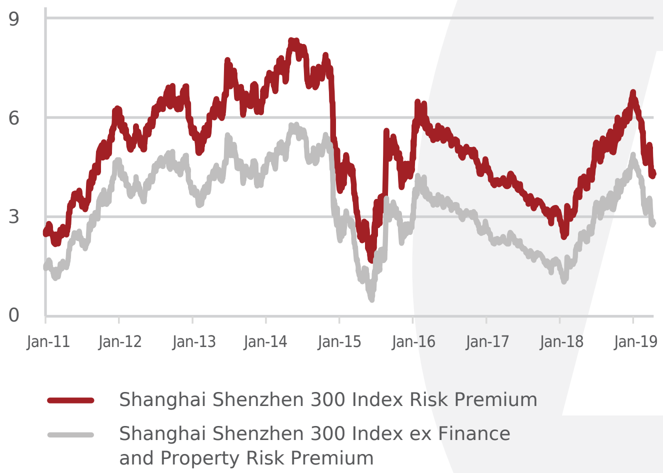
Monthly Bulletin

China Equity Market Outlook

The China A shares market has delivered a remarkable 30% performance year to date, 20% after Chinese New Year on February 5th. We believe this rally is a policy driven rebound from an over-sell level at the end of 2018, and assess the current valuation to be at a fair level (Figure 1).

Figure 1: China Shanghai Shenzhen 300 Index Risk Premium



We believe People's Bank of China (PBoC) has conveyed a message; expanding easing is coming to a stop. The market has priced in this signal, and liquidity is expected to remain, although it will be contained. Economic slowdown continues, but 19Q1 data offers some comfort. We expect the equity market to be volatile in the coming months, due to monetary policy and economic growth not being aligned. A US-China trade deal is well anticipated, and only bad news could distress the market.

China Economic Outlook

On the fiscal front, infrastructure investment spending cuts remain in place since 18Q1, while exports were impacted by a stronger CNY in 18H1 and the US-China trade tension from 18Q2. The standoff between the two countries is the worst since 2001, and has weighed down confidence significantly. Another notable change is a reduction in compensation paid to homeowners for shantytown redevelopment projects nearby.

Fixed asset investment still accounts for 40% of China's GDP (Figure 2) and is the main source of its variability. Real estate's GDP contribution holds up for now, although it may turn negative in 2020, as household debt is already high and sales may drop. Manufacturing has picked up from its suppressed level of 2017-18, yet with exports trending downwards it is unlikely to perform as before.

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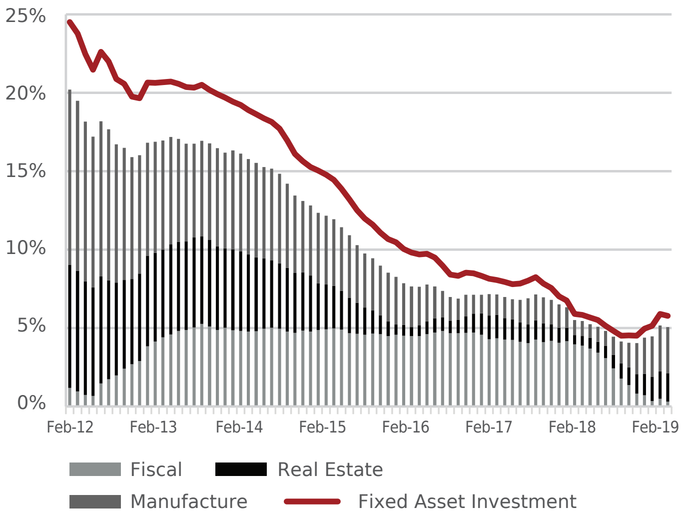
Figure 2: China Fixed Asset Investment by Type



Exports faced pressure from a stronger CNY and the US-China trade tension, as well as weaker trade partner growth - especially in the Eurozone. Exports fell sharply in 18H2 (Figure 4), and net exports dragged growth throughout 2018. With CNY exchange rates adjusted to a fairer level and US and China close to a trade deal, we assess exports not to be a significant drag going forward. Yet we don't expect a positive surprise from exports either, as China's global market share has reached a stable level and trade partner growth is trending downward.

Fiscal policy tightened mainly due to the authorities' efforts to contain local government financing and policy makers' optimistic assessment of growth since 2017. Fiscal investment growth slowdown accelerated in 2018, after policy makers moved to tackle local governments' excess financing and implicit debt (Figure 3). We believe this move is justified, and expect its pace to be carefully calibrated in the future. Combined with a tightening monetary policy in 18Q1, a mini-sized credit crunch struck the economy in 18Q2-Q3.

