OCBC TREASURY RESEARCH

Greater China – Week in Review

6 September 2021

Highlights: More pledges to open-up

Tommy Xie
Xied@ocbc.com

Carie Li
Carierli@ocbcwh.com

Market sentiment in China consolidated last week despite weaker than expected August PMI. China's official manufacturing PMI fell to 50.1 in August from 50.4 in July. In addition, non-manufacturing PMI declined to 47.5 from 53.3, below the threshold line for the first time since March 2020.

The decline of manufacturing PMI in August was mainly due to softening demand, which was mainly attributable to three factors including the disruption to supply chain due to floods, weakening demand for high energy consumption products due to China's efforts to contain carbon emission and softening external demand.

Despite weaker than expected PMI, business sentiment remained stable with business expectation remained high at 57.5, down slightly from 57.8 in July.

The decline of non-manufacturing PMI was not a surprise given the sporadic outbreak of delta variant in July and August, which affect China's mobility due to China's zero tolerance towards virus. Given this round of outbreak has been under control, we expect China's non-manufacturing PMI to recover in September led by service PMI.

China's top policy makers used the China International Trade Fair for Trade in Services, which was opened by President Xi last Thursday as the platform to reassure the world about China's commitment to open-up.

President Xi announced China will implement a negative list for cross-border service trade. Meanwhile, China also committed to share development opportunities of the services trade with all countries. In addition, China will scale up support for the growth of the services sector in the Belt and Road partner countries.

On the operational level, both PBoC deputy governor and CSRC deputy Chairman said China will continue to deepen the opening-up of the financial sector and further promote the institutional opening-up of the capital market.

However, there is limited takeaways from US climate envoy John Kerry's visit in China last week as China plans to follow its own roadmap to achieve its climate goal according to the media.

Foreign ownership of China's RMB bond continued to go up in July despite increasing market volatility. Despite CNY47.5 billion outflows from negotiable certificate of deposits, the aggregate CNY75.7 billion inflows to China's government bonds and policy bank bonds showed the demand for RMB bond remained strong.

China's senior health official said last week that China is not ready to change its zero tolerance Covid-19 strategy. China will only consider making adjustment if all three factors including strict public health controls, high vaccination rate and therapeutic treatment are fulfilled. Currently about 900 million people about 60% of total population has been fully vaccinated.

On financial stability, PBoC said China's macro leverage ration declined in 4Q 2020 and stabilized in the first half of 2021 after 23.5% increase in 2020 due to pandemic.

In addition, the latest banking system stress test results showed that average capital adequacy ratio will decline to 13.6%, 13.35% and 13.01% respectively in 2022 for 30 major banks under mild, moderate, and severe stress scenario, all well above the regulatory requirement.

In **Hong Kong,** PMI for private sector rose to the highest since February 2014 of 53.3 in August despite weak external demand amid Delta variant outbreaks. This reinforces our view that domestic demand will be the main growth driver of local economy in 2H21 thanks to the well-contained local epidemic and e-consumption vouchers. Nonetheless, the economic recovery may remain uneven until border reopens. In July, retail sales missed expectations and were 20.8% lower compared to July 2019. The muted growth may be partially attributable to the households' preference to delay spending in the run-up to the launch of e-consumption vouchers on 1 August. If this is the case, retail sales may have rebounded in August. The faster-than-expected decline in unemployment rate may have lent some support as well. However, the retail sector may remain far away from the pre-pandemic levels due to the frozen inbound tourism (border reopening looks unlikely in 3Q21) and the ongoing social distancing measures.

Southbound bond connect reportedly will be launched ahead of China's National Day Holiday. Given the low availability of bonds and the relatively attractive yield of China's onshore bonds, net inflows from Mainland China to Hong Kong may be muted at the early stage. Having said that, should the coverage of southbound bond connect be expanded, the interests in offshore bonds may increase given the onshore investors' strong needs to diversify their portfolio. This together China's expected monetary easing and the moderated southbound equity outflows may support Hong Kong's RMB deposits (dropped by 0.05% mom to RMB820.8 billion in July) to rebound and have further upside.

In **Macau,** gaming revenue plunged by 47.4% mom to MOP4.44 billion in August, the weakest since last September amid the rebound in local Covid-19 cases and China's Delta variant outbreaks. Due to the very slow recovery of the gaming sector, we further cut our 2021 gaming revenue growth forecast from about 90% yoy to about 70% yoy.

