China's Feel-Good Fiscal Non-Stimulus

- New bond issuance worth 10% of current GDP, but spread over several years, will be primarily used for debt swaps rather than new spending...
- ...but the debt swaps will nonetheless help heal local government balance sheets and improve economic sentiment.
- Stocks are pricing in the government's charm offensive, rather than earnings growth. We await evidence of stronger and broader earnings growth before upgrading Chinese stocks.
- Still, economic momentum is improving, led by strong export growth and recovering consumer spending.
- Moreover, there are signs the housing recession is bottoming out, which will remove a major headwind to economic growth.

Chinese policymakers' charm offensive that began with monetary easing in September has continued with an impressive sequence of market-friendly announcements. Last week it was the turn of the Standing Committee of the National People's Congress (NPC) to convince investors that fiscal stimulus will reinforce monetary stimulus, and that this year's 5% GDP growth target will be achieved.

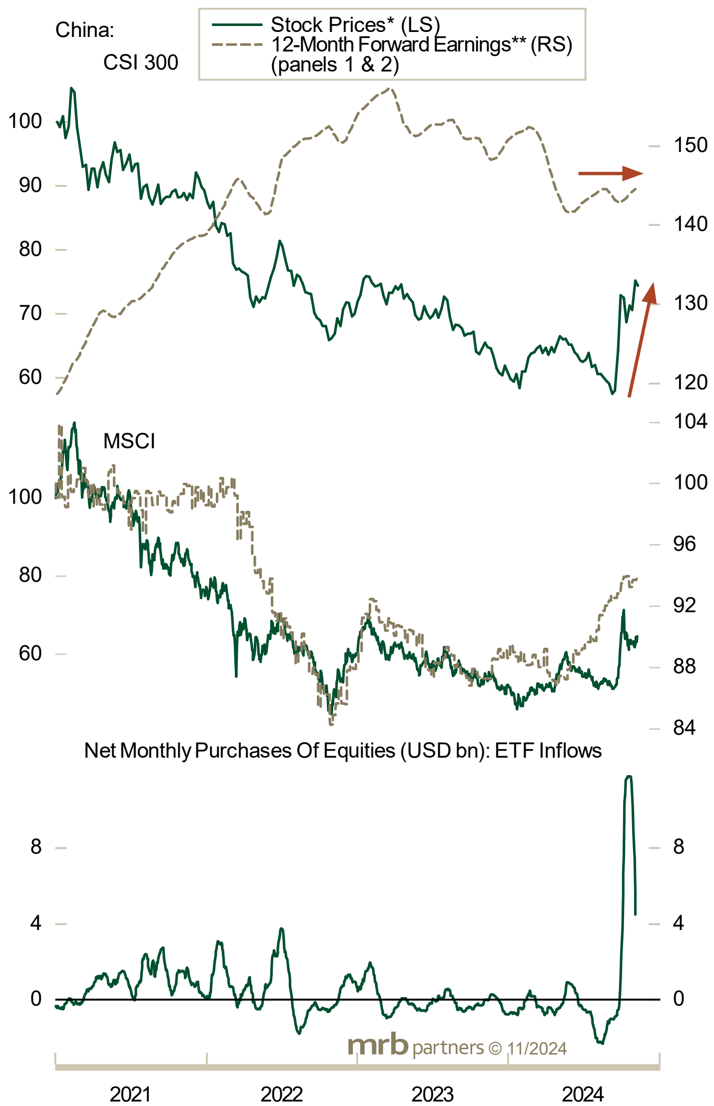
The charm offensive launched by policymakers in September continued last week with the NPC Standing Committee's approval of new debt issuance

The reality is far more prosaic, albeit relatively constructive. On the one hand, "around 5%" growth was anyway achievable (doubtless with some help from upward revisions) because current growth momentum is already accelerating thanks to very strong exports and improving consumer sentiment and spending. On the other hand, the impressive numbers being banded about for government bond issuance largely represent refinancing, rather than new spending aimed at goosing growth.

Stocks, Bonds And The Yuan

The stock market's initial euphoric reaction to September's monetary stimulus has paused, as investors looked for direct fiscal policy support that would inject earnings support for the rally (**chart 1**). What they got was a directive from Xi Jinping to ensure

Chart 1 Stock Prices Outpacing Earnings Expectations

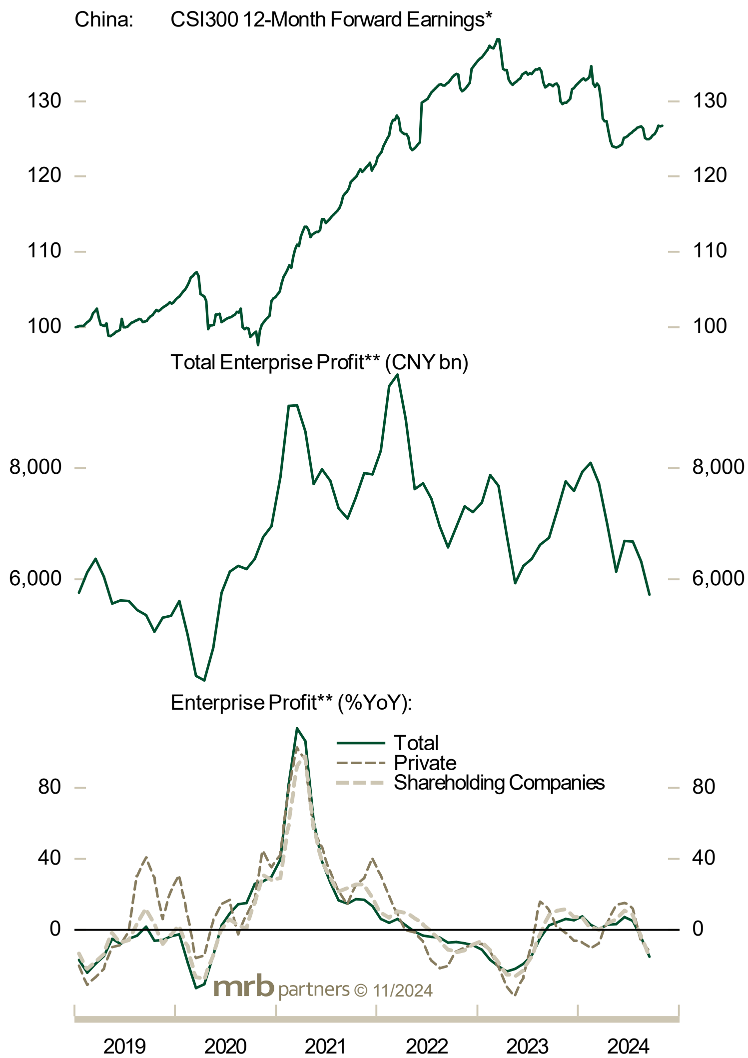


* Local currency; rebased; sources: Bloomberg, MSCI
** Local currency; rebased; source: Refinitiv I/B/E/S Global Aggregates

that the 5% growth target for this year is met, but little in the way of evidence of what government policy will do to achieve this outcome in the next six weeks.

In the meantime, foreign investors have expressed significant interest in returning to a market that many had dismissed as "uninvestable". Inflows into foreign-listed China ETFs have shot to all-time peaks, although it remains to be seen

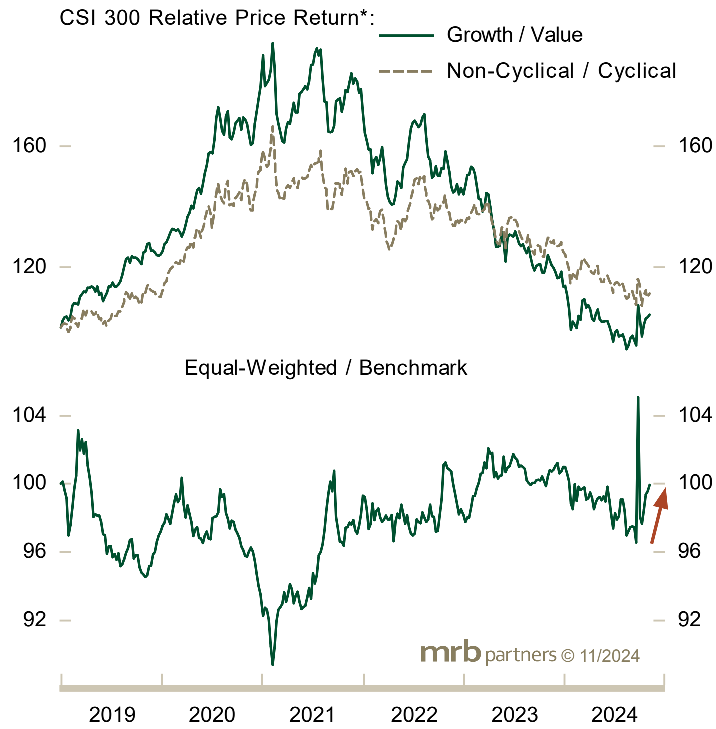
Chart 2 Corporate Profits Still Under Pressure



* Rebased; source: WIND
** Smoothed; source: China National Bureau of Statistics

whether this represents a punt on stimulus, or a lasting buy-and-hold investment. The initial reaction to Trump's election victory has been to assume that it will prove to be bad for China-themed investments (because of trade war fears), so it is likely that some of these inflows will now reverse in short order.

Chart 3 Growth Stocks Start To Outperform



* Local currency; rebased; source: Bloomberg

Most foreign investors invest in funds comprised of Chinese stock benchmarks that include the mega-cap internet platform companies, which are largely listed offshore and included in MSCI China. Forward earnings expectations for those companies have been improving of late and are now back to levels last seen in mid-2022, so the positive rate of change offers some comfort.

