

China holds the key to avoiding a global recession



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China will prevent the global economy from sinking, but it won't send it flying.

In 2009, while developed market economies were stuck in the mud amidst the Global Financial Crisis, China powered through with unprecedented stimulus. In hindsight, fiscal and monetary efforts in the US and, especially, Europe, were much too weak amid the GFC. In China, stimulus was sizable and effective, and the country rocketed out of reach of the tentacles of the financial crisis.

We can't expect China's 2023 reopening to be a 2009 redux. In contrast to 15 years ago, China's growth potential is lower and its fiscal firepower is limited. In 2009, China was the locomotive that dragged the global economy back to growth. In 2023, China is the emergency lever that will prevent it from falling off the tracks.

After a sluggish start to the recovery in late-2022, Chinese economic data is picking up slowly but surely. Mobility statistics are heading towards pre-pandemic levels. Subway ridership in China's largest cities has bounced strongly (Figure 1). Domestic flight activity has almost tripled since the government scrapped its COVID-zero restrictions. But overall household spending has only recovered weakly. Household consumption was anemic in 2022, as consumers were squeezed by plunging property values and stringent stay-at-home orders. The moderate upturn in consumer spending year-to-date all but excludes the scenario of a booming economic recovery in China. It'll take time for consumer sentiment to heal, especially with the Chinese government having shown no desire to directly transfer cash to households.

China's government is following the 2009 playbook, but at a much-reduced scale. For the past few months, it has been boosting lending by state banks and financing infrastructure investments. New yuan loans exceeded forecasts in January and February. Over the past three months, the rate of credit creation is on par with that of the first half of 2020, when China successfully recovered from the first wave of COVID lockdowns (Figure 2). The bulk of fresh credit is directed towards exporting businesses and local governments, as it was in 2009. Fixed asset investment growth in February beat expectations (5.5% vs. 5.1%). Industrial production has lagged but purchasing managers indices (PMIs) have been surging, suggesting that a bounce in production is around the corner.

HIGHLIGHTS

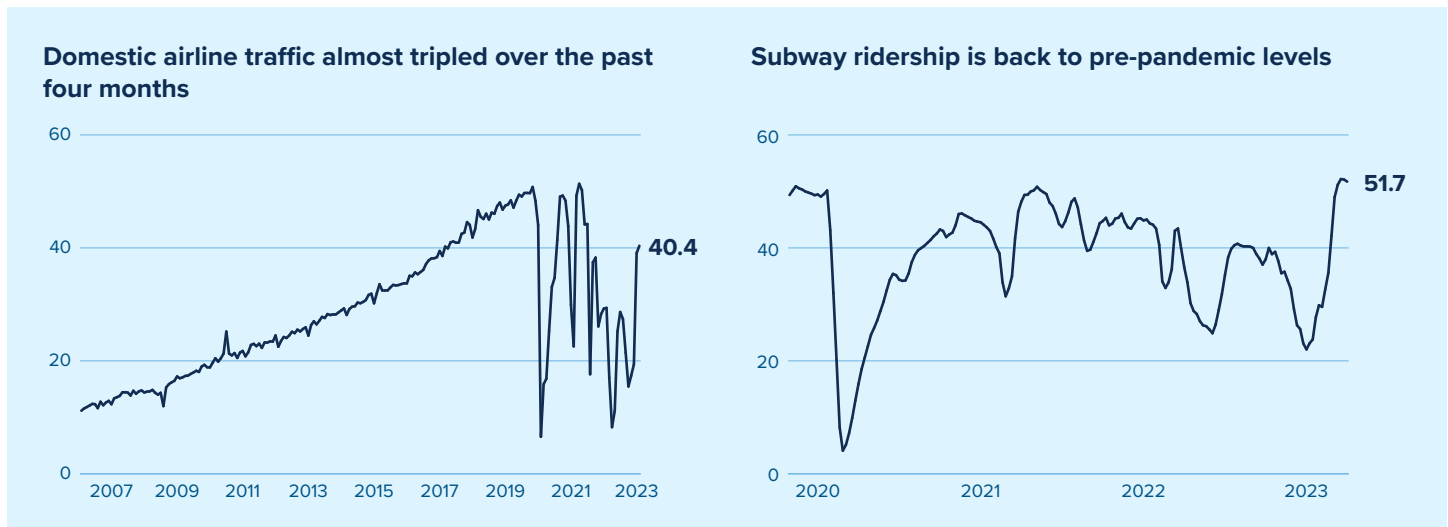
China's economy was probably shrinking in 2022. Its return to growth in 2023 should allow the world economy to avoid a recession.

