Equities Are Riding The Dragon's Tail

- The sharp rally in stock prices has been driven mostly by re-rating and unrealistic expectations of government stimulus.
- While the earnings backdrop is improving for MSCI China, it is deteriorating for the CSI 300 and is still too narrowly based to warrant an upgrade in Chinese equities.
- A prolonged rate-cutting cycle has not prevented the steady deceleration in credit demand. The credit impulse is negative.
- Consumption activity and net exports are positive drivers of economic momentum. Fiscal thrust, fixed asset investment and housing remain the primary headwinds.

When you grab the dragon's tail, expect a wild ride. Some investors who bought into the notion of massive policy stimulus at the end of September were nonplussed by the subsequent lack of fiscal support[1]. Others simply focused on the dubious belief that the central bank's printing presses will be directed to buy stocks. And investors who were outright short Chinese stocks because of an erroneous belief in demographic decline and imminent debt deflation have been scrambling to cover their positions.

The volatility of market sentiment reflects investors' reliance on out-dated mental models…

From a structural perspective, the volatility of sentiment reinforces the fact that market participants use faulty mental models when analyzing the Chinese economy that results in outsized expectations of "stimulus"[2]. From a cyclical perspective, the fact that the economy is merely trundling along at close to its slowly declining underlying trend, with some segments expanding and others contracting, greatly reduces confidence in the outlook for corporate earnings.

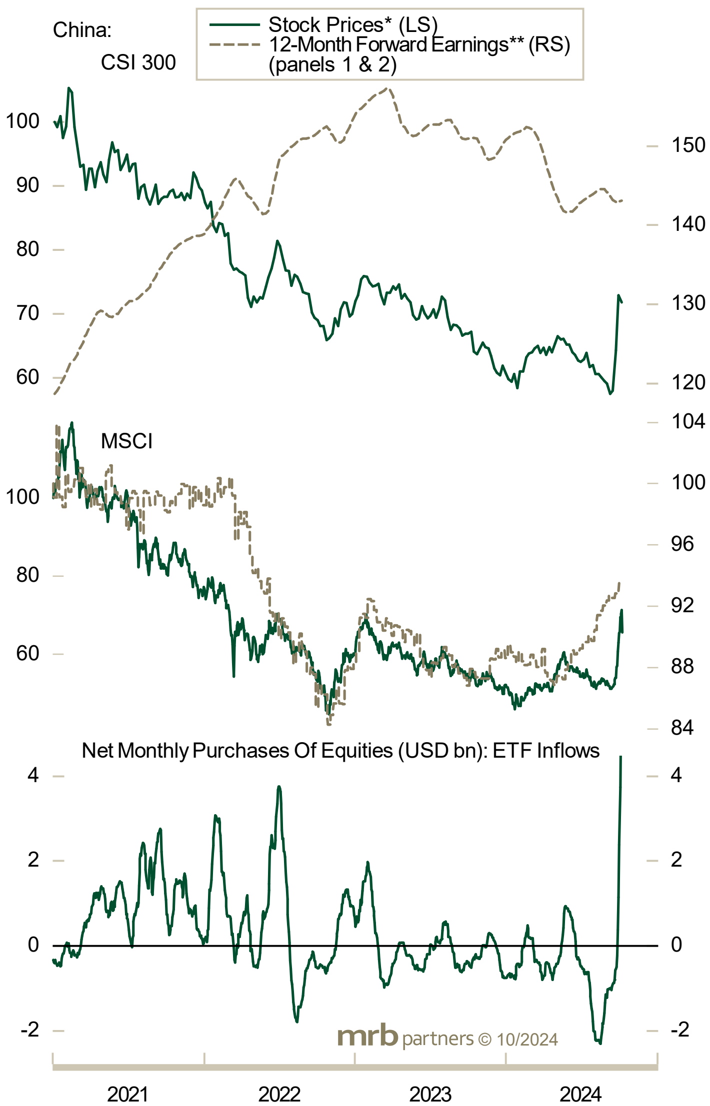
… and a misplaced expectation for the scale and timing of policy stimulus

Behind all the market noise, economic momentum is broadly positive. China is participating in the revival of global trade, more so on the export side than for imports. But even there, China's imports from the U.S. and key Asian markets are growing solidly, ensuring that it remains a positive contributor to global trade and economic growth. China's economy underpins a broadly constructive global macro outlook, even if many investors remain bearish about its assets.

[1] The latest variant of such hopes is for a "bazooka" to be unveiled during a briefing from the Ministry of Finance scheduled for October 12, 2024.

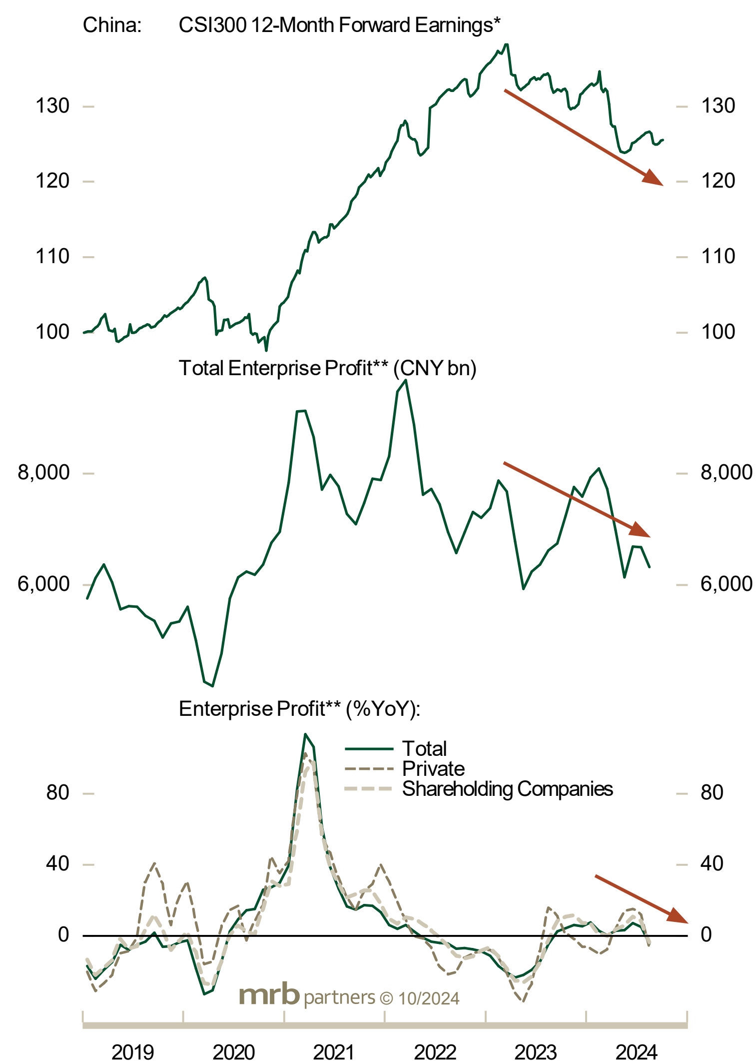
[2] **MRB:** "***Theme – China: The Hazards Of Mental Models***", October 8, 2024

Chart 1 Stocks Pop Despite Mixed Earnings Outlook



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

Chart 2 Mainland Corporate Earnings Are Still Very Weak



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

Stocks, Bonds And The Yuan

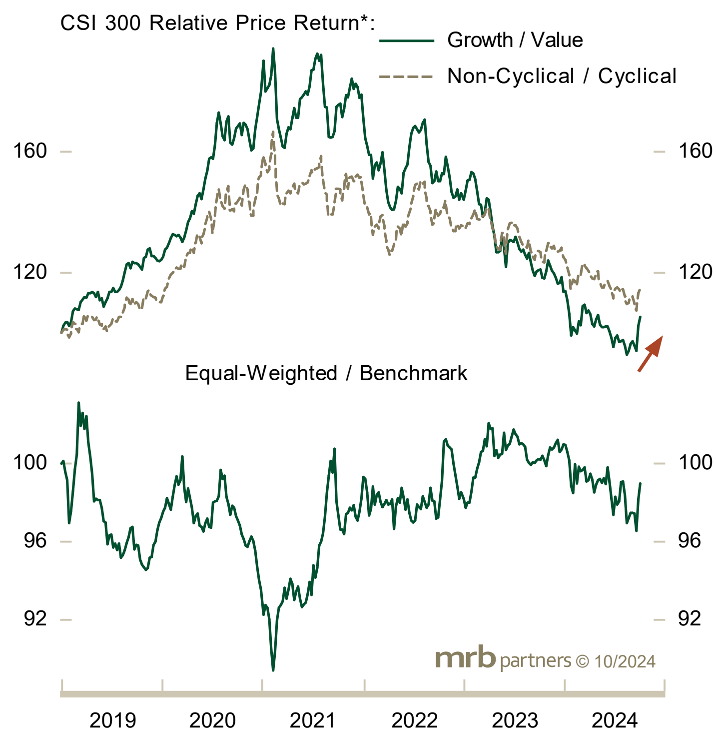
Chinese stocks have reacted euphorically to the package of support measures announced at the end of September[3]. A combination of panic buying by domestic retail investors, short covering by foreign hedge funds and heavy buying of foreign-listed ETFs triggered a near-vertical jump in stock prices (**chart 1**). At the same time, the lack of fiscal policy backup has injected massive two-way price volatility. While the runup in prices had solid support from an improvement in forward earnings in the MSCI China benchmark, no such support was available in mainland-listed

[3] **MRB**: "*China: PBoC Fires Its Bazooka, Banks Will Suffer The Collateral Damage*", September 27, 2024

stocks that comprise the CSI 300, where earnings remain in a downtrend. The disconnect between prices and earnings will persist, implying that the rally is exclusively driven by rerating.

