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October 2021

Navigating the changing regulatory landscape

UBS Asset Management I China Outlook 2022

China Outlook 2022

Contents

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The views expressed are a general guide to the views of UBS Asset Management as of October 2021.

Summary

- China has delivered on its promise to open up its financial markets, and as a result foreign investment flows have been very strong in the past few years.
- Chinese equity and bond markets have declined significantly since the introduction of government regulations across a broad range of sectors. We are at a juncture as the economy decelerates and investors worry about policy risk.
- The current backdrop, taking into account structural changes to the economy, elevated levels of volatility and valuation spreads, we believe is a good environment for stock pickers and alternative asset classes.
- While we have seen sharp drawdowns in Chinese equities, in our view current valuations imply that most of the concerns are already discounted in the market. If government policies are adjusted in the coming months, we expect this to be positive for Chinese equity markets.
- Valuations in the Chinese high yield market are now at record lows however, this does not stem from a negative macro backdrop, which is a positive for high yield investors and, in our view, could present an attractive entry point into the asset class.
- Chinese onshore government bonds look attractive versus other government bonds, where central banks are looking to taper their bond purchase programs and/or raise rates.

Economy

By Gian Plebani, Portfolio Manager, Investment Solutions

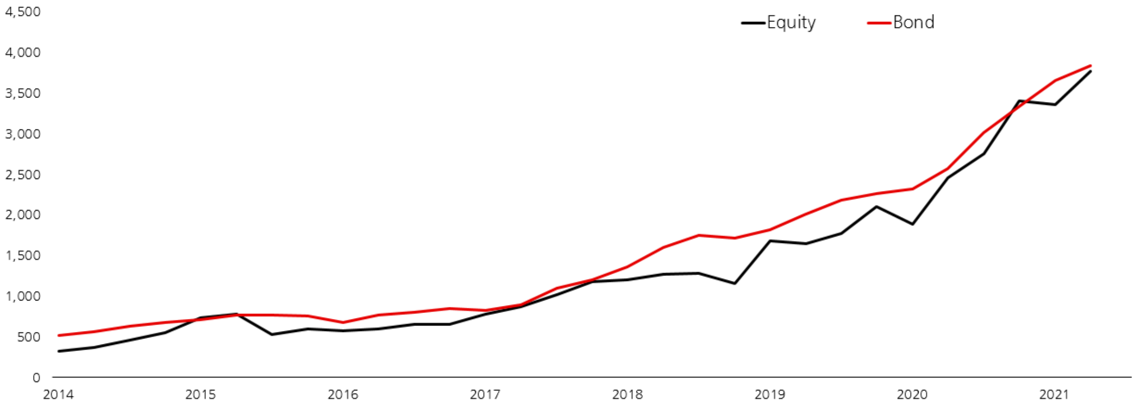
Key points

- China has delivered on its promise to open up its financial markets, and as a result foreign investment flows have been very strong in the past few years.
- Chinese equity and bond markets have declined significantly since the introduction of government regulations across a broad range of sectors. However, this has made selected areas attractive from a valuations perspective and going forward this should be a good environment for stock pickers.

To what extent have international investors taken to investing in China?

China has delivered on its promise to open up its financial markets, and as a result foreign investment flows have been very strong (Chart 1). In the last five years, foreign holdings of Chinese domestic equities and bond flows have increased 8-fold. There's been a strong foreign push into China.

Chart 1: Strong flows into China over the last five years
Foreign Holding of Domestic Assets (RMB bn)

