交銀國際 BOCOM International

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China Market Strategy

Outlook 2H21: Value Still Striking Back

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- China's PPI-CPI gap is approaching its historical peak last seen during the 2016 supply-side reform. It is another sign that the cyclical strength is about to crest. Concurrently, the PBoC's balance sheet expansion will likely moderate. The momentum in yield, stock price and the yuan will wane. It will be difficult to offset exogenic inflationary pressure with endogenic policies. After all, China does not have enough mineral resources to sate her demands.

  Nobody knows for sure how much further commodity prices will rise in the near term, as the US continues to strengthen. After all, topping is a process. But whether bond yield will rise further or not because of persisting inflationary pressure is irrelevant: if so, it will hurt the economy and stocks; if not, it will suggest a risk-off event amid a growth slowdown. Either way, it is not as conducive to take risk as last June and last November when we published our outlook reports.

- The outperformance of cyclical sectors is also peaking in tandem. The easiest money has been made. But value is yet to completely reverse its underperformance, both in cyclical and non-cyclical sectors. And the outperformance of China's growth stocks is still elevated relative to value, and relative to China's credit cycle. Note that cyclical does not equal value, as cyclical is defined by earnings sensitivity to economic cycles, while value is here *narrowly* defined by valuation multiples. It is just that when we made the value call last June, cyclicals were trading on depressed valuation and largely coincided with the value stocks in the market.

  If value is still striking back while cyclical strength is about to ebb, then non-cyclical value sectors such as energy, healthcare, and utilities should offer opportunities. Meanwhile, fund managers are still huddling in defensive growth stocks such as Moutai and the entire consumer and tech sectors. Consequently, positions in commodities, energy and utilities are still nearing multi-year lows. A position rebalancing alone is enough to sustain the performance in these sectors that have done well. And the allocation to these sectors hints at a defensive posture.

- The PBoC's forex fund position has been steady since the introduction of the counter-cyclical factor in setting the yuan reference rate. Portfolio inflow has been strong due to market access reform and the prospects of China. But the PBoC's recent warning on "one-sided" bet on the yuan appreciation suggests the incursion of speculative inflows. Such inflow can oblige the PBoC to expand its balance sheet to steady the yuan when inflation pressure is already high – a disruptive process that will be conducive to an asset bubble with costly consequences learned from June 2015. In China, stocks and bonds offer value in any global portfolio. Globally, value's relative performance vs. growth, and commodities are still near historical lows. The return of value and the secular rise of commodities have just begun. (for details, please refer to our special report *"**The Long Waves in Commodities: Three Centuries of Evidence**"*)

