UBS

For professional / qualified / Institutional clients and wholesale fund selectors investors only

17 March 2022

Can China's policy shift turn things around?

Geopolitical headlines drove punishing volatility in Chinese equity markets this week, but more monetary, fiscal and credit support from Beijing is likely to be on its way

In summary

Market volatility in China has been tremendous in recent weeks due to the culmination of a series of expected and unexpected events. A slowing economy, deteriorating COVID situation in various cities such as Shenzhen and Hong Kong as well as lingering fears of further regulatory clampdown exacerbated the investor nervousness that was already heightened from the shock of Russia's invasion of Ukraine, high commodity prices, weaker global growth prospects, the threat of US delisting of China-based companies and the start of the Federal Reserve's interest rate hikes.

Under the gravity of external and internal issues, China wrapped up its annual parliamentary meetings called the Two Sessions last week, laying out long-term plans for social, economic and environmental policies while calling economic stabilization an immediate priority. With the announcement of a 5.5% growth target for 2022—higher than market expectations—we believe stronger monetary, fiscal and credit support is likely to have to come from Chinese policymakers to provide the economy and markets with more backup. And backup is needed: Selloffs in Chinese equities this month were indiscriminate—though most also bounced back in subsequent rally.

What led to this precarious position were war in Ukraine and China's close ties with Moscow. Speculation on China's involvement runs rampant, even though Chinese leaders have called for dialogue between Russia and Ukraine, and have offered to play a mediator role to help move towards a peaceful settlement. Nonetheless, these speculations will continue to cloud markets in the near term. In this environment, is the China investment case still sound, and where should investors focus?

More monetary policy tools available

With heightened uncertainties and new downward pressure, this much is clear: China faces significant risks and challenges both at home and abroad. The 5.5% growth target for 2022 is the lowest official target for the economy in decades, albeit higher than expectations, and it's slightly lower than last year's already modest goal of 6%. The economy sharply decelerated in the final quarter of 2021 under "triple pressure"—shrinking demand, supply shocks and weakening sentiment—as well as regulatory crackdown in the property and technology sectors. We think China's economy will bottom in the first quarter and be set to recover over the rest of 2022. As the industrial cycle troughs, improvement should become more obvious starting in the second quarter. We believe import and Purchasing Managers Index (PMI) numbers should begin to recover, making a mid-year recovery a possibility.

In stark contrast to high consumer and producer prices around the world, inflation in China is relatively subdued. At the Two Sessions, the consumer inflation target was set at 3%, unchanged from last year, when consumer prices rose 0.9% for 2021 and consumption during Chinese New Year remained well below pre-pandemic levels. This gives the People's Bank of China (PBOC) a large monetary policy toolbox, and we believe the central bank is likely to continue to ease following its cuts to loan prime rates and the reserve requirement ratio early in the year. This runs opposite to the hawkish stance and monetary tightening of other major economies like the US and European countries that are struggling with high inflation.

That said, despite the push to bolster the Chinese economy with credit supply, financing available to the real economy remained tight and could take more time to reverse. Policy rate cuts are not as effective as they have been in the past, perhaps paradoxically because of the clampdown on shadow banking back in 2017-2019. The flip side of reining in overheating risks and market "froth" is that credit markets may be less agile, leaving the increased liquidity trapped in financial markets longer and not reaching the real economy right away. Even with signs that money and credit growth are starting to pick up, we believe economic growth will struggle to lift off in the first half of this year.

Fiscal support on the way

Policymakers are also looking to step up fiscal spending. Despite slower growth in fiscal revenue, the target for budget spending goes up 8.4% year-over-year, much higher than the 1.8% target in 2021. Some of the spending will be directed to boost domestic demand through large-scale subsidies, in

keeping with the long-term goal of moving towards a services-based economic model. A series of relief measures from tax exemptions to credit facilities are being offered to the service industry and small businesses that have been particularly hard hit by the pandemic lockdowns and restrictions.

