ASIA MACRO STRATEGY

China Update - Trade War and Policy Direction

Report | 15 August 2019

For Professional Investors only in Hong Kong and Accredited Investors (in respect of accounts opted-in to be treated as Accredited Investors) and Institutional Investors only in Singapore

Latest on Trade War

In a surprising move, President Trump has back-pedalled on his tariff measures against China.

Most of proposed 10% tariffs on consumer electronics will be pushed back to 15 December 2019, from the initial 1 September deadline. These should account for roughly half of the targeted $300bn in Chinese exports. The delay will provide modest support to China's near-term growth.

China's response is important especially if Beijing returns with stepped-up agricultural imports from the US – an item that is high on Trump's re-election agenda. Given Trump's concession, there are increased chances of continued trade talks in September.

Beyond that, our confidence remains low in the two sides' showing greater flexibility to close the gap on key fundamental issues of market access, forced technology transfers and state subsides. The limited relieved rally in global equities reflects investors' lingering concerns on trade-war uncertainty. These concerns will continue as tariff deadlines are delayed.

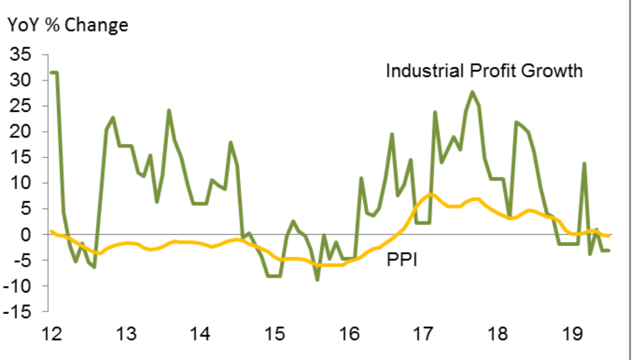
The Economy and Policy Focus

As trade uncertainty and the risk of Trump's continued tariff/non-tariff decisions remain in the picture, policy responses will be a key market driver. China's economy remains reasonably resilient but definitely not firm enough for Beijing to be relaxed and refrain from moving policy stimulus to higher gears.

Indeed, after the strong pick up in most domestic demand indicators in June, snapbacks occurred in July from industrial production to retail sales and fixed asset investment.

The industrial sector dipped into deflation with contracting factory gate prices and profit growth. The relapse in domestic demand is a policy alert. Specifically, falling profits in China's state-owned enterprise-dominated industrial sector should add pressure to policymakers to step up policy accommodation.

China Industrial Profits And Producer Price Inflation (PPI)

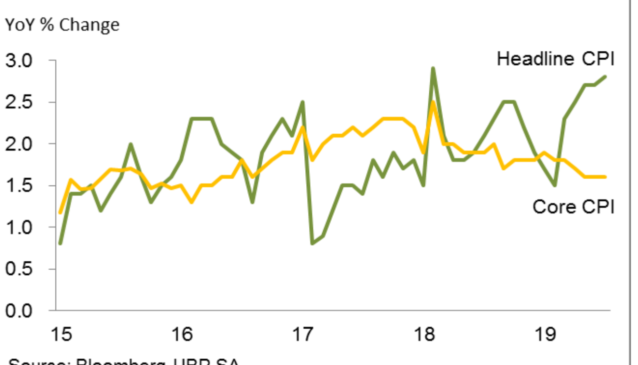


Source: Bloomberg, UBP SA

In addition, rising headline consumer price index inflation (to 2.8% year-on-year/yoy in July mainly on a surge in pork prices) should not pose a significant inflation threat to policy easing.

By contrast, the underlying weakness in the economy is better reflected in the tame, and still softening, core inflation trend which has declined to 1.6% yoy in July.

China Inflation Trends



Source: Bloomberg, UBP SA

Policy Dynamics

China's new credit expansion was disappointedly modest in July after the surge in the prior month. The People's Bank of China's (PBOC) second quarter (2Q/19) monetary policy report fails to lift expectations beyond its usual prudent policy stance with an emphasis on targeted liquidity injections.

The central bank is understandably facing a tough balancing act between preventing re-leveraging risk and providing effective policy stimulus to fight the trade war.

