China Bulletin

China Equity Market Outlook

China A share market risk premium is at a fair level after its remarkable rally in 19H1, and large cap is outperforming small cap, but a directional bull or bear market is unlikely. Large cap stocks' advantages will remain, such as better access to lower cost financing, higher business and financial risk tolerance, more publicity and in some cases local government support.

Figure 1 SHSZ 300 Index Risk Premium

We maintain our view that the equity market will be volatile in the coming months, in response to unaligned information from policy and growth, as well as developments in trade talks. PBoC resumes its relatively easy stance on monetary policy and deleveraging will slow its pace, yet growth momentum will keep slowing and US-China trade tensions are likely to escalate from time to time. We think that the equity market will continue to respond to good and bad news, and trading will remain range bound.

China Economic Outlook

Growth slowed to 6.2% in 19Q2 and weakened across the board, due to cyclical forces and external shocks. Structural problems will intensify, especially regarding fixed asset investment, with only consumption offering certain hope. Fiscal stimulus will step in to cushion a hard landing, and exports will pick up amid trade tension. Inflation is rising and may rise further, keeping monetary policy from further easing.

Consumption Shows Early Signs of Improvement

Final consumption was responsible for more than half of economic growth in the last several years, and it has been decreasing since 18Q2 due mainly to a tightened deleveraging policy and lower levels of cash compensation being distributed as part of shantytown redevelopments. Data shows that consumption is expected to stabilize from 19H2, notably in the auto sector.

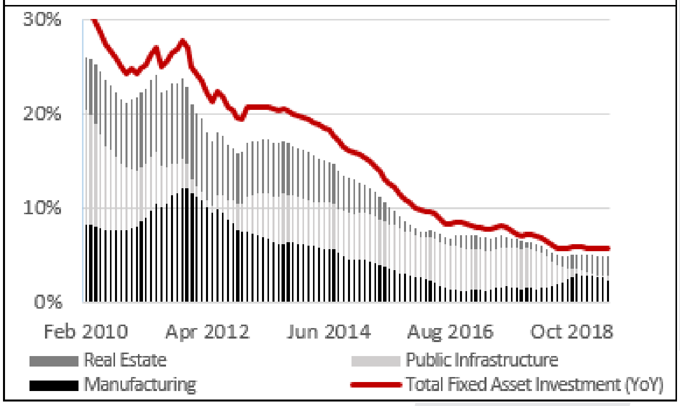
2nd Floor | 75 King William Street
London EC4N 7BE
+44 203 617 5260
marketaccess@chinapostglobal.co.uk
www.chinapostglobal.com

Pick-up in auto sales is expected to help maintain a decent level of growth in retail sales, having recently been heavily influenced by the drag on general consumption, in addition to being hit by a shift in emission standards scheduled for July 2019. However, we project that these headwinds will weaken from 19H2 onwards.

Fixed Asset Investment Weakens and Structural Problem Worsens

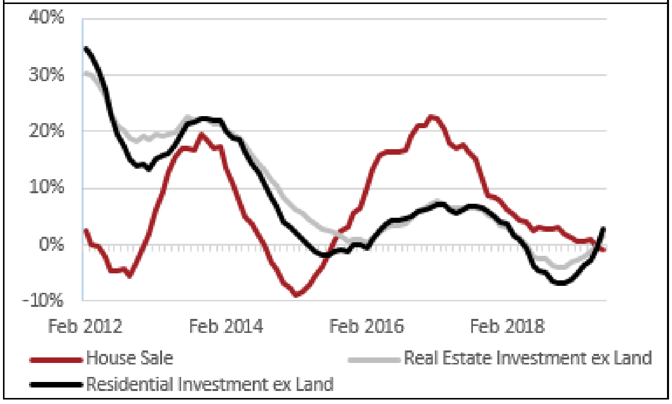
Fixed asset investment continued to slip through 19Q2, with manufacturing having decreased the most due to trade conflicts while the upstream sector and real estate sector picked up. We expect fixed asset investment to remain subdued, though fiscal side stimulus may step in to contain the slippage.

