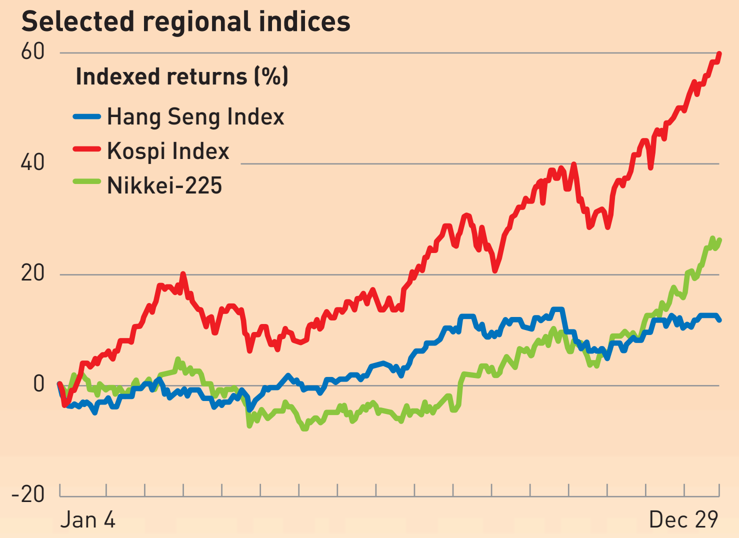
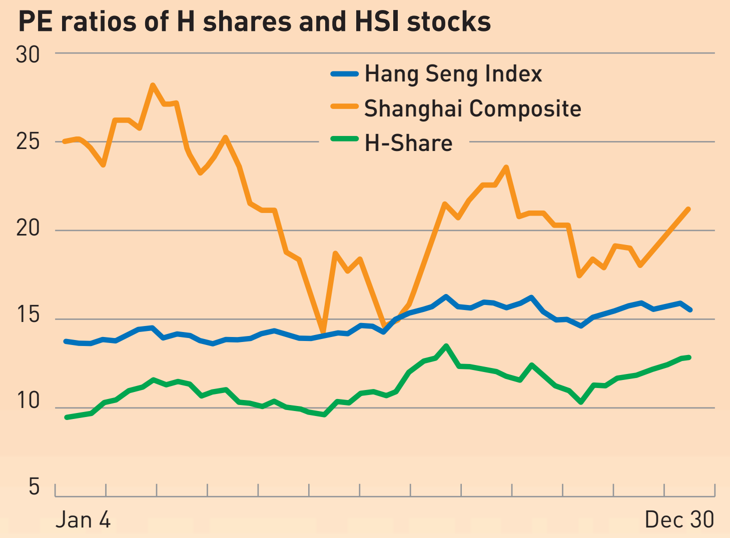
Strategists feeling upwardly mobile

Despite the threat of the China syndrome as the central government hoses down the mainland economy to curb speculation, an end to the Fed-led interest-rate rise cycle looks like unleashing property and banking bulls in the Hong Kong stock market

HUP AND AWAY





H shares, 2005 change (%)

Guangzhou R&F Properties*	▲	153.7
Harbin Power	▲	153.6
Shandong Weigao	▲	107.3
Zijin Mining Group	▲	97.1
Guangzhou Pharmaceutical	▲	92.0
Dongfang Electric	▲	66.3
Shanghai Electric*	▲	54.4
PetroChina	▲	53.0
Nanjing Panda Electronics	▲	47.1
Bank of Communications*	▲	41.0
Sinotrans	▲	40.0
China Life Insurance	▲	33.0
China Oilfield Services	▲	32.9
Jiangsu Expressway	▲	28.6
Dongfeng Motor*	▲	16.2
China Shenhua Energy*	▲	14.0
China Construction Bank*	▲	13.8
Xiamen International Port*	▲	10.8
Sinopec Yizheng Chemical	▲	3.0
China Telecom	◆	0
Weiqiao Textile	▼	12.0
Guangdong Nan Yue Logistics*	▼	15.0
Jiangxi Copper	▼	15.5
China Cosco*	▼	19.4
Lianhua Supermarket	▼	24.0
Guangshen Railway	▼	26.1
China Southern Airlines	▼	26.4
China Eastern Airlines	▼	26.7
Great Wall Motor	▼	27.1
Yanzhou Coal Mining	▼	27.3
Weichai Power	▼	39.3
Guangdong Kelon Electric	▼	41.0
Avichina Ind. & Tech.	▼	45.1
Beijing Media	▼	51.0
Irico Group	▼	80.2

