China Growth Outlook: Weaker Than It Appears?

A slowdown in industrial activity may indicate global growth has peaked.

Dirk Hofschire, CFA | Senior Vice President, Asset Allocation Research
Lisa Emsbo-Mattingly | Director of Asset Allocation Research
Tyler Earle | Research Associate, Asset Allocation Research
Cait Dourney, CFA | Analyst, Asset Allocation Research

Key Takeaways

- We believe China's industrial activity has slowed more than is widely appreciated, implying that investor expectations have yet to acknowledge China's weakening cyclical outlook.
- China's broader economy hasn't weakened as much as it did during its slowdown in 2015, but policy efforts to rein in credit and heavy industry appear to be taking their toll on growth.
- Recent actions by China's central bank may represent an acknowledgement of these trends and a policy shift toward easing.
- The global economy remains in solid shape with low risk of recession, but growth may have already peaked.
- Elevated market volatility is more likely amid the maturing global business cycle and shift toward monetary normalization, implying smaller cyclical portfolio tilts are warranted at this stage of the cycle.

Industrial production slowing more than appreciated

Our proprietary industrial production diffusion index has dropped precipitously in recent months and is showing the weakest industrial activity in China in years (Exhibit 1). In contrast, China's government data continues to show stable industrial production, much as it did during the major manufacturing deceleration that led to China's growth recession in 2015. Similar to 2015, when China's slowdown eventually rattled the global economy and financial markets, we are concerned that official data and consensus investor expectations are not acknowledging the weakening trends in China's cyclical outlook.

Broader economy not as weak as in 2015

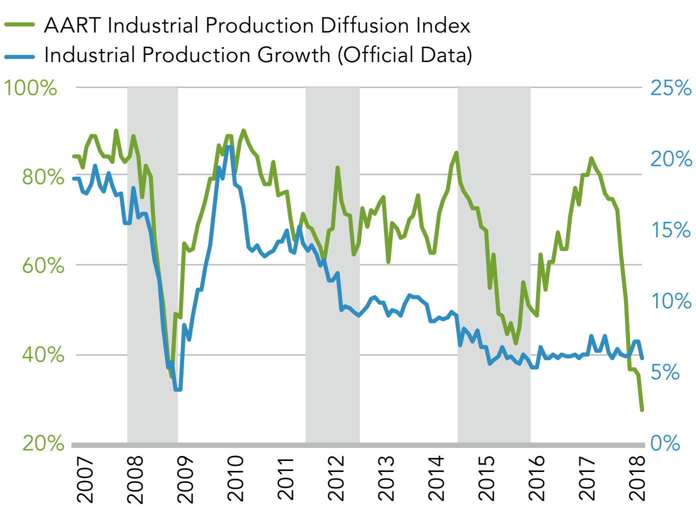
When we compare trends across all of China's economic sectors today to the period of industrial slowdown in 2015, we find that the weakness is not as broad based as it was three years ago (Exhibit 2). Housing market activity has flattened but is not outright contracting. The global economy is in much better shape overall and external demand from Europe, the U.S., and other countries is boosting China's export growth. In addition, China's consumer is playing a greater role in driving economic growth, although consumption growth was also strong in early 2015 before eventually following industrial production lower.

One high-level explanation for China's deceleration is that economic policymakers are directionally tightening economic conditions. The large fiscal and monetary response to 2015's slowdown has given way over the past year to an emphasis on improving the quality of growth and accepting some moderation in its pace. Production restrictions on steel and other heavy industries are aimed at reducing pollution and addressing chronic overcapacity, while the crackdown on shadow financing is an attempt to rein in China's credit boom and help the economy digest the massive leverage built up in the system over the past decade.

Credit growth has slowed markedly over the past two years and is at roughly the lowest level since the 2008 global financial crisis (Exhibit 3, page 3). While some of this is intentional on the part of policymakers, our models indicate that China's recession risk is rising and we believe the risks to the growth outlook have shifted to the downside.

EXHIBIT 1: Despite official Chinese industrial data showing steady activity, our proprietary industrial production index is exhibiting significant weakness.

