GavekalDragonomics

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The Chinese Consumer In 2019

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Outline: cyclical outlook & thematic opportunities

Cyclical outlook: stabilizing after a slowdown

- **Consumer spending has continued slowing** in 2019, as shown by both the household survey and retail sales data. The household consumption share of GDP has stopped rising, and its support for growth has weakened.
- The **deteriorating labor market** is the fundamental reason for this slowdown. Manufacturing layoffs have surged again due to the US-China trade conflict, and also the dual downturns in the global economics cycle and domestic auto sales. These downturns are now showing signs of bottoming out, pointing to fewer layoffs.
- The 2018 cut in personal income taxes helped **aggregate income growth remain resilient**, though the benefits skewed to top earners. The one-time boost from the tax cut is fading, but lessening pressure from the job market means income growth should be stable in 2020.
- **Car sales are still the weakest part** of consumer spending, though more for supply-side than demand-side reasons. The rushed transition to new emissions standards and withdrawal of electric vehicle subsidies have been a drag on auto sales. But it's likely sales will return to positive growth, helped by base effects.

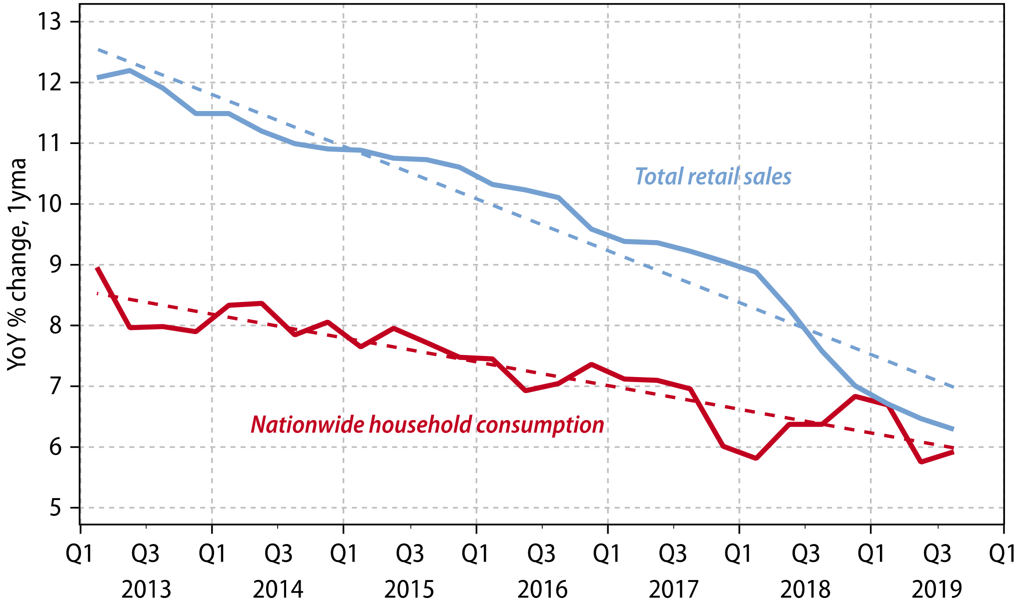
Thematic outlook: sectoral opportunities remain

- China has been living through its **worst pork crisis** ever, with African swine fever causing a massive shortage and surging prices. Consumers' marginal substitution to other meats is also boosting their prices.
- **Widening income inequality is good for luxury sales.** Middle income households are most exposed to the weaker labor market, while top earners have outperformed with gains from property. Luxury sales have been picking up again as the Gini coefficient rises.
- **Cosmetics sales are booming** thanks to lower taxes, the expansion of domestic duty-free sales channels and the increasing impact of online influencers.
- **Spending on overseas tourism has declined** in 2019 due to a weaker currency and rising international tensions. The Hong Kong protests have pushed mainland Chinese travelers to visit other countries instead.
- **Growth of online retail sales continues to slow** as a saturated market offers limited room for further penetration. Traditional retailers are still struggling even though the integration of online and offline retail continues to advance quickly, especially in food.

Consumer spending has slowed in 2019

Consumer spending is still on a steadily slowing trend

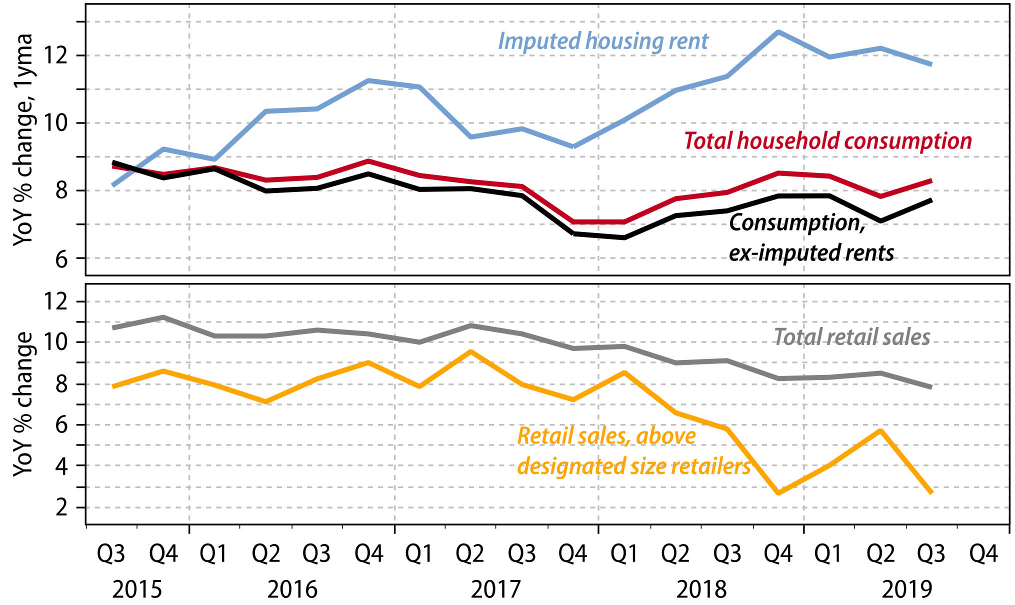
Real growth in the two main measures of consumer spending, with linear trend



CEIC, Gavekal Data/Macrobond

Actual consumer spending could be weaker than headline data shows

Nominal growth in the two main measures of consumer spending



China Household Survey Yearbook, Gavekal Data/Macrobond

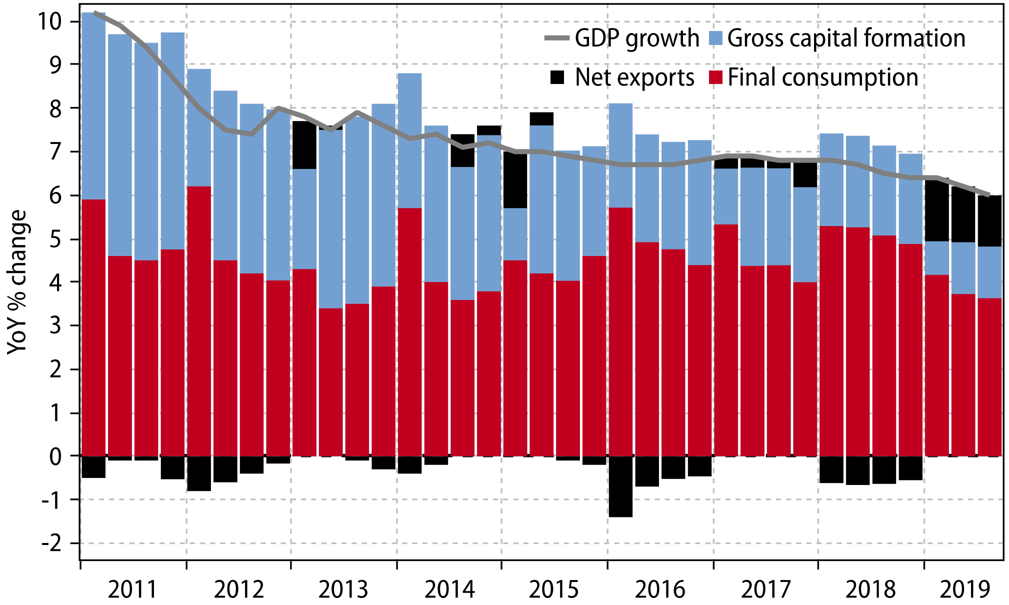
Chinese consumer spending has continued its slowing trend in 2019, according to both major sets of indicators. National household consumption from the household survey slowed to real growth of 5.7% in the first three quarters of 2019, from 6.8% in 2018. Retail sales have slowed to 6.2% YTD as of October, from 7% in 2018, dragged down by the decline of car sales. So far, government policies to support consumption have been fairly modest, and are unlikely to change the cyclical direction on their own.

The underlying trend is probably somewhat worse than the headline data indicate. In the household survey, a rising share of consumption comes from imputed rents on owner-occupied housing. Without it, consumption growth would be 0.6-0.8pps slower. In the retail sales data, direct reports by large retailers are showing only 3.8% YoY nominal growth in Q3, well below the 8.1% growth in total retail sales. The total retail sales figure is less reliable as it imputes sales from smaller retailers on the basis of a narrow sample.

