China Watch

# PROFIT CRASH

China Team

## Markets

- Infrastructure investment will lead government stimulus efforts
- But a run of negative economic figures is likely before such fiscal stimulus kicks in
- After a strong performance in Q1/19, equities appear fully valued

## Economics

- PPI decline will weigh on profits and investment
- 2019 will be another record year for corporate defaults
- Nominal GDP growth below 7% will trigger a strong policy response

## Politics

- Structural reforms will be resisted
- Communist Party stresses political security
- Anti-corruption campaign takes on new dimension

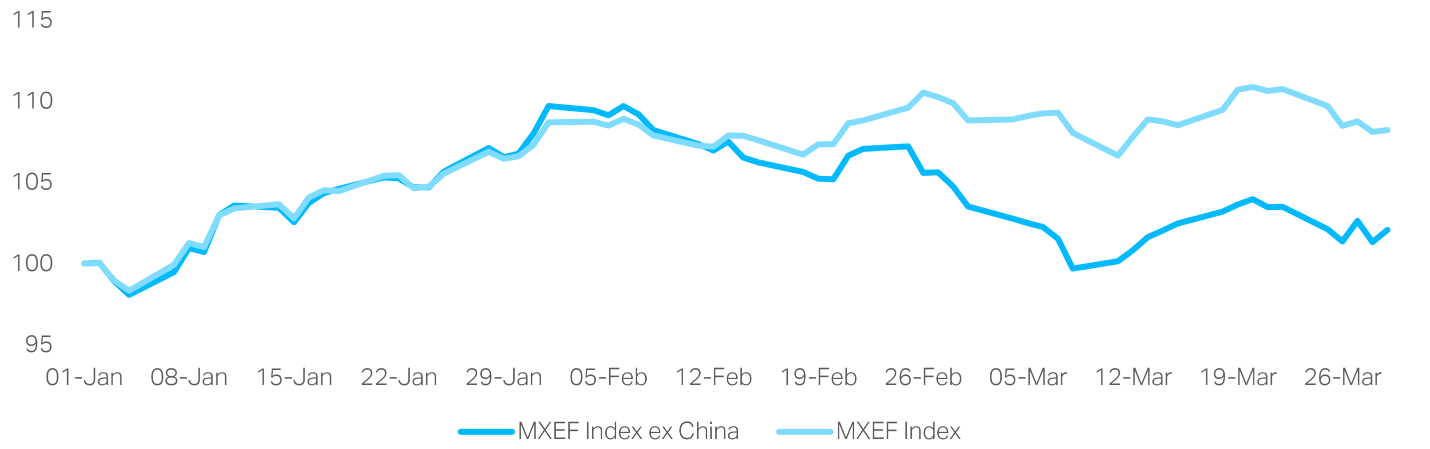
# Markets: Near-term economic outlook remains mixed

- **Infrastructure investment will lead government stimulus efforts**
- **But a run of negative economic figures is likely before such fiscal stimulus kicks in**
- **After a strong performance in Q1/19, equities appear fully valued**

**The National People's Congress last month brought few surprises**. The annual fiscal deficit target was raised, but only from 2.6% to 2.8% of GDP and not to the 3%-plus that we had expected. At the same time, however, it is clear that fiscal, rather than monetary, stimulus will lead government efforts to boost growth. Fiscal stimulus measures such as cuts in taxes and various fees have been approved, but decentralized spending will take the lead via more aggressive targets for local government bond issuance and measures to speed up their being met. To boost infrastructure spending, the yearly quota for special local government bonds has risen from Rmb1.35trn last year to Rmb2.15trn and instructions have been given to accelerate the issuance of these project-related bonds. Preliminary figures show that an estimated 38% of the combined Rmb3.1trn annual local government bond quota (including the Rmb930bn general borrowing quota) had been met by the end of March. And local governments were told to complete their borrowing programmes by September, highlighting policymakers' concerns about jumpstarting growth. This confirms our earlier judgment that state-led infrastructure spending will be the primary driver of FAI this year.

