# Quickview: Hong Kong market momentum not based on fundamentals

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**The recent euphoric rally in Hong Kong shares has largely been driven by valuation gaps and positive regulatory support for mainland investors to invest in the Hong Kong market.**

The surge in Hong Kong's stockmarket on Thursday has added a second consecutive day of strong gains as liquidity and bullish sentiment on domestic China A-shares is having a spillover effect on the Hong Kong market. Meanwhile, the valuation gap between A shares (listed in China) and H shares (listed in Hong Kong) has widened considerably recently as the Shanghai Composite has risen over 90% since late June last year.

**Valuation gaps**

We believe this valuation gap between select A and H shares, in an environment where regulators are gradually lowering the barriers to the Hong Kong market for mainland investors, is driving mainland fund inflows into the market. Clearly, this is serving as a positive catalyst for the near-term rally. On the reform front, the China Securities Regulatory Commission (CSRC) announced new guidance at the end of March for publicly offered securities investment funds (i.e. mutual funds) in China to invest in Hong Kong-listed equities through the Shanghai-Hong Kong Stock Connect Scheme. The Southbound component of the stock connect scheme allows eligible investors, with at least 500,000 yuan in their trading account, to buy a select range of Hong Kong-listed stocks.

By removing a pre-approved qualification process for onshore mutual funds, these funds can now invest through the Southbound scheme. This trend of sharp rises in share prices has been reflected by the substantial increase in trading volume of late. In addition, Southbound investment with the Shanghai-Hong Kong Stock Connect Scheme has surged to its highest level since the programme was launched in November 2014.

The rising A/H premium could also serve as another factor that drives China onshore capital south. Chinese investors were increasingly looking to capitalise on the price gaps between onshore and offshore markets. Yesterday's moves took the average premium of domestic-listed A-shares over Hong Kong-listed H-shares down from 35% to 28%. With the A-share market still rising in spite of weak economic data and poor company earnings in China, H shares are becoming an increasingly attractive alternative. However, valuations are generally starting to look expensive which makes us cautious about chasing some stocks.

What has happened in fund flows could be just the beginning. This is because the majority of China domestic mutual funds have their mandates limited to A-share investments. To participate in the Southbound trade under the new guidance, they will need to launch new products or modify existing mandates.

**Sticking to fundamentals**

Whilst the broader macro and policy-driven environment brings up interesting investment themes and ideas, our focus remains on taking a disciplined bottom-up approach to active investing and selecting quality businesses with strong fundamentals. As China works through its reform agenda, the initial and obvious opportunities around broader sectors and themes will make way for more discerning stock selection to drive longer term returns.

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