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Authors:
Stefanie Holtze-Jen
Chief Investment Officer APAC

Jason Liu
Head of Chief Investment Office APAC

Swati Bashyam
Investment Officer APAC

China's economy: awaiting the right cues

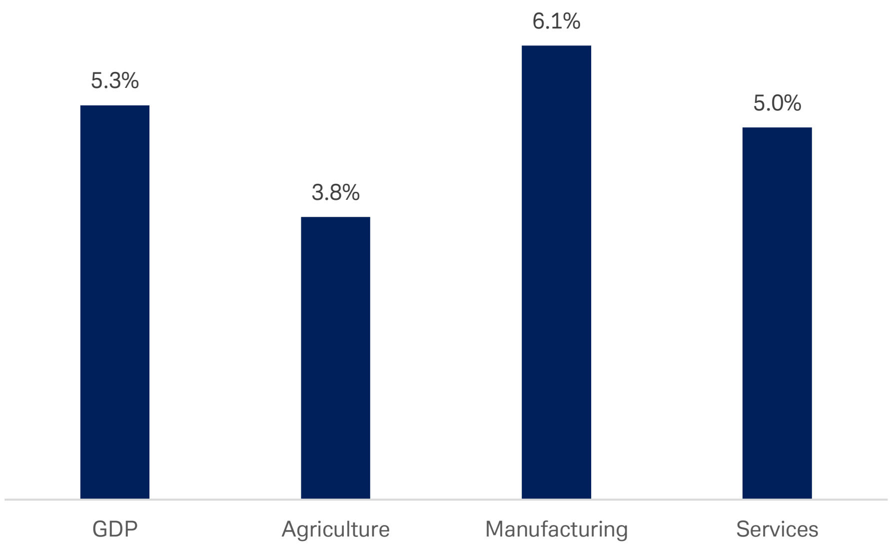
Key takeaways

- China's Q1 GDP was higher than expectations. However, household confidence has yet to recover. property sector weakness has continued, and China's exports disappointed in March.
- The PBoC is willing to support the CNY in the near term. But the stronger USD, as well as modest domestic growth in China, could contribute to depreciation pressures in next 12 months.
- We stay cautious on Chinese equities in the short-term. We would consider reentering when there is a clearer turn-around in macro-economic data, likely in H2 this year.

01 Macroeconomic update

China's Q1 2024 GDP growth came in better than expectations at 5.3% YoY vs. consensus estimates of 4.6% and the government's full year target of 5.0%. GDP increased by 1.6% QoQ, in Q1, up from 1.2% in the previous quarter. Manufacturing sector showed faster growth than services. Overall, the Q1 GDP data was a positive surprise as it showed that China's economy continues to recover despite ongoing market concerns.

Figure 1: Sectoral composition of Q1 GDP growth



Source: National Bureau of Statistics, China, Deutsche Bank AG. Data as of April 17, 2024.

