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Mild rebound, not trend reversal

Monthly Economic Update for July

SUMMARY. Amid multiple downside risks, central banks around the global flag more easing and US Fed hinted to take a "precautionary" interest rate cut in July. Chinese economy recorded a short-term rebound in June and downside pressure will continue in 2H19. We expect China to reply more on fiscal policy to support economy given that it still has fiscal space.

- **Overseas macro:** Global manufacturing experienced significant drop with declining new orders, new exports and manufacturing activities. Exports of East Asian export-oriented economies such as Japan, South Korea, and Hong Kong continued to fall, reflecting weakening external demands. The escalation of trade tensions between Japan and South Korea in early July will hit South Korea's semi-conductor industry hardest. IMF urged major central banks to get prepared for steeper global slowdown and backed monetary easing by central banks. The downside risks of precautionary interest rate cut is emerging asset bubbles.
- **Chinese economy:** With slowing resident income growth, heightening employment pressure and weakening property sales, consumption growth remains under pressure. Dipping land acquisition expenditure combined with tightening real estate trusts and US debt policies, signal the downward pressure on property market will remain in 2H19. The escalation of trade friction between Japan and South Korea may affect the import of some products in China. Looking forward, in the face of stricter regulatory measures in property market, limited quota of special bonds, waning personal consumption and possible escalation of trade skirmish, China's economic growth remains under huge downward pressure, while fiscal policies are expected to continue to bolster the economy.
- **Monetary policy:** Demand for corporate financing remains weak in China amid sluggish internal and external demands as well as trade friction. The surge of special bond issuance and the reduction in off-balance sheet financing could explain more than 95% of Jun TSF rebound, which is however not sustainable and 2H19 TSF growth remains under pressure.
- **Fiscal policy:** The growth rate of general public budget revenue continued to decline due to the greater impact of tax cuts. If tax income growth further decelerates in 2H19, it is expected the government will raise the profits turned in by designated state-owned financial institutions and enterprises directly under the central government. Government pumps up spending on infrastructure, demonstrated by higher spending growth in transportation, environmental protection and technology development. Chinese government will also rely more on fiscal support to counter downside risks.

	GDP	Fixed assets investment	Retail sales	TSF	Real fiscal deficit rate	10-year gov. bond yield	FX (USDCNY)
2019H2	6.3	6.2	7.8	11.0	4.5	2.9-3.3	6.75
2020	6.1	5.5	7.8	11.2	5.0	3.1	6.60

Source: Wind, CMB Research Institute, CMBIS

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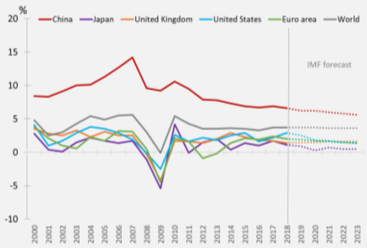
Real GDP growth rate of main economies and forecast



Source: IMF, CMBIS

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Overseas macro:

Central banks flag more easing to combat risks

- **Global economy:** Global manufacturing experienced significant drop with declining new orders, new exports and manufacturing activities. Production of metals and mining, automotive and auto parts continued to shrink. Countries suffering manufacturing contraction include China, Japan, Germany, South Korea, Russia, etc. We expect 2Q19 GDP growth of US, UK and other main economy will fall well below their 1Q19 readings.

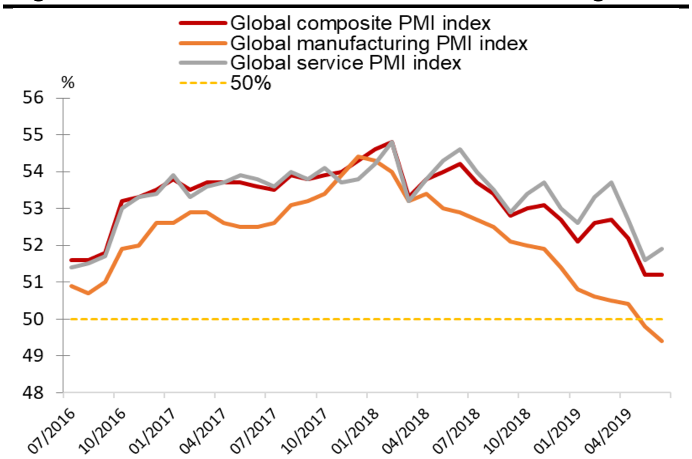
- **Global trade**: Exports of East Asian export-oriented economies such as Japan, South Korea, and Hong Kong continued to fall, reflecting weakening external demands and the trade plight across the globe.

