FLASH NOTE

CHINA: COVID WEIGHS ON GROWTH DESPITE STRONG Q1 GDP FIGURES

DOWNSIDE RISK TO OUR BELOW-CONSENSUS GDP FORECAST

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SUMMARY

- Chinese Q1 2022 GDP growth came in higher than expected at 4.8% y-o-y, mainly driven by strong business activity data for the first two months of the year.
  However, growth momentum decelerated sharply in March, reflecting tightened covid containment measures in China.
- The deteriorating covid situation and the Chinese government's zero-covid strategy are weighing heavily on economic activity, especially household consumption, and have become the dominant near-term headwinds to growth. There has been little improvement in the property sector either.
- The government and the People's Bank of China (PBoC) have increased policy support, as indicated by strong local government bond issuance and the PBoC's recent cut to banks' required reserve ratios. However, we believe that the current policy easing is insufficient to offset the growth headwinds and that more stimulus will be needed to stabilise the economy. More importantly, the Chinese government needs to adjust its covid policies.
- In light of the stronger-than-expected Q1 GDP figures but more severe damage on the covid front, we have decided to keep our below-consensus Chinese GDP forecast at 4.5% unchanged for the time being, but with the risk tilted to the downside.

Mounting growth concerns despite the upside surprise in Q1

Chinese GDP expanded by 4.8 y-o-y in Q1 (2.3% q-o-q, seasonally adjusted), according to the Chinese National Bureau of Statistics, well above consensus and our own expectations. However, this strong Q1 number is mainly due to the surprisingly high growth figures in the first two months of the year, while economic activity slowed sharply in March as containment measures were tightened in response to the recent covid outbreak, the largest in China since early 2020. The weakness clearly has extended into Q2 as some of China's largest cities, including Shanghai, were still under strict or partial lockdown at time of writing.

In our view, the deteriorating covid situation and the government's zero-covid strategy are the dominant growth headwind in the near term, on top of the continued drag from the property sector. The covid situation has actually added to that sector's difficulty by curtailing housing sales. Hence, we remain quite cautious about the outlook for the Chinese economy.

While the stronger-than-expected growth figures in Q1 will mechanically push up the full-year GDP forecast, we have revised down our expectations for the period ahead, especially for Q2, to reflect the impact of the covid shock. So overall, for the time being, our Chinese GDP forecast for 2022 remains unchanged at 4.5%. While this forecast is

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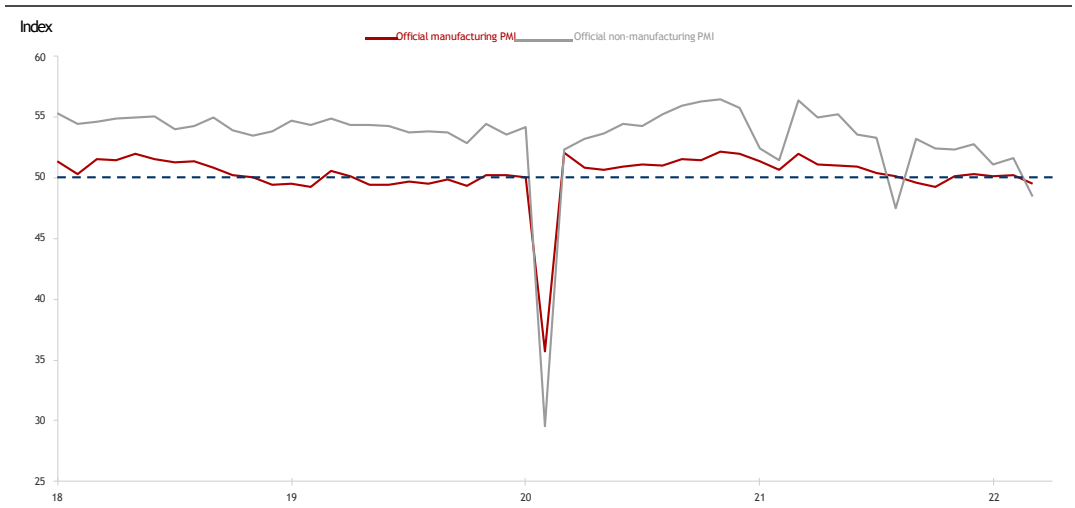
already below consensus, we believe it is more probable that Chinese GDP growth this year will be below this figure than above it.

