China: A Path Towards "Whatever It Takes"

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Key Points

- The late-2024 stimulus announcements from China's central bank and the country's Politburo have sparked hopes of a "whatever it takes" moment.
- This round of stimulus measures differs from the previous ones seen since the end of China's pandemic-era lockdowns in late 2022, in that they are laying the foundations to help avert the risk of Japan-style "lost decades" in the years ahead.
- In our view, the measures announced since late September are positive steps towards building a comprehensive policy response within China. However, lessons from Japan, Europe, the US, and China itself since 1989 suggest that these actions may still be too cautious and not yet broad enough to meet the "whatever it takes" threshold.
- Donald Trump's re-election could act as a catalyst for a more proactive and broad-based policy stance in 2025. Notably, the US renegotiation of its free-trade agreement with Mexico and Canada will be a key development for China investors, potentially triggering a shift in policy direction.
- Given this shifting landscape, we favour a managed-risk approach to China exposures, with stock selection remaining critical as the restructuring and reform phase advances. Capital-protected China strategies present a viable way to achieve controlled exposure, especially with China's indices trading at around 10x forward earnings.
- For investors hesitant about venturing back into China directly, Singapore equities provide an alternative exposure, as they are poised to benefit from the unfolding cyclical and structural shifts globally and as policy changes in China materialise in 2025.

What Would It Take For "Whatever It Takes"?

A NEW ROUND OF STIMULUS TAKES SHAPE

In September, the People's Bank of China (PBoC) announced a 50-basis-point (bps) cut in reserve requirements for Chinese banks, while simultaneously providing guidance that they would cut these further by the end of the year, and trim policy rates by 20 bps to reduce the cost of funding.

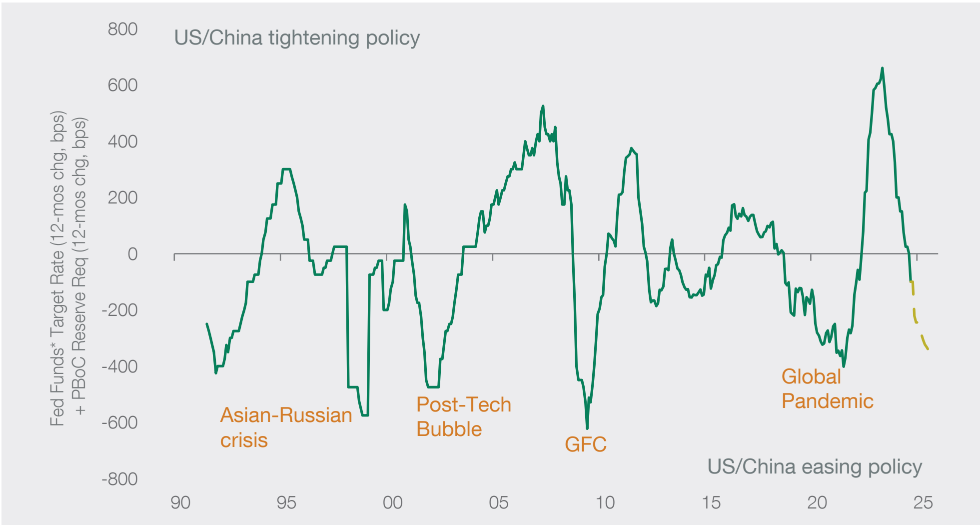
Currently, the PBoC deploys measures to put a floor on asset prices within China – both equities and real estate prices – in order to slow wealth erosion and its impact on consumption across the wider Chinese economy, more specifically, on activating leverage – swap and re-lending facilities of CNY 800 billion (ca USD 115 billion) for the stock market – as well as cuts to required down payments and mortgage rates in an attempt to spur on demand.

In addition, following the regular monthly session of Politburo of the Chinese Communist Party, China's leaders committed to implement "necessary fiscal spending" to achieve its 5% growth target for 2024 (vs. 4.7% y/y through June), noting that "new situations and problems" required both "responsibility and urgency", suggesting that China is embarking on a new approach following a series of failed reflationary efforts since the pandemic ended in China in late 2022.

