Market Bulletin

August 12, 2019

China's economy and policies: A mid-year review

In brief

- Amid renewed U.S.-China trade uncertainty, Chinese growth figures dipped in 2Q19, dampening sentiment among investors.
- Facing growth pressure, the People's Bank of China (PBoC) has shifted to a more supportive policy stance. However, given the persistent concern over a debt bubble, the central bank still prefers more gradual approaches to support specific economic sectors.
- With personal and corporate tax reduction already in place, the next stage of fiscal stimulus is focused on infrastructure investment, which is likely to have a more immediate impact on domestic demand.
- As stimulus measures increase, the Chinese government could prevent a hard landing and achieve the lower end of its goal of 6.0%-6.5% year-over-year real gross domestic product (GDP) growth.
- That said, short of a strong signal for improvement in both the internal and external environments, the prospect for stock market returns seems lackluster in the near term. The low valuations justify a long-term investment strategy, and investors need to be selective to control risk exposure to the trade friction.

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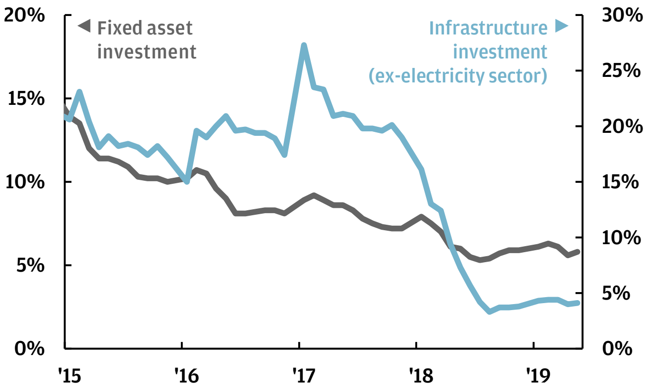
SOFTENING GROWTH MOMENTUM IN 2Q 2019

In 1Q 2019, China's economy remained resilient, and investors were optimistic amid fading trade tensions between China and the U.S. Against that backdrop, domestic policy makers took a step back from strong stimulus and advocated for neutral monetary policies in April. However, the earlier-than-expected pause in stimulus, compounded with resuming trade friction, weighed on economic growth in the second quarter.

China's real GDP growth eased to 6.2% year-over-year in 2Q 2019, 0.2 ppt below the previous quarter's reading of 6.4%. The slowdown mainly happened from April to May, as credit conditions tightened, dragging down investment activities (**Exhibit 1**). In June, economic activity data unexpectedly picked up, in line with faster credit expansion, particularly increases in local government special bond issuance.

Tightened credit conditions dragged down investment activities
EXHIBIT 1: INVESTMENT ACTIVITIES REMAIN WEAK
YEAR-TO-DATE, YEAR-OVER-YEAR CHANGE



Source: China National Bureau of Statistics, Wind, J.P. Morgan Asset Management. Data reflect most recently available as of 31/07/19.

Despite the recovery in June, pressures on the economy continue to mount, especially on the trade front. To counter the external shocks and ensure stability, incremental policy support is expected in the coming months.

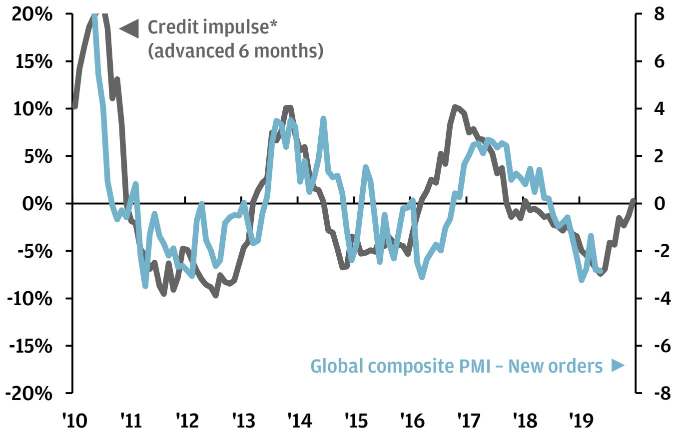
Monetary easing: Targeted easing as the major tool

