SPECIAL REPORT

September 30, 2024

Chinese Bazooka

In This Report

The Chinese government has finally capitulated to growing deflationary pressures and the rising risk of an economic implosion, announcing a slate of aggressive measures to stimulate the economy. It is too early to know whether this much-needed and long-overdue monetary reflation will be a game changer, but the sharp rally in Chinese stocks is an encouraging sign.

"Three Arrows"

The People's Bank of China's (PBoC) actions last week can be summed up as "Three Arrows", targeting the problem of monetary contraction, the meltdown in housing and the slump in the equity market, specifically:

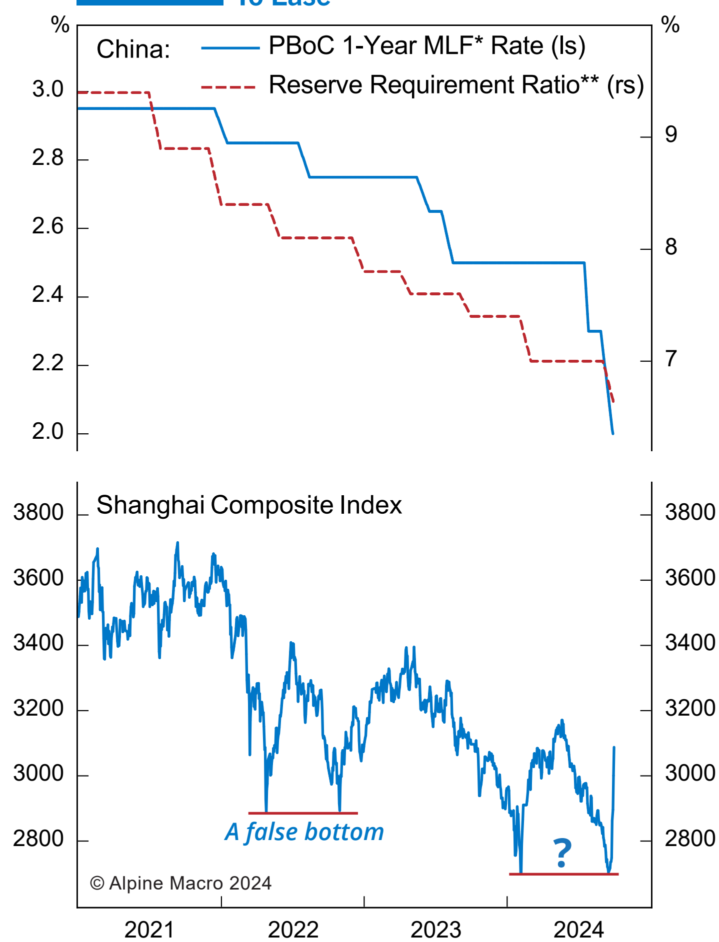
Monetary Easing:

- The reserve requirement ratio (RRR) was cut by 50 basis points (**Chart 1**), releasing RMB1 trillion (US$143 billion) in liquidity. More RRR cuts are possible, if needed.
- The short-term repo rate was cut by 20 basis points, with a further reduction of 25-50 basis points possible before year-end.
- An injection of core Tier-1 capital for state banks to provide more liquidity for lending.

Housing Market:

- Aligning existing mortgage rates with those on new mortgages, effectively reducing the average mortgage rate by 50 basis points. This will help 50 million households, with an average saving of

