Chinese equity – spotlight on innovation driven themes

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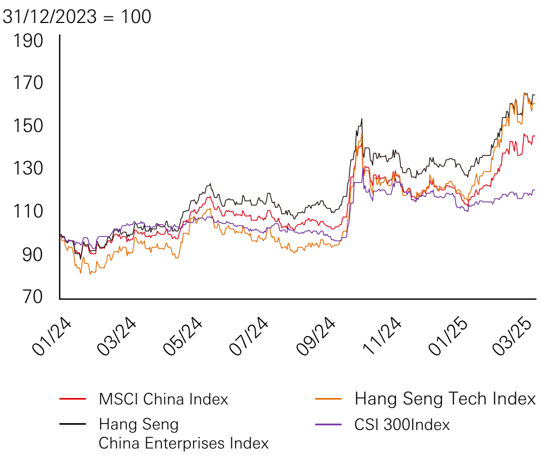
HSBC Asset Management

Innovation themes drive Chinese equity re-rating opportunities

DeepSeek's breakthrough in artificial intelligence (AI) has gained a considerable amount of investor attention, lifting sentiment towards Chinese assets. In particular, offshore Chinese equities (e.g., those listed in Hong Kong) have performed strongly since the start of the year, given the market's larger exposure to AI-related themes, defying ongoing worries about mainland China's economic recovery and uncertainties over US trade policies (Fig.1 & 2). Around 60% of the MSCI China Index, for example, is made up of constituents with AI tech-related themes, which include data and cloud, infrastructure and power, and software application names.[1]

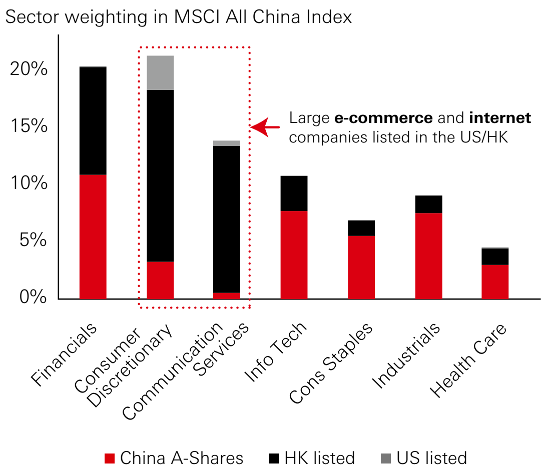
Some industry participants have already expressed scepticism about the recent market performance, believing that the latest developments in AI are overhyped. Risks associated with new technologies, including regulatory changes or controls and ongoing export restrictions on certain technology goods from the West, should also be considered. While we acknowledge these risks, we also believe that AI advancements have an important role to play in key technology segments, which could contribute to the country's long-term growth outlook.

Fig 1: Strong performance in offshore Chinese equities year-to-date



Indices show are in total return USD terms. Source: Bloomberg, HSBC Asset Management, 16 March 2025

Fig 2: Offshore Chinese equities have higher exposure to AI-related themes



Source: MSCI, as of December 2024

Note 1: FactSet, MSCI, Goldman Sachs Global Investment Research, March 2025
Source: HSBC Asset Management, March 2025.

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Recent AI advances solidify China's competitiveness

China has entered a new phase of AI development with the emergence of new large language models (LLM), including DeepSeek-R1, opening up opportunities for mass AI adoption.

While China has already been recognised for its existing open source LLM ecosystem, what DeepSeek demonstrated was the ability to achieve comparable performance relative to other existing popular LLMs, such as Open AI's GPT-4, but with significantly reduced costs, thereby presenting transformative opportunities for companies to cut costs and increase productivity.

Recent advances can also result in Chinese companies increasing corporate spending on AI infrastructure. In the longer term, wider AI adoption could open more possibilities for new business opportunities and revenue sources.

DeepSeek's breakthrough was in part made possible by China's supportive and evolving AI hub. For over a decade, the central government has been committed to AI development, with strategic plans, funding, supportive policies and public-private cooperation. The country has been focusing on a number of fields in its AI race beyond GenAI, including computer vision, autonomous driving, and AI chips.

DeepSeek is amongst the top six Chinese tech startups, nicknamed the "six little dragons" (Fig. 3), all based in Hangzhou, a city that has cultivated a diverse range of cutting-edge products and services and emerging industries. These rising companies' innovative capabilities in the AI space and beyond – including in gaming, humanoid robots, brain-computer interface and spatial intelligence – are now catapulting the city to a tech powerhouse status.

Fig 3: China's "six little dragons":

Source: HSBC Asset Management, March 2025.

