

What's the implication for H-share market of USD fluctuation?

Weak USD – a contributor to the market exuberance

The USD index has unexpectedly slid 3.14 points in 2018 year to date to reach to 89.12 points (31 January close). While we believe bullish investor sentiment on the China market and improved outlook for the US and global economies are the anchor that has supported strong flows, a softened USD has also contributed to the market exuberance. A weak USD could help pump funds into Emerging Markets (EM), where China accounts for the largest market cap proportion, leading to valuation appreciation of HK-listed Chinese companies. However, influence on fundamentals is mixed and not imminent for most sectors, in our view. Airlines and Chinese property companies are potentially the largest and most direct beneficiaries.

Weak USD adds to attractiveness of China market

The most direct and profound impact on the China market of USD weakness against the RMB is in terms of fund flows and valuations, in our view. Since 1Q07, ETF fund flows to EM equities have shown a -21% correlation with the quarter-on-quarter change in the USD index. Amid USD weakness: 1) funds are prompted to search for higher returns in riskier emerging markets; 2) concerns over hefty debt burden of developing countries can be temporarily mitigated; and 3) commodity exporters could benefit from rising commodity prices. Hence, HK-listed Chinese companies could see increased fund flows and enjoy valuation appreciation.

Southbound investors need to assess price returns and FX losses

On the flip side, a weakening USD and strengthening RMB could erode returns of southbound investors using the Stock Connect channel. Although they are essentially using RMB to buy RMB assets, stock price reaction does not strictly follow a linear relationship with forex changes, and valuation appreciation may not fully offset the currency losses. So, they need to compare the expected price returns and exchange rate losses. Recent southbound flows indicate that a high level of investor confidence on price returns in the HK stock market and strong allocation needs have trumped potential forex losses, given there is no clear consensus that the RMB will depreciate significantly.

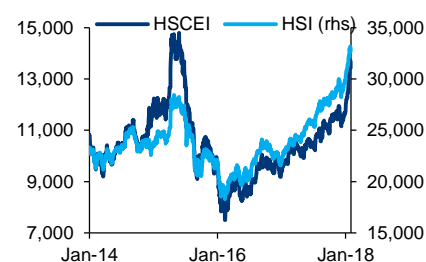
Potential winners and losers from weak USD and strong RMB

Potential beneficiaries include: 1) sectors with a high degree of dependence on imports; 2) companies with significant levels of USD-denominated debt or obligations and which mostly receive RMB cash flows; and 3) Chinese companies seeking to go global by acquiring foreign assets or participate in overseas investment, and related financial services providers. Potential victims are: 1) export oriented companies, especially low-end OEM contractors with little bargaining power; 2) the marine transportation sector because of China's net-exporter status; and 3) companies with high exposure to overseas assets. That said, we believe that due to recovering global demand and the complexity of companies' forex exposure, most sectors may see no immediate nor notable influence. In addition, further strengthening of the RMB could encourage consumers to take more short trips abroad, benefiting local retailers and consumer service companies.

Cheng LV
Strategist

+86 21 2897 2057
lvcheng@htsc.com

Index performance



Source: Bloomberg, Huatai HK Research

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Implication to fund flows and market valuations

In our [annual outlook report](#) on 4 December 2017, we highlighted that fund flows will be the largest swing factor of market performance in 2018. While we believe bullish investor sentiment on the China market and improved outlooks for the US and global economies are the anchors that have led to strong flows, the softened USD also buoyed up market sentiment, in our view.

The USD index unexpectedly slid rapidly by 3.14 points in 2018 year to date and reached 89.12 points at 31 January close. The Huatai economist sees the USD entering a long-term weakening cycle because of the narrowed gap between the recovery cycles of the US and other developed countries and the more synced monetary policies of key central banks. He forecasts the median of the USD index at 88 in 2018 and CNY/USD at 6.3.

Given the large presence of Chinese companies, which are essentially RMB assets, in the Hong Kong equity market, a softer USD and, as a result, stronger RMB can potentially add to the attractiveness of the China market on top of the resilient and better quality growth. The most profound positive implications could be on fund flows and asset valuations, which benefit the overall China market, while the influence on corporate fundamentals could be mixed and less imminent for most sectors, in our view.

