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Pyrspectives

Q3 2024

The PBoC put

China has announced a wave of stimulus measures including cuts to its benchmark interest rate as Beijing battles a slowdown in the world's second-largest economy. Scepticism on China's ability to meet the government's full year growth target of 5% is growing, prompting the People's Bank of China (PBoC) governor Pan Gongsheng to justify the raft of measures as a way to support stable economic growth and promote a moderate rebound in prices.

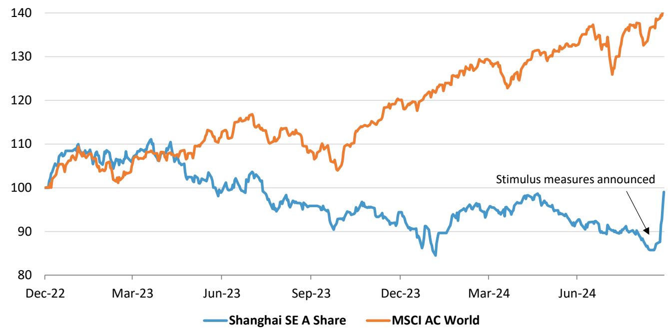
Reserve rate requirements were cut 50bps alongside cuts to lending and deposit rates with the aim of boosting liquidity in the banking system and support lending activity. The issue is that businesses and households are looking to reduce leverage as the fallout from China's property market continues.

Downpayments on second home purchases were cut (from 25% to 15%) and a facility whereby lending is provided to state owned enterprises for buying unsold inventory from property developers announced. Finding a remedy to the vast unsold housing stock is needed to revive the economy though funding or debt restructuring would arguably be more impactful.

To revive the stock market, a 500bn RMB fund to help brokers, insurance companies and funds buy stock was announced. The PBoC will also provide funding to help companies undertake share buybacks. What excited the market further was reports on the 26th September of plans to issue 2 trillion yuan (US$284 billion) of sovereign bonds with the aim of promoting consumption and tackling local government debt problems. Both monetary and fiscal stimulus measures suggests a coordinated effort though this proved to be too much for markets to handle as the Shanghai stock exchange struggled to process orders in the early hours following the announcement.

China equity underperformance

Index in USD rebased to 100



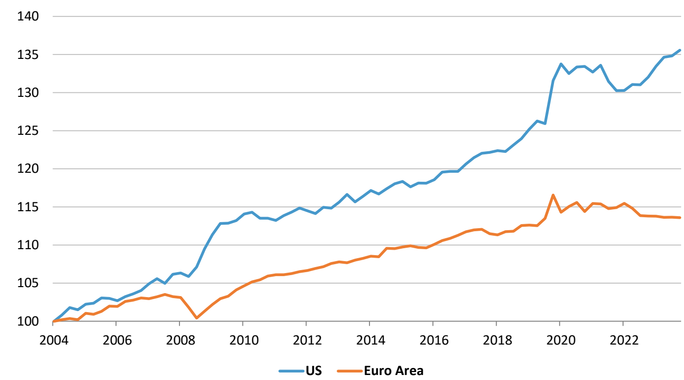
Source: Refinitiv Datastream

The fact that the PBoC has reached for unorthodox policy suggests an element of panic is creeping through Beijing. The reality is that whilst the measures are welcome, they are not likely to generate wholesale change in the economy. They are variations or expansions on existing schemes that have proven ineffective in increasing demand. Boosting the consumer has long been the only way to transition away from infrastructure investment or building goods for foreign companies. China might be short-term tradeable but the measures announced so far are not a game changer

Euro Area's growing productivity gap

It's becoming a bit of a sad pastime, opining on Europe's endless woes as it falls further behind its developed peers. The crux of the problem can be captured in the chart below showing the growing divergence in productivity between the Euro Area and the US. The last 5 years have been particularly worrying, with real GDP per hour worked in the US growing 7.4% since Q4 2019, vs only 0.9% in the Euro Area.

Labour productivity per hour worked, 2004 = 100



Source: Refinitiv Datastream

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Of course, the disproportionate effects of the energy crisis on European activity are well known. We would also point to differences in policy in the aftermath of the pandemic which encouraged creative destruction in the US and did the opposite in Europe. For example, new business applications in the US totalled a record 5.4 million in 2023, with the monthly pace of applications still growing twice the rate in 2019. Meanwhile in Europe, labour hoarding has discouraged the movement of workers to more productive industries. Total business registrations have flatlined for the last 6 years.

This lack of dynamism was one of three areas for action highlighted by Super Mario Draghi in a ~400-page report released this month titled 'The future of European competitiveness.' The other two were in regard to decarbonisation and reducing dependencies. How much would it cost to turn around the EU's fortunes? Draghi suggests an additional annual amount of EUR 750 to 800 billion or 4.4 to 4.7% of EU GDP. That compares to 1-2% of GDP during the Marshall plan of 1948-51.

