NOVEMBER 2022

Hong Kong/China Equity Perspectives

Getting Ready for the Next Chapter

Summary

The 20th CCP[1] National Congress was concluded on 22 October 2022 without significant changes in the directions of economic and public health policies. Economic strategies including "common prosperity" and "dual circulation" have been officially written into the Constitution of the CCP. Meanwhile, "housing is for living in, not speculation" was reiterated. From the standpoint of stock investors, we are interested in how these concepts and ideas, now being raised to a higher and permanent level, will shape government decisions in the foreseeable future. Broadly speaking, we believe the economic system of China will be fundamentally different from what it was five years ago. This in turn will change the risk premium of the shares of companies in different industries.

In terms of broad market action, investors have returned. As we suggested last month, fund managers and stock investors were busy assimilating China's new strategies and goals for 2023 into their portfolios after the conclusion of CCP National Congress. Between 24 and 31 October 2022, the average daily market turnover of the Hong Kong Stock Exchange rebounded to 50% higher than the first three weeks of October 2022. This was the same for A-share market that the average daily market turnover in the same period was 17% higher than the first three weeks of October 2022.

As the US federal funds rate is likely to "stay higher for longer", we advise dividend-seeking investors to pay more attention to the potential for "dividend growth" of their holdings.

1. CCP: Chinese Communist Party
2. P&C: Property & Casualty
3. E&P: Exploration & Production

Notable developments in selected sectors

- China Wind Energy: Carbon neutrality by 2060 is one of President Xi's key pledges made to the world. We expect the transition from fossil fuel to renewable energy sources will continue to gain traction in 2023-2027.
- China Sportswear: The sector has been under pressure lately as international brands are haunted by excess inventory.
- China Securities Brokers: Trading volume in Shanghai, Shenzhen and Hong Kong rebounded notably after the CCP National Congress.
- China Insurance: All major insurance companies in China have reported results for Q3 2022. We reiterate our preference for insurers with higher exposure to P&C[2] business.
- China Banks: Share price performance of most banks has been less disheartening in the current bear market so far this year.
- Oil & Gas: Looking ahead, earnings growth of oil & gas E&P[3] companies could eventually turn negative in Q1 and Q2 2023.

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Getting Ready for the Next Chapter

The 20th CCP National Congress was concluded on 22 October 2022 without significant changes in the directions of economic and public health policies, while there were re-articulations of China's perspectives on diplomatic relations and national security. Economic strategies including "common prosperity" and "dual circulation" have been officially written into CCP's Constitution. Meanwhile, "housing is for living in, not speculation" was reiterated during the meeting. From the standpoint of stock investors, we are interested in how these concepts and ideas, now being raised to a higher and permanent level, will shape government decisions in the foreseeable future. Broadly speaking, we believe China's economic system will be fundamentally different from what it was five years ago. This in turn will change the risk premium of the shares of companies in different industries.

