The recent data disappointments did not change narratives about China

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- **China's zero tolerance approach towards Covid-19 is the key catalyst for short term disruption.**
- **But China's domestic drive to technology self-sufficiency and pause of supply chain shift remain supportive.**
- **Infrastructure investment is likely to be a 2022 story.**
- **Two news challenges arising from global chip shortage and uncertain property outlook.**
- **Despite the drag on China's growth, Chinese government is unlikely to roll back its curb in property market. This may create downside risk to China's growth. But we are in no rush to revise our GDP forecast.**

China's August economic indicators certainly disappointed with consumption missed the forecast by a big margin. You probably have read negative headlines from the major newswires in the past 24 hours. Nevertheless, after looking at the industrial and sectoral breakdowns of those major indicators in details. **My takeaway from those numbers is that they have not changed the narratives about China's economic fundamental though two new challenges have been confirmed.** In this article, we would like to discuss current four narratives about the Chinese economy and two new challenges in more details.

Part 1: Four narratives

There are currently about four narratives about Chinese economy. First, China's zero tolerance approach towards Covid-19 means more short-term disruption to economic activities. Second, China's road to technology self-sufficiency means more investment in high-tech industries. Third, the recent outbreak of delta variants in ASEAN may prolong China's first in first out benefit with the pause of supply chain shift. Fourth, infrastructure investment is likely to be one of the main drivers to Chinese growth in 2022.

1)Impact of zero tolerance.

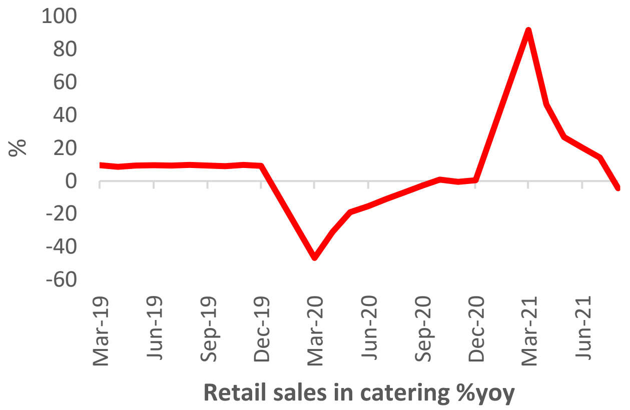
Retail sales was the weakest link in August. On two-year average, retail sales growth decelerated to 1.5% yoy from 3.6% yoy in July. The sharp deceleration of retail sales was mainly attributable to two factors including the decline of catering sales and weak car sales. Catering sales fell by 4.5% yoy in August, down sharply from growth of 14.3% yoy in July, the first decline in 2021. This is not surprising given the falling mobility as a result of the sporadic delta variant outbreak across more than 15 provinces in early August. We will leave the car sales to the discussion later in part 2.

In addition, China's air passenger travels in August fell by 51.5% yoy to 22.41 million and was only about 36.6% of that recorded in August 2019 according to data from the Civil Aviation Administration of China. The decline was due to the resurgence of Covid-19 in late July and early August.

Although the booking data from online travel agencies showed the number of air passenger trips will rise notably according to CAAC official, the hope for the air travel to recover in the upcoming two festivals including Mid-Autumn long weekend from 19-21 Sep and the National Day golden week from 1-7 Oct may be dampened by the recent resurgence in Fujian Province.

Chart 1: China's retail sales on two-year average slowed down

Chart 2: Retail sales in catering declined in August due to virus outbreak



2) Domestic drive to technology self sufficiency

Fixed asset investment was largely in line with expectation in August. The deceleration of property investment and infrastructure investment was partially offset by strong manufacturing investment. Fixed asset investment in manufacturing sector increased by 15.7% yoy in the first eight months. On two-year average, it grew by 3.3% yoy, up from 3.1% yoy in the first seven months. Of which, fixed asset investment in high-tech sectors increased by 13.4% yoy on two-year average on the back of China's industry upgrade and pursuing tech self-sufficiency.

Meanwhile, high-tech manufacturing production accelerated to 18.3% yoy in August, highest since the data was published in 2018. We think China's road to technology self-sufficiency is likely to put the floor on growth.

