21 May, 2023

# Outlook 2H2023: This Time is Different

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**Chinese version:**

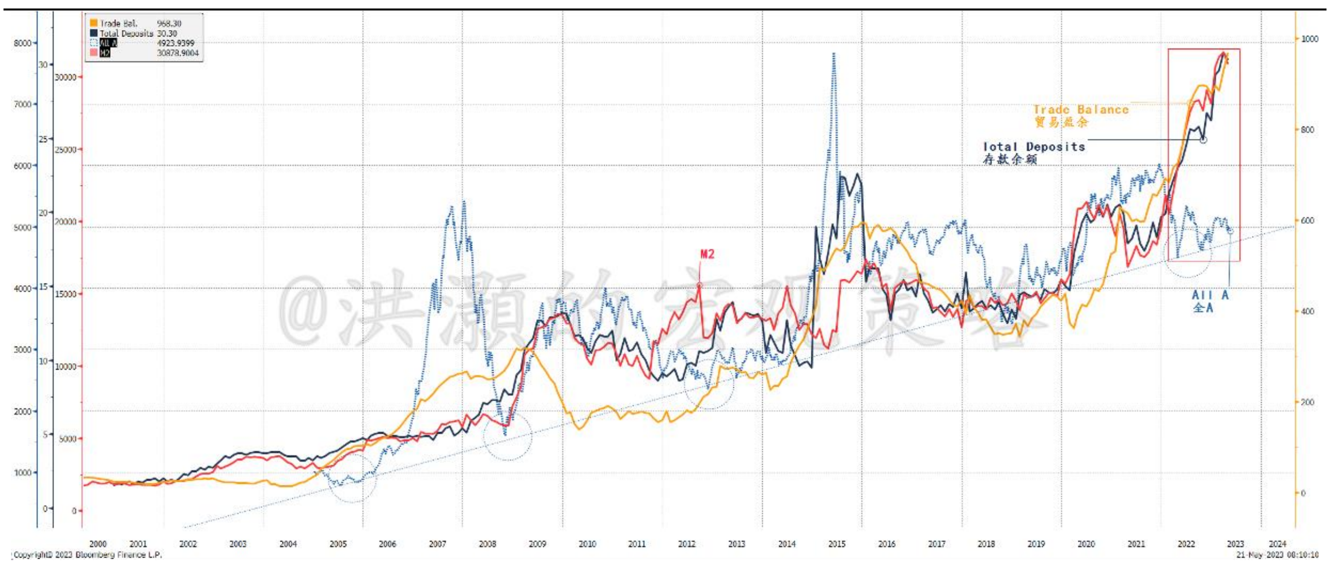
《2023 年下半年展望：进则无咎》

- China's record trade surplus mirrors the surge in deposits and M2. It is a testament of China's manufacturing prowess. But such comparative advantage also means that Chinese exports have been the key to cope with the slowdown during the pandemic. The US demand is now being tampered with by the Fed, hampering China's manufacturing and exports strength. As such, commodities, energy, and Chinese stocks are frail despite China's reopen.
- Chinese households are overextended during the pandemic, and are not in a strong position to borrow more. This is why lending lags money growth, and "revenge consumption" is fleeting. Further, consumption is a much smaller part of the Chinese economy, and thus the foreign recovery experience won't easily apply – contrary to consensus belief.
- If the US avoids a recession, Chinese manufacturing and exports will pull through. Bottoming industry profits and recovering confidence both in the US and China are hinting at rising probability. If so, the recovery will take some time to eventuate, and risk assets will perform later. If not, the market will take a dive, but then the PBoC will likely ease further to support the recovery – much like it did in 2014 to 2015. In either scenario, we must take a deep breath, and hold onto our faith a little longer.

## Why is China's recovery sputtering?

After a strong start in 1Q, economic momentum started to wane in April. Retail growth was below consensus, and investment was still declining Y/Y – against the backdrop of historic monetary easing, with M2 growing by more than 30 trillion yuan YTD in an economy that is worth 120 trillion yuan. Stimulus feels like shooting blanks. Many start to question whether the recovery is for real.

### Figure 1: Chinese stocks splitting from record trade balance, M2 and deposits.




*Source: Bloomberg, GROW Research*

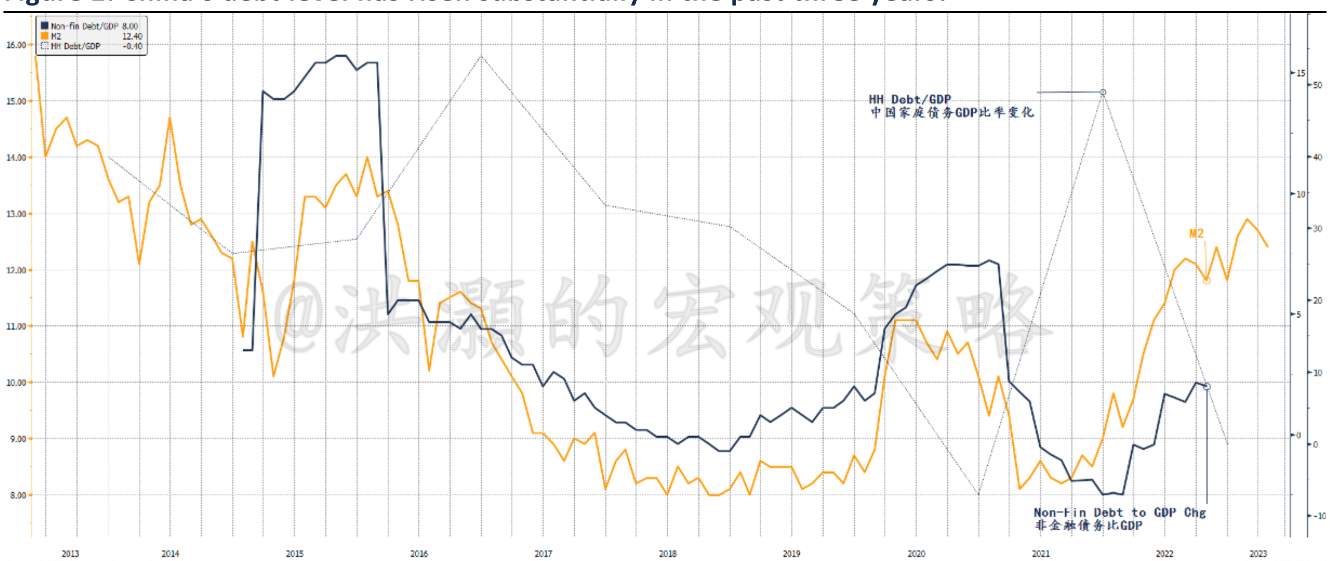
The outlook is murky, and some unprecedented phenomena that have never occurred in China's economic history are dumbfounding pundits. *First and foremost, Chinese stocks are puking back the gains since late last October, and the Hang Seng Index has indeed sunk into the bottom of the world market ranks – despite record liquidity* (**Figure 1**). Why?

