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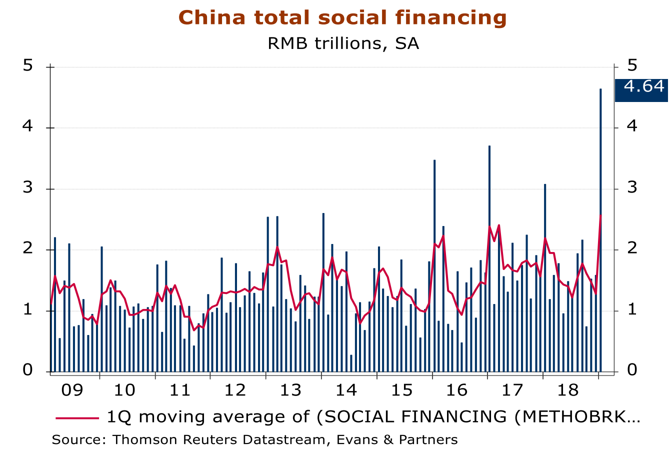
China's green light

One of the critical issues for 2019 is the extent to which China steps back from its reform agenda and allows a reacceleration of credit. January's record credit data suggests this might now be occurring. Other policy easing was not likely to have much impact without an easing in credit restrictions.



This pattern appears similar to what occurred in 2016. At that time a reversal in local government funding restrictions saw a burst of activity that filtered through the economy.

Such a change will likely have implications for a range of asset classes. In 2016 the effect was most apparent in emerging market equities, commodity prices and the Australian dollar. Emerging market equities surged 30% in 2016, commodity prices rose 10-15% and the Australian dollar jumped nearly US$0.10 over a few months. We expect similar but more muted effects this time and have increased our year-end forecast for the Australian dollar to $US0.75.

China's green light

One of the critical issues for markets and the macro outlook is the extent to which China steps back from its reform agenda and allows a reacceleration of the economy.

Weaker conditions over the past year have been overwhelmingly due to financial reforms that are positive for the long-term outlook, but have resulted in a funding squeeze, particularly for the private sector. This sector has typically been most dependent on the shadow banking system and has suffered from the clampdown in this area.

There has been growing evidence of policy easing in China in recent months. This has included easing property purchase restrictions, new infrastructure announcements, lower reserve ratio requirements and personal tax cuts. However, these measures have not yet led to higher economic growth because of credit restrictions.

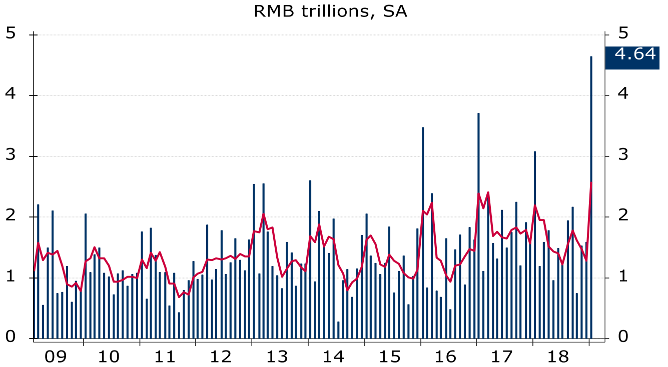
The credit engine restarts

China's credit data for January was a significant event in this story. January was the biggest ever month for new credit issued, as shown in the chart below. China was never going to make an official announcement that the financial deleveraging program was at an end, but this arguably comes close.

It is also significant that there was a large jump in shadow financing, as this is the area where controls were tightest. This shows that China may have capitulated on financial sector reforms, at least for the time being.

China total social financing

RMB trillions, SA



Source: Thomson Reuters Datastream, Evans & Partners

January is always the most important month for credit because most banks still operate with loan quotas that work on an annual basis. They tend to run out of quota towards the end of the year and then clear the backlog in January. A big January credit number is indicative that loan quotas have been generous, and that strong credit conditions will be sustained through the year.

A repeat of 2016?

These circumstances are very similar to what occurred in 2016. The previous years had also seen a weak economy on the back of structural reforms, although at that time it was the anti-corruption campaign that had caused the disruption. Then in late 2015 a reversal in local government funding restrictions saw a burst of activity. The first signs of this were the credit data of January 2016, which were a record at the time. This strength lasted through 2016 and into 2017.

