FEBRUARY 2022

ASIA MACRO

China: Additional policy support to spur activity after Winter Olympics

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 in Singapore only

KEY TAKEAWAYS

- The macroeconomic backdrop will remain challenging in Q1-22. However, we will likely see an inflexion point following the much-anticipated policy pivot. GDP growth to accelerate from 3.0% y/y in Q1-22 to 5.0% on average in 2022.
- The PBOC's stance has officially shifted from "cross-cyclical adjustment" to "counter-cyclical support". We expect more monetary policy easing to be announced in Q1-22. Fiscal policy will take over after the March Congress.
- We believe risks for Chinese equities are asymmetric and tilted to the upside, owing to: 1) relatively cheap valuations; 2) The government has stepped up efforts to support activity and markets; 3) Tighter regulations are mostly priced in.
- However, this scenario is subject to some risks, including China's zero-COVID approach and intensifying US-China tensions in the months ahead.

Growth to bottom in Q1-22 and recover in Q2-22

On February 4, Beijing hosted the opening ceremony for the 2022 Winter Olympics. Global sporting events like this are usually a bonanza for the host country, attracting billions in investment and generating windfall revenues from tourists. However, this time round will be quite different. The Beijing Winter Olympics are taking place against the backdrop of some of the strictest virus containment measures in the world. Athletes and staff involved in the running of the event are operating within a special corridor, without any contact with the outside world. Additionally, Chinese authorities have been scrambling to lockdown several cities to eradicate flare-ups ahead of the event. Notable examples include the city on Xi'an (December 22 – January 24) and the port of Ningbo-Zhousan (January 1 – now).

But such draconian measures come at a cost. China's private services industry grew at the slowest pace in five months, with the Caixin services PMI falling to 51.4 in January, down from 53.1 in December and marking the weakest reading since August (**Chart 1**). Domestic tourism revenues over the commercially important Chinese New Year period fell around -4.0% y/y, as residents were urged not to travel. Air passenger traffic declined -36.0% y/y in Dec 2021. We expect a sharper contraction in the coming months, owing to ongoing COVID-19 restrictions and base effects (air passenger traffic reached an all-time high of 215.7% y/y in March 2021 and a record low of -84.5% in February 2020). Most importantly, domestic consumption has remained sluggish, as households avoid public gatherings to minimize lockdown risks. Retail sales slowed more rapidly than any of the other main activity indicators in December, declining to 1.7% y/y, down from 3.0% in November (**Chart 2**). Due to seasonal factors around the Chinese New Year, the National Bureau of Statistics (NBS) always publishes January-February data as in March. High-frequency indicators are nevertheless pointing to a sluggish start to the quarter. For example, movie ticket sales were down 23% from a year earlier during Chinese New Year, reaching 3.5 billion yuan (USD 550 million), according to data by entertainment service provider Maoyan.

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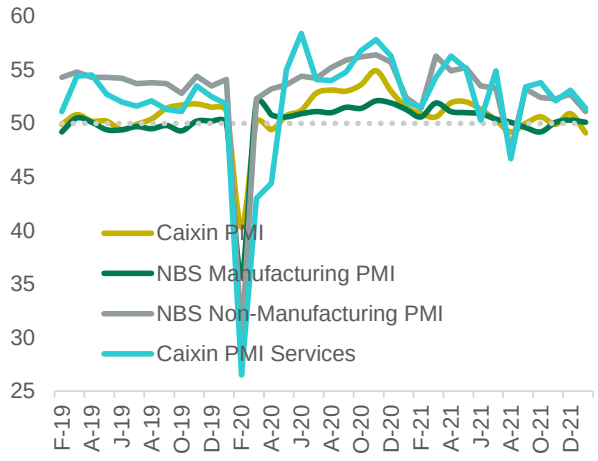
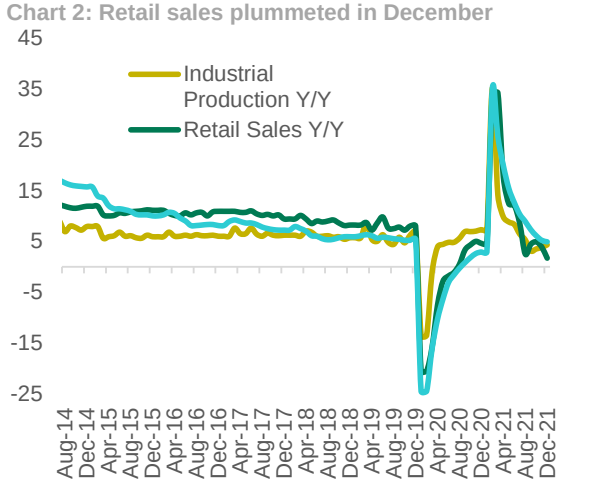
Chart 1: PMIs to decline in Q1-21 before recovering



