PICTET WEALTH MANAGEMENT

China: Strengthening policy support and emerging signs of industrial stabilisation

Continue to expect moderate recovery in the rest of the year

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SUMMARY

- Since late August, we observe that policy support from the Chinese government has picked up pace and strength. While the measures announced are no 'bazooka', they are concrete enough and are being implemented quickly so that they could lead to some real improvement in the near term.
- Many of the policy measures are focused on the property sector and have shown some initial signs of effectiveness in boosting housing demand. Fiscal measures have also picked up speed.
- In addition to measures to help the real economy, the government has made efforts to boost sentiment in the equity market.
- Recent PMI surveys show some early signs of improvement in Chinese industrial activity, in line with the rising price of industrial commodities in the country.
- These developments strengthen our conviction that we will see a moderate recovery in the Chinese economy over the rest of this year.

POLICY SUPPORT PICKS UP PACE AND STRENGTH

China's post-covid recovery was disappointing and, until very recently, the authorities were widely considered as being 'behind the curve' when it came to policy support, which was very modest. Consequently, the measures taken so far have failed to arrest sliding momentum in the economy.

In a previous publication, we discussed the possible reasons behind such a restrained policy response in the face of a significant economic downturn. In a nutshell, the policy makers may have formed the view that another round of massive credit-fuelled stimulus such as the one unleased in response to the 2008-09 global financial crisis could create even bigger problems down the road and would

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contradict the Chinese government's pursuit of 'quality growth'. (See Flash Note: *What's wrong with China's post-covid recovery and how to deal with it?* 21 July 2023.)

Since late August, however, the pace of new support measures has increased significantly. While these are still quite targeted and surely do not qualify as a fiscal or monetary 'bazooka', they are concrete enough and they are being implemented quickly so that they could lead to some real improvement in the near term.

Significant policy easing in the property sector

Most of the newly announced policy actions focus on the property sector.

In recent years, in response to rapidly rising housing prices, the Chinese government introduced various home-purchase restrictions (HPR) to contain property speculation. While most of such restrictions have been gradually removed in smaller cities as the housing market has slumped, they remain in place in top-tier cities like Beijing and Shanghai.

On 30 August, Guangzhou, one of the tier-one cities in China, announced a significant loosening of the definition of first-time home buyers. Such buyers enjoy much lower down-payment requirements and lower mortgage rates than non-first-time buyers. For example, before the loosening of definitions, the down payment required for a first-time buyer in Guangzhou was 30% at a mortgage rate of 4.2%, while the down payment required for a second-time buyer was 70% at a mortgage rate of 4.8%. The new policy could benefit home buyers who would like to move but were previously deterred by the prohibitively high down-payment and higher mortgage rate. Other tier-one cities—namely Shenzhen, Beijing and Shanghai—have quickly followed Guangzhou's lead.

On 31 August, the People's Bank of China (PBoC) and the National Administration of Financial Regulation (NAFR) announced a cut in the nationwide minimum down payment ratio for first-time buyers to 20% (from 30% previously) and for second-time buyers to 30% (from 40% previously and in some cities as high as 70% in practice).

In addition, the PBoC and NAFR have instructed commercial banks to lower the interest rate on existing mortgages taken out by first-home buyers. This could potentially see over 40 million homeowners benefit from an average reduction in their mortgage rates of the order of 0.8%, according to the state-backed Shanghai Securities News.

In our view, the scope of these policy measures exceeds market expectations and will likely boost housing demand and market sentiment in the near term. Meanwhile, the reduced financial burden on many homeowners may help bolster the recovery in household spending, which has been sluggish because of low confidence.

Acceleration in fiscal support and continued monetary easing

Despite considerable growth headwinds, the deployment of fiscal resources in the first seven months of this year lagged the level seen in 2022. Local government bond issuance, for example, amounted to RMB5.0 trn in the first seven months of 2023, compared to RMB5.7 trn in the same month last year (Chart 1). This partly explains the waning momentum in infrastructure investment.

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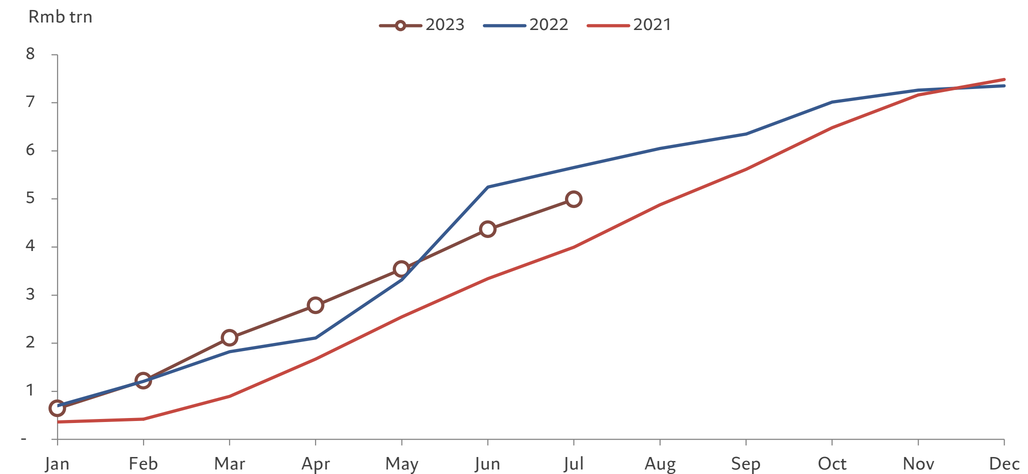
Chart 1: Local government bond issuance in China