Early returns on the reopening are promising, with most sectors showing signs of strength, buoyed by state banks' credit creation.

But don't expect a revolution. China's economy will remain imbalanced and government stimulus will wane in the second half of 2023.

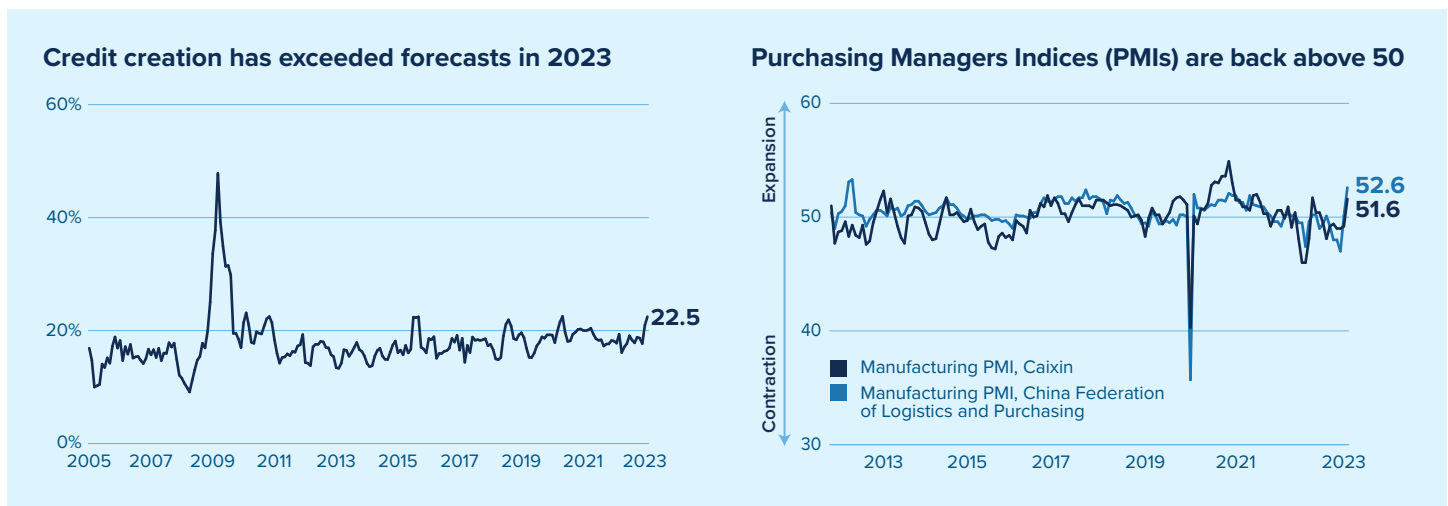


FIGURE 1. MOBILITY DATA HAS RECOVERED QUICKLY



Notes: Via Bloomberg as of March 28, 2023. Seasonal adjustment for airline passengers by author. Subway ridership chart adds up daily passengers for the ten largest Chinese cities with available traffic data.

FIGURE 2. THE CREDIT-FUELLED RECOVERY HAS PROGRESSED MODESTLY



Notes: Via Bloomberg as of March 28, 2023.

The Chinese government set low expectations for the ongoing recovery when it established its 2023 GDP growth target at 5%. Authorities have been humble when it comes to their ability to stimulate investment and exports. The days of double-digit growth in China are over, for three reasons:

1. Potential growth is lower in China, and many new investments are unproductive.
2. Debt levels are high, especially at the local government level.
3. Chinese authorities have been hesitant to take the tough steps needed to shift the Chinese economy from an export-driven model to a modern consumption economy.

