08 April 2022

Research China

Three new headwinds to delay recovery

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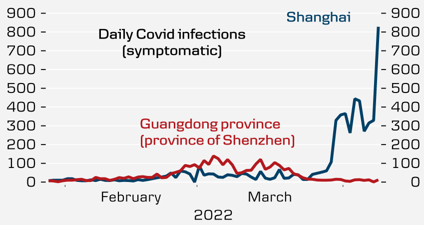
- **The Chinese economy has been hit by three new headwinds from covid outbreaks, the Ukraine war and financial stress. We expect this to delay a recovery into H2. We expect more economic stimulus, as China needs to step harder on the gas to lift the economy out of the current slump. The China weakness will add a further drag on the global economy in coming months, not least on Europe.**
- **Freight rates have continued to fall despite the Shanghai lockdowns suggesting the fundamentals are improving and shipping costs will be disinflationary in 2022. Other factors (wage growth, commodities) keep global inflation pressures high.**
- **A recovery in H2 should give upside for Chinese stocks. We also look for USD/CNY to turn higher as the Chinese trade surplus is set to come down.**

The stars were lined up for a Chinese recovery in the beginning of 2022, as China entered a year with stability being the number one priority ahead of the 20th National Congress of the Communist Party. Stimulus picked up going into the year and the worst of the property crisis seemed to have passed. However, after decent data for January and February, the PMI for manufacturing and the service sector saw sharp declines in March. A number of headwinds have piled up for China lately, which will likely postpone the recovery into H2 and require more easing measures. Especially three factors now weigh on the economy:

1. **Covid outbreak:** Covid hit the big cities in March leading to restrictions in first Shenzhen, which was locked down for a week and now Shanghai being in lock-down for the second week. The two cities constitute 7% of China's economy. While China managed well with Omicron from mid-December to February, the virus now has a bigger impact providing a new challenge for private consumption growth and the service sector. As highlighted in this *Covid update* recently, we do not see China leaving the 'dynamic zero-covid' policy on this side of the Congress in the Autumn.
2. **Ukraine war:** The Russian invasion of Ukraine is likely to weaken Chinese exports considerably as we expect Europe to be at brink of recession over the coming 3-6 months. The US manufacturing sector also shows signs of weakening. Exports was the main engine of growth in 2021 but is now set to be a drag on overall growth in 2022. The war has also led to rising commodity prices and generally increased uncertainty, which is likely to weigh on private investments.
3. **Financial stress:** Over the past months, China has seen increased financial stress, both in property debt markets as well as in the equity market. Stress intensified after the Ukraine war broke out and was exacerbated by a significant capital outflow by foreign investors. Fears over possible sanctions on China if they sided with Russia caused what looked like panic-selling at some point with severe declines in Chinese offshore stocks.

Covid outbreaks hit the big cities in March

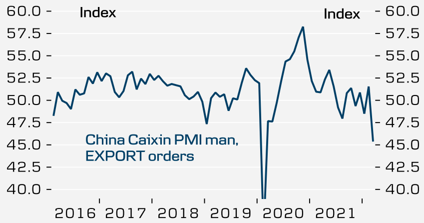


Source: Macrobond Financial, Bloomberg. Note: Past performance is no reliable indicator of current or future performance.

Weaker data on China's key export markets

Source: Macrobond Financial, ifo, ISM

Chinese export orders took a dive in March



Source: Macrobond Financial, Markit

Chief Analyst
Allan von Mehren
+45 4512 8055
alvo@danskebank.dk

In the China USD offshore high yield market, yields rose to new highs in mid-March peaking at 27.9%. The financial stress causes new challenges for private investments, both within manufacturing and construction. Stress has eased somewhat lately after the Chinese government signalled new easing and stated that the regulation of the internet industry would soon be over. Fears over sanctions on China has also faded as China has showed it aims to respect the sanctions on Russia and expressed it is against the war, albeit refrained from condemning Russia.

On top of the new challenges, China already struggled with a record strong CNY due to a massive trade surplus. Weak employment also weighed on consumption growth even before the latest covid outbreak.

Outlook: Recovery delayed into H2

China's new growth target of 5.5% is going to be a stretch to achieve for the government. China has moved away from the 'big-stimulus' policies seen during the financial crisis and is in our view unlikely to splash a lot of money on the economy just to reach a specific growth rate. The hangover from the major stimulus in 2008-09 lingered for a long time – and to some extent still does as it led to a big increase in debt that China is still struggling to reduce. Xi Jinping has therefore highlighted 'quality over quantity' since taking over as Chinese leader in 2013.

