5 October 2018

Strategy - Hong Kong

A Longer Darkness Before Dawn

Stocks Covered: 80
Ratings (Buy/Neutral/Sell): 50/22/8

Hong Kong's stock market is still factoring in the probable slowdown of China's export and manufacturing segments. While a turnaround is not likely to occur in 4Q, we believe China will roll out more supportive measures to mitigate the pains in the near term. These include loosening funding channels, potential individual tax cuts, and a more neutral monetary policy. We pare down our HSI trading range to 25,000-27,000pts (-0.5 to -1 SD), as its valuation is set to stay sluggish. We suggest focusing on sectors with favourable policy supports, such as infrastructure and construction. We also suggest that investors buy on dips selectively, on Tencent and China property developers.

Fixed asset investments (FAI), consumption and a neutralised monetary policy to the rescue. As the US imposed new tariffs on USD200bn of Chinese imports, which took effect on 24 Sep, China's leading indicators confirm that the trade war is likely to cool down activity in the manufacturing and export sectors. Whilst China's YTD exports look unaffected, it was mainly thanks to Chinese exporters front-loading their orders.

We expect China to roll out more supportive measures in the coming months:

i. Loosening funding channels of local governments to finance FAI;

ii. Potential reduction in individual tax rates to stimulate consumption;

iii. A more neutralised monetary policy to channel more funding into the real economy, micro businesses, and small and medium enterprises (SMEs).

Sluggish valuation amidst wariness over an economic slowdown. China's trade dispute with the US is unlikely to be resolved in 4Q, given the hawkish stance of the leaders of the two countries. Together with the concerns on the slowdown of economic growth and CNY depreciation, investors may remain sceptical and adopt a wait-and-see attitude towards China's incentives to offset the economic downturn. We expect the HSI to remain sluggish and revise down the trading range to 25,000-27,000 (-0.5 to -1SD). Signs of a turnaround are not likely to emerge ahead of the mid-term election in the US on 6 Nov.

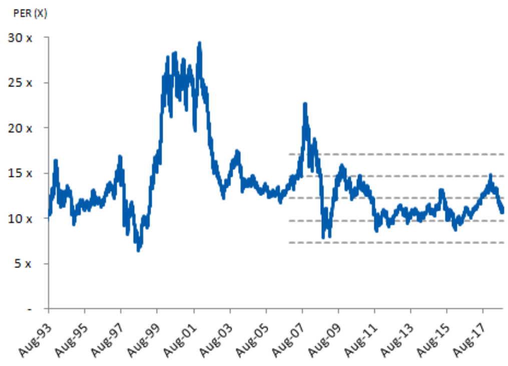
Focus on infrastructure sector with favourable policy backdrops. Given the cautious market sentiment, we suggest that investors focus on sectors with a favourable policy backdrop. We like the infrastructure and construction players and, in particular, transportation names, ie China Railway Group (390 HK, BUY, TP: HKD7.97) and China Railway Construction (1186 HK, BUY, TP: HKD12.50).

Buy on dips selectively on Tencent and property developers. We like Tencent's (700 HK, BUY, TP: HKD450.00) indirect exposure to online sales. Coupled with its recent pullback since February's high, concerns over its gaming segment has almost been priced in.

Also, investors can hunt for bargains in China's property sector, given its undimmed fundamental outlook. We believe the cooling land market works well for developers to replenish their landbank at favourable costs. Furthermore, home buyers' appetite remains resilient, given the policy controls on presale ASP where primary properties are selling at a discount to secondary properties. Finally, the sector should benefit from any potential loosening of the monetary policy.

