Stars Aligning in the Year of the Rabbit

Summary

There are plenty of reasons to adopt an upbeat 2023 outlook for the Hong Kong/China market. On top of easier comparison against a very sluggish 2022, cyclical trends are already turning in 2023. First, China's speedy reopening in 2023 could give rise to a strong rebound in private consumption. Second, we believe the solvency risks in the property sector is now confined. Third, regulatory overhauls in tech appears to be easing. Lastly, valuations remain cheap. The macro backdrop of China is in sharp contrast to the global economy, especially Europe and the Americas, which are forecasted to experience significant GDP[1] growth slowdown in 2023.

The eventual reopening of China's border coincided with a much higher level of COVID immunity, which entails lower mortality and a smooth transition to normal life. Many Chinese municipal governments are aiming for 5-6% GDP growth in 2023.

China equities and other equity markets have shown weak correlations over the years. Given the gloomy economic outlook and possibly choppy stock markets in the US and Europe, prudent investors should rebalance their investment portfolio across low-correlation markets. Indeed, global funds have started rebuilding positions in China's equity market in late 2022. According to IIF[2], foreigners net bought USD8.5 trillion and USD6.3 trillion of China equities in November and December 2022 respectively, more than reversing a USD8.5 trillion sell-off in October 2022.

1. GDP: Gross Domestic Product
2. IIF: Institute of International Finance
3. DCMM: Dual Counter Market Making Programme
4. NEV: New Energy Vehicle
5. PMI: *Purchasing Managers' Index*

Notable developments in selected sectors

- China Internet: The pendulum of China's internet sector regulations has swung from stringent guidelines to potential loosening.
- China Banking & Insurance: Credit risks related to property sector loans have been dramatically reduced.
- China Property: The liquidity provided by the government-led rescue package could plug the capital holes in unfinished real estate projects.
- Hong Kong Financial Services: We expect DCMM[3] to bring new opportunities such as arbitrage and broader product offerings.
- China Travelling & Airlines: Huge pent-up demand for travelling by mainland Chinese after three years of lockdowns.
- China Automobile Manufacturing: We expect NEV[4] penetration rate to continue to rise and price competition to remain.
- China Metals & Materials: Manufacturing PMI[5] in contraction territory suggests that demand for metals & materials could remain weak in the near term.
- China Oil & Gas: The macro backdrop for 2023 appears to be a mirror image of 2022.

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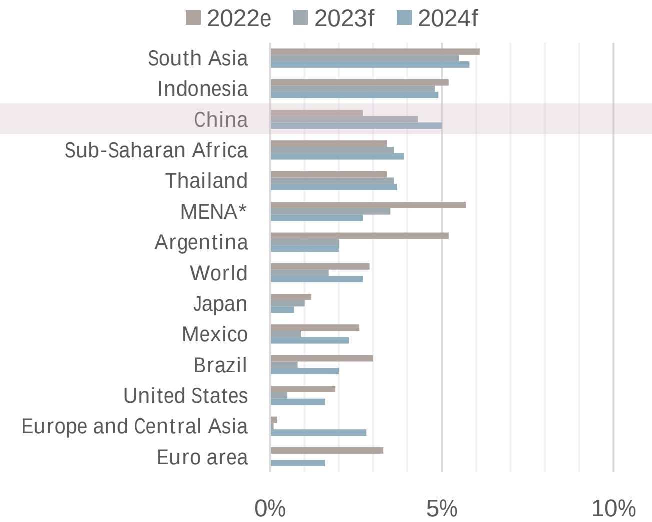
Year 2023: Stars Aligning

There are plenty of reasons to adopt an upbeat 2023 outlook for the Hong Kong/China market. On top of easier comparison against a very sluggish 2022, cyclical trends are already turning in 2023. First, China's speedy reopening could give rise to a strong rebound in private consumption. Second, we believe the solvency risk in the property sector is now confined. Third, regulatory overhauls towards the tech sector appear to be easing of late. Lastly, valuations remain cheap in terms of price-to-earnings ratio, cash flow yield and expected long-term earnings growth. The macro backdrop of China is in sharp contrast to that of the global economy, especially Europe and the Americas, which are forecasted to experience significant GDP growth slowdown in 2023 (see Chart 1).

