China's policy pivot: Looking beyond the euphoria

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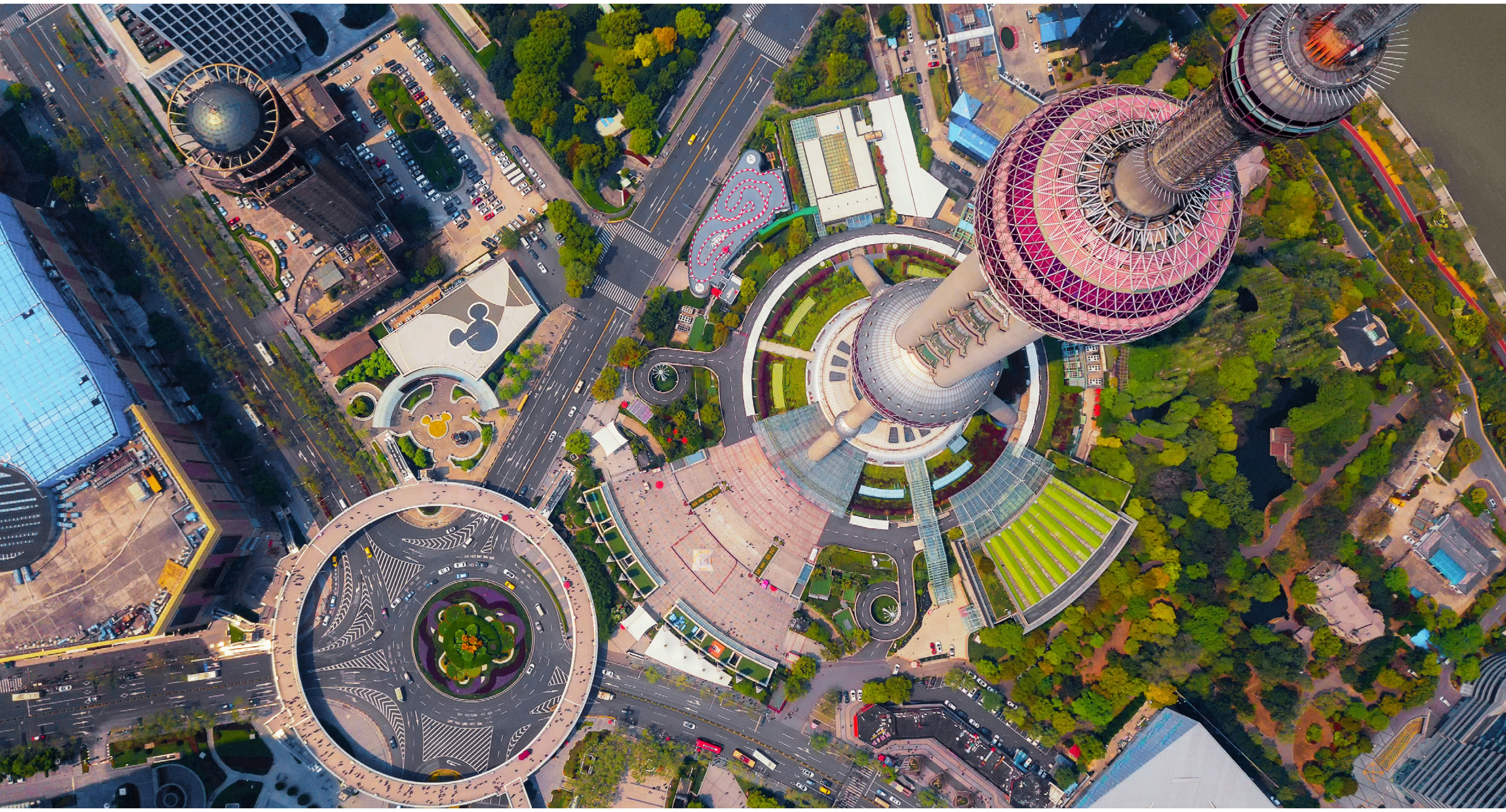

While not front-page news in North America, a shift in global financial markets is taking place that could impact Canadian investors.

On September 27th, 2024 Chinese authorities unleashed an arsenal of monetary and fiscal initiatives to boost the Chinese economy, with a signal of more to come. This announcement ignited domestic animal spirits, propelling Chinese risk assets in one of the biggest weekly returns on record. This is in stark contrast to an equity market that has languished for years, under pressure from overcapacity in the property market and related financial woes.

As the world's second-largest economy, it is important for Canadian investors to understand how they could be impacted by these dramatic shifts. Below, Eric Morin and Michael Sager answer key questions about this development.

Q1: Please describe the recent policy shifts in China. Why are Chinese authorities making these changes now? And what comes next?

An important policy pivot is underway. The Chinese economy is in bad shape and the government's pain threshold has been reached. Home prices have continued falling, causing a large negative wealth effect. Consumption has remained weak. The youth unemployment rate has risen near 20%, close to the peak seen during Covid lockdowns. China is at risk of a vicious cycle involving low inflation, excessive indebtedness, weak confidence, falling home prices, and high and rising unemployment.

In response, the government recently announced or signaled pro-several growth initiatives, including a commitment to stabilize the housing market and a large increase in government bond issuance. It is important to emphasize that the size of policy initiatives will likely fall short of the amount needed to completely turn the Chinese economy around. But incrementally, these initiatives are welcome and will help to minimize the risk of really bad outcomes for the Chinese economy.

