

China's reboot

Frédérique Carrier – London

China's economy has been stuck in a morass of low growth of late, and the spell of healthy growth at the beginning of the year following the end of COVID-19 restrictions is but a distant memory. Authorities are proactively attempting a course correction, and their approach, while seemingly measured, may well be more comprehensive than is generally recognized. We shed light on these efforts and discuss how to position global equity portfolios.

A sputtering economy

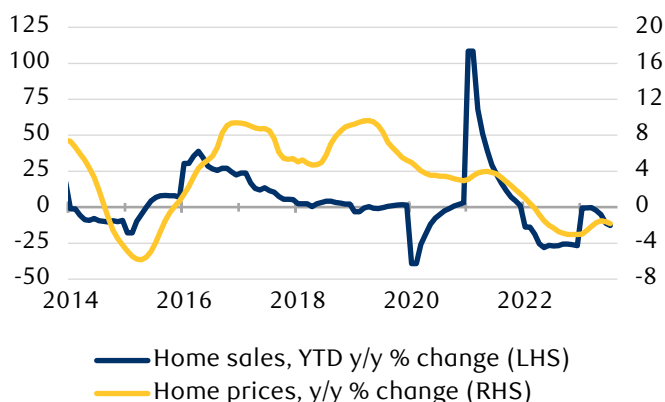
Recent economic data in China makes for uninspiring reading, according to RBC Global Asset Management Inc. Chief Economist Eric Lascelles.

Housing activity, an important driver of the economy, is struggling. Home sales and home prices have been dropping rapidly as the policies introduced a few years ago to deflate the country's housing bubble continue to bite. With their primary investments no longer appreciating, Chinese consumers are reluctant to dig into their pocketbooks and retail sales growth has decelerated sharply.

Chinese trade is also shrinking. Measured in local currency, or the renminbi, exports are down nearly 10 percent while imports are also falling on an annual basis. Weakness in exports may be the result of tepid global demand for goods, but we think it could also be explained by some countries' moves to diversify their supply chains away from China at the margin. Meanwhile, soft imports also reflect a weakening domestic environment. Lascelles emphasizes that while China remains a global trade power, trade isn't driving the economy today (see chart on the next page).

Much attention has also been given to China slipping into deflation, with July headline annual inflation dipping to -0.3 percent. Though annual inflation in August rebounded into positive territory, to 0.1 percent, the situation remains perilously close to deflationary levels.

China housing on a downward trajectory



Note: Home price change is an average of price changes in primary and secondary markets.

Source - China National Bureau of Statistics, Macrobond Financial, RBC Global Asset Management; data through July 2023

Lascelles points out many countries would probably welcome a spell of deflation as it would enable them to claw back some of the crippling price increases they've had to endure. But China never had such a sustained inflation spike, so it doesn't need an unwinding to that extent.

Should a deflationary trend become entrenched in China, it would be cause for concern. In a deflationary environment,

For perspectives on the week from our regional analysts, please see [pages 3–4](#).

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Priced (in USD) as of 9/13/23 market close (unless otherwise stated). Produced: 9/14/23 1:45 pm ET; Disseminated: 9/14/23 1:52 pm ET

consumers and businesses typically delay their purchases as they expect everything ranging from consumer goods to capital expenditure to become cheaper in the future. This serves to weaken the economy, driving prices down even more, as a vicious circle takes hold.

To be clear, a deflationary trend in China has not been established, and Lascelles does not expect one. Still, we think it's worth keeping an eye on how headline inflation behaves in the coming months.

A measured response?

Authorities are responding to the economic malaise with incremental measures that pale in comparison to the much more forceful approaches taken to deal with past slowdowns. For instance, to mitigate the impact of the global financial crisis in 2008, China launched a stimulus program of more than \$575 billion.

Yet, according to Lascelles, authorities are doing a little more than is generally recognized. Below, we highlight some of the main measures announced.

