Market Insight: ChinaAMC update on key topics about China

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1. China-US trade tension

Recent updates on the China-US trade frictions indicate that both countries are still working towards fulfilling the "Phase I" agreement. Chinese Vice Premier Liu He, US Treasury Secretary Steven Mnuchin and US Trade Representative Robert Lighthizer spoke on the phone on May 8. According to a press release, both countries will continue to support the "Phase I" agreement, which took effect earlier this February. The US administration said that both sides "agreed that in spite of the current global health emergency, both countries fully expect to meet their obligations under the agreement in a timely manner."

Meanwhile, China's Commerce Ministry released a statement saying that the two sides agreed to improve the atmosphere for the implementation of the "Phase I" agreement. According to this, China would increase its purchases from the US by US$200 billion over two years, compared to the 2017 baseline.

Growth of China's imports from the US remained low due to COVID-19 but started to show signs of ramp-up. China's goods imports from the US in January-April 2020 declined by 5.6% year-over-year, due to the impact of COVID-19, and decreased by US$13.4bn compared with the same period in 2017. China's imports from the US declined by 11.1% year-over-year in April, which was slightly smaller than the 12.8% decline in March. In Q1 2020, China's pork imports from the US jumped, and soybean imports recovered, while growth of energy and manufactured goods imports was relatively slow.

There is also some positive news regarding the technology sector. The US Department of Commerce recently drafted a new rule allowing US companies to cooperate with Huawei on setting 5G standards, marking a partial reversal of last year's decision to blacklist Huawei. The loosened grip by the US on Huawei suggests that room exists for positive competition and co-development between US companies and China's Tech giant moving forward.

2. Removal of QFII[1] and RQFII[2] investment quotas will promote further opening of China's financial market (from different angles: investment managers, investors, etc.)

On May 7, the PBoC[3] and SAFE[4] announced a new regulation change on foreign securities investment, which will officially remove investment quotas, effective on June 6. The new regulation confirms SAFE's announcement last September about the quota removal. In our opinion, this marks another milestone in China's opening-up of its financial markets. As of March 2020, foreign investors accounted for 3.4% and 3.3% of China's stock and bond markets. We believe the removal of QFII/RQII quotas will attract more global investors and influence China's financial markets in several important ways:

- With more foreign participation (foreign investors, brokers, asset managers, etc.), the A-share market, which is still dominated by local retail investors, will become more internationalized.
- A-share valuation will gradually converge with global markets.
- There will be increasing correlation between domestic and global markets, with more flexible cross-border capital flows.

New rule highlights:

- Removing quota restrictions for QFII and RQFII. This is consistent with the announcement made by SAFE in September 2019. Qualified investors do not have to apply for investor quotas before investing but must register with the regulator.
- Facilitating inward and outward remittance. This is a newly-mentioned feature since the announcement last September. We believe the free flow of funds (principal and profits) is equally important for investors. Compared with Stock Connect, the current QFII and RQFII system is less flexible with respect to fund repatriation, so the new rule may help the QFII/RQFII scheme gain popularity over the Stock Connect channel.
- Removing the limit on the number of custodians. Investors may choose one custodian as the main reporter.
- Allowing foreign investors to hedge FX risk with derivatives. The amount of hedging is restricted to curb speculation.
- Positioning the regulator's role as operational and post-operational oversight rather than pre-operational approval. This reflects a more market-oriented regulation environment, in our opinion.

3. Resurgence of infected cases: 1) new local cluster in China and 2) premature lifting of lockdowns over the world

- China has seen a large resumption of work and production. Recently, despite repeated signs of epidemics in a few regions, the general trend of resumption of work and production continues to deepen.
- Compared with the time at which work and production resumed in China; Germany, France, Italy and Spain are far behind. In contrast, the newly confirmed cases have not yet effectively declined in the UK.
- The overall epidemic situation in the United States is still a concern; the epidemic situation in some states in the Midwest, where the lockdowns have been lifted, is still at an accelerated stage. It is worth noting that there may be a risk of another outbreak in the future.