Indeed, both fiscal and monetary policymakers unveiled potential new tools in their announcements. China's central bank floated the prospect of nearly CNY 1 trillion (ca USD 142 billion) in new capital for China's banking system, which has been struggling under the weight of a growing bad debt burden from the property sector. Fiscal authorities also weighed in with a "one-time cash allowance" for those in "extreme poverty", mimicking the fiscal transfers deployed by the US during the pandemic and by European governments amidst the 2022 energy shock following Russia's invasion of Ukraine.

However, it remains to be seen how different this approach will be in China. Investors can take solace in the fact that the global backdrop against which China is beginning its renewed stimulus effort is more supportive than any time since 2022.

CHINA'S STIMULUS COMES AGAINST A FED EASING CYCLE
FOR THE FIRST TIME SINCE THE GLOBAL PANDEMIC



Sources: Federal Reserve Bank of Atlanta, Bloomberg Financial L.P. and UBP
* Using FRB Atlanta Wu Xia Shadow Fed Funds rate to take into account quantitative easing impacts.
Note: The yellow dashed line represents US Federal Reserve Summary of Economic Projections for Fed funds rate cuts through 2025 and the People's Bank of China's forward guidance surrounding reserve requirement changes.

Indeed, China's late-2022 pandemic exit came both a full year after the US economy had reopened and six months after Russia's invasion of Ukraine; this combination resulted in a rapid Fed tightening cycle through 2022 and into 2023. In other words, as China had been providing countercyclical support to its flagging economy since 2022, the tightening Federal Reserve Board worked to counter their efforts.

Now, the Fed's signalling of an easing trajectory through late 2025, meaning the unfolding of China's easing policy, provides a two-pronged stimulus effort seen only four times in the past twenty years: amidst the 1997/98 Asian/Russia/LTCM crises; in 2001/02 following the bursting of the tech bubble and China's joining the World Trade Organization; in 2008/09 as the global financial crisis unfolded; and most recently, in 2020 amidst the global pandemic.

Should the Fed and the People's Bank of China follow through on their guidance through late 2024 and 2025, investors could see policy ease to levels only seen during those crises.

LOOKING AT CHINA'S "WHATEVER IT TAKES" MOMENT THROUGH THE LENS OF GLOBAL CRISES SINCE 1989

From a directional perspective, the shift in China's policy stance is notable. Putting this into the context of the framework outlined in November 2023[1], the moves towards a joint fiscal-monetary policy as well as signs of an imminent injection of capital into the banking system are two of the key pillars that laid the foundations of the post-crisis recoveries in both South Korea and the United States.

CHINA'S MOVES BEGIN TO REPLICATE THE MEASURES THAT SPURRED POST-CRISIS RECOVERIES

	Japan Abenomics 2013–2014	South Korea Crisis (1997)	US sub-prime/GFC 2007–2009	Eurozone (2011)	China 2015-2023	China (change since September 2024)
Joint monetary-fiscal Policy	YES	NO	YES	NO	NO	YES - SIZE?
Weak currency	YES	YES	YES	YES	NO	NO
Bank recapitalisation	YES	YES	YES	GRADUAL	NO	YES - SIZE?
Write-down/restructuring	NO	YES	NO	NO	LIMITED	UNCERTAIN
"New" industries	YES*	YES*	YES	NO	IN PROGRESS	IN PROGRESS
Domestic social costs	LIMITED	LARGE	MODERATE	MODERATE	LIMITED	GROWING
Political change	NO	YES	NO	NO	NO	NO

Source: UBP

* No "new" industries, but Japanese corporate restructuring and reform under Abenomics.

However, while the change in direction of travel is a good step, so is the increased urgency to act (as happened in previous crises); however, ensuring that the scale of the response is adequate to the task also remains critical.

Japan, as China, previously tried standalone monetary and fiscal measures with both being suboptimal in terms of size relative to the challenges to the economy. We saw the same in the Asian financial crisis, with the IMF forcing a very aggressive solution on South Korea and Indonesia, and a more moderate one on Thailand (and no IMF programme for the Philippines or Malaysia, for example).