Rate cuts: The People's Bank of China cut interest rates by 15 basis points on August 15. Given how low inflation is and the economic weakness, one could be forgiven for expecting more dramatic cuts from the central bank. However, Lascelles points out that Chinese authorities are worried about the renminbi depreciating further.

Since mid-January 2023, it has weakened close to 10 percent against the U.S. dollar. Though this may aid the competitiveness of the country's exports by making them cheaper, China is mindful that it needs a relatively stable currency as it aspires to enhance its status as a global trade power. A widely fluctuating currency could result in buyers of exported goods losing confidence in the prices they pay.

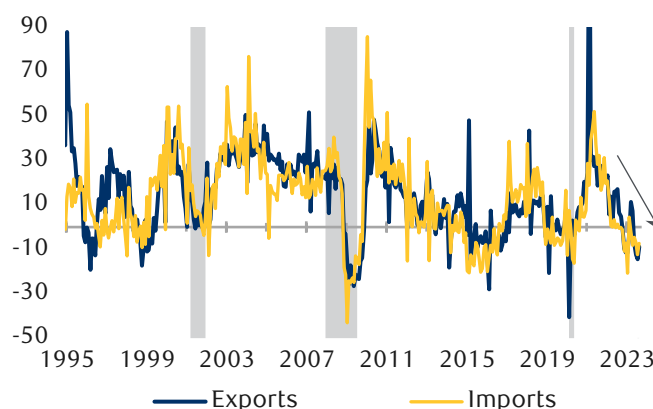
Large currency moves are thus not ideal and authorities are striving to stabilize the renminbi. Yet some currency weakness can be helpful in that it makes imports more expensive, thus helping to fuel some inflation pressures.

Solutions for local governments: Local governments have long been saddled with heavy debt loads. The central government will now allow many provincial governments to issue renminbi bonds to repay problematic off-balance sheet liabilities. In itself, this measure is not enough to solve the local government debt problem, in Lascelles' view, but it could address the most urgent cases.

Housing stimulus: Having tried to cool the housing market in the past, policymakers are now looking to revive it in pursuit of economic growth. The central government has asked banks to lower mortgage rates for existing mortgage holders. This acts as a rate cut, but not one which weakens the currency. In addition, the minimum down payment ratio for first- and second-time homebuyers will be lowered. Moreover, the four Tier-1 cities (Beijing, Shanghai, Guangzhou, and Shenzhen) have relaxed the eligibility requirements for first-time homebuyers. These are all significant steps, in Lascelles' view.

Chinese trade growth decelerates

China trade in goods (y/y % change)



Note: Trade in goods in U.S. dollars. Shaded areas represent U.S. recession periods.

Source - Macrobond Financial, RBC Global Asset Mgmt.; data through Aug. 2023

Fiscal support for individuals: China will allow additional tax deductions for expenses for child and elderly care as well as for education.

Corporate stimulus: Tax relief for small businesses will be maintained through the end of 2027, and authorities have discussed the creation of a more stable business environment, enhancing corporate governance and encouraging entrepreneurship. There is a degree of skepticism among market participants regarding these measures given the current Chinese administration has not been consistently friendly to businesses. Other measures include the central government cutting fees for stock market transactions and encouraging restaurants to lengthen their hours of operation, and rural regions subsidizing the purchase of big-ticket items.

Hukou reforms: Hukou is a system of household registration used in mainland China. The government tightly restricts where citizens can live, and the system determines an individual's eligibility for social services such as health care and education. Some of these restrictions are being relaxed, which could in time allocate labor more efficiently throughout the country and improve productivity, according to Lascelles.

Tallying it all up

China seems to be doing more to revive its economy than is generally recognized. Lascelles believes the economy can stabilize from here, though growth may not be as impressive as it had been in the past. Lascelles is now forecasting growth of just under five percent this year, slightly below the consensus. We recommend a Market Weight stance in Asia (ex Japan) equities for global equity portfolios. Such positioning would enable investors to take advantage of Chinese equities' attractive valuations, in our view, as well as any turnaround in investor sentiment, which is currently very negative and could easily reverse if these policies start to have a positive impact and/or more measures are announced.

