



2019 Outlook: Don't Fight the PBOC

December 18, 2018

by Team
of VanEck

Jan van Eck, CEO, shares his investment outlook.

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“Don’t fight the Fed” is an old investing mantra, suggesting that investments should align with the Federal Reserve’s monetary policies instead of against them. After assessing the impact of the People’s Bank of China’s (PBOC’s) deleveraging efforts and the potential impact ahead of its stimulative policies, we believe a key theme for 2019 will be “Don’t fight the PBOC.”

What Went Wrong With Chinese Equities in 2018

Before looking at 2019, let’s start by reflecting on 2018. The big surprise was the underperformance of Chinese equities. With both good corporate profitability growth and a good economy, why did Chinese equities fall so much?

The answer may lie with what central banks are doing. In China, I think stocks fell as a result of the deleveraging in its economy that started a year or two earlier. While there is a lot of time spent talking about short-term things like trade tensions and politics, my view is that we should really look at liquidity—that is, what central banks are doing to the markets.

In China, this deleveraging should have signaled something. Starting this summer, however, the PBOC cut short-term rates by 200 basis points. It was stimulative. It usually takes about six to twelve months to kick in, so in either the first or second quarter next year, I think we can expect a boost to Chinese assets and the country’s economic growth.

Shanghai Interbank Offered Rate (SHIBOR)¹: Three Moves of at Least 2% Since 2014



Source: Bloomberg; Cornerstone Macro

Between now and then, there is going to be some uncertainty. First, we don't know when the stimulus will kick in. Second, there are trade tensions. And, third, with Chinese New Year falling in either January or February, sometimes it takes until March before we know what happened.

Markets tend not to like uncertainty, but I believe at least one of the stories of 2019 will be the rise of Chinese assets due to central bank easing.

No More “Boom! Boom!”, But Still Solid Growth

Looking forward, investors should get 8-10% GDP growth out of their minds, as I think China will more realistically see GDP growth closer to 4-5%. But the economy is large enough now that at 4% growth, companies can still grow profits at 10-20%, with some sectors growing at even higher rates.

Besides central bank policy, understanding the nature of the regulatory environment in New China is also important—not least because President Xi Jinping favors state-owned enterprises (SOEs)². Policies that help SOEs tend to be negative for China's private companies as well as for foreign private companies doing business in China.

The direction of China's economic policy has been uncertain, but in the last couple months, President Xi has signaled that he understands that private enterprise generates most of the jobs in China. That's a key component, but we will continue to watch this space. China is competing for our investment dollars, based on not just growth rates, but also regulatory climate, and it's a competitive world.

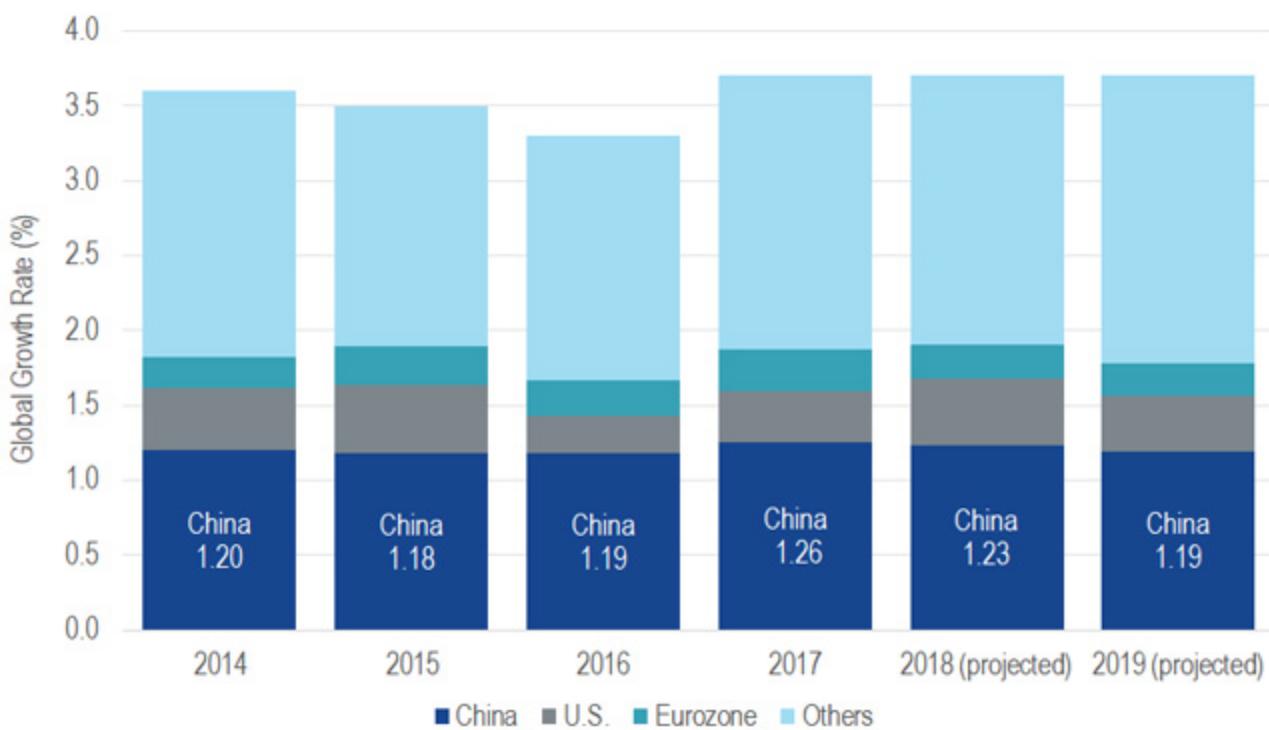
Don't Fight the PBOC

Despite a growth slowdown and other market economic imbalances, the Chinese government has been doggedly pursuing a reduction in shadow financing. Small and medium-size companies are the major consumers of shadow financing. This raises the question: How can the government be stimulating, when at the same time, it's trying to fix the imbalances in the country's financial system – which is inherently not stimulative, especially for those companies that can actually drive growth?

My answer would be that there are other fiscal and regulatory steps that China is taking that I believe will be net stimulative. Although, close up, the story is much more complicated, at the big picture level, I believe it is a case of "Don't fight the PBOC."

To oversimplify the world economy, there are essentially two engines driving it: China and the U.S. If the Chinese growth rate does start to look a little bit more attractive six to twelve months from now or if the U.S. starts pushing forward, then I think that should help on the margin for commodity demand.

China Is the Biggest Single Contributor to Global Growth



Source: VanEck; Bloomberg; IMF World Economic Outlook

Shifting Bond and Equity Correlation

Looking beyond China, an interesting change has happened to the correlation between stocks and

bonds in the U.S. This correlation has started to trend upwards. This means that using long-duration bonds as a shock absorber or hedge in a portfolio may become more difficult. Investors may need to look elsewhere for defensive positioning against equity risk.

Download the full Research Outlook for 2019: Don't Fight the PBOC.

IMPORTANT DISCLOSURE

¹The Shanghai Interbank Offered Rate (or SHIBOR) is a daily reference rate based on the interest rates at which banks offer to lend unsecured funds to other banks in the Shanghai wholesale (or "interbank") money market.

²A state-owned enterprise (SOE) is a legal entity that is created by a government in order to partake in commercial activities on the government's behalf.

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