

The State strikes back and the squeeze is on...

Insights

Since China initiated its economic reforms in 1978, the nation has experienced an average GDP growth rate of over 9% per year, lifting nearly 800 million people out of poverty.

This remarkable trajectory had set high expectations, particularly in 2023, when many anticipated China's economy would bounce back with vigour after the lifting of its stringent zero-COVID policy. The reopening of shops, tourism, and everyday life promised a robust recovery. It was supposed to be the beginning of another era of impressive growth.

However, the post-pandemic rebound failed to materialize as hoped. Instead of accelerating, China's economic momentum had gradually decelerated. The first quarter of 2024 registered growth of 5.3%, which fell to 4.7% in the second quarter, leading to rising concerns about China's long-term economic trajectory. The International Monetary Fund (IMF) had projected further deceleration, forecasting growth to dip to 3.3% by 2029, with even that figure potentially at risk. Amid increasing doubts from market watchers and economists, the consensus around China's ability to meet its full-year 5% GDP growth target for 2024 has started to erode, with many predicting it could fall short.

Nevertheless, just as skepticism reached its zenith, China appears to be preparing a strong counter-response. At the recent State Council press conference, PBOC Governor Pan announced a comprehensive package that surpassed market expectations, highlighting a strategic shift in macro policy of the country. The package is aimed at boosting confidence, stabilizing markets, and re-energizing the economy.

The package includes:

(I) Interest Rate Reductions:

- A 20 basis point (bp) cut to the 7-day reverse repo rate (the primary policy rate), reducing it from 1.7% to 1.5%.
- A 30bp cut to the 1-year Medium-term Lending Facility (MLF) rate.
- A 20-25bp reduction in both the Loan Prime Rate (LPR) and deposit rates.

(II) Reserve Requirement Ratio (RRR) Reduction:

- A 50bp cut to the RRR, resulting in a net liquidity injection of approximately 1 trillion yuan.
- The PBOC also hinted at the possibility of further RRR cuts, potentially by an additional 25-50bp, before the end of the year.

(III) Mortgage Policy Relaxation:

- Unification of the mortgage downpayment requirements: the minimum downpayment for second home mortgages will be lowered to 15%, aligning it with first home mortgage requirements.
- A 50bp reduction in mortgage rates for outstanding loans through refinancing, estimated to save borrowers around 150 billion yuan in interest payments.
- Modifications to the re-lending facility, originally created in May with a 300 billion yuan re-lending fund to support the purchase of housing inventory. The share of re-lending funds in such operations will now increase from 60% to 100%.

(IV) Support for Stock Market Development:

- The introduction of new instruments to foster stock market development, including a special refinancing facility for share buybacks and shareholdings.

- Banks will be guided to provide loans to support listed companies and shareholders in their buyback and shareholding activities.
- This comprehensive package aims to support the Chinese economy by addressing liquidity, stimulating the property market, and bolstering the stock market through a combination of monetary easing and targeted financial instruments.

On the fiscal policy front, while there hasn't been a substantial shift in the official narrative, market expectations are starting to build. The official statement emphasized two key points:

- Ensuring Necessary Fiscal Expenditure: This includes maintaining sufficient fiscal spending to support economic growth.
- Issuance and Proceeds Utilization of Ultra-Long Chinese Government Bonds (CGB) and Special Local Government Bonds (LGB): This focus on bond issuance was already highlighted in the July Politburo meeting, and special LGB issuance has seen a notable increase since then.

And the markets reacted positively.

As of writing (2nd October) the CSI Index has risen close to 30% from the February 2024 lows in USD. Hang Seng is higher by 37% and MSCI China Index is up 40% over the same period. Just for context, between the peak of 2021 and trough 2024, i.e. in three-and-a-half years, the CSI 300 index lost -46%, Hang Seng lost 41% and MSCI China lower by 50%.

Although it looks like we are at the head of a cyclical bull market now, unlike the previous two bull markets, which saw Chinese indices rise by around 150%, this time the recovery is likely to be more modest against the backdrop of a balance sheet recession, which occurs when high levels of private sector debt cause individuals or companies to collectively focus on saving by paying down debt rather than spending or investing, causing economic growth to slow or decline.

Will these interventions be enough to address the structural issues beneath the surface, or are they simply short-term fixes for deeper, more systemic problems? As the narrative continues to unfold, investors and global market participants are watching closely to see if this is the turning point for China's economic recovery—or simply another phase in its gradual deceleration.

We maintain the view that while these stimulus measures may provide short-term relief, they fail to address China's more entrenched, structural challenges. The government's ongoing emphasis on "common prosperity" continues to influence capital allocation, which has historically been suboptimal in many instances (e.g., the overproduction of EVs for which demand is minimal or restricted by regulation). Furthermore, China's over-reliance on the real estate sector, persistent issues with shadow banking and high leverage, and unfavourable demographic trends present obstacles that will require more substantive, long-term reforms rather than temporary policy

adjustments. Crucially, these measures do little to mitigate geopolitical risks, including the tariff risk associated with the upcoming U.S. elections and the ever-present tail risk surrounding Taiwan.

Much like the market's response to escalating conflicts in the Middle East, investors are once again compartmentalizing long-term risks, choosing instead to focus on immediate developments. At present, China's stimulus measures have captured attention, and with relatively few investors holding significant positions in the country, the market squeeze is intensifying. As a result, ample capital is poised to re-enter China's markets at the first signs of stabilization. This could lead to a classic "fear of missing out" scenario, as buyers are lured back into the market in hopes of capitalizing on short-term gains. Long-term issues remain however, and there is no silver bullet that will return China to the double-digit growth levels it once enjoyed. The structural challenges of debt, deflation, and demographics are too deep-seated for any single policy to resolve. While the stimulus may offer short-term support, these more profound issues will require sustained, comprehensive reforms to ensure long-term economic resilience.

Another looming risk that could offset the positive effects of the stimulus is the 2024 elections in America, where the potential for increased tariffs or more stringent policies against China remains a real possibility.

As the months unfold, we can expect market reactions to reflect whether investors regain confidence in China's economic narrative or remain cautious amid global uncertainties. Vigilance is critical, as geopolitical tensions and domestic economic challenges continue to influence China's future. That said, the stimulus package is at least a step in the right direction—a sign that Chinese policymakers are acknowledging the urgency of re-energizing their economy.

For now, we maintain a Neutral stance on Chinese equities within our Global Balanced – Asia Tilt Strategy, as we wait for more concrete signs of recovery in the real economy and for China to return from a week long celebrations for National Day Golden Week.

For now though the squeeze is on!

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