China Bulletin: Market View

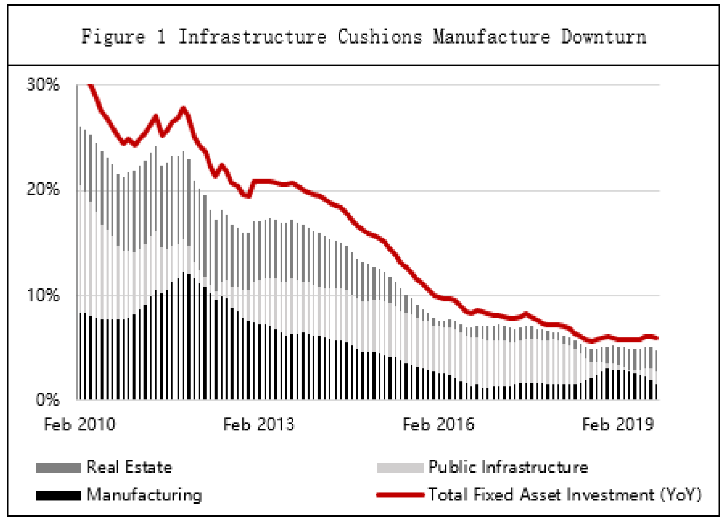
Q3 Economic data from China is mixed

China Q3 economic data looks balanced yet is tilted slightly to the downside. GDP growth recorded a 6.0% increase per annum, which is the lowest in more than two decades, dragged down by reduced exports and - to a lesser extent - fixed asset investment. Consumption picked up, which was consistent with retail sales and industrial production, and the unemployment rate remained stable. Financial data confirmed an ongoing shift away from shadow banking, and October Loan Prime Rate (LPR) remains unchanged from September, implying concerns about inflation.

The slowdown remains gradual, as shown by the monthly data. The 3rd quarter suffered from some idiosyncratic shocks, such as an unexpected escalation of trade disputes, a credit squeeze following the take-over of a distressed bank and the politburo's unusually tough statement about real estate.

China has struggled to maintain a decent level of growth during its implementation of structural reform aimed at guiding resources to more efficient sectors away from the housing sector and local government. This has been due to ongoing macroeconomic events such as the global slowdown and trade disputes with the US. Economic policies are well placed but fiscal-side stimulus still needs to be stepped up in terms of infrastructure investment in order to soften the slowdown.

External shocks also complicated the situation and if trade disputes don't escalate further, growth may bottom out from 20Q2.



Resilient housing sector offers latitude for structural reform

The housing sector has delivered decent growth year to date, enabling policy makers to continue the consolidation of local government debt and crackdown on shadow banking. Even after policy tightening has suppressed house sales and property developers' financing, housing investment still managed to grow at 10% yoy. The trade dispute has hit the manufacturing sector through reduced fixed asset investment, and the effect is expected to peak in 20H1 and to wane afterwards.

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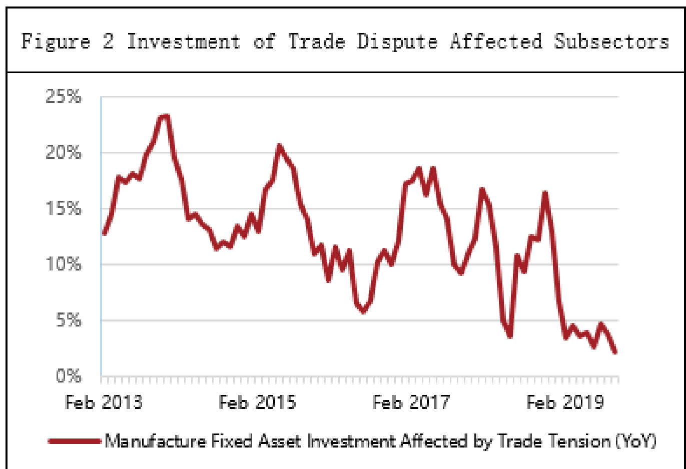


Figure 2 Investment of Trade Dispute Affected Subsectors

Implicit debt of local governments, an overheating housing market, and shadow banking are all entangled with each other and are major downside risks. Shadow banking operates disguised as asset management by absorbing saving from the general public with an implicit guarantee of banks, and then using the proceeds to finance real estate developers and local government financing vehicles for higher returns and perceived lower risk. The crackdown campaign, which was accelerated in 18Q1 causing a minor credit crunch, is scheduled to achieve a periodic breakthrough by 2020.

Policy makers are determined to solve the entangled problems through a delicate balance of policies. To suppress shadow banking calmly, financial regulators plan to 1) isolate asset management arms from banks and introduce a regulatory framework, 2) facilitate the shift of off-balance-sheet lending to on-balance-sheet loans, and 3) fine-tune monetary policy to entice banks to extend credit to small businesses and the manufacturing sector. To reduce local governments' reliance on shadow banking, fiscal policy makers have 1) extended applicability and raised the ceilings of local government revenue bonds, 2) directed local governments to consolidate financing vehicles and resolve existing obligations, and 3) coordinated with banks to guarantee rollover of maturing debts. The effect, however, depends largely on fiscal system reform, which is expected to be laid out in the upcoming 4th plenary session.

