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China Market Strategy

This Christmas, Hong Kong in Deep Value

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"There is prodigious strength in sorrow and despair." – Charles Dickens, A Tale of Two Cities

Why has Hong Kong underperformed throughout 2021? More importantly, why has Hong Kong underperformed Shanghai, despite both being important markets of China? Indeed, all off-shore Chinese indices have underperformed those on-shore, such as Chinese ADRs, Chinese internet companies, and the Hang Seng Tech index. After all, these indices are supposed to reflect the fundamentals of the Chinese economy.

In 2021, the Chinese economy has decelerated, but its monetary policy has diverged from that of Western central banks. The slowdown can be seen in macroeconomic data across the board, such as VAI, PMI, and FAI, amongst the others. And the Hang Seng peaked around February, in tandem with the macro slowdown. Yet, Shanghai has remained resilient, eking out small gains for the year and diverging from the Hang Seng's downtrodden trend (**Figure 1**).

Some cited tightening internet regulation as the cause. True - the leading internet platform companies are listed offshore, and their underperformance has contributed to the Hang Seng's mire. Indeed, last November when we published our 2021 outlook, we called the Chinese tech firms a "bubble", urging investors to avoid them and to long commodities instead. But what about those leading Chinese consumer and healthcare companies listed in Hong Kong, which are not regulated but also performed poorly? As such, we believe tightening regulation is only part of the story.

Figure 1: The HSI bears the brunt of China's slowdown, but not Shanghai.

Source: Bloomberg, BOCOM Int'l

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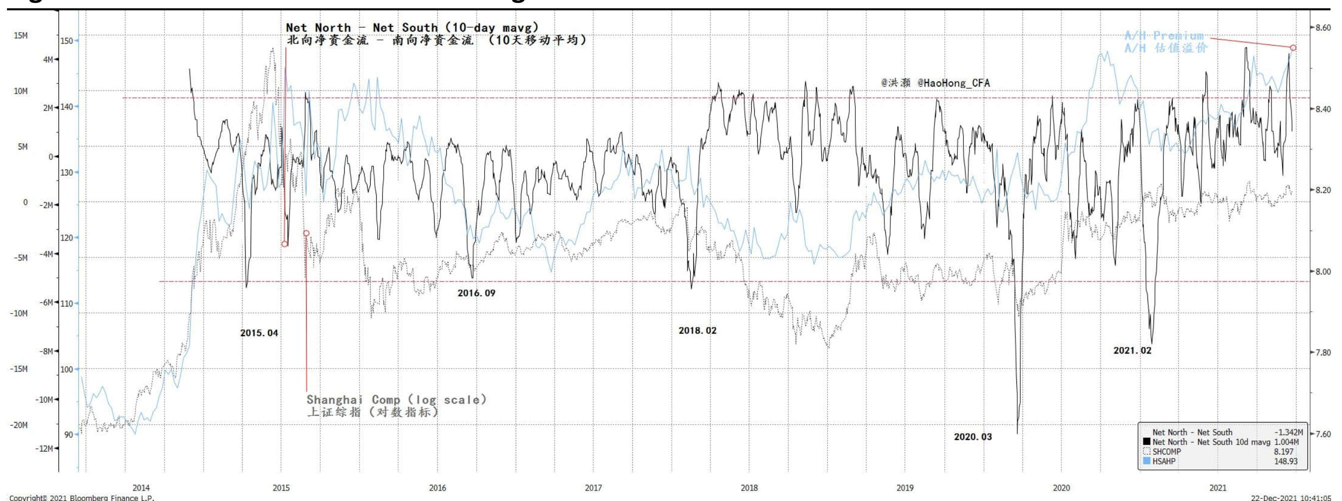
One of the most notable characteristics of the Chinese economy in 2021 is the persistent strength in Chinese exports, and the accumulation of China's current account balance back to a height not seen since late 2007 – the halcyon days of Chinese exports after China's accession to WTO. While the strength in Chinese exports has supported China's growth when COVID-19 is still ravaging the global economy, its endurance has surprised every single economist we know.

In our 2022 outlook "***Shadow Fed Tightening***" published on November 15, we have discussed in detail how export strength has translated into surging forex deposit in Chinese commercial banks, and how this accumulation of US dollar liquidity correlates closely with risk asset prices in China. Given the surprising strength in Chinese exports amid a world that is re-opening in 2021, some speculative capital must have flowed into the Chinese market this year, bidding up stock prices and making the market blind to the decelerating fundamentals. We believe this is the reason why the PBoC had raised the forex RRR twice this year. Last time the PBoC made such moves was in May 2007.

The other time we saw market diverging from weakening fundamentals was in the summer of 2015. That is, the strength of China's current account at the moment is more than just a reflection of the relative relationship between Chinese production and US consumption. Foreign capital's influence in China's onshore market can also be seen in the net northbound flows, which have been pushing the top end of its historical range (**Figure 2**).

And gullible domestic news headlines have been excited about these epic northbound flows. While these inflows can support the onshore market, their sudden outflow can pressure stock prices, especially at critical market disarray. Capital inflow is a double-edged sword – no wonder over the weekend the CSRC stopped Hong Kong brokers from opening trading accounts for mainland investors.