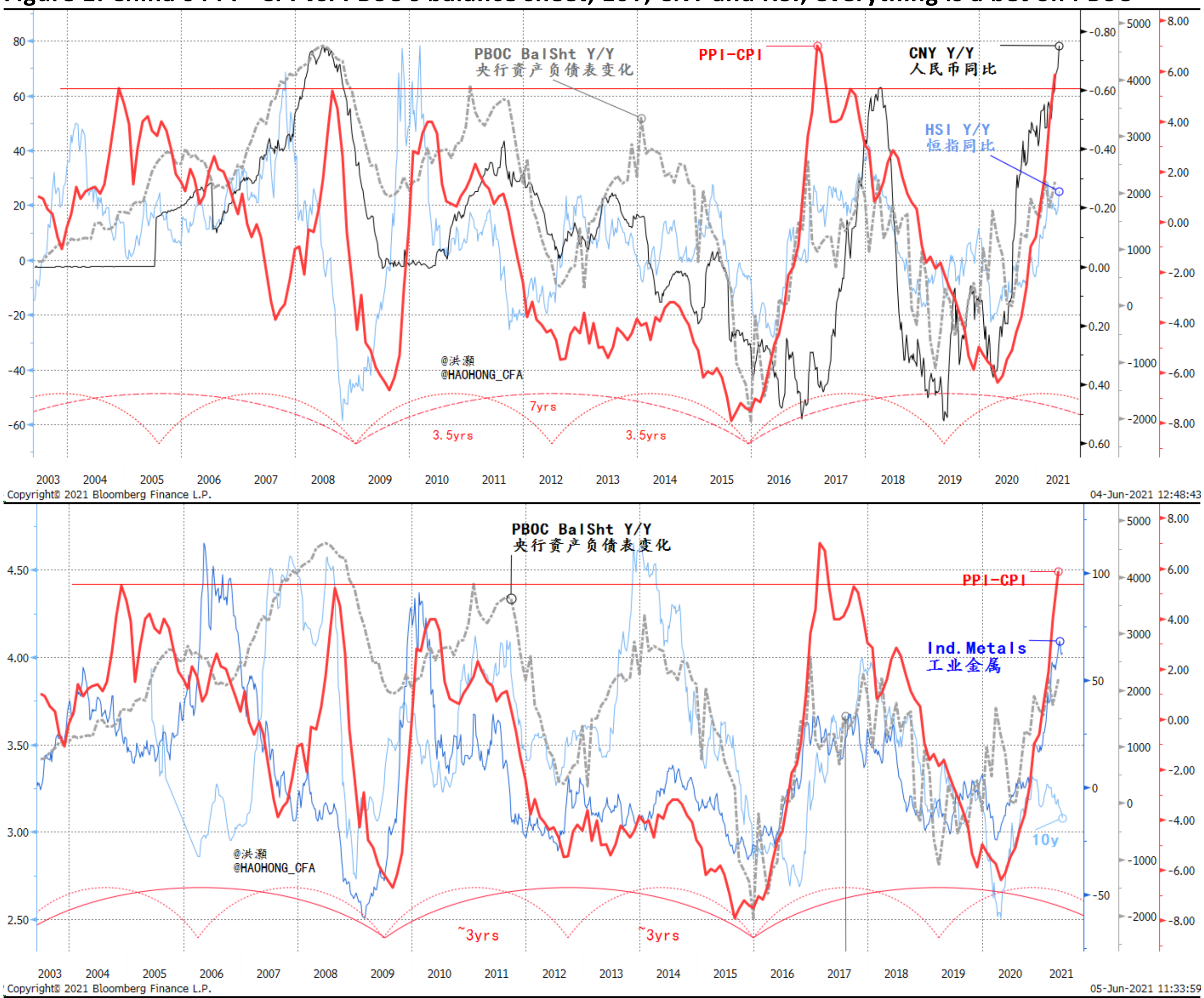
Value Still Striking Back

Cyclical strength is peaking

Is this time different?

The short economic cycle is peaking, as measured by the gap between PPI and CPI (**Figure 1**). It is approaching its historical peak last seen in 2016 during China's supply-side reform, when the reduction of excess capacity spurred a commodity rally. That said, peaking is a process. The time of cyclical peaking tends to be a transition rife with confusion, and concurrent with rising market volatility.

Figure 1: China's PPI - CPI vs. PBoC's balance sheet, 10Y, CNY and HSI; everything is a bet on PBoC



Source: Bloomberg, BOCOM Int'l

Currently, the upstream cost pressure is induced by commodities that have been rallying on compounding factors of epic global fiscal and monetary policies, supply bottlenecks around the world and economic recovery. As such, the upstream cost pressure is mostly imported.

Due to the containment of the swine flu, pork price has been falling for the past five months, suppressing China's CPI. As the hog cycle is governed by the husbandry time required for hog farming, which tends to last up to 18 months, the abundant supply of hogs will help contain China's CPI. Such diverging circumstances in up and downstream created a gap between PPI and CPI that is approaching its historic peak.

In the past, key macroeconomic variables such as the expansion and contraction of the PBoC's balance sheet, the PPI-CPI gap, the 10-year yield, stock markets (with the Hang Seng Index as a proxy), as well as the yuan exchange rate have been highly correlated (**Figure 1**).