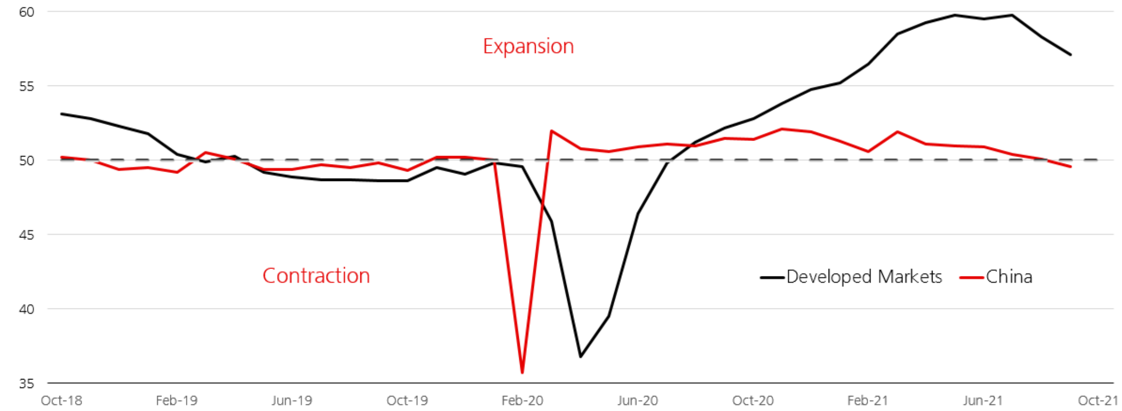


Sources: CEIC, UBS estimates as of September 2021

How is China's economy doing?

In terms of what's going on in China's economy today, let's look at the manufacturing purchasing managers' indexes (PMIs) as they are a very good early indicator of the health of the overall economy (Chart 2). You can see that there is a great divergence between what is going on globally, particularly in developed markets, and what is going on in China. Globally the economy is recovering but China is slowing. The manufacturing PMI in China has fallen below 50 which indicates a contraction. This is driven mainly by the government's regulatory actions which have focused on a massive deleveraging campaign particularly in the real estate sector. We are still seeing weak retail activity. On top of that, there is an energy shortage which, if it continues, could have a detrimental impact on manufacturing activity and investment.

Chart 2: Manufacturing PMIs in China have turned negative

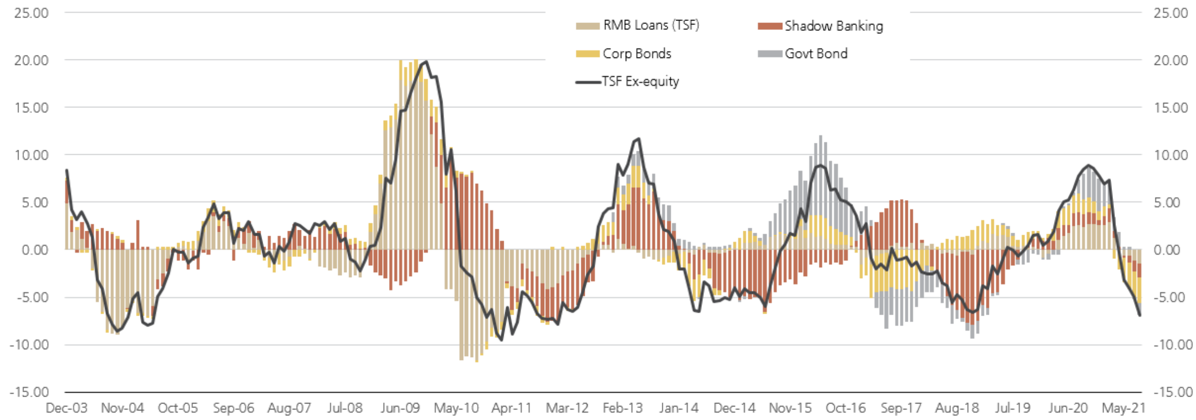


Sources: UBS, DataStream, Bloomberg, as of September 2021

When is China's economy likely to turn around?

