Daily Note

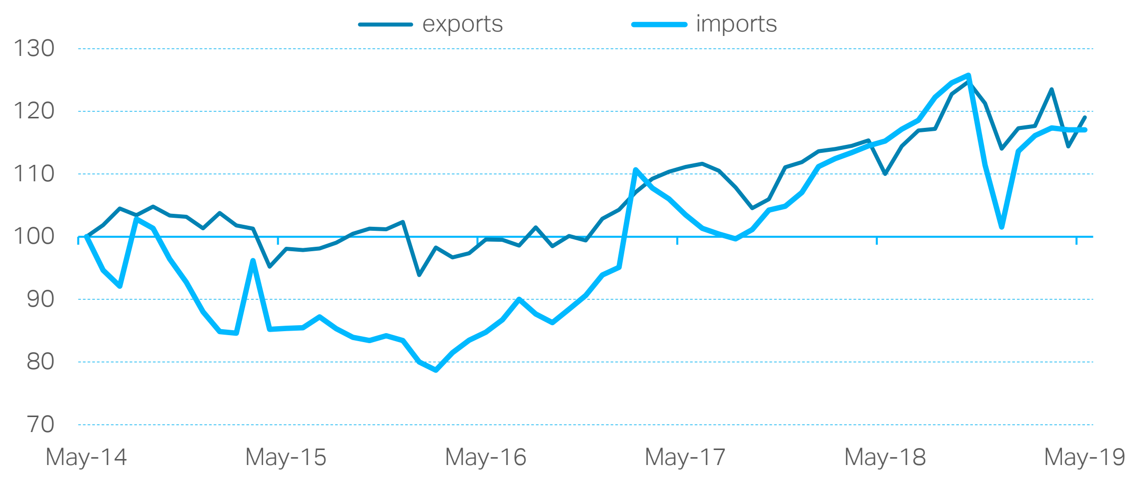
CHINA'S PAST ITS LOW POINT

Charles Dumas / Rory Green

- **Trade growth returns as inventories re-stock**
- **Asia trading bloc is forming**
- **China processing trade under severe pressure**

The basic pattern revealed by China's May goods trade is that exports have levelled off – but may be a while before returning to growth – **while imports are no longer depressed** by last winter's liquidation of inventory, and could soon resume growth, if more modestly than in the past. This could provide some relief to the world economy, with the other traditional US locomotive still slowing. But while infrastructure spending to spur recovery may help import growth, especially in the region, longer-term trends could shrink the share of trade in China's economy. These include the starting point of an unusually large share of trade for a country with such a large population and economy, the shift from heavy industry and 'metal-bashing' to hi-tech and services, and from globalisation into regional blocs, a natural result of the dangers of trade war, but accelerated by trade diversion to skirt round potential US tariffs.

Levelling-off - recovery to be import-led, May-14 = 100



Source: CEIC, TS Lombard

The violent seasonal impact of the Chinese New Year is wearing off, and exports have settled at a level since November that is down a little from 2018's late-summer peak (as US importers hastened to pre-empt the proposed tariffs), but without any clear trend, upward or downward. (Price effects are minimal, as producer prices are neither inflation nor deflating.) Businesses responded to the earlier surge of exports and the threat of poorer growth by cutting inventory strongly. Imports have rebounded from very low levels in November-January. But processing imports have been strong relative to processing activity with imported materials (see chart below-right). So even if general domestic recovery starts to suck in imports, the weakness in the past few months of fuel and raw material imports supports a cautious view of China as 2019's global locomotive.

Processing trade slump. Imports and exports for processing both fell to a record low share of China's total trade. Processing imports collapsed in December as export-orientated manufacturers were reluctant to build stock ahead of tariff increases and falling demand. Inventories have since recovered as optimism over a trade deal encouraged a rapid restocking. Meanwhile processing exports are holding up as the latest round of tariff hikes has yet to bite. Absent an unexpected tariff roll back at the G20 meeting later this month, both import and export processing are likely to fall further.

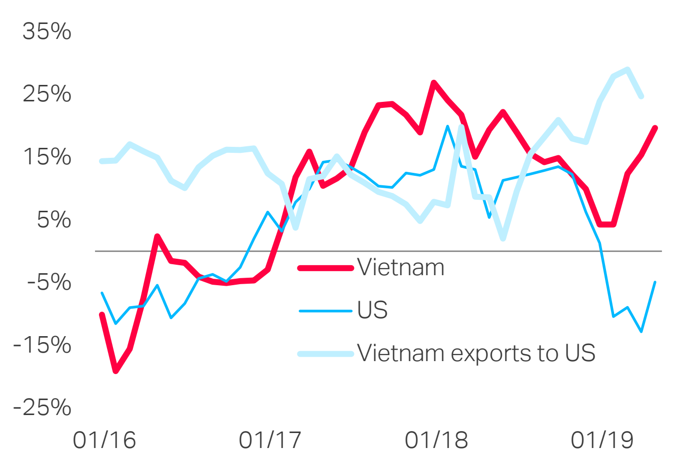
The Asian bloc

Signs of a structural shift in Chinese trade patterns are increasingly clear. Last year **we forecast** that tariff pressure would induce market forces to create a new Asian trading bloc with China at its centre. Our thesis was simple the market always finds the cheapest way. It is increasingly evident that the "way" is via ASEAN and in particular Vietnam.

Chinese exports to ASEAN +10% 3mma yoy, and Vietnam +20% 3mma yoy continue to lead broader growth (chart below left). In turn, as Chinese goods are re-routed, ASEAN and Vietnamese exports to America are growing at over 20%. So evident is the trade re-routing that the Vietnamese government announced last week that it would form a special committee to ensure the sanctity of the "Made in Vietnam" label and limit the re-labelling and transhipment of Chinese goods.

Rerouting is a stop-gap measure, shifting production is a permanent solution for Chinese exporters. Chinese firms are finding ways around tariffs by transferring production abroad, sourcing inputs from China and sending the finished product to the US. It makes the most sense for such production shifts to take place within Asia where new supply chains can be easily created and logistic costs minimised. **Our analysis** of the Chinese solar industry's response to US tariffs in 2012 shows how firms evaded US levies by moving manufacturing to Malaysia and other Southeast Asian countries. This is occurring again, with Vietnam a key beneficiary. YTD China FDI to Vietnam is already greater than the whole of 2018, which was in itself a record high.

China exports (3mma yoy %)



Source: CEIC

Processed exports: ratio of imports/activity

Source: CEIC.