

## Summary

### **China's rate hike – a strong vote of economic confidence**

*On 19<sup>th</sup> October, China announced that it would raise the lending and deposit rates by 25 basis points, effective from 20<sup>th</sup> October – marking the first time it has done so since end 2007.*

*Predictably, the market greeted the news with surprise, as the People's Bank of China (PBOC) had recently reiterated that alternative tightening measures were working well, after having raised reserve requirement ratios and enforcing loan quotas over the course of 2010.*

*We are positive on the move, as it signals confidence in the economic recovery and helps to curb inflation before it becomes a problem.*

### **A show of confidence**

Fundamentally, we are bullish on the China markets despite tightening measures. The reason is simple: a pre-emptive move at this stage is good for the economy in the medium to long-run before runaway prices get out of hand. Already, there have been growing concerns of asset bubbles in Asia, driven by the flood of liquidity sloshing out from developed markets.

Therefore, the rate hike should be seen as a pre-emptive move to reduce the risk of any bubble in China – a positive for stock markets. The domestic property crackdown has also led to more liquidity flowing into equities.

### **Any sell-off likely to be temporary**

Technically speaking, monetary tightening is not necessarily a bearish signal, based on China's historical experience. Between 2006 and 2007, Asian markets rallied despite China raising its interest rate seven times, and hiking the reserve requirement ratio 11 times over the same period (See chart on next page). And while we acknowledge that the latest move may trigger off a wave of selling, we view such correction as knee-jerk and temporary.

**Policies' impact on the Chinese stock market 2005-2010**



Source: Bloomberg, various news flows, BofA Merrill Lynch research, 19 October 2010

As mentioned earlier, a tightening represents a show of China's confidence in the economy and an attempt to nip inflation in the bud. We believe that global investors will eventually come round to the idea, and this will lend support to equity markets.

Indeed, we have already seen evidence of China's sequential economic growth having bottomed after July 2010. Besides, the liquidity situation is also improving too with M2 growth on a sequential rising trend since July. As a comparison, we note that India had also raised interest rates a number of times this year, but its stock market remains one of the top performers in Asia.

The interest rate hike will also benefit certain sectors in China, such as banks and insurance. Specifically, the symmetrical rate hike will enhance earnings for most Chinese banks through an improvement in net interest margins, while insurance companies benefit from higher yield spreads.

We also continue to be bullish on the consumer sector, which will enjoy strong support from supportive government policies and other industries that will benefit from the 12<sup>th</sup> five-year plan. On the other hand, companies in the cyclical, commodities and property sectors with high gearing will likely be negatively affected.



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