Greater China – Week in Review

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Highlights: Setting the tone for the second half

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Market sentiment in China calmed down slightly last week on the back of vocal support from the state media as well as meeting between China's Security regulator and major investment banks to reassure that China's commitment to open-up remains intact.

The spillover from the US listed Chinese stocks to domestic stocks then to RMB in the beginning of last week has caught us by surprise. Given portfolio is usually not the key driving factor to RMB movement. Against the backdrop of still resilient basic balances surplus, we think the impact of equity induced volatility on RMB is unlikely to be sustainable. For our thoughts about recent volatility, you may refer to our latest China Q&A.

The article from Xinhua News Agency last week is certainly a good read as it offers five perspectives about China's capital market including economic foundation, liquidity support, long term development, no rollback of open-up and domestic reform. The conclusion here is that China's resilient economic outlook remains the cornerstone for the positive development of capital market.

However, the recent market rout in China failed to catch the attention of the top policy makers. The July Politburo meeting had no mention of that. This is not unexpected as capital market has never topped ruling party's agenda. Nevertheless, the reassurance of China's open-up in the meeting statement showed that the recent clampdown on China's private education sector is a standalone event. This may help ease concerns that China is decoupling from global financial market.

In the latest Politburo meeting, the concept of cross cyclical adjustments of macro policy resurfaced as China plans a smooth transition from this year's macro policies to next year's macro policies. Against the backdrop of the heightening uncertainty from spread of new variant, rising domestic credit risk and more complex external environment, the highlight of cross cyclical adjustments of macro policy showed that China is likely to be more sensitive to softening economic cycle such as weaker exports and collapse of property investment.

The latest July manufacturing PMI in China may add some concerns as both supply and demand moderated further. The decline of new export orders to 47.7 was a sign of weakening external demand amid vaccine induced resumption of global economy. In addition, the widening gap between large companies and SMEs with manufacturing PMI for medium sized companies and small companies fell further to 50 and 47.8 respectively from 50.8 and 49.1 shows China's uneven recovery.

The support to SMEs is likely to gain traction on macro policy settings against the backdrop of uneven recovery. Although the tone on monetary policy remains unchanged, monetary policy was also given a new role to support the recovery of SMEs. PBoC has already cut RRR in early July to ease pressures on SMEs from the rising raw material prices. We think it is possible for PBoC to lower the RRR or via other targeted liquidity measures further to support the SMEs.

China's politburo reiterated to stabilize commodity prices in its July meeting. China's top planning agency National Development and Reform Commission said last Friday that China's top fertilizer companies will temporarily suspend the fertilizer export. In addition, China also announced to hike export tariffs for 2 steel products and remove export tax rebate for 23 steel products.

This demonstrated China's policy toolkits to stabilize the commodity prices. Nevertheless, **the shift to prioritize domestic demand over external demand may raise the concern about China's export of inflation**, which could add extra problem to global central banks.

Last but not least, the recent spread of delta variants in China is also a cause for concern in the near term. Although China has demonstrated its mass testing capacity to identify the infection earlier, China's zero tolerance policy is likely to be double edged sword. This means the sporadic outbreaks should it spread to more provinces may affect the service activity in the summer holiday season, which may pose potential downside risk to our forecast.

In **Hong Kong,** GDP slightly missed expectations and expanded by 7.5% yoy in 2Q. The two main drivers of GDP growth in 1Q including fiscal stimulus and strong external demand remained intact in 2Q. In contrast, despite the rebound, private consumption expenditure and fixed investments were still down by 8.3% and 3.5% respectively from 2Q 2019. Worse still, due to the frozen tourism, exports of services (+2.6% yoy in 2Q) fell by 43.3% from 2Q 2019. This indicates that the economic recovery remained slow probably due to the ongoing containment measures in particular border controls. Going forward, the support from fiscal stimulus and external demand may have peaked as the government looks unlikely to roll out additional relief measures while the developed countries have been reopening the economy. On a positive note, we expect local consumption to see further recovery given the faster-than-expected decrease in jobless rate, the rising vaccination rate and the e-consumption vouchers. The resultant improvement in business conditions may boost fixed investments as well. However, any stronger economic recovery may require further relaxation of containment measures, in particular travel restrictions. In conclusion, we keep our GDP growth forecast unchanged at 5-6% for 2021 on assumption of partial border reopening in 2H.

