Market Outlook for 2019 2H

During the first half of 2019, the Chinese market went up first and then slid down, as the trade conflict was still the main external factor affecting market sentiment. In the first quarter, Chinese market rebounded, led by ChiNext, and risk appetite picked up thanks to better-than expected economic data, easier monetary environment , stimulus from macro policies such as tax cuts and fee reductions, as well as softened tensions between China and the US. However, as the downside pressure on the economy gradually emerged in the second quarter, worsened China-US relation after US export bans on China's high-tech sector, and the severe credit risk case of a Chinese Bank, the performance of safe-haven assets began to outperform risk assets, with the weakening of stock market.

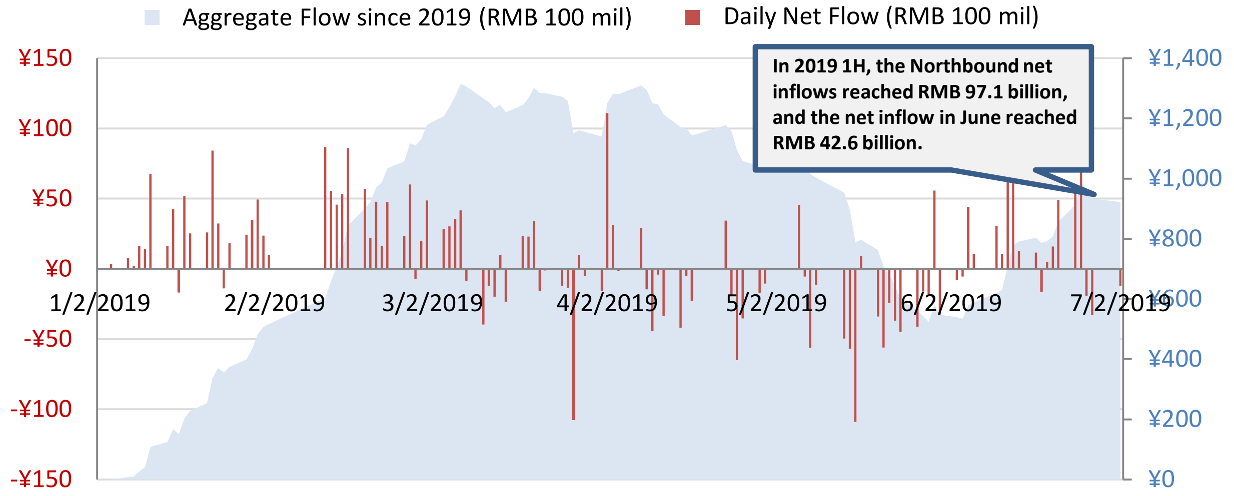
- Regarding index performance, as of June 30, 2019[1], the FTSE China A50 Index surged 36.4% in the first half of the year, outperforming other major A-shares indices. CSI 300 Index gained 32.6%, Shanghai Composite Index rose 23.5%, ChiNext Index gained 27.8%, and Shenzhen Component Index climbed up 33.5%. The RMB forex recorded a V-shape movement. At the year beginning, the CNH was at 6.88 per USD. It at once weakened to 6.94 level before bouncing back to 6.87~6.88 per USD in late June.

- **Foreign capital contributed to market inflow in 1H 2019.** With the inclusion of A-shares into the global benchmarks by MSCI and FTSE Russell in 2019, foreign capital further flowed into the A-shares market. On May 28, 2019, MSCI increased the inclusion factor of China A Large Cap shares from 5% to 10%, and 26 China A-shares (18 of which are ChiNext stocks) were added to the MSCI China Index, representing it's first time to add ChiNext into MSCI Index family. On June 24, 2019, FTSE Russell kicked off the first phase of its A-share inclusion , which is estimated to attract US$2 billion worth of inflow into the A-share market. In addition, Chinese bonds were also included in the Bloomberg Barclays Global Aggregate Index in April.

  With the acceleration of Chinese market being included into global indexes in 2019, the proportion of A-shares held by foreign investors also further increased.

