

## China's turn

EDITION 32 – 20 OCTOBER 2011

### Oliver's Insights



#### Key points

- > Slowing exports, tight credit and a slowing property market suggest the risks regarding China have increased. Policy makers may also be slow to respond, resulting in further short-term uncertainty.
- > So far there is no sign of a hard landing and it's unlikely due to spending on social housing, solid consumer demand and a likely easing in economic policy late this year or early next year.
- > Chinese shares are cheap, but probably require monetary easing before their fortunes turn decisively.

#### Introduction

After Europe and the US have effectively played tag team in causing consternation for investors over the last six months, it seems China may be joining in as well. Sentiment regarding China is constantly swinging between boom and bust. Right now it has swung back to the bust side, with increasing concern about a Chinese hard landing.

This comes at a time when Europe and the US are looking somewhat better, or at least a bit less worrisome. Recent US economic data points to an economy continuing to grow, albeit slowly, but not in recession. And Europe appears to be moving to write off more Greek debt, recapitalise its banks and enhance the role of its bailout fund to provide more support for Italy and Spain. Much uncertainty remains, but the worst case of a US recession and European financial meltdown looks to be receding in likelihood. Providing that Europe delivers some sort of coherent plan as promised, this augurs well for further gains in shares into year end. But just as the risks appear to be receding a bit regarding the US and Europe, concerns about China are on the rise.

#### China concerns

Pessimism regarding China can be summarised as follows: it has overinvested in infrastructure and property, with talk of “bridges to nowhere” and “ghost towns”; this has been associated with much higher-than-reported public debt levels and will likely result in a sharp rise in bad loans in the banking system; monetary tightening has led to a credit crunch which is now squeezing property developers; exports are now slowing as a result of slower global growth; and thanks to higher public debt and high inflation, along with the leadership changeover next March, the authorities won't respond quickly. Several high profile rail accidents and media stories of credit problems in Wenzhou have added to the gloom. This has all seen the Chinese share market fall back to last year's lows, which is 30% below the post-Global Financial Crisis (GFC) high in August 2009 and 60% below the pre-GFC high of October 2007.

Wenzhou is a coastal city which is regarded as the country's private sector heartland. It has a very active non-bank, or curb, lending market. Informal lending surged in response to monetary tightening and rates of interest range from 20% to 40%. With the recent slowing of the economy, exports and property markets, over 90 Wenzhou factory owners are reported to have disappeared and

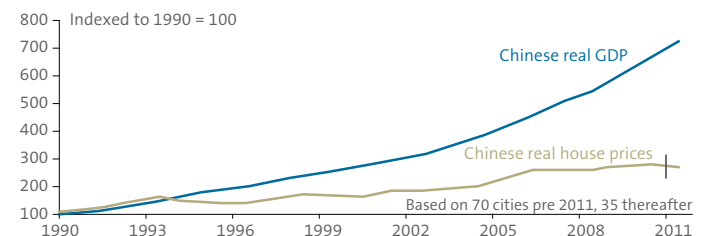
thirty are reported to have committed suicide after not being able to pay their debts. Many see this as a sign of things to come for China.

#### Some perspective

Many of these concerns are not new. The following points are worth noting.

- > Per capita income in China is less than 10% of US and Australian levels. As such, pent up demand is huge, making it almost impossible for China to overinvest in infrastructure or property. Today's glut quickly becomes tomorrow's shortage. Shanghai's Pudong district is a classic example – once a huge ghost town, it is filling up.
- > Bubble-like conditions have clearly existed in some cities' housing markets and affordability is poor. However, nationwide house price increases have lagged income gains and moves to slow the residential property market appear to be working, with house price growth slowing to an average of less than 4% over the year to September. What's more, household debt is low, only 11% of residential property buyers are investors, average deposits are around 40% of values and 20% of buyers pay in cash. Hardly the stuff of bubbles.

#### Chinese house prices have lagged growth in GDP and are now falling in real terms



Source: Bloomberg, AMP Capital Investors

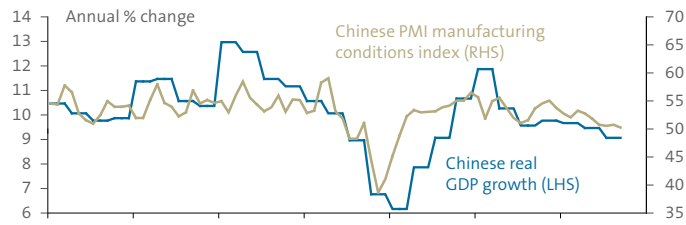
- > Allowing for the surge in local government debt, as a result of the 2008-09 stimulus, most estimates put China's gross public debt at around 50% of GDP. However, several points are worth noting in relation to this. First, it's still well below US, EU and Japanese levels, which are around 100% of GDP or higher. Second, unlike the US and many troubled European countries, China is not dependent on foreign funding of its public debt. In fact, China is now the world's biggest creditor nation and once allowance is made for its huge foreign exchange reserves and sovereign wealth fund holdings, its net public debt is around zero. Chinese government asset holdings are also massive compared to most countries. Third, China's budget deficit is just 2% of GDP and fiscal revenue is growing 20 to 30% p.a., all of which makes public debt levels easily serviceable.
- > While bank non-performing loans will likely rise with the inevitable failure of some infrastructure projects, a reasonable estimate is that the non-performing loan ratio for major banks could increase from a very low 1.5% or so at present to around 7%, compared to 24% a decade ago. It's also likely the central government will underwrite many of the bank loans to local government as they were an arm of fiscal policy.
- > Wenzhou is unlikely to be indicative of the whole country. Curb lending in Wenzhou has a long history, with a big proportion of households and firms participating. However, Wenzhou accounts for less than 1% of national GDP and small business reliance on curb lending is far less elsewhere, funding around 6% of capital spending.

