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CHINA: THE UNEVEN RECOVERY CONTINUES

MORE SUPPORTIVE POLICY TO BOOST DOMESTIC DEMAND IN H2

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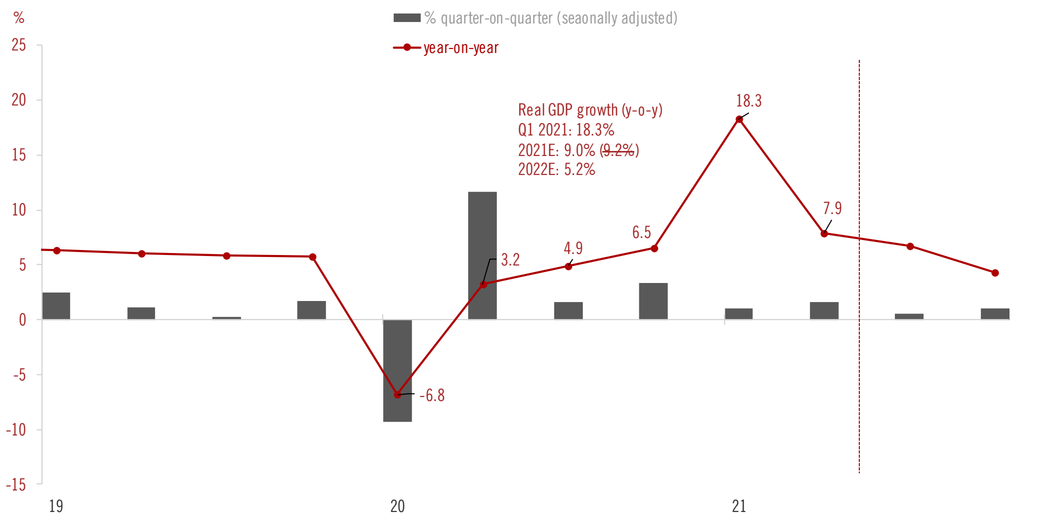
SUMMARY

- China's Q2 GDP figures as well as some major activity data for June released last week continue to paint a macro picture of strong external demand paired with slower recovery in the domestic economy.
- The rapid spread of the Delta variant of the coronavirus globally, particularly in Southeast Asia, could delay the recovery of production capacity outside of China. This means the strengths in Chinese exports could extend well into the second half of 2021.
- While the recovery of domestic demand in China lags the rebound in exports, there are some encouraging improvements on the household consumption and fixed-asset investment fronts.
- On the policy front, on top of the recent reserve-requirement ratio cut by the People's Bank of China (PBoC), we expect some back-loaded fiscal support in the second half of the year to give domestic demand a boost.
- We have adjusted our full-year Chinese GDP forecast for 2021 slightly downward to 9.0% from 9.2%, but it remains above consensus.

According to the National Bureau of Statistics, the Chinese economy expanded by 7.9% y-o-y in Q2 after surging by 18.3% in Q1 (*Chart 1*). On a two-year average basis, growth picked up in Q2 to 5.5% from 5.0% in Q1. Putting the first two quarters together, the Chinese economy expanded by 12.6% in H1 compared to the same period last year.

CHART 1: GROWTH IN REAL GDP (INCLUDING FORECASTS)



Source: PWM - AA&MR, National Bureau of Statistics of China, July 2021

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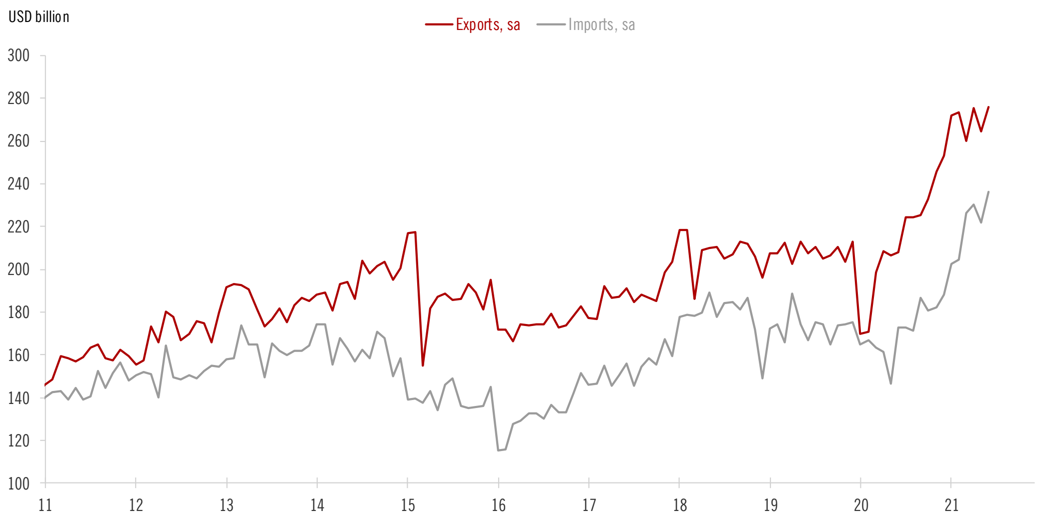
A more detailed examination of the Q2 GDP numbers and some recent activity data continues to show a macro picture characterised by strong export performances but slower recovery in domestic demand. However, some green shoots are emerging on the domestic front, and we expect macro policies to turn more supportive in the second half of this year to boost domestic demand.

