CHINA: SHARP DECELERATION IN Q3 ON MULTIPLE HEADWINDS

POLICY FINE TUNING NOT SUFFICIENT TO BOOST NEAR-TERM GROWTH

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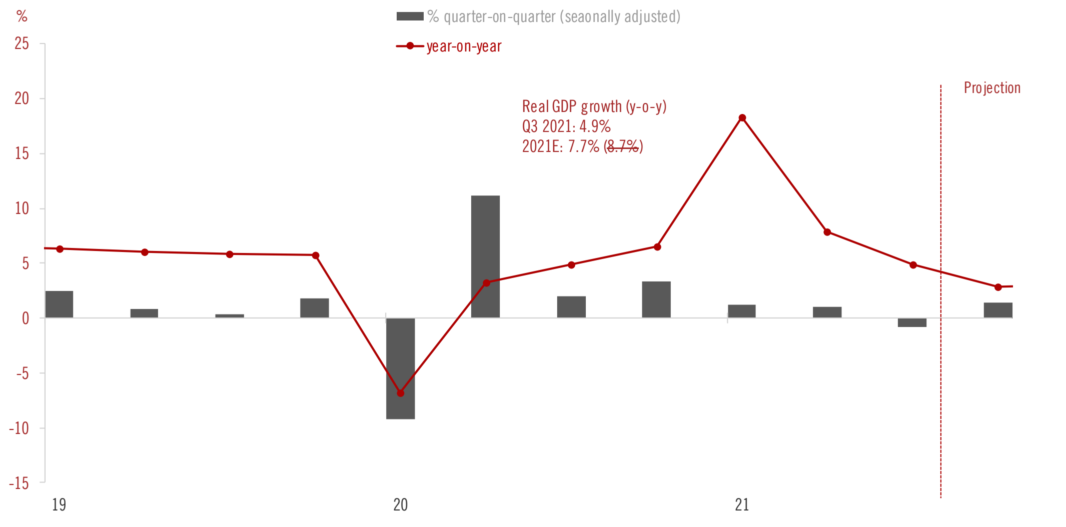
SUMMARY

- The Chinese economy decelerated sharply in Q3. The lingering threat from covid, troubles in the property sector and the recent energy shortage all contributed to the slowdown.
- The shift in Beijing's policy priorities towards sustainable growth and social equality explain a large part of the slowdown. While many of these policies could bring long-term benefits to the Chinese economy, they could continue to cause pain in the short term.
- In response to the sharp deceleration in growth, the government has started to adjust some of its policies, but this may be insufficient to fully offset the pressure on growth momentum. Hence, we have decided to revise downwards our 2021 GDP forecast for China from 8.7% to 7.7%.

China's Q3 GDP came in well below market expectations at 4.9% year-on-year (y-o-y), compared to 18.3% in Q1 and 7.9% in Q2. The Chinese economy expanded by 9.8% y-o-y in the first three quarters of 2021 overall, down from 12.6 % in the first half (*Chart 1*).

CHART 1: CHINA REAL GDP GROWTH, INCLUDING PROJECTIONS



Source: PWM - AA&MR Wind, NBS. Data as of October 2021

Although exports continued to hold up strongly, other parts of the economy decelerated quite sharply in Q3 due to lingering impact of covid and the government's sweeping regulatory campaign. A serious energy shortage further weighed on China's industrial sector. While we expect some policy fine-tuning to ease the pains in the near term, the broad thrust of government policy is unlikely to change. Ongoing fiscal easing should help, but the pace and magnitude of such support may be insufficient to fully offset the headwinds the Chinese economy is facing.

