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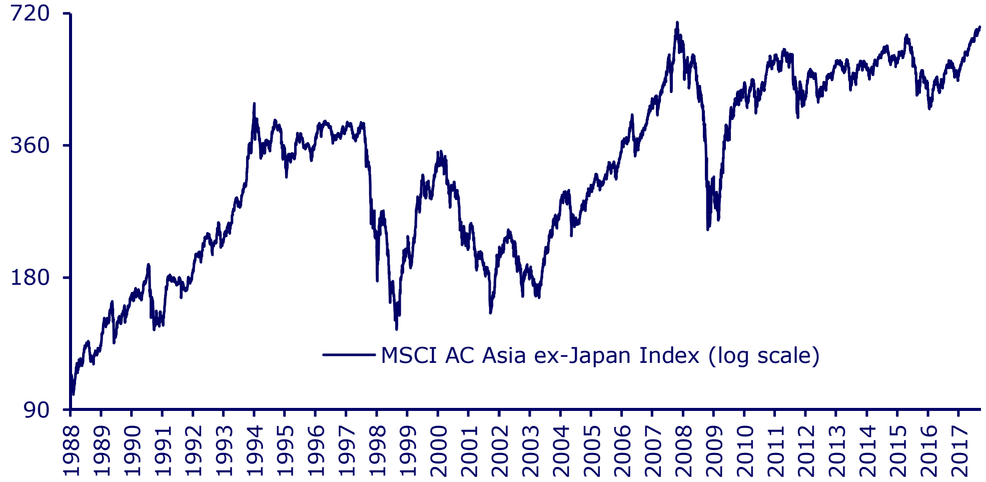
Breakout coming

Hong Kong

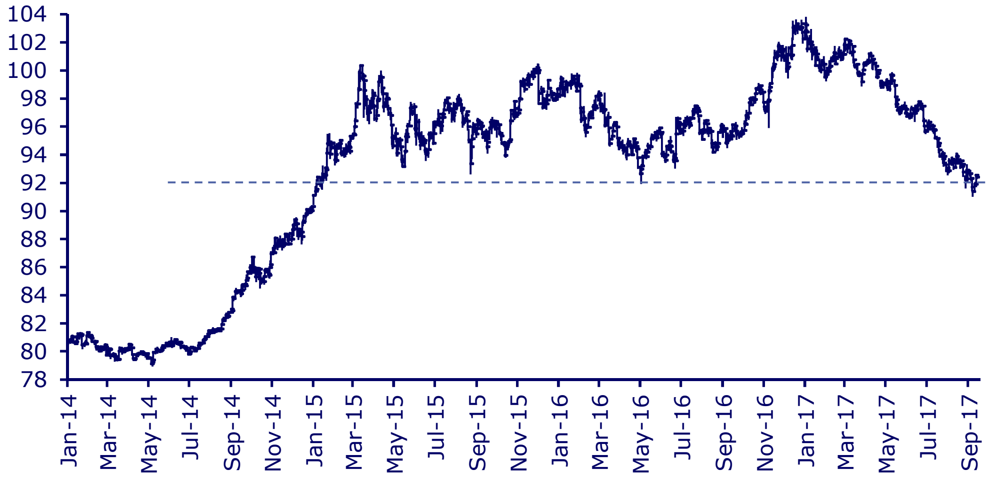
The sentiment for Asian equities has been distinctly upbeat at this year's 24th CLSA Investors' Forum. It is always nice to be a contrarian. Still *GREED & fear* shares the upbeat mood, most particularly towards China and Indian equities. The regional chart also looks poised for a "breakout" (see Figure 1).

Figure 1
MSCI AC Asia ex-Japan Index (log scale)



Source: Datastream

Figure 2
US Dollar Index



Source: Bloomberg

The biggest risk to continuing Asian and emerging market outperformance remains a counter trend dollar rally. The American currency has been perilously close to breaking below major support levels of 91.92-92.62 on the US Dollar Index, as previously identified by CLSA's technical analyst Laurence Balanco. The US Dollar Index fell to an intraday low of 91.01 last Friday though it has since risen to 92.37 (see Figure 2). *GREED & fear* continues to take the view that the most likely trigger for a dollar rally would be a sudden renewed belief that tax reform will be implemented in America sooner rather than later. This was not the message Steve Bannon delivered to a packed conference room on Tuesday at the annual CLSA Investors Forum in Hong Kong. Rather his view appeared to be that there was more likely only going to be tax cuts rather than ground-breaking tax reform.