Exports remain extraordinarily strong

In June, Chinese exports grew by 32.2% y-o-y, up from 27.8% in May. Note that these extraordinarily high growth figures were not due to any favourable base effects, as Chinese exports had already recovered to pre-covid levels by May last year (*Chart 2*). In other words, the robust June figure truly reflects continued strong demand for Chinese goods, as production capacity in many other parts of the world has not recovered yet.

At time of writing, the Delta variant of the coronavirus was spreading rapidly around the world and restrictive measures were being re-introduced or strengthened in many countries, particularly in Southeast Asia. In our view, this may lead to a slower-than-expected recovery of production capacity outside of China, and thus the strength in Chinese exports could extend well into the second half of 2021.

CHART 2: VALUE OF CHINESE EXPORTS AND IMPORTS IN USD TERMS, SEASONALLY ADJUSTED



Source: PWM - AA&MR, China Customs, July 2021

In line with the strong export performance, Chinese industrial activity has remained buoyant in recent months. In June, Chinese industrial production grew by 8.3% y-o-y, down from 8.8% the previous month. However, on a two-year average basis (which reduces the extreme base effects), industrial production expanded by 6.5% in June, only slightly down from 6.6% in May, and well above the growth rate prevailing prior to the covid crisis (5.8% in full-year 2019).

Recovery in domestic demand is much slower

In comparison, the recovery in China's domestic demand remains slower, with growth generally below pre-covid levels. For example, retail sales expanded by 12.1% y-o-y in

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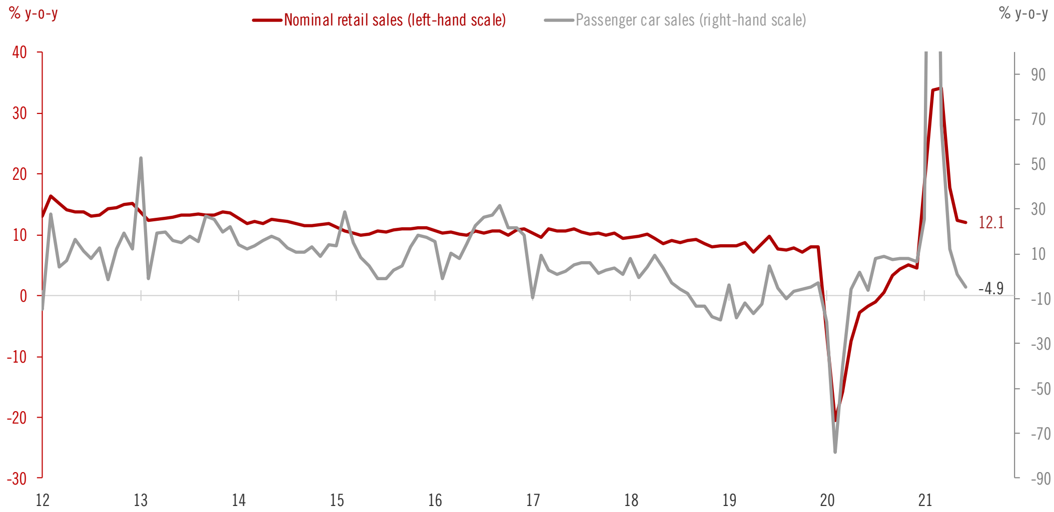
June, or 5.3% on a two-year average basis, compared to the prevailing growth rate of about 8% before the covid crisis hit (*Chart 3*).

CHART 3: GROWTH IN RETAIL SALES AND PASSENGER CAR SALES



Source: PWM - AA&MR, National Bureau of Statistics of China, July 2021

The slower recovery in Chinese domestic demand is mainly due to two reasons.