* IPO this year

HSI stocks, 2005 change (%)

Lenovo Group	▲	50.5	BOCHK	▲	0.3	HSBC Holdings	▼	5.6
China Mobile (HK)	▲	39.2	SHKP	▼	2.2	Hang Seng Bank	▼	6.2
Sino Land	▲	26.1	Johnson Electric	▼	2.6	Denway Motors	▼	6.3
CNOOC	▲	25.0	BEA	▼	2.6	Cosco Pacific	▼	8.0
New World Dev.	▲	23.8	Citic Pacific	▼	2.7	Cathay Pacific	▼	8.1
MTR	▲	22.9	PCCW	▼	3.0	Henderson Land	▼	8.7
Esprit	▲	17.9						
China Resources	▲	17.3						
China Merchants	▲	15.4						
Li & Fung	▲	14.5						
Swire Pacific 'A'	▲	9.1						
Cheung Kong	▲	9.1						
HK Electric	▲	8.1						
Cheung Kong	▲	3.3						
China Unicom	▲	3.2						
HK & China Gas	▲	2.7						
Yue Yuen	▲	2.1						
Hutchison	▲	1.8						
Wharf Holdings	▲	1.8						
Hang Lung Prop	▲	1.6						
CLP	▲	0.8						

Guo Shuqing, chairman of China Construction Bank, waves at the Hong Kong Stock Exchange during the company's IPO listing debut in October

SCMP Graphic Source: Bloomberg

ROB HART
Head of Hong Kong strategy
Morgan Stanley

The key factor determining Hong Kong market performance next year is likely to be interest rates. The economy performed extremely well this year, with real GDP growth over 7 per cent, unemployment falling to close to 5 per cent and salary growth of 2.5 to 3 per cent driving domestic consumption growth up to 4.6 per cent during the third quarter. This virtuous circle is likely to continue and domestic consumption growth should improve further as rising mortgage rates will offset wage growth less next year.

Until the end of October, the MSCI Hong Kong index lagged its Asian peers significantly because of rising rates. Since the beginning of November, however, the Hong Kong market has begun to focus on the fact that Fed Funds Futures are pricing-in an end to rate rises by the end of the first quarter. As a result, the MSCI HK rose by 3.9 per cent in November, which we believe is a sign of things to come. Historically, the best performing sectors in Hong Kong once rates stop rising are banks and property developers, and we believe that New World Development, Sino Land, Wing Hang Bank and Wing Lung Bank should perform well in the coming year.

Valuations are supportive at less than 16 times pre-exceptional earnings next year because of the static stock market combined with a 31 per cent earnings growth forecast for the MSCI HK this year.

LINUS YIP
Strategist
First Shanghai Securities

The market is likely to post new highs in 2006 as the interest-rate-rise cycle is coming to an end. Inflation risks will be tamed thanks to the drop in oil prices from record high levels and monetary authorities will place more emphasis on how to maintain steady economic growth.

We expect there will be another 50 basis point rate rise in the first half of the year and then the interest rate will stay put for a while. A stable rate environment will be the main theme for the market, enabling it to extend a bull run which originated in 2003.

Property plays which have lagged in the fourth quarter should have a chance to outperform, while industrial stocks will attract attention again after a two-year drop as raw material prices are expected to fall in line with crude oil prices.

Capital inflows to China are well underway, which strengthens the expectation of a further yuan revaluation.

The mainland banking sector is the top-pick, as it should be the key beneficiary of the re-ignition of the economic growth engine. The airline sector, which has been oversold in the past two years, shows signs of bottoming out.

