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Chief Investment Office

PERSPECTIVES Viewpoint Equity

China – Upside driven by AI optimism and policy stimulus

March 13, 2025

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Key takeaways

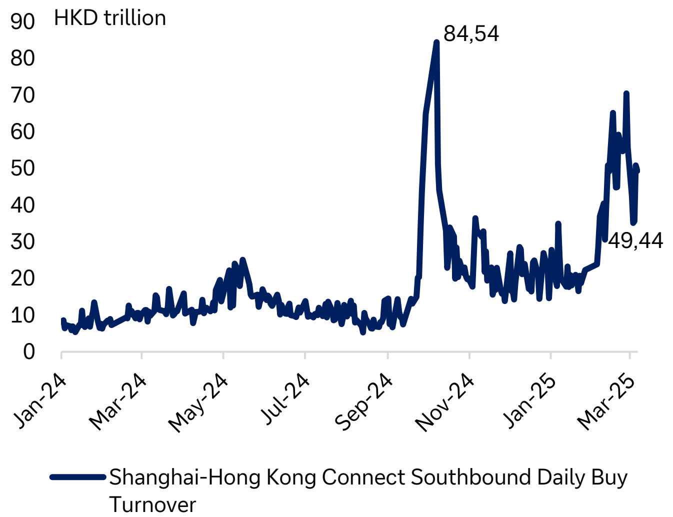
- The benchmark Hang Seng Index has rallied 17.6% YTD, beating major indices such as the S&P 500, Nasdaq 100 and Stoxx Europe 600, driven by strong inflows into AI stocks.
- Looking ahead, the upcoming April 2 review of U.S. trade policy, as a potential new date for new tariff announcements, currently still overshadows the decoupling potential that could be present for Chinese equities.
- However, we believe the influx of long- and medium-term capital into Chinese equities is likely to further bolster recent rallies and enhance market sentiment in 2025. Some factors that could support the rally going forward include the AI buildout and its implications for productivity and profitability, sustainability of the macroeconomic recovery driven by policy support and improving corporate earnings expectations.
- Valuations remain attractive with Chinese indices trading at a significant discount to global peers. The MSCI China is trading at a 1-year forward P/E of 11.2x with EPS growth expectations of 8.6%, Hang Seng at 10.3x and 4.6% vs the S&P 500 at 21.1x and 11.5% and the Stoxx Europe 600 at 14.0x and 6.6%. We reiterate our preference for the IT, consumer discretionary and green energy sectors.

What has driven the rally in Chinese equities?

The benchmark Hang Seng Index (HSI) (83 stocks) of mainland China's blue-chip companies, which is largely comprised of financials (33% of market capitalisation), consumer discretionary (28%) and IT (16%), has rallied 17.6% YTD, beating major indices such as the S&P 500 (-4.8%), Nasdaq 100 (-6.7%) and Stoxx 600 (+6.6%). The Hang Seng Tech index (30 stocks) rose 30.8% YTD on the back of the news on DeepSeek's disruptive AI training model. The tech sector optimism also spread to other sectors with China's H share index (50 stocks), which tracks mainland Chinese companies and has a similar composition to the HSI, rising 19.1% YTD.

Mainland Chinese indices have not risen in tandem, however, with China A-shares, the CSI 300 and the Shanghai Composite remaining largely flattish at 0.6%, -0.2%, and 0.6% respectively in 2025. This is because of strong southbound inflows (i.e. from the mainland to Hong Kong) of approximately HKD286.9bn YTD – the majority of which went into AI-related stocks. That said, foreign inflows into mainland China equities have also risen following the recovery in consumption during the Lunar New Year holiday season.

