Citi Wealth Management

Investment & FX Insight

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July 22, 2024

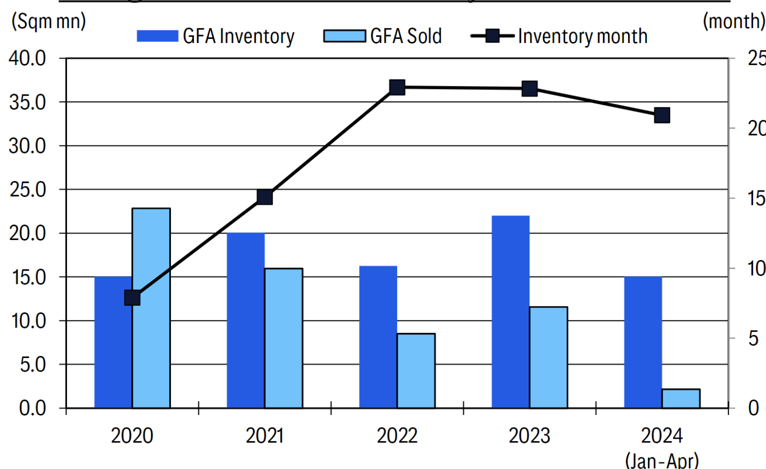
Property Destocking : Pilot Programs Give Cause for Optimism

- The property sector's health is improving with comprehensive policies to accelerate the soft-landing with lower land supply (new low since 2008), credit support and destocking (28-month inventory).
- For banks, property destocking could ease asset quality concerns, reducing systemic risks and equity risk premiums.

After the initial euphoria around China's historic measures (dubbed 517) to stabilize the property sector, market sentiment is gradually cooling off. Implementation challenges notwithstanding, Citi Analysts believe it is too premature to write off the far-reaching positive impact 517 could have on the property and banking sectors. Citi Analysts are optimistic for two reasons:

1. recent destocking pilot programs in Zhengzhou and Jinan have succeeded; and
2. the 517 measures, Citi Analysts believe, will continuously get policy backing.

Zhengzhou new home inventory month since 2020



Source: Citi Analysts, Zhengzhou Bureau of Statistics, as of Jul 12, 2024.

The Zhengzhou Model managed to achieve decent unit economics backed by

- Attractive dividend yield at c.3%, as:
  i. Zhengzhou Urban Development was able to purchase projects at c.30% discount to market FV; and
  ii. property price in Zhengzhou has already sufficiently corrected by c.36% from the peak;
- Manageable funding cost at 2.4%, as the property inventory purchase was c.80%/20% financed by debt/equity. Given bank loan interest rate at c.3%, the blended overall project funding cost works out to 2.4% (= 3% *80%), which leaves modest gross profit margin for project operator to cover OPEX
- Importantly, government subsidy of >2%, including:
  i. purchase subsidy of RMB200/sqm, (equivalent to c.2.5% of purchase cost per Citi Analysts' estimate) and
  ii. interest subsidy equivalent to c.2% of loan amount per year for 10 years, starting from the second year of project purchase.

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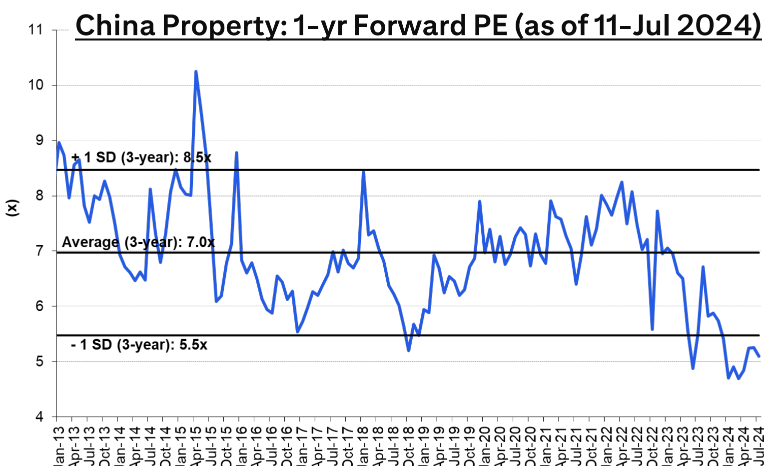
Property Destocking : Pilot Programs Give Cause for Optimism

Success factors of local pilot property destocking in 2023 were:

1. large price correction & rental yield >1.9%, underpinning a project's commercial viability;
2. selecting a good execution entity, focusing on 1-2 large local SOE/market-oriented LGFVs with property development expertise and decent credit rating to access financing;
3. a solid capital structure, e.g., an equity-heavy financing mix could help manage down project-level debt servicing costs and support project breakeven even if rental yields are low;
4. local government subsidy for scaling up property de-stocking; and
5. developers were more willing to offer steep discounts to sell inventory in cities with large destocking pressures. The pilot programs give Citi Analysts optimism that regulators will adjust existing destocking programs to make 517 measures more effective.

