

China's looming destocking cycle: Are investors ready?

China's fragile economic recovery has been unbalanced and driven in large part by the supply side. H1 2022 industrial activity grew by a (comparatively) healthy 3.4% y/y, compared with a measly 1.8% y/y growth in the services sector, and a downright depressing retail sector, with sales shrinking 0.7% y/y.

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Key takeaways

- **With industrial activity consistently outpacing domestic demand, inventories have skyrocketed, and companies are getting anxious to destock.** This development could be bad news for bottom lines, prices, and the fragile domestic economic recovery – not to mention global growth and asset prices.
- **There is a bulging steel inventory that is costly and inefficient to store.** And while steel may be grabbing the spotlight, the phenomenon is being repeated in other upstream industries. Over the past 12 months, inventories of chemicals have increased by 28% and petroleum by 40%, while the storage ratio for cement reached 74% by the end of June – a seven-year high.
- **We think at some point soon, producers will face the inevitable and massively scale back production, slash prices, and aggressively run down surplus stocks.** In fact, this is already starting to happen in some parts of the economy, from chemicals to steel to television screen panels.
- **Such broad-based destocking could become a major problem for Beijing, given the potential for disinflation – or outright deflation – and related output cuts.** If consumers and businesses recognize that prices are falling and adjust their expectations to factor in this new trend, they will delay purchases, leading to further price falls.
- **What makes this threat particularly potent right now is China's unbalanced economic structure.** Growth already relies too much on investment rather than consumption, so a deflationary period that further stifles private and business consumption will only worsen this imbalance.
- **As such, the importance of Beijing's infrastructure stimulus cannot be understated.** A well-executed stimulus could help to avert an aggressive destocking cycle and the related pullback in output. However, if the stimulus is sub-optimal, the likelihood of a sustained period of destocking will increase.
- **At this stage, investors largely seem unprepared for the possibility of a disinflationary destocking cycle out of China** – and its attendant implications. However, we think such a scenario will likely play out over the next two to three quarters.

China's looming destocking cycle

The Chinese economy is somewhere between terrible and awful. One key issue keeping the economic trajectory from substantially improving is that the partial recovery from the Q2 Covid-related lockdowns has been out of balance and primarily driven by a boost in supply-side activity. In H1 2022, industrial activity grew by a (comparatively) healthy 3.4% y/y, compared with a measly 1.8% y/y growth in the services sector, and a downright depressing retail sector – where sales shrank 0.7% y/y.

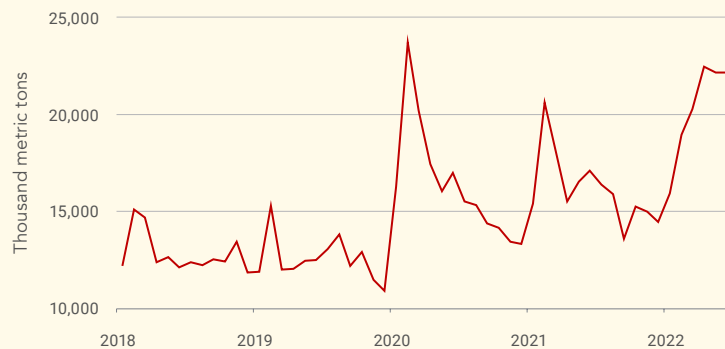
This two-track picture is even more evident when looking at the monthly data. Throughout the April and May lockdowns, retail sales shrank 11.1% and 6.7% y/y, respectively, while industrial output performed much better – shrinking by 2.9% y/y in April and growing 0.7% y/y in May.

Since then, industrial activity has consistently outpaced domestic demand. So, where's all this industrial output going? Mostly nowhere. Inventories have skyrocketed, and companies are getting anxious to destock. This dynamic could be bad news for bottom lines, prices, and the fragile economic recovery in the months ahead.

Build me up

The steel sector is at the center of the inventory buildup. Beijing's zero-Covid policy has slammed construction and manufacturing, drastically reducing demand for the alloy. In July, the manufacturing PMI fell to 49 – the fourth drop in five months – signaling yet another contraction in activity, and the demise of the once-mighty property sector continues. Real estate floor space under construction has been in the red almost every month since early 2021, culminating with a 48.1% y/y slump in June. The decline in the sector's value-added output also deepened to 7% y/y in Q2 from 2% y/y in Q1.

