29 March 2018

Global trade war? Not our base case – Domestic factors are more important for China and Hong Kong equities

On 23 March, US President Donald Trump announced up to $60 billion in tariffs against Chinese imports. Kai Kong Chay, Senior Portfolio Manager, Greater China Equities, believes that a global trade war is not the base case scenario, while the fundamentals underpinning China and Hong Kong equities are still in place.

Last week, US President Donald Trump announced additional tariffs against Chinese imports. Restrictions were also placed on Chinese companies purchasing US companies and the transfer of technology between the two countries. The Trump administration has 15 days to announce a final list of affected products, followed by a 30-day public consultation period before tariffs take effect.[1]

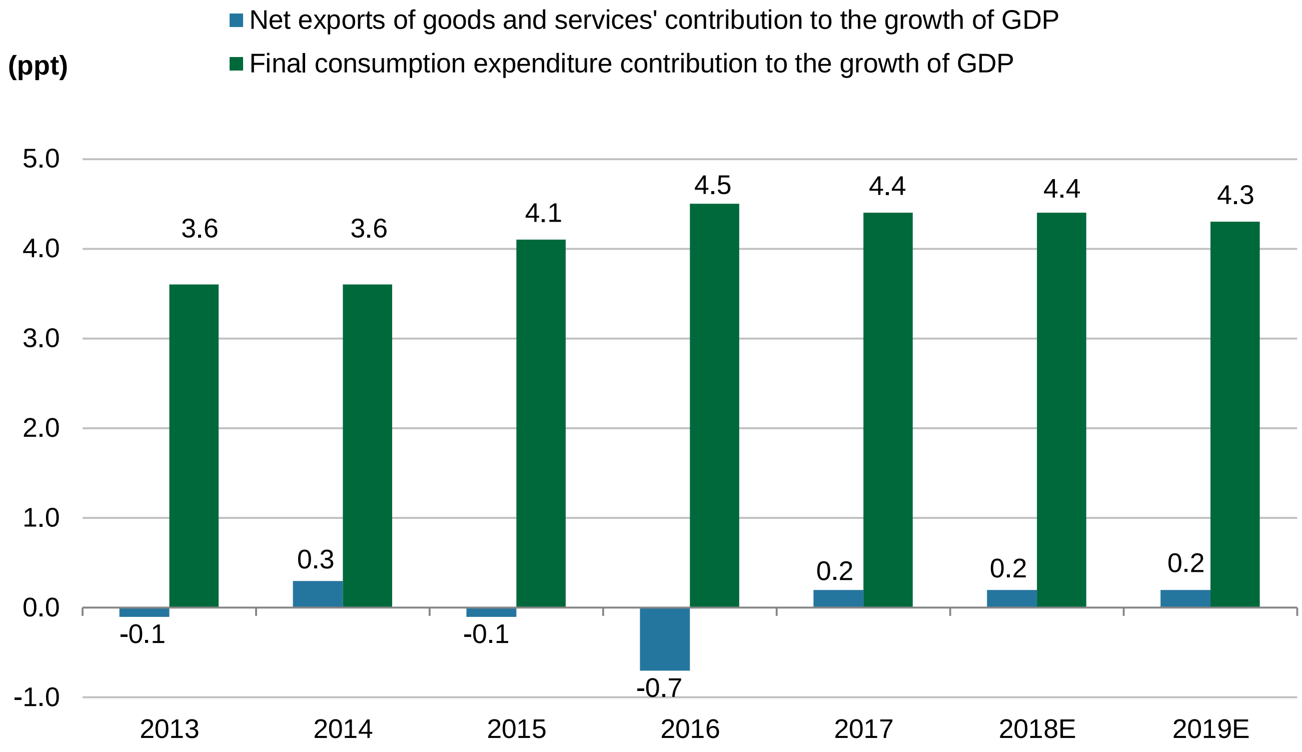
Despite these potential new sanctions, we believe that China and Hong Kong equities are well placed for two reasons: 1) China's economy is increasingly powered by domestic consumption; 2) The MSCI China Index is more dependent on domestic revenues than US-based revenues for growth.

Domestic consumption plays a key role in China's GDP growth

The Chinese economy's structure is changing. The proposed sanctions are estimated to lower China's GDP by only 0.1% (even if assuming full tariff pass-through to consumers)[2]. This is due to the limited scope of the sanctions (up to US$60 billion) compared to the overall size of China's economy (U$12.8 trillion in 2017)[3], as well as China's structural economic transition away from exports towards domestic consumption. In the past 5 years, net exports contribution to GDP growth has gradually stabilised at 0.2 percentage point over time (see Chart 1), while household consumption has steadily increased to over 4 percentage points. China has also diversified its trading partners: bilateral trade is rapidly increasing with the EU and ASEAN trading blocs.

[1] Financial Times, 23 March 2018; Bloomberg, 26 March 2018.
[2] UBS Global Research, as of 23 March 2018.
[3] National Bureau of Statistics of China, 2016.

Chart 1: China's economic structure is changing[4]



Domestic revenue matters more to Chinese companies

Moreover, the China and Hong Kong equities market is more dependent on domestic revenue than overseas revenue. Estimated overseas revenues accounted for approximately 15% of MSCI China constituents' total revenue in 2016[5]. For US-based revenue exposure, the main sectors in MSCI China are textiles (19%), furniture and household durables (17%), auto components (15%), and tech hardware (15%)[6].

Domestic demand investment themes dominate

At times of uncertainty, focusing on bottom-up stock selection by identifying companies with solid fundamentals is key. We continue to focus on three domestic-driven investment themes – research and development (R&D), consumer upgrade and policy-driven beneficiaries.

- For the "R&D" theme, we continue to focus on healthcare-related companies with recent progress on healthcare reform. We also like internet companies that are using artificial intelligence (AI) to offer better target advertising. Overall, Chinese companies with strong R&D capabilities are incentivised to invest locally with robust commercial opportunities available.

[4] National Bureau of Statistics of China, CEIC; 2018 and 2019 figures (E) are estimates from Morgan Stanley, March 2018.
[5] UBS Global Research, as at 23 Mar 2018.
[6] Citi Global Research, as at 22 Mar 2018.

- For the “consumption upgrade” theme, we prefer consumption-related companies that are domestically driven. Examples of this include a domestic apparel designer brand targeting different age/ gender groups and a leading education provider focusing on after-school tutoring for children in mainland China.

- For the “policy-driven beneficiaries” theme, we continue to favour companies that can benefit from opportunities in environmental protection. Reforms are domestically driven and thus are sheltered from the external environment.