China Insights

Update on Chinese markets

March 2019

Summary

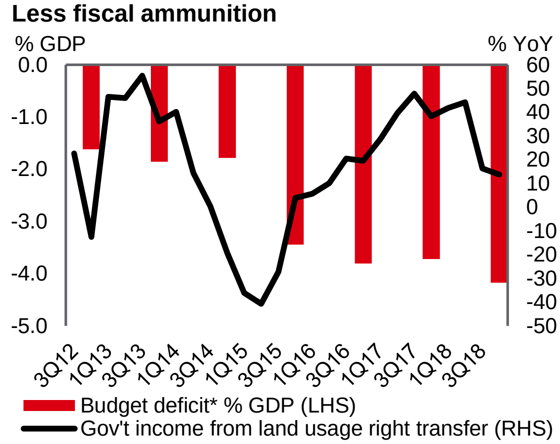
- *As the economy cools, Beijing will boost its infrastructure spending through local government and policy bank bonds, stretching the balance sheets of the central and local governments*
- *The overall funding conditions have improved significantly, but funding channels such as private-public partnership (PPP) and land sales are less desirable given tepid market appetite*
- *Chinese equity and bond markets have benefited from a reversal in risk appetite since the start of the year, with fiscal and monetary policy support driving up asset prices*

Raising infrastructure funding to boost support for the economy

As the pace of growth in China appears to be slowing faster than expected since the second half of last year, fiscal stimulus has been ramped up in the form of tax cuts and funding for infrastructure projects. Infrastructure investment, championed by the Chinese authorities during the 2008 global economic downturn, is back on the policy agenda to counter economic slowdown and shore up confidence.

There have been a host of infrastructure plans announced since third quarter of last year, including a renminbi (RMB) 230 billion inter-city railway project in the Jiangsu province. Railway spending was one of the first areas to experience a turnaround, with the actual spending for 2018 exceeding the original target by 1% year-over-year (YoY) at RMB803 billion. The pickup in project approvals and construction starts at the end of last year suggests that the 2019 railway investment target could be maintained at around or above RMB800 billion. The latest official data also pointed to a pick-up in infrastructure spending. The December infrastructure growth came in at 4.8% YoY, bringing 2018 full-year growth to 3.8%.

Less fiscal ammunition



Note: Budget deficit unadjusted for government-managed funds, utilized carryover and surplus funds and funds from other sources. Source: Bloomberg, CEIC, HSBC Global Asset Management, February 20, 2019. Past performance is no guarantee of future results.

HSBC Global Asset Management

Stimulus hopes

State budget approval for infrastructure projects is expected to accelerate and the government is likely to set a larger general budget deficit target for 2019 than 2018's 2.6% of GDP. However, the room for fiscal ammunition has narrowed amid a widening budget deficit trajectory. According to the IMF's estimate, the "augmented" fiscal deficit, which includes local government financing vehicles (LGFVs) and other off-budget activity, was running at above 10% of GDP in 2016-18 and is expected to remain high at this level in 2019.

The authorities have pledged more aggressive tax reductions in 2019 and, with a cooling property market, fiscal revenues from tax-related income and land sales are expected to moderate in 2019. The government will likely have to rely extensively on greater deficit financing outside the general budget, such as local government special bond issuance, LGFV borrowing and policy bank financing, to fill the funding gap. At the conclusion of a key annual planning meeting in December last year, the top economic officials pledged to increase local special government bond sales to fund infrastructure. The total quota for the net issuance of local government special bond for 2019 is expected to exceed RMB2 trillion, representing about 60% YoY growth from RMB1.35 trillion in 2018. The State Council has approved RMB1.39 trillion of bond quota for local government issuance so far this year in a move to speed up the approval process before the 2019 budget is approved by the National People's Congress in early March.

> The central bank still has the wiggle room to go deeper into its monetary toolbox to shore up growth

PPP projects are another funding channel for infrastructure projects. Despite easing restrictions on PPPs, there remain challenges in executing the PPP projects, most notably the weak ability of local governments to make their own portion of the payment and difficulties raising funds from the capital market due to unclear risk profiles. Infrastructure financing via shadow-banking channels, particularly trust products, remains under strict regulatory scrutiny.

