AUGUST 2022

Hong Kong/China Equity Perspectives

Focus on Quality

Summary

China's GDP grew 2.5% YoY[1] to RMB56.3 trillion in the first half of 2022. Q2 2022 GDP[2] managed to stay in the positive territory, at 0.4% YoY, even when the country had faced severe COVID outbreaks. A strong rebound in June 2022, driven by industrial output and retail sales, more than offset the steep decline in the lockdown-stricken April and May 2022. The rebound came after both the central and local governments put forth fiscal stimulus to boost consumption.

Despite a quick economic recovery in June, the GDP growth target of 5.5% for 2022 is increasingly remote in our view. With only 2.5% growth in the first half of the year, the country needs to post above 8% growth in the second half in order to meet the full year target. The last time China delivered GDP growth north of 8% was in 2012. Furthermore, the mild resurgence of COVID since early July 2022 and the looming mortgage boycotts/defaults throughout the country are two roadblocks standing in China's growth path. At the World Economic Forum, Premier Li Keqiang signalled the government would be "flexible on the economic growth target". We interpret the Premier's message as a subtle acknowledgement that the government will revise its GDP growth target.

We advise investors to focus on high quality names in selected sectors with strong policy support and a favourable macroeconomic backdrop. We see opportunities in (i) new energy vehicles, (ii) domestic consumer brands, (iii) public infrastructure, and (iv) Hong Kong-based big banks. Meanwhile, we continue to think the risks on China banks and China property are skewed to the downside.

Notable developments in selected sectors

- **Mortgage Boycott:** The prolonged construction delays of pre-sold properties have provoked homebuyers to call for suspension of mortgage loan repayments. We think the mortgage boycotts will put pressure on banks' asset quality, but are unlikely to threaten bank solvency.
- **Travel & Tourism:** The domestic tourism sector saw an encouraging recovery throughout June and July 2022.
- **China Oil & Gas:** Share prices of the China oil & gas majors have pulled back notably along with oil prices, on top of adjustments for hefty semi-annual dividends.
- **Inclusion of ETFs[3] in Stock Connect:** Stock Connect expanded its scope to include ETFs in July. We see the move as more symbolic than price impactful.
- **Hong Kong Banks:** Hong Kong interbank liquidity has shrunk 50% since May. This has pushed up HIBOR[4] and will eventually trigger banks to raise prime rates in the coming months.

1. GDP: Gross domestic product
2. YoY: Year-on-year
3. ETFs: Exchange-traded funds
4. HIBOR: Hong Kong Interbank Offered Rate

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Focus on High Quality Companies in Selected Sectors

China's GDP grew 2.5% YoY to RMB56.3 trillion in the first half of 2022, according to the National Bureau of Statistics (NBS). In Q2 2022, GDP managed to stay in the positive territory, at 0.4% YoY, even when the country had faced severe COVID outbreaks. A strong rebound in June 2022, driven by a 3.4% YoY growth in value-added industrial output of major enterprises and 3.1% YoY growth in retail sales, more than offset the steep decline in the lockdown-stricken April and May 2022. The rebound in retail sales came after both the central and local governments put forth fiscal stimulus to boost consumption, in particular the tax-cuts and subsidies on car purchases. According to the China Association of Automobile Manufacturers, 2.5 million cars were sold in June, up 23.8% YoY.

Despite a quick economic recovery in June, the GDP growth target of 5.5% for 2022 is increasingly remote in our view. To avoid confusion, the market consensus has been that the official GDP growth target is overly optimistic since its initial announcement in March 2022. Strategists and analysts predict that GDP growth for 2022 is likely to be in the 3%-5% range. With only 2.5% growth in the first half of the year, the country needs to post above 8% growth in the second half in order to meet the annual target of 5.5%. The last time China delivered an economic growth north of 8% was in 2012, when the aggregate GDP was less than half of what it has today. Furthermore, the mild resurgence of daily reported COVID cases since July 2022 and the looming mortgage boycotts/defaults throughout the country are two roadblocks standing before China's growth path. At the World Economic Forum on 19 July, Premier Li Keqiang signalled the government would be "flexible on the economic growth target". We interpret the Premier's message as a subtle acknowledgement that the government may revise its GDP growth target sooner or later.

As global recession risks grow, we advise investors to focus on high quality names in selected sectors with strong policy support and a favourable macroeconomic backdrop. We see opportunities in (i) new energy vehicles which are still in the early innings of a long-term megatrend, (ii) domestic consumer brands leveraging post-COVID pent-up demand, (iii) public infrastructure backed by policy support, and (iv) Hong Kong-based big banks benefitting from rising interest rates. Meanwhile, we continue to think the risks on China banks and China's property sector are skewed to the downside.

