China Insights

Update on Chinese markets

April 2019

Summary

- Despite surging 27% year-to-date, the price-to-earnings ratio of Chinese stocks remains undemanding
- Moving away from deleveraging, China's policymakers will focus on providing "adequate and ample" liquidity
- MSCI's decision to add more China A-shares in its key benchmark indices will drive USD73 billion in inflows this year and could potentially improve market transparency and corporate governance over the long term

China's bull run extends as MSCI ups A-share exposure

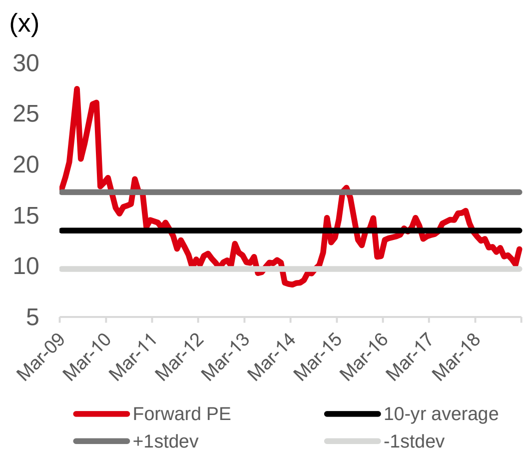
China's USD7 trillion onshore stock market is on a tear, with the benchmark CSI 300, an index of the country's largest three hundred companies, reversing most of last year's losses by rallying more than 27% year-to-date (30.4% in USD terms).

In many ways, the run-up in Chinese stocks over the first quarter has evoked a sense of déjà vu, bringing to mind the bull markets of 2006-2007 and 2014-2015 when prices rose swiftly and subsequently went south with risk appetite soured by a weakening outlook for economic growth and tighter monetary conditions. This time around, market sentiment has clearly shifted to a more a positive territory, after last year's pessimism, amid hopes for a resolution to the prolonged trade tensions between China and the United States and the shift in Beijing's policy stance from "credit tightening" to becoming more "pro-growth" to shore up its slowing economy.

But, we believe the latest surge is more than just a reversal in sentiment, as structural changes such as MSCI's decision to add more of China's A-shares to its key indices are acting as catalysts for the market rally.

MSCI's recent decision to lift the weighting of China A-shares in its indices, starting in May 2019, by increasing the inclusion factor from 5% to 20% in a three-step process is yet another recognition of the country's efforts to open

Figure 1: Valuations of China A-shares look undemanding



Source: Bloomberg, HSBC Global Asset Management, March 22, 2019. Past performance is no guarantee of future results.

HSBC Global Asset Management

MSCI boon: An estimated USD73 billion of inflows into China A-share this year, providing more fuel to the market

up its domestic capital markets. The change could lead to USD73 billion in equity inflows into A-shares this year, adding more fuel to the red-hot market. Since the MSCI announcement in February, some A-share companies have stopped taking buy orders from foreign investors as they are inching close to hitting the 30% foreign holdings limit. We believe the weight increase could have a more profound impact on the development of the Chinese capital market than merely attracting capital inflows, with expectations for better market transparency and corporate governance over the long term.

Lending more structural support to the equity market rally are China's efforts to bring down the borrowing costs for private-sector companies since the second half of 2019. This could potentially result in better corporate earnings and stronger balance sheets. In addition to various monetary easing measures, Premier Li Keqiang of the State Council of the People's Republic of China announced further tax cuts and reduction in fees during the National People's Congress meeting in March, amounting Renminbi (RMB)2 trillion mostly in corporate tax cuts for 2019. Acknowledging the pressures on the economy, Premier Li also stressed the need for more measures to ensure "adequate and ample" liquidity, officially signaling a move away from the government's deleveraging stance. All these measures bode well for China's stock markets.

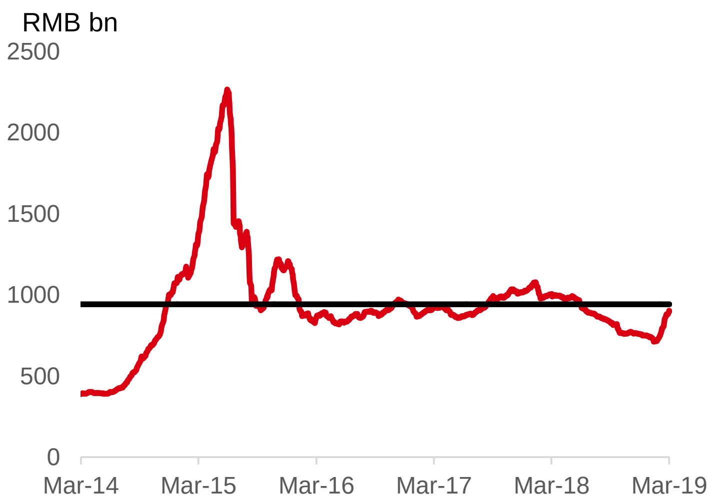
Valuations of A-shares are still supportive despite the sharp rally. Price-to-earnings ratio of the CSI 300 Index stocks remain undemanding, trading at around 11.9x forward earnings, below its 10-year average (Figure 1).

