Macro Insights Weekly

China trip notes: Isolating property sector risks

Group Research

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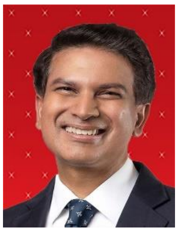

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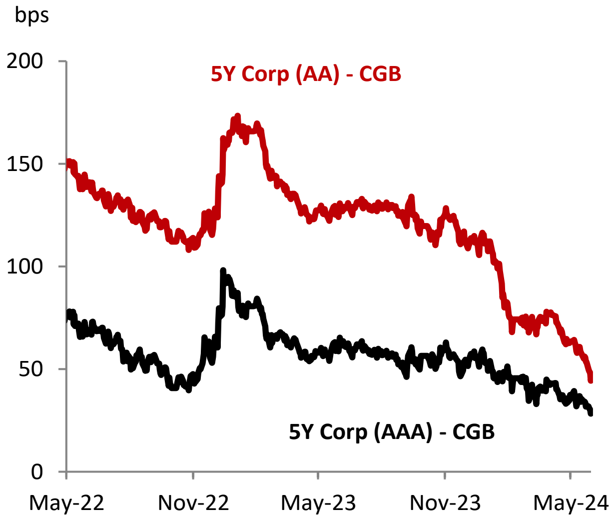
- *During an engaging China trip last week, we saw dynamism in policy making, green transition, and new tech. We also saw lingering uncertainties afflicting consumption and investment.*
- *Weak aggregate demand persists, even though economic momentum is not alarming.*
- *Demand weakness reflects real estate, capital markets, and regulatory headwinds.*
- *Policy easing is reaching critical mass, helping deal with the debt crisis.*
- *Stepping into China is to see green transition in action.*
- *Concerns galore, but strategies to deal with a more challenging world are in motion.*

Chart of the Week: Easing China financial stress

China's property sector risk is far from resolution, and its potential impact on the financial sector remains an overhang, but steady policy rate cuts and liquidity injection measures are helping. Corporate spreads have narrowed considerably over the past year, with the cost of RMB loans and refinancing at historic lows. Confidence has yet to recover fully, as reflected by subdued market activities, but for a wide range of borrowers outside of the property sector, good times are here.

China: Onshore Credit Spreads



Source: Bloomberg, DBS

China: Isolating Property Sector Risks

An engaging week of travels through Shenzen, Shanghai, and Beijing gave us proximity to China's imperatives and risks. We found the nation full of dynamism, driven by policy measures aimed at boosting demand and supporting key technologies and sectors. We also picked up a great deal of unease about the future, with concerns about aging, property sector, national security risks, and geoeconomic fragmentation.

With many balls up in the air, the key area of private and public urgency is the property sector, where stagnant or falling prices, massive unsold inventory and incomplete projects, and a mountain of debt continue to sap consumer and business confidence, while taking up the bulk of policy space.

The authorities are balancing the need to prevent an implosion of the property sector, which could unleash a prolonged debt-deflation dynamic, against ensuring the restructuring of the sector goes ahead without causing substantial moral hazard problems. We are sure there will be capital loss, balance sheet consolidation, company liquidation, and years of difficulties in the sector. Looking at the plethora of recent measures, we also have high conviction that China is not at the edge of Japan-like multi-decade stagnation.

Eight takeaways from the trip:

1. **Weak aggregate demand persists, even though economic momentum is not alarmingly slow.** Substantial rate cuts, liquidity injection, fiscal support for industries, and structural reforms are addressing both the cyclical and long-term issues afflicting the economy. Still, weak export demand, a dearth of foreign investment and international tourists, intense competition and margin compression in certain sectors, and long lag between policy measure and demand response are concerning.

2. **The reasons for weak aggregate demand go beyond the malaise in the property sector**. They also reflect chronic weakness in capital market activities, uncertainty about employment, scarring from the harsh Covid pandemic-related lockdown, and hangover from the regulatory crackdown in tech and other sectors.

3. **There is considerable variation among regional economies and sectoral performances**, unsurprising given the scale and complexity the economy. Some industries, autos and pharmaceutical, for example, are energised, with continued FDI, innovation, and expansion. Others, not just property, but steel and construction as well, are facing serious headwinds. There is also variation in regional leadership dynamism. Some provinces have provided far more support to the property sector than others.

4. **Some companies and sectors may be facing profit pressure, but it has never been this cheap to finance consumption or investment** in China. Perhaps equally powerfully, for debt-burdened households and firms, refinancing debt is also a historically cheap proposition. Aggregate demand may be on a weak footing, but it is getting plenty of support, which is bound to help eventually. Looking at year-to-date performance of the equity and credit markets attest to the fledgling upside.

5. **Stepping into China is to see green transition in action**. In Shenzhen and Shanghai, it appeared that most cars on the roads were EVs, offering consumers with highly attractive value propositions. The improvements in air quality and reduction in road noise are apparent to repeat visitors, a testament to not just the ongoing EV revolution, but world-leading investment and innovation in renewable energy production, transmission, and storage. According to the (Centre for Research on Energy and Clean Air), "*Clean energy contributed a record CNY11.4tn (USD1.6trln) to China's economy in 2023, accounting for all of the growth in investment and a larger share of economic growth than any other sector. China's investment in clean-energy sectors is almost as large as total global investments in fossil fuel supply in 2023 – and similar to the GDP of Switzerland or Turkey.*"

6. **With tariffs and non-tariff barriers rising, Chinese manufacturers are pursuing a two-pronged strategy**. First, at the low end of the cost spectrum, the view is a degree of competitiveness would be maintained even with tariffs, case in point being entry level EVs. Second, for the mid- and high-end, Chinese firms are moving production to the likes of Mexico and Poland. The second strategy is particularly for members of free trade blocs like USMCA and EU, with the narrative that such investments are creating local jobs and allowing tech transfer in partner countries.