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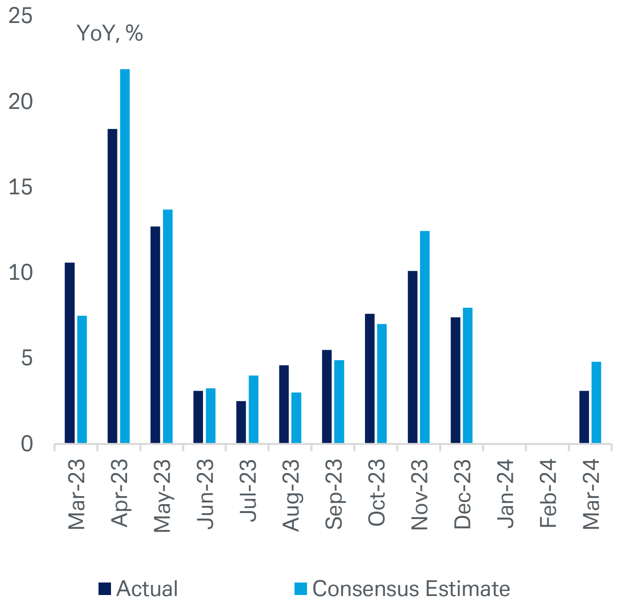
Faster growth in fixed asset investment was one key growth driver. Capex growth excluding real estate sector was strong at 9.3% YoY in Q1. Private investments (excluding real estate) grew 7.7% YoY. Growth in manufacturing and infrastructure investment was particularly strong at 9.9% YoY and 6.5% YoY, respectively, with hi-tech industries' investments up 11.4% YoY. The hi-tech manufacturing sector continues to be a government policy priority, especially in key strategic sectors where there is a perceived need for greater technology self-reliance. Investment in manufacturing of aerospace vehicle/equipment and computer/office devices grew 42.7% YoY and 11.8% YoY respectively. We highlighted in our CIO Viewpoint - China equities: selective opportunities published on February 23, that there are investment opportunities, especially in the sectors with government support, including consumer discretionary, technology, and green energy. These sectors continue to receive government subsidies and their capex investment has risen fast as a result. We see continued longer term investment opportunities, with favourable policy support.

Household confidence has yet to recover, however. Chinese consumers have become more conservative in their spending patterns in face of and uncertain job market and weak income prospects. Retail sales grew 3.1% in March YoY, vs. estimates of 4.6%, illustrating slowing growth momentum after the Lunar New Year holidays in February. With weak consumer demand in March, consumer price inflation (CPI) for March disappointed at +0.1% YoY vs. estimates of +0.4% and previous month's level of 0.7% which reflected strong demand during the Lunar New Year week in February.

The surveyed urban unemployment rate eased marginally to 5.2% in March vs. 5.3% in February despite ongoing structural challenges. The real disposable income per capita for urban households rose 5.3% in March YoY; for rural households it increased by 7.7%. However, this failed to translate into domestic demand growth, reflecting the cautious consumer sentiment noted above. China's government recently undertook several measures, including an easing of car loan requirements, in an attempt to raise consumer confidence. We believe these measures should lead to a gradual improvement in demand in H2 2024.

Meanwhile, the property sector has continued to languish. Home prices declined again in March albeit at a slower pace. The impact of weakness in the property sector was felt on other related industries with cement output falling by a record 22% MoM and steel output down 7.8% YoY, YTD in 2024. Demand for iron ore also came in lower than expectations, in turn leading to higher exports of steel. Overall, property sector investment declined further in March, down -9.5% YoY. International rating agencies downgraded some major Chinese developers in March due to their weakening sales and declining profit margins. As the Chinese households continue with their deleveraging efforts in face of uncertain labour market conditions, we think China's property sector could remain weak in the near term. However, the government seems likely to continue to support the financing activities of developers, in order to avoid any systematic risks.

Figure 2: Retail sales growth vs. expectations



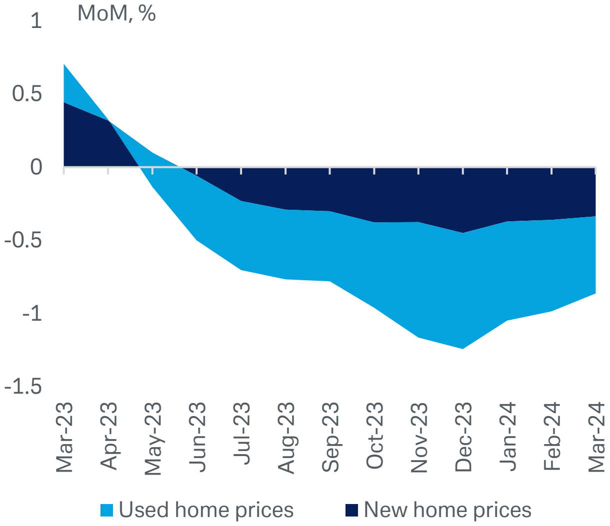
Source: LSEG Datastream. Deutsche Bank AG. Data as of April 17, 2024.