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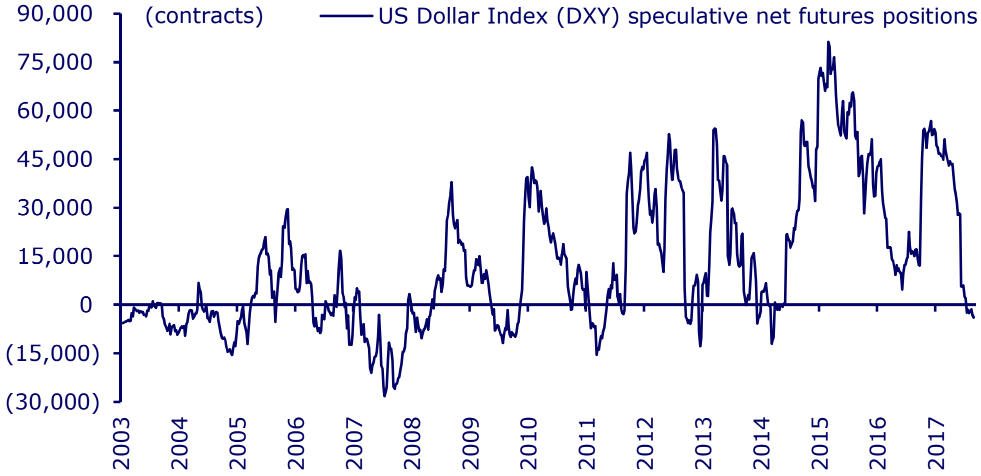
Still Bannon is no longer in the administration. It is clear that ongoing discussions regarding a tax package continue between the administration and senior Senate and House of Representatives Republicans. So in *GREED & fear*'s view it would be wrong to write off the chances of progress on this front completely. But if the sceptics are right, and nothing is agreed, then the chart suggests that the dollar will break current support at which point the technicals will suggest a decline to 80 on the US Dollar Index. In *GREED & fear*'s view such a breakdown would trigger a whole new wave of inflows into the Asian and emerging market asset class.

As for investor positioning, it is worth noting that the latest data released last Friday by the US Commodity Futures Trading Commission (CFTC) shows that US Dollar Index futures' net speculative positions have declined from a recent high of a net long of 56,712 contracts in mid-December to a net short of 3,944 contracts in the week ended 5 September, the lowest level since April 2014 (see Figure 3).

Figure 3
CFTC US Dollar Index (DXY) speculative net futures positions



Source: Bloomberg, US Commodity Futures Trading Commission (CFTC)

Figure 4
China Construction Bank and ICBC share prices (H shares)

Source: Datastream

Meanwhile, the key driver of Asian index returns *GREED & fear* is currently looking at is a further rally in the "Big 4" Chinese banks as investors focus on the improvement in reported asset quality (see Figure 4). In this respect, it is worth highlighting how cheap the biggest Chinese banks still look by conventional valuation metrics. ICBC, China Construction Bank, Bank of China and Agricultural Bank of China are now trading at 0.7-0.8x 2017 book. This

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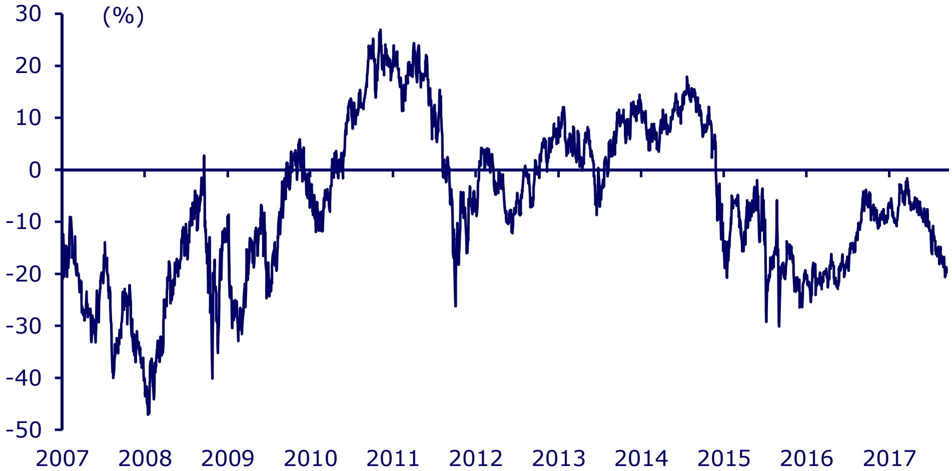
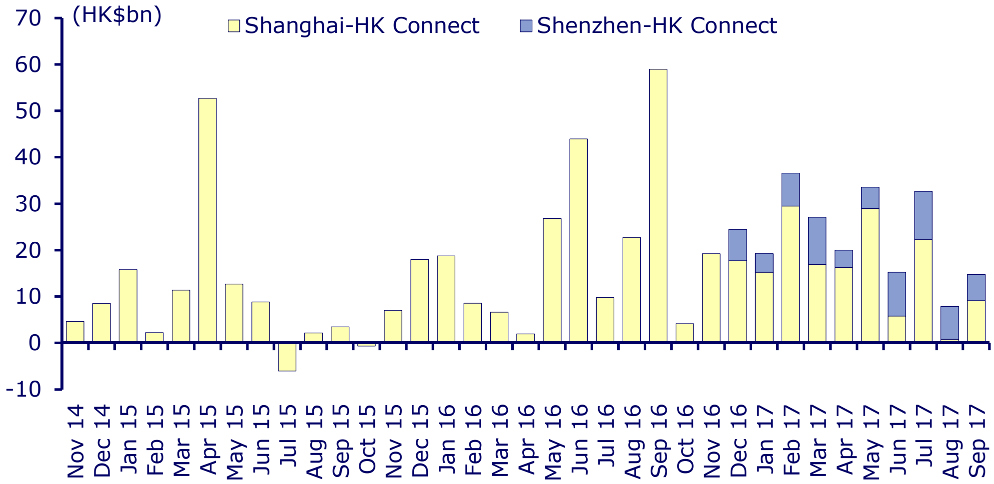
suggests to *GREED & fear* that this rally in China banks has further room to run. It is also worth noting that the discount of Chinese banks' H shares relative to A shares has widened again. The Big four banks' H shares' average discount to their A share counterparts has risen from only 2% in mid-March to 20% (see Figure 5).

