TS Lombard

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China Watch

POLICIES POINT TO SUB-6.5% GROWTH IN H2

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Economics

- **While tightening bias is removed, monetary easing will not live up to current market speculation**
- **Infrastructure investment growth will rebound to 6-8% in 2018H2 while property investment slows**
- **We retain our lower-than-consensus GDP forecast of 6.5% for 2018**

Politics

- **China's aims reach beyond trade fight**
- **PRC liberalises ownership rules to attract foreign investment**
- **Japan follows EU as partnership target**

Markets

- **China's import growth is holding up, but will likely slow**
- **EM economies and markets will be hit as China's imports decline**
- **And trade war supply chain risks are not yet reflected in markets**

Change to China Watch publishing

From this issue of China Watch onwards we are changing the way we publish this service. You will now receive a comprehensive piece every two weeks (previously weekly) on Thursday. Between the regular publications you will receive additional and more timely coverage of the economic, political/policy, and market drivers that matter in China. This change will ensure that our analysts have the flexibility required to respond to developments more quickly and deliver more timely advice as well as continuing to provide clients with thoughtful specialised analysis on a regular basis. If you have any questions please contact your account manager or email nick.bourne@tslombard.com.

Economics: Slowdown due to policy shifts, pointing to below 6.5% growth for 2018H2

- **While tightening bias is removed, monetary easing won't live up to current market speculation**
- **Infrastructure investment growth will rebound to 6-8% in 2018H2 while property investment slows**
- **We retain our lower-than-consensus GDP forecast of 6.5% for 2018**

Recent macro data confirm our view that aggressive deleveraging efforts have pushed real growth into a slowing trend. We expect this to continue into 2018H2. Real GDP growth edged down by 0.1ppt to 6.7% YoY in 2018Q2, mainly dragged down by slower investment growth. As imports grew faster than sales abroad, the contribution of net exports in GDP growth declined from 0.6ppt in 2018Q1 to -0.7ppt in 2018H1, compared with 0.6ppt in 2017. Resilient growth in services and consumption provided a cushion to these developments, suggesting an improved growth structure. Meanwhile, nominal GDP growth moderated to 9.8% YoY in 2018Q2, from 10.2% in 2018Q1, led by lower price inflation in food and services.

Infrastructure investment growth has plunged, as we expected. This is largely the result of stricter financial regulations on shadow banking, rising funding costs, increased PPP project scrutiny and sustained tightening of local government financing. Our calculation shows infrastructure investment growing by only 1.7% in 2018Q2, compared to 9% in 2018Q1 and 14.3% in 2017.

Slowing trajectory for property investment is evident in the medium term. The large decline in infrastructure investment didn't bring down headline GDP growth in the first quarter of this year because it was largely offset by a surprise factor – a rebound in real estate investment from 7% in 2017 to 9.7% in 2018H1. However, as we pointed out two weeks ago, the China Development Bank has recently tightened the use of the PBoC's low-cost pledged supplementary lending guidelines for shantytown redevelopment to rein in the financial activities of local governments. As a result, strong housing sales in lower-tier cities supported by such redevelopments are likely to ebb soon. In light of this development, we expect property investment growth to slow to around 5% in 2018H1.

On a positive note, manufacturing and private sector capex continued to show resilience. Manufacturing investment grew 6.8% in 2018H1 after rising 3.8% in 2018Q1 and 8.3% in 2018Q2. The improvement was supported by a better capacity utilization rate and a continuous increase in industry profits resulting from stronger growth in producer prices. We continue to expect decent manufacturing investment expansion thanks to Beijing's support for high-tech manufacturing and respectable profits growth over the past 18 months.

Consumption remains a main driver for growth in Q2, contributing 78% of real GDP growth, or 5.3 ppts. The unexpected drop of retail sales growth in May appears to have spooked the market. But the slide may be temporary owing to deferred purchases of cars after the May announcement of tariff cuts on imports, beginning in July. Excluding auto sales, retail sales were reasonably strong in June.

