CAPITAL ECONOMICS

GLOBAL MARKETS UPDATE

What China's grim economic picture means for its markets

- **With the headwinds growing for China's economy, we think its equity markets will struggle, its 10-year yield will continue to fall and its currency won't rebound as quickly as we'd thought.**
- **At the start of the year China's economy was powering ahead. But the picture has gradually worsened since, and now looks quite bleak**. We've covered all the data on our dedicated *China Economics* service, but in short, it looks as though China's economic growth has slowed to a crawl. The property sector, which has been struggling over the past couple of years, has failed to rebound and is in particularly poor shape, as evidenced by the struggles of developer Country Garden. While policymakers now appear to be stepping up economic support, including the PBOC's rate cut earlier this week, the outlook is clearly much worse than we – and others – had previously thought. As such, we've recently revised down our growth forecasts.
- **Against this backdrop, investor sentiment around China's markets has continued to worsen.** The country's stock market has struggled, its sovereign bond yields have fallen and its currency has weakened. **We think there are three points to note on how things could play out from here.**
- **First, while it's hard to see a catalyst for a lasting turnaround in China's equity market, a lot of bad news is already discounted in it. So, while we've pushed down our forecasts for the major Chinese benchmark equity indices a bit to account for the bad economic news; our central scenario remains that they make little-to-no gains rather than crashing**. Valuations, especially of offshore equities, are still low relative to their histories and to those of equities elsewhere. (See Charts 1 & 2.) And earnings expectations have fallen some way, judging by analyst surveys. So even further bad news may not do much to push sentiment even lower. A financial crisis sparked by the property sector is the obvious catalyst for a more substantial deterioration, but our sense is that, despite the recent troubles at Country Garden and Zhongzhi, the authorities ultimately have the tools and, probably, the willingness to prevent such an outcome.
- Admittedly, already- downbeat market sentiment suggests equities have the potential for a rapid *rebound* if the news flow improves. Announcements of policy support – of various kinds – have been the catalyst for such turnarounds in the past. But we're sceptical it would lead to a sustained rebound, partly because many of China's economic problems look structural to us; disappointing growth is probably here to stay. **Our end-2023 forecast for the HKD MSCI China Index, for example, is 61, around its current level.**
- **Second, long-term bond yields probably have a little further to fall as the PBOC continues to ease to support the economy**. Admittedly, the 10-year yield, for example, has already been on a downward trajectory for much of this year, suggesting some additional monetary easing is already discounted. But our sense is that the central bank is still keen for financial conditions to ease further; that, we suspect, will mean further rate cuts, increased liquidity and still-lower yields. **We forecast the 10-year Chinese government bond yield to fall to 2.4% by end-2023, from its current level of ~2.6%. That's slightly below our previous forecast of 2.5%, and implies the 10-year yield reaching its lowest level in two decades. (See Chart 3.)**
- **Third, between lower interest rates, a slowing economy, and worsening investor sentiment, we think the case for the renminbi to rebound soon has weakened. We now expect the USD/CNY rate to end the year around its current level of 7.3 (previous forecast: 6.9), and that it will go above 7.3 in the near-term before falling back.** That reflects our view that while the outlook for China has worsened, we still think US interest rates will fall back sharply over coming months, unwinding much of the pressure on the renminbi from the US-China yield gap (which since mid-2021 has moved in favour of the dollar, see Chart 4.)
- **As ever when it comes to China's currency, the preferences of policymakers play a key role.** While the PBOC does not appear to have intervened directly recently, it has signalled its preference for a stronger renminbi (or at least a slower pace of depreciation) by setting the daily USD/CNY "fix" at a stronger level than implied by spot prices. There have also been reports that the state-owned banks have again sold dollars over recent days (though in what quantities is not clear). That is arguably a form of "proxy intervention". In the absence such support, it is probable that the renminbi would have weakened further than it has.
- **Our assessment is that policymakers remain reluctant to see a sharp move lower for fear of setting off a destabilising cycle of capital outflows (as happened in 2015-16), and have the tools required to prevent that from happening**. But given the need to stimulate the economy, the PBOC may at this point be more willing to accept some further currency weakness – especially if the pressure from high US interest rates persists for longer than we anticipate. As such, we think that even with our new, lower forecast for the renminbi. the risks around that forecast remain skewed to the downside.

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Chart 1: Price/Earnings Ratios Of China's Equity Indices

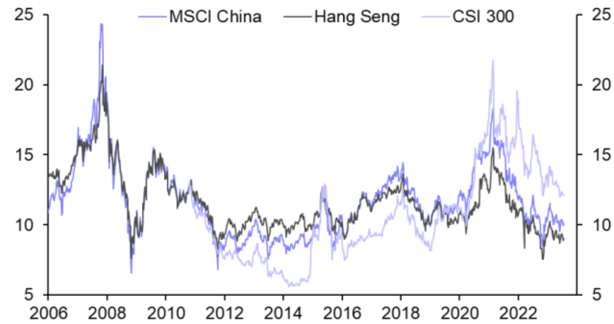


Chart 2: MSCI China PE Ratio Less MSCI ACWI

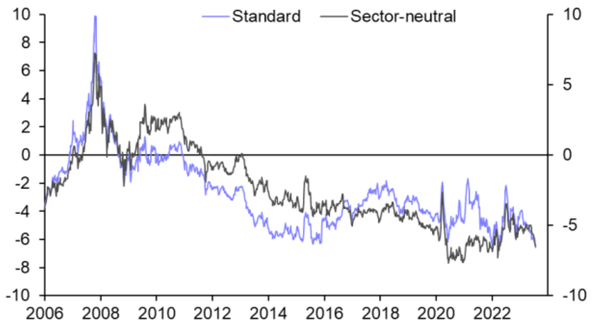


Chart 3: China Government Bond Yields (%)

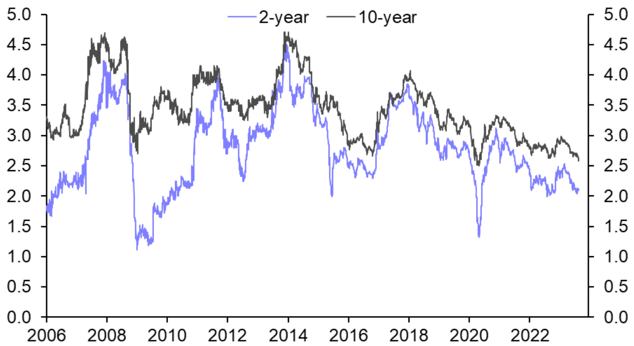
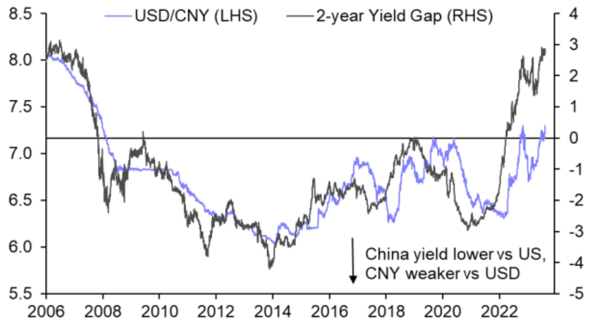


Chart 4: USD/CNY & US Less China 2-year Government Bond Yield Gap (pp)



Sources: Refinitiv, Capital Economics