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China Market Strategy

Unconventional Risk Hedging Strategies at Cycle's End

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The market crash in the past two weeks has been truly historic: its probability of occurrence is ~0.1% since 1896; the velocity of the plunge and of the VIX surge is the fastest on record; and the 10-year is at all-time low. The Chinese market, however, weathered the storm quite well at first. After an epic crash on the first day of trading after the lunar new year, major indices have recovered most lost grounds, and the ChiNext has even made a new high – till last Friday when all indices suffered significant losses again amid the epic global sell-off.

During this episode of epic risk aversion, my fund manager friend asked me to recommend some stocks to hedge the risks. Being a cautious value investor who has been warning of the current crash two weeks ago, I carefully suggested some names with good earnings visibility and strong management execution records. He glanced over the list with an incredulous look on his face and said: "*but these are quality companies with earnings. When there are earnings, there will be risk. I really want those without any earnings at all*." His logic was so impeccable that I was left dumbfounded and speechless.

On second thought, his arguments are not without merits. Otherwise, how would one explain the strong momentum in the ChiNext and the SME board amid the coronavirus crisis? Meanwhile, the US dollar and gold, the traditional risk haven, have both weakened at the same time. And the US market had largely held up after the virus spread worsened since the Wuhan lockdown – till two weeks ago when the odds of a global contagion surged. Since then, the yield on the US 10-year has plunged to record low.

Logically, the prices of safe assets should rise during risk aversion, as these assets assume the role to hedge risks. Following the sequence of asset price increase aforementioned, we can see an unconventional hedging strategy rotating across various assets: the ChiNext/SME board as a hedge to China's mainboard, the US market as a hedge to China, gold and USD to the US market, and finally, the 10-year treasury to the US/global equities.

As you can discern, the scope of the hedging strategy continues to increase as the coronavirus spread. However, at a record low of ~1% yield, and the core PCE inflation at ~1.7%, what is going to hedge the 10-year treasury in the end? The past decade has seen the twin bulls in equities and bonds, and those 60/40 balanced portfolios have done exceedingly well. With the Fed funds rate at 1.5%, the US real interest rate is now effectively negative. Even the US treasury can soon lose its ultimate safe haven status. That is a real concern.

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In the near term, the question is what next for the market after such an epic plunge? In our previous research report titled "*A Definitive Guide to Forecasting China Market*" (20190920), we discussed the role of the 850-day moving average in forecasting market cycle. Simply put, the 850-day market cycle is a reflection of the underlying 3.5-year economic cycle, with a duration of 3.5years x 12months x 20.2days ~= 850 days.

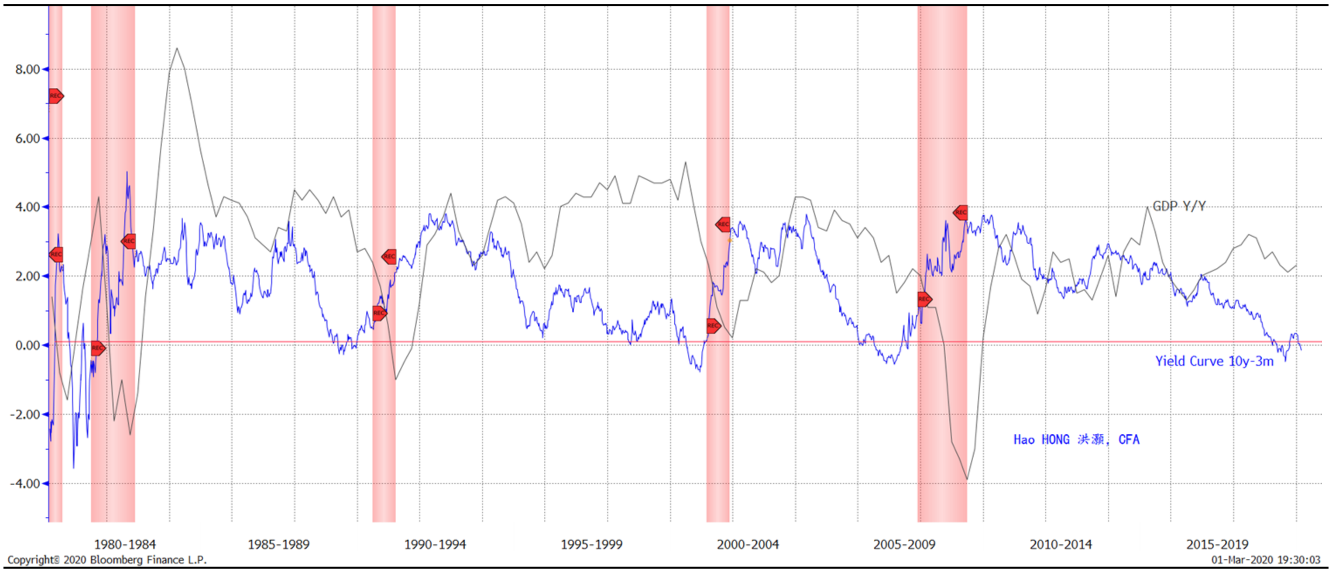
This long-term average is a secular rising trend line for the US stock market indices. In history, the US market corrections tended to bounce once they arrived at the 850-day moving average. Only when there was recession did the equity indices puncture beneath the 850-day moving average. At its deepest point, the current correction is only a touch above this moving average - similar to the steep correction in late 2018 when the Fed was too tight (**Figure 1**).

