

December 2017

Macro Update: A Safe Landing In 2018

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The policy direction since the Party Congress

- **The 19th Party Congress has set the direction for the medium term**
 - The Congress further strengthened Xi Jinping's leadership.
 - He wants reasonably fast but high-quality growth, which likely means the GDP growth target will be retained but gradually reduced.
 - The anti-corruption campaign is being institutionalized, increasing the central government's ability to enforce policies at the local level.
 - The state sector will retain a major economic role.
 - Environmental rules and housing policy are getting high-level attention.
- **Tightening financial regulation is the major theme of macro policy**
 - The campaign to de-risk and de-leverage the financial sector is going on longer than many anticipated.
 - New asset-management rules aim to further reduce regulatory arbitrage and contain the growth of hidden credit.
 - Banks are still facing pressure to reduce their "investments" and off-balance-sheet exposure and to expand their loan books.

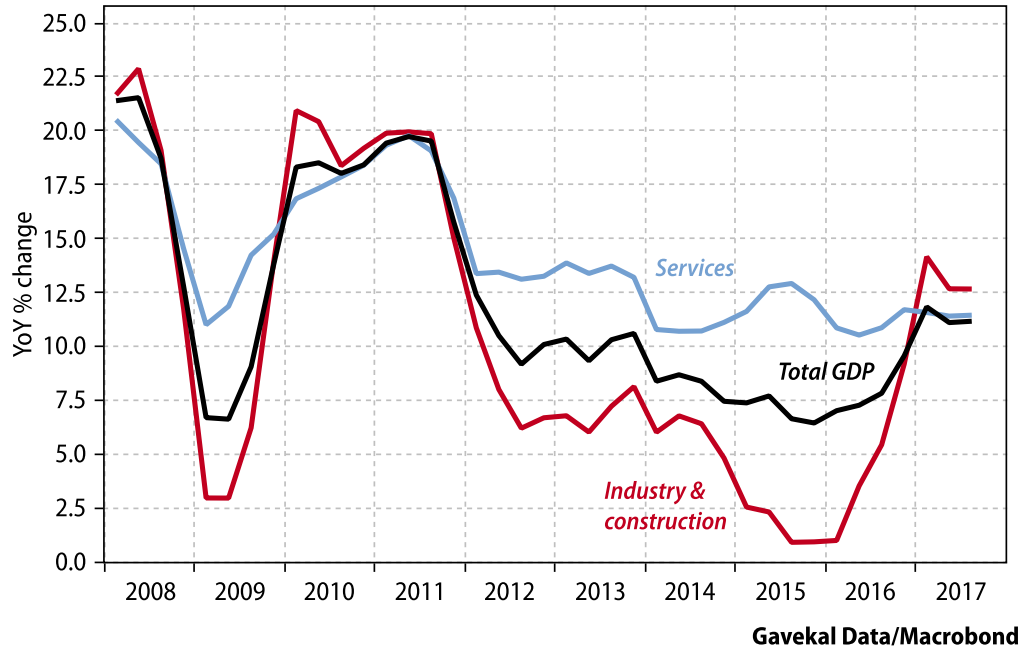
The outlook for 2018

- **The business cycle has peaked and momentum is cooling**
 - The housing cycle has turned and sales volume is likely to fall in 2018.
 - Financial regulation is still tightening, and credit growth is slowing.
 - The government seems willing to allow some deceleration in growth in order to achieve other policy goals such as environmental protection.
- **The base case is still a gradual and moderate slowdown, for these reasons:**
 - Low inventories support growth in construction and real-estate investment.
 - The financial tightening is aimed at interbank leverage, not corporate credit.
 - Supply-side reform will keep industrial prices high, boosting corporate margins. Strong corporate profits in turn flow into wages and consumption.
 - The synchronized global recovery will continue to benefit exports.
 - The official growth target is unlikely to be much lower than 6.5%.
- **The main domestic risks:**
 - Property policies and financial conditions could be tighter than anticipated. A squeeze on local government funding could hit infrastructure spending.

China is still benefiting from a major industrial recovery

The nominal rebound in industrial growth has been striking

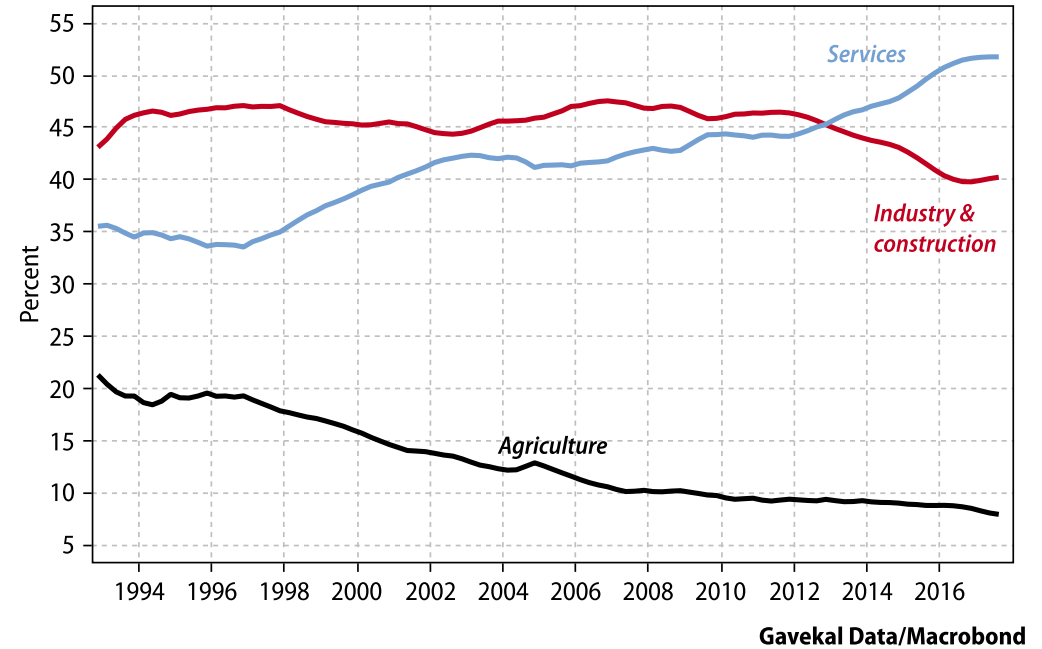
Nominal value-added by sector



2017 has been a year of stabilization for the Chinese economy, after a recovery in 2016. Real GDP growth is up nearly 7%, beating the growth target, but nominal growth is even more striking. After rebounding sharply from 6% to 11.8%, nominal GDP growth managed to stay above 11% for a full year—the best performance since 2011. Services have maintained fairly high growth but industry and construction are the heart of the story.

