Private Bank

Citi Global Wealth Investments

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China may ease policy while others tighten

- On the heels of the Evergrande event, China is rationing power supply across the nation, especially the economic powerhouse provinces along the coast. **Economic growth has most likely fallen well below 6% in 3Q and risks of sub-4% growth are rising for 4Q.** Stopping this "rot" would require immediate policy support across not just monetary and fiscal policy, but now also short term de-carbonization actions.

- **The People's Bank of China (PBOC)** held an unscheduled meeting on Sep 27 and pledged to safeguard the orderly operation of the property market, and to protect homebuyers. The central bank also conducted a large amount of reverse repo operations to inject liquidity into the system nearly everyday since the Mid-Autumn Festival, amounting to over CNY700bn in net liquidity injections.

- **Power rationing** became the latest major drag on activity, shutting both heavy industry and curbing residential use in late September. But the National Development and Reform Commission said that China would increase coal imports, and may adjust electricity pricing to better reflect market supply and demand.

- **Property sales** collapse is also threatening growth. After a 19%y/y drop in August, property sales are poised for deeper declines in September, as potential homebuyers fear whether their pre-sale purchases would be delivered, in addition to the usual eligibility and mortgage restrictions. Ensuring delivery and easing purchase and financing policies are needed and likely.

- While the policy responses appear to have a "whack-a-mole" pattern, the clear signal is that **growth is slowing beyond desired by authorities and policy priority has moved from structural tightening to cyclical easing**. We suspect that markets would take longer to restore confidence, particularly as more uncertainties arise from US and Europe.

- As a result, China appears likely to be easing policy in 4Q and into 2022, while Fed and several other central banks consider reducing stimulus. **This may be negative for the CNY, but is likely positive for Chinese equities after a prolonged period of underperformance.**

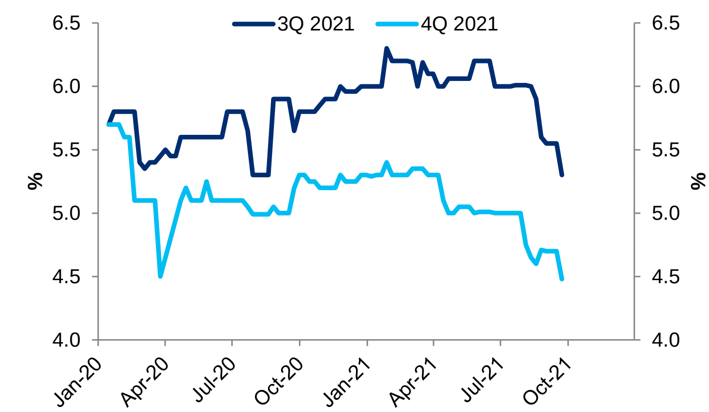
Deeper Economic Weakness Requires Greater Policy Response

Adding insult to injury, power shortages have become widespread in September, while real estate investment may have declined in 4Q, after sales faltered in Aug-Sep. The cumulated effect of prior tightening in credit and regulations have yet to be fully expressed in data. As a result, real GDP growth likely fell well below 6%y/y in 3Q and for 4Q, the level to defend is likely 4% rather than 5%, much less the policy target of 6%. Bloomberg Consensus GDP forecasts for 3Q and 4Q 2021 have fallen below the levels expected during the depths of the pandemic last year (**Figure 1**).

Manufacturing PMI dropped to 49.6 in September, the lowest since Feb 2020's pandemic contraction. The services PMI rebounded from the lull in August on a likely one-time bounce in transport and hospitality, while financial, real estate and power shortage effects are likely to bring October readings down. The slowdown in retail sales seen in August may have been relieved somewhat, as catering rebounded in September, but the real estate and power situations are likely to drag fixed investment and industrial production.

