Something needs to give

China's Q1 GDP result may give the impression that all was hunky dory at the start of the year, but few are convinced.

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Key takeaways

- The headline GDP growth figure is inconsistent with several of the more micro-level indicators that point to continued weakness in the economy.
- Moreover, the economic picture has deteriorated significantly since the end of the first quarter, with COVID-19 lockdowns wreaking havoc on supply chains, production, and consumer spending.
- The data for the start of this year showed that companies and households were going into this period of economic disruption with their finances already under pressure. Industrial profit growth was slowing and household income growth remains stuck below pre-pandemic levels.
- Meanwhile, while there was some evidence of effective stimulus in the Q1 data, it wasn't nearly enough to offset the slowdown in other parts of the economy. Specifically, a solid rise in infrastructure investment was undercut by a fall in real estate construction. Similarly, government bond issuance (to fund infrastructure investment) is accelerating, but lending to other parts of the economy remains weak – again, largely due to the collapse in credit demand in the real estate sector.
- What's more, there is little sign that officials intend to adjust their policy strategy in the property sector toward boosting economic growth. Instead, policymakers have been focused on measures to bail out industries that are struggling because of lockdowns.
- This disconnect between the present state of the economy, Beijing's current policy position, and the ambitious GDP growth target that officials have set for this year is not sustainable.
- At some point soon, Beijing will have to start messaging that this year's GDP goal is unachievable, or officials will have to undertake a more forceful move toward stimulus.
- Now is the key timeframe for any potential policy shift in 2022. The late-April Politburo meeting will mark an important opportunity for senior policymakers to update their economic support program.
- But while the odds of a move toward more aggressive stimulus have certainly increased in recent weeks, investors are ultimately set to be disappointed by Chinese economic performance this year.

Superficially, China's economy appears to be back on track. The official GDP growth print in the first quarter of the year was 4.8% y/y, up from 4.0% y/y growth in the final three months of 2021. The GDP print was almost universally dismissed, however, with many analysts – including us – pointing to the disconnect with more micro indicators.

For example, the main driver of the official Q1 GDP recovery was strong industrial sector activity. This increased 6.4% y/y in real terms in Q1, versus growth of 3.8% in Q4 2021. The data for electricity consumption in the sector, however, shows a shallower rebound. Electricity usage in the industrial sector increased by 3.1% y/y in Q1 2022, compared with 1.4% y/y growth in the final quarter of 2021.

A recovery in investment also supported the official GDP growth print. Gross capital formation accounted for 26.9% of real GDP growth in Q1 2022, up from an 11.6% drag on growth in Q4 2021. The fixed-asset investment (FAI) data also shows a strong recovery, with spending increasing 9.3% y/y in the first three months of 2022 versus a 1.1% y/y fall in Q4 2021.

Again, however, this conflicts with other data. Credit growth in China has seen far less of a recovery, rising just 30bp from 10.3% y/y at the end of last year to 10.6% y/y growth in March. Meanwhile, growth in the outstanding value of medium- and long-term corporate loans, which are used to fund FAI, decelerated from 14.1% y/y at the end of December to 12.4% y/y in March.

Finally, a recovery in FAI in China has typically corresponded with increased demand for steel and cement. That hasn't been the case this year, however. Production of steel and cement fell 10.5% y/y and 12.1%, respectively, in Q1 2022.

If things were bad then...

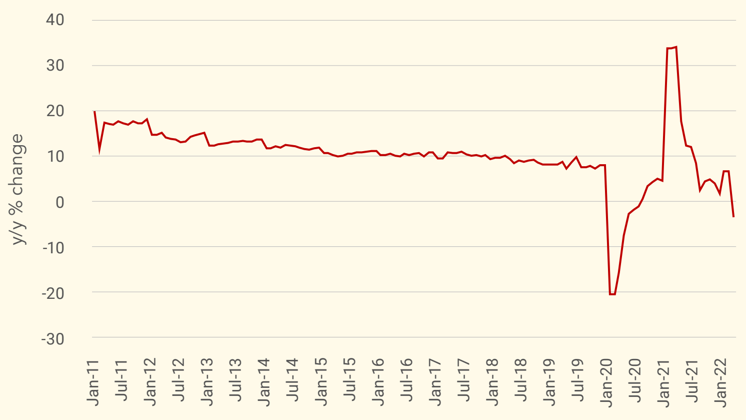
That growth at the start of the year was weaker than the headline GDP data suggests is highly concerning, especially given that the economic situation has only deteriorated further since the end of Q1. COVID-19 lockdowns – particularly in major economic hubs like Shanghai – are wreaking havoc with supply chains, production and consumer spending. This is hitting the economy when it is already down.