Figure 3: CPI vs. expectations

Source: LSEG Datastream. Deutsche Bank AG. Data as of April 17, 2024.

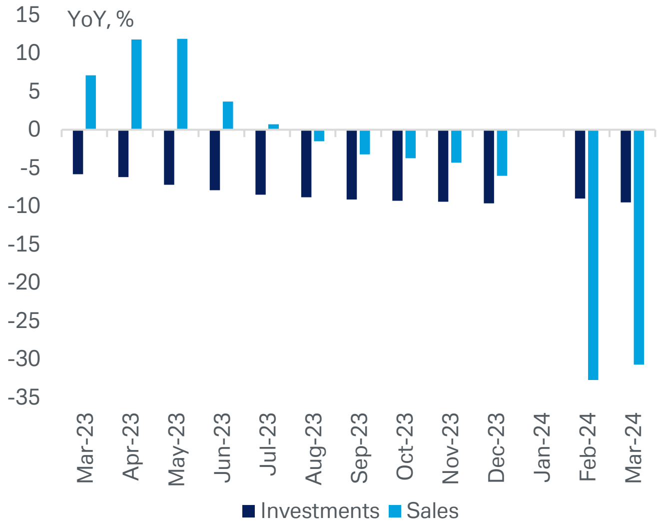
This domestic weakness has tilted manufacturing towards exports. Official manufacturing PMI for March turned expansionary for the first time in six months, with the NBS manufacturing PMI for March coming in at 50.8 vs. 49.1 in February (and consensus estimates of 49.9). The Caixin manufacturing PMI also remained in expansionary territory. However, producer price inflation (PPI) for March stood at -2.8%, in line with estimates and has now been negative YoY 18 consecutive months, in the face of weak domestic demand. The manufacturing sector is now increasingly dependent on export performance given lacklustre demand in the domestic market. A turnaround in manufacturing could support market sentiment, but the lack of improvement in U.S.-China relations represents a key risk.

Figure 4: New and used home prices



Source: LSEG Datastream. Deutsche Bank AG. Data as of April 17, 2024.

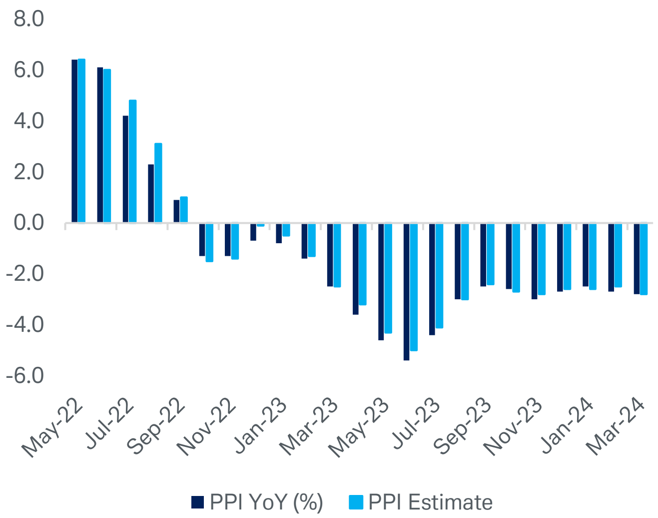
Figure 5: Housing market investment and sales



Source: LSEG Datastream. Deutsche Bank AG. Data as of April 17, 2024.

