China Insights

Monthly update on Chinese markets

March 2020

Summary

- It remains difficult, if not impossible, to quantify the potential economic fallout as the situation is still evolving, but the longer it takes to contain the virus, the bigger the impact on China's economic activities is likely to be
- In terms of policy support, authorities have rolled out more monetary and fiscal measures to ensure growth stays within a reasonable range
- Looking ahead, we expect the government to step in in a calibrated manner, depending on the severity of the situation and impact on the economy

Hot topic: Investing amid virus worries – tackling the toll of containment

The outbreak and spread of the coronavirus triggered a wave of risk-off sentiment globally, led by China. However the sell-off in Chinese assets was relatively short-lived and offset by a sharp rebound after the initial kneejerk reaction amidst hopes that the number of new infections would continue to slow.

Even as the markets bounced back swiftly it seems likely that the virus outbreak will have a significant, albeit transitory, impact on China's near-term economic activities, especially as containment efforts continue to restrict people's mobility and hurt tourism, consumer spending and services sectors. While it remains difficult, if not impossible, to quantify the potential economic fallout as the situation is still evolving, it stands to reason that the longer it takes to contain the virus, the bigger the impact on China's economic activities is likely to be.

Revisions to China growth forecasts currently range between 1-2pp off Q1 growth. However, assumptions of a sharp rebound mean that annual 2020 growth forecasts are only 0.2-0.6pp lower. It should be noted that forecasters seem to be assuming the initial hit to Q1 growth would be comparable to SARS. This may prove to be too optimistic with factors such as the US China trade dispute, structurally high levels of debt and excess domestic capacity also weighing on the Chinese economy's ability to grow at a faster pace.

Against this backdrop, the Chinese government has moved swiftly to buffer the impact from the virus outbreak and shore up the economy through various measures – (*contd on page 2*)

HSBC Global Asset Management

> We continue to expect policymakers to prioritise urgent relief or rescue measures including both fiscal and credit support targeted at the hardest hit sectors, regions, households and companies

Proactive approach

To cushion the potential economic fallout from COVID-19, the government has announced a slew of targeted, micro/sector-level, “disaster relief” measures and is expected to roll out more fiscal/interest subsidies, waivers/reduction/delays in tax payments and/or social security contributions, funding support (especially working capital) and debt forbearance, etc. for affected entities.

The Ministry of Finance has also announced an increase in the front-loaded local government bond issuance quota from RMB1 trillion to RMB1.848 trillion. The People’s Bank of China has cut de facto policy rates (reverse repo rate, MLF and LPR rate) by 10bp in February and injected large amount of short-term liquidity into the banking system to provide credit support to virus-affected sectors, including loan rollover and working capital support.

We continue to expect policymakers to prioritise these urgent relief or rescue measures including both fiscal and credit support targeted at the hardest hit sectors, regions, households facing financing/ repayment difficulties due to the coronavirus, and companies - especially SMEs which are particularly vulnerable in the area of financing and employment and companies engaged in epidemic control business and medical supplies. More policy efforts will also be dedicated to enhancing the supply of medical goods and other daily necessities and controlling their prices. Additionally, local governments have also rolled out various relief measures with some cities relaxing property policies, including their home purchase restrictions.

> More broad-based, medium-term demand-boosting measures will probably become a policy focus at a later time given the lack of clarity around the exact damage to economic activity at the moment