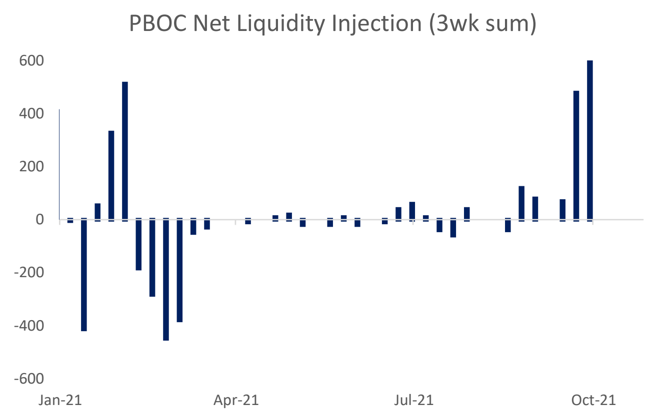
The PBOC held an unscheduled meeting on Sep 27 and pledged to safeguard the orderly operation of the property market, and protect homebuyers. The central bank also conducted a large amount of reverse repo operations to inject liquidity into the system nearly everyday since the Mid-Autumn Festival, amounting to over CNY700bn in net liquidity injections (**Figure 2**).

Figure 1: Consensus GDP forecast for China for 3Q and 4Q 2021 have fallen below those during initial pandemic



Source: Bloomberg, as of 29 Sep 2021

Figure 2: The slowdown in all major growth indicators was already pronounced in August, before real estate and power shortages weighed further in September



Source: Haver Analytics, as of Aug 2021

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Gas power? Not so fast…

On the heels of the Evergrande event, China is rationing power supply across the nation, In the past month, 16 out of 31 provincial jurisdictions – from industrial powerhouses in the south to the rust belt in the northeast – have rolled out electricity rationing measures. As a result, in order to stop the decline in growth, policy support is needed not just from the monetary and fiscal side, but also de-carbonization policy. The National Development and Reform Commission have said that China would increase imports of coal and adjust power prices to better reflect supply and demand.

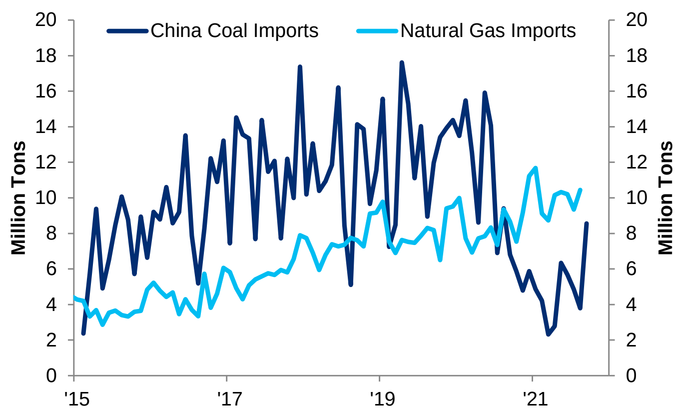
The power shortage came from efforts to swap coal for natural gas as source of power generation, as part of China's pledge to achieve peak carbon emissions by 2030 and carbon neutrality by 2060. According to a recent report by the International Energy Agency (IEA), China needs to cut demand for coal by more than 80% by 2060, oil by around 60% and natural gas by more than 45%. However, the reduction coal production and imports were much faster than the ramp up in natural gas supply (**Figure 3**), resulting in broad-based shortages even before the winter gas demand surge starts.

Similar problems have emerged in Europe with shortages of natural gas, which exacerbated the surge in prices. In addition, prices of thermal coal have soared to a record high this year as factories reopened, quadrupling since last May

(**Figure 4**). This has squeezed the margins of coal-fired plants, many of whom are loss making, raising the need to raise electricity prices during the coldest months of December to February. But in order to minimize inflationary impact on households, subsidies are needed as well.

