China

Short-term pain, long-term gain

• We expect growth to slow further in the short term but look for a gradual recovery during 2019 on the back of more stimulus and a trade deal.

• The ceasefire in the trade war is good news and we believe it paves the way for an end to the US-China trade war in 2019.

• We look for more policy easing next year and for USD/CNY to rise to 7.20 in 12 months, giving support to exports.

• A further escalation of the trade war is the main short-term risk for China. Debt and property markets are still medium-term risks.

• 2018 is the 40-year anniversary of the ‘reform and opening’ policy. China has taken steps to speed up opening for investments and trade.

• We expect China to continue the catching-up process and to surpass the US economy by 2030. A long-term rivalry with the US has only just begun.
Growth set to get worse before it gets better

The US-China trade war as well as financial tightening over the past years have taken their toll on Chinese growth this year. After a decent start to 2018, the Chinese economy slowed down over the summer and into the autumn. Stock markets are down more than 20% since Trump kicked off the trade war in May and economic indicators across the board have pointed to weaker demand. Export companies have taken a hit and the heightened uncertainty has restrained private investments as well. Consumers have also held back on big ticket purchases such as cars. The trade war with the US hit China when a slowdown was already under way due to the campaign to fight financial risks through deleveraging and a crackdown on shadow banking.

In the short term, we expect growth to suffer further. Exports will hit a vacuum in Q1 as some exporters have pushed forward shipments to Q4 due to the possibility that the announced increase in US tariffs from 10% to 25% on goods worth USD200bn will go ahead and be implemented on 1 January. However, we do not expect China to have a hard landing. The stimulus already provided will increasingly kick in during 2019 and we expect new stimulus to further underpin demand. In addition, we are cautiously optimistic that the US and China will be able to negotiate a trade deal during 2019. Since May, US President Donald Trump has been keen to say that ‘now is not the time to talk to China’ – most likely because he felt his hand has been strengthening as long as the US markets and economy are strong while the Chinese markets were selling off. However, this picture seems to be changing. We are seeing signs that US markets are becoming more wobbly and some indicators suggest that growth is slowing a bit. Therefore, Trump might not be able to retain the stronger hand in the poker game with China. We see this as the main reason for the recent ceasefire and his wish to re-start trade talks. We also believe he wants a trade deal before going into the 2020 election year.

We expect that the Chinese property sector will support growth in 2019. Lower yields normally feed through to higher home sales (see chart to the right) and given that inventories of empty houses are generally low, the construction sector should see decent activity over the coming year.

Risk factors: trade war and financial developments

The key risk for China is that Trump will be unhappy with Chinese concessions and decide to escalate the trade war further after the 90-day truce agreed upon at the G20 meeting. In that case, we could be looking at US tariffs on all Chinese goods. This would clearly prolong the downturn in China.

Another risk is the continued high debt level, which China has built up over the years, as well as the more interconnected financial system. China has been forced to slow down the deleveraging campaign due to the trade war. The economic slowdown and tighter financial conditions have led to a rise in bankruptcies, not least among developers. In some ways, we see more defaults as a healthy process, as more ‘zombie’ companies are closed and inefficient companies are not bailed out. However, it should be watched closely in case it spins out of control.
More policy easing and weaker CNY

China has taken many steps to ease policy to compensate for the trade war headwinds:

First, monetary policy has been eased through a reduction in the Reserve Requirement Ratio three times since April. It has freed up liquidity that has fuelled a big decline in money markets rates. This in turn has been the driver behind a 10% weakening of the CNY versus USD. We look for a further weakening of CNY to 7.20 versus the USD in 12 months from the current level of 6.95.

Second, China has announced plans to boost bond financing for private firms to ease the credit squeeze in the private sector. It has also signalled bank lending targets for the private sector, not least aimed at small and medium-sized companies that are feeling the pinch from the trade war and shadow banking crackdown.

Third, China has increased infrastructure spending as the government has given the go-ahead for a series of urban infrastructure projects after a 12-month pause.

Fourth, household taxes have been reduced by raising the tax-free threshold, expanding the income range for lower tax brackets and adding new tax deductions. We expect more stimuli in 2019 through further tax cuts to households and a reduced tax burden for businesses. Lower taxes for the corporate sector and small businesses fit well into a long-term goal to reduce costs for the business sector - a central part of China’s supply side reforms. We also look for a further reduction in the Reserve Requirement Rates for banks in Q4 18.