First, unlike many developed-country governments, the Chinese government did not offer any direct fiscal subsidies to households during the crisis. As a result, average household disposable income in China was hit badly during the crisis and is now recovering only gradually. This is in sharp contrast with some developed-countries where households' disposable income actually rose during the crisis as a result of government handouts. The more 'organic' recovery in China means that consumer spending will only come back gradually.

Second, the Chinese central bank was the first to normalise its monetary policy after China first emerged from the covid crisis. Since May last year, the PBoC has been guiding credit growth lower and domestic interest rates higher. On a 12-month rolling basis, total social financing (a measure of Chinese aggregate credit used by the PBoC) has been decelerating since reaching a peak in October 2020, contracting 2.8% y-o-y in June 2021 alone (*Chart 4*). The slower pace of credit creation has dampened momentum in fixed-asset investment, especially infrastructure investment.

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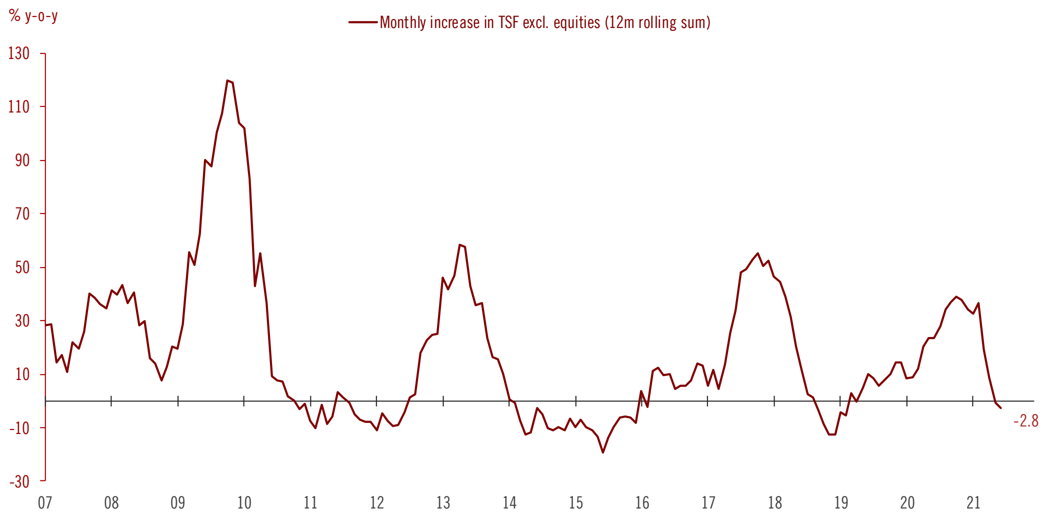
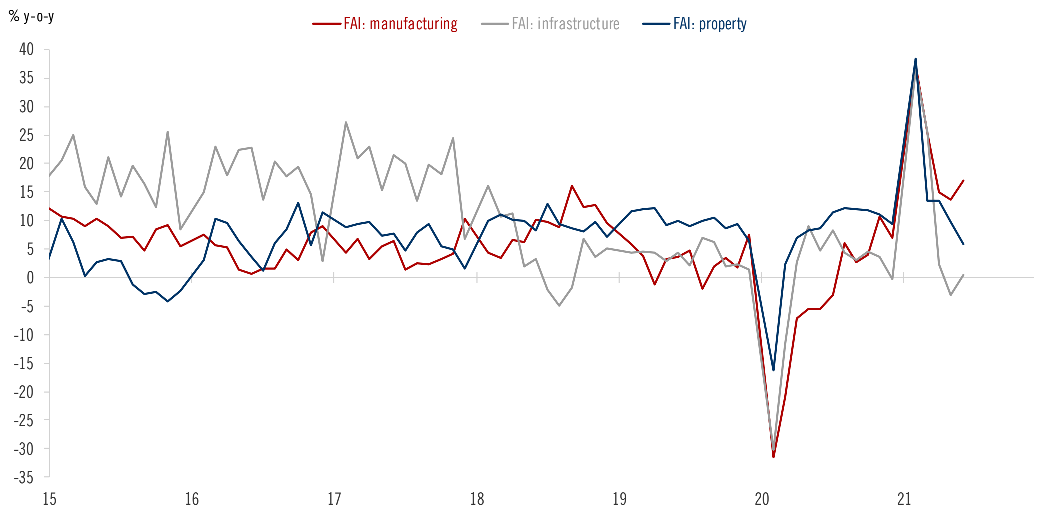
CHART 4: GROWTH IN TOTAL SOCIAL FINANCING



Source: PWM - AA&MR, PBoC, July 2021

However, the data for June also show some encouraging signs of improvement in domestic demand. While the underlying growth rate of retail sales was still below pre-covid levels, it picked up noticeably last month from May, when the two-year average growth in retail sales was only 4.4%. Note that the improvement was achieved despite a decline in car sales in June (-4.9% year on year compared to +1.1% in May, due to strong sales last year and thus an unfavourable base effect), indicating a healthy acceleration in retail sales growth in other areas.

