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INVESTMENT TALKS

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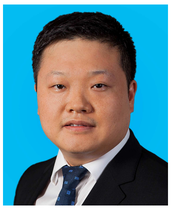
China assets hit by trade talks: What expect from now

Angelo Corbetta
Head of Asia Equity

Debora Delbò
Senior Strategist

Vincent Mortier
Group Deputy CIO and Asia ex Japan supervisor



Qinwei Wang
Senior Economist

With the contribution of:

Nicholas McConway,
Senior Portfolio Manager

- *The US-China relationship appears to be deteriorating. US recently published a list of an additional $200bn of Chinese products subject to 10% tariff rates that will be put forward for the public hearing process by 30 August and could possibly be implemented in September.*
- *As trade talks intensify, Chinese assets are under pressure, with the potential for corrections to the renminbi (RMB) and equity market occurring.*
- *While uncertainty looks relatively high in the near term, our central scenario is that serious escalations could be avoided and US tariffs applied to imports from China should have relatively mild macro impact. We estimate that the direct impact of a 10% tariffs on $200bn (40% of US good imports from China) could knock off around 0.2% of China's GDP, given US imports account for around 3% of China's GDP (in value-added terms).*
- *While we are waiting to see what China might introduce as possible retaliatory measures, we expect potentially more meaningful policy supports in H2 to soften negative impacts.*
- *Economic fundamentals and clear messages from the PBoC since last week look set to prevent the RMB from overreacting and our 12-month USD/CNY target is not far off recent levels given the current scenario.*
- *The sharp depreciation in the RMB, combined with deteriorating growth expectations in China in recent weeks seems to have negatively affected market sentiment. Nonetheless, we believe that a moderate slowdown, along with very gradual deleveraging could represent a very likely positive outcome in the medium term.*
- *On equity, the MSCI China A-share[1] market is down almost 30% since the peak seen at the end of January 2018. It offers an attractive premium in both absolute and relative terms to the H-share market on an historical basis.*
- *In the short term, we prefer to remain cautious on both the A-share and H-share markets, at least until we receive more clarity on a near term resolution to negative drivers. We think that on a medium- to long-term horizon, the A-share market looks attractive, and we are looking for entry points. At a stock level, we believe that the best opportunities are in domestic and consumption driven stocks.*
- *Beyond the short-term weakness, from an investor's perspective, we think it makes more sense to consider China as a new investment asset class in its own right, not just as part of an emerging market exposure, to take advantage of the transformation of the Chinese economy and its global economic power.*

What are the main reasons behind the recent decline in the value of the renminbi?

Q Wang: So far, it looks like the recent correction in the Chinese renminbi was mainly a result of short-term market pressures. After the recent correction, the RMB has returned to roughly around the level seen in Q4 of last year against both the US dollar and the trade-weighted basket, while less than 3% from the lowest levels against basket and less 5% against USD. The main trigger has been trade-related issues in recent weeks, following President Trump's aggressive comments regarding the imposition of additional tariffs on China which has caused the market to become concerned about a serious escalation and potentially a descent into a full-blown trade war. Furthermore, there have been other external factors that have added downward pressures on the RMB, such as the overall risk-off environment in EM and a seemingly strong outlook for the US economy and a rebound in the USD. In addition, there were some near-term concerns about deleveraging in China being too harsh, which are

[1] The MSCI China A Onshore Index captures large and mid-cap representation across China securities listed on the Shanghai and Shenzhen exchanges in local currency. The MSCI China H index regroups all large and mid-cap names traded in Hong Kong. H-shares are available to all investors; only Chinese domestic investors and Qualified Foreign Institutional Investors can trade A-shares.