Figure 5
China Big 4 banks' H share premium/discount to their A share counterparts



Note: Average premium/discount of Bank of China, Agricultural Bank, China Construction Bank and ICBC. Source: Datastream, CLSA

Figure 6
Hong Kong Stock Connect Scheme monthly net southbound flows



Note: Data up to 13 September 2017. Source: HKEx, Bloomberg, CLSA

The Hong Kong stock connect scheme also remains a major positive for the H share asset class as a whole given the continuing valuation discount southbound and the likelihood of continuing inflows given that the discount has again widened. On this point, there has been a total of HK$593bn (US$76bn) of inflows since the southbound connect scheme was launched in November 2014 (see Figure 6). True, the connect scheme was initially introduced in part as a way of allowing mainland investors to hedge perceived renminbi depreciation risk. This was always a bit silly since a buyer of ICBC's H shares was still in reality taking renminbi risk. But as the depreciation hype on the renminbi has faded, with the renminbi up 6% against the US dollar so far this year (see Figure 7), the real long-term impact of the connect scheme has become much clearer. That is that it has opened up a new category of buyer in the Hong Kong stock market as mainland institutional investors have become much more aware of the valuation arbitrage available in Hong Kong. This became very evident to *GREED & fear* in meetings with mainland institutional investors in Shanghai the week before last. It is also the

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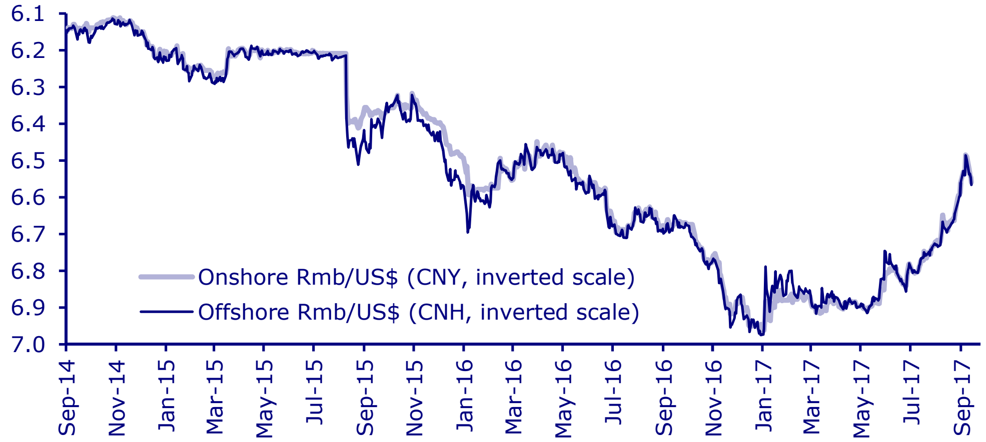
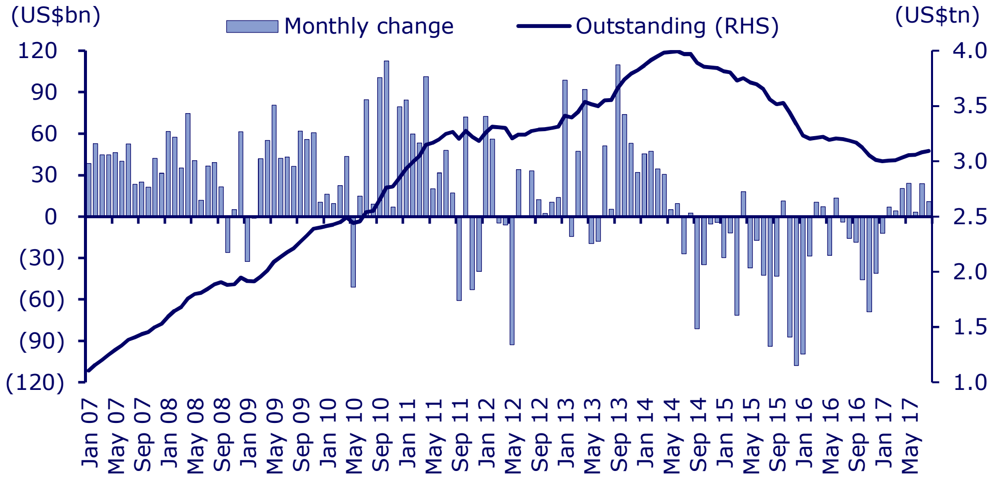
case that domestic mutual fund investors are all scrambling to increase their quota to invest southbound. CLSA's head of China Capital Access Alexious Lee forecasts that, based on the renminbi remaining stable in the Rmb6-6.9/US$ range, domestic mutual funds will increase their quota to invest southbound to about 10% of total inflows this year and 15% next year, up from 5% in 2016.