The first constraint is the latest official release of China's total debt count. Total debt outstanding rose 5.1% points of gross domestic product (GDP) in (1Q/19) to 249% of GDP (or $33trn), indicating rising leverage in the economy again.

The second constraint is a renewed sign of an overheating housing market (average residential property price inflation increased to 11% yoy in July) and there is an increasing need to prevent excess liquidity from flowing into the housing market.

In our view, PBOC's policy response is credible given its policy constraints. Instead of pouring excessive liquidity into the economy as they did during the global financial crisis (GFC) a decade ago, targeted liquidity injection to support local consumption, infrastructure projects and the private sector should maximise the policy effect – albeit with some lag.

The year-long monetary easing has not brought down effective borrowing cost for firms to desired levels. PBOC's immediate focus will be on reforming China's interbank rate system. Corporate prime lending rate can then be more sensitive to lowering short-term interbank rates as a means to lower the funding costs for the real economy.

If push comes to shove, the last resort will be continued cuts in the bank's reserves requirement ratio (RRR) to release locked liquidity back into the banking system.

Currently at an average of 13.5%, RRR cuts have high flexibility considering that the level was merely at 5%-6% in the early 2000s. For the coming year, we think a measured reduction of 100-200 basis points (bps) represents prudent easing, and RRR reduction is expected to become increasingly targeted to benefit specific financial sectors.

Finally, as argued before (see Asia Macro Strategy – Turning Up the Fiscal Tap, July 11, 2019), China leads in using fiscal stimulus to complement monetary easing. Such flexibility should remain barring a deep economic recession ahead.

Policymakers in other major economies may envy China's relative policy dynamics, although its current position compares pale to that during GFC when its total debt/GDP ratio was at 150% and fiscal balance was in surplus.

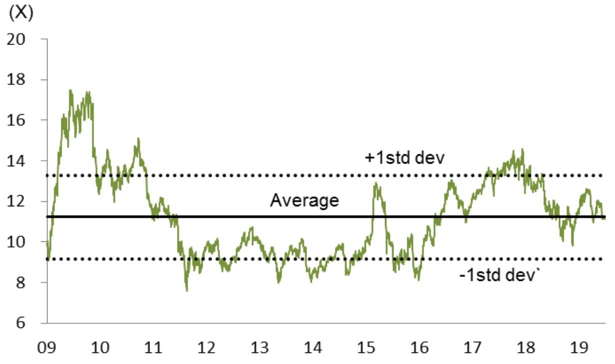
Market Valuation

MSCI China's forward P/E has remained resilient at about 11x (at historical mean level) after the decline in early May on Trump's new tariff hike on Chinese exports.

The market seems to have priced in reasonable confidence in China's policy capability to cushion future growth. This is in view of the low forward P/E at 9.8x in early January given heightening trade war uncertainty. We expect Beijing's continued roll-out of policy support plus protracted trade talks should maintain market valuation at around current levels.

Upside could see multiple expansion to around 12.5x P/E similar to April/early May when news on an imminent trade deal was the focus. On the downside, a market correction of another 10%-15% will knock down forward P/E to below 10x and will begin to make risk and reward attractive.

