18 July 2023

China holiday wrap-up

Growth revised lower again, US-China tensions ease

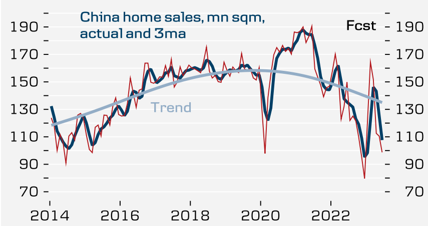
Economics:

- **Data wrap-up – more downside risks:**
  - **GDP weaker than expected**: Chinese GDP for Q2 was up 0.8% q/q, which was in line with expectations but the annual growth rate disappointed at 6.3% y/y vs consensus of 7.1% y/y. In nominal terms growth was only 4.8% y/y pulled down by a decline in the deflator of 0.7% y/y. It was the biggest decline since the global financial crisis in 2008 and shows that in GDP deflator terms, China is already seeing mild deflation.
  - **Housing and exports weigh on economy:** Key weak spots are the two important sectors housing and exports, which together represent roughly 40% of the economy. The level of home sales dropped further in June to a level 25% below the long-term trend. House prices also declined in June, for the first time since December, with new home prices down 0.1% m/m while existing home prices dropped 0.4% m/m. Export growth moved lower in June to -12.4% y/y from -7.5% y/y in May. Foreign sales were strong during the pandemic due to high goods demand in US and Europe but weak goods consumption since then has hampered Chinese sales.
  - **Consumption holding up:** Retail sales were weaker than expected in June falling back to 3.1% y/y (consensus 3.3% y/y) down from 12.7% y/y. The decline is partly due to base effects, though, and looking at the level of retail sales it still shows a decent trend. However, with consumer confidence waning and other parts of the economy being weak, it is key that the government provides further support for the consumer engine.
    - **Consumer stimulus:** On Tuesday, China released an *11-point package* aimed at "*unleashing the potential of household consumption*". It includes support for households to buy new smart home appliances and improved access to credit to buy household products. Director of the National Development and Reform Commission's policy research office Jin Xiandong, stated that "*People's ability and expectation of consumption is still rather weak and the infrastructure and environment for consumption need to be improved*".
  - **Credit growth higher in June:** Aggregate finance increased a bit more than expected but the numbers are very volatile so I prefer the credit impulse instead, which looks at the change over six months. It still points to GDP growth around 4½-5% and PMI levels around 50. Credit growth is weighed down by lacklustre housing finance and low credit demand for investments from private companies whereas infrastructure finance underpins it.

Weaker Q/Q GDP growth in Q2

Source: Macrobond Financial, NBS

Home sales fell back again in Q2



Source: Macrobond Financial, NBS, Danske Bank

Level of retail sales holding up so far

Source: Macrobond Financial, NBS, Danske Bank

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– **Flirting with deflation:** Chinese CPI inflation was 0.0% in June but excluding food consumer prices declined 0.6% y/y, so you can argue China is already in deflation. It highlights the weak demand and excessive inventories. Since inflation is falling faster than nominal rates, the real rate has increased.

- **More stimulus needed:** As the run-down highlights China needs more support to sustain growth and the government is gradually rolling this out. <u>However, following the weak Q2 data I have revised down my forecast yet again for 2023 to 5.2% from 5.8% and to 4.6% in 2024 from 4.8%.</u> To reach the government's 5% target, China needs to grow around 1% q/q in Q3 and Q4 and thus slightly stronger than in Q2. As seen from my forecast, I still expect this to be realized as I look for the drag from exports to come down a bit in H2 as the CNH has weakened and there are some signs of a moderate turn higher in global manufacturing in H2 in some of our models. More Chinese support measures for housing and monetary stimulus (rate cuts and reduction in Reserve Requirement Ratio) are also expected to drive a moderate improvement in housing from Q2. However, overall stimulus is likely to be moderate and mainly aimed at keeping growth close to the 5% growth target.

- **More charm offensive towards private and tech sector:** In its' quest to lift confidence in the private sector and not least among tech companies, the Chinese government *continues the charm offensive* highlighting the central role tech companies play in China's development and innovation. China's premier Li Qiang spoke at a symposium with China's leading digital companies, including Alibaba, Meituan and JD.com, where he also pointed to the sector providing new channels of employment and entrepreneurship. China's National Development and Reform Commission, vowed further support for platform operators. While the message is important to remove the uncertainty of the government's commitment to the private sector, it will be hard to lift confidence until the companies see sustained stronger demand as well.

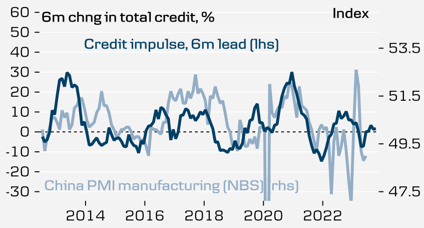
<u>Markets:</u>

- **Stocks:** Chinese equities continues a seesaw pattern at a low level as growth risks continue and stimulus expectations are low. A lot of bad news are priced into markets but until we see a turn in the global manufacturing cycle lifting Chinese exports, Chinese stocks are likely to continue to trade at low levels.