Figure 1: Shanghai-Hong Kong connect southbound daily buy turnover

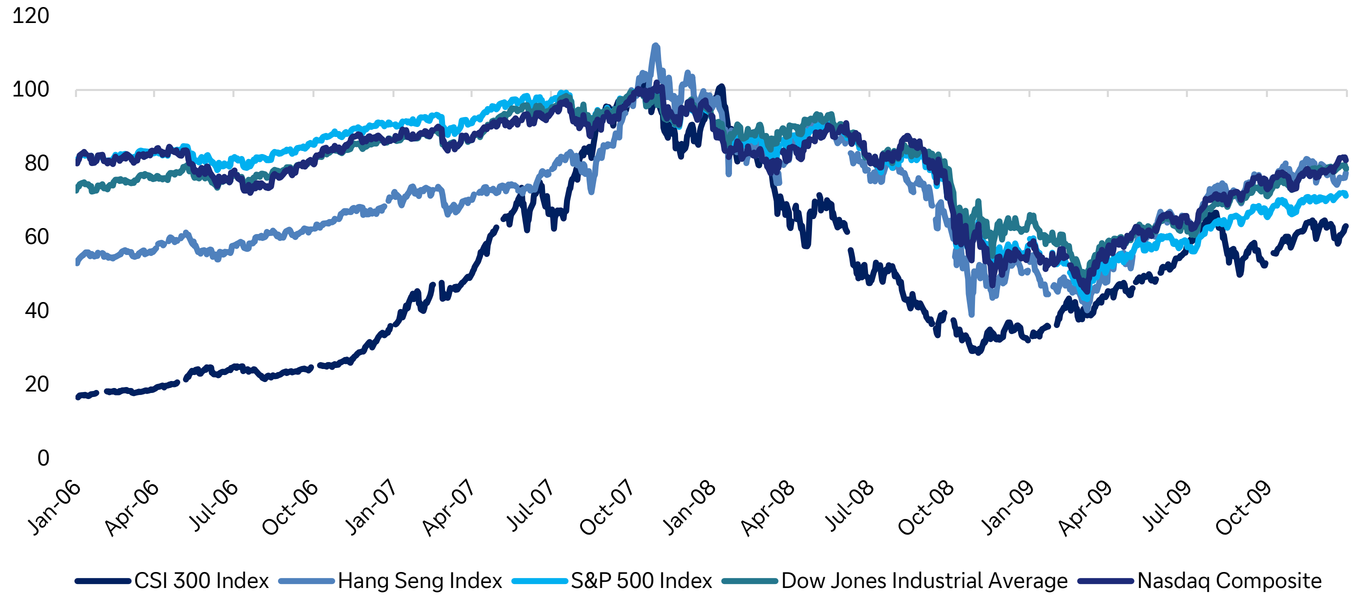


Source: Bloomberg Finance L.P., Deutsche Bank. Data as of March 7, 2025

Implications of a U.S. growth slowdown

With rising uncertainties around U.S. growth prospects and looming recession risks, Chinese equities may face downward pressure from their U.S. counterparts, should U.S. underperformance persist.

Figure 2: Chinese equity moves around 2007 S&P crash (October 9, 2007, indexed 100)



Source: Bloomberg Finance L.P., Deutsche Bank. Data as of February 28, 2025.

History shows that when U.S. equity indices crashed in 2007, Chinese equities displayed stronger correlation to U.S. price movements in periods after the peak than before it. The Hang Seng Index, being more exposed to capital flows and international investors, was more synchronized with the S&P 500 than the CSI 300. The latter displayed greater volatility and larger drawdowns too, given its heavily onshore investor base.

Compared to 2007, China's foreign trade volumes with the U.S. are much higher, and companies listed in the U.S. and China have footprints globally. Lower U.S. growth momentum this year could potentially have negative implications for Chinese manufacturing industry, hence resulting in lower GDP growth. Earnings for companies with a U.S. presence may come down, compounding the downward pressure despite positive signals from domestic Chinese economic developments.

Potential impact of tariffs

A cumulative 20% tariff became applicable on all Chinese products imported into the U.S. from March 4, 2025. This new tariff is in addition to the 25% imposed by President Trump during his first term on approximately USD370bn worth of goods. Last year, under former President Biden, some of these products had already experienced significant tariff increases, including a doubling of duties on Chinese semiconductors to 50% and a quadrupling of tariffs on Chinese electric vehicles to over 100%. The additional 20% tariff also applies to previously unaffected goods, including smartphones, laptops, videogame consoles, smartwatches, speakers and Bluetooth devices.

