China Insights

Update on Chinese markets

June 2019

Summary

- US and China could reach a deal ultimately, but the timing, format/terms of the deal and details of implementation are difficult to predict
- Even with a potential trade deal on the horizon, investors are factoring in downside risks from a slowdown in earnings and economic growth
- The re-escalation of trade tensions triggered a deep sell-off in emerging markets (EM) in May. However, Chinese bonds finished on a stronger footing generally, benefitting from the risk-off sentiment

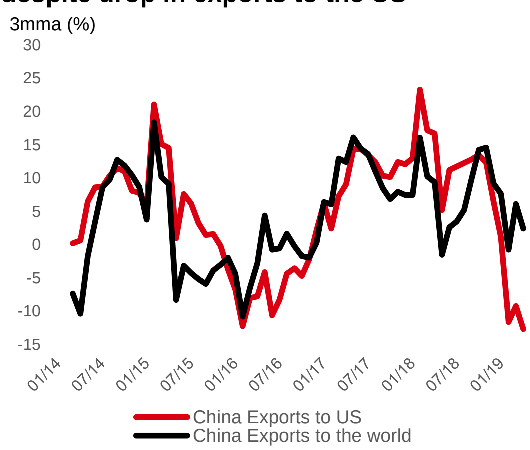
Hot topic: Beyond tariffs and trade talks

The trade conflict between US and China is back in focus. On May 10th, US increased tariffs on USD250 billion of Chinese exports to 25% from 10%. Retaliation swiftly followed. China raised tariffs on USD60 billion of US goods between 10% to 25%, from the 5% to 10% range since September 24th of last year.

Shortly after the latest hike, the Office of US Trade Representative said it is mulling punitive levies on another USD325 billion worth of Chinese exports. As the US imported just under USD540 billion of Chinese goods last year, the new tariffs being considered would likely cover all remaining US imports from China this year, from tennis shoes to cell phones.

But the US-China trade dispute goes beyond trade--in our view, it is also about technology, fair competition and security. This became more evident in mid-May when the US issued an executive order banning telecommunication networking and other technology from foreign adversaries that could pose a threat to national security. The US Commerce Department added China's largest telecommunication equipment/smartphone manufacturer and 70 of its affiliates to its so-called "Entity List," a list which bars companies from accessing US-origin technology without a license/US government approval.

China's export growth remains resilient despite drop in exports to the US



Source: Customs General Administration, HSBC Global Asset Management, data as of April 30, 2019.

HSBC Global Asset Management

Leaders of US and China could meet next month on the sidelines of the G20 summit in Osaka to resolve trade disputes, but long-term divide over global technology dominance remains

In our view, the impact of increased tariffs is economically manageable for China, with the additional 15% tariff hike trimming 0.2-0.3 percentage points off China's GDP growth over the next 12 months, according to our estimates. However, the estimate does not capture the impact on corporate confidence and investments, including any potential supply-chain realignments, which could be substantial in the longer term. Separately, electronic supply chains for products such as handset and surveillance systems are likely to be disrupted by the imposition of restrictions on the purchase of US semiconductors and software.

For investors, the latest round of tariff hikes and the proposed increase in tariffs on a larger list of imports are also concerning as they could have an impact on the outlook for US inflation which, in turn, could prompt the US Federal Reserve (Fed) to abandon its dovish position.

Hopeful but realistic

US and China could reach a deal ultimately, but the timing, format/terms of the deal and details of implementation are difficult to predict. The procedural timeframes imply that the newly-increased tariffs would likely not be implemented until end-June/early-July at the earliest. Officials on both sides are still willing to talk before the Osaka G20 meeting summit on June 28-29, where the heads of the two countries are expected to meet and potentially announce a resolution.

Financial markets have been rocked by each new trade-conflict headline, with both the US and Chinese markets retreating more than 10% from their peaks this year. Recently, the yield on US 10-year Treasury fell to a 20-month low as escalating trade talks and elevated concerns over a slowing global economy continued to drive interest in the safe-haven assets.

