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Investment Research

China's outlook remains positive despite the recent equity setback

UBS House View - Daily Europe

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Thought of the day

The three-month rally in Chinese equities due to optimism around its economic reopening has waned since the Lunar New Year holiday. The MSCI China index fell last week for a third consecutive week amid a lack of fresh reopening catalysts. Recent US-China tensions over Russia and the US downing of a Chinese balloon have also contributed to the consolidation in Chinese equities. Meanwhile, renewed concerns that the Federal Reserve may have to raise policy rates for longer to temper US inflation also weighed on global risk sentiment.

As a result, MSCI China fell 2.2% last week, following the 2.9% and 4.9% declines in the prior two weeks. While the index has got off to a positive start this week, the recent retreat has pared its year-to-date gain to 4.9%, down from as high as 17.2% earlier in the year.

But despite the recent consolidation, we believe that the outlook for the Chinese economy remains positive this year, and we maintain a most preferred stance on emerging market equities, including China, in our global strategy.

The latest setback in Chinese equities is a healthy consolidation after a three-month rally. Chinese equities have rallied 46% in three months since the government began to dismantle its COVID-19 curbs in November. Therefore, we view the 8.4% decline in the past three weeks as a healthy consolidation attributed to profit-taking after the Lunar New Year holiday as investors await fresh catalysts on the reopening.

Furthermore, we believe the benefits of China’s reopening have not been fully reflected in the current valuations of MSCI China. We expect the start of the earnings season this week to provide some fresh upside catalysts and expect company management to reaffirm their post-reopening earnings recovery. We note that negative earnings revisions have started to ease while net earnings revisions in the consumer sector have begun to turn positive.

Market update

Nikkei 225 –1.3%, Japan leading regional declines.
EURUSD +0.2%, trading above 1.06
Gold +0.3%, near USD 1,829/oz.

What to watch: 23 February 2023

- Fed's Bostic and Daly speak
- Japan January CPI

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Consumption to lead economic recovery, buoyed by reopening and policy focus. We expect China's GDP growth to rebound to around 5% this year from 3% in 2022, led by a rebound in consumption and investment due to the reopening and the government's targeted policy focus. We forecast China's retail sales to grow by 7% in 2023 after contracting 0.2% last year.

Tentative signs of a recovery in consumption were already evident over the Lunar New Year holiday as catering and movie box-office sales reached 114% and 112.4% of 2019 levels, respectively, while domestic tourism recorded the strongest visitor and revenue levels since the pandemic. President Xi Jinping also signaled last month that domestic consumption will be key to economic recovery this year. Shortly after his remarks, the Ministry of Commerce announced that it plans to roll out policies to boost consumption, with automobiles and home appliances among the key focus areas.

Infrastructure investments are also likely to provide tailwinds to the economy. Based on the heavy investment plans announced so far, we believe that infrastructure spending will also be a key pillar for China's economic recovery this year. As of 12 February, local governments have unveiled CNY 21.5tr in infrastructure projects, of which CNY 3.4tr are planned for 2023. The investments are largely targeted at traditional infrastructure such as transport, city renovation, and water conservancy, as well as smart infrastructure including 5G, AI, and big data centers. Furthermore, 29 of the 31 municipal governments have set growth targets of at least 5% this year, reflecting a strong desire by Beijing to boost growth.

So, we remain most preferred on emerging market equities, including China, in our global strategies. Within Chinese equities, we like the direct beneficiaries of reopening, including sectors such as pharmaceuticals, medical equipment, and transportation. Broader emerging market equities also look set to benefit from China's reopening, in our view.

Caught our attention

Fed minutes show officials favor maintaining a restrictive stance. The minutes of the Fed's most recent meeting, ending on 1 February, indicated that "almost all" participants favored slowing the pace of tightening to 25 basis points, down from 50 basis points in the December gathering, and 75 basis points at the prior four meetings. But the minutes also revealed that "participants generally noted that upside risks to the inflation outlook remained a key factor shaping the policy outlook," and that interest rates would need to move higher and stay elevated "until inflation is clearly on a path to 2%." Overall, "participants observed that the uncertainty associated with their outlooks for economic activity, the labor market, and inflation was high."

Our view: The Fed meeting was held before January's disappointing consumer price index, strong labor market, and robust retail sales data. All this has led to a more hawkish tilt in Fed rhetoric. Several key policymakers have said that a 50-basis-point hike in March is possible, although market pricing still heavily favors a 25-basis-point hike. Meanwhile, markets have moved to price in a peak in rates of 5.37% later this year, up from 4.8%

at the start of February. Investors will now be looking to the release of the January PCE index, the Fed's favorite measure of inflation, on Friday.

Report: Deeper Russia export cuts coming. Reuters reported Russia is planning to cut oil exports from its western ports by up to 25% month-over-month in March, citing unnamed Russian oil market sources. If this materializes, the export cuts would exceed the 500,000 barrels per day production curbs previously announced for March. This comes amid a mild winter in the Northern Hemisphere that has reduced fossil fuel demand, and follows the launch of a G7 price cap mechanism and other sanctions on Russia.

Our view: We recently tempered our oil price forecasts, with Brent now expected to trade near USD 100/bbl and then USD 105/bbl in September and December. Still, the outlook remains positive. Russian oil production looks likely to continue declining as a result of the European embargo on Russian oil imports. China's reopening remains another key driver, with Chinese demand anticipated to rise 0.8mbpd in 2023. Risk-taking investors can consider adding long positions in longer-dated Brent oil contracts, or selling downside price risks over the next six month. We continue to like energy sector stocks, which should be more resilient than growth stocks if inflation proves sticky or rates move higher.

Appendix

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