Implications for China property — The initial size of destocking program is not as important as the need to prevent risk and help stabilize secondary prices/ household expectations. Until these goals are achieved, Citi Analysts see the PBOC and local govts launching more policies to accelerate relending and local inventory purchase. The property sector's health is improving with comprehensive policies to accelerate the soft-landing with lower land supply (new low since 2008), credit support and destocking (28-month inventory). The property sector is already on the mend, making its c.5.5x one-year forward P/E attractive.



Source: Citi Analysts, DataStream, as of Jul 12, 2024.

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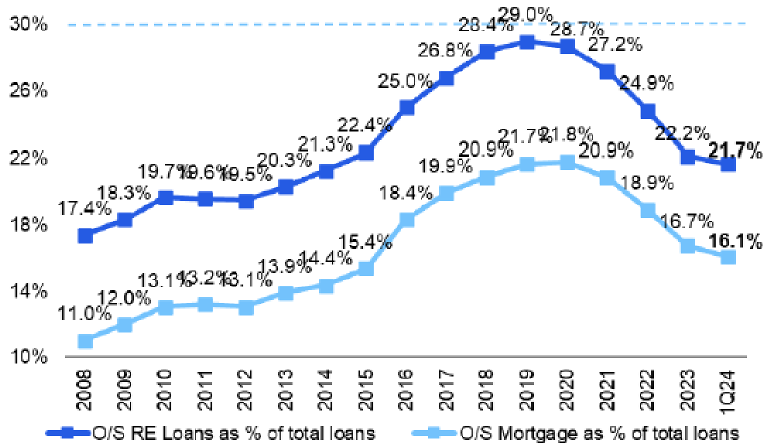
Property Destocking : Pilot Programs Give Cause for Optimism

Outstanding Real Estate Loans as % of Total loans



Source: Citi Analysts, PBoC, as of Jul 12, 2024.

Local property de-stocking is essentially a "Property Debt Swap" for banks to shift exposure from developers to SOEs/LGFVs with better re-financing capability. This could hurt banks' Net Interest Margin (NIM) but reduce systemic risk and banks' equity risk premium, the more critical drivers of bank valuations (banks still trade well below book value), considering that:

i. Local SOEs/LGFVs are taking more of the national service burden in destocking program, even in the case of loss-making rental property project, local SOEs would still be liable for interest and loan principal repayment.

ii. China banks' overall risk profile could be reduced by the de-stocking program, as it essentially shifted some of the banks' property developer exposure to established LGFVs/ local SOEs, that carry lower credit risk (vs. property developers) and have better refinancing capability.

iii. Systemic risk concern / equity risk premium on banks could be reduced: China banking system's total direct and indirect exposures to the property sector amounted to RMB158.7tn in 2023, accounting for 38% of banking assets in 2023. So long as ongoing property destocking initiatives could keep developer risk contained, i.e. no contagion to related sectors or property price, Citi Analysts think it could help ease overall systemic risk concern for the China banking sector, thus reducing their equity risk premium.

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US Semiconductors: Remain Wildly Bullish on Semis

- Citi Analysts believe the TAM expansion of the SOX driven by AI justifies the multiple expansion.
- Citi Analysts believe the SOX index can trade higher as long as estimates continue to grow.

Citi Analysts expect the 2Q24 earnings season to be a positive catalyst for the semi space with aggregate estimates moving higher driven by AI strength, stabilization in the PC, wireless and data center end markets (combined 62% of semi sales) along with better prints/guides from analog companies as the Industrial end market undergoes inventory replenishment. Although valuations are high, Citi Analysts think the SOX can continue to move higher and cite Citi Analysts' semi investing rule #1: "Do not buy or sell based on valuations".

The AI market continues to grow, and Citi Analysts' checks indicate Total Addressable Market (TAM) expansion with government agencies, universities, and large/medium businesses all buying AI chips.

End Market	% of Semi TAM	2Q24	3Q24E
PC	21%	Stable	Stable
Wireless	17%	Stable	Stable
Industrial	13%	Falling	Mixed
Consumer	9%	Stable	Stable
Comm Infra	4%	Weak	Weak
Automotive	14%	Falling	Mixed
Server	23%	Improving	Improving

Source: Citi Analysts, Company Reports, as of July 15, 2024.

