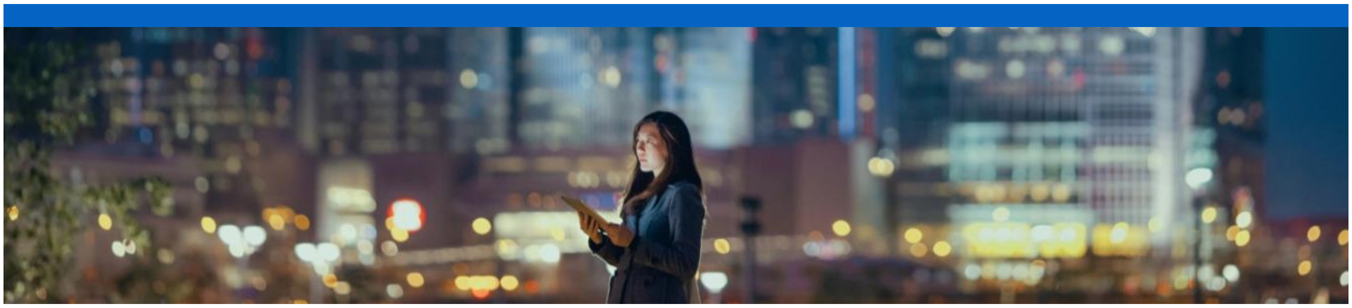
Citi Global Wealth Investments



April 16, 2022

CIO Strategy Bulletin

China Under Pressure

David Bailin, Chief Investment Officer and Head of Citi Global Wealth Investments
Steven Wieting, Chief Investment Strategist and Chief Economist
Ligang Liu, Head Asia Pacific Economic Analysis
Ken Peng, Head of Asia Pacific Investment Strategy
Calvin Ha, Asia Pacific Investment Strategy
Cecilia Chen, Asia Pacific Investment Strategy
Shurong Wang, Asia Pacific Economic Analysis
Maya Issa, Global Investment Strategy

SUMMARY

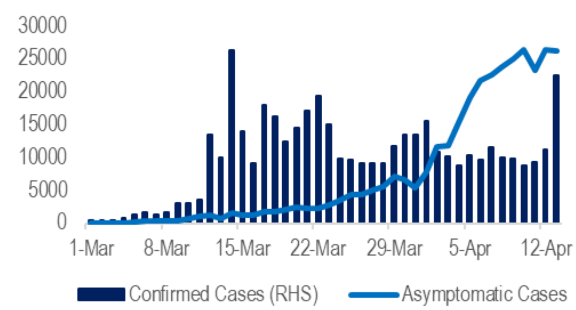
- The three-week Shanghai lockdown may have slowed the spread of omicron, but China's "Zero Covid" policy is clearly failing. The latest road and air traffic data in and around has dropped significantly, just shy of Wuhan lockdown levels. The Purchasing Managers Index (PMI) data from auto and auto parts, computer and electronic equipment and oil refining are as bad as those reached during the Wuhan lockdown.
- The speed at which Covid has surged and retreated across many geographies suggests that its impacts are temporary. Covid has forced Chinese policymakers and producers to adapt and to avoid output indiscriminately. However, the near-term outlook for Covid in Greater China will worsen the lingering supply/demand imbalances of 2021. And this will intersect with the commodity supply disruptions related to the war in the Ukraine.
- It is now possible that China could experience a Q2'22 GDP contraction. Fears of a recession in the second quarter would make China's 5.5% growth target for 2022 unachievable.
- Premier Li announced new fiscal measures to support the national economy. The PBoC just announced the first of several rate cuts and the March credit data points to a large credit easing.
- Historically, the performance of Chinese equities has a strong positive correlation with the country's monetary policies rather than its immediate economic performance. There is often a lag of a few months between the launch of significant stimulus and a rally in equities. According to our analysis, the valuation of Chinese equity markets is just 53% of the S&P 500, an historic low.
- Given the expected additional fiscal policy stimulus and expected further monetary policy easing, Chinese asset prices will likely see support. We maintain our view that long-term investors should remain in China's equity market.

