China Insights

April 2021

Onshore equities – a valuation reboot

Summary

- As of 9 April, the Shanghai Shenzhen CSI 300 index has been down 13 per cent (in CNY terms) since the pre-New Year peak, but it still outperforms other major world indices since the beginning of 2020 on USD basis
- The recent market decline was concentrated in companies with larger market capitalisations and higher valuations
- In our view, as investors anticipate more opportunities to open up in the advanced stages of an economic recovery, they no longer place as high a valuation premium on certain large enterprises

Post-holiday withdrawal

The festive atmosphere of the Chinese New Year holiday did not spill over into the post-holiday onshore stock market. After a year-long march upwards and reaching its peak on 10 February 2021, the Shanghai Shenzhen CSI 300 index has since come down 13 per cent (in CNY terms as of 9 April 2021). For comparison, the index experienced a drawdown of 16 per cent in March of 2020, at the onset of COVID-19. Perspective is important though – the CSI 300 index was one of the best performing among major world indices in 2020 (see Table 1). Hence even after its recent weakness, the index, as of 9 April 2021, still outperforms its global counterparts since the beginning of 2020 (see Table 1). The onshore benchmark is not technology-heavy, so the recent decline has nothing to do with the Archegos incident in late March where a hedge fund had to unwind its sizable positions in a few big Chinese tech names (see page 4). So what happened exactly? Let us dig a little deeper into the data to find out.

Table 1. Total USD return of major world indices

Index	31 Dec 2019 to 31 Dec 2020	31 Dec 2019 to 9 Apr 2021
Shanghai Shenzhen CSI 300 Index	37.0%	34.3%
Nikkei-225 Index	24.7%	28.2%
S&P 500 Index	18.0%	31.1%
Euro Stoxx 50 Index	7.3%	16.3%
Hang Seng Index	-0.6%	5.1%
FTSE 100 Index	-7.4%	-0.3%

Source: Bloomberg, as of 09 April 2021
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A re-evaluation of stock valuation

As mentioned previously, the Shanghai Shenzhen CSI 300 index came down by 13 per cent since the pre-Chinese New Year peak. But the recent negative performance has a bias towards stocks in the index with larger market capitalisations. Dividing the 300 companies in the index evenly into three groups by market capitalization (as of the index's peak on 10 February 2021), we arrive at Table 2 with their performance statistics. It is apparent that the onshore stock market moved in an asymmetric fashion, in the sense that the recent decline was concentrated in the larger companies. As illustrated by Table 2, the bottom third of the index, by market capitalization, has remained relatively unscathed since 10 February. This is mainly due to that larger companies might have seen their valuations grown too rich during the post-Covid run-up, as corroborated by the last column in the table.

Table 2. Breakdown of Shanghai Shenzhen CSI 300 index performance by market capitalisation (From 10 Feb 2021 to 09 Apr 2021)

Market capitalisation (10 Feb; in CNY)	No. of stocks	% of index's market capitalisation	% of stocks whose prices declined	Median performance	Median PE ratio (10 Feb)
Greater than 127 billion	100	75%	**79%**	**-14.7%**	25.2
61 billion to 127 billion	100	17%	**68%**	**-6.4%**	22.6
Less than 61 billion	100	8%	**48%**	**0.2%**	17.0