The weakness of the forward earnings outlook is not restricted to CSI 300 stocks (**chart 2**, previous page). Total enterprise profits, a series published by the National Bureau of Statistics (NBS), shows similar weakness indicating a broad-based deterioration in profits among privately-owned and listed companies alike. Ironically, as the package of market support measures includes financing facilities for stockbrokers and insurance companies to purchase stocks, as well as to finance share buybacks, it is the domestically-listed stocks which are likely to be the most direct beneficiaries, rather than the overseas-listed big cap stocks that drive the MSCI China benchmark. Within the CSI 300, the recent rally has favored growth over value and large-cap stocks (**chart 3**).

Chart 3 **Recent Rally Has Helped Growth Stocks**



* Local currency; rebased; source: Bloomberg

While we have had a neutral weight with an upgrade bias on Chinese stocks within an EM portfolio, the upgrade is predicated on a broad-based earnings recovery. No evidence for such a recovery is yet apparent (**charts 4A** and **4B**). Within the CSI 300 benchmark, only five sectors have forward earnings higher than they were a year ago, and forward earnings of the biggest sectors in terms of market capitalization (financials and industrials) are still falling.

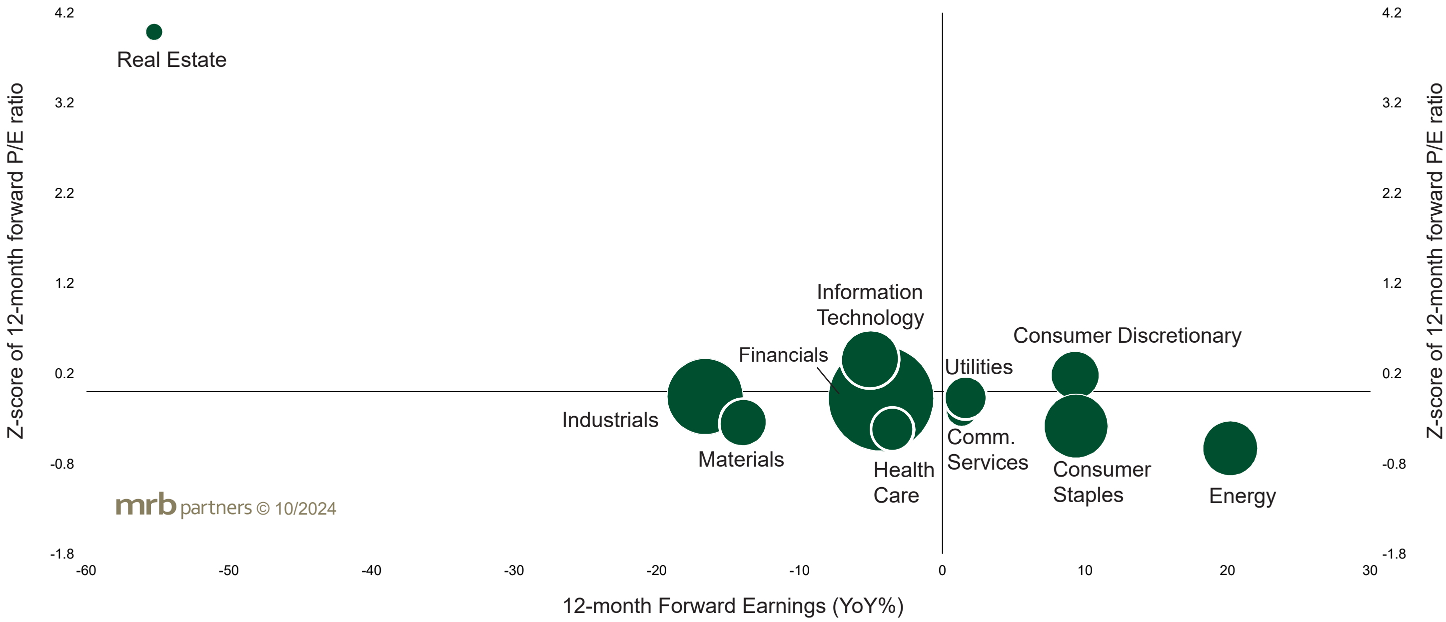
Earnings expectations are still too weak, and narrowly-based, to warrant an upgrade in our view...

In the MSCI China benchmark, the largest sectors are consumer discretionary and communication services, which account for more than half of the market cap and contain the large internet platform companies. The latter are indeed showing positive forward earnings momentum, but this is the only bright spot – forward earnings for the majority of sectors are still declining.

...although forward earnings for MSCI China are stronger than for mainland-listed stocks

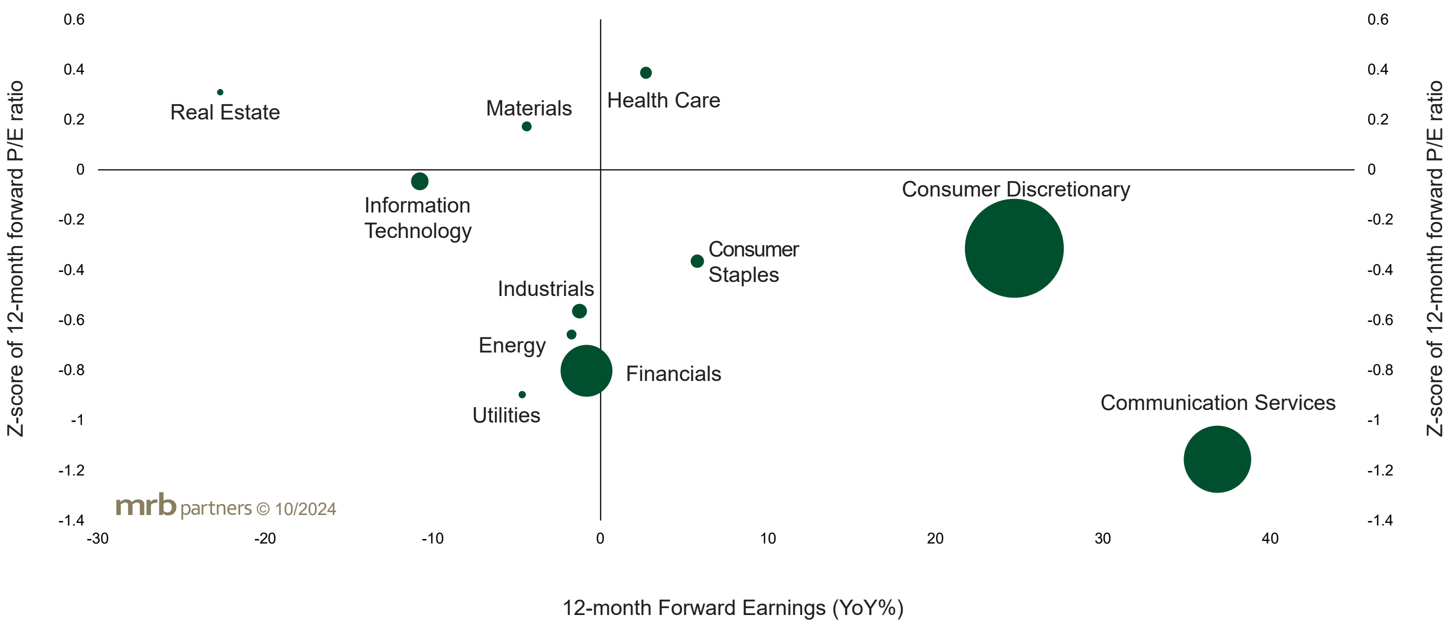
Ultimately, given the outsized weight of the financial sector, and banks in particular, our bias to upgrade will be closely tied to the outlook for bank earnings. Until the recent rally, financial stocks had generally been outperforming thanks to their defensive characteristics and decent dividend yield. Such relative performance was not related to earnings, although at least banks' forward earnings have stopped