The role of consumption in driving GDP growth has weakened

Consumption has weakened as a driver of GDP growth in 2019

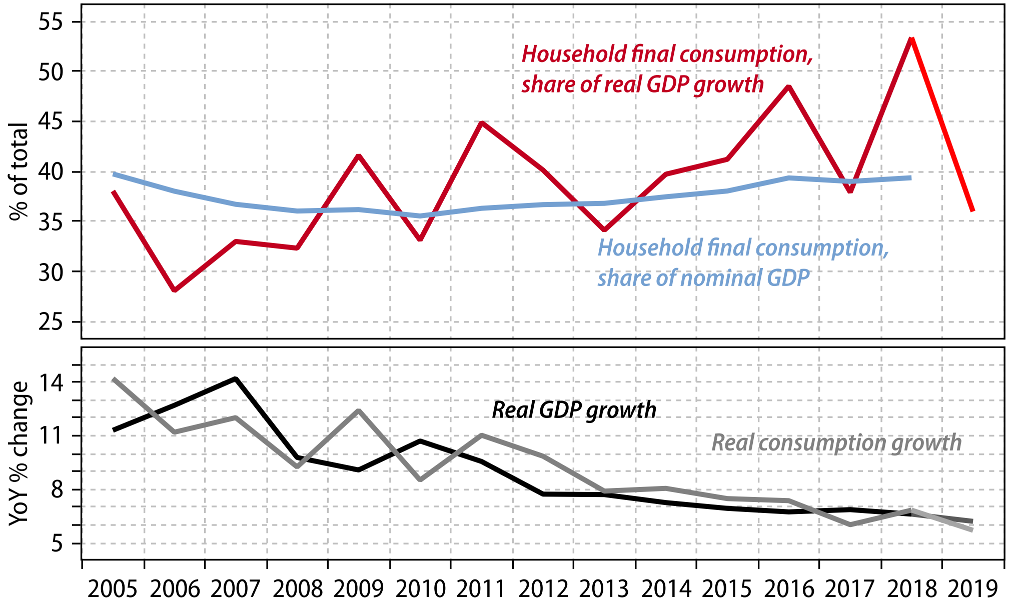
Contribution to real GDP growth



Gavekal Data/Macrobond

The share of household consumption in GDP has stopped rising

Household final consumption share of GDP and GDP growth, forecast for 2019



Gavekal Data/Macrobond

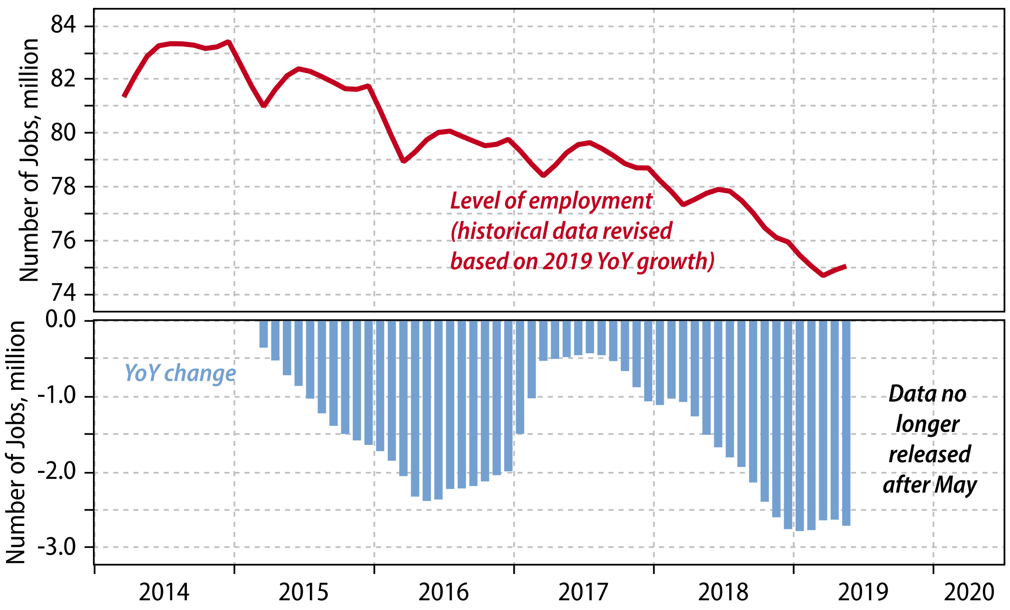
With exports and domestic investment both weakening, China's government hopes that consumer spending can support growth. But consumers have not done much to keep the economy on track in 2019. The contribution of final consumption to real GDP growth has fallen to 3.6pp in Q3, from 5pp in 2018. Most of that slowdown has come from household rather than government consumption, which has been more stable.

As household consumption grows more slowly than overall GDP, the share of household consumption has stopped rising since 2016: it has been stable around 39%. GDP has instead increasingly been supported by government final consumption and fixed capital formation, both of which have seen their share in total GDP rise modestly. Growth in government consumption has also outpaced growth in household consumption since 2015.

The labor market has suffered from the industrial downturn

Layoffs in the industrial sector worsened as the trade conflict escalated

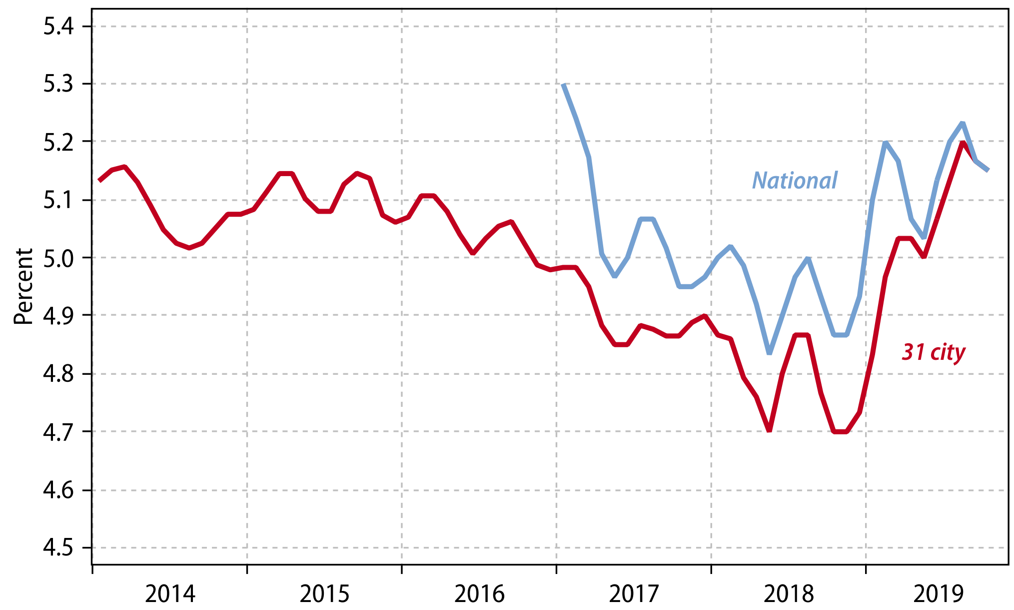
Total employment in large industrial enterprises, 3mma



CEIC, Gavekal Data/Macrobond

China's official jobless rate has picked up in 2019

Survey-based unemployment rates, 3mcma



CEIC, Gavekal Data/Macrobond

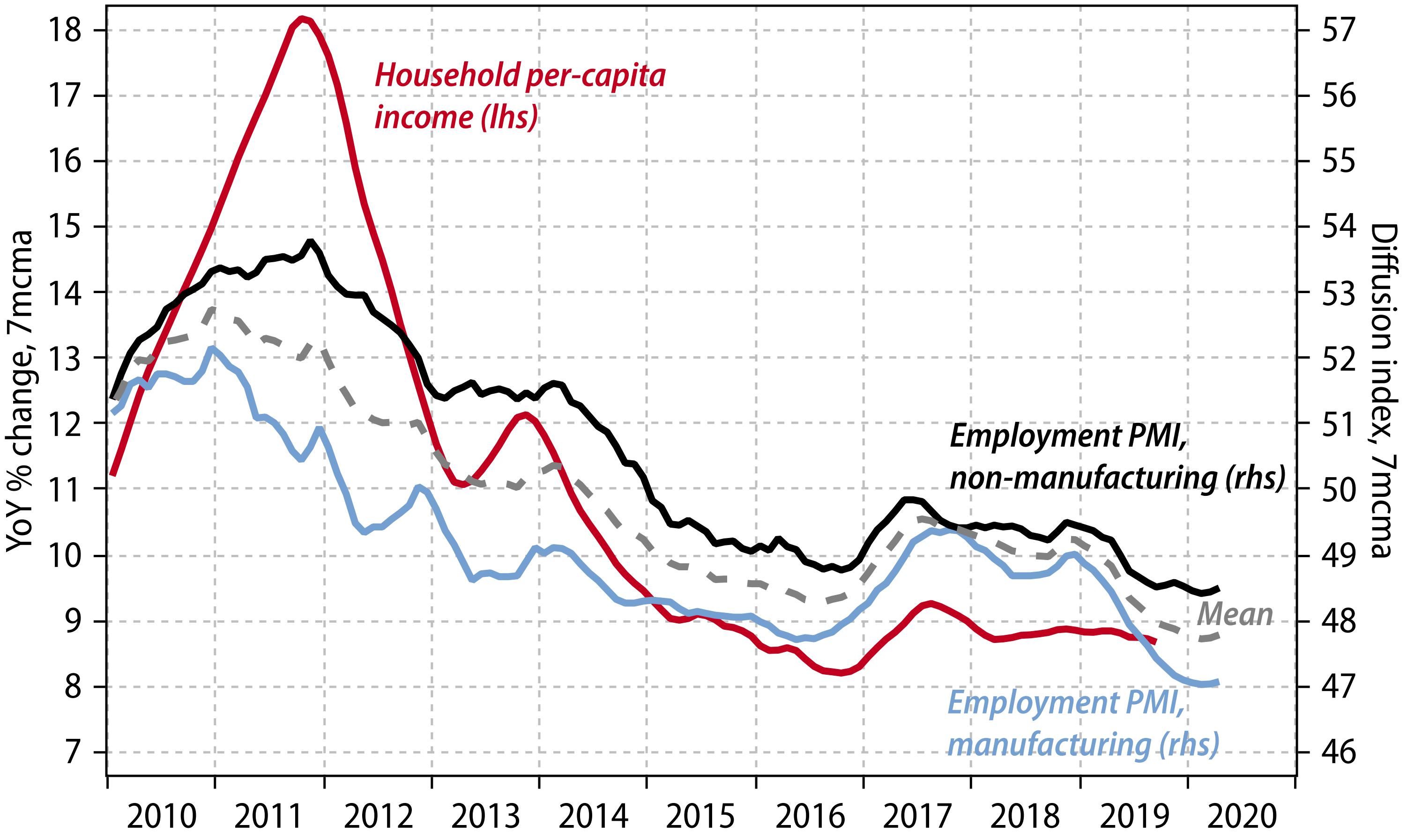
The US-China trade conflict has affected Chinese consumers mainly through the labor market. As export growth weakened in 2H18, the pace of layoffs in the industrial sector accelerated, and quickly matched and exceeded that seen during 2015-16. Layoffs showed signs of stabilizing in early 2019, but the NBS has stopped publishing the data series since May. Since then, the impact of US tariffs has worsened, with exports to the US in deep decline. But the global electronics cycle has showed signs of bottoming out, which is good news for hiring.

The official unemployment rate has also continued to worsen in H2. While the new survey-based measure is not very useful because of its minimal volatility, the direction of marginal change does seem to give some information about the state of the labor market. The nationwide jobless rate hit a recent high of 5.3% in February and again in July, but has come back down a bit to 5.1% in October, which jibes with other signs that pressure on the labor market is starting to ease a bit.

Outlook for 2020: pressure on household incomes will lessen

Labor markets seem to have bottomed out

PMI surveys advanced two quarters



CEIC, Gavekal Data/Macrobond

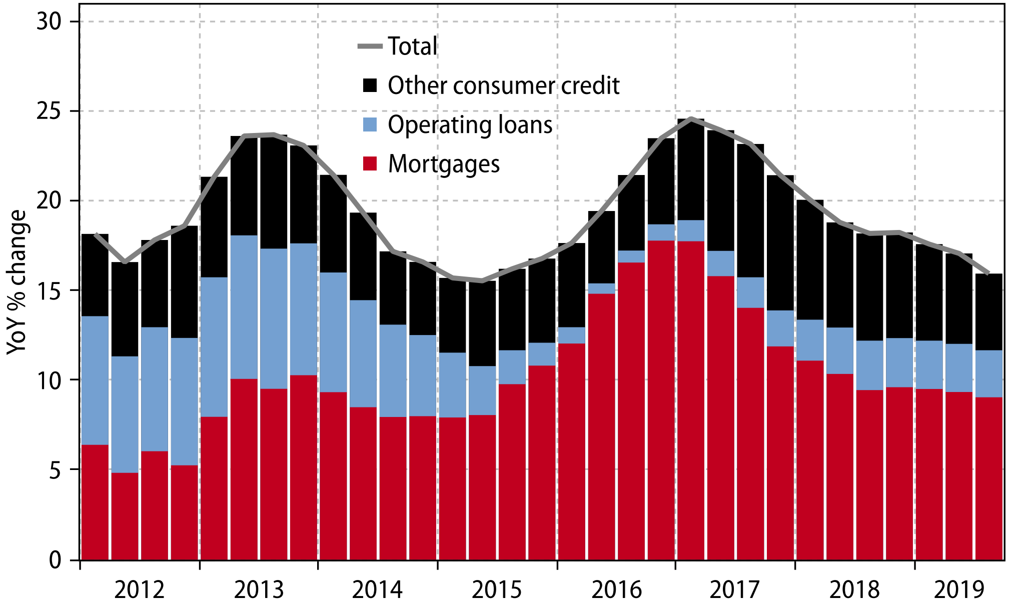
Employers' hiring intentions, as reflected in the PMI surveys, are a decent leading indicator of labor market outcomes (wage growth). But the weakness in both manufacturing and services employment in 2018-19 was somewhat offset by the frontloaded income tax cut that began in 4Q18.

