CHINA: Q2 GROWTH LOWEST IN DECADES

DOWNWARD PRESSURE PERSISTS AMID TRADE TENSIONS

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SUMMARY

- Chinese real GDP growth came in at 6.2% year-over-year (y-o-y) in Q2, down from 6.4% in Q1, and the lowest quarterly growth in over two decades.
- The tertiary sector (mainly services) continued to lead growth, expanding by 7.0% y-o-y in Q2, the same as in Q1. In comparison, growth in the secondary sector (mainly manufacturing) declined to 5.6% y-o-y, from 6.1% in the previous quarter.
- From an expenditure perspective, consumption contributed 3.8% to the 6.2% headline growth in the first half of the year, while capital formation and net exports contributed 1.2% and 1.3% to headline growth, respectively.
- Lingering impact of deleveraging policies and the damages by the trade disputes will likely continue to create headwinds to Chinese growth in the second half of the year.
- We expect the Chinese government to maintain its policy easing to limit the downside risk. However, the government's policy response will be event and data dependent. Without the significant further escalation of trade tensions, the policy response may remain measured and contained.
- Recent data for June show some early signs of stabilisation in the economy, especially in consumption and industrial production. However, they do not necessarily represent a decisive turning point yet, in our view. But we expect growth to pick up moderately in Q4 as policy easing gradually feeds into the economy, especially in the space of infrastructure investment.

Further deceleration in Q2

China's latest GDP report shows that the total output of the economy amounted to Rmb23.75 trillion (roughly USD3.45 trillion) in the second quarter of 2019. In real terms, the economy expanded by 6.2% y-o-y, slightly below the consensus and our own forecast of 6.3%, and down from 6.4% in the first quarter of this year. This is the lowest quarterly GDP growth for China in more than two decades. For the first half as a whole, the Chinese economy has expanded by 6.3% compared to last year.

On a quarter-over-quarter (q-o-q) basis, our own seasonal adjustment shows that Q2 growth likely slowed to 5.9% annualised, compared to 6.6% in the previous quarter.

The tertiary sector (mainly services), which accounts for over half of the economy, continued to lead growth, expanding by 7.0% y-o-y in Q2, the same as in Q1. In comparison, growth in the secondary sector (mainly manufacturing) declined to 5.6% y-o-y from 6.1% in the previous quarter. Growth in the primary sector improved to 3.3% in Q2 from 2.7% in Q1 (*Chart 1*).

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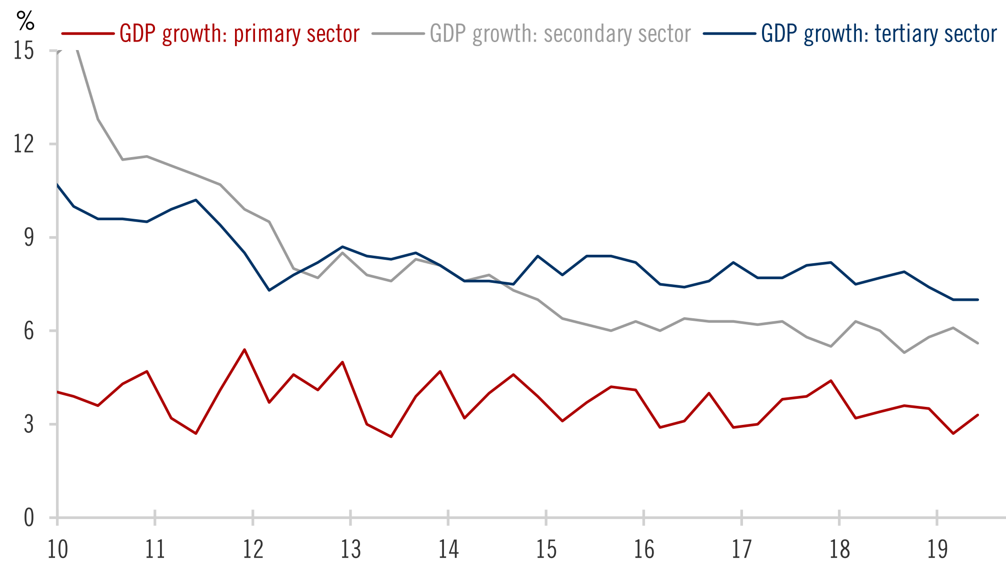
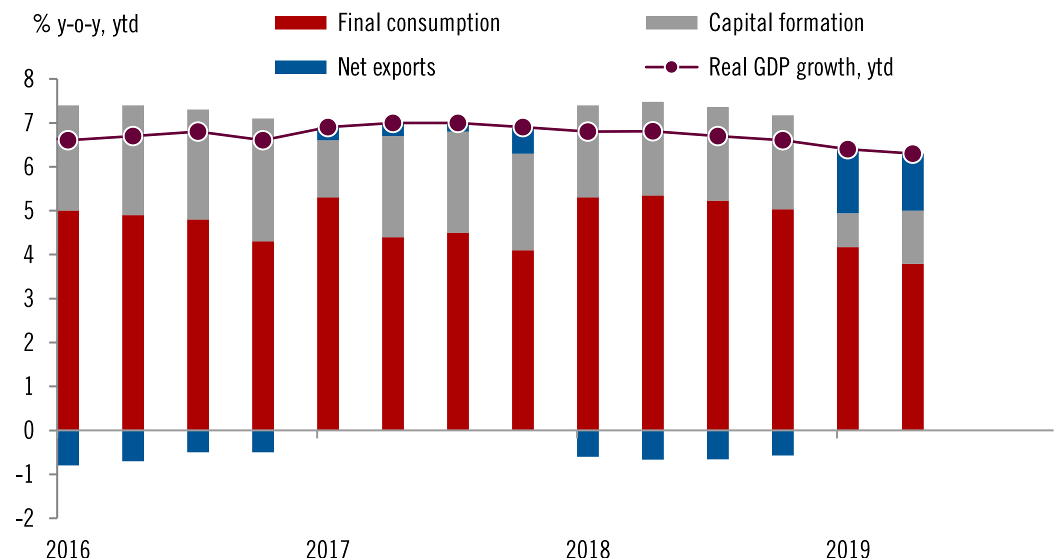
CHART 1: GROWTH IN REAL CHINESE GDP BY SECTOR