- **USD/CNH lower, EUR/CNH higher:** The yuan has finally seen some respite versus the dollar, but it is mostly an image of dollar weakening following the low US CPI print last week. USD/CNH moved has moved lower from 7.27 in early July to 7.17. However, the EUR/CNH has continued the trend higher in tandem with the increase in EUR/USD. Until we see signs of the USD depreciation fading, momentum is likely to continue higher in EUR/CNH.

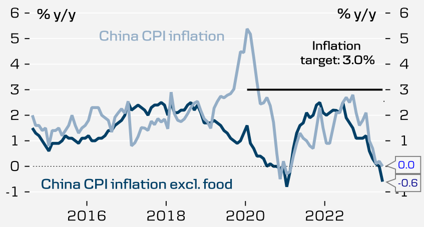
- **Bond yields lower:** Chinese 10-year bond yields have continued lower over the past weeks as expectations of monetary policy easing increases. The 10-year yield level now stand at 2.64%, close to the lows seen in the autumn last year before the economy was reopened from covid lockdowns

Credit growth underpinning the economy



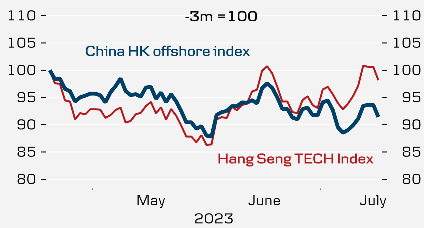
Source: Macrobond Financial, NBS, Danske Bank

Deflation outside food



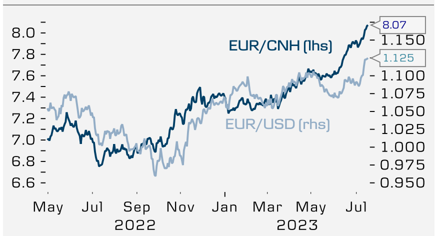
Source: Macrobond Financial, NBS, Danske Bank

Stocks range trade at low level



Source: Macrobond Financial, Bloomberg

EUR/CNH continue trend higher



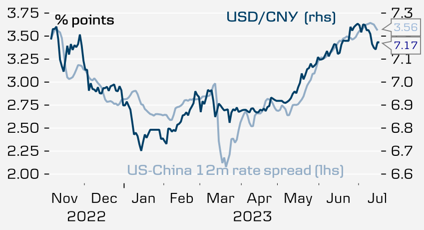
Source: Macrobond Financial, Bloomberg

Geopolitics:

Yellen visit to Beijing underlines more dialogue: US Treasury Secretary Janet Yellen was on a four-day visit last week in China in yet another sign that communication is back on track. Yellen seemed to bring a *message to China* that the goal of the US is not to hold China's development back but rather to diversify supply chains and have restrictions in place when national security is at stake. Is the US getting concerned that China will move too far in self-reliance due to US export restrictions? That is clearly the risk of the current strategy, which could end up hurting US businesses as they gradually lose market share in China. It is already be happening with for example *Boeing getting fewer orders* relative to Airbus. The US Semiconductor Industry Association *has also warned* that further chip curbs on China could hurt American companies competitiveness as they miss out on important revenues needed for R&D to stay ahead.

It is hard to know exactly what the motive is behind the softer approach by the US administration, but there does seem to be a change in signals. However, Beijing does not seem to buy it and has complained louder and louder about the US tech restrictions. It culminated lately with restrictions on Chinese exports of two rare earth elements used in chip production and other tech manufacturing. Xi Jinping has openly talked about suppression of China by US and its' allies and China is set to continue efforts to become more independent on US technology to reduce its vulnerability to new trade sanctions in the future. Yet, it is positive that dialogue is on the table and at least we have not seen a tit-for-tat escalation following the recent Chinese announcement on the rare earth elements restrictions. Also in the area of climate, dialogue is resuming with US climate envoy *John Kerry visiting China* this week.