The impact of this adrenalin shot can be seen from the sharp bounce in the manufacturing PMI in the early months of 2016. There was a broad-based jump in activity across the economy, including the property and infrastructure sectors. It is feasible we may now see the same effect. Note that the starting point for the PMI is about the same as in late 2015.

China manufacturing PMI measures

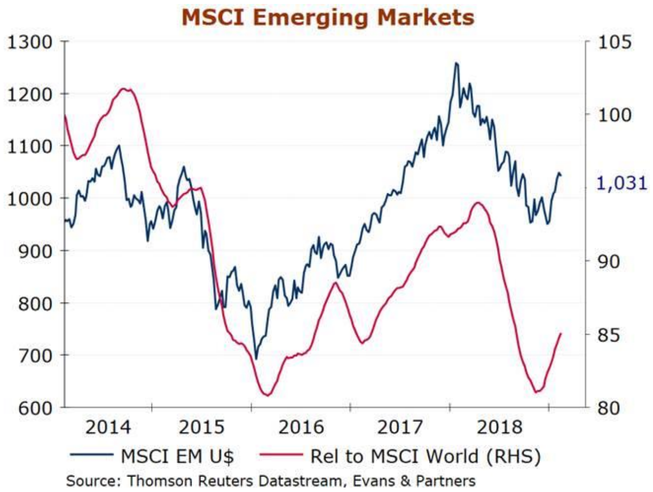
Index, 50 = no change

Source: Thomson Reuters Datastream, Evans & Partners

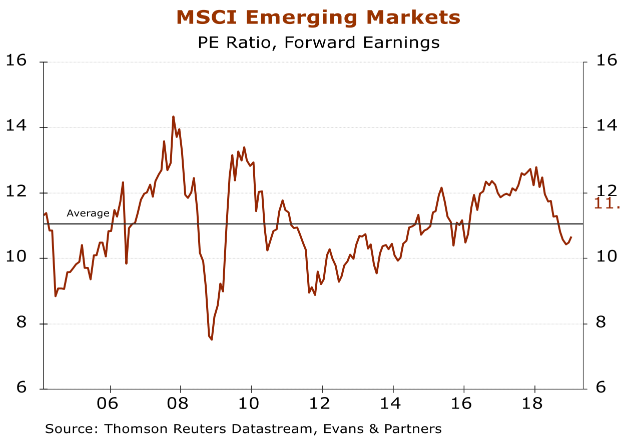
Good for emerging markets and commodities

Such a change will have implications for a range of asset classes. In 2016 the effect was most apparent in emerging market equities, commodity prices and the Australian dollar.

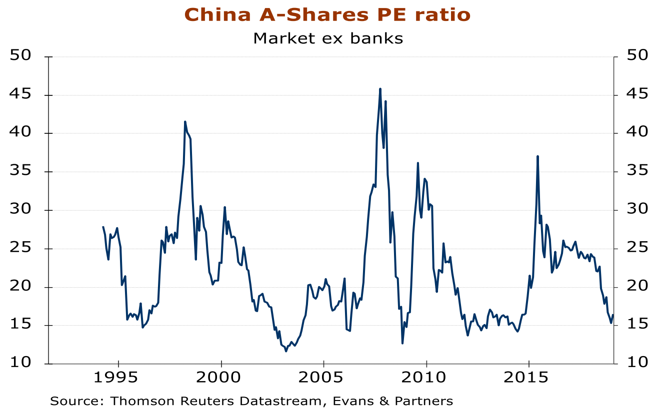
Emerging market equities surged 30% in 2016 and significantly outperformed global equities. This was then sustained into 2017, when other regions such as Europe benefitted from the Chinese recovery.



This time around, emerging market equities have already begun to outperform, and valuations are supportive of a further rally. The forward price to earnings ratio (PE) is in line with long-term average valuations.