Figure 4: China Exports vs Real Effective Exchange Rate (REER)

Figure 3: China Fiscal Investment YoY

Another notable development is the trade tension's impact on confidence, which although difficult to measure does affect the outlook significantly; from policy makers to fixed asset investment decision makers. We believe worsening confidence was behind the China A share

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oversell in 18H2, and its improvement contributed to the recent rally. We assess the tension between the US and China to be a long-lasting conflict both in economic and trade affairs, and expect that its impact on the Chinese economy will become less and less over time.

Fiscal steps since 18Q4

China's general fiscal deficit retreated from 4% to 3% in 2018, and expanded again to 4% from 18Q4 (Figure 5). We assess the most appropriate policy combination at this point to be a loose fiscal policy through tax cuts and infrastructure investment carried out by the central government, combined with a neutral monetary policy, and to make local government implicit financing part of formal financing. We view the current policy combination as being in line with our expectation.

Inflation picks up, preventing expanding easing

Inflationary concerns have risen recently, and although in our view this is not sufficient to trigger a change of monetary stance yet, it does prevent PBoC from expanding easing. Core inflation is running at 1.8-1.9%, and is expected to remain more or less at current levels with a slowing growth momentum. The largest component, food, is at 4%, almost solely due to African Swine fever. The headline inflation series is seeing continuous pressure from the food component.

Figure 5: General Fiscal Balance to GDP

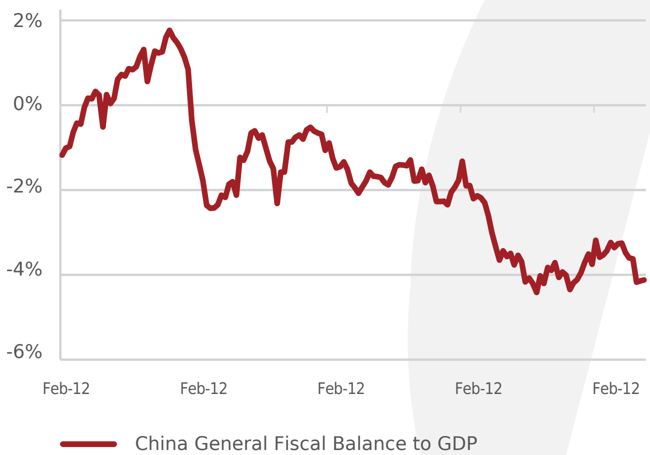
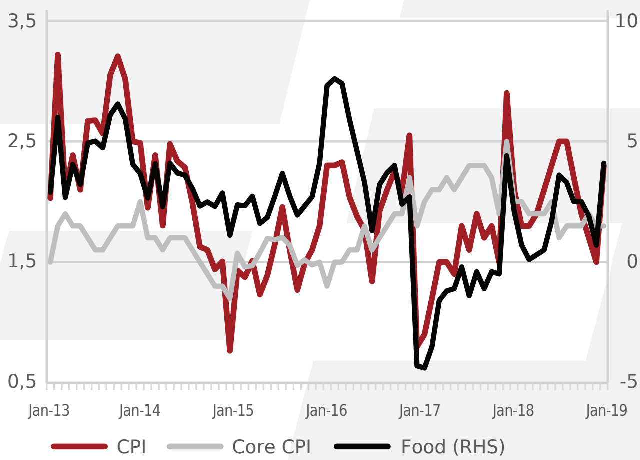


Figure 6: CPI and Components



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Developments in China's monetary policy

PBoC changed its stance in mid-2018, following the credit crunch triggered by a series of tightening financial policies known as "New Rules on Asset Management" which aimed at cracking down on shadow banking. Policy makers aimed to structurally adjust their policy in order to grant more access to financing to the private sector. However, we think this structural target is very difficult, if not impossible, for monetary policy to achieve. Recently, with China's economic and financial data surprising on the upside, and its equity market rallying strongly, PBoC slightly changed its tone and conveyed the message of ceasing to expand easing. The latest development is PBoC's announcement of a cut in the reserve requirement ratio (RRR), and the substitution of the medium-term lending facility (MLF) with shorter-term open market operations (OMO) in April.
We view this change of monetary policy stance as being warranted, as the recent slowdown is a cyclical slowdown combined with a credit shock and trade tension. Policy makers are projecting a pessimistic outcome for the US-China tension, perhaps preparing for the worst-case scenario of a larger-scale conflict. With the latest economic data showing reduced pressure, and a trade deal being close, we expect monetary policy to resume focus on its target of containing financial risk.