Figure 1: The Dow tended to rebound from its 850-day mavg when no recession

Source: Bloomberg, BOCOM Int'l

The US market sentiment and technical indicators are extremely depressed after this plunge, as suggested by the put-call ratio, junk bond spread, the percentage of equity index components oversold, and the historic speed of the plunge***. A technical reprieve is in store in the coming week, if history is a guide. That said, if the coronavirus contagion proves to be worse than feared, and the global economy slips into recession due to excessive quarantine to save lives while impeding growth, an economic crisis will ensue***. We note that the yield curve has just inverted again, and such inversion tends to lead recession by up to 18 months (**Figure 2**). ***If so, the US indices will be halved or more, and the emerging technical rebound will be fleeting and technical in nature.*** There are MMT talks about the Fed going into negative interest rate. But that will be a true disaster – as the Fed is the world's central bank, and the US treasury is the world's safe haven. Negative interest rate policy pursued by the Fed will be fundamentally different from that by the other central banks, with disastrous consequence.

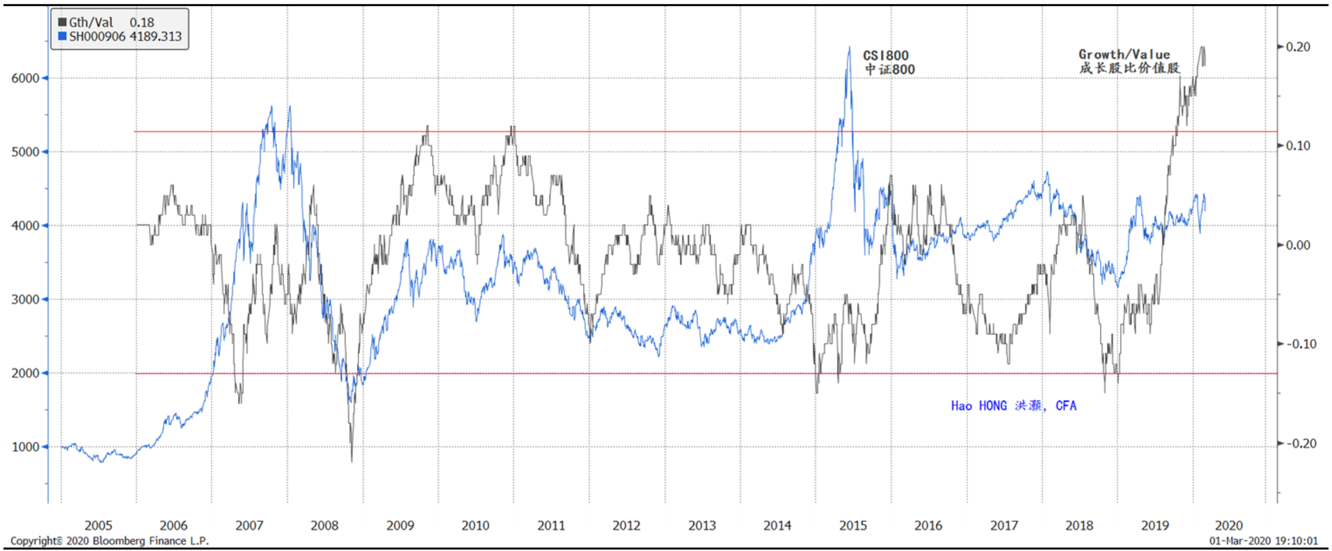
Figure 2: The yield curve inverts again, boding ill for economic outlook



Source: Bloomberg, BOCOM Int'l

In China, the strong relative performance of growth over value is at its extreme – the highest in history indeed – suggesting speculative fervor (**Figure 3**). ***In the past when growth outperformed value at such level or higher, the Chinese market tended to be under pressure***. This time should not be any different. Yet, the ChiNext remains very strong, although its strength will consolidate in the near term (**Figure 4**). With thematic ideas such as the rollout of the registration-based IPOs, and the speculative logic mentioned at the beginning of this report, brash traders may disregard the expensive valuation of the ChiNext Board, and continue to use it as an unconventional risk hedge. Value investors, will of course find distaste in such reckless "strategy", which portends another potential bubble candidate on the horizon.

Figure 3: Growth relative performance over value at its extreme



Source: Bloomberg, BOCOM Int'l

Figure 4: ChiNext has shown strong momentum

Source: Bloomberg, BOCOM Int'l

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