建银国际 CCB International

CCBI Securities | Research

The Big Picture： Macro Outlook 2020

Pulling through the fog of the trade war

Li Cui
(852) 3911 8274
cuili@ccbintl.com

Claire Huang
(852) 3911 8012
clairehuang@ccbintl.com

Ying Xue
(852) 3911 8013
xueying@ccbintl.com

Growing manufacturing momentum in China and the world. In China, recent years have been marked by corporate consolidation and debt restructuring. While corporate health has improved, incremental growth has been held back by uncertainties related to the macro environment. A recovery by the global IT cycle, stabilization of trade risks and an increase in high-tech FDI are all catalysts for industrial growth in China next year.

Weak leverage growth and macro uncertainty continues to curb overall growth. We expect policy to continue to refrain from large credit stimulus while relying on reforms and opening up to unleash private sector growth. Domestic construction and property will remain on a soft footing. The economy remains on a reflationary path with pockets of price surges (e.g. pork in the near term). Overall, however, inflationary pressure is likely to be contained.

Domestic interest rate will be affected by headline inflation and global conditions. We expect headline inflation and improving sentiment to be the drivers supporting long-term bond yields in 1H20F, but lower inflation readings will see long-term yield to ease in 2H20F. Domestic liquidity conditions are likely to remain accommodative, but space for easing is likely to be preserved for future downturns. A pick-up of global bond inflows with index inclusion will have a moderate downward impact on yields. The risk of imported easing could argue for stable or even tighter liquidity conditions later in the year.

Global economy remains resilient. Central banks suspend further easing, supporting UST yields. Stabilizing economic growth and receding recession fears are likely to encourage the central banks to suspend further easing, supporting a pickup in global yields. A collapse of US-China trade talks however will raise the odd of further Fed cuts and lower yields in the near-term. Meanwhile, receding safe haven demand could cause the US dollar to weaken, benefiting EMs. Uncertainties remain on the US election alongside corporate debt risks.

Renminbi exchange rate to hold strong as trade surplus rises and capital inflows pick up. Under the threat of decoupling, import substitution has emerged as a source of productivity growth, supporting China's trade balance. Capital inflows will lend additional support to China's balance of payments. We expect the RMB to appreciate modestly next year.

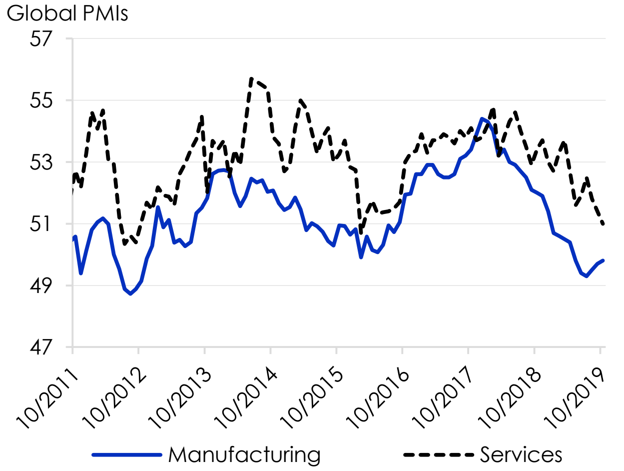
Our key macro forecasts are in Table 1 (page 3) and Table 2 (page 14).

Global backdrop improving

Global and China growth slowed in 2019, primarily due to soft manufacturing as global trade decelerated and uncertainties related to the trade war mounted. In the coming months we expect the US and China to continue their negotiations and refrain from levying new tariffs in 2020F. It is unclear when the phase-one deal will be signed and whether or not future phases of deals will be made; still, we expect tariff-related policy noise to quiet down after 1Q20F. Non-tariff measures, including entity list restrictions, could persist, casting a shadow on the long-term outlook for the global supply chain.[1]

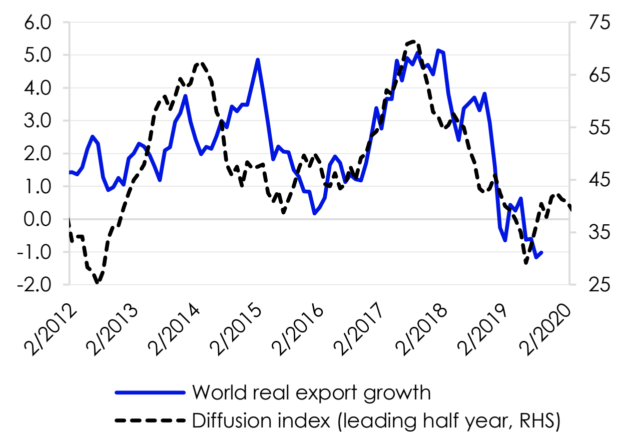
As near-term policy uncertainties subside (albeit towards more mixed prospects), global growth is on track to stabilize next year. Developments over the past few months have reinforced our view of a soft landing rather than recession by the global economy[2]. In contrast to the downbeat industrial data, services have held up (Fig 1), underpinned by a resilient labor market and private consumption. In addition, recent indicators confirm that the slide of the global manufacturing sector since 2018 has come to an end, with leading indicators painting to a more convincing recovery (Fig 2). Slower but still-positive growth for DMs remains our baseline. A relatively-low capacity utilization rate (below its historical average), accommodative financial conditions and the buoyant job market will support domestic demand and consumption.

Fig 1: Global services sector performed better than manufacturing…



Source: Markit IHS, CCBIS

Fig 2: …and leading indicators now point to improvement in global trade and manufacturing



Source: CEIC, CCBIS

[1] CCBIS-The Big Picture: Domestic substitution under the cloud of the trade war (19 Sep 2019)
[2] CCBIS-The Big Picture Macro Outlook 4Q 2019: Treading water (30 Sep 2019)

For China, better, not faster growth

Chinese growth has been soft in recent years as the private sector continues to consolidate and restructure, while policy has refrained from large credit easing and leverage. Corporate restructuring has seen overcapacity and economy-wide deflationary pressure recede with a few areas even enjoying price surges, mainly related to supply-side factors. While corporate balance sheets have generally improved, the new growth cycle has been held back by uncertainties related to the trade war and tight domestic policy.

We expect 2020F to mark another year of soft overall growth and inflation as the government focuses on debt risk. Liquidity conditions will be kept accommodative but the credit cycle is likely to remain weak. Domestic construction and property will remain on a soft footing. Reforms and opening up will be the mantra of China's policymakers, who are keen to stimulate private investment and job growth. The technology sector will be a rare bright spot with the potential to support manufacturing momentum. A recovery in the global IT cycle, stabilization of trade risks, 5G-related investment, and an increase in high tech FDI are key catalysts. The economy remains on a reflationary trend, supporting corporate profit gains. Our key macro and policy projection is outlined below and followed by a more detailed discussion.

