China Insights

Monthly update on Chinese markets

October 2019

Summary

- Despite a surge in pork prices, core consumer inflation excluding food and energy remains largely stable, offering authorities some leeway to ease policy
- With aggressive monetary policy easing looking less likely, counter-cyclical measures such as infrastructure spending look like a safer bet to buffer slowing growth
- Over the longer term, more reform measures are required to boost the effectiveness of policy transmission

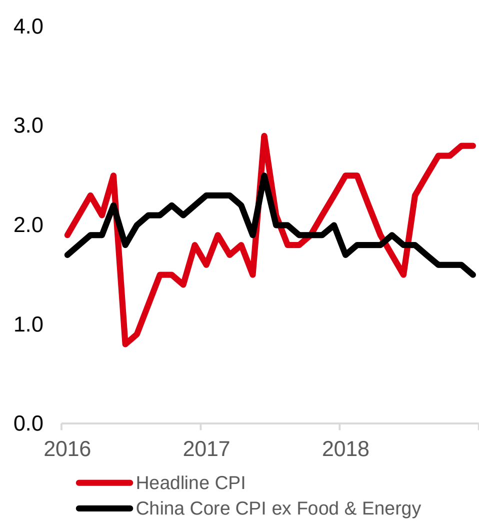
Hot topic: Is it time to start worrying about inflation?

China's headline consumer price inflation (CPI) has accelerated to 2.8% year-on-year in August, the fastest pace in 17 months, driven by rising food prices. Furthermore, the price of pork, which accounts for more than 60% of the country's meat consumption, rose at its fastest clip in eight years. Pork prices soared almost 47% year-on-year with supplies crimped by African swine fever, a highly infectious virus that is deadly for pigs but not harmful to humans.

The National Statistics Bureau estimated that the rise in pork prices pushed up the headline number by more than a percentage point in August and the surging pork prices could last until the middle of next year given shrinking sow population. Headline CPI inflation could rise above 3% toward the year-end.

This brings up a couple of important questions for policymakers to address before launching a new round of anti-cyclical measures. What do rising consumer prices imply for the monetary policy, against the backdrop of a slowing economy? What other measures can be considered as an alternative to monetary policy?

China consumer prices (yoy%)



HSBC Global Asset Management

Hot topic: Is it time to start worrying about inflation? (cont)

Taming prices

To address the surging pork prices, the government has rolled out measures to increase supply and cushion the impact on consumers. The authorities announced that vehicles transporting piglets and chilled pork would be exempt from vehicle tolls and released pork supplies from its central reserves as a way to tame soaring prices.

Policymakers will strive to strike a balance between inflation risk and monetary easing amid slowing growth

On a brighter note, core CPI inflation, which excludes food and energy, remained low and stable, reflecting tepid demand pull pressures. It moderated to 1.5% year-on-year in August from 1.6% in the prior month. Furthermore, the year-on-year producer price deflation indicates limited (upstream) firm pricing power and supply-side cost push.

Balancing risk and growth

We think rising headline inflation and the potential impact on inflation expectations could be a hurdle for aggressive monetary easing, but low and stable non-food, underlying inflationary pressures will likely still allow policy flexibility to stay accommodative.

In a press conference on 24 September, Mr. Yi Gang, the governor of the People's Bank of China (PBoC), said that despite the recent slowdown, China's growth and inflation remain in appropriate ranges, suggesting that inflation does not appear to be a big threat despite surging pork prices. Governor Yi reiterated the central bank's prudent and targeted easing stance and that it will not flood the economy with too much liquidity. In early September, PBoC cut banks' reserve requirement ratio for the third time this year, freeing up RMB800 billion in liquidity. However, the central bank kept the one-year medium-term lending facility (MLF) rate unchanged at 3.3%, disappointing the market and sending both onshore equity and bond markets lower that day.

In the global context, central banks around the world have changed their stances to accommodative, potentially paving the way for Beijing to consider easing further.

We think the authorities' cautious easing aims to strike a balance between reflating the economy and safeguarding financial stability/ debt sustainability. That said, we still see the possibility of an MLF rate cut in the coming months, which could help induce a measured decline in loan prime rate (LPR), a new interest rate benchmark launched in August. In the global context, central banks around the world have changed their stances to accommodative, potentially paving the way for Beijing to consider easing further. Meanwhile, to improve monetary policy transmission, further reforms are also needed, including measures to strengthen the effectiveness of the MLF as a de facto policy rate to improve the signalling effect.

