

China's slowdown

Oliver's insights



Key points

- Chinese growth has already slowed significantly on the back of slowing exports and a property slump. Growth is likely to slow to 8% in 2009.
- However, a hard landing (say 5% growth) is unlikely: the global financial turmoil won't have a direct impact on China's financial system, monetary conditions are now being eased, significant fiscal stimulation is on the way and consumer spending should remain solid.
- The downturn in China combined with recession in the US, Europe and Japan is negative for commodity prices which are unlikely to start recovering until global growth turns back up again, probably some time next year.
- Chinese shares are down about 70% from their high. Further falls are possible, but they are now good value from a long term perspective.

Introduction

China's economy is now slowing significantly. This note looks at the likely severity of the slowdown and implications for commodity prices and China's share market.

The Chinese economy is slowing

The evidence is now overwhelming that China's economy has slowed significantly:

- Growth in real GDP has slowed from a peak of 12.6% over the year to the June quarter last year, to 9% over the year to the September quarter this year, its slowest pace in over five years;
- Industrial production has slowed from annual growth of around 18% a year ago to 11.4% last month;
- Auto sales fell 2.8% for the year to September, the first fall since early 2005;
- China's average house prices have fallen about 4% from their peak in January and home sales are down 42% from a