China Bulletin: Market View

The Central Financial Work Conference, convened every five years and chaired by President Xi, has set an optimistic tone for the medium-term development of China's financial market and system. In a notable departure from its stance in 2017, the conference statement downplays the significance of risk control, instead identifying the concentration of government debt at local level and the ailing property sector as the primary risks to the financial system. Recent policy initiatives, such as the swap of local government debt and central government fiscal expansion, are moving in the right direction to enhance fiscal sustainability, although the goal may take several years to achieve. Despite these efforts, the housing sector, which exhibits limited signs of improvement and only modest progress in debt restructuring, may continue to exert a dampening effect on growth while posing only limited risks to the financial system.

China's equity market continues to defy positive economic developments on multiple fronts, once again testing new lows. Despite the backdrop of accelerating domestic growth and corporate earnings, more supportive policies for select sectors, fiscal consolidation, a healthy financial system resilient to the housing sector's contraction, and even slight de-escalation of tensions between China and the US, the Chinese equity market remains unmoved. Major indices are trading at year-to-date lows. One of the most noteworthy factors contributing to this underperformance, in our observation, is pessimism resulting from concern about policy uncertainty. Although this pattern has been seen in previous cycles, it may take longer to reverse this time due to the complexities of structural transformation, possibly stretching over several quarters.

Despite a dramatic tightening of liquidity in the money market towards the end of October, the bond market appears to be weathering the stress relatively well. The overnight repo rate, a frequently referenced short-term funding cost, surged to as high as 50%. Massive government bond issuances and seasonal patterns may have contributed to this strain, but a more fundamental factor could be the People's Bank of China (PBoC) withdrawing liquidity support amid a more proactive fiscal policy stance. The resilience of the bond market, largely attributed to the swap of financing vehicles' debt for local government bonds, may face increasing pressure from tighter liquidity conditions. Considering the acceleration in growth momentum and the shifting economic policy mix, we maintain a cautious outlook on China's bond market.

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