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Oversold Chinese stocks present a potential tactical opportunity

The recent surge in COVID-19 infections in China hit a two-year high on Tuesday, driving stocks in the region to end the day at 21-month lows and raising serious concerns about the economic costs in the government's quest to contain the disease. Makers from flash drives to glass for Apple's iPhone screens are facing large setbacks as they comply with new stringent curbs, further straining global supply chains. Four cities (including Shenzhen, the home of major local tech firms like Huawei, Tencent, ZTE, Oppo, etc.) have been locked down, and Shanghai is also at risk of a lockdown.

China activity data so far exceeded expectations in the first two months

It was one reason why the PBoC didn't deliver the expected MLF cut and may lower its sense of urgency for further actions. However, it is worth noting that headline numbers have benefited from the low base from Jan-Feb 2021, especially for manufacturing investment and infrastructure investment as well as retail. External demand likely also supported industrial production. Fixed asset investment growth jumped from 4.9% y/y in 2021 to 12.2% y/y during the Jan-Feb period. Retail sales also beat expectations, up 1.7% y/y in December to 6.7% in the same period.

However, property weakness and the recent outbreak pose significant headwinds to growth ahead

Despite the affordable housing development, property-related indicators like new starts and land acquisition have remained weak. Medium-/long-term household loans declined for the first time in February, showing an unusually weak credit appetite amid the property downturn. Meanwhile, under the current wave of COVID-19, cities with high/medium risk areas now cover 16.7% of China's GDP. In short, policy support remains essential for sustaining the growth momentum, and our view is that the easing cycle is not over yet.

Progress in mRNA

As of February 25th, China had fully vaccinated 85.5% of its +1.4bn population. While vaccination rates are comparable to other major DM and neighboring Asian countries, the issue lies in booster rates, which are lagging significantly. Boosters are important because research shows that the antibodies from Sinovac's vaccine declines significantly six months after two shots.

However, some bright spots have emerged. China approved the usage of urgent COVID pill Paxlovid in February, paving the way to introduce foreign mRNA vaccines. Meanwhile, the domestic mRNA vaccine from Walvax is under the final stage of its phase three experiment.

Citi's take – oversold markets may present a tactical opportunity

Citi's analysts predict that the new wave of infections may lead to a sizeable economic impact of ~0.5-0.8ppt of GDP in 22Q1, assuming no policy interventions, and will likely require more and imminent policy support to achieve the 5.5% annual growth target.

The re-imposition of social distancing measures will further delay the recovery of the services sector to 22H2. Meanwhile, borders are likely to remain shut until the next NPC meeting in March 2023.

Chinese stocks traded in the US recouped some losses overnight as dip buyers emerged following a 29% slump over three days. The intense selloff in Chinese and Hong Kong equities had several clear macroeconomic drivers (geopolitical risks, COVID-19 lockdowns, new regulatory concerns, the impotence of stimulus), but it was also exacerbated by technical fallouts (mainly the unwinding of leveraged and derivative positions), which have not only affected offshore shares, but also onshore A-shares.

Our CIO sees the market as oversold and may be presenting a tactical opportunity, even though volatility is expected to remain elevated in the medium-term. The Hang Seng Index cash and short-term investments are now worth 1.6x its market cap as of March 15th, by far the highest on record. When it reached above 1.2x in 2009, 2012, and 2020, the following 12-month returns were 24-54%.

Macro drivers are likely to get some breakthroughs, particularly COVID and stimulus. Short squeezes could follow selloffs like this one. However, the Russian debt default risk and lingering regulatory uncertainties in China continue to pose headwinds and may keep volatility elevated in the medium-term.

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