Chart 1 PBoC Takes Bigger Steps To Ease



*Medium-term lending facility
**Weighted average of financial institutions

Chart 2 The Precarious State Of The Chinese Economy

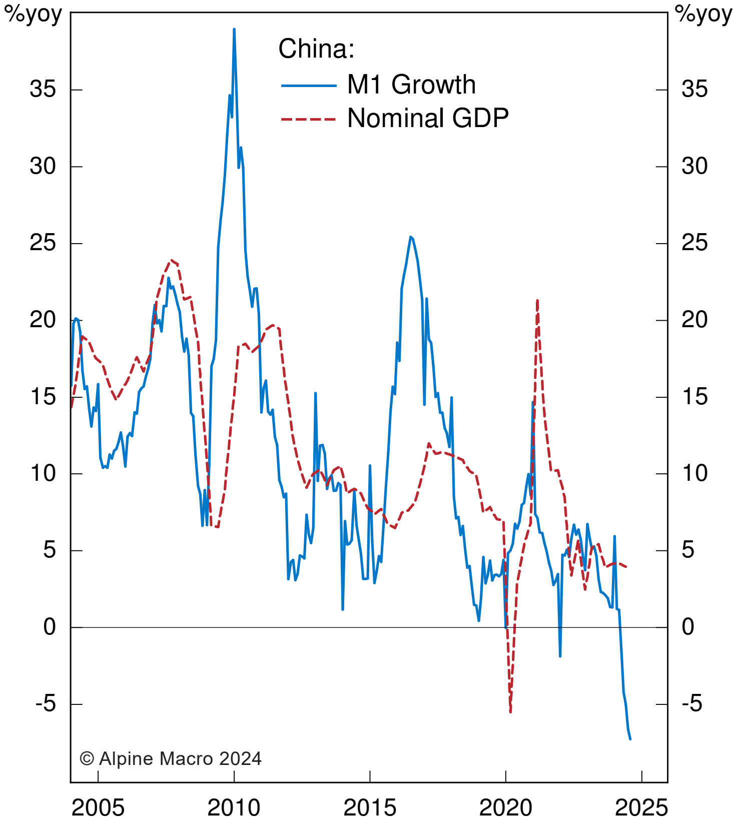
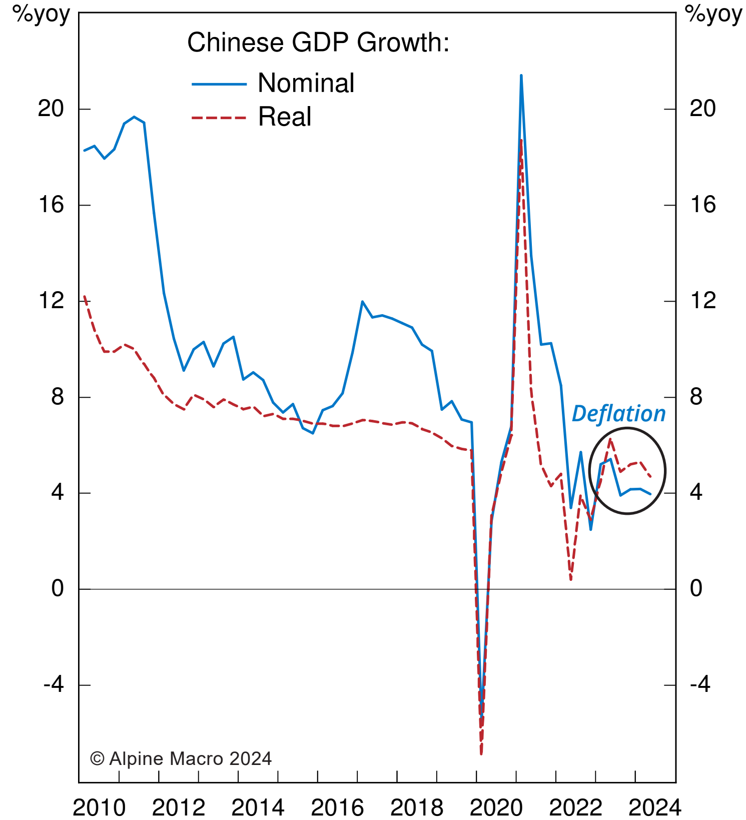


Chart 3 China GDP: Nominal Is Below Real Growth



$428 per household annually from lower mortgage costs.

- A further reduction in the downpayment ratio to 15% from 25%, regardless of how many homes are purchased.
- The central bank will provide 100% financing for local governments to buy unsold homes. The financial support for property developers will be extended to 2026 to help property developers speed up home delivery.

Equity Market:

- The PBoC now allows non-banking financial institutions to use "swap facilities" to obtain liquidity by using their equity holdings as collateral.
- A special loan facility will be established to help and support stock buybacks. The pool of money is small, starting at $42 billion, but more funding will be provided if the program works well.
- A stabilization fund will be established to steady the stock market, whenever necessary.

What's Different And Why Now?

China has announced many piecemeal actions to shore up its economy in recent years and until now, these actions and announcements were poorly received by markets. Financial markets were not happy because the scale of the previous actions was often puny, and the tone of authorities was often less certain.

Last week's monetary stimulus package is more aggressive and comprehensive than all previous reflation efforts. Central bank governor Pan Gong-sheng sounded more determined than ever to steady the economy.

