China Insights

Monthly update on Chinese markets

June 2018

Summary

- *Bond defaults in China have increased gradually, but we think these developments don't pose a systemic threat to China's economy and markets or to the overall Asian credit market*
- *CSRC unveiled additional guidance and trading details surrounding the pilot program of Chinese Depository Receipts (CDR), a plan which will facilitate the trading of overseas shares on the Chinese onshore market*
- *RMB may see some downward pressure against the dollar as trade disagreements escalate, but sharp devaluation is off the table*

Hot Topic - Bond defaults in China: No pain, no gain

> Key take away from recent events is that, while defaults in China will continue to increase gradually, these developments don't pose a systemic threat

There has been a lot of noise about rising defaults in China in recent weeks, which has affected sentiment in an already sluggish credit market. More than a dozen companies have defaulted since the beginning of the year, adding to concerns around China's ongoing deleveraging campaign and tighter liquidity conditions. Our key take away from these events is that, while defaults in China will continue to increase gradually, these developments don't pose a systemic threat to China's economy and markets or to the overall Asian credit market. Here's why:

Problem areas and red flags

In a nutshell, the two major negative news recently were (1) a few Tianjin-based SOEs defaulting on their onshore bonds or had difficulties refinancing and (2) a Chinese oil and gas producer defaulting on its USD1.8 billion offshore bond obligations. In our opinion both of these are isolated incidents that were set in motion by specific problems which can be contained.

Tianjin appears to be a prime example of an area that is vulnerable to the ongoing deleveraging in China. It has long been a region with a relatively high level of leverage. Even on its own, this situation is not sustainable, especially in light of China's the clearly stated goal of reducing financial leverage. The outlook is further complicated by the fact that Tianjin is an area with a high concentration of the "old economy" industries, such as textile, manufacturing and metalwork.

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There are some obvious "red flags" that can help identify the more problematic areas amidst deleveraging in China - (1) Companies whose leverage level is already high, (2) Companies in old economy sectors as they tend to have a more negative business outlook, and are likely to receive less government support and (3) State-owned enterprises (SOEs) that on the whole tend to be less efficient when compared with the private sector.

With regard to the default of the Chinese oil and gas producer mentioned earlier, even without conducting a detailed analysis it is not difficult to conclude that this was not triggered by a deterioration in the macro or business environment, as the issuer defaulted in May even though its most recent USD issuance was completed less than 6 months ago. This implies that there are factors well beyond China's ongoing deleveraging at play in this particular instance.

Nonetheless, deleveraging in China will continue and some companies will find it increasingly difficult to refinance. We also expect more defaults in China. However, it is also important to note that the default rate in China is still very low, so a gradual increase is healthy for the market as it encourages better credit risk pricing, which is still lacking in the onshore bond market. This deleveraging process is a managed maneuver by the authorities to improve the health of the economy and a pro-active step to avoid systemic problems when credit quality turns sour. So it is not reasonable to assume the Chinese authorities will allow a sudden sharp increase in defaults because that in itself would create a systemic problem which is exactly what China is trying to avoid by proactively reducing leverage.

Take some, give some

China is currently in the third year of its deleveraging initiative to mitigate risks in its financial system. The government has made measurable progress in reducing dependence on undesirable funding sources for companies, such as shadow banking. However, in the process it has also triggered concerns about tightening credit conditions and increased default risks.

There are ongoing attempts at policy fine-tuning aimed at supporting domestic demand and credit supply, as well as reducing bank and corporate funding costs.

More policy support is expected in the second half of 2018, especially after economic and credit data for May surprised to the downside. To be clear, economic activity had held up quite well and was actually better than expected until April. The weakness in the May activity data was driven by certain distortions or transitory effects.

