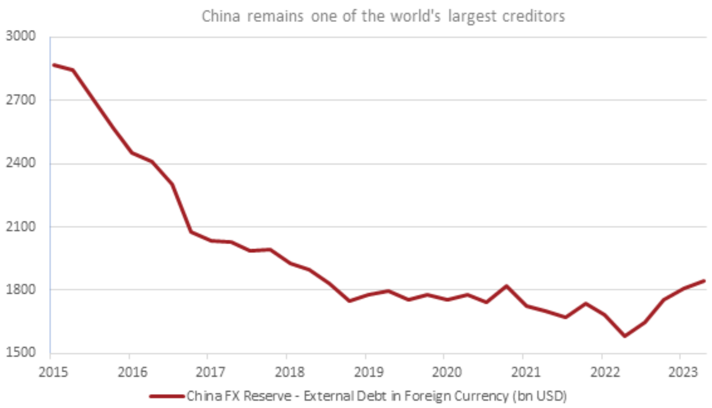
China Bulletin: Market View



Moody's recent decision to revise China's rating outlook to negative has sent ripples through the onshore equity market. However, the true impact of this move may be less significant than initially feared, as China stands as one of the world's largest creditors. Moody's statement shines a spotlight on the mounting pressure on China's fiscal health, a consequence of efforts to address debt risks linked to local authorities, as well as the ongoing structural downsizing of the property sector and its implications for the broader economy. As we have previously stated, dismantling local governments' accumulation of implicit debt, through restructuring and conversion into explicit debt, is imperative for long-term fiscal sustainability and to mitigate systemic risks. While banks may experience adverse effects on net interest margins and profitability, they can anticipate an improvement in asset quality, potentially elevating the sector's valuation from its current state of extreme undervaluation.

China's downward shift of potential growth, frequently cited as a prominent factor weighing on market sentiment, is exacerbated by the ongoing structural transition. Indeed, a structurally smaller sector, an aging population, and a shrinking labor force collectively contribute to a long-term growth reduction. However, the recent slowdown is predominantly attributed to the slump in housing investment. The annual contribution of the real estate sector to nominal growth has declined to -1.5% over the past eight quarters, down from 0.8% during the 2016-2020 period when the economy expanded by 5.6% and 8.0%, respectively. Considering the spillover effects and the shock of the pandemic, economic data does not substantiate the popular belief that the recent slowdown marks the commencement of a prolonged growth deceleration.

China's onshore bond market has remained relatively composed in the wake of Moody's rating action and tightening liquidity conditions. The yield curve has flattened significantly, with long-term rates held down by prevailing pessimism regarding growth prospects, while short-term rates have risen in tandem with higher money market rates. Notably, as LGFV (Local Government Financing Vehicle) bonds constitute a substantial portion of the credit bond market, credit spreads have continued to narrow following efforts to address implicit debt concerns. An exceptionally low term premium reflects both seasonal and fundamental forces, and the curve could potentially bear steepen as a result, while credit spreads may remain compressed. Overall, we maintain a cautious stance on China's interest rates, particularly for the long-term segment.

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