Last week, the volatile financial market also caught the market's attention as USDHKD spot and forward both increased while southbound flows under stock connect have seen net outflows since 19 July. This was due to concerns about capital outflows as China's sweeping regulatory crackdown resulted in fierce sell-off of HK stocks. On a positive note, with some stabilization in Hong Kong stock market, USDHKD spot and forward wiped out some gains. However, given the lingering fear of uncertainty about China's next move, investors remain cautious about Chinese assets. As such, HKD spot refrained from taking another leg higher after the strong rally. That said, we do not expect USDHKD spot to test 7.80.

In **Macau,** though gaming revenue rebounded by in July and unemployment rate dropped to 2.9% in 2Q, the improvement may once again be hindered by the virus resurgence in China.

Key Events and Market Talk	
Facts	**OCBC Opinions**
▪ China's Politburo set the tone for its major economic policies for the second half of 2021 in its July Politburo meeting chaired by President Xi.	▪ We have four takeaways from the July Politburo meeting. ▪ First, the concept of cross cyclical adjustments of macro policy resurfaced as China plans a smooth transition from this year's macro policies to next year's macro policies. Against the backdrop of the heightening uncertainty from spread of new variant, rising domestic credit risk and more complex external environment, the highlight of cross cyclical adjustments of macro policy showed that China is likely to be more sensitive to softening economic cycle such as weaker exports and collapse of property investment. As mentioned by the politburo, fiscal policy will be more active to counter any potential risk. The window of issuance of local government bond will also be increased in the second half. ▪ Second, although the tone on monetary policy remains unchanged, monetary policy was also given a new role to support the recovery of SMEs against the backdrop of uneven economic recovery. PBoC has already cut RRR in early July to ease pressures on SMEs from the rising raw material prices. We think it is possible for PBoC to lower the RRR or via other targeted liquidity measures further to support the SMEs. ▪ Third, as expected, green economy remains a key word. Other than explicit support to the development of electric vehicles, China also called for an action plan to achieve carbon peak in 2030. However, the meeting also called for an end to whirlwind campaigns. This could help alleviate the concern about the economic shock from the "great leap". ▪ Fourth, the recent market rout in China failed to catch attention of the top policy makers. This is not unexpected as capital market has never topped ruling party's agenda. Nevertheless, the reassurance of China's open-up showed that the recent clampdown on China's private education sector is a standalone event and does not mean the rollback of China's open-up to foreign investors.
▪ China's top economic planning agency National Development and Reform Commission said in its website last Friday that it has summoned the major fertilizer companies for discussion to tackle rising prices.	▪ The statement also said that China's fertilizer companies will temporarily suspend exports and ensure the supply in the domestic market. China's shift to prioritize domestic demand over external demand may raise the concern about the export of inflation to the global market.
▪ China announced to increase export tariff for two steel products effective from 1 August. Meanwhile, export tax rebate for 23 steel products will also be cancelled.	▪ This was the second time this year for China to adjust its export tariffs for steel products. The move sent a signal that China plans to reduce steel production as part of China's push for reducing carbon emission. Nevertheless, the environmental driven move to suppress exports of steel products showed that China is moving away from exporting deflation with cheap steel products.
▪ USDHKD spot rose to above 7.7800, the highest since April. Meanwhile, USDHKD forward swap points were paid up across the curve. Southbound flows under stock connect have seen net outflows since 19 July. ▪ This was due to concerns about capital outflows	▪ Lately, in the absence of short-term liquidity draining events to support HKD demand, HKD spot's movement has been driven mainly by stock market movements. As such, with some stabilization in Hong Kong stock market, USDHKD spot and forward wiped out some gains. However, given the lingering fear of uncertainty about China's next move, investors remain

as China's sweeping regulatory crackdown resulted in fierce sell-off of HK stocks.	cautious about Chinese assets. As such, HKD spot refrained from taking another leg higher after the strong rally. ▪ That said, we do not expect USDHKD spot to test 7.80. First, the US dollar's upside may be capped given the cautious stance of the Fed. Second, the USD-HKD yield differential is relatively narrow and therefore may not trigger any sharp increase in carry trade. Third, any short-term liquidity draining events such as seasonality or large IPOs may boost HKD demand as well.