Whilst a lingering trade war and the possibility of additional future tariffs remain concerns, the reality is that China has been much less of a focus of the new Trump administration than originally anticipated by market participants. Looking ahead, the upcoming April 2 review of U.S. trade policy, providing a potential new date for new tariff announcements, currently still overshadows the decoupling potential that could be present for Chinese equities.

Whilst the situation remains dynamic, we acknowledge Chinese equities are not immune to global uncertainty and risk-off sentiment. However, the tariff situation itself is of less concern, especially as tariffs have so far remained less onerous than was expected going into 2025.

China has reiterated its opposition to unilateralism and protectionism in all forms, as stated in the Government Work Report. The Drafting Committee referred to a "follow-up macroeconomic policy plan" which will be adjusted in response to unfolding external events. China has recently announced a 15% tariff on imported chicken, wheat, corn and cotton, while a 10% tariff is to be imposed on sorghum, soybeans, pork, beef, aquatic products, fruits, vegetables and dairy products. China's counter tariffs were set below 20%, indicating that negotiation rather than escalation of the conflict remains its preferred course of action.

Will the rally continue or fizzle out?

We evaluate some factors that could impact the rally in future, including the AI buildout and its implications for productivity and profitability, sustainability of the macroeconomic recovery and earnings expectations of various sectors.

a. AI impact

The Chinese government recently indicated a strategic shift in stance towards the tech sector with President Xi Jinping's meeting the heads of the country's leading tech companies. The move was aimed at bolstering private sector confidence, a change from the previous regulatory crackdown on the tech sector. Following the meeting several Chinese companies announced huge capex plans to build AI and the cloud infrastructure needed to process and distribute large amounts of AI-generated data. These investments are among the largest to date, exceeding the combined tech investments of the past decade. That said, U.S. technology companies with planned investments of up to hundreds of billions of U.S. dollars per year, are ahead of their Chinese counterparts, who plan investments in the low tens of billions. The willingness of companies to invest is critical to the pace of innovation. The conditions must also be right. Beijing could now move quickly to follow through on its recent commitment to the private sector and regain the confidence of international investors.

Meanwhile, the Chinese government in its recently concluded NPC report mentioned strategies to support the growth of "unicorns" and smaller "gazelle" companies, promote the healthy and well-regulated development of the platform economy, and foster "emerging industries of the future". These agenda items reaffirm our belief that the Chinese technology sector is likely to continue benefitting from the measures. While AI investments are largely still in the nascent stage, some companies could lead the way in terms of adoption. Despite the scale of planned investment, the impact in terms of productivity and profitability gains is likely still a few years away. Only quick adopters and first movers are likely to outperform. We remain selective on sectors, given the still subdued Chinese macroeconomic environment and tariff risks.

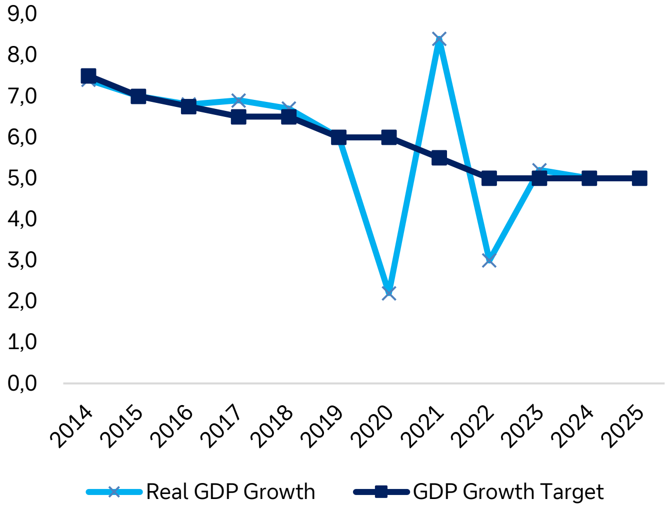
b. Fresh policy support highlights pro-growth policy

We highlighted the positive consumption trends observed over the Chinese New Year holiday period in a recent CIO Memo (China – Holiday effect and AI boost sentiment) . However, the sustainability of the macro recovery remains to be seen. Manufacturing PMI remained expansionary at 50.2 in February due to front-loading of export orders ahead of tariffs. However, export growth in February was underwhelming at 2.3% YoY – well below consensus expectations of 5.0%. Inflation data also came in lower than expected, with February CPI at -0.7% and PPI at -2.2% prompting calls for more fiscal action.