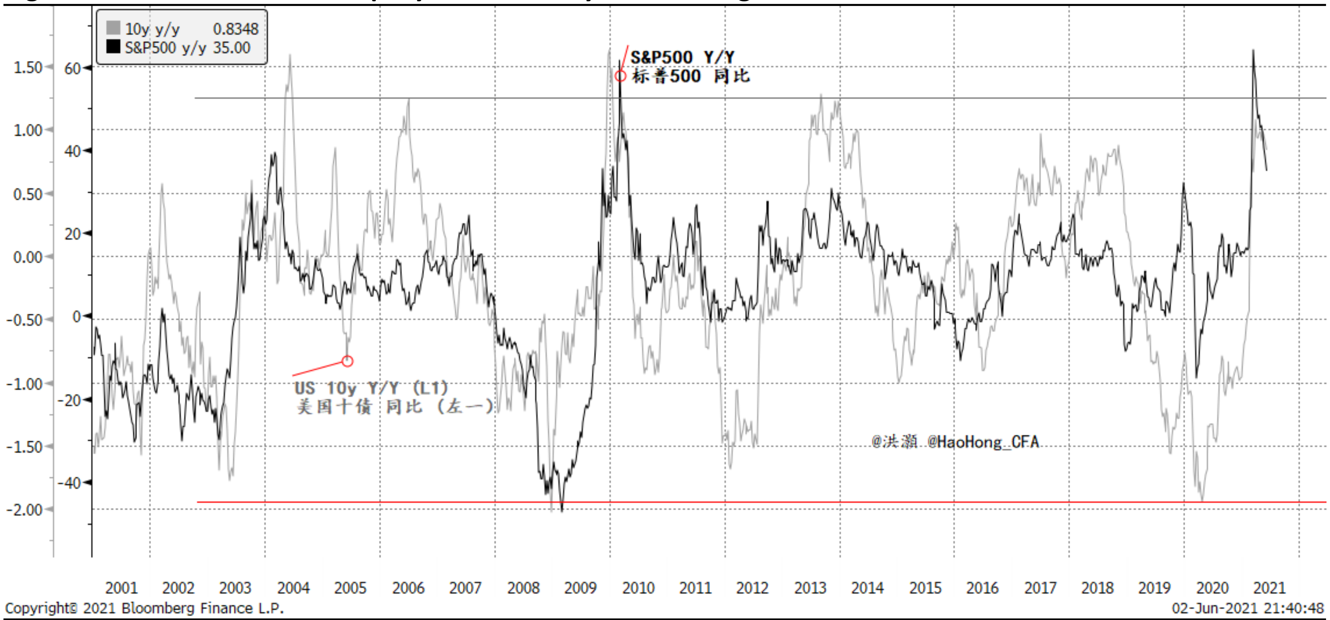
We believe that the change in the PBoC's monetary policy is the common factor that is driving the tight correlations between these important macro variables. The peaking of the PPI-CPI gap tends to coincide with the turn in the speed with which the PBoC's balance sheet changes. When the gap peaks, the central bank's balance sheet slows down its expansion, or even contracts. Such fluctuations in the central bank's balance sheet adjust the money supply in the system, inducing ebbs and flows in the economic cycle (for detailed discussions, please refer to our report "***A Definitive Guide to Forecasting China Market***" published on 20 Sep 2019, and our best-selling book "***Forecast***" published by the CITIC Press Group last year.)

Currently, the upstream costs are driven by global circumstances that are not within China's realm – unlike in 2016 during China's supply-side reform. As such, as the US recovery goes from strength to strength, and the global recovery continues as the vaccine rolls out, it is likely that the global demand for commodities will continue to rise, while the supply bottlenecks are unlikely to be resolved for some time, straining supply further relative to demand. If so, upstream cost pressure will persist and squeeze PPI and the gap even higher in the coming months.

Meanwhile, upstream costs will start to be passed to downstream, as evident in the US inflation data that produced the largest jump in four decades. But pork prices will help contain China's CPI. Regardless, such rapid rise in upstream costs will start to put a dent in economic cycle strength, as the PBoC starts to rein in inflation expectations.

Already, we are seeing China's 10-year yield start to dip. It is a baffling occurrence, given the flagrant inflation pressure. We are observing a similar development in the US market, where bond yields fail to break new grounds, but inflationary pressure is at its decade high (**Figure 2**). Regardless of whether the long yield is rising further because of inflation, or inflecting lower because of peaking cyclical strength, it is a sign of a looming risk-off event in the second half. Rising bond yield will hurt stocks' valuation, while falling bond yield will take funds away from stocks. That said, as the Fed continues its meddling, the market correction has become difficult to time since last year.

