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What is behind the recent China slowdown?


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In brief

- Market sentiment around and investor confidence in the outlook for China has deteriorated notably as the macroeconomic backdrop turned less favorable. Two headline-grabbing issues have led this shift: U.S.-China trade tensions and Chinese domestic policy tweaks.
- Fears about a trade policy-induced slowdown are premature—protectionism will have an economic impact on China, but the effect will show up in 3Q18 data and beyond. Presently, domestic policy changes deserve the greater share of investors' attention.
- China is in the midst of a long-run downshift in the rate of economic growth as the economy matures, but growth will fluctuate around this trend rate quarter to quarter. The second quarter of 2018 saw growth decelerate below trend primarily as a result of policy initiatives.
- Chinese authorities will continue to try to balance short- and long-run economic goals; stricter financial regulations will likely remain in force, but fiscal policy will turn more countercyclical, as confirmed by recent announcements.
- Investment markets cycle through policy changes much faster than economies do. Sentiment in Chinese markets remains challenged by reforms to the financial system and ongoing trade tensions with the U.S., but corporate fundamentals and the macro environment will likely improve later this year.

SLOWING GROWTH, BUT FOR GOOD REASONS

The recent release of China's macroeconomic data for the second quarter confirmed our expectations for a moderate slowdown. Real gross domestic product (GDP) growth decelerated to 6.7% year-over-year and fixed asset investment, industrial production and credit growth also evidenced a slowdown. After a strong 2017 and policy changes effected between the end of 2017 and now, this slowdown was not unexpected. The broader narrative around Chinese growth often centers on the long-run economic trend, but Chinese markets will respond to cyclical fluctuations around this trend. The theme of China in transition—a catch-all phrase for the changing engines of growth as China grows richer and economic growth slows—is alive and well, but successful investing in China requires responding to these policy-driven mini-cycles as well.

Policy & growth in 2018

A robust global environment and increasing worries about financial stability buoyed Chinese authorities' confidence to press ahead with large-scale supply-side reforms in recent quarters. These moves contributed to the current rollover in growth momentum, but should support more sustainable economic growth in the years ahead. Reforms aimed at reducing overcapacity, controlling debt growth, promoting higher value-add industries as the engines of growth and improving corporate health are deemed long-run net positives for the Chinese economy, but implementation is likely to pressure output and investment growth in the short term.

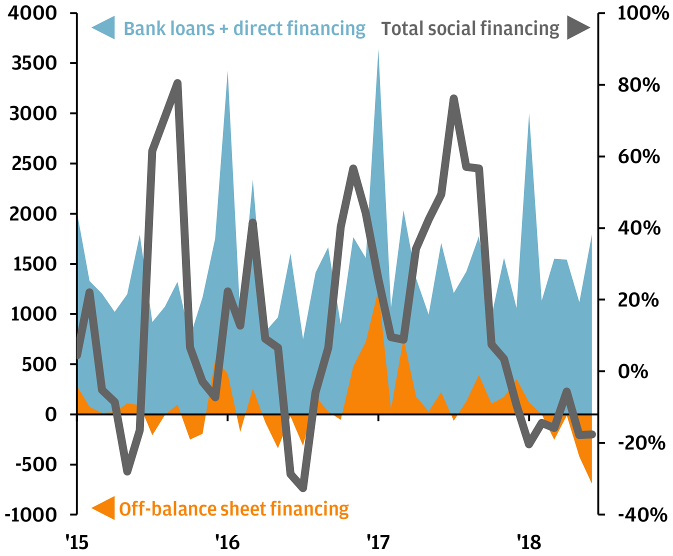
FOLLOW THE MONEY

Financial system reforms have been a high priority for authorities. After a large run-up in leverage, particularly within the financial system, in the 2015–mid-2017 period, Chinese policy makers focused on reunifying debt creation and economic growth (*refer to Market Bulletin published in 2017– Tackling China's debt mountain needs more than SOE reform*), while also deepening financial markets. To accomplish these goals, the People's Bank of China (PBoC) adopted a combination of what they termed, "neutral monetary policy and prudent financial regulation".

