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Asia Strategy

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China: A Pivot to Easing, A Spur for Stronger Markets

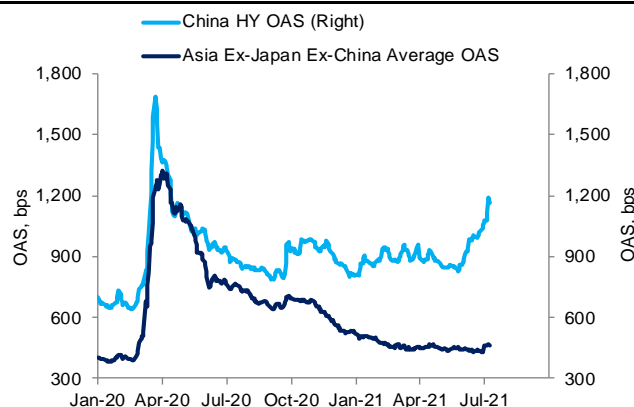
- A harrowing half year of policy tightening by China has left investors puzzled. As we said in early 2021, this wouldn't last, and we expected a dovish turn in 2H 2021.
- In the second week of July, China's central bank cut the required reserve ratio, after a significant rebound in credit expansion in June. We see these as a strong signal of a shift from "prudential tightening" to growth support. It likely marks a turning point for a better performance in China equities, as well as the high yield bond market.
- On the tech regulation front, we believe that the government aims to transition the internet and data businesses to a more sustainable model. This will see the sector post slower growth compared to the under-regulated hyper growth phase of the past decade. However, this won't preclude solid growth in demand for their services.
- Unlike the views seen in western press coverage, we believe the regulatory rules are largely set and the campaign is in a "tying up loose ends" phase. This would be consistent with central policy pivot towards supporting growth.

Figure 1: A bottoming in the credit cycle would typically mean a bottoming in equity valuations. We expect Chinese equities to strengthen in the second half



Source: Bloomberg, as of July 12, 2021

Figure 2: Chinese high yield credit spreads widened markedly to 1200bps, highest since last May. Easing credit policy would likely narrow these spreads just as markedly



Source: Bloomberg, as of July 12, 2021

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A Pivot to Easing, A Spur for Stronger Markets

China had implemented a jaw dropping series of tightening measures in the past half year. Sentiment towards the economy and financial markets has taken a heavy toll. We have had the view that this type of tightening cannot be sustained and the policy stance is likely to turn more accommodative in the second half (see [Asia Strategy | Darkness Before Dawn](#)). In the second week of the second half, we have already gotten the confirmation of such a dovish shift.

China's macro policies tend to move in tandem. When the senior leadership decided to squeeze bubbles at the turn of the year, monetary, fiscal, credit and regulators moved in tandem. Now, the same leadership decided that the economy needs help, it is likely to be implemented on all fronts too.

The State Council called for a cut in the required reserve ratio (RRR) to support the economy, which the central bank obliged three days later. Credit expansion already picked up in June. This is a major shift of policy priority from macro-prudential tightening to supporting economic growth. These types of turning points have historically been associated with higher valuations in both equities (**Figure 1**) and bonds (**Figure 2**). We expect stronger performance in both asset classes in the second half.

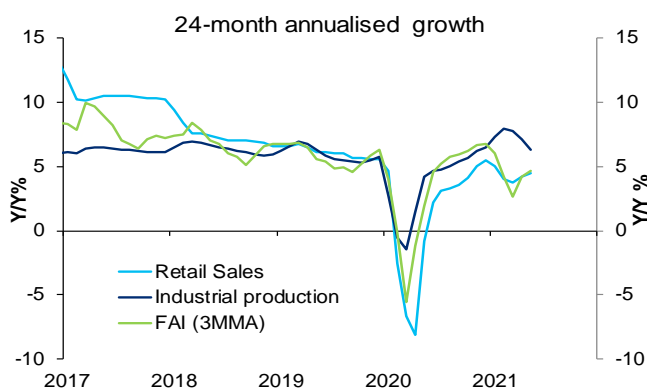
Most importantly, the market has priced substantial bad news. Earnings prospects have been setback by the higher cost of regulatory compliance. But the demand, both from consumers and from the stance of US-China competition, have not diminished. We believe the Chinese tech space is entering a stage of more sustainable growth, albeit at a lower rate. In this backdrop, the sector's valuation discount looks attractive.

