China: After 6% GDP growth in 3Q, we raise our 4Q forecast

China's economy grew at the target rate of 6% in the third quarter, and despite uncertainty over the trade war, we are raising our forecast for fourth quarter growth

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The perfect 6

GDP grew by 6% in the third quarter, down from 6.2% year-on-year in the second quarter.

Infrastructure projects are the pillar of growth

The main growth driver was still infrastructure projects. These projects have moved from the investment stage to the production stage. Fixed asset investment growth stabilised at 5.4% from 5.5% in August. The transition from investments to production has supported industrial production, which grew by 5.8% in September from 4.4% in August. Transportation grew 10.5% YoY, which also boosted mining investments by 26.2%YoY YTD.

Private sector manufacturing activities continued to shrink, e.g. smartphone production contracted by 3.6% YoY in September. This highlights that some production lines in the private sector could have been scaled down in China and moved to other locations in Asia due to the US tariffs.

Retail sales grew on essential items

Consumption made up 60.5% of the GDP growth in the third quarter, higher than the 60.1% recorded in the first half. Overall retail sales grew 7.8% YoY in September from 7.5% in the previous month.

It seems to have been a good month for consumption but the details paint a slightly different picture. Only essential items saw strong growth. For example, food, household items and drugs grew more than 10% YoY in September. The only non-essential item that grew more than 10% was cosmetics. In contrast, automobile spending fell 0.7%. This tells us that, when it comes to non-essential purchases, consumers prefer small-ticket items to bigger, more expensive items.

Looking forward in 4Q19

We expect infrastructure projects to continue to be the central pillar of growth in the fourth quarter.

There is another CNY1 trillion yuan from the local government special bond quota, borrowed from next year, to be used until the end of 2019. These bonds are the source of financing for infrastructure projects. As such, both investment and industrial production will continue to rely on infrastructure.

This will mark even bigger differences between private and public sector growth. The private sector will continue to suffer from the scaling down of factory activity due to the US tariffs. This will add even more uncertainty in terms of job security and salary growth which, in turn, will put pressure on consumption, even if substantial public sector growth acts to counter these negative pressures.

The good news is that we expect 5G infrastructure, production and services to start to make a visible contribution to the economy from the fourth quarter. Although it is still uncertain how much 5G can help China's exports, domestic usage of 5G alone should offer good support to the economy.

Trade war is still an uncertainty

While both China and the US say they are drafting the texts of a "phase one" trade deal, it's still unclear what exactly will be in the agreement. China has asked for a rollback of all tariffs imposed by the US before it commits to increasing annual purchases of US agricultural products.

Meanwhile, the technology war rages on. Just before the last round of trade talks, the US added eight Chinese technology companies to its Entity List, effectively blocking US companies from doing any business with these companies. China could retaliate with its own unreliable entity list.

All of this is negative for the future growth of the Chinese economy.

If the US decides to roll back some of its tariffs, the picture will change. Manufacturers may think twice before moving factories to another location, which is very costly. Unfortunately, this is not our base case.

Monetary policy will loosen in 4Q19

To facilitate a lower interest cost for local government special bonds-which will support infrastructure investments- we expect a five basis point cut in the Loan Prime Rate on 20 October, and a 0.5 percentage point cut in the required reserve ratio (RRR) in the fourth quarter.

Without a lower interest rate, the economy may not be able to sustain growth of 6% in the fourth quarter.

Forecasts

We are raising our forecast for 4Q19 GDP growth from 5.8% to 6.0%. As such, our GDP growth forecast for the whole of 2019 will be 6.15%.

If the trade agreement in November is drafted in line with market expectations, i.e., China purchases $50 billion of US agricultural produce annually without the US rolling back its current tariffs, the USD/CNY could trade around the 7.0-7.1 level. If the US does roll back some of the tariffs, we may see USD/CNY strengthen below 7.0. But again, this is not our base case.

Then there are the planned US tariffs in December. If the US does not defer those tariffs, the USD/CNY will weaken to around 7.20 or even higher.

In short, volatility should remain high, and the progress of trade talks will be key.