China Watch

CHINA TRADE : WORSE TO COME IN Q1

Rory Green

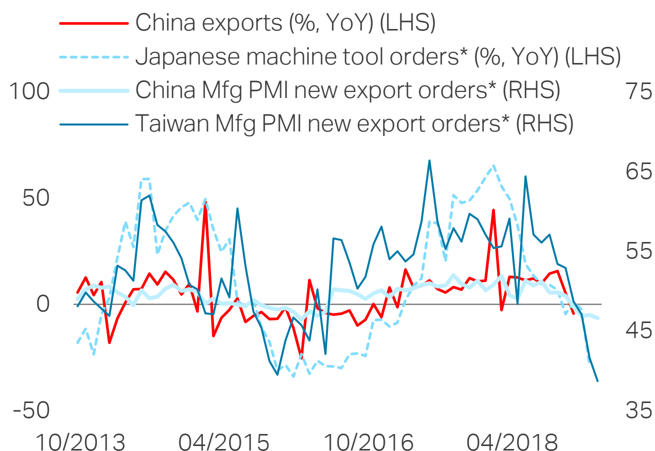
- **Trade talks turning positive but export slowdown already baked-in**
- **Lagged trade war effects and weak demand to weigh on Chinese trade**
- **Disinflation risks rising fast, export prices to weaken**

Chinese trade data confirms the start of a lagged trade war induced downturn in China-US trade which will weigh on global goods flows. Falling Chinese demand in addition to reduced purchases of goods for re-export caused imports to fall 7.6% YoY, while Trump's tariffs finally impacted Chinese exports which fell 4.4% YoY. China export growth will weaken further and remain negative in H1/19 as domestic and global demand continues to decline. Export growth for 2019 will be positive. Chinese promises to import larger quantities of American agriculture and energy products, mean import growth will recover.

China Q1/19 export growth will decelerate. We noted in September, that a combination of; US firms' frontloading (Chart below right), a trade war induced decline in Chinese Q1/19 export orders, and base effects from an exceptionally strong Q1/18, mean Chinese exports growth will slow this quarter. February data is likely to be the weakest month thanks to a combination of the Lunar New Year holiday and base effects.

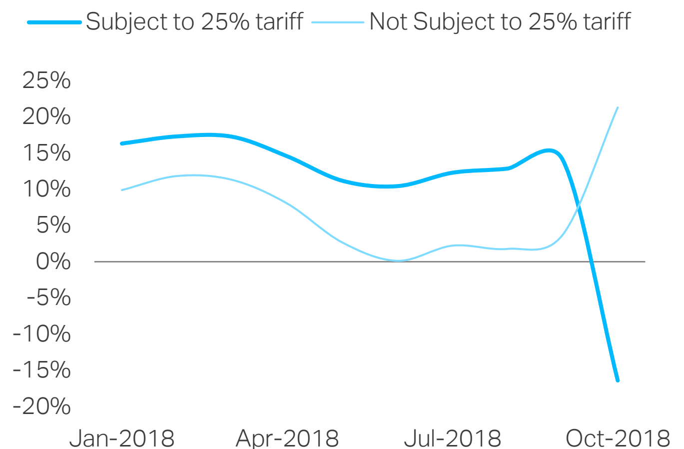
Exports will decline irrespective of continued progress on trade talks. Our expectation is for China to offer further non-structural concessions to the US in order to gain multiple extensions of the current tariff hike delay. We may have past "peak Trump" in terms of the US-China trade war. Nevertheless, we do not expect exports to the US to rebound in the near future.

Leading indicators point to export weakness



Source: CEIC, *(indicator advanced 3 months)

US imports from China (% yoy)



Source: USTR, Bloomberg, TS Lombard

After significant frontloading in Q4/18, US firms have limited inventory space and credit capacity to further increase imports from China. Moreover, softening US and global demand will weigh on Chinese exports. We expect China exports to remain soft through H1/19. A selection of indicators (chart above left) with an approximate three-month lead suggest a bottom for export growth rates will form in Q2/19 at the earliest.