Whilst recent data releases peer into the rear-view mirror, the recently concluded "Two Sessions" provide forward-looking perspectives.

China set its GDP growth target for 2025 at 5% and raised its deficit-to-GDP ratio by 1 percentage point to 4%, as widely anticipated. The Consumer Price Index (CPI) growth target has been moderated by 1 percentage point, down to 2%. The Drafting Committee for the Government Work Report expressed confidence in these targets, citing several positive factors for economic growth, including a rebound in consumption and travel, recovering asset prices, and improved business sentiment.

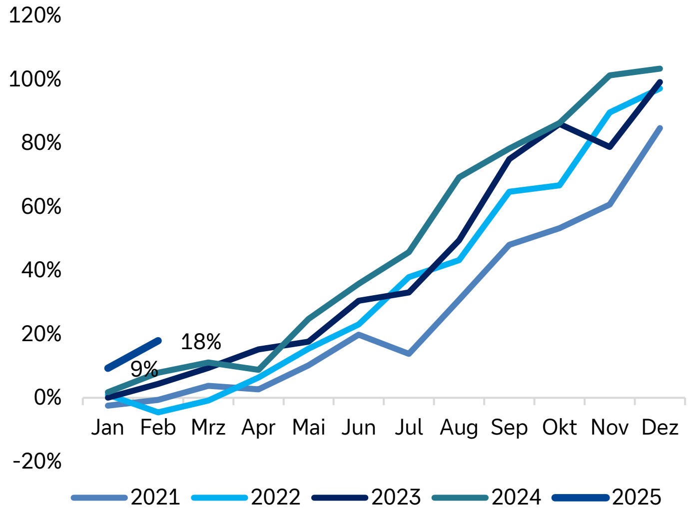
Figure 3: Chinese growth vs. targets over the last decade



Source: NBS, Deutsche Bank. Data as of March 12, 2025
Note: Real GDP growth figures are official and revised

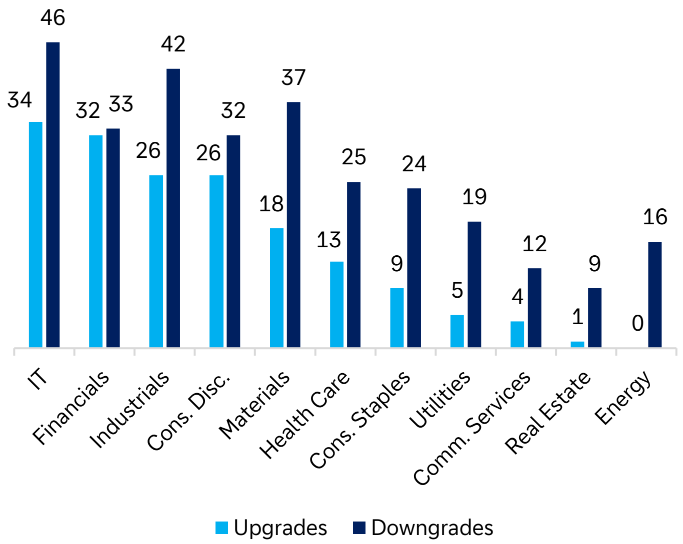
In addition, issuance of a total of CNY1.3tn (approximately USD182bn) of ultra-long term special treasury bonds (up CNY0.3tn vs 2024) was announced, alongside CNY4.4tn (USD614 bn) of local government special-purpose bonds. With a higher fiscal deficit target set at 4% of GDP, government bond net-financing has accelerated this year. The announcement of additional fiscal stimulus, a commitment to proactive monetary policy measures to achieve 5% growth and the emphasis on structural topics – for instance, the acknowledgement of the role of private companies in AI and tech as positive contributors to innovation, employment and consumption – are a continuation of China's pro-growth policy. We consider these measures critical for sustaining heightened market sentiment and reinforcing confidence in Chinese equities. The influx of long- and medium-term capital into the market is expected to further bolster recent rallies and further enhance market sentiment.