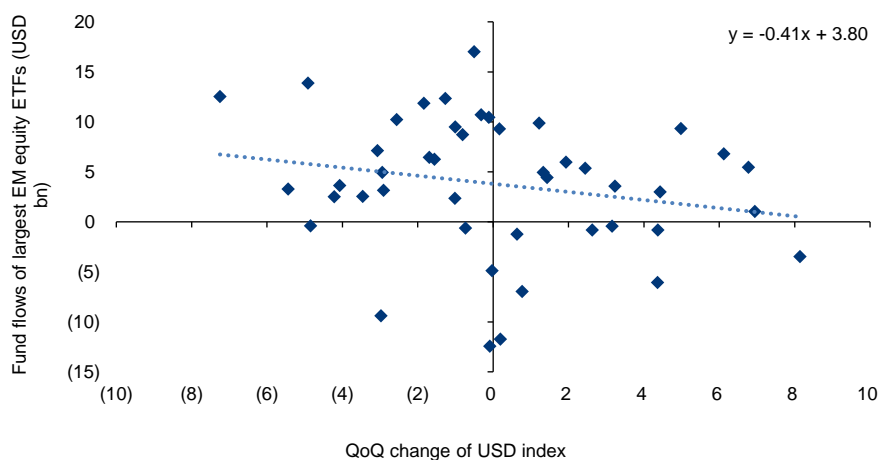
Weak USD could add to attractiveness of the China market...

A weak USD is certainly not the sole factor explaining fund flows, but it could help pump funds into Emerging Markets, by: 1) encouraging investors to chase higher returns and more risky assets, such as emerging market stocks; 2) partially assuaging concerns on the debt risks of developing countries that bear hefty USD-denominated debts; and 3) lifting prices of commodities that are quoted in USD and benefiting commodity exporters.

A statistical study shows the negative relationship between the USD index and the passive fund flows to EM equities. The correlation between the quarter-on-quarter change of USD index and fund flows of EM equity ETFs is -21% since 1Q07. If periods in which the quarterly appreciation or depreciation of the USD index were smaller than 1 are excluded, the correlation amplifies and reaches further*cut* to -29%.

The China market, as the largest EM member, tends to benefit from such flows as a result. This could lead to a valuation appreciation across different asset classes, including the China stock market.

Fig.1. Quarter-on-quarter change of USD index and equity ETF fund flows to EM



Note: includes largest 50 equity ETFs tracking Emerging Markets

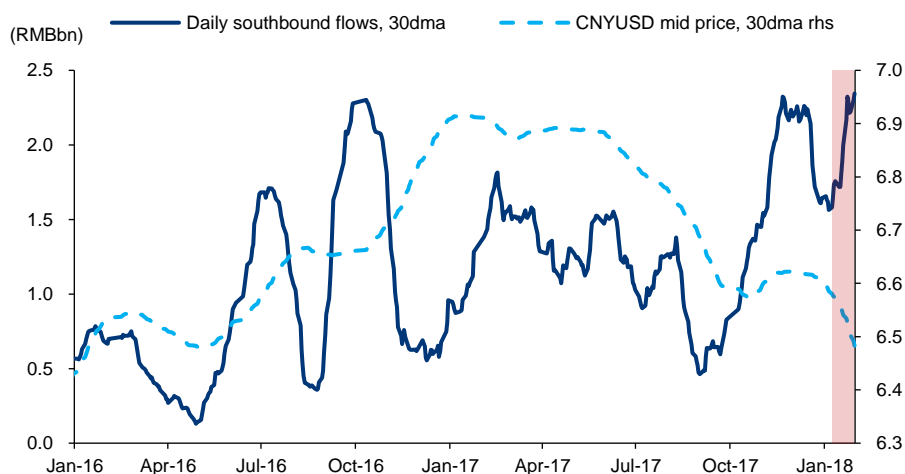
Source: Bloomberg, Wind, Huatai HK Research

...but strengthened RMB could erode returns of southbound investors

On the flip side, a weakening USD and a strengthening RMB could erode the returns of southbound investors using the Stock Connect channel. In theory, when investing in HK-listed Chinese companies, southbound investors use RMB to buy RMB assets, so should be immune to forex fluctuation. In reality, because the quoting currency, HKD, is pegged to the USD and the stock price reaction does not strictly follow a linear relationship with the change of CNY/USD, forex fluctuation may not be fully offset by valuation changes and returns of southbound investors will deviate from price returns. This effect could be amplified, especially during abrupt forex changes or during a long holding period.