China import demand slows to match weaker economy. We previously noted, that PRC import growth belied slowing domestic activity. In our view the counterintuitive strength of imports was indicative of a top-down policy to increase imports from US allies as an inducement for countries to remain neutral in the trade war. With further tariff pauses increasingly likely, the policy has ended and import demand now reflects a weaker domestic economy as well as a decline in component demand for re-export.

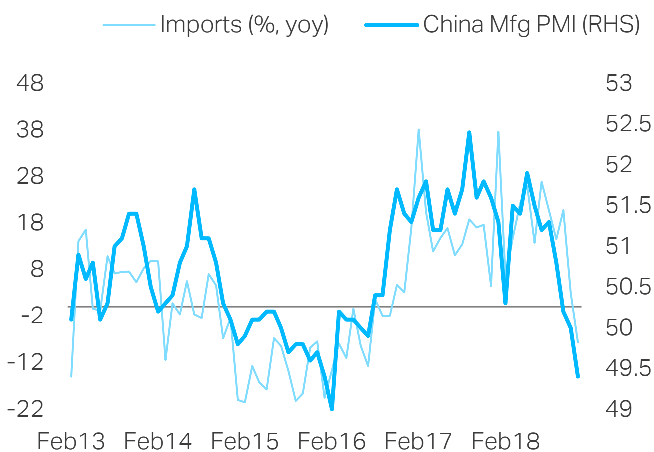
An overlooked lagged effect of the trade war is that the deflation of prices of Chinese manufacturers will mount. We noted last week that Chinese firms facing existing tariffs and fearful of possible new ones, will aggressively move to reorient underused capacity to production for domestic markets. Parallel efforts will focus on increasing sales outside the US, i.e. other EMs, Japan and Europe. The net result will be increasing deflationary pressures, not only in China's domestic market but potentially in other markets as well.

Disinflation means export prices for Chinese goods will remain weak until inventory levels are cleared and/or strong external demand materializes. (chart below right) Trade competitor countries' export prices will need to adjust to both a weaker RMB and lower prices. Export unit prices are already trending down in trade bellwether nations Korea and Taiwan.

A current account deficit is now almost inevitable. While the temporary tariff ceasefire is positive, any potential deal will involve a significant effort to reduce bilateral trade imbalances. Whatever the outcome of negotiations, China's current account will feel the impact. Exports falling faster than imports and a large service deficit will drive a deficit of some US$20bn in 2019. Amid increased monetary easing, the market will force further depreciation of the yuan.

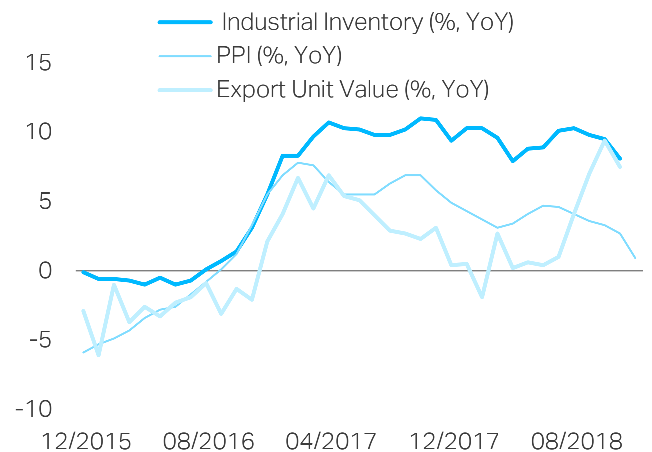
2018 trade war winners will lose out in 2019. Should the trade war continue to moderate, the need for re-routing and alternate sourcing of goods will diminish. Countries that have benefited from the disruption, namely Canada (re-routing) and Brazil (soybeans), will suffer. Commodity exporters such as Qatar and Australia may also lose out as any US-China deal will include provisions to increase imports of Ag commodities and LNG from America.

Import demand reflects domestic slowdown



Source: CEIC, Bloomberg

China export prices under pressure



Source: CEIC

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