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China Economy in Aug

Still in a trough & why we bet on stabilization in 4Q

China's Aug economic data came in with few highlights, indicating the economy is still in a trough in light of structural changes and external tensions. However, we expect stabilization in 4Q19, albeit temporarily for several reasons. China-US trade talk may progress steadily and we foresee room for RMB appreciation.

- **Aug economic data highlights.** 1) infrastructure investment picked up (+4.2% in Jan-Aug) and is likely to continue firming up; 2) real estate investment showed resilience and declined only modestly thanks to robust construction expenditures; 3) consumption growth (excluding car sales) stayed largely stable.

- **Negatives/risks.** 1) Industrial value-added growth plunged to record low (+4.4% YoY in Aug). High-tech industries have been weighed on by trade tensions and industry down cycles; 2) Manufacturing investment turned weak; 3) Lackluster car sales, which continued to drag retail sales growth.

- **Reasons why we bet on stabilization in 4Q19, albeit temporarily.** 1) Previous supportive policies will gradually take effect. Regarding monetary policies, we expect MLF operating rate to be cut by 10bp on 17 Sep when the next batch is scheduled to mature; 2) Infrastructure spending will firm up as construction may speed up to make up for delays due to summer weather; 3) Consumption will likely be prompted by car sales. We expect car sales to rebound in 4Q19, and 4) Timing effect. The 70th National Day and earlier Lunar New Year in 2020 may uplift economic activities in 4Q19.

- **RMB likely to strengthen.** In the short run, USD/CNY may find support at around 7.10 based on several evidence. 1) The authorities have been lifting USD/CNY mid-rate since the end of Aug; 2) RMB has depreciated "too much" from the perspective of CFETS Index, implying room for appreciation. Future strengthening factors include alleviation of China-US trade tensions, potential stabilization of China's economy in 4Q19, etc.

- **China-US trade talk – back to economic rationale.** As the Oct top-level talk approaches, both sides showed gestures of "good will" to break the deadlock, represented by the U.S. delaying tariff hikes and China exempting U.S. soybeans and pork from planned penalty tariffs. Businesses and corporates from both countries are holding more active dialogues, pushing the trade talk back on economic rationale. We maintain our view that China-US trade negotiation is progressing in a favorable direction, and is likely to yield some partial deals by year end. The best option for the two countries is to seek common grounds while setting aside differences temporarily.

Data Summary

YoY growth (%)	Apr-19	May-19	Jun-19	1H19	Jul-19	Aug-19
Industrial value-added	5.4	5.0	6.3	6	4.8	4.4
Fixed asset investment, YTD	6.1	5.6	5.8	5.8	5.7	5.5
- Manufacturing FAI	2.5	2.7	3.00	3	3.3	2.6
- Real estate FAI	11.9	11.2	10.9	10.9	10.6	10.5
- Infrastructure FAI	4.4	4.0	4.1	4.1	3.8	4.2
Retail sales value	7.2	8.6	9.8	8.4	7.6	7.5

Source: NBS, CMBIS

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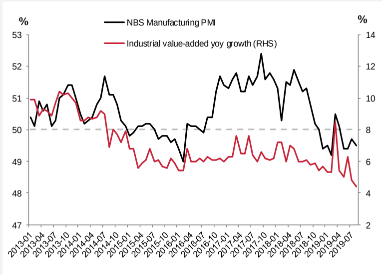

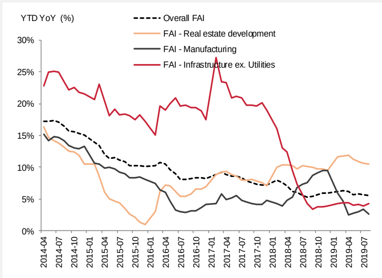

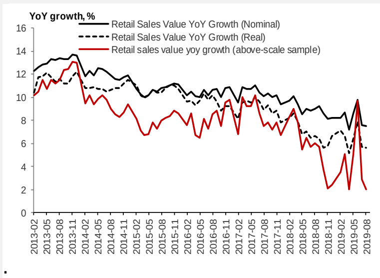

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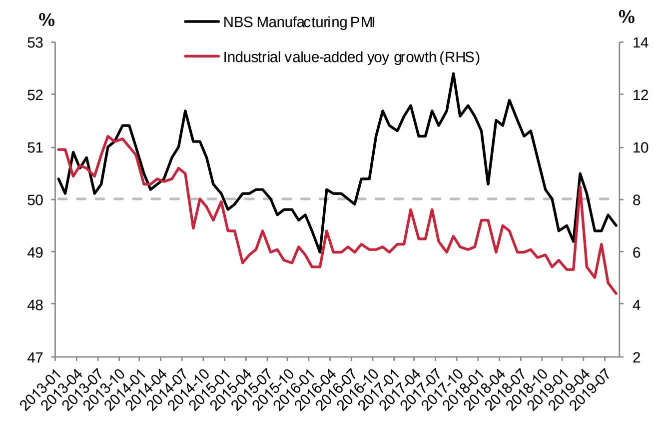
Industrial value-added growth continued to decelerate

Industrial value-added growth hitting record low.
In Aug, industrial value-added increased 4.4%, down 0.4ppt from Jul and hitting historical low. YTD growth slipped to 5.6% YoY. All three sectors, mining, manufacturing and electricity, gas & water supply, reported decelerating growth in Aug. Automobile industry's value-added reversed decline by increasing 4.3% YoY in Aug, narrowing YTD decline to 1.0%.

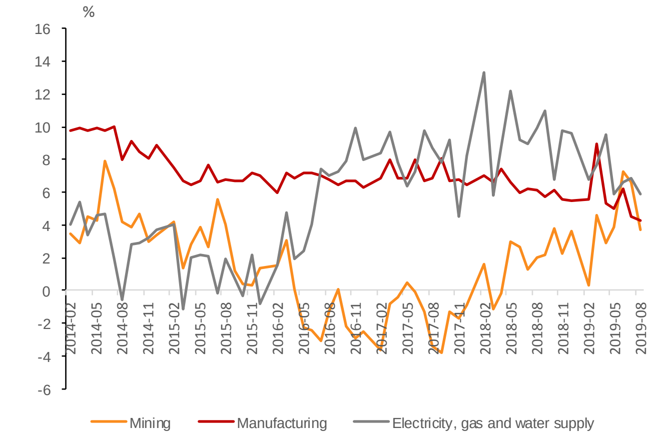
High-tech and equipment manufacturing continued to lose steam.
Likely resulting from trade war, value-added from high-tech manufacturing increased 6.1% YoY, growth rate down 0.5ppt from Jul. Value-added growth of computer, telecommunications & electronics manufacturing and rail, ship, aerospace and other transport equipment manufacturing advanced 4.3%/7.8% YoY, respectively, growth rates down 1.4ppt/7.9ppt from that in Jul. General and special equipment manufacturing also decelerated expansion.