Figure 2: The return on US equity and treasury is inflecting

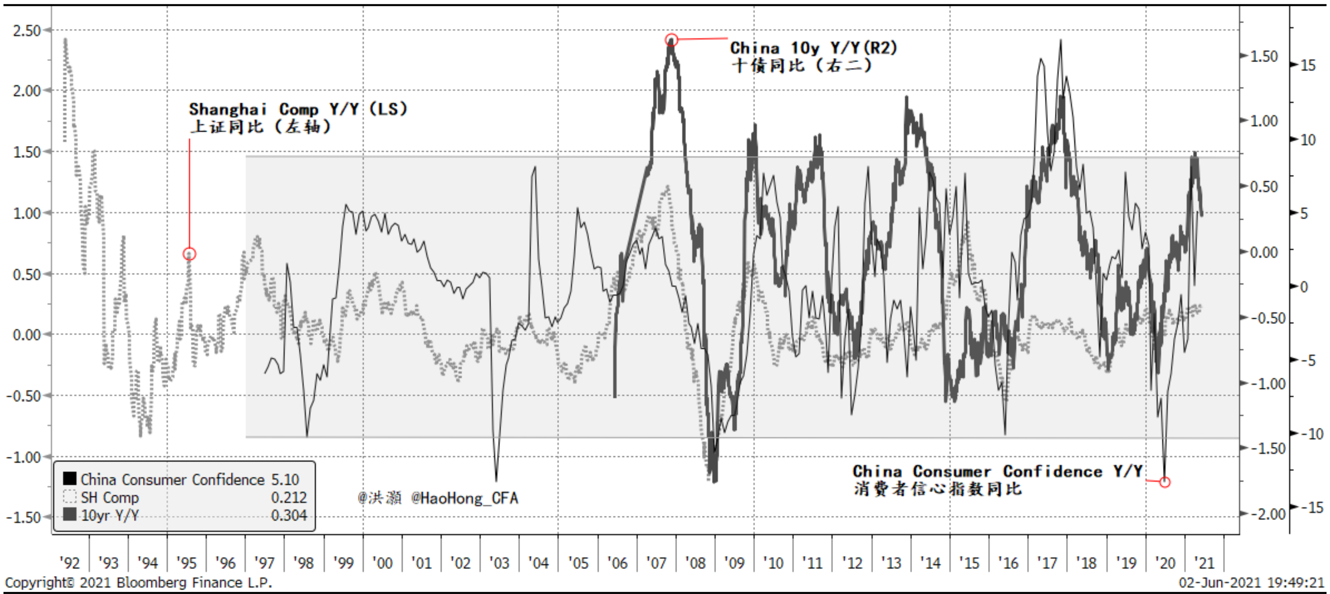


Source: Bloomberg, BOCOM Int'l

The dip in Chinese 10-year bond yield is consistent with the change in Chinese consumer confidence. Historically, bond yield and consumer confidence are highly correlated (**Figure 3**). This is because both bond yield and consumer confidence are reflections of the underlying strength in the economy.

When economic growth decelerates, bond yield will fall to reflect the slowdown, and consumers will be less confident to spend. With bond yields at current levels, higher yields will hurt growth, and yields will eventually back down. And lower yields reflect waning confidence, and hence lower consumption growth and slower inflation.

Figure 3: Historically, bond yield and consumer confidence are highly correlated



Source: Bloomberg, BOCOM Int'l

Cyclicals vs. Value: value continues to reflate

As the PPI-CPI gap is peaking, so is the relative performance of the cyclical sectors. Historically, the gap and cyclicals' relative performance have been highly correlated (**Figure 4**). This is understandable, as the strength of the upstream sectors shows through the PPI-CPI gap, cyclicals outperform.

We are now confronted with the question of what to do with cyclicals, given that the cyclical strength is peaking, and we have been among the first and the most vocal advocates of buying into cyclicals on the prospects of a global recovery since last June.

In our recent special report "***The Long Waves in Commodities: Three Centuries of Evidence***" published on 25 May 2021, we have constructed a proprietary commodity index to identify the long wave structure in commodities. In that paper, we posit that commodity is in its fourth long wave of the past three centuries, and its absolute price level is set to explode higher in the coming years. Even so, we cannot trade the long waves spanning decades or even centuries within a short economic cycle that typically lasts around three years.

The continuing US recovery can create further demand to push commodity prices higher, but its momentum is peaking. Even if commodity prices rise further, its impact on company earnings is likely to have been reflected in analysts' expectations. As such, on the margin, the relative performance of cyclical stocks is likely to wane. Such waning outperformance is likely to be caused by diverging performance within the cyclical sector, with the leaders of the sector faring much better than the laggards. Regardless, we are likely to see some profit-taking within this space, after a strong rally that has seen many cyclical stocks surging multiple times since last June.

Figure 4: Cyclical sector relative performance is inflecting from its peak, together with PPI-CPI

