DBS Flash

China: Not a rate cut cycle yet

Mainland China/ Economics/Monetary/Rates

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Samuel Tse
Economist
samueltse@dbs.com

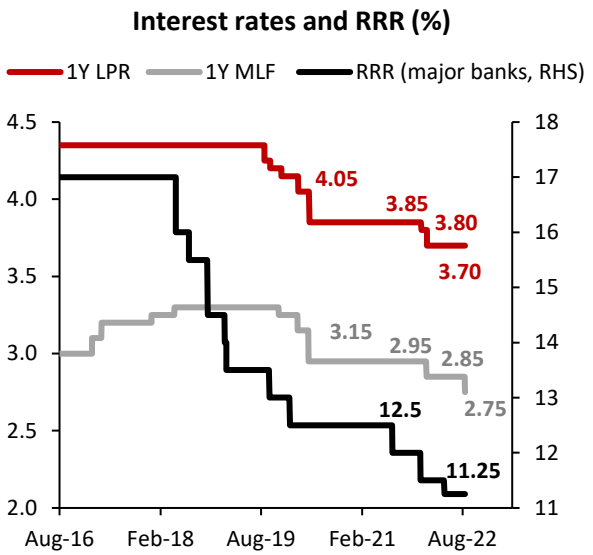
Duncan Tan
Rates Strategist
duncantan@dbs.com

Please direct distribution queries to
Violet Lee +65 68785281

- *The PBoC cut the 1Y MLF rate by 10bps to 2.75% this morning.*
- *Retail sales growth decelerated from 3.1% YoY in June to 2.7% in July.*
- *Export-led industrial production edged down from 3.9% to 3.8%.*
- *Fixed asset investment fell visibly from 6.1% YoY YTD to 5.7%.*
- ***Implication to our investors:***

  (i) We expect another 20bps of 1Y-LPR and MLF cut in this year only. The PBoC could also cut the RRR by 50bps. (ii) 2Y and 10Y CGB yields will hover around 2.2% and 2.7% in 2022 respectively.

Macro: Weakening fundamentals (Samuel Tse)



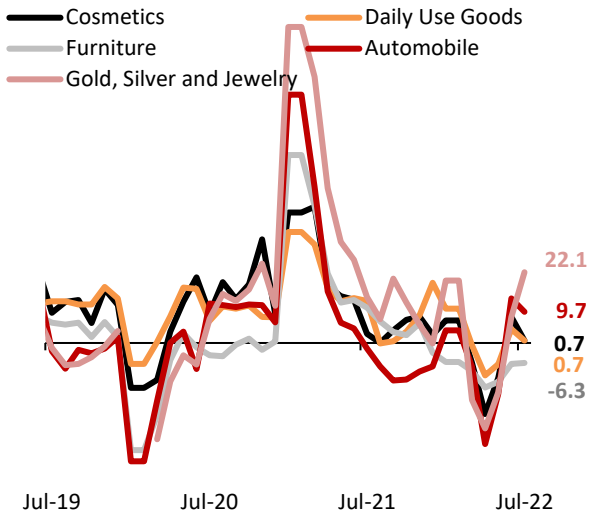
Source: Bloomberg, DBS

The PBoC cut the 1Y MLF rate by 10bps to 2.75% this morning. Accordingly, the 1Y LPR will likely be cut from 3.70% to 3.60% next week. These are largely a combined result of modest economic recovery and lingering mortgage boycott. This is, however, unlikely the beginning of an aggressive rate cut cycle because this will exert downward pressure on the CNY. In fact, the impact of such a mild cut on multiple fronts was muted this morning. 10Y CGB yields fell 6-7bps; USD/CNY held stable at 6.75. We expect there another 20bps of 1Y LPR and MLF cut in the next four months. The PBoC could also cut the RRR by 50bps.