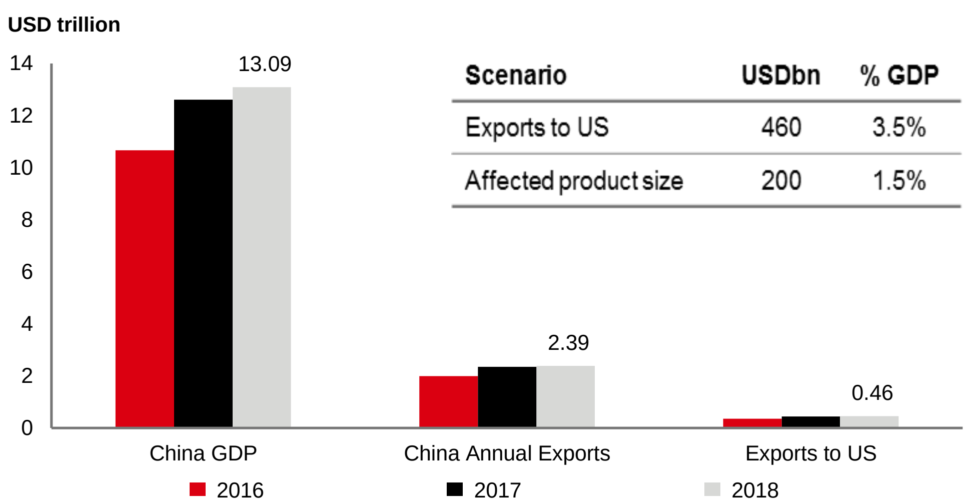
At the same time, investors are starting to embrace potential downside risk from a slowdown in earnings and economic growth even with a potential trade deal on the horizon, as consumers and select sectors, such as agriculture, will bear the brunt of the new and higher tariffs. In our view, investors will potentially need to adjust to a longer period of geopolitical uncertainties, especially as we move closer to the 2020 US Presidential elections where US-China relations are sure to be on campaign agendas.

RMB valuation

Domestically in China, the weakness in the RMB has rekindled discussions over the value of the Chinese currency as it reversed from a 2% gain in the first quarter to a 2.4% decline in May amid US dollar strength. In our view, the authorities in Beijing would not let the currency devalue significantly against the greenback since most of the country's foreign reserves are denominated in the US dollar and China has sizable exposure to the US treasury market. The world's second-biggest economy currently owns about 7% of the USD16.18 trillion outstanding US public debt, its lowest share in 14 years and significantly lower that its peak of 14% in 2011.

The policy and macro backdrop may be less negative now for the RMB than last year when the trade frictions escalated. Nevertheless, the Chinese currency still faces downward pressure and could potentially fall below the psychologically important level of 7% if further tariffs are imposed on USD325 billion of Chinese exports to the US.

Tariff hikes not a significant threat to Chinese economy



Scenario	USDbn	% GDP
Exports to US	460	3.5%
Affected product size	200	1.5%

Source: Bloomberg, HSBC Global Asset Management, data as of May 24, 2019. Scenarios are hypothetical and do not represent actual investment accounts. Results are provided for illustrative purposes only and are no guarantee of future performance. Hypothetical examples have many inherent limitations and are generally prepared with the benefit of hindsight. In addition, there can be sharp differences between hypothetical results and actual results.

Equity market

- As of May 24th, MSCI China and the onshore benchmark CSI 300 Index retreated 12.8% and 10.2% (in US dollar terms), following renewed trade tensions between China and the US. Earlier in the month, the US raised tariffs to 25% from 10% on USD200 billion of Chinese goods. Beijing retaliated by increasing levies on about USD60 billion of US imports

- There is also a growing concern over the spillover effect of the ongoing tensions between the US and China into the Technology sector, amid news that US officials are considering sanctions on a list of Chinese technology companies

> The growing trade and technology conflicts between the US and China has prompted equity investors to offload their bets