**While significant fiscal stimulus measures are in the pipeline, the next two to three months will see a run of negative figures before new infrastructure spending kicks in**. Widespread optimism about signs of an economic rebound are misplaced, in our view. PMI data released last Sunday jumped above 50, but this reading does not indicate that the bottom of the economic cycle has been passed: March PMIs have rebounded annually for the past 15 years as they follow widespread factory shutdowns during the earlier New Year holidays. While the data do point to some improvements in domestic demand and production, they also highlight continuing weakness in export orders and employment.

**MSCI EM Indices, 31 December 2018=100**




Source: Bloomberg.

**Of more importance are the strengthening deflationary pressures.** Industrial profits in January-February declined 14%, the sharpest drop since 2008-09; the reasons included slower domestic growth, the falloff in exports following last year's trade war-related surge and the collapse of producer prices from nearly 5% yoy last June to almost zero currently. As industrial profits and the PPI are closely correlated, we do not expect a turnaround in profits anytime soon because a negative March reading for PPI is likely later this month. Declining profitability, in turn, will have a knock-on effect on manufacturing investment. At the same time, we doubt that the property sector can provide a sustained support to a recovery later this year, despite the unexpected 11.6% growth of real estate investment in January-February: growth in housing starts collapsed from 23.4% yoy in December to 4.3% and sales fell 3.2% in the same period.

**In our view, the near-term outlook for the economy remains mixed.** We expect a strong surge in infrastructure investment later this year, albeit amid weak trends in the manufacturing and property sectors. Such a one-legged stimulus is a pale shadow of past stimulus cycles. And what is new is that the recovery will be constrained by the spread of producer price deflation, which will drive down industrial activity and fuel consumer uncertainty, thus capping any rebound in retail.

**These considerations lead us to conclude that the equity market is likely to correct and consolidate until stronger GDP growth emerges in H2/19.** An additional reason for our caution is that the outperformance of Chinese equities so far this year stands in stark contrast with broader EM equity market trends. Above we chart the MSCI EM Index (MXEF, in US dollar terms), which includes Chinese equities, and the same index without Chinese equities. Both indices rose strongly during January but then diverged: the MXEF Index hit a high on 20 March, up 10.9% ytd and then eased to end the quarter up 8.2%. By contrast, the ex-China index reveals a marked divergence in performance: from a peak of nearly 10% on 6 February, this adjusted measure recorded overall growth for the quarter of just 2.1%, i.e. EM equities other than China have fallen 7% since their peak in early February. We think Chinese equities are fully valued relative to current and historical forward P/Es; we see no reason to change this view.

## Our outlook in brief

| | Latest | Next 12 months |
|---|---|---|
| Inflation yoy% | 1.5 | Rising deflationary pressure to keep CPI around 2% in 2019 |
| GDP growth% | 6.4 | Growth weakening before recovery in H2; 6.2% on average |

## Macro views

| | |
|---|---|
| Politics | A limited US-China trade deal appears likely but the timing is uncertain |
| Economics | Growth weaker in H1/19; recovery is unlikely until H2/19 |

## Markets

| | |
|---|---|
| Equities | A correction is likely following recent strength |
| Currency | We expect stability in the RMB over the next six months |
| Local rates | Further interest rate declines appear unlikely |

# Economics: The Party, profits and PPI

- **PPI decline will weigh on profits and investment**
- **2019 will be another record year for corporate defaults**
- **Nominal GDP growth below 7% will trigger a strong policy response**