Easing can prevent further growth deterioration

The easing came not just in the RRR cut, but also with substantial rebound in credit expansion in June. Some suspect that this may imply a much worse economic trajectory than previously thought. But **the worse economic outlook is a direct result of policy tightening, and a reversal of the policy would help to improve the outlook.**

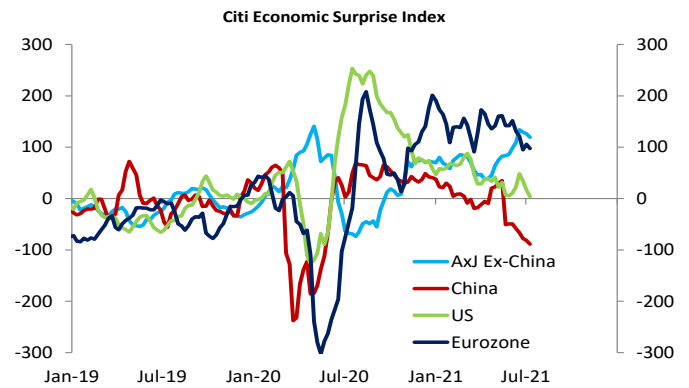
Indeed, growth was already slowing visibly. Rather than measuring y/y growth, which would still be above 8% in 2Q thanks to "base effects" from the year-ago period, we look at 24-month annualized growth to compare to the pre-pandemic pace. Industrial production (IP) growth remains at par with the pre-pandemic level, but is likely to taper off in 2H along with exports. Growth in retail sales and fixed investment are both below pre-pandemic levels as credit tightening had targeted consumer, property and local government financing (**Figure 3**). The Citi Economic Surprise Index showed that China is falling farthest below expectations. The US has also fallen to about par with consensus, while Europe and rest of Asia appear more buoyant (**Figure 4**).

Figure 3: China's economic growth is visibly slowing down amid tightening in 1H



Source: Bloomberg, as of May 2021

Figure 4: The extent of economic weakening was worse than expected and compared to other major markets



Source: Bloomberg, as of 9 July 2021

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Aggregate financing jumped to CNY3.67tn in the month of June, nearly double the year ago pace and well above expectations. When adjusted for seasonality, the bounce in aggregate financing in June was even more notable and came from a period of tightening that was deeper than the 2018 episode (**Figure 5**).

Among the different channels, the key highlight is bond issuance (**Figure 6**). Local government bond issuance jumped to CNY747bn, more than double the average monthly rate in Jan-May. This would provide a key source of funding for fixed investment in 2H. Corporate bond issuance amounted to CNY370bn in June, after a CNY134bn contraction in May. The drop in May came from a flurry of postponed issuance, as Evergrande struggled on the brink of default. **Reviving the credit market is critical to restoring confidence in the economy.**

Meanwhile, traditional bank loans amounted to 2.12tn, also exceeding expectations. But off-balance sheet bank financing, such as discount bills and trust loans, remained in contraction. This points to continued vigilance against shadow banking, rather than a complete reopening of liquidity flood gates.