Beyond monetary policy measures

Aside from monetary easing, policymakers have emphasised the importance of implementing the policy measures more effectively. For instance, the State Council has requested that by the end of October, all proceeds from local government special bond (LGSB) issuances should be allocated to the corresponding projects, and about 20% of the funds can be used as equity capital to support major infrastructure projects. At the same time, the special bond quota for 2020, which is forbidden to be used for land reserve, property related projects, or debt swap programmes will be utilised in advance this year. We think these efforts to improve utilisation of local government special bonds will likely lead to a pickup in infrastructure investment growth from low to high single digits toward year-end. In addition, the government also rolled out measures to stabilise employment, including unemployment insurance refunds for firms that do not lay off staff and subsidies for all jobless young people aged 16-24, among others.

In conclusion, while there is potentially some room left for further monetary policy easing, fiscal measures, such as increased infrastructure investments, will stay in the spotlight as China attempts to prop up flagging growth.

Equity market

- MSCI China and MSCI China A Onshore Index – the offshore and onshore benchmarks – advanced 1.0% and 1.2% in the month of September (as of 26th Sep), respectively, following news of the resumption of high-level trade discussions between the world's two largest economies and after central banks across the world adopted a more dovish stance

- Both China and the US have shown signs of softening their stance ahead of the high-level trade talks in early October, fueling optimism around the prospect of a trade truce. Beijing has re-started purchase of US agricultural products including soybean and pork with tariff exemption, while the Washington delayed tariffs scheduled on October 1st by two weeks as a gesture of goodwill. Besides the resumption in US-China trade talks, accommodative monetary policies by global central banks has renewed risk appetite in the near term

Northbound inflows stayed strong at USD8.7 billion in September amid renewed hopes for a trade truce

- In China, the country's foreign exchange regulator said it had decided to remove quota restrictions on two major inbound investment programmes – the QFII and RQFII, as part of Beijing's commitment to open up its financial markets to foreign investors. The removal of quotas comes amid slowing domestic growth and recent weakness in the Chinese currency against the dollar

- At the macro level, China's retail sales and investment gauges softened further in August, reinforcing views that Beijing needs to roll out more easing measures to buffer a sharp slowdown. The August retail sales rose 7.5% from a year earlier, a tick down from the 7.6% gain in July, while industrial output rose 4.4% year on year during the month, versus 4.8% in July. Both figures came in below market expectations. The August consumer inflation rose 2.8% year on year, driven by a surge in pork prices. The August pork prices jumped 46.7% year on year due to a shortage in pork supply, up from July's 27% gain. Overall, the liquidity conditions remains accommodative, as the PBoC cut the amount of cash that banks must hold as reserves for the third time this year, freeing up RMB800 billion in liquidity

- In terms of fund flows, net inflows via Northbound trade rose to USD8.7 billion in September, the biggest monthly gain since February. On the flip side, net inflows through the Southbound – Chinese investors' purchase of Hong Kong-traded shares – moderated to USD1 billion during the month, down from USD7.5 billion in August

- The forward 12-month price-earnings ratio of MSCI China A onshore is currently trading at 13.6x, after the onshore benchmark rallied over 30% so far this year, while the MSCI China is trading at 12.2x, a tad below its 10-year average of 12.4x

Onshore stocks extend rally

Source: Bloomberg, HSBC Global Asset Management, as of 26 September 2019. Total return in local currency terms.

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Sector views*

Sector	Views
Consumer Discretionary	◆ We are overweight on consumer discretionary sector. In particular, we like the education space as it is relatively less sensitive to macro headwinds.
Consumer Staples	◆ We are overweight on consumer staple sector as the trend of premiumization on the back of rising income underpins higher pricing power and margin expansion capability of selected strong staple brand names. VAT cut and the recent pickup in inflation also bodes well for consumer staple plays.
Energy	◆ We are underweight on energy as oil price is expected to trade within a narrow range.
Financials	◆ We are underweight on banks as lower rates may put pressure on their net interest margin
Healthcare	◆ We are overweight on healthcare and favour those with strong R&D capabilities on innovative drugs
Industrials	◆ We are underweight on this sector as we do not see any near-term catalysts
Information Technology	◆ We are underweight on this sector as it could be impacted by the ongoing US-China trade conflicts
Materials	◆ We are underweight on commodities as we do not see any upside on the demand front
Property	◆ We are negative on Chinese property developers as government intends to control property prices
Communication Services	◆ We only like telecommunication company that may benefit from 5G development. We are conscious that competition amongst major telecoms remains intense.
Utilities	◆ We are underweight on utilities sector as we see limited catalysts in this sector