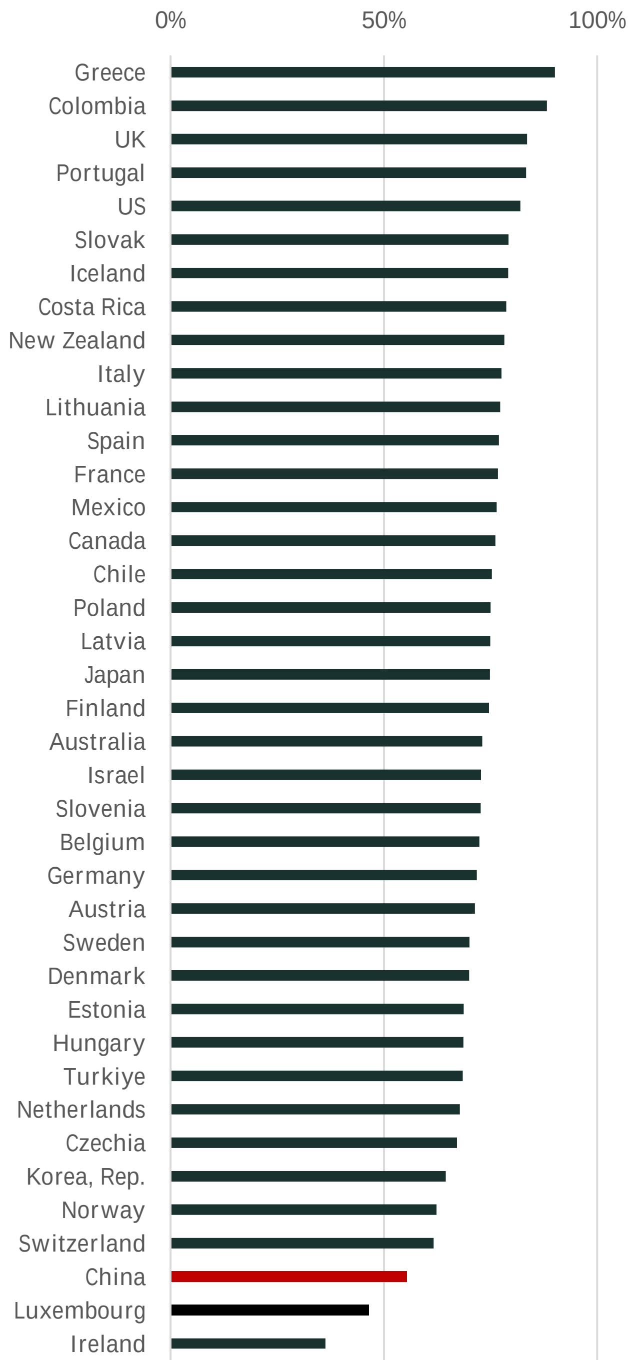
Common Prosperity: The government will build an institutional framework for income distribution, with an aim of raising the share of personal income in national income. President Xi highlighted the roles of taxation, social security and transfer payments (via charitable and public-interest initiatives) in the report to the CCP Congress. He also explicitly suggested to regulate the means to wealth accumulation. Therefore, we expect the government to become more active in engineering wealth redistribution from rich to poor, and from large corporations to small businesses and individuals. However, these measures would probably knock off future profits from listed companies, which are typically large corporations supposed to maximise return for shareholders.

Meanwhile, China has a quantitative target of becoming a "medium-level developed country' by 2035, which means doubling real GDP per capita between 2020 and 2035. We reckon that common prosperity will drive outsized growth in consumer spending against GDP growth in the coming decades. In fact, according to World Bank, China's consumption as percentage of GDP is relatively low compared to OECD[4] countries (see Chart 1).

<u>Potential beneficiaries</u>: Consumer staples, mass market-oriented consumer discretionary (e.g. household appliances, sportswear, home furnishings, automobiles and restaurants).

<u>Potential sufferers</u>: Labor intensive businesses, industries deemed to earn excessive returns from time to time (e.g. oil & gas, property development and pharmaceutical).

CHART 1. CONSUMPTION AS % OF GDP



4. OECD: Organisation for Economic Co-operation and Development

Source: World Bank, as of 31 October 2022

Dual Circulation: President Xi elaborated on the focus on and mechanism of dual circulation at the 20th CCP National Congress. He mentioned "a new pattern of development that focuses on the domestic economy and features positive interplay between domestic and international economic flows." We believe this helps clear up some market ambiguity on "internal circulation" and "external circulation". Our interpretation is that:

i. China will be putting a lot more weight on "internal circulation" (domestic economy) than "external circulation".

ii. "Science and technology" are being regarded as a primary productive force. We believe government policies will continue to skew towards domestic companies with critical technology/innovation capabilities.

iii. China will facilitate "external circulation" by appropriate shortening of the negative list for foreign investment, and lawfully protect the rights and interests of foreign investors. The goal is to attract foreign direct investments. We note that some market participants previously thought "external circulation" centers on China exports, which we believe is a misinterpretation.

iv. In our opinion, "external circulation" should be viewed as a peripheral system that sucks in foreign direct investments to enhance "internal circulation".

Potential beneficiaries: Semiconductor, new energy vehicle, advanced manufacturing.

Potential sufferers: Industries currently on the "negative list for foreign investment" but not subject to national security, such as agriculture, tobacco, transportation & postal, medical institutions, entertainment.