CHART 1. GDP GROWTH FORECAST FOR MAJOR ECONOMIES



Source: World Bank, as of 10 January 2023
* MENA: Middle East and North Africa

China Reopening at Lightning Speed

China's "20 measures to enhance epidemic control" announced by the central government on 11 November 2022 marked the turning point of the country's COVID policy. Despite the countrywide resurgence in cases, the central government had made it very clear that local governments should remove all unnecessary curbs.

Then, at the Central Economic Work Conference (CEWC) in December 2022, China's senior leadership set reviving domestic consumption a top priority for 2023. The government will tackle this year's economic issues through opening up the economy, deepening the reform of state-owned enterprises (SOEs), and magnetising foreign investments.

The eventual reopening of China's border on 8 January 2023 coincided with a much higher level of COVID immunity, which entails lower mortality and a smooth transition to normal life. Based on the experience of other countries, COVID waves commonly peak in 1-2 months after the initial upswing of new cases. As the last outbreak in China began in mid-November 2022, the number of new infections presumably dwindled in January 2023. The majority of citizens across all age groups should either be fully vaccinated or have acquired natural immunity against various COVID variants.

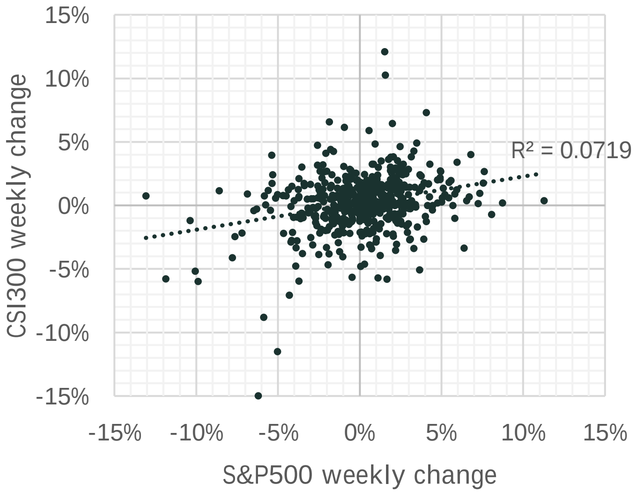
In an Upside Down World

The world's real GDP growth forecast for 2023 is between -0.4% and 4.5%, according to Bloomberg. Assuming a median growth rate (2.1%), the world economy is expected to expand at the third slowest pace, after the pandemic-hit 2020 (-3.0%) and crisis-struck 2009 (-0.8%). Our Chief Investment Officer reckons Europe may already be in a recession and sees a 65% chance of US recession in the 2Q23. On the other hand, we expect China's GDP growth to rebound to 4.5%. Of note, many municipal governments (e.g. Shanghai, Guangdong, Jiangsu and Zhejiang) are aiming for 5-6% GDP growth in 2023.

Also, China equities and other equity markets have shown weak correlations over the years (see Chart 2). Given the gloomy economic outlook and possibly choppy stock markets in the US and Europe, prudent investors should rebalance their investment portfolio across low-correlation markets. Indeed, global funds have started rebuilding positions in China equities in late 2022. According to IIF, foreigners net bought USD8.5 trillion and USD6.3 trillion of China equities in November and December 2022 respectively, more than reversing a USD8.5 trillion sell-off in October 2022 (see Chart 3).

