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2020 MID YEAR OUTLOOK – STAYING AHEAD

PERSPECTIVES FROM CHINA

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Once the epicentre of the COVID-19 outbreak, China was the first economy to emerge from the lockdown. Amid questions over the sustainability of China's recovery, Shanghai-based Michelle Qi highlights five key considerations for investors in the China A market:

- **Chinese economy to continue growing in 2020, albeit at a slower rate**
- **China's structural drivers – domestic consumption, technological innovation and shifting demographics – remain intact**
- **Further upside potential exists for China's A-share market**
- **Deteriorating asset quality will not present systemic risks**
- **Weak external demand and worsening US-China relationship are key risks.**

1 WHAT IS THE OUTLOOK FOR CHINA'S ECONOMY OVER THE NEXT 6 TO 12 MONTHS?

Against the backdrop of a nationwide lockdown in response to the COVID-19 outbreak, the Chinese economy contracted in the first quarter of 2020, for the first time in over 40 years. However, most economic activities began to show signs of recovery since March 2020, on the back of successful containment measures and supportive policies. As such, we expect the Chinese economy to continue to normalise over the course of the year. We also expect more monetary and fiscal stimulus measures to be implemented as presented in the recently-concluded National People's Congress (NPC).

The NPC set a larger budget deficit for 2020, representing over 3.6% of GDP, up from 2.8% in 2019. The overall fiscal expansion will be even greater if we consider the RMB 1 trillion special treasury and the RMB 3.75 trillion special local government bonds, which collectively represent more than 10% of GDP.

The NPC also called for a "notable increase" in monetary and credit growth. We, therefore, expect more cuts in interest rates and the required reserve ratio to follow in the next few months. These measures, coupled with work resumption, will help sustain China's recovery and mitigate the potential negative impact on the labour market from the slowdown in Chinese exports. Accordingly, we expect China's GDP to continue to grow in 2020, though at a slower rate of around 3%. Nevertheless, it will take time for consumer spending to recover, and therefore inflation will likely remain muted.

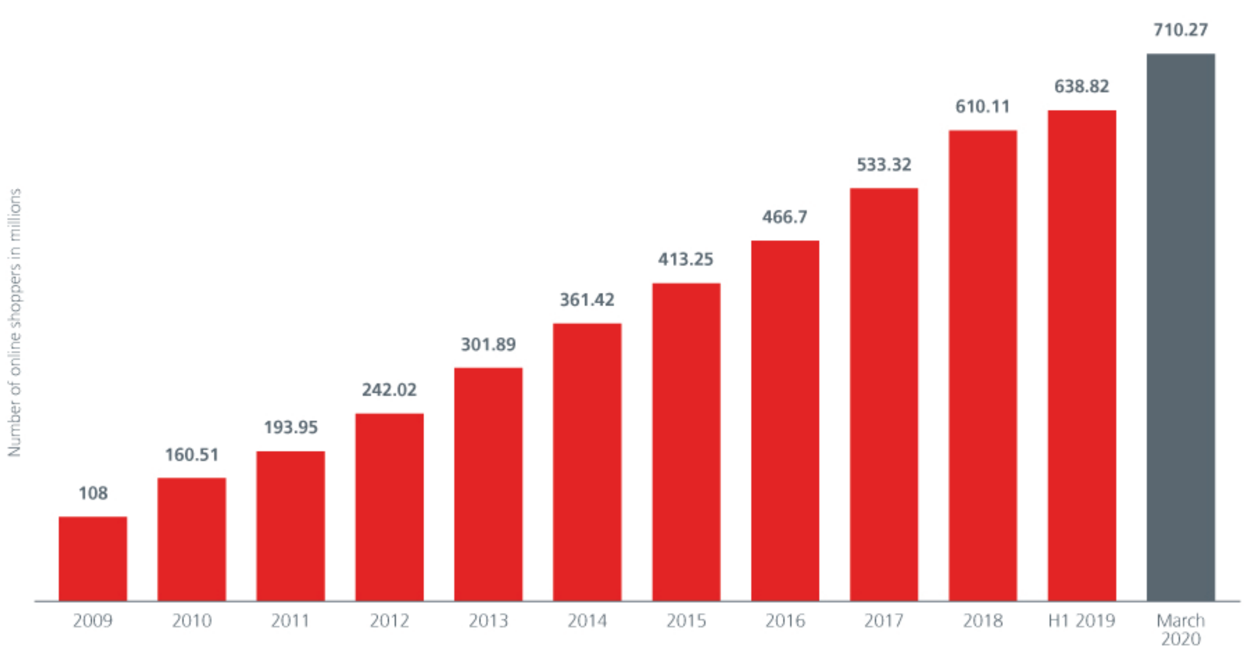
2 HAVE THERE BEEN CHANGES TO CHINA'S LONG-TERM DRIVERS SINCE THE COVID-19 OUTBREAK?