Source: Bloomberg, HSBC Global Asset Management, as of September 2019.
*NOTE - Sector views of HSBC Global Asset Management's offshore Chinese equity team
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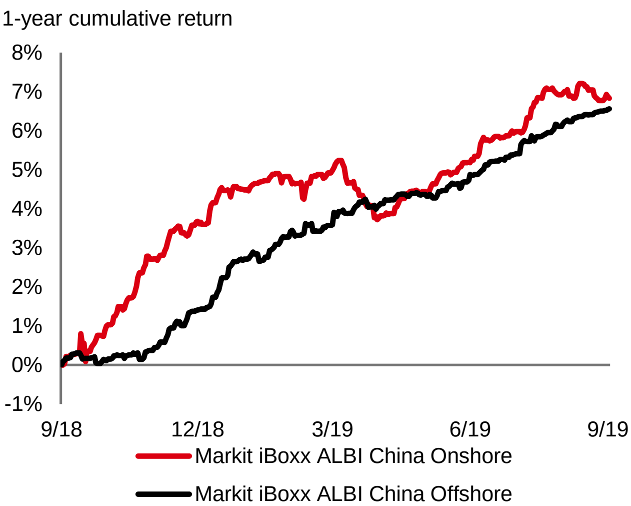
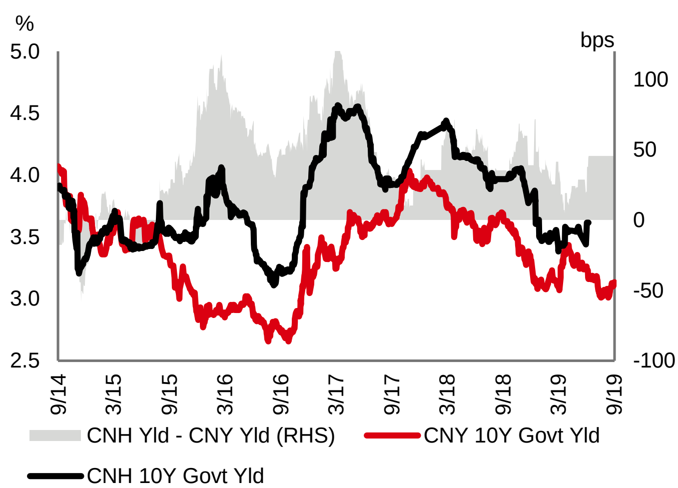
Fixed income

Renminbi was largely stable in September reflecting policy commitment to stabilizing sentiment

- The US Federal Reserve cut its interest rates by 25bp for the second time this year, effectively confirming concerns around slowing global growth and sluggishness in exports and business investments
- Aside from the expected Fed cut, the sharp pick up in the US overnight borrowing rates prompted the New York Fed to intervene in the repo market for the first time since the financial crisis rattled the market, underscoring investors' jitters over an anticipated fresh financing squeeze at the end of the quarter
- In China, the People's Bank of China partially rolled over its RMB200 billion of one-year medium-term lending facility in mid-September but kept the lending rate unchanged at 3.3%, suggesting an inclination to avoid aggressive stimulus measures to shore up growth. The monetary operation came after the central bank cut the amount of cash banks must hold as reserves for the third time this year in early September, releasing RMB800 billion in liquidity to shore up the slowing economy
- On 24th September, PBoC governor Yi Gang said the current interest rates are appropriate and the country has ample monetary leeway to manoeuvre, while signalling further reduction in reserve requirement if needed
- The yield curve of government bonds remained largely unchanged in the month of September, but the yield on benchmark 10-year bonds edged up slightly to 3.1% from 3.0% in the prior month. The spread between the onshore bond and its US counterpart has steadily risen to 137bp in late September, up from 56bp in early January, supporting the value of the renminbi, which has reversed its recent weakness over the past month
- The onshore and offshore bonds were largely unchanged in September, as market stability is likely seen as top priority heading into the last quarter of the year. This has been evidenced with continued strong and stable renminbi midpoint fixing levels at 7.07-7.08 during the month. In the dollar space, the JACI China, the benchmark for Chinese dollar credit, was flat in the past month, on the back of a rebound in renminbi against the dollar. On a year-to-date basis, the dollar has pick up 2.5% against a basket of currencies
- Going forward, we favour government and policy bank papers amidst expectations that interest rates would be lower for longer, while remaining constructive on selective names that should benefit from further easing measures. On a cautious note, we anticipate a steady rise in non-performing assets as the economy slows

Chinese bonds rally amid signs of global easing





Source: Bloomberg, Markit data as of 26 September 2019. Total return in local currency terms.
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Data watch

