Private Bank

Citi Global Wealth Investments
Asia Strategy Bulletin

December 23, 2021

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China's Policy Signal: It's what you've been waiting for

- In December, China's leadership shifted its policy stance to fully support growth, and "appropriately early". After the self inflicted pains in 2021 driven by a political drive to realign economic direction towards common prosperity, the leadership is pivoting to another major political goal—to ensure stability and restore growth ahead of the 20th Party Congress in 2022.

- We note that previous Party Congress years had produced positive credit impulse, as well as positive results for the equity market.

- Property related tightening have caused a dramatic decline in bond prices and economic growth. The easing of these policies will likely bring about a similarly notable recovery in 2022. Though default risks remain, we see financing access is being restored and would likely contain systemic risks. Property prices are falling, but likely limited as homebuyer leverage is low and would unlikely cause broad panic selling. The proposed property tax trials are likely to take over five years and would only apply to a small portion of home owners.

- We see a tactical opportunity in property sector bonds in 2022 amid easing. But their long term prospects remain fraught as there may be more rounds of deleveraging until the sector's capacity is more in line with demand.

- China's COVID policy is evolving from "zero tolerance" to "dynamic clearance". As Omicron has already entered China, potential tightening in COVID restrictions could slowdown economic activity in 1Q. However, we see gradually more flexible policy towards foreign visitors (with quarantine) and towards quarantine free travel between Mainland and HK as signs that China may be more resilient to future variants.

- In between two incompatible regulators, the Chinese ADRs face an uphill battle. Investors should shift to HK listed shares at the earliest. But potential delisting before 2024 should not detract dual listed firms' potential to recover earnings.

- As the rest of the world moves towards less policy stimulus and lower growth in 2022, China may be moving in the opposite direction. This may be cause for outperformance after a harrowing year of uncertainty.

For months, many investors can see that Chinese equity valuations are potentially alluring, but are hesitating because there had not been a clear catalyst of a turn in policy. We believe this turn had just taken place in December at the Central Economic Work Conference (CEWC). The PBOC and Insurance Regulatory Commission (CBIRC) already followed up by calling for more explicit support to property sector in the week of December 20. Still, there are fears that the pivot to easing might be too little too late, particularly as real estate credit risks continue to spread.

Naturally, policy changes take time to lift the economy, but the key here is that a political problem needs a political solution. The tightening in 2021 was a political drive to realign economic direction towards common prosperity and to affirm a clear leadership. Now, this leadership is pivoting to another major political goal—to ensure stability and restore growth ahead of the 20th Party Congress in 2022. The CEWC made this pivot very clear.

Main messages from the CEWC:

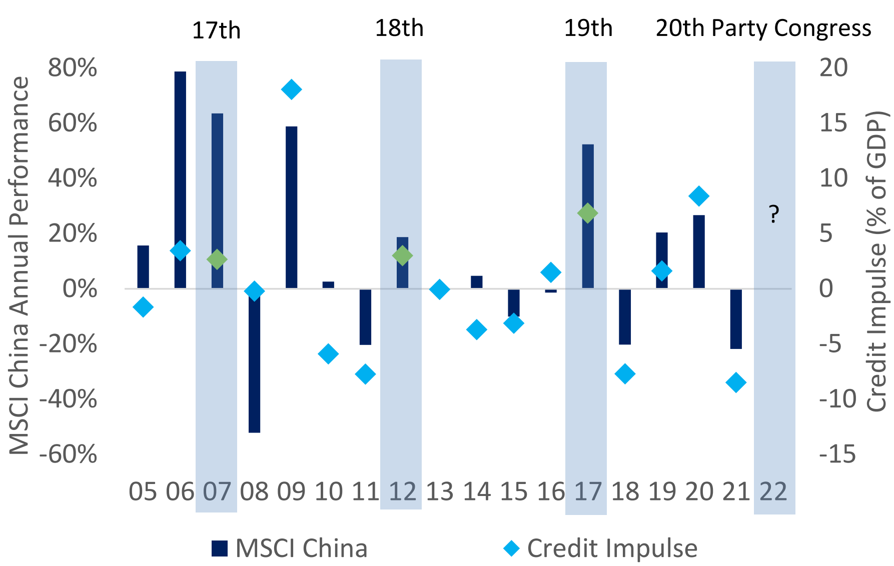
- **Recognizing the threat to growth**: "Triple pressures of demand contraction, supply disruptions and weakening expectations" amid a "more complex, severe and uncertain" external environment. 4Q 2021 is likely to see GDP growth to fall to about 3%y/y, or the lowest on record aside from the pandemic. Restoring this to a likely 5% target for 2022, would require significant policy help.