Bond Market View

Following PBoC conveying its message of ceasing to expand easing, money market rates remained largely unchanged, with 10Y China Development Bond (CDB) yield rising 20bps and 10Y China Government Bond (CGB) 25bps in a month. Yield curve is still steep, but we expect some flattening in the following weeks, with the short end rising in response to the new monetary stance and the long end falling due to continued slowing growth.

Figure 7: Money Market Rates

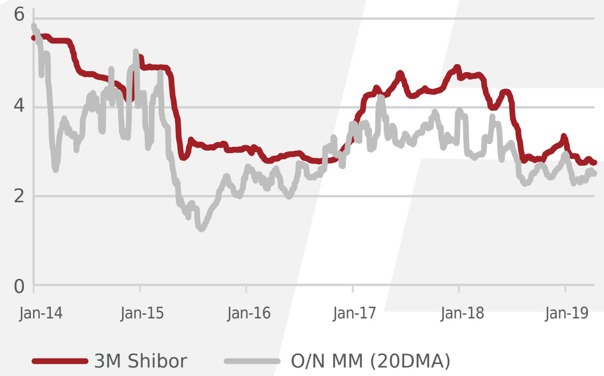
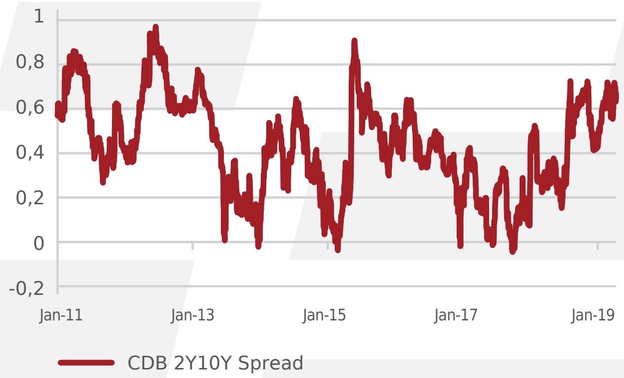


Figure 8: CDB 2Y10Y Spread



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Despite policy makers' efforts to direct financing to private firms, financing is still mainly routed to state-owned enterprises (SOEs) and local government financing vehicles (LGFVs) as well as some large private firms. Credit spreads of LGFVs and AAA corporates (mainly SOEs) remain tight, while those of lower rated corporates rose by 100bps (Figures 9 and 10).

Figure 9: 5Y Corporate Credit Spread

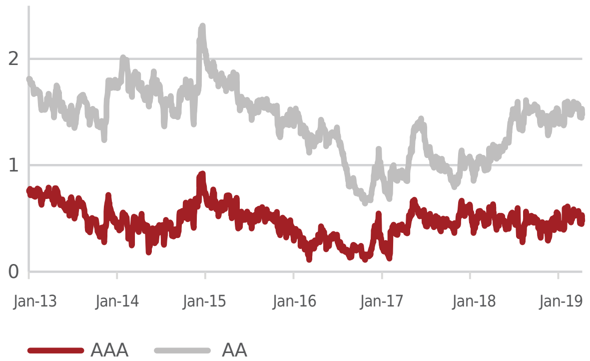
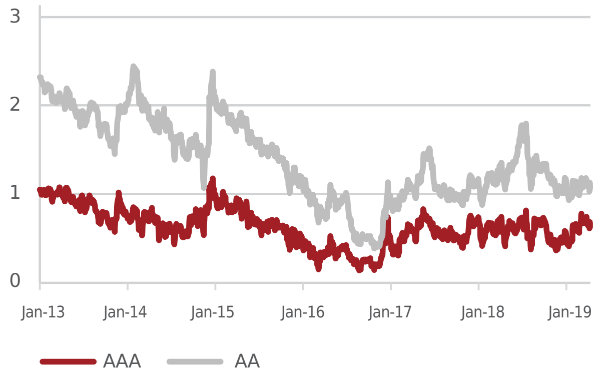


Figure 10: 5Y LGFV Credit Spread



Based on our growth outlook and current market conditions, we assess that the current rate rise is close to an end, with further developments needed for rates to resume their downward trend. Credit spreads of higher rated corporates will remain contained, and those of lower rated issues are unlikely to improve significantly. LGFVs need to be looked at case by case, with some issues still offering attractive risk-return potential.

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