The latest batch of macro data in July is discouraging. Retail sales decelerated from 3.1% YoY in June to 2.7% in July. Sales growth of automobiles eased from 13.9% to 9.7%, while necessities such as daily used goods, cosmetics and clothing saw decreases of different magnitude. F&B continued to contract by 1.2% compared to a year earlier. Furniture fell by

6.3% amid the housing mortgage boycott. The latest COVID lockdowns in Hainan and Tibet negatively impacted recovery momentum during the summer season.

Retail sales by category (YoY, %)



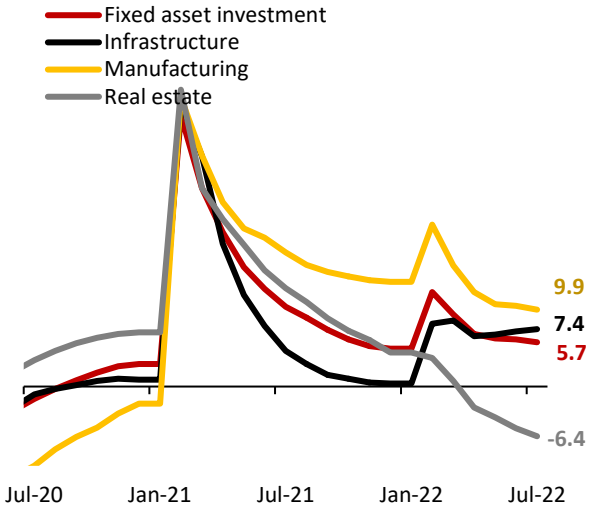
Source: CEIC, DBS

Export-led industrial production also edged down to 3.8% YoY in July from 3.9% in June. The textile and medical production drop extended to 4.8% and 10.3% from 3.9% and 8.5%, respectively. The domestic supply chain is still far from wholly normalized, as indicated by the highway traffic of major ports. Exports volume fell by 4.6% YoY in July, compared to 18.0% growth in value terms. Looking ahead, external demand will moderate amid rate hikes. US GDP contracted for the second quarter in a row in QoQ terms. Tariff reduction negotiation with the US has remained inconclusive.

Fixed asset investment fell visibly from 6.1% YoY YTD in June to 5.7% in July. Manufacturing investment slowed from 10.4% to 9.9% from a decline in total social financing to 10.7% from 10.8%; and a fall in loan outstanding growth to 11% from 11.2% New corporate mid-loan term loans fell by 7.7% YoY YTD. Meanwhile, real estate investment plunged further from -5.4% to 6.4% amid extended mortgage boycotts. Overall property price declined further by 0.11% MoM, with floor space started and sold falling 45.4% YoY and 30.3% respectively. Source of funding for real estate enterprises recorded double-digit drops for 6 months in a row. Amongst all, mortgages account for 15.8% of the total funding. In fact, new mid-long term household loans fell by 55% YoY in January-July.

On a brighter note, infrastructure investment accelerated from 7.1% YoY YTD to 7.4%. Planned investment year to date has increased by 10.8%. Improvement in import growth also indicates stronger infrastructure investment ahead. This could help counter the shortfall of real estate investment.

Fixed asset investment (YTD YoY, %)



Source: Bloomberg, DBS

On the inflation front, CPI rose to 2.7% YoY in July from 2.5% in June. The rise in CPI was attributed to rising food costs. Pork price rose by 20.2% after recording 21 months of decline due to decreasing supply due to sows culling since last year. Excluding food and energy, the consumer price eased to 0.8% from 1.0% amid weak consumption sentiment. As the economic outlook remains cloudy, the propensity to save is heightened. 58.3% of respondents would like to save more based on a PBoC survey.