For example, in the first two months of 2022, profit growth at industrial firms had already slowed from 34.3% y/y in 2021 to just 5.0%. At private companies, profits were down 1.7% y/y in the January-February period.

Chinese households are also entering this period of economic disruption in bad financial shape. Household discretionary income growth still remains well below pre-pandemic levels: it increased 6.3% y/y in Q1 2022 in nominal terms, up slightly from 5.4% y/y growth in Q4 2021 but still well down from the 8.9% y/y expansion recorded in 2019.

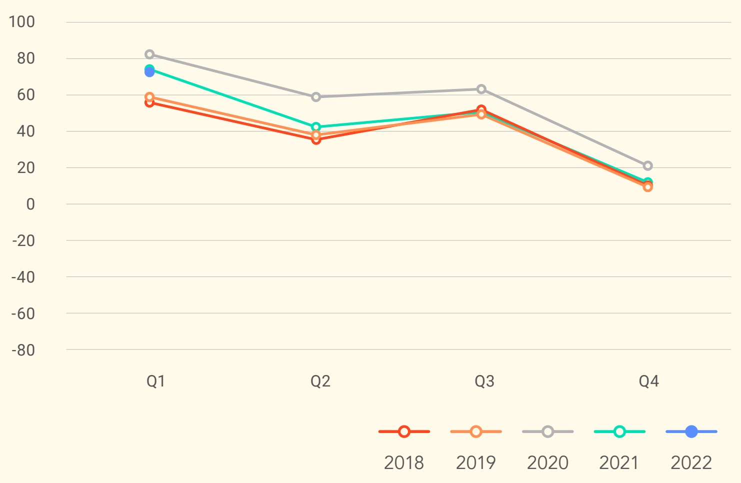
Weak income growth was one factor behind the sharp fall in retail sales in March. Purchases dropped 3.5% y/y last month [FIG 1]. While this partly reflected the impact of COVID-19 restrictions, the fact that online purchases slowed together with bricks-and-mortar sales shows that the financial pressures that households are facing also played a role. Offline retail sales of consumer good fell 3.9% y/y in March, but online purchases were up only 2.9% y/y, considerably down from the 12.0% y/y growth recorded in 2021.

Fig. 1 - Retail sales



Household financial concerns are also seen in the fact that savings rates rose in the first three months of 2022, returning to the levels seen in 2020 [FIG 2]. It's not hard to see why families are increasing precautionary savings. The official unemployment rate in China rose to 5.8% in March, the highest since May 2020, and the number of new formal jobs created in Chinese cities last month was down 18.1% from the same period last year. This month's lockdowns would have almost certainly exacerbated these employment problems.

Fig. 2 - Household savings rate



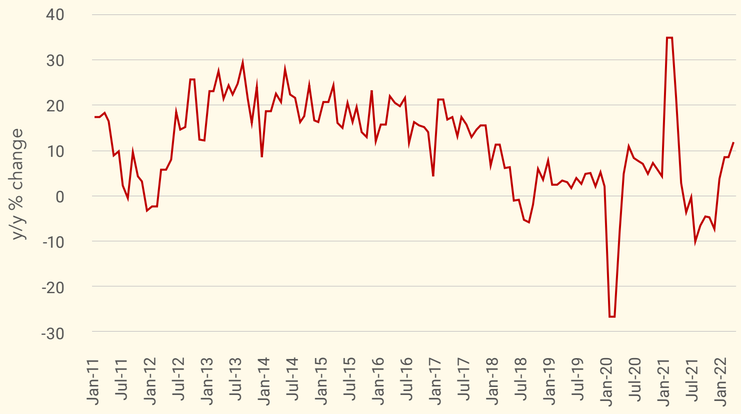
A challenging goal at the best of times

This throws into relief just how challenging this year's GDP growth target of "around 5.5%" is going to be.

While there was some evidence of stimulus taking effect in the Q1 data, the problem is that it wasn't enough to offset the slowdown in other parts of the economy – let alone to make this year's GDP goal achievable.

