

China Watch

2024 – YEAR OF THE SLIDING DRAGON

Rory Green

- Property contraction is far from over, but policy put triggered
- Stimulus means China activity will remain “L-shaped” next year
- Trades for 2024: long policy rumours into Q1, short underwhelming economic impact into H2

2024 is the Chinese year of the dragon – an auspicious year. The marriage and birth rate will certainly increase significantly above trend and “dragon”-themed equities are already outperforming. The economy, however, will not soar higher; rather, it is set to slide lower as China’s multi-year structural slowdown continues. We expect Beijing to set a growth target of “around 5% yoy” (the same as this year) and engage in much more proactive policy in order to meet that target, especially in H1/24. Expanded fiscal and property support will keep China on its weak, “L-shaped” recovery path, with a slower real estate contraction, consumption normalization, and improved investment (ex-property) driving official growth of roughly 5% yoy. The reality, of course, will be weaker, with TSL’s measure of GDP forecast 1.2 percentage points lower than Beijing’s 2024 target. Stabilization may well beat bearish expectations (Chart 1 below), with equities and FX to strengthen and rates likely to bull-steepen in response. But such moves will be cyclical at best, while a prospective rally will roll over as policy support merely prevents a slowdown rather than reaccelerating activity.

The key question for China macro and markets is can the economy stabilize while the property sector is contracting? In July, we answered “yes, but with difficulty”. That forecast has now been borne out in the data. As the charts below show, the growth rates for industrial production, retail sales, manufacturing and infrastructure investment, electricity consumption (industrial, service

Chart 1: Data surprised bearish expectations



Sources: Citi, Bloomberg.

and residential) and a range of PMIs are either flatlining or seeing modest improvements. Stabilization has come through a combination of post-Covid demand, government stimulus and base effects that flatter H2 numbers.

Lurking behind the appearance of stability is an accelerated weakening of the property sector and, along with it, increasing negative spillovers for investment and consumption via wealth, confidence and financial stability channels. Despite the rosy picture painted in current activity indicators, M1 (one of our key leading indicators) is at its lowest level ever, pointing to increased downward pressure this quarter. The property drag threatens to pull the dragon from a slide into a crash landing – aka a second post-Covid growth slowdown. To maintain activity at current levels in 2024 and hit a growth target of “around 5% yoy” while base effects and post-Covid consumption are weakening, Beijing will need to accelerate government spending, particularly for real estate.

Chart 2: Improving, but well off pre-Covid trend

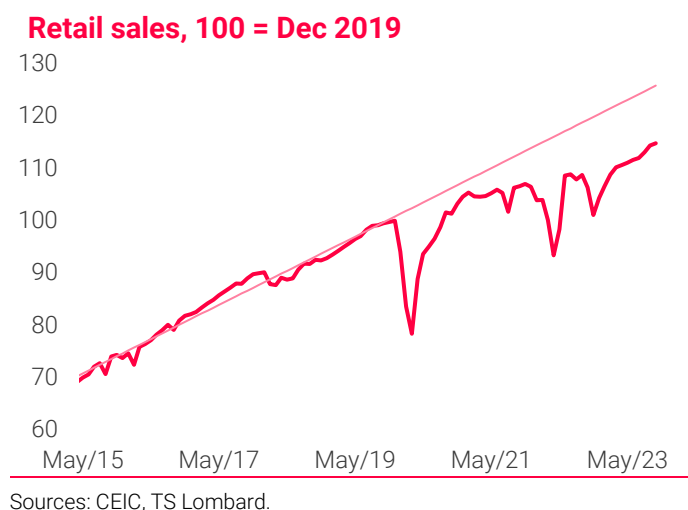
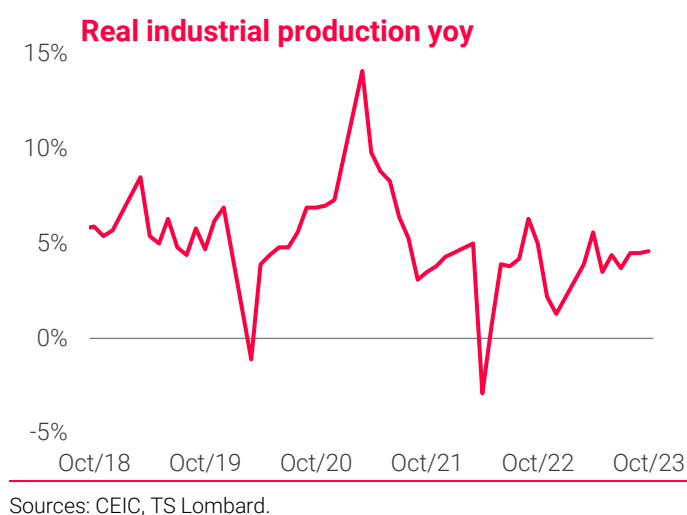