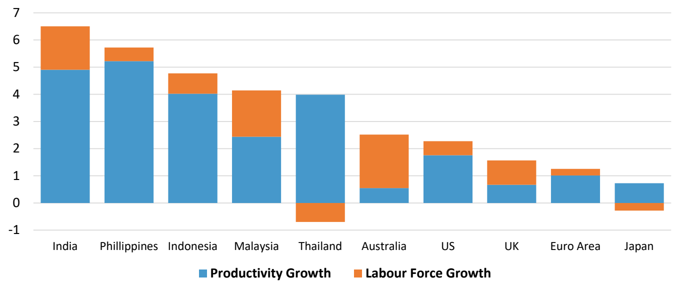
Whilst the solutions have always been fairly obvious, the inability to make coordinated decisions at a European level has stifled progress. We expect the status quo to remain for now given the lack of capital to fund such grand investment ambitions. For example, the proposal to issue more joint EU debt to fund investment was immediately shut down by Friedrich Merz, leader of the CDU in Germany and potentially the next Chancellor of the country. He pledged to do 'everything he can' to prevent new EU debt. Similarly, the Capital Markets Union proposed back in 2015 was supposed to deepen public capital markets offering companies cheaper sources of capital than traditional bank lending. Capital markets remain fragmented across the continent with companies still receiving 75% of financing through banks and 25% from capital markets. In the US it's the other way around.

In the context of aging populations and growing fiscal deficits to fund healthcare needs, productivity gains become that much more vital. Germany's reluctance to take on a greater fiscal burden now may simply be setting them up for a bigger package in the next crisis and this time around it's not the periphery economies that look to be in danger. For the first time since 2007, France's 5-year government bond yield exceeds that of Greece and Spain.

Zooming in on ASEAN

We move to more bustling and dynamic parts of the global economy. In the last three months we've highlighted the impressive performance of Southeast Asian economies with equity markets in Indonesia, Malaysia, Thailand, and the Philippines the top gainers in USD terms over the quarter. A quarter hardly makes a trend, and part of the gains are only clawing back underperformance over the last two years. But economic fundamentals are promising in terms of both productivity and labour force growth. In fact, other than India, most economies are likely to struggle to post the growth rates of these ASEAN nations.

Average annual potential growth forecasts 2024-2028 (%)



Source: Oxford Economics, Refinitiv Datastream

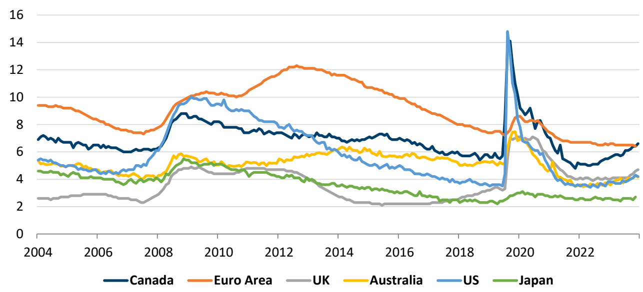
Whilst these are forecasts, the growth rates are not too dissimilar to current numbers as well as those in the 5 years preceding the pandemic. In stark contrast to Europe, these economies (with the exception of Thailand) are in the midst of a mini-investment boom set to drive future productivity gains.

Indonesia is accelerating the build out of its new capital city in Nusantara. Gross fixed capital formation has grown at an average of 8% over the last 3 years. In Malaysia, private and public investment grew by 10.6% and 10.3% respectively in the first half of 2024. Data centre investment has been a large contributor, attracting large FDI sums from the likes of Google, AWS, and Microsoft earlier in the year. Other mega projects include the construction of highways connecting the Malaysian states of Sabah and Sarawak on the island of Borneo. Finally, total investment in the Philippines accelerated to 6.5% in the first half of 2024, from 5.9% in 2023. Public construction rose by 19.5% over the previous 12 months across various infrastructure projects including, ports, railways, and highways.

The Final Word

And so we have it, a 50 bps cut to mark the start of the Fed's easing cycle, followed by a step change in policy out of China. How have financial markets absorbed this latest wave of stimulus? Equity markets have bounced across the board with the S&P 500 in the US climbing to new heights. Yield curves have steepened with the 30-year US bond yield a touch higher than its level at the start of the year. Most notably, gold has taken off, up 30% year to date. Makes you wonder how 'real' all these gains truly are. The Fed has rightly shifted its attention to the labour market which remains intact for now. We leave you with a chart of unemployment across the major economies with the UK and Canada seeing uncomfortable spikes over the last quarter.

Unemployment Rate %



Source: Refinitiv Datastream

With earnings expectations and valuations elevated in the US, the onus is on the real economy to accelerate and grow into its current multiple. Any signs of a crack in growth will be met with sharp downward reactions regardless of the Fed response. Until next time… a new leader of the free world awaits us as we close out an exciting finish to 2024.

Pyrford International
30 September 2024

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