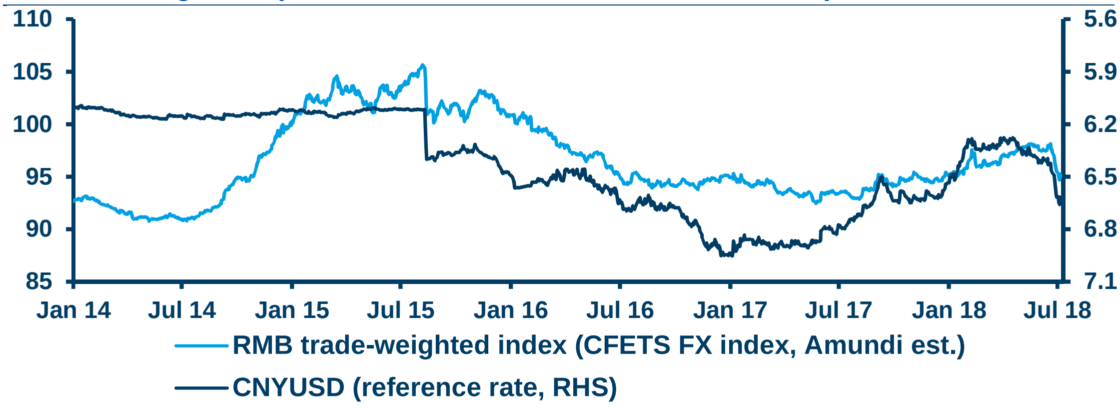
“The direct impact of a 10% tariffs on $200bn (40% of goods imported to the US from China) could knock off around 0.2% of China’s GDP”.

“We don’t expect China to use significant devaluations of the RMB as a tool in US-China trade tensions. But, if necessary, the PBoC appears prepared to intervene to prevent overreaction by the markets”.

weighing on the whole economy, due to recent disappointing macro figures and pickup in corporate bond defaults.

What might the implications and effects of US-China trade tensions be in the future?
Q Wang: The US recently published a list of an additional $200bn in Chinese products that could be affected by 10% tariff rates. A public hearing process on proposed tariffs is scheduled by 30 August and the list could possibly be implemented in September. While uncertainty looks relatively high near term, our central scenario is that serious escalations can be avoided and US tariffs applied to imports from China should have relatively mild macro impact, with negotiations looking set to continue. We estimate that the direct impact of a 10% tariffs on $200bn (40% of US imports of goods from China) would be a decline of around 0.2% for China’s GDP, given that US imports account for around 3% of China’s GDP (in value-added terms). Despite PBoC having all the tools to stage a “managed devaluation”, we don’t expect China to use large RMB devaluations as a tool regarding the US-China trade tensions, as this would negatively affect China’s own financial stability and damage its long-term projects of RMB internationalisation. Conversely, China’s policy strategy should remain relatively consistent, pushing for talks, and continuing to deliver the reforms that US has requested, such as the recently announced cut in import tariffs, opening of a range of sectors, and reducing barriers for foreign investors. In fact, China’s economic fundamentals are more resilient than a few years ago, with systematic risks under control, following a meaningful cut to overcapacity and property destocking, with non-performing loans (NPLs) peaking and macro leverage (credit/GDP) stabilising while default ratios remain far below other EM. As a result, we expect the RMB to remain stable in the short term, especially after the clear messages from the PBoC in early July, and our 12-month USD/CNY target range is not far off recent levels. Nonetheless, in the near term, much will also depend on how the US-China trade relationships unfolds and how China fine-tunes its policy in reaction. If necessary, the central bank seems ready to intervene via multiple tools to prevent overreaction by the markets.

RMB exchange rate (onshore CNY, end-2014 = 100, from 2016)



Source: Amundi Research, Bloomberg. As of 5 July 2018.

“We prefer to remain cautious on both the A-share and H-share markets for now, at least until we see some near-term resolution to currently unclear negative drivers”.

Do you see opportunities opening up in Chinese equities after the recent correction?
A Corbetta, D Delbò, N McConway: The overall deteriorating growth outlook in the near term has clearly negatively impacted the earnings growth expectations for stock markets. China markets have suffered material setbacks since the highs reached in Q1 of this year, with the MSCI A-share index declining almost 30% since the peak seen at the end of January 2018. The performance has been particularly negative since the beginning of June coinciding with the first tranche of A-shares inclusion in the MSCI China index. With the MSCI set to increase the weight of A-shares in its global indices again in September, investor attention should remain high. As a consequence of the strong correction in the market, China A-share valuations improved significantly vs the H-share index, the MSCI China index, and other EM indices. The de-rating of China A-shares vs H-shares resulted in quite attractive valuation levels, with the MSCI A-share index currently at around 11x next year’s earnings. The A-share premium