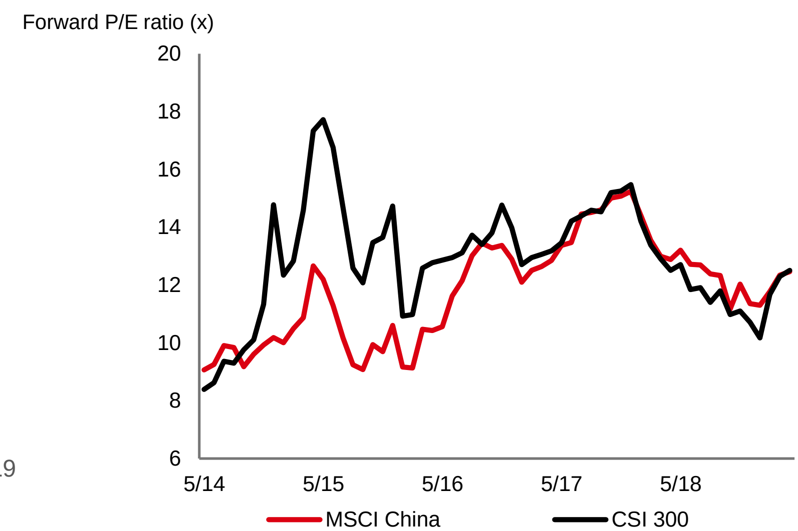
- Among the 11 sectors included in the MSCI China, Utility companies were the most resilient over the past month, finishing 4.9% lower in May. Companies in the Information Technology sector, such as makers of smartphone and optical lenses, plunged 17% in the same period, as the prospect of a prolonged tariff stand-off added uncertainty to the export-driven industry

- In our view, companies in the Consumer Staples sector are also positioned to withstand further shocks from the trade negotiations, as they are likely to benefit from government's policy easing measures and investor preference for their earnings visibility

- Investors continued to offload their China A-shares through the stock connect channels for the second month, trimming almost USD8 billion-worth of the domestically-traded shares. Southbound investors were net buyers for the third-consecutive month, with a net inflow of USD1.8 billion in May

- In terms of valuations, forward price-to-earnings (P/E) ratios for both the MSCI China and China A-share indexes are trading slightly above their 10-year averages at 12.0x and 11.7x, respectively. When measured by the price-to-book (P/B) ratio, the former is trading at its 10-year average of 1.7x, while the latter is about 17% below its 10-year average of 2.2x

Chinese equities moderate as trade conflicts with US remains



Source: Bloomberg, HSBC Global Asset Management, as of May 24, 2019. Total return in local currency terms. Past performance is no guarantee of future results.

Sector	Comment
Financials	◆ Loan growth may pick up on the back of more relaxed monetary policies. We favor insurance as a pickup in the equity market could drive insurers' investment returns
Consumer Staples	◆ Trends of premiumization as a result of rising income underpin higher pricing power and margin expansion capability of select strong staple brand names. Pickup in inflation also bodes well for consumer staple plays
Consumer Discretionary	◆ We like the education space as it is relative insensitive to macro headwinds. We also like home appliance as it may benefit from the government's further stimulus measures
Property	◆ We like leading players who have higher exposure to top-tier cities and strong refinancing capabilities
Healthcare	◆ We are highly selective on Healthcare names and only favor those with strong research and development capabilities in innovative drugs
Industrials	◆ We do not see any near-term catalysts for this sector
Communication Services	◆ We only like Telecommunication companies that may benefit from 5G development. We are conscious that competition for major telecoms remains intensive
Energy	◆ Oil price is expected to trade within a narrow range as global demand and supply stabalize
Materials	◆ While demand-supply dynamics are healthy, we do not see any near-term catalysts
Utilities	◆ We see limited catalysts for this sector
Information Technology	◆ Industries such as technology hardware could be victims of the US-China trade conflicts