Figure 1: Industrial value-added growth dipped further to 4.4% YoY in Aug



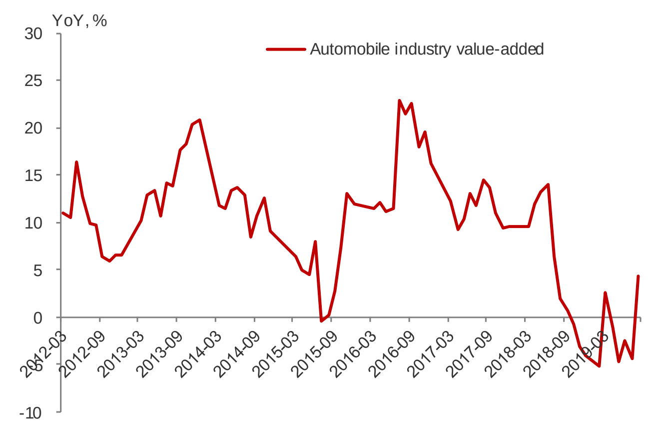
Source: NBS, Wind, CMBIS

Figure 2: Growth of mining, manufacturing, utilities all muted in Aug



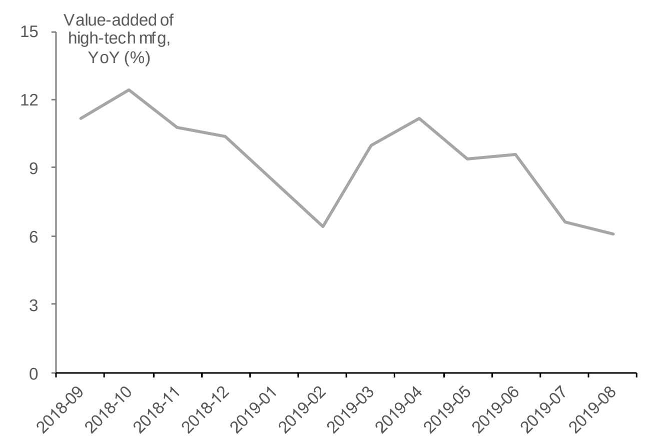
Source: NBS, Wind CMBIS

Figure 3: Automobile industry value-added reversed decline in Aug



Source: NBS, Wind, CMBIS

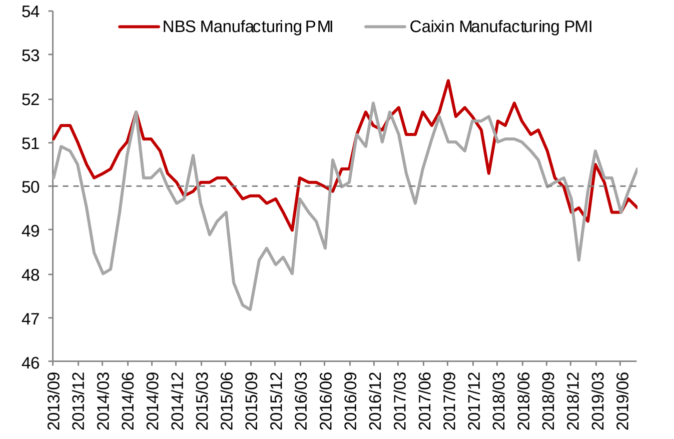
Figure 4: Value-added growth of high-tech manufacturing muted since Jul



Source: NBS, Wind CMBIS

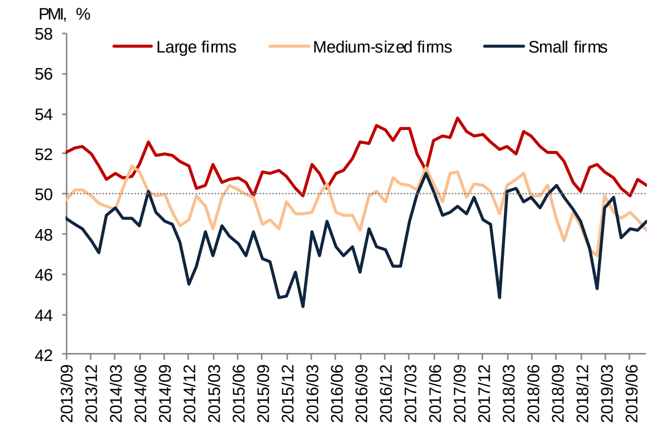
… however, leading/High frequency monitors performed relatively stable

Figure 5: PMI



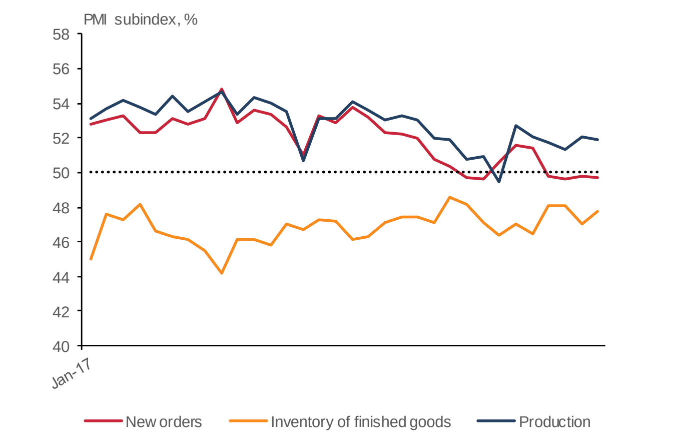
Source: NBS, Wind, CMBIS

Figure 6: PMI by firm type



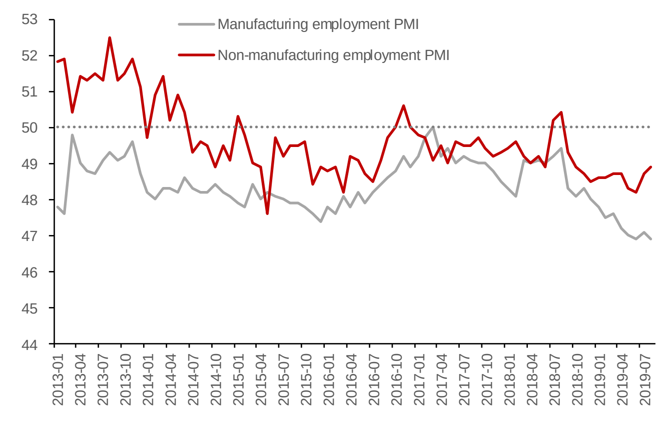
Source: NBS, Wind CMBIS

Figure 7: PMI subindices



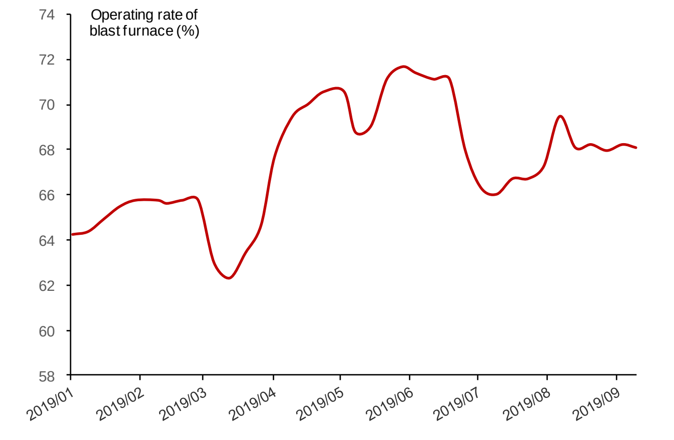
Source: Wind, CMBIS

Figure 8: PMI Employment index – Service employment has been trending better since Jul



