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China exposure: Toughing out the tariffs

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With financial markets focusing on the impending risk of higher US tariff rates, China's equity markets have come under pressure. Investors might be tempted to overreact to this threat and the likely attendant increased volatility. We would caution against this and advise investors to maintain a Neutral portfolio weighting on China equities but skew it toward defensives. In the fixed income space, the high all-in yields offered by Asia IG are still attractive.

In the wake of Donald Trump's presidential election win in the US, the 3-week climb for China equities began to reverse. While disappointment over Beijing's policy stimulus contributed to the negativity, growing market expectations of higher US tariff rates in the months to come are probably the greater and the more enduring driver. The new US administration's cabinet selections have also provided increasing clarity on its seriousness about using tariffs, likely contributing to the accelerated decline in both the CSI 300 and the MSCI China (MXCN) over the past week. With tariff-related uncertainty likely to continue, if not intensify, investors are likely to continue to feel stressed about their exposure to China.

Notwithstanding the continued uncertainty, investors should avoid getting tunnel vision—there are other important drivers for the performance of China's equity markets. Chief amongst these would be the policy stimulus that China's policymakers are likely to enact as a countermeasure to the US tariffs. An attendant determinant for China's policy response, and thus financial markets, will be the pace of tariff rate hikes, especially with respect to China. We would thus advise investors to avoid knee-jerk reactions to news headlines, and instead stay the course and make incremental adjustments to well-diversified and balanced portfolios.

Our base case is that we are likely to only see selective (targeted) tariffs, and these are most likely to be phased in only gradually. We suspect that universal tariffs will be a lot harder to pull off politically, and that the Trump administration is more likely (at a 65% probability) to instead resort to tariffs on a range of goods or sectors from a country or region based on those powers afforded to the US president. In our base case, we expect the effective US tariff rate on all Chinese goods to be gradually raised to 30% from the current 10% by end-2026, with initial steps by mid-2025. And we see China's GDP growth suffering a cumulative hit of 70-100 bps over three years. We anticipate though that this would suffice to prompt a more muscular fiscal policy stimulus.

Remain Neutral on China equities. Although this might seem questionable in the face of the impending tariff rate hike and its detrimental impact on China's economy, we expect Beijing to respond. In our base case, China is likely to raise its fiscal deficit ratio for 2025 from 3% to about 4%, likely involving greater government bond issuance and monetary easing. These two issues are likely to be the main the driver for China equities in the coming 6-12 months. While GDP growth is still likely to decelerate in 2025, and we have also lowered our MXCN targets, we still project upside from 63 currently to 67 in June 2025 and 74 in December 2025. But we do expect volatility stemming from tariff announcements, stimulus surprises—oth positive and negative—and external macroeconomic conditions to continue in the near term.

Defensive exposure to balance downside risks and upside potential. To benefit from potential policy stimulus in China, while still being relatively cushioned against tariff risks, investors will need to skew their China equity exposure toward defensives. We expect defensive and high-yielding value sectors to outperform. These include sectors such as financials, utilities, energy, and telecoms where the average dividend yield is around 6%, fully four percentage points above Chinese government bond (CGB) yields.

Avoid CGBs for China convertibles and Asia IG. In the fixed income space though, investors might need to be even more selective, and perhaps also explore a less familiar segment. While bonds do also benefit from liquidity injections, fiscal expansion is likely to be a bit of a drag on the CGB segment as supply increases. Generally, we think Asia investment grade (IG) would be the more attractive segment in the Asian bond space, especially South Korean and Indonesian IG. We think spreads there can remain tighter for longer given robust fundamentals and a positive technical picture. High absolute yield levels (a little below 5.5%) should continue to spur demand. One other interesting and potentially attractive area for China onshore investors is convertible bonds. These contain an embedded call option that provides investors with equity-like upside potential if these stimulus measures prove effective.