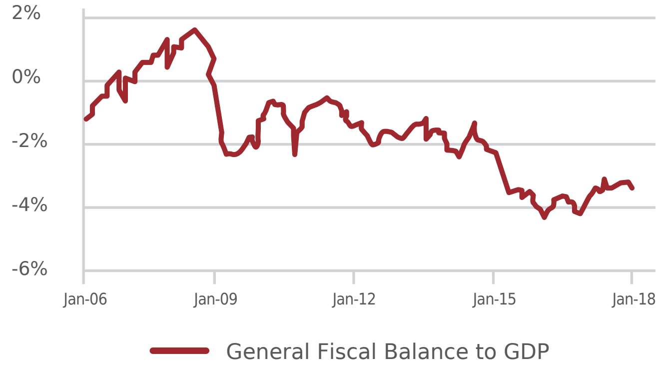
# Monthly Bulletin

Figure 1: General Fiscal Balance to GDP

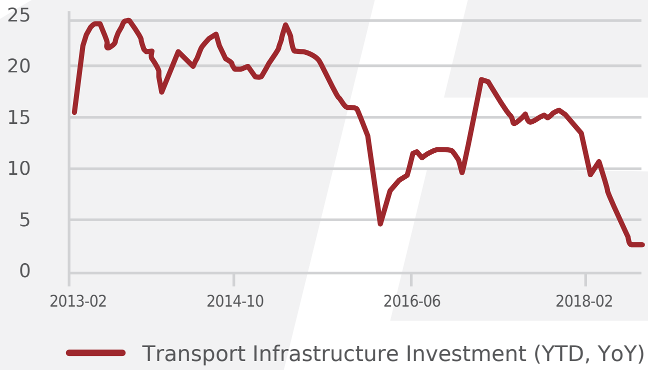



## Tightening fiscal policy and net exports weigh down growth

Various data confirms a slowdown of growth in China, and we attribute this mainly to a tightening fiscal policy, shrinking net exports, and growing concerns over the gradual heating of the US-China tension. We see more pressure in 18Q4, notably in residential investment and net exports.

China's fiscal deficit has retreated from 4% to 3% in 2018 (Figure 1). Tightening fiscal policy causing a drag to growth sparked a rare public quarrel between the Ministry of Finance and People's Bank of China (PBOC) earlier this year. The main channel for growth at this point is infrastructure investment (Figure 2), as central authorities crack down on local governments' excessive borrowing activities and the Ministry of Finance pushes sustainable fiscal discipline. We assess the most appropriate policy at this stage to be a loose fiscal policy carried out by the central government combined with neutral monetary policy, and tightening regulation over shadow banking and local government borrowing. We view a loose fiscal policy carried out by both the central government and local governments, and a tilt to monetary easing as the most likely policy mix. In both cases fiscal policy would give a boost to China's economy.

Figure 2: Transport Infrastructure Investment




Net exports continue to be a drag following the drastic appreciation of CNY in 2017 (Figure 3), and may remain subdued due to Trump's trade policy. US-China tension has just shown the first sign of slowing down, with both countries' presidents reporting a cordial discussion. The mainland China investment community remains quite sceptical about the likelihood of a future trade agreement. We think any constructive agreement is only likely after the US midterm elections. Net exports had a negative contribution of -0.7% to overall growth in 18H1, and newly imposed tariffs combined with CNY depreciation are estimated to be a drag on the economy of

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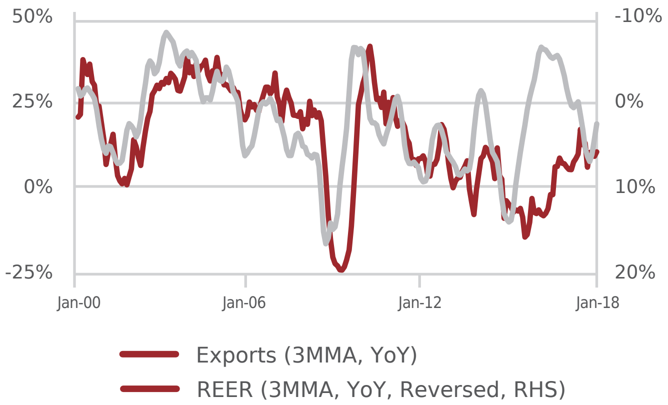
0.8-1% in 2019. Based on this estimate the risk is controllable, whilst we don't see the tension ending at this point. We view imposing tariffs as a regular measure going forward, and are monitoring potential geopolitical risks, especially via the Taiwan channel. Another notable factor is declining investment confidence following the

Figure 3: Exports and REER




structural shift of the Chinese economy away from its old development paradigm. In our view, China's development over the last two decades was driven by high household savings which were directed to developed countries (up to 2008), and ambitious investment (by the private sector, as well as local governments). During this period labor productivity and capital per capita grew rapidly, along with a buildup of foreign exchange reserves and non-financial sector debt. After years of aggressive investment, China reached a point where return on investment declined substantially and debt reached high levels. The supply-side reform hasn't yet fully replaced the fixed asset investment of the past, which means growth is negatively impacted. We see a growth rate of over 8% as nearly impossible, and a pickup in productivity being the main driver of growth which, in our view, will be gradual.

