JULY 2022

Hong Kong/China Equity Perspectives

Mid-Year Review and Outlook

Summary

Up till late-May 2022, we had been mindful of short-term challenges but remained cautiously optimistic on China equities in the longer term. Last month, we turned outright positive and called for immediate action to long the China equity market. We argued that the market was about to turn the corner, driven by strong determination of China's top leaders to reflate economic growth before the 20th National Congress of the Chinese Communist Party in the second half of 2022. Mercifully, our predictions have been mostly correct in this brutal global market environment.

Looking ahead, the market is on track to rally further in the coming months. At the 14th BRICS[1] Summit, President Xi vowed to take more actions to meet China's 2022 targets. At the State Council executive meeting, Premier Li and other top leaders identified "consumption" as the key pivot in restoring economic growth. The State Council unambiguously advocated rolling out consumption stimulus as much as possible. The Standing Committee of the National People's Congress approved the revision of the antitrust law, effective 1 August 2022, aiming to create a unified, open, competitive and orderly market.

In our opinion, it is better to keep dancing until the music stops. We think every minor market step-back in the coming month will be proved to be the chance for investors to step forward buying.

1. BRICS: Brazil, Russia, India, China, and South Africa
2. MIIT: Ministry of Industry and Information Technology
3. ADRs: American depositary receipts
4. NMPA: National Medical Products Administration

Notable developments in selected sectors

- China Automobile: The State Council has identified the car industry as one of the focus areas to drive economic growth through policy support. We expect more provinces and cities to roll out car purchase stimulus policies in the coming weeks.
- China Consumption: MIIT[2] disclosed that it will roll out a new round of household appliance subsidy programme following the new energy vehicle subsidy programme.
- Southbound Stock Connect: Hong Kong Government has been actively engaging mainland China regulators to allow Chinese ADRs[3] with secondary listings on Hong Kong's stock exchange.
- China Internet: The Chinese government recently adopted a more positive tone towards the platform economy. Regulatory oversight will remain, but we are seeing fewer negative surprises on this front.
- China Healthcare Technology: NMPA[4] published an opinion draft on law amendment that explicitly states that third-party platform providers cannot be directly involved in the sales of drugs.

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Mid-Year Review and Outlook

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- In January 2022, we believed **China internet stocks would remain lukewarm** despite undemanding valuations, and prescribed a buy-on-dip strategy.
- In February, we recommended investors to **stay patient and be agile**. Potentially faster-than-expected US rate hikes would be the key market-moving factor.
- In March, we advised investors to **sail through the storm by appropriate sector rotations** and prepare for a cyclical rebound later this year.
- In April, we reiterated our cautiously optimistic view in the medium term while **remaining selective in the near term**. We highlighted that eventual implementations of fiscal stimulus in China would be the light at the end of the tunnel.
- In May, we remained **hopeful for synchronised monetary and fiscal stimulus** soon after the COVID outbreak in mainland China was brought under control.
- In June, we urged investors to opportunistically accumulate high-quality H-shares and A-shares. As long as the Chinese government is committed to its ambitious GDP growth target, we believed **the China equity market is tilted to the upside**.

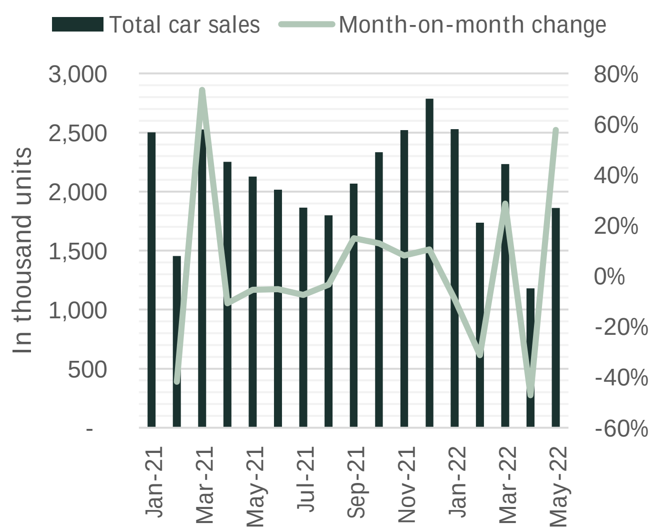
Looking ahead, the market is on track to rally further in the coming months. At the 14th BRICS Summit, President Xi vowed to take more actions to meet China's 2022 targets. At the State Council executive meeting, Premier Li and other top leaders identified "consumption" as the key pivot in restoring economic growth. The State Council unambiguously advocated rolling out consumption stimulus as much as possible. The Standing Committee of the National People's Congress approved the revision of the antitrust law, effective 1 August 2022, aiming to create a unified, open, competitive and orderly market.

