Common prosperity: The new path of development
Investing in China

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- President Xi’s recently reiterated vision for “common prosperity” and related regulatory changes have impacted China’s financial markets. Although volatility may remain elevated in the short term, we think the policy goals point to a healthier, more sustainable economic balance over the long run.
- Economic indicators eased further in July. Policy has turned pro-growth, and in 2H, we expect more RRR cuts, faster local government bond issuance, and larger fiscal spending.
- Consumer durables & services should benefit from the policy direction, internet platforms’ medium- to long-term growth prospects remain robust given the policy focus on bolstering innovation, and greentech remains favored.
- We remain defensive on bonds and prefer short-dated bonds from green-labeled developers under three-red-lines policy for carry. We think it’s attractive to be outright long commodities, and still advise US-based investors to cut or hedge their CNY longs.

Key macro messages
- Expect China’s GDP growth to slow to around 5.5% in 2H from 12.7% in 1H
- Policy has turned pro-growth

Equities
- Most preferred
  - Consumer durables & services
  - Renewable energy
  - Materials & energy
  - Long term thematic
  - Intelligent infrastructure
  - EV OEMS and supply chain (new)
- Least preferred
  - Real estate
  - Consumer staples

Bonds
- Most preferred
  - Select short-dated bonds from green-labeled developers
  - Front-end Macau gaming HY
  - Investment grade SOE (new)
- Least preferred
  - Long-dated IG
  - LGD

Currencies
- Cut CNY longs for USD-based investors

Inside pages
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- Spotlight: China leads the way on 5G transformation
- Sustainable Investing: A key player in "common prosperity"
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- Key financial indices

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Common prosperity: The new path of development

Yifan Hu, Regional CIO & Head Macroeconomics APAC
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In 1992, Deng Xiaoping famously proclaimed that China should “let some people get rich first” when describing his approach to economic development. Nearly 30 years later, China has minted almost 700 billionaires and more than 5 million millionaires in US dollar terms—both rank as the second most globally (behind the US).

Now that “some people” have gotten rich, President Xi Jinping is embarking on a new vision for China’s development: “common prosperity.” President Xi’s vision, first announced in 2017 and recently reiterated at the Central Committee for Economic and Financial Affairs meeting in August, takes direct aim at worsening social inequality and the growing might of private sector champions.

The aim of “common prosperity” is for affluence to be “shared by everyone, both in material and cultural terms, and shall be advanced step by step,” and to accelerate the economic model’s transition from prioritizing fast growth to sustainability. It’s important to distinguish between “shared by everyone” and “equal distribution”; the former refers to upward mobility for all, not complete redistribution. “Common prosperity” means raising household incomes, improving the social welfare system, and narrowing wealth inequality.

Investors have already felt the effects of this seismic change. The regulatory clampdown targeting the education sector and cooling measures to rein in housing prices are rooted in these ideals. But while such structural changes are likely to keep volatility elevated in the short term, we believe the end result will be a healthier, more sustainable economic balance.

The three rounds of distribution

The strategy to achieve “common prosperity” is broken into three “distributions.” The first focuses on increasing wages and improving labor conditions and protection. The government aims to increase the proportion of the middle-income class by making the economy’s income distribution an olive shape. Beijing is focused on bringing three groups into the middle-income segment: 30% of the low-income rural population, migrant rural workers residing in cities, and most of the elderly.

The second aims to promote social equality through taxes, social security, government transfers, and other measures. China’s current Gini coefficient is 0.47, above the UN’s international inequality threshold alert line (0.4). Here, the goal is to enlarge the middle-income group, raise the incomes of low-wage earners, and ban illegal income streams. These are expected to narrow the existing income gaps.

This may mean the introduction of a capital gains tax, an inheritance tax, or a wealth tax; more stringent collection of taxes targeting hidden incomes, including undocumented overseas and internet income; and centralized local land revenues and transfers to less-developed regions and groups. These measures may first begin in pilot cities and then rolled out gradually across the country.

The third is about developing charities and other social welfare undertakings and incentivizing charitable contributions from firms and wealthy citizens.

Beijing also seeks to “balance growth and financial regulation tightening” (the first reference since late 2018) to prevent secondary financial risks, and believes that “high-quality growth is the key to reducing systemic risks.” We expect further policy easing—e.g., more RRR cuts faster local government special bond issuance—and larger fiscal spending to support the real economy in 2H.

