China macro update

China's economy: Green shoots or red herrings?

May 2019

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Key takeaways:

- Defying global concerns around its growth, China's first quarter GDP and March activity data provided further evidence that policy easing effects are coming through and growth is bottoming out, helped partly by an export recovery
- However, the growth rebound is nascent, and uncertainty around its sustainability and strength remains, particularly over a turnaround in underlying demand conditions
- Policy measures already in the pipeline are still coming through, though new stimulus may not be necessary at the moment
- We think a trade deal is still possible, though the timing and the terms have become more uncertain following US President Trump's threat to increase tariffs on USD200bn worth of Chinese goods from 10% to 25% on May 10th and levy a new 25% tariff on all remaining imports from China
- We do not foresee any major shifts in fiscal, monetary, regulatory or housing policies in the near term, although policy stance could shift toward neutral if/when sustained growth stability is confirmed and a trade deal between China and the US is signed

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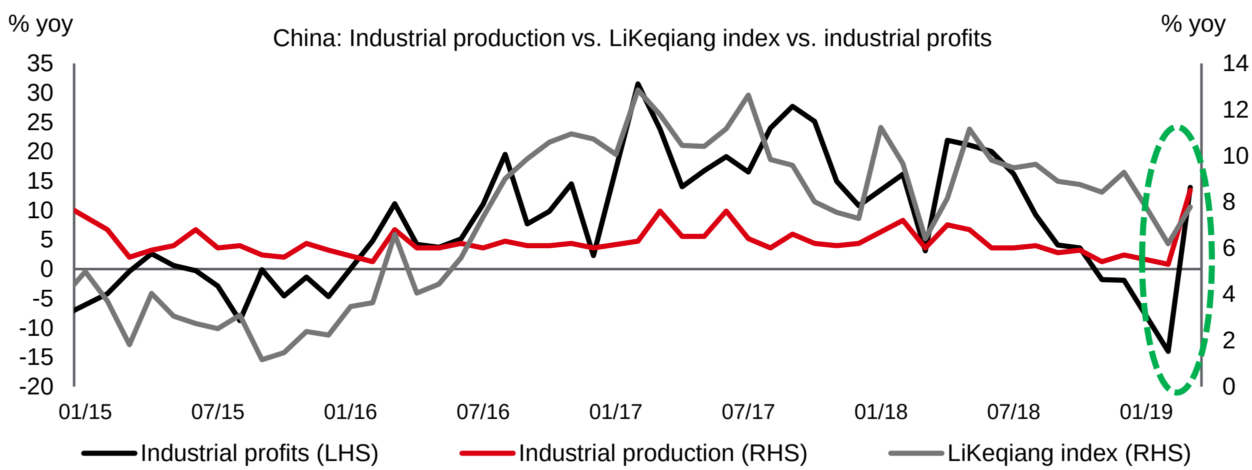
Good news first

Defying global concerns around growth, China's first quarter (Q1) GDP and March activity data provided further evidence that policy easing effects are coming through and growth is bottoming out, helped partly by an export recovery. China's real GDP grew 6.4% year-on-year (yoy), the same pace as in the final quarter of 2018. Moreover, March indicators rebounded remarkably from the January-February levels and the April numbers that have trickled in so far seem to point to more green shoots in the economy. Here's a round-up of the headline numbers:

- A strong pickup in credit growth, front-loading of fiscal stimulus in the form of an increase in local government bond issuance (+541% yoy in Q1) and tax cuts support domestic demand, particularly benefiting the credit-sensitive part of the economy (e.g., property and infrastructure)
- Newly-increased total social financing in Q1 jumped 40% yoy, led by robust bank loan growth, a pickup in both corporate and special bond issuance and bottoming out of off-balance sheet credits
- Local government bond issuance boosted government spending and investment in Q1. Faster project approvals, improved local government financing vehicles (LGFV) financing and normalization of public-private-partnership (PPP) project implementation also support infrastructure
- Property sales improved, home prices recovered modestly and real estate investment picked up in Q1, amid city-level policy fine-tuning, improved funding conditions for developers, a more favorable mortgage policy and better market sentiment. Contract sales by major listed developers suggested that the market recovery broadened in April
- Real retail sales growth was still tepid with auto remaining a drag. However, the yoy decline in auto sales has narrowed as firms have lowered prices to boost sales. Personal income tax cuts have helped raise disposable income and the labor market remains resilient. The government is mulling more measures to promote durable goods consumption, particularly consumption upgrades of home appliances, consumer electronics and autos
- On the external front, the rebound in March export growth, while partly due to the holiday distortion from the Lunar New Year earlier this year, suggested that the paybacks from previous exports front-loading in anticipation of higher tariffs may be largely behind us now. Some near-term stabilization in global growth, particularly in capital expenditure (capex) and technology demand, following a soft patch in Q1 could be supportive
- Progress is being made on US-China trade negotiations. We think a trade deal is still possible, though the timing and the terms have become more uncertain following US President Trump's threat to increase tariffs on USD200bn worth of Chinese goods from 10% to 25% on 10 May and levy a new 25% tariff on all remaining imports from China
- April Purchasing Managers Index (PMI) eased after a notable rise in March, but remained in expansionary territory. Trade-related indices and PMI for small enterprises continued to improve albeit still in contraction territory, while the new-order-to-inventory ratio rose further