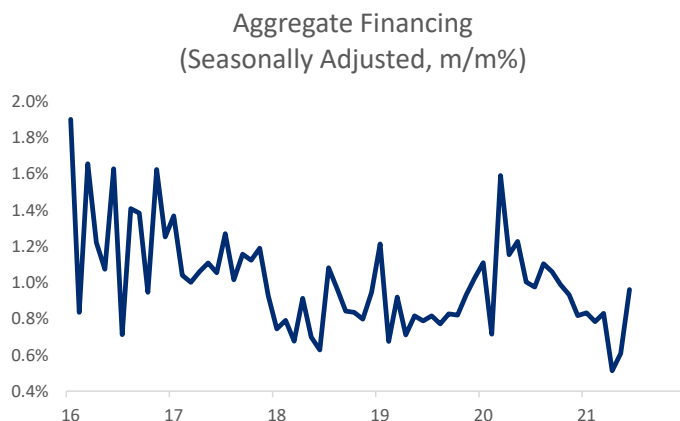
As we noted previously, new credit relative to GDP has shrunk by 7 percentage points from Nov 2020 to June 2021. This has dragged valuations of Chinese equities notably lower. The bottoming of this measure points to recovering valuations later in the year (**Figure 1**).

We believe the credit market is the primary direct beneficiary of the revival of corporate and local government bond issuance. Investors have been worried about credit risk in Huarong and Evergrande, as well as a collection of other highly leveraged issuers. The credit easing is unlikely to lift them out of trouble, but could buy them more time to “digest” problems. This would help to narrow the credit spreads that had widened markedly from 820bps in late May to 1200 bps in early July, which was the widest since May 2020 when the pandemic shut down the world. We see Chinese high yield credit as one of the key opportunities created by this round of easing (**Figure 2**).

In equities, the Financials sector is likely to be a main tactical beneficiary of this easing. Banks could get some relief from credit risk. Insurers may take a break from asset quality worries and see improved investment returns. Real estate may see temporary respite from the implementation of the three red lines. And brokers may benefit from the tightening overseas listing rules as more issuers and investors are likely to flow to HK/China.

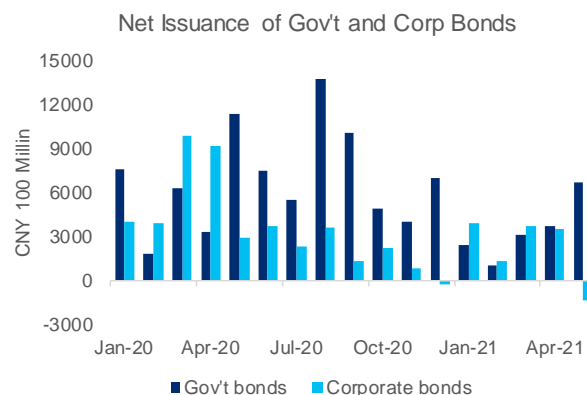
Monetary and credit easing are likely to benefit the high yield bond market most directly

Figure 5: The bounce in June was a significant turning point in credit policy



Source: Bloomberg, as of June 2021

Figure 6: The credit rebound is led by government and corporate bond issuance



Source: Bloomberg, as of 9 July 2021

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Is China killing its tech sector or just making it more sustainable?

A Historical Perspective

The pattern of boom and bust by policy has happened repeatedly in the past since China opened its economy in the early 1980s.

First, price liberalization led to an abundance of goods, but also hyper-inflation. Then manufacturing privatization led fast industrial expansion and mass unemployment. Creating the securities exchanges brought China into the norms of modern finance, but saw rampant speculation and volatility. Enabling local governments to finance fixed investment helped to build the nation's infrastructure but created a debt overhang. Property privatization led to household wealth gains, but sharp price increases threatened social stability.

In each case, a set of reforms and deregulation created a significant boom, which goes a bit too far. Then, a combination of oversight and regulation brought down initially fast growth but enabled sustainability, not only for the industry, but also for the economy as a whole.

The information industries are new and not a result of reforms, but the situation is ultimately similar in nature. Low regulation in a new industry enabled two decades of hyper growth. This growth created giants, whose practices threatened the authorities' ability to maintain social and political stability, as well as business leaders who overestimated their power and influence over policy. This is also taking place at a time when China's foreign relationships are becoming more challenging, with heightened sensitivity to security.

Similar to concerns over hyper-inflation or mass unemployment or social grievances, data security has just been added to the list of requirements for sustainability.