- **A political refocus towards growth**: In preparation for the 20th Party Congress in October 2022, the CEWC called to "keep the economy operating within a reasonable range". The word "stability" was mentioned 25 times in the statement. In fact, the last four Party Congress years all had strong equity performance. Not by coincidence, China's credit impulse also were positive during the Party Congress years, while most of the non-Congress years saw negative impulse or deleveraging, aside from 2009 and the pandemic (**Figure 1**).

- **Mea Culpa**: The CEWC called on officials to strengthen professional capacity to manage the economy, rather than simply conducting campaign style implementation of long term objectives. Many market observers had noted that local and mid-level officials were over-zealous in executing decabonization and common prosperity policies this year that had excessively hurt economic development. We believe this message seems a good start to address the problem.

- **Do it soon, everybody**: "All regions and departments shall assume responsibility for economic stability and proactively launch growth-supporting policies" and "policy should exert its impact appropriately early". This meeting took place just ahead of weak November data and additional woes in the real estate credit market.

Figure 1: Past Party Congress Years have seen strong equity performance



Source: Haver Analytics, as of Aug 2021. Credit impulse is the periodic change of total social financing as % of GDP. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. For illustrative purposes only. Past performance is no guarantee of future results. Real results may vary. All forecasts are expressions of opinion, are not a guarantee of future results, are subject to change without notice and may not meet our expectations due to a variety of economic, market and other factors.

Fiscal & Monetary policy implications

- Fiscal expansion is likely to focus on green transformation, industrial infrastructure reconstruction and logistics networks. There is likely to be additional local government bond quotas for 2022, while unused quota from this year is likely to be issued early in 2022. We have already seen a sequential month-on-month pickup in fixed asset investment in November driven mostly by manufacturing industries, while real estate and infrastructure remained in decline.

- Easier credit policy is already visible recently to offset the weakness in real estate. A second cut this year to the required reserve ratio (RRR) was announced just days ahead of the CEWC, after Premier Li Keqiang called for such a move at an earlier meeting. Additional easing is likely, which we expect would include interest rate cuts, additional credit easing for real estate, as well as for SMEs and de-carbonization efforts.

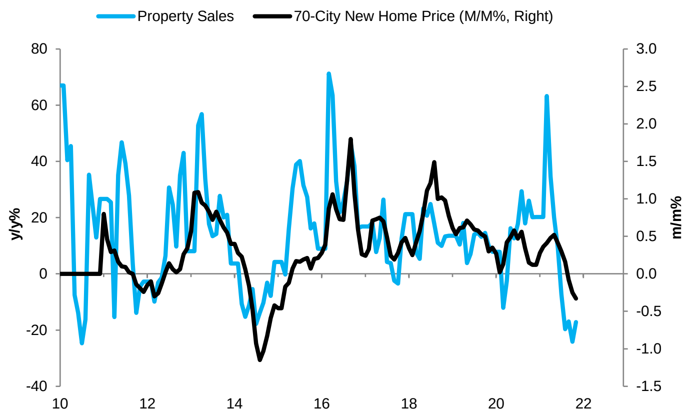
What does this mean for the property market?