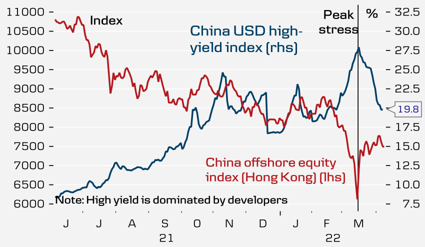
However, we do expect China to step harder on the gas and add a bit more stimulus to avoid growth from falling below the government's (unofficial) lower bound of growth and ultimately to drive a recovery when the current headwinds eventually fade. However, we expect the recovery is delayed in to the second half of the year, which is why we only see 4.7% growth this year followed by a stronger 5.3% growth rate in 2023. The recovery is set to be driven by a) the Ukraine shock starting to fade assuming the war does not escalate further and commodity prices do not run away, b) stimulus measures increasingly lifting the property sector and overall investments.

China's current stimulus measures span a wide range of areas. To lift construction investments and improve liquidity for developers, China has eased conditions for buying homes, which already looks like it has lifted the level of home sales. In addition, China has already announced 1 trillion CNY of tax cuts to small businesses to alleviate the current struggle for this part of the economy. As China has many small business owners this will provide some support to consumption. China is also likely to front-load even more infrastructure projects in so-called 'new infrastructure', which in contrast to making bridges, roads, ports etc. includes ultra-high voltage, 5G stations, electric vehicle charging stations. China has increased tax deductions for high-tech investments and R&D to spur more investments in this area. Finally, we expect more monetary easing via rate cuts and reduction in the reserve requirement ratio over the coming months.

Effect from Asia on global economy: Drag in H1, recovery in H2

The global economy is set to feel a drag from China and Asia over the coming months. Apart from the slowdown in China, the rest of Asia is also shifting into a lower gear after a strong post-covid rebound over the winter months. Asia was facing a big covid outbreak in late summer of 2021 that led to widespread restrictions and declines in production. It triggered a strong rebound on the other side as there was some catching up to do and businesses rebuilt inventories. PMI data suggest we have seen the peak of this re-opening effect. After hovering around strong levels from October to February, PMI manufacturing moved lower again in March.

Severe financial stress in March

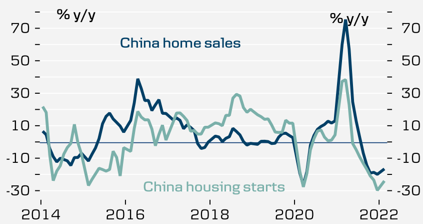


Source: Macrobond Financial, Bloomberg. Note: Past performance is no reliable indicator of current or future performance.

Weak employment picture a challenge for consumption

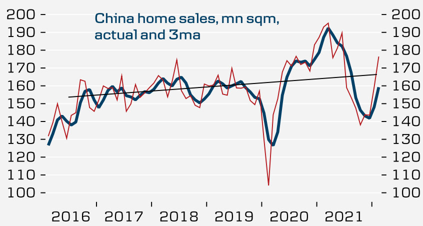
Source: Macrobond Financial, NBS

Boom bust in housing market



Source: Macrobond Financial, NBS

But signs of a rebound in home sales following easing measures



Source: Macrobond Financial, NBS

The weakness in Asia will especially weigh on Europe, which has a high exposure to Asia relative to the US. It will add to the struggle for the European economy in coming months.

However, the expected recovery in China during H2 should help underpin global demand again in Q4 taking into account the usual lag from China to the global economy of a few months.

Freight rates lower despite lockdowns

Freight rates and global inflation: Shipping costs are still at elevated levels but they have started to come down. Weekly freight rates frow Drewry World Container Index, released Thursday, fell again. There is some seasonality in this, as rates tend to come down after the Chinese New Year but the move is too big to be only explained by seasonal factors. The fact that they decline despite the disruption to port operations in Shanghai suggest that the underlying balance between demand and supply is starting to improve. Trade volumes may finally be starting to come down as goods demand in the US is moving lower and the 'extra demand' from many companies rebuilding inventories may also be fading. The Chinese export order index does indeed indicate that the number of goods being shipped from Chinese ports are set to moderate in the short term.

The development indicates that the high inflation impact from the surge in freight rates is starting to fade and becoming disinflationary. Of course, freight is only one inflation input and pulling in the other direction in April is the latest increase in energy and food prices following the outbreak of the war. Shortage of components from Ukraine and Russia could also become an issue. And rising wage inflation also underpins inflation. We generally look for inflation rates in US and euro area to rise further in April before starting to move lower from very elevated levels – mainly driven by lower increases in commodity prices.

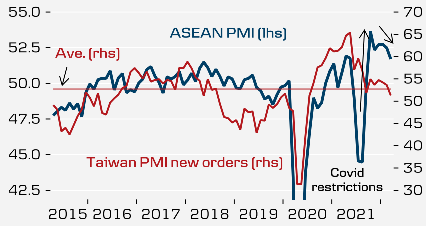
Inflation in China is more muted due to the weak domestic demand and lack of pricing power as well as low food price inflation. Chinese inflation currently stands at 0.9% (March) leaving plenty of room for economic stimulus.