Cause for caution?

The China A-share market, which is notoriously known for wild price swings, is still primarily driven by retail investors, who make up over 80% of the daily turnover. In recent weeks, we have noted an uptick in margin financing, which is a gauge of retail sentiment. At the same time, fundamental factors such as earnings quality seem to be less of a concern for the retail punters who bet on momentum and concept stocks. For instance, the 30 best-performing stocks in China have collectively surged 176% so far this year, even though half of them are expected to see a contraction in earnings growth in 2019 (only eight of these companies are expected to post earnings growth and seven have no analyst forecasts).

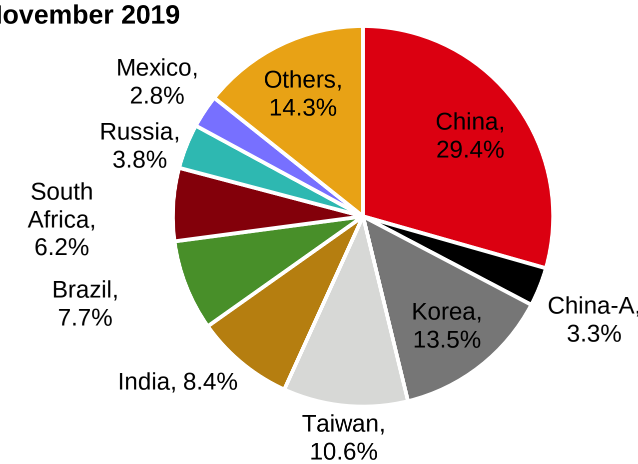
Margin financing has picked up from RMB710 billion in early February to about RMB900 billion on March 22, according to China Securities Finance Corp, a data provider controlled by the State Council. China's securities regulators have been closely monitoring the use of leverage among retail investors. We believe regulators may step in to curb further speculation once margin financing crosses a certain threshold (Figure 2).

Figure 2: Margin financing recorded since February 2014



Source: Bloomberg, HSBC Global Asset Management, as of March 22, 2019. Past performance is no guarantee of future results.

Figure 3: When inclusion factor=20% in MSCI Emerging Markets Index in November 2019



Source: MSCI, HSBC Global Asset Management, as of February 28, 2019.

Equity market

- As of March 22nd, the MSCI China Index and the onshore benchmark CSI 300 Index advanced 17.1% and 30.4% year-to-date (ytd) (in US dollar terms), compared to a 9.7% increase in MSCI Emerging Markets Index

- In March, the US Federal Reserve (Fed) joined the Chinese central bank to adopt a more dovish monetary stance, setting the scene for a prolonged period of low rates. Generally speaking, subdued headline inflation globally and accommodative funding conditions are fuelling the global stock market rally, even though the prospect for earnings growth looks less rosy

> The month of February saw the biggest net monthly northbound trade at USD9 billion since the launch of the stock connect program in 2014

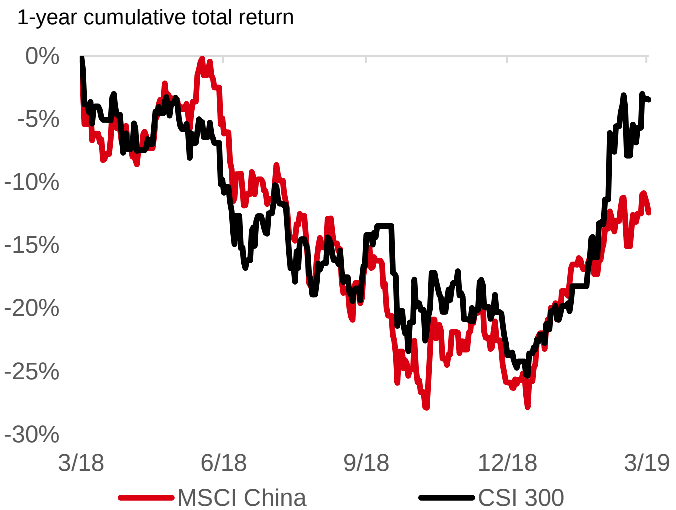
- For China, the onshore market's swift recovery from last year's heavy losses has been primarily driven by signs of an end to the long-running US-China trade tensions. The rally also underscores Beijing's efforts to lower the cost of borrowing in a slowing economy and MSCI's decision to increase the weight of China A-shares in its benchmarks. The CSI 300 lost 25% in value last year