In our view, orienting stimulus towards consumers rather than businesses would turbocharge the recovery. But the Chinese government has been resisting a pivot towards a consumption-lead economic model for a decade now. We argued [back in November](#) that China's reopening would be an inflationary shock for the rest of the world. The effect would be even sharper if China emulated the US's consumer-focused recovery strategy of 2020-2021. Instead, China, will keep channeling liquidity to export-oriented businesses by recycling balance of payment inflows and lowering bank reserve requirements. We also expect authorities to depress the value of the yuan to stimulate exports. As a result, we are short yuan in our Global Macro Fund.

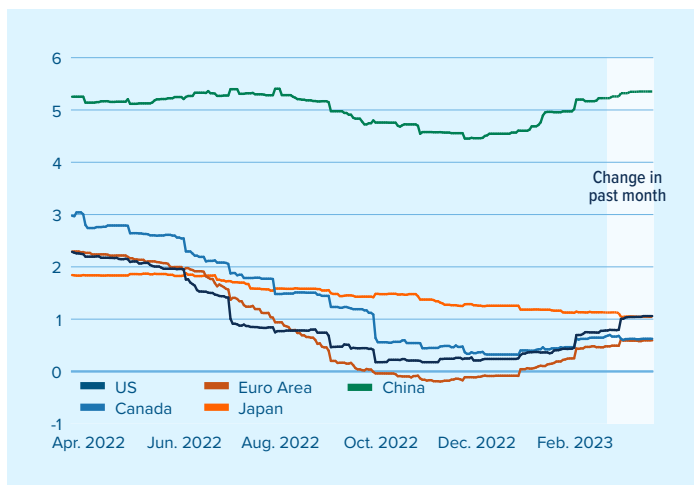


Global macro update

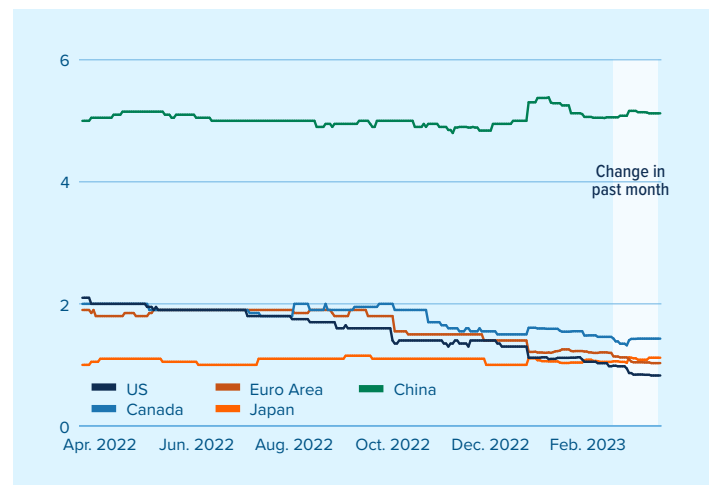
Consensus growth forecasts for China improved in February, as a modest recovery takes form. As explained above, China credit-fuelled stimulus is ramping up. On March 27, the People's Bank of China cut the reserve requirement ratio for banks, effectively releasing 500 billion yuan of liquidity. This should help maintain the credit creation momentum from the first two months of the year.

Consensus forecasts for 2023 and 2024 US inflation rose over the past month. In our view the recent events around the banking sector had a net-neutral effect on inflation expectations. On one hand, the banking shock will lead to a tightening in lending standards, blunting credit creation and lowering aggregate demand. On the other hand, the Federal Reserve will now be more hesitant to bring rates up to 6% to quell inflation once and for all.

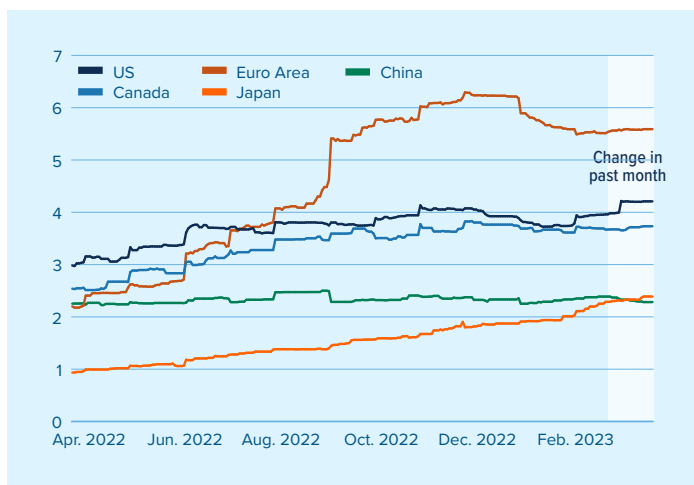
2023 REAL GDP GROWTH FORECAST (% , CONSENSUS)



