Emerging Markets

Green shoots in China

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> The recently announced fiscal and credit stimulus in China should be sufficient to create a growth stabilisation in 2019. First signs of a Chinese growth stabilisation were already visible in the first two months of the year, before the stimulus measures were announced.
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> We think that as these measures take effect, shares in Chinese and Hong Kong companies, as well as Western companies with a large exposure to China, should provide a tactical investment opportunity for 2019.

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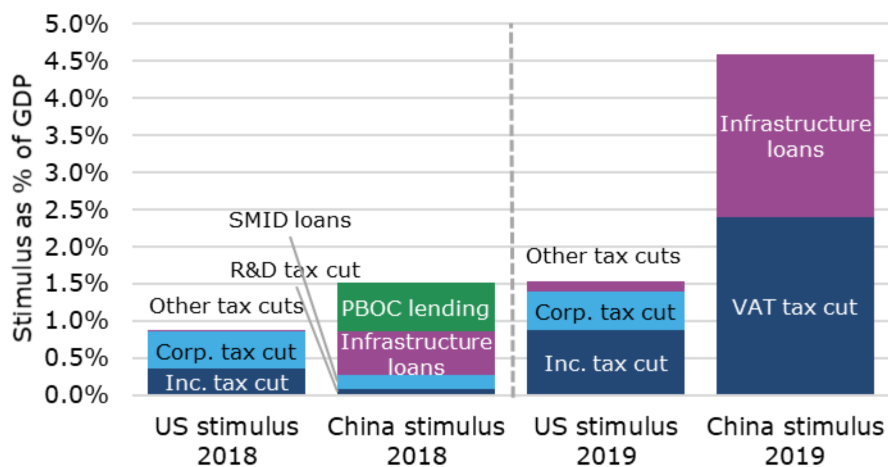
A massive stimulus to halt the slowdown

In our latest Long View report, we described how the current Chinese growth slowdown could impact Western developed economies and how to assess it against the backdrop of the long-term evolution of the Chinese economy.[1] Since then, the Chinese government has not only reduced its growth target for 2019 but, more importantly, announced an increase in the issuance limit of special government bonds (typically used to finance infrastructure projects) to CNY 2.15tn and VAT tax cuts that will likely save businesses taxes in the order of CNY 2tn. This is roughly the same amount as the CNY 4tn invested between 2008 and 2010 to protect the country from the effects of the Global Financial Crisis (GFC).

Fig. 1 provides a comparison of the Chinese stimulus programme with the current fiscal stimulus in the US from the 2018 tax reform. In order to facilitate the comparison, we have expressed each stimulus in terms of the country's GDP. The announced 2019 stimulus package in China amounts to a whopping 4.6% of Chinese GDP, while the impact of the income and corporate tax cuts in the US amount to a mere 1.5% of US GDP. In other words, the Chinese stimulus is massive, even without any announced monetary stimulus from the People's Bank of China.

Fig 1: US and Chinese stimulus in comparison



Source: US Congressional Budget Office, People's Bank of China, China Government Work Report, Fidante Partners.

[1] https://www.fidante.com/resources/the-long-view-q1-2019

The potential impact of this stimulus on Chinese GDP growth can be estimated using the fiscal multipliers calculated by an IMF study in 2017.[2] That study estimated the average fiscal multiplier to be 0.8 and the credit multiplier to be 0.2. However, the authors note that the fiscal multiplier may have increased to 1.4 in recent years, while the credit multiplier may have declined to zero, indicating that loan provision does no longer increase GDP growth.

> The good news is that the impact of the announced stimulus should be enough to boost Chinese growth to the 6.0% to 6.5% range in 2019.

