GROW Research
China Market Strategy

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Saving Hong Kong

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- ✓ Chinese PPI, Chinese 10-year yield and US NFIB hiring data suggest US inflation has peaked. These are obscure indicators/relationships. But slowing inflation augurs for a US recession – it is not a cause for rejoice.
- ✓ The hedging relationship between stocks and bonds still works in China - unlike in the US. As such, China is still a normal market where prices can be more informative.
- ✓ Hong Kong is deeply oversold. Despite US recession risks, there is a trade here.

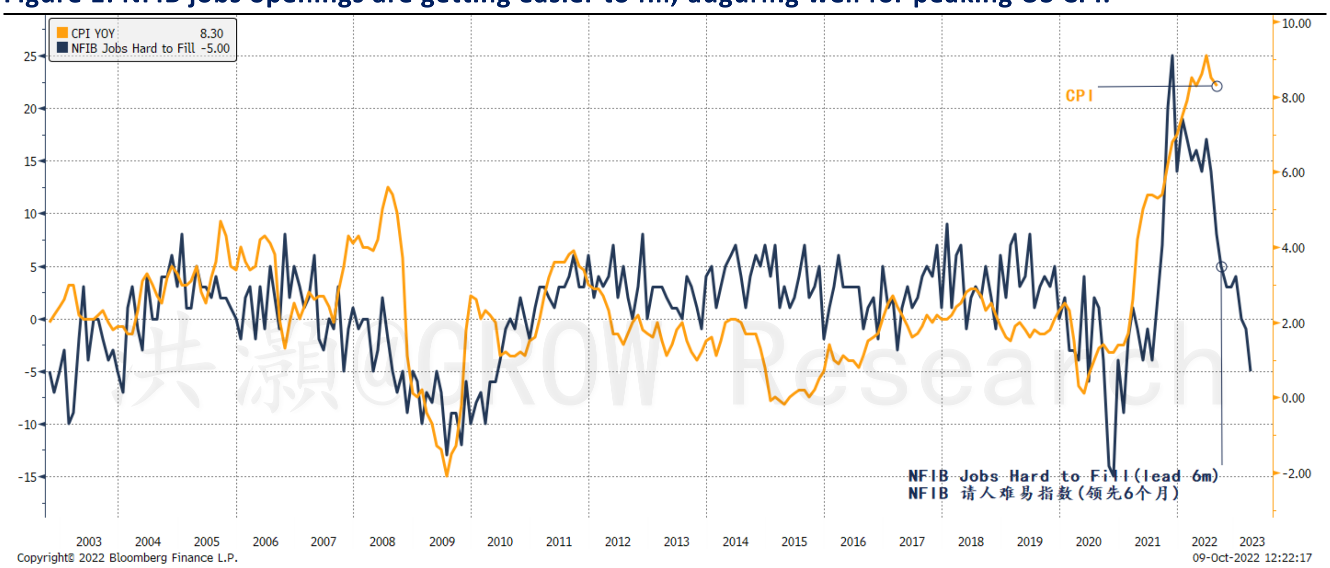
Chinese version:
《拯救港股》

US Inflation has peaked.

The US market was spooked by better-than-expected jobless rate on Friday, regurgitating almost all gains made in the first three days of October. While Fed officials are still adamant about the hike path, longer-term yields have started to price in a pause early next year.

The alternative economic indicators that we used to track the global inflation cycle are also suggesting slowing US growth and falling US demand ahead. For instance, job openings are getting easier to fill, according to the NFIB. This measure tends to lead the US CPI by up to six months (**Figure 1**). If tight labor supply is being alleviated, then inflation pressure will likely lessen in the coming months due to waning demand.

Figure 1: NFIB jobs openings are getting easier to fill, auguring well for peaking US CPI.



Source: Bloomberg, GROW Research

What China holds for the US economy

In today's world, we could no longer analyze any country's macroeconomics in isolation. China's slowdown is a much-discussed topic in the global investment community. After almost two years of relentless selloff in both on- and off-shore Chinese markets across the board, many China-focused funds are on the brink of capitulation.