UNITED STATES

Atul Bhatia, CFA – Minneapolis

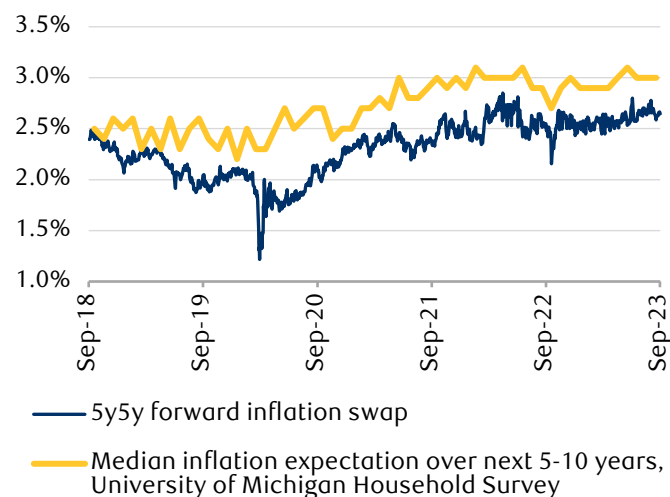
■ **U.S. inflation picked up in August, with the Consumer Price Index (CPI) rising 0.6% from July's level.** Higher food and energy costs accounted for much of the move, as so-called core prices outside those areas rose only 0.3%. Economists surveyed by Bloomberg ahead of the data had expected a slightly slower rise in core prices, but investors largely shrugged off the difference. Treasury bond yields drifted slightly lower after the data was released, and futures prices shifted to reflect a lower likelihood of the Fed raising interest rates at its September meeting. Futures continue to reflect a roughly 50% chance of another rate hike this year, most likely in November, before a switch to cuts next year.

■ **Despite the Fed's recent progress in slowing price increases, concerns remain regarding the central bank's longer-term prospects for success.** One of the few market-based indicators of medium-term inflation is the 5y5y CPI swap, which is based on annual inflation over a five-year period starting five years in the future. This measure, as well as inflation projections in the University of Michigan's survey of consumer expectations, remains high relative to both recent history and the Fed's target. Until the central bank succeeds in calming concerns about longer-term price stability, it may have difficulty switching to less restrictive policy.

■ **A partial federal government shutdown could occur on Oct. 1** if Congress fails to pass annual appropriation bills or a stopgap funding measure before that date. One legislative hang-up is the level of spending. The Senate and White House are looking to implement reductions

Future price stability remains a concern in the U.S.

Market pricing and survey data reflect inflation worries



Source - RBC Wealth Management, Bloomberg; data period: 9/14/18–9/13/23

agreed to in June's debt ceiling deal, while some House members are holding out for steeper cuts or political concessions before allowing legislation to move forward. The economic stakes with a potential shutdown are much lower than with the debt ceiling. **Only a quarter of federal spending would be impacted by a shutdown, and key payments like Social Security, Medicare, and Treasury debt servicing would be unaffected.**

CANADA

Sean Killin & Richard Tan, CFA – Toronto

■ **Despite a material increase in interest rates over the past year, Canadian residential mortgage delinquency rates are still relatively low by historical standards.** For context, the Q2 2023 delinquency rate came in at 25 basis points or 0.25%, a modest quarter-over-quarter improvement. We believe this can be partly attributable to stronger-than-expected labour market conditions and the unemployment rate remaining below pre-pandemic averages. On the flip side, we acknowledge that housing affordability has deteriorated and that mortgage amortization periods are likely biased upward in a higher-for-longer rate environment. As an example, the Office of the Superintendent of Financial Institutions estimates that approximately CA\$369 billion of variable-rate fixed mortgages (roughly 18% of the outstanding Canadian mortgage market) now have amortizations longer than 35 years. All else equal, we believe this trend will continue as more mortgages are renewed into 2024 and 2025. Overall, we are maintaining a cautious stance on banks given their exposure to Canadian real estate.