7. **The number of significant support measures for the property market has risen considerably this year.** They range from removal of the floor on mortgage rates to reduction in downpayment ratios, from PBOC-underwritten loans to SOEs to buy unsold homes to easing of residency requirement for home purchases. Given the mountain of inventory and lingering concerns about property value, these measures are unlikely to transform China's beleaguered property market expeditiously. But regional leadership is beginning to take charge instead of just relying on Beijing to dictate all actions. Guangzhou's move to substantially ease residency requirement to buy multiple homes could act as a powerful demonstration effect for other regions, in our view.

8. **Social welfare, pension, healthcare, and education reforms, essential to transitioning toward consumption-led growth, are on the agenda**, but not moving fast enough to create economic ripples or revive sentiments. Local governments need more revenues and decision-making powers, but such shifts are also far from being achieved.

We left China on an early-summer day, with bright blue skies and the sun shining over Beijing. The government has many global and geopolitical imperatives, but looking at the weekend crowds at the city's parks, we were reminded that its ultimate responsibility is to its citizens, to provide them with the opportunities and security to live a life of prosperity and stability. China's population have seen transformational changes in the past four decades, but their aspirations are for an even more gainful and meaningful life. There can be no compromise on that.

Taimur Baig

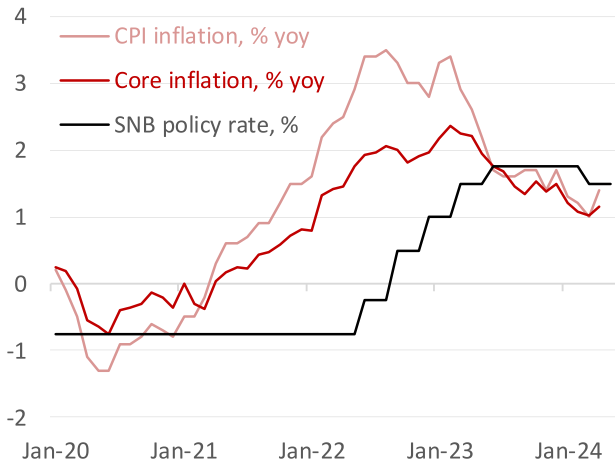
FX: USD to extend its weakness into June

We are vigilant of downside risks in the USD in June. The Fed's narrative to be patient on interest rate cuts has become more bark than bite without the backing of US data. At next week's FOMC meeting, we expect the Fed to set a high hurdle for a rate hike and to stay the course for later and fewer rate cuts. With the US economy moving from exceptional growth towards a soft landing, the Fed will expect inflation to cool in 2H24, more so if Friday's US nonfarm payrolls hold below 200k for a second month. More importantly, the EU and the UK economies have exited their technical recession in 1Q24. Other global central banks have also become more aligned with the Fed's patience on rate cuts.

EUR/USD to break above its 1.08-1.09 range if the European Central Bank delivers a hawkish interest rate cut at its June 6 meeting. The ECB will not pre-commit to another cut after CPI inflation increased to 2.6% YoY in May, higher than the 2.5% consensus and 2.4% in the previous month. Core inflation also increased to 2.9% in May vs. the consensus for it to stay unchanged at April's 2.7%. Last week, ECB Chief Economist Philip Lane said the governing council will follow a data-dependent and meeting-by-meeting approach.

USD/CHF is more likely to break below its two-month range of 0.90-0.92 than above it. Two events hijacked the only attempt to push above 0.92 on May 1. First, Fed Chair Jerome Powell said on May 1 that the Fed did not see the next interest rate move as a hike. Second, Switzerland's CPI inflation release on May 2 rebounded from 1% YoY in March to 1.4% YoY in April, slightly below the Swiss National Bank's policy rate of 1.4%. On June 6, another surprise in CPI inflation should end the odds for a back-to-back rate hike at the SNB meeting on June 20. Last week, SNB President Thomas Jordan warned of upside risks to the central bank's inflation forecast from the CHF's weakness and an R star (natural rate of interest) that could be higher than the present estimate of 0%.

SNB will refrain from a back-to-back cut in June



Sources: DBS Research, Bloomberg data

USD/CAD has been confined to a 1.36-1.38 range since mid-April. The Bank of Canada is widely expected to lower its overnight lending rate by 25 bps to 4.75% at its June 5 meeting. On May 28, Finance Minister Chrystia Freeland fuelled rate cut bets with her comments that the federal budget presented in April would create the conditions for inflation to fall and the BOC to bring rates down. Last Friday, the Canadian economy also disappointed. Apart from growing by an annualized 1.7% QoQ saar in 1Q24, slower than the 2.2% consensus, 4Q23's GDP growth was revised to 0.1% from its preliminary 1% estimate.

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