more give, less take

China’s economy at a glance

by NAB Group Economics

15 July 2015

National Australia Bank

China’s economic growth was stable in Q2, but can services maintain momentum post equity correction?

- An influx of new investors and a sharp increase in margin finance contributed to the surge in equity prices since late 2014. Following a correction starting in mid-June, China’s government implemented a range of policy measures to curb the falls – raising some concerns around the Government’s broader appetite for reform.
- Second quarter national accounts data showed China’s economy expanded by 7.0% yoy, unchanged from the March quarter – although this doesn’t correspond with official quarterly growth rates. Services were the key driver of growth, but reflecting the impact of the equity boom on Q1 GDP, there are questions as to the sustainability of this growth. Our forecasts are unchanged (7.1% in 2015; 6.9% in 2016).
- Although it has remained weak on a historical basis, China’s industrial output strengthened again in June – increasing by 6.8% yoy (compared with 6.1% in May).
- China’s fixed asset investment has continued to edge away from a thirteen year low in April, with growth at 11.4% yoy in June (compared with a 10% increase in May). In part this may reflect the impact of policy measures across the first half of the year.
- China’s latest trade data showed a slight narrowing in the overall surplus – down to US$46.5 billion (from US$59.5 billion in May). This contraction was driven by a month-on-month strengthening in imports (albeit imports remain well below levels from 2014).
- In late June, the People’s Bank of China (PBoC) cut interest rates – in part a response to the share market plunge. The benchmark one-year lending rate was cut to 4.85% – a record low – along with targeted (RRR) cuts. Further policy easing is expected across the second half of this year.

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Special update – Chinese equity markets

- We previously highlighted concerns around the rapid rise in prices in Chinese equity markets since late 2014. Prices on the Shanghai and Shenzhen Stock Exchanges peaked on June 12 before falling sharply, triggering a series of policy responses from China's government. The run up in prices came as something of a surprise, given the slowing in the domestic economy and weak profit trends.

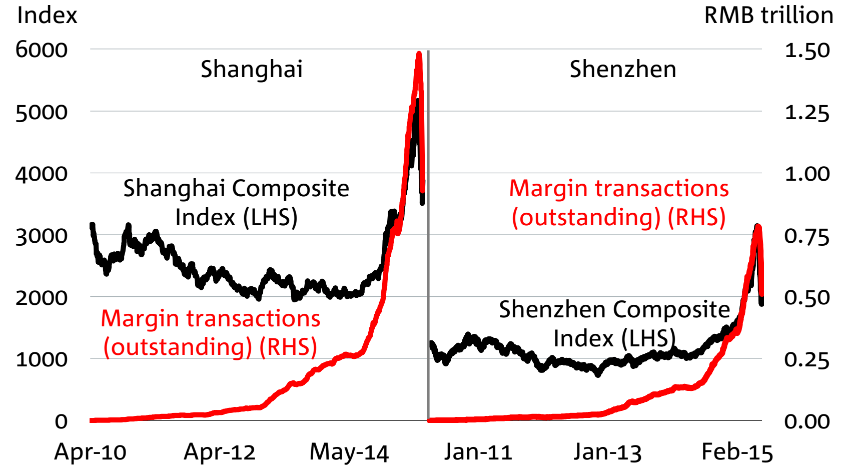
- Key drivers of the surge appear to have been the influx of new investors – the majority of whom had limited education – along with promotion in state-run media and a sharp increase in margin financing (which has only been permitted in Chinese markets since March 2010). At its peak, outstanding margin transactions totalled RMB 2.27 trillion. As prices began to fall, the share of margin transactions to market capitalisation peaked at 3.8% in early July – above the trend levels of US and key Asian markets.

- As prices began to fall, the downward pressure was exacerbated by margin calls – which forced investors to liquidate positions. From peak to trough, the combined losses on the Shanghai and Shenzhen Stock Exchanges totalled over RMB 24 trillion (equivalent to almost US$4 trillion), a fall of 34%. However, prices are still around 113% higher over the past twelve months (at the time of writing).

- China's government stepped in with a range of policy measures – including cutting interest rates, allowing greater pension fund investments and relaxing financial restrictions (a comprehensive list of measures is here). Many stocks were also removed from trade as the market recovered from its lows.

