PGIM FIXED INCOME

THE BOND BLOG

PGIM India Mutual Fund

October 1, 2020

A Visual Tour of China's Strong, Yet Unsettled, Recovery from the Great Lockdown

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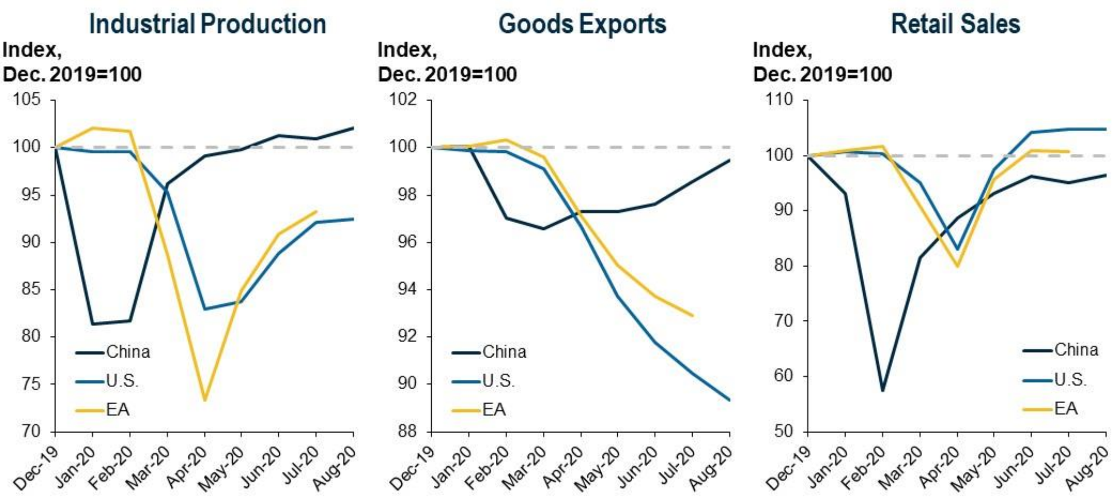
China's strong recovery from the Great Lockdown (to borrow the IMF's phrase) is yet another turn in a year full of surprises. In contrast to officials in other major economies, Chinese authorities have stressed the need to avoid large scale stimulus. This has once again led some observers to marvel at China's ability to outgrow its western peers in a presumably more sustainable fashion. We would argue that this view is quite mistaken as observed below.

A Mirror Image Recovery Thanks to Overflowing Stimulus Elsewhere

China's economic data have generally surprised to the upside since May, thus foreshadowing the upgrades currently underway for global and developed market economic projections. China's economic recovery is also taking a much different shape based on the now-common letter and symbol taxonomy. China's industrial production and exports have resembled "square root" and "swoosh" shapes, respectively, and have far outpaced those in the U.S. and euro area. On the other hand, China's consumption—proxied by retail sales—severely lags the V-shaped recoveries in the U.S. and the EA (Figure 1).

Figure 1: China's Industrial Production, Goods Exports Near Pre-Virus Levels; Retail Sales Lag



Source: PGIM Fixed Income and Haver Analytics

Besides these glaring differences, these patterns also fly in the face of conventional wisdom. What about the fears of protectionism, the implementation of tariffs and technology restrictions, and the "rebalancing" of China's growth model towards consumption?

Contrary to Popular Conception

China's export strength reflects the overflow of developed-market demand stimulus. Stimulus measures outside of China focused on supporting incomes via generous transfers, thereby supporting demand while production remained locked down through much of the year. Therefore, China's prioritization on production enabled it to meet the demand surge, and goods exports recovered to 2019 levels as a result.

Fulfilling demand stimulus allowed China to limit its monetary stimulus, which may already be reversing based on readings of money supply growth (Figure 2) and central bank assets. In addition, while China's fiscal deficit is very large, it has not expanded by much from 2019, thus preventing large-scale income support for consumers. As a result, the income shock to poorer households has not been offset by income adjustments, and this has become a key factor in the lagging consumption recovery.

This is not to say that China has eschewed stimulus completely. Indeed—and contrary to official pronouncements—the country has embarked on traditional investment-driven stimulus, which is again quite different to policies elsewhere, as public investment (mostly infrastructure and property) has staged a V-shaped recovery (Figure 2) while private-sector investment has been more depressed as has been the case in the rest of the world.

