2019 mid-year outlook — Greater China equities

July 2019

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Hong Kong/China equities staged a strong rebound in the first four months of 2019 before trade tensions re-emerged in May[1]. The pause in bilateral negotiations between the world's two largest economies triggered a market correction[2], which stabilised towards the end of the first half of the year as both sides agreed to renew trade talks after G20 meeting. That said, our view is that US-China trade tensions, even if a nominal trade deal is reached, are structural in nature — they may ultimately transform the current global trading order. As active managers, we focus on planning for long-term opportunities, what we refer to as the "day after tomorrow", carefully selecting investment themes that should benefit from China's economic transition even amid day-to-day volatile trade tensions.

Planning for the day after tomorrow

Looking beyond market noise

After greater China equity markets recovered in the first quarter of 2019, the escalation of trade tensions between the US and China in May has once again dominated market sentiment. Indeed, although the ratcheting up of tariffs and boisterous rhetoric has been the daily focus of market attention, we believe the real story for investors is the Chinese government's strategic support for the economy, both over the short-term and long-term, to transition to consumer-based, value-added economy.

Government policy reforms promote better business environment

Overall, China has held up relatively well in the recent months, primarily due to Chinese government monetary and fiscal policies. The People's Bank of China has adopted an accommodative policy stance, cutting the reserve rate requirement for banks and maintaining ample liquidity amid volatile markets. The government has also progressively unpacked its fiscal policy tool-box to make it less expensive for companies to conduct business and consumers to keep more income. Indeed, businesses benefitted from numerous policies including the three-percentage-point cut in the value-added tax (VAT) at the highest tranche and a reduced pension contribution rate for employers [3] that will lessen the cost of doing business in China. The property[4]and infrastructure[5] sectors have also benefitted from preferential government policies

At the same time, the Chinese economy has benefitted from ongoing economic restructuring and structural reforms, through alleviating city pollution and improving the health of industries plagued by overcapacity. In addition, some enterprises have strengthened their ability to pay down debt, which in turn has bolstered the financial system, where the banking industry has recorded the lowest problem-loan ratios in five years [6]. In our view, these measures have put China's economic fundamentals on better footing than they were just a year ago.

[1] Source: Bloomberg, as of 14 June 2019.
[2] In the world of investments, a correction is generally defined as a decline of 10% or greater in the price of equities from its most recent peak.

[3] The pension contribution rate will be cut from a ceiling of 20% to 16 % of the overall wage bill to reduce the burden on businesses. South China Morning Post: "China is plugging pension hole by tapping into US$25 trillion in equity in state-owned enterprises", 21 May 2019.
[4] South China Morning Post: "New home prices rise in almost all Chinese cities as lower mortgage rates, lighter restrictions spur demand", 16 May 2019.
[5] Financial Times: "China infrastructure stocks climb as Beijing offers support", 11 June 2019.
[6] CBIRC, as of 10 May 2019. Problem loans are defined as special mention loans and non-performing loans.

Earnings: Arrows in the string

These improved fundamentals were reflected in earnings. During the first quarter, insurance and consumer staples companies delivered better-than-expected results, and we believe that the insurance sector is bottoming out after a sharp slowdown in 2018. Many insurers have sold more protection policies, resulting in strong VNB [7] growth and improving margins, and that momentum should continue for the rest of the year. Some consumer staples companies are seeing gross margins improve as material costs drop.

After the release of first-quarter corporate results, markets began revising up estimates. The market was originally expecting double-digit earnings growth for FY2019. Although tariffs are likely to shave two and three percentage points off earnings in 2019 and 2020 [8], respectively, we expect that Corporate China's bottom line will hold up over the short-term. We believe that in the second half government measures to help mitigate the economic impact from Sino-US trade tensions will provide support to Greater China equities, although we anticipate continued market volatility.

Amid short-term volatility, our long-term investment themes stand

While focusing on short-term developments can be important, closely following daily market gyrations and volatility of the bilateral trade talks can obscure the bigger picture. Amid the recent volatility, we have held to our long-term convictions that many attractive opportunities exist in China's transition to a more consumer-based, value-added economy.

Indeed, even before bilateral trade tensions erupted into the open, we were planning for "the day after tomorrow", and we selected three long-term investment themes where we believe investors would be well positioned to profit from China's gradual economic change:

- **Consumption Upgrade** We believe that Chinese consumers will continue to be a primary beneficiary of China's growing economy. As consumers' disposable income grows, even at a slower pace due to economic difficulties, they will continue to spend on upgrading their quality of life; including helping their children obtain better education. Thus, we are constructive on sectors such private educational providers and property management services, which are tethered to structural domestic growth stories.

- **Research and development (R&D) / Innovation** — China's government and corporations have put increasing emphasis on R&D and innovation to improve competitiveness. This shift is not new: companies increased R&D investment already under the 13th 5-year plan (2016-2020) [9], but the emphasis has clearly accelerated as trade tensions have led to US bans on some Chinese firms' imports of certain intermediate goods and changing global supply chains. We believe Chinese companies will continue to increase investment in this critical area, particularly basic research, as a means to move up the value-added ladder. We are constructive on upstream technology, industrial applications, and the country's burgeoning health-care sector.

- **Policy Driven** — China's government has selected several key policy areas to target fiscal spending over the long-term. Environmental protection, which includes supply side reform, natural gas, waste-to-energy, and wastewater treatment, are key areas that will continue to receive government support. As the government unveils further measures, we will remain vigilant to identify the next key beneficiaries of government support.

[7] VNB stands for "value of new business". The metric indicates the value of an insurer based on the level of new business achieved over the past year.
[8] Morgan Stanley, 14 May 2019.

[9] The 13th 5-Year Plan (2016-2020) set a goal of R&D expenditure reaching 2.5% of GDP by 2020. In 2018, R&D expenditure accelerated to 2.18% of GDP, National Bureau of Statistics of China, as of 28 February 2019.

With these themes in mind, we view protracted Sino-US trade tensions (in some form) as a structural feature of the market landscape moving forward. The implications of recent trade policies, particularly restricting Chinese technology companies' access to US suppliers, have injected greater uncertainty into the Chinese investment landscape. Even if the trade sanctions are ultimately removed, we believe the bifurcation of global technological supply chains into two "camps"— the US and China — is a real possibility that may potentially give short-term pain but also serve as a long-term catalyst for Chinese companies to upgrade their competitiveness on a more urgent timeline.

Planning for the "day after tomorrow" must be done today

When the "fog" of uncertainty from US policies finally dissipates, we expect significant opportunities could emerge for investors, and when they do, they will likely fall into the themes we have already identified. Indeed, investors should draw on the talents of an experienced and nimble team that can not only apply rigorous bottom-up research to companies in the region's markets, but also seize emerging opportunities. We believe our on-the-ground presence in the region, coupled with its skilled portfolio managers and rigorous investment selection methodology can make it the right pick to navigate China's new investment landscape.

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