USD/CNY lower in past weeks



Source: Macrobond Financial, Bloomberg

Bond yields back to autumn lows

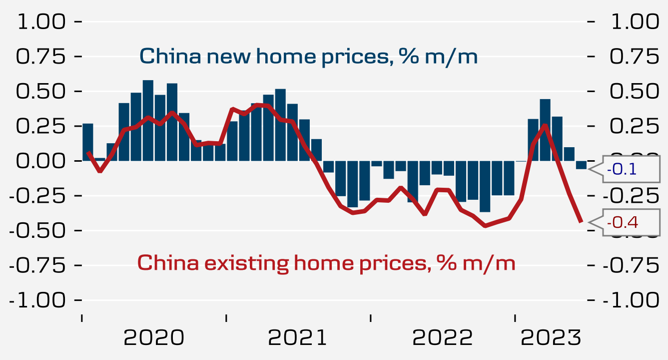
Source: Macrobond Financial

- **New US investment to have narrow focus:** The US has been preparing a ban on US companies' technology investments in China for a long time, which points to some internal disagreements on how wide they should be. According to Bloomberg today the plan *will end up being narrowly focused* on investments within AI, semiconductors and quantum computing. Areas the US sees as crucial to stay ahead for military purposes and keep China from developing improved military capabilities using US technologies.
- **Germany releases new China strategy:** Germany finally released its first *China strategy*, which has been some time under way. Internal divisions between the hard-line Greens party in the government represented by foreign minister Annalene Baerbock and a more pragmatic line by German Chancellor Olaf Scholz of the SPD have led to a strategy representing a compromise. It is on the one hand clearly critical of China in areas of human rights and foreign policy and also points to the need for diversifying supply chains and reducing dependence. At the same time, it underlines continued cooperation and trade as key pillars in the future and it leaves flexibility for businesses and trade organisations to continue to pursue opportunities in the Chinese market. The way the strategy is actually implemented also remains to be seen.
- **NATO Summit with Asian participants:** While the Ukraine war is of course the present focus of NATO, the Summit in Vilnius last week left little doubt that China is looming in the background as the main long-term focus of the alliance. A communique from the Summit stated that Beijing's ambitions posted "*systemic challenges*" to "*Euro-Atlantic security*" and it referred to "*mutually reinforcing attempts to undercut the rules-based international order*" by Moscow and Beijing. The view from China on the other hand is that NATO is causing uncertainty about other countries' security with block mentality, policy of encirclement via gradual expansions of the alliance and that the rules in the rules-based order only applies when it suits the US (the usual example

mentioned is the second Iraq war taking place despite *violating international law*). China sees NATO de facto *expanding into Asia* despite being a North-Atlantic organisation as part of an encirclement strategy of China. The four Asia-Pacific countries Japan, South Korea, New Zealand and Australia (the so-called Indo-Pacific 4 Four or IP4) were all represented at the Vilnius Summit. NATO also had plans to open an office in Japan, but this has been *vetoed by France*.

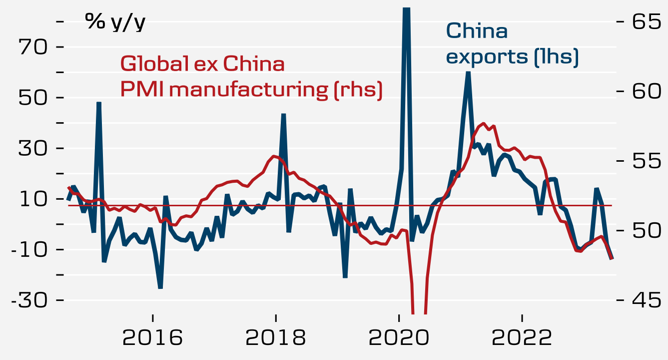
More charts

China home prices down in June



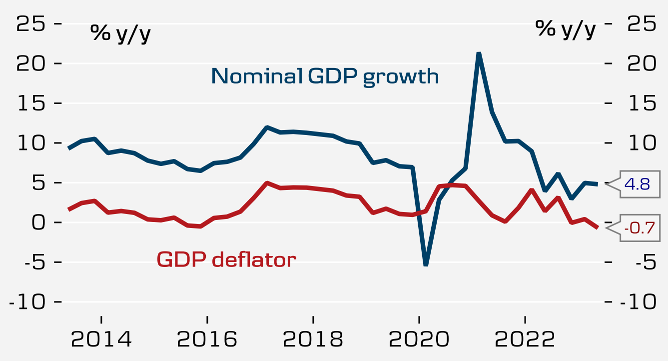
Source: Macrobond Financial, NBS

Downbeat China exports as global manufacturing still weak



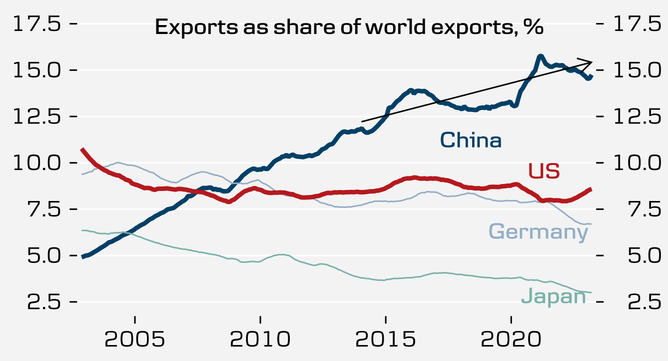
Source: Macrobond Financial, GAC

Nominal GDP growth still low in Q2 and deflator in negative territory



Source: Macrobond Financial, NBS

China global export market share still trending higher but down from peak levels seen during pandemic



Source: Macrobond Financial, GAC

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