Table 1: China economic forecasts

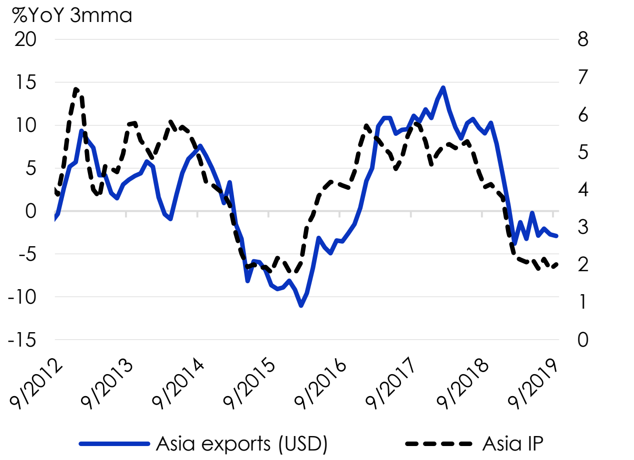
	3Q19	4Q19F	1Q20F	2Q20F	3Q20F	4Q20F	2018	2019F	2020F
Real GDP (YoY %)	6.0	6.0	6.0	6.1	6.0	6.0	6.6	6.1	6.0
IP (YoY %)	4.9	5.2	5.3	5.4	5.4	5.4	6.2	5.5	5.4
FAI (YoY %)	4.8	5.4	5.5	5.5	5.6	5.6	5.9	5.4	5.6
Exports (YoY %)	-0.5	0.0	1.0	2.3	2.6	2.0	9.9	-0.1	2.0
Imports (YoY %)	-4.0	0.5	0.6	0.9	1.5	1.1	15.8	-3.7	1.0
CPI (YoY %)	2.7	4.5	5.4	4.6	3.7	1.6	2.1	3.0	3.8
PPI (YoY %)	-0.8	-1.0	0.6	0.6	1.4	1.5	3.5	-0.2	1.0
US$/RMB (period-end)	7.1	7.0-7.1	7.0	7.0	6.9	6.9	6.9	7.0-7.1	6.9
China 7-day repo (EOP %)*	2.55	2.50	2.45	2.40	2.40	2.40	2.55	2.50	2.40
Reserved requirement ratio (EOP %)	12.5	12.5	12.0	12.0	12.0	12.0	14.0	12.5	12.0
China 10-year bond yield (EOP %)	3.1	3.3	3.5	3.4	3.2	3.0	3.2	3.3	3.0
Current account (% of GDP)							0.4	1.5	1.6
Budget balance (% of GDP)	-	-	-	-			-2.6	-2.8	-2.8
Budget balance, ex. transfers (% of GDP)	-	-	-	-			-4.2	-4.8	-4.8

Source: CEIC, CCBIS estimates

Industrial sector to gain momentum supported by high tech sectors

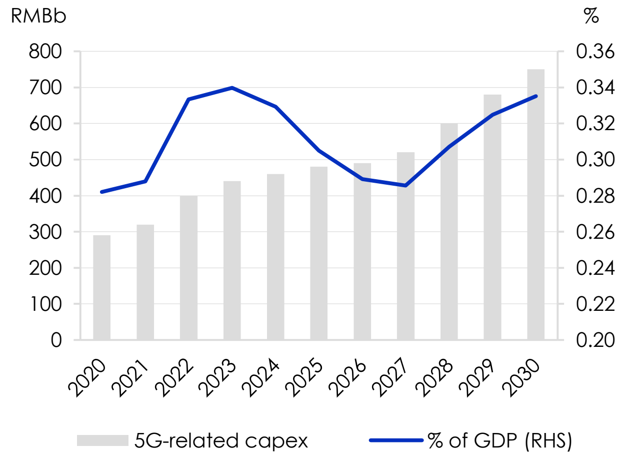
In 2019 high tech sectors (hardware, consumer electronics and high-end equipment) were a major drag on the industrial sector due to soft demand growth and uncertainties related to the trade war. Together, these sectors accounted for roughly half of the IP slowdown in 2019 year-to-date. We see three catalysts for stronger momentum ahead. First, global IT sales are picking up with the semiconductor cycle turning more positive as trade war uncertainties dissipate. The result has been stabilizing Asian exports and industrial production growth (Fig 3). Second, the 5G cycle is likely to gain momentum over the next few years. We estimate that 5G and related investment could add 0.1-0.3 ppt to China's GDP growth in coming years (Fig 4). Third, import substitution will accelerate, prompted by global trade policy uncertainties and protectionism (Fig 5 & 6). This, along with the rise in high tech FDI, will fuel stronger manufacturing momentum and upgrade in 2020.

Fig 3: Asia export and output growth stabilizing



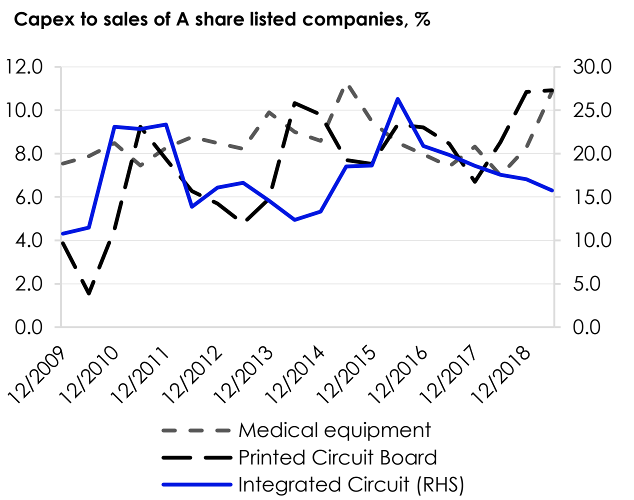
Source: CEIC, CCBIS

Fig 4: Expect 5G investment to pick up gradually



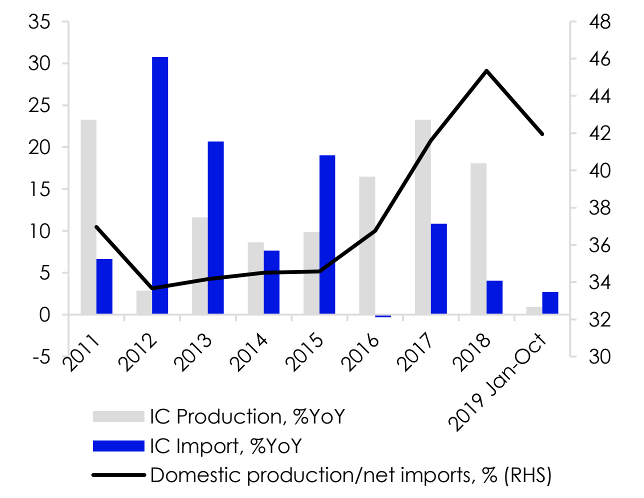
Source: CAICT estimate, CCBIS

Fig 5: Industries that benefit from import substitution have seen strong capex



Source: CEIC, CCBIS

Fig 6 Domestic production of semiconductors is on the rise



Source: CEIC, CCBIS

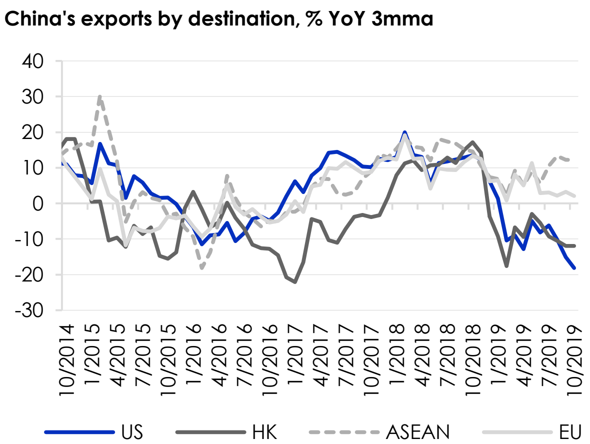
Trade war: Direct impact manageable; China's opening up provides a productivity lift

The direct impact of tariffs on the Chinese economy has been modest, in line with our view.[3] On the trade front, Chinese exports have held up relative to peers thanks to the greater pricing power of Chinese exporters and some trade diversion to non-US regions (Fig 7). China's trade surplus and net exports have increased as companies increasingly source domestically (Fig 28, page 11). For the broader economy, trade now plays a smaller role due to economic rebalancing. While low-end manufacturing sectors with low pricing power in the US face downward pressure on investment, other sectors have generally held up (Fig 8).

