People's Bank of China cuts interest rates again

On July 5, the People's Bank of China (PBoC) announced a further 31bp rate cut to the one-year lending rate and a 25bp cut to the one-year deposit rate, effective July 6. This is the second rate cut in about a month, following the previous move on June 7. We share here views from our fixed income and equity teams.

Insights from Manulife Asset Management China Fixed Income Team

The timing of the action was a surprise, ahead of the release of the June economic data. In addition to the cut, banks are now allowed to give a 30% "discount" on interest rates charged for loans, up from 20%. The "premium" on the deposit rates above official rates remains unchanged at 10%.

The move sends a signal to the markets that China is willing to further liberalize China's interest rate framework, confirming what we had mentioned following last month's cut. However the timing of the cut is clearly a surprise to market participants. We believe that the government is increasingly concerned about growth and the lack of credit demand. It is trying to promote sustainable healthier growth over quick growth by favoring further loans to private businesses and combating housing speculation. However we think that, given the weak global demand, the corporate sector may not be willing to increase capital expenditures ("Capex") and remain cautious for the time being. Nevertheless, as inflation has been trending downwards and is expected to remain around 3% and below this year, we expect the PBoC to keep its accommodative stance as it will have enough room to cut rates further in the medium term.

China's cut coincided with other central banks' loosening actions such as yesterday's European Central Bank's policy rate cut to a historical low of 0.75 per cent from 1 per cent as well as its cut to the interest rate on its deposit facility to zero, the Bank of England's increase of quantitative easing level by £50bn to £375bn. Two weeks ago, the Fed had announced an extension of its operation twist program.

With regard to the banking sector, we expect that the asymmetric reduction between the lending and deposit rates will hurt banks' margin further. The Chinese government seems to be willing to focus on supporting the suffering corporate sector rather than supporting the thus-far relatively profitable banks.

Manulife Asset Management's Ronald Chan, Head of Equity, Asia shares his insights

The cuts will bring down the benchmark one year lending rate to 6% and the deposit rate to 3%. In addition, banks are allowed to give a 30% discount on interest rates charged for loans, up from 20%. The ceiling for deposit rate is unchanged at 10% above the benchmark rate.

The rate cut is likely to boost sentiment and will help lower the cost of corporate and local government borrowing and boost credit demand at the margin, facilitate economic activities and improve the economic outlook. The view is that this move is in response to the lack of credit demand, soft investment activities and the general concern about growth.

We believe the asymmetric reduction between the lending and deposit rates will have a negative impact on bank margins. The rate cut should benefit the cyclical sectors and interest rate sensitive sectors as cost of funding decreases. For instance, the property sector should benefit as the cost of mortgage falls and first home buyers are able to get a better discount of up to 30% to benchmark rates. Utilities and airlines are typically highly geared sectors and will benefit as cost of financing falls. As yield of bank deposit falls, Chinese insurers are expected to outperform as demand of insurance products increase.

Corporate earnings have been squeezed due to slower economic growth, we believe the Chinese authority has stepped up its effort in stabilizing the economy. Inflation expectation has fallen. This should provide an environment for more aggressive policy easing. Our expectation is for more monetary policy easing to come for the rest of the year, including one more policy rate cut and two more Reserve Requirement Ratio (RRR) cuts.

However, there are inherent risks that need to be considered. The timing of the cuts has hinted that the growth in 2Q is worse than the government expectation. The government current actions have reaffirmed that it will take every measure needed to stabilize the economy.

Over in Europe, the European Central Bank (ECB) Governing Council cut the main refinancing rate by 25bps to 0.75% right after the PBoC's move. The ECB also surprised the market with its unanimous decision to set the deposit rate to zero. The ECB has very clearly shifted focus from crisis management and liquidity provision to economic growth stabilization. The euro zone economy has been broadly flat over the past year and there are signs of weakness among its major trading partners, namely the US, UK and also emerging economies.

On the positive side, the European Union leaders' summit was successful in identifying an important problem, but questions on policy implementation remain unanswered. The broad global economic picture looks to be somewhat brighter as the risks seem to be contained thanks to recent steps from European policy makers at last week's summit. The progress that was made at the summit concerning financial assistance for Spain, region-wide banking supervision and the potential for greater banking sector recapitalization went well beyond what was thought beforehand to be politically feasible.

At a broader global level, policymakers now appear to be responding more forcefully to the turbulence that has engulfed the world economy over the last few months. A global trend towards a more growth friendly policy stance has now clearly emerged, just as it did in previous years.

Source: Manulife Asset Management (Asia), Citi Research, UBS Investment Research, CS Securities Research & Analytics