ECOGNOSIS ADVISORY LTD

From the Greek: ΟΙΚΟΝΟΜΙΚΗ ΓΝΩΣΙΣ (Ekonomiki Gnosis, Knowledge of Economics). Ecognosis is a global financial, economic advisory and information service, covering economic and financial developments, equities, fixed income, forex, commodities and other assets. Econotes is a research publication available free on our internet site and to the public in Hong Kong. It is not a solicitation for business and neither does it contain investment suggestions on specific and named securities including any buy, sell or hold advice. It is written by Dr. Andrew F. Freris based on 47 years of market experience which includes senior positions with GT Capital, Salomon Brothers, Bank of America and BNP Paribas as well as senior academic posts with universities in London and in Hong Kong

8/F, 2 Exchange Square, 8 Connaught Place, Central, Hong Kong. Tel: 852 3167 4591, Mob 852 9738 0944
Email: afreris@ecognosisadvisory.com Website: www.ecognosisadvisory.com

ECONOTE No. 34 **29/4/2015**

So what next in global markets? (With a weary look at the China- Hong Kong)

Summary

Global markets seem to have been stuck in a strange mixture of bull markets (China, Hong Kong and Japan) which some investors believe will not last, the Fed is backtracking and is unlikely to hike in 2015, the ECB is assuring anyone who will listen that QE works, while the Greeks, well… never mind….And as for Japan we will be grateful for any meaningful news over the third arrow (or was it fourth?).Asian markets which did well in the last 12-18 months are doing poorly (India, Thailand) while oil and commodity prices stay low and the AUD seems to be slowly recovering despite RBA's efforts to the contrary.

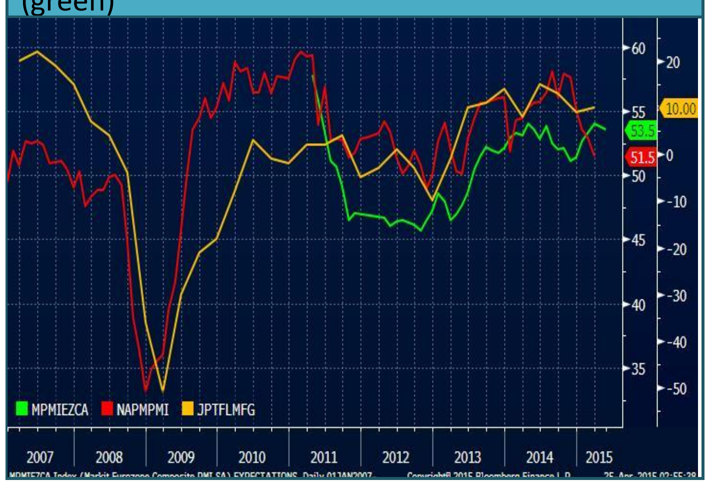
Investment Conclusions

Are liquidity- driven equity markets reliable as long term propositions? As for the EU and Japanese equities, the former are doing very well in EUR terms but much less so in USD terms and both, however, are driven by the massive QEs by the ECB and BoJ. In neither market have the authorities shown willingness to introduce the much needed labor market and other reforms. China is in a bubble dragging along Hong Kong, but still leaving some of the smaller Asian markets attractive.FI assets in the EU and Japan are expensive allowing for better yields in the riskier HY markets in USD and local currency terms

Expecting the best and getting the worst?

Expectations levels measured by diffusion indices in the G3 are not encouraging with the "large" Tankan in Japan struggling to stay flat, the US ISM pointing further south, although still over 50, and with the EU Markit still range bound. (Chart 1).But as we all know, the equity markets are driven by expectations, definitely not by macros. **Which leads directly to China and Hong Kong.** After months of unimpressive performance, the Shanghai market exploded in December 2014 to become the best performer in Asia, and one of the best in the world. In the process, mainland investors, using the Hong Kong-Shanghai stock connect scheme, flooded funds into Hong Kong and drove the HSI to a record high, the best since 2009. As Chart 2 shows there are several problems with these performances. First, the China macro picture remains flat although not deteriorating, but in no way bright enough to justify this type of performance or a dramatic turnaround of the poor earnings expectations. But then macros do not influence stock markets! Monetary conditions have been loosened with interest rates and bank reserve requirements cuts and this, undoubtedly, pushed the markets. Secondly, Hong Kong's performance is even less justified by macros and especially by the near certainty that the Fed will hike rates, not in 2015,but very possibly in 2016 and thus put an end to negative real interest rates-the outcome of the HKD-USD peg.Thirdly, the China stock boom is domestically driven by volatile retail investors with a steep rise in the number of accounts. Fourthy, the HK-Shanghai stock connect has injected a great deal of funds into HK. At the start of the the year China used less than 10% of its quota whereas now the use is about 40% accounting for 7% of the turnover in Hong Kong

Chart 1: ISM US(red),Tankan Jap(yellow) PMI EU (green)



