
# Dosage Adjustment

# 105 – 20 September 2021

## Key points

- China is slowing down, but it has ample policy space to re-start
- Uncertainty continues to mount on the next steps for Biden's fiscal plans
- European Central Bank (ECB) communication sounding very confident – the market is taking notice

A cluster of disappointing data suggest the Chinese economy is slowing down significantly, and it is starting to show in European exports. It is not the first time China goes through a "bad patch" since it has become a crucial source of traction for global trade. In 2015 already, Chinese demand softened, with a transitory but visible impact on German GDP. This time as well, bad news on the cyclical front is compounded by financial stability concerns.

Our baseline is that there is ample policy space in China to re-start the economy swiftly, and that Beijing has no interest in allowing "warning shots" to the over-leveraged real estate turning into a systemic crisis. The Chinese government has to constantly find the right dosage between addressing the imbalances of its economy and the sources of social tension– which sometimes implies a transitory cost to growth – and supporting the improvement in living standards which is also key to preserving political stability. The pendulum has gone too far in favour of the first goal recently, and some adjustment in the dosage is needed.

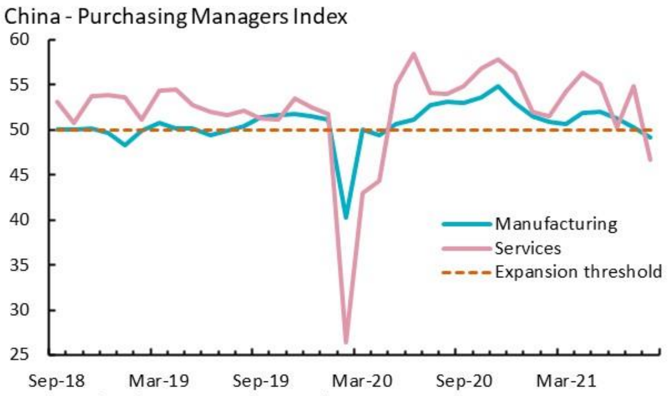
Meanwhile, in the US the data flow last week has been decent, but we suspect the publication of the next payroll data on 8 October will be a big test. In the meantime, the market is likely to focus on the latest fiscal developments in Washington DC. Biden is having difficulties with his own party to get his USD3.5trn over the line.

Between the slowdown in China and the uncertainty in the US, policymakers everywhere should be extremely cautious. We thought Lagarde had found the right balance at her last press conference between welcoming the good news on the European dataflow and keeping an otherwise non-committal approach to any policy normalization. However, since then the communication from the ECB has been very confident, triggering some market movement. The expected timing of the first ECB rate hike has been brought back to late 2024: the impact of the surprisingly dovish revised forward guidance unveiled in July has been entirely lost.

## Chinese slowdown redux

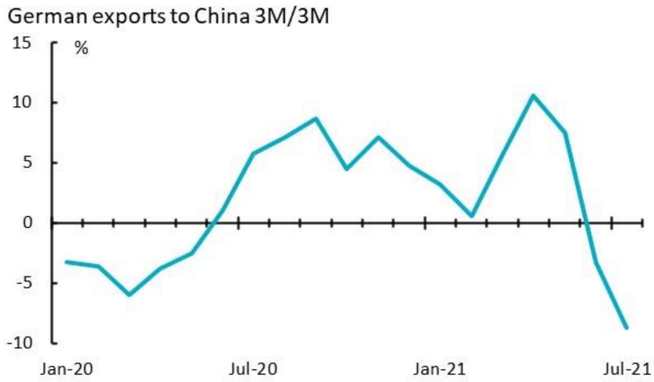
**For a change, investors may focus more on cyclical developments in China than in the United States, with questions on financial stability over there adding to the concerns.** The last weeks have come with a steady flow of disappointing data releases. The Purchasing Managers Index (PMI)s fell into contraction territory in August in both manufacturing and services (see Exhibit 1), while retail sales and industrial production came out below expectations and decelerating from July. The slowdown in Chinese activity is starting to affect the performance of key economic partners. Trade data can be very volatile, but when smoothing seasonally adjusted German exports to China over three months, a steep decline has emerged since June (see Exhibit 2). This will hurt.