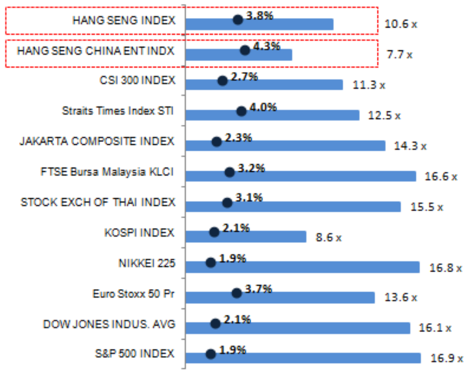
Top Picks	Target Price
China Railway Construction (1186 HK) – BUY	HKD12.50
Tencent (700 HK) – BUY	HKD450.0
Shimao Property (813 HK) – BUY	HKD30.80

HSI to trade within 25,000-27,000pts in 4Q18



Source: Bloomberg, RHB

Major indices' 12M forward-rolling P/E & dividend yield



Source: Bloomberg, RHB

Company Name	Rating	Price	Target	% Upside (Downside)	P/E (x) Dec 19F	P/B (x) Dec 19F	Yield (%) Dec 19F
AGRICULTURAL BANK OF CHINA	BUY	HKD 3.64	HKD 5.80	59.3	4.7	0.6	6.5
TENCENT	BUY	HKD 308.40	HKD 450.00	45.9	24.5	8.0	0.1
SHIMAO PROPERTY HOLDINGS	BUY	HKD 17.84	HKD 30.80	72.6	3.8	0.7	10.6
CHINA RAILWAY CONSTRUCTION	BUY	HKD 10.32	HKD 12.50	21.1	5.0	0.7	3.1
CHINA RAILWAY GROUP	BUY	HKD 7.70	HKD 7.97	3.5	7.2	0.9	2.0
GREAT WALL MOTOR CO	SELL	HKD 4.74	HKD 3.70	(21.9)	4.7	0.6	6.4

Source: Company data, RHB

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Focusing On Rescue

Trade war derailing exports and, potentially, economic growth

China's trade surplus with the US grew to a record high of USD31.5bn in August (July: USD28.1bn), thanks to China exporters front-loading their export orders and a relatively robust US economy. However, we see evolving uncertainties in China's export growth in 2019 and beyond, as total US tariffs applied to China amounted to USD250bn worth of goods – equivalent to 57.7% of China's exports to the US in 2017 – gradually kick in.

Leading indicators already confirm that the trade war is likely to cool down the growth of China's manufacturing and export sectors. Last month, Caixin/Markit's Manufacturing Purchasing Managers' Index fell more than expected to 50.0, from 50.6. The neutral 50-pt mark divides expansion from contraction on a monthly basis. September was the first time China's manufacturing sector had not seen expansion since May 2017. Similarly, new export orders contracted for the fourth straight month, with the sub-index falling to 48.0 from 49.4 in August.

Taken together, we expect China to roll out more supportive measures in the coming months. These should include:

i. Loosening funding channels of local governments to finance FAI;

ii. A potential reduction in the individual tax to stimulate consumption;

iii. A more relaxed monetary policy to channel more funding into the real economy and make financing more accessible and affordable for micro businesses and SMEs.

Figure 1: Summary of consensus economic forecasts

	2015	2016	2017	2018F	2019F
Real GDP growth (%YoY)	6.9	6.7	6.9	6.6	6.4
Nominal export growth (%YoY)	-2.8	-7.7	7.9	10.6	9.0
Nominal import growth (%YoY)	-14.1	-5.5	15.9	17.7	7.0
Trade balance (CNY bn)	3686.5	3347.3	2813.9	3417.0	4620.0
Industrial production growth (%YoY)	6.1	6.0	6.6	6.4	6.3
Fixed asset investment	10.0	8.1	7.2	5.6	5.5
Retail sales growth (%YoY)	10.7	10.4	10.2	9.3	10.2
M2 (%YoY)	13.3	11.3	8.2	8.5	8.2
CPI (%YoY)	1.4	2.0	1.6	2.2	2.6
PPI (%YoY)	-5.2	-1.4	6.3	3.6	1.9
USD/CNY	6.76	6.78	6.53	6.90	6.57

