Look to Beijing as well as Washington

The recent calm in financial markets was broken by political turmoil in Washington (and Brazil) but we believe of greater importance for the sustainability of the current global economic upturn is the scaling back of recent extraordinary policy stimulus by Beijing.

Market Insight

by
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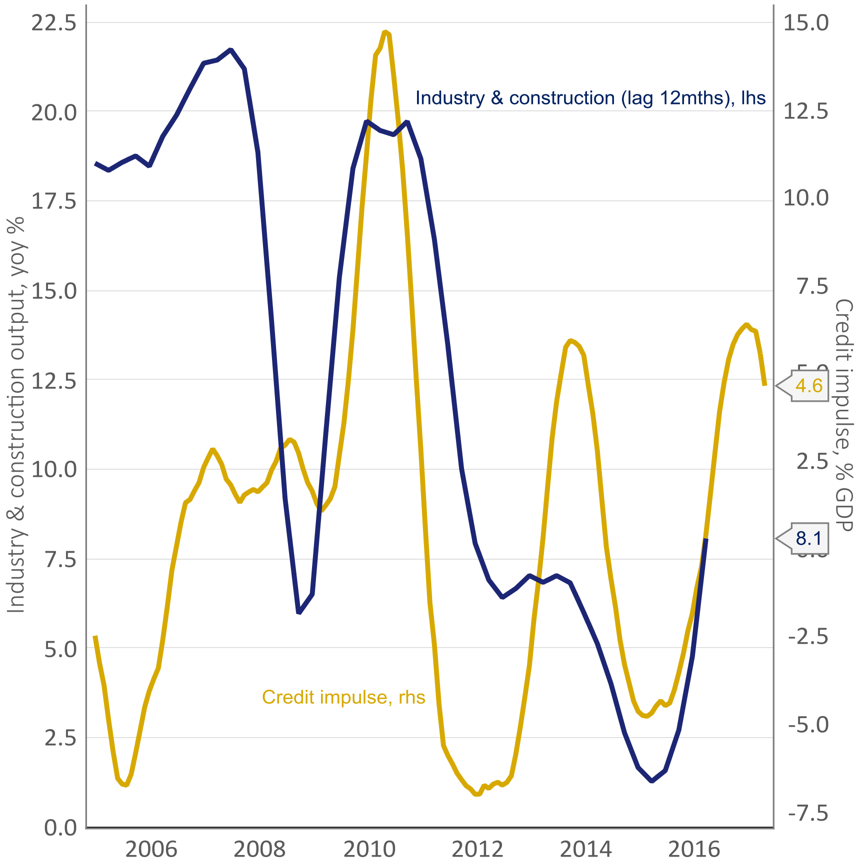
Our assessment is that the impact on China's growth will be gradual but the risk of a policy mistake cannot be wholly discounted. In Washington, it is Congress and the Federal Reserve (Fed) rather than the White House that investors should look to. In our opinion, the market is under-estimating the determination of Republicans to pass tax cuts before next-year's mid-term elections and the Fed to hike rates further.

In Fig. 1, the 'credit impulse' – the rate of change in credit relative to GDP – is shown by the gold line (12 month moving average). Industrial and construction output – the blue line – lags the credit impulse by around 12 months. Beijing switched from an emphasis on deleveraging to growth in mid-2015, driving a strong rebound in China growth and inflation. China powered global reflation was initially ignored by Western government bond markets that rallied in response to the UK's 'Brexit' referendum.

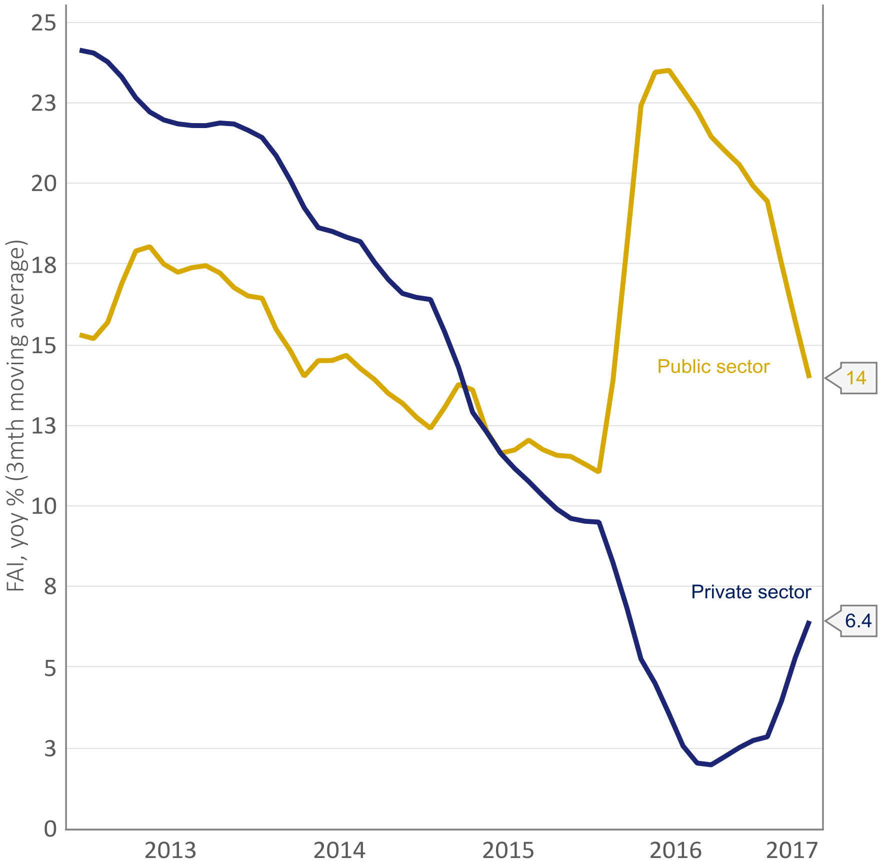
Fig 1: China credit impulse and industry & construction output



