Private Bank

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Asia Strategy

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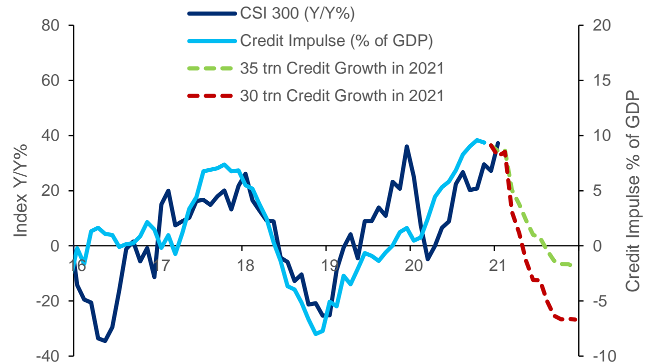
China: Beyond 2015 and Hello 2007

- After 36% returns in 2020, Chinese equities reclaimed the 2015 high in early 2021, with the 2007 peak within sight. Investors are concerned about a bubble.
- **We see several supportive factors, including stronger fundamentals**, not just from cyclical earnings recovery (**Figure 1**), but also better long term prospects. **Valuations** are no longer cheap, but they remain consistent with earnings. **Foreign fund inflows** are strong, supported by low US interest rates and weak USD, as well as foreign institutional investors allocating to quality growth in China.
- **The main risk comes from domestic credit impulse likely turning downward** (**Figure 2**). The 2016-17 rally ended three months after credit impulse peaked. This time, the credit peak may have been last November. This may leave overall index vulnerable, while sector rotation takes place. The bull market could return after credit conditions normalize, as evidenced in 2019-20.
- **We remain committed to the cyclical recovery across the region, which is likely more visible in Southeast Asia this year.** Still, given improved fundamentals, we remain committed to China's positive longer term prospects beyond near term volatility.

Figure 1: China's export growth recovered sharply in 2020, which also points to stronger EPS growth in 2021

Source: Bloomberg, as of 11 Jan 2020

Figure 2: Credit Impulse suggest less support for equities from domestic credit in coming months



Note: Estimates based on assumptions of 35tn or 30tn new credit in 2021 and normal seasonal patterns. Source: Bloomberg, as of Nov 2020

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China: Beyond 2015 and Hello 2007

After significant equity rallies, we see 3 main supporting factors for China, along with a key headwind

Chinese equities led global markets in 2020 and has surpassed the 2015 peak at the start of 2021, with the 2007 all time peak within sight. Investors are worried about another bubble. Looking at the underlying earnings growth, valuation and fund flow trends, we believe the rally is well supported and we remain long term positive on Chinese equities.

However, looking at the policy and credit backdrop, we also see some headwinds, which could lead to volatility in the coming months. But the bull market may resume after credit conditions stabilize, as stronger market fundamentals remain in place.

While recovery from pandemic continues, we expect Southeast Asian markets to outperform

Even though there are legitimate concerns over credit conditions in China, we believe the recovery from the pandemic in the rest of Asia would remain powerful. This favors laggard markets like Southeast Asia and industries like Energy, Financials and Industrials.

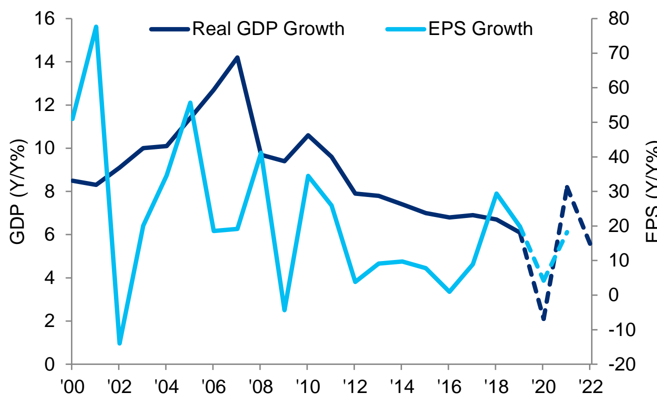
Earnings growth to rise more along with economic recovery

Thanks to the pandemic and expected recovery, China's GDP growth is likely to bounce from 2.1% in 2020 to 8.2% in 2021 (**Figure 3**). The majority of the pickup would likely come from consumption, particularly in services, which was the hardest hit in 2020. This would be taking place as exports are already booming from a 15% decline in early 2020 to a 15% growth by 4Q (**Figure 4**).