■ **Canadian labour market data is providing mixed signals on the surface,** as an imbalance between rising population growth and job creation has driven the unemployment rate from its cyclical trough. Job growth has averaged 41,000 per month this year, highlighting resilience in the economy. But this rate of job creation has not kept up with a notable increase in the working population, as Canada's population rose by 103,000 in August alone. Consequently, the 0.5% increase in the unemployment rate over the past three months has challenged the view of a resilient labour market as a whole. As RBC Economics has highlighted, labour market softness is building, and the effects of tighter monetary policy are slowing the economy. Despite growing signs of weakening economic momentum, the data-dependent Bank of Canada reiterated the option for further rate increases, if needed.

EUROPE

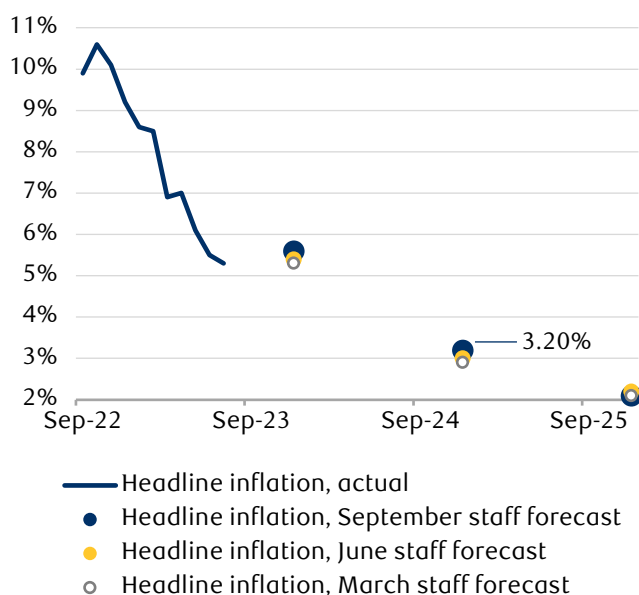
Rufaro Chiriseri, CFA – London

■ **A “solid majority” within the European Central Bank (ECB) Governing Council voted in favour of raising interest rates by 25 basis points (bps) on Sept. 14 to reach a deposit rate of 4%,** according to ECB President Christine Lagarde—the tenth consecutive hike since July 2022. In the run-up to the meeting, market expectations for a hike increased after a Reuters article highlighted potentially higher ECB inflation forecasts for 2024. Though the council indicated that price pressure indicators are showing signs of easing, it placed more weight on the risk of higher inflation due to the projected upward trajectory of energy prices affecting the ECB staff’s 2023 and 2024 estimates.

■ **The staff inflation estimates for 2023 and 2024 were revised upward to 5.6% and 3.2%, respectively, while the 2025 estimate was revised downward to 2.1%.** During the post-meeting press conference, Lagarde reiterated that “interest rates have reached levels that, maintained for a sufficiently long duration, will make a substantial contribution to the timely return of inflation to the target.” However, she was noncommittal on whether this marks the end of the hiking cycle, and instead referred to the caveats within the Governing Council statement—which is hawkish, in our view. While the risk of upside surprises in inflation remains, we think maintaining optionality is pragmatic for the central bank. Our base case is that interest rates will remain higher for longer, and that the latest increase likely marks the end of the road for hikes.

■ **The euro rallied against the U.S. dollar in the wake of the ECB announcement, but this knee-jerk reaction**

European Central Bank expects higher inflation in 2023 and 2024



Source - European Central Bank, Bloomberg; data as of 9:45 am ET, 9/14/23

quickly faded as the market digested the staff forecasts. In the bond markets, 2-year German Bunds initially rallied to 3.12% before reaching intra-day highs of 3.17%.