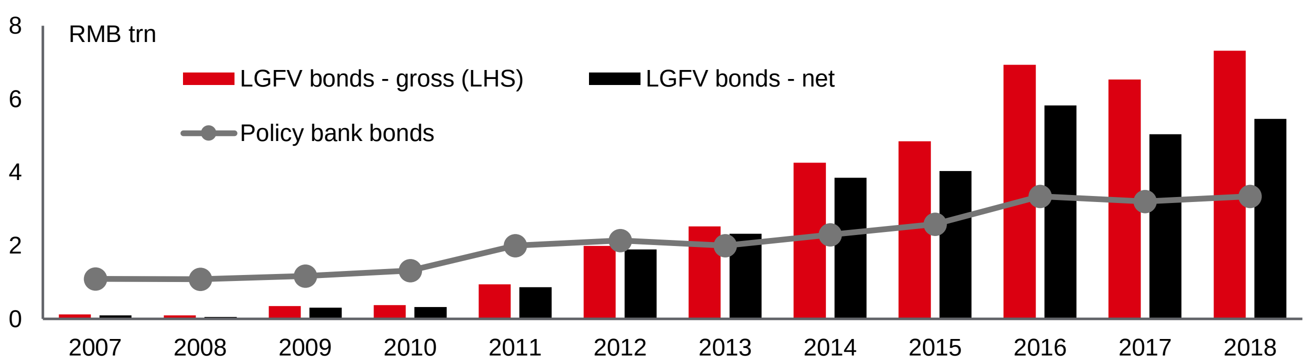
While the floodgates have broadly reopened, local governments have turned more cautious about piling up debt to push up spending significantly. We think they will selectively boost their spending based on their own balance sheets. Given the concerns about debt sustainability and financial stability risks, we believe authorities will still strive for a balance between supporting growth and keeping a lid on ballooning debt. Overall, we expect infrastructure investment to remain a key policy focus and a driver for investment growth, but we do not expect a significant rebound driving a turnaround in the economy. Meanwhile, monetary policy will need to maintain sufficient liquidity to accommodate a ramp-up in local government bond issuance, while ensuring the rise in public financing will not crowd out the private sector borrowers.

What are the market implications?

Chinese equity and bond markets have benefited from a reversal in risk appetite since the start of the year, with fiscal and monetary policy support driving up asset prices, especially in high-beta securities. Within the infrastructure investment universe, we have an prefer the railway and high-speed train sectors over commodities and base metals, which are faced with operating pressures due to domestic structural reforms and weakness in commodity prices.

In the bond market, we favor policy bank bonds with long-dated maturities, while taking a selective stance on the LGFV sector, which has a wide spectrum of different credit profiles measured by local debt to GDP.

LGFV and policy bank bonds have picked up since last year



Source: Bloomberg, CEIC, HSBC Global Asset Management, January 31, 2019. Past performance is no guarantee of future results.

Equity market

> Onshore cyclical consumption stocks rose significantly, underpinned by optimism over earnings growth

- Buoyed by expectations for policy easing and signs of a potential trade deal with the US, Chinese shares extended their rally into February, outperforming their emerging markets (EM) peers. As of February 20, MSCI China and the onshore benchmark CSI 300 Index advanced 13.2% and 14.7% year-to-date (YTD), compared to a 8.7% increase in MSCI EM Index

- The outperformance of the onshore stocks underscores the bullish sentiment among domestic investors, who are buying more high-beta and cyclical-consumption stocks. From a fundamental perspective, the rally in the cyclical-consumption stocks is supported by higher earnings growth forecast this year. The earnings of companies in the sector are expected to expand 31% this year, the highest among the 11 sectors

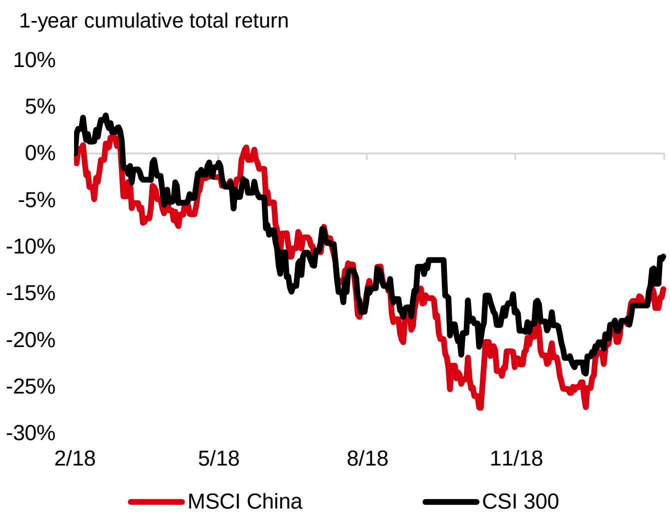
- The positive view on Chinese shares is supported by People's Bank of China's dovish monetary stance since the central bank has introduced several policy measures to boost lending in the economy, including the sale of perpetual bonds by commercial banks and series of reserve requirement ratio (RRR) cuts in the past 12 months, as well as dedicated lending to the small and private sectors. To site a few examples, the amount of new loans reached an all-time high in January, while the total social financing also hit a fresh record

