China Insights

Jan/Feb 2021

Hot topic: China walks policy tightrope between growth and risks

Summary

- The recent liquidity tightening is as part of counter-cyclical policy adjustment in response to market conditions and economic data, rather than sending asset bubble warning or policy tightening signals, in our view
- We continue to expect the reduction in virus risk due to mass vaccination coupled with swift policy response to support the ongoing recovery in consumer spending and strong growth for 2021
- Policymakers are expected to strike a balance between supporting economic recovery and preventing risks such as an increase in the macro leverage ratio, growing non-performing loans, and external uncertainty

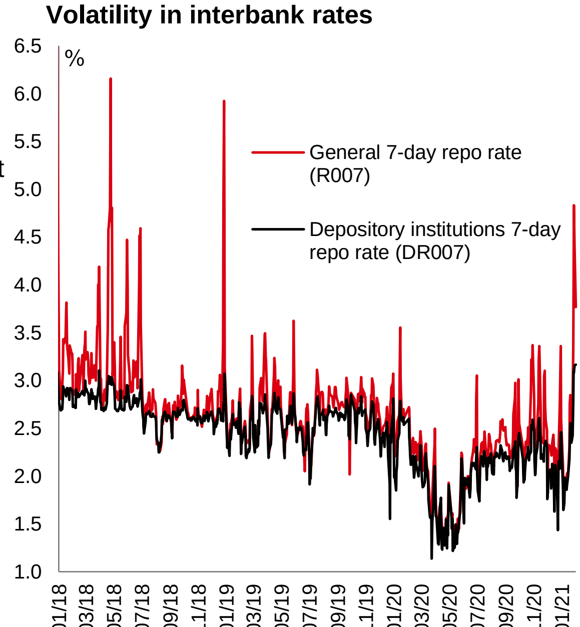
Hot topic: China walks policy tightrope between growth and risks

Short-term money market rates rose sharply in January as the People's Bank of China (PBoC) drained funds from the financial system amid concerns over overheating risks in the country's asset markets. At the same time, demand for cash was seasonally higher due to the end-of-month regulatory checks and tax payments as well as the upcoming Lunar New Year (LNY) holiday. Banks reduced credit supply to non-bank financial institutions (FIs) and/or charged higher interest rates. The tighter liquidity environment followed liquidity loosening in November-December, when interbank rates dropped, partly aimed at restoring investor confidence following rising corporate bond defaults, in our view. As a result of lower funding costs, signs emerged of FIs leveraging up to boost returns on short-term bond investments and more liquidity/ retail deposits being channeled to the stock and property markets. PBoC adviser Ma Jun said that monetary policy should adjust to curb asset bubbles in certain areas.

Policy trade-offs between economic growth and financial risks

It is possible that the recovery in onshore corporate bond issuance in the recent few weeks and economic data still pointing to an ongoing cyclical recovery (including solid Q4 2020 growth of 6.5% yoy) have provided the PBoC with confidence to resume normalising its liquidity stance, while it remains mindful of excess risk-taking in financial markets and reports of material property price rises in selected cities.

Volatility in interbank rates



Source: CEIC, Bloomberg, HSBC Global Asset Management, January 2021
For illustrative purpose only.

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However, we think the recent liquidity tightness and rate spikes are likely to be temporary. Interbank rates retreated in early February. We interpret the January liquidity tightening as part of PBoC's counter-cyclical policy adjustment in response to market conditions and economic data, rather than sending asset bubble warning or policy tightening signals. Currently we do not see strong signs of equity market bubbles, gauging from the margin trading and/or stock pledge statistics, while property market performances remain divergent across cities. The PBoC is unlikely to tighten policy materially or raise financing costs amid lingering uncertainties over the outlook, including the pandemic situation domestically and globally and a still-uneven recovery. Meanwhile, underlying/ core CPI inflation is modest as the recovery of services consumption remains gradual and the pass-through effect from PPI reflation to CPI inflation due to higher commodity prices and firm pricing is likely to be limited in the near term. Corporate default risks still warrant a close watch, with policies deferring small and medium-sized enterprises' (SMEs) loan repayments due to expire.