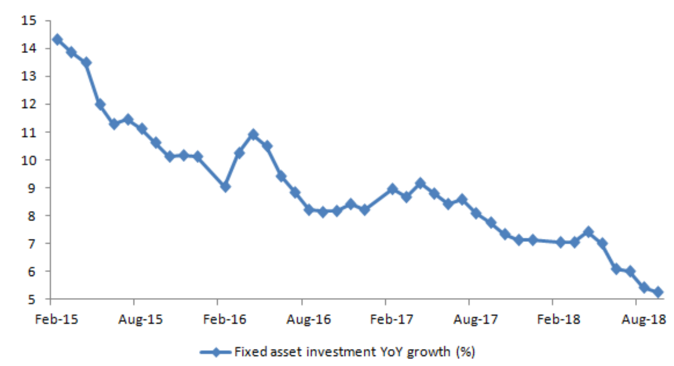
Source: WIND, RHB

Infrastructure seeing supports

According to FT Confidential Research, local governments that appear to have been given a break from cleaning up their funding from local government-financing vehicles are issuing over CNY740bn of special bonds to fund more infrastructure spending, on top of CNY2.1trn in regular borrowings.

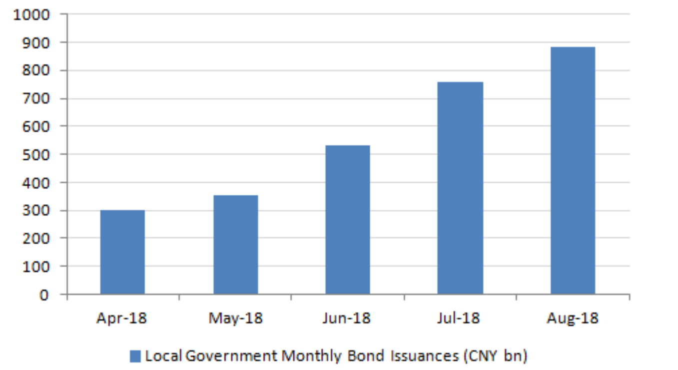
Meanwhile, National Development and Reform Commission (NDRC) also indicated that it will roll out new measures to attract capital for infrastructure spending, and specifically in areas such as agriculture, poverty alleviation, transportation and environmental protection. These together should stimulate the growth of infrastructure investments and drive FAI growth to our estimate of 7.2% YoY for 2018F. For 8M18, infrastructure investments increased 4.2% YoY, down from +5.7% YoY for 7M18.

Figure 2: Potential rebound in FAI despite the declining trend



Source: NBS, WIND, RHB

Figure 3: Local governments' bond issuances have been gradually increasing since April



Source: CEIC, NBS, WIND, RHB

Potential individual tax cut will stimulate consumption

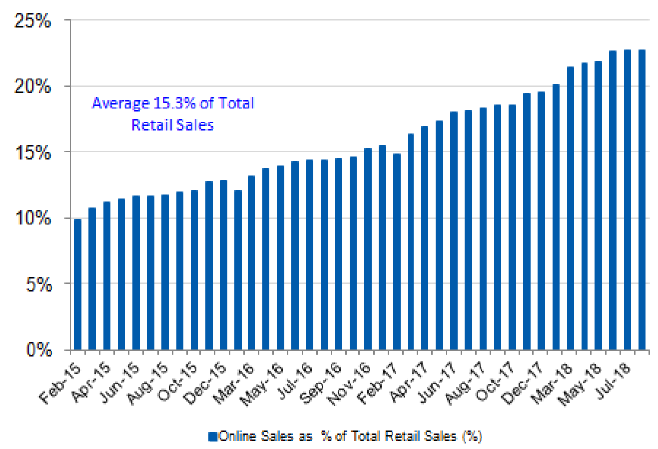
As at 8M18, retail sales increased 9.3%, maintaining the same growth rate for 7M18. Among all consumption goods, automobiles are the only consumption good that posted declining YoY sales growth rate for 8M18, to 1.3% from 2% in 7M18, or declined from 9.7% for 2M18.

As automobiles are the most luxurious consumption goods other than properties, the change in auto sales trends warrants attention, in our view. The decelerating auto sales might imply that purchasing power of consumers is declining, despite a still-resilient labour market. The labour demand-supply ratio held steady at 123% as at 1H18, and the unemployment rate stood at 5%, vs 5.1% in July.

