January 2019

China Insights

Monthly update on Chinese markets

Summary

- As concerns grow of a slowing economy, Chinese policymakers will need to act decisively to buffer the slowdown
- Properly addressing the private sector's funding needs is vital to demonstrate Beijing's willingness to continue structural reform and provide a level playing field for all the market participants
- Unlike in 2008, Beijing has less room for a massive stimulus and fiscal policy will likely be the preferred tool to stabilise growth

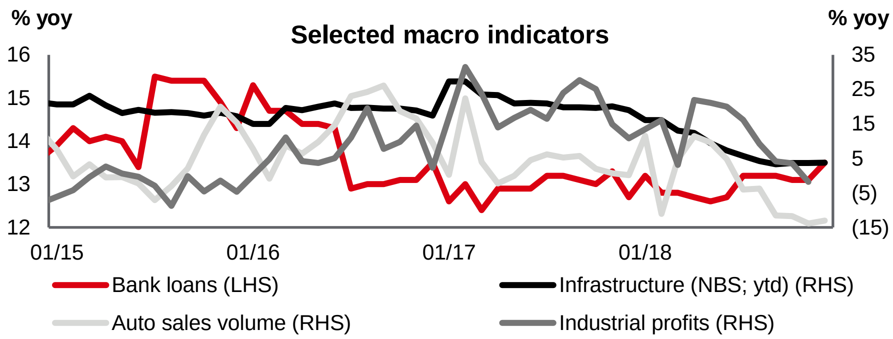
China 2019 outlook: Testing economic and policy resilience

Concerns over US-China tariff escalation have eased somewhat in recent weeks following the temporary truce agreed upon by the two presidents at their G20 meeting, as the bilateral trade talks progress. However, worries about a sharp slowdown in China and uncertainty about the pace of US Federal Reserve (Fed) tightening have persisted. Growth in China has been on a downtrend since mid-2018, amid the lagged impact of the past deleveraging campaign (including the crackdown on shadow banking activities and tighter control on implicit local government debt, etc) and a less favourable external environment (mainly US-China trade tensions).

The latest dataflow points to subdued growth momentum in the near term, despite policy easing efforts that began in the second half of 2018. Manufacturing PMI, new exports and domestic orders have deteriorated; industrial profits fell YoY in November and sectoral data suggests a more challenging operating environment for industrial enterprises; exports lost momentum towards the year-end; retail sales have disappointed with declines in auto sales; property and land sales have slowed; and there are signs of slowing employment and household disposable income growth.

However, fixed asset investment (FAI) growth has recently stabilised with infrastructure bottoming out amid policy support. Property new starts, FAI, and construction activities have been resilient. Credit growth also has been showing signs of stabilisation lately, amid higher bank loan growth, pickup in capital market financing and bottoming-out in shadow banking credit growth, given monetary easing and regulatory relaxation.

Mixed macro data: still soft momentum but signs of policy effect in select areas



Source: Bloomberg, CEIC, HSBC Global Asset management, January 31, 2019

HSBC

Policy effectiveness in focus

Investor skepticism toward China's growth outlook has strengthened in the absence of signs thus far that policies have been effective. Countercyclical macro policies have been adopted with a pro-growth policy shift since April 2018, amid a slowdown in domestic demand and rising trade tensions with the US. The Peoples Bank of China (PBoC) has lowered the reserve requirement ratio (RRR) for large commercial banks by 350 basis points. The government cut the value-added tax (VAT) by 1 percentage point last May and implemented the individual income tax reform, including the increase in standard deduction in October and the introduction of a special deduction in January 2019, benefiting largely low-income households. Local government financing for infrastructure has improved while public private partnerships (PPP) projects are making a comeback.