In **Figure 1**, we highlighted the strong historical correlation between China's trade balance, M2, household deposit and stock market index. But after 2022, stocks started to diverge from M2, deposits and trade balance. It is a glaring departure from history.

China's record trade balance suggests that China has been coping with the economic downturn during the pandemic by supplying foreign demand – mostly the US and EU. Such strong trade surplus showcases China's manufacturing prowess, but then also highlights China's weak domestic demand.

Indeed, official data indicated that Chinese household expenditure growth outpacing income during the pandemic. Or that the Chinese households had experienced dissaving, as their income was affected. Consequently, the household debt level has risen by around 7% -- from 56% to 63% (**Figure 2**). Such increase in debt also explains why the Chinese households are not borrowing more now despite record low interest rate and monetary expansion. They are paying off existing debt instead.

**Figure 2: China's debt level has risen substantially in the past three years.**




*Source: Bloomberg, GROW Research*

As production and consumption are the two sides of an economy, and given how weak consumption has been, it is reasonable to conclude that it was the manufacturing sector that had been supporting the Chinese economy during the pandemic. Note that since the outbreak, Chinese industry profit has been less correlated with the Chinese monetary policy (M2 growth as proxy), but more with US policy (**Figure 3**), despite a close historical correlation that has intuitive appeal.

That is, Chinese manufacturing had been supplying US (and the world's) demand during the pandemic. External demand met by Chinese exports was significantly stronger than domestic demand partly met by imports. This differential explains the record trade balance and China's export strength during the pandemic.

**Figure 3: China's IP more correlated with US M2 during COVID; China/US monetary policy splitting.**


*Source: Bloomberg, GROW Research*

In sum, China's record trade surplus signifies China's manufacturing and export prowess. It also symbolizes China's ability to attract foreign savings into domestic deposits, as seen by trade surplus rising in tandem with domestic deposits to all-time-high. Eventually, these deposits constitute a substantial part of China's broad money supply and macro liquidity.

And now the reason why stocks decoupling from strong macro liquidity is clear: Chinese households' ability to take on more debt has been eroded during the pandemic. Instead, they are saving, not spending. Hence the subpar retail growth, record deposits and stocks faltering for a lack of growth drivers. Record money supply has not completely turned into credit expansion (**Figure 6**). And even though there has been some credit growth, it has mostly gone to the corporate and manufacturing side to sustain its strength. And hence the surprisingly resilience in exports.

But why can't the production part of the economy help the economy and stocks? As **Figure 3** shows, China's industry profits are now more correlated with the US M2. That is, Chinese production are affected by the US (and foreign) demand that is being tinkered by the Fed (and other foreign central banks') tightening campaign to combat the highest inflation in over four decades.

Unless the pressure from the Fed lets up and US demand is thus reprieved, it would be hard to see Chinese exports regain its full strength as seen in the past three years. Weak Chinese manufacturing sectors also reveal how the current economic cycle is different: China appears to be cyclically recovering from last year's abyss, but upstream commodities that are key inputs into China's manufacturing sector are not doing well. It also explains why Chinese stocks are fumbling, as many Chinese stocks are strong cyclical plays.

## How will the Chinese economy recover?

We called the epic market rebound on October 31, 2022 with our research report titled "***Mai! Mai! Mai!***". Since then, and till early February, the Hang Seng Index surged more than 50% and the Hang Seng Tech Index more than doubled. Despite initial sneering from the uninitiated consensus, the roaring market has been the best rebuttal.

Now the same crowd is starting to doubt the sustainability of the recovery. Even those who came around after we published our research note have begun to waver. After all, many important economic data such as household long-term borrowing, property sales and investment, as well as retails growth, have been shaking confidence. That said, our proprietary economic cycle model continues to suggest a recovery is unfolding (**Figure 4** and **Appendix 1 - 4**).

**Figure 4: China economic cycle continues to heal.**


*Source: Bloomberg, GROW Research*

Many economists have been advocating stimulus for consumption as a way to sustain the recovery momentum. At first glance, it sounds plausible, as the country has been striving to stave off investment-driven growth for years. Meanwhile, exports that are corresponding to Chinese manufacturing sectors are still being affected by the Fed's policy to tamper with US demand. And local government's debt burden is starting to crack, with some local municipal bonds beginning to default. As such, boosting consumption seems to be the most obvious policy choice.

But unlike consumption in the developed economies, Chinese consumption is a much smaller part of the economy. Further, as aforementioned, the Chinese household leverage has risen significantly during the pandemic, it is not really in the place to borrow more. It is one of the reasons why "revenge consumption" has been fleeting. As such, while stimulating consumption seems to be easy picking, the recovery experience after the pandemic in the developed economies is not entirely transferrable to China.

We witnessed a nascent property recovery in the first quarter. But then the amber turned cold going into April. While the secondary market had seen some strong growth y/y, the recovery in the primary market is patchy at best. Out of the concerns of “unfinished buildings” and limited supply of new units, people opted to buy second hand – if they had to buy.

