Boring!

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China's economy is boring, but that's not necessarily bad for investors.

Boring because manufacturing, investment and exports are weak. But consumption and services, the largest part of the economy, are healthy, and employment is stable. The government seems prepared to tolerate boring, rather than turn to stimulative monetary and fiscal policy. Domestic investors also don't seem to mind being bored, with the Shanghai Composite Index up 18% from the start of the year through July 15.

Anxiety leads to boring results

Two sources of anxiety are leading to a boring economy. The first is tensions with the Trump administration, which have led China's business community to reduce output and defer investment. Real (inflation-adjusted) industrial production rose 5.6% year-over-year (YoY) in the second quarter, down from 6.6% in 2Q18. Nominal investment by privately owned companies rose 5.3% in the second quarter, down from 6.4% during the first quarter and 8.7% in 4Q18. (It is worth noting, however, that corporate investment is slowing globally as well.)

Corporate demand for credit is similarly weak. During the first half of the year, mid- to long-term loans to companies, a reflection of investment spending, accounted for only 36% of all new loans, down from a 53% share in the first half of 2017, when the manufacturing sector was stronger.

The second source of anxiety is the Chinese government's ongoing campaign to reduce risks in the financial system, which has led to a sharp crackdown in off-balance sheet, or shadow credit, which *declined* 8.4% YoY in June. This has reduced systemic risks, but has also meant that the firms that relied on non-standard credit sources, especially small private companies, have struggled (even more than usual) to get access to credit.

Boring . . . but not too bad

The macro picture may be boring, but it isn't too bad, largely because Chinese consumers aren't very worried by the Trump tariff tantrum. This is important because this is the eighth consecutive year in which the (tertiary) services and consumption sector is the largest part of GDP.

Nominal retail sales rose 9.8% YoY in June and 8.4% for the first half of the year. This is cooler than the 9.4% pace during 1H18, but still quite healthy. Sales of cosmetics, for example, rose 22.5% in June, and household appliance sales were up 7.7%. Online sales of goods rose 21.1% last month.

This spending was supported by strong income growth. Real per capita disposable income rose 6.5% in 1H19, close to the 6.6% pace a year ago. China remains, in my view, the world's best consumer story.

The housing market also held up better than I had expected, given that the government cut spending by half on renovation of low-income units this year. New home sales (by square meter) fell by 1% YoY during 1H19, compared to increases of 3.2% a year ago and 13.5% two years ago.

But that still translates into full-year sales of about 12 million new apartments, and inventories are low, so investment in residential property rose 15.8% during the first half, up from 13.6% a year ago. Housing starts rose 9.9% during 2Q19, down from 16.6% a year ago.

Another important factor is that the surveyed unemployment rate has been relatively stable: 5.1% last month, compared to 4.8% a year ago.

Beijing is tolerating boring

The Chinese government is clearly tolerating boring, both because the consumer story and job market are healthy, and because officials are wary of taking steps that would further increase the national debt burden. For more on China's debt problem, please see my March 2019 *Sinology*.

Government economists I spoke with last week in Beijing indicated that while they are prepared to intervene with stimulus if current conditions deteriorate, investors should not anticipate material changes to monetary and fiscal policy.

At this point, we've seen only a very modest increase in credit from the state-controlled banking system. The growth rate of outstanding augmented total social finance (TSF), the most comprehensive metric for credit in the economy, accelerated to 11.3% YoY in June, up from 11.1% in May and 11% in April. But, to put this into context, the 11.3% pace in June was slower than the 11.7% pace in June 2018; the 13.1% in June 2017 and 16.8% in June 2016.

Another way to illustrate the modest scope of the credit stimulus is to look at the gap between the growth rate of augmented TSF and the growth rate of nominal GDP. In the first half of 2019, the gap between the growth rate of credit and of nominal GDP was 3.2 percentage points (pps), just a bit larger than the 1.5 pps gap in 1H18, and significantly smaller than the 9.8 pps gap in 1H16. To put this into further context, in 2009, as Beijing was responding to the Global Financial Crisis, the gap was 26.8 pps.

On the fiscal side, Beijing also refrained from turning on its traditional public infrastructure stimulus taps. Infrastructure investment rose only 4.1% YoY in 1H19, down from 7.3% a year ago and 21.1% two years ago. The current pace of spending on public infrastructure is so slow that it is a drag on overall economic growth, rather than a stimulus.

But, isn't this the slowest GDP growth rate since the Tang Dynasty?

Many media reports on the just published 2Q macro data emphasize that the GDP growth rate of 6.2% is the slowest pace in many years. This is true. It was also expected. And it is OK.

China's GDP growth rate peaked in 2007 at 14.2%, and slowed gradually to 6.6% last year, and now 6.3% for 1H19. But it is important to remember that these growth rates are multiplied against a base which has expanded rapidly. Even if GDP growth were to slow to 6% this year, significantly slower than a decade ago when growth was 9.4%, the base today is 182% larger, so the incremental expansion in the size of China's nominal GDP would be 130% bigger than the expansion 10 years ago at the faster pace.

This base effect applies to many aspects of the Chinese economy. Nominal retail sales, for example, rose 9% last year, far slower than the 21.6% pace a decade earlier. But, because the base last year was more than 270% larger, the incremental expansion in nominal retail sales was over 50% larger than in 2008.

As a result, opportunities for companies and investors are greater at the currently slower growth rates.

Eventually, Chinese leaders will be happy with the low single-digit growth rates that are considered satisfactory in developed economies, and I don't hear anyone in Beijing talking about efforts to artificially re-accelerate growth.

Cautious optimism on U.S.-China trade deal

I remain optimistic about prospects for a trade deal in the near future, despite limited engagement between the two sides since Trump and Xi Jinping met at the end of last month in Osaka. I believe Trump wants a deal because he recognizes that a trade war with China would damage the U.S. economy and equity markets, and thus his re-election prospects.

All signs are that Xi also continues to want to reach a deal. While tariffs are not a huge problem, as China is no longer an export-led economy, failure to conclude a deal would open up the risk that a full-blown trade war leads to restrictions on China's access to American tech, everything from semiconductors to research collaboration. That would be a setback to China's economic growth, which Xi wants to avoid.

The future beyond a trade deal is less clear, but after listening to Trump downplay the national security tensions between the U.S. and China while describing the bilateral relationship as one of “strategic partners,” I am less pessimistic than I was a month ago about prospects for the broader bilateral relationship. We will soon see if the president turns his recent rhetoric into actions that promote engagement over containment.

Regards,

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Sources: Matthews Asia, CEIC, National Bureau of Statistics (NBS).