THE FAILED SHANGHAI LOCKDOWN

The three-week Shanghai lockdown may have slowed the spread of omicron, but China's "Zero Covid" policy is clearly failing. More smaller cities are under partial or full lockdowns. And in spite of these actions, nationwide cases continue to rise (**Figure 1**). Meanwhile, social discontent is rising, and economic costs are mounting. The only good news is that severe illness and deaths are extremely low.

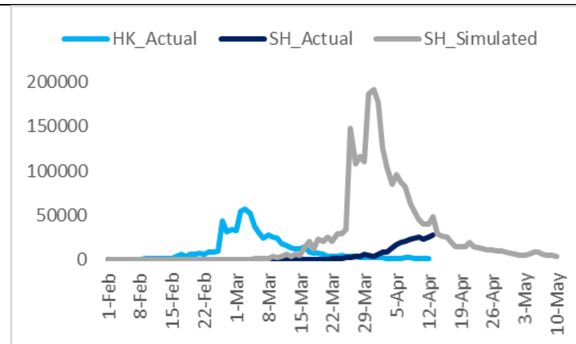
In the case of Shanghai, it is clear to everyone that the lockdowns have not stopped Covid's rise (**Figure 2**). Yet, had the government adopted Hong Kong's more tolerant approach to the pandemic, we believe that Shanghai would have seen 200,000 daily cases. This would have brought more scrutiny to the poor efficacy of China's vaccines.

Figure 1: National cases continue to rise regardless of the lockdowns



Source: Haver Analytics as of April 14, 2022.

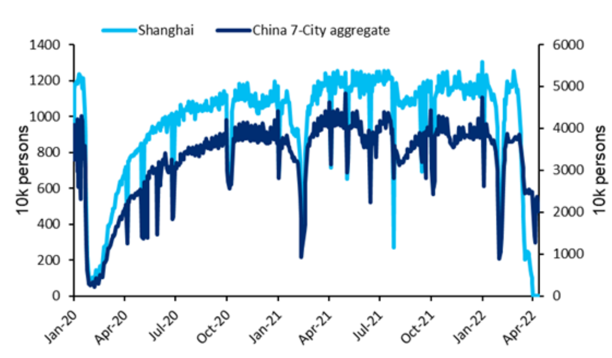
Figure 2: Adopting the HK approach to Covid would lead to 200,000 daily infections in Shanghai



Source: Haver and Office of the Chief Investment Strategist, as of April 14, 2022.

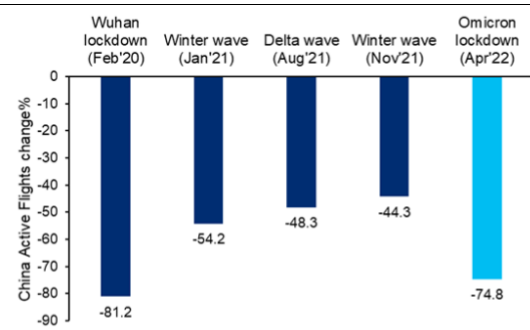
Shanghai is not only China's financial and international trade centre, but also the transport and logistic centre of the Yangtze River Delta. Following Shanghai's lead, other nearby provinces have set up roadblocks, enforced strict PCR testing requirements and even imposed quarantines on truckers. This race to be "more strict than Shanghai" has sharply slowed truck and air traffic in and around the Yangtze River Delta. The latest road traffic data in Shanghai and seven other major cities have dropped to levels comparable to early 2020. In April, air traffic also dropped significantly, also just shy of Wuhan lockdown levels (see **Figures 3-4**).

Figure 3: Subway passenger volume in Shanghai and other reached a low level akin to Wuhan lockdown



Source: Haver Analytics, as of Apr 11, 2022. Note: 7 cities include Beijing, Chengdu, Guangzhou, Shanghai, Nanjing, Suzhou and Zhengzhou.

