ASIA MACRO STRATEGY

China's Macro, Equity and Credit Outlook

Report | 14 January 2020

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Despite heightening military confrontation between the United States and Iran, China equities enjoyed a solid start in the new year. The market is riding on 2019's strong performance with MSCI China (MXCN) rising by some 20.5%, beating the 15.5% gain in MSCI Emerging Market (MXEF).

In China equities, onshore A-shares have outperformed offshore (The CSI 300 index led MXCN by some 16% last year). We expect this relative outperformance should stay the course in 2020 thanks to relative valuations (to their respective own history), investment flows and policy directives.

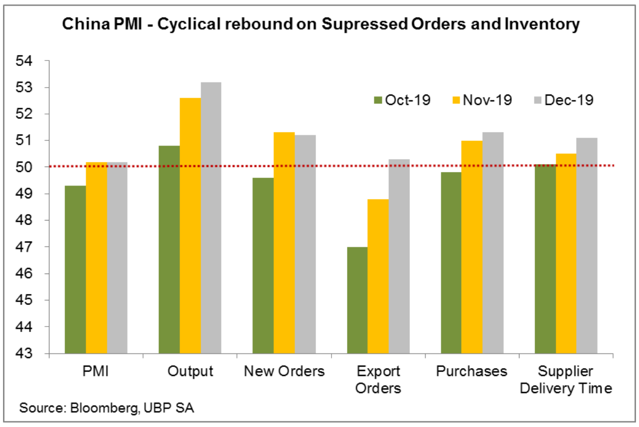
The tariff rollback in the China-US trade deal together with continued policy easing will continue to support China equities.

We still prefer China A-shares due to the new economy, domestic structural changes and associated investment sectors such as healthcare, education, online entertainment and technology. But we also see sector rotation opportunities emerging in industrials and materials thanks to cyclical recovery on low inventory and depressed capital expenditure from the lingering trade war.

Exporters regaining confidence

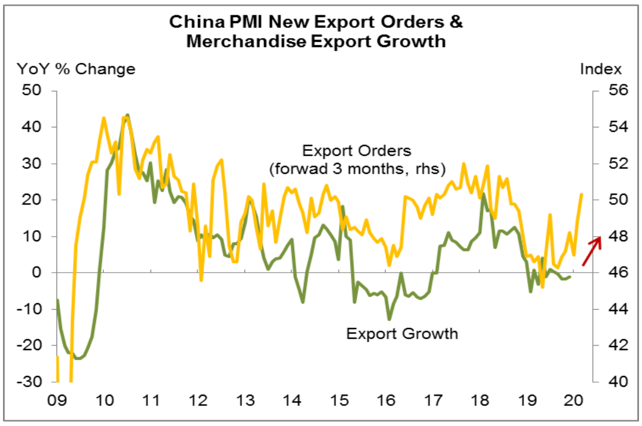
The three-month trend in China's manufacturing purchasing managers' index (PMI) show that exporters have regained some confidence in normalising their production flows.

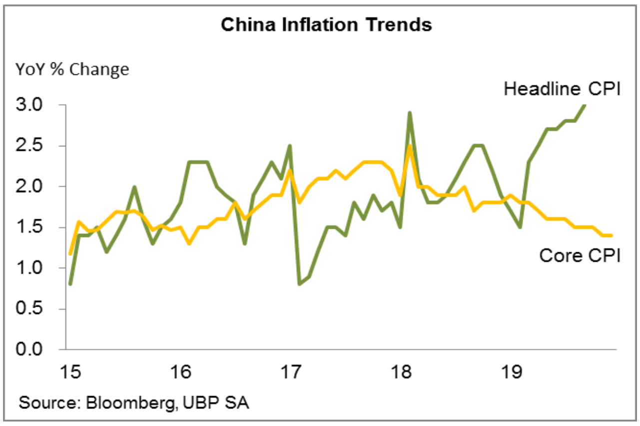
There is solid evidence of a revival in output, purchases, and new orders, and they are now back to the >50 expansion level. The new export orders component of China's PMI provides an accurate three-month lead on China's actual export growth. The latest pick-up is pointing to a noticeably export recovery after a prolonged contraction.



China's central bank, the People's Bank of China (PBOC), cut the banks' reserve requirement ratio (RRR) by 50 basis point (bps) at the start of 2020 to release about RMB800bn or $115bn – buoying market performance.

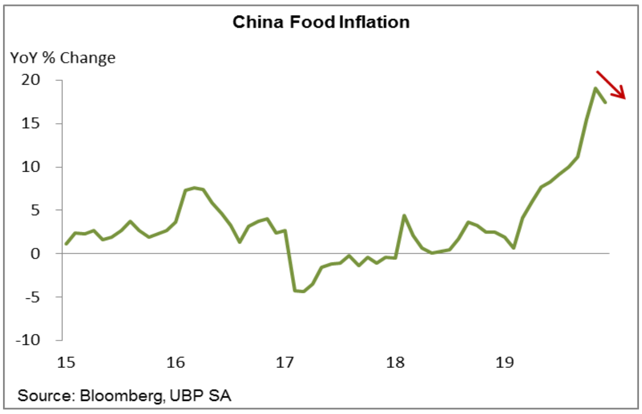
Although the liquidity injection is partly aimed at accommodating the usual higher liquidity demand during the upcoming Lunar New Year, it will also provide room for banks to trim their prime lending rates (loan prime rate, LPR, currently at 4.15%) to cushion the economy's down-cycle. We expect a modest 5bps cut in LPR and will see two more rounds of similar RRR-led interest rate reductions in the coming year.





Inflation to remain stable

Equally important, China's inflation has shown sign of peaking and this should remove market worry of its potential curb on monetary easing and domestic consumption. We have argued for a while that PBOC has looked beyond the temporary spike in headline inflation from surging pork prices and will continue to lower the funding cost for the economy. Nonetheless, pork prices show signs of firmer moderation (up 97% yoy in December vs. 110% in November and 101% in October) – that is a positive trend.



Headline consumer price index (CPI) has stayed unchanged at 4.5% yoy in December with core inflation (excluding food and energy) remaining stable and tame at 1.4%.

With food inflation normalising and a more favourable base effect kicking in from 2Q/20 onwards, there should be a noticeable retracement in headline inflation ahead. We expect inflation will average 2.2% in 2020 (vs. 2.9% in 2019) which will not have much erosion effect on household consumption.

Trade deal effect partly priced in

Details of the phase one trade deal should be released on around January 15 when it is officially signed. The recent strong rally in China equities should have mostly priced this partial trade agreement. But signs of greater cooperation in the phase two negotiation or a larger potential tariff rollback may see modest multiples expansion left in the current rally with forward P/E of MXCN rising to about 13.0x from current 12.3x.

For China USD high yield credits, the strong rally over the past weeks have pushed average credit spread down to 610bps from recent high of 730-740bps in early December 2019.

Strong risk-on inflows plus trade deal expectations and easing of tightening policy in China's housing market have soothed concerns over a potential rise in credit default risk.

We expect China's credit spread will stay tight and to have a good chance of further tightening to around 550-570bps. This is the level similar to that during 2Q/19 which was supported by constructive sentiment on China-US trade negotiation and an accommodative stance in China's housing policy.

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