2022 China A share market outlook

Chin Ping Chia
Head of China A Investments

Chris Liu
Senior Portfolio Manager

While the China A share market experienced significant market volatility driven by a series of regulatory tightening measures in 2021, we expect a more supportive policy environment in 2022. The key priority for China this year is that economic growth remains stable. China's domestic policy environment still has ample room for easing as compared to overseas markets, particularly the US.

After the widely anticipated reserve requirement ratio (RRR) cut in December of last year, we saw sector rotations away from growth and toward value sectors in early January. Sectors such as property, construction, building materials and even financials have rebounded on expectations of more accommodative monetary and fiscal policies. The market expects that the current policy environment could help small and medium enterprises (SMEs) bolster employment and thus indirectly support consumption recovery. It also provides some breathing room for developers to meet their payment obligations (i.e., pay their contractors, purchase land, etc.). The market also anticipates more fiscal stimulus on the infrastructure side and infrastructure investment growth is expected to pick up in 2022 to help offset the slowdown in property investment.

This being the case, we caution that historical rallies on China cyclical stocks as a result of policy stimulus tend to be short lived. China's high debt ratio rules out the possibility of a big stimulus, and the financial impact of policy stimulus on cyclical sectors has become smaller and smaller in the more recent rounds of economic cycles.

China's consumption recovery will depend on how the COVID-19 pandemic develops in the short term. While China's "zero-tolerance" policy has been effective in preventing the widespread contagion of the Delta variant, the recent Omicron variant could create some short-term uncertainties. Long term, regulations imposed on the property and education sectors in 2021 are likely to have positive implications on the future consumption power of Chinese households. A correction in property prices in big cities and reduction in education expenses could be helpful to redirect household spending towards consumer goods and services.

Export growth is the other equation of the dual circulation policy. China's export numbers have been very strong in the past two years because the country was able to contain the spread of the pandemic more swiftly than many other counties. However, if the global COVID pandemic wanes in 2022 and overseas production and overseas supply chains recover, China's export growth rate might also see a decline this year.

Looking forward, we expect market sentiment towards the A share market to gradually improve after impact of these supportive policies start to kick in. We believe that market liquidity for the A share market is likely to remain abundant in 2022 with a continuous structural shift in demand away from wealth management products and toward mutual funds.

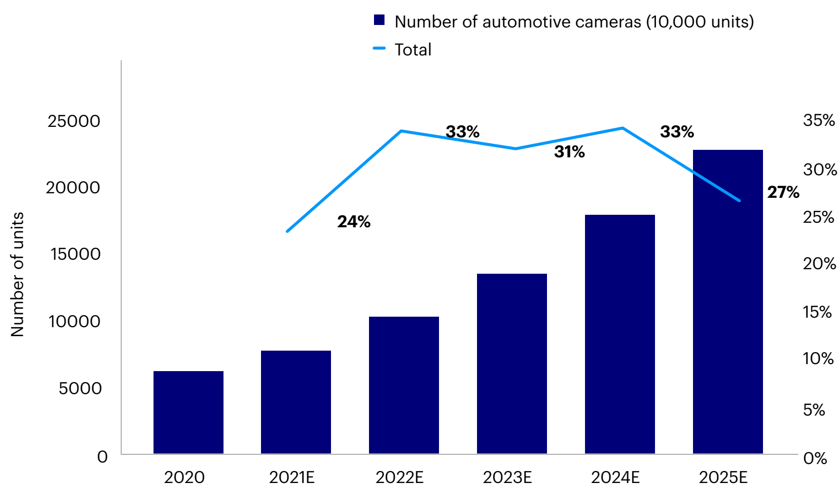
The sectors that we favor for 2022 include electric vehicle (EV) supply chain, electronics, and healthcare, because their long-term fundamentals remain strong. We outline our outlook for these three sectors and also cover our expectations for the property and financial sector in 2022.

