Strategy

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Huatai Research

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Strategy | China

Short-term market volatility likely to continue

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H-share market rout followed US equity sell-off

On 6 February, the China/HK market experienced their largest daily retreat since 8 July 2015, with HSCEI and HSI plummeting by 5.9% and 5.1%, respectively. The market rout was caused by the US equity sell-off on the previous day, the magnitude and timing of which exceeded the expectation of most investors. We highlighted on 16 January that after the rapid rise, the market could enter short-term doldrums and be prone to high volatility. We think short-term volatility might not have ended and that it could extend into the Chinese New Year holiday. However, a sustained deep market correction is not justified, in our view, given resilient fundamentals. After previously stretched valuation for some sectors is lowered and value emerges, the dip will provide buying opportunities for long-term allocation funds, in our view. We continue to like financials (especially banks and insurers), new economy sectors (healthcare and internet leaders), and select consumption names in the long term.

Emerging signs of a risk-off mode

The US equity market sell-off may stem from the recently mounting expectation of higher inflation and concerns over US 10-year treasury bond yield rising too fast. Some investors suspect this triggered the massive sell-off by quantitative funds, which exacerbated the market plunge. Since year-start, market expectations of corporate fundamentals have remained sanguine, and the S&P500 index's 12-month forward PE has continued to climb, even with revised-up earnings outlooks. The drastic market reaction to the latest concerns, therefore, could mainly be a trigger to offload previously stretched valuations. However, we do notice emerging signs of a risk-off mode, including a stabilized US 10-year treasury bond yield, a small uptick of the USD index, and this year's first outflow from the largest ETFs tracking EM equities, on 5 February.

Short-term volatility may have not ended yet…

After the strong market run since the start of the year, the fluctuation of overseas fund flows will continue, in our view. Meanwhile, Stock Connect southbound trading will be closed from 13 to 21 February. HK stock market prices could be highly influenced by US market performance and volatility could remain high.

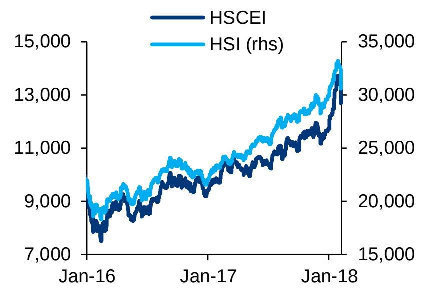
…but fundamentals should provide some support to valuation

Our key thesis for investing in the China market this year remains intact so far: slower but better quality growth of Chinese companies being the key driver of market performance with mild valuation expansion seen in Chinese companies, led by financials (see our annual outlook on 4 December 2017). After the market slump, 12-month forward PE of the HSCEI dropped to 7.9x, flat with the level at end-2017; HSI's forward PE declined to 11.8x (12.2x at end-2017). We believe that despite short-term volatility, resilient fundamentals should provide some support to valuations, and hence to the market.

Risks to our view

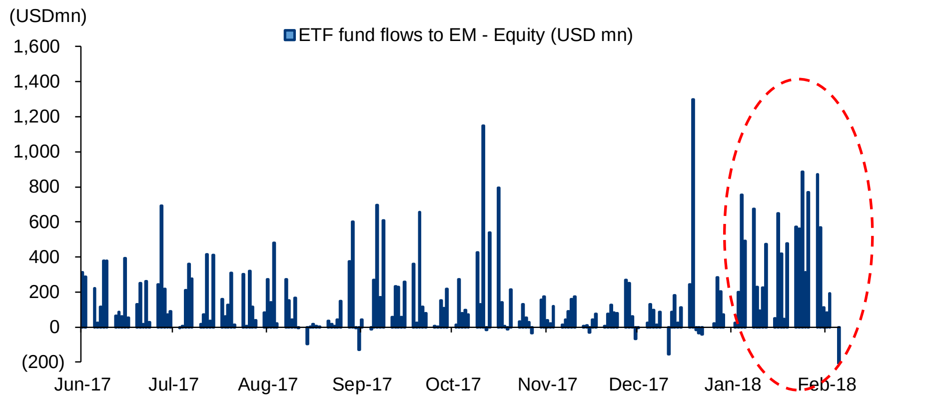
Widespread concerns in the financial market and severe risk-off could impact the real economy and, therefore, corporate fundamentals. Investors being deterred from all risky asset classes, for example corporate bonds, could lead to rising financing costs and greater default risk.

Index performance



Source: Bloomberg

Fig.1. This year's first outflows from largest ETFs tracking EM equities was on 5 Feb



Note: includes largest 50 ETFs tracking EM equities; data as at 5 Feb 2018
Source: Bloomberg, Huatai HK Research

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