Figure 7
Onshore and offshore renminbi/US$ (inverted scale)



Source: Bloomberg

Figure 8
China foreign exchange reserves



Note: Data up to August 2017. Source: PBOC

Returning to the subject of the renminbi, this week saw the relaxation of measures introduced during the past two years to try and discourage speculation against the Chinese currency. Thus, starting Monday, the People's Bank of China will scrap a two-year-old rule that requires financial institutions to set aside reserves for trading currency forwards (see *The Wall Street Journal* article "*Beijing Strives to Contain Resurgent Yuan*", 11 September 2017 by Lingling Wei). Under the rule, banks buying dollars while selling renminbi under a forward contract were required to deposit US$20 with the PBOC for every US$100 traded. The same article also reported that China would soon clarify rules on overseas investment following the crackdown seen this year. This would encourage investment overseas in areas such as technology while maintaining tight control on purchases of toy assets such as overseas property or soccer teams. Meanwhile, the latest foreign exchange reserve data has further confirmed the lack of capital outflow pressures. Foreign exchange reserves increased by US$10.8bn last month to US$3.09tn at the end of August, following a US$23.9bn increase in July. This is the first time China's foreign exchange

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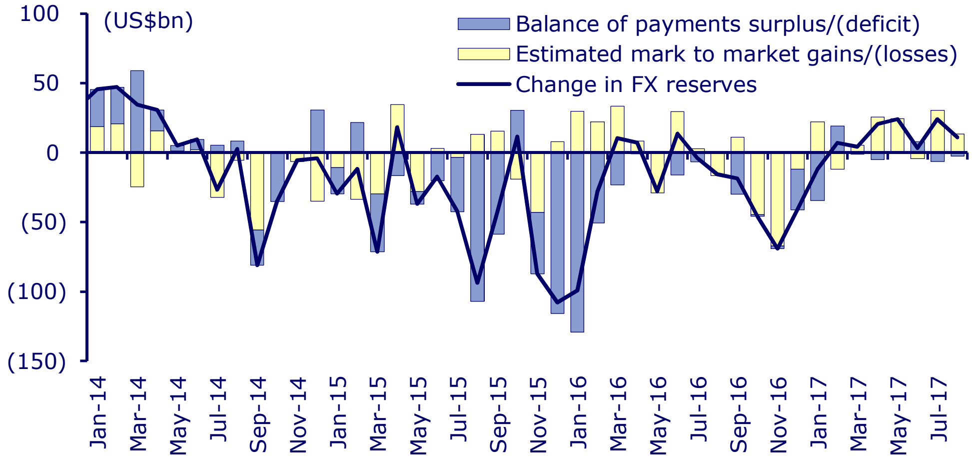
reserves have risen for seven consecutive months since June 2014 (see Figure 8). CLSA's economics team estimates about a US$13bn mark-to-market gain in August, implying an estimated balance of payments deficit of only US$2.5bn in August compared with around US$6bn in July (see Figure 9).

Figure 9

China change in forex reserves and estimated balance of payments

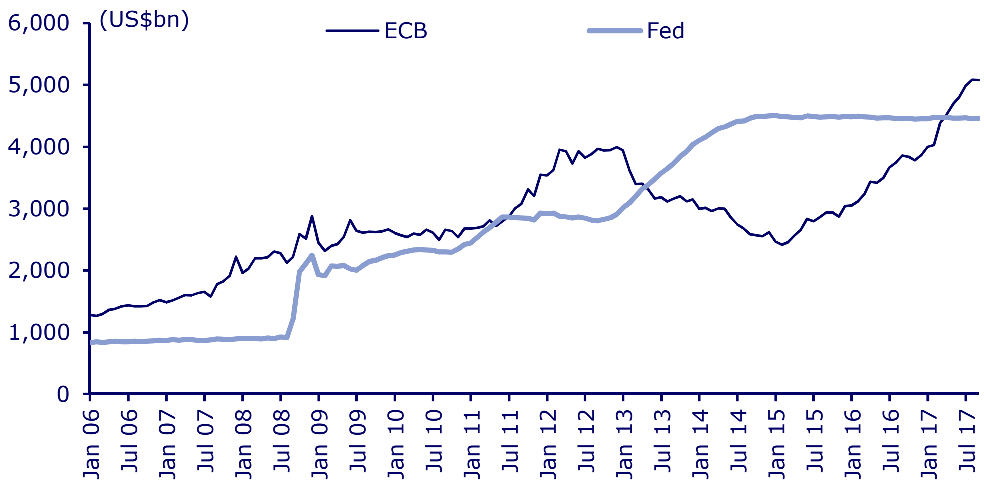


Source: Bloomberg, PBOC, CLSA

The appreciation of the renminbi should continue to be seen in the context of euro strength. This is because the PBOC is tracking its trade-weighted basket, albeit with a depreciation bias, and the euro is the second biggest component of that basket (16.3%) after the US dollar (22.4%). This means the direction of the renminbi is in large part a call on the direction of the euro. The possibility of a continuing appreciation of the euro against the dollar is real. In fact in *GREED & fear*'s view it remains the base case unless there is a reactivated Trumponomics trade triggered by renewed excitement on tax reform as already discussed. First, foreign exchange markets will have much more confidence in the potential for tightening in the Eurozone than is the case for the Fed. This is because the Fed has already stopped QE while the ECB is still buying €60bn of assets a month (see Figure 10). It is also the case that euro short-term interest rates are still a negative 37bp while the effective federal funds rate is a positive 1.16%. Finally, the Eurozone has a current account surplus currently running at 3.1% of GDP (see Figure 11).