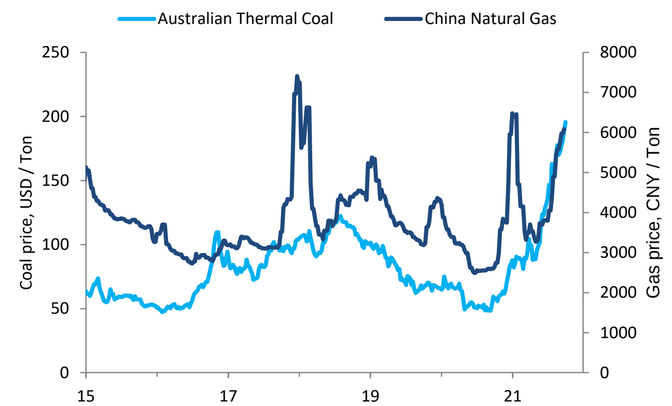
It takes some time for China to augment coal supply by raising domestic output and imports from countries such as Mongolia and Russia. Power shortages may persist through the Winter. Power producers who focus on renewable energies are expected to outperform coal-fired ones and it supports one of the "unstoppable trends" – "Greener and Sooner" – that we have frequently highlighted since the beginning of this year.

Figure 3: The drop off in coal imports was far quicker than the ramp up in natural gas imports



Source: Bloomberg, as of Aug 2021

Figure 4: Coal & gas prices have both surged, squeezing power producers and would require higher power prices and/or subsidies

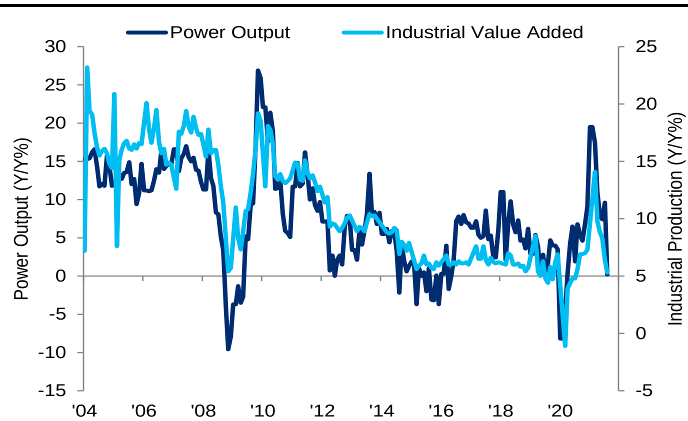


Source: Bloomberg, as of 29 Sep 2021

The goal of carbon neutrality by 2060 is noble, but economic growth will be dampened immediately, given the power cuts to heavy industries in late September and the expected continued supply tightness for coal and gas during the winter heating season (**Figure 5**). This adds another facet to policy that needs to be eased to restore growth and investor confidence, and China is deviating yet further from its growth targets.

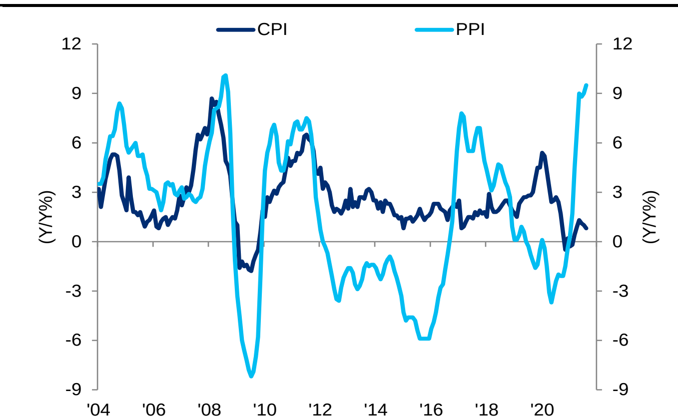
Fortunately, inflation is not really a major hurdle for monetary policy at this point as CPI remained depressed at 0.8%y/y (**Figure 6**) and 1.9%y/y excluding food. The rise in energy prices would lift CPI in the coming months, but not likely to a level to constrain monetary policy. PPI inflation at 9.5%y/y is harmful for corporate profitability, and would need to be addressed by administrative and fiscal policies such as pricing adjustments and subsidies.