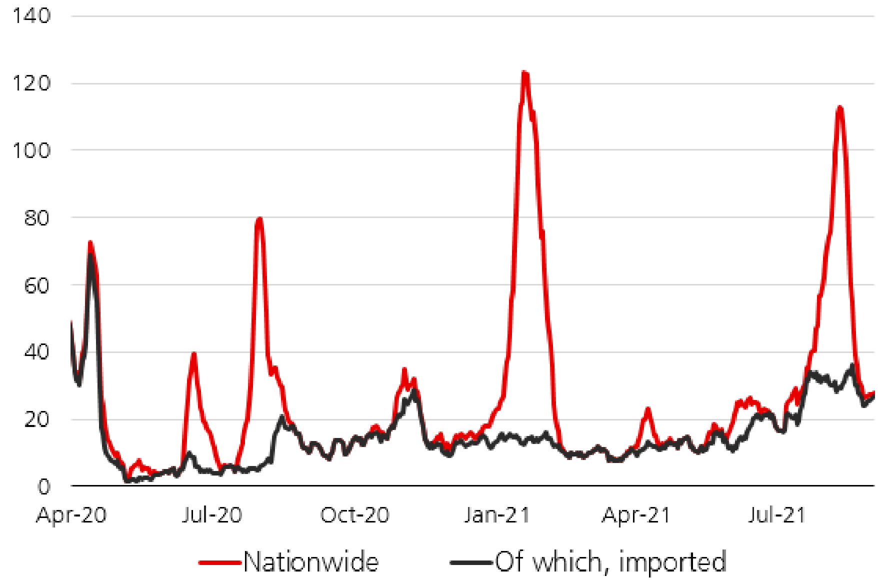
One of the best ways to look at China's economy is to look at its credit impulse indicator (Chart 3). This shows new credit creation in relation to the GDP growth, and displays China's historic cycles. Today, the credit impulse is at its previous cycle lows. So purely from this picture you could infer that China is heading for a turnaround. However there are risks to the credit rebound in the short term. These include COVID-19. While China has been successful in suppressing the virus there are flare-ups here and there. We have to keep monitoring the situation closely. Due to the zero-case policy and its drastic lock-down response to local flare-ups, it could result in regional production shutdowns and supply outages. Nevertheless China has been very effective in delivering the vaccine to their population, so that should keep a lid on things (Chart 4).

Chart 3: The credit impulse indicator has turned sharply negative



Sources: UBS, Wind, Bloomberg, as of September 2021

Chart 4: China – daily new cases of COVID-19 (7-day moving average)



Sources: UBS, Wind, Bloomberg, as of September 2021

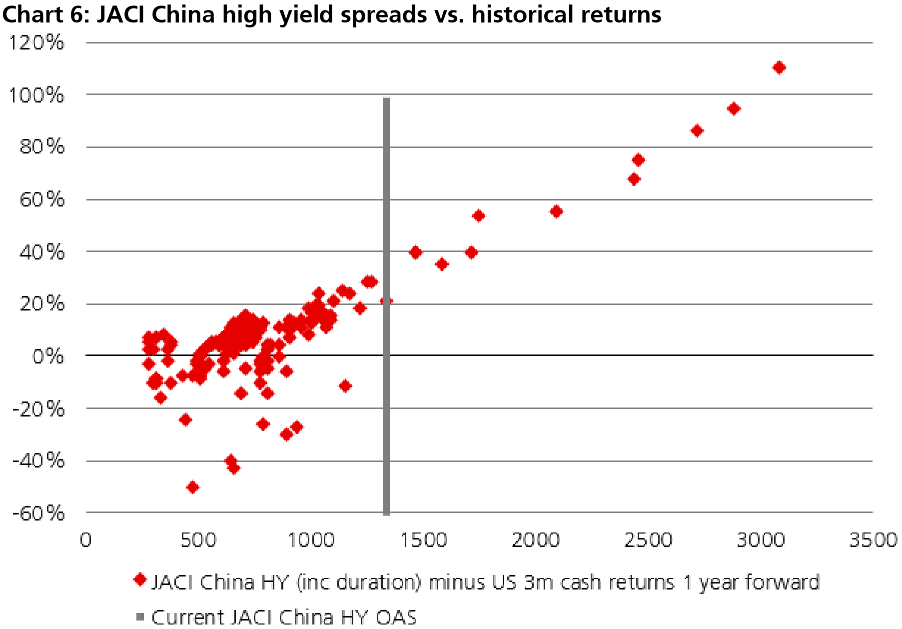
Aside from a flare-up of COVID-19, what are currently the main risks to investing in China?

