January 2018

China Insights

Monthly update on Chinese markets

Summary

- Property market has significant influence on the Chinese economy and investors have shown concerns about its slowdown on the back of the government's tightening measures
- We think consumption will be one of the key macro themes in the medium term given strong rise in GDP per capita and positive wealth effect from property price boom
- We expect the government continue to roll out new rules to fill existing loopholes in the bond market and rein in leverage

Hot Topic: Chinese housing market moderates, albeit healthily

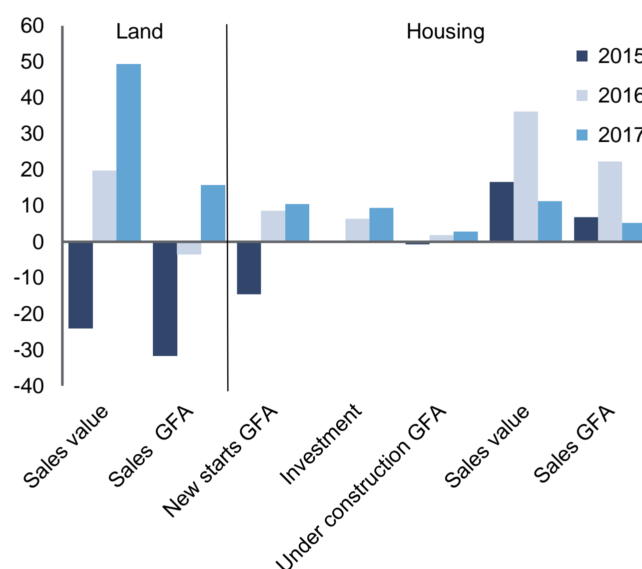
Housing market was surprisingly resilient in 2017

Property market has significant influence on the Chinese economy and investors have shown concerns about its slowdown on the back of the government's tightening measures, such as home purchase and sales restrictions, tightened mortgage policies and price caps.

Despite facing these headwinds, residential property market proved to be resilient in 2017, with the cooling off in tier-1 and 2 cities offset by robust activity in lower-tier cities. In larger cities, market supply remains tight but activity and price gains have been constrained by policy. In many small cities, local governments have substituted affordable housing projects with a financial subsidy for beneficiary households to purchase commodity housing.

The resilience in property market can be partly attributed to de-stocking of housing inventory, which has driven unsold residential property gross floor area (GFA) to the lowest level since November 2013. Low inventory levels supported a pick up in real estate investments, new housing starts GFA, land sales GFA and land sales value.

Chinese property market indicators (% yoy)



Source: CEIC, HSBC Global Asset Management, data as of January 2018

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Hot Topic: Chinese housing market moderates, albeit healthily

However, home sales growth decelerated in 2017 after a strong 2016.

2018: Market to remain resilient despite tight policy stance in the near term

We expect property sales volumes to moderate further in 2018, with stable, or mild rebound from low base, as sales in tier 1-2 cities offset softer sales in tier 3-4 cities. Some cities have recently fine-tuned property policy marginally, mostly by loosening *hukou* rules to allow well-educated migrants to buy property. While the central government has given local governments more flexibility to determine their own city-specific policy, it has not signaled a U-turn in the nationwide policy stance.

We expect overall housing policy stance to remain tight in the near term. Administrative policy and credit controls are likely to remain in place through most of 2018. Credit control will likely restrain financing for small developers and highly leveraged home buyers. However, we also think further aggressive policy tightening is unlikely as the overall market now looks under control, and as the government would not want a sharp market correction.

New housing starts lost some momentum in H2 2017 and real estate investments cooled in Q4, but could remain resilient in 2018 given the notable increase in land sales area in 2017. The current low inventory levels remain a supporting factor. However, we expect land sales volume growth to moderate in 2018, pressured by slower home sales and high land prices and by large land-bank major developers have accumulated over the past two years.