Figure 5: Power Output fell to zero growth in August and likely to sink into negative in September and may persist in the winter heating season due to tight coal and gas supply



Source: Bloomberg, as of Aug 2021

Figure 6: CPI inflation remain depressed and allow for monetary policy flexibility. High PPI inflation would create supply response and typically fade in the following year



Source: Haver Analytics, as of Aug 2021

"Evergrander" policy easing needed to contain property spillover to growth

Evergrande is technically in default after missing the Sep 23 and 29 coupon payments, and are now in a grace period pending announcement of restructuring plans. Its bonds are trading at a level that implies eventual default and about 25% recovery. It could take a long time before bondholders find out what the actual recovery is and that process would reveal how China's distress asset process works.

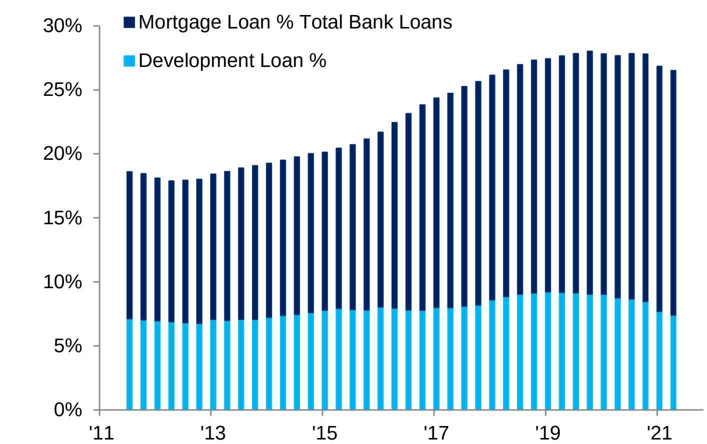
We continue to believe that systemic fallout would be very limited, as the highest Chinese authorities are managing this specific issue. The central bank had just joined the Ministry of Housing and Urban/Rural Development and the State Council Financial Stability Development Committee to ensure the proper functioning of the property market and financial stability. The financial press like to quote that 27% of China's CNY200 trillion of bank loans are in real estate. While this is true, it misses a critical fact that 19% of these are mortgages, which are much lower risk than developer loans that amount to 7% (**Figure 7**).

Over time, Evergrande would likely become a case study for how not to manage leveraged expansion amid years of clearly adverse policy backdrop. But it would not be remembered as China's Lehman or LTCM.

But containing the fallout from Evergrande appears no longer sufficient at this stage. Property sales have fallen by 18.7%y/y in August and appears poised to fall much further in September. In past episodes of sales decline like 2007-08, 2011 and 2013-14, other parts of fixed investment picked up the slack. This time, non-property investment is also under heavy pressure (**Figure 8**). Policy easing was what stopped the decline each time.

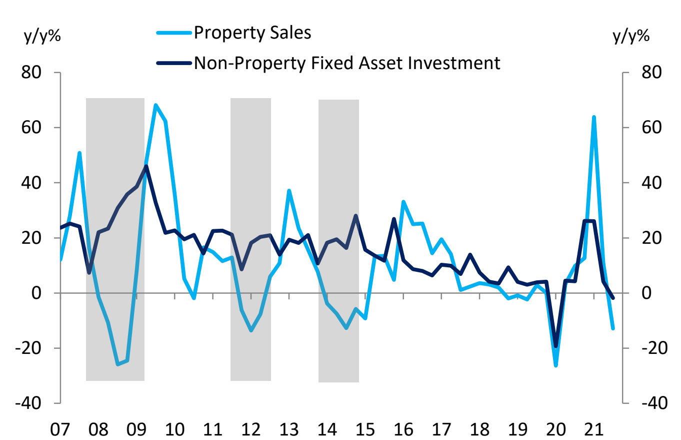
The easing actually doesn't have to be substantial, because it is not really a demand problem. The current sales decline is driven by potential buyers' fear of incomplete buildings, especially for highly levered developers. As noted, MOHURD and PBOC are both trying to restoring this confidence by pushing project completion. Limiting default risk to just Evergrande and a handful of highly levered names would also help to restore some confidence. In addition, easier mortgage policy and looser purchase restrictions have been very effective.

