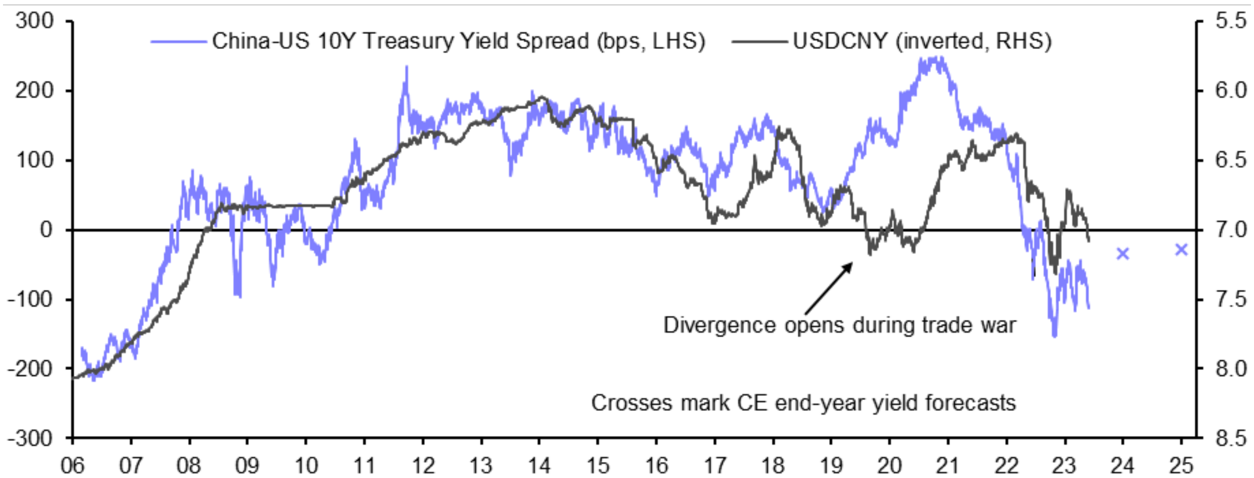
CHINA CHART BOOK

Renminbi unlikely to revisit last year's lows

- The renminbi strengthened sharply against the US dollar in response to China's move away from zero-COVID. But the currency has since reversed much of those gains and is now approaching 7.10/$, its weakest level since December. Optimism over China's reopening recovery and foreign capital flows into the country have given way to pessimism and renewed outflows. Yield differentials have also moved against the renminbi recently, amid stubbornly high core inflation in the US and growing expectations for monetary easing in China. We doubt this depreciation pressure will persist, however. Investors have turned overly pessimistic on China's reopening recovery, which still has some way to go in our view. And while we expect further monetary easing from the People's Bank, this is likely to be more modest than what is currently priced into markets. At the same time, we think US yields will drop back before long as the US economy slips into a recession and inflation comes down sharply. On our forecasts, the China-US yield spread will soon be back at levels last seen when the renminbi was trading under 7.0/$ (See Chart 1.) We still expect the currency to end 2023 at around 6.9/$.
- **Output & activity indicators** show that services are still driving the recovery while industry has faltered.
- **Consumer indicators** are still making headway amid improving sentiment and falling unemployment.
- **Business indicators** show that corporate profits remain under pressure.
- **Property indicators** suggest that struggles in the housing market are far from over.
- **External indicators** point to cooling foreign demand.
- **Inflation indicators** aren't as downbeat on the recovery as they might seem.
- **Monetary indicators** suggest that some policy loosening may be needed to shore up credit demand.
- **Financial markets** have continued to sell off, with the renminbi weakening sharply.
- **Hong Kong indicators** suggest that the rebound is still going strong thanks to the return of tourists.

Chart 1: Renminbi Exchange Rate vs China-US Yield Differential



Sources: Refinitiv, CEIC, Capital Economics

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Output & Activity

- The economy rebounded strongly in Q1 following the move away from zero-COVID. The improvement was concentrated in real estate, transport, retail and hospitality, the sectors hit hardest by the pandemic **(2)**. The China Activity Proxy (CAP), our in-house alternative to official GDP, suggests that this recovery continued at the start of Q2 **(3)**, with much of the improvement driven by the service sector **(4)**.
- Construction activity has also edged up in recent months, though it has yet to regain the levels it reached in early 2021. Property investment continues to decline as developers cut back on new projects **(5)**. But this has been offset by a pick-up in infrastructure activity thanks to a front-loading of fiscal support.
- Despite this prop, industrial activity stagnated at the start of Q2 **(4)**. Softer foreign demand was the main culprit, with container throughput at Chinese ports dropping back **(6)**. More timely data suggest that the industrial sector continued to struggle in May **(7)**.

Chart 2: GDP by Sector (2019 = 100, seas. adj.)

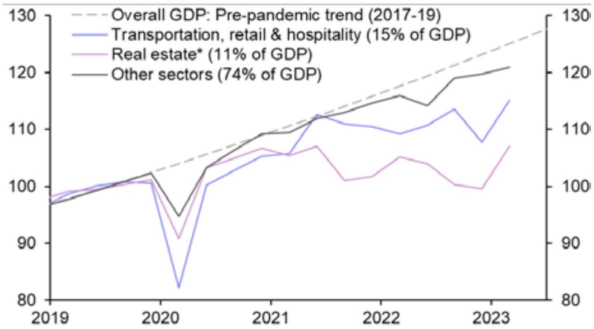


Chart 3: CE China Activity Proxy & Official GDP (2019 = 100, seas. adj.)

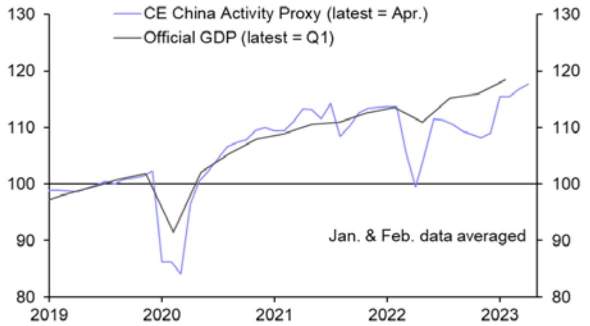


Chart 4: CAP – Sector Proxies (2019 = 100, seas. adj.)