Activities in affordable housing should continue to support overall construction activities and investment. Affordable housing market has grown rapidly, with 36 million units built in 2011-15 followed by 18 million units built under shanty town renovation in 2015-17. The government plans to renovate another 15 million units of shanty town homes in 2018-2020. Meanwhile, rental housing market is still at an early stage. We need more policy clarity on how and in what magnitude the government will increase the rental housing supply. The boost from rental housing is likely to be limited in the near term but meaningful in the medium-term given the government policy push.

Gov't policy focus: more long-term and structural

The 19th Party Congress stated that China's housing supply should come from multiple channels and be provided by multiple entities. The property policy will focus on developing a long-term market mechanism. These include land supply, housing structure (buy vs. lease, private vs. public), ownership rights and taxation.

One key focus is on meeting residential demand in urban area by developing a three-pronged market system, i.e. rental housing, affordable housing (including shanty town re-novation), and commodity housing. The rental market will receive more policy support (e.g. land supply, taxes and finance, etc.) to complement the ownership market. The government will also push forward rural land reform (usage of rural collectively owned lands) to increase the source of land supply.

The development of the rental market could accelerate the formation of cluster cities and urbanisation, since the housing hurdles for migrants have been lowered. Those who cannot afford or qualify for home purchases can now rent. We think discussion of the framework and legislation of property tax could start this year, but the entire process is likely to take a long time before implementation.

What do these mean for the market?

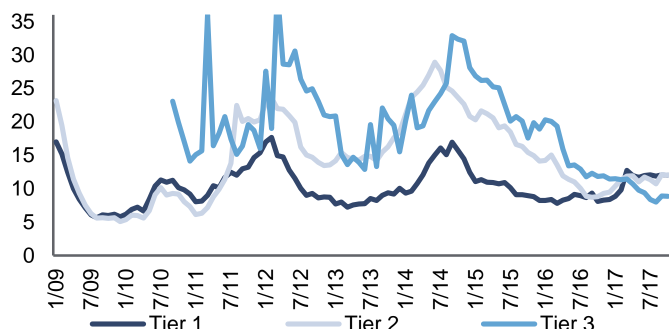
Fuelled by better sentiment and reported earnings, shares in property companies have surged by 16% (as of 19 Jan) this year. While recent easing in property curbs has further spurred property shares, its impact should be limited as the measures benefit only very remote areas

The government appears to have achieved its short-term goal of property market management i.e. cooling down the red-hot tier 1-2 cities and de-stocking in tier 3-4 cities.

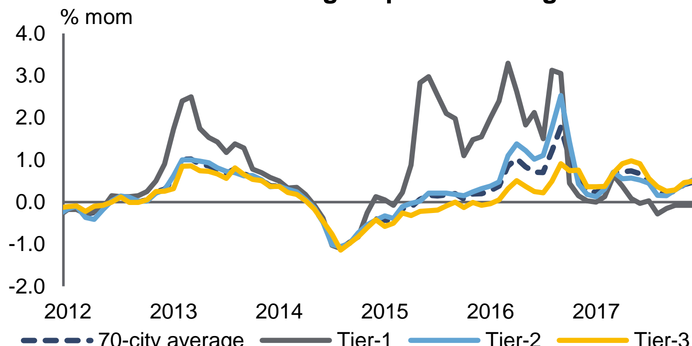
In light of the current policy, we expect market consolidation to continue, with leading players with stronger balance sheets and branding benefiting from better contracted sales and land purchases.

Although we expect property sales to moderate, the slowdown should not spill over to construction, commodity and infrastructure sectors as inventory remains low.