The key near-term uncertainty for the market is the 15% tariff hike to take effect in mid-Dec covering a broad range of consumer products. As these tariffs target more consumer and final goods than intermediate goods as was the case previously, the impact is likely to be larger. However, even with such tariffs, the direct impact on the Chinese and US economies will be small, ranging from -0.2 to -0.1 ppt, though the impact on US consumer inflation may be slightly higher. However, should the US market correct as a result, the likely tightening of financial conditions will increase the odds of a Fed rate cut in 1Q.

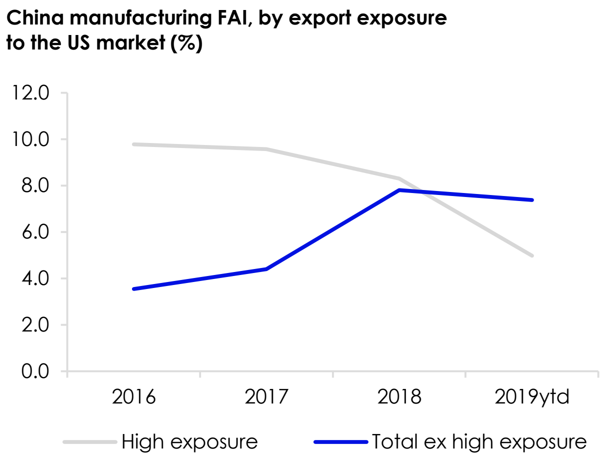
At stake is the long-term outlook of the global supply chain and its impact on productivity growth. A shorter supply chain and more domestic sourcing is likely to be a direct result.[4] The negative shock to productivity growth from a US-China de-coupling scenario will be partly offset by China's commitment to further opening-up and improving the business environment. Acceleration in the opening-up process has seen a pickup in FDI growth to 6.6% in 2019, up from 0.9% in 2018, led by the high tech services sector. Global leaders in auto, aircraft and healthcare have announced plans to expand production in China in the coming years.

Fig 7: Weak exports to the US offset by strong trade elsewhere



Source: CEIC, CCBIS

Fig 8 Outside of a few sectors directly exposed to the US market, manufacturing FAI has generally held up



Source: Wind, CEIC, CCBIS

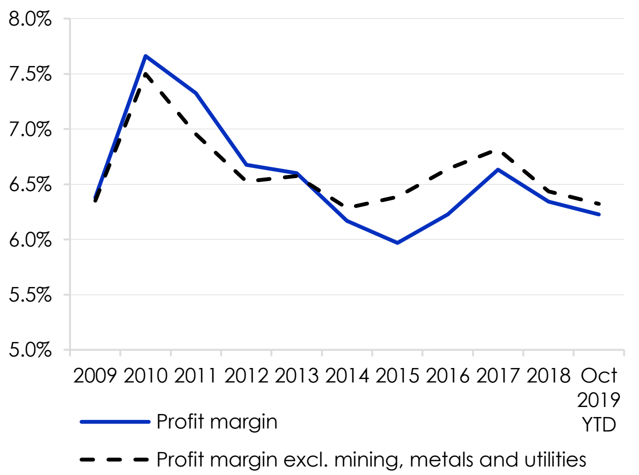
[3] CCBIS- The Big Picture: *Trade war – Can China sustain a tariff shock?* (10 Apr 2018)
[4] CCBIS-The Big Picture: *Domestic substitution under the cloud of the trade war* (19 Sep 2019)

Corporate sector: Healthier with consolidation, supporting reflation and profitability

Supply-side reforms in recent years have generally led to an improvement in corporate health. Profit margin improved in 2016-2017 as supply-side reforms sharply reduced oversupply and increased corporate pricing power (Fig 9). With a comparatively low concentration ratio across a wide range of sectors, including real estate, the industrial sector and light industries, consolidation is likely to continue (Fig 11).

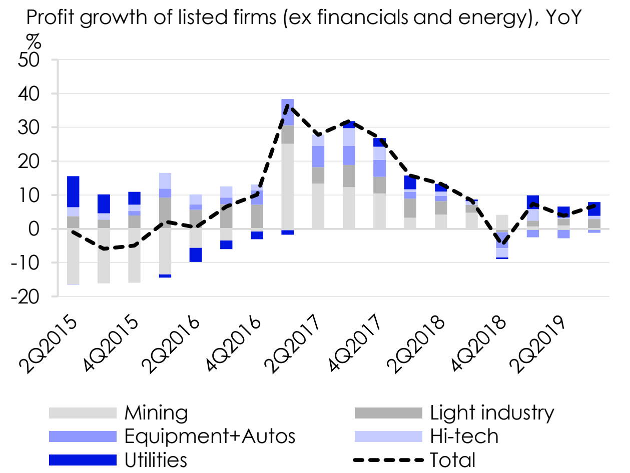
However, corporate profit margin has softened since last year under soft demand conditions. The government relied on tax measures to cushion the negative impact on the corporate sector, benefiting manufacturing margins, especially food, tech and equipment (Fig 10).[5] Earnings improvement will pave the way for corporate capex and R&D, when demand conditions improve.

Fig 9: Margins narrowed in the last two years due to soft demand yet they remain well above the trough



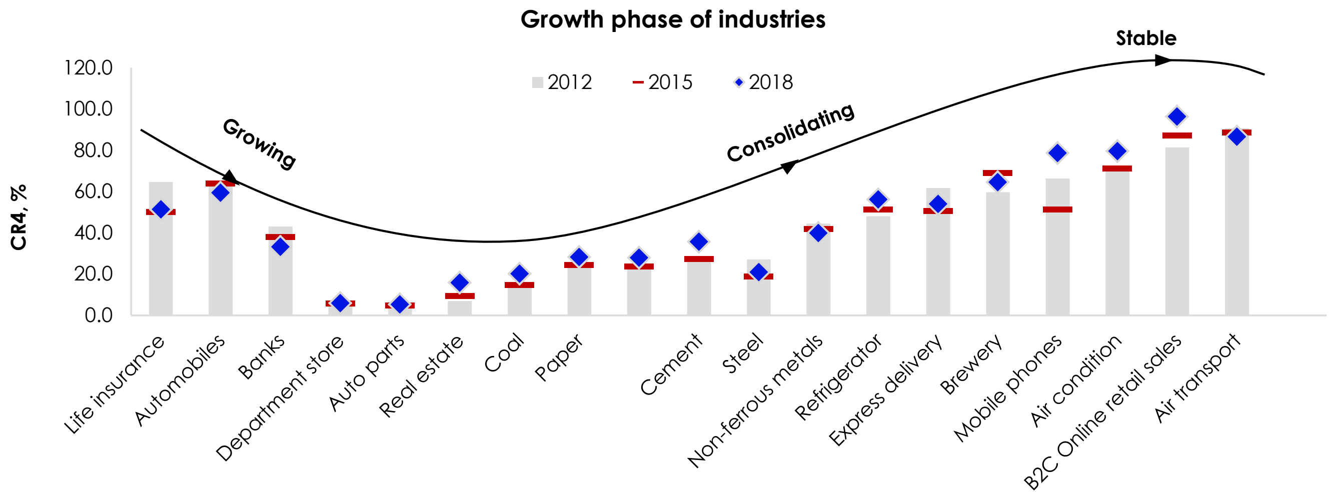
Source: CEIC, CCBIS

Fig 10: Profit growth held up in 2019 led by equipment and high tech



Source: Wind, CEIC, CCBIS

Fig 11: Most sectors have consolidated since 2015

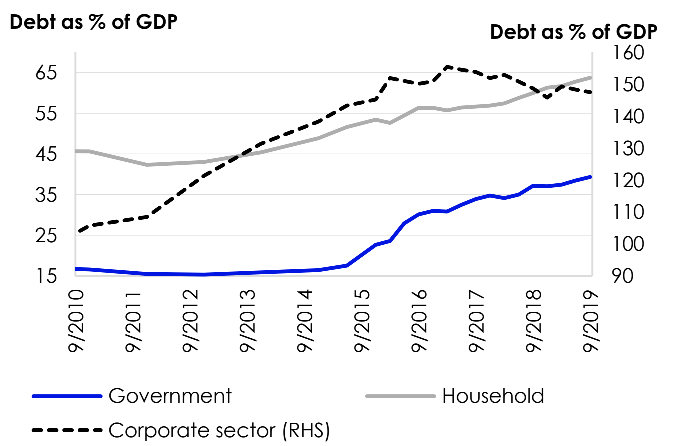


Source: Industry associations, CEIC, CCBIS

[5] CCBIS-The Big Picture: Tax and fee cuts to the rescue (11 Nov 2018)

