14 August 2023

China holiday wrap-up – part 3

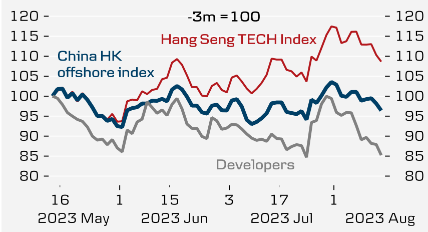
Risks of a financial crisis resurface

This update is part 3 of China holiday wrap-up with summary of news over the summer period. Here are links to part 1 and part 2.

Economics: Deflation, property stress and financial contagion

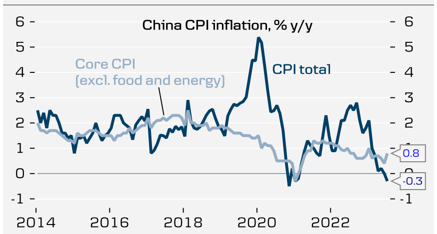
- **Summary**: The past weeks saw another turn in sentiment on China as property stress resurfaced, signs of shadow banking problems appeared and economic data disappointed. The new financial challenges is a blow to China's efforts to restore confidence and lift private demand and it highligts downside risks to growth in coming quarters. The set-back followed shortly after rising optimism on the back of the Politburo meeting in July, which pointed to more forceful efforts to support growth. Below is a short overview of the recent events and economic data:
  - **Property stress returns:** China's biggest private developer Country Garden is *seeking to delay payments* on a private onshore bond for the first time, according to a source. The developer has been seen as one of the stronger names, and its' prospect of default underlines the amount of big stress in the sector. Weak home sales give developers too few cash to meet their obligations feeding a negative confidence spiral as the negative headlines hurts buyer sentiment and home sales even more. There is a clear need for the government to step in more forcefully to lift home sales and provide adequate funding for the stronger developers. Chinese policy makers continue to be behind the curve and while it adds stimulus it is so far not strong enough to turn the tide.
  - **Contagion to shadow banking:** On top of the property woes, signs of contagion to other parts of the financial system has emerged this week. Trust funds linked to the financial giant Zhongzhi Enterprise Group have missed payments on several high-yields investment products. Many of these trust products are linked to developer loans and clearly exposed to contagion from developer stress. As these products are held by private households, it provides a risk that money is pulled out of the shadow banking system if big losses start to materialise. This could trigger a drain of liquidity and a credit crunch, again adding to current financial challenges. With confidence already weak, there is a real risk the a financial snowball keeps getting bigger making it more and more difficult for Beijing to rein it in. While it controls a large part of state funding via state-owned banks, there are no guarantees on trust products and money could start to flow out of these quickly if fears rise. While I do believe Beijing understands these risks (it is a key reason it has cracked down on shadow banking since 2016), it doesn't rule out that they come too late or with too little force because the underestimate the magnitude of the challenge. When financial confidence is shaken the policy response is crucial. I do expect policy makers to take steps soon to stabilize confidence and for example provide life lines to big financial companies and developers. <u>But risks have clearly increased and this space needs to be monitored closely.</u>

Another equity rally falters



Source: Macrobond Financial, Bloomberg. Note: Past performance is no guarantee of future performance

Headline CPI in deflation but core inflation still above zero



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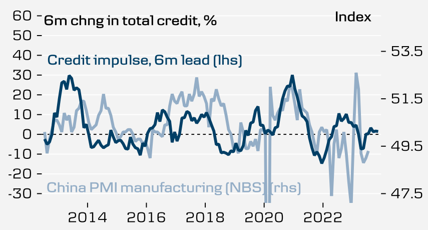
Credit impulse still supports a muddling through scenario



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- **Deflation arrives but not as bad as it looks:** While the financial risks are real, I believe the deflation hype is a bit overblown. Headline CPI fell into negative territory in July with a print of -0.3% y/y. However, it is driven by lower energy and food prices and excluding these components, inflation stood at 0.8% y/y. The fact that consumers pay less for energy is actually positive for the spending power. The overall level of core inflation is still low, and a reflection of too weak demand relative to supply and it *is* dampening retailers profit growth. But consumer demand has been rising this year, which was also visible in the earnings report from the e-Commerce giant Alibaba which posted the *strongest revenue growth in two years* last week and beating analyst expectations. There should not be any danger of negative deflation dynamics at this point. When looking at the monthly changes in core CPI and adjust for seasonality, prices were up 0.4% m/m in July, again not showing widespread deflation.