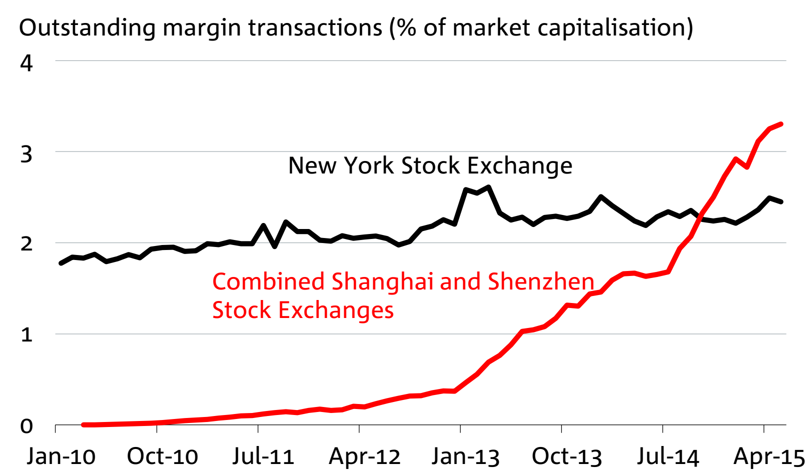
- These policy responses raise some concerns around the Government's appetite for reform and may signal an increased likelihood of stimulus should economic growth slow significantly. However the comparatively low share of equities in household wealth should limit the downside risk to consumption from the recent correction.

Sharp increase in margin loans appears to have driven the surge in China's equity markets



Source: CEIC, NAB Economics

The rapid acceleration in margin transactions has pushed China's position beyond international peers



Source: CEIC, NYSE, NAB Economics

Gross Domestic Product

- Second quarter national accounts data showed China's economy expanded by 7.0% yoy, unchanged from the March quarter. While this result meant a pause in the slowing trend evident across recent years, growth remains at its weakest level since March 2009. That said, this result was stronger than market expectations, at 6.8% yoy in Bloomberg's analyst survey.

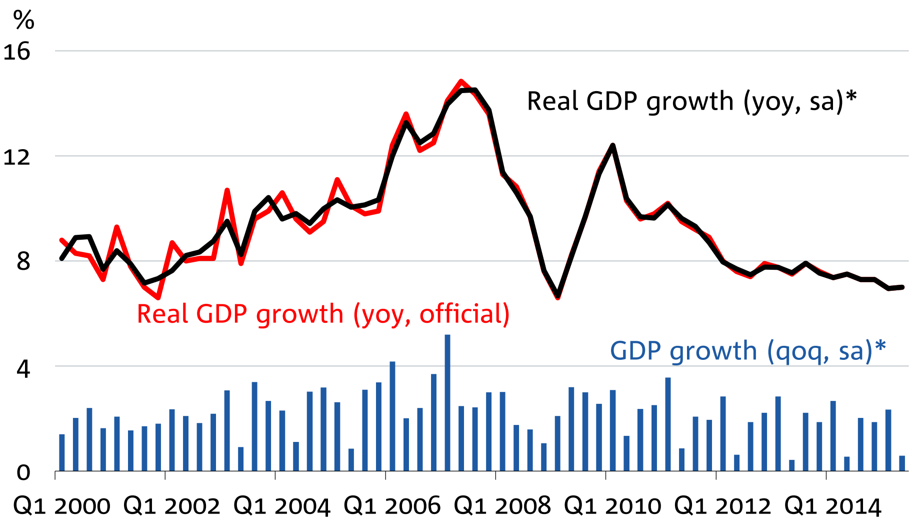
- That said, the headline data doesn't completely correspond with seasonally adjusted quarterly growth data produced by the NBS. We can create an index based on this quarterly profile, which shows a slowing year-on-year trend in the second quarter, at 6.7% (down from 6.9% yoy in the March quarter).

- The transition away from heavy industry as China's key engine for growth has continued – with the services sector dominating growth. In the first half of the year, real growth in services was 8.4% yoy, compared with just 6.1% yoy for the secondary industries over the same period.

- That said, we have previously noted the impact of the equity boom on Q1 service growth – raising questions around the sustainability of this growth over the second half of 2015.