Source: HSBC Asset Management, Bloomberg, as of 09 April 2021
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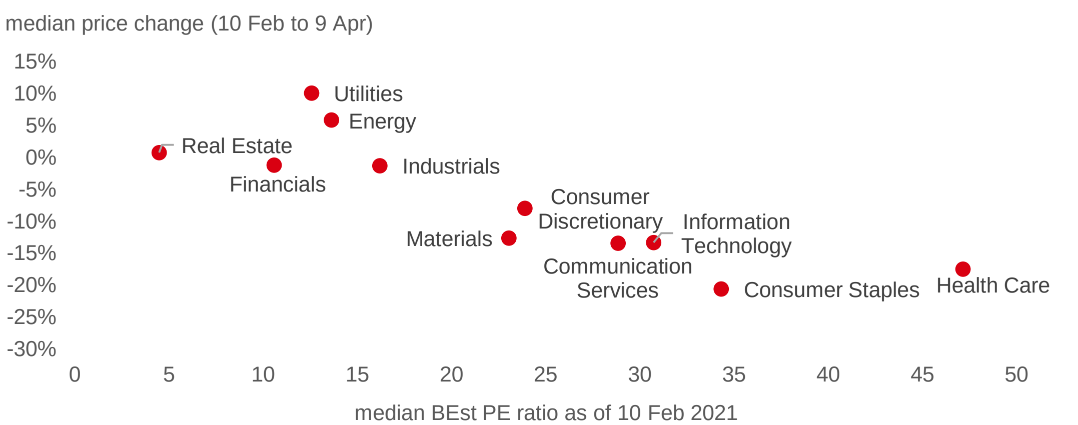
In fact, the idea that the prospect of economic normalisation would reduce investors' appetite for highly valued stocks ties in well with the recent phenomenon of sector rotation. As the chart below shows, there is a visible negative correlation between the recent performance of sectors and their valuations as of the day the market peaked. Consumer staples, for example, with the second most elevated price-to-earnings ratio of 35 times in February, have dropped by a fifth.

Figure 1. Shanghai Shenzhen CSI 300 index sector performance vs forward PE ratio



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We suggested that the recent decline of the index could be attributed to a relatively small group of companies with large market capitalisations, but how small and concentrated that group is might surprise you. Some simple calculations reveal that just 30 companies were responsible for 72 per cent of the index's post-holiday negative performance; indeed they represented approximately one third of the index's total market capitalization right before the holiday. Furthermore, it's interesting to note that 5 of these 30 companies are breweries and that they alone contributed almost a quarter of the index's drop. As expected, these 30 companies had a median price-to-earnings ratio of as high as 41 times going into the Chinese New Year (that of the 5 breweries were even higher at 48 times).

To summarise, the onshore stock market was indeed off to a bad start in the year of the Ox. But looking to a longer time horizon, the Shanghai Shenzhen CSI 300 Index still outperformed other major world indices since the beginning of 2020, due to its better handling of the pandemic (so the market did not suffer as much in March 2020) and its subsequent early commencement on the recovery track, ahead of the rest of the world. In our view, the recent market contraction was mainly due to investors no longer placing a high valuation premium on certain large enterprises, as they anticipate more opportunities to open up in the advanced stages of an economic recovery – ones that might have been suspended previously by the pandemic.

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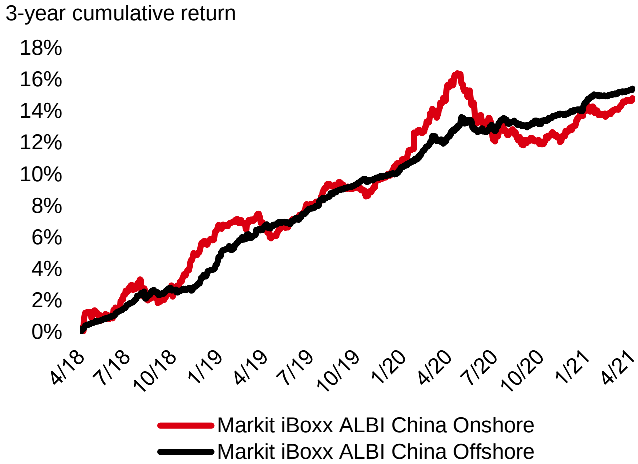
In the following pages we will take a deeper look at how recent events and policy measures are impacting Chinese fixed income and equity markets:

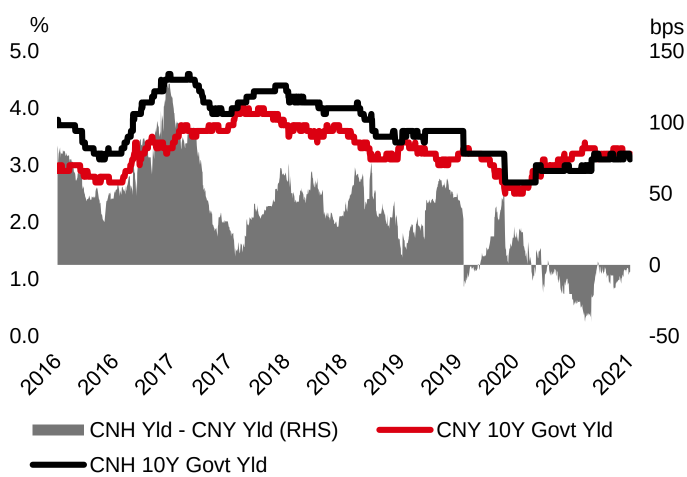
Fixed income

FTSE Russell's inclusion of Chinese government bonds (CGBs) into its World Government Bond Index is projected to attract an inflow of USD 130 billion into the asset class over the course of three years.

- The Chinese Government Bond (CGB) 5-year and 10-year yields both fell by 5 bps and 9 bps respectively in March. The sharp rise in long-end US Treasury yields year-to-date has triggered a sell-off in government bonds globally, with Chinese and Japanese government bonds experiencing the mildest impact, relatively speaking
- The iBoxx ALBI China Onshore and Offshore indices retreated 0.4% and 0.9% in USD terms in March, respectively, largely due to RMB depreciation against the dollar. For comparison, the Bloomberg Barclays Global Aggregate, a gauge of global investment-grade debt from twenty-four local currency markets, lost 1.9% in March
- Following in the footsteps of its two main competitors with their major fixed income indices, FTSE Russell has confirmed in late March to include Chinese government bonds (CGBs) in its flagship product – World Government Bond Index (WBGI). The estimated weight of CGBs in the index will be 5.25 per cent by the end of the inclusion process, which will span three years starting November 2021. With assets under management tracking the benchmark estimated at around USD2.5 trillion, this roughly translates to USD130 billion of foreign capital inflow over the course of three years, or USD3.6 billion per month
- In terms of fund flows, the onshore bond market recorded USD1.4 billion net foreign outflows in March, bringing the year-to-date inflow total down to USD46 billion, still 28% of the 2020 total. Given a favourable RMB outlook, a persistent yield spread over developed markets credit, and the recent confirmation by FTSE Russell to include Chinese government bonds into its World Government Bond Index, we anticipate continuing strong inflows throughout the year
- The spread between the Chinese and US 10-year government bond yield has tightened another 43 bps in March, to 145 bps. The spread has been relatively stable since the week of 22 March, as US 10-year yield has stablised at around 1.7%. The dollar index, which measures a basket of currencies, bounced back from 89 in December to 92 currently. In 2021, we hold a positive outlook on Chinese fixed income on the back of strong foreign inflows and a continuing economic recovery