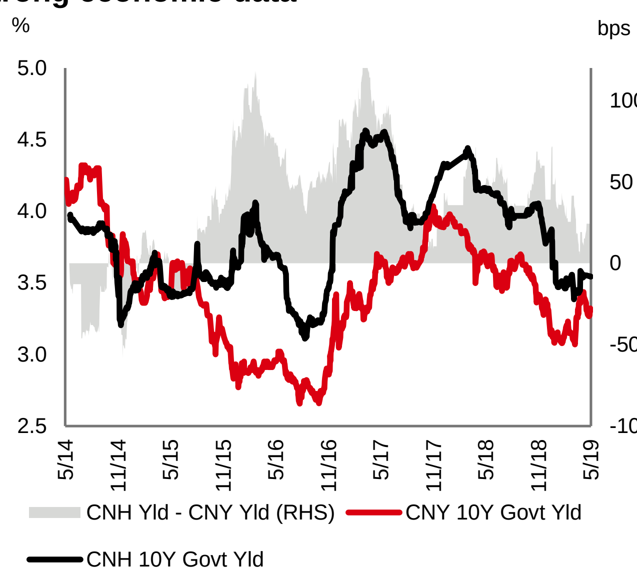
Source: Bloomberg, HSBC Global Asset Management, as of May 24, 2019.

Fixed income

The re-escalation of US-China trade tensions rattled emerging markets globally, while Chinese bonds remain resilient

- The re-escalation of trade tensions triggered a deep sell-off in EM. However, Chinese bonds generally finished on a stronger footing, benefitting from the risk-off sentiment as investors re-evaluated geopolitical risks
- In addition, China's credit growth slowed more than expected in April after record expansion in the first quarter, prompting renewed concerns over the strength of the recovery in the economy. The aggregate financing was RMB1.36 trillion in April, compared to almost RMB2.9 trillion in March, and was well-below the market forecast of RMB 1.65 trillion
- Onshore Chinese bonds advanced 0.53% as of May 24th, reversing from a 1.3% decline in April. Offshore Chinese bonds added 0.14% in May, the fifth-consecutive monthly gain. In the offshore dollar market, Chinese credits edged up 0.5% in May, delivering a 5.5% increase on a year-to-date (YTD) basis, in part thanks to a recent US dollar strength and continued strong flows into this asset class
- Against the backdrop of increasing tariff threats, the RMB dropped against the US dollar, reversing the pick-up witnessed earlier this year. Spot rates fell to 6.9179 on May 17th, the lowest this year. May saw the Chinese currency fall 2.4% against the greenback, while dropping 0.3% on a YTD basis. On the other hand, authorities continued to reiterate maintaining a stable currency
- On May 5th, the Chinese central bank decided to cut reserve requirement ratios to release about RMB280 billion for some small- and medium-sized banks, in a targeted move to help companies struggling amid an economic slowdown
- On May 14th, the central bank lent RMB200 billion to financial institutions via its one-year medium-term lending facility (MLF), with the interest rate unchanged at 3.3%. With RMB20 billion of reserve repos maturing on the same day, the central bank injected a net RMB24 billion via open market operations
- It appears that the authorities intend to keep liquidity loose in China as well as keep monetary policy on a loosening bias, which would be beneficial for the bond market

Retreat in onshore and offshore bond yields amid strong economic data



Source: Bloomberg, Markit data as of May 24, 2019. Total return in local currency terms. Past performance is no guarantee of future results.