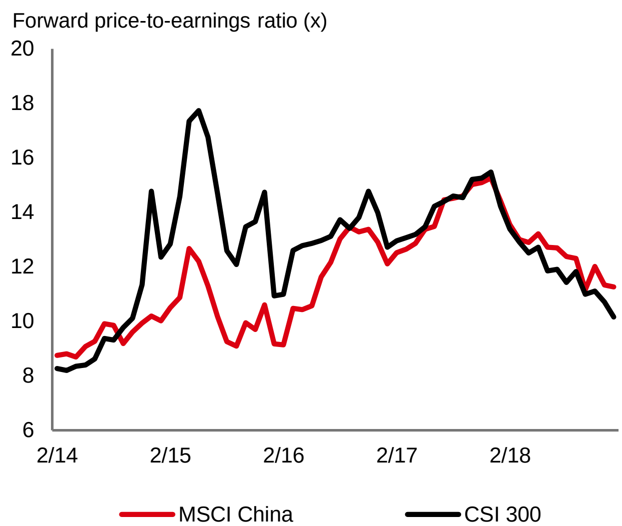
- In terms of valuation, forward price-to-earnings ratios for both MSCI China and MSCI China A share indexes are trading below their 10-year averages at 11.55x and 11.05x, respectively. When measured by the price-to-book ratio, the former is trading at 1.69x and the latter at 1.55x, reflecting a 3% and 30% discount to their 10-year averages

- In essence, the market is currently pricing in further policy easing from Beijing and a constructive outcome from the trade negotiations, yet we understand the full details might come on or before March 1st

- MSCI is considering a further increase in the weight of China's A-shares in its EM universe by raising the inclusion factor from 5% to 20%. If this occurs, about USD38 billion is likely to flow into the onshore market

Chinese equities have turned more attractive after recent correction





Source: Bloomberg, HSBC Global Asset Management, as of February 20, 2019. Total return in local currency terms. Past performance is no guarantee of future results.

Sector	Comment
Consumer Discretionary	◆ 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 the higher pricing power and margin expansion capability of select strong brand names
Energy	◆ 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. We are selective on insurance.
Healthcare	◆ The healthcare space is subject to unfavorable policy changes such as increasing import of foreign drugs and stretched valuation
Industrials	◆ We like the capital goods industry as favorable government policies should prompt higher capital expenditure on industrial equipment
Information Technology	◆ We are watchful of the IT sector especially technology hardware due to smartphone sales weakness, limited room for smartphone spec upgrade, and the fact that they could be victims of the US-China trade conflicts
Materials	◆ Softness in fixed asset investment activities suggests soft demand for commodities
Property	◆ The government may further fine-tune its tightening policy to support the sector amid severe external headwinds. We are positive on Hong Kong-based REITs for their defensiveness
Communication Services	◆ We like companies in the telecommunication towers space which should benefit from 5G development but competition between major telecoms is intense. We also like major internet companies as we see secular growth potential in China's internet space
Utilities	◆ We have a neutral stance overall but we do favor companies which may benefit from coal price weakness

Source: Bloomberg, HSBC Global Asset Management, as of February 20, 2019.

Fixed income

Adding Chinese bonds into the Bloomberg Barclays index could attract USD120 billion of passive inflows over a 20-month period

The PBoC is looking to broaden the investor base for banks' perpetual bonds in a move to provide fresh demand and lower the funding costs

- Onshore and offshore bonds extended their rally since the start of the year, delivering 1.1% and 1.8% in local currency terms (as of February 20th), respectively. Sharing the improving sentiment in the equity markets, Chinese bond markets have also been buoyed by expectations for more loosening measures from the People's Bank of China (PBoC)

- On February 14th, Bloomberg confirmed its inclusion of Chinese onshore bonds and released further details. Over a 20-month period from April 2019, the mainland-traded bonds, which include government and policy bank bonds, will represent 6.06% of the Bloomberg Barclays Global Aggregate Index. The final weighting is slightly higher than our previous estimates and implies total passive inflows of USD120 billion, or USD6 billion per month

