Strategy Report

China's NPC Meeting Preview

The National People's Congress (NPC) will convene its annual meeting on 5 March. Premier Li Keqiang will give China's growth & development targets as well as major policies for 2022 in the cabinet work report. We preview what to expect on growth target and major policies, and highlight stocks that may benefit.

- **Growth & development targets for 2022:** i) GDP growth target may be at around 5.5%; ii) CPI growth target may be at 3%; iii) Urban registered unemployment rate target remains at 5.5% and urban incremental employment target should be at 11 million; iv) Energy consumption per unit GDP may be targeted to decline by 3%.
- **Macro policies:** i) China would maintain prudent monetary policy yet with easing bias; ii) will maintain proactive fiscal policy with additional tax cut; iii) may continue to loosen property policy to stabilize property market and avoid systematic risks; iv) will pledge to expand domestic consumption with common prosperity; v) will commit to green development; vi) will continue to accelerate the development of digital economy.
- **Policy implications from the Russia-Ukraine tensions**: i) China will take more effort to assure its energy & grain supply security; ii) will be more determined to develop its own chip and hard tech industries; iii) will further enhance its cyber security; iv) will firmly development the CIPS and improve the resilience of its financial system to external shocks.
- **HK stock market attractive after correction:** After the recent correction, the HSI is again highly attractive compared to other major indexes worldwide. HSI's P/B has now returned to the trough level 0.92x. H-shares' discount to A-shares is near decade-high. China's pro-growth policies could drive re-rating in the HSI moderately.
- **Sector rotation – from Energy & Banks into Internet:** Energy stocks, after strong gains YTD, is unattractive relative to other sectors. HK banks may pull back as U.S. rate hike expectations cooled on Ukraine crisis. On the other hand, Internet sector's EPS estimates are bottoming out. Prefer online gaming leaders **NetEase (NTES US / 9999 HK)** and **Tencent (700 HK)**.
- **Sectors to benefit from China's policies:**
  1. **New Energy:** China will probably accelerate the development of wind and solar power generation to reduce its reliance on energy imports. The recent share price correction presents a chance to accumulate.
  2. **New-Energy Vehicles:** China may provide subsidy to rural households to purchase NEV. We prefer the leading NEV trio – **XPeng (XPEV US / 9868 HK), Li Auto (LI US / 2015 HK), NIO (NIO US)**, as these pioneers have been creating new values for consumers.
  3. **Chinese Banks:** China may continue to loosen policy to stabilize property market and avoid systematic risks, which should alleviate concerns on banks' asset quality. Prefer SOE banks for their better fundamentals. Top pick is **PSBC (1658 HK)**.

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Market Data

Hang Seng Index	22,343
52-week High / Low	29,912/22,299
3-month avg. daily t/o	HK$124.0bn

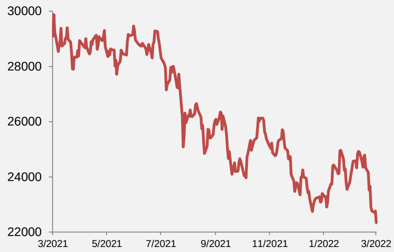
Source: Bloomberg

Indices Performance

	HSI	HSCEI	HSTECH
1-month	-6.1%	-5.3%	-7.4%
3-month	-6.0%	-6.5%	-15.4%
6-month	-13.7%	-14.9%	-25.5%

Source: Bloomberg

12-month HSI Performance



Source: Bloomberg

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The National People's Congress (NPC) will convene its annual meeting on 5 March. Premier Li Keqiang will give China's growth & development targets as well as major policies for 2022 in the cabinet work report. Following is our preview on the main topics.

Growth & development targets for 2022

i) GDP growth target may be at around 5.5%. This is evidenced by the growth targets of some key municipalities and provinces. In recent years, the GDP growth targets of Beijing, Shanghai, Guangdong, Liaoning and Chongqing have been basically in line with China's national GDP growth target. Only Beijing set its 2022 GDP growth target at 5%, partially due to the pandemic control during the Winter Olympics. The GDP growth targets of Shanghai, Guangdong, Liaoning and Chongqing are all at 5.5% for 2022.

