

## Market Commentary

### China's growth is slowing

Authors: Elisa Belgacem, Christoph Siepmann,  
Vladimir Oleinikov

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#### China's real activity data surprised again on the downside, boding poorly for Q3 growth

- China's August real activity data came predominately in on the weak side. We see the reasons in a range of local Covid-19 lockdowns, the flurry of regulatory tightening measures and a relatively "harsh" downscaling of monetary and fiscal policy support in H1. Accordingly, retail sales and service production have been hit most.
- Given fresh Covid outbreaks in September, it will be difficult for retail sales to recover. Moreover, news about the real estate developer Evergrande have led to worries about the stability of the sector amid China's deleveraging policy. Taken together, that creates downside risks to our (already reduced) growth forecast of 8.1% in 2021.
- We expect China's economic policy to ease but see no full refaltion cycle. The PBoC could cut its RRR by 50 bps and step up liquidity. Fiscal policy has so far been underwhelming and could increase bond issuance even within the limits given by the National People's Congress. However, there are also hurdles for local infrastructure investment from the strong oversight of local shadow debt. The reportedly sanguine tone of presenting the data still makes us think that a PBoC rate cut is not on the cards.
- Chinese stocks (A shares) are starting to look attractive. In the short-term, we are cautious on the MSCI China (slight UW) due to possible lingering market volatility and a temporary Chinese slowdown but see an upside potential in the mid-term. We favour A shares, though, because of more appealing valuations, lower regulatory pressure due to sector composition and their higher sensitivity to policy support.

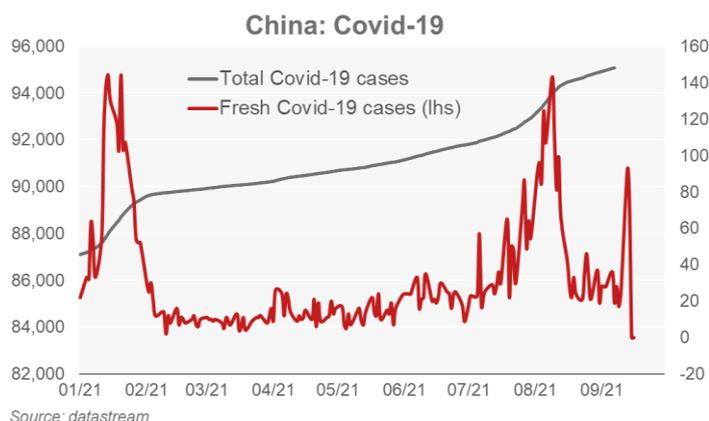
**China's August activity data surprised again on the downside.** We see several reasons: First, the delta variant of Covid-19 spread to multiple provinces. Second, August saw a range of regulatory tightening measures. And third, support from monetary and fiscal policy was scaled down in H1 more than initially expected, combined with some supply bottlenecks.

**In more detail, China saw another Covid-19 outbreak which peaked in early August.** While the absolute numbers were small by Western standards, fresh infection induced a wide range of local lockdowns under China's zero tolerance policy. This had a negative impact predominantly on private consumption. Retail sales took a hard hit, receding from 8.5% yoy to 2.5% yoy of late, which was even worse than with the past New Year outbreak. Among components, the catering spending growth turned negative again. Most recently in September, the Fujian province has been strongly affected by fresh Covid-19 cases, which resulted in another round of local lockdowns. Thus, there are already concerns that poor retail sales numbers could stay for (at least) another month.

**Covid-19 also impacted production.** Industrial production growth decelerated from 6.4% yoy to 5.3% yoy. The slowing was "pre-announced" by the weak manufacturing PMIs, which dropped in the case of the Caixin manufacturing PMI into contractionary territory. The drop was even more pronounced in service PMIs, and accordingly, service output receded from 7.8% yoy to 4.8% yoy. Other influence factors played a role as well. On the positive side, exports surprised on the upside, accelerating surprisingly to 25.6% yoy. But imports also increased by 33.1% yoy. Moreover, producer price inflation reversed its previous slowing, reaching again 9.5% yoy. This suggests that supply side bottlenecks also played a role.

