December 2018

Monthly Commentary

China/Hong Kong update

- China, Hong Kong stocks rebound on hopes of easing trade tensions
- Following Trump-Xi meeting, US agrees to suspend tariff hikes and begin fresh talks
- Tech sector up on solid corporate earnings; **Tencent** posts better-than-expected results
- Healthcare stocks lag broader market following new drug-procurement policy

Market overview

Chinese and Hong Kong equities rebounded in November, mirroring gains across other Asian bourses. Sentiment was primarily buoyed by hopes for a thaw in US-China trade tensions, ahead of a meeting between leaders Donald Trump and Xi Jinping at the G20 summit. The outcome was encouraging, with the US agreeing to suspend tariff hikes temporarily to allow for fresh talks.

The rest of November was just as eventful, with markets further boosted by positive external developments. The US midterm elections brought clarity, while investors also cheered dovish comments from the US Federal Reserve. Meanwhile, oil had its weakest month in more than a decade, falling after the US unexpectedly granted waivers on the Iran oil sanctions to several countries, which reignited oversupply concerns, while President Trump's subsequent pressure on Saudi Arabia cast doubt on OPEC's ability to control output. The energy sector declined, as a result.

Trade war hopes and worries

In November, hopes for easing US-China trade tensions ahead of the Trump-Xi meeting generally drove stocks higher. In the end, a temporary detente was achieved. The US will leave tariffs on US$200 billion of Chinese imports at 10%, instead of lifting it to 25% in January. Both sides will also begin talks aimed at reaching an agreement within 90 days. While this gave stocks some respite, we still expect sentiment to remain cautious in the short-term. It remains to be seen if even a partial compromise can be reached on the complex and contentious disagreements. However, this may give Beijing some breathing space, if only for a while, in rolling out fresh stimulus to support the economy.

However, it was not entirely smooth sailing, with markets still volatile before the deal was reached. While surveillance-equipment maker **Hangzhou Hikvision** ended the month higher, its gains were capped by worries that it may be banned from importing components from the US. But we think the impact will be manageable, as most of the components can be sourced locally.

Meanwhile, American authorities proposed limits on foreign investments in some new technology sectors, such as biotechnology, artificial intelligence, data analytics and robotics. The restrictions could hamper Chinese investments in the American biotechnology industry, which weakened sentiment towards **Wuxi Biologics**. The contract-research organisation for biological drugs derives a large proportion of its revenues from US clients. However, we remain comfortable with our position because most of Wuxi's technology is developed organically, and is unlikely to be affected directly.

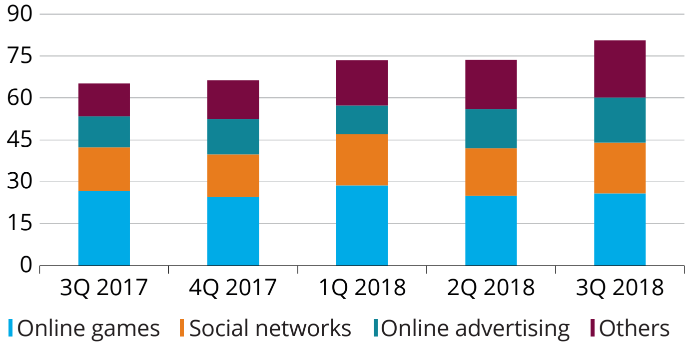
Tencent boost for tech

The technology sector, among the hardest hit by the trade war, largely shrugged off the proposed new US restrictions, with solid corporate earnings providing additional support.

Notably, **Tencent**'s third-quarter results were better than expected, with net profits increasing by 30%. The internet giant's online advertising, mobile payments and cloud businesses all reported robust growth, and offset sluggishness from its online games segment, which was to be expected, given Beijing's ongoing clampdown on online game approvals. While Tencent's immediate outlook remains hostage to regulatory uncertainty, our investment case is unchanged. We like the company for the quality of its ecosystem, and see good potential for its advertising business and other revenue streams.

