ASIA MACRO STRATEGY

Turning Up The Fiscal Tap

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

Asymmetric Strategies

Signs of better fiscal and monetary policy coordination are emerging in major economies. This should provide a more powerful policy platform to underpin global growth amid current deceleration.

Although fiscal expansion is still a stretch, the increasingly supportive policy backdrop suggests that investors should seek to participate in markets in a risk-managed way. With volatility dipping back to recent lows, we recommend expanding exposure to asymmetric strategies in portfolios to take advance of current low protection costs while leaving room for upside potential.

Global Fiscal Efforts

On the fiscal front, the US's Trump administration has proposed a second round of tax cuts (albeit relatively small in size at around $100bn over 10 years). This will be through adjusting the capital gains tax in parallel with the debate around infrastructure spending.

In Europe, there are rising expectations for more expansionary fiscal measures after the European Central Bank's (ECB's) President Mario Draghi called for a pro-cyclical budgetary policy along with renewed quantitative easing should economic conditions continue to deteriorate.

In Asia, Japan's Prime Minister Shinzo Abe has yet to confirm the scheduled October value-added tax (VAT) hike from 8% to 10%. If the hike goes ahead as planned for the sake of Japan's medium-term fiscal consolidation (i.e. a balanced budget by 2025), many expect that Abe will follow up with a supplementary budget in 2020. This will help offset the hike's negative impact on domestic consumption and investment should downside risk increases.

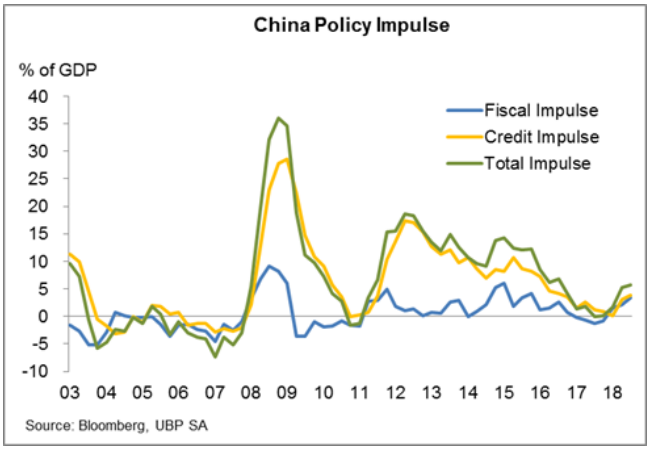
Indeed, the policy debate on the pros and cons of turning up the fiscal tap in a prolonged quantitative easing era has persisted for a while. Our take is that, as global interest rates remain low (some are now falling back to negative territory) and well below nominal growth rates, monetary policy has basically run to its limit.

But with benign interest rates, fiscal stimulus through modest budget deficit can therefore be sustained for a much longer period without risking a sharp rise in public debt to gross domestic product (GDP) ratio and a runaway debt burden.

China's Proactive Stance

China is in a slightly different situation as the People's Bank of China (PBOC), China's central bank, has yet to force into the quantitative easing mode.

Monetary policy flexibility remains. However, its high debt level (270% of GDP) and a medium-term deleveraging plan has placed China ahead in deploying fiscal expansion to help share the monetary easing burden of an economic down-cycle .



Indeed, China's fiscal policy tends to be counter-cyclical. By opting for targeted tax cuts rather than the big spending spree deployed during the 2008 global financial crisis, the country has already been running a bigger cyclical budget deficit since last year. Moreover, off-budget fund allocations have stepped up to support local government and infrastructure investment.

Most investors are still constructive on Beijing's ability to deliver 'China's policy easing 2.0' should growth nose-dive down the road.

While PBOC has stayed surprisingly prudent in policy action following the bold liquidation injection in the first quarter, there are more signs over the past few weeks of an increased reliance on fiscal measures in an attempt to buffer the downturn.

The key measures are:

- **Expand financial special bond usage to boost infrastructure investment.** In response to renewed weakness in infrastructure investment growth (down to a mere 1.6% yoy in May from high single-digit level earlier in the year), NDRC (National Development and Reform Commission) announced that special bonds can now be used as capital for infrastructure projects to leverage up bank loans (3-4 times) for investment.

- **Ministry of Finance announced tax exemption for property transactions within family members**, effectively hoping to boost housing demand beyond first-home buying. More supportive measures for the housing market – the backbone of the Chinese economy – will sure to come if external pressure builds and further drags growth performance.

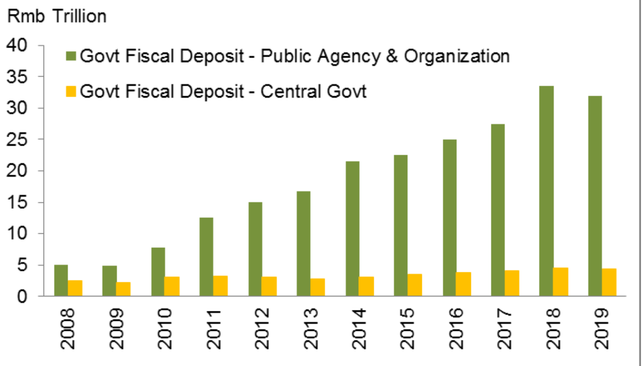
- **NDRC proposed measures to boost new-energy vehicles (NEV) and home appliance consumption** to buttress domestic demand as exports slow down. Instead of giving direct cash subsidies as seen in similar supportive policies in the past, the government is aimed at reducing purchase restriction on NEV (because of local traffic pressure) in metropolises.

Fiscal Deposits - Hidden Treasure?

China's 'fiscal expansion 2.0' is slowing taking shape. This, along with our expectation for a near-term reserve requirement ratio (RRR) cut of 50-100 basis points (bps) in July will buttress growth and earnings expectation already cushioned by the current trade truce between China and US.

In fact, China's fiscal strength is potentially much stronger than generally thought - only if the government can effectively utilise its sizeable cumulative fiscal deposits (owned by government departments, public organizations and agencies). Currently, these combined deposits add up to RMB32trn ($4.7trn) – larger than the total liquidity being locked up by the mandatory RRR of banks (RMB23trn or $3.4trn) as well as China's foreign exchange reserves of $3.12trn.

China Fiscal Funding Could Potentailly Be Much Bigger Than Thought



Source: HSBC, UBP SA

Past usage of fiscal deposits was low because they are untapped funds or savings of public expenditure by individual government departments outside of annual budget allocations.

But when push comes to shove, assuming half of the cumulative amount or about RMB15trn or $2.2trn (17% of GDP) is mobilized used for fiscal pump-priming. This could be a power policy tool and potentially become some 4-5 times bigger than running a headline fiscal deficit of the 4-5% of GDP that we forecast for China in the coming year.

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