Near-term consumption uncertainty due to latest Covid-19 resurgence; growth impact likely to be manageable

The recent resurgence of Covid-19 cases in some northern cities casts uncertainty over the near-term growth outlook. The central government and many local governments have tightened restrictions on travelling and gatherings during the Lunar New Year holiday period, and encouraged migrant workers to stay in the cities of their workplaces for the festival season. People who travel from medium- and high-risk areas as well as those who travel to rural areas are subject to mandatory nucleic acid tests and quarantine/ homestay monitoring. Beijing has also imposed stricter border controls. That said, the virus-containment measures with regulations varying across cities and provinces depending on the risk level are more targeted this time around compared to the nationwide lockdown in February 2020

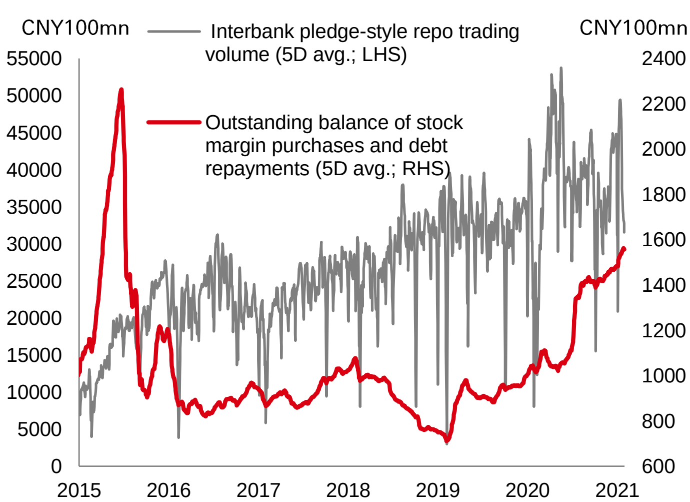
Tighter mobility restrictions may weigh on private consumption in the near term, with offline retail sales and services, particularly transportation, tourism/ hospitability, and leisure & entertainment taking a hit. This could further delay the growth rotation from exports and investment to consumption as well as from manufacturing production to services, a key trend we expect for 2021. That said, the consumption impact could potentially be offset by seasonally stronger production activity and exports as more workers staying in the cities where they work could help factories stay open and running. We expect the overall economic damage to be much smaller than a year ago, given the more targeted containment approach, swift policy responses and improved tracing and testing technology to contain the virus spread, the vaccine rollout (about 1% of the population has been vaccinated as of late January, though the current progress is lagging behind the original plan of vaccinating 50 million people before the LNY holiday), as well as higher adaptability of consumers and companies to social distancing (e.g. set-ups for working from home and online activities).

Monetary policy normalisation in 2021 with targeted support to continue; no abrupt policy turn

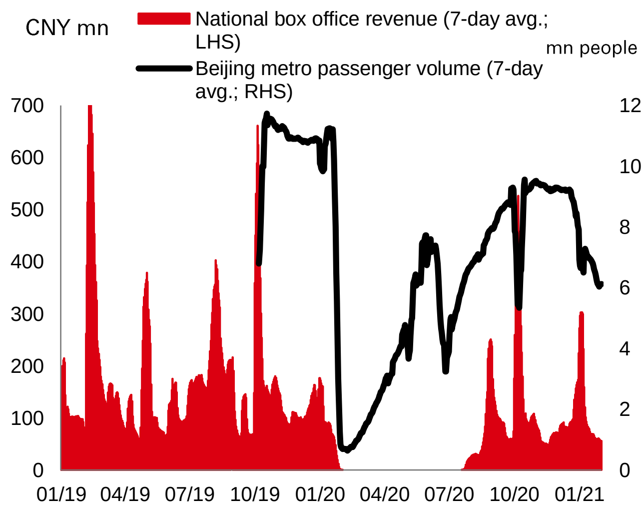
We expect the authorities to continue tapering its emergency support, with gradual liquidity/ market rate normalisation, moderate deceleration in credit and money-supply growth, as well as tighter property and financial regulation and local government debt risk control. The PBoC will continue its prudent liquidity operations to manage money-supply growth, ensure targeted credit extension to the real economy, and avoid excess liquidity flows to the financial and property markets. We also believe that authorities would use macro-prudential measures to rein asset bubble risks rather than conventional monetary policy such as rate hikes, as the latter would have larger and broader economic impacts.

The leadership, including President Xi Jinping and PBoC Governor Yi Gang, has sent reassuring message that there will not be an abrupt policy turn or premature exit from supportive policies. Governor Yi has stressed policy stability and continuity: policy will strike a balance between supporting economic recovery and preventing risks, including risks from an increase in the macro leverage ratio, growing non-performing loans, and external uncertainty. The potential growth impact from policy normalisation could be cushioned by improving corporate profits and household income.