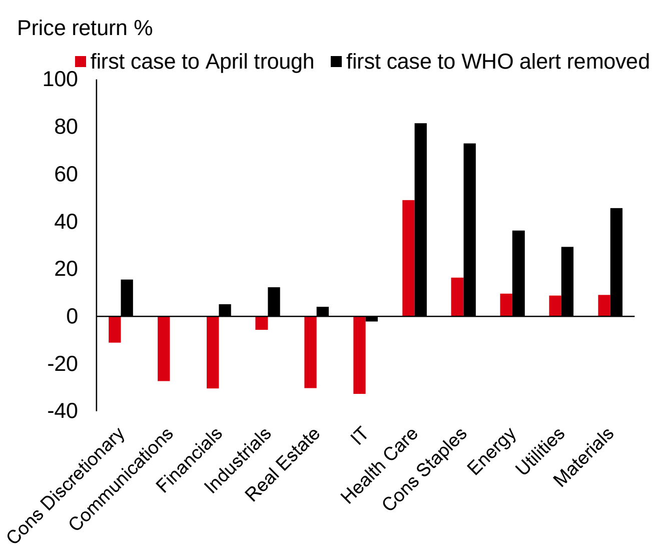
Further policy action needed

We think more broad-based, medium-term demand-boosting measures will probably become a policy focus at a later time given the lack of clarity around the exact damage to economic activity at the moment. However, any large, outright and lasting stimulus is unlikely given the economic impact from the virus is typically seen as transitory.

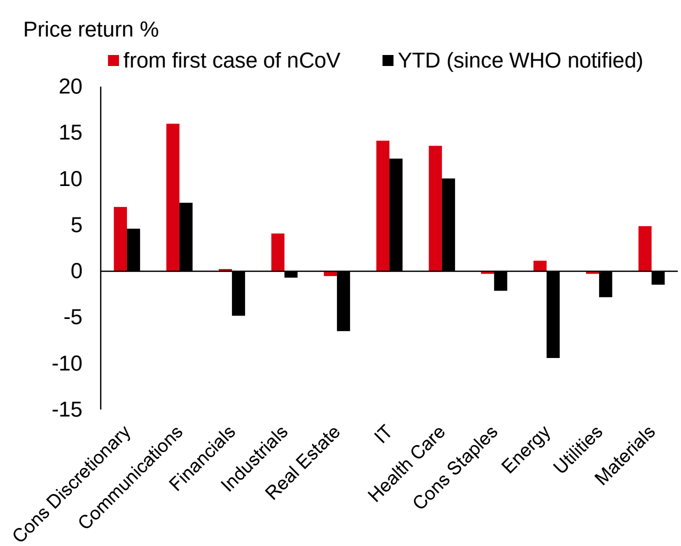
We would think such stimulus would become more of a focus after overall economic activities show clear evidence of normalisation i.e. the coronavirus fear subsides, disruptions to activity including the extensive efforts to contain its spread (e.g. transport/ travel restrictions) can be removed or reduced, business operations/factory production resume, and people are back to work, etc. Otherwise, policy measures may not be effective in reviving demand.

In the meantime, further monetary/credit easing (including modest rate cuts, more liquidity injection, macro prudential relaxation and regulatory flexibility), fiscal stimulus (taxes/fees, social security contributions, subsidies, for corporates plus infrastructure and consumption-boosting measures – likely to do most of the heavy lifting in supporting growth), and potentially some property-easing measures are likely. Local governments likely now have more discretion to roll out property supportive measures (the first batch of supportive measures aimed at relieving liquidity pressure for developers), though policymakers still try to rein in expectations about aggressive easing in property at a national level.

MSCI China during SARS period…



…and during the novel coronavirus outbreak



Source: HSBC Global Asset Management, Bloomberg as of 19 February 2020

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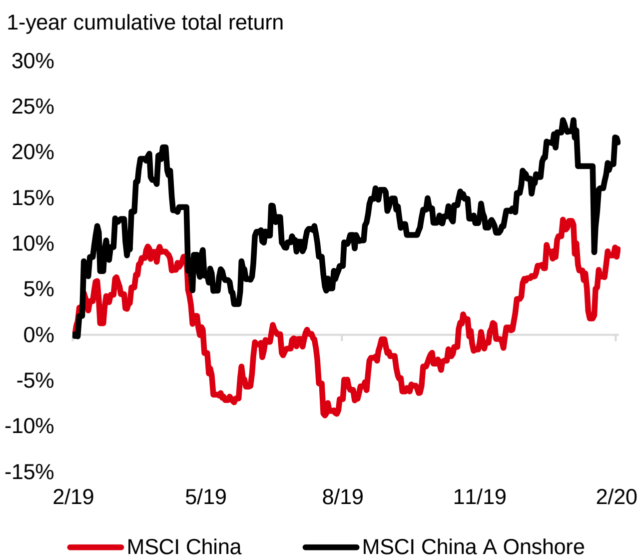
Equity market

