CHINA ECONOMICS WEEKLY

Debt woes widely known but far from priced in

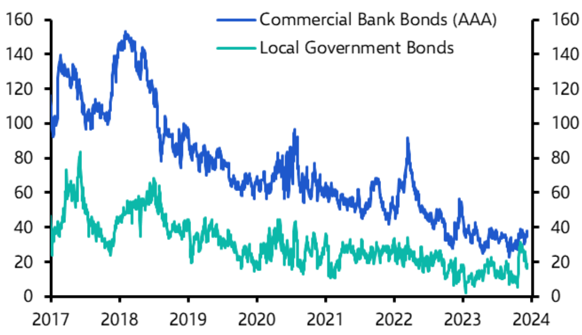
Faith in the state backstop as strong as ever

Earlier this week, Moody's downgraded the outlook on China's sovereign credit rating from "stable" to "negative" and made similar changes to its ratings outlook for Chinese banks, local governments and corporates. While the move garnered plenty of media coverage, the market reaction was muted. The pricing of credit default swaps on the US dollar bonds issued by China's central government and its big four state banks did edge up slightly on the news, but only by a few basis points.

That's not surprising given that the issues flagged by Moody's - the structural slowdown in China's economy, and the challenges in managing local government and property sector debt – are already widely known. But while there is now much greater awareness of China's weaknesses than there was prior to the pandemic, the deterioration in the economic outlook has not triggered any substantial repricing of credit risk (beyond the offshore high yield market).

To the contrary, despite bad debt piling up on their balance sheets in recent years, local governments and large banks can still issue bonds at less than 40bps above sovereign yields, with credit spreads actually lower now than before the pandemic. (See Chart 1.) This reflects an assumption among market participants that the authorities will stand behind the liabilities of local governments and state banks (or at least their formal ones), averting defaults.

Chart 1: Credit Spread over Sovereign (bps, 5Y)



Sources: CEIC, WIND, Capital Economics

Perversely, market participants appear to be betting that China's economic woes make it more likely that the state backstop will hold. There is a certain logic to this – policymakers may be less likely to let the cost of resolving bad debt be borne by the market if they are concerned about the health of the economy. Still, the increasingly large disconnect between credit market pricing and the underlying financial health of borrowers creates dangers.

For a start, it dampens market signals and hinders the flow of economic resources from less productive entities to more productive ones, resulting in zombie banks and firms. This serves as a drag on productivity and further undermines the country's growth outlook, worsening the debt situation.

More importantly from an investor's perspective, the distortions to the pricing of credit risk caused by implicit state guarantees mean that future actions by policymakers that call state backing into question could trigger a large repricing of risk. The metaphor "picking up pennies in front of a steamroller", often used to describe the tail risk from options strategies, also applies to much of China's bond market.

Politburo readout underscores growth push

The CPC Politburo, the country's top leadership group, held its quarterly meeting to discuss the economy today. The tone of the readout was dovish, emphasizing the need to do more to stabilise the economic situation. This suggests that more policy support is on its way, especially from fiscal policy, which will be intensified according to the readout.

That's consistent with our own expectations. In our quarterly China Outlook published this week we laid out the case for a near-term cyclical rebound, underpinned by a step up in fiscal spending.

The week ahead

The recent ramp up in government borrowing will be reflected in the credit data. And with the renminbi recovering and deflation still lingering, the PBOC is likely to do its part in supporting growth too, resuming rate cuts as soon as Friday.

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Data Previews

Sat. 9th Dec. – CPI, PPI (Nov.)