Key Economic News	
Facts	**OCBC Opinions**
▪ China's manufacturing PMI softened further in July to 50.4 from 50.9 in June.	▪ Both supply and demand sub-components moderated in July. Production fell to 51 from 51.9 probably due to electricity shortage and natural disaster. New orders fell to 50.9 from 51.5 with new export orders slipped to 47.7 from 48.1, a sign of weakening external demand amid vaccine induced resumption of global economy. ▪ The gap between big companies and SMEs widened further in July. Manufacturing PMI for large companies remained resilient at 51.7, intact from the reading in June while manufacturing PMI for medium sized companies and small companies fell further to 50 and 47.8 respectively from 50.8 and 49.1. This shows China's recovery is uneven. ▪ Raw material input prices rebounded slightly in July to 62.9 from 61.2. This showed that China will continue to step up measures to stabilize the commodity prices.
▪ Hong Kong's GDP slightly missed expectations and expanded by 7.5% yoy in 2Q, down from the upwardly revised growth of 8% yoy in 1Q. On seasonally adjusted basis, GDP shrank by 1% qoq, also shy of expectations.	▪ Zooming in, government expenditure (+2.9% yoy in 2Q) and exports of goods (+20.3% yoy in 2Q) were up by 13.2% and 17.7% respectively from 2Q 2019. This suggests that the two main drivers of GDP growth in 1Q including fiscal stimulus and strong external demand remained intact in 2Q. ▪ In contrast, despite the rebound amid well-contained local epidemic and improved economic growth outlook, private consumption expenditure (+6.5% yoy in 2Q) and fixed investments (+23.7% yoy in 2Q) were still down by 8.3% and 3.5% respectively from 2Q 2019. Worse still, due to the frozen tourism, exports of services (+2.6% yoy in 2Q) fell by 43.3% from 2Q 2019. This indicates that the economic recovery remained slow probably due to the ongoing containment measures in particular border controls. ▪ Going forward, the support from fiscal stimulus and external demand may have peaked as the government looks unlikely to roll out additional relief measures while the developed countries have been reopening the economy. On a positive note, we expect local consumption to see further recovery given the faster-than-expected decrease in jobless rate, the rising vaccination rate and the e-consumption vouchers. The resultant improvement in business conditions may boost fixed investments as well. ▪ However, any stronger economic recovery may require further relaxation of containment measures, in particular travel restrictions. Having said that, until border reopens fully and

	safely, exports of transport and travel services may remain far from pre-pandemic levels. The upside of consumption and fixed investment may be capped as well. In conclusion, we keep our GDP growth forecast unchanged at 5-6% for 2021 on assumption of partial border reopening in 2H.
▪ Hong Kong's exports and imports both surprised to the upside in June with a growth of 33% yoy and 31.9% yoy respectively as demand for Chinese goods remained solid amid virus resurgence in some parts of the globe.	▪ Except for Malaysia and Vietnam, imports from all other major trading partners including Mainland China (+32% yoy), Taiwan (+41.8% yoy) and the US (+42.7% yoy) all saw double digit growth. Exports to 10 major trading partners all recorded strong growth as well. In particular, exports to Asia and the US advanced by 35.6% yoy and 19.2% yoy respectively. ▪ Going forward, we expect exports and imports growth to slow down moderately as production resumes in major economies and consumption shifts from goods to services the demand. However, external demand for Chinese capital goods and intermediate goods may have strengthened with the resumption of production. As such, we expect exports and imports may grow by about 20% this year. Still, we will watch out for some downside risks, including supply chain bottleneck and the shock of Delta variant to global economic recovery.
▪ Hong Kong: Excluding the deposits created by the IPO-related loans, total deposits and Hong Kong dollar deposits increased by 0.3% mom and 0.7% mom respectively in June. HKD CASA deposits to HKD deposit ratio surged to record high of 70.6% mainly due to an uptick in IPO activity. ▪ Excluding IPO-related loans, total loans and advances increased by 1.4% mom in June. ▪ Affected by IPO effect, HKD loans grew at a faster rate than HKD deposits which drove HKD loan to deposit ratio up from 82.6% to 84.2%, the highest since last September.	▪ On loans front, loans for use outside of Hong Kong dropped for the fourth consecutive month by 2.6% yoy. Given the tightened grip on overseas M&A activities of Chinese companies and the lowered cost of USD funding in onshore market, loans for use outside of Hong Kong may remain subdued. In contrast, loans for use in Hong Kong surged by 8.6% yoy in June and the quarter-on-quarter growth accelerated from 3.6% in 1Q to 5.8% in 2Q, mainly led by trade finance and loans to stockbrokers, according to the HKMA. Owing to the robust housing market, approved new mortgage loans saw double-digit growth for the seventh consecutive month by 38.4% yoy in June. Going forward, local loan demand is expected to strengthen further given the improving consumer/business sentiments. We expect total loans and advances (+4.4% YTD excluding the IPO-related loans) to see low single digit increase in 2021. ▪ On deposits front, as the IPO market turned quiet amid rising market volatility, HKD CASA deposits to HKD deposit ratio is likely to come off. Having said that, total deposits (+2.7% YTD if excluding IPO-related deposits) are expected to show low single-digit growth this year. First, global major central banks including the Fed may tighten policy only gradually. Second, the expected rebound in loan demand may lead to increase in deposits as well. ▪ In conclusion, we expect HKD loan to deposit ratio to stay below 85% in the near term, which may allow short-dated HKD rates to remain low for some time.
▪ Hong Kong's RMB deposits barely changed at the highest since January 2016 at RMB821.2 billion in June as the upside was capped by the half-year end effect.	▪ Moving into July, we expect RMB deposits to drop. First, due to tax payment season of China's onshore companies, offshore RMB liquidity remained relatively tight with USDCNH 12M forward swap points staying elevated. Second, recent outflow concerns amid China's regulatory clampdown have briefly led to RMB depreciation and dampened demand for RMB assets. ▪ In the longer term, however, we expect offshore RMB liquidity