However, the domestically listed version of China's stock market, as proxied by the CSI 300 index, has seen ***no meaningful improvement*** in overall forward earnings. This is confirmed by macroeconomic data that shows total enterprise profits in China remaining under severe pressure, with year-over-year declines for the aggregate of listed companies as well as for private sector companies (**chart 2**).

CSI 300 stocks are primary beneficiaries of government support measures and have outperformed...

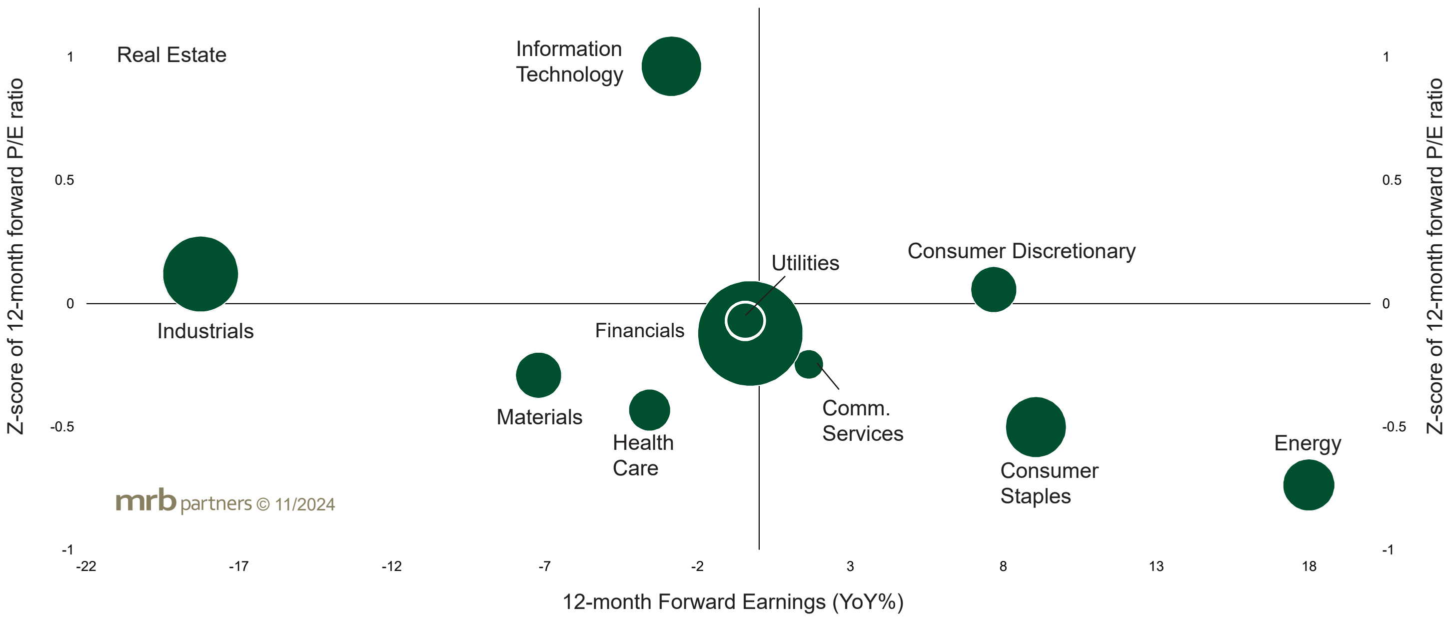
Within the CSI 300 universe, the recent rally has benefited growth stocks relative to value stocks, and is expressed as broad-based strength, with the equally-weighted benchmark outperforming the market-cap weighted index (**chart 3**). Such performance might typically be taken as a sign of investors smelling a solid cyclical turnaround, although it is noteworthy that cyclical stocks have ***not*** been outperforming defensives.

... but show no signs yet of a recovery in forward earnings

Nevertheless, the rally seems to be primarily anchored in policy ***expectations***, as well as in the availability of government support for market intermediaries and companies to increase their equity inventories as well as for share buybacks. These funds are available only for domestically listed stocks and explain the outperformance of the CSI 300 versus MSCI China in recent weeks.

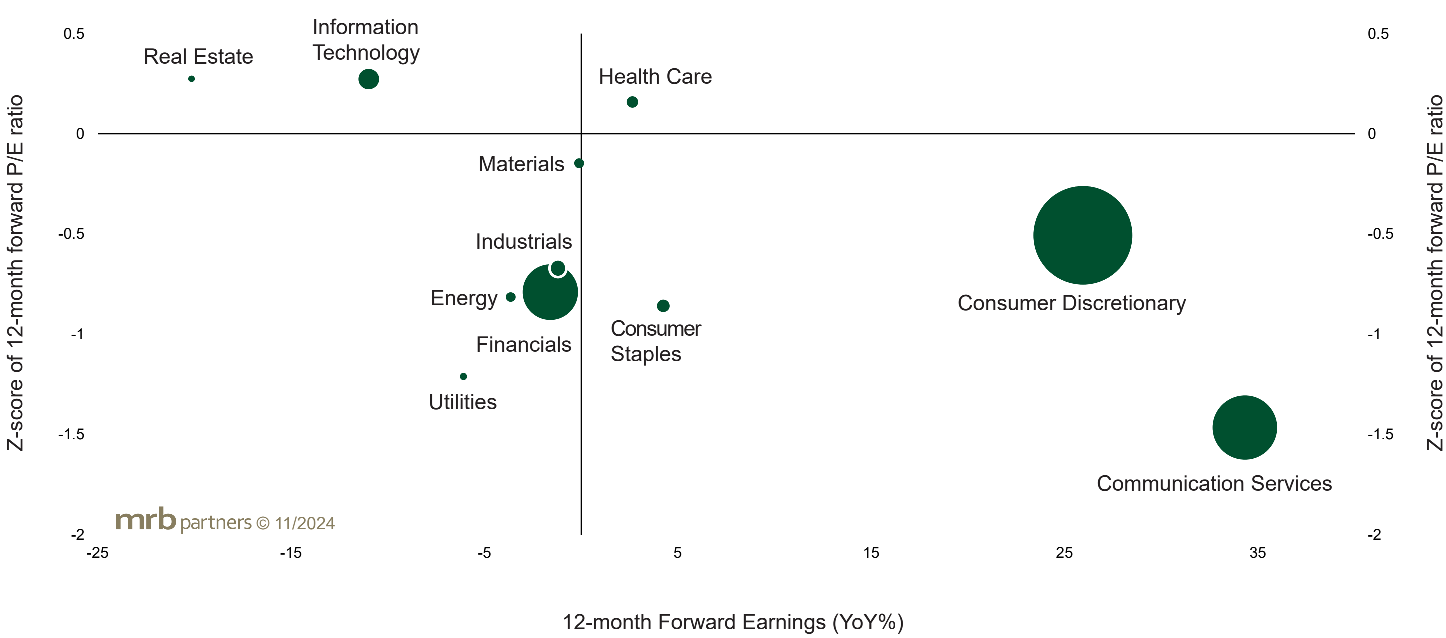
While earnings expectations for CSI 300 stocks have not been improving in aggregate terms, as noted above, the sectoral distribution of earnings growth does point to a gradual broadening of such expectations, with the dominant financial sector no longer a drag (**chart 4A**). For CSI 300 sectors, earnings expectations are positive for

Chart 4A CSI 300 Earnings Momentum Is Flat Overall



Size of bubble represents market capitalization of each sector
Source: WIND
Note: Excludes real estate sector

Chart 4B MSCI Earnings Growth Is Positive But Too Narrowly-Based



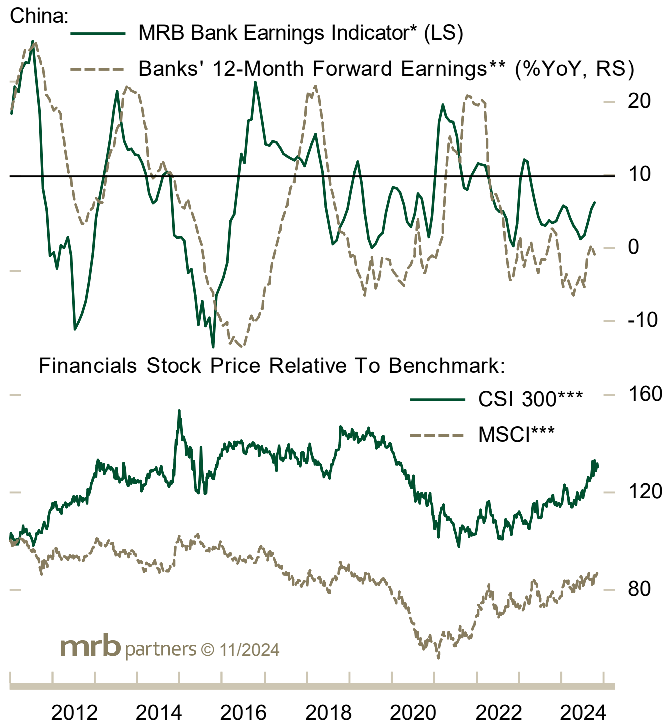
Size of bubble represents market capitalization of each sector
Source: MSCI

energy, consumer staples, consumer discretionary and communication services, and they are flat for financials and utilities. Earnings expectations are falling for the other five sectors.

On the other hand, while overall earnings expectations are improving for MSCI China, in this case the improvement is very narrowly based (**chart 4B**, previous page). The two sectors which contain the mega-cap internet platform companies – consumer discretionary and communication services – are responsible for practically all the growth in forward earnings. Almost everything else is a drag.

The outlook for the financial sector is critical for earnings expectations in China. It is the largest single sector, and its earnings are most reflective of domestic economic momentum. The *MRB Bank Earnings Indicator* is showing a small improvement in the earnings outlook, while banks' forward earnings have stopped falling and are now flat in year-over year terms (**chart 5**).