[1] Looking Beyond China, *https://www.ubp.com/en/news-insights/newsroom/looking-beyond-china*

Unsurprisingly, South Korea recovered most quickly, spurred on by its supply-chain connection to the 1999 tech bubble. Similarly, the foundations laid post-1998, combined with the China-led commodities boom in the early 21st century, led to Indonesia's rebound. In contrast, Thailand spent many years raising new capital for its banks and took comparatively longer to recover. The Philippines and Malaysia, which did not have the external pressure to restructure and reform, looked a bit more like Europe and had to de-leverage more gradually and required a longer period to recover following the crisis.

Therefore, China's moves are a step in the right direction, although investors should now focus on the scale and the intensity of their next moves.

Europe's response to the eurozone sovereign crisis of 2011/12 compared to the United States' reaction to the sub-prime and subsequently the global financial crisis of 2008/09 are useful guides to any potential upcoming policy moves from China.

In 2012, then ECB President Mario Draghi committed to doing "whatever it takes" to preserve the euro amidst a domestic crisis spreading across the continent. Looking back, Draghi undoubtedly committed all the weapons in the European Central Bank's arsenal by accumulating distressed debt assets across the single currency area, growing its balance sheet from EUR 2 trillion to EUR 5 trillion, driving 10-year German yields below 0% and structurally weakening the euro.

While Draghi – stretching the mandate of the ECB – did indeed do "whatever it took", the same cannot be said for the euro area's fiscal authorities, which simultaneously turned to fiscal austerity, leaving the aggregate deficit shrinking as a share of the economy through 2019. This left the euro area in a fragile state as it entered the 2020 global pandemic, ultimately and belatedly requiring nearly EUR 3 trillion in fiscal support during the pandemic via the supranational European Recovery Fund.

The US, facing its own "whatever it takes" moment in 2008, likewise saw the US Federal Reserve drive policy rates to 0% and the doubling in size of its balance sheet in 2008 alone, and then doubling it once again through 2014 in support of the economy, pushing 10-year Treasury yields to their lowest levels since World War II and below the rate of inflation. American fiscal authorities supported these moves with capital injections of nearly 2% of GDP to recapitalise the banking system, along with tax cuts and other fiscal measures totalling nearly 2% of GDP.

These differences in policy responses help explain the comparative speed with which the US economy has recovered from the crisis post-2008 relative to the decade-long recovery process in Europe following the crisis that battered its southern shores in 2011/12.

CHINA’S POLICY RESPONSE TO DATE AND IN THE FUTURE

Unlike Japan through the 1990s and early 2000s, China appears ready to deploy the combined monetary and fiscal stimulus that eluded Japan for several decades, representing important first steps along the “whatever it takes” road.

Monetary policy

From a monetary policy perspective, both the US and Europe moved quickly to push domestic interest rates below the rate of inflation – i.e. to have negative real interest rates –, easing the debt service burden on borrowers. In contrast, China is maintaining a positive real interest rate profile, making it difficult for corporates, households and local governments to service outstanding debt.

Moreover, as policy rates reached 0% on both sides of the Atlantic, the Fed and the ECB turned to former Fed President Ben Bernanke’s guidance to Japan’s Society of Monetary Economics in 2003 to take the opportunity for “monetary innovation”, including:

1. fiscal and monetary policy coordination (which China appears to be embarking upon)
2. forward guidance (which the PBoC has recently begun)
3. drawing on Bernanke’s 1999 work at Princeton University, *A Case for Self-Induced Paralysis*, and carrying out “non-standard” open-market operations (i.e. quantitative easing) by
   a. purchasing both performing and non-performing assets at above-market values and,
   b. as the US did during the global pandemic, money-financed transfers or “helicopter drops” of money (which earned Dr. Bernanke the nickname “Helicopter Ben”).

The measures mentioned above resulted in the rapid growth of the Fed’s and the ECB’s balance sheets during their respective crises, providing easy financial conditions so their economies could heal and eventually recover from the crisis.

