China | A bumpy V-shape recovery in Q3

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October 26, 2022

Chinese economy has experienced a bumpy V-shape recovery after Shanghai lockdown was lifted in June 1st, as economic indicators have experienced an uneven recovery since June. The supply side recovery has been faster than the demand side, which is the same pattern since the aftermath of Wuhan lockdown back to Q1 2020. Q3 GDP is higher than expected to reach 3.9% y/y (consensus: 3.4%), making our 3.6% 2022 forecast easier to achieve. GDP figures have confirmed the V-shape recovery path from 4.8% y/y in Q1 to 0.4% y/y in Q2 (due to Shanghai lockdown) and a recovery to 3.9% in Q3. We maintain our 2022 prediction at 3.6% (IMF: 3.3%, Bloomberg consensus: 3.4%) and anticipate growth will bounce back to 5.3% in Q4. As US and EU lowered their 2023 GDP forecasts to a larger extent to reflect the recession fear, we accordingly lowered our 2023 GDP from 5.2% to 5% modestly, reflecting a decelerating external demand. However, due to the statistical base effect and the 20th National Congress' growth target of 2020-2035 which requies an annual growth of 4.5-4.7%, we do not lower our 2023 forecast to a larger extent.

However, the economy continues to be dragged by two main risks: "Zero Covid" policy and real estate crash. From policy perspective, the authorities gave up the 5.5% growth target, indicating the policy will become more prudent without a deluge of massive stimulus. The pace of economic recovery in the rest of the year depends on several factors: (i) whether further large-scale lockdown will be imposed again in large cities and the length of the lockdown; (ii) how large is the policy room for monetary and fiscal easing, as the recent trending-up inflation due to pork price surge, RMB sharp depreciation to above 7 and capital outflows may shrink the room for easing measures; (iii) how effective the easing measures, in particular, how effective of the monetary transmission mechanism to direct the liquidity to households and enterprises; and (iv) how to rebuild market sentiments in real estate and secure a soft-landing.

On the supply side, the year-on-year growth of industrial production in September picked up to 6.3% y/y from 4.2% y/y in the previous month, higher than the market consensus at 4.5% y/y, and its seasonal adjusted m/m growth also accelerated to 0.84% m/m from 0.35% m/m previously. By categories, the highest growth component continued to be the electric vehicle production which maintained its strong growth momentum at 110% y/y, compred with117% y/y in the previous month (ytd y/y: 112.5%), supported by the authorities' priority of green economy and new energy sector to fulfill the carbon neutrality target in 2030. Other sectors also recorded recovery of growth. For instance, the general automobile manufacturing growth increased to 25.4% y/y and powergenerated electricity equipments also picked up to 73.8%. (Figure 1) That means, very similar to the recovery pattern in the aftermath of Wuhan lockdown, the supply-side industrial production led the growth recovery and surpassing the demand side since Shanghai lockdown was lifted.

On the demand side, retail sales remained lackluster due to the "zero Covid" strategy while fixed-asset investment (FAI) fares well expect for the real estate FAI continues crash.

In particular, retail sales decelerated from previous 5.4% y/y to 2.5% y/y in September, significantly lower than the market consensus at 3.3% y/y. By component, restaurant sales dipped significantly from 12.9% in August to -1.7%

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y/y in September, given that "zero Covid" restrictive social distancing measures in pandemic affected areas persists. Other sectors of retail sales also dropped, including wines and smoke (-8.8% y/y), domestic appliance (-6.1%) and cosmetic (-3.1% y/y) etc., amid a lower income expectation and higher surveyed unemployment rate, particularly in 16-24 age group's unemployment rate above 20%. In sum, we maintain our view that Chinese government's persistence of "zero tolerance" strategy on Covid-19 pandemic by contrast of other countries' "co-existence" policy will continue to constrain China's consumption recovery in the rest of the year. (see our recent Economic Watch: China | Will the country abandon "zero tolerance" strategy on Covid19?) (Figure 4)

By contrast, fixed-asset investment (FAI) marginally picked up to 5.9% ytd y/y from 5.8% ytd y/y in the previous month, lower than the market consensus of 6% ytd y/y, while its month-on-month growth also ticked up to 0.53% m/m from 0.39% m/m. By components, manufacturing FAI marginally picked up to 10.1% ytd y/y from 10% ytd y/y previously, which surpassed the infrastructure FAI at 8.6% ytd y/y (prior: 8.3% ytd y/y) and real estate FAI at -7.5% (prior: -7.4% ytd y/y) to lead the investment growth recovery. It also indicates that infrastructure FAI achieved significant improvement due to the recent expansionary fiscal measures (see our recent Economic Watch: China | Will infrastructure investment become a key growth stabilizer in 2022?) while real estate crash remains to be the largest headwind to drag China's economy and at the same time to threaten the regional financial stability due to the mortgage boycotts and small banks' bankruptcy.