Housing is for living in, not speculation; Renewal energy & infrastructure upgrade: The contraction of the housing sector is likely to continue in our view. The risks have cascaded down to financial intermediaries, and then to the shadow banking system. The problem is inadvertently complicated by the regulators' priority in ensuring delivery of presold home. We think a recent high-profile dispute between a listed property developer and the trustee for a collective investment scheme (CIS) is an illustrative example. The property developer was appraised as a top-five property developer in China in 2000 by the China Real Estate Association. One of the property developer's projects in Wuhan sources funding from a CIS. In late October 2022, the trustee of the CIS disclosed that the property developer had stolen over RMB1 billion from the CIS's bank. The money involved was the proceeds from the pre-sale of the yet-to-be completed project, and was supposed to be repaid to investors of the CIS. The developer responded that the funds were transferred to a third-party bank account, which was controlled by the Wuhan city government, in order to secure project completion. Although there are tons of irregularities in this bizarre case, we believe the investors of the CIS are very likely to be left with deep losses.

On the other hand, the government has restated its support for renewable energy and infrastructure upgrades. We believe the construction of new renewable energy capacity and infrastructures will "kill many birds with one stone": to meet China's carbon neutrality target; to reduce dependence on oil & gas; to build a solid foundation (advanced infrastructure) for economic growth; and most importantly, to provide jobs for low-skilled workers and absorb excess supply of building materials.

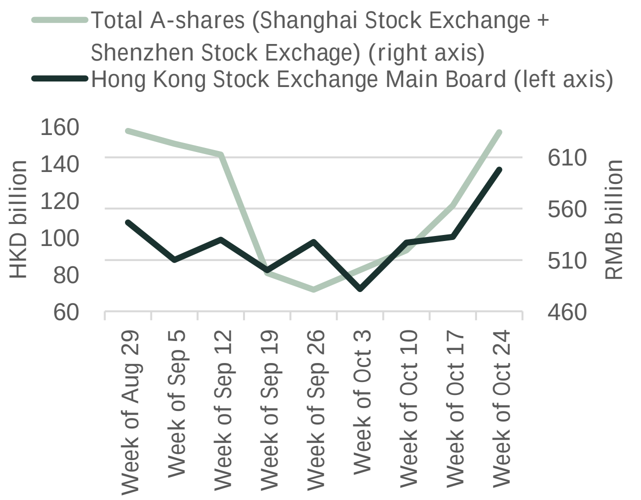
Potential beneficiaries: Renewable energy, infrastructure operators.

Potential sufferers: Property developers, asset management companies.

Hong Kong Economy: Hong Kong's economy reported its worst quarterly contraction in more than two years as weak demand and reluctance to further relax COVID-related curbs battered the international city. GDP plunged 4.5% year-on-year (YoY) in Q3 2022, on top of the -1.3% and -3.9% YoY slump in the first two quarters of 2022, according to estimates by the Hong Kong government. This raises the likelihood that the uneventful city will finish the year in recession for the third time since 2019.

Stock Market Technicals: In terms of broad market action, investors have returned. As we suggested last month, fund managers and stock investors were busy assimilating China's new strategies and goals for 2023 into their portfolios after the conclusion of the CCP National Congress. Between 24 and 31 October 2022, the average daily market turnover of the Hong Kong Stock Exchange rebounded to HKD136.7 billion, which was 50% higher than the first three weeks of the month and 46% higher than September 2022. This was the same for the A-share market that the average daily market turnover between 24 and 31 October 2022 was RMB633.5 billion, which was 17% and 15% higher than the first three weeks of October 2022 and the whole month of September 2022 respectively (see Chart 2).