Chart 4A CSI 300 Earnings Growth Is Poor And Narrowly-Based



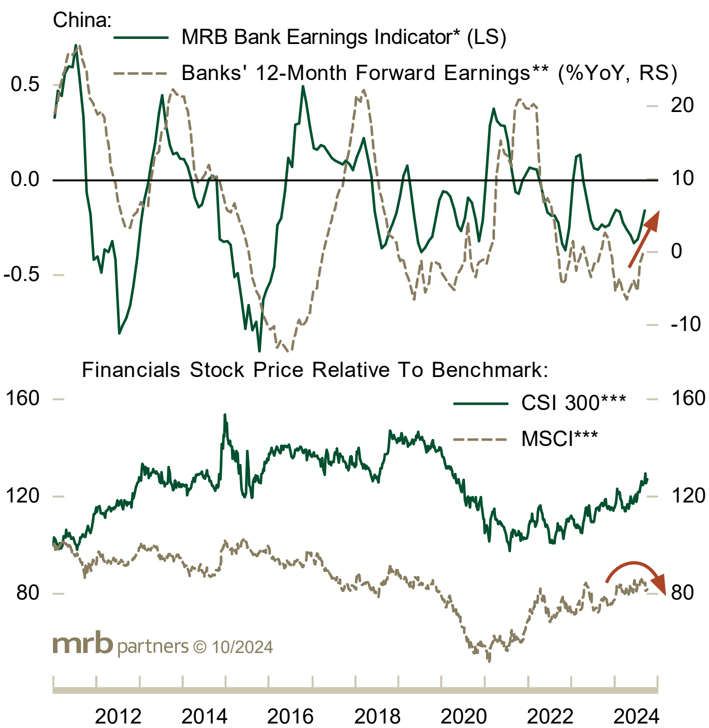
Size of bubble represents market capitalization of each sector
Source: WIND

Chart 4B MSCI China Earnings Are Improving But Too Narrowly-Based



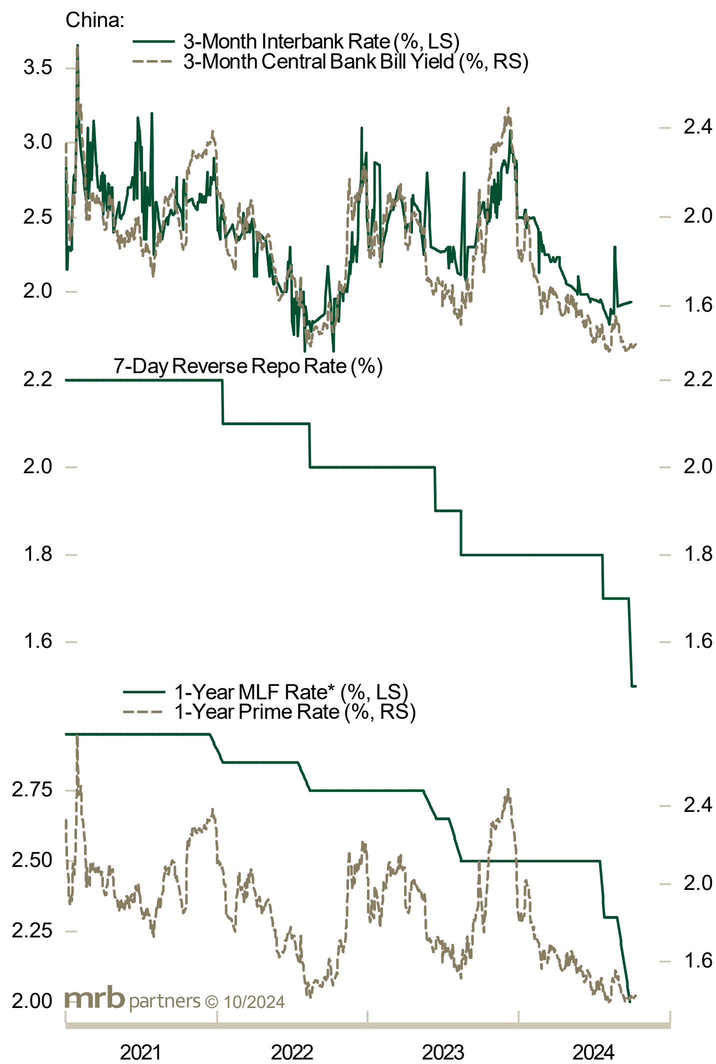
Size of bubble represents market capitalization of each sector
Source: MSCI

Chart 5 **Required Capital Raising Will Delay Recovery In Bank Earnings**



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

Chart 6 **Pushing On A String With Another Policy Rate Cut**



* Medium-term lending facility; source: PBoC

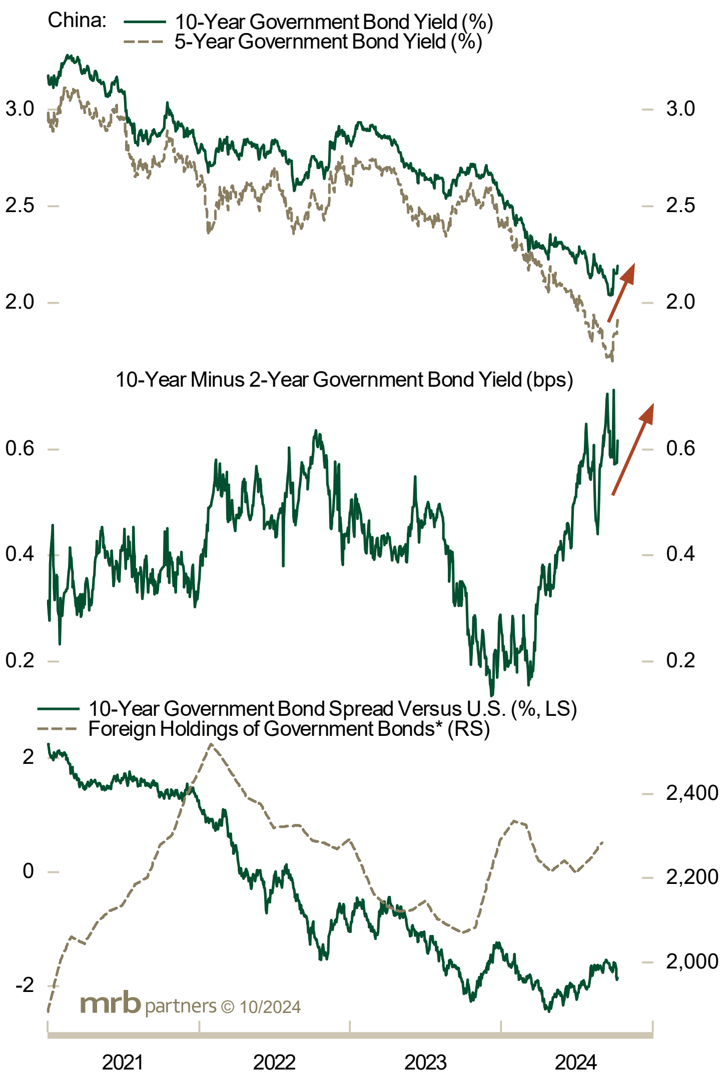
falling and the *MRB Bank Earnings Indicator* is suggesting fewer headwinds ahead (**chart 5**).

However, the September market support package contained some bad news for future bank earnings. Not only will the entire mortgage book earn less (a 50 bps cut in the rate for ***existing*** mortgages was included in the package), but banks will need to raise their Tier 1 capital despite the fact that they are already well-capitalized. Some of this capital increase will come directly from the central government, but capital raising is generally dilutive for minority shareholders and, historically, has usually involved diverting a significant element of retained earnings.

The cut in mortgage income and need for capital increases will weigh on future bank earnings

The bottom line for Chinese stocks is that while the support measures have undoubtedly injected some enthusiasm among domestic retail investors, who will sustain the rerating rally for as long as there are new investors entering the market, the fundamental outlook remains as uncertain as it was before the announcements. A steady improvement in economic momentum will, eventually, sustain better earnings. Until that plays out, the current rollercoaster rally is a trade, not an investment.

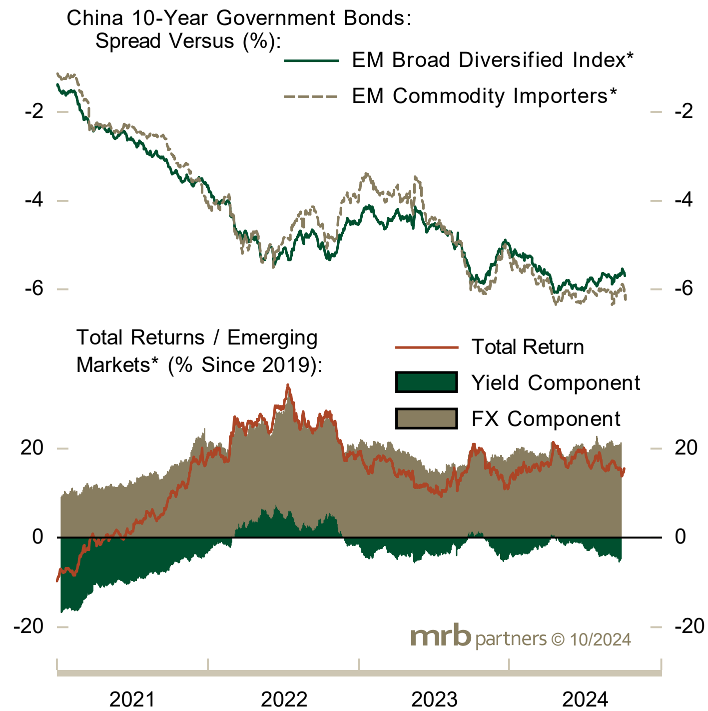
Chart 7 Bond Yields Pop After Stimulus Package



