The big tussle

Hong Kong's Hang Seng Index has been entangled in a narrow trading range in the first half of 2014. The local stock market is likely to continue struggling in the absence of any catalyst to uplift the equity market in the second half. Oswald Chan reports.

For the rest of the year, laggard economic growth on the mainland, the gradual tapering of the US monetary quantitative easing (QE) policy and weak Hong Kong economic data could impede the Hang Seng Index's (HSI) upward potential.

Whether the central government can stick to its targeted economic growth of 7.5 percent for 2014 has been a topic for hot debate — the nation's economic growth in this year's first quarter managed to hit 7.4 percent.

The central government had, in the past two months, introduced mini-stimulus measures, such as increasing investment in transportation, social housing and the utility sector. Local governments have relaxed housing purchase curbs to shore up the mainland's property market.

At the end of May, the State Council pledged to lower financing costs for companies, increase financing support for the services sector and strengthen re-lending support for small firms and project-specific financial bonds, in order to stabilize economic growth on the mainland.

The central bank — the People's Bank of China (PBOC) — unveiled the latest RMB reserve ratio (RRR) in May that's estimated to inject 70 billion yuan into the mainland banking system. CCB International Securities (CCBIS) has forecast a 0.5-percent cut in RRR, or a 0.25-percent interest rate cut in the third quarter that would allow banks to accelerate lending in the second half of the year.

But, despite the string of economic stabilization packages, prospects for the mainland's economic growth are up in the air.

"The balance of risk to growth is still on the downside. For these (economic) signs of stabilization to turn into a sustainable recovery, investments need to pick up. And for that to happen, borrowing costs need to come down further. It's therefore encouraging to see the monetary policy increasingly becoming more flexible to support growth," said HSBC Greater China economist Julia Wang.

"Downside risks to growth remain substantial. The still unimpressive new export orders indicate that recovery in global demand has yet to turn convincing. Domestically, a more pronounced downturn in real estate would lead to a significant spill-over into other sectors and overall growth," Royal Bank of Scotland chief China economist Louis Kuijs said.

Second, continued US tapering of its monetary QE policy is also taking a toll on investment sentiment in the local equity market.

Earlier this month, the US Federal Reserve (Fed) trimmed its bond-buying program for the fourth time, reducing its bond-buying amount to $35 billion monthly — down by $10 billion a month. The Fed began unwinding its QE program in December last year from the original bond-buying level of $85 billion per month. The financial market expects the Fed to stop bond purchases completely by the end of this year.

The only uncertainty that remains is when will the Fed raise interest rates — a move that definitively will induce Hong Kong interest rates to follow suit, and this will have a negative spill-over effect on the local equity market. Under Hong Kong's Linked Exchange Rate System, the city's interest rates will go up if US interest rates climb.

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> CASTOR PANG
> HEAD OF RESEARCH, CORE PACIFIC-YAMAICHI

No rate hike hint

The US Fed has predicted that interest rates are not likely to move upwards until mid-2015, based on US economic data on labor market conditions, inflationary pressures and overall financial developments.

Third, the HKSAR's faltering economic growth is creating headwind for the local stock market.

The city's bleak economic growth expectations for 2014 emerge from the muddy confluence of feeble retail sales, anemic exports and a potential housing bubble — factors that have already started a continuous economic growth downward cycle in Hong Kong since 2011.

Economic growth in 2012 stood at 2.9 percent and 1.5 percent last year. Economic growth rates in the past five years have been much lower than the 10-year average of 4.5 percent. The situation did not improve during the first quarter of 2014, when the city's economy grew by only 2.5 percent — below the 2013 fourth-quarter rise of 2.9 percent.

Clouded by these uncertainties, Hong Kong's equity market, basically, is trading within a narrow range in the first half of this year (See table below) and the market momentum is predicted to remain sluggish in the next six months.

"Defaults of local government debts on the mainland, possible US interest-rate hikes in the second/third quarter of 2015 and the political ramifications of the 'Occupy Central' campaign may create downward pressures on the share market," Tengard Fund Management investment manager Patrick Shum told China Daily.

He predicted the HSI will remain in a narrow trading range of between 21,000 and 24,000 points in the coming six months. "Investors have to adopt an even shorter mentality in investing in local shares, like a guerrila fighter. The investment time horizon may be as short as just one or two days. There's really no long-term investment anymore," Shum noted.

CCB International Securities (CCBIS) estimates the Hong Kong equity market should trade between the range of 19,600 and 23,500 points by yearend. Downside risks would come from faster-than-expected property investment deceleration, financial defaults and premature QE tapering in the US.

According to CCBIS, the Hang Seng China Enterprise Index looks more attractive than the HSI in terms of valuation recovery in the second half of this year. The brokerage house assessed HSI's P/E ratio in 2014 at 10.8 times and the HKCEI's at 7.3 times for the same period.

"Long-term outperformers in the new economy, investment opportunities arising from the 'through train' between Hong Kong's bourse and the mainland's A-share market, as well as state-owned enterprises' (SOEs) reform beneficiaries are the three major investment themes for the local share market," CCBIS Managing Director and Co-Head of Research Peter So said.

UBS holds a neutral rating on the Hong Kong share market, believing there's no catalyst to fuel a share market surge in the next six months.

However, UBS is bullish on conglomerates, Hong Kong-based banks, gaming operators, capital-goods companies and high-yield, real-estate investment trusts (REITs) because these shares can offer growth and income potential as the economic cycle improves.

Equities 'under-weighed'

But, Goldman Sachs is even more bearish, saying Hong Kong equities should be under-weighed, given valuations and tightening global financial conditions.

According to the investment bank, the local equity market is trading at 14.9 times price-to-earnings (P/E ratio) and 1.3 times price-to-book (P/B) ratio — higher than that of the Asia Pacific region, excluding Japan (with a 11.9 times P/E ratio and 1.6 times P/B ratio). A higher P/E ratio and P/B ratio suggests the share market valuation is expensive and the market may probably fall afterwards.

However, not all analysts concur. Core Pacific-Yamaichi head of research Castor Pang is bullish about the local stock market for the second half of the year. "Fixed-asset investments on the mainland will pick up in the coming six months and, with a possible US interest-rate hike in 2015 and Hong Kong's share market valuation likely to be re-rated, the local stock market should turn stronger in the coming six months," Pang told China Daily, adding that the HSI in the second half of 2014 should hover between 24,200 and 24,800 points.

Dickie Wong, research director at Kingston Securities, reckoned that the HSI could hit 25,000 points by the end of this year, or 9.3 percent upside potential from the current trading level, depending on the speed and volume of capital flow into the local share market.

"Given the fact that the mainland's economy is gradually improving, the US being unlikely to raise interest rates before mid-2015, and Hong Kong-listed shares not really influenced by local economic growth figures (their businesses have already been diversified into the mainland and other countries), capital inflow is the only factor that can boost the share market," Wong said.

"The Shanghai-Hong Kong Stock Connect, to be launched in October, will attract more capital from the mainland to purchase Hong Kong-listed shares, thus injecting much-needed capital to buttress the market," Wong added.

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> LOUIS KUIJS
> CHIEF CHINA ECONOMIST
> ROYAL BANK OF SCOTLAND

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World indices' performance from December 31, 2013 to June 20, 2014

Indices	Increase/Decrease
Hang Seng Index	-0.48%
Hang Seng China Enterprises Index	-3.89%
CSI 300	-8.30%
Tokyo Nikkei 225	-5.78%
Dow Jones Industrial Average	2.23%
London FT 100	1.13%