Notable developments in selected sectors

1) China Automobile – Subsidies and tax cut

China's car sales has demonstrated a strong recovery, according to the China Association of Automobile Manufacturers. Estimated car sales in May 2022 reached 1,862 thousand units, representing a 58% month-on-month rebound (see Chart 1). As car factories and component suppliers in Shanghai resumed production gradually, the year-on-year decline in sales narrowed sharply from -47.6% in April to -17.1% in May. Sales recovery is expected to continue in the coming months, boosted by government stimulus and car manufacturers' large order backlogs.

CHART 1. CHINA MONTHLY CAR SALES



Source: China Association of Automobile Manufacturers

The State Council has identified automobile as one of the focus areas to drive economic growth through policy support. In addition to the central government's decision to reduce purchase tax on selected passenger vehicles (those with an engine of 2.0 litres or less and priced RMB300,000 or below), several cities have already rolled out new stimulus to support the industry. For example, Shanghai offers purchase subsidies of RMB10,000 and RMB20,000 per unit respectively for cars priced below and above RMB150,000; Guangdong offers a RMB3,000-10,000 per vehicle replacement subsidy and a RMB8,000 new energy vehicle (NEV) purchase subsidy; Beijing rolled out subsidies of as much as RMB10,000 per vehicle for replacing an old car with an NEV; Xi'an issued car consumption coupons of RMB100m for June through September. Last but not least, the government of Zhengzhou, Henan has announced to hand out RMB200m of car consumption coupons. We expect more provinces and cities to follow suit in the coming weeks.

2) Other China Consumption Stimulus

The fine print in the State Council's 33 stimulus measures mentioned a renewed "Household Appliances to the Countryside" scheme for the first time. The MIIT disclosed that it will roll out a new household appliance subsidy programme following the NEV subsidy programme. Although the MIIT has yet to announce the details of this nationwide programme, we think the provincial subsidy programme in Guangdong in 2020 could be a useful reference. In 2020, Guangdong citizens could browse for household appliances on a government-developed smartphone app. Selected products were sold at a 10% retail discount, with the discounted amount split between the government and the participating household appliance makers.

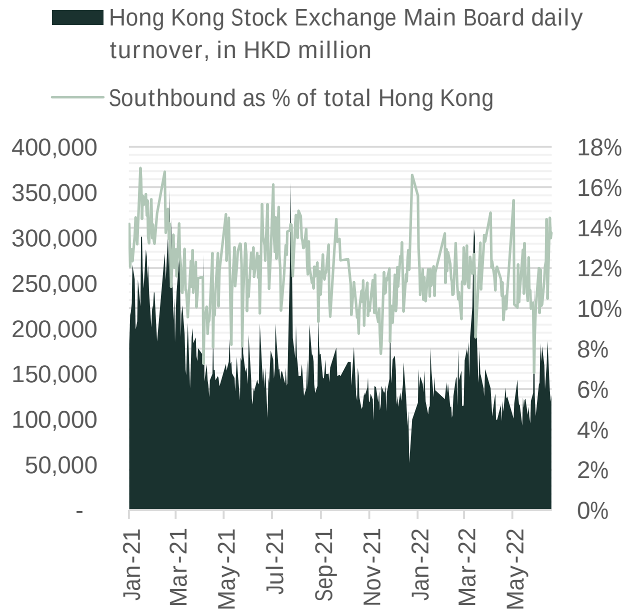
It was estimated that the previous nationwide household appliance subsidy programme in 2009-2012 handed out around RMB90 billion worth of subsidies to spur consumer demand. The overall living standard in China improved remarkably, especially in lower-tier cities. As the last programme was wrapped up 10 years ago, we reckon there is huge replacement demand for consumer goods that have long passed their life cycles. We anticipate the upcoming subsidy programme will focus on upgrades of obsolete devices to smart devices with internet-of-things (IoT) capabilities.