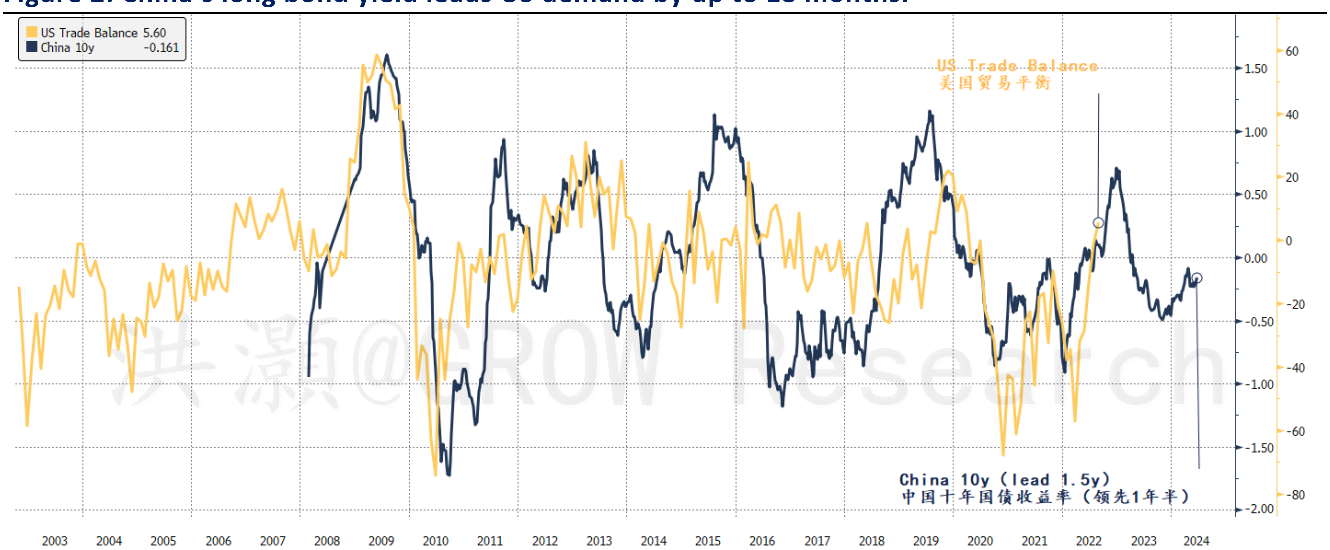
What is happening in China's economy and market indeed holds the one of the keys to understand global markets at this juncture. Note that both bonds and stocks plunged in the US this year, as well as many developed markets. The China may be one of the few remaining markets where the hedging relationship between stocks and bonds continue to work. That is, China is one of the few remaining markets still functioning normally.

Reading clues from US bonds that have behaved abnormally this year may not give a plausible diagnosis of the US, as well as the global market. Instead, reading from a normal-functioning market such as China can be more helpful.

To gauge the strength of US demand in the coming months, we can use the US trade balance as a proxy. The US imports heavily from China. Indeed, the US goods trade deficit vs. China is at one of its highest in history. In part because of strong US demand, exports have been a key pillar holding up Chinese growth this year. But as the Fed striving to cool domestic demand by hiking interest rate, US demand for Chinese goods will likely wane in the coming months.

Chinese 10-year yield has long foretold this looming change in these two important trading counterparts' external accounts. Chinese 10-year yield historically led the US demand by up to 18 months (**Figure 2**). Falling Chinese 10-year yield for the past year has indeed heralded waning US imports and better US trade deficit in the coming months.

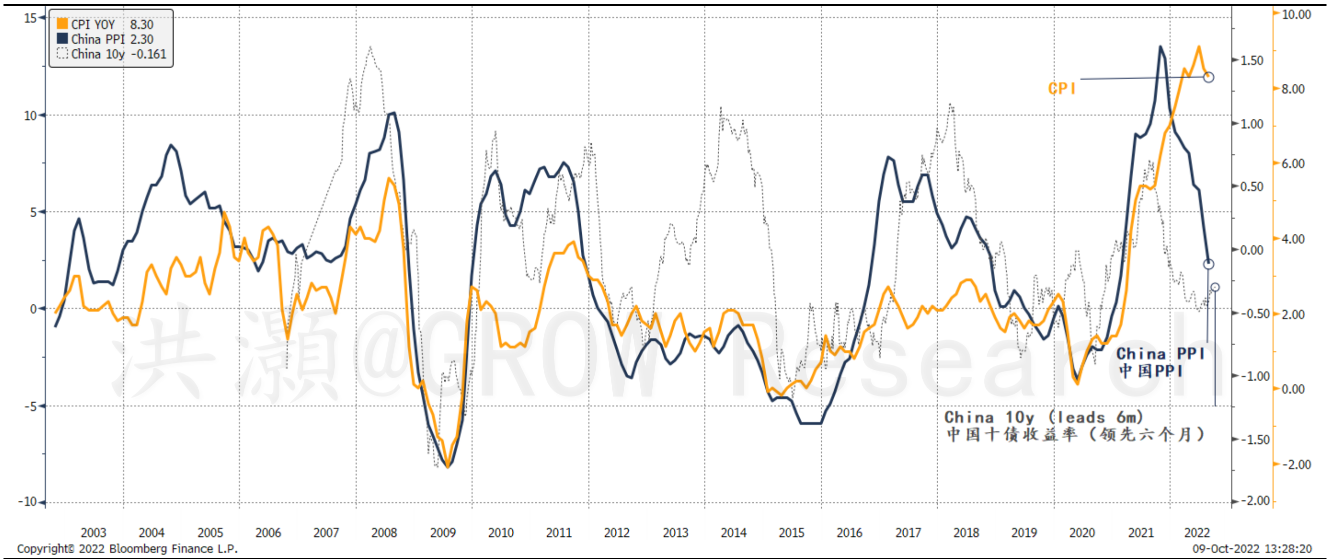
Figure 2: China's long bond yield leads US demand by up to 18 months.