ERIC FU
Director of intermediary business
Fidelity Investments
Management (HK)

The economic outlook for Hong Kong remains positive, driven by continued reflation, low real interest rates, steady employment growth and benefits from China's growth.

The stock market is still attractively valued; the increase in price is supported by continuing strength of underlying company earnings. After 12 rate increases since 2003, the market expects that US monetary policy will be very close to neutrality.

If the Fed's interest rate rises are to pause, this may be beneficial to the banking and real estate sectors in Hong Kong.

China's growth story will continue to benefit Hong Kong, with the growing demand from the emerging Chinese private enterprise sector. In addition, as Hong Kong has become the first choice for stock market listings for Chinese firms, the financial sector should benefit from China's corporate fund raising and state enterprise reform.

Overall, companies in Asia have historically low levels of debt, as a result of improved balance sheets under the leadership of quality management. This fiscal prudence is being recognised by foreign investors, and markets in the region including Hong Kong are likely to have positive net cash flows.

On the downside, investors should be mindful of the impact of possible further interest rates rises, while at a broader level, the potential for an avian flu pandemic, protectionism against Chinese exports and Taiwan-China relations could affect market uncertainties as we enter the new year.

MARK SIMPSON
Head of HK research
Macquarie Securities

Macquarie remains a bull but our index target of 18,400 will merely move the market to its long-term average price-to-earnings ratio of 15 times during a time of continued strong global growth.

Japan's reflation story is important to Asia and China's total trade is forecast to grow 19 per cent, versus 23.5 per cent this year. Currency as a policy tool to offset continued strong inflows will result in an appreciation of the yuan to 7.5 against the US dollar by the year's end and Qualified Domestic Institutional Investor (QDII) inflows to Hong Kong could also emerge.

Local leverage to these themes will continue through strong creation of higher-paid jobs, which will underpin rising confidence. The end of the US rate-rise cycle will allow this to flow through to demand, which has been muted late this year. Recovering primary property transactions will be a key feature of this shift.

Essentially, the reflation trade has further to go and property developers (Henderson Land) and investors (Hongkong Land, Wharf) are key picks. Additionally, the revived consumer story will boost TVB, Midland Realty and Wing Hang Bank.

Reits will continue to develop as an attractive asset class but focus will shift to companies best leveraged to rising mainland consumption. Hang Lung Properties and Kerry Properties stand out in this context, while Peacemark is attractive within the broader consumer story.

SPENCER WHITE
Chief regional strategist
Merrill Lynch Asia Pacific

Our key theme for Hong Kong next year is relatively simple – the pursuit of growth. Investor appetite for earnings growth will remain high and our sense is that this theme should dominate stock performance.

Economic momentum should start strong but ebb into the second half with rates peaking sometime in the first half. However, returns from the broad index are likely to be below 10 per cent as earnings momentum could be fairly insipid.

Against this backdrop, we think investors should focus on where they can find decent earnings momentum. This is harder among traditional interest rate sensitive stocks such as the developers because costs are rising too quickly but we expect more reit-related activity to maintain a high level of interest in this sector – as we have seen in Singapore.

China will continue to dominate initial public offerings (IPOs), led by the banks. Our sense is that ultimately, this would serve to drain some liquidity away from other sectors. Secular growth stories in China, such as life insurance and telecoms, should also do well. Investment in 3G equipment will be a driver of earnings for key telecom suppliers.

Stocks to consider: Cathay Pacific Airways, Guangzhou R&F, Geely Automobile, Hysan Development, China Mobile and Kingboard Chemical.

CONITA HUNG
Head of equity markets
Delta Asia Securities

The stock market is expected to gain further in 2006, driven mainly by an expected peak in the interest rate cycle, together with sustained economic growth and an inflow of capital triggered by a continuous expectation of yuan appreciation.

With an anticipated phase-out of China's austerity measures, the Chinese government is now in a better position to ease monetary policy to stimulate domestic consumption. Together with a further opening-up of the mainland's financial services sectors in accordance with the WTO agreements, this will lead China-related stocks to outperform.