Exhibit 1 – It's getting very soft…



Source: Markit and AXA IM Research, September 2021

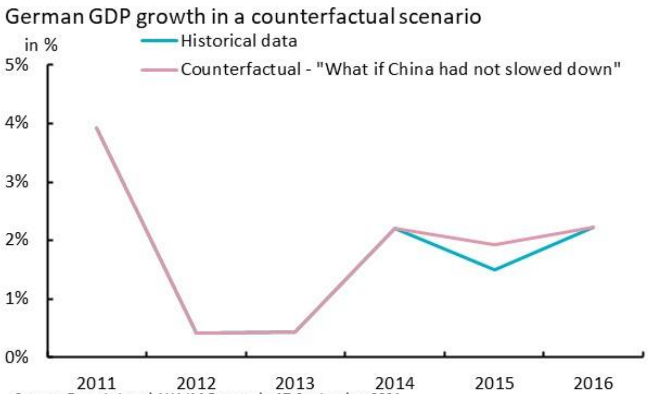
Exhibit 2 – …and it is already showing outside China



Source: Bundesbank and AXA IM Research, September 2021

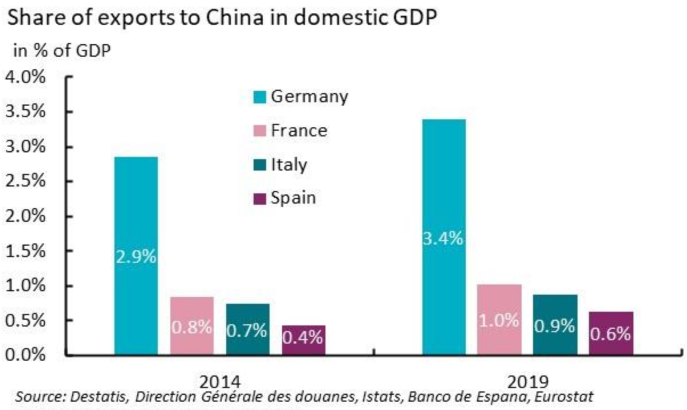
**This is not the first time the world economy has to deal with a "bad patch" in China since it became a key source of traction for global trade**. We have often commented in Macrocast on the role Beijing accepted to play in 2009 to offset the global recession. However, one of the consequences of China's economic outperformance then had been a significant appreciation in its currency (+25% against the dollar from 2007 to 2015). Although the government strategy at the time was – already – to rebalance its economy towards domestic demand and consumption in particular, China's export performance had started to deteriorate markedly, enough to take the manufacturing sector and domestic investment along. In August 2015 – when China stunned the market with a surprise devaluation in its currency – its manufacturing PMI had fallen to 47.1. Moreover, on the domestic side the post-2009 stimulus combined with the emergence of mass access to financial markets had pushed the valuation of assets unsustainably high, resulting in a steep correction of the equity market in the summer of 2015.

Exhibit 3 – It hurt in 2015



Source: Eurostat and AXA IM Research, 17 September 2021

Exhibit 4 – China's impact even higher today



Source: Destatis, Direction Générale des douanes, Istats, Banco de Espana, Eurostat and AXA IM Research, 17 September 2021

**The impact of the 2015 "Chinese bad patch" was visible on the German economy.** We can build an illustrative counterfactual German GDP by keeping for 2015 the average growth rate in German exports to China observed over the previous 10 years (14%), instead of the actual data – it troughed at -8.3% in Q3 2015. Using this simple approach, the Chinese slowdown directly shaved 0.3% off German GDP growth in 2015 (see Figure 3). It is probably a conservative quantification, since this calculation does not consider the second-round effects from lower Chinese demand on German exports to third countries and on German investment and employment. Since 2015, the Chinese market has become even more important (see Exhibit 4). The same shock today would thus mechanically leave a deeper imprint on Germany's growth rate. Losing roughly half a point of GDP to a Chinese slowdown looks small when compared to the massive gyrations in GDP observed since the beginning of the pandemic, but it would be significant in normal circumstances given the "cruise speed" of the German economy (its potential growth rate does not stand markedly above 1%). In a first-round view, the replication of the 2015 "bad patch" would only have a marginal impact on the other big Euro area economies which remain much less reliant on the Chinese market, but they would quickly feel some consequences of a less dynamic German export machine given the intensity of trade integration in the European Union (EU).