Source: Bloomberg, GROW Research

We also note that the US CPI is diverging significantly from China's PPI – to its widest in the past two decades. Divergence such as this is clearly untenable and will soon converge. Meanwhile, China's 10-year bond yield leads the US CPI by up to 18 months (**Figure 3**). Falling Chinese 10-year yield over the past year, as well as falling Chinese PPI, suggest that the US CPI has peaked.

Figure 3: Falling Chinese PPI/bond yield suggest peaking US CPI; China's 10y leads US inflation.



Source: Bloomberg, GROW Research

These are obscure inflation indicators and less-discussed relationship in the global community. Friday's market panic over lower unemployment rate hints at market's confusion about the outlook of US inflation. But if the US market has not been functioning normally so far this year, and the US bond market is at its worst in history – ever, then we should listen to a market free of dislocations and distortions.

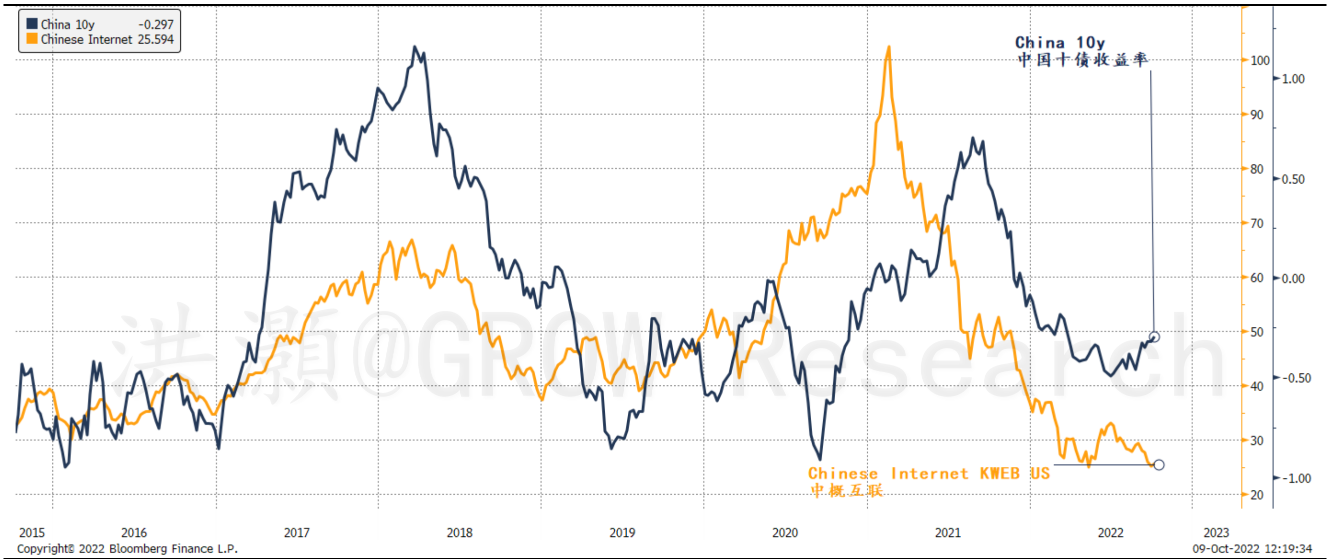
Hong Kong is truly madly deeply oversold.

Chinese 10-year yield has indeed started to notch up, diverging from China's growth assets represented by Chinese internet platform companies (**Figure 4**). Given a tepid inflation outlook in China, this uptick in bond yield probably suggests a growth recovery, no matter how mild it is going to be.

Some may point out that the relationship between Chinese 10-year and Chinese growth didn't hold up well during the pandemic. At that time, lower bond yield was translated into lower discount rate and hence higher valuation for growth stocks. Further, because of global mobility restrictions, internet platforms have become an essential part of our everyday lives.

