Special Coverage:

Re-rating led by AI breakthrough supports our upgrade of Chinese equities to overweight

Key takeaways

- We see an attractive re-rating opportunity for Chinese equities as DeepSeek's breakthrough is unlocking a new phase of AI investment, adoption and monetisation across the country, causing new growth engines to support activity and boost private consumption. To tap into China's emerging AI autonomy and monetisation opportunities, we **upgrade Chinese equities to overweight** from neutral, which also raises our allocation to **Asia ex-Japan equities to overweight**.
- The development of China's AI autonomy further spurs market expectations of productivity gains through upgrading the AI ecosystem, which could lead to a more sustained and broad-based recovery of growth and equity valuations. We see room for potential earnings upgrades for MSCI China, led by technology.

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- Within Asia ex-Japan, we now prefer China over India due to China's distinctive AI re-rating driver and compelling risk-reward profile, conservative foreign investor positioning and a significant valuation discount. We favour AI enablers and adopters, including Chinese industry leaders in the internet, ecommerce, software, smartphone, semiconductor, autonomous driving, and humanoid robotics sectors. We also like beneficiaries of stronger corporate spending in AI infrastructure and applications.

What happened?

- On 17 February, a high-level symposium was chaired by Chinese President Xi Jinping with prominent tech leaders, which reflected a significant policy pivot towards a friendlier and more supportive government stance to bolster the private sector and support tech innovation.
- The symposium came at a critical juncture when the domestic economy is fighting against deflation pressures, property market stress and global trade uncertainties. The last time President Xi hosted a similar high-level symposium with private entrepreneurs was in November 2018.
- In a speech delivered at the symposium, President Xi reassured government policy support for the technology sector and urged private enterprises to invest more in tech innovation.
- We expect the National People's Congress (NPC), which will start on 5 March, to roll out more policy initiatives to support tech innovation and AI investments, which are heralded as "new productive forces" and rising economic growth engines for years to come.
- The very rapid rise of DeepSeek has shifted investor sentiment, as it has demonstrated China's under-appreciated capability to deliver significant technological innovation despite US export restrictions on advanced chips and technologies.
- The tech-heavy Hang Seng Index (HSI) and Hang Seng Tech Index (HSTECH) have rallied 15.3% and 23% YTD, respectively, driven by the DeepSeek excitement. However, the Hang Seng Index and MSCI China are still trading at 10.3x and 11.3x 12-month forward P/E, respectively (i.e. 54% and 50% discounts to the 22.6x forward P/E of the S&P 500 Index).

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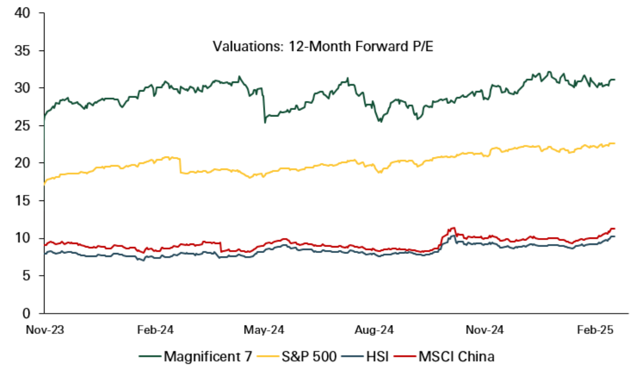
Investment implications

- The development of China's AI autonomy further spurs market expectations of productivity gains through upgrading the AI ecosystem, which could lead to a more sustained and broad-based recovery of growth and equity valuations.
- We also see room for potential earnings upgrades for MSCI China, led by positive earnings momentum in the technology sector. Accelerating deployment of AI applications should underpin upside potential in earnings expectations. In addition, further fiscal stimulus measures to be announced at the NPC session in March could provide support for domestic consumption recovery and property market stabilisation.

The Hang Seng Index and MSCI China are trading at steep valuation discounts to S&P 500 and Mag-7



Source: Bloomberg, HSBC Global Private Banking and Wealth as at 17 February 2025. Past performance is not a reliable indicator of future performance.

- As a result, we upgrade Chinese equities to overweight from neutral, which also raises our allocation to Asia ex-Japan equities to overweight from neutral. Within the region, we now have a stronger preference for China versus India due to China's distinctive AI re-rating driver and compelling risk-reward profile underpinned by the conservative positioning of foreign investors and significant valuation gaps with the global and regional peers.
- We favour beneficiaries of DeepSeek's low-cost, open-sourced AI models, which are expected to accelerate mass deployment of generative AI devices, autonomous driving, and humanoid robotics across China in a scalable way. With favourable industrial policy support, we expect strong corporate spending in AI infrastructure, enablers and applications, including cloud services, e-commerce, AI smartphones, AI laptops, consumer electronic goods, semiconductors, OEMs, software and AI agents. The three state-owned telecom giants have quickly integrated DeepSeek's AI models into their infrastructure and products.
- Chinese smartphone companies will also benefit from the integration of their phones with the localised low-cost, high-performing AI models. China's autonomous driving and humanoid robotic technologies command strong competitive edges at the global stage. China's EV and robotics industries are well positioned to benefit from the AI breakthrough.
- So far, the Chinese equity rally is not broad-based and concentrates mainly on tech stocks. This means investors will continue to look for broader policy stimulus. We also believe that more convincing demand-side fiscal stimulus measures are required to support a broader earnings improvement beyond the AI supply chain. Hence, we favour Chinese internet and technology leaders for growth and quality Chinese SOEs for high dividends.

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