The Dragon Code

Chinese equities remain our top choice in Asia

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In line with other emerging markets, Chinese equities have been affected this year by trade tension, the rising US dollar and yields, and geopolitical developments. We believe the heightened volatility since late January is a natural market development in which asset prices are adjusting to the new normal in the financial market, and investors should welcome its return and actively position into long-term structural opportunities. Offshore Chinese equities remain our top choice in Asia given:

- A stable macroeconomic environment with the focus shifting to high-quality growth.
- Continued efforts on reforms and the acceleration in further opening up the domestic market, which is a positive surprise.
- Potential for further deployment of policy tools in countering external headwinds.
- Multiple attractive investment themes and solid market fundamentals.

External developments pose new challenges

We expect domestic policy implementation in China on both economic and political fronts to remain consistent with President Xi Jinping smoothly transitioning into his second term, but we believe the external developments we have seen this year represent some new challenges for the government, and they can have a much longer-term impact.

Trade tension is a top issue. The US government has displayed an increasingly hawkish stance towards trade with multiple protectionist actions targeting not only China, but also its traditional allies including the EU and Canada. China is particularly in the spotlight given the magnitude of trade deficits with the US and its role in the global trade and manufacturing supply chain.

We believe the recent actions by both the US and Chinese governments to progress with tariffs despite a previous agreement to avoid a trade war has complicated the situation. However, we maintain our baseline view that negotiations will continue as no country can gain from rising trade barriers in an integrated world. It might, however, take longer than expected to settle on concrete terms, and there can be unexpected developments that dominate short-term sentiments.

US monetary policy and geopolitics to be sentiment factors. We expect the dollar and yield trend to be mainly driven by US monetary policy and to more likely affect other emerging economies. However, we believe sentiment towards Chinese equities will unlikely be immune to the broader market movement. Despite recent depreciation of RMB, we believe the Peoples' Bank of China (PBoC) has sufficient policy tools to maintain the stability of the currency, and we expect the pressure on capital outflows to be manageable given the relatively tight capital controls that remain in place.

On the geopolitical front, we expect China will continue to play a crucial role in regional affairs relating to North Korea and other key partners. And we also expect it to become an increasingly visible player in other regions given its growing economic importance. We don't expect those events to produce any immediate and substantial economic impact on China in the near term.

Macroeconomic environment to remain stable

We believe the macroeconomic environment in China will remain stable for the rest of 2018.

Growth moderated sequentially but remained resilient. The slight moderation in real GDP growth to 6.7% in the second quarter from 6.8% in the first quarter has caused market concerns. We believe investors should focus on the real transition of the Chinese

economy and the government's competence in maintaining stable growth rather than being purely driven by numbers. It is encouraging that consumption remained the largest contributor to GDP growth, and the service sector modestly accelerated in the second quarter. Even though fixed asset investment growth continued to be subdued as a result of weaker property and infrastructure investments, we believe investors should view it as a positive development as these areas represent old engines of growth in China, and any further slowdown in their expansion is in line with the government's overarching objective to pursue high-quality growth. Moreover, export growth in the first six months of 2018 accelerated to 12.8% year-on-year from 7.9% in 2017, pointing towards resilient global demand despite the noises surrounding trade.

Economic activities to slow down in the second half. We expect economic growth in 2018 to achieve the government's target of around 6.5%, but to slow down in the second half due to cyclical headwinds. We expect fixed asset investment growth to trend down further; however, given the more easing stance by top leadership, we believe any negative impacts on growth will likely be mitigated by further policy supports. We believe exports growth will also likely moderate in the second half due to a high base and potential drag from trade frictions, but we expect the impact on growth to be limited given rising importance of domestic sectors to economic growth. In addition, we continue to believe consumption and service will be the key growth drivers going forward amid rising household income.

Deployment of policy tools to be flexible. We believe the Chinese government is mindful of both domestic structural issues and external uncertainties, and is striving to achieve high-quality growth with the flexibility to proactively deploy policy tools in a prudential and gradual manner to maintain stability. Indeed, top policymakers have been fine-tuning their policy stance in recent months and stated in the latest State Council and Central Politburo meetings that both monetary and fiscal policies will be more supportive in the second half.