The main risks today of investing in China come from policy and regulation. Over the long term, the government has the goal of 'common prosperity' focused on areas such as income inequality, financial stability, enhanced social protections and increased environmental protections. Of the regulatory changes implemented so far, those impacting the property sector have had the most high-profile impact to the economy. That is clearly the biggest risk for investors today. Equity valuations have been negatively impacted, while the earnings outlook has also been hurt (Chart 5). In Chinese sub-investment grade bonds (the majority of which are related to the real estate sector), valuations have been hit significantly. However looking at historical data (Chart 6), spreads at today's levels have often been associated with strong future returns, so this part of the market could be attractive, however you will have to be prepared to withstand high levels of volatility. So overall, current markets could be a huge opportunity for stock pickers.

Chart 5: MSCI China valuations

Sources: UBS, Wind, Bloomberg, as of September 2021

Chart 6: JACI China high yield spreads vs. historical returns



Sources: UBS, Wind, Bloomberg, as of September 2021

Fixed Income

By Hayden Briscoe, Head of Fixed income, Global Emerging Markets and Asia Pacific

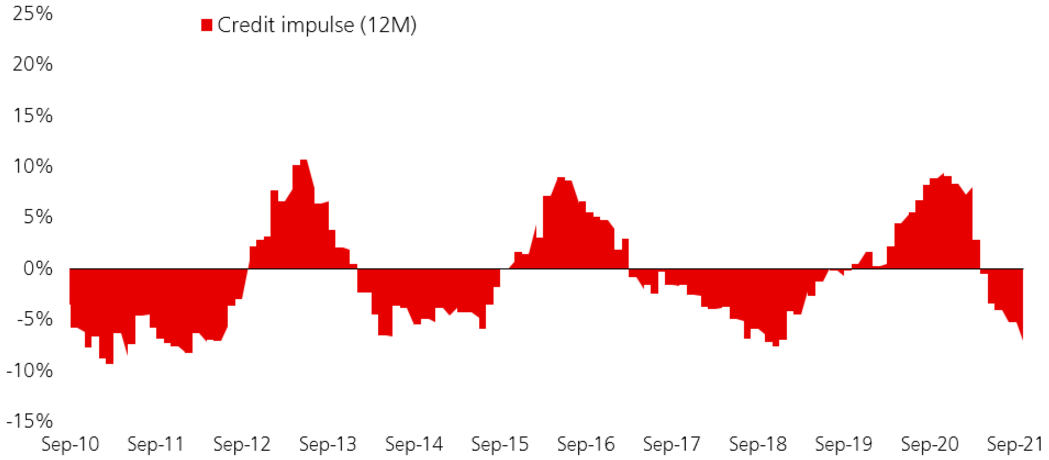
Key points

- The Chinese government has acted to withdraw liquidity from the economy at an unprecedented rate.
- Valuations in the Chinese high yield market are now at record lows; however, this does not stem from a negative macro backdrop, which is a positive for high yield investors and, in our view, could present an attractive entry point into the asset class.
- Chinese onshore government bonds look attractive versus other government bonds, where central banks are looking to taper their bond purchase programs and/or raise rates.

What's the impact of China's policy tightening on domestic credit markets?

This can be seen through the lens of the credit impulse indicator (Chart 1), which measures the change in new credit issued as a percentage of GDP and typically marks turning points in economic activity. The chart clearly shows that historically the Chinese credit impulse has cycles, and that post-peak troughs follow a pattern. The impact of China's policy tightening has resulted in a notably sharp decline in the credit impulse. This is because in previous cycles, the tightening of credit availability was aimed at individual sectors. However, numerous industries have been targeted across the economy during the last downturn: credit has been taken away from the economy as a whole very quickly. Therefore, it follows that the decline in the credit impulse is more acute than in the past.

Chart 1: China's Credit Impulse indicator (YoY % change)