The effect of the tax cut is fading, and income growth could weaken further due to the lagged impact of a weak labor market. But in recent months, the employment surveys have stopped deteriorating with the bottoming of the electronics and auto cycles. If the trade outlook does not deteriorate, household income growth and consumption should stabilize in 2020.

Household debt growth is slowing, but still fast

Growth in household debt has cooled but is still rapid

Contribution to growth of total household debt, by component



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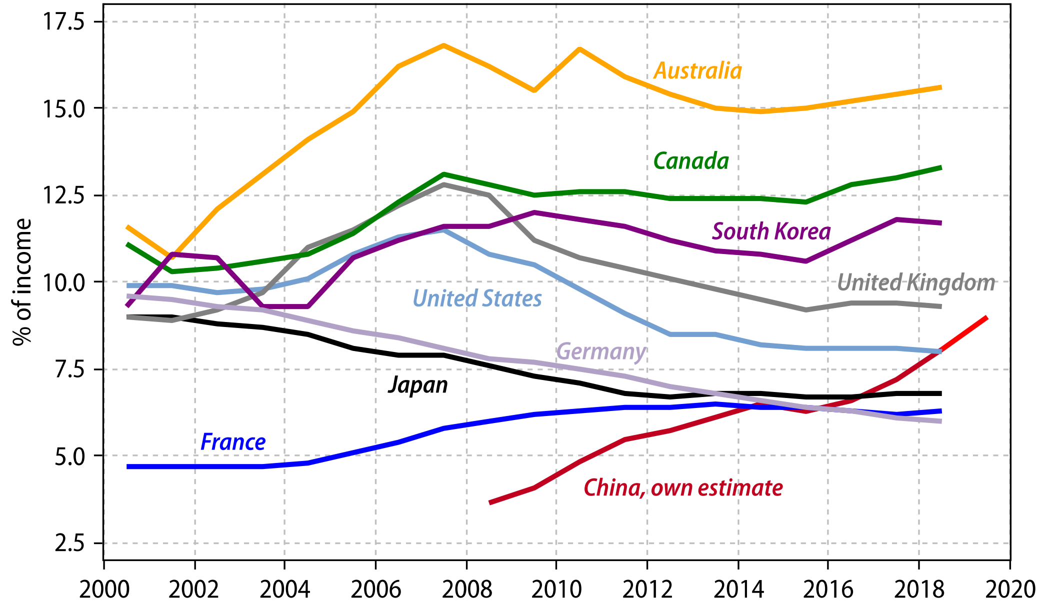
China's household debt service ratio is rising rapidly

Household debt service ratios, by country (BIS estimates except for China)



BIS, PBOC, CEIC, Wind, Gavekal Data/Macrobond

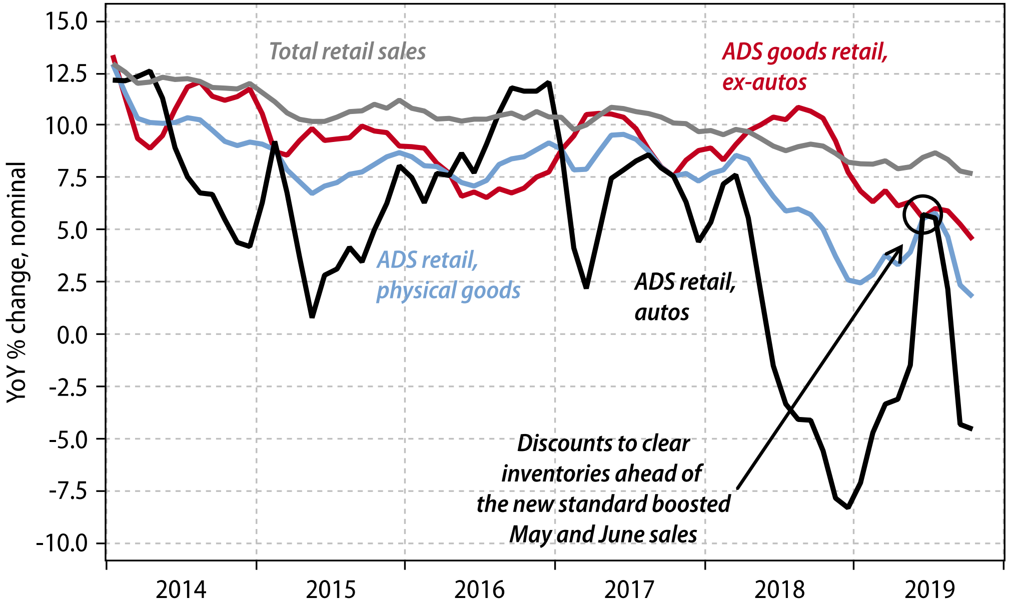
The rapid rise in China's household debt remains of wide concern, as it could weigh on consumer spending. With regulators tightening up on some forms of household debt, growth in the total stock of debt has cooled off to 16% YoY in Q3 from its peak of 25% in 2017. Most of the slowdown has been in consumer credit, which tends to have high rates and short duration. Mortgages are still the biggest driver of household debt, but growth has also eased a bit to 16.8% in Q3 from 17.8% in 2018.

While total household debt has slowed a bit, growth in the household debt service burden was still 15% YoY in Q3, well above the 8% gain in household income. That means servicing household debt continues to suck up more of Chinese household income, though it is less of a shock to budgets and consumption growth than in the past two years. The aggregate household debt service ratio is on pace to reach 9% in 2019, outpacing the US and getting close to the 10-13% range considered risky by international standards.

Cars are the still weakest part of consumption

Autos are the biggest drag on retail sales

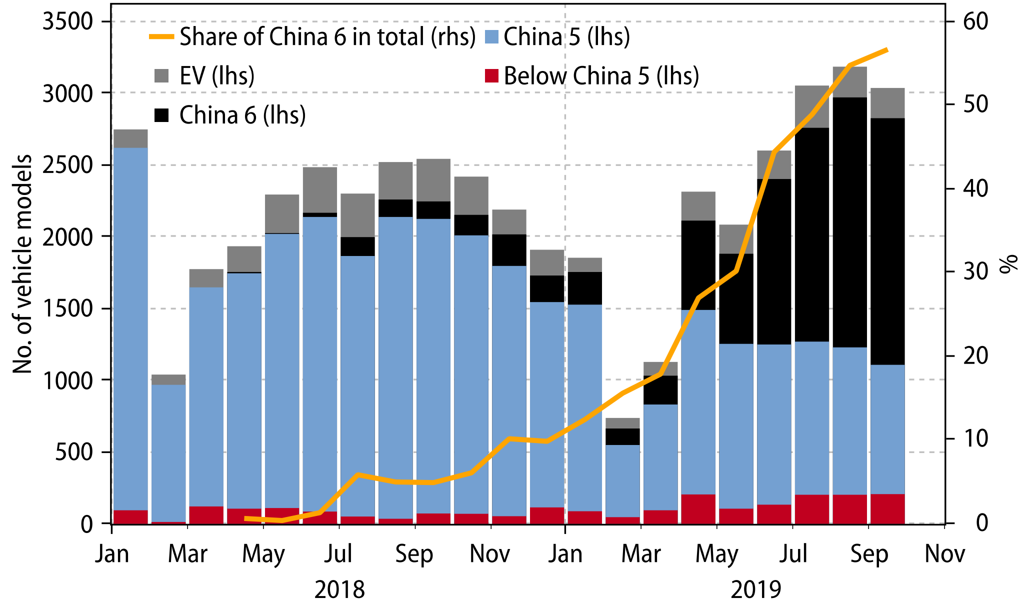
Retail sales of consumer goods, above designated size (ADS) retailers, 3mma



CEIC, Gavekal Data/Macrobond

The transition to the new emissions standard is not yet complete

Monthly production of vehicle models, by emission standards



Vehicle Emission Control Center, Gavekal Data/Macrobond

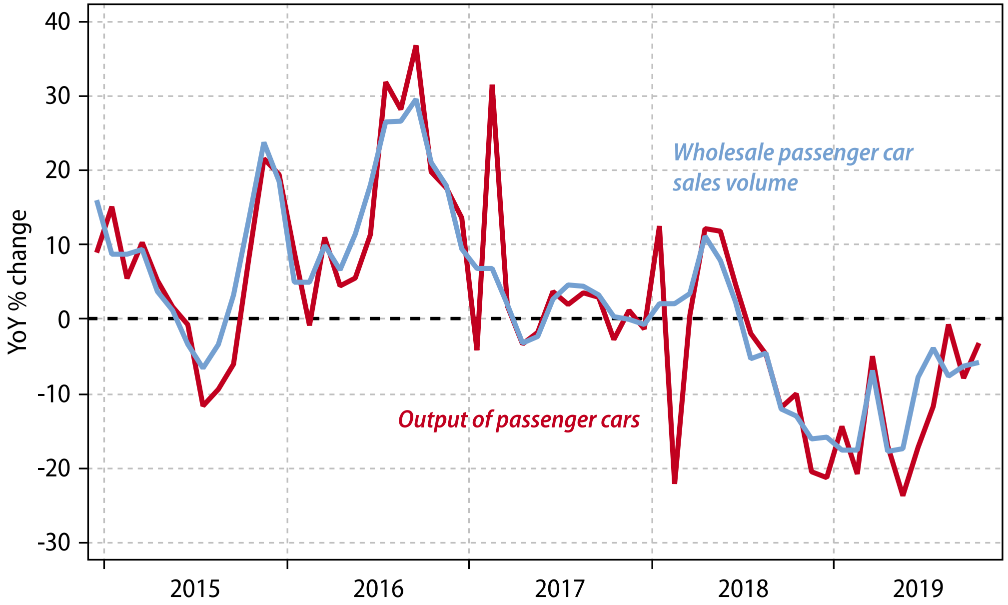
The expiration of tax breaks on car purchases led to the first decline in auto sales in more than a decade in 2018, and 2019 is headed for an unprecedented second year of decline. The nominal value of retail sales of automobiles declined by 0.7% YoY in the first ten months of 2019, dragging down growth in total retail sales of goods by 0.2pp. Auto retail sales spiked in June when car dealers were trying to clear out their inventory of older models before the new emissions standards took effect. But sales have continued to decline since.

