

China 2020 outlook

Bonds, equities and the economy



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China outlook 2020 – in 60 seconds

- China's economy is expected to grow 5.8% in 2020, compared with 6.1% in 2019, according to estimates by the Organization for Economic Co-operation and Development (OECD);
- We expect the People's Bank of China government to ease interest rates in H1 2020;
- For equities, our strategies remain focused on long-term themes, like tech innovation and premiumization, and we see opportunities from SOE reform;
- China fixed income continues to look attractive in a world of negative yield, and Chinese and Asian High Yield are bright spots if global bond markets;
- Multi-asset strategies are tilted toward equities, particularly on China A markets, where companies will benefit from the Chinese government's ongoing policy support efforts

China's economy in 2020

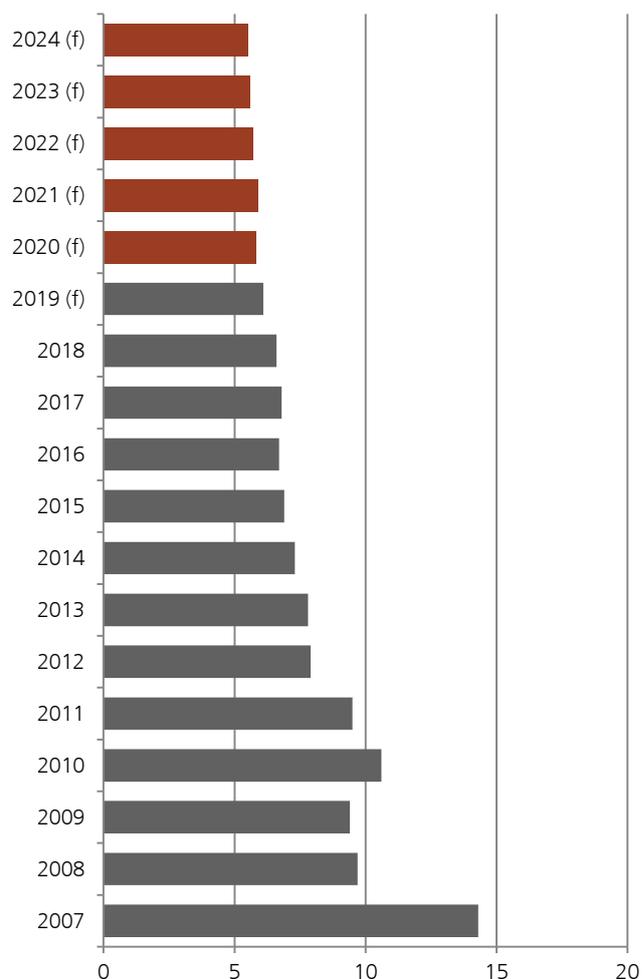
Hayden Briscoe, Head of Fixed Income, Asia Pacific

China's economy is expected to grow 5.8% in 2020, compared with 6.1% in 2019, according to estimates by the Organization for Economic Co-operation and Development (OECD)¹.

China's economy is going through what we call an L-shaped recovery, and we expect growth to stabilize around the 5.8%-6.0% number in the coming years.

In part, that's because China's government has stepped up with policy support, like interest rate and tax cuts, during the past year, and that is slowly finding its way into the economy.

China: Real Economic Growth YoY (%), 2007-2024 (f)



Source: Organization for Economic Co-operation and Development, November 2019

¹ Organization for Economic Co-operation and Development, November 2019

China real estate and consumer demand in 2020

Looking into current trends in China, domestic demand is holding up quite well.

Retail sales remain strong, despite fears around the trade war, with official statistics showing 9.2% growth YTD, according to China's National Bureau of Statistics.

Additionally, despite market restrictions, real estate sales are growing, which tells you that fundamental drivers, like urbanization and upgrading, remain robust.

And while the trends in real estate are, we think, a good indicator of demand, they are also a leading indicator of future investment trends.

China's real estate developers have been selling houses faster than they can build them recently, and the investment in building product has yet to come through, so we see that overhang firming up the headline economic numbers in 2020.