Source: Bloomberg, BOCOM Int'l

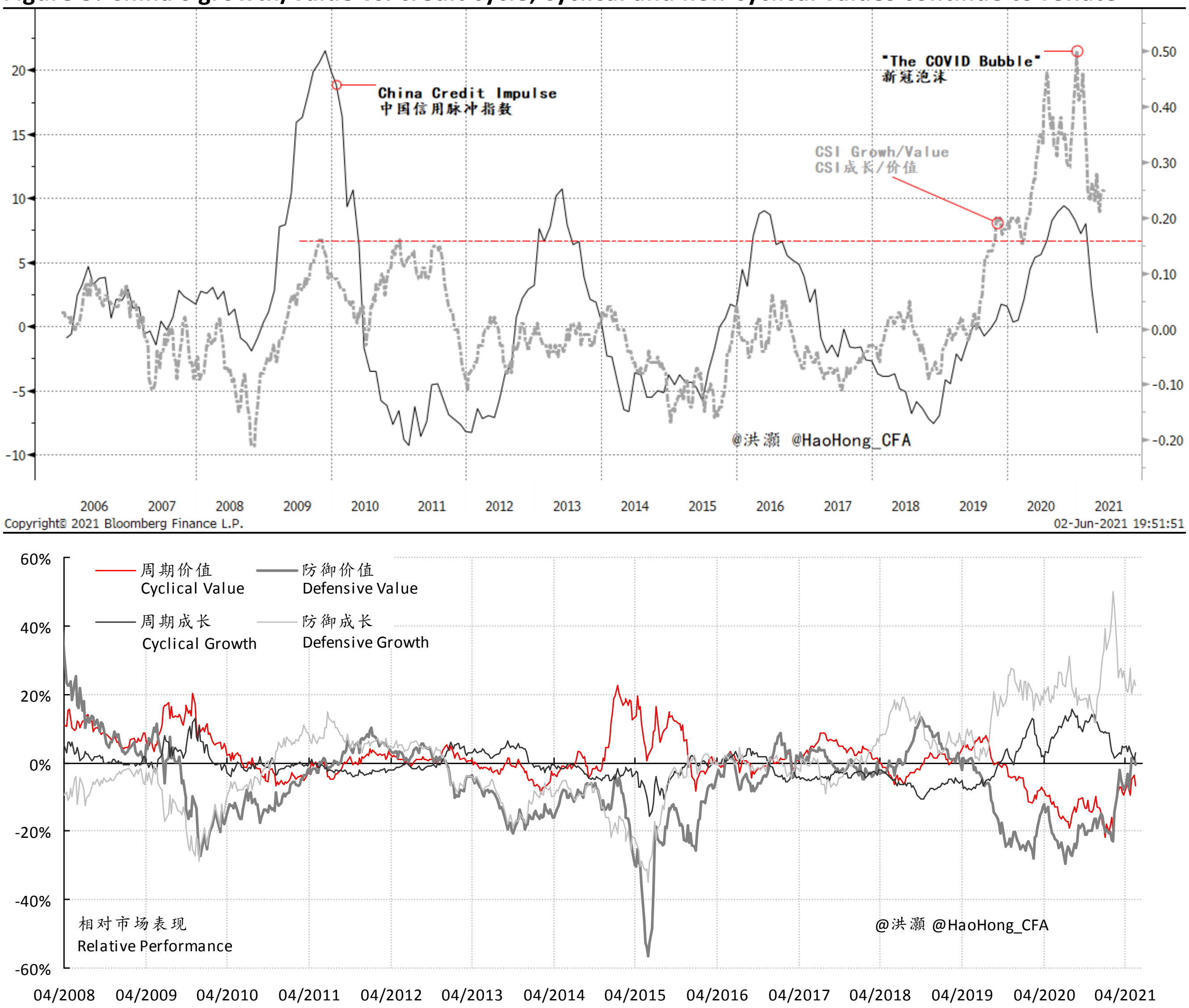
There is also much confusion about cyclicals versus value. Many cyclical stocks are misconstrued as value stocks, and vice versa. When we wrote our report "***Outlook 2021: Value Strikes Back***" on 20 Nov 2020, we had carefully defined cyclicals versus value – cyclicals are classified regarding their earnings sensitivities to economic cycles, while value is defined by its valuation multiples in the narrowest sense. That is, the definition of cyclicals is absolute, while that of value is relative. The constituents in the cyclical space are fixed, while stocks can shift in and out of the value domain depending on the calculation of their valuation.

In this report, we narrowly define value using valuation multiples, even though in real life, value investing is much more encompassing and cannot be simply defined by valuation multiples. (Please refer to my name-verified Weibo for video recordings of my three-month book tour late last year. These videos recorded my in-depth discussions with live and online audiences during my tour regarding what value really is.)

At the time of our cyclical call 12 months ago ("***Outlook 2H20: The Dragon Awaits***" on 10 Jun 2020), cyclicals were of depressed valuation. The consensus then was fixated on the tech stocks, ignoring the return prospects of the cyclical stocks. Simply put, at that moment in time, cyclical is value, and value is cyclical. "Value Strikes Back" really means "Cyclical Strikes Back". And cyclical sectors and commodities are the best-performing stocks and asset class year to date. But now we have arrived at a cyclical inflection point.

To see how value is performing, we further segregate cyclical and defensive sectors into cyclical value, non-cyclical value, cyclical growth, and non-cyclical growth. Not surprisingly, both cyclical and non-cyclical values continue to improve relative to growth, even though growth is still stubbornly high (**Figure 5, upper**). As China's credit cycle continues to decelerate, or the PBoC's balance sheet expansion slows, growth will continue to deflate relative to value. This is different from the US, where the deceleration of growth has been far more pronounced than in China. As **Figure 4** argues against cyclicals, and **Figure 5** against growth, the intersect leaves us with non-cyclical value (**Figure 5, lower**). Non-cyclical value includes energy, healthcare and utilities. We believe that cyclical value should also represent some opportunities for bold investors. But as said earlier, the performance within the cyclical sectors is likely to diverge to test stock-picking skills. Cyclical value now mainly includes financials, consumer discretionary, and materials.