China's earnings recovery is likely to continue, with the largest improvements in cyclical sectors

This swing may be easy to spot, but consensus earnings growth expectations are 4.2% in 2020 and 18.2% in 2021, a much milder EPS swing than implied by either GDP or exports. Compared to 2015, when GDP and EPS growth were both falling, the current rally is better supported fundamentally.

Figure 3: China's GDP growth is expected to bounce from 2.1% to 8.2%, while consensus EPS expectations show much smaller swing



Source: Haver Analytics, Citi Research forecasts, MSCI Consensus EPS growth, as of 4 Jan 2021.

Figure 4: China's export growth has recovered sharply in 2020, which also points to stronger EPS growth in 2021

Source: Bloomberg, as of Dec 2020.

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The sectors that are likely to see the biggest earnings swings like Energy and Industrials have lagged in 2020 and are candidates for some catching up in performance (**Figure 5** and **Figure 6**). Healthcare's rally and earnings path appear consistent with performance. Financials are likely to benefit from recovery as well, especially for insurance, while banks are likely to still see mediocre growth.

The Consumer Discretionary sector performance is driven by the high flying e-commerce and electric vehicles, while consumer services remain lagging. In 2021, we

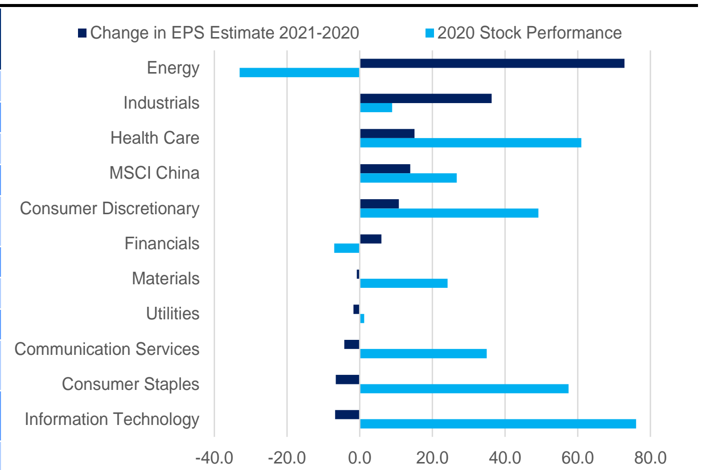
expect the lagging part of this sector to lead, partly because of the recovery, and partly because of regulatory issues associated with e-commerce platforms. The pending anti-trust and financial regulations are likely to hold back performance for the large e-commerce platforms in the near term, but likely would not affect their longer term development significantly.

Figure 5: Most Chinese equity sectors are expected to see strong growth in 2021

	Earnings Growth Estimate			2020 Stock Performance
	2020	2021	Change	
Energy	-44.0	28.9	72.8	(33.0)
Industrials	-10.6	25.7	36.3	8.9
Health Care	30.1	45.2	15.1	61.0
MSCI China	4.2	18.2	13.9	26.7
Consumer Discretionary	26.1	36.8	10.8	49.2
Financials	9.7	15.7	5.9	(7.0)
Materials	17.4	16.7	-0.8	24.2
Utilities	14.1	12.4	-1.7	1.2
Telecom Services	19.9	15.6	-4.3	35.0
Consumer Staples	25.9	19.3	-6.6	57.5
IT	32.7	25.9	-6.7	76.0

Source: Bloomberg, MSCI Consensus EPS growth, as of 1 Jan 2021.

Figure 6: Sectors with largest earnings swings like Energy and Industrials may catch up in performance



Source: Bloomberg, MSCI Consensus EPS growth, as of 1 Jan 2021.

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Telecom services sector performance is dominated by Tencent and its peers, but it also contains the traditional providers currently being delisted by the NYSE and removed from global benchmarks. These have been some of the worst performing names in 2020 and there may be a potential tactical opportunity, as buyers from China are likely to move in to replace the US investors.

