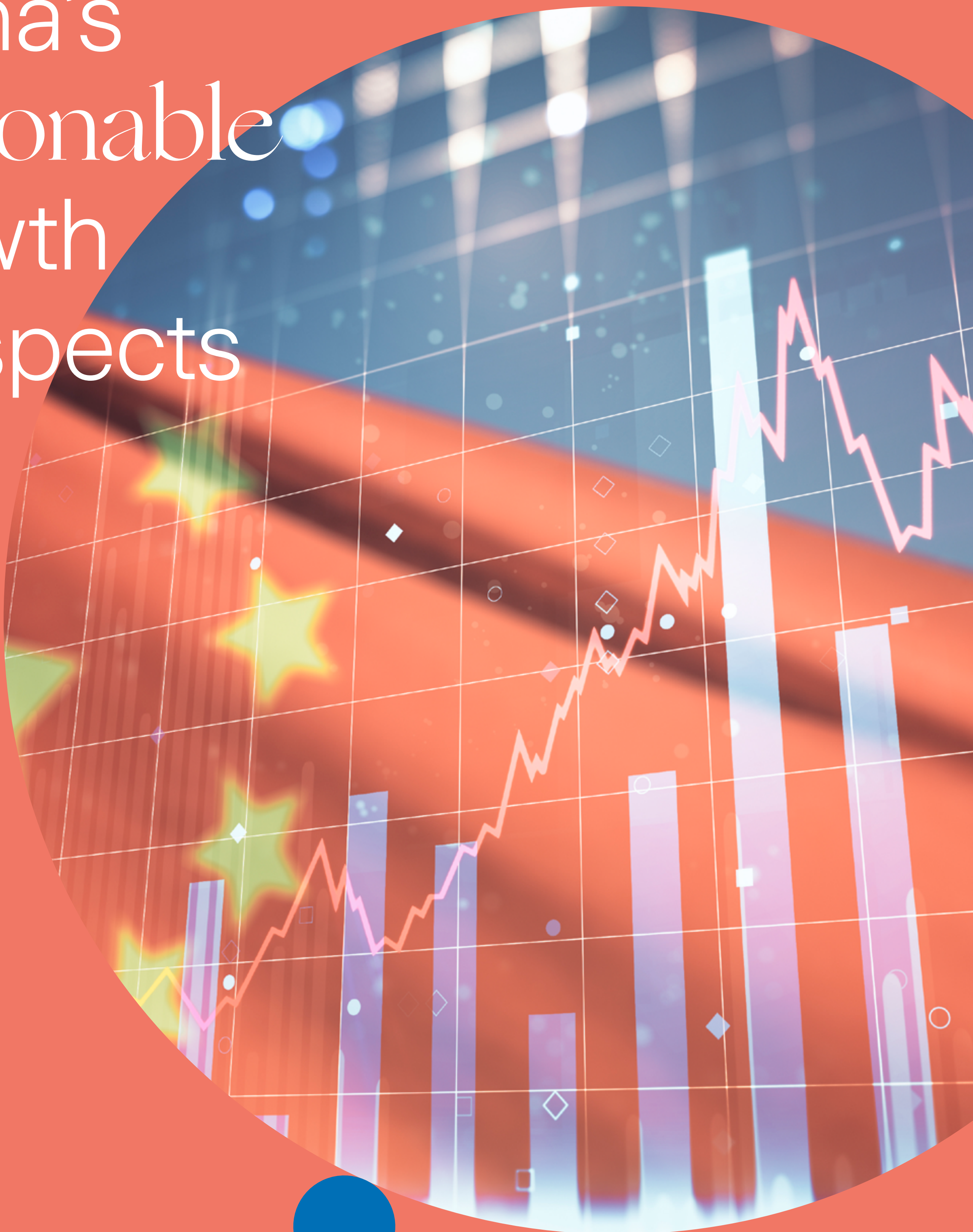
ZURICH

Topical Thoughts
August 2022

China's reasonable growth prospects

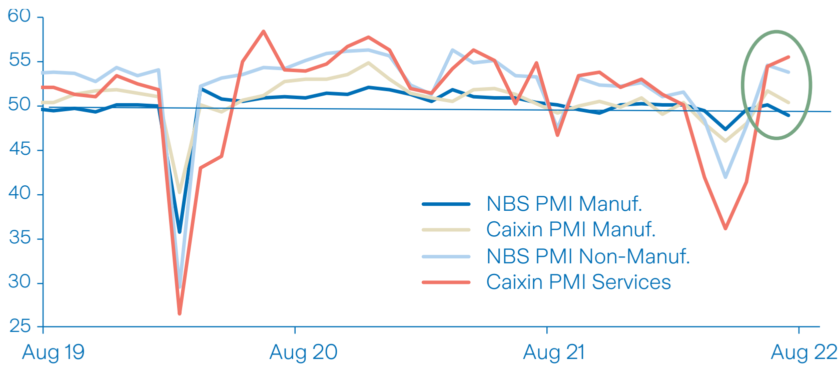


Slowing exports, a still vulnerable property market and Omicron will be headwinds in the second half of the year, while infrastructure investments are a bright spot.

Amid global fears about inflation and recession, China is marching to the beat of its own drum. To gain further insights into the general state of China's economy we need to dig a bit deeper into the latest facts and figures released by the National Bureau of Statistics of China.

China's economic development was favourable until the Omicron wave disrupted the positive trend. Following solid growth of 5.7% on a sequential basis in annualised terms both in Q4 last year and Q1 this year, the economy contracted by 10.8% in Q2, mainly impacted by broad-based lockdown measures and subsequent supply chain issues. In year-on-year terms, economic growth barely registered a positive number, up a meagre 0.4% YoY, the second worst since quarterly GDP statistics have been released. Only in Q1 2020, following the outbreak of Covid, was a contraction reported.

PMIs recover following a slump in Q1, but the Manufacturing PMI is back below 50



Source: NBS, Caixin, Bloomberg

Front cover image
source: iStock

Defining the growth target in a centrally planned economy – and its pitfalls

The current soft growth rate certainly pales in comparison to the double-digit growth rates recorded earlier this century and calls into question the official growth target of 'about 5½%' for this year. Interestingly, the government's growth target has never been undercut in modern history. For 2020, no growth target was set due to the outbreak of Covid. The 2021 growth target was exceeded by a huge degree, which, however, had purely statistical reasons due to the 'overhang' effect from Q4 2020.

This begs the question whether the 'about 5½%' official growth target for 2022 needs to be achieved by whatever means necessary, especially considering the important 20th Communist Party Congress coming up this autumn. The official growth target is usually set at the annual Economic Work Conference in November each year, only to be officially announced during the Economic Work Report at the annual National People's Congress in spring the following year.