3) Southbound Stock Connect

In mid-June 2022, Hong Kong Financial Secretary Paul Chan revealed that the Hong Kong Government has been actively engaging mainland China regulators to allow Chinese ADRs with secondary listings on Hong Kong's stock exchange. Currently a number of popular Chinese ADRs, mostly stocks of technology companies, are not eligible to be included in the Southbound Stock Connect. Those secondary listing companies are principally regulated by the rules and authorities of the foreign jurisdiction where they are primary listed.

Apart from those ADRs potentially to be added to Southbound Stock Connect, we expect stock brokerage firms, investment banks and financial services providers will benefit from higher trading volume. We expect that a broadening list of eligible stocks will boost average daily turnover. In recent months, Southbound turnover accounted for about 10-14% of the Hong Kong stock market's daily turnover, whereas the last peak was at 17% in January 2021 (see Chart 2). On top of a higher Southbound turnover, we expect improving market liquidity to help attract international investment funds to Hong Kong stock market.

CHART 2. HONG KONG STOCK MARKET TURNOVER



Source: Bloomberg, as of June 2022
Past performance is not indicative of current or future performance.

4) China Internet

The Chinese government recently adopted a more positive tone towards the platform economy, highlighting its role in boosting consumption recovery and employment. We have seen some encouraging developments since then, which have been supportive for the sector's performance.

To be sure, regulatory oversight will remain, but we are seeing fewer negative surprises on this front.

Cybersecurity

According to a Bloomberg news article, China's Cyberspace Administration may conclude its probes against three China companies that are listed in the US market, including the largest car hailing company. Upon this potential lift of the probe, it is believed that the companies may commence a new listing in Hong Kong.

This is a widely positive development for the Chinese technology sector overall. It implies an orderly, transparent investigation and resolution of regulatory breaches, as opposed to arbitrary, company-specific and punitive responses.

Mobile gaming

China's National Press and Publication Administration approved 60 new online games on 7 June 2022. Although the approval list was again consisted mainly of titles from smaller studios, the market should still read this as a positive sign to the whole sector as the approval process has been revived. Moreover, more games were approved this round than the previous round in April where 45 titles were approved.

For the large players, revenue momentum could be more back-end loaded due to the prioritisation of smaller gaming studios in game approvals, as well as the timing of their new game launch pipeline.

ADR delisting

According to Bloomberg, China has been discussing with US regulators on allowing on-site audits of US-listed China ADRs. On-site inspections would be a step towards satisfying the US that its inspectors will get full access to audit papers required by legislation passed during the Trump administration.

