China Insights

A new agenda in the making

September 2020

Summary

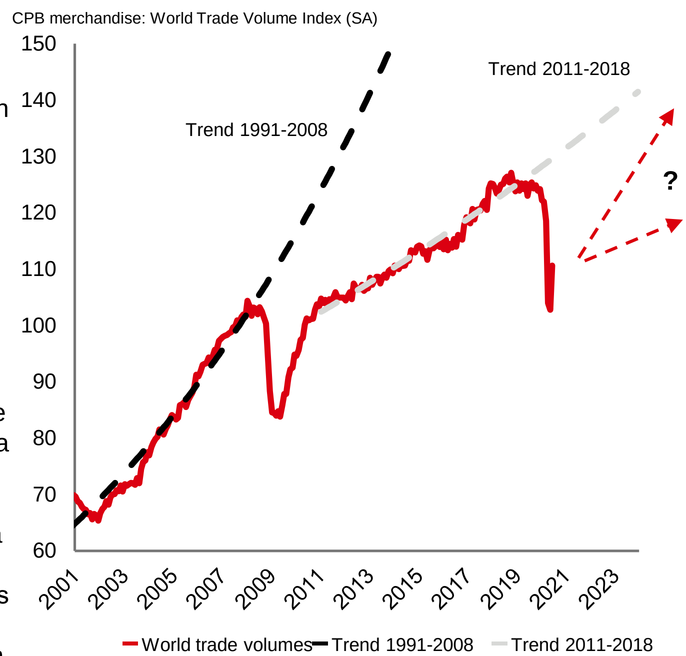
- In the face of external uncertainties and to address some of China's domestic issues, its leaders have been promoting a so-called "dual circulation" growth model as a new economic and social development plan
- Overall, China will likely speed up reforms to unlock domestic potential and accelerate internal rebalancing while managing external risks better by improving domestic economic, market and supply-chain resiliency
- China is also is likely to seek greater autonomy over key technologies and advanced manufacturing, but challenges are expected as it moves up the value chain

A new agenda in the making

Major reforms tend to forge in times of crisis. The Covid-19 pandemic has caused substantial global demand and supply shocks, such that it may be difficult to see the global economy return to pre-pandemic output levels for a few years. The health crisis is also likely to transform the world, change various business models permanently and accelerate some ongoing global trends, such as slowbalisation, supply chain diversification by multi-national companies (the "China+1" or regionalisation strategy), geopolitical tensions and the risk of US-China technological de-coupling.

In the face of external uncertainties and to address some of China's domestic issues such as economic re-balancing/transformation and the role of the state, leaders have been promoting a so-called "dual circulation" growth model as a new economic and social development plan. No details have been provided for the strategy, and the implementation is not clear to us at this stage. But we interpret the key message as a strategic focus on strengthening self-sufficiency while deepening efforts to open up the economy and improve China's economic resilience. "Dual circulation" is seen as the most important policy direction after the supply-side structural reform drive, and will likely serve as the policy framework of the upcoming 14th Five-Year Plan.

China's domestic economic pivot amid external challenges



Source: Bloomberg, CEIC, HSBC Global Asset Management, as of August 2020
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A focus on "domestic circulation" to expand domestic demand and strengthen China's supply-chain resiliency

The new development pattern will focus on "domestic circulation" to expand domestic demand, address weak links in the supply system and strengthen China's supply chain resiliency, reducing its reliance on overseas markets and foreign suppliers in key areas such as high-end technology and natural resources. The goal is to improve the security, efficiency, sustainability and fairness of China's growth model, by focusing on higher-quality development, in our view. Rebalancing from export-led to domestic demand-driven growth, as well as the transition to domestic consumption as the key engine of growth, has long been an objective for China, especially after the 2008-09 global financial crisis (GFC). China's foreign trade dependency ratio, measured as the ratio of total goods and services trade to GDP, peaked at 64.5% in 2006 and has since fallen to 35.7% in 2019. Such a reorientation of growth drivers is even more urgent now.

