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China slowing, not collapsing, and shares look attractive

Key points

- The slowdown now underway in China should be seen as a normalisation of growth. It is unlikely to turn into a hard landing.
- China's moves to prevent overheating and rebalance its economy have been successful, and tightening measures will start to be relaxed some time in the next two to three months.
- Chinese shares have been leading global shares lately and are worth keeping an eye on. Right now they are cheap and, with policy tightening largely over, may be in the process of bottoming ahead of a leg higher into year end. If this is the case, it augurs well for Asian and Australian shares, and for global shares generally.

China from too much to too little

With major developed countries structurally weakened by high levels of private and public debt, the outlook for China is now seen as critically important for the global economy. For example, the International Monetary Fund (IMF) is forecasting growth in China to account for a quarter of world economic growth this year and next. Against this backdrop, moves by Chinese authorities to slow growth (and recent indications this is working) at a time when growth in the US and Europe looks soft have added to nervousness about a double dip back into global recession.

China's economy is normalising, not collapsing

Contrary to worries about a hard landing, our view is that China's economy is behaving just as the Government has hoped, and growth is simply normalising after last year's surge. After the massive policy stimulus of 2008/early 2009, China's economy surged, with growth reaching 11.9% for the year to 31 March 2010. Fears of overheating came to the fore, with surging property prices in some cities, rising inflation and unsustainable loan growth. Authorities understandably responded with measures to cool things off, though it's worth noting these measures were not aimed at simply crunching growth but were highly targeted and aimed at rebalancing the economy as well as cooling it down. The focus has been on reducing housing speculation, reducing excessive borrowing and investment by local governments, and cutting back on industries with overcapacity while at the same time continuing to boost consumer spending and growth in inland provinces. As a result, tightening measures have been very selective, including directives to banks to cut back growth in lending, increasing bank reserve requirements, and tighter conditions for people borrowing for second or third homes. **That the authorities are not trying to crunch growth overall is reflected in the fact interest rates have not been increased, fiscal policy has not been tightened and measures to boost consumer spending have remained. The evidence suggests this has worked** and the authorities are now getting what they wanted, namely:

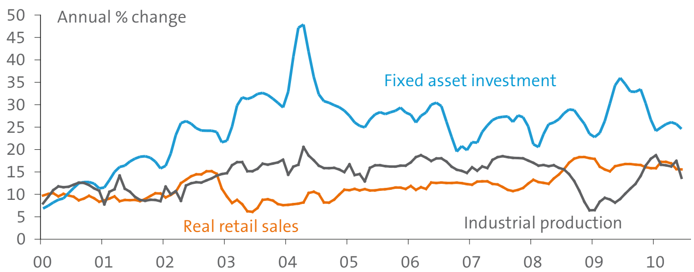
- Property transactions have slowed sharply and property prices have stalled since April;
- Overall gross domestic product growth has slowed to 10.4% for the year to 30 June 2010, with the annualised quarterly pace actually slowing to 8%, which is down from a high of 14% a year ago;

China's economy has slowed

Source: Thomson Financial, AMP Capital Investors

- Fixed asset investment has slowed from an annual growth rate of 35% a year ago to 25% in June, and growth in industrial production has cooled;
- Retail sales remain strong, consistent with policies to rebalance the economy toward consumption;

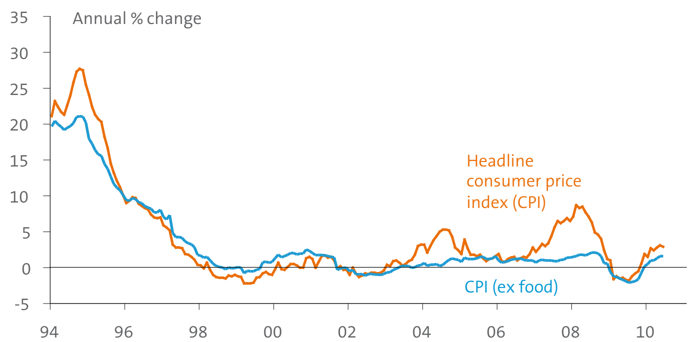
Chinese production and investment have cooled but consumer spending remains strong



Source: Thomson Financial, AMP Capital Investors

- Loan growth has slowed sharply from last year's levels; and
- Inflation looks to be peaking at around 3%.

Chinese inflation appears to be peaking at 3%



Source: Thomson Financial, AMP Capital Investors

So the bottom line is that the economy has slowed, bubbly conditions in some cities' property markets appear to be subsiding, and inflation remains under control.

