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Market views and strategy

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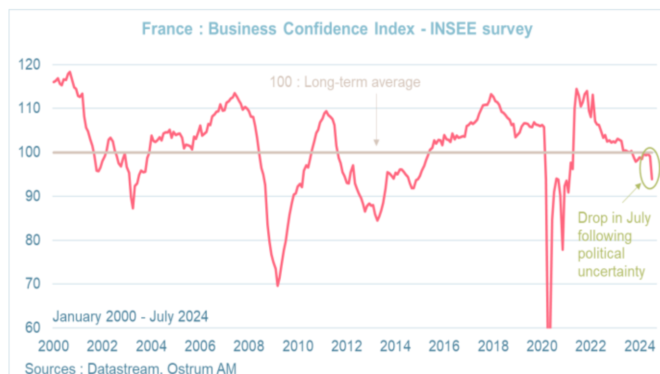
Topic of the week: China: remember August 2015
by Axel Botte

- The third plenum of the Chinese Communist Party failed to address the causes of persistent imbalances in the Chinese economy;
- The supply-centric model has been reaffirmed with priorities set to make supply chains more self-reliant and enhance investments in advanced manufacturing;
- Domestic demand remains weak whilst central government transfers are needed to make up for local governments' revenue shortfall;
- The PBoC keeps easing monetary policy adding to downward pressure on the Chinese yuan;
- Devaluation of the yuan could be the end game.

Market review: Markets need a Fed nod
by Axel Botte

- Fed, BoE and BoJ to hold important meetings this week;
- US growth surprises on the upside (2.8% in 2Q) but most surveys are downbeat;
- Curve steepening resumes amid tensions on euro sovereign debt markets;
- US mega-cap earnings disappoint.

Chart of the week



French business confidence dropped by 5.2 points in July to stand at 93.9. It is at its lowest level since February 2021. Business confidence had been hovering near its long-term average since May 2023, signaling a lackluster but resilient growth amidst various shocks. However, the drop is traceable to political uncertainty. The survey was conducted from June 27 to July 22, therefore incorporating the results of the elections. The lack of visibility on the economic policy has led business leaders to adopt a wait-and-see approach. The deterioration in activity and demand prospects is clear. All sectors are affected, most notably services and retail trade. The employment index also fell, dropping by 3.5 points to 96.2, well below the long-term average of 100, and at its lowest level since April 2021.

Figure of the week

18

Each Olympic medal will contain 18 grams of puddled iron from the Eiffel tower.
Source: Mairie de Paris

Topic of the week

China: remember August 2015

The third plenum was an opportunity to deal with imbalances in the Chinese economy linked to a chronic shortfall in domestic spending and over-reliance on exports at a time when international relations have grown more complex. The PBoC has an impossible task of combating domestic deflationary forces whilst maintaining stability in the foreign exchange market amid net capital outflows. Given the supply-centric growth strategy of Xi Jinping, the end game could be a devaluation of Chinese Renminbi.

China's growth model may only worsen imbalances

Was the third plenum a lost opportunity?

The Communist party's Central Committee typically uses the third plenum to announce new medium-and long-term policies. This year's plenum failed to put forward the policy measures needed to tackle the growth challenges. Growth slipped to 4.7%y in the second quarter amid persistent weakness in retail sales (+2%y) and property investment (-10%y). The shortfall in domestic demand makes it harder to tackle high youth unemployment. Industrial production was somewhat stronger (+5.6%y). China's economy needs to grow by, at least, 4.5% to achieve the government's long-term objective of doubling per-capita income to about $25,000 by 2035. Instead, the IMF estimates that China will struggle to keep growth above 4% over the medium term.

Is China's growth model too unbalanced to be sustained?

