REPORT
7 May 2020

ASIA MACRO STRATEGY

Capture on China's Rebound, and Check Risks Ahead

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China remains ahead on the virus containment and production normalisation curve.

This will continue to be the key driver for investing in the China markets, despite higher valuations and tail risks of a potential second outbreak, structural supply chain disruption as well as US President Donald Trump's renewed hostility towards China for causing the global pandemic and demanding compensation.

The official economic data for March has already shown a sharp V-shaped rebound in key activities. Industrial production and retail sales have recovered noticeably, and fixed asset investment has also rebounded on firmer recovery in housing and infrastructure investment.

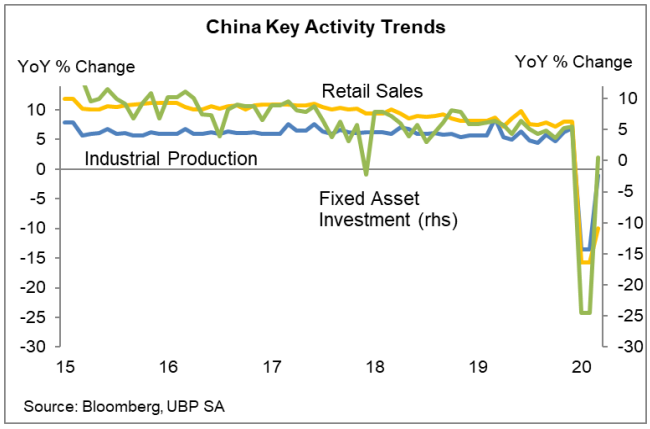
China's broad range of high frequency data – from UnionPay to reflect consumption to daily energy used, highway traffic and even pollution index – have consistently shown accelerated economic normalisation towards end-March in response to the initial easing of lockdowns. That momentum has extended into April.

Opportunities and Risks

Our investment themes for China (particularly in equities) have focused on the following:

Short-term cyclical to capture the initial rebound of activities from the easing of lockdown restrictions

Long-term structural trend to capture the policy direction and some permanent changes in consumer behaviour post-COVID-19.



We summarise our investment ideas into five major areas. Three of them are opportunities in the current cycle and the remaining two are risks that may intensify ahead.

1) Post-lockdown bounce. As recovery is already underway, this will immediately benefit consumption, retail and services in step with China's gradual social distancing reduction. Domestic tourism has also picked up markedly especially within province during the Golden Week holidays. This will spill over onto increased transportation and logistics activities.

2) Capture the policy tailwinds. Infrastructure investment is top on the reflation agenda including new and old projects which suffered a sudden stop during the virus outbreak. The National Development and Reform Commission (NDRC, China's economic planner) will double the size of special bond issues to RMB4trn ($567bn) to accelerate road, highway and railway projects. The ministry of finance may

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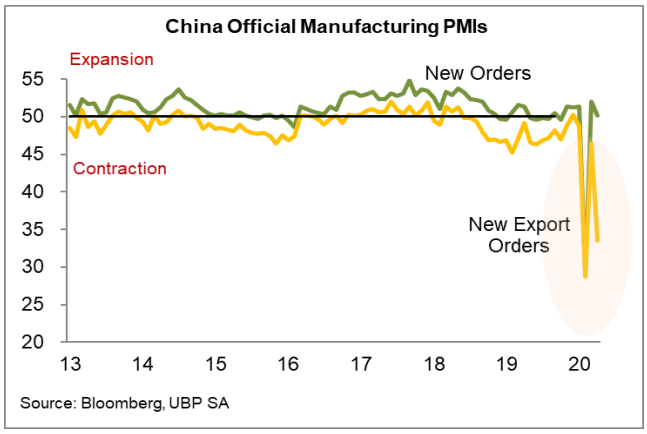
also issue special treasury bonds to add on to these investments' funding pool.

Moreover, housing policy will be relaxed further to reinvigorate demand and purchase subsidies will increase for automobiles (except top-end new energy vehicles). There is evidence of a sudden rise of car ownership for safe travel to avoid crowds in public transport.

3) Permanent change in consumer behaviour. Post-COVID-19 will boost the theme of 'digital acceleration' in online learning, entertainment, gaming and shopping as well as e-commerce transactions. Beijing's push towards a digital economy will make 5G and cloud computing as priorities for years to come. There will also be more emphasis on healthcare and increased spend on health products and boosted insurance protection.