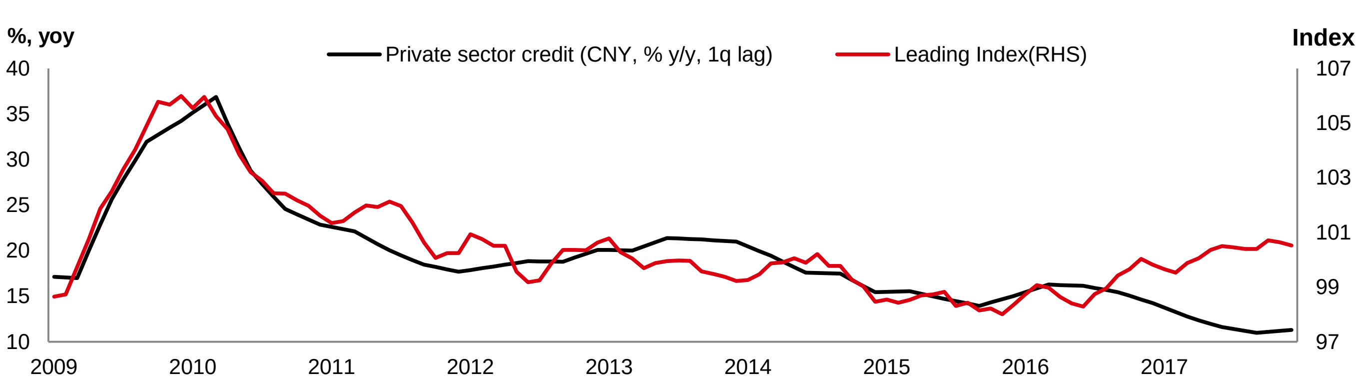
However, the data still pointed to some softening of growth momentum amidst the lagged effect of tightening credit conditions, especially the shrinkage of shadow banking activities and the rise in bank lending/market borrowing rates. Additionally, downside risks to growth have increased amid external uncertainties, such as rising US-China trade tensions and the Federal Reserve's policy tightening move. Credit tightening has also come into focus with the emergence of defaults and the widening of credit spreads.

In a bid to boost credit supply to smaller companies, China's cabinet on 20 June called for the use of targeted reserve requirement ratio (RRR) cuts and other monetary policy tools (e.g. re-lending) for small and micro enterprises (SMEs). On 24 June, The PBoC cut RRR by 50bps, releasing about CNY700bn liquidity, to support the debt to equity swap programme and SME loans, effective on 5 July. There are expectations that the central bank could cut RRR further this year, citing slowing credit growth.

Also, the PBoC has expanded the range of instruments that qualify as collateral for its medium-term lending facility (MLF) to include lower-rated credits such as AA or above rated SME bonds, AA+ and AA rated corporate credit bonds and quality SME loans and green loans. A series of fiscal, tax and financial incentives will also be put in place to help relieve SME funding stress. The government pledged to keep liquidity 'reasonably sufficient', a change from the previous stance of 'reasonably stable', to maintain financial stability and ensure the economy performs within a reasonable range.

We don't think the government will resort to large fiscal stimulus or monetary easing, or reverse its course on controlling leverage and cleaning up shadow banking activities. But aggregate credit growth is unlikely to decelerate much further as China continues to try and strike a balance between reducing risks in its financial system and maintaining credit supply and growth in its overall economy.

Abrupt deleveraging unlikely in China



Note: The components used to calculate China's Leading index include: Hang Seng Mainland Freefloat Index, industrial sales, M2 money supply, new fixed asset investment, logistics index (total freight traffic and volume of transportation in major harbors), real estate investment (land and construction of residential properties), consumer expectations index, Treasury yield spread (spread between treasury securities with maturities of 7+ years and those with less than 1 year maturity). Source: Bloomberg, Macrobond, HSBC Global Asset Management, June 2018.