There tends to be some time lag for the feed-through of policy easing to hard economic data, but the easing so far in this cycle has been milder, and more selective, than in previous periods of significant growth weakness/risks. Policymakers intend to shore up cyclical growth without falling back on debt-fuelled stimulus and they have to strike a balance between maintaining growth stability and advancing structural reforms. The need to maintain a tight lid on risks to financial stability (eg risks of re-leveraging and RMB/capital flows) is a key constraint. Local governments are reluctant to push up spending significantly despite increased financing as they face other constraints (eg debt sustainability). Controls over local government debt and local government financing vehicles (LGFV) remain tight.

There is also less ammunition than before as debt levels are higher (both local government debt and private sector leverage), the fiscal deficit wider (particularly taking into account the off-budgetary funding gap), interest rates lower and the current account surplus narrower than at the onset of the last slowdown.

Importantly, low private sector confidence has weakened policy/credit transmission, amid an uncertain domestic and external environment and doubts about the government's willingness and ability to push through structural reforms. Corporate credit demand for capex remains subdued and banks are reluctant to increase lending (to SMEs) despite liquidity easing (and banks' lending is constrained by capital requirements). Consumers have also been cautious about spending amid higher debt burden, softer income prospects and rising job security concerns.

Countercyclical macro policies in full swing

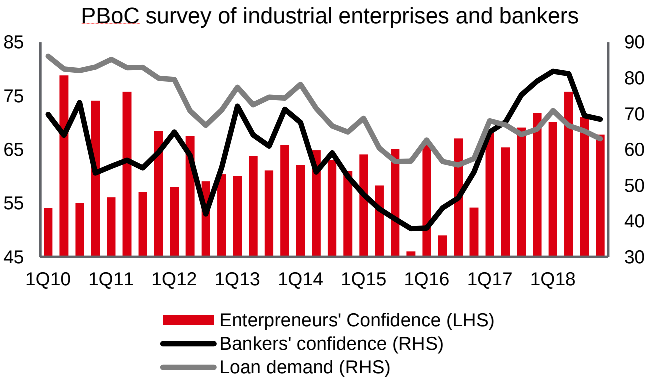
Amid few signs of a turnaround in the economy and risks that the downdraft in growth is beginning to weigh on the labour market, managing the growth cycle has become the top policy priority since Q4 2018, with intensifying and broadening policy measures and de-emphasis on de-leveraging.

The focus of monetary policy remains on improving the transmission mechanism, and facilitating banks to pass on the lower interbank funding costs to corporate and household borrowers. We expect further liquidity easing via RRR cuts to encourage bank lending and accommodate more proactive fiscal policy and increased local government bond issuance. More recently, the central bank has announced a series of measures to boost demand for banks' perpetual bond issuance, which could help boost their capital cushions and reduce their liquidity risk. In addition, the debt-to-equity swap programme could be accelerated, aimed at freeing up more funds for bank lending. Efforts to build multi-layer capital markets for financing will continue. The new wealth/asset management product regulations could be relaxed further to ease the contraction of off-balance-sheet credit.

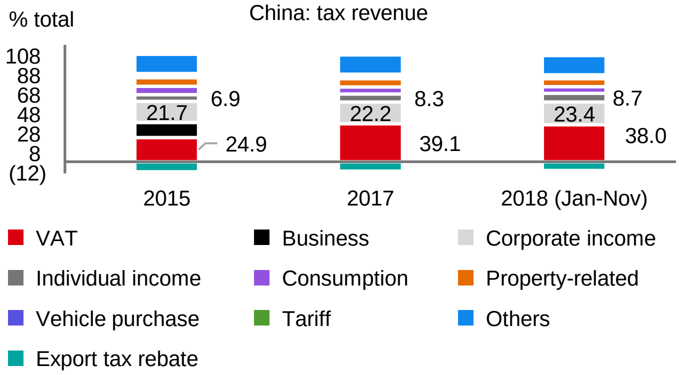
Fiscal policy will remain in the driver's seat, with a wider fiscal deficit and a larger quota for local government special bond issuance. The government is likely to roll out a sizeable tax and fee cut with the reduction expected to reach the equivalent of, or even surpass, 1% of GDP. Beyond the VAT cuts, there is ample room to further reduce the corporate tax burden, such as mandatory social security contributions. The approval of infrastructure projects has accelerated since Q4 2018. The advanced quota for 2019 special government bond issuance will help mitigate the near term risk of weakening infrastructure FAI to help stabilise confidence and growth outlook.