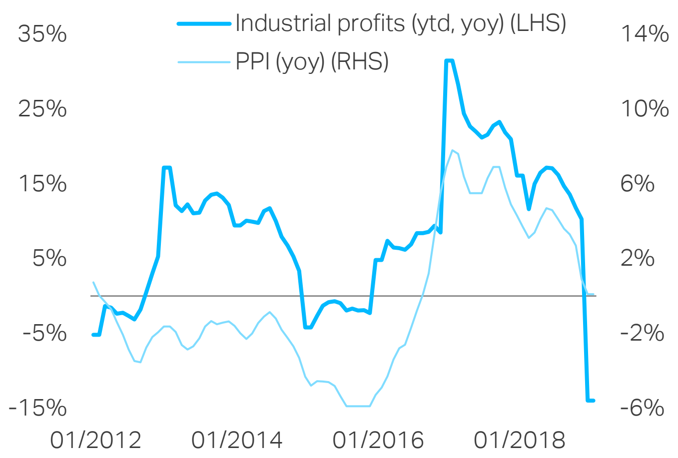
Producer prices are a strong leading indicator of industrial activity in China. We expect outright PPI deflation in Q2/19 to weigh heavily on operating rates, profits and investment. Falling prices will hurt nominal growth and increase private-sector defaults, and as such a sustained deflationary period (PPI at -2% or below for more than three months) will trigger a strong policy response. This is not our base case; we expect fiscal stimulus to foster an infrastructure-led PPI recovery in H2/19, supported by measured monetary and credit easing.

**Supply side hangover remains.** The 2012 deflation cycle, which bottomed in 2015 at –5.9% was a manifestation of chronic oversupply in upstream industrial sectors. Beijing engineered inflation via aggressive government-mandated capacity cuts and seasonal pollution-related production restrictions. A contraction in supply in conjunction with strong monetary and fiscal stimulus spurring demand supported the PPI recovery. In addition, base effects after five years of deflation were a key factor driving the rebound, accounting for 70% of PPI growth in 2017.

**H2/18 saw falling demand and a reversal in pollution, capacity and base effects**. As the marginal impact of supply-side reform and base effects fade, we are entering the second leg of China deflation. On the pollution front, Beijing did not impose significant winter production restrictions last year. Producers and consumers had built-up inventory levels in anticipation of mandatory shutdowns during the winter heating season. But amid already slowing activity and demand, Beijing dialled back pollution restrictions, allowing inventory levels to depress prices.

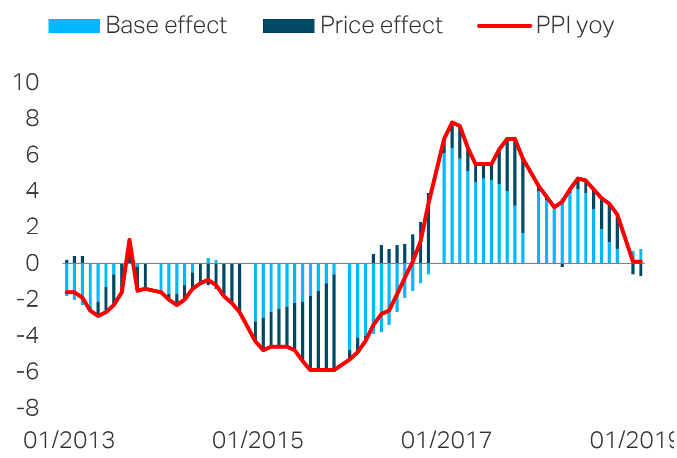
The threat of deflation has seen central authorities strengthen existing pollution restrictions in key steel producing regions. The scope of the production restrictions is currently marginal and will not impact headline PPI. Of greater importance is the recovery in global commodity prices. That China has not already entered deflation this year is largely due to gains in iron and oil prices. As the impact of the Brazil mining disaster lessens, domestic headwinds to PPI will dominate.

### PPI and profits falling (%, yoy)




Sources: CEIC, TS Lombard.

### PPI: Price and base effects (% point)




Sources: CEIC, TS Lombard.