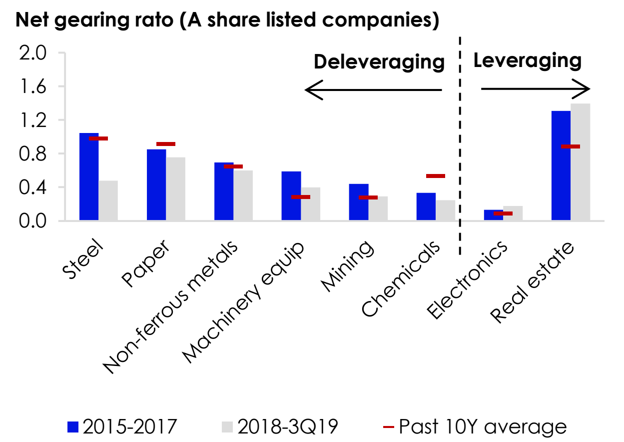
Along with consolidation, the corporate balance sheet has improved. The combination of public balance sheet expansion, corporate M&A, and defaults of non-viable companies, has lowered corporate leverage and debt risks (Fig 12 & 14). Outside of LGFV and the property sector, corporate leverage has declined (Fig 13) and debt payment burden has eased. The credit differentiation continues, corresponding to the divergence between front runners and laggards within industries (Fig 15).

Fig 12: Corporate sector debt has declined



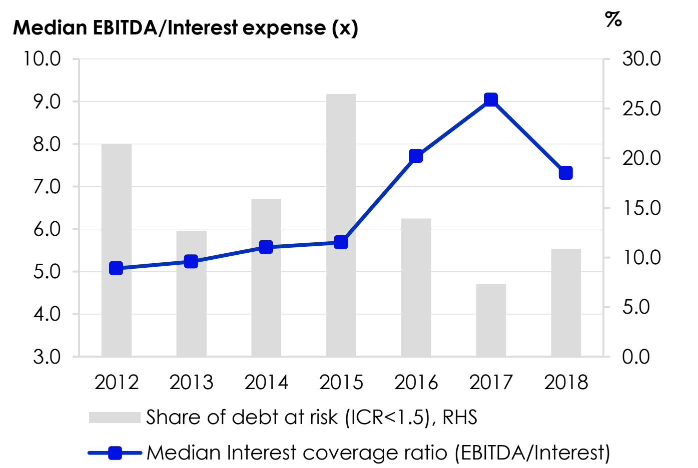
Source: Wind, CEIC, CCBIS

Fig 13: Deleveraging trend continues for most sectors except property



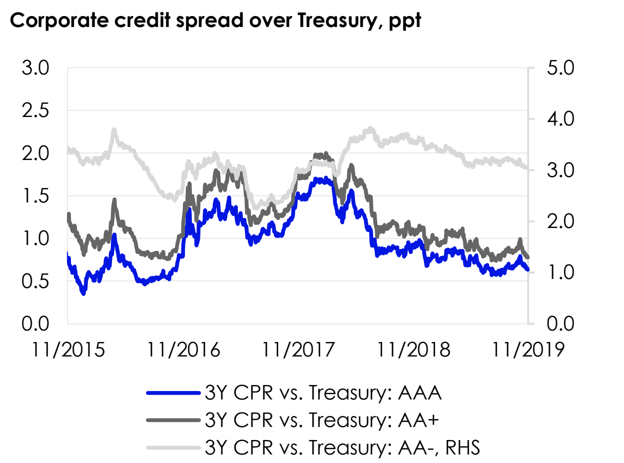
Source: Wind, CEIC, CCBIS

Fig 14: Debt at risk remains low



Source: Wind, CCBIS

Fig 15: Credit differentiation continues in the debt market



Source: Wind, CEIC, CCBIS

Corporate consolidation and debt restructuring have removed significant deflationary pressure in the economy. The economy remains on a reflation path, in our view, but inflationary pressure is being limited by soft demand. We expect PPI to rebound next year to around 1-2% growth, supporting top-line industrial profit growth.

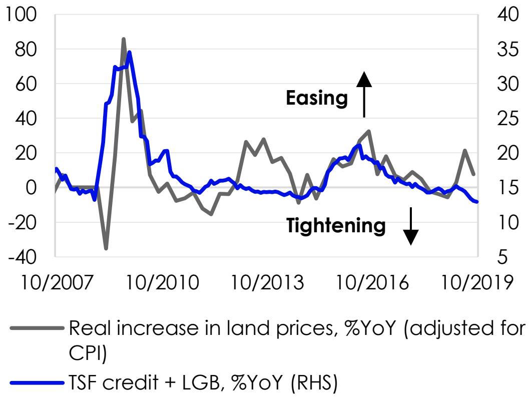
Chance of a large credit stimulus remains low

We expect the policy bias towards tight credit to remain in place. There are a number of reasons supporting a relatively prudent policy of credit expansion. First, recent history suggests credit expansion is insufficient to support sustained economic growth. The recent recovery in manufacturing has had more to do with an earnings recovery on the back of consolidation amid tighter credit conditions. Second, there are the financial risks to consider. Following several rounds of credit stimulus, half of the overall credit is now tied to illiquid infrastructure and housing investment, which implies pressure for refinancing and rollover risks. Third, there are the side effects of rising credit to push up property and land prices. These increase rather than decrease borrowing cost of the corporate sector (Fig 16). These constraints have stayed the hand of the Chinese government from rolling out large stimulus. [6]

Meanwhile, fiscal policy is likely to stay supportive. We estimate 2019's full-year deficit to be around 4.8% of GDP, up from 4.2% in 2018, due to tax cuts. Special local government bond issuance also rose from 2018. For 2020F, the official fiscal budget deficit target may hold unchanged at 2.8%. That said, to spur public investment, we expect the quota of special local government bonds to be raised from RMB 2.15t in 2019 to RMB 2.7t in 2020F.

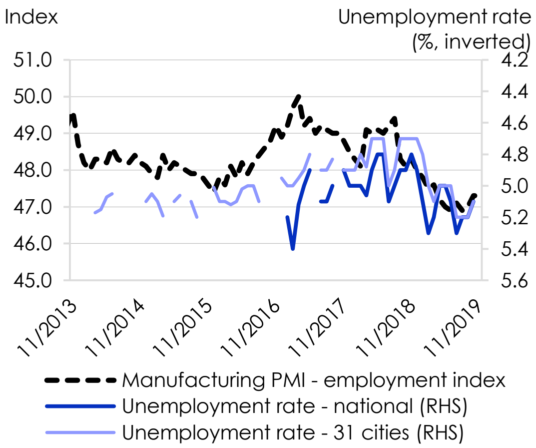
Job market conditions are being addressed through targeted policy support rather than macro easing. The unemployment rate edged up from a year ago, driven by the worsening outlook for the manufacturing sector (Fig 17). However, given steady income and inflation dynamics and a structural shift of employment into services (Fig 18), soft manufacturing job growth is likely to be managed through targeted remedies such as job training rather than broad macro easing.