- **Trade disputes:** The escalation of trade tensions between Japan and South Korea in early July will hit South Korea's semi-conductor industry hardest. To respond, Bank of Korea unleased surprise rate cut, the first time since 2016.

- **US economy:** US consumption data picked up in June. Going forward, we see that private consumption and government expenditure will bolster the US economy in the short term, while investment will remain fragile. It is expected that the US GDP growth will become moderate in the second quarter, decelerating from the 3.1% in the first quarter.

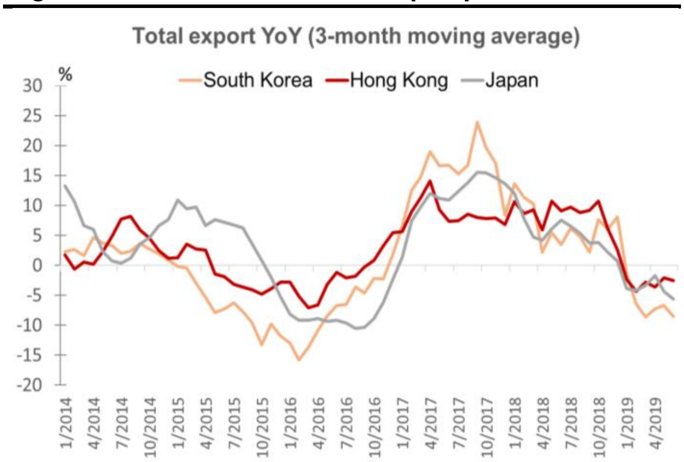
- **Central banks:** IMF urged major central banks to get prepared for steeper global slowdown and backed monetary easing by central banks. Since June, central banks of Russia (25bp), India (25bp), Chile (50bp), Australia (25bp) and South Korea (25bp) have taken turn in cutting their interest rate. The Fed also hinted to take a "precautionary interest rate cut" in July while we expect a 25bp cut of US Fed at the end of July. The downside risks of precautionary interest rate cut is emerging asset bubbles.

Figure 1: Global manufacturers see contracting



Source: CEIC, CMB Research Institute, CMBIS

Figure 2: Global trade sees steep export fall



Source: CEIC, CMB Research Institute, CMBIS

Figure 3: Composite PMIs for major economies

	6/18	7/18	8/18	9/18	10/18	11/18	12/18	1/19	2/19	3/19	4/19	5/19	6/19
US	56.2	55.7	54.7	53.9	54.9	54.7	54.4	54.4	55.5	54.6	53	50.9	51.5
Eurozone	54.9	54.3	54.5	54.1	53.1	52.7	51.1	51	51.9	51.6	51.5	51.8	52.2
UK	55.1	53.5	54.2	54.1	52.1	50.8	51.4	50.3	51.5	50	50.9	50.9	49.7
Japan	53.1	51.7	52.1	51.8	52	50.7	52.5	52.4	52	50.9	50.7	50.7	50.8
China	53	52.3	52	52.1	50.5	51.9	52.2	50.9	50.7	52.9	52.7	51.5	50.6

Source: Bloomberg, CMB Research Institute, CMBIS

Real economy:

Short-term rebound and continued downside pressure

- **Consumption**: The sharp rise in automotive consumption growth was the main driver for the rebound in retail growth in June, which was however not sustainable. With slowing resident income growth, heightening employment pressure and weakening property sales, consumption growth remained under pressure.