At this stage, we expect various segments in the technology sector to benefit from the expected accelerated adoption of AI, including:

Cloud platforms

AI has become a significant driver of cloud adoption for enterprises. We expect cloud service providers to deliver improving revenue contribution from AI-driven cloud revenue growth

Application software

With lower computation costs, app developers are enabled to process more complex applications with high reasoning requirements. This could improve software companies' research and development (R&D) efficiency, saving costs and driving earnings growth

Semiconductors

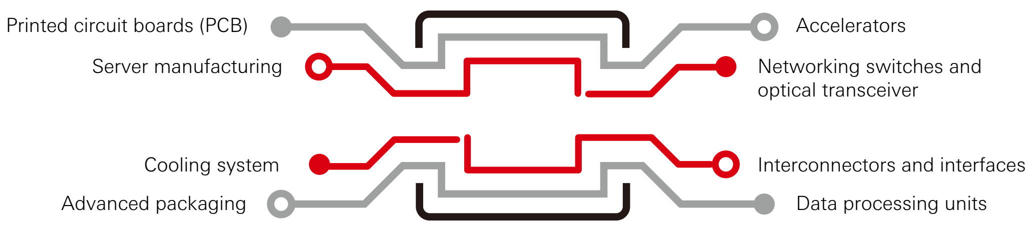
AI development will likely speed up China's AI computation hardware localisation. The reduction in AI costs may lead to increased demand for advanced chips that enable faster processing and enhanced capabilities, benefiting semiconductor manufacturers

Devices

The greater availability of AI applications will likely shorten device replacement cycles as hardware upgrades are needed to accommodate new functions. This should benefit smartphone and PC makers, as well as related supply chains

Other electronic component manufacturers and suppliers are also expected to benefit from the accelerated adoption of AI (Fig 4).

Fig 4: Hardware electronic components



Source: HSBC Asset Management, March 2025

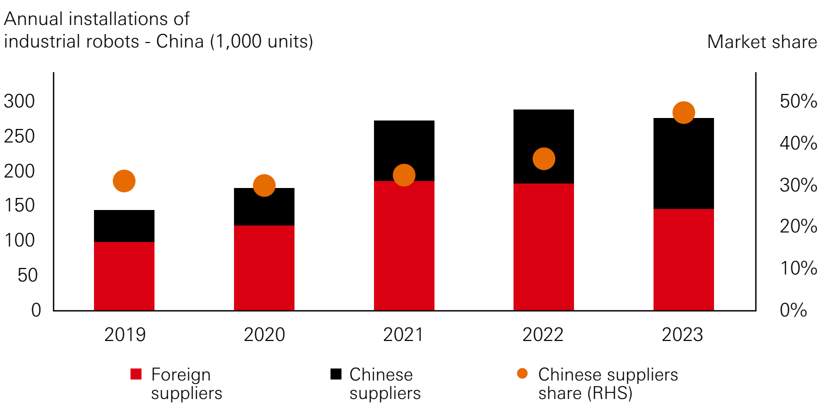
Despite the AI-driven rally in Chinese equities so far, we believe that China's AI-related advancements have longer term implications for earnings, valuations, and overall fundamentals of Chinese equity beneficiaries.

Advancements in AI positive for the robotics sector

The field of robotics is making huge progress in the country. Robotics, like other innovative segments, are expected to be another long-term driver of China's economy. China already dwarfs other major economies in terms of annual robot installations. Since 2021, the country had more than 250,000 units installed every year, while the US, Germany, Korea and Japan each only had 25,000-50,000 units per year.[2] Locally, domestic suppliers are also gaining more market share from the growing installations of industrial robots, thanks to their improving capabilities and cost advantages (Fig. 5). In total, industrial robots installed in China's factories now account for 51% of global demand.[2]

AI advancements also have positive implications for robotics, especially in humanoid robots, which are expected to be mainstream in the long term. The global shipment of humanoid robots from major players in the US and China are expected to be more than 10,000 units in 2025, and this is estimated to exceed 5 million by 2030 as AI developments could significantly lower manufacturing costs and support wider adoption.[3] We are already seeing investment opportunities in this space in mainland China, such as in robotic manufacturers and component makers that benefit from established supply chains and cost control advantages.

Fig 5: Chinese suppliers gaining more market share in industrial robots



Source: International Federation of Robotics, September 2024 report

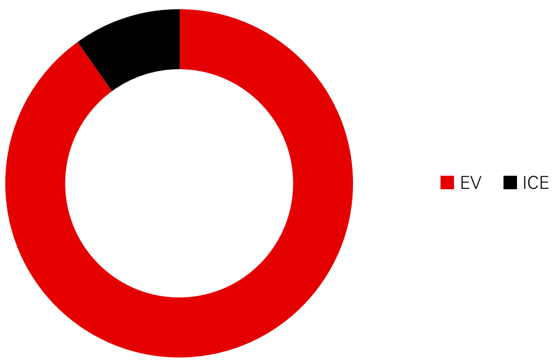
Note 2: Source is International Federation of Robotics press release, September 2024
Note 3: Source is Citic Securities report, 13 February 2025
Source: HSBC Asset Management, March 2025.

China continues to lead the global EV market

Chinese electric vehicle (EV) brands are already leading the world, accounting for more than 70% of global market share.[4] EV penetration in China has also significantly increased, where about half of cars sold in China in 2024 were EVs or plug-in hybrids versus only 5% in 2019.[5] At the same time, the increased integration of advanced driver assistance systems (ADAS) technologies into EV models should help Chinese companies maintain their competitiveness – major domestic car makers are announcing plans to roll out higher level ADAS functions, with recent AI breakthroughs expected to further accelerate ADAS adoption.