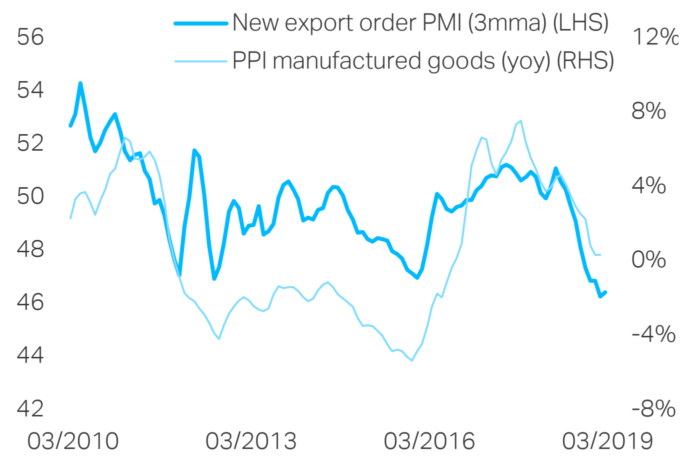
**Trade war and falling domestic and global demand have added pressure on mid- and downstream prices.** Last September, we noted a collapse in Chinese export orders for delivery after the January 2019 tariff deadline. Concurrently, US firms frontloaded import demand in H2/18. This caused a build-up in inventories on either side of the Pacific. As domestic retail sales remain tepid and US firms struggle to clear frontloaded inventories, disinflation is beginning to manifest in mid- and downstream PPI (see left-hand-side chart below). March PMI releases point to continued pressure on Chinese export orders. As we noted in January, Chinese exporters are reorienting production and sales to non-US markets, putting pressure on regional export prices. Even excluding China and the US, world inventories are high in general and demand is softening, further impacting prices and exports.

**The latest industrial profit data reflect the broad disinflation trend.** Of the 41 industries tracked by the NBS, profits fell in 20. The biggest profit declines were in the upstream industrial sectors which have seen the largest price pressure. Mining (-13%), chemicals (-27%), steel (-42%) and fuels (-70%) led the fall. The NBS calculates that if upstream sectors and autos (see below) were excluded from profit data, industrial enterprises recorded a 0.2% yoy increase in profits. We are not expecting a recovery in industrial commodity prices until H2/19. Since upstream sectors account for 30% of total profits, moderating commodity prices will weigh on headline industrial profits through H1/19.

**Downstream, auto makers were the big loser with profits falling 42% yoy.** This is largely due to the expiration of past government tax cuts and the contraction in consumer credit. A turn in the global tech cycle and the aforementioned inventory build-up hurt export orientated manufacturing. Profits for computer and communication and other electronic equipment industries, which account for nearly half of total industrial sales categorized as exports, fell by 21.6 %. We expect softening global activity and declining pricing power to continue to weigh on the sector's performance. Positive profit growth in special and general equipment manufacturing – at 14% and 0.8%, respectively – is a bright spot that offers some indication of infrastructure spending beginning to impact the real economy.

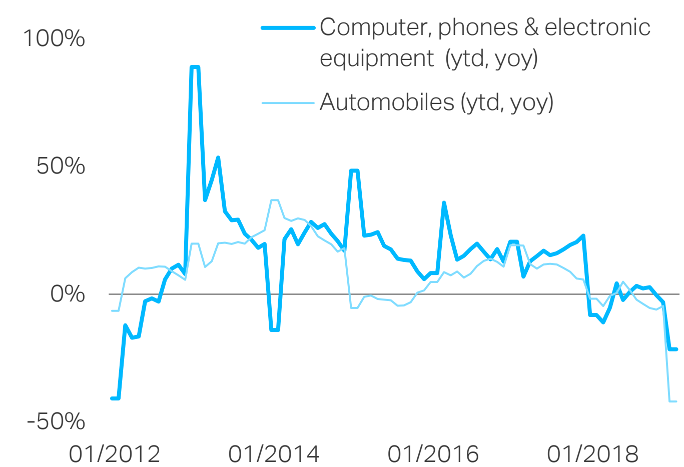
**PPI deflation was also reflected in profit performance by company ownership.** SOEs, which dominate the industrial economy, registered a post-GFC record profit decline of -24% yoy. Private firms had the best relative performance: profits fell by *only* 5.8%. Joint stock and foreign enterprises declined 14.5% and 13.5% yoy, respectively.