Inventory turnover months by cities (tiers)



Policies have led to divergent prices among cities



Source: CICC, CEIC, HSBC Global Asset Management, data as of January 2018

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Equity market

- **MSCI China Index** wrapped up 2017 with a total return of 54.4%, led by real estate (+103%), information technology (+94%), consumer discretionary (+64%) and health care (+59%)
- **Earnings growth** accounted for two-thirds of 2017 price gains and we expect this upgrade to continue to underpin the positive momentum in 2018, with the market now forecasting earnings per share growth of 15%
- **Valuations** are off their previous lows but remain reasonable. The MSCI China Index is trading at price-to-book of 2.1x versus the 10-year historical average of 1.7x. Forward price-to-earnings of the index has become rich now, but taking out ADRs that were added in 2015, the index's valuation is trading at around its 10-year average. Moreover, Chinese equities continue to trade at a discount when compared to the US and developed markets
- **China A-shares** were up 20% in USD terms in 2017 with less than one-third of stocks finishing in positive territory, meaning there are opportunities to take positions in attractively valued stocks that benefit from China's structural trends, such as increasing consumption in premium products on the back of positive wealth effect

> Net southbound flows from mainland Chinese investors into the Hong Kong market in 2017 was USD44 billion. Strong southbound flows are expected to continue as the A/H premium gap remains wide

- **Economic activities** remained upbeat in December, with a pick up in services PMI, hinting at an acceleration in consumption, and rise in manufacturing PMI, highlighting further industrial upgrades in China. Both manufacturing investments and exports continue to be robust, with gauges pointing toward a continuous shift from labour intensive to higher value-added products
- **Net southbound flows** from mainland Chinese investors into the Hong Kong market in 2017 was USD44 billion, bringing total net flows since launch to USD94 billion. Strong southbound flows are expected to continue as A/H premium gap remains wide, and certain stocks are only available offshore and are trading at discount to those in the same sector onshore
- The recent introduction of **full circulation of H-shares** will grant management and major shareholders rights to sell their domestic shares, increasing liquidity in the Hong Kong equity market by as much as HKD2.6 trillion. While the near term impact of the scheme is limited given it is a gradual process involving only a handful of stocks initially, this is yet another step from China to open its capital market and may increase China's attractiveness to major index providers and foreign investors

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- We think consumption will be one of the key macro themes in the medium term as real income per capita has doubled since the Global Financial Crisis and as the wealth effect from surge in property prices in lower tier cities kick in. As such, demand for premium products such as cars and entertainment related goods may continue to rise in near future. With higher income, Chinese people may also turn more conscious in terms of sustaining a healthier lifestyle, thereby allocating more money into healthcare products and services and insurance policies

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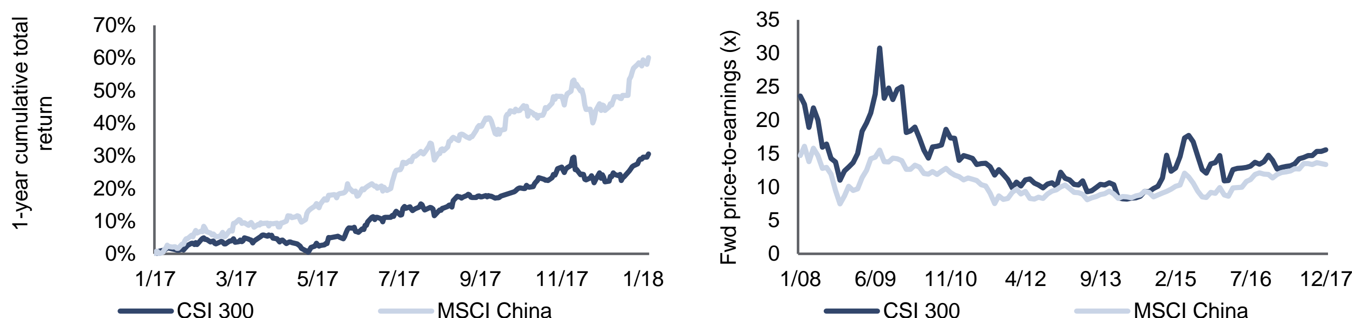
Equity market

Both onshore and offshore equities have rallied in January



Source: Bloomberg, HSBC Global Asset Management, as of 17 January 2018. Total return in local currency terms. Investment involves risks. Past performance is not indicative of future performance.