Lessening reliance on games

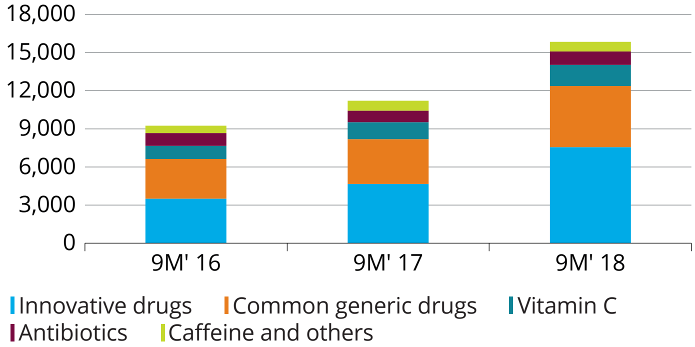
Tencent's revenues by segment (Rmb bn)



Source: Company data, November 2018

Innovative drugs drives growth

CSPC Pharma's revenues by segment (HK$mn)



Source: Company data, November 2018

Another holding that rebounded from prior weakness was online car portal **Autohome**. While its auto sales in the mainland declined in the third quarter, Autohome's earnings were resilient, largely thanks to its strong platform value, and a 400% jump in revenues from its online marketplace business. Its forecasts for the fourth quarter were upbeat, and management appeared cautiously optimistic in its 2019 outlook.

On the whole, we are cautious about the short-term prospects for the tech sector, which has de-rated substantially in the year to date. However, we remain optimistic in the longer term. Despite trade war worries, China continues to boast the most comprehensive tech supply chain, while the upcoming introduction of 5G technology should drive another cycle of innovation. Therefore, we view the recent volatility as a good opportunity to build up long-term positions.

Game-changer in healthcare

Healthcare stocks lagged the broader market amid concerns over the government's new centralised drug procurement program. Under the new policy, hospitals in 11 major cities, including Beijing and Shanghai, will purchase up to 70% of their drugs via a tender process. The company that wins the tender for each drug will subsequently be the sole supplier of that medication to those cities. We think the policy could be a game-changer, as it could level the playing field between bigger and smaller pharmaceutical companies, and cut healthcare costs.

Although **CSPC Pharmaceutical** was pressured after the pricing details of the centralised-procurement policy were leaked, its third-quarter results suggested that growth of its existing products remained on track, especially its innovative drugs.

Encouragingly, our other healthcare holdings were more resilient, with **Aier Eye Hospital** and **China Resources Sanjiu** both outperforming. In particular, Aier Eye Hospital's third-quarter results met expectations, with revenues growing steadily. We think its growth is being supported by increasing brand awareness and its expansion into lower-tier cities. China Resources Sanjiu also posted robust profit growth.

Overall, the healthcare landscape in China is changing rapidly due to the new regulations, which adversely alters the near-term outlook for certain segments. That said, the penetration rate in the mainland remains poor, which presents opportunities for growth over the longer-term. Many of the bigger companies are still investing in research and development and expanding capacity, which should help them to ride the growth in structural demand.

What we've been busy with

In November, we trimmed our exposure to **SAIC Motors**, given our more negative view on the auto sector. We also topsliced **China CYTS Tours** on valuation grounds.

Note: Any changes refer to those of our model portfolio, which is the basis for actual portfolios we manage that have similar investment objectives. However, there might be minor variations, so the comments may not apply to all portfolios.

Outlook

The twin challenges of an intensifying trade conflict and a moderating economy will continue to sway sentiment in China. Despite the recent ceasefire, we harbour doubts over the likelihood of a full compromise amid fresh tensions after the arrest of Huawei's CFO and Beijing's corresponding retaliation. This, along with the continued moderation of the mainland's economic momentum, has prompted authorities to loosen liquidity and introduce favourable fiscal policies. How Beijing manages the rebalancing of its economy will have implications for the regional and global economy. That said, we are still upbeat about China's long-term potential. Financial deleveraging and liberalisation of its economy should put growth on a more sustainable footing. We are also positive on the outlook for domestic consumption, and expect the growing middle class to continue pursuing a better quality of life, which will benefit companies across various sectors. The quality of our holdings gives us further comfort. Their robust fundamentals, clear growth prospects, sensible management and improving governance standards should stand them in good stead.

We hold the companies in bold.

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