

China is back: Tracking the progress of China's accelerated re-opening



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The Chinese government set a GDP growth target of around 5% at the recent National People's Congress. We expect China's economic recovery to take place in three stages and see further upside for the China A-share market as the recovery supports earnings growth and investors shift from beta seeking to alpha generation.

HOW HAS THE RE-OPENING IMPACTED THE CHINESE ECONOMY TO DATE?

Consumer spending was strong through the Chinese New Year and the latest data show that the 18-city subway passenger traffic (7-day moving average) has reached 115% of 2019's level. Restaurant revenue and movie ticket sales have also exceeded 2019's levels. Credit demand, as measured by M2 and corporate loans, has shown signs of improvement. Meanwhile, both China's manufacturing and non-manufacturing Purchasing Managers' Indices (PMI) returned to above 50 in January and improved further in February, signalling a relatively broad-based recovery.

We see China's economic recovery unfold in three stages. In stage 1, the demand for services should rise as mobility normalises but still-weak employment and lacklustre household income may cap demand. Policy support will play a key role in the next stage of the recovery. For the first time in four years, we expect China's covid management, economic and

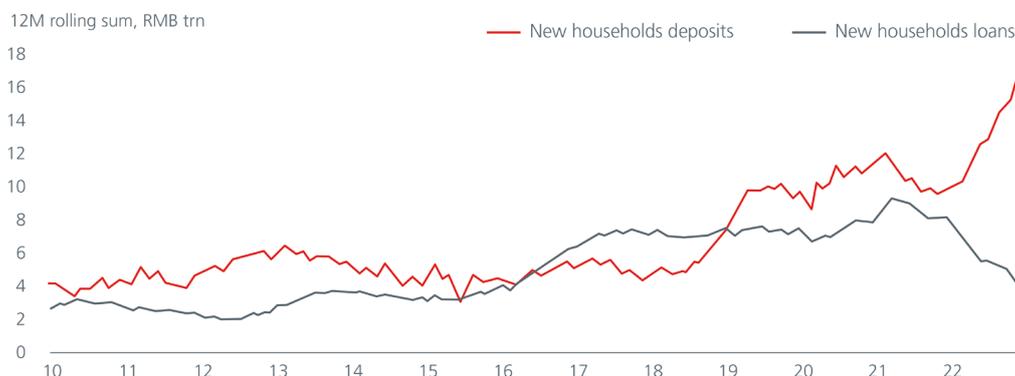
regulatory policies to be aligned to revive economic growth. For the recovery to be sustained in stage 2, corporates must feel confident enough to increase spending and production. Earnings may pick up as the de-stocking cycle ends, potentially in the second half of the year.

In the final stage of the recovery, following the improvement in corporate earnings and household income, excess household savings is expected to boost consumption. Household deposits have surged on the back of weak spending in 2022, as well as lower home purchases and financial investments. See Fig. 1. For consumption to rebound strongly in 2023, consumer confidence and the labour market would need to improve.

WHAT WERE THE KEY TAKEAWAYS FROM THE NATIONAL PEOPLE'S CONGRESS (NPC)?

The main objectives set out in the Government Work Report at the NPC meeting were at the lower range of market expectations with the GDP growth target set around 5% and the budget deficit at 3% of GDP. There was some disappointment in the market that the government did not announce a big stimulus, especially for the property market. That said, we note that property sales have been quite resilient year to date and the government's overall tone appears supportive for the sector – with a focus on minimising systemic risks for leading property developers and reducing the interest burden for local governments. The government

Fig. 1. Households have been accumulating deposits while mortgages have fallen



Source: JP Morgan. Eastspring Investments. As of January 2023.

appears comfortable with the current pace of recovery and is unlikely to roll out massive stimulus as long as the recovery is sustainable and there are no systemic risks. We believe that the policy directives continue to support our stance of seeking opportunities in strategic sectors such as high-end manufacturing, new energy, consumer and medical services.

HAS OR WILL CHINA’S RE-OPENING LIFT INFLATION?

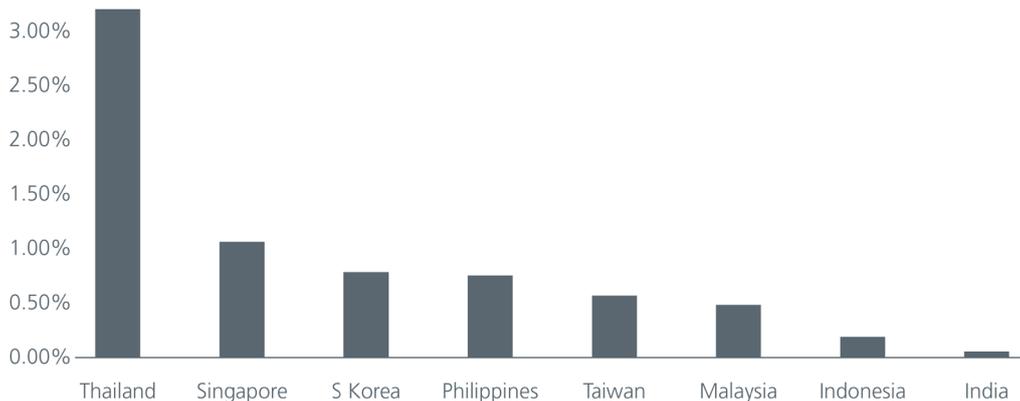
China’s CPI inflation was 1.0% in February, rising at the slowest pace since February 2022. Relatively muted inflationary pressures in China to date have given the central bank room to keep interest rates low, in contrast to the rest of the developed and emerging economies. With pork prices peaking and still weak domestic demand, inflation is likely to remain moderate in the first half of 2023. As such, the People’s Bank of China would probably maintain an easing bias until domestic demand and credit growth rebound more materially. The risk however is that domestic inflation accelerates on the back of a stronger than expected recovery in demand.