Chart 5 **Bank Earnings Still Only Flattish**



* Includes measures of credit volume, lending spreads & 12-month forward earnings revisions; MRB calculation
** U.S. dollars; source: MSCI
*** Local currency; rebased

Big capital injection for banks despite adequate Tier 1 capital is a sure sign that policymakers are anticipating significant degradation of loan quality in the near future

As we have noted since the announcement in September that the major state-owned banks will be recapitalized, any such exercise would not typically imply earnings out-performance. While the central government will inject capital via a special long-term bond issue, the implication is that minority shareholders will either be diluted or will participate via lower dividends.

Nevertheless, such concerns have so far been ignored by investors and financial stocks continue to outperform the broad market for both the CSI 300 and MSCI China benchmarks. Given that Tier 1 capital was already more than adequate for the big banks, the recapitalization must be anticipating a significant uptick in loan delinquencies. When those loan problems are recognized, investors may well have second thoughts and start fretting about earnings expectations for banks.

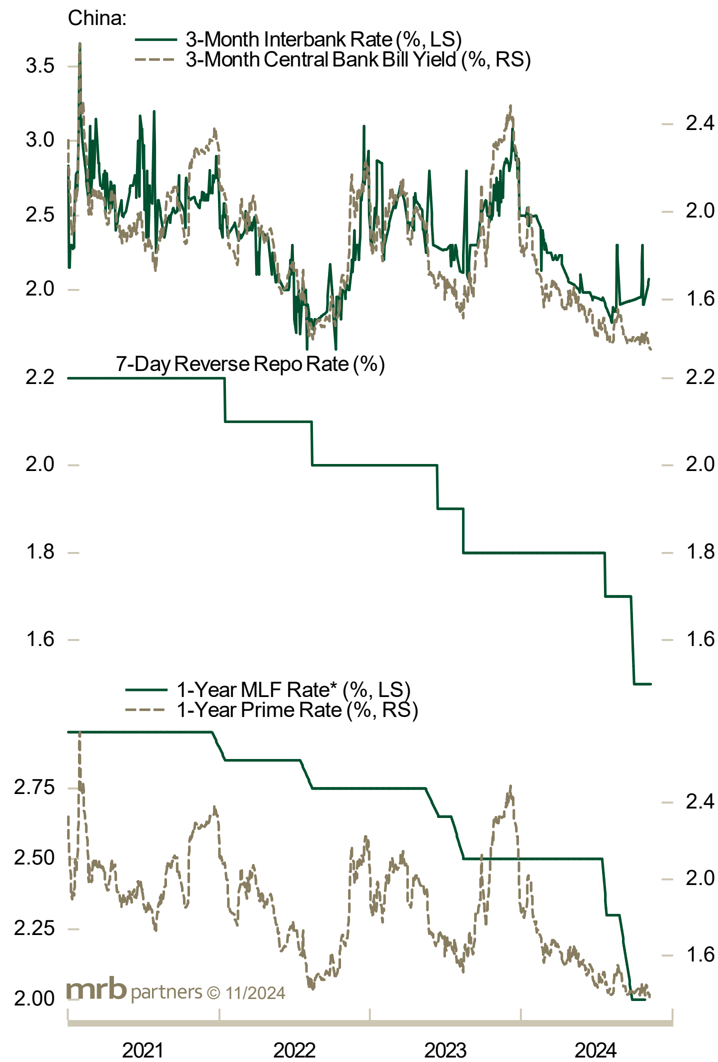
We have a bias to upgrade our view on Chinese stocks but are still recommending a neutral position within an EM equity portfolio. Any such an upgrade will be contingent upon evidence of a broad-based growth in earnings, which is what we expect to eventually emerge in the months ahead as a result of organic economic growth. Currently, the ***earnings backdrop is still too patchy to justify an upgrade,*** even if this means not fully embracing the price upside associated with monetary injections and hopes of a policy stimulus.

The outcome of last week's NPC Standing Committee showed that "fiscal stimulus" is more of a confidence-building exercise than a counter-cyclical policy. Indeed, the fiscal deficit target was left unchanged. As we have argued previously, hopes for a big policy bazooka to lift overall growth are in any case based on faulty mental models of economic policy in the Xi Jining era[1].

As is often the case during periods of heavy bond issuance in China, short-term interbank rates have edged higher as liquidity is mopped up (**chart 6**). This has occurred in recent weeks despite cuts is policy rates (the current target rate is the 7-day reverse repo, the former target rate is the 1-year MLF, both have been cut twice recently).

Meanwhile bond yields have remained in a choppy sideways band, which is a break from the waterfall in yields that played out over the past year (**chart 7**). It is likely that the heavy issuance calendar has prevented a continued decline in yields, which is supported by the steepening yield curve (10 year minus 2 year). With the negative spread offered by yuan bonds relative to U.S. Treasurys widening along with the backup in the latter's yields, holdings of yuan bonds by foreigners have edged down. The latter suggests that foreign investors are not taking up much of the new issuance.

Chart 6 **Monetary Policy Is Very Easy**



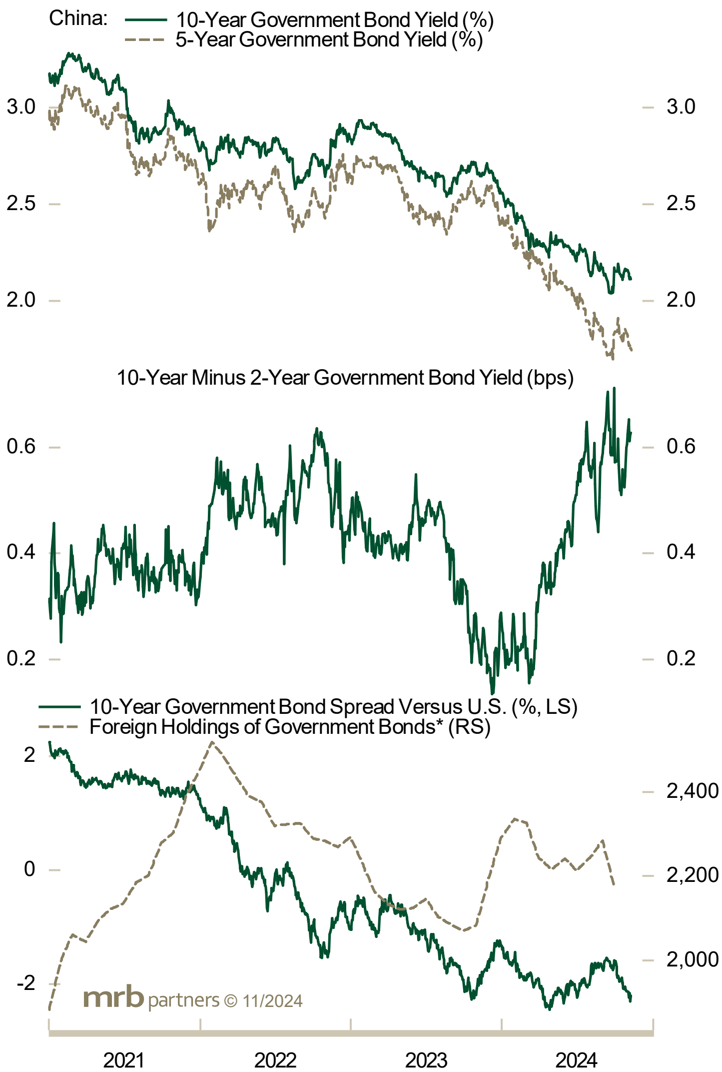
* Medium-term lending facility; source: PBoC

With limited yuan bond and currency volatility, most of the changes in relative performance for yuan bonds primarily reflects non-Chinese factors over the past month. Bond yields rose among EM peers and the negative spread widened, while the yuan's low beta meant that the currency outperformed, which resulted in overall yuan bond outperformance (**chart 8A**). Meanwhile, relative performance versus U.S. Treasurys was positive (yuan bonds outperformed), because U.S. yields rose sharply enough to overcome the performance drag of a stronger U.S. dollar (**chart 8B**).

The yield curve has steepened appreciably as heavy bond issuance is announced

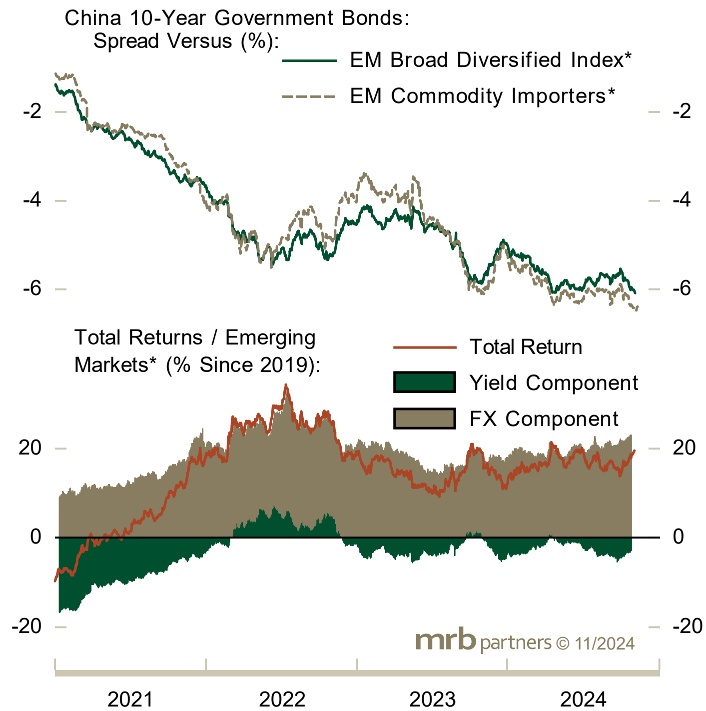
[1] **MRB:** "*China: The Hazards Of Mental Models*", October 8, 2024