The PBoC's policy priority has been balancing between growth and de-leveraging in recent years, and the pendulum has swung back to growth. That said, Chinese central bankers remain alert to the high debt level in the economy and threat of a bubble in the property market, and therefore, they will refrain from flooding the market with excessive liquidity that could potentially lead to speculative activities. Targeted approaches might be escalated to support specific parts in the economy, such as small- and medium-sized enterprises (SMEs) and technology sectors, according to PBoC Governor Yi Gang.

The major goal of targeted easing is to address the structural liquidity shortage for smaller banks, and encourage banks to lend to SMEs at lower interest rate. Following a 350 bps cut to the required reserve ratio (RRR) for small- and medium-sized banks, the PBoC has scaled up its relending and liquidity facilities since May. On July 23, the PBoC injected Chinese renminbi 297.7billion via targeted mid-term liquidity facilities (TMLF) to support bank lending to SMEs. The PBoC sets lower interest rates and longer maturity for TMLF than its other policy tools, in the hope of supporting banks' long-term lending to SMEs.

Given the recent easing measures, China's credit impulse, an indicator to measure the year-over-year change in aggregate credit, bottomed out (**Exhibit 2**). As the historical pattern suggests, this usually drives up global demand after a six-month time lag.

China's credit impulse bottomed out
EXHIBIT 2: CREDIT IMPULSE ON THE RISE, SUGGESTING POTENTIAL IMPROVEMENT IN GLOBAL DEMAND
% OF NOMINAL GDP, Y/Y CHANGE DIFFERENCE FROM ONE YEAR AGO



Source: Chinese Ministry of Finance, FactSet, People's Bank of China, J.P. Morgan Economic Research, J.P. Morgan Asset Management. Data reflect most recently available as of 31/07/19.
*Credit impulse measures the year-over-year change of credit flow (net total social financing plus government financing) as a percentage of nominal GDP.

That said, uncertainties still exist in the effectiveness of those targeted measures. Commercial banks still seem reluctant to lend to SMEs given the rising credit risks amid an economic downturn. Furthermore, tight restrictions to property-related loans will limit the pace of credit expansion. Given such uncertainties, the sustainability of credit expansion remains questionable. For this reason, across-the-board measures might be justified if growth data remains stagnant. In 2H 2019, it is likely to see the PBoC have RRR cuts of up to 100 bps, and a de facto lending rate cut via a liberalization reform.

Fiscal stimulus: Focused on infrastructure investment in 2H 2019

Fiscal stimulus, including tax reduction and infrastructure investment, is playing a leading role in this round of policy easing. The impact of tax cuts seemed insignificant on consumption and investment, since households and enterprises tend to hold back on expenditures when they are facing increasing uncertainties. Therefore, the government is putting more effort into boosting fiscal investment, which might be transmitted into domestic demand more immediately.

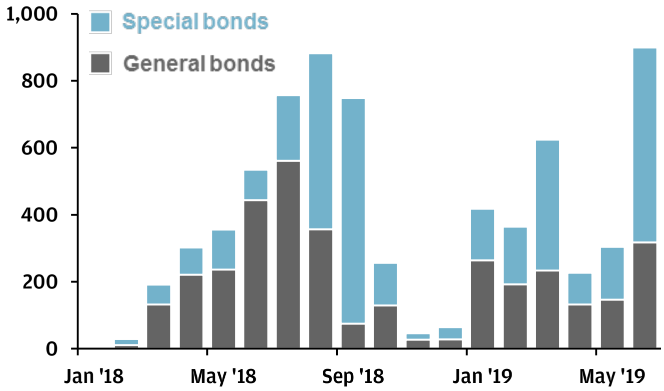
Given the elevated debt level of local governments, the Ministry of Finance (MOF) is attempting to maintain fiscal discipline when increasing investment capability. Specifically, the special local government bonds, which are monitored by the MOF, were introduced to raise funds for infrastructure projects. Meanwhile, China Development Bank is providing long-term and low-cost loans to local government financing vehicles (LGFVs), helping them to repay current debts with shorter terms and higher interest rates. With these tools, local governments' investment capacities might be improved, along with the transparency of their financing.

