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Managing your China exposure

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China equities have risen over the last 6-7 weeks in reaction to a strong 2Q25 GDP growth number, plus positive developments in trade talks with the US. But China's economy is not out of the woods yet, and we remain Neutral on broad China equities but view China tech as Attractive. On the USDCNY, we think the recent bounce is likely to be transitory, and still see the pair declining to 7.00 by the middle of 2026. We also note that China's policymakers have taken deliberate steps to make onshore bonds more attractive to offshore investors.

From its recent low on 9 July, the MSCI China (MXCN) rose around 8%. Over that time, China's 2Q25 GDP release beat expectations and gave us cause to raise our full-year forecast, and the China-US trade negotiations have also taken a turn for the better. Although the negotiations are set to continue, China is being allowed to import mid-tier GPU chips again, potentially reviving the AI development scene there.

While we agree that things have started to look up for China on multiple fronts, it might be too soon to assume that things have turned the corner for good. For starters, the strong 2Q25 and 1H25 GDP growth rates were boosted in large part by front-loading of external demand ahead of potential tariff rate hikes. On that note, June data showed that momentum had already begun to flag in both consumption and investment; consumption had also been front-loaded to May on account of a major online promotion. Furthermore, the housing market remains soft, and this should continue to pose a drag on consumption going forward.

Additionally, on the trade front, while the tone from both sides has noticeably improved, a binding deal has not yet been confirmed, never mind inked. The more benign outlook should not obscure the fact that even in our expected scenario of a 30-40% effective tariff rate of Chinese exports to the US, it would still mean a significant rise in the tariff rate, and we see China's growth slowing in 2H25. While we do expect more moderate policy easing and targeted fiscal support, these will likely only be sufficient to limit the slowdown.

All these suggest investors should still stick to being selective about their exposure to China, and we discuss these below.

China's tech sector remains Attractive, but a refresh is needed. We remain Neutral on China broad equities but still expect the technology sector to outperform. Nonetheless, we see the need to refresh our exposure within the sector. China's AI trade has hit a slow patch due to weaker-than-expected cloud revenue growth, concerns over margin pressure, and lower-than-expected capex among mega-caps, plus a lack of further progress in AI development since 1Q. Elsewhere, competition between China's e-commerce platforms and local services delivery has intensified. E-commerce leaders will likely need to sustain a stream of new investment in the form of subsidies to both users and merchants in order to defend their core businesses and capture more market share. This could pressure their near-term earnings.

We remain constructive on the overall China tech sector but recommend that investors take a selective approach to positioning. We remain constructive on AI development in China over the medium term and expect improvements in core business fueled by AI, accelerating cloud revenue, AI application revenues, and the potential launch of DeepSeek R2, to serve as catalysts to revive sentiment. In the meantime, we recommend shifting the investment focus to the entertainment platforms segment, given relatively benign competition there, high earnings visibility, and robust cash flow.

USDCNY downside trend intact. Alongside the USD's (DXY index) 2.3% rise over the last week, the USDCNY also climbed from 7.15 to 7.19. However, we note that the fundamentals seem to have shifted in favor of the CNY. China's outflows for services, investment, and offshore assets have moderated, while foreign investor flows have stabilized. China's policymakers seem to be comfortable enough with the erosion of confidence in the USD to risk some outflows by accelerating capital account liberalization and RMB internationalization. We maintain our USDCNY forecasts at 7.10 at end-2025 and 7.00 by mid-2026, with risks still skewed toward further downside. Investors looking to diversify away excess USD exposure can consider the lower-volatility CNY as an alternative.

Boosting the appeal of onshore China bonds. China's policymakers seem to be acutely aware of the ongoing de-dollarization drive and have announced changes to the Bond Connect Scheme, which would notably expand the appeal of onshore CNY-denominated bonds to international investors. The Northbound Connect has two new features that should help facilitate foreign ownership. Offshore investors can now (1) re-hypothecate onshore bonds; and (2) conduct cross-currency repos. These will likely mostly be used on CGBs, with the new measures improving collateral utility, funding flexibility, and liquidity for offshore investors. In an environment of diversification away from excess holdings of USD assets, these measures to entice increased foreign participation in CNY bonds, seem likely to prove timely. Given the economic slowdown, we anticipate an additional 50-100bps of reserve requirement ratio (RRR) cuts and 20-30bps of policy rate cuts in 2H25, following a 50bps RRR cut and a 10bps rate cut in May. This should help lower the 10-year China government bond (CGB) yield to around 1.55% by the middle of 2026 from close to 1.75% currently.

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