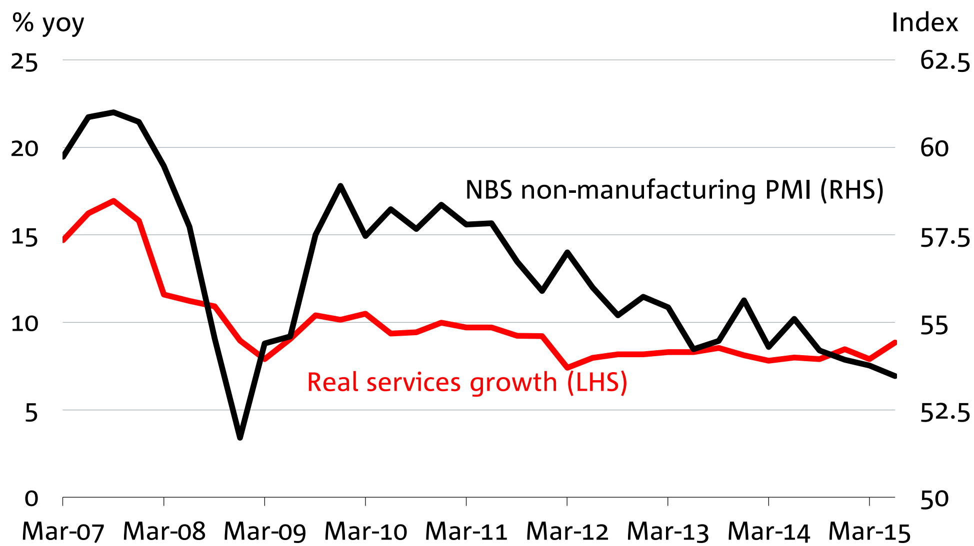
- Given the stronger than anticipated growth in the second quarter, our forecasts for headline real GDP growth remain unchanged at 7.1% in 2015 and 6.9% in 2016. In our view, Chinese authorities are unlikely to tolerate growth below the annual target for a second straight year.

Headline real GDP unchanged in Q2 at 7.0% yoy, though quarterly data indicates a slowing trend



* Seasonally adjusted growth series are estimated by NAB.
Source: CEIC, NAB Economics

Service sector the key driver of growth in the first half of 2015 (but will the equity correction slow second half?)



Source: CEIC, NAB Economics

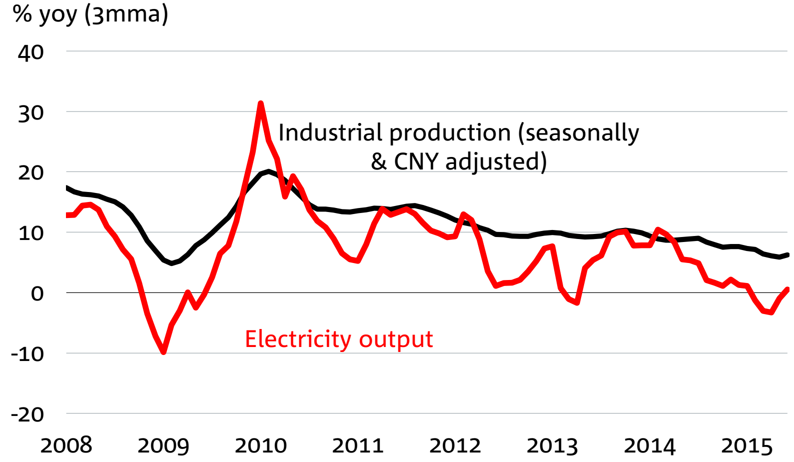
Industrial production

- Although it has remained weak on a historical basis, China's industrial output strengthened again in June – increasing by 6.8% yoy (compared with 6.1% in May). This result was considerably stronger than market expectations, which had anticipated a slowing trend to 6.0%.

- That said, conditions remain mixed by industry sub-sector, with construction related sectors like cement (-5.8% yoy) and crude steel (-0.8% yoy) remaining subdued. In contrast, motor vehicle output rose by 0.7% yoy (compared with -1.6% previously) and electricity production was 0.5% yoy higher (unchanged from a year earlier in May).

