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Citi Global Wealth Investments

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Ken Peng
Head – Asia Investment Strategy
+852 2868-8904
ken.peng@citi.com

Ligang Liu
Head – Asia Economic Analysis
ligang.liu@citi.com

Calvin Ha
+852 2868-8477
calvin.ha@citi.com

Wang Shurong
+852 2868-8977
shurong.wang@citi.com

Recovery Amid Escalations and Delays

- Whether intended or not, US House Speaker Nancy Pelosi's visit to Taiwan may have fundamentally changed the US-China-Taiwan relationship. It would become more difficult for the US and China to reach a common interpretation of the "One China policy". China's response is likely to be long term in nature, and may gradually increase its control of water and airspace surrounding the island. Markets appear content with the lack of direct US-China conflict.

- After a brief recovery from the depths of lockdown, China's economy lost momentum in July due to the mortgage boycotts, which may weigh on the progress of recovery in 3Q. Rising recession risks in the US may weigh further on external demand in 2023. Policymakers did not address these concerns at the July Politburo meeting.

- We continue to expect more policies to emerge to support the recovery. Indeed, some local remedies for the property market and a more flexible and selective COVID policy are being adopted to extend the recovery. We expect the recovery process to take longer and last well into 2023.

- We retain our constructive view of Chinese equities, because China remains the only major market in the world that is easing monetary and fiscal policy, seeing rising growth, and remain at attractive valuations. The policy delays and the geopolitical issues represent key risks, but likely do not change the direction of recovery.

Reactions don't always happen right away

Whether intended or not, US House Speaker Nancy Pelosi's visit to Taiwan may have fundamentally changed the US-China-Taiwan relationship. China's response to the trip is likely to take time to be fully revealed.

The military exercises that China announced just after Pelosi's landing in Taipei would break several precedents and may represent a change of strategic direction. The live munition military exercises would take place around the entire Taiwan island over four days. Most of the locations are well beyond the median line in the Taiwan Strait, while some are also inside Taiwan's territorial waters. Missile flyovers were also a significant feature. These represent meaningful departures from exercises of the recent past.

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China's original concern over Pelosi's visit is that it sets up a risky precedent that others will copy, such as politicians from the UK, Australia, Japan, or still higher-ranking officials from the US. China would like to stop the expectation that such behaviour is okay, but convincing the US and other politicians has clearly proven very difficult. As a result, China can only try to convince Taiwan to not welcome such visits, possibly by increasing its presence and control of the water and air space surrounding the island.

This has been the tactic in recent years. For example, China (and Japan) has set up regular coast guard patrols around the Diaoyu (Senkaku) islands after Japan nationalised the islands in 2012. In the South China Sea, China set up naval bases on several shoals and elevated the administrative status of Sansha to a city to oversee the effective control of nearby waters. In both instances, no major armed conflict occurred.

In the near term, the market may be content with the lack of direct conflict between China and US. This is likely the correct assumption. Over the longer run, we may have entered a new paradigm, in which Taiwan may become a more central piece of the competition between the US and China, with much more frequent developments, rather than an issue that could be set aside for a more distant future. As a result, there may be an added risk premium for equities in China, HK and Taiwan.

Further Delays in China's Recovery, Further Policy Help Needed

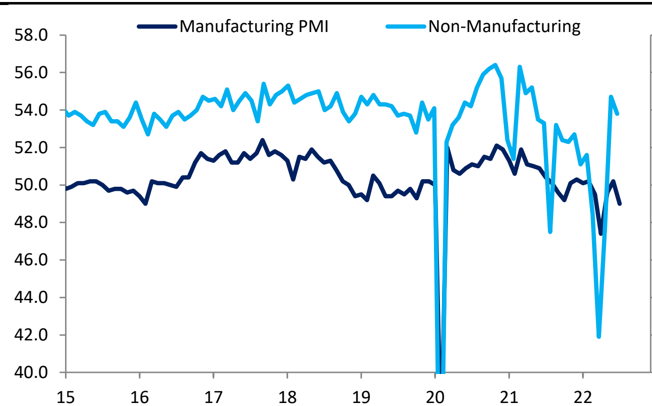
Geopolitical tensions added to worries, but the core of the problem for markets is whether China's recovery is stalling. After a brief recovery from the depths of lockdown, China's economy appears to be deteriorating in July. Central policymakers at the July Politburo meeting chose to make the growth target more flexible, without making clear policies that could tackle property risks, restore consumption and broader economic growth.