## Demand weighs on downstream PPI




Sources: CEIC, TS Lombard.

## Tech and auto cycle hit profits




Sources: CEIC, TS Lombard.

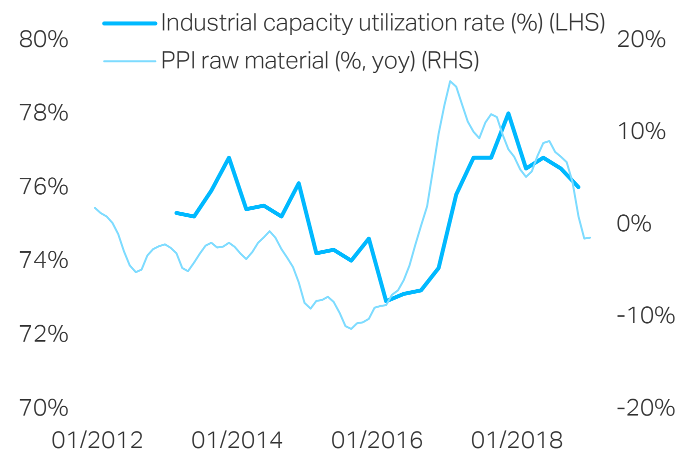
**Corporate balance sheet and liquidity measures deteriorated over the first two months of the year too.** Net accounts receivable grew at 12% yoy, the fastest pace in five years, compared with a rise in sales of 3%, pointing to funding difficulties across the supply chain. Gross margins, calculated as total profit over revenue, declined to 4.79%. Meanwhile, spending on interest rate costs rose by 6% yoy.

**Falling profits and prices are already impacting activity.** Manufacturing investment grew strongly through 2017 and 2018 on the back of profit growth and expectations of rising prices and demand. As PPI falls and drags down profits with it, we expect manufacturing FAI growth to remain in single digits. As a whole. manufacturing profits declined 14% yoy in January-February, while FAI slowed to 5.9% yoy, down from 9.5% in December. We expect utilization rates to fall in H1/19 below their long-run average of 75% (see left-hand-side chart below). Tax cuts and the reduction in mandatory social security contributions will provide support for manufacturing firms, particularly those with labour-intensive production processes. However, increasingly cash constrained firms will likely use tax relief for operations and servicing debt rather than for new investment. Infrastructure will be the sole investment driver in 2019.

**PPI is a key debt metric and therefore a leading indicator of credit stimulus.** As profits fall and asset quality worsens, firms' ability to service existing debt deteriorates. Government concern about corporate debt repayment will resurface when nominal GDP growth falls below 8%. Corporate debt defaults will accelerate when that indicator falls below 7%. We believe 7% nominal corporate revenue growth will not be enough to cover nominal interest-rate payments so that outstanding corporate debt can be rolled over. We expect nominal GDP growth to decelerate further to ~8% owing to PPI deflation in H1/19. The 7% level will not be breached, meaning that credit support will remain modest only.

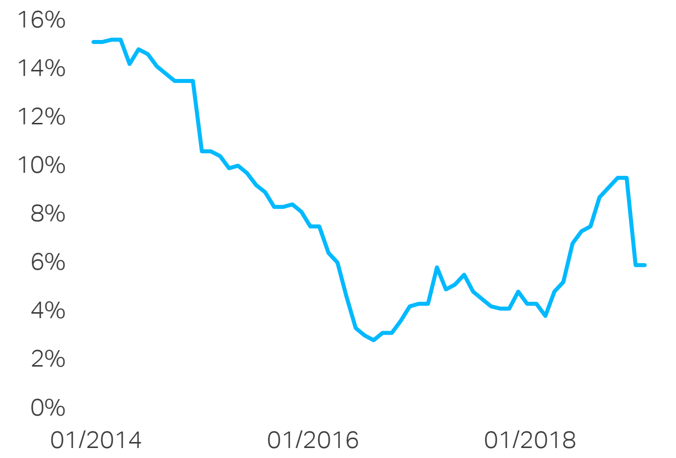
**A final word on PMIs.** The rebound in both NBS and Caixin manufacturing PMI does not indicate a bottom has formed. We are still in the Chinese New Year seasonally affected zone. The lunar holiday causes low January-February PMIs, followed by a rebound in March, a sequence that has taken place every year for the past 15 years. The monthly sequential improvement of the NBS PMI in March was 1.3 – just 0.2 points above the nine-year average post-Chinese New Year rebound. The survey data do point to improving demand and production, especially among small and medium-sized enterprises. However, new export orders and employment remain firmly in contraction territory.