China Industrial Activity Reported vs. Proprietary Index



Gray bars denote China "growth recessions," or significant declines in activity relative to a country's long-term economic potential. We have adopted the "growth cycle" definition for China and most developing economies because they tend to exhibit strong trend performance driven by rapid factor accumulation and increases in productivity, and the deviation from the trend tends to matter most for asset returns. We use the classic definition of recession, involving an outright contraction in economic activity, for developed economies. Source: China National Bureau of Statistics, Haver Analytics, Fidelity Investments (AART), as of March 31, 2018.

EXHIBIT 2: Despite some weakening across indicators, current economic trends are more constructive than they were prior to China's growth recession in 2015.

China Cyclical Outlook

● Worsening Trend ● Neutral Trend ● Improving Trend

Category	Indicator	Trend Q1 '15	Trend Q1 '18
Economy	Industrial Activity	Worsening	Worsening
	Housing Activity	Worsening	Neutral
Policy	Total Credit	Worsening	Worsening
Sentiment	Consumer	Improving	Improving
External Conditions	Global PMI	Neutral	Improving
	Trade	Worsening	Improving

Source: Bloomberg, China National Bureau of Statistics (official data), Fidelity Investments (AART), as of March 31, 2018.

Policymakers ease: Sign of major policy shift?

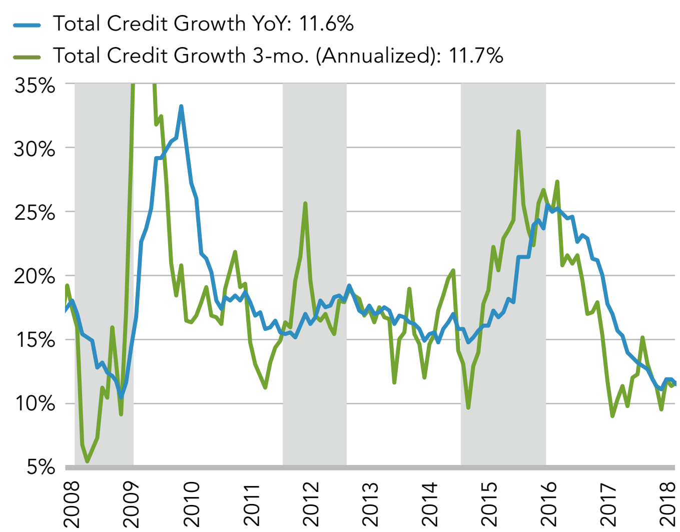
On April 17, China's central bank announced a 1% decrease in the required reserve ratio (RRR) for banks, to free up additional funds for lending. Historically, policy easing via RRR cuts—particularly of this magnitude—has occurred only after economic growth has significantly deteriorated (Exhibit 4). According to our business cycle framework, RRR cuts implemented over the past decade occurred only after the Chinese economy had entered a growth recession.

So is the RRR easing evidence that Chinese policymakers are aware of the degree of the slowdown and have now shifted to a broad-based easing policy? We suspect the answer is directionally, yes. But more evidence is needed to ascertain whether this is a small shift or a big one. According to the People's Bank of China (PBOC), 70% of the RRR cut is aimed at large banks that will simultaneously be required to pay back medium-term loans of the same amount. In other words, the RRR action for large banks was a reshuffling of funding as opposed to a net easing of credit conditions. The other 30% of the RRR cut was an outright easing of lending conditions for small- and medium-size banks. Going forward, we're watching to see whether the PBOC takes further action we would interpret as policy easing, including additional RRR cuts, allowing outstanding medium-term loans to be rolled over, and currency depreciation.

It's important to keep in mind, however, that even an outright shift toward policy easing may not immediately be greeted as a welcome sign from investors. If consensus expectations are too optimistic about China's near-term outlook, the first step may be recognition of the growth

EXHIBIT 3: Credit growth in China has decelerated sharply due to tightening of financial conditions by policymakers.