70% of semi demand is stable/improving. Citi Analysts are positive on the group given AI demand and inventory replenishment, but Citi Analysts believe stabilization in the PC, wireless and consumer end markets (combined 47% of semi TAM) will catalyze inventory replenishment. In addition, We are likely through the worst of the correction in industrial end markets (13% of semi TAM), although there is still more downside in the auto and comms infrastructure end markets (combined 18% of semi TAM). Strength in the AI server market also more than offsets weakness in the traditional CPU market.

PC market looking good. May notebook shipments increased 15% MoM, ahead of Citi Analysts' expectations driven by strength in the consumer and commercial segments.

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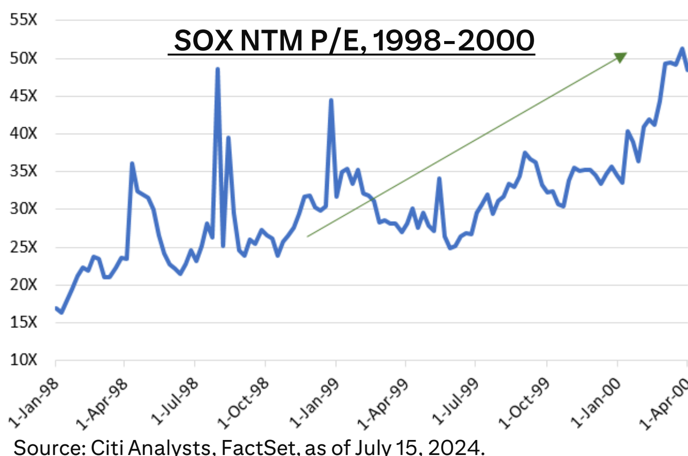
Citi Analysts are expecting PC units to increase 1% YoY to 256 million units in 2024 on a Windows 10 refresh and a normalized inventory channel. Citi Analysts expect the market to normalize at 270 million units by 2026.

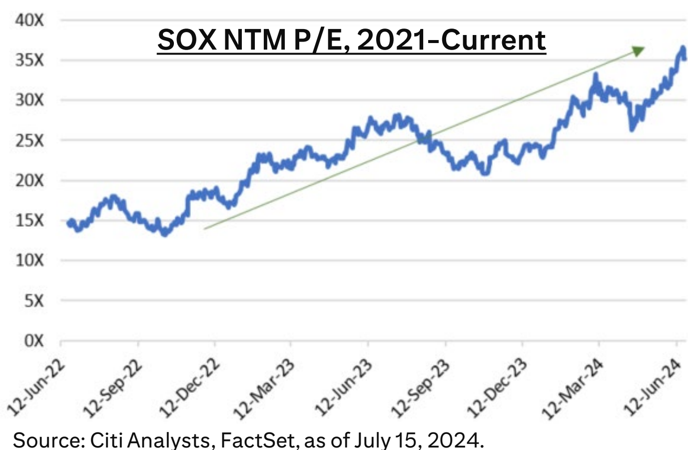
Data center is improving as inventory is normalizing. Citi Analysts are modelling traditional C24 server units to grow 8% YoY, following a 20% decline in 2023. However, Citi Analysts continue to expect data center spending (23% of semi TAM) to be impacted by the cannibalization of traditional data center CPUs in favor of GPUs.

Citi Analysts note the similarities in valuation between the dot-com bubble and the last two years from 2022-2024. The SOX index rose more than 550% from late 1998 to early 2000, with its Next Twelve Months (NTM) P/E doubling from 25X to more than 50X. Today, the SOX index is up more than 165% from its bottom in late 2022, with its NTM P/E more than doubling from 16X to 35X.



Source: Citi Analysts, FactSet, as of July 15, 2024.

Many investors have raised concerns that valuations are unsustainable and too high, however, Citi Analysts believe the TAM expansion of the SOX driven by AI justifies the multiple expansion. Citi Analysts estimate the AI data center semiconductor TAM of roughly $400 billion by 2027. Today, the SOX index relative to the S&P 500 is roughly 1.7X, up from roughly 0.9X in late 2022. Citi Analysts believe the SOX index can trade higher as long as estimates continue to grow.



Source: Citi Analysts, FactSet, as of July 15, 2024.

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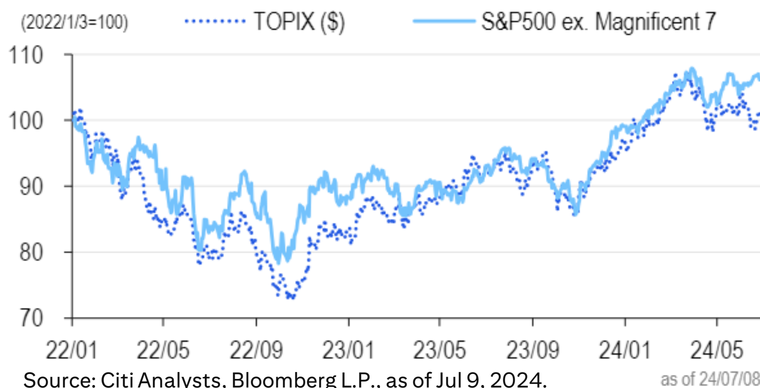
TOPIX PE Ratio trend tends to be highly correlated with long-term interest rate trend

- Higher long-term interest rates are generally seen as negative for valuations, but valuations could expand for industries and stocks where growth expectations rise in tandem with long-term interest rate rises. The TOPIX PE ratio trend tends to be highly correlated with long-term interest rate trend.