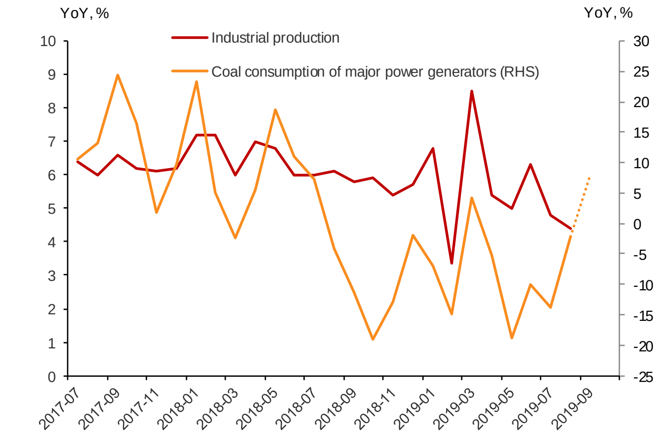
Source: NBS, Wind CMBIS

Figure 9: Operating rate of blast furnace has been stable in Sep



Source: Wind, CMBIS

Figure 10: Coal consumption of major power generators likely resumed growth in Aug and Sep

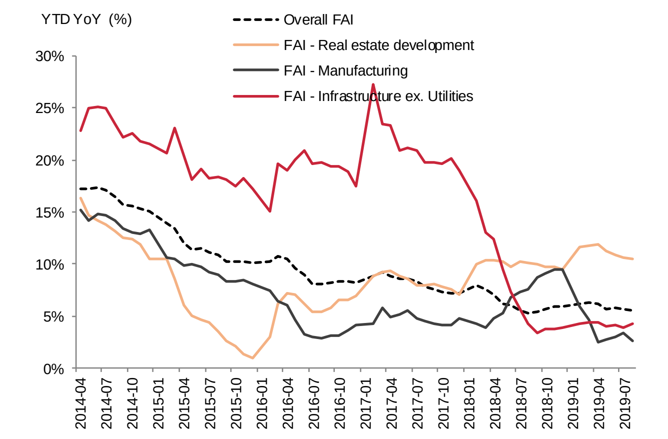


Source: NBS, Wind CMBIS

FAI: manufacturing muted, infrastructure picked up

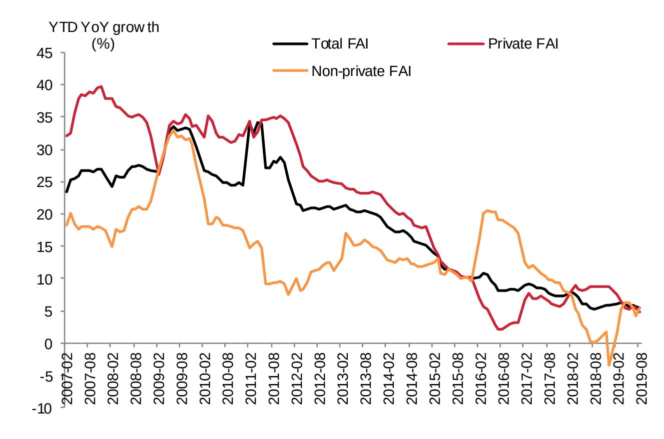
Overall FAI growth in Jan-Aug decelerated to 5.5% YoY from 5.7% YoY in Jan-Jul. The primary drag was manufacturing FAI, of which growth plunged to 2.6% YoY in Jan-Aug from 3.3% in Jan-Jul. Infrastructure FAI strengthened to grow 4.2% in Jan-Aug, up 0.4ppt from Jan-Jul. Real estate FAI growth declined modestly to 10.5% YoY.

Figure 11: FAI



Source: NBS, Wind, CMBIS

Figure 12: FAI: private vs. non-private

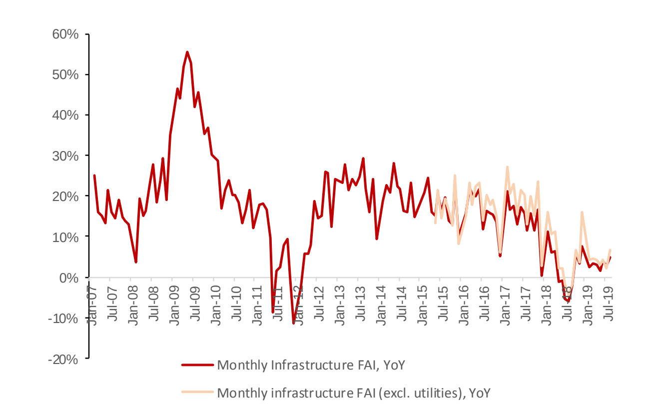


Source: NBS, Wind CMBIS

Manufacturing FAI muted and still under pressure.
Decline enlarged for rail, ships, aerospace and other transportation equipment mfg (-10.7% YoY, down 0.3ppt from that in Jan-Jul), electric machinery mfg (-8.0% YoY, down 0.5ppt), non-ferrous metal smelting and rolling processing (-4.3% YoY, down 0.5ppt). Growth decelerated for chemicals mfg (7.9% YoY, down 1.5ppt), general equipment mfg (1.2% YoY, down 0.9ppt), special equipment mfg (6.6% YoY, down 0.6ppt). Encouragingly, FAI growth of computer, communications & electronic equipment kept accelerating to 11.1% YoY, up 0.6ppt from that in Jan-Jul. Going forward, we think manufacturing FAI growth may remain under pressure due to, 1) PPI decline, and 2) high base last year.

Infrastructure FAI strengthened and is likely to continue firming up.
YTD YoY growth rose to 4.2% from 3.8% in Jan-Jul. We expect construction activities will gradually recover after summer. Recent policies regarding local government special bonds and launch of key projects nationwide will further extend support for infrastructure investment. We forecast infrastructure FAI is likely to pick up to 5% before year end.

