Investment Strategy Update

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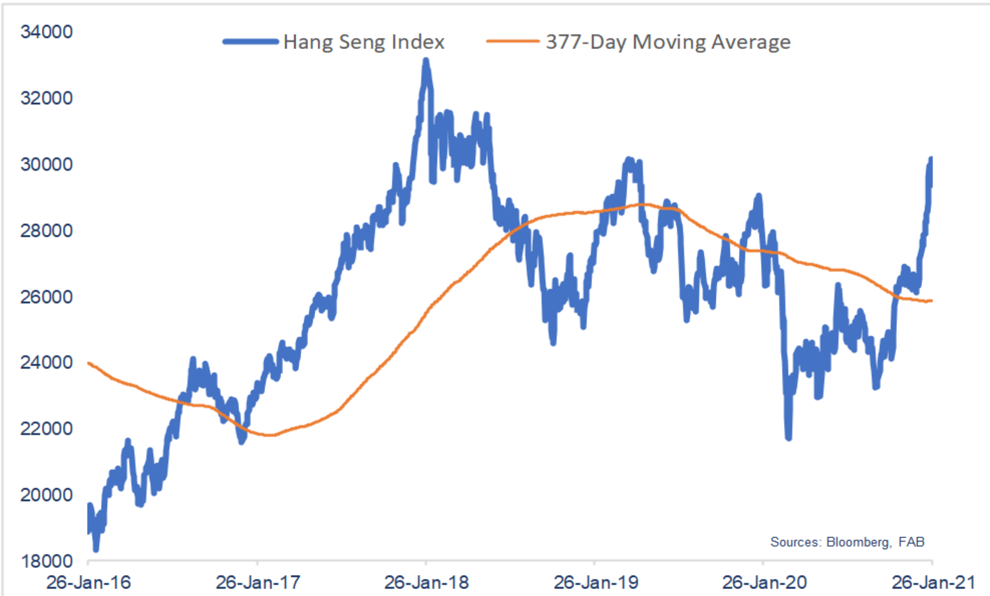
A primer on Hong Kong stocks as the Hang Seng revisits highs

- **The Hong Kong market is up 7.93% year-to-date, and is now near its highest since May, 2019.**
- **At 13.23x expected earnings, the index is trading at a 10x discount to the forward P/E of the S&P 500, compared to a historic discount of about 4x.**
- **The index last peaked on 29 January 2018, at almost 33,000. Reaching that apex again would entail a 12.3% gain.**
- **The index is heavily skewed to Chinese companies, which is why it was down 2.55% today.**
- **The FAB AAC has an overweight position in equities, IG and EM bonds, and gold, and underweight alternatives.**



When the FAB Asset Allocation Committee decided last week to increase its exposure to equities, one of the markets that drew some discussion was Hong Kong's. The market is often seen as a more liquid, easier-to-trade way to get exposure to China, even though many of the stocks in the Hang Seng index are not necessarily of Chinese companies.

Companies from the mainland are, however, the heavyweights in Hong Kong. Tencent, the ubiquitous platform that owns WeChat, is the biggest component of the Hang Seng at 10.7%, while Meituan, the Chinese online retailer, is the fourth heaviest weight in the index. Numbers two and three, however, are respectively insurer AIA Group and HSBC. In fact, overall, financials represent 41% of the index, followed by technology, which accounts for roughly a quarter of the index, if internet companies such as Tencent and Meituan are included there.

The importance of financial services in the index helps to explain why it retreated 2.55% today after a key adviser of the People's Bank of China (PBOC) was quoted as saying that the central bank needs to be mindful of potential bubbles. On the same day, the PBOC also withdrew some liquidity from the local economy, a surprising move ahead of the Lunar New Year, a time when bank liquidity needs increase.

The Hang Seng Finance subindex fell 2.17% on the news, dragging the broader index. The weight of financials can also be partly blamed for the Hang Seng's recent underperformance. The benchmark is up 35.5% since 23 March, while the developed markets index MSCI World has rallied 72.08% in the same period.

This underperformance adds to the allure of the index. While there is a growing chorus of people questioning some valuations in the US, it is hard to attack the Hang Seng with that argument.

The Hang Seng is trading near a three-year high, but still has room for more gains

The index is trading at 13.2 times expected earnings for the next 12 months, compared to 23.2 times for the S&P 500. This is despite what seem pretty bullish earnings forecasts, with the consensus of analysts surveyed by Bloomberg expecting earnings in the Hang Seng will grow 22.7% this year and 17.5% in 2022.

Again, some of the hurdles the Hong Kong market has faced could make it attractive this year. Its leverage to China and financials, and the underperformance derived from that could spur it in 2021. The US-China trade war is over, as are the protests in Hong Kong, both of which had slowed gains in the Hang Seng. Finally, banks could see earnings rise this year. At least on the face of it, there is reason to be bullish about Hong Kong.

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