- Property related policy tightening brought a dramatic decline in bond prices. The easing of these policies will likely bring about a similarly notable recovery in 2022. There remain acute credit risks among the highly levered developers, as market confidence has not recovered sufficiently to resume financing of the weaker developers. Still, financing for asset purchases by stronger issuers and for working capital is being restored, which would help to gradually ease financial conditions for the sector. There may still be defaults in 2022, but given the amount of policy attention, we believe that the risks of systemic fallout is well contained. On December 20, PBOC and CBIRC urged large private and state-owned property companies to acquire real estate projects from troubled developers, and urged financial institutions to strengthen financial support for such activities accordingly. China's National Development and Reform Commission (NDRC) reiterated economic stability and prevention of cross-sector risk transmission the following day. These all pointed to a more proactive policy support for property sector. Even prior to the CEWC, authorities have eased some pressure on the real estate sector, including more mortgage disbursements, re-opening the interbank bond market and the asset backed securities market for those with light leverage and good credit standing. Some local governments like Chengdu, Shanghai and Nanjing have eased restrictions on both the buyer and seller sides. With the CEWC call, more such easing are likely to come.

- Clearly, not all problems have been resolved. The fallout from one of the biggest developer's attempt to transfer capital from its stronger services unit to its troubled developer unit showed that even a BB+ issuer who have not crossed any "red lines" can also be under liquidity pressure. But at the same time, this is a new level of spillover to an area previously thought to be relatively safe. This is the type of spillover that should raise more alarms at financial authorities if they want to contain the negative impact on confidence and the broader economy. We see it as a catalyst to expedite easing measures, which may include some bailout deals for the developers who stayed inside the "red lines".

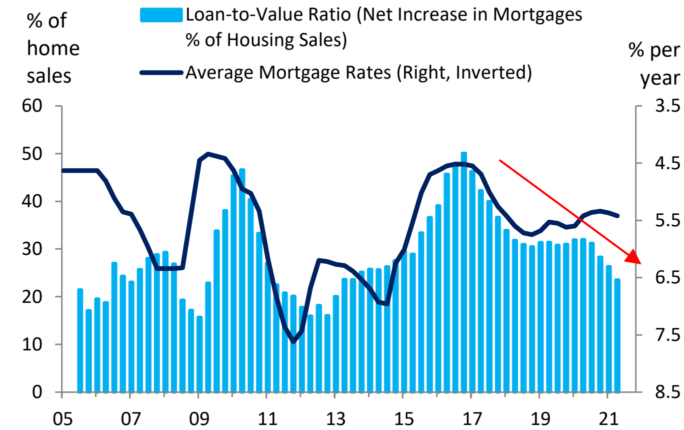
- In terms of **property prices**, there clearly are downside risks, but are more limited in our view because the tightening ultimately cuts back excess supply. In 2014-15, a more moderate decline in home sales caused a 7% drop in new home prices over 12 months. This time, there is likely to be greater impact depending on the duration of the sales decline (**Figure 2**). However, leverage of homebuyers is very low, with loan-to-value ratio of only 25% over the past year (**Figure 3**). This means that there would unlikely to be a major rush to sell due to negative equity.

Figure 2: In 2014-15, a decline in home sales led to a 7% decline in new home prices over 12 months. This time the drop in sales appears twice as intense as in 2014-15.



Source: Haver Analytics, as of Aug 2021

Figure 3: Mortgages only account for less than a quarter of new home sales in China, implying very low home buyer leverage, and hence little pressure from negative equity