Source: Pictet Wealth Management, Bloomberg Finance LP, as of 06.09.2023

Following the Politburo meeting in late July, the Standing Committee of the Chinese National People's Congress (NPC) convened on 1 August and decided to accelerate the issuance of local government special bonds (LGSB). LGSBs are a fiscal instrument that specifically supports infrastructure investment. At the end of July, RMB1.34 trn of the RMB3.8 earmarked for issuance in 2023 was still unused. With this in mind, the Standing Committee told local governments to complete planned new issuance for 2023 by end-September, and to fully deploy the proceeds by end-October. In our view, this could provide a meaningful boost to infrastructure investment in the near term. In addition, as in past years, we could see front-loading of part of 2024's debt issuance programme to this year.

Important measures have also been taken to address the ballooning local government debt problem, especially debt borne by the so-called local government financing vehicles (LGFVs). Following the call for a comprehensive debt restructuring plan at the July Politburo meeting, the central government is reported to have approved RMB1.5 trn of special financing bonds to address the most acute liquidity stress at some local governments, according to a Caixin report. We believe this marks the beginning of a multi-year debt restructuring process.

On the monetary front, we expect the PBoC to stay in easing mode. After the earlier-than-expected rate cuts in August, the central bank may reduce banks' reserve requirement ratio again before the end of this year.

Direct support to the equity market

One item is worth noting in the account issued of the July Politburo meeting. The account suggests that the government should "enliven the capital markets and boost investor confidence". This is the first time that capital-market investors have ever been specifically mentioned in a Politburo meeting report.

Chinese equity markets' significant underperformance has arguably depressed confidence further. In our view, the Politburo's call to invigorate capital markets (essentially the equity market) aims to boost consumer confidence indirectly by spurring a market rally as well as by providing stimulus to the real economy.

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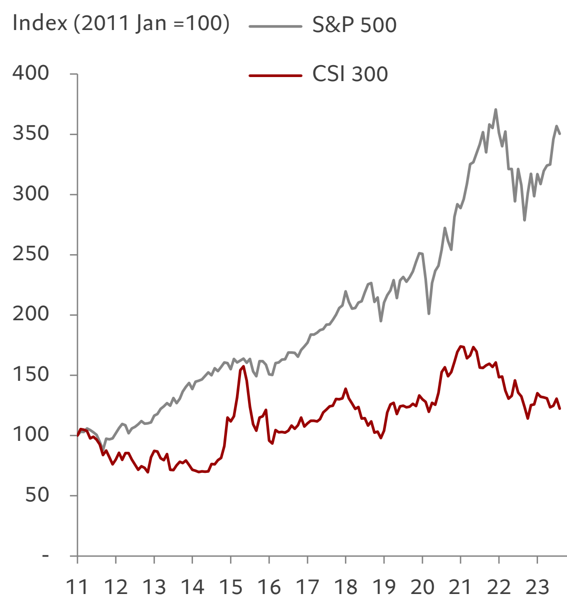
So far, the actual measures announced by the authorities to "enliven the capital markets" are the following:

1. On 27 August, the Ministry of Finance announced a cut in the stamp duty on equity trading from 10bps to 5bps. This was the first reduction in stamp duty since the global financial crisis in 2008.
2. On the same day, the China Securities Regulatory Commission (CSRC) said it would reduce the required margin ratio for equity trading to 80% from 100%, allowing for higher leverage.
3. The regulators announced they would slow down the pace of initial public offerings (IPO) and tighten new issuance by existing listed companies.
4. In addition, new restrictions were introduced to control stock sales by major shareholders of companies that did not reach certain minimum requirements in areas such as dividend pay-outs and price-to-book ratios.

Chart 2A: S&P500 vs. CSI300 price indices



Source: Pictet Wealth Management, Bloomberg Finance LP, as of 06.09.2023.

Chart 2B: Chinese equity market cap as % of US equity market cap

Source: Pictet Wealth Management, Bloomberg Finance LP, as of 06.09.2023.