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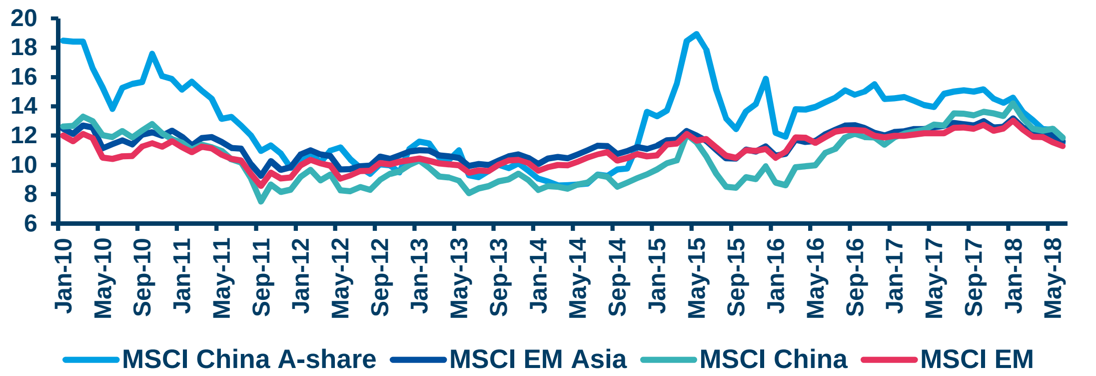
"In spite of more attractive valuations, we continue to stay defensive and prefer quality companies exposed to consumer and cyclical sectors".

remains in place, but is now close to its lowest levels since 2015. This may appear to be an attractive entry level in both absolute and relative terms vs H-shares on an historical basis, but it is also a reflection of current very depressed expectations for future growth and earnings. Compared to other EM, the positive dynamics in earnings also contributed to the decrease in the P/E multiples. Currently, the China A-share index is trading at the same forward P/E as the MSCI China, the MSCI EM and Asia indices. Within A-share sectors, consumer and software show expensive valuations while banks and property look cheap.

Forward 12M P/E ratios



Source: Amundi Research, Factset. As of 6 July 2018.

We expect trade negotiations to ultimately resolve in a rational way, even if there is a significant risk that negotiations could get worse before they get better.

Despite attractive valuations, three other critical factors should be watched closely: 1) Earnings momentum (revisions) of the index has slowed markedly. On this issue, the next reporting season will be key; 2) The index will remain under pressure due to concerns about China's deleveraging process and tightening monetary conditions in US; and 3) The US-China trade dispute is very likely to continue and investors should be aware of the potential for a trade war. In this regard, we expect trade negotiations ultimately to be resolved in a rational manner, even if there is a significant risk that negotiations could deteriorate before improving. All in all, we believe that the A-share asset class could be attractive on a medium- to long-term horizon, and we are waiting for potential entry points in the near future as well as closely monitoring risks associated with China's deleveraging policy. Despite a more consensual view that growth will continue to be negatively affected by trade tensions with the US, we believe that stabilizing a moderate slowdown, along with very gradual deleveraging could be a very likely positive outcome. However, due to the risk scenario, we prefer to remain cautious on both the A-share and H-share markets in the short term, at least until we see some near-term resolution to negative drivers. Therefore, we remain defensive and prefer quality companies in domestic consumer and cyclical sectors.

What are your key messages for investors looking at Chinese assets today?

"It's time to consider China as an asset class in its own right over a long-term perspective".

V Mortier: Despite near-term noise, the path towards RMB internationalisation is still moving forward, the benchmark inclusion of equities and local bonds is likely to attract more capital inflows in the coming years, and China is speeding up necessary reforms for its structural transition. In this regard, the escalation of trade tensions looks to helping push China to accelerate its reform agenda which includes, at the top of the list, the (further) opening up of the country's financial sector to foreign investors. The opening-up of China's financial markets is among the government's key reforms to facilitate a structural transition towards a high-quality growth model (more focused on domestic demand and higher value added sectors). Overall this should help Chinese equity valuations to remain attractive, and, with the MSCI changes, from an investor perspective, it will be favourable to consider China as a new investment asset class in its own right and not just as a part of EM exposure. This is especially true for long term investors who, in our view, can no longer afford to bypass the Chinese markets for a diversified investment portfolio.

Important Information

Date of First Use: 13 July 2018.

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