Arguably, the most important recent development is evidence of political willingness to stabilize the housing market. Details are still scarce, but the commitment matters. Achieving housing stabilization likely requires two complementary policies initiatives: financial support for the completion of construction projects that are currently stalled; and housing upgrade policies that incentivize households to move from existing low-quality homes to newly finished units. We expect housing policies to be announced after the US elections, perhaps early in 2025.

In addition, more government bond issuance will help the central government target several objectives: provide financial support to local governments facing a substantial revenue shortfall; finance additional consumption subsidies; and ensure that public investment in tech & infrastructure remains a tailwind for Chinese GDP growth. We expect bond issuance announcements before the end of 2024 and in 2025.

In terms of next steps, the most important development will be the size and features of prospective fiscal policy announcements. Most importantly, we expect new housing measures equivalent to about 2% of GDP; housing growth multipliers are the highest and so are likely most impactful to GDP growth and financial market sentiment. We also expect more stimulus targeting the consumer and high-tech investment. Adding in other measures designed to alleviate local government revenue shortfalls, the total policy package could reach 4-5% of GDP. Policymakers could announce an even bigger number if they choose to communicate a multi-year plan, but this is not our base case given limited policy leeway.

Q2: Anecdotally, many Chinese investors appear eager to jump on board the rally. While the initial reaction is euphoria, one wonders if this is simply a sugar-high. Why have Chinese markets reacted so strongly to these new policies? Will this positive reaction persist?

Markets have reacted strongly because there had been no expectation that the government was willing to stabilize the housing and equity markets. The timing and size of policy announcements was a surprise to market participants. sequently, upside in the Chinese equity market could have further legs and euphoria could persist for several months, depending upon the magnitude of follow-on policy announcements. Precedents exist from 2008-09, 2011-12, 2016-17 and 2020-21. In all cases, in response to unexpected policy stimulus the equity market rally by a range of about 34% to 116% over the course of an average of 18 months.

The positive impact of recent policy announcements on investor sentiment will likely be helped incrementally by Chinese manufacturers continuing to move up value chains, as well as a continued rapid increase in China's share of emerging market demand for manufactured goods. Chinese manufacturers also have an unmatched comparative advantage in the global renewable energy transition.

However, in the medium term these tailwinds are likely outweighed by several important economic headwinds, meaning that the positive momentum of Chinese equity markets is likely unsustainable. Policy stimuli implemented earlier in 2024 will likely soon begin to weigh on economic growth (stimulus borrows growth from the future). The extent of excess housing supply and a declining population make it unlikely that housing will become a sustained growth engine beyond the near term; the latest policy initiatives are just not big enough to fundamentally change the outlook for the housing market. Local government finances are in disarray due to the collapse of land sales that previously contributed about 1/3 of revenues. And the risk of higher US and EU tariffs, as well as a broadening out in the range of goods impacted, poses a significant headwind to growth.

Q3: What impacts could this have beyond China's borders in terms of trade and financial markets spillovers? How might this impact Canadian investors with exposure to USD, equities, credit, and government bonds?

Chinese policy stimulus can help solidify an already constructive global market outlook; one in which most central banks are cutting interest rates, fiscal policy is becoming more supportive of economic activity, and global investment spending is likely to become a growth tailwind. In this environment, we think balanced portfolios can continue to perform relatively well. Political risk will likely remain the primary challenge to this constructive outlook.

Due to the extent of trade linkages, Asia-Pacific equity and currency markets should benefit the most from Chinese policy stimulus and reduced downside risks surrounding the Chinese economy. Because we don't expect a policy bazooka from the Chinese government, we see limited positive spillovers to oil prices and the Canadian dollar (CAD). Indeed, CAD is likely to underperform other cyclical currencies in response to Chinese stimulus, many of which are also cheaper than CAD compared with long-term valuations and so have more fundamental headroom to strengthen. CAD could potentially outperform USD, which is less cyclical and one of the most expensive currencies compared to fair value. But this outcome will also depend upon the result of the US elections, which remains highly uncertain.

Q4: With more liquidity being added to the global financial system, does this change the policy trajectory for the Federal Reserve (FED) and Bank of Canada (BoC)?

Not really. For the Fed and BoC, the marginal impact of Chinese stimulus on US and Canadian growth and inflation should be small, owing to limited trade linkages and a lackluster medium-term Chinese growth outlook. While the People's Bank of China will likely inject more liquidity into the Chinese economy, the impact on global liquidity should be limited as Chinese capital flows remain tightly controlled.

Overall, we think the market consensus is expecting too much cutting by the Fed and BoC over the next couple of years. Chinese policy stimulus doesn't change this view.

Q5: Could Chinese stimulus have geopolitical implications?

Perhaps. The stimulus could exacerbate geopolitical tensions over the medium term as we expect additional Chinese policy support to focus on high-tech investment and manufacturing supply chains of high value added products. This could make the US and EU more concerned about Chinese military/tech dominance and unfair commercial practices. In this context, stimulus may increase the incentive to pursue more protectionist policies.

Conclusion

The marginal effects of increased monetary and fiscal stimulus in China are expected to be a net positive to the already constructive investment environment. While the impact may be small, it adds the tailwind supporting Canadian investors holding balanced portfolios.

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