We expect pro-growth policy measures to eventually help restore confidence and stabilise cyclical growth prospects. A rebound in private sector confidence, driven by improvements in US-China trade relations, clear signs of stabilisation in the Chinese economy; real progress in structural reforms such as SOE reform to create an environment for fair competition, etc, could potentially kick-start a positive feedback loop in the near term. However, US-China trade talks remain a wild card for better or worse outcomes, while policy effectiveness (eg credit transmission, the multiplier for corporate tax cuts, etc) remains key to the outlook

Weak confidence impedes policy transmission



Room to cut corporate tax burden



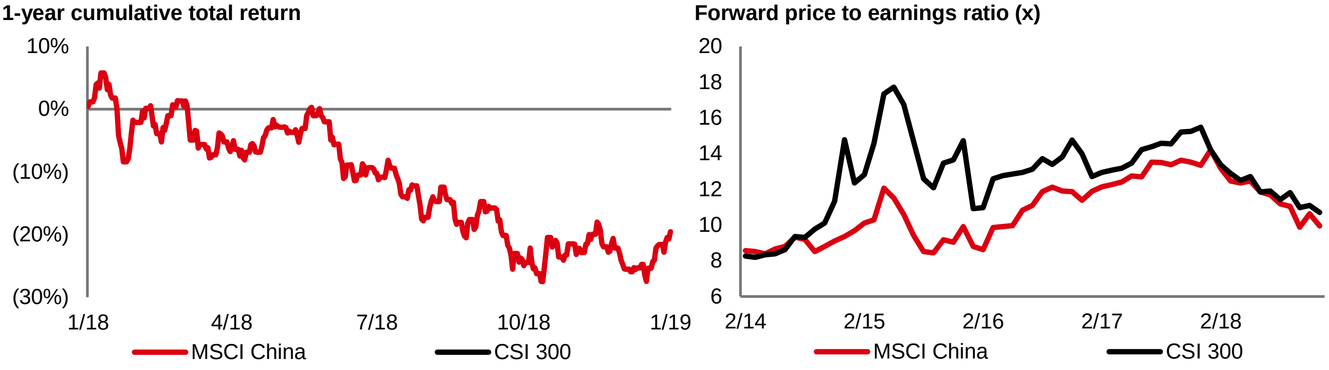
Source: Bloomberg, CEIC, HSBC Global Asset Management, data as of January 31, 2019.

Equity market

Chinese policymakers have plenty of room to maneuver if they need to shore up economic growth and market confidence

- Chinese shares started 2019 higher after a volatile end to 2018. Key offshore market benchmarks such as MSCI China and Hang Seng Index marginally outperformed their onshore counterparts, with the former jumping over 5.8% and the latter rising 4.5% (as of January 22). The Shanghai Composite Index has edged up 3.5%, while the Shenzhen Composite Index, a gauge of manufacturing and technology companies, has added another 3.8%
- The outperformance of offshore Chinese equities suggested that investors see better value in offshore Chinese stocks than their onshore counterparts, as uncertainties surrounding Brexit and the Fed's outlook for rate increases remain the major swing factors
- Meanwhile, overall market sentiment has gradually improved this year, lifted by optimism over a resolution of trade tensions between the US and China. In addition, the strength in Chinese stock markets underscores rising expectations for government efforts to boost domestic consumption and infrastructure spending, as well as further tax cuts for households and corporates
- 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 10x and 9.4x, respectively. When measured by the price-to-book ratio, the former is trading at 1.52x and the latter at 1.46x, reflecting a 13% and 34% discount to their 10-year averages
- The State Administration of Foreign Exchange in mid-January said the quota for overseas investors in the country's equities has been doubled to USD300 billion, a move that allows global funds to get more funds into mainland-listed stocks
- S&P Dow Jones Indices in December said it will include Chinese A-shares in its global benchmarks on September 23, following a similar move by MSCI and FTSE Russell
- In short, we believe there are plenty of themes and market trends such as domestic consumption and 5G upgrades for equity investors to explore in the Year of the Earth Pig, even though social and economic challenges remain evident