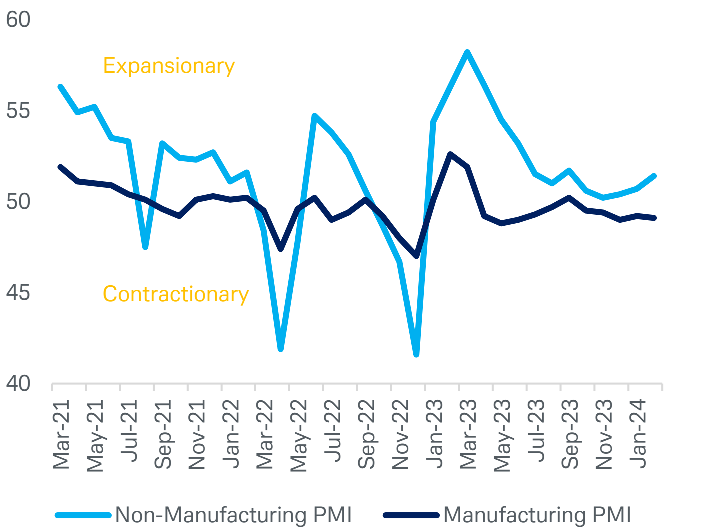
Monthly data on the external sector has disappointed recently with exports falling -7.5% YoY in March vs. estimates of a -2.3% decline and +7.1% YoY growth in February. Imports came weaker than estimates dropping -1.9% YoY in March vs. a +3.5% jump in February and estimates of a +1.4% rise. Furthermore, the export sector could be impacted by ongoing trade talks with the U.S. and Europe, where authorities have raised concerns over China's manufacturing overcapacity and alleged dumping of exports. Recently U.S. Treasury Secretary Janet Yellen also threatened sanctions on China banks supporting the Russia/Ukraine war. Four bipartisan bills have also been introduced to the U.S. Congress, dealing with U.S. investment in China, and the U.S. Science and Technology Agreement has been further tightened. This could lead to lower U.S. investments in China. The recent visit by German Chancellor Olaf Scholz to China is an illustration that diplomatic efforts however are still underway.

Figure 6: Producer price inflation



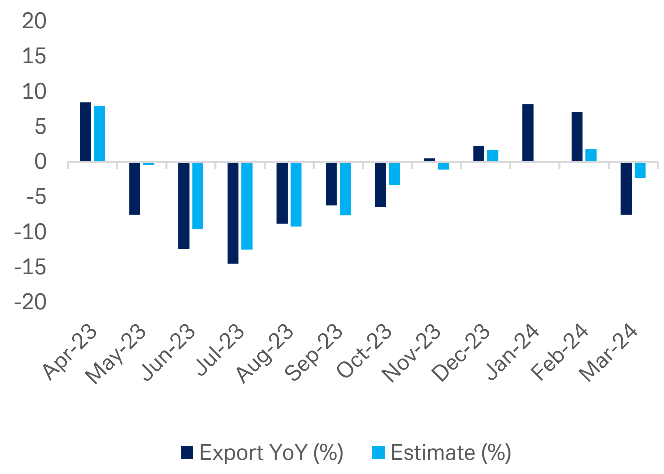
Source: LSEG Datastream. Deutsche Bank AG. Data as of April 17, 2024.

Figure 7: Manufacturing and non-manufacturing PMI



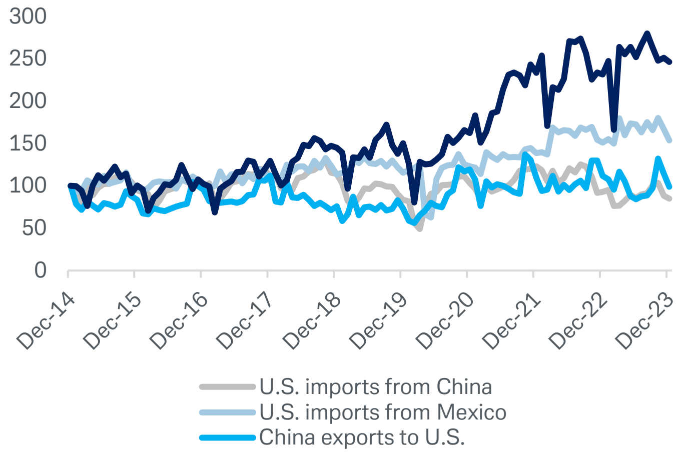
Source: LSEG Datastream. Deutsche Bank AG. Data as of April 17, 2024.