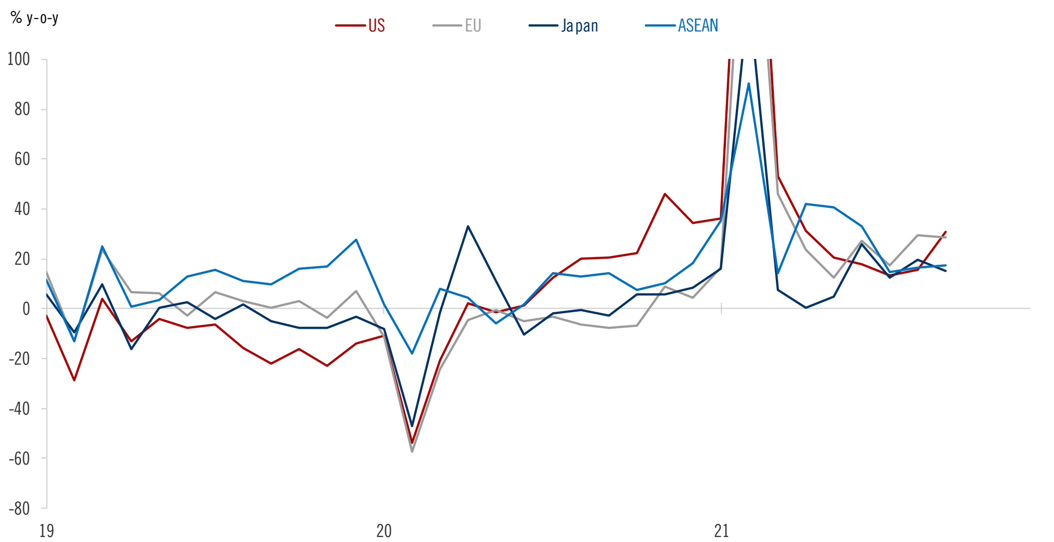
Overall, the latest data releases point to a Chinese economy that has decelerated faster than we had expected (although we have been warning of downside risk to our growth forecasts), and the possible rebound in Q4 may be modest. Hence, we have decided to revise down our full-year GDP forecast for China to 7.7% from 8.7%.

Below are some more details of the recent data releases.

Growth deceleration despite strong exports

Chinese exports continued to surprise on the upside in September, rising by 28.1% y-o-y, following an equally impressive 25.6% rise in August. This reflects a robust recovery in developed economies (especially the US and EU, *Chart 2*) and, possibly the diversion of export orders from Southeast Asia due to covid disruptions in that region.

CHART 2: GROWTH IN CHINESE EXPORTS BY MAIN DESTINATION



Source: PWM - AA&MR, China Customs. Data as of October 2021

However, other parts of the economy have continued to slow. Industrial production in Q3 declined by 1.8% quarter-on-quarter (q-o-q), compared with 3.3% growth in Q1 and 0% in Q2. The output of steel and steel products slumped further in September, reflecting the output restrictions imposed on carbon-intensive sectors and slowing fixed-asset investment (FAI). For example, real estate investment declined for the first time since February 2020 in September, when it dropped 3.7% y-o-y. Infrastructure investment also contracted in September, by 6.2% y-o-y, although it showed some signs of bottoming as fiscal policy has turned more supportive. Manufacturing investment was the only bright spot in the FAI space, expanding by 10.2% y-o-y. This may indicate rising capital expenditure by some manufacturers in response to strong export demand (*Chart 3*). Overall, however, FAI declined by 2.4% y-o-y in September compared with growth of 0.9% in August.

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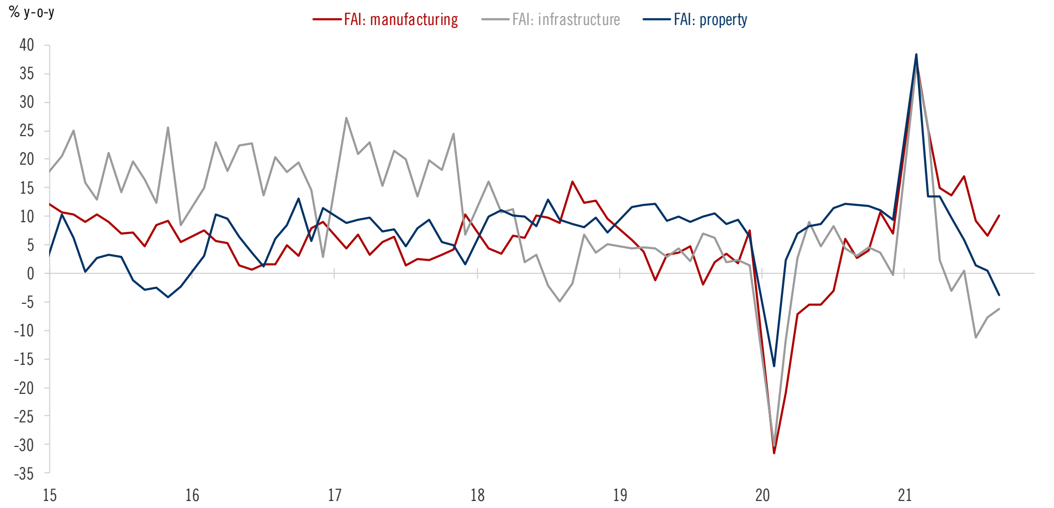
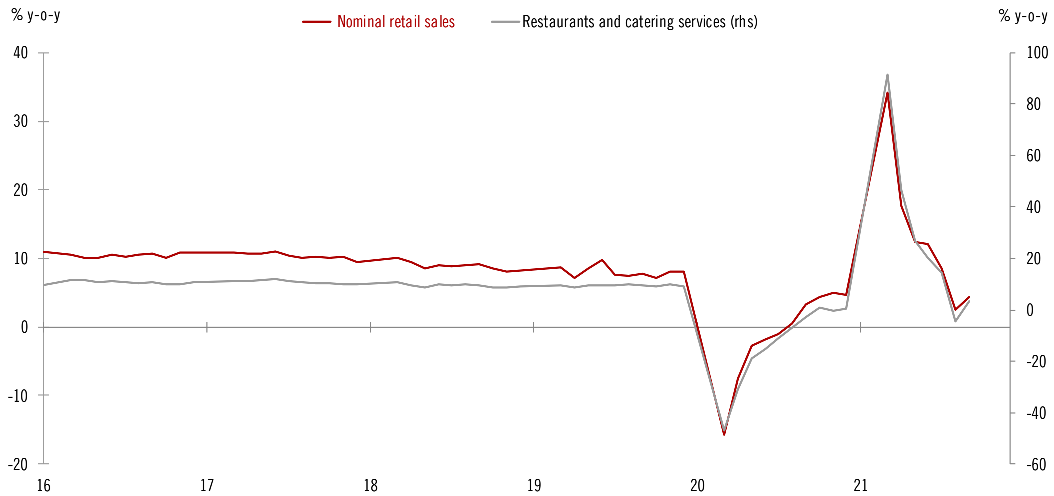
CHART 3: GROWTH IN CHINESE FIXED-ASSET INVESTMENT BY SECTOR