Notable developments in selected sectors

1) Mortgage Boycott

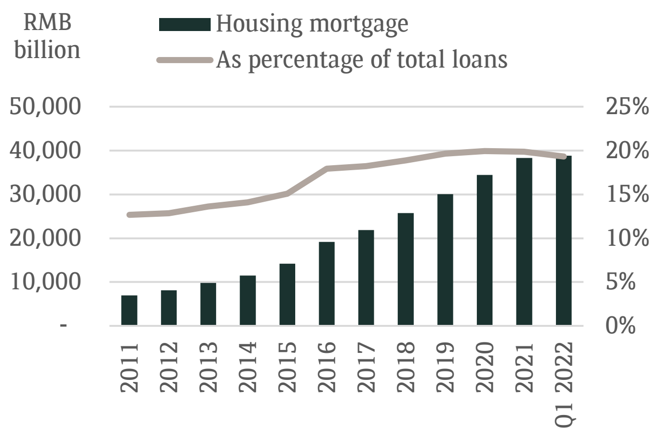
The prolonged construction delays of a slew of pre-sold properties have provoked homebuyers to call for suspension of mortgage loan repayments. Reports about petitions by mortgagors have quickly caught public attention since early July 2022, then hundreds more mortgage boycotts have sprouted up across China. While most of these unfinished properties are located in low-tier cities, there are also projects in tier-1 cities such as Shenzhen, Shanghai and Nanjing.

The China Banking and Insurance Regulatory Commission (CBIRC), the financial industry regulator, vowed to maintain the continuity and stability of financing policies for the real estate sector. CBIRC will guide financial institutions to participate in risk disposals, and will coordinate with the Ministry of Housing and Urban-Rural Development and the People's Bank of China (PBoC) to ensure housing project deliveries. The regulators summoned banks and local authorities for an emergency meeting to get hold of the situation, according to news reports. In our view, CBIRC's statement of maintaining stability of real estate financing is meant to dissuade banks from enforcing mortgage repayments. The banks are also advised to continue providing funds to in-construction real estate projects. While the regulators are working together to minimise loan default risks, the banking sector is likely to bear the brunt of potential asset write-offs.

The major banks have made announcements to calm the public. Some banks disclosed that the value of mortgage loans at risk was far less than 0.1% of their loan balance. Although the figures are possibly underestimated in our view, we agree that the risks are controllable.

We think the mortgage boycotts will put pressure on banks' asset quality, but are unlikely to threaten bank solvency. PBoC data show that outstanding housing mortgage and real estate development loans totalled circa RMB38.8 trillion at the end of Q1 2022, or 19% of total loans of financial institutions (see Chart 1). However, the majority of this RMB38.8 trillion are for completed projects and existing housing, which are not the subject in focus. Between January 2021 and June 2022, total residential property sales amounted to RMB22 trillion, according to the NBS. Mortgage loan origination has been steadily around 40% of property sales, according to PBoC's data. Therefore, the size of mortgage loans related to property sold in the last 18 months should be around RMB8.8 trillion. As it is estimated that currently around 5%-10% of real estate projects are being delayed, the mortgage loans at risk are around RMB0.44-0.88 trillion, in the ballpark of 0.2%-0.4% of total loans of financial institutions. Even in an extreme scenario where 20% of the properties sold in the last 18 months would never be completed and the banks would have to write off the related mortgages, the impact would be equal to only 0.8% of total loans.

CHART 1. PROPERTY RELATED LOANS



Source: *People's Bank of China*

According to Reuters, the State Council has approved a proposal of establishing real estate fund(s) to acquire insolvent and uncompleted property projects. The initial size of the real estate fund will be RMB200-300 billion, including RMB50 billion capital from a state-owned bank, RMB30 billion from PBoC and the remaining to be raised from the capital market. We hold the view that the inception of the real estate fund to remove bad assets from the market is a good idea, though the suggested fund size of RMB200-300 billion is far too small in view of the multi-trillion property sales per annum.

2) Travel & Tourism

The domestic tourism sector saw an encouraging recovery in June and July 2022. Domestic flights rebounded to over 11,000 flights per day in the second week of July, from less than 4,000 flights per day prior to the lifting of COVID containment measures in late-May 2022. We envisage the recovery of domestic flight capacity will be just in time to capitalise on pent-up demand in the coming summer holiday peak season.

As for international tourism, we noticed a solid recovery globally, with the International Air Transport Association (IATA) expecting the momentum of worldwide air traffic recovery to continue throughout the year and to reach 86.9% of 2019 levels. The easing of travel restrictions has released pent-up demand that the number of scheduled passengers is expected to reach 3.8 billion, which is 82.4% of 2019 levels. Meanwhile, demand for air cargos remain strong. The industry is expected to carry over 68 million tonnes of cargo in 2022, which is a record high. Although cargo yield is expected to fall 10.4% compared with 2021 as the trading environment has softened slightly, that will only partially reverse the yield increases of 52.5% in 2020 and 24.2% in 2021.