Fig 16: Credit revival would push up land premiums



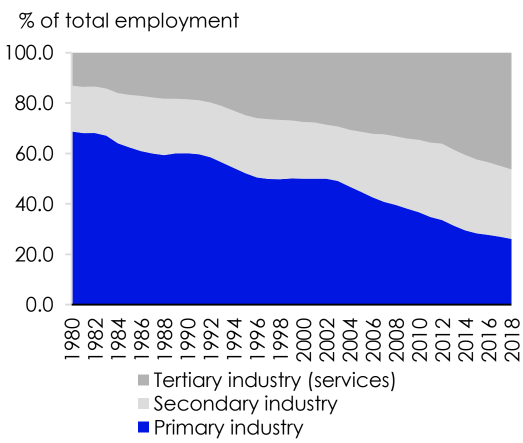
Source: CEIC, CCBIS

Fig 17: Unemployment rate edges up, driven by the manufacturing sector...



Source: CEIC, CCBIS

Fig 18: ...but the structural shift into the services sector has cushioned the impact



Source: CEIC, CCBIS

[6] *CCBIS-The Big Picture: What to expect from the new credit cycle (25 Feb 2019)*

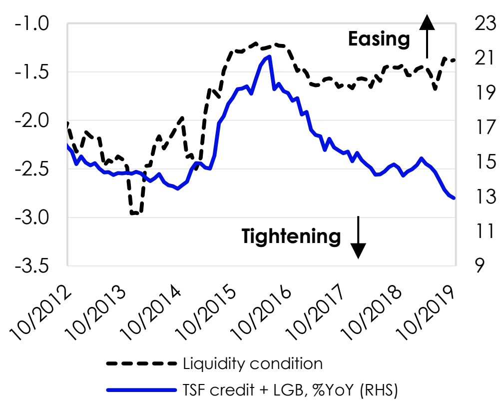
Monetary policy track 1: Easy liquidity; interbank rates affected by domestic and global factors

The government has focused on controlling leverage in the real economy while providing a liquidity buffer in the interbank market to offset the negative shocks associated with de-leveraging. Thus, while policy rates and interbank rates have continued to fall, the general lending rate has picked up through 3Q, and the mortgage rate for first-home buyers has continued to climb. Overall credit has decelerated (Fig 19).

Easy liquidity to continue into next year. In light of slowing growth, we expect the PBoC to stay accommodative. Room for further cuts is small however as the PBoC has indicated the need to preserve the monetary space for future downturns, with Chinese short-term rates only slightly higher than the US (Fig 21). We expect the CPI increase to be front loaded next year, driven by the pork cycle (Fig 20), which could cause headline CPI to top 5% early in the year, followed by deceleration in 2H. The probability of further interest rate cuts is low before early next year. Instead, the PBoC may employ an RRR cut to signal support for the economy and avert a rapid climb in yields associated with rising CPI.

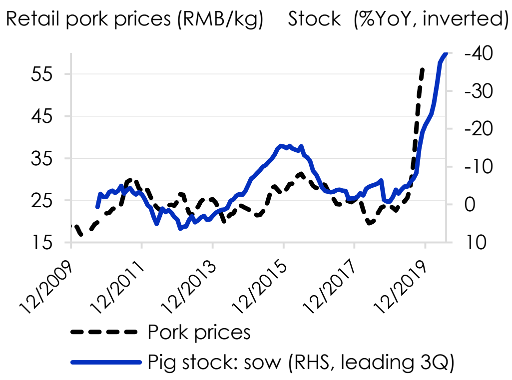
Chinese long-term bond yields to be driven both by domestic and global factors. Rising domestic prices and improving data could push up rates further early in the year. Meanwhile, global bond inflows could climb further with index inclusion. We expect about US$150-200b in bond inflows next year, up from US$80b per year in recent years (Fig 22). While foreign inflows are a bullish factor for the CGBs in the long term, the risk of imported easing could argue for stable or even tighter liquidity conditions later in the year to contain the fall in domestic rates.

Fig 19: Monetary policy has been easy on liquidity but tight on credit



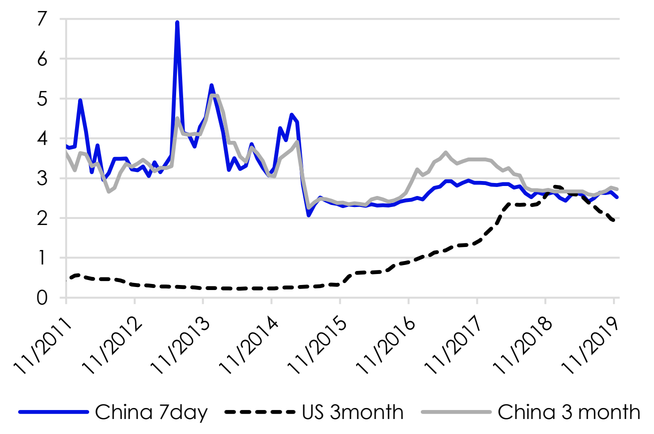
Source: CEIC, CCBIS

Fig 20: Pork supply shortage likely to drive prices up further throughout 1H20



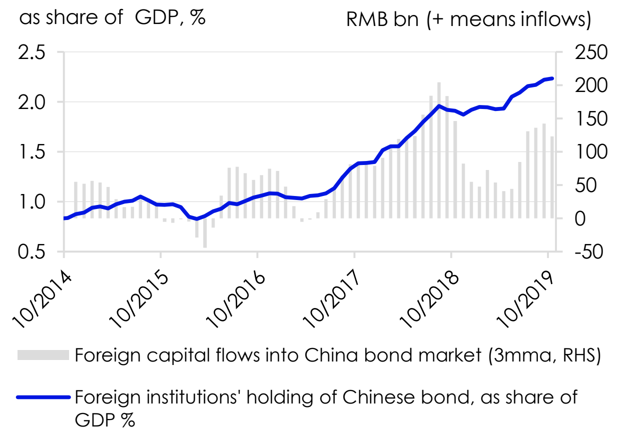
Source: CEIC, CCBIS

Fig 21: Chinese short-term rates are just slightly higher than the global level



Source: CEIC, CCBIS

Fig 22: Foreign purchases add to demand for Chinese bonds



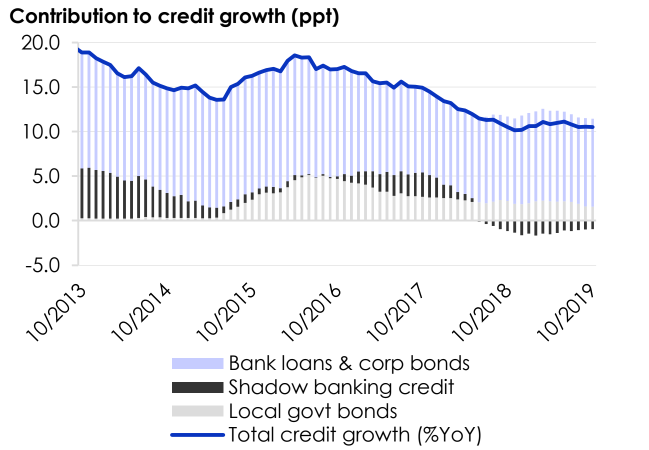
Source: CEIC, CCBIS

Monetary policy track 2: Credit cycle to stay weak

We expect bank lending to remain flat next year. Meanwhile, local borrowing will be constrained by the debt sustainability requirement and LGB quota. We look for the overall credit growth to soften next year (Fig 23).

