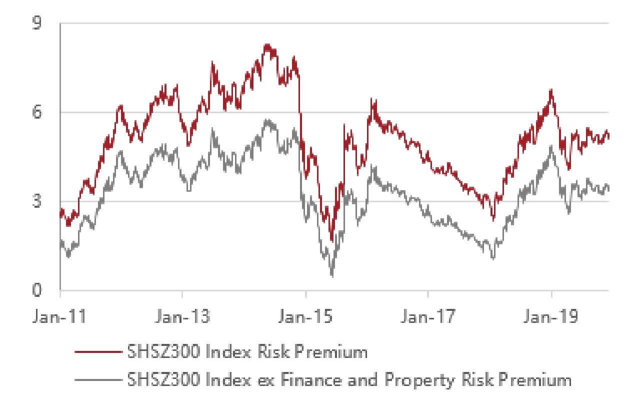
China Bulletin: Market View

China Equity Market Outlook

Outlook towards the China equity market becomes cautiously optimistic as growth is expected to bottom out and structural policy loosens marginally. Trade tension dominates short-term market volatility, and the phase one deal could introduce months of peace. The Shanghai-Shenzhen 300 Index risk premium shows that equity is still more attractive than rates.

Figure 1 SHSZ 300 Index Risk Premium



Large cap names, commercial and investment banks may continue to be preferred into 2020, yet popular high-tech and construction material names may be tested. The recovery, if confirmed, is still a weak one and benefits mainly large cap names as their market concentration keeps increasing. Commercial banks and investment banks are favored due to the improvement of their asset quality and expectations of loosening financial regulation.

High-tech names with potential to substitute imported equipment delivered a very remarkable return in 2019 but may not be as popular as they were if they are unable to prove the substitution is possible. The construction material sector is upheld by buoyant real estate investment growth, which is expected to weaken, and infrastructure investment may not step up as much as the market expects.

Hong Kong Equity Market Outlook

The Hang Seng Index saw a volatile year dictated by US-China trade tensions, slowing global growth momentum, austere policy of China and local incidents. Trade tensions eased slightly after the tentative deal, but if any further escalation is confined to tariffs and limited technology embargoes, the influence of trade tensions will wane into 2020. Global growth slows at a slower pace than expected, and China shows signs of picking up. Policy of China will maintain its structural stance while it may be adjusted marginally with the aim of eliminating poverty. Local incidents can hardly impact market sentiment unless the situation worsens into an acute status. Market valuation is lagging behind business confidence tracked by the Caixin Purchasing Managers Index (PMI), and will catch up if the trend continues.

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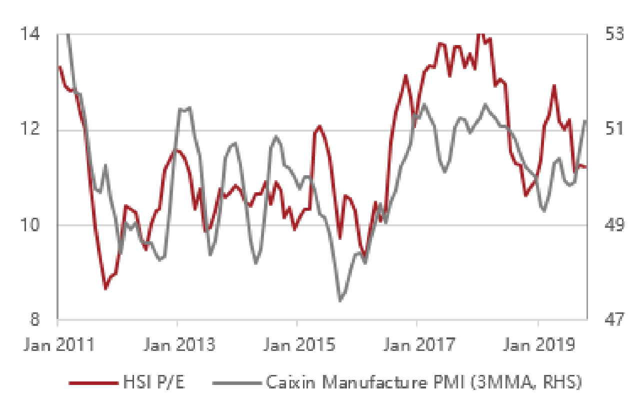
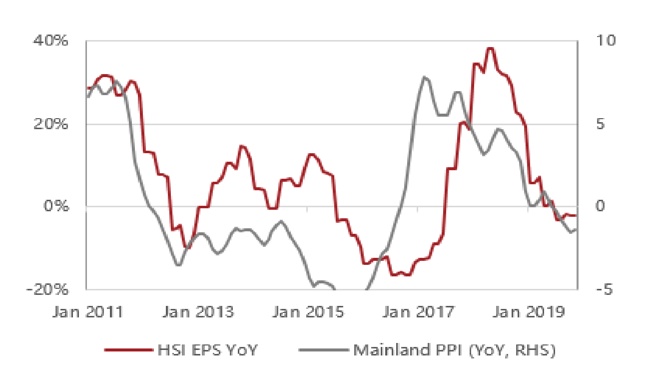
Figure 2 HSI P/E vs Caixin PMI