Most importantly, the central bank's announcement was immediately followed up by a Politburo meeting last Wednesday when President Xi was forthright about the economy's key challenges and reaffirmed his commitment to use "active" fiscal and monetary policies to stabilize the housing market and the economy.

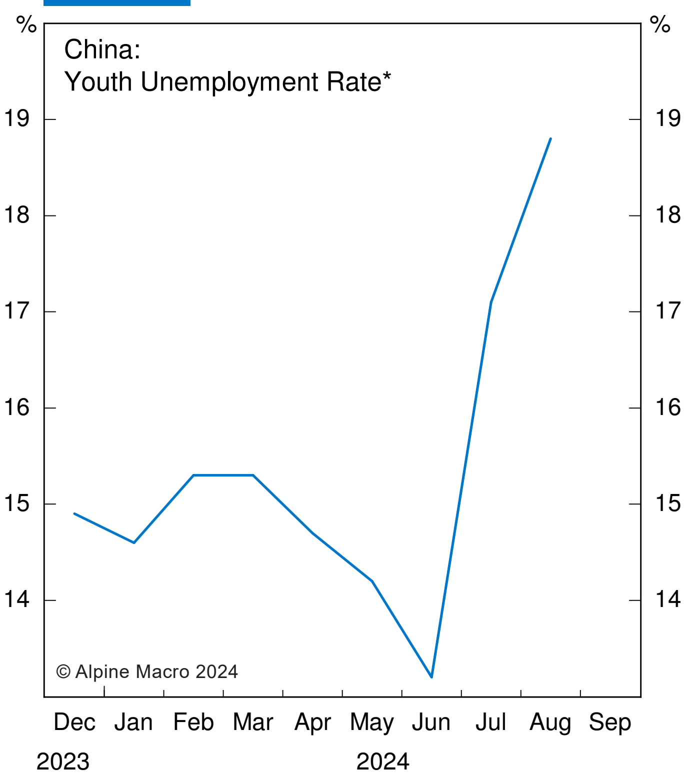
Chinese stocks, both the onshore and offshore markets, have also embraced the announcement with a big rally, a significant departure from typical disappointing responses to Beijing's policy announcements in recent years.

Why have authorities become more proactive now? There could be several reasons:

First, a key concern that has prevented the PBoC from reflating aggressively has been fears of a sharp fall in the CNY, particularly if China eases while the Federal Reserve does not. With the Fed having begun to cut rates aggressively this month and the dollar trading on a softer path, the fear of a plunging CNY has greatly diminished, allowing the PBoC to take bolder steps to reflate.

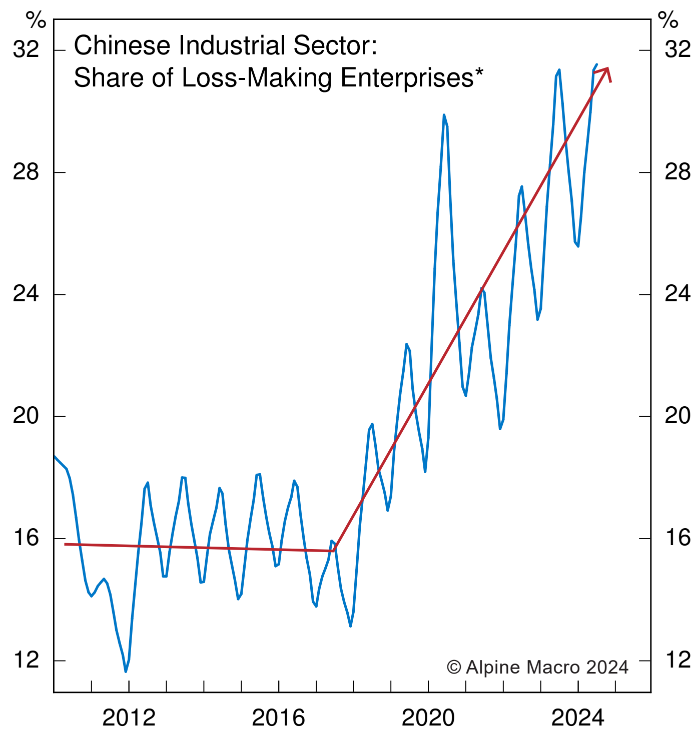
Second, China's economic growth is faltering (**Chart 2**), and nominal GDP has fallen below real GDP growth, a rare occurrence (**Chart 3**). The economic pain is palpable, with youth unemployment having surged to nearly 19% and over a third of Chinese companies are bleeding money (**Chart 4**).