Figure 13: Infrastructure FAI picked up in Aug



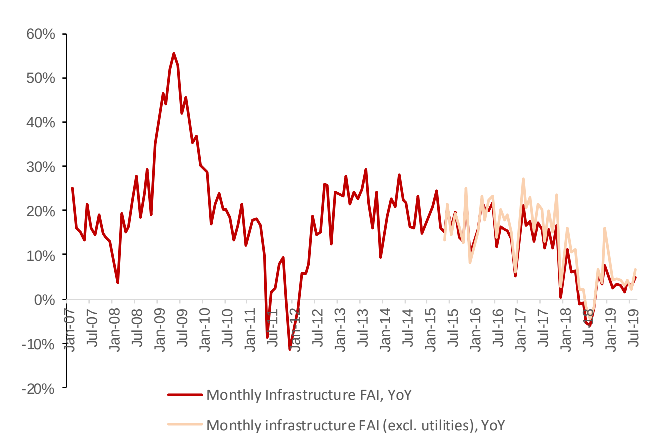
Source: NBS, Wind, CMBIS

More supportive policies for local government special bond – 1) larger amount; 2) wider use; 3) higher leverage.

The State Council meeting urged next year's quota of local government special bond issuance to be arranged in advance this year to guarantee funding for key infrastructure projects. The meeting also relaxed restrictions so that proceeds from special bonds can be used for a wider range of infrastructure investments. Moreover, the special bonds are allowed to be used as equity capital to leverage bank loans by as much as five times. We estimate this could boost infrastructure FAI by another RMB 500bn, or lifting YoY growth by ~0.3ppt.

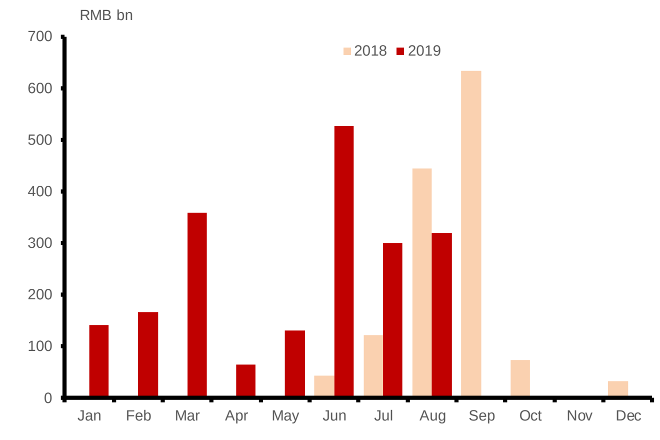
Up till 31 Aug 2019, new issuance of local government special bond reached RMB 2.01tn, or 93.3% of annual target, among which 79%, i.e. RMB 1.59tn has already been allocated to projects. This year's new issuance of special bonds should be completed before the end of Sep and be applied to infrastructure projects before the end of Oct.

Figure 14: Infrastructure FAI picked up in Aug



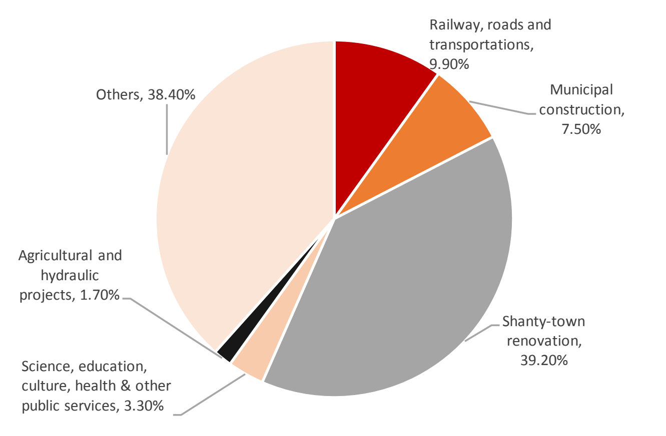
Source: NBS, Wind, CMBIS

Figure 15: Local government special bond new issuance amounted to RMB 2.01tn as of 31 Aug 2019



Source: Ministry of Finance, Wind CMBIS

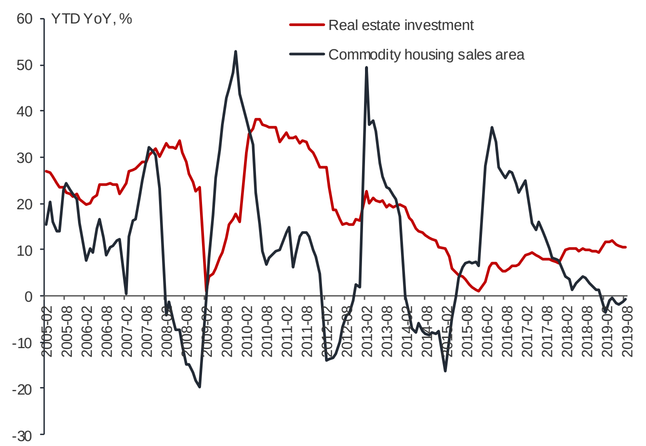
Figure 16: YTD Allocation of local government special bond (RMB 1.59tn being allocated)



Source: Ministry of Finance, CMBIS

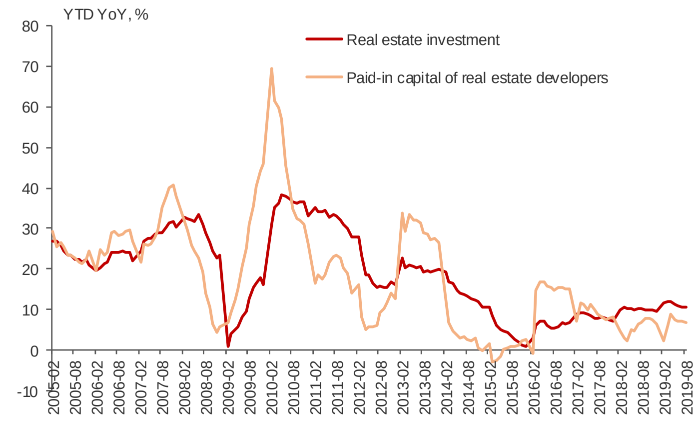
Real estate FAI growth slipped slowly to 10.5% YoY. Similar to its trend in previous months, real estate investment growth declined modestly. Land acquisition investment declined but construction spending remained robust. We expect real estate investment to continue declining gradually due to stringent measures on real estate developers.