CHART 5: GROWTH IN FIXED-ASSET INVESTMENT BY SECTOR



Source: PWM - AA&MR, National Bureau of Statistics of China, July 2021

Fixed-asset investment also showed some improvement in June, rising by 5.5% on a two-year average basis in June, up from 4.7% in May. Growth momentum varied across

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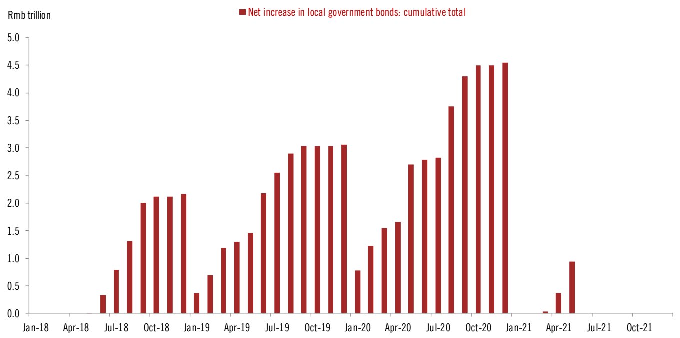
sectors, reflecting differing macro and policy conditions. Investment in the manufacturing sector was especially robust in June (up 17.0% y-o-y), suggesting capacity expansion in response to extraordinarily strong export demand. Infrastructure investment barely expanded (up 0.4% y-o-y), but showed signs of stabilising after the 3.0% drop in May. Property investment continued to decelerate, rising by 5.8% y-o-y in June, down from 9.8% in May, reflecting the government's efforts to curb speculation (*Chart 5*).

Policy may turn more supportive in H2

We expect a more supportive policy environment in the second half of 2021. The PBoC recently cut banks' required-reserve ratios (RRR) by 50bps, releasing roughly Rmb1 trn of liquidity into the financial system. This move came as a surprise to the market and may indicate policy makers' desire to mitigate the impact of the sharp tightening of financial conditions on the domestic economy since early this year. While we do not interpret this move as the start of a new easing cycle, it probably does indicate that policy 'normalisation' (i.e. tightening) by the PBoC is over and that its monetary policy stance is now back to neutral.

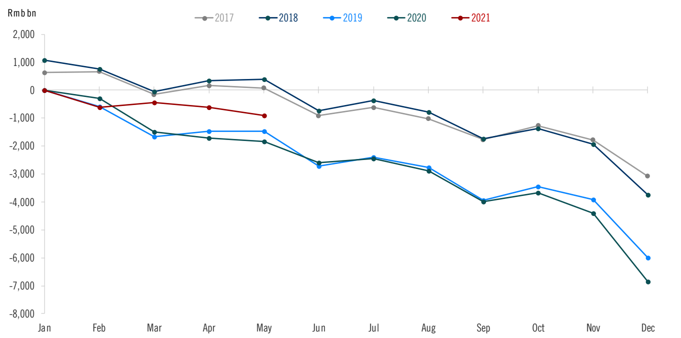
Fiscal stimulus in China has been noticeable by its absence. For example, the pace of local-government bond issuance so far this year is well behind the levels of 2019 and 2020 (*Chart 6A*) and so is fiscal spending (*Chart 6B*). We could therefore see an acceleration in the deployment of fiscal resources in the second half of this year. Combined with a less stringent monetary environment, this may boost domestic demand in the quarters to come.

CHART 6A: YTD NET INCREASE IN LOCAL GOVERNMENT BONDS



Source: PWM - AA&MR, Ministry of Finance of China, July 2021

CHART 6B: CUMULATIVE GOVERNMENT FISCAL BALANCE IN CHINA



Source: PWM - AA&MR, Ministry of Finance of China, July 2021

Overall, the latest set of data releases indicates that China's economic recovery is still well on track. While domestic demand still lags the external sector, we have seen some improvement in consumption and fixed investment in certain sectors. Macro policies may turn more supportive in H2, further helping the recovery. In light of the most recent data, we have decided to adjust our full-year Chinese GDP forecast for 2021 slightly downward to 9.0% from 9.2%— but it still remains above the consensus.

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