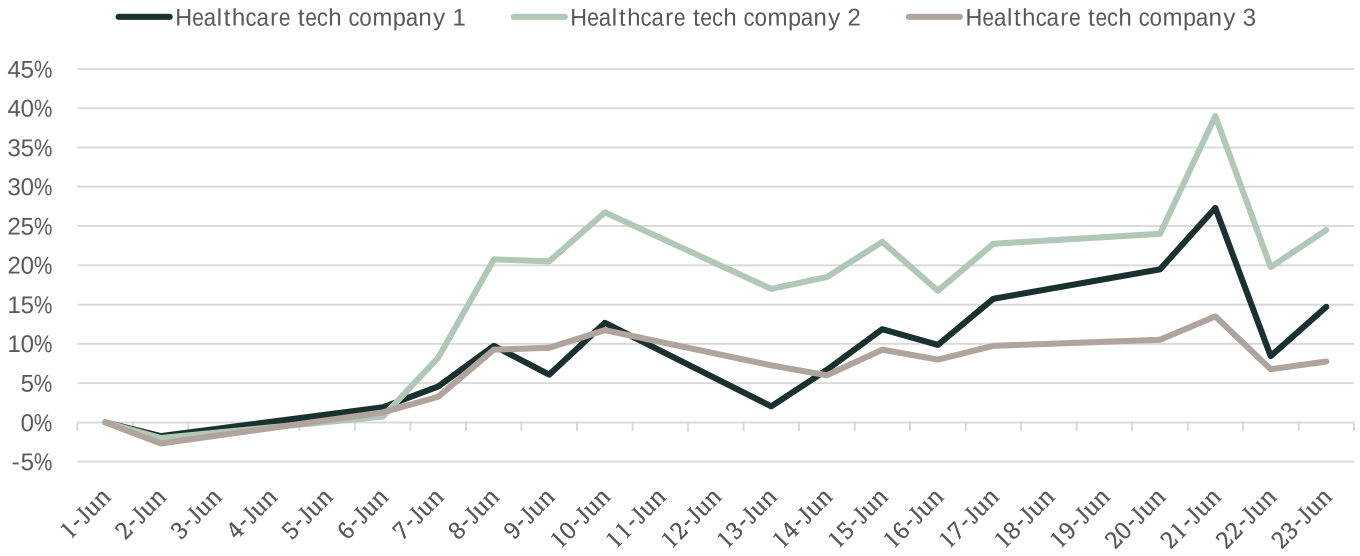
Progress on on-site inspections (which previously had been a potential source of impasse, especially for firms which hold sensitive data) would demonstrate that Beijing is serious about bolstering market confidence and balancing national security concerns with business needs. It is still at a very early stage, but the China Securities Regulatory Commission is reportedly confident in reaching a deal and is speaking with the Public Company Accounting Oversight Board (PCAOB) actively to resolve the dispute.

5) China Healthcare Technology

In late June 2022, the China National Medical Products Administration published an opinion draft on the proposed amendment of the Drug Management Law (DML Draft). The DML Draft explicitly states that third-party platform providers cannot be directly involved in the sales of drugs. In other words, if the amendment is passed, healthcare technology companies will have to limit their business scope to either be (i) a technology service and system provider to hospitals/pharmacies or (ii) a pure online drugstore. We think this limitation will preclude synergy between healthcare system developers, medical service providers and drugstores.

This is a sharp change in regulatory direction in our view, especially as the recently announced "Internet Diagnosis and Treatment Rules - Trial Implementation" (IDT Rules) essentially removed worries over further regulatory tightening. The General Office of the National Health Commission and the National Administration of Traditional Chinese Medicine jointly published the IDT Rules on 9 June 2022. The IDT Rules, largely unchanged from the draft version announced on 27 October 2021, clearly define the responsibilities of and prohibitions on various parties in providing internet healthcare services. Share prices of healthcare technology companies had been on steroids since the beginning of June 2022. But the announcement of the DML Draft immediately erased half of the their price gains (see Chart 3).

CHART 3. SHARE PRICE PERFORMANCE OF CHINA INTERNET HEALTHCARE STOCKS



Source: Bloomberg, as of June 2022
Past performance is not indicative of current or future performance

In case the DML Draft is fully implemented, we reckon the leading healthcare technology companies will have to segregate their core businesses into separate entities – an online drugstore and an information technology company specialised in healthcare systems. We find that there are too many moving parts for how the industry will evolve. In a blue-sky scenario, online drugstores with dedicated logistics networks should grow with high demand for safe and convenient medicine/supplement purchases. Healthcare system developers may also see opportunities of penetrating into markets of other medical products and devices. On the other hand, the bear case scenario is that online drugstores would engage in head-to-head competition against their e-commerce platform parents. Even worse, the IDT Rules that ban third-party healthcare platforms from collecting patient data have carved out one of the most valuable elements from healthcare systems.

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