## Inflation picks up but won't be a worry

The Consumer Price Index (CPI) has risen in recent months, causing some inflationary concerns. We believe we've seen the peak of inflationary pressure, and neither has it been nor will it be sufficient to trigger an adjustment of monetary stance. Core inflation was running at 2-2.5% in 17H2, echoing Producer Price Index (PPI)'s high level of 6-7% in 17H1. With growth momentum slowing down, core inflation will remain sluggish. Headline inflation is seeing some pressure from the food component (Figure 4), almost solely due to the recent outbreak of African swine fever. In our view inflationary pressures tend to be benign during slow down periods as reflected in PPI (Figure 5), and the shock from the food component is unlikely to force PBOC to reconsider its stance.

Figure 4: CPI and Components

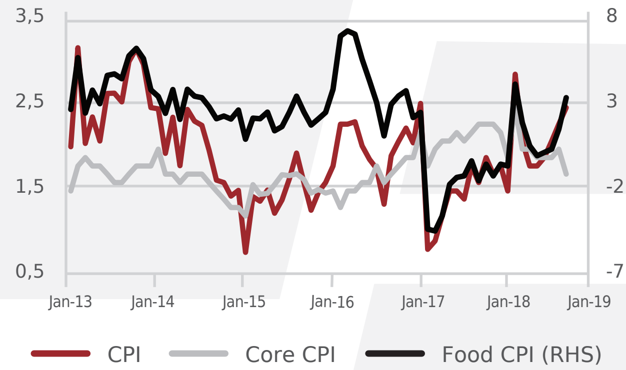
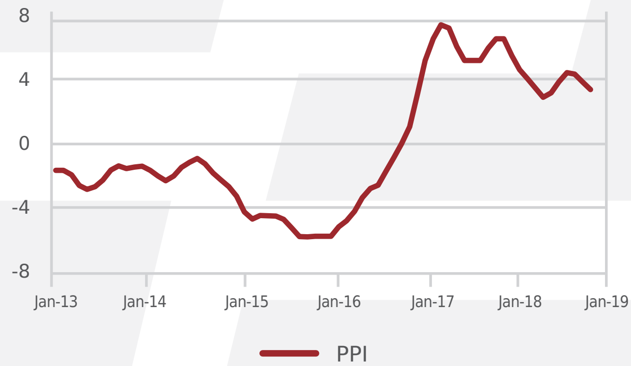



Figure 5: PPI





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## Regulators reassure investors

The Vice Premier, the governor of PBOC, the chairman of China Banking and Insurance Regulatory commission (CBIRC) and the head of China Securities Regulatory Commission (CSRC) – China's top financial regulators, all made comments on October 19, after a sharp drop in China's stock market. Their comments were a reiteration of their stance instead of a change in terms of policy. We think two possible reasons are behind these comments: 1) a continuing market drop could impose significant pressure on stock pledges, which is a very common and cost efficient funding channel for listed companies totaling 4.1 trillion CNY; and 2) in early October there were rumors that the intervention fund created in 2015 to support the equity market is pulling out of the market, and authorities needed to focus on stabilising the market.

Though relatively small, stock pledges could introduce systemic risk if the stock market went into a further down trend and investment banks were forced to sell to secure their funding. Local authorities have been mobilized to set up bail-out funds in order to replace investment banks as a pledgee. We view the purpose of these policy initiatives to be easing funding during a period of credit crackdown, while its effect remains to be seen.

## Fiscal authorities take steps to boost growth

The Ministry of Finance exceeded market expectations with the introduction of new rules for tax deductions as part of a major overhaul of China's individual income tax law, and continues making adjustments to the current taxation system. As per our analysis, we see fiscal spending accelerating from 18Q4, and being a great boost to the whole economy if the National People's Congress sets the deficit target for 2019 at 4%. Infrastructure is another channel for growth;  central fiscal policies could raise funds and increase infrastructure construction and growth. We believe China doesn't have too much infrastructure, and that what is key is that infrastructure is funded at low cost, and following careful cost-benefit analysis. Short term, infrastructure construction could be needed to offset the downward pressure from declining residential investment, which we expect to impose increasing pressure from 19Q4.

## Bond market update

Following the introduction of loosening monetary policies in mid-2018, PBOC's open market operations have suppressed money market rates (Figure 6). The short end of the yield curve rallied more than 100 bps, and the yield curve bull steepened. Local Government Financing Vehicle (LGFV)'s credit spreads didn't touch their 2014 heights during the credit crackdown (Figure 9), but corporate credit spreads reached new highs until PBOC's monetary policy kicked in (Figure 8). We see this as being key to China's credit squeeze - LGFVs enjoy an implicit local government guarantee and attract a major share of credit, and as long as this remains the case any measure will only squeeze the credit issued to the private sector.