Zhejiang experiment as a model of common prosperity

The central government stated that Zhejiang province has been chosen as a pilot zone for the new initiatives to narrow the wealth gaps across regional, urban-rural, and income groups. The Zhejiang government released detailed blueprints in June, identifying 30 indicators to measure common prosperity in six categories, including economic development, wealth-gap narrowing, public...
service, spiritual culture, ecological civilization, and social harmony.

Key takeaways from the plan, which will likely be expanded nationally after the two sessions next year, include:

- **High-quality economic development led by innovative sectors.** The focus here is on hard tech, internet, healthcare, new materials, advanced manufacturing and modern services. The blueprint also encourages more "hidden champions"—i.e., SMEs—to stand out in subdivided sectors.

- **Environmental innovation** and the creation of a compliance monitoring system and rights trading markets for various products, including pollution, energy, water and carbon emissions. The strategy also outlines a carbon emissions peak plan that sets various emissions targets for the province.

- **Broaden sources of income and expand consumption,** especially via asset investment, and alleviate cost pressure on households. The blueprint vows to increase the percentage of non-wage gains in households’ total income by encouraging people to diversify investment products and participate in employee stock ownership plans. The government aims to establish a whole-coverage healthcare system and whole-coverage aging care network. Urban Hukou restrictions are to be relaxed and rural land rights are to be traded.

- **New controls over housing and land.** Future land supply will be linked to net population inflows and housing prices. Rental housing is seen as key, especially letting the tenant and landlord have the same access to local public goods and services such as schools and hospitals. The blueprint also suggested the local government might allow housing sales only after project completion, versus the current practice of pre-sales during construction, but it’s unknown if this will happen given the lack of detail provided on implementation. We’ll monitor this situation closely. If the change were to roll out in Zhejiang and other cities in China, it would dampen financial conditions for the real estate sector.

- **Regulatory oversight continues.** Anti-trust measures will be strengthened to avoid “the disorderly expansion of capital.” Greater governance over platform ecosystems implies regulatory pressure is likely to persist in the near term at least.

### Investment implications

The focus on lifting disposable incomes, growing the middle class, and supporting employment is positive for long-term consumption growth and is in line with the domestic circulation policy direction. Greater social welfare and public service coverage would help shift household incomes from savings into discretionary areas. China’s household consumption rate is much lower (under 60%) than developed economies’ rates and has plenty of room to rise.

In our view, it is wrong to assume that “common prosperity” will lead to a vast wealth redistribution. So we think the market has overreacted to the impact of the third distribution. Even though the associated policy changes could present headwinds for sectors like the ultra-luxury segment, we believe the future policy direction is supportive of the general consumption upgrade. We see consumer durables and services as key beneficiaries, and are therefore among our most preferred sectors.

Rising disposable incomes and Beijing’s stringent property price control may gradually shift more wealth into long-term financial assets, including mutual funds and insurance. Moreover, an improved pension system and the trend of encouraging pension investment in capital markets should support the financial market’s development. This is also in line with the long-term capital market reform direction.

Another key tenet, as seen with Zhejiang province’s pilot plan, is that technology innovation and self-sufficiency are still important strategic goals. We believe the recent anti-trust and cybersecurity policies aim to create a fairer and safer environment for technology to develop, with policy support for innovation still in place. So despite the heightened uncertainty in the short term, we think China’s internet platforms’ medium- to long-term growth prospects are still intact.

On the other hand, we expect the potential property tax pilot rollout, together with the stringent policy scrutiny on controlling developers’ financing and property prices, to continue weighing on the sector’s near-term share price performance. We therefore keep real estate equities at least preferred. That said, the plan for more centralized land supply in the future and the recent changes in local-level land auction rules suggest that land prices could be better controlled, which would support developers’ profitability in the long term.

Finally, we continue to favor the greentech sector for its long-term structural growth prospects. To achieve more sustainable economic development, greentech initiatives, including local carbon emissions peak plans, could be a focus over the next few decades.