Chart 7 Yuan Bond Yields Stop Falling



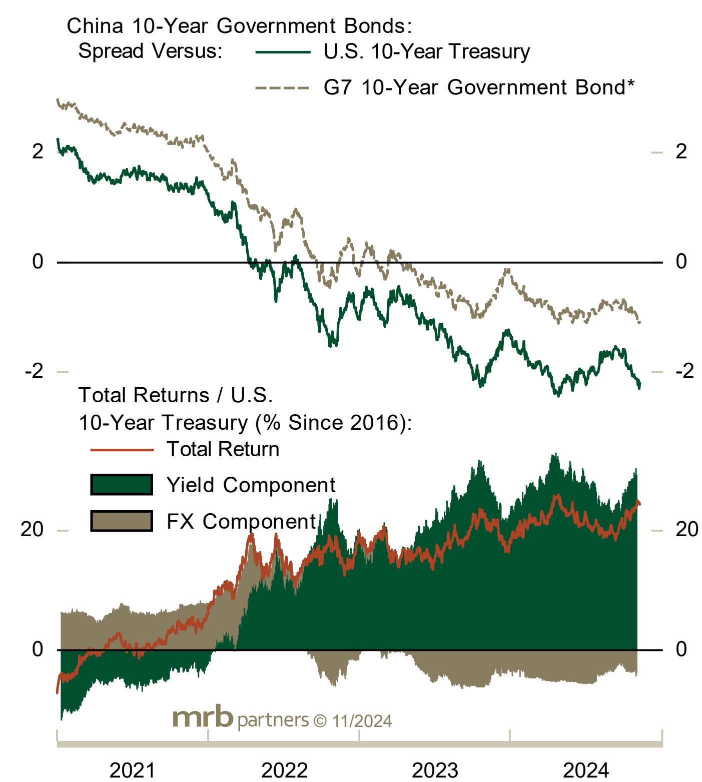
* Billion CNY; source: Chinabond

Chart 8A Yuan Bond Returns Outpace EM Peers



* Equally weighted EM aggregate

Chart 8B Yuan Bond Returns Massively Beat U.S. Treasurys

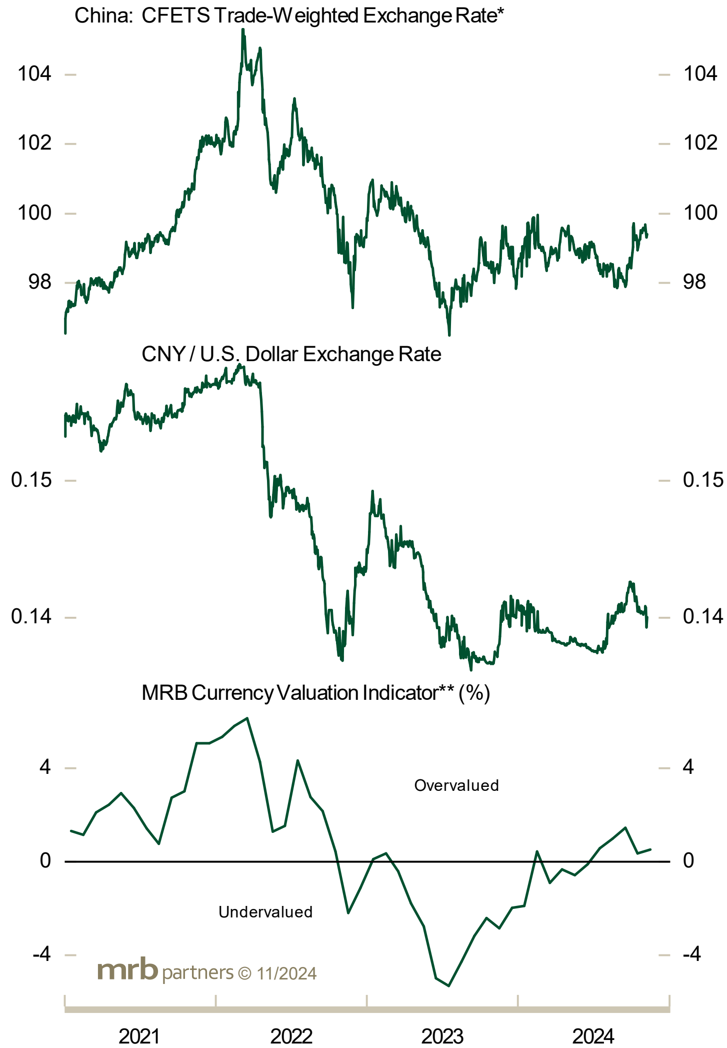


* Equally weighted G7 aggregate

The yuan's performance relative to the U.S. dollar was also primarily driven by broader movement in the U.S. dollar (**chart 9**). Even before the sharp dollar appreciation in the aftermath of Trump's election victory, the dollar had been strengthening relative to DM majors and this resulted in downward pressure on the yuan, whose movement is constrained by the currency management regime. Relative to the U.S. dollar, the yuan remains close to the fair value estimate of the *MRB Currency Valuation Indicator*.

Final Word: *Remain neutral on China within an EM equity portfolio, based primarily on a supportive policy backdrop and attractive valuations. We have a bias to upgrade China to overweight once we see evidence of earnings growth that is both positive and broadly-based. For the time being, it is too patchy to beat the prospects available in selected EM ex-China markets[2]. The yuan should modestly underperform its EM peers, given the strictures of its currency management regime and low carry[3] and EM currencies are expected to modestly appreciate versus the U.S. dollar. Yuan bonds will underperform EM local-currency denominated bonds as the scope for interest rate cuts is greater in EM ex-China[4].*

Chart 9 Yuan Weakens As U.S. Dollar Strengthens



* Rebased; MRB calculation based on China Foreign Exchange Trade System CNY index weights
** Deviation from MRB Fair Value Estimate

Economic And Trade Momentum

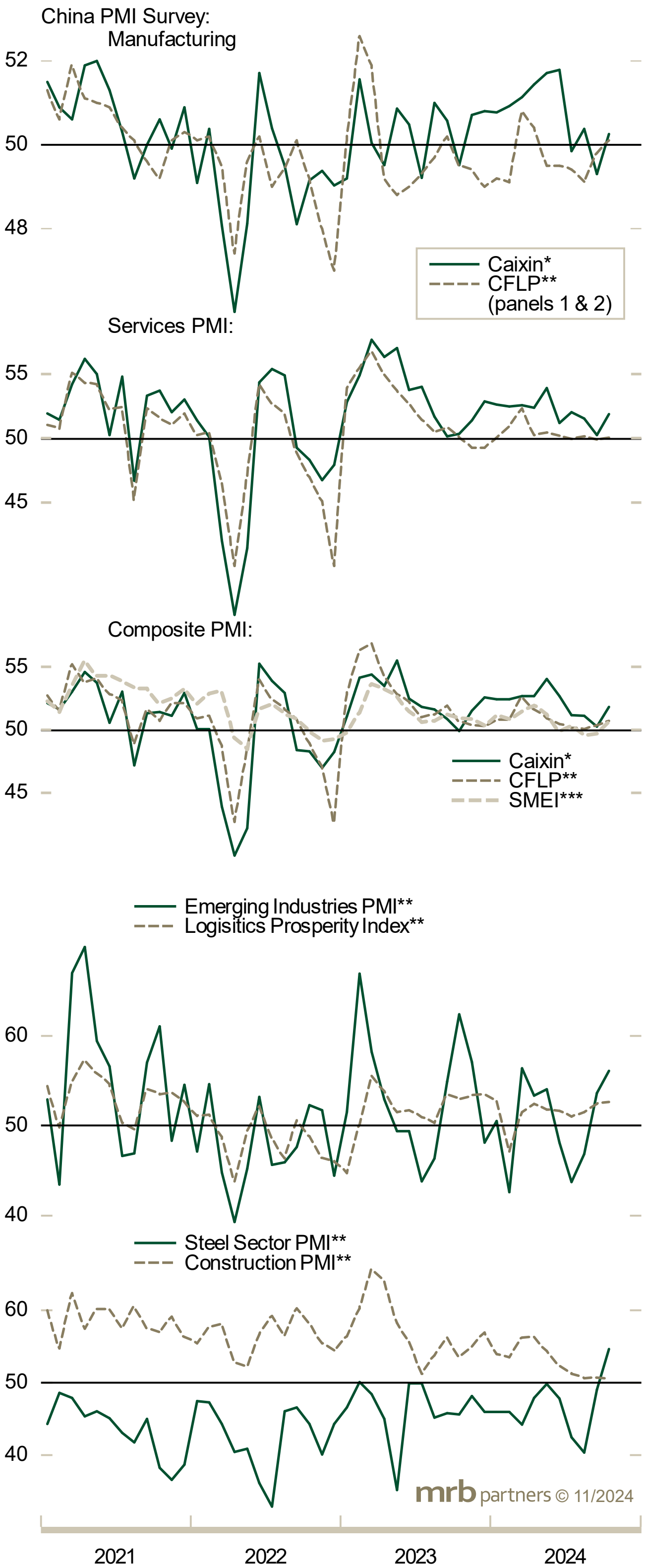
October's crop of PMI surveys indicated expansionary conditions and, in some cases, expectations were exceeded (**chart 10**). The two surveys of the overall manufacturing sector (the official CFLP survey and the Caixin survey, which has larger exposure to private sector companies) both improved and showed expansionary conditions, after contractions were reported in the prior month. Sector-specific surveys also improved or showed expansion for emerging industries, logistics, steel and construction. Service sector surveys also registered expansionary conditions, as did composite surveys, including the SMEI survey which focuses on small and medium sized enterprises.

