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ASIA MACRO STRATEGY

China Market Outlook Amid Policy Easing

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With growing uncertainty around the Sino-US trade war and that relationship at a low ebb, investors are increasingly focusing on policy response to assess market outlook.

Some observers favour China over the US in policy easing speed and breadth, thanks to the former's highly centralised regime. Others argue that China's hands are increasingly tied due to high leverage, worsening credit quality and private sector growth. We believe that Beijing can afford to stretch out policy easing in 2019 to overcome the downside shock.

But if the drag gets amplified and protracted beyond 2020 (for example, if manufacturing migration or capital flight becomes more severe than currently envisaged), the stimulus game will be a much tougher play for China. Beijing will need to make alternative strategic alliances to boost production and attract foreign capital to make up the losses.

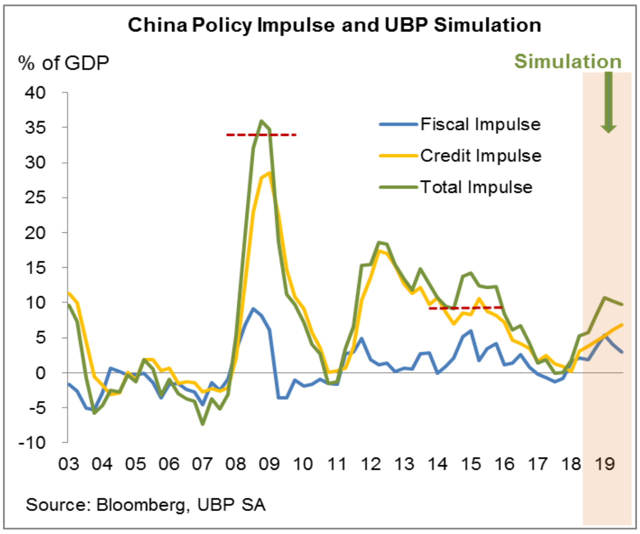
Overall, we remain constructive on Chinese assets in the next 6-9 months.

Policy Assessment

A worst-case scenario of 25% tariff on all Chinese exports to US will cut about 1.4% of China's GDP growth, including the multiplier effect. This means about RMB1.28trn or $190bn in potential economic loss needs to be offset.

This resembles the 2015-16 policy response cycles, although it will be far less severe than the global financial crisis in 2008-09. That meltdown required a massive policy stimulus which China simply can't afford today.

Compared to the last three policy easing cycles of 2008-09, 2011-12, and 2015-16, China's current easing remains at a relatively early stage. Growth support will take priority over leverage concerns when fighting a trade war. We expect Beijing will ramp up policy impulse (which measures the extent of stimulus) to levels similar during 2015-16.



To pump $190bn back to the economy, our simulation suggests that China's fiscal deficit will expand to around 6% of gross domestic product (GDP) on a four-quarter rolling sum basis. With an additional 100-150 basis points (bps) reduction in banks' reserve requirement ratio (RRR), credit impulse may resume to a 10%-15% growth rate from the current low single-digit level and add about 7% of GDP new debt stock to the already high level over 12-month horizon.

China Policy Easing Cycles and Policy Responses

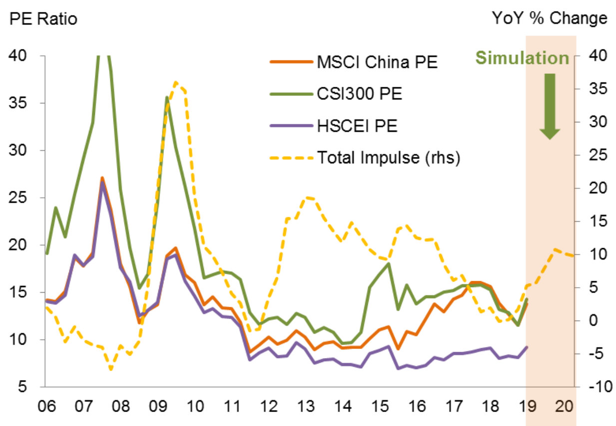
China Easing Cycles	RRR cut (bps)	Change in TSF/GDP ratio* (% pt of GDP)	Change in Fiscal Bal. (% pt of GDP)	Change in GDP growth (Peak to Trough) (% pt)
2008-09	-300	30.8	-2.8	-7.9
2011-12	-150	14.0	-0.5	-2.4
2015-16	-250	15.3	-1.7	-0.7
2018-1Q/19	-350	2.3	-0.9	-0.4
Present to 2020	**-100 to -150**	**7.0**	**-1.5**	**-1.4**

Based on our simulation of extend of policy easing that will need to offset 1.4% loss in GDP growth (assumed all Chinese exports to US are tarriffed at 25%)
** TSF = Total Social Financing or Aggregare Credits*
Source: Bloomberg, UBP SA

Market Assessment

Historically, China's policy easing tended to result in earnings recovery and price/earnings (P/E) multiples expansion in both A- and H-shares equity markets, as well as spread compression in China's US dollar (USD) high-yield (HY) and investment grade (IG) credits.

China Policy Impulse and PE Trends



Source: Bloomberg, UBP SA

If 2015-16 is a reasonably good yardstick to judge the current market outlook, both Chinese equities (P/E and earnings recovery) and USD credits (spread compression) are roughly half-way through their respective recovery cycles.

China Policy Easing Cycles and Market Imapct

China Easing Cycles	Change in PE Multiples (x) (Trough to Peak)			Change in EPS (% chg) (Trough to Peak)			Change in USD Credit Spread (bps) (Peak to Trough)	
	CSI 300	MSCI China	HSCEI	CSI 301	MSCI China	HSCEI	China HY	China IG
2008-09	14.1	7.9	3.7	12.8	76.1	57.1	-279	-84
2011-12	1.2	2.3	1.9	15.5	15.0	28.3	-1257	-131
2015-16	2.5	2.5	2.2	7.7	39.4	25.2	-409	-96
2018-present	1.5	1.5	1.0	3.9	-0.8	12.4	-252	-42

Note - Trailing PE and EPS are used in the analysis
Source: Bloomberg, UBP SA

As stated before, Chinese equity valuation is not too stretched relative to its history and to the global index.

While China's credit spreads have tightened markedly since early 2019 and have stayed tight, HY spread has widened by a mere 8bps since Trump's new tariff imposition on May 10. IG spread has gapped up only 2bps while the upside cap remains significant from risk/reward perspective.

However, the credit market will be underpinned by monetary easing and delayed deleveraging and credit default risk. HY credits will get additional support from extended policy accommodation in the housing market as policy easing persists.

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