Source: PWM - AA&MR, National Bureau of Statistic of China

From an expenditure perspective, consumption continued to be the largest contributor to growth in the first half of 2019, adding 3.8% to the headline growth of 6.2% (61.3% of the total). But this is lower than the sector's contribution of 4.2% in Q1, implying a slowdown in consumption growth in the second quarter. Capital formation added 1.2% to the headline growth in the first half of the year, rising significantly from 0.8% in Q1. Finally, net exports continued to contribute to growth in Q2, but to a lesser degree than in Q1. As a result, its contribution declined to 1.3% in the first half of the year, down from 1.5% in Q1 (*Chart 2*).

CHART 2: GROWTH IN REAL CHINESE GDP (YTD) BY SOURCE OF DEMAND



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

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Downward pressure persists

In our view, the deceleration in Q2 is part of a long-term downward trajectory in Chinese growth, due to a declining working-age population and moderating productivity growth. In addition, earlier government policies that forced a deleveraging of the economy and the elevated trade tensions with the US have also contributed to the cyclical downturn.

Although deleveraging is no longer a policy priority after growth started to weaken early last year, its impact on the Chinese financial system still lingers, especially in the shadow-banking sector, affecting small and medium-sized enterprises (SMEs) and various local-government financing vehicles (LGFVs).

On the trade front, we believe the renewed truce between the US and China following Trump and Xi's G20 meeting in Osaka could be fragile, given the deep-rooted differences between the two countries in many areas, including ideology, the pursuit for technological supremacy and geopolitical interests. The poor prospect of reaching a lasting agreement in the near term could continue to weigh on business sentiment and corporates' incentive to invest both domestically and globally.

In addition, the direct damage of tariffs on Chinese exports will likely become more severe going forward as the effect of the tariff rate hike on USD200 billion of Chinese goods from 10% to 25% starts to show up and the impact of export front-loading fades.

These factors, especially the direct and indirect damages related to trade tensions, will likely continue to create headwinds to Chinese growth in the second half of the year.

Policy provides support but no massive stimulus

In the presence of such downward pressure, we expect the Chinese government to maintain its policy easing to limit the downside risk. Since Q2 last year, the PBoC started to ease its monetary policy by lowering required reserve ratios (RRR) for commercial banks, followed by fiscal stimulus toward the end of the year, mainly in the form of tax cuts for households and corporates, and supplemented by increased fiscal spending.

Although policies are clearly geared towards easing, the magnitude of the stimulus so far is fairly conservative, in our view. Taking monetary easing as an example, this time around the rebound in the growth of total social financing (TSF), a gauge of aggregate credit in the economy, is much more muted than in previous episodes of monetary stimulus (*Chart 3*). On the fiscal front, the scale of the tax cuts is indeed unprecedented in China, but the impact of tax cuts on the economy is likely much less direct and will take a longer time to materialise than the usual approach of increasing government expenditure.

