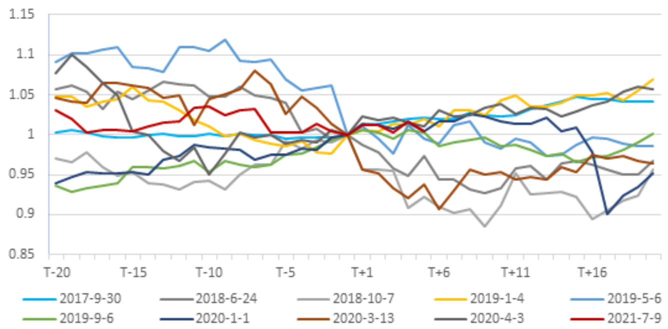
China Bulletin: Market View

Shanghai Shenzhen 300 Index pre & post RRR Cut



The surprise policy move of cutting the Required Reserve Ratio (RRR) reflects Chinese policy makers' focus on manufacturing. And their awareness of the difficulties facing this sector due to skyrocketing commodity prices and sluggish domestic demand. PBoC's 1-year term policy rate, known as the Medium-term Lending Facility (MLF) and updated around the 15th of every month, has been left unchanged. The next key rate to watch will be the Loan Prime Rate (LPR) published on July 20th. The RRR move is widely perceived as a structural measure instead of the beginning of an easing cycle. June economic and financial data beats market consensus and indicates that growth momentum remains resilient. We reiterate that external demand is key to China's growth in the short term.

The equity market still favors growth stocks and new energy names, as well as cyclical names. As shown in the figure, a Required Reserve Ratio cut does not often help the equity market. Commercial banks and the healthcare sector are obvious losers, given a more pessimistic outlook for asset quality and policy headwind respectively. In our view, a less tight monetary environment does not necessarily mean deteriorating asset quality for commercial banks, yet does mean a lower cost of funding. The risk/reward tradeoff is attractive at current levels, although banks may underperform in the short-term. The healthcare sector also has a promising outlook and the setback is expected to be temporary. Moreover, markets should not underestimate policy makers' determination to defend data security and to rein in internet monopolies. Equity market volatility will likely continue to increase, and a low volatility portfolio is recommended.

China's bond market is thrilled at the move, and the curve trades substantially lower by 13-15bps. 5Y saw the most significant rally, as 3Y and 10Y are blocked by a cautious outlook in money market rates and resilient growth momentum. Credit spreads are compressed significantly as well, especially for shorter duration investment grade bonds. As mentioned before, the cut does not mark the turn of monetary policy, but works as a measure to alleviate pressure facing the manufacturing sector. External demand may recede yet the pace will likely be gradual and its level may remain above 2018-2019 levels. We suggest a cautious stance regarding China's bond market.

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