We believe that the key for the "domestic circulation" is to boost and upgrade domestic demand while continuing with supply-side structural reforms. China has a large and robust industrial ecosystem, strong manufacturing production capacity, highly-educated and skilled workforce, well-developed infrastructure, and a huge domestic market with a fast growing middle-income class. To unlock the domestic potential and boost China's international competitiveness, we think further industrial upgrade (including ensuring secure, controllable and, to some extent, self-reliant technologies), investment in basic and smart infrastructure, new urbanisation strategy (focusing on developing city clusters and metropolitan areas), and agricultural modernization, are required to support a domestic demand-oriented development model. In the area of technological innovation, President Xi urged more efforts to raise the capacity for China's indigenous innovation and for faster progress in core, cutting-edge technologies. To accelerate its bid for global leadership in key technologies, China will invest an estimated CNY10 trillion (USD1.4 trillion) over six years to 2025 through the roll-out of everything from 5G wireless networks to data centers that can power artificial intelligence (AI) and Internet of Things (IoT) technologies, helped by private high-tech giants.

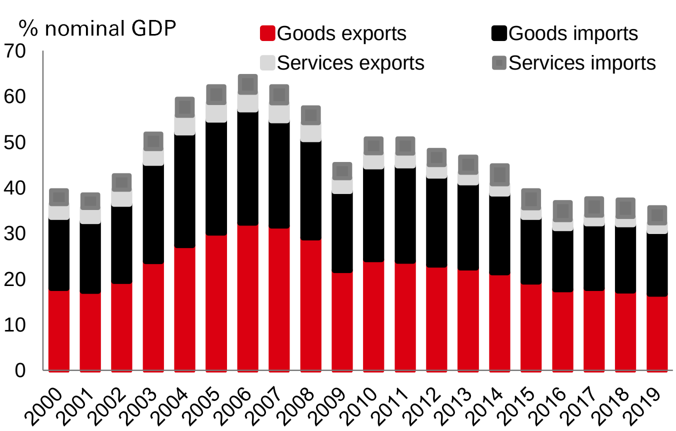
"Domestic circulation" is not about a closed-door policy; to be supplemented by "international circulation"

However, this domestic economic pivot is not about isolation or a closed-door policy. Rather, the strategy features domestic and international "dual circulations" that are complementary, mutually reinforcing, synergetic and sustainable. This will help China develop its domestic market competency and reshape its strength in international cooperation and competition. Promoting foreign trade, attracting foreign investment and engaging global scientific and technological co-operation remain important, with a greater emphasis on diversifying its trade/business partners to better manage risks. China will continue pressing ahead with opening up efforts and financial/capital-market liberalisation. Overall, China will likely speed up reforms to unlock domestic potential and accelerate internal rebalancing while managing external risks better by improving domestic economic, market and supply-chain resiliency.

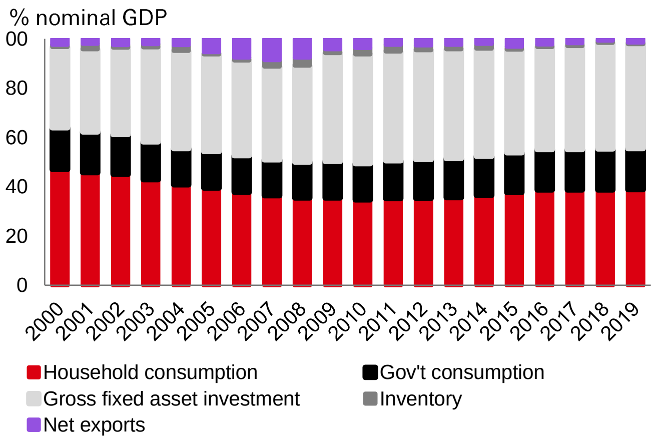
The growth model based on domestic consumption and indigenous technology development faces challenges

However, China's rebalancing toward consumption remains slow and uneven. The wealth gap is wide. The pandemic has hit the labour market and household income, leading to an even more difficult situation for disadvantaged/ lower-income groups. The weak social safety net and the rising debt burden have held back households' spending tendency. We think the domestic economic pivot will need policies/ reforms to empower consumer spending power (e.g. improving social security net and medical coverage, rural land and labour market reforms, and wealth/income redistribution), which will likely involve tough structural transformation of the political and economic system (e.g. dismantling its state-led model). China's bid for technological self-sufficiency may also face challenges given its deep integration with global supply chains and years of benefiting from technology transfers via FDI. Difficulties in gaining access to leading technologies could still be a headwind despite China's rapid climb up the tech value chain. That said, we think a complete decoupling of the Chinese and US economies is unlikely in the foreseeable future.