For bonds, the newly proposed control tools on housing and land could structurally change the property sector. This explains the greater spread widening of China HY property bonds than in previous credit cycles and further divergence between BB and B yields. We remain defensive on the sector overall and prefer short-dated bonds from green-labeled developers under three-red-lines policy for carry.
The 5G era is upon us. With 5G, connections are expected to be 20 times faster than 4G and latency 90% lower. Such power could enable applications that weren't feasible before because of 4G's limitations (i.e., high latency). Fixed wireless access, autonomous driving, immersive augmented and virtual reality (AR/VR) technologies, artificial intelligence, tele-surgery, massive industrial Internet of Things (IoT), data-driven agritech, and highly connected smart cities are areas that we think will ascend in this new age.

Globally, more than 110 operators in over 50 markets worldwide offer the new wireless standard. And with global 5G penetration still only in the single digits, we expect rollouts to accelerate in the years ahead. China is in the lead with more than 350 million 5G connected devices. And with the average run-rate of around 2,000 5G base stations installed per day, China is home to more than 900,000 5G base stations—twice the number of base stations installed worldwide.

By 2023, the Chinese government aims to enroll more than 560 million 5G users, achieving a nearly 40% penetration rate, and develop an integrated ecosystem for more 5G applications in various key industries. We believe the latter is crucial to unlock 5G's true economic value potential. According to Ericsson, the annual 5G enabled consumer service revenues globally for service providers should grow from USD 14bn in 2020 to USD 324bn in 2025 and to USD 712bn in 2030. As a result, the cumulative revenue opportunity should reach USD 3.7tr by 2030.

In addition to opportunities in the consumer space, we believe the B2B and enterprise segments will rise thanks to the proliferation of IoT devices and standalone 5G networks. According to a recent survey by GSMA, telecom operators globally see manufacturing, financial services, and retail as the top three areas to monetize over the next five years beyond plain vanilla connectivity services. The rollout of autonomous driving and edge computing services should further expand the set of enterprise opportunities in the medium to long term.

Despite the strong outperformance of 5G-related names in the past one year, we maintain our bullish view on the 5G theme and see mid- to high-teen earnings growth per year on average. We believe investors would be best rewarded with a diversified global approach in both enablers and platform companies. For more details, please consult our regularly updated equity preference lists.
Sustainable Investing

A key player in “common prosperity”

Stephanie Choi, Sustainable & Impact Investing Strategist

Common prosperity focuses on the widening wealth gap. China’s top 10% owned 67% of total personal wealth in 2015, a 15ppt jump from 2005. The pace and scope of this widening is the highest among countries covered by World Inequality Data, although the uptrend is globally prevalent.

According to the UN, 71% of the world’s population live in countries where inequality has grown, and as of 2018, the 26 richest people in the world held as much wealth as half of the global population (down from 43 people the year before). Nations and investors around the world are seeking more sustainable growth to address the increasing imbalance.

Environmental, social and governance (ESG) factors lie in the heart of business sustainability, and a comprehensive sustainable investing approach that incorporates such ESG factors could have a key part to play on the road to common prosperity. ESG factors matter not only in identifying thematic or top-down drivers, but also in understanding responsible business practices and opportunities from the bottom-up.

For example, applying the UBS SI framework to the insurance sector can more fully capture its holistic risks and opportunities. The following topics are considered material for the sector:

- **Products & services**: At its core, access to quality insurance offers risk protection and improves financial inclusion for society. This is particularly relevant in China, where insurance penetration remains at only 5.95% in 2020 (+73bps y/y, roughly half of that in the US). So the topline growth trajectory for insurance coverage and the positive social impact are considerable. That said, the industry has also been subject to regulatory pressure around product pricing, as well as controversial sales and distribution tactics. ESG leaders with stronger governance, embedded affordability, and transparency in products may therefore be better aligned for long-term gain.

- **Climate change**: According to Munich Re, just 40% of natural disaster losses in 2020 were insured globally; this stands at only 2% in China. As we anticipate more frequent and severe extreme climate events, demand for P&C insurance and insurers’ need for commensurate risk management products (such as long-dated green bonds) will likely increase. Climate change may therefore shape not only topline growth, but also insurers’ assets and liabilities management.

- **People**: Insurance is labor intensive, putting employee benefits, training, and management in focus. Digitalization also heightens the need for robust data privacy management.

