OCTOBER 2022

Hong Kong/China Equity Perspectives

Waiting Silently Is Just the Hardest Thing of All

Summary

Everyone is just waiting. Waiting for the economy to revive, for the PBoC[1] to ease money supply, for a mid-October surprise, or perhaps for the border checkpoints to reopen. Even though recent data published by the National Bureau of Statistics showed that the economy was more springy than expected, Hong Kong and China stock markets remained silent with the average daily turnover shrinking significantly. Meanwhile, we believe the mild inflation in China is providing the government more flexibility to beef up fiscal stimulus.

On the policy front, the central government has rolled out incremental stimulus in the run-up to the 20th National Congress of the CCP[2], which is probably the most important political event in China for 2022. There are two key agenda for this week-long event: to form a new leadership group and to adopt new party lines as the basis for policymaking. Subsequently, the 13th National Committee of the CPPCC[3] will convene its 24th meeting. By the end of this October, fund managers and investors should be busy assimilating China's new strategies and goals into their portfolios. Grand strategies such as common prosperity, dual circulation and "housing is for living in, not for speculation" are expected to be reiterated. We would suggest investors to watch for any subtle change in the dynamic zero-COVID policy and count the number of appearance of the magic words "refrain from a deluge of strong stimulus policies".

1. PBoC: *People's Bank of China*
2. CCP: Chinese Communist Party
3. CPPCC: Chinese People's Political Consultative Conference
4. P&C: Property & Casualty
5. CDMOs: Contract development and manufacturing organizations

Notable developments in selected sectors

- China Insurance: Year-to-date, P&C[4] insurers have outperformed life insurers in terms of earnings growth, attributable to higher premium income growth, sales mix shift, as well as inherent difference in duration gap.
- Hong Kong Banking: The leading lenders in Hong Kong raised the prime rate by 12.5 basis points. This was the first prime rate hike in four years, and marked the beginning of a long-overdue interest rate up-cycle. We are expecting further hikes in Q4 2022.
- Hong Kong Tourism and Retail: Hong Kong government scrapped the compulsory hotel quarantine for arrivals, greatly improving the visibility into the eventual recovery of travels in-and-out of Hong Kong.
- Macau Gaming: After Hong Kong shuffled and cut its travel restrictions, Macau government is ready to draw its cards from the deck too.
- China Biopharmaceutical: US President Biden signed an executive order which includes up to USD1 billion for developing biomanufacturing infrastructure over five years. We reckon a displacement of Chinese CDMOs[5] is not practical in the near term.

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Waiting Silently Is Just the Hardest Thing of All

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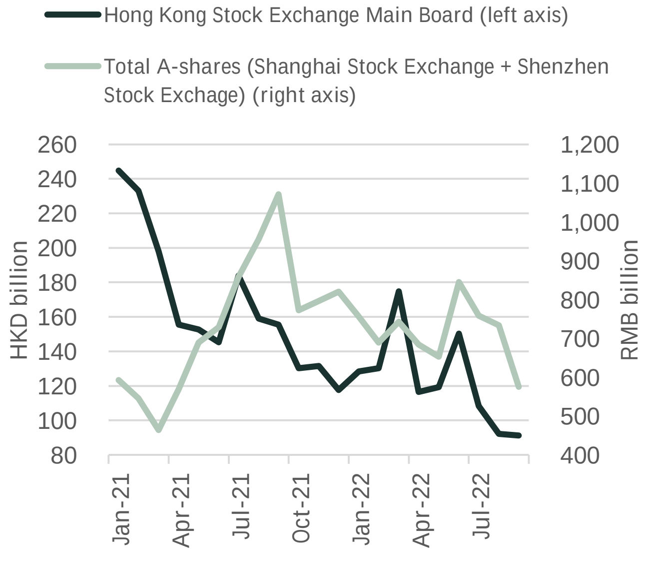
Even though recent data published by the National Bureau of Statistics showed that the economy was more springy than expected, Hong Kong and China stock markets remained silent. The average daily turnover of the Hong Kong Stock Exchange Main Board from 1 to 26 September 2022 shrank significantly to only HKD92.1 billion, which was 41% less than the same period last year (HKD156.7 billion) and 28% less than the first eight months of 2022 (HKD128.0 billion). A-shares were no better. The combined average daily turnover of Shanghai and Shenzhen stock exchanges from 1 to 26 September declined 49% year-on-year (yoy) and 22% compared to the first eight months of 2022 (see Chart 1).