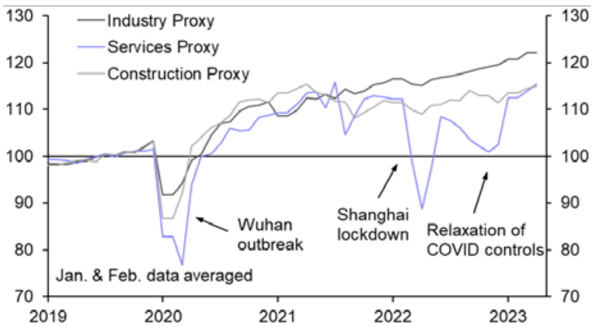


Chart 5: Fixed Investment (Dec. 2019 = 100, seas. adj.)

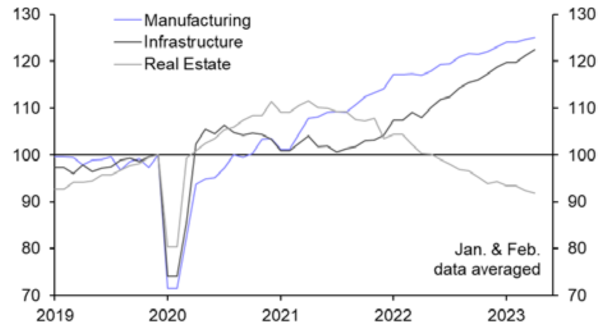


Chart 6: Freight & Seaport Traffic (2019=100, seas. adj.)

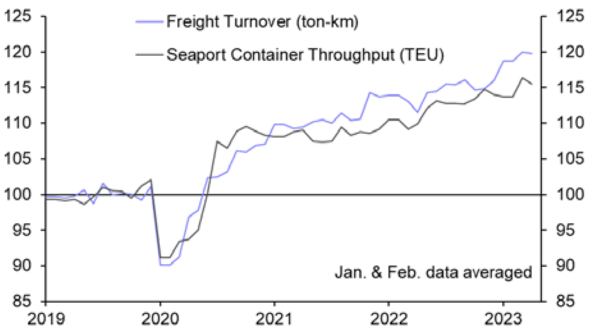
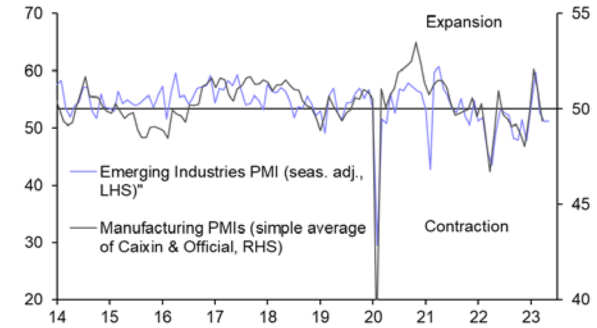


Chart 7: Manufacturing & Emerging Industry PMIs



Sources: CEIC, Wind, S&P Global, Capital Economics

Consumer Spending

- Most indicators suggest the recovery in consumer spending is still making headway. Retail sales picked up again in April, with in-person services such as catering the main beneficiaries **(8)**. And tourism spending over the Labour Day holiday earlier this month returned to pre-COVID levels **(9)**. This largely reflects an improvement in sentiment **(10)** thanks to the removal of virus restrictions and fading fear of infection.
- The pick-up in consumer activity is helping to support employment. The labour market is likely to tighten further as consumer-facing service industries continue to bounce back. And although high unemployment among the young is partly structural, they too will benefit from rising labour demand **(11)**. The sharp fall in the savings rate suggests the improving economic outlook is making households more comfortable about returning to normal spending patterns **(12).**
- Outbound travel is now back to just under a third of its pre-pandemic level **(13)**. As supply-side constraints – such as insufficient capacity on international airline routes and in tourism sectors in destination countries – ease, numbers should rise much further. Our forecast is for outbound tourism to reach 75% of pre-pandemic levels by the end of the year.

Chart 8: Retail Sales (Dec. 2019=100, seas. adj.)

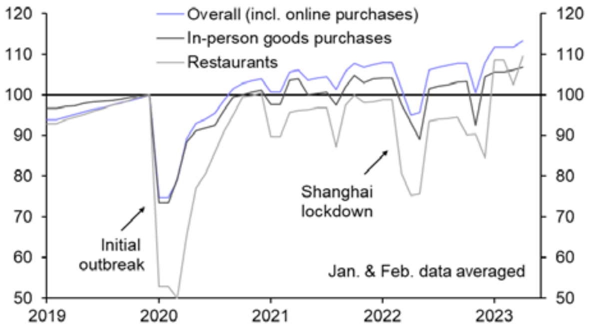


Chart 9: Tourism Spending (2019=100)

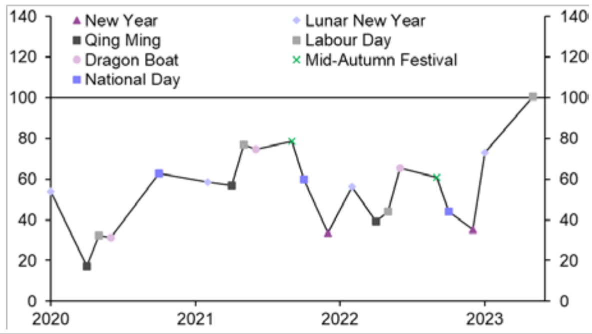


Chart 10: Consumer Confidence Indices

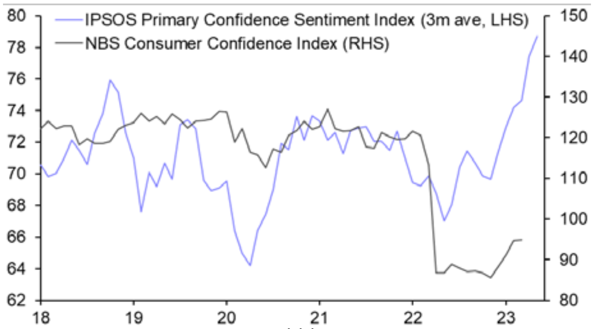


Chart 11: Surveyed Unemployment Rate (%, seas. adj.)