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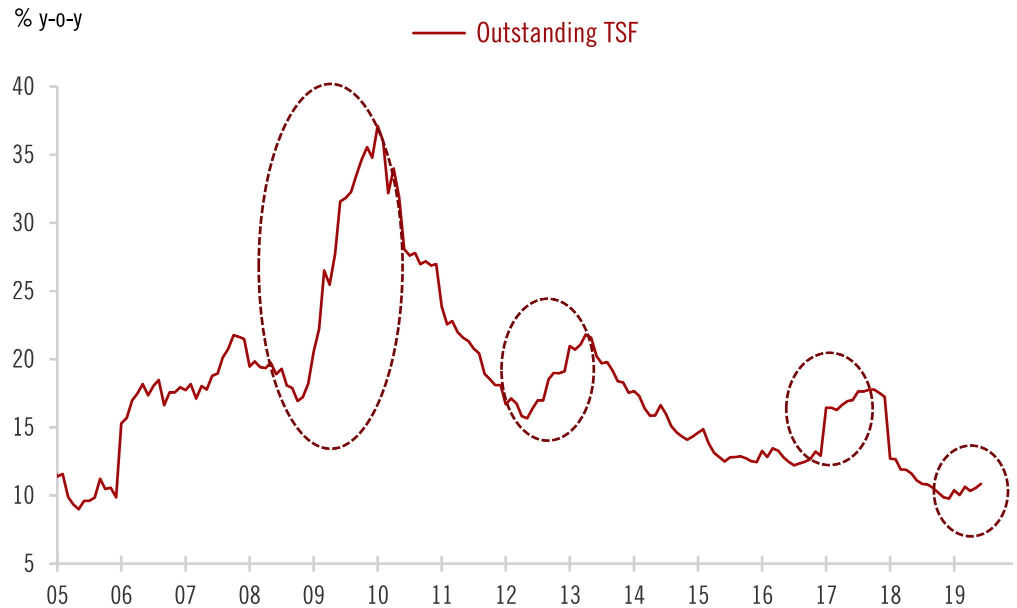
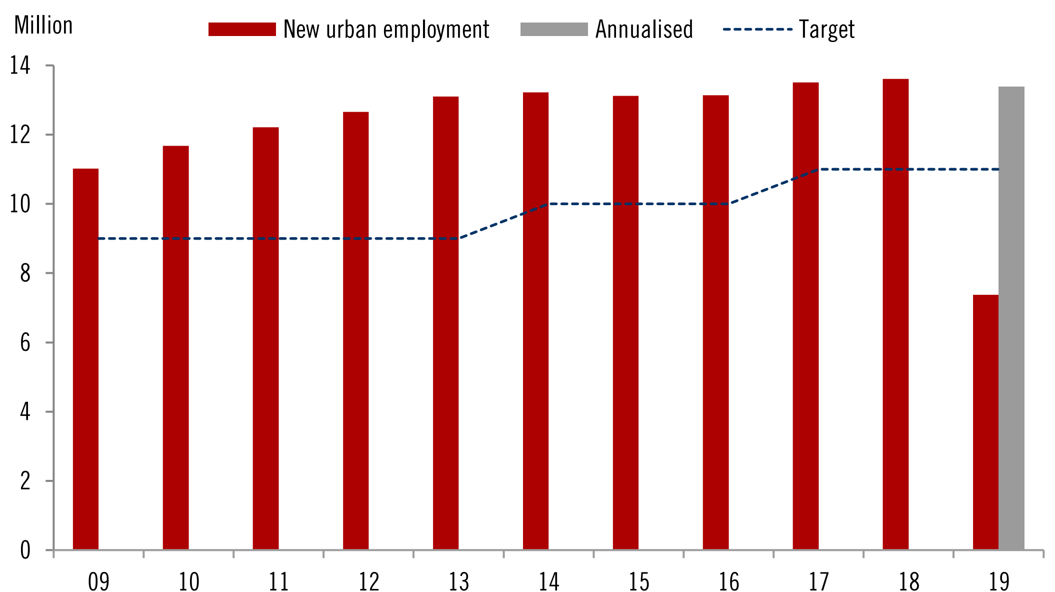
CHART 3: GROWTH IN THE OUTSTANDING BALANCE OF TSF



Source: PWM - AA&MR, PBoC

The restrained policy response may point to the government's preference of avoiding boosting short-term growth at the price of long-term sustainability, which is a principle highlighted by the Chinese leadership in recent years (see *Flash Note: China: PBoC cuts banks' required reserve ratios again, 8 October 2018*).