The secondary sector is regaining share after years of relative decline

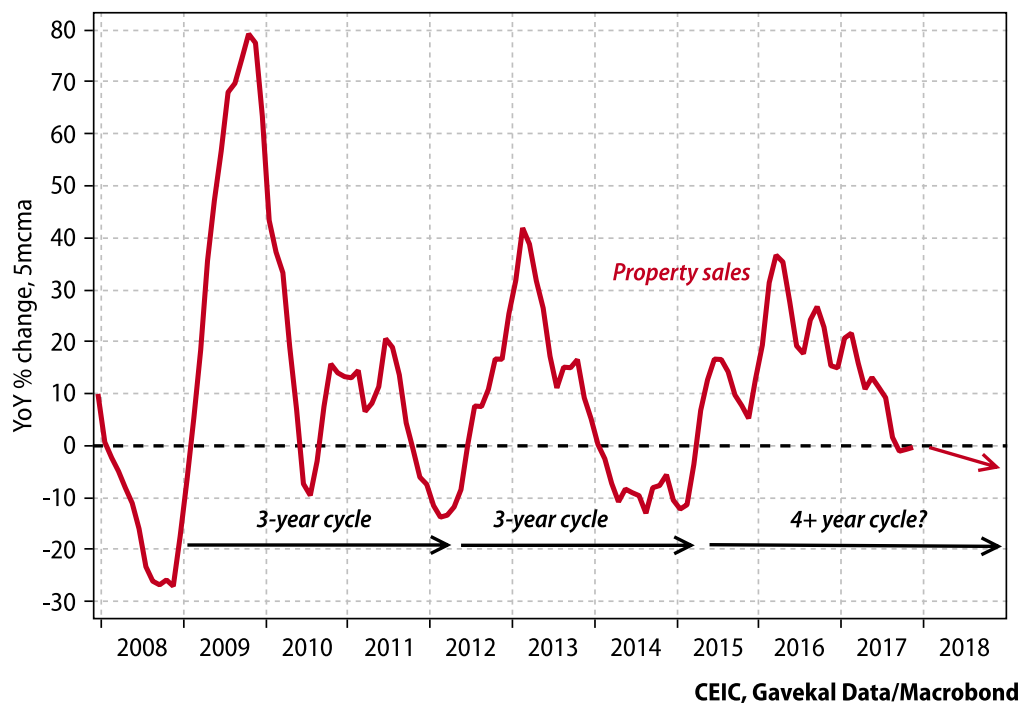
Share of GDP by sector, 4q rolling sum



The share of the secondary sector (industry and construction) in GDP declined to under 40% by the end of 2016, while services' share rose to over 51%. However, the recovery of industrial sector has seen the multiyear decline pause, and it is likely that 2017 will be the first year since 2011 that the secondary sector will increase its share of the economy. The share of services has been stable while the share of agriculture continues to gradually shrink.

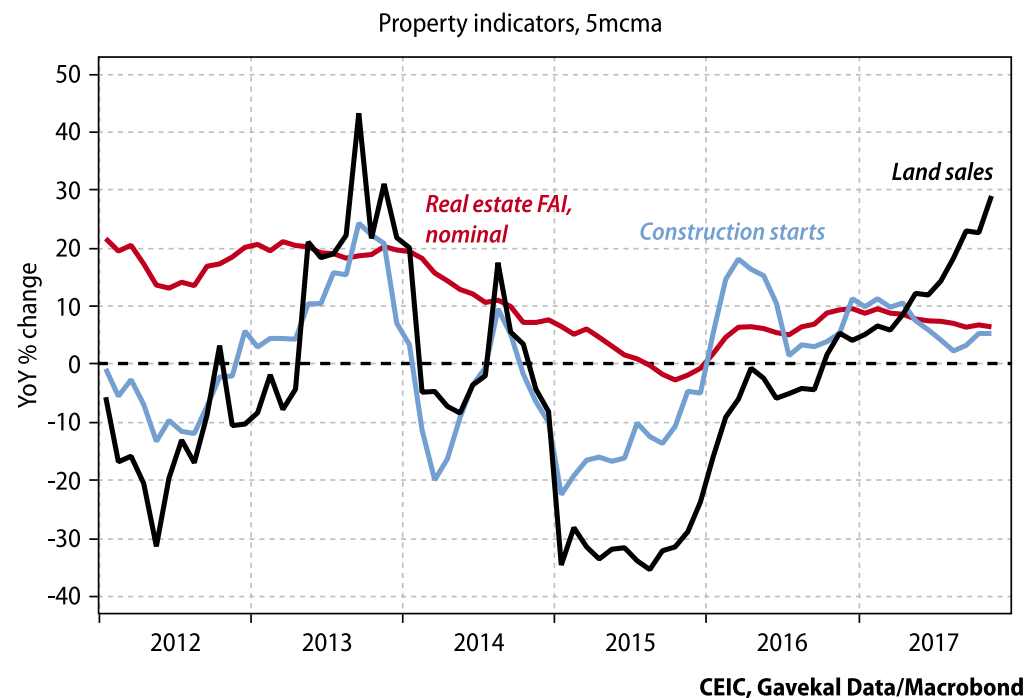
Property market continues to cool off, but gradually

This property downcycle is longer and more gradual than before



A strong and extended property cycle has been key to the recovery. Property sales declined YoY in September and October after rising for 30 months, but rebounded to 5% growth in November. The pattern of mini-cycles along a very gradual downward trend is therefore continuing. While property sales are still headed for a decline in 2018, the correction is likely to be shallower than previous ones. But if policy tightens further there is a downside risk.

Construction activity has not slowed as much as property sales

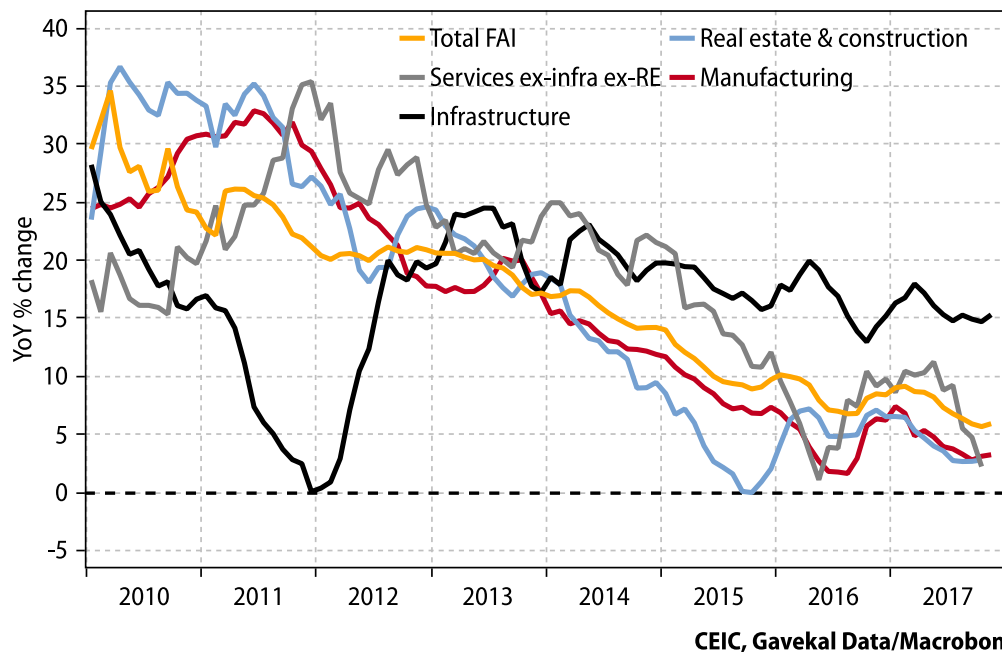


Construction and real-estate investment have also slowed, but they are holding up much better than sales growth, and starts rebounded to 18% YoY growth in November. Even with a slower pace of sales, inventories are so low that developers still need to replenish their inventories of projects, and land sales have actually accelerated. Construction activity should therefore slow down only moderately in 2018 even with a decline in property sales.

