International Commentary — April 18, 2022

China's Still Stumbling Economic Momentum

Summary

With the Chinese Lunar New Year passed, China activity and sentiment data are now being released on a more regular schedule. Just recently, a wave of economic data were released, which in our view, suggest China's economy is still decelerating. Another wave of COVID infections and strict virus-containment policies placed pressure on consumer spending nationwide, and while Q1-2022 GDP and activity data were underwhelming, these data likely do not fully reflect the economic impact of the government's Zero-COVID approach to the virus. In our view, lockdowns will make China's 5.5% annual growth target for this year exceedingly difficult to achieve. We believe China's economy will grow only 4.9% this year, and as PBoC policymakers ease monetary policy further, the renminbi should weaken gradually over the remainder of this year.

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Slow Start For China's Economy This Year...

Previously one of the only success stories of the COVID pandemic, China's economy has struggled to gather any significant momentum for the last 12 months. We can point to a deteriorating real estate sector as a contributor; however, Chinese authorities' commitment to the "Zero-COVID" policy remains the primary rationale for China's economic deceleration. Over the last year, China's economy has experienced sporadic spikes in COVID cases. In each scenario, government officials responded by completely locking down each infected area, and instituting mass-testing and other virus-containment protocol. These COVID-control policies have weighed on local retail activity and manufacturing, while also exacerbating global supply chain disruptions given China's role as a major producer and exporter. Toward the end of March, China was hit with a new wave of infections that has resulted in the highest daily confirmed cases since the start of the pandemic. In addition, recent government imposed restrictions have resulted in the most stringent lockdowns since March 2020.

To put China's recent COVID issues into context, at the end of February 2022, China was recording an average of 350 infections nationwide. By the end of March, daily infections topped 7,000, and currently in mid-April, China is reporting over 25,000 COVID cases per day. Major cities across multiple provinces have been thrown into lockdown, most notably the technology hub of Shenzhen as well as the most populated and industrialized city of Shanghai. In total, around 375 million people in China are living under some type of restrictions, which amounts to over 25% of China's population. Now that the Chinese Lunar New Year has passed, economic data are being released on a more regular schedule and are shedding up-to-date light on the health of China's real economy. Data releases, including Q1-2022 GDP as well as March activity and sentiment data, in our view and according to our economy gauge, suggest China's economy is still struggling. **Although data associated with the first three months of this year are underwhelming, authorities commitment to the "Zero-COVID" policy should result in even weaker data over the course of Q2 and make the government's stated annual growth target of 5.5% exceedingly difficult to achieve.**

As a recap, March alternative indicators of economic activity slowed significantly. The China Activity Proxy, a higher frequency measure of overall activity remained positive, but still fell to the lowest point since August of last year when China experienced another spike in virus cases. Also, the economic surprise index, which measures actual data releases against consensus forecasts, dropped sharply from early 2022 highs, suggesting March data underperformed relative to expectations. March sentiment data are particularly concerning. The official manufacturing and non-manufacturing PMIs, as of March, are both in contraction territory, falling to 49.5 and 48.4 respectively. Same can be said for the unofficial PMIs as both the Caixin manufacturing and services indices are also below 50. In fact, February 2020, the depth of the COVID crisis in China, was the last time the official as well as the unofficial manufacturing and non-manufacturing indices were in contraction territory all at the same time. Historically, PMIs falling below the 50 level have been indicative of a decelerating economy. In terms of "hard data" on the manufacturing and services sectors, March industrial production rose 5% year-over-year, slightly better than expected and surprising given the lockdowns across manufacturing cities. However, consumer spending was more disappointing as retail sales contracted 3.5% year-over-year. March retail sales were also the weakest since China's original lockdown in early 2020.

In addition to activity and sentiment indicators, the external sector reveals fissures as well. While exports jumped, imports cratered in March. Technically, high exports and low imports would mean a positive contribution in terms of calculating GDP; however, we interpret the collapse in March imports as a negative development for the economy. In our view, the decline in imports is reflective of the stringency of COVID restrictions as well as a lack of overall local consumer demand. Imports contracted in early 2020 when local demand for goods and services imploded, and we believe the underlying story is the same in the current episode. So while our economy gauge shows the decline in March imports as a positive, the underlying dynamics around that number are of concern to us. And as far as investment and financing conditions, fixed asset investment slowed relative to February; however, the 9.3% year-over-year rise was stronger than consensus estimates. Social financing and M2 money supply growth both rose in March, signaling policy is turning to more broadly support China's economy given the amount of pressure the economy is under. In the sense of policy turning accommodative, if we were to extend our dashboard into mid-April, we would also see authorities recently lowered the Reserve Requirement Ratio (RRR) 25 bps for major banks in an attempt to allow for more liquidity and make monetary policy more supportive of overall economic activity.