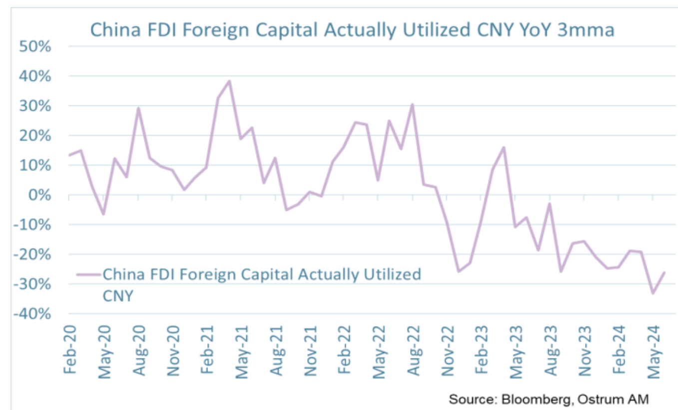
At the plenum, Xi Jinping doubled down on his commitment to advanced manufacturing (including technology, green transition capital goods) despite the trade tensions and the protectionist threat from the US and Europe. Xi Jinping stressed issues including supply chain self-reliance and technological innovation as top priorities. The technological dependence from the US must be reduced. China's growth model will thus remain supply-centric, even as the world economy would greatly benefit from stronger Chinese domestic demand. The growth model favors productivity gains over jobs in a bid to overcome the challenges from a shrinking labor force. Demand is not the focus of the Politburo. Still, the third plenum document alludes to measures to expand the social safety net and facilitate internal migrations of workers (Hukou registration system). These changes would encourage households to spend more.

Furthermore, getting the finances of local governments into better balance will require consolidation efforts from Beijing. The property slump has made longstanding revenue shortfalls at local governments even more unsustainable. Local government deficits totaled more than CNY15 trillion in 2023. A fiscal reform should thus target measures to expand local tax revenue sources, increase transfers to local governments and direct spending from the central government (90% of public spending is assumed by local governments at present).

Managing imbalances… until it breaks

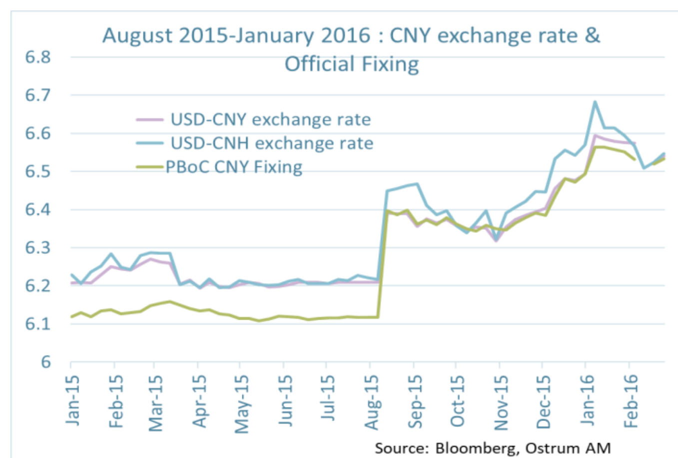
Monetary policy easing may lead to yuan devaluation

The PBoC is in a corner now. Chronic weakness in domestic demand and fast-expanding supply have magnified deflationary forces. Inflation is nil with producer prices in outright deflation territory. Meanwhile, the government's crackdown on entrepreneurs over the past few years have led to large net capital outflows from China. Foreign direct investment has collapsed (-29.1%y YTD in June 2024) in the context of international trade sanctions and a challenging growth outlook in China.



Against this backdrop, the continued monetary easing from the PBoC (with the latest 10 bp cut immediately after the plenum) has further weakened the Chinese Renminbi in currency markets. The USDCNY fixing (7.11) grinds higher, but the market exchange rate is trading near the cheaper end of the band (7.27 or 2% on the cheap side). The CNH exchange rate is even cheaper.

To manage the currency slide and keep the yuan afloat, the PBoC needs to sell US dollars. In May, the Chinese monetary authority sold a record $42 billion worth of US securities, with US Treasury bonds making up more than half that amount. The current acceleration in Treasury bond sales may foreshadow a devaluation in the Chinese yuan. In August 2015, the PBoC shocked the world with a 3% devaluation and, in January 2016, the currency depreciated further.