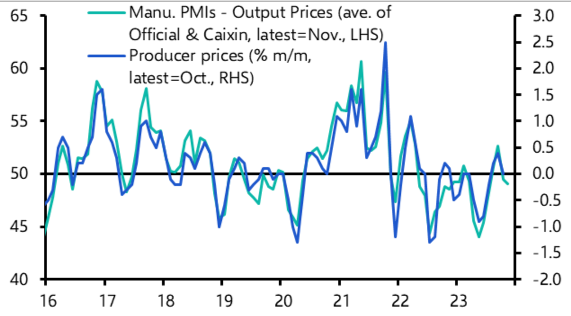
Forecasts	Time (China)	Previous	Consensus	Capital Economics
CPI (% y/y)	09.30	(-0.2%)	(-0.2%)	(-0.2%)
PPI (% y/y)	09.30	(-2.6%)	(-2.8%)	(-2.8%)

Disinflationary pressures look to have persisted

CPI dipped below zero again in October, and we think it stayed in negative territory last month. High frequency data suggest that food price inflation remained deeply negative, and energy price inflation slipped back into deflationary territory.

Producer price deflation deepened for the first time in four months in October due to a higher base for comparison. Factory-gate prices were unchanged in m/m terms. But the manufacturing PMIs point to a renewed decline in factory-gate prices last month, suggesting a further deepening of producer price deflation. (See Chart 2.)

Chart 2: Producer Prices & PMI Output Prices



Sources: CEIC, Capital Economics

9th – 15th Dec. – Net New Bank Loans, M2, AFRE (Nov.)

Forecasts	Time (China)	Previous	Consensus	Capital Economics
Net New Bank Loans (RMB)	-	+738bn	+1,300bn	+1,280bn
M2 (% y/y)	-	(+10.3%)	(+10.0%)	(+10.1%)
Aggregate Financing “AFRE” (RMB)	-	+1,850bn	+2,600bn	+2,650bn

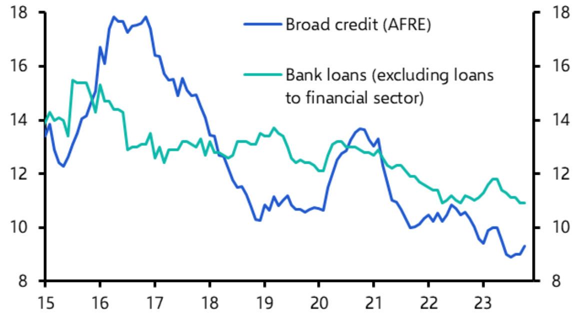
Fiscal support shoring up credit growth

Bank loan growth has continued to trend down recently but broad credit growth has picked up, thanks to a surge in government bond issuance. (See Chart 3.)

We think bank loan growth held steady last month. Although recent property easing has failed to put a floor beneath the volume of new home sales, sales values have at least stabilised recently.

Realtime data indicate slower corporate bond issuance and equity financing. But this has been offset by stronger government bond issuance, which should lead to a slight acceleration in the year-on-year growth in outstanding AFRE, the PBOC’s broad credit measure.

Chart 3: Growth of Outstanding Credit (% y/y)



Sources: CEIC, Capital Economics

Fri. 15th Dec. – Medium-term Lending Facility Rate (Dec.)

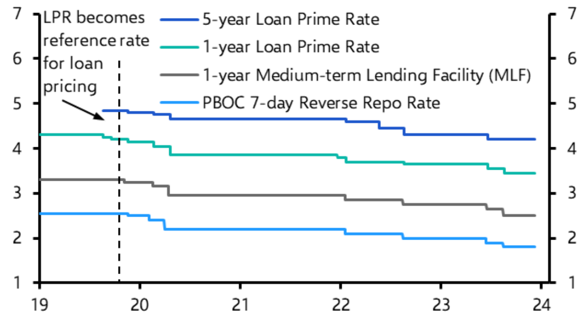
Forecasts	Time (China)	Previous	Consensus	Capital Economics
MLF Rate (1-year)	09.20	2.50%	2.50%	2.40%

Rate cuts likely to resume

The PBOC has kept its policy rates unchanged for the past few months. (See Chart 4.) But we anticipate a rate reduction soon and have pencilled in a surprise cut to the rate on its Medium-term Lending Facility next week.