Indicator	Date	Actual	Consensus	Prior	Analysis
Industrial production (IP) (yoy)	Aug	4.4%	5.2%	4.8%	August activity indicators continued to show soft growth momentum. IP weakness could partly reflected the effects of one fewer working day this year vs. last year and bad weather, but also indicated soft external and domestic demand and inventory de-stocking. Pollution curbs ahead of National Day celebrations may curb September IP growth. There are growing concerns that policy easing so far has proved insufficient to put a floor under the growth slowdown. We think the authorities' cautious easing aims to strike a balance between reflating the economy and safeguarding financial stability/ debt sustainability. They would not want to deplete the room for policy ammunition given the risk of protracted trade policy uncertainty, in the absence of signs of a sharp slowdown. Meanwhile, the growth deceleration also reflect structural headwinds that cannot be addressed by countercyclical stimulus measures. Overall, we expect a pro-growth policy stance to stay firmly in place in the near term, but this also needs to be accompanied by reform steps such as the SOE reform as well as better policy communications to shore up private sector confidence.
Fixed Asset Investment (FAI) (ytd, yoy)	Aug	5.5%	5.7%	5.7%	Concerns over prolonged trade tensions have suppressed business confidence and continued to weigh on manufacturing FAI despite the stimulus measures including tax cuts and targeted credit easing. Industrial profits growth remained tepid with the risk from weak upstream firm pricing power as reflected in depressed PPI. Meanwhile, infrastructure FAI growth edged higher, helped by the intensified policy support. We think efforts to improve utilisation of local government special bonds could lead to a modest pickup in infrastructure FAI growth. Property sector activities also held up relatively well, with largest stable MoM property sales and home prices. Construction activity data were mixed but resilient, with moderation in new starts but slightly higher real estate FAI and completion. Tighter credit policy, cooler land sales this year and weaker sales in lower-tier cities pose some downside risks, but city-level policy fine-tuning and the overall reasonable inventory levels provide some cushion.
Retail Sales (yoy)	Aug	7.5%	7.9%	7.6%	Auto sales remained a key drag, weakening in July-August after a strong rebound in June likely reflecting the impact of the new industry policy regarding stricter emission standards. Non-auto sales picked up modestly albeit staying tepid, while online sales maintained relatively higher growth. Concerns about the labour market and broader economy and equity market volatility may cap consumer sentiment, but tax cuts and measures to support consumer durables and employment could help at the margin.
Exports (USD) (yoy)	Aug	-1.0%	2.2%	3.3%	The trade data continued to show soft external and domestic demand, albeit nascent signs of bottoming. China's trade with the US deteriorated further, with additional tariffs on each other imposed since 1 September posing downside risks. Investor optimism has grown of a breakthrough in trade talks (at an early October meeting), with the goodwill gestures from both sides, such as China's resumption of agriculture purchases (and signal of willingness to buy more), the US delaying the next round of tariffs by two weeks, and tariff exemptions on some products by each other. That said, we think challenges remain to achieve a comprehensive deal, as there appears no significant shift in the US or Chinese positions on key trade issues. Outside the US, trade with Europe and Japan were also weak. Robust exports to some markets in ASEAN and Taiwan could partly reflect the effects of production relocation. Import demand for processing trade continued to post large YoY contraction, while non-oil ordinary imports, a gauge for domestic demand, was sluggish but showed tentative signs of bottoming. Import volumes for major commodities were mixed. Overall, we do not expect a major turnaround in domestic demand, though policy support helps.
Imports (USD) (yoy)	Aug	-5.6%	-6.4%	-5.3%	
Trade Balance (USD)	Aug	34.8 bn	44.3 bn	44.6 bn	
CPI Inflation (yoy)	Aug	2.8%	2.7%	2.8%	Rising food prices (especially pork) continued to drive headline CPI inflation higher towards the 3% upper inflation target, which will likely be a hurdle for aggressive monetary easing, though low and stable core CPI inflation allows policy flexibility to stay accommodative. The government has rolled out measures to address the surging pork prices (e.g. increasing supply, providing some subsidies and supporting pig farming, etc.). PPI YoY deflation deepened on lower oil prices and weakness in oil-related sectors, indicating limited producer/supply cost-push pressures.
PPI Inflation (yoy)	Aug	-0.8 %	-0.9%	-0.3 %	
Total Social Financing (TSF)(RMB)	Aug	1,980 bn	1,605bn	1,003 bn	Narrower declines in off-balance sheet credits supported the YoY credit growth, off-setting a slowdown in local government special bond issuances, while bank loans and corporate bond issuances also fell YoY. We expect policy easing to support a modest pickup, but not a strong rebound, in credit growth. The interest rate reform, mainly via using the loan prime rate (LPR) to replace the benchmark lending rate as the reference rate for new loan pricing and linking the LPR to the medium-term lending facility (MLF) rate (which better reflects banks' average marginal funding cost), is aimed at improving policy transmission to lower corporate financing costs.
New yuan loans (RMB)	Aug	1,210 bn	1,200bn	1,060 bn	

Indicates improved data on month-on-month/quarter-on-quarter/year-on-year basis

Indicates worsened data on month-on-month/quarter-on-quarter/year-on-year basis

Indicates no change in data on month-on-month/quarter-on-quarter/year-on-year basis

Source: Bloomberg, HSBC Global Asset Management, as of September 2019

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