To counter growth headwinds, the authorities have introduced a plan to cut personal income tax for the first time since 2011. The annual threshold will be raised from RMB42k to RMB60k and deductions will be added to support private consumption. Lower effective rates for a majority of tax payers could take effect in 2018Q4, boosting household disposable income, especially for the urban middle class. Overall, we expect consumption to stay stable in 2018H2 and retail sales growth to reach 9.8% for the whole of 2018.

The near-term negative impact on growth due to trade friction with the US should be manageable. Since the collapse of the preliminary agreement in May, no further negotiations have been scheduled. Both sides appear committed to a long and ugly standoff on outstanding trade and technology issues. This means that a near-term compromise is unlikely. We estimate the direct first-order negative impact at up to 1% of GDP growth if the aggregate value of affected Chinese exports rises to US$450bn. But, with the current tariff rate on the first US$53 bn of Chinese goods, the negative impact on GDP growth will be manageable at 0.24ppt. Looking ahead, the direct impact of the trade tensions will start to show up in 2018H2 economic data as most tariff implementation took effect on 6 July. For more details, see our note: "How escalation of the trade war will affect China growth".

Financial deleveraging continued. Overall credit growth continued decelerating. Total social financing (TSF) rose only 9.8% in June, falling to single digits for the first time since the PBoC started the series in 2003. Adjusted for local government bond issuance, total credit growth also hit a record low at 11.1% in June, from 13.7% in 2017. Within TSF, the pace of bank loan growth edged up to 12.7% in June, the same level to 2017. However, shadow credits including trust loans, entrusted loans and bill financing continued to tumble across the board with a record net decline of RMB692bn in June, reflecting continued financial deleveraging to bring off-balance-sheet lending back to regular on-balance-sheet bank loans. Meanwhile, bond financing recovered moderately in June, as yields declined along with other financial market interest rates, thanks to RRR cuts and medium-term lending facility (MLF) liquidity injections.

Recent monetary policy moves point to the removal of the tightening bias. To avoid the risks of policy over-tightening and a larger-than-expected deceleration in economic growth, the monetary policy stance is returning to neutral, with easing measures such as recent RRR cuts and lowered financial market interest rates partially offsetting slowing credit growth. As the impact of financial deleveraging and tighter local government financing wanes, total credit growth is likely to stop falling in 2018H2, with more open market injections, RRR cuts, higher loan quotas, and faster local government bond issuance. We expect further RRR cuts of 100bp in the next six months, while the PBoC is likely to be more flexible on bank loan quotas, along with other measures to support stable loan growth. In addition, there could be administrative window guidance for financial institutions so the non-loan TSF activities become less of a drag. The PBoC was this week rumoured to be ready to provide additional MLF to support banks which have invested in corporate bonds.

This shift in monetary policy is towards fine-tuning rather than a change in direction. The efforts to contain financial risks, in particular, deleveraging and strengthened financial regulation, are not likely to be reversed. So, without any major growth deceleration, we do not think monetary easing in 2018H2 will live up to the current market speculation. Any monetary easing will be gradual and measured because the PBoC will want to avoid re-igniting capital flight given the US rate-hike cycle. The next key event to watch is the mid-year Politburo meeting on the economy, likely to take place next week. This should give a sense of the leadership's concern about the slowing in growth and indications of how policy might change. We believe that any aggressive measures will await stronger signs of economic deceleration and the initial effects of the new US tariffs on activity.

There is still room for proactive fiscal policy in 2018H2. In the first half of this year, the sharp drop in infrastructure investment growth was partly a direct outcome of slow local government bond issuance. But in June, net issuance of local government debt rebounded to RMB465bn from a monthly average level of RMB158bn in Jan-May. Despite this surge, we estimate that local governments still have an RMB2.7 tr debt quota based on earlier announced targets from the National People's Congress (NPC) in March. Such a sizeable pipeline for the rest of this year will help accelerate infrastructure spending and, as the clean-up of the PPP project bank was more or less completed in May, local governments are bound to pick up the pace in implementing projects.