Overall investment spending is slowing

Infrastructure is supporting fixed-asset investment growth

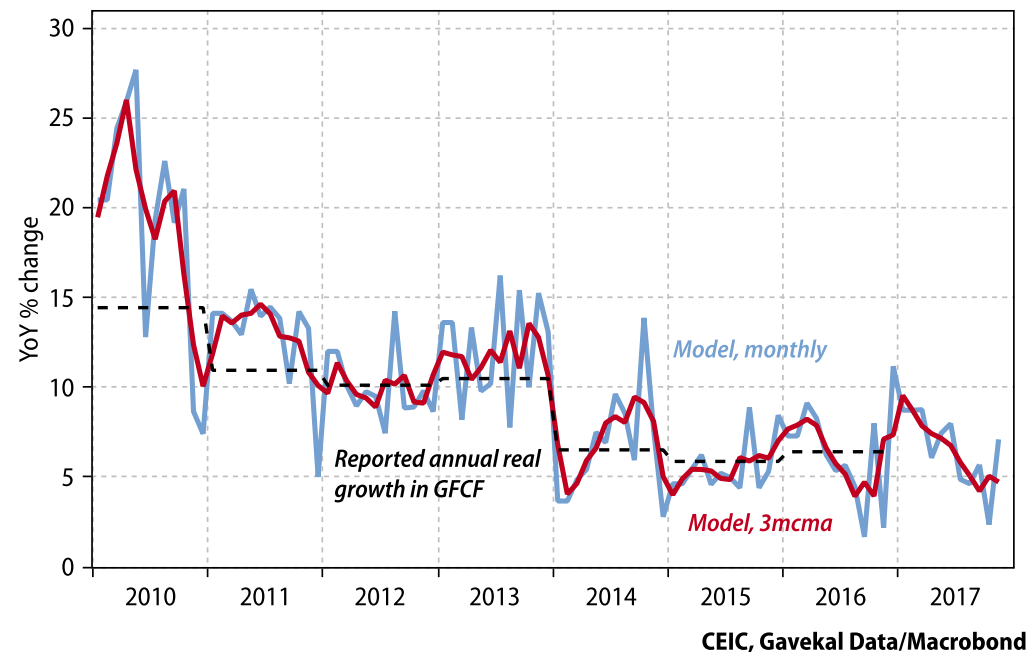
Fixed-asset investment by sector, nominal, 5mcrma



Total fixed-asset investment spending has decelerated this year driven by the simultaneous slowdown in real-estate and manufacturing investment; services investment has also slowed notably. Infrastructure is still a major support to overall FAI spending, and its share in FAI has increased substantially. With the central government tightening rules for local government funding, there is uncertainty on whether infrastructure investment can hold up in 2018.

Capital spending has stabilized recently after its slowdown

Model of real growth in gross fixed capital formation

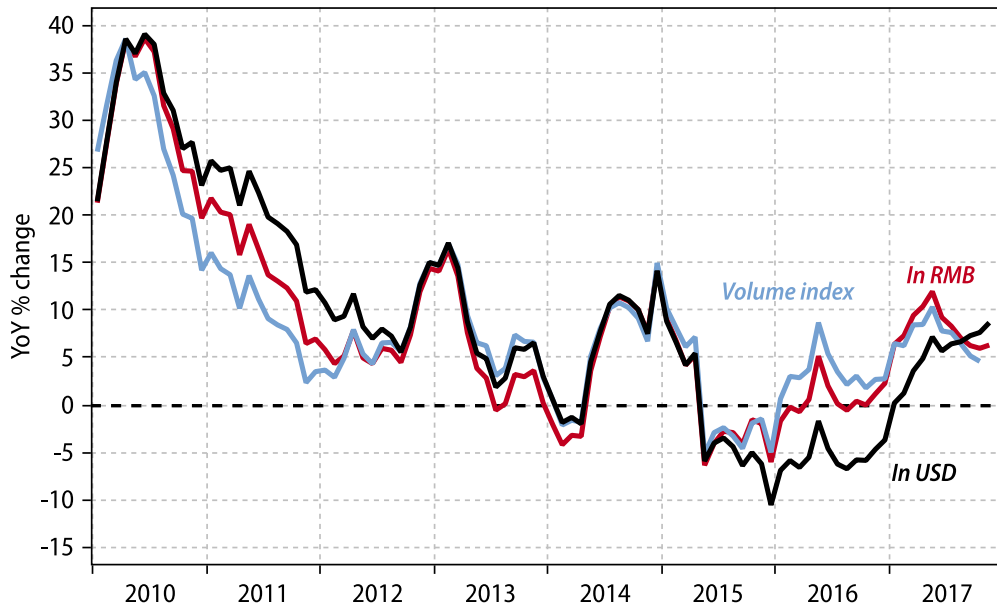


While nominal FAI is up 7.2% YTD in 2017 vs. 8.1% in 2016, and real FAI growth has showed even more sharply, the underlying trend in capital expenditure is likely a bit more positive. Our model of real growth in gross fixed capital formation has averaged 6.6% YTD in 2017 vs 6.4% in 2016. Manufacturing and real estate investment have stabilized in recent months, so if construction holds up a modest slowdown in total investment in 2018 is achievable.