* Billion CNY; source: Chinabond

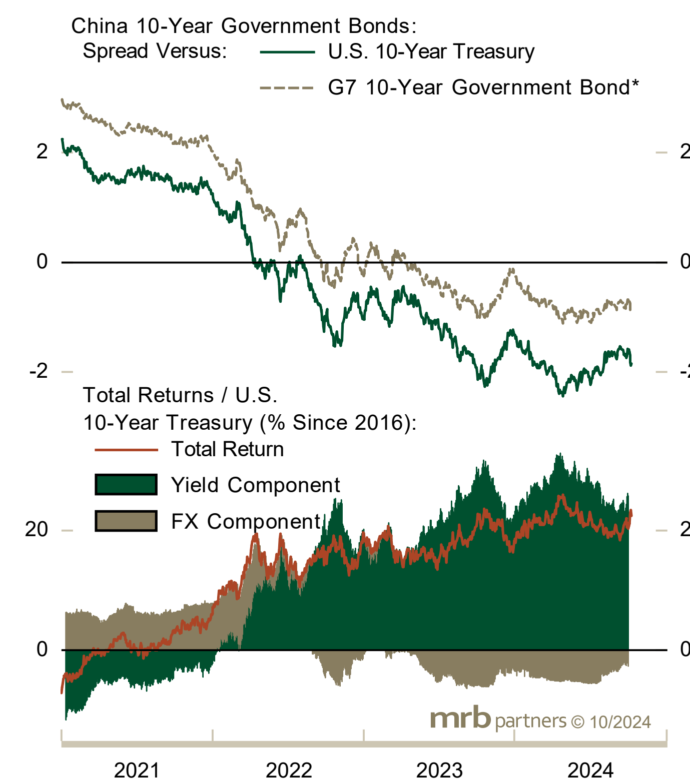
At the end of September, the PBoC's ninth successive rate cut in its current easing cycle (which began at the end of 2019) brought its central policy rate (the 7-day reverse repo) to its lowest ever level, at 1.5% (**chart 6**, previous page). Other short-term interest rates were cut at the same time. However, there was some volatility in the interbank market, probably related to a sharp yuan appreciation. The stimulus package also triggered a selloff in yuan bonds, with yields nudging higher and the yield curve steepening (**chart 7**). There is some evidence of foreign

Chart 8A Yuan Bonds Underperform EM Peers



* Equally weighted EM aggregate

Chart 8B Yuan Bonds Outperform U.S. Treasuries



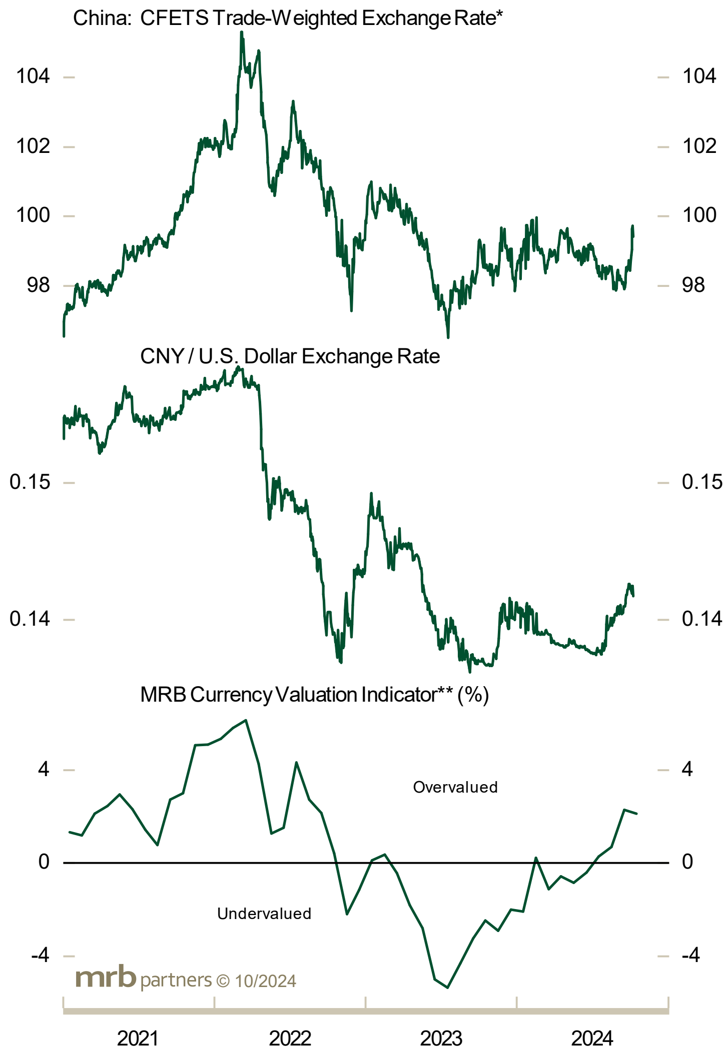
* Equally weighted G7 aggregate

buyers returning to the yuan bond market (they had in previous months expressed a preference for shorter-term bills and certificates of deposit). The renewed interest in bonds coincided with narrowing negative spreads under U.S. Treasuries and the strength of the yuan.

The relative performance of yuan bonds has been mixed recently (**charts 8A** and **8B**, previous page). Relative to EM peers, yuan bonds have underperformed as yields fell faster in key EM bond markets. The yuan held its own relative to other EM currencies, but the yield component ensured underperformance. Relative to U.S. Treasuries, these dynamics played out in reverse: yuan bonds outperformed thanks primarily to currency appreciation, with the yield component being a headwind for yuan bonds.

The yuan's strength has been due to broad-based U.S. dollar weakness and its future path will likely also be primarily driven by moves in the dollar (**chart 9**). The CFETS trade-weighted basket appreciated materially, as did CNYUSD, with the yuan now in the center of its intervention band, rather than hugging the weak side of the band as had been the case for the past several months. We would characterize the yuan as being close to fair value relative to the U.S. dollar, with *MRB Currency Valuation Indicator*'s readings slightly above fair value, but within its error term.

Chart 9 **Yuan Strengthens As U.S. Dollar Softens**



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

Without improvement in underlying earnings, the current rally is a trade, not an investment

Final Word: *While there has been some improvement in the MSCI China earnings backdrop, stocks are re-rating strongly on hopes of government intervention. Foreign investors are playing a part in the rally by buying ETFs and short covering, but the primary impetus for the rally is panic buying on the part of domestic retail investors. We continue to recommend holding China equities at a neutral weight within an EM portfolio, recognizing that select EM ex-China markets offer superior upside[4]. However, we still have a bias to upgrade our China view as and when earnings momentum broadens and strengthens. The yuan should modestly underperform its EM peers, given*

4 **MRB:** "*EM Equities: Earnings Are Outperforming, Prices Will Follow*", September 10, 2024

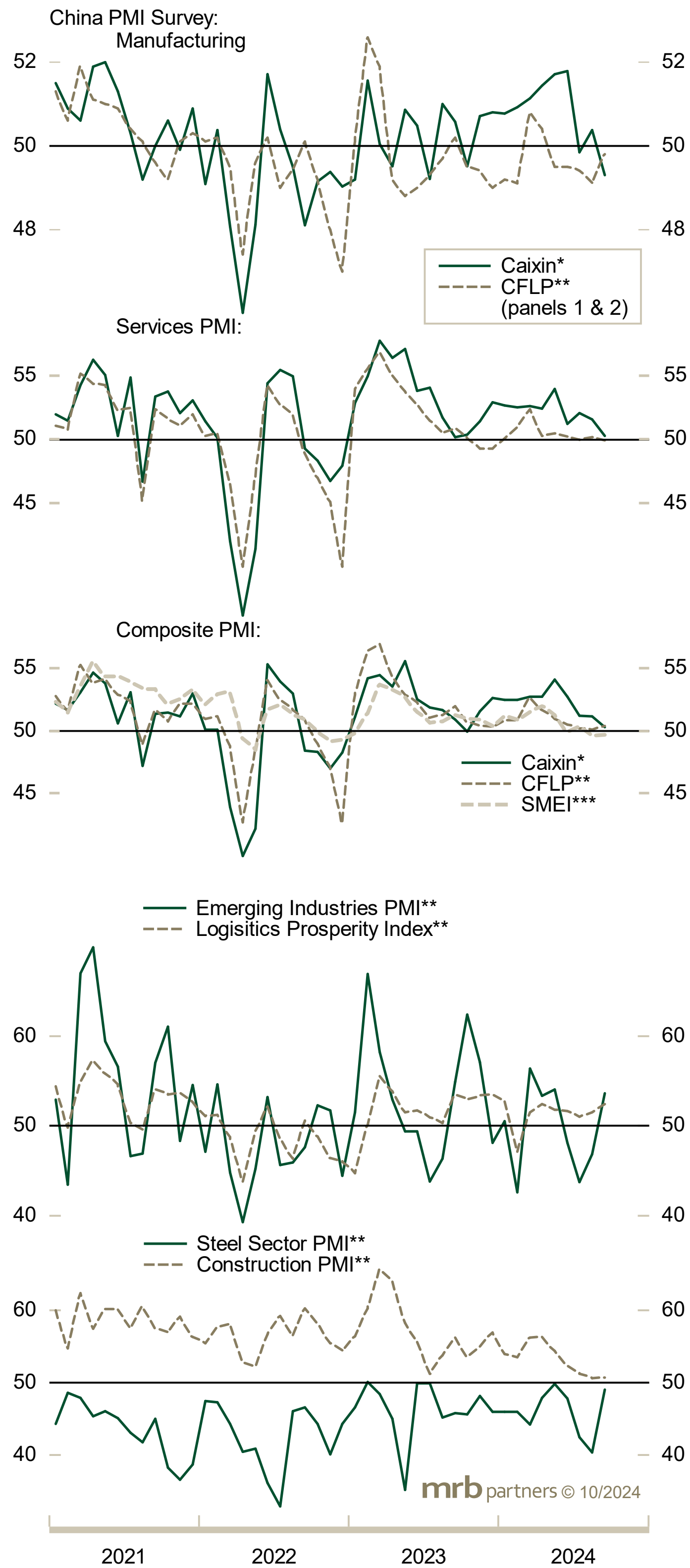
the strictures of its currency management regime and low carry[5] and EM currencies are expected to modestly appreciate versus the U.S. dollar. Yuan bonds will underperform EM local-currency denominated bonds as the scope for interest rate cuts is greater in EM ex-China[6].