Tech could also see some relief, as the shift in policy stance may also be applied to tech regulation as China's macro policies tend to move in tandem. We believe that the government aims to transition the internet and data businesses into a more sustainable model. This will see slower growth compared to the under-regulated hyper growth phase of the past decade, but wouldn't stop the meaningful demand growth for the sector's services.

Before the intensive tightening of 2021, China was well behind the US and Europe in terms of regulatory environment for the technology and information industry. Business models hatched under an unregulated environment in a centrally controlled market of China's size were clearly not compatible and sustainable.

Data security had just been added as an essential element for sustainability. This is not unique to China. The US sanctions against China under Trump and carried over to the Biden administration highlight data as a national security issue. International cyber attacks have remained a common headline. Data security is a major policy issue across the globe, and could present potential headwinds for tech companies worldwide. China's approach has chilled investors, but it is also a necessary step to bring the industry into a state that could be sustainable in the political economic system in China.

As we noted previously, the antitrust and fintech rules are largely laid out. The data security regulatory environment is yet to be complete, which still leaves some vulnerabilities to tech equities. Still, we believe the regulatory rules are largely set and the campaign is in a "tying up loose ends" phase, which would be consistent with central policy pivot towards supporting growth.

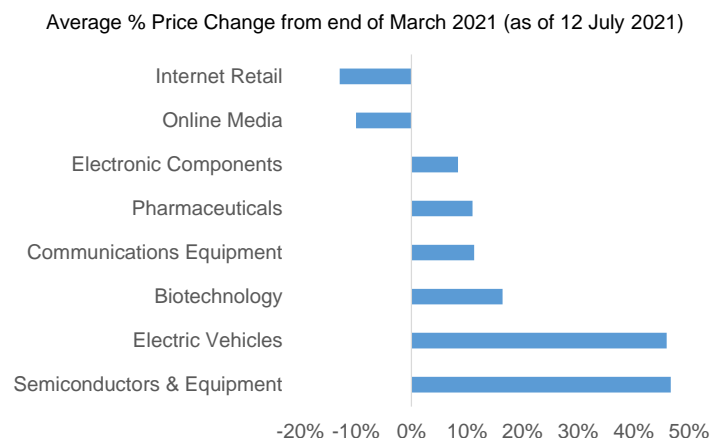
Does China still plan to compete with the US?

Of course, China does. Tech is still the most important arena. But this is also why regulation is necessary.

The ecosystem of the major platforms have increasingly relied on size and dominating market share. Tremendous innovation is taking place at the applications level, where every effort is made to attract additional hours of usage and spending. This may be the natural choice of business, but might not necessarily contribute to the type of technologies critical to competing on the global stage. A part of the rationale for regulating the "internet app culture" is to redirect innovative energy towards core technologies.

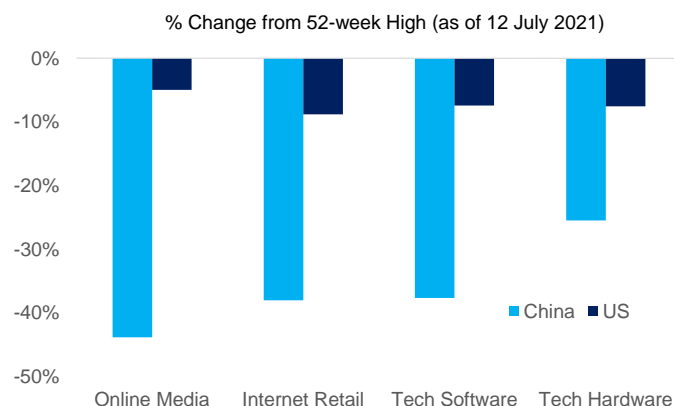
While the regulation of internet data intensified, hardware companies did not feel the wrath of the regulators at all. Industries like semiconductors, the electric vehicle (EV) supply chain and biotech may have suffered from market volatility, but not from regulatory tightening. In fact, since internet regulation accelerated in 2Q, the MSCI China IT sector index rose 6.3% (4 in 5 members gained), led by semiconductors & equipment (47%), telecom equipment (11%) and electronic components (8%). The EV industry gained 46% and the biotech industry added 16% (**Figure 7**).