Manufacturing activity has picked up across the board

The *MRB Economic Activity Indicator* also ticked higher and is now suggesting that economic momentum is running slightly ahead of the underlying trend (**chart 11**). We estimate the latter is currently 4.5-5%, or slightly below the government's target for "around 5%" real GDP growth in 2024. The *Indicator*'s current reading is thus consistent with statements from Chinese officials, including Premier Li Qiang last

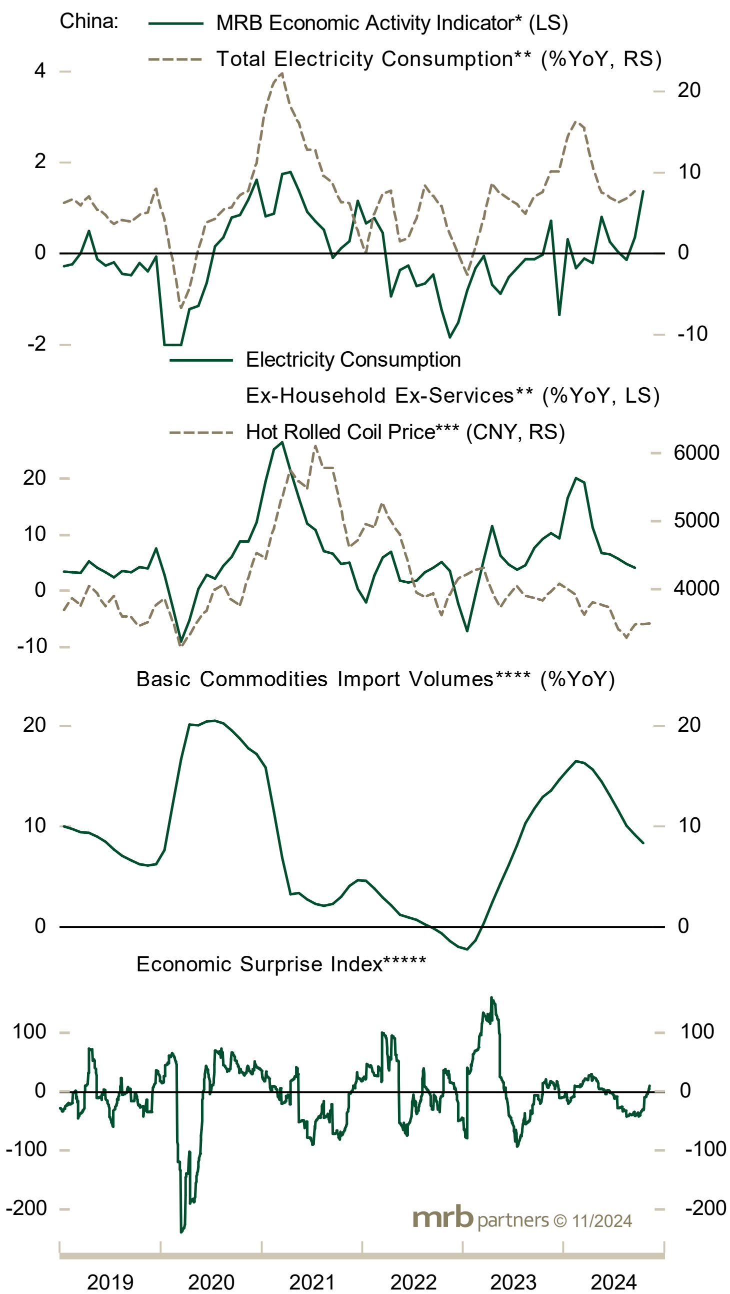
[2] **MRB***:* "*Why We Prefer EM Over U.S. Semiconductor Stocks*", October 3, 2023
[3] **MRB***:* "*The Stars Are Aligning For EM Currencies*", October 17, 2023
[4] **MRB***:* "*EM Fixed Income – EM Debt: Stick With High Yielders*", July 25, 2024

Chart 10 PMI Surveys Indicate A Manufacturing Turnaround



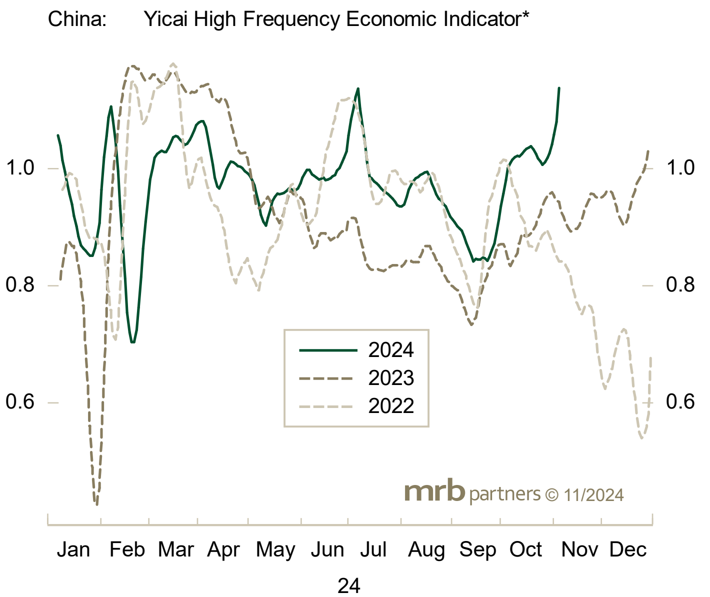
* Source: Caixin
** China Federation of Logistics & Purchasing
*** Source: Standard Chartered Bank

Chart 11 Economic Momentum Is Ahead Of Underlying Trend



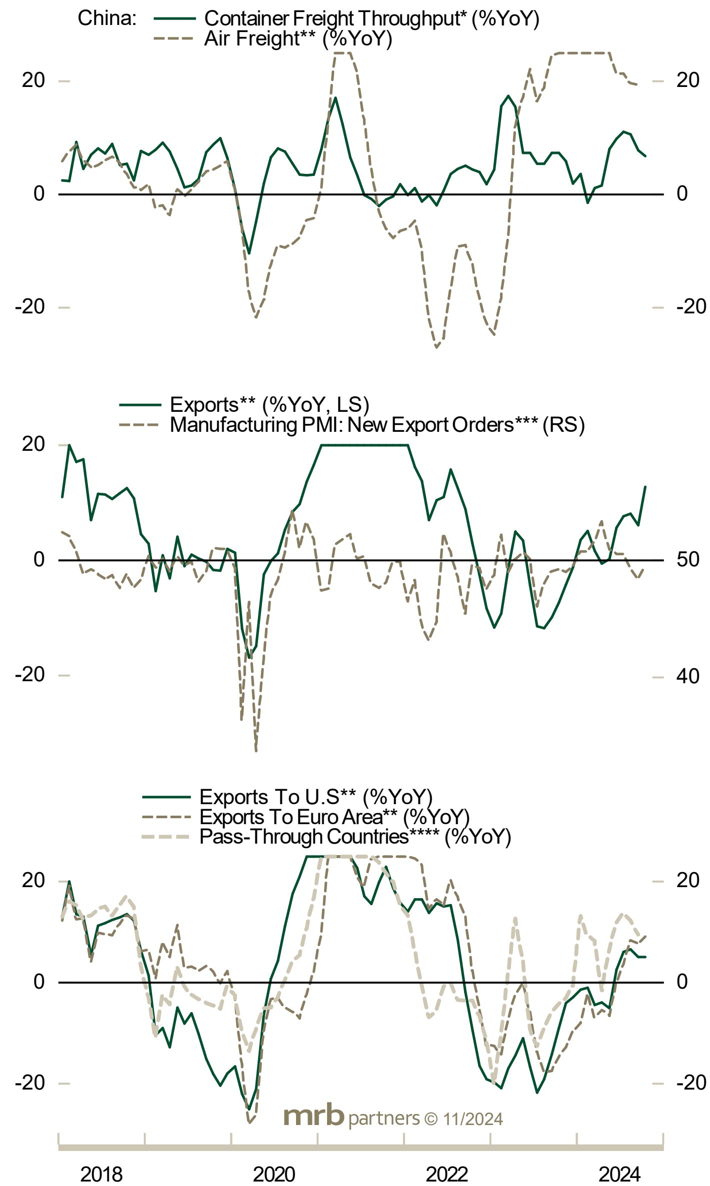
* Measure of deviation from trend growth; truncated below -2; standardized
** China National Energy Administration
*** Source: Antaike Information Development
**** Includes equally weighted iron, copper, crude oil, coal and natural gas imports; rebased; source: China General Administration of Customs
***** Source: Citigroup

Chart 12 **High Frequency Data Confirms Solid Q4 Pace**



* Includes traffic data, metro traffic, coal consumption for power generation, air pollution, commercial housing sales and Baidu search terms for "unemployment" and "bankruptcy"; source: Yicai Research Institute

Chart 13 **Export Growth Strengthens**



* Source: Ministry of Transport
** Truncated above 25; U.S. dollars; smoothed; source: China National Bureau of Statistics
*** Source: Markit Economics
**** Truncated above 25; smoothed; includes Hong Kong, Mexico, Singapore & Vietnam

week, reiterating 5% for 2024 as an achievable target, despite Q3 GDP growth running at only 4.6% year-over-year[5]. Electricity consumption growth and commodity import growth is robust (albeit lower than recent peaks) and the *Citigroup Economic Surprise Index* has bounced back from its recent trough and has turned positive.

High frequency data also confirms the firming up of economic momentum (**chart 12**). The *Yicai High Frequency Economic Indicator*[6] has followed its seasonal pattern and strengthened appreciably since its summertime lows, and is far ahead of levels this time last year.