We continue to expect such policies to emerge, but the recovery process is likely to take longer than expected and last well into 2023. The economy lost significant momentum in July due to the mortgage boycotts, which may weigh on the progress of recovery in 3Q. Rising recession risks in the US may weigh further on external demand in 2023. These developments are likely to drag growth lower than our last round of forecasts for the Midyear Outlook.

Still, we are not turning away from our more constructive view of Chinese equities, because China remains the only major market in the world that is easing monetary and fiscal policy, seeing rising growth, and remain at attractive valuations. The policy delays and the geopolitical issues represent key risks, but likely do not change the direction of recovery.

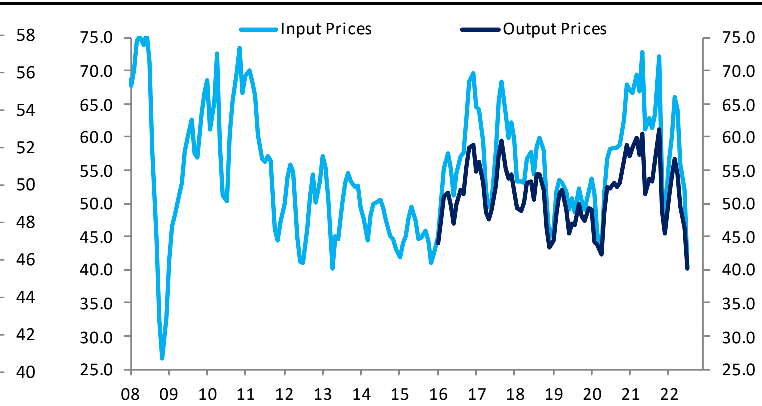
Industrial headwinds

Figure 1: Manufacturing PMI fell back to contraction in July, while Services held up better



Source: Haver Analytics, as of July 2022

Figure 2: Prices indices in PMI indicate acute industrial deflationary risks



Source: Bloomberg, as of July 2022

In July, multiple data signalled slower momentum in the recovery. PMI for manufacturing fell back to contraction territory at 49.0 (**Figure 1**), with new orders and new export orders both showing deeper contraction. The more worrying sign is that prices for both inputs and outputs have fallen to about 40, which was lower than the initial pandemic period and the lowest since the global financial crisis (**Figure 2**). The drop in prices indices was common across the global in July, given the decline in commodities prices. But the depth of the decline in China is unparalleled.