Figure 7: Amid intensifying internet regulation, tech heavy hardware, EVs and healthcare equities rallied



Source: Bloomberg, as of July 12, 2021

Figure 8: Chinese tech shares have experienced much greater drawdowns than US counterparts



Source: Bloomberg, as of July 12, 2021

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Does regulation reduce demand?

Total consumption growth is slowing along with China's GDP growth, which is a natural development after the economy reached a large size. But there remains tremendous space for upgrades, as consumers seek higher quality products, more leisure, aspirational spending like environmentally friendly products, and of course a longer life and better healthcare.

These trends are consistent with ageing demographic and more advanced urbanization. Online delivery of these products and services would remain the clear path forward.

Even though total retail sales growth has slowed to the 5-6% range, online sales are still growing at 12%. Cosmetics, sports products, media and culture products are still growing at a 15% pace or more.

Curbing monopolistic behavior and securing personal data does not take away from key trends in consumption.

Curbing monopolistic behavior and securing personal data do not take away from these trends in consumption. Companies who can develop business models to capture these trends can potentially continue to generate high growth, albeit with higher cost of compliance.

As a result of tightening policies, Chinese tech equities have taken significant drawdowns. On average, Chinese tech equities have fallen by 32% from this year's highs, while their US counterparts averaged about 7% (**Figure 8**). The performance gap is partly a result of the poor sentiment from regulatory uncertainties, and partly due to lower earnings growth expectations under a tighter regulatory environment.

We believe that new regulatory actions could take a softer approach in the second half, which would help to remove policy uncertainty and restore some sentiment. This could help to stabilize the market and generate a mild recovery. But the earnings expectations could take longer to recover, as investors and analysts may need to see 3Q-4Q results to get a clearer picture of the impact.

After the earning impact is clearer, investors are likely to again focus on potential demand growth. We see now as a good entry point for getting greater exposure to these developing trends.

Curbing VIEs could boost HK/China capital market

Chinese issuers of ADRs typically use the variable interest entity (VIE) structure. US authorities clearly saw this as a loophole for accounting standards. The Chinese regulators also see the VIE as a loophole for foreign ownership limits and, more recently, a loophole for data security controls.

But curbing VIEs could also help to enrich China's own capital market, which is being made more accessible to global investors. With narrower regulatory arbitrage firms would be more inclined to list in HK or China.

China has had long standing curbs on foreign ownership of Chinese companies, particularly in strategically important industries, which includes the broadly defined internet industry. But companies have been using the VIE structure to set up shell companies in some jurisdictions which allows for firms to transfer profits to the shell. These could then be listed in the US or HK or other jurisdictions for foreign investors to have access. Allowing this back channel was seen as a compromise for China away from easing foreign investment controls.

The VIE was never banned nor officially approved by Chinese regulators. With heightened sensitivity on data security, the VIE appears to be a major loophole in China's data security system. Now, China's Cyberspace Administration has been added to the regulators to oversee foreign listed firms and may play a role.

The increased scrutiny on foreign listings could benefit HK and mainland exchanges and boost China's efforts to develop its capital market. This is consistent with further opening up access to these markets and beefing up domestic regulation and investor protection oversight.

But the recent spate of regulatory tightening has raised investor concerns worldwide. If our views are correct, the fears may take some time to settle down.

Be Careful of ADRs

Our near-term and long-term optimism for Chinese equities does not apply to all areas. The US listed American Depositary Receipts (ADRs) are one such area. We believe investors should avoid companies that do not have a secondary listing and may be at risk of delisting either at the behest of Chinese or US regulators.