Figure 5: China's growth/value vs. credit cycle; cyclical and non-cyclical values continue to reflate



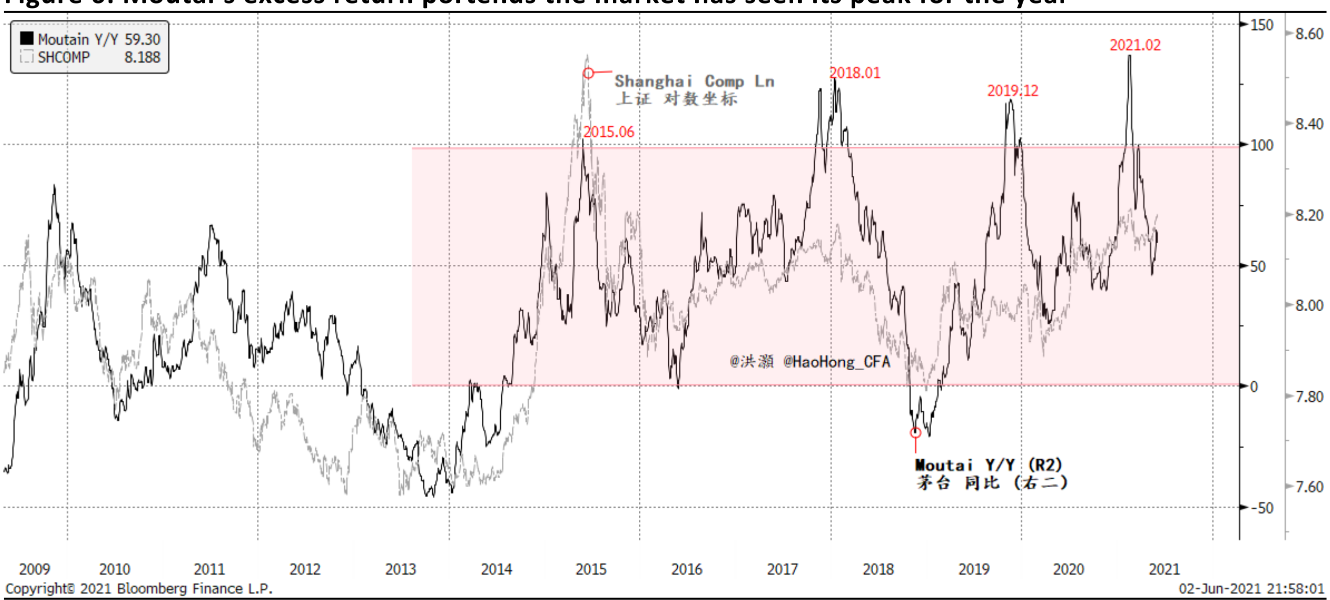
Source: Bloomberg, BOCOM Int'l

The best representative of a defensive-growth stock is arguably Moutai, China's legendary national baijiu. Moutai has been generating consistent earnings growth over the years, and it is one of the largest market cap and highest value consumer staples stocks in China. Because of its high valuation multiple and consistent growth profile, it is defined as a defensive growth stock.

Interestingly, Moutai's excess performance can be used as a good market timing indicator. In the past, the market crested every time Moutai's excess performance peaked (**Figure 6**). It is likely because Moutai is one of the largest index components, and is widely held by Chinese investors and increasingly so by foreign investors. Moutai's excess performance has peaked in February this year. So the high point in the Shanghai Composite in February can be the high point for the year, if history is a guide.

Moutai's performance, as well as the entire baijiu sector's performance helps to explain why the performance of growth stocks in China refuses to back down like its US counterparts. Fund managers' adamant affection towards this stock makes the return of value in China a more arduous journey.

Figure 6: Moutai's excess return portends the market has seen its peak for the year