Earnings growth has been trending down dramatically since the surge in 2018 and is still struggling in negative territory. Gauged by higher frequency data, growth slowdown began in 18Q2 and the producer price index followed, hitting corporate profits. Recovery is visible in certain manufacturing sub-sectors and the producer price index is expected to have reached its trough as well. Should the trend continue, along with the correction of market valuation, the Hong Kong equity market is seeing optimistic outlook in the short term. Mainland names are preferred, especially commercial banks and 5G names, for related infrastructure investment and could boost profits. Local HK names are under stress as local protest incidents may continue to damage profitability. In the medium to long term, however, US-China trade tensions and local political developments remain as major risks.

Figure 3 HSI EPS vs China Mainland PPI



China Economic Outlook

Continuous slowdown, due to determined domestic structural reforms and external shock spurred bleak outlook, stabilizes as signs of moderation show on both sides. Policy makers recognize periodic achievements of structural reforms and emphasize eliminating poverty, a goal set to be accomplished by 2020, which calls for a more active fiscal policy. The phase one deal between US and China offers some relief, and if the standoff doesn't effectively spill over into causing more detrimental consequences, business confidence will recover gradually. Shortage of pork pushed consumer inflation higher, and may cause a wider round of price hikes. Monetary policy remains prudent and flexible to balance the need to shore up slowing economic growth and the need to contain inflation expectations and growth of debt.

Consumption remains stable after car sales growth stabilizes

Final consumption contributed more than half of growth in the last year and slowed since 18Q2 due to tightening credit policy and emission standard upgrades. Car sales growth declined in response, bringing down final consumption, and reached a standstill in 19H2. As credit policy marginally eased and the shift completed in 2019, consumption growth is expected to revert to positive in 2020 and would help improve production and fixed asset investment in related sectors.

Fixed asset investment remains stable

Fixed asset investment growth remains stable, mainly because housing investment is resilient and fiscal spending on infrastructure investment increased marginally, though the manufacturing sector is still unable to uphold fixed asset investment. Credit crunch and trade disputes severely damaged business confidence in 2018 and 2019, and the effect is expected to wane into 2020.

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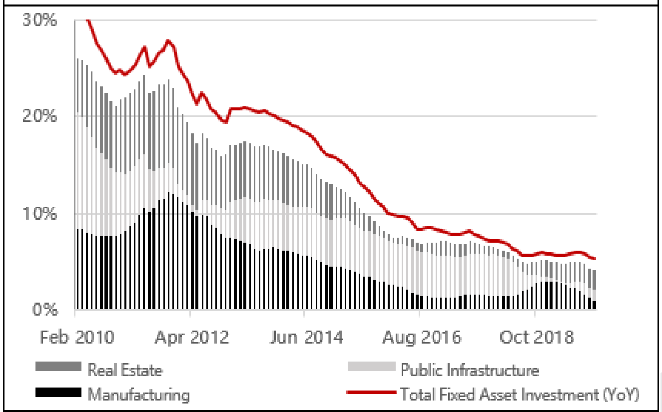
The crackdown on shadow banking is proceeding at a calm pace and credit creation is recovering to normal levels. The trade standoff between US and China is currently limited to tariffs and a de facto embargo against certain Chinese companies, and the damage is fading after bilateral trade decreased almost 1/6 in 2019. Improvement of domestic and external conditions could lift private fixed asset investment.

