November 26, 2014 - China's Stock Market Rebounds With Interest Rate Cuts - By Jeffrey Hagenmeier

Now that China has joined the club of trying to stimulate the economy through monetary policy, investors can expect an improving stock market in that country. As stated in the article on the blog yesterday, it was done with an interest rate cut and a reduction of reserve requirements for banks in China. What is also quite evident, is that China will continue with stimulative efforts, in order to keep their slowing economy above the 7% growth rate. If the domestic economy drifts below that level, there will be a spike in unemployment in China. This in turn would create a host of problems for the government that it obviously intends to avoid.

The interest rate cut (the first in two years), brought the Chinese stock market to a three year high. There are of course, a number of market analysts that doubt the action will be lasting. What they are not considering is that China has two distinct advantages in this sphere. The first is that now that it has been determined by the central government to make growth their main priority, the strategy of a looser monetary policy is likely to continue.

The second consideration is that China has a great deal of flexibility in what it can do. Unlike in Europe and the United States where interest rates are at 0.05% and 0.25% respectively, China even with the recent rate cut, has its benchmark set at 5.6%. With official inflation at just 1.6%, China can bring interest rates down substantially if need be.

In addition, China could continue to lower the RRR (reserve requirement ratios) that banks are needed to hold. It is important to note, that the government of China has a much tighter hold on the financial sector than is standard practice in the West.

China could also begin other quantitative easing (buying of debt) methods that are being employed elsewhere in the world. The United States just ended a 6 year stint with this practice, Japan is gearing up for even more, and now it looks like Europe will begin its own version in 2015.

Another important asset enjoyed by China is the huge trade surpluses and currency reserves, that have been built up over the preceding years. They are on the whole, much more capable of purchasing debt on various levels.

China could also easily afford a massive stimulation effort, if it is deemed necessary to impact the economy. There are many infrastructure needs in the country, that will have the added advantage of improving productivity once the money is spent. There will be great economic benefit, to money that is spent in the transportation and communication sectors.

The only downside at present, is that too much monetary stimulation will start overheating the Chinese domestic real estate market again. It is already a bubble that is waiting to implode with prices dropping in 67 out of 70 major urban areas. However, if there is the alternative of a rising domestic stock market, many local investors would naturally turn in that direction, for alternative money making opportunities.

One rate cut will most likely not be sufficient, but rest assured more will follow along with other stimulative and monetary loosening. Even before the rate cut, the market was up in anticipation of one. The Shanghai Composite alone has gained 18% in the past year. This gives it the title of being the best performing major equity market in the world for 2014.

One can therefore expect that Chinese domestic stocks will outperform those in Europe, Japan or even the United States moving forward towards 2015. Recommendations on specific stocks will be forthcoming in the near future.