JK Capital Management Ltd.

# Week of 19th July 2021

What's on our mind this week?

## What to make of China's latest macro data? To paraphrase a Hollywood movie, "It's complicated"

We always knew that Chinese macro data for the second quarter would be confusing. That proved to be an understatement. Not only the year-on-year comparisons turned out to be as meaningless as we thought given the hugely distorted base effect twelve months ago, but in addition the interpretation of these data was made even more complicated by the central bank's decision to cut its Required Reserve Ratio (RRR) just a few days prior to the release of the Q2 data.

What is the RRR? It is the amount of cash all banks need to keep permanently at the People's Bank of China (PBoC), the central bank. It is one way for the government to control the amount of credit flowing into the economy. Except that five years ago, the Chinese government decided to shift its focus away from the RRR and towards Open Market Operations whereby the PBoC intervenes directly on the interbank market through Repurchase Agreements ("Repos", used to siphon liquidity) and Reverse Repurchase Agreements ("Reverse Repos", to inject liquidity). The RRR had stopped being an active monetary policy tool.

What happened? Out of the blue, Premier Li Keqiang hinted at a possible cut in the RRR "at the appropriate moment" during a meeting of the State Council on 7th July. The justification he gave was "to counter the negative impact of rising raw material prices", even though administrative measures to that effect are already bearing fruits, as we wrote in our June monthly comment (available here). The 50bps RRR cut that returned RMB1tn of cash to the Chinese banks was announced by PBoC two days later, on 9th July. The reason put forward by PBoC in its official statement was to help banks repay medium-term lending facilities (MLF) that the PBoC had decided not to roll over. In other words, PBoC was asked by the State Council to use what had been in the past a very high-profile monetary policy tool to execute a technical treasury operation that was not worth writing about. And it all happened two days before China was scheduled to announce its GDP numbers for the second quarter and a series of high-profile macro data for the month of June.

It was not difficult for analysts to jump to the conclusion that some scary numbers were about to be released and that the government was proactively managing the impact by loosening its monetary policy. But to everyone's surprise, that was not the case, even though the Q2 numbers proved to be particularly confusing.

Looking at the Q2 headline numbers taken at face value, growth collapsed from 18.3%YoY in Q1 2021 to 7.9%YoY in Q2 2021, slightly below the analysts' consensus of 8.0%. But of course, the Q1 2021 YoY comparison had been massively inflated by the -6.8% GDP contraction that occurred in Q1 2020 when Covid hit. The same comment can be made for any country around the world when it comes to year-on-year economic comparison made between the first half of 2021 and the first half of 2020. Which is why analysts find it more relevant to compare Q2 2021 numbers with Q1 2021 numbers, i.e. focus on quarterly growth instead of annual growth, or to compare Q2 2021 with Q2 2019, i.e. do a 2-year annualised growth analysis. The picture looks totally different using that perspective: China had a good second quarter even though most analysts were expecting the economy to start slowing down. Instead, it kept on accelerating.

On a QoQ basis, seasonally adjusted Q2 GDP growth was +1.3%, up from +0.6% in Q1. On a 2Y-o-2Y basis, annual compounded growth increased from 5.0% in Q1 to 5.5% in Q2. This is not very far from the last pre-Covid growth in Q4 2019 of 5.8%. For the full year 2021, the Bloomberg consensus for GDP growth remains at 8.5%. This consensus number remained unchanged following the release of the Q2 data.

Looking now at the June numbers that were announced simultaneously and once again focusing on annualised 2y-o-2y comparisons, the picture is quite similar. Nominal retail sales accelerated from an annualised 2-year growth rate of 4.5% in May to 4.9% in June. Adjusted by inflation, real retail sales accelerated from an annualised 2-year growth of 3.0% in May to 3.3% in June. Retail sales in China are now well ahead of their pre-Covid level. This is important as retail sales had been the laggard among Chinese macro data throughout last year.

Industrial production was slightly lower with an annualized 2-year growth rate of 6.5% in June vs 6.6% in May whereas fixed assets investments accelerated to 5.7% in June vs 4.7% in May.

Other numbers announced included the unemployment rate of China which remained at a two-year low of 5.0% for the second month in a row. Household incomes are now 11.5% above their pre-pandemic level. On the import/export front, the trade surplus of China reached USD51.5bn in June, up from USD45.4bn in May and above the consensus estimate of USD44.8bn.

In conclusion, Q2 GDP numbers and June activity statistics surprised us on the upside as we were anticipating a visible slowdown. It was quite the opposite in the end, even though the headline numbers taken at face value can give a very different impression. We do not really understand why PBoC cut the RRR, other than to execute immediately a decision made by the State Council that had been announced by China's Premier and that could not be disregarded. This would not be the first time as there is no such thing as an independent central bank in China.

Economists are split when it comes to the direction of China's monetary policy for the rest of the year, whether rates will be cut, hiked, or left unchanged. There are too many moving parts for them to reach a consensus, one of them being obviously the possible impact on China of the Delta variant of Covid. However, there is a consensus as to the fact that China is expected to sequentially slow down, on a month-on-month basis, even though it has not transpired in statistics yet.

*Sources: Bloomberg, Nomura, Citi, Capital Economics, Pantheon Macroeconomics – July 2021*