Moreover, many infrastructure projects in transportation, logistics and telecommunications as well as advanced manufacturing and technology are being fast tracked, offering cash-strapped local governments larger funding transfers from the central government. Local infrastructure projects in Shanghai, Sichuan, Jiangsu, Zhejiang, Anhui and Hebei have been pushed forward, financed by new local government special purpose bond issuance. The cap for local bonds to fund infrastructure projects is set at 3.65 trillion yuan—about the same level as last year. The rush to launch could potentially bring renewed debt concerns, but in our view, a more proactive approach with fiscal spending is welcomed news.

Patience and confidence in the China equity story

We believe pro-growth measures are among several reasons to be constructive about China equities. Policy was key to last year's equity selloffs—and could be key to turn the market around this year. Recent regulatory probes on technology and healthcare companies are mostly extensions and implementations of last year's edict, but we think we are past the turning point in terms of policy risk.

In many ways, the Chinese market is more policy-driven than economy-driven. Case in point: The potential US delistings of Chinese technology companies added to regulatory concerns and helped set off broad declines in an already shaken market. The US Securities and Exchange Commission (SEC) added five Chinese American Depositary Receipts (ADRs) to a provisional list that might face the risk of delisting by 2024 if they failed to submit audit working papers for review. The SEC's move is not a surprise, nor is the timeline. Under new US regulations, all foreign US-listed companies must allow US authorities to access their audit records or face delisting after two to three years of noncompliance. However, Chinese companies are prohibited from providing access without Beijing's permission. We believe the five companies named by the SEC were cited because they were among the first US-listed Chinese companies to submit their 2021 annual reports. We expect more similar announcements in the coming weeks.

At this point, the US and China are actively working to resolve this current dispute, and we think they could reach an agreement on auditing disclosures within the coming year. While the US-China rivalry is not going away, a complete decoupling between the two countries is highly unlikely as the economic and financial linkage has deep roots. There is a low probability that all Chinese companies will be delisted from US exchanges.

Even if the two parties cannot come to an agreement, many major Chinese companies with ADRs have already opted for a secondary or dual listing in Hong Kong, in addition to their ADRs in the US. This should also in turn benefit Hong Kong in terms of increased flows. Hong Kong-listed shares and US-listed ADRs are fungible and can be freely converted in both directions with low conversion costs. As such, we continue to believe that the delisting threat is a manageable risk.

Ultimately, the selloff was overdone in our opinion, to an extent confirmed by the relief rally that followed. While we had underestimated the intensity of the market's risk-off sentiment, it's hard to tell whether stocks have hit bottom or when volatility would ease with an unpredictable war in Europe in the backdrop. As valuations fall to very compelling levels, however, we continue to focus on what matters in the long run: the fundamentals. We believe that investing in high quality Chinese companies with a strong track record of delivering sustainable growth and having proven themselves to be resilient under changing market conditions, should deliver strong returns over the long term for patient investors. And of course, the long-term trends that make China attractive remain, for example, the Chinese government's commitment to transitioning to a more domestic, service-oriented growth trajectory, increasing spending on healthcare, automation and digitization, and the move towards green energy and a cleaner environment. These, coupled with the continued relative underinvestment by international investors and the opening of Chinese capital markets, should provide opportunities for the active investor.

We continue to believe an active approach is critical to investing amid extreme market fluctuations. We rely on bottom-up, fundamental research to identify high quality companies that we think will prosper over a period of years, not months. Security selection should allow us to pick potential long-term winners among the oversold. An understanding of China's over-arching objectives however, and their potential implication on various sectors and companies, is an increasingly important consideration in our stock selection (see Figure 1).

When will property distress be over?

While we find China's monetary and fiscal policy shift promising, more supportive measures in our view are still needed to stabilize and drive a recovery in the beleaguered property sector. Home sales among the 100 largest property developers in the first two months of the year plunged 43% from a year earlier. The rapid decline in housing prices finally decelerated in January after being in negative territory for months, but the average 70-city property prices have not looked up. Top-tier cities are experiencing some price recovery, though lower-tier cities are likely still vulnerable to more declines. Construction starts have not picked up, partly

hampered by local Omicron resurgences. Several lower-tier city governments relaxed down payment requirements or lowered mortgage rates—and we expect more cities to follow suit—but home sales demand has yet to recover. The increased number of COVID cases in China and the resultant lockdowns of several cities are also hampering home sales recovery.