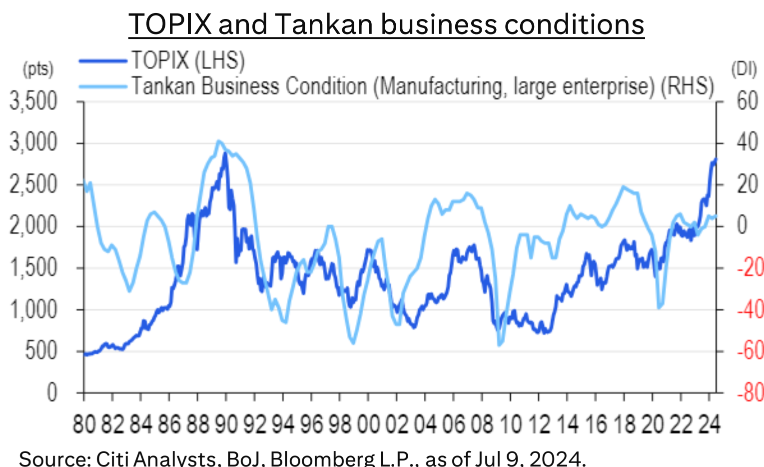
Since late June, Japan equities have been possessed with a sudden vigor, have parted ways with the range they had previously been bound in, and have set fresh YTD highs. The rally has come despite a lack of particularly significant newsflow either in Japan or overseas but if pressed, Citi Analysts would call attention to the following factors.

1) A rectification of their laggard status versus US equities. Japan equities had been underperforming US equities even once the Magnificent 7 are excluded, so they were primed to move higher in a correction of their laggardness.
2) Yen weakening has largely ceased. The likelihood of the FRB beginning to cut rates in September is rising, in Citi Analysts' view, while the Japanese market is increasingly projecting that the BoJ will hike by year-end, which has taken pressure off yen weakness. This has made it easier for dollar-based investors to purchase Japan equities.
3) Third, the business conditions DI in the June Tankan improved, and firms also revised up their capex plans significantly, underscoring the firmness of business sentiment at corporates.



Source: Citi Analysts, Bloomberg L.P., as of Jul 9, 2024.

TOPIX and Tankan business conditions



Source: Citi Analysts, BoJ, Bloomberg L.P., as of Jul 9, 2024.

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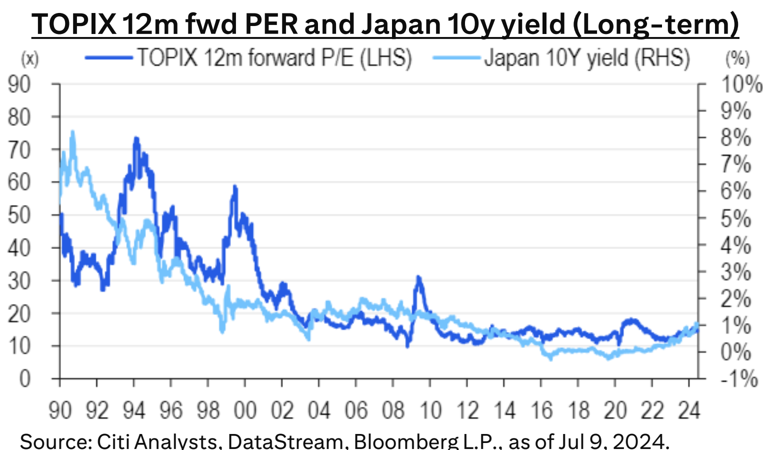
The catch-up of Japan equities vis-à-vis US equities excluding the Magnificent 7 is almost complete, and Citi Analysts think Japan equities are now susceptible to a temporary topping out. Meanwhile, visibility on forex stability and a domestic demand recovery, which Citi Analysts regard as preconditions for bullish Japan equity scenario, is improving, and Citi Analysts see no need to revise previous index targets through Financial Year-end of 45,000 for the Nikkei and 3,100 for TOPIX.

Moving forward, Citi Analysts are forecasting falling long-term interest rates in the US and rising ones in Japan. In phases like this in the past, financials have outperformed overall and retail, foodstuff, and other domestic demand sectors have tended to deliver positive returns, too.