- On the monetary front, we believe the government remains committed to deleveraging. However, in light of its impact on liquidity and external uncertainties, we are encouraged that the government is willing to engage with precautionary moves. This was evidenced by the cuts in the reserve requirement ratio in April and June and by the relaxed guidance on wealth management products (WMP) that we believe are positive for infrastructure financing and related Public Private Partnership (PPP) projects. We expect the PBoC to conduct further easing policies to make sure domestic liquidity conditions are ample and reasonable.

- On the fiscal front, we expect the government to adopt more proactive fiscal policies by continuously rolling out supportive measures to alleviate tax burdens and by increasing spending on infrastructure projects whose investments have been decelerating lately. During the State Council meeting in July, the government pledged RMB1.1 trillion in tax and fee reductions in 2018 for both individuals and corporates, and expanded R&D related deductibles amounting to RMB65 billion to all enterprises from only tech small to medium enterprises in the past. The government also indicated that it will accelerate local government bond issuance and support reasonable financing requirements by local government financing vehicles (LGFVs), which we believe will help hold up infrastructure investment in the second half.

Reforms well on track with upside surprise

Deleveraging remains the key. We believe high leverage is the very long-term structural issue that China needs to address in order to maintain economic sustainability and reduce the discounts international investors are placing on Chinese equities. We are encouraged with the positive progress the Chinese government has made on this front:

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China's debt-to-GDP ratio has stabilized since 2016, and corporate leverage, the largest component to overall debt, has shown a positive declining trend in particular. Top Chinese leadership has been consistently emphasizing the importance of preventing major financial risks, and we believe deleveraging will remain a top policy priority going forward.

We believe supply-side reforms, together with tighter environmental protection regulations, have already made good progress and will continue. We believe the ultimate objective of reducing excess capacities and improving corporate profitability and efficiency also requires lowering the debt level of highly leveraged companies concentrated in the energy, materials and related sectors.

Upside surprise on liberalization measures. President Xi Jinping delivered a keynote speech at the Boao Forum in early April to reassert China's commitment to reform and opening-up. We have already seen multiple measures being rolled out following Xi's talk, including granting foreign players wider access to the domestic market and reducing import tariffs, and we believe the Chinese government will continue to put in place further liberalization policies to address trade imbalances and improve the quality of growth and people's lives.

Innovation to gain growing importance. We believe the trade dispute with the US is a wake-up call to China that the country still lacks key technology capabilities. Xi has given multiple talks since April, urging companies to step up their technology capabilities. We believe innovation will gain importance and remain a top policy agenda.

China remains our top choice within Asian equities

We are upbeat towards China's stable macroeconomic environment and pro-reform policies. We are also excited with the strength of Chinese corporates and believe current market fundamentals remain attractive against their robust growth potentials.

Valuation back to historical mean. The MSCI China Index was trading at a price-to-earnings ratio of 11.1x as of early August, back in line with the historical mean from the peak reached in late January. We believe investors will once again find the valuation attractive should there be more clarification on the trade front and domestic macroeconomic conditions prove stable.

Earnings supported by sustainable growth sectors. We maintain our view that earnings growth will remain in at the double-digit level in 2018, and that the downward revisions on earnings growth lately is more a reflection of rising uncertainties rather than a new reality.

Structural liquidity support. Despite mild moderation recently, we believe investors should look beyond short-term fluctuations: Southbound inflows have been robust and accelerating since the inception of the Stock Connect program. We remain positive and believe they represent a structural allocation from mainland investors into offshore markets and will continue to be a key positive driver to Chinese equities.

Conclusion

We believe many Chinese companies will emerge as long-term winners on the back of structural opportunities. We are particularly optimistic towards investment themes that can gain from China's transition to a consumption- and service-led economy, which includes consumption upgrades, innovation, internet and advanced manufacturing among others. We believe they will thrive over time and present themselves as the most exciting space across global equities for research and investment.

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