CNY Rates: Liquidity to stay supportive for longer; We revise lower our CGB yield forecast (Duncan Tan)

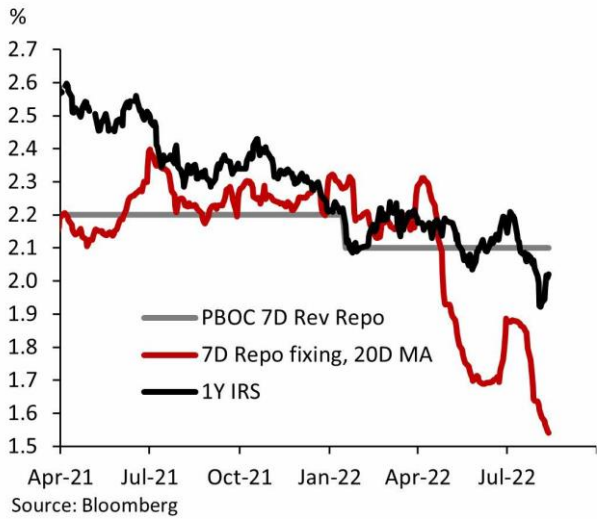
This morning's 10bps cut to 1Y MLF and 7D reverse repo (OMO) rates certainly surprised markets. Onshore IRS curve parallel-shifted lower by 10bps. Longer-tenor IRS declined as much as the shorter tenors, reflecting reduced growth expectations on the back of the underwhelming economic data releases. 12M CNY/CNH forward points dropped 100 pips as markets reprice for policy divergence between US and China to persist for longer. 10Y CGB yields also fell 6-7bps.

It has become increasingly clear that the economic recovery will be slow and bumpy. And therefore, markets should expect monetary support to be in place for some time rather than being unwound. We expect CNY rates and CGB yields to stay low in the near term until we see more positive economic data. The rebound in rates and yields that we had been expecting is likely to be pushed further out now and consequently, we revise lower our end-22 CGB yield forecast.

7D repo fixing rates have been in a 1.55-1.85% range over the last 3 months, significantly below PBOC's OMO rate of 2.0/2.1%. Liquidity will likely stay very supportive in the near term until the recovery appears to be on a firmer footing. We think that the IRS curve should bull-steepen over the next few days.

Today's rate cut should encourage market participants to discount the possibility of rate hikes and expect 7D repo fixing to stay low for an extended period. Positioning is likely already heavy, but we expect even more interest to receive 1Y and 2Y CNY IRS/NDIRS to monetize the associated attractive carry.

1Y IRS levels are biased lower.



Source: Bloomberg

	Revised Forecast		Previous Forecast	
	End-22	End-23	End-22	End-23
2Y CGB (%)	2.2	2.6	2.4	2.6
10Y CGB (%)	2.7	3.0	2.8	3.0

Group Research

Economics & Macro Strategy

Taimur Baig, Ph.D.
Chief Economist
Global
taimurbaig@dbs.com

Chang Wei Liang
FX & Credit Strategist
Global
weiliangchang@dbs.com

Ma Tieying, CFA
Senior Economist
Japan, South Korea, Taiwan
matieying@dbs.com

Nathan Chow
Senior Economist
China, Hong Kong SAR
nathanchow@dbs.com

Radhika Rao
Senior Economist
Eurozone, India, Indonesia
radhikarao@dbs.com

Chua Han Teng, CFA
Economist
Malaysia, Philippines, Thailand, Vietnam
hantengchua@dbs.com

Irvin Seah
Senior Economist
Singapore
irvinseah@dbs.com

Violet Lee
Associate
Publications
violetleeyh@dbs.com

Daisy Sharma
Analyst
Data Analytics
daisy@dbs.com

Eugene Leow
Senior Rates Strategist
G3 & Asia
eugeneleow@dbs.com

Duncan Tan
Rates Strategist
Asia
duncantan@dbs.com

Chris Leung
Chief Economist
China, Hong Kong SAR
chrisleung@dbs.com

Samuel Tse
Economist
China, Hong Kong SAR
samueltse@dbs.com

Philip Wee
Senior FX Strategist
Global
philipwee@dbs.com

Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations)