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***A Turning of the Tide:* China has finally acted to support the economy, Westminster Asset Management Investment Strategist Peter Lucas considers whether this easing cycle is likely to be quite different to those of the past.**



Last week's 0.5% cut in the Reserve Requirement Ratio (RRR) for Chinese banks – which increases the amount that the banks can lend – will help to negate investors' worst fears regarding the economy and could be an important turning point for China and global markets.

This policy easing, described by Gavekal's Wei He as "cautious", is consistent with the country's recent measured approach to economic management, which contrasts heavily with past easing cycles as well as with policies currently being deployed in much of the developed world.

There have been those that have been predicting that the yuan would weaken in response to the country's current economic problems, most notably in the property sector, and the policy response that it would elicit. However, thus far at least, we have seen none of that. Indeed, in the past 4-5 months the yuan has strengthened against an otherwise strong US dollar. Furthermore, it has strengthened further, even after the cut in the RRR, strength that has taken it further below an important 7-year trend line highlighted in earlier reports.

A strong yuan suits China, for at least three reasons: it promotes the use of the yuan as a reserve currency; it helps to transform the economy into a more consumer-based economy; and it enables China to export any inflation it may be experiencing. So, the thinking is that China will likely continue to resist the temptation to throw the kitchen sink at the economy. However, the cut in the RRR does probably mark the beginning of a new *measured* easing cycle and that may be enough to turn the tide for the beaten-up Chinese stock market.

The consensus view is that the US dollar will remain strong on the basis that the Fed is starting to talk tough on inflation. However, it is far from clear that the Fed is willing to back up its words with action. And even if it is, the starting point for the real Fed Funds rate is a 50-year low – interest rates could well be a long way from where they need to be. The bottom-line is that if inflation proves to be stickier than expected, the US dollar could go down rather than up, particularly if the yuan remains strong. And a weaker dollar would stoke up US inflation and unsettle the bond market, which to date has remained remarkably resilient.

In short, a quietly resurgent and economically responsible China, is yet another reason why investors should favour emerging markets, commodities, and value, whilst approaching US equities, growth, bonds and the US dollar with some degree of caution.

Peter Lucas

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