Chart 4 China: Youth Jobless Rate...



*Aged 16-24, excluding students

...And Loss-Making Firms Have Surged



*Shown as 6-month moving average

Local governments have run out of money. Tax collections have fallen quickly as nominal growth slowing to a crawl and corporate losses mounting, and fiscal crises at local levels have further strained the economy, creating a vicious circle. Beijing no longer has the option of staying on the old policy course. This may be another reason pushing Beijing to reflate much more aggressively.

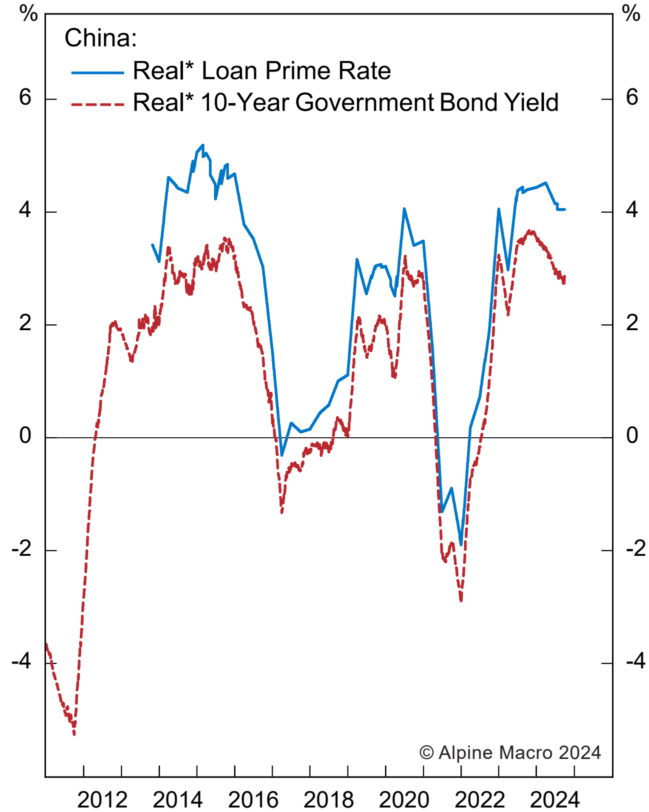
Third, heading into the final quarter of the year, the economy might have lost too much momentum to hit the government's 5% target, which would make President Xi look bad. Perhaps, the Chinese authorities have finally woken up to the fact that they have actually pursued a senseless policy of self-destruction.

The sudden policy reversal last week is reminiscent of the sudden reversal of the stubborn and senseless "zero-Covid policy" in 2022. The whole world had told Beijing that "zero Covid" was unsustainable and unviable, but the government stuck with it until the economy collapsed and infections ran amok, forcing authorities to abandon the policy suddenly.

Finally, with the U.S. on the verge of a changing government and acrimony growing in Congress towards Beijing, President Xi's China faces an even more unpredictable global environment.

The problem is that with Chinese consumers more interested in saving than spending, China's economy has become even more dependent on exports. This might have doubled up the pressure on the Chinese government to change course, with an aim to boost domestic spending to reduce the dependency of the Chinese economy on Western demand.

Chart 5 Real Borrowing Costs Are Too High



*Deflated by GDP deflator

Is It Sufficient?

Viewing the PBoC program in isolation, the measures announced are not enough to turn around the economy. The interest rate reductions are small, and the RRR cut is also within its historical range. Nevertheless, what is encouraging is that authorities have indicated that last week's actions are the first installments of policy stimulus. More support is forthcoming.

The key question here is what needs to be done for the Chinese government to catch up to the deflationary curve.

First, aggressively slash interest rates. Chart 5 shows that China's benchmark Loan Prime Rate

(LPR) is still held high in real terms by falling prices. Similarly, real bond yields are also too high. None of these real rates reflect the deflationary reality of the Chinese economy.

Thus, the PBoC needs to cut rates very aggressively to lower borrowing costs for consumers and businesses. While the rate cuts last week were not enough to provide any true relief to borrowers, the PBoC's tone was much firmer than before, and more easing is likely. This is the key reason both the stock and currency markets have responded positively to the central bank's new stimulus blitz.