Figure 8: Chinese exports vs. expectations



Source: LSEG Datastream. Deutsche Bank AG. Data as of April 17, 2024.

Figure 9: U.S. trade with China and Mexico



Source: LSEG Datastream. Deutsche Bank AG. Data as of April 17, 2024.

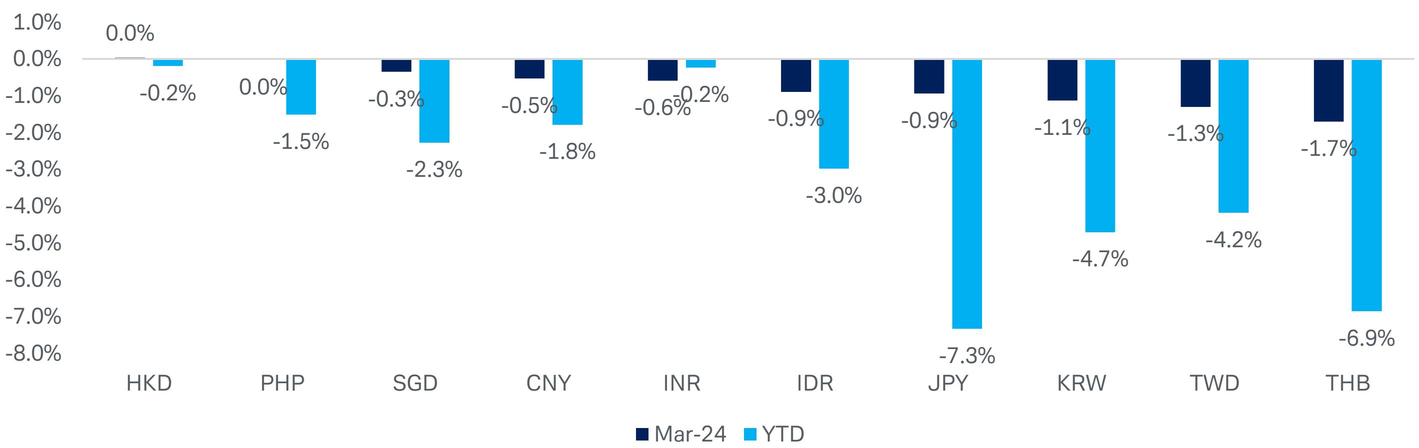
02 CNY and the PBoC

The CNY has depreciated 1.3% against the USD since the beginning of the year. Other Asian currencies have also depreciated against the USD on the back of stronger-than-expected U.S. economic performance. Rising interest rate differentials between the U.S. and China are also likely to weigh on the CNY. Rising geopolitical risk on the back of escalation of Iran-Israel conflict could trigger further USD strengthening, with the currency seen as a safe haven asset.

In summary, depreciation pressures for CNY still exist and our 12-month target for USD/CNY is at 7.35. However, China's willingness to support the currency and a strong forex reserve balance (USD 3.2tn as of March) should provide a comfortable buffer to manage any currency depreciation. However long-term investments have also been returning with net FDI positive in the first two months of 2024 at USD9.2bn.