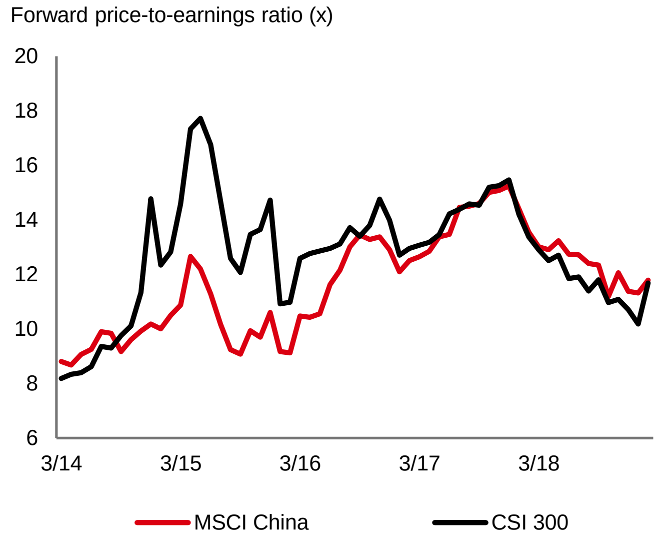
- Fund flows into China A-shares have also picked up this year with foreign investors buying shares more aggressively. The month of February saw the biggest net monthly northbound trade, at USD9 billion since the launch of the stock connect program in 2014. This was also the third consecutive month of inflows

- The risk-on sentiment is more apparent in small-capitalization growth stocks. Shenzhen's startup board ChiNext Composite Index, traditionally a hotbed for speculation, has surged more than 35% so far this year, partially driven by retail punters who are eager to score outsized returns through leveraged bets

- In terms of valuation, forward price-to-earnings ratios for both MSCI China and MSCI China A-shares indexes are still trading below their 10-year averages at 10.7x and 12.4x, respectively. When measured by the price-to-book ratio, the former is trading at its 10-year average of 1.74x, while the latter is trading at about 20% below its 10-year average of 2.20x

Chinese equities rally on the back of easing measures





Source: Bloomberg, HSBC Global Asset Management, as of March 22, 2019. Total return in local currency terms. Investment involves risks. Past performance is no guarantee of future results.

Sector	Comment
Consumer Discretionary	◆ We are selective on the consumer discretionary sector. Policies such as tariff cuts and relaxation of foreign ownership dented the outlook for the auto sector. We are more positive on the home appliance industry on the back of favorable policies from the government
Consumer Staples	◆ The trend of premiumization, on the back of rising income, underpins higher pricing power and margin expansion capability of select strong brand names
Energy	◆ We have a neutral view on energy as oil prices are expected to trade within a narrow range as global demand and supply stabilize
Financials	◆ Loan growth may pick up on the back of more relaxed monetary policies. A pickup in the equity market could drive insurers' investment return
Healthcare	◆ We are highly selective on healthcare names and only favor those with strong research and development capabilities in innovative drugs
Industrials	◆ We like the capital goods industry as favorable government policies could prompt higher capital expenditures (capex) on industrial equipment
Information Technology	◆ We are wary of the IT sector especially technology hardware due to weakness in smartphone sales, limited room for smartphone specifications upgrade and the fact that they could be impacted by US-China trade conflicts
Materials	◆ Softness in fixed asset investment activities suggests soft demand for commodities
Property	◆ We like leading players who have higher exposure to top-tier cities and strong refinancing capabilities
Communication Services	◆ We like telecommunications companies that may benefit from 5G development. We are conscious that competition for major telecoms remains intensive. We also like major internet companies as we see secular growth potential in China's internet space
Utilities	◆ We see few catalysts for this sector

