China is First to Blink

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September 28, 2024

The People's Bank of China (PBoC) stands as the first major central bank to provide stimulus to its citizens in the aftermath of the global inflationary shock triggered by the response to the COVID-19 pandemic. As previously discussed in these pages, China has been grappling with its own version of the Great Financial Crisis, centered around the implosion of a $50 trillion housing bubble that has unleashed powerful deflationary forces. Some estimates suggest China's unoccupied housing stock could shelter over 1 billion people. To manage these deflationary pressures, China has been flooding global markets with low-cost goods, effectively exporting deflation. Economist Richard Koo, in a Bloomberg interview, aptly describes this as a "balance sheet recession.":

"He defines a balance-sheet recession as a situation in which households and businesses divert more of their income toward paying down debt, rather than consuming or investing. Koo argues that was a key reason for Japan's descent into deflation, and for the slow US and European recoveries from the 2008 financial crisis."

When a country becomes overleveraged, and the value of the underlying assets tied to that leverage begins to decline, the burden of servicing debt intensifies. As interest coverage deteriorates, it becomes increasingly difficult for businesses and households to manage their obligations. At the same time, incomes often shrink, placing additional strain on consumers. Consequently, a growing portion of income is redirected toward debt repayment rather than consumption. This dynamic, when widespread, can trigger a deflationary spiral, as reduced spending leads to slower economic activity, further suppressing asset prices and deepening the downturn. The measures the PBOC has taken to begin to combat the pullback in consumption and help its citizens out are:

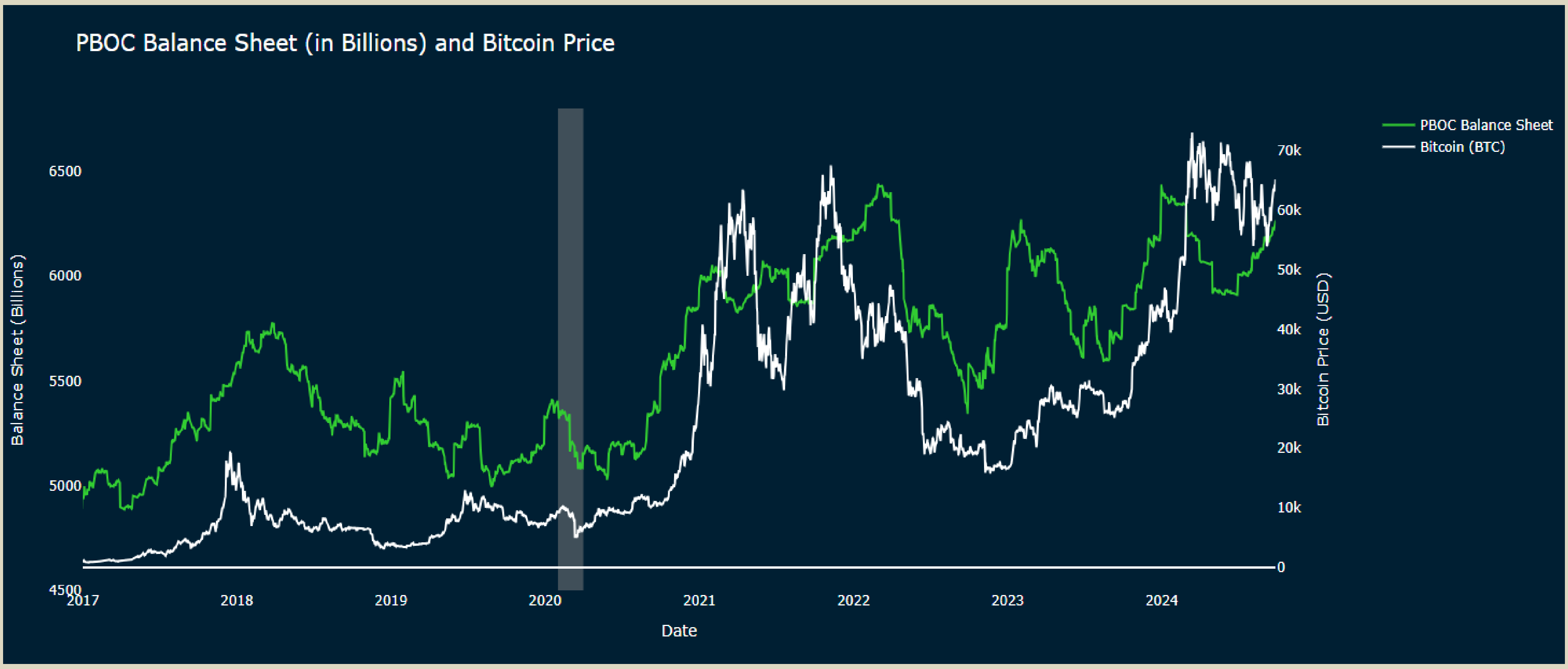
- Cutting the reserve requirement ratio by 50 basis points
- Cutting repo rates by 20 basis points
- Lowering the minimum downpayment on homes from 25% to 15%
- Allowing institutional investors to get liquidity from the PBOC to buy stocks, with an initial total amount of 500B Yuan ($50 Billion)
- Providing 1 time allowances for the impoverished (there are no details on how extensive this will be yet)