‘Reform and opening’ speed up

This year marks the 40-year anniversary of the ‘reform and opening’ policies, which started in December 1978 under Deng Xiaoping. Since then, China has moved along the ‘reform and opening’ path step-by-step in the usual gradualist way in China. However, criticism has increased not only from the US but also the EU and Japan, among others, of protectionist behaviour and failing to create a level playing field between foreign and local companies. This year, China has taken many steps to continue opening up as well as pushing along the reform processes further. According to the IMF article IV Consultation report published on 26 July 2018, China’s ‘reforms progressed in several key areas. A wide range of regulatory reforms reduced financial sector risks, overcapacity reduction progressed, anti-pollution efforts intensified and opening-up accelerated recently’. The IMF also stressed, though, that it is vital that reforms continue in a wide range of areas.

China’s policies focus increasingly on quality over quantity, increased efficiency in the state-owned sector, closing ‘zombie’ companies, rebalancing the economy towards new growth drivers, a rising role for innovation and technology, fighting financial risks, eliminating poverty and reducing inequality across regions and incomes. Xi Jinping has stressed his support for the private sector after concerns had mounted that the government would increasingly prioritise the state sector at the expense of the private sector. On 21 October, Xi Jinping wrote an open letter to private entrepreneurs saying, ‘any words or acts to negate or weaken the private economy are wrong…It is always a policy of the Central Committee of the Communist Party to support private business development, and this will be unwavering’.

Lower yields normally feed through to stronger home sales

Monetary policy easing has triggered weaker CNY - we look for a bit more to come

China to surpass the US by 2030 and be double the size in 2050
China to surpass the US by 2030 – are we headed for a new Cold War?

The large US-China trade deficit is only part of the explanation behind the ongoing trade war. Equally important is the beginning of a new power rivalry between the US and China. While we expect a deal on the trade front in 2019, the rivalry is most likely here to stay. There are clear signs that sentiment has shifted fast in Washington these years from a policy of engagement to a focus on strategic competition (see, for example, the speech by Vice-President Mike Pence at the Hudson Institute on 4 October). And the shift is happening across party lines.

Most long-term projections forecast the US will be surpassed economically by China within the next 10-15 years [see for example the IMF report on the People’s Republic of China: 2018 IV Article Consultation, 26 July 2018]. However, it is unlikely to stop there. With four times more people than the US, we expect China to become a significantly larger economy than the US by 2050. We project China to be close to double the size of the US by the middle of the century. All it requires is that China reaches 50% of GDP per capita in the US. China’s recipe to continue its ascent of the economic ladder is a strong focus on technology, innovation, education and continued reforms and opening. These are all key elements in China’s development strategy as laid out in Xi Jinping’s Work Report at the 19th National Congress of the Communist Party on 18 October 2017. Heavy investment in green technology is also key for the economic rise to be sustainable.

The increasingly sharp tone between the US and China and more frequent confrontations with respect to economic relations, the South China Sea, Taiwan and China’s Belt and Road Initiative have led to a discussion of whether we are witnessing the beginning of a new Cold War. Our view is that the relationship between the US and China is likely to be one of intense rivalry in years to come, which may resemble the rivalry between the US and the Soviet Union. The US can be expected to work to create closer allies in opposition to China and vice versa. However, the world today is much more integrated and most countries can be expected to have significant relations with both countries rather than belonging only to one block, as was the case during the Cold War.
Disclosures

This research report has been prepared by Danske Bank A/S [‘Danske Bank’]. The authors of this research report are Jakob Ekholdt Christensen [Chief Analyst], Allan von Mehren [Chief Analyst], Mikael Olai Milhøj [Senior Analyst], Piet Christiansen [Senior Analyst], Aila Mihr [Analyst], Bjørn Tangaa Sillemann [Analyst] and Vladimir Miklashevsky [Senior Analyst].

Analyst certification
Each research analyst responsible for the content of this research report certifies that the views expressed in the research report accurately reflect the research analyst’s personal view about the financial instruments and issuers covered by the research report. Each responsible research analyst further certifies that no part of the compensation of the research analyst was, is or will be, directly or indirectly, related to the specific recommendations expressed in the research report.