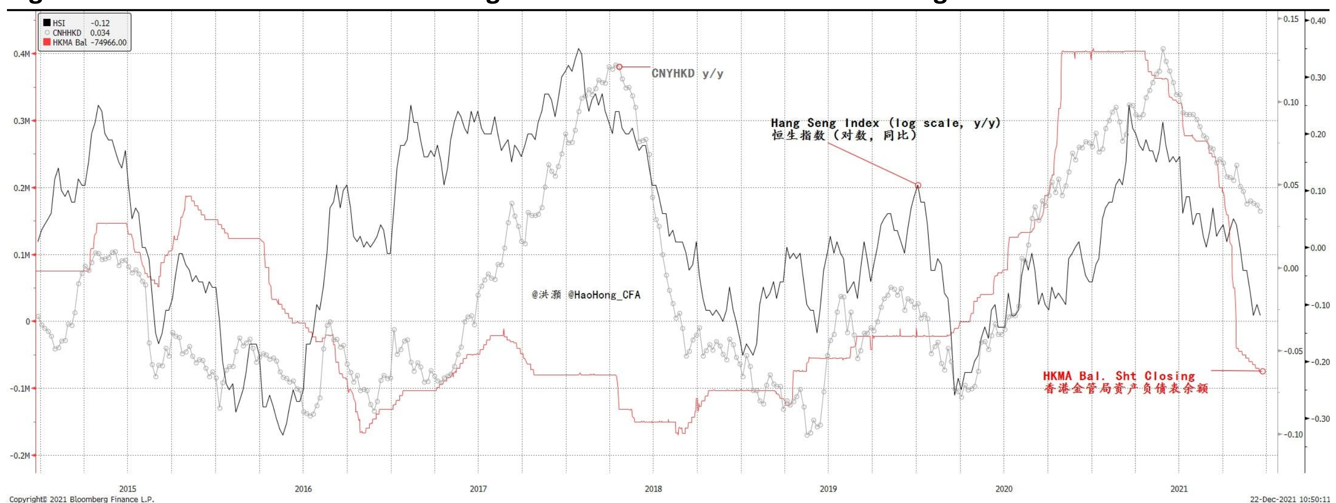
Figure 2: Northbound net flows receding from extreme.



Source: Bloomberg, BOCOM Int'l

The relative liquidity abundancy between on- and off-shore Chinese markets can also be seen in the cross-currency rate between the HKD and the CNY. The CNY has been strengthening all year till recent months, after the PBoC significantly lower the CNH reference rate. Meanwhile, the HKMA has been reducing its aggregated balance sheet position, and thus reducing liquidity in Hong Kong. This is a prudent move before the Fed finishes QE and starts raising interest rate in 2022. The Hang Seng unfortunately is the sacrificial lamb in this process (**Figure 3**). That said, the most rapid reduction of the HKMA's balance sheet position has been done, and thus the pressure on the HSI should start to alleviate.

Figure 3: The HKMA has been reducing its balance sheet. But most damage has been done.



Source: Bloomberg, BOCOM Int'l

In sum, the PBoC can afford a different monetary path in 2021, diverging from her Western counterparts, because there is abundant liquidity in the Chinese market. The ample liquidity can be seen in falling interest rate in domestic market, surging forex deposits, strong cross-border capital flow and historic northbound net flows.

The unusual strength in Chinese exports and the CNY, as well as the forex inflow, suggest that some speculative capital flow must have disguised as trade flow to enter the Chinese domestic market. It is the reason why the PBoC has taken precautions to raise forex RRR and guided the CNY reference weaker, and why the CSRC stopped Hong Kong brokers from opening accounts for mainland traders.

As China's capital flow is still tightly regulated, it has created an insulated haven from the volatility in the foreign market, and from the impact of China's hawkish regulation on many of its domestic sectors. Meanwhile, the offshore Chinese stocks have borne the brunt to reflect the domestic policies, as well as a shrinkage in offshore liquidity. This dichotomy in liquidity conditions is the reason why in 2021, the offshore Chinese market has been diverging significantly from the onshore market. But will it last?

By now, under the double whammy of shrinking liquidity and domestic hawkish regulation, Hong Kong has sunken into deep value territory. Our allocation model is showing strong value in portfolio allocation towards Hong Kong – like the periods of Asian Crisis and Russian Default, 9-11 in 2001, the subprime crisis in 2008, the burst of market bubble in June 2015, and the epic COVID selloff in March 2020 (**Figure 4**). China's relationship with the US remains delicate and represents an element of uncertainty that would be difficult, if not impossible, to price. But at these depressed levels, valuation must have at least reflected some of the uncertainties. Bottoming is a treacherous process, yet great gifts from Santa are delivered through a long and dark chimney on a night of frightful weather outside.

We wish you and your family a Merry Christmas and a Happy New Year!

Figure 4: The Hang Seng is showing deep allocation value.

Source: Bloomberg, BOCOM Int'l

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