Chi Time

FOR PROFESSIONAL INVESTORS – 1 December 2017

CHINA'S 2018 OUTLOOK AND IMPLICATIONS

The past, like the future, is indefinite and exists only as a spectrum of possibilities.

Stephen Hawking

Real growth momentum is slowing but by a lesser extent than I have expected. Real GDP growth slowed to 6.8% in 3Q 2017 (versus my 6.7% expectation) from 6.9% in 1H 2017. Growth will continue to nudge down due to a slowing housing market[1], scaling back of fiscal stimulus, the lack of "animal spirits" (Chart 1) and easing export growth.

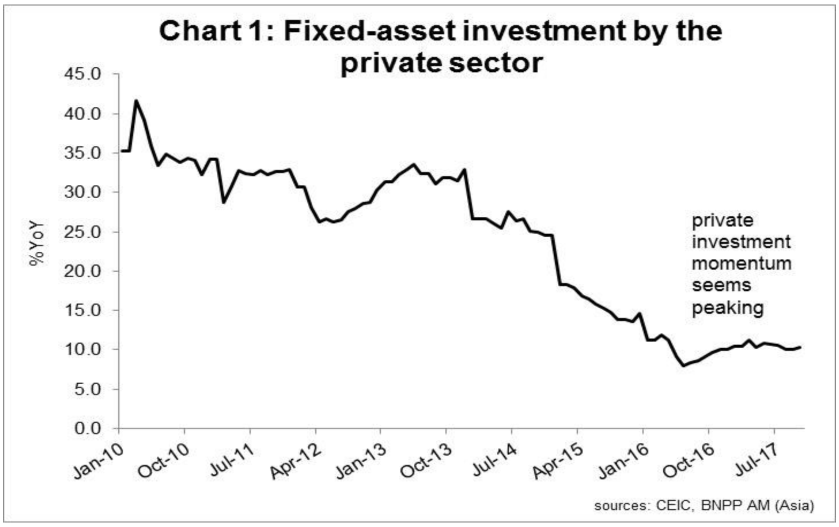


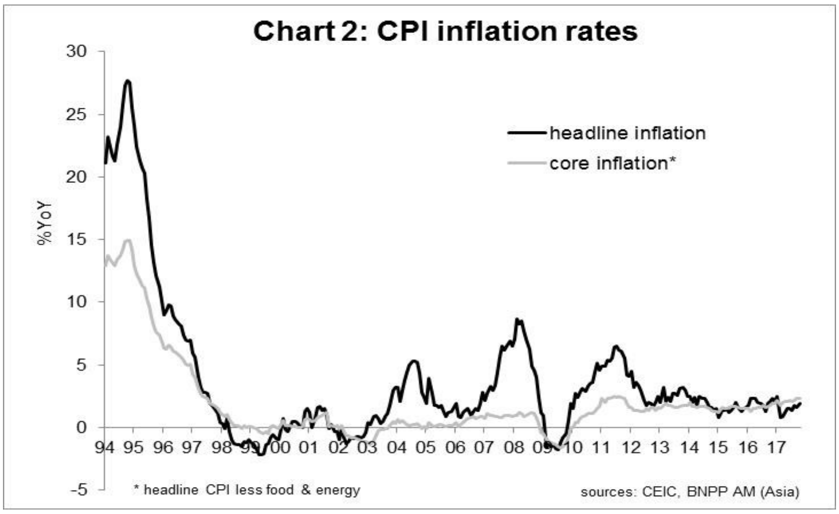
Chart 1: Fixed-asset investment by the private sector

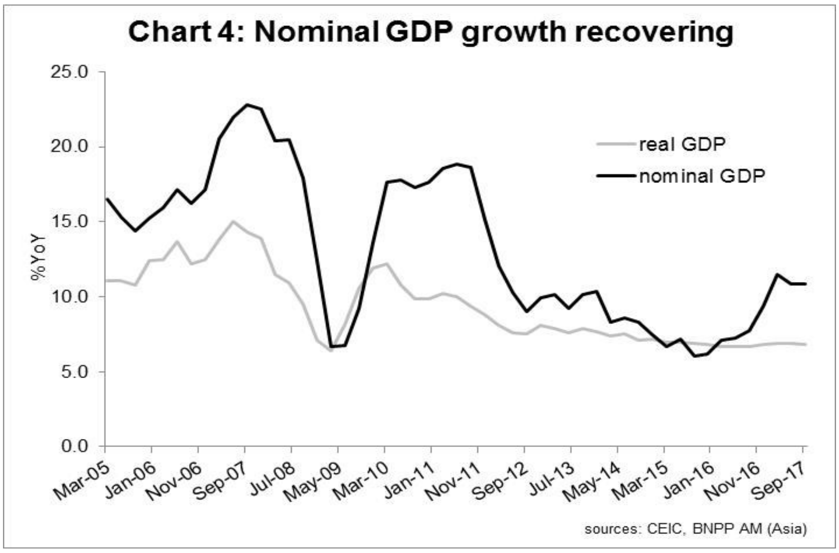
[1] Property sales have been contracting since September, construction starts have turn negative since October and mortgage lending growth has weakened recently as more city governments have tightened policies on mortgages and housing sales.