Figure 2: Money Supply Growth Rolls Over; Public Investment Exceeds Pre-Virus Levels

Source: PGIM Fixed Income and Haver Analytics

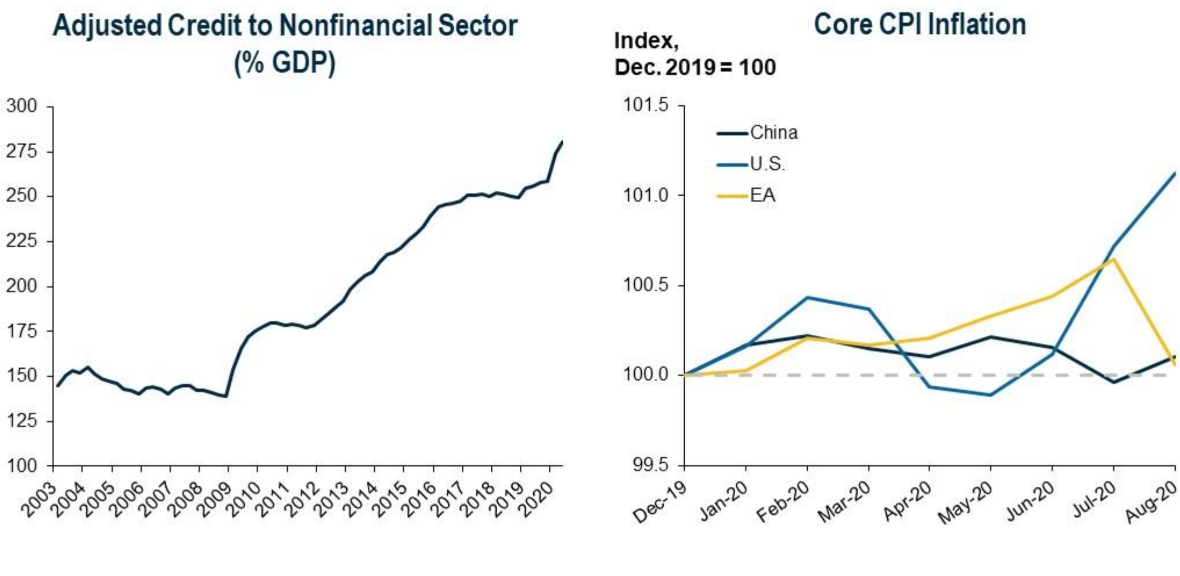
Open Questions Ahead

While China's recovery is impressive, it is incomplete and likely unsustainable based on current trends. First, the recovery has re-invigorated patterns that had been thought to be remnants of the past, i.e. quickly rising trade surpluses and domestic leverage. Second, China faces tangible deflationary risks, and its balance of payments depicts some concerning trends.

Domestically, the surge in investment is once more highlighting the potential of excess capacity and renewed property bubbles. Moreover, the increase in investment has one again re-ignited debt growth, which has set a course to exceed 300% of GDP and has dashed deleveraging hopes (Figure 3). Moreover, with monetary easing constrained and banks increasingly asked to assume non-profitable, quasi-fiscal tasks, strong demand for investment credit is once again fuelling the shadow banking system. As a result, much of the perceived gains in economic rebalancing and financial de-risking/de-leveraging over last eight years have been quickly lost.

The combination of tight monetary policy, investment driven growth, and reliance on external demand are triggering disinflationary—if not outright deflationary—pressures (Figure 3). Low inflation has emerged as an additional threat to achieving high nominal economic growth, which heretofore has been a key factor underpinning Chinese debt sustainability.