### PPI leads industrial activity




Source: CEIC.

### Manufacturing investment (ytd, yoy)




Source: CEIC.

# Politics: Trade won't shift political red line

- **Structural reforms will be resisted**
- **Communist Party stresses political security**
- **Anti-corruption campaign takes on new dimension**

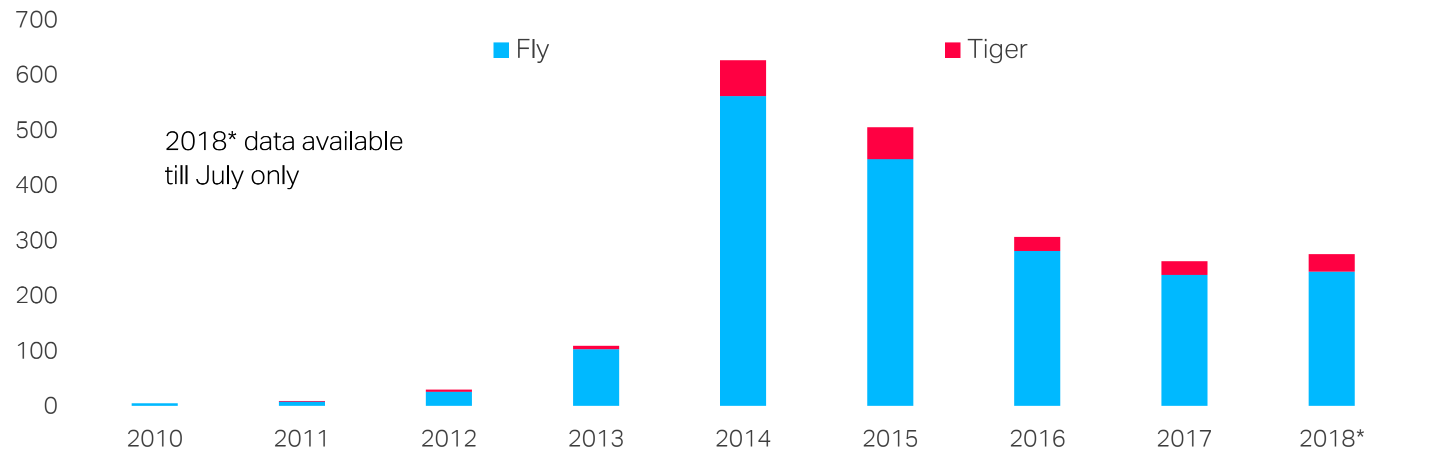
For all the positive spin being put on the latest round of China-US trade talks, the fundamental differences between the two sides risk becoming ever more entrenched. With its insistence on monitoring and enforcing mechanisms, the US team, headed by Robert Lighthizer, is set on achieving structural changes in China's economy that would entail reducing state power and thereby loosening the grip of the Communist Party (CCP) on the country. Whatever their offers to increase imports from the US, improve treatment of foreign businesses and take specific steps - such as the banning of fentanyl – Xi Jinping and the leadership in Beijing cannot entertain the Lighthizer route because of the structural challenge it poses to the power structure they command. (It is also particularly unacceptable because it comes from abroad at a time when the powers that be in Beijing are stressing the importance of China following its own route, with the Communist Party as its guide, and rejecting the "decadent" Western model.)

