Private Bank

CIO Strategy Bulletin

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The Repricing of Chinese Equities

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Summary

Given that China went into and has come out of the pandemic six-months ahead of the rest of the world, its economy is ahead in normalizing to post-pandemic realities. Slower growth, transitioning back to pre-pandemic levels seems likely. Similarly, the pandemic beneficiaries in tech and retail will see slowdowns in their absolute growth rates. These expected events are partially to blame for China's recent negative equity performance. In addition, new regulations designed to promote competition among many leaders as well as caution about excessive credit expansion are sending signals that China is more worried about the long-run quality of its markets rather than the short term impacts these actions have on investor sentiment.

We see this cyclical shift in Chinese markets to be nearing its end and not a sign of continued distress. Thus, Chinese equities are nearer to a "buy" given their relative valuations, particularly in technology where China is determined to accelerate its innovation and development in competitive global industries. Given the significant size, earlier stage of development and comparatively younger demographics of its region, China has room to sustain growth for more than a decade.   This means that forward-looking valuations of its shares are favorable in our view.

The Repricing of Chinese Equities

Just as we have seen a recent repricing of tech shares in the US, we have also seen a repricing of tech and consumer shares in China. This negative performance was driven by a broad tightening in credit and regulatory policies that Citi Global Wealth Investments (CGWI) identified in January when we reduced our China allocation down from overweight to neutral.

The correction in Chinese equities appears much more advanced than in the US and have priced in a lot more potential bad policy news. Since February 17th, when global markets began to correct, MSCI China has fallen 18%, while A-shares were down by 10%. China is also among the few global markets that have recorded a year-to-date decline (Figure 1). This underperformance brings the MSCI China's forward PE ratio to **15x**, versus the US at **21x**. This 29% (China/US) valuation gap is about half standard deviation below the 15-year average reading (Figure 2).

Figure 1: Chinese equities underperformed the world since mid-February

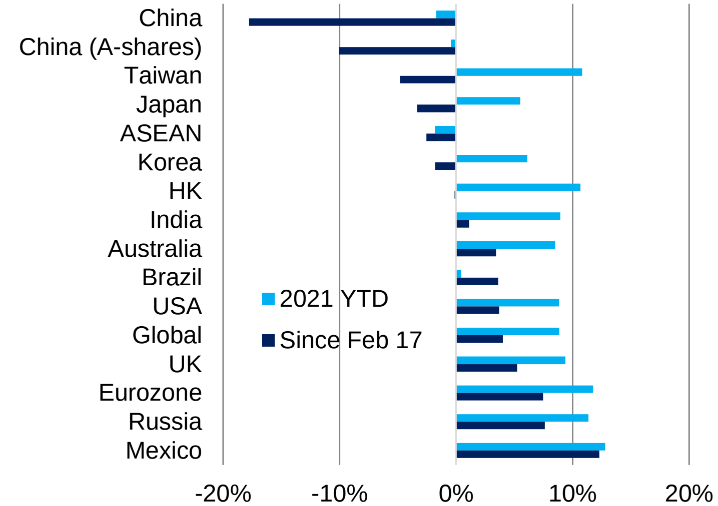


Figure 2: MSCI China forward PE is now 29% below that of the US

Figures are national MSCI indices. Source: Bloomberg, as of May 18, 2021. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future results. Real results may vary.

Sources of Concern: Credit Tightening and Regulation

The main culprits for the recent equity underperformance are active credit policy tightening and substantive regulatory changes.

On the credit front, there are general worries about certain corporate credits, such as Huarong, but overall credit conditions are not significantly worse. Aggregate new credit in the past 12 months up to April amounted to 29% of GDP, which is down from 34% last November. The reduction in new credit so far is consistent with the drop in valuations of Chinese equities. While a further decline in new credit to GDP would likely weigh-on equities, we estimate that the implied valuation impact of less credit in a period of rising earnings represents less than a 10% downside from current index levels (Figure 3).