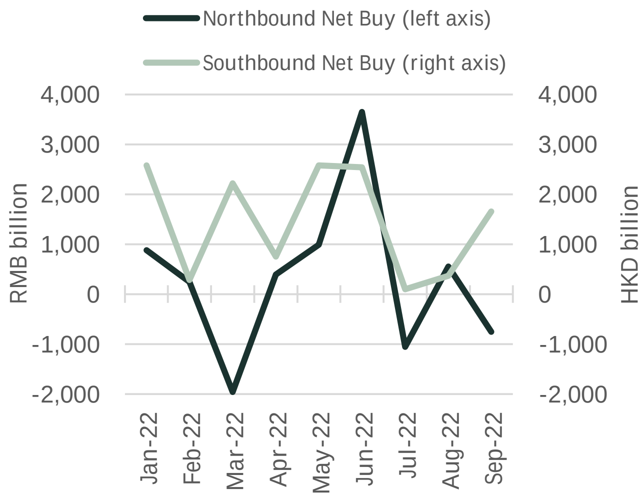
CHART 1. AVERAGE DAILY TURNOVER OF HONG KONG/CHINA STOCK EXCHANGES



Source: Bloomberg, as of 26 September 2022

However, it is noteworthy that mainland China investors snapped up Hong Kong-listed shares in September 2022. Southbound flows have stayed in the "net buy" territory in every single month year-to-date (YTD) (see Chart 2). On the other hand, Northbound flow was lukewarm in Q3 2022.

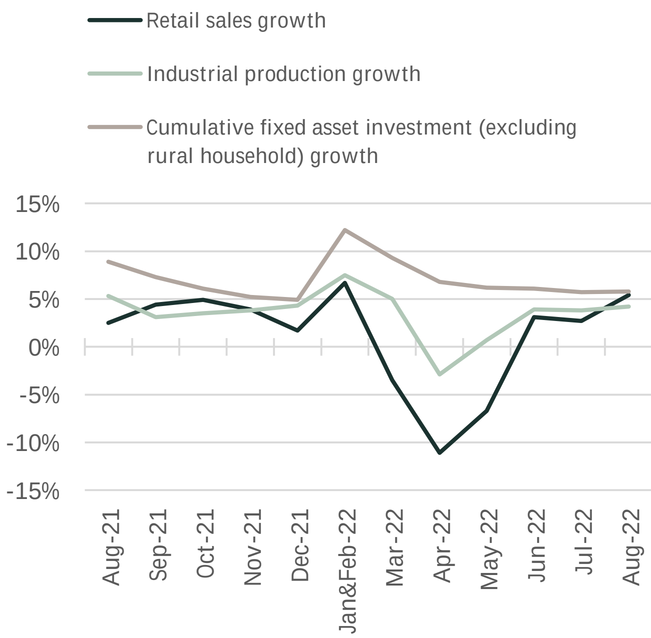
CHART 2. STOCK CONNECT NET FLOWS



Source: Bloomberg, as of 26 September 2022

Economic activity in August 2022 was better than expected. Retail sales growth accelerated to 5.4% yoy, which doubled form 2.7% yoy in July and beat the consensus (Bloomberg survey median) of 3.3%. Industrial production growth was 4.2% yoy and above the consensus for a flat 3.8%. Cumulative fixed asset investment (excluding rural household) impressively edged up by 0.1 percentage point from the previous month to 5.8% yoy for January-August 2022, when the consensus was calling for a decline to 5.5% yoy (see Chart 3).

CHART 3. ECONOMIC ACTIVITY INDICATORS



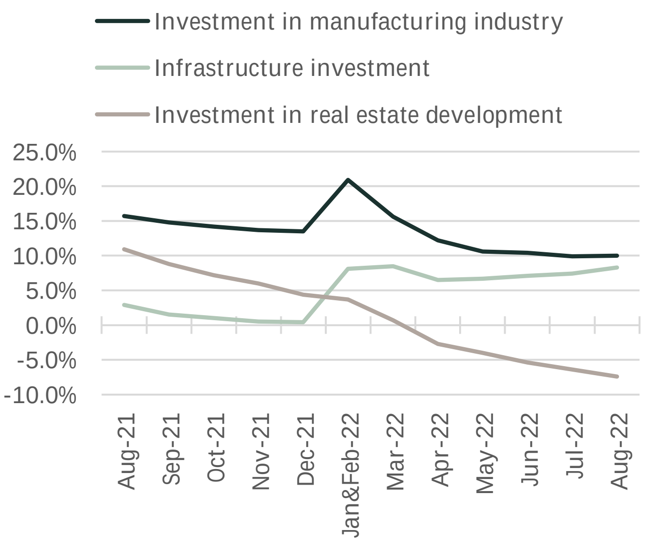
Source: National Bureau of Statistics, 16 September 2022