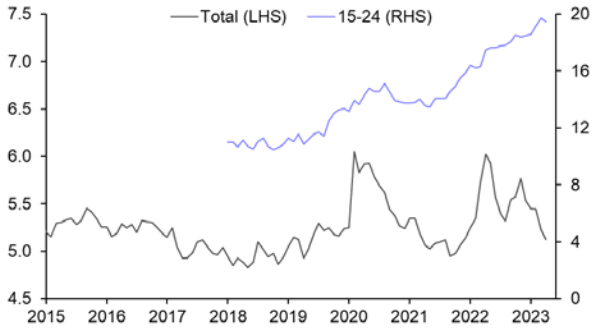


Chart 12: Household Savings Rate (constant prices, %)

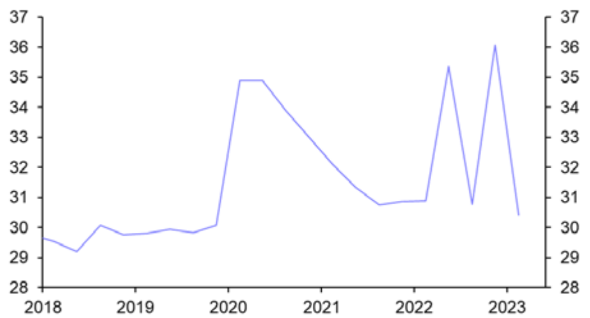
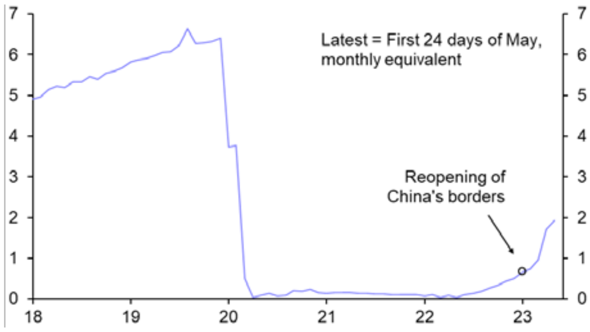


Chart 13: International Flights (person-km bn, seas. adj.)



Sources: CEIC, Wind, Capital Economics

Business

- Official surveys, which skew towards large firms and heavy industry, suggest that profit margins remained under pressure at the start of Q2 **(14)**. Inventories of finished goods have risen again relative to sales, surpassing the highs reached during the Shanghai lockdown **(15)**. But unlike then, when supply chain disruptions were rife, surveys now point to increasing slack in supply-chains **(16)**. This suggests that a slump in demand is to blame. The weakness is concentrated in the export sector, where sales are much weaker than a year ago **(17)**.
- Consistent with a deterioration in business conditions, the share of firms that are loss-making has risen and is just a touch under the peak reached during the initial outbreak in 2020 **(18)**.
- Although the current operating environment remains challenging for some parts of industry, the dismantling of the zero-COVID policy has removed one key source of uncertainty. This is helping to shore up firms' investment intentions **(19)**.

Chart 14: Net Profit Margins (%, seas. adj.)

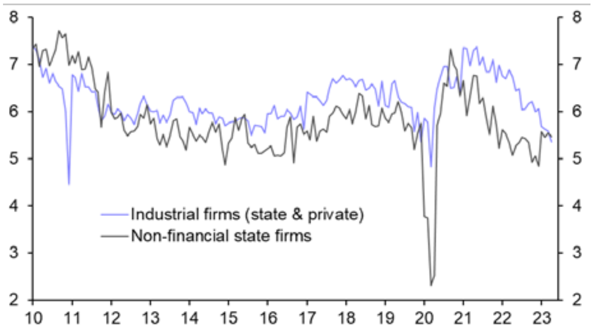


Chart 15: Final Goods Inventory (days of sales, seas. adj.)

Chart 16: Manu. PMIs – Suppliers' Delivery Times (Official & Caixin Ave.)

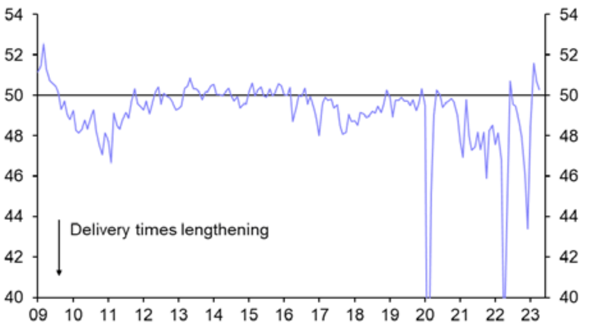


Chart 17: Industrial Sales (Dec. 2019=100, seas. adj.)

Chart 18: Loss-making Share of Industrial Firms (%, seas. adj.)