Well before the events surrounding the Didi IPO, US Congress had passed the "Holding Foreign Companies Accountable Act" (HFCAA) in Dec 2020, which requires ADR issuers to make accounts fully auditable to the US accounting oversight board. It also requires issuers to certify that it is not controlled by a foreign government and specifically declare the role of the Chinese Communist Party in the company. Those who cannot meet these requirements for three years will be forced to delist.

If the three-year period looked too long, the US Senate just passed a bill in June 2021 to bring the deadline up by one year. Negotiations between US and China on the HFCAA have not produced any compromise (such as joint audits) and the odds of reaching a potential compromise is dropping. ADR issuers would likely want to devise a solution well before the deadline.

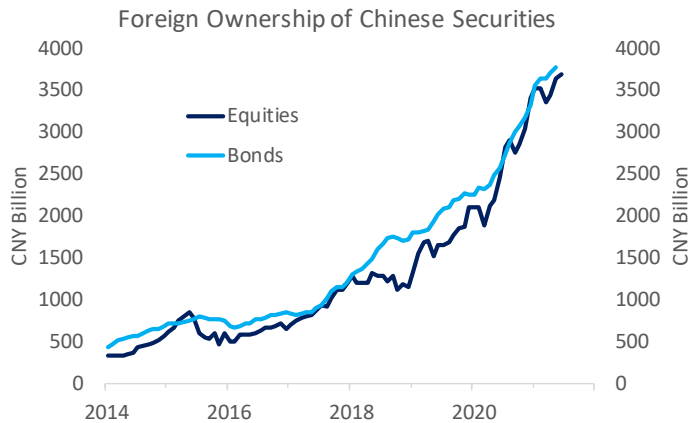
Fortunately, most ADRs already have secondary listings. Investors in these ADRs would find it relatively easy to transfer to HK listed shares. Most of those that do not have a secondary listing are eligible to list in HK and are likely to take that path, without going through privatization.

But there are some that do not meet the requirement of listing in HK, such as those that lack a profitability track record. These may need to be taken private by owners when delisting from the US. There may be downward pressure on the shares before they're taken private, as the owners would likely want to privatize more cheaply before relisting. Investors should avoid exposure to these companies.

Interestingly, despite the regulatory tightening, foreign investors have not given up on China. The performance setbacks in the past months did cause a small dip in foreign ownership of Chinese equities and no disruption to the rise in foreign ownership of Chinese bonds (**Figure 9**).

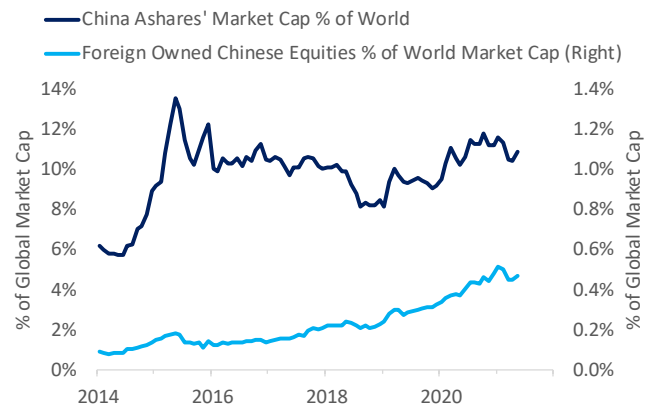
After the Connect programs opened in 2014, Foreign ownership of Chinese equities and bonds have risen 7-fold in value. However, that surge only totaled 0.5% of global equity market cap. Meanwhile, China's total market cap share is about 11% for A-shares and 4-5% for HK and US listed shares (**Figure 10**). The large gap in foreign ownership of Chinese securities is still likely to narrow in the future.

Figure 9: After the Connect programs opened in 2014, Foreign ownership of Chinese equities and bonds have risen 7-fold in value...



Source: Haver Analytics, as of June 2021

Figure 10: ...But that only added up to 0.5% of global market cap, while China's total market cap share is about 11% for A-shares plus 4-5% for HK and US listed shares



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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 Depositary 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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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		
	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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