Figure 17: Real estate investment vs. commodity housing sales



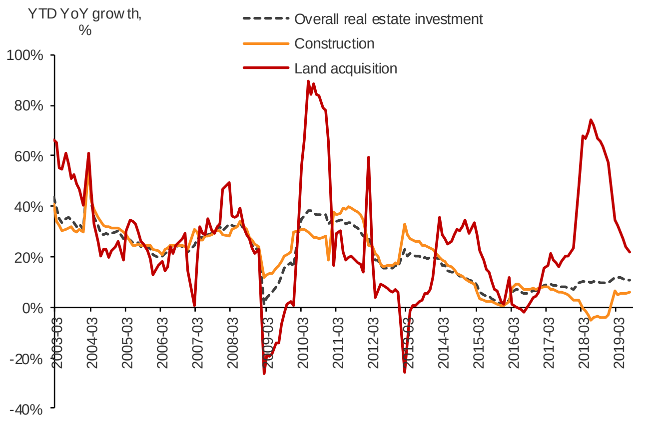
Source: NBS, Wind, CMBIS

Figure 18: Real estate investment vs. paid-in capital of developers



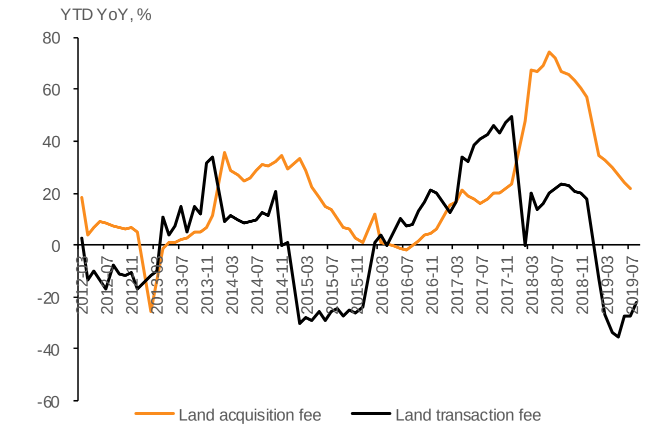
Source: NBS, Wind, CMBIS

Figure 19: Land acquisition decelerated while construction expenditures were robust



Source: NBS, Wind, CMBIS

Figure 20: Land transaction fee dropped 22% in Jan-Aug



Source: NBS, Wind CMBIS

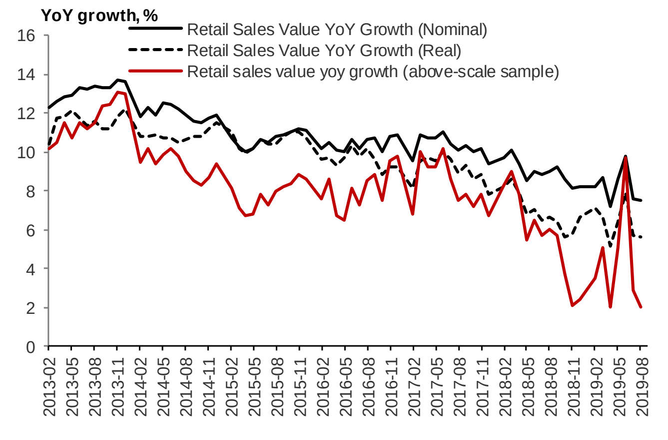
Retail sales dragged by weak car sales again

Ex-car retail sales accelerated; expect rebound of car sales in 4Q19

Headline retail sales value growth decelerated to 7.5% YoY. Stripping out cars, however, retail value increased 9.3% YoY in Aug, up 0.5ppt from Jul. Car sales dropped 8.1% YoY in Aug to reflect previous emission standard switch which overdrawn demand and reduced subsidies for new-energy vehicles. We expect car sales to stabilize in 4Q19 thanks primarily to 1) supportive policies, such as releasing purchase restrictions, etc., and 2) launch of flagship models by car makers.

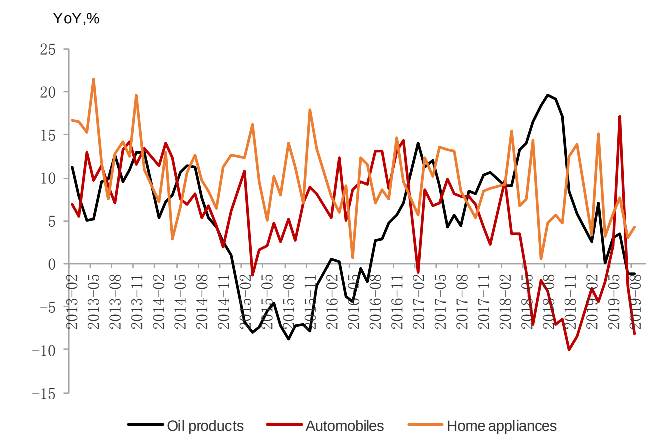
Besides cars, sales value of oil-related products also declined 1.2% YoY due to decline of crude oil prices. But recent changes in global crude oil supply conditions may boost oil prices in the following months, thereby lifting retail sales value as well as CPI.