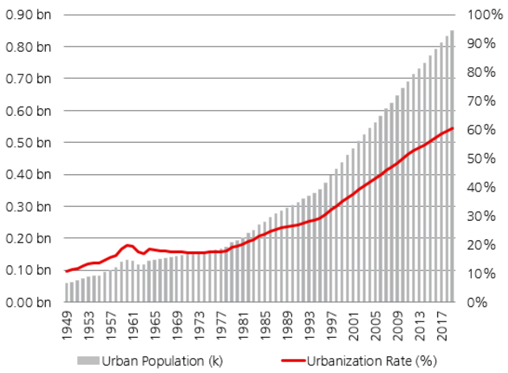


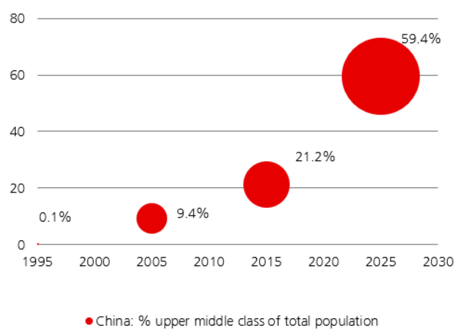
Source: Bloomberg. As of end September 2021

Why is the government implementing tighter credit conditions?

The government realizes that it must face up to some serious demographic issues. In order to increase its youth population, the family planning policy was changed to allow up to three children per family. Additionally, the country also has a growing middle-class population that is increasingly urbanized (Charts 2 & 3). While these sections of the population are still smaller in relative percentage terms compared to the US and Europe, the societal trend is strong and structural demand for more urban housing will likely remain robust. Adding the government's rhetoric around the social goal of 'common prosperity', and it's clear they want a financially healthier, de-levered real estate sector.

Chart 2: The ongoing urbanization trend in China (LHS) **Chart 3: Growing middle class in China (RHS)**





Sources: Wind, China Bureau of Statistics, as of end October 2020

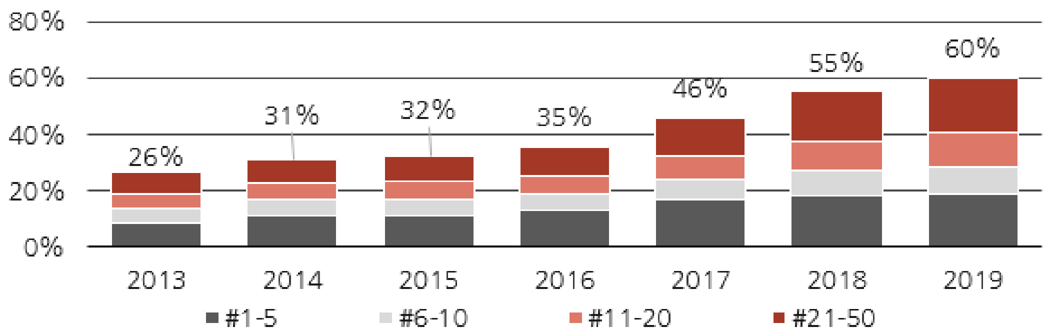
What does this mean for the property sector?

Property developers have become increasingly highly leveraged and systemically important – accounting for an estimated one-third of China's economy – whilst also becoming more concentrated. Back in 2013, the top 50 developers accounted for approximately a quarter of property development (Chart 4). Fast-forward to 2019 and they account for 60% of new building activity. In our view, when 2021 numbers are published, they are likely to show a figure of around 70%, making it especially important that the government acts to ensure they are financially viable. The 'three red lines' policy is designed to reign in the property development companies, slowing the speed of over-leveraging and preventing firms from taking on more obligations than they are capable of repaying (which may lead to their collapse and failure to deliver properties).

In China, as opposed to the West, people typically pay for their properties up front before they are built. Given that property is expensive relative to average incomes – Chinese property prices have been appreciating by 5% annually on average since 2007 (Chart 5) indicating that property remains peoples' preferred asset – it is important to the government that the sector is sensibly levered. Thus, while there's now a big slowdown in property developers' activity, this is not because of a lack of demand. Fundamentally, demand is still outstripping supply, and will likely be the case for many years.