In recent days, the market focused on Huarong, the troubled, systemically significant, state-owned manager of distressed assets. The New York Times published a story[1] that the government is contemplating a restructuring plan that would likely involve significant losses to bond holders, generating another bout of selling in Huarong paper. We believe authorities are more likely than not to find money to meet near term debt obligations, while seeking to dispose of assets and reduce counterparty risk over a prolonged period of time. Nonetheless, we believe that the Huarong issue requires close monitoring as it is systemically important (think Lehman) and any negative resolution would impact confidence in the overall system (see Asia Strategy | China's Credit Tightening Coming to Roost).

Beyond Huarong

Looking more broadly at China's corporate bond default trends, markets look a bit better. China's credit tightening had brought defaults to a record US$16.4bn as of 1Q2021. This was most concentrated in February, when $9.3bn of defaults too place, of which $1.5bn was in offshore USD bonds. Since then domestic defaults were $1.9bn in April, a slower than average rate since 2018 (**Figure 4**).

[1] China's Biggest 'Bad Bank' Tests Beijing's Resolve on Financial Reform, *The New York Times* , May 18, 2021.

Figure 3: The pace of credit expansion as % of GDP may still slow in June, but the majority of the tightening appears complete

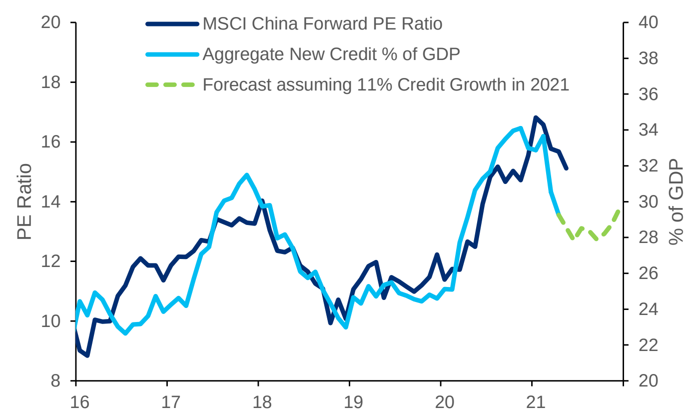
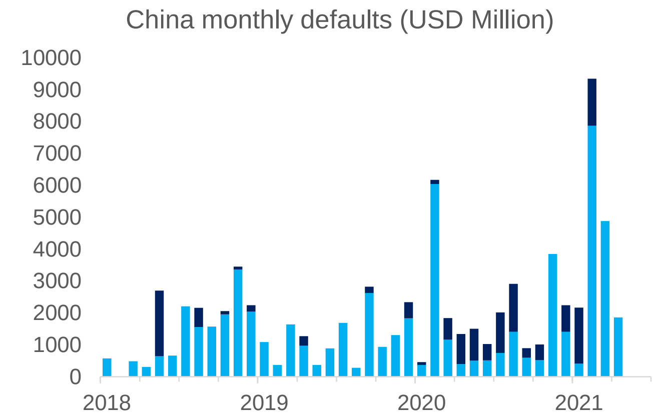


Figure 4: China's defaults have eased since February, with zero offshore USD bond defaults in past two months



Source: Bloomberg, as of May 18, 2021. . All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future returns. Real results may vary.

It is not possible to identify with certainty whether the drop in defaults is due to government leniency or a recent uptick in economic activity. Being six months or more ahead of the US recovery, April saw a slowdown in the growth of Chinese industrial production (IP) and retail sales. For IP, this appears to be a result of the normalization of industrial utilization across the globe that affects China most as it was the first manufacturing hub to recover from the pandemic. The fading demand for domestic autos, after last year's surge, has also contributed to the decline in Chinese IP. That said, looking back to pre-pandemic levels, China's IP is running 6.6% above April 2019 levels, which is consistent with China's pre-pandemic growth rate (**Figure 5**).

Just as we expect for the US next year, China's retail sales missed recent expectations, as consumers bought fewer home electronics and autos while boosting their purchases of "leave your home" services. Real retail sales growth lost some momentum in the spring, but remains well above pre-pandemic levels. Thus, we can see parallels in the US and China, the two countries who are likely to lead the post-pandemic recovery, but will also be the first to normalize relative to laggards globally (**Figure 6**).