Key Events and Market Talk	
Facts	**OCBC Opinions**
▪ China's macro leverage ratio increased to 279.4% in 2020 up by 23.5% according to PBoC 2021 Financial Stability Report.	▪ The increase of macro leverage ratio was partially due to slower nominal GDP growth as a result of disruption from the pandemic. Nevertheless, macro leverage ratio declined slightly in the last quarter of 2020 and stabilized in the first half of 2021 after China recovered from the pandemic. The rise of corporate leverage ratio and government leverage ratio in 2020 were the result of policy supports while the rise of household leverage ratio flagged the risk. Nevertheless, with the growth of mortgage and personal consumption loan has been under control, PBoC see low risk from the household debt. ▪ In addition, the latest banking system stress test results showed that average capital adequacy ratio will decline to 13.6%, 13.35% and 13.01% respectively in 2022 for 30 major banks under mild, moderate, and severe stress scenario, all well above the regulatory requirement. However, 16 banks failed the stress test under the severe scenario while 3 banks failed the stress test under the severe scenario without taking 2.5% capital reservation buffer into account.
▪ China pledged its open-up policies and sustainable development goals in the opening of the 2021 China International Trade Fair for Trade in Services.	▪ President Xi announced China will implement a negative list for cross-border service trade. Meanwhile, China also committed to share development opportunities of the services trade with all countries. In addition, China will scale up support for the growth of the services sector in the Belt and Road partner countries. ▪ PBoC deputy governor said China will step up to fix weaknesses in financial technology regulation and continued to deepen the opening-up of the financial sector. The Vice Chairman of CSRC also said China will further promote the institutional opening-up of the capital market.
▪ Southbound bond connect reportedly will be launched ahead of China's National Day Holiday. At the initial stage, only HKD bonds and RMB bonds will be available for Mainland investors.	▪ Given the low availability of bonds and the relatively attractive yield of China's onshore bonds, net inflows from Mainland China to Hong Kong may be muted at the early stage. In fact, QDII quota, which has been expanded last year, has never been fully used so far. Having said that, should the coverage of southbound bond connect be expanded, the interests in offshore bonds may increase given the onshore investors' strong needs to diversify their portfolio.

Key Economic News	
Facts	**OCBC Opinions**
▪ China's official manufacturing PMI fell to 50.1 in August from 50.4 in July. ▪ In addition, non-manufacturing PMI declined to 47.5 from 53.3, below the threshold line for the first time since March 2020.	▪ The decline of manufacturing PMI in August was mainly due to softening demand with new order index fell from 50.9 to 49.6, below 50 for the first time since March 2020. Production remained relatively stable with production index slipped slightly to 50.9 from 51. ▪ The weakening demand for manufacturing goods was mainly attributable to three factors. First, the disruption to supply chain due to floods this summer could dampen demand. Second, the demand for high energy consumption products

	also weakened probably due to the impact of China's campaign to reduce carbon emission. Third, external demand softened further with new export order fell to 46.7 from 47.7. ▪ Interestingly, PMI for both medium sized and small sized manufactures rebounded to 51.2 and 48.2 respectively from 50 and 47.8 previously while PMI for large companies fell by 1.4 to 50.3. Nevertheless, PMI for small companies has been below 50 for four consecutive months, indicating the pressure for smaller companies remain. ▪ Despite weaker than expected PMI, business sentiment remained stable with business expectation remained high at 57.5, down slightly from 57.8 in July. ▪ The decline of non-manufacturing PMI was not a surprise given the sporadic outbreak of delta variant in July and August, which affect China's mobility due to China's zero tolerance towards virus. Given this round of outbreak has been under control, we expect China's non-manufacturing PMI to recover in September led by service PMI.
▪ Foreign ownership of China's RMB bond continued to go up in July despite increasing market volatility.	▪ Foreign ownership of Chinese government bond and policy bank bond increased by CNy50 billion and CNY24.5 billion respectively to CNY2.18 trillion and CNY1.04 trillion. In addition, foreign ownership of local government bond also increased by CNY1.21 billion to CNY5.93 billion. The percentage of foreign ownership of CGB increased to a record high of 10.63% in July. ▪ However, foreign investors reduced their exposure to negotiable certificate of deposit with outstanding of holding by foreigners falling by CNY47.5 billion.
▪ Hong Kong's retail sales increased by 2.9% yoy in July, way below expectations and 20.8% lower compared to July 2019.	▪ Zooming in, alcoholic drinks and tobacco (+11.2% yoy), clothing, footwear and allied products (+30.6% yoy), electrical goods and other consumer durable goods (-2.5% yoy), goods in department stores (-9.6% yoy), jewelry, watches and valuable gifts (+27.1% yoy) as well as medicines and cosmetics (+0.5% yoy) dropped by 79.8%, 27%, 8.3%, 28.7%, 41.9% and 52.6% respectively from July 2019. This reinforces the fact that the frozen inbound tourism and the ongoing social distancing measures have together kept the retail sector far away from the pre-pandemic levels. ▪ Nonetheless, the muted growth may be partially attributable to the households' preference to delay spending in the run-up to the launch of e-consumption vouchers on 1 August. If this is the case, retail sales may have rebounded in August. The faster-than-expected decline in unemployment rate may have lent some support as well. ▪ However, since border reopening looks unlikely in 3Q while the latest retail sales have surprised to the downside during June and July, we cut our retail sales growth forecast in 2021 from about 15% yoy to about 10% yoy, assuming partial border reopening in 4Q 2021. Should border remains closed, retail sales growth may only print around 6% yoy for 2021.
▪ HKD loan-to-deposit ratio retreated to 83.7% in July from 84.2% in June as HKD loans (-5.3% mom) fell at a faster pace than HKD deposits (-4.9% mom) after the IPO effect abated.	▪ Total loans (+0.7% yoy in July) may see low single digit growth in 2021. First, trade finance (+17.7% yoy in July) rose for the third consecutive month and may remain resilient amid strong trade activities. Second, loans for use in HK (excluding trade