	Jun-20	Jul	Aug	Sep	Oct	Nov	Dec	Jan-21	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan-22	Feb	Mar
Economic Activity Proxy																						
Li Keqiang Index	9.0	7.3	8.9	8.0	7.7	8.4	9.3	16.4	17.6	15.6	13.9	10.2	8.1	7.5	5.9	6.8	6.5	7.1	5.7	6.3	6.3	
China Activity Proxy	12.6	4.8	11.5	13.3	10.2	11.1	8.8	3.4	0.7	9.5	7.9	8.6	5.5	3.1	-4.8	6.4	6.6	6.4	7.3	8.0	5.7	2.5
Economic Surprise Index	-0.2	65.0	34.5	54.0	28.7	31.4	36.3	22.6	2.5	-6.2	24.7	-48.6	-81.1	-40.6	-43.1	-65.3	-64.7	10.8	20.7	46.0	27.4	11.8
Manufacturing																						
Industrial Production (a)	4.8%	4.8%	5.6%	6.9%	6.9%	7.0%	7.3%			14.1%	9.8%	8.8%	8.3%	6.4%	5.3%	3.1%	3.5%	3.8%	4.3%			5.0%
Manufacturing PMI	50.9	51.1	51.0	51.5	51.4	52.1	51.9	51.3	50.6	51.9	51.1	51.0	50.9	50.4	50.1	49.6	49.2	50.1	50.3	50.1	50.2	49.5
Caixin Manufacturing PMI	51.2	52.8	53.1	53.0	53.6	54.9	53.0	51.5	50.9	50.6	51.9	52.0	51.3	50.3	49.2	50.0	50.6	49.9	50.9	49.1	50.4	48.1
Services																						
Retail Sales (a)	-1.8%	-1.1%	0.5%	3.3%	4.3%	5.0%	4.6%			34.2%	17.7%	12.4%	12.1%	8.5%	2.5%	4.4%	4.9%	3.9%	1.7%			-3.5%
Non-Manufacturing PMI	54.4	54.2	55.2	55.9	56.2	56.4	55.7	52.4	51.4	56.3	54.9	55.2	53.5	53.3	47.5	53.2	52.4	52.3	52.7	51.1	51.6	48.4
Caixin Services PMI	58.4	54.1	54.0	54.8	56.8	57.8	56.3	52.0	51.5	54.3	56.3	55.1	50.3	54.9	46.7	53.4	53.8	52.1	53.1	51.4	50.2	42.0
External Sector																						
Exports (a)	0.2%	6.8%	9.1%	9.4%	10.9%	20.6%	18.1%	24.6%	154.6%	30.4%	32.1%	27.7%	32.1%	19.2%	25.4%	28.0%	26.9%	21.7%	20.9%	24.2%	6.3%	14.7%
Imports (a)	2.3%	-1.6%	-2.3%	12.7%	4.4%	3.9%	6.5%	28.7%	18.9%	39.1%	44.0%	52.0%	37.1%	28.2%	32.7%	17.2%	20.4%	31.4%	19.5%	19.9%	10.5%	-0.1%
FX Reserve Adequacy (b)	20.0x	19.9x	19.7x	19.0x	18.8x	18.8x	18.7x	15.9x	17.3x	15.8x	15.5x	15.4x	15.1x	15.1x	14.9x	14.6x	14.7x	14.5x	14.5x	13.3x	15.0x	14.5x
Investment & Financing Conditions																						
Fixed Asset Investment (a)	-3.1%	-1.6%	-0.3%	0.8%	1.8%	2.6%	2.9%		35.0%	25.6%	19.9%	15.4%	12.6%	10.3%	8.9%	7.3%	6.1%	5.2%	4.9%		12.2%	9.3%
Total Social Financing (a)	13.4%	13.5%	13.9%	14.2%	14.3%	14.3%	14.0%	13.8%	14.0%	13.1%	12.4%	11.8%	11.8%	11.5%	11.1%	10.8%	10.8%	10.9%	11.1%	11.2%	11.0%	11.3%
M2 Money Supply (a)	11.1%	10.7%	10.4%	10.9%	10.5%	10.7%	10.1%	9.4%	10.1%	9.4%	8.1%	8.3%	8.6%	8.3%	8.2%	8.3%	8.7%	8.5%	9.0%	9.8%	9.2%	9.7%
GDP Growth & Policy Rates																						
Reserve Requirement Ratio (c)	12.5%	12.5%	12.5%	12.5%	12.5%	12.5%	12.5%	12.5%	12.5%	12.5%	12.5%	12.5%	12.5%	12.0%	12.0%	12.0%	12.0%	12.0%	11.5%	11.5%	11.5%	11.5%
Actual GDP Growth (a)	3.1%	4.8%	4.8%	4.8%	6.4%	6.4%	6.4%	18.3%	18.3%	18.3%	7.9%	7.9%	7.9%	4.9%	4.9%	4.9%	4.0%	4.0%	4.0%	4.8%	4.8%	4.8%
Actual GDP Growth (d)	11.6%	3.4%	3.4%	3.4%	2.6%	2.6%	2.6%	0.5%	0.5%	0.5%	1.2%	1.2%	1.2%	0.7%	0.7%	0.7%	1.5%	1.5%	1.5%	1.3%	1.3%	1.3%