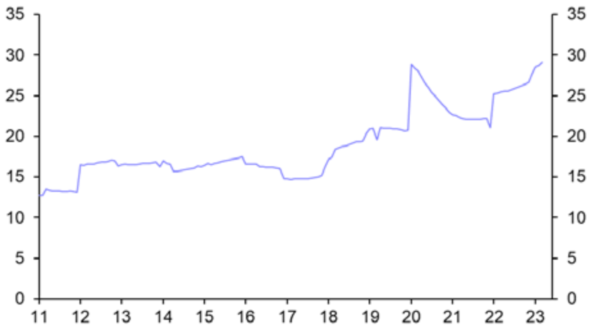
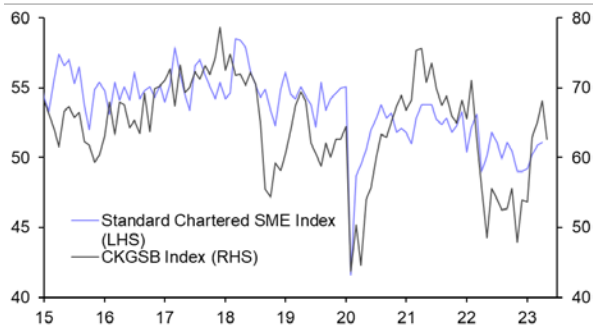


Chart 19: Future Investment Intentions



Sources: CEIC, S&P Global, Bloomberg, Capital Economics

Property

- Policy has been eased substantially, resulting in faster mortgage loan disbursement, and sharp declines in mortgage rates and downpayment requirements **(20)**. Support has also been extended to developers to help them resume stalled projects. Together with the lifting of the zero-COVID policy, these moves have boosted homebuyers' sentiment and driven a modest turnaround in the housing market. Sales in large cities are 17% above their November low **(21)**. And home prices have been rising since February **(22)**.
- However, struggles in the housing market are far from over. Homebuyer sentiment hasn't fully recovered. Developers' financial woes means homebuyers remain wary about purchasing pre-sold homes and increasingly favour completed homes instead **(23)**. But the latter is in short supply, which is keeping many potential buyers on the side-lines.
- What's more, the relaxation of constraints on developer access to financing has not resulted in much of a pick-up in their borrowing **(24)** – developers remain cautious and focused on repairing their finances. Given the scale of existing projects that have yet to be completed and the depressed level of new housing starts, a further decline in property investment is likely in the coming months **(25)**.

Chart 20: Proxies for Property Controls

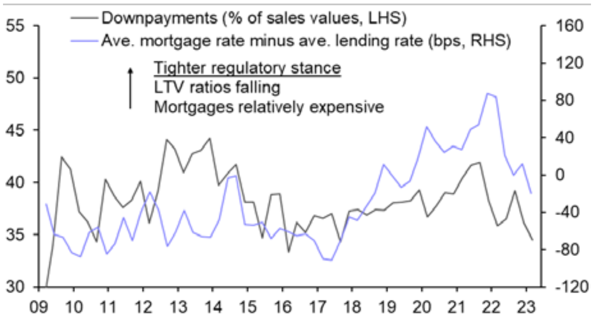


Chart 21: New Home Sales (million sqm, seas. adj.)

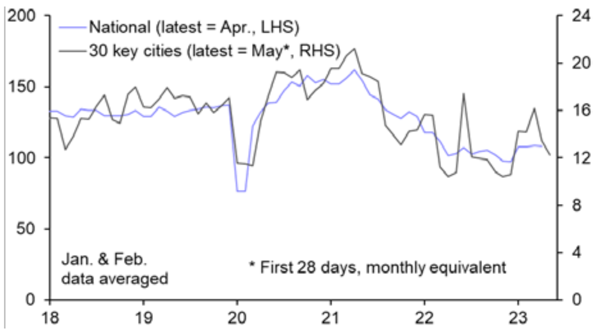


Chart 22: New House Price (% m/m, 70 city ave.)

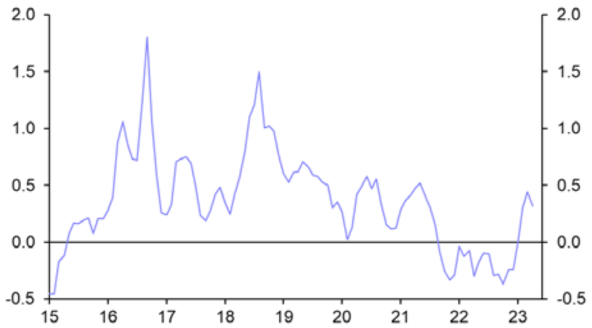


Chart 23: New Home Sales (% of total, 12m sum)

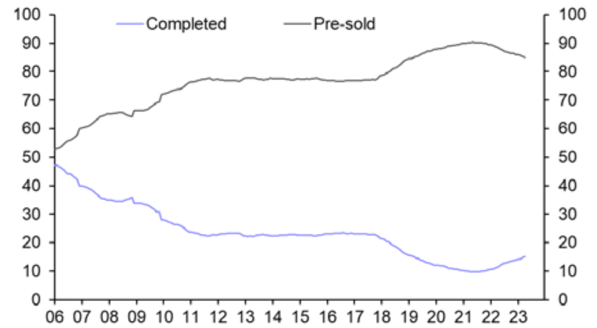


Chart 24: Developer Financing (% of trend GDP, seas. adj.)

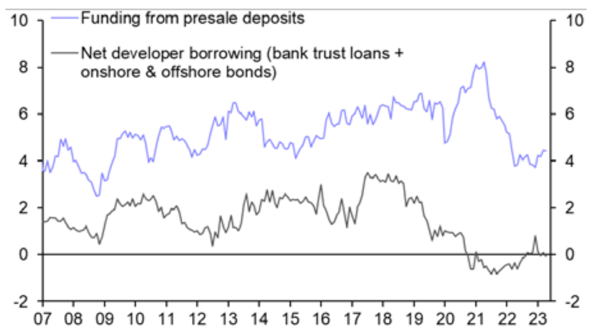
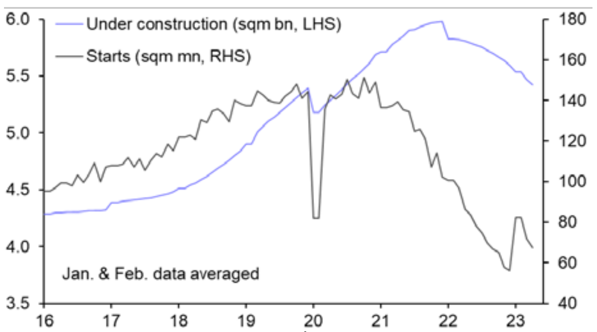


Chart 25: Property Construction Activity (seas. adj.)



