KGI CHINA DEVELOPMENT FINANCIAL

Market Strategy

Taking some risk off before the holidays

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- Optimism about the Phase One trade deal has driven global equities since the start of the fourth quarter of 2019. We believe that most of the positive factors surrounding the deal is now fully discounted by investors.
- Basing solely on technical factors, we believe a more cautious approach over the coming 3-4 weeks is warranted, and recommend reducing exposure to risk assets while hedging with precious metals.
- Most of the gains in equity markets were largely driven by valuation expansions, which coincided with the aggressive expansion of the Fed's balance sheet. Furthermore, the strong rally in December has pushed the main indices significantly above their 200 day moving averages, fuelled as well by short covering.

A year for the history books. Global equity markets closed out the year with one of the best performances in the decade despite the slowest global economic expansion since the financial crisis in 2009, defying consensus forecasts that was expecting the bull market to finally be upended by the US-China trade war. Although the record-setting rally in 2019 was almost derailed twice in May and August, US indices went on to gain as much as 37% (inclusive of dividends reinvested back into the index) as hopes that the combination of lower interest rates and easing trade tensions will help sustain the longest bull market in US history.

US and European stocks continued to hit record highs going into 2020, which we later explain have largely been driven by technical factors and positive expectations, and highly likely to reverse upon a surprise event to the global economy.

Figure 1: Global Equity Benchmarks

Bloomberg Ticker	Index	Year To Date Total Return (%)	Total Returns - 1 Jan-31 Dec 2019 (%)
	AMERICAS		
INDU Index	DOW JONES INDUS. AVG	2.9	25.3
SPX Index	S&P 500 INDEX	3.1	31.5
CCMP Index	NASDAQ COMPOSITE INDEX	4.7	36.7
SPTSX Index	S&P/TSX COMPOSITE INDEX	3.3	22.8
IBOV Index	BRAZIL IBOVESPA INDEX	2.8	31.6
	EURO		
SX5E Index	EURO STOXX 50 PR	1.6	29.4
UKX Index	FTSE 100 INDEX	1.5	17.2
CAC Index	CAC 40 INDEX	1.8	30.5
DAX Index	DAX INDEX	2.3	25.5
	ASIA		
NKY Index	NIKKEI 225	0.9	20.7
HSI Index	HANG SENG INDEX	-0.6	13.0
SHSZ300 Index	CSI 300 INDEX	0.6	39.2
AS51 Index	S&P/ASX 200 INDEX	5.7	25.0
KOSPI Index	KOSPI INDEX	1.9	8.4
NIFTY Index	NIFTY 50	0.3	13.0
TWSE Index	TAIWAN TAIEX INDEX	1.0	28.8
JCI Index	JAKARTA COMPOSITE INDEX	-0.9	4.2
FBMKLCI Index	FTSE BURSA MALAYSIA KLCI	0.0	-2.8
STI Index	STRAITS TIMES INDEX STI	0.5	9.4
PCOMP Index	PSEI - PHILIPPINE SE IDX	-4.5	6.5

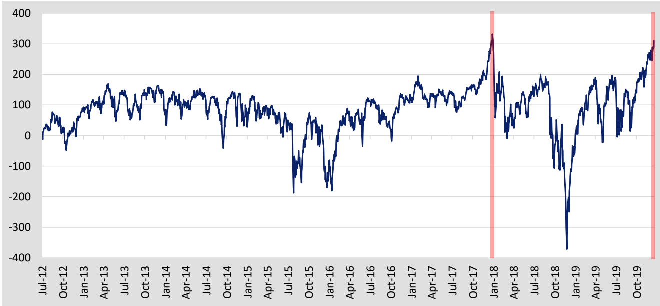
Source: Bloomberg, KGI Research

Technical reasons to reduce risk exposure in the short term. While there are fundamental reasons to be optimistic on the stock market's outlook in 2020, markets in the short-term tend to either overshoot or undershoot their long-run equilibrium as a result of various factors, one of which is the monetary policies prevalent during the period.

As such, we have identified four technical-based data points which are signalling reasons to be cautious in the coming weeks, as it looks increasingly likely to us that we may have overshot on the upside.

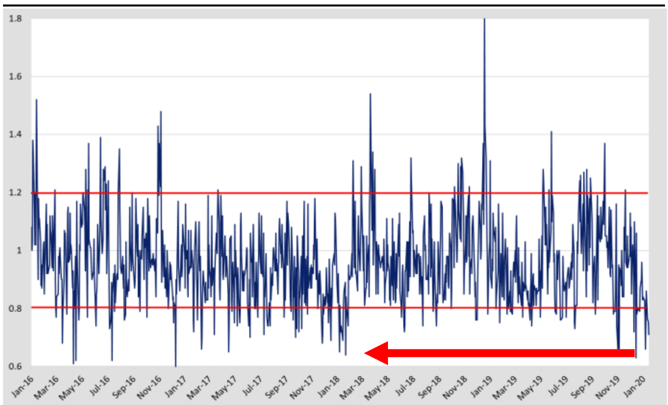
First, the S&P 500 Index is more than 300 points above its 200-day moving average (Figure 2); this is near the levels prior to the "Short volatility" trade which blew up in February 2018, and subsequently saw the S&P 500 plunge by 10%. We counted 13 instances from 2010 to 2019 where the index fell 6%-20% after such rallies. Furthermore, the Pull/Call ratio for the S&P 500, which reflects fear when above 1 and confidence when below, also shows the overconfidence in markets.