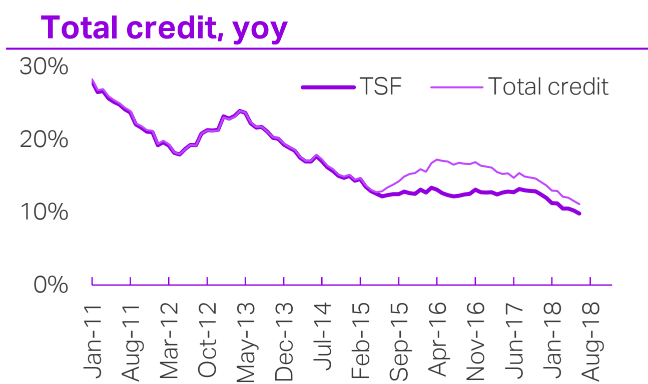
Looking ahead, we expect infrastructure investment to rebound going into 2018H2. Regarding fiscal budget implementation, there appears to have been slower progress in government budgetary spending so far this year, with an increase of 7.8% YoY in 2018H1, compared with 16.1% in 2017H1. The accumulated fiscal deficit was RMB726 bn at the end of June, compared with a deficit of RMB918 bn in the same period last year. There is thus some room for fiscal budget spending to be more growth-supportive while overall infrastructure investment growth will bottom out in 2018H2 with a nominal expansion of 6-8%, up from 1.7% in 2018Q2.

More measures to help corporates and boost consumption. Apart from more support for infrastructure investment and personal income tax reduction, other measures will be introduced to lower corporate financing costs and reduce the corporate tax burden. So far this year, the growth of corporate tax revenues has remained in double-digits, despite government pledges for more tax cuts in 2018. We expect increased VAT rebates for tariff-impacted exporters and support for manufacturing investment, with a special focus on advanced technologies that have come under threat amid the trade tensions. As part of the drive to reduce poverty, new initiatives could target rural consumption and low-income urban households.

More proactive fiscal policy in 2018H2 doesn't mean another investment-focused stimulus cycle. Acceleration of local government bond issuance and/or tax cuts are part of the existing policy announced during the NPC plenary session in March. What the government needs to do is to accelerate implementation and focus on structural policy support rather than across-the-board easing.

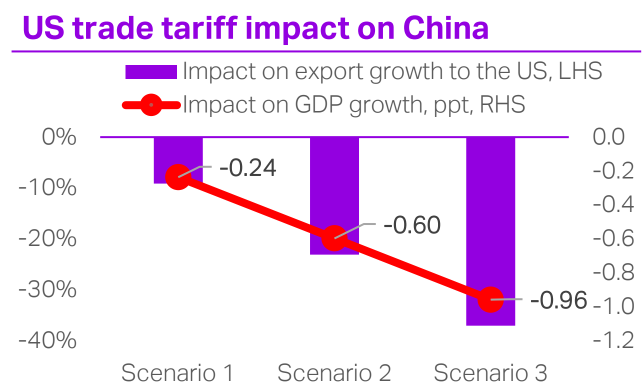
We maintain our lower-than-consensus GDP forecast of 6.5% for 2018. This implies that GDP growth will fall below 6.5% YoY in the second half of this year, despite the fine-tuning policies discussed above. In particular, we would watch out for headwinds on both the external demand and the property investment front. Although we do not expect a catastrophic impact on growth from the escalating trade war, the indirect impact is likely to be felt via business sentiment, domestic investment and consumer confidence which could pose a further downside risk in 2019.