On the other hand, we are encouraged by recent news reports suggesting that the rules governing escrow accounts (trusts holding pre-completion cash) are to be eased. This would provide much needed liquidity to property developers after last year's cash crunch and indiscriminate write-offs. State-owned enterprises (SOEs) are playing a greater role, moving in to carry out M&A activities by acquiring projects or other assets from distressed developers. On a local level, regulators have been rolling out easing policies in a number of provinces and cities to provide relief for developers, e.g. easing regulations on property sales or land banks.

We believe these coordinated policy actions point to China ensuring there's a solid base under economic growth for 2022. On the back of these policy moves, we're already seeing the new issue bond market opening up. We are optimistic that conditions will continue to improve, particularly for the better-capitalized companies that also have more readily-accessible funding channels, even though we think not all companies in the sector will survive. But it is clear to us that policymakers are serious about providing a supportive, sector-wide solution.

China's yield advantage is unchanged

In this changing environment, we remain bullish on Chinese bonds over the medium to longer term. Which segments should investors focus on? Answers can be found in China's credit impulse (see Figure 2). Credit impulse, or supply of credit to the market, is a forward-looking indicator that could signal an upturn in the economy. For the first part of the year, we like interest rate sensitive bonds because we believe credit impulse will likely bottom out in the first or second quarter before an economic rebound. Typically there is a 10-month delay once the credit impulse starts to bottom out. As it begins to pick up in the second half of 2022, that would make us slightly more bearish on interest rate sensitive bonds.

Credit impulse is not the only signal we watch for. In the stock market, we closely follow one of the largest banks in the world—and the blood supply of the Chinese economy—and use it as a bellwether. When that bellwether's stock starts to climb, together with an expanding credit impulse, we interpret that as a sign that things are starting to look better.

When the economy turns around, possibly in the second half, there may be opportunities in the USD credit markets. Investment grade and high yield spreads in the US and Europe are still very tight compared to China high yield's, and this could be the time to consider China high yield securities, and in particular property. It's true that the property market is not out of the woods yet, but with the current market pricing in what we believe to be an unrealistically high 70% default rate, we think valuations are attractive and there are quality companies to choose from for the long-term investor. For investors who are already in Asia high yield, a shift into China high yield could be beneficial as a means to express a more pointed exposure.

In the end, it's important to remember that China's yield story hasn't changed even though policy is changing and global uncertainties are high. Today Chinese sovereign bonds offer a 1-2.5% yield pickup over main global bond markets, delivering real yields through low correlations (see Figure 3). China high yield credit spreads are at their all-time widest. After last year's buoyancy, the bond market still presents many investment opportunities. And with the government's commitment in supporting a growth trajectory evident at the Two Sessions, we maintain a positive outlook for the overall economy and the China investment case.

Diversifying through a multi-asset approach

Investing in China is complex. For those investors who want to take a balanced approach, we believe allocating capital between the onshore and offshore assets can allow investors to benefit from different catalysts and the difference in investor behavior. Chinese stocks are relatively volatile, and there is also limited diversification benefit between Chinese bonds and equities. Hence, dynamically moving in and out of risk assets in different market environments may help to achieve better risk-adjusted returns.

Idiosyncratic opportunities for China long/short

China is no longer just all about traditional equities and bonds, or even onshore vs. offshore. There are idiosyncratic opportunities for the long/short investor that may also benefit from the Wealth Management Connect and last year's financial reforms, which were key for relative value investors.

The use of short selling as a risk management tool to protect long positions has always been limited by the availability of short borrowers. The implementation of the new rules allows active long/short investors to reach out to domestic investors such as domestic mutual funds, life insurance companies and corporate investors—doubling the size of the pool could mean a five times growth for the relative value market when it matures in the long term.