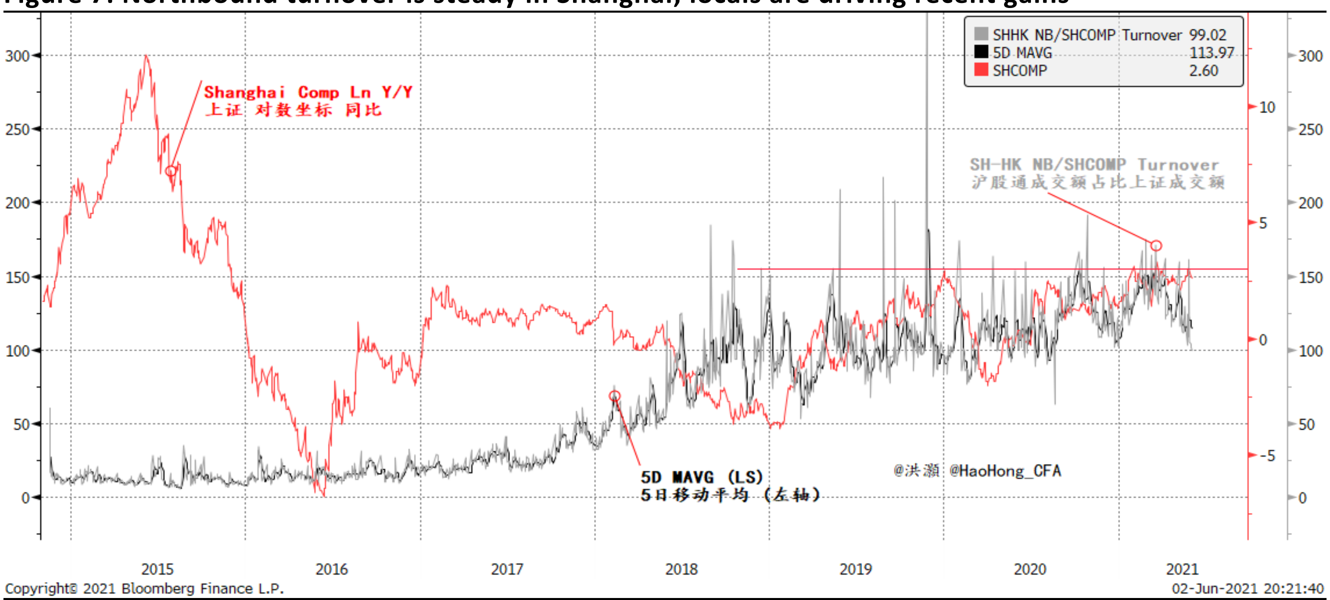
Source: Bloomberg, BOCOM Int'l

China's appeal to foreign capital

There has been a brief but strong rally in the Chinese market recently. It is nothing new for a Chinese market veteran. Pundits believe that foreign investors have been buying up the market, pointing to the increased inflow via the Connect program. Yet, our data analysis shows that, as a percentage, northbound turnover in the overall market turnover has indeed declined.

If we think of foreign capital as the "smart money" and the local as the "dumb" money, as implied by the enthusiasm of the pundits toward northbound flows, then northbound turnover percentage of the overall market is a relative indicator of foreign sentiment vs. local. Our analysis shows that, if the percentage is low, as it is now, or the foreign capital is less excited than the local, then market outlook is clouded, and vice versa (**Figure 7**).

Figure 7: Northbound turnover is steady in Shanghai; locals are driving recent gains

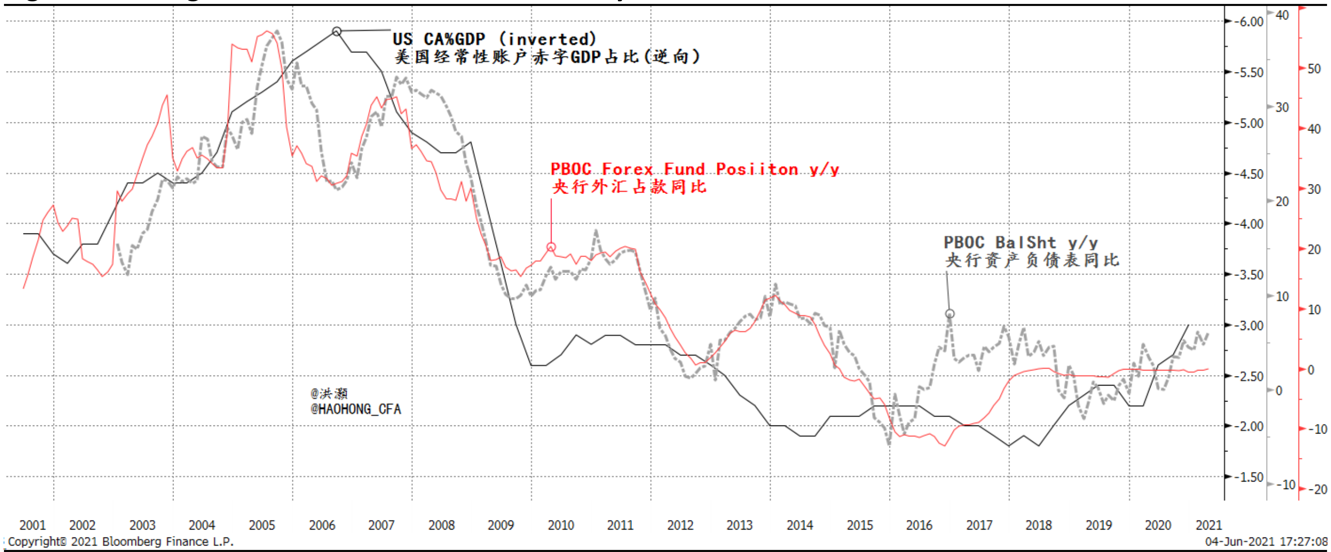


Source: Bloomberg, BOCOM Int'l

But we shall not dismiss the importance of foreign capital. As China opens up, foreign capital is attracted to China by her attractive government bond yield with strong credit standing, as well as the abundant opportunities in her stock market.

