Manulife Investment Management

Investment Note

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The ongoing coronavirus (COVID-19) outbreak, coupled with recent oil-price volatility, have placed pressure on Hong Kong and China equities. In this investment note, Kai Kong Chay, Greater China Specialist, provides an update on the asset class and explains why he thinks that corporates will weather the uncertain backdrop and still deliver positive earnings growth in 2020.

What's next after the sell-off? Hong Kong and China equities update

Despite the coronavirus outbreak and the oil-price slump, offshore Hong Kong and China equities have been resilient, with the MSCI China Index outperforming the MSCI World Index by over 12 percentage points. Furthermore, the Shenzhen Stock Exchange Composite Index is one of the world's most resilient indices this year[1]. In this investment note, we will share our views on some of the investment themes that have been affected by the recent uncertainty, such as consumption, and provide an update on our secular long-term themes.

Earnings outlook

In an early effort to contain the virus, the Chinese government extended the Lunar New Year holiday, introduced quarantine measures and imposed traffic restrictions. As a result, factory production and new orders in the country collapsed to record lows in February[2]. Therefore, it will not be a surprise if the first-quarter earnings of China's corporates are negatively affected. It is now mid-March, and we can already see a gradual and orderly resumption of industrial production in 90%[3] of the country's provinces (excluding Hubei). Also, the government's supportive policies, such as lowering benchmark lending rates, suspending corporates' social security payments, and the potential for further fiscal stimulus with new infrastructure projects, mean that the impact of COVID-19 on China's economy should be relatively limited this year.

As the COVID-19 outbreak has now extended globally, earnings forecasts for Chinese equities have declined to 8%.[4] Nevertheless, investors shall continue to see investment opportunities in companies that have the potential to deliver solid earnings growth over the next two-to-three years.

Consumption services in, travel names out

Seasoned investors have taken the sell-off opportunities to reinforce high conviction ideas and avoid names with more downside risks. Considering the global outbreak of COVID-19, investors should fine-tune their focus within consumption sector—cautious in travel and tourism related names and positive on domestic-driven consumption services. We believe there may be more negative surprises from travel-related sectors in the first quarter and the first half of this year, as restrictions on movement are now being extended globally and are should remain in place for the next few months.

The recent commodity-market tumble has fanned the flames of an already volatile stock market. US Brent crude oil collapsed by as much as 34% on 9 March[5], after Saudi Arabia shocked the market by launching a price war against Russia.

[1] Bloomberg, as of 16 March 2020. Year-to-date index price returns in local currency: MSCI China Index: -15.11%; MSCI World Index: -27.80%; Shenzhen Stock Exchange Composite index: -0.63%.
[2] Caixin/Markit Manufacturing Purchasing Managers' Index, February 2020.
[3] HKEJ, 17 March 2020

[4] Bloomberg, 17 March 2020. China equities refer to MSCI China.
[5] Bloomberg, 10 March 2020.

Cautious in the energy sector

We believe investors should maintain defensive approach to the energy sector[6]:

- From a tactical perspective, cautious in the upstream energy sector, particularly oil companies.
- Avoid petrochemical-related commodities.
- Remain selective in some indirect investments in downstream utilities, such as domestic gas distributors, which are expected to be net beneficiaries of the lower gas prices, which, in turn, may boost consumption.

Despite this uncertain backdrop, the key secular trends that form the basis of our three investment themes remain unchanged:

1. Consumption Upgrade

We believe the current market volatility presents a good buying opportunity to education, property management and other omni-channel driven e-commerce names.

For example, the penetration increase of online education hit the highest by more than one year due to school closures. Leading providers are exhibiting clear competitive advantages by merging offline learning with online. This is due to scale, a timely ramp-up in online content and high execution capabilities.

We believe these structural changes in consumer behaviour will not be reversed when the overall situation normalises.

Property-management service is another area where structural growth should persist. The gross floor area for properties under management in the residential and commercial space is expected to increase by 10.1% and 16.0% respectively[7]. This will translate into robust demand for quality property services, and we believe that top-tier property managers with good execution capabilities will gain market share in the medium term.

2. Research and Development (R&D)

On the healthcare side, there has been talk of an approved COVID-19-related vaccination, but we think that speculative opportunities such as this will be short-lived.

We acknowledge that while governments need to speed up the approval of vaccines and virus-related drugs, the approval of other medications (e.g. cancer drug) may be delayed. Nevertheless, the investment case for healthcare remains solid – the sector is supported by an ageing population and unmet medical needs. Investors should continue to focus on biotech and medical equipment companies, where import substitution, favourable government policies and industry consolidation will allow high-quality winners to surface. Furthermore, investors may consider capturing exposure to outsourced research service providers (Contract Research Organisation, CRO) that do not need to bear binary risks but enjoy the ongoing growth in demand for biotech R&D projects.

3. Technology

Our interest in companies that will benefit from the rollout of 5G services remains in place, as we believe that 5G eco-systems will be a prominent theme in Chinese equities. Investors should continue to capture this thematic opportunity from multiple fronts, including upstream equipment, semiconductors, downstream handset components, big data analytics, and cloud services. Close attention will also be paid to valuation levels along the entire supply chain, and we will look to rotate into quality holdings, such as handset components, that have corrected in the broad-based market sell-off.

A focus on longer-term themes

The COVID-19 outbreak is undoubtedly causing a great deal of uncertainty among investors that is translating into heightened market volatility. However, by remaining calm and looking through the near-term disruption, we can see that current events may not necessarily act as a drag on

[6] Manulife Investment Management, 10 March 2020.
[7] Estimate compound annual growth rate (CAGR) from 2018 to 2023. CNInsights, China Property Management Association, January 2019.

China's economic and earnings growth. As such, investors should focus on the longer-term investment themes that are designed to provide stable and secular growth.

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