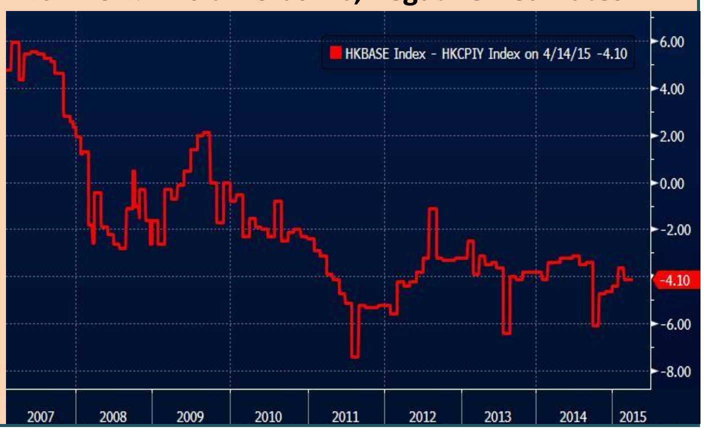
Source: Bloomberg

ECONOTE No.34

Finesing the HK-Shanghai picture

As Chart 2 shows, the SHCOMP (red) has outperformed the HSI (yellow) and within the HSI, H shares (blue) have done well reflecting the boom in Shanghai.This, however, did not reduce the premium of A shares in Shanghai over their HK traded counterparts (H shares) thus indicating that little or no arbitrage has taken place.This might appear to be a "good thing" as far as Hong Kong is concerned as a crash in Shanghai may not have a symetrical impact on H shares in Hong Kong. More worrying , howeer, is the fact that the "Red Chips" (green) have underperformed all the other indices showing that investors in Hong Kong do not have much faith, in relative terms, in the outlook for the HK- China related business. Bottom line is that the stock boom in China does not, for now, have a basis of recovery-related

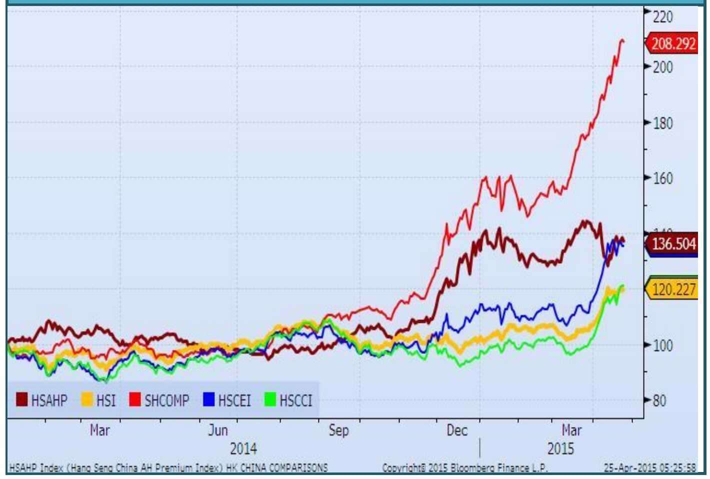
FACT BOX:HK's time bomb, negative real rates



Bloomberg

growth, let alone earnings and is, EU and Japan-style, liquidity driven. Furthermore retail-driven stock booms in China have always ended up in tears (2006-7). As for Hong Kong, the stock boom owes a great deal to China, with an overriding consideration still being the support by negative real rates (See Fact Box). Once the Fed gets serious, the stock and property sectors in Hong Kong will need to adjust fast to higher real rates. The markets will not wait for the Fed to hike and, hence, our concerns over the impossibility of timing the Hong Kong markets, especially when it is also driven by the events in China. Hong Kong's case is further complicated by the fact that the longer the Fed delays its hike, the more the market will delay its fall.

Chart 2: Hong Kong and China indices, 2014=100



Source : Bloomberg

Choices, choices….

For equity investors this has been an awkard time, not because cicumstances are special or diificult, but because the China equity boom, in conjunction with the steep rises of stock indices in Japan and the EU, counterposed the poor performance of the S&P 500, even at the time when the Fed was, clealry, not about to hike.The EU performance is not impressive in USD terms coupled with the still poor macro performance. As for Japan, there is little or no macro basis for the Nikkei performance, coupled with further downgrades in growth, deflation outlook and sovereign ratings and a growing national debt. This leaves the US as a reasonable, but low yielding equity bet, as well as some Asians relying on strong macros, such as the Philippines, (but too small to make a portfolio difference), or India where the Modi honeymoon is over but where the RBI may stil cut rates.There is, finally, S.Korea where the gradual improvement in macros as well as supportive policies have pushed the market. We have left FI deliberately as a footnote to this report as clearly the negative Bund yields and the near zero Japanese govie yields explain why UST are still popular with the Japanese and why investors have taken a new interest on HY, both in USD and in local currencies, as well as on the AUD, still after much mauling, the best yielder among the G20 and likely to stay so as the RBA is not cutting rates.

Andrew Freris (writing completed on 29/4/2015)