The PBOC restated its intention to reduce financing costs for the real economy in its latest quarterly report. The main barrier to PBOC rate reductions since the middle of this year has been the strength of the dollar. However, US yields have fallen and the renminbi has strengthened recently. The currency has now returned to levels that the PBOC is more comfortable with, which should open the door to a resumption of rate cuts.

Chart 4: Policy Rates (%)



Sources: CEIC, Capital Economics

Fri. 15th Dec. – Activity & Spending (Nov.)

Forecasts	Time (China)	Previous	Consensus	Capital Economics
Industrial Production (% y/y)	10.00	(+4.6%)	(+5.7%)	(+5.2%)
Fixed Asset Investment (ytd % y/y)	10.00	(+2.9%)	(+3.0%)	(+3.0%)
Retail Sales (% y/y)	10.00	(+7.6%)	(+12.5%)	(+13.0%)

Recovery underway

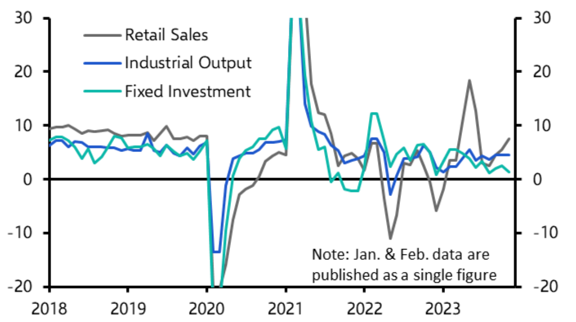
Except for fixed investment, the activity data for October were fairly encouraging, especially the acceleration in retail sales. (See Chart 5.) Admittedly, base effects have turned more flattering recently, but our assessment is that the recovery has continued to make headway, even in seasonally adjusted m/m terms. We think this momentum will have been sustained in November.

Admittedly, new home sales continued to slide last month, as did car sales. But express deliveries ticked up and there was a further improvement in the IPSOS consumer sentiment index. Meanwhile, the average of the official and Caixin services PMIs rose for the first time in eight months. On balance, we therefore expect faster gains in retail sales and wider services activity.

Growth in fixed investment probably remained more subdued amid the ongoing contraction in property investment. But the official construction PMI suggests that downward pressure eased somewhat last month thanks to infrastructure spending funded by the recent ramp up in government borrowing, which quickened in November.

Finally, industrial output growth probably remained resilient thanks in part to the ongoing strength of export volumes, which hit a new record high last month.

Chart 5: Activity & Spending (% y/y)



Sources: CEIC, Capital Economics

Economic Diary & Forecasts

Upcoming Events and Data Releases

Date	Country	Release/Indicator/Event	Time (China)	Previous*	Median*	CE Forecasts*
December						
Sat 9th		**Chn** Consumer Prices (Nov.)	(09.30)	(-0.2%)	(-0.2%)	(-0.2%)
		Chn Producer Prices (Nov.)	(09.30)	(-2.6%)	(-2.8%)	(-2.8%)
Fri 15th		**Chn** 1-Year Medium-Term Lending Facility (MLF) Auction (Nov.)	(09.20)	2.50%	2.50%	2.40%
		Chn Home Prices (70 Cities) (Nov.)	(09.30)	-0.4%	-	-
		Chn Industrial Production (Nov.)	(10.00)	(+4.6%)	(+5.7%)	(+5.2%)
		Chn Retail Sales (Nov.)	(10.00)	(+7.6%)	(+12.5%)	(+13.0%)
		Chn Fixed Asset Investment (Nov., YTD)	(10.00)	(+2.9%)	(+3.0%)	(+3.0%)
		Chn Property Investment (Nov., YTD)	(10.00)	(-9.3%)	(-9.4%)	(-15.2%)
		Chn Surveyed Unemployment Rate (Nov.)	(10.00)	5.00%	5.00%	5.00%
		Chn Foreign Exchange Net Settlement and Receipts (Nov., RMB)	-	-57.8bn	-	-
Also expected during this period:						
9th - 15th		**Chn** Aggregate Financing "AFRE" (Nov., RMB)	-	+1850bn	+2600bn	+2650bn
9th - 15th		**Chn** M2 Money Supply (Nov., RMB)	-	(+10.3%)	(+10.0%)	(+10.1%)
9th - 15th		**Chn** Net New Lending (Nov., RMB)	-	+738.4bn	+1300bn	+1280bn
11th – 18th		**Chn** Foreign Direct Investment (Nov., RMB)	-	(-9.4%)	-	-
TBC		**Chn** Vehicle Sales (Nov.)	(09.30)	-	-	-