Figure 21: Retail sales growth slid further in Aug primarily due to car sales



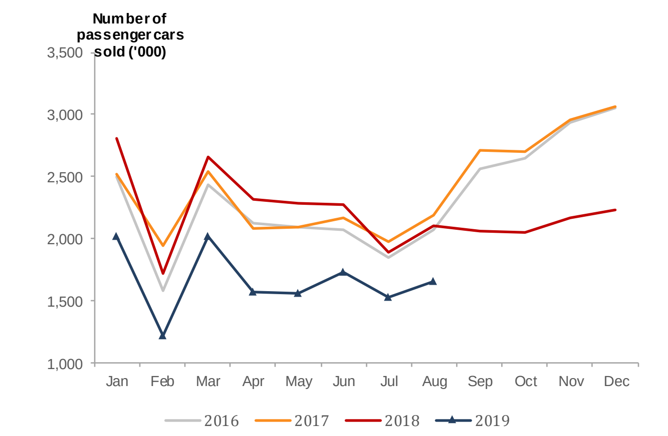
Source: NBS, Wind, CMBIS

Figure 22: Car sales dropped 8.1% YoY in Aug



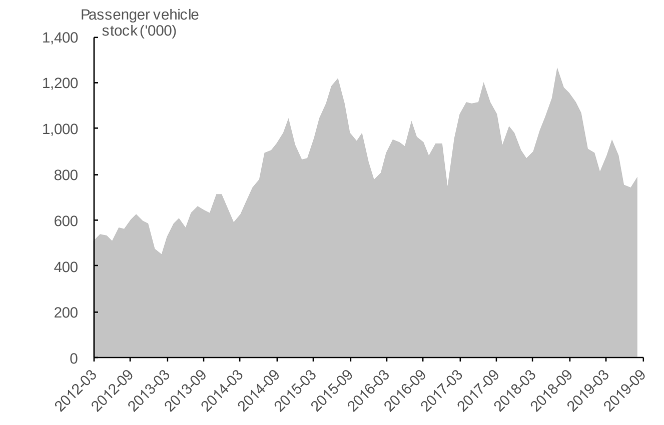
Source: NBS, Wind CMBIS

Figure 23: Number of passenger cars sold by month



Source: China Automobile Association, Wind, CMBIS

Figure 24: Stock of passenger vehicles



Source: Wind CMBIS

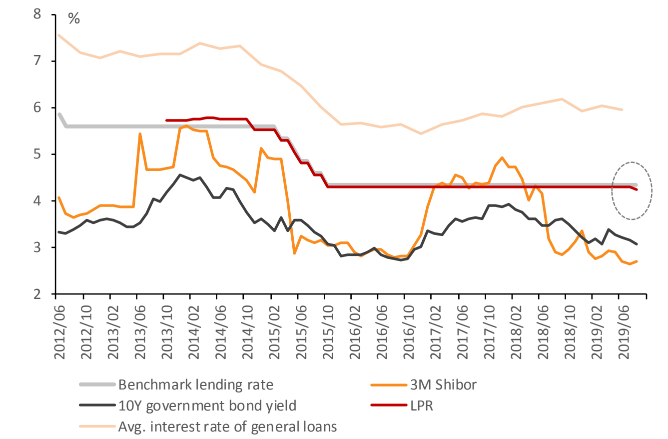
Monetary policies: MLF operating rate cut on the way

LPR reform and RRR cut in the past month. In Aug, the PBoC 1) unveiled the LPR reform scheme to cut financing cost for the real economy. As the first step, LPR is now quoted with reference to MLF operating rate instead of benchmark interest rate. It is refreshed each month and set by a wider scope of commercial banks. On 20 Aug, the first LPR after reform was 4.25%, 6bp below previous level. 2) Conducted broad as well as targeted RRR cut, which is estimated to release a total of RMB 900bn.

Next step of LPR reform? Would be necessary to lower MLF operating rate, i.e. the reference. The PBoC did not renew the RMB 176.5bn MLF matured on 9 Sep possibly because RRR cut was announced just before that weekend and Fed's Sep FOMC meeting was more than one week away and there might be uncertainties in between. Instead, the PBoC conducted a net of RMB 190bn reverse repos to add to liquidity in the week ended 13 Sep.

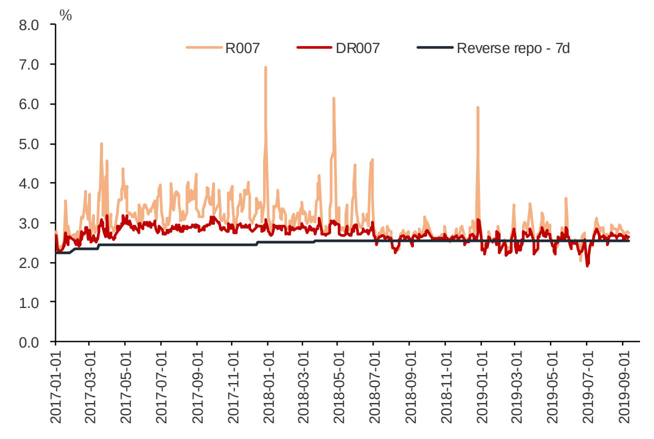
We expect the 1-year MLF operating rate will be cut by 10bp when another batch of RMB265 bn MLF is scheduled to mature on 17 Sep. The PBoC may consider cutting MLF rate again in 4Q19.

Figure 25: LPR was cut 6bp to 4.25% on 20 Aug



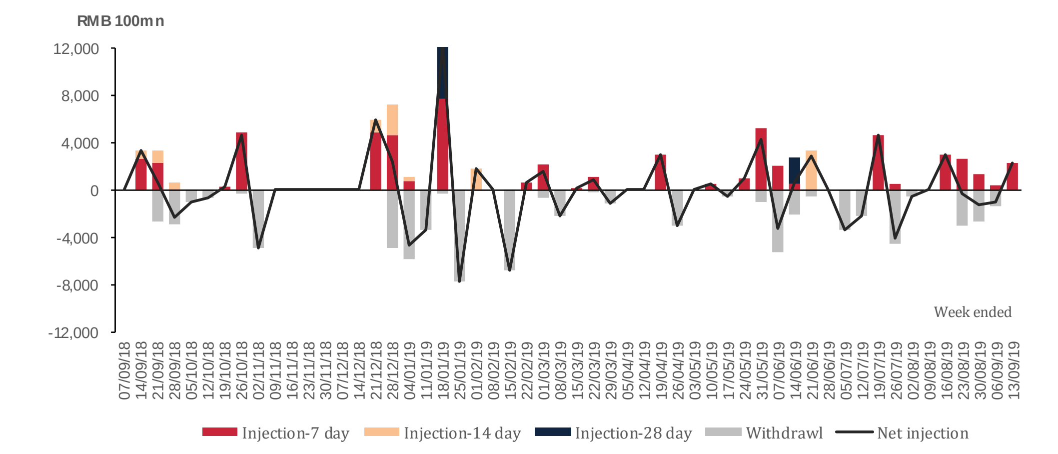
Source: PBoC, Wind, CMBIS

Figure 26: Market-based interest rate



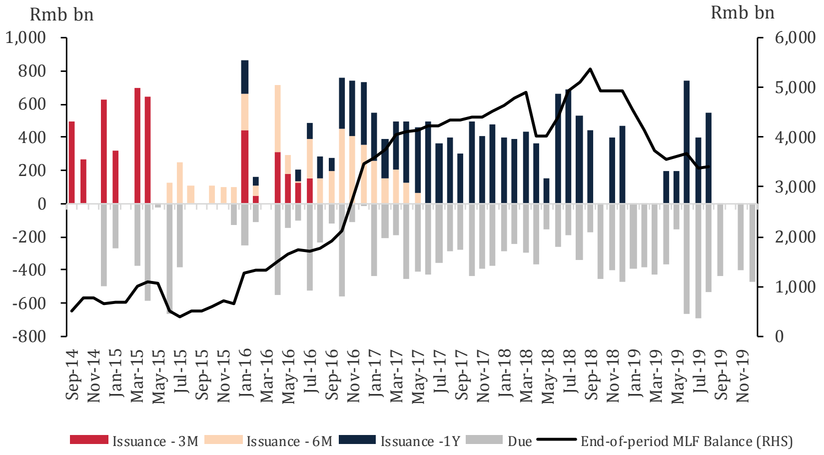
Source: PBoC, Wind CMBIS

Figure 27: The PBoC conducted RMB 230bn reverse repo to add to liquidity, although it did not renew MLF matured on 9 Sep



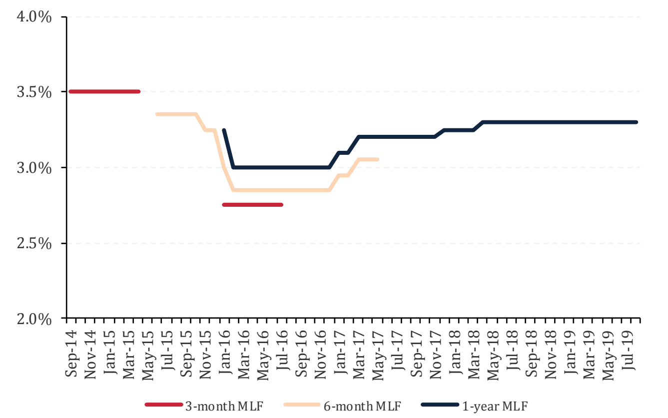
Source: PBoC, Wind, CMBIS

Figure 28: MLF operation and maturity schedule before YE2019



Source: PBoC, Wind, CMBIS

Figure 29: MLF operating rate



Source: PBoC, Wind, CMBIS

Reasons for stabilizing of China's economy in 4Q19

Consolidating high frequency monitors and evidence we collected, we think China's economic growth may firm up in 4Q19, albeit temporarily. for the following reasons.