Figure 7: Development & mortgage % of Loans



Source: Bloomberg, as of 23 Sep 2021

Figure 8: Property sales are already down 19%y/y in Aug, while other fixed investment is not making up the slack



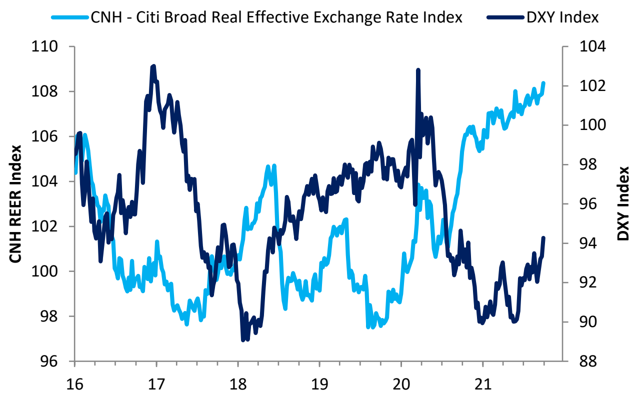
Source: Haver Analytics, as of Aug 2021

CNY may cheapen even if exports are not the target

Aside from property, easing can be targeted at infrastructure, SMEs and pandemic victims. The PBOC can cut interest rates. These actions could weigh on the CNY, which could help to support exports, particularly when US and European demand is recovering as re-opening takes place.

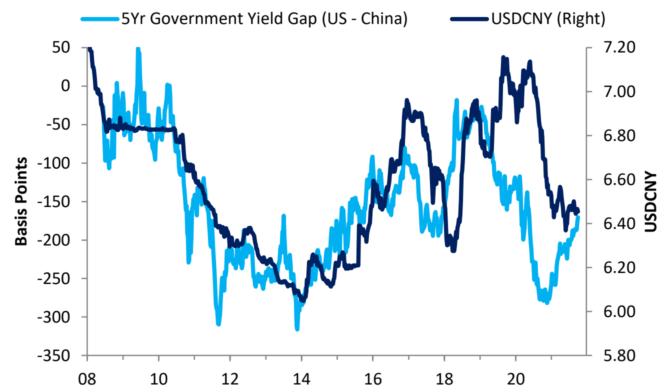
Throughout the regulatory and real estate tightening, the Chinese currency had remained remarkably stable, roughly unchanged versus the USD from the start of the year, while the USD strengthened. This meant that the real effective exchange rate (REER) of the CNY had appreciated by 2.5% year-to-date, after 7.2% appreciation in 2020 (**Figure 9**). This is clearly inconsistent with the 93bp narrowing in the positive carry between China and US (**Figure 10**). In essence the CNY appears to be at fair value, further slowdown in Chinese growth and fall in interest rates, while US rates are likely to be pick up, could result in weaker Chinese currency.

Figure 9: China's REER had strengthened this year despite USD strength, implying loss of competitiveness versus other exporters



Source: Bloomberg, as of 29 Sep 2021

Figure 10: China's positive carry over US narrowed by 93bps in 2021 so far, while the USDCNY held unchanged. Further slowdown in China could weaken the CNY



Source: Bloomberg, as of 29 Sep 2021

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The A-share resilience and opportunity

The global risk asset selloff on September 20 may have been triggered by Evergrande, but reflect broader worries over growth. It may take a while longer for confidence to return, especially amid an energy crunch that is affecting both Europe and China. But we believe the business cycle expansion would continue in 2022 and well beyond (See CIO Strategy Bulletin | Excessive Worrying May Be Costly for Investors).

