

Fund Manager Perspective

June 2018

Stock Market

The escalation of the Sino-US trade war led to an across-the-board decline in the stock market. After the US government announced that it would impose a 25% tariff on about 50 billion US dollars of goods imported from China on June 15, China also decided a 25% tariff on 50 billion US dollars of goods imported from the US on June 16. Earlier, China had declared that it would reduce the vehicle tariff rate to 15%, and after the announcement an additional 25% tariff will be imposed on the vehicles involved. On June 18, President Trump said that if China refuses to back away from the rapidly escalating trade war between the two countries, the United States will draw up a list of 200 billion US dollars of Chinese products, which will be subject to a 10% increase in tariffs. With the fear of the escalating Sino-US trade war, China's stock market tumbled across the board on June 19.

It is expected that the Sino-US trade war will continue in the medium term. According to the sources, what worries the US most is that China is energetically developing some specific technologies such as chips and new energy vehicles through government subsidies and other means, posing a threat to the US's advantageous industries. Therefore, there was the incident that the United States tried to cut off the ZTE's supply chain. Since the ZTE incident, China has been more aware of the need for independent and controllable technologies in the core technology field. Therefore, China will not give up vigorously developing these key industries. As a result, the differences between China and the United States in these areas will be irreconcilable. It is expected that Sino-US trade war will continue in the next three to five years.

There will be little impact on the economy as a whole. China's annual export value to the United States is about US\$450 billion, and the United States exports about 150 billion US dollars of goods to China each year, with China's trade surplus with the United States at about US\$300 billion. The total US GDP is about US\$20 trillion, compared with about US\$12 trillion for China. China's total import and export volume is about US\$4.1 trillion, with the annual exports at US\$2.3 trillion and the annual imports at US\$1.8 trillion. The annual import and export volume of the United States is about US\$3.9 trillion, with the exports at US\$1.5 trillion and the imports at US\$2.3 trillion. On the one hand, both China's total economic volume and total trade volume have been totally equal to those of the United States; on the other hand, the trade war has little effect on GDP as a whole, and even considering the 10% tariff on the additional 200 billion US dollars of goods, it is estimated that the GDP growth will be dragged down by about 0.5%, which is completely affordable.

The financial deleveraging process may slow down. This round of drops in the stock market seemed

to be caused by the Sino-US trade war. In fact, China's financial de-leverage had an inherent substantive impact. In May, the total amount of social financing fell by 50% from the previous month, which directly led to insufficient liquidity in the stock market. Recently, the social financing has shown obvious signs of slowing down possibly. On June 24, the central bank announced to lower the deposit reserve ratio by 0.5 percentage point, representing a sign of relaxation.

The stock market has already fallen excessively. Under the influence of the internal factor that the internal liquidity was tightened rapidly due to the financial deleveraging, the escalation of the Sino-US trade war triggered the across-the-board decline in the stock market. In the 5 months since the end of January when the highest point was reached, the stock market has dropped by about 20%, and we believe that the stock market has already fallen excessively.

Bond Market

In June, the bond market showed a trend of further differentiation. The yields of the interest rate bonds and high-grade credit bonds went down remarkably, while the yields of the low- and medium-grade products and urban construction investment bonds rose generally, showing that the overall market risk appetite moved downward. Specifically, the long-term interest rate bonds have the highest returns in the holding periods, while the medium-and-long-term low-rated corporate bonds have negative returns in the holding periods.

On June 24, the central bank lowered the reserve requirement ratio (RRR). The People's Bank of China decided to reduce the RMB RRR of state-owned large commercial banks, joint-stock commercial banks, Postal Savings Bank of China, urban commercial banks, non-county rural commercial banks and foreign banks by 0.5 percentage point starting on July 5, 2018. In operation, the RRR cut is a “universal” one as the RRR for all deposit institutions is reduced by 0.5 percentage point across the board, unleashing a total of RMB700 billion of liquidity, higher than the RMB400 billion released earlier by cutting RRR to replace the MLF and the RMB450 billion released by targeted RRR cut. Therefore, from the perspective of the total amount, both the strength and mode of this RRR reduction are beyond the previous market expectations for “targeted RRR cut”.

In the bond market, the liquidity supply higher than expected will contribute to the further decline in the interest rates of funds, but it is worth noting that currently the financing demand has not significantly weakened, and the efficiency of transferring the release of the base currency to the physical credit is relatively high. The probability of recessionary easing is still low, and the potential increase in the supply of local government bonds in the future makes it difficult for banks' allocation to effectively support the bond market.

Monetary policy shifts to equilibrium. At the end of June, the central bank held the second quarter regular meeting on monetary policy, releasing two major signals. First, the monetary policy was further turned to the tone of easing. Second, it was proposed to “effectively control the strength and pace of structural de-leverage.” Changes in the presentation of monetary policy represent more an after-the-fact confirmation of a series of measures for liquidity regulation taken by the central bank in the past period of time, and what is more worthy of attention is the marginal change in the central bank's attitude toward deleveraging.

Economic downside pressure increases. On June 29, the United States officially announced a list of tariffs on US\$50 billion of imports from China, and China immediately declared counter-measures, indicating that the real Sino-US trade war is inevitable. The breakout of the trade war means that the ability of overseas market demand to drive the economy will be further weakened. In 2017, the contribution of net exports to domestic GDP reached 0.6 percentage point, the highest figure in recent years. Not only have the developed economies such as the US and Europe maintained strong growths, but also emerging markets have showed signs of improvement. The simultaneous recovery of the global economy is the main reason for the increasing external demand; but since the beginning of 2018, the simultaneous recovery has been developing towards differentiation, with the US maintaining a good momentum of growth, the economic climate of the Eurozone slowing down significantly, and emerging markets facing greater pressure of capital outflow. The U.S. economy “outshining others” means that it has become the main source of global demand, and the Trump administration’s trade protectionism is just based on this advantage. With the formal breakout of the Sino-US trade war, the function of external demand in driving the domestic economy is expected to diminish gradually in the second half of the year.

In summary, the most important focus in the next period of time is the financial data for June. On the one hand, we should observe the extent of credit growth, that is, how much spontaneous financing demand there is with the central bank’s deregulation of quota limit; on the other hand, we should observe the overall social financing, that is, to what extent the on-balance sheet expansion can cushion the off-balance sheet contraction. If the credit growth in June is less than expected, then it can be judged that the financing demand of the real economy has shrunk, the downward pressure on the economy has increased, there are obstacles to returning non-standard assets to on-balance sheet assets, the pattern of “loose currency + tight credit” continues, and interest rate bonds and credit bonds continue to differentiate; otherwise, if the credit growth is more than expected in June, reaching more than RMB2 trillion for example, it means that the economy is still resilient, the monetary easing has the effect of alleviating credit tension, and the “loose currency + tight credit” turns to “loose currency + stable credit”, which will benefit the credit bonds instead of the interest rate bonds.