Figure 5: China's IP has outgrown the US during the pandemic, but is losing some momentum as global manufacturing capacity opens up

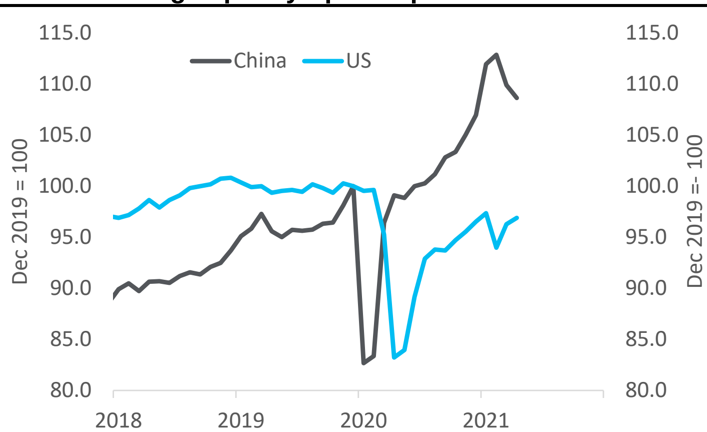
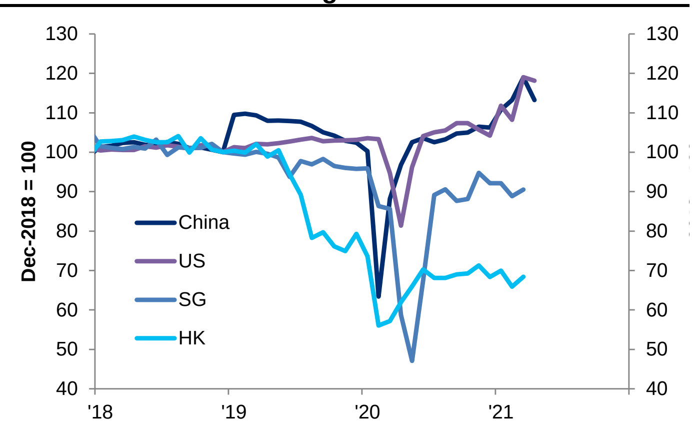


Figure 6: Real retail sales in China and US have both rebounded to over pre-pandemic levels, while others like HK and SG lag



Source: Bloomberg, as of May 18, 2021

Source: Bloomberg as of April 30, 2021

China's Tech Troubles

China's tech troubles center on anti-trust, anti-competitive behavior, fintech regulation and advertising rules (see Asia Strategy | Looking Through 2Q Risks). China's most recent actions included penalizing unnecessary data gathering within navigation apps and punishing false advertising at online education providers. These actions follow the famous Alibaba fine, rules against predatory competitive behavior and a bolstering of fintech capital requirements.

As a result of these comprehensive regulatory changes, Chinese tech stocks have fallen by over 30% on average from their 52-week highs, compared to 13% on average for their US counterparts (**Figure 7**). Moreover, less tech heavy industries have also seen intense drawdowns in recent months. Tech-reliant industries, such as logistics, education, biotech and health tech, were impacted by both tech regulations and credit tightening in some instances. We have also seen significant selloffs in certain non-tech industries like real estate, distilling, insurance and brokerage (**Figure 8**). That said, the regulatory overhang and credit tightening are likely to lessen, which may improve share price performance in 2H 2021.

The 100th Anniversary

July 1st marks the 100th Anniversary of the founding of the Chinese Communist Party. The policy priority surrounding the celebratory months is stability, which historically means "taking the foot off the brakes" in terms of economic policy. That said, in order to set the nation's development on the right path, several key policy principles are likely to remain long after the celebrations end. These include driving greater efficiency and competitiveness, controlling systemic risks and allowing capital markets to function with greater depth. These objectives are likely to improve sustainability in many of China's growth industries over the long-run.