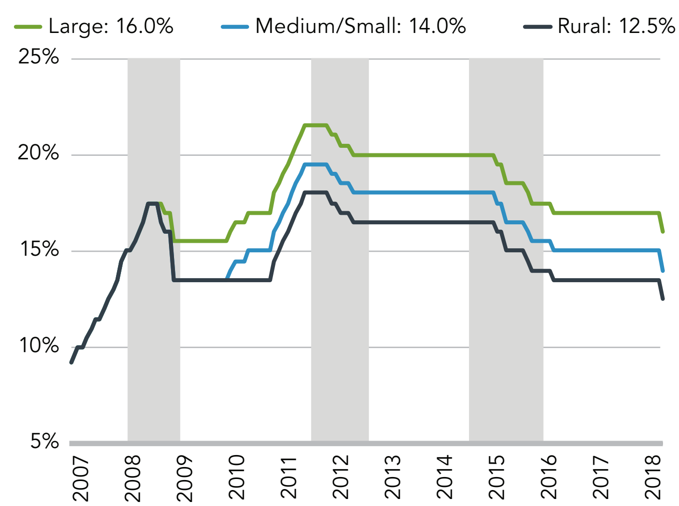
China Credit Growth



Note that the 11.6% year-over-year and 11.7% 3-month annualized growth rates represent current levels as of March 31, 2018. Gray bars denote China growth recessions. Source: People's Bank of China, Haver Analytics, Fidelity Investments (AART), as of March 31, 2018.

EXHIBIT 4: In April, policymakers eased by cutting the required reserve ratio, which has historically happened after economic growth had slowed significantly.

China Required Reserve Ratio by Institution Type



Note that the required reserve ratios listed above (16.0%, 14.0%, and 12.5% for large, medium/small, and rural banks, respectively), represent current levels as of April 30, 2018. Gray bars denote China growth recessions. Source: People's Bank of China, Haver Analytics, Fidelity Investments (AART), as of April 30, 2018.

disappointment. For example, policymakers cut the RRR in the first quarter of 2015, but it took nearly one year for global equity markets to fully digest the extent of China's slowdown.

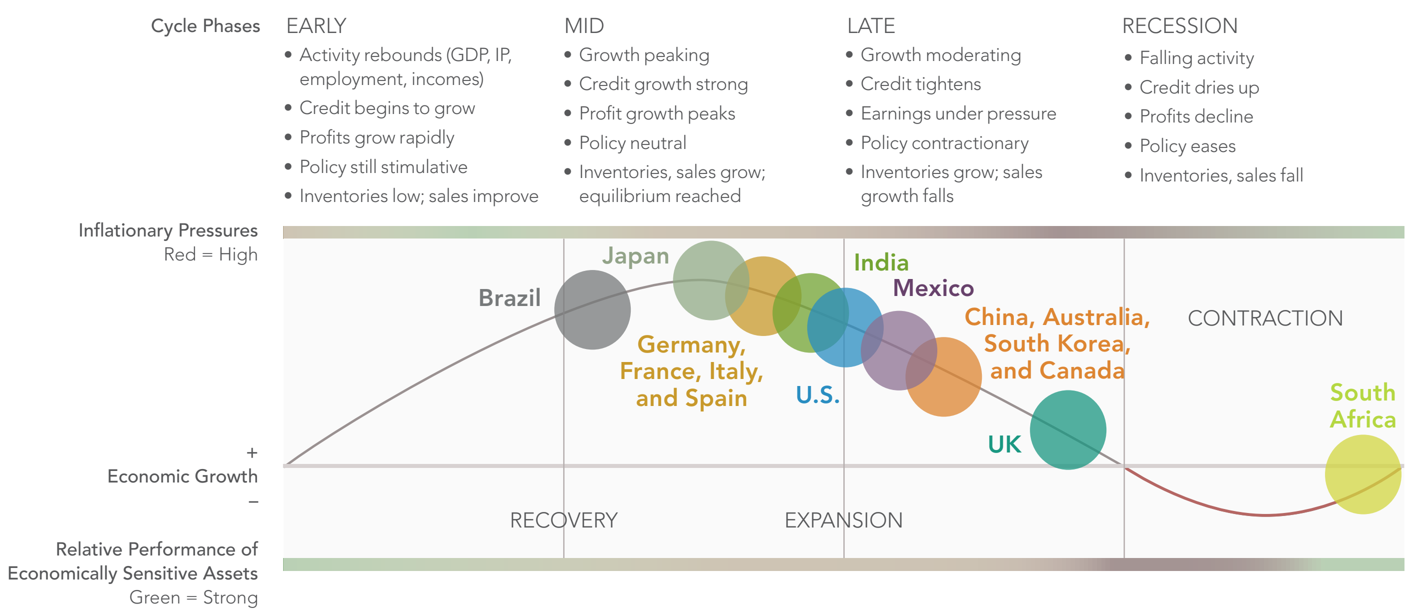
Global business cycle is maturing

Since China's economy emerged from its growth recession in early 2016 it has provided a positive catalyst for global growth via its influence on trends in global trade, industrial activity, and commodity prices. Two years later, the switch from a massive policy stimulus to the early stages of tightening has begun to restrain growth and push China into the late-cycle phase of expansion (Exhibit 5).