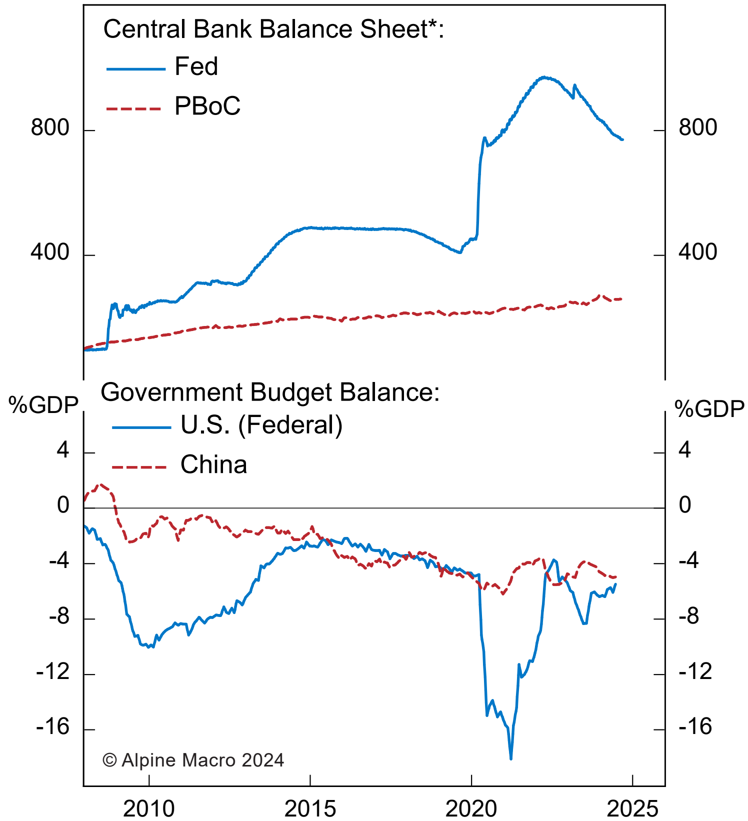
Second, with the economy stuck in a liquidity trap, fiscal stimulus is far more important than monetary policy to stop the rot of the economy.

Although the Chinese government has announced RMB2 trillion (US$285 billion) in bond issuance, the planned fiscal stimulus seems small (1.5% of GDP) relative to the seriousness of the economic problem. That being said, China's fiscal and monetary stimulus is often mixed together, and the line is frequently blurred. For example, the 2008 stimulus programs were entirely funded by bank deposits rather than bond issuance, and spending was also done *via* government-directed loans.

This time around, we can also detect a fiscal component from the monetary action. For example, the PBoC will cover 100% of loans to local governments buying unsold homes with cheap funding. Clearly, this is fiscal stimulus dressed up as monetary policy.

The key difference here is that President Xi was very explicit in last week's Politburo meeting, stressing

Chart 6 **China: Paying The Price For Misguided Fiscal And Monetary Conservatism**



*Rebased to Jan 2008=100

that active fiscal and monetary policy, particularly public sector spending, are necessary to safeguard economic growth.

The PBoC needs to underwrite Beijing's fiscal expansion and do so quickly. The key indicator to watch is the speed and magnitude of the PBoC's balance sheet expansion. So far, there is no sign of a significant liftoff yet.

Both the PBoC's balance sheet expansion and Beijing's fiscal deficit pale in comparison to the U.S. (Chart 6). This not only highlights monetary and fiscal conservatism under President Xi but also underscores the huge potential for large-scale monetary and fiscal expansion. Going forward, should the PBoC ramp up its balance sheet quickly, it would be a very bullish sign for asset markets in China.

Finally, is it possible that the recent stimulus package will fade, leaving the economy to continue to struggle? The risk cannot be ruled out. Xi's economic policy and philosophy is to de-risk at all costs, and the fundamental reason that he rejects large-scale stimulus is for fear of debt accumulation, which he fears may sow the seeds of financial instability down the road.

Besides, President Xi has a track record of frequent flip-flops when it comes to economic policy. The key risk here is that Xi may backpedal again.