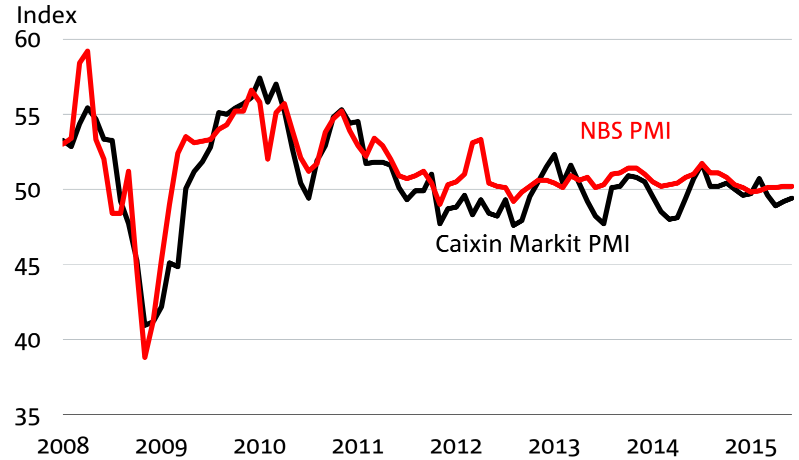
- China's main industrial surveys also remain subdued. The official NBS PMI was unchanged in June at 50.2 points – a result that is essentially neutral. The Caixin Markit PMI edged up slightly (but remained negative) to 49.4 points (from 49.2 points in May).

China's industrial sector showing signs of a modest recovery from weak conditions in Q1



Source: CEIC, NAB Economics

Industrial surveys subdued – neutral NBS PMI unchanged; Caixin Markit survey marginally less negative



Source: CEIC, NAB Economics

Investment

- China's fixed asset investment has continued to edge away from a thirteen year low in April, with growth at 11.4% yoy in June (compared with a 10% increase in May). In part this may reflect the impact of policy measures across the first half of the year.

- Trends at an industry level remain highly divergent. Investment in real estate has continued to slow – in line with the soft property market conditions – with growth down to 2.1% yoy (on a three month moving average basis). Similarly, manufacturing investment has softened to 9.3% yoy.

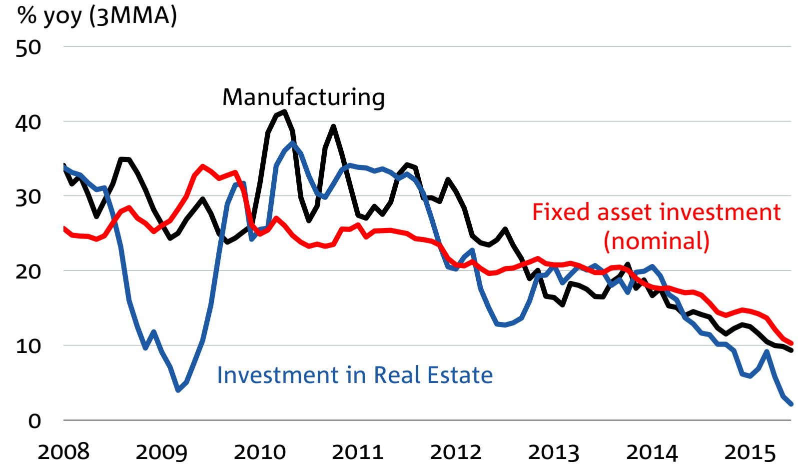
- In contrast, investment has been considerably stronger in industries such as transport, storage & postal services and water conservancy, environment & utility management – with the latter growing by almost 25% yoy in June. Combined, these sectors comprised 18% of total investment in June.

- While real estate investment is still trending down, conditions in the property sector are continuing to improve. At a national level, China Index Academy data showed prices rose by 0.3% month-on-month in June (on a three month moving average basis), led by growth in China's largest cities.

- Tier 1 cities recorded significant gains – with prices up by 1.2% mom (3mma), while tier 2 cities were unchanged (following twelve months of falls). Smaller cities (tier 3 and below) fell once again, but by just -0.2% mom (3mma) – edging closer to neutral levels.

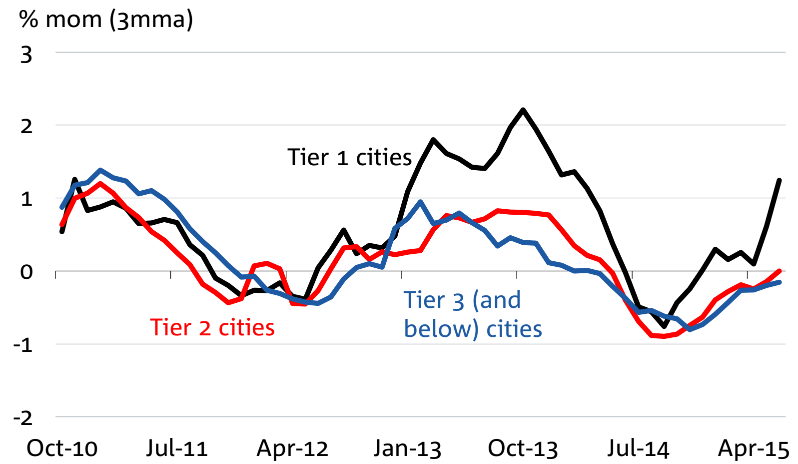
- We expect stabilising prices to provide minimal support for new construction activity. Over the first half of 2015, residential construction starts fell by -17.2% yoy. This has contributed to the relative weakness in steel and cement output, and iron ore and coal imports (having a flow through effect to Australia).