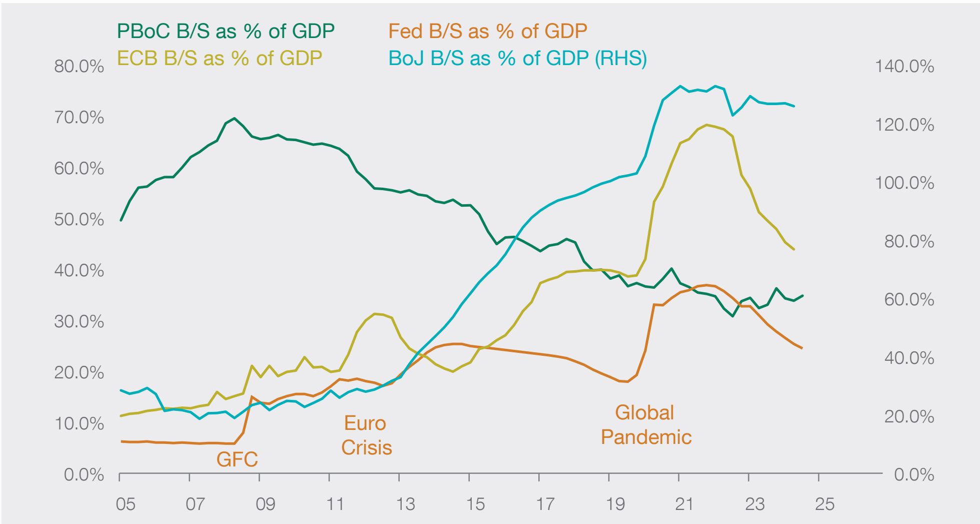
China’s central bank, on the other hand, has been less aggressive, with the PBoC’s balance sheet growing at less than 4% per annum. Admittedly, the PBoC’s balance sheet sits at nearly 34% of GDP compared with the 25% of GDP reached by the Fed and the nearly 40% of GDP reached by the ECB before they began winding down their respective quantitative easing programmes in 2015 and 2017, highlighting the support Chinese monetary authorities have undoubtedly been providing.

With the global pandemic calling central bank balance sheets into action once again, the US central bank’s balance sheet reached nearly 40% of gross domestic product (GDP) while the ECB’s balance sheet soared to nearly 70% of GDP by 2022. However, the Chinese central bank stood out, having shrunk its balance sheet from 37% of GDP at the end of 2019 to 34% in mid-2024.

Thus, as part of its reflationary efforts, the People's Bank of China may yet need to follow in the footsteps of the Bank of Japan in 2013 which supported then-Prime Minister Abe's reflationary "Three Arrows" plan and grew the central bank's balance sheet from near 30% of GDP to a peak over 130% of GDP in support of economic recovery.

While China's recent monetary measures are welcome, the country, like Japan, Europe, and the United States before it, will likely need to turn to its own version of "monetary innovation" as it calibrates the next phases of monetary policy.

CHINA, LIKE JAPAN, EUROPE, AND THE US BEFORE IT,
WILL LIKELY NEED TO TURN TO "MONETARY INNOVATION"



Sources: People's Bank of China, European Central Bank, Bank of Japan, US Federal Reserve, Bloomberg Financial L.P. and UBP

Bank recapitalisation

A key mistake Japan made in the wake of its own late-1990s banking system crisis was a delayed restructuring and recapitalisation of Japan's failed banks. As Dr. Takeo Hoshi and Dr. Anil Kashyap noted in their 2008 paper *Will the U.S. Bank Recapitalization Succeed? Lessons from Japan*, in 1997, the Japanese government deployed JPY 10 trillion (ca 1.7% of GDP) in support of the banking system. By 1998, another recapitalisation was required, this time reaching JPY 13 trillion (ca 2.5% of GDP), though even this was insufficient to stabilise the system. Once again, in 1999, yet another recapitalisation effort was undertaken using Japanese government purchases of preferred shares, though Dr. Kashyap's work suggests that by 2002 the system remained insolvent.

It was not until Heizo Takenaka's 2002 Program for Financial Revival that regulators not only addressed restoring sufficient capital into the system, but also built a structural framework to evaluate bank assets and to strengthen the governance of the recapitalised banks so that the problems of the past did not return.