US-China tensions are likely to stabilize somewhat after Trump leaves office

There remain some worries about the US-China relationship, as the last days of Trump saw a slew of attacks on Chinese firms listed in the US. Here, we highlight two main points:

- The Biden administration likely intends to stabilize the relationship and would unlikely prioritize immediate economic and financial decoupling. The Trump executive orders that have not yet been implemented (sanctions against tech companies for example) have lower odds of execution under a Biden administration and a Treasury led by Janet Yellen. This is especially so since the investment bans did not get written into the National Defence Authorization Act in 2020.
- The delisting of telecom firms and the investment ban on firms related to the military may continue, as are other potential delisting of ADRs under the Holding Foreign Companies Accountable Act. However, the selling pressure generated from these actions are likely to be offset to a great extent by buying from China elsewhere.

Delisting of military affiliated companies and ADRs for accounting purposes could create near term drag, but unlikely to have lasting impact as there are other buyers

Valuations have closed the historic discount, but are not stretched

Looking at valuations, investors would easily note that both offshore (H-shares and ADRs) and onshore (A-shares) Chinese equities are at the highest in more than a decade (**Figure 7**).

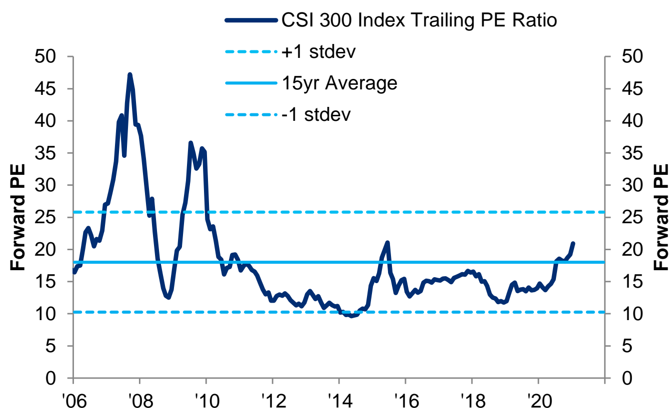
But this alone does not prove overvaluation. The index components have had revolutionary changes, with tech driven high growth companies taking up nearly two thirds of the index now, versus less than one third just ten years ago. While low growth sectors have shrunk. This has affected the offshore market a lot more than the

Even after the 2019-20 rally, Chinese valuations remain consistent with earnings, and are still at deep discount to US

onshore listed equities, which boosted the MSCI China valuations more than for the CSI 300.

In both cases, the expected long term growth for earnings is higher now than during the valuation swamp that Chinese equities experienced during 2011-18 (**Figure 7**). Even after the 2019-20 rally, Chinese equity valuations remain 25% below that of the US (**Figure 9**)

Figure 7: A-share PE has risen above 2015 levels, but remain close to historical average



Source: Bloomberg, as of 7 Jan 2021.

Figure 8: The MSCI China index had added far more tech components in the past decade, which boosted valuations more than for the A-shares market

Source: Bloomberg, as of 7 Jan 2021.

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EPS has doubled since 2007, while the index level is 6.5% lower (**Figure 8**). With the notable exception of 2007, A-shares had been fluctuating in a wide but upward trending range. Today's level is near the high end of the range, but still inside the range, especially considering the likely over 20% growth in EPS in 2021.

Looking forward, China's long term plan of investing in technological self sufficiency and sustainable development would continue to attract capital. Favoured industries would include, 5G, AI, e-commerce, green energy, electric/autonomous vehicles, fintech, industrial automation and consumer brands.

Figure 9: Despite recent rally Chinese equities remain at about 25% discount to the US

Source: Bloomberg, as of 7 Jan 2021.

Figure 10: The Chinese equity rally has not outpaced earnings nearly as much as in 2007

Source: Bloomberg, as of 7 Jan 2021.

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Fund flows and currency remain supportive

Foreign investors have begun to invest in quality growth industries in China, but cumulative inflows remain small

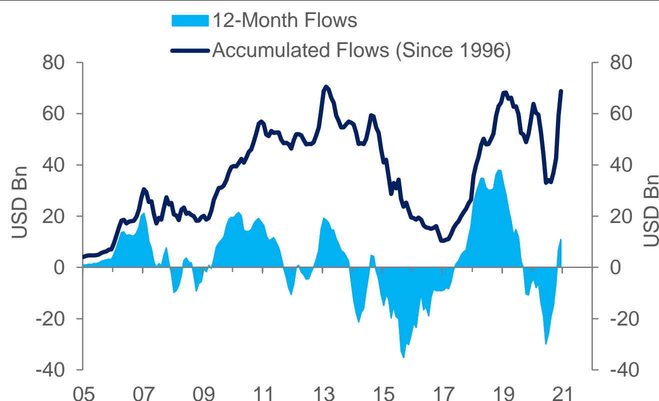
Foreign investors are increasingly keen to capture the emergence of sustainable growth industries in China. This has accelerated in 2020 thanks to CNY currency strength and cheap USD financing. A long term implication is that Chinese equities will be increasingly owned by institutional investors.

