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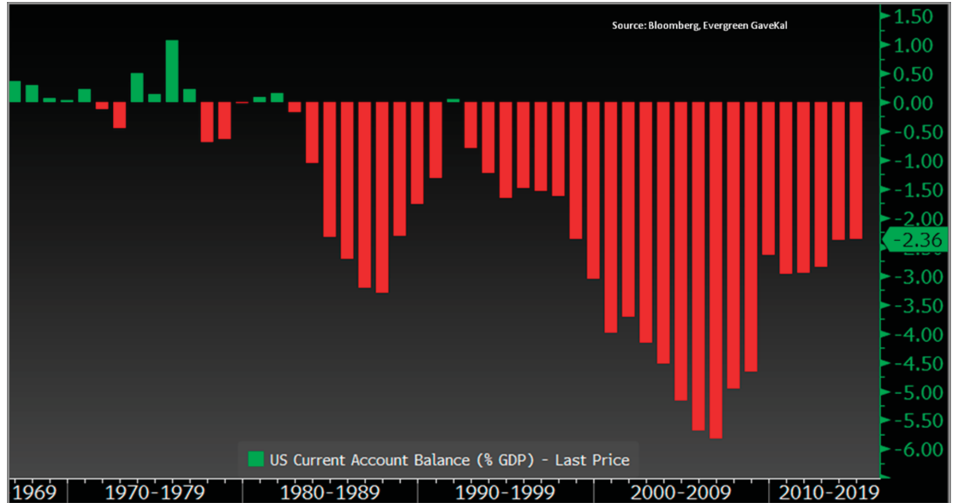
Falling Fed deficits have neutered any serious efforts for fiscal reform. The trend is not our friend in this regard.



Slumping Growth, Booming Market

Chen Long

The gap between China's booming stock markets and slumping economic growth just got a lot wider. Figures for the first quarter published today showed a picture of nearly unrelieved gloom, with most growth readings at their weakest since the first quarter of 2009 when China was suffering from the global financial crisis. This poor performance is not surprising, given the structural slowdown in the housing market, falling corporate profits, anemic investment, fiscal tightening, and seasonal weakness at the start of the year (see Let's Watch That Movie Again). But economic indicators will stabilize somewhat over coming months as the government continues to ease policy. Meanwhile, China's surging stock markets are very likely to simply ignore the bad data and continue to ride the momentum from record volumes.

Headline GDP growth of 7% Year-over-Year was in line with the government's target for the year, but most other indicators were much worse. Annualized Quarter-over-Quarter GDP growth slumped to 5.3%, and nominal GDP growth was down to 5.8%, with the

Checking The Boxes
Our short take on the latest news

Fact	Consensus belief	GK Research reaction
US retail sales rose 0.9% Month-over-Month in Mar, from -0.5% in Feb; ex-auto & gas rose 0.5%	Less than the expected bounce-back of 1.1% and 0.6% respectively	Real sales growth ex-gas has been steady since 2012 (around 2.9% real); it's still on that trend
Eurozone industrial production rose 1.6% Year-over-Year in Feb, from 0.4% in Jan	Higher than 0.8% expected; 11% below 2008 peak	New export orders supported by weak euro & higher real incomes breeding confidence in recovery
China GDP growth slowed to 7% Year-over-Year in 1Q15 from 7.3%; slowest growth in six years	In line with expectations, but annualized Quarter-over-Quarter figure slowed 5.3% from 6.1%	The slowdown calls for more fiscal spending and further interest rate cuts
China total credit growth slowed to 12.7% Year-over-Year in Mar, from 13.8% in Feb	New bank loans RMB 1.2trn versus expected RMB 1trn; aggregate financing missed exp. RMB 1.5trn	Despite rate cuts, curbs on shadow financing continue to weigh on overall credit growth

GDP deflator in negative territory. Monthly data for March, including key indicators like industrial production, exports, fixed asset investment and retail sales, also failed to show any of the improvement that many observers had expected. One of the few pieces of good news is that household incomes grew 8.1% in real terms, faster than GDP, while the economy created 3.2mn new urban jobs, on track to meet the annual target of 10mn. Part of the reason is that the current economic distress is concentrated in state-controlled commodity and heavy industrial sectors, which are less labor intensive and not as quick to cut workers.

So far neither the real economy nor credit growth has shown much response to the two interest rate cuts of the last six months. Although bank loan growth has picked up marginally from 13.2% to 14% since October, the increase has largely been offset by tighter controls over shadow finance. Consequently total credit growth has fallen to 12.7%, the slowest since 2006. Falling nominal growth rates also argue for more interest rate cuts. With nominal GDP growth at 5.8%, the average corporate borrowing cost of 6.3% looks too high.

The central bank has already cut benchmark lending rates to their 2009 level. But as the banks have greater autonomy in setting rates today and the risk premium has risen, the central bank needs not only to cut the benchmark rate but also to reduce interbank rates. To achieve the latter, the People's Bank of China needs to cut reserve requirements aggressively (see [China] The Relevance Of Bank Reserve Cuts). We now expect another 50bps of interest rate cuts this year, 25bps more than our previous forecast, and at least 200bps of cuts in the reserve requirement ratio. More support will also come from the fiscal side, as the promised refinancing of RMB1trn in local government debt gets under way in the second quarter. Corporate profits, which have been falling for months as margins contract, are also likely to start turning up in the second half of the year. Combined with some of the usual seasonal pick-up, economic indicators are likely to stabilize somewhat, if not improve slightly, over the rest of 2015.

The equity market's performance has been driven mostly by the government's policy response, rather than by the economic data. While economic growth has continued to weaken, Chinese stock markets have enjoyed the biggest rally since 2007, with a huge run-up in the domestic A-share market, which has now spilled over to Hong Kong. The flows last week were especially heavy, forcing the Hong Kong Monetary Authority to intervene in the currency market to offset huge capital inflows—despite a big gain in the US dollar. A strong US dollar usually means a weak Hong Kong stock market, but the relationship has broken down because this time Chinese funds, rather than global investors, are driving the bull run.

Chinese investors and Western investors have had very different reactions to the equity rally. Many Western investors have held back, because of concerns about weaker economic fundamentals and slowing earnings—a "bad news is bad news" argument. Chinese retail investors have played it differently. Initially they followed a "bad news is good news" logic, and so the decisive easing of monetary policy triggered the rally from November. The subsequent momentum has become increasingly self-sustaining, especially as China's government continues to encourage the bull market. Consequently, both the A-share and H-share markets have seen record high volumes in the past month. Given this unprecedented momentum, economic news that is moderately good or moderately bad is unlikely to change investor behavior. Barring a major policy mistake or unanticipated economic shock, the stock market's rally can continue.

See Test Your Knowledge on the next page.

Test Your Knowledge

The 28% year to date rise in the Shanghai stock market is impressive. But which is the world's best performing market so far this year in US dollar terms?

a) Argentina
b) Venezuela
c) Peru
d) Colombia

Answer: b) Peru. Investors may have written both countries off as economic basket cases, but Venezuela's stock market has climbed 42% per cent this year in US dollar terms, while Argentina's Merval index is up 34%. The catch is that both countries operate exchange controls. Calculating performance using prevailing black market exchange rates rather than the offical rates paints a slightly different picture: Venezuela is up 39% year to date, while Argentina has gained 36%. Both Peru and Colombia are down -16% in US dollar terms. Find black market exchange rates here.

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