Chinese bonds remain relatively steady amidst economic recovery





Source: Bloomberg, Markit data as of 12 April 2021. Total return in local currency terms.
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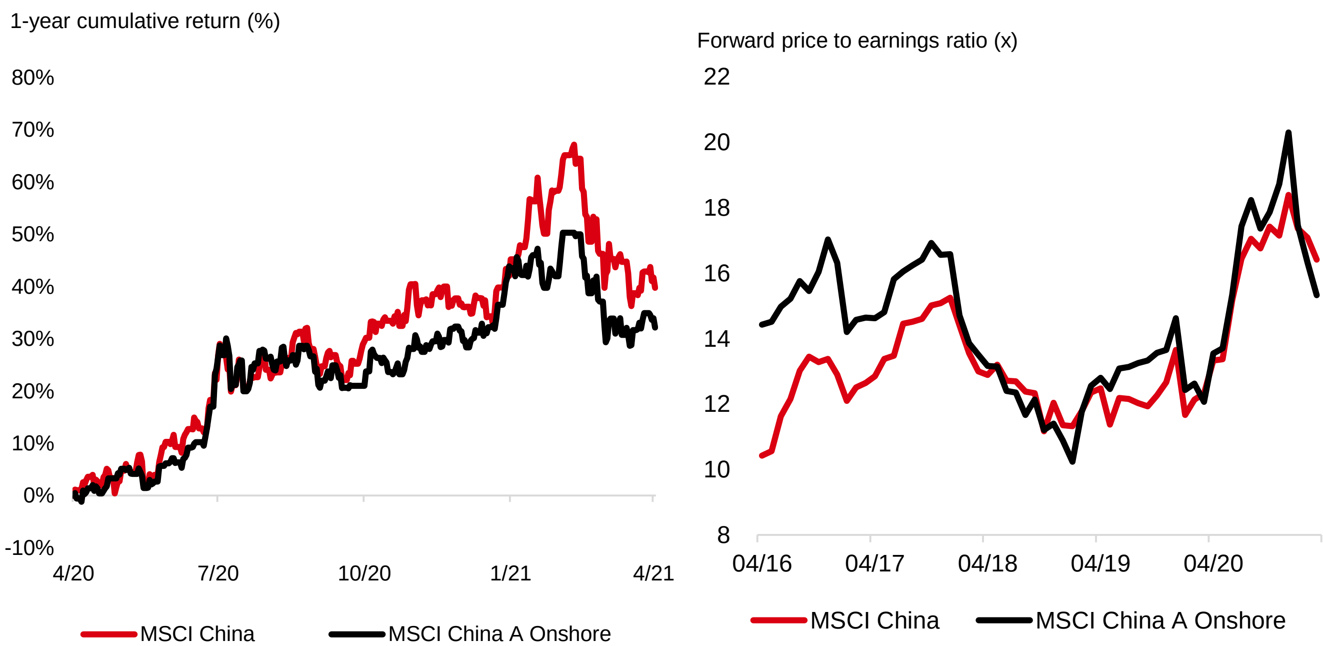
Equity market

The underperformance during this period could generally be attributed to a reduction in valuation premium on certain large enterprises including internet companies, rising US treasury yields, earnings downgrades and uncertain US-China relations.

- MSCI China A Onshore and MSCI China – the onshore and offshore gauges – retreated 6.2% and 6.3% respectively in March in USD terms. Locally the CSI 300 Index of the country's largest companies lost 6.6% in USD terms, while its offshore counterpart, the Hang Seng Index, fell 2.0%
- For MSCI China, the negative performance in March (-6.3%) resulted primarily from a sell-off in big internet names, largely due to the Archegos Capital incident – a leveraged hedge fund having to unwind their positions in Chinese internet stocks because of margin calls – and partly due to cautious sentiment toward uncertainty around the implications of future regulations to be imposed on the ADRs. On the other hand, defensive sectors, such as financials and utilities, recorded modest gains in March
- Since the stock market peak right before the Chinese New Year holiday, MSCI China A Onshore, MSCI China and CSI 300 lost 13.7%, 14.9%, 14.5% respectively (as of 9 April 2021 on USD basis). The underperformance during this period could generally be attributed to a reduction in valuation premium on certain large enterprises including internet companies (see the first two pages), rising US treasury yields, earnings downgrades and uncertain US-China relations. In the meantime, the Hang Seng index was only down 4.5% because of its relatively large weight in financials, which has gone up by 2.1%
- The southbound channel, which allows mainland investors to buy Hong Kong-listed companies – saw USD1.6 billion outflows (back to mainland) in March, bucking a trend of consistent monthly inflows since March 2019, mainly due to withdrawal from a major online food delivery company. Conversely, northbound trade amounted to USD2.9 billion inflows, roughly half of the February amount
- In terms of valuations, the 12-month forward price-to-earnings of MSCI China and CSI 300 are now trading at 16.3x and 13.4x, respectively, with a 2021 consensus earnings growth of 22% for the former and 35% for the latter