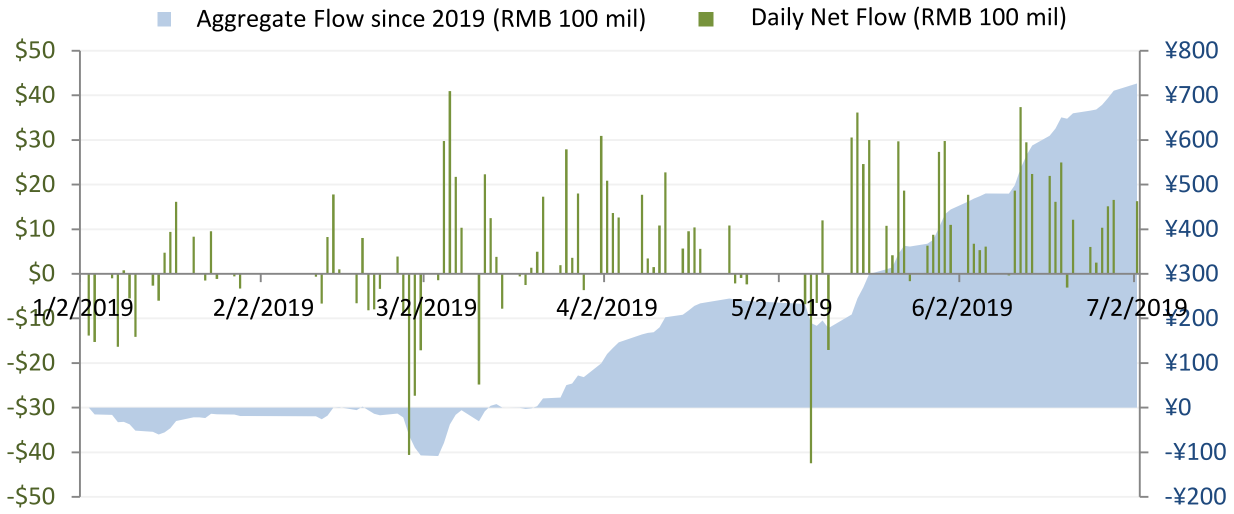
- **Northbound inflow slowed down, but the overall trend unchanged.** In 2018, Northbound capital inflows into the A-shares market reached 294.2 billion yuan. In the first half, despite capital outflow in the second quarter, the Northbound channel under Stock Connect recorded 97.1 billion yuan net inflow.

Northbound Flows through Stock Connect in 2019 1H



Source: CSOP, HKEX, date as of June 28, 2019

Southbound Flows through Stock Connect in 2019 1H



Source: CSOP, HKEX, date as of June 28, 2019

Market Views and Comments

- **Equity Market: External factors may still bring short-term fluctuations, but the market is constructing the bottom in the medium and long-term**

<u>China-US trade war becomes see-saw game.</u> The G20 summit achieved better-than-expected results. China and the United States agreed to restart trade talks, and the US promised no to impose new tariffs on Chinese exports. Compared with the deterioration of trade conflict since May, the relationship between China and the US in the next one or two months should a relatively stable. However, different perspectives between the two countries still exists, especially in the high-tech sector. If the negotiation enters into details again, the friction and confrontation may appear again. From the perspective of investment, it is not appropriate to be overly pessimistic, and it is essential to grasp the opportunities in the relatively moderate external environment adequately.

<u>The macro economy is facing pressure, but the possibility of deterioration is not high.</u>

Despite the unfavorable factors in the external environment, the flexibility of the macro counter-cyclical policies is increasing, and we expect the acceleration of structural reforms such as tax cuts and fees reductions, the credit environment improvement of private companies and SMEs, and reducing the restrictions on foreigner investors. The key driver for China's economic growth lies in domestic demand. Since the second half of 2018, China's macro policies have been serving the purpose of "Stabilizing employment, finance, trade, foreign capital, investment and market expectations." As the negative factors in domestic economy are partly set off by macro policies, the downside pressure on A-share market is less than it was in 2018, therefore we expect to see a higher market bottom this year.

