FEBRUARY 2023

China equities outlook

China equities to bounce further in the Year of Rabbit?

Summary

- We remain positive on China equities, both onshore and offshore, and believe the "buy-on-dips" story remains intact.
- The consumption-led recovery still have room to go further, the government is still easing, corporate earnings are set to improve, positioning is far from crowded as domestic onshore and foreign investors just started to return and the still attractive valuations are key reasons for the uptrend to go further in the Year of Rabbit.

A faster-than-expected reopening

The rapid shift in Covid policy, plus the wrap up in regulatory policy for the big internet companies, saw a sharp rebound in China equities over the past three months with the MSCI China (offshore Chinese equities) up 58% and CSI 300 (A-shares)up 20% from the end-October lows.

The fast and furious rally has been largely driven by short-covering by hedge funds (mostly on the internet companies), significant Southbound Stock Connect buying (for Hong Kong-listed China equities), and robust Northbound buying (for on-shore A-shares).

In fact, Southbound saw net inflows of USD 49 bn in January, while the Northbound net inflows reached a record high (since the Stock Connect began in 2014) of USD 34 bn in January (vs only USD 13 bn for the whole 2022).

We turned more positive on overall China equities (both onshore and offshore) in early December amid more certainty about the re-opening and the still depressed valuations.

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The rally still has legs. Why?

After such a strong run, it is reasonable to see a consolidation recently. The next question is "Do we think there is still room for more upside?"

We believe Chinese equities, both on-shore A-shares and offshore Chinese equities (H-shares, ADRs), could bounce further in the Year of Rabbit due to the following reasons.

(1) A consumption-led economic recovery

Massive excess savings (estimate to be around 10% of GDP) during the pandemic will unleash pent-up demand, couple with an improvement in the labour market, should see a strong turnaround in private consumption this year.

With Covid infections already peaked (which suppressed sentiment previously), we expect to see a V-shaped recovery in consumer and real economy data in coming months.

We have just started to see evidence from the high frequency mobility data, such as domestic tourism, hotel revenues and theater box office numbers, moving back to 80-90% of the 2019 levels during the Chinese new year holidays.

(2) China is still in easing mode

Beijing vowed to prioritize economic growth this year with plans on more tax/fee cuts and financing support to relieve pressure on stressed SMEs. State Council and provincial level meetings were held in major economic hubs, such as Beijing, Shanghai and Guangdong, with signals to boost confidence of private companies. We recently revised up our 2023 China GDP growth forecast from 4.5% to 5.1%. This is in contrast to the tightening mode and recession risks for other major economies.

(3) Corporate earnings estimates are set to revise upwards

After the re-rating (valuation recovery) in Chinese equities over the past three months, the next phase of the rally will likely be driven by earnings.

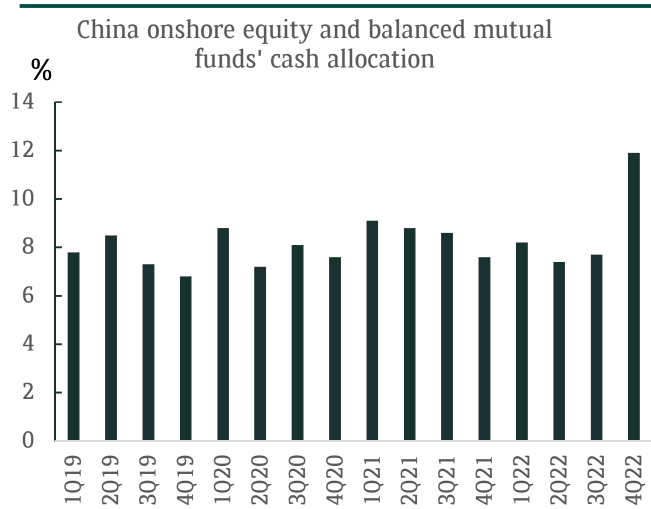
Earnings estimates have just started to bottom out for the CSI 300 (onshore) and begun to stabilize for the MSCI China (offshore). Continued upward revisions in earnings estimates usually bode well for equity markets.

(4) Pre-position before onshore investors are back

The onshore A-share market is generally a domestic retail-driven market as they usually dominate over 60% of fund flows. Turnover in A-shares markets remained subdued in January, implying a lack of participation by domestic retail investors. There is also no sign of pick up in retail investor account opening yet, while margin financing balance has just rebounded from multi-year lows in recent days.

Furthermore, onshore institutional investors are heard to have largely missed the rally in the past three months. The onshore mutual funds' cash holdings were at a 3-year high of 12% in 4Q 2022.

ONSHORE MUTUAL FUNDS STILL HAVE A LOT OF ROOM TO DEPLOY CASH



Source: Wind, Morgan Stanley, BNP Paribas (WM), as of 31 Jan 2023. Past performance is not indicative of current or future performance.

(5) Foreign investors have just returned very recently

We believe we are still early in the cycle as net buying from foreign investors in Hong Kong-listed Chinese equities has just returned in recent weeks after six months of continued weekly net outflows in 2H 2022.

On positioning, long-only global funds are nearly universally underweight China (reduced their underweight recently but still underweight). On average, Asian and GEM funds are modestly engaged in recent months, while global funds stayed relatively cautious. Given the current low exposure, there are plenty of room for foreign investors to increase weighting in China in their global portfolios especially after they had missed the initial sharp rally and have to chase back performance.

(6) Valuations remain attractive

Despite the sharp rebound, the MSCI China and CSI 300 are trading at 11.2x and 12.4x forward PE respectively, still lower than their respective historical 5-year average of 12.3x and 13.4x.

Both onshore and offshore China markets are also trading at a discount to MSCI Asia ex-Japan's 13.2x and MSCI EM's 12.4x, as well as a huge discount to S&P 500's 18.4x forward PE.

Moreover, we are overweight Emerging Markets as a whole, thanks to the peaked dollar and peaking monetary tightening cycle in most of the major EM countries.

Key risks

Geopolitical tensions would be a key factor to watch. One of the key risks is a potential US broad ban on investment in China's technology-related sectors. That said, there are some signs of stabilization in the bilateral US-China relationship with Vice Premier Liu He's meeting with US Treasury Secretary Janet Yellen at Davos in mid-January, followed by US Secretary Blinken's upcoming visit to China on 5-6 February.

Premature tightening soon after the rebound in economic activity, continued weaknesses in the property markets and a deeper-than-expected recession in the US are other key risks to our bullish view on China equities.

Conclusion

The Fed's peak hawkishness is already behind us, which is also an indication that the dollar has peaked. A medium-term declining trend in the greenback (expect to see some consolidation in near term after consecutive few months of weaknesses) is a tailwind for EM and Asia assets, including China.

We continue to stay positive on Chinese equities, both onshore and offshore, and expect the performance decoupling between China and US equities to continue. Therefore, any corrections are buying opportunities.

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