Manager’s Report

I.1H21 Review

China and Hong Kong market experienced a roller-coaster performance in 1H21. The rally mainly occurred in Q1 amid market optimism in ADR’s return listing in HK as well as normalization of global economic recovery. The so called “old economies” sectors such as financial, infrastructure, material outperformed during Q1. Shortly after a relief rally on COVID-19 vaccination hopes in China and then Rest of World in Jan-Feb21, market retreats from shrinking liquidity and renewed US-China Tensions, which dragged the Hang Seng Index to sink to 27,500 level in March from 31,000 in less than a month. While HK/China economy continued to recover from low-based 1H20, the recovery has not been broad-based. In short, the Hang Seng Index rallied 5.86% in local currency terms in 1H.

II. Equity and Fixed Income Outlook

1. Equity outlook

While we see a strong economic data and corporate earnings YTD, we see the earnings momentum is normalized. While we see further monetary tightening is limited on import inflation and easing on overheating, we see no easing in near term. Overall normalization remain the key word to summarize our asset allocation strategy and key themes for 2021. We see slower earnings momentum post strong Q1 earnings given the cost pressure. In China, PBOC stopped net injection into the market since Feb. Such tight liquidity triggered a re-allocation of assets from new economy sectors back to old economy sectors. Our belief in range trading remains intact with fair value Hang Seng index (i.e. H.S.I) at 13 x 2020 forward PE of 28,500 level. We see HSI to trade between 27,000 – 30,000 range continues in Q2 and see opportunities below 28000 level.

In 2H21, we also expect PBOC would need to inject more liquidity into the market in 2H on a higher base economy and exports tampering, hence, we anticipate a rebound towards 29,000 – 30,000 level will continue in near term. We continue to see high market volatility to continue, hence, we expect cash level of portfolio may change from time to time. Key downside risk will be mainly from valuation de-rating of escalating Global political tensions against China and major disappointments on vaccine deployments.

On the macro front, post the China's NPC meeting, with major economic objectives and policy stimulus announced, albeit with the government de-emphasizing GDP growth target, we expect a faster recovery with more aggressive easing fiscal/credit policy stance for the rest of the year with more RRR cuts and policy rate cuts, acceleration of Hukou and land reform, and more opening-up, IP protection and innovation. Hence, we see there would be an improvement on all major indicators (e.g. Fixed asset investment, Money supply, retail sales, and PMI) would see a rebound. Given a more investment friendly monetary policy, we expect liquidity would gradually flow back to financial market.

As for Hong Kong economy, we also see a moderate recovery but political vows after the implementation of National Security Law together with another round of outbreak in COVID-19 would drag the recovery in particular in domestic consumption and commercial activities.

1.1 Investment themes

Cyclicals reflation

In 2021, China will continue to focus on structural reforms which targets boosting domestic consumption and productivity upgrades through technology breakthroughs as well as efficiency improvement. We see China GDP in 2021 to recover from low base with a

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stronger CNYUSD profile, particularly in 1H21. Given 2021 will be the first year of 14th 5-year plan, we expect a gradual but solid recovery with dual circulation strategy to support domestic economy. Post-COVID economic recovery in the US and China were faster than expected, as evidence by PMI and escalating asset prices. With global economic activities began to resume and re-stocking in trend, strong demand in upstream resources led to sharp surge in global commodity prices. With such backdrop, cost push inflation worries raised concern of central banks to hold up easy money policies.

Boosting consumption and infrastructure spending

Global pandemic is expected to ease international passenger traffic flow in 2H21, we see transportation and consumption is expected to recover. With infrastructure spending to pick up post the 100th anniversary of the Chinese Communist Party in July 1. We expect boosting measures and subsidy for “consumption upgrade” and will have growing needs in consumer services and better quality products and personal experiences like movie, arts. We also see the easing of third-child policy to boost birth rate with supportive measures and tax incentives.