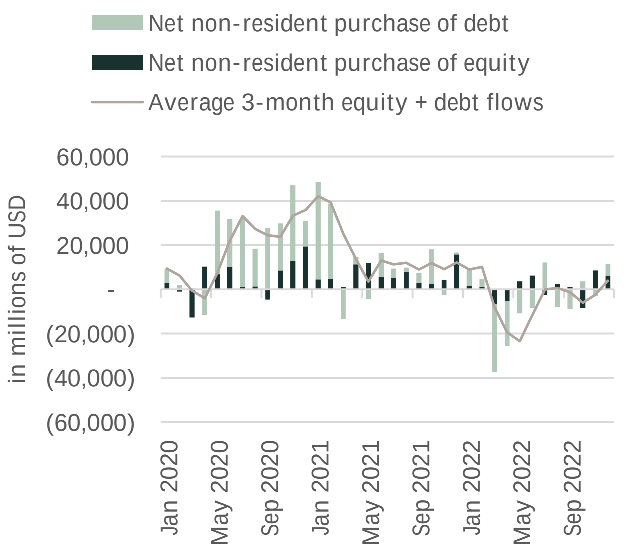
Last but not least, we wish you a joyful and prosperous 2023!

CHART 2. WEEKLY CHANGE IN CHINA CSI300 INDEX VERSUS US S&P500 INDEX



Source: Bloomberg, as of 20 January 2023
Past performance is not indicative of current or future performance.

CHART 3. NON-RESIDENT PURCHASE OF CHINA EQUITY & DEBT, 2020-2022



Source: Institute of International Finance, as of 11 January 2023

Notable developments in selected sectors and industries

1) China Internet

The pendulum of China's internet sector regulations has swung from stringent guidelines at the end of 2020 and most of 2021, reinforcement of controls in 2022, and now potential loosening in 2023. Comparing the press releases of CEWC 2021 and CEWC 2022, there was a notable positive change in the attitude towards the internet sector. The government now advocates vigorous growth of the platform economy and normalisation of regulatory standards. It also calls for internet platforms to lead developments, create jobs and display global competitiveness. These are in stark contrast to the previous year's themes of strengthening supervision and preventing unrestrained growth.

Separately, after months of suspension, China has begun to resume the approvals of online/video games of large game developers since September 2022. Prior to this, approvals had been granted specifically to small and medium-sized developers, but recent rounds started to also include the large players, which would bode well for the tech sector.

In addition to a more constructive view that the internet sector should play a bigger role in China's economy, the top leaders vowed to fortify support for private enterprises. CEWC specifically requested fair treatment of private enterprises, i.e. policies will lean less towards SOEs. As all of the leading China internet companies are privately owned, they are set to regain strength in a more business-friendly environment in 2023.

Valuations of China internet companies were wrecked in 2021-22 amid regulatory clampdowns, realignments of business strategies and COVID disruptions. Despite the sharp market rebound that began in early November 2022, share prices of leading China internet companies are still far off their historical highs (see Table 4). As the focal point of China's policy is moving from pandemic control to revitalising the economy, we think the China internet sector will not just be facing fewer hurdles, but may also receive blessings from the government in 2023. Each of these companies has thousands of employees and indirectly provides hundreds of thousands of jobs at small and medium-sized enterprises that depend on these industry colossuses. Therefore, we will not be surprised to see favourable policies and requests from the government to renew business expansion. By segment, we favour e-commerce, followed by advertising and lastly mobile gaming.

TABLE 4. SHARE PRICE PERFORMANCE OF LEADING CHINA INTERNET COMPANIES

	Last share price peak date	Change from last peak
E-Commerce #1	27 Oct 2020	-62.2%
E-Commerce #2	17 Feb 2021	-54.2%
E-Commerce #3	17 Feb 2021	-42.0%
Food Delivery #1	17 Feb 2021	-62.8%
Online Travel #1	16 Mar 2021	-14.1%
Search Engine #1	19 Feb 2021	-60.1%
Mobile Gaming #1	25 Jan 2021	-44.1%
Mobile Gaming #2	11 Feb 2021	-31.0%