As the world gradually adjusts to the post-COVID state, the relationship between Chinese bond yield and Chinese growth should normalize to what it was before 2020, when rising bond yield suggested growth and growth assets responded in tandem.

Figure 4: Chinese internet diverging from Chinese 10-year yield.



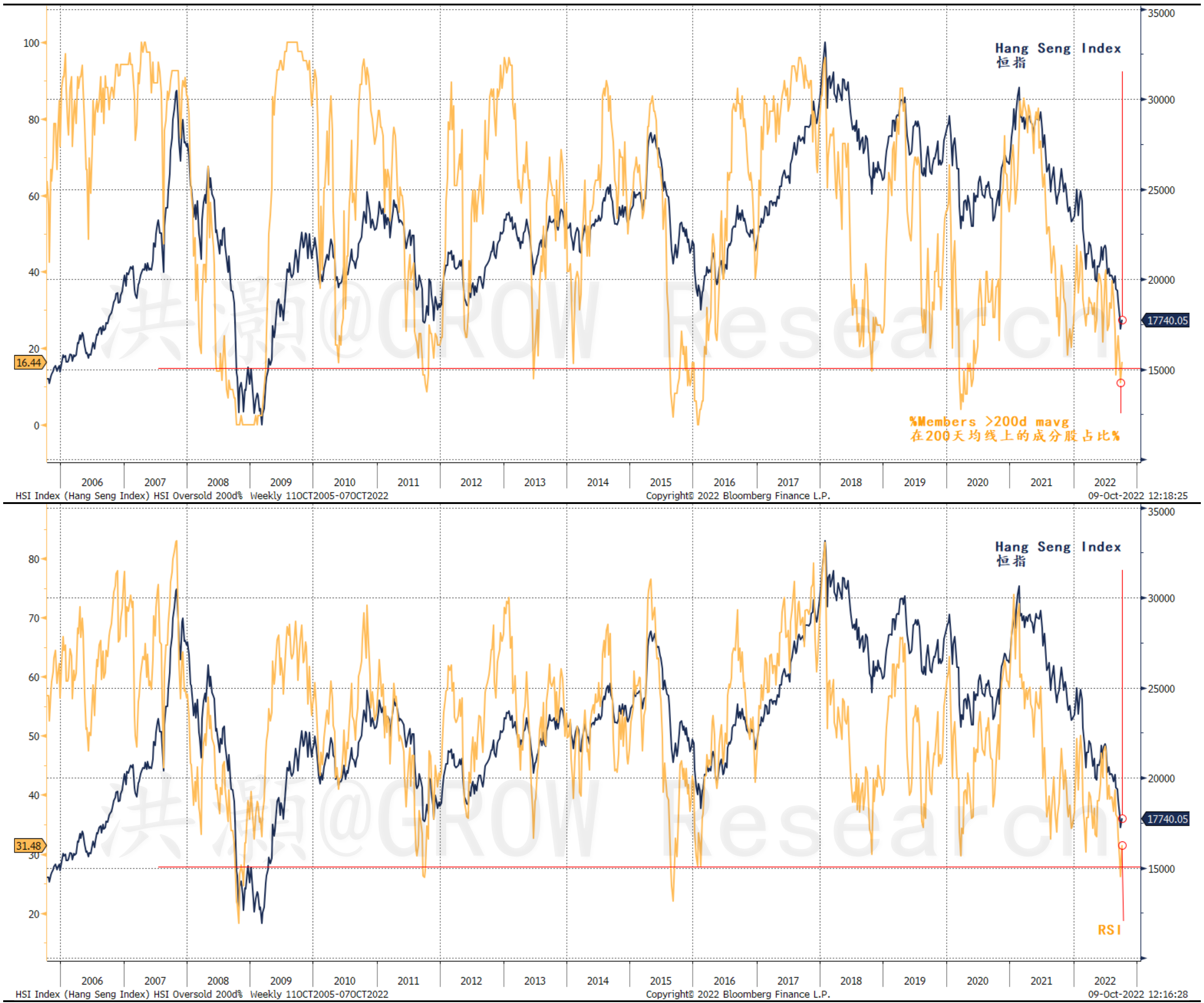
Source: Bloomberg, GROW Research

But not just Chinese internet, the entire Chinese market is not responding to the growth signal, however faint it may be. The Hang Seng is at its lowest in more than a decade, and is at a similar level of 1997 during the Asian Financial Crisis.