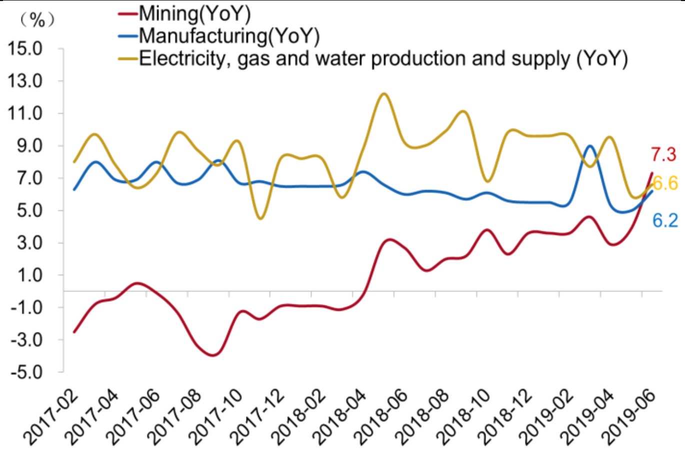
- **Investment:** 1H19 urban fixed-asset investment rose 5.8% YoY, mainly driven by infrastructure and manufacturing investment. There is room for further improvement in infrastructure spending, and possible issuance of special bonds for raising capital is likely to fuel infrastructure investment growth by 2ppt. Given slack internal and external demands as well as exports, manufacturing investment continued to face downside pressure. It is expected land acquisition expenditure will keep dipping. This, combined with tightening real estate trusts and US debt policies, signal the downward pressure on property market will remain in 2H19.

- **External trade**: Decelerating trade surplus is unlikely to reverse in the short term. As the growth rate of imports was relatively high, and the weakening of domestic demand due to the base effect will make the subsequent import growth facing a large downward pressure. At the same time, the escalation of trade friction between Japan and South Korea may affect the import of some products in China.

- **Inflation:** CPI inflation about to fall. CPI in June stayed flat MoM with the support of fruits and pork supplies, while tax and price cuts offset the downward pressure of PPI. PPI is likely to witness deflation in 3Q19, but to a moderate extent. CPI tends to stay high throughout 2019, however unlikely to break through 3%.

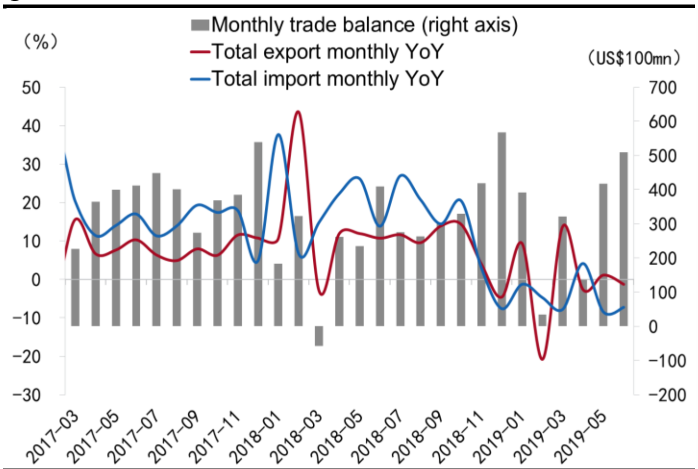
- **2H19 outlook:** China's GDP in real terms rose 6.2% YoY in 2Q19, and grew 6.3% YoY in 1H19, in line with our interim forecasts. Looking forward, in the face of stricter regulatory measures in property market, limited quota of special bonds, waning personal consumption and possible escalation of trade skirmish, China's economic growth remains under huge downward pressure, while fiscal policies are expected to continue to bolster the economy.