Fig. 6: China's new car models in 2025e are dominated by EVs

EV vs internal combustion engine (ICE) car launch (%)



Source: CAAM (including estimates), HSBC Global Research, January 2025

Note 4: Source is Rho Motion, February 2025
Note 5: Source is HSBC Global Research, January 2025
Source: HSBC Asset Management, March 2025.

Chinese-made innovative drugs expected to catch up to other market leaders

The country's healthcare sector has become more competitive globally, particularly in the field of innovative drugs. Innovative drug out-licensing activities have risen in the past few years with the country producing more high-quality medicines that meet international standards (Fig. 7). While the number of Chinese-made first-in-class (FIC) (pioneering) innovative drugs still lag developed markets, we expect China to narrow the gap in the next few years, supported by the generally lower labour and R&D costs in the country, as well as ongoing government support (Fig. 8).

Fig 7: China's increasing momentum of out-licensing activities

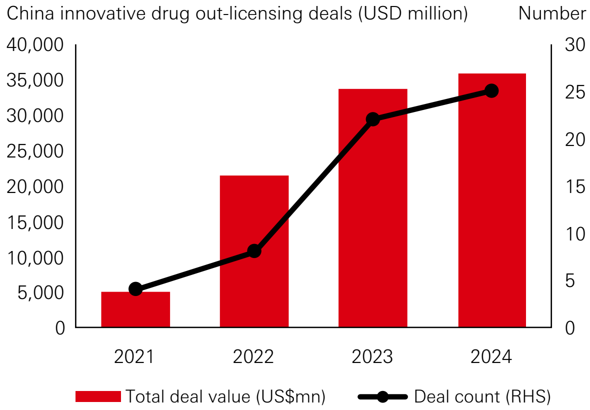
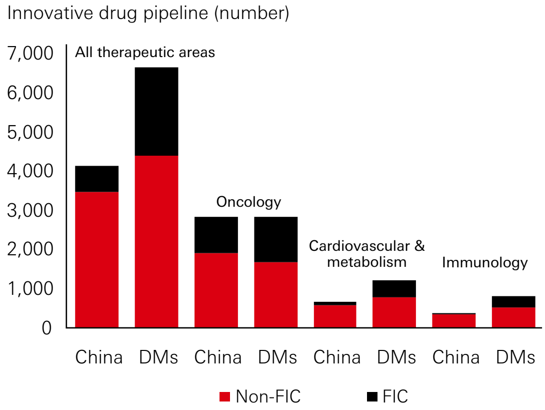


Fig 8: China vs developed markets – China catching up in FIC oncology innovative drugs



Source: Pharmcube, Bernstein analysis, as of December 2024, FIC: first-in-class or potentially first-in-class.

Source: HSBC Asset Management, March 2025.

Government support and self sufficiency

Government support for innovative technologies is expected to continue in the coming years. During the Two Sessions (annual meetings of China's top legislature) held in March, policymakers reiterated their commitment to step up efforts to drive innovation. In its 2025 working report, the government has called for the application of large-scale AI models and development of smart manufacturing equipment, including intelligent new-energy EVs, AI-enabled devices, and intelligent robots.

The government already gave signs of support towards AI development in February, when a rare high-level symposium between President Xi Jinping and tech leaders was held. Among the companies that attended were the "six little dragons". The meeting reflects a more supportive stance towards the private sector, particularly promoting tech innovation and contributing to China's modernisation.

Innovation is also supported by China's competitive advantages in technology and industrials, thanks to the country's growing talent pool. In AI alone, it is estimated that China generates nearly half of the world's top researchers.[6] Students are also encouraged to take STEM (science, technology, engineering, and mathematics) related programmes, with a STEM internship scheme offered by local universities, including those in the Greater Bay Area.

Overall, these are all in line with China's goal of building a more self-reliant society, with innovation being a key component. We expect that given the ongoing technology export restrictions from the US, Chinese policymakers may continue to roll out more efforts to accelerate the country's self-sufficiency goals.

Note 6: MarcoPolo, Paulson Institute report March 2024
Source: HSBC Asset Management, March 2025.

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Chinese equities a key beneficiary of China's innovation driven themes

Given the latest developments in mainland China, we believe there is potentially an attractive re-rating opportunity for the Chinese equity market. Valuations remain attractive relative to other markets, with discounts remaining high despite the recent rally. Coupled with the light positioning of foreign investors, we expect further inflows into the market.

While we are constructive about innovative opportunities in China, we remain mindful of ongoing concerns in the economy, including the recovery of consumption and geopolitical developments. While the government has recently expressed plans to roll out more supportive measures, we believe policy implementation is key.

In our HSBC Chinese Equity strategy, our investment focus includes AI-related industries, humanoid robots, as well as consumption recovery themes. We continue to believe that bottom-up fundamental research remains crucial, especially during periods of heightened market volatility, and continue to favour high-quality names with earnings visibility that could provide attractive risk-adjusted returns.

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Source: HSBC Asset Management, March 2025.

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