There is much debate among official experts about the GDP growth target for 2022. Some radical experts support the 5.5% target as they believe China should maintain its incremental GDP above that of the US. Regardless of exchange rate and price factors, China's GDP growth should be at least at 5.4% if the US GDP grows 4% in 2022. Other experts think China should set a lower growth target at 5%-5.5% as the stress in property sector and the resurgence of Covid-19 virus makes the country difficult to achieve a growth around 5.5%.

ii) CPI growth target may be at 3%. Despite strong commodity inflation especially in energy sector, China's core CPI growth remains weak due to tepid consumption. The PPI growth should significantly slowdown this year. China's inflation risk should be low in 2022.

iii) Urban registered unemployment rate target remains at 5.5% and urban incremental employment target should be at 11 million. The resurgence of Covid-19 virus has a negative impact on the employment condition in small business in service sectors. But China's registered unemployment rate cannot reflect the full picture of the labour market. The urban incremental employment target should be easier to achieve because labour is still flowing from agriculture sector and rural area to service sector and urban area.

iv) Energy consumption per unit GDP may be targeted to decline by 3%. China will continue to push forward energy saving and carbon reduction process, but in a more pragmatic way. After the energy crunch last September, China has paid more attention to lowering energy consumption per unit GDP instead of total energy consumption. Meanwhile, consumption of new energy and energy used for material has not included in the evaluation. More flexible evaluation provides some upside room for traditional energy production this year. In the medium to long term, China targets continuing shift towards the new energy driven.

Figure 1: China's Growth & Development Targets

		2020		2021		2022F	
		Target	Actual	Target	Actual	Target	Forecast
GDP	YoY (%)	-	2.3	6 or higher	8.3	5.5	5.2
CPI	YoY (%)	<=3.5	2.5	3.0	1.4	3.0	2.1
Urban incremental employment	Mn	9.0	11.9	11.0	12.7	11.0	12.0
Urban unemployment rate	(%)	6.0	5.2	5.5	5.1	5.5	5.1
General fiscal deficit	(Rmb bn)	3,760	3,760	3,570	3,570	3,500	3,500
General fiscal deficit as % of GDP	(%)	3.6	3.7	3.2	3.1	2.8	2.8
Local govt special bond quota	(Rmb bn)	3,750	3,750	3,650	3,650	3,650	3,650
Local govt special bond quota as % of GDP	(%)	3.6	3.7	3.3	3.2	2.9	2.9
M2	YoY (%)	Notably higher than last year	10.1	in line with nominal GDP growth	9.0	in line with nominal GDP growth	9.5
Energy consumption per unit of GDP	YoY (%)	-1.6	-0.1	-3.0	-2.7	-3.0	-3.0

Source: Wind, CMBIGM estimates

Macro policies

i) China would maintain prudent monetary policy yet with easing bias. The monetary policy should be more easing this year as the stress in property sector and the resurgence of Covid-19 virus brings downside pressure on growth.

Firstly, the central bank should maintain ample liquidity condition. It is possible to see another RRR cut within this year.

Secondly, credit policy should be more loosening than last year to stabilize housing market and boost capital expenditure. Banks are urged to lower loan contract rates and expand loan supply to manufacturing, service business, SMEs, agriculture, technology, green development projects and social rental housing projects. Mortgage loan policy are also eased with a decline of down-payment ratio and contract rates for first-home buyers. It is possible to see another LPR cut, but uncertainty still exists. The central bank could use window guidance to induce a decline of banks' loan contract rates.

Thirdly, renminbi exchange rates will be more flexible to absorb external shocks. Renminbi has been stronger than the Sino-US interest spread dynamics has implied. The main reason is due to strong forex inflow amid huge trade surplus and China's financial market opening. The strong renminbi gives China more room to ease its monetary policy.

ii) China will maintain proactive fiscal policy with additional tax cut. China has already announced additional tax cuts at the cabinet's meeting in February. We estimate the tax and social insurance cost relief may reach RMB1.3trn in 2022. The tax cut mainly targets manufacturing sector to stimulate equipment investment and R&D expense as well as SMEs in service sectors to alleviate the pandemic's impact. The tax cut is mainly supported by the unused fiscal funds last year. Due to commodity inflation, the fiscal revenue exceeded the planed amount by over RMB1trn last year, which will be used this year.