As a result, southbound investors need to compare the expected price returns and forex losses when the RMB strengthens against the USD. Recall that RMB depreciation used to be one of the key reasons to draw southbound fund flows, when the pace of southbound flows was more or less dependent on the exchange rate and investor expectation on future exchange movement. Interestingly, the recent accelerated southbound flows suggests that such a link has broken, as highlighted in the chart below. What's more, investor confidence on price returns in the Hong Kong stock market and strong allocation needs have trumped the potential forex losses, given there is no clear consensus on sizable RMB depreciation in the future.

Fig.2. The relationship between southbound daily flow and CNY seems broken



Source: Wind, Huatai HK Research

Hence, we believe we are at the sweet spot where the weak USD could help attract overseas inflows and the RMB is not so strong as to deter southbound investors from increasing their allocation in the Hong Kong stock market. And given our view on the USD and CNY for this year, as mentioned earlier, the largest CNY/USD appreciation could likely be behind us, and currency risks, therefore, should be less of a major concern to southbound investors.

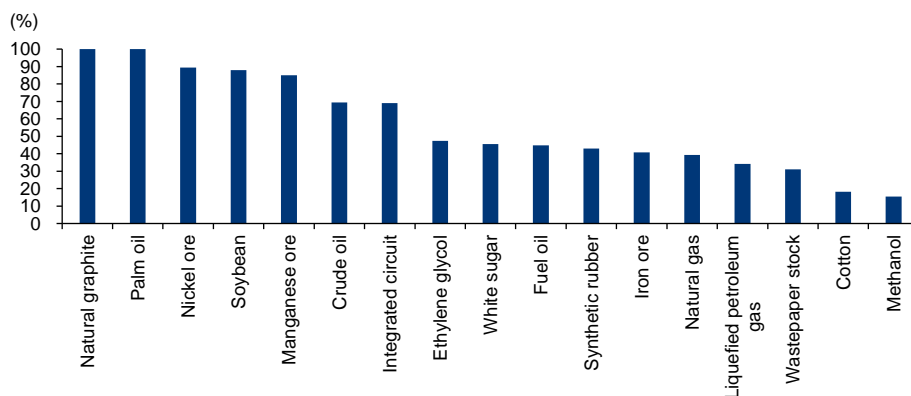
Winners and losers from strong CNY and weak USD

Different from the direct impact to fund flows, the implication of exchange rate changes to companies and sectors' fundamentals could be more complicated and influenced by: 1) the denominated currency of a company's revenue and costs; 2) geographical breakdown of assets, debts, and cash flows; 3) a company's position in the global supply chain; and 4) any strategy to hedge currency risks.

Three types of sector/company are potential beneficiaries

- 1) Sectors with a high degree of dependence on imports, such as natural graphite, palm oil, nickel ore, soybean, manganese ore, crude oil, and integrated circuit, could lower the cost of imports thanks to a strong RMB. That said, we think commodity prices are mostly decided by supply-demand dynamics. The effects of change in exchange rates, therefore, could be easily washed out by commodity price volatility.

Fig.3. Dependence on imports by product



Source: Wind, USDA, Chyxx, Huatai HK Research estimates

- 2) Companies with a large proportion of USD-denominated debts or obligations are likely to benefit. But if these companies have overseas assets to support the overseas debts or revenue and cash flows in USD to pay for such interest expenses, the net positive effect will be smaller. We screen a list of companies with a high proportion of USD-denominated debts in Fig.4. Among these companies, we think airlines and Chinese property companies are the largest winners because of property companies' mostly domestic oriented businesses and heavy USD-denominated debt, and airline companies' huge long-term obligations in USD.

