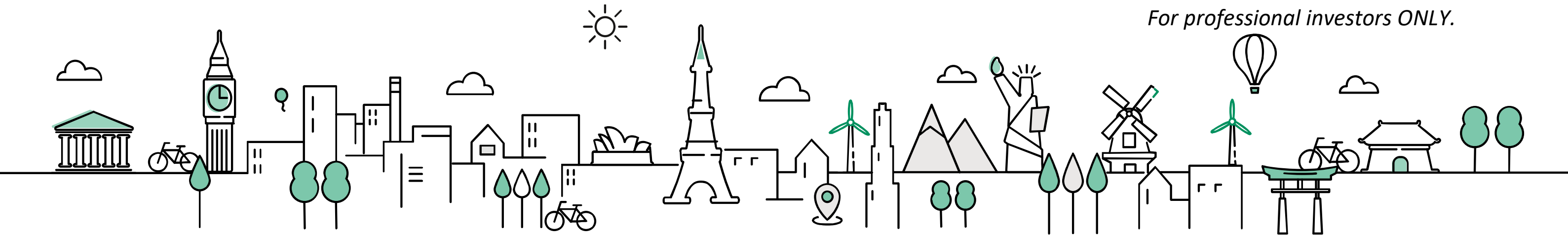

China equity market outlook for 2020

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Seven themes for China 2020:

Theme #1: Trade war moving into stage II

Theme #2: Monetary easing & fiscal policies: Doing just enough

Theme #3: Bottoming of industrial activity

Theme #4: Deflationary forces obscured by food prices

Theme #5: Stable renminbi

Theme #6: Robust earnings outlook (led by 'New China')

Theme #7: Reasonable valuations

Key risks: Domestic (longer-than-expected duration of the coronavirus outbreak, lower than expected policy support) & external (trade dispute & US elections)

Outlook 2020: China in 7 themes

China is the second largest economy in the world and is expected to set to overtake that of the US by 2030, according to the International Monetary Fund. China's economic development is a unique success story. Chinese consumers have become one of the most powerful forces shaping consumption behaviours in the world, and China's stock markets offer unrivalled access to these remarkable transformations.

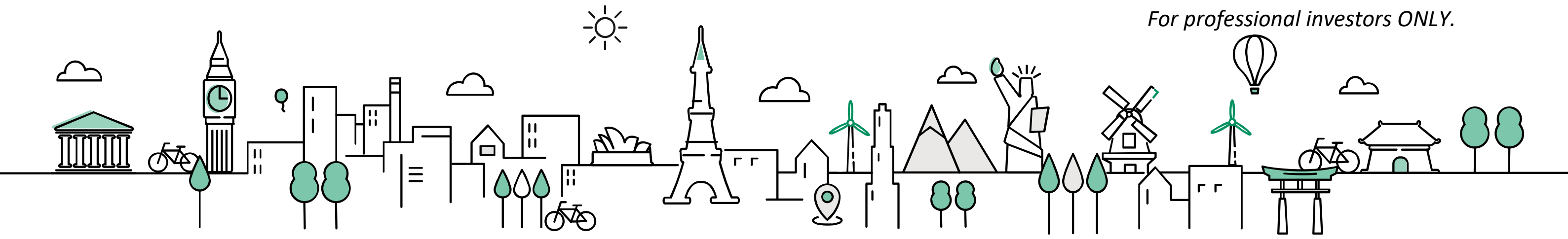
Although China's economy slowed materially in 2019 and the unexpected coronavirus outbreak hit Chinese equity markets early 2020 (dampening investor sentiment in the short term), we believe that downside risk to growth for the full year 2020 is limited so far. We see opportunities in the market rebound once the situation will stabilise. The combination of trade tensions stabilisation, recovery in global industrial activity and flexibility for greater fiscal support should favour some sequential reacceleration during 2020. So far, we believe China's GDP should grow by 6.1% YoY in 2020. China is likely to keep the current selective easing policy stance sustaining a muddle-through growth environment. This should be mildly positive for Chinese stocks for the full year.

Theme #1: Trade war moving into stage II

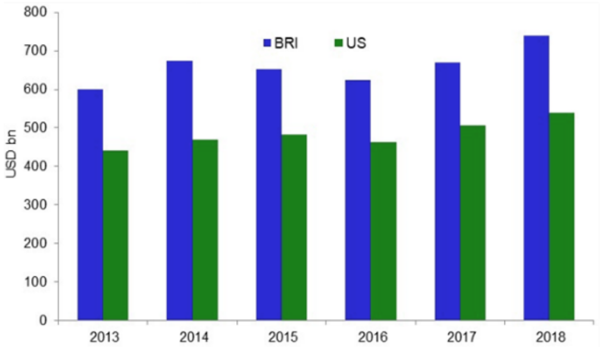
In our view, any final settlement of China's trade dispute with the US will probably be a long time coming. Indeed, the ultimate economic problem lies in the global savings-investment imbalance, led by China (with surplus savings and under-consumption) and by the US (with too-low savings and over-consumption). As the US has trade deficits with over 100 countries, we believe that a bilateral trade war with China cannot solve this trade deficit with the rest of the world.