Following the Takenaka plan's implementation, the Japanese banking system saw capital levels rise by JPY 15 trillion or nearly 3% of GDP – not dissimilar to the EUR 260 billion in capital (2.5–3% of GDP) that euro area banks built up from 2011–16. Similarly, the US injected nearly 2% of GDP into its banking system in 2008.

Indeed, China itself seems to have followed a similar roadmap to Japan in the aftermath of the 1997/98 Asian/Russian crises and has responded forcefully, delivering a 3% of GDP injection of capital into its banking system in the face of a decade or more of state-driven lending problems. This was followed by external capital injections from foreign partners and initial public offerings to raise capital after the turn of the century.

Like Japan, China's regulators accelerated the write-off of bad loans and established asset management companies to buy and restructure these non-performing loans (NPL) from state banks, with regulators simultaneously enforcing global standards of NPL classification. To ensure this accumulation of bad debts did not happen again, banks were required to allocate credit on a commercial basis which increasingly redirected credit allocations in the Chinese banking system towards private companies from 2000–2008, giving rise to China's entrepreneurs of the 21st century.

Looking at the moves China announced in late September, with fiscal authorities floating the prospect of a CNY 1 trillion (USD 142 billion) injection of capital into China's banks, at <1% of GDP, the reported size appears dwarfed by similar steps taken by European, US, Japanese, and even Chinese policymakers facing their own crises in the past thirty years.

Fiscal policy

With economies ranging from being on the verge of deflation (China), those bordering on recession (Europe), those struggling to achieve a permanent escape from decades of deflation (Japan), and those in outright expansion (the United States), all four run surprisingly similar fiscal balances, with budget deficits ranging from 3.5% in the eurozone to 6.5% in the US at the end of 2023.

Japan, understandably has run a structural deficit since the mid-1990s, while the series of shocks since 2008 have since translated into growing deficits in the US, Europe and China.

As highlighted above, despite former ECB President Draghi's successful "whatever it takes" efforts to end the acute phase of the eurozone crisis, the fiscal consolidation mandated by the Maastricht Treaty from 2012–2019 doomed Europe to its own decade of lost growth.

With China's fiscal balances tracking the eurozone's at rarely beyond 5% of GDP even amidst global crises, investors should look for China's commitment to "necessary fiscal spending" and the deployment of a new set of tools to address its "new situations and problems" to mimic the eurozone's largest stimulus package ever, at EUR 2 trillion or nearly 2% of GDP per annum through 2027.

Admittedly, the long-term benefits of the European spending remain uncertain. However, the short-term benefits have been clear for the Italian economy which sat on the precipice of deflation as a result of the global pandemic shock.

Indeed, seeking productivity-enhancing investments and avoiding Japan's "bridges to nowhere" fiscal spending of the 1990s, when budget deficits regularly came in at 5–10% of GDP will be key for China's fiscal policymakers. Similarly, while growing social strains may make stimulus for Chinese households and consumers politically necessary, as was the case in Europe in particular in response to its energy shocks of 2022, predominantly consumer-driven stimulus may prove fleeting and result in a relapse such as those seen in previously unsuccessful stimulus efforts.

Thus, much as Ben Bernanke criticised Japan's policymakers for not deploying sufficient and timely monetary stimulus measures, China's fiscal policymakers face a similar choice to those that Europe's and Japan's faced more than a decade ago: do they replicate the two-pronged fiscal and monetary stimulus that allowed the US and Japan (belatedly) to repair private sector balance sheets (admittedly at the expense of the public sector) and ultimately emerge from its crisis? Or, do China's policymakers take a more fiscally prudent approach and follow Europe's example which risks its own second lost decade of growth?