Figure 2 China Fixed Asset Investment by Type



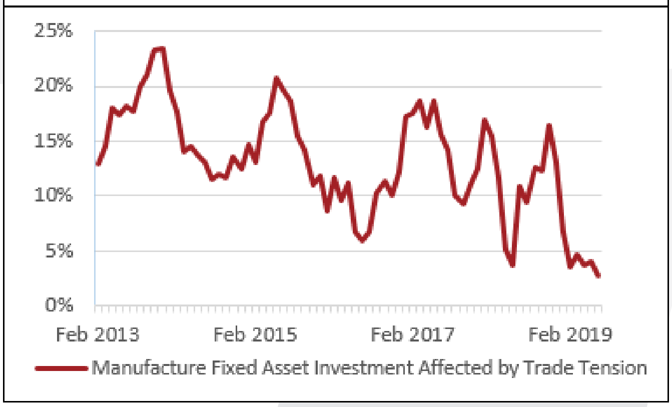
Real estate investment remains surprisingly solid since 18Q4, though the momentum is unlikely to remain as house sales have been suppressed by the deleveraging policy and sluggish household income growth. We think that the turning point to a weaker level of real estate fixed asset investment may appear in 19Q4 to 20Q1.

Figure 3 China Real Estate Investment and House Sales



Manufacturing fixed asset investment as well as private investment trended down after the US-China trade conflict broke out, especially in the machinery and textile sectors, which make up one seventh of the total fixed asset investment in the manufacturing sector. This is also the main reason we find behind the worsening structural problem. We assess the standoff between the US and China to be long-lasting. Luckily, it should be confined mainly to economic and trade affairs, and its impact should become less and less influential over time.

Figure 4 Trade Tension Hit China Investment



2nd Floor | 75 King William Street
London EC4N 7BE
+44 203 617 5260
marketaccess@chinapostglobal.co.uk
www.chinapostglobal.com

Fiscal Steps in since 19Q2

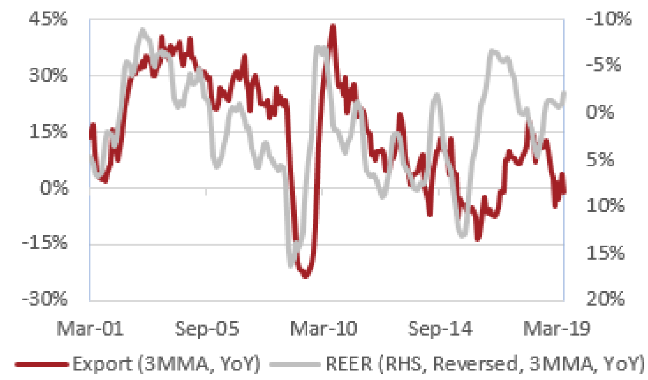
Fiscal policy stepped in cautiously from 19Q2, though 19Q1 saw an unprecedented amount of local government bond issuance. Our view is that fiscal measures will act as a cushion rather than an economic stimulus though. Another notable point is the withdrawal from shantytown redevelopment in many provinces, causing certain headwinds to personal consumption and house sales as mentioned before. This is part of a trend, with fiscal spending shifting gradually away from investment in infrastructure towards environmental protection and education, with an aim to accelerate structural reform.

Additionally, this round of fiscal stimulus leans more heavily on bond issuance than loans and other non-standard measures. We applaud this change as it is critical and necessary in order to contain shadow banking and skyrocketing LGFV debt.

Exports Picked Up amid Trade Tension

Exports took a hit in 2018 but have been steadily recovering since Q4 that year. Though with the US-China trade tensions remaining unsolved, exports are unlikely to boost economic growth 2018 saw stronger CNY, increased trade tensions and weaker trade partner growth, and net exports dragging down growth through the year. Despite trade tensions remaining and the continued economic slowdown of China's trading partners, we believe exports will only be a mild drag on the economy going forward, given the tailwind provided by the ongoing CNY exchange rate adjustment.