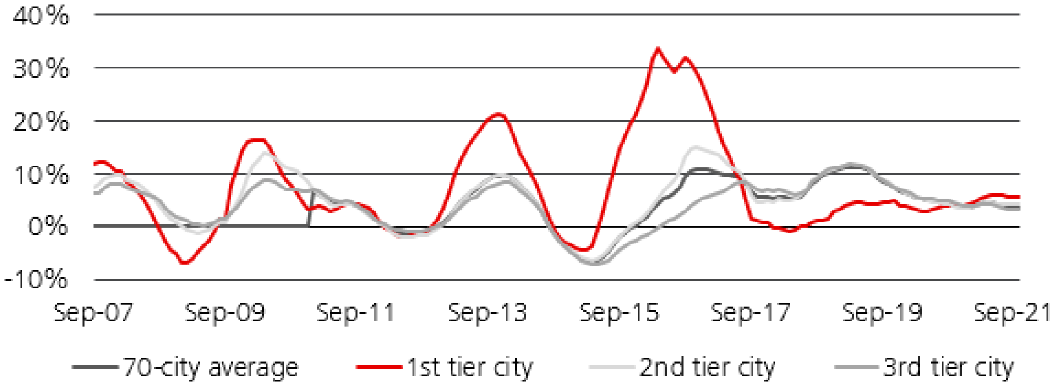
To balance the strong demand for housing whilst creating a healthier property development sector, implementing the 'three red lines' policy is the government's way of managing a property development corporation at the balance sheet level. We have never seen this done anywhere in the world until now. Shunning de-leveraging is no longer an option for property companies, as they will be forced to do it. Companies who get through this will look good from an investors' perspective: property developers will no longer be able to exceed 15% leverage, compared to a high leverage of 20%, 30% before the policy was implemented. From a creditor's perspective, the asset class is likely to experience lower volatility because of these leverage caps.

Chart 4: Market Share of Top 50 Developers



Source: Bloomberg, Wind. As of end February 2021

Chart 5: China property prices



Source: Bloomberg, Wind. As of end February 2021

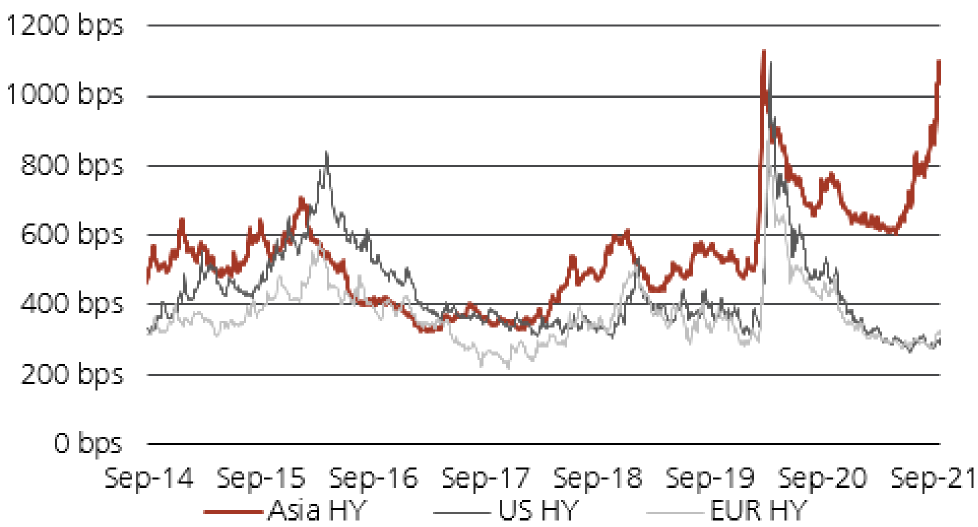
What's the implication for high yield markets?

The Chinese high yield market, which is dominated by real estate developers, accounts for half of the Asian high yield market (in terms of index composition). As a result of the regulatory crack-down on the sector, spreads in both China and Asia high yield are close to or are at all-time wides (Chart 6 & Table 1). This compares to the US and Europe high yield markets, where spreads are at all-time tights. This is a highly unusual situation; for China's high yield valuations to be as low as they are today, you'd normally expect to see a very negative macroeconomic backdrop. But that isn't the case. The macro backdrop is still very positive; instead, the low valuation reflects the government wanting to take the 'heat' out of the sector and slow growth down, ensuring that property prices don't increase any more than they already have. For an investor, this can be viewed as an opportunity to enter the sector, as it is one of the few 'beaten up' assets in the world today.