Meanwhile, we believe the mild inflation in China is providing the government more flexibility to beef up fiscal stimulus. Producer price index (PPI) and consumer price index (CPI) upped 2.3% yoy and 2.5% yoy respectively in August 2022, compared to the Bloomberg survey median estimates of 3.2% yoy and 2.8% yoy.

On the policy front, the central government has rolled out incremental stimulus in the run-up to the 20th National Congress of the Chinese Communist Party (CCP) opening on 16 October 2022. At the State Council meeting on 13 September 2022, it was decided that micro, small and medium-sized enterprises and self-employed households in the manufacturing sector could defer the payment of "five taxes and two fees" by another four months starting from 1 September 2022 retrospectively. The arrangement shall enable RMB440 billion of tax relief. While the listed manufacturers are too large to be eligible for the deferral, we expect listed raw material suppliers and parts & component manufacturers should indirectly benefit from lower default risk by continuous flows of new orders from their smaller customers.

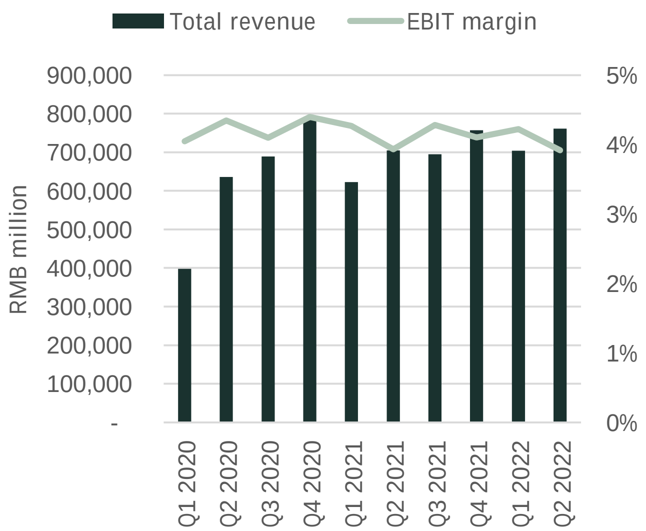
Besides, infrastructure investment, which has been an important growth pillar in offsetting sluggish property investments this year (see Chart 4), is expected to maintain its strength in the months ahead. Policy banks (including the China Development Bank and Agricultural Development Bank of China) have already deployed RMB300 billion and are ready to raise another RMB300 billion to finance major infrastructure projects, according to the state-owned China Securities Journal. An additional local government special bond (LGSB) quota of RMB500 billion was also announced in late August 2022*. According to business newspaper 21st Century Business Herald, at least 14 local governments have published bond issuance plans to raise over RMB230 billion in aggregate in October 2022. The infrastructure construction sector had dismal share performance since this April, despite very resilient 2Q22 financial results (see Chart 5). In our view, the sector appears to be overlooked by the market amid overwhelming negative news from the property sector.

CHART 4. FIXED ASSET INVESTMENT (CUMULATIVE) YEAR-ON-YEAR GROWTH



Source: National Bureau of Statistics, 16 September 2022

CHART 5. TOTAL REVENUE AND EBIT MARGIN OF THREE LEADING CHINA INFRASTRUCTURE CONSTRUCTION COMPANIES



Source: the Companies, BNPP WM, as of 27 September 2022

The upcoming 20th CCP National Congress is probably the most important political event in China this year. There are two key agenda for this week-long event: to form a new leadership group, and to adopt new party lines as the basis for policymaking. Shortly afterwards, the Standing Committee of the 13th National Committee of the CPPCC, China's top political advisory body, will convene its 24th meeting from 31 October to 2 November 2022.