Sources: CEIC, Wind, Capital Economics

External Trade

- Customs reported that exports have been robust over the past couple of months **(26)**. But the less volatile data on industrial export sales suggest that foreign demand has fallen to its weakest in 28 months **(27)**. This is consistent with Korean exports, a bellwether of global trade, which have retreated below the levels last seen at the start of 2021 **(28)**. Freight rates point to still cooling external demand too **(29)**.
- Import volumes dropped to a 12-month low in seasonally-adjusted terms last month **(26)**. Both imports for re-export and those for domestic use declined, with the latter falling to its lowest in 26 months **(30)**. And the decline in imports was broad-based **(31)**. It appears that the reopening has not fed through into strong import demand, perhaps because the consumer-facing services that have benefited the most from reopening are not import-intensive. One exception is air and car travel, whose recovery might have been anticipated to push up crude oil imports. But China expanded its crude oil stockpiles during the pandemic and refineries are now tapping those onshore supplies, reducing the demand for additional imports.

Chart 26: Goods Trade ($bn, seas. adj. 2010 prices)

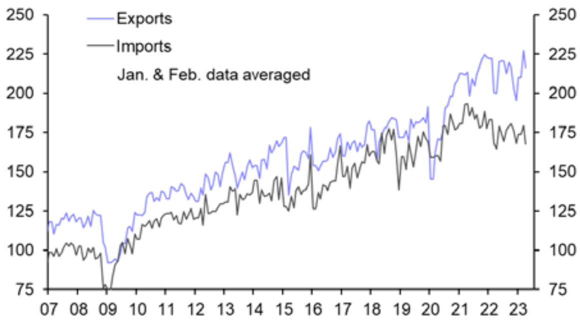


Chart 27: Exports & Industrial Export Sales ($, Dec. 2019=100, seas. adj.)

Chart 28: Goods Exports ($, Dec. 19 = 100, seas. adj.)

Chart 29: Container Freight Rates for China/Asia Outbound Routes (Dec. 19 = 100)

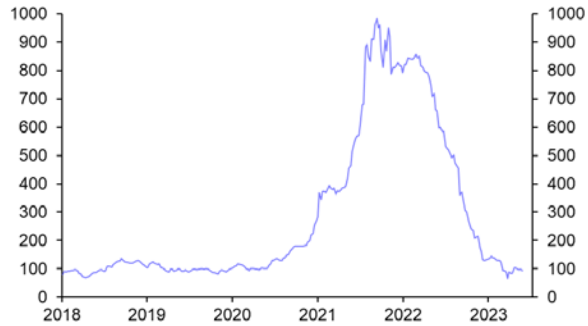


Chart 30: Import by Use ($bn, seas. adj.)

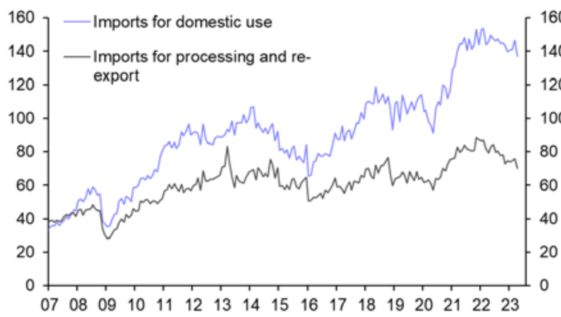
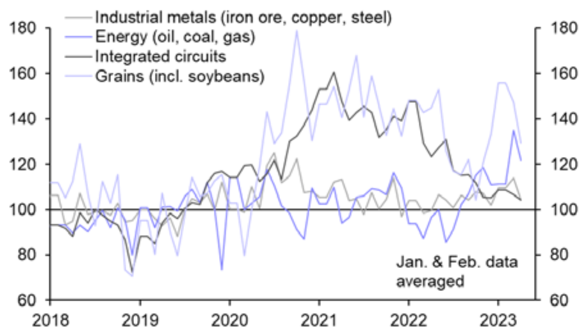


Chart 31: Imports Volumes by Product (2019 = 100, seas. adj.)



Sources: CEIC, Refinitiv, CPB, Capital Economics

Inflation

- Consumer price inflation has dropped sharply recently, reaching its lowest in over two years in April **(32)**. The main driver has been fluctuations in food and energy prices. For example, fuel price inflation fell to a 27-month low last month **(33)** due to a higher base for comparison – oil prices jumped early last year. Fuel price inflation is expected to stay negative in the coming months, keeping headline inflation at a low level.
- Core inflation has picked up slightly in the past few months **(34).** The lack of a more significant pick up isn't too concerning in our view since it partly reflects idiosyncratic factors such as the price war in the auto sector. The PBOC appear to agree and downplayed concerns about China's low inflation rate in their latest monetary policy report. Services inflation, which is a better guide to the underlying health of the economy, has rebounded to a greater extent, especially in areas linked to reopening such as travel **(35)**.
- Producer price deflation has deepened over the past couple of months, reaching a 35-month low in April **(36)**, due to both a lower base for comparison and a sequential decline in prices. Weekly data suggest that output prices at Chinese factories have continued to fall in recent weeks **(37)**.