Total credit, yoy



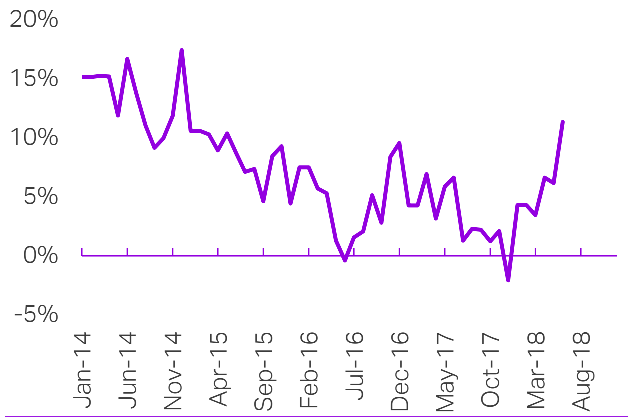
Sources: CEIC and TS Lombard.

US trade tariff impact on China



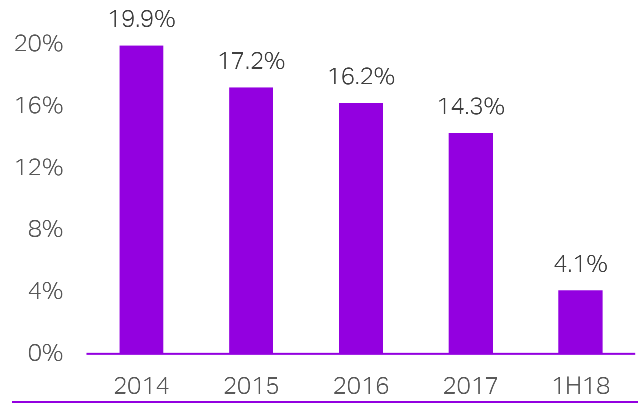
Sources: CEIC and TS Lombard.

Manufacturing investment, yoy



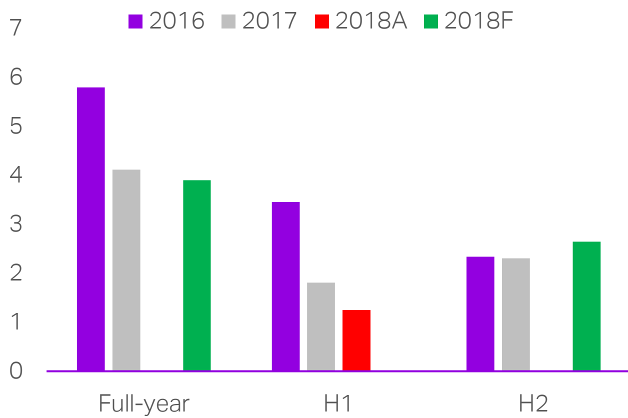
Sources: CEIC and TS Lombard.

Infrastructure investment, yoy



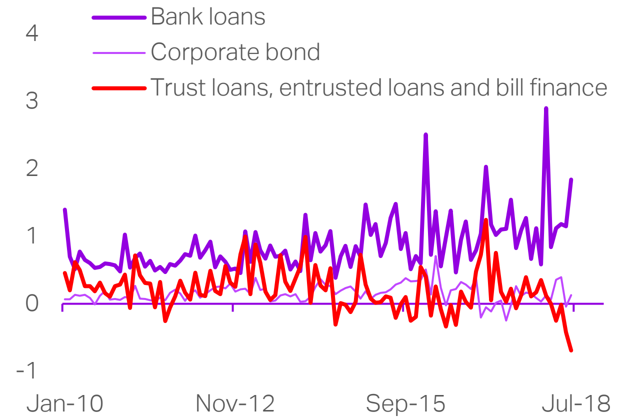
Sources: CEIC and TS Lombard.

Local bond issuance, RMB tr



Sources: CEIC and TS Lombard.

Incremental TSF, RMB tr



Source: CEIC.

Politics

- **China's aims reach beyond trade disputes**
- **PRC liberalises ownership rules to attract foreign investment**
- **Japan follows EU as partnership target**

China is set on a policy of building bridges with the European Union and Japan in reaction to the escalation of tariffs by the Trump administration. This is aimed at serving both the PRC's short-term strategy as the trade war gathers pace and Xi Jinping's longer-term aim of putting his country at the forefront of a recalibration of the global order to serve Chinese interests better. A Foreign Affairs Work Conference Xi chaired last month – the first in four years - made clear that the leadership sees the international target of establishing China centre-stage in global affairs as being closely linked to domestic economic development led by the Communist Party. The political thrust is evident in the way in which the Chinese leader has designed the party he heads as the shaper of foreign relations, above the government. So, whatever happens in the current trade confrontation with the US, the over-arching tension between the two countries is set to continue.