Industrial output and profits rebounded in March



Source: Bloomberg, CEIC, HSBC Global Asset Management, as of March 31, 2019.

… but uncertainty on growth sustainability remains

However, the growth rebound is nascent, and uncertainty around its sustainability and strength remain, particularly over a turnaround in underlying demand conditions. The swing in Q1 data partly reflected distortions from the Lunar New Year seasonality and the April 1st value-added tax (VAT) cut, which affected production and purchasing decisions. For example, producers accelerated the purchase of input goods before April 1st so the VAT deductible would be calculated based on the old, higher VAT rate, while importers may be inclined to postpone custom clearing of imports to pay the lower VAT on imported goods. As hinted by PMIs, some payback or normalization in industrial activity in April from March's post-holiday rebound and VAT-related distortions is expected.

Manufacturing investment has been weak, though an expected bottoming out in industrial profits and demand stabilization should help. Property sales in lower-tier cities may face challenges from a decline in the official target of shantytown renovation and related subsidies, though higher-tier cities could see solid sales growth. The target for 2019 is guided to be 2.85 million units, sharply lower than in 2018 (target: 5.8 million units; actual: 6.26 million units). Meanwhile, a US-China trade deal is not done yet, while global growth and trade activity still face significant uncertainties. US President Trump's tariff threat suggests that US-China negotiations might have reached a sticking point, particularly regarding the enforcement mechanism and the rollback of existing tariffs**.** It reintroduces the risk of further tariff escalation and raises the uncertainty over US-China trade policies. The recent recovery in real activities has been supported by policy stimulus, and there is not yet clear evidence of a self-sustaining recovery.

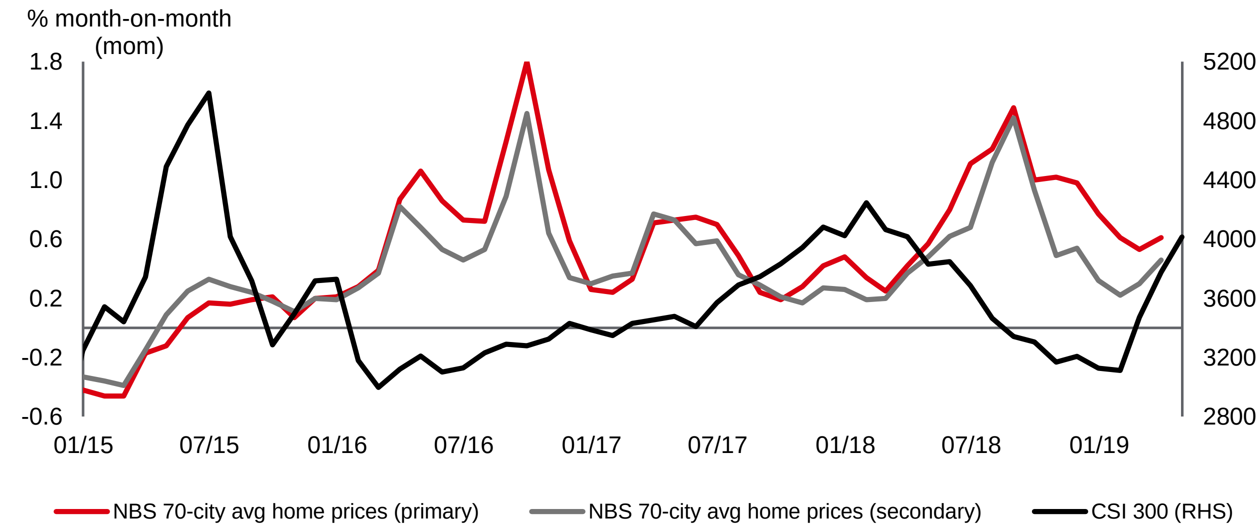
To stimulate or not to stimulate

Given the resilience of the economy, strong credit growth and concerns about asset price bubble risks in the equity market and property markets in some big cities, it is not surprising to see the government turning more cautious around further stimulus and wanting to tackle some of the structural issues confronting the economy. After all, further stimulus could run the risk of diminishing incremental effect on real activities, further deterioration in debt and fiscal sustainability and reflating asset price inflation.