Figure 2: Difference between the S&P 500 Index and its 200-Day Moving Average shows that it is at the same level as back in January 2018.



Source: Bloomberg, KGI Research

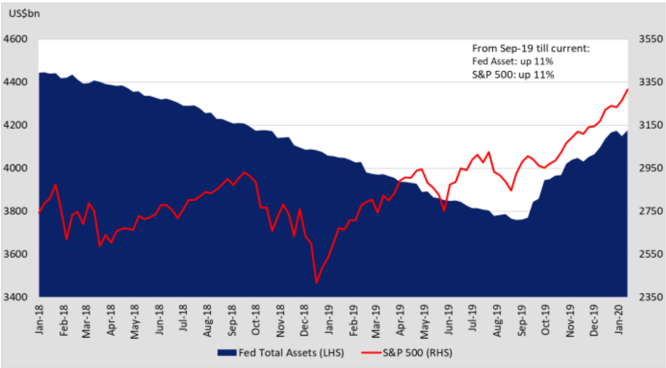
Figure 3: S&P 500 Put/Call Ratio used to determine market sentiment shows confidence returning to the levels reached in January 2018



Source: Bloomberg, KGI Research

Second, the rally since September 2019 coincided with the rapid expansion of the Fed's balance sheet, a significant U-turn precipitated by the repo incident (where short term cash markets seized up) in the prior month. Since then, the Fed's balance sheet has increased to US$4.18 trillion versus US$3.8 trillion in September 2019, and there is still about US$230 billion in repo interventions outstanding. The Fed expects to keep its repo operations going until at least mid-February.

Figure 4: US Fed's balance sheet expansion and the S&P 500 Index



Source: Bloomberg, KGI Research

Third, the >5% rally month-on-month can also partly be attributed to short covering. The short interest as a percentage of total float of the US market reached a 3-year high in 3Q19, and the most recent data shows the short interest ratio starting to reverse in December 2019. Prior instances of declining short interest coincided with a rising S&P 500 index. Although we acknowledge that correlation does not imply causation, it does bear similarities to the rally in 4Q18 as highlighted in the graph below.

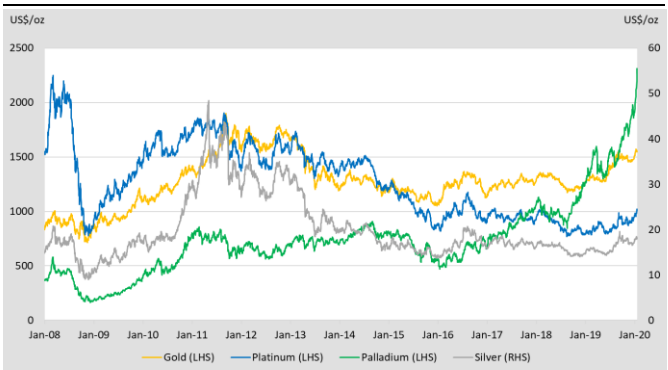
Figure 5: Short interest vs float ratio for US equity market

Source: Bloomberg, KGI Research

Go for gold and other shining objects. We think a reduced risk exposure especially ahead of one of the longest stretches of holidays in North Asian markets would be prudent. Precious metals, in particular gold and silver, remain one of our top picks in 2020.

Investors should also consider underperforming precious metals such as platinum, which has significantly lagged gold and palladium (best performing precious metal in 2019) over the last four years. Platinum prices plunged from around US$1,800/oz in 2011 to a low of US$751/oz in 2018 as slowing demand pushed the market into surplus in 2017 and 2018. However, platinum prices have since recovered back to around US$1,000 and we believe current levels present an attractive opportunity to accumulate.

Figure 6: Precious metals price performance (2008-2020)



Source: Bloomberg, KGI Research

Market holiday. We have one of the quietest trading week ahead as many Asian markets close for the Chinese New Year Holidays. Chinese factories typically close between one to two weeks before the start of the holidays in China. Officially, China will celebrate the New Year holidays from 24 January to 30 January; Taiwan markets will be closed 24-29 January; Hong Kong markets closed on 25-28 January; Singapore 25-27 January.

On behalf of the research team...

工作顺利，家庭幸福，身体健康，万事如意！

Happy Chinese New Year and Best Wishes for the year of the Golden Rat.

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