Source: PWM - AA&MR, Wind, NBS. Data as of October 2021

After a covid-induced slump in August, retail sales rebounded only moderately to 4.4% y-o-y in September (*Chart 4*), around half the level before the pandemic. In particular, growth in restaurants and catering services remained subdued at 3.1% y-o-y, compared to a five-year average of 10.4% in 2015-2019. This, together with weak tourism figures for the National-Day Golden Week holidays, suggests that China's zero-covid policies are holding back household consumption, particularly of services.

CHART 4: GROWTH IN CHINESE RETAIL SALES



Source: PWM - AA&MR, NBS. Data as of October 2021

Shifting policy priorities are the main cause of the deceleration

Since the Chinese government launched anti-monopoly investigations against some major internet companies late last year, sweeping new policies and regulations have sent shockwaves around large parts of the Chinese economy. The government’s broad aim is to arrive at a more sustainable growth model and a better balance between growth and

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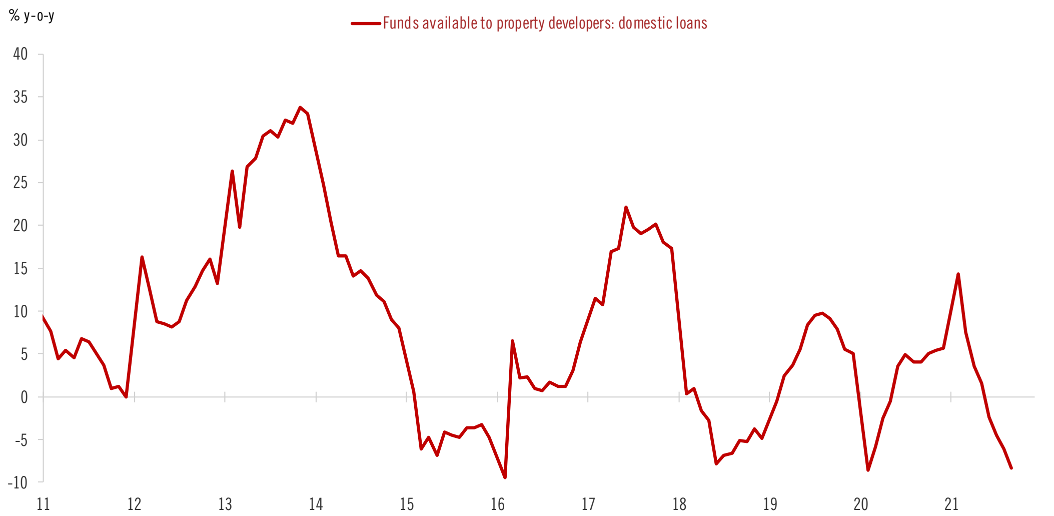
social equality. For example, highly leveraged property developers are being required to reduce their debt, manufacturers are being required to adhere to more stringent carbon emission standards, while internet giants have been told to correct their anti-competitive practices and pay much more attention to the protection of user data.