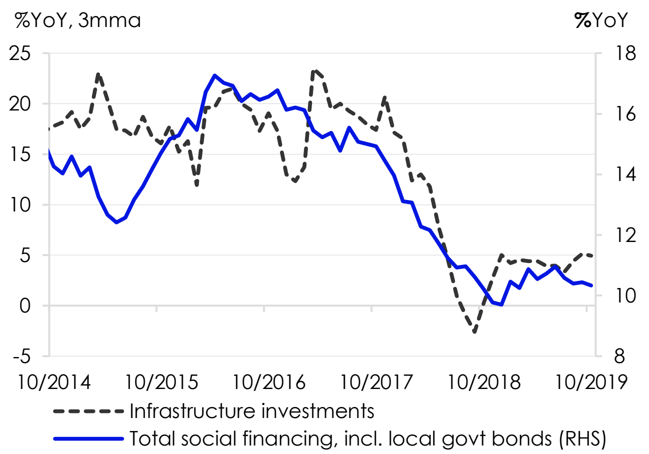
Given the soft credit cycle, we expect a modest 5.0% expansion in infrastructure investment compared with 4.2% in 2019 YTD (Fig 24). For the housing market, we expect some recovery in sales as local policies ease at the margin and mortgage rate declines with LPR (Fig 25). Property investment should hold steady however as developers shift away from aggressive land acquisition strategies amid tighter credit policies (Fig 26).

Fig 23: Overall credit growth is cooling, but bank loans and corporate bonds are holding firm



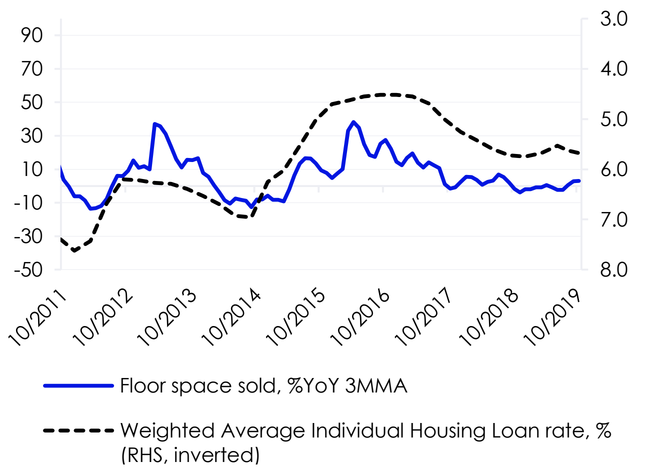
Source: CEIC, CCBIS

Fig 24: Rebound of infrastructure investment has been modest



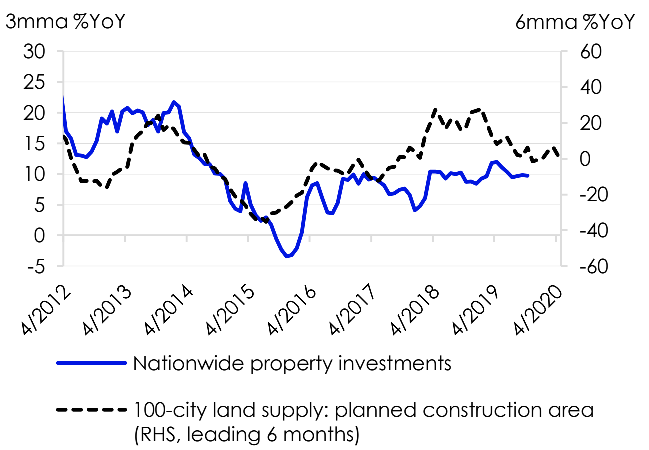
Source: CEIC, CCBIS

Fig 25: Ease in housing policies and mortgage rates may see a small rebound in housing sales



Source: CEIC, CCBIS

Fig 26: Sluggish land sales point to moderating investment



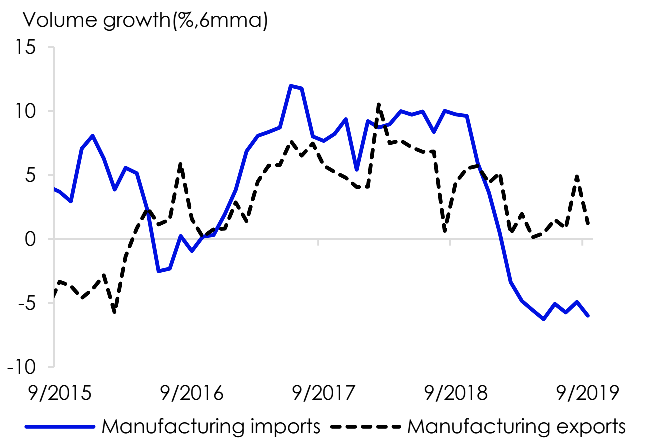
Source: CEIC, CCBIS

RMB exchange rate to stay range bound before appreciating

Despite rising trade tensions, we anticipate improvement in China's trade balance in the coming years, thanks in large part to greater import substitution as global supply chains shorten under trade protection. The improving terms of trade will also help. The past year has seen China's imports slow much more than exports (Fig 27) as China's trade surplus has climbed (Fig 28). FX reserves have held stable over the year thanks to strong foreign inflows, which reduces the depreciation pressures on the renminbi compared to the 2015 episode (Fig 29). The solid trade balance and China's status as an international creditor (Fig 30) provide fundamental support to the renminbi exchange rate in coming years.

The near-term path will still be affected by the US-China trade spat. We maintain our view that the USDCNY will strengthen slightly as progress is made in trade negotiations.

Fig 27: Imports slowed much more sharply than exports, led by supply chain trade

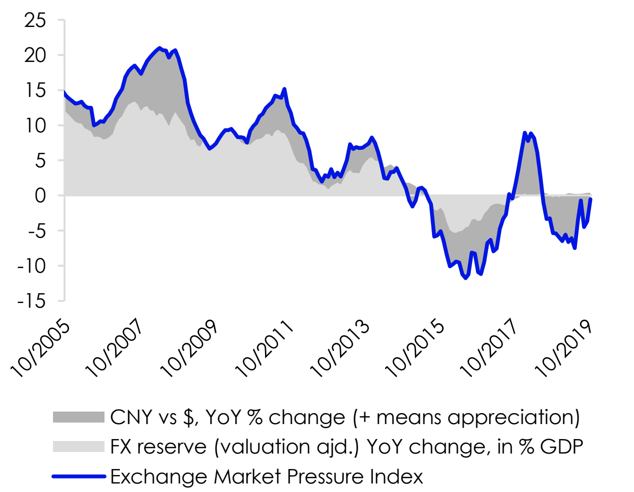


Source: CEIC, CCBIS

Fig 28: China's trade balance continues to climb

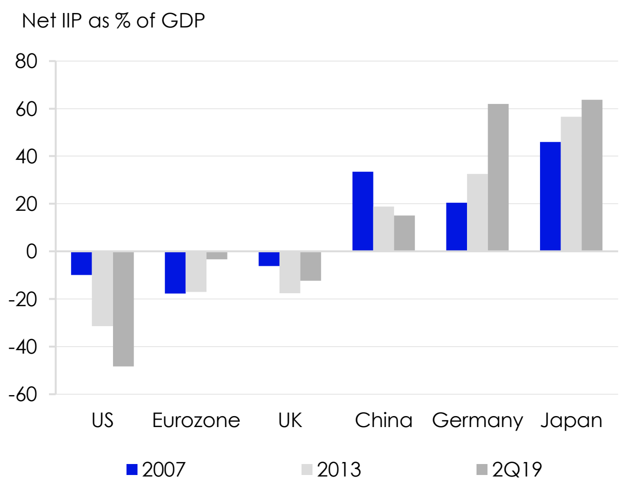
Source: CEIC, CCBIS

Fig 29: RMB depreciation pressure much less pronounced than it was in 2015



Source: CEIC, CCBIS

Fig 30. China's net IIP remained positive compared with negative levels in most advanced markets

