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China braces for tariff turbulence

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The latest round of tariffs on China constitutes our downside scenario that could see China's growth rate fall below 4%. Market reaction to the moderate tariff rate hikes has thus far been negative but orderly. China's policymakers will likely step up its monetary and fiscal policy stimulus, while also intensify its medium-term efforts toward self-sufficiency in tech. Externally, China is also likely to try and deepen its trading relationships with non-US partners. Given the potential volatility in the months to come, investors might want to position into selected SOE sectors and stocks with high dividend yields. We believe the continued support for innovation will benefit a range of sectors, from internet platforms, EV, to data center operators.

The Trump administration's 2 April tariff announcements by and large came out harsher than both we and markets had been anticipating. This is especially true for China, which was slapped with reciprocal tariffs of 34% plus another 20% previously announced, for a total incremental tariff of 54%, which takes the overall tariff rate to 74%. What are the prospects for the economic outlook and should investors turn risk averse on China?

Although this tough tariff stance is likely to mean a loss of around 200bps of growth over the next two years, which could well lower the annual GDP growth rate for 2025 and 2026 below 4%, this will likely be sufficient to push China's policymakers to enact enhanced policy stimulus. A combination of both fiscal and monetary policy stimulus will likely be brought to bear on the cyclical downturn, which means there will still likely be pockets of the China equities markets where investors would be advised to shelter from the tariff troubles.

Policy stimulus as both buffer and rudder. Thus far, China's policymakers have been keeping their powder dry, likely awaiting confirmation that the Trump administration wasn't bluffing with its tariff threats. With that out of the way, we expect Beijing to roll out more muscular stimulus packages aimed consumption, to help moderate the cyclical downturn. The end-April Politburo meeting is likely to be the occasion that many of these measures are unveiled. We now expect Beijing to lower the reserve requirement ratio by 100-200bps and implement 30-50bps of policy rate cuts.

China's policymakers are also likely to see this as an opportune moment to through more weight behind the pursuit of its medium-term goals to pursue self-sufficiency and innovation in the tech space, and to improve "internal circulation" and achieve higher-quality growth. Policymakers have recently signaled an end to the regulatory crackdown on the private sector, especially in the tech space/

External response will likely also be muscular. Unlike in 2018/2019, China has signaled an unwillingness to take this tariff hike on the chin and absorb the damage. Already, the PBoC has indicated a commitment to keeping the USDCNY steady, likely to try and anchor market confidence in investing in China. Similarly, China's manufacturers are not willing to absorb the tariffs by eating into their already-slim margins. For Beijing, this probably provides the added benefit of redounding onto imported inflation in the US and complicating the US policy response.

Defensively, China is also likely to try to deepen its trading relationships with non-US partners. In and of itself, the US universal tariffs are likely to push the rest of the world into closer trading relationships, including with China. China might leverage this and lower bilateral tariffs and expand investment agreements, and enlarged currency swap agreements. Direct investment and supply chain localization could also be enhanced between China and regions like EU, Middle East, Southeast Asia, Japan and South Korea. Already, it has been reported that China, Japan and South Korea have agreed to strengthen supply chain cooperation and engage in more dialogue on export controls agreed to strengthen supply chain cooperation and engage in more dialogue on export controls.

"Safe harbors" within China equities. We remain Neutral on Chinese equities overall owing to negative economic impact of the US tariff and potential retaliation. We do see select thematic growth opportunities. We believe in medium term, China's AI, including embodied AI, should provide favorable growth prospects, considering the policy commitment expressed recently. The PBoC also recently announced an increase in loan quotas for re-lending facilities for tech innovation. We believe the continued support for innovation will benefit a range of sectors, from internet platforms, EV, to data center operators.

Nevertheless, in the face of the potential volatility in the months to come, we recommend investors concerned about the tariffs risks position in select SOE sectors and stocks with high dividend yields in the financial, telecom, utilities, and energy sectors. Attractive yields should help stabilize portfolio returns in the volatile markets. Banks would be an interesting instance of this despite the planned recapitalization. With credit demand growth still at a reasonable level and limited risk to net interest margins (NIMs), the low price-to-book ratio (PB) at 0.5x on average, along with an attractive dividend yield of over 6%, are appealing and offer investors some buffer from the volatility ahead.

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