Chart 3: ‘L-shaped’ recovery



After a brief pick-up in home transactions following government stimulus, there was a deterioration in sales and funding for developers last month, exerting more pressure on debt sustainability and further denting public confidence. Policymakers have reacted. While a drip-feed

Chart 4: Credit impulse pointing upward

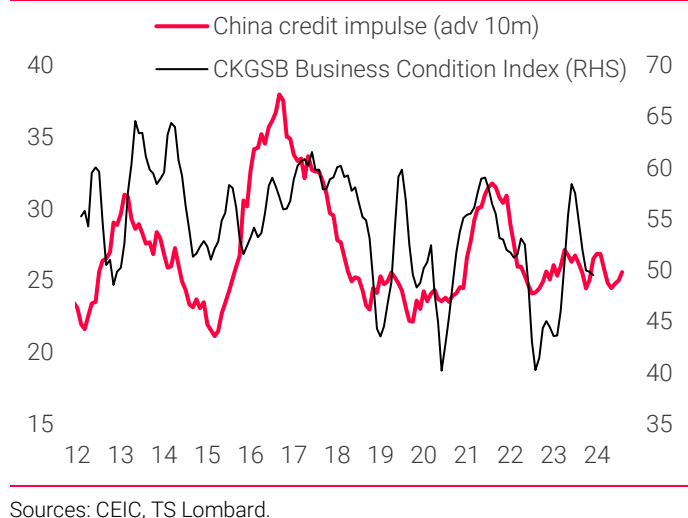
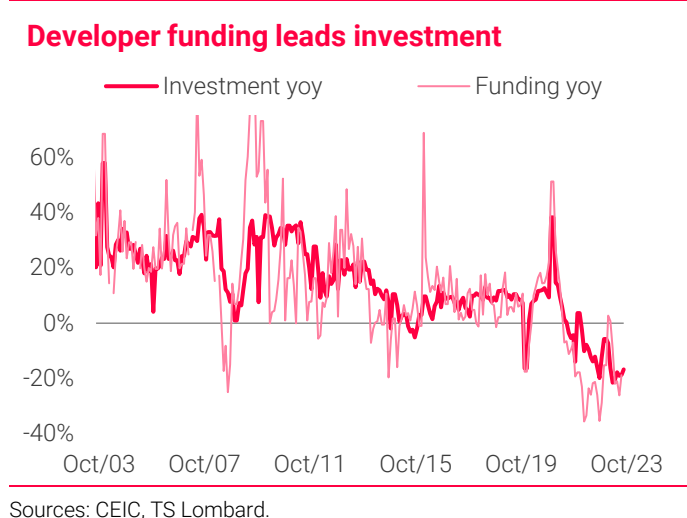