While many investors cheered the initial news of China's stimulus earlier in the week, equating it with government or central bank interventions designed to prop up asset prices, a closer look at the details reveals a more tempered reality. The measures China introduced are primarily monetary in nature, aimed at stimulating bank lending and supporting the domestic stock market. However, this is far from the massive liquidity "bazooka" that would spark a global asset rally. It's a step in the right direction, but not one that significantly alters the broader outlook. Monetary policy alone is less effective in addressing China's deep-seated economic challenges compared to fiscal measures. Moreover, these moves do little to address the country's poor demographics or the looming threat of global trade sanctions. And an even bigger question arises: Why did Beijing feel compelled to announce such a surprise intervention if economic conditions weren't dire? This is certainly a situation to watch closely, and any broader measures that may emerge could significantly shift our perspective.

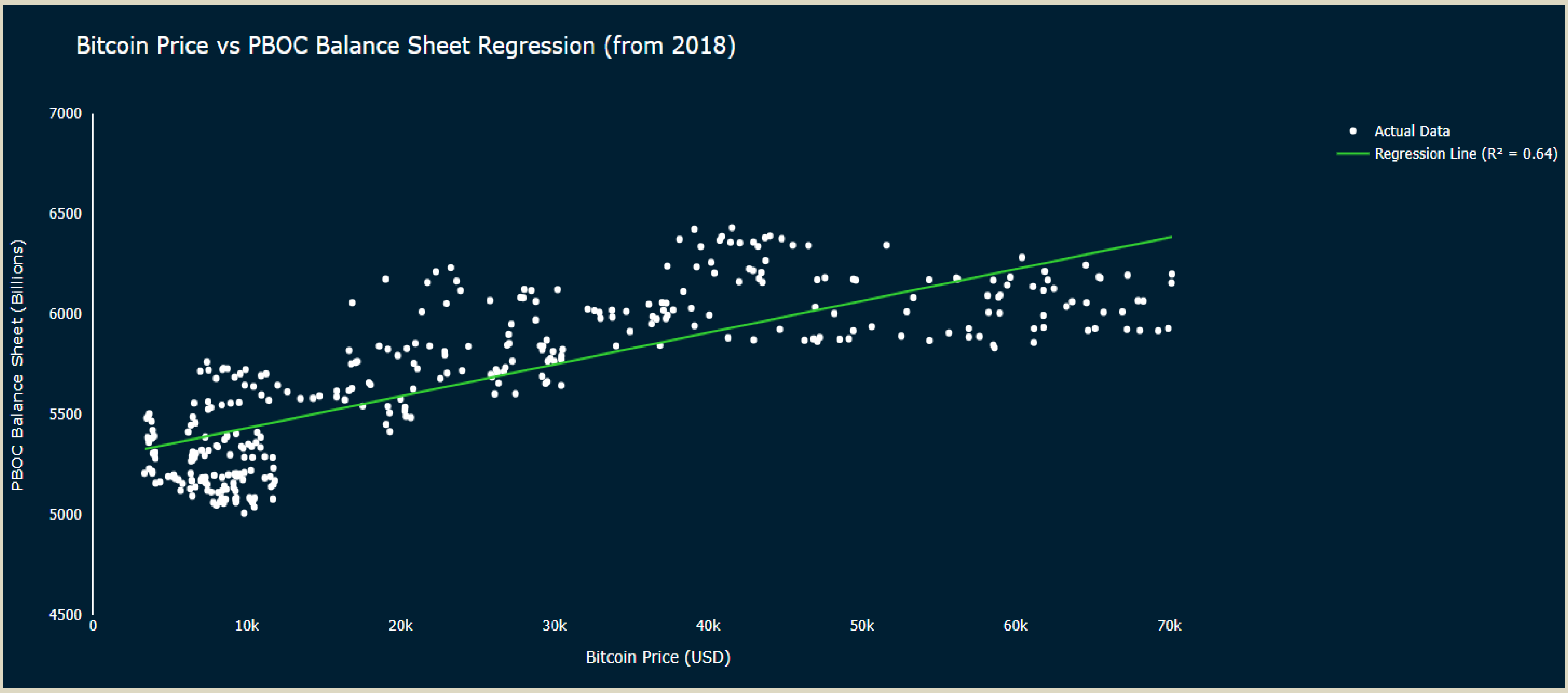
Following the news, large-cap Chinese equities surged. While the stimulus is clearly targeted at boosting their domestic stock market, significant geopolitical risks remain. However, after years of being heavily oversold, Chinese equities could present a compelling opportunity for investors comfortable with the inherent risks of investing in a market tightly controlled by the CCP. For those willing to navigate these uncertainties, the current environment may offer a unique entry point.

