MAY
10
2022

# Raining Vows of Easing Amid Resolute Covid Controls

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**Daunted by sharply rising and not-so-transitory inflation, global central banks are in various stages of unwinding ultra-easy monetary policies, and many countries are learning coping strategies for "living with Covid." These moves toward normalizing economic activity make China stand out even more. With inflation being relatively benign, China has prioritized stability and safety in a highly political year. It is the only country that still insists on resolute "zero-Covid" policies and reluctant policy easing. This policy divergence likely will have significant investment implications for financial assets in both developed and emerging market (EM) countries.**

## Repeated Vows of Easing…

As the first in on Covid, China was also the first out in unwinding the related economic easing, launching multi-faceted, full-throttle tightening in November 2020. However, it reversed to an easing bias in July 2021 due to the renewed growth slowdown. But easing has been targeted and reluctant, hardly offsetting the property market woes and various regulatory clampdowns. Now, China faces daunting challenges as a new Omicron outbreak goes head-to-head with the zero-Covid policy. The much-awaited Politburo meeting on April 29 maintained the 5.5% growth target but acknowledged increased challenges from Covid, Federal Reserve (Fed) tightening, and the Russia-Ukraine war, and called for stronger policy support to stabilize the economy. Here are the major easing signals from the meeting:

- Enhance infrastructure investment and encourage local government easing on property market: The meeting called for further property policy easing to support housing demand and better management of developers' pre-sales. While the likelihood of nationwide property market easing remains very low, more local government easing policies were encouraged, like lowering mortgage rates and down payments, and removing purchase restrictions. Infrastructure investment will center around promoting "national security," including transportation, water conservation, and high technologies like cloud computing and AI.
- Stabilize employment and consumption through SMEs and supply chains: Encouraging factory reopening, smoothing transport and logistics flows, and normalizing supply chain operations, along with a fiscal subsidy to encourage small and medium-size enterprise (SME) hiring, should help create jobs and spur consumption. No fiscal transfer directly to households was mentioned, but several policy measures supporting SMEs were announced.
- Complete rectification on internet platform companies and shift to normal supervision: The harsh clampdown will pause for the time being.
- Potentially refine zero-Covid policy: While no change to the zero-Covid policy was made, policymakers called for minimizing its social and economic impacts, implying some fine-tuning is likely.

## …Continue to Fall Short

Despite frequent vows from policymakers to ensure stability, China's easing policies have been underwhelming and focused on the following:

- Focus on fiscal rather than monetary easing: Considering the Fed and some other central banks are tightening to contain inflation, China tried to stave off portfolio outflows triggered by narrowing interest rate differentials. As a result, interest rate and reserve requirement ratio (RRR) cuts have been very limited. Easing has expanded the quantity of credit rather than the price of credit. Consequently, credit lending picked up in January and February 2022 after the credit impulse bottomed in late 2021. Fiscal easing has played a major role and has been front-loaded to early this year with a special bond issuance quota to be completed by September 2022. Spending has been concentrated on building a modern infrastructure system and tax/fee cuts for SMEs.
- Focus on stimulating corporations rather than households, and supply easing rather than demand easing: Little has been done to boost household disposable income and spending, despite the job market weakening to 5.8% unemployment, a historical high. As a result, disposable income growth has slowed, and households have been increasing their propensity to save, negatively impacting consumer sentiment and spending.
- Focus on targeted easing rather than across-the-board easing: Policymakers have been restraining from broad easing, fearful of stimulus leaking to property market speculation. Instead, targeted easing has been applied to favored growth sectors, like green energy, high-end manufacturing, innovative technology, inland rural development, etc. Meanwhile, the property sector's woes continue.

Policymakers at the National People's Congress meeting in March 2022 resolved to stabilize the economy in a critical power-transition year and reverse 2021's multi-faceted tightening. However, despite an ambitious growth target of 5.5%, a "do whatever it takes" mantra, and repeated vows of easing, the measures have been disappointing and reluctant. Will the Politburo meeting mark an inflection point?