From the perspective of broad fiscal deficit, the proactive fiscal policy is not as strong as expected. Broad fiscal deficit including general fiscal deficit & local government special bond quota may decline from 6.3% of GDP in 2021 to 5.7% of GDP in 2022. Specifically, general fiscal deficit and local government special bond quota is expected to decrease from 3.1% and 3.2% of GDP in 2021 to 2.8% and 2.9% of GDP in 2022. Local government special bond financing will be mainly used in projects in transportation infrastructure, energy security, agriculture, water conservancy, environmental protection, logistics facility, municipal facility, social housing, education & public health.

The major constraint on broad fiscal expansion should be the shrinkage of land revenue and control over local government contingent debt. Due to the stress in the property sector, local governments' land revenue is expected to drop over 15% in 2022. Meanwhile, the MoF still tries to control local government contingent debt. These two factors will restrain the magnitude of broad fiscal expansion.

China would further restructure the fiscal expenditure with more on social development and less on general administration expenditure. Due to the aging population, fiscal expenditure on healthcare & social insurance subsidy will continue to increase. To facilitate urbanization and employment stability, fiscal expenditure on social housing, education and employment support (skill training) should also increase. To facilitate green development and tech innovation, fiscal expenditure on energy saving, carbon reduction and R&D subsidy may also increase. But general administration expenditure may further decrease to balance the fiscal system.

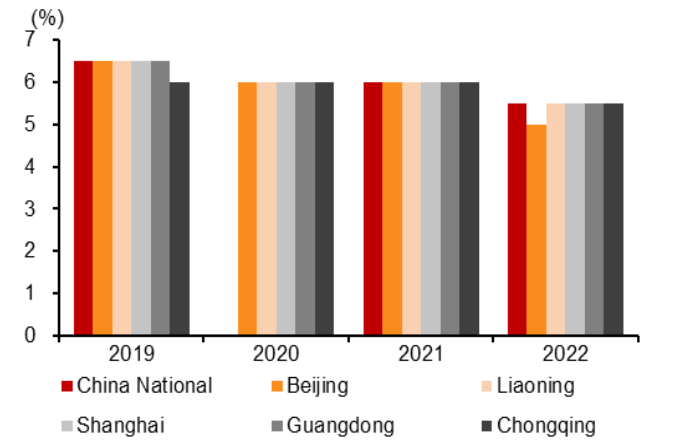
iii) China may continue to loosen property policy to stabilize property market and avoid systematic risks. China may further ease mortgage supply and credit policy for developers to stabilize the property market as demand for housing and land remains weak. Meanwhile, China would expand social rental housing projects in 40 largest cities to facilitate the urbanization of young workers as well as to partially offset the decline of property development investment. In addition, the policymakers encourage state-owned developers to play more important role in stabilizing the market as they would gain more market share in future.

iv) China will pledge to expand domestic consumption with common prosperity. The most important thing is to expand urban employment and middle-income class. China will improve the social security system to facilitate the urbanization and support SMEs in manufacturing and modern service to provide more high-quality employment opportunities. The country will provide subsidy to rural households to purchase electric vehicles and urban households to upgrade their home appliance. China will also support the development of tourism, sports, cultural & recreation services to facilitate consumption upgrading.

v) China will commit to green development. The country will continue to increase the share of wind and solar power generation and facilitate the electric transition in power consumption side. The cabinet will target higher share of clean energy use in North China.