Chart 3: Fixed asset investment in manufacturing remained resilient

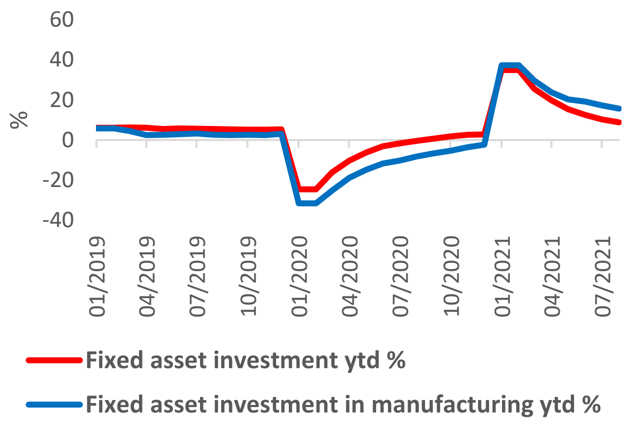
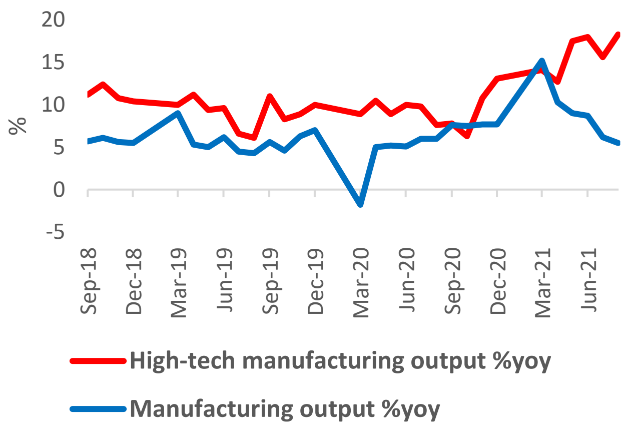


Chart 4: Growth of high-tech manufacturing output hit a record high since the launch of data in 2018



3) External demand remains supportive

China's goods trade continued to surprise on the upside in August with total trade hit a record high of US$530.3 billion. External demand from G3 economies remained strong probably due to replacement demand for products from other parts of Asia. On production, pharmaceutical production reaccelerated to 32.9% yoy in August, second highest in record.

The strong demand for computer, communication equipment and electronic equipment also supported resilient investment in those sectors as shown by chart 6 below.

Chart 5: Pharmaceutical Output remained strong on the back of strong external demand

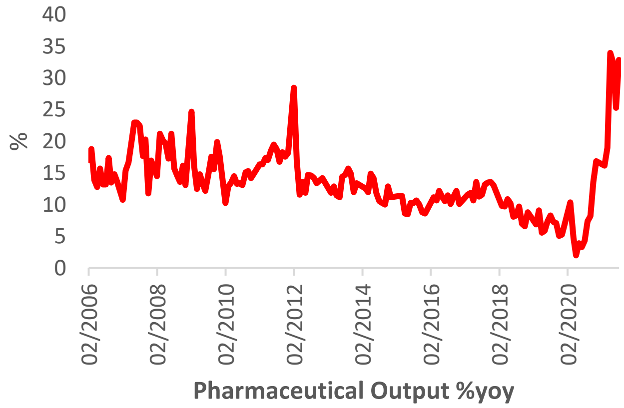
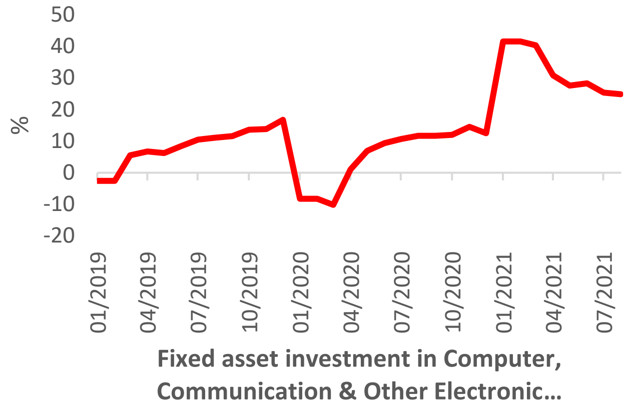


Chart 6: Resilient investment in manufacturing of computer communication equipment.