The People's Bank of China (PBoC) faces a challenging task of stimulating domestic demand and managing currency depreciation concerns. The PBoC kept the one-year medium term lending facility rate unchanged at 2.5% at its April 15 meeting in line with our expectations. Recent macro data including the CPI and PPI numbers and export growth have been underwhelming, highlighting the need for more stimulus measures. Loan growth was also much weaker than expected in March with new yuan loans or 3.09tn vs. estimates of 3.56tn. Developments in the U.S. also remain unfavourable for the PBoC with the Fed pushing back on rate cut expectations amid a surprisingly U.S. resilient economy. This has led to higher rate differentials between the China and the U.S. eventually (as noted above) weighing on the CNY. Monetary loosening could probably lead to more yuan weakness, with the USD continuing to strengthen with rate cut repricing. In the wake of domestic challenges, a relatively weak global growth backdrop and intensifying geopolitical concerns, the PBoC needs to weigh carefully which tools to deploy to stimulate domestic demand whilst counter-balancing external pressures. We expect a reserve requirement ratio (RRR) cut and gradual currency depreciation rather than outright rate cuts.

Figure 10: CNY currency moves YTD

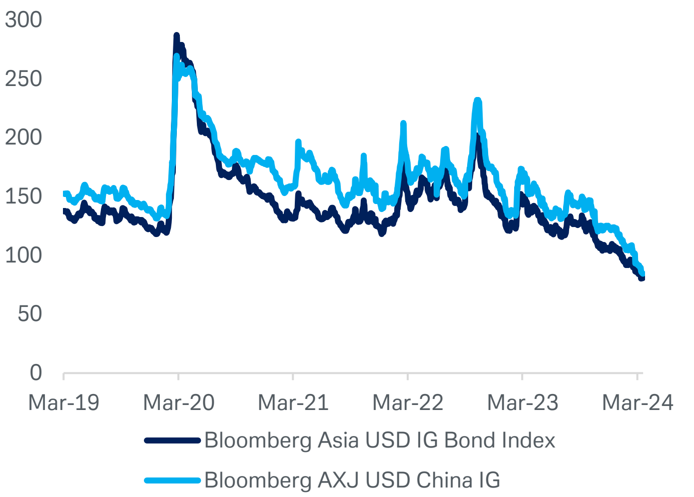


Source: Bloomberg L.P., Deutsche Bank AG. Data as of April 17, 2024.

03 Asset classes

China's credit rating (S&P/Moody's/Fitch: A+ Stable / Aa1 Neg / A+ Neg) remains under downward pressure as two international rating agencies have a negative outlook. Fitch recently revised the outlook for China's sovereign rating to negative from stable and affirmed its A+ rating. Following this move, Fitch also revised the outlook for Chinese state banks, insurers, GREs and leading internet companies to negative as the ratings of these entities are capped by the sovereign rating. Given the stable outlook on rates and negative sovereign rating pressure, we don't see any further tightening as likely for investment grade (IG) spreads, which are already trading tight.

Figure 11: Chinese and Asian IG spreads

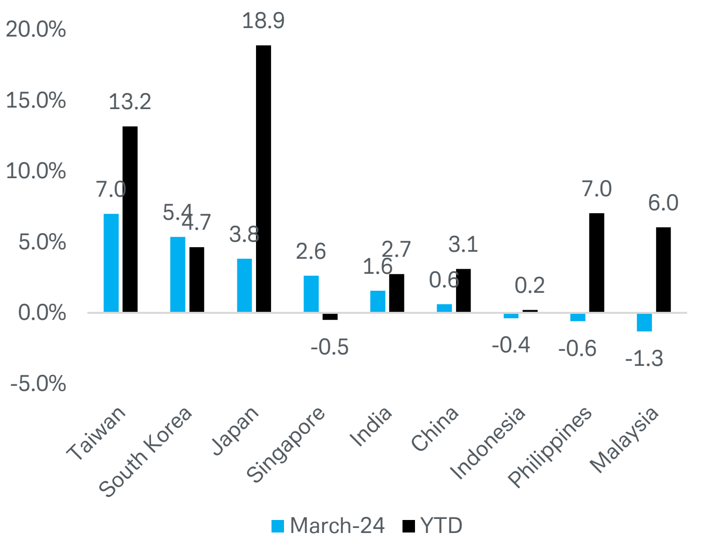


Source: Bloomberg L.P., Deutsche Bank AG. Data as of April 17, 2024.