Meanwhile, banks are still reluctant to lend to the property sector. Consequently, source of funds for property development is still mostly self-generated by developers, namely, proceeds from sales. Banks are still reluctant to lend to developers, especially the private ones. But if not enough new units sold, then funds for property construction will be limited. Hence the slowdown again in property investment in April. It is a chicken-and-egg problem.

Therefore, we need the production side of the economy to do better, if the consumption side is still frail. But the manufacturing part is externally dependent to a large extent, i.e. depending on how resilient the foreign demand can be amid Fed tightening.

While the outlook is still murky, some of our indicators are starting to bottom out. In **Figure 5**, we have shown that China’s industry profits growth is nearing its cyclical bottom, while PPI-CPI, a proxy of relative strength of foreign demand vs. domestic, exports vs. imports, is also nearing its cyclical low concurrently. At the same time, household confidence is healing, and this improvement in confidence is also reflected in the offshore yuan CNH, too.

**Figure 5: Industrial sectors bottoming out; household confidence recovering along with CNH.**


*Source: Bloomberg, GROW Research*

If China were to ease further in the second half of the year, we suspect that the new liquidity would still go into the manufacturing sector, rather than boosting consumption. The Chinese consumer is quite extended in terms of borrowings. But if so, it would not be bad news, as the new growth will be driven by investment in manufacturing rather than further extension of the property bubble.

At the current juncture, the PBoC is adopting a wait-and-see approach after the historic monetary expansion in the past six months. And even if the central bank opts to ease further now, it won't help as much, as the manufacturing sector is heavily external dependent, and people are not buying properties as they used to despite record low interest rate. Easing now would not be as effective.

## How will the Chinese market perform?

Another puzzle in the current recovery is that Chinese stock rally fizzled out after a strong rebound from late last October. It is as if stocks are losing faith in the China recovery story.

As aforementioned, the record trade surplus, the resultant domestic deposits and money supply have not turned into commensurate lending growth. Indeed, the growth differential between lending and M2 has been falling since early 2021, but appears to have found its footing (**Figure 6**).

Historically, stocks tended to do better when lending substantially outpaced broad money supply growth. It is intuitive: as money supply turns into loan growth, credit in the economy expands, and then the economy starts to grow again as a result. Credit is the blood circulating in the real economy. If it flows and grows, so will the economy. Right now, credit expansion is still in its early days. And stocks are waiting for further evidence of recovery.

**Figure 6: Lending growth < M2, depressing stocks. But it seems to be bottoming.**


*Source: Bloomberg, GROW Research*

One of the investment themes that has delivered this year is the SOEs. Many of the SOEs that have been ignored for ages despite their very low valuation are roaring back to life, returning 50-100% and substantially outpacing the overall market. Consensus is quick to attribute this strong relative performance to SOEs' low valuation and cashflow certainty.

But there is a more straightforward explanation: the SOEs are highly correlated with bond yield (**Figure 7**). Indeed, with very low valuation and attractive dividend yield, they can be seen as bonds with relatively steady principal and stable yield. In many ways, these names have been bond-like instruments with a call option in their stock prices.

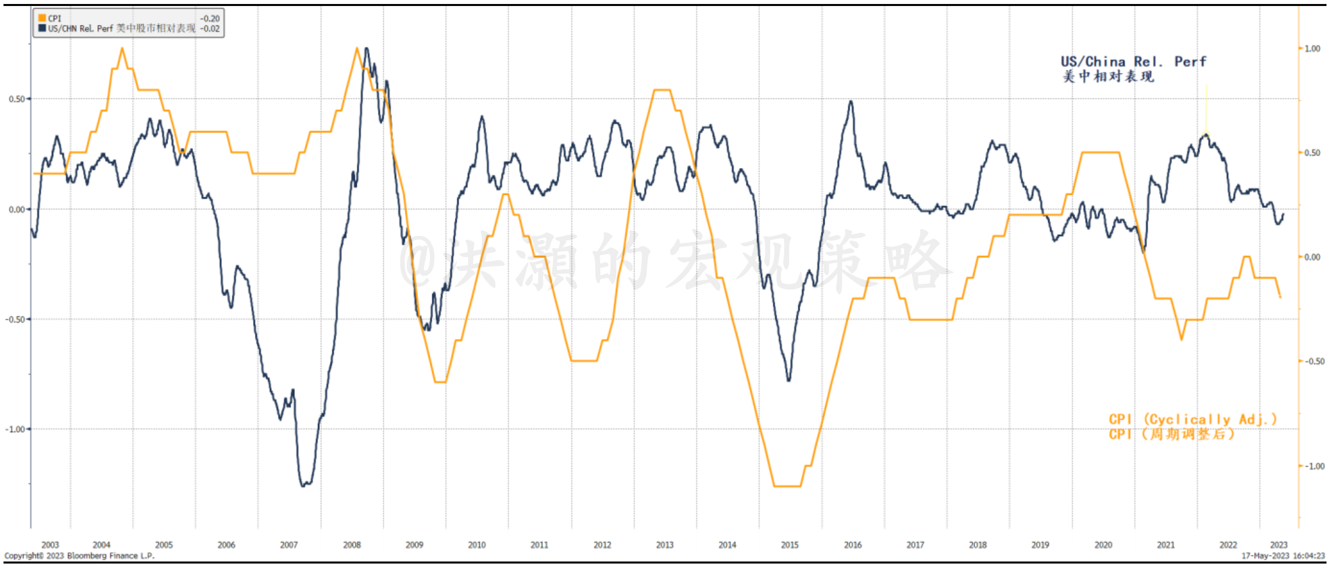
**Figure 7: SOEs performance highly correlated with bond yields, but now splitting.**


*Source: Bloomberg, GROW Research*

Recently, the SOEs' performance has been splitting from long bond yield as well. Long bond yields are falling back towards their all-time-low, while SOEs remain resilient. Or bonds are seeing challenges in the path to recovery ahead, while SOEs are sticking to their guns. While historically bonds are more prescient, SOE stocks are taking a leap of faith.

