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Flash Note

China: Jan-Feb data better than expected

We continue to expect moderate deceleration in 2018

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The first batch of 2018 Chinese data on investment and industrial production came in stronger than expectation. However, details of the data suggest that actual growth momentum may not be as strong as the numbers indicate.

Property investment rebounded to 9.9% y-o-y in the first two months of 2018 from 7.0% in 2017, while investment in the manufacturing sector and infrastructure moderated slightly. However, we do not expect the high growth in property investment to be sustainable

External demand continues to be supportive of Chinese manufacturing, but the outlook for Chinese exports is more uncertain as the Trump administration turns more protectionist.

With the wealth effects from rising housing prices fading, we expect consumption growth to moderate in 2018, but the long-term trend of rising consumption in China remaining intact.

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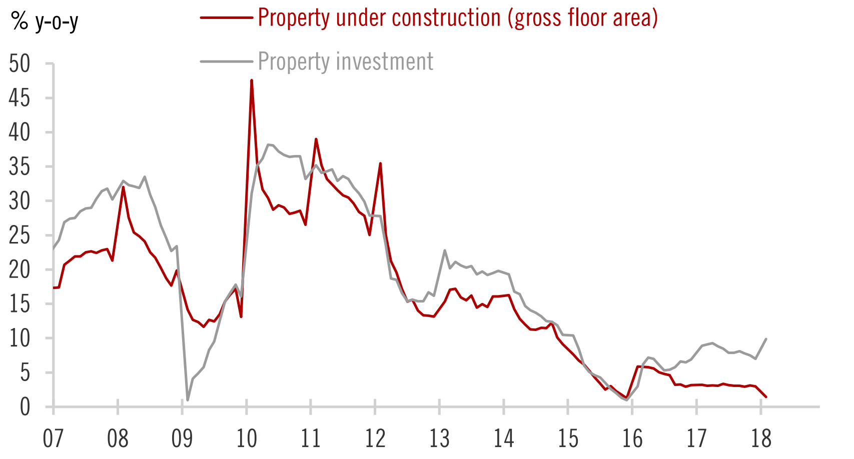
The first batch of Chinese data in 2018 on investment and industrial production came in stronger than expected, which largely dissipates the previous concerns of a sharp deceleration in Chinese growth in Q1. However, details of the data suggest that actual growth momentum may not be as strong as the numbers indicate. Retail sales were a bit weaker than expected, for example. With the wealth effects from rising housing prices fading, we expect household spending growth to moderate in 2018— although the long-term trend of rising consumption in China remaining intact.

Below are some details of the latest data releases.

Fixed asset investment (FAI) grew by 7.9% year-over-year (y-o-y) in the first two months of the year, up from 7.2% in full-year 2017. Property investment showed an especially strong rebound to 9.9% y-o-y from 7.0% in 2017, while investment in the manufacturing sector and infrastructure moderated slightly.

Chart 1: Growth in Chinese property investment and property under construction



Source: Pictet WM - AA&MR, National Bureau of Statistics of China

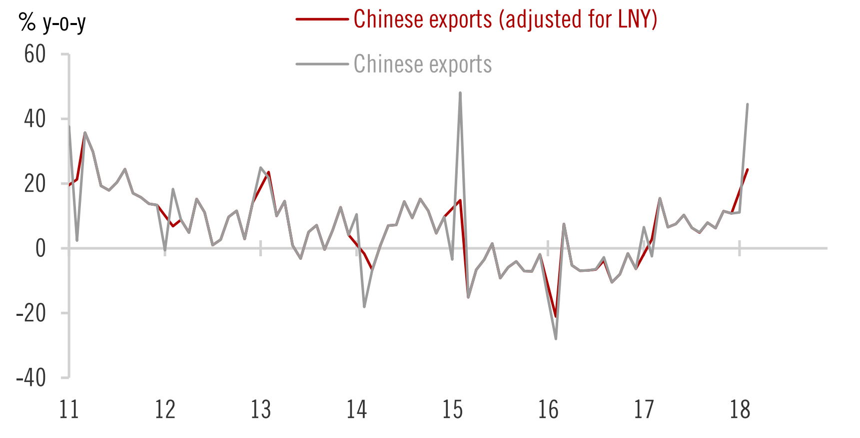
The very strong growth in property investment is surprising, especially in the context of the government's tight control on housing speculation and cooling market transactions. In our view, the rise in investment may be partly due to the property developers' strong land acquisitions in late 2017, the value of which is counted in property investment and amortised over time. But actual construction activity is far less strong, as shown by the declining growth in property under construction (measured in gross floor area; *Chart 1*).