Chinese equities have turned more attractive after recent correction



Source: Bloomberg, HSBC Global Asset Management, as of January 22, 2019. Total return in local currency terms. Investment involves risks. Past performance is not indicative of future performance.

Sector	Comment
Consumer Discretionary	◆ We are underweight the consumer discretionary sector. Policies such as tariff cuts and relaxation of foreign ownership cloud the outlook for the auto sector. RMB weakness may negatively impact Macau gaming, HK retail and the tourism industry in China. We have turned more positive on the home appliances industry on the back of favourable government policies
Consumer Staples	◆ We are selective in the consumer staple sector as the trend of premiumisation amid rising incomes underpins an increase in pricing power and margin expansion potential for select staples brand names
Energy	◆ We are underweight on energy amid an oil price peak out and concerns over weakening global demand
Financials	◆ We are overweight Chinese banks as loan growth may pick up on the back of more relaxed monetary policies. We are selective on insurance
Healthcare	◆ We are underweight on the healthcare space in light of unfavorable policy changes such as increasing imports of drugs and stretched valuations
Industrials	◆ We are neutral in this sector but we like the capital goods industry in particular as favourable government policies should prompt higher capex toward industrial equipment
Information Technology	◆ We are underweight the IT sector especially technology hardware due to the weakness in smartphone sales, limited room for smartphone specs upgrade, and the fact that it could be a victim of the US-China trade conflicts
Materials	◆ We are underweight this sector as softness in fixed asset investment activities suggests soft demand for commodities
Property	◆ We are overweight the Chinese property sector as the government is expected to fine-tune its tightening policies amid severe external headwinds. Valuations are attractive too. We are also a buyer of Hong Kong based REITs for their defensiveness
Communication Services	◆ We are overweight this sector. We like major telecoms because of their defensiveness amid the current volatile environment. We also like major internet companies as we see secular growth potential in China's internet space
Utilities	◆ We are neutral to the utilities sector but overweight players that may benefit from coal price weakness

Source: Bloomberg, HSBC Global Asset Management, as of January 31, 2019
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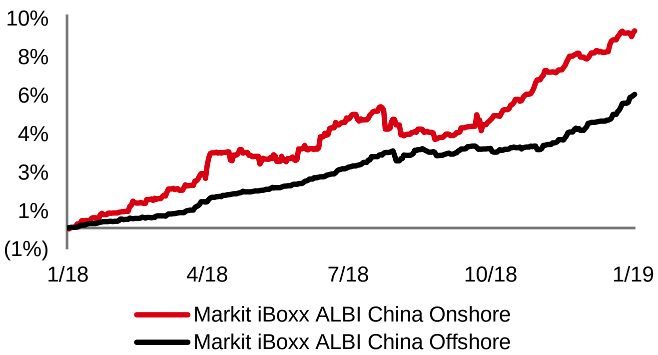
Fixed income

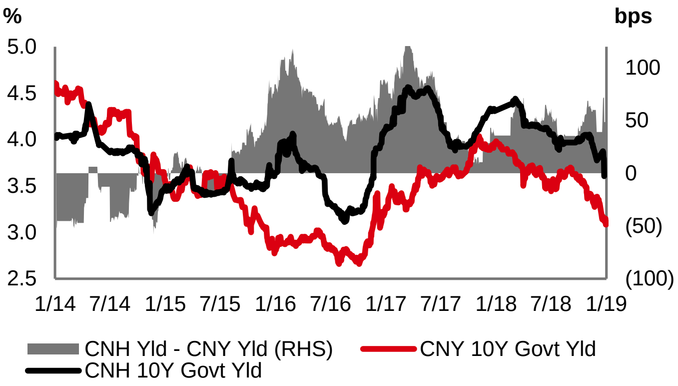
The Chinese central bank is committed to boost lending to support the slowing economy amid a trade dispute with the United States