Financial Market Implications

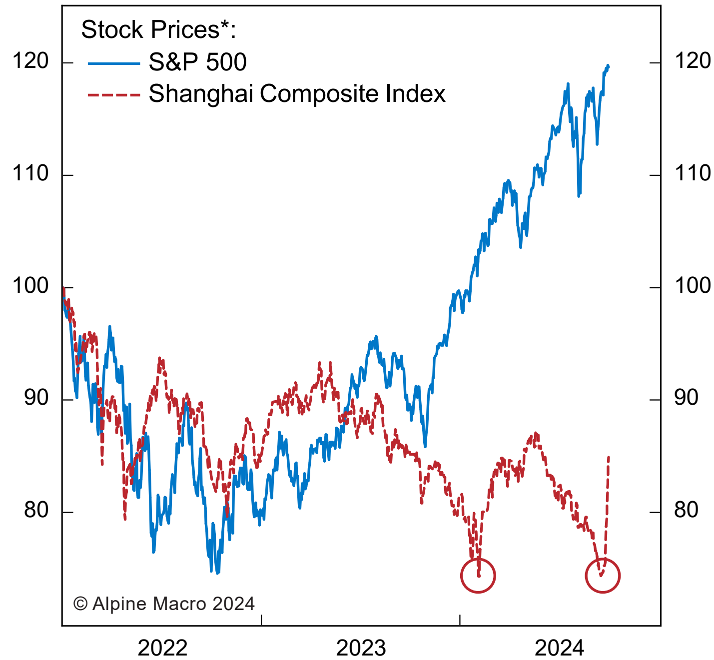
Chinese equities have performed miserably since 2022 and massively underperformed the S&P 500 (**Chart 7**). Needless to say, sentiment towards Chinese shares has been at a pessimistic extreme.

There have been many false rallies since the bear market started in early 2022, and there is no guarantee that the rally since last week is not one of these bounces. To have a sustainable run in the Chinese equity market, policy reflation has to kick start economic recovery.

Our sister publication, *Emerging Market & China Strategy* (EMC), has held long positions in Chinese stocks and overweighted China within an EM portfolio. These positions have performed well. A few additional observations are worth noting:

First, MSCI Chinese equity forward earnings have stopped falling, probably due to a combination of share buybacks and profit recovery in some very competitive sectors. However, the forward P/E for the Chinese All-Cap Index is 9 times, and large caps are selling at 8.6 times (**Chart 8**).

Chart 7 Chinese And U.S. Equity Performance In Perspective

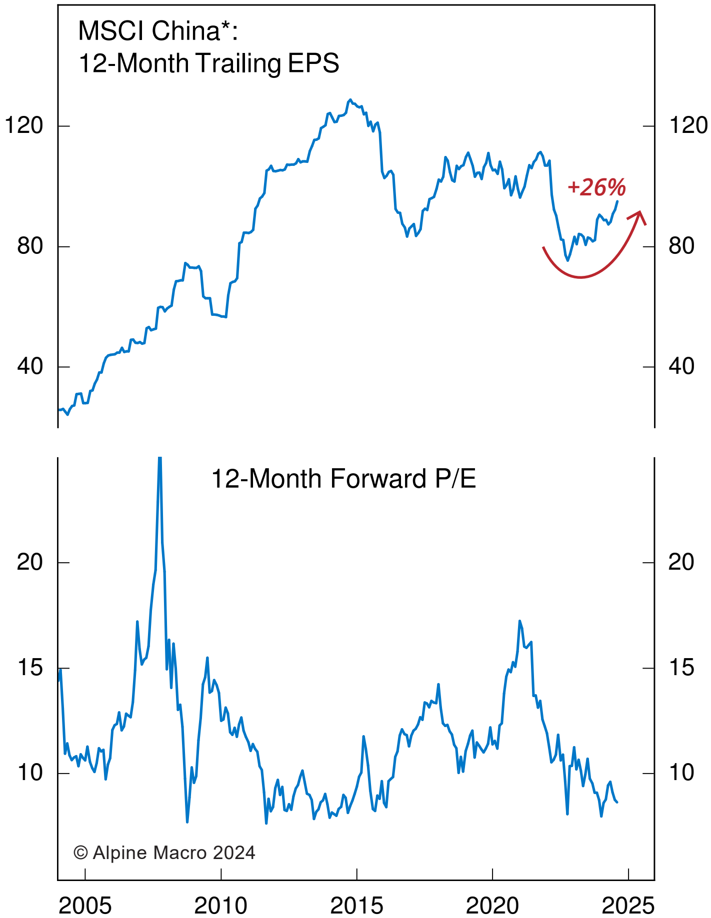


*Rebased to Jan 2022=100

These multiples mean that a lot of bad news has been discounted by the Chinese equity market, which might have overlooked the improving profit picture. Of course, there is nothing guaranteeing that improving profit and cheap valuations will necessarily lead to an immediate outperformance in Chinese stocks. All we can say is that Chinese equities may represent a value play over the longer run.

