China Watch

UK TRIP – WAKE UP TO DEFLATION RISK

Bo Zhuang

- **London-based investors are turning cautiously optimistic on China's growth outlook amid the latest easing measures in January**
- **There is still little awareness about the rising deflation risk**
- **Interest in the trade war has subsided**

We met more than 20 institutional investors in London during our China macro marketing trip in late January (see our chart deck presentation published on Monday, 28 January 2019). In general, we encountered more optimism than during our previous visit in November. Most investors started meetings with questions about when, how and at what level to expect new stimulus. While many are becoming excited about the more active policy response since the beginning of the year, we believe policy is not yet sufficiently strong to stabilize the growth slowdown. Throughout H2/18, our judgement was that the scale of credit easing would be smaller than the market expected. This played out almost exactly as we had thought with the "neutral" monetary policy stance in H2/18. Following the December Central Economic Work Conference, monetary policy appears to be moving towards measured easing. The 100bps RRR cuts and the frontloading of the local government bond quota marked the start of a shift towards prioritizing growth.

While there was some disagreement about the timing of sequential growth improvement in China, almost all investors think growth will be slower, either in Q1/19 or Q2/19, before stabilizing in H2/19. For our part, we expect yoy real GDP growth to bottom out in Q2/19. Some questioned how long we will continue to see the 6%+ growth target before the economy hits the wall. We think China will still aim to meet the long-standing growth target of doubling GDP between 2010 and 2020, which will require growth of 6.1-6.2% in 2019 and 2020. This would be in line with Xi Jinping's political ambition of declaring the personal victory of having delivered economic success at the centenary of the establishment of the Communist Party in 2021. On the other hand, post-2020, Beijing will have much more freedom to set a lower growth target – one that is more in line with the underlining growth potential. In other words, we continue to expect China to grow above its potential rate in 2019-20, but thereafter the 6%+ growth target could then easily be abandoned.

Moderate credit easing compares to 2015-16

Given the expected growth slowdown in the coming months, most investors agree further stimulus measures are needed. Indeed, many are still counting on China launching a stimulus cycle similar to that of 2015-16. In our view, unless growth faces the imminent threat of collapse, Beijing will not risk a credit expansion of a magnitude like that of 2015-16 because this could lead to Japanification or a financial crisis within five years. To put this into perspective, we expect total credit growth to rebound from the current level of 10.7% in December to around 14.5% by the end of this year. But the recovery will be much weaker than in the previous credit-easing cycle, during which total credit growth rebounded from 12.6% in May 2015 to 20.6% in November 2016.

With regard to fiscal policy, the official deficit target will be hiked to more than 3% of GDP in 2019 vs 2.6% last year. The quota for special local government bond issuance will rise to more than RMB2 trillion in 2019, which will support infrastructure investment growth. The overall tax reduction could reach RMB1-1.2 trillion in 2019, but the short-term impact on growth will disappoint owing to the smaller multiplier effect. Apart from those fiscal measures that have already been announced, Beijing might roll out direct subsidies and further tax cuts to support falling real retail sales.

PPI deflation and nominal GDP growth

It was quite a surprise to discover that only a handful of investors were aware of the rising deflation risk in China. There was very little pushback on our new theme of emerging deflationary risk. In the past 10 years, PPI has been a reliable gauge of the economic cycle. As falling producer prices drive down industrial utilization, profit growth will slow as China enters a new cycle of corporate revenue growth. Lower PPI also means lower nominal GDP growth. In our view, market concern about corporate debt repayment will resurface when nominal GDP growth falls below 8% and more corporate debt defaults will start to accumulate when that indicator falls below 7%. This is because 7% nominal corporate revenue growth will not be enough to cover nominal interest rate payment so that outstanding corporate debt can be rolled over. We expect nominal GDP growth to rapidly decelerate to ~8% owing to PPI deflation in H1/19. In addition, domestic PPI deflation led by both primary goods and final manufactured goods could lead to the mainland exporting deflation to the rest of the world. Overall, we think investors have not paid enough attention to the emerging deflationary pressure in China.

Encourage banks to lend to SMEs

Another necessary step to stabilize growth is the relaxation of macro prudential policies. This would include window guidance measures to make banks more willing to lend to the real economy, particularly privately-owned enterprises (POEs). The latest launch of the perpetual bonds will help large banks to raise core capital to meet the Basel III capital requirement. The PBoC's Central Bank Bills Swap increases demand on perpetual bonds. Together with the targeted Medium-term Lending Facility (TMLF) and differentiated RRR, these factors mean that commercial banks will be motivated to ramp up bank lending to POEs, particularly SMEs.

Given that POEs tend on average to be more profitable and more efficient than SOEs, channelling more capital in this direction would naturally improve the efficiency of the economy. However, directing credit to POEs has always been a policy challenge in China. Using administrative measures to push banks to lend more to SMEs at rates below market clearing level is clearly not the optimal way to deploy credit in the long run. But over the next 12-18 months, increasing credit allocation to POEs would mean that short-term GDP growth would be supported by less credit growth, which, in turn, would mitigate debt sustainability concerns and boost overall sentiment.