Financial effects: upside for stocks and USD/CNY

Stocks: In January we called for higher Chinese offshore stocks this year based on a gradual economic recovery and low valuation following a year of tech crackdowns, see *Research China: Top 5 questions for 2022 – and financial implications*, 13 January 2022. So far, that call has not turned out well. As mentioned above, Chinese offshore stocks were unloaded on big scale by foreign investors following the outbreak of the Ukraine war as fears of sanction on China grew. Concerns over de-listing of Chinese stocks in the US and more regulation (albeit small) on internet companies added to the perfect storm.

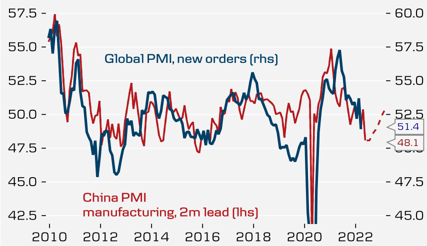
In recent weeks, Chinese stocks have recovered some of the lost ground and our call is still for Chinese offshore stocks to end the year higher than they started (but admittedly, the uncertainty is higher than normal). First, it would seem that those who wanted to sell the market has already done so. The capitulation in the market was very violent. It was followed by a strong rebound and the market has since then proven quite resilient to negative news showing only limited volatility even on days when global sentiment has weakened. Second, it still seems likely that the tech crackdown is set to fade this year. Following a meeting in the Financial Stability Development Committee, led by vice-premier and economic tsar Liu He, China signalled that the regulation of the tech sector would "end soon" and that China would take steps to stabilize both the economy and markets. Subsequently China also drafted new rules for audits of foreign-listed companies, that at least for now has calmed the fears over possible de-listings.

ASEAN re-opening rebound is behind us, Taiwan also slowing



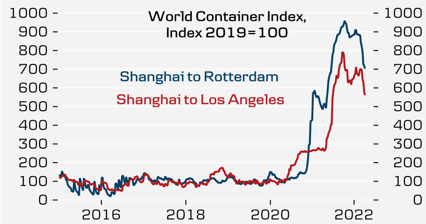
Source: Macrobond Financial, Bloomberg. Note: Past performance is no reliable indicator of current or future performance.

China leads global cycle around 2 months – weakness in the short term



Source: Macrobond Financial, NBS, Markit

Freight rates have declined lately



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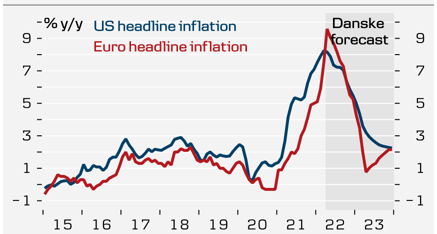
US and euro inflation to peak soon but remain at high levels for some time

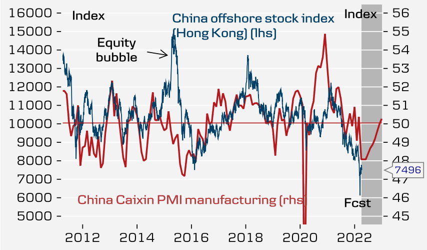


Source: Macrobond Financial, Danske Bank.

The market will probably struggle to move much higher in the short term due to still high uncertainty over the Ukraine war and economic data that is set to remain weak in the next couple of months. But if the forecast of a gradual recovery during H2 turns out to be right, this would normally lift Chinese stock prices (see chart).

USD/CNY: Following a year of CNY appreciation despite all the challenges hitting China, we believe USD/CNY will move moderately higher over the next 12 months. It seems the main driver behind the strong CNY has been a huge trade surplus driven by very strong exports as China has shipped a large amount of goods to especially the US, where consumer goods demand as well as business demand have been very strong. As mentioned earlier, we already see signs exports will slow this year and later in the year, imports should start to recover on the back of stronger domestic demand. We look for a rise in USD/CNY to 6.50 in 12M from the current level around 6.36. For EUR/CNY we look for some downside still as general strengthening of the USD tends to also imply a stronger CNY versus EUR.

Stocks have upside in medium term – but requires China escapes sanctios



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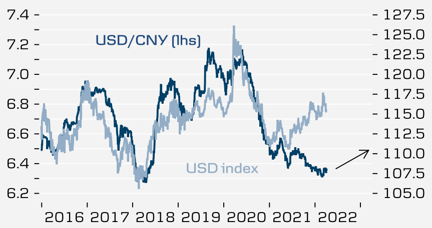
CNY stronger versus USD this year despite overall strengthening of USD



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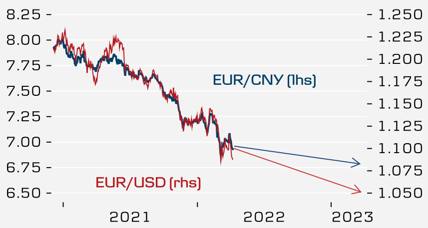
Lower EUR/USD expected to drive EUR/CNY down as well



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This research report has been prepared by Danske Bank A/S ('Danske Bank'). The authors of this research report is Allan von Mehren, Chief Analyst

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