Using these estimates, the likely impact of the announced stimulus measures in China would be to boost growth between 2.4% and 3.4% cumulative over two years. In our Long View publication, we showed that Chinese GDP growth was likely in the order of 5.7% in 2018 instead of the official number of 6.4%. In another study, the Brookings Institution recently estimated, that Chinese nominal GDP growth was overstated by 1.7% per annum between 2008 and 2016.[3]

No matter which result one uses, the good news is that the impact of the announced stimulus should be enough to boost Chinese real GDP growth to the 6.0% to 6.5% range in 2019, even if the underlying economy continues to weaken. This is great news for investors, because it could remove one driver of the economic slowdown observed in the Eurozone and the US. As a result, we are more confident than before that our expectation of no recession in the Eurozone and the US in 2019 may come to pass, and that any recession in either region will likely only materialise in 2020.

Investment activity is picking up

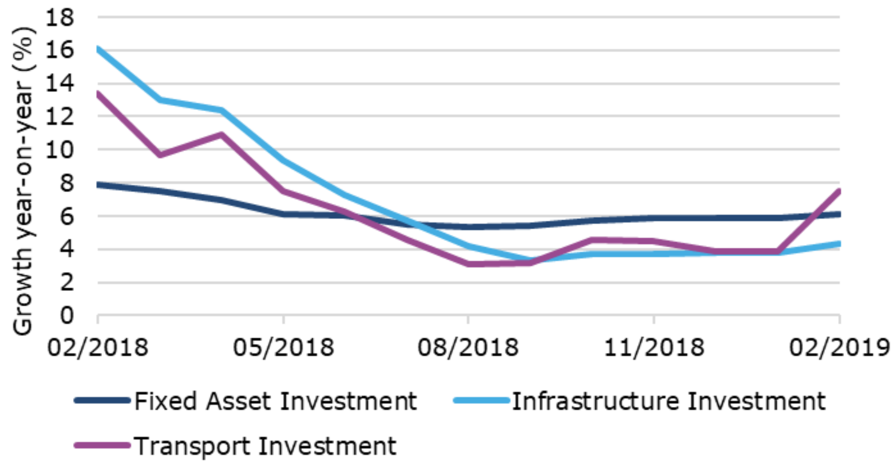
Even though the stimulus measures in China were only announced on 26 February, regional governments and state-owned enterprises (SOE) seemed to have opened their investment taps already before that date. Fig. 2 shows that fixed asset investment growth accelerated only a little from 5.9% at the end of 2018 to 6.1% year-on-year in February but infrastructure investments accelerated more, from 3.8% to 4.3%. Even more pronounced was the increase in investments in transportation infrastructure, rising from 3.9% growth year-on-year at the end of 2018 to 7.5% year-on-year in February.

Fig. 3 shows that it is mostly SOE that have engaged in this additional investment activity and that these projects seem to be predominantly financed by special government debt. Investment growth by SOE increased from 1.9% at the end of 2018 to 5.5% year-on-year in February, while the growth in special government debt accelerated from 32.6% to 37.5% over the same time frame.

[2] https://www.imf.org/en/Publications/WP/Issues/2017/12/12/Credit-and-Fiscal-Multipliers-in-China-45460

[3] https://www.brookings.edu/bpea-articles/a-forensic-examination-of-chinas-national-accounts/

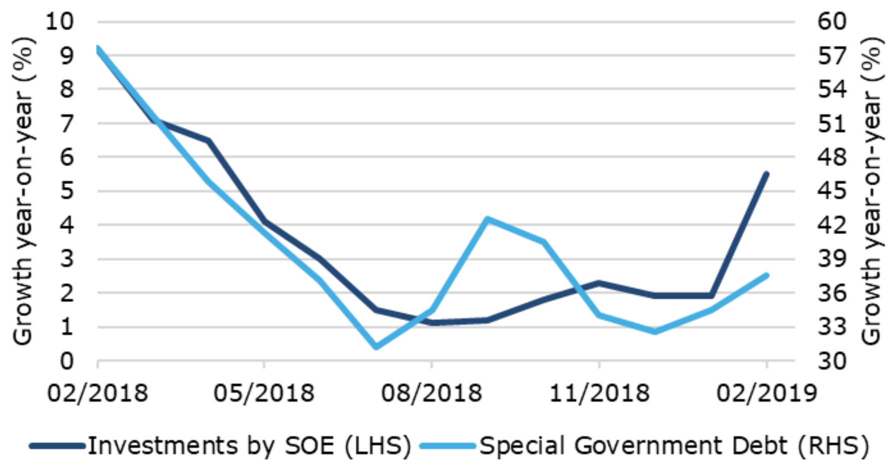
Fig 2: Chinese fixed asset investment growth



Source: China National Bureau of Statistics, Fidante Partners.