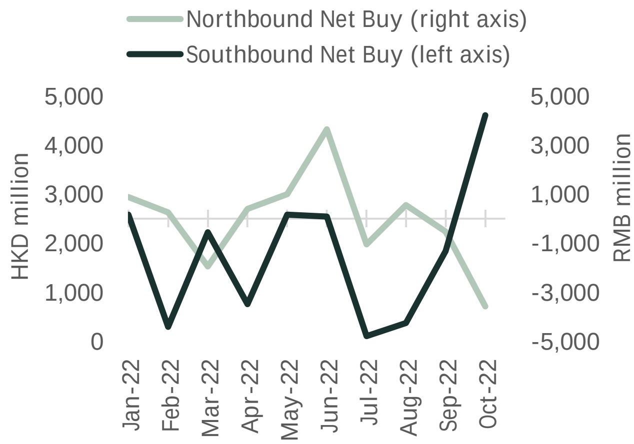
CHART 2. AVERAGE DAILY TURNOVER OF HONG KONG/CHINA STOCK EXCHANGES



Source: Bloomberg, as of 31 October 2022

It is interesting to note the contrasting actions of mainland China investors versus the rest of the world. Mainland China investors have turned more bullish that the average daily net buy through Stock Connect shot up to HKD4.6 billion in October 2022, over 3 times of the average for January-September 2022 (see Chart 3). Also, Southbound flows have stayed in the "net buy" territory in every single month year-to-date (YTD). On the other hand, non-mainland China investors were net sellers of A-shares. In fact, Northbound out flow accelerated since the beginning of October 2022.

CHART 3. STOCK CONNECT NET FLOWS



Source: Bloomberg, as of 31 October 2022

There have been conflicting messages from different sources – some of China's central government officials stressed adherence to the zero-COVID policy, while there were signs of relaxation from the public transportation industry. For example, a major Chinese airline resumed weekly flights of a few dozens of international routes at the end of October 2022; railways in Guangdong no longer require passengers to show nucleic acid test results. Judging from recent market reactions, it has revealed (1) how important and sensitive the zero-COVID policy is for China, and (2) how much short interests there are in the Hong Kong stock market.

Besides changes to "zero-COVID", other potential key catalysts are: (1) concrete measures to rectify problems in China's property market, and (2) flexibility of policy easing on Chinese tech companies. Any confirmation of these factors will likely drive up Hang Seng Index significantly, given how far down it is YTD.

As the US federal funds rate is likely to "stay higher for longer", we advise dividend-seeking investors to pay more attention to the "dividend growth" potential of their holdings. For instance, a global bank that has significant presence in Hong Kong and the UK, recently launched a 3-year senior unsecured paper at over 7% coupon rate. In our view, there is little reason to buy stocks with poor growth prospect and offering less than 8% in dividend yield. We reiterate our preference for China telecommunication networks that have a clear dividend policy, generous dividend payout ratio and solid earnings growth trajectory. Conversely, we are less optimistic of the Hong Kong utilities and telecom sectors.

Notable developments in selected sectors and industries

1) China Wind Energy

Carbon neutrality by 2060 is one of President Xi's key pledges made to the world. We expect the transition from fossil fuel to renewable energy sources will continue to gain traction in Xi's third term from 2023 to 2027. The Global Wind Energy Council forecasts that worldwide new installation of wind capacity will accelerate (see Chart 4).