Figure 4: China's air traffic in April dropped to the level reached at the Wuhan lockdown in Feb '20



Source: Airportia, as of Apr 11, 2022

COVID'S ECONOMIC COSTS RISE AS GROWTH DECELERATES

China's "Covid Zero" strategy remains a national policy mandate and local officials have no qualms implementing full and partial lockdowns. We estimate that 374 million Chinese and areas producing over 40% of China's GDP are presently affected (see **Appendix**).

Meanwhile, China's growth has been slowing for some time. In March, China's Purchasing Managers Index (PMI) fell into contraction territory at 49.5, down from 50.2 in February. However, some sectors were hit harder than others. For example, the PMIs of auto and auto parts, computer and electronic equipment, oil refinery, and air transport were **as bad as those reached during the Wuhan-Hubei lockdown in Q1 2020**. (**Figures 5 and 6**).

Figure 5: The PMI and new order subindex of the Auto and Auto-parts sector

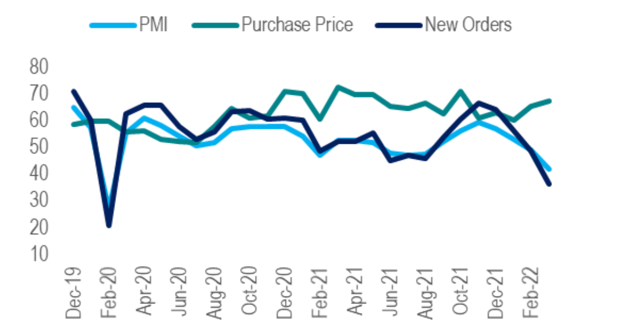
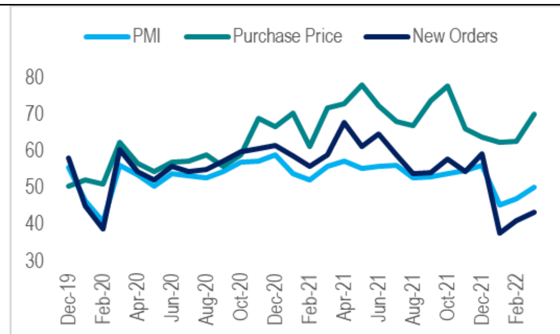


Figure 6: New orders of computer and electronic equipment lower than Feb 2020



Source: Haver Analytics as of April 14, 2022.

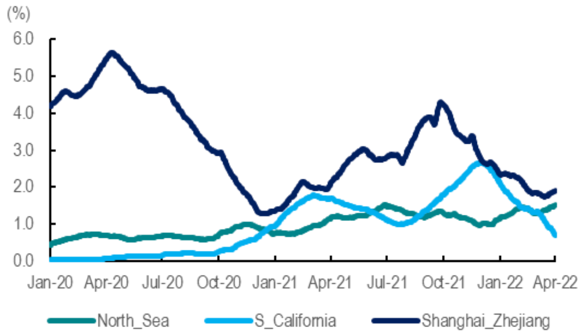
GLOBAL SUPPLY CHAIN IMPACTS

Shanghai is one of the busiest container ports in the world, responsible for 7% of Chinese exports and 3% of its imports. While there are anecdotal reports that the manufacturing supply chains have been affected, the rise in the number of container ships waiting in Shanghai-Zhejiang ports has been modest through mid-April (**Figure 7**). Freight rates for ships departing from Chinese ports continue their downward trend (**Figure 8**).

For the moment, global supply chains appear to be modestly impacted. We think this will worsen. While Asia as a whole has experienced and treated COVID in a heterogenous way, mainland China is not alone in experiencing a Covid resurgence. As **Figure 9** shows, Taiwan has also seen a sudden rise in new cases.