Figure 10

Federal Reserve and ECB balance sheets



Source: ECB, Federal Reserve, Bloomberg

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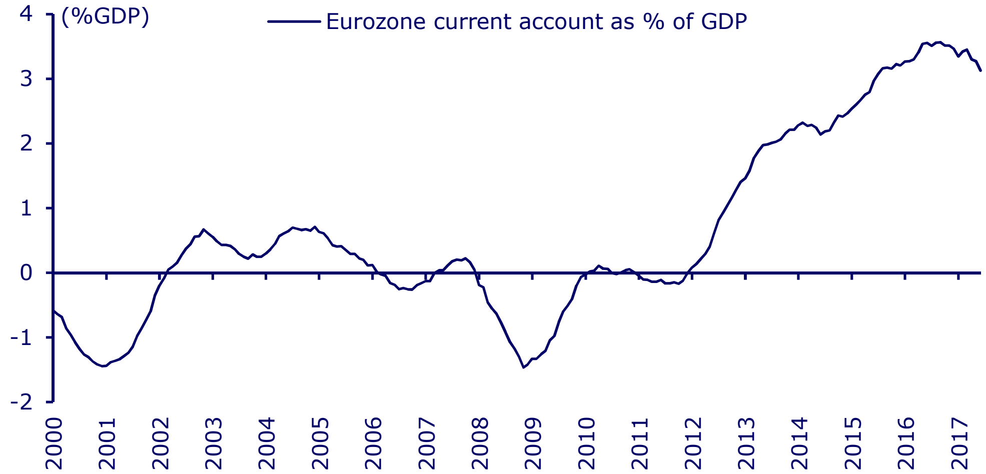
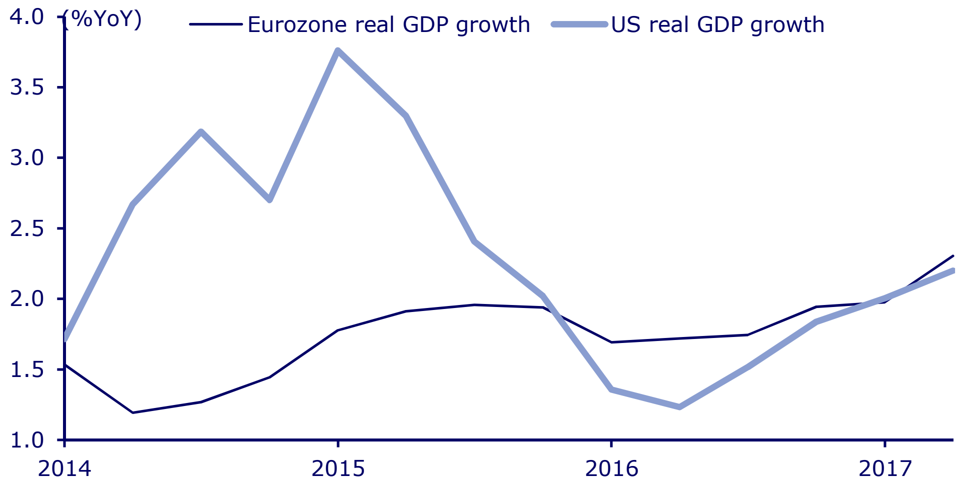
Figure 11
Eurozone current account as % of GDP



Source: ECB

The above is another reason why *GREED & fear* will maintain the overweight in Eurozone equities with a focus on domestic demand stocks in the context of the continuing evidence of cyclical recovery. On this point, Eurozone economic data has continued to be better than American data. Thus, Eurozone real GDP rose by 2.3% YoY in 2Q17, the highest level since 1Q11, and is up an annualised 2.0% over the past two years. While US real GDP increased by 2.2% YoY in 2Q17 and is up an annualised 1.7% over the past two years (see Figure 12).

Figure 12
Eurozone and US real GDP growth



Source: Datastream, CLSA

But if ongoing cyclical improvement and relatively lower valuations provide the context for the Eurozone overweight, the really exciting story is the potential for a renewed drive towards fiscal integration which could lead in financial market terms to a renewed convergence trade. The relevant story here remains the most important development in Western politics this year which continues to be underplayed by an Anglo-Saxon dominated Western media. *GREED & fear* refers to the election in May of Emmanuel Macron in France and the control of the legislature by his own political party *La République En Marche*.