Source: Bloomberg, as of 20 January 2023

2) China Banking & Insurance

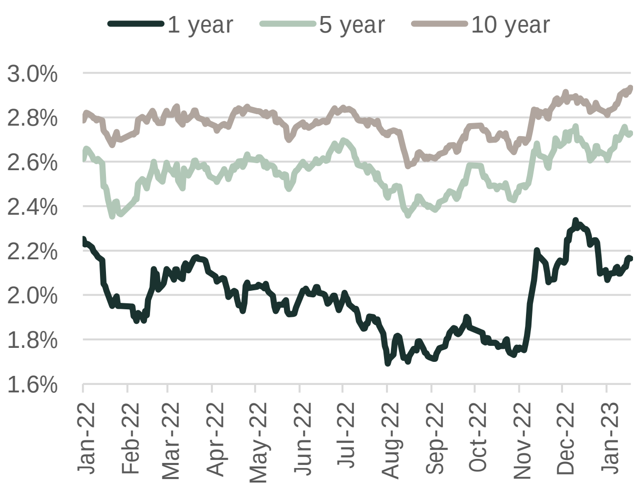
Although credit risks related to property sector loans have been dramatically reduced by the regulators' "16-point financial plan" published on 11 November 2022, it appears that the market is more concerned about declining profits from wealth management products (WMPs), net interest margin (NIM) compression, as well as slower loan growth in 2023. We hold a contrarian viewpoint that the China banking sector, especially the large SOE banks, should perform well in the post-pandemic recovery.

On the back of the regulators' rescue package and the People's Bank of China (PBoC)'s monetary easing via cutting reserve requirement ratios, several Hong Kong-listed property developers successfully shored up capital in the past two months through share placements and secured new credit lines. The coordinated actions have triggered a sharp rebound in China high-yield bond prices, which suggests lower default risks for property sector loans.

One of the most pronounced market headwinds for Chinese banks is that a significant portion of outstanding mortgage loans had their annual interest rates reset on 1 January 2023. The benchmark 5-year loan prime rate (LPR) was cut from 4.65% to 4.3% in August 2022. On top of the rate cut, PBoC and the China Banking and Insurance Regulatory Commission cancelled the floor rate for mortgages in September 2022, following the decision to cut the floor rate from LPR to LPR-minus-20 basis points (bps) in May 2022. We estimate that many residential mortgages saw interest rate reduction in the north of 55 bps. However, we believe PBoC is granted flexibility to launch more monetary easing initiatives when needed. We also noticed that top government officials and regulators did not reiterate the phrase "refrain from a deluge of strong stimulus policies" in their recent announcement and speeches. Therefore, we think new loan growth, driven by rising money supply, will offset NIM shrinkage. We also think banks can fill the commission income gap left by lower WMP sales with higher bancassurance sales.

For insurance companies, the opportunities arising from the ongoing shift in sales mix – from agents to the bancassurance channel – is a two-edged sword. While banks are incentivised to help drive gross written premium growth for life insurers, the inherently lower profit margin of bancassurance products will inevitably weigh on life insurers' average new business value margin. In 2023, we are inclined to perceive insurance companies as stocks with a high beta to China's bond and equity markets. According to China Central Depository & Clearing Co., the benchmark ChinaBond Government Bond Yields have rebounded across all maturities since November 2022 (see Chart 5). Considering that life insurers tend to have negative duration gaps, their intrinsic value should have rallied with interest rates.