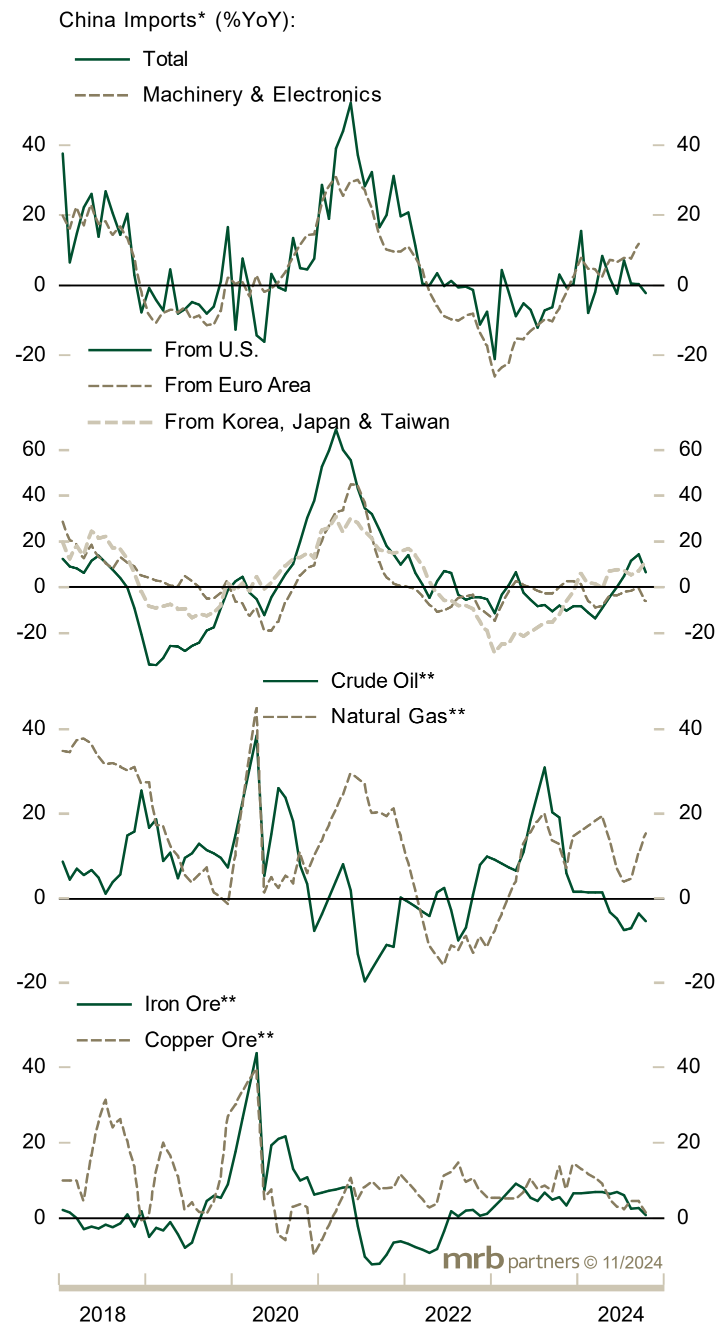
Export volumes are holding up well, as indicated by the volume growth of air freight and container freight throughput (**chart 13**). However, new export orders have remained in contractionary territory for the third straight month for both the CFLP and Caixin surveys, although the latter declined at a slower pace than before.

[5] Quarter-on-quarter growth so far this year registered 1.5, 0.7 and 0.9% respectively. To reach 5% for the year, a 1.9% Q4 print would be required, which would be the fastest pace since Q1 2023 when the economy was recovering from COVID lockdowns. While this may seem a high hurdle, upward revisions for earlier quarters may yet make the 5% target achievable.

[6] Includes traffic data, metro traffic, coal consumption for power generation, air pollution, commercial housing sales and Baidu search terms for "unemployment" and "bankruptcy".

Export growth in both yuan and U.S. dollar terms continues to expand rapidly, with headline year-over-year growth hitting 13% in October. The fastest-growing geographic component of exports is to pass-through countries[7], where the ultimate source of demand is most probably in the U.S. (but are masked to avoid tariffs). Direct exports to the U.S. are also expanding in double digit terms, with exports to the euro area expanding at a slower pace. Autos and integrated circuits are among the fastest-growing large segments of exports.

Chart 14 **Overall Imports Are Flat, But Machinery & Electronics Booming**



* U.S. dollars; source: China National Bureau of Statistics
** Import volumes; source: China General Administration of Customs

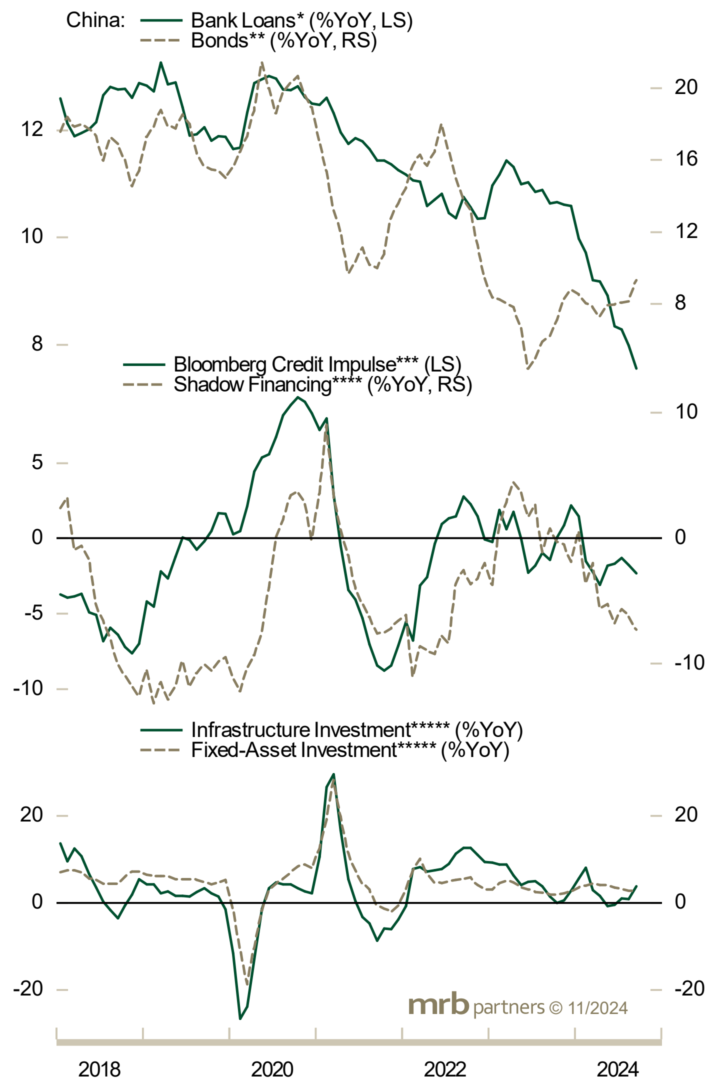
In sharp contrast to the robust growth of exports, overall import growth has stalled (**chart 14**). Nevertheless, imports of machinery and electronics are strong and accelerating, and this is the largest single component of imports. Among major trading partners, imports from the U.S. are growing the strongest, are broadly flat from Japan, Korea and Taiwan, and are falling from the euro area. The picture for key basic commodity imports is mixed: iron and copper ore are barely growing in year-over-year terms, while natural gas imports are booming, and crude oil imports are falling. Nevertheless, it is notable that BHP, Australia's largest copper producer, has recently provided positive guidance on the outlook for copper demand from China's housing sector. That said, published data suggests merely that a bottoming out, rather than a recovery, is underway in housing (see below).

Final Word: *Q4 economic momentum has picked up significantly, even in the absence of any palpable impact from the recent bout of confidence-building monetary policy measures. The pickup partly reflects seasonal effects, as well as ongoing tailwinds from the export sector, whose health has historically been positively correlated with employment,*

[7] Hong Kong, Mexico, Singapore and Vietnam.

and, by extension, consumer confidence. Export growth will continue to provide a strong tailwind to economic activity until it is upset by another jolt of U.S. protectionism. The impact of the latter can only be judged after a period of noisy negotiation and in any event will likely be obscured by a surge of precautionary stock building (i.e. front running.)

Chart 15 Despite Rising Bond Issuance, Credit Impulse Is Negative



* Includes local and foreign currency loans; source: PBoC
** Includes corporate and local government bond; source: PBoC and China Central Depository & Clearing Co.
*** Source: Bloomberg
**** Includes bankers' acceptances, entrusted loans, trust loans; source: PBoC
***** Smoothed; source: China National Bureau of Statistics

Credit, Consumption And Housing

The growth of bond issuance is the primary source of credit growth in the economy, outpacing bank loans that had been the historic driver (**chart 15**). Very substantial new tranches of special and long maturity bonds have been announced that will ensure the primacy of bond issuance in the months ahead (see following page).

However, the overall credit impulse remains negative and is deteriorating because the pace of bank lending is rapidly diminishing, and shadow financing is shrinking anew. The latter is tightly bound up with borrowing by local governments, whose balance sheets are severely stressed and who have been in a multi-year deleveraging process kicked off by the 2021 crackdown on property developers.

The typical policy outcomes associated with credit growth remain subdued. Infrastructure investment and fixed asset investment are both growing slower than GDP, although the former ticked higher when measured in year-on-year terms because of base effects[8].

Consumption activity is ticking along, with growth rates running faster than current GDP growth (**chart 16**, page 14). However, retail sales (and online sales, which is the cleaner measure) as well as per-capita household consumption had until recently decelerated since earlier this year. This has emboldened analysts (including, crucially,

[8] Investment in transportation and public investments faded at the end of 2023.