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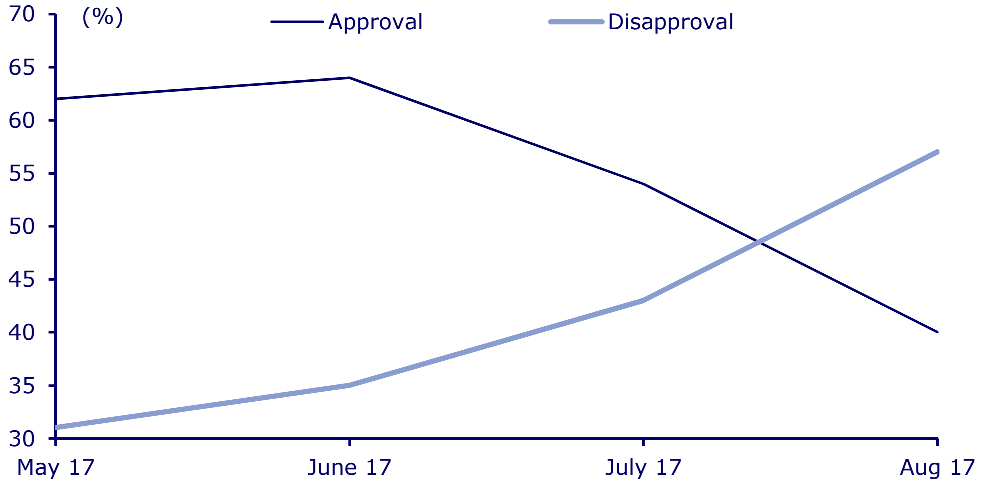
Figure 13
Emmanuel Macron's approval rating



Note: Ifop polls. Source: Ifop

While the press of late has been focusing on the short term noise of a decline in Macron's poll ratings over the summer (see Figure 13), the far more important development is that the French president has announced his labour market reforms as promised. The most important point is a major decentralisation of collective bargain given that previously, so far as *GREED & fear* understands, companies were constrained by sector-wide agreements negotiated at a national level. Individual companies will now have much more freedom to negotiate their own terms with their employees.

The French legislature is due to either confirm or reject the presidential decrees on labour reform on 21 September. Since Macron controls the legislature this looks like a done deal which means the real issue is how many people hit the streets to protest. On this point, it is interesting that so far the opposition does not look so formidable. Only one of France's three major union groups has called for a day of protest, namely the General Confederation of Labour (CGT). This occurred on Tuesday with police estimating the size of the protest in Paris at only 24,000 people.

If Macron pulls off this reform it will, as previously discussed here (see *GREED & fear - Phillips questioned*, 27 July 2017), send a signal to Germany that it has a leader in France it can now work with. This in *GREED & fear*'s view will lead to a revived Franco-German partnership, and *GREED & fear* is assuming here that Frau Merkel will win the general election to be held later this month easily (see Figure 14). With her increased political capital, *GREED & fear* also assumes that Merkel will go some way to accommodate French demands for moves towards greater fiscal integration in the Eurozone even if it means acting against the wishes of the German political right. Merkel has "form" on this front since in reality it was her support that enabled Mario Draghi to break the founding rules of the ECB by buying Eurozone government bonds during the Eurozone crisis. Similarly, with one eye on her legacy, Merkel should prove willing to back a Macron who has proven himself a serious reformer. In political terms this will be seen as a chance to consolidate the gains against the populist threat represented by Macron's victory. While in financial market terms renewed moves toward integration will create expectations for a renewed convergence trade which would be extremely bullish for interest rate-sensitive stocks in the Eurozone periphery.

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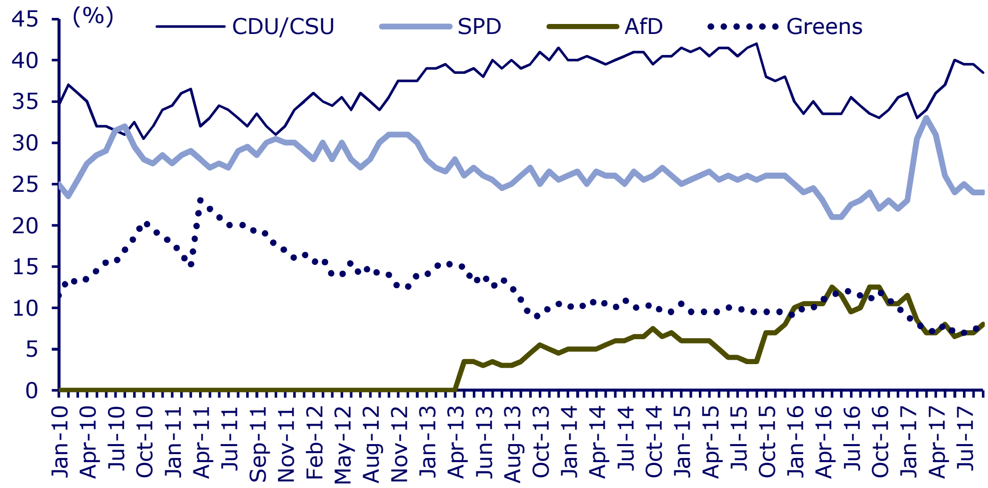
Figure 14