MSCI China 12M Forward PE Ratio



Source: Bloomberg, UBP SA

Anthony Chan
Chief Asia Investment Strategist

Disclaimer

This document is a marketing communication containing GENERAL INFORMATION on the financial services and/or financial instruments, and reflecting the sole opinion of Union Bancaire Privée, UBP SA and/or any entity of the UBP Group (hereinafter "UBP") as of the date of issue. It may contain generic recommendations but should not be deemed an offer nor a solicitation to buy, subscribe to, or sell any currency, product, or financial instrument, make any investment, or participate in any particular trading strategy in any jurisdiction where such an offer or solicitation would not be authorised, or to any person to whom it would be unlawful to make such an offer or solicitation. This document is meant only to provide a broad overview for discussion purposes, in order to determine clients' interest. It does not replace a prospectus or any other legal document relating to any specific financial instrument, which may be obtained upon request free of charge from UBP or from the registered office of the fund concerned, where applicable. The opinions herein do not take into account individual clients' circumstances, objectives, or needs. In this document UBP makes no representation as to the suitability or appropriateness, for any particular client, of the financial instruments or services described, nor as to their future performances. Clients who wish to obtain more information about any specific financial instruments can request it from UBP and/or their Relationship Manager. Where an investment is considered, the information on the risks linked to each financial instrument shall be provided in good time by separate means before the investment decision is taken. In any case, each client must make his/her own independent decisions regarding any securities or financial instruments mentioned herein and regarding the merits or suitability of any investment. Before entering into any transaction, clients are invited to carefully read the risk warnings and the regulations set out in the prospectus or other legal documents and are urged to seek professional advice from their financial, legal, accounting and tax advisors with regard to their investment objectives, financial situation and specific needs. This generic information is therefore not independent from the proprietary interests of UBP or connected parties, which may conflict with the client's interests. UBP has policies governing cases of conflicts of interest. The investments mentioned herein may be subject to risks that are difficult to quantify and to integrate into the valuation of investments. Generally speaking, products with a high degree of risk, such as derivatives, structured products or alternative/non-traditional investments (such as hedge funds, private equity, real estate funds, etc.) are suitable only for clients who are capable of understanding and assuming the risks involved. The value of any capital investment may be at risk and some or all of the original capital may be lost. The investments are exposed to currency fluctuations and may increase or decrease in value. Fluctuations in exchange rates may cause increases or decreases in the client's returns and/or in the value of the portfolio. The client may be exposed to currency risks if a financial instrument or the underlying investment of a financial instrument is denominated in a currency different from the reference currency of the client's portfolio or from the currency of his/her country of residence. For more information on risks, the brochure called "Characteristics and risks of certain financial operations" should be consulted. The information contained in this document is the result neither of financial analysis within the meaning of the Swiss Banking Association's "Directives on the Independence of Financial Research" nor of independent investment research as per the EU's regulation on MiFID provisions. In principle, EU regulation does not govern relationships entered into with UBP entities located outside the EU, including but not limited to Union Bancaire Privée, UBP SA in Switzerland, which is subject to Swiss law and Swiss regulation, in Hong Kong, and in Singapore, and the subsidiary in Dubai. Reasonable efforts have been made to ensure that the content of this document is based on objective information and data obtained from reliable sources. However, UBP cannot guarantee that the information the Bank has gathered in good faith is accurate and complete. Circumstances may change and affect the data collected and the opinions expressed at the time of publication. Therefore information contained herein is subject to change at any time without prior notice. UBP makes no representations, provides no warranty and gives no undertaking, express or implied, regarding any of the information, projections or opinions contained herein nor does it accept any liability whatsoever for any errors, omissions or misstatements in the document. UBP does not undertake to update this document or to correct any inaccuracies which may have become apparent after its publication. This document may refer to the past performance of financial instruments. Past performance is not a guide to current or future results. The value of financial instruments can fall as well as rise. All statements in this document, other than statements of past performance and historical fact, are "forward-looking statements". Forward-looking statements do not guarantee future performances. The financial projections included in this document do not represent forecasts or budgets, but are purely illustrative examples based on a series of current expectations and assumptions which may not happen as forecast. The actual performance, results, market value and prospects of a financial instrument may differ materially from those expressed or implied by the forward-looking statements in this document. The projected or targeted returns are inherently subject to significant economic, market and other uncertainties that may adversely affect performance. UBP also disclaims any obligation to update forward-looking statements, as a result of new information, future events or otherwise. Any performance data included in this document does not take into account fees, commissions, expenses charged on issuance and redemption of securities, or any other costs, nor any taxes that may be levied. The tax treatment of any investment depends on the client's individual circumstances and may be subject to change in the future. This document does not contain any tax advice issued by UBP and does not necessarily reflect the client's individual circumstances. This document is confidential and is intended to be used only by the person to whom it was delivered. This document may not be reproduced, either in whole or in part. UBP specifically prohibits the redistribution of this document, in whole or in part, without its written permission and accepts no liability whatsoever for the actions of third parties in this respect. This document is not intended for distribution in the US and/or to US Persons or in jurisdictions where its distribution by UBP would be restricted. UBP is authorised and regulated in Switzerland by the Swiss Financial Market Supervisory Authority ("FINMA").