CHART 5. CHINABOND GOVERNMENT BOND YIELDS



Source: China Central Depository & Clearing Co., BNPP WM, as of 20 January 2023

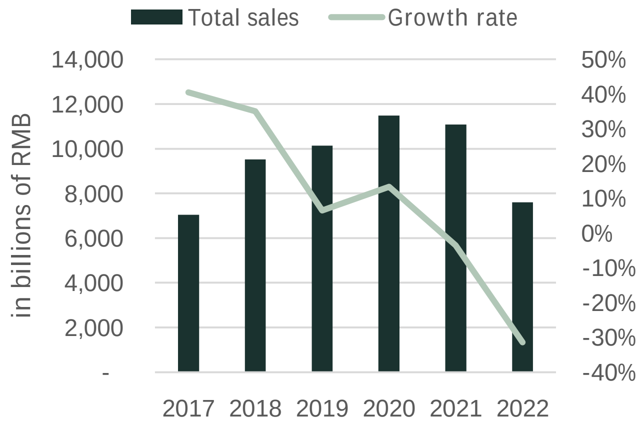
3) China Property

A comprehensive rescue package to ease the liquidity crunch in the property sector is certainly positive for the economy and especially for property-related industries. We think the liquidity provided by (i) a government-led property stabilisation fund of circa RMB300 billion approved in August 2022, (ii) RMB200 billion of targeted loans provided by three national strategic banks, and (iii) a maximum of RMB1.275 trillion from the strategic cooperation agreements among six state-owned banks and a handful of selected property developers, could plug the capital holes in unfinished real estate projects. According to the China Real Estate Index System, total sales of the top 100 property developers was RMB7.6 trillion in 2022, accounting for 39% of market share. In other words, the aggregate financial support was equal to about 23% of property sales of the country's top 100 developers last year.

In November 2022, the China Securities Regulatory Commission (CSRC) also rolled out coordinated measures to facilitate recapitalisations of property developers, including (i) reauthorising financing for mergers and acquisitions of listed property developers; (ii) reauthorising non-public refinancing for projects that are in line with government-supported housings; (iii) overseas listed companies will enjoy the same policies as A-share listed companies; (iv) promoting the issuance of real estate investment trusts; and (v) facilitating private equity investment in existing real estate projects.

However, at the end of the day, the value of a company is determined by its long-term profitability and sustainability. In the event of a massive market consolidation, we reckon the few survivors would be able to claim much larger market share, though the total market size probably will not beef up to the pre-2021 monstrous size (see Chart 6), as long as the "housing is for living in, not for speculation" theme is being upheld. We believe property developers that have secured strategic cooperation agreements with banks and those that have successfully raised capital in the equity market are more likely to be the survivors.

CHART 6. TOTAL SALES OF TOP100 CHINA PROPERTY DEVELOPERS



Source: China Real Estate Index System, as of 31 December 2022

4) Hong Kong Financial Services

Hong Kong is introducing a HKD-RMB Dual Counter Model and DCMM in the first half of 2023. These new initiatives aim to enhance market liquidity and minimise price discrepancies between RMB and HKD counters of the same underlying securities. (Note: To make it clear, RMB counters are HK-listed shares that are quoted in RMB, but not A-shares via Northbound Stock Connect.) We see upside potential for the Hong Kong stock market's turnover in the medium to long term. We also anticipate DCMM to bring new opportunities – arbitrage and broader product offerings – to security brokers.

Under the proposed DCMM, investors will be able to interchange HKD-RMB dual counters with enhanced trading and settlement arrangements. To put it simply, Mainland China investors will be able to trade HK-listed stocks without the hassle of RMB-HKD conversion. Meanwhile, brokers/market makers will provide necessary liquidity for RMB-quoted trades via seamless tax-free interchange of the underlying securities at the backend, with a potential extra-layer of profits from latency arbitrage. An empirical study in the UK[#] suggested that latency arbitrage constituted about 20% of daily trading volume of the FTSE350 Index.

[#]https://www.nber.org/digest/202110/race-exploit-stock-price-differences-between-exchanges

More details on DCMM is scheduled to be published in 1Q23. By then, the market should have more granularity to forecast the incremental stock trading volume.

5) China Travelling & Airlines

The long-awaited reopening of China's border happened a lot sooner than expected, whilst many analysts had assumed gradual reopening after March 2023 in their earnings forecasts. Although some countries (including Canada, India, Italy, Japan, South Korea, Malaysia, the UK and the US) quickly tightened their COVID-screenings against arrivals from China, we do not think such measures will impede mainland Chinese travelling abroad. We believe there is a huge pent-up demand for travelling by mainland Chinese after three years of pandemic. Online travel agencies are a prime beneficiary of the speedy reopening, which should enhance both sales volume and gross profit margin.