Asset bubble risks look manageable at present



Passenger traffic volume weakened recently



Note: WIND, CEIC, Bloomberg, HSBC Global Asset Management, January 2021

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

Onshore bond market received USD155 billion inflows in 2020, more than double the USD66 billion inflows in 2019

- The Chinese government bonds (CGB) sold off by 3-12bps across maturities in January, largely due to a liquidity tightening in late January. As a result, the short-end of the CGB curve sold off by 20-30bps while the 10-year widened 6bps in the last week of January. The AAA rated onshore credit widened 9bps (*See Hot topic for more details*)

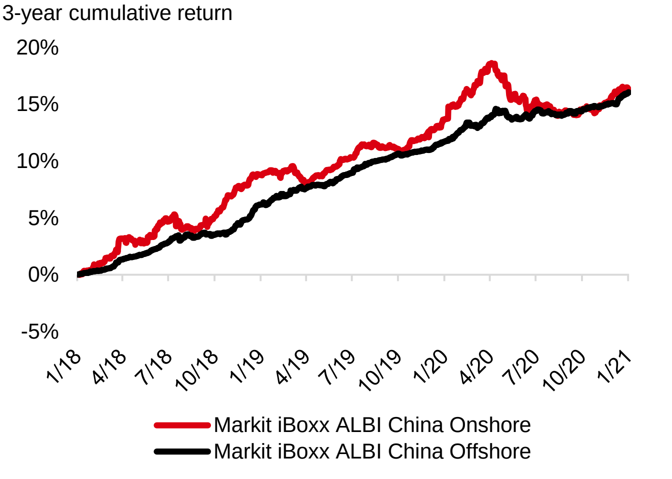
- Generally speaking, the tight liquidity conditions are raising the risk of defaults amidst real estate developers, coupled with growing signs that the authorities are stepping up efforts to curb speculations in the property market and the use of leverage by developers and homebuyers. In January, a mid-sized developer failed to meet its onshore debt obligations, triggering a sharp sell-off in its onshore and offshore bonds. Outside of the property space, a once high-flying aviation conglomerate said its creditors were seeking to push the company into bankruptcy court and restructure its outstanding debt

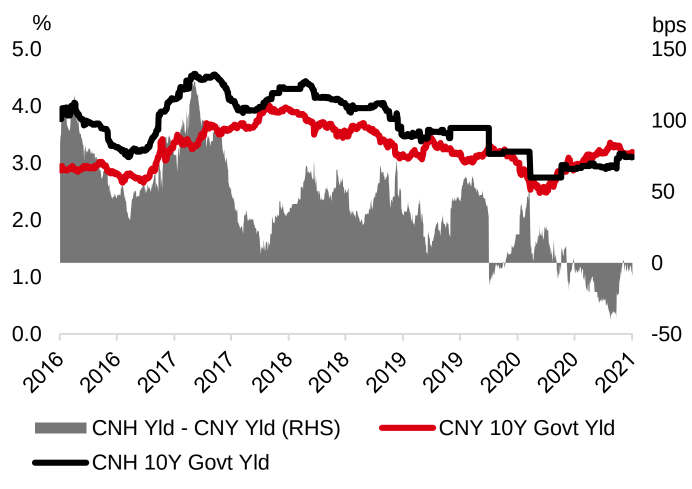
- On a brighter note, the iBoxx ALBI China Onshore and Offshore indices advanced 1.6% and 1.5% in USD terms in the month ending January 31, respectively, largely due to RMB appreciation against the dollar. Conversely, the Bloomberg Barclays Global Aggregate, a gauge of global investment-grade debt from twenty-four local currency markets, retreated by 1.1% for the same period, while overall China dollar credit slid 0.2% due to selling in some property and industrial names

- In terms of fund flows, the onshore bond market received USD155 billion inflows in 2020, more than double the USD66 billion inflows in 2019, largely from long-term institutional investors. We believe the currency strength and enlarged yield spread with developed markets such as US and Eurozone is likely to persist in the next 12 months and prompt more inflows over the long run

- The spread between the Chinese and US 10-year government bond yield was largely unchanged at 210bp in the end of January, while the RMB has advanced 1% against the greenback so far this year. US Treasury yields rose on stimulus optimism, shaking off weak macro data and dollar weakness in the past year. The dollar index, which measures a basket of currencies, bounced back from 89 in December to 91 currently. In 2021, we have a positive outlook on Chinese fixed income backed by strong fund flows and continued economic recovery in the world's second-largest economy. In addition, further upbeat Covid-19 vaccine news and dollar weakness are also supportive of the asset class

