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If my client is richer, I will be too

China 2017 GDP means good news for Europe

This morning, Chinese GDP figures came out significantly better than expected: 4Q yoy growth was 6.8%, one tenth higher than expected, which leaves 2017 growth at 6.9%, two tenths higher than 2016 and comfortably far over the authorities target of 6.5%.

This is very good news for some of the key variables that may impact markets in 2018, namely European growth, global inflation and Chinese policies.

Growth at the same time imbalances are addressed

One of the key takeaways of **these figures is that they happen at the same time imbalances are being reduced**. Back at the start of 2016 figures and expectations for the Chinese economy were quite pessimistic. That's why Chinese authorities kept pumping stimulus even though worries about imbalances were already building up. At the same time, financial regulation started driving money out of savings and into consumption. And that may be part of the reason for recent good performance.

In 2017, the total debt to GDP ratio seems to have grown much less than the year before. Bloomberg estimates (no official figure yet) it went up by 5 pp, to 264%, whereas in 2016 it grew by 19 pp. At the same time, government expenditure is contracting by more than 8% yoy (from a positive 20% at the start of 2017) and M2 is slowing to about 12% yoy rates from 25% at the start of 2016.

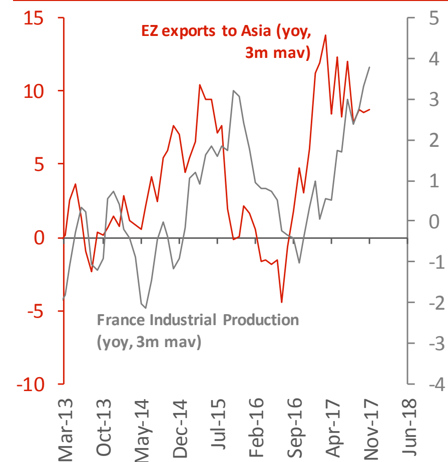
On the other hand, **consumption growth seems to be outpacing investment**. This is good news for the structure of the demand side, which is slowly turning into a more developed-like picture. This was being talked about since the early 2000s, but only since 2016 consumption started to grow quicker than investment, and only in 2017 this development has been solid enough to be considered structural, although sparked initially by regulations. From the supply

side, services now account for more than 50% of GDP, again slowly going towards a developed country structure.

Benefits for Europe

The surprise on European growth in 2017 is partly due to China growing more than expected. Actually, net exports in the Eurozone turned from dragging about 0.75 pp in 2016 to a positive contribution in 2017. That's the largest increase in any component of the GDP, with steady contribution from consumption and investment. Moreover, the Eurozone CA surplus is higher than that in 2007 (the peak of the previous cycle) and even Spain and Italy are now running current account surpluses. So, excess growth of the Eurozone in 2017 is broadly based in exports.

Chart 1. Exports to China drive production



Source: Bloomberg / Mapfre

In 2017, Eurozone exports to China grew at more than 9% on average (December figures still pending), from 1% in 2016 and 5% in 2015. Just for comparison, exports to the US grew at about 4.5% in 2017, from being flat in 2016 and growing more than 16% in 2015. So **China seems to be responsible for the bulk of the increase in exports of the Eurozone.** Chart 1 illustrates clearly this point. French industrial production seems to react to exports to China. Actually, the spark in such exports starts in summer 2016, when the combination of stimulus and regulation started to drive up consumption imports in China.

One of the main worries in 2018 is how will Europe sustain its overachievement in growth. Actually, surprises have been so high that most analysts bet they can't be sustained. **Excess growth in China is one of the best indicators to stay optimistic in Europe**.

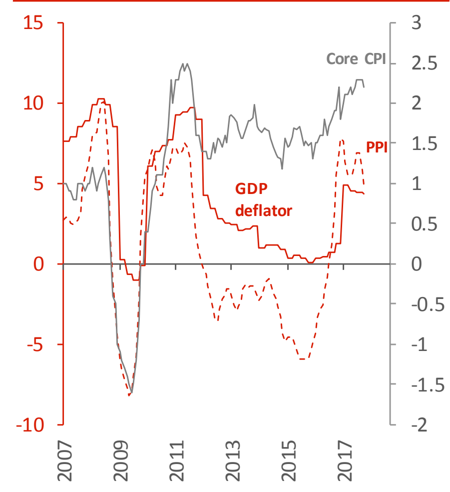
Consequences for inflation

As we have stated several times before, for us, Chinese CPI is not the best gauge for Chinese inflation. Actually, GDP deflator and production prices may be more accurate metrics. So, this morning GDP figures mean good news for inflation too. Nominal GDP grew at 11% yoy in Q4, slowing from 11.2% in Q3. **With higher real growth this means a lower deflator, which now stays at about 4.3 pp**.

One of the worries for 2018 in China is inflation pressures building up, since PPI was growing at more than 7% yoy at the start of the year, in addition to a 4.9% GDP deflator by that time (Chart 2). If these pressures proved to be growing, then probably, Chinese authorities would execute tighter policies this year, since inflation is a major threat for their political regime. But now, **today's figure, also with PPI slowing to 4.9% may relieve such worry**, although these numbers are still way higher than 2016´s.

The combination of these lower figures with higher imports from Europe **reduces the chance of China exporting inflation to Europe**. As we have stated in other reports, CPIs in Europe (and in the US to a less extent) are driven mainly by external developments, with China being one of the most important. So risk for upside surprises in European CPIs is now a bit lower. With Eurozone inflation at 1.1%, this reasoning may seem a complete nonsense, but we consider it important, for developments from 2019 on and for the stance of central banks' liquidity provision.

Chart 2. Prices metrics in China (yoy)



Source: Bloomberg / Mapfre

Some drawbacks

Although the release of the GDP has been positive, there are some drawbacks. First, **these figures still mirror the stimulus pumped in 2016, whereas the impact of recent tightness in government expenditure and slowing M2 may not be reflected in full yet**. So there is a significant chance of GDP slowing quite a bit in 2018. Bloomberg consensus stays at 6.4% yoy.

At the same time, lower inflation could make us think of a lower chance of more tightening in monetary policy (which in fact is already being tightened). But this may prove misleading. Actually, speeches by government officers show how growth is not the priority nowadays, but deleveraging. That means addressing imbalances first, and allowing growth to slow a bit in exchange, through eventual tighter policies. They would tighten in pursue of such goal, as long as inflation is not very low. Strong nominal growth is a healthy way of deleveraging which may allow reaching such goal without the need for tighter policies. So it's important that growth does not slow too much.

Conclusion and consequences for asset allocation

All of the above reinforces our central scenario for 2018 in which European growth keeps its good performance and China and inflation play a key role in shaping investors' expectations.

This means **European equity markets catch up with US, so they may show higher returns** (this being one of the main bets this year). It also means an **overweight of exporters and consumption goods** as well as a **higher risk for fixed income assets**.

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