When the 'about 5½%' growth target decision for 2022 was made in autumn 2021, the government could not have foreseen the outbreak of the highly infectious Omicron strain. The record high mortality among unvaccinated elderly in Hong Kong was a warning sign that pushed China's government to initiate mass testing and enact severe lockdown measures, which affected about one third of the population, including major cities like Shanghai and Beijing. Consequently, both demand and supply collapsed in Q2.

Services consumption and the property market suffered a blow in Q2

Sources: NBS, PBoC, Nomura, Barclays, Bloomberg

We believe there are only two options to achieve the 'about 5½%' target this year. Either growth needs to accelerate significantly in H2 by about 8½% YoY, which seems highly unlikely, or statistics need to be 'massaged'. As nominal growth statistics seem to be calculated and released in a plausible manner, that would only leave the GDP deflator to help lift real growth statistics. Though this approach may have been taken in the past to smooth quarterly growth rates, we believe it will not be an option this year, particularly considering the nationwide campaign urging regional and local authorities not to manipulate statistics purely to show that they have achieved predefined growth targets.

Premier Li takes a realistic approach

We note that Premier Li Keqiang clarified at the 'Special Virtual Dialogue' with global business leaders, hosted by the World Economic Forum (WEF) in Beijing on July 19, that the government '…will not introduce supersize stimulus measures, issue excessive money supply, or sacrifice future interests to go after an excessively high growth speed. We will take a realistic approach and do the best within our means to strive for fairly good results in economic development for the whole year. We responded with resolute and swift action. We put stable growth higher on the agenda, held our ground against a massive stimulus, worked to front-load the policies set, and introduced and implemented a policy package of 33 measures for stabilizing the economy.'