Chinese stocks continue to climb supported by ongoing recovery



Source: Bloomberg, HSBC Global Asset Management, as of 9 April 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 logistics systems. We also prefer names that benefit from tourism recovery given good progress on global vaccination.
Consumer Staples	-	Valuation of most names has become stretched. We prefer selective Chinese liquor names that could provide long term growth, as their margin expansion capabilities remain large, and that possess higher pricing power and ecommerce channels.
Energy	+	Vaccination progress has increased market expectation of global economy activity normalisation. Energy stocks will benefit from cyclical rotation.
Financials	-	The rate has seen its bottom and the worst time for the sector has passed. Cyclical rebound and rotation would benefit the sector most, having relatively low valuation and attractive yield. We have reduced our underweight to banks and insurance companies at low valuation, given a value factor pick-up.
Healthcare	-	Valuation of some names has become stretched. We favour service providers and medical device manufacturers 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 on innovative drugs will also outperform.
Industrials	-	Industry leaders with accelerated capacity expansion can gain more global market share. We prefer beneficiaries in the electric vehicles production chain and machinery manufacturers with technological advancement.
Information Technology	+	We like names that can benefit from continuous tech upgrade. Technology localization trend will sustain for longer term as well. We also prefer semiconductor names as demand for hardware tech is still strong and semi inventory remains low.
Materials	O	We prefer copper mining companies within the sector as electric vehicle penetration will require additional copper for batteries and charging stations.
Real Estate	-	The potential new "three red lines and four categories" policy may hinder long term growth of developers. Policy tightening in the property market is likely to continue, and there is no sign of loosening in the near terms.
Communication Services	+	We selectively prefer gaming and social media platform companies as market share has increased in global gaming market and several short-video platforms have demonstrated early monetisation. We are underweight telecom names due to the lack of catalysts.
Utilities	-	Increasing supplies from alternative sources such as wind, solar and nuclear continue to drive down sector returns. Demand remains lacklustre due to slower economic growth.

Source: Bloomberg, HSBC Global Asset Management, as of March 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 service 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 will likely 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)	Feb	35.0%	40.9%	--	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)	Mar	30.6%	38.0%	154.9%	Exports surged 30.6% yoy in March, as Covid-driven demand for tech/ work-from-home and personal protective equipment stayed strong, albeit a bit weakened compared with the fourth quarter of 2020. Imports rose strongly by 38.1%, vastly beating consensus, reflecting recovering domestic demand and demand for trade processing as well as higher commodity prices. We expect China's exports to hold up amid a 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. China is likely to benefit from a more stable and predictable trade relationship with the US under a Biden administration. That said, we think the pressure may remain on China to respond to US bipartisan concerns about structural 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 activity recovery and supported by commodity price reflation.
Imports (USD) (yoy)	Mar	38.1%	24.4%	17.3%	
Trade Balance (USD)	Mar	$13.8bn	$52.0bn	$37.9bn	
CPI Inflation (yoy)	Mar	0.4%	0.3%	-0.2%	After two months below 0, CPI inflation is back in positive territory at 0.4%, driven mainly by a rise in gasoline price. PPI inflation continues to be supported by commodity price increases. Looking beyond, we see moderation of headline CPI inflation in 2021, largely due to the base effect and easing pork price inflation as supply is expected to improve. Core inflation should pick up modestly as services consumption recovers further. Supply side pressure from food price volatility and rising oil/ commodity prices need to be watched, but the pass-through to CPI inflation still appears relatively weak. We think inflation is unlikely a major policy consideration or constraint in the near term.
PPI Inflation (yoy)	Mar	4.4%	3.6%	1.7%	
Aggregate financing (AF) (RMB)	Mar	3340bn	3700bn	1710bn	AF growth eased to 12.3% yoy from 13.3% in February. Bank loan growth eased modestly with solid growth in medium- and long-term loans. Corporate bond issuance picked up somewhat in March, along with moderate government bond issuance. Meanwhile, following a modest expansion in January, shadow credit contracted in March, led by bankers' acceptance bills. Overall, the credit data are consistent with policy normalisation. We expect tighter financial regulation and moderately slower credit growth in 2021, though targeted credit support will likely continue.
New yuan loans (RMB)	Mar	2730bn	2300bn	1360bn	

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, Wind, HSBC Asset Management, as of April 2021

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