Fig.4. Chinese companies with high USD denominated debts

Ticker	Name	Industry group	FY16 USD		FY16 total USD denominated		
			denominated debt (RMBmn)	FY16 total debt (RMBmn)	assets (RMBmn)	debt as % of total debt	Debt as % of total assets
1208 HK	MMG LTD	Materials	71,154	71,154	105,692	100.0	67.3
316 HK	ORIENT OVERSEAS INTL LTD	Transportation	28,388	28,388	65,265	100.0	43.5
2343 HK	PACIFIC BASIN SHIPPING LTD	Transportation	5,824	5,824	14,624	100.0	39.8
603 HK	CHINA OIL AND GAS GROUP LTD	Utilities	4,481	4,804	12,175	93.3	39.5
1886 HK	CHINA HUIYUAN JUICE GROUP	Food, Beverage & Tobacco	6,631	7,224	20,457	91.8	35.3
861 HK	DIGITAL CHINA HOLDINGS LTD	Software & Services	5,774	6,860	21,226	84.2	32.3
1600 HK	CHINA TIAN LUN GAS HOLDINGS	Utilities	2,341	3,601	7,633	65.0	47.2
2866 HK	COSCO SHIPPING DEVELOPMENT-H	Transportation	62,572	97,878	125,460	63.9	78.0
151 HK	WANT WANT CHINA HOLDINGS LTD	Food, Beverage & Tobacco	5,890	9,904	27,209	59.5	36.4
855 HK	CHINA WATER AFFAIRS GROUP	Utilities	5,864	10,026	22,683	58.5	44.2
1919 HK	COSCO SHIPPING HOLDINGS CO-H	Transportation	31,989	57,377	119,653	55.8	48.0
127 HK	CHINESE ESTATES HOLDINGS LTD	Real Estate	7,011	13,059	40,969	53.7	31.9
2678 HK	TEXHONG TEXTILE GROUP LTD	Consumer Durables & Apparel	2,976	6,109	15,284	48.7	40.0
3308 HK	GOLDEN EAGLE RETAIL GROUP	Retailing	4,308	9,428	21,893	45.7	43.1
1883 HK	CITIC TELECOM INTERNATIONAL	Telecommunication Services	3,118	7,077	16,274	44.1	43.5
1107 HK	MODERN LAND CHINA CO LTD	Real Estate	4,221	10,021	28,507	42.1	35.2
1589 HK	CHINA LOGISTICS PROPERTY HOL	Real Estate	2,040	5,236	15,541	39.0	33.7
1055 HK	CHINA SOUTHERN AIRLINES CO-H	Transportation	41,567	107,726	200,442	38.6	53.7
272 HK	SHUI ON LAND LTD	Real Estate	16,474	47,123	122,213	35.0	38.6
884 HK	CIFI HOLDINGS GROUP CO LTD	Real Estate	10,130	29,391	88,480	34.5	33.2
1628 HK	YUZHOU PROPERTIES CO	Real Estate	8,602	25,787	68,861	33.4	37.4
1966 HK	CHINA SCE PROPERTY HOLDINGS	Real Estate	5,291	18,278	50,835	28.9	36.0
688 HK	CHINA OVERSEAS LAND & INVEST	Real Estate	43,179	158,444	511,301	27.3	31.0
3383 HK	AGILE GROUP HOLDINGS LTD	Real Estate	11,690	43,996	131,725	26.6	33.4
169 HK	WANDA HOTEL DEVELOPMENT CO L	Real Estate	2,001	7,546	14,893	26.5	50.7
6839 HK	YUNNAN WATER INVESTMENT -H	Utilities	1,953	8,298	20,058	23.5	41.4
1112 HK	HEALTH AND HAPPINESS H&H INT	Food, Beverage & Tobacco	1,514	6,760	14,205	22.4	47.6
106 HK	LANDSEA GREEN PROPERTIES CO	Real Estate	1,360	6,083	18,007	22.3	33.8
694 HK	BEIJING CAPITAL INTL AIRPO-H	Transportation	2,303	10,803	33,904	21.3	31.9
1157 HK	ZOOMLION HEAVY INDUSTRY - H	Capital Goods	6,970	32,797	89,101	21.3	36.8
1313 HK	CHINA RESOURCES CEMENT	Materials	3,332	15,985	46,680	20.8	34.2

Note: includes Chinese companies with a total market cap greater than USD500mn, USD denominated debt as % of total debt higher than 20%, and debt as % of total assets higher than 30%.