There is no justification for monetary tightening. Inflation has remained in check (Chart 2). PPI inflation has peaked (Chart 3) but remained elevated at around 6% YoY. Upstream inflation has boosted nominal growth (Chart 4) and corporate earnings for the industrial sector (witness the strong recovery in industrial profit growth this year). The lack of trickling down of PPI inflation to CPI argues for constrained growth momentum and no monetary tightening.

Impact on Chinese equities

This benign macroeconomic backdrop should be favourable for Chinese equities in the coming year. Furthermore, the recent liberalisation measures to allow a significant increase in the share of foreign ownership in the onshore financial sector and gradual repositioning of global funds to trim their underweight positions on China should help increase foreign demand for onshore equities. Inclusion of Chinese onshore stocks and bonds in international benchmark indices from 2018 onwards will help improve investors' sentiment towards renminbi assets further.

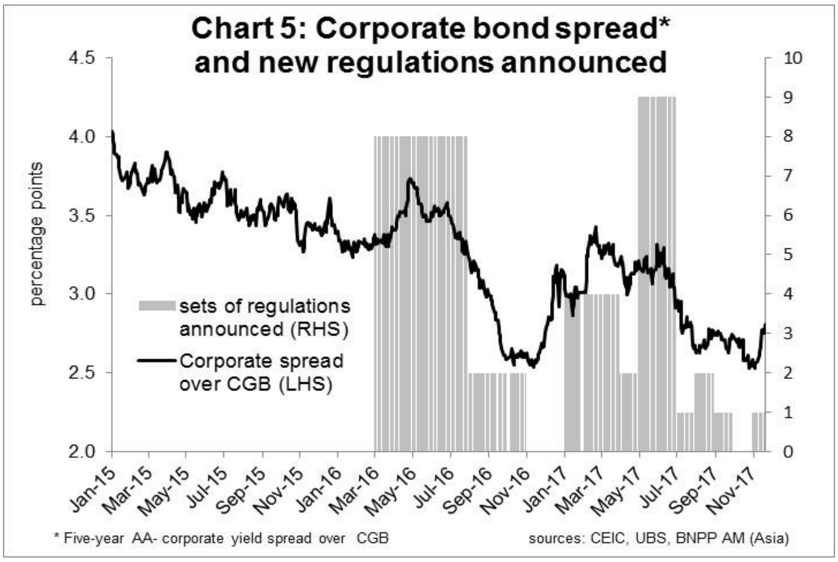




Intensifying deleveraging effort

A stabilising economy has encouraged Beijing to move sooner than expected to intensify its debt-reduction efforts after the 19th Party Congress. Since October this year, the authorities have started tightening up regulations again after a four month pause to rein in the asset management business to further reduce regulatory arbitrage and systemic risk.

This has caused a knock-on effect on the onshore bond market as asset management companies and other non-deposit-taking financial institutions (NDFIs) have been forced to shrink their balance sheets and sell off assets to comply with the new regulations. Indeed, onshore yield spread has risen since Beijing started flooding the system with new regulations early last year to improve supervision on financial innovation (Chart 5).



The selective tightening of monetary and regulatory policies this year aims at reducing debt in the wholesale funding market where most of the financial risk resides. Credit growth to the rest of the system has not been affected.

The objective of the debt-reduction policy at this stage is to reduce systemic risk and encourage banks to diversify lending to the new economy[2], but not to cut the debt ratio to any specific level. In stage two, which will likely start in 2018 (in my view), the effort will shift from cutting local-government and NDFI debts to SOE debt, which should then start to reduce the debt-to-GDP ratio[3].

Upside risk for Chinese yields

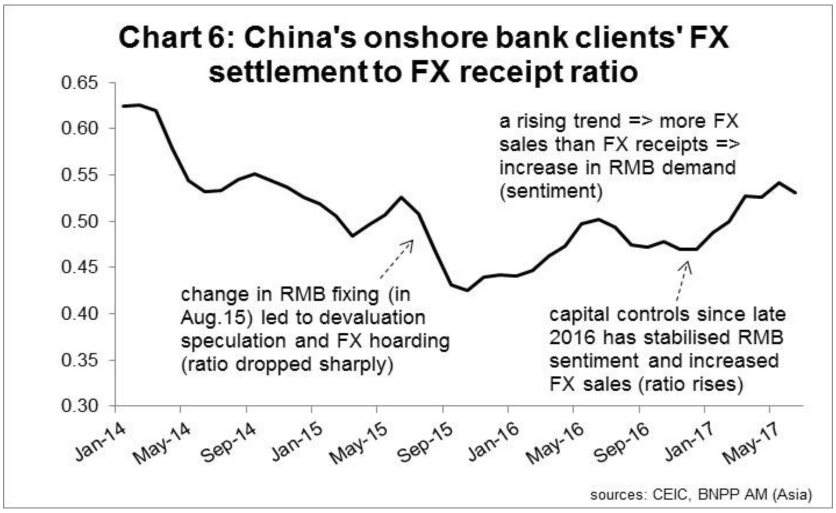
Meanwhile, even though CPI inflation has remained low at less than 2% YoY, core CPI inflation has risen slightly above 2% and higher than the headline CPI inflation (see Chart 2). Together with the PPI strength sustained at 6% YoY, investors are starting to pay attention to the inflation trajectory again with some worrying about unexpected monetary tightening (even though the macroeconomic backdrop still argues for no such risk).

