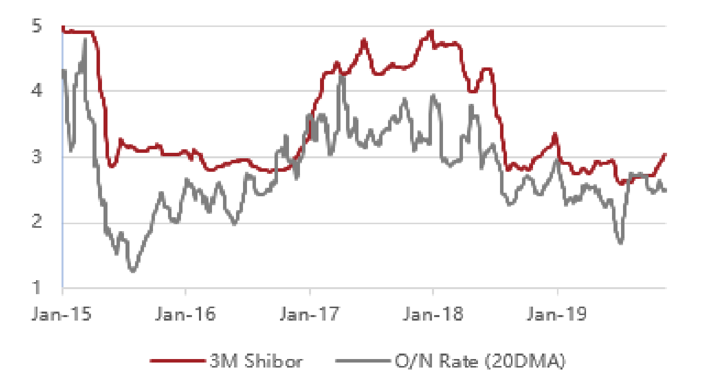
China Bulletin: Market View

PBoC lowers policy rate and LPR follows

PBoC cut the rate on its medium-term lending facility (MLF) and seven-day reverse repo open market operations (OMO) rate by 5bps in two consecutive weeks, just ahead of the November loan prime rate (LPR) publishing date. In response, the November LPR reports both 1Y and 5Y term loan rates as 5bps lower than they were in October. The intention of the move was to show that monetary policy remains accommodative even if inflation spikes, and to guide down financing costs in the continuing slowdown. Yet uncertainty about policy trajectory remains, due to rising consumer inflation and concern about the efficiency of monetary policy.

Policy makers recognise the structural nature of rising consumer prices, but still need to take measures to contain potential inflation. The peak of consumer inflation is expected in 20Q1 as Chinese New Year traditionally pushes up pork prices and worsens the already fragile dynamic. The risk is that if consumer inflation remains high after 20Q2 onwards, monetary policy would be in a very thorny position. Thus, PBoC would likely have to reduce liquidity injections into the money market and elevate borrowing costs accordingly, to avoid being too accommodative.

Figure 1 CNY Money Market Rate



PBoC is navigating through a trilemma that consists of deleveraging, fostering employment and containing inflation, all while monetary policy's efficiency at supporting the economy decreases given the high levels of debt across all sectors. Experience from 2015 has shown that monetary accommodation is inefficient at improving financing demand, as during this period aggressive monetary stimulus fueled only the housing market and financial market trading. Additionally, PBoC is increasingly employing regular monetary policy tools instead of structural ones, showing they are concerned about the downturn. However, our view remains unchanged, and it is that under current circumstances fiscal policy is more effective and therefore PBOC may increase spending on infrastructure from 20Q1.

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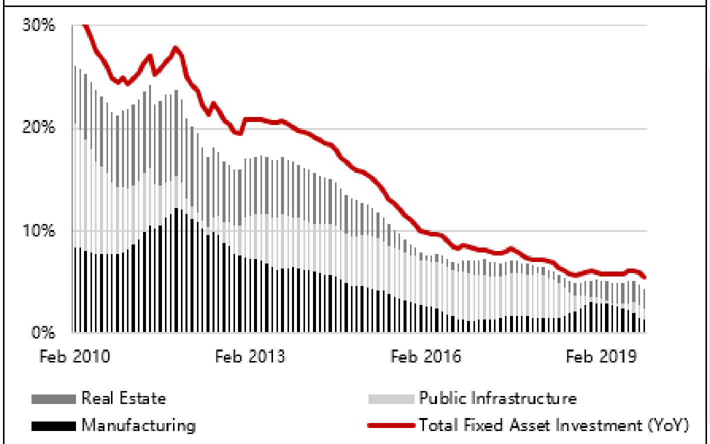
Continued slowdown calls for more active policy

The economic slowdown continues, especially in manufacturing fixed asset investment and the export sector, with consumption remaining stable. As mentioned in a previous report, manufacturing investment is stalling due to decreasing profitability and rising financing costs in addition to excess capacity, trade protectionism and structural reform. Consumption looks to be bottoming out, after the car market recovered from the shock of a subsidy cut and an emission standards upgrade. The most conspicuous employment indicator is the surveyed jobless rate, which remains stable yet at a high level.