As the growth in housing sales and new project starts continues to decline, we do not expect the high growth rate in property investment seen in the first months of the year to be sustainable. On the other hand, housing inventory remains at low levels. Unsold housing totalled 302 million square metres by the end of February 2018, which was 35% less than the peak reached two years ago and was roughly equivalent to the level of late 2013. Low inventory should provide some support to property construction going forward, and the potential downside to property investment might be fairly limited.

Industrial production was also stronger than expected, growing by 7.2% y-o-y in the first two months of the year, up from 6.2% in 2017. The mining and utilities sectors showed an especially strong rebound, while growth in the manufacturing sector was fairly stable. External demand continues to be supportive to Chinese manufacturing sector for the moment. In February, Chinese exports surged by 44.5% y-o-y. While this figure was likely distorted by the lunar New Year, adjusted growth (combining the January and February data) was still over 24%, indicating that global demand remains strong (*Chart 2*).

However, the outlook for Chinese exports is more uncertain as the Trump administration turns more protectionist. So far the tariffs announced on steel and aluminium may only have limited impact on Chinese exports, but we cannot exclude the possibility that Trump imposes high tariffs on a broader range of Chinese products. At the moment, a full-blown trade war between the US and China is not our base-case scenario, but the risk of more destructive trade friction is definitely rising.

Chart 2: Growth in Chinese exports



Source: Pictet WM - AA&MR, China Customs

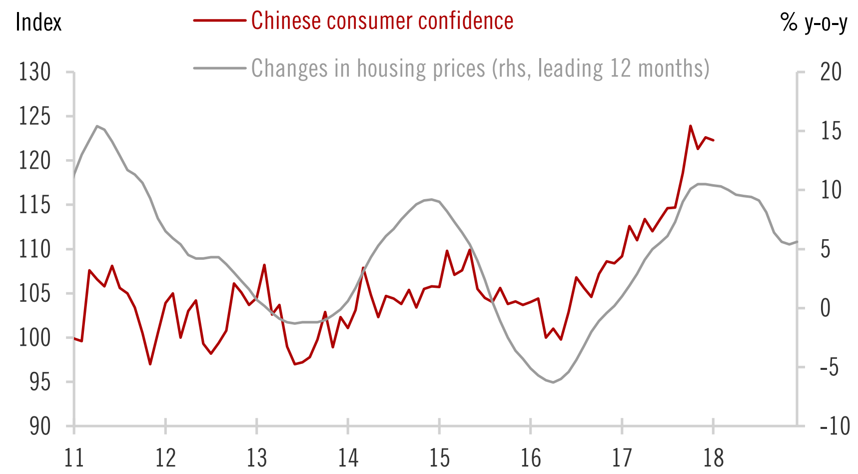
Retail sales grew by 9.7% y-o-y in January and February, slightly below the market expectation of 9.8% but higher than growth of 9.4% in December 2017 and 9.5% in the same period last year. Auto sales picked up from low levels, rising 3.9% y-o-y in the first two months combined, compared to average growth of 2.4% in Q4 2017. SUV sales continued to do better than car sales in general, rising 11.6% y-o-y in January and February. Online sales held up strongly, rising 43% y-o-y, significantly higher than the growth in retail sales as a whole.

Looking ahead, we expect the growth in consumption to moderate in 2018 as the wealth effects associated with rising housing prices start to fade. Since

2010, there has been a fairly close correlation between the changes in housing prices and Chinese consumer confidence, with the former leading by roughly 12 months (*Chart 3*). In our view, the sharp rise in housing prices since 2016 likely contributed to the strong growth in consumption of the past two years. With housing prices rising at a much lower pace in response to the government's tightening policies, the growth in consumption may also slow.

However, the long-term trend of rising Chinese consumer spending will likely remain intact, as it is driven by structural factors such as the shift in the demographic structure, the expansion of the middle class and changes in the Chinese growth model. We expect consumption to continue to be the most important contributor to GDP growth going forward.

Chart 3: Chinese consumer confidence and changes in housing prices



Source: Pictet WM - AA&MR, National Bureau of Statistics of China

To summarise, the latest data releases regarding Chinese economic activity are general upbeat, especially for FAI and industrial production. However, the underlying growth momentum seems consistent with our expectation of some moderation in growth in 2018. As a result, we are keeping our GDP growth forecast of 6.5% for China in 2018 unchanged for now.

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