Exports have been solid, but the trade surplus shrank

Chinese exports have rebounded nicely

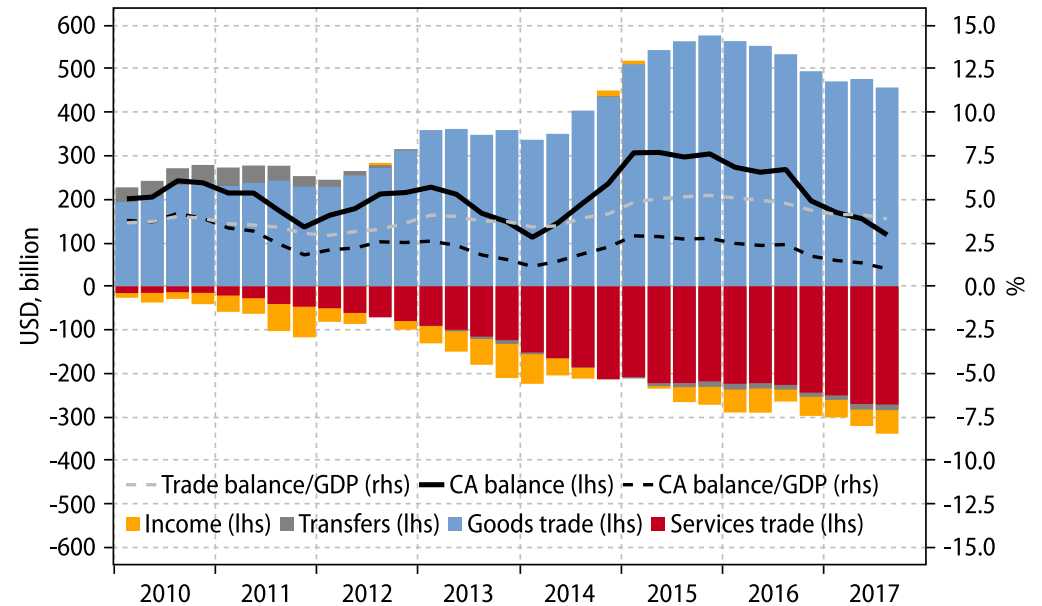
China exports, various measures, 5mcoma



CEIC, Gavekal Data/Macrobond

The current-account surplus has shrunk to 1% of GDP

Current account, 4q rolling sum



Gavekal Data/Macrobond

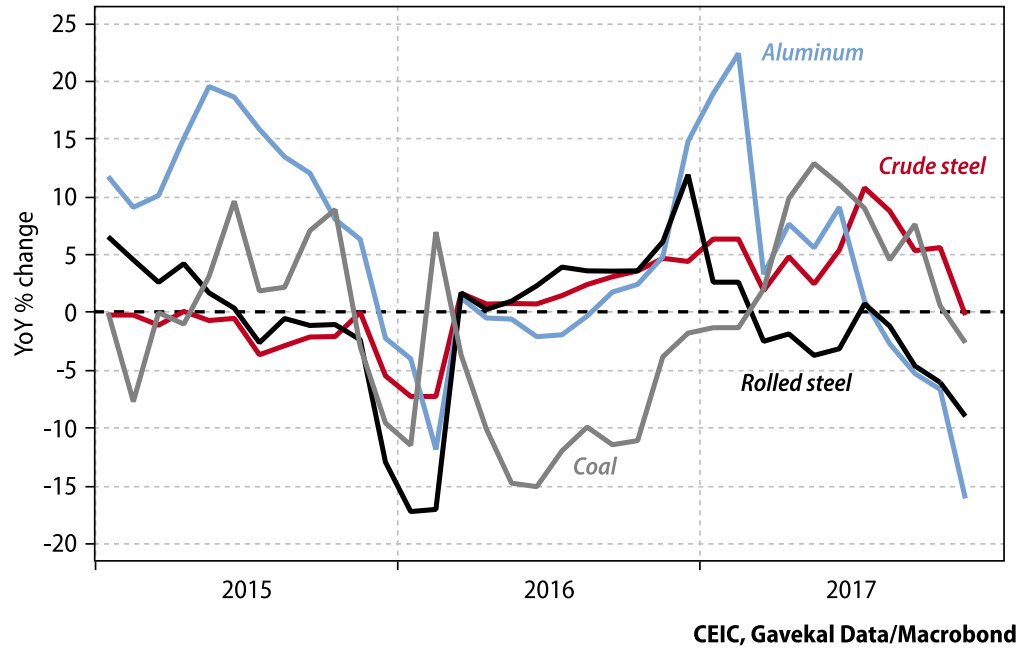
Exports have been a bright spot in 2017 after almost two years of negative growth, thanks to a strong global recovery and a boost from exchange-rate depreciation. Export growth has cooled from the rapid pace of H1 but remains well above the pace of recent years. Trade frictions with the US and other countries have grabbed headlines this year but have not had a meaningful impact on growth, and the risk of an all-out trade war is still low.

Despite strong export growth, China's trade and current account surpluses both continued to decline in 2017. This is mainly because of strong nominal imports, with solid domestic demand and a rebound in commodity prices. Also, the services trade deficit continued to widen thanks to strong overseas spending by Chinese travelers. As a result, China's current account surplus is likely to shrink to 1% or less of GDP in 2017, the lowest level since the 1990s.

Upstream prices stay elevated thanks to supply constraints

Supply-side policies have variously affected coal, steel and aluminum

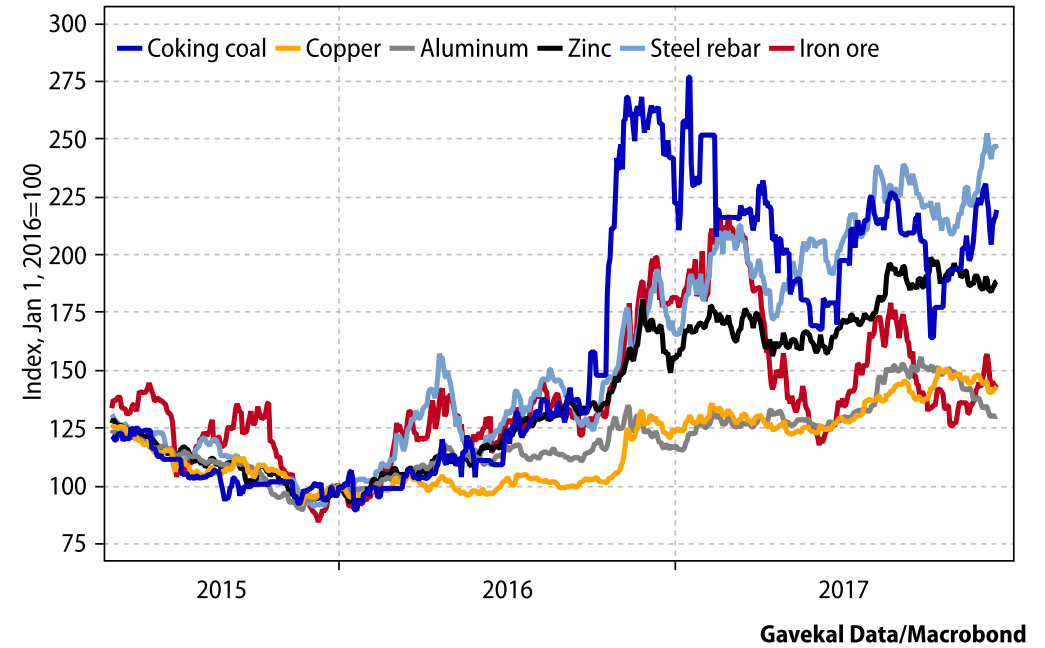
Domestic output of materials subject to capacity cuts



Growth in industrial value-added slowed to 6.1% YoY in November after averaging 6.8% in H1. Autos and equipment are part of the story, but there has also been a major slowdown in metals and energy production in Q4. Supply-side policies are still in place, and heavy industry is facing tight restrictions in North China to improve air quality. Aluminum output fell 16.8% in November, and steel, coal and other non-ferrous metals also declined.