Foreign trade dependency ratio has peaked off



Rebalancing toward household consumption is slow



Source: CEIC, Bloomberg, HSBC Global Asset Management, data as of August 2020

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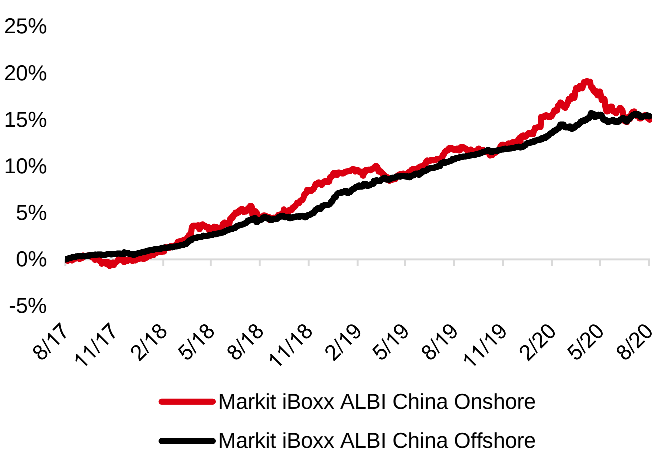
In the following pages we will take a deeper look at how recent events and policy measures are impacting Chinese fixed income and equity markets:

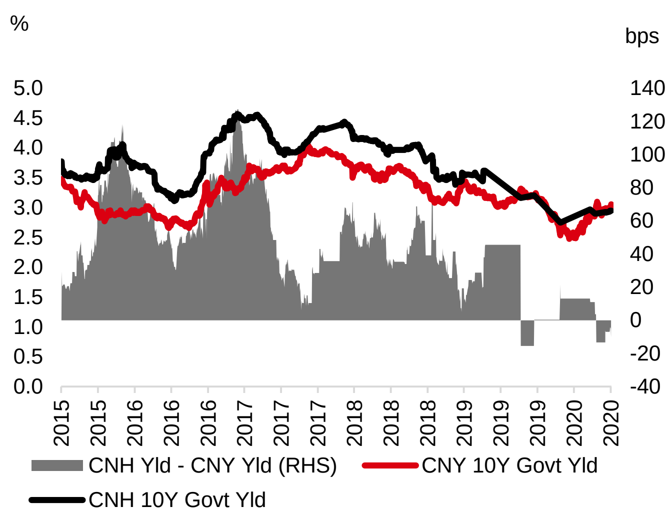
Fixed income

> Looking ahead, the onshore default trend may pickup again with the focus on credit cleanup whilst debt forbearance for select segments will remain in place

- In August, the yield curve of Chinese government bonds continued to edge higher, with selling pressure on the front and belly part of the curve. Notably the yields of the 3 and 5-year notes were up 40bps each during the month while the 7-year and 10-year bonds advanced 20 to 30bps. The selloff reflected improving risk appetite and rotation into equities, as well as still heavy supply and medium-term funding pressure
- Despite an improving macro backdrop in China, onshore RMB bonds, measured by iBoxx ALBI China Onshore Index, shed 0.3% in the month ending 25 August, bringing down the year-to-date gain to 1.5%. The correction partly reflects rotation into the stock markets from bonds and concerns over the continuation of easing efforts after benchmark interest rates remained unchanged for fourth straight month. With the recent pick up in yields domestically, the authorities may adopt a less dovish stance given their emphasis on the need for coordination with fiscal policy
- Despite a rebound in Q2 GDP, the labor market in China remains fragile, especially for migrant workers amidst the operating pressure on small and medium businesses. We believe there may still be room to lower effective lending rates but more focus will be on quantitative instruments to support credit growth and create jobs. In short, we believe more targeted easing and macro prudential policies are required to foster credit transmission to the real economy besides the already expansionary monetary and fiscal framework
- On the other hand, the offshore gauge, the iBoxx ALBI China Offshore Index, fell 0.2% for the same period. Elsewhere, China dollar credit market, investors continued to prefer risky assets, with high-yield bonds rising 1.0% over the month, even though the US dollar has weakened since its March peak. The investment grade universe edged up 0.1% in August
- The dollar index continued to slide in the month, due to concerns over the faltering recovery and a sharp pickup in short-term yield. The greenback dropped 0.9% against a basket of major currencies in August, following a 1.3% decline the prior month
- Looking ahead, the onshore default trend may pickup again with the focus on credit cleanup whilst debt forbearance for select segments will remain in place, particularly for those which were the hardest hit by the Covid-19 pandemic and are deemed critical to the overall growth recovery momentum