# China's Biggest Gamble: Resolute Covid Control

China faces many challenges in achieving the 5.5% growth target, but the primary risk is its resolute zero-Covid policy. In early April, more contagious variants prompted various degrees of lockdowns in cities that had accounted for roughly 40% of China's gross domestic product (GDP), including Shanghai, a city of 25 million. Since then, the situation may start to improve on the margin, but the restrictions on mobility threaten supply chains, sentiment, and consumption and pose the most severe threat to China's economy, with likely spillover effects on global growth.

Understanding China's dogged commitment to its zero-Covid stance requires an acknowledgement of the policy's early relative success before March 2022, often attributed to the Party's strong governance, and President Xi's priorities for this political year of stability and safety with growth secondary. However, the motto of "Human beings can conquer nature" is failing to overcome growing discontent among the populace, especially when there is no clear exit plan on the horizon. Policymakers, becoming more cognizant of the heavy blow to supply chains and logistics, also are calling for a more scientific and targeted approach. The government needs to ease more decisively to mitigate the economic impacts of its zero-Covid policy, including issuing more fiscal relief and consumption support.

# Conclusions with Investment Implications

Zero-Covid policy is likely to stay until the political transition is completed in early 2023. Also, easing measures likely will remain reluctant and targeted for fear of inflating asset bubbles and triggering financial systemic risk. With many global central banks tightening, the People's Bank of China (PBOC) will have limited room for interest rate cuts. The messages out of the Politburo meeting are encouraging, but there is a sequence to follow to enable those easing policies to be effective. Policymakers must contain Covid first or adopt a more sensible approach to coexist with it. Otherwise, rolling lockdowns will blunt any easing measures. In the meantime, we think the ability of supportive measures to boost global growth and risk assets, especially commodity prices, will be limited.

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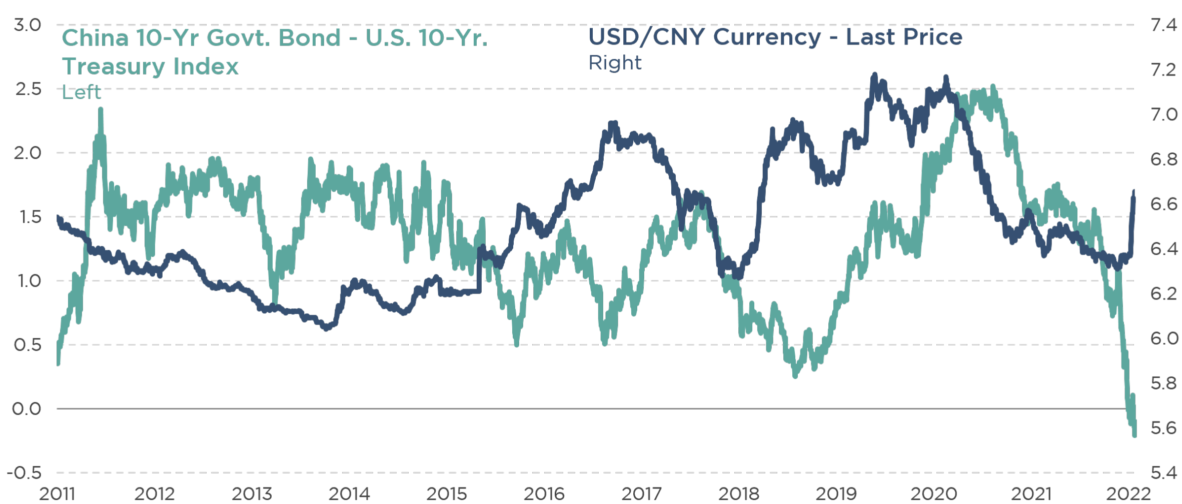
## 2. Renminbi:

The renminbi (RMB) has been one of the best performing currencies since 2020 due to China's successful Covid containment, healthy balance of payments, portfolio inflows, and resilient foreign direct investment. However, since mid-April, RMB has seen a sharp depreciation of over 4% within two weeks against the U.S. dollar (USD). We think RMB has more room to depreciate against both USD and the China Foreign Exchange Trade System basket, facing many pressures from the following forces:

- Not only is RMB's valuation rich, but the PBOC is allowing depreciation by fixing RMB lower on a daily basis, albeit at a gradual pace. The recent yuan (CNY) depreciation against USD is the largest since the last two depreciation cycles of 2015 and 2018. The interest rate differential between China 10-year and U.S. 10-year government bonds has turned negative, reducing the carry and triggering portfolio outflows from Chinese bonds and equities (see Exhibit 1). However, the real yield differential is still positive.

1 USD/CNY vs. Difference between Chinese and U.S. 10-Yr. Government Bond Yields
% (Left), Exchange Rate (Right) As of 5/5/2022

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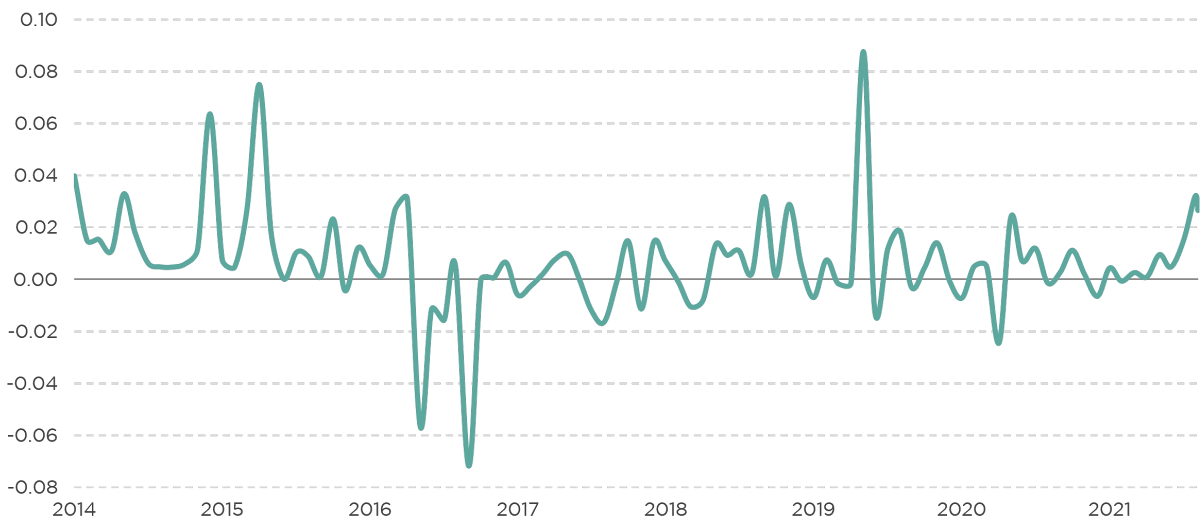
- The recent sharp depreciation will fuel further depreciation expectations and change onshore corporations' behavior in managing their foreign exchange (FX) positions. Onshore corporations may increase their FX purchases, and exporters may lower their FX conversion ratio, which can trigger further CNY depreciation.
- China's exports are set to slow, indicated by the PMI export data, as other developed market economies slow or shift spending to services from goods, combined with weaker European demand.
- The wider CNH/CNY basis, or the offshore market yuan weakening more over the onshore-traded CNY, highlights offshore investors' enthusiasm in chasing higher USD/CNY and how market forces are driving RMB weaker (see Exhibit 2).