This time Chinese exports are one of the rare bright spots in the Chinese data flow and there is no pressing need to change the FX regime, but otherwise the resemblance in the trajectory in soft data and some features of market turmoil between the current slowdown and the 2015 is uncanny. Your humble servant remembers the kilometers of op-eds hastily written at the time arguing the Chinese economy was in for a long and painful adjustment. However, with a few fits and starts, by the spring of 2016, the improvement was significant. **We consider that this time again Beijing's policy space is wide enough to re-start the economy quite swiftly.** The Chinese government must constantly find the right dosage between addressing the imbalances of its economy and the sources of social tension – which sometimes implies a transitory cost to growth – and supporting the improvement in living standards which is also key to preserving political stability – its ultimate goal. Some adjustment in the dosage is needed.

## Time to hit the "pause" button?

**The current loss of altitude in Chinese domestic demand is largely self-inflicted.** We've been discussing in Macrocast since the middle of last year Beijing's choice not to "over-stimulate" in response to the pandemic crisis, which has resulted in a lingering weakness in consumer spending. The cyclical cost of the Chinese government's focus on containing runaway leveraging behaviours may be too high.

**The interplay between cyclical and financial stability concerns is always key to understand Chinese policymaking**. In 2015, some domestic policy actions contributed to ignite the market downturn, for instance a probe into the interbank market to curb leverage, followed by a clampdown on margin trading in the stock market, not dissimilar to today's crackdown on some speculative activities. Beyond the short-term relief it triggered for Chinese exporters, the currency devaluation of 2015 was presented as an essential step in a process of partly liberalizing the capital account and moving towards a more market-based management of the currency which was itself a key plank of the wider economic reformist agenda at the time. This was de facto saluted by the International Monetary Fund (IMF) which included the Chinese currency in its basket of reserve currencies in 2016.

Not all of the ongoing slowdown can be traced back to policy decisions – the resurgence of the pandemic in China triggering the return to tough mobility restriction measures on a localized basis of course played a role – but restraining policy support since 2020 as well as the ongoing volatility-inducing regulatory push are no doubt complementary aspects of a conscious strategy. What is the current policy agenda? Our colleagues Aidan Yao and Shirley Shen have just written a very compelling piece on the recent regulatory sweep in China, with action in four different realms: (i) de-risking the economy; (ii) ensuring fairer competition; (iii) better controlling data and (iv) promoting social equality and addressing China's demographic challenges. **Their common denominator is that they all respond to the Chinese leadership focus on "common prosperity"** in their search for a more inclusive and social stability-supporting economic model which may imply some sacrifice on intensive growth. To take a concrete example, China's property boom has of course boosted growth, but far-rising home prices are contributing to inequality and social tension. Curbing unfettered growth in this sector combines political and financial stability objectives.

**In our view, beyond the political preferences expressed in the "common prosperity" strategy, it may also be that the Chinese leadership is thinking hard about ways to avoid the fate of Japan 30 years ago.** The parallel has its limits of course – Japan is a full market economy which remained a strategic ally of the US even at the peak of their economic rivalry – but there are still some lessons for China. Japan's remarkable economic catch-up in the 1960s and 1970s seemed to threaten the US economic dominance at home, and it is striking how the same texts deploring the loss of the US economic substance to Japanese competitors in the 1980s could be re-used almost word for word today, simply substituting China for Japan. This seemingly irresistible march was however stopped when the accumulated domestic imbalances, notably in the real estate sector, triggered the financial crisis of the late 1980s, ushering in 30 years of unconventional monetary policy to deal with the debt transfer from the private to the public sector.

**It is in this context that we think we need to consider the Evergrande issue.** This is the second biggest real estate company by sales in China, which has run USD300bn of liabilities, and which according to Bloomberg is not going to be able to meet its debt obligations on 20 September. The Financial Times reported that local authorities have already refused to bail out the company. The editor in chief of the state-backed "Global Times" opined last Thursday that the central government should not intervene and let lenders deal with the situation, which has been interpreted in the market as an indication that Beijing is not going to help here.

**Still, dealing with moral hazard in times of cyclical weakness is a delicate art.** While Beijing seems to be ready to send a "warning shot" to other leveraged players in the real estate sector, we suspect the authorities are also keen to avoid systemic contagion, especially as the economy as a whole is softening. Beyond the individual fate of Evergrande, the Chinese government directly controls more levers than its Western counterparts, especially via the banking sector. In a nutshell, **the correction of excess in the real estate sector will have systemic consequences only if the Chinese government allows it**. All this would be consistent with a shift to an accommodative monetary and policy stance and some postponement of the next steps of the regulatory push.

