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China tech sector can ride out tariff troubles

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The latest tariff outburst from the Trump administration provides a timely reminder that China is not yet out of the woods despite the surprise de-escalation earlier this month. Nevertheless, we remain comfortable with our Attractive view on China's tech sector given the range of earnings drivers powering the different constituents of the sector. In particular, we like leading China internet and EV names, as well as domestic chip gear makers.

Barely a fortnight after the Geneva agreement between the US and China de-escalating their bilateral trade conflict, tariff escalation rears up again, this time with the EU. Over the weekend, US President Donald Trump threatened to impose 50% reciprocal tariffs on the EU beginning 1 June, on account of unsatisfactory progress in bilateral tariff negotiations. This re-escalation comes with an acceleration of the timeline (from the current 9 July negotiation deadline). The Hang Seng China Enterprises Index (HSCEI) fell 1.7% on Monday even though the tariff hike was subsequently delayed to 9 July; this likely reflects concern that this foreshadows what might befall the US-China negotiations before too long.

We, however, remain sanguine about our recent upgrade of our view on China's tech sector to Attractive, which happened even before the Geneva agreement. We had felt then that the 11% fall in the Hang Seng Tech (HSTECH) Index was an adequate pricing in of tariff tensions. Additionally, we felt that China's tech sector enjoyed enough organic growth drivers to enable it to outperform even through an extended tariff standoff. The ongoing AI innovation, positive cloud trends, and Beijing's support for AI and chip self-sufficiency should all help drive healthy earnings growth for the sector.

Notwithstanding occasional hiccups, we think that peak tariff risks are likely behind us. We thus think that the market's focus should turn to the sector's likely-robust 2025-2026 earnings growth. The sector's risk-reward balance is improving, especially given the starting point of attractive valuations at 16x forward P/E (0.7 standard deviations below the average

from 2022). Clearly, the surprise de-escalation has strengthened our belief, but it is still useful to review the case for China tech, including at a more granular level.

China internet segment enjoying AI-driven recovery. We favor China's internet sector, with its undemanding valuation of around 14x forward P/E. The sector continues to trade at a discount to its US peers, which we believe makes it attractive to international investors looking to rebalance their global portfolios. We continue to see robust AI demand from China's cloud vendors, following the release of the DeepSeek R1 earlier, which has generated a surge in inference workloads. We expect the sector to be supported by accelerating cloud revenue, which should start to show up in the upcoming results season. Additionally, the internet segment would likely be a key beneficiary further stimulus on account of its significant exposure to domestic consumption.

China EVs might be relative beneficiaries. China's EV industry is primarily dependent on domestic demand and thus benefits from increased government support, including enhanced trade-in subsidies. China's EV-makers have no presence in the US and thus are relatively unimpacted by the tariff rate hikes. Instead, China's EV exports mostly go to emerging markets, which remain attractive, offering higher prices and profit margins relative to the domestic Chinese market. While overseas expansion may encounter growing pains and cyclical challenges, we expect the export drive to continue. Additionally, Chinese EV OEMs are investing heavily in AI and humanoid robotics research, and might thus be well-positioned to exploit synergies in the two segments (EVs and AI), like enhanced intelligent driving, cockpit systems, and overall vehicle capabilities. The China EV segment is thus a key contributor to our overall positive view on China tech.

Chip-making self-sufficiency to continue receiving policy support. Last, but certainly not the least, China's pursuit of self-sufficiency in chip-making – amid US efforts to limit China's access to high-tech chips – should drive continued investment in the segment. Although domestic chip-makers are still not on at the same level as their top global rivals, China's domestic AI chips are gaining significant traction, with their share of the local market more than tripling from just 10% in 1H23 to 34% in 2H24. We expect China's chip self-sufficiency to reach about 90% by 2029. As domestic chip innovation accelerates, we see strong opportunities for equipment makers which are well positioned to benefit from rising local demand.

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