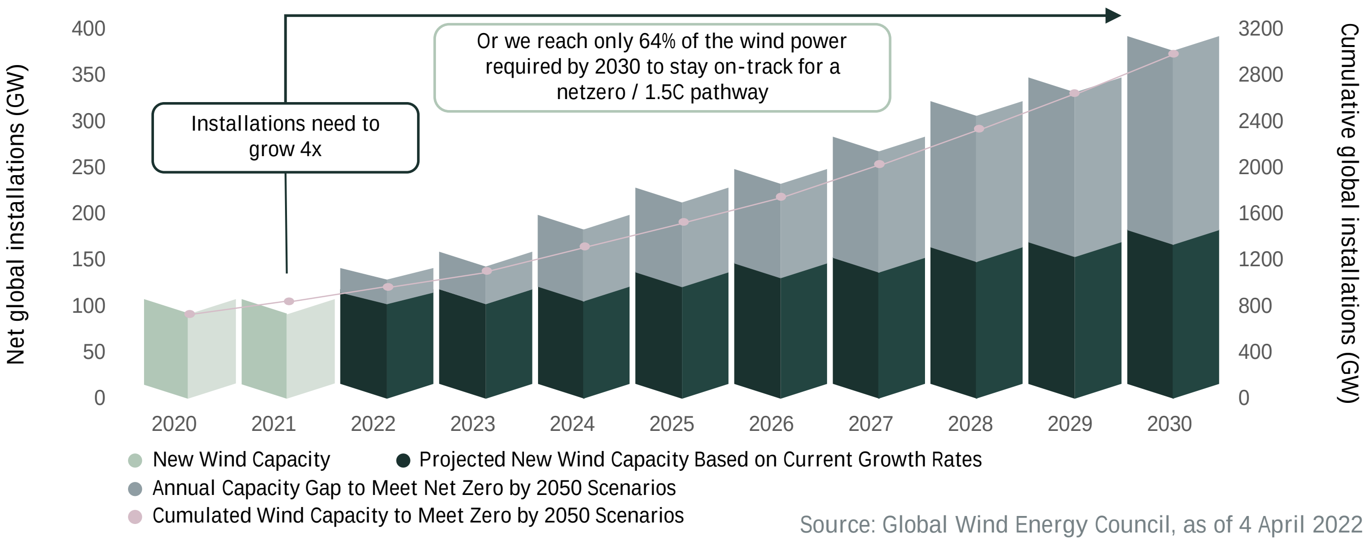
In 2021, China accounted for circa 56% of global new wind capacity installation, and we expect China to continue to be a major source of global renewable energy capacity growth in the years to come. On 9 October 2022, the National Energy Administration of China (NEA) announced the publication of the Operational Plan for Carbon Neutrality Standard Upgrade. NEA indicated that wind and solar energy will be the pillar of China's renewable energy system.

China's southern regional power market, which is a standardised interprovincial marketplace for electricity transactions, commenced trial operation on 23 July 2022. The southern regional power market covers spot transactions, mid- to long-term contracts and ancillary services. The National Development and Reform Commission is targeting to build a country-wide unified power market by 2025. A country-wide market with standardised power products should greatly improve the market depth for electricity transactions, which in turn would facilitate investments in low-cost power sources. Onshore wind energy and solar energy have achieved grid parity (total cost comparable to the price of power from electricity grid), while offshore wind energy is expected to reach grid parity according to NEA estimates. In conjunction with tightening carbon emission standards and the national rollout of carbon trading in China, we expect wind turbine installation to accelerate from 2022 to 2025.

2) China Sportswear

Shares of China sportswear brands were sold off in October 2022. The sector has been under pressure lately as international brands are haunted by excess inventory. Our recent conversation with one of the largest garment suppliers for major sportswear brands suggested that the largest US sportswear brand might continue inventory clearing until the end of 2022, whilst a major European brand probably needs more time and is unlikely to fix its own problems before Q1 2023. On the other hand, the garment supplier continued to see strong order growth from domestic sportswear brands in the second half of 2022.

CHART 4. GLOBAL NEW WIND CAPACITY INSTALLATION FORECAST, 2020-2030



Source: Global Wind Energy Council, as of 4 April 2022

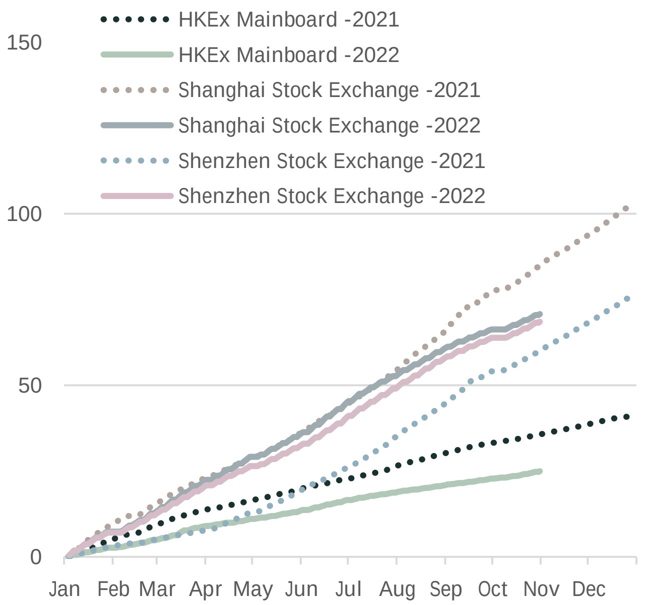
On top of the deteriorating market sentiment, one of the leading domestic sportswear brands was hit by criticisms on its latest winter apparel line-up. The design was said to resemble the look of Japanese military uniforms during World War II. Some media emphasised that the sportswear brand's CEO was born in China but acquired Japanese nationality. It is worth noting that the aforementioned winter apparel line-up was revealed on 20 September 2022, but had not been linked to World War II criticisms until mid-October 2022. In our opinion, domestic brands are very sensitive to their Chinese heritage. It is hard to imagine any of them would make such public relations crisis that promote anything related to the Japanese military. Domestic sportswear brands have gained significant market shares in China at the expense of international brands after the Xinjiang cotton controversy in 2021. However, the patriotism movement could also be a two-edge sword for brands.

