Economics

DBS Flash

China: More policy support in the pipeline

Group Research

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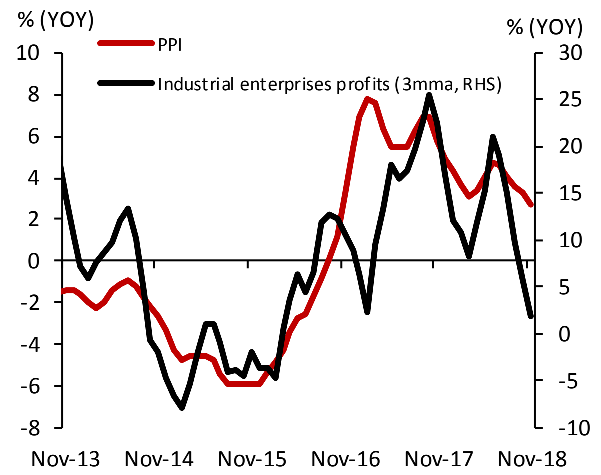
The People's Bank of China (PBoC) announced last Friday a blanket 100bps reduction of banks' reserve requirement ratio (RRR) to 13.5%. The reduction will be divided into two stages of 50bps, effective 15 January and 25 January respectively. Half of the freed-up liquidity will be used by banks to repay medium-term lending facility (MLF) loans. The net impact would be a cash injection of RMB800bn, the largest of the five cuts since 2018.

The timing of the move is in line with our expectation. **Sizable cash injection is warranted before Lunar New Year to offset huge drain of cash demand from households.** Corporate tax payments and maturities of interbank debts also prompted authority to replenish liquidity. By our estimation, the former will drain about RMB1tn from the system and RMB800bn for the latter.

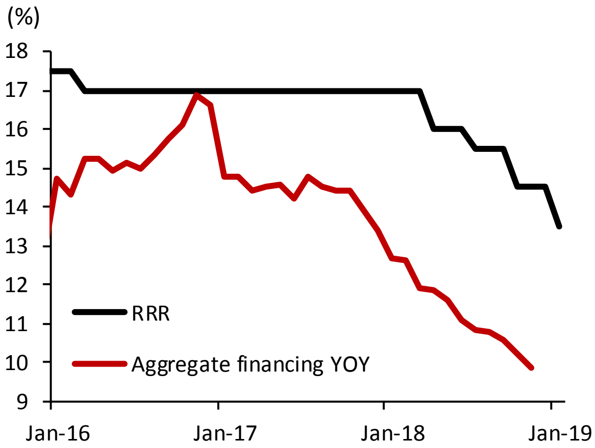
This reduction, the first all-inclusive cut since March 2016, also reflects government's heightening concerns over the worsening outlook. Retail sales growth tumbled to its lowest level in 15 years in November due to plunging car sales accounted for two-thirds of consumer durables. Trade data were weak due to faltering global demand. PMI also contracted after two years of expansion. As a result, industrial profits contracted for the first time in three years (Chart 1).

Chart 1: PPI vs profits



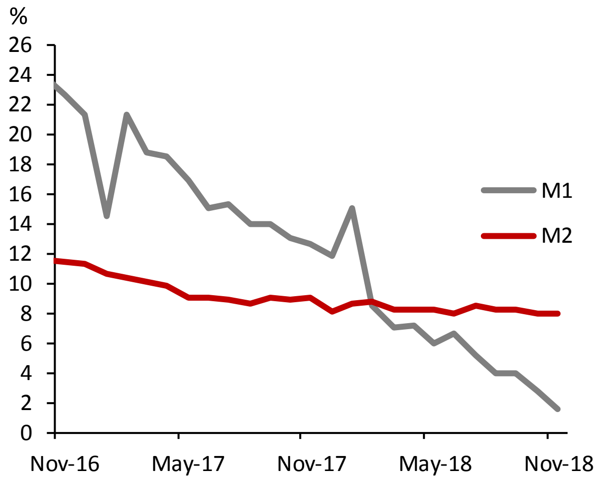
Economic uncertainties created by the lingering trade war will continue to dampen confidence before a deal is reached on 1 March. The China-US negotiations this week will be closely watched. Even If a partial deal is reached, broader tensions between the two nations on technology and industrial policy will remain, thereby impinging investment sentiments. PBoC's monetary policy will remain accommodative. We expect two more reductions on the reserve ratio alongside cutting reverse repo rate.

Chart 2: Aggregate financing and Required reserve ratio (RRR)



Unclogging the transmission mechanism is crucial. Despite a pro-growth policy tilt since H2 2018, credit expansion has not improved meaningfully due to heightening risk aversion. Aggregate financing moderated for the 16th consecutive month in November (Chart 2). Smaller companies face tremendous difficulties in securing loans in spite of high borrowing costs. The deterioration of corporate cash flow is evident by collapsing M1 growth (Chart 3).

Chart 3: M1 and M2 YOY growth



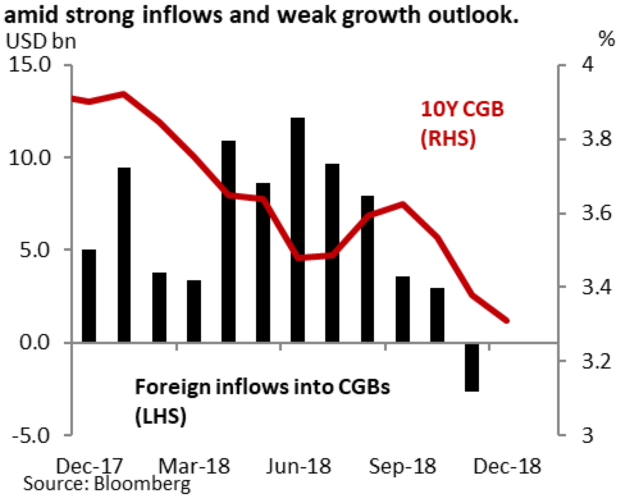
More measures are warranted to rectify policy transmission. In our view, the parameters for Macro-Prudential Assessments should be relaxed so as to strengthen banks' lending ability without compromising too much on risk assessments. Accelerating the pace of bad-loan sales is also an option.