## No sign of a hard landing yet

September data for China points to a clear slowing in growth but no sign of any hard landing.

- > GDP growth has slowed to 9.1%, from a peak of 11.9% last year, and business conditions indicators (PMIs) are running around levels consistent with around 9% growth. While export growth has slowed on the back of reduced demand from Europe, indicators of domestic demand i.e. retail sales (up 17.7% year on year (yoy)), fixed asset investment (+24.3% yoy), industrial production (+13.8% yoy) and electricity consumption (+12.2% yoy) all remain solid.

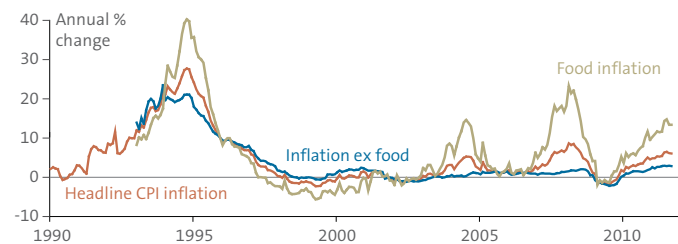
### China's economy has slowed but no sign of a hard landing



Source: Thomson Reuters, AMP Capital Investors

- > Growth in lending and money supply has cooled down, with money supply growth at a decade low.
- > The property market has cooled, but there is no evidence of a collapse with property sales up 9.5% over the year to September. Housing starts have slowed to 8.9% annual growth as developers have started to slow new projects.
- > Meanwhile, inflation appears to have peaked at 6.5% in July and has since slowed back to 6.1%. Non-food inflation appears to have peaked at 3%.

### Inflation looks like it is peaking



Source: Thomson Reuters, AMP Capital Investors

This all points to an economy coming back under control, although it has taken much longer than anticipated to bring inflation under control following persistent food inflation.

## Outlook

Our assessment is as follows. Firstly, growth is likely to slow to around 8% in 2012, led by a further slowing in exports in response to weaker global growth and a fall in residential property construction. Social housing construction, solid consumer spending and steady fixed asset investment should help provide an offset.

Secondly, inflation is likely to moderate in lagged response to peaking food price inflation, slowing economic growth and slowing money supply growth – just as it did in 2008-09.

Finally, the authorities may be slow to respond in easing due to the desire to control inflation and keep property prices subdued, to avoid another surge in public debt and to ensure a smooth leadership transition. This could cause some short-term consternation in investment markets and a dip in growth below the 8% year on year level cannot be ruled out at some point in the next year – just as growth dipped briefly to 6.2% in March 2009.

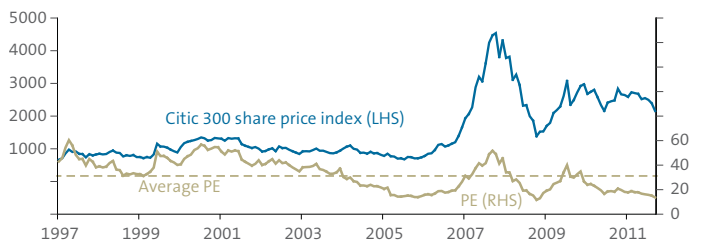
However, policy easing is still likely either late this year or early next year. Cooling inflation is making way for monetary easing, as is growing evidence of tight credit conditions. The budget deficit and public debt are still low by global standards leaving scope for fiscal stimulus - but don't expect anything like the massive four trillion Renminbi stimulus program of 2008-09, which in hindsight was overkill. It's hard to see Premier Wen Jiabao not responding if it looks like growth is slowing sharply over the next five months. In fact, selective policy easing is already starting with measures announced to help small businesses. This is a clear sign authorities are well aware the threat to growth has increased.

The biggest threat to China would be a deep European recession (which is not our base case), as more than 20% of China's exports go there.

## What about Chinese shares and commodities?

Chinese shares have struggled over the last two years in response to inflation, monetary tightening, and now concerns about the problems in Europe and the US dragging on exports. From a longer-term perspective though, valuations are attractive – with a price to earnings ratio of 13.3 times against a long-term average of 32. This suggests a Chinese hard landing is already factored in and points to the potential for attractive returns on a long-term basis. A decent upswing is probably contingent on monetary easing in the short term.

### Chinese shares are cheap



Source: Thomson Reuters, AMP Capital Investors

Having risen sharply over the last two years, commodity prices have fallen over the last few months on the back of worries about the US, Europe and China. Volatility is likely to remain high in the short term, but provided China avoids a hard landing as we expect and Europe doesn't blow up, then the secular rising trend in commodity prices is likely to resume. This should ultimately be positive for Australia's terms of trade and resources stocks.

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