Sources: NBS, Markit, Bloomberg, UBP

Chart 2: Retail sales plummeted in December



Sources: NBS, Bloomberg and UBP

China's "zero-COVID" strategy will also impact manufacturing. The Caixin Composite PMI fell to 50.1 in January, down from 53.0 in December. Industrial profits also declined to 4.2% y/y in December, down from 9.0% in November. This was the slowest reading since April 2020. Similarly, electricity consumption contracted -3.39% y/y in December, the first time since March 2020. The decline can be traced back to the previously mentioned lockdowns, but also pollution curbs to ensure blue skies ahead of the event. The level of fine particulate matter smaller than 2.5 microns (PM 2.5) in Beijing fell drastically from around 40 on average in 2021 to just 4 in early February.

We therefore expect to see a sequential contraction in activity in Q1-22, which will include broad-based declined across most major activity indicators, including PMIs. GDP growth will decelerate to around 3.0% y/y in Q1-22, before rebounding in Q2-22. A floor of around 5.0% will likely be announced at the National People's Congress (NPC) in March. This is the minimum rate of growth – emphasis on minimum – that would be required for China to achieve "middle-income" economy status by 2025. Going from 3.0% to 5.0% will entail a meaningful shift in gears.

More stimulus ahead – expectations for the NPC

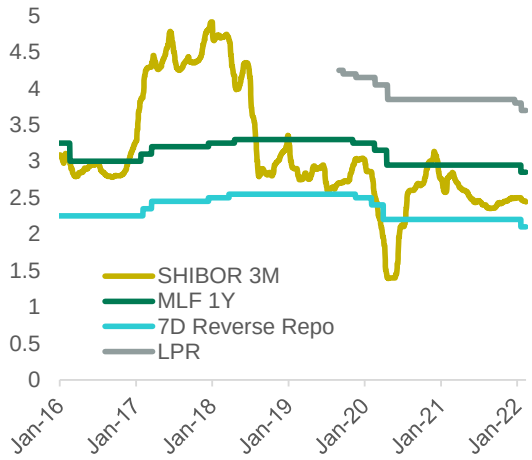
After tightening for the most part in 2021, the PBOC pivoted towards a more accommodative stance during the Central Economic Work Conference, on December 10. The PBOC's stance has therefore officially changed from "cross-cyclical adjustment" to "counter-cyclical support". Since late December, the PBOC has implemented broad-based interest rate cuts to the 1-year Loan Prime Rate (LPR), 5-year LPR, 1-year Medium-term Lending Facility (MLF) and 7D Reverse Repo (**Chart 3**). The bank also trimmed the Reserve Requirement Ratio (RRR), unleashing CNY 1.2 trillion in additional liquidity. Beyond the usual tools, the PBOC also pledged to deploy an entire "arsenal" of measures to stabilize the economy in 2022. We started to see that in credit figures for January. New yuan loans expanded by CNY 3980 billion in January, exceeding expectations of CNY 3700 billion and up from CNY 1130 billion in December. Meanwhile, M2 growth expanded to 9.8% y/y vs expected 9.2% y/y and up from 9.0% y/y in December. Outstanding credit growth reached 10.5% y/y, up from 10.3% y/y in December. Going forward, the PBOC's best bet is to front-load monetary policy stimulus to Q1-22, while inflation remains below target. The CPI declined to 1.5% y/y in December, down from 1.7% y/y in November, and is expected to remain subdued around 1.0% in Q1-22. However, inflation will start its gradual ascent starting in April, amid rising energy prices, base effects and a normalization in domestic pork supply chains.