> Despite an adverse impact from the virus spread, both northbound and southbound routes have continued to pick up, bringing year-to-date inflows to USD11.4 billion and USD9.1 billion

- Both onshore and offshore Chinese equities were in the black, month to date, clawing back 11% and 7% from the lows in early February amid the COVID-19 outbreak. The MSCI China A Onshore Index and CSI 300 Index rose 2.2% and 1.2% this month, while the offshore benchmarks MSCI China and Hang Seng advanced 7.5% and 5.1%, respectively. The Shenzhen's startup board ChiNext rose 11% in the month, reaffirming the V-shape recovery in Chinese shares. Elsewhere, the ADRs added 8.8% on the back of gains in technology shares
- On a year-to-date basis, companies in the semiconductors, software and healthcare equipment were leaders in the market, as they are largely unaffected by the economic woes. Sector heavyweights such as banks and real estate developers were down by mid-single digit, highlighting concerns over their short-term profitability
- On a brighter note, the Ministry of Finance announced a partial quota of 2020 local government bond issuance of RMB1.8 trillion, or 60% of the 2019 total. As a result, stocks in cement and infrastructure surged since early February
- On February 12, MSCI announced quarterly index rebalancing results, with MSCI China adding 6 constituents and deleting 3, effective March 2. For China A Onshore Index, there will be six additions and no deletions from the onshore benchmark
- As of February 19, the northbound channel saw inflows of USD5.83 billion during the month, slightly up from USD5.54 billion in January. Meanwhile, the Southbound channel recorded inflows of USD5.54 billion, the largest monthly inflow since January 2018. The purchases by mainland investors were mostly concentrated in financials and communications services. On a year-to-date basis, the stock purchases via northbound and southbound has reached USD11.4 billion and USD9.1 billion, respectively
- According to market consensus, the 2020/2021 earnings growth is 10%/13% for MSCI China and 15%/12% for CSI 300, respectively. In the last four weeks, both onshore and offshore analysts made positive revisions to their earnings forecast for consumer staples companies, while they are generally bearish on the prospect of energy and utilities sectors. In terms of earnings revision, MSCI China was down by 0.8% in the past 4 weeks and there was no change for CSI 300 as a 1.7% increase for consumer staples was offset by a 1.8% decline in energy. The forward 12-month price-earnings ratio of MSCI China A onshore is currently trading at 13.0x, while MSCI China is trading at 12.5x
- All said, the markets appear too optimistic about the potential upside, in our view. Going into March, we might see some downward revisions as the impact of the virus on economic activity starts to emerge

Onshore and offshore Chinese stocks extend rally



Source: Bloomberg, HSBC Global Asset Management, as of 19 February 2020. Total return in local currency terms.

Investment involves risks. Past performance is not indicative of future performance