China Tech localization/Internet plus/ IoT Connectivity and AI

Similar to 2020, we continue to see solid connectivity demand growth in wireless communications modules on rising Internet of Things (IoT) demand. IoT proliferation will further expand the total addressable market for Radio Frequency (RF) products, which will be a long-term growth driver. We also expect wider adoption in 3D sensing on facial recognition and gesture control will be a long term theme. With 5G demand going forward, we see Chinese Internet giants have home market advantages with increasing spending in high tech areas through both R&D and M&As, overall automation/machinery demand are driving the new capex cycle. It is a key proxy for rising adoption of more automation tools and locally made robots in China. We also see the capex upcycle in electronics, autos, and battery segments.

1.2 Valuation and Strategy

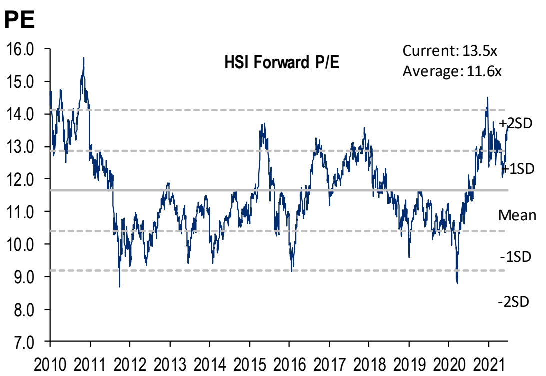
We continue to see range trading based on current tightening situation, which is equivalent to 13x forward PE and 1.3x forward P/B, tracking +1SD level to 10-year average forward P/E and par to 10-year average forward P/B. We would be turning more optimistic towards weakening economic data in near term, which China has more room to ease both in fiscal and monetary policies (Scenario 1, Bull case). Nevertheless, our bear case scenario including a resumption of global pandemics outbreaks for extensive lockdowns and escalating recessions risks (Scenario 4). It will hit the market to trade below to historical low est. forward PB of 0.8x, equivalent to 22,000 of the index level, tracking to -2SD level.

Figure1: Scenario analysis post coivd-19 pandemic and global recovery on HSI target

Scenario analysis for COVID-19 epidemic and impact on global growth on Hang Seng Index targets										
	Current Price	Index Fair Value	Index Fair Value EPS YoY		Consensus EPS YoY		Fair Value	Fair Value	Consensus	Consensus
	30/06/2021	FY2021E	Dec-21	Dec-22	Dec-21	Dec-22	Est. PE	Est. PB	Forward PE	Forward PB
Base Case	28,310	28,000	11%	10%	17%	15%	13.0x	1.3x	13.3x	1.3x
Bull Case	28,310	30,000	14%	12%	17%	15%	15.1x	1.4x	13.3x	1.3x
Bear Case	28,310	27,000	8%	10%	17%	15%	10.5x	1.1x	13.3x	1.3x
Dump Stage	28,310	22,000	6%	7%	17%	15%	9.0x	0.8x	13.3x	1.3x

Source: Bloomberg estimates, data as of June 2021.

Figure 2: HSI Forward P/E



Source: Bloomberg, data as of June 2021.

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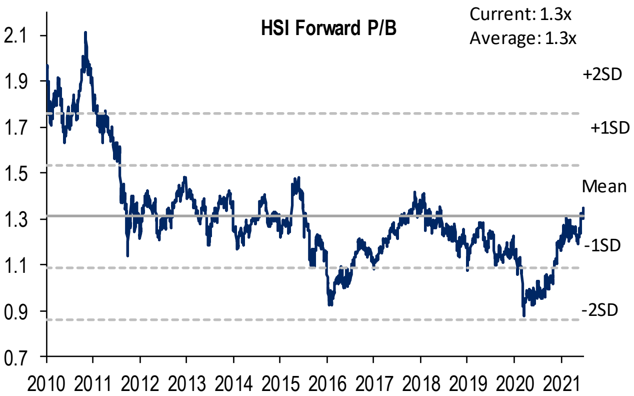
Figure 3: HSI Forward P/B



Source: Bloomberg, data as of June 2021.