Figure 4: Government bond net financing as % of fiscal deficit target



Source: Deutsche Bank. Data as of March 12, 2025.

Figure 5: MSCI China 12m forward EPS revisions by sector over the past one month



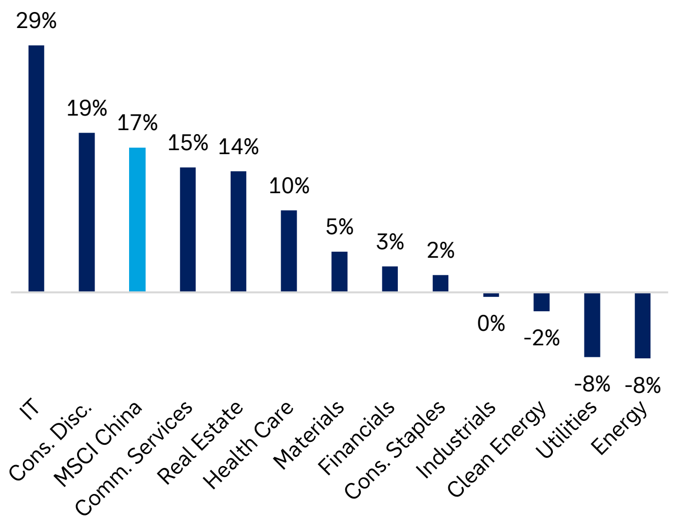
Source: LSEG Datastream, Deutsche Bank. Data as of March 12, 2025.
Note: For MSCI China indices

c. Earnings lifted by AI and tech outperformance

About 24% of the Hang Seng Index companies have released Q4 2024 earnings to date with an average beat of 14.25% on profits and 2.81% on sales. The beat was mainly driven by AI and tech sectors with some big companies reporting strong earnings surprises. These companies are also planning to make huge investments in AI over the coming years. According to industry estimates, wide adoption of AI could uplift China corporate profits by 2% every year for the next decade while AI benefits are expected to drive up valuations by 15-20% and net inflows by USD200bn over the next decade.

For the CSI 300, 23% of the index by market cap had reported Q4 2024 earnings as of March 9, with a beat/miss ratio of 43%/55% and EPS growth of 34.3% YoY despite a 1% YoY decline in revenues. About 25% of the MSCI China index (580 constituents) by market cap have reported earnings with a beat/miss ratio of 46%/50%, EPS growth of 16.2% YoY and revenue growth of 8.1% YoY. In terms of sector earnings revisions, IT, consumer discretionary, financials and industrials saw the most upgrades to their 12-month forward EPS estimates.

Figure 6: MSCI sectoral returns, 2025 YTD



Source: LSEG Datastream, Deutsche Bank. Data as of March 12, 2025.

Sectors we like

Whilst the initial rally was mainly driven by a focus on China's innovation ability around AI, we expect the rally to broaden over time. Sectors that should benefit continue to be those of strategic importance to China that enjoying ongoing government support. Our top sector picks since February 2024 – IT, consumer discretionary and green energy – are within this group. We reiterate our preference for these sectors.

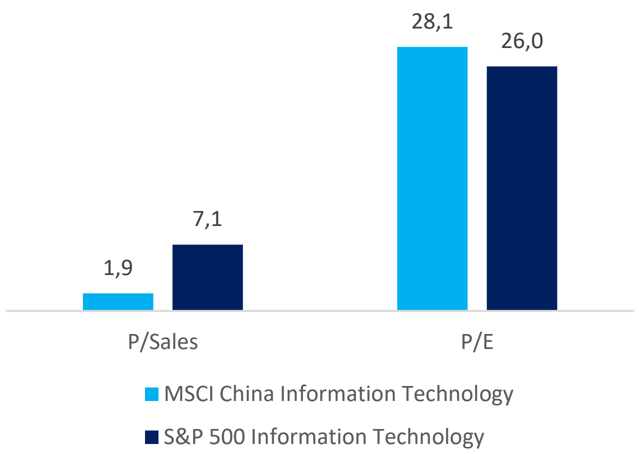
a. Information Technology

We see potential for earnings growth and re-rating in the IT sector, driven by AI adoption and policy support. China is likely to see a similar pattern to its U.S. peers with AI infrastructure providers as well as AI end-users expected to benefit from AI innovation. China's gaming industry is expected to be a quick adopter of AI technology in game production which should boost game quality and product launches.