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Sector views*

Sector	Views
Consumer Discretionary	◆ We are overweight consumer discretionary sector. In particular, we like the education space as it is relatively insensitive to macro headwinds. We favour e-commerce companies as their share of China's consumption continues to increase. We also like online gaming plays as a more favourable policy backdrop this year could result in a more robust pipeline for key companies.
Consumer Staples	◆ We are overweight in consumer staples sector as the trends of premiumisation on the back of rising income underpin higher pricing power and margin expansion capability of selected strong staple brand names. Demand should remain stable.
Energy	◆ We are neutral as oil price has dropped to lower levels, and any supply improvement (due to geopolitical or OPEC cut) could pose upside risk. Chinese oil majors are trading at very attractive valuation even at current low oil price.
Financials	◆ We are underweight banks as lowered rate may bring pressure to their net interest margin. We expect more loosening monetary policy in the next few months due to the weak economy.
Healthcare	◆ We are overweight healthcare and favour those with strong R&D capabilities on innovative drugs and service providers with high growth visibility.
Industrials	◆ We are currently underweight this sector but might see improvement in 1Q / 2Q20
Information Technology	◆ We are positive on the handset lens upgrade trend and we like names that can benefit from continuous tech upgrade
Materials	◆ We are underweight commodities as we question the sustainability of the demand strength
Property	◆ The coronavirus outbreak is putting developers' cash flow under great pressure but there could be sector wide policy support ahead. We prefer property management companies from the longer term perspective..
Communication Services	◆ We are turning positive on telecoms due to historical low valuation with business improvement
Utilities	◆ We are underweight utilities sector as we are not positioned defensively in the current market

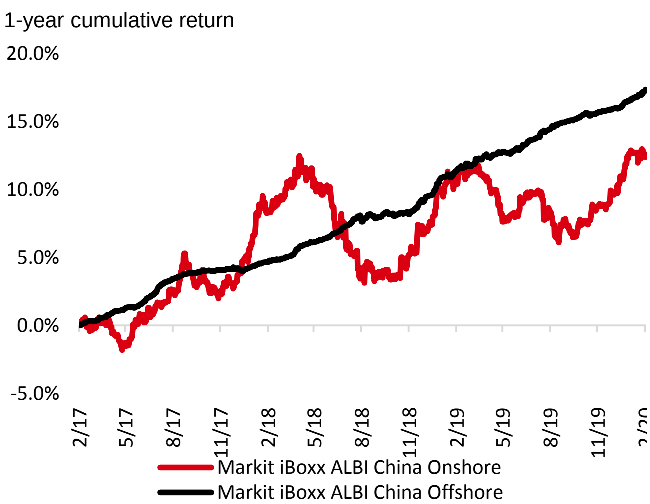
Source: Bloomberg, HSBC Global Asset Management, as of February 2020.
*NOTE - Sector views of HSBC Global Asset Management's offshore Chinese equity team

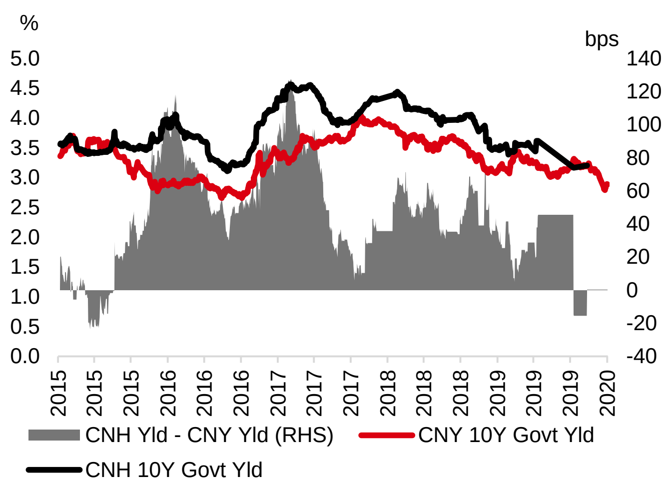
Fixed income

> Foreign ownership of onshore Chinese bonds reached USD308 billion in 2019, with 3.3% market share

