China's letter to markets: What does it mean for investors?

A potential new approach to economic growth could have longer-term positives and short-term negatives

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A front-page article attributed to high-ranking Chinese policy officials was recently published in the People's Daily, the communist party's official newspaper, surprising markets with suggestions of a revised approach to economic growth. The weekend article provided rare insight into the authorities' macro thinking - especially the dangers of boosting growth with increasing leverage - and emphasized the need for structural reform over short-term stimulus to achieve sustainable growth. Depending on how this new approach is implemented, Invesco Fixed Income believes this new information could have significant repercussions for global financial markets and economies.

Below are the main points of the article:

- Excessive easing needs to be avoided, growth cannot be achieved via higher leverage, and supply-side reforms (via the allowance of corporate bankruptcies rather than forms of debt relief, for example) will be firmly implemented.
- China's growth path is likely to be L-shaped, not U- or V-shaped. The L-shape is likely to last for some time, although China's solid potential growth should provide a floor.
- In the near term, supply-side reform will be the major focus. Investment expansion should be moderate, not excessive. Massive easing to stimulate the economy should be avoided, as excessive easing would leave undesirable effects after a short-term rebound.
- High amounts of leverage bring high risks, which, if not controlled, could lead to systemic financial crisis or even negative economic growth.
- The equity, currency and property markets should revert to their original functions rather than serve as vehicles to provide stimulus. The equity market needs to recover its financing function, the currency market needs to be based on greater monetary policy autonomy, and the property market's inventory de-stocking should be achieved via urbanization rather than supported with increased leverage. Excessive stimulus risks creating bubbles, which should be avoided.
- Volatility in the stock and currency markets earlier this year reflected the financial system's vulnerability to high amounts of leverage. The idea of increasing gross domestic product via massive monetary easing should be abandoned in favor of reduced leverage. Non-viable companies should be shut down or entered into bankruptcy, rather than supported via forms of debt relief. Workers made redundant via closures of failing companies need to be supported with job training and transfers.

What are the market implications?

The thinking outlined in the article seems to mark a reversal from recent tactics aimed at monetary and fiscal stimulus to boost growth. Monetary and fiscal loosening (combined with tighter controls over capital outflows) has recently appeared to pay off - the Chinese currency has largely stabilized, signs of Chinese growth have emerged, and global markets have felt the positive effects of a steadier China.

However, Invesco Fixed Income has long believed that global market stability was likely temporary and vulnerable to a number of potential negative catalysts that could disrupt markets – such as a more hawkish US Federal Reserve (Fed) or renewed pressure out of China. We believe the views expressed in the People's Daily article could be just such a negative catalyst. While the approach outlined is likely positive for China's longer-term growth outlook, we believe it could be quite negative for short-term growth, which could reverse global markets' current "risk-on" sentiment.

What does a slower China mean?

A slowdown in China's stimulus and moves to restrain leverage could have negative implications for China's construction and property sectors (which have been providing much-needed economic support of late) and lead to renewed market focus on deflationary pressures emanating from Asia (although we have been cautious on China for some time and continue to view Asia as the epicenter of deflation).

Perhaps most significantly, the measures outlined in the article – aimed at curbing leverage in the Chinese economy – could lead to a renewed tightening of global financial conditions, an issue we have monitored closely. We believe that tighter global financial conditions have played an important role in softening monetary policy among the major central banks in recent months, including the Fed. China's new approach could further tighten financial conditions, which in turn could generate potential headwinds to reflation globally, exert downward pressure on global interest rates and drive peripheral Asian currencies weaker against the US dollar. This could have negative implications for commodity prices, risk assets and other financial markets. As such, we advocate caution with respect to risky asset exposure.

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