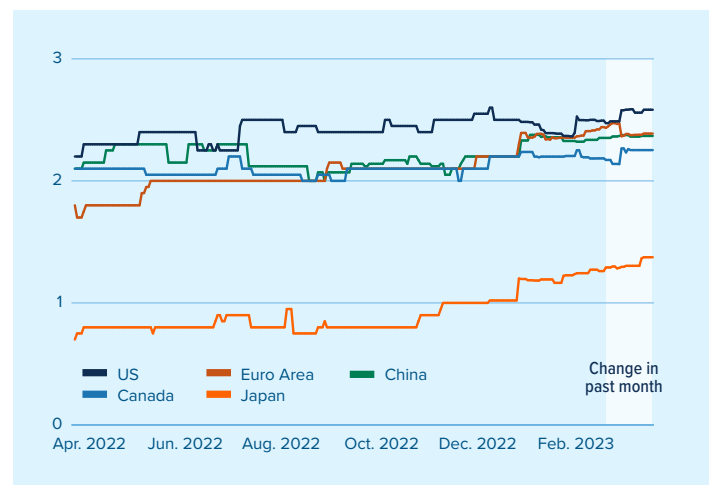
2024 REAL GDP GROWTH FORECAST (% , CONSENSUS)



2023 INFLATION FORECAST (% , CONSENSUS)



2024 INFLATION FORECAST (% , CONSENSUS)



Notes: Consensus Economics as of March 31, 2023.

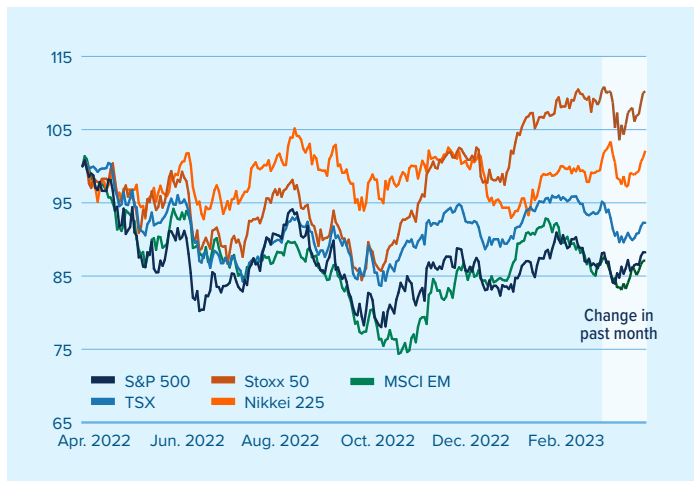


Capital markets update

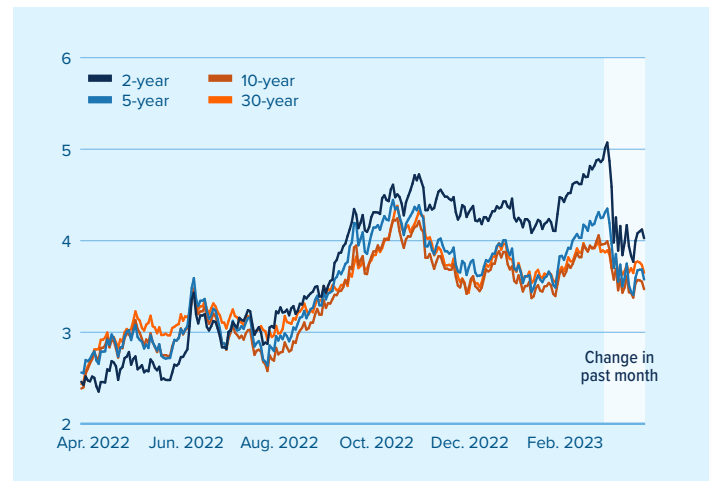
March saw the **US dollar** depreciate against most currencies. For the past few quarters, investors had gotten used to the US dollar behaving as a perfect hedge for macro shocks. Every time a risk emerged, USD rallied. But in the aftermath of Silicon Valley Bank's collapse, the dollar depreciated. Why? First, the shock was US-centric. Second, long-term interest rates collapsed, rendering the US dollar less attractive than other currencies. The Japanese yen was the main beneficiary, gaining 4% against the dollar in March. The US dollar remains broadly overvalued, so the banking hiccup could mark the resumption of the USD slide that began in the fourth quarter of 2022.

