China Economic Comment

Q4 GDP Growth Softened as Headwinds Grow

Economics

China

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Q4 GDP 6.8% y/y, 2015 growth 6.9%

China's real GDP growth edged down to 6.8%y/y in Q4, as its sequential growth also moderated. Exports and property investment continued to hold back the economy while service sector growth slowed as well. Nominal GDP growth slid to 6% in Q4, with nominal industrial sector growth close to 0.

Property adjustment continues to be a key headwind

Destocking pressure continues to weigh on property construction and investment. Property new starts contracted more sharply in Q4 to 17.7%y/y while total construction (ytd floor space under construction) slowed further from 3%y/y previously to 1.3%y/y. Property investment declined at a faster pace of 3.2%y/y in Q4.

Consumption remains resilient but faces headwinds

Consumer expenditure picked up pace in Q4 according to household survey data, which is also corroborated by a uptick in retail sales, which grew by 10.3% y/y in Q4 in real terms. However, with growth of real household disposable income slowing and expected negative impact on employment and wages from closing of excess capacities, consumption will face headwinds in the coming year.

We maintain our 6.2% GDP growth forecast

We continue to see GDP growth grind lower as ongoing destocking in the property sector and its knock on effect on industrial and mining activities overwhelm additional policy support. We do not expect exports to offer much help as G3 recovery remains weak and RMB exchange rate is unlikely to depreciate significantly. We expect USDCNY to trade at 6.8 by end 2016.

Top concern is capital outflows getting out of control

We think the biggest risk to growth is deeper and more prolonged property destocking and greater knock on effect on the rest of the economy. However, for financial markets, uncontrollable capital outflows, not slower GDP growth, is the top concern. We think the Chinese government will use tighter capital controls, FX reserves and RRR cuts to manage the scale and consequences of capital outflows, but do expect the market to be extremely sensitive to any sudden large outflows and/or glitches in liquidity management in the coming year.

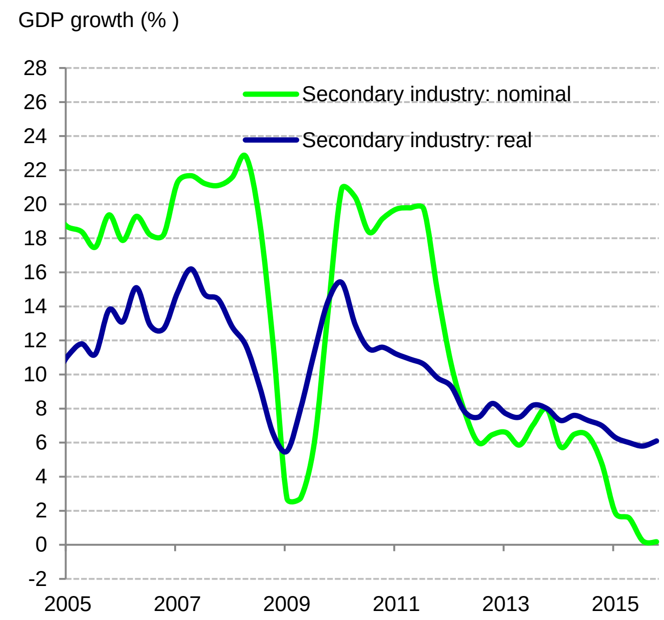
Q4 GDP Growth Softened as Headwinds Grow

China's real GDP grew 6.8%y/y in Q4 2015, slightly slower than Q3's pace, taking full year GDP growth to 6.9%. In line with official q/q growth numbers, we estimate that Q/Q growth momentum slowed from 7.2% to 6.4% on a seasonally adjusted annualized basis. Exports and property construction continued to hold back the economy, as both stayed in contraction. Service sectors kept up a robust but slower pace, growing at 8.2%y/y, dragged down likely by less active financial activities and slower property sales. Thanks to the trickling through of intensified policy support, overall fixed investment growth improved from 8.7%y/y in Q3 to 9.3%y/y in Q4, and industrial production stayed largely stable at 5.9%y/y in Q4.