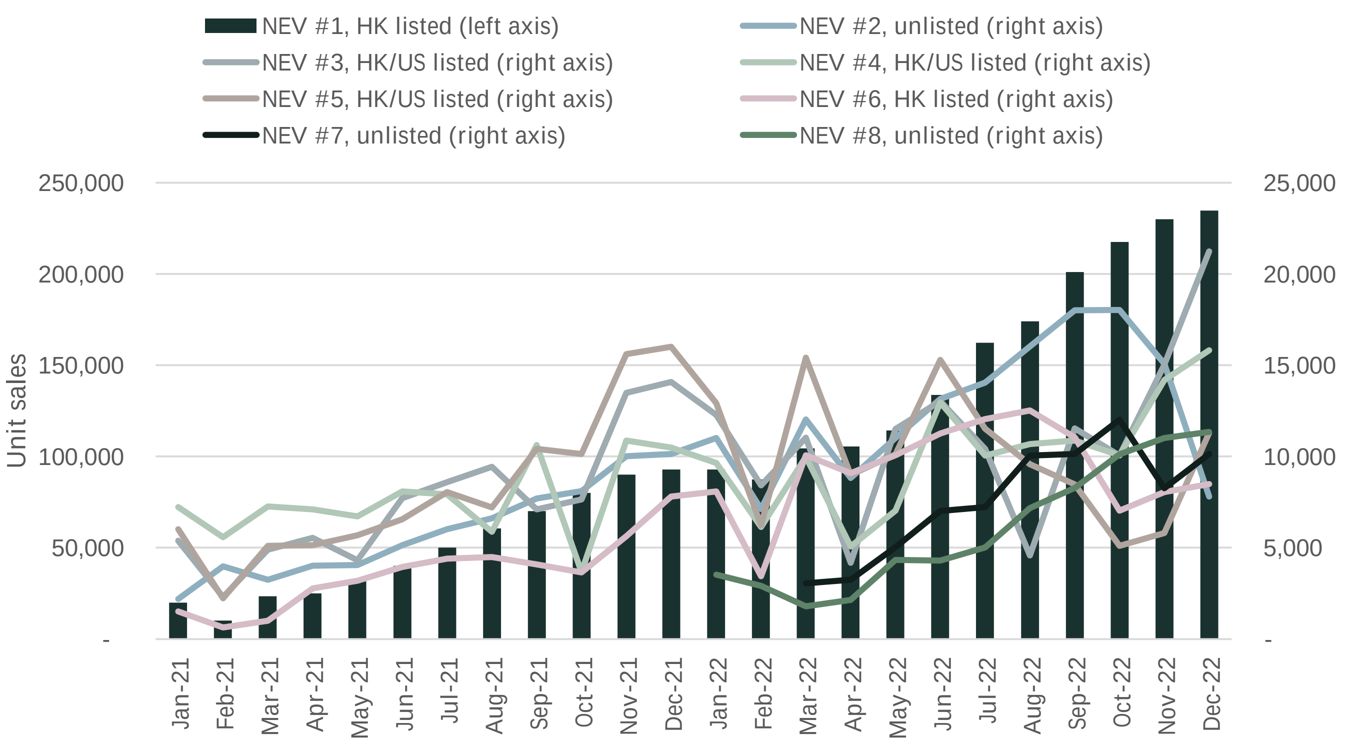
We maintain a constructive view on the Chinese airlines. The timing of operating profit recovery of airlines will mostly depend on their pricing strategies in the coming months, while it takes time to ramp up capacity back to pre-COVID levels. However, we recommend to accumulate shares of the airlines upon price pullbacks. Indeed, we have seen profit takings at the shares of other countries' airlines after their respective major hubs reopened borders. Share price retreats of around 10%-15% from the recent peaks should present good entry points to ride on potential re-rating of the China aviation sector.

6) China Automobile Manufacturing

The unit sales of many China NEV brands rebounded in the last two months of 2022 (see Chart 7), partly driven by a rush for utilising purchase subsidies (RMB4,800-12,600 per NEV) before expiration at end of the year.

While the NEV sector delivered mixed 3Q22 results, shares of all NEV makers rebounded across the board. We believe the upward momentum in share prices was mainly fueled by a rapid U-turn in market sentiment from risk-off to risk-on, and supplemented by the improving outlook for gross margins and unit deliveries.