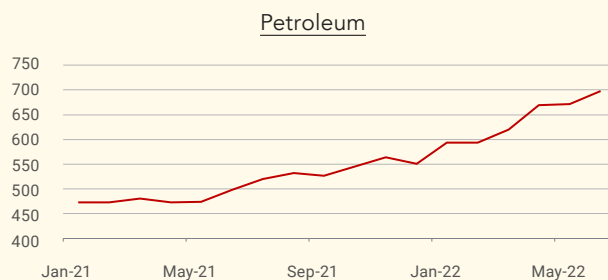
Meanwhile, amid the doom and gloom, upstream steel producers have continued doing what they do best – producing steel. And boy, have they been busy. Following a huge decline throughout 2021, production of steel products has increased almost 20% over H1 2022, reaching near-record highs of 120 million metric tons a month. Shutting down and then restarting operations is hugely expensive and not always logistically feasible, so despite the woes of their key customers, steelmakers have kept going, hoping for a rebound in demand – especially from the property sector, which accounts for 35% of domestic steel consumption. The result has been a bulging inventory of steel that is costly and inefficient to store [Fig. 1]. Inventories of steel products have increased by a whopping 40% since the beginning of the year and reached their second-highest peak ever recorded in April. The only time steel inventories were higher was in February 2020, just after China entered its first Covid-related lockdown.

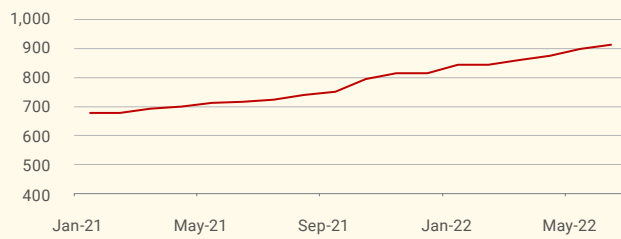
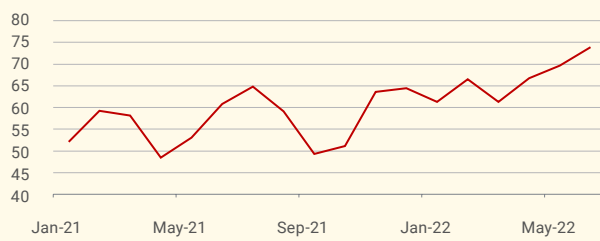
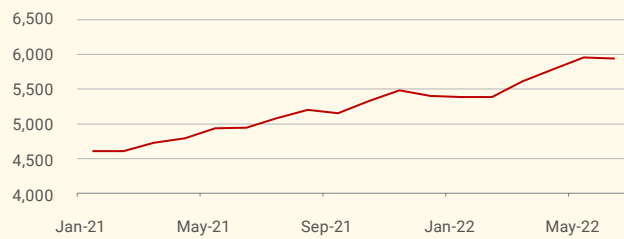
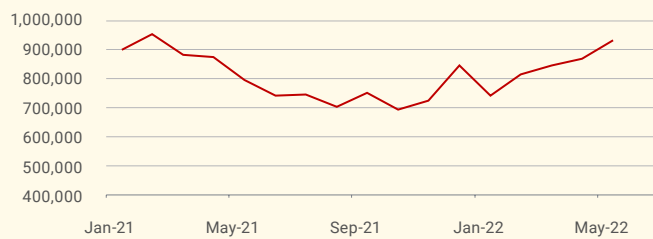
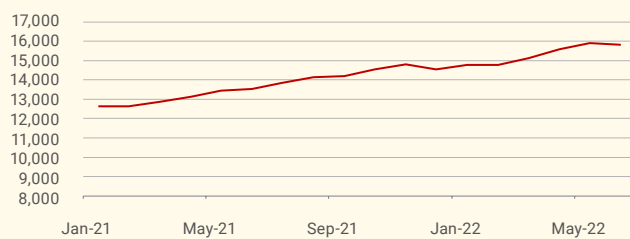
Fig. 1 – Inventories of steel products

Source: CEIC

While steel may be grabbing the spotlight, the same phenomenon has also been occurring in other upstream industries. Over the past 12 months, inventories of chemicals have increased by 28%, and petroleum by 40%. The storage ratio for cement, meanwhile, reached 74% by the end of June – a seven-year high.