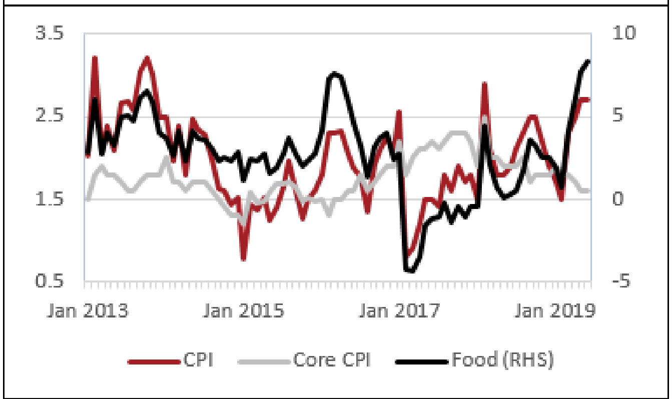
Figure 5 China Export vs REER



Inflation Concerns Materialize and Prevent Expanding Easing

Inflation is rising along with the pork price and, though we don't think it is sufficient to trigger a turn of monetary stance, it is preventing PBoC from expanding easing. Core inflation trended lower to 1.6% in Jun from the previous 1.8-1.9% band, and is expected to remain stable given slowing growth momentum. Food prices grew 8.3% [year-on-year] last month and are expected to move higher from this level, almost solely due to African Swine fever. This development leaves headline inflation facing continuous pressure and testing PBoC's 3% target. We expect PBoC will adopt a more cautious stance and fine tune its OMO and communication to strike a balance between containing inflation and promoting growth.

Figure 6 CPI and Components



China Monetary Policy Outlook

19Q2 saw a new round of regulation tightening marked by the take-over of Baoshang Bank by PBoC and CBIRC, which was followed by a squeeze on structural financing by lower rated issuers. This clearly shows regulators' attitude as the take-over happened a couple of weeks after the US escalated trade tension.

As growth momentum continues to slow, we think monetary policy will remain accommodative, yet the likelihood of large-scale monetary easing is remote. Structural policy aiming to promote small and private enterprises is working very slowly if at all. With the result that large cap stocks continue to outperform small cap stocks.

Financial regulation, also known as deleveraging policy, will continue to play an important role, though sometimes it may be set aside temporarily for other policy priorities such as employment. If market risk sentiment is too positive, regulation may tighten to curb the unwarranted optimism.

China Bond Market Outlook

At this moment we believe China rates to be at a fair level, as slowing growth and elevated inflation limits both upside and downside potential. After tightening in 19Q2, PBoC will resume its accommodative policy and maintain relatively ample liquidity, as shown by their reduction of money market rates. Free from a liquidity shock triggered by the Baoshang Bank takeover, rates traded down to a fairer level as dictated by slowing growth momentum and accommodative monetary policy. The yield curve flattened in response to a less optimistic outlook and rising inflation concern.

Figure 7 Money Market Rates

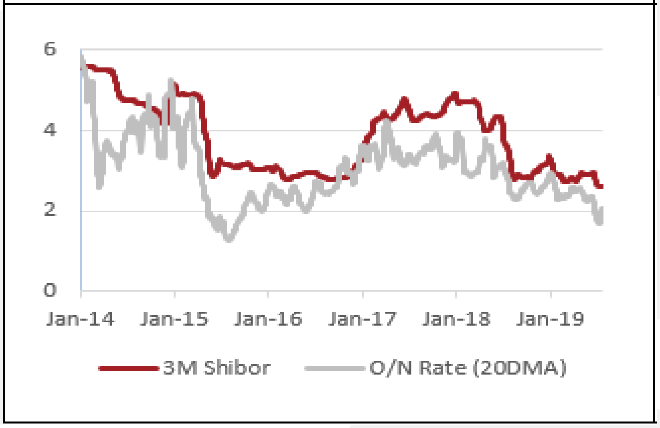
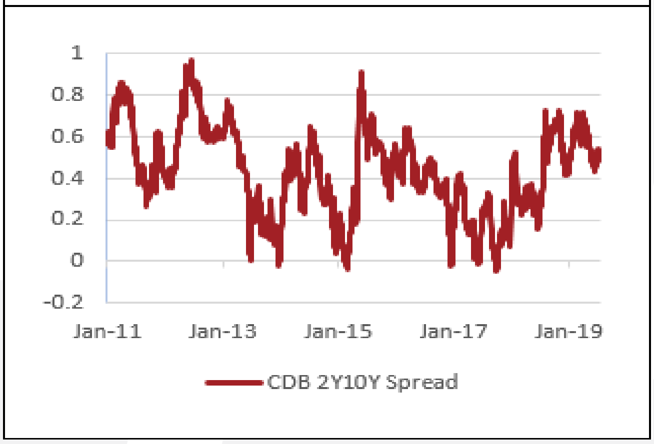