Chart 32: Consumer Prices (% y/y)

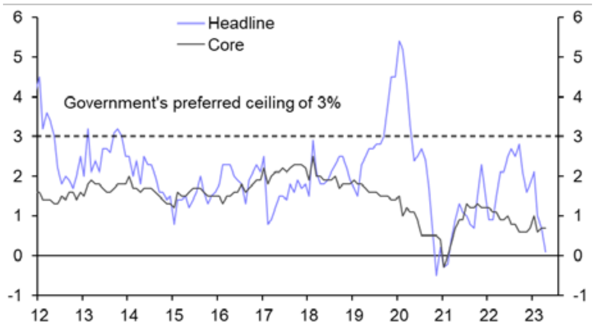


Chart 33: Oil & Vehicle Fuel Prices (% y/y)

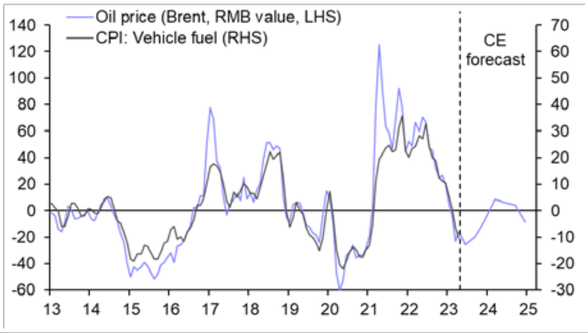


Chart 34: Consumer Prices (% 3m/3m, annualised, SA)

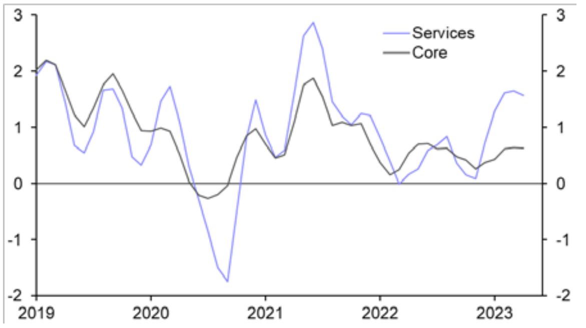


Chart 35: CPI – Tourism Services (% y/y*)

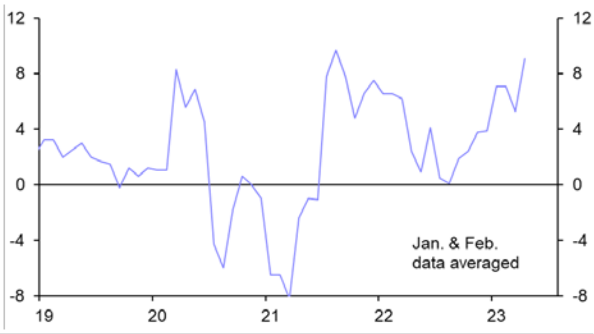


Chart 36: Producer Prices

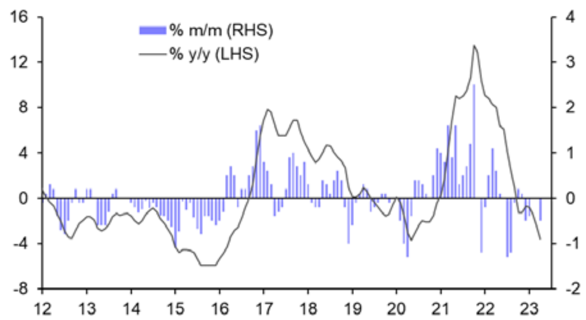


Chart 37: Weekly Producer Prices (23rd Feb. 20 = 100)

Sources: CEIC, Refinitiv, Capital Economics

Monetary

- The PBOC has kept its key policy rates on hold since the shift away from zero-COVID **(38)**. Although the PBOC has hinted at potential monetary easing, it will probably prioritize other tools such as RRR reductions instead of policy rate cuts, which would add pressure to banks' net interest margins. This would not be a new approach – the PBOC has already engineered a 70bp decline in the cost of new bank loans since the end of 2021, despite only lowering the 1-year LPR by 20bps **(39)**.
- Credit growth was weaker-than-expected last month. Bank lending growth stagnated, with the breakdown showing lending growth to corporates and to households flat too **(40)**. Growth on the PBOC's broad credit measure also stayed unchanged **(41)**. Considering the weak base for comparison from one year ago due to the Shanghai lockdown, they point to faltering demand for credit.
- We expect credit growth to slow in the coming months. Lending will encounter regulatory constraints **(42)**. And year-on-year growth in local government special bond issuance should also decelerate, as issuance in May and June looks set to be significantly lower compared to the same period last year **(43)**.

Chart 38: PBOC Policy Rates (%)

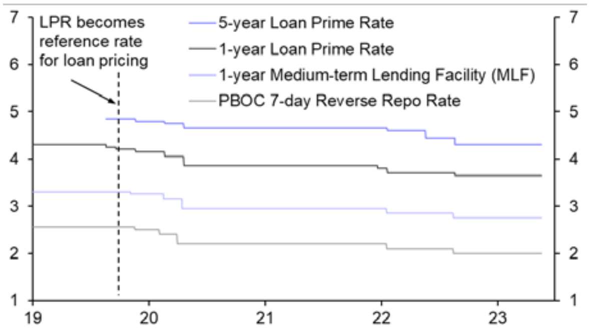


Chart 39: Bank Lending Rate and 1-Year LPR (%)

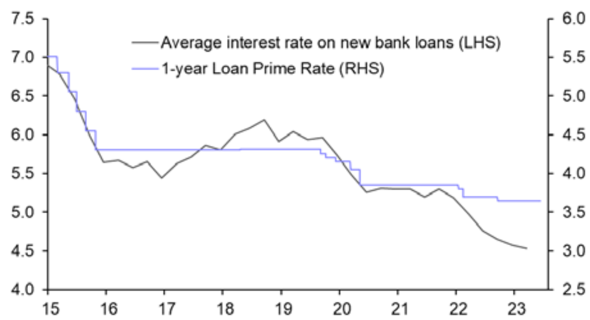


Chart 40: RMB Bank Loans (Outstanding, % y/y)

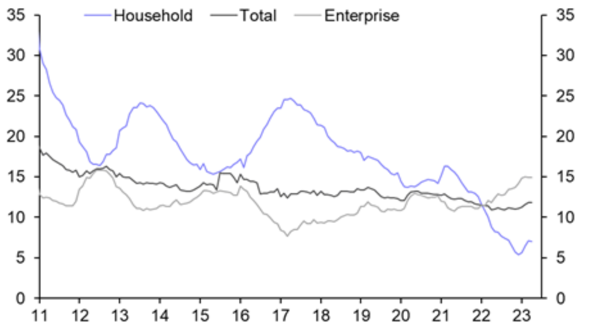


Chart 41: Growth of Outstanding Credit (% y/y)