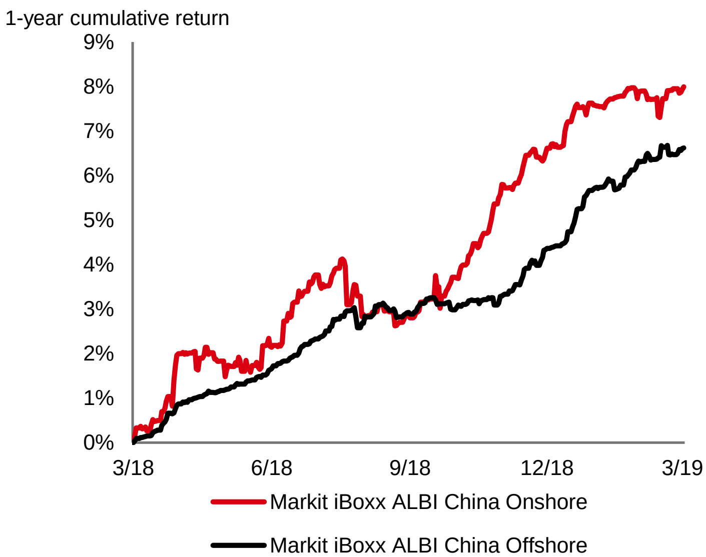
Source: Bloomberg, HSBC Global Asset Management, as of March 22, 2019.

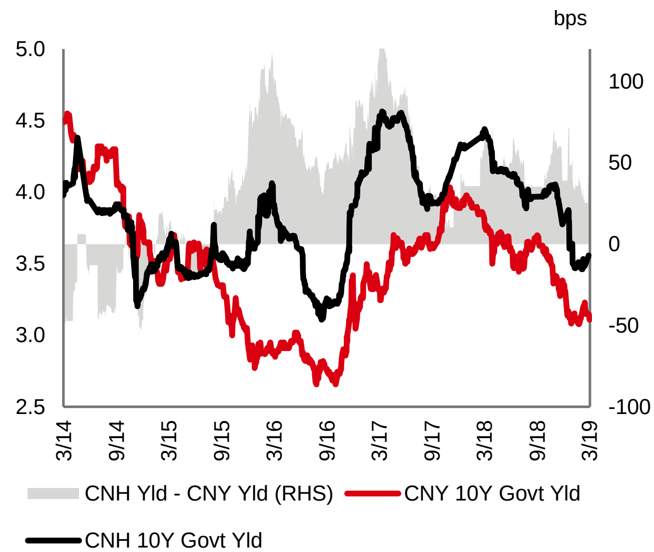
Fixed income

> The People's Bank of China is likely to lower funding costs further for the private-sector companies amid ongoing trade tensions

- As global liquidity continues to improve, both the onshore and offshore RMB-denominated bonds have extended their rally since the start of the year, rising 1.2% and 0.7% in local currency terms (as of March 22), respectively
- In the offshore dollar space, Chinese credit has advanced almost 2.6% so far this year as general market sentiment remains very positive, with Chinese high-yield property developers performing well. As a result, the blended spread of Chinese credit has come down from 350 basis points (bps) in early January to about 300bps currently, near its five-year average
- Before Bloomberg Barclays Global Aggregate adds a list of 364 Chinese onshore bonds to its benchmark on April 1st, the yield on the 10-year Chinese government bond moderated by a few basis points over the past month to 3.13% in late March, while its offshore counterpart was largely unchanged. Over a 20-month period, the inclusion is expected to draw USD150 billion of inflows into the onshore market, or USD7.5 billion per month
- The yields of China's AA-rated corporate bonds remained largely stable across the maturity curve over the month, reflecting robust demand for relatively risky debt
- The People's Bank of China (PBoC) signaled its preference to lower the benchmark lending rates rather than cutting the reserve-requirement ratio (RRR) – the amount of cash each bank must hold – further. The central bank recently cut the RRR ratio by 100bps in January, freeing up around RMB800 billion
- Looking at the Chinese currency, the onshore RMB has regained about 2.4% so far this year against the greenback, after weakening by about 6% last year. In our opinion, the 2019 outlook for the RMB has turned somewhat more constructive, while the future of US-China trade talks and the US interest rate policy remain the biggest swing factors for the Chinese currency
- In summary, offshore high-yield bonds issued by certain Chinese property developers remain attractive going into the second quarter, as the government is likely to stimulate the economy by boosting consumption and relaxing some tightening measures in the property market

Onshore and offshore yields have moderated since second half of 2018





Source: Bloomberg, Markit data as of March 22, 2019. CNH: offshore currency. CNY: onshore currency. Total return in local currency terms. For illustrative purposes only and does not constitute any investment recommendation in the above mentioned asset classes, indices or currencies. Past performance is no guarantee of future results.