Looking at current valuations, our analysis indicates that a 20% default rate would be needed to lose money in the next 12 months. Is the government going to let property developers default on that scale, given the number of people who have paid up-front for their newly built property and the impact this would have on the population? Our sense is that's not the case. Having said that, government policies can be heavy-handed, which isn't unusual. China is looking at its next five-year plan and when they look at the policies in detail, there may be flexibility to amend some of these policies if they see that the policies aren't quite having the intended effect.

Given the importance of the property sector to the economy – property is about 30% of the economy, while infrastructure spending is about 15% – if property developers aren't feeding into that spending on infrastructure, then it's no surprise that the economy is slowing down, as reflected in the credit impulse signal. So, chances are that while the policies are here to stay, their implementation may be allowed to take longer than currently planned.

Chart 6: Asia, US and EUR high yield credit market spreads since 2014



Source: Bloomberg, J.P. Morgan. As of 15 October 2021

Table: Asia, US and EUR high yield spreads

Spread	Asia HY	US HY	EUR HY
Latest	1039	301	324
MTD Change	+178	+25	+32
YTD Change	+400	-75	-28
All-time wides	1,274	1,971	2,013
All-time tights	154	233	183
Current percentile	99%	7%	21%

Source: Bloomberg, J.P. Morgan. As of 15 October 2021

What's your view of Chinese government bond markets?

The global picture for government bonds is one where bonds are under pressure: governments are looking at ending or slowing bond purchase programs and are looking at raising rates in the face of higher inflation. Globally, developed market government bond yields are more prone to rising than falling.

However, Chinese onshore bonds are rallying. Charts 7 & 8 shows yields on 5-year, 10-year and 30-year Chinese bonds as well as the Chinese yield curve. These charts show that yields have rallied, but still remain high versus developed market government bonds. The balance of risk/reward is, in our view, currently in investors' favor. We believe that investors should consider Chinese government bonds as an alternative for bonds in other parts of the world which are offering no yield or negative real/nominal yields and where central banks are looking to unwind quantitative easing programs.

Chart 7 – Chinese Government Bond Yields (LHS)

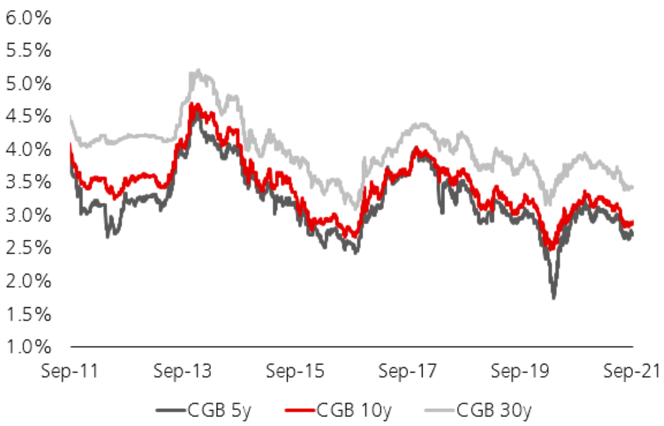
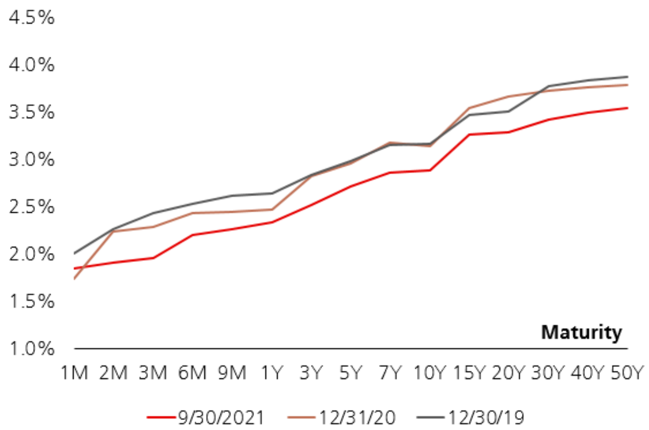


Chart 8 – Chinese Government Bond Yield Curves (RHS)



Source: Bloomberg, ChinaBond. As of end September 2021

Equities

By Bin Shi, Head of China Equities

Key points

- We are at a juncture as the economy decelerates and investors worry about policy risk.
- While we have seen sharp drawdowns in Chinese equities, in our view current valuations imply that most of the concerns are already discounted in the market. If government policies are adjusted in the coming months, we expect this to be positive for Chinese equity markets.
- Investors should not be overly distracted by the policy tightening so far. They should focus on individual opportunities and to wait for an adjustment in policies.