Chinese bonds remain steady amidst new rounds of global easing





Source: Bloomberg, Markit data as of 25 August 2020. Total return in local currency terms.
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Equity market

- Both onshore and offshore Chinese equities extended their positive run in August, in line with a bullish sentiment globally, with the S&P 500 and Nasdaq setting new closing highs. Meanwhile, signs of progress in developing treatments and vaccines for the Covid-19 raised hopes for a faster economic recovery in the world's seconf largest economy, which still has monetary and fiscal leeway to launch new policy support to address downside risks

- On a month-to-date basis (25 August), MSCI China A Onshore and MSCI China gained 1.2% and 6.2%, respectively. Locally the CSI 300 Index of the country's largest companies added 2.5% in US dollar terms, while the Hang Seng Index added 3.6%. During the month, the Hang Seng Index announced it will add two mainland tech companies into the blue-chip benchmark from 7 September, becoming the first companies with weighted voting rights or secondary listing in the index. China's largest drug development and manufacturing services provider will also join the index in September

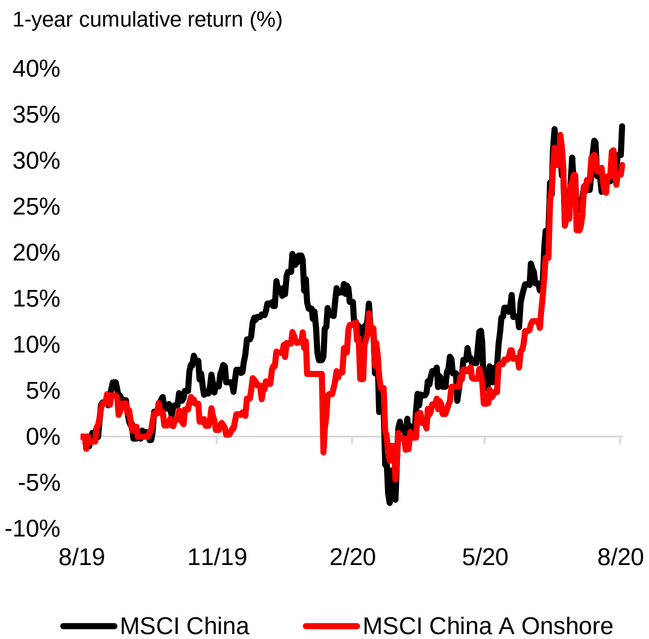
> Amid rally in tech shares, 12-month forward price-to-earnings of MSCI China and CSI 300 Index are now trading at 14.8x and 14.1x, respectively

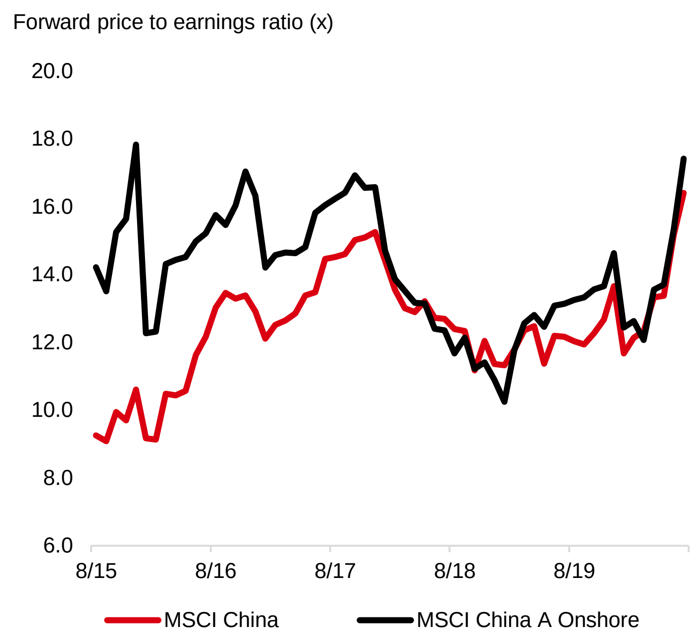
- Despite a recent flare-up in the US-China relations, tech-heavy ADRs gained 11.2% in August. The Trump administration further restricted a Chinese telecom company's access to US technology, and added another 38 of its affiliates to the US' economic blacklist. Separately, the US State Department warned American colleges to divest their Chinese holdings ahead of the imposition of enhanced listing standards for Chinese companies. In China, the ChiNext index, the gauge of small-cap tech stocks in China, dropped 3.4% as investors took profits following a 50% rally this year

