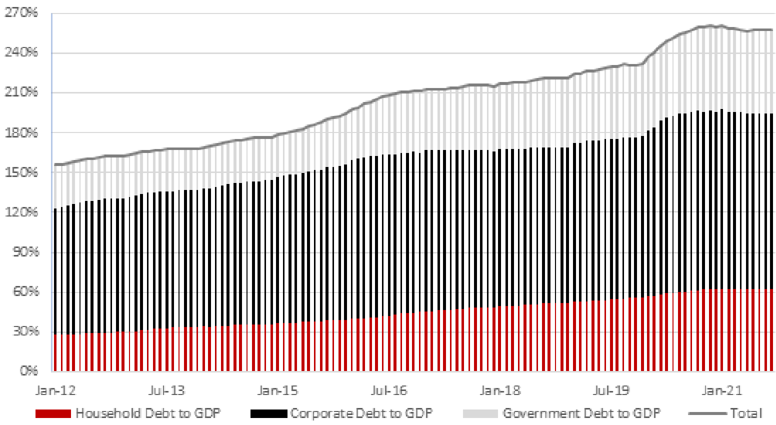
China Bulletin: Market View



The last fortnight of 2021 has seen increasing volatility in equity markets, though the bond market is pricing a policy rate cut. Tech names, including new energy and semiconductor supply chain, are trading lower. Meanwhile the healthcare sector is gaining strength from a less pessimistic earning projection, reversing the trend since the 2021 Chinese New Year. From a long run perspective, new energy names, the healthcare sector and semiconductor manufacturers are all likely to deliver decent returns, despite navigating various tailwinds.

New energy names will enjoy worldwide policy support, including a global shift to a cleaner energy system, in addition to technological and cost advantages against foreign competitors. The healthcare sector still benefits from China's aging population and continuous domestic substitution. Even taking into consideration the lower growth due to government agencies' efforts to lower the cost of the national medical insurance fund by adopting a centralized procurement mechanism.

Semiconductor producers, however, tell a different story, as the de facto selective embargo by the US leaves the Chinese market to relatively immature domestic players. Being hit the most by the policy crackdown in 2021, internet and media sectors may have a break and the outlook is turning promising as the consumption of content is just unfolding in China.

The Chinese economy continues to slow down, and policy is accommodative but not aggressive. The most significant uncertainty comes from the real estate sector, suffering from falling sales amid a pessimistic outlook. Monetary policy still refrains from cutting the policy rate, which is perceived as the most symbolic policy move, and prefers fine tuning policies such as carbon reduction support policy and required reserve ratio policy. As a result, the 1-year loan prime rate, quoted by commercial banks as the short-term loan pricing benchmark, saw a 5bp cut in December. Furthermore, the 5-year loan prime rate - the long-term benchmark - remains unchanged despite two cuts to the required reserve ratio, in July and December. This has led the market to expect cuts to the policy rate. We believe the easing cycle depends largely on the relative pace of fiscal expansion and the economic slowdown, or more specifically the contraction in the real estate sector. Calendar effects make it difficult to draw a conclusion before Chinese New Year, which is the beginning of February in 2022, hence limited necessity for the PBoC to move to cut the policy rate.

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Although we can expect a more active fiscal policy, especially regarding new energy related investment, the Ministry of Finance still intends to tighten the fiscal grip over local government, squeezing one of two main channels for credit expansion in the last decade. Additionally, the skyrocketing debt ratio leaves very limited monetary policy room. Debt is remarkably high, and much higher than 5 years ago across private sectors. Household debt is now around 62% of GDP, compared with below 40% in 2016, and corporate debt to GDP ratio has risen from below 120% to above 130% in the same period. Therefore, policy makers will be more cautious about employing monetary policy to stabilize the economy and will favor a stable monetary environment.

Regarding fixed income, the Chinese bond market is pricing rate cuts with strong confidence. Yield curve bull steepens, and rates moved lower by 5-10bp in the last trading days of 2021 in face of a tighter year-end funding market. We therefore recommend a cautious stance on the Chinese bond market as the expectation is overdone. A rate cut by the PBoC, even if delivered before Chinese New Year, may not be able to push rates further lower. The Credit market is no better, as the spread remains compressed in general and the risk to reward is not very attractive.

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