Goldman Sachs The Markets

Does the China rally have legs?

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Chris Hussey: Chinese stocks have soared since policymakers announced a broad stimulus package. Are more gains ahead? This is The Markets. I'm Chris Hussey with Goldman Sachs Research, and my guest is Lu Sun, a senior Asia macro strategist in our Global Banking and Markets business. She joins us from Hong Kong. Lu, thanks for making the time on what must be a very busy week for you.

Lu Sun: Great to be here. Hi, Chris.

Chris Hussey: All right. Let's start with the basics. What drove the stimulus announcement, and what's in the package?

Lu Sun: Yeah, sure. So, you know, following the much weaker-than-expected GDP data for second quarter and also the Fed cuts 50 business points. I think overall this gave China a lot more policy room. And it seems that the top authority has decided that the policy put is triggered given how weak the domestic growth has been.

So far we got details from monetary side, property policy, and in equity. And most of them are above market expectation, in particular on monetary. The amount of rate cuts and [UNINTEL] cut are two times over the market originally expected. And on property as well, not only they cut inventory mortgage by 50 basis points in last few days, top tier cities in China all announced easing of home purchases restrictions, which led to an immediate rebound of the property transaction.

And in equity, it's the first time in recent history that CDNC announced direct to lending to market for them to buy equity by two facilities. They also talk about potential stabilization fund and also they want to channel more long-term funds as pension, etc., into the equity market. So I think overall, the package has been above market expectation, tell you that the policy put has been triggered from the very top authority. And the next one to watch is the fiscal down the road.

Chris Hussey: All right, so a policy put above market expectations, but we also know the Chinese economy has been grappling with some pretty significant issues. How much can this stimulus help fundamentally? Is it enough?

Lu Sun: Yeah. I think that's definitely a very pressing question. Among the already announced policy, especially in the monetary and property, the GIR economists estimate around 40 basis point boost to growth. Now, these are still pretty much supply-side measures, meaning that they are just making funding cheaper and easier for markets. But what we really need is demand-side policy, especially on fiscal, which is what the market is waiting for. And there has been a lot of reports, in particular there's one report by Reuter's saying they're going to do two trillion additional special CDB among which one trillion will focus on consumption, which is very important.

There's also market news talking about additional one trillion special CDB to help recap the large banks, which, if that gets realized, will be the first time they do that since the GFC.

So I think if these kinds of reported news get realized on the fiscal side, I expect some mild rebound in growth in fourth quarter and first quarter next year. As that continue to do relatively well, especially the property market is still in decline even after the mortgage rate cuts. The cost of funding in the mortgage market up 2% is still higher than the rental yield in top-tier cities, which is below 2%. So I think we're still adjusting. And I think for upside supplies, we really need more fiscal, more demand-side measures than what the market is currently expecting.

Chris Hussey: Okay. So we still need more, but it does seem like we did get something of an upside surprise. Markets were up a lot. Were you surprised by the extent of the reaction in Chinese stocks and bonds?

Lu Sun: I think the coming into the stimulus market was extremely bearishly positioned on China. If you look at our [UNINTEL] hedge fund allocation to Chinese equities has fallen to multi-year lows and mutual fund is very underweight China. Everybody you talk to, onshore, offshore, are very bearish on China. So I think a lot of this very fast rally is short covering, and especially on the long-only side, we keep seeing them buying given the outperformance of Chinese equities is very painful to their underweight positions in China.

And hedge funds have participated from very early on, I would say from the Tuesday monetary announcements, the foreign hedge funds really started to participate very early on. And we already see some signs of profit taking. What I think is very interesting is the onshore animal spirit has returned for the equity markets. For the first time since 2020 and 2021, I would say, there have been various local news reporting that the amount of accounts opening is reaching very, very high levels, even during the Golden Week that a lot of the security houses are working extra days to help people open accounts. So this will still have legs. Probably the fastest days of rally is behind us, but I think the bearish positioned is still adjusting. And most importantly, I think the onshore positioning, onshore animal spirit, will be the more important driver going forward.

Chris Hussey: All right. So does that imply that we have not gone too far, too fast? It's just going to take a long time to erase a decade of underperformance?

Lu Sun: So if you look at the recent change in valuation, the PE ratio has increased from eight times in early September to currently 11 times, which is almost actually at the height of the reopening level, like January 2023. So I wouldn't say it's stretched, given the onshore momentum is gathering. I would expect we could have further room.

And momentum itself, a recent rally is showing the strongest momentum since 2020-21, and historically when we see such very strong momentum from low to high we have seen Chinese equities rally either 50% or sometimes, in some cases, over 100% in 2014 and '15. So yeah, I think at this moment, authorities are probably happy given a lot of their measures are geared towards the equity market. And I think it's too early for them to put it to a stop or say any bubble. There's I think put valuation is not stretched. So I think this is likely to continue to have legs, although it's unrealistic to have 8% rally every day. So I would expect some of the early participants from offshore hedge funds to take some profits, and so the rally may slow down somewhat.

Chris Hussey: Very encouraging. Now, you mentioned that local Chinese are opening up new brokerage accounts, but what's the role do you think Chinese equities can play in portfolios of international investors? In the US particular, should investors now be making room for China again?

Lu Sun: Definitely I think the real long-term money participation in China is still pretty low for either equity or stocks, given the concern about geopolitical risk and also political and policy uncertainty. However, I would like to point out that throughout recent years China risk parity has done well, if you long both bond and equity with the right ratio. In general, it's been working well. This is because China does not have inflation, so that the policy response can be more geared towards growth. And if that's not efficient, then bond market will rally to express further easing potentially down the road.

So I think China risk parity, long bond plus long equity is a pretty option to have in the portfolio. And most importantly, it has unique diversification benefits, given China's correlation to global bonds and equity is very low. Like, in recent years, the bond EBITDA is essentially zero and also very minimal for equity as well.

Chris Hussey: Great point. Last question for you, Lu. As you mentioned, it is Golden Week this week, an annual holiday where people take the whole week off in mainland China. But folks will be back next week. What are you going to be watching out for next week?

Lu Sun: Yeah, sure. First is that the active data on the Golden Week because we've seen this massive equity rally. The policy fact may translate into better consumption data. And also the property sales has already seen some uptick in recent days following the poverty policy relaxation and mortgage rate cuts. So we need to see the property transaction data, whether it is going to look a lot better than the previous weeks. I think that will give us some early indicator about the policy effectiveness or the wealth defect from the equity rally.

And the second is really fiscal. As I mentioned, a lot of the announced measures are supply-side measures. The market will be keenly waiting for demand-side measures, a.k.a. fiscal. So I think the fiscal quota will be out as soon as end of the Golden Week but can also wait another month until the next National People's Congress Standing

Committee.

So yeah, I think these will be the key market drivers in the next few weeks.

Chris Hussey: Great stuff. Watch the data. Watch the policy. Lu, thanks so much for joining us.

Lu Sun: Great pleasure. Thank you.

Chris Hussey: That does it for this week's episode of The Markets. I'm Chris Hussey. Thanks for listening. And if you want to hear more from Goldman Sachs, listen to Exchanges, our weekly podcast about the long-term trends impacting the economy and investors' portfolios.

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