Nominal GDP growth slide further from 6.2% in Q3 to 6% in Q4, as nominal growth of secondary industry (industry and construction) stayed barely above zero (0.2%y/y, same as in Q3) (Figure 1). With corporate revenue, profits and wage growth all denominated in nominal terms, investors and employees alike are relating more to this continued nominal deceleration than the headline real GDP trend.

Reflecting deflationary pressures and worsening cash flow difficulties, PPI slid more sharply to -5.9%y/y in Q4 (Q3: -5.7%y/y) due to a steeper drop in both investment good prices (-7.6%y/y) and consumer good prices (-0.4%y/y). Meanwhile, consumer price inflation weakened from 1.7%y/y in Q3 to 1.5% in Q4. December CPI's improvement to 1.6%y/y was led mainly by food prices (including cold-weather related rise in prices of fresh vegetables and pork), while non-food prices grew 1.1%y/y with zero sequential growth. 2015 full year PPI printed -5.2% (2014: -1.9%) while CPI printed 1.4% (2014: 2%).

Figure 1: Nominal growth of secondary industry stayed barely above 0%



Source: CEIC, UBS estimates

Property headwinds continued to grow as de-stocking continues

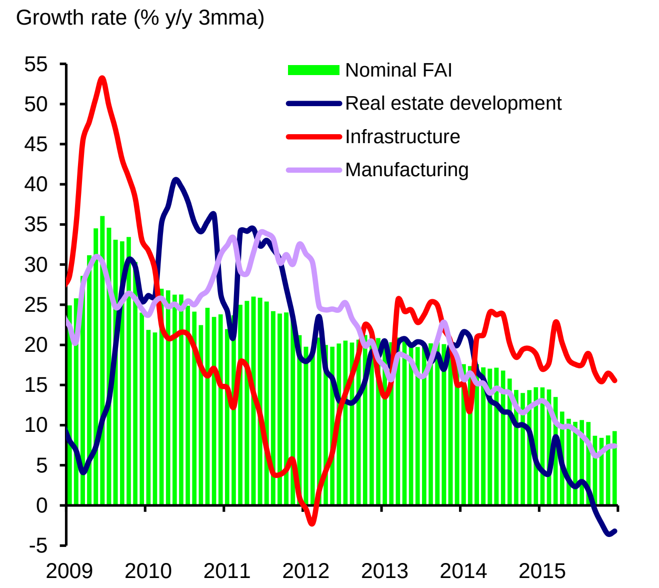
Property investment led Q4's growth headwinds, deepening its previous pace of contraction from -0.6%y/y to -3.2%y/y in Q4 (Figure 2). This was due to the faster deterioration of new starts which contracted by a deeper -17.7%y/y in Q4 as developers continued to de-stock from still-high inventory levels (Figure 3). This, plus apparent project suspensions further dragged down current construction growth (YTD floor space under construction down from 3% previously to 1.3% as end

Q4). Land purchases meanwhile declined by less than previously, at -26%y/y in Q4, taking the full year print to -32% (2014: -14%). Property sales in contrast sustained positive growth – albeit at a cooler pace of 4.8%y/y in Q4 from 13.5%y/y previously. Near-term sales momentum eased visibly, from 8.6%y/y in November to 1.6%y/y in December, due partly to a high base last year.

Manufacturing investment decelerated to 4.7%y/y in December, reflecting muted corporate investment appetite as overcapacity issues and negative spill-over from the property construction downturn suppressed corporate revenues and profitability. In addition, despite the government's concerted efforts to expedite implementation of public infrastructure works via policy guidance and enhanced financing, infrastructure FAI lost steam visibly from 23%y/y previously to 12%y/y in December, taking full-year infrastructure investment growth to 17.3% (20.3% in 2014). As a result, December's overall FAI thus softened from 10.2%y/y to 8.2%y/y, taking full year FAI to 10% - down from 2014's 15.7%.

