China’s recovery stalls as K-shaped divergence widens

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China got off to a sluggish start in the second half of the year, with the economy’s K shaped divergence still widening, and policymakers signalling that stimulus will likely be incremental and targeted

China’s K-shaped divergence continues to widen

China’s data has deteriorated again in recent weeks, underscoring that the slowdown hasn’t bottomed as the third quarter gets underway.

China’s K shaped divergence is widening this year. External demand remains a strong leg, with exports up 18.5% year on year in the first seven months thanks to surging shipments of cars, ships, and chips. And despite an even bigger jump in imports, net exports have swung back into positive territory – a sign that trade is doing more heavy lifting as domestic momentum softens.

But domestic demand indicators once again missed forecasts across the board. Retail sales and fixed asset investment both slumped to post-pandemic lows, while the property sector and credit data continue to contract sharply year-on-year.

Modest policy support expected ahead

China’s July Politburo meeting drew intense scrutiny for signs of fresh stimulus. The tone was upbeat enough, but the substance underwhelmed: leaders offered little in the way of new support and instead signalled a preference for incremental and targeted easing through existing tools.

On the fiscal front, the priority will be accelerating the use of already approved funds, not rolling out new quotas. Bond issuance is expected to accelerate in the coming months to finish using this year's existing quotas.

The government announced a set of policy measures to support domestic demand at the start of August, centred on broadening the scope of interest subsidies for consumer loans.

The loan ceilings were also raised. The next few months of data will show whether the policy shift is gaining traction, but we expect any boost to be modest at best.

More help does appear to be coming. On 21 August, the Ministry of Finance signalled that additional fiscal measures are in the pipeline, with more spending aimed at households and consumption, and tighter coordination across fiscal, monetary, and industrial policy to amplify the impact. We still see a solid case for a 10bp rate cut before year end, especially with inflation and growth momentum both fading and credit demand still soft.

Lowering growth and inflation calls as momentum stalls

Given the soft start to the second half and signs that policy support will remain relatively modest, we’re trimming our 2026 GDP forecast slightly – to 4.6% YoY from 4.7%.

On the inflation side, we see persistent drags from food and rent, which are denting the reflation theme. Price competition for the economy as a whole remains significant despite "anti-involution" efforts in select industries. Higher energy prices and broadly steady core inflation should keep headline inflation comfortably positive this year, but we’re trimming our full year forecast to 0.9% YoY from 1.2%.

We’re keeping our 6.67–6.92 USDCNY fluctuation band for the yuan in the second half of 2026. But risks are increasingly skewed toward CNY strength. Appreciation expectations remain firm, and China’s current-account surplus and pent-up buying pressure from Chinese exports continue to support the CNY.

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