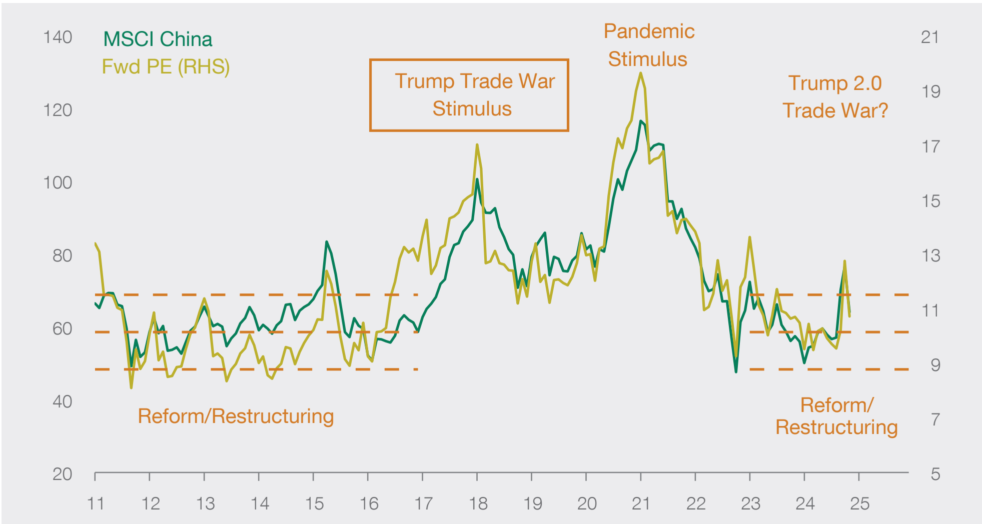
INVESTING WITH THE PROSPECT OF "WHATEVER IT TAKES" IN CHINA

With markets once again disappointed that China's policymakers have not delivered the hoped-for fiscal boost following the November National People's Congress Standing Committee sessions, the September rally is beginning to unwind, not unlike previous reform and restructuring-phase rallies.

For tactical investors, this is likely to mean that the expansion in valuations that drove China equities in recent months will likely retrace in the months ahead towards and potentially below 10x earnings as we have seen in similar episodes since 2011.

Just as earlier this year, the 10x threshold has historically provided trading opportunities for tactical investors. Since 2011, when China traded below 10x forward earnings, investors have earned median returns of 11% over the next six months, with positive returns over 88% of the time.

CHINA IS REPRICING BACK TOWARDS THE "REFORM/RESTRUCTURING" VALUATION RANGE FOLLOWING THE "WHATEVER IT TAKES" DISAPPOINTMENT IN LATE 2024, BUT TRUMP 2.0 MAY BE A CATALYST FOR POLICY ACTION IN 2025



Sources: MSCI, Bloomberg Financial L.P. and UBP

2025, however, introduces a new variable into the equation for China equity investors: the US president-elect, Donald Trump.

Back in 2016, candidate Donald Trump, who campaigned on an "America First" platform, put China in his crosshairs as valuations were below the 10x earnings threshold.

Following Trump's first election, China's President Xi Jinping visited the United States in April resulting in a preliminary – albeit narrow in scope – trade agreement between the world's two largest economies. This was followed by a Trump visit to China in November, where the US President shifted towards his campaign-era rhetoric, despite the signing of over USD 250 billion in new trade deals. By 2018, however, the Trump administration completed its pivot, enacting wide-ranging tariffs which were expanded through 2019.

In 2024, with valuations once again approaching the 10x earnings threshold, it is looking unlikely that a second Trump administration will wait until its second year in office to once again confront China, which is no longer its largest trading partner. Indeed, the Financial Times has already reported that one of Trump's first appointments in his second term may be former US Trade Representative and architect of the Trump 2016–2020 trade policy, Robert Lighthizer, suggesting that US-China trade and trade generally may be a first-year priority for the incoming administration.

In light of this report, China looks to be a primary target in 2025. However, Mexico may also be a target for the new administration, as a beneficiary of the recent US "friend-shoring" policies.

In 2017, tariffs on Mexican and Canadian imports were part of Trump's first-year agenda, as well bringing both nations to the table to renegotiate the 1992 North American Free Trade Agreement, which culminated in the 2020 US-Mexico-Canada Agreement (USMCA) that laid the foundations for the US "friend-shoring" strategy under President Biden.

In 2026, the USMCA is scheduled to be reviewed by its signatories, opening the door for Trump to seek to put pressure on Mexico's new president, Claudia Sheinbaum, and Canada's prime minister, Justin Trudeau, in 2025.