Since the beginning of this year, China's CSI 300, a capitalization-weighted index that replicates the performance of the top 300 stocks in the Shanghai and Shenzen stock exchanges, has soared 30% as of the end of April. Margin trading debt has rapidly built up since February, however, the outstanding balance is still well below its 2015 peak. The equity rally has been driven more by valuation expansion amid liquidity easing and a rebound in investor sentiment than fundamentals with earnings downgrades though market consensus for this year's earnings remains solid. We think the authorities are keen to avoid a repetition of the 2015 equity market boom-and-burst scenario. Policymakers have also re-emphasized property regulation to contain market overheating risks in light of the recent rebound in home prices.

Property and stock markets have rebounded in 2019

Concerns over asset price bubbles have made authorities more cautious around further stimulus



Source: Bloomberg, CEIC, HSBC Global Asset Management, as of April 30, 2019.

… yet concerns over tightening may be exaggerated

However, concerns about policy tightening may be overdone. We believe the government will likely want confirmation of a sustained recovery before it considers a policy exit. It has reiterated a proactive fiscal policy, though fiscal spending is expected to slow into the second half of 2019 given the front-loading we have seen. We think policymakers are likely taking a "wait-and-see" and data-dependent approach now. Policy measures already in the pipeline are still coming through, though new stimulus may not be necessary at the moment. There will still be some lagged passthrough effects from previous easing to support the economy. Moreover, any escalation in trade tensions with the US could prompt further policy easing to aid domestic demand.

The focus of monetary policy has shifted from broad-based liquidity injection to lower interbank rates and funding costs for financial institutions toward targeted support to desired areas (e.g., private enterprises/small- to medium-sized enterprises (SMEs) and consumption upgrades). The aim is to improve policy transmission to reduce the risk premium for SMEs and reallocate resources to more efficient private sectors. Echoing the call of the State Council to build a new policy framework to establish a lower reserve requirement ratio (RRR) for small- and medium-sized banks to boost lending to SMEs and private enterprises, the People's Bank of China (PBoC) announced the lowering of RRR to 8% on May 6th for small banks serving county-level markets, effective May 15th. Tax cuts and a reduction in the social security contribution rate also help support private-sector spending. Policy stimulus focusing on the private sectors coupled with structural reforms could generate larger, more broad-based and sustainable benefits.

Higher crude oil and food/pork prices pose upside risk to the headline Consumer Price Index (CPI) inflation, but inflation mainly driven by supply-side cost push (e.g., a hog price upcycle amplified by the African Swine Fever) may have little policy implications for now. The VAT cut could also partly fed through to lower retail prices going forward. CPI inflation will unlikely become an imminent constraint for monetary policy or force the PBoC to tighten in our view, particularly as core inflation has been stable.

Meanwhile, the "tightening" of property policies announced by several cities in April is merely a reiteration of the official principle that "property is for living and not for speculation" and/or the tightening magnitude was rather mild. The recovery in property sales only began recently, its sustainability remains uncertain, and the risk of overheating is only confined to some cities. Property policies will likely remain differentiated based on local market conditions. Any tightening would be restricted to those cities which saw a relatively heated market, while policies could potentially be eased in lower-tier cities facing weaker demand.

Expecting a modest cyclical recovery; structural reforms are key

Overall, we expect the ongoing cyclical recovery to continue in the coming months as the effects of macro policy support continue to feed through, despite lingering uncertainties on the global growth outlook, US trade policies and strength in underlying domestic demand. An improvement in March-April manufacturing PMI readings echoed the rebound in PBoC's Q1 survey of bankers and entrepreneurs, sending encouraging signs for the near-term outlook. However, an anticipated cyclical recovery will likely be a modest one in the context of the supply-side constraint of the economy and structural headwinds. US-China trade relations are still a key factor for private sector sentiments and the export outlook. President Trump's tariff threat and the resulting knee-jerk market reaction with a sharp decline in Chinese equities and the RMB could serve as a reminder that the market might have been too sanguine about the potential terms of a trade deal and medium-term US-China trade relations.

We do not foresee any major shifts in fiscal, monetary, regulatory or housing policies in the near term, although policy stance could shift toward neutral if/when sustained growth stability is confirmed and a trade deal between China and the US is signed. The key to a sustainable recovery lies in market-oriented structural reforms. Reforms aimed at improving policy transmission and credit risk pricing, corporate capital market financing and leveling the playing field for private enterprises and foreign investors would help reallocate resources to more efficient sectors and sustain longer-term growth prospects and investment returns in Chinese asset markets.

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