In this backdrop, we may see China easing policy in 4Q and into 2022, while the rest of the world reduces policy stimulus. This could potentially reverse some of the underperformance caused by the unilateral policy tightening China conducted in 2021. Some may question whether there is political will to restore growth. But considering that 2022 is the last year of the 19th Party Congress and President Xi's second term, it is unlikely that the leadership would want to miss a major KPI in the work report ahead of the 20th Party Congress next October.

While offshore Chinese equities toiled under policy uncertainties, onshore A-shares actually outperformed. As **Figure 11** shows the CSI 300 large cap A-Share index is down 7% year-to-date, outperforming the MSCI China, which includes HK and US listed shares as well as many members of the CSI 300 index, by 10%.

The A-share market has the natural advantage of being more insulated from foreign capital movements, which has weighed heavily on the offshore markets. The A-shares are also a beneficiary of property tightening, which squeezes savings into the domestic equity market.

A-shares has lighter weighting to the internet sector, which is split between e-commerce in the Consumer Discretionary sector and online media in the Telecom Services sector, both of which are heavy weights in the MSCI index (**Figure 12**). Instead, Industrials, Energy and Materials had been the main positive contributors to the outperformance. Aside from the cyclical tilt, A-shares also have more exposure to sustainable themes such as electrification, mass market brand names, sustainable energy, electric vehicles, advanced manufacturing, and core technologies like semiconductors and telecom equipment. The two markets have similar valuations at 13.5x forward PE for CSI 300 and 13.0x for MSCI China.

The A-share market appears closer to what authorities want to develop in terms core competitiveness. While foreign investors remain skeptical of Chinese policy, we're likely to see continued A-share outperformance. A-shares also have the potential to do well in the initial stage of monetary and credit policy easing. If China risk premium rises further, A-shares are likely to be more resilient. If China risk premium subsides, the higher beta market would be the offshore market.

Figure 11: Chinese A-shares have outperformed offshore listed shares

Source: Bloomberg, as of 29 Sep 2021

Figure 12: Industry differences make A-shares more consistent with domestic policy

	MSCI China	CSI 300	Gap (CSI - MSCI)
Cons. Discretionary	16%	8%	-8%
Telecom Services	7%	2%	-5%
Healthcare	9%	8%	-1%
IT	10%	10%	0%
Utilities	2%	3%	0%
Materials	8%	8%	1%
Energy	4%	5%	1%
Consumer Staples	10%	12%	2%
Industrials	11%	15%	4%
Financials	20%	29%	9%

Source: Bloomberg, as of 24 Sep 2021

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Asset allocation definitions

Asset classes	Benchmarked against
Global equities	MSCI All Country World Index, which represents 48 developed and emerging equity markets. Index components are weighted by market capitalization.
Global bonds	Barclays Capital Multiverse (Hedged) Index, which contains the government -related portion of the Multiverse Index, and accounts for approximately 14% of the larger index.
Hedge funds	HFRX Global Hedge Fund Index, which is designed to be representative of the overall composition of the hedge fund universe. It comprises all eligible hedge fund strategies; including but not limited to convertible arbitrage, distressed securities, equity hedge, equity market neutral, event driven, macro, merger arbitrage and relative value arbitrage. The strategies are asset-weighted based on the distribution of assets in the hedge fund industry.
Commodities	Dow Jones-UBS Commodity Index, which is composed of futures contracts on physical commodities traded on US exchanges, with the exception of aluminum, nickel and zinc, which trade on the London Metal Exchange (LME). The major commodity sectors are represented including energy, petroleum, precious metals, industrial metals, grains, livestock, softs, agriculture and ex-energy.
Cash	Three-month LIBOR, which is the interest rates that banks charge each other in the international inter -bank market for three-month loans (usually denominated in Eurodollars).
Equities	
Developed market large cap	MSCI World Large Cap Index, which is free-float adjusted and weighted by market capitalization. The index is designed to measure the equity market performance of the large cap stocks in 23 developed markets. Large cap is defined as stocks representing roughly 70% of each market's capitalization.
US	Standard & Poor's 500 Index, which is a capitalization -weighted index that includes a representative sample of 500 leading companies in leading industries of the US economy. Although the S&P 500 focuses on the large cap segment of the market, with over 80% coverage of US equities, it is also an ideal proxy for the total market.
Europe ex UK	MSCI Europe ex UK Large Cap Index, which is free-float adjusted and weighted by market capitalization. The index is designed to measure large cap stock performance in each of Europe's developed markets, except for the UK.
STOXX 600	The STOXX Europe 600 Index has a fixed number of 600 components, representing large, mid and small capitalization companies across 18 countries of the European region.
Japan	MSCI Japan Large Cap Index, which is free-float adjusted and weighted by market capitalization. The index is designed to measure large cap stock performance in Japan.
Asia Pacific ex Japan	MSCI Asia Pacific ex Japan Large Cap Index, which is free-float adjusted and weighted by market capitalization. The index is designed to measure the performance of large cap stocks in Australia, Hong Kong, New Zealand and Singapore.
China & HK	The MSCI China Index is a free-float weighted equity index, representing Chinese companies listed in Hong Kong, as well as American Depository Receipts listed in the US. MSCI HK Index is a free-float weighted equity index, representing HK companies listed in HK.
Emerging market	MSCI Emerging Markets Index, which is free-float adjusted and weighted by market capitalization. The index is designed to measure equity market performance of 22 emerging markets.