Since May 2019, the Chinese government has been in consensus on engaging in an extended trade dispute with the US even at the cost of more domestic economic pains. The strategy being used is to exhaust the US by employing a rotating tactic of fighting and negotiating.

In the meantime, China is diversifying its exports to new markets, notably to countries along the 'Belt and Road Initiative' routes (62 countries, as of 2018).



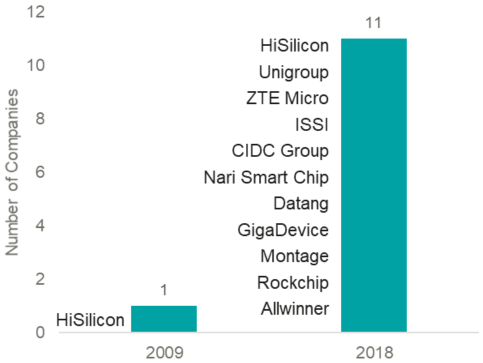
China is diversifying its exports to the BRI ('Belt and Road Initiative') countries to reduce the proportionate impact of US tariffs



Source: BNPP AM, CEIC, as of September 2019

In our view, the trade war is transforming from a macroeconomic risk of economic imbalances to a microeconomic risk of technology competition. Technology remains the largest Chinese import sector (21%), with goods mainly coming from the US, Japan and Germany. China's success tends to be higher in application, assembly, mobile and wired applications, but remains low in key components (e.g. logic chips). Therefore, localisation is becoming a national priority in China. China is now boosting new industries, notably in semiconductors, robotics, aircraft, biotech, AI, electric vehicles, aerospace and other technologies.

China has now 11 of the top 50 fabless firms (those that design microchips but contract out their fabrication rather than owning their own factories)



Source: Credit Suisse, IC Insights as of 4 November 2019

More crucially to the direction of the future trade war is the ban on US sales of technology to Huawei. Instead of strangling Huawei, the US sales ban has prompted it to survive without US chips. Indeed, Huawei continues to survive by building new smartphones and developing 5G base stations without using US chips. Its latest smartphone Mate 30, released in November 2019, which competes with iPhone 11, contains no US chips at all. Huawei has moved away from American parts at an unexpectedly fast speed.

According to our senior economist Chi Lo: "In the longer term, the US's effort to decouple from China by breaking up the global supply chains will be quite disruptive to the world's production ecosystem. De-globalisation will also result in financial fragmentation, which will disrupt the global technological landscape".

Theme #2: Monetary easing & fiscal policies: Doing just enough

To strike a balance between easing monetary policy and containing potential inflationary pressures, the Chinese regulator has opted for a low-profile easing approach, in our view, by adjusting liquidity and interest rates via the money market (reverse repo rate) and lending facility (MLF injection and interest rate). Policymaking in 2019 was a constant balancing act between the need for cyclical stimulus to protect growth and structural control of debt and asset bubbles. The latter would imply setting up a policy to complete the financial cleanup that the Chinese government started in 2017. As a result, these conflicting policy objectives have led the government to opt for the strategy of selective easing.

Barring any significant domestic credit events and escalation, we believe that some additional easing is needed to keep the economy on the rails in 2020, so we would expect more to be implemented over the year, with greater fiscal support. With the trade war risk, we believe the macroeconomic environment will be mildly positive for Chinese assets in the coming year.

The above-mentioned securities are for illustrative purpose only, are not intended as solicitation of the purchase of such securities, and does not constitute any investment advice or recommendation.

Theme #3: Bottoming of industrial activity

Some green shoots suggest the global industrial cycle may be at its bottom. For instance, the global manufacturing PMI seems to have been stabilising in recent months. A moderate upturn in global industrial activity should boost Chinese exports.

Consumption in China may accelerate as multiple headwinds to consumption could fade in 2020. For instance, automobile consumption was relatively weak in the last two years given that payback effects after 2015-2017 purchase tax cut curbed demand. Today, China's automobile penetration rate has room to grow. As payback effects might start to fade, this should support a gradual pick-up in automobile consumption.

High consumer confidence and stronger housing-related consumption (led by further housing completions) may also contribute to stronger consumption growth in 2020. Property pre sales have been strong since 2016, but completions were lagging behind most likely due to tight financial conditions and the government's promotion of furnished apartments. Since October 2019, we have seen a rebound in housing completions. As completions could catch up to property presales, this is likely to drive an improvement in home appliances, furniture and decoration materials consumption in 2020.