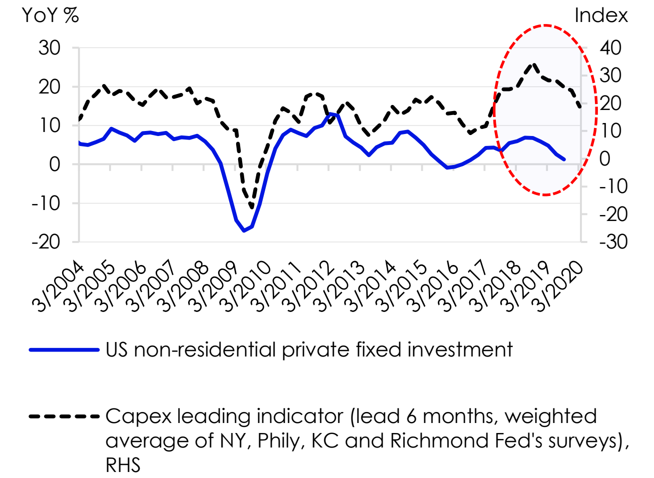


Source: Haver, CCBIS

US growth slows, but recession risks remain low

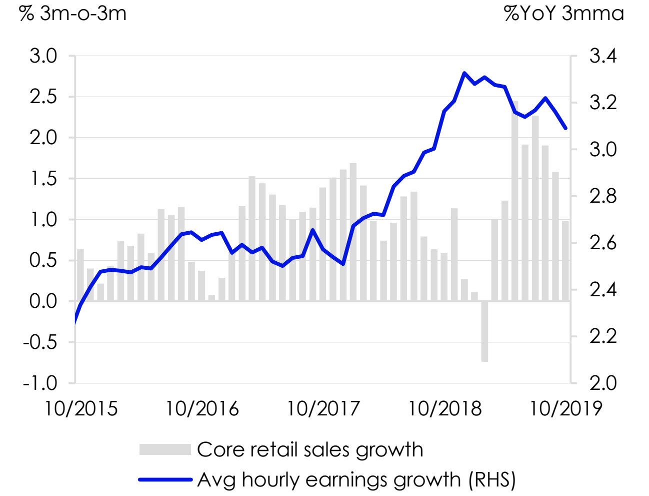
Late cycle expansion in the US. US business investment has cooled as earnings have slowed and labor costs have climbed. Nevertheless, our leading indicators point to still healthy growth (Fig 31). Meanwhile, the resilient labor market, underlined by solid wage growth, will continue to support private consumption (Fig 32). Risk of a recession in the US remains low, in our view.

Fig 31: Business surveys point to slower, yet still expanding US capex



Source: Fed, CEIC, CCBIS

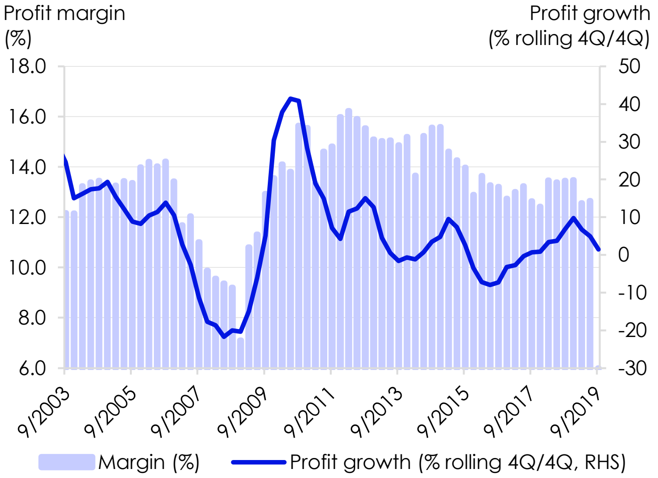
Fig 32: US consumption growth still solid



Source: CEIC, CCBIS

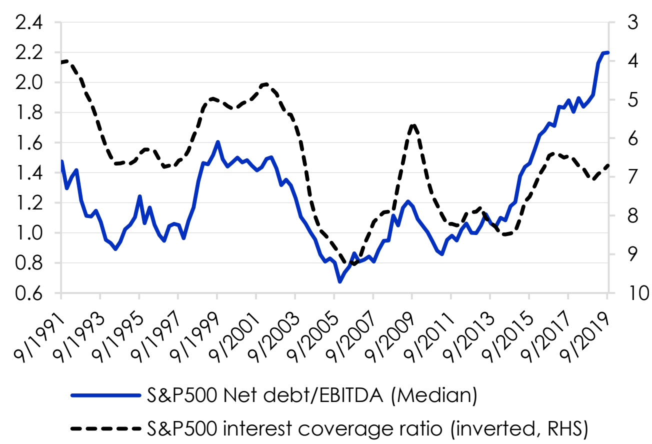
Corporate sector has weakened. Tight credit spreads of US corporate bonds have come under pressure to widen due to slowing earnings growth and high leverage across most non-financial sectors (Fig 33 & 34). Downgrades in the corporate sector have picked up in 2019. In a low growth environment, we see the US high yield space as a source of vulnerability next year.

Fig 33: US corporate profit margin under pressure…



Source: CEIC, CCBIS

Fig 34: …and corporate leverage has reached new highs with a rising interest burden



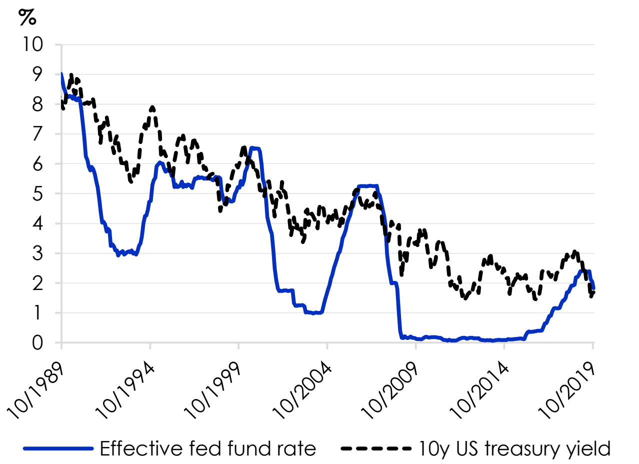
Source: Bloomberg, CCBIS

DM central banks refraining from injecting more stimulus; bond yields rebounding

DM monetary easing suspends. The Fed has signaled that it has completed its mid-cycle adjustment (Fig 35), while the ECB remains divided about its future policy path as a growing number of members have expressed reservations about further easing. With the backdrop of modest growth, we do not expect additional monetary easing from these two economies at least through 1H20F.