Figure 4 China Fixed Asset Investment by Type

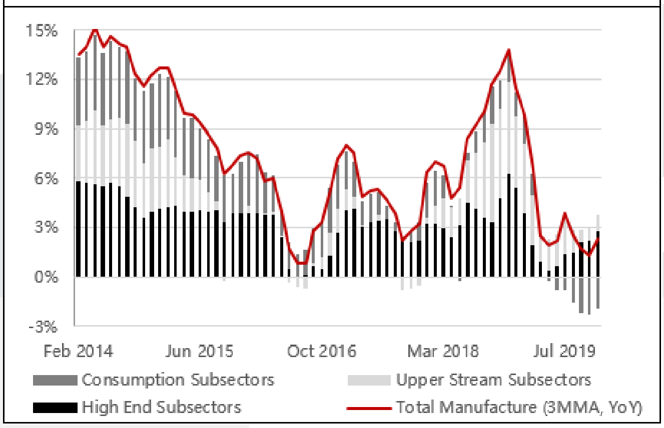


Real estate investment remained strong through 2019, supported by resilient house sales despite strict housing market policy. Buoyant residential investment is a rebound from its previously suppressed level, and long-term perspective is widely doubted, as overall housing supply is plentiful and household debt levels are increasing at an unsustainable pace. The momentum is difficult to sustain and may weaken steadily.

Figure 5 China Housing Investment and House Sale (3MMA)

Manufacturing fixed asset investment growth remains subdued due to the pessimistic outlook, although recovery in certain sub-sectors can be identified, noticeably in high end manufacturing sub-sectors. Non-durable consumer sub-sectors, accounting for 1/4 of total manufacturing fixed asset investment, are taking the most severe hit from trade tensions. Upper stream sub-sectors cyclically benefit from upbeat housing investment and may slow down with housing investment as well. Higher end sub-sectors benefit from trade tensions as de facto embargoes force domestic substitution and policy favors fixed asset investment in these sub-sectors.

Figure 6 Manufacture Investment by Subsectors



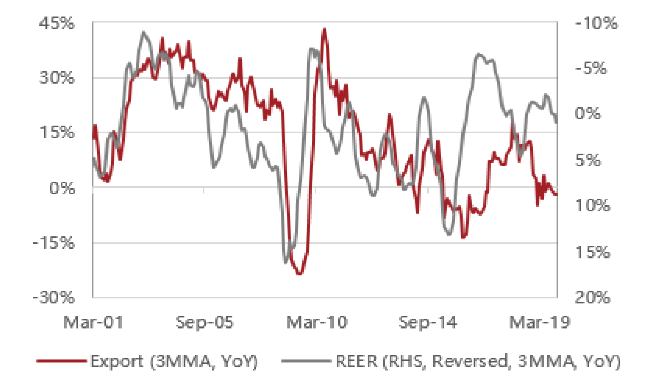
Fiscal policy maintains cautious stance and focuses on consolidation

Fiscal measures increasingly lean towards cutting tax instead of increasing infrastructure investment, while fiscal consolidation continues. Policy makers intend to replace local government financing vehicles (LGFV) with local revenue bonds as the main financing channel for local government, and the intention will be tested by the first maturity peak in 2020. Fiscal consolidation to align revenue and spending of central and local government is critical and scheduled to unfold soon. If housing investment remains upbeat, fiscal policy may refrain from expanding easing to support growth and employment.

Exports remain resilient amid trade tension

Export growth is suppressed to a subdued level by increasing tariffs and pessimistic outlook. However, it remains resilient, even though trade between China and the US has dropped 15% on a yearly basis. Global growth momentum keeps slowing. CNY exchange rate is expected to maintain its current level, unable to offer extra impetus to exports. The tension is slowing fixed asset investment growth in many sectors and forcing supply chain to shift out of China, partially offset by redistribution of production. Trade tension will remain as a headwind in 2020.

