China’s global impact
How China’s monetary policy is changing the global outlook
UBS Asset Management

The smart money is moving into China fixed income: overseas investors were the top buyers onshore in May and boosted their holdings 94.9% year-on-year (y-o-y). Looking at our flows, EU and Japanese clients are dominant and that’s hardly surprising considering the low-to-zero yields in their domestic markets.

This is largely due to the fact that China fixed income has been a top performer this year, rewarding investors with diversification and strong performance versus global markets. Looking ahead, we continue to see it as an interesting area to invest tactically and strategically, particularly as the outlook for the global economy is expected to change, and that’s because of China.

Firstly, a word on trade
Thinking about global strategy, we’re prepared for a lot of noise on the China-US trade relationship which we expect to see all the way into the US midterm November elections.

Initially, Trump’s focus on the US-China merchandise trade deficit misses the sizeable surplus in services, notably Chinese tourism.

Secondly, there’s the issue of what impact US-China trade tensions will have on the global economy. This isn’t a hard Brexit-style structural change in the trading relationship, but we view it as ongoing tensions between two countries that ultimately can’t survive without each other.

Finally, focusing on trade issues misses out what’s really impacting the global economy, and for that you have to look at how China is conducting monetary policy.

China has been tightening monetary policy over the past 18 months, and that’s meant clampdowns on shadow banking, controls on wealth management products (WMP), curbs on local government debt and limits on real estate lending.

Domestic trends matter
How this policy impacts the domestic economy directly translates into global growth and signs of a domestic slowdown are becoming obvious.

We’re seeing a growing number of defaults onshore in China because new regulations don’t allow certain borrowers from funding in loan or bond markets and are putting smaller joint stock, city commercial and rural banks under pressure in the wholesale funding markets we invest in.

As credit policy has tightened, so money supply growth has slowed noticeably, feeding into much weaker growth in fixed asset investment (FAI) (see Exhibit 1).

Exhibit 1: FAI and M2 growth (%-YoY 3M MA), Jul 2008-Apr 2018

Source: Bloomberg, May 2018.
Importantly, FAI is the bedrock of China’s economy, accounting for 50.6% of total GDP in Q1 2018 and when growth slows in this segment the outlook typically deteriorates for China.

**A closer look at the ‘new economy’**

While it’s true that the above indicators give an insight into old economy drivers, data from ‘new economy’ indicators suggests the slowdown is more widely felt.

The services sector which has been the key to the growth of China’s new economy, has slowed this year, with 7.5% y-o-y growth in Q1 2018 lower than the 8% reported in 2017, the 7.7% reported in 2016, and 8.2% reported in 2015.

Looking more closely at the services sector (see exhibit 2), IT services is the dominant subsector (worth 18% of total services output) and is a capital, rather than labor, intensive industry.

In most subsectors y-o-y growth has been flat to down, hence we caution interpreting from a western lens the robustness of the service sector. We feel the manufacturing, capex heavy, large employers and those still heavily reliant on credit are the key driver of China’s economic cycle.

And the slower growth that we’re seeing in both the old and new economy sectors is now transferring overseas.

**China’s credit policies have global significance**

Our Global Credit Impulse (see exhibit 3), which measures global credit growth, shows a marked retraction from precisely the time that China started tightening monetary policy in late 2016.

This marks a change from Q3 2014, when China expanded credit to boost the economy and laid the foundation for the upturn in global economic growth in 2016 and 2017.
Because monetary policy takes between nine to 18 months to directly impact the real economy, the China-driven drop in global credit growth that took hold in H2 2017 is now going to impact official bell weathers of global growth, challenging the street’s view of a global synchronized growth upswing.

Take our tracking of global credit growth, China imports and world industrial production (IP). When China boosted global credit growth in late-2015/early-2016, imports and world IP picked up (see exhibit 4).

Now that the deleveraging policy which started in early 2017 is being felt, growth momentum is stalling and we’re expecting weaker import demand and global IP through 2018, and we believe trade tensions will only exacerbate this cycle and dampen business confidence.

When we dig into data from China’s key regional trading partners for clues and correlations with the global cycle we see similar patterns that indicates warning signs.

For example, when looking at South Korea’s export sector, yoy growth in exports are closely tied to China and has been a good lead on global EPS growth. That’s starting to drop now, which may impact forward-looking EPS assumptions (see exhibit 5).

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**Exhibit 4: China imports & world industrial production (YoY-%), Mar 2013-Mar 2018**


**Exhibit 5: South Korea exports & global EPS, Jan 2005-May 2018**

Source: Bloomberg, May 2018.
The Eurozone is also starting to feel the impact of China’s slowdown. China is the EU’s second largest trading partner and growth has slowed markedly so far this year, entering negative territory in February and March and pushing our three-month moving average of trade growth numbers towards zero (see exhibit 6).

The outlook for H2 2018 and into 2019
So, we expect China’s approach to monetary policy means slower growth in China and the world economy through H2 2018 and into 2019.

Recent cuts to reserve-requirement ratios show limited, targeted support but should not be interpreted as a sign of monetary loosening.

We see very little likelihood that the Chinese government will roll back on its tough monetary policy line. President Xi Jinping himself cited financial risks as ‘a critical battle’ for the future and with his people in place at the top of the party, we can expect tough credit policies to continue, on top of the WMP, local government, and real estate curbs amid soaring house prices, already seen.

This implies slower growth, but China’s leaders seem comfortable with it. Premier Li Keqiang mentioned that unemployment might grow this year and recent news shows the government is getting more comfortable with defaults, with news that 19 companies have been allowed to default so far this year.

Ultimately, China’s tough line is good for the economy’s long-term sustainable growth. Ridding the financial system of its debt overhang and reforming the way it allocates capital will change the way the economy operates and promote efficiency, as well as new industries.

But with a slower economic outlook in the next 12-18 months, investors need to prepare accordingly, and there’s a strong outlook for China fixed income. This category has been the standout performer in global fixed income markets so far in 2018, and with China’s continued tough line on monetary policy, and a slowing economy, they make a compelling investment for the future.

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**Exhibit 6: EU exports to China (YoY%, 3M MA)**

![Graph showing EU exports to China](source: Bloomberg, May 2018)

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**Exhibit 7: Global bond aggregates YTD return (%)**

<table>
<thead>
<tr>
<th>Bond Category</th>
<th>YTD (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>EM USD Aggregate</td>
<td>-3.76</td>
</tr>
<tr>
<td>Global HY</td>
<td>-2.04</td>
</tr>
<tr>
<td>Global Inflation-Linked HY</td>
<td>-1.92</td>
</tr>
<tr>
<td>Global Aggregate</td>
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</tr>
<tr>
<td>US Treasury</td>
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<tr>
<td>Pan-European HY</td>
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<tr>
<td>US Corporate HY</td>
<td>0.57</td>
</tr>
<tr>
<td>China Aggregate</td>
<td>3.88</td>
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</tbody>
</table>

*Source: Bloomberg, June 26, 2018*
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