The earnings potential of mainland banks looks promising and policy changes are also favourable to mainland insurance firms in the coming year. Our major picks are Bank of Communications and Ping An Insurance. Large-sized domestic consumption stocks are also worth a look given their market shares and earning growth potentials.

We focus only on selected property investment stocks and on developers with sales of high-class residential flats and abundant land banks, such as Sino Land and Swire Pacific. We also favour individual industrial stocks such as TPV Technology.

The potential risks of Sino-American trade disputes and an expected slowdown in external trade activities of either side are likely to dampen market sentiment to some extent. We would advise avoiding investing in port and transportation stocks in the year ahead. Also, raw materials and power stocks are expected to underperform.

ELEANOR WAN
Director, head of funds business
Allianz Global Investors

Since the mid-1990s, the stock market has been dramatically affected by the economic liberalisation of the mainland. In particular, the increasing number of China-related IPOs in Hong Kong is changing the structure of the territory's stock market. As a result, Hong Kong has been able to attract large amounts of capital as it has developed into one of the principal conduits linking China to global financial markets.

In the long run, it is likely that Hong Kong will face competition from other centres but it remains extremely well placed to benefit from this trend.

The recent wave of IPOs, some of which such as The Link Reit have been enormous, highlight another positive factor. Hong Kong investors continue to hold huge amounts of money which can, if the right opportunities become available, be moved into the stock market.

China's economic fortunes will continue to drive economic developments locally. After 18 months of gradual monetary policy tightening, China's economy is still growing strongly. This is in spite of other challenges, such as the rise in the prices of oil, energy and other mineral resources over the last year or so. In the meantime, we see no reason the Chinese economy and that of Hong Kong should slow dramatically.

Indeed massive increases in the number of mainland tourists visiting Hong Kong and Macau show that both cities are well placed to benefit from structural changes in China, such as the rapid emergence of the world's largest concentration of middle-class people.

AMAR GILL
Head of HK research
CLSA

The coming year will be challenging for equity investors. The start of the year should see momentum as investors position for a topping out of interest rates, gain confidence that the developers will be able to re-launch successfully and that the market will catch up after underperforming in the second half.

The risks for the market, however, are likely to show up pretty soon. We see interest rates in the US rising higher than the consensus view, as the world's largest economy continues to be robust in the first half.

Meanwhile, signs that the mainland is already slowing down are exemplified in recent data on electricity sales. The coupling of higher rates and a slowdown in China will be a vice lock against the Hong Kong market.

Eventually, higher rates will slow the US economy and be signalled by bond yields. As US rates come off in the latter part of the year, quite likely with hopes still of a soft landing for China – only to be dashed in 2007 – there is scope for a rebound in the local market around the year's end.

Investors will shift tactically as the themes evolve. However, sectors that are undervalued going into 2006 that should outperform include hotel stocks such as Regal, industrials such as Johnson Electric, and Cheung Kong, the lowest price-to-earnings ratio large cap index stock.

ANDY MANTEL
Managing director
Pacific Sun Investment
Management

Investment themes for next year include a continued revaluation of the yuan, strong merger and acquisition activity supported by reduced trade and investment barriers, and a stronger, self-reliant Chinese economy on the back of a more legitimate private sector.

This year's ambitious non-tradable share reforms will continue to bring volatile market conditions in China's domestic markets. These reforms are necessary, however, and once a credible track record has been established, the past eight years of falling share prices may be matched by eight years, and perhaps more, of rising share prices.

We like food and beverage, consumer, transport, agriculture, and telecom-related stocks and are positive on China Green, China Resources Enterprises and China Telecom. Companies benefiting from value creation due to spin-offs and other restructuring efforts should also do well this year. Golden Meditech may continue to benefit in this area following the successful listing of China Medical this year.

Key risks include corruption, a slowing global economy, geo-political tensions, and social issues. We are bearish on car, steel, and semiconductor stocks.

