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Global Strategy

INVESTMENT TEAM

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My Iron Lung

On Monday China will release Q2 GDP growth numbers, which after the trade figures released last week, are likely to come in on the disappointing side of expectations. The Q1 print came in higher than expected at 6.4% annual growth, but that is likely to slow to something just over 6% in this Q2 release. Last week's trade numbers showed that US tariffs are starting to bite, and that export growth is slowing, but more worryingly so too is import growth into China, and by more. While that is good news for the Chinese trade surplus, it is bad news for the economy because slower import growth is likely to signal weakening domestic demand. While the Chinese economy seems likely to have slowed somewhat in Q2 this year, it is far from requiring life support, but another adrenalin shot in the arm now seems likely.

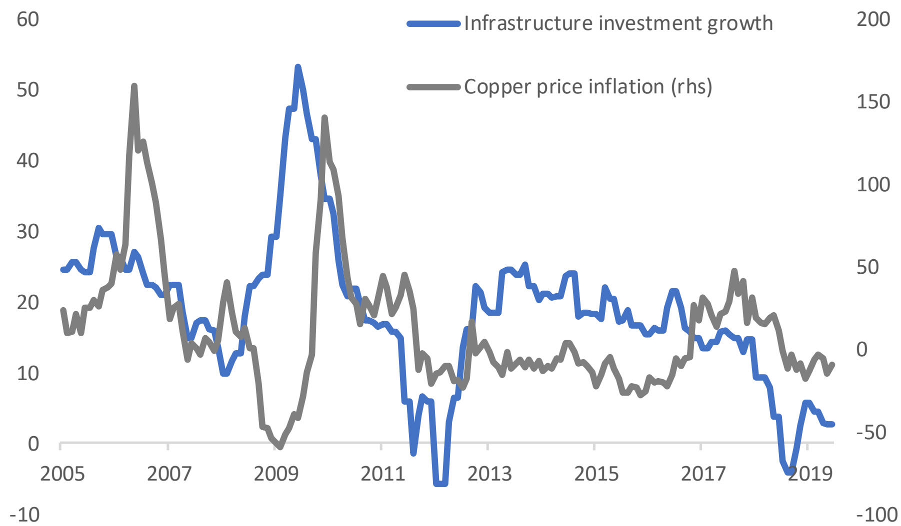
What form might that stimulus take? We have already seen 6 cuts to the Reserve Requirement Ratio (RRR) in the past year, with special targeting of smaller rural banks with a lower RRR than their larger counterparts. There are some signs that this is encouraging lending to smaller enterprises, but more is needed. Small business growth is unlikely to support fading domestic demand growth, nor will it stave off deflation in producer prices which seems like an increasingly likely prospect. While the growth challenges are not insurmountable, they are not trivial either. It may now be time for policy makers to set aside longer-term ambitions of rebalancing economic growth to achieve shorter-term goals and meeting growth targets in the wake of a trade dispute with the US. That may mean we will soon see a cut in the Chinese benchmark interest rate, perhaps timed to coincide with a likely move in US rates?

More likely, however, is a return to the old ways of infrastructure spending. Last month the Chinese authorities announced plans to increase local government bond issuance to support key areas and major projects. The government has shown flexibility in changing the rules on project financing in the past, and more flexibility along with this announcement on bond issuance might just provide a significant boost to infrastructure investment in a timely support to domestic demand growth. Policy makers have been successful in the past, seeing off hard landing threats several times through this cycle already, and this time should be no different.

Figure 1 shows the relationship between Chinese infrastructure investment growth and copper price inflation. It is not a perfect relationship, but it shows that higher rates of investment growth usually feed through directly into higher copper prices. Ironically, the likely weaker growth in Chinese second quarter GDP growth may well be taken as positive catalyst for copper and industrial metal prices more generally. The lower the growth print, the more likely the stimulus, and the more likely it will include infrastructure spending support.

The Chinese economy, like the US economy, has shown resilience and is not in need of life support, but it has entered a softer patch of growth. That is likely to have been at least partly induced by the technology and trade dispute with the US. Perhaps now, we will see the worlds second largest economy following a Fed if it makes a dovish pivot. Watch out for near term support for industrial metal prices, and the miners more generally on a weaker set of Chinese growth numbers this Monday.

Figure 1: Chinese infrastructure investment growth (yoy, %)



Source: Bloomberg, Canaccord Genuity Wealth Management