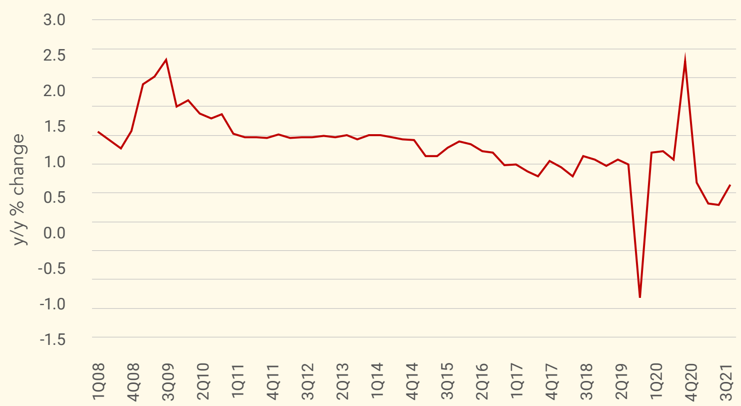
On the positive side, infrastructure investment jumped 11.8% y/y in March. That was up from 8.6% y/y growth in the first two months of the year, and a substantial improvement on the 0.2% y/y increase recorded in 2021 [FIG 3].

Fig. 3 - Infrastructure FAI



That said, more infrastructure spending did little to boost construction activity throughout China. The GDP sector breakdown shows that value-added output in the construction industry increased just 1.4% y/y in Q1 2022 in real terms. That was up from a dismal 2.1% y/y fall in Q4 2021, but it is still significantly below the 5.2% y/y increase seen in 2019 [FIG 4].

Fig. 4 - Value-added output in the construction sector, real growth



The issue here is that the rise in construction associated with infrastructure projects is being undercut by the fall in construction activity in the real estate sector. Floor space newly started in the real estate sector fell 17.5% y/y in Q1 2022.

It's the same problem with the looser fiscal policy that Beijing is pursuing more generally. The outstanding value of government bonds was up 17% y/y at the end of March, as officials accelerated issuance to boost economic activity. That compares with growth of 15.2% y/y at the end of last year. However, growth in other forms of credit was much weaker, with the remaining components of total social financing increasing just 9.3% y/y in Q1 2022, the same pace of expansion as at the end of 2021.

Again, much of the blame for this can be laid at the door of the real estate sector. Developer funding from domestic real estate development loans fell sharply in Q1 2022, dropping 23.5% y/y. Developers also reported weaker cash inflows from mortgages, which dropped 18.8% y/y in the first three months of 2022.

One key to generating a genuine economic recovery – and to hitting this year's ambitious GDP growth target of around 5.5% – will be reviving the real estate sector. But there is little sign that officials are looking to pursue that path, after a year-plus of policy tightening in the sector. Indeed, home sales in March fell by 29.1% y/y, a further step down from the 22.1% y/y decrease seen in the first two months of the year, and the biggest y/y drop in transactions since January-February 2020.

While officials have expressed more and more concern about the growth trajectory – last week Premier Li issued his third growth warning in less than a week – they have, so far, shied away from any meaningful loosening of real estate policy, or broad macro stimulus such as substantial cuts to lending rates. Instead, policymakers have been more focused on measures to bail out struggling industries, including targeted tax cuts, subsidies, and suspending social security and housing provident fund payments.

There is, therefore, a real disconnect between the present state of the economy, Beijing's current policy position, and the GDP growth target that officials have set for this year – so something will need to give. With the economic outlook further darkening, there is little chance that this year's growth target will be met with the current policy mix. At some point soon, Beijing will either have to begin messaging that this year's GDP goal is unachievable given the change in circumstances created by the latest wave of COVID-19 infections, or senior officials will have to send a very forceful signal that much more aggressive stimulus is forthcoming.

On this front, the April Politburo meeting – which will take place late in the month – will be critical. That meeting will mark the quarterly economy-focused gathering of senior Chinese officials, and will be the last best opportunity for senior leaders to change tack toward more aggressive, forceful economic support measures. At this stage, we don't foresee a bazooka-style stimulus being unleashed by policymakers at that meeting, but the odds of such a move have certainly increased in recent weeks. Ultimately, then, investors are likely to be disappointed by Chinese economic performance this year. And if officials aren't willing to back off the GDP growth target outright, we'll see more juking of the headline numbers over the quarters to come. Such an outcome will continue to drive a disconnect from the reality on the ground, and result in seemingly unusual weakness in a range of China-related asset prices, which will grate against official growth proclamations.