China Bulletin: Market View

China's unexpected fiscal expansion plan has the potential to provide a significant boost to the nation's economic growth and business confidence. This marks a significant departure from the norm as, for the first time in over two decades, the People's Congress has increased the approved fiscal deficit outside the typical cycle. This adjustment amounts to 0.8% of GDP, approximately 1 trillion CNY, achieved through central government bond issuance. The adjusted fiscal deficit now stands at 3.8% of GDP, not only the highest level since 2010 but also surpassing the traditional threshold of 3%, which was last seen during the pandemic. From our perspective, this change represents a meaningful shift toward a more pragmatic fiscal policy framework. In the last decade, the finance ministry's stringent fiscal discipline, combined with policymakers' desire to modernise infrastructure nationwide, led to massive off-balance-sheet borrowing at unsustainable costs. Recent policy moves, including the swap of local government financing vehicle (LGFV) debt for government bonds and fiscal expansion led by the central government, are integral to a critical fiscal reform aimed at streamlining the fiscal system and aligning spending with revenue.

The lacklustre performance of China's equity market following the fiscal surprise reflects subdued sentiment. Many attribute the substantial underperformance of China's equity market in recent quarters to the withdrawal of overseas investors, which is only part of the story. Onshore market confidence is exceptionally fragile, in our view, due to the ongoing contraction in the housing sector and the absence of robust stimulus. Although official figures indicate that growth momentum picked up in the third quarter of 2023, the equity market remains sceptical about the sustainability of this acceleration. Despite the market's doubts, we maintain an optimistic outlook. A smaller housing sector implies less drag on the economy, efforts to restore consumer and business confidence can bolster domestic demand, and fiscal consolidation will alleviate the pressure on local governments.

Bond yields have experienced a marginal increase amid the tightest liquidity environment in a year, with banks borrowing above the policy rate. The relatively swift issuance of government bonds led to a temporary shortage of long-term funding among banks and an increased demand for liquidity, which pushed money market rates above the policy rate. If this overshoot continues, it typically implies a substantial shift in the People's Bank of China's (PBoC) monetary policy towards a more neutral stance. We maintain a cautious stance regarding the onshore bond market in general.

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