1) **Previous supportive policies will gradually take effect and be translated into economic performance**

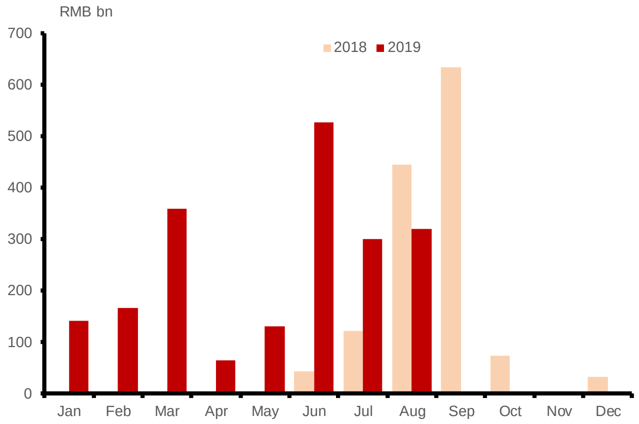
   These policies encompass fiscal expansion, monetary easing and more importantly, industrial policies to provide incentive and guidance.

2) **Infrastructure spending will catch up while construction is likely to speed up to make up for delays due to summer weather;**

3) **Consumption and retail sales will likely to be prompted by car sales. We expect car sales to rebound in 4Q19.**

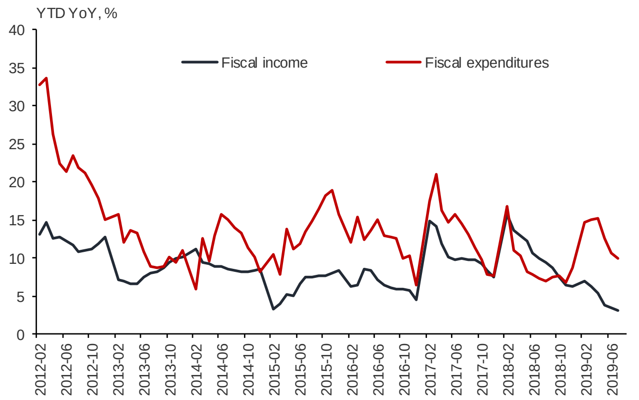
4) **Timing effect.** The 70th National Day and earlier Lunar New Year in 2020 may uplift economic activities in 4Q19.

Figure 30: Local government special bond new issuance amounted to RMB 2.01tn as of 31 Aug 2019



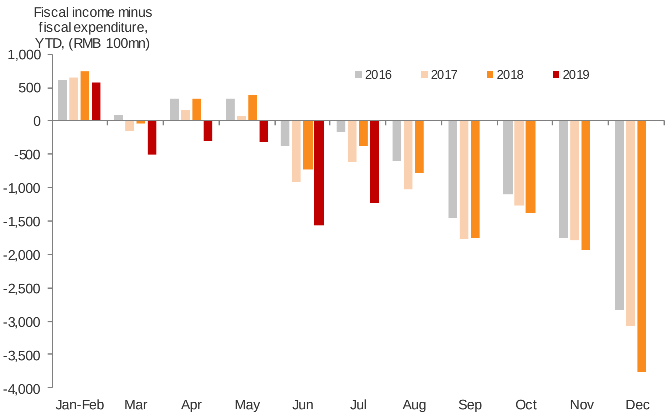
Source: Ministry of Finance, Wind, CMBIS

Figure 31: Fiscal expenditure has been outpacing fiscal income



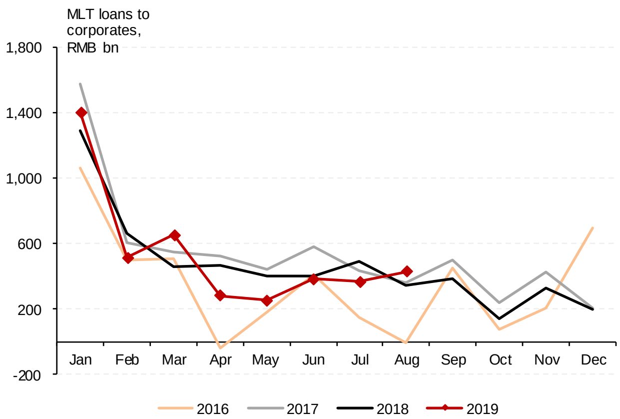
Source: MoF, Wind CMBIS

Figure 32: More aggressive fiscal spending this year



Source: Ministry of Finance, Wind, CMBIS

Figure 33: MLT loans to corporates rebounded



Source: MoF, Wind CMBIS

RMB – likely to strengthen

USD/CNY finding support around 7.10. Several findings from data,

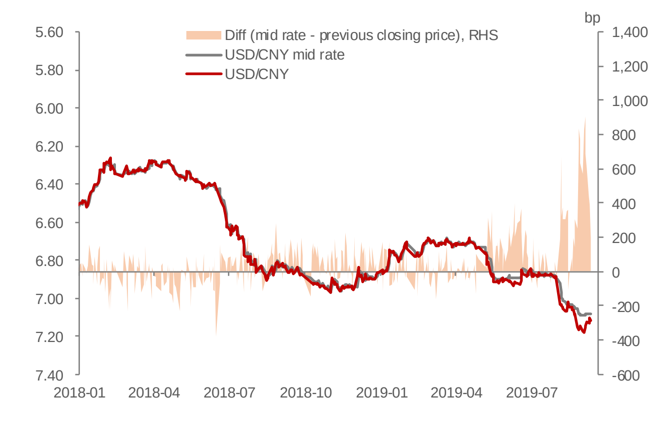
1) The authorities have been lifting USDCNY mid-rate since the end of Aug (and also after 5 Aug when the U.S. labeled China as currency manipulator). This showed an intention to put brake on RMB weakness. Average difference between USD/CNY mid-rate and last closing price was >600bp since 27 Aug, representing the largest discrepancy since the exchange rate reform on 11 Aug 2015.