– **Export challenges continue:** The headwinds for exports are real, though. China's exports declined by 14.5% y/y in July (consensus -13.2% y/y) down from -12.4% in June. It mainly reflects the weak consumer goods growth in US and Europe where service consumption has been the main growth engine since the pandemic ended. The outlook for exports is still weak, unfortunately. With both exports and housing in recession, China's growth relies a lot on consumers and infrastructure stimulus.

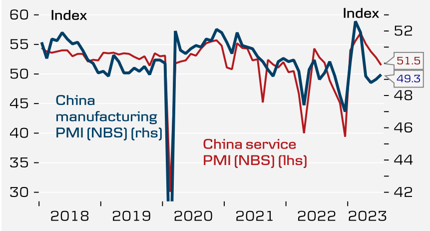
– **PMI and credit growth look OK:** That stimulus is managing to keep the economy afloat for now is indicated by the still decent credit impulse (chart on page 1) and tentative rebound in NBS manufacturing PMI in July from 49.0 to 49.3. NBS service PMI was 51.5 in July and although it is lower than in previous months it is still at a level in line with moderate growth in the service sector. But as mentioned above, risks are skewed to the downside now depending on how China manages the financial stress.

- **Plan for attracting foreign investments:** China's State Council on Sunday *released a 24-point plan* for improving the business environment for foreign investors and multinational companies. One of the points is that they pledge to investigate government actors that don't ensure fair participation in procurement processes and allow foreign companies to submit complaints when they are unfairly excluded. The challenge for Beijing has often been that central directives are not followed locally by government entities due to vested interests such as tight connections between local mayors and Chinese companies. The new plan goes a step further to give foreign companies more possibilities of cutting through the local government protectionism. It remains to be seen if it will work, but it is the strongest signal so far that Beijing wants to put more pressure on local governments and give foreign investors tools to make sure the policies are followed. Only time can tell how it is enforced but it does seem that under the new Premer Li Qiang, policy implementation is much more in focus to ensure policies are not just on paper but actually implemented.

Markets: Sentiment souring

- **Stock rally faltering again:** Chinese equities suffered yet again (see chart on page 1) after a false dawn as the post Polit-buro rally in July faltered in August due to the factors described above. The decline has been driven by developers and anything exposed to financial risks. Tech stocks are also lower but still in an upward trend supported by stronger consumption and a clear easing of the tech crackdown that hurt tech stocks in the past couple of years.

Service PMI lower but still at decent level



Source: Macrobond Financial, Bloomberg. Note: Past performance is no guarantee of future performance

Exports struggling due to weak global goods demand

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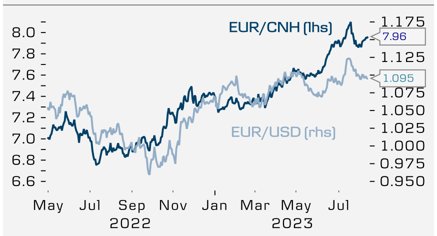
EUR/CNH higher over past week widening 'gap' to EUR/USD



Source: Macrobond Financial, Bloomberg. Note: Past performance is no guarantee of future performance

Monetary policy divergence to drive USD/CNY higher still

Source: Macrobond Financial, Bloomberg. Note: Past performance is no guarantee of future performance

- **CNH weaker:** The negative sentiment has also affected CNH, which has seen a return of the weakening trend against the USD (see charts). I continue to look for a rise in USD/CNH towards 7.40 in 12M, while EUR/CNH should be more anchored by our expectation of a lower EUR/USD. However, if financial risks escalate EUR/CNH could be heading higher still.

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