China: Trade war, cyclical demand and 5G seen in data

The trade war has accelerated the deterioration of a downward economic cycle in China, especially on consumption. 5G should be the new growth engine in 2020

Source: Shutterstock

Investment data shows trade war damage

Fixed asset investment grew only 5.2% year-on-year, year-to-date in October, the slowest growth rate since the data started in 1998. The weakness here shows that Chinese business investment has been highly affected by the trade war.

Investment in the textile industry (-8.5%YoY YTD) and electric equipment (-7.5%YoY YTD) actually contracted. Investment in these areas is only likely to recover when there is substantial progress in the trade negotiations.

For most of 2019, investment has been supported by transportation infrastructure investment via the issuance of local government special bonds. As the end of the year approaches, investment in these projects has slowed, shrinking 5.9%YoY YTD though we expect a pick up from 1Q20.

Industrial production shows cyclical pressure from trade war and local consumption

Headline industrial production growth slowed to 4.7%YoY in October from 5.8% in the previous month.

Industrial production of two items in particular, vehicles (-11.1%YoY) and smartphones (-7.3%YoY), show how the trade war has affected exports as well as local demand. Vehicles and smartphones share two similar features; they are both expensive and demand for new models from consumers is low without an obvious reason to upgrade. As demand is weak, production shrinks as inventory must be sold.

It's not all bad though. Production of integrated circuits grew 23.5%YoY in October and we expect this to remain strong due to the production of 5G parts and products.

Retail sales hit by big ticket items

Headline retail sales grew at 7.2%YoY, lower than the market expectation of 7.8%YoY, and the lowest this year. The growth was supported by spending on necessities (12%).

Uncertainty about job security is a key reason why consumers are cautious about spending on big-ticket items. Data shows that spending on vehicles fell 3.3%YoY and jewellery was down 4.5%YoY even though there was a long holiday in October.

People did spend on smartphones (22.9%) as some Chinese brands began selling 5G phones in October. This confirms that 5G is the new growth engine of the economy.

Growth prospects rest on trade and 5G

We expected that the process of getting a Phase One trade deal would be full of uncertainty. It is unfortunate that we are correct. Chinese companies will continue to defer investments if they are in the export business. However, if Chinese companies are involved in building and producing 5G infrastructure, equipment, parts, and final goods and services, they are highly likely to enjoy decent growth, even though they may not be able to export their products to some parts of the world.

Unless these factors change, we won't be revising our GDP forecast of 6.2% for 2019 and 5.9% for 2020.

Yuan outlook

For the market, all of this means that USD/CNY will be very volatile.

The yuan will weaken a lot if there is no Phase One deal and we can't rule this out even if the chance is small. On the other hand, the currency will strengthen if tariffs on $112 billion worth of goods, imposed in September, are lifted.

Volatility will continue even after a Phase One deal is agreed because the market will then start to question the likelihood of a more comprehensive follow-up agreement.

We are forecasting USD/CNY at 7.0 by the end of 2019 and 6.85 for the end of 2020, which mostly depends on the progress of the trade talks.

The market will soon realise that a simple Phase One deal is by no means the end of the trade war.

Author

Iris Pang
Chief Economist, Greater China
iris.pang@asia.ing.com