Real estate investment has continued to slow, constraining growth in investment



Source: CEIC, NAB Economics

The modest recovery in property markets continued in June – led by growth in Tier 1 city prices

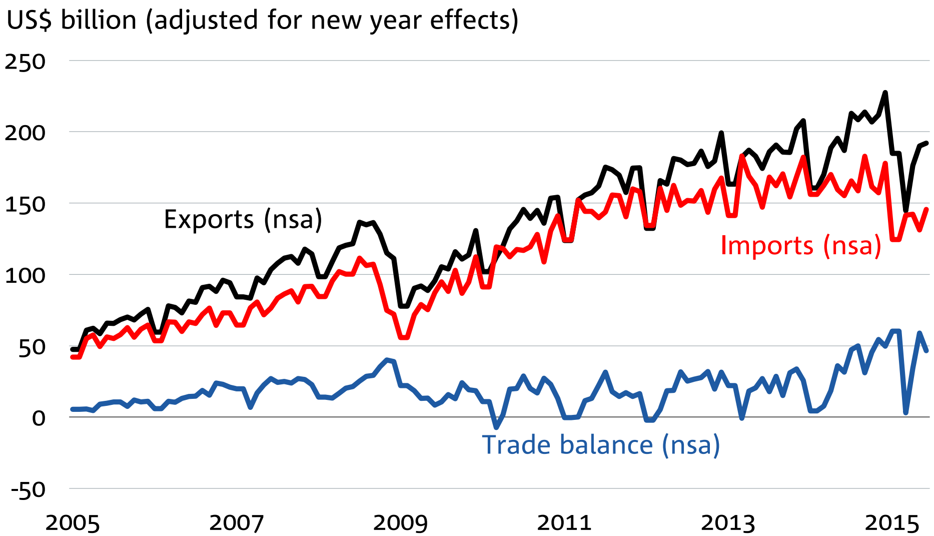


Source: China Index Academy, Datastream, NAB Economics

International trade – trade balance and imports

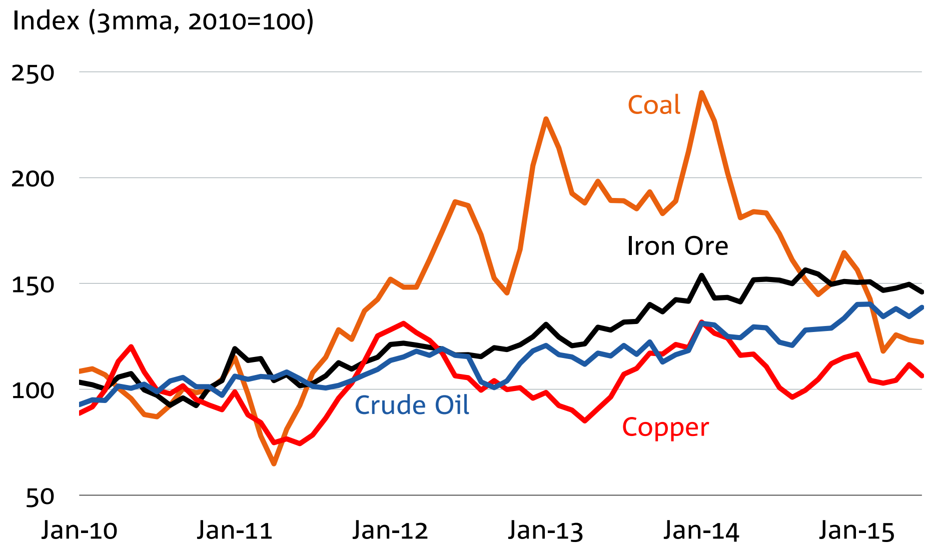
- China's latest trade data showed a slight narrowing in the overall surplus – down to US$46.5 billion (from US$59.5 billion in May). This contraction was driven by a month-on-month strengthening in imports (albeit imports remain well below levels from a year ago).
- China's imports totalled US$145.5 billion in June (up from US$131.3 billion in May) – a year-on-year decline of -6.1%. To some extent, falling commodity prices have contributed to this trend – with the RBA Index of Commodity Prices falling by -25% yoy in June.
- That said, import volumes have also fallen. According to our estimations, volumes declined by around 7.1% yoy in the first five months of the year.
- Weaker volumes of coal (down -38% yoy in the first half of 2015), copper (-11% yoy) and iron ore (-0.9% yoy) have contributed to this trend. In contrast, crude oil volumes have continued to rise – up by 7.5% yoy.