Notes: (a) Year-over-Year Percent Change, (b) Import Cover, (c) Reserve Requirement Ratio For Major Banks, (d) Quarter-over-Quarter Percent Change

Source: Bloomberg Finance L.P. and Wells Fargo Economics

...While Zero-COVID Not Even Fully Captured Yet

Recent data culminated in a Q1-2022 GDP print that was above consensus forecasts, but in-line with our expectations. On a year-over-year basis, China's economy expanded 4.8%, stronger output than the 4% rise in Q4-2021, and higher than the 4.2% consensus expectation. However, in our view, we feel economic momentum is working against China, and the economy is likely to experience a slowdown in Q2 as a result of COVID-related lockdowns. As mentioned earlier, around 25% of China's population is operating under some kind of restriction, while many business hubs such as Shanghai are completely locked down. In our view, **March data do not fully capture the effects of the latest round of lockdowns and Zero-COVID protocols.** If retail sales are an indication, consumer spending has little momentum and will likely remain at subdued levels in April. Also, the local jobless rate jumped to 5.8% in March from 5.5% in February, another indication that the consumer may not be willing or able to engage in normal spending patterns. Toward the middle of March, we revised our Q2 GDP forecast lower, and while we acknowledge risks around our forecast are to the downside, **as of now we believe China's economy will grow only 4% year-over-year in Q2-2022. Subdued Q1 activity combined with sluggish Q2 growth should result in annual GDP growth that falls well short of the government's 5.5% growth target.** In our view, current growth dynamics should result in 2022 GDP growth that slows to below 5%, and as of now, **we forecast China's economy to grow 4.9% in 2022, with risks tilted toward even slower growth.**

With China's economy still in deceleration mode, we believe the People's Bank of China (PBoC) will continue to ease monetary policy. While the latest RRR cut was less than we expected and authorities chose not to lower medium-term lending facility rates, we still believe the policymaker bias is toward more accommodative monetary policy. In Q2-2022, **we expect another reduction to the RRR, while we also expect lending rates to move lower in the coming months**. **Despite less-than-stellar economic activity and slowing growth prospects, the Chinese renminbi has been remarkably steady**. Diverging paths for monetary policy between the PBoC and the Federal Reserve have so far not placed much depreciation pressure on the renminbi, even as the yield premium for Chinese government bonds over U.S. Treasuries has eroded this year as the PBoC lowers rates and the Fed tightens monetary policy. Typically, when the yield gap narrows, as it has this year, these dynamics translate to a weaker Chinese currency: however, year-to-date the renminbi has been resilient despite no nominal yield advantage for Chinese government bonds over U.S. government bonds. In addition, the potential for geopolitical spillover from the Russia-Ukraine conflict via U.S. and Western allies sanctions imposed on China has not prompted selling pressure on the yuan. We can point to China's robust 2% of GDP current account surplus, and possibly PBoC FX intervention to keep the currency stable, as justification for a stable currency over the first few months of the year. However, **given our view for further PBoC easing and aggressive Fed tightening, as well as the possibility of geopolitical spillover, we maintain our view that the Chinese renminbi should weaken over the remainder of 2022**. Chinese equity and debt markets have already experienced outflows as geopolitical and economic concerns build, and we believe these risks are not likely to dissipate in the near future. To that point, **we forecast the USD/CNY and USD/CNH exchange rate to reach CNY/CNH6.4200 by the end of this year**, a rather gradual selloff that reflects China's current account surplus. A move to 6.42 implies about a 1% renminbi depreciation from current levels.

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