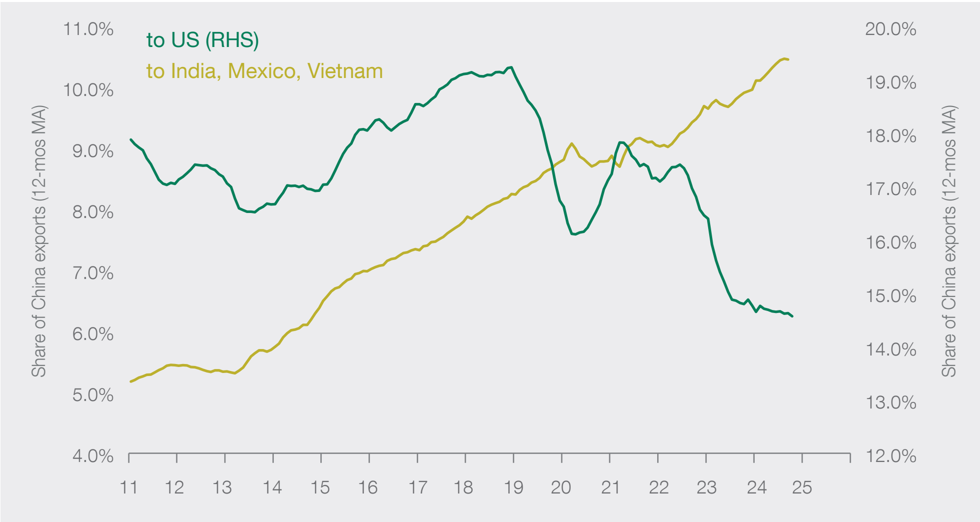
With China's policymakers avoiding the "whatever it takes" fiscal policies that markets had been calling for following its National People's Congress Standing Committee's meetings in November, it may be that, as in 2018, China is seeking more visibility on US trade policy and the shape of the USMCA renegotiation before deploying its own policies in response.

Indeed, while Trump's campaign promises of substantially higher tariffs on imports from China appear daunting, the tariffs under the first Trump administration have already reduced imports to the US substantially as a share of overall US trade.

A renegotiated north American trade deal which limits access of Chinese corporates to Mexico's manufacturing base for onward export to the United States may be potentially more concerning to China's policymakers. Chinese companies have been deploying this strategy to ease the impact of Trump 1.0 tariffs on China-sourced production.

Indeed, countries through which China trans-ships its exports – Mexico, Vietnam and, increasingly, India – have seen their share of exports from China nearly double over the past decade, averaging over 10% of China's total exports throughout 2024, or approximately equal to the decline in China's direct exports to the United States, since 2018 (see chart).

MEXICO, VIETNAM AND INDIA HAVE TAKEN UP THE VAST MAJORITY OF CHINA'S EXPORTS, LIKELY OUTPUT TRANS-SHIPPED TO THE UNITED STATES



Sources: People's Republic of China Customs General Administration, Bloomberg Financial L.P. and UBP

Should the renegotiation of the US-Mexico-Canada Agreement become a framework for discussions with Vietnam and even India, while new tariffs under a Trump 2.0 administration are of concern, USMCA renegotiations could be more consequential for China's trade strategy than an expansion of Trump's 2018/19 tariffs.

Just as the first Trump term's trade policy resulted in a meaningful policy response from China to offset the impact on China's economy, a further increase in US tariffs and progress to close off important trans-shipment avenues like Mexico or Vietnam would elicit a 2018/19 policy response from China's leaders.

For investors cautious about venturing back into China in light of both cyclical policy uncertainty and the governance challenges in recent years, Singapore equities offer a credible alternative.

Singapore, which has long been a play on the global economy and Fed easing cycles, stands to benefit should a Fed rate-cutting cycle unfold in 2025. Moreover, it offers a gateway to structurally high-growth economies in south-east Asia, as well as India, and it is trading at just off 2020-pandemic-era low valuations and near valuations seen in the 2015 China devaluation and restructuring period. Singapore equities offer attractive risk-reward for investors seeking to position themselves for the easing backdrop of the world's largest economy, premium growth trends across south and south-east Asia, as well as optionality around the prospect of stimulus out of the world's second-largest economy.

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