Sharp slowdown since March

Various indicators show that growth momentum in China slowed quite sharply in March, likely reflecting the tightened covid containment measures in some of China's most economically significant areas since the second half of the month. For example, official purchasing manager indexes (PMIs) for manufacturing and non-manufacturing both fell into contractionary territory in March (*Chart 1*). The composite PMI declined to 48.4, its lowest reading since the start of the pandemic in February 2020. Growth in power consumption fell sharply to 3.5% in March from 16.9% in January and February combined.

As the lockdowns in some major cities (including Shenzhen and Shanghai) were only imposed in mid-March and the restrictions extended well into April, the Q1 GDP figures clearly do not fully capture the impact of the heightened restrictions on the economy.
According to our estimate, the regions where containment measures (of varying degrees) are currently in force (as of 19 April) represent about 62% of Chinese GDP. High- frequency data show there has been a notable disruption in logistics and a sharp contraction in a wide range of activities, including transportation, property transactions, movie box offices and so on, likely pointing to much weakened growth in the coming months.

CHART 1: CHINA OFFICIAL MANUFACTURING AND NON-MANUFACTURING PMIS



Source: AWM- AA&MR, National Bureau of Statistics, Wind, April 2022

Consumer spending and property face strong headwinds

Consumer spending has been hit especially hard by the containment measures. Nominal retail sales contracted by 3.5% y-o-y in March, a reversal from growth of 6.7% y-o-y in January and February combined. In real terms, the contraction in retail sales was even

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sharper, falling by 6.0% in March, the lowest reading since April 2020 (*Chart 2*). The weakness was seen across the board, from catering services to most other consumer goods, with an exception for petroleum products due to the recent surge in crude oil prices.

CHART 2: GROWTH IN RETAIL SALES IN NOMINAL AND REAL TERMS

Source: AWM- AA&MR, Wind, National Bureau of Statistics, April 2022

Despite some marginal easing of regulations announced since late last year, including relaxation in home-purchase restrictions in some cities, there has been little improvement in the property sector either. Liquidity conditions for many property developers remain acutely tight, with total funding available to developers in the first quarter overall dropping by -19.6% y-o-y (compared with -17.7% in the first two months of the year). In our view, the escalated covid restrictions on household mobility have further added to the sector's difficulties. Company-level data show that property sales slumped by -43% y- o-y in Q1 on weaker buyer confidence and demand.

Persistently weak domestic demand, especially in the services sector, has weakened the labour market, with the official unemployment rate rising for the fourth consecutive month to 5.8% in March. Youth unemployment (age 15-24) jumped to 16.0%, marking the second highest reading since data were made available in 2018 and significantly higher than the average two-year rate of 11.4% in the pre-covid years (2018-2019). This has led to a decline in household income growth and household savings, which may lead to further weakness in consumer spending ahead.

More supportive policies are needed to offset strong headwinds

Since late last year, the Chinese government has repeatedly emphasised that maintaining economic stability would be its priority in 2022. So far, an acceleration in local government bond issuance has been driving overall credit growth, which came in above market expectations in March, in contrast with downbeat business activity data. Total social financing (TSF) jumped by 37.7% y-o-y in March, after falling a sharp 31.0% y-o-y

For illustrative purposes. Past performance should not be taken as a guide to or guarantee of future performance. Performances and returns may increase or decrease as a result of currency fluctuations. There can be no assurance that these projections, forecasts or expected returns will be achieved. The projection is not based on simulated past performance.