<u>A-shares valuation still attractive for institutional allocation.</u>

As inclusion process of A-shares into MSCI and FTSE continues, the trend of foreign capital inflows China market remains unchanged in the mid and long term. Domestic regulators are expected to introduce corresponding favorable policies to help promoting A-share inclusion, and the allocation of foreign capital on A-shares is expected to increase further.

As for the HK stock market, it is more affected by external factors. The US Fed has released a clear dovish signal that interest rate cut in the second half of the year is fully expected by the market. Combined with the ECB's easing policy, the HK stock market still has a chance to be boosted in the short term. However, the market movement still depends on global economic situation, and the HK stock market may still face pressure if the low interest rate fails to stabilize the economic growth. In terms of sectors, China's consumer demand and industrial upgrading still have huge room to grow. In the long run, consumer services and pharmaceuticals sectors still have a positive outlook.

- **Fixed Income Market**

Economic growth still relies on consumption, as infrastructure investment and the export situation not quite optimistic. From the macroeconomic perspective, the more-than-expected real estate investment in the first half may not last in the second half. On the one hand, the policy stance that “houses are for living in, not for speculation” has not changed. On the other hand, the financing environment for property developers is still not optimistic. Infrastructure investment is the main driver of the government's counter-cyclical stimulus policy this year. However, as the restrictions on local government debt financing have not been relaxed, the overall space for infrastructure investment is limited. If there are other easing policies in the future, it may open up further space for infrastructure investment. Manufacturing investment meanwhile is also under pressure due to prudential market expectations on economic growth and the financing environment, but the positive impact of tax cuts and fees reductions still worth further observation. Consumption sector is unlikely to improve largely in the short term when taking into account of the leverage ratio of the residents. However, considering the policy of “houses are for living in, not for speculation” and tax cuts and fees reductions in the long term, consumption sector still has the potential to grow. In the aspect of international trade, affected by China-US trade conflict, the situation in the second half may not be optimistic. With respect to the RMB exchange rate, the probability for RMB/USD to break 7 thresholds has increased to some extent.

Do not underestimate the repetitiveness and uncertainty of China-US trade conflict. The repetitiveness and uncertainty of China-US trade conflict are increasing. The US presidential election is just around the corner, and China-US trade conflict will be more like a political game rather than just the wrestling of trade and economic behavior. The development of China-US trade war is likely to influence and incite the existing political and economic structure of the whole world. As the uncertainty of global economic development has increased, enterprises are facing with more challenges including business environment, strategy making and implementation, as well as investment and financing arrangements.

Interest rate securities fluctuated in the short term, but the bull market environment still exists in the medium term. Domestic government treasuries continued to fluctuate in the first half of the year, and the overall yield curve was steeper as of the end of the second quarter. Looking ahead, the fundamentals and the liquidity showed a relatively contradictory signal in the short-term, so the short-term market is expected to remain volatile until a clear signal from fundamentals and monetary policy is seen. In the medium term, the bull market environment still exists, and the wdie spread between Chinese and U.S. 10-year treasury rates has also provided space for further declines in Chinese government bond yield. In the long run, with the slowdown of China's economic growth and the development of interest rate marketization, there is still a downside trend for risk-free interest rates.

China Corporate USD bonds to see a good entry point. In terms of RMB bond market, affected by various factors, such as the domestic economic condition, China-US trade talks, and domestic credit transmission mechanisms, the credit spread still face a risk to be broader in the second half.

Regarding USD bonds issued by Chinese companies, after the rise of various risk assets' prices in the first half of the year, the credit spread of Chinese corporate USD bonds, especially high-yield categories, narrowed sharply to the level at the beginning of 2016. Due to increasing external uncertainty, risk assets are generally facing pressure, and credit spreads are facing modest expansion again. Benefiting from the synergy of various factors including the overall low level of corporate external debt burden, low real default risk, relatively stable RMB foreign exchange rate, early refinancing of mature companies through foreign debt financing arrangements, financing channels and cost advantages due to the improvement of domestic credit environment, we expect the extent of technical correction will be relatively controllable compared to 2018 and thus it will provide a better entry point for investors.

[1] Source: Bloomberg, date as of Jun 30, 2019