Selected future data releases and events:

December

Tue 19th		**HK** Unemployment Rate (Nov.)
Wed 20th		**Chn** Loan Prime Rate (Dec.)
Thu 21st		**HK** Consumer Prices (Nov.)
Also expected during this period:		
TBC		**Chn** Central Economic Work Conference
TBC		**Chn** 3rd Plenum of the 20th Central Committee of the Chinese Communist Party

Main Economic & Market Forecasts

%q/q annualised (%y/y), unless stated	Latest	Q4 2023	Q1 2024	Q2 2024	Q3 2024	2022	2023f	2024f	2025f
Official GDP	+1.3(+4.9)*	(5.1)	(3.9)	(4.5)	(4.3)	(3.0)	(5.0)	(4.5)	(4.0)
GDP (CE CAP-derived estimates)	+0.7(+6.8)*	(9.6)	(6.1)	(4.3)	(4.6)	(-3.5)	(8.0)	(4.5)	(3.0)
Consumer Prices	(-0.2)**	(0.0)	(0.7)	(0.9)	(1.3)	(2.0)	(0.5)	(1.0)	(1.5)
Producer Prices	(-2.6)**	(-3.4)	(-3.1)	(-1.9)	(-1.3)	(4.0)	(-3.0)	(-1.5)	(-0.5)
Broad Credit (AFRE)	(+9.3)**	(10.2)	(9.4)	(9.8)	(9.8)	(9.6)	(10.2)	(9.7)	(8.3)
Exports (US$)	(+0.5)***	(-8.0)	(-16.0)	(-18.0)	(-15.5)	(7.0)	(-6.0)	(-14.0)	(1.5)
Imports (US$)	(-0.6)***	(-7.5)	(9.0)	(0.0)	(-4.0)	(0.5)	(-7.5)	(1.0)	(1.0)
RMB/$†	7.15	7.10	7.10	7.00	6.90	6.95	7.10	6.80	6.50
7-day PBOC reverse repo† %	1.80	1.70	1.60	1.60	1.60	2.00	1.70	1.60	1.60
1-year Loan Prime Rate† (LPR) %	3.45	3.35	3.25	3.25	3.25	3.65	3.35	3.25	3.25
1-year MLF Rate† %	2.50	2.40	2.30	2.30	2.30	2.75	2.40	2.30	2.30
10-year Government Bond Yield† %	2.69	2.60	2.50	2.50	2.50	2.85	2.60	2.50	2.40
RRR (major banks)† %	10.50	10.25	10.25	10.25	10.25	11.00	10.25	10.25	10.25
CSI 300 Index†	3,405	3,800	3,900	4,000	4,100	3,872	3,800	4,200	4,900
Hong Kong GDP	(+4.1)*	(5.1)	(1.2)	(3.8)	(5)	(-3.5)	(3.5)	(4.0)	(3.5)
Hang Seng Index†	16,338	17,500	18,188	18,875	19,563	19,781	17,500	20,250	23,250

Sources: Bloomberg, Refinitiv, CEIC, Capital Economics *Q3; **Oct.; ***Nov; †End of period