Despite all that, we remain positive on retail sales growth as we see encouraging signs from the Standing Committee of the National People's Congress, which is considering a revision of the personal tax bill to improve consumers' purchasing power and stimulate spending.

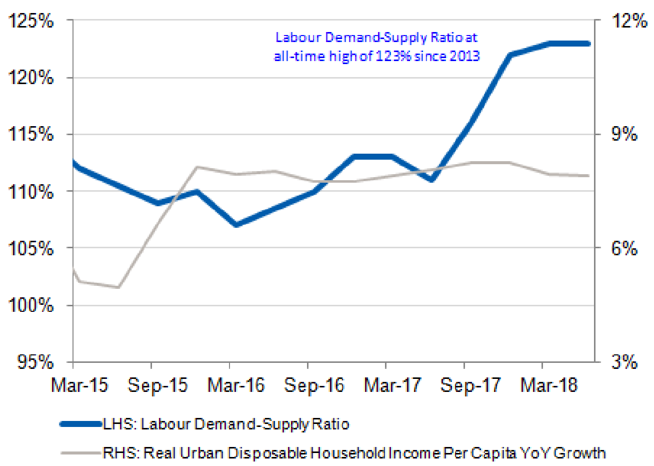
We also like the increasing contribution to retail sales from online sales, which came in at 22.8% in August, from 22.7% in July and 18.3% in Aug 2017.

Figure 4: Increasing contributions from online sales



Source: NBS, WIND, RHB

Figure 5: Robust job market to drive household income



Source: CEIC, NBS, WIND, RHB

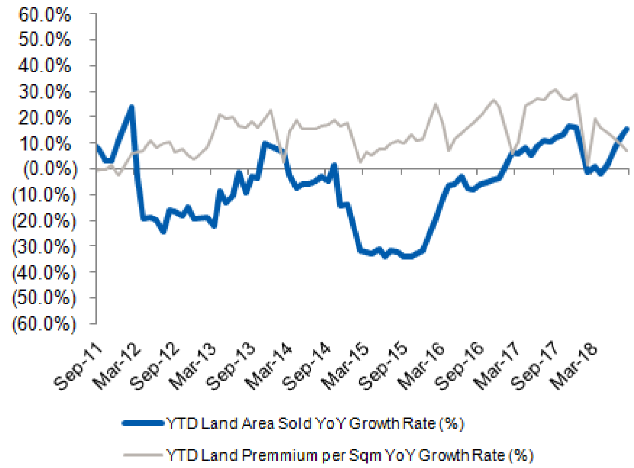
Neutralised monetary policy diverting funds to real economy

As deleveraging is still underway, we anticipate the monetary policy to remain neutral. Whilst the People's Bank of China (BoC) will continue to inject liquidity through medium-term lending facility (MLF) and reserve requirement ratio (RRR) cuts, the liquidity is expected to flow into the real economy and making financing more accessible and affordable for micro businesses and SMEs. Despite a recent relaxation in local government bond issuances to boost infrastructure funding, we anticipate funding to the property sector to remain tight, to contain the housing market from overheating.

Figure 6: Deleveraging is still underway

Source: NBS, WIND, RHB

Figure 7: Land market is likely to cool down



Source: CEIC, NBS, WIND, RHB

Market Overview

Concerns on trade war and slowing economic growth in China

As we see it, China's trade dispute with the US is unlikely to be resolved in 4Q18, given the hawkish stance of the leaders of the two countries. Whilst China's YTD exports look unaffected, it was mainly thanks to Chinese exporters front-loading their orders. Early indicators in September already suggested that Chinese exports are going to take a hit shortly.

Coupled with China's stabilising consumption growth and the Central Government's efforts to rein in leverage, investors may remain sceptical on the effectiveness of China's incentives to offset the slowdown of economic growth in the near term.