A stable labour market and relatively stable wage growth could also provide support to nominal household income growth.

Moving-in related consumption (e.g. home appliances, furniture) could improve given stronger housing completions

Source: BNPP AM, Goldman Sachs, data as of November 2019.

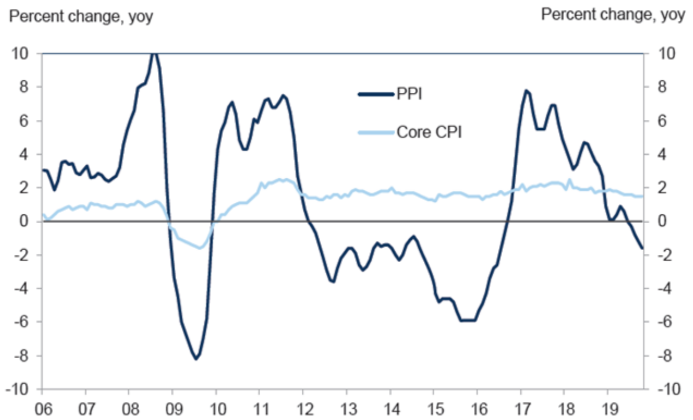
Theme #4: Deflationary forces obscured by food prices

A surge in pork prices, due primarily to the effects of the African swine flu, has driven headline inflation above policmakers' comfort zone. Headline CPI inflation accelerated to 4.5% YoY in December 2019, posing challenges for further loosening monetary policy recently.

However, this obscures a broadly soft inflationary environment. Core inflation remains low (below 2%), and producer prices have become slightly negative. Downside risk to growth remains, with deflationary pressures remaining prevalent. With core (and upstream, PPI) inflation pinned to the floor, we expect headline CPI inflation to stay at a reasonable level (average 3.0% in 2020).

As a result, despite the recent rise in the headline CPI inflation rate, we believe that inflation should pose no threat to further monetary easing.

Despite high CPI, core CPI has been mild and PPI dipped back to deflation, reflecting commodity price disinflation



Source: BNPP AM, Goldman Sachs, data as of November 2019.

Theme #5: Stable renminbi

The RMB exchange rate has been mainly driven by developments in the US-China trade tensions. We believe that any rolling back of the US tariffs on Chinese exports may suggest the renminbi could appreciate in the near term.

However, any further rise in trade tensionsin the short term may prompt China to scale back its FX intervention and allow the renminbi to weaken further under market forces as part of the negotiation tactic, in our view. This does not mean that China has a devaluation policy, but it does imply that the tail risk of the trade war igniting another round of currency war has risen.

Towards a more stable renminbi against the USD and basket

* Using expanded CFETS basket starting from 2017.
Source: BNPP AM, CEIC, data as of September 2019.

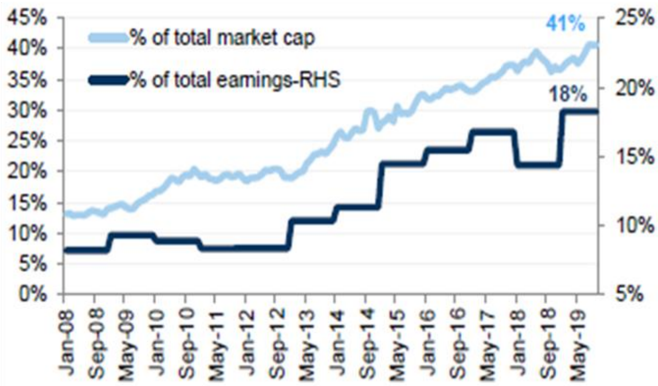
Theme #6: Robust earnings outlook (led by 'New China')

Despite some macroeconomic concerns, China's profit growth has been resilient. The financial market is expecting an average of 10% growth for MSCI China (China offshore) for 2020. 'New China' contributed a rising earnings share in the equity universe, growing earnings by over 20% in 2019.

Key factors driving the microeconomic outperformance include:

- 'New China' has been outgrowing the broader universe in earnings terms over the past decade
- Industry consolidation is developing across industries, particularly in real estate and several consumer sectors. This has led to increasing profit concentration in large-scale and listed industry leaders
- Tax cuts and government subsidies have helped boost net margins and earnings growth
- Housing activity has been stronger in recent months, with potentially further housing completions accelerating into 2020.

The New China's market cap and earnings share in the aggregate listed universe have been increasing steadily over the past decade (New China as % of all China)



Source: FactSet, Goldman Sachs Global Investment Research, 24 November 2019.

In terms of our portfolio strategy, we believe that China's equity markets are increasingly driven more by structural than cyclical factors. We see investment opportunities in the sectors that are most likely to benefit from these structural changes: 1) technology & innovation; 2) consumption upgrading; and 3) industry consolidation.