- On February 19th, the PBoC said it will provide further support for perpetual bond issuance by banks, including examining ways to broaden the investor base, to help boost lending in the economy. The latest move could provide new demand for the bonds without a maturity date and compressing the funding cost for the issuers

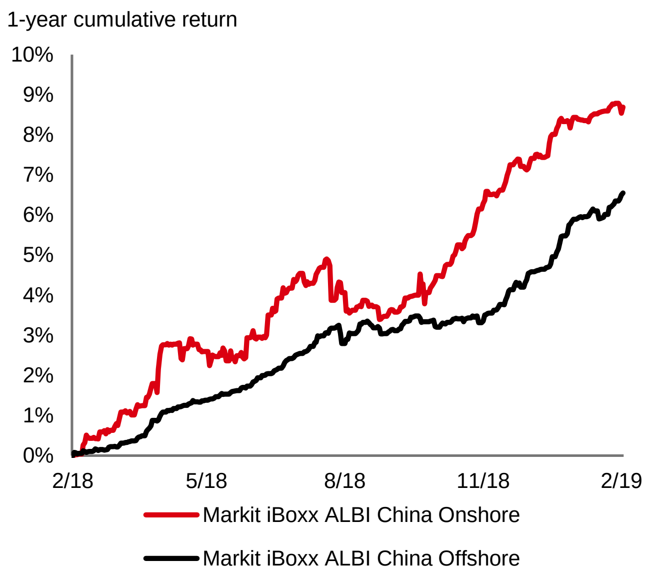
- The onshore yield curve has continued to move lower as fundamental conditions remain favorable for bonds. The yield on 10-year government bonds declined significantly to 3.077% on February 12th, the lowest level in the past 12 months, before slightly bouncing back to 3.12% on February 20th

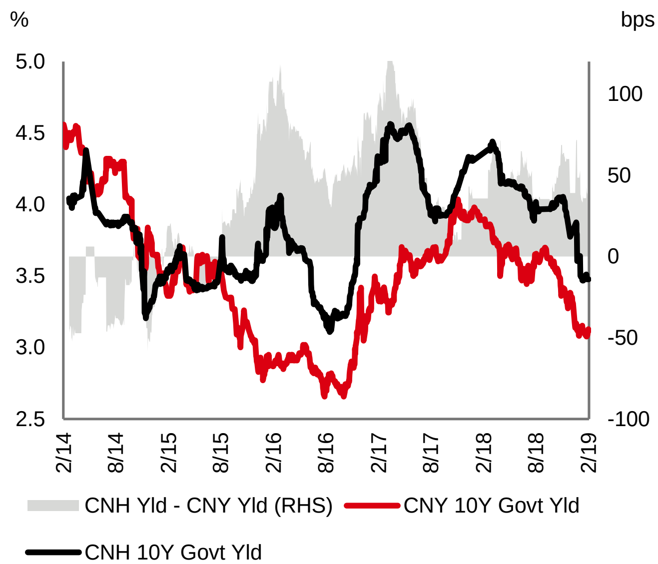
- Thanks to the government's increasing efforts to maintain reasonable and sufficient liquidity, onshore corporate bonds performed well as the government pledged more financing support, mainly for smaller and private enterprises. The yield of China's AA-rated 3-year corporate bonds continued to drift down to around 4% in February, down from 6% in early-2018

- Looking at the Chinese currency, the onshore renminbi has advanced almost 2.3% so far this year against the US dollar, reversing from a 5.6% decline in 2018. In 2019, we expect the US dollar to stabilize or slightly weaken as investors may start to price in a softer US Federal Reserve rate hike path and a slowing global growth

- In the offshore dollar market, we believe the property sector provides better risk-adjusted returns on the back of accommodative policy, while favorable onshore conditions could impact the overall net supply in the offshore market