Economic And Trade Momentum

PMI surveys for September produced what has become a new normal mixture of divergent results. With different segments of the manufacturing sector witnessing a widening divergence of activity between the weak rust belt segments associated with housing and construction, and booming new energy segments, the disconnect between different survey results is to be expected. In September, it was the official CFLP manufacturing sector PMI which bounced out of contractionary into expansionary readings, while the Caixin survey did the opposite (**chart 10**). The CFLP survey's improvement coincided with a similar pickup in the Emerging Industries survey, and there was a notable bounce in the steel sector PMI as well. All three surveys are published by official sources, and presumably have a similar bias in favor of state-controlled enterprises.

Service sector PMI surveys showed some softening, albeit remained in expansionary territory, as did the composite surveys. On the other hand, the construction sector PMI (which is a key component of the CFLP non-manufacturing

Chart 10 Mixed Crop Of PMI Surveys



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

5 MRB: "EM Foreign Exchange: Riding The Coattails Of Improving Global Trade", June 20, 2024

6 MRB: "EM Fixed Income – EM Debt: Stick With High Yielders", July 25, 2024

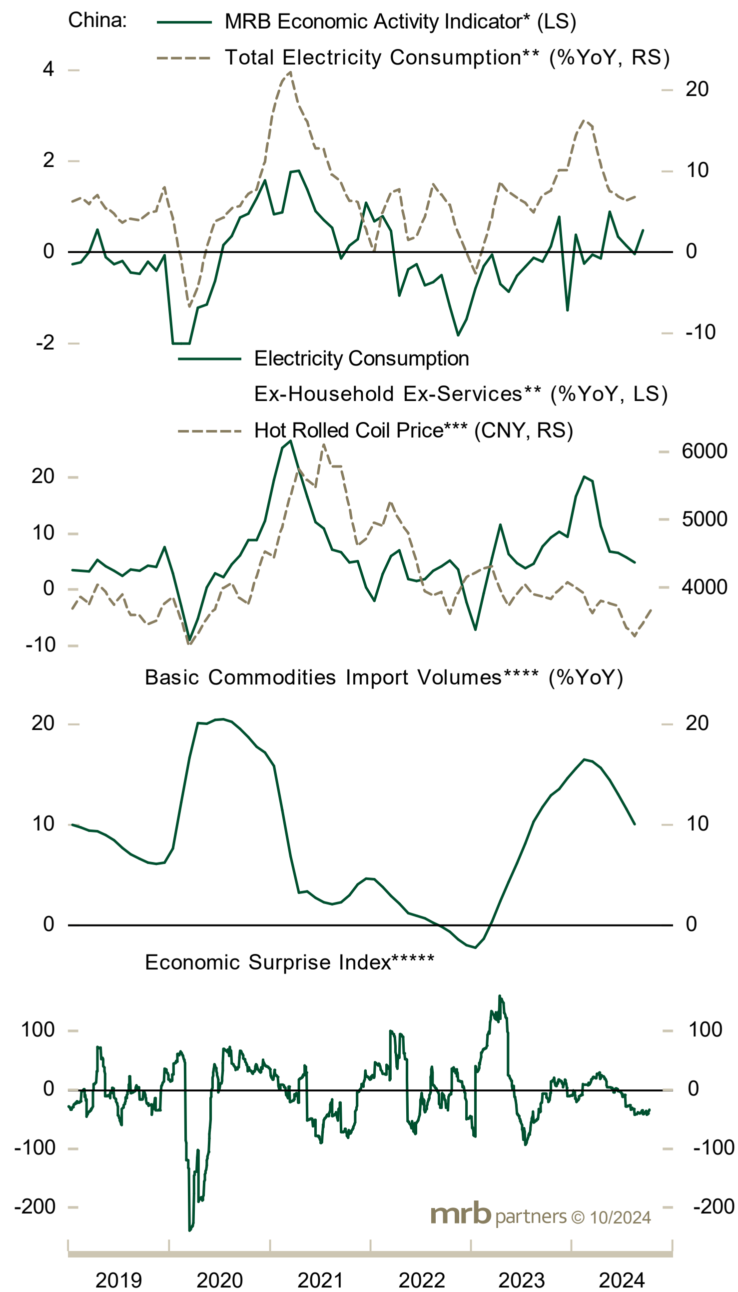
survey) continued its steady retreat as did the Logistics Prosperity index. The overall picture offered by this plethora of surveys is that Chinese economic momentum faltered somewhat in September, while remaining in expansion mode.

Hard data (most of which relates to August, rather than September) continues to show an economy chugging along at close to its underlying trend growth rate (**chart 11**). The sharp increases in electricity consumption that were apparent earlier this year have faded somewhat, but year-on-year (yoy) growth is still a very respectable 7%, with industrial demand growing at a 5% yoy pace, which is close to our estimate of the underlying rate of GDP growth. The growth rate of imports of key commodities (in volume terms) has also eased off from its frenetic pace earlier this year but remains in double digits in yoy terms.

On the other hand, an economy that is merely trundling along still manages to disappoint many observers. The *Citigroup Economic Surprise Index* is negative (i.e. data is coming out below expectations) and there has been some softening in key commodity prices, although not to the extent of breaking below five-year ranges.

There is some seasonality associated with the ebb and flow of Chinese economic momentum, which is difficult to filter out as most economic data is published on a non-seasonally adjusted basis. However, this seasonal effect is captured by the *Yicai High Frequency Economic Indicator*[7] (**chart 12**). August is one of two low points during the year (the other being during the lunar new year in January/February). Nevertheless, high frequency data suggest that this year's momentum fade was slightly less severe than in the two previous years. Thus, data should appear sequentially stronger for the remainder of this year.

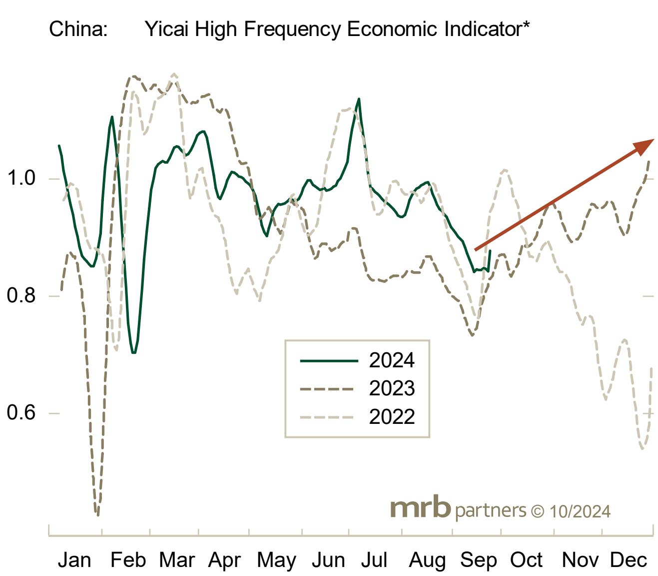
Chart 11 **Economic Momentum Remains Close To Underlying Trend**