Supply-side problems have weighed on the auto market in 2019. The political pressure for tougher environmental policies led several provinces to move up the China 6 emissions standard, originally planned for 2023, to July 2019. Automakers had not fully prepared their factories and supply chains to produce vehicles for the new standard. While provinces under the new standard account for 65% of China's auto market, only 44% of vehicle models were compliant by June, though that rose to 57% by September.

Auto sales are not yet rebounding

The decline in autos has bottomed, but the recovery is weak

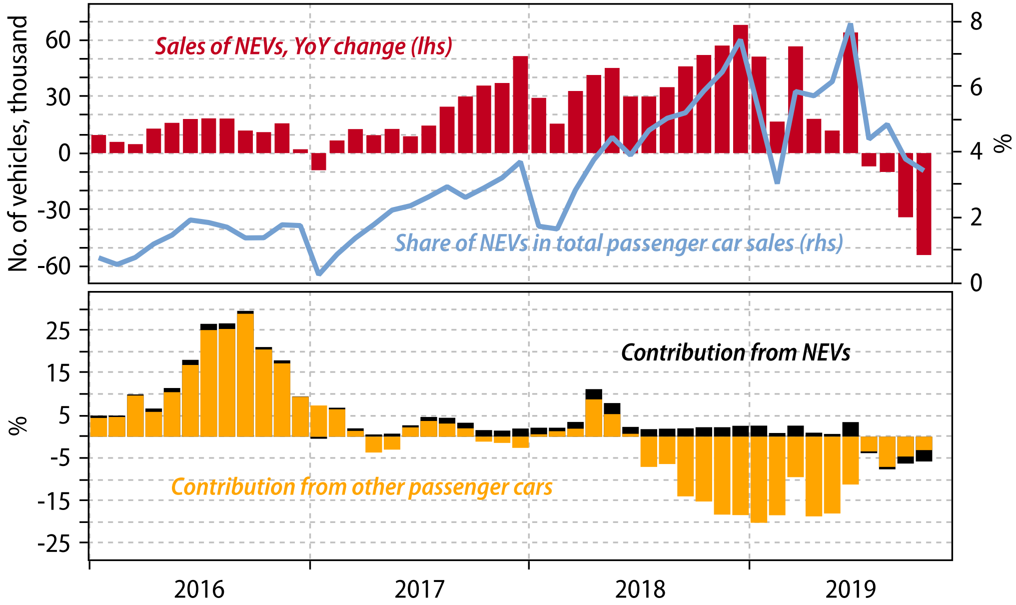
Passenger car output and wholesale shipments



CEIC, Gavekal Data/Macrobond

The collapse in sales of electric vehicles is a new drag on auto sales

New-energy vehicles (NEVs), contribution to passenger car sales



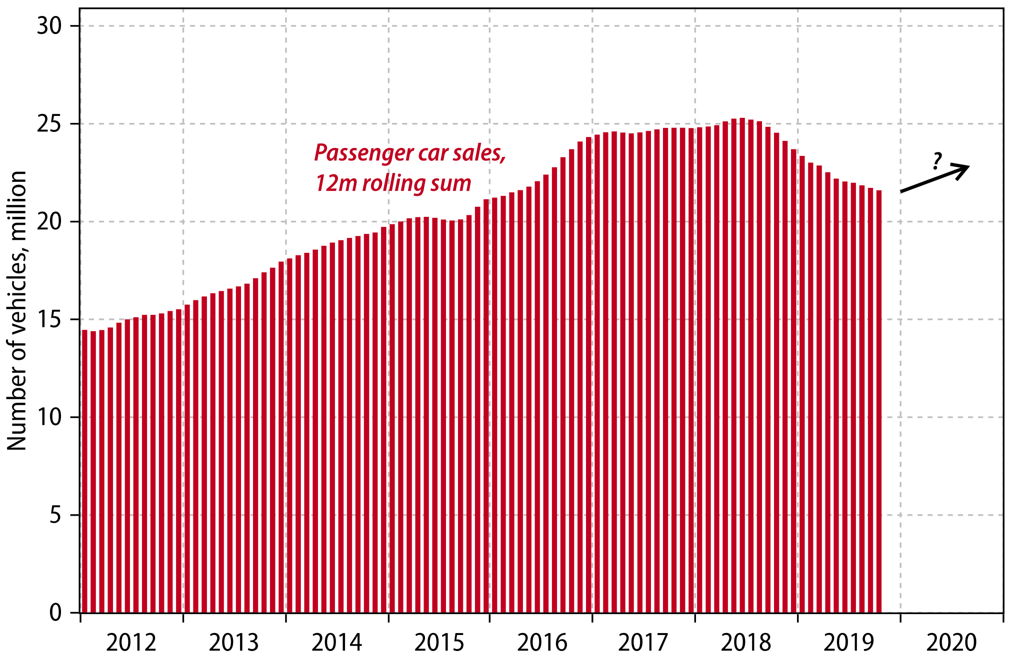
CEIC, Gavekal Data/Macrobond

The disruption from the transition to the new emissions standard has gradually faded. The decline of passenger car output and sales bottomed in Q3, but manufacturers will still need a few more months to complete the transition of their facilities and supply chains. Car dealers are also still clearing out inventory of older models. Auto production and sales should return to positive YoY growth by Q4, though that apparent recovery will owe a lot to the very low base of comparison for late 2018.

Just as automakers were digesting the new standards, car sales took a hit from changing policies on new-energy vehicles. The central government withdrew most consumer subsidies for NEVs in June; sales swung from 88% YoY growth in June to a 45% decline in October. While NEVs vehicles only account for about 5% of auto sales in China, the huge decline is enough to have a noticeable effect on overall sales. NEVs dragged down auto sales by 2.6pp in October, while the drag from internal-combustion engine cars has narrowed.

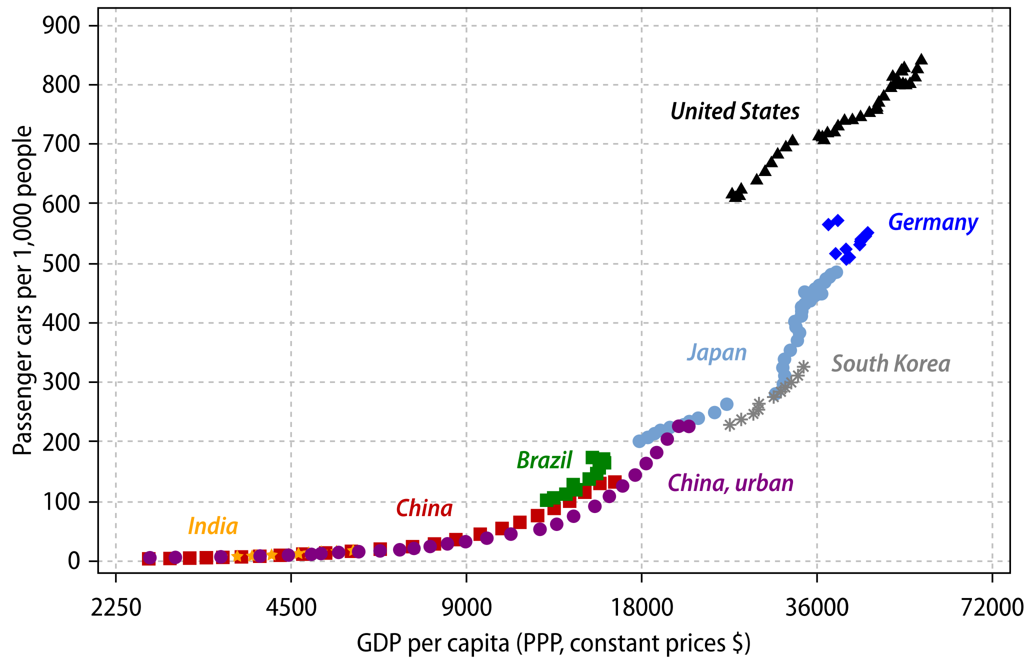
China's auto market should still have room to grow

Has China's auto market peaked?



CEIC, Gavekal Data/Macrobond

China's passenger car ownership still has room to grow



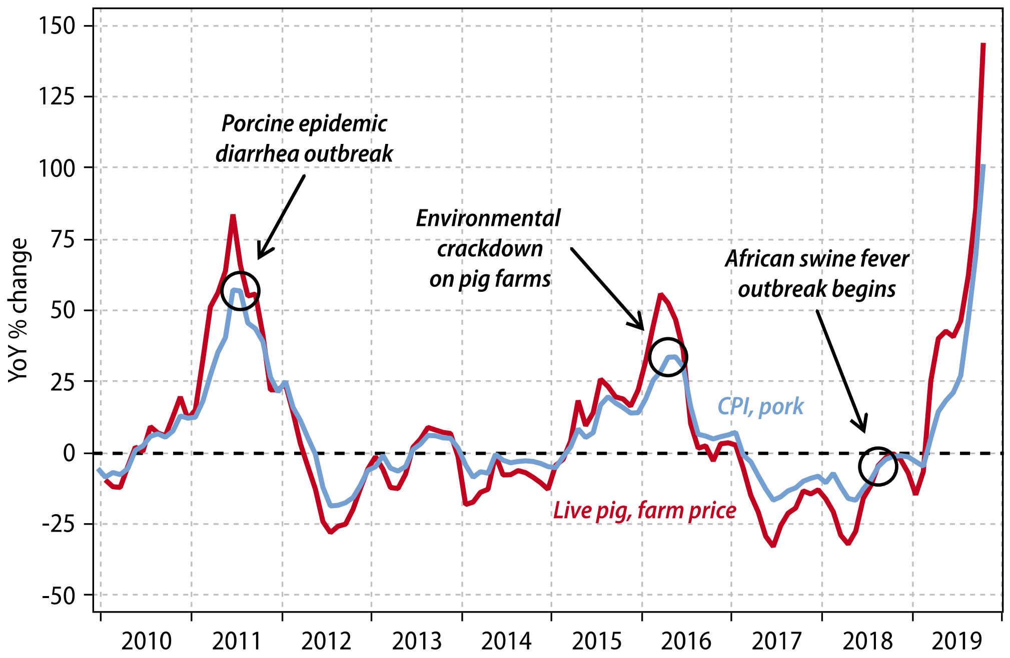
CEIC, Gavekal Data/Macrobond

With passenger car sales set for a second consecutive annual decline, there are increasing concerns that China's auto market has peaked. The automotive sector accounts for approximately 5% of GDP, so its decline has been a major drag on economic growth in 2019, and peak autos would mean that drag continues. The short-term disruptions to auto sales from regulatory changes should end soon, and auto sales can grow in 2020. But whether auto sales can continue to reach new highs after this correction has been called into question.

Over the longer term, China's auto market still has potential to grow. Currently there are about 23 cars for every 100 urban residents in China, a ratio close to Japan's in 1985 at similar levels of per-capita GDP. If economic growth in China does not come to a halt, then its rate of passenger car ownership should continue to increase. But it is quite likely that the rate at which car ownership rises in the future will be slower than in the past. The restrictions on car purchases and driving in major cities are also a factor.