■ **In the UK, the July labour data release showed unemployment rising for the fourth month in a row while the number of job vacancies dropped below one million for the first time in almost two years.** However, private sector pay remains elevated, with wage growth easing to 8.1% from 8.2% in the three months through July. We continue to expect a 25 bps hike from the Bank of England to mark the end of this hiking cycle, but the UK central bank is likely to keep all options on the table, which is a risk to our view.

ASIA PACIFIC

Nicholas Gwee, CFA – Singapore

■ **Japan equities reacted positively to Bank of Japan (BoJ) Governor Kazuo Ueda’s comment that “ending negative interest rates is an option,”** which he made during an interview with the Yomiuri Shimbun newspaper on Sept. 9. The yield on 10-year Japanese Government Bonds (JGBs) rose to 0.716% during the week, a level not seen since 2014, and the yen temporarily appreciated versus the dollar to the 145 range. Both the TOPIX and Nikkei 225 indexes are up for the week as of this writing. The overall market reaction suggests momentum remains healthy despite the prospect of an early move away from negative interest rates. Our national research correspondents expect the BoJ to further relax its yield curve control policy in early 2024, and to lift negative interest rates in H2 2024. We think Ueda’s comment may have been driven by the recent weakness in the yen, due in part to U.S. interest rates remaining high and data suggesting U.S. inflation is still sticky with rising commodity prices. **Notwithstanding the weaker yen, which is positive for Japanese exporters, we reiterate our preference for Japan equities in the developed market space.**

■ **Softbank Group Corp.’s (9984 JP) Arm Holdings, a UK-based chip designer, will be the largest IPO globally so far in 2023.** At \$51/share, Arm will be valued at about \$54.5 billion. Bloomberg reported the IPO was more than 10 times oversubscribed.

■ **In a surprise announcement over the weekend, former Alibaba CEO Daniel Zhang stepped down as chairman and CEO of Alibaba Cloud just three months after taking the helm,** with new Alibaba Group CEO Eddie Wu succeeding him as head of the cloud business for the time being. Zhang will now steer a \$1 billion technology investment fund on the company’s behalf. The abrupt management changes led Alibaba Group’s (9988 HK) share price to fall more than 5% during the week, weighing on the broader Hang Seng Index.

MARKET Scorecard

Data as of September 13, 2023

Equity returns do not include dividends, except for the Brazilian Ibovespa. Bond yields in local currencies. Copper Index data and U.S. fixed income returns as of Wednesday's close. Dollar Index measures USD vs. six major currencies. Currency rates reflect market convention (CAD/USD is the exception). Currency returns quoted in terms of the first currency in each pairing.

Examples of how to interpret currency data: CAD/USD 0.73 means 1 Canadian dollar will buy 0.73 U.S. dollar. CAD/USD 0.0% return means the Canadian dollar is even with the U.S. dollar year to date. USD/JPY 147.47 means 1 U.S. dollar will buy 147.47 yen. USD/JPY 12.5% return means the U.S. dollar rose 12.5% vs. the yen year to date.

