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China: Q2 GDP confirmed steady recovery

Key take aways

- China's Q2 GDP turned positive at +3.2% YoY, a sharp turnaround from Q1 and higher than consensus.
- We think China's recovery could shift from production to household consumption in H2. Meanwhile, the U.S.-China trade tensions, any rise of COVID-19 infections again and the summer floods could affect the growth.
- We remain constructive on Chinese equities and credit with the steady economic recovery and government's pro-growth policies.

1. What happened?

China's GDP expanded 3.2% YoY in Q2, higher than market expectations of 2.5% YoY. It was after the sharp decline of -6.8% YoY in previous quarter. China's GDP surprised on the upside with a recovery in production signaling a turnaround from the negative Q1 GDP growth amid the coronavirus headwinds. For the first half of 2020, the Chinese economy stands at -1.6% YoY growth (vs. -2.4% expected).

Key data releases for June were broadly positive, with industrial production rising in line with expectations at +4.8% YoY and fixed asset investment at -3.1% YoY (vs. -3.3% expected). However, despite the resumption of the economy in Q2, retail sales disappointed expectations with -1.8% YoY (vs. 0.5% YoY expected).

On the trade front, exports grew by 0.1% in Q2, mainly thanks to global demand for personal protective equipment and pharmaceutical products. Imports contracted 9.7% during the quarter, but were up 2.7% in June (up from -3.3% in May). This is mainly attributed to demand for electronic components and commodities.

2. How did markets react?

Asian markets traded lower today, despite the positive GDP figure. The Shanghai Composite Index declined 4.5% and Hong Kong's benchmark, the Hang Seng Index declined 2.0%. This could be more attributed to market concerns over PBoC's possible monetary tightening measures with the solid economic recovery. The Chinese Yuan exchange rate depreciated slightly by 0.14% to 6.9987 on the day.

3. What does it mean for investors?

We think the higher-than-expected GDP data in Q2 was an indication that the country's handling of their COVID-19 caseload is now fostering a steady recovery. China's rebound was driven by the improving industrial production and construction activities. Industrial capacity utilization rose to 74.4% in Q2 compared to 67.3% in the previous quarter. Construction activities were backed by increased government expenditures in infrastructure spending and the property sector. The export sector trend was also improving in recent months, with the reopening of other major economies, including the U.S. and Europe since May.

Looking ahead, we think China's recovery would likely spread from industrial production to household consumption in H2 of this year. The government further loosened its travel restrictions across provinces and eased the rules in the entertainment industry for things like cinemas. As the economy continued to recover, we think labor market conditions could improve, starting with household incomes leading to broader consumption. We expect China's growth to recover back to their trend growth of 6%-7% in H2 this year. Meanwhile, the key risks could be 1) the summer flood situation at Yangtze river could affect the infrastructure and Capex investments in Q3; 2) any increased risks of COVID-19 infections as we enter the colder months of the year in Q3 and Q4; 3) any deterioration of U.S.-China trade tensions in H2.

We remain constructive on Chinese equities and credit. We think the Chinese equity market could likely outperform because of the faster recovery of the economy along with the index's current composition which contains a higher weight of "new economy" companies. The valuation of Chinese equities is also lower compared to those of other emerging markets and developed markets. We favor the information technology and healthcare sectors given their structural growth stories. We also like the cyclical sectors (such as consumer discretionary, industrials) with the economic recovery.

We are also constructive on Chinese credit. We think credit spreads could continue to tighten in general, but investors become more selective. We think investors should consider the high-quality short-dated bonds in the current environment, as the long-term global outlook and monetary policy environment are still uncertain.

We think the continued economic recovery and government's stimulus measures should support the outperformance of Chinese equities and credit. Meanwhile, we suggest a diversified portfolio under strategic asset allocation approach in the current uncertain environment.

Glossary

CNY is the currency code for the Chinese yuan.

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

The Hang Seng Index (HSI) includes the 50 largest companies traded on the Hong Kong stock exchange.

The People’s Bank of China (PBoC) is the central bank of the People's Republic of China.

The Shanghai Composite Index contains all shares traded on the Shanghai exchange.

A strategic asset allocation process involves setting preferred allocations for asset classes on a medium to long-term time horizon.

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