We continue to look for good short-selling opportunities among the mainland "technology" companies listed on Nasdaq, although it is difficult to recommend a better such investment than our call this year on www.51job.com.

HERBERT LAU
Chief investment officer
CASH Asset Management

After two years of strong economic recovery and property boom, Hong Kong corporate earnings momentum has started tapering off, while the rise of the HSI has been decelerating since 2003. China's economy is expected to remain buoyant in 2006, with targeted GDP growth of 8.8 per cent. Main drivers should still be investment and exports, which are forecast to grow by 20 per cent.

Exports will probably lose steam on rising protectionism and yuan appreciation, but continuing investment and domestic consumption may help cover any shortfall.

Continuing liquidity flight to other regional markets and the lack of new catalysts, coupled with modest corporate earnings growth, are expected to cap the upside of Hong Kong stocks in 2006.

A softening housing market and the end of an environment with abnormally low interest rates may not bode well for the local rate sensitive property and banking sectors, and not will the absence of asset revaluation earnings.

The market will also have to face mounting uncertainties this year, including commodity prices, a possible reversal of the strong US dollar and a continuing rate hike cycle, as well as the bird flu scare.

We are overweight on mainland finance and consumption-related sectors, including banking, insurance and retailing, which will benefit from a spending boom. In commodities, we would buy of alumina- and gold-related stocks on any price dip. Coal, steel and petrochemical producers will continue to be plagued by overcapacity. Textile stocks are turnaround buys, whereas telecom equipment makers are situation buys on the issuance of mainland 3G licences.

ROBIN PARBROOK
Head of Asian equities
Schroder Investment
Management (HK)

Although the oil price is unlikely to double this year and US interest rates only set to move another 50 to 75 basis points higher, we are not very bullish on Hong Kong equities.

The market is already reflecting much of the "Goldilocks" scenario (inflation and growth that is neither too hot nor too cold). Valuations are high relative to historic levels and earnings momentum next year is moderate at best.

Indeed, for many key sectors, we expect to see analysts having to downgrade their overly exuberant forecasts made mid-this-year as Disneyland has not resulted in hordes of mainland tourists spending billions of yuan in Hong Kong shopping malls and the property market has stalled on rising interest rates.

Meanwhile, the picture for China stocks is mixed. The manufacturing sector is likely to continue to face margin pressure, oil stocks are unlikely to perform unless oil prices make another leg upwards and many of the highly rated retail and consumer stocks are facing margin pressure as the sector becomes ever more competitive.

This is not to say we are completely bearish, we would characterise ourselves as more "realistic". The market is well supported by the global backdrop and the outlook remains healthy, it is more that better opportunities exist elsewhere in the region. Locally, we see opportunities in the Chinese consumer and infrastructure sectors and we believe that some financials and groups offer value with good dividend yields and the correct management and strategy to prosper in the medium term.

Compiled by Anette Jönsson and Fiona Lau

CALLS TOO BULLISH BY HALF

Analysts, strategists and fund managers polled by the *South China Morning Post* were overly bullish in their projections for the Hang Seng Index in 2005, overshooting its closing level by 5.73 percentage points on average.

According to forecasts made more than 12 months ago, the index would rise 10.5 per cent to end the year at 15,729 points. Instead, the index climbed only 4.54 per cent to 14,876.

The closest, and most conservative, prediction came from Guotai Junan Securities, who predicted the market would close the year at 15,360 points.

Tai Fook Securities were also close to the money with their safe prediction that the index would top 15,000.

The predictions ranged as high as 16,500 points, by DBS Vickers.

Calls on the H-share index were more realistic, with the average estimate of 5,477 coming in only 2.75 per cent above the actual close for the year.

Guotai Junan Securities hit the bullseye with its prediction that the index would end the year at 5,330 points and Standard & Poor's Asia Pacific Equity Research came a close second with their estimate of 5,310 points.

Pacific Sun Investment and Celestial Asia Securities were the furthest from the mark with their predictions of 5,600 points.

Cameron Dueck