Chinese gaming companies are seeing strong revenue growth given their high market share in domestic as well as global markets and their ability to release chartbuster games. Similarly, Chinese smartphone manufacturers have been rapid adopters of technologies such as 5G, AI etc., enabling them to charge a premium for new models.

China's tech sector is trading at a significant discount to the U.S. tech sector on some measures (26% of U.S. tech P/Sales) offering attractive buying opportunities. The recent strong southbound inflows were largely directed towards AI-related sectors, with internet services, ecommerce providers and IT firms attracting over 50% of these inflows.

Figure 7: Tech sector valuations



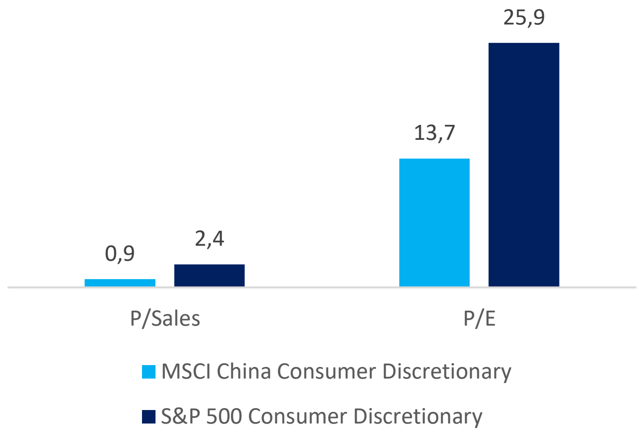
Source: LSEG Datastream, Deutsche Bank. Data as of March 12, 2025.

b. Consumer Discretionary

Within consumer discretionary, automobiles and autonomous driving in particular are expected to see strong growth, driven by expectations of rapid AI adoption. Chinese electric vehicle (EV) makers have shown a strong desire to increase capabilities in cutting-edge technology. For example, a leading Chinese EV maker announced its plans to produce flying cars and industrial robots on a commercial scale by 2026, although regulatory hurdles remain and the financial impact may not be immediately visible. EV and hybrid sales have soared to record high levels thanks to the trade-in programme for green vehicles. Sales of new energy vehicles (NEVs) rose 40% YoY in 2024 due to the trade-in schemes, accounting for nearly 47% of total car sales. However, industry profit margins are narrowing due to intense price competition.

Household appliances should also benefit from a trade-in programme and adoption of AI into smart appliances. Ecommerce companies are likely to benefit from the rising sales of smartphones and home appliances on the back of the government's doubling of the allocation to the consumer goods trade-in programme this year to CNY300bn from CNY150bn in 2024.

Figure 8: Consumer discretionary valuations



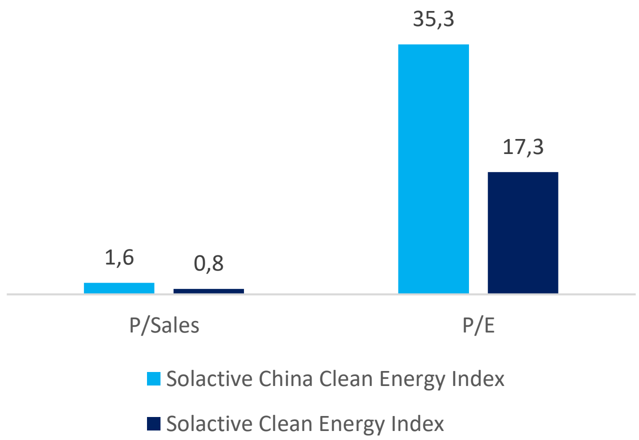
Source: LSEG Datastream, Deutsche Bank. Data as of March 12, 2025.

