



Market Watch

Riding on China's liquidity rush

Summary

China's central bank (PBoC) measures and Politburo meeting signal policymakers' willingness to support economy and markets. PBoC measures improve liquidity and market sentiment, but further fiscal policy easing key to improving growth outlook.

Equity rally likely to extend short term. The Hang Seng Index, after sharply breaking above technical resistance at 20,000, could move beyond our 'base scenario' range of 20,000-22,500 to the 'bull scenario' level of 22,500-24,500 if any fiscal stimulus comes in above market estimates of around CNY2 trn. Next key resistance is 22,700.

Fiscal policy, global risks key to sustaining equity market gains over the long term. China's deflationary pressures, debt levels and US elections are key risks to monitor in the coming months. How these balance against the magnitude of any upcoming fiscal stimulus would likely determine the sustainability of the rally over 6-12 months.

Background

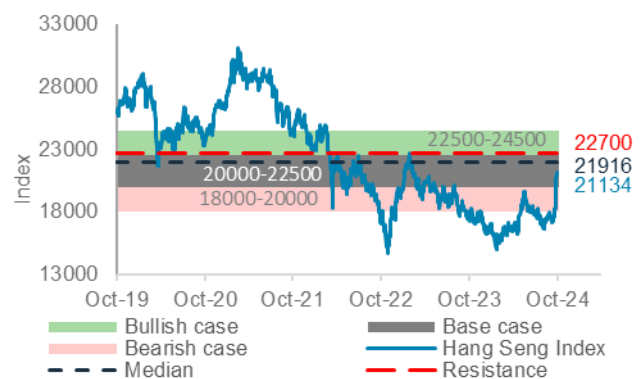
Chinese equity markets rally sharply on policy optimism. Early last week, the PBoC announced a package of measures to support the economy. These included an interest rate cut and a reserve requirement ratio cut. For the housing market, announced measures included lower mortgage downpayment requirements for second homes and a 50bps cut to existing mortgage rates.

Several measures also announced to support stock market liquidity. Authorities also announced a CNY500bn swap facility to allow non-bank financial institutions to borrow directly from the PBoC using bonds, stock ETFs and CSI 300 constituent stocks as collateral. An additional CNY300bn relending program is also to be set up for banks to support listed companies' stock buyback activity. The combined CNY800bn plan represents approximately 2% of the onshore (A-shares) market capitalization.

Expectations of fiscal policy easing key to growth outlook. In addition to the announced PBoC measures, a special Politburo meeting was conducted on 26 September, wherein the nation's top leadership committed to undertaking counter-cyclical fiscal policies to address the new challenges facing the economy.

Bond yield, currency and stock markets rallied after the week's announcements. Since 23 September, the Hang Seng Index has risen 15.8%, onshore CSI 300 A-shares have risen 25.0%, China's 10-year bond yield has risen 17bps while the CNY has gained 0.4%.

Hang Seng Index (HSI) rose above its 5-year median
HSI 5-year median, resistance, Base/Bull/Bear scenarios



Source: Bloomberg, Standard Chartered; 30 Sep close

HSI and CSI 300 indices still 30% below 5-year highs

HSI and CSI300 index 5-year peaks vs. last close



Source: Bloomberg, Standard Chartered; 30 Sep close

China bond yield rise implies reduced deflation risk

China 10-year government bond yield over last 5 years



Source: Bloomberg, Standard Chartered

What does this mean for investors?

PBoC measures improve liquidity, directly targeting market stability. Rate cuts, reduced bank reserve ratios and swap facilities directly introduce greater liquidity into the domestic financial system. In the short term, these are positive for equity markets, particularly since further rate and bank reserve ratio cuts are expected. Swap facilities are likely to be particularly potent in the short term given their relatively direct impact on liquidity.

Willingness to use fiscal policy a positive signal. While there has been significant monetary policy loosening, many investors believe that a more sustained growth (and equity market) rebound is likely to require greater fiscal support. This is where the Politburo's announcements become more significant. While actual measures have thus far not been announced, the announcement suggests a fiscal response is also likely to be forthcoming. Such a policy response is likely to be well received by markets because they raise the prospects of a sustained consumer spending-led growth rebound.

Equity rally likely to extend short-term. The debate over long-term sustainability aside, we see room for the equity rally to extend in the short term. Liquidity is one factor, as we outlined above. However, this comes against the backdrop of still-inexpensive valuations (MSCI China index still trades at a multiple of below 11x) and still-light investor positioning (a recent survey showed over a quarter of global funds surveyed had zero exposure to Chinese assets).

Technical outlook: From a technical standpoint, the Hang Seng Index broke above prior resistance at 20,000, with the next key resistance at 22,700. Pending further clarity of the magnitude of the anticipated fiscal policy package, we set the 'base case' range at 20,000-22,500. Should the fiscal stimulus to boost consumption and fiscal spending surpass market expectation, the index can trade up to our 'bull case' range of 22,500-24,500, within +1SD above the 5-year historical average. Should the fiscal support come in later/lower than expected, and risk-off sentiment result from Middle East tensions and/or US elections, the index may pull back to the 'bear case' range of 18,000-20,000.

Bond yield, CNY rebound likely to slow. China's 10-year bond yield and the CNY both rebounded alongside the rally in equity markets. However, these are likely to be more sensitive to the long-term growth and inflation expectations compared with equities, which are likely more directly supported by improved sentiment following recent policy measures. For USD/CNH, this means that, while a brief test of 6.95 is possible, further CNH gains may require greater fiscal support.

Deflationary pressures, debt levels and US elections key risks to monitor. A positive domestic policy backdrop does not eliminate several key risks. The risk of deflation has partly eased following the monetary policy measures. However, markets are likely to closely monitor the impact of upcoming easing. Chinese bond yields are likely to provide one barometer of the market's assessment of these risks.

Overall debt levels remain a second indicator to monitor. With China's national debt at 300% of GDP, any significant fiscal support could raise the focus on this risk in the long run. Finally, US elections remain a key external risk, particularly if the new US administration adds trade and tariff measures on Chinese exports and investments.

USD/CNH hovers around 7.0



Source: Bloomberg, Standard Chartered

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