In the last four months of 2020, flows to China focused ETFs and mutual funds amounted to $35bn, after $25bn of outflows in the prior eight months, according to EPFR data. This is significant especially considering the US government's multiple efforts to prevent US investors from buying various types of Chinese equities. US-China tensions have pushed more investors to HK, rather than reduce overall investor interest. Yet, even after the latest inflows, cumulative flows into China funds amounted to less than $70bn in the EPFR dataset, which is only about flat with 2013 levels (**Figure 11**). As a comparison, cumulative flows to Japan funds were $388bn.

Cheap borrowing cost and weaker USD are aiding inflows

Foreign investors' enthusiasm is also buoyed by cheap USD funding and a strong Chinese currency. The rush for quality assets applied just as strongly for Chinese equities, as it did for US ones. The weaker USD provided an additional boost to returns, with the yield gap between US and China pointing to still stronger CNY of 6.10 to 6.20 area (**Figure 12**).

Figure 11: Inflows to China ETFs and mutual funds had been strong in late 2020 despite US tensions, but still only just returned to 2013 levels



Source: EPFR Global, Haver Analytics, as of Dec 2020.

Figure 12: Yield gap between US and China suggest further CNY strength to 6.10 to 6.20 area

Source: Bloomberg, as of 7 Jan 2020.

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Domestic credit and policy risks may present some headwinds

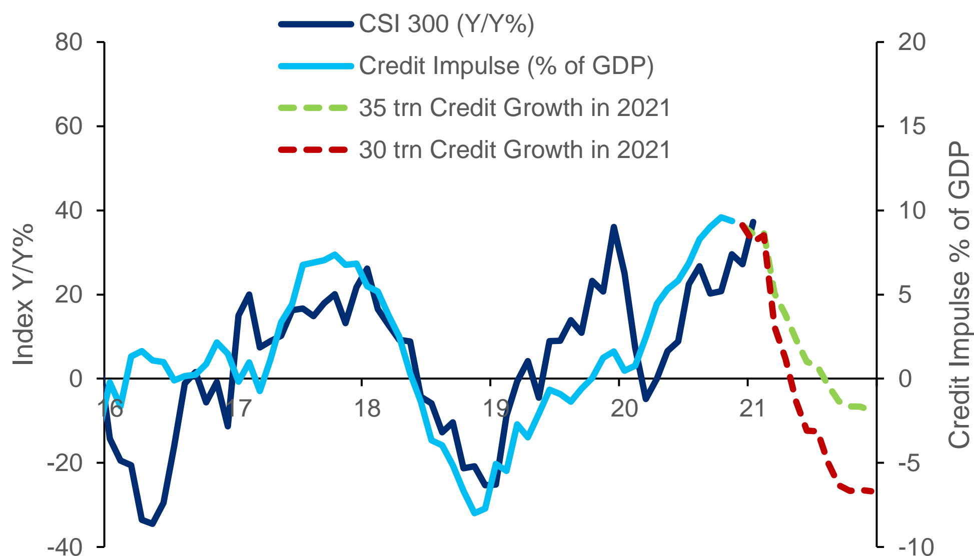
The key risk is when and how will the monetary backdrop change, both by the PBOC and the Fed.

We watch potential changes in credit conditions for signals of near term caution

For the Fed, its preference for higher inflation than 2% remains a key policy anchor. There could potentially be some odds for slowing down the monthly purchases if the Democratic controlled government steps up stimulus, but its balance sheet is still likely to expand well into 2022. As for rate hikes, 2023 is still the earliest possible timing. In sum, we are not too worried about the status of cheap USD financing. This would continue to support foreign fund flows.

The direction of China's domestic credit, however, could be more prone to change. In 2020, aggregate financing increased by CNY 35 trillion, or 34% of GDP. The so called credit impulse amounted to 9% of GDP and contributed to the remarkable 36% rally in the CSI 300 index.