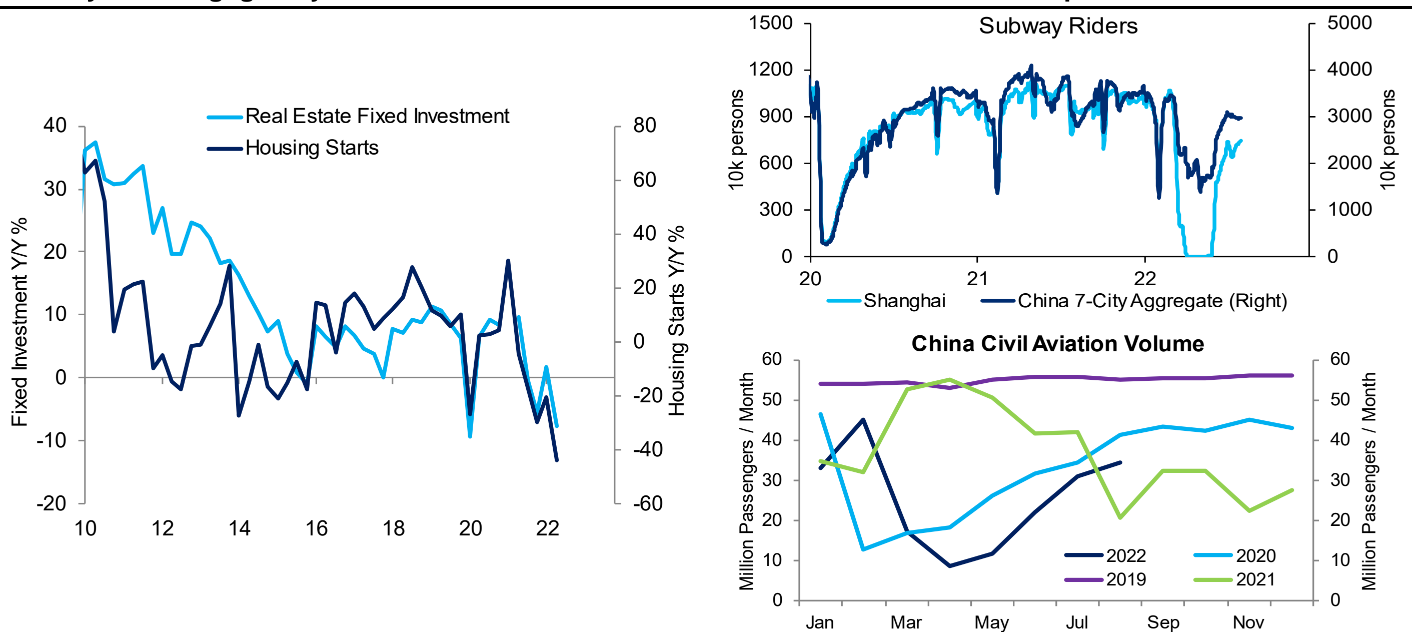
The weakness in manufacturing can be partly attributed to slower export growth, which had been a priority during the lockdowns and avoided deeper declines in industrial activity. But since June, real estate investments and sales dropped sharply due to the mortgage boycotts (**Figure 3**). This could have added to the slowdown in manufacturing, especially for durable household goods. Other anecdotal evidence such as steel furnace activity also point to a slower July.

Consumer recovery appears more intact

Services PMI held up much better after a much deeper decline during the lockdown period. This is consistent with mobility data holding up okay, such as subway ridership in Shanghai and other cities holding onto gains made in June, though still below 2021 levels. Civilian flight passenger volume has also recovered to mid 2021 levels, but remain 30% below 2019 levels (**Figure 4**). These indications reflect that recent new restrictions in response to the latest flair up in COVID cases have not meaningfully constrained mobility for most people. This suggest that retail and service recovery is more intact than that for manufacturing.

Figure 3: Housing Starts and Investment fell sharply in during the tightening since 2H 2021, but deepened recently on mortgage boycotts

Figure 4: Mobility indicators suggest less restrictive COVID policy despite recent flair up in cases, giving more momentum to consumption



Source: Haver Analytics, as of July 2022

Source: Haver Analytics, as of July 2022

Policy actions take time to have effect

The market was notably disappointed at the July Politburo meeting, which did not provide any additional assurances for supporting the economy. Instead, it downplayed the growth target, reaffirmed COVID-zero policy and tasked local governments with restoring property market order.

On property risks:

- We continue to believe that there is little systemic risk from the property market rout, but it still remains the key risk for economic growth. As we noted in Asia Strategy Bulletin | China's Mortgage Boycott: A Lehman Moment

(Again) or A Tempest in a Teapot?, the banking sector's exposure to high risk mortgages and high risk developers add up to about 1% of total loan book, which is still under coverage of existing NPL provisions.

- The key is to complete the projects and restore proper function in the market. To this end, the PBOC has set up a RMB300bn relending facility specifically for completing unfinished projects. China Construction Bank, together with the PBOC, has set up a fund to provide liquidity for troubled developers who are trying to complete projects.
- Local governments in Henan, the epicenter of the mortgage problems, are trying to team up with distressed asset managers to facilitate construction, sell assets and restructure troubled developers. These moves are essentially what the Politburo called for. Even though they are unlikely to provide much new hope for the troubled developers themselves, they could be important step towards restoring market function.

