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Defensive stocks can help during tariff tensions

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Investors hoping for muscular policy stimulus measures from the CEWC were again disappointed, and the prospect of an imminent US tariff rate hike adds to the gloom. But China's hesitancy reflects the desire to properly calibrate the magnitude of stimulus rather than a lack of ability to respond. We expect concrete measures to be revealed in March, and these might well provide a meaningful boost to the economy. In the meantime, investors should maintain a near-term tactical preference for defensive high-yielding value sectors.

China's final policy event of the year, the Central Economic Work Conference (CEWC), resulted in a broadly pro-growth statement that contained language indicating a greater commitment to expansive fiscal and monetary policies. However, the absence of concrete and quantifiable action or measures seems to have disappointed China equity investors. A week after the CEWC statement, the MSCI China, CSI 300, and HSCEI are down 3.5%, 2.2% and 2.4%, respectively. The 20 January inauguration of Donald Trump as the next US president is likely to herald the rise of trade tariffs, which is a major market concern. Even if this is merely a negotiating tactic, some increase in tariffs at the very least appears inevitable, given the strength of bipartisan support in the US.

However, China is not without the ability to ameliorate the negative impact of tariffs. We might see a policy response as the Trump administration gets underway on 20 January and China's National People's Congress (NPC) may potentially unveil policy specifics in March, when the tone of US tariff policy is more likely to be known.

Calibrating fiscal and monetary stimuli at the NPC. We think that boosting domestic demand is the most effective way to counter the negative economic growth impact of tariffs. China's policymakers though seem to be wary of the risks of over-stimulating the economy. We expect a phased increase in the effective US tariff rate on all Chinese goods to 30% by end-2026 from around 10% today. This in turn is likely to prompt a raising of China's official fiscal deficit target for

2025 to 4% from the estimated 3% for 2024. This should be accompanied by around CNY 2 trillion in special treasury bond issuance. We also expect 50-100bps of RRR cuts and 20-50bps of policy rate (7-day reverse repo) cuts through 2025. Additionally, we expect an accompanying annual fiscal package of CNY 2-4tr covering local debt resolutions, property destocking, consumption, and bank recapitalization, among others. These measures would help offset a moderate tariff hit to GDP of around 0.7-1.0 percentage points and keep growth in the mid-4% range in 2025.

Retaliatory measures likely largely symbolic. Besides allowing for moderate currency depreciation, with the USDCNY likely climbing to 7.50 by end-2025, most of the likely retaliatory countermeasures would not materially change the underlying trade dynamics with the US. We believe a large depreciation is unlikely given the potential for damaging capital outflows and competitive retaliation from trade partners. Aside from CNY depreciation, Beijing might restrict US exports to China via tit-for-tat tariffs on targeted goods, or access to China's critical material exports or entity-specific restrictions.

Remain tactically defensive but watch for medium-term opportunities. Our base case assumes that any adverse tariff impact potentially poses a de-rating risk for Chinese equities. We maintain our near-term tactical preference for defensive high-yielding value sectors like financials, utilities, energy, and telecoms, which would also be more insulated against the impact of US tariffs. This should be maintained at least till we get more clarity on the tariff equilibrium between the US and China.

Investors would also do well to keep an eye on more medium-term opportunities, specifically exposure in select leading internet companies in China, especially in the event of an outsized correction there. Given their undemanding valuations, solid growth prospects, and decent shareholder returns, a selloff in China's leading internet stocks would be a buying opportunity over the medium term, in our view.

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