CIO Special

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China: growth key to market upside

Key takeaways

- China's manufacturing sector is staging a modest recovery. Consumption continues to improve but the property market remains weak.
- Tactically there could be some more momentum left in Chinese equities, but the property market will continue to provide a drag.
- The ongoing re-evaluation of China by investors supports our expectations of a broad and sustained recovery in Chinese equities in H2.

01 Manufacturing recovery

China's GDP grew by 5.3% year-on-year (YoY) in Q1 2024, and some early indicators point to continued modest growth in Q2. The manufacturing sector continues to expand output and improved demand indicators may point to an imminent reduction in over-capacity.

The official National Bureau of Statistics (NBS) Manufacturing PMI remained above the 50-point growth threshold in April for the second consecutive month, at 50.4. Its production component rose by 0.7 points to 52.9, its highest level in 13 months. The Caixin manufacturing PMI, which focusses on private small and medium-sized export-oriented companies, climbed to 51.4 in April. Here too, the rise in the output component from 52.8 to 53.1 points signalled the strongest level of activity for almost a year. (Note, however, that the NBS Composite PMI fell from 52.7 to 51.7 points in April indicating some slowdown in momentum in services, as discussed below.)

Higher output is prompting concerns that excess supply may be building up as a result of subdued domestic and foreign demand, and that this could exert prolonged downward pressure on prices. At first glance, the decline in the purchase component of the NBS PMI (by 1.9 to 51.1) might seem to confirm this. However, this sub-index had previously risen sharply by four points in March, so the two-month trend remains positive for forward-looking demand in the manufacturing sector. Moreover, the export orders component of the Caixin Manufacturing PMI rose for the fifth consecutive month in April, reaching 53.3, its highest level since December 2020. Manufacturing prices also provide some grounds for optimism. The NBS input price component rose sharply by 3.5 points to 54.0 (the highest level in seven months), while the input price component of the Caixin PMI increased by 2.5 points to 51.4 (the highest level in six months).

China's merchandise exports increased by 1.5% YoY in April, compared to a decline of -7.5% in March, with strong exports of autos and high-tech products. Imports increased by 8.4% YoY. Better-than-expected exports could indicate improving external demand on the back of better global economic conditions. Exports to Southeast Asia had the strongest regional growth.

All in all, we think expansionary PMIs and export growth suggest a continuing gentle improvement in China's manufacturing sector.

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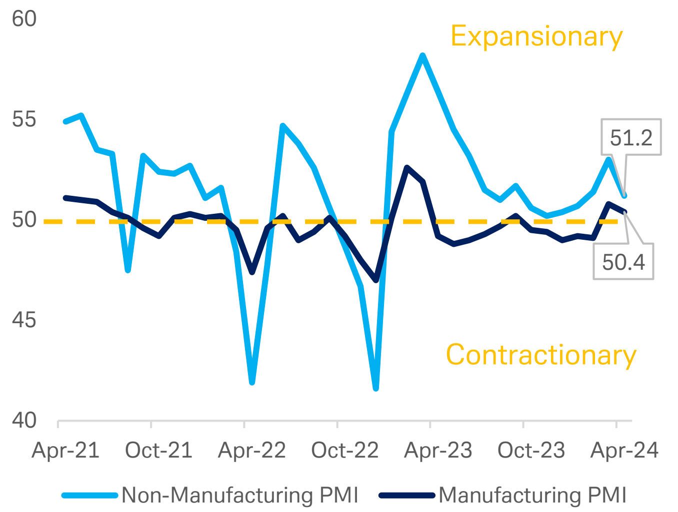
Figure 1: Manufacturing PMIs stay expansionary



Source: LSEG DataStream. Deutsche Bank AG.
Data as of May 13, 2024.

Figure 2: Export and import growth up in April

Source: LSEG DataStream. Deutsche Bank AG.
Data as of May 13, 2024.

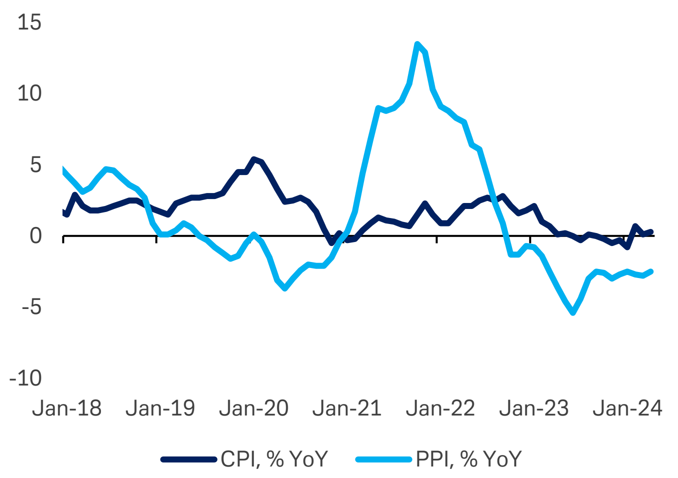
02 Consumption and prices

Travel spending suggests a moderate and ongoing consumption recovery. According to China's Ministry of Culture and Tourism, there were 295 million visitors to China's tourism attractions during the 5-day Labour Day holiday in 2024, up 7.6% compared to same period last year. Tourism spending increased 12.7% compared to last year although average spending per person remained lower than the pre-Covid levels in 2019. This is likely due to the nature of domestic tourism, with more domestic travellers from lower-income groups, and more trips therefore being made to smaller towns and cities, where average spending would usually be lower. Higher-income groups may also prefer to travel abroad during these holidays.