As China consumes almost one fifth of the world’s oil, over half of the world’s refined copper, nickel, zinc and more than three fifths of its iron ore, the impact of China’s re-opening on commodity prices bears monitoring. That said, the current recovery is consumption-led, unlike previous recoveries which were concentrated in infrastructure and fixed investments. So, the impact on commodity prices may be more muted. At the same time, the deceleration in the developed economies should weigh on commodity demand and provide some offset.

WHAT DOES CHINA’S RE-OPENING MEAN FOR THE REST OF ASIA?

Besides impacting commodity prices, China will affect Asia via the tourism and trade channels. Asia is one of the key destinations for Chinese outbound travel and should enjoy tailwinds as Chinese tourists return. Based on 2019 data, Thailand, Singapore and Korea had enjoyed the greatest amount of Chinese tourist spend (as a percentage of GDP) within Asia. See Fig.2.

Fig. 2. Chinese tourist spend as % of GDP (2019)



Source: WTTC, HSBC. February 2023.

Asian exports should also benefit from China’s recovery. Historically, within Asia, Taiwan, South Korea and Malaysia have accounted for the highest value add in consumer goods supply to China (as a percentage of GDP). However, with consumption likely to be biased towards the pent-up demand for services (such as domestic and cross-border travel, dining in etc) rather than goods, the uplift to Asian exports may be more moderate.

THE CHINA A-SHARE MARKET HAS RALLIED 12% SINCE NOVEMBER, FOLLOWING OPTIMISM OF CHINA’S RE-OPENING. IS THERE MORE UPSIDE FOR THE MARKET?

We believe that there is further upside for the China A-share market. Compared to the China offshore market, China A-shares’ higher correlation to China’s macro policies and higher representation of local champions (“little giants”), suggest that the market should benefit to a greater extent from the government’s supportive policies.

The market’s initial rally was led by investors’ desire for greater beta exposure and had largely benefitted benchmark and large capitalisation stocks. Inflows had also focused on re-opening plays such as the consumer-related stocks. As confidence over China’s recovery increases, we expect to see inflows seeking alpha opportunities and focusing on sectors which in line with the government’s strategic priorities. These would include the Electric Vehicle (EV) and EV supply chain, renewables, healthcare, and advanced manufacturing industries.

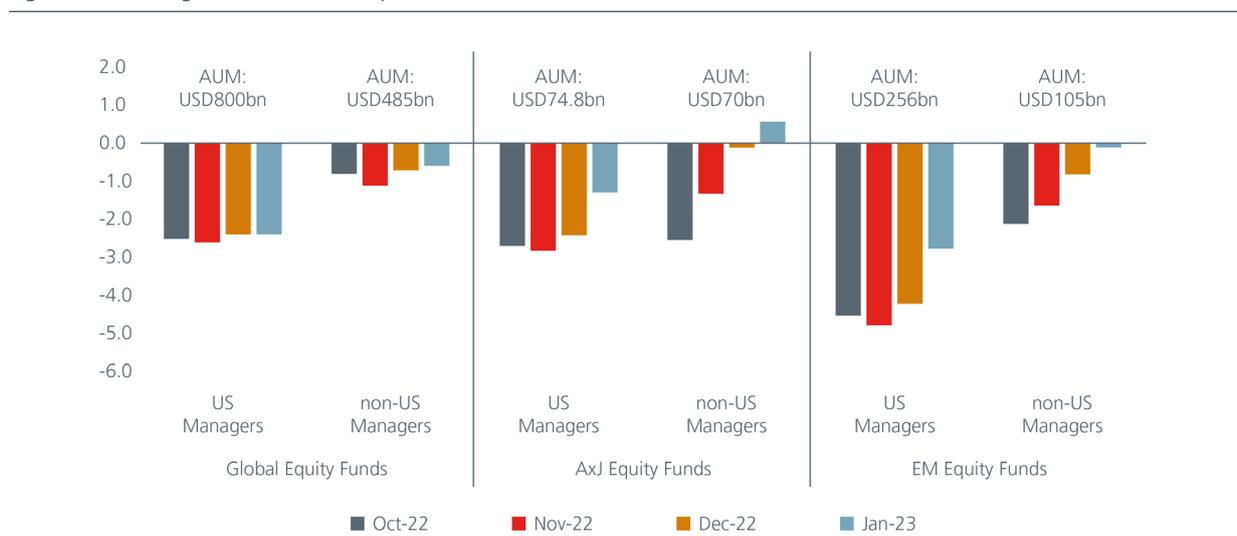
Easing regulatory crackdown on the internet platforms may also help boost investor sentiment. The sector’s recent news flow has been positive – China’s central leadership has reportedly given an initial nod to restart Ant’s listing plans in Shanghai and Hong Kong. Didi, China’s ride hailing giant, has also been allowed to register new users after a one-and-a-half-year hiatus. In addition, regulators handed out 88 video games licenses in January. The recent shift in the government’s stance acknowledges the internet platforms’ importance in creating employment and lifting consumer confidence.

