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Brewin Dolphin

Markets in a Minute

Guy Foster, Chief Strategist, discusses new Chinese stimulus measures and their potential impact on the country's economy and equity market. Plus, Janet Mui, Head of Market Analysis, analyses fresh economic data from the UK, Eurozone and the U.S.

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September was the month of monetary stimulus, with the European Central Bank cutting interest rates a few weeks ago and the Federal Reserve cutting rates the week before last. But neither move has had quite the same market impact as the latest stimulus measures from China.

A banner week for Chinese stocks

Chinese equities rallied last week following a range of stimulus measures announced by the Chinese state. Economists remain sceptical that China can overcome the massive structural problems that have grown in the world's second largest economy, but investors have embraced the move wholeheartedly.

Hong Kong-listed shares rose 12% last week, while the Shanghai and Shenzen-listed CSI 300 index rose by more than 16%. They started this week in rude health too.

What exactly was announced? Unfortunately, Chinese policy operates very differently to those in regions we're more familiar with, so it can seem a bit confusing.

Quite commonly, monetary stimulus comes through cuts to the reserve requirement ratios (RRR) of banks. The RRR is the percentage of deposits that commercial banks are required to hold in reserve, rather than using them to make loans or invest in other assets.

For example, if the RRR is 10%, a commercial bank with ¥100 in deposits must hold ¥10 in reserve and can use the remaining ¥90 to make loans or invest in other assets. Thus, cutting the RRR means more credit can flow into the economy.

Last week was no exception, with the RRR cut by 0.5 percentage points. For context, the RRR for small banks has now been cut to 6.5%, just 0.5% above its all-time low, and the governor of the People's Bank of China, Pan Gongsheng, seemed to suggest further cuts are coming.

That said, the RRR was 15% in 2018 and has been cut many times since. The cuts so far this year look pretty average for what we've seen in recent years, as policymakers have been reluctant to see big increases in borrowing as a way of arresting the growth slowdown.

Lowering the cost of borrowing

Over recent years, borrowing has slowed, because giving banks capacity to lend doesn't help if nobody wants to borrow.

One way of encouraging borrowing is to make it cheaper by cutting interest rates. China also did that last week. They have a plethora of different interest rates directly manipulated by the central bank, as well as "effective" interest rates, which are heavily centrally influenced. This means the government influences the interest rates paid by businesses and households more directly than is the case in other countries.

Like in any economy, the policy interest rate is a factor affecting the cost of money to banks, which then determine the rates they charge customers. But in China, these lenders are often state-owned, and their lending is driven by state objectives rather than a quest for profitability.

There have been various reforms to the interest rate-setting environment in recent years, but the crucial one – allowing interest rates to be set by market forces rather than political dictate – remains a step the government is unwilling to take.

This means that China's perennial problem of misallocated resources will likely continue.

Will it be enough?

Even cutting interest rates may not be enough to encourage lending if potential borrowers feel over-leveraged or don't expect to make a positive return on their borrowing. Here lies the central challenge for the Chinese economy.

China's relationship with property has been a complex and variable one.

In the early decades of the People's Republic, a person's home was an asset of the state. Although private ownership of property was possible following reform in 1980, it was still very unusual. It took until 1998 before widespread commercialisation of property was possible. Since then, property has become a mainstay of economic activity and wealth accumulation, leading to a substantial property bubble.

The current status of the Chinese economy is that most consumers have the majority of their wealth tied up in housing, but property values have been declining. As a result, many households are in negative equity, while others are discouraged from buying homes because of the decline in property values. Meanwhile, developers are discouraged from embarking on new building activity.

This leaves little appetite to spend from both the household and 'private' commercial sectors of the economy, resulting in slowing economic activity and falling interest rates. Chinese industrial profits fell almost 18% in the 12 months to August.

What to do?

The prescription is for government demand to pick up the slack left by the lack of private sector demand. This requires a big increase in spending at a time when the Chinese government is already running a substantial budget deficit of around 5%. The main impediments to growth are a willingness to take on sufficient debt to offset private sector deleveraging, and the availability of projects to deploy government investment spending.

Perhaps the most meaningful announcement was that the Ministry of Finance is planning a significant fiscal support package. It's expected that part of this will be used to subsidise upgrades to existing consumer goods (most notably cars), as well as an explicit payment per child for families having more than one child – a significant incentive to have more children at a time when China's demographic woes are coming into sharp focus.

The main question is how long these fiscal stimuli will last. Without a firm commitment, the child benefit could be expected to expire at some stage, in which case it forms a temporary compensation for having had children (which would likely be saved by the households receiving it).

Alternatively, if the Chinese public can be convinced payments will continue in perpetuity, this is far more likely to bring about the kind of change in behaviour that would see them spending their windfalls.

Despite the uncertainty about what exactly the fiscal support package will look like, the stock market rallied as there were measures within the stimulus package that affected it directly. The People's Bank of China announced a swap programme, whereby institutional holders of risky assets could swap those assets with the central bank and receive liquidity in return – if they then invested that liquidity in stocks. Unsurprisingly, this has had a catalytic effect on Chinese stocks.

Aside from these fireworks in China, last week was relatively quiet.

The U.S. economy shows some fragility

From an economic perspective, there was further evidence of a slowdown in manufacturing activity. The flash purchasing managers indices suggested the sector remained weak in most jurisdictions during September.

The U.S. saw a particularly abrupt slowdown in activity, though its services sector remained quite robust.

Other data last week continued to suggest that growth in the U.S. is running at a healthy 3% as we approach the end of the third quarter, essentially maintaining the pace of the second quarter.

In Europe, there was some evidence the manufacturing slump is continuing. The services sector seems to be losing momentum as well. The case for interest rate cuts in Europe is strong.

Is the government talking down the economy?

Although interest rates in the UK will inevitably decline as well, the need is a little less pressing than on the continent.

Economic activity levels remain high, but higher interest rates are gradually offsetting the boost from wage increases and tax cuts.

Business leaders have warned the downbeat tone from the government risks damaging the economy. This was hinted at the week before last by market research company GfK's consumer confidence index, and partially reflected in a decline in the British Retail Consortium's measure of consumer expectations.

In response, the tone from the Labour Party conference was one of continued tough choices, emphasising fiscal credibility to avoid spooking global bond markets. However, Chancellor Rachel Reeves' speech hinted at a relaxation of rules that would currently restrain investment in the economy, and news at the end of last week suggested plans to end the non-domicile tax regime will be tweaked to reduce the draining effect on spending and investment that a widescale departure of influential businesspeople could have.

Japan elects a new prime minister

Finally, Japan's governing Liberal Democratic Party has selected its new leader, Shigeru Ishiba. He was confirmed as prime minister this morning.

Although there were monetary policy differences between the two run-off candidates, Ishiba and Sanae Takaichi, it was unlikely there'd be much government influence on interest rates. The Bank of Japan would be too concerned about the impact on borrowing costs as a result of even a suggestion of government influence.

Despite this, speculation of a victory for the more dovish Takaichi had weighed on the yen and been supportive for Japanese stocks. The yen rallied hard on Friday after the result was announced, and stocks suffered a sharp decline when the stock market opened on Monday.

This week, China's stock market is closed for Golden Week, its national day celebrations. We'll also see some important speeches from policy makers, but the highlight, as ever, will be Friday's U.S. employment report.

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