Our Views on Key Macro Questions

By the Macro Strategies Team

KEY TAKEAWAYS

- US economic data should improve through the second quarter, and we expect stronger second-half results.
- The Fed appears set for a September rate hike, and rate expectations are supporting the US dollar after recent consolidation.
- For Europe to parlay its cyclical upswing into a self-sustaining recovery, capital spending will be key.
- China is easing policy, but a surge in economic growth looks unlikely.
- Risks are rising in the Chinese stock market, but local investors have been buying the dips so far.

As we head into the second half of 2015, our senior economists, sovereign analysts and macro strategists tackle key questions on the US economy, the dollar and rates, Europe and China's growth trajectory and equity markets.

When will US data bounce back?

We expect improving data through the second quarter and a stronger second half of the year, led by consumers. First-quarter data were hit by winter weather, disruption from the West Coast port slowdown and strike, and flawed government seasonal adjustment procedures. Despite weakness in the export sector, improving economic trends should support growth going forward.

- As a net oil importer, the US benefits from the collapse in oil prices. But the hit to domestic oil drilling seems to have happened quickly, while the benefits for the consumer are accruing more slowly. By and large, gains from higher real disposable incomes were saved. Even so, growing employment, firming wages, low inflation, a rising stock market and higher house prices should result in solid consumer spending in the last six months of the year.
- Other pro-growth trends include the end of household and business deleveraging, a shrinking backlog of delinquent mortgages, a declining number of housing vacancies, rising "pent-up" demand for business capital spending, infrastructure spending and housing construction. Fiscal policy is no longer being tightened. And energy prices remain relatively low.
- The trade balance and the manufacturing sector have been hurt by the strong US dollar and weakness in some major trading partners. The trade sector is likely to remain a drag on the economy.

When will the Fed hike?

The Federal Reserve (the Fed) appears on course for a September hike; risk centers on the timing of the rebound from the first-quarter malaise. Chair Yellen continues to steer the market toward a 2015 hike so long as she sees "further improvement in the labor market" and is "reasonably confident that inflation will move back to its 2% objective over the medium term."[i] We think she'll have the confidence to hike by September.

Are we at the beginning of another leg stronger in the US dollar?

Dollar weakness during March and April was driven mostly by Fed rate expectations being pushed out. During that period, some high-beta emerging market (EM) currencies, such as the Brazilian real, rebounded; however, EM performance was not universally bullish. This suggested dollar weakness might be brief and ready to reverse, which we think is now underway.

The Japanese yen per US dollar exchange rate appears to be breaking out from a narrow ¥116 to ¥121.5 trading range, while the euro recently peaked around $1.15 and has since dropped. Without major policy news out of Japan and Europe, these moves primarily reflect expected US rate support and are a good sign the dollar is making a comeback after a period of consolidation.

Breakeven inflation rates for Europe recently rolled over, which may have encouraged foreign exchange markets that the higher euro was deflationary. Same for the yen, policy makers have had to push out the time frame for reaching their inflation target. Weak exchange rates have been a critical tool for boosting inflation expectations.

What will it take for Europe's upswing to become a solid recovery?

Currently, the key question in the euro area is whether the solid economic cyclical upswing can transform into a self-sustaining recovery. So far, growth has been buoyed by renewed consumer activity. Consumer confidence has risen on the back on easier European Central Bank (ECB) policy and cheaper energy. We believe the key to this upswing becoming a solid recovery is business investment, such as capital spending on production and equipment as well as research and development; euro area spending in this critical area has lagged since the global financial crisis.

Is China doing QE?

We think recent policy easing in China has three goals:

1. To allow for the orderly refinancing of the local government debt.
2. To revitalize the property market sufficiently to stabilize sales and new construction.
3. To restore lost liquidity as Chinese yuan are converted to dollars and head offshore.

We expect the People's Bank of China (PBOC) to continue tweaking policy to manage these dynamics, but we do not think the loosening will reignite a strong growth path for the Chinese economy.

CHINA HAS EASED POLICY BY:

1. Cutting loan and deposit rates.
2. Lowering the required reserve ratio twice since February 2015 to the current level of 18.5%.
3. Supplementing banks' lending capacity through the PBOC's Medium-Term Lending Facility and the Standing-Lending Facility.
4. Having the PBOC make equity contributions to the policy banks (e.g., the China Development Bank and the Agricultural Policy Bank) to expand their lending capacity.
5. Implementing programs such as the "Silk Road" and the Asia Infrastructure Investment Bank (AIIB), which will expand Chinese investment in the region.
6. Peeling away restrictions on bank lending in the property sector.

Is Chinese investment spending accelerating?

Policymakers seem willing to allow gradual growth deceleration rather than risk another surge in credit. However, the sharp property slowdown has raised concerns; thus, we have seen some reversion recently to the most reliable policy tool—government investment spending on infrastructure. The Silk Road program is a pro-growth domestic policy in disguise: the China Development Bank lends $10 billion to Pakistan, for example, which Pakistan in turn uses to purchase Chinese construction projects using Chinese materials and labor. All of which adds to Chinese GDP.

Detroit Comes to China?

Local government debt boomed from 2009 to 2012; now these loans are coming due, and many cannot be repaid. Beijing is looking to engineer an orderly deleveraging by extending maturities via the so-called local government "debt swap" program, essentially the largest forced debt exchange in the history of the world. (In most parts of the world, a forced debt exchange is known as a default.) Since the Chinese government controls both sides of the trade, it can handily arrange the issuance and purchase of the debt. Everybody is still whole and no write-offs are necessary. But these actions do not create new investment in the economy and typically drag on growth.

Are Chinese stocks a bubble?

Chinese equity valuations have soared. Earnings multiples for Shenzen stocks (mostly industrials, services and technology) have jumped from 28x trailing earnings to over 70x in the past 18 months, with actual earnings about flat.[ii] Shanghai exchange listings ("A" shares) have soared from 10x to 24x earnings.[iii] While Shanghai "red chips"[iv] are not extremely valued on a price-to-earnings (P/E) basis, valuations in some sectors, particularly smaller capitalization companies and recent public offerings, are in bubble territory. In Hong Kong, China "H" shares trade at a more down-to-earth 11x earnings, up from about 9x, but importantly, these shares are weighted nearly 50% to the typically more conservatively valued banking and insurance sectors.[v]

Chinese stocks are just a few months into this aggressive mark-up phase. We recognize risks are rising, but local investors have been buying the dips so far. Growing global investor access to Chinese equities through broader representation in major global indices should be positive in the long term. In the near term, the surge in margin lending and relative inexperience of Chinese locals in managing volatility is a concern. A sharp drop in prices could further weigh on the Chinese macro outlook if newfound wealth is suddenly curtailed. For global investors, a severe decline in some of the more speculative stocks may not pose a major problem since most global exposure to Chinese equities is within the more conservatively valued "H" shares listed in Hong Kong.

WHAT'S BEHIND THE 140+% SURGE IN SHANGHAI AND SHENZEN STOCKS?

- Monetary easing by central authorities.
- Lower expected returns in property investment spurring a shift into equity.
- Expansion of the Hong Kong/ Shanghai connect program; Hong Kong/Shenzen expected later this summer.
- Liberalization of margin lending.
- Waves of successful initial public offerings.
- Government encouragement of opening multiple brokerage accounts.

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Endnotes

[i] *Transcript of Chair Yellen's FOMC Press Conference, May 18, 2015.*

[ii] *Bloomberg.*

[iii] *Bloomberg.*

[iv] *Stocks of mainland China companies incorporated outside mainland China and listed in Hong Kong.*

[v] *Bloomberg.*

Disclosure

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