Going forward, we should expect these trends to intensify as more infrastructure loans are rolled out and the tax cuts provide an incentive for businesses to invest in capital goods and other tangible assets.

Fig 3: State-owned enterprises and regional governments lead the way

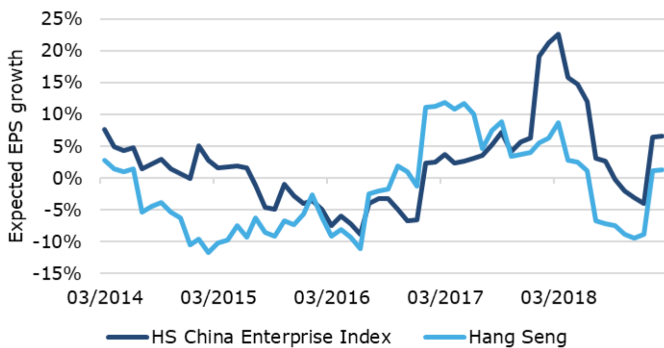


Source: China National Bureau of Statistics, Fidante Partners.

A tactical opportunity in Chinese shares

This development indicates to us that stocks with large exposure to the Chinese market, of which there are two types, should provide stronger earnings growth in 2019 than previously expected, and may be amongst the most attractive investments for the remainder of the year. The first type is the stocks of Western companies with a large export share to China, though the uncertainties around the trade war between the US and China complicate these investments. The second type is the shares in Chinese companies listed in China and Hong Kong. Fig. 4 shows the changes in consensus EPS growth over the last five years. Once the stimulus package was announced, expected EPS growth accelerated, though analysts still expect on average earnings to grow only 6.5% for China H-shares (i.e. the Hong Kong-listed large Chinese companies, such as Tencent or ICBC, that are represented in the HS China Enterprise Index), while the shares in the Hang Seng index in Hong Kong are expected to have flat earnings. This means that while analysts have become more optimistic about Chinese earnings growth, the hurdle to jump is still extremely low and there is plenty of room for positive surprises.

Fig 4: Optimism about Chinese earnings growth rises



Source: Bloomberg, Fidante Partners.

While earnings expectations for Chinese and Hong Kong stocks remain muted, the valuation discount of these markets relative to the MSCI World is still large. The Hang Seng trades at PE-ratios that are currently one third below the MSCI World and the HS China Enterprise Index is trading at a discount of c. 50%. And while these discounts are at the upper end of the range of the last five years, they are still much bigger than the discounts observed in 2010 or 2011. We believe a stable to potentially accelerating growth in China vs. declining growth in the US could be the trigger to narrow this valuation discount of Chinese and Hong Kong shares in 2019.

Fig 5: Valuation discount is shrinking

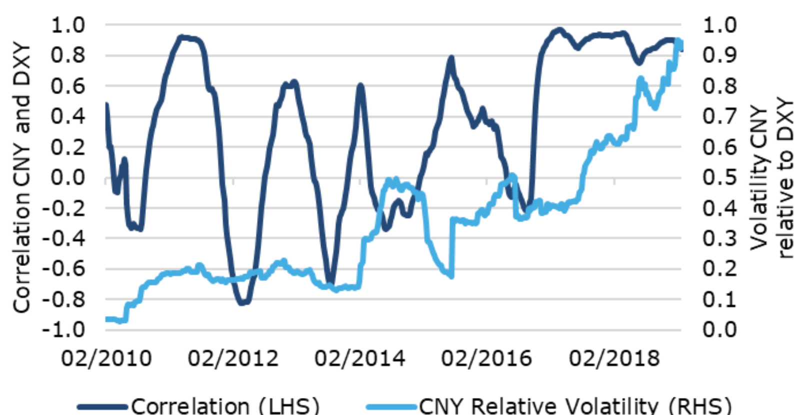
Source: Bloomberg, Fidante Partners.