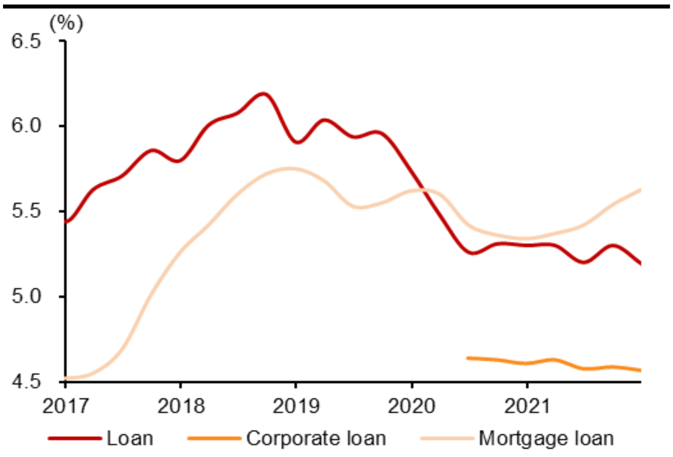
vi) China will continue to accelerate the development of digital economy. The country will continue to encourage digital innovation and applications in traditional industries to facilitate industrial upgrading. The government will encourage telecom companies to accelerate the 5G network investment and boost the development of digital industries.

Figure 2: National & Provincial GDP Growth Targets



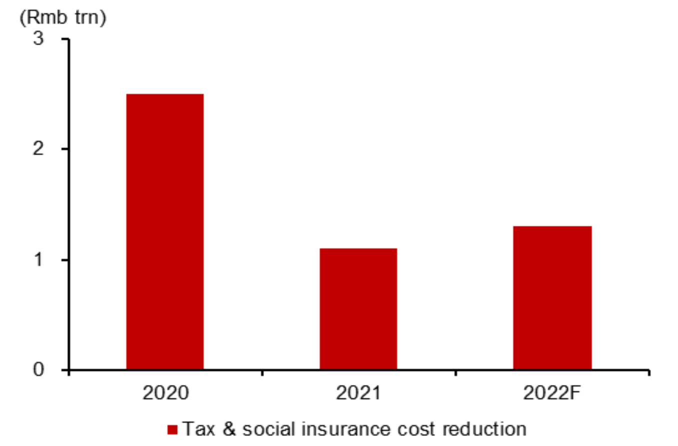
Source: Wind, CMBIGM estimates

Figure 3: Average Rates for Outstanding Loans



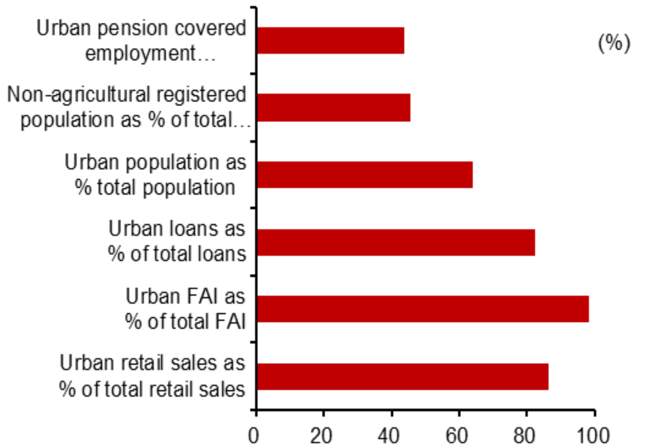
Source: Wind, CMBIGM estimates

Figure 4: Tax & Social Insurance Cost Relief



Source: Wind, CMBIGM estimates

Figure 5: Urbanisation Rates



Source: Wind, CMBIGM estimates

Policy implications from the Russia-Ukraine tensions

i) China will take more effort to assure its energy & grain supply security. China will continue to diversify its energy and agricultural imports. Meanwhile, China will accelerate the development of wind and solar power generation to reduce its reliance on energy imports. The country will support R&D and innovation in grain seed technology.

ii) China will be more determined to develop its own chip and hard tech industries. US and EU's sanctions on Russia in chip and technology remind China to develop its own chip and hard tech industries.

iii) China will further enhance its cyber security. The cyber-attacks in the Russia-Ukraine conflict remind China to develop its internet technology and enhance its cyber security.

iv) China will firmly development the CIPS and improve the resilience of its financial system to external shocks. US and EU's use of SWIFT messaging system to sanction Russia would make China more determined to develop its CIPS as an alternative to protect its business interest. Meanwhile, China will continue to improve the resilience of its financial system to external shocks.