Favour infrastructure sector and online consumptions

Given the cautious market sentiment, we suggest that investors focus on sectors with a favourable policy backdrop. Thus, we like infrastructure and construction players and in particular transportation names including China Railway Group and China Rail Construction. These two companies should benefit from the potential commencement of new projects in the northwest area, where infrastructure is still developing and report rising new orders, better-than-expected topline growth and improving operating cash flows.

We also like Tencent for its indirect exposure to online sales. Coupled with its recent pullback since its share price hit a high in February, we believe the concerns on its gaming segment have almost been factored in.

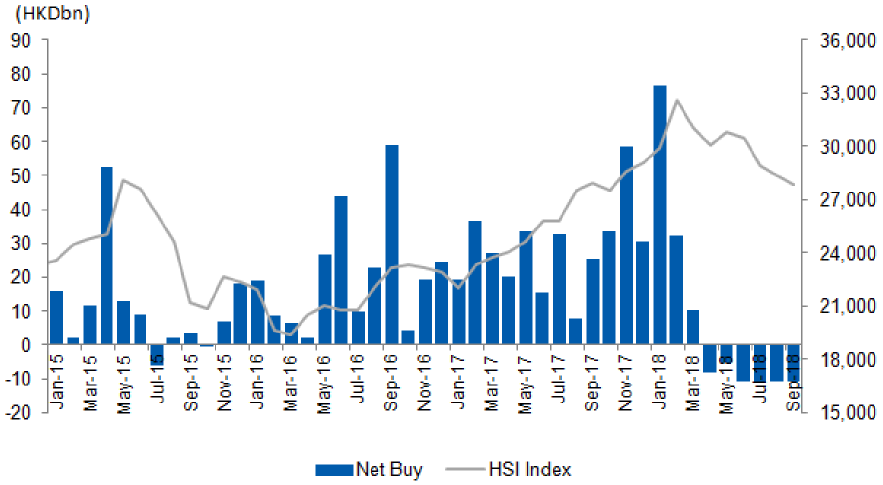
Against the odds – OVERWEIGHT on China property for resilient growth

We also suggest that investors hunt for bargains among China property stocks, given the sector's undimmed fundamental outlook. We believe the cooling land market works well for developers to replenish their landbank at favourable costs. Furthermore, home buyers' appetite remains resilient – given the policy control on presale ASPs, where primary properties are selling at discounts to secondary properties. Finally, the sector will benefit from any measures taken to loosen the monetary policy.

Southbound outflow continues

As Chinese investors tend to be momentum-driven whilst foreign investors tend to be contrarian, Mainland China investors have fled the market on weakness and have caused a drop in liquidity at unprecedented levels. Meanwhile, thanks to the weakness in the A-share market, foreign investors have sought to buy on dips for mainland stocks, via the stock connect programmes.

