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Chinese growth slows

Loss of momentum, likely exacerbated by floods

The loss of growth momentum, as reflected by the July activity data, is likely to be exacerbated by the severe flood in China. Investment activity was particularly affected by the reportedly factory shutdowns and businesses delaying purchase decisions. We expect the subsequent rebuilding to make up for some of the output losses in the coming months. That said, our forecast of a gradual growth deceleration in the second half of 2016 is unchanged. A shift of policy focus from growth stabilization to reforms and capacity reduction will put pressure on the economy, while concerns about financial risks may limit monetary stimulus in the second half of the year. We are comfortable with our below-consensus growth forecast of 6.4%. As for the financial market, we expect near-term stability in the renminbi (RMB) ahead of the G20 meeting and the SDR inclusion. The equity market will await the Shenzhen-HK Stock Connect, which we expect to be announced before the G20, but will unlikely move the market significantly.

The latest activity data for July shows a larger-than-expected easing of growth momentum. Both domestic and external demand weakened sequentially, but we suspect the domestic weakness was exacerbated by the severe flood – the worst since 1998, which has affected more than half of the country since June. The slowdown in fixed asset investment was particularly noticeable, with year-on-year growth dropping almost 1ppt to 8.1%. This is where the flood could have the most tangible impact – halting factory production and delaying investment decisions. Sub-sector data suggests an across-the-board slowdown in manufacturing (3%), real estate (5.3%) and infrastructure (17.5%) investment. Easing investment growth in turn took a toll on industrial production (6%yoy), consistent with the drop in the Purchasing Managers Index. Even consumer spending was not immune from the soft patch, with retail sales growth easing to 10.2% from 10.6%. **Overall, today's data shows a broad-based and sudden downshift in the economy. But to the extent that this is exacerbated by the flood, we expect the weakness to be offset, at least partially, by the subsequent rebuilding in the coming months**. We hence advise against reading too much into the July numbers.

Notwithstanding the transitory effect of the flood, we do continue to expect economic growth to decelerate in the second half of 2016. A key driver of this slowdown is our expectation of a cooling housing market. Growth in house sales has, in fact, already peaked in May and is starting to put downward pressure on construction. Adding concerns to the current growth model is the reliance of the economy on official stimulus and credit. The most obvious example is the continuous divergence between the public and private-sector fixed asset investment (FAI) growth (c. 22%, 2.1%), with the former supported by fiscal stimulus. The latter has prompted a swift reaction by the government, but reversing the current trend will be difficult in the near-term. Finally, credit growth, while it has slowed lately, is still significantly above nominal GDP growth, suggesting ongoing problems of credit misallocation. Addressing the issue will require the government to undertake tough reforms, which could weigh on the economy in the near-term. **All considered, we remain comfortable with our forecast of gradual growth deceleration in the second half of 2016, and 6.4% for the year**.

On the policy front, we think the government will stick to the policy mix of "proactive fiscal policy and prudent monetary policy" to keep growth within its targeted range. Barring a sudden loss of momentum, we expect the government to shift its focus from growth stabilization in the first half of the year to reforms, capacity reduction and managing financial risks for the second half. The message from the latest Politburo meeting reinforces this view, and is consistent with our expectation that the speed of corporate reforms and capacity reduction will accelerate. The mention of "potential asset bubbles" in the Politburo meeting (as well as the People Bank of China's second quarter Monetary Policy Report) was new. We think this may be referring to the housing market in top-tier cities and pockets of exuberance in the shadow banking system. This implies that shadow banking policies will be tightened, and further monetary stimulus will likely be applied more cautiously than before. **We see risks to our call of two Reserve Requirement Ratio cuts and one interest rate cut not being fully realized this year**.

As for the financial market, we continue to watch the RMB as a key barometer of investor sentiment. A mild reversal in the CNY/USD, after reaching 6.7, seems to be consistent with the latest USD moves. Some stabilization in the currency is welcomed and preferred by China ahead of the G20 meeting in

September and the Special Drawing Rights basket inclusion in October. **We are comfortable with our 6.7~6.9 year-end forecast for the CNY/USD, and suspect that more depreciation will take place in the fourth quarter, as China slows more evidently and the Fed tightens monetary policy**. For the equity market, we think that the government will likely announce the Shenzhen-HK Stock Connect before the G20 meeting, paving the way for its launch before the year-end. The Hong Kong market should benefit more from it as mainlanders try to diversify their currency risks and seek relative value in the H shares. **In that regard, we are more constructive on offshore stocks, on a relative basis, but this is not enough to alter our overall cautious view on Chinese equities**.

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