Sector	Comment
Consumer Discretionary	• We are overweight the consumer discretionary sector on the back of long term trends such as economic restructuring and rising household income and middle class
Consumer Staples	• We are overweight consumer staples sector as the trend of premiumisation and CPI inflation underpins higher pricing power and margin expansion capability of selected strong staple brand names
Energy	• We have gone UW upstream oil as we see limited upside on oil price after the strong rally in 2017
Financials	• We are positive on insurers on the back of rising bond yields and ongoing strong premium growth trends. We are UW banks given the unattractive outlook for earnings growth
Healthcare	• We are overweight the healthcare space as low penetration rate of biochemical drugs and rising concerns around health-related issues in China will drive demand for healthcare products. We prefer players with a strong R&D capabilities and product pipeline
Industrials	• We are UW industrials as most companies in the sector exhibit a weaker growth profile than other sectors in China
Information Technology	• We remain positive on the IT sector, as we believe select names will see secular earnings growth on the back of mobile gaming growth, improved monetisation efforts and the ongoing shift towards online purchasing.
Materials	• We are selective on commodity plays as the end of winter suspension later this quarter may bring pressure to certain materials companies
Property	• We are neutral on property. We expect property sales in top-tier cities to be more stable this year after the significant decline in sale volume last year. Meanwhile lower tier cities may see volume drop given the high base effect from last year
Telecommunication	• We are underweight the telecoms, with concerns over increasing government intervention, fierce competition in the 4G market, and increasing capital expenditure in relation to 5G development
Utilities	• Uncertainty around tariffs and the long term outlook for profitability has prompted an underweight position in the sector

Source: Bloomberg, HSBC Global Asset Management, as of January 2018

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Fixed income

> We think yield will remain stable in the near term with short-end yields likely to trend lower

- Onshore and offshore bond markets have kicked off 2018 by delivering 1.3% and 1.7% returns in USD terms, respectively, extending the gains made in 2017

Onshore market

- 10-year bond yields edged down further in December, in line with our expectations, as the previous yield level was not fundamentally justified, and the PBoC likely does not prefer persistently high funding cost. We think yield will remain stable in the near term with short-end yields likely to trend lower, and that would support more favorable conditions for longer end bonds too
- PBoC and the market regulators announced a new bond trading and reporting rule, with one year grace period, for bond repurchase and forward transactions to control related leverage. We expect the government to continue to roll out new rules to fill existing loopholes and rein in leverage. The regulations, along with the targeted RRR cut and temporary liquidity facility, should further mitigate liquidity tightness and funding cost, which are critical to corporate profitability as we see high refinancing needs in 2018
- PPI moderated to 4.9% yoy, partly due to high base effect from last year for excavations and metals, which were supported by supply side reforms. CPI ticked up slightly to 1.8% yoy, with easing food deflationary pressure. We believe inflation will remain stable in the medium term and government should maintain a neutral stance on monetary policy
- CNY has appreciated against USD by 1.2% in the first two weeks of 2018, and China's FX reserves have gone up for 12 consecutive months. Given much better sentiment on the currency, the government recently dropped the counter cyclical factor that was introduced in May 2017 to curb excessive currency volatility, showing its confidence in CNY and support to liberalising the currency