The Malaysian stock market has been rallying since August, and this latest news adds further momentum. If China leans into stimulus measures, we expect neighboring Asian markets, including Malaysia, to see increased capital inflows. Investors are likely to favor countries in the region with close economic ties to China, as they stand to benefit from the spillover effects of these policy shifts.

When discussing the excitement around China's stimulus, no community was more enthused than the crypto space. Crypto thrives on liquidity injections, and after the Federal Reserve, the PBOC's balance sheet has one of the largest impacts on global liquidity. To put things in perspective, the global stock market is valued at approximately $110 trillion, while the bond market sits around $130 trillion. In the U.S. alone, stocks have a total market cap of about $45 trillion, and bonds are around $55 trillion. Compare this to crypto, with a market cap hovering near $2 trillion, and the disparity is clear. With the combined balance sheets of the Federal Reserve and the PBOC sitting at roughly $14 trillion in USD terms, it's easy to see why new liquidity from central banks has an outsized effect on crypto. When fresh money is created and interest rates fall, those who receive that liquidity don't just buy goods—they invest in assets, often moving out the risk curve in search of higher returns. Crypto, with its relatively small market cap compared to traditional markets, is extremely sensitive to these liquidity surges. It doesn't take much to drive significant price movements in the space. In plotting the balance sheet of the PBOC against Bitcoin going back to 2017 the correlation between the two becomes pretty clear.