While these new regulations could bring long-term benefits to the Chinese economy and society at large (if well implemented), they may well cause near-term pain, in particular in the most affected sectors. So far, two set of policies seem to have had the greatest direct impact on growth: property sector deleveraging and carbon emission restrictions.

CHART 5: GROWTH IN DOMESTIC LENDING TO DEVELOPERS



Source: PWM - AA&MR, NBS. Data as of October 2021

The liquidity crisis currently faced by some highly leveraged Chinese developers is a direct consequence of the government's decision to significantly limit these developers' ability to raise new debt. In the first nine months of the year, domestic loans available to developers contracted by 8.4% y-o-y (*Chart 5*), leading to the rapid slowdown in the property sector previously mentioned.

As for climate policies, activity in carbon-intensive industries has plummeted since some local governments imposed aggressive measures to meet their annual target for containing energy use and carbon emissions. Nor has the decline in the property sector helped. For example, in September ferrous metal smelting & processing declined by 9.7% y-o-y, while cement production contracted by 13% *(Chart 6)*. The Chinese government's push towards a green economy has also restricted coal production, still by far the largest source of energy in China. These restrictions have contributed to power shortages in parts of the country and caused industrial disruption.

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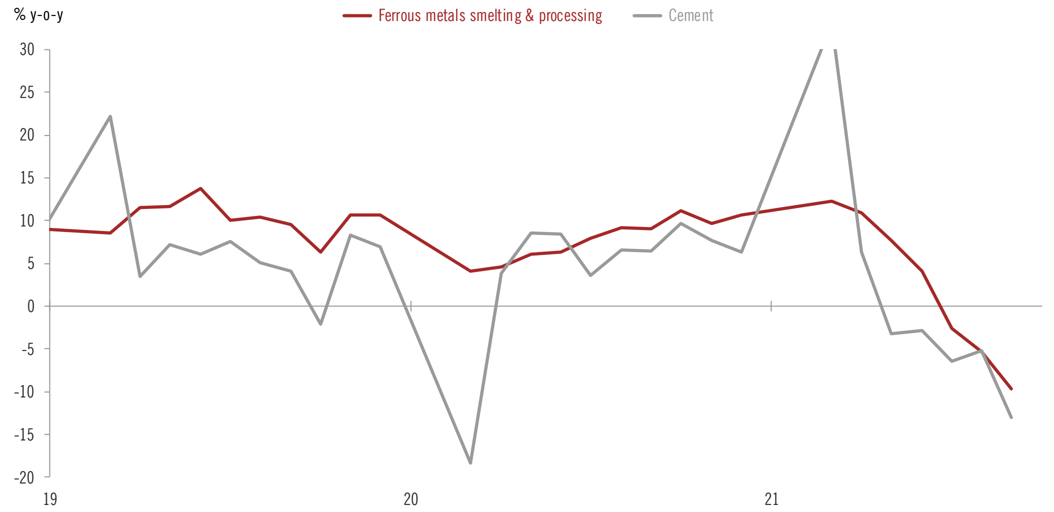
CHART 6: GROWTH OF OUTPUT IN SELECTED CARBON-INTENSIVE SECTORS



Source: PWM - AA&MR Wind, NBS. Data as of October 2021

Fine-tuning of policies, but no U-turn

In response to the sharp deceleration in growth, the government has started to adjust some of its policies. For example, it has removed many of the restrictions on domestic coal production and stepped up imports of the fuel. These measures should alleviate the acute coal shortage in the coming months—but we do not expect the government to scrap its climate goals of achieving carbon peak by 2030 and carbon neutrality by 2060.

Although credit available to developers remains tight, the monetary authority seems to have relaxed regulations on mortgage approvals, leading to a sequential rise in mortgage loans in both August and September. In other words, we have seen some fine tuning of policies, but no U-turn in the government's broad direction. In our view, there has been a paradigm shift in the government's policy agenda, with many new regulations here to stay.

On the fiscal policy front, the pace of local-government bond issuance has picked up speed since the middle of the year. At the end of September, total bond issuance year-to-date had almost caught up with the level seen at the same point last year, after having lagged significantly in H1. This will likely provide some marginal support to infrastructure investment but will not lead to a major boost on a year-over-year basis.

The People's Bank of China may stay accommodative, providing liquidity as necessary to the financial system. However, we no longer expect a cut in banks' required reserve ratios (RRR) in the rest of 2021. Instead, the central bank will most likely resort to open-market operations and other targeted tools to manage financial system liquidity.

In summary, despite the government's recent moves to mitigate the downward pressure on growth momentum stemming from its own policies, the adjustments may not be enough to fully offset the growth headwinds that China is facing. As a result, we have decided to revise down our 2021 GDP forecast to 7.7% from 8.7% previously.

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