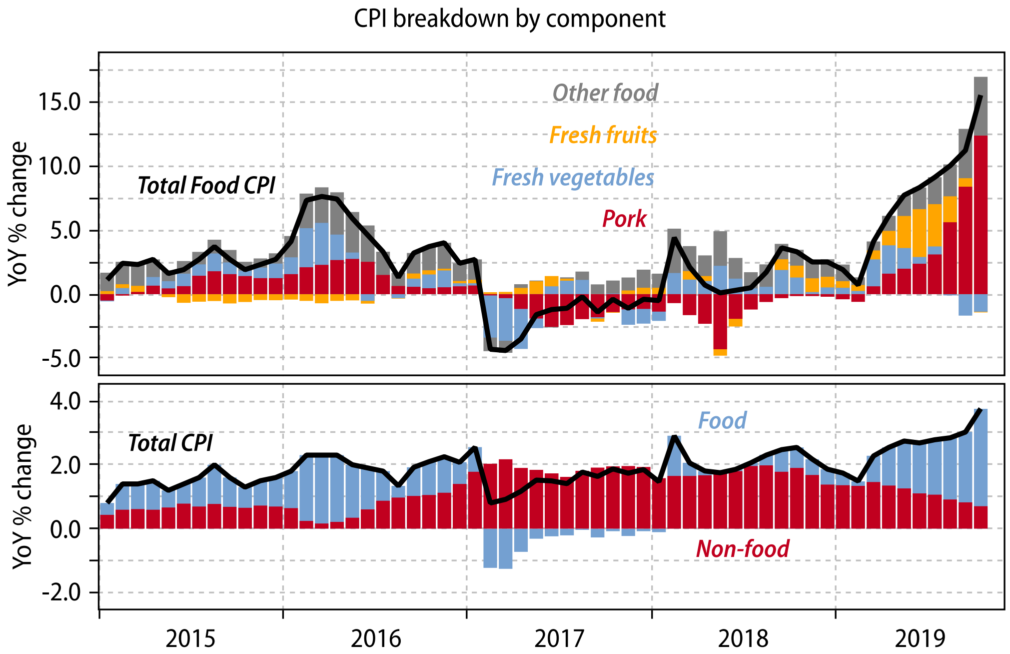
The worst pork crisis in history

The current pork crisis is China's worst ever, with prices hitting new highs



CEIC, Gavekal Data/Macrobond

Food price is mainly driven and will continue be driven up by pork



NBS, Gavekal Data/Macrobond

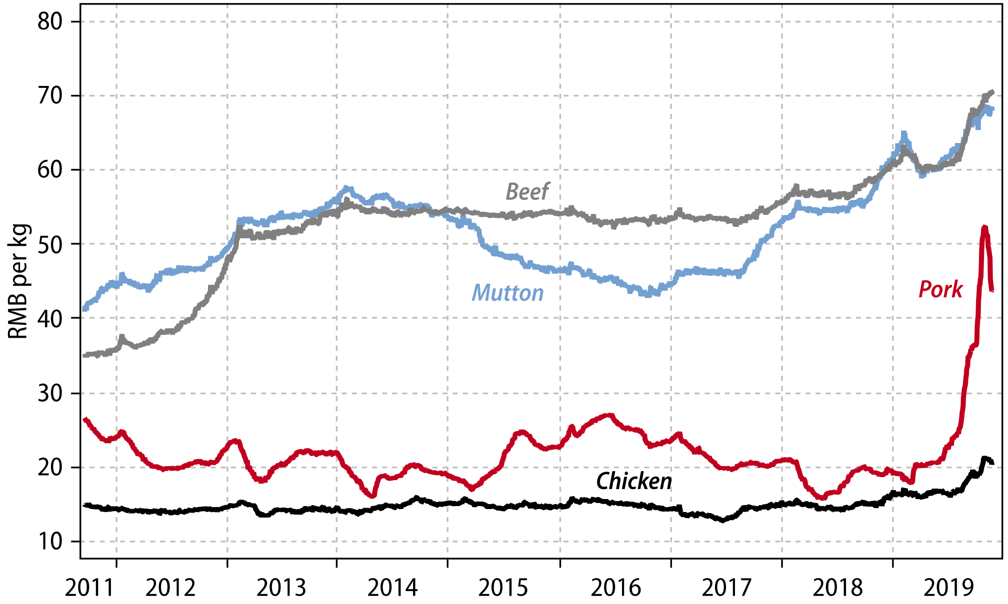
While China has frequently experienced pork price spikes in the past, the deadly epidemic of African swine fever is a much bigger disruption than any previous cycle. The total hog stock in China has declined by 40% YoY already, and prices for hogs and pork were up by 140% and 101% YoY in October. Since there is no treatment or vaccine for the disease, and no near-term solution to boost pork production, pork prices are likely to remain at historic highs. Still, the demand response from consumers can soften the momentum of price increases.

The surge in pork prices has pushed up food prices significantly, driving up overall inflation. Food prices in the CPI are up 15% YoY in October, the highest monthly increase since 2008. Pork alone contributed 2.4pp of the 3.8% in total CPI inflation in October, which was up from 3% in September. The base effect for pork prices is also very high, as mass slaughtering in late 2018 depressed prices. The prices of other meats are also rising as substitution away from pork boosts demand, adding more inflationary pressure.

China's pork eaters are faced with unattractive choices

The spike in pork prices has driven up demand for other proteins

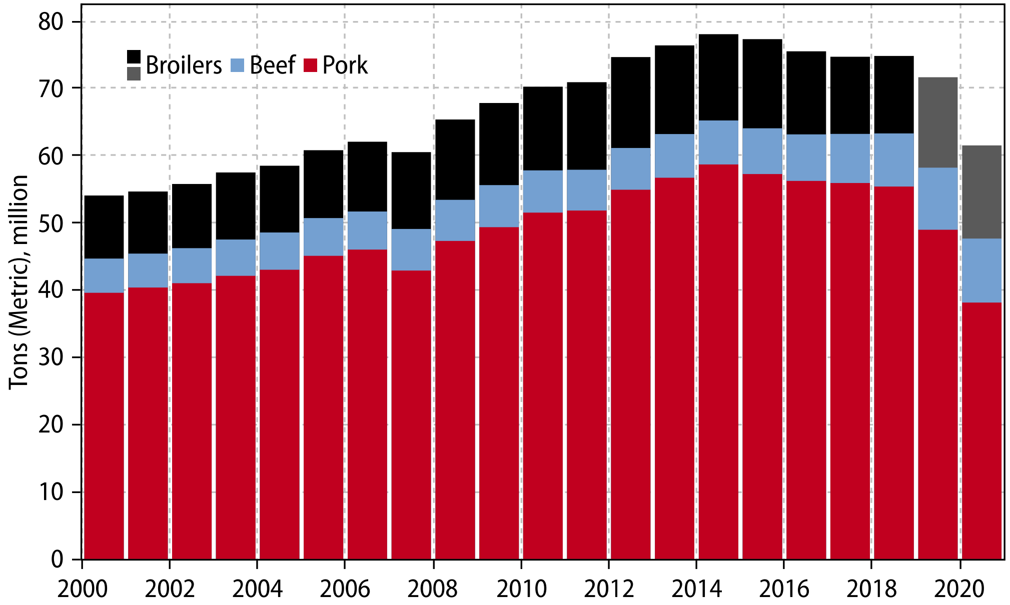
Daily wholesale price of major meat products, MARA



CEIC, Gavekal Data/Macrobond

Replacement of pork for other proteins could be limited

Domestic consumption of major proteins, USDA estimates (own forecast for broilers)



Gavekal Data/Macrobond

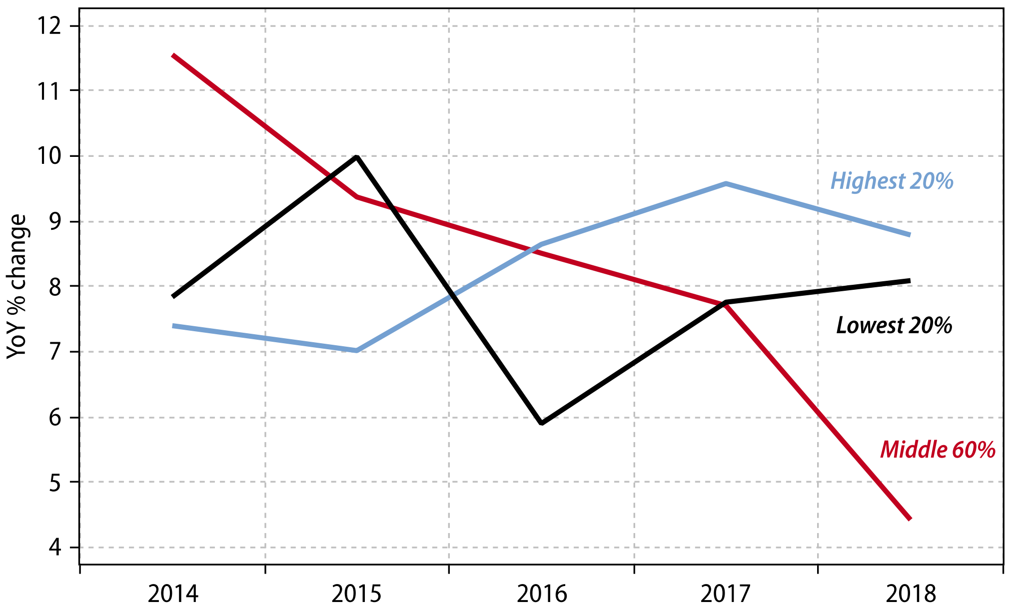
As pork prices have spiked, consumers have increased their purchases of other meats: prices for beef, mutton and chicken have all hit record highs. But beef and mutton remain much more expensive than pork, so are not the most attractive substitutes. Chicken is much cheaper than pork and has gotten relatively more attractive with the spike in pork prices. But demand for chicken is only a fifth the size of the demand for pork, which means chicken consumption would have to increase by 150% to offset a 30% decline in pork.

Consumer demand for pork is likely to remain relatively sticky. Pork is still the mainstay of Chinese cuisine, accounting for half of household meat consumption. There can be more marginal substitution to other meats, but the changes will be small relative to the big shock on the supply side. There is also a trend for replacing more meat with non-meat proteins such as tofu, but the aggregate effect is still marginal. That means China's demand for pork will exceed its much-reduced domestic supplies for some time to come.