This policy combination does have the undesired consequences of hurting the manufacturing sector and small businesses, which are also under pressure from unfavorable external shocks. Manufacturing fixed asset investment continues to slide and the unemployment rate is also climbing. This distress may ease gradually if external shocks wane through 2020 as expected. High-end manufacturing sub-sectors, including machinery, equipment and medicine manufacture, are now under the spotlight. Fixed asset investment in these sub-sectors, currently around 40% of total manufacturing investment, recovered from the previous trough. Policy tailwinds and more favorable financial conditions could help secure the positive outlook, though it still needs to be monitored how effective these factors will be at upholding manufacturing fixed asset investment and economic growth.

Figure 3 High End Manufacture Fixed Asset Investment

Exports stall even though CNY REER depreciated

The export sector stalled around flat after the outbreak of trade tension, but remains far from its previous low in 2016 with the help of REER depreciation. It is believed exporters are trying to front run tariffs and exports may see a sharp decline into 2020. The consequences are mainly in slowing manufacturing production and fixed asset investment, shifting supply chain, and currency depreciation pressure. PBoC has loosened the currency trading band to accommodate this pressure, and depreciation is being used as another form of monetary easing. Subdued fixed asset investment and the shift of supply chain can only be mitigated by the growth of higher end manufacturing subsectors.

Figure 4 China Export vs REER

CNY depreciation expectation remains contained, due to regulators curbing credit flowing into the asset market and curtailing capital outflows, as well as the Fed turning dovish alleviating the pressure. Though China's balance of payments implies CNY is close to equilibrium in the near term, exchange rates are included in the trade negotiation between Beijing and Washington, introducing further uncertainty to future developments.

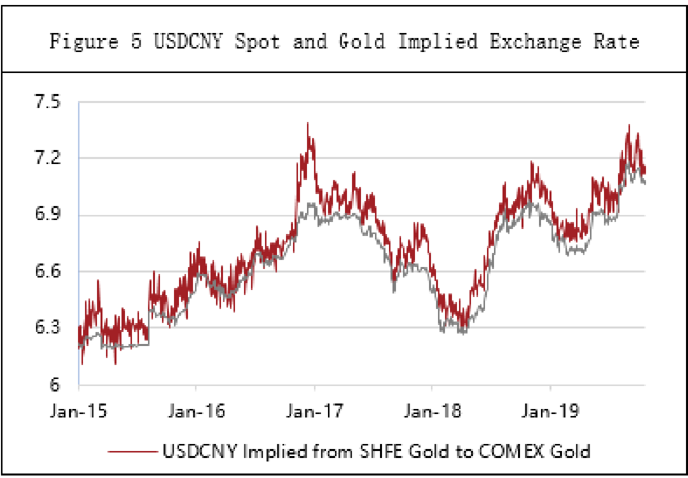


Figure 5 USDCNY Spot and Gold Implied Exchange Rate

Inflation climbs due to supply shortages and restricts monetary policy

Consumer inflation rose to policy target in Sep for the first time in 6 years, and is strongly expected to go higher subsequently, causing a dilemma for PBoC. Both consumer and producer inflation gauges show that inflationary pressure is muted in broad terms and is concentrated on the food component alone. African swine fever destroyed pork supply across China and pushed the price of pork and all meat higher as a result. Due to the nature of the fever and the extraordinary amount of pork consumption in China, the shortage may exist for a while and keep consumer inflation above policy target until at least 20Q1.

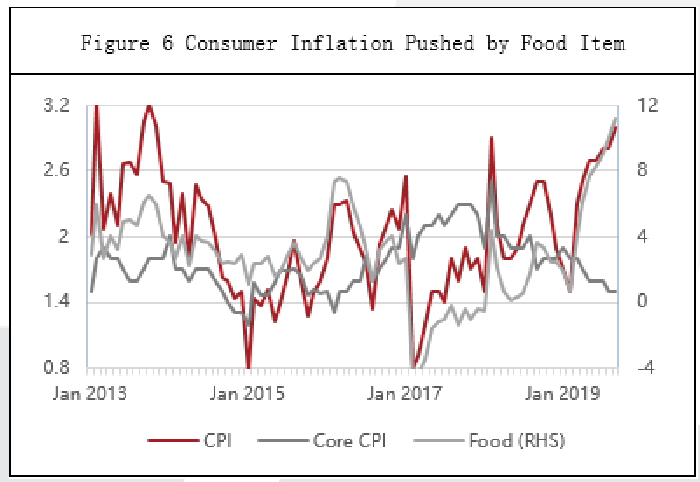
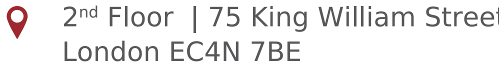


Figure 6 Consumer Inflation Pushed by Food Item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The inflation cannot be solved through monetary policy, but it surely ties PBoC's hands from stepping up accommodation. PBoC's open market operations, most noticeably reverse repo and MLF, remain unchanged even though the growth slowdown continues and the economic impact from trade disputes has materialized. The LPR rate remains the same in response, and rates are also trading gradually higher after the consumer inflation data. PBoC reduced accommodation from April and stepped up accommodation in September marked by a reserve requirement ratio cut. In our opinion, PBoC will withhold further accommodation in the next couple of months but, if inflation worries fade in 20Q2, monetary policy may turn to accommodative again.

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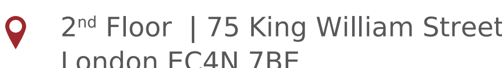
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