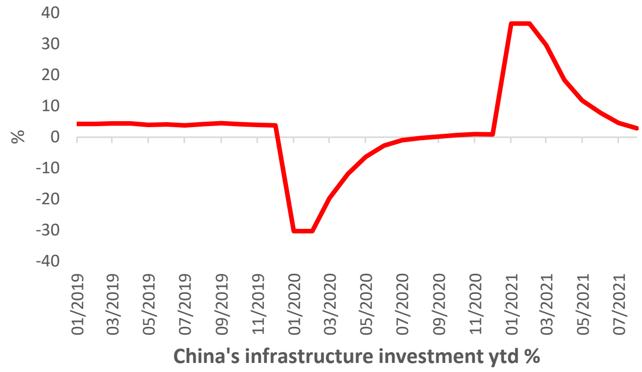


4) Infrastructure investment is not a 2021 story

Despite acceleration of local government special bond in August, which net increased by CNY951.4 billion, infrastructure investment growth continued to decelerate to 2.9% yoy in the first eight months from 4.6% yoy in the first seven months. On two-year average, infrastructure investment only grew by 0.2% yoy in the first eight months. This probably showed the lagging effect from the issuance of government bond to infrastructure investment. In addition, China's cleanup of hidden debt of local government may also dampen appetite for investment.

Nevertheless, given the pace of issuance of local government special bond is likely to double in the last four months of 2021, we think there is room for infrastructure investment to reaccelerate. But this is likely to be the 2022 story.

Chart 7: Infrastructure investment failed to pick up



Part 2: Two new challenges

However, the Chinese economy is also facing two new uncertainties arising from the recent global chip shortage and China's property tightening measures.

1) Chip shortage

The recent outbreak of delta variant in Malaysia has not only affected Malaysia economic outlook but threatened to prolong global chip shortage as well. The disruption from the chip shortage has affected both car production and sales in China.

The deceleration of industrial production in August was partially attributable to sharp decline of car production as a result of chip shortage. Auto production fell by 12.6% yoy. In addition, China's Auto retail sales in August fell by 7.4% yoy. Retail sales excluding car sales increased by 3.6% yoy, better than 2.5% headline growth. Other than demand issue, the supply disruption could also be responsible for weak car sales.

Chart 8: Automobile output fell

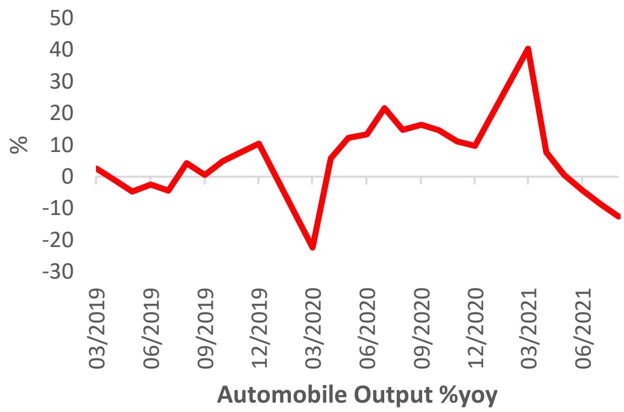
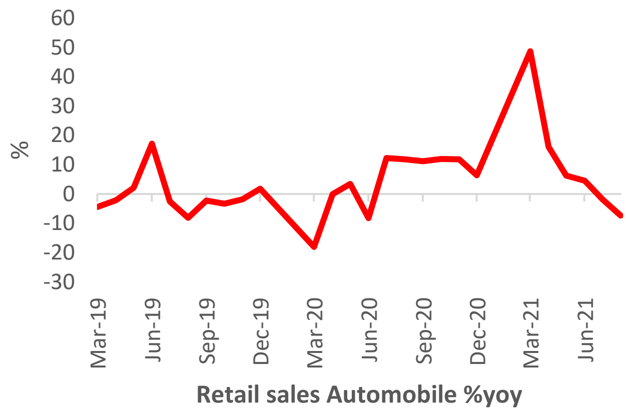


Chart 9: Car retail sales also fell



2) Softening property market

Fixed asset investment in property sector continued to moderate. On two-year average, property investment slowed down to 7.7% yoy in the first eight months from 8% yoy in the first seven months as a result of tightening measures.

All property related data in August pointed towards further slowdown in the coming months. Property sales fell by 15.5% yoy in the month of August probably (Chart 11) due to tightening mortgage standard. Floor space started in August fell by 16.8% yoy while floor space completed rose by 28.4% yoy in August (Chart 12). The divergence between floor space started and completed showed the increasing funding pressures for developers. Therefore, developers have to accelerate the completion and slow down the new projects to recycle their capitals. As such, it is not surprising to see land purchased by developers in August fell by 13.9% yoy (Chart 13). Looking ahead, the need to recycle capitals to avoid credit events may indicate loss of momentum of property investment in the coming sessions. This may create additional downside risk for China's growth.