Middle-income households are doing worse

The middle of the income distribution has done much worse

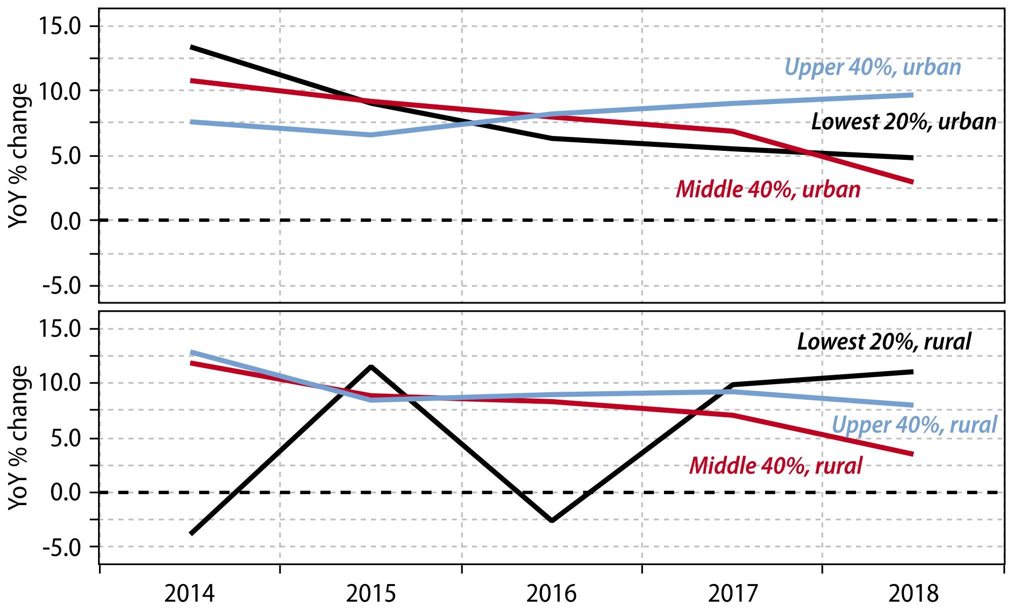
Nominal growth in nationwide household per-capita income, by income quintile



CEIC, Gavekal Data/Macrobond

The biggest gainers are the top urban and bottom rural groups

Nominal growth in household per-capita income, by income group, urban & rural



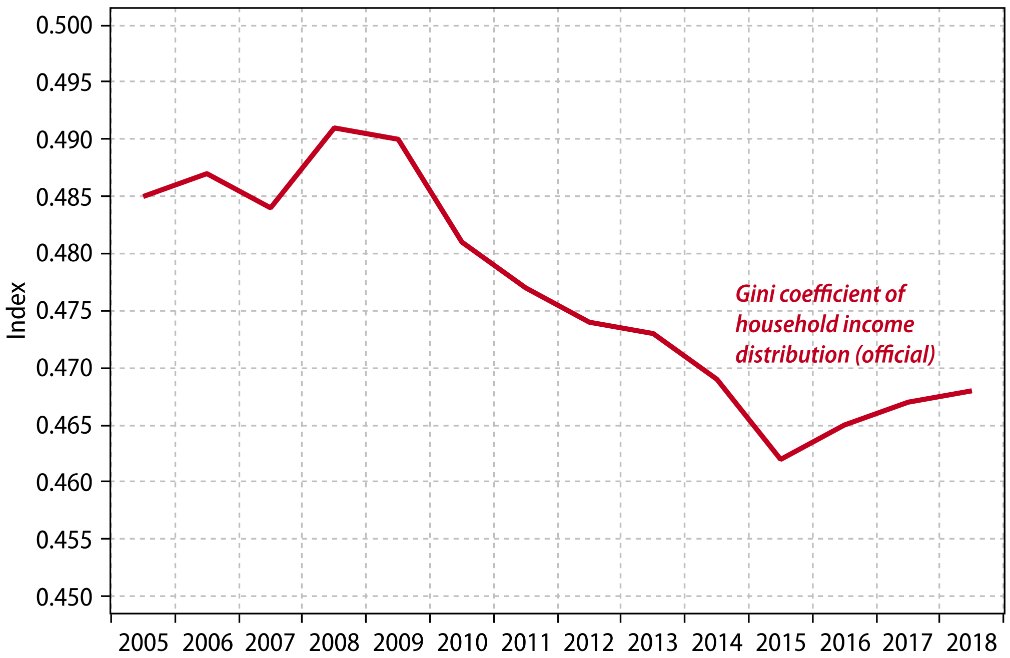
CEIC, Gavekal Data/Macrobond

Income distribution data is available only with a lag but offers some insight into consumption trends. Although aggregate household income growth slowed slightly in 2018, there was a much more dramatic deterioration for the middle 60% of the distribution, the group probably most exposed to manufacturing layoffs. The top quintile continued to have the strongest income growth, though it slowed slightly. Only the bottom 20% saw income growth accelerate, thanks to more poverty alleviation and other redistributive policies.

Specifically, the middle quintiles among both urban and rural households are doing worse than other income groups. The fastest income growth is from the top 40% of the urban population, who may benefit from the boom in housing prices. The bottom quintile, which gets the most public support, is seeing the biggest gains among rural households. As these trends likely continued in 2019, it helps explain the weak growth in retail sales: mass-market consumer goods are usually driven by the large middle-income population.

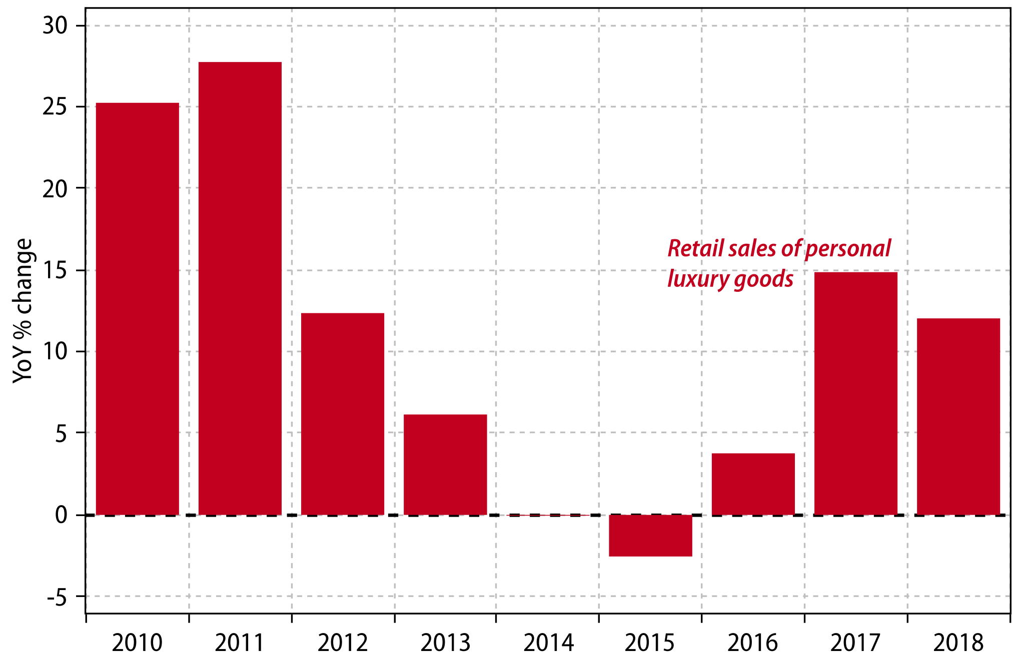
Rising inequality helps luxury goods sales recover

China's income inequality has widened since 2016



CEIC, Gavekal Data/Macrobond

Consumer spending on luxury goods has rebounded



Euromonitor, Gavekal Data/Macrobond

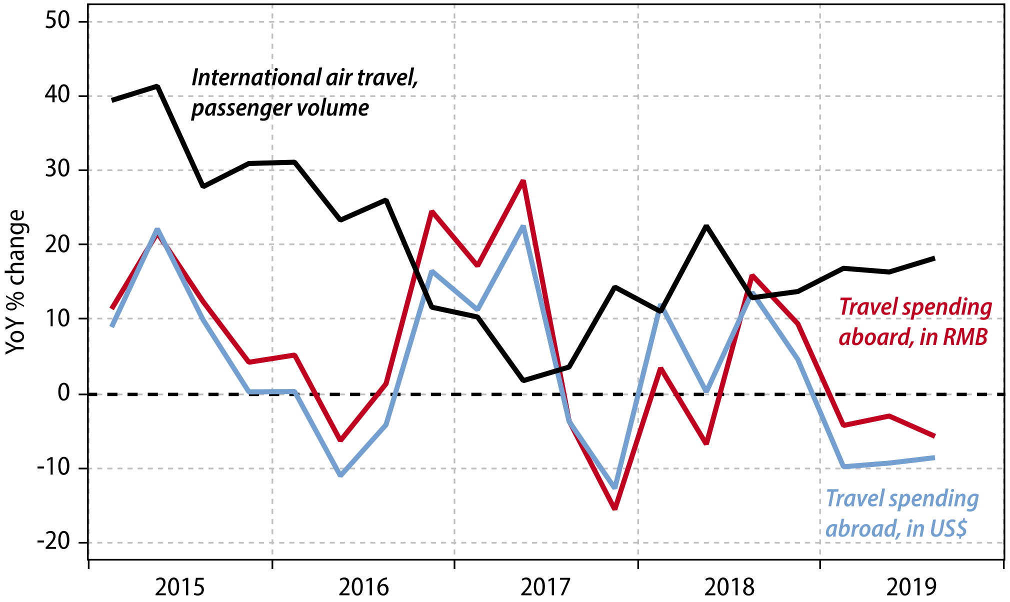
The fast income growth for those at the top of the income distribution implies that inequality has widened, and indeed the official Gini index confirms that income inequality has started increasing again since 2016. Even though the government has tried to narrow inequality through redistributive policies, the effects are outweighed by the rapid gains of the high earners. These appear to be driven mainly by income from property and financial assets rather than wages—an effect of the sustained boom in housing prices.

As incomes at the top started to accelerate, so did sales of personal luxury goods: after declining in 2015, they recovered in 2016 and growth has returned to double digits in 2017-18. Cuts in consumption taxes and import tariffs for luxury consumer goods have also supported this trend. It's also notable that sales of luxury cars have continued rapid growth even as the overall auto market has gone through a deep correction. Rising inequality supports consumer demand for more premium products.

Tourism spending has weakened as politics change travel patterns

China's international tourism spending has weakened in 2019

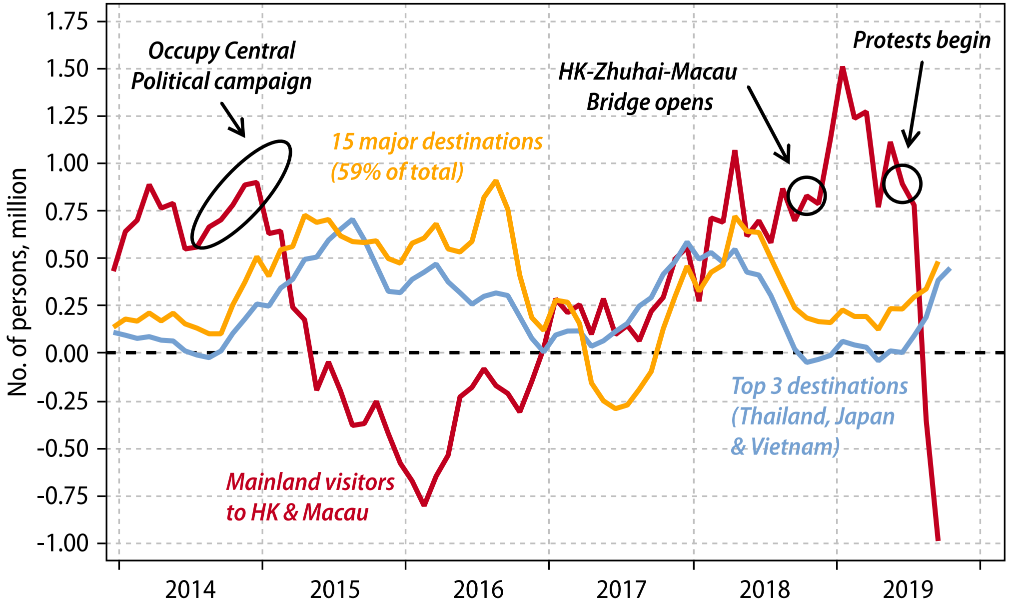
Gross debit for travel in the balance of payments vs traveler numbers



