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Global Macro 360

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Weekly Note: China – An Evolving Risk

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Until last Friday's headline regarding the Mueller investigation, US equities had posted new all-time highs on every benchmark, powered by boomy data (global manufacturing PMI made a near seven-year high) and expectations of tax reform. With each week of equity gains, we have maintained that non-US equities can rise further on their respective domestic earnings momentum for 2018, and that DM bonds could enter a broad bear market next year even if tax reform fails. These remain core views, and thus there is no change in strategy despite this week's headline barrage from Washington.

The Mueller investigation will likely remain a source of recurring but random market stress because it can distract the Beltway from a potentially transformative policy agenda. Those looking for asymmetric hedges against an adverse outcome should consider selling USD vs JPY, as the yen already has an upward bias in 2018. This is, of course, only true if our view that the BoJ will lift its yield curve target as core inflation rises is correct.

TABLE 1 THIS WEEK IN MARKETS

Name	YTD %	MTD %	WTD %
DOW JONES	22.36%	-0.38%	1.44%
S&P 500	17.45%	-0.68%	0.10%
RUSSELL 2000	11.76%	-1.77%	-1.28%
NASDAQ COMPOSITE	25.62%	-1.63%	-2.17%
Euro Stoxx 50	8.51%	0.02%	-0.36%
FTSE 100	2.59%	0.01%	-1.78%
DAX 30	13.65%	0.19%	-0.08%
NIKKEI 225	16.02%	-2.41%	-1.86%
HANG SENG	28.67%	-2.98%	-4.44%
S&P/ASX 200	4.94%	-0.41%	-1.09%
EUR-USD X-RATE	12.44%	-0.66%	-0.19%
EUR-GBP X-RATE	-3.31%	-0.20%	0.09%
Gold Spot $/Oz	10.51%	-0.54%	-1.21%
Crude Oil	6.98%	0.12%	0.30%

Outside of intra-day volatility spikes seen last week, one struggles to identify stress in the global economy or in financial markets. Not that we and clients haven't unpacked several of these for the year ahead. One is in China, where some activity data is softening as liquidity stress emerges in the interbank and the bond markets Another is in oil, where the OPEC-Russia decision to extend production cuts without further consideration until June 2018 highlights the risk of a disorderly regime change next year. A third is in Japan, where an uptick in medium-term rate volatility (as it falls in Treasuries and Bunds) reflects investor suspicions that the BoJ may raise its yield curve target next year, an event that would be quite bullish for the yen and bearish for DM rates.

Let's focus, however, on China and their upcoming liquidity stress, since it is the issue that has been percolating the longest and the one that could impact some markets durably into Q1 2018. Chinese funding rates have been rising steadily since the October National Party Congress refocused attention on financial deleveraging; they did this partly by prioritizing balanced growth and partly by aligning Party objectives with the State's, at all levels.

Since mid-October, 3-month SHIBOR rates are up 35bp; 10Y government bond yields up 30bp (more than almost every other bond market in the world); 5Y AA corporate bond yields up 60bp; and 5Y BBB corporate yields up 60bp. Even though these moves are more market than policy driven – the policy-linked 1-week SHIBOR rates have been stable around 2.9% since May – yield levels across the curve and credit spectrum suggest greater funding pressure than occurred last spring, when global markets were briefly obsessed with China credit tightening.

Should this episode of Chinese liquidity stress, which seems to resurface about annually, matter more for markets than previous ones? Recall that the summer 2015 episode, when 1-week SHIBOR rose over 100bp, culminated in the August crash of both the S&P and Shanghai Composite. The more protracted credit tightening in Q1/Q2 this year, when 1-week SHIBOR rose about 60bp, was associated with 5% declines in some commodity currencies, 10% declines in base metals, and 20% decline in resource stocks.

The answer varies by market. We have always expected modest but selective tightening in Chinese liquidity conditions as part of policymakers' continuous focus on deleveraging. Corporate indebtedness has only peaked at record levels (166% of GDP) rather than begun a trend decline. Our key message has been for sector-specific and limited-duration tightening (like city-specific restriction on housing, tapered fiscal spending, rollovers of short-term lending facilities) rather than economy-wide measures (like changes in PBoC lending rates or reserve requirements). This more tactical approach is reflected in the stability of 1-week SHIBOR rates, unlike the summer 2015 and spring 2017 episodes.

For longer-term investments like equities, slightly less short-term growth to promote more longer-term stability could be seen as a positive, particularly if a market is relatively cheap versus its peers (MSCI China is one of the few global indices whose forward PE is less than one sigma above its long-term average.) Moreover, if economic rebalancing favours sectors with a heavy index weighting (MSCI China comprises about 45% new economy sectors like IT and e-commerce), then aggregate growth matters less that growth's composition for market performance.

The same optimism does not extend to commodities or the commodity complex. The problems for base metals are two-fold: the slowing sectors (fixed investment) are the commodity-intensive ones, and most base metals entered November a good 10% higher than what their cyclical correlates like a global PMI would justify. It's true that supply curbs for those metals subject to early-stage Chinese environmental restrictions (like aluminium) would ultimately outperform those without such controls (like copper), but in the short term, overvalued markets almost always de-rate at cyclical turning points. We would stay very cautious on Commodities.