- **Global:** The global economy is experiencing a steady expansion, with most developed economies in more mature (mid-to-late) stages of the business cycle with low risk of recession. However, Germany and Japan are beginning to show the effects of weaker demand from China, as industrial and export activity have rolled over from high levels and leading indicators are inflecting negatively. More broadly, just over half of the forty largest economies in the world are exhibiting positive leading indicators over the past six months, down from 70% at the beginning of the year, signaling global activity may have peaked.
- **U.S.:** The U.S. has remained on a gradual progression through its business cycle, experiencing mid- and late-cycle dynamics, and low risk of recession. Growth remains healthy, but growth rates have likely peaked and have limited upside. Tighter employment markets have

EXHIBIT 5: Most global economies remain in steady but maturing expansions; China and a handful of other economies are in the late stage of the business cycle.

Business Cycle Framework



Note: The diagram above is a hypothetical illustration of the business cycle. There is not always a chronological, linear progression among the phases of the business cycle, and there have been cycles when the economy has skipped a phase or retraced an earlier one. Source: Fidelity Investments (AART), as of April 30, 2018.

put upward pressure on wages, and enabled the Federal Reserve (Fed) to tighten monetary policy. We expect the Fed to continue to gradually hike rates as the cycle matures.

Trade risk is a wild card

The more aggressive U.S. policy stance in 2018 is increasingly targeting China's alleged unfair trade and investment practices, and represents a risk to the global economic outlook—and to China in particular. With Chinese exports providing a stable bright spot amid a broad industrial deceleration, a significant increase in trade barriers would further undercut China's economic momentum. We believe an all-out U.S.-China trade war is not the most likely scenario, but we expect the U.S. to continue adding restrictions to Chinese trade and investment in certain sectors. This could lead to Chinese retaliation and raise additional risks for China's near-term growth outlook.

Asset allocation outlook

China's deceleration is a sign of the maturing global business cycle. Global growth and inflation remain solid enough to continue supporting a broad move away from monetary policy accommodation, but China's industrial deceleration represents downside risk to the outlook and makes it likely that global activity has already peaked.

From an asset allocation standpoint, we remain constructive on global equities, which are being bolstered by a strong rebound in corporate profits. However, we expect the maturing business cycle and China's deceleration to be accompanied by elevated market volatility, which implies that smaller cyclical portfolio tilts are warranted at this stage of the cycle. Facing both downside risks to growth and upside risks to inflation, portfolio diversification across multiple asset categories is even more important than usual.

Authors

Dirk Hofschire, CFA | Senior Vice President, Asset Allocation Research

Lisa Emsbo-Mattingly | Director of Asset Allocation Research

Tyler Earle | Research Associate, Asset Allocation Research

Cait Dourney, CFA | Analyst, Asset Allocation Research

The Asset Allocation Research Team (AART) conducts economic, fundamental, and quantitative research to develop asset allocation recommendations for Fidelity's portfolio managers and investment teams. AART is responsible for analyzing and synthesizing investment perspectives across Fidelity's asset management unit to generate insights on macroeconomic and financial market trends and their implications for asset allocation.

Asset Allocation Research Team (AART) Senior Analyst Jacob Weinstein, CFA, and Research Analyst Joshua Wilde, CFA, also contributed to this article. Fidelity Thought Leadership Vice President Christie Myers provided editorial direction.