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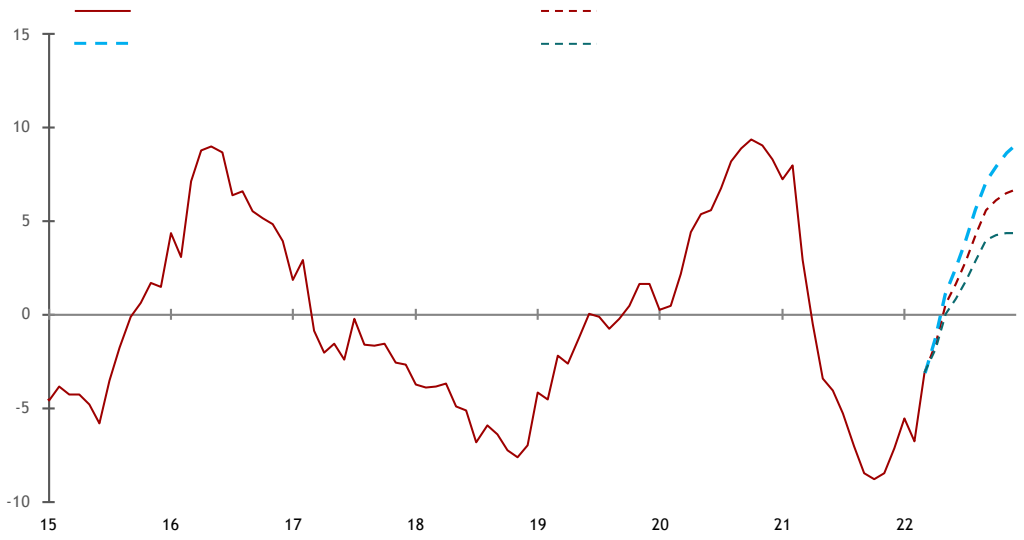
in February. As a result, the credit impulse (in terms of 12-month rolling changes) also improved, to -3.1%, compared with-6.8% in February (*Chart 3*).

CHART 3: CHANGES IN CHINESE CREDIT IMPULSE (12-MONTH ROLLING)



Source: Aura Solution Company Limited

However, the policy easing so far seems insufficient to offset the strong growth headwinds. The People's Bank of China (PBoC) recently announced a reduction in the reserve requirement ratio (RRR) for all commercial banks by 25 bps (and an additional 25bps cut for small banks), but kept the policy rate (medium-term lending facility (MLF) rate) unchanged at 2.85%. This move was below our expectations and points to the
Chinese monetary authority's reluctance to resort to large-scale stimulus, especially against the backdrop of monetary tightening by other major central banks.

Nevertheless, we still expect further supportive macro policies in the near term to stabilise the economy and to try to ensure the ambitious growth target of 5.5% announced at the National People's Congress in March is met. In particular, fiscal stimulus will likely play an important role in supporting infrastructure investment, and possibly household consumption as well. More targeted monetary policy tools may be deployed to support micro and small businesses (MSBs) and sectors heavily affected by the recent covid outbreaks.

But what is probably more important is for the Chinese government to find a proper exit from its current zero-covid strategy, which is imposing an increasingly heavy burden on the economy as the highly transmissible omicron variant spreads. The experience in Shanghai shows that it is hard to stamp out the virus entirely, even through the most stringent lockdowns, and that these lockdowns have an extremely high economic and social toll. So far, we have not seen any concrete evidence that the Chinese government is going to reverse its zero covid policy in the near term, but this is an extremely important area to watch for the rest of the year.

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In conclusion, despite the strong Q1 GDP number, more recent data point to a broad- based slowdown in economic activity since March. We do not believe policy easing so far is sufficient to stabilise the economy in the near term. As such, our macro outlook for China remains cautious. We have decided to keep our full-year GDP growth forecast of 4.5% unchanged for the time being but recognise that there could be further downside risks to growth.