A more flexible Renminbi should lead to a stronger Renminbi

Another outcome of this temporary Chinese growth stabilisation/acceleration could be a stronger Renminbi. Since 2016, the People's Bank of China (PBOC) has allowed the Renminbi to float more widely. As Fig. 6 shows, this meant that the correlation between the US Dollar-Renminbi exchange rate and the Bloomberg Dollar Index (DXY) has increased to levels above +0.8. Similarly, the volatility of the US Dollar-Renminbi exchange rate is by now almost as high as the volatility of the DXY.

In other words, the Renminbi is increasingly behaving like a free-floating currency, rather than a managed currency. Given the structural slowdown in Chinese growth, there is little incentive for the PBOC to abolish the managed exchange rate regime and enter a floating exchange rate regime anytime soon. But the bands in which the Renminbi can float are now wide enough so that traditional exchange rate mechanisms can have a material impact.

Fig 6: Increasing volatility and correlation in the Renminbi



Source: Bloomberg, Fidante Partners.

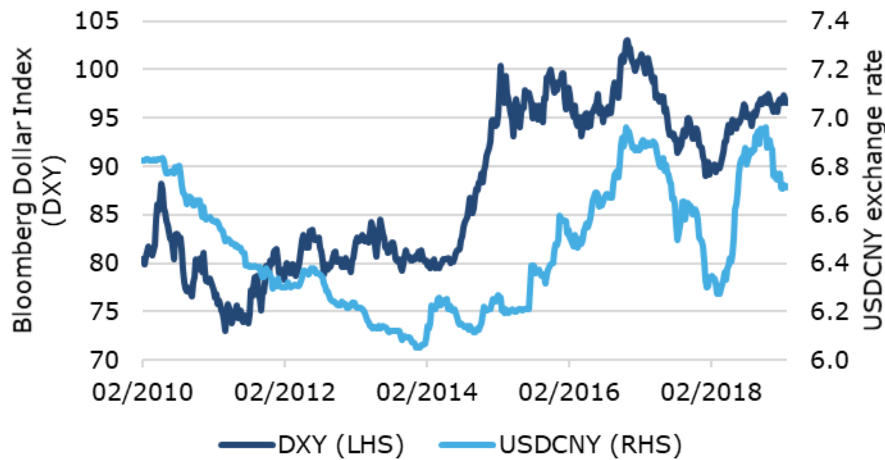
In early December 2018, the US Dollar-Renminbi exchange rate was flirting with CNY 7 per US Dollar, but since then the Renminbi has appreciated by 3.5% while the Bloomberg Dollar Index has declined only 0.6%.[4] But as the Federal Reserve in the US has revised its monetary policy stance towards a more dovish outlook and is increasingly likely to cut interest rates later in 2019, we should expect the US Dollar to remain soft in 2019. The Euro is unlikely to benefit from this changed interest rate and economic outlook in the US since the Eurozone is subject to similar developments as the US, both on the economic and monetary policy side. With stable growth in China, however, we expect the Renminbi to strengthen against the US Dollar, especially if the US economy does weaken later in 2019.

However, we should not expect this Renminbi strength to be too pronounced, for several reasons. First, a stronger Renminbi creates a drag on the demand for Chinese exports, something that could potentially undermine the efforts of the Chinese government to prop up economic growth. Second, we expect the US Dollar to strengthen once recession fears in the US and Eurozone become so dominant that markets get caught in a prolonged risk-off phase. During such an episode, repatriation flows into the US and increasing demand for US Treasuries as safe haven investments should lead to a stronger US Dollar. Thus, any strength in Renminbi is likely to be tactical in nature and may not last until the end of the year.