Better management of ESG risks is correlated with better financial performance for companies, a finding supported by extensive academic studies (Friede et al, 2015; Whelan, 2021). We therefore believe that a comprehensive sustainable investing approach could not only offer resilience to the regulatory focus on ESG issues, but also provide a systematic framework for identifying winners.
Targeted easing on slower recovery

Yifan Hu, Regional CIO & Head Macroeconomics APAC

Key statistics

- July economic indicators eased further: the mfg. PMI dipped to 50.4, export growth slowed to 19.3% y/y (38.6% in 1H), FAI growth fell to 10.3% y/y (12.6% in 1H), consumption growth was slower than expected at 8.5% y/y (23.0% in 1H).

- July CPI stayed mild at 1% y/y and should remain subdued for the whole year. July PPI edged up to 9% y/y (8.8% in June) and is likely to peak in 3Q and moderate in 4Q.

- July credit growth eased to 10.7% from 11% y/y in June. Together with pro-growth monetary policy, credit growth for 2021 is likely to reach ~11% y/y with downside risk.

- We expect GDP growth to slow to around 5.5% y/y in 2H (12.7% in 1H), with downside risk, due to slow consumption and decelerating exports. Infrastructure investment is key for growth in 2H.

Key policy trends

- Policy tone has turned pro-growth, and we expect more RRR cuts, faster local government bond issuance, and larger fiscal spending in 2H.

- LGB issuance is set to accelerate, as only 42% of CNY 4.47tr quota was used by July, to support infrastructure investment.

Key highlights

- Common prosperity was reiterated at the 10th meeting of the Central Committee for Economic and Financial Affairs. High-quality growth and the third round of distribution were emphasized.

- Zhejiang province is chosen as a pilot zone for new initiatives. A detailed blueprint released in June identified 30 indicators to measure common prosperity in six categories (see Focus).
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Positioning amid the volatility

Eva Lee, CFA, Strategist
Hyde Chen, CFA, Analyst
Summer Xia, CFA, Analyst

Performance

• MSCI China fell 12% over the past month and is down nearly 18% over the past two months. Regulations targeting the after-school tutoring sector have dampened market sentiment. The overall regulatory uncertainty, especially targeting the new economy, has caused the market’s notable underperformance versus APAC equities.

Key trends

• New economy companies’ managements have turned more prudent in their 2H21 operational outlooks. They are still adjusting to new/potential regulatory guidance. We expect the sector to face some earnings forecast downgrades for 2021/22.

• The materials sector’s reported 2Q21 results have positively surprised the market, even after the earlier announcement of profit alerts, helped by global demand amid the broader economic re-opening.

• A major renewable energy operator delivered better-than-expected earnings for 1H21, driven by greater power generation demand and improving operation efficiency. This has led us to be more constructive on the renewable energy sector’s outlook.

Investment ideas

• Due to the regulatory uncertainty, we recommend against bottom-fishing new economy names despite attractive valuations. The sector’s volatility will likely keep the offshore market range bound.

• We recommend investors to stay on the sidelines in sectors with high policy risk, including property, healthcare, and internet. We prefer sectors that will benefit from the reflation and reopening themes, including energy and consumer services. We expect the greentech sector to continue outperforming.

We recommend against bottom-fishing in the new economy sector due to lack of regulatory clarity, and recommend investors to stay on the sidelines in sectors with high policy risk.

Recent reports

• What’s next for China? 23 Aug 2021
• ADRs and VIEs - do investors need to worry? 6 August 2021

Some reports may not be available for US investors

Stabilizing polysilicon prices alleviate concerns over solar supply chain

Historical trend of polysilicon price in domestic and global markets

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Source: PV link
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Prefer short-dated bonds from green-labeled developers
Wendy Luo, Analyst

Performance
- IG is up 0.9% this month (+0.6% YTD, spreads 17bps tighter, yield at 2.5%) on positive news relating to Huarong, and HY is up 2.5% (~5.4% YTD, spreads 77bps tighter, yield at 12.3%) after last month’s correction. The 10-year US Treasury yield is unchanged from last month (1.25%). The Fed is likely to announce tapering of its QE purchases before the year-end.

Key trends
- In July, housing sales declined 7% y/y. Residential prices grew 3% y/y (10% in 1H), falling into the regulator’s target range of ±5%, offering room for less restrictive measures. The centralized land auction’s premium limit of 15% in Sept–Oct should help developers’ profit margins.
- Our covered developers’ interim results for 2Q are largely in line with our expectations of 0–5% earnings growth on average (gross profit margin down 5–10pts to 15–25%, debt down to 10%).
- Zhejiang province announced guidance that it might allow property sales only after project completion, vs. pre-sales during construction, while a property tax is in sight. We remain defensive on the property sector.
- China’s AMC sector has recovered thanks to the Huarong bailout. Despite the uncertainties in the rescue, we think this development will restore investor confidence in the SOE sector.