Stock market reforms are likely to prove a key driver for equities. The State Council last week issued draft rules to promote high quality development of the capital market through the following measures: improving the standards for listing, enhancing corporate governance and information disclosure, intensifying criteria for delisting to protect minority shareholder rights, increase scrutiny of trading activities, increasing supervision of securities and funding institutions, encouraging dividend payouts and promoting medium-and-long term investment in the market. The Shanghai, Shenzhen and Beijing stock exchanges published new guidelines for listed companies based on China Securities Regulatory Commission (CSRC) draft proposal. This is the third round of reforms in the past two decades following ones in 2004 and 2014. The move follows similar moves by the Japan stock exchange in 2023 and South Korea in February 2024.

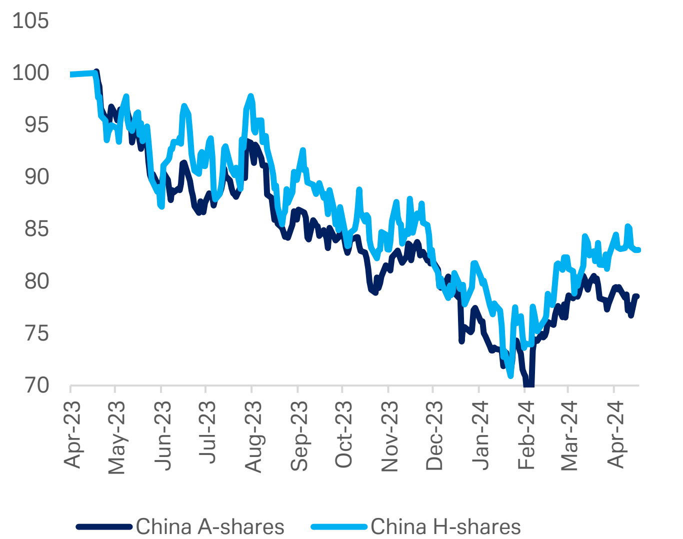
China's equity markets stabilized in February following the regulatory clampdown on short selling and other stimulus measures such as RRR cut and easing of restrictions in the property and gaming sectors. Chinese equities had positive returns in March and YTD returns turned positive as well. However, with risk-off global market sentiment, we see limited possible positive catalysts for Chinese equities in the near term. That said, more sustained domestic macroeconomic recovery, especially of household consumption, and any further fiscal stimulus measures may support sentiment in second half this year. As highlighted in a previous Viewpoint note ("China equities: selective opportunities" published on February 23), opportunities in the consumer discretionary, tech and green energy sectors could become attractive once the domestic economy starts turning around. These sectors seem likely to benefit the most from supportive government policies.

Figure 12: Asian stock market returns compared



Source: LSEG Datastream. Deutsche Bank AG. Data as of April 17, 2024.

Figure 13: Chinese A and H-share trends (April 2023 = 100)



Source: LSEG Datastream. Deutsche Bank AG. Data as of April 17, 2024.

04 Conclusion

China ended Q1 with some signs that government stimulus is working. Domestic sentiment and consumption appear to be picking up, but any improvement needs to be sustained. Property market developments remain in focus. Given low growth and a difficult external economic backdrop (with intensifying debate around U.S./China trade), monetary policy makers will still have to perform a delicate balancing act to stimulate demand. Monetary policy tools such as RRR cuts and currency depreciation are likely to be deployed.

Since we tactically moved to the sidelines in Chinese equities earlier this year (CIO Memo – China equities: closing the tactical trading call), observed data and subsequent market reactions have supported our stance of staying cautious in the short-term. We would re-enter the market when there is a clearer turnaround in macro-economic data, as well as local and international investor sentiment: inflows will follow .

Performance table

CNY is the currency code for the Chinese yuan.