Chinese bonds remain steady amidst economic recovery





Source: Bloomberg, Markit data as of January 2021. Total return in local currency terms.
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Equity market

- Both onshore and offshore Chinese equities continued to rally in the first month of 2021, as more macro data pointed to a continued recovery in the economy. December industrial profits accelerated to 20.1% from a year earlier, up from November's 15.5%. In addition, there was some progress on normalisation of relations between China and US with the latter delaying the implementation of its ban on investment in certain Chinese companies to May 27

- Despite a major pullback in the last week of the month, the MSCI China A Onshore and MSCI China – the offshore and offshore gauge – advanced 2.4% and 7.4%, respectively, in January. Locally the CSI 300 Index of the country's largest companies added 4.3% in US dollar terms, while the Hang Seng Index rose 3.9% on the back of record southbound flows. The 7-day repo rate jumped as high as 7.5% intraday on January 29, and moderated to 3.2% the next day (*See more details in our Hot topic*)

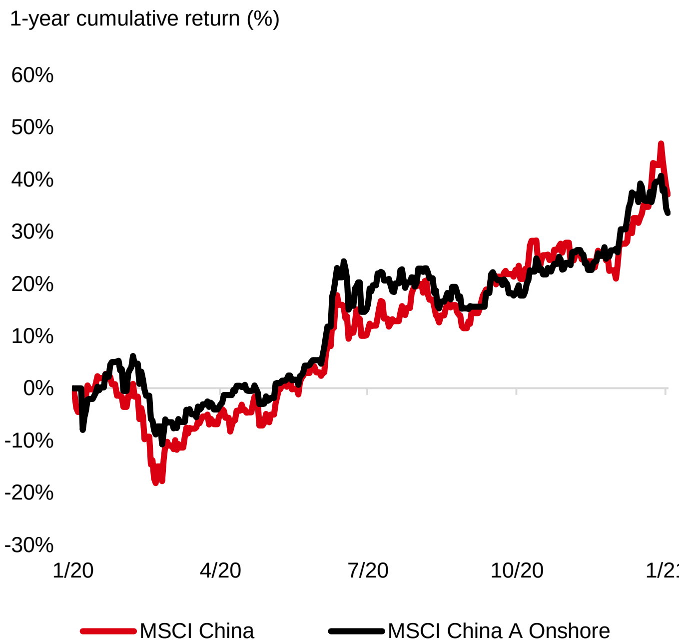
Bouncing back from the pandemic-induced slump, the 12-month forward price-to-earnings of MSCI China and CSI 300 are now trading at 16.9x and 15.9x, respectively

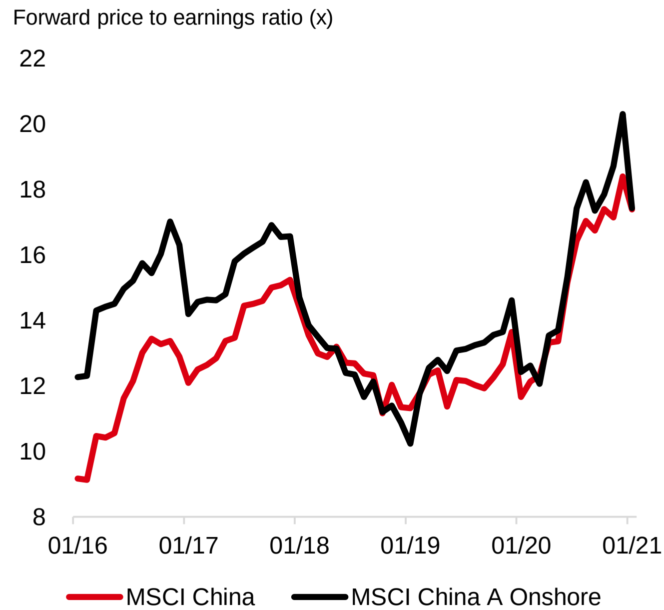
- The southbound channel, which allows mainland investors to buy Hong Kong-listed companies – saw USD40 billion inflows in January, compared with USD4 billion the same period a year earlier and almost half of the USD87 billion that came in all of last year. The record-breaking inflow into Hong Kong is primarily driven by buying of US restricted names and buoyant fund-raising activities by onshore mutual funds. Conversely, northbound trade was relatively muted, with USD6 billion inflows after some selling pressure in the last week of the month