Figure 13: Credit Impulse suggest less support for equities from domestic credit possibly from 2Q



Note: Credit Impulse is the change in aggregate financing over the past 12 months, as % of GDP. Source: Haver Analytics, as of 7 Jan 2021.
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During the 2016-17 rally, credit impulse had a similar swing from negative to positive, peaking in October 2017. Then equities peaked 3 months later in January 2018 (**Figure 13**). This time, the credit impulse may have just peaked in November 2020.

Current conditions for credit impulse appear similar to early 2018, which preceded visible correction in Chinese equities

Chinese authorities are unlikely to tighten credit policy in a significant way, as the economy has still not fully recovered. Meanwhile, 2021 is the 100th anniversary of the founding of the Chinese Communist Party, which is a key milestone for the leadership. There would be major efforts to contain both downside economic risks and overheating risks. As a result, keeping credit expansion steady is probably the preferred path rather than substantial moves in either direction.

Pressure from credit impulse may become more visible in late 1Q to early 2Q

Still, if the pace of credit expansion were to remain the same as in 2020, or about CNY35 trillion, then we're likely to see credit impulse moderate in 2021. If authorities were to decide to trim credit growth, to perhaps a still large CNY30 trillion, then the gap to current index levels becomes wider (**Figure 13**). In 1Q, credit growth typically remains robust as that is when the most refinancing is done for the year. But there could be more concerns in 2Q.

As noted above, earnings growth, valuations, fund flows and cheap USD funding remain supportive of Chinese equities. Being at the start of a new business cycle also provides cyclical upside. As a result, the relationship between equities and domestic credit may be evolving.

But we believe credit conditions would ultimately stabilize and the bull market can resume after consolidation

The macro credit conditions could create some near term consolidation, but the bull market could resume after credit conditions stabilize. We remain positive on the long term prospects for Chinese equities. For the CSI 300, we suspect that the index could return towards the middle of the upward trending range in **Figure 8**, but would retain the upward trend, thus providing an opportunity.

Asian regional recovery intact

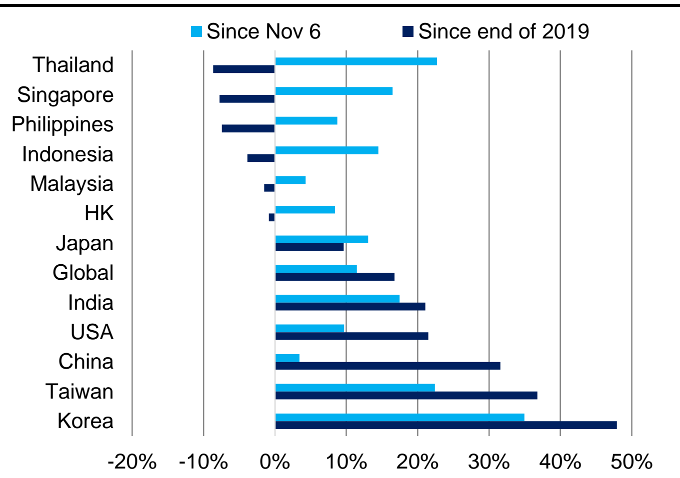
A moderate rationalization of credit would not stop the recovery in China, nor in the region more broadly. In this backdrop, the rest of Asia could potentially be catching up in terms of equity performance.

Figure 14: Asian GDP growth is likely to swing back to above trend in 2021

	2020E	2021E	Change
India	-8.0	11.0	19.0
Philippines	-7.9	7.0	14.9
Thailand	-8.6	4.0	12.6
Malaysia	-5.0	7.0	12.0
Singapore	-7.0	5.0	12.0
Hong Kong	-6.3	3.5	9.8
Japan	-5.4	2.0	7.4
China	2.1	8.2	6.1
Indonesia	-2.1	3.6	5.7
South Korea	-1.4	3.0	4.4
Taiwan	1.7	3.6	1.9
ASEAN	-6.1	5.3	11.4
EM Asia ex-CN, TW, SK	**-6.5**	**7.8**	**14.3**

Source: Haver Analytics, Citi Research forecasts, as of Dec 2020.

Figure 15: Southeast Asian equity market performance lagged in 2020, but is catching up



Source: Bloomberg, as of 7 Jan 2020.