On COVID-zero policy:

- The Politburo called for continued vigilance, even highlighting the political reasons for the policy. Indeed, the lockdown in Shanghai was a magnified political message from the central government that was intensified by lower level of government, resulting in overzealous implementation.
- Now, the length of quarantine has been shortened. The recent flair-up in cases saw very localized restrictions and increased testing over shorter periods, but no broad extended lockdowns.
- The desire at the local level to implement restrictions has actually fallen, with greater desire to revive economic activity because unemployment has risen, particularly among the young.
- Dynamic clearance is likely to stay until after the Party Congress, after which we expect the political imperative to maintain this policy would ease. If domestic mRNA vaccines can be developed and deployed, there could be greater chance for further re-opening, perhaps in Spring 2023.

At this moment, with just two months left to the 20th Party Congress, there is likely little willingness to take risks at the local government level. The attitude towards the economy is likely to prevent major downside risks, rather than producing upside momentum. As a result, preventing systemic risks remains a top priority, while achieving growth target is no longer. Major policy changes, including those that might result in restructuring defaulted developers or those that might relax COVID restrictions, may have to wait until after the Congress.

We continue to expect recovery in Chinese equities

In July, the setback in property and industrial activity were reflected in another round of correction to Chinese equities. The MSCI China forward PE ratio had fallen to under 11x again. But at the same time, credit growth continued to pull forward. The aggregate new credit reached nearly 28% of GDP in June, exceeding the year ago level for the first time since March 2021. The transmission of easy credit policy was somewhat disrupted by the mortgage strikes causing renewed default and banking worries. But as noted previously, we believe systemic risks are contained. As such, the credit growth still point to further repair in valuations in the near future (Indeed, multiple relatively small companies have successfully listed in the US, Switzerland and HK. Even though the delisting risk remains for US listed ADRs, the revival of offshore new listing represent a potential catalyst. As we noted in Asia Strategy Bulletin | Cyclical Divergence, Pick the Recovering Side, stabilized tech regulations and progress towards resuming IPOs in HK may be critical catalysts for recovery in the Chinese equity market.

Figure 5: Credit expansion continue to point to more valuation repair despite the July setback	**Figure 6: Chinese growth stocks have substantially outperformed cyclicals since March bottom**

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Some parts of the Chinese equity market have done better than others. Compared to the March 15 lows, growth sectors (Consumer Discretionary, IT, Telecom Services and Healthcare) remain 20% above, despite the July correction. In contrast, cyclical sectors (Financials, Industrials, Materials and Energy) have barely moved (**Figure 6**).

The growth outperformance comes from more clarity in tech regulation. The July Politburo meeting stated to support the "platform economy". Specifically, the meeting called for launching a batch of "green light" investment cases, implying to push for the IPO of platform companies that are considered compliant of the new regulatory environment. Analyst

expectations for earnings may start to improve in 3Q-4Q amid a more stable regulatory environment and as consumer recovery continues.

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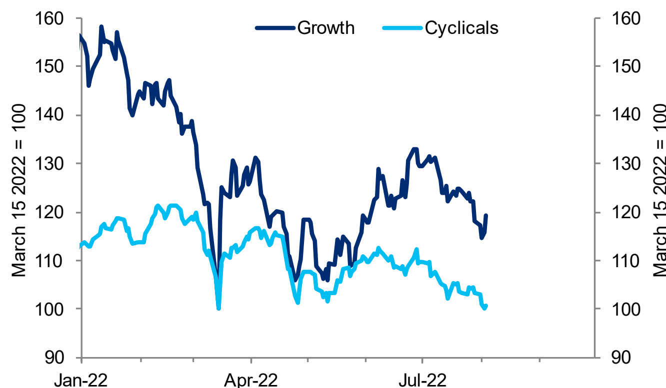

Source: Bloomberg, as of 4 Aug 2022

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The path of recovery is likely to be a bumpy road, but we retain our constructive view of Chinese equities, because China remains the only major market in the world that is easing monetary and fiscal policy, seeing rising growth, and remain at attractive valuations. The policy delays and the geopolitical issues represent key risks, but likely do not change the direction of recovery.

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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
In default	C	D	D

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