Union Bancaire Privée

ASIA MACRO STRATEGY

China's Policy Stimulus: What's Really Going On?

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For Accredited Investors in Singapore and Professional Investors in Hong Kong only

At the press conference on China's policy easing on January 15, senior officials from People's Bank of China (PBOC), Ministry of Finance (MOF) and National Development of Reform Commission (NDRC, the state planner) jointly reiterated the message of a deepening counter-cyclical policy to cushion the current economic slowdown.

This is essentially follows earlier announcements at the all-important Central Economic Work Conference in December.

Cutting through the rhetoric, we see three key points:

- The PBOC will pursue a flexible monetary policy but stressed the importance of **not flooding the economy with excess liquidity again.** An additional objective is aimed at improving the policy transmission mechanism to **lower funding costs.**
- The MOF rehashed further tax cuts and fee reductions, and emphasised targeted funding to **support infrastructure, consumers and private firms.**
- The NDRC will **fast-track the approval process of infrastructure projects** to complement the sector's funding increase.

Burden falls on fiscal policy

As the PBOC has consistently stated their cautious policy stance, the market remains cautious on the scale of monetary easing during the current economic slowdown.

The bigger policy burden has shifted to fiscal policy to support growth. Further targeted tax cuts and fee reductions are expected in the pipeline, although it is clear that China will **not** embark on big fiscal spending as seen 10 years ago during global financial crisis.

Even with the official statement of fiscal policy turning to a more 'proactive' stance, we still think it is difficult for MOF to significantly breach the 3% of GDP fiscal deficit guidance (the red line) in 2019 (the deficit in 2018 should be at around 2.6-2.8% of GDP).

Total tax concessions for the coming year will be around RMB1.6-1.7 trillion (about USD250 billion or 1.6-1.7% of GDP).

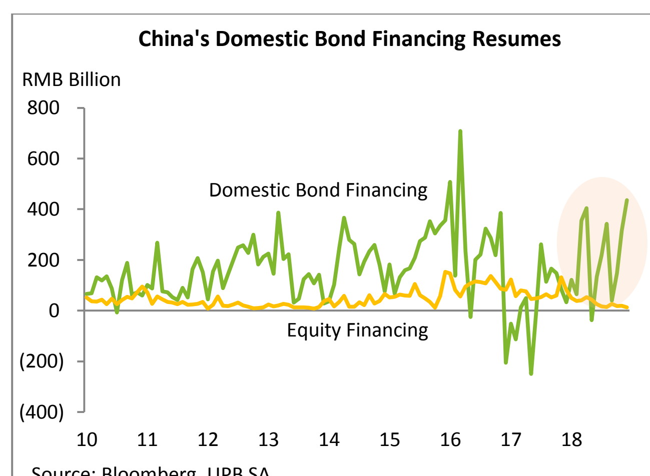
It becomes clear from recent policy statements that the bigger stimuli will come from **"off-budget"** channels via special bonds (mainly for local governments' infrastructure projects), policy bank bonds, likely resumption of construction bonds and expansion of Pledged Supplementary Lending (PSL). All of these funding can easily top another 3-5% of GDP.

A fine balance

The Chinese government appears to be fully aware of the risk of overloading the economy with excess liquidity again. And so, it goes for second-best option – a resumption of **credit rationing** and heavy reliance of central directives to earmark lending to the right sectors, such as infrastructure, consumers and private firms.

The past six-months of liquidity easing has not really benefited the economy with a lowering of lending rate. The PBOC has therefore increasingly provided banks with lower cost liquidity – replacing medium-term lending facility (MLF) with reserve requirement ratio cut and the new targeted MLF – to ensure that they will have room to **cut the benchmark lending rate** soon (we expect this in the first quarter of 2019).

The latest release of China's December total credit data (Aggregate Financing, AF) supported our argument. AF flow has resumed noticeably to RMB2.28 trillion (USD340 billion). What stands out is the great normalisation of **domestic corporate bond issues** and the size of new issuance (RMB436 billion) has almost returned to previous peak levels (see chart). This implies increased bond funding for corporate and local government financial vehicles (LGFVs).



This is a **tough balancing act** for China – not over-stretching policy again but hopefully easing policy sufficiently to cushion (not revive) the downturn, and to make sure that the money goes to the right sectors. But this is all China can do with the current protracted trade negotiations with the US.

How this will affect investors

We propose several short-term China investment themes:

1. **Domestic demand** plays especially **infrastructure** projects and firms that benefit from targeted funding.

2. **Consumer sector** boosted by tax/fee cuts and higher disposable income (consumer staples, travel, gaming, education)

3. **Internet gaming** given more pro-market game approvals ahead

4. Potential trade deals that benefits **manufacturers** in key supply chains

5. **Housing** policy turns more supportive on a city-by-city basis

6. **Financials** that benefit from continued gradual monetary easing.

7. Lowering of interest rates will continue to make **local bonds** more attractive.

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