Source: Haver Analytics, as of Aug 2021

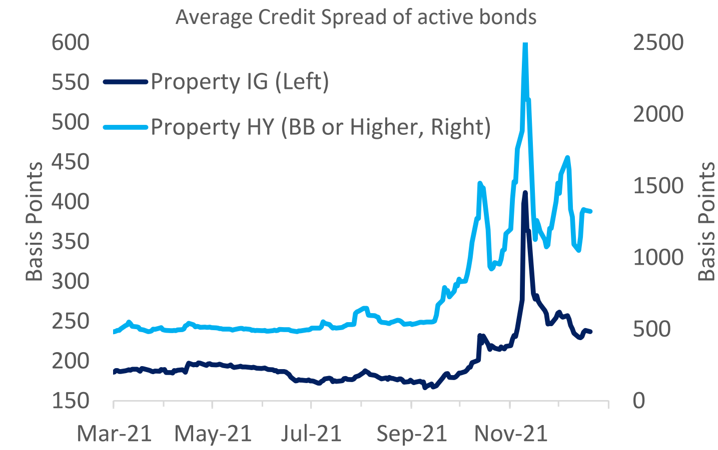
- **The potential property tax trials** are unlikely to cause major shock to property prices. The State Council's announced plan is to roll out more trials in some cities over the next five years. The increment in 2022 would be minimal if any. The plan would spare the first property and all rural properties. Then taxes would likely be progressive, targeting higher priced larger properties. The impact is likely to be broader than the Shanghai and Chongqing trials of the past ten years, but would likely be limited on a nationwide basis and would apply only to owners of multiple properties.

- **Overcapacity in the developer industry** has not yet been resolved. We estimate that the sector's annual underlying demand for new housing units amount to about 8-10 million, including about half each from newly formed households and from replacing old or demolished units. The industry is set to complete about 6 million units in 2021, which looks reasonable. But there are also 14 million new units started in 2021 and 64 million units currently under construction. Clearly, the overcapacity would require years to correct. Past attempts at curbing over development had been undermined by developers' collective desire to become too big to fail for the credit market. That mentality likely have changed after this year.

- In 2022, easing policies may bring a tactical opportunity to the property space. For those with strong balance sheets, a period of consolidation and shift towards the landlord business model is likely. We see REITs and property services as industries of growing investor interest, particularly those seeking dividend income. The bonds of these stronger developers are likely to see notable spread narrowing (**Figure 4**), as the severe dislocations and contagion fears would fade when financial conditions have improved.

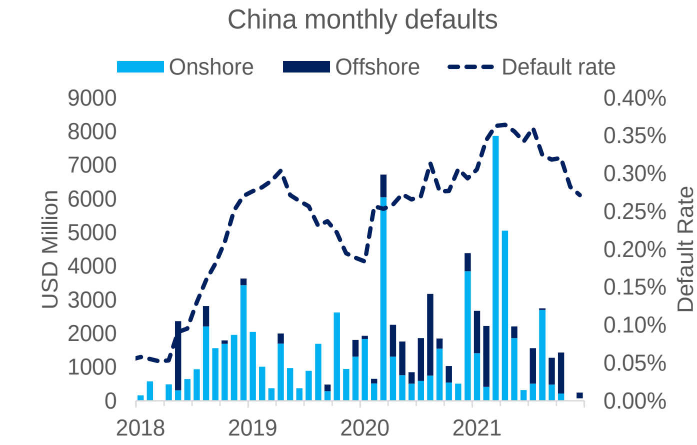
- Longer term, however, we would expect additional rounds of tightening. Developers who depend too much on leverage and turnover would continue to experience default risk in the medium to long run, until the development industry reaches a steady state with capacity likely at least 20% below where we are now. The next round of tightening may come when default risks are lower and other economic vitals are stronger (**Figure 5**).

Figure 4: Credit spreads have narrowed since authorities began easing policy in November, further easing is likely to bring further narrowing in 2022



Source: Haver Analytics, as of Aug 2021

Figure 5: Default rate in China shows little spillover so far, further drop is likely as policy turns to support growth in 2022, but more rounds of deleveraging may come later on



Source: Haver Analytics, as of Aug 2021

What does this mean for zero case policy?

- Two years into the pandemic, China's draconian COVID restrictions have evolved from strict "zero case" policy to a "dynamic clearance" strategy, with more emphasis on tracing and testing. Facing the emerging Omicron threat, China is likely to maintain most of its stringent COVID measures, as advocated by the State Council to "prevent imported cases externally, and suppress the resurgence internally". This suggests potential for another round of restrictions on domestic travel and movement. Similar to renewed restrictions being implemented in the US and Europe, economic growth may be hurt in China in 1Q if such restrictions materialize.