Easing will not be restricted to monetary policy. We expect additional fiscal stimulus measures to be announced ahead of the National People's Congress (NPC) in early March. The consensus so far has focused on targeted spending on new infrastructure. This would provide impetus behind economic activity, while simultaneously avoiding exacerbating pressures on perceived asset bubbles such as the real estate market. Recent policy announcements certainly point in this direction. For example, the PBOC launched the 1-year carbon emission reduction facility (CERF) on November 9. The CERF stands at 1.75% vs 3.70% for the LPR, meaning the interest rate for these projects will be lower. Similarly, on January 12 the State Council issued a circular on China's plan to increase the digital economy to 10% of GDP by 2025. The plan mentioned sectors like quantum computing, 5G networks, semiconductors, artificial intelligence, block-chain, and new materials. The announcement will likely be followed up with specific investment targets, most likely at the NPC in March.

Targeted fiscal spending alone will not suffice to get China from 3.0% y/y GDP growth in Q1-22, to 5.0% in 2022. The authorities will likely resort to traditional fiscal spending to ensure this goal is achieved – i.e. more infrastructure. Local governments have reportedly been selling "special bonds" earmarked for 2022 since January 1. The special bond

quota is not approved until after the NPC, but China has allowed local governments to sell in advance since 2020.

Chart 3: Real rate differential with the US (%)



Source: PBOC, Bloomberg, UBP

Chart 4: Equity markets (Index: 01/01/2020 = 100)

Sources: Bloomberg, UBP

Implications for investors

The macroeconomic backdrop will remain challenging in Q1-22. However, we should see an inflexion point in terms of activity in Q2-22, following the much-anticipated policy pivot since December. In this context, it is no surprise that many investors have started to query about Chinese equities. We believe risks are asymmetric and tilted to the upside starting in Q2-22, owing to the following reasons:

1) **Valuations:** After experiencing multiple compression in 2021, valuations have become more compelling relative to global equities. The Shanghai Composite is trading at 14.7x earnings and 1.6x book value, slightly above its 10-year average. Meanwhile the Hang Seng Index – which was the worst performer in Asia last year – is trading at 9.8x times earnings and 1.0x book value, significantly below its 10-year average. On the contrary, the S&P Index is trading at 23.0x earnings and 4.4x book, above its 10-year average.

2) **Government support:** Monetary and fiscal policy support should benefit Chinese equities, especially as central banks in other parts of the world start to taper. Additionally, state funds have been intervening to stabilize the equity market since January. Although the "National Team" alone can't orchestrate a rally in the market, this should help to support the emergence of a floor on multiples, allowing for better visibility on earnings going forward. It is also important to mention that part of the Hang Seng Index's recent outperformance (5.0% YTD) can be partially attributed to USD appreciation. This has resulted in increased southbound flows, with state funds pouring into offshore equities to gain exposure to HKD assets.

3) **Fewer tightening risks:** This is not to say that Chinese authorities will backtrack, but markets have mostly priced regulatory risks. Although sectors that continue to benefit from policy tailwinds, such as core technology and consumption, offer more shelter, valuations for these companies are not cheap. For example, the ChiNext Index is trading at 50.3x earnings and 6.9x book. In addition, we do not expect momentous easing on the housing front, which should benefit equities. This is because 60% of wealth is linked to real estate. Consequently, a protracted approach to alleviating pressures in the housing sector should entail some wealth transfers from real estate to onshore equities.

Lastly, there are some downside risks that investors need to keep in mind. Chinese policymakers have remained adamant about adhering to "zero-COVID", which may entail additional downside risks. However, China's National Medical Products Administration's decision to approve Pfizer's COVID-19 drug Paxlovid is an encouraging sign that policymakers are gearing towards gradual reopening in H2-22. Furthermore, US-China frictions could intensify in 2022. According to figures by the Peterson Institute of International Economics, China only met 62% of its obligations under the phase one trade deal. That means President Biden will be under pressure to adopt a harsher stance on China in 2022. We could witness increased regulation to restrict Chinese companies from accessing US technology and capital markets as a result. For example, Wuxi Biologics, which is listed in Hong Kong, declined -30% after the US included the company in an "unverified list" of exporters, even as the index recovered on state support. Similar bouts of volatility may become more frequent.

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