## 2 | Basis between Offshore Yuan (CNH) and Onshore Yuan (CNY)

Spread, As of 05/06/2022

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- **The steep depreciation in the Japanese yen (JPY) also exerts pressure on RMB, which potentially erodes China's export competitiveness (see Exhibit 3).**

## 3 | CNY/JPY Has Reached an Extreme due to Yen's Sharp Depreciation

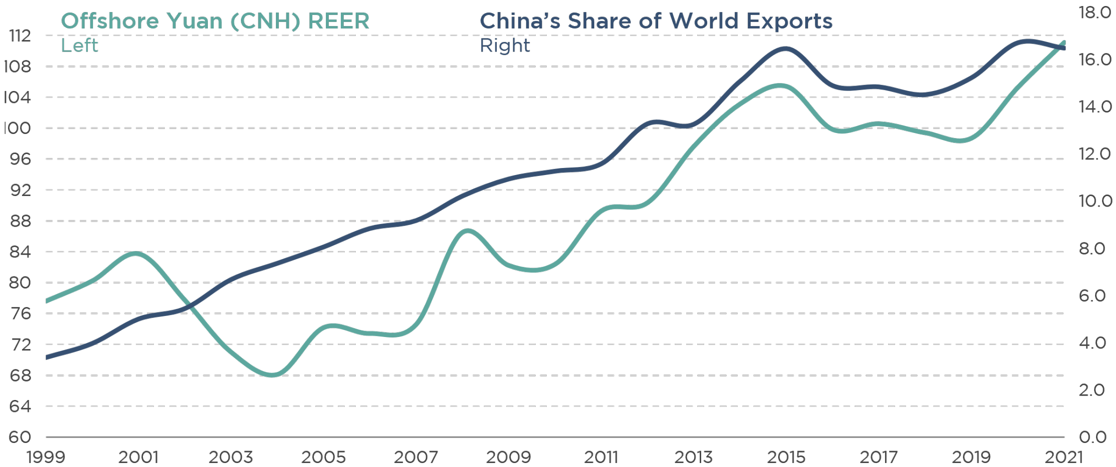
Exchange Rate, As of 5/05/2022


Source: Bloomberg (© 2022, Bloomberg Finance LP)

**We do not think the PBOC will devalue the currency to enhance China's export competitiveness. The rise in China's share of global exports has been accompanied an uptrend in the RMB real effective exchange rate (REER) (see Exhibit 4). Hence, export competitiveness has not been hampered by CNY appreciation.**

## 4 China's Share of Global Exports vs. Offshore Yuan Real Effective Exchange Rate (REER)

% (Right), CNH REER, As of 12/31/2021

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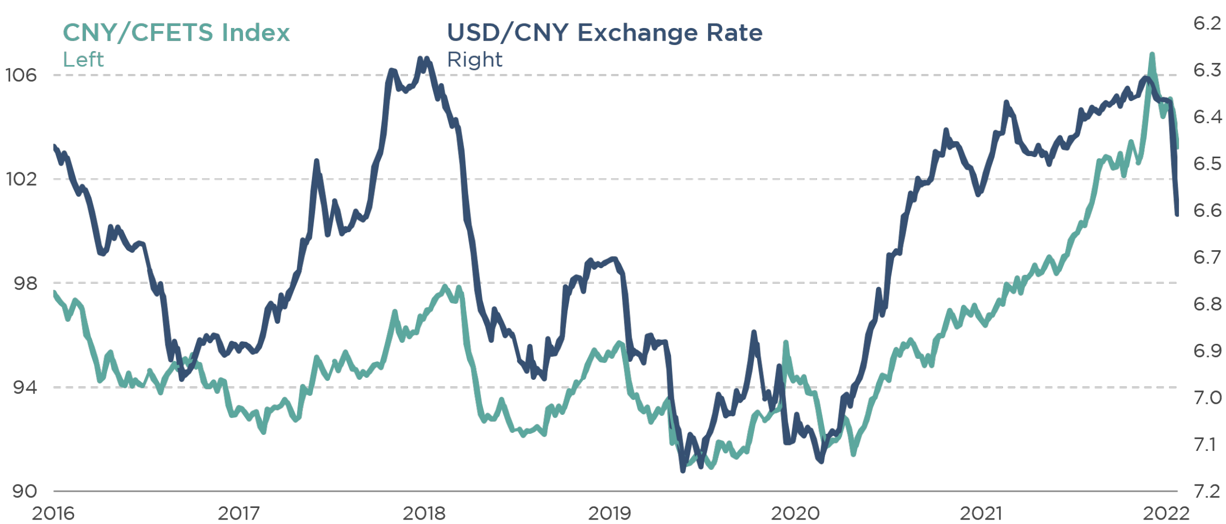
**However, the PBOC likely will allow RMB to be driven more by market forces while managing the pace of depreciation. To slow the pace of depreciation, the PBOC recently lowered the foreign exchange reserve ratio by 100 basis points. A relatively stable RMB is necessary, since China still strives for internationalization its currency. The recent weakness has been driven more by the strong USD, weaker JPY, and Covid-related economic weakness (see Exhibit 5). CNY still has room to depreciate against the CFETS basket as the ratio over 102 still looks elevated.**

