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Market Update: 26th September 2019

China splutters into the final quarter of the year in a low gear

After a challenging first half of the year marred by trade tensions and slowing global growth, early indicators suggest that China's economy continued on a slower trajectory in September, with weakness in manufacturing and retailing combining with the trade war to undercut growth. As a result, it now appears that the Chinese economy is headed for the slowest expansion in almost three decades.

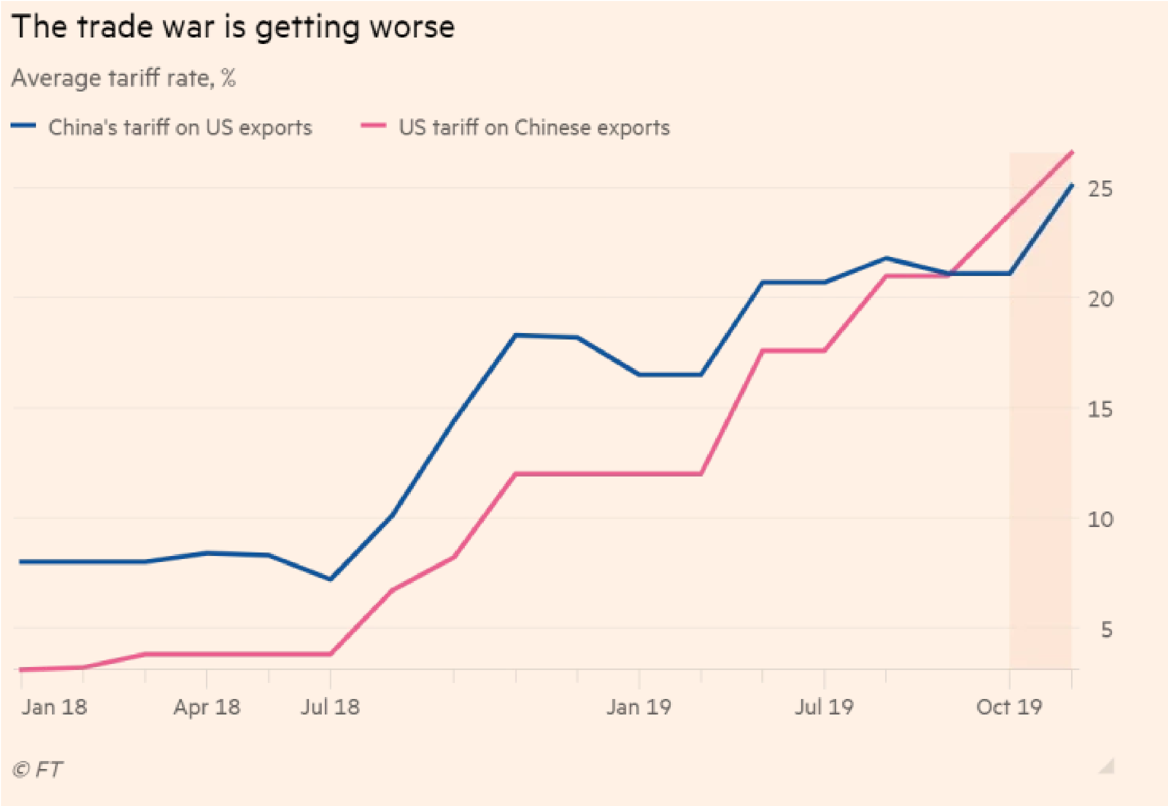
According to Bloomberg's initial estimates from financial markets and businesses, the Chinese economy cooled for a fifth month, with data on trade, factory prices and small business confidence all continuing to deteriorate over the month of September. This suggests that despite a recent easing in trade tensions, global demand remained weak, with no immediate reprieve for exporters and manufacturers. Growth in retail sales and investment also appears to be slowing as the domestic economy continues to decline. With problems remaining in the domestic economy while external pressures remain, there is no obvious driver to pick up the slack in the Chinese economy. This is causing concern for economists and market participants, as a sharp slowdown in Chinese growth is likely to have significant negative impacts on the wider economy which is already grappling with lower growth amid geopolitical tensions and country-specific political and economic issues.

Q3 Expectations

The first official data for the month is expected to be released on Monday, as the September Manufacturing PMI data is announced. The expectation is that manufacturing will remain in contractionary territory, albeit with a slight improvement from August's figures.