Marginally stronger imports drove a slight narrowing in China's trade surplus for June



Sources: CEIC, NAB Economics

While price effects have driven the fall in imports, volumes are also lower, led by coal

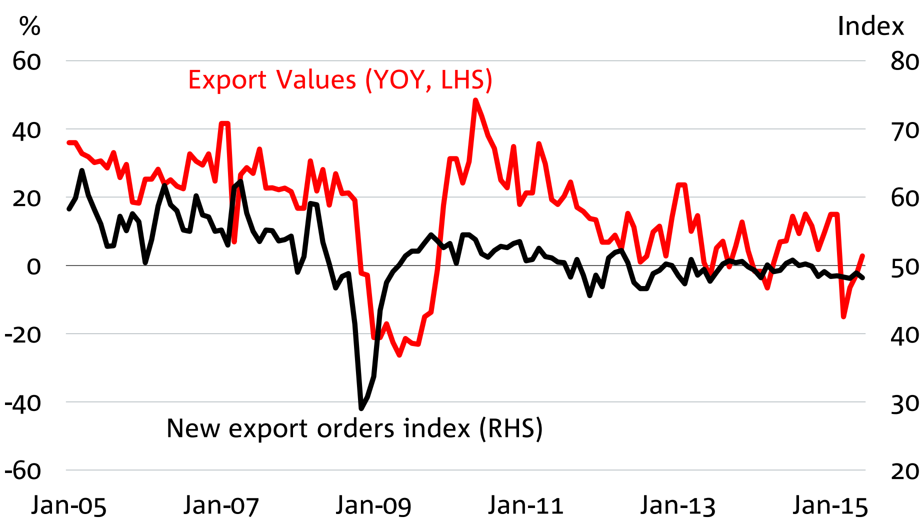


Sources: CEIC, NAB Economics

International trade – exports

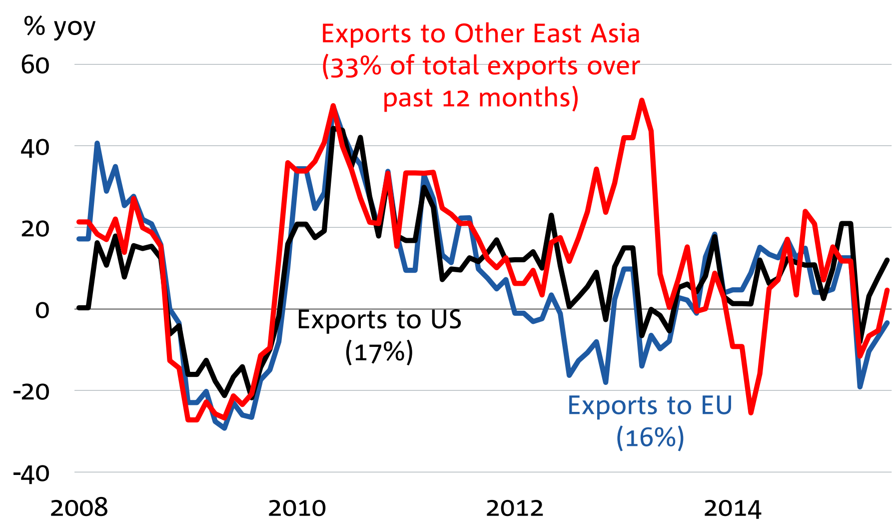
- China's exports totalled US$192.0 billion in June, a modest increase of 2.8% yoy (following three months of declines). This increase came despite ongoing weakness in the new export orders index in the NBS PMI survey – with this measure trending down to 48.2 points in June (from 48.9 points previously).
- Exports trends improved in each major market. Exports to the United States rose by almost 12% yoy in June (from 7.8% in May), while exports to East Asia rose by 4.6% yoy (compared with a fall of -4.2% previously). In contrast, exports to Europe fell once again in June, down -5.3% yoy (though this was less negative than the -6.9% fall previously).
- Exports to Hong Kong have fallen in 2015, however the decline was comparatively modest in June – at -0.5% yoy (from -6.9% previously). In contrast, there was growth in exports to non-Hong Kong Asia, up by 9.0% yoy (from -1.9% in May).
- That said, the disparity in reported trade between Hong Kong and mainland China has gradually widened in recent months – out to US$4.8 billion in May – albeit this level remains narrower than the averages recorded in 2013 (US$11.2 billion) and 2014 (US$8.9 billion).