Investment ideas
- Despite property bonds’ high yields (BB at 7%, B at 14%), we prefer short-dated bonds from green-labeled developers under the three-red-lines policy.
- At 4–5% yield, we think Macau gaming front-end bonds offer diversification benefits for portfolios.
- IG SOEs following the Huarong development.

Recent reports
- China Huarong Asset Management: In a lifeboat on a choppy sea, 19 August 2021
- Asia bond monitor: Navigating the turbulence, 28 July 2021
- Updating our CGB rates outlook, 23 July 2021

Source: UBS

Some positive developments relating to new housing price caps, funding costs, and land auction measures, but the presale regime change would be a significant headwind for developers
In lower gear

Dominic Schnider, CFA, CAIA, Strategist
Teck Leng Tan, CFA, Strategist
Wayne Gordon, Strategist

Performance

- Broadly diversified commodity indexes, like the BCOM and CMCI indexes, are up 19–24% this year, one of the strongest year-to-date returns on record.
- On the forex side, the USD has strengthened further on a broad basis, up by around 4% year-to-date. USDCNY has traded sideways in a tight range, hovering around the 200-day moving average lately.

Key trends

- Our mid- to high-single-digit return outlook for the commodity asset class, which includes positive roll gains, assumes global growth stays firmly above trend into next year and commodity-specific factors push prices higher.
- As economies reopen, mobility is expected to improve further this year and next, favoring higher crude oil prices. We expect Brent to trade at or above USD 75/bbl over the next six months. We expect gold prices to slip into a USD 1,600–1,700/oz range.
- USDCNY’s tight trading range has also pushed the CNY steadily higher in trade-weighted terms (NEER). We are skeptical about CNY NEER strength from here and guide for USDCNY to reach 6.65 over the next 12 months to soften the NEER impact from a stronger USD.

Investment ideas

- We advise being outright long commodities, and forecast returns in the mid- to high single digits for the asset class over the next six months.
- For precious metals (i.e., gold and silver), we remain negative overall and advise investors to hedge the downside price risks.
- USD-based investors are advised to cut or hedge their CNY longs. For EUR-, CHF- or JPY-oriented investors, we suggest staying long CNY.

We think it’s attractive to be outright long commodities, and we remain negative overall on precious metals. USD-based investors are still advised to cut or hedge CNY longs.

Recent reports

- Crude oil: Reiterating our positive price outlook, 24 August 2021
- Commodities: In lower gear, 23 August 2021
- Silver Guiding for more weakness, 23 August 2021
- USDCNY: Subdued volatility for how long?, 23 August 2021

Average performance of commodities and different sectors after global PMIs peaked

Total return values standardized to 100

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Key financial indices

**Equities: CSI 300 Index**

Dec-16 Dec-17 Dec-18 Dec-19 Dec-20

- CSI 300
- 55-Day Moving Avg.
- 200-Day Moving Avg.

**Equities: MSCI China**

Dec-16 Dec-17 Dec-18 Dec-19 Dec-20

- MSCI China
- 55-Day Moving Avg.
- 200-Day Moving Avg.

**Equities: Hang Seng China Enterprise Index**

Dec-16 Dec-17 Dec-18 Dec-19 Dec-20

- Hang Seng China Enterprise Index
- 55-Day Moving Avg.
- 200-Day Moving Avg.

**Bonds: JACI China Blended Spread (basis points)**

Dec-16 Dec-17 Dec-18 Dec-19 Dec-20

- JACI China Blended Spread
- 55-Day Moving Avg.
- 200-Day Moving Avg.

**Bonds: China 10Y Govt Bond Yield (in percentage)**

Dec-16 Dec-17 Dec-18 Dec-19 Dec-20

- China 10Y Govt Bond Yield
- 55-Day Moving Avg.
- 200-Day Moving Avg.

**Forex: USDCNY**

Dec-16 Dec-17 Dec-18 Dec-19 Dec-20

- USDCNY
- 55-Day Moving Avg.
- 200-Day Moving Avg.

Source: Bloomberg, UBS, as of 30 August 2021
Appendix

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