Rates fell across the Treasury curve in March, but the drop was especially violent in the front-end of the curve, as traders reassessed expectations for Fed rate hikes. The spread between rates on a 2-year Treasury and a 10-year Treasury dropped by almost 50bps on the day SVB failed, the largest one-day change since 9/11. In our view, the drop in rates is probably a bit overdone. Markets now expect two to three rate cuts by the Fed over the rest of 2023, an unlikely scenario.

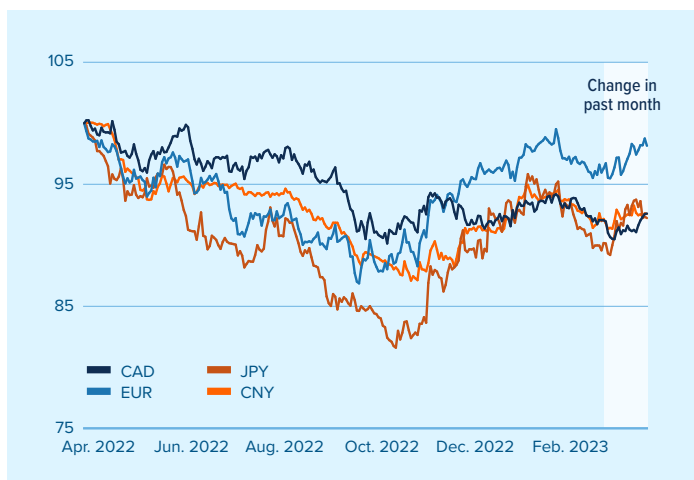
EQUITY INDICES (ONE YEAR AGO=100)



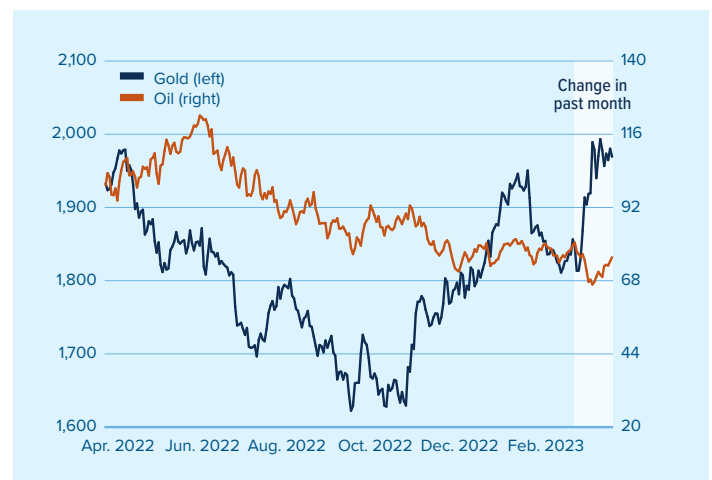
US TREASURY YIELDS (%)



CURRENCIES (RELATIVE TO USD, ONE YEAR AGO=100)



COMMODITY PRICES (USD)



Notes: Financial data from Bloomberg as of March 31, 2023. Total return equity indices are in local currencies, except MSCI EM, which is denominated in USD.

What we'll be watching in April

April 12: Bank of Canada rate decision

- We expect the Bank of Canada to stand pat at its April rate-setting meeting. Markets see a non-zero chance of a rate cut by the Bank, but a cut is extremely unlikely in our view.
- Inflation has eased significantly in Canada but is still running at around a 3.5% trend. The labour market is still exceptionally tight. Unless we see job losses in the hundreds of thousands when the March employment number is released, the Bank won't feel any urgency to begin easing. Plus, cutting rates would send a signal of weakness to markets, triggering a depreciation of the Canadian dollar, something we know Governor Macklem hopes to avoid.

