CIO Perspectives

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Key Points

- PBOC's new loan rate is a move toward lower effective borrowing rates.
- The banking sector to stay resilient as the drop in new lending rates is compensated by a lower cost of funding and a potential boost to loan growth.
- China financials trade at an estimated book value of 0.78x, excluding insurance companies and large banks, which are trading at the current year's estimated price-to-book valuation of c.0.6x.

China's lending reform – The loan prime rate

What happened?

On 17 August, the People's Bank of China (PBOC) announced a new loan rate quotation method that changes the way commercial banks set their lending rates. The intention is to provide cheaper funding for qualified corporates at a time when the world's second-largest economy needs a boost.

What does this mean?

The new loan prime rate (LPR) is linked to the rate of medium-term lending facility (MLF), which is the cost for banks to borrow from the PBOC. 18 participating banks will submit their LPR quotations – the interest rates banks their most creditworthy clients – to PBOC on a monthly basis. This is considered a de facto rate reduction as the MLF rate of 3.3% stands below the central bank's benchmark lending rate of 4.35% (Figure 1). The revamped LPR rate will be applicable to new loans and could help to lift capital expenditures and corporate investments.

A gradual reduction in borrowing costs is deemed timely as the country's leverage ratio has crept up since the global financial crisis which happened more than 10 years ago. The nation's corporate debt stands at 165% of its gross domestic product (GDP) value, of which a considerable portion is tied to state-owned enterprises, while the government's debt levels remain manageable (Figure 2).

As trade tensions linger, China's policymakers have proactively introduced different forms of monetary stimulus and fiscal measures to spur domestic growth. This revamp was also in line with other central banks in their respective policy rates reduction over the past two months.

This introduction of a revamped LPR is generally welcomed by China's corporate sector, especially those with credible business models and are well-positioned to jump on the bandwagon of surging domestic consumption – they account for more than 50% of the country's GDP.

What should you do?

We expect the banking sector to stay resilient as the drop in new lending rates is compensated by a lower cost of funding and a potential boost to loan growth. Large banks with stronger deposit franchise may stand to perform better given their abilities to better manage their balance sheets.

We are also constructive on China Financials given compelling valuations, supportive fundamentals, and robust balance sheets.

Rationales:

1. The non-performing loans (NPLs) are contained at 1.8% while the loan loss provisions (LLPs) are high (Figure 3). The NPLs have been below 2% whereas the LLPs have risen more than 3.5x since the start of the decade.
2. The decline in return on equity (ROE) is primarily due to a consistent higher growth rate in shareholders' equities, from the accumulations of retained earnings (Figure 4).
3. Compelling valuations and stable earnings outlook. China Financials trade at an estimated book value of 0.78x, excluding insurance companies and large banks, which are trading at the current year's estimated price-to-book valuation of c.0.6x (Figure 5).
4. The high earnings yield of 16% and dividend yield of c.5% offer room for re-rating, as the earnings outlook is expected to stay stable and interest rates continue to remain supressed. The c.6% dividend yield among China's large banks will be another catalyst (Figure 6).

We continue to advocate Asia ex Japan equities and reiterate our constructive stance on China Financials (large banks) which is integral in the income generating side of the Barbell portfolio, given its solid fundamentals and convincing operating framework. Another income generating sector in our Barbell portfolio is Singapore real estate investment trusts (REITs).

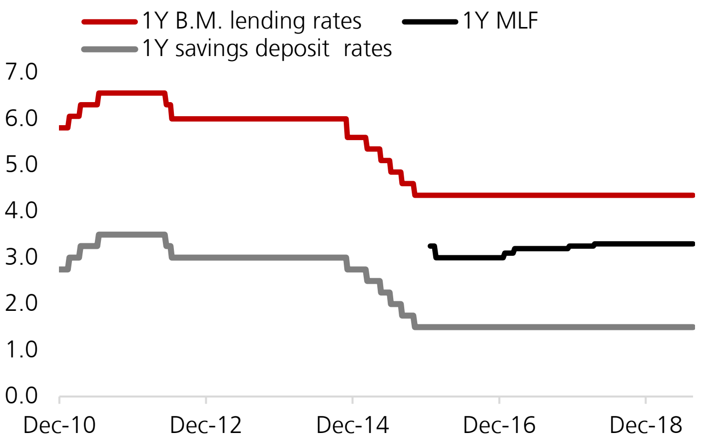
Global cross assets

Returns of cross assets around the world

Index	Close	Overnight	YTD
DJIA	26,252.24	0.2%	12.5%
S&P 500	2,922.95	-0.1%	16.6%
NASDAQ	7,991.39	-0.4%	20.4%
Stoxx Europe 600	374.29	-0.4%	10.9%
DAX	11,747.04	-0.5%	11.3%
CAC 40	5,388.25	-0.9%	13.9%
FTSE 100	7,128.18	-1.1%	5.9%
MSCI AxJ	605.37	-0.8%	1.5%
Nikkei 225	20,628.01	0.0%	3.1%
SHCOMP	2,883.44	0.1%	15.6%
Hang Seng	26,048.72	-0.8%	0.8%
MSCI EM	975.66	-0.8%	1.0%
UST 10-yr yield*	1.61	2.4	-107.1
JGB 10-yr yield*	-0.24	-0.1	-23.8
Bund 10-yr yield*	-0.65	2.5	-88.6
US HY spread*	3.93	-4.0	-133.0
EM spread*	375.41	-4.8	-59.2
WTI (USD)	55.35	-0.6%	21.9%
LMEX	2,734.90	-0.9%	-2.4%
Gold (USD)	1,498.06	-0.3%	16.8%