The latest RRR cut would pose limited pressure on the CNY in the short term. Benign domestic inflation and a less hawkish Fed are providing leeway for PBoC to manoeuvre its toolkit. Meanwhile, the authority has repeatedly signalled tougher currency management since November in order to restrain capital outflow.

Bullish 10Y govvies

Friday's RRR cut is probably the first of several easing steps for 2019 and underpins our view that CNY rates will be held low in the coming quarters. Our China Nowcast model continues to show a downward trend in China's growth trajectory. Growth is projected to fall below 6.5% in 4Q2018 and below 6.0% in 1Q2019. This combination of slowing growth, increasing liquidity, further stimulus and easing should provide for a very favourable backdrop for China Government Bonds (CGBs). In 2019, we expect CGB yields to stay low and see the 10Y tenor (3.31% at end-2018) falling towards 3% in the short term.

Chart 4: CGB yields decoupled from rising global rates amid strong inflows and weak growth outlook.



Source: Bloomberg

Foreign inflows into CGBs have been very strong in 2018 (USD70bn through November) while much of EM saw outflows. Global investors could continue to find CGBs attractive for their prospect of capital gains (from falling yields) and portfolio diversification (from low correlation to US Treasuries). Foreign demand should also get a big boost from CGBs' upcoming inclusion in the Bloomberg Barclays Global Aggregate Index (expected April 2019). With USD2.5tn of AUM tracking the index, CGBs could see inclusion inflows of USD22-27bn in 2019 (based on 5.5%

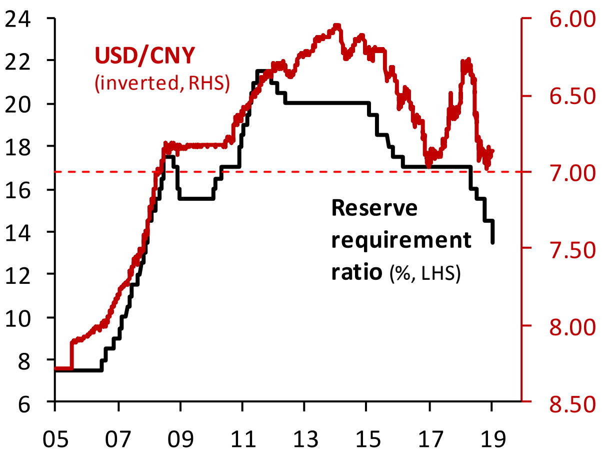
weight to be phased-in over 20 months and roughly equal split between CGBs and policy banks bonds).

To be sure, onshore interest rates have fallen significantly and positive new narrative on a possible China-US trade deal could drive yields higher. However, we think that China is still in the midst of a cyclical slowdown and there is little fundamental reason why rates should head higher just yet.

Chinese yuan is still at risk of breaking below 7

China's latest decision to lower the RRR by a total 100 bps in January underpins our expectations for the Chinese yuan to depreciate past 7 against the US dollar in 2019. We see two more reductions in the RRR totalling another 100-200bps later this year. Pay attention to the real GDP data release on 21 January; growth could fall below 6.5% YoY for the first time since 2009. This will support our call for China's economy to slow to 6.2% in 2019 from 6.6% in 2018.

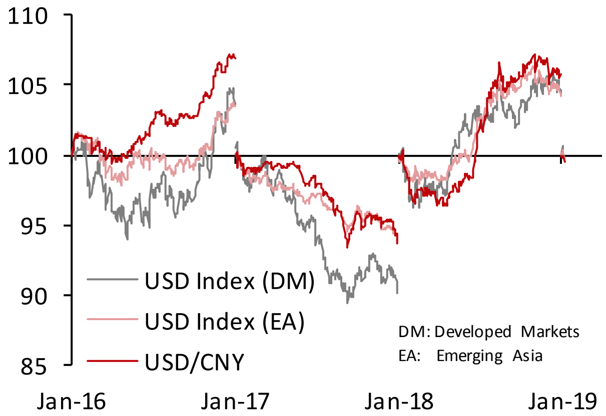
Chart 5: CNY to fall past 7 vs USD as China cushions its economy against trade tensions



On the other side of currency pair, we see another two increases in the Fed Funds Rate (in 2Q and 3Q) totalling 50bps to 3%. This should keep the US dollar firm against the currencies of China's trading partners especially those in Asia. After the one-off devaluation in August 2015, the yuan has been increasingly aligned with the major USD indices on an indexed basis.

Chart 6: USD/CNY is aligned with global USD trends

Indexed to previous year-end levels



Until the outcome in latest US-China trade truce proves as substantial as the working level discussions, the risk remains for more tariffs on each other's goods. According to our estimates, if the US reinstates the decision to lift the tariff rate on USD200bn worth of China's goods to 25% from 10%, the yuan could depreciate to 7.30. Under the worst-case scenario, US will impose a 25% tariff on the remainder of China's goods. This could pressure the yuan to 8 with negative spill-over effects into other Asian currencies.

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Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).