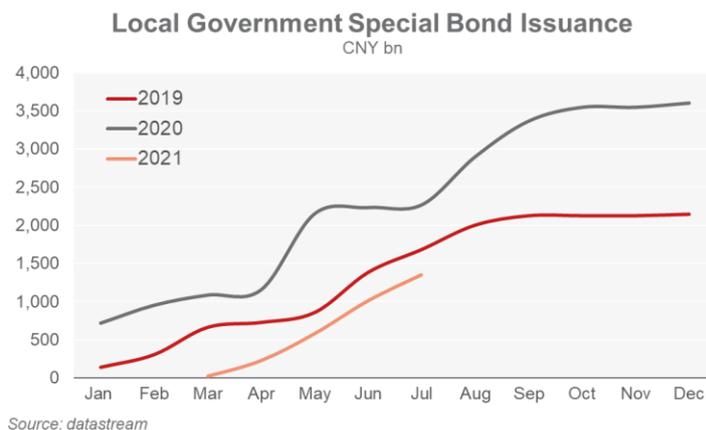
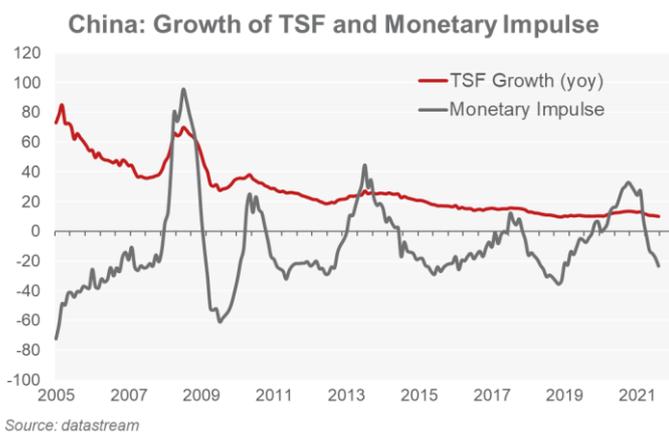
**Meanwhile, fixed asset investments came in with 8.9% yoy,** year-to-date (ytd) very close to consensus expectations with 9.0% yoy ytd. On a 2y annually compounded rate basis, which is intended to neutralise the base effects, fixed asset investment increased slightly 4.3% yoy, after 2.8% yoy before. Manufacturing investment has maintained its expansion path, while infrastructure investment only narrowed its negative yoy growth rate. The Politburo push for more infrastructure has still some

way to go. Special LGB bonds issuance increased to 48% of its annual quota. Still, local infrastructure spending seems to suffer from strict oversight of LGFV shadow debt.



**Real estate investment growth continued its downtrend.** Property sales growth turned slightly negative on a 3-month moving average. The cooling is not least due to the government's tightening measures like the "Three red-lines approach" and the PBOC caps on property lending and mortgage loans for commercial banks (see Focal Point - [China: Tackling the "Grey Rhinos"](#)). On top, Evergrande news had been worrying recently. Basically, real estate lending is systemically important in China. A potential default on Evergrande could represent a systemic risk for the Chinese financials sector as its bank and trust loans represent 0.27% of the total amount of loans in China. Similarly, it will be a shock for the Chinese bond market as Evergrande's bonds represent more than 2% of the Chinese offshore USD bonds outstanding. The Chinese offshore market is the second biggest USD denominated, so it might have some spillover effects outside China. However, so far it seems that the market has had enough time to digest the information as the HY global Index keeps tightening since the beginning of September. Moreover, typical stress indicators show no heightened levels and markets seem to be rather calm on a systemic problem (so far).

**On the monetary side of the economy, headline CPI inflation eased to 0.8% yoy**, from 1.0% yoy before. However, this is basically due to food prices, while non-food inflation and core inflation are much higher with 1.9% yoy and 1.2% yoy. Nevertheless, the latter also slowed a bit in August. Total social financing (TSF) growth receded slightly further to 10.3% yoy, while M2 edged down to 8.2% yoy, defying market consensus expectations of a slight increase to 8.4% yoy. Monetary data imply that the credit impulse continued its negative trend. The underwhelming special bonds issuance by local governments as well as the continued slowing in the credit impulse have clearly contributed to the stronger than expected cooling of the economy.