Regulation
Danske Bank is authorised and subject to regulation by the Danish Financial Supervisory Authority and is subject to the rules and regulation of the relevant regulators in all other jurisdictions where it conducts business. Danske Bank is subject to limited regulation by the Financial Conduct Authority and the Prudential Regulation Authority (UK). Details on the extent of the regulation by the Financial Conduct Authority and the Prudential Regulation Authority are available from Danske Bank on request.

Danske Bank’s research reports are prepared in accordance with the recommendations of the Danish Securities Dealers Association.

Conflicts of interest
Danske Bank has established procedures to prevent conflicts of interest and to ensure the provision of high-quality research based on research objectivity and independence. These procedures are documented in Danske Bank’s research policies. Employees within Danske Bank’s Research Departments have been instructed that any request that might impair the objectivity and independence of research shall be referred to Research Management and the Compliance Department. Danske Bank’s Research Departments are organised independently from, and do not report to, other business areas within Danske Bank.

Research analysts are remunerated in part based on the overall profitability of Danske Bank, which includes investment banking revenues, but do not receive bonuses or other remuneration linked to specific corporate finance or debt capital transactions.

Financial models and/or methodology used in this research report
Calculations and presentations in this research report are based on standard econometric tools and methodology as well as publicly available statistics for each individual security, issuer and/or country. Documentation can be obtained from the authors on request.

Risk warning
Major risks connected with recommendations or opinions in this research report, including as sensitivity analysis of relevant assumptions, are stated throughout the text.

Expected updates
This publication is published twice a year.

Date of first publication
See the front page of this research report for the date of first publication.
General disclaimer

This research report has been prepared by Danske Bank [a division of Danske Bank A/S]. It is provided for informational purposes only. It does not constitute or form part of, and shall under no circumstances be considered as, an offer to sell or a solicitation of an offer to purchase or sell any relevant financial instruments [i.e. financial instruments mentioned herein or other financial instruments of any issuer mentioned herein and/or options, warrants, rights or other interests with respect to any such financial instruments] (‘Relevant Financial Instruments’).

This research report has been prepared independently and solely on the basis of publicly available information that Danske Bank considers to be reliable. While reasonable care has been taken to ensure that its contents are not untrue or misleading, no representation is made as to its accuracy or completeness and Danske Bank, its affiliates and subsidiaries accept no liability whatsoever for any direct or consequential loss, including without limitation any loss of profits, arising from reliance on this research report.

The opinions expressed herein are the opinions of the research analysts responsible for the research report and reflect their judgement as of the date hereof. These opinions are subject to change and Danske Bank does not undertake to notify any recipient of this research report of any such change nor of any other changes related to the information provided herein.

This research report is not intended for, and may not be re-distributed to, retail customers in the United Kingdom or the United States.

This research report is protected by copyright and is intended solely for the designated addressee. It may not be reproduced or distributed, in whole or in part, by any recipient for any purpose withoutDanske Bank’s prior written consent.

Disclaimer related to distribution in the United States

This research report was created by Danske Bank A/S and is distributed in the United States by Danske Markets Inc., a U.S. registered broker-dealer and subsidiary of Danske Bank A/S, pursuant to SEC Rule 15a-6 and related interpretations issued by the U.S. Securities and Exchange Commission. The research report is intended for distribution in the United States solely to ‘U.S. institutional investors’ as defined in SEC Rule 15a-6. Danske Markets Inc. accepts responsibility for this research report in connection with distribution in the United States solely to ‘U.S. institutional investors’.

Danske Bank is not subject to U.S. rules with regard to the preparation of research reports and the independence of research analysts. In addition, the research analysts of Danske Bank who have prepared this research report are not registered or qualified as research analysts with the NYSE or FINRA but satisfy the applicable requirements of a non-U.S. jurisdiction.

Any U.S. investor recipient of this research report who wishes to purchase or sell any Relevant Financial Instrument may do so only by contacting Danske Markets Inc. directly and should be aware that investing in non-U.S. financial instruments may entail certain risks. Financial instruments of non-U.S. issuers may not be registered with the U.S. Securities and Exchange Commission and may not be subject to the reporting and auditing standards of the U.S. Securities and Exchange Commission.

Report completed: 3 December 2018, 13:00 CEST
Report first disseminated: 4 December, 07:00 CEST