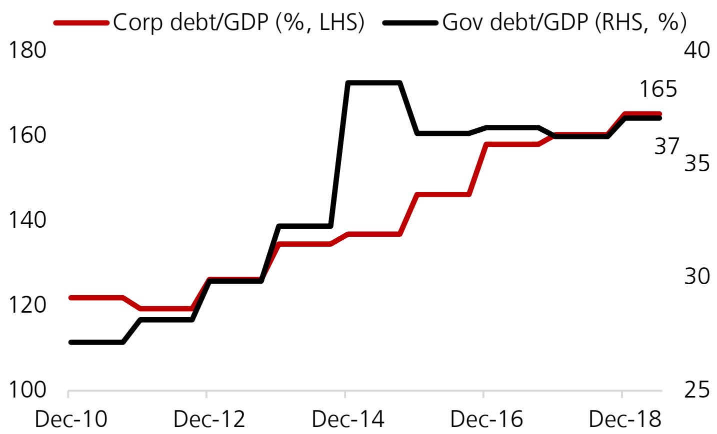
Source: Bloomberg
* Changes are in basis points

Figure 1: China's interest rates



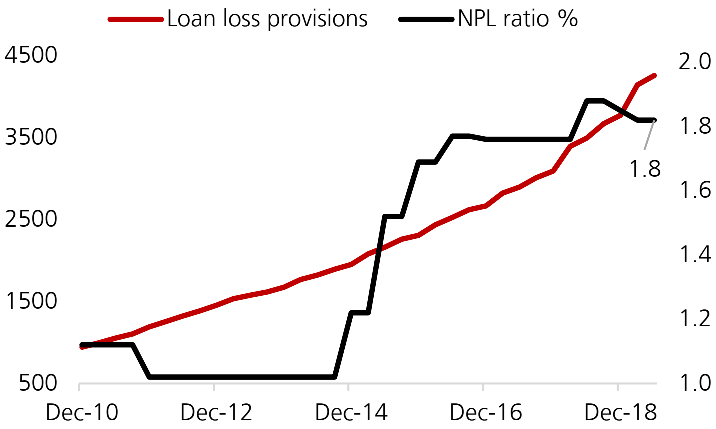
Source: Bloomberg, DBS

Figure 2: The country's leverage ratio has crept up



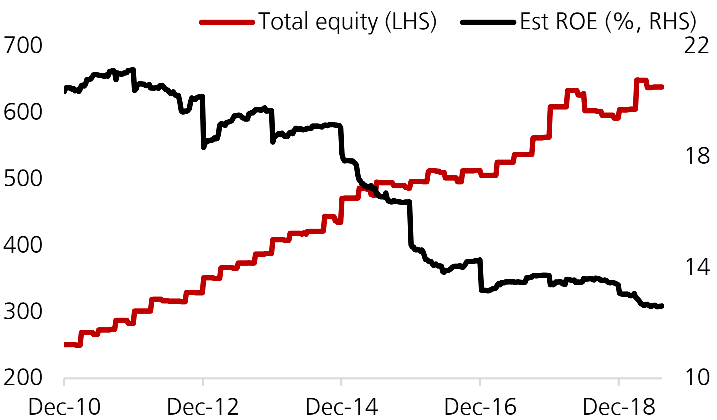
Source: Bloomberg, DBS

Figure 3: Rising LLPs on contained NPL ratios



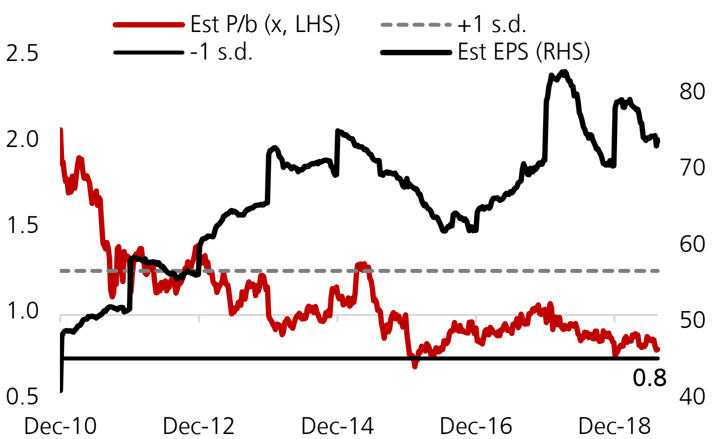
Source: Bloomberg, DBS

Figure 4: Banks are well-capitalised while earnings continue to grow



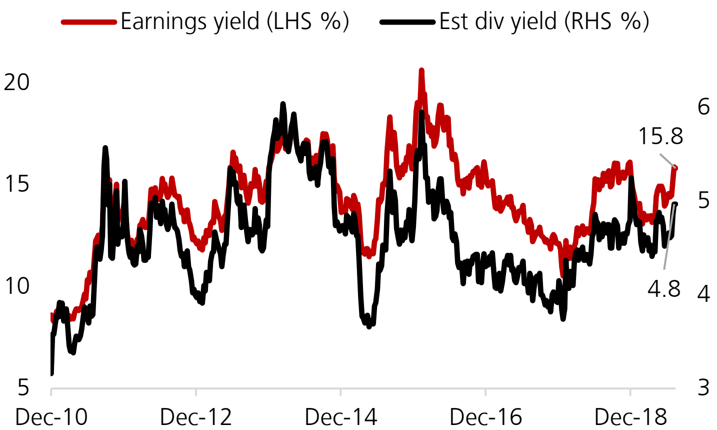
Source: Bloomberg, DBS

Figure 5: Price-to-book at a low range, earnings stay resilient



Source: Bloomberg, DBS

Figure 6: China financials on 16% earnings yield



Source: Bloomberg, DBS

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