The Politburo wants to keep growth within a reasonable range

A few days later, Premier Li's statement was reflected at the Politburo meeting on July 28. Though the growth target has not been abandoned officially, reading between the lines, we believe that the focus has shifted towards achieving employment and inflation targets instead of the growth target. The communique clearly stated that their focus was, '…to keep economic growth within a reasonable range.' Economically important provinces should take the lead, and some provinces with good conditions should try to achieve this year's social and economic development targets. This statement makes us feel comfortable with our 4.3% real GDP growth forecast for this year, which is roughly in line with the average consensus forecast, though we note that several respectable investment brokers are forecasting even lower GDP growth in the 3%-4% range, in line with the latest IMF forecast of 3.3%. Only one Chinese SOE bank is sticking to its 5.5% growth target. We are also sceptical about earlier rumours that the Politburo has set a 2022 growth target that needs to surpass that of the US.

source: iStock

source: iStock

Slowing services were a drag on Q2 GDP growth

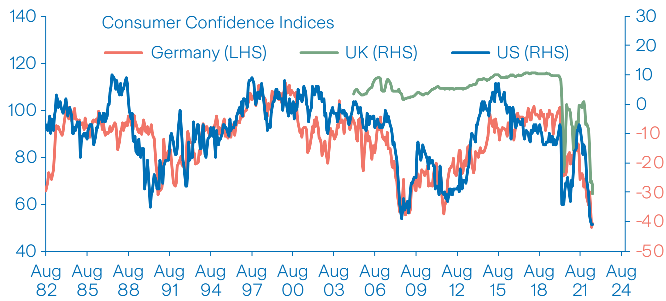
Digging a bit deeper into China's recent economic performance, we note that the service sector was the main drag in Q2, while manufacturing industries held up better. Indeed, services sector GDP even contracted in Q2, while manufacturing sector GDP performed better. Within the services sector, retail sales took a beating during the intense lockdowns in major cities, with both auto and jewellery sales collapsing. Retail sales were down 4.6% YoY in Q2. Of course, online sales held up better, but slowed as well. As quarantine restrictions loosened in June, auto, jewellery, cosmetics, and apparel sales as well as services consumption recovered quickly, but were not able to compensate for the bad performance in April and May.

Weak consumer confidence in Western countries will exert pressure on China's exports and production

Turning to the industrial sector, production recovered to 3.9% YoY in June from 0.7% in May. This was partly impacted by the 'closed loop' system within overall lockdowns, as workers were able to keep production running while staying within the factories overnight instead of returning to their homes. Solid new export orders underpinned production, even though supply chain disruptions negatively impacted deliveries.

However, we assume export orders will weaken in the second half of the year and into 2023 as demand from Western countries is likely to slow amid intensifying recession fears. This is already visible in falling consumer confidence in Europe, where the GfK Consumer Confidence Index fell to record lows in August, below -40 in the UK and -30 in Germany, compared to pre-Covid levels of around +10, and in the US, with the University of Michigan Consumer Survey hovering at a record low of around 50, far below the above 100 level in early 2020. Consumer confidence has also significantly deteriorated to multi-year lows in Japan and Australia. North America, Europe, Japan, and Australia make up roughly half of China's total exports ex Hong Kong. Tumbling consumer confidence is likely to be reflected in weaker demand for Chinese products. Consequently, China's export orders and industrial production are likely to suffer a lag, despite the record high trade surplus and stronger than expected export growth registered in July. We also note that imports of processing products, which are used for re-exports, fell in July, hinting at slowing export orders.

Consumer confidence at record lows in the US and Europe



Sources: GfK, University of Michigan

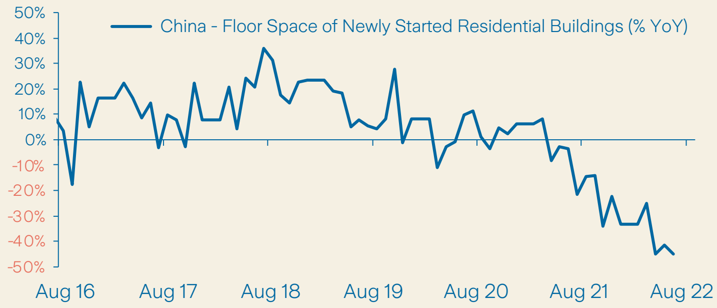
Manufacturing and infrastructure investments are shining, while property investments keep tumbling

Fixed asset investments reveal a mixed picture. While improving by 5.8% YoY in June from 4.7% in May, we need to analyse the main segments to find divergent trends. Manufacturing investments were solid, up nearly 10% YoY, driven by segments such as electrical machinery and equipment as well as chemical products, again benefitting from strong overseas demand.