The combination of "prudent, but neutral" policy from the PBoC lowered the growth of non-standard credit dramatically this year. As shown in **Exhibit 1**, off-balance-sheet financing fell precipitously year-to-date. In practice, prudent but neutral policy looks like slower liquidity injections and raising rates on certain instruments the PBoC uses to provide liquidity. For example, the December 2017 and April 2018 rate hikes on medium-term liquidity facilities gradually raised the cost of capital for lenders while keeping the majority of financial activities profitable. Additional administrative regulations, like what risk-weighted capital institutions must hold against wealth management products and interbank lending, also contributed to an overall slowdown in credit growth this year, particularly in the off-balance sheet category (**Exhibit 1**).

Off-balance-sheet financing declined, lowering overall credit growth

EXHIBIT 1: MONTHLY TOTAL SOCIAL FINANCING FLOWS



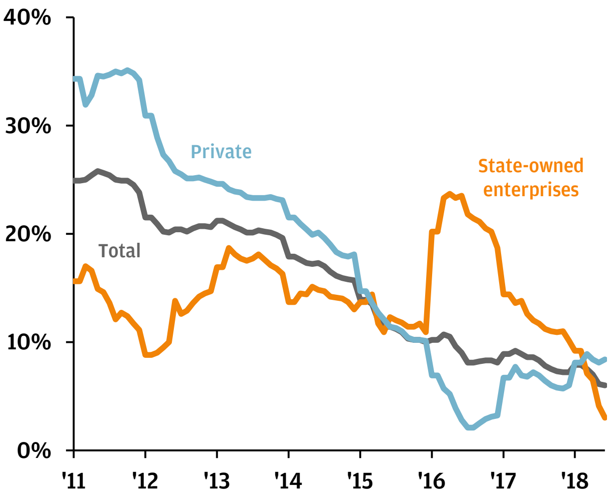
Source: Wind, People's Bank of China, J.P. Morgan Asset Management
Data reflect most recently available as of 26/07/18.

THE DRAG OF FISCAL DISCIPLINE

The government increased its scrutiny of and restrictions on the investment activities of local governments in 2018. Heightened controls on the use of funds by public-private partnerships (PPP) and local government financing vehicles, as well as limiting acceptable sources of these funds, lowered fixed asset investment (**Exhibit 2**). These controls led the Ministry of Finance to suspend over 2,000 PPP projects year-to-date, in contrast to approving 14,424 PPP projects in the 2015 to 2017 period.

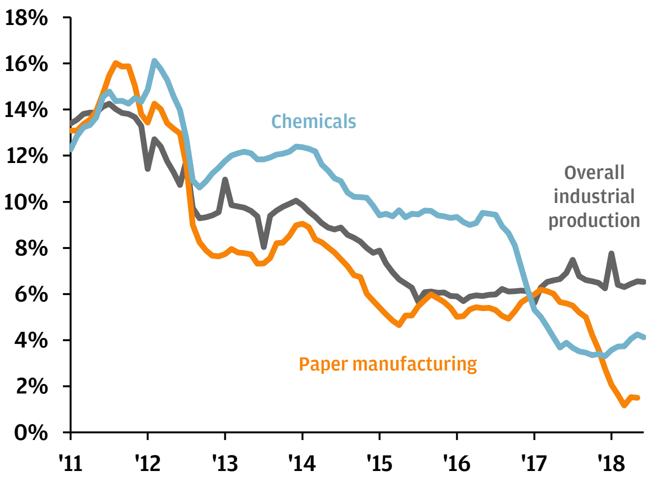
To further enhance local government fiscal discipline, Chinese authorities have implemented regulatory measures to standardize their finances, effectively barring local governments from most informal financing channels and pushing them into the municipal debt market. Furthermore, the Ministry of Finance restricted bond issuance in this market between January and May of 2018. Such actions will likely improve the long-run fiscal health of local governments, but contributed to the sharp drop in state-linked fixed asset investment, which also dragged on growth.