Retail sales in tier 1 cities appear to be stabilising with the bottoming-out of the property sector. The recent bailout of a huge property developer and other measures focused on the property sector announced during the NPC by the Chinese government should also help boost consumer confidence.

c. Green energy

China's government is working towards liberalising the renewable energy sector. By the end of 2025, wind and solar power producers will have to sell electricity at market rates instead of the pre-guaranteed offtake agreements that constituted nearly 50% of their revenues previously. The liberalisation move is aimed at fostering competition, improving efficiency and reducing the reliance on fossil fuels.

Figure 9: Green energy sector valuations



Source: Bloomberg Finance L.P., Deutsche Bank. Data as of March 12, 2025.

Despite the removal of subsidies to the renewables sector, the green energy sector should benefit from the ongoing global green transition. China has already achieved its 2030 renewable energy target capacity of 1,200 GW five years in advance. China is a key exporter of power transformers which are expected to see strong demand growth globally while the penetration rate for smart meters remains low in emerging markets.

Upcoming catalysts

The upcoming data on new bank lending and retail sales will provide insights into consumer sentiment following the upbeat spending during the Lunar New Year holidays. After hitting a record high level of CNY5.13tn in January due to New Year holiday seasonality, new yuan loans will likely have eased in February. Retail sales for February are expected to have increased by 4.0% YoY, up from 3.7% YoY in the previous month. PMIs will be a key monitorable to gauge any sustained improvement in business sentiment following the Lunar New Year activity surge.

In addition to the fiscal stimulus, PBoC's rate/RRR cuts could also support the pace of recovery. Q1 GDP numbers to be released in mid-April should likely factor in the Lunar New Year spending optimism and the impact of the recent fiscal measures. In terms of political events, Politburo meetings in late April and July will be followed by the NPC Standing Committee meeting in late October and the Central Economic Work Conference (CEWC) in December. Additional fiscal policies to support domestic demand could be announced at these events in the event of any economic slowdown caused by higher tariffs.

Conclusion

The current rally in Hong Kong equities is now being tempered by concerns of U.S. trade policies stoking a possible recession in the U.S. The pullback is not due to a negative view on China but an overall risk-off sentiment globally. As discussed above, Chinese equities may face downward pressure from their U.S. counterparts should the underperformance persist. However, it should be limited to companies with U.S. exposure. While the lingering trade war and the possibility of future tariffs remain concerns, China has been much less of a focus for the new Trump administration than originally anticipated by market participants. Looking ahead, the upcoming April 2 review of U.S. trade policy, as a potential new date for new tariff announcements, currently still overshadows the decoupling potential that could be present for Chinese equities. China's continued fiscal support is critical for sustaining heightened market sentiment.

While the initial rally was mainly driven by China's innovation ability around AI, we expect the rally to broaden over time. Chinese equities are trading at a significant discount compared to global peers. The MSCI China is trading at 1 year forward P/E of 11.2x with EPS growth expectations of 8.6%, Hang Seng at 10.3x and 4.6% vs 21.1x and 11.5% for the S&P 500 and 14.0x and 6.6% for Stoxx 600. The influx of long- and medium-term capital into the market is expected to further bolster recent rallies and enhance market sentiment in 2025. Sectors that will benefit continue to be sectors of strategic importance to China, enjoying continued government support. We reiterate our preference for the IT, consumer discretionary and green energy sectors that could benefit from AI-related trends, fiscal policy support and attractive valuations.

Glossary

The **Central Economic Work Conference (CEWC)** takes place annually in People's Republic of China to set economic and strategic priorities.

Chinese A-shares are shares of mainland companies, with limited accessibility to foreign investors.

Chinese H-shares are shares of mainland companies, listed on Hong Kong stock exchange.

CNY is the currency code for the Chinese yuan.

The **CSI 300** Index consists of 300 A-shares traded on the Shanghai and Shenzhen stock markets.

DeepSeek is a Chinese artificial intelligence company.

The **deficit-to-GDP** ratio is the ratio between a country's government deficit to GDP.

Earnings per share (EPS) are calculated as a companies' net income minus dividends of preferred stock all divided by the total number of shares outstanding.

HKD is the currency code for the Hong Kong dollar.