[4] Past performance is not a reliable indicator of future outcomes.

Furthermore, if the Renminbi remains too strong and Chinese exports suffer too much, the PBOC can always engage in monetary policy stimulus which should weaken the Renminbi again. In fact, given the large fiscal stimulus announced in February, we think that it is unlikely we will see additional fiscal stimulus in 2019. If additional support for the Chinese economy is needed, it is likely to come from the monetary policy side.

Fig 7: Expect Renminbi to strengthen in 2019



Source: Bloomberg, Fidante Partners.

The trade war wild card

Of course, assessing investment opportunities in China would be much easier if we did not have to worry about the US-China trade negotiations. We remain optimistic that the two countries will be able to find a solution to their dispute this year, but the longer the negotiations remain in limbo, the more stimulus China will need to prop up economic growth.

Information about the current state of negotiations is scarce, but it seems as if China has tentatively agreed to allow the Renminbi to float more freely and purchase more manufactured and agricultural goods from the US in the future. Apparently, the US and China are also in agreement that more needs to be done to fight intellectual property (IP) theft. But this also seems to be the biggest remaining challenge. From what we know, the US is looking for ways to enforce Chinese compliance with these rules on IP theft and reliable mechanisms to punish China in case of a violation of these agreements. The Chinese trade representatives seem to be unwilling or unable to agree to any of the enforcement mechanisms proposed by the US.

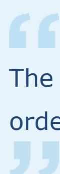
Eventually, we think these obstacles will be overcome, in which case we would expect an additional boost to Chinese stocks and to stocks of Western companies exporting to China. Since the beginning of the year, increased trade-optimism, together with the announced stimulus package, has already led to a 11.7% advance in the HS China Enterprise Index and a 11.2% advance in the Hang Seng Index. After the strong underperformance of Chinese markets in 2018, this puts the performance of these markets on a par with US equities and the MSCI World, but well ahead of the FTSE 100 or the EuroStoXX 50, since the start of 2019.[5] A resolution of the US-China trade war and a reversal of some, if not all, of the US tariffs on Chinese imports, would trigger another leg up in the current rally, in our view.

[5] Past performance is not a reliable indicator of future outcomes.

Conclusions: A short-term break in a long-term decline of growth

Before any of our readers complain that we suddenly have become China bulls, let us state that the long-term trend in the Chinese economy is unchanged. Chinese growth is on a secular downward trend that cannot and will not be stopped because it is driven by demographic factors and structural imbalances, such as the excessive credit growth in recent years.

However, the sheer size of the stimulus package that has been announced in late February leads us to conclude that Chinese growth is likely to accelerate from the low levels of 2018. Unfortunately, this growth acceleration is unlikely to be reflected in official Chinese GDP data, which is systematically distorted. In the official growth data, we expect to see another number somewhere in the targeted growth range of 6.0% to 6.5%.



> The Chinese stimulus is a step back in order not to endanger the way forward.

But for investors, official statistics matter less than actual economic activity, and there we should see an acceleration of growth throughout most of 2019. This, in turn, should lead to solid earnings growth of Chinese companies as well as Western companies with a large exposure to China.

However, China will not be able to defy gravity forever. The announced stimulus measures will, to some extent, boost the already inflated infrastructure and manufacturing sector in the country, thus increasing some of the imbalances that the Chinese government tried to reduce in previous years. This Chinese stimulus is a step back in order not to endanger the way forward for the country.

But this also means that the current stimulus has its limits. Should it fail or prove inefficient, the Chinese government will be unable to double down with more of the same stimulus measures because it would risk increasing the current imbalances (e.g. the credit and housing bubbles in China) to breaking point.

And while central banks in the US and Europe will have to fight the next recession with little or no ammunition, the situation in China will be somewhat similar. Should economic growth decline too much in 2020 and beyond, the government is increasingly running out of options to fight that slowdown.

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