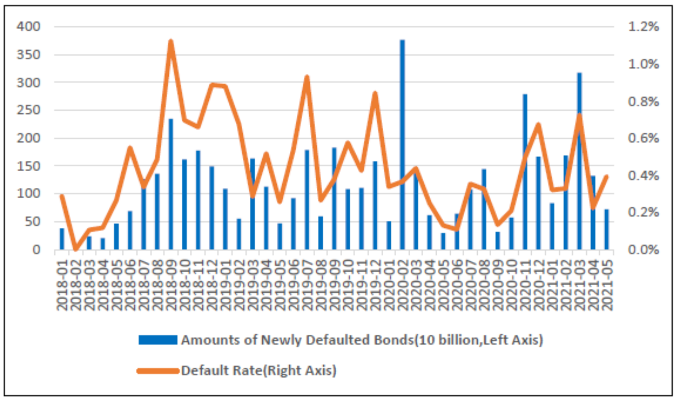
2. Fixed Income – volatilities in high yield bonds

In bond market, we see record high of Chinese bond defaults i.e. New onshore corporate bond defaults have reached 105.8b yuan ($16.43b) May YTD, including 16 private and 59 public offerings and major names like Founders, Tsinghua Unigroup, China Fortune Land, Tahoe, etc. We also see heightening market concerns on rating downgrades like Huarong and Sichuan Languang has impacted the bond market sentiment further.

Given a higher number of debt profiles to face maturity refinancing for the rest of year, the absolute number of corporates' defaults would expect to rise in the second half. Nevertheless, we continue to see the total value of defaults to remain below Rmb200bn and manageable at <1%, considering the size of the total Chinese bond market. With the sub-sectors, the default companies are mainly focused on manufacturing, wholesale, retail trade and construction sectors, which are mainly impacted by trade war and virus outbreak.

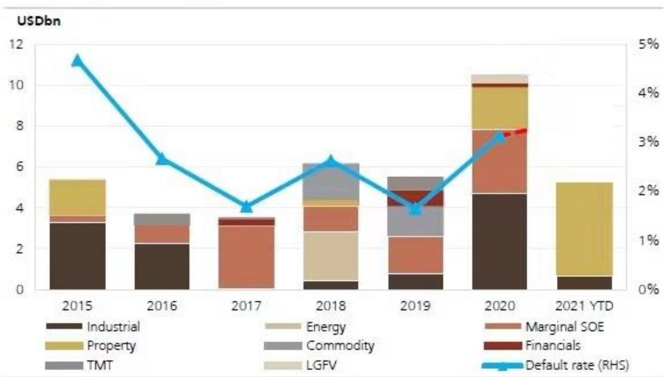
We continue to believe the default rate is relatively low in Chinese property developer sectors and banking sectors given the strong YTD property presales and modest credits. Especially for the property sector, proactive cash flow management through market access in 1H21, should keep defaults low. For the onshore bond market, Chinese privately-owned enterprises (POEs) are likely to face bigger default risks on waning demand for lower-rated bonds, but more targeted measures in supporting SMEs have kept POE default rates under control.

Figure 4: Monthly Onshore Defaults



Source: CDDC, data as of June 2021

Figure 5: Total Offshore Defaults



Source: UBS, data as of June 2021

2.1 Fixed income Outlook

Though we continue to expect the US Federal reserve to maintain a stable interest rate policy for the rest of the year, however, while rate hike expectation still ligers, global liquidity is bias to tighten after Q3. Overall, we expect the Fed will not propose a timetable to reduce QE until Q4.

Despite a benign interest rate backdrop, we envisage a higher volatilities in the China corporate bond especially

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in the high yield segment in 2H given a tighter than expected domestic monetary policy by the policy makers as well as government has been pursuing to cut leverage and toughen up its corporate sector. As more defaults are expected, spread on China US dollar high yield bonds spreads are expected to linger at a higher level during 2H.

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