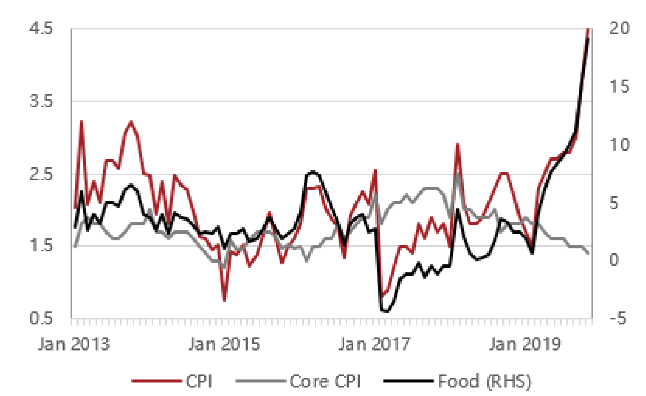
Figure 7 China Export vs REER



Inflation indicates approach of stagflation

Inflation has been pushed higher by the rising pork price, and any secondary effect may be spoiled due to the persistent shortage of pork supply (following the African Swine Fever epidemic). Headline inflation is recording its highest level after massive credit stimulus induced its last peak in 2011. 4.5% annual inflation was recorded in November, well above PBoC's 3% target. The core inflation series has continued to trend down since 18Q1, and is close to its historic low at 1.2%, implying sluggish growth momentum in the last quarter. The divergence presents typical signs of stagflation, and leaves PBoC the dilemma of containing inflation while supporting growth.

Figure 8 China CPI and Components



China Monetary Policy Outlook

The PBoC is determined to find a balance between growth and inflation and is adjusting monetary policy at a very gradual pace. PBoC lowering of policy rates and the Loan prime rate (LPR) after headline inflation breached the inflation target shows its intention of supporting growth, and the margin of 5bps implies awareness of rising inflation expectations. Policy makers are clear that monetary policy is not as helpful as before in boosting growth, while deleveraging policy could cause a credit squeeze and hit business confidence as it did in 18Q3 and again in 19Q2.

We expect tightening financial regulation may loosen cautiously and avoid sudden tightening. This contradicts the market consensus that monetary policy will step up progressively despite headline inflation being above target. Domestic and external uncertainty remains but the acuteness has lessened, thus a friendly financial condition is warranted but not too much to spark an asset bubble, as the last round of stimulus in 2015-2016 proved. Long-term corporate loan growth has recovered to normal levels, further reducing the necessity for monetary stimulus. PBoC may continue to cut the required reserve ratio, remain cautious about cutting policy rates, and deploy structural policies to ease the financing problems of small and private enterprises as before.

China Bond Market Outlook

The China onshore rate may remain tepid in 2020, and confined to a narrow range as the risk to both sides is largely balanced. The 10Y China government bond rate traded between 3% and 3.4% throughout 2019, elevated by upbeat expectation in 19Q1, suppressed by the credit squeeze and escalation of trade tension in 19Q2, and pushed higher by rising inflation and inflation expectations in 19Q4. Going into 2020, growth shows signs of weak recovery yet is still fragile, inflation concerns remain and may intensify further, and external uncertainty has reduced temporarily though does not disappear. The central bank intends to keep borrowing costs in a prudent range, thus onshore rates see a balanced risk as in 2019, with slightly higher upside risk.