There are quite a number of reasons to explain real estate investment dip which has maintained in the negative territory for more than half a year. Chinese authorities cracked down the housing market in 2021, taking use of the precious time-window to press ahead "common prosperity" and regulatory reforms. In addition, lower income expectation and high unemployment rate particularly in age 16-24 group (20%) significantly deteriorate house purchase demand. Although the authorities eased housing policy from both demand and supply side recently, as the principle of "housing is to live not to speculate" remains, a soft-landing will take some time. As long as the housing price increase expectation (which lasted for the past 20 years) is broken, it is difficult to re-build market sentiments, no matter how low the interest rate is. That means, real estate sector needs more time to achieve a soft-landing going forward. (See our recent China Economic Watch: China | Real estate sector needs a soft-landing) (Figure 2 and 3)

In sum, higher-than-expected Q3 GDP and September economic indicators show the resilience of Chinese economy after the plummeting data during Shanghai lockdown, amid the continuous easing monetary and fiscal policy support. However, it is noteworthy that going forward the policy measures will become more prudent given that the authorities have given up the 5.5% growth target. The interest rate cut in August does not indicate a start of a continuous interest rate cut cycle, as the PBoC has never ever continuously cut interest rate amid FED rate hike cycles in history balancing between stimulating growth and financial stability. In addition, the authorities also beefed up fiscal expansionary measures to early use up local government bond issuance quota in 1H 2022 to the total scale of more than RMB 5.2 trillion, together with tax cut, fee reduction, State's Financing Guarantee Fund and the recent funding through policy bank to support infrastructure investment. Going forward, it remains challenging that the authorities have to strike a balance between "zero Covid" and a decent growth figure and at the same time secure a housing sector soft-landing.

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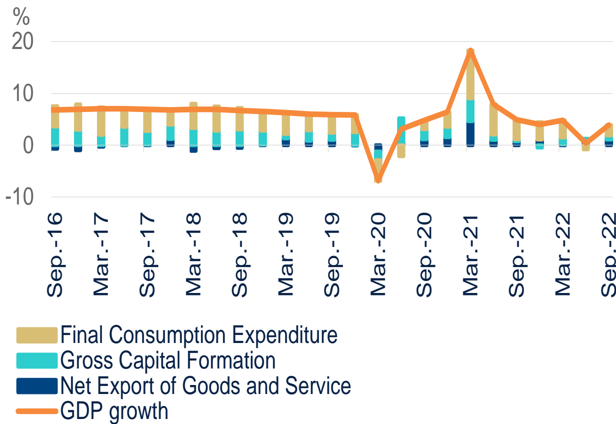
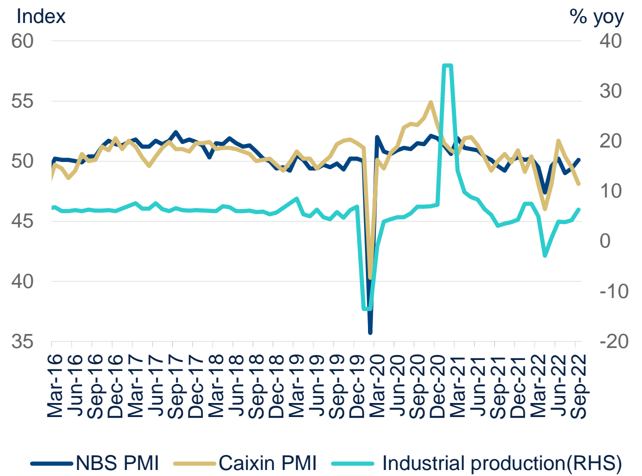
Figure 1. **THE GROWTH DIPPED FROM 4.8% IN Q1 2022 TO 0.4% IN Q2 AND BOUNCED BACK TO 3.9% IN Q3**



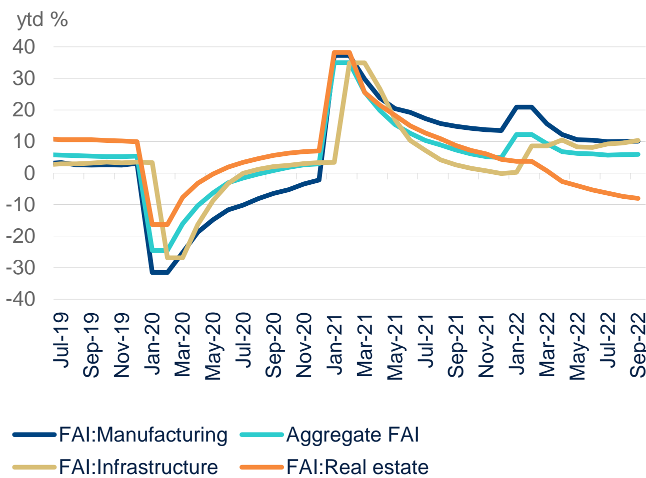
Source: CEIC and BBVA Research

Figure 2. **NBS AND CAIXIN PMI DIVERGED IN SEP., INDICATING PRESSURE ON EXPORTS AND SMES; IP BOUNCED BACK TO 6.3% FROM 4.2%**



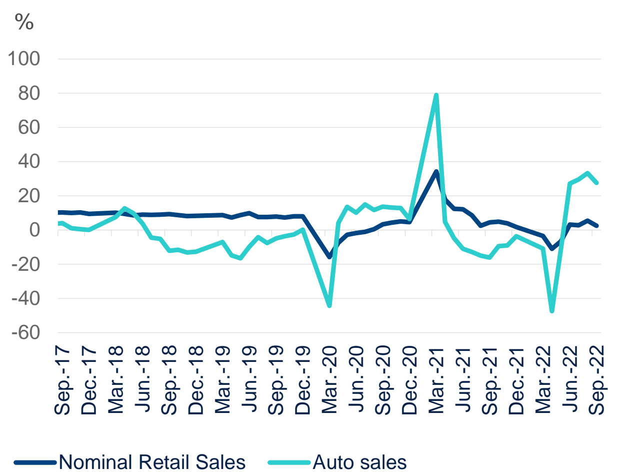
Source: CEIC and BBVA Research

Figure 3 INFRASTRUCTURE FAI PICKED UP TO 8.6% AMID EXPANSIONARY LOCAL GOVERNMENT BOND ISSUANCE; MANUFACTURING UP TO 10.1%



Source: CEIC and BBVA Research

Figure 4 RETAIL SALES SLOWED FROM 5.4% TO 2.5% DUE TO CONTUNUOUS "ZERO COVID"



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