- Development on the COVID-19 outbreak continued to be the key factor affecting investor sentiment. The onshore bond market was largely flat after the central bank launched a series of easing measures to support firms hit by the epidemic, while the offshore CNH bonds were slightly up by 0.5% in the month (as of February 19)
- Starting with the 10bp reverse repo rate cut on February 3, other policy rates such as the interest rate on its medium-term lending and standing lending facility have been lowered, in a move to maintain banking system liquidity at a reasonably ample level. On February 17, the central bank lowered the rate on RMB200 billion worth of medium-term lending facility (MLF) loans to financial institutions by 10 basis points to 3.15% from 3.25% previously
- On February 20, China cut the benchmark lending rate, as widely expected, as the authorities move to lower funding costs for businesses. The one-year loan prime rate was lowered by 10 basis points to 4.05% from 4.15%, while the five-year rate, which is a benchmark for home mortgages, was lowered by 5 basis points to 4.75% from 4.8%
- The onshore renminbi spot rate against the US dollar was relatively resilient in February, supported by decent northbound inflows. Meanwhile, the recent decline in commodity prices may also help China save around USD7 billion per month in import costs. The RMB has outperformed many of its Asian and Emerging market peers
- In terms of fund flows, portfolio inflows into the onshore Chinese bond market were USD73 billion in 2019, mainly from instructional investors and less from central banks. As a result, foreign ownership of onshore Chinese bonds reached USD308 billion, with 3.3% market share
- Following Bloomberg's move to add onshore Chinese bonds into its benchmarks last year, JP Morgan will include China bonds in its GBI-EM index from February 28. China's weight will be capped at 10% of its main GBI-EM Global Diversified index. The move is expected to drive USD3 billion per month into the onshore market over a 10-month period. The next up is FTSE Russell, which is scheduled to announce its decisions regarding its WGBI gauge later this year after deciding to delay China's inclusion in 2019

Chinese bonds rally amidst signs of global easing





Source: Bloomberg, Markit data as of 19 February 2020. 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. The views and opinions expressed herein are subject to change at any time.