Asset allocation definitions

Bonds	
Developed sovereign	Citi World Government Bond Index (WGBI), which consists of the major global investment grade government bond markets and is composed of sovereign debt, denominated in the domestic currency. To join the WGBI, the market must satisfy size, credit and barriers-to-entry requirements. In order to ensure that the WGBI remains an investment grade benchmark, a minimum credit quality of BBB–/Baa3 by either S&P or Moody's is imposed. The index is rebalanced monthly.
Emerging sovereign	Citi Emerging Market Sovereign Bond Index (ESBI), which includes Brady bonds and US dollar -denominated emerging market sovereign debt issued in the global, Yankee and Eurodollar markets, excluding loans. It is composed of debt in Africa, Asia, Europe and Latin America. We classify an emerging market as a sovereign with a maximum foreign debt rating of BBB+/Baa1 by S&P or Moody's. Defaulted issues are excluded.
Supranationals	Citi World Broad Investment Grade Index (WBIG)—Government Related, which is a subsector of the WBIG. The index includes fixed rate investment grade agency, supranational and regional government debt, denominated in the domestic currency. The index is rebalanced monthly.
Corporate investment grade	Citi World Broad Investment Grade Index (WBIG)—Corporate, which is a subsector of the WBIG. The index includes fixed rate global investment grade corporate debt within the finance, industrial and utility sectors, denominated in the domestic currency. The index is rebalanced monthly.
Corporate high yield	Bloomberg Barclays Global High Yield Corporate Index. Provides a broad-based measure of the global high yield fixed income markets. It is also a component of the Multiverse Index and the Global Aggregate Index.
Securitized	Citi World Broad Investment Grade Index (WBIG)—Securitized, which is a subsector of the WBIG. The index includes global investment grade collateralized debt denominated in the domestic currency, including mortgage -backed securities, covered bonds (Pfandbriefe) and asset -backed securities. The index is rebalanced monthly.