Commodity prices are volatile but have stayed elevated

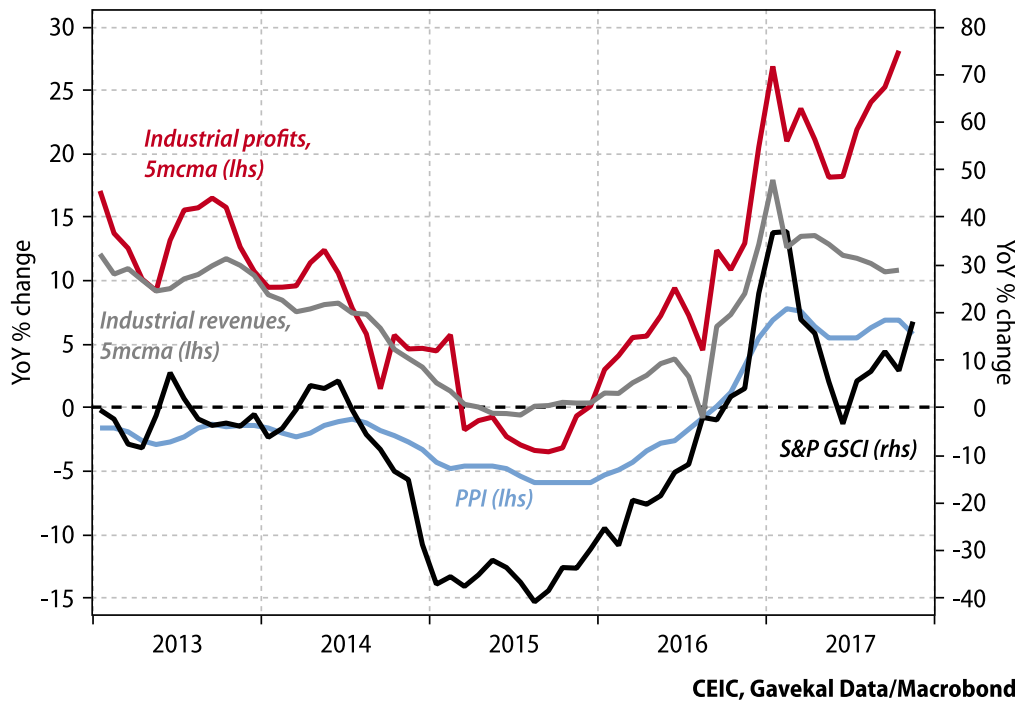
Domestic commodity futures



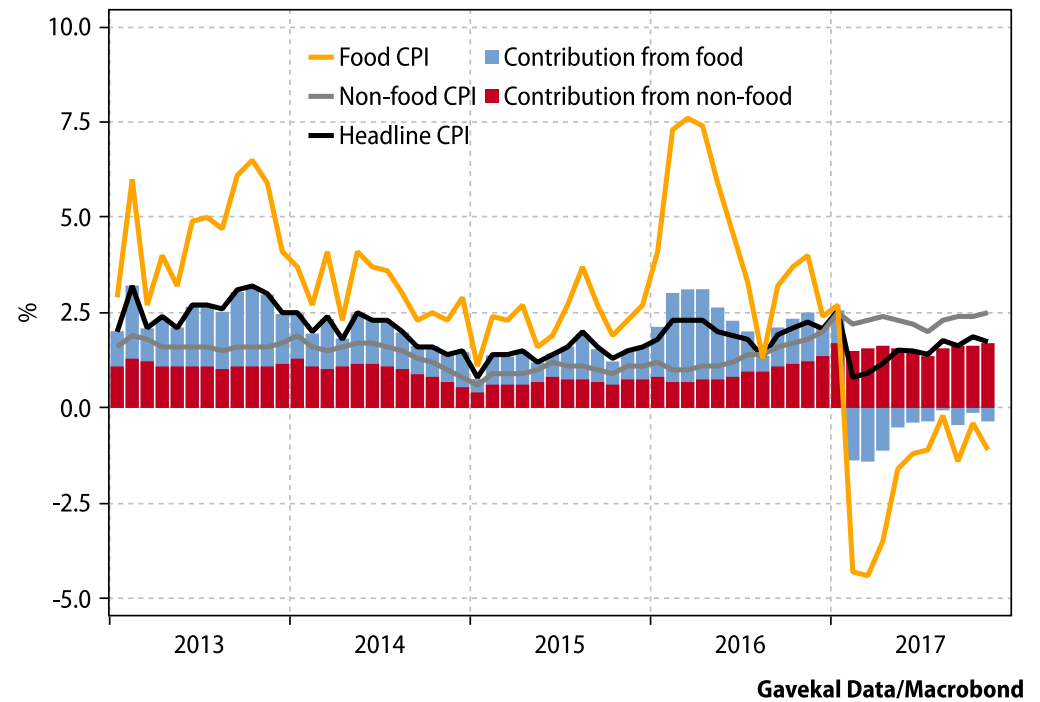
Steel, coking coal and iron ore prices had another rally recently, with the rebar price bouncing to a new high thanks to the reduction in supply. This is likely related to the new restrictions on steel output during the winter heating season, but it also suggests that demand is holding up. The environmental restrictions that have reduced coal use in favor of gas for heating have also led to a surge in LNG prices.

PPI inflation is high, and CPI inflation has picked up slightly

The rebound in commodities extends the profit cycle



Food prices are keeping headline CPI contained, but for how long?

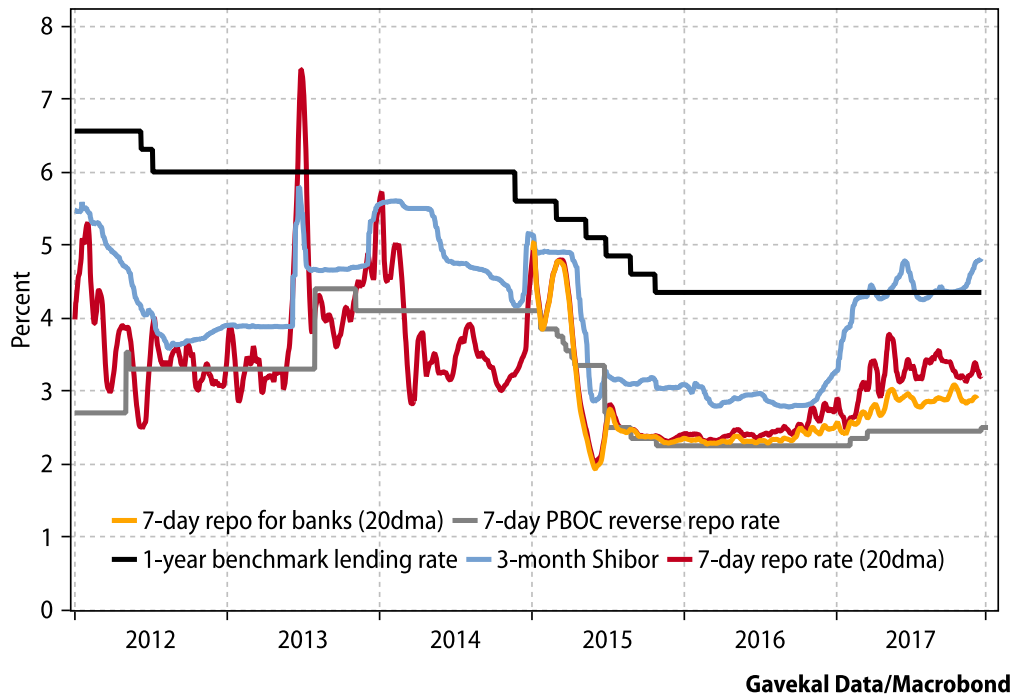


With commodity and metal prices still high, producer price inflation surprised on the upside in H2, and by November PPI was still up 5.8% YoY. This is a lot higher than our expectations earlier this year, since we thought the high base effect would cause PPI inflation to roll over to 2-3%. The high PPI continues to boost nominal GDP growth as well as industrial profits. In 2018, PPI inflation is likely to slow down a bit but there is still some upside risk.

CPI inflation has been subdued for years, and is still below 2% in 2017. But the rise in the non-food CPI to 2.5%, the highest since 2011, has drawn some attention. Some of this is to do the medical component rising a lot as a result of healthcare reform. For 2018, the main risk is that food price inflation will pick up again after being negative for a full year. I think this will push up overall CPI to around 2.5%, which is still not very worrisome.

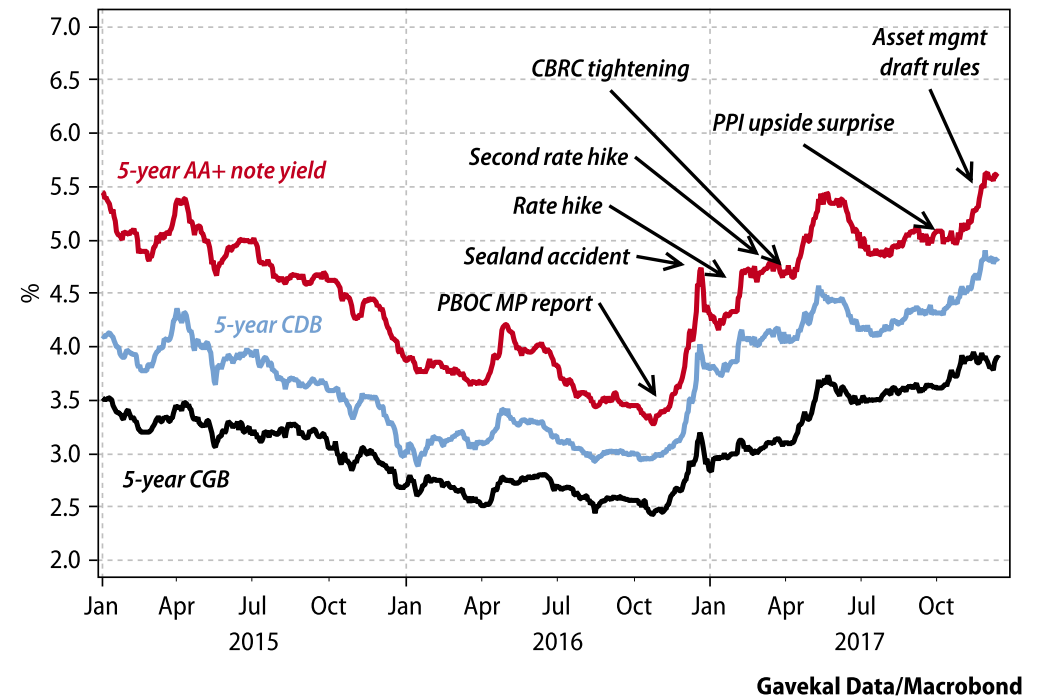
Bonds sold off again despite a stable money market