The greatest positive correlation (Japan 10y yield & 12m FWD PE Ratio) is exhibited in the interest rate-sensitive insurance (0.89) and banking (0.73) sectors, and real estate (0.48) and construction (0.78), where inflation tends to have a positive impact on earnings. Meanwhile, the negative correlation is most defined for defensive industries such as pharmaceuticals (-0.61) and services (-0.51).

Higher long-term interest rates are generally seen as negative for valuations, but valuations could expand for industries and stocks where growth expectations rise in tandem with long-term interest rate rises. The TOPIX PER trend tends to be highly correlated with long-term interest rate trend.

TOPIX 12m fwd PER and Japan 10y yield (Long-term)



Source: Citi Analysts, DataStream, Bloomberg L.P., as of Jul 9, 2024.

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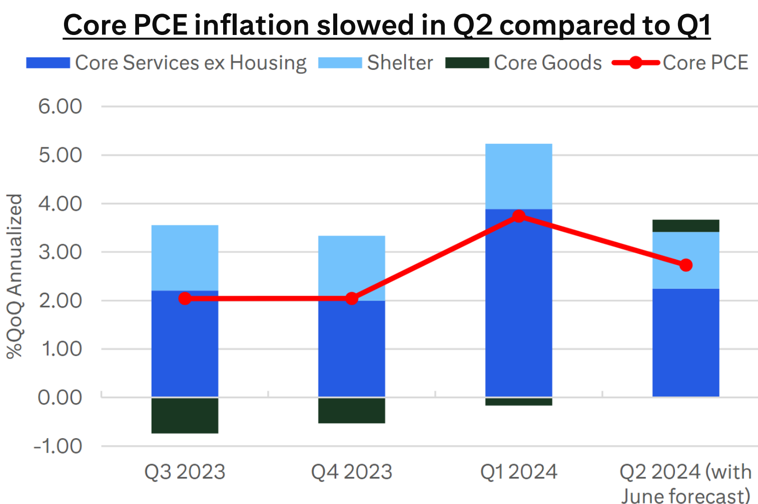
Fed cutting rates at every meeting beginning in September, down to a terminal policy rate of 3.25-3.50% reached next year

- Cooler inflation alone makes 25bp cuts in September and December very likely. Risks are balanced to a further rise in unemployment that would have the Fed cutting more aggressively and Citi Analysts' base case remains for cuts at every FOMC meeting starting in September, including three cuts this year.

Economic activity is slowing, the unemployment rate is rising, and inflation is cyclically cooling. Softer-than-expected 0.06%MoM June core CPI and elements of PPI imply a benign 0.16%MoM core PCE. Even before the cooler inflation reading, Fed Chair Powell had declared that risks to inflation and the labor market were in balance; in Citi Analysts' view, the weakening labor market may soon dominate Fed attention. Cooler inflation alone makes 25bp cuts in September and December very likely. Risks are balanced to a further rise in unemployment that would have the Fed cutting more aggressively and Citi Analysts' base case remains for cuts at every FOMC meeting starting in September, including three cuts this year.

Chair Powell has been steadily adjusting his rhetoric and is now explicitly calling out upside risks to inflation and downside risks to employment as "balanced." He emphasized that, statutorily, the two mandates should be given equal weight by the central bank. And, cooler June inflation readings – released subsequent to Powell's testimony – should allow Fed officials to shift attention even further to employment.

Three consecutive softer inflation readings following the Q1 upside surprise would allow Fed officials to view Q1 as more of an aberration relative to a slowing trend. The details are somewhat supportive of this interpretation with elements of "supercore" (services ex-shelter) inflation that surged in Q1 reversing in Q2.



Source: Citi Analysts, BEA, as of July 12, 2024.

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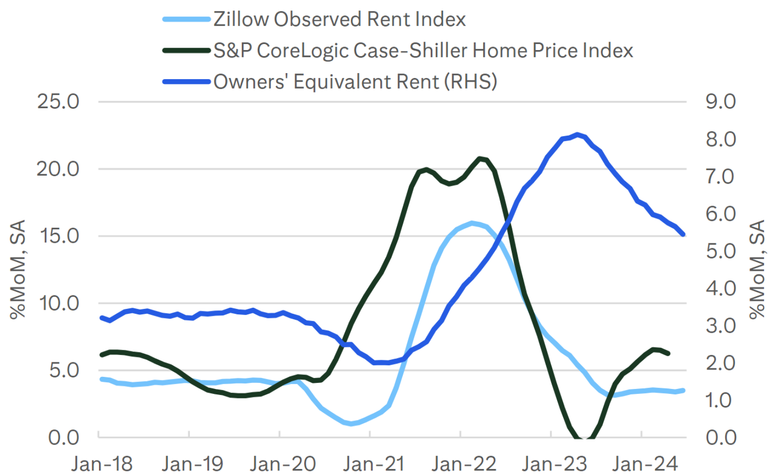
Perhaps most important for Fed officials will be the sharp slowing in owner's equivalent rent (OER) from 0.43%MoM in May to 0.27%MoM in June. Fed officials have long been awaiting a slowdown in shelter that accounts for about 40% of core CPI and about 20% of core PCE. While Zillow (mainly apartment) rents had slowed over a year ago, the rapid rises in house prices meant measured rents for single-family homes were still rising rapidly. But now housing activity and prices have cooled and the BLS "new tenant rent index" slowed sharply, suggesting that the slowdown in shelter prices will persist.