Electric vehicle (EV) supply chain – shifting from beta to alpha
Most EV stocks did well in 2021 on the back of strong policy support and rapid growth in China and overseas. After a healthy correction late last year, investment opportunities are reemerging. However, unlike the sector-wide rally that we saw in 2021, we believe that opportunities this year would be company specific. In other words, stock selection is key. We favor stocks that have high barriers to entry and those that are making use of new technologies such as artificial intelligence (AI) and Internet of Things (IoT) as well as autonomous driving.

Battery is one of the most critical components of EVs. Despite the rising penetration of EVs in China, problems of short battery life and long charging times still prevent some customer from switching. EV battery companies and their upstream suppliers who can innovate and tackle these issues are likely to sustain competitive advantage.

On the other hand, as lithium prices rises, there are worries in the market that the cost of upstream raw materials could affect the downstream demand for EVs. To compete, EV makers need to focus on user experience and product differentiation. Within the sector, we expect intelligent automobiles and application of new technologies to become the main investment theme for 2022. Some consumer electronics companies could also benefit from this theme (given the demand for displays, cloud storage, cameras and radars in areas such as autonomous driving and intelligent cockpit). We predict the interest in intelligent cockpit and advanced driver-assistance systems (ADAS) will drive the demand for intelligent cameras, displays, laser radars, etc. For example, we expect that the number of automotive cameras will increase from 1 to 10 to 12 cameras per autonomous vehicle.[1] The same can go for displays as intelligent cockpits become more important in attracting future customers. We also expect laser radars to be another growth area driven by the adoption of ADAS.

Figure 1: Forecast of the number of automotive cameras globally



Source: Invesco Great Wall Technology Insights - Report on New Energy Vehicles; data as of December 2021.

1. Invesco Great Wall Technology Insights - Report on New Energy Vehicles (景顺长城科技洞察报告之- 新能源汽车), December 2021

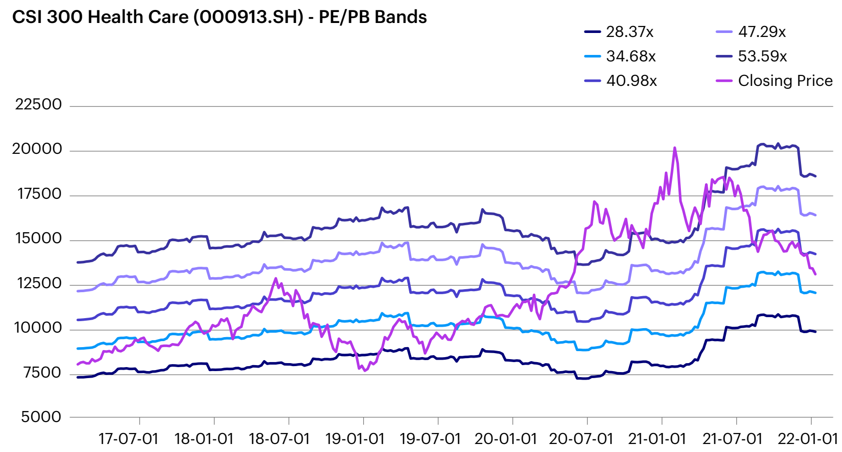
Electronics sector outlook
Valuations of electronics have come down to historically average levels after recent corrections. We believe that fundamentals in the electronics sector for 2022 look promising and anticipate a stabilized mobile phone supply chain. Specifically, we expect that foldable smartphones will be a new catalyst.

Apart from mobile phones, other growth drivers for electronics are areas such as auto electronics, virtual reality (VR)/ augmented reality (AR), smart wearables and Internet of Things (IoT). We expect to see more applications of these technologies in 2022 as the concept of metaverse becomes more mature.

Healthcare sector outlook
China healthcare is a secular investment theme. The country's aging population, rising healthcare needs and healthcare innovation underpin the foundation of healthcare investing.

