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China: rate cuts amid economic weakness

Key takeaways

- China released weaker-than-expected industrial production and retail sales data and the PBoC delivered earlier-than-expected rate cuts today.
- Chinese equities were down today due to rising concerns over China's macro weakness. CNY depreciated to a 9-month low due to rate cuts.
- On Chinese equities, we think the market has possibly priced in the short-term challenges. We retain our constructive longer-term views on stimulus and low valuations.

1. What happened?

Today the PBoC cut the rate at which it lends 1-year liquidity to the Chinese banking system, the so-called Mid-Term Lending Facility (MLF) rate, by 15 bps to 2.5%. In addition, the 7-day reverse repo rate was cut by 10 bps to 1.8%. The earlier-than-widely-expected rate cut was likely triggered by disappointing macro data also released today.

In July, both industrial production and retail sales growth slowed from June and came in below the median analyst forecast (industrial production: +3.7% YoY vs. 4.3% expected, retail sales: +2.5% YoY vs. +4.0% expected), echoing the earlier reported slump in private credit demand in July and increased deflationary pressures. In addition, the urban unemployment rate rose to 5.3% (vs. 5.2% expected). Youth unemployment was not reported today. In the first seven months of the year, fixed asset investment grew 3.4% YoY (vs. 3.8% Jan-Jun), missing market forecasts of 3.8%.

Following today's move, an equivalent cut in the 1-year and 5-year loan prime rates (LPRs), the rates that Chinese commercial banks lend to their best corporate and retail clients, is likely next Monday. However, an asymmetric cut, such as a 15 bps cut in the 1-year LPR and a 20 bps cut in the 5-year LPR, could also be on the table, as weakness in the housing market is the biggest short-term headwind to the economic recovery and the latter serves as a benchmark for mortgage rates. In addition, a 25 bps cut in the Reserve Requirement Ratio in Q3 would provide more liquidity to the economy and also support the issuance of special local government bonds going forward.

2. How did markets react?

China's equity indices were generally down due to the weak macro data. Hong Kong's Hang Seng Index was down 1.0% and the Hang Seng Tech Index was down 0.7% today. The Shanghai Composite Index was down 0.1%, while the Shenzhen Component was down 0.7%. CNY depreciated 0.34% against USD to 7.283 as of 6pm Hong Kong Time today due to the rate cuts – its lowest level in 9 months.

3. What does it mean for investors?

With the weak macro conditions, we expect further housing policy easing measures (in lower tier cities) in the coming weeks, such as loosening the definition of first home mortgage and home purchase restrictions, and lower downpayment requirements, as well as additional fiscal support to boost infrastructure and targeted tax cuts for high-end manufacturing.

Meanwhile, the more difficult task for policymakers remains to restore confidence among home buyers and consumers to support a recovery in household consumption of goods and to encourage private entrepreneurs to increase their investment activity to boost employment and household incomes.

So far, China's economic recovery has been uneven and largely driven by strong demand for services - mainly travel, leisure, accommodation and restaurants. While it is difficult to imagine a significant change in this pattern during the current summer season - the first without travel and contact restrictions in three years - a return to "normality" in the autumn could lead to a more balanced development in the coming quarters, which is likely to increase the multiplier effect of the support measures implemented so far and those expected to be implemented in the future. Such a scenario could underpin rising demand for goods, leading to an increase in manufacturing output, and an improvement in earnings growth for Chinese companies - possibly finally setting the stage for a stabilisation of investor confidence in Chinese equities.

This could also be supported by a possible reduction in stamp duty on stock transactions. Although the China Securities Regulatory Commission has yet to issue an official statement on the matter, such a move could support market sentiment, as Chinese equity markets are sensitive to policy changes that affect market liquidity.

Chinese equities traded down much more throughout the day and stabilized later on. In aggregate, today we got quite a lot of news, but the price action suggests that the market has possibly priced in the short-term challenges and has taken away from today's policy action that the Chinese government is keen to address investor sentiment by (1) lowering rates earlier than expected, (2) pausing the display of youth unemployment and (3) contemplating to drop stamp duty on stock trading. We retain our slightly more constructive views in longer term due to the likely more aggressive stimulus measures and the low valuations.

Glossary

CNY is the currency code for the Chinese yuan.

The Loan Prime Rate (LPR) is the interest rate that banks use as a basis to set rates for different types of loans, credit cards and lines of credit.

Medium-term Lending Facility (MLF) refers to the monetary policy tool provided by the central bank to provide medium-term base money.

The NASDAQ index is a market-capitalization weighted index of around 3,000 equities listed on the Nasdaq exchange.

The People's Bank of China (PBoC) is the central bank of the People's Republic of China.

Reverse repo rate (RRR) is the rate at which the central bank of a country (Reserve Bank of India in case of India) borrows money from commercial banks within the country.

USD is the currency code for the U.S. Dollar.

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