Additionally, despite partial factory closures in Q2, downstream manufacturing output has consistently outpaced household consumption [Fig. 2]. In April, automobile sales hit a 24-month low and were 60% lower than pre-Covid levels. The slump triggered a 26% jump in stocks of unsold vehicles between January and May this year, leading the China Automobile Dealers Association to warn that inventory levels had reached unsustainable levels. At the same time, lockdowns, movement restrictions on people and goods, and controls on travel due to Covid led to the closure of thousands of shopping malls and stores across the country. That's pushed inventories of finished products up 39% since the start of the Covid outbreak, reaching a historical high in June of almost RMB 6 trillion.

Fig. 2 – Inventory growth for upstream and downstream industries (all measurements in RMB thousand bn except for cement, measured in storage ratio %, and automobiles, measured in units)

ChemicalsCementFinished productsAutomobilesIndustrial enterprise

Source: CEIC

This buildup of inventories – across the industrial and manufacturing space – imposes a significant burden on producers in terms of higher warehousing costs, maintenance, the risk of products becoming obsolete or perishing, and the opportunity cost of money tied up in stock.

This is concerning for the economic outlook because at some point – and we think some point soon – producers will face the inevitable and significantly scale back production, slash prices, and aggressively run down surplus stocks. Such a destocking cycle will put additional downward pressure on Chinese economic growth at a time when the headwinds to economic activity are already numerous and proliferating.

Indeed, the turn toward destocking is already happening in some parts of the economy. In July, the Hunan Iron and Steel Group announced a strategy to “go all out” to reduce inventories, while northern steel mills have already sold off significant stocks. In July alone, national steel inventories decreased by more than 12%. Major Chinese producers of TV screen panels are reported to have slashed prices, and plan to scale back production by 16% in Q4. In the tech sector, there are reports of excessive inventories of semiconductors, and leaders across the electronic chip industry have indicated they are planning significant efforts to reduce stocks. Chinese producers of urea – a chemical used to make plastics and drugs – have also started slashing prices to attract orders.

So it appears the inventory bubble is already bursting, and from steel rods to post-it notes, markets could soon be flooded with cheap, surplus inventory. Critically, such broad-based destocking could become a major problem for Beijing – as it would depress industrial and manufacturing output, which have been critical drivers of the supply-driven post-lockdown bounce in activity so far. Additionally, such a destocking cycle would lead to significant disinflationary pressure. The central bank (PBoC) might welcome this in the short term. Still, it could lead to further easing in household and business demand as economic actors delay key purchases in the hope of securing goods at lower prices in the future. In the extreme, such a scenario could lead to a dangerous deflationary cycle in China – something that is difficult to imagine now, given the sharp focus on widespread global inflation at present, but which would work to further entrench a range of economic headwinds in China.

What it all means for China...

Of course, destocking cycles are not, in and of themselves, necessarily a concerning development – especially if they entail a one-off reduction in stocks due to flagging demand as part of a typical business cycle. Indeed, under normal economic circumstances, destocking can help to stabilize economic activity. As inventories are drawn down, and prices fall, consumers and downstream factories take advantage of time-sensitive deals and discounts, bolstering demand. As upstream inventories start to run low, full production resumes, stabilizing economic activity and prices.

But these are exceptional times – as evidenced both by the historically high and broad-based buildup of industrial and manufacturing inventories and by the tepid pace of household consumption growth that has persisted for over a year now. Indeed, Covid-related restrictions on business and household activity have limited consumers' ability to shop in brick-and-mortar stores. More importantly, uncertainty about future

lockdowns and job prospects – as well as the negative wealth effect of subdued property prices – have created more intractable headwinds for private consumption.

Moreover, whereas disinflationary pressures – or an outright deflationary cycle – are most often caused by a weakening in aggregate demand, destocking-induced deflation is caused by supply-side issues. This is particularly the case when inventories have accumulated to dangerous levels thanks to overcapacity and oversupply – as is the case in China now. The risk, then, is that disinflation driven by overly aggressive inventory drawdowns triggers a further negative demand-side response that aggravates falling prices.

This threat is particularly potent in China right now because of the country's unbalanced economic structure. Growth already relies too much on investment rather than consumption, so a disinflationary period that further stifles household expenditures would only worsen this imbalance. It would also put a spanner in the works of Xi Jinping's Dual Circulation Strategy (DCS), a new(ish) economic framework aimed at reorientating China's economy towards domestic consumption. The DCS is critical to Xi's long-term strategy to transform China's economic structure and put the country on a more sustainable growth path. A damaging period of extended destocking, and disinflation, would block progress on that front, at least in the short term.