The outbreak has significantly impacted the Chinese economy, but it is unlikely to undermine the country's structural drivers which include higher health consciousness and healthcare affordability, shifting demographics, higher domestic consumption and technological innovation.

For the past decade, the establishment of the public healthcare insurance system has been the driver of healthcare spending, which has greatly improved the health consciousness and healthcare affordability for the public. We expect more government spending on public health infrastructure post the epidemic, which will further drive domestically manufactured products to substitute foreign imports. The ramping up of research and development expenditure is also an inevitable trend and is driving structural change and industry upgrade. We expect the size of China's rapidly aging population and resulting healthcare spending to become increasingly important in the longer run, which creates both opportunities and challenges for the industry.

With domestic consumption contributing to more than 70% of China's GDP[1] along with the rise of e-commerce, online consumption was already ubiquitous in China's top-tier cities before the outbreak. See Fig. 1. As supermarkets promoted

Fig 1: Number of online shoppers in China continues to grow steadily



Source: Statista, data release in April 2020.

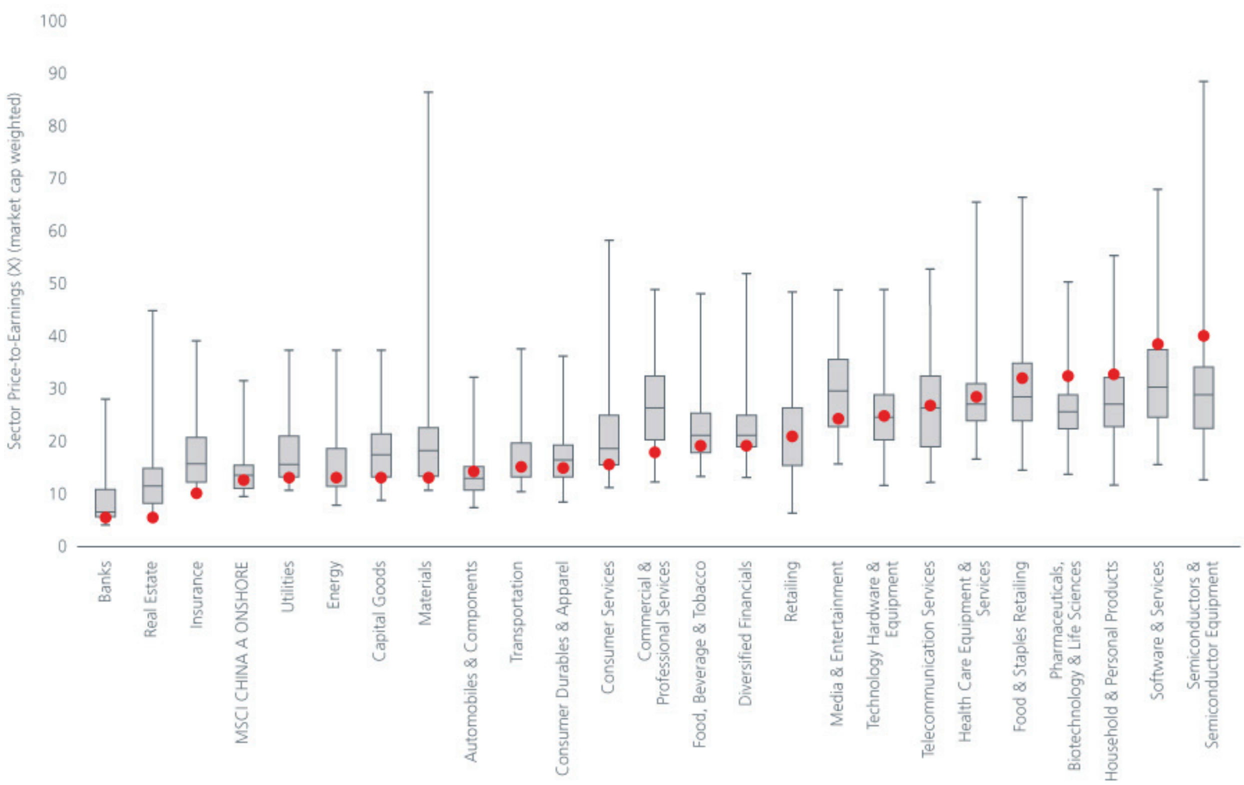
Source: [1]McKinsey Global Institute: China and the world, July 2019. P. 48.