Data watch

Indicator	Data as of	Actual	Cons-ensus	Prior	Analysis
Industrial production (IP) (year-on-year (yoy))	Jan-Feb	5.3%	5.6%	5.7% (Dec)	January-February real activity growth remained soft but was subject to the lunar new year holiday distortions. The National Bureau of Statistics stated that the yoy IP growth adjusted for the distortions would have been 6.1%. IP growth is likely to rebound in March due to a low base. Overall, domestic demand indicators showed some positive signs recently, likely reflecting policy easing effects, although they do not yet signal a growth turnaround. We expect the stepping up in policy support to help stabilize the cyclical growth, particularly if this is coupled with structural reforms to facilitate policy transmission and level the playing field for private corporates. Unlike previous easing cycles, which tended to focus on highly-leveraged state-owned enterprises, property and infrastructure sectors, this time the stimulus mainly targets at private enterprises/small-and-medium-sized enterprises (SMEs) and consumers with tax cuts and financing support (along with moderate support for infrastructure). This should improve the allocation of new credit and fiscal resources, helping to cap the credit intensity of economic growth in the medium term, while enabling the recovery to be more broad-based and sustainable. It will likely take longer for the stimulus to filter through to greater private sector spending and the fiscal multiplier tends to be lower. Moreover, the bulk of the tax cuts will be implemented from April 1st and the easing is likely be to milder, and more selective, than in the previous cycles.
Fixed Asset Investment (FAI) (ytd, yoy)	Jan-Feb	6.1%	6.1%	5.9% (Dec)	An acceleration in real estate FAI, despite a sharp slowdown in land sales, helped offset a slowdown in manufacturing capex while infrastructure FAI stayed in a modest recovery as policy efforts were coming through. Weaker industrial profit growth and lingering trade uncertainty will likely remain near-term headwinds for manufacturing FAI. While property sales slowed further and new starts cooled, we still expect more city-level policy relaxation but no large-scale nationwide easing given the official concerns over housing speculation and household leverage and few signs of a significant property market downturn.
Retail Sales (yoy)	Jan-Feb	8.2%	8.2%	8.2% (Dec)	The stable retail sales growth was helped by a narrower contraction in auto sales, though sales of housing-related items and staple goods weakened. Policy measures to boost the consumption of autos and electronic home appliances will likely have a limited impact, given fiscal constraints and as tax incentives for the auto sector was rolled out not long ago in 2015-17. Individual income tax cuts should improve personal disposable income and spending, but rising household debt and recent signs of slower employment growth are concerns.
Exports (USD) (yoy)	Feb	-20.7%	-5.0%	9.3%	Exports and imports fell 4.6% yoy and 3.2% in January-February, respectively, after rising 3.9% and 4.4% in Q4 2018, reflecting sluggish external and domestic demand, as well as the fading of exports front-loading the second half of 2018 to avoid being subject to higher US tariffs. Trade with the US slowed significantly. The softening of imports was in part driven by imports of intermediate goods for processing trade and weaker commodity prices. The reported good progress in US-China trade negotiations has raised the prospect for a deal to be reached. However, uncertainties remain over key structural issues, especially the monitoring and enforcement mechanism and whether the existing tariffs would be removed or reduced and, if so, the timeframe. Recent RMB gains are a near-term headwind for exports. Any rise in global protectionism will hurt China's trade flows.
Imports (USD) (yoy)	Feb	-5.2%	-0.6%	-1.6%	
Trade Balance (USD)	Feb	4.1 bn	26.2 bn	39.8 bn	
CPI Inflation (yoy)	Feb	1.5%	1.5%	1.7%	Headline Consumer Price Index (CPI) inflation is likely to rise moderately to around 2% or slightly above in coming few months, partly driven by pork prices, due to the decline in sow stock since last April. However, CPI inflation should remain modest and not be a major constraint on monetary policy easing. Meanwhile, the material easing of Producer Price Index inflation since July 2018 has contributed to deceleration of sales and profit growth of the industrial sector while pushing up real interest rates and keeping real debt servicing costs elevated. This has clouded the corporate capex outlook.
PPI Inflation (yoy)	Feb	0.1 %	0.2%	0.1 %	
Total Social Financing (TSF) (RMB)	Feb	703 bn	1,300bn	4,635 bn	Despite the substantial pullback in February, newly increased TSF in the first two months still rose by 24% yoy. The share of short-term loans and bill financing in new bank loans dropped in February, partly reflected tighter regulatory scrutiny over the latter, but remained high when combined with January data. The PBoC noted SMEs widely use short-term, liquid bill financing as an important funding vehicle, but also acknowledged the risk of speculation and pledged to keep monitoring the development. Going forward, we expect solid corporate bond issuance amid low market interest rates, good liquidity and policy support, while shadow banking activities will likely normalize given a pause in deleveraging.
New yuan loans (RMB)	Feb	886 bn	950 bn	3,230 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 March 22, 2019.

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