Figure 7: The pace of credit expansion as % of GDP may still slow in June, but the majority of the tightening appears complete

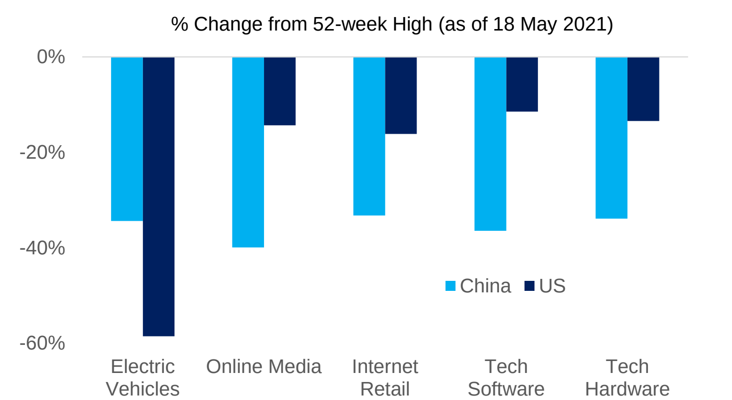
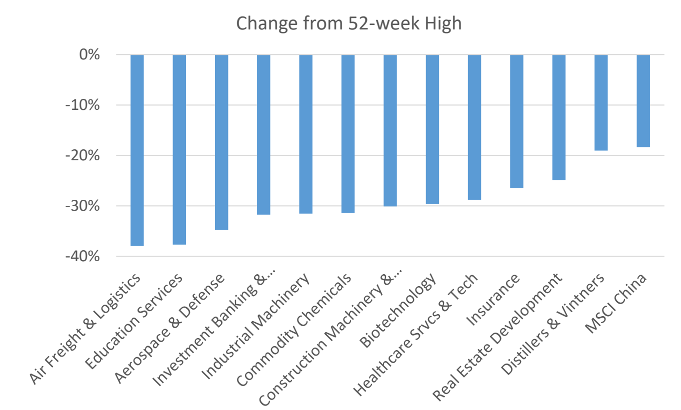


Figure 8: MSCI non-tech industries that have gone through significant corrections from 52-week highs



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Conclusion

Given that China went into and has come out of the pandemic six months ahead of the rest of the world, its economy is now normalizing to post-pandemic realities. Slower growth as the economy transitions to pre-pandemic levels seems likely. Similarly, the pandemic beneficiaries in tech and retail will see slowdowns in their absolute growth rates. These expected events are partially to blame for China's recent negative equity performance. In addition, new regulations designed to promote competition among many leaders as well as caution about excessive credit expansion are sending signals that China is more worried about the long run quality of its markets rather than the short term impacts these actions have on investor sentiment.

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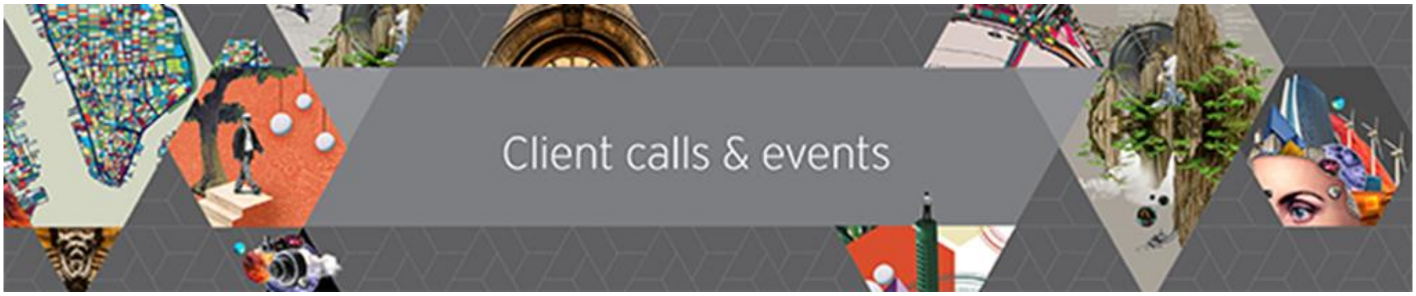

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