their home delivery services aggressively, the outbreak has increased the penetration of online groceries, particularly among the older generation. This trend may continue after the pandemic. Looking ahead, we expect China's e-commerce market to grow as major retailers continue to adopt new initiatives and technologies. For example, through live streaming and leveraging on big data analysis, retailers are engaging with consumers more effectively, not only in the top-tier cities, but also in lower-tier cities and hard-to-reach areas. With the advancing shift from offline to online activities, other online services such as gaming, streaming of media content and education will continue to grow with an increasing number of active users, longer usage time, and higher paid user conversion rates.

3 GIVEN THE MARKET VOLATILITY IN THE FIRST HALF OF THE YEAR, HOW ARE YOU NAVIGATING THE INVESTMENT LANDSCAPE?

We see upside potential in the China A share market in the second half of 2020. We believe current market valuations (around the historical average) already reflect the expectations of further relaxation in fiscal and monetary policies. Nevertheless, if the economic recovery is sustained as per my expectations, improving corporate earnings will further boost the stock market. Fragile external demand as well as US-China tensions, on the other hand, are likely to be the major sources of downside risks. With these factors in mind, we are monitoring the impact of the outbreak on

Fig 2: Market forecast price-to-earnings in different sectors (China A-share universe)



Source: FactSet, MSCI, Wind, UBS Quantitative Research. Data from 1 January 2006 to 30 April 2020. Box plot display summary statistics of the maximum, Q3, median, Q1, and the minimum. Latest levels are marked in red dots.

corporate earnings, and favouring companies with the following attributes:

1. Stocks that have limited overseas exposure and can benefit from domestic policy easing, such as selected building materials, consumer and real estate companies.
2. Stocks that benefit from the global pandemic, such as selected healthcare players.
3. Leaders that have developed strong online distribution channels to benefit from changing consumer habits.
4. Laggards that are expected to recover along with the gradual restart of the global economy, and which face limited supply chain disruptions.