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Equity market

- The **MSCI China Index** (USD terms) was down 0.6% month-to-date (as of 20 June) while the **CSI 300 Index** was down 3.9%, with the two markets suffering a multi-day sell off between mid-June and month-to-date, as US-China trade tensions further intensified. Investor sentiment was subdued, more so in the onshore market. This follows a positive performance in the month of May, where the MSCI China Index outperformed the MSCI Emerging Markets Index, and returned 1.8% during the month, with healthcare, consumer staples, and utility leading gains, and telecommunication services, real estate, financials, and materials lagging

Net northbound inflows month-to-date totaled USD 4.9 billion, bringing the year-to-date inflows to USD 25.6 billion

- The economic stakes are high for the US and China trade relationship. Both sides would have sufficient incentive to resolve their trade issues through negotiations. China is making concessions when it comes to increasing imports, improving its investment environment, increasing IP protection, and further opening up its financial sector

- In line with its market liberalisation agenda, the China Securities Regulatory Commission (CSRC) unveiled additional guidance and trading details surrounding the pilot program of **Chinese Depository Receipts** (CDR), a plan which will facilitate the trading of overseas shares on the Chinese onshore market. According to the CSRC, China is advancing the plan in a manner that enhances the inclusivity and competitiveness of China's financial system. The CSRC also recently approved the launch of six CDR focused mutual funds

2018 earnings for Chinese equities is registering a 26% year-on-year growth

- The month of June began with **MSCI effectively adding** about 230 Chinese onshore A-share names and 68 Chinese offshore H-share and ADR names to the MSCI Emerging Markets Index. The construction of the MSCI China Index is based on the Chinese equity universe within the MSCI Emerging Markets Index, thus the resulting in the same standardized definition for the Chinese equity opportunity set, according to MSCI. This means that A-shares have also been added to the MSCI China Index, MSCI Asia ex Japan Index, and MSCI All Country World Index

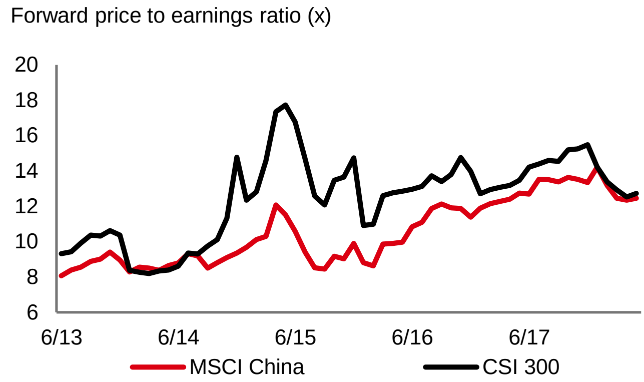
- Although China A shares are down month-to-date, net **northbound inflows** for the same period totaled USD 4.9 billion, bringing the year-to-date inflows to USD 25.6 billion

- In the **southbound direction**, while we have seen outflows in the recent months, we believe this is a temporary slowdown amidst heightened market volatility. Given that there is still a wide A/H premium, we expect continued strong inflows via the Stock Connect channel

- **Valuations** of offshore equities remains attractive relative to other global markets and earnings strength is expected to continue. 2018 earnings for Chinese equities is expected to register a 26% year-on-year growth

- We are like the energy sector and select upstream players, in particular, in light of their compelling valuations and attractive yields. Recent strength in oil price also underpins our positive view on these companies

Chinese equities have turned more attractive after recent correction



Source: Bloomberg, HSBC Global Asset Management, as of 18 June 2018. Total return in local currency terms. Investment involves risks. Past performance is not indicative of future performance.