▪ Due to the waned IPO effect, HKD CASA to total HKD deposit ratio retreated from 70.6% in June to 69.3% in July.	finance) grew by 0.5% yoy despite the subsided base effect. In the medium term, local loan demand especially residential mortgage loans (+26.6% yoy in July) may recover along with the economy. Loans for use outside of HK, which fell for the fifth consecutive month by 1.4% yoy, may rebound should USD liquidity normalize and border reopening revive overseas M&A activities of Chinese firms. ▪ Total deposits continued to see steady growth of 3.1% yoy in July. Two implications behind the solid growth. First, local loan demand may have rebounded amid gradual economic recovery. Second, owing to the flush global liquidity, risk of capital outflows remains manageable despite the new wave of emigration. However, due to the high base effect and the cautiousness about Hong Kong equity amid China's regulatory risks, we expect total deposits to see low single-digit growth by end of 2021. ▪ In conclusion, until loan growth picks up pace and deposits drop amid Fed's tightening, HKD loan-to-deposit ratio may remain relatively low and in turn cap the upside of HKD rates despite the HKMA's additional bills sales.
▪ Hong Kong's RMB deposits dropped by 0.05% mom to RMB820.8 billion in July.	▪ This is in line with the notable increase in 12M USDCNH forward swap points during the month which reflects relatively tight CNH liquidity. The reasons behind the tight liquidity condition could be concentrated tax payments of Chinese companies, record high southbound equity outflows under stock connects and continuous net inflows to onshore bond market. ▪ On a positive note, southbound equity outflows moderated in August. Besides, the PBoC has cut RRR to reduce the funding costs of SMEs and has injected liquidity via open market operation to meet short-term liquidity demand. This helps to improve onshore and offshore RMB liquidity. Going forward, we expect RMB deposits to rebound and have further upside should new investment connect schemes be launched and prompt net inflows from China to Hong Kong.
▪ Hong Kong's housing transaction volume rose for the 15th consecutive month by 27% yoy in August. However, it dropped on monthly basis for the second straight month to 5546 deals, the lowest since January. ▪ For the week ended 22 August, CCL index, a secondary housing price tracker, dropped for the second consecutive week and dropped 1% from the record high seen in early August.	▪ The retreat in housing market may be attributable to the stock market rout and concerns about economic outlook during August as Delta variant outbreaks across the globe including China have weighed on investor sentiment. ▪ On a positive note, with China's epidemic brought under control, concerns about global economic growth outlook have eased. This together with the eased worries about China's regulatory risks and Fed Chair's cautious stance regarding rate hike have supported stock market rally. On top of this, a combination of rising housing rental, low interest rates, notable improvement in the labour market and the prospect of limited home supply may help to support a rebound in the housing market. However, stronger property market growth looks unlikely until border reopening provides additional impetus for local economy and brings in foreign investors. ▪ In conclusion, we expect housing price index (+4.32% YTD as of Jul 2021) to grow 5% yoy by end of this year.
▪ Macau's gaming revenue grew by 234% yoy but plunged by 47.4% mom to MOP4.44 billion in	▪ The plunge in gaming revenue was mainly attributable to the rebound in local Covid-19 cases and China's Delta variant

August, the weakest since last September when the border with Mainland China reopened.	outbreaks. On a positive note, both local and Chinese epidemic has been brought under control and the travel restrictions on Mainland visitors have been relaxed gradually. This may support a rebound in the gaming sector. However, given the lingering pandemic uncertainty and China's crackdown on overseas gambling (such as clamping down the overseas gambling trips), the road to recovery may remain bumpy for the gaming sector. Due to the very slow recovery of the gaming sector, we further cut our 2021 gaming revenue growth forecast from about 90% yoy to about 70% yoy.

RMB	
Facts	**OCBC Opinions**
▪ The USDCNH broke 6.45 last week on the back of broad dollar weakness.	▪ RMB's underperformance against its major trading partners showed that there is no idiosyncratic drivers against the RMB strength. And the USDCNY is likely to take cue further from broad dollar movement.

Treasury Research & Strategy

OCBC Greater China Research

Tommy Xie
Xied@ocbc.com

Carie Li
Carierli@ocbcwh.com

Co.Reg.no.:193200032W