## 5 USD vs. CNY and CNY vs. China Foreign Exchange Trade System Basket

Exchange Rate, As of 4/29/2022

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**Are we in for the third RMB depreciation cycle? By comparing the two depreciation cycles (see Exhibit 6), we learned that:**

- **In the 2015 - 2016 cycle, RMB depreciation against USD was triggered by financial stability risks.**

In the 2018 - 2019 cycle, RMB devaluation was due to the trade war.

- During these periods, RMB depreciated 13% and 12% against USD, and the cycles lasted 17 months and 18 months, respectively. Currently, depreciation is around 4%.
- The main driver for the first cycle was capital outflows while current account deterioration drove the second.
- Both depreciation cycles were accompanied by GDP slowdowns and Fed interest rate hikes. This time around, the depreciation, while also accompanied by a Fed rate hike cycle, is mostly triggered by Covid disruptions and the property market downcycle.
- Conclusion:

RMB depreciation may still be in an early stage with more room to go, given the macroeconomic similarities to past cycles. This depreciation should exert downward pressure on other EM currencies, especially Asian EM currencies. However, policymakers, learning from past mistakes, should have stronger command of financial tools to contain risks.

6 Comparing Current RMB Depreciation with Two Previous Depreciation Cycles

Exchange Rate, As of 4/29/2022

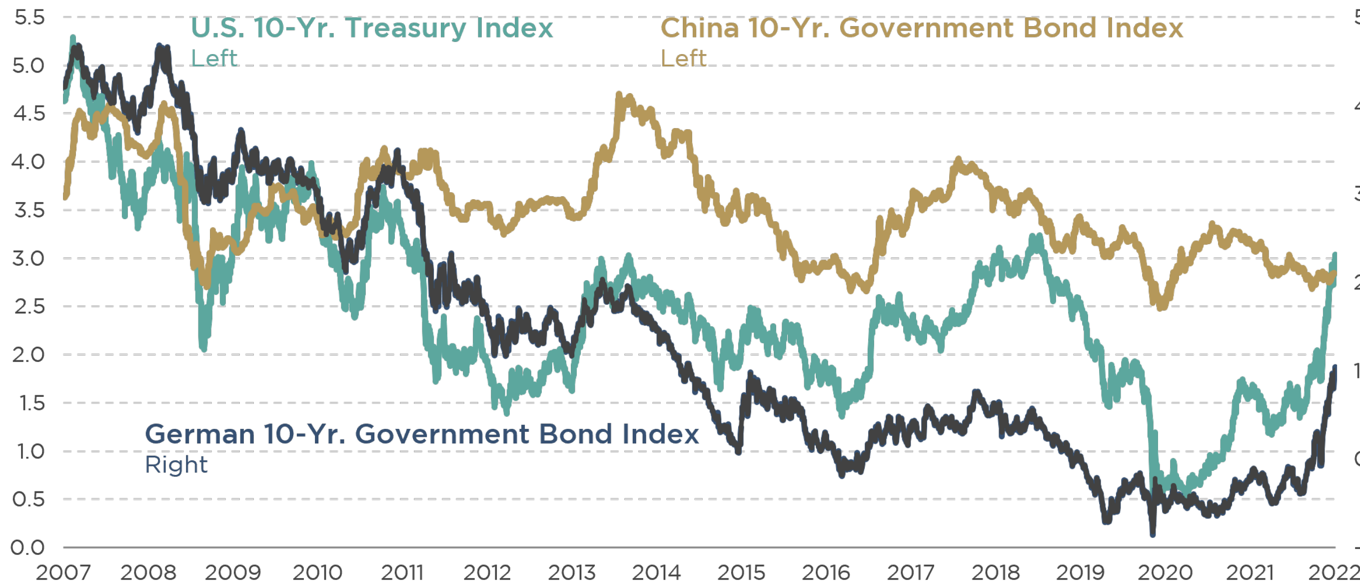

Source: Bloomberg (© 2022, Bloomberg Finance LP)

## Government Bonds:

We are neutral on Chinese government bonds. The PBOC injected enough liquidity, keeping interbank rates very low. The short end of the yield curve is well anchored, and we expect to see some curve steepening. Prior to the Russian-Ukraine war, Chinese bonds were behaving like alternative safe-haven assets, with high Sharpe ratios and low correlation with global bond markets over the long term. However, valuations are relatively full at this point and do not reflect the geopolitical risk premium related to China's ties with Russia. Recent foreign capital outflows from both China's equity and bond markets are somewhat concerning, even though foreign investors' share of China's bond market is only around 9%. While Covid and geopolitical risks remain, we believe China's growth should stabilize around the third quarter, albeit at a lower level, with inflation contained due to weak domestic demand. We believe the yield on the China 10-year government bond can end this year around low-to-mid 3%, on par with the U.S. 10-year Treasury yield (see Exhibit 7). The interest rate differential likely will not diverge too much from here.