Sector	Comment
Consumer Discretionary	◆ We are selective on consumer discretionary sector. We favour Hong Kong retail and Macau gaming which are direct beneficiaries of Chinese economic rebound, RMB appreciation and rising demand for leisure and shopping from Chinese consumers. We also like the education space as demand for high quality education service is strong in China
Consumer Staples	◆ We are overweight the consumer staples sector as the trends of premiumization and better macro backdrop underpin higher pricing power and margin expansion capability of selected strong staple brand names
Energy	◆ We are overweight energy and in particular selected upstream players in light of their compelling valuations and attractive yields. Recent strength in oil price also underpins our positive view on these players
Financials	◆ We are neutral on Chinese banks as we only favour big banks whose asset quality is heading for further improvement along with the overall economic recovery and continued deleveraging in the country. We are selective on insurance and overweight only those with diversified businesses
Healthcare	◆ We are overweight the healthcare space as low penetration rate of biochemical drug and rising concerns on healthcare issue in China will drive demand for healthcare products. We prefer players with a strong R&D capabilities and product pipeline
Industrials	◆ We are underweight industrials as most industrials names exhibit a weaker growth profile than other sectors in China
Information Technology	◆ We are selective on the IT sector, as only selective names will see secular earnings growth on the back of mobile gaming growth, improved monetization efforts and the ongoing shift towards online purchasing
Materials	◆ We are overweight the materials sector but we are only overweight to commodities which is seeing attractive demand-supply dynamics in the medium term
Property	◆ We are neutral on property. We only buy market leaders who have strong fund souring capabilities amid the current tightening credit environment. We also prefer players with higher exposure to first tier cities as we expect sales in top-tier cities to be stronger this year after the decline last year (easier base effect)
Telecommunication	◆ We are underweight 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 prompts an underweight position

Source: Bloomberg, HSBC Global Asset Management, as of June 2018
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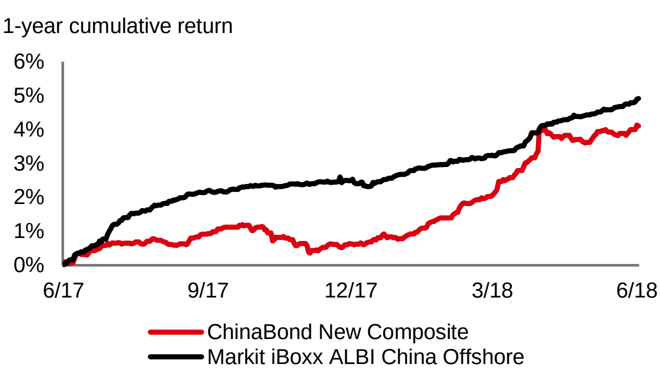
Fixed income

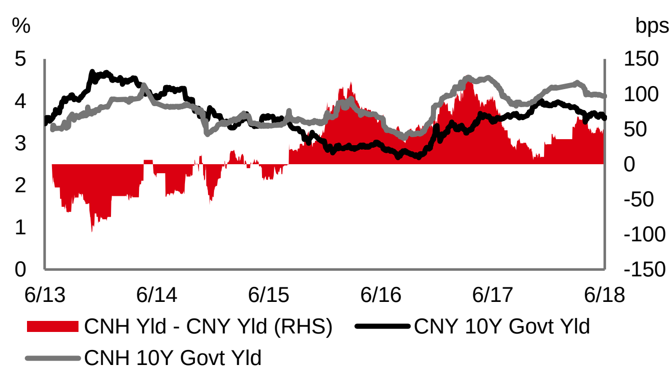
> Divergent interest rate cycles have contributed is an attractive aspect for investors who seek total return and portfolio diversification

> RMB may see some downward pressure against the dollar, but sharp devaluation is off the table