China's consumer price inflation was 0.3% YoY in April, compared to 0.1% in March – the third month in a row that it has been positive YoY. April's slightly higher CPI rate may reflect a gradual improvement in domestic consumption in recent months but is of course still far lower than the government's target of 3% inflation for this year. Producer price inflation however stayed negative at -2.5% YoY in April (vs. -2.8% in March).

We believe that China's consumption recovery is still affected by the relatively weak labour market conditions. Looking for work remains difficult, especially for younger people, and this may have encouraged more people to spend carefully during their holiday travels. There is also a negative wealth effect from the property market , as people feel that their total wealth is declining along with lower property prices in most cities. However, we think further export and manufacturing sector recovery later this year may lead to further labour market improvement. Consumption may see a firmer recovery later this year on the back of this labour market recovery.

Figure 3: CPI stays positive; PPI decline stabilises



Source: LSEG DataStream. Deutsche Bank AG.
Data as of May 13, 2024.

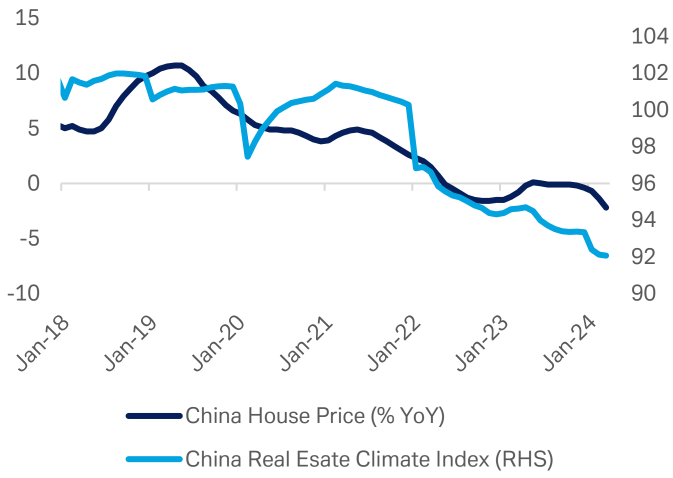
03 Property sector

Service sector PMIs continued to be dragged down by the property sector. The NBS Non-Manufacturing (Service) PMI, which reflects sentiment among China's service providers and construction businesses, fell from a strong 53.0 in March to 51.2 in April, well below expectations. However, under the surface, there are clear sectoral differences. While rail and road transport as well as postal and telecommunication services have reported solid activity growth, with readings above 55, property service providers are still in a process of contraction.

The downward trend in the residential property sector continued in April and there are still no signs of a bottoming out. In the first four weeks of April, new home sales were down -40% YoY and fell -57% compared with the 4-year average.

At last Tuesday's Politburo meeting, policymakers kept their overall guidance for the property sector largely unchanged. However, the new intention "to study how to digest the existing housing inventory and optimize the new housing supply" could be viewed as a slight positive for property policy. In recent weeks many tier-1 and tier-2 cities have also significantly loosened or lifted purchase restrictions to further support property transactions. Recently, Chengdu, a 20-million metropolis in western China, has announced the lifting of purchase restrictions and Nanjing, a 10-million city on the Yangtse river 300 kilometres west of Shanghai, has relaxed its official residency controls under the local hukou (population registration) system. However, we would caution against overly optimistic expectations of a rapid and sharp increase in property demand. There is much to suggest that the property sector is unlikely to make a positive contribution to growth in coming quarters.

Figure 4: Property sector shows further weakness



Source: LSEG DataStream. Deutsche Bank AG.
Data as of May 13, 2024.

04 Chinese equities

From an investor's perspective, a positive start to Q2 for Chinese equities has made up for some of the earlier pain. Since its trough in late January, the HSCEI has rebounded by more than 30%, outperforming other EM and DM markets which have generally generated single-digit gains. The recovery was further supported by measures announced by the China Securities Regulatory Commission to strengthen Hong Kong's status as a financial centre, e.g. through supporting the listing of leading mainland companies in the HK market and enhancing mutual fund recognition.

The rebound in Hong Kong-listed developers has been even more pronounced. They rallied by an impressive 20% in the second half of April, reducing their YTD losses to around -6%. The rebound was mainly driven by speculation about further easing of property purchase restrictions in major tier 1 and tier 2 cities.

While it is true that property companies account for less than 3% of total H-share market cap, the sector is important for investor sentiment as it still contributes around 20% to the country's GDP. As a result, we expect developments in China's property market to continue to have a significant impact on the equity market as a whole. As long as a turnaround in property demand and prices is not in sight, the associated uncertainty might therefore add to a higher risk premium, not only for the sector itself but also for the broader equity market, putting the historically still low valuations of H-shares (NTM P/E of less than 10x) into a slightly different perspective.