April 12: US CPI for March

- When the US Bureau of Labor Statistics released CPI for February back in mid-March, markets mostly snubbed the slightly-hotter-than-expected inflation print, keeping their eyes fixed on the chaos around Silicon Valley Bank.
- Now that the fire in the banking sector has been controlled, markets will turn their attention back to inflation. We expect inflation to keep running at around a 5% trend in the US over the coming months.

April 13: Eurozone industrial production for February

- With the energy crisis now a risk of the past for the eurozone, we expect industrial production to keep showing strength. Industrial production grew 8.0% annualized in January, above the 3.6% growth expected by forecasters.

Emerging theme

The Silicon Valley Bank debacle has shifted the market's expectations for Bank of Canada rates. Why is that?

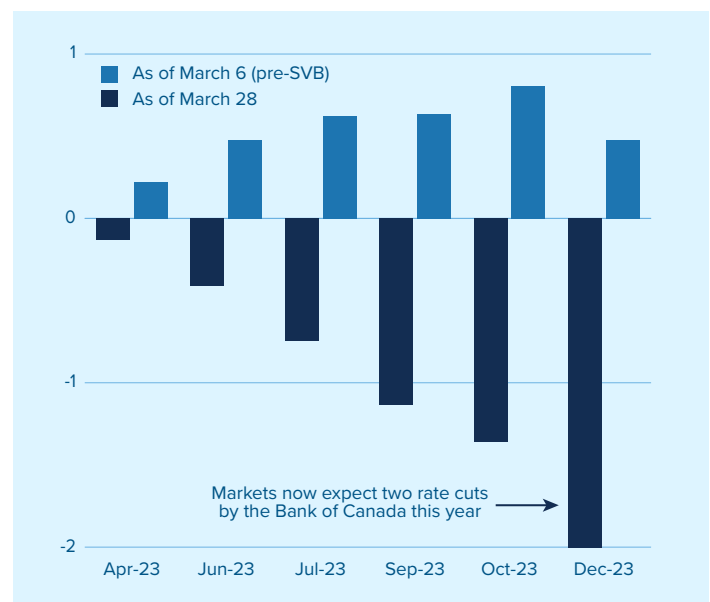
In the US, banking sector woes could change the Fed's hiking plans through two different (but related) channels: slower credit creation and financial stability risks.

The BoC doesn't face the same trade-offs. Higher BoC rates certainly aren't going to worsen US bank instability, and Canadian banks are far from insolvency. They're well capitalized, and their balance sheets aren't hiding worrying levels of unrealized losses on securities.

Tighter lending and slower credit creation in the US could impact growth in Canada. But the effect is uncertain, and indirect to say the least. Plus, lower US long-term interest rates partly compensate for the negative macro effects of the banking shock.

So, in contrast to the Fed, the BoC will remain fully focused on macro data. If inflation sticks above 2%, jobs hold up, and the rate pause breathes some air into the housing market, hard to see the BoC contemplating cutting rates this summer, as implied by markets.