In our view, points 3) and 4) will likely be the most effective in boosting the Chinese equity market's performance. Interestingly, despite the massive underperformance of Chinese equities relative to their US peers since at least 2011 (Chart 2A), China's total equity market cap relative to the US has stayed virtually unchanged at around 20%, although there have been big fluctuations (Chart 2B). China's market cap has not dropped relative to the US mainly because of continuous large-scale capital raising in China over the past 12 years (through IPOs or stock placements), whereas in the US capital-raising on public markets has been relatively limited, especially after taking into account the steady stream of share buybacks by large, cash-rich companies. A slowdown in capital raising and share sales by major shareholders could

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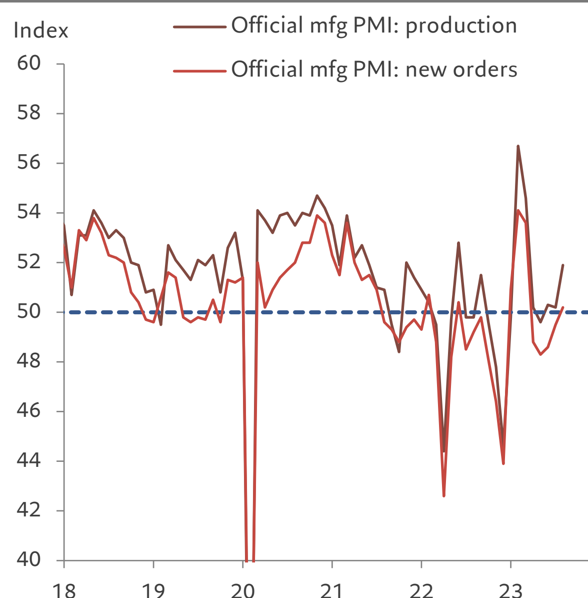
help stabilise the share prices of existing quoted companies and boost investor confidence.

GREEN SHOOTS OF RECOVERY IN INDUSTRIAL DEMAND

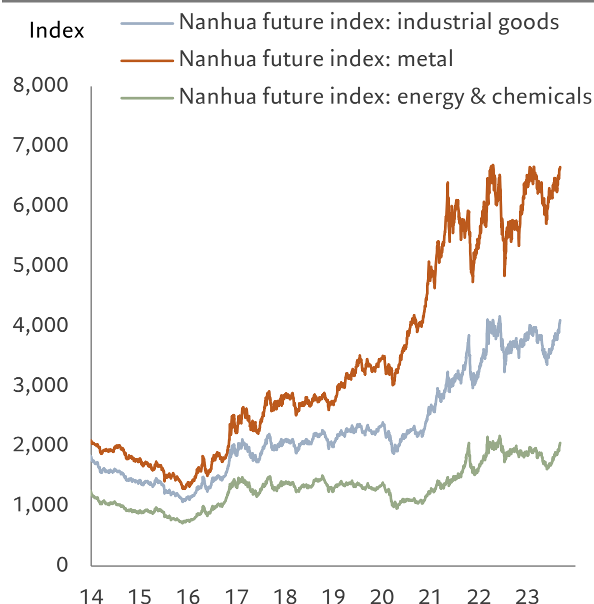
The official Chinese manufacturing purchasing manager index (PMI) improved for the third consecutive month in August, rising to 49.7 from an average of 49.0 in the previous three months, although still in contractionary territory. Encouragingly, beyond the headline figure, both production and new order sub-indices rose above the 50-threshold in August (Chart 3A). Business expectations inched up to 55.6 in August on the back of the more supportive measures previously discussed. The Caixin manufacturing PMI (whose sample tilts towards smaller export-oriented private companies) also surprised to the upside, rising to 51.0 in August from 49.2 in July. In our view, these improvements are early signs of stabilisation in industrial activity in China and are consistent with the rise in commodity prices in China since around June (Chart 3B).

Chart 3A: Chinese official mfg PMI: production and new order sub-indices



Source: Pictet Wealth Management, Bloomberg Finance LP, as of 06.09.2023.

Chart 3B: Nanhua future indices in China



Source: Pictet Wealth Management, Wind, as of 06.09.2023.

To summarise, since the Politburo meeting in late July, policy support has started to intensify in both pace and strength. The magnitude of some policy measures has exceeded our expectations.

While these measures may not be strong enough to engender a sharp rebound of the economy, the ones that target the property sector may serve to draw a line under very depressed sentiment in the housing market. Indeed, right after the announcement of the cuts in down payment ratios and the expansion of the first-time buyer definition, housing transactions surged in Beijing and Shanghai, according to media reports.

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These developments, combined with some nascent signs of stabilisation in manufacturing activity, have strengthened our conviction that the Chinese economy may recover moderately in the second half of 2023 after a sharp deceleration in Q2. We have decided to keep our current GDP forecast for 2023 unchanged at 5.2% for now, slightly above the government's growth target of around 5%.

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