UK: UBP is authorised in the United Kingdom by the Prudential Regulation Authority, and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority (PRA).

Dubai: This marketing material has been communicated by Union Bancaire Privée (Middle East) Limited, a company regulated by the Dubai Financial Services Authority ("DFSA"). It is intended for professional clients and/or market counterparties only and no other person should act upon it. The financial products or services to which this material relates will only be made available to a client who meets the professional client and/or market counterparty requirements. This information is provided for information purposes only. It is not to be construed as an offer to buy or sell, or a solicitation for an offer to buy or sell any financial instruments, or to participate in any particular trading strategy in any jurisdiction.

Hong Kong: UBP is a licensed bank regulated by the Hong Kong Monetary Authority (HKMA) and a registered institution regulated by the Securities and Futures Commission (SFC) for Type 1, 4 & 9 activities only in Hong Kong. The securities may only be offered or sold in Hong Kong by means of documents that (i) are addressed to "professional investors" within the meaning of the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong) and any rules made thereunder (the "SFO"); or (ii) are defined as "prospectuses" within the meaning of the Companies Ordinance (Chapter 32 of the Laws of Hong Kong) (the "CO") or constitute offers to the public within the meaning of the CO. Unless permitted to do so under the laws of Hong Kong, no person may issue or have in his/her possession for the purpose of issuing, whether in Hong Kong or elsewhere, any advertisement, invitation or document relating to the securities, directed at, or likely to be accessed or read by, the public in Hong Kong, except where the securities are intended to be disposed of only to persons outside Hong Kong, or only to "professional investors" within the meaning of the SFO.

Singapore: UBP is a bank regulated by the Monetary Authority of Singapore (MAS), is an exempt financial adviser under the Financial Advisers Act (Cap. 110 of Singapore) to provide certain financial advisory services, and is exempt under section 99(1) of the Securities and Futures Act (Cap. 289 of Singapore) to conduct certain regulated activities. This document has not been registered as a prospectus with the MAS. Accordingly, this document and any other document or material in connection with generic recommendations may not be circulated or distributed, whether directly or indirectly, to persons in Singapore other than (i) to institutional investors under Section 274 of the Securities and Futures Act (Cap. 289) of Singapore ("SFA"), (ii) to relevant persons pursuant to Section 275(1), or any person pursuant to Section 275(1A) of the SFA, and in accordance with the conditions specified in Section 275 of the SFA, or (iii) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA. This advertisement has not been reviewed by the Monetary Authority of Singapore.

Luxembourg: UBP is registered by the Luxembourg supervisory authority the Commission de Surveillance du Secteur Financier (CSSF).

Italy: Union Bancaire Privée (Europe) S.A., Succursale di Milano, operates in Italy in accordance with the European passport – held by its parent company, Union Bancaire Privée (Europe) S.A. – which is valid across the entire European Union. The branch is therefore authorised to provide services and conduct business for which its parent company, Union Bancaire Privée (Europe) S.A., has been authorised in Luxembourg, where it is regulated by the Luxembourg financial supervisory authority, the Commission de Surveillance du Secteur Financier (CSSF).

Monaco: This document is not intended to constitute a public offering or a comparable solicitation under the Principality of Monaco's laws, but might be made available for information purposes to clients of Union Bancaire Privée, UBP SA, Monaco Branch, a regulated bank under the supervision of the Autorité de Contrôle Prudentiel et de Résolution (ACPR) for banking activities and under the supervision of the Commission de Contrôle des Activités Financières for financial activities.

Union Bancaire Privée, UBP SA

Hong Kong Branch
Level 26 | AIA Central | 1 Connaught Road Central
Hong Kong
T +852 3701 9688 | F +852 3701 9668
Union Bancaire Privée is incorporated in Geneva, Switzerland, as a limited liability company

Singapore Branch
Level 38 | One Raffles Quay | North Tower
Singapore 048583
T +65 6730 8088 | F +65 6730 8068
Co Reg No T13FC0154G