Figure 8: Southbound outflows continue



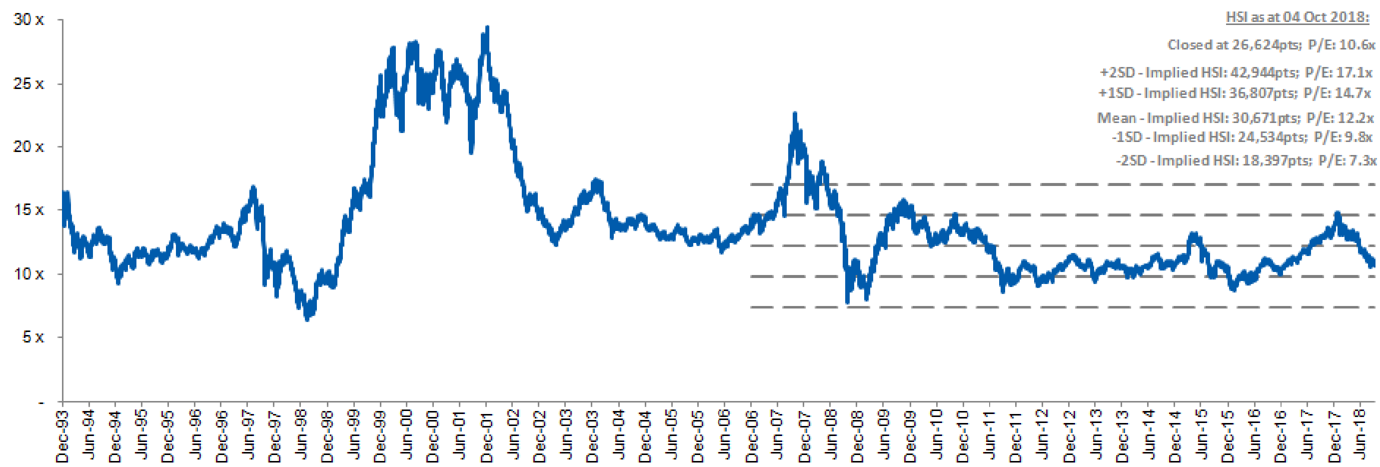
Source: Bloomberg, RHB

Index Valuation

All in all, we anticipate the HSI remain sluggish and revise down the trading range to 25,000-27,000 pts (-0.5 to -1SD), given the aforementioned reasons. Any signal of a softening in the US-China trade dispute is undoubtedly a strong catalyst for a turnaround, but it is not likely to occur ahead of the mid-term elections in the US on 6 Nov.

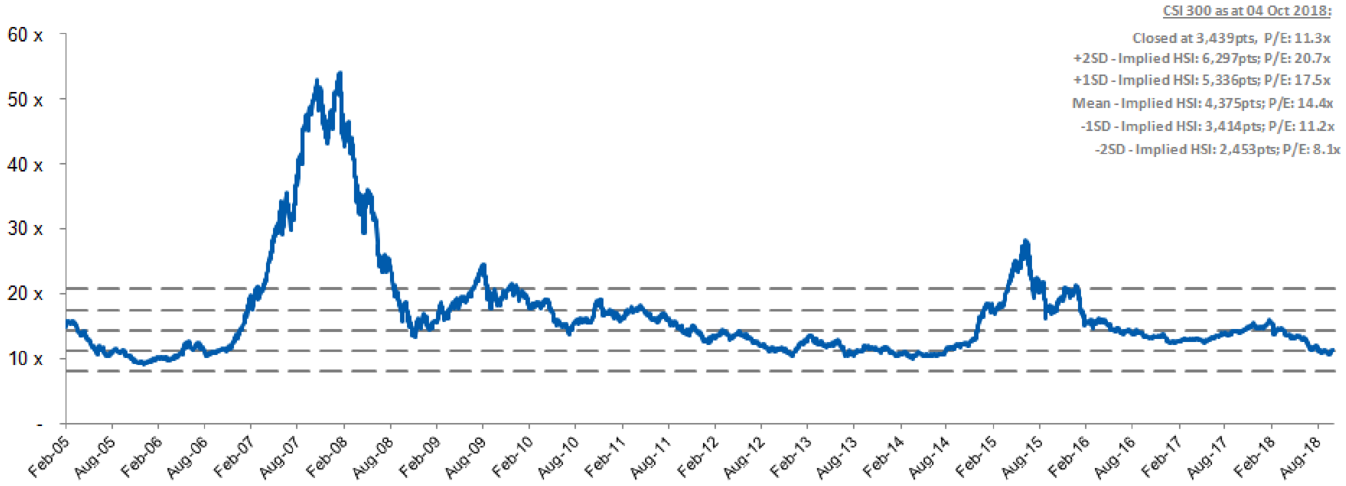
Despite turning more bearish on the market's near term performance, we advise investors to buy on dips selectively, including Tencent and the China property developers. Meanwhile for sector rotation play, we like the infrastructure and construction sectors which should benefit from favourable policy support and believe they will outperform other sectors in the short term.

Figure 9: HSI and forward-rolling P/E band (1993 - YTD 2018)



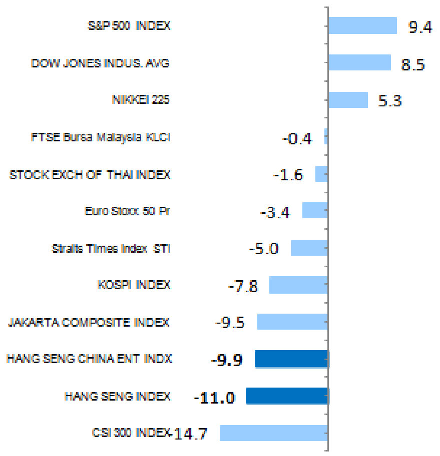
Source: Bloomberg, RHB

Figure 10: CSI300 and forward-rolling P/E band (2005 - YTD 2017)



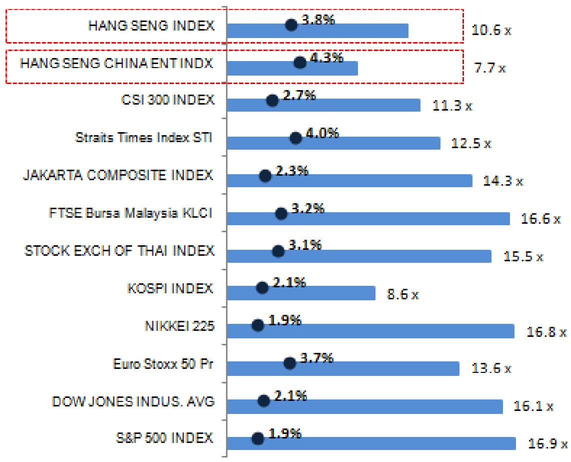
Source: Bloomberg, RHB

Figure 11: Major indices – YTD performance (%)



Source: Bloomberg, RHB

Figure 12: Major indices – 12M forward-rolling P/E and dividend yield



Source: Bloomberg, RHB

Figure 13: Comparison of major indices

INDEX	Price	2017 performance	2018 YTD performance	FY18F P/E	FY19F P/E	FY18F EPS YoY%	FY19F EPS YoY%	3-Yr EPS Cagr (%)	FY18F P/BV (x)	FY19F P/BV (x)	FY18F Div Yield (%)	FY19F Div Yield (%)
HANG SENG INDEX	26,624	36.0	(11.0)	10.6	9.8	(5.0)	7.9	4.0	1.2	1.1	3.8	4.1
HANG SENG CHINA ENT INDX	10,548	24.6	(9.9)	7.7	7.1	3.2	7.2	6.6	1.0	0.9	4.3	4.7
CSI 300 INDEX	3,439	21.8	(14.7)	11.3	10.2	12.7	10.9	12.9	1.6	1.4	2.7	3.0
Straits Times Index STI	3,233	18.1	(5.0)	12.5	12.1	(7.8)	2.8	0.9	1.1	1.1	4.0	4.2
JAKARTA COMPOSITE INDEX	5,749	17.8	(9.5)	14.3	13.2	36.1	8.7	17.8	2.2	2.0	2.3	2.6
FTSE Bursa Malaysia KLCI	1,790	9.4	(0.4)	16.6	16.1	14.8	2.8	8.2	1.8	1.7	3.2	3.4
STOCK EXCH OF THAI INDEX	1,725	13.7	(1.6)	15.5	14.5	10.4	6.6	8.7	2.0	1.8	3.1	3.3
KOSPI INDEX	2,274	21.8	(7.8)	8.6	8.6	26.7	0.8	11.2	1.0	0.9	2.1	2.3
NIKKEI 225	23,976	18.9	5.3	16.8	15.1	2.9	11.8	6.2	1.8	1.7	1.9	2.0
Euro Stoxx 50 Pr	3,385	7.1	(3.4)	13.6	12.6	17.9	7.6	11.3	1.6	1.5	3.7	4.0
DOW JONES INDUS. AVG	26,828	24.7	8.5	16.1	15.5	18.3	3.8	10.1	4.1	3.7	2.1	2.3
S&P 500 INDEX	2,926	18.9	9.4	16.9	16.3	24.9	3.9	12.6	3.4	3.1	1.9	2.0

Note: Data as at 4 Oct 2018
Source: Bloomberg, RHB

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