Short-term repo rate was stable but 3-month funding has picked up



The PBOC raised interest rates on its reverse-repo and other lending facilities by 5bps to 2.5% on Dec. 14, reacting to the Fed's 25bps rate hike. But short rates in the interbank market were largely stable in Q4 and they have been higher than the PBOC reverse-repo rate. Rates for 3-month or longer money have also come up as banks look for more stable funding into the new year. Meanwhile, the PBOC has not moved benchmark lending rates for a year.

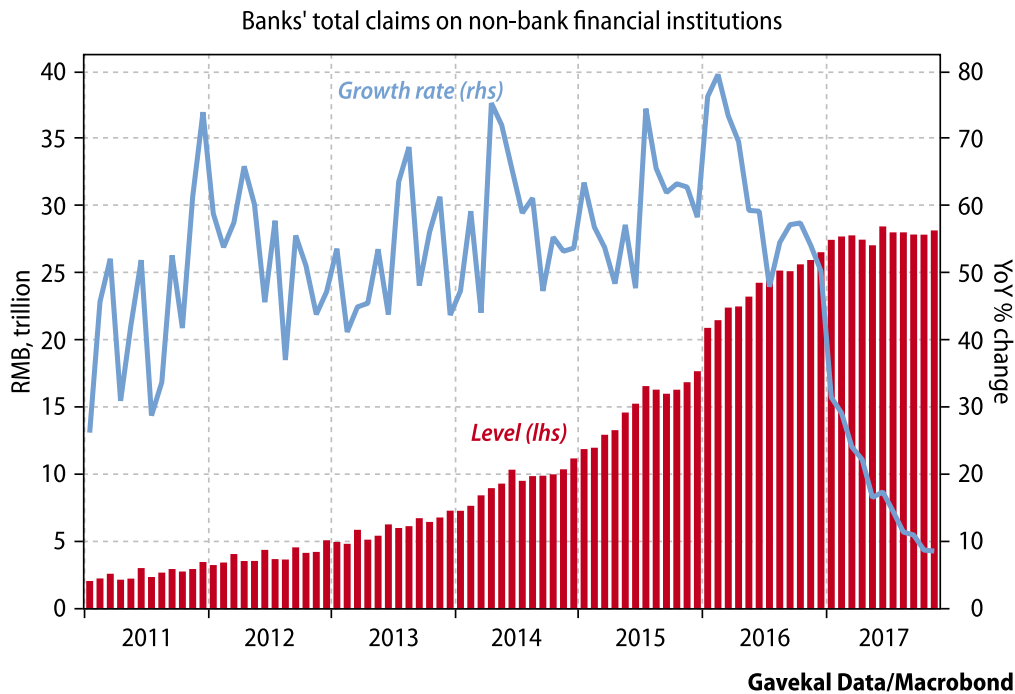
How the bond market responded to events



The onshore bond market experienced another sell-off starting in October. While the government bond yields only went up slightly, policy bank bonds and corporate bonds sold off more. CGBs are largely held by banks, but other bonds have more short-term investors who were facing pressure to shrink their operations under tightening financial regulation. Higher-than-expected inflation was also a factor, and continues to be a risk.

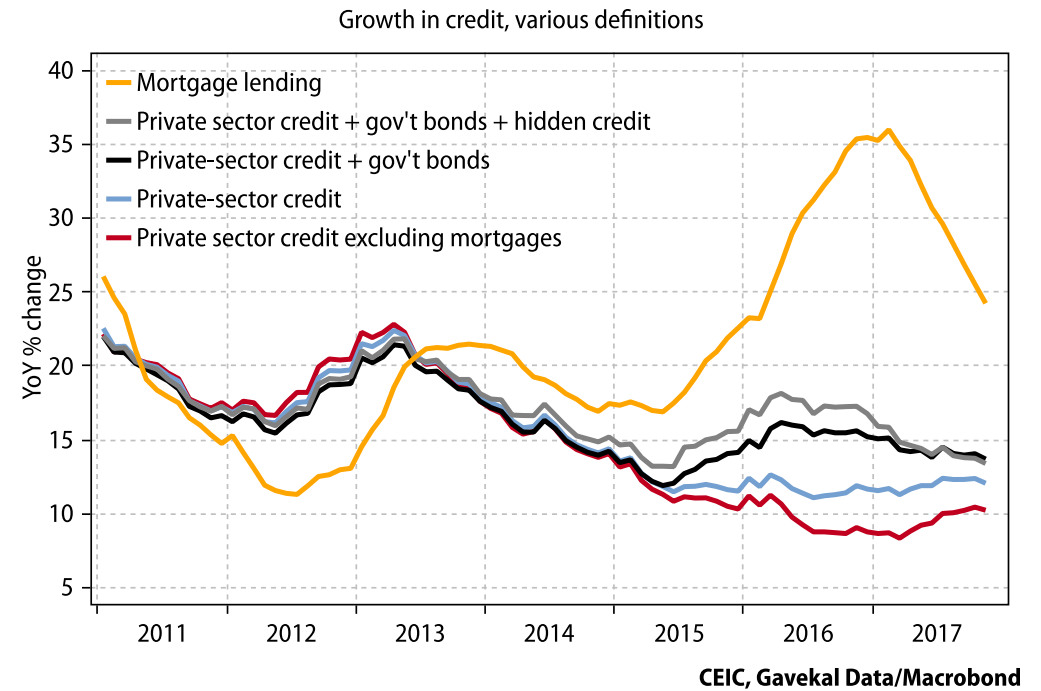
Credit growth slows gradually despite financial de-leveraging

Bank lending to NBFIs has almost stopped growing



The tightening of financial regulation continues to weigh on the links among financial institutions. Banks' claims on nonbank institutions have been almost frozen in recent months, and YoY growth has fallen to single digits. This trend will likely continue in 2018 as there is no sign that regulators are going to reverse policy any time soon. In fact, new asset-management regulations suggest that banks will need to keep adjusting their business models.