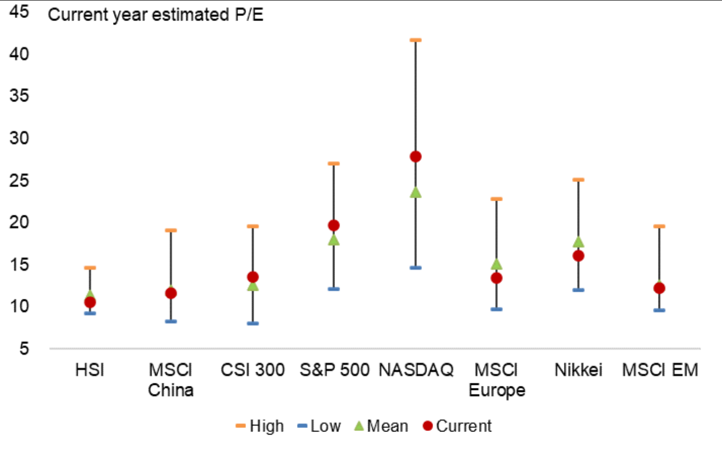
HK stock market attractive after correction

■ HSI cheapest among major global stock indexes

In the first six weeks of year 2022, Hong Kong stock market was one of the best performing in the world. Its cheap valuation, after significantly underperformed in 2021, was a major reason behind that catch-up. In the last 2-3 weeks, the Hang Seng Index corrected sharply by 11% as the Russia-Ukraine crisis unfolded.

After this retreat, the **HSI again appears to be highly attractive compared to other major indexes worldwide**. Trading at 10.5x FY22E P/E, the HSI's valuation is the lowest among major indexes shown in Fig. 6, and is also the closest to its 10-year trough P/E, while other markets are trading at above or close to their respective 10-year mean.

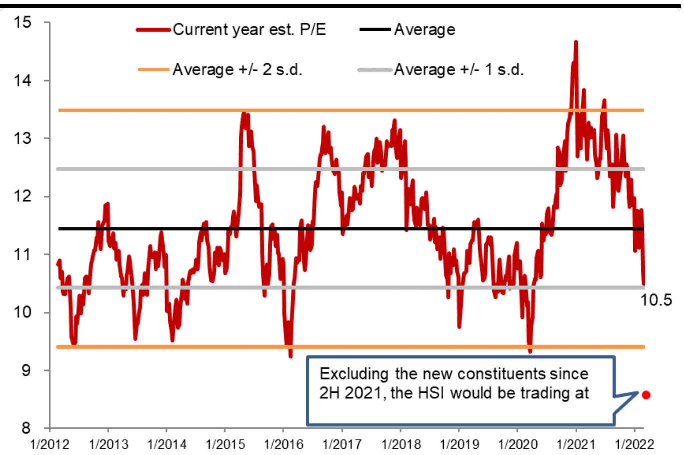
Figure 6: HSI cheapest on absolute and relative terms



Source: Bloomberg, CMBIGM estimates

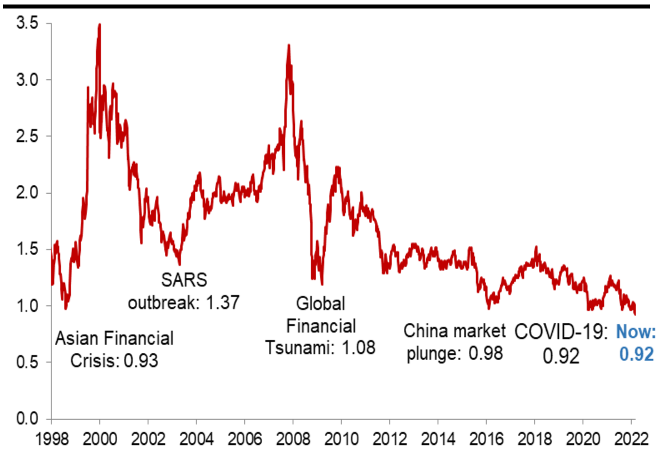
HSI's P/B has now returned to the trough level 0.92x during the pandemic-induced global selloff in Mar 2020, and is even lower than all the other crisis-lows over the past quarter of century (Fig. 8).

