Special Coverage: China's bifurcated economy and the full-arc AI opportunity

Key takeaways

- The YTD performance gap between China's A-shares (e.g. CSI300: +8.4%) and the MSCI China Index (-15.5%) or Hang Seng Index (-10.0%) is material. The gap is even wider in the tech space. Year-to-date, the ChiNext Index, a Nasdaq-style board on the Shenzhen Stock Exchange, recorded 36.5% of return vs HSTECH's -20.1%.
- While this is to some extent reflective of the structure of the global AI rally so far, the difference is amplified by China's K-shape economic story. For that reason, we currently prefer A-shares over H-shares, driven primarily by A-share's much larger exposure to AI-related hardware beneficiaries.

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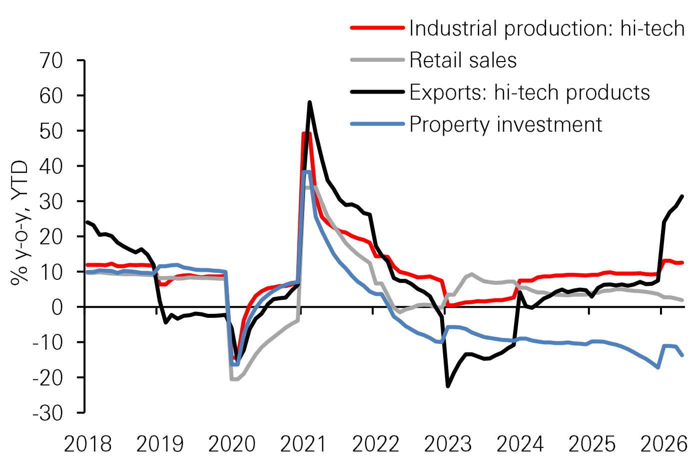
- Having said that, we believe it's important to be positioned in the full-arc AI opportunity set in China, which means taking exposure to some of the large offshore listed internet and cloud players, which are critical enablers of AI transition and adoption.

What happened?

- The K-shaped bifurcation of the Chinese economy may be deepening. The upper arm of the K, AI compute, semiconductors, and advanced equipment and hardware, is expanding rapidly, fuelled by policy support, export-driven demand and domestic substitution. The lower arm, consumption, property, and discretionary spending, remains structurally impaired. According to economic activity data in May, the two arms have diverged even further.
- In May, China's exports grew by 19.4%. According to Bloomberg, chips and computers contributed nearly half of export growth, with overseas sales of semiconductors surging by 111%. Against this backdrop, industrial production of high-tech and equipment manufacturing ramped up 15.1% and 9.5% y-o-y, respectively. Yet this factory-floor strength has conspicuously failed to transmit into household income and spending confidence. In May, retail sales declined 0.6% y-o-y, the first negative print since December 2022.

China's K-shaped economic recovery suggests more policy support is needed to boost domestic demand



Source: Wind, HSBC Private Bank and Premier Wealth as at 25 June 2026.

- Government policy is attempting to bridge this gap. From January to May 2026, the Chinese government allocated RMB125 billion in ultra-long special bonds for the initial phase of the 2026 consumer trade-in subsidies. While these programmes have provided modest support, more structural and broad-based measures to restore confidence is called for, including property market stabilisation and sustained wage growth among the low-income groups.

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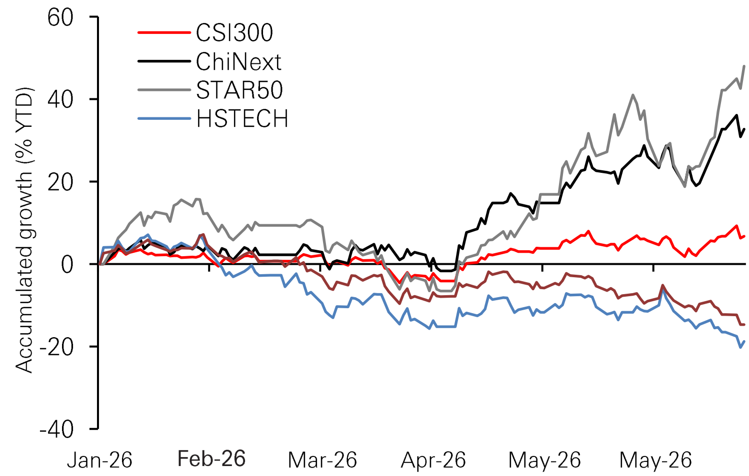
- The global AI rally of 2025–26 has been concentrated in AI hardware enablers (semiconductors, advanced packaging, optic modules, and AI servers), asset classes where A-share listings on the ChiNext and the STAR50 board dominate.
- By contrast, H-share technology names (China's large internet platforms and AI application adopters) are dragged by consumption weakness, regulations and near-term capex overhang. We believe such divergence is predominantly a market composition story.
- But the performance gap is amplified by China's aforementioned bifurcation and the large platform companies' big exposure to the over-competitive consumer market. This is on top of ongoing waves of regulatory scrutiny, ranging from fines imposed by the market regulator (SAMR) for merchant food safety breaches to the latest review of e-commerce subsidies, tax compliance issues, and cross-border investment restrictions.

YTD, onshore tech indices outperformed the offshore Hang Seng Tech Index (HSTECH) by a material margin



Source: Wind, HSBC Private Bank and Premier Wealth as at 25 June 2026.

Investment implications

- While some of these factors may stay as headwinds for the offshore listed Chinese internet giants in the near term, the case for staying invested across the entire AI ecosystem, not merely the hardware layer, is strengthening.
- China's AI infiltration into enterprise and consumer workflows is real and accelerating. Token usage across major domestic model providers has surged through 1H26. As AI gets more deeply embedded in actual workflows, we expect the current hardware-led rally to broaden to the application and platform layers as monetisation visibility improves.
- China's cloud infrastructure market has accelerated sharply on AI tailwinds, with leading domestic players consolidating market share. Alibaba, Tencent and Huawei, the top three players, collectively command around 60-70% of the market as of late 2025, underscoring an oligopolistic structure that favours large players with integrated ecosystems. Recent quarterly earnings also point to standout performance in both cloud business growth and AI contribution. However, investors have largely overlooked these successes, choosing to focus instead on massive capex and the sluggish, highly competitive traditional businesses.
- Concurrently, we think a potential rotation within the global AI equity value chain from upstream hardware towards midstream platforms, cloud infrastructure, and applications can also offer a re-rating opportunity for the Hong Kong-listed Chinese internet giants.
- On top of that, valuations are becoming more compelling. As of mid-June 2026, HSTECH's forward P/E has fallen to a historically low level (17.9x). The low valuation (and thus significant risk premium) means that China's internet large caps listed in Hong Kong are trading at a 49% PE discount (vs. a historical average of 28%) to US names, while Chinese AI names are trading at a 43% P/E discount.
- At current valuations, successful execution of cloud/AI monetisation could drive meaningful multiple expansion and relative performance catch-up. With China's domestic AI self-reliance push providing policy support and data moats from massive user bases remaining intact, these HK-listed giants are positioned to capture midstream value, which should form a critical part of investors' overall playbook when looking at China's full AI ecosystem.

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