Source: Bloomberg, Wind, Huatai HK Research

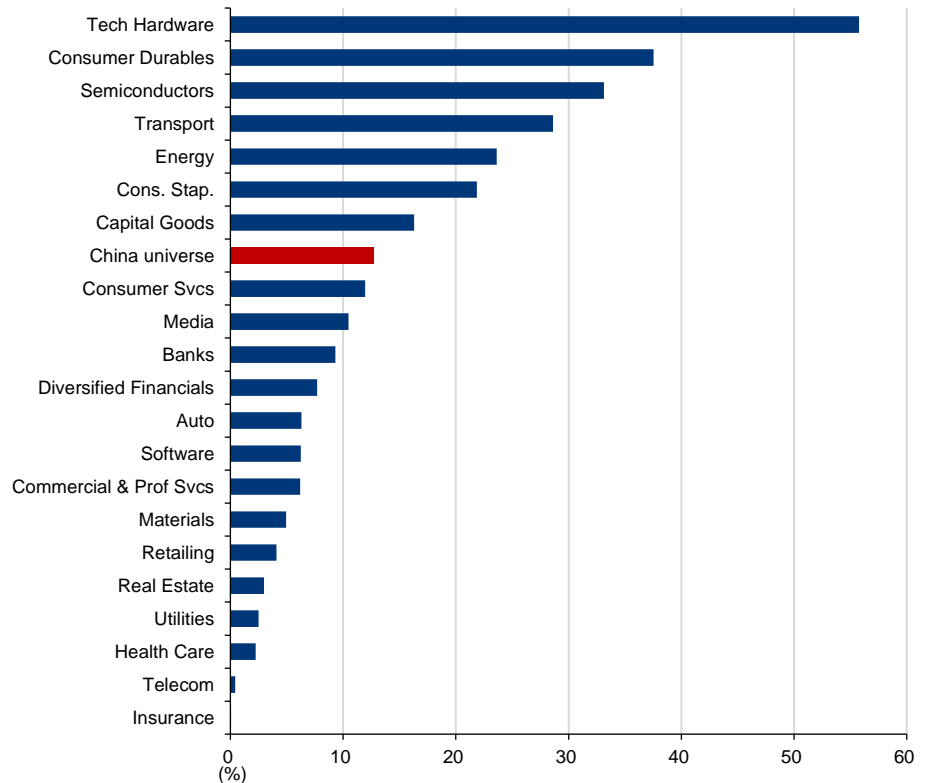
- 3) A strong RMB could also lead to more favorable prices for Chinese companies to acquire overseas assets and to participate in overseas investment projects. Although expectations of a weakening RMB could motivate Chinese companies to move their RMB assets offshore, a strong RMB could help Chinese companies to go global more easily. Meanwhile, financial service companies can also reap a harvest from more cross-border business and a stronger need for RMB from overseas clients.

Three types of sector/company are potential victims:

- 1) Export-oriented companies that are low-end OEM contractors, for example some home-appliance manufacturers, are likely to face narrower margins. For high-end manufacturers with their own brand and innovative technologies, a strong RMB will not influence their orders or margins, thanks to their strong bargaining power, in our view. In FY16, 12.7% of HK- and US-listed Chinese companies' revenue was from outside mainland China. Among them, tech hardware (55.8% of revenue from overseas markets), consumer durables and apparel (37.5%), semiconductors (33.1%), transportation (28.6%), energy

(23.6%), consumer staples (21.9%), and capital goods (16.3%) are more export-oriented sectors.

Fig.5. Overseas revenue as % of total revenue by sector



Note: includes HK- and US-listed Chinese companies with a total market cap greater than USD500mn. Data as of FY16.

Source: Bloomberg, Huatai HK Research

- 2) The marine transportation sector could be negatively influenced, because China as a net-exporter is likely to be affected by a strong RMB. However, for 2018, we think such concerns could be small as the global economic recovery will support resilient global demand.
- 3) Companies with large exposure to overseas, USD-denominated assets might benefit less from RMB appreciation from a valuation perspective.

In conclusion, a strong RMB could affect airlines and real estate companies the most positively, while influence on other companies and sectors' fundamentals could be mixed and might not be imminent.

Influence on household spending could be limited

In the short term, households' overseas spending and outbound tourism might not be influenced by RMB exchange rate, in our view. Structural changes in consumption have been prominent in recent years ([annual outlook report](#), 4 December 2017). The key drivers are an accumulation of household wealth, along with increasing demand for healthcare, and better quality goods and services, entertainment and travel, and education. In addition, overseas spending and outbound travel also are confined by the limited public vacations. Consumers, therefore, may not be highly sensitive to small price changes caused by currency volatility.

However, a further strengthening of the RMB is likely to attract consumers to take more short trips near China, which could benefit local consumer services companies and retailers.

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Unit 5808-12, 58/F, The Center, 99 Queens Road Central, Central, HONG KONG

Tel: +852 3658 6000

Fax: +852 2169 0770

Email: research@htsc.com

<http://www.htsc.com.hk/>