CHART 7. MONTHLY PASSENGER NEV UNIT SALES OF CHINESE BRANDS, RANKED BY TOTAL DELIVERY IN 2022



Source: the companies, as of 3 January 2023

Despite a parabolic increase in battery-grade lithium price from less than USD14,000/metric ton in July 2021 to over USD70,000/metric ton since Feb 2022, China's largest NEV maker, who is also set to top the global NEV unit shipment standings for 2022, successfully enhanced its gross margin through economies of scale and price hikes.

The other NEV brands have less spectacular trends in our view. On top of ongoing supply chain disruptions, we have seen stiffening price competition across all price segments. Domestic mid-to-high-end NEVs are under pressure after the leading US battery electric vehicle maker slashed prices twice in less than three months (in October 2022 and January 2023) due to weak new orders. Meanwhile, the initial public offering document of a low-end NEV maker disclosed that the company sold cars at a negative 20% gross margin.

On the other hand, some of the large traditional car makers are showing encouraging transition to NEV from internal combustion engine (ICE).

In 2023, we expect NEV penetration rate to continue to increase at the expense of ICE sales, while price competition will remain. Therefore, we prefer (i) traditional car makers that have demonstrated continuing progress in ICE-to-NEV transition, and (ii) NEV makers with distinctive technologies and a clear marketing strategy.

7) China Metals & Materials

Manufacturing PMI went deeper in the contraction territory in 4Q22 (see Chart 8), suggesting that demand for metals and materials could remain weak in the near term. Both the National Bureau of Statistics and Caixin, the publishers of the PMIs, cited COVID resurgence as the primary reason for the miserable sentiment in late 2022. Yet, both institutions also said the survey respondents were expecting improvements in the coming months, though their views did not sync with the 8-month low PMI New Orders Index at 43.9%, falling 2.5 percentage points month-on-month, for December 2022. We think the weakness indeed stems from weak end-consumer demand from overseas, which could persist in the first half of 2023. The gloomy macro backdrop poses downside risks to demand for corrugated boxes.

CHART 8. CHINA MANUFACTURING PMI

Source: China National Bureau of Statistics, Caixin Global, as of 3 January 2023

Meanwhile, China reportedly held talks with four major coal importers on proposals to lift the unofficial import ban on Australian coal. The import ban, which was first imposed in October 2020, has resulted in significant supply deficit and sharp increase in domestic coal prices. According to Chinese customs data, Australian coal accounted for 48% of China's total coking coal imports in 2020. We note that Australian FOB Newcastle 5,500 kcal/kg NAR coal price traded at a >40% discount to comparable China domestic coal. The resumption of Australian coal imports is expected to depress China's coal prices, which in turn should relieve the gross margin pressure on heavy coal/electricity users such as steel mills and cement plants.

8) China Oil & Gas

In 2022, the year-on-year (YoY) increase in international oil prices lifted the profitability of oil & gas exploration and production industry. Meanwhile, COVID restrictions had disrupted domestic demand for refined oil and chemicals. The macro backdrop for 2023 appears to be a mirror image of 2022 – falling oil prices meeting rebounding domestic demand for refined oil and chemicals.

The China oil & gas megacaps have released operational data or preliminary results for the fiscal year of 2022. Oil producers are on track to report all-time-high profits for 2022, mostly driven by international crude oil prices (see Chart 9). On the other hand, oil refiners may see tough YoY and quarter-on-quarter comparisons due to the COVID outbreak in November and December 2022.