As a product of that structure, which he has spent his whole adult life ascending, Xi appears set on further consolidation of power around himself and the political machine he leads, undeterred by slowing growth or sporadic on-line criticism of authoritarianism from intellectuals. The message from the top acknowledges the risks China faces, both internally and externally. But this is viewed primarily through the lens of political power. Chen Yixin, Secretary-General of the Party's Political and Legal Commission and a close Xi associate, stressed in a speech a week ago that political security was a constant concern, underlining the need to "prevent economic and financial risks from becoming political and social risks".

**For the leadership, the best defence lies in the promotion of stability** (as defined by the CCP) by strengthening Party control in all domains and safeguarding Xi's role as its "core". At a practical level, this is being actively pursued on multiple fronts – from the clampdown on Uyghur Muslims in Xinjiang to the promulgation of "the Xi Jinping Thought" app, from the rolling out of the social credit programme for monitoring the behaviour of citizens to the suspension of a prominent law professor who criticized the leader's authoritarianism in an Internet posting last year. The number of highly placed "tigers" and grassroots "flies" investigated under the anti-corruption campaign launched by Xi to clean up the CCP after he became General Secretary at the end of 2012 has declined from its initial peak, but, far from ebbing away like previous anti-graft purges, it regained momentum last year. In the first seven months of 2018 more "flies" and "tigers" were caught than over the entirety of 2016 and 2017 respectively (see chart below). Among "tigers" hit in recent months are the one-time chief Internet regulator, the former President of Interpol, senior provincial officials including a former Governor of Xinjiang, and a leading general, who has been given a life sentence for taking bribes in a case reported to involve more than 300 military personnel.

**The campaign is now set to broaden to include going after "political deviation",** according to its extra-legal enforcement organization, the Party Discipline Commission. Those found guilty of corruption are increasingly accused of "disloyalty", alongside pecuniary crimes. At the same time, the Party Commission and the National Supervisory Commission, which monitors officials, have defined their "most fundamental mission" as being not only to protect the CCP' Central Committee but also to safeguard "Xi's status at the core", the Xinhua news agency reported.

## CCDI investigations and sentencing (Number of cases)




Sources: CCDI, TS Lombard.

The ideological message was hammered home this week by the first-ever publication of the text of a speech Xi made to Party cadres in 2013, tracing a single victorious course for China's development path uniting Mao Zedong, Deng Xiaoping and the current leadership under the aegis of CCP infallibility. The timing of the text's appearance on the front pages of most Chinese newspapers as well as on news sites was clearly intended to provide a consistent narrative for the 70th anniversary of the People's Republic in October. But it also formed part of the current drive to strengthen the hold of both the CCP and its General Secretary, bolstering Xi personally as a long-range seer and seeking to rally Party cadres. "Socialism with Chinese characteristics", the leader assured them, had proved its superiority over foreign models (including, it goes without saying, the changes now sought by Lighthizer and his colleagues). Cadres just need to keep the faith and "must not be depressed or swayed by difficulties and adversity, must endure all the risks and challenges, and resist the erosion of decadent ideologies".

The key position occupied by CCP politics does not mean that all suggestions of change are rejected by a leadership, which appears aware of the flaws in the ruling system. But, for China's leaders, reform has to strengthen, rather than threaten to dissipate, the authority of the political apparatus they head (see our 13 February 2019 note Why the Party State stands firm). This may prove short-sighted and stand in the way of beneficial economic policies - for instance, in boosting the private sector or opening up SOEs to competition. But it flows from the nature of the Party-led system, which the leadership is dedicated to preserving as it pursues the centralization of decision-making and presents the collapse of the Soviet Union as a warning of what happens when control is eased. Whatever Xi Jinping and Donald Trump may sign up to this spring, achieving a positive outcome to trade talks is not going to shake the Chinese leadership's prime aim of ensuring continued Communist Party rule under its "core" chief.

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