Following three months of declines, exports rose yoy in June, albeit modestly compared with previous trends



Source: CEIC, NAB Economics

Exports to Europe continued to contract year-on-year, but growth in Asia re-emerged in June

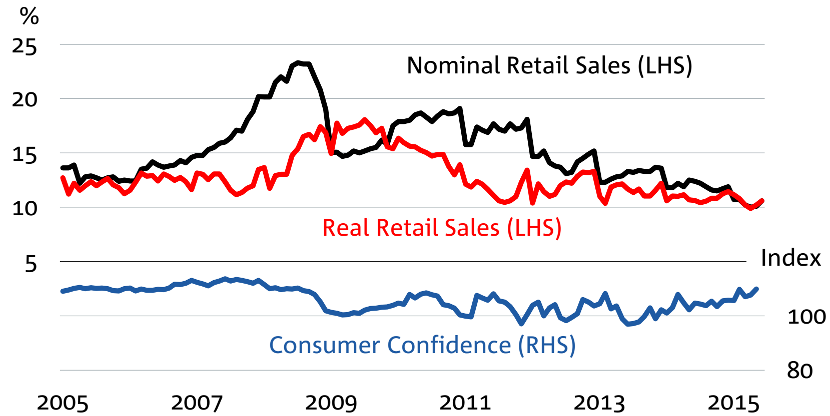


Sources: CEIC, NAB Economics

Retail sales and inflation

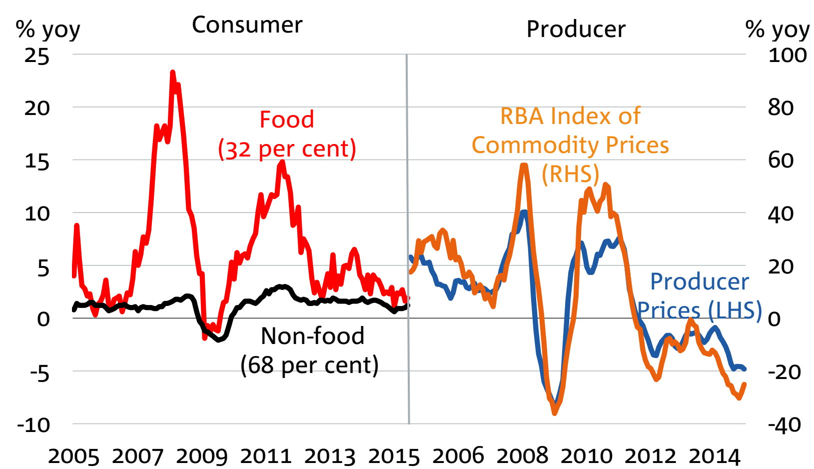
- China's retail sales pushed a little higher in June – rising by 10.6% yoy (compared with 10.1% in May). While nominal sales have steadily trended downwards from the post-GFC peaks of late 2010, retail price inflation has softened as well – supporting real sales values. In real terms, retail sales were also at 10.6% yoy (up from 10.2% previously) – marginally below the trend growth of the past two years.
- Consumer confidence has continued to trend higher – at least until May. It will be interesting to see whether the correction in equity markets begins to impact on confidence (despite the likely limited impact on household wealth).
- Headline inflation has remained subdued – with the CPI rising by 1.4% yoy in June (slightly up from 1.2% in May) – with prices continuing to exhibit the modest growth trends evident over the past eighteen months.
- Growth in food prices was marginally stronger – at 1.9% yoy in June (from 1.6% in May) – but still historically soft. Prices for fresh vegetables were considerably higher, while prices for eggs and fresh fruit fell year-on-year.
- Non-food price growth has modestly accelerated, edging up to 1.2% yoy (from 1.0% in May). That said, price growth remains sub-trend, with lower transport & telecom prices continuing to constrain inflation.
- Producer prices fell once again – with prices down for the fortieth straight month – by -4.8% yoy in June (from -4.6% in May). Commodity prices remain the key influence – the RBA Index of Commodity Prices fell by -25% yoy in June, and producer price falls remain larger in heavy industry (-6.3% yoy) than in light industry (-1.0% yoy).