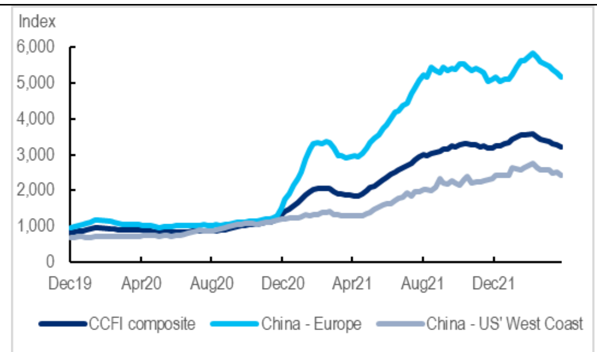
The speed at which COVID has surged and retreated across many geographies suggests that its impacts are temporary and will not define a full year's economic results. Even in China, COVID has forced policymakers and producers to adapt and to avoid output indiscriminately. However, the newly impacted zones of COVID in Asia are interfering with advanced components production, such as semiconductors (**Figure 10**). Therefore, the near-term outlook for COVID in Greater China will worsen the lingering supply/demand imbalances of 2021. And this will intersect with the commodity supply disruptions related to the war in the Ukraine.

Figure 7: Global freight capacity "waiting" in Shanghai



Source: Kiel Trade Indicator and Citi Research as of April 14, 2022.

Figure 8: Freight rate of routes departing from China continues to fall



Source: Shipping Intelligence Network and Citi Research as of April 14, 2022.

Figure 9: Taiwan: New COVID Infections

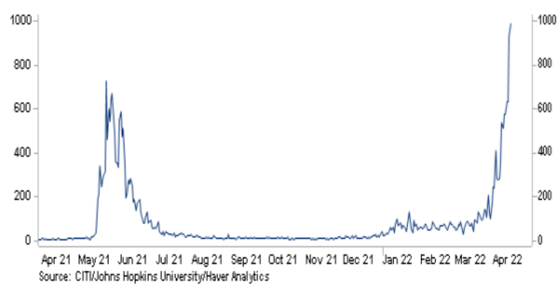
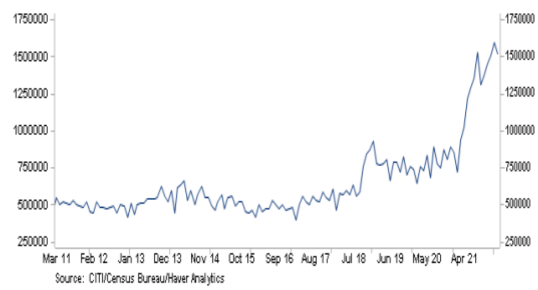


Figure 10: US Imports of Semiconductors from Taiwan



Source: Haver Analytics as of April 14, 2022.

THE LOOMING RISK OF A Q2 RECESSION IN CHINA

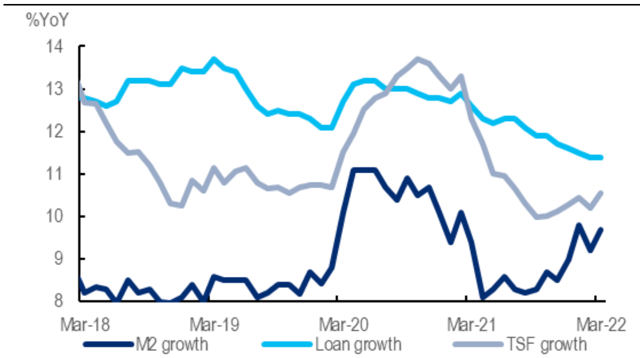
Assuming a continued Covid Zero Strategy (CZS), China's Q2 economic activity could be materially impacted by both manufacturing shortfalls and transport slowdowns. We expect April monthly economic activity indicators will show even sharper declines in May. Thus, it is now possible that China could experience a Q2 GDP contraction. Widespread lockdowns have led to temporary production shutdowns in industrial hubs across many provinces. Alarms are rising as the State Council is concerned that local governments are slowing truck transport across the country. It has ordered local governments not to set up any unauthorized checkpoints within the national highway system. Yet, local governments routinely ignore national orders in the name of Covid-19 containment.