China monetary policy

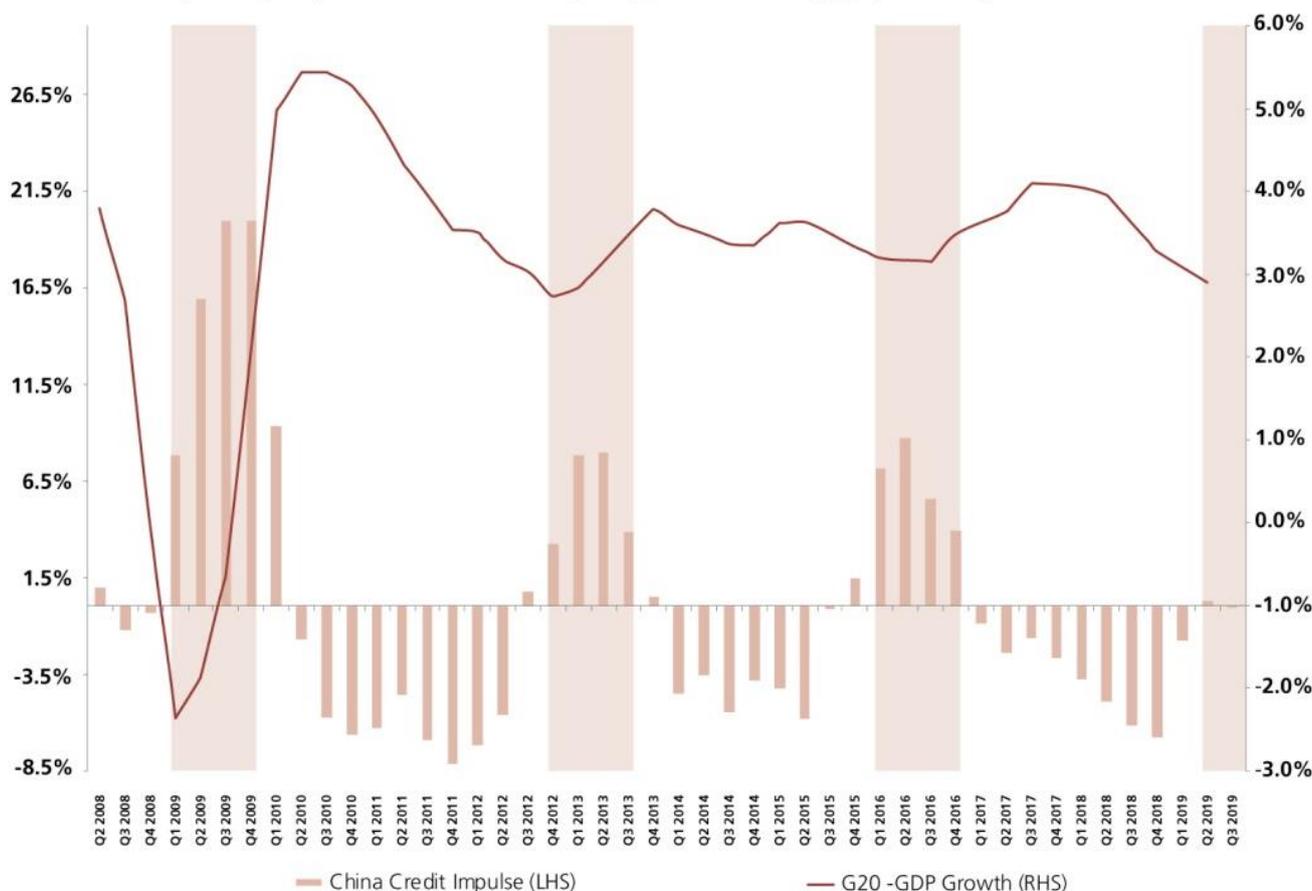
Historically, the People's Bank of China (PBoC) - China's central bank – has boosted credit to support the economy. To a limited extent, this has been true in the past 12 months, but we doubt the PBoC will significantly increase the money supply in 2020.

Two reasons explain why: firstly, the PBoC is worried about stoking inflation and, secondly, China is intent on deleveraging the financial system, so it is keeping a tight rein on credit creation.

That's why monetary policy support in 2020 has been like targeted, drip-feed irrigation, rather than the 'flood-the-fields' approach taken in the past.