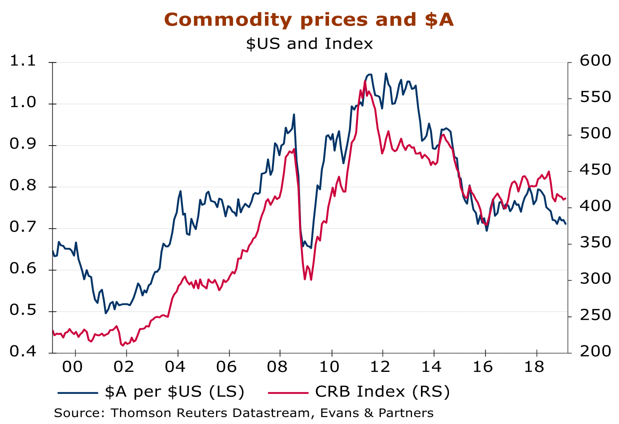


The one asset that we believe is significantly undervalued, and therefore where there is most potential for upside, is local Chinese shares, or A-shares. The PE of the A-share market is at the very bottom of historical ranges (15 times on a 12-month trailing basis). The A-share market has been constrained by the pledged share issue. Many companies used their own shares for collateral to access funds last year when credit was tight, and this led to fears of forced selling, as markets declined last year.



In 2016, Chinese stimulus also led to a rise in commodity prices and the Australian dollar. The CRB index rose by around 15% and this pushed the Australian dollar around AU$0.10 higher against the US dollar. The effect may be more muted this time because commodity prices have remained elevated during the downturn – and iron ore prices have already jumped higher in recent months due to supply issues.

Note that based on the relationship between commodity prices and the Australian dollar in the chart below, the Australian dollar is trading on the low side of fair value. This is arguably because concerns about local interest rates and the sustainability of commodity price increases have held it back.



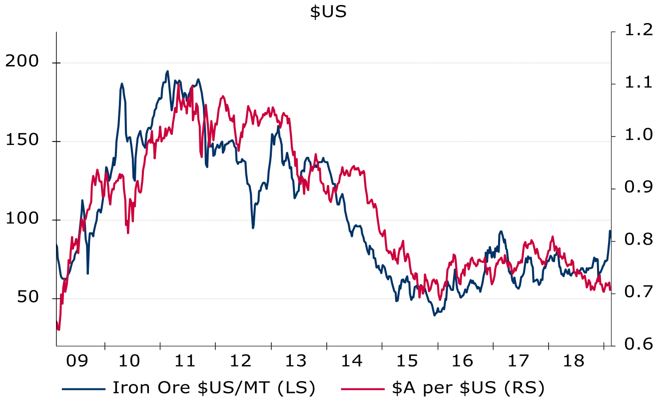
Upside risks to the Australian dollar: raising our forecasts

The prospect of higher commodity prices, even if there is less of a rise than in 2016, represents an upside risk for the Australian dollar. This needs to be balanced against domestic risks in the Australian economy that could see interest rates fall.

The recent jump in the iron ore price represents another upside risk to the Australian dollar. An iron ore price that is sustained at these levels has historically been consistent with a level closer to US$0.80. Currency markets have probably not priced this in because there are questions around the sustainability of the bounce, given it is due to supply disruption. However, it is becoming increasingly clear that the supply issues linked to the dam collapse in Brazil will linger.

Iron ore and $A

$US

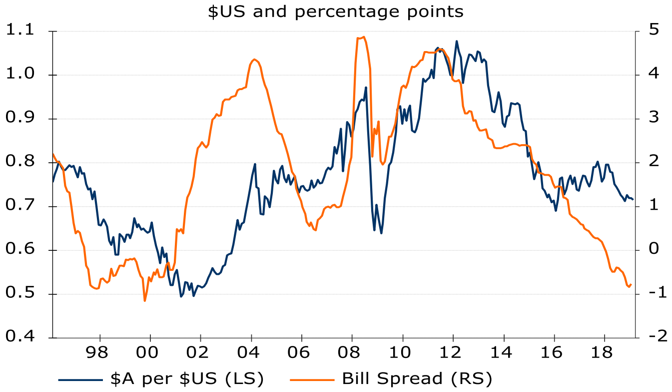


Source: Thomson Reuters Datastream, Evans & Partners

A counterpoint to the strength in commodity prices is interest rates. There is probably further downside risk to the bill spread (the gap between US and Australian 3-month rates) as concerns about Australian recession risks persist. Note however that interest rates have not played a major role in movements in the Australian dollar in recent years.

3 Month Bill Spread and $A

$US and percentage points



Source: Thomson Reuters Datastream, Evans & Partners

Based on this analysis, we are increasing our 2019 year-end forecast for the Australian dollar to US$0.75. Note there is upside risks to these numbers if the easing in Chinese credit conditions is sustained, and if economic conditions in Australia remain relatively stable.

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