- Onshore and offshore bonds edged up mildly in May, rising 0.2% and 0.3%, in local currency terms, respectively
- Fed has hiked rate for the second time this year in June by 25bps, but PBoC has not followed through. Divergent interest rate cycles have contributed to tighter yield spreads and is an attractive aspect for investors who seek total return and portfolio diversification. We believe the divergence will last in the near term as the Chinese government would like to aim for a moderate yet decent growth, maintain liquidity, and prevent downside risks from trade tensions
- In light of heightened trade concerns, the PBoC pledged to use monetary policy comprehensively to mitigate the potential consequences of US import tariffs. Following the expansion of the list of eligible collateral for the medium-term lending facility (MLF) in early June, the central bank injected USD30 billion liquidity via MLF, alleviating tight liquidity and helping borrowers to refinance. While deleveraging and some defaults will still be ongoing, we think further cuts in required reserve ratio (RRR), last done on 24 June, is also another option to increase liquidity and manage the pace of growth
- Uncertain environment, benign inflation, neutral monetary policy and liquidity support should push yields lower in near term and flight to quality will benefit high quality issues. In the onshore space, we like shorter term corporate issues, and prefer policy banks bonds over government bonds
- USD has strengthened against most major currencies in the past month as trade disagreements have escalated. RMB may see some downward pressure against the dollar, but sharp devaluation is off the table as two-way, stable currency movement is supported by the PBoC, and as foreign investors continue to top up ownership in onshore assets. FX reserves have risen by RMB100 billion, but current account surplus is slowly shrinking, partially due to lower household saving rate and increasing spending on foreign goods and outbound tourism. However, we think mainland investors are still positive on the currency, with no obvious preference for hard currency bonds over RMB bonds despite the newly approved QDII quota
- With yield advantage (4.5%) and shorter duration (3 years) over bonds from economies of similar size or same credit rating, offshore CNH bonds remains an attractive investment choice. The demand-supply technicals are still positive, and we continue to see rising CNH deposits. In the offshore space, we like long-end government bonds given the still favourable yield premium over their onshore counterparts. We also favour short-end corporate issues

Chinese bond yields have remained stable despite higher treasury yields





Source: Bloomberg, data as of 20 June 2018. Total return in local currency terms. Investment involves risks. Past performance is not indicative of future performance. For illustrative purposes only and does not constitute any investment recommendation in the above mentioned asset classes, indices or currencies. The views and opinions expressed herein are subject to change at any time.