Figure 2 Infrastructure Cushions Manufacture Downturn

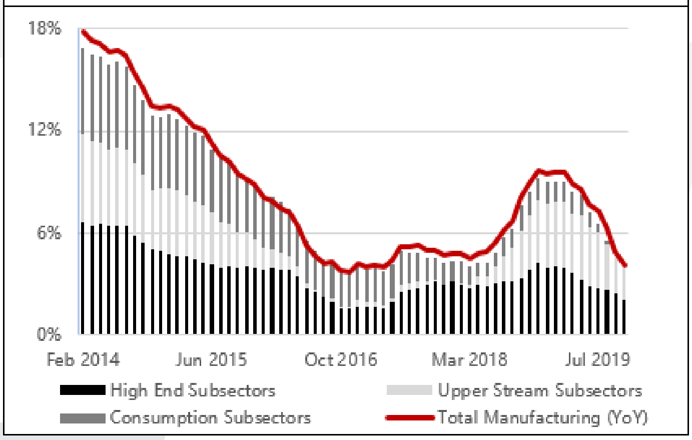


Policy makers are set to increase stimulus to cushion the slowdown, while maintaining structural policies aimed at lifting potential growth. 2020 is expected to see an accomplishment of several periodic objectives, leading to the popular expectation of active policy ahead. Traditionally, policies have directed household savings to local government and property developers through home sales, in order to encourage infrastructure investment and house construction. Yet given policy makers' reiterated determination that stimulating the housing market must not act as a short-term stimulus measure and that local governments sort out explicit and implicit debt, policy makers need to find a way to deploy fiscal stimulus more efficiently.

Decreasing manufacturing investment is more resilient than data suggests

Consumption subsectors dragged down manufacturing investment, while upper stream and high-end sub-sectors remained resilient. These consumption sub-sectors are predominantly export oriented industries, such as paper and textile manufacturing. The trade dispute between the US and China has worsened the outlook for these sub-sectors and dragged fixed asset investment down in the short term. These sub-sectors are also victim to the supply chain shift away from China to countries with cheaper labour, even without the trade dispute, and before this shift reaches an equilibrium, fixed asset investment may remain sluggish. Upper stream sub-sectors benefit from resilient real estate investment and construction, and are expected to remain stable through 20H1 before tight housing policy brings down home sales.

Figure 3 Manufacture Investment by Sub-sectors



High end manufacturing sub-sectors, including machinery, equipment, automobile and medicine manufacture, are expected to be a new source of growth and employment. Fixed asset investment in these sub-sectors accounts for about 40% of total manufacturing investment and has recovered from the previous trough in mid-2019. Policy makers adopted structural monetary policy tools to create favorable financing conditions during the crackdown on shadow banking and implemented fiscal policy in the form of substantial cuts to the tax rate and social security contribution rate. Yet the effectiveness and sustainability of these policies is still uncertain.

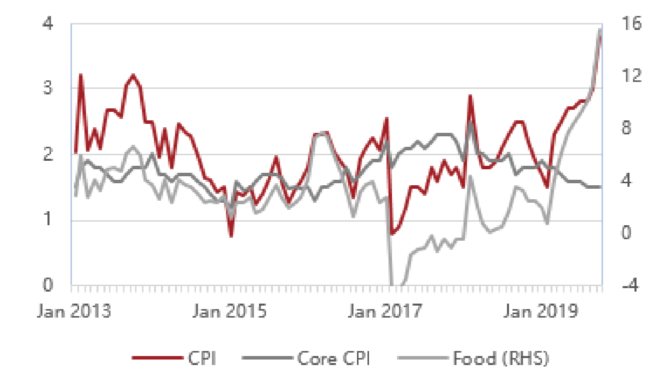
Figure 4 High End Manufacturing Fixed Asset Investment

Sudden rising inflation poses temporary constraint to monetary policy

After the rise in September, consumer inflation in October surprisingly jumped above its policy target and is widely expected to go even higher subsequently. Both producer and core consumer inflation gauges show that inflationary pressure is muted across the board and that the headline series is pushed up almost solely by African swine fever's influence on the price of pork. Supply shortages and seasonality are also likely to lift the headline series even higher in 20Q1. In anticipation of rising inflation and a tightening of monetary policy, rates traded higher in September and October, triggering PBoC's cut. However, the cut is symbolic and monetary policy is unlikely to be accommodative in real terms before it can be confirmed that inflationary pressures have eased.

After 20Q2, if the headline series does show signs of disinflation, PBoC will have more confidence to adopt these accommodative policies.

Figure 5 Consumer Inflation Pushed by Food Item



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