4. REIT trials

On April 30, the China Securities Regulatory Commission and the National Development and Reform Commission unveiled a pilot scheme for infrastructure REITs. REITs may provide a sound channel for investors to exit infrastructure projects, accelerate capital turnover and lower the debt ratio of infrastructure project investors. This initiative might face some challenges in the short term, such as having fewer eligible projects and uncertainty on whether project owners will participate. However, the initiative could help the infrastructure industry establish a closed-loop of investment, financing, management and exit mechanisms for infrastructure projects in the medium/long term. It is a significant leap for capital markets and real estate assets, and we are confident that similar pilot schemes might also be implemented for the commercial real estate market in the next three-to-five years.

5. Any policy support for the economy was launched in the annual parliament meeting

Due to delays caused by COVID-19, the 2020 National People's Congress (NPC) session was rescheduled for May 22. Premier Li Keqiang indicated in his annual government work report to the NPC, the Chinese central government did not set GDP growth target for 2020 as China faces extraordinary uncertainty amid COVID-19 pandemic and current world trade environment. Although dropping the GDP growth target for the first time since 2002, China will implement new measures to boost growth. The government has pledged at least $4 trillion yuan worth of cuts in business costs, aimed at saving businesses and jobs and putting economic growth back on track. The government allocated 1 trillion yuan of special treasury bond issuance quota and set the target of expanding fiscal deficit to 3.5 per cent of GDP from last year's 2.8 per cent. Premier Li also said the government will push for innovative industries such as smart manufacturing, industrial internet, e-commerce and other online services. It would also grant the issuance of 3.75 trillion yuan worth of local government bonds to support the construction of new infrastructure, 5G mobile network and charging stations for new energy vehicles.

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6. Updates on listed companies' Q1 2020 earnings after the reporting season

Due to the negative impact of COVID-19 and the oil price decline in Q1 2020, the China A-share market experienced a 24% decline in revenue. The magnitude of this decline was comparable to the one experienced during the global financial crisis, when Q1 2009 saw a drop in revenue of 24.6%. In terms of earnings, the A-share market had a decline of 8.7% in Q1 2020, compared to a decline of 12.1% in Q1 2009. The global financial crisis had a larger impact on the financial sector, while the COVID-19 pandemic impacted the real economy.

When grouping listed companies into five by market cap, revenue for large cap industry leaders was least impacted by the pandemic, compared to other groups. From the sector and industry perspective, cyclical industries saw the heaviest revenue impact, including airlines and airport services, road and rail and non-ferrous metals. Discretionary consumption and service-related industries, such as restaurants, travel and leisure, hotels, apparel and textile, trading and the automobile industry were similarly impacted.

Some industries had positive revenue growth or experienced much less impact. The industries that benefited from the pandemic included staples like agriculture and food, some health care companies, and gold. Others included consumer electronics and semiconductors that are in an industry boom cycle and banks with relatively stable fundamentals.

7. Outlook and portfolio strategy

Currently, infections that are both locally and imported have been under control in China, and economic activity has begun to recover. Globally, China is in the best position at the moment in terms of containing the pandemic, and we believe that those industries and companies that have seen their share prices plummet as a result of the outbreak in the early stages will gradually rebound. The overall A-share market valuation is low, in our opinion meaning we believe now may be a relatively good time for investment in the A-share market. Based on the microeconomic data, we have seen recovery in both the consumer discretionary and consumer staples sectors. Manufacturing — including photovoltaics and consumer electronics — also recorded high working resumption rates, which underlined the advantage of the Chinese manufacturing industry and makes us confident in the A-share market.

In terms of portfolio management, we will likely overweight healthcare, consumption and technology, and select quality companies from those sectors based on the bottom-up investment method. We will particularly increase our holdings in companies whose stock prices were dragged down significantly due to the COVID-19 outbreak, but have performed well recently.

[1] Qualified Foreign Institutional Investor
[2] RMB Qualified Foreign Institutional Investor
[3] People's Bank of China
[4] State Administration of Foreign Exchange

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