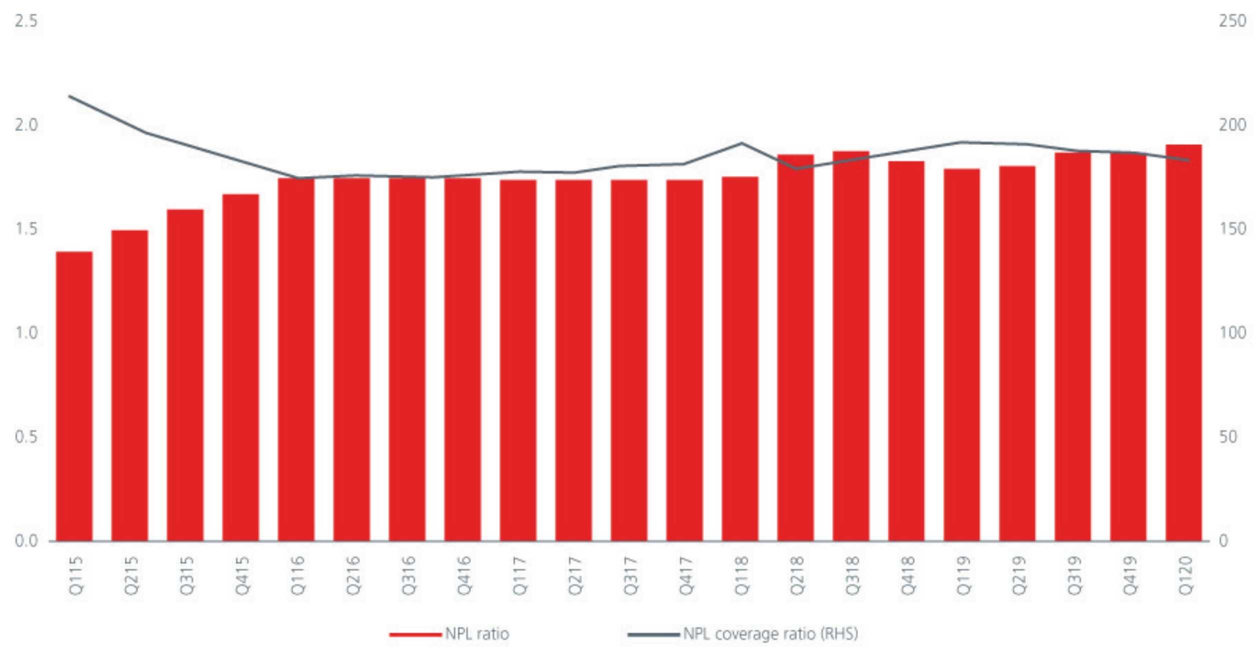
We will also be paying close attention to international dynamics; in particular, the implementation of the 'Phase One' trade agreement reached in January this year. In exchange for the US reducing duties on Chinese products, China had agreed to increase its purchase of US goods and services, open its financial services market to US competition, and exempt selected US imports from additional tariffs. Upcoming talks are expected to focus on how well both countries have met their obligations in the Phase One agreement amidst the global health crisis.

4 WILL THE UPTICK IN NON-PERFORMING LOANS PRESENT A SYSTEMIC RISK FOR CHINA?

We expect to see some pressure on Chinese financial institutions' asset quality as non-performing loans (NPLs), especially in the consumer segment, may increase as the economic slowdown drives up unemployment and weighs on household income. The risk, however, can be largely mitigated given sufficient provisions and capital buffers within the financial system. China's NPL ratio appears manageable and the banks are still able to absorb potential losses. See Fig. 3.

In addition, while the People's Bank of China has injected adequate liquidity and lowered interest rates to support the economy, the government has also been strictly monitoring financial leverage over the past few years in order to mitigate systemic risks.

Fig 3: Non-performing loan (NPL) ratio & NPL coverage ratio



Source: Wind, Eastspring Investments, as at 31 March 2020.

5 WHAT ARE THE KEY RISKS FOR CHINA'S ECONOMY AND FINANCIAL MARKETS OVER THE NEXT 12 MONTHS?

First, weak global demand for Chinese exports will weigh on the Chinese economy and on employment. Although China's exports rebounded in April, this was probably driven by the delivery of postponed export orders, as well as rising demand for medical goods and consumer necessities given the supply disruption in the rest of the world. The weak PMI for export orders in April suggests that external demand remains sluggish.

Next, overly aggressive policy easing would aggravate financial leverage, fuel property speculation and pose a risk to long-term financial stability. Armed with the lessons from the Global Financial Crisis in 2008-09, where a massive stimulus package lifted China's debt to GDP ratio from 150% of GDP to 253% of GDP by September 2018, China's policymakers have been more prudent in dialling up the stimulus this time around.

There is also a risk that US-China tensions will escalate and extend beyond trade. The US recently imposed new restrictions on Huawei, limiting its ability to use US technology and software to design and manufacture its semiconductors abroad. The new rule will affect multiple foreign producers which sell to Huawei and its affiliates. The outcome, at the point of writing, is still uncertain. In the meantime, however, the negative impact on investor risk appetite cannot be ignored.

Finally, a potential resurgence of COVID-19 in the coming winter could again weigh on economic growth.

Source: [2]Bloomberg. As at 27 May 2020.

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