- As part of China's market liberalisation, a list of 12 companies listed on the STAR board – a Nasdaq-style listing venue in Shanghai – has become available to foreign investors through the northbound route from February 1

- In terms of valuations, the 12-month forward price-to-earnings of MSCI China and CSI 300 are now trading at 16.9x and 15.9x, respectively, with a 2021 consensus earnings growth of 24% for the former and 17% for the latter. In the past month, earnings forecast of real estate companies have seen the biggest downward revisions by analysts, due to increasing tightening measures against the use of leverage by developers and homebuyers. Meanwhile, the prospects for energy and materials companies have been revised upwards, reflecting interest in renewable energy such as solar and wind

Chinese stocks continue to climb supported by ongoing recovery





Source: Bloomberg, HSBC Global Asset Management, as of January 2021. Total return in local currency terms.

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Sector*	Outlook	Comment
Consumer Discretionary	O	In particular, we like e-commerce platforms with faster adoption rates and expanding net margins along with better logistical systems. We prefer companies that are likely to benefit from a recovery in domestic consumption, such as automakers.
Consumer Staples	+	We prefer Chinese liquor names that can provide long term growth as their margin expansion capability remains considerable with higher pricing power and the availability of ecommerce channels.
Energy	-	Vaccine hope has increased market expectation of economy activity normalisation. However, actual demand will take time to pick up.
Financials	-	We are underweight banks as lowered rates may add pressure to their net interest margin and asset quality remains cloudy. However, we have reduced our underweight position in banks and insurance companies given a value factor pick-up.
Healthcare	+	We favour service providers with high growth visibility and solid business models, which are less affected by the national reimbursement drug list policy. Companies with strong R&D and clinical development capabilities in innovative drugs will also outperform.
Industrials	+	We prefer beneficiaries in electric vehicles production chain and machinery with higher environmental standards. Industry leaders with accelerated capacity expansion can gain more global market share.
Information Technology	+	We like names that can benefit from continual tech upgrade. The Biden administration is expected to provide more consistency and predictability to the markets, especially with regards to restrictions imposed on some tech companies. Technology localisation trend is expected to sustain in the longer term. We also prefer semiconductor names as demand for hardware tech is still healthy and inventory remains low.
Materials	O	We prefer copper mining companies within the sector as electric vehicle penetration will generate incremental demand for batteries and charging stations.
Real Estate	-	The potential new "three red lines and four categories" policy may hinder long term growth for developers.
Communication Services	-	We selectively prefer gaming, social platform and cloud services companies as coronavirus outbreak has sped up technology adoption. We underweight telecom names due to the lack of catalysts.
Utilities	-	We are underweight the sector due to increasing supplies from alternative sources such as wind, solar and nuclear, which have lowered the overall return.