7 China, U.S., and German 10-Yr. Government Bond Yields

%, As of 5/5/2022

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## Property Developers:

**As for Chinese high yield property developer names, we believe it is a game of survival. Property sales are still on a downward trend but may stabilize by year end with more defaults of weaker developers. Few developers boast sound balance sheets. Some state-owned enterprises (SOE) or high-quality private names with better balance sheets and no imminent maturity pressure may look attractive.**

## Equities:

**For Chinese equities, we suggest following the "visible hand" by focusing on sectors favored by China's strategic development, i.e., infrastructure, green/clean energy, high-end manufacturing, rural and inland development, and advanced technologies. Despite the Politburo message suggesting a shift to more normal oversight, we recommend caution on internet platforms, property developers, insurance, and other sectors that may continue to face regulatory pressures. With regard to real estate, we believe the years of extreme boom and bust are over. China's real estate market should become more plain-vanilla and more dominated by SOEs. Policymakers likely will not allow sharp moves in housing prices—in either direction—and will not use housing as a stimulus tool.**

**Once its best line of defense in controlling the impact of the pandemic, China's zero-Covid policy has now become its biggest economic threat. China must either emulate other countries' strategies for living with the virus or introduce more sweeping stimulus to outweigh the policy's negative impact on growth—or some combination of the two. Since China is unlikely to completely abandon its zero-Covid policy this year, we believe the government needs to offset the economic harm by overcompensating in terms of fiscal relief and**

**consumption support. Therefore, we believe some of the easing measures from the Politburo meeting will be implemented. It will be a challenging balance, but all things being equal, we expect the Chinese economy to stabilize later in the year, although at a slower rate of growth.**

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