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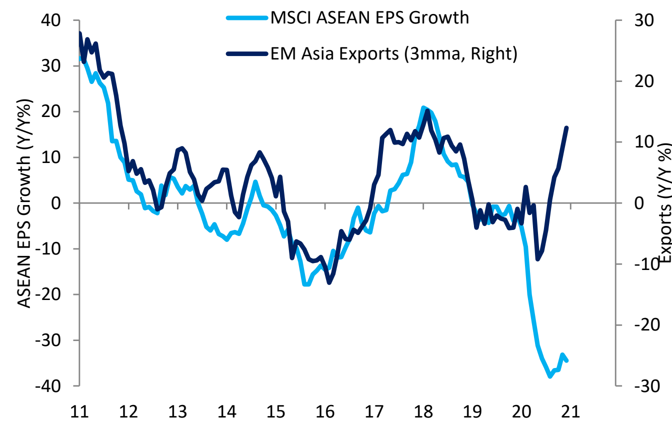
In 2020, Southeast Asia, along with India and even Japan, had economic contractions of 5 to 9%, much worse than China's 2% growth. In 2021, China is still expected to be leading the pack at 8.2% (second only to India), but the swing would be much stronger in the more vulnerable markets (**Figure 14**). The more pronounced recoveries in Southeast Asia and Japan will likely translate into asset price performance.

Southeast Asian equities may outperform during cyclical recovery from pandemic, after lagging in 2020

The key risk to our view is if effective vaccines and treatments do not become widely available in the first half of 2021. However, even with possible delays, we would still expect ongoing progress towards economic re-opening. This goes not only for the economies that managed the pandemic most effectively, but also in the "vulnerable" group including India, where economies remained open despite high infection rates.

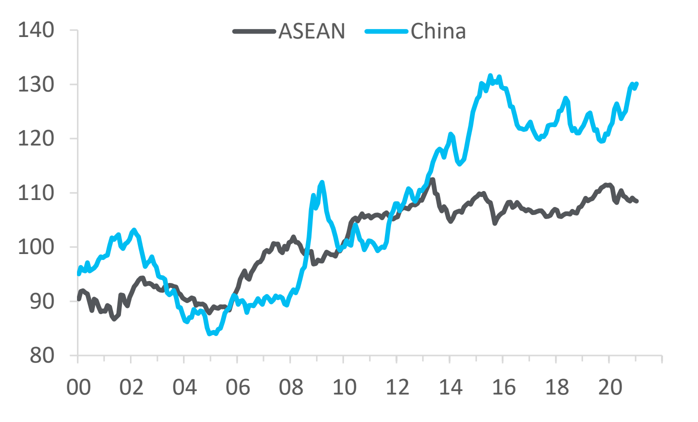
In 2020, China, Korea and Taiwan led equity performance not just in the region, but also globally, driven by effective pandemic management and heavy tech weightings. These advantages may fade in a broader recovery in 2021.

Figure 16: Export growth suggest substantial rebound in ASEAN earnings



Source: Haver Analytics, Citi Research forecasts, as of Dec 2020.

Figure 17: Real effective exchange rates of ASEAN had been broadly stagnant, while CNY strengthened



Source: Bloomberg, as of 11 Jan 2020.

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Meanwhile, Southeast Asia, even after the vaccine driven rally since November, are still lagging. This provides more room for upside surprises in 2021. Regional exports have already rebounded by 13% year-on-year as of Nov 2020, with further gains likely. We believe that this points to potentially above-30% earnings growth in these markets for 2021 (**Figure 16**).

Southeast Asian currencies have also lagged in performance, but could see some catch up

Moreover, in the environment of weaker USD and low US borrowing rates, Southeast Asia also stands to benefit more (**Figure 17**). Here ASEAN currencies had also been the laggards, not just during the pandemic, but also over the past decade. China's predominance in global supply chains and tech development contributed to this divergence. In the coming decade, there are likely more investments going to ASEAN, as firms try to diversify supply chains and the G2 powers compete for influence in this region.

Glossary

Terms	Definition
AxJ	Asia ex-Japan
AFC	Asian Financial Crisis (1998-99)
GFC	Global Financial Crisis (2008-09)

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.
2 The ratings from AA to CC by Standard and Poor's and Fitch Ratings may be modified by the addition of a plus or a minus to show relative standing within the category.

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