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Stay picky with China equities

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In the wake of the apparent trade deal with the US, China equities have recently demonstrated capacity to respond strongly to recoveries in risk sentiment. We would however caution that uncertainty over tariffs, China's economic recovery, and policy support linger on. Investors should continue to calibrate their exposure to China equities accordingly. We favor China's technology sector within H-shares and defensive high-yielding stocks within A-shares. We would also encourage exposure to the gradual CNY appreciation over the next year.

With the shadow of the tariff dispute with the US now receded somewhat, China equities have of late been more responsive to improvements in risk sentiment. The Hang Seng China Enterprise Index (HSCEI) has even outpaced the S&P 500 since 20 June, rising 2.7% versus 1.9% as market sentiment regarding the hostilities in the Middle East recovered on the back of expectations of a fairly quick end to the fighting.

While caution is obviously still advisable regarding the geopolitical situation, investors should also not breathe a sigh of relief over the overall economic situation facing China equities, especially with regard to the damage from tariffs. Although the London deal between the US and China affirmed and fleshed out the terms of an apparent agreement, thus stabilizing the negative risks to markets, there remain outstanding concerns.

First, the US tariff rate on Chinese imports was only lowered to 55%—much higher than at the start of the year. Second, the deal has yet to be finalized and ratified—a meaningful risk given how unpredictable the Trump administration has been. Third, although latest China data have been robust and point to an acceleration of momentum in 2Q25, there is still little sign of a broad-based recovery, with the property sector and lingering tariff impact serving as drags on any recovery. Fourth, the trade deal and the economic resilience are likely to lead to Chinese policymakers declining to intensify their stimulus efforts.

To be clear, we still see China's policymakers maintaining an accommodative monetary policy stance. We anticipate an additional 50-100bps of reserve requirement ratio (RRR) cuts and 20-30bps of policy rate cuts in the second half of the

year, following a 50bps RRR cut and a 10bps rate cut in May. Also, we expect the stable effective tariff rate to end up around 30-40%, which might mean exports to the US declining around 30% over the remainder of the year, leaving overall exports growth for 2025 around 0%. Investors should thus still remember the meaningful residual negative impact of tariffs and exports exclusions on trade, growth, and inflation; and calibrate their exposure to China equities accordingly.

China tech stands out in the H-share space. The sector's earnings growth for 2025-26 is likely to remain strong on the back of ongoing AI innovation, positive cloud trends, and policy support for self-sufficiency in AI and chip manufacturing. The sector's impressive 1Q25 earnings reports reflected resilient demand across core businesses and accelerating AI-driven growth. Within the tech sector, the internet and EV segments stand out. Internet firms remain focused on monetization and leveraging AI applications in advertising and customer management. EV manufacturers meanwhile are applying AI to enhance manufacturing processes and advance innovative features.

Dividend stocks attractive in the A-share market. The uncertainty over further policy support leaves us with a constructive yet measured view for A-shares. In this declining yield environment however, dividend-yielding stocks are particularly attractive. These include banks, insurance, utilities, and telcos—where payout ratios are steady and earnings visibility is high. Their dividend yields offer a decent 1-3 percentage point pickup over the 10-year CGBs. Insurance funds seeking high yields are likely to continue to pour inflows into this segment as regulatory guidance continues to encourage insurers to raise their equity allocation. Against this backdrop, we favor value and defensive sectors with a focus on high-dividend stocks.

Seek exposure to CNY appreciation. We expect the USD to weaken in the latter half of the year and take the USDCNY gradually down to 7.00 over the coming 12 months. Chinese exporters have been accumulating USD earnings and delayed conversion to the CNY since 2024. Although the start of this process has been slower than expected, we expect the conversion of substantial USD reserves to CNY to persist and potentially accelerate, thus contributing to further USDCNY downside. Investors can gain exposure to this move by reducing the hedging on their CNY assets, and/or selling the USDCNY on upticks (possibly due to spikes in geopolitical risk) to 7.225.

Investors might also want to keep an eye on the USDHKD, which remains stuck at the ceiling of its tradable band of 7.75-7.85, as the USD's interest rate premium remains unusually wide. HKMA Chief Executive Eddie Yue has threatened to turn the tables: he cited emergent carry trades and warned that the HKMA might need to intervene if this situation persists till the end of June. Investors should note that the HKD is best suited to serve as a funding currency (especially for real asset purchases) when the USDHKD is near the 7.75 trading band floor—this is where the potential for FX losses is minimized.

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