- On a brighter note, 35% of the China-listed universe, or 1354 companies listed in onshore and offshore markets, have reported first-half corporate results with earnings rising 6% year on year and accounting for 44% of full-year consensus estimates

- In terms of fund flows (as of 22 August), the southbound trade through the Stock Connect has recorded USD53 billion of net buying so far this year, while the northbound trade has seen USD18 billion of net purchases for the same period after having some mild outflows due to heighted tensions between the US and China. Amid rally in tech shares, 12-month forward price-to-earnings of MSCI China and CSI 300 are now trading at 14.8x and 14.1x, respectively, with a 2020 consensus earnings growth of -1% for the former and 8% for the latter

Chinese stocks rally amidst global volatility





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Sector*	Outlook	Comment
Consumer Discretionary	O	In particular, we like the education space as it is relatively less sensitive to macro headwinds. Amid domestic consumption recovery, we prefer local brand names with strong online sales channel and low inventory level, like sportswear companies. We reduced some Macau names after recently rally as tourism recovery is still slow.
Consumer Staples	+	Margin expansion capability of select strong staple brand names remains significant with higher pricing power and using the ecommerce channel. Demand should recover quickly after COVID-19 outbreak, specially for alcoholic beverage. We like their defensiveness amid rising geopolitical risk and virus worries.
Energy	-	Oil price has dropped to lower levels with sharp drop in demand due to lockdown and travel bans during global coronavirus outbreak, which we believe will take a long time to recover
Financials	-	We are underweight banks as lower rates may add pressure to their net interest margins. We prefer some high quality insurance companies with long term growth opportunities at attractive valuations.
Healthcare	+	We favour those with strong R&D capabilities in innovative drugs and service providers with high growth visibility and solid business models
Industrials	-	More infrastructure projects to boost economy are on the cards and full resumption of construction works is underway but focus will be on "New Infrastructure" instead
Information Technology	+	We are positive on the handset lens upgrade trend and we like names that can benefit from continuing tech upgrade as smartphone demand remains stable despite the coronavirus outbreak and ahead of the upcoming new product launches by Apple.
Materials	O	Demand for construction and industrial materials have been further impacted by heavy rainfall and flood. We prefer gold mining companies within the sector given the surge in gold prices amidst global uncertainty.
Real Estate	O	We prefer property management companies from the longer term perspective as a defensive business with strong cash flow and ongoing market consolidation. Recent capital raising activities could reduce market uncertainty.
Communication Services	-	We selectively prefer gaming, social platform and cloud services companies as the coronavirus outbreak has speed up technology adoption. We are underweight telecom names due to the lack of catalysts.
Utilities	-	We are not positioned defensively in the current market

Source: Bloomberg, HSBC Global Asset Management, as of August 2020.
*NOTE - Sector views of HSBC Global Asset Management's offshore Chinese equity team; "+" = positive, "–" = negative, "O" = neutral
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Data watch