Figure 7: HSI's forward P/E at 1 s.d. below mean



Source: Bloomberg, CMBIGM estimates

Figure 8: HSI's P/B at crisis-low



Source: Bloomberg, CMBIGM estimates

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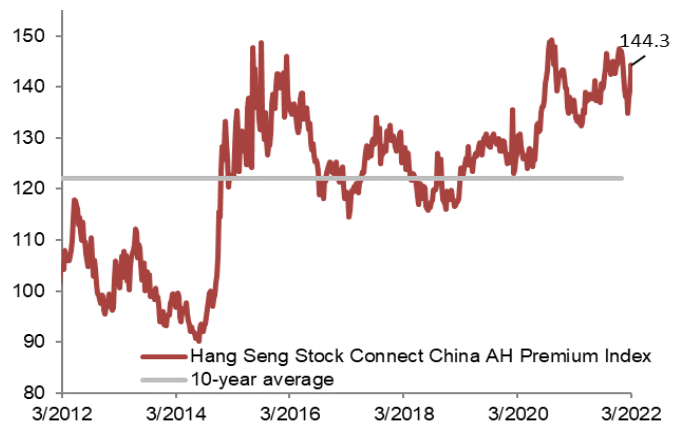
■ Wide discount to A-shares should attract Southbound buying

HK market's discount to Mainland market is again near decade-high. H-shares' discount to A-shares briefly narrowed in the first six weeks of this year, but now the A-H premium Index has rebounded to 144, close to decade high. History suggests such a large discount in H-shares would attract Mainland investors. Expect Southbound net buying to increase, lending some support to Hong Kong market.

Figure 9: A-H premium near decade high

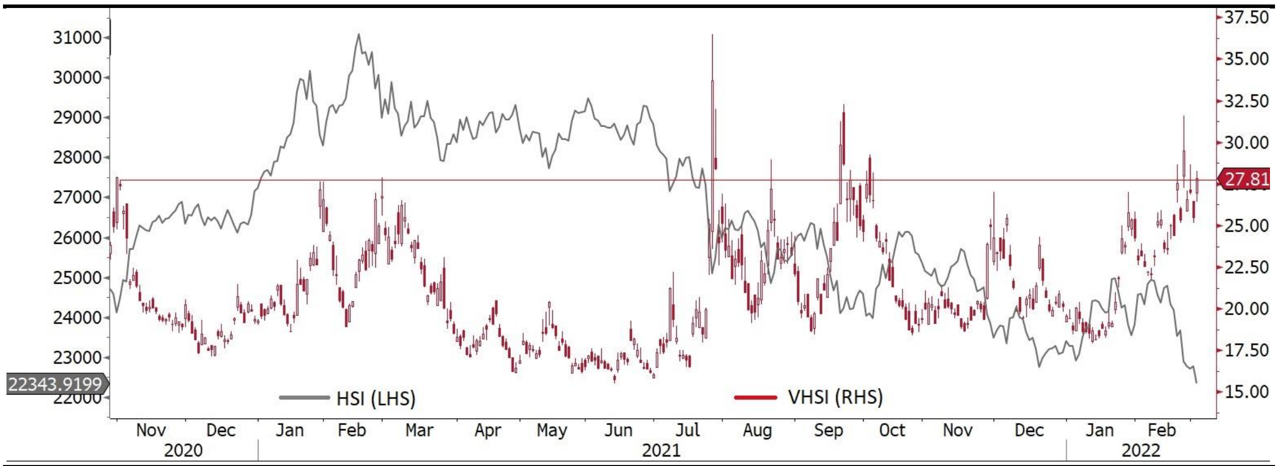


Source: Bloomberg, CMBIGM
*Above 100 indicates A-shares trade at premium

■ VHSI at panic level may precede market bottom

The latest and ongoing Russia-Ukraine military conflicts led to risk-off trades in global markets. The HSI Volatility Index (VHSI), so called "Fear Index", jumped to 31 on 24 Feb, the day Russian troops moved into Ukraine, and stood at around 28 on 2 Mar. In the past, the VHSI surged to 28 or above usually signalled market panic, and the HSI often bottomed out, at least in the short term.