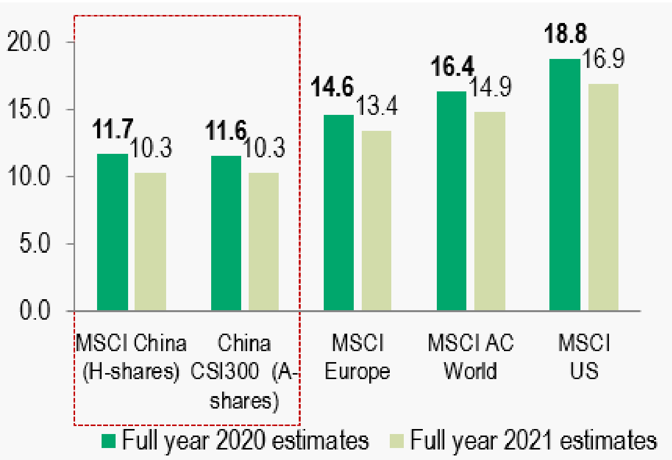
Theme #7: Reasonable valuations

Valuations of both China A- and H-shares are undemanding: they are trading at a discount relative to those of developed markets. Despite attractive valuations, China equities remain under-owned: global funds remained underweight China offshore equities by 290bp (as of 24 November 2019, source: Goldman Sachs estimates).

We are still seeing a further opening up of China's equity markets. We believe that further inclusion of A-shares into the key major indices (MSCI, FTSE Russell, and S&P) will help support the renminbi and improve the China A-shares market's investor structure from being retail-focused to a more balanced mix of institutional and retail investors.

The investment opportunities in China today are too big to ignore, but the Chinese markets require local expertise to navigate their waters successfully. While a purely passive approach has limitations, we believe that exposure to the China market could benefit an investor's portfolio over the long term, by enhancing the risk-return profiles of their global portfolios.

China equity valuations look moderate vs. developed markets



Source: Bloomberg, BNPP AM, as of 2 February 2020.

Key risks

The key downside risks to our expectations hinge on domestic factors (e.g. longer-than-expected duration of the coronavirus outbreak, lower than expected policy support) and external headwinds (e.g. escalation of trade tensions, US elections).

Focus on Coronavirus

Implications on markets

Amid accelerating coronavirus cases, Wuhan being the epicentre of the epidemic outbreak, rising risk aversion led to a sharp fall in Chinese equities when markets re-opened on 3rd February 2020. This followed an extended period of the Chinese New Year holiday. The MSCI China index (China offshore) dropped by 6.7%, while the CSI 300 index (China onshore) fell by 9.9% from the peak of 13rd January (as of 4th February 2020). This correction can be attributed to panic selling by retail investors mostly.

What's different this time with SARS?

In contrast to SARS, fast reaction of the government and degree of transparency, the city lockdowns and warnings against travelling to Wuhan, the more advanced medical system today (vs. 2003) as well as better communication are the main differences. Hubei, the epicentre of the coronavirus outbreak, only accounts for 4.6% of China's GDP, whereas Guangdong and Beijing (the most affected regions in 2003) accounted for 15.2%.

Portfolio Positioning

We believe that this market correction provides a good entry opportunity for long-term investors for the following reasons:

1) The downside risks to near-term growth are expected, but the impact on overall GDP growth may be limited, in our view. This is supported by:

    - The importance of the policy goal of doubling real GDP growth by 2020 (vs. 2010) is pressuring China to increasing easing. We believe there is room for China to set up more supportive measures on both monetary and fiscal fronts.
    - Trade war risk is stabilising.
    - The recovery of China's autos and electronics demand is on the path, albeit delayed by the current epidemic outbreak.

2) Attractive valuation and potential inflows:

    - Valuations of both China A- and H-shares are undemanding vs. developed markets.
    - Given that foreign inflow quickly resumed in May 2003 after the SARS outbreak was brought under control, investors will be keenly watching out for the turning point of new infection cases as well as the timing of resumption to work across the country.

Sectors to be most hit hard in Q1/Q2 2020:

- Retail sales
- Transportation and leisure
- Properties
- Travel and cultural sectors (tourism, hotel, catering services, offline entertainment, Macau gaming)

Sectors to most benefit in Q1/Q2 2020:

- E-commerce, IT
- Online video, PC/mobile games
- Packaged food and food retailers
- Healthcare (increased demand for vaccines/health check-ups)

Overall, our Greater China equities team's preference remains centered on IT / Healthcare / Consumer and selective macro-driven sectors such as cement.

Conclusion

We remain constructive on China equities, for a number of reasons: a still-benign profit growth outlook, reasonable valuations, as well as a constructive portfolio flow amid light investor positioning. We believe that the market impact of the epidemic will be a short-term event. We remain optimistic about the long-term market trends and we believe 2020 offers an interesting entry point into China equities to benefit from long-term sustainable returns.

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