Source: Bloomberg, HSBC Global Asset Management, as of January 2021.
*NOTE - Sector views of HSBC Global Asset Management's offshore Chinese equity team; "+" = positive, "–" = negative, "O" = neutral
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Indicator	Date	Actual	Consensus	Prior	Analysis
Industrial production (IP) (yoy)	Dec	7.30%	6.90%	7.00%	Q4 GDP growth picked up further to 6.5% yoy from 4.9% in Q3, taking the full-year growth to 2.3%. In sequential terms, GDP growth grew 2.6% qoq sa after expanding 3.0% in Q3. Q4 growth was driven by strong exports and broadening of domestic activity recovery from investment to consumption. Tertiary industry growth accelerated to 6.7% yoy from 4.3% in Q3, with gains across sectors (catering & accommodation turned to a positive YoY growth of 2.7% after three quarters of declines) and amid continued strength in IT, financials and real estate services. Manufacturing growth also picked up to 6.9% in Q4 from 5.6% in Q3. Recent data show an ongoing solid cyclical recovery into 2021, despite near-term risks to offline and services consumption due to the latest Covid-19 resurgence in some northern China cities and tightening of restrictions over traveling and social distancing measures. The impact on industrial sector activity will likely be limited while export strength may provide some offsets. We expect a strong 8.0-8.5% growth rebound in 2021, led by consumption, manufacturing capex and services. Export momentum should remain positive, though property sector activities and infrastructure investment may soften on fading policy support. We expect monetary policy normalisation, fiscal consolidation and tighter property and financial regulation, but no material policy tightening. In terms of monthly data, robust IP growth was aided by a pick-up in mining and electricity generation and robust manufacturing activity. Industrial profits continued to register solid growth (+20.1% yoy) with full-year profit growth coming in at 4.1%, reversing the pre-Covid decline of -3.3% in 2019. Benign demand backdrop and PPI reflation should support industrial profit growth in coming months.
Fixed Asset Investment (FAI) (ytd, yoy)	Dec	2.90%	3.20%	2.60%	For full-year 2020, FAI growth was driven by infrastructure FAI (+0.9%) and real estate FAI (+7.0%) amid policy support and credit easing, while manufacturing FAI contracted -2.2%. Going into 2021, we expect public and real estate investment to moderate, amid fiscal policy consolidation and normalisation in credit policy, while solid industrial profits and continuing economic recovery should support manufacturing capex. Financial tightening in the property sector aimed at curbing the sector leverage and asset bubble risks as well as guiding credit to priority sectors may result in slower land purchases though construction may stay solid. We also expect tighter central government scrutiny of local government debt risks.
Retail Sales (yoy)	Dec	4.60%	5.50%	5.00%	Slower December retail sales were led by goods consumption, likely in part reflecting the payback from strong November sales boosted by the Singles' Day shopping festival promotion. Online goods sales and auto sales eased, while catering sales growth edged higher partly due to the base effect. Surveyed urban unemployment rate stayed at 5.2%. In the near term, more restrictive policies on travel and holiday activities nationwide around the Lunar New Year holiday could weigh on consumer spending, but improving employment conditions and income growth should continue to support consumption as the virus situation will likely remain manageable. More policies to boost consumption upgrading are also likely.
Exports (USD) (yoy)	Dec	18.10%	15.00%	21.10%	Exports continued to show strength, with shipments to most major markets remaining solid. By product categories, tech/ work-from-home and personal protective equipment continued to post strong gains amid resurgence of coronavirus cases and tightening of restrictive measures globally. Acceleration in import growth was led by non-oil imports. Import volume of major commodities lost some steam following recent strength, with weaker growth partly also due to the base effect. We expect China's exports to hold up amid recovering global economy, despite expected easing of pandemic-related demand amid vaccine deployments and a catchup in production capacity elsewhere from Q2, while this year's global recovery is likely to be more driven by services normalisation, which tends to be less trade intensive. That said, uncertainties remain over global virus containments and US-China relations. China is likely to benefit from a more stable and predictable relationship with the US under a Biden administration, which will likely take a more multilateral and collaborative approach. That said, we think the pressure may remain on China to respond to US bipartisan concerns about issues such as SOE subsidies and fair trade, market access, forced technology transfers, and intellectual property right protection, etc. The US-China (tech) competition will likely remain fierce in the medium-to-long term. Meanwhile, imports should continue to pick up amid an ongoing domestic recovery and supported by commodity price reflation.
Imports (USD) (yoy)	Dec	6.50%	5.70%	4.50%	
Trade Balance (USD)	Dec	$78.17bn	$72.00bn	$75.4bn	
CPI Inflation (yoy)	Dec	0.20%	0.00%	-0.50%	The rise in headline CPI inflation was largely driven by higher food (in particular, pork) prices due to supply disruption partly owing to cold weather and higher cost of production, while underlying inflation remained muted with core inflation (ex. fresh food and energy) edging slightly lower to 0.4% yoy from 0.5% in November. Meanwhile, PPI deflation eased further as global oil and commodity prices continued to rise. Headline inflation may moderate in 2021 on base effects, but core inflation is likely to pick up modestly as services consumption recovers. PPI is expected to show a modest recovery as global goods demand continues to recover supporting commodity prices. Modest inflation does not support policy tightening.
PPI Inflation (yoy)	Dec	-0.40%	-0.70%	-1.50%	
Aggregate financing (AF) (RMB)	Dec	1720bn	2185bn	2130bn	Data showed more signs of credit growth normalisation. AF growth eased further to 13.3% yoy from 13.6% in November. M2 growth also softened to 10.1% from 10.7%. Off-balance sheet items continued to decline. Weakness in corporate bond issuance likely was affected by bond default concerns. Credit policy will likely remain focused on targeted support for SMEs and the manufacturing sector, while credit flow to property developers should be restrained. We expect tighter financial regulation and credit growth deceleration in 2021, though unlikely to slow sharply as policy normalisation will likely be gradual and flexible.
New yuan loans (RMB)	Dec	1260bn	1250bn	1430bn	

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 January 2021

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