4) External supply chain pressure. The slump in new export orders in China's purchasing managers index to 33.5 in April and even worse at 28.7 in February reflects the dire stage of overseas' market demand and revenue pressure on China's manufacturing supply chain.



A brief rebound in exports may occur if city's lockdowns in the west can be eased smoothly and inventory starts to rebuild. Beyond that, the long-term concern around structural disruption to global production lines will hurt China's export-driven coastal regions as more production facilities may relocate to other manufacturing sites. The risk of accelerated de-globalisation in the aftermath of global pandemic will reshape China's development model.

5) Renewed China-US friction. While it is still at an early stage, the market has sold off on Trump's stepped-up rhetoric on China and has threatened to hike tariffs on Chinese exports again to compensate for the pandemic cost to the US government. He has also talked about abolishing China's trillion-dollar US treasury holdings if push comes to the shove.

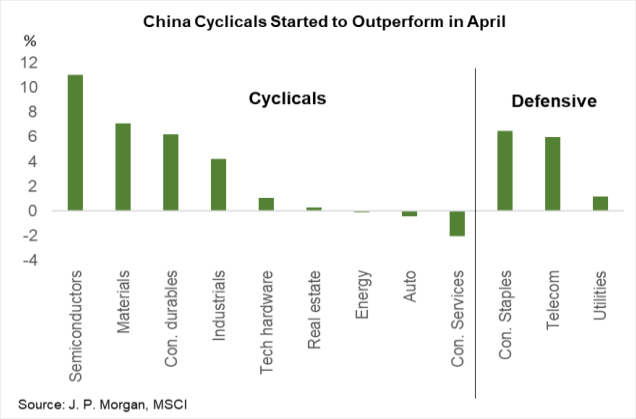
Trump's rhetoric is likely to intensify in the months ahead. But the question is in how strongly Trump will pursue action given the US' deep economic recession and as the presidential election draws closer.

What would be more likely are increased efforts to curb US's investment flows into China, speeding up relocation of manufacturing away from China and expanding political and economic links with Taiwan. These may unsettle financial markets again.

Market Trends and Valuations

The stock market index MSCI China is down 9% year-to-date (ytd), outperforming the MSCI World (down 16%) and MSCI EM (down 20%).

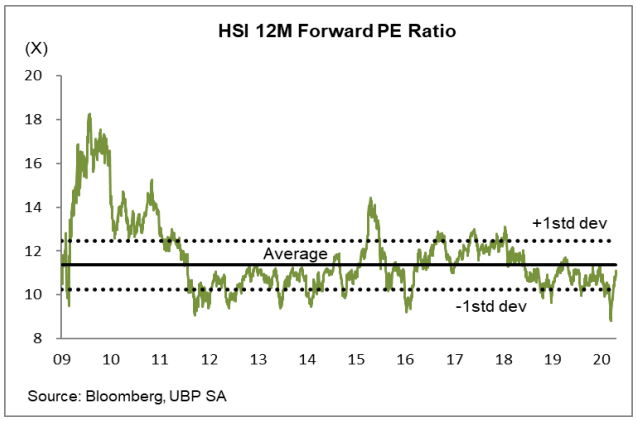
China's performance lagged in April as developed markets caught up on the equity rebound. China's normalisation has already triggered market sector rotation into cyclicals from defensive. Consumer durables, industrials and materials have gained momentum and should be extended and broadened as recovery gathers steam.



MSCI China earnings have dropped drastically from over 10% in early 2020 to a contraction of about 5% currently – broadly tracking the GDP contraction of 6.8% yoy in 1Q20.

If China manages well in preventing a second outbreak to accelerate economic normalisation, 2Q20 may see some stability or even manage a firmer growth resumption.

Despite the market recovery, China equity markets remain undemanding especially against their US peers. MSCI China's forward P/E (13.2x) is trading at slightly above +1 standard deviation of its 10-year average, CSI300 (12.4x) and HSCEI (8.8x) are trading marginally higher than their respective 10-year mean, and Hang Seng Index (8.8x) is just at mean level despite the recent rally.



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