Figure 10: VHSI surging to panic level often coincided with short-term bottoms in the HSI



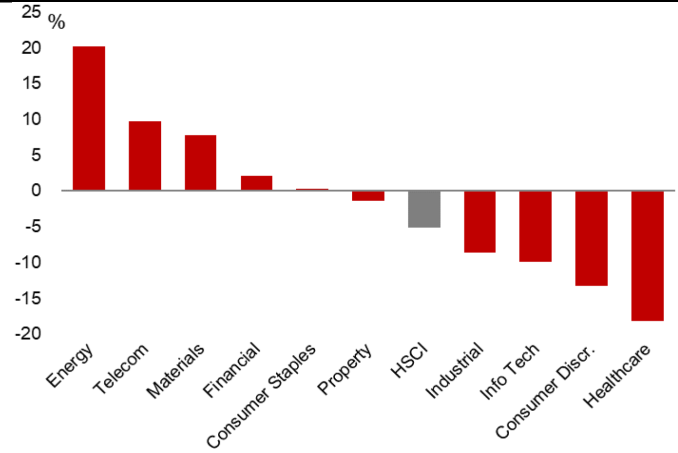
Source: Bloomberg, CMBIGM

Sector rotation – from Energy & Banks into Internet

■ Energy relatively unattractive after strong gains YTD

By style / sector, value and old-economy stocks led gains in HK market YTD, as Energy surged along with oil prices, and Banks with higher bond yields. On the other hand, growth stocks suffered more from risk-off trades and thus valuation contraction.

Figure 11: Energy stocks led gains in HK market



Source: Bloomberg, CMBIGM; Hang Seng Composite sector indexes

While Hong Kong market is cheap, and every sector under the Hang Seng Composite Index is trading at below-average P/E, Energy is the least attractive sector compared to 5-year average P/E, P/B and dividend yield (Fig. 12). In case the Russia-Ukraine crisis leads to a further spike in oil prices (rather uncertain), Energy stocks could extent their strong run, but bear in mind that geopolitical factors typically do not last long. Once the tension shows some signs of easing, Energy share prices could pullback rapidly.

Figure 12: HSCI sub sectors' valuation vs. 5-year average

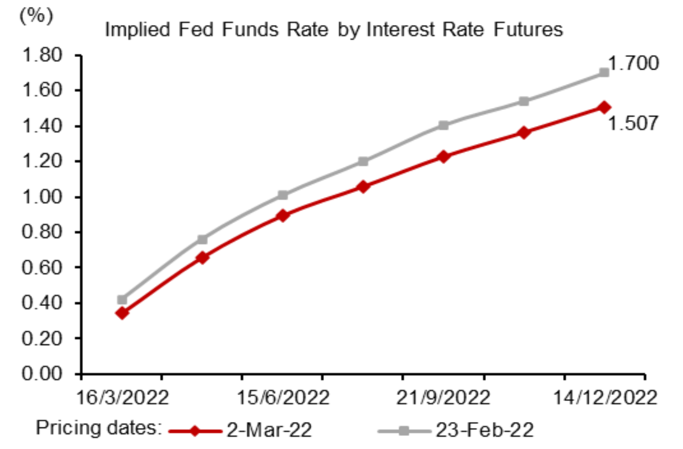
HSCI sub sector	P/E (12-month blended fwd)	No. of s.d. above/below 5-yr avg	P/B	No. of s.d. above/below 5-yr avg	Yield (%)	No. of s.d. above/below 5-yr avg
Financials	6.4	-1.4	0.9	-1	5.5	1.1
Real Estate	8.6	-1.4	1.2	-1.4	5.6	2.1
Health Care	18.1	-1.3	3.1	-1.1	0.8	0.6
Materials	7.2	-1.1	1.5	-0.1	4.3	0.3
Consumer Staples	20.2	-1.0	4	-0.8	2.7	1.2
Industrials	8.1	-1.0	1.8	-0.6	3.7	0.6
Technology	18.6	-1.0	2.7	-0.4	1.2	-0.1
Consumer Discretionar	15.5	-0.7	3	-0.7	2.1	0
Utilities	10.5	-0.5	1.4	-0.5	3.9	0.6
Communications	18.0	-0.4	2.2	-1	2.3	1.3
Energy	10.0	-0.3	1.2	-0.4	4.1	0.2
HSCI	**12.3**	**-1**	**2.1**	**-0.8**	**3.3**	**0.8**