Augmented total credit grew 10.7% in December, reflecting a slowing pace of decline. The contraction in off-balance sheet lending continued while bank lending accelerated to 13.5% yoy – its strongest since July 2016. In our view, this means Beijing is trying to pump liquidity to official channels such as bank lending and bond issuance, while keeping a cap on shadow banking channels. We call this "measured easing" that is focused on providing cheaper liquidity to corporates via official channels, which is different from the "broad easing" that took place in 2015-16. In our view, monthly net flow of shadow banking credit is a good proxy for whether the authorities have moved towards "broad easing". An acceleration of corporate and local government bond issuance is likely to offset the contraction in off-balance sheet lending in Q1/19. We believe total credit growth will start to rebound in January.

Interest in the trade war has largely subsided

Despite the importance of the China-US trade negotiations taking place this week, investors seem to have lost interest in the potential outcomes of the talks. In general, they perceive a mitigated risk of a full-scale tariff war and expect the 90-day negotiation to bring the two sides closer to some form of agreement. This is in line with our house view that while the Washington talks will not end the trade war, they will reveal a pathway to a patchwork deal that will fall short of US aims. Dispelling US concerns over Chinese industrial policy and the state directed growth model is not possible. But Beijing will offer limited concessions to gain an extension of the talks. At least, no one expects trade tariffs to be ratcheted up from the current level in the near term.

The current account will move into deficit

There was some disagreement over whether China would have a current account deficit this year owing to lower commodity prices and the ongoing trade talks between China and the US. Despite the disagreement, all expected the current account surplus to continue to narrow. We believe that a deficit is inevitable whatever the outcome of the trade negotiations. The question, however, is whether it will last for a prolonged period. We believe China running a persistent current account deficit is extremely unlikely in the medium term because it needs domestic savings to be trapped locally so that companies and official sectors can continue to be financed cheaply in the local market. Nor do we see sources of savings from other countries flowing to finance the Chinese current account deficit in the near future.

RMB outlook

On the currency, investors' views remain mixed. Some expect RMB to remain below 7.0 in 2019 because they remain convinced that 7.0 is the psychological threshold owing to fear of larger capital outflows and that makes it politically important. We think RMB will most likely remain stable until March because of the ongoing trade negotiations. However, it is hard to imagine that "twin deficits" and the continued narrowing of the US-China interest rate differential will lead to RMB stability or strength beyond H1/19. Our previous call of larger-scale RMB devaluation under the full-scale trade war scenario may no longer stand because Trump has changed his mind owing to the changed domestic economic situation in the US. But we stick to the view that the Chinese authorities will choose to allow moderate passive yuan devaluation as part of their response to the growth slowdown. Hence, we maintain our call that a break above 7.0 for USD/CNY is possible.

In our view, it would be riskier to stoke domestic demand through across-the-board credit easing and higher leverage in order to keep growth above 6% in 2018-19. Such an approach would defeat the longer-term goal of financial deleveraging and make a financial crisis more likely. If China went further down this route, it would face either Japanification or a financial crisis within the next three to five years. In other words, defending the yuan through domestic stimulus and aggressive credit easing would be more likely to plunge China into a debt crisis than to save it from one. Following the latest trade moves, a cheaper yuan would help offset some of the impact of tariffs on exporters without significant spill-overs to domestic sectors.

There was some pushback among investors on the effectiveness of RMB weakness as a policy tool to support growth. We do not think a moderate RMB devaluation would help China gain a much larger share of the global export market; but it will certainly help mainland producers to remain competitive and stabilize domestic investment confidence to slow the pace of production relocation overseas.

More pessimism on property easing

Since 2016, housing demand in China has been vastly inflated by direct transfer payments from government to households in connection with shantytown redevelopment. As much as 25% of residential housing purchases in 2017 was financed by PBoC "helicopter money". Since the housing inventory is no longer a systemic risk, we do not expect the central government to embark on a new round of property easing at the national level, although cosmetic city-specific easing at the local level is likely. Over a longer timeframe, annual housing sales in gross floor area peaked in 2018. Further ramping up of the housing sector could significantly increase the risk of the domestic property bubble bursting. Headline real estate investment stripping out land sales grew -3.2% in 2018, and since there was massive housing sale front-loading in 2016-17, it is highly unlikely that this year's housing sales and investment growth will outperform 2018. We are not predicting China's property bubble to burst in 2019, but one strong macro implication is that a rebound in infrastructure investment growth will be offset by weaker housing investment this year. Plunging PPI and anaemic industrial profit growth are likely to constrain manufacturing FAI. Therefore, overall FAI could remain weak throughout H1/19.

Consumption uncertainty

Quarterly real retail sales in Q3/18 were the lowest since Q1/94. This suggests weaker consumption growth is not solely auto sales-related. Higher household leverage, slower consumer credit growth and P2P defaults are the key factors for the sales slowdown. Although we expect Beijing to roll out more consumption stimulus measures to add to personal income tax cuts, there is still some level of risk associated with the overall consumption slowdown. Since consumption contributed 76% of GDP growth in 2018, any downside surprises would have much larger impact on headline real GDP growth than would capex investment or net exports. However, we highlighted to clients that the rapid slowdown in real retail sales might have exaggerated the full consumption picture because it does not capture growth in services. Growth in services sector has constantly outpaced overall GDP growth since 2011.