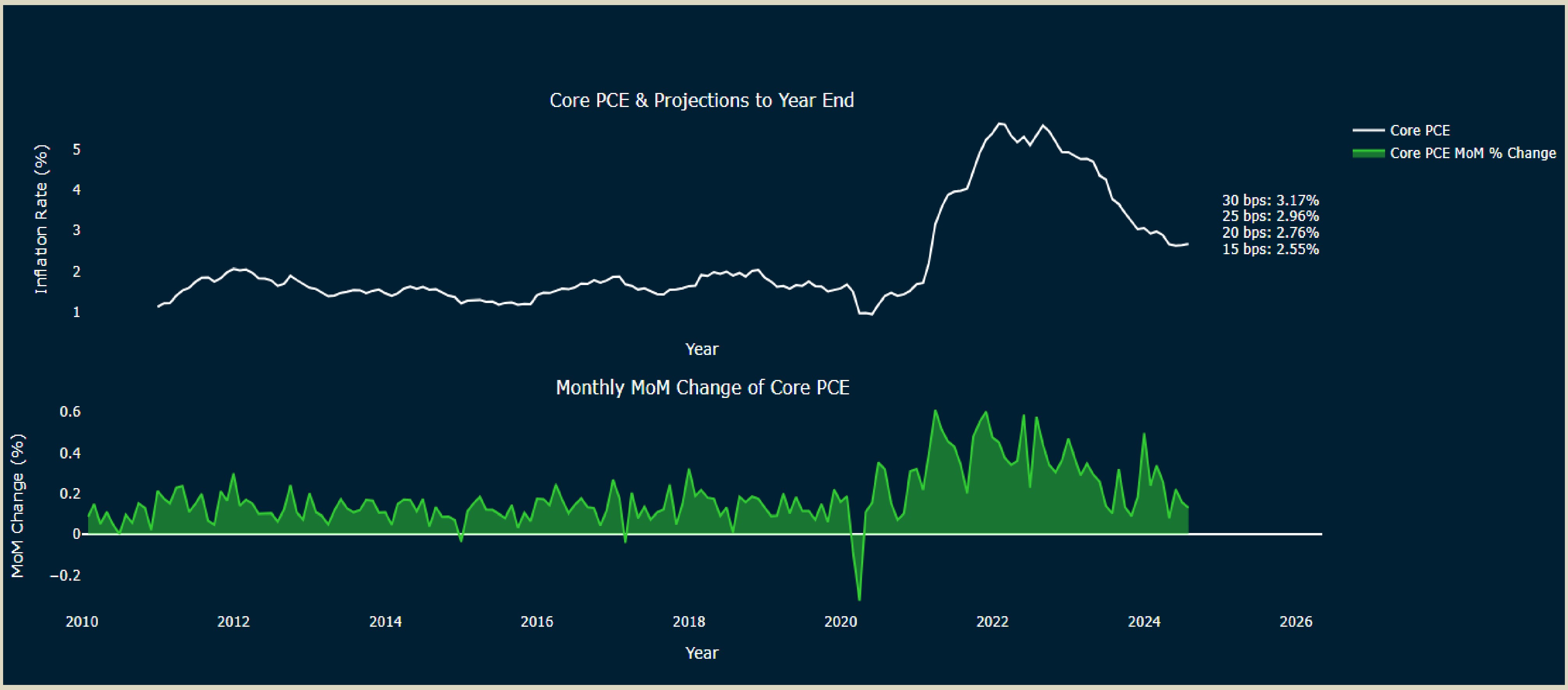


In running a regression between the two datasets the R2 is 0.64



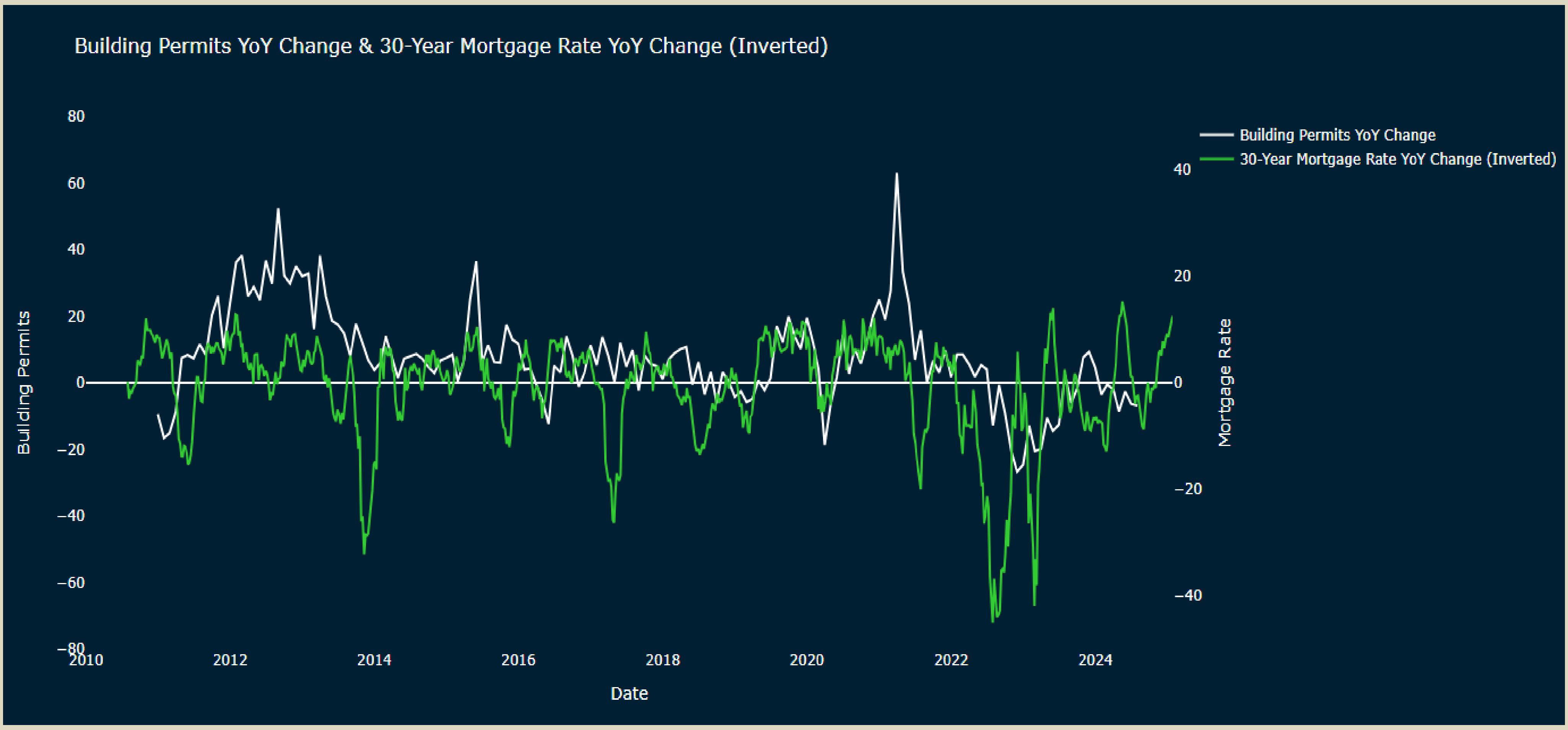
On Friday, we received the PCE data for August, but it seems the market and investors have largely moved past it. Unless we see a sharp deflationary print or a resurgence in inflation that threatens the 200+ basis points of rate cuts already priced in by the market, this data is unlikely to sway sentiment. However, it's worth noting that the month-over-month numbers came in below expectations for both headline and core PCE. On a year-over-year basis, PCE inflation eased from 2.5% last month to 2.2% this month. The progress is notable, considering that just 12 months ago, inflation was running at 3.39%, and even three months ago, we were still at 2.57%.

The year-over-year core PCE did tick higher, moving from 2.6% to 2.7%, despite a modest 0.13% month-over-month reading. This uptick is largely attributed to base effects in the 12-month look-back period. Last August, the month-over-month reading was 0.102%, which exerted upward pressure on this month's year-over-year comparison. Looking ahead, to meet the Fed's year-end target of 2.6% core PCE, we need to average monthly readings of 0.15%. Should the data come in higher than this, it could introduce some uncertainty around rate cuts and may push the Fed to pause. Next month's base effects are favorable, so we might see a dip in the year-over-year figure. However, October and November will face tougher comparisons, with last year's numbers at 0.13% and 0.09%, respectively.