Total credit growth has slowed only modestly as bank loans pick up

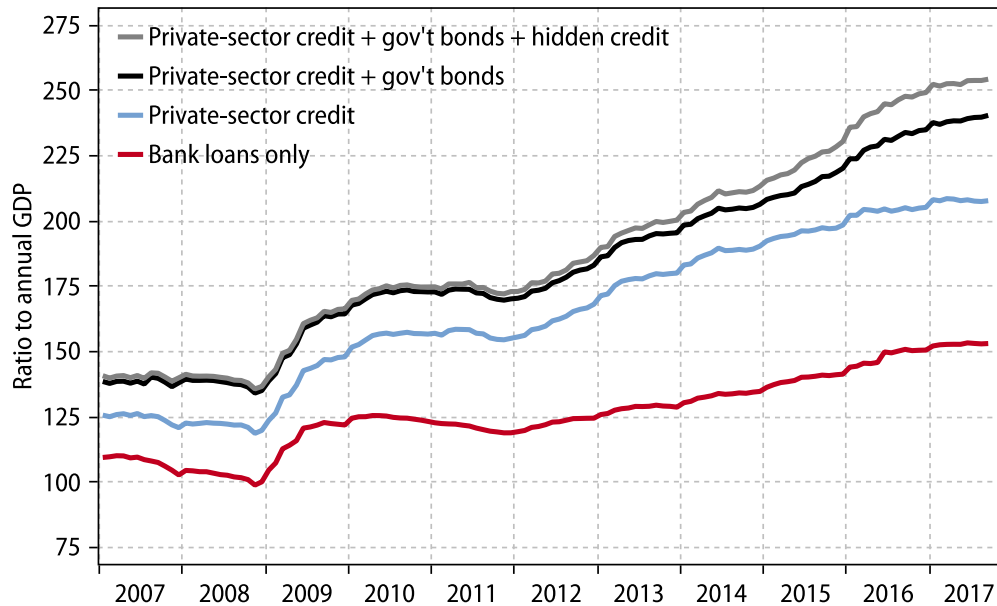


Yet the regulatory tightening has still not had much effect on lending to the real economy. Banks are creating more credit via traditional lending channels to offset the shrinking off-balance-sheet channels. Total credit growth has decelerated only slightly to below 14% YoY in Q4, mainly because of slowing mortgage lending, but credit to the corporate sector has actually picked up to over 10% YoY. These trends should last into 2018.

Leverage has stabilized amid a rotation to households

National leverage grew more slowly in 2017

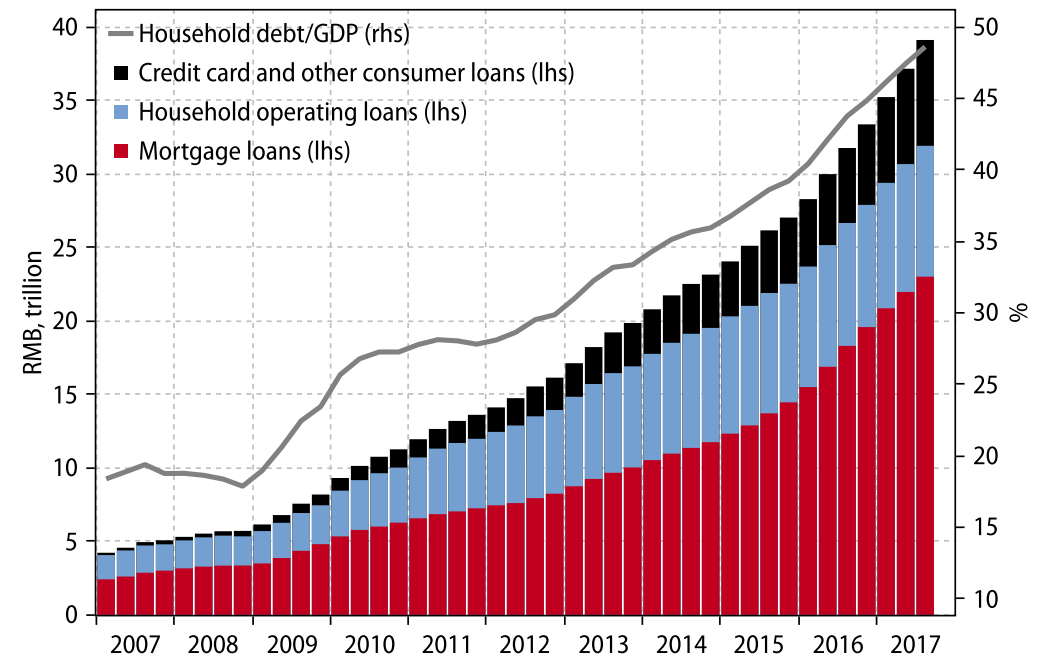
Stock of outstanding credit relative to GDP, on various definitions



CEIC, Gavekal Data/Macrobond

The combination of strong nominal GDP growth and moderate credit growth meant that overall leverage was relatively stable in 2017. Our estimate of the total debt/GDP ratio rose by only 5pp to 254%, the smallest gain since 2011. The corporate sector in particular has probably reduced its leverage, while households and government levered up. Policymakers will want to keep leverage stable, but it is hard to see it declining.