- The significantly more transmissible nature of the Omicron variant may pose renewed risks to reopening plans in the near term. The sudden shutdown of many factories in Zhejiang Province in Mid-December underlines such risks, though yet unrelated to Omicron. Over the past 10 days, Zhejiang has reported close to 300 locally transmitted cases, with roughly two-thirds in one district of Shaoxing. At least 20 listed companies in Zhejiang were told to suspend production, sparking fears of the economic cost under China's stringent Covid measures. The province accounts for 6% of China's total economy in 2020 and is a hub for manufacturing and exports.

- Moreover, the most commonly used vaccine in China from Sinovac had shown to have poor effectiveness against Omicron if taken two doses. A third dose has shown to lift effectiveness dramatically, but would take time to distribute. Having had largely closed borders for the past two years, China's population could be more susceptible to Omicron. Given that two cases of Omicron have already been found in China, the risks of further spread is meaningful. An outbreak plus related shutdown could drag activity in 1Q.

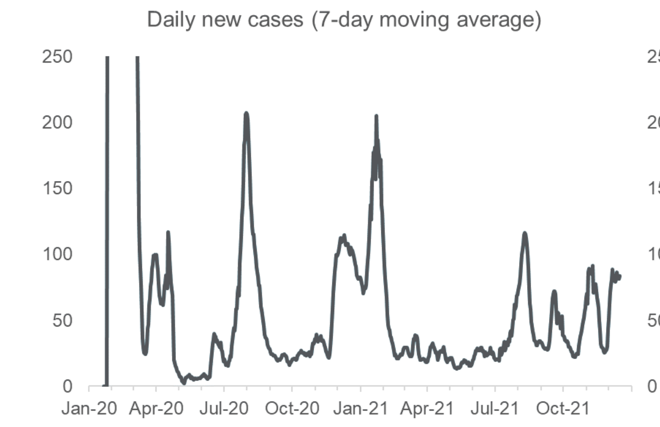
- Fortunately, there appears to be a sense of readiness to face the Omicron and future variants. According to Zhang Wenhong, an infectious disease expert who is one of China's most prominent advisers on Covid strategy, China's current rapid response strategy is capable of dealing with all types of new variants. China has enhanced its tracing and screening system since the start of the year. Movement in and out of high-risk areas (50+ local cases) are suspended. Along with China's widely adopted mobile phone tracing, resurgence of cases could be curbed sooner than before (**Figure 6**).

- In this backdrop, China is gradually easing its border restrictions to international travelers. These are still done with 2-3 weeks of government administered quarantine, but at least more people from outside of China may enter China if they choose to go through the quarantine. Since March 2021, those coming for work or for family from 23 countries can apply for visas, residents may also return. China also has a Fast Lane agreement with Singapore and South Korea. More quarantine facilities for foreign travelers have been built across the nation in preparation for the Winter Olympics.

- More importantly, the re-opening of limited quarantine free travel between Mainland and Hong Kong is about to begin in late December, despite the threat of Omicron. There remain uncertainties, as the reopening could be halted if scattered cases of Omicron turned into "cluster outbreaks". But it appears that the Chinese government has higher tolerance for cases this time around, as compared to several months ago when it required zero case for 14 days in Hong Kong as a precondition of reopening. Alternatively, China has tightened Covid screening and self-quarantine measures to satisfy prerequisites for border reopening.

- A more flexible COVID policy, as the virus becomes less lethal, would be consistent with the spirit of restoring growth. Each wave of COVID restrictions on mobility have caused less marginal impact on industrial activity (**Figure 7**), though retail impact is more visible. If there were to be COVID related shutdowns of industrial activity, there is also likely to be related fiscal and monetary policy help. If this takes place, we would expect e-commerce and "stay at home" enabling businesses to benefit the most.