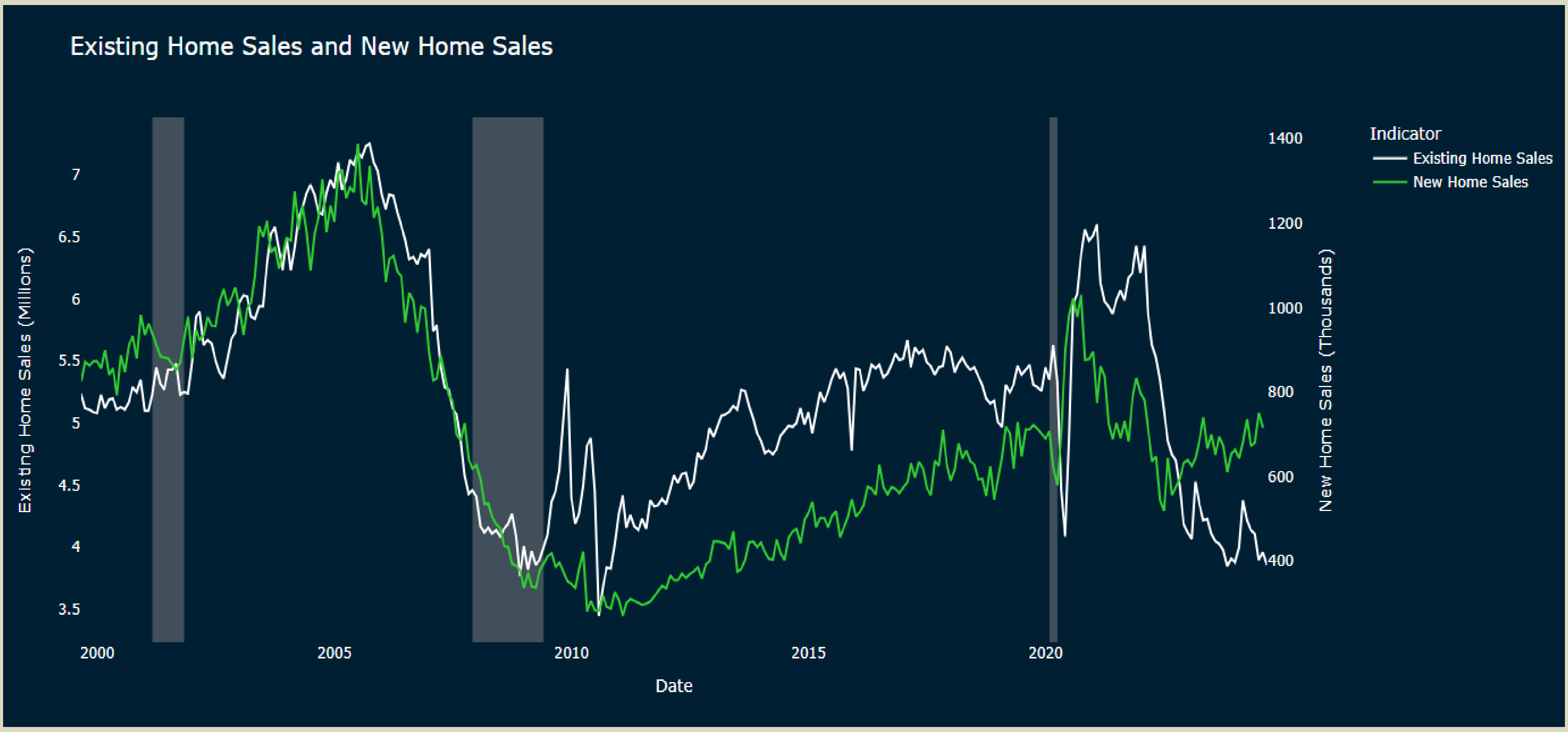


On to housing, We will continue to closely monitor this data as a key indicator for whether a soft landing remains achievable, rather than an outright recession. With mortgage rates easing to just over 6% for a 30-year fixed rate and buy-downs for new homes bringing rates closer to 4% in some cases, we should anticipate a gradual rebound in housing activity. The recent uptick in the MBA Purchase Index, which tracks U.S. mortgage application volumes, shows signs of life over the past few weeks. As the Fed continues to ease, we expect further momentum in housing demand, signaling that the consumer may not be as strained as initially feared. This will be critical in gauging the resilience of the economy.

Falling interest rates also signal that we should expect building permits to gain momentum, and indeed they did in August, rising by 67,000 to a seasonally adjusted annual rate of 1.47 million—representing a 4.9% month-over-month increase. Historically, changes in mortgage rates tend to lead housing activity by about three months, and with the recent decline in rates, building permits are likely to move into positive territory on a year-over-year basis.



We should expect these changes in the housing market to begin unlocking the existing supply of homes, which currently represents 85% of the market but has remained locked up. As noted, rate buydowns are allowing new home buyers to enter the market at rates below current market levels, helping drive an increase in new home sales. Housing analysts believe that rates in the 5% range could start to unlock the existing supply. It's important to remember that during the pandemic, mortgage rates hovered around 3%, and over half the country refinanced at those historically low levels. These ultra-cheap mortgages have effectively become assets, keeping homeowners locked in place. Until rates reach a level that makes it enticing to give up those low-cost loans, existing supply is likely to stay constrained.



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