With offshore investors still mostly underweight China in their portfolios (See Fig. 3.), there is upside for the A-share market as portfolio exposures rise. We believe that there are ample stock picking opportunities for active investors going forward as portfolio managers have not had the opportunity to visit and conduct due diligence on new companies in the last three years – just in 2022 alone, the A-share market raised a record USD84 bn in new listings from 428 IPOs. Although the China A-share market is no longer as cheap as it was at the end of 2022, China’s economic recovery should support earnings growth going forward.

IS CHINA’S PROPERTY SLUMP OVER?

Since November 2022, the central government has rolled out a series of policies to improve the liquidity position of property developers and stabilise the property sector. Policy support has continued in the new year. Locally,

Fig. 3. Active weights of China/HK equities (%)



Source: MorningStar, FactSet, EPFR, Morgan Stanley Research; notes: the fund universe of each category is formed by the largest 30 active mutual funds under MorningStar regional category. We exclude ESG funds, income funds and systematic funds. All the covered funds are benchmarking to either MSCI or FTSE standard regional indices of All Country World, Asia ex-Japan, or Emerging Markets. February 2023.

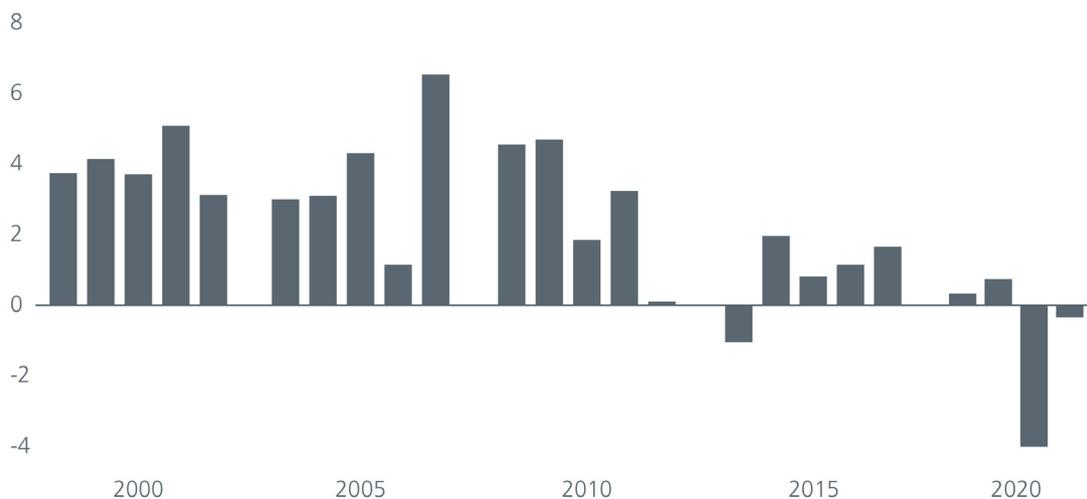
cities have cut first home mortgage rates, lowered down payments and extended home subsidies. Since the start of the year, a number of developers has selectively replenished their landbanks, suggesting improving liquidity positions. Furthermore, the ability of property developer Dalian Wanda to successfully tap the offshore bond market twice in 2023 is also a sign that confidence is slowly returning, although investors remain highly selective. In addition, recent sales data showed a notable pick up especially in the secondary housing market, pointing to better home buyer sentiment as well. It will take time for the recovery in the secondary market to fully feed through into new home sales, but we expect the overall property market to stabilise and see some turnaround no later than in the second half of 2023. On balance, the sector should be less of a drag to growth in 2023 compared to 2022. Fig. 4.

WHAT ARE SOME OF THE KEY RISKS THAT INVESTORS NEED TO BE MINDFUL OF?

Besides keeping an eye on inflation, the nascent stabilisation of the property sector also bears monitoring as access to financing remains key. Active management and hedging strategies can help mitigate these risks.

The state of US-China relations will also continue to be an important consideration for investors. The US technology sanctions and especially chip embargos potentially hurt China's production and export of technology products. However, as US-China tensions accelerate import substitution, there is room for local champions to emerge in the software, semiconductors, industrial automation, and medical devices sectors, potentially creating attractive opportunities for investors.

Fig. 4. Growth contribution to GDP of the property sector (%)



Source: UBS. February 2023.

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