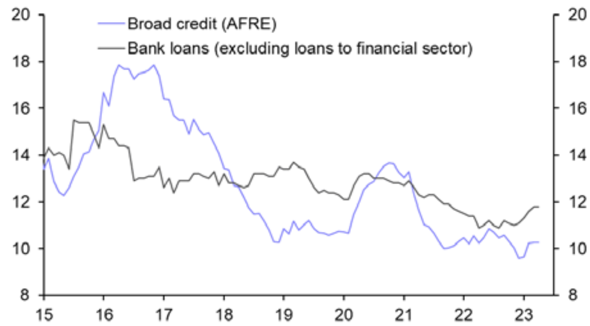


Chart 42: Bank Lending & Loan Approval Conditions

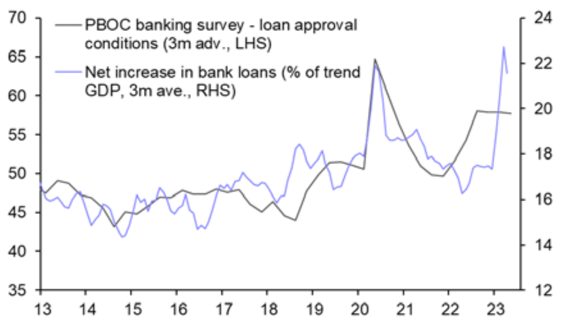
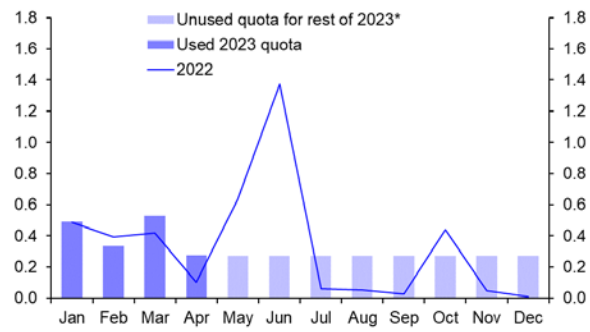


Chart 43: New Local Government Special Bond Issuance (RMBtrn)



Sources: CEIC, Wind, Refinitiv, Capital Economics

Financial Markets

- China's stock markets have continued to sell off during the past month **(44)**. One reason for the poor performance is that foreign investors' purchases of Chinese equities have dried up **(45)**. The valuation of China's equities relative to developed stock markets has dropped back close to record lows **(46)**. While this large discount partly reflects structural factors such as increased geopolitical risk, it does hint at some potential upside to Chinese stocks in the coming months if, as we expect, the economic data come in better than feared.
- The renminbi has weakened beyond 7/$ for the first time since December **(47**). This is primarily due to wider dollar strength but the renminbi has also weakened in trade-weighted terms, implying some China-specific drags. This is most likely due to growing investor pessimism over the health of the reopening recovery. The PBOC has responded with warnings against currency speculation, and has started to use its fixing rate to push back against depreciation, though not yet to the same extent as it did last year **(48)**.
- The reopening rally in offshore bonds has partially reversed in the past few months **(49)**, coinciding with signs that the recovery in housing demand is faltering.

Chart 44: Equity Indices (20th Jan. 2020 = 100)

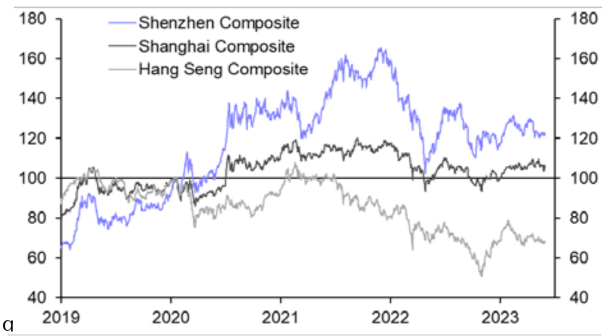


Chart 45: Net Inflows to Mainland Equity Markets via SH-HK & SZ-HK Stock Connect ($bn, 30d ave.)