CEIC, Gavekal Data/Macrobond

Tourism to nearby countries has benefited from the HK protests

Chinese outbound travelers by destination, YoY change, 3mma



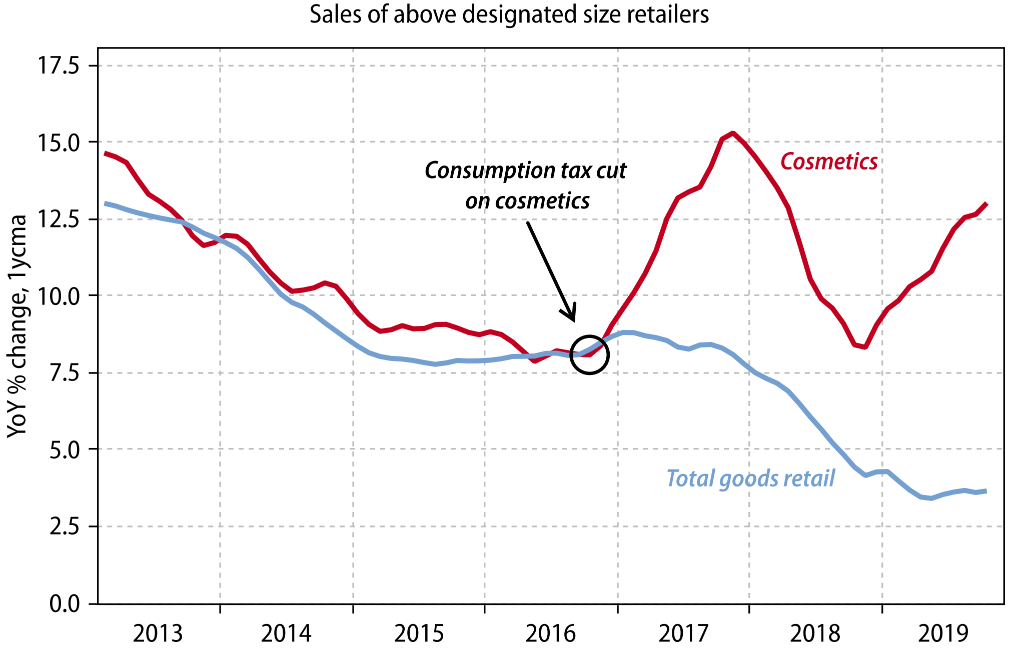
CEIC, Gavekal Data/Macrobond

China's overseas travel is being hit with a double whammy of weakening currency and rising international tensions. The balance of payments shows spending by travelers abroad fell by 9% YoY in US$ terms in the first three quarters of 2019, much weaker than in 2018. The number of international air passengers, a good proxy for total travel, has continued to maintain decent growth. There has been a big divergence among different regions: Chinese travel to the US is declining, while travel to Asian countries has picked up.

The continuous protests in Hong Kong caused a plunge in visitors from mainland China. That seems to have stimulated tourism to nearby countries: Thailand, Japan and Vietnam have seen a big rise in Chinese visitors since June. Those three countries together account for ~40% of total Chinese outbound travelers. South Korea is the 4th largest destination country, but has not benefited as China has still not lifted tour restrictions imposed for a diplomatic slight. China also imposed a new ban on tours to Taiwan in August.

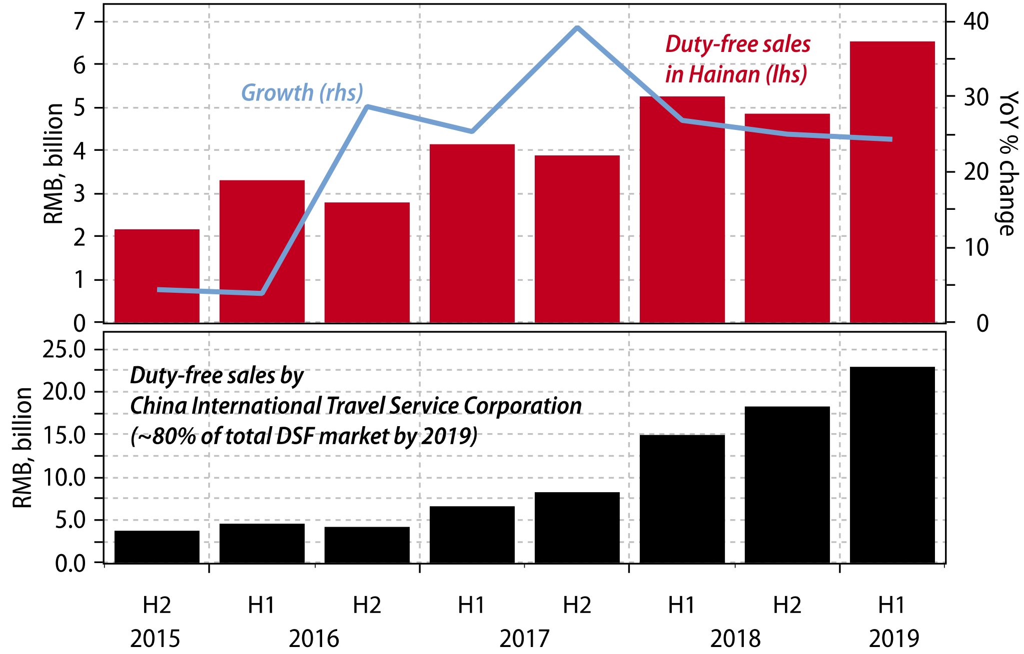
New sales channels have helped cosmetics sales boom

Sales of cosmetics has been much stronger than general consumer goods



CEIC, Gavekal Data/Macrobond

China's duty-free sales are rising rapidly



Wind, Gavekal Data/Macrobond

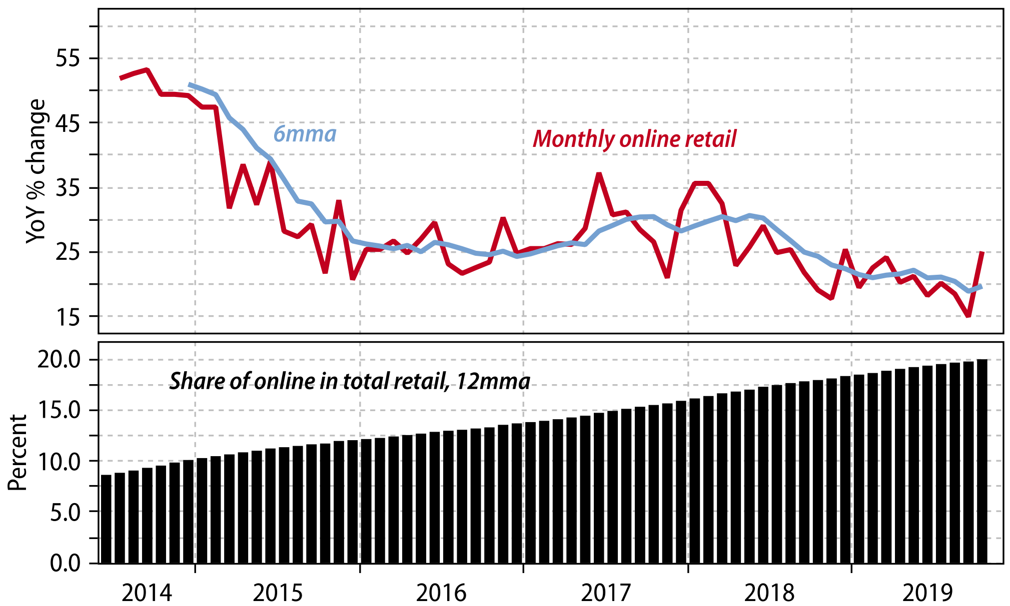
One of the major growth sectors in consumer goods in recent years have been cosmetics. Retail sales of cosmetics have outpaced overall retail since the government cut the consumption tax on cosmetics in late 2016. Major cosmetics brands also cut retail prices in 2017, further boosting sales. The momentum of cosmetics sales softened in 2018, but then strengthened again in 2019. The expansion of new sales channels and the widening impact of popular online influencers have been supporting growth.

Another factor boosting cosmetics sales is the expansion of domestic duty-free stores. Hainan province is now a duty-free zone where even domestic travelers can make tax-free purchases, leading to double-digit growth in its duty-free sales since 2017; the quota was further increased at end-2018. Chinese consumers now know they don't have to travel abroad to get good deals, since they can buy cosmetics at DFS in local airports. This helps divert consumer spending away from overseas shopping trips and back to domestic retailers.

Online retail sales have slowed as getting new customers becomes harder

Online retail growth has further slowed, but its share is still rising

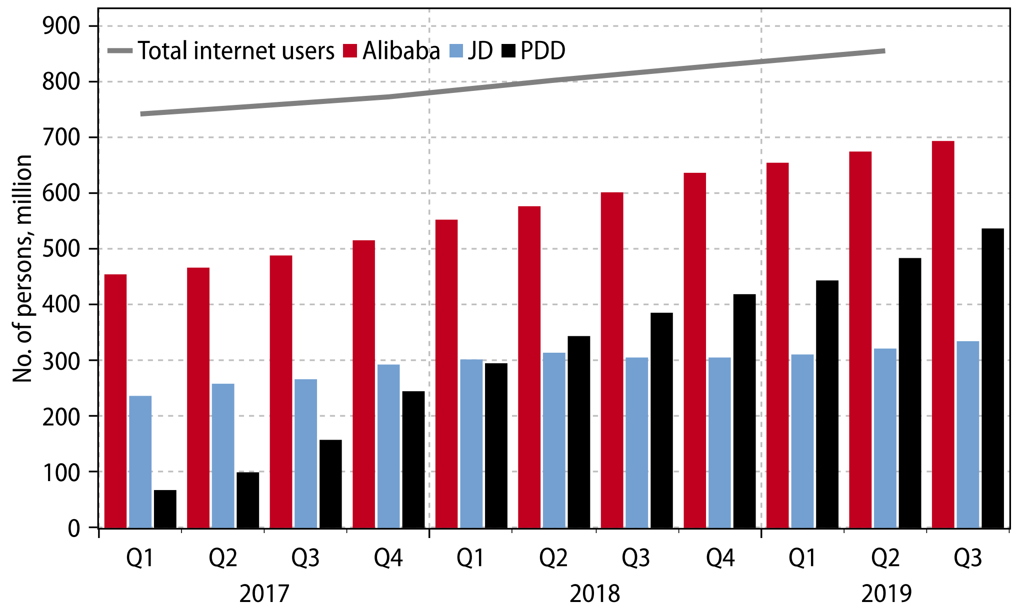
Value of online retail sales, NBS estimate



CEIC, Gavekal Data/Macrobond

There's not much room left for online retailers to attract new customers

Active customers of China's key online retail platforms, for the 12-month period ended