Figure 3: China's Debt Growth Surges With the Lockdown Recovery While Inflation Flatlines

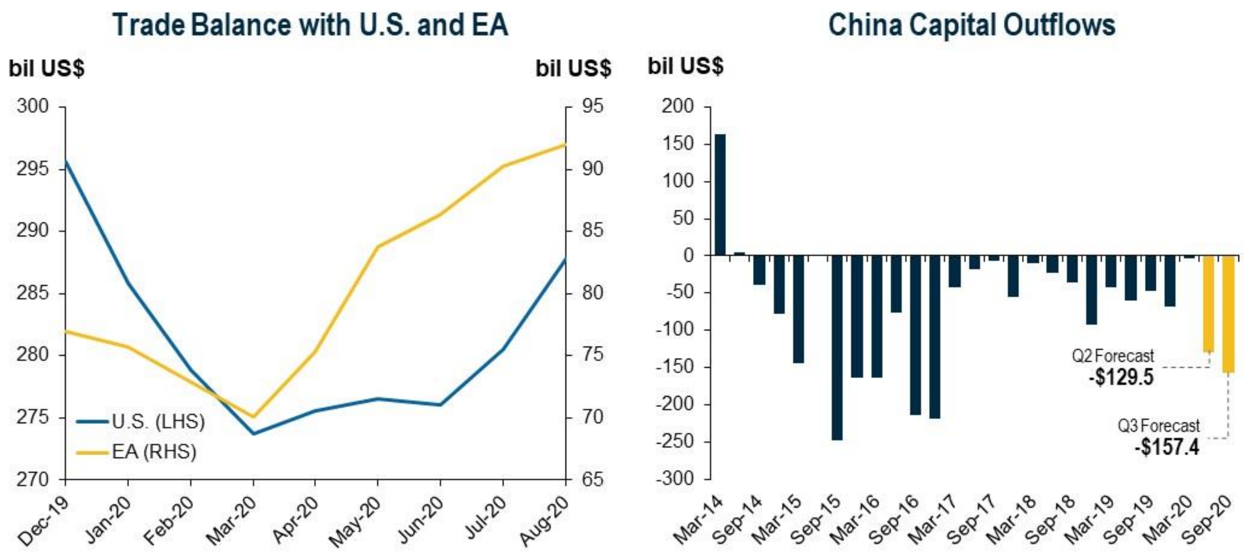


Source: PGIM Fixed Income and Haver Analytics

Moreover, the trends over recent months threaten to unleash a new round of protectionism. China's trade surpluses have surged, potentially raising the political stakes leading up to the U.S. elections. Moreover, China's trade surplus with the euro area has exceeded its year-end 2019 level, which may also lead to some pushback given Europe's dependency on exports (Figure 4).

Finally, the risks above may not have been lost on Chinese investors as the balance of payments has witnessed an estimated level of about $275 billion in Q2 and Q3 (Figure 4). The outflows are particularly surprising given the strong inflows from surging current account surpluses and the bond market ahead of index inclusions. The underlying nature of the outflows remains difficult to identify at this point. They could be benign, e.g., the PBoC rebuilding its forward book, or more concerning, e.g. corporations not repatriating profits or households finding new ways to stash savings abroad. This is a topic for investors to closely follow.

Figure 4: Trade Surpluses Climb, But Outflows Curiously Pick Up As Well



Source: PGIM Fixed Income and Haver Analytics

A Cloudy Forecast

Against this background, a few tentative conclusions can be drawn:

- President Xi's second term has not been a happy one. His signature economic initiatives—capacity cuts, deleveraging, rebalancing, providing strong income gains for the poor, and technological upgrades (China 2025)—have faltered. Moreover, even with expected positive growth of about 2.5% in 2020, China's growth target of 6.5% under the 2016-2020 five-year plan won't be met, a first in the post-reform period of the last 30 years. With a new five-year plan forthcoming, it remains to be seen if any policy adjustments will be made and whether President Xi might face increasing political headwinds in his third term.
- There is a risk that, irrespective the outcome of the U.S. elections, global protectionism may broaden. Partly in response to Chinese moves in a variety of international areas, more broad-based push-back has occurred, e.g., within India and the 5G restrictions in European countries. A return to large trade surpluses would likely trigger a turn for the worse.
- We expect more substantial Chinese macro stimulus. Most likely, given deflationary risks and maxed-out debt, this will involve monetary easing, including policy rate cuts. In this context, it is essential to monitor capital outflows as Chinese savers may decide to diversify elsewhere, with attendant exchange rate pressures.
- Headline growth will likely be strong as statistical base effects will flatten growth in 2021. Even with fairly moderate sequential growth in 2021, this carry over effect puts our 2021 growth projection at 9%. Therefore, investors will be well served to look beyond headline growth figures given the unsettled nature of China's recovery thus far.

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2020-6207