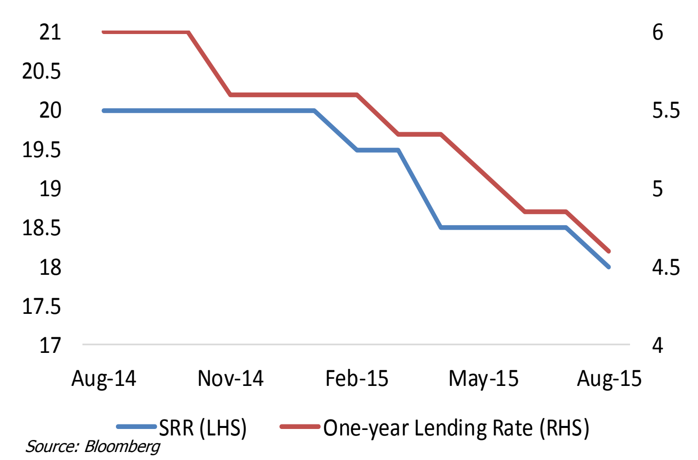
Economic Insight

2015/85 | 28 August 2015 Amanah Mutual Berhad

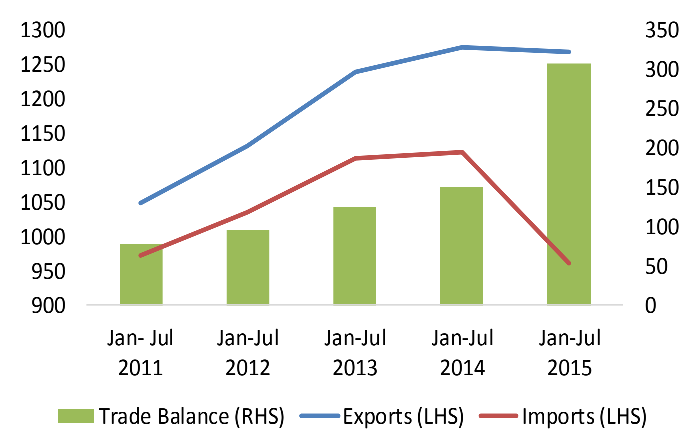
When Dragon Dances With The Bear

CHART 1: MONETARY POLICY CHANGES



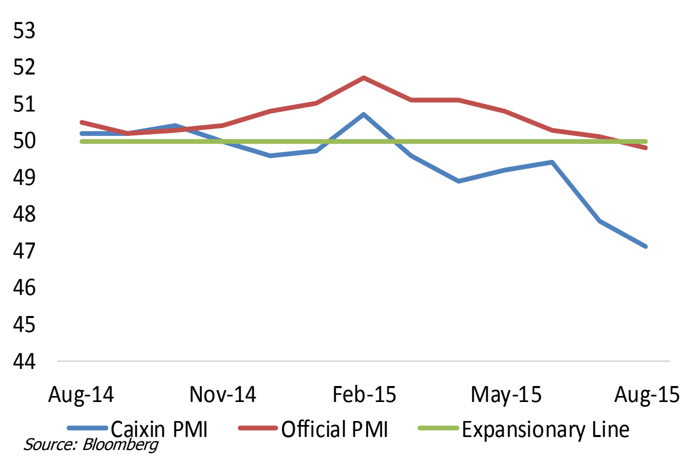
Source: Bloomberg

CHART 2: CHINA'S TRADE ACTIVITIES ($ BILLION)



Source: Bloomberg

CHART 3: CAIXIN & OFFICIAL MANUFACTURING PMI



Source: Bloomberg

- Global market meltdown on Monday and Tuesday had forced the People's Bank of China (PBOC) to swiftly act after market closed on Tuesday, as it slashed interest rate and the amount of reserves kept at the central bank. The PBOC cut one-year lending rate from 4.85% to 4.6% and the statutory reserve requirement (SRR) from 18.5% to 18%.

- It was the fifth rate cut since November last year, amidst the immense pressure faced by Chinese authorities. And the reduction in the SRR was the third one in the same period. Whilst the slowdown in China's economy is a well-known fact for quite some time, the latest sell-off in global equity markets had largely stemmed from the yuan devaluation two weeks ago, and the drop in Caixin Manufacturing PMI last Friday.

- Official figures still point towards modest expansion in economic activities, as the GDP grew by 7% in 2Q15, the same pace as in 1Q15. Industrial production slowed from 6.8% in June to 6% in July, while both official and Caixin manufacturing PMI trended downwards (refer chart 3). Caixin PMI which is the bellwether for the manufacturing industry had shown contractions for six consecutive months.

- Shanghai Composite Index dropped by 8.5% on Monday and 7.5% Tuesday. On the other hand, Shenzhen Composite Index declined by 7.7% on Monday and 7% on Tuesday. The rapid downward movement could perhaps be explained by its previously extraordinary increase.

- As signs of a slowdown begin to appear more clearly last year, authorities loosened rules and encouraged more retail participation in the stock market, as a way to mask the weakness the real economy. The government even allowed a trading link between Shanghai and Hong Kong in November 2014, to boost the market. As a result, both Shanghai and Shenzhen markets had defied gravity, skyrocketing by 126% and 165% respectively, in the 12-month period to May.

- However, what goes up must always come down. The government cannot do much to support the equity bubble. We have seen diverging direction between the real economy and the stock markets for quite a while. Sooner or later, the two would have to converge, which is happening now.

- The is still room to cut interest rate, but the PBOC cannot cut too much, as it would precipitate capital outflows, making it more costly for the government to support yuan. Besides, the government would be adverse to creating another bubble in the economy. The pain must be felt, either now or later. Overly loose monetary and fiscal policies could perhaps delay the inevitable correction, for a few years, but it won't last very long, for sure.