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Figure 6: Money Market Rates

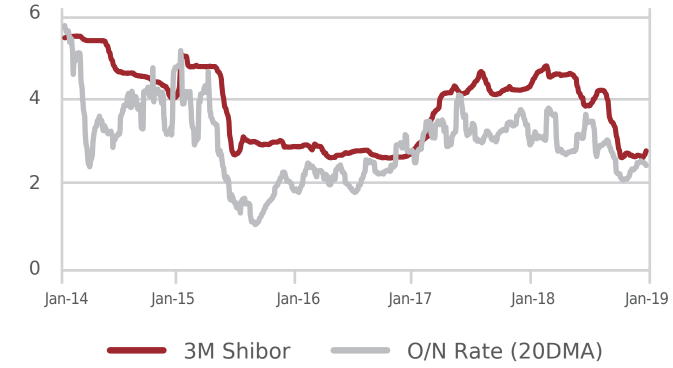



Figure 7: CDB 2Y10Y Spread

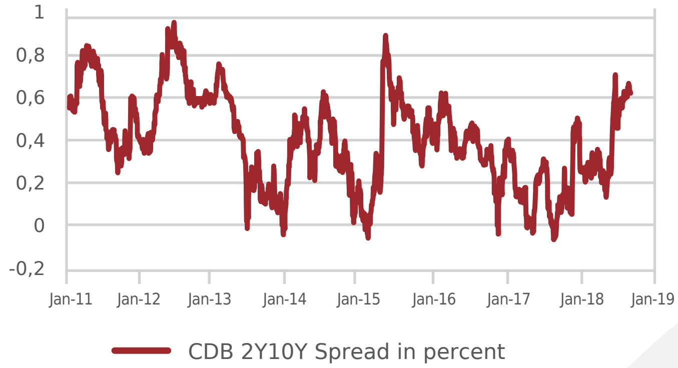



Figure 8: 5Y Corporate Credit Spread

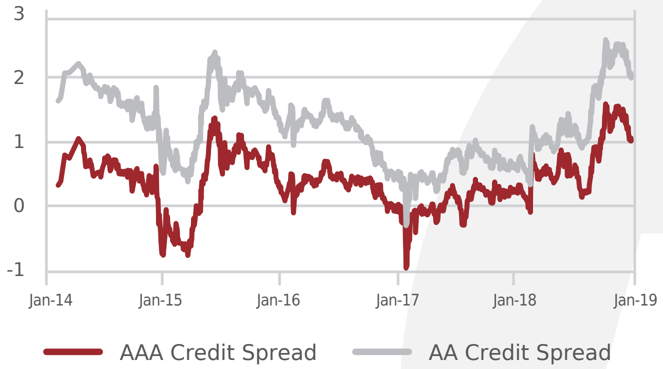
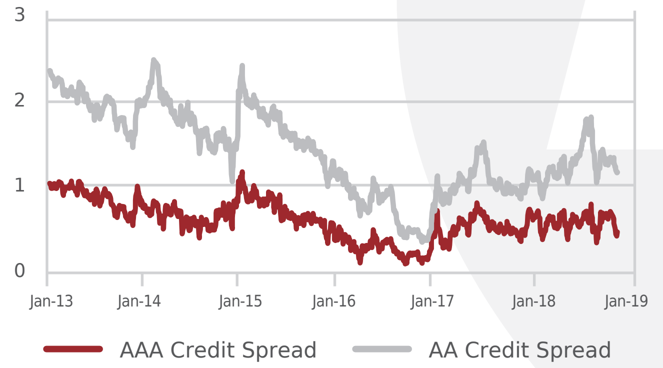



Figure 9: 9 5Y LGFV Credit Spread




We believe government debt and LGFV inefficiencies can only be addressed if there is a consensus among top policy makers, and we have high expectations of the 4th general meeting of the Central Committee which will draw the reform agenda for the following 5 years.

## Equity market update

Equity market sentiment has been overly bearish, most notably in October. Before regulators' efforts to ease concerns over the equity market, China's large cap index had dropped ca. 25% YTD and its medium cap index around 36% YTD (Figures 10 and 11).

China's economy is slowing down, but we don't see this downturn being more serious than the 2015-2016 one, when a cyclical downturn coincided with a structural downturn, an external shock and a stock market correction.

Our outlook for consumption related sectors and strategic emerging industries is positive, as household savings remain high and policies continue to focus on reducing savings and encouraging consumption. In addition, policy makers are working on building China's competence in high tech industries. Another sector worth noticing is the financial sector, including banks and security firms, as valuations are low on the basis of a negative outlook and credit crackdown, to the extent that banks trade significantly below their book value.

To summarize, we assess equity market valuations to be attractive, growth outlook to be more positive than market's expectation, and some sectors showing signs of long term growth.


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Figure 10: Large Cap Index P/E ex Finance & Real Estate


Figure 11: Medium Cap Index P/E




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