Indices	
CFETS RMB Basket Index	The China Foreign Exchange Trade System (CFETS) RMB currency basket measures the RMB versus foreign exchange currency pairs listed on CFETS. This index refers to the currency basket accepted by CFETS and the 13 currencies which make up the basket were selected based upon international trade-weights with adjustment of re-export trade factors.
DXY Dollar Index	The U.S. Dollar Index (USDX) indicates the general international value of the USD. The USDX does this by averaging the exchange rates between the USD and major world currencies. The ICE US computes this by using the rates supplied by some 500 banks.
ADXY Index / Asian Currency Index	This Bloomberg JPMorgan Asia Dollar Index is a trade and liquidity weighted index of 10 EM Asian currencies' exchange rate versus the US dollar.
Bloomberg Barclays Multiverse Total Return Index	The Multiverse Index provides a broad-based measure of the global fixed-income bond market. The index represents the union of the Global Aggregate Index and the Global High-Yield Index and captures investment grade and high yield securities in all eligible currencies.
Bloomberg Barclays Asian-Pacific ex-Japan local currency bond index	The Bloomberg Barclays Asian-Pacific Non-Japan Total Return Index Value Unhedged USD is a market capitalisation weighted index and measures the performance of local currency denominated government-related and corporate bonds of the Asia ex-Japan region.
iBoxx Asian US dollar Bond Index	Markit is a global index provider which is involved in designing, administering and calculating this index that covers USD segments of Asian fixed income markets.
CRB Industrial Commodities Price Index	A Thomson Reuters/Core Commodity Excess Return Index which uses an arithmetic average of commodity futures prices with monthly rebalancing.
CRB Industrial Metals Index	This data represents Commodity Research Bureau BLS Spot Indices (1967=100). The metals sub-index includes aluminum, copper, gold, iron ore, nickel, silver and steel rebar.
MSCI Asia ex-Japan Index	The MSCI Asia ex-Japan Index captures large- and mid-cap representation across 2 of 3 Developed Market countries (excluding Japan) and 9 Emerging Market countries in Asia. With 955 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. DM countries in the index include: Hong Kong and Singapore. EM countries include: China, India, Indonesia, Korea, Malaysia, Pakistan, the Philippines, Taiwan and Thailand.

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Bond rating equivalence

Alpha and/or numeric symbols used to give indications of relative credit quality. In the municipal market, these designations are published by the rating services. Internal ratings are also used by other market participants to indicate credit quality.

Bond credit quality ratings	Rating agencies		
Credit risk	**Moody's[1]**	**Standard and Poor's[2]**	**Fitch Ratings[2]**
Investment Grade			
Highest quality	Aaa	AAA	AAA
High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

1 The ratings from Aa to Ca by Moody's may be modified by the addition of a 1, 2, or 3 to show relative standing within the category.
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Changes in Regulatory or Tax Treatment of Energy Related MLPs. If the IRS changes the current tax treatment of the master limited partnerships included in the Basket of Energy Related MLPs thereby subjecting them to higher rates of taxation, or if other regulatory authorities enact regulations which negatively affect the ability of the master limited partnerships to generate income or distribute dividends to holders of common units, the return on the Notes, if any, could be dramatically reduced. Investment in a basket of Energy Related MLPs may expose the investor to concentration risk due to industry, geographical, political, and regulatory concentration.

Mortgage-backed securities ("MBS"), which include collateralized mortgage obligations ("CMOs"), also referred to as real estate mortgage investment conduits ("REMICs"), may not be suitable for all investors. There is the possibility of early return of principal due to mortgage prepayments, which can reduce expected yield and result in reinvestment risk. Conversely, return of principal may be slower than initial prepayment speed assumptions, extending the average life of the security up to its listed maturity date (also referred to as extension risk).

Additionally, the underlying collateral supporting non-Agency MBS may default on principal and interest payments. In certain cases, this could cause the income stream of the security to decline and result in loss of principal. Further, an insufficient level of credit support may result in a downgrade of a mortgage bond's credit rating and lead to a higher probability of principal loss and increased price volatility. Investments in subordinated MBS involve greater credit risk of default than the senior classes of the same issue. Default risk may be pronounced in cases where the MBS security is secured by, or evidencing an interest in, a relatively small or less diverse pool of underlying mortgage loans.

MBS are also sensitive to interest rate changes which can negatively impact the market value of the security. During times of heightened volatility, MBS can experience greater levels of illiquidity and larger price movements. Price volatility may also occur from other factors including, but not limited to, prepayments, future prepayment expectations, credit concerns, underlying collateral performance and technical changes in the market.

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