* 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

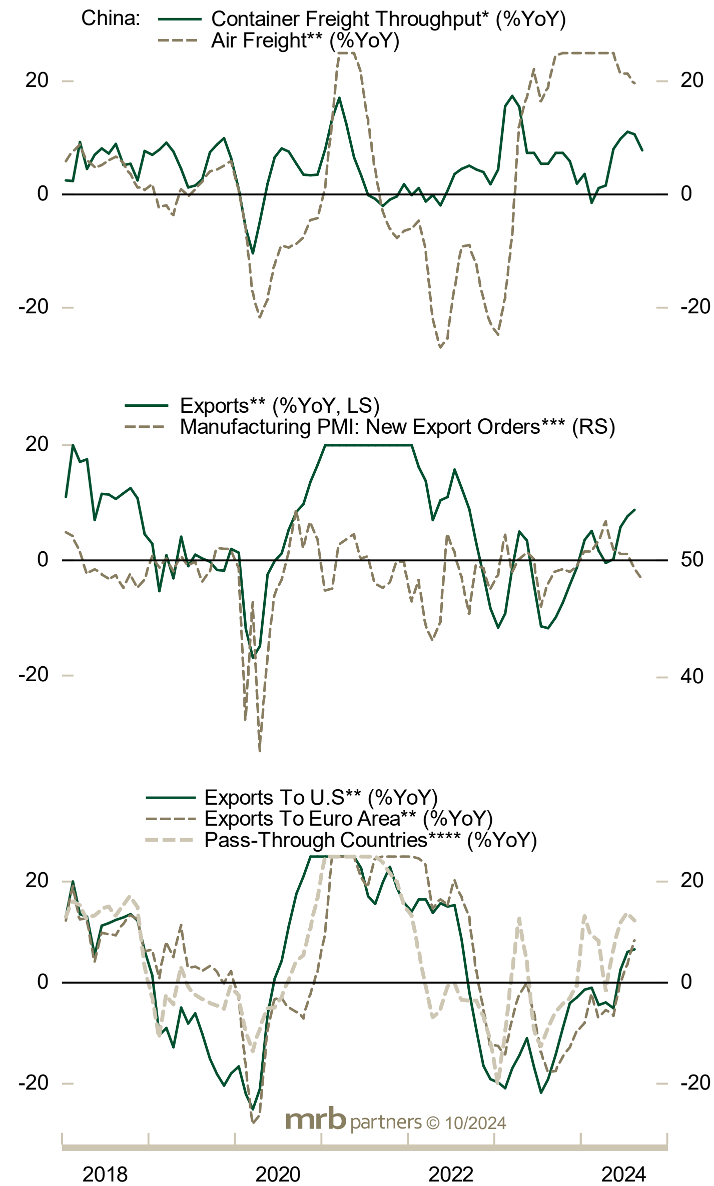
[7] Includes traffic data, metro traffic, coal consumption for power generation, air pollution, commercial housing sales and Baidu search terms for "unemployment" and "bankruptcy".

Chart 12 **High Frequency Data Likely To Improve Henceforth**



* 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**



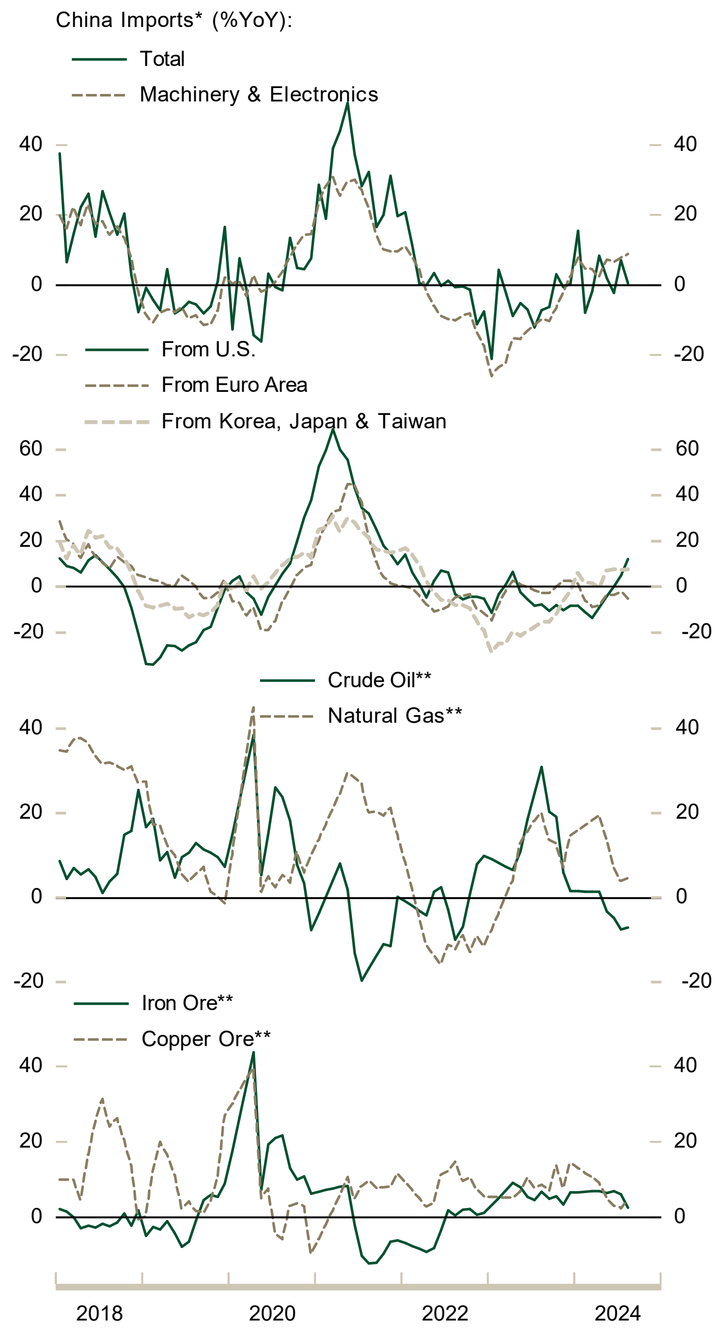
* Source: Ministry of Transport
** Truncated above 25; U.S. dollars; smoothed; source: China National Bureau of Statistics
*** Source: Markit Economics
**** Truncated above 25; smoothed; includes Hong Kong, Mexico, Singapore & Vietnam

A bright spot in the Chinese economy is the trade sector. Exports are recovering nicely: the volume of shipping container throughput up 8% yoy, and air freight up 20% yoy with headline exports growing at their fastest pace in two years in value terms (**chart 13**). Exports to the three top destinations (the U.S., euro area and four "pass-through" destinations) are all accelerating. The only fly in the ointment is several back-to-back months of contractionary results for the export order component of the Caixin manufacturing survey.

The recovery in imports is not as marked as that of the export sector, although the largest component of imports, namely machinery and electronics, is growing strongly (**chart 14**). Overall import growth is flattish, but imports from the U.S. as well as from Korea, Japan and Taiwan are all growing solidly. On the other hand, imports from the euro area have slumped and are now contracting meaningfully in yoy terms. As noted above, imports of key commodities such as natural gas and iron ore have eased back in volume terms, while imports of crude oil are contracting in yoy terms.

Final Word: *China's economic momentum continues to trundle along at close to its underlying trend, which implies real GDP growth of 4.5-5% this year. Such a pace is modestly supportive of global trade momentum, especially for manufactured goods, although it is noteworthy that the trade-sensitive euro area manufacturers are missing the boat according to Chinese import statistics. The latter are seeing a decline in their share of the Chinese market, probably for structural reasons.*

Chart 14 **Imports Gain Momentum, Except From Euro Area**



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

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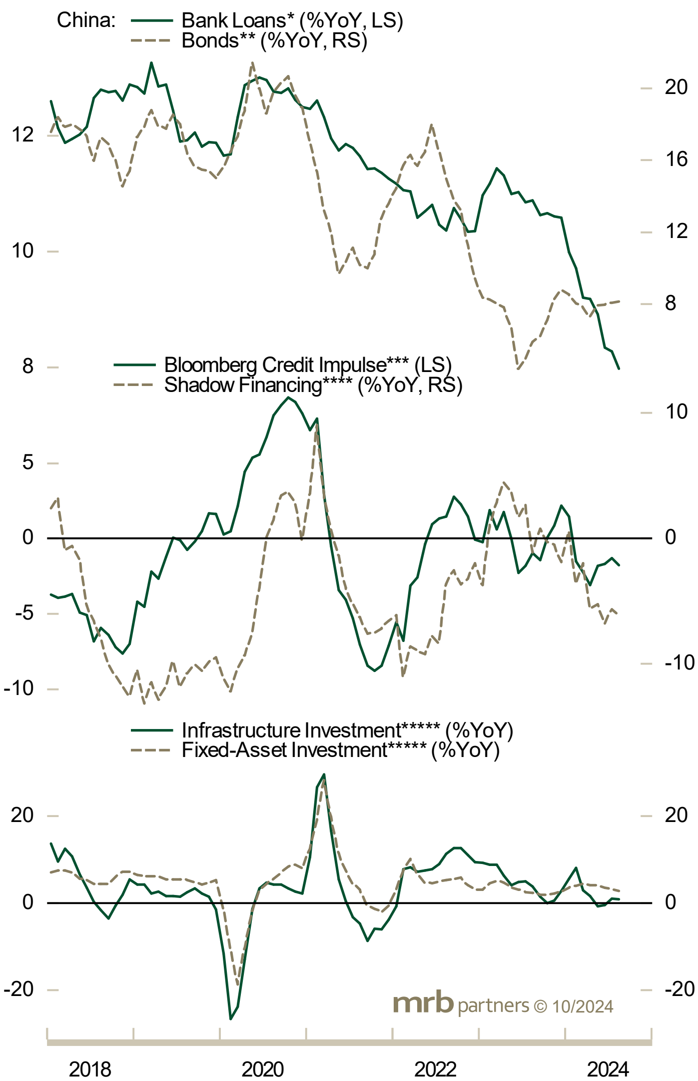
Credit, Consumption And Housing

Credit data for August confirmed that most components of the credit impulse are weakening (**chart 15**). Although the pace of bond issuance is holding up in yoy terms and will likely strengthen as a heavy calendar of fresh long term bond issuance unrolls during the fourth quarter, other segments are weakening. Bank credit growth has rarely been as weak as it is currently (albeit still expanding at a pace faster than nominal GDP growth), and the volume of outstanding shadow financing is shrinking in yoy terms. As a direct consequence, the outcomes that are most closely associated with credit growth continue to show a marked deceleration: infrastructure investment is barely growing in yoy terms, while fixed asset investment is just 3% ahead of this time last year, meaning that it is far from fulfilling its historical role as a driver of GDP growth, and is now failing to keep up with nominal GDP growth.