Source - Bloomberg; data as of 9/13/23

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	4,467.44	-0.9%	16.4%	13.6%	0.0%
Dow Industrials (DJIA)	34,575.53	-0.4%	4.3%	11.2%	-0.8%
Nasdaq	13,813.58	-1.6%	32.0%	18.7%	-8.6%
Russell 2000	1,840.84	-3.1%	4.5%	0.5%	-17.8%
S&P/TSX Comp	20,278.94	-0.1%	4.6%	3.2%	-1.9%
FTSE All-Share	4,097.89	0.9%	0.6%	1.0%	0.6%
STOXX Europe 600	453.94	-0.9%	6.8%	7.8%	-2.9%
EURO STOXX 50	4,223.48	-1.7%	11.3%	17.8%	0.8%
Hang Seng	18,009.22	-2.0%	-9.0%	-6.8%	-30.2%
Shanghai Comp	3,123.07	0.1%	1.1%	-4.3%	-15.9%
Nikkei 225	32,706.52	0.3%	25.3%	14.3%	7.4%
India Sensex	67,466.99	4.1%	10.9%	11.4%	16.0%
Singapore Straits Times	3,218.93	-0.4%	-1.0%	-2.2%	4.7%
Brazil Ibovespa	118,175.97	2.1%	7.7%	6.7%	1.5%
Mexican Bolsa IPC	51,518.26	-2.8%	6.3%	9.5%	0.0%
Gov't bonds (bps change)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Treasury	4.250%	14.2	37.6	84.2	292.5
Canada 10-Yr	3.687%	12.3	38.7	49.2	246.7
UK 10-Yr	4.347%	-1.3	67.5	117.6	360.2
Germany 10-Yr	2.651%	18.5	8.0	92.1	298.2
Fixed income (returns)	Yield	MTD	YTD	1 yr	2 yr
U.S. Aggregate	5.13%	-0.8%	0.5%	-0.5%	-13.2%
U.S. Investment-Grade Corp	5.78%	-0.9%	1.8%	1.4%	-14.9%
U.S. High-Yield Corp	8.54%	-0.2%	6.9%	6.5%	-4.6%
Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot \$/oz)	1,908.43	-1.6%	4.6%	12.1%	6.4%
Silver (spot \$/oz)	22.84	-6.6%	-4.7%	18.1%	-3.8%
Copper (\$/metric ton)	8,367.50	-0.4%	0.0%	4.7%	-12.4%
Oil (WTI spot/bbl)	88.52	5.8%	10.3%	1.4%	27.8%
Oil (Brent spot/bbl)	92.12	6.1%	7.2%	-1.1%	25.3%
Natural Gas (\$/mmBtu)	2.70	-2.3%	-39.6%	-67.4%	-42.6%
Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	104.7640	1.1%	1.2%	-4.6%	13.0%
CAD/USD	0.7379	-0.3%	0.0%	-2.8%	-6.7%
USD/CAD	1.3551	0.3%	0.0%	2.9%	7.1%
EUR/USD	1.0731	-1.0%	0.2%	7.6%	-9.1%
GBP/USD	1.2490	-1.4%	3.4%	8.7%	-9.7%
AUD/USD	0.6422	-1.0%	-5.7%	-4.6%	-12.9%
USD/JPY	147.4700	1.3%	12.5%	2.0%	34.1%
EUR/JPY	158.2400	0.3%	12.7%	9.8%	21.8%
EUR/GBP	0.8592	0.4%	-3.0%	-0.9%	0.7%
EUR/CHF	0.9589	0.1%	-3.1%	0.0%	-12.0%
USD/SGD	1.3611	0.7%	1.6%	-3.3%	1.4%
USD/CNY	7.2717	0.2%	5.4%	4.9%	12.7%
USD/MXN	17.1410	0.6%	-12.1%	-14.6%	-13.7%
USD/BRL	4.9154	-0.8%	-6.9%	-5.3%	-5.8%

Authors

Atul Bhatia, CFA – Minneapolis, United States

atul.bhatia@rbc.com; RBC Capital Markets, LLC

Frédérique Carrier – London, United Kingdom

frederique.carrier@rbc.com; RBC Europe Limited

Rufaro Chiriseri, CFA – London, United Kingdom

rufaro.chiriseri@rbc.com; RBC Europe Limited

Sean Killin – Toronto, Canada

sean.killin@rbc.com; RBC Dominion Securities Inc.

Nicholas Gwee, CFA – Singapore

nicholas.gwee@rbc.com; Royal Bank of Canada, Singapore Branch

Richard Tan, CFA – Toronto, Canada

richard.tan@rbc.com; RBC Dominion Securities Inc.

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			Count	Percent
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Sell [Underperform]	49	3.37	3	6.12

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