German political parties' support rating for next federal election



Source: Allensbach Institute

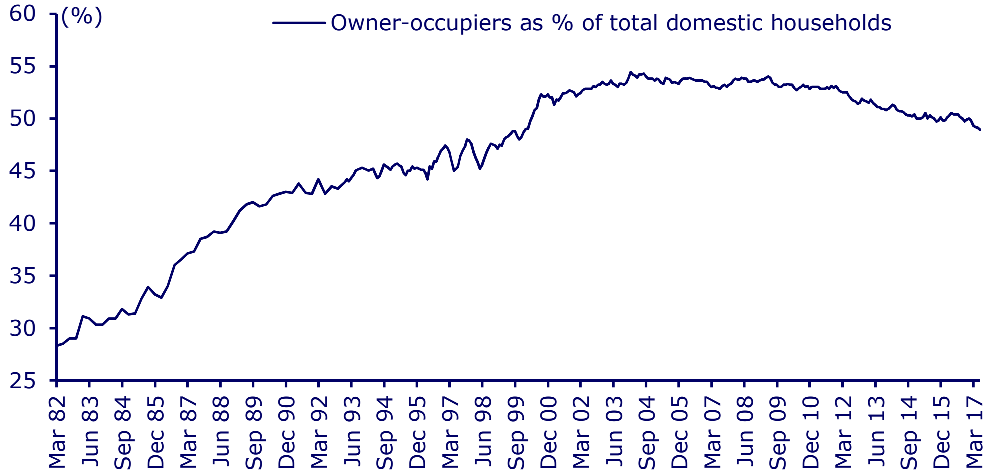
But before this all happens, and it is probably more a 2018 story, Macron needs to prove he can deliver on reform. Scepticism is enormous on the part of investors. But his track record suggests he should be given the benefit of the doubt. *GREED & fear* would also highlight an interview published earlier this month in the pinko paper with Macron's labour minister Muriel Pénicaud (see *Financial Times* article "*France sets 2-year goal to overhaul welfare*", 4 September 2017 by Anne-Sylvaine Chassany). In this article the former head of human resources at French yoghurt maker Danone vowed to overhaul France's welfare system in less than two years, including revamping France's unemployment insurance system which currently costs €34bn annually.

Amidst such talk, short-term focus on opinion polls is irrelevant. Macron will reform nothing if he worries about short-term swings in opinion polls – just as the late and great Margaret Thatcher would have achieved nothing if she had done the same. The point is that it makes sense to do the important reforms in the first months after election, most particular if there is control of the legislature. This is precisely what Macron is doing.

In Hong Kong this week *GREED & fear* has picked up news of an important pending change in policy toward the residential property market. The new Chief Executive Carrie Lam is expected to announce in her maiden policy address next month liberalisation of policy towards the development of farmland for constructing residential property. *GREED & fear* hears that developers will be given more generous land plot ratios with the *quid pro quo* being a commitment that part of the development should be allocated to subsidised flats, which can be sold to young first-time buyers who do not currently qualify for government flats but cannot afford private housing. Lam is expected to announce a plan under which large-size farmland plots in New Territories can be turned into private housing estates, with the development undertaken through a public-private partnership model (see *Hong Kong Economic Journal* online article "*Lam expected to boost home supply by utilizing some NT farmland*", 6 September 2017).

Such a policy will help, via boosting supply, to ease the chronic affordability issue in Hong Kong residential property where the homeownership rate remains at only 49% (see Figure 15). But it should also prove a positive for those developers with large agricultural land banks. They are Sun Hung Kai Properties, Henderson Land and New World Development, which owned a combined 92m square feet of farmland as at the end of 2016 (see Figure 16).

Figure 15
Hong Kong homeownership ratio



Source: Hong Kong Census and Statistics Department

Figure 16
Hong Kong property developers' share price performance

Source: CLSA, Datastream

Elsewhere in Asia, it is worth noting that net inflows into Indian equity mutual funds surged to a record high of Rs204bn in August, up from Rs127bn in July (see Figure 17). This was prompted by locals "buying the dip" after a 4.2% decline in the Sensex last month. Net inflows into Indian equity mutual funds have now totalled Rs810bn (US$12.5bn) in the first eight months of 2017 and Rs2.77tn (US$43bn) since Prime Minister Narendra Modi took office in May 2014. The base case is that these inflows continue.

Finally, some changes will be made in the Asia ex-Japan long-only portfolio. The investment in BDO Unibank will be removed and replaced by an investment in H-share listed China Construction Bank (CCB). The discount of CCB in the H share market, relative to the A share, is currently 19%. For more information on the investment case for the "Big 4" Chinese banks read a recent research report by CLSA's head of China financial research Patricia Cheng (*China Banks – Buy the Big 4*, 5 September 2017). A 3% investment will also be initiated in Indian consumer finance play Indiabulls Ventures. This will be paid for by shaving the existing investments in HDFC Bank, Indiabulls Housing Finance and Bajaj Finance by one percentage point each (see Figure 18).

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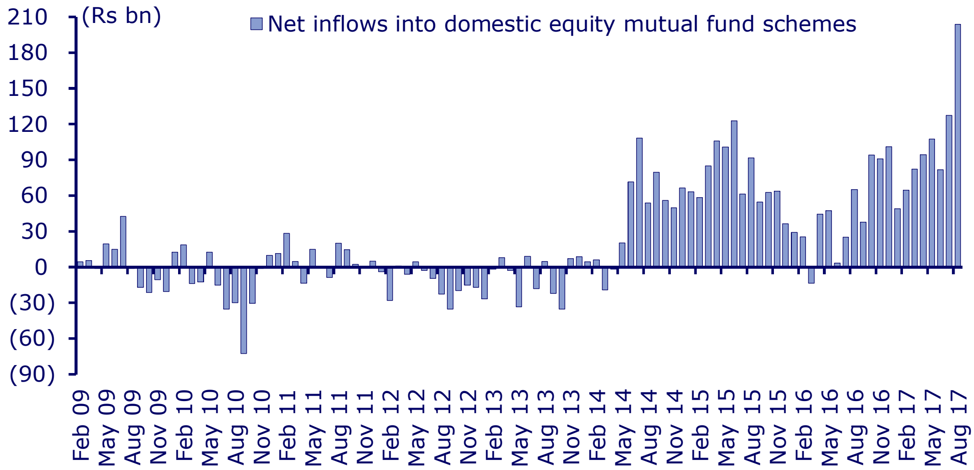
Figure 17

India net inflows into domestic equity mutual fund schemes



Note: Include equity funds and ELSS funds, but not balanced funds. Source: Association of Mutual Funds in India (AMFI)

Figure 18

Asia ex-Japan thematic equity portfolio for long-only absolute-return investors

Australia gold mining	4%	Newcrest Mining
China banks	3%	China Construction Bank
China online marketplace	3%	58.com Inc
China coal producer	4%	China Shenhua
China infrastructure	4%	China Communications Construction
China internet media	5%	Tencent
China steel	4%	Maanshan Iron & Steel
China technology	4%	Sunny Optical
Hong Kong insurance	5%	AIA Group
India autos	4%	Maruti Suzuki
India private sector banks	9%	HDFC Bank (4%), IndusInd Bank (5%)
India state-owned banks	3%	State Bank of India
India housing finance	12%	HDFC (5%), GRUH Finance (3%), Indiabulls Housing Finance (4%)
India non-bank finance	7%	Bajaj Finance (4%), Indiabulls Ventures (3%)
India insurance	4%	ICICI Prudential Life Insurance
India cement	5%	ACC Limited
India media	5%	Zee Entertainment
India property	4%	Godrej Properties
India textile	4%	Arvind Limited
Malaysia banks	3%	CIMB
Philippines infrastructure	4%	Metro Pacific

Note: Readers should refer to the relevant CLSA research reports for detailed analysis & disclosures. Source: CLSA

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Companies mentioned

58.com (WUBA US - US$67.59 - O-PF)
ACC (ACC IB - RS1,840.5 - O-PF)
Agricultural Bank - A (601288 CH - RMB3.83 - SELL)
Agricultural Bank (1288 HK - HK$3.59 - BUY)
AIA (1299 HK - HK$59.10 - BUY)
Arvind (ARVND IN - RS411.7 - BUY)
Bajaj Finance (N-R)
Bank of China - A (601988 CH - RMB4.19 -)
Bank of China (3988 HK - HK$4.02 - BUY)
BDO Unibank (BDO PM - P129.80 - O-PF)
CCB - A (601939 CH - RMB6.98 -)
CCB (939 HK - HK$6.72 - BUY)
CCCC (1800 HK - HK$10.06 - BUY)
CIMB (CIMB MK - RM6.73 - O-PF)
CK Property (1113 HK - HK$67.10 - O-PF)
Danone (N-R)
Godrej Prop (GPL IB - RS632.9 - BUY)
GRUH Finance (N-R)
HDFC (HDFC IB - RS1,777.3 - BUY)
HDFC Bank (HDFCB IB - RS1,842.6 - BUY)
Henderson Land (12 HK - HK$53.00 - U-PF)
ICBC - A (601398 CH - RMB5.94 -)
ICBC (1398 HK - HK$5.78 - BUY)
ICICI Prudential Life (IPRU IN - RS427.3 - BUY)
Indiabulls Housing (IHFL IS - RS1,268.8 - BUY)
Indiabulls Ventures (N-R)
IndusInd Bank (IIB IS - RS1,744.8 - BUY)
Magang (323 HK - HK$4.10 - BUY)
Maruti Suzuki (MSIL IB - RS8,121.1 - BUY)
Metro Pacific (MPI PM - P6.77 - BUY)
New World Dev (17 HK - HK$11.34 - O-PF)
Newcrest Mining (NCM AU - A$22.34 - SELL)
Shenhua (1088 HK - HK$19.20 - BUY)
SHKP (16 HK - HK$136.80 - O-PF)
State Bank of India (SBIN IB - RS273.4 - BUY)
Sunny Optical (2382 HK - HK$128.10 - O-PF)
Tencent (700 HK - HK$337.00 - BUY)
Zee Entertainment (Z IB - RS532.5 - BUY)

The above shows our fundamental ratings on these stocks.

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the 12-month total forecast return (including dividends) for the stock against the 12-month forecast return (including dividends) for the market on which the stock trades.

We define as "Double Baggers" stocks we expect to yield 100% or more (including dividends) within three years at the time the stocks are introduced to our "Double Bagger" list. "High Conviction" Ideas are not necessarily stocks with the most upside/downside, but those where the Research Head/Strategist believes there is the highest likelihood of positive/negative returns. The list for each market is monitored weekly.

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Overall rating distribution: BUY / Outperform - CLSA: 64.52%; CLST only: 67.61%, Underperform / SELL - CLSA: 35.48%; CLST only: 32.39%, Restricted - CLSA: 0.00%; CLST only: 0.00%. Data as of 30 June 2017.

Investment banking clients as a % of rating category: BUY / Outperform - CLSA: 4.77%; CLST only: 0.00%, Underperform / SELL - CLSA: 2.98%; CLST only: 0.00%, Restricted - CLSA: 0.00%; CLST only: 0.00%. Data for 12-month period ending 30 June 2017.

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