After transient deceleration in April and May, the issuance of special bonds hiked to Chinese renminbi 581.8billion in June (**Exhibit 3**). Furthermore, a new rule was announced to boost the power of these bonds. Local governments are allowed to invest their proceeds from special bond issuance as equity capital in qualified projects, including railways and highways, and then leverage up with additional loans from banks. Under this new rule, an additional Chinese renminbi 1.3trillion might be raised. With these measures, the infrastructure investment growth might rebound to 10% year-over-year during the remainder of this year.

Chinese government continues to boost fiscal investment

EXHIBIT 3: SPECIAL LOCAL GOVERNMENT BOND ISSUANCE PICKED UP IN JUNE**

RMB BILLIONS



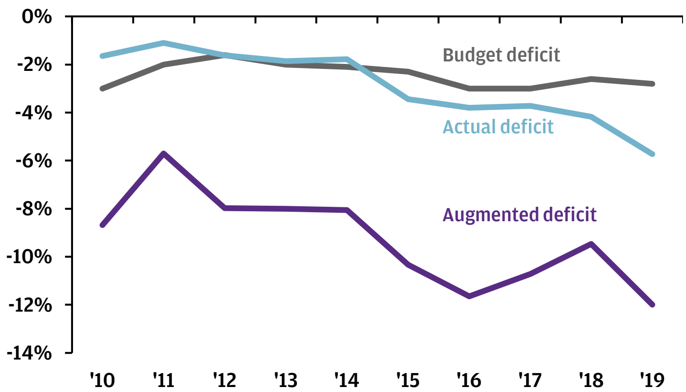
Source: CEIC, China Central Depository & Clearing Co. Ltd., J.P. Morgan Asset Management. Data reflect most recently available as of 31/07/19.
**A general local government bond is issued to raise funds and offset fiscal deficit so as to maintain the ordinary operation of local government. It is backed by the future fiscal revenue of the local government. A special local government bond is issued to support the investment in a specific infrastructure or public project. It is backed by the future revenue from the project.

Based on the current pace of fiscal expansion, the augmented government deficit, which covers fiscal deficit and government-led investment, is likely to reach 12% of GDP in 2019. If the growth pressures continue to mount, the MOF might increase stimulus measures, including upward revisions to the deficit target and debt ceiling for local governments.

China's augmented government deficit to rise further

EXHIBIT 4: AUGMENTED GOVERNMENT DEFICIT* MIGHT HIT 12% OF GDP**

% OF NOMINAL GDP



Source: Agricultural Development Bank of China, CEIC, China Development Bank, China Trustee Association, People's Bank of China, J.P. Morgan Asset Management. Data reflect most recently available as of 31/07/19.
***Actual deficit = tax and government fund revenue - government expenditure. Budget deficit = actual deficit adjusted with the fiscal stability fund. Augmented deficit is an estimate of all the fiscal resources motivated by the government to support economic growth, i.e. fiscal balance plus investment via local government financing vehicles, policy banks and other channels. 2019 is a J.P. Morgan Asset Management estimate.

Investment implication

Although the Chinese economy faces near-term pressures, the likelihood of a hard landing is low given the government's accommodative policies. We have also observed positive development in long-term policies, e.g. accelerated opening up of financial markets and enhanced protection for intellectual property rights. These might herald a new round of reforms to improve China's long-term growth potential. The current low valuation of China stocks reflects cautious sentiment, while it might imply a higher safety margin and a long-term entry point.

As uncertainties sustain in trade policy and global growth, a more active approach in sector and company selection within China is required. We prefer sector leaders in consumer, health care and industrials, which have less exposure to the trade uncertainties. Meanwhile, investors may consider increasing bond investments as a way to diversify the risks.

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