POLICY RESPONSES ARE STEPPING UP

Fears of a Q2 recession would make China's 5.5% growth target for 2022 unachievable. Thus, we expect stronger policy easing ahead. Additional fiscal stimulus focusing on maintaining household income and boosting consumption is likely. Local governments are taking actions. After one week of lockdowns, the Shenzhen government has issued 30 policies, ranging from fees and tax reductions to increasing various fiscal subsidies for firms to compensate their losses and boost business confidence. Shanghai has similarly issued its policies to address the difficulties experienced by local businesses.

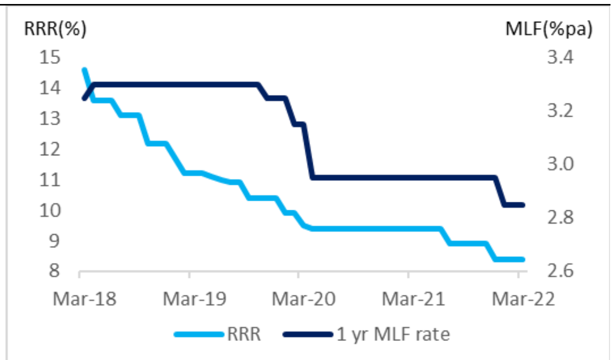
At the Wednesday State Council Executive Committee meeting, Premier Li announced new fiscal measures to support the national economy. New policies to support the service sectors hit by the lockdowns and policies to support auto and other durable goods consumption were announced. Meanwhile, monetary policies may become far more accommodative. While the PBoC has repeatedly signalled that it will not copy the US and flood the market with liquidity, the March credit data points to a large credit easing indicated by rapidly rebounding aggregated financial and M2 growth (**Figure 11**). The State Council has already cut required reserve ratios again (**Figure 12**).

Figure 11: New loans growth approaches stabilization; M2 and TSF growth rebounded strongly



Source: Haver Analytics, as of Apr 11, 2022.

Figure 12: There is still room for RRR and MLF policy rate cut in China



Source: Haver Analytics as of April 14, 2022.

CHINESE EQUITIES ARE LIKELY BENEFICIARIES OF POLICY RESPONSES

Historically, the performance of Chinese equities has a strong positive correlation with the country's monetary policies rather than its immediate economic performance. Following the outbreak of Covid-19 in 2020, the loose monetary policy, together with strict social distancing measure, helped the equity markets rebound quickly from the pandemic. Although policy makers have refrained from deploying any massive stimulus in 2021, China's financial policy has shifted to prop up growth in 2022. There is often a lag of a few months between the launch of significant stimulus and a rally in equities. However, external shocks including the Ukraine war rising delisting risks for ADRs and the possibility of sanctions against China may delay or mitigate the typical response in Chinese equities.

The valuation of Chinese equity markets has become far more attractive after the recent correction. MSCI China is now only valued at 53% of the S&P 500, an historic low (**Figure 13**). In addition, according to a collection of five valuation metrics, Chinese equities are now at levels close to those in late 2018 (**Figure 14**).

Figure 13: MSCI China is valued at 53% of S&P500, an historic low

Figure 14: A collection of five valuation metrics are 1.6 standard deviations below average of the past 12 months, similar to levels seen in late 2018

Source: Bloomberg, as of 1 April 2022 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.

Over time, the Covid Zero policies may be relaxed. For example, some districts in Shanghai won't require infected persons to be quarantined in temporary make-ship hospitals, recognizing vast majority of omicron cases in Shanghai only show mild symptoms. Together with China's high tech contact tracing capacity and effective social organization, the policy fine-tuning of CZS may allow China to refocus on its economic objectives.

In summary, given the expected additional fiscal policy stimulus and further monetary policy easing, Chinese asset prices will likely see support. We maintain our view that long-term investors should remain in China's equity market.

