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Opportunities amid southbound China flows

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Amid all the focus on tariffs and trade tensions, increased southbound Stock Connect flows and enhancement to the southbound Bond Connect have perhaps received less attention than they deserve. We expect southbound participation to continue growing, and see China tech as particularly attractive. We maintain a constructive view on USD China SOE credit thanks to the resilient fundamentals and continued policy support. With our negative USD view still in place, USDCNY spikes north of 7.20 should be transitory, and we expect the pair to gradually decline to 7.00 by 1Q26.

While the narrative surrounding China has improved markedly, the benefit has not been felt by onshore equity markets. Instead, the Hang Seng China Enterprises Index (HSCEI) has outperformed the CSI300 22% to 14% since the 7 April trough, and by an even starker 22.3% versus 4.3% year to date.

We would note though that the drivers of this could potentially persist in the near term. Over the past year, there has been a notable change in the investor mix for Hong Kong-listed Chinese companies. Specifically, southbound investment via the Stock Connect scheme has accounted for 23% of total turnover year to date, from 18% in 2024 and just 9% in 2020. This appears to be due to three key factors: (1) the higher dividend yield offered by dual-listed companies such as banks; (2) exposure to Chinese internet stocks (not available in A-shares); and (3) the greater number of leading A-share companies with a dual listing in Hong Kong.

Investors should also note the recent enhancements to the southbound Bond Connect, which extends Mainland investor access to securities firms, fund houses, insurers, and wealth managers, beyond just major banks. This will provide mainland onshore investors with access to offshore fixed income products, and onshore investors now are able to diversify their

global allocations into USD, EUR, HKD, and CNH bonds in Hong Kong. These enhancements should boost demand for offshore Asia bonds, potentially inducing a rise in issuance in the Hong Kong market.

We discuss the asset class implications of the ongoing increase in southbound flows below.

China tech outperformance likely to continue as new catalysts emerge. Both year to date and from 7 April, the Hang Seng Tech Index (HSTI) has outperformed even the HSCEI, rising 24% and 26%, respectively. We believe this will continue, as improved access to leading-edge chips will likely accelerate the development and deployment of DeepSeek R2, which could emerge as the next key catalyst for the sector and provide a boost to risk sentiment and accelerate AI adoption. The timing and market response to new AI product launches will be critical in driving the next leg of sector performance. Elsewhere in China's internet space, entertainment platforms are preferred to the extremely competitive e-commerce. We continue to favor top names in online gaming, cloud services, online travel, and EVs, where strong fundamentals and ongoing innovation support an attractive medium-term outlook.

Beyond tech, we are likely to see growing participation from southbound investors in growth and high-yielding stocks, particularly select SOEs in the financial, telecom, energy and utilities sectors.

Attractive segments in the USD China credit space. We maintain a constructive view on China SOE credit thanks to the resilient fundamentals and general stability in this segment, plus continued policy support. Although current valuations are comparable to those of other Asia IG credits and should thus limit further tightening, all-in yields are attractive and should underpin returns in 2H25.

Utilities and engineering & construction (E&C) companies should be able to capture value from the ongoing shift toward renewable energy, electrification, and AI-driven power demand, supported by favorable green financing conditions. Meanwhile, asset management companies (AMCs), quality local SOEs, and local government financing vehicles (LGFVs), as well as corporate perpetual bonds, offer balanced risk-reward tradeoff for investors open to adding risk for enhanced yield.

CNY appreciation to benefit HSCEI and HKD. Although denominated in HKD, HSCEI firms largely derive their revenues in CNY—a lower USDCNY would boost earnings in HKD terms. We sense that the PBoC is getting more supportive of and comfortable with a stronger CNY, likely for two key reasons: (1) to make up for persistent weakness in trade-weighted terms, and (2) a preemptive move as the US ramps up negotiations with other countries. Accordingly, new policies to cut excess capacity and rebalance supply and demand could well encourage exporters to repatriate earnings, further supporting the currency. We believe the PBoC will likely keep CNY volatility highly contained and limit any bouts of depreciation. With our negative USD view still in place, we believe USDCNY spikes north of 7.20 should be transitory, and we expect the pair to gradually decline to 7.00 by 1Q26.

The USDHKD meanwhile remains stuck at the top (weak HKD) end of its tradable range of 7.85 despite a sharp drop in the HKMA's aggregate balance (key measure of interbank liquidity) from HKD 174bn to HKD 86bn in just four weeks. HKD funding costs remain unusually low, prompting carry trades funded with HKD. However, as the aggregate balance continues to decline, HIBOR is likely to rise gradually, with the three-month HIBOR likely ending the year at 2.75% from around 1.6% currently. Indeed, as the seasonal factors fade, US Fed cuts begin, and the CNY appreciates, we see the USDHKD drifting back down toward 7.80.

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