CHART 4: NEW URBAN EMPLOYMENT IN CHINA



Source: PWM - AA&MR, Ministry of Human Resources and Social Security of China

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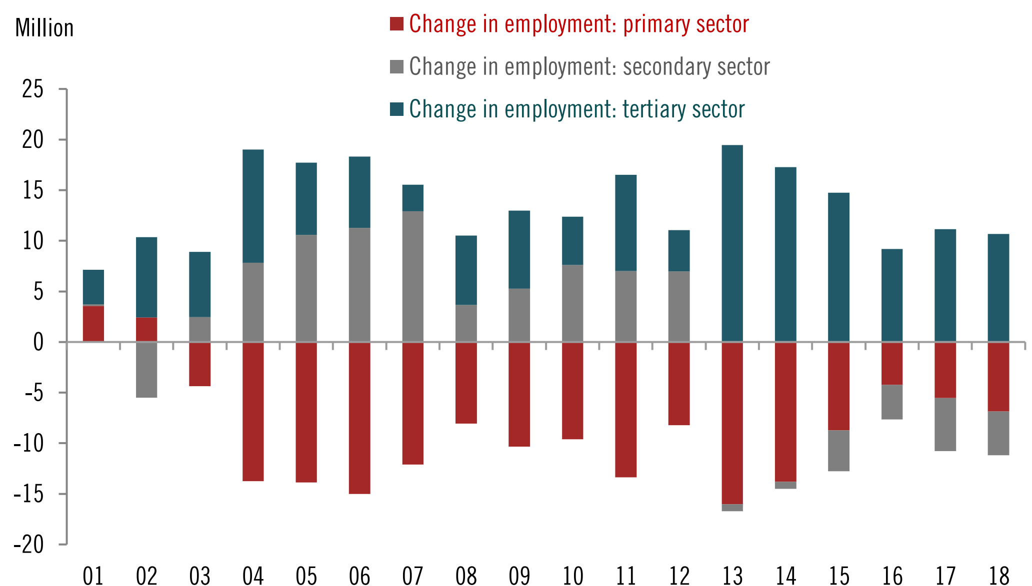
Another factor that has likely allowed the Chinese government to stay calm is the stable labour market. In the first half of 2019, new urban employment amounted to 7.4 million jobs (13.4 million annualised). While this is slightly below the 13.6 million of new employment actually created in 2018, it is still significantly higher than the government's target of 11 million for 2019 (*Chart 4*). Unemployment was at 5.1% in June, slightly higher than in the previous two months (5%), but within the government's target of 5.5%.

The stellar labour-market performance may seem puzzling as it contradicts with the gloomy picture depicted by the latest manufacturing PMI surveys, where the employment sub-index in June was at a historical low and even worse than the time when the global financial crisis hit (see *Flash Note: Asia: Manufacturing in contraction, 10 July 2019*). The answer to this puzzle lies in the fact that while employment in the manufacturing sector is indeed declining, the loss is more than compensated by the increase in employment in the services sector, a trend that started in 2013 (*Chart 5*). In line with the fairly stable employment conditions, growth in the average urban disposable income in Q2 actually picked up slightly.

CHART 5: CHANGES IN EMPLOYMENT BY SECTOR



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

Against this backdrop, we expect the Chinese government's policy response in the second half of the year to be event and data dependent. To a large extent, it will be determined by the development of the US-China trade dispute. In the absence of significant further escalation in trade tensions, we expect Chinese government's policy response to remain measured and contained, although no change in its easing stance.

On the monetary front, we expect the PBoC to cut the RRR by another 100bps, possibly in Q3. But part of the liquidity released will be used by banks to pay back the medium-term lending facility (MLF) loans that are to mature and the net increase of liquidity will be moderate. Market interest rates will likely be kept low. The likelihood of cuts in the traditional benchmark deposit and lending rates is low, as these rates have become less

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relevant in guiding banks' pricing behaviours and will likely be abandoned in the future, in the context of broad interest rate reform.

On the fiscal front, the focus will likely be continued implementation of the previously announced tax cuts, as well as the newly announced policy that allows the proceeds of special local government bonds to be used as seed capital in selected infrastructure projects. In addition, there could be more measures to support home appliance consumption going forward, although the impact of such measures may be limited.