Further, **Figure 8** shows that Chinese CPI, one of the measures of the state of the Chinese economy, is highly correlated with the US/China relative performance. If CPI were to fall further, it would suggest weak Chinese domestic demand and hence a struggling economy. If so, the US would actually underperform, as the Chinese economy is key to the US economy, as well as the world.

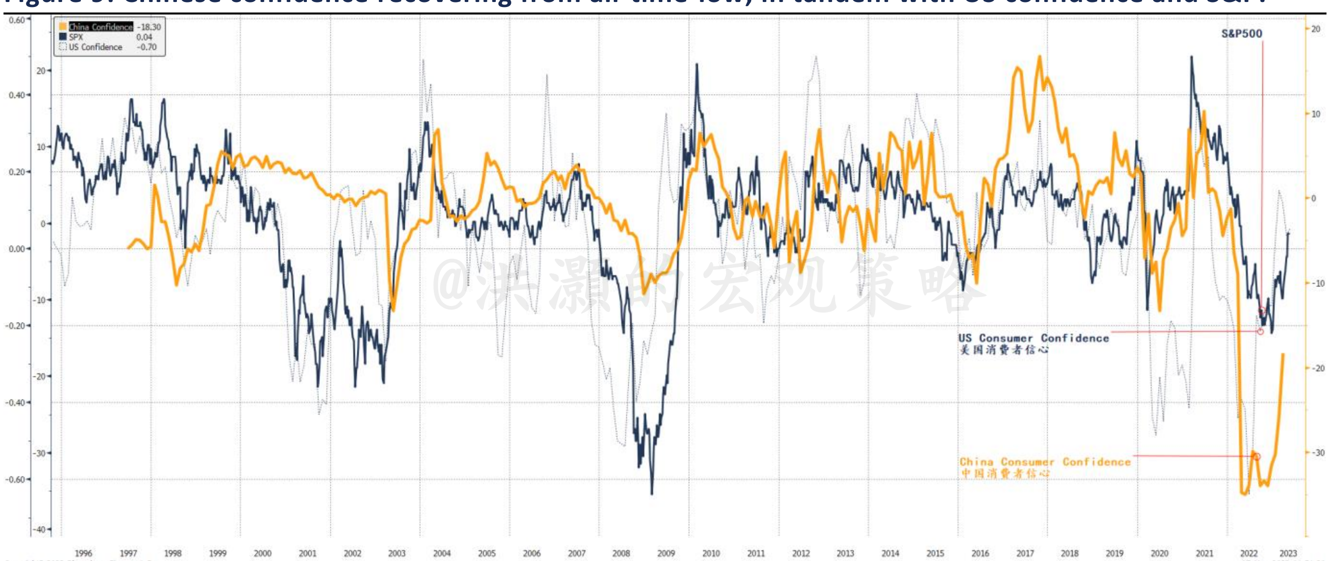
## Figure 8: Chinese CPI highly correlated with US/China relative performance.




*Source: Bloomberg, GROW Research*

Fortunately, Chinese confidence is recovering from historic low. And the US confidence is bouncing back from its lows as well (**Figure 9**). Historically, these measures show strong correlation with US stocks. And the logic is too plain to explain.

## Figure 9: Chinese confidence recovering from all-time-low, in tandem with US confidence and S&P.




*Source: Bloomberg, GROW Research*

## Conclusion

Chinese manufacturing supplies the US and foreign demand, and is now more correlated with the US monetary policy than with China's own. Record trade surplus and deposits are testaments of China's manufacturing prowess. But the Fed, although nearing the end of its tightening campaign, is still tampering with the US demand. Hence China's manufacturing sector is biding its time. These observations explain how this cycle is different: there is not yet an upstream recovery after China reopened. And anemic performance in commodities, energy, and stocks splitting from record M2.

Meanwhile, Chinese consumption and property are still brittle, as households had leveraged too much during the pandemic to borrow more now. Chinese consumption is too small a part of the Chinese economy to make the recovery experience in the developed economies entirely transferable. And the "revenge consumption" has been fleeting. We cannot rely on Chinese consumption as the key driver of a recovery – contrary to consensus advocates.

If the Fed will be done with its tightening soon, and the US and foreign demand remain resilient, then Chinese manufacturing and exports will shine again. Already, we are seeing US consumer confidence recovering from its lows and the Chinese confidence continue to recover. And China's industry profit growth and margin are bottoming out. The likelihood of this scenario is rising, and it is very different from the consumption recovery that the consensus was hoping for. If Chinese manufacturing recovers to supply the foreign demand again, then cyclicals, value and commodities will do well again. This will be the traditional economic cycle we have all known by heart.

If the US demand falters and the US sinks into recession, then China's manufacturing will struggle to recover. And as aforementioned, we cannot rely on the overextended Chinese households. If so, then it is likely that policy easing will make another significant move – similar to 2014 to 2015. And stocks should rally in this scenario.

The first scenario will take time and investors will have to negotiate some rough waters. In the second scenario, the market will take a dive first, but then with the PBoC riding to the rescue it will produce a tearing rally. Recent CNY weakness seems to be reflecting this scenario. No matter which scenario eventuates, at today's vantage point, we need to take a deep breath and hold onto our faith.