The **Hang Seng Index (HSI)** includes the 50 largest companies traded on the Hong Kong stock exchange.

The **Hang Seng Tech Index** tracks the 30 largest technology companies listed in Hong Kong.

The **MSCI China** includes various share types (H shares, B shares, red chips, ADRs etc.) listed on Shanghai or Shenzhen indices with a focus on large and mid caps.

The **National People's Congress (NPC)** is China's legislative assembly which holds annual sessions every spring.

Price/earnings (P/E) ratios measure a company's current share price relative to its per-share earnings. In this context, LTM refers to last twelve months' earnings.

Price-to-Sales (P/S) ratio compares a company's stock price to its revenue.

The **Nasdaq 100** Index is a collection of the 100 largest, most actively traded companies listed on the Nasdaq stock exchange.

The **People's Bank of China (PBoC)** is the central bank of the People's Republic of China.

Reserve requirement ratios (RRR) determine the proportion of banks' deposit liabilities that must be held as reserves.

The **EuroStoxx 50** Index tracks the performance of blue-chip stocks in the Eurozone; the **Stoxx Europe 600** has a wider scope, taking in 600 companies across 20 European Union countries.

The **S&P 500** Index includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

TikTok is a video-sharing social media owned by Chinese technology company known as **ByteDance**.

USD is the currency code for the U.S. Dollar.

Appendix

Historical performance

Performance	12.3.2020 - 12.3.2021	12.3.2021 - 12.3.2022	12.3.2022 - 12.3.2023	12.3.2023 - 12.3.2024	12.3.2024 - 12.3.2025
S&P 500	59.0%	6.6%	-8.2%	34.0%	8.2%
STOXX Europe 600	43.5%	1.9%	5.2%	11.6%	6.9%
Nasdaq 100	78.1%	2.8%	-11.1%	54.0%	7.6%
Nasdaq Composite	85.0%	-3.6%	-13.3%	46.0%	8.5%
Dow Jones	54.6%	0.5%	-3.1%	22.2%	6.0%
Hang Seng	18.2%	-28.5%	-6.0%	-11.5%	38.1%
Hang Seng Tech	83.9%	-49.8%	-10.9%	-3.7%	60.4%
China H shares	14.9%	-36.8%	-8.7%	-7.7%	45.9%
CSI 300	30.3%	-16.3%	-7.9%	-9.3%	9.2%
China A shares	18.1%	-4.2%	-2.4%	-5.4%	10.3%
Shanghai Composite	18.1%	-4.2%	-2.4%	-5.4%	10.3%
Shenzhen Composite	22.1%	-2.1%	-4.0%	-15.2%	18.1%
MSCI China	45.4%	-39.8%	-6.1%	-10.6%	35.3%
MSCI China Energy	2.2%	20.5%	14.7%	16.7%	-11.8%
MSCI China Materials	39.0%	-7.8%	-11.3%	-22.9%	11.1%
MSCI China Industrials	12.3%	-3.4%	-6.4%	-20.6%	16.0%
MSCI China Cons. Disc.	51.9%	-51.7%	1.0%	-20.4%	44.0%
MSCI China Cons. Staples	37.1%	-19.2%	-1.9%	-29.7%	-0.6%
MSCI China Health Care	38.7%	-36.9%	3.5%	-32.2%	2.3%
MSCI China Financials	6.7%	-19.6%	-6.1%	-11.7%	37.5%
MSCI China IT	35.7%	-29.4%	-13.7%	-19.4%	93.4%
MSCI China Comm. Services	57.6%	-42.7%	-1.2%	-21.2%	56.6%
MSCI China Utilities	12.1%	-1.3%	-6.8%	-16.3%	0.5%
MSCI China Real Estate	-8.5%	-38.7%	-24.8%	-47.8%	29.4%
S&P 500 Information Technology	75.9%	43.1%	-13.3%	-26.8%	-5.1%
S&P 500 Consumer Discretionary	73.5%	-1.1%	-18.5%	36.1%	8.6%
Solactive China Clean Energy Index	125.4%	-6.9%	4.3%	-16.7%	0.6%
Solactive China Energy Index	91.9%	49.5%	-15.6%	-28.1%	-0.8%

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