The question now becomes whether growth will slow too much and we end up with a hard landing, particularly with export growth likely to ease over the next year as the slowdown in Europe and the US hits. **A further slowing in China's annual growth rate is likely but our view is a hard landing is unlikely and growth will probably stabilise around 9%**. There are several reasons for this.

Firstly, consumer spending will continue to benefit from policies to boost consumption, with Premier Wen Jiabao foreshadowing further measures to boost consumption in the current half year.

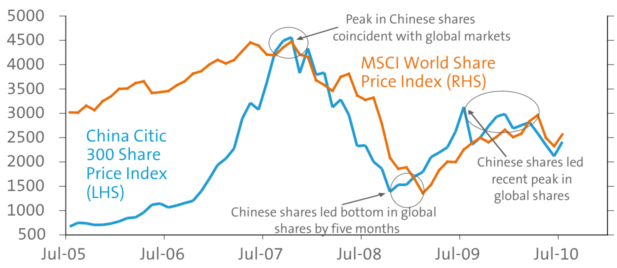
Secondly, growth in fixed asset investment is unlikely to fall too far given plans to boost the supply of low income housing and measures to upgrade infrastructure in the Western provinces. In relation to the latter, the Government has announced the approval of 23 major infrastructure projects worth 680 billion renminbi.

Finally, while the authorities will not rush to ease, our take is that worries about too little growth – particularly as sluggish developed country demand constrains exports – must be playing on the minds of policy makers and will likely lead to some relaxation of tightening measures in the next three months or so.

What is the Chinese share market telling us?

For many years, the Chinese share market told us little as it bore little relationship to the Chinese economy. But in recent times it has become a good directional barometer of the Chinese economy, falling sharply from October 2007 ahead of the downturn in Chinese growth through 2008, troughing in November 2008 ahead of the growth rebound through 2009, and falling 32% from its high in August last year ahead of the recent slowdown in growth. More importantly, its swings have increasingly led global share markets, e.g. Chinese shares bottomed in November 2008, four months ahead of the bear market bottom in global shares in March 2009, and peaked in August 2009, leading this year's correction in global shares. So while swings in Chinese shares can be exaggerated by the highly speculative nature of its share market and big variations in capital raisings, the direction of the Chinese share market is worth watching!

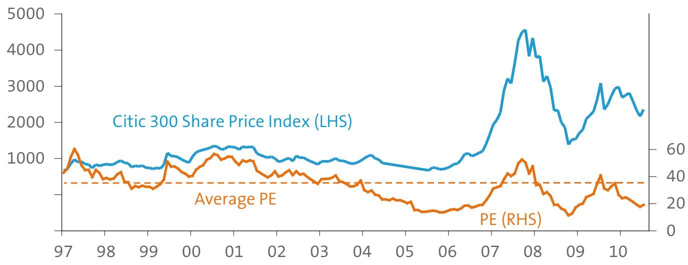
Chinese shares have recently been leading global shares



Source: Bloomberg, AMP Capital Investors

Our assessment is that the Chinese share market has seen or come close to its bottom, with strong gains in prospect by year-end and next year. Firstly, after a big slump since last August, Chinese shares are cheap. The price to earnings (PE) multiple based on historic earnings has fallen from 41 times last August to 19 times currently, which is well below the average over the last decade of 34 times. With consensus earnings growth expectations of 29% this year and 22% next, the forward PE multiple is 14 times, which is quite low for a country with China's growth potential.

Chinese shares are cheap



Source: Thomson Financial, AMP Capital Investors

Secondly, speculative froth has been unwound, with trading volumes and new account openings well down. This is often positive from a contrarian perspective.

Thirdly, capital raisings have reached near-record levels on the back of the Agricultural Bank's initial public offering and may be nearing a top, with banks having largely recapitalised and softer share prices likely to cause some capital raisings to be delayed.

Finally, just as talk of policy tightening saw the Chinese share market peak last August, talk of a relaxation of policy tightening is likely to see it bottom. And given the recent leading relationship from Chinese to global shares, a bottoming in the former would be good for the latter.

Conclusion

The Chinese economy is likely to stabilise with growth around 9%. This should be seen as a normalisation in growth and is likely to be facilitated by moves to relax tightening measures some time in the next three months. A soft landing in the economy and reduced tightening measures should be positive for the Chinese share market. This should in turn be positive for Asian and Australian shares (as the slump in Chinese shares over the last six months has weighed on regional share markets), and should also provide a good lead for global shares.

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