But while we expect tight control on the money supply, we expect the People's Bank of China to ease interest rates in H1 2020, as it brings rates in line with the Fed and the global economy.

China Credit Impulse (LHS) & G20 GDP Growth (RHS) (%/YoY Change), Q2 2008-Q3 2019



Source: Bloomberg, October 2019

Note: China's credit impulse refers to the change in the growth of aggregate credit in the economy to GDP, (2) G20 comprises 19 countries and the European Union. The 19 countries are Argentina, Australia, Brazil, Canada, China, German, France, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, the United Kingdom and the United States

China equities

Bin Shi, Head of China Equities

China equities had quite a strong year in 2019, and we are constructive on China equities going into the new year.

There are solid companies within our investment universe that we believe will continue to deliver resilient earnings growth. Moreover, we witness more quality companies coming into the public market, which may not be well-understood by the investors.

On the policy front, while we do not expect the Chinese central government to roll out a large scale stimulus package next year, policies will likely be supportive and targeted.

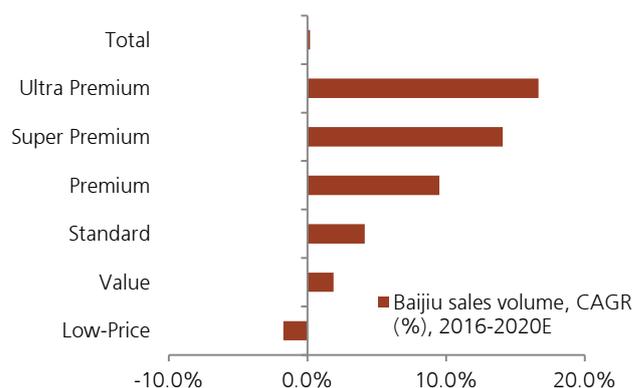
Reform of state-owned enterprises (SOEs) can be a potential wild card that could unlock hidden value in many Chinese SOEs.

On the other hand, the development on the US-China relations remains uncertain and our view is that the rivalry will run for a longer period of time.

That said, the China portfolios are oriented to domestic consumption and have little direct exposure to industries impacted by the tariffs.

Overall, we maintain our focus on long term themes, such as China's rebalancing into services and consumption, increasing share of discretionary spending and premiumization, increasing spending on R&D and technology leading to innovations and market consolidation within segments

Sales of premium-brand baijiu in China are forecast to grow



Source: IWSR, NBS, Canback, Bernstein analysis and estimates, updated September 2019

China fixed income

Hayden Briscoe, Head of Fixed Income, Asia Pacific

USD 13 trillion worth of global debt, or 25% of the global market, offered negative yields at the end of October 2019, according to Bloomberg¹.

So where do investors go for yield? Global government yields remain on the floor, and global inflation keeps surprising to the downside – so it's likely that monetary policy will remain loose.

Against this backdrop, China fixed income - in particular 10 year govt bonds – offer offers attractive nominal and real yields compared to global markets, and that's a key differentiator in a world of low-to-negative yields.

More than the technicals, we see capital appreciation opportunities in 2020 from two key sources: firstly, from the expected interest rate cuts we expect from the Chinese government and, secondly, from what we expect will be an influx of investor capital into the asset class as index inclusion continues to play out.

But looking beyond China government bonds, we see good opportunities in the China and Asian High Yield markets more generally.

Asia and China High Yield offer an attractive yield pick-up compared with global markets, and come with significantly lower duration compared to US and European High Yield.

