phase of the recovery?

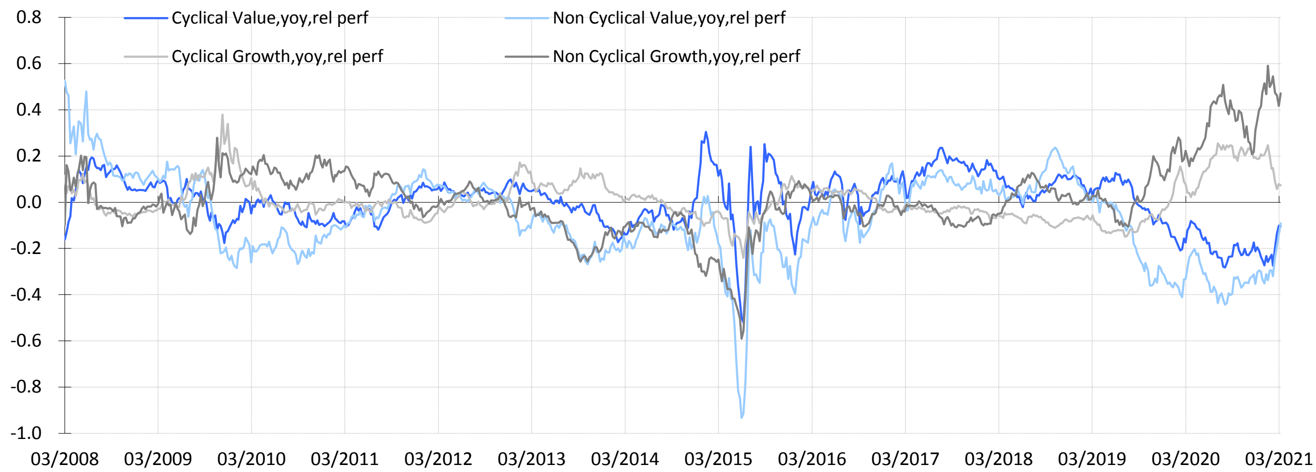
Figure 6: Cyclical sectors have outperformed, as the recovery unfolds

Source: Bloomberg, BOCOM Int'l estimates

We can further dissect value and growth into cyclical value/growth and non-cyclical value/growth. We can show that both cyclical growth and non-cyclical growth have outperformed, although their outperformance is unwinding. Meanwhile, cyclical value and non-cyclical value are reverting some of their underperformance (**Figure 7**). These observations are consistent with **Figure 5** and **6** in previous sections.

That is, even though value is striking back, its strength is still crescent. But the strength in growth stocks is ebbing. As such, the value stocks, be they cyclical or non-cyclical, will remain the best place to be in the next phase of economic recovery.

Figure 7: Cyclical and non-cyclical value is strengthening, while cyclical and non-cyclical growth is waning



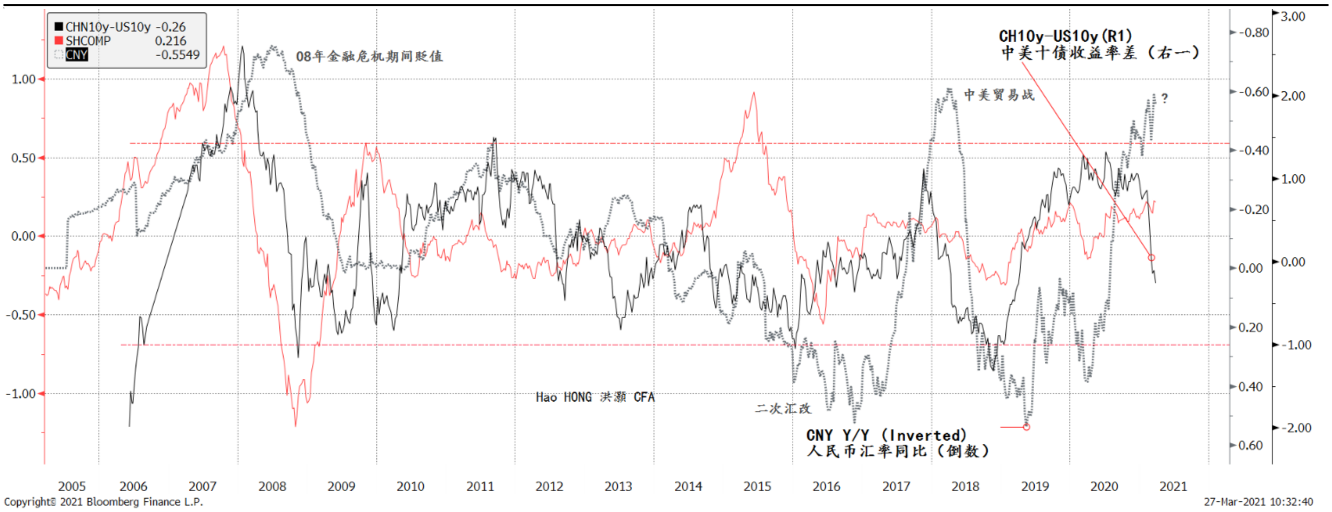
Source: Bloomberg, BOCOM Int'l estimates

Geopolitical Risks Likely to Hamper the Market

The exchange of harsh rhetoric during the recent high-level dialogue in Alaska highlighted the tension between the two great powers. Geopolitical risks abound, and RMB has been a good proxy of such risks historically. We can show that each time the depreciation of RMB coincides with political or economic risks, such as during the 2008 financial crisis, and during the 2018 China-US trade war (**Figure 8**).

Further, the weakening of the RMB tended to lead by the yield gap, which is now rapidly narrowing. The RMB depreciation is likely concurrent with a weak Shanghai Composite. Of course, currency, bond yield and the stock market are merely a reflection of the underlying economy that tends to underperform amid economic or geopolitical risks. But the ongoing recovery is likely to offset these headwinds to a certain extent.

Figure 8: Geopolitical risks abound, and yield gap is narrowing, presaging a weakening currency



Source: Bloomberg, BOCOM Int'l estimates

Overall, the market return relative to economic growth is high compared with historical trends. The YoY change in the ratio of market value (MV) to GDP tends to top out at around 7%. Above that level, it is either during the bubble years of 2007 and 2015, or during the 2009 recovery phase. Even when the YoY change in MV/GDP ratio rose above 7% after early August 2009, the Shanghai Composite stopped making new highs and lingered sideways for months before falling again in early 2010, when the PBoC started to tighten. As such, we continue to believe that the market's opportunity lies with value rotation, or a change in internal market structure, rather than the absolute index level.

Figure 9: Market return high by historical standard

Source: Bloomberg, BOCOM Int'l estimates

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