2) RMB has depreciated "too much" from the perspective of the CFETS Index. The latter declined 2.66% to 91.07 as of 12 Sep 2019 from 93.56 as of 2 Aug 2019. To the extent that monetary authority aims to maintain relative stability of RMB against a basket of CFETS currencies, RMB has room for appreciation from where it is now.

We maintain YE19 USD/CNY forecast at 7.0.

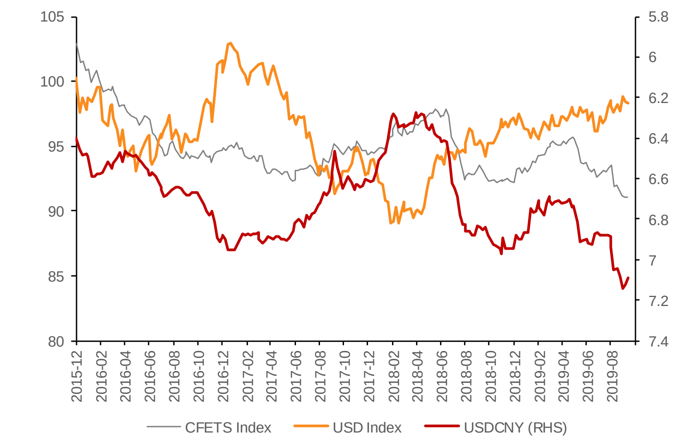
Strengthening factors include, 1) alleviation of China-US trade tensions. Exchange rate between the two currencies has always been on agenda of most of the top-level negotiations; 2) China's economy may exhibit marginal firming up in 4Q; 3) long-term capital market liberalization and relatively attractive yield on fixed income investment encouraging capital inflow.

Figure 34: Authorities have been lifting USD/CNY mid-rate to put brake on RMB weakness



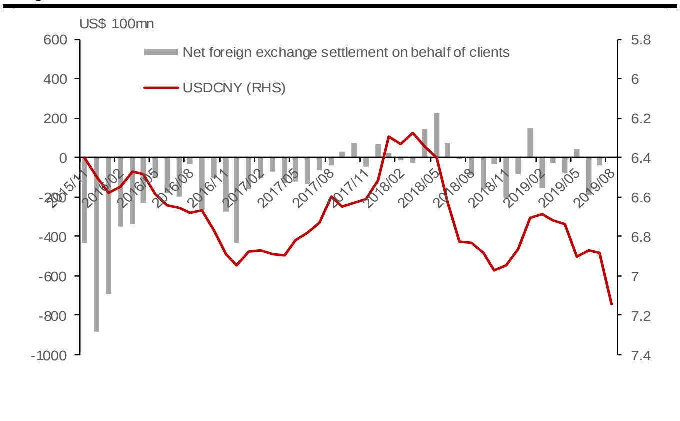
Source: CFETS, Wind, CMBIS

Figure 35: CFETS Index declined 2.66% in Aug, indicating that RMB has depreciated "too much"



Source: CFETS, Wind, CMBIS

Figure 36: Net FX settlement data looks normal



Source: NBS, Wind, CMBIS

US-China Trade Negotiations: back to economic rationale

Both sides showed gestures of "good will" to break the deadlock
As the Oct top-level talk approaches, both China and the U.S. are showing benign efforts to alleviate tensions around the Chinese mid-autumn festival.

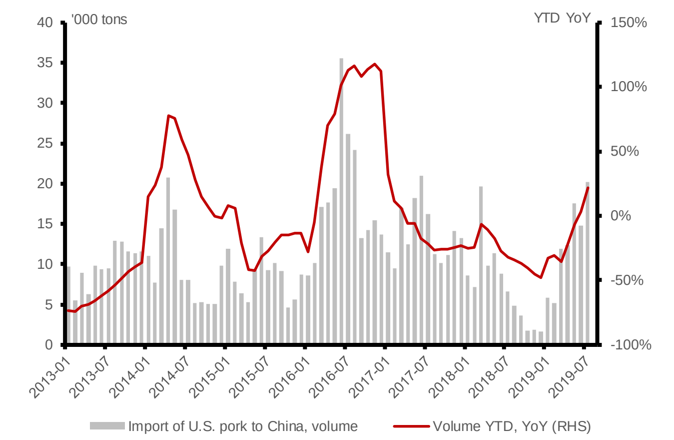
1) On 11 Sep (Beijing time), China exempted some U.S. goods from previous tariff hikes. Exemption list mainly covers industrial chemicals and appliances.

2) On 11 Sep (EST), Trump pledged to postpone additional 5% tariff hike on US$ 250bn Chinese goods from 1 Oct to 15 Oct as a sign of "good will".

3) On 13 Sep, China exempted U.S. soybeans and pork from next tariff hikes planned on 1 Oct.

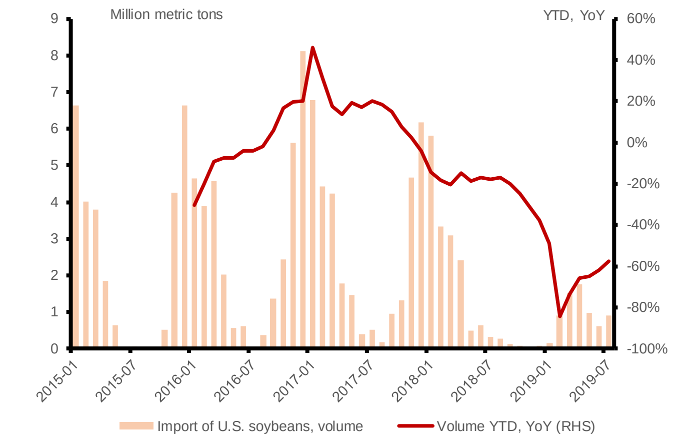
Although exemption and delay do not necessarily imply complete call-off, we think the above steps are positive signs of both sides pushing for a consensus in alleviate tariff woes, which have already inflicted businesses, consumers and corporate confidence.

Figure 37: Import of U.S. pork



Source: CFETS, Wind, CMBIS

Figure 38: Import of U.S. soybeans



Source: CFETS, Wind, CMBIS

Back to economic rationale; active dialogues between China-U.S. businesses
Over time and eventually, business interests would triumph over irrational threats. That trend is becoming more prominent as pure threats failed to strike favorable deals for the U.S. While top-level negotiations have been somewhat bumpy, we observed more frequent talks in the business world between corporate leaders, former officials and scholars from both China and the U.S. driven by mutual interests.

Seek common grounds while setting aside differences temporarily
We admit that U.S.-China tensions will continue to be the background music with discords. While the U.S. seeks immediate solutions in IP protection, foreign investment environment and may even bring up national security issues, China tends to confine the scope of negotiations to only trade and tariffs at this stage. We think both parties should move in the direction of seeking common grounds in the short run, and setting aside long-term disparities for the time being.

We maintain our view that China-US trade negotiation is progressing in a favorable direction, and is very likely to yield some partial deals by year end.

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