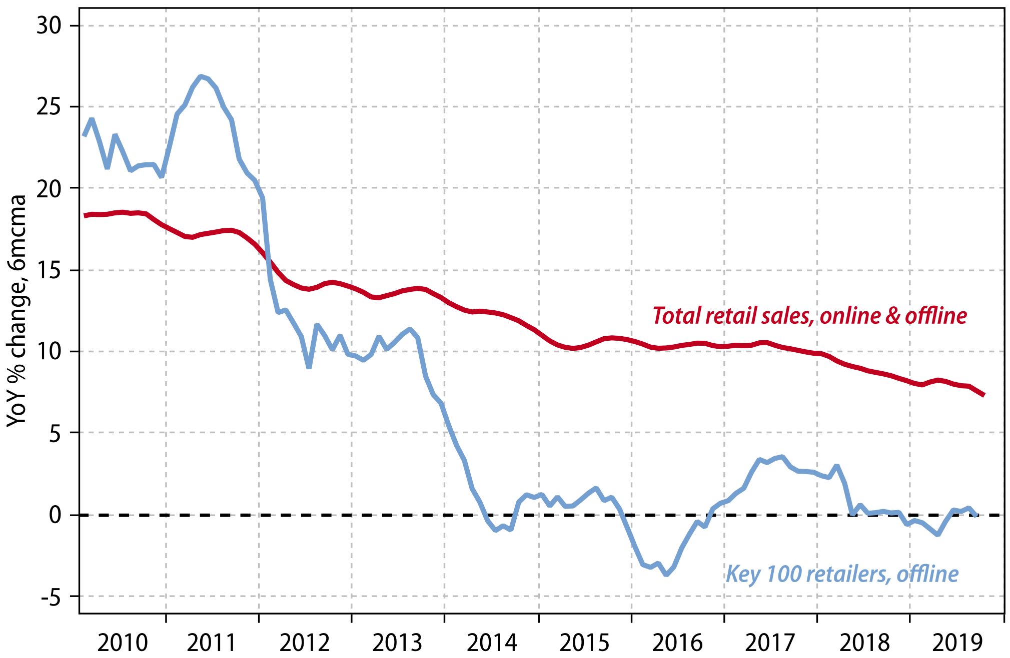
Wind, company reports, Gavekal Data/Macrobond

The rapid growth of online retail sales has cooled further in 2019, falling below 20% YoY for the first time in Q3 after maintaining 25-30% growth in recent years. Online retailing in China is in fact an increasingly mature and established business, as the companies themselves have recognized. Online retail is still growing much faster than traditional retail sales, pushing up its share in total retail sales to around 20% in 2019. Further increasing the penetration of online retail is becoming more challenging.

One main reason for slowing growth in online retail is the increasing difficulty of getting new customers. China's largest online retail platform Alibaba already had 693mn active customers as of Q2, over 80% of internet users in China. JD.com has had active users steady around 300mn since H2 2018. The fastest growing platform is Pinduoduo, which has more engagement with consumers in smaller cities and rural areas. But it has also already covered over 60% of China's internet users.

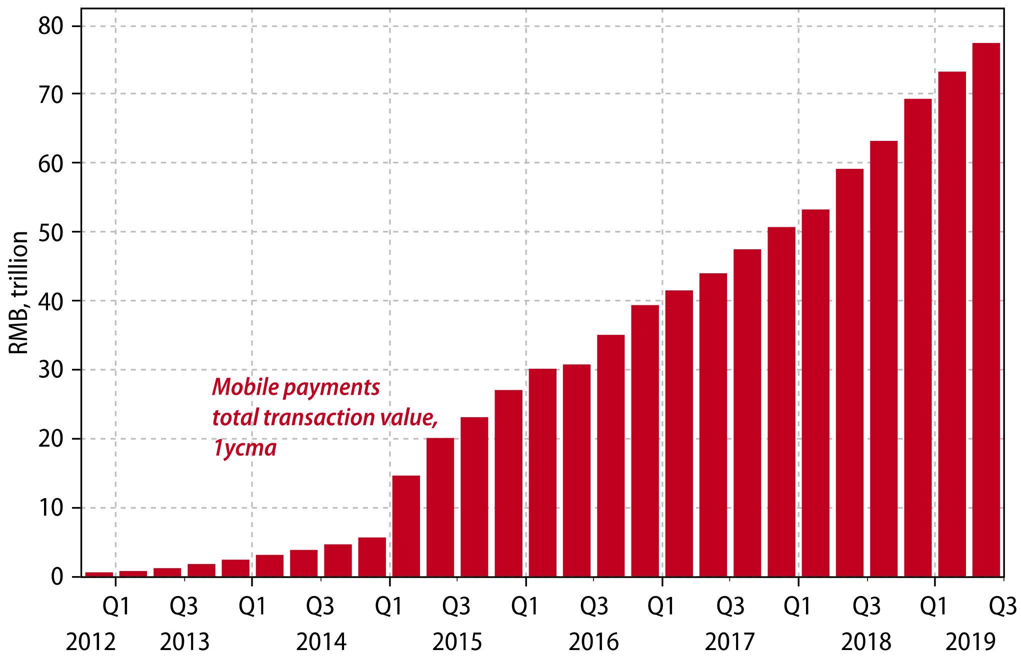
Traditional retailers are still struggling, even after online integration

Traditional retailers are underperforming as purchases shift online



CEIC, Wind, Gavekal Data/Macrobond

Mobile payments have connected online and offline commerce



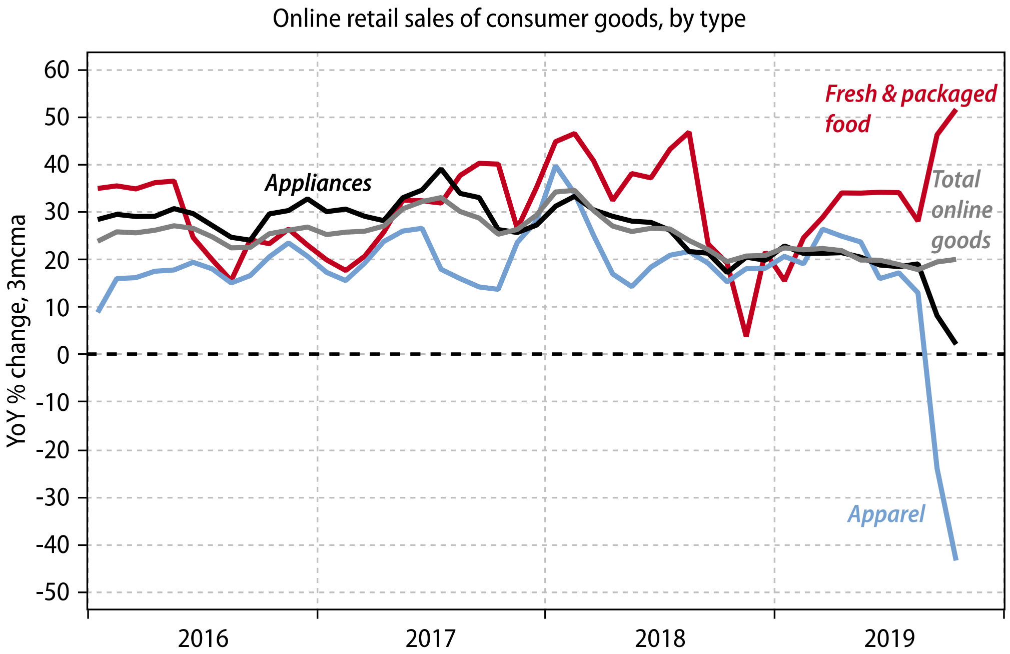
PBOC, Gavekal Data/Macrobond

Traditional retailers have been underperforming since the emergence of online retailing. First they suffered a big downturn in revenue when online purchases replaced in-person shopping. Things improved a bit during 2016-18 when traditional retailers began to adopt online promotion and payment systems, and also started offering delivery of online orders. But with this model also becoming increasingly standardized and mature, traditional retailers' sales became stagnant again from mid-2018.

The key connection between online and offline retail is the development of mobile payments, which started to surge since 2015. According to the central bank, total payments through mobile terminals reached RMB150trn in 1H19, 7x the annual transaction value in 2014. Consumers can now easily order groceries or food from nearby offline stores using their mobile phones. This phenomenon has blurred the boundaries between online and offline retail and created opportunities to mix the best of both worlds.

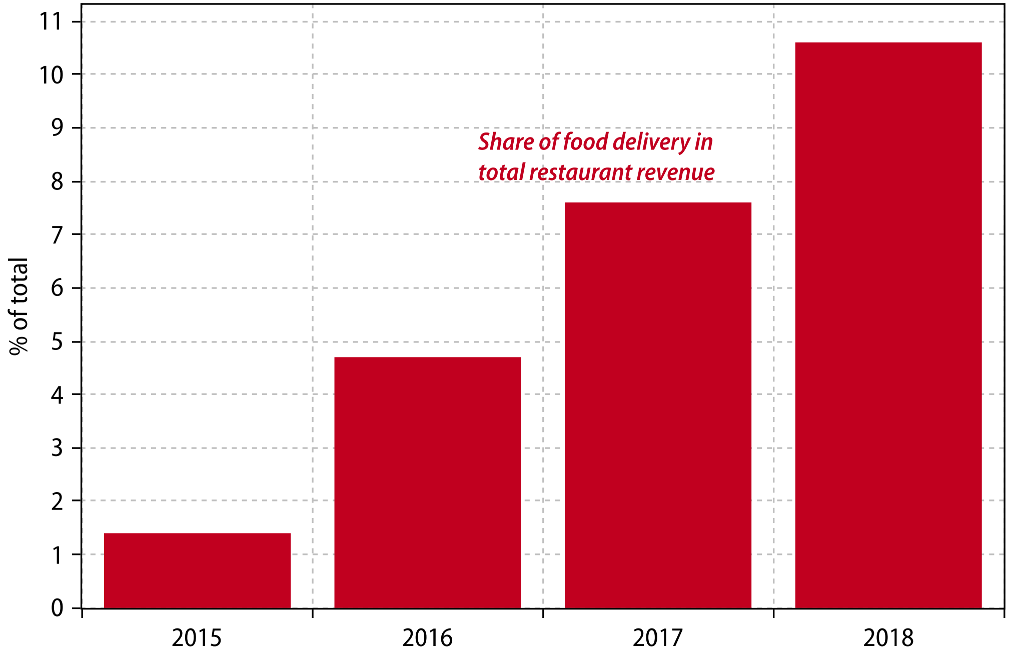
Ordering food online is becoming more popular

Online food retail has been more popular than apparel & appliances



CEIC, Gavekal Data/Macrobond

Ordering meals online has become increasingly popular



SIC, Gavekal Data/Macrobond

Online retail sales of groceries grew at 35% YoY in the first 10 months of 2019, far outpacing other categories of online sales. The main reason for this outperformance is the fast development of the delivery industry, with better cold-chain logistics and expanding last-mile delivery services. Better cold chains improve the quality of fresh food, allowing the development of new businesses like online seafood markets. Neighborhood deliveries by groceries and convenience stores have also proved very popular with consumers.

Online delivery from restaurants has also become a major business in Chinese cities, with restaurants seeing an increasing share of revenues from online orders. As of 2018, delivery had contributed 11% of total restaurant revenues in China, up from only 1.4% in 2015. The last-mile delivery market is now dominated by the duopoly of Meituan and Eleme (owned by Alibaba), who are also expanding their services from restaurant delivery to groceries. The boundaries between online and offline retail are blurring further.

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