Indicator	Date	Actual	Consensus	Prior	Analysis
Industrial production (IP) (yoy)	Jul	4.80%	5.20%	4.80%	July activity indicators showed that the economic recovery continues into early Q3, though the pace of improvements slowed following an initial strong rebound driven by resumption of work, some pent-up demand and policy stimulus. IP appears to have lost some momentum. The recent heavy rains and floods may have dragged on production and construction activity in affected areas. That said, IP continued to find support from solid exports and recovering domestic demand. High-tech and auto manufacturing led gains, as machinery & equipment and infrastructure/construction-relates sectors posted robust growth. Services production picked up to 3.5% yoy in July (vs. 2.3% in June). We expect a cyclical recovery to continue, as the laggard sectors such as catering, domestic travel/tourism and offline entertainment continue to normalise and consumption recovers. However, the outlook faces uncertainties related to consumer demand strength, labour market recovery and corporate insolvency/ default risks amid external demand uncertainty and geopolitical tensions. Macro policies will likely remain supportive of a sustained recovery, though further stimulus may be less likely. The Politburo emphasised that policy making will look beyond the current business cycle and need to preserve policy space. We think economic policies will likely focus on reforms to promote longer-term, sustainable growth, such as the "dual circulation" economic strategy.
Fixed Asset Investment (FAI) (ytd, yoy)	Jul	-1.60%	-1.60%	-3.1%	The FAI recovery was led by acceleration in real estate investment, while infrastructure FAI growth moderated but was resilient amid improved financing supports. Manufacturing capex also continued to recover but still contracted YoY. Property activities were supported by continued release of pent-up demand, accommodative monetary and credit conditions, land and hukou reforms, and the government's plan to double old town renovation. New housing starts, property sales and developer funding gained further momentum, The simple average of new home price inflation across 70 cities slowed to 0.5% mom in July from 0.6% in June, after rising for four consecutive months. Weaker property price inflation in big cities may reflect the impact from local tightening measures announced recently to prevent the risk of overheating. Despite Beijing's recent hawkish stance on the property sector (e.g. recently reported stricter bond financing requirements for developers), we expect the government to continue its differentiated policy stance, given the divergence across cities and markets.
Retail Sales (yoy)	Jul	-1.10%	0.10%	-1.8%	Auto sales rebounded strongly, while online sales maintained a robust growth momentum. The recovery of offline, discretionary services consumption still lagged in the recovery, with catering falling 11.0% yoy. However, high-frequency data show continued normalisation of services activities in August: restaurant orders already exceeded early-January levels while movie box office revenue rebounded quickly since the re-opening of Cinemas in low risk areas starting 20 July. Domestic tourism trips also jumped since China allowed cross-provincial group tours on 14 July. That said, the consumption recovery still faces challenges from weaker near-term labour income prospects, limited direct government support/transfers for household income and rising household debt. The survey-based unemployment rate was steady at 5.7% in July, down from 6.2% in February but still higher than 5.3% in July 2019. Newly increased urban employment still declined 22.6% yoy in the first seven months.
Exports (USD) (yoy)	Jul	7.20%	-0.60%	0.50%	The export strength was driven by robust medical, tech and consumer goods shipments and reflected China's "first in, first out" status and COVID-19-related demand. Import data were consistent with recovering domestic demand, particularly construction activities, with import volume of key commodities maintaining solid momentum. While the worst of the global recession seems to be behind us, uncertainties remain over the global demand recovery in light of the recent resurgence in coronavirus cases and re-imposition of stricter containment measures in many countries. US-China tension remains a risk, though we think the phase one trade deal is likely to remain intact even as tensions flare up in non-trade areas (e.g. technology, financial markets/access to capital, and geopolitics, etc.). US exports to China of covered products in H1 amounted to USD33bn, only at 23.2% of the 2020 annual target, but China has increased imports from the US notably lately, particularly of agricultural products.
Imports (USD) (yoy)	Jul	-1.40%	0.90%	2.70%	
Trade Balance (USD)	Jul	$62.33 bn	$42.60 bn	$46.42 bn	
CPI Inflation (yoy)	Jul	2.70%	2.60%	2.50%	Headline CPI inflation pickup was driven by food prices (especially pork and vegetables) partly due to the recent heavy rains and floods in parts of the country. However, the weather-induced supply disruption is likely transitory, while recent data show a rebound in pork supply/stock with domestic production capacity being restored and import volume of pork also rising, which could drive down pork prices toward Q4 2020 and into 2021. Non-food CPI inflation fell further to 0.0% yoy in July from 0.3% in June, while core inflation slowed to 0.5% from 0.9%. Assuming a moderate pickup in core inflation amid an ongoing economic recovery, we still expect moderation in headline CPI inflation going forward partly reflecting the high base effect. The recovery in consumer demand for services has been gradual. The recent modest acceleration in money supply growth is not expected to be inflationary.
PPI Inflation (yoy)	Jul	-2.40%	-2.50%	-3.0%	
Aggregate financing (AF) (RMB)	Jul	1690 bn	1850 bn	3430 bn	Growth of outstanding AF rose to 12.9% yoy from 12.8% in June, with RMB loans and bond issuance maintaining strong growth while the YoY contraction of off-balance-sheet items narrowing further. Strength in medium- to long-term loans to corporates and households may indicate increasing support to the real economy, though credit growth could be easing given a more balanced ("neutral"), targeted and flexible (data-dependent) monetary policy stance, with PBoC's continued emphasis on lowering funding costs for the corporate sector.
New yuan loans (RMB)	Jul	992.7 bn	1200 bn	1810 bn	

Indicates improved data on month-on-month/quarter-on-quarter/year-on-year basis

Indicates worsened data on month-on-month/quarter-on-quarter/year-on-year basis

Indicates no change in data on month-on-month/quarter-on-quarter/year-on-year basis

Source: Bloomberg, HSBC Global Asset Management, as of August 2020

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