## Bidenomics stuck

**In contrast with China's, the US dataflow was decent last week**, with a retail sales print for August coming out above expectations. This helped dampen the concerns over an erosion of consumers' appetite to spend but digging a bit deeper the message was more ambiguous. US retail sales are not corrected for inflation, so the volume of spending is not yet available, and the July data was revised markedly down. The Michigan survey for September was also released last week and confirmed long-term inflation expectations are not de-anchoring, but the current price spike, combined with the Covid resurgence, may be deterring expenditure**. Looking at the details of restaurant booking data, we find it concerning that cities with a high vaccination rate such as New York still have activity in this sector 52% below the 2019 level** in the first two weeks of September on average, a much steeper decline than what is seen in states with much lower vaccine take-up (only -2.7% in Dallas Texas). The most Covid-aware segments of the population tend to get vaccinated faster…. but may also adjust their consumption patterns to the Covid risk more readily.

Although the number of casualties continues to rise**, there are tentatively positive signs on the circulation of the virus and the number of hospitalizations in the US in the most recent data.** Besides, the impact of the inflation spike on purchasing power should remain small in comparison with the quantum of cash accumulated by households since the beginning of the crisis. As of July 2021 (last available data), the cumulative excess saving (which we estimate as the difference between the observed personal savings ratio since March 2021 and the post-Great Financial Crisis average of 7.2%) has reached 22 months of "ordinary savings" and nearly 3 months of consumer spending. Yet, it may take time before we get clarity on the underlying strength of the US economy.

**We suspect that for the market the next big test of the US economic health will be the release of the September payroll on 8 October**. We are still puzzled by the intensity of labour shortages given the size of the employment gap relative to before the pandemic which remain to be plugged. While the impact of the generalization of the termination of the federal unemployment benefits will materialize in the October data only, the drop in the unemployment rate between June and August in the 25 states which terminated the top-up early has not been different from the national average (-0.25 percentage points). This casts a doubt on the capacity of this particular supply-side issue to explain much of the "labour puzzle. True, looking for a simple correlation is overly simplistic.

Incentivizing unemployed people to take back jobs by removing benefits may have collided with a higher-than-average drop in the demand for labour in Republican states which have been hit hard by the delta variant. Yet it is fair to say that for now no overwhelming explanation has emerged. **We suspect immigration patterns may have played a role**: some of the worst-performing sectors at the peak of the pandemic, such as hospitality, employ a disproportionate share of immigrants, who may have left the US during that phase and it may take time to get them back on the US territory but, while anecdotal "evidence" abounds, real-time immigration data is scarce.

Whatever the source of the current "employment puzzle", we highlighted two weeks ago the extreme volatility in the data, which helped limit the market reaction to the disappointing August print, but two bad monthly prints in a row would probably raise the alarm. **We are also mindful of the latest developments on the fiscal side in the US, or rather lack thereof.** While the market has probably become very blasé when it comes to the now regular "debt ceiling drama", Joe Biden's difficulties with his big USD 3.5trn structural package matter. Over its 10-year course, the programme is in principle fiscally neutral, but the immediate spending boost and the fact that most of the tax hikes would be levied on those at the highest levels of the income ladder – and hence with a lower propensity to consume – would help prolong the current stimulus. The Democrats' marginal majority in Congress is proving to be a problem there, with moderates such as Manchin and Sinema demanding a downward adjustment of the spending plan (Manchin has mentioned a limit of USD 1.5thrn) a move which would be opposed by the left of the party.

Beyond the macro effect of having to significantly scale down the second step of Biden's fiscal plans, a failure to bring a significant share of the intended package across the line less than a year after the elections would send a message of "policy paralysis" in Washington DC which could alter sentiment in the US and beyond.

## And "pop" goes the ECB forward guidance

In sum, between the slowdown in China and the uncertainty in the US, policymakers everywhere should be extremely cautious. We thought Lagarde had found the right balance at her last press conference between welcoming the good news on the European dataflow and keeping an otherwise non-committal approach to any policy normalization. However, since then the communication from the ECB has been very confident, triggering some market movement.

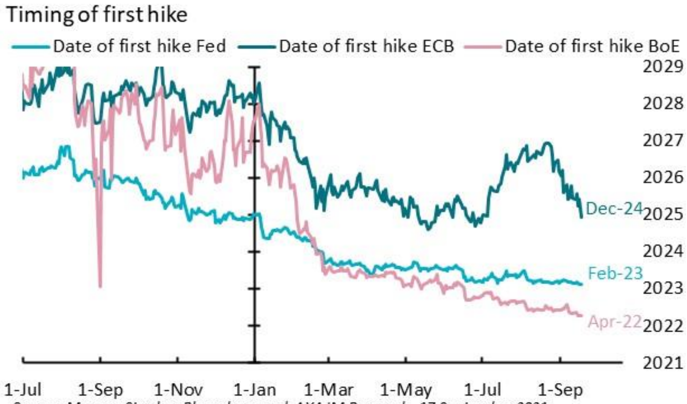
**An article published in the Financial Times (FT) late on Thursday has been making the rounds.** It claims – this has been contested by the ECB – that in a call the ECB's Chief Economist Philip Lane mentioned that some central bank's unpublished medium-term projections have inflation back to 2% in 2025. The FT concluded that this could be consistent with the central bank hiking rates as early as in late 2023. Indeed, according to the revised forward guidance unveiled in July, policy rates can move when the forecasts hit 2% inflation at the "mid-point" of their horizon, and do not decelerate again after that (*observed* core inflation must also be converging to 2%). In December 2023 the ECB will extend its forecasts to 2026, making 2025 the "mid-point".

On substance, we would not be surprised if the ECB *currently* expects to hit its target in 2025. Arguably if a central bank itself does not believe that at some point *beyond* its current policy horizon (their published forecasts today don't go beyond 2023) it will be able to deliver on its mission, who will? Anyway, the ECB has a long history of being overly bullish on inflation in its forecasts, to be constantly forced to push its expected trajectory forward, projection after projection. Forecasting 2% for 2025 in September 2021 sheds little light, by experience, on what the ECB will be forecasting for 2025 in its December 2023 batch.

**We would then be tempted to dismiss this signal, were it not for the accumulation of statements from other members of the Governing Council sounding quite confident on the growth and inflation outlook**, or elaborating on upside risks to the inflation forecasts, a point we had already found surprising at the September meeting. The latest speech by Isabel Schnabel is a case in point. True, she argued in the first half the "dovish case" to a German audience, pointing for instance to the fact that real deposit rates had spent long phases in negative territory before the ECB took over, and spoke in favour of a "forceful" monetary policy while highlighting the dangers of withdrawing the stimulus too early. But she then also discussed at some length the possibility that inflation would hit its 2% target on a sustained basis earlier than what is in the forecasts published 2 weeks ago. The Governor of the central bank of Ireland publicly mentioned that "some in the ECB think the inflation forecasts are too pessimistic".

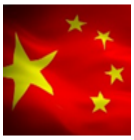
Unsurprisingly, the market is taking notice. While the revised forward guidance had surprised on the dovish side in July, triggering a pushback of the market expectations for the first hike, they have now returned to their early July level (see Exhibit 5).

Exhibit 5 – The benefit of the revised forward guidance is gone



*Source: Morgan Stanley, Bloomberg and AXA IM Research, 17 September 2021*

For our part, these new market expectations are in line with our own forecast (we expect the ECB to hike the policy rate in 2024, a year after the Fed), but we are concerned by what the "hawkish noises" coming from the Governing Council may mean for the remainder of the ECB arsenal. Indeed, there is more and more pressure to sever the link between Quantitative Easing (QE) and the policy rates in the forward guidance (in its current formulation QE is supposed to stop only shortly before the first hike). If the ECB were indeed readying a first hike in 2024, it could now mean that QE could be terminated in 2023. That year is going to be delicate. Indeed, in principle the EU fiscal surveillance system will become enforceable again for the 2023 budgets. If at the same time governments lose the direct support of the ECB on their bond market, this could prompt them to opt for a too brutal fiscal tightening.