With a reversal of dollar strength and policy relaxation in China, offshore USD property credits offer attractive risk-adjusted returns

- Onshore and offshore bonds have registered positive returns since the start of the year (as of January 22), delivering 0.86% and 1.20% in local currency terms, respectively. Sharing the improving sentiment in the equity markets, Chinese bond markets have also been buoyed by expectations for more supportive policies from Beijing
- To ward off a sharp slowdown, Beijing has in recent months unveiled a raft of policies, including tax cuts and a reduction in the amount of cash that commercial banks must hold, to revive consumer confidence and overall economic activity
- On January 4, the PBoC announced a cut in lenders' reserve requirement ratio (RRR) by 100 basis points in two stages, showing support for the real economy and sending a clear signal that the government is committed to spur growth. The first installment of the cut took place on January 15 and the second phase will take effect on January 25. The RRR reduction followed a rate cut via targeted medium term liquidity facility (TMLF) in December 2018, a policy tool designed to boost lending to small and medium firms
- On January 16 the central bank injected a record $83 billion through open-market operations, the largest net single-day liquidity injection into the country's financial system
- The onshore yield curve has continued to move lower as fundamentally conditions remain favorable for bonds. The yield on 10-year government bonds moderated significantly to 3.081% on January 17, the lowest level in the past 12 months
- 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 10-year corporate bonds fell sharply to 4.6% in mid-January, down from 5.89% a year ago
- Looking at the Chinese currency, the onshore renminbi has advanced almost 1% so far this year against the US dollar, following a 5.6% decline in 2018. In 2019, we expect the US dollar, which has strengthened by 5% against a basket of major currencies, to stabilize as investors may start to price in a softer Fed rate hike path
- In the offshore dollar market, we believe the property sector provides better risk-adjusted returns on the back of an accommodative policy stance

Onshore and offshore yields moderated over the past few months





Source: Bloomberg, Markit data as of January 21, 2019. Total return in local currency terms.
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Data watch