Onshore and offshore yields moderated over the past few months





Source: Bloomberg, Markit data as of February 20, 2019. Total return in local currency terms. 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	Consensus	Prior	Analysis
Industrial production (IP) (YoY)	Dec	5.9%	5.3%	5.4%	Purchasing Managers Index readings indicate lackluster IP momentum in the near term. Economic activity is likely to remain subdued in early 2019 on slower global growth, cooling property/land markets and persistent structural headwinds (e.g., high debt levels). It is challenging to interpret macro data at the beginning of the year due to the limited data availability around the Lunar New Year (LNY) holiday and seasonality factors around the timing of the holiday. However, the better-than-expected trade and credit data for January have supported a recovery in confidence that policy easing is taking effect and cyclical growth momentum could start to stabilize in coming months.
Fixed Asset Investment (FAI) (YTD, YoY)	Dec	5.9%	6.0%	5.9%	A modest recovery in infrastructure FAI and solid manufacturing FAI offset a moderate easing in real estate FAI. Property sales recovered and land area purchases picked up, while new starts maintained a strong pace. However, property prices have eased further. We expect modest cooling in housing market activity, especially in lower-tier cities where the shantytown renovation targets in 2019 will likely be slashed. While large scale or nationwide policy loosening looks unlikely, more policy fine-tuning at city levels is expected. Moderate levels of housing inventory and policy support for rental housing help. Weaker industrial profits and trade uncertainties are headwinds for manufacturing FAI in the near term. Infrastructure will remain a key driver for FAI.
Retail Sales (YoY)	Dec	8.2%	8.1%	8.1%	The auto sector remained the key drag, while retail sales ex-auto picked up. The stimulus measures to boost the consumption of autos and electronic home appliances will likely have a limited impact, given fiscal constraints and high local government debt levels. Individual income tax cut should improve personal disposable income, but rising household debt and recent signs of slower employment growth are concerns.
Exports (USD) (YoY)	Jan	9.1%	-3.3%	-4.4%	The export rebound likely largely reflected the LNY holiday timing effect as exporters front-loaded shipments before the holiday. Some payback is expected in February, and we will look at the combined two-month data for a better sense of the underlying trend. Shipments to major destinations ex-US picked up. The YoY import contraction narrowed and imports rebounded on a seasonally adjusted month-over-month (MoM) basis, particularly from countries outside the US. President Trump said he will extend a deadline to raise tariffs on USD200bn of imports from China beyond March 1st, citing "substantial progress" in trade talks. The ongoing negotiations on structural issues (intellectual property, technology transfer, services market access, agriculture, currency and non-tariff barriers) have raised expectations for a deal to be reached in the near future. However, it remains uncertain whether the two sides can reach agreements on these structural issues and the enforcement mechanism, leading to a comprehensive roll-back of existing tariffs and toward a full resolution. China's industrial policy, including subsidies to state-owned-enterprises (SOEs), are a key structural issue but not a part of the current negotiations. Uncertainties about future tariffs and (tech) restrictions, etc. from the US may linger.
Imports (USD) (YoY)		-1.5%	-10.2%	-7.6%	
Trade Balance (USD)	Jan	39.2 bn	34.3 bn	57.1 bn	
CPI Inflation (YoY)	Jan	1.7%	1.9%	1.9%	CPI inflation deceleration was led by food and fuel prices, despite an earlier timing of the LNY holiday. Core CPI inflation (ex-food and energy) edged marginally up. PPI inflation fell further, across the mining, raw material and manufacturing sectors, which reflected stalling oil & commodity prices, subdued consumer and investment demand, a high base effect in upstream sectors and relaxation of supply-side restrictions. Overall, non-food inflation should remain modest amid tepid demand growth. PPI inflation could slide into negative territory in the coming months, posing an economic risk by putting downward pressure on nominal GDP and corporate sales and profit growth while pushing up real interest rates and keeping debt servicing costs elevated.
PPI Inflation (YoY)	Jan	0.1 %	0.3%	0.9%	
Total Social Financing (TSF) (RMB)	Jan	4,640 bn	3,307bn	1,590 bn	The data showed the effects of policy easing efforts have started to kick in, despite some seasonality around the LNY holiday. Growth of TSF outstanding picked up to 10.4% YoY from 9.8% in December, following a prolonged period of slowdown since August 2017 amid deleveraging. The rebound in TSF was led by bank loans, bond financing (corporate and local government bonds) and bankers' acceptance bills (BACs). The off-balance-sheet credit ended ten months of MoM contraction. Monetary easing focus will likely remain on improving the policy transmission for abundant liquidity to be directed to the real economy through more (bank) lending and capital market financing. The policy goal will also increasingly be for financial institutions to pass on lower interbank funding costs to borrowers. However, the short-term benefit to the economy from faster credit growth comes at the cost of increased medium-term financial stability risks related to higher leverage in the economy.
New yuan loans (RMB)	Jan	3,230 bn	3,000bn	1,080 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 February 20, 2019.

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