Figure 4: Rebound of industrial output growth in June



Source: Wind, CMB Research Institute, CMBIS

Figure 5: Export growth slowed in June, and import growth rebounded



Source: Wind, CMB Research Institute, CMBIS

Monetary policy:

Rebound of TSF in June is not sustainable; 2H19 growth remains under pressure

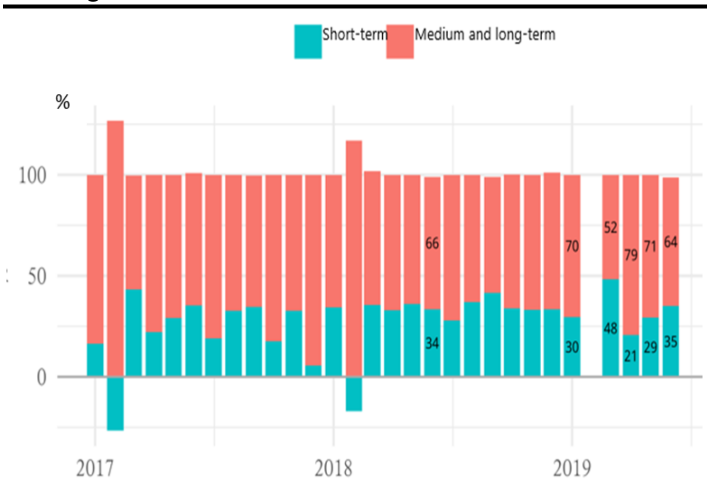
- **New loans:** Demand for corporate financing remains weak amid sluggish internal and external demands as well as trade friction. New bank loans extended in June were estimated at RMB 1.66tn, which was RMB 180bn lower than June of 2018. Household loans increased more quickly than corporate loans, indicating the resilience of real estate sales. Medium and long-term loans continued their contraction since 2Q19, and willingness to take spend on CAPEX remained weak. However, there is a clear substitution relationship between the newly added short-term loans and the on-balance sheet bills. The on-balance sheet bill financing has shrunk, which is likely to be related to the Baoshang takeover event.

- **TSF:** In June, TSF rose to RMB 2.26tn from RMB 1.4tn in May. The surge of special bond issuance and the reduction in off-balance sheet financing could explain more than 95% of Jun TSF rebound.

- **Money supply:** The M2 rose 8.5% YoY to RMB 192.14tn at the end of June, the same growth pace as it of May, negatively affected by the decline of non-bank deposits and fiscal deposits. The M1-M2 gap also converged.

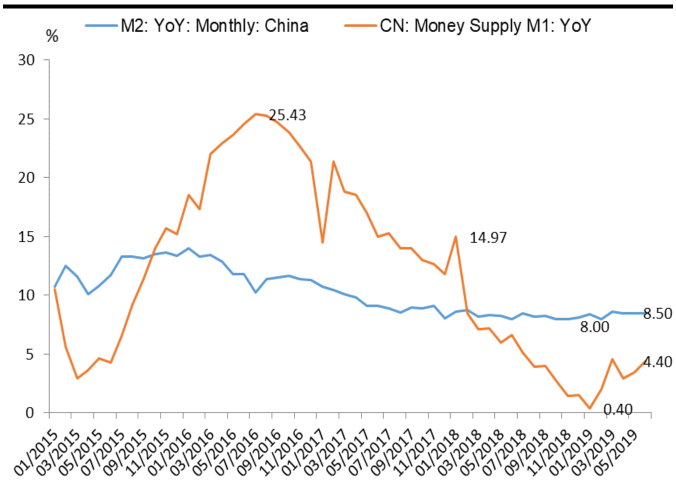
- **Our forecast:** Looking forward, there is still pressure on TSF growth in the second half of the year. First of all, amid weak domestic and foreign demand and trade frictions, corporate financing demand is still weak. Secondly, the local special bond issuance has obviously sped up this year. In the second half of the year, the remaining amount of special bond issuance is lower than that of the same period last year; Under the principle "housing is for people to live in, not for speculation" promoted by the government, regulation on REIT is reinforced while off-balance sheet financing growth is still under pressure. Finally, the small-scale bank contraction that may be caused by credit stratification is also unfavorable for social growth and is worth the attention.