The Consumer Price Index (CPI) measures the overall change in consumer prices based on a representative basket of goods and services over time.

The China Securities Regulatory Commission (CSRC) is a government agency directly under the State Council of the People's Republic of China. It is the national regulatory body that oversees the securities and futures industry in China.

Foreign direct investment (FDI) is a category of cross-border investment in which an investor resident in one economy establishes a lasting interest in and a significant degree of influence over an enterprise resident in another economy.

GRE refers to Government-related entities in China.

Gross domestic product (GDP) is the standard measure of the value added created through the production of goods and services in a country during a certain period.

The National Bureau of Statistics (NBS), is a deputy-cabinet level agency directly under the State Council of the People's Republic of China.

The National People's Congress (NPC) is China's highest legislative body which holds annual sessions in spring to discuss on policy matters.

People's Bank of China (PBoC) is the central bank of the people's republic of China.

Purchasing manager indices (PMI) provide an indicator of the economic health of the manufacturing sector and are based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment. The composite PMI includes both manufacturing and services sectors. They can be published by public sector or private agencies (For example, Caixin, Nikkei etc.)

Producer price inflation (PPI) measures the change in prices received by producers (e.g. firms) for their output.

The Reserve ratio requirement (RRR) determines the amount of cash banks have to keep in reserve with the central bank.

USD is the currency code for the U.S. Dollar.

Performance table

Performance	17.4.2019 - 17.4.2020	17.4.2020 - 17.4.2021	17.4.2021 - 17.4.2022	17.4.2022 - 17.4.2023	17.4.2023 - 17.4.2024
CSI 300	-6.1%	29.3%	-15.7%	-0.9%	-14.1%
Shanghai Composite	-13.0%	20.7%	-6.3%	5.4%	-9.3%
India Nifty	-21.4%	57.7%	19.6%	1.3%	25.1%
Singapore Strait Times	-21.9%	22.5%	4.2%	-0.5%	-5.0%
Indonesia Composite	-28.5%	31.3%	18.9%	-6.2%	5.1%
Philippine Composite	-26.1%	12.2%	7.5%	-6.9%	-0.9%
Taiwan Composite	-3.6%	61.9%	-0.9%	-6.1%	26.6%
Korea Kospi 200	-12.2%	69.6%	-18.2%	-5.6%	5.7%
Kuala Lumpur Composite	-16.5%	16.5%	0.0%	-10.1%	8.2%
Japan Topix	-11.4%	36.6%	-4.8%	6.9%	38.3%
China A Shares	-8.5%	42.4%	-10.7%	-8.5%	-20.9%
China H Shares	-17.2%	12.4%	-33.0%	-4.5%	-18.5%
Bloomberg Asia USD IG (Spreads)	98.9%	-43.0%	-4.0%	-7.2%	-39.9%
Bloomberg AXJ China IG (Spreads)	69.7%	-22.9%	-15.4%	-7.4%	-45.3%
USD/HKD	1.2%	-0.3%	-0.9%	-0.1%	0.2%
USD/PHP	1.7%	5.1%	-7.4%	-6.7%	-2.3%
USD/SGD	-4.9%	6.6%	-1.6%	1.7%	-1.9%
USD/CNY	5.8%	-7.8%	-2.3%	7.9%	5.3%
USD/INR	10.3%	-2.6%	2.4%	7.4%	9.7%
USD/IDR	9.5%	-5.6%	-1.5%	3.1%	9.7%
USD/JPY	-4.1%	1.2%	16.2%	6.4%	14.8%
USD/KRW	NA	-8.3%	9.7%	7.1%	5.8%
USD/TWD	-2.6%	-5.7%	2.3%	5.2%	6.5%
USD/THB	2.5%	-4.2%	7.8%	2.1%	7.1%

Source: LSEG Datastream. Deutsche Bank AG. Data as of April 17, 2024.

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