Infrastructure investments were up 12%, driven by the government's decision to use infrastructure as the main tool to boost growth for the rest of the year. We note that local government bond issuance surged in June and believe issuance will remain strong in H2 as allocations will likely be moved forward from H1 2023 to H2 2022. The Ministry of Finance appears to be considering allowing local governments to front-load RMB 1.5tn of next year's special bond quota to H2 this year, the first-time special bond issuance having been fast-tracked. This should help to finance more infrastructure projects in H2 in a difficult financial environment as local government finances are stretched because income from land sales has tumbled.

Within fixed asset investments, property investments remain the weak link, with the downturn even accelerating to -9.4% YoY in June. New housing starts tumbled by 45%, while floor space under construction contracted by 48%. For a deeper analysis of the current state of the property sector please refer to our latest Topical Thoughts paper "Will China's mortgage crisis be contained?", which specifically highlights the impact of China's mortgage crisis on the economy.

Housing construction remains in the doldrums

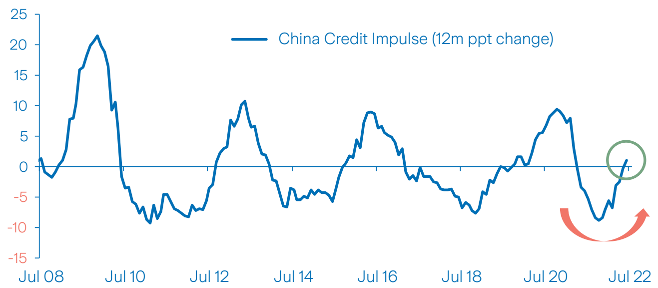


Source: Bloomberg Intelligence

Both fiscal and monetary policy will remain accommodative

While fiscal policy will do the heavy lifting to support growth, we believe monetary policy will remain accommodative. Currently, quantitative measures trump policy rate cuts. While the loan prime rate (LPR) may remain stable, we foresee more RRR cuts and liquidity injections through MLFs (medium-term lending facilities) and OMOs (open market operations) instead of policy rate cuts. We highlight that the credit impulse has not only bottomed out but has already moved into positive territory.

Credit impulse is turning into positive territory



Source: Bloomberg

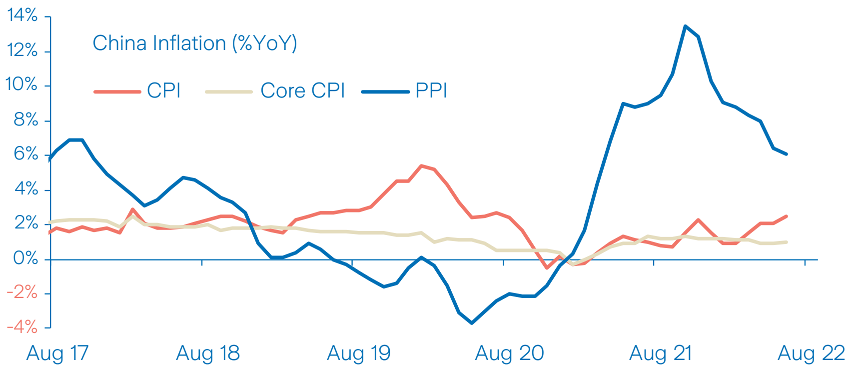
Note: Credit impulse measures the acceleration of credit versus GDP growth

Inflation is not an issue currently

Contrary to most countries, inflation is currently not a major concern in China. Consumer price inflation has been creeping higher from -0.5% in autumn 2020 to 2.5% recently, mainly because the pork supply cycle has been turning again. However, CPI inflation remains below the government's target of 3% for this year, a target that we believe will only be reached later this year. More importantly, core inflation as well as services inflation remain low at around 1% YoY.

Meanwhile, producer price inflation has eased from 13.5% YoY in autumn last year to 6.1%, mainly due to a favourable base effect. Easing supply chain disruptions should help to bring down producer price inflation even further in H2. We also want to highlight that the Input Prices PMI fell to a ten-year low of 40.4 in July, down from its twelve-year high of 72.8 about a year ago, based on statistics provided by the China Federation of Logistics and Purchasing.

Inflation is not a concern



Source: NBS

Targeting 'reasonable' growth is prudent

Summarising and classifying our outlook, we highlight that China is speeding up its infrastructure investments in the second half of the year, supported by an accommodative monetary policy. However, China is not delving into massive stimulus as seen after the Lehman crisis in 2008, even though it is experiencing strong headwinds from the property market downturn, rising Omicron infections and weaker global demand. We would characterise the approach to achieve 'reasonable' growth as prudent.

Disclaimer and cautionary statement

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