Figure 9 Money Market Rates

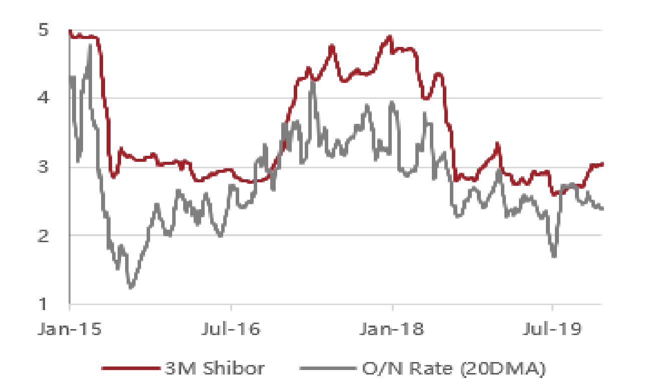
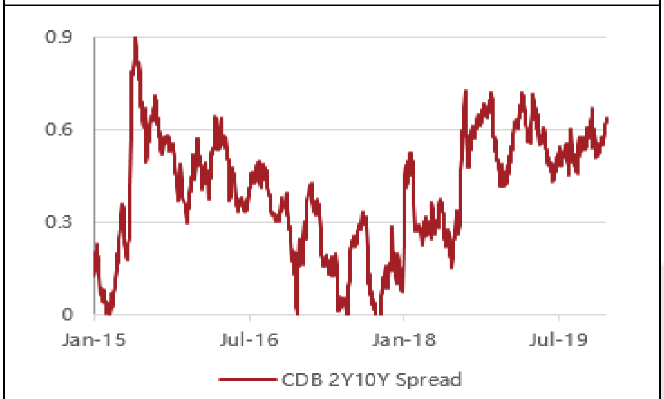


Figure 10 CDB 2Y10Y Spread



Credit spreads have moved to a very compressed level, dragged by sluggish financing demand despite abundant liquidity available. Various factors are discouraging fixed asset investment and reducing financing demand along with credit spreads. As with other sectors, the financial sector is facing structural problems. Despite policy makers' best efforts to direct financing to small and private firms, financing is still clogged at the top, i.e. highly rated issuers, mainly central state-owned enterprises, provincial LGFVs and some large private corporates. The crackdown on shadow banking continues as non-standard financing has shrunk by 15% from its previous peak. This is forcing weak borrowers to turn to bank loans, and forcing even weaker ones out of business. Without an unprecedented easing policy from the PBoC, credit spreads are unlikely to move below their historic low.

Figure 11 5Y Credit Spread AAA vs CDB

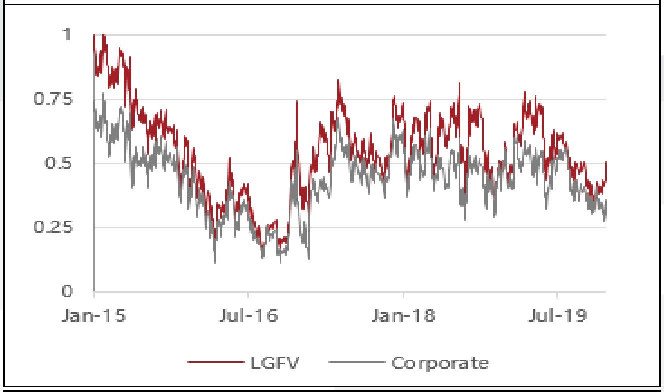
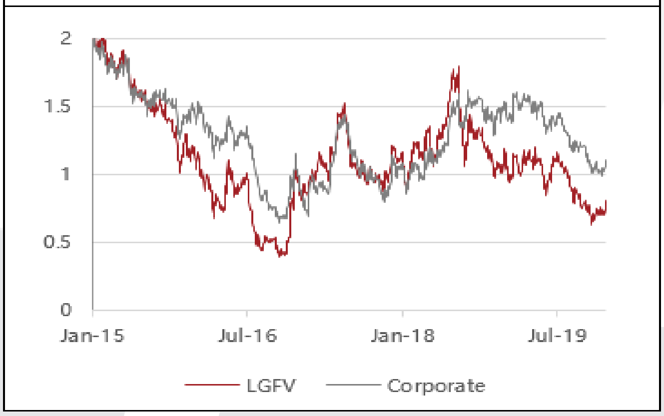


Figure 12 5Y Credit Spread AA vs CDB



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