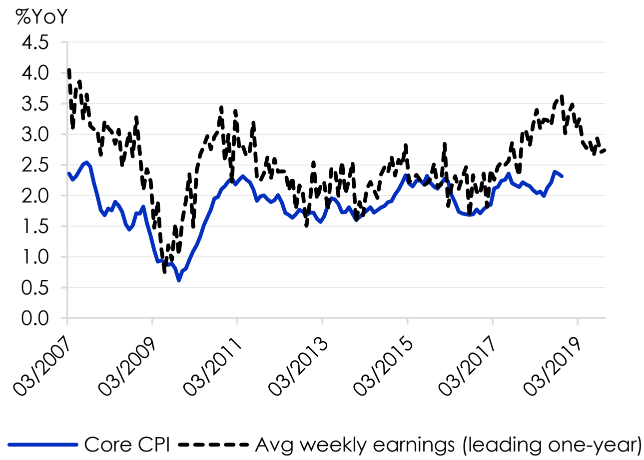
Long-term yield is likely to be supported by lowered expectations of easing and signs of inflation. We expect the tight labor market and solid wage growth to underpin modest strengthening of underlying inflation (Fig 36), while the consensus expects core PCE inflation to climb to just around 2%. Subdued inflation expectations coupled with cautious optimism in the market are expected to exert limited upward pressure on yields. We forecast the10-year UST yield to climb to 2.25% by the end of 2020F.

Fig 35: Fed indicates limited easing, reducing downside in bond yields



Source: CEIC, CCBIS

Fig 36: US wage inflation could see core CPI to rise next year



Source: Bloomberg, CEIC, CCBIS

The policy focus has shifted towards fiscal stimulus, but absent a large slowdown, the odds of an orchestrated fiscal expansion are low. Recent policy discussions have highlighted the limited power of monetary easing to propel growth and the need for fiscal policy to step in to support the economy. The implementation of fiscal support, however, is unlikely without a meaningful downturn, in our view, and therefore is likely only in a handful of DM economies such as the UK and Australia. In the euro area, the biggest economies have little space for fiscal expansion, with self-imposed constraints in the case of Germany or public debt in breach of the Maastricht criteria in the case of France, Italy, and Spain.

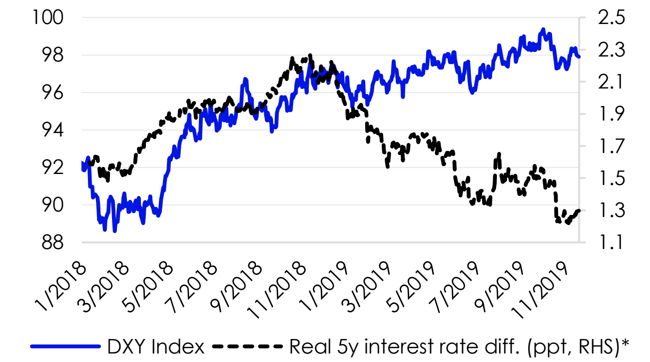
The US election will kick into full gear in 2H next year accompanied by significant expectations about likely policy changes. A Democratic victory (Senate/White House) implies higher corporate tax revenue, fiscal expansion, higher interest rates, and stricter regulation on finance and tech sectors. So far, however, polls and prediction websites suggest that a second Trump term is a more likely outcome.

CCB International 建银国际

Weak dollar; stay positive on Chinese bonds

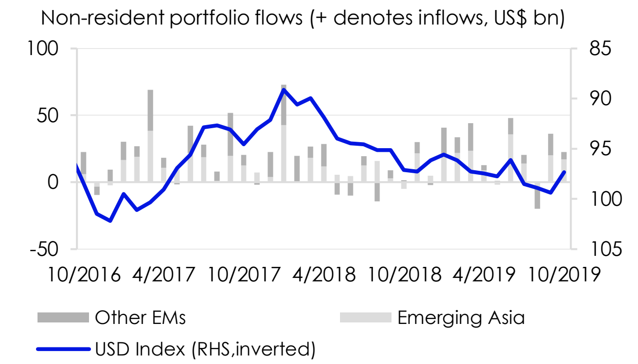
Moderate depreciation in US dollar expected. The US-euro area growth performance difference and the risk aversion sentiment in the market have supported dollar strength this year. However, as the interest rate differential continues to narrow (Fig 37) and the euro economy stabilizes, we expect US dollar strength to wind down. A weaker dollar favors flows into emerging markets, which have shown signs of recovery (Fig 38). For the offshore dollar bond market, the high yield spread narrowed in the last two months as we anticipated in Sep.[7] Valuations are still attractive from a global standpoint, and we expect Chinese bonds to perform well in a weak dollar environment (Fig 39). Default cases in China's corporate bond market have continued to emerge but haven't shown any sign of systematic stress (Fig 40).

Fig 37: Interest rate differential has declined, bearish for dollar



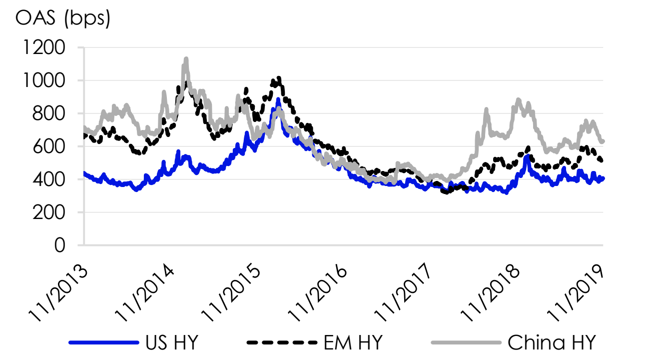
Source: Bloomberg, CCBIS

Fig 38: Softening dollar positive to EMs capital inflows



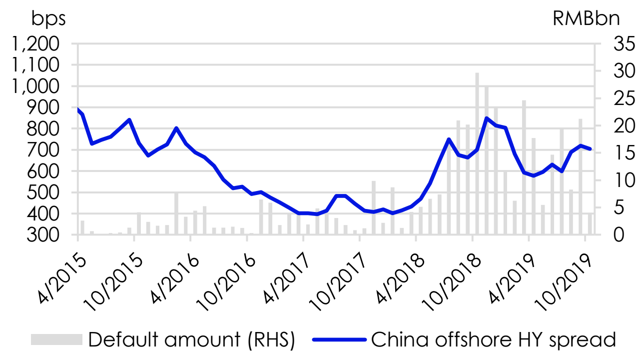
Source: IIF, Bloomberg, CCBIS

Fig 39: US high-yield market a risk but China offshore debt cushioned by valuation



Source: ICE BofAML, Bloomberg, CCBIS

Fig 40: Default cases of Chinese credit have increased but not surged



Source: Wind, CCBIS

Table 2: US economic assumptions and forecasts

	3Q19	4Q19F	1Q20F	2Q20F	3Q20F	4Q20F
US GDP (% QoQ SAAR)+	2.1	1.6	1.7	1.9	1.8	1.8
US core PCE inflation (% YoY)	1.7	1.8	1.9	1.9	1.9	2.0
US Fed fund target range (EOP %)	1.75-2.00	1.50-1.75	1.50-1.75	1.50-1.75	1.50-1.75	1.50-1.75
US 10-year bond yield (avg %)	1.7	1.8	2.0	2.1	2.2	2.25

+ Bloomberg consensus forecasts on 14 Nov 2019

Source: Bloomberg, CEIC, CCBIS estimate

[7] *The Big Picture Macro Outlook 4Q 2019: Treading water (30 Sep 2019)*

Rating definitions:

Outperform (O) – expected return > 10% over the next twelve months
Neutral (N) – expected return between -10% and 10% over the next twelve months
Underperform (U) – expected return < -10% over the next twelve months

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CCB International Securities Limited
12/F, CCB Tower, 3 Connaught Road, Central, Hong Kong
Tel: (852) 3911 8000 / Fax: (852) 2537 0097