We believe there is a large investment opportunity in the next five to seven years at least, as liquidity improves on both the long and short side. We also are looking at quantitative strategies in China and we are closely studying their credit and fixed income markets. These strategies may bring about much

more efficiency and allow us to invest in a much more diverse way across the onshore Chinese equity markets.

Figure 1 - The Big Picture: China's Over-arching Objectives

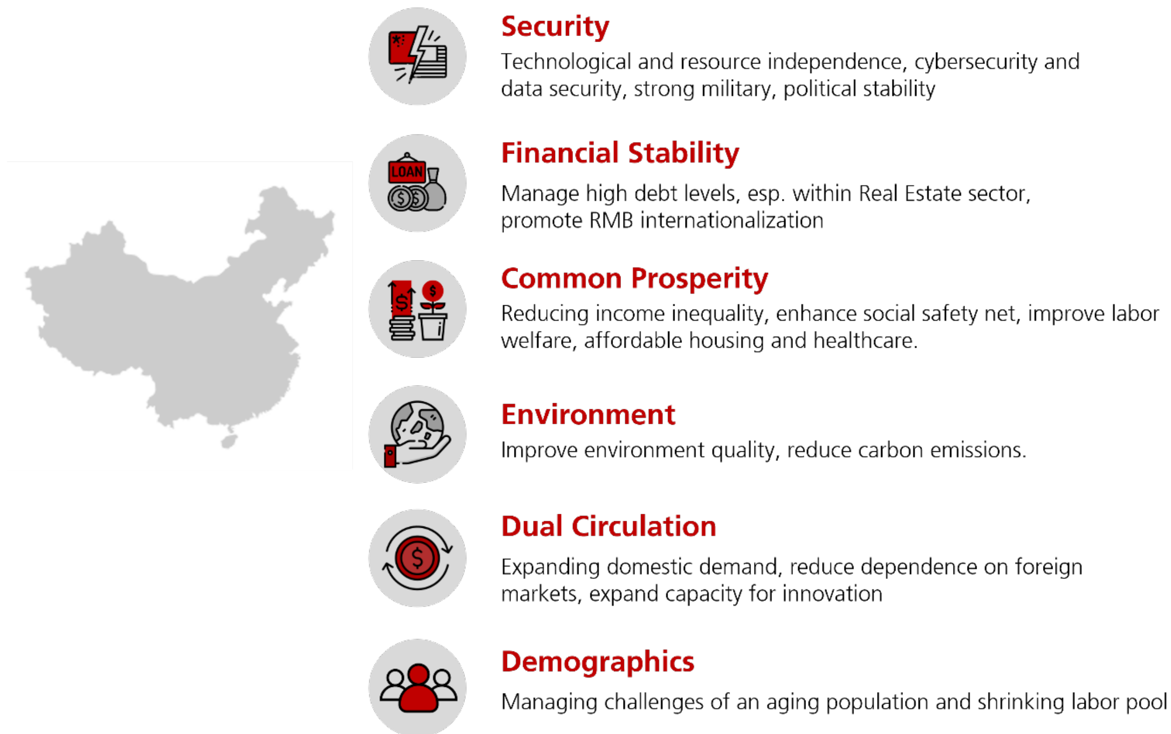


Figure 2

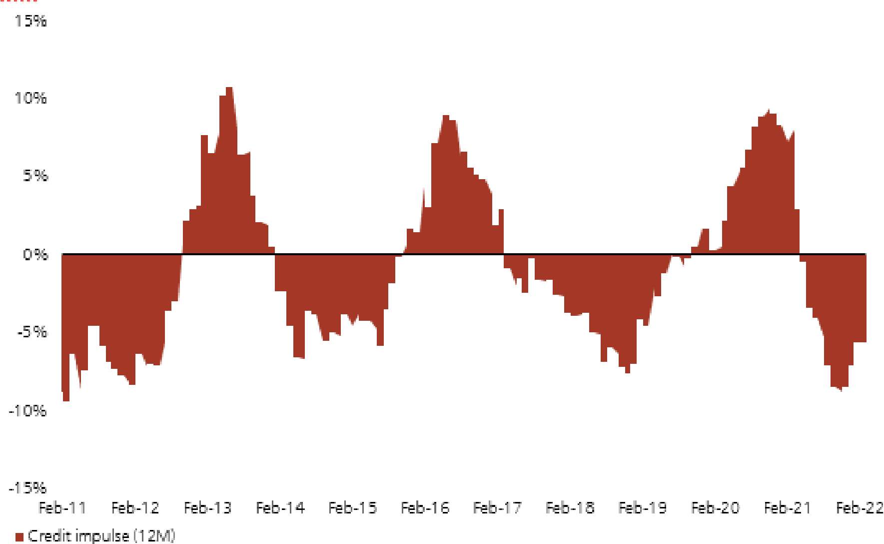
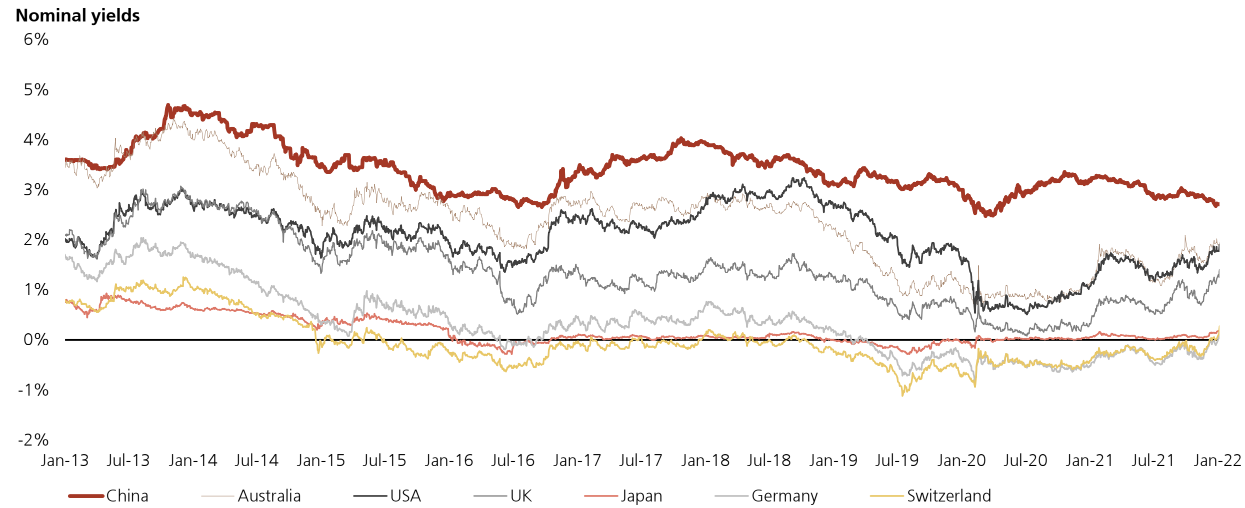


Figure 3



Yields	US	China	Germany	Japan	UK	Switzerland	Australia
End of Feb 2022	1.83%	2.79%	0.14%	0.19%	1.41%	0.26%	2.14%

Source: Bloomberg. Based on 10-year sovereign yields. As of end of February 2022.

**For information purposes by UBS. For professional / qualified / institutional clients and investors only.
Published March 2022**

This document does not replace portfolio and fund-specific materials. Commentary is at a macro or strategy level and is not with reference to any registered or other mutual fund.

Americas
The views expressed are a general guide to the views of UBS Asset Management as of March 2022. The information contained herein should not be considered a recommendation to purchase or sell securities or any particular strategy or fund. Commentary is at a macro level and is not with reference to any investment strategy, product or fund offered by UBS Asset Management. The information contained herein does not constitute investment research, has not been prepared in line with the requirements of any jurisdiction designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research. The information and opinions contained in this document have been compiled or arrived at based upon information obtained from sources believed to be reliable and in good faith. All such information and opinions are subject to change without notice. Care has been taken to ensure its accuracy but no responsibility is accepted for any errors or omissions herein. A number of the comments in this document are based on current expectations and are considered "forward-looking statements". Actual future results, however, may prove to be different from expectations. The opinions expressed are a reflection of UBS Asset Management's best judgment at the time this document was compiled, and any obligation to update or alter forward-looking statements as a result of new information, future events or otherwise is disclaimed. Furthermore, these views are not intended to predict or guarantee the future performance of any individual security, asset class or market generally, nor are they intended to predict the future performance of any UBS Asset Management account, portfolio or fund.