Besides the current economic environment, China could decide to devalue to mitigate the impact of looming trade tariffs. There is indeed bipartisan support in the US to take the hard line on China. From 2018, President Trump put tariffs on Chinese goods, and Biden only added to them while introducing export restrictions on various technologies, such as

semiconductors. This certainly draws comparisons to the US-Japan trade tensions in the 1980s, that eventually led to large currency adjustments.

Looking forward, the recent reform of the PBoC's monetary framework leaves the door open for asset purchases. The consolidation of local government finances will likely require central government borrowing. Quantitative easing to facilitate government bond issuance will only exacerbate downside risks to the Chinese currency.

Looking into the market impact of the August 2015 devaluation

The shock devaluation in August 2015 took a toll on risky asset prices

The PBoC devalued the yuan over a three-day period to August 13th, 2015. In this section, we look at the market's reaction to the surprise devaluation across a range of assets. In the initial 3-day period, the S&P 500 lost 1% and Shanghai barely moved. US 10-Yr note yield fell 3 bps to 2.18%. The kneejerk reaction to the news of a higher CNY fixing was sharp though with a 10-bp fall in yields. The US yield curve initially flattened at the margin. The 2s10s spread shrank by 4 bps with 10s30s spread unchanged.

In the period through the end of the September quarter, financial markets moved much more. The PBoC decision fed into the Fed's decision to hold rates unexpectedly at its September meeting. This may have stoked expectations of slower growth abroad. The S&P 500 lost 7% between August 13 and the September close. Shanghai stock market was down 22%. US yields fell by 15 bps with 10-Yr bonds outperforming both 2-Yr notes and 30-Yr bonds. The 10s30s spread indeed widened by 15 bps. Importantly the US dollar index (DXY) remained stable through this period.

Conclusion

China's supply-centric growth model is hard to maintain in a confrontational world. Tariffs and trade restrictions limit the growth potential from exports whilst chronic weakness in domestic demand exacerbates deflationary forces from the property slump. Capital outflows only make matters worse so that the PBoC may be forced to devalue the yuan. A surprise devaluation would be detrimental to risk assets if August 2015 is any guide.

Axel Botte

Market review

Markets need a Fed nod

The downturn in surveys and the mediocre quarterly results of the top American companies are prolonging the stock market correction, as investors' attention now turns to the meetings of the Fed, the BoE and the BoJ this week.

The financial environment has deteriorated since the beginning of the month. The stock market correction initiated by the US mega-cap American companies is only partially offset by the rotations into small-cap stocks. The rebound of the Japanese yen, which is regaining its safe-haven status in anticipation of a rate hike by the BoJ, the price of gold close to $2400 per ounce, and the slight tension on sovereign spreads are all signals of risk aversion. The steepening of yield curves seems to be a nudge to the Fed, and even to the BoE. Meanwhile, the PBoC is doubling its efforts to stimulate a faltering domestic demand. The volatility of stocks is also notably on the rise this week in the United States.

The downside risks to growth, recently mentioned by Christine Lagarde, seem to be materializing considering the latest surveys (PMI, IFO, INSEE, etc.). Economic activity has been slowing down since May. The improvement in consumer confidence is the only glimmer of hope to reverse this trend in the second half of the year. In the United States, growth came in at 2.8% in the second quarter thanks to strong business investment. The rebound also reflects the end of inventory drawdown, so that first-half growth is in line with potential. The rise in unemployment (4.1% in June) must be monitored. However, consumer spending picked up between April and June, driven by durable goods purchases. PCE inflation (PCE) eased slightly to 2.5% in June. In China, growth below 5% in the second quarter is insufficient for the authorities. Exports are the sole engine of activity. The real estate situation requires restructuring of the financial sector. About forty banks, made non-viable by bad real estate loans, have been hastily merged. In this context, the PBoC has no choice but to lower its interest rates. Inflation near zero leaves little doubt about the continuation of this trend. On the contrary, market participants anticipate a rate hike by the BoJ, perhaps as early as Wednesday, to consolidate the rebound of the Japanese currency towards 153 yen to the dollar.

