China: Steadier growth needed to lift investor confidence

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Better visibility and steadier economic growth are needed before investors would embrace the China A market's attractive valuations. We expect the government to roll out more pro-growth measures and believe that fiscal rather than monetary policies will be more effective in stabilising near term growth.

Amid domestic and external concerns, heightened investor risk aversion has weighed on the China A-share market. The CSI 300 Index is trading at 10x 12-month forward price to earnings ratio, near the bottom of its long-term historical range. Although the market's valuations look attractive, steadier economic growth is needed for a sustained V-shape rebound.

A RAPIDLY SLOWING ECONOMY CALLS FOR GREATER SUPPORT

The Chinese economy grew 4.8% in the first quarter of 2022, largely in line with the market consensus. However, data in the coming months are likely to provide a more accurate assessment of the sharp slowdown caused by the recent lockdowns across multiple Chinese cities, supply chain disruptions, rising unemployment, and still weak property activities.

As a harbinger of what is to come, the top 100 real estate companies registered total sales of RMB 379.6 bn in March, down 54.5% from the year before. 35.76 million square meters of floor space was sold in March, a year-on-year decrease of 57.1%. As the outbreak of the Omicron variant gathered pace, high-frequency data such as cement and steel production have weakened. Not surprisingly, consumption has been hurt. Retail sales grew 6.7% yoy in January to February but contracted 3.5%yoy in March. With the prices of upstream commodities such as oil and metals remaining high as a result of the Russia-Ukraine war, the risk of stagflation is rising.

The market is likely to focus on whether policymakers will lower 2022's economic growth target, and how the government intends to balance the need to stabilise near term growth and implement long term structural reforms. Given the rapid slowdown, we expect the government to focus on stabilising near term growth.

FISCAL, NOT MONETARY, POLICIES ARE LIKELY TO BE MORE EFFECTIVE

While the People's Bank of China has cut the reserve requirement ratio (RRR) by 25 bp on 15th April to inject more liquidity into the financial system, the effectiveness of China's monetary easing remains to be seen. Earlier RRR and interest rate cuts did not lift the real economy, as seen from the still deteriorating economic data. The central bank recently published 23 measures encouraging financial institutions to support local government infrastructure projects and the property sector, as well as provide financial services to industries hit by the pandemic. In our view, supportive fiscal policies in terms of direct financial subsidies to spur consumption and boost consumer/business confidence may be more effective at this stage.

A number of pro-growth measures are already being rolled out. Housing policy has become more supportive at the city level, with more favourable mortgage rates, down payments as well as more relaxed home purchase and/or resale restrictions. Meanwhile the Ministry of Finance is expected to return RMB1.5 trn in tax credit to the corporate sector starting from April and accelerate special bond issuance and deployment. The boost to infrastructure investment (II) also seems to be coming through - infrastructure investment accelerated from 8.1% yoy in January - February to 8.5% yoy in the first quarter of the year. In addition, targeted measures including tax rebates, fee reductions and rent exemptions are being introduced across cities, which could potentially reduce the corporate burden by RMB75 bn in Shenzhen and RMB140 bn in Shanghai[1]. That said, the existing pro-growth measures are still insufficient to fully offset the downward pressure on the economy. We see growth momentum weakening further and potentially hitting a trough in the second quarter of the year. The biggest risks/ uncertainties lie with the ongoing development of the Omicron variant and the associated lockdown measures.

STILL OPTIMISTIC ON CHINA'S INVESTMENT OPPORTUNITIES

We believe that investor risk appetite will return when the epidemic situation improves, and growth stabilises on the back of supportive monetary and fiscal policies.

It is key that economic policies remain relatively stable, sustainable, and predictable. Clear communication of policy objectives as well as efficient implementation will help to shore up investor confidence further. As would a timely response to market concerns.

We remain optimistic about the medium and long-term development of China's economy as it transitions to a new growth model. We believe that stable and sustainable policy support will foster internationally competitive enterprises, providing attractive opportunities for long term investors.

We continue to favour the high-end manufacturing sector given its higher barriers to entry and the government's strong push for domestic substitution. We also like new economy sectors which includes new energy, consumer and medical services that are likely to benefit from rising domestic consumption.

[1]Citi Research. Growth pessimism perhaps overdone. 18 April 2022.

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