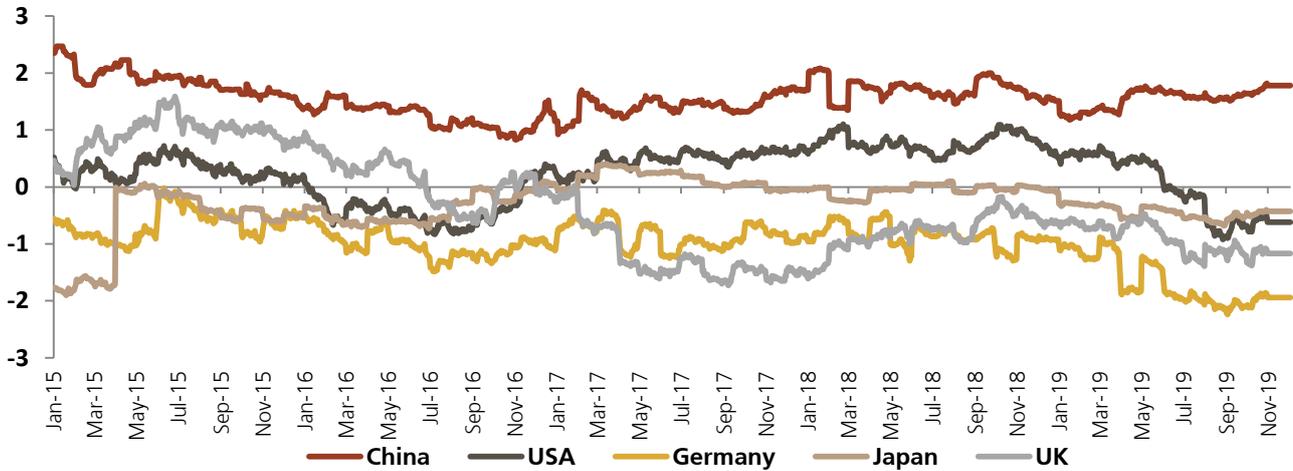
Additionally, underlying credit fundamentals are improving, and we're seeing stronger balance sheets for selected companies in the Chinese and Asian high yield universe.

| | Yield (%) | Duration | Spread (bps) |
|-----------------------------|------------|------------|--------------|
| USD High Yield | 5.7 | 3.1 | 392 |
| EUR High Yield | 3.9 | 4.1 | 383 |
| Asia USD High Yield | 7 | 3.1 | 535 |
| China USD High Yield | 8.1 | 2.4 | 648 |

Source: Bloomberg, J.P. Morgan. As represented by Bloomberg Barclays US Aggregate Corporate Index, Bloomberg Barclays Euro Aggregate Corporate index, JACI Investment Grade Index, Bloomberg Barclays US Corporate High Yield Index, Bloomberg Barclays Pan-European High Yield Index, and JACI Non-Investment Grade Index. As of end October 2019

¹ Bloomberg, Bloomberg Barclays Global Aggregate Index MV USD, as of 31 October, 2019

Real yields (%) on 10-yr government bonds compared, Jan 2015-Nov 2019



Source: Bloomberg. Real yields are based on core CPI. As of end November 2019

China multi-asset – the current strategy

Gian Plebani, Portfolio Manager, Investment Solutions

In terms of portfolio positioning, as of end Nov, we are neutral to risk assets with a preference of equities over bonds while balancing risks with an allocation to cash and onshore government bonds.

We are holding more onshore equities compared to the historical average as we see domestic sentiment improving thanks to rebounding economic activity and growing international demand thanks to index inclusion.

As for the fixed income allocation, we have a preference on USD denominated HY bonds and we are constructive on onshore RMB bonds exposure as an efficient diversifier in the portfolio context. We hedged out part of our CNY exposures to protect the portfolio valued in USD.

Over the past year, the China authorities have used a broad range of monetary, fiscal and regulatory stimulus measures to try and cushion the growth slowdown prompted by deleveraging initiatives, tighter financial sector regulation and rising trade tension with the US.

Importantly in our view, recent monetary and fiscal stimulus measures have carefully targeted more capital efficient private sector corporates and consumers rather than the highly indebted property and state owned enterprise sectors.

We see this as a welcome differentiator to previous reflationary stimulus initiatives, reducing structural capital intensity and the volatility of China's longer-term growth prospects.

On the other hand, international capital should increasingly flow into Chinese assets following the inclusion of onshore Chinese equities and Chinese bond market in the widely followed global indexes.

Moreover, we do not doubt China's willingness and ability to provide additional stimulus should conditions warrant.

While we are convinced that China's stimulus measures and global liquidity improvement are the two main reasons for China's improving outlook, uncertainty around the US-China trade development could be a dominating factor that weighs on China's economic growth.

Taking all into account, we are still constructive of China's recovery towards the first half of next year.

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