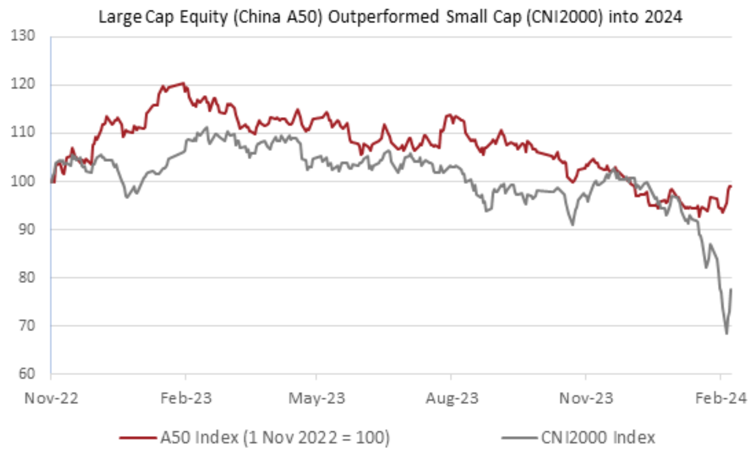
China Bulletin: Market View



The People's Bank of China has increased its structural support through Pledged Supplementary Lending (PSL) to cushion the drag from the housing slump. We suggest not to view recent policy moves, including structural monetary easing and loosening of home purchase restrictions in core cities, as signals of stimulating housing demand since the pace and measures differ significantly from the approach in 2015-16. As the housing downturn continues to weigh on growth and sentiment, the pressure on household incomes and expenditure is building. This is shown by a declining year on year tax revenue as of Q4 2023. The housing sector's profound influence on China's growth has been widely recognized over the past two decades. Hence the sector's soundness is viewed as a prerequisite for a solid recovery, partially explaining the recent weakness of confidence. However, as we have detailed previously, housing investment is not likely to play as important a role in future as before, implying the headwind on sentiment may linger longer than previously expected.

Small cap stocks underperformed substantially in the Chinese equity market in late 2023 and early 2024, spurring fresh concerns about market stability. Valuation of growth style equities approached the extremely low level seen in late 2018 when the stock market was dragged into a vicious circle exacerbated by forced selling of pledged shares. While largely controllable, the risk particularly concentrates on small cap stocks, erasing their gains of the past five years. Small cap stocks may still underperform while facing market imbalances, overvaluation and gradual recovery, despite multiple regulatory measures to boost the equity market. On the other hand, large cap stocks offer attractive rewards given their significant underpricing relative to their improving fundamentals. We still recommend against exposure to the housing sector except for the largest banks, which are expected to benefit from their sound financial position and increased appetite for stable cash flows.

China's ultra-long government bonds are much sought-after to hedge the persistently falling equity market, and also to hunt for yield amid low-rate expectations. The 30Y interest rate and the term premium are hitting historical lows, while the money market and front-end rates are trading around the central bank's policy rate. China's consumer inflation index is at its lowest level since 2009, reflecting households' hesitance to spend. However, we remain cautious on China rates and expect the curve to stay flat even if the equity market rebounds. That's because the ongoing "debt swap program" replacing local governments' implicit debt will continue to compress termspread and credit spreads.

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