	to improve once the seasonal factors abate. First, RMB yield may remain attractive as the Fed may not raise rate until 2023. Second, the spillover effect of China's regulatory crackdown to RMB may be limited. Third, China is set to launch new connect schemes which may become the new sources of offshore RMB liquidity.
▪ Hong Kong's exchange fund posted a strong investment income of HK$51.4 billion in 2Q and HK$102.7 billion in 1H 2021.	▪ Bonds investments reversed a huge loss of HK$16 billion in 1Q and saw an income of HK$17.3 billion in 2Q as renewed virus concerns, lowered inflation expectation and eased expectation of Fed's premature tightening have supported a strong rebound in US Treasury bonds. On the other hand, the investment return of HK equities moderated from HK$7.6 billion in 1Q to HK$4.9 billion in 2Q while that overseas equities rose from HK$18.8 billion to HK$27.6 billion during the same period. The continuous gains of HK and overseas equities were mainly attributable to the eased concerns about premature tightening of PBoC and Fed. Finally, foreign exchange income remained moderate at HK$1.6 billion in 2Q as the broad dollar index traded sideways during the period. ▪ Going ahead, as we expect economic recovery to keep gathering pace despite recent virus resurgence while the major central banks may only tighten the monetary policy gradually, US Treasury yield may rebound while overseas and HK stock markets to have some room for rally. Meanwhile, the risk on the broad dollar index is tilted to the upside in 2H. In conclusion, we expect exchange fund to see moderate investment return in 2H.
▪ Macau's gaming revenue increased by 528% yoy or 29.2% mom to MOP8.4 billion in July. ▪ Macau's unemployment rate dropped slightly from 3% during March to May to 2.9% in 2Q while underemployment rate also fell notably by 0.7 percentage point to 3.5% during the same period. However, the employed population of gaming & junket activities (-5.8% yoy), construction (-24.9% yoy), wholesale & retail trade (-9.1% yoy) as well as hotel & similar activities (-13.4% yoy) all dropped in 2Q.	▪ The rebound of gaming revenue was mainly attributable to the relaxation of travel restrictions on Mainland visitors. This also indicates that inbound tourism would have rebounded in July. Owing to the gradual recovery of the two pillar industries including gaming and tourism, we expect the overall jobless rate to have peaked. ▪ However, recent virus resurgence in China may once again hinder the recovery. Worse still, there is no update regarding the discussion between Macau and Hong Kong about conditional border reopening. As such, we cut our gaming revenue growth forecast from over 100% to about 90% for 2021. In this case, this year's gaming revenue may only return to about 40% of 2019's level. ▪ Given the slow recovery of tourism and gaming coupled with the slowdown in construction activities, the unemployment rate may only drop moderately in 2H 2021.

RMB	
Facts	**OCBC Opinions**
▪ The USDCNY returned to 6.45-6.5 range after broke 6.5 in the beginning of the week.	▪ The spillover from the US listed Chinese stocks to domestic stocks then to RMB has caught us by surprise. The theme is moving quickly from the risk-off sentiment on Monday to concerns about capital outflows on Tuesday. This also sent RMB down significantly against both dollar and its major trading partners. ▪ Given portfolio is usually not the key driving factor to RMB

	movement. Against the backdrop of still resilient basic balances surplus, we think the impact of equity induced volatility on RMB is unlikely to be sustainable.

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