Appendix Figure : Cities under lockdown or partial lockdown, affected population and GDP size						
Province/Municipality	**City**	**Risk Level**	**Type of lockdown**	**Population Affected (mn)**	**GDP (RMB bn)**	**Share of National GDP**
Shanghai	Shanghai	Medium	Full lockdown	24.9	4321.5	3.78%
Jilin	Changchun	High	Full lockdown	9.1	710.3	0.62%
	Jilin	High	Full lockdown	3.6	155.0	0.14%
Jiangsu	Nantong	Low	Full lockdown	7.7	1102.7	0.96%
	Xuzhou	Medium	Partial lockdown	9.1	811.7	0.71%
	Suqian	Medium	Partial lockdown	5.0	371.9	0.33%
	Suzhou	Low	Partial lockdown	12.7	2271.8	1.99%
	Wuxi	Low	Partial lockdown	7.5	1400.3	1.22%
	Nanjing	Low	District-based lockdown	9.3	1635.5	1.43%
	Taizhou	Low	District-based lockdown	4.5	602.5	0.53%
	Changzhou	Low	District-based lockdown	5.3	880.8	0.77%
	Zhenjiang	Low	District-based lockdown	3.2	476.3	0.42%
Zhejiang	Jiaxing	Low	Partial lockdown	5.4	635.5	0.56%
	Ningbo	Low	Partial lockdown	9.4	1459.5	1.28%
	Hangzhou	Low	District-based lockdown	11.9	1810.9	1.58%
Beijing	Beijing	High	District-based lockdown	21.9	4027.0	3.52%
Tianjin	Tianjin	High	District-based lockdown	13.9	1569.5	1.37%
Fujian	Fuzhou	Low	District-based lockdown	8.3	1132.4	0.99%
	Quanzhou	High	District-based lockdown	8.8	1130.4	0.99%
	Putian	Medium	District-based lockdown	2.8	288.3	0.25%
Shandong	Weihai	Medium	District-based lockdown	2.9	346.4	0.30%
	Binzhou	High	District-based lockdown	3.9	287.2	0.25%
Liaoning	Shenyang	High	Partial lockdown	9.0	725.0	0.63%
	Yingkou	High	District-based lockdown	2.3	140.3	0.12%
	Dalian	Medium	District-based lockdown	7.5	782.6	0.68%
Hebei	Tangshan	High	Full lockdown	7.7	823.1	0.72%
	Langfang	High	Partial lockdown	5.5	355.3	0.31%
	Xingtai	Low	Partial lockdown	7.1	242.7	0.21%
	Handan	Low	Partial lockdown	9.4	411.5	0.36%
Guangdong	Guangzhou	Medium	District-based lockdown	18.7	2823.2	2.47%
	Shenzhen	Low	District-based lockdown	17.6	3066.5	2.68%
	Dongguan	Medium	District-based lockdown	10.5	1085.5	0.95%
	Foshan	Low	District-based lockdown	9.5	1215.7	1.06%
Anhui	Hefei	Low	District-based lockdown	9.4	1141.3	1.00%
	Fuyang	Medium	District-based lockdown	8.2	307.2	0.27%
	Lu'an	Medium	District-based lockdown	4.4	192.4	0.17%
	Wuhu	Medium	District-based lockdown	3.6	430.3	0.38%
Heilongjiang	Jiamusi	High	District-based lockdown	2.2	81.6	0.07%
	Harbin	Medium	District-based lockdown	10.0	535.2	0.47%
	Mudanjiang	Medium	District-based lockdown	2.3	87.5	0.08%
Gansu	Lanzhou	Medium	District-based lockdown	4.4	323.1	0.28%
Inner Mongolia	Chifeng	Medium	District-based lockdown	4.0	197.5	0.17%
Hubei	Wuhan	Low	District-based lockdown	12.3	1771.7	1.55%
Hunan	Changsha	Medium	District-based lockdown	10.0	1327.1	1.16%
Jiangxi	Nanchang	Medium	District-based lockdown	6.3	665.1	0.58%
Summary Statistics				**373.0**	**46158.8**	**40.35%**
Source: Various Chinese Media reports and CPB Strategy Research						

As of April 14, 2022.

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