Unless otherwise disclosed to you, any investment or management recommendation in this document is not meant to be impartial investment advice or advice in a fiduciary capacity, is intended to be educational and is not tailored to the investment needs of any specific individual. Fidelity and its representatives may have a financial interest in any investment alternatives or transactions described in this document. Fidelity receives compensation from Fidelity funds and products, certain third-party funds and products, and certain investment services. The compensation that is received, either directly or indirectly, by Fidelity may vary based on such funds, products and services, which can create a conflict of interest for Fidelity and its representatives. Fiduciaries are solely responsible for exercising independent judgment in evaluating any transaction(s) and are assumed to be capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies.

Information presented herein is for discussion and illustrative purposes only and is not a recommendation or an offer or solicitation to buy or sell any securities. Views expressed are as of the date indicated, based on the information available at that time, and may change based on market or other conditions. Unless otherwise noted, the opinions provided are those of the authors and not necessarily those of Fidelity Investments or its affiliates. Fidelity does not assume any duty to update any of the information.

Investment decisions should be based on an individual's own goals, time horizon, and tolerance for risk. Nothing in this content should be considered to be legal or tax advice and you are encouraged to consult your own lawyer, accountant, or other advisor before making any financial decision.

In general the bond market is volatile, and fixed income securities carry interest rate risk. (As interest rates rise, bond prices usually fall, and vice versa. This effect is usually more pronounced for longer-term securities.)

Fixed income securities carry inflation, credit, and default risks for both issuers and counterparties.

Investing involves risk, including risk of loss.

Past performance is no guarantee of future results.

Diversification and asset allocation do not ensure a profit or guarantee against loss.

All indices are unmanaged. You cannot invest directly in an index.

Increases in real interest rates can cause the price of inflation-protected debt securities to decrease.

Stock markets, especially non-U.S. markets, are volatile and can decline significantly in response to adverse issuer, political, regulatory, market, or economic developments. Foreign securities are subject to interest rate, currency exchange rate, economic, and political risks, all of which are magnified in emerging markets.

The Business Cycle Framework depicts the general pattern of economic cycles throughout history, though each cycle is different; specific commentary on the current stage is provided in the main body of the text. In general, the typical business cycle demonstrates the following:

During the typical early cycle phase, the economy bottoms out and picks up steam until it exits recession then begins the recovery as activity accelerates. Inflationary pressures are typically low, monetary policy is accommodative, and the yield curve is steep. Economically sensitive asset classes such as stocks tend to experience their best performance of the cycle.

During the typical mid-cycle phase, the economy exits recovery and enters into expansion, characterized by broader and more self-sustaining economic momentum but a more moderate pace of growth. Inflationary pressures typically begin to rise, monetary policy becomes tighter, and the yield curve experiences some flattening. Economically sensitive asset classes tend to continue benefiting from a growing economy, but their relative advantage narrows.

During the typical late-cycle phase, the economic expansion matures, inflationary pressures continue to rise, and the yield curve may eventually become flat or inverted. Eventually, the economy contracts and enters recession, with monetary policy shifting from tightening to easing. Less economically sensitive asset categories tend to hold up better, particularly right before and upon entering recession.

Third-party marks are the property of their respective owners; all other marks are the property of FMR LLC.

The Chartered Financial Analyst (CFA) designation is offered by the CFA Institute. To obtain the CFA charter, candidates must pass three exams demonstrating their competence, integrity, and extensive knowledge in accounting, ethical and professional standards, economics, portfolio management, and security analysis, and must also have at least four years of qualifying work experience, among other requirements.

If receiving this piece through your relationship with Fidelity Institutional Asset Management® (FIAM), this publication may be provided by Fidelity Investments Institutional Services Company, Inc., Fidelity Institutional Asset Management Trust Company, or FIAM LLC, depending on your relationship.

If receiving this piece through your relationship with Fidelity Personal & Workplace Investing (PWI) or Fidelity Family Office Services (FFOS), this publication is provided through Fidelity Brokerage Services LLC, Member NYSE, SIPC.

If receiving this piece through your relationship with Fidelity Clearing & Custody Solutions® or Fidelity Capital Markets, this publication is for institutional investor or investment professional use only. Clearing, custody, or other brokerage services are provided through National Financial Services LLC or Fidelity Brokerage Services LLC, Member NYSE, SIPC.

844463.1.0

Title: China Growth Outlook: Weaker Than It Appears? (Business Cycle Update)

Description: A slowdown in industrial activity may indicate global growth has peaked.