Figure 6: Composition of new short-term household lending



Source: CEIC, CMB Research Institute, CMBIS

Figure 7: M1-M2 gap has converged



Source: CEIC, CMB Research Institute, CMBIS

Fiscal policy:

Growing reliance on fiscal support

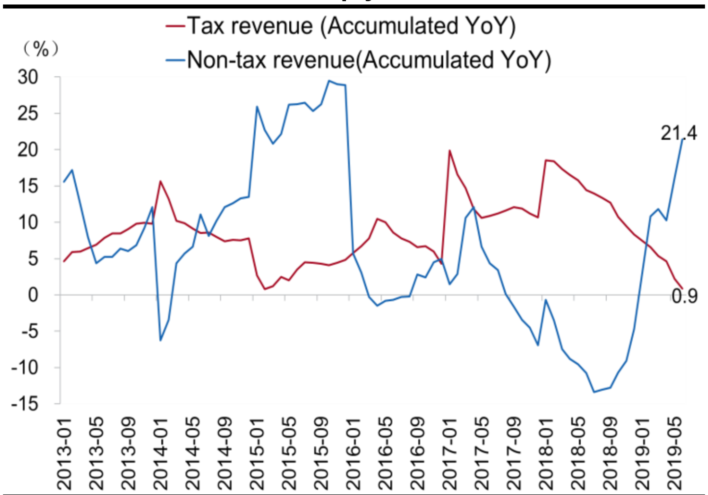
- **Fiscal revenue:** 1H19 government revenue was exposed to greater impact of tax cuts, showing significant "front-loading" effect. The growth rate of general public budget revenue continued to decline as the YoY growth rate has dropped to 3.4%, the second lowest since 2013. The growth rate of tax revenue declined, and non-tax revenue rose sharply, the highest since 2016, as a result of revitalizing state-owned funds and assets via multiple channels.

  If tax income growth further decelerates in 2H19, it is expected the government will raise the profits turned in by designated state-owned financial institutions and enterprises directly under the central government, as well as revenues from the compensated use of state-owned resources.

- **Fiscal expenditure:** Subject to the sharp drop in tax revenue, the growth rate of general public budget expenditure has slowed down. In 1H19, the national general public budget expenditure grew at a rate of 10.7% YoY, a decrease of 1.8pt from the previous five months. Although it is still higher than the average level since 2013, it has obviously been constrained by the decline in tax revenue growth.

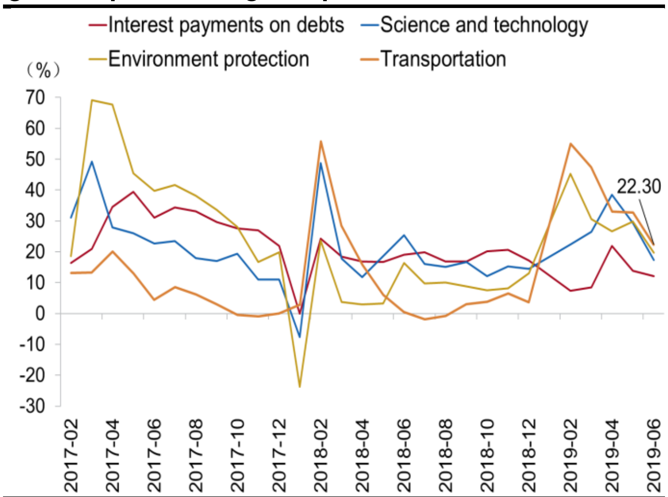
  Government pumps up spending on infrastructure, demonstrated by higher spending growth in transportation, environmental protection and technology development. The growth rate of transportation expenditures leads all general public budget expenditures. Chinese government will also rely more on fiscal support to counter downside risks. That said, if the downward pressure on the economy is controllable in the second half of the year, it is expected that the fiscal stimulus will not be significantly increased, so as to leave room for the policies of next year.

Figure 8: The growth rate of tax revenue declined, and non-tax revenue rose sharply



Source: Wind, CMB Research Institute, CMBIS

Figure 9: Transportation expenditures led all general public budget expenditures



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