Source: Macrobond; BlueBay calculations; latest monthly data April 2017

Beijing has begun to tighten policy targeted at 'shadow financing' (wealth management products and off balance sheet local government spending) and the pace of credit growth is slowing. However, total social financing (a broad measure of credit) rose by 12.8% year-on-year in April, faster than nominal GDP growth. More positively, corporate and mortgage lending remained strong while 'shadow' lending declined and private investment growth is accelerating even as the growth in public investment slows (see Fig 2). While our forecast is for growth to gradually slow over the coming quarters, we don't expect a China 'growth scare' to roil global financial markets in part because the authorities also have tightened control over capital outflows and the exchange rate. Nonetheless, we acknowledge that the policy authorities are engaged in a delicate balancing act between supporting growth while preventing, in the words of the People's Bank of China, "..excessive credit expansion and a further rise in the leverage ratio."

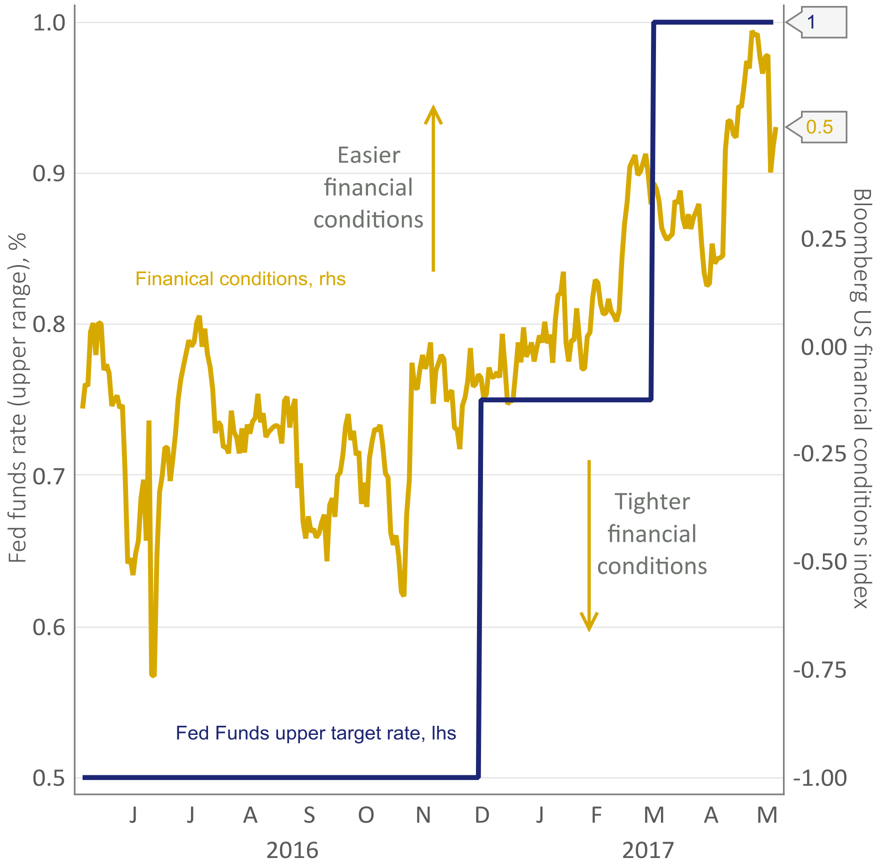
Fig 2: Public and private fixed asset investment, yoy %



Source: Macrobond; BlueBay calculations; data at 04/2017, 04/2017

Turning back to Washington, the unfolding drama following President Trump's dismissal of James Comey as FBI director against the backdrop of the agency's investigations into possible links between Russia and the Trump campaign sparked a bout of market volatility. But financial conditions in the US remain easier than before the Fed resumed its interest rate hiking path in December (see Fig 3). Moreover, the economy is performing in line with Fed expectations with growth at annual rate of around 2% and unemployment continuing to fall, consistent with inflation converging to the Fed's 2% target. With or without a 'Trump bump' to growth from tax cuts and de-regulation, the bar is high to deflect the Fed from its path of gradual increases in interest rates, including at its June 14-15 meeting.

Fig 3: Fed policy rates and US financial conditions



Source: Macrobond; Bloomberg; data at 19/05/2017, 18/05/2017

Recent meetings in Washington DC underscored the strong political commitment of Republican leaders in Congress to deliver tax cuts before next year's mid-term elections, an outcome largely priced-out of the Treasury market. In our view, the outlook for US rates appear more skewed to surprise market expectations on the upside than at any time this year and we retain our short US duration bias across several investment strategies.