Premier Li Keqiang said at the World Economic Forum that China will further increase international passenger flights in an orderly manner, under the premise of ensuring safety against COVID infections. This echoes the Civil Aviation Administration of China's statement in early July that the administration is holding discussions with some countries on gradually increasing international passenger flights.

We expect the performance of online travel agencies and airlines to hit the trough in Q2 2022 and see sequential recovery in the later half of 2022, assuming China will not re-tighten COVID controls gravely.

3) China Oil & Gas

Share prices of the China oil & gas majors have pulled back notably along with crude oil prices since June 2022, on top of adjustments for hefty semi-annual dividends. Global oil supply is expected to outgrow demand temporarily (see Chart 2), which may put a cap on crude oil prices in Q3 2022. However, the double-digit dividend yields of China oil & gas stocks could provide downside protection for investors.

In July 2022, Reuters reported that China extended record imports of low-priced Russian oil into June, despite reduced energy demand due to lockdowns. Imports of Russian oil are estimated to be about 2 million barrels per day, or 15% of China's demand for crude oil. It is reported that some of the imports were bought at deep discounts at as much as USD20 per barrel below benchmarks. We believe the China oil & gas majors, who are top buyers of Russian oil, are pocketing above-the-norm gross profit from the oil import businesses. We believe the extra income should bolster their lofty dividends in the near term.

4) Inclusion of ETFs in Stock Connect

Stock Connect, the mutual market access programme linking Hong Kong's and mainland China's equity markets, expanded its scope to include ETFs in July 2022. Southbound Stock Connect added 4 HK-listed ETFs, while 83 A-share ETFs are introduced to Northbound Stock Connect.

The broadening of the Stock Connect eligible list certainly bodes well for stock exchange operators and the ETFs' liquidity, but we see the move as more symbolic than price impactful. We do not expect significant benefits for the first batch of ETFs in the scheme. The target audience are arguably retail investors who may have already been investing in similar listed funds. In the first 15 trading days since the inclusion (4-22 July), Southbound ETF turnover accounted for only 1% of total Southbound turnover, and 0.1% of that of the Hong Kong market.

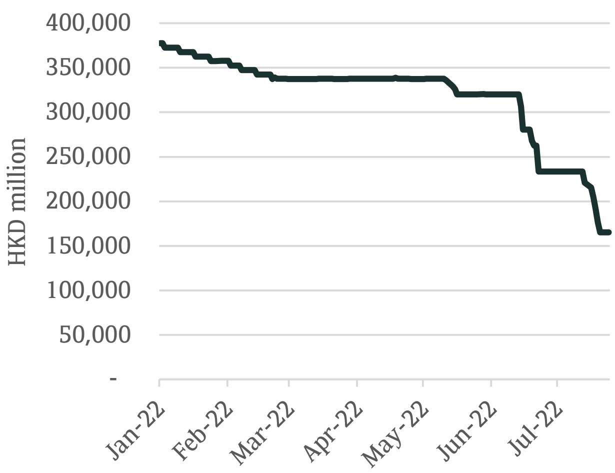
CHART 2. WORLD LIQUID FUEL PRODUCTION AND CONSUMPTION BALANCE

Source: US Energy Information Administration, as of July 2022

5) Hong Kong Banks

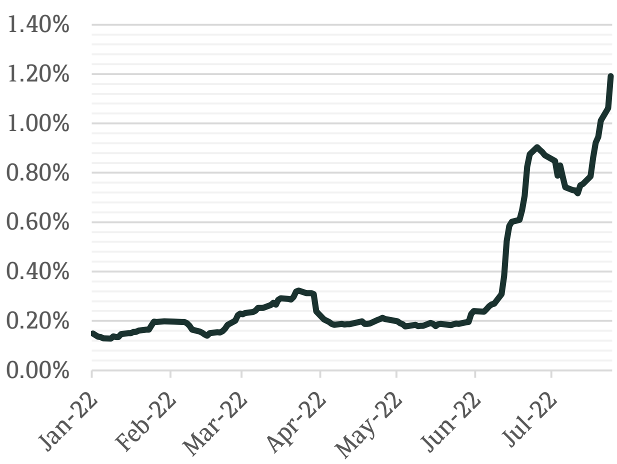
We notice that some small local banks offer as much as 3% interest rate on 1-year fixed deposits, which is above the best interest rates on new mortgage loans. Hong Kong interbank liquidity, which is measured by the aggregate balance with the Hong Kong Monetary Authority, has shrunk 50% since May 2022 (see Chart 3). This has pushed up HIBOR (see Chart 4) and will eventually trigger banks to raise prime rates in the coming months. Large local banks tend to have high current and savings account ratios (CASA ratios), and thus we expect them to report rapid widening of net interest margins in the second half of 2022.

CHART 3. HONG KONG INTERBANK LIQUIDITY



Source: Hong Kong Monetary Authority

CHART 4. HIBOR FIXING 1-MONTH



Source: Hong Kong Association of Banks
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