China's immediate aim is to promote the mainland as an investment destination with the leadership's focus on an industrial modernization programme and the expansion of services as a magnet. At a series of top-level meetings he has chaired in Beijing in recent weeks after the ZTE moment of truth, Xi has stressed the need to focus on the development of indigenous high-technology innovation. To attract the technology it wants in the context of continuing US hostility, the PRC is showing a new willingness to free foreign manufacturing companies from the requirement to form joint ventures with domestic enterprise, starting with automobiles, pharmaceuticals and chemicals. Nevertheless, as part of their tight management of reporting of the trade confrontation, the authorities have told domestic media to avoid mentioning the Made in China 2025 programme for fear of alarming foreigners about the country's ambitions, the prime attraction of major companies from Europe and Japan is to get into the PRC's modernization plans with advanced technology to replace low-cost manufacturing.

Despite the sovereignty dispute between the two countries in the East China Sea, China is keen to improve economic relations with Japan, which signed its major trade deal with the EU this week. Following a visit to Tokyo by Prime Minister Li Keqiang, China and Japan say they want to press ahead with negotiations for a free trade agreement that would also include South Korea, China's main provider of semi-conductors. A survey issued by Japan's Mizuho Research Institute this week reported that Japanese manufacturers found China more stable and predictable as the result of current economic policies and felt increasingly satisfied with it as an investment destination. Following the decision to bury the hatchet with Seoul over the deployment of the THAAD anti-missile system, Premier Li has invited South Korean firms to expand on the mainland, especially in electronics and components; the government has just approved a $2.3 billion display panel plant in Guangzhou in a joint venture in which LG Display will have a 70% stake.

Beijing's desire to strike deals for tactical positioning was evident in the flurry of agreements during Li's trip to Germany earlier in the month to allow that country's chemical, automotive and engineering companies to expand on the mainland, including projects in which they will be permitted to operate without Chinese partners. These include BASF's planned $10 billion plant in Guangdong while Volkswagen, Daimler and BMW are all now involved in projects for driverless cars. Bosch, meanwhile, is to provide sensors and control systems for electrical vehicles made by the NIO start-up group. For Daimler and BMW, increased production on the mainland could

compensate for the negative effect of tariffs on vehicles they manufacture in the US and export to China. For China, the deals are a fresh stage in realizing its ambitions to take the lead on electric and autonomous cars, further boosted by this month's announcement of Tesla's plan for a wholly-owned factory in Shanghai capable of turning out half-a-million vehicles annually and with a battery plant included. Li has told his French opposite number that restrictions on foodstuffs from France will be eased. This month, he cast China's net to east and central Europe meeting leaders there under the banner of the 16+1 association which offers Chinese aid for infrastructure and other projects in the region.

There was suitable rhetoric at the China-EU summit in Beijing this week with a joint statement on the "strong" commitment of the two sides to support the multilateral trading system, back the WTO and resist protectionism. This was immediately followed by the Commerce Ministry in Beijing announcing that it had filed a complaint to the world body against Washington's proposal last week to levy 10 per cent tariffs on US$200 billion of Chinese products. The agreement to issue the joint statement was notable since it had been shelved at the last two sessions of the summit because of differences over the PRC's demand for recognition of market economy status and European complaints about Chinese steel exports. The EU and PRC have also formed a joint group to draw up proposals for WTO reform while assuring Washington that they do not want to exclude the US.

All this does not mean that the EU, or other nations have dropped their objections to enforced technology transfer, intellectual property infringements or other Chinese misdemeanours - the EU Chamber of Commerce in China reports that nearly half the firms covered in its latest survey of members said they had found business on the mainland is becoming more difficult to conduct in the past twelve months. But building bridges that serve the leadership's modernization ambitions is providing a second string for China's trade war strategy that fits neatly into Xi's ambitions to sway global governance in his country's long-term interests.