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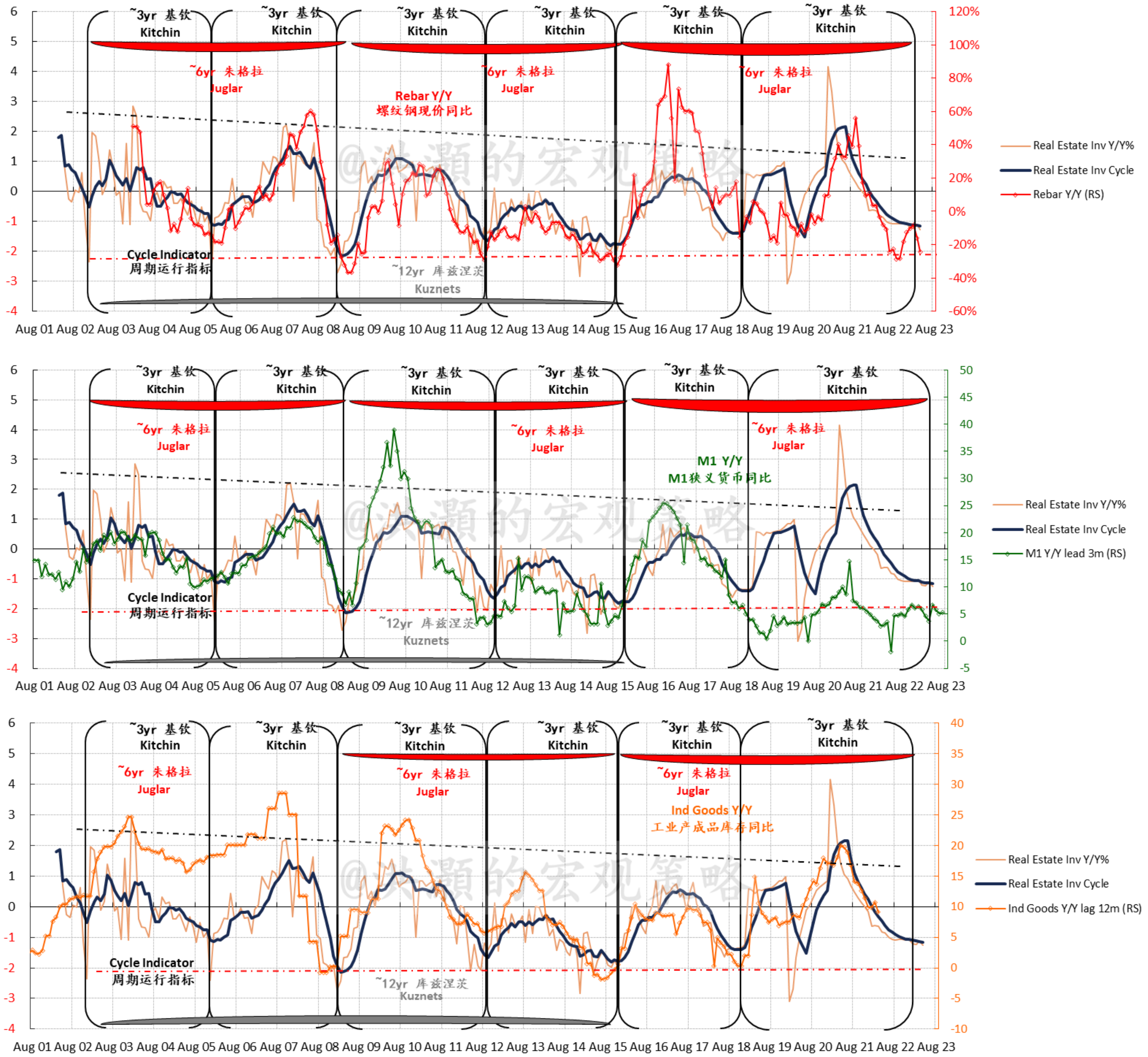
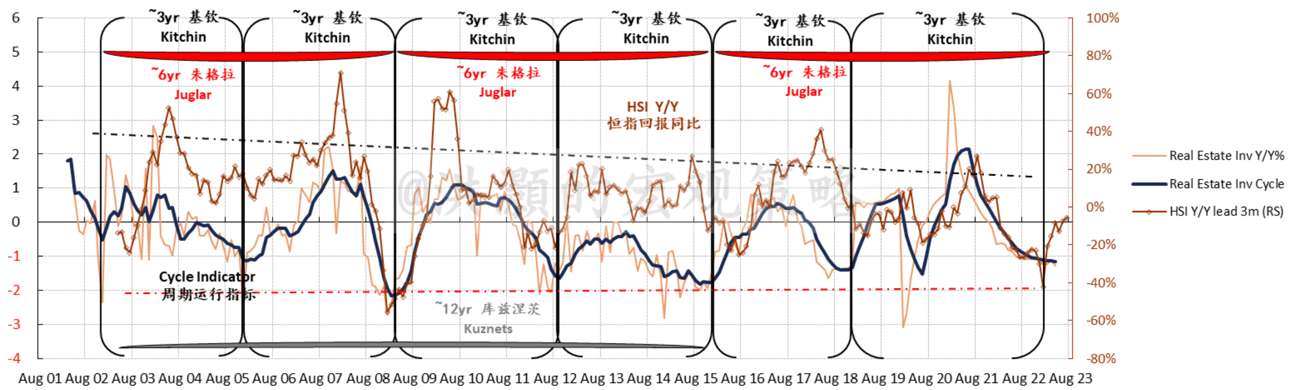
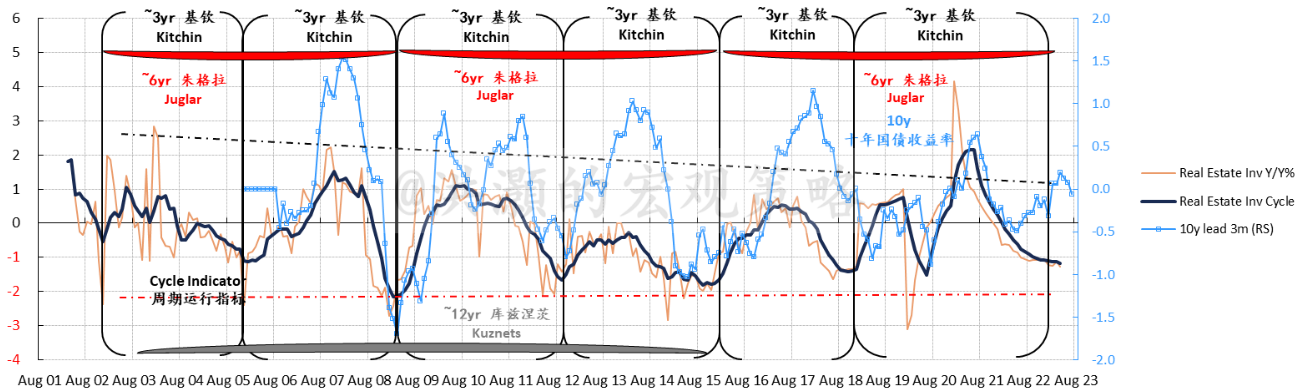
## Appendix 1: China economic cycle (1/4).

