UNION BANCAIRE PRIVÉE

ASIA MACRO STRATEGY

Update on China's Economy: Growth and Policy Effect

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The Chinese economy, in its current stage, is fine with steady growth deceleration. This is despite protracted external headwind arising from the on-going trade war which has continued to curb investment appetite and spurred financial market volatility.

Beijing has faced a tough balancing act for over a year between limiting re-leveraging risk and supporting domestic growth with targeted policy easing while shadow credits (previously the funding backbone for private-sector activities) remain under tight scrutiny.

This explains why policy easing has been more measured and reactive in the current cycle than in past major down-cycles. Obviously, swings in trade talks with US President Donald Trump and growing fear of the US' long-term isolation policy on China may have forced Chinese policymakers to be cautious in saving the bullets for a likely protracted war.

It is increasingly likely that Beijing is more willing to accept a slower structural growth outcome rather than stretching policy stimulus too aggressively and inflating the risk of credit bubbles and a major fiscal slippage.

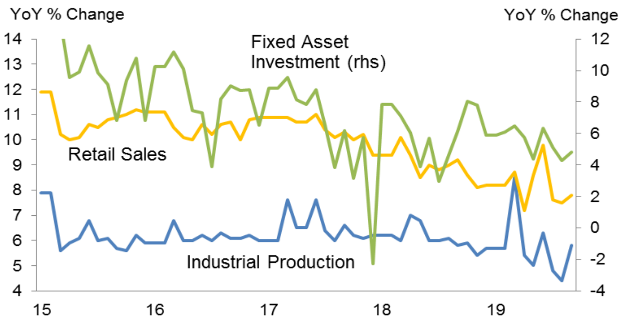
We think this balanced approach of steady but targeted rollout of policy stimulus will continue as trade talks linger further. China's policy support is still sufficient and perceived as a net 'supportive' factor for the markets by most investors. Moreover, sector rotation into long-term domestic structural plays – such as on-line entertainment, education and insurance – will continue to best capture the current investment themes.

Summary of key trends

The third quarter 2019 (3Q/19) gross domestic product (GDP) came in at 6% year-on-year (yoy), down from previous quarter's 6.2% and consensus 6.1%. It is actually in line with our 3Q/19 GDP forecast and we keep 4Q/19 projection at 5.9% to result in full-year 2019 at 6.1%.

A sector breakdown shows that the main drag in 3Q/19 GDP came from the much slower growth in agriculture output (to 2.9% yoy from 3.5% in 2Q), while industrial output was surprising resilient at 5.6% yoy even though most would have expected a more pronounced deceleration caused by the trade war. Our current forecast of 5.9% for 2020 GDP growth may be subject to downside adjustment as the year progresses.

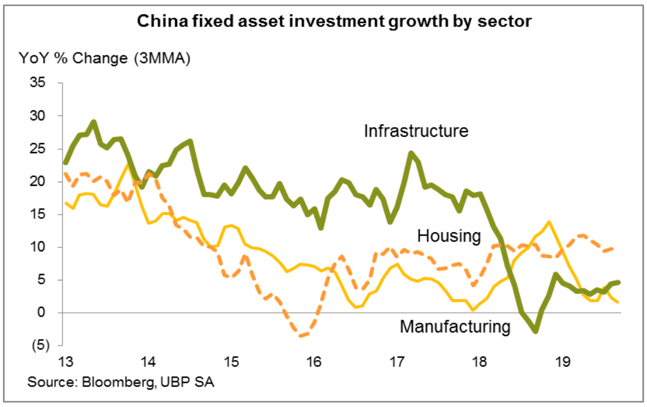
China Key Activity Trends



Source: Bloomberg, UBP SA

Among the major activity data, the bounce in September's industrial output was a pleasant surprise, while retail sale growth has stayed firm and infrastructure investment growth has shown further recovery (to 5.9% yoy after dipping into a low of just 2.8% in July) thanks to the government's doubling of their efforts in ensuring sufficient bond financing.

Housing investment growth has continued to march on firmly, but housing starts have further eased (but not dramatically). Housing prices have stayed high in major cities, but the momentum has begun to taper off slightly. We still think that the Beijing housing policy is aiming to cool down the sector and any price surge, rather than cracking down investment when external headwinds linger.


China fixed asset investment growth by sector

Source: Bloomberg, UBP SA

August's and September's total credit growth have picked up somewhat with the help of reserve requirement ratio (RRR) cuts, lowering of loan-prime rate and increase in bond financing.

Diverging credit and domestic demand trends

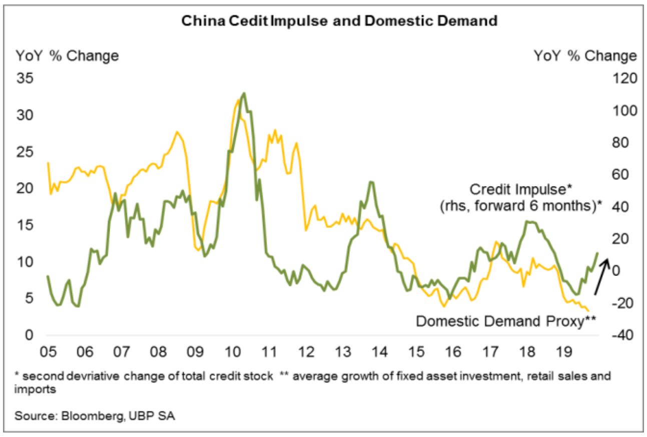
Our Credit Impulse indicator continues to revive and suggests that a recovery in domestic demand growth is likely six months later. However, we have become more cautious and have found the gap between the two trends has widened considerably of late mainly because of two main factors.

First, the trade war with US has caused an unusual slump in China's import growth (a variable we used in calculating our domestic demand proxy) especially from the US (down 16% yoy in September).

Second, the curb on shadow credits has handicapped the traditional financial intermediation, or credit multiplier effect to the real economy, since they account for one-third of China's aggregate financing.

Beijing may need to pump in a lot more liquidity to match the overall effect on boosting real growth as in the past when shadow credits were booming. Or targeted credit allocation needs to be extremely efficient and effective in boosting productivity and growth needs of specific sectors.

Or, accept a slower GDP growth outcome to alleviate the policy burden. China seems to be slowly moving to the latter direction.


China Cedit Impulse and Domestic Demand

* second devriative change of total credit stock ** average growth of fixed asset investment, retail sales and imports

Source: Bloomberg, UBP SA

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