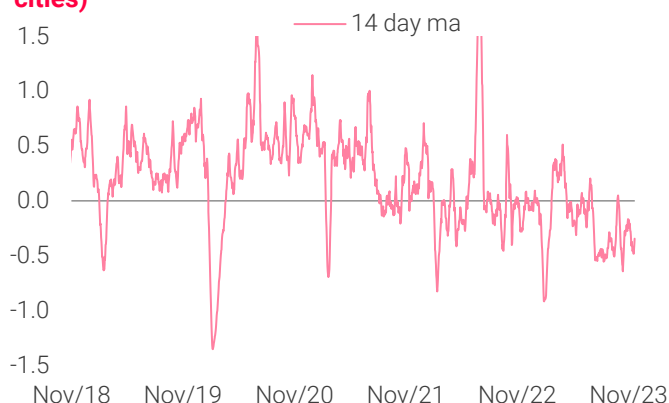
Chart 5: Property investment will fall further



stimulus approach is being maintained, the size and frequency of sector support is noticeably increasing. In the past two weeks, officials have sent clear signals to promote the “three new drivers” of property development – urban village renovation, affordable housing and urban infrastructure – including RMB1trn in funding for urban construction and the creation of a funding “whitelist” of 50 public and private developers. None of this will be sufficient to halt a deterioration in sales, but the direction of travel is clear: officials will continue to increase sector support until the pace of the property contraction moderates.

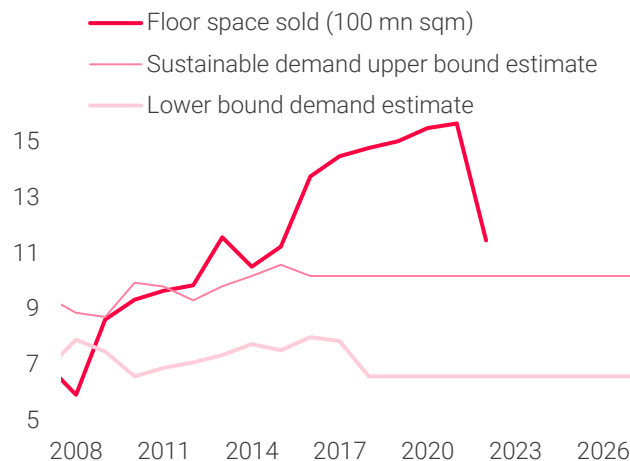
Chart 6: Property sales hammered

Z score property sales by volume (14 tier 2 cities)



Sources: CEIC, TS Lombard.

Chart 7: Contraction far from over

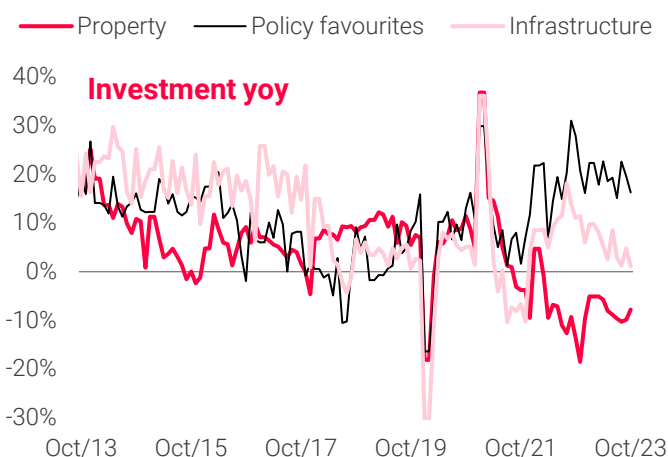


Sources: CEIC, TS Lombard.

Policy put triggered. We think Beijing is adopting a more pro-growth stance and believe that a GDP target of 5% is the minimum Xi Jinping can set for 2024. Officials have finally started to show signs of panic, with triggers for greater easing, growth target threat, financial stability and unemployment risks all flashing. The rhetoric has changed and a number of relatively more aggressive and unusual stimulus measures have come in to play, most notably on the fiscal side with the issuance of RMB1trn in sovereign debt and an expansion of the central budget deficit.