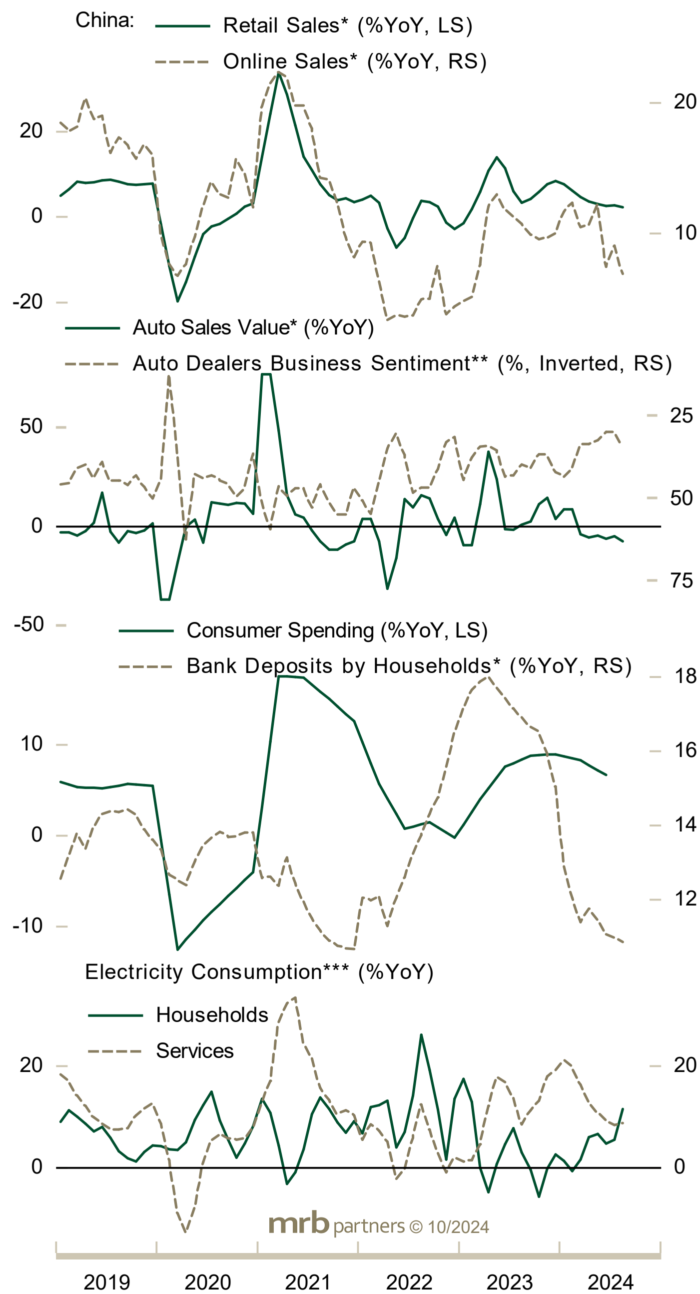
With fixed asset investment now the caboose, rather than the locomotive of economic growth, and with the central and local governments all in a fiscally restrictive mood, it falls to domestic consumers to deliver on the government's 5% 2024 real GDP growth target. Per capita household consumption during the first half the year delivered a decent boost, growing

Chart 15 Credit Impulse Stays 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

Chart 16 Consumption Is Holding Up, But Not Booming



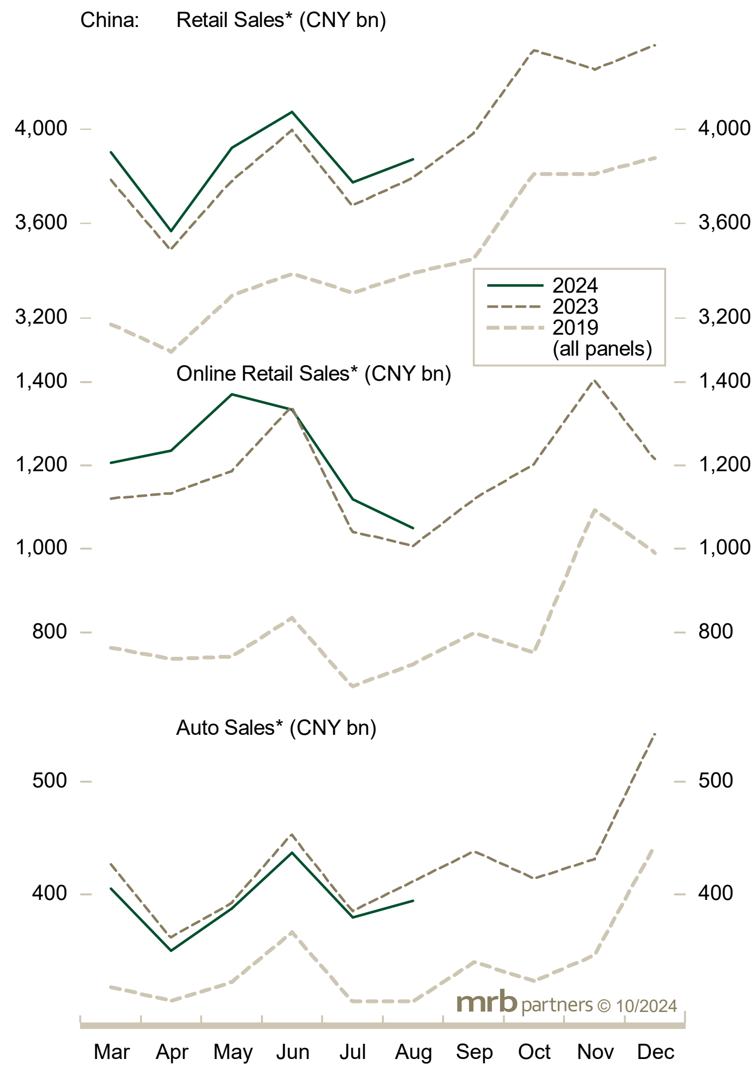
* Smoothed; source: China National Bureau of Statistics
** Source: China Automobile Dealers Association; readings above 50 = high inventories/poor trading conditions
*** Source: China National Energy Administration

comfortably faster than GDP, the pace softened during the third quarter according to retail sales indicators (**chart 16**). The overall retail sales aggregate, which is a closely-followed but unreliable series as it includes "consumption" expenditure by government and corporate sector entities, is up merely 2% in yoy terms.

Online retail sales, which is a better indicator of household demand, is up 7% in yoy terms, which is well ahead of GDP growth. Another indicator worth noting is the double-digit pace of growth in electricity consumption by households, albeit a part of this strength may be related to secular, rather than cyclical, factors.

The summer months mark a nadir for retail sales in seasonal terms (**chart 17**), albeit with slightly different patterns. Overall retail sales and auto sales typically trough in July, which was the case again this year, and there was the expected pickup in August in month-on-month terms. For online sales, however, the monthly sales usually bottom out in August. The best measure of the strength (or weakness) of consumption trends will therefore likely play out when September data are published. Watch this space.

Chart 17 **Expect Seasonally Stronger Retail Sales Till Year End**



* Source: China National Bureau of Statistics

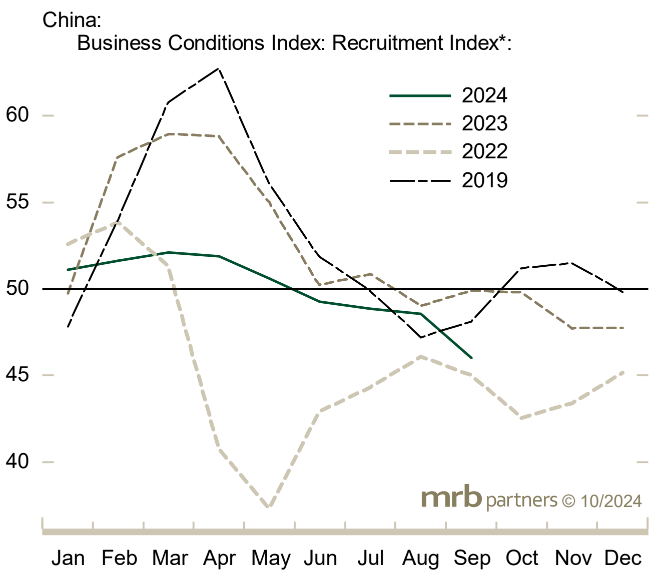
The key to understanding the relatively soft pace of consumption this year is the apparent loss of consumer confidence. Regrettably, the official survey measuring consumer confidence has very little credibility, which means that two proxies need to be watched. The first is the growth of household bank deposits, which picks up when confidence is falling, as was the case in 2023. This measure is now back to its pre-pandemic pace, which suggests that households are not increasing their savings rate at an unusual rate.