Low inflation has maintained real retail sales near the trend levels for recent years



* Adjusted for Chinese New Year effects
Source: CEIC, NAB Economics

Recent low inflation levels have persisted, with producer prices falling for over three years

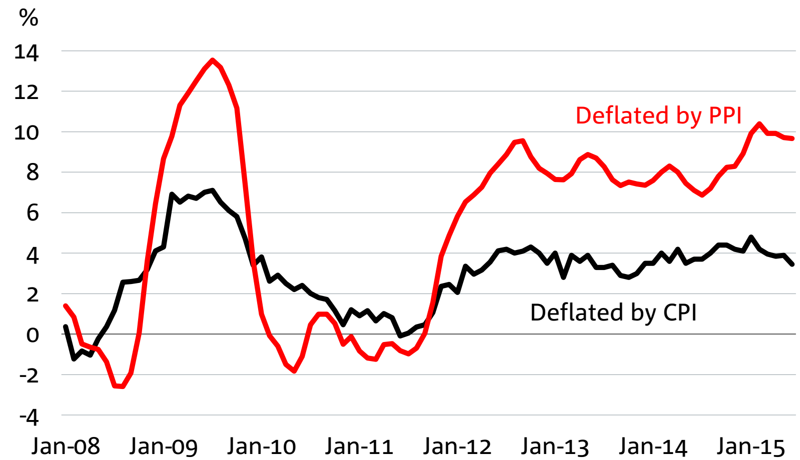


Sources: CEIC, RBA, NAB Economics

Credit conditions

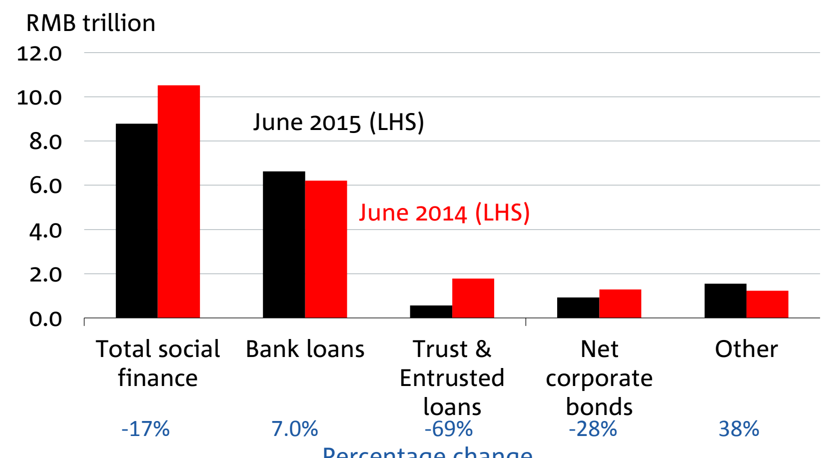
- In late June, the People's Bank of China (PBoC) cut interest rates – in part a response to the share market plunge. The benchmark one-year lending rate was cut to 4.85% – a record low – along with targeted (RRR) cuts (50 basis points for commercial banks serving rural areas, agriculture and small business; 300 basis points for non-bank financial institutions).
- Despite recent interest rate cuts, inflation has remained low since the latter part of 2014, maintaining real interest rates at comparatively high levels – particularly when rates are deflated by producer prices.
- Further monetary easing is expected in the second half of the year, to support economic growth. We anticipate one further rate cut in Q3 (to 4.6%), and at least 50 basis points of cuts to the RRR in both Q3 and Q4 (largely to maintain liquidity in the face of capital outflows).
- Growth in new credit has remained weak over the first half of 2015. Total social financing totalled RMB 8.8 trillion over this period, around -17% yoy.
- Bank loans have continued to grow – increasing by 7.0% yoy over the first six months to RMB 6.6 trillion. In contrast, non-bank loans have contracted by -50% yoy – reflecting the concerted efforts to control the shadow banking sector. Key components such as trust loans and entrusted loans have fallen by a combined -69% yoy.

Weak inflation trends have maintained real interest rates at comparatively high levels (despite recent cuts)



Source: CEIC, NAB Economics

New credit growth was weak in the first half of 2015, despite growth in bank loans



Sources: CEIC, NAB Economics

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