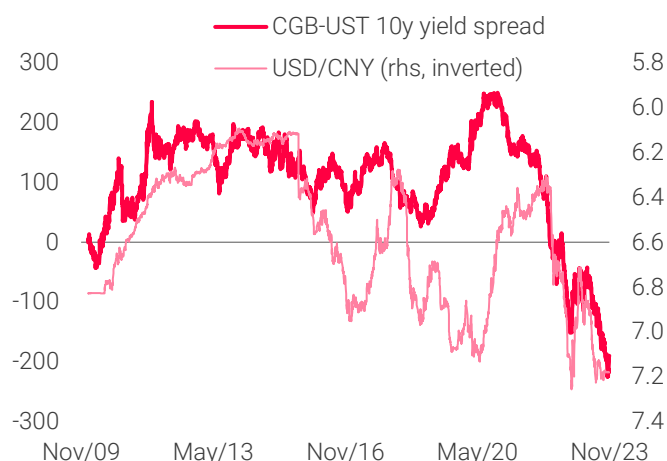
Looking ahead, the main thrust of government support in 2024 will come from continued fiscal expansion: the headline government deficit is set to expand to 3.4% from 3% set in March this

Chart 8: New growth model drives investment



Sources: CEIC, TS Lombard.

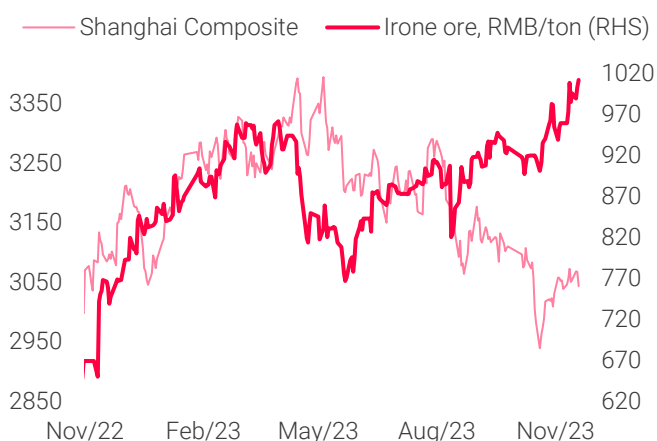
Chart 9: Growth and rate differentials to improve



Sources: CEIC, TS Lombard.

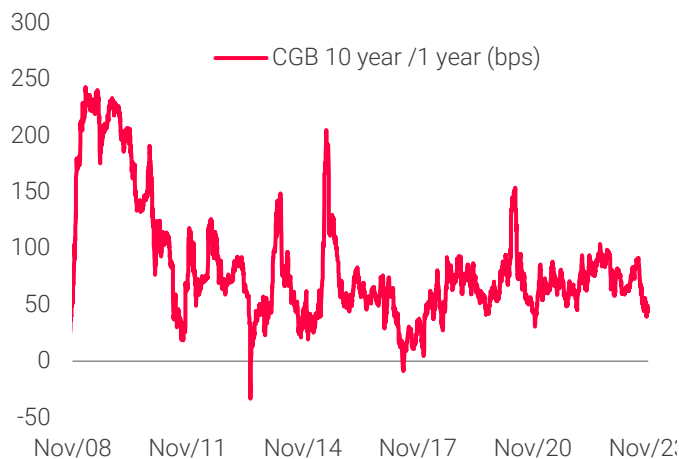
year – its highest level since 2020. At the same time, local government special purpose bond quotas are expected to reach RMB 4.2trn – one of the highest total on record. Monetary easing will take a secondary role: we anticipate 50bps of RRR cuts throughout the year and a 10-20 bps cut to the policy rate corridor. Structural lending tools for policy-favoured sectors and pledged supplementary lending (PSL) will facilitate construction activity.

Chart 10: Equities and iron ore to recouple?



Sources: BBG, TS Lombard.

Chart 11: Yield curve to bull steepen



Sources: BBG, TS Lombard.

With regard to property, policymakers will be forced into increasingly broader industry funding schemes as pressure grows from pre-sale homeowners who are yet to take delivery of unit builds. Approximately, 20mn pre-sold homes are awaiting completion. We estimate a construction cost of RMB23trn to complete all homes currently under construction. The pre-sale model, which delivered roughly 40% of developer funding, is broken: it relied on expectations of rising prices and developer solvency to drive purchases of homes before construction. Beijing will need to address both these issues if it wants sales growth to reaccelerate. We think policymakers will continue to cut rates and increase funding (partly via PSL and through PBoC's as yet untapped property lending programme), which will help slow the rate of contraction but fail to address structural imbalances.