* http://www.gov.cn/premier/2022-08/24/content_5706689.htm

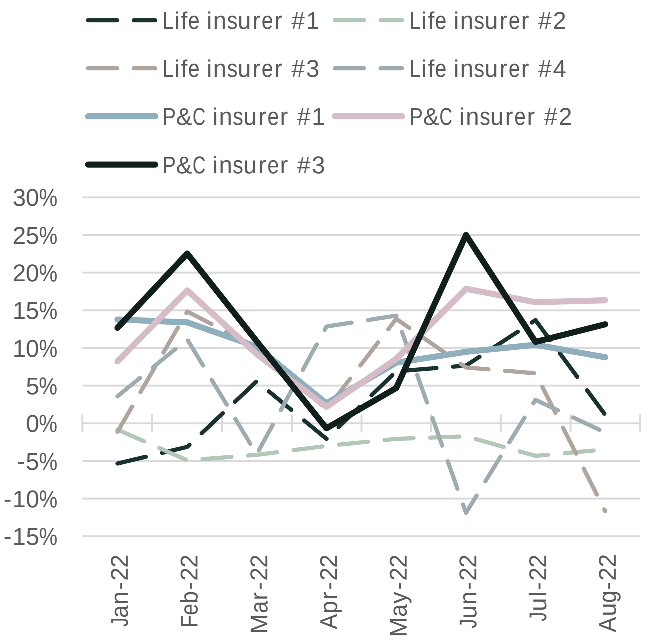
By the end of this October, fund managers and stock investors should be busy assimilating China's new strategies and goals for 2023 into their portfolios. Common prosperity, dual circulation, "housing is for living in, not for speculation" and other grand strategies are expected to be reiterated in the new party lines. We would suggest investors to watch for any subtle change in the definition of "dynamic zero-COVID policy" and count the number of appearance of the magic words "refrain from a deluge of strong stimulus policies".

Notable developments in selected sectors and industries

1) China Insurance

P&C insurers have outperformed life insurers in terms of earnings growth YTD. This is attributable to generally higher premium income growth at P&C insurers (see Chart 6), sales mix of annuity products shifted to the bancassurance channel, as well as the inherent difference in duration gap. We favour China insurance companies with higher exposure to P&C insurance, and expect P&C insurers will continue to report stronger premium income growth than life insurers in the near term.

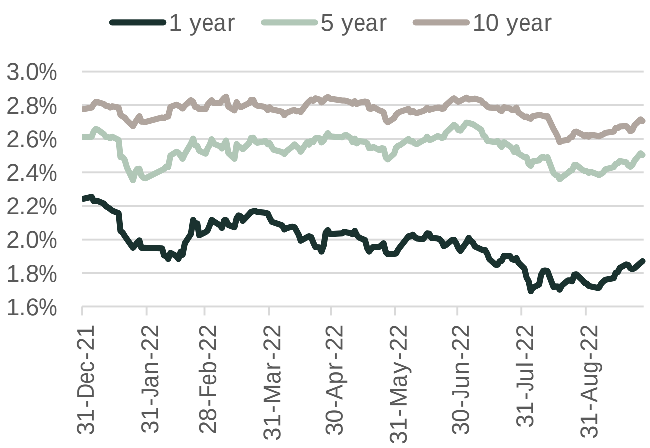
CHART 6. MONTHLY PREMIUM INCOME GROWTH, YEAR-ON-YEAR



Source: the Companies, BNPP WM, as of 27 September 2022

PBoC has cut the medium-term lending facility (MLF) rate twice this year (in January and August 2022), from 2.95% to 2.75%. In mainland China, all of the leading insurance companies use data from the state-owned China Central Depository & Clearing Co. (CCDC) for estimating the fair values of their assets/liabilities. According to CCDC, short-term ChinaBond Government Bond Yields (CGB) have been more sensitive to the MLF cuts that 1-year CGB has fallen over 37 basis points (bps) YTD. On the other hand, the long-term 10-year CGB was stationary until mid-August (see Chart 7). Since life insurers tend to have negative duration gap, due to the long policy period of life insurance and annuity products, their equity values are expected to fall with declining interest rates.