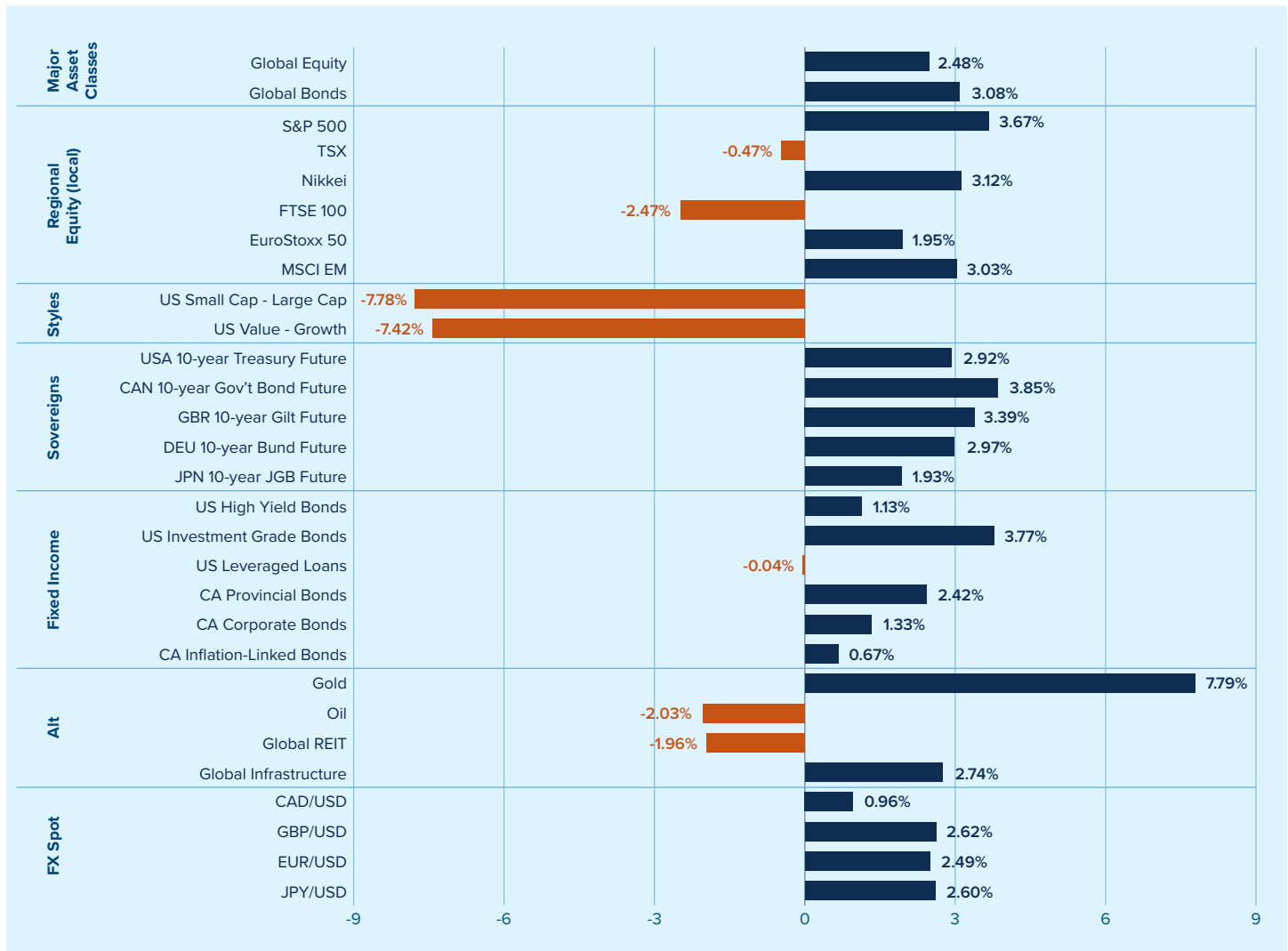
RATE HIKE EXPECTATIONS FOR THE BOC DROPPED AFTER SVB FAILURE



Notes: Via Bloomberg as of March 28, 2023.



Capital market returns in March



Notes: Market data from Bloomberg as of March 31, 2023. Index returns are for the period: 2023-03-01 to 2023-03-31. In order, the indices are: MSCI World (Icl), BBG Barclays Multiverse, S&P 500 (USD), TSX Composite 60 (CAD), Nikkei 225 (JPY), FTSE 100 (GBP), EuroStoxx 50 (EUR), MSCI EM (Icl), Russell 2000 - Russell 1000, Russell 1000 Value - Russell 1000 Growth, USA 10-year Treasury Future, CAN 10-year Gov't Bond Future, GBR 10-year Gilt Future, DEU 10-year Bund Future, JPN 10-year JGB Future, BAML HY Master II, iBoxx US Liquid IG, Leveraged Loans BBG (USD), Provincial Bonds (FTSE/TMX Universe), BAML Canada Corp, BAML Canada IL, BBG Gold, BBG WTI, REIT (MSCI Local), Infrastructure (MSCI Local), BBG CADUSD, BBG GBPUSD, BBG EURUSD, BBG JPYUSD.

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