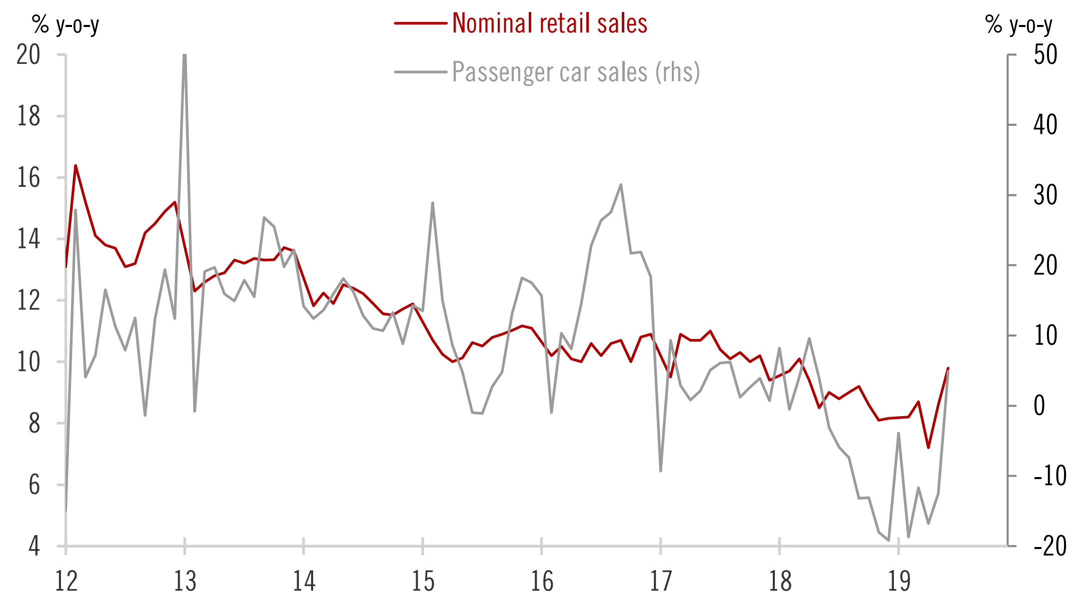
Regarding currency, as we have elaborated before, we do not expect the Chinese government to resort to currency devaluation to counter the impact of the trade war (see *Flash Note: Currencies: Chinese renminbi, 25 July 2018*). The likelihood for the USD/CNY to breach 7 is low at this stage, especially as the Federal Reserve has turned dovish, which puts pressure on the dollar, and the US and China have resumed trade talks.

Early signs of stabilisation but no turning point yet

Recent data in June show some early signs of stabilisation in the economy, especially in consumption and industrial production. Fixed-asset investment also saw some improvement in June (FAI).

On the consumption front, growth in retail sales rebounded in June to 9.8% y-o-y from 8.6% in May and 7.2% in April. Auto sales were the main driver. After staying in negative territory for 12 consecutive months, auto sales bounced back to positive growth in June (+4.9% y-o-y, *Chart 6*).

CHART 6: GROWTH IN RETAIL SALES AND PASSENGER CAR SALES



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

Growth in industrial production also bounced back after two consecutive months of decline, coming in at 6.3% y-o-y in June, compared to 5.0% in May. The improvement was broad-based, although more in the mining sector than in manufacturing.

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Last but not least, some green shoots are in the FAI space as well. Fixed investment expanded by 5.8% y-o-y in the first half of the year, compared to 5.6% in the first five months. Growth in manufacturing investment rose for the second consecutive month in June after dropping sharply in early 2019. Growth in infrastructure investment also edged up slightly. Growth in property investment moderated somewhat in June but remained at elevated levels.

Although these are encouraging developments, they do not necessarily represent a decisive turning point yet, in our view. The downward pressure from the external sector is mounting and will likely weigh on industrial activities ahead, especially as the effect of the tariff rate hike starts to show up in actual trade data.

In addition, some idiosyncratic factors may have also contributed to June's rebound in data, and thus it may not be a lasting trend. For example, new vehicle emissions standards were scheduled to be implemented in over 20 Chinese provinces on 1 July. As a result, many auto makers and distributors conducted large-scale promotional campaigns to clear their inventory before the new standard rolled out. This could have contributed to the strong rebound in auto sales in June, but will not be lasting.

For these reasons, we remain fairly cautious about China's near-term growth outlook in Q3, given the various headwinds. But we expect growth to pick up moderately in Q4 as policy easing gradually feeds into the economy, especially in the space of infrastructure investment, the growth rate of which is still at low levels. We also expect consumption to hold up well in H2 2019, supported by the resilient labour market conditions and cuts in personal income tax. At this point, our full-year Chinese GDP forecast of 6.3% for 2019 remains unchanged.

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