Indicator	Data as of	Actual	Consensus	Prior	Analysis
Industrial production (IP) (yoy)	Dec	**5.9%**	5.3%	5.4%	Q4 real GDP growth decelerated to 6.4% yoy/6.1% qoq annualised from 6.5% yoy/6.6% qoq annualized in Q3. Nominal GDP growth fell to 9.2% yoy in Q4 from 9.4% in Q3, putting downward pressures on corporate earnings/profits. For the full year, real GDP growth eased from 6.8% in 2017 to 6.6% in 2018, the lowest since 1990 but meeting the official target of "about 6.5%." Meanwhile, the monthly activity data was mixed for December, but largely confirmed the economy ended the year on a soft footing. The higher IP growth was driven by a rebound in mining IP, but manufacturing and utility IP growth eased. PMI readings indicate lacklustre IP momentum in the near term. Overall, economic activity is likely to remain subdued into early 2019 on weaker export growth, cooling property and land markets, and persistent structural headwinds (eg high debt levels). However, we expect the intensifying and broadening policy easing to eventually help stabilise confidence and the cyclical growth momentum, particularly if trade tensions subside.
Fixed Asset Investment (FAI) (ytd, yoy)	Dec	**5.9%**	6.0%	5.9%	A modest recovery in infrastructure FAI amid policy support and still-solid manufacturing FAI offset a moderate easing in real estate FAI growth. Property sales recovered in December, largely driven by increased new launches as developers actively pushed for sales towards the year-end. Land area purchases also picked up. Land prices fell further. New starts GFA maintained a strong double-digit pace and property under construction picked up. Overall inventory levels remain low, despite gradually building up, especially in lower tier cities following developers' active acquisitions in the past two years. This should help prevent a sharp decline in starts and construction. While large scale/nationwide property policy loosening led by the central government looks unlikely, there has been incremental easing in some cities. Funding conditions for developers generally remain tight, but access to both onshore and offshore bond markets could become easier. Continued policy focus on shantytown redevelopment, rental housing and affordable housing projects also help. Meanwhile, weaker industrial profits and trade-related uncertainties mean headwinds for manufacturing FAI in the near term. Infrastructure should 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, though sales of jewelry, cosmetics and fuel eased. Real retail sales growth rose to 6.7% yoy from 5.8% in November. The individual income tax cut should improve personal disposable income, while measures to support autos and household appliances spending will be introduced, although rising household debt and recent signs of slower employment growth are concerns.
Exports (USD) (yoy)	Dec	**-4.4%**	2.0%	3.9%	The sharp slowdown in trade activities likely reflected the negative impact of US-China trade tensions, a tech down-cycle as well as softer external and domestic demand. The fading front-loading effect due to the step-by-step implementation of tariff measures could have also been behind the export weakness. Exports to the US fell noticeably, but broad-based slowing was also seen in exports to other major markets. In 2018, China registered a record high bilateral trade surplus at USD324bn (~92% of the total trade surplus). Import growth also dropped on weakening domestic demand and lower commodity prices. Looking ahead, export growth is likely to remain soft in the near term, off a high base in 2018, given slower global demand growth and US-China trade uncertainties, while China's overall import growth could be curbed by weaker domestic demand, though its imports of US goods may pick up in coming months as part of the US-China negotiation pledges.
Imports (USD) (yoy)	Dec	**-7.6%**	4.5%	2.9%	
Trade Balance (USD)	Dec	**57.1bn**	51.6bn	41.9bn	
CPI Inflation (yoy)	Dec	**1.9%**	2.1%	2.2%	The fall in headline CPI inflation was driven by non-food prices (especially fuel). Soft inflation readings reflected a decline in oil/commodity prices and weakness in demand growth, particularly regarding the significant softening of upstream price pressures. The implicit relaxation of supply side constraints from regulations related to work safety and environment protection may have contributed to the sharp fall in PPI inflation. Looking ahead, while the impact from the spread of African swine fever cutting the pork supply needs monitoring, non-food inflation is likely to remain muted given cautious consumer spending. PPI inflation could slide into negative territory in some months if oil and industrial material prices consolidate at
PPI Inflation (yoy)	Dec	**0.9%**	1.6%	2.7%	

					current levels or pull back as investment demand stays tepid. Up and midstream sectors will face downward pressure in earnings growth.
Total Social Financing (TSF) (RMB)	Dec	**1,590bn**	1,300bn	1,524bn	TSF growth showed signs of stabilisation, as bank RMB loan growth rose to 13.5% yoy, the highest since December 2016. A recovery in corporate bond financing also helped while banks increased bad debt write-offs. Meanwhile, financial deleveraging continued, with off-balance-sheet items continuing the declines, though the contraction has narrowed. The data could potentially show tentative signs of the impact of monetary easing efforts. However, medium-and-long-term corporate and household loans (mainly mortgages) stayed subdued, likely reflecting the corporate sector's weak sentiment and credit demand for capex and the recent weaker property sales. Money supply M2 growth edged higher, and deposit growth recovered moderately. Overall, TSF growth is likely to pick up modestly in coming months, driven by higher bank loan growth, pickup in capital market financing and bottoming-out in shadow banking credit growth amid policy/regulatory easing.
New yuan loans (RMB)	Dec	**1,080bn**	825bn	1,250bn	

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 January 2019

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Expiry date: April 30, 2019

DK1900058A, H201812013, H201901018, HD190131 - E190430.