All this has pushed up onshore bond yields again since October this year after a four-month decline/stabilisation. Short-term downward pressure on the onshore bond market is now intensifying with local firm- and sector-level risks rising but not systemic risk. Staying short duration is a preferred tactic at this time.

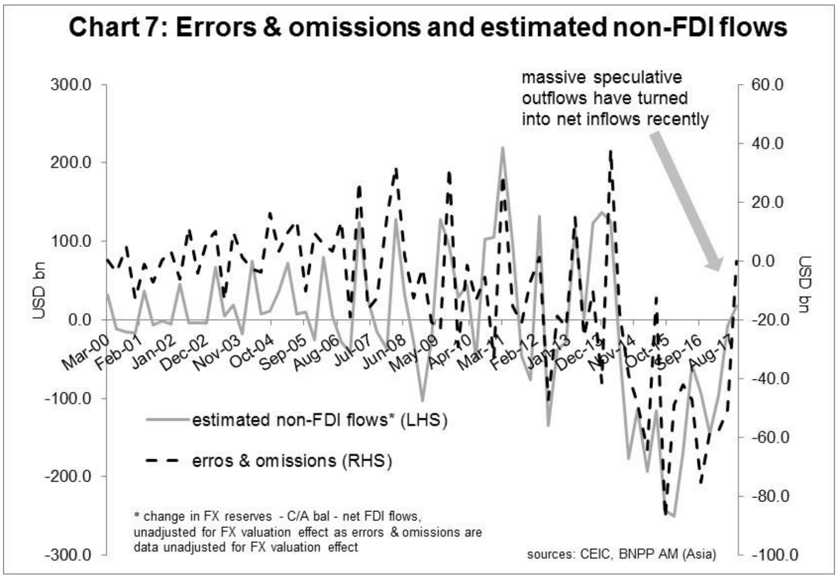
Structurally, the recent opening up of the onshore financial sector to more foreign participation is credit positive for the Chinese capital market over the medium- to long-term by increasing market discipline and inflows of foreign liquidity.

Renminbi and FX policy

The renminbi has strengthened against the USD since H2 this year on improving capital flows dynamics, with improving renminbi sentiment (Chart 6) and effective capital controls reducing speculative capital outflows (Chart 7). Meanwhile, China's current account has remained in a surplus of about 2% of GDP. Unless the USD soars again in the coming year, these capital flow dynamics will continue to underpin the strength of the renminbi, which is expected to rise by another 2% YoY against the USD in 2018, in my view.



[2] See "*Chi Flash: Questions and Answer for the PBoC's Surprised Cut in the Bank Reserve Requirement Ratio (RRR)*", 4 October 2017.
[3] See "*Chi on China: China's Deleveraging Strategy and Evidence*", 22 November 2017.



The PBoC is expected to continue its dirty-float FX policy, in my view, by shifting between targeting the CNY-USD cross rate and trade-weighted exchange rate (CFETS) depending on renminbi sentiment[4]. In general, the PBoC uses the CNY-USD cross-rate as an adjustment factor during normal times to anchor a stable CFETS index. But when renminbi sentiment becomes extremely negative and volatile, as seen in 2015-2016, causing rampant capital outflows, the PBoC shifts to target a stable CNY-USD cross-rate and allows the CFETS index to adjust.

With renminbi sentiment turning positive due to a stabilising Chinese economy, declining capital outflows and receding worries about a debt crisis in China, and if the USD remains stable or weakens further, a return by the PBoC to target a stable CFETS index points to a strengthening renminbi against the USD in the coming year, *ceteris paribus*.

What can go wrong?

China seems to be moving into a Goldilocks state where growth and inflation are not too hot and not too cold, but just right for macroeconomic policy to hold steady to support an average of 6% growth and facilitate more structural reform and deleveraging efforts in the coming year. The risks that could derail such a benign backdrop would be Beijing's overly hawkish deleveraging and property market policies leading to credit events triggering broad economic volatility, significant strengthening of the USD and escalating geopolitical risk especially from North Korea and South China Sea.

Chi Lo, Senior Economist, BNPP AM

[4] See "*Chi Flash: China's FX Policy Tactics and the Renminbi's Outlook",* 22 May 2017.

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Hotline: 2533 0088 Address: 30/F, Three Exchange Square, Central, Hong Kong.