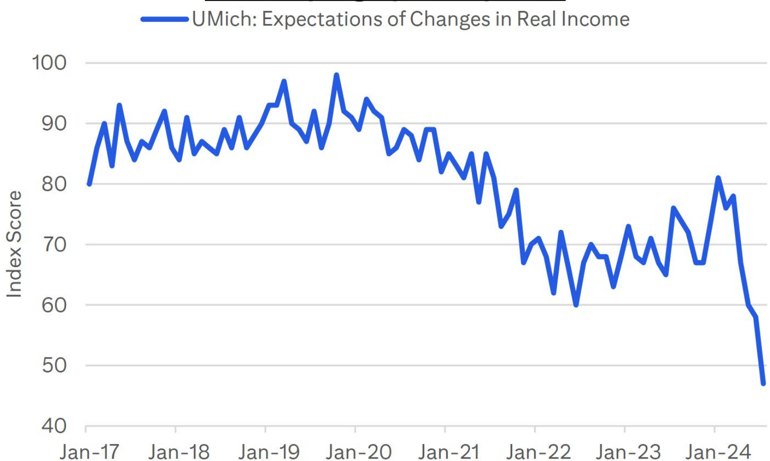
Owner's equivalent rent is slowing down sharply



Source: Citi Analysts, BLS, ZIllow, S&P, as of July 12, 2024.

"Soft" data from the University of Michigan survey showed that, even with inflation expectations coming down, consumer sentiment is not improving. In particular, consumers are less willing to make purchases at high prices as they become more concerned that incomes are not keeping up with prices. This confirms what Citi Analysts already know from the "hard" data.

Consumers increasingly believe that their incomes are not keeping up with prices



Source: Citi Analysts, University of Michigan, as of July 12, 2024.

Goods consumption has been declining this year. The housing sector which had been resilient in the face of higher rates now seems to have entered a generalized contraction.

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Fed cutting rates at every meeting beginning in September, down to a terminal policy rate of 3.25-3.50% reached next year

Fed officials should now see an increasingly compelling case to begin lowering rates. With inflation more clearly slowing, nominal policy rates will need to fall to maintain the same level of restriction. And, with the labor market having loosened to pre-pandemic levels, consumer spending pulling back, and the housing sector in contraction, some Fed officials will likely want to decrease the level of restriction. In Citi Analysts' base case, a further rise in the unemployment rate and broader softening of activity will have the Fed cutting rates at every meeting beginning in September, down to a terminal policy rate of 3.25-3.50% reached next year. Citi Analysts expect a strong signal at the July FOMC that, providing data come in as expected, a rate cut would be likely at an upcoming meeting.

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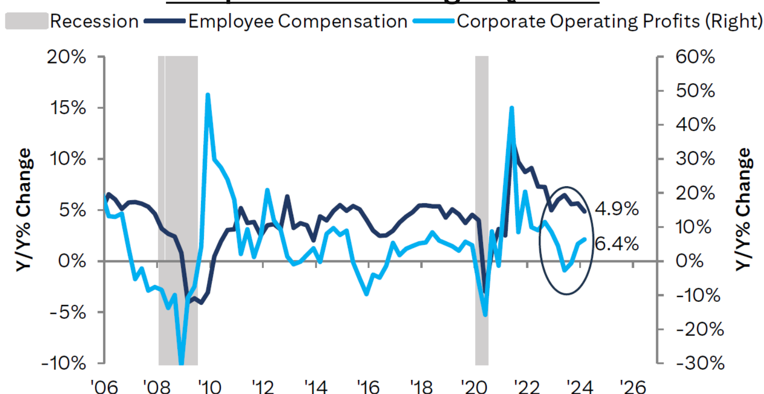
Labor Market Slowing, Corporate Profits Growing

- The healthcare sector in particular is worth watching after the largest EPS drop for the sector on record in 2023.
- Estimates for 2024 suggest a broader healthcare recovery. 2Q results may help determine if this is near at hand or further off in the future.