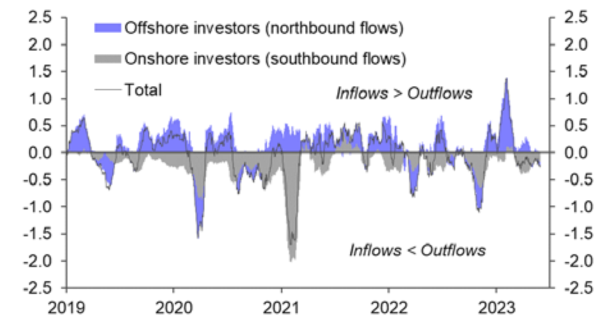


Chart 46: MSCI China vs MSCI World Forward PE Ratio

Chart 47: Renminbi Exchange Rate

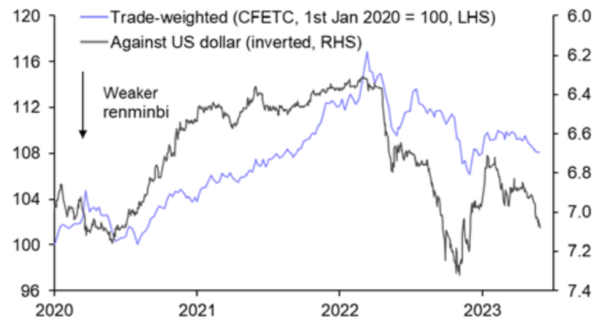


Chart 48: USD/CNY Fix vs Previous Close

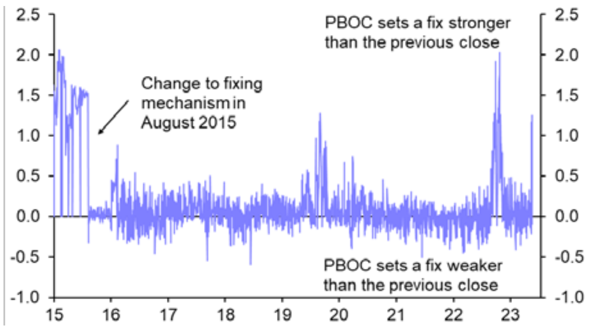
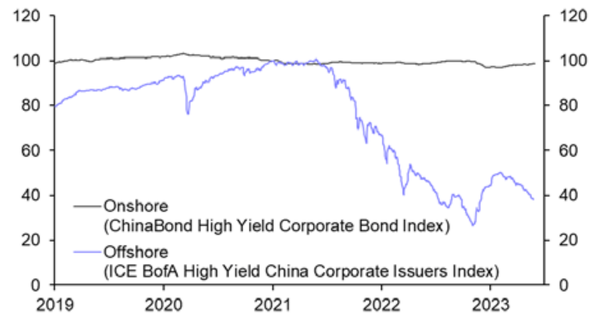


Chart 49: China High Yield Corporate Bond Indices (4th Jan. 2021 = 100)



Sources: CEIC, Refinitiv, Wind, Bloomberg, Capital Economics

Hong Kong

- Hong Kong's economy rebounded more quickly than anticipated in Q1 after it held steady in Q4 **(50)**. The breakdown shows that this was thanks to a jump in services exports and a further pick up in consumption **(51)** as foreign visitors returned rapidly **(52)**. The resumption of normal flows of people and goods into and out of the city also boosted investment **(51)**. Goods exports also picked up for the first time since Q4 2021.
- More timely data suggests that the recovery is still going strong. Foreign visitor arrivals are now roughly half of its pre-protest levels **(52)**. That's providing a sizeable boost to the retail and hospitality sectors **(53)**. Restaurant spending and reservation data for the Labour Day holiday and Mother's Day suggest momentum remained strong at the start of this month
- But pockets of weakness remain. Goods exports reversed some of their gains in March **(54)**, a trend which might persist for a while as backlogs of orders are gradually cleared and foreign demand remains soft amid a still weak global picture. And the rebound in investment is likely to lose some momentum – as the reopening boosts fades, the drag from high interest rates will become apparent again. Our forecast is that interest rates will only start to drop back later in the year **(55)**.

Chart 50: Hong Kong GDP Growth

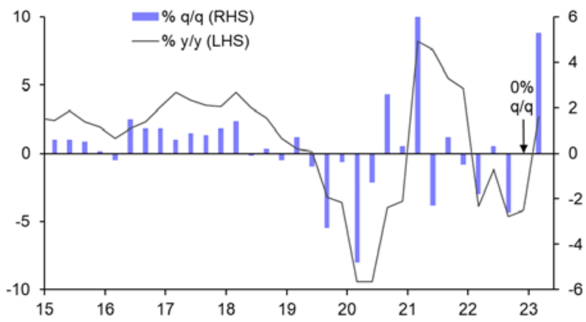


Chart 51: GDP Breakdown (Q1 2019=100)

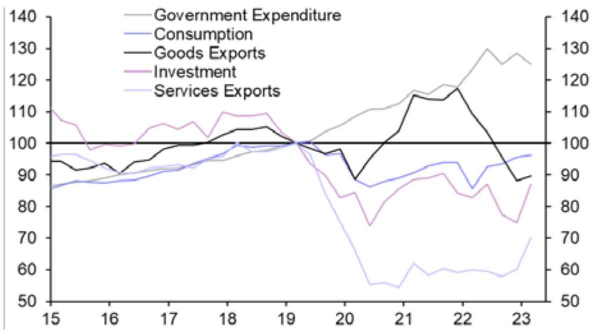


Chart 52: Hong Kong Passenger Arrivals Breakdown (mn, seas. adj.)

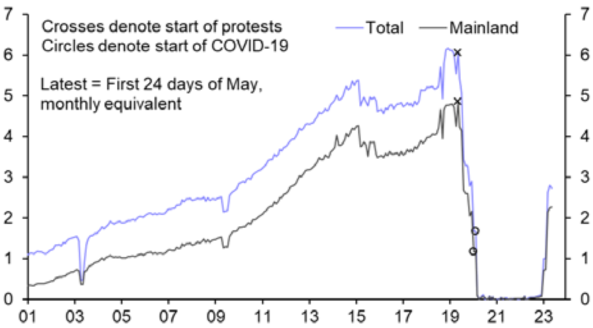


Chart 53: Retail Sales Volumes (May 2019 = 100, seas. adj.)

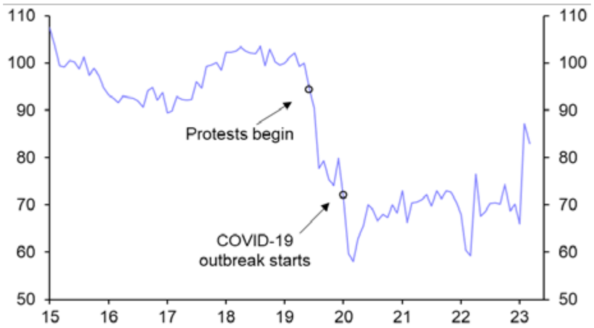
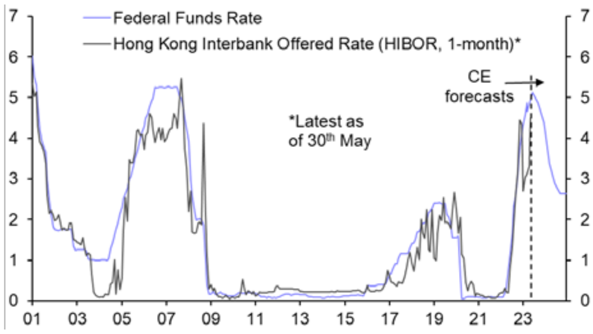


Chart 54: Goods Exports (Dec. 2019 = 100, seas. adj.)

Chart 55: Interest Rates (%)



Sources: CEIC, Capital Economics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