Markets

- **China's import growth is holding up, but will likely slow**
- **EM economies and markets will be hit as China's imports decline**
- **And trade war supply chain risks are not yet reflected in markets**

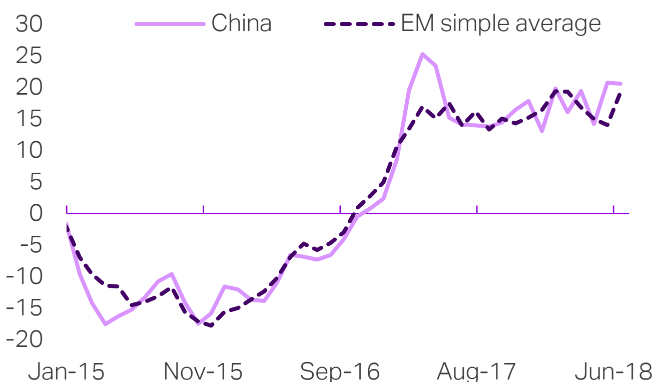
China's import growth is holding up relatively well despite fears of an economic slowdown. Notwithstanding a decline of import growth in June, to 14% YoY, the 3 month moving average remains above 20% – close to its highest level for more than a year, and in line with the continued strong growth of imports in other EM economies (see Chart 1).

The rise in China's year-on-year import growth from 2016 was closely correlated with higher exports from broader emerging markets and also with improving EM equity performance (see Chart 2). While in some cases this correlation may indicate causation: the economies of Southeast Asia are the most directly dependent on China as a destination for exports, there is also likely an extent to which EM economies benefited from the overall increase in world trade volumes, of which China was an important part. Nonetheless, the slowing of China's economy and the prospect of reduced imports is a risk for broader EM that are already facing multiple external threats (see last week's EM Watch).

The fall from the peak in China's import growth likely contributed to this year's reversal of fortunes for EM economies and equities, and we expect to see a further decline in China's import growth for the remainder of this year. The TS Lombard recalculation of China's real GDP growth and our analysis of the economy suggests that China is well-placed to weather the deteriorating global environment (see our 17 July Daily Note). Nevertheless, the rebalancing of the economy away from infrastructure and heavy industry towards consumer spending and high-tech manufacturing will reduce China's relative demand for energy and industrial commodities. At the same time, the prospect of a protracted trade war will intensify the authorities' efforts to redirect demand toward domestic suppliers, thus further reducing imports. Declining Chinese imports will inevitably weigh on EM exports. By contrast, China's exports will likely be boosted in the short term by increased demand ahead of the planned tariff imposition.

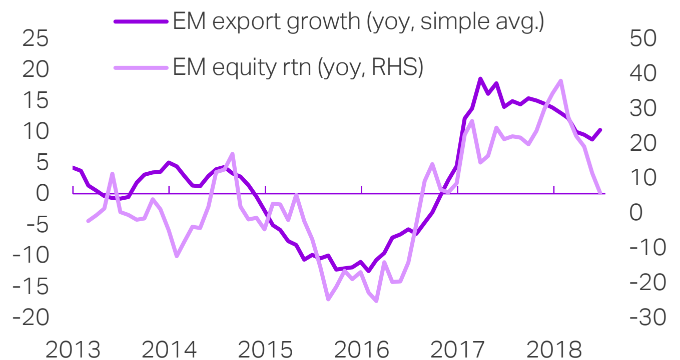
EM equity markets are likely to fall further as exports decline. EM equities have staged a modest recovery this month but overall have fallen by more than 7% year-to-date, 15% from the January peak, and have wiped out around 12 months' of gains (MSCI index in dollars).

Chart 1: Import growth (yoy, 3 month ma)



Source: Bloomberg, TS Lombard.