China's household debt is reaching 50% of GDP

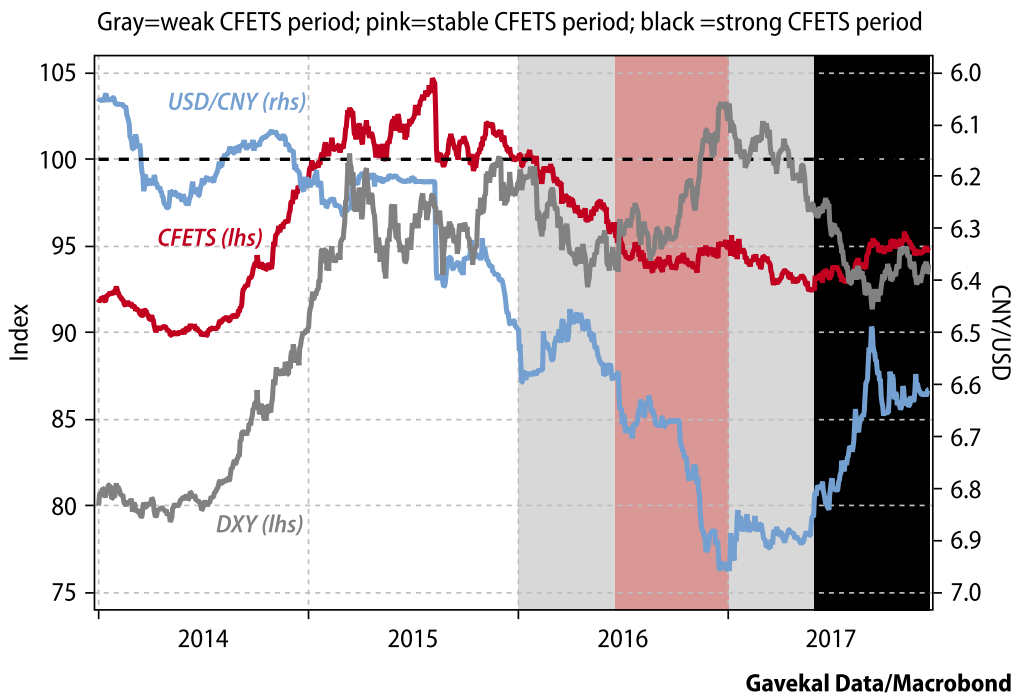


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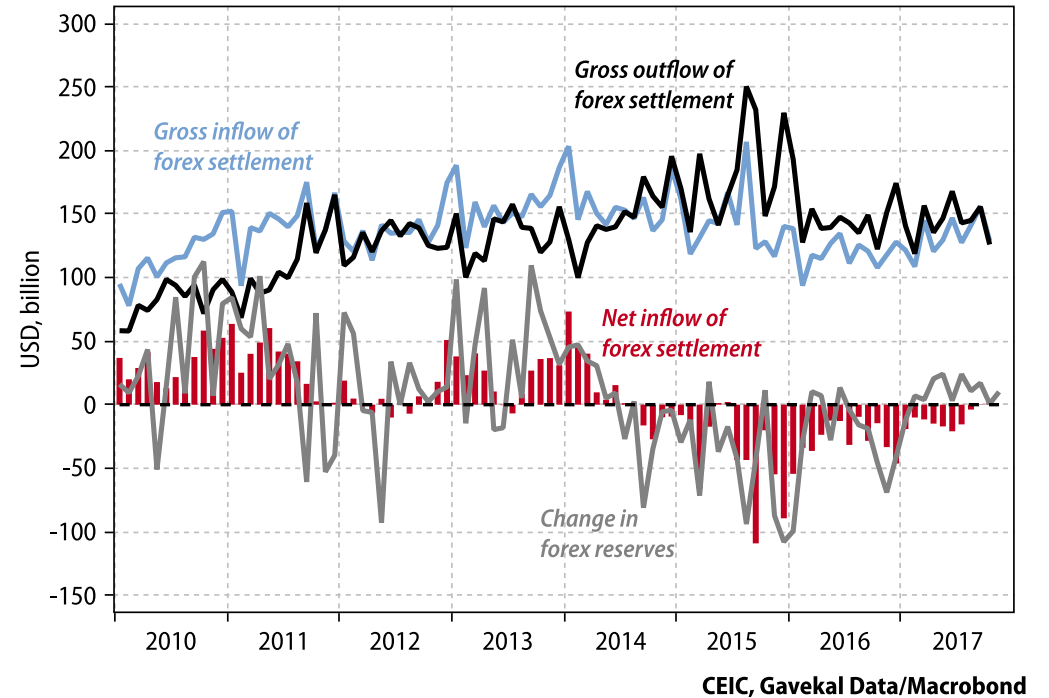
Household debt continued to rise rapidly this year, thanks to continued fast growth in mortgage lending as well as a rise in short-term consumer credit. Despite some slowdown, outstanding mortgage loans are still up 25% YoY in 2017, which delivered major support to the property market. Household debt levels are no longer low but are not extremely high in an international context. However this fast rate of increase may not be sustainable.

Capital flows are balanced with few currency surprises

The renminbi gained 5% against the dollar in 2017



Cross-border capital flows have become more balanced



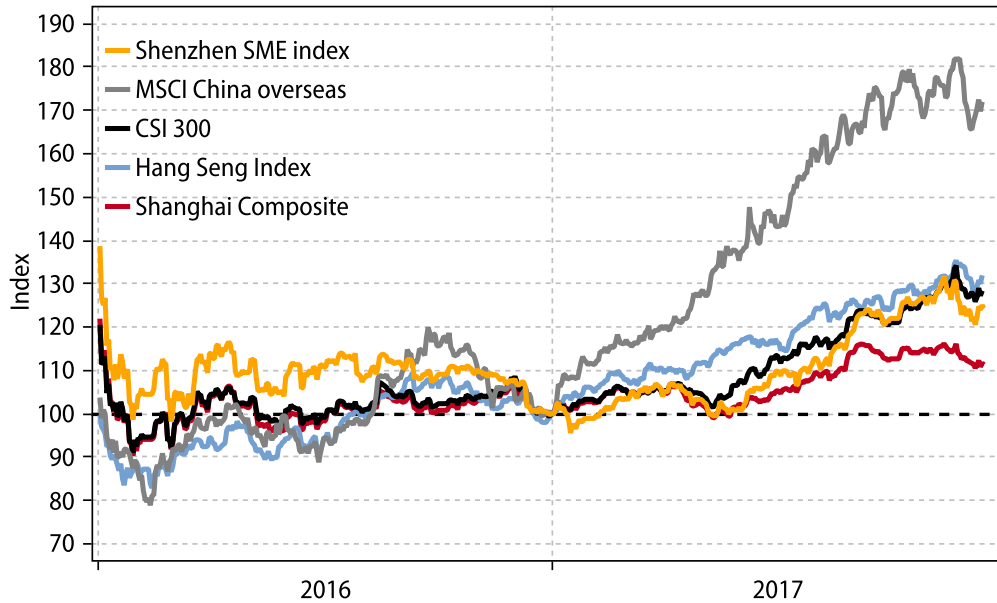
The renminbi largely range-traded during Q4, as the US dollar was directionless and the trade-weighted CFETS index has been stable around 95. The PBOC seems comfortable with CFETS at this level, so the currency trajectory mainly depends on the USD. The outlook for the USD is a bit uncertain: the US is cutting taxes and the Fed is raising rates, but the cycles in Europe and Japan also are picking up. At Gavekal we are still not bullish on the USD.

Cross-border capital flows have stayed balanced as fading expectations of renminbi depreciation encourage corporates to sell their USD. Banks' net foreign exchange purchases turned positive for the first time since mid-2015, rising US\$0.29bn in September and US\$2.8bn in October. The nominal value of forex reserves also increased slightly to above US\$3.1trn. Absent surprises in the forex market, this pattern can continue in 2018.

Domestic equities are up, but lag offshore Chinese stocks

Chinese equities are rising but the real bull market is in offshore shares

Rebased to end-2016=100, in USD terms

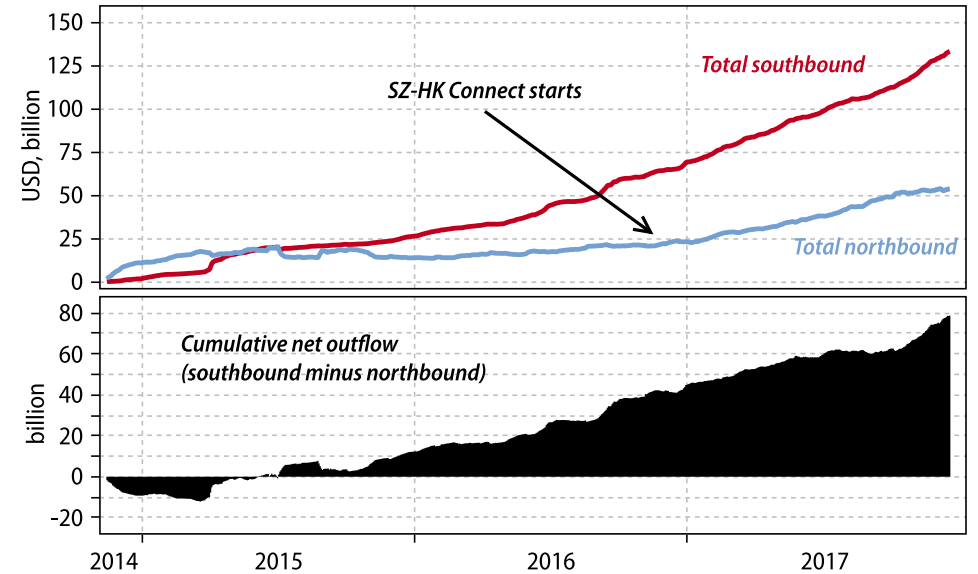


Gavekal Data/Macrobond

Chinese stock markets have mostly had a strong year, although there was some correction in late November. But the divergences are striking: The MSCI China Overseas is up about 70% as it has the big offshore-listed internet firms, while the Shanghai Composite is only up 10% since it is dominated by large old-economy SOEs. The major indexes like the CSI 300 and Hang Seng are up about 30%, and I think they can continue their steady gains in 2018.

Mainland investors' purchases of HK shares are steadily rising

Cumulative flows through Shanghai- and Shenzhen-Hong Kong Connect



CEIC, Gavekal Data/Macrobond

The Stock Connect programs have become more popular with investors on 2017. The southbound flow has totaled US\$64bn YTD, almost equal to the total before this year. Northbound flows also increased to US\$30bn, doubling the cumulative total to US\$53bn. The northbound inflows are concentrated in domestic consumer goods stocks, while southbound flows are focused on technology stocks and financials.

Contact and disclaimer

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