The MSCI China P/E has now risen by more than 20% from January lows. However, its current 10x valuation still seems inexpensive relative to the 10Y-average. Despite an improvement in foreign inflows, overall investor positioning remains low.

On May 12 China decided to stop displaying real-time data on transactions of A-share stocks via trading links between the mainland and Hong Kong. Instead, they will only report the daily transaction data and the top 10 most-traded stocks after the trading day is over. This is an effort to limit the impact of real-time data on foreign buys and sells on the A-share market. In some circumstances, foreign funds' sales of A-share stocks could worsen market sentiment. Foreign investors have returned to mainland equity market, as so-called "northbound" investors (from Hong Kong to the mainland) in net terms bought China A-shares for the third consecutive month in April. Data from Bloomberg suggests that such investors have added back more than half of what they had sold since August 2023.

Tactically there could still be some more momentum in Chinese equities, given equities seem to anticipate the success of some of the policy measures used to support the market while macro-economic data gradually turns around. However, the property market continues to provide a drag. From a medium and long-term perspective, we would prefer first to see evidence of a more solid recovery in the macroeconomic environment and at least stabilization in the property sector.

Pro-active fiscal and monetary measures are likely to continue for the rest of the year. The global economy is also expected to exit its recent soft patch, which should support China's export sector growth later this year. Household consumption is likely to recover further with the continued improvement in labour market conditions. We would favour those sectors which are likely to receive more policy support, including consumer discretionary, technology and green growth-related sectors.

05 Conclusion

The recent positive performance by Chinese equities has been mainly driven by a modest improvement in macroeconomic data, the government's continued support for the property sector (impacting consumer sentiment) and foreigner investors' increased positioning in the market. Recent momentum could continue in the short term on the back of this shift in sentiment and flow allocation, although our preference would be to see more robust stabilisation in macroeconomic data first. The ongoing re-evaluation of China by investors supports our expectations of a broad and sustained recovery in Chinese equities in H2.

Figure 5: Comparative valuation of HK/China equities

Source: LSEG DataStream. Deutsche Bank AG.
Data as of May 13, 2024.

Glossary

CNY is the currency code for the Chinese yuan.

The Consumer Price Index (CPI) measures the overall change in consumer prices based on a representative basket of goods and services over time.

The China Securities Regulatory Commission (CSRC) is a government agency directly under the State Council of the People's Republic of China. It is the national regulatory body that oversees the securities and futures industry in China.

Foreign direct investment (FDI) is a category of cross-border investment in which an investor resident in one economy establishes a lasting interest in and a significant degree of influence over an enterprise resident in another economy.

GRE refers to Government-related entities in China.

Gross domestic product (GDP) is the standard measure of the value added created through the production of goods and services in a country during a certain period.

The National Bureau of Statistics (NBS), is a deputy-cabinet level agency directly under the State Council of the People's Republic of China.

The National People’s Congress (NPC) is China’s highest legislative body which holds annual sessions in spring to discuss on policy matters.

People’s Bank of China (PBoC) is the central bank of the people’s republic of China.

Purchasing manager indices (PMI) provide an indicator of the economic health of the manufacturing sector and are based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment. The composite PMI includes both manufacturing and services sectors. They can be published by public sector or private agencies (For example, Caixin, Nikkei etc.)

Producer price inflation (PPI) measures the change in prices received by producers (e.g. firms) for their output.

The Reserve ratio requirement (RRR) determines the amount of cash banks have to keep in reserve with the central bank.

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

Performance	10.5.2019 - 10.5.2020	10.5.2020 - 10.5.2021	10.5.2021 - 10.5.2022	10.5.2022 - 10.5.2023	10.5.2023 - 10.5.2024
Hang Seng	-15.1%	18.0%	-31.3%	0.7%	-4.0%
Shanghai Composite	-1.5%	18.4%	-11.4%	9.3%	-5.0%
FTSE 100	-17.6%	20.0%	1.7%	6.9%	8.9%
DAX	-9.6%	41.2%	-12.1%	17.4%	18.1%
Japan Nikkei	-5.5%	46.3%	-11.4%	11.3%	31.3%
Taiwan Composite	1.8%	58.1%	-6.8%	-2.6%	32.4%
India Sensex	-15.5%	56.4%	9.8%	13.9%	17.3%
S&P 500	1.7%	43.0%	-4.5%	3.4%	26.2%
Nasdaq 100	21.5%	44.9%	-7.6%	8.1%	36.1%
Hang Seng China Enterprises	-9.7%	7.9%	-37.5%	0.4%	0.5%
China A Shares	7.0%	39.5%	-22.2%	-1.0%	-14.8%
China H Shares	-9.7%	7.9%	-37.5%	0.4%	0.5%
MSCI China	0.4%	28.5%	-39.6%	0.7%	-1.8%
USD/CNY	3.9%	-9.3%	4.8%	3.0%	4.4%

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