Chart 2: China import growth, EM export growth and equity returns



Source: Bloomberg, TS Lombard.

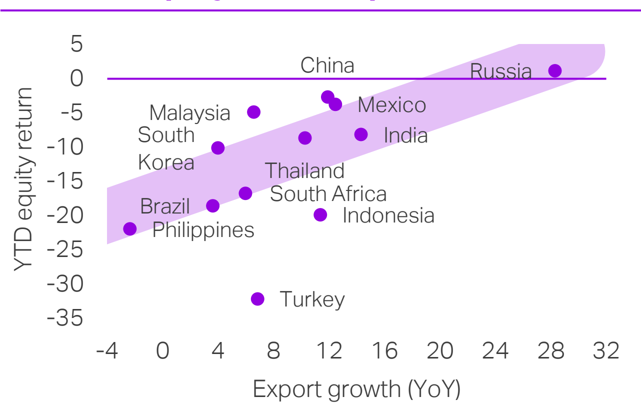
Exports are more important for some EM economies than others in terms of share of GDP, but there is nonetheless a high correlation between year-to-date equity returns and export growth (see Chart 3). Indeed, in an effort to maintain currencies at a competitive level in order to boost faltering exports, central banks in some EM countries risk falling behind the curve in their fight against inflation, with negative consequences for both investor sentiment and valuation of local currency assets in dollar terms.

The next phase of the trade war will hit supply chains. The trade war has so far had little impact on China's economy, although the risk of direct economic consequences will increase as hostilities deepen; second order economic effects are less predictable and could become more serious still (see last week's China Watch). Trade war impact on commodity prices has been strongest in soybeans and related products. While the greatest impact on financial markets has been via the appreciation of the dollar as a result of investors' risk aversion, that has intensified the global financial tightening initiated by the Fed and other global central banks. The next phase of trade war escalation will raise tariffs on consumer goods, including electronics and manufactured products, which will turn attention to global supply chains.

The risk of supply chain disruption is not fully reflected in markets. The broad correlation of EM equity returns with export growth highlights the relationship between trade and markets. There is no such correlation between markets and countries' participation in global supply chains. Year to date equity returns show little relation to the share of foreign value added in exports (see Chart 4). In Asia, manufacturing supply chains are longest in South Korea, Malaysia and Thailand, yet equity losses in these markets are less than those in many others, while the markets that have suffered most have been those that are most vulnerable to tighter liquidity conditions (for our EM resilience score analysis see our 25 June EM Watch).

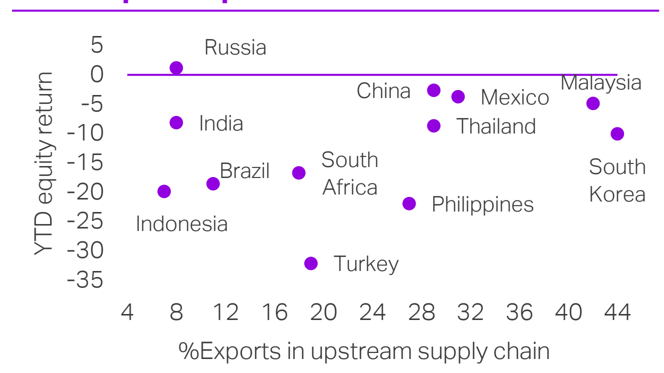
In the medium term, of course, regional supply chains will adjust to whatever is the new reality. Indeed, US action makes it more likely that China will seek to increase trade with regional economies that present a less hostile environment, particularly in areas such as high-tech manufacturing that are essential to China's strategic goals. Furthermore, for ASEAN economies, the share of exports that go to China is still relatively low compared with that of smaller countries in other regions to the corresponding large regional importer, suggesting that the longer term adjustments arising from the trade war will ultimately be positive for Asian economies (see our 11 June EM Watch).

Chart 3: Equity rtn vs export



Source: Bloomberg, TS Lombard.

Chart 4: Equity rtn vs upstream supply chain participation



Source: Bloomberg, TS Lombard.