Figure 6: Each wave of COVID in China has seen lower peak new cases and shorter duration, which reflect the more effective management strategies



Source: Haver Analytics, as of 17 Dec 2021

Figure 7: Each wave of COVID restrictions on mobility have caused less marginal impact on industrial activity

Source: Haver Analytics, as of 30 Nov 2021

What does this mean for ADRs?

- The fate of Chinese firms listed in the US, or American Depositary Receipts (ADRs), depends on how US and Chinese politicians. The US SEC plans to release a list of names that are on the forefront of delisting by Feb 2022. Even though the firms have until 2024 to actually delist if required, investors may choose to sell well before that. As such, we suggest investors to switch to HK listed shares whenever possible and to avoid ADRs that are sole listings.

- According to the Chinese securities regulator, negotiations are ongoing with its US counterpart. A greater policy emphasis on stability may also make negotiations more likely to progress. But there are fundamental differences between the regulators, as the US would like to ensure audit access to data and no ties with the Chinese government or with the Party, while the Chinese side want to ensure capital account and data security compliance. These are conflicting objectives in many cases.

- Still, the ADR situation does not deeply affect the companies' operations, especially if the vast majority of business is domestic. If earnings can begin to recover in 2022, it would likely lift invest interest again before actual delisting takes place. Even in this case, we would still prefer the HK listed shares of these companies whenever possible.

What does this mean for your portfolio?

- As we enter 2022, China is likely to be the only major economy easing policy, while the rest of the world removes stimulus, particularly in the US and other developed markets. China's economic growth is likely to be about 3% in 4Q, the lowest on non-pandemic record, and likely to rebound to about 5% that is likely to become the official target for 2022. The rest of the world is likely to see a moderate deceleration in growth.

- Regulatory policies towards the internet business and other common prosperity policies were tightening sharply in 2021, but are likely to at least stabilize in 2022. Firms have frontloaded a lot of related costs in 2021, such as the provisions for social responsibility funds. In 2022, we're likely to see earnings and analyst revisions bottom and begin to rebound. After all, even President Xi recognizes that the digital economy is the future of the country. China would continue to invest in cloud, AI, cybersecurity, fintech, semiconductors and all the building blocks of the metaverse. And of course, the evolution to green would also forge ahead.

- For investors who already have heavy exposure to Chinese equities and bonds, there may be potential opportunities to adopt strategies to reclaim 2021 losses more swiftly. For those who have too little exposure, we believe China represents a potential opportunity for outperformance in 2022.

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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
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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.

Alternative investments referenced in this report are speculative and entail significant risks that can include losses due to leveraging or other speculative investment practices, lack of liquidity, volatility of returns, restrictions on transferring interests in the fund, potential lack of diversification, absence of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than mutual funds and advisor risk.

Asset allocation does not assure a profit or protect against a loss in declining financial markets.

The indexes are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance.

Past performance is no guarantee of future results.

International investing entails greater risk, as well as greater potential rewards compared to US investing. These risks include political and economic uncertainties of foreign countries as well as the risk of currency fluctuations. These risks are magnified in countries with emerging markets, since these countries may have relatively unstable governments and less established markets and economics.

Investing in smaller companies involves greater risks not associated with investing in more established companies, such as business risk, significant stock price fluctuations and illiquidity.

Factors affecting commodities generally, index components composed of futures contracts on nickel or copper, which are industrial metals, may be subject to a number of additional factors specific to industrial metals that might cause price volatility. These include changes in the level of industrial activity using industrial metals (including the availability of substitutes such as manmade or synthetic substitutes); disruptions in the supply chain, from mining to storage to smelting or refining; adjustments to inventory; variations in production costs, including storage, labor and energy costs; costs associated with regulatory compliance, including environmental regulations; and changes in industrial, government and consumer demand, both in individual consuming nations and internationally. Index components concentrated in futures contracts on agricultural products, including grains, may be subject to a number of additional factors specific to agricultural products that might cause price volatility. These include weather conditions, including floods, drought and freezing conditions; changes in government policies; planting decisions; and changes in demand for agricultural products, both with end users and as inputs into various industries.

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