EMEA
The information and opinions contained in this document have been compiled or arrived at based upon information obtained from sources believed to be reliable and in good faith, but is not guaranteed as being accurate, nor is it a complete statement or summary of the securities, markets or developments referred to in the document. UBS AG and / or other members of the UBS Group may have a position in and may make a purchase and / or sale of any of the securities or other financial instruments mentioned in this document.

Before investing in a product please read the latest prospectus carefully and thoroughly. Units of UBS funds mentioned herein may not be eligible for sale in all jurisdictions or to certain categories of investors and may not be offered, sold or delivered in the United States. The information mentioned herein is not intended to be construed as a solicitation or an offer to buy or sell any securities or related financial instruments. Past performance is not a reliable indicator of future results. The performance shown does not take account of any commissions and costs charged when subscribing to and redeeming units. Commissions and costs have a negative impact on performance. If the currency of a financial product or financial service is different from your reference currency, the return can increase or decrease as a result of currency fluctuations. This information pays no regard to the specific or future investment objectives, financial or tax situation or particular needs of any specific recipient.

The details and opinions contained in this document are provided by UBS without any guarantee or warranty and are for the recipient's personal use and information purposes only. This document may not be reproduced, redistributed or republished for any purpose without the written permission of UBS AG.

This document contains statements that constitute "forward-looking statements", including, but not limited to, statements relating to our future business development. While these forward-looking statements represent our judgments and future expectations concerning the development of our business, a number of risks, uncertainties and other important factors could cause actual developments and results to differ materially from our expectations.

UK
Issued in the UK by UBS Asset Management (UK) Ltd. Authorised and regulated by the Financial Conduct Authority.

APAC
This document and its contents have not been reviewed by, delivered to or registered with any regulatory or other relevant authority in APAC. This document is for informational purposes and should not be construed as an offer or invitation to the public, direct or indirect, to buy or sell securities. This document is intended for limited distribution and only to the extent permitted under applicable laws in your jurisdiction. No representations are made with respect to the eligibility of any recipients of this document to acquire interests in securities under the laws of your jurisdiction.

Using, copying, redistributing or republishing any part of this document without prior written permission from UBS Asset Management is prohibited. Any statements made regarding investment performance objectives, risk and/or return targets shall not constitute a representation or warranty that such objectives or expectations will be achieved or risks are fully disclosed. The information and opinions contained in this document is based upon information obtained from sources believed to be reliable and in good faith but no responsibility is accepted for any misrepresentation, errors or omissions. All such information and opinions are subject to change without notice. A number of comments in this document are based on current expectations and are considered "forward-looking statements". Actual future results may prove to be different from expectations and any unforeseen risk or event may arise in the future. The opinions expressed are a reflection of UBS Asset Management's judgment at the time this document is compiled and any obligation to update or alter forward-looking statements as a result of new information, future events, or otherwise is disclaimed.

You are advised to exercise caution in relation to this document. The information in this document does not constitute advice and does not take into consideration your investment objectives, legal, financial or tax situation or particular needs in any other respect. Investors should be aware that past performance of investment is not necessarily indicative of future performance. Potential for profit is accompanied by possibility of loss. If you are in any doubt about any of the contents of this document, you should obtain independent professional advice.

Australia
This document is provided by UBS Asset Management (Australia) Ltd, ABN 31 003 146 290 and AFS License No. 222605.

Source for all data and charts (if not indicated otherwise): UBS Asset Management

© UBS 2022. The key symbol and UBS are among the registered and unregistered trademarks of UBS. All rights reserved.

© UBS 2022. All rights reserved.
www.ubs.com/am