Employee compensation in the US slowed to a roughly 5% growth pace in the first quarter. This counts both the newly employed and the wages, salaries and benefits of those already employed in total. Preliminary data for the second quarter suggest a similar pace, decelerating through quarter end. Meanwhile, we expect US companies to report a gain in EPS of greater than 10% in the second quarter, or double the rate of national employee compensation in coming weeks.

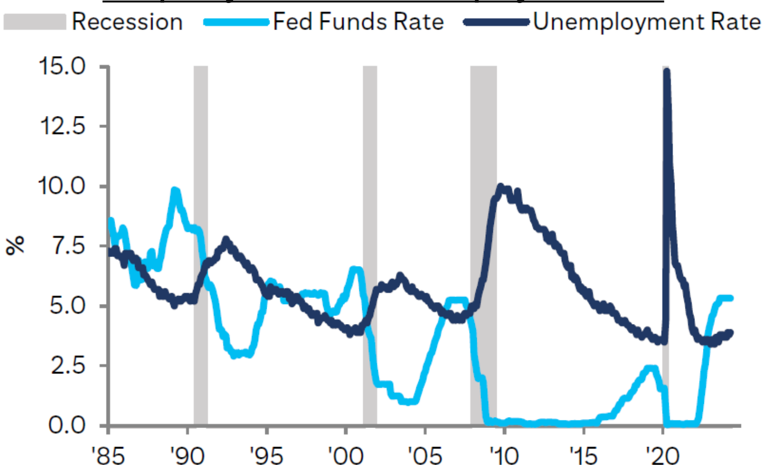
US corporate operating profits and employee compensation through 1Q 2024



Note: The circled area indicates the still rising employee compensation and the simultaneous rebound in corporate profits.
Source: Haver Analytics, as of July 9, 2024.

Profits earned by companies and their shareholders are far more volatile than sales or costs. What is uncommon is for profit growth across the economy to accelerate while compensation decelerates – that is outside of the beginning periods of a new economic recovery.

Fed policy rate above unemployment rate



Source: Haver Analytics, as of July 9, 2024.

With the US unemployment rate rising more than a half a point in the past year, wage growth decelerating and the Fed's policy rate above the rate of unemployment, we believe that only "committee inertia" will keep the Fed on hold when its policymaking committee meets late this month.

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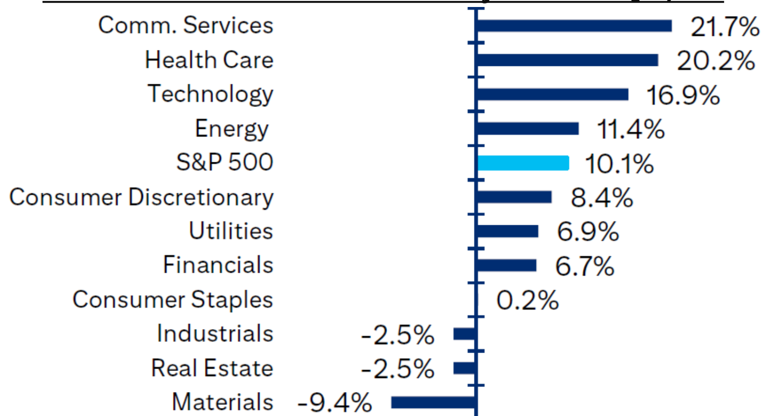
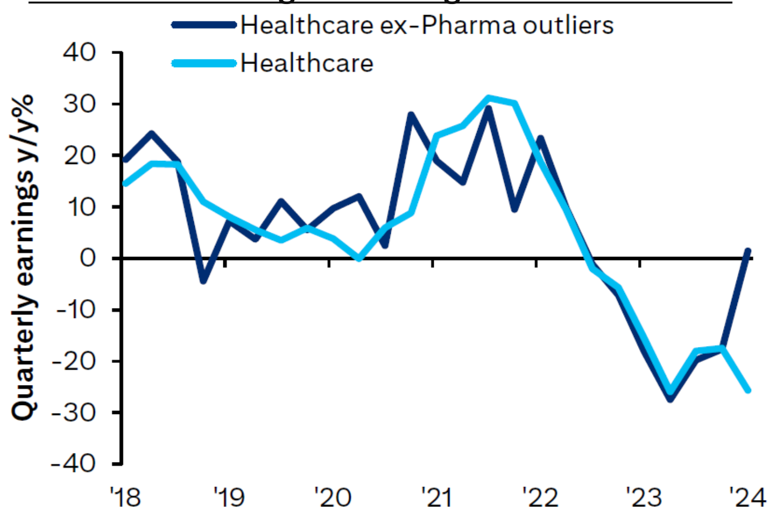
By September, we would expect some likely action to move US monetary policy away from the Fed's self-described "restrictive" stance. If so, the Fed will be doing this while corporate profits are growing.