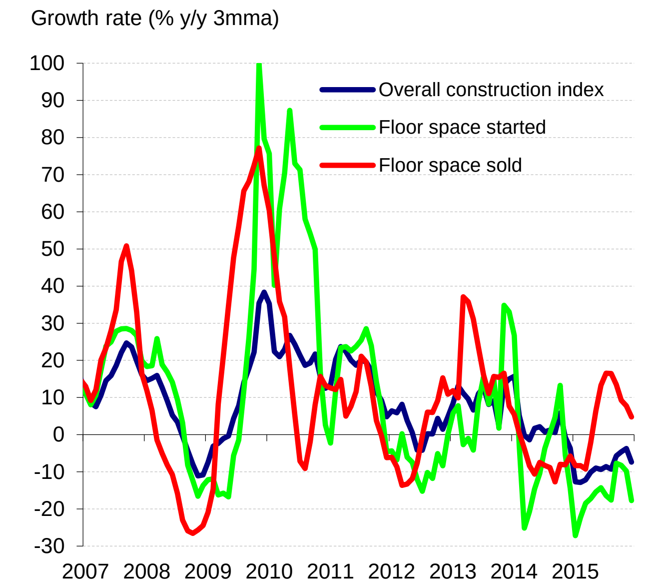
December's headline IP growth edged down from 6.2%y/y previously to 5.9%y/y on the back of a high base while sequential momentum also softened slightly. While auto production grew strongly (16.3% y/y) on the back of better sales, production of construction-related steel products, cement and non-ferrous metals all contracted, and power generation slipped back into contraction (-3.7%y/y) . Q4 average IP growth held steady at 5.9%y/y, similar to Q3's pace, taking full year IP growth to 6.1% (2014: 8.3%).

Figure 2: Property investment remains the biggest drag



Source: CEIC, UBS estimates

Figure 3: Property construction weakened in December

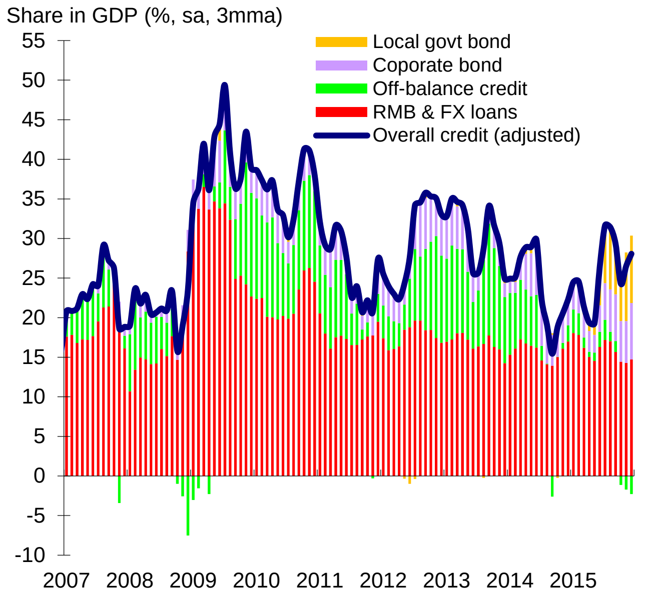


Source: CEIC, UBS estimates

Robust credit growth should help stabilize near-term investment

China's credit growth ends strongly in 2015 (Figure 4), with both new RMB loans to non-financial institutions and new TSF beating expectation (see 2015 Credit Growth Ends Strong). Except local government bonds and FX loans, most credit channels (especially off balance-sheet) recorded strong reading in December, pushing up total credit growth (TSF + local government bonds outstanding) to 15% in 2015, slightly higher than that in 2014. It should reflect the government's recent intensifying calls for stronger financial support to the economy, and possibly a faster pace of financing for public projects. The earlier abolishment of loan-to-deposit ratio likely helped as well. We expect monetary and credit policy easing to continue in 2016, with multiple RRR cuts to offset capital outflows, and 2 benchmark rate cuts to rein in deflationary pressure and lower financing cost. We see a benchmark rate cut and RRR cut to likely come ahead of Chinese New Year.