Data watch

Indicator	As of	Actual	Cons-ensus	Prior	Analysis
Industrial production (IP) (year-on-year)(yoy)	Apr	5.4%	6.5%	8.5%	April activity data surprised on the downside almost across the board. Some payback from March's notable strength largely due to holiday- and VAT-related distortions was expected. Producers accelerated the purchase of input goods before April 1st so the value-added tax (VAT) deductible was calculated based on the old, higher VAT rate. Some other one-off factors could have also played a role. That said, the underlying momentum is soft even after controlling for the distortive factors. This coupled with the re-escalation in US-China trade/technology tensions posing downside risks suggests macro policies will likely remain accommodative for longer. The effects from the previous and ongoing policy easing (especially fiscal) should continue feeding through the real economy in the coming months. The government may further adjust policies, if necessary, with greater support for private corporates, consumption stimulus, faster infrastructure spending, more liquidity provision and lower market interest rates, etc. Further escalation in trade tensions will likely be matched by more easing, even including property policies.
Fixed Asset Investment (FAI) (YTD, yoy)	Apr	6.1%	6.4%	6.3%	Sluggish manufacturing capital expenditure was a key drag, due to a higher base effect, the lagged effects of recent soft industrial profits and lingering trade uncertainties. Tepid domestic demand momentum and renewed external headwinds cloud the near-term outlook for industrial activities and profits, despite the VAT cut, cut to social security contributions and other easing measures providing support to corporate profits. Infrastructure FAI growth was relatively stable, despite a fall in local government bond issuance after the heavy front-loading in the first quarter, likely due to faster project approvals and improved local government financing vehicles (LGFV) financing. Real estate FAI showed resilience, amid solid new housing starts, policy fine-tuning at city levels and a moderate improvement in financing conditions. Property sales have recently stabilized, especially among higher-tier cities, and housing construction has held up. However, further weakness in land purchases could weigh and risks remain for softening sales in lower-tier cities given the reduced official target for shantytown renovation. We still expect modest easing in real estate FAI growth this year.
Retail Sales (yoy)	Apr	7.2%	8.6%	8.7%	The meaningful and broad-based (both auto and non-auto) sales slowdown is a concern, though labor market conditions have been rather stable and cuts to personal income tax and VAT should support consumer purchasing power and spending. The shift in the May Chinese Labor Day holiday timing resulted in two more working days this April than last year and likely a delay in holiday purchases by consumers from April to May. Purchase decisions on big-ticket items could have also been postponed on expectations/report of consumption stimulus measures.
Exports (yoy)	Apr	-2.7%	3.0%	13.8%	The yoy contraction of exports was partly due to a high base last year and likely reflected soft external demand and lingering tariff impacts. This was a payback after a nascent recovery in the first quarter. The import rebound likely reflected the distortion from the VAT cut (importers delayed custom clearing from March to April to pay lower taxes) and better domestic demand. Commodity imports saw a broad-based improvement. The tariff impact via the trade channel is likely manageable, particularly considering policy/foreign exchange offsets. However, the impact on corporate confidence and investments, including any potential supply-chain realignments, domestic income effects and the effect from tightening financial conditions could potentially be material. The US-China trade dispute is also about technology and fair competition. Any acceleration of business disengagement between the two via non-tariff actions could have a profound impact on the structure of global trade.
Imports (yoy)	Apr	4.0%	-2.1%	-7.9%	
Trade Balance (USD)	Apr	13.8 bn	34.6 bn	32.4 bn	
CPI Inflation (yoy)	Apr	2.5%	2.5%	2.3%	The higher CPI inflation was driven by food prices while core inflation remained steady. Higher PPI inflation was broad-based across sectors, especially raw materials and the upstream industries. Food prices will likely remain a key factor for the near-term CPI outlook, and upward trend in pork prices will likely persist in the coming months due to the supply shock. However, the VAT cut could partly feed through to lower retail prices going forward, while demand-pull pressures remain modest at the moment. An upward trend in CPI inflation driven by supply-side cost push will unlikely become an imminent constraint for monetary policy.
PPI Inflation (yoy)	Apr	0.9 %	0.6%	0.4 %	
Total Social Financing (TSF)(RMB)	Apr	1,360 bn	1,650 bn	2,863 bn	The slowdown was mainly due to a decline in new RMB bank loans as well as a retreat in off-balance sheet credit items and local government special bond issuance. Corporate bond issuance remained robust. This likely reflected a fine-tuning of money policy stance toward less stimulus in April. We expect a policy status quo in the near term with possible targeted and reactive (rather than pre-emptive) policy adjustments, if necessary, in light of persistent trade risks.
New yuan loans (RMB)	Apr	1,020 bn	1,200 bn	1,690 bn	

Indicates improved data on month-on-month/quarter-on-quarter/year-on-year basis

Indicates worsened data on month-on-month/quarter-on-quarter/year-on-year basis

Indicates no change in data on month-on-month/quarter-on-quarter/year-on-year basis

Source: Bloomberg, HSBC Global Asset Management, as of May 24, 2019

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