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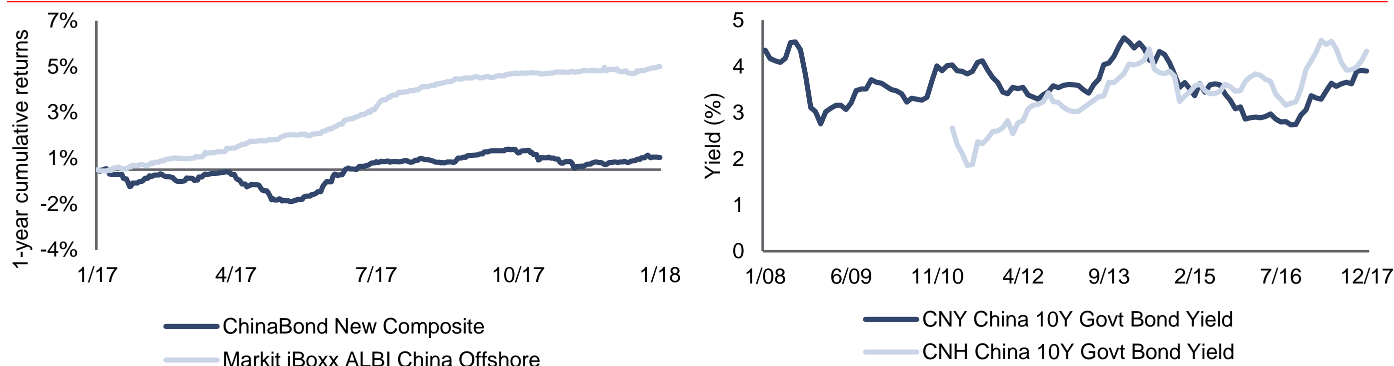
Offshore market

- Yields edged up in December as investors locked in profit before year-end. We continue to favour the CNH bonds, which offer a good yield of 4.5% with short duration of just 3.1 years. In the offshore space, we like CNH government bonds and short duration corporate issues
- The demand-supply dynamics should remain attractive for CNH bonds as supply stays muted and bond maturities have been reinvested in the secondary market