In **Figure 5**, we show the extent of oversold of the Hang Seng Index. We can see that both relative strength and the constituents that are above their 200-day moving average are at their lowest in history.

Granted, HK is confronted with some daunting geopolitical challenges. The US is expanding its ban on semiconductor technology exports to China, and the Chinese ADRs audit is another overhang. Not to mention the HKMA has been slow to raise its prime rate in tandem with the Fed, and chosen to burn its forex reserve instead to defend the USD peg. But at these levels, a lot of the bad news must have already been in the price.

Figure 5: Hang Seng is truly madly deeply oversold.

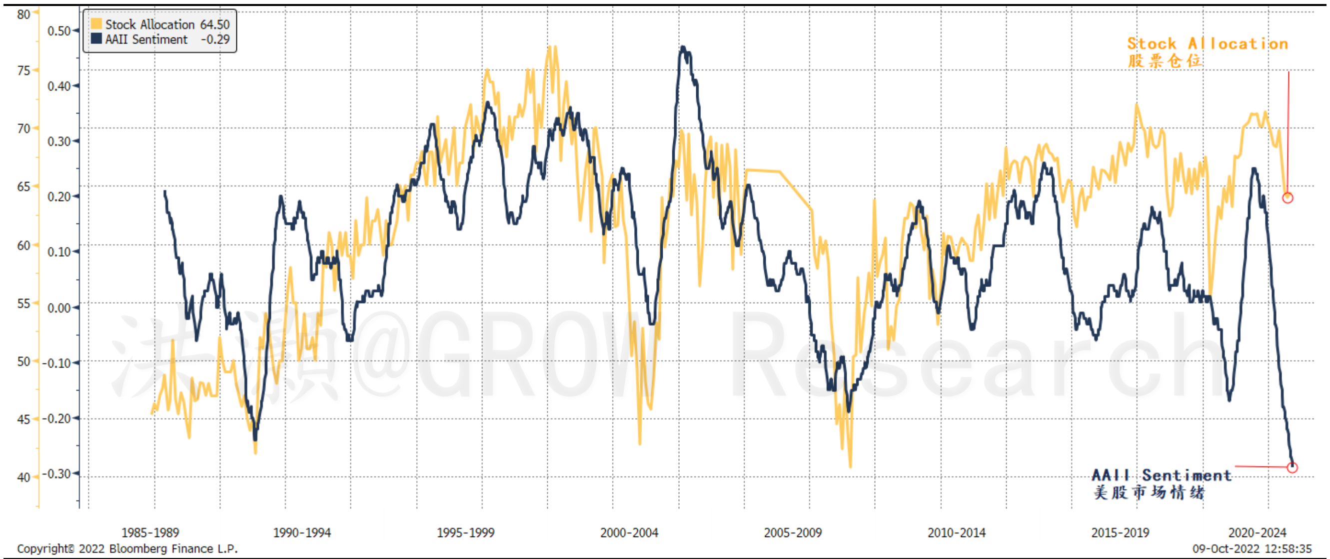


Source: Bloomberg, GROW Research

As discussed above, the US market is still undecided about the US inflation outlook. Thus, the US market sentiment is fickle and can turn on a dime. It is one of the reasons why we don't rely on sentiment indicators to time this cycle, as many historical relationships have become unreliable, and the hedging relationship between stocks and bonds in the US has flipped.

We look at the actual positioning of stocks in portfolios instead. We note that stock positioning is still too high, given the professed depressed market sentiment (**Figure 6**). Granted, the last data point on stock positioning we had is for the end of August, and should be lower than what it is now after a month of selloffs. But it still won't be at a level that historically augurs for a market bottom. If so, the US will continue to be a source of volatility for China's on-and off-shore markets, as they striving to find their footings.

Figure 6: US market sentiment most depressed ever, but stock allocation far from it.



Source: Bloomberg, GROW Research

Conclusion

The US inflation has peaked. Falling Chinese 10-year yield over the past year has long heralded the arrival of this day in the coming months. But it is not a cause for rejoice, as slowing inflation reflects waning demand, and hence a US recession.

Instead of reading into a dysfunctional US market where the long-held hedging relationship between stocks and bonds has broken down, we take cues from Chinese 10-year bond yield instead. It is notching up, hinting at a mild growth recovery ahead. If so, Chinese growth assets such as the Hang Seng and Chinese internet, should respond eventually.

Of course, daunting geopolitical challenges remain. And the US clearly has not bottomed, and will remain as a source of volatility for the Chinese markets. We are torn between our former sell-side ego to call a bottom and maximize return, and our current buyside self to preserve capital and minimize risks.

Regardless, there is a trade here for the brave.

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