Fixed asset investment fell because State-directed investment slowed
EXHIBIT 2: GROWTH OF FIXED ASSET INVESTMENT
YEAR-TO-DATE, YEAR-OVER-YEAR CHANGE



Source: Wind, National Bureau of Statistics, J.P. Morgan Asset Management.
Data reflect most recently available as of 26/07/18.

High pollution sectors are leading the slowdown in industrial production
EXHIBIT 3: GROWTH OF INDUSTRIAL PRODUCTION
YEAR-OVER-YEAR CHANGE, 6-MONTH MOVING AVERAGE



Source: Wind, National Bureau of Statistics, J.P. Morgan Asset Management.
Data reflect most recently available as of 26/07/18.

ANTI-POLLUTION MEASURES BITE

Pollution controls are cutting growth in heavy industrial sectors. Measures aimed at cleaning up China's environment are an important component of the supply-side reforms. The most recent campaign, focusing on the air quality in North China, represented the seventh wave of such measures. A large number of small firms in high pollution industries, such as paper making and chemicals, have been shut down, exerting additional downward pressure on industrial production, which had already been negatively affected by overcapacity reductions (**Exhibit 3**).

Second half 2018 & beyond

Policy changes, along with the rollover in momentum from an exceptionally strong 2017, lowered growth in the second quarter of 2018. A wholesale reversal in these policies is unlikely, but policy makers will attempt to mitigate the slowdown. Both monetary and fiscal policies will likely be further fine-tuned to stimulate domestic demand without unleashing another credit boom. To this end, the State Council recently announced three policy changes: 1) funding for ongoing infrastructure projects via an additional RMB 1.35 trillion of local government bonds; 2) targeted tax rebates for select industries by the end of September; 3) a Research and Development tax credit amounting to RMB 65 billion of savings.

Monetary policy will continue to be the government's favored tool, although its effectiveness is increasingly questionable. To support liquidity, and ensure small and medium enterprises (SMEs) do not face a financing crunch while broader tightening measures take effect, the PBoC cut required reserve ratios twice explicitly for lending to SMEs. This example perfectly illustrates authorities using their administrative controls—specifying this cut was to support SMEs—to target policy changes at narrower and narrower parts of the financial system. We expect targeted easing like this to continue, which is unlikely to reflate asset prices if the PBoC restrains itself from an across-the-board liquidity injection.

Negative sentiment generated by rising U.S.-China trade tensions is showing up in markets, but the macro effects will take time to feed through. Overall, companies exporting products facing tariffs will undoubtedly see a hit to profits, but the net macroeconomic impact on China will be mild. The market implications will be more severe. Listed firms are typically more globally exposed, and therefore more susceptible to tariffs, than the Chinese economy as a whole. Yet, Chinese corporate profits are domestically generated to a greater degree than their U.S. counterparts. Authorities are likely to address the eventual macro impact of tariffs in two ways: the government will double down on official support for industries driving future growth and will implement measures to support household consumption—like a personal income tax cut—soon.

Bringing it back to markets

A mid-cycle domestic slowdown and rising uncertainties in the external environment have been a drag on equity market confidence. A-share valuations are now near cyclical lows, which may be an attractive entry point for long-term investors, but the market requires two catalysts to turn around: clarity on the direction of domestic policy and a cooling of trade tensions with the U.S.

Meanwhile, from a fundamental perspective, sustained earnings growth and healthy balance sheets may offer highly selective investors a discount on quality companies. Consumption-linked firms remain more attractively positioned to take advantage of future growth. Despite recent weakness in retail sales numbers, the importance of consumption continues to rise, widening the opportunity for leading service providers, given households' bias toward services such as travel and education. Household spending could also be supported in the near future by policy changes.

Balancing short- and long-run economic goals will likely continue to cause China's economic growth to cycle around its slowing trend. Markets will respond to these developments more quickly than macroeconomic data. With this in mind, investors who can tolerate the resulting volatility (and the higher volatility of the A-shares market in general) may find this mid-cycle low an attractive entry point into Chinese equities. Domestic policy and global developments may knock sentiment further—especially as trade tensions look unlikely to ease—but fundamentals and the macro environment will likely grow more supportive into the end of the year.

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