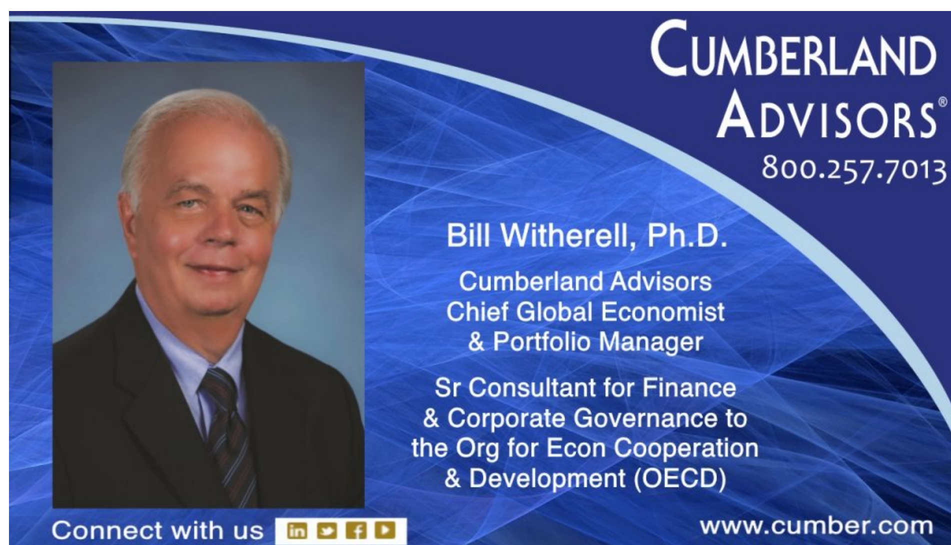
China Slowdown and Financial Markets

The Shanghai Stock Exchange was the worst performing major stock market in 2018, with the benchmark Shanghai Composite Index falling 25% over the course of the year. Concerns about a slowing economy deepened in the second half as current indicators surprised on the downside. While many economists cautioned that a major slowdown in China was not likely, much less a recession, investor, domestic consumer, and business sentiment have all clearly worsened.



As discussed below, our base-case expectation is that the slowdown will prove to be modest, with the pace of economic activity beginning to pick up in the second quarter of 2019. Risks to this outlook, however, are mainly on the downside.

The Chinese economy clearly did slow during the second half of 2018. GDP growth eased to a 6.5% annual rate in Q3, the slowest growth since early 2009, and looks likely to have moderated further to a 6.3% pace in Q4. Estimated economic growth for the year is 6.6%, moderately slower than the 6.9% rate for 2017, but still relatively robust.

Data releases in the fourth quarter intensified concerns about

the likely magnitude and duration of the slowdown. The Caixin China General Manufacturing Index for December weakened in December to 49.7, its lowest level since May 2017. Note that 50 is the reading that separates expansion from contraction. New orders fell marginally, and domestic demand weakened. More positive data was reported several days later but got limited attention. The Caixin China General Services PMI for December registered a solid upturn in services activity, achieving a six-month high. This resulted in a five-month high in overall business activity, combing manufacturing and services, in December. Also ending the year on a positive but still subdued note, business sentiment improved in both the manufacturing and services sectors.

The leading cause of China's economic slowdown appears to be a serious liquidity crunch that falls most heavily on small, privately owned companies. These firms contribute some 60% of GPD growth and 90% of new jobs. Government policies unintentionally led to these liquidity problems. Back in mid-2016, China's economic policy switched from stimulus to restraint in response to concerns about a rapid buildup of unregulated shadow-bank lending, often to risky borrowers. Restrictions were placed on shadow banking with the laudable objective of enhancing financial stability. These measures tended to cause funding problems for smaller firms and also for infrastructure projects, while state-owned enterprises continued to have preferential access to bank loans.

China's central bank has recognized this problem and is moving in a determined way to pump increased liquidity into the economy. It announced last week a $117 billion reduction in required bank reserves. Also, the government urged China's three largest commercial banks to boost their lending to small privately owned businesses. At a meeting in early December, China's economic policy officials signaled that tax cuts and increased fiscal spending would be coming this year. Last week, Premier Li repeated these intentions for strengthened

countercyclical adjustments in macroeconomic policy, including further monetary policy easing.

This policy switch back to stimulus should be sufficient to counter the credit crunch and is the main reason that we expect the weakening trend in the economy to end in the first quarter, followed by modest strengthening in the remaining three quarters of 2019. Growth for the year 2019 is projected at 6.3%. A critical assumption underlying this relatively sanguine outlook is that the US-China trade negotiations progress constructively. Nothing is certain, but both sides have a strong interest in reaching positive outcomes, probably in a sequence of steps that will take considerable time to achieve.

The trade conflict does not appear to have had a great impact on China’s exports in the closing quarter of 2018, as traders front-loaded shipments before the year-end deadline. But the US-China trade war has negatively affected market sentiment in China and around the globe, stoking fears of a more substantial economic slowdown in China and other countries, particularly in Asia. And the slowdown of the globe’s second largest economy from 6.9% in 2017 to an estimated 6.3% in 2019 will have significant effects on other economies and product markets.

Another possible headwind that has picked up recently is China-Taiwan relations. China’s president Xi Jinping last week asserted China’s right to use military force against “foreign powers” that intervene on the issue of self-rule for Taiwan. This pushback followed President Trump’s signing a law providing US arm sales and high-level visits to Taiwan. This issue risks making the trade negotiations much more difficult or even impossible if all parties are not very prudent.

In sum, investors do have reasons to be cautious about China’s stocks. With last year’s substantial correction and prospects for an early end to the current modest slowdown in China’s

rapidly growing economy, valuations do look attractive. If the trade negotiations appear to moving in a positive direction, markets will surely respond favorably. But there will remain significant risks. Chinese stocks historically have been volatile, and that volatility is likely to continue.

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Sources: Financial Times, Markit Economics, Barclays Research, Geopolitical Futures, OECD

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