Source: Bloomberg, CMBIGM

■ **HK banks pull back as U.S. rate hike expectations cooled on Ukraine crisis**

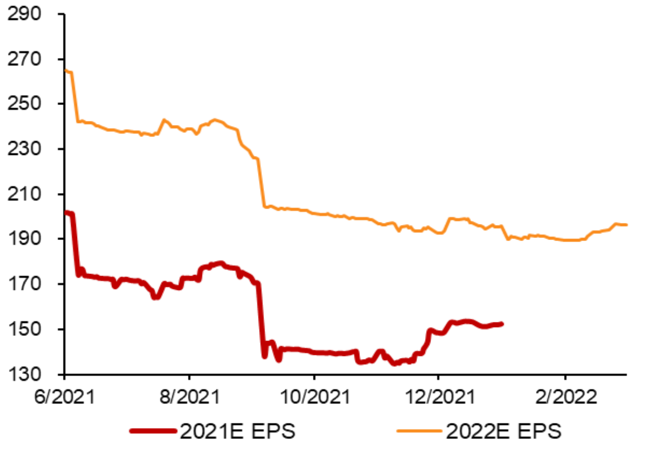
As inflations were shooting up in the U.S., expectation of Fed funds rate hikes had been heightening until the Russian-Ukraine conflict broke out. Interest rate futures are implying 5-6 rate hikes in 2022, cooled from the 6-7 hikes priced in right before Russia's military action in Ukraine, as the Fed will probably weigh the conflict's potential negative impact on the economy (Fig. 13). HK banking stocks have had a strong run since Dec 2021 on optimism of NIM-expansion. A cool off in rate hike optimism would not bode well for the sector.

Figure 13: Implied Fed Funds rate moved down



Source: Bloomberg, CMBIGM

Figure 14: HSTECH's EPS revising upward



Source: Bloomberg, CMBIGM

■ **Internet sector's EPS estimates bottoming out**

In contract to Energy and Banking sectors, China's Internet has suffered a double whammy of earnings downgrade and valuation contraction over the past three quarters on regulatory risks. Recently, earnings estimates are improving, with FY22E EPS of the Hang Seng TECH Index (75% weighting in Internet stocks) being revised up by 3.5% in February (Fig. 14). Expect fundamentals of Internet stocks to start improving in Q2 2022, and with regulatory risks have been largely priced in, EPS estimates and valuation could enjoy mild upward revision from here. Prefer online gaming leaders **NetEase (NTES US / 9999 HK)** and **Tencent (700 HK)**.

Sectors to benefit from China's policies

■ **New Energy**

China has been supporting the new energy industry for some time and, after the outbreak of Russia-Ukraine conflict, will probably accelerate the development of wind and solar power generation to reduce its reliance on energy imports. The power outage in China a few months ago has made the progress of carbon reduction more pragmatic and flexible, and led to a correction in new energy share prices. This correction presents a chance to accumulate industry leaders.

■ **New-Energy Vehicles**

We expect China, as part of its plan to expand domestic consumption with common prosperity, to provide subsidy to rural households to purchase new energy vehicles. We prefer the leading NEV trio – **XPeng (XPEV US / 9868 HK), Li Auto (LI US / 2015 HK), NIO (NIO US)** – over traditional automakers, as the pioneers have been creating new values for consumers.

■ **Chinese Banks**

Although China's monetary policy is prudent with an easing bias, and thus banks' NIM should not be expected to expand, we argue that Chinese banks' re-rating potential lies more in the improvement in asset quality than NIM expansion. We expect China may continue to loosen property policy to stabilize property market and avoid systematic risks, which should alleviate concerns on banks' asset quality. Prefer SOE banks for their better fundamentals. Top pick is **PSBC (1658 HK)**.

Key Risks

1. **Russia-Ukraine conflicts escalates** to the point that nuclear weapons are used, or the West may be pressured to intervene militarily (so far only diplomatically and by sanctions).
2. **Oil and gas prices surge much further due to a sharp cut in supply from Russia,** causing i) even higher inflations and thus potentially more aggressive monetary tightening by major central banks, and ii) negative impact on discretionary spending and the broad economy, and thus stagflation risks.

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