Figure 8 CDB 2Y10Y Spread



2nd Floor | 75 King William Street
London EC4N 7BE
+44 203 617 5260
marketaccess@chinapostglobal.co.uk
www.chinapostglobal.com

China Post Global

Market Access
Exchange Traded Funds

Credit spreads for lower rated issuers are still elevated, and credit is seeing higher spreads than LGFVs, reflecting the market's expectation of fiscal measures. Despite policy makers' efforts to direct financing to small and private firms, financing is still clogged i.e. to SOEs and LGFVs, as well as some large private firms. Shadow banking used to provide financing to small and private firms at the cost of increasing systemic risk and high financing costs, but it is now under strict scrutiny. LGFVs saw improved credit spreads after growth slowed down, as fiscal expansion through LGFVs has been common practice in the past decade. Given this, we think that the credit spread is difficult to compress much further.

Figure 9 5Y Corporate Credit Spread

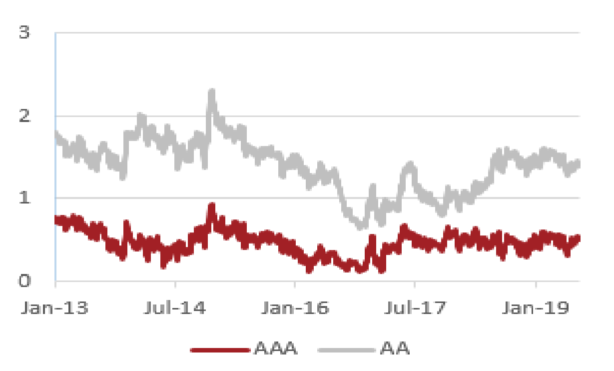
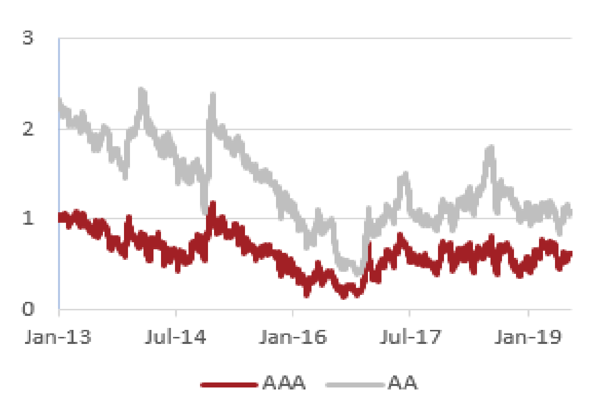


Figure 10 5Y LGFV Credit Spread



Based on our outlook for growth and the current market situation, we believe current rates are at a fair level. Credit spreads for higher rated corporates will remain contained, and for lower rated issues they are unlikely to improve significantly. LGFVs must be treated case by case, and some issues still offer an attractive risk return reward.

2nd Floor | 75 King William Street
London EC4N 7BE
+44 203 617 5260
marketaccess@chinapostglobal.co.uk
www.chinapostglobal.com

China Post Global

Market Access
Exchange Traded Funds