In China, here comes the bounce

01 April 2019, 4:40 pm CEST, written by UBS Editorial Team

China’s closely watched PMI manufacturing gauges rebounded more sharply than expected in March, adding to the market narrative that the worst may be over for the world’s second-largest economy.

Both the small and medium sized enterprise-focused private PMI (50.8 vs. consensus 50.0) and the state-owned-enterprise heavy official gauge (50.5 vs. consensus 49.5) returned to expansionary territory. Markets rallied on the turn in business sentiment, with the Hang Seng China Enterprise index rising 1.7% and the onshore CSI 300 adding another 2% to reach a one-year high.

Chinese growth is now showing signs of having bottomed out. This latest activity data is in line with our expectations for only a controlled slowdown in China that won’t derail the global economy or markets:

• The recovery in China’s March PMI extends beyond typical seasonal outperformance on work resuming after Chinese New Year, with the sub-index readings reflecting improvements across the board. China’s continued monetary policy easing and fiscal stimulus measures appear to be taking hold, offering an improved macro outlook for the second quarter. We forecast China’s economy to grow by 6.1% this year.

• The tone of US-China trade negotiations has turned more positive in recent weeks, with “productive” high-level talks to resume in Washington this week, and hints of more tangible Chinese concessions on non-tariff barriers. Our base case is for a partial resolution to the trade dispute in the months ahead.

• China’s more nuanced approach to stimulus this time around has nonetheless translated into a pronounced market bounce. Strong inflows and a step-up in liquidity over the last few weeks have helped extend MSCI China’s rally to nearly 25% from its January trough. And yet valuations are still within 0.2 standard deviations of their long-term historical average, and both H and A-shares look attractive on an equity risk premium basis.

So we maintain a moderately risk on stance, and continue to prefer offshore China equities within our Asia portfolios. But these positive developments mentioned above do not mean all risks have been resolved. A US-China trade deal has not yet been finalized and could still falter. China’s government stimulus, while supportive, won’t be of the magnitude of 2009 or 2015. The China earnings downgrade cycle, while slowing, is not yet complete.

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Content is a product of the Chief Investment Office (CIO).

Original report: In China, here comes the bounce I 1st Apr 2019
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