Indeed, since China joined the WTO in 2001, foreign capital has started to flow into China via China's current accounts, as the rest of the world, especially the US, buys China's exports. Consequently, the PBoC's balance sheet has been a mirror of US current account deficit. The more the US buys, the larger the current account deficit, and thus the greater the demand for the PBoC to sell the yuan and to recycle the dollar into its account of forex funds position (**Figure 8**).

Figure 8: Change in PBoC balance sheet inversely mirrors US current account deficit



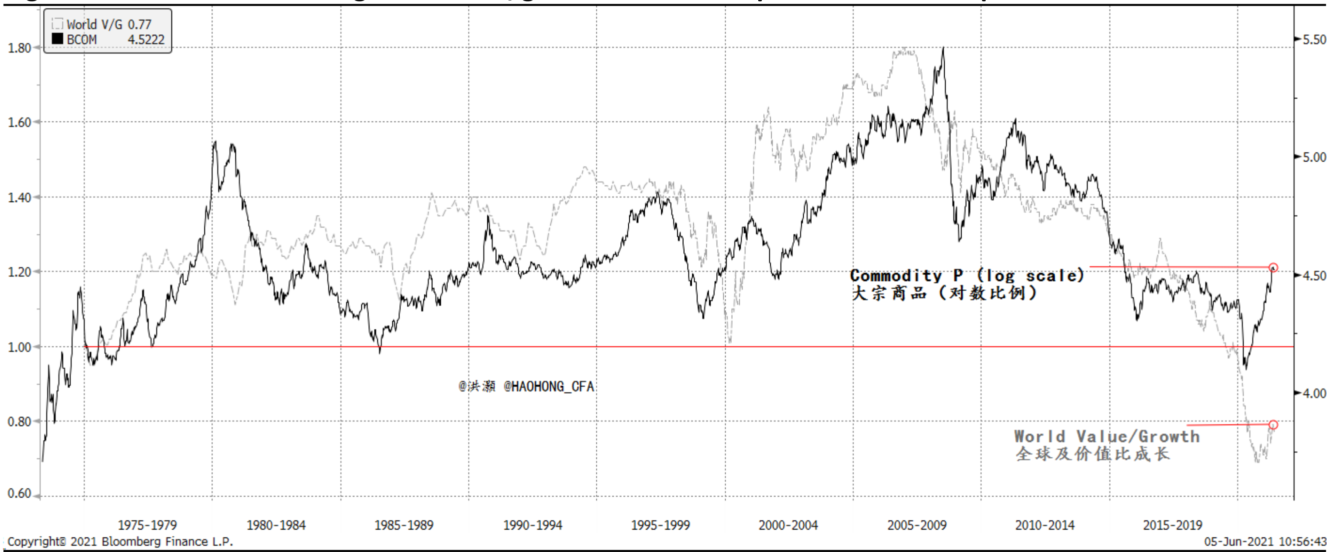
Source: Bloomberg, BOCOM Int'l

Since the forex reform in August 2015 and the introduction of the counter-cyclical factor in exchange rate reference setting, the forex fund position on the PBoC balance sheet has remained steady. It is evident that the yuan exchange rate is largely determined by the market, and that forex funds in commercial channels are enough to meet typical exchange demand.

The yuan's recent strength, as well as the PBoC's recent warning against speculating on "one-sided" appreciation of the yuan, suggests that there must have been speculative forex inflows. If such inflows persist unfettered, the PBoC may be forced to expand its balance sheet again, in the face of inflation headwinds. Such inflows will put further upward pressure on the yuan, undermining China's export strength and obliging the PBoC to sell more yuan to keep the currency steady. Meanwhile, the capital market will be confronted by the risk of asset bubble that will prove to be too costly in the end.

Longer term, an orderly market will continue to attract foreign capital to China, providing an important source of value to foreign funds. After all, the country's value stocks are still substantially undervalued relative to growth. Globally, the return of value, and commodities' secular rise, are just starting (**Figure 9**).

Figure 9: Commodities and global value/growth at the inception of secular uptrend



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