**Looking ahead**, we expect monetary and fiscal policy to ease somewhat. We see a cut of the RRR by 50 bps and more liquidity injections. However, the reportedly sanguine tone in the presentation of the August data still makes us believe that a policy rate cut is not (yet) on the cards (while its odds are clearly rising). This could change if the slowing were to substantially accelerate. We expect fiscal support to accelerate, which is possible even within the bounds of the NPC guidelines. Overall, we already reduced our 2021 growth forecast to 8.1% but see again downside risks, depending on the development of the Covid-19 lockdowns and the real estate sector risks.

As far as **Chinese equities** are concerned, the MSCI China's PEs have derated by 26% from the recent peak in February. This was due both to the regulatory clampdown and weaker economic data. In mid-February, our fair value indicator (12-month forward earnings / 10-year yields) for the MSCI China showed an overvaluation of 35%, which has dropped to a current 4%.

Chinese stocks are starting to **look attractive** within global equity universe. Judging by our country score, which takes into consideration different valuation measures – a mix of value and growth approaches to valuation, **both the MSCI China and Chinese A-shares rank quite high** in the universe of 45 countries: within the top 15 and above the rank of the aggregate EM. In terms of conventional PE, the **MSCI China trades at a premium vs. A-shares** (by one st. deviation above the historical average).

Should the Chinese policy aimed at stimulating the economy disappoint and the regulatory uncertainty prolong, the investment sentiment index **could fall to past historical troughs** (see chart), weighing on the market performance. In this case, we get a downside of nearly 10%-12%, should the Sentix reach the cited cyclical bottom.

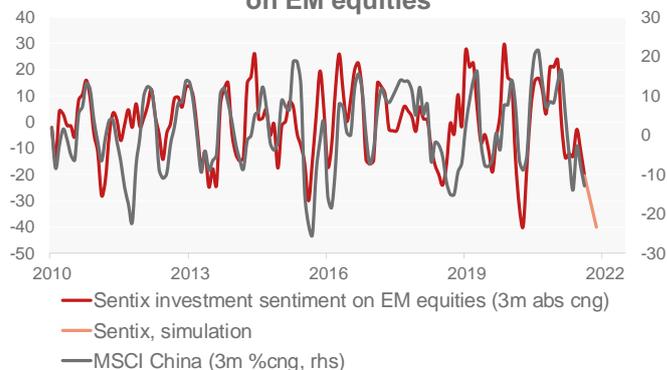
That said, **short term we remain cautious on the MSCI China** (slight UW) amid unresolved regulatory uncertainty (while mostly priced-in), which would cause higher volatility, and weaker post-pandemic growth prospects. Given recent softness in most macro data, Beijing will **likely engage in more support by fiscal and monetary policy**, though. For this reason, we do not adopt a full underweight position, while **favouring A-shares** (slight OW), due to more attractive valuations and a lower regulatory pressure as well as a lower Tech weight.

**MSCI China: Value indicator**



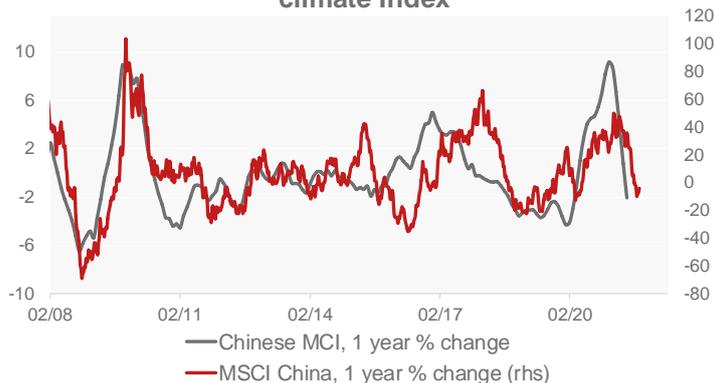
Source: Datastream, GIAM calculations

**MSCI China vs Sentix investment sentiment on EM equities**



Source: Datastream, GIAM calculations

**MSCI China and Chinese macroeconomic climate Index**



Source: Datastream, GIAM calculations

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