Burgeoning Balance Sheet Bonds

In addition to a slew of monetary policy easing measures and funds made available for supporting the stock market[9], 14 trillion yuan (US$2 trillion or approximately 10% of current GDP) worth of sovereign bond issuance was approved by the NPC Standing Committee. The bonds will be issued over 3-5 years and are primarily earmarked for local government debt swaps. Priority will be given to clearing heretofore unrecognized debts, and local governments have been scrambling in recent months to identify as much of these liabilities as possible so that they can be refinanced.

While this has been loosely described as "fiscal stimulus", something that many analysts and investors had been hoping for, in reality it represents only the beginning of what will likely be an extensive program of reducing local government leverage. The central government's much healthier balance sheet will thereby assume debts accumulated by local governments, and, more importantly, by local government financing vehicles as well as unrecognized local government debt such as accounts payable.

The real economy multiplier effects of such "balance sheet bonds" is far smaller than those of either project-related bonds or bonds used to finance a wider general budget deficit. Nevertheless, their future impact is still not zero. Local governments with stressed balance sheets (primarily in poorer provinces and rural areas) have been delaying payments to contractors and in some cases even delaying salaries. Such delays have significant (albeit highly localized) knock-on effects, which will likely be eased as liquidity trickles down from the central government's debt issuance.

There are also anecdotes of local governments aggressively pursuing alleged corporate malfeasance and imposing fines as a way of securing additional revenue. To the extent that liquidity pressures ease and such activity declines, it will be positive for business confidence. However, it seems unlikely that the measurable aggregate impact of the new sovereign bond issuance on GDP growth will be significant, despite the large headline numbers.

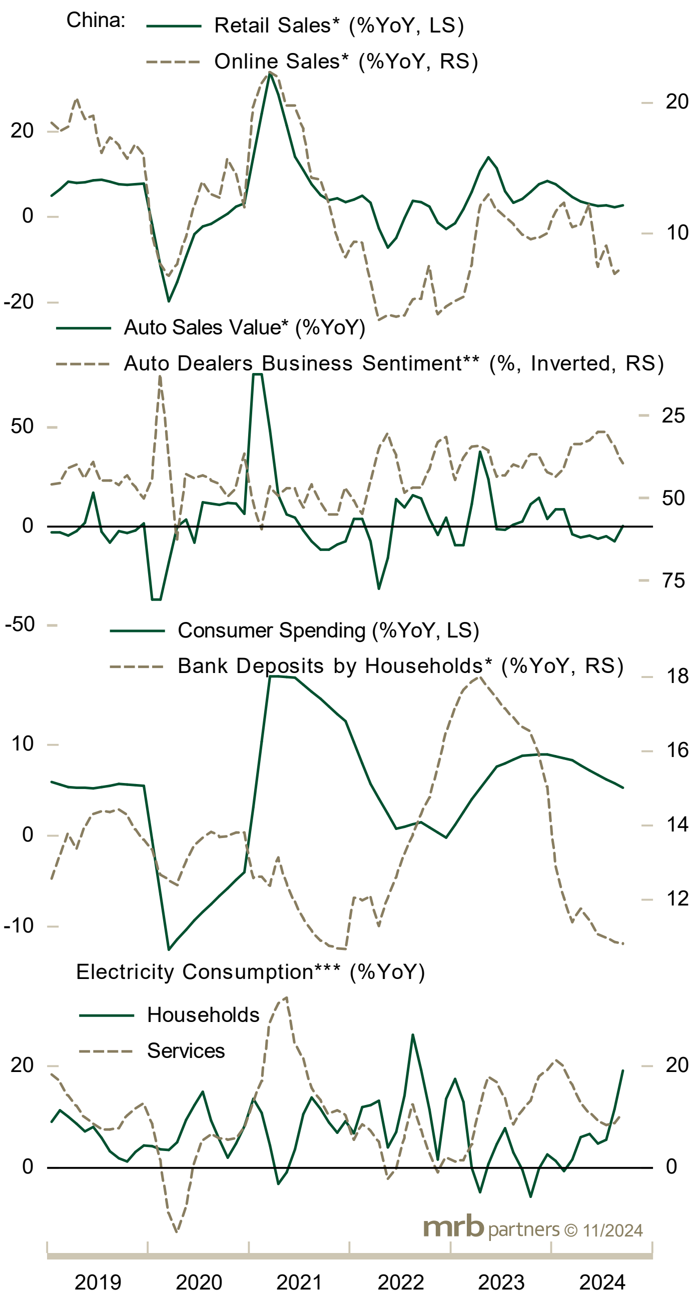
domestic commentary in the tightly controlled press) who argue that consumption is "too weak" and therefore that much more policy stimulus is required.

Single's Day sales are set to improve and consumption activity is picking up again

Seasonal patterns are now following their typical upswing in the fourth quarter (**chart 17**). In terms of online promotions, this year's 618 event in June was disappointing, but early indications suggest that November's Single's Day (which typically delivers the highest online sales of the year) will deliver solid growth. Auto sales volumes continue to be strong, although heavy discounting has suppressed the yuan value of sales. However, even here, the latest data shows a pickup in sales values and positive growth in year-over-year terms.

[9] PBoC Fires Its Bazooka, Banks Will Suffer The Collateral Damage, September 27, 2024

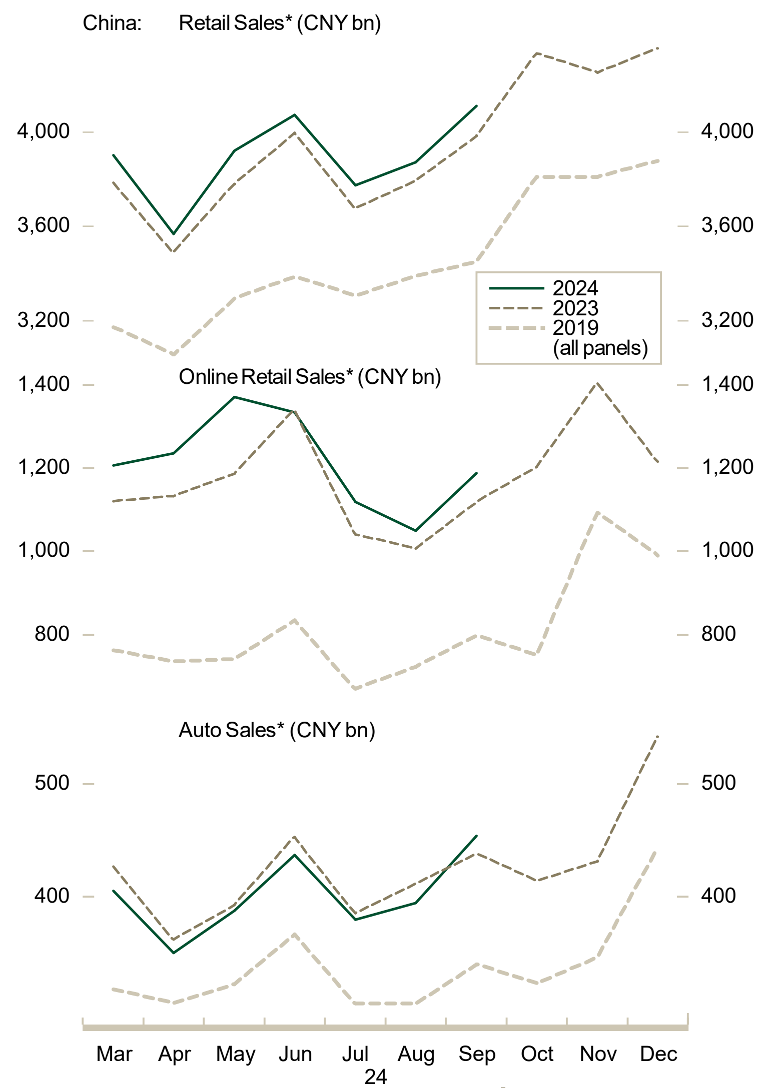
Chart 16 Consumption Growth Will Likely Improve



* Smoothed; source: China National Bureau of Statistics
** Source: China Automobile Dealers Association; readings above 50 = high inventories/poor trading conditions
*** Source: China National Energy Administration

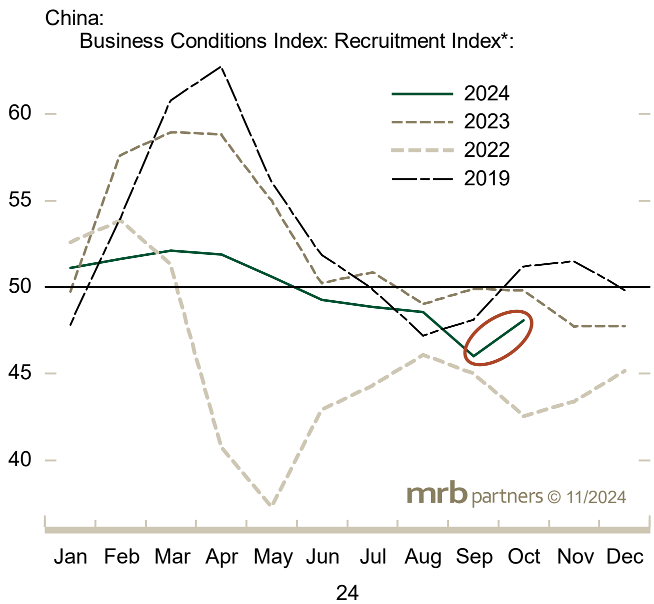
The improvement in consumer sentiment cannot be entirely attributed to hopes of stimulus. Historically, labor market conditions are a critical component of sentiment, and China's data on the former are notoriously poor. Nevertheless,