Chart 10: Property investment growth has peaked

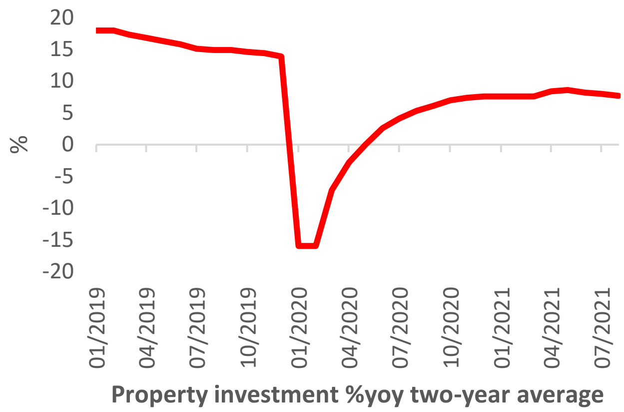


Chart 11: Property sales slowed notably in August

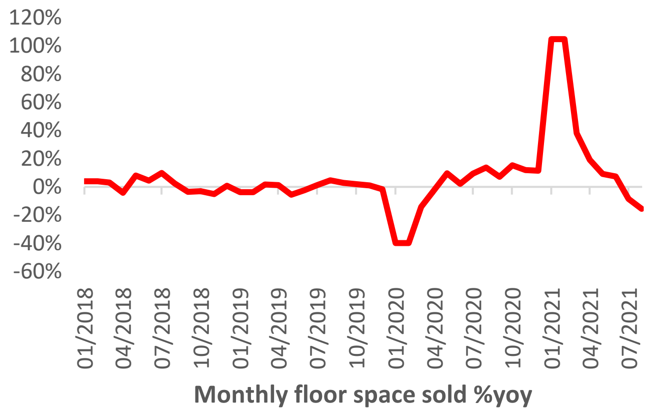


Chart 12: Rising urgency to recycle capital

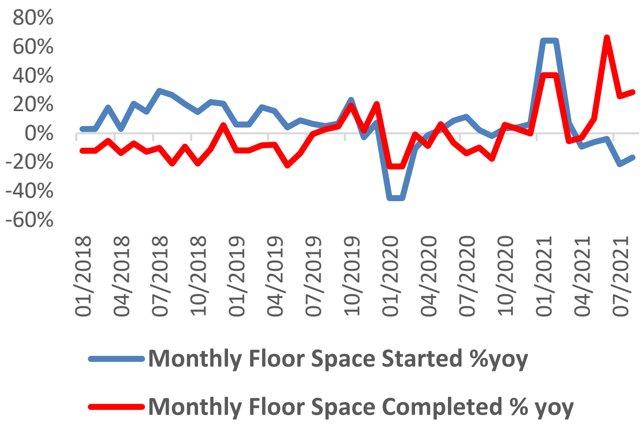
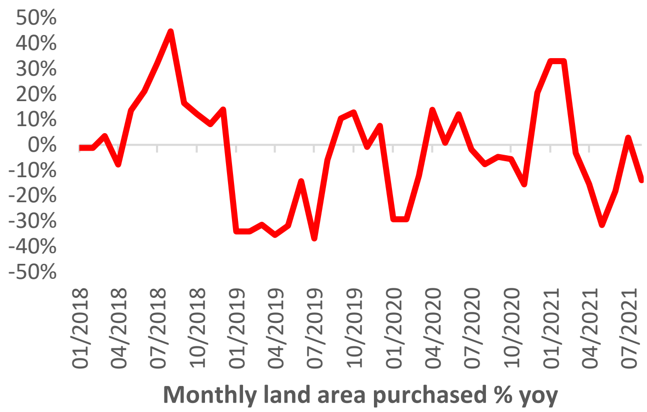


Chart 13: Falling demand for land purchase



To sum up. China's domestic drive to pursue technology self-sufficiency and pause of supply chain shift due to outbreak in ASEAN may continue to offset the negative impact from China's sporadic virus outbreak and chip shortage. The recent moderation in property market is likely to be the cause for concern. In addition, we think despite the drag on China's growth, Chinese government is unlikely to roll back its curb in property market given its goal for common prosperity and rebooting population growth. This may create downside risks to China's growth. **The outlook of China's growth in the last quarter and 2022 will probably hinge on whether infrastructure investment is able to pick up to offset the loss of momentum in property space.**