...and the global knock-on effects

We also have concerns about what a potential aggressive destocking cycle in China would mean for global economic growth and inflation outlooks.

China accounts for upwards of 56% of global steel production, 45% of chemical production, 42% of refined copper output, and 47% of zinc – just to name a few of the upstream sectors where the country has an outsized presence. If Chinese producers were to start flooding global markets with cheap steel, chemicals, and non-ferrous metals, the impact would be wide-ranging. Of course, struggling businesses and households in developed economies would welcome cheaper imports of Chinese commodities and manufactured products, and global central bankers might breathe a temporary sigh of relief as the sting came out of global inflation pressures. But those short-term positives would soon be outweighed by the distortions that such a flood of cheap industrial products and manufactured goods would have on a range of businesses and economies.

Most obviously, Chinese-led disinflationary pressures would hurt a range of other commodity-producing nations, as well as manufacturers in both developing and developed economies. For one thing, China is so deeply embedded in global supply chains that any price shock will reverberate worldwide. Prices for iron ore, the key ingredient for steel, would drop sharply, hurting the export revenues of the likes of Australia and Brazil. In July, Goldman Sachs revised its six-month price forecast for iron ore to USD 85 a metric ton from USD 110 – and any additional dumping of steel from Chinese producers would add significant pressure for prices to move lower.

Meanwhile, dampened steel prices would harm export revenue from steel producers like India, Japan, and South Korea. Meanwhile, the EU's

chemical manufacturing sector, the second largest in the world (behind China), would struggle to compete with discounted products dumped on the global market.

All that is to say that, for many economies, the positive aspect of weaker upstream inflation thanks to Chinese destocking would be outweighed by weaker revenues in key sectors and a related slowdown in global output. Reduced domestic consumption and business investment in China would also hurt companies exporting to China – who are already being negatively impacted by weak Chinese purchases.

The upshot of all of this is that a China-led weakening in global output and weakening in inflationary pressure now looks like a distinct possibility. And while we have highlighted this scenario in our writing over the past month or so, many investors still seem to be behind the curve in considering these potential outcomes. That seems to be largely because many investors are betting on stimulus from China to finally start bearing fruit in the coming months – and taking up the slack of recent over-supply and inventory buildup. We are skeptical on this front, but it is a critically important variable in determining the speed and intensity of the looming inventory drawdown in China.

A little less conversation, a little more action

Indeed, the stakes are high regarding the success – or lack thereof – of China's recently announced infrastructure stimulus, which now amounts to close to RMB 4 trillion of committed capital spending, or 3.5% of GDP, according to our estimates. This stimulus will need to be executed relatively quickly and effectively to boost demand for upstream inputs into infrastructure construction and avert what appears to be a looming and aggressive destocking cycle. That said, even despite the large amounts of capital the government has earmarked for stimulus spending, we remain cautious about how effectively this policy support program will be in closing the current gap between supply and demand.

For one thing, we've been consistently skeptical about the likely impact of the proposed infrastructure stimulus due to several factors, including the lack of shovel-ready projects, concerns that policy banks won't have enough takers for the money they are supposed to lend, and the overall weak demand for credit.

Moreover, even if the stimulus measures are well executed, new infrastructure investment will primarily fill the hole created by weak property activity. Infrastructure spending can only do so much to absorb excess steel inventories, for example, in the face of ongoing sluggishness in new property starts. Additionally, poor growth in housing completions will continue to dent demand for a range of manufactured goods, like home appliances – which producers are currently looking to offload. And more generally, the property malaise will continue to weigh on household sentiment via wealth impacts, meaning that consumer spending will likely underperform for at least several months.

That's not to mention the potential for another round of widespread Covid lockdowns if another outbreak spreads throughout China.

The upshot, then, is that the key variable that could stave off a significant and intense destocking cycle in China – and absorb enough of the

current excess supply to keep output from slowing in the coming months – looks to us to have significant execution risks.

Given that, investors should think through the myriad impacts on the global economy – and on a range of asset prices – of a China-led disinflationary inventory drawdown in the coming months. Indeed, the significant run-up in inventories we are seeing across a range of industrial and manufacturing sectors, and the early-stage signs of price-cutting and destocking that we are now observing, lead us to believe such a scenario is highly probable over the next two to three quarters.