Figure 4: Credit growth ends strongly in 2015



Source: CEIC, UBS estimates

Consumption stayed resilient but faces headwinds

Growth of real consumption expenditure per capita picked up to 6.6%y/y (Q3: 5.6%y/y), despite a slower growth of per capita real disposable income which dropped to 6.5%y/y in the Q4 household survey from 7.9%y/y previously. Retail sales meanwhile edged down marginally to 11.1%y/y in December (10.7%y/y in real terms), taking Q4 real growth up to 10.3%y/y from Q3's 9.8%y/y. Growth of online goods sales stayed robust at 26%y/y in Q4, following Q3's 28%y/y, making up for 10.8% of total retail sales in 2015 (as per NBS official data). December's auto sales continued to benefit from earlier tax cuts, growing at a solid pace of 8.1%y/y in value and 15.6%y/y in volume, though both a bit slower than the previous pace. Considering that growth of disposable income is slowing and that closing of excess capacities will likely affect employment and wages, we think consumption growth will face some headwinds in the coming year.

The 2016 outlook

The latest data does not change our 2016 growth forecast, which remains at a below-consensus 6.2% (see China Economic Outlook 2016~2017). Despite our base case for a sustained property sales recovery, continued destocking in property construction will continue to weaken investment and industrial activity in 2016. We do expect policy support continues to be intensified to prevent a hard landing, including a larger fiscal deficit (to help with more infrastructure investment, tax cuts and improvement of social safety net) and further monetary and credit easing (including two more interest rate cuts in H1 2016 and multiple RRR cuts). However, as we have explained in earlier reports, policy effectiveness will inevitably turn increasingly blunt and unlikely be sufficient to fully offset the downward pressure. In addition, the new emphasis on supply side reform will also likely lead to some closure of excess capacity and zombie companies, which would also undercut near-term growth (see more details in China's Policy Plans for 2016).

Against this backdrop, consumption will likely come under more pressure this year from cooler employment and wage growth. That said, we still expect consumption and retail sales to stay relatively resilient, buffered by policy measures helping to boost employment and strengthen China's social safety net.

We do not expect external demand to offer much help. Net exports should contribute positively to growth again in 2016, thanks to improving demand from G3 economies and depressed imports growth caused by weak domestic investment. That

said, import intensity of advanced economies have declined and we do not expect China to use a sharp RMB depreciation to help its exports. China should still have a sizeable current account surplus (of around 3.3% of GDP), which can help offset capital outflows partially and provide some support to the currency. We expect RMB to depreciate by about 5pct against the USD but stay relatively stable against a trade weighted basket of currencies (see What Does Better Trade Data Mean for CNY?).

Key risks in 2016

The top downside risk to China's growth this year is still a deeper and more prolonged property destocking process, with a greater knock-on effect on industrial activity and investment. Related to this is the risk of policies being ineffective or insufficient, or reforms progressing too slowly, to prevent investment from falling more sharply. Weak domestic demand and insufficient policy easing may aggravate the negative feedback loop in weak real activity, worsening already rising deflationary pressures and increasing debt burdens.

For the financial markets, the top concern on China among investors is capital outflow getting out of control, leading to a sudden tightening of domestic liquidity and sharp depreciation of the currency, resulting in market turbulence in China and elsewhere in emerging markets. We still think the probability of such a scenario is very low as we think the government will use tighter capital controls, FX reserves and RRR cuts to manage the scale and consequences of capital outflows (see What Next for the RMB and our latest view on RMB and capital flows). Nevertheless, the market will likely react with extreme sensitivity to any larger-than-expected outflows and to any glitches in domestic liquidity management in the coming year.

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