Many investors are wary of China right now. What is your message to these investors?

Many investors have bifurcated views on China. The Chinese government has cycles in policy making; we have seen regulations getting intense before. But we believe that the government cares about economic growth and the livelihood of the people and if they consider their goals to be at risk, then they are likely to adjust policy. As such, we think it likely that there is going to be policy adjustment in the coming months. In equities, companies in certain sectors are trading significantly below book value or at only two or three times earnings. We think many companies are looking very attractive from a valuation perspective.

You visited China over the summer: what were your thoughts?

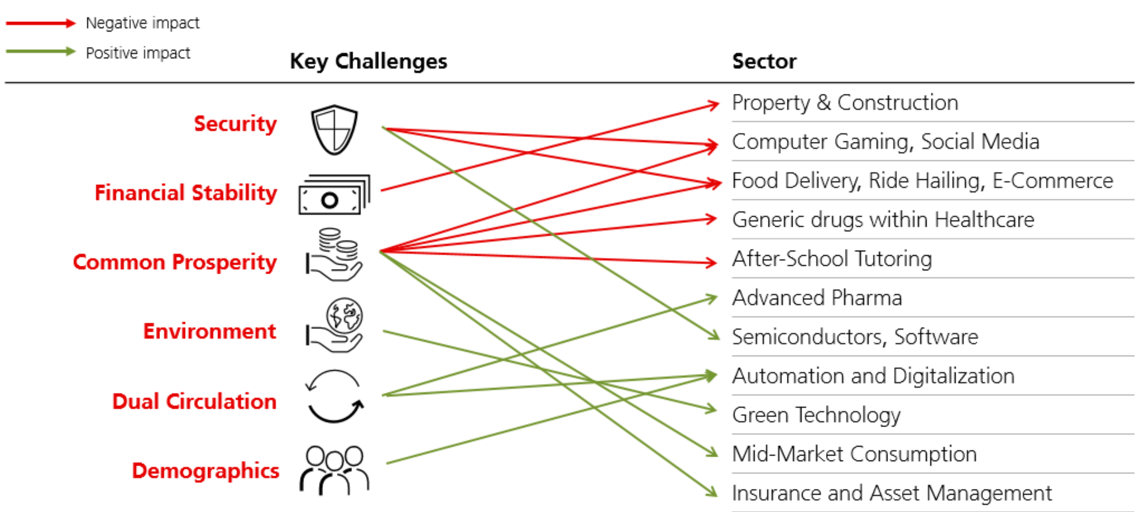
I was in China between May and August. People's lives were back to normal. Trains and restaurants were packed. Since August we have seen a deceleration of the Chinese economy, and a particularly sharp slowdown in the property market. We have also seen power cuts to factories and manufacturers while some coal mines are having to restrict or stop production due to carbon neutral policies. We believe that carbon neutrality is a long term goal and can't be achieved overnight, so coal miners will probably be allowed to increase production and prices will start to normalize from here. We expect that over time there will be more supportive government policies and investors' confidence is likely to come back.

How long is this challenging environment likely to last and how can investors navigate their way through it?

We'd argue that the point where fear is greatest is the closest to the turning point. We have seen sharp drawdowns in Chinese equities. But I would argue that now most of the concerns are reflected in valuations. At this point, there is no shortage of liquidity, but a loss of confidence. If we see policy adjustment, people will start to look ahead. And if confidence returns over the long term outlook, investors will come back.

We take lots of factors into account when we construct our portfolios. We have looked into sectors which are favored by the government as part of the approach – the red and green lines in the illustration below reflect whether the different policies are likely to have a negative or positive impact on different sectors of the economy. However, policy support alone is not enough, investors still need to consider the sustainability of the policy and whether valuations are fair.

Illustration: Short-term adjustments / pain for certain sectors as the government pursues longer-term objectives



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