Onshore and offshore bond yields diverged



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Indicator	Data as of	Actual	Consensus	Prior	Analysis
Industrial production (IP) (yoy)	Dec	6.2%	6.1%	6.1%	Real GDP growth rose to 6.9% from 6.7% in 2016, exceeding the government's "about 6.5%" growth target, and is the first annual acceleration since 2010. December IP growth edged up, despite tighter environmental protection requirements, as stronger utility sector IP helped to offset slower manufacturing production. IP grew 6.6% in 2017 vs. 6.0% in 2016. The government's ongoing anti-pollution campaign as well as supply-side reforms including excess capacity cuts and SOE deleveraging will likely continue to weigh on IP and related investment activities. Going forward, we expect growth moderation in 2018 (to around 6.5%), amid tighter financial conditions on the back of deleveraging and regulatory overhaul; structural adjustments; a smaller fiscal impulse; and cooler property activities. Nevertheless, resilient consumer spending and services, industrial upgrades and policy supports should underpin growth
Fixed Asset Investment (FAI) (ytd, yoy)	Dec	7.2%	7.1%	7.2%	A rebound in manufacturing FAI growth helped offset deceleration in infrastructure and real estate FAI growth in December. For the full year of 2017, manufacturing FAI was rather sluggish (+4.8% yoy vs. 4.2% in 2016), despite a notable increase in corporate profits and cash-flow. While upstream sectors are benefited from supply discipline and pricing power, restrictions on expansion can suppress profits. Down-stream enterprises' profit growth has been more subdued amid higher input costs. Overall, we expect a modest pickup in manufacturing FAI growth in 2018 on the back of last year's low base, robust profit growth and easing industrial over-capacity pressure. However, catalysts such as a strong rebound in down-stream profits, easier monetary conditions and/or policy measures may be needed for a meaningful acceleration in corporate capex growth. We expect infrastructure FAI growth to remain robust but soften in 2018. Local governments' investment has slowed on the back of financing constraints and reflecting a policy shift at the national level toward quality of development from growth rates. The recent PPP regulation tightening to contain "hidden risks" in local government debt could pose headwinds to (local) infrastructure investment growth.
Retail Sales (yoy)	Dec	9.4%	10.2%	10.2%	The slowdown in December sales was mainly driven by auto sales and likely also reflected the distortion from the 11th November Singles' Day shopping festival which led to advanced consumption in November. Overall, consumption stayed resilient, supported by stable income growth and labour market. The 2017 full-year urban new job creation exceeded 13 million, surpassing the government's 11 million target. Average nationwide household disposable income per capita (in real terms) increased by 7.3% in 2017, up from 6.3% in 2016.
Exports (USD) (yoy)	Dec	10.9%	10.8%	11.5%	External demand remained resilient, supporting steady export activity. The sharp slowdown in import growth was mainly led by softer commodities imports, likely partly reflecting temporary production and construction activity suspensions for environmental protection requirements. An on-going global cyclical recovery should support China's exports in the coming months, but the tailwinds from the tech upcycle and inventory restocking and RMB weakness (on REER terms) are likely fading. US-China trade tensions remain a risk, particularly in selected sectors/areas, given the continued increase in bilateral trade imbalances and with ongoing US investigations that could potentially lead to higher tariffs on imports from China in relevant sectors. Greater US scrutiny of China FDI is likely. Investment import demand is likely to soften in 2018 amid the impact of tighter financial conditions and a cooler property market.
Imports (USD) (yoy)	Dec	4.5%	15.1%	17.6%	
Trade Balance (USD)	Dec	54.7bn	37.0bn	39.0bn	
CPI Inflation (yoy)	Dec	1.8%	1.9%	1.7%	The further deceleration in PPI yoy inflation was mainly due to a high base, while PPI on a sequential mom basis rose. The full-year 2017 PPI inflation jumped to 6.3% from -1.3% in 2016. Meanwhile, CPI inflation averaged to 1.6% in 2017 vs. 2.0% in 2016. We expect CPI inflation to rise moderately in 2018, on the back of food price normalisation (after deflation in 2017) and a gradual (and modest) pass-through of higher input costs/PPI inflation to non-food CPI. PPI yoy inflation will likely ease in 2018 due to the base effect, though we think the anti-pollution campaign will restrict output in certain sectors and lend some support to PPI.
PPI Inflation (yoy)	Dec	4.9%	4.8%	5.8%	
Manufacturing PMI Official	Dec	51.6	51.6	51.8	Both production and new orders sub-indexes of the manufacturing PMI fell. The raw material and producer price sub-indexes rebounded after two months' falls. Higher construction PMI offset a lower services PMI in the non-manufacturing PMI. Overall, the PMI readings at above 50 point to firm near-term economic growth, consistent with the December real activity data.
Non-manufacturing PMI Official	Dec	55.0	54.7	54.8	
Total Social Financing (TSF) (RMB)	Dec	1,139.8bn	1,500.0 bn	1,619.6 bn	Weak December new RMB loans were due to lower household and corporate new loans and possibly as the loan quota became more a constraint by year-end. Outstanding TSF growth of 12% in December met the 2017 target. By components, RMB loans remained the largest driver of TSF in 2017 (71% of total). The share of banks' off-balance sheeting items rose to 18.4% in 2017 from 6.1% in 2016. Net corporate bond issuance accounted for 2.3%, down from 16.8% in 2016. M2 growth fell to another record low of 8.2%, reflecting the effect of on-going deleveraging and slower loan growth. We expect broader credit growth, adjusted for local gov't t debt swap and shadow banking credits not captured by the TSF, to likely slow further in 2018, amid financial deleveraging and tighter (macro-prudential) regulations
New yuan loans (RMB)	Dec	584.4bn	1,000.0 bn	1,120.0 bn	

Indicates improved data on month-on-month/quarter-on-quarter/year-on-year basis

Indicates worsened data on month-on-month/quarter-on-quarter/year-on-year basis

Indicates no change in data on month-on-month/quarter-on-quarter/year-on-year basis

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