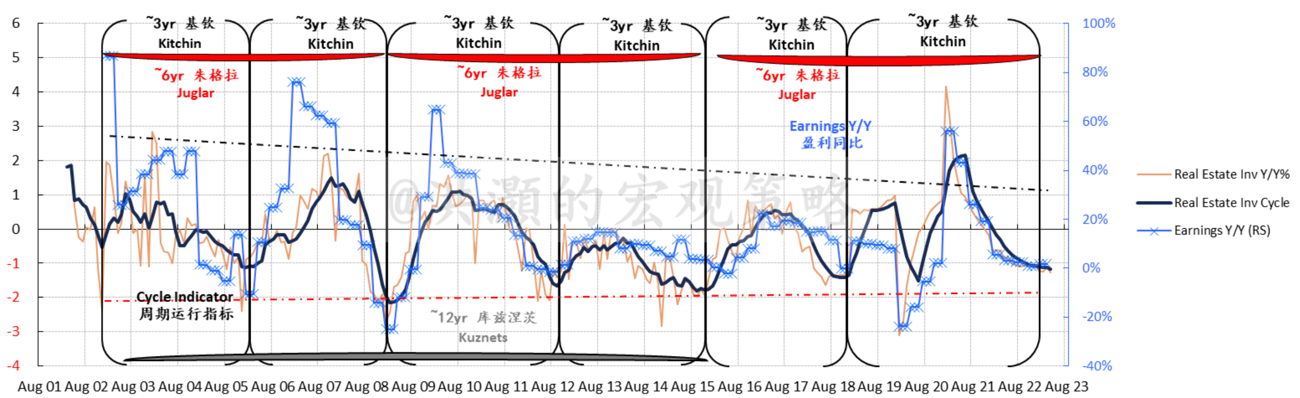



*Source: Bloomberg, GROW Research*

## Appendix 2: China economic cycle (2/4).

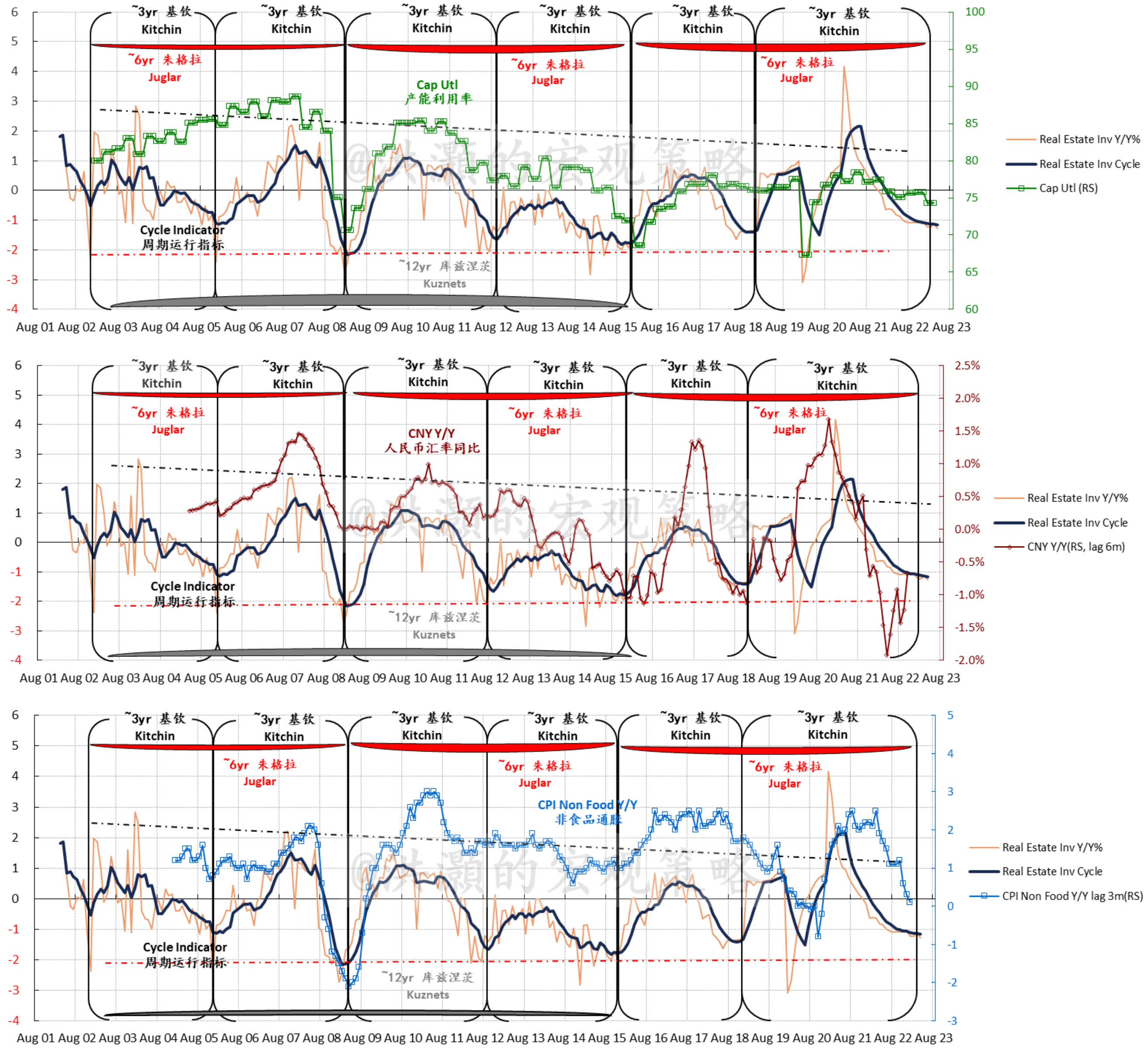


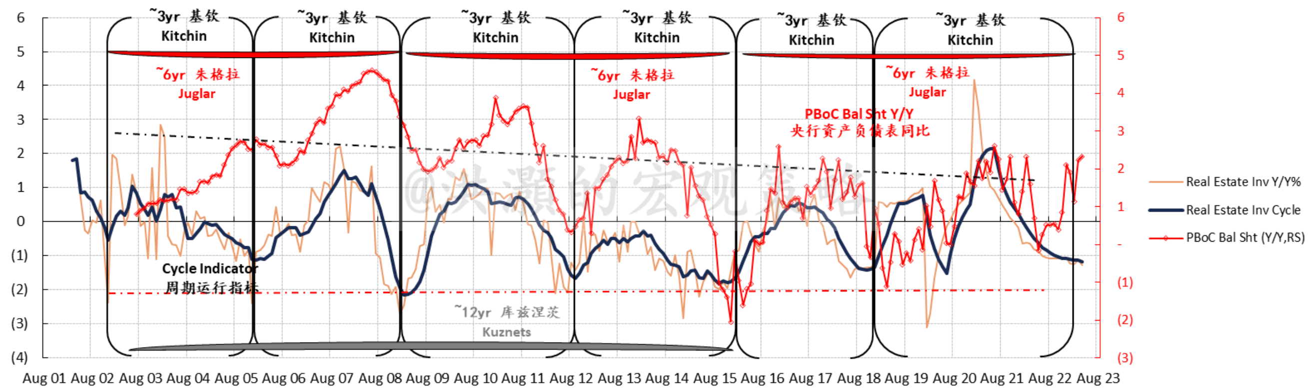

*Source: Bloomberg, GROW Research*