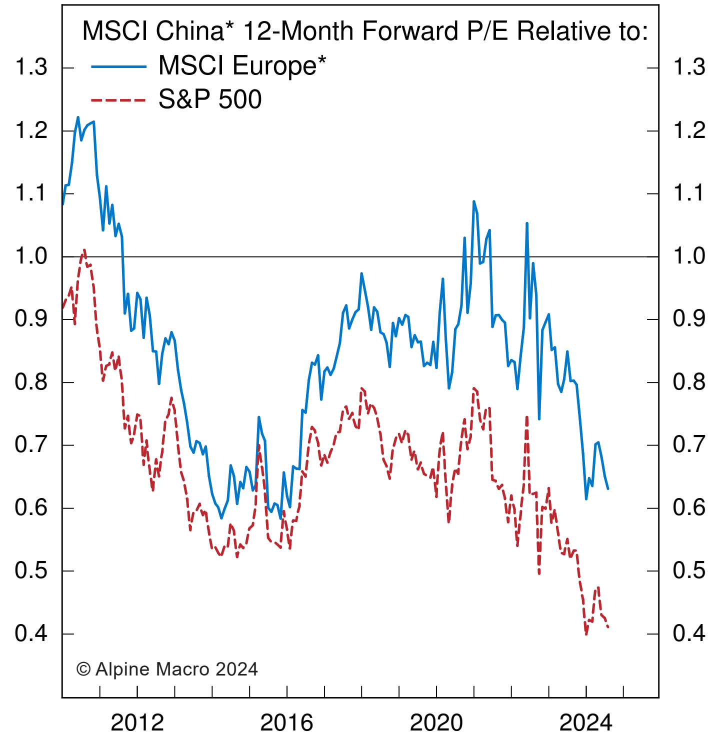
Second, the world has changed profoundly and the intensifying geopolitical strife between China and the West means that Chinese shares should trade at a sizeable discount. The issue is what the appropriate discount should be. Currently, Chinese shares

Chart 8 Chinese Equities: EPS And Multiples



*Large Caps

Chart 9 Chinese Shares Are Selling At Huge Discounts



*Large Caps

are selling at a 60% and 40% discount to U.S. and European equities, respectively (**Chart 9**). These seem excessive, in our view.

Third, the monetary stimulus package is a positive for the industrial commodity market. China remains the biggest consumer of various industrial commodities and oil, and a stabilizing Chinese economy will help commodity prices.

Chart 10 shows that copper prices have crept higher this year despite the dismal economic news out of China, which may herald a "double-bottom" price formation for Chinese shares.

The key point here is that if the Fed quickens its pace of monetary easing, the dollar could weaken more from current levels. This should pave the way for more aggressive policy reflation from China.

Should the Chinese government follow through with more policy stimulus and the economy gains some traction, industrial commodity prices may have another good run. Otherwise, a bull market in the broader commodity market will remain elusive, sporadic and hesitant.

We are taking a long position in copper to express our cautious optimism towards more policy reflation from Beijing.

Fourth, the CNY has strengthened considerably, flirting with the 7.0 level for the first time since

Chart 10 Is Copper Signaling Things To Come In China?