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Indicator	Data as of	Actual	Consensus	Prior	Analysis
Industrial production (IP) (yoy)	May	6.8%	7.0%	7.0%	May activity data pointed to some softening of growth momentum, especially domestic demand, amid the lagged effect of tightening credit conditions with the shrinkage of shadow banking activities and the rise in bank lending/market borrowing rates. However, part of the slowing (especially regarding retail sales) may be transitory. Policy fine-tuning towards more supportive of growth is ongoing. The authorities will use targeted RRR cuts and other monetary policy tools to boost credit supply to small and micro enterprises (SMEs). A series of fiscal, tax and financial incentives will also be put in place to help relieve SME funding stress and reduce corporate funding costs. Overall, we expect slower economic growth in H2, but not a sharp slowdown. In terms of IP, the upgrading of industrial structure continues, with key emerging sectors such as tech/electronics and these related to consumer upgrading continuing to post robust growth. Efficiency in the manufacturing sector is also steadily improving. The overall industrial sector capacity utilisation rate came in at 76.5% in Q1 2018 (vs. 75.8% in Q1 2017); the industrial enterprise liability to asset ratio of 56.5% in April was lower than 57.2% in April 2017; and industrial profits maintained robust 15% yoy growth in the first four months of the year.
Fixed Asset Investment (FAI) (ytd, yoy)	May	6.1%	7.0%	7.0%	A sharp slowdown in infrastructure investment was the main drag on total FAI growth. While the weak FAI figure (particularly infrastructure) this year could partly be due to the FAI computation methodology change in some localities, it still likely reflects tighter local government financing amid deleveraging and upcoming implementation of new rules on asset management products. Nevertheless, we think infrastructure FAI may stabilise going forward, as there is room for fiscal spending to speed up with more public-private-partnership (PPP) projects to start. We may also see a greater issuance of local gov't bonds, particularly special bonds, to support infrastructure. Meanwhile, real estate FAI and new housing starts maintained robust growth, but we still expect the momentum to slow given softer property sales growth and cooler land purchases this year by developers. We think any nationwide property policy easing is unlikely, especially given the recent rise in home prices. Manufacturing FAI showed a further moderate recovery, given a low base and helped by still solid industrial profit growth, higher capacity utilisation rates and policy measures to reduce corporate burdens. We expect manufacturing investment to improve further, particularly as high tech and consumption-upgrade related investment maintained robust growth.
Retail Sales (yoy)	May	8.5%	9.6%	9.4%	The drop in retail sales growth was a surprise. We think deferred consumption and the holiday effect were the main one-off factors. As the auto import tariff cut will be effective on 1 July, some buyers delayed their purchases of imported cars in anticipation of price cuts, leading to a 1% yoy decline in auto sales in May. The Dragon Boat Festival fell in May last year but in June this year, shifting the timing of holiday-related consumption. The underlying sales momentum may not be as soft as the headline suggested, amid a largely stable labour market, solid household income growth, and fiscal policy support (the plan to raise the personal income tax threshold from CNY42,000 to CNY60,000 with various deductions will be implemented in H2). However, while we expect consumption to remain the key growth driver, some factors are weighing on/ could weigh on consumer spending, e.g. the fading effect of "monetarisation" of the shantytown renovation programme as part of the property destocking policy. More difficult access to consumer finance and higher mortgage debt burden could potentially cap consumption growth.
Exports (USD) (yoy)	May	12.6%	11.1%	12.6%	Exports remained supported by solid external demand and tech sector. However, downward pressure on exports have surfaced due to potential slowdown in global demand growth, rising trade tensions with the US, and the lagged impact of RMB REER appreciation. Meanwhile, the strong import growth was boosted by higher commodity prices and consistent with the gov't's pledge to increase imports, although auto imports fell 2.2% yoy in May, likely due to domestic importers postponing import orders until the tariff reduction will become effective on 1 July. There is also the possibility that importers may have been front-loading their imports to hedge the heightened uncertainty over trade negotiations between the US and China.
Imports (USD) (yoy)	May	26.0%	18.0%	21.5%	
Trade Balance (USD)	May	28.8bn	27.8bn	28.8bn	
CPI Inflation (yoy)	May	1.8%	1.8%	1.8%	CPI inflation remained stable amid lower food prices and still moderate core CPI, offsetting a tick-up in gasoline prices. The rise in PPI inflation was a combination of low base effect and an uptick in prices in the upstream industries. Oil prices remain an uncertainty but slower domestic demand may help cap underlying inflationary pressures. The pass-through from PPI inflation to CPI inflation remains modest. Overall, inflation is not an imminent concern for policy.
PPI Inflation (yoy)	May	4.1%	3.9%	3.4%	
Manufacturing PMI Official	May	51.9	51.4	51.4	Higher prices and output, as well as solid domestic demand orders, were the main contributors to the headline manufacturing PMI. The sub-index for large enterprises improved significantly, but that for small enterprises dropped to a contractionary 49.6, possibly due to tighter financing conditions amid shadow banking crackdown. Meanwhile, services sector activities held up.
Non-manuf. PMI Official	May	54.9	54.8	54.8	
Total Social Financing (TSF) (RMB)	May	760.8 Bn	1,300.0 bn	1,575.0 Bn	Part of the MoM decline in TSF reflected seasonality, but the magnitude of slowdown signalled tightening credit conditions. Much of the weakness came from non-bank financing, a result of the government's regulatory squeeze on interbank leverage and WMP funding of off balance sheet lending. Corporate bond financing was also weak (-CNY43bn in May) as demand for new issuance dropped amid rising bond defaults. Bank loan growth has been more stable but also slowed. The gov't has granted more loan quota to help banks bring non-standard credit assets back onto balance sheet as loans and alleviate the hit on overall credit supply, but commercial banks' willingness and capability to lend has been constrained by sluggish deposit growth and weak risk appetite amid rising default concerns. The PBoC has taken measures to revive banks' deposit growth, but we expect policy banks to play a key role in lending.
New yuan loans (RMB)	May	1,150.0 bn	1,200.0 bn	1,180.0 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

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

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