3) China Securities Brokers

It is undeniable that global stock markets are in a bear market. According to our conversations with investors, many of them are on the sidelines even though they also agree that the overall market valuation is not demanding. Accumulated traded value of the Hong Kong Stock Exchange, despite having recovered slightly in late-October 2022, has been very thin and fell 30.1% YoY as of 31 October 2022. Nonetheless, stock market liquidity in Shanghai and Shenzhen held up very well that total traded value as of 31 October 2022 was only 3.3% lower than last year. Although daily traded value has levelled off since mid-July 2022, the accumulated traded value of the Shenzhen Stock Exchange increased by 14.8% YoY while Shanghai decreased by 16.1% YoY (see Chart 5).

Indeed, the A-shares market has been surprisingly busy with initial public offerings (IPO) so far in 2022. In the first nine months of 2022, total IPO proceeds increased 25% YoY to RMB512 billion, which was partly driven by the onshore listings of two mega-sized state-owned enterprises. The Shanghai Stock Exchange and Shenzhen Stock Exchange topped the global IPO league table (see Chart 6 & 7) and represented a striking 51% of the global IPO proceeds.

CHART 5. ACCUMULATED TRADED VALUE, IN TRILLIONS OF LOCAL CURRENCY



Source: Bloomberg, as of 31 October 2022

CHART 6. GLOBAL IPO LEAGUE TABLE BY IPO PROCEEDS

	Rank	Stock Exchange	IPO Proceeds (USD billion)
2022 Q3 YTD	1	Shanghai Stock Exchange	46.8
	2	Shenzhen Stock Exchange	24.8
	3	Korea Stock Exchange	11.2
	4	Frankfurt Stock Exchange	9.4
	5	HKEX	7.4

	Rank	Stock Exchange	IPO Proceeds (USD billion)
2021 Q3 YTD	1	NASDAQ	71.4
	2	New York Stock Exchange	51.3
	3	Shanghai Stock Exchange	42.8
	4	HKEX	37.2
	5	London Stock Exchange	17.1

Source: Bloomberg, KPMG, as of 25 September 2022

Trading volume in Shanghai, Shenzhen and Hong Kong rebounded notably after the CCP National Congress, as a key uncertainty – the party leadership – had been removed. We reckon an increase in market activity will boost the revenue and earnings of securities brokers. Therefore, we think shares of the Chinese securities brokers can be a trade now for the brave souls.

CHART 7. A-SHARE IPO MARKET ACTIVITY

	SSE - Traditional	SZSE - Traditional	SSE - STAR	SZSE - ChiNext	BSE#	Total
2022 Q3 YTD	RMB 121.4B 28 deals	RMB 27.9B 32 deals	RMB 210.2B 95 deals	RMB 145.8B 116 deals	RMB 6.7B 35 deals	**RMB 512.0B 306 deals**
2021 Q3 YTD	RMB 172.7B 79 deals	RMB 33.2B 31 deals	RMB 115.3B 126 deals	RMB 87.0B 145 deals	N/A	**RMB 408.2B 381 deals**
2021 Full Year	RMB 188.7B 93 deals	RMB 38.7B 38 deals	RMB 202.9B 162 deals	RMB 147.5B 199 deals	RMB 2.0B 11 deals	**RMB 579.8B 503 deals**

Note: All analysis is based on WIND Data and included REIT deals as of 25 September 2022, adjusted to number of confirmed listings up to 30 September 2022, unless otherwise stated #Beijing Stock Exchange began to trade on 15 November 2021. The above statistics excluded companies transferred from NEEQ Select to BSE.