## Appendix 3: China economic cycle (3/4).



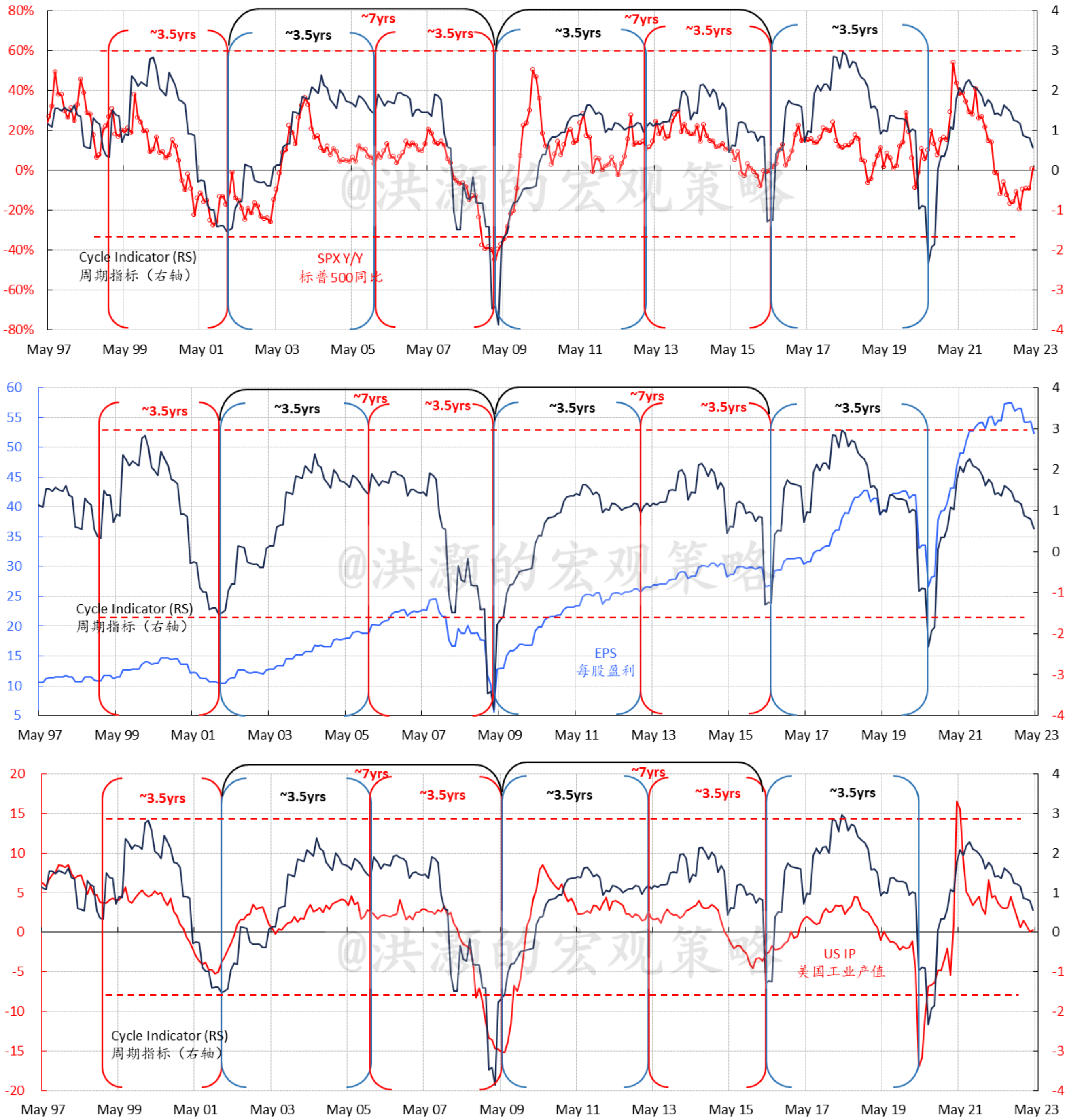

*Source: Bloomberg, GROW Research*

## Appendix 4: China economic cycle (4/4).



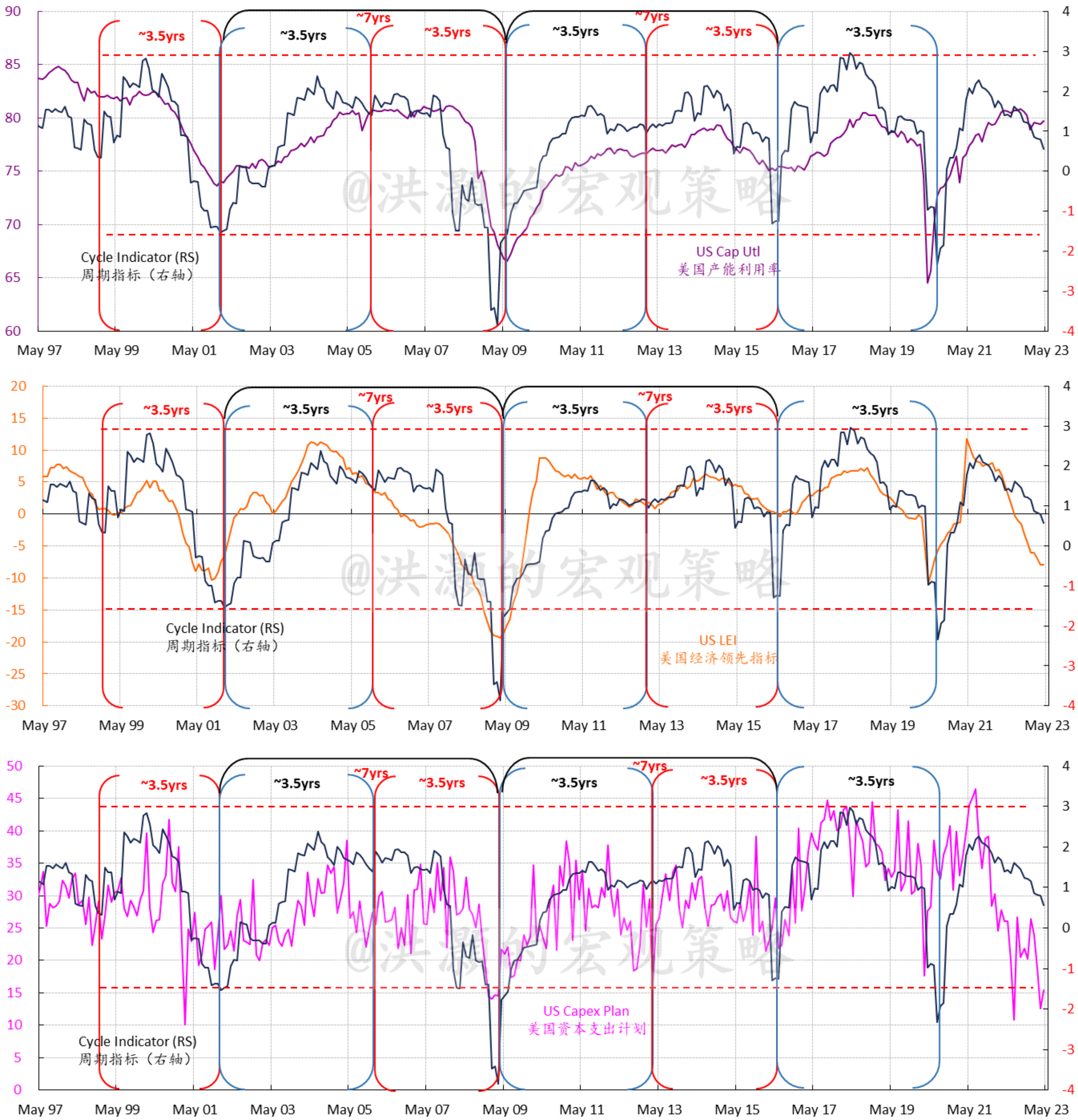

*Source: Bloomberg, GROW Research*

## Appendix 5: US economic cycle (1/3).



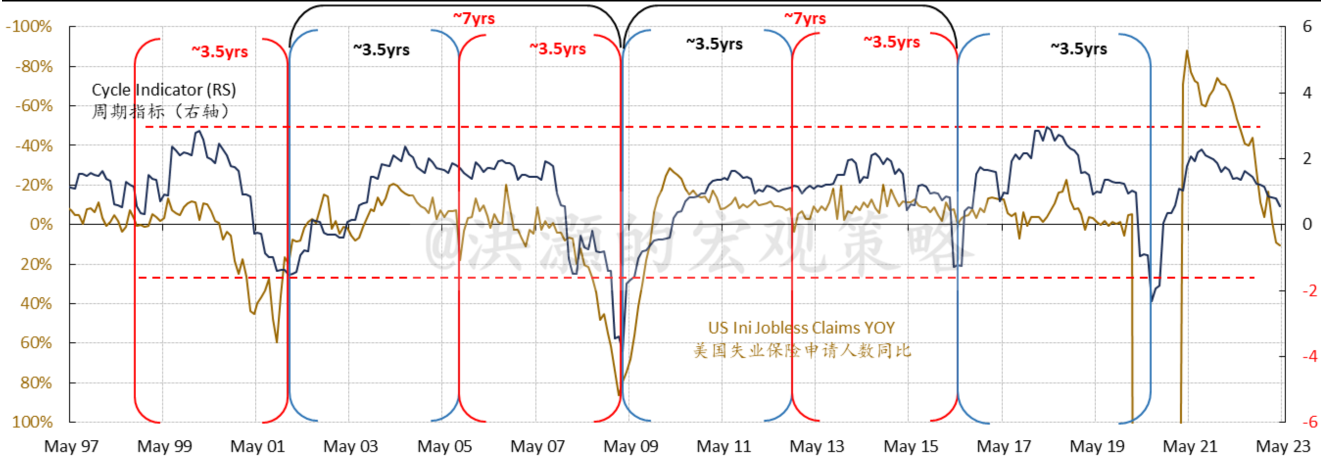

*Source: Bloomberg, GROW Research*

## Appendix 6: US economic cycle (2/3).




*Source: Bloomberg, GROW Research*

**Appendix 7: US economic cycle (3/3).**




*Source: Bloomberg, GROW Research*

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