In the U.S. bond markets, the yield curve steepening, initially associated with the possibility of a second Trump presidency, has resumed amid expectations of Fed rate cuts. Jerome Powell will likely prefer to wait until September for a first cut of 25 bps. The Treasury refinancing announced on Wednesday is not expected to change the issuance profile. The extension of the Treasury debt maturity may be postponed until 2025. The T-note (4.20%) is thus supported by the expected monetary policy stance and the weakness in equity markets. In the euro area, the Bund struggles to break through the 2.40% threshold despite poor economic surveys. Sovereign spreads are on the rise. The rumour of a repeal of the pension reform in France has led to selling pressure on the OAT (71 bps), which seems to be spilling over to the eurozone government bonds.

Stocks end the week sharply lower. The earnings reports from Tesla and Google disappointed, as did those from luxury giants in Europe. The S&P has dropped 4% since July 16. This correction resembles that of April, with more pronounced rotation movements and a noticeable increase in implied volatility, leading to position unwinding.

Axel Botte

Main market indicators

G4 Government Bonds	29-Jul-24	1wk (bp)	1m (bp)	2024 (bp)
EUR Bunds 2y	2.59%	-24	-25	+18
EUR Bunds 10y	2.35%	-14	-15	+33
EUR Bunds 2s10s	-23.6bp	+10	+10	+15
USD Treasuries 2y	4.37%	-15	-39	+12
USD Treasuries 10y	4.16%	-10	-24	+28
USD Treasuries 2s10s	-21.2bp	+5	+15	+16
GBP Gilt 10y	4.02%	-14	-15	+49
JPY JGB 10y	1.03%	-3	-6	-41
€ Sovereign Spreads (10y)	29-Jul-24	1wk (bp)	1m (bp)	2024 (bp)
France	70bp	+5	-10	+17
Italy	134bp	+6	-23	-33
Spain	82bp	+5	-10	-14
Inflation Break-evens (10y)	29-Jul-24	1wk (bp)	1m (bp)	2024 (bp)
EUR 10y Inflation Swap	2.11%	-7	-12	-2
USD 10y Inflation Swap	2.45%	-5	-7	+4
GBP 10y Inflation Swap	3.57%	-5	-9	+3
EUR Credit Indices	29-Jul-24	1wk (bp)	1m (bp)	2024 (bp)
EUR Corporate Credit OAS	110bp	+0	-10	-28
EUR Agencies OAS	64bp	+2	-7	-6
EUR Securitized - Covered OAS	63bp	+2	-6	-16
EUR Pan-European High Yield OAS	377bp	+13	+9	-22
EUR/USD CDS Indices 5y	29-Jul-24	1wk (bp)	1m (bp)	2024 (bp)
iTraxx IG	54bp	+1	-4	-5
iTraxx Crossover	295bp	+3	-15	-19
CDX IG	51bp	+1	-1	-5
CDX High Yield	332bp	+6	-10	-24
Emerging Markets	29-Jul-24	1wk (bp)	1m (bp)	2024 (bp)
JPM EMBI Global Div. Spread	395bp	+3	+3	+11
Currencies	29-Jul-24	1wk (%)	1m (%)	2024 (%)
EUR/USD	$1.084	-0.505	0.894	-1.8
GBP/USD	$1.284	-0.735	1.486	0.8
USD/JPY	JPY 154	2.093	4.967	-8.3
Commodity Futures	29-Jul-24	-1wk ($)	-1m ($)	2024 (%)
Crude Brent	$81.1	-$1.3	-$3.9	6.9
Gold	$2 395.3	-$1.3	$63.4	16.1
Equity Market Indices	29-Jul-24	-1wk (%)	-1m (%)	2024 (%)
S&P 500	5 459	-0.83	-0.03	14.5
EuroStoxx 50	4 868	-0.59	-0.52	7.7
CAC 40	7 513	-1.44	0.44	-0.4
Nikkei 225	38 469	-2.85	-2.82	15.0
Shanghai Composite	2 892	-2.44	-2.55	-2.8
VIX - Implied Volatility Index	16.76	12.41	34.73	34.6

Source: Bloomberg, Ostrum AM

Additional notes

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