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News & Views

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Mixed signals on China growth

With Sino-US trade likely to be a key factor influencing global fixed income markets in 2019, Mellon's[1] senior sovereign analyst Aninda Mitra went to Hong Kong to gauge market sentiment. Here, he reflects on views on the ground and possible economic and trade moves in the year ahead.

Many China analysts based in Hong Kong are more optimistic about the Chinese authorities' room for policy manoeuvring and Sino-US trade, than it might appear from the news. Following a January meeting in Hong Kong with sell-side economists, strategists and buy-side analysts to gauge their views on the Chinese macroeconomic outlook and trade relations, there appears to be less concern than the hype would suggest.

China's balance of payments position was seen as reasonably secure. Even if the current account slipped into a deficit, later this year, a commonly held view is that there is enough space for policymakers to continue delivering a steady drip-feed of stimulus while also accommodating US trade demands. This relatively upbeat sentiment is predicated on capital controls on resident outflows remaining highly effective. Moreover, a stable-to-weakening trend in the US dollar (USD) was also seen as ballast for the China Yuan renminbi (CNY).

Views of Sino-US relations were also relatively sanguine. This seemed predicated on the view of existing tariffs being contained to a standstill and that wider trade frictions could be disentangled from more intractable technology-related disputes. It was also felt that, in the US, President Trump increasingly needs to publicly demonstrate some form of victory or breakthrough in trade talks.

Trade challenge

In contrast, we think risks surrounding Sino-US trade remain significant and a more positive outlook could be somewhat premature. This is because leverage in negotiations with China centres on linking one set of issues with another. Until verifiable trade and at least some meaningful intellectual property adjustments by China materialise we see little reason to become more bullish about the prospects of a quick resolution.

In fact, we believe the best markets can hope for is for the current level of tariffs to come to a standstill with ongoing monitoring and verification of Chinese adjustments. But even then this standstill could last for only a few months or until such time as domestic politics in the US or China offer another catalyst for a shift in stance further down the road.

This is why we continue to think that the longer a trade resolution, to a near ex-ante situation, eludes us, the greater the odds are of the People's Bank of China's foreign exchange reserves dipping below US$3 trillion or of the CNY weakening versus the dollar.

[1] **Mellon was formed on 31 January 2018, through the merger of The Boston Company and Standish into Mellon Capital. Effective 2 January 2019, the combined firm was renamed Mellon Investments Corporation.**

Where we could go wrong is if the US dollar weakens much more than expected. But in the current backdrop, the Chinese authorities should, we believe, remain creative and persistent.

Inflationary pressures

Expectations remain hopeful inflation will stay above 2% based on relative optimism about price deflators and firmer food prices. Moreover, a firmed fiscal impulse and greater consumption could also stem the risk of widespread disinflationary trends.

In contrast, many local commentators I spoke with were generally more pessimistic about the outlook for private sector businesses and their likely contribution to growth. Some are struggling to make sense of the Chinese governments' desire to increase lending to the privately owned enterprises (POEs) without concurrent market reforms to shore up the risk-based allocation of capital.

The Chinese government has taken some additional steps to help ease financing such as plans to launch a central bank bills swap (CBS) designed to provide liquidity to finance the issuance of perpetual bonds by the banks. Perpetual bonds are seen as one potential way to raise capital amid a deeply frozen equity market and facilitate more risk-weighted loans.

That said, the process of getting more loans to privately-owned enterprises, which are riskier than government-backed state-owned enterprises, will likely remain slow though it appears to be a step in the right direction.

Perpetual bonds

Much also depends on how quickly the banks are able to issue perpetual bonds and shore up capital to meet heightened pressure from the authorities who want to see a third of all new loans go to privately-owned enterprises. Recent measures to swap the perpetual bonds for up to three years may provide more liquidity but do not guarantee a pick-up in capital ratios to spur more riskier lending.

In our view, unless the privately-owned enterprises get on a decisively stronger footing, it will remain difficult for nominal Chinese GDP growth to stay above 8% in 2019. We believe that a full year rate of over 7% nominal growth in China is realistic and will still amount to a decent result for global macro conditions, but anything below 7% would be stressful and could raise the likelihood of a greater-than-expected depreciation of the Chinese Yuan/Renminbi.

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