EPS estimates show a broadening even when accounting for the routine downward bias in estimates just before reporting time. Wall Street analysts expect that drugmaker and medical devices profits grew in Q2 relative to a year ago, potentially ending an unprecedented streak of 6 straight quarters of earnings declines.



Source: I/B/E/S and Bloomberg L.P., as of July 9, 2024.

After Q1 earnings, muted guidance across the health care landscape limited the scope for more meaningful upward revisions. We believe this narrative could finally shift if consensus expectations for 20% Q2 EPS growth materializes. Among drugmakers, inventory overhangs and one-off charges will make comps much favorable in the year ahead. In the medical devices space, procedure volumes remain robust and new product launches continue apace. The outlook for life sciences tools is closely tied to spending on drug research, which should continue to see new spending dollars as financial conditions ease and amid intense focus on weight loss, diabetes, Alzheimer's, and cancer treatments.



Source: Bloomberg L.P., as of July 9, 2024.

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Labor Market Slowing, Corporate Profits Growing

Industrials, a highly diverse sector, tick a lot of thematic boxes as well. Within the sector we can identify firms directly engaged in providing electrical equipment and materials to power data centers running AI processes, defense shares, and companies tied to the energy transition. Staples retailers, meanwhile, have exhibited much lower volatility and along with healthcare may be a defensive way to play the market after a strong first half rally ahead of typically choppier summer trading.

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https://ir.citi.com/PuXs6xELNHAu7UqkjgvWxnihtUeLtAtDxeEh%2B2qaPpPb7uukpx8Qw1vzcuidtMtqgn1BWqJqak8%3D for details on the Citi Analysts ratings system.
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Important Disclosure on High Yield Bonds

Unrated or non investment grade Debt Securities typically offer a higher yield than investment grade Debt Securities, but also present greater risks with respect to liquidity, volatility, and non-payment of principal and interest. As a result of being classified as non investment grade Debt Securities, these Debt Securities present a greater degree of credit risk relative to many other fixed income Debt Securities.
Higher Credit Risk – Unrated or non investment grade Debt Securities generally have predominantly speculative characteristics with respect to the issuer's capacity to pay interest and repay principal. There is greater risk of non-payment of interest and loss of principal. Many issuers of these Debt Securities have experienced substantial difficulties in servicing their debt obligations, which has led to default and restructurings. The issuers of these Debt Securities generally have to pay a higher rate of interest than investment grade Debt Securities.
Higher Liquidity and Secondary Market Risk – The markets in which unrated or non investment grade Debt Securities are traded are generally more limited than those in which investment grade Debt Securities are traded. This lack of liquidity may make it more difficult to resell these Debt Securities and obtain market quotations.
Downgrade Risk – Downgrades in the credit rating of unrated or non investment grade Debt Securities by rating agencies are generally accompanied by declines in the market value of these Debt Securities. In some circumstances, investors in the unrated or non investment grade Debt Securities market may anticipate such downgrades as a result of these credits being placed on "credit watch" by rating agencies, causing volatility and speculation of further credit deterioration.
Higher Vulnerability to economic cycles - During economic downturns, unrated or non investment grade Debt Securities are typically more susceptible to price volatility and fall more in value than investment grade Debt Securities as i) investors may reevaluate holdings in lower-quality bonds in favor of investment-grade corporate Debt Securities; ii) investors become more risk averse; and iii) default risk rises. This is often referred to a "flight to quality".
Event Risk – This includes any of a variety of events that can adversely affect the issuer of unrated or non investment grade Debt Securities, and therefore the issuer's ability to meet debt service obligations to repay principal and interest to Debt Securities holders. Event risk may pertain to the issuer specifically, the industry or business sector of the issuer, or generally upon the overall economy. It could have a direct or indirect impact on the issuer and their outstanding debts.

Important Disclosure on RMB

Risk relating to RMB – If you choose RMB as the base currency or the alternate currency, you should also note the following:
RMB is currently not freely convertible through banks in Hong Kong. Due to exchange controls and/or restrictions imposed on the convertibility, utilization or transferability of RMB (if any) which in turn is affected by, amongst other things, the PRC government's control, there is no guarantee that disruption in the transferability, convertibility or liquidity of RMB will not occur. There is thus a likelihood that you may not be able to convert RMB received into other freely convertible currencies.
CNH exchange rates and CNY exchange rates are currently quoted in different markets with different exchange rates, whereby their exchange rate movements may not be in the same direction or magnitude. Therefore, the CNH exchange rate may be different from the CNY exchange rate.