Going into 2022, we think that the risk-reward ratio for China healthcare sector is becoming more positive. After the correction in 2021, valuations in the healthcare sector have come down to below 5-year averages in terms of their trailing 12-month P/E ratios. In the past 10 years, China's healthcare sector has only had 2 large drawdowns before the one last year. They were all short-lived (lasting less than 1 year) given the fact that China's healthcare sector is supported by robust long-term drivers.

Figure 2: PE band chart for China's healthcare sector over the past 5 years



Source: WIND; data as of December 31, 2021.

Although China has been able to contain COVID quite effectively, there is no sign that it is going away anytime soon. COVID-related businesses such as vaccines, COVID testing and even vaccine contract development and manufacturing organizations (CDMOs) could continue to see sustained demand over the medium term. On the other hand, there remain plenty of non-COVID related healthcare issues that need to be tackled and these represent significant opportunities for the China healthcare industry.

From the regulatory risk perspective, price controls from the government's volume-based procurement is one to watch out for. As we have highlighted in the past, healthcare is both a necessity and a public good. Medicine accessibility and healthcare affordability will continue to be the central policy tenet as China advances its universal healthcare coverage agenda. While the market has tended to overreact to news of volume-based procurement in the past 4 years, most generic drugs and essential medical devices have now been included into the national reimbursement drug list (NRDL). Profitability pressure of drug makers especially those with an innovation focus on should continue to ease.

Property and financial sector outlook
The property sector in China is currently facing significant downward pressure as some private developers are facing default risks. Historically, high property prices have been a key reason for the low birth and marriage rates in big cities in China. High rents and mortgage costs also prevent households from being able to spend. Policy tightening in large cities such as Shenzhen in 2021 dragged down property prices. As a result, property sales have come down, creating funding problems for developers, and eventually impacting property investment growth and local government land sales.

To prevent the defaults of large developers, local governments are expected to loosen on the supply side, mainly by providing favorable funding terms to developers in order to complete more projects. While on the demand side, we believe there will be some relaxation for first-time home buyers as the policy tone that “housing is for living and not for investment and speculation” is still unchanged. Although the blanket implementation of property tax could be delayed in the short term, we expect this to come into effect sooner or later.

Property stocks have risen recently on the back of recent supportive policies, but we do not believe this is sustainable given that consumption rather than property is expected to be the key growth driver for China in the next 5 years.

Looking at the financial sector, we expect that banks may need to support the economy in order to prevent the defaults of large private sector developers. At the same time, the structural shift in customer demand away from banks’ wealth management products and towards mutual funds could hurt the growth in banks’ fee incomes. In our view, the recent medium-term lending facility (MLF) policy rate cut signals the potential for more loan rate cuts in the future, which could put pressure on banks’ net interest margin (NIM).

Brokers on the other hand could benefit from reforms of registration-based IPOs and we expect to see more direct financing to SMEs through more registration-based IPOs in 2022. We also anticipate that brokers can benefit from the boom in the wealth management business in China. Abundant market liquidity amid an expansionary monetary environment is positive for brokers as their transactions volumes in 2022 can remain high.

Investment risks
The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

When investing in less developed countries, you should be prepared to accept significantly large fluctuations in value.

Investment in certain securities listed in China can involve significant regulatory constraints that may affect liquidity and/or investment performance.

Important information

This document is issued in the following countries:

- in Hong Kong by Invesco Hong Kong Limited景順投資管理有限公司, 41/F, Champion Tower, Three Garden Road, Central, Hong Kong. This document has not been reviewed by the Securities and Futures Commission.
- in Singapore by Invesco Asset Management Singapore Ltd, 9 Raffles Place, #18-01 Republic Plaza, Singapore 048619.
- in Taiwan by Invesco Taiwan Limited, 22F, No.1, Songzhi Road, Taipei 11047, Taiwan (0800-045-066). **Invesco Taiwan Limited is operated and managed independently.**

AP1998116