Data watch

<table>
<tr><th>Indicator</th><th>Date</th><th>Actual</th><th>Consensus</th><th>Prior</th><th>Analysis</th></tr>
<tr><td>Industrial production (IP) (yoy)</td><td>Dec</td><td>6.9%</td><td>5.9%</td><td>6.2 %</td><td>December activity data added to the year-end signs of cyclical stabilisation, particularly a recovery in the manufacturing sector, amid a US-China trade truce with the phase-one deal and continuing talks, the feed-through of policy easing over 2019 and ongoing, and better global demand. Production of autos and a few key commodities such as crude oil and steel products picked up in December. However, the COVID-19 outbreak will likely have a transitory but significant impact on China's near-term economic growth. Strict control measures against further spreading of virus, such as travel/flight restrictions (in and outside China), transport and logistic blockages, and other lockdown policy efforts have led to a partial shutdown of the Chinese economy, causing short-term demand- and supply-side shocks. These could compound the demand shock from the fear factor making people avoid travel or even going out. Any fear of job insecurity or income losses could further amplify such shock. The negative economic impact is likely to be concentrated in Q1 and a growth recovery is expected once there are clear evidences that the coronavirus has been contained, driven by some pent-up or restocking demand. However, the overall economic impact will depend on the severity and duration of the coronavirus, how long the control measures/ disruptions to activity continue, and policy responses. In addition to additional liquidity injection and modest cuts to de facto policy rates, the government has announced a slew of micro-level "relief" measures targeted at the hardest hit sectors and regions, firms (especially SMEs) and households running into temporary difficulties, as well as companies engaged in epidemic control business and medical supplies. More relief measures are expected, in terms of subsidies, taxes, social security contributions/ fees, rents, utility costs, employment, and funding supports.</td></tr>
<tr><td>Fixed Asset Investment (FAI) (ytd, yoy)</td><td>Dec</td><td>5.4%</td><td>5.2%</td><td>5.2%</td><td>A rebound in manufacturing FAI growth offset slower infrastructure and property FAI in December. Daily property sales volume in 30 major cities stayed very low three weeks after the first day of the Lunar New Year; the land market also cooled down, with many planned auctions being suspended or postponed. Q1 property sales will be severely affected by the coronavirus outbreak. While developers will speed up sales after the situation calms down and policy stimulus on demand may start to take effect in H2, the recovery path could be bumpy. Local governments now have more discretion to roll out property supportive measures. Measures have been announced to relieve developers' liquidity pressure. The PBoC mulls relaxing quotas on property-related loans. We expect a continued policy focus on infrastructure, including a quota of CNY1.848trn in local government bonds allowed to be issued before the official annual quota is approved.</td></tr>
<tr><td>Retail Sales (yoy)</td><td>Dec</td><td>8.0%</td><td>7.9%</td><td>8.0%</td><td>Higher retail inflation offset slower real retail sales (4.4% yoy vs. 4.9% in November). Auto sales (which has been a key drag) recovered. The coronavirus will likely cause short-tern demand shock. Retail sales will be affected, though the rapid growth in e-commerce and online entertainment and other services could provide some offset, and demand for non-discretionary items or necessities may see short-term stockpiling. While some consumption may just be delayed, others (especially services activities) may be lost permanently as the opportunity of time passes. The government vows more policy support for consumption, such as 5G phones and applications, healthcare and autos.</td></tr>
<tr><td>Exports (USD) (yoy)</td><td>Dec</td><td>7.6%</td><td>2.9%</td><td>-1.3%</td><td rowspan="3">The upbeat export data were consistent with signs of stabilisation in the global economy and manufacturing before the COVID-19 outbreak and likely reflected de-escalation of US-China trade tensions. The import pickup likely indicated better domestic demand, a recovery in processing trade, increased demand for key commodities, and higher oil prices. The near-term trade outlook faces the risk of weaker Chinese domestic demand (consumer durables, commodities, etc.) and/or import demand for manufacturing, and regional/global supply disruption due to potential shortage in China-made components.</td></tr>
<tr><td>Imports (USD) (yoy)</td><td>Dec</td><td>16.3%</td><td>9.6%</td><td>0.8%</td></tr>
<tr><td>Trade Balance (USD)</td><td>Dec</td><td>46.8 bn</td><td>45.7 bn</td><td>37.6 bn</td></tr>
<tr><td>CPI Inflation (yoy)</td><td>Jan</td><td>5.4%</td><td>4.9%</td><td>4.5%</td><td rowspan="2">The acceleration of headline CPI inflation was largely driven by a surge in food/pork prices and likely partly reflected the early impact of the coronavirus outbreak. Non-food inflation rose on higher fuel prices and medical services prices. The virus-related supply-side disruption to the economy, especially regarding production activity and transport and logistics, may continue to impose an inflationary bias to headline CPI/food prices in the near term, despite the government's efforts to control the prices of necessities (e.g. groceries) and medical supplies. Even after the virus is contained, it may still take time for the supply to catch up. The hog cycle that heavily shapes CPI dynamics may peak only around mid-2020. That said, the demand shock may be disinflationary especially for services like transportation and residence. The underlying inflationary pressure as measured by core inflation should stay contained and modest. The rise in PPI inflation mainly reflected a low base effect and led by the mining and raw materials industries.</td></tr>
<tr><td>PPI Inflation (yoy)</td><td>Jan</td><td>0.1 %</td><td>-0.0%</td><td>-0.5 %</td></tr>
<tr><td>Aggregate financing (AF) (RMB)</td><td>Jan</td><td>5,070 Bn</td><td>4,200bn</td><td>2,103 Bn</td><td rowspan="2">Outstanding AF growth remained stable at 10.7% yoy (under the new definition which includes Treasury bonds and local government general bonds). The jump in new bank loans largely reflected seasonality while government bond issuance increased. Further monetary easing via liquidity injection, de facto policy rate cuts, targeted credit support, and macro-prudential policy relaxation is likely to cushion the COVID-19 impact.</td></tr>
<tr><td>New yuan loans (RMB)</td><td>Jan</td><td>3,340 Bn</td><td>3,100bn</td><td>1,140 bn</td></tr>
</table>

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 2020

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