Property is the one sector that will have an easier base of comparison. Following two years of contraction, the sector accounts for roughly 18% of GDP, down from our estimate of 25% in 2021. It has to contract approximately another 20-30% in the coming years to reach our estimate of sustainable demand (Chart 8). Taking the base effect with a larger policy put, the pace of the contraction is likely to be slower next year. Our forecast for full-year nominal sales is -10% yoy and for investment -7% yoy.

The backdrop of economic uncertainty and falling property valuations is not conducive to surging consumer spending. This year, pent-up demand helped offset pandemic scarring of labour markets, household balance sheets and confidence: services spending drove strong retail sales growth of 6.9% ytd yoy. Normalizing economic activity, income and job creation started to support spending in late Q3/23, when the savings rate began to drop marginally. Going into 2024, services-sector job creation and particularly contact services (which accounted for 60% and 20%, respectively, of all employment in 2019) will continue to gradually recover, thereby supporting income growth, a savings drawdown and consumption. Retail sales will remain well below pre-Covid trend levels but will continue to expand at 5% yoy next year.

Infrastructure improving as manufacturing remains steady. Despite accelerated local and central government bond issuance, infrastructure FAI has decelerated over the past few months. This is partly a function of the lagged impact from funding to spending and partly reflects constrained financing conditions at the local level. While the former will begin to fade, the latter will persist, capping growth at 8% yoy, with most of the pick-up in H1/24. Another factor behind subdued government investment is China's new development model. Tech hardware and innovation are prized over traditional industry. As we wrote earlier this year, "Xi wants 5nm chips more than 5% GDP". The push to reallocate resources and undertake a massive multiyear bet on "technology" shows up in advanced manufacturing investment rather than roads and rail. Our measure of "policy favourites" – a mix of clean energy, EVs and chips – has seen investment increase at 20% yoy in 2023, and that pace is likely to continue next year. These newish industries remain a small part of the overall investment mix, at ~8%, but help to lift the total manufacturing growth rate, which should also benefit from a slight pick-up in profits (PPI will turn positive) and the end of the inventory destocking cycle. We put manufacturing FAI at 6% yoy in 2024.

Exports – the last component of GDP – have been contracting mainly owing to weaker global imports as a result of the tech recession. With the semiconductor cycle starting an upswing, inventory destocking almost complete and a shift back to goods spending under way, exports should improve going into 2024 compared with this year. However, based on our forecast that subdued US and European growth, foreign trade will prove insufficient to drive activity in the PRC, we expect nominal exports to grow just 1% yoy.

How to trade this outlook? Tactically and with caution! For equities this may finally be the year in which Chinese consumer internet stocks show some life following the covid/regulatory/geopolitical hit. As regular readers will know, our long term buy and hold China equity picks are "policy favourites" (tech hardware), however valuations offer little upside. Internet companies will benefit from improving consumer spending, regulations and less inclement geopolitics. A few weeks ago we mooted a long China internet short iron ore trade as a means to hedge further property declines. The position is just in the red thanks to strong iron price gains, but with government intervention to limit iron price increases the trade looks attractive.

Turning to rates we think bull steepening is likely. The curve is near its flattest in 20 months and we think stabilizing activity, stimulus and improving PPI could see the long end rise, while the PBoC keeps short term rates loose to support property.

In FX, growth and rate differentials should move in China's favour over the next couple of months. Household capital outflows will certainly continue, but portfolio flows are moderating. We also think there is some asymmetry long RMB trades as the PBoC has committed to defend the 7.3 level. The policy put pushed us +1 Chinese FX in October. However, the current move looks overdone and we would look for entry points closer to the PBoC's line in the sand. CNY is likely to do well vs the EUR and the INR, and to a lesser extent the dollar. RMB depreciation is set to resume again in Q2.

After a disappointing reopening this year, there is little cause for excitement going into 2024. China is set to muddle through the next 12 months with expanded stimulus and normalizing labour markets partly offsetting another year of painful property contraction. In other words, a cyclical bottoming amid a structural slowdown.

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