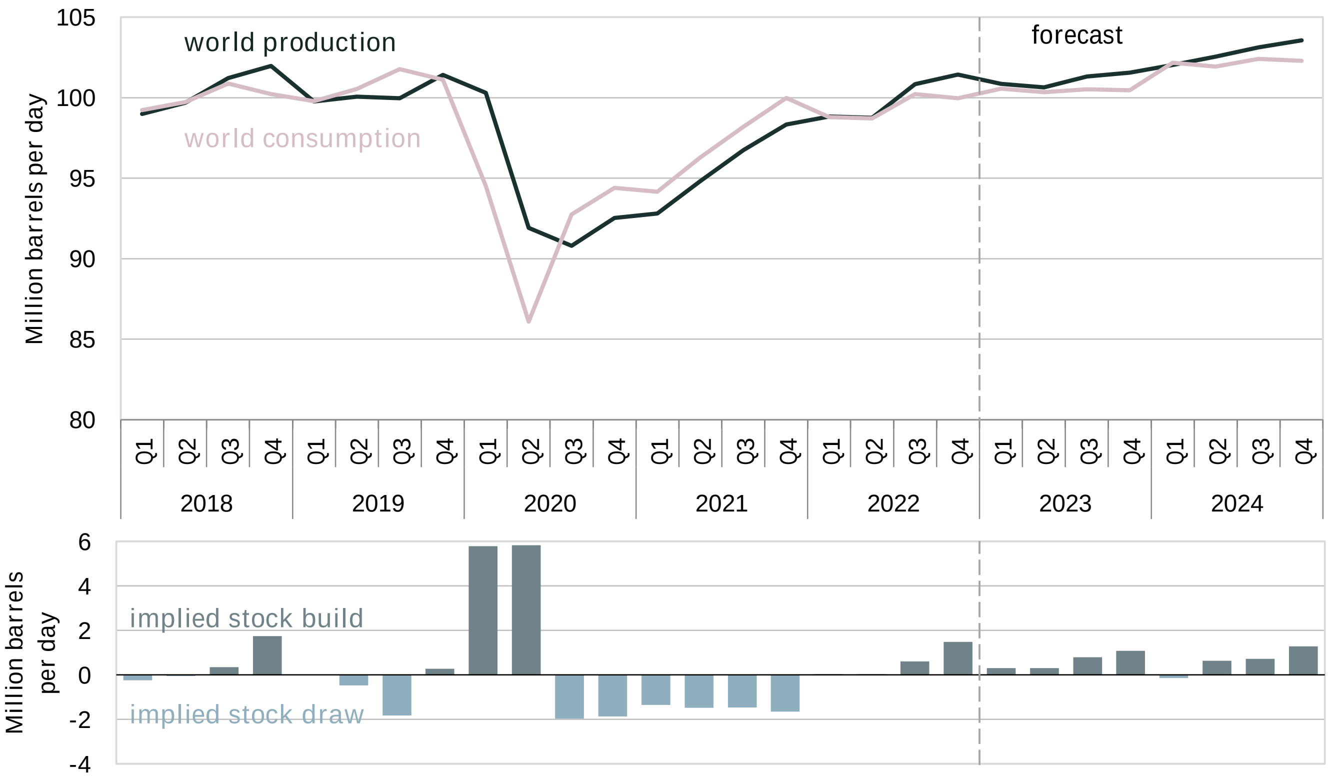
The latest global oil supply-demand forecast by the US Energy Information Administration is pointing at worsening over-supply throughout 2023 (see Chart 10). World production of liquid fuels is expected to increase by 1.1 million barrels per day (mbpd) in 2023 and 1.7mbpd in 2024. This increase reflects large output growth in several non-OPEC countries (namely the US, Canada, Brazil, Guyana and Norway) and also within OPEC, which would more than offset the 1.5mbpd decline in Russian production. On the other hand, oil consumption largely reflects trends in economic activity. Growth in global demand for oil is forecasted to slow in 2023 before picking up in 2024. As a result, we believe crude oil price momentum is skewed to the downside in the near term.

CHART 9. BRENT CRUDE OIL SPOT PRICE

	Q1 2021	Q2 2021	Q3 2021	Q4 2021	Q1 2022	Q2 2022	Q3 2022	Q4 2022
Average price	60.7	68.6	73.0	79.4	99.5	112.8	99.1	88.3
YoY	-				64%	64%	36%	11%

Source: Bloomberg, as of 25 January 2023

CHART 10. WORLD LIQUID FUEL PRODUCTION AND CONSUMPTION BALANCE



Source: US Energy Information Administration, 5 January 2023

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