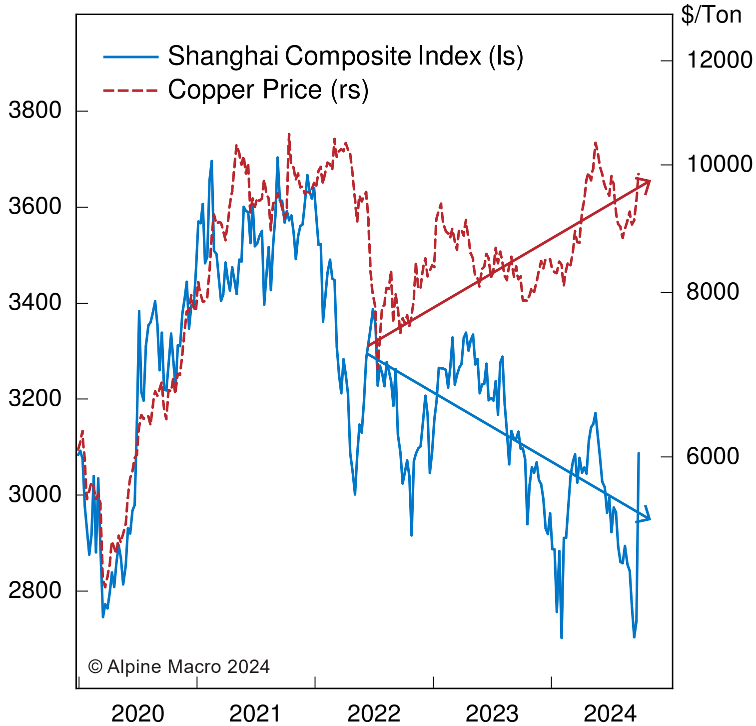
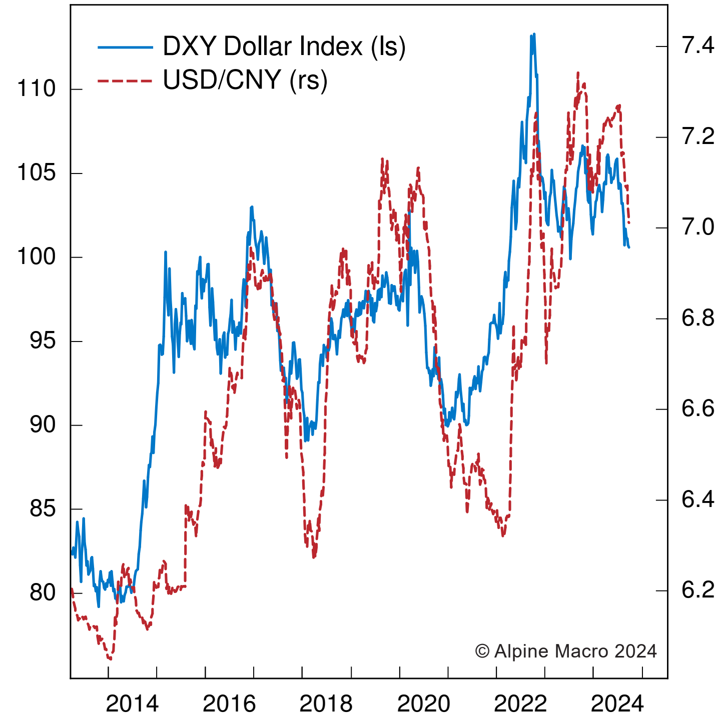


Chart 11 CNY Strength In Perspective



2023. Some of the CNY strength stems from dollar weakness. **Chart 11** shows that DXY has weakened more than 6% against the currency majors, while USD/CNY has fallen 4%.

Regardless, the combination of a stronger CNY and price deflation (GDP deflator) means that Chinese authorities need to double up on their reflationary policy or the deflationary impulse from a strong CNY could easily offset the fresh stimulus. We are more optimistic than before that the PBoC will step up monetary stimulus, particularly if the CNY strengthens further.

Finally, China's policy reflation is a positive for U.S. equities, but not so for U.S. bonds. If the Chinese economy improves on the policy stimulus, it will help improve earnings growth for many U.S. multinationals that operate in the mainland.

It is particularly worth noting that a recovering Chinese stock market is good news for Germany and Japan because both economies are closely integrated with China's. With China reflating, the German DAX, JPY and EUR should rally more than they otherwise would. The flip side is that a stronger Chinese economy and a weaker dollar will be mildly negative for Treasury bonds, all else being equal.

Chen Zhao
Chief Global Strategist

Investment Recommendations

Tactical Investment Positions (3 - 6 months)

Recommendations	Open Date	Open Levels	Stop	Closing Date	Closing Levels	P&L Since Inception
Long U.S. Regional Banks (ETF: KRE)	12/04/2023	48.12	53	-	-	19.9%
Long Gold (ETF: GLD)	04/01/2024	207.82	Rolling -5%	-	-	17.9%
Long Long-Dated Treasury Bonds (ETF: TLT)	06/10/2024	90.89	95	-	-	9.5%
Long U.S. Financials (ETF: IYF)	08/19/2024	101.30	-	-	-	2.5%
Long Russell 2000 (ETF: IWM)	08/19/2024	215.20	-	-	-	2.7%
Long Nikkei 225 Unhedged	08/19/2024	37,389	-	-	-	9.1%
Short Brent Oil	08/26/2024	80.00	79	-	-	9.1%
Long Copper[1]	09/30/2024	-	-	-	-	-

Note: P&L is calculated using daily closing prices.
[1] We are initiating a Long Copper trade.

A Unique Mind On The Markets