| Country/Region | What we focused on last week | What we will focus on in next weeks |
|---|---|---|
|  | • Retail sales (Aug) surprised +1.8%mom ex autos, provides some upside risk to Q3 GDP<br>• CPI inflation (Aug) dipped to 5.3%yoy from 5.4%, core to 4.0% from 4.3%, with 0.1%mom. Import price fell by 0.3%<br>• Manufacturing made subdued gains in August (+0.2%), but surge in Empire and Philly (Sep) surveys suggests easing in supply constraints<br>• House W&M Committee passed tax proposals of $2.1tn. Expect delays in broader passage | • FOMC meeting. Expect statement to say taper imminent but avoid date. We still expect Dec announcement. Latest SEPs watched for 'dot plot' as well as inflation/labour forecasts<br>• Focus on housing market with new and existing home sales and housing starts (Aug)<br>• Progress on passage of $3.5tn bill<br>• Any signs of progress on parallel budget and/or debt ceiling continuation resolution – former due following week |
|  | • EMU Q2 wages fell by 0.4%yoy but strongly distorted by base effects as it accounts for exceptional income support during the crisis<br>• July EMU IP rose unexpectedly by 1.5%mom, Belgium is up by 5%, Ireland +7.8%, Port +3.5%<br>• EMU Aug hicp confirmed at 3%yoy, core:1.6% | • Sep domestic and EC consumer confid surveys may slightly fade but should remain robust<br>• Business surveys in Mfg and Svcs with Flash PMIs in Fr, Germ, EMU level and Ifo in Germ. Stabilisation at current high level is expected<br>• Aug Spain overnight stays for touristic season |
|  | • CPI inflation (Aug) rose to 3.2% from 2.0% in July, in part on Eat Out base effect<br>• Retail sales (Aug) surprise drop -0.9%, following -2.8% in July. Services rebound should help broader consumption in August<br>• Solid labour market, concerns of lbr shortages | • BoE meeting. No expectation of policy change, but watch for signs of Committee's increasing worry of supply shortage/inflation persistence<br>• Manu & services PMIs (Sep, p) robust pace expected to persist<br>• GfK cons conf (Sep) expected to rise >-8 last |
|  | • Despite lower support in polls, Kishida has better chance to become PM-stronger internal support<br>• Mixed news from Mfg sector as Q3 bus survey improved from Q2 but Tankan idx fell to 18 from 33. Aug real exports fell 3.7% mom (auto:-15%) | • BoJ September meeting should be a non-event<br>• August CPI should slightly rise from July with strong energy base effects. Indices still heavily impacted by recent changes in methodology<br>• Sept Mfg PMI should soften from Aug (52.7) |
|  | • August activity data misses expectations by a large margin, mainly due to weaker consumption and services growth against the COVID resurgence | • Some expect next week's Loan Prime Rate (LPR) fixing to register a lower rate. We expect it to stay steady |
|  | • CPI cooled for a fifth consecutive month in Argentina (Aug: 2.5%mom) although yoy CPI is still high (51.4%)<br>• Aug retail sales picked up in Colombia (26.9%yoy), while Aug IP slowed slightly (13.5%yoy)<br>• Aug BoK minutes suggest that policy normalization is expected to be gradual | • CB: A hike is expected in Brazil (+150bps), while South Africa should keep its rate on hold<br>• Aug CPI should tick up to 4.9%yoy in South Africa. (Jul: 4.6%)<br>• Q2 GDP figures to be published in Argentina |

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|---|---|---|
| **Upcoming events** | **US :** | Mon: NAHB housing market inx; Tue: Current account (Q2), Housing starts & building permits (Aug); Wed: Existing home sales (Aug), FOMC announcement; Fri: New home sales (Aug) |
| | **Euro Area:** | Mon: Ge PPI (Aug); Tue: EZ Consumer confidence (Sep,p); Thu: EU19, Ge & Fr PMI (Sep,p), Fr manu conf (Sep), Sp GDP (Q2,f); Fri: Ge IfO inx (Sep), It bus & cons confidence (Sep) |
| | **UK:** | Tue: public finances (Aug), CBI survey; Thu: PMI (Sep,p), MPC decision; Fri: GfK consumer confidence (Sep), MPC's Tenreyro on public finance |
| | **Japan:** | Mon: Public Holiday; Wed: BoJ announcement; Thu: Public holiday, Fri: CPI (Aug), Manufacturing PMI (Sep,p) |
| | **China:** | Sun: Public Holiday; Wed: 1yr loan prime rate |

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AXA Investment Managers SA
Tour Majunga – La Défense 9 – 6 place de la Pyramide 92800 Puteaux – France
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