Global trade and investment have been weaker in the third quarter of the year, and the combination of slowing external demand and subdued domestic demand mean that the downward pressure on the Chinese economy has been increasing. According to a recent research note from the Bank of China's Research Institute, the risk is that the quarterly growth rate could fall below 6%, which would likely trigger a sharp selloff in risk-on assets as algorithmic trades react to lower growth than expectations. South Korean exports which are typically regarded as an Asian bellwether are declining, and business surveys indicate broad-based weakness for companies. At the same time, deflation is deepening, placing further stress on industrial companies' profits.

According to PMI surveys, business conditions fell to the lowest level in more than six years last month, and this continued throughout September according to World Economics, as manufacturing managers showed clear concern about the current business climate and outlook. The data suggests that the trade war may be beginning to bite on domestic and overseas Chinese business interests. As shown in the following chart, since the start of the trade war, the average US tariffs on Chinese exports rose to more than 23% from 3.1% in January 2018.



The expectation is that the Chinese economy may still stabilise in the fourth quarter of the year due to support from policy and the resumption of China-US trade talks, however with the likelihood of a deal remaining low and with central bank stimulus appearing to be ineffective in stimulating the Chinese economy so far, this remains questionable and risks remain tilted to the downside. As we know, a lot can happen in the last quarter of the year.

Stimulus

To combat the weakness in the Chinese economy, the Chinese central bank has introduced a series of stimulus measures, however these are moderate (some say minimal) and this lack of effective stimulus has big repercussions for the world economy. Where in the past, China has turned on the credit taps on the smallest sign of uncertainty, they now act with great caution, so as not to damage the economy further by sharp policy moves. In 2008 for example, five cuts to the lending rate and a hefty stimulus package triggered an avalanche of bank lending which set in motion one of the fastest accumulations of debt in history, and this debt still weighs on the Chinese economy.

In response to rate cuts and stimulus from the Fed and the European Central Bank in recent weeks, People's Bank of China Governor Yi Gang highlighted this week that the central bank is not in a rush to roll our massive rate cuts or QE like others, and is attempting instead to redirect lending away from state owned enterprises to smaller, more efficient private companies, and by strengthening the regulatory system to reduce systematic risk. It has also been reducing bank reserve requirements, guiding market rates lower and issuing bonds for infrastructure spending. Its next step is likely to involve a significant tax cut in a bid to stimulate growth.

While China appears to be acting to stabilise growth in the long term, the stimulus methods used have resulted in a drag on growth where other policymakers are being more proactive in their approaches, with slowing Chinese growth likely to remain a headwind for growth in the coming years.

China is obviously adopting a more targeted approach to stimulate than before, however current data indicates that so far it has been ineffective. A significant danger is that the economy slows more than expected, resulting in widespread unemployment and a downturn that is hard to reverse. Should growth tumble much below 6%, this could be a key test for the central bank's reserve.

US-China Trade Developments

Despite conciliatory gestures made by both sides ahead of talks next month, the gestures remain small, and the two sides still appear unlikely to obtain a deal in the near term as they remain far apart on important issues such as intellectual property. Both leaders have taken hard lines throughout the conflict, and President Trump may lead the spat into early next year to provide a strong backdrop to his re-election campaign. Additionally, this week's developments regarding the calls for impeachment of the US President may result in the Chinese side being more motivated to hold out for a change in leadership in hope of getting a better deal.

Our Expectations

Although negotiators agreed to return to the table this month, trade tensions continue to weigh on the Chinese economy and nearby nations that supply goods to its factories. Initial data suggests that South Korean exports dropped by the most since 2009 in the first 20 days of September. All areas of the Chinese economy appear to be struggling, with low inflation and manufacturing decline being the main drivers of the deterioration. Based on this data, we expect further weakness to become evident on the release of the Q3 data, and regard a Q4 revival as unlikely given the weakness of the Chinese consumer, with little domestic strength to drive a recovery. We continue to view a trade deal as unlikely in the near term, and there is already significant weakness in the global economy to bring about further deterioration, supporting our expectations for a decline in corporate profitability in Q3 and Q4 which brings about a decline in global equity markets. For this reason, we continue to support a defensive strategy and maintain our current asset allocation.