Chart 17 Seasonal Spending Pickup Is On Track



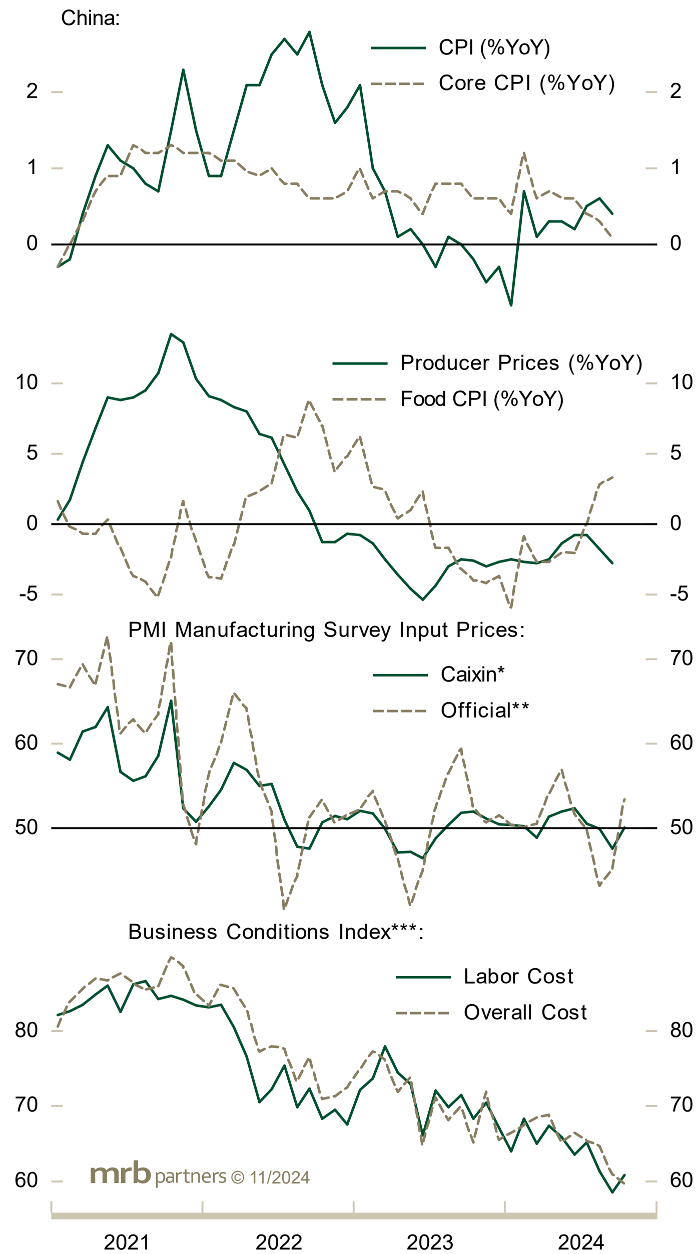
* Source: China National Bureau of Statistics mrb partners © 11/2024

Chart 18 First Sign Of Healing Labor Market?



* Source: Cheung Kong Graduate School of Business

Chart 19 Food Inflation Lifts Headline CPI



* Source: Caixin
** Source: China Federation of Logistics and Purchasing
*** Source: Cheung Kong Graduate School of Business

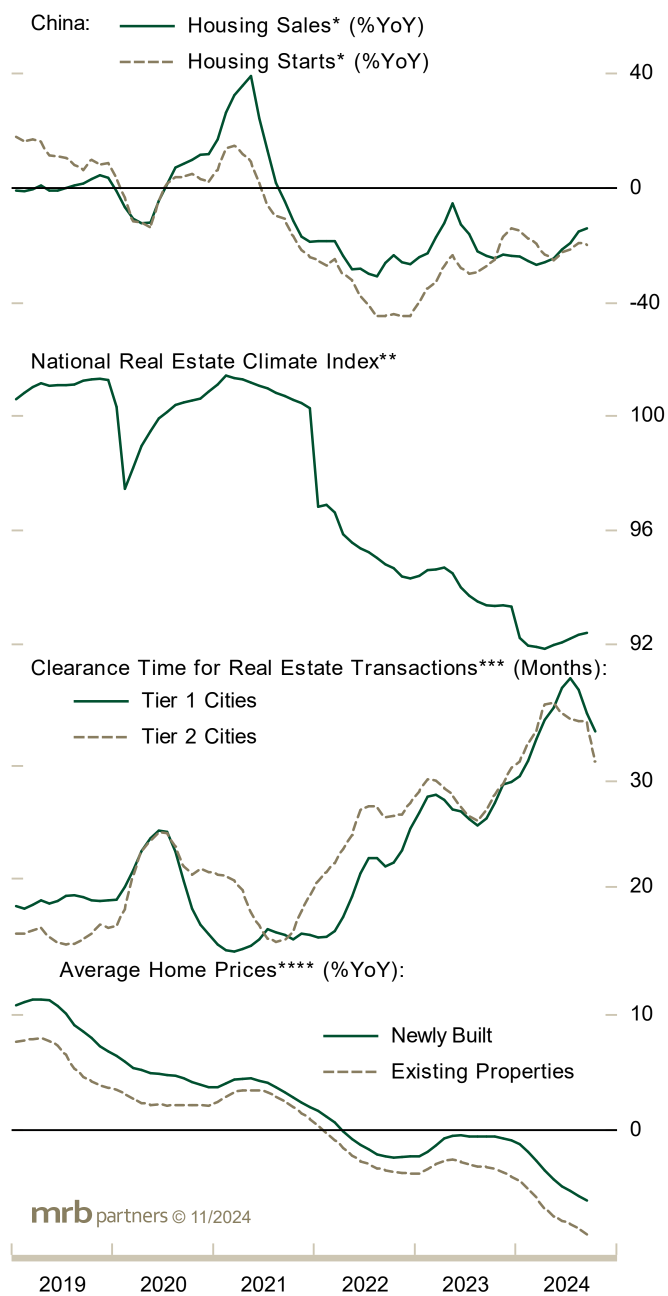
the recruitment index published by Hong Kong's Cheung Kong School of Business (CKGSB) suggests an uptick in recruitment activity (**chart 18**). Prior to the pandemic, there was a secondary peak in recruitment at this time of year (the main recruitment season is March through May) and this year may be the first time since then to see a similar pickup. Watch this space. This pickup is feeding through into improved consumer sentiment, and reinforcing the spending turnaround.

A spike in food prices has put much of the deflation discourse to rest for the time being (**chart 19**). Core inflation, while positive, is at its lowest for five years. Manufacturing input prices are either flat or rising, depending on which survey is followed. Labor costs and overall costs are still rising, according to the CKGSB survey, albeit at a much lower pace than in prior years.

In any event, much of the angst over China's "overcapacity" causing it to "export deflation" is misplaced. It is true that hyperactive industrial policy has stimulated rapid growth in output in strategically important sectors, which has triggered intense competition and price discounting. The export of such goods underlines China's competitive advantage in such sectors and is an effective subsidy for consumers in other countries. In other words, it is reflationary, rather than deflationary. While Chinese export price index is showing prices lower than a year ago, this largely reflects the base effect from last year's export prices being particularly strong. China publishes its export and import prices in terms of year over year change only, so it is difficult to get a sense of actual price levels.

With much of the thrust of recent policy announcements directed at staunching the losses arising from the steep housing sector recession, it is not surprising to see some (still modest) signs of bottoming out (**chart 20**). Housing starts and sales are still declining in year-over-year terms, but at a less drastic rate. The *National Real Estate Index* has improved for three successive months, and the backlog of unsold properties is beginning to unwind when expressed in terms of the number of months it would to take to sell them all at the current sales rate. Nevertheless, average prices continue to fall for both new builds and existing properties.

Chart 20 **Housing Sector May Be Bottoming Out**



* Volume; smoothed; source: China National Bureau of Statistics
** Source: National Bureau of Statistics
*** Source: SoulFun-CREIS
**** 70-city price index; source: China National Bureau of Statistics

Final Word: *Consumption spending will likely improve solidly through year-end and into 2025 as confidence-building measures announced by the government, together with improving labor market conditions, repair battered sentiment. Despite the impressive numbers associated with "fiscal stimulus", this will be directed towards refinancing rather than fresh counter-cyclical spending. Bond issuance will continue to soar, while bank credit growth slows to a crawl and shadow financing shrinks further. There are signs of a bottoming out in the beleaguered housing sector, which implies that the powerful growth headwinds from the segment of the economy will disappear in 2025.*

Mehran Nakhjavani I Partner, Emerging Markets

MacroResearchBoard

mrb partners

Independent Investment Strategy

MRB - Macro Research Board is an independent top-down research firm that provides integrated, global, multi-asset investment strategy as well as actionable absolute and relative return ideas. Our views incorporate a long-term outlook based on in-depth thematic research, together with a rigorous set of frameworks and forecasting models/indicators that drive 6-12 month asset market performance. MRB's team of analysts and strategists leverage the firm's robust research engine and their extensive experience to form one cohesive house view and ensure that investment strategy is articulated in a client-friendly manner.

For more information, please contact:
Client Relations
clientrelations@mrbpartners.com

London
24 Old Bond Street, 3rd Floor,
London, W1S 4AP, United Kingdom
Tel (+)44 (0) 20 3523 9618

Montreal
1275 Ave. des Canadiens-de-Montréal, Suite 500
Montreal, Quebec H3B 0G4, Canada
Tel +1 514 558 1515

New York
1345 Avenue of the Americas, FL 2
New York, NY, 10105, United States
Tel +1 212 390 1148

MRB Research Coverage

- Weekly Macro Strategy
- Global Macro & Investment Themes
- Global Asset Allocation
- Absolute Return Strategy
- U.S. & Developed Market Strategy
- China & Emerging Market Strategy
- Regional Equity Strategy
- U.S. Equity Sectors Strategy
- Global Fixed Income Strategy
- Foreign Exchange Strategy
- Commodity Strategy
- Webcasts & Live Events