The other approach to getting the pulse of consumer confidence is to look at labor market conditions. The official unemployment rate offers little insight as it rarely changes and says nothing about small businesses, especially in the informal sector. An imperfect, but still helpful, proxy is the recruitment component of the *Business Conditions Index* published by the Cheung Kong Graduate School of Business (CKGBS), which is based in Hong Kong, but surveys conditions on the mainland (**chart 18**).

Recruitment has been weak in 2024, which underpins the fragility of consumer confidence

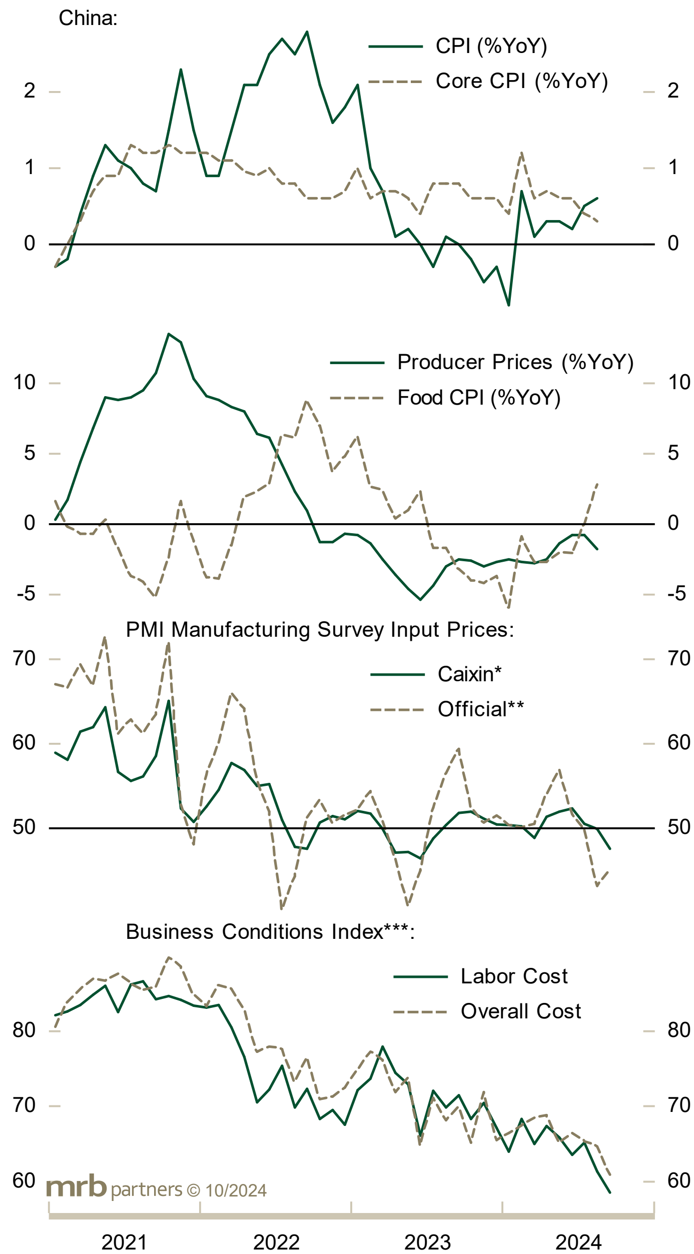
This indicator, whose structure is similar to a PMI survey, has a pronounced seasonal pattern, with the typical bulge in recruitment occurring between in February and April. This year's pattern failed to register much of an expansion during this peak period, which is a strong indication that the chance of getting a job for this year's cohort of entrants was exceptionally poor. This helps explain the malaise apparent among consumers this year. The corollary is that a key component of consumer

Chart 18 **2024's Recruitment Wave Was Exceptionally Weak**



* Source: Cheung Kong Graduate School of Business

Chart 19 **Food Price Spike Will Crimp Household Budgets**



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

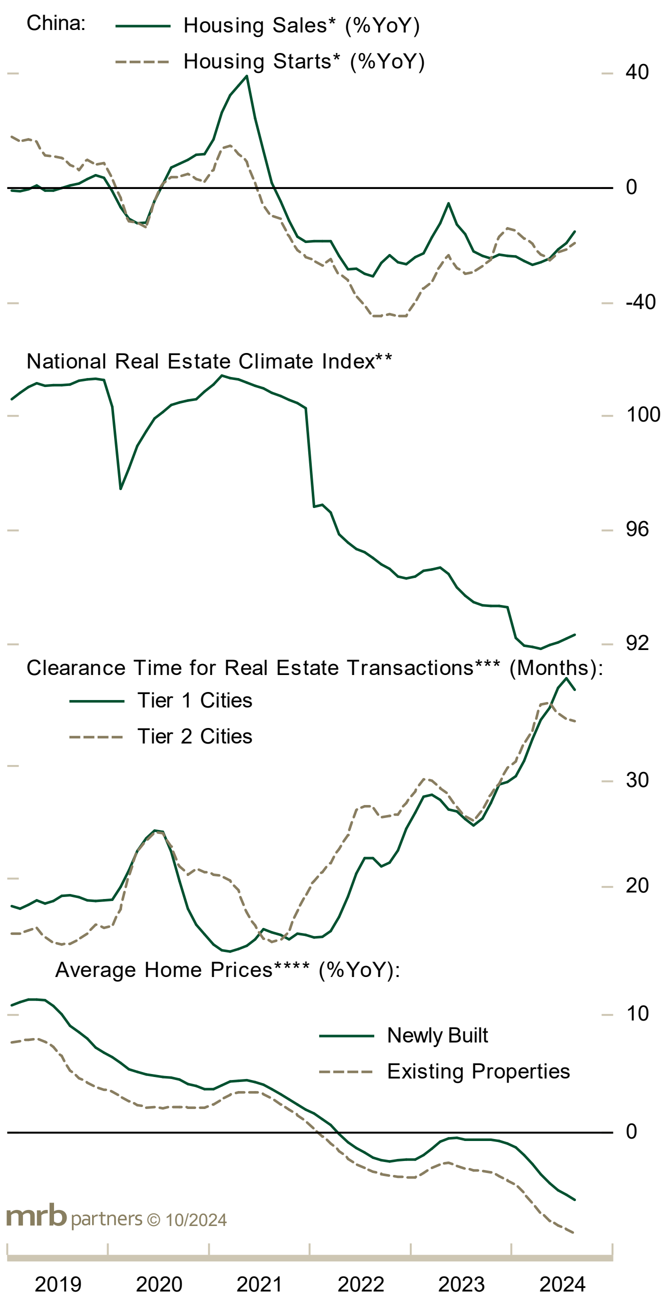
sentiment in any given year is cemented in place during the early-year recruitment period, which is something to watch closely in 2025.

Another, and somewhat unaccustomed, headwind for Chinese consumers is the recent spike in food prices (**chart 19**). Although overall consumer price inflation remains subdued, and the rate of core inflation is basically nil (i.e. the price index has barely budged over the past year), food represents some 30% of the household consumption basket. The last time Chinese food prices spiked was in early 2020 and again in mid-2022, when overall consumption trends were obscured by the upheavals associated with pandemic restrictions. However, prior to that, rising food prices were associated with slowdowns in the ***growth*** of consumption, although not with its ***level***. Coupled with the pickup in food prices, labor costs for companies are now growing at their most modest pace for many years, according to the CKGCB survey (bottom panel of **chart 19**). For households this implies that any spike in food prices is not being softened by higher wages.

The most recent package of measures aimed at supporting the beleaguered housing market arrived just as tentative signs of a bottoming out of the housing recession were already becoming apparent (**chart 20**). Reports from some top tier cities suggest that there has been a pickup in sale closing during the holiday last week, and given the low base, the numbers appear impressive. However, there have been similar blips in the sales data at various times over the past three years, with no appreciable improvement in the hard data when it is published officially. While still shrinking, housing starts and sales have been declining at a slower pace, and the *National Real Estate Climate Index* is no longer at its all-time lows. However, the scale of the problem to be tackled is huge: unsold housing inventory in top tier cities represent more than three years' worth of sales at the current pace, and house prices continue to decline in yoy terms for both new builds as well as existing properties. Even with the stimulus package, the housing sector is unlikely to re-establish itself as an engine of growth, although the stiff headwinds it has generated in recent years may fade.

Final Word: *As we have noted elsewhere, the most recent package of "stimulus" measures is aimed more at asset prices than at the real economy. The sole area that may benefit may be housing, where there were already tentative signs of a bottoming out. To the extent that improved investor confidence leaks into more general consumer confidence, there may be a secondary positive impact on consumption activity, which has been fighting the twin headwinds of rising food prices and weak job creation. Nevertheless, seasonal factors will in any case reinforce consumption activity during the fourth quarter*

Chart 20 **Housing Recession Is 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

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- Regional Equity Strategy
- U.S. Equity Sectors Strategy
- Global Fixed Income Strategy
- Foreign Exchange Strategy
- Commodity Strategy
- Webcasts & Live Events