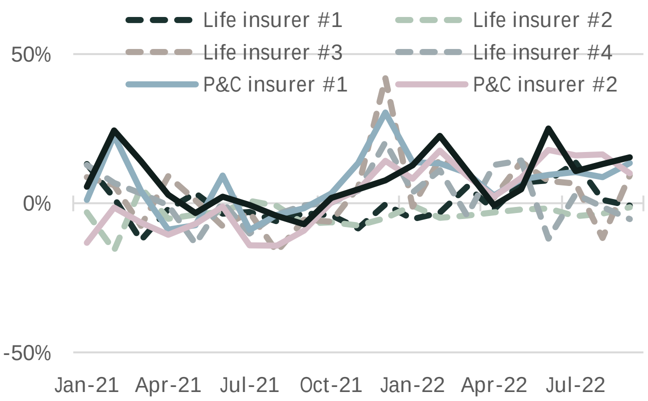
Source: WIND, KPMG, as of 25 September 2022

Trading volume in Shanghai, Shenzhen and Hong Kong rebounded notably after the CCP National Congress, as a key uncertainty – the party leadership – had been removed. We reckon an increase in market activity will boost the revenue and earnings of securities brokers. Therefore, we think shares of the Chinese securities brokers can be a trade now for the brave souls.

4) China Insurance

All of the major insurance companies in China have reported results for Q3 2022. Property & Casualty (P&C) insurers continued to outperform life insurers in terms of earnings growth. This is attributable to the generally higher premium income growth of P&C insurers (see Chart 8), sales mix of annuity products shifting to the bancassurance channel, as well as the inherent difference in duration gap. We reiterate our preference for insurers with a higher exposure to P&C business, and expect P&C insurers will continue to report stronger premium income growth than life insurers in the near term.

CHART 8. MONTHLY PREMIUM INCOME GROWTH, YEAR-ON-YEAR



Source: the Companies, BNPP WM, as of 31 October 2022

5) China Banks

Share price performance of most Chinese banks has been less disheartening in the current bear market so far this year (with the exception of a bank that was gloried for its wealth management business in the past few years). We think the sector's relatively high dividend yield and systematic importance to the economy (too big to fail) have bolstered their share prices.

All of the major banks have reported results for Q3 2022. Generally speaking, the reported net income of the banks are better than expected despite pressures on net interest margin (NIM) and fee income. New loan origination and growth in loan balance more than offset the decline in NIM, thereby resulted in positive net interest income growth in the quarter. All of the banks reported flat to slightly better non-performing loan (NPL) ratio at the end of September 2022, as fewer cities were under stringent COVID-curbs versus the previous quarter. We also think that the double-digit increase in loan balance, which was the result of aggressive new loan origination, had a temporary dilutive impact on NPL ratio. Net fee income growth remained sluggish on weak capital markets. Yet, we do not expect trading revenue and sales of investment products to recover any time soon, on the back of heightened market risks.

We notice that the mortgage rate for first-time homebuyers in several tier-1 and tier-2 cities, including Dalian and Shijiazhuang, has fallen below 4% in early October 2022. Since mortgage loan is the relatively more profitable loan type for Chinese banks, we believe the cancellation of the floor rate will have a disproportionate negative impact on NIM of the China banking sector.

6) Oil & Gas

It is not surprising that the net income of two of the largest state-owned oil & gas Exploration & Production (E&P) companies grew strongly on a YoY basis but declined on a quarter-on-quarter (QoQ) basis in Q3 2022. The ups and downs in earnings, as usual, were mainly driven by crude oil prices.

Looking ahead, earnings growth at oil & gas E&P will continue to be solely dependent on the YoY change of oil prices. In Q4 2022, we expect their earnings to increase YoY but to fall QoQ again, due to the YoY/QoQ changes in crude oil prices (see Chart 9). However, YoY earnings growth could eventually turn negative too in Q1 and Q2 2023 due to tough YoY comparison.

CHART 9. BRENT CRUDE OIL SPOT PRICE

Source: Bloomberg, as of 31 October 2022
Past performance is not indicative of current or future performance.

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