CHART 7. CHINABOND GOVERNMENT BOND YIELDS



Source: China Central Depository & Clearing Co., as of 27 September 2022

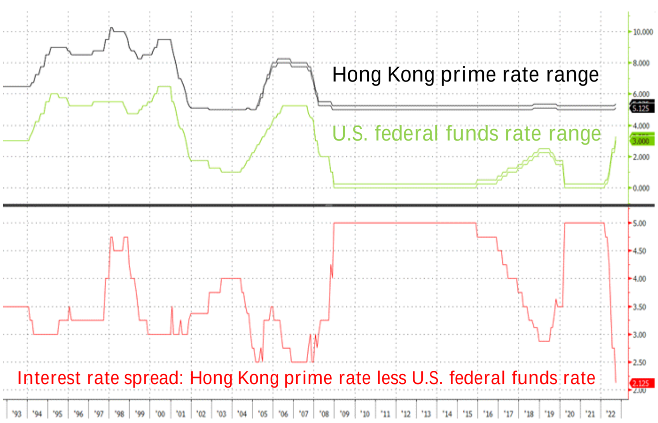
2) Hong Kong Banking

After another 75 bps increase in the US federal funds rate on 22 September 2022, the leading banks in Hong Kong raised the prime rate by 12.5 bps to 5.125%-5.375%. This was the first prime rate hike in four years, and marked the beginning of a long-overdue interest rate up-cycle in Hong Kong. We are expecting further prime rate hikes in Q4 2022.

Hong Kong prime rate, which is the anchor for HKD denominated loans, is 212.5 bps above the federal funds rate range of 3%-3.25%. Over the last 30 years, the spread between Hong Kong prime rate

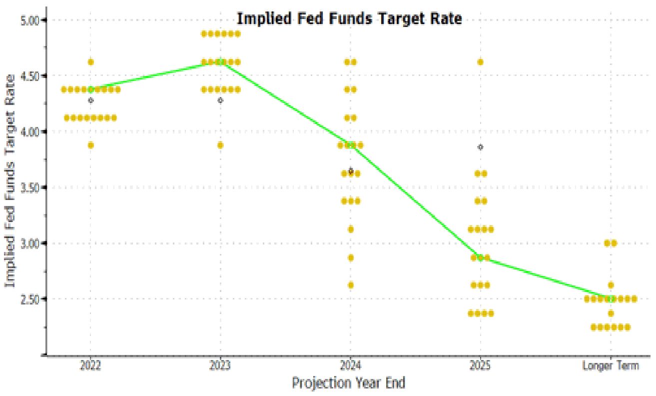
And US federal funds rate was bounded between 2.5% and 5% (see Chart 8). The latest Federal Open Market Committee (FOMC) dot plot signals more rate hikes in November and December 2022, by a total of 125 bps, and another 25 bps in 2023 (see Chart 9). We expect banks in Hong Kong to raise prime rate by over 150 bps till year end, in order to restore the interest rate spread to above 2.5%. This will inevitably lead to higher net interest income, and therefore higher earnings growth, for Hong Kong local banks. In fact, the Hong Kong Monetary Authority sets its base rate mechanically according to a pre-set formula that replicates changes in the US federal funds rate.

CHART 8. HONG KONG PRIME RATE VS. U.S. FED FUNDS RATE, 1992-2022



Source: Bloomberg, as of 27 September 2022

CHART 9. FOMC DOT PLOT



Source: Bloomberg, as of 23 September 2022

3) Hong Kong Tourism and Retail

On 23 September 2022, the Hong Kong government scrapped the compulsory hotel quarantine for arrivals, which is replaced by a much less restrictive "0+3" scheme (zero-day quarantine and three-day medical observation). The earlier-than-expected reopening of Hong Kong to international travelers is undoubtedly positive news to local tourism and retail sectors. Immediately after the "0+3" scheme announcement, the Hong Kong-based airlines reported high traffic on their websites due to a sudden rush by Hong Kong residents to book flights. Airfares for the coming few months lifted off such that reportedly the price for a Hong Kong-Japan round-trip had doubled. Undoubtedly, there is a large pent-up travel demand among Hong Kong residents. The fact that HKD has appreciated against almost every non-USD currencies further propels the desire. Share prices of airlines and travel agencies surged on the policy change which greatly improved the visibility into the eventual recovery of travels in-and-out of Hong Kong.

Meanwhile, share price reaction of tourism-related retailers and retail landlords has been relatively muted. The Hong Kong General Chamber of Commerce and various health experts are now urging the government to further relax restrictions to a "0+0" scheme. We expect the recovery of inbound visitors may follow shortly, despite a couple of cancelled major international events originally scheduled for late-2022.

4) Macau Gaming Industry

After Hong Kong shuffled and cut its travel restrictions, Macau's government is ready to draw its cards from the deck too. The city's chief executive Ho Iat Seng said on 24 September 2022 that Macau aims to resume e-visa and group tours from mainland China in November for the first time in almost three years. The only place in China with legal casinos has implemented stringent COVID-19 pandemic restrictions with tight border controls since 2020, resulting in a major plunge in casino gaming revenue. In the first phase, the resumption of group tours will come from five provinces/cities – Fujian, Guangdong, Jiangsu, Shanghai and Zhejiang – which represented almost 60% of mainland visitors to Macau in 2019. Shares of Macau casino resorts rallied on the back of the earlier-than-expected partial reopening announcement.

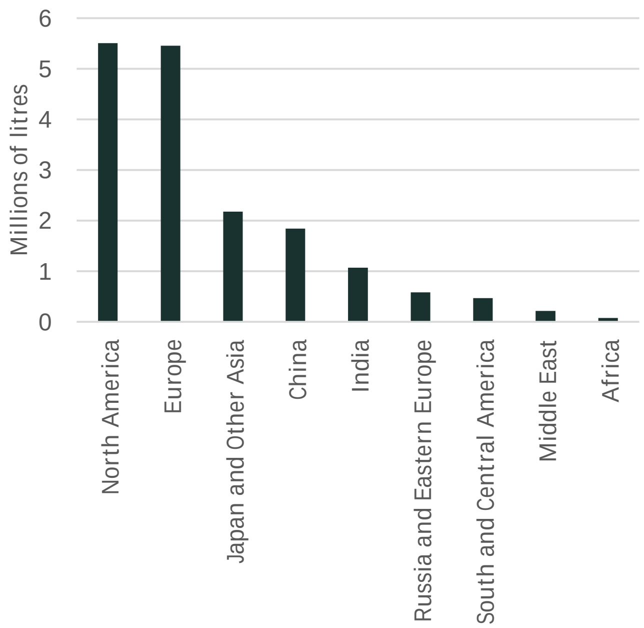
Earlier, in mid-September 2022, Malaysian billionaire Tan Sri Lim Kok Thay placed a surprise bid for the upcoming Macau gaming concessions. He is joining the existing six gaming concessionaries who have also submitted public tender bids. We think it is an opportunistic bid by the Malaysian billionaire, given that the total number of gaming concessions is limited to 6 as stipulated by law and the new concession term will be 10 years only (versus 20 years currently). Since it takes at least 2-3 years to build a new casino resort from scratch, that means the payback period before gaming concession expiry is 8 years or less, which may not be sufficient in our opinion.

Our base case scenario assumes the existing casino resort owners/operators will be able to renew their gaming concessions. They have an upper hand in the public tender because of their massive capital investments in Macau over the years. We think serious new contenders in Macau gaming should take over one of the existing gaming concessionaries with its up-and-running properties. However, for those who choose to roll the dice and try to outbid existing players, the stake is high as the loser may have to sell their resorts at depressed value. Our preferred names in the sector continue to be those who have resilient balance sheets and are more accommodated to Macau's goal to promote non-gaming business/tourist attractions.

5) China Biopharmaceutical

US President Biden signed an executive order (EO) for the National Biotechnology and Biomanufacturing Initiative (NBBI), which provides up to USD1 billion for the establishment of biomanufacturing infrastructure over five years. There are market concerns over the initiative's negative impact on Chinese CDMOs. Given that the detailed implementation plan will not be available until mid-2023 and it will take a few years to construct new biomanufacturing capacity, we reckon a displacement of key Chinese CDMOs is not practical in the near term. For reference, the total biomanufacturing capacity in North America and that in China are 5.5 million litres and 1.8 million litres respectively (see Chart 10).

CHART 10. GLOBAL BIOMANUFACTURING CAPACITY



Source: BioProcess International, as of 31 May 2021

The EO aims to accelerate biotechnology innovation and grow the US bio-economy across multiple sectors. Within 180 days of the EO announcement, various US government agencies will submit reports on biotechnology and biomanufacturing matters. Then, within 100 days of the White House receiving the aforementioned reports, an implementation plan will be developed. Therefore, the actual implementation date of the initiatives will be about 9 months from now. In our view, the imminent threats to Chinese CDMOs are more related to market sentiment rather than business fundamentals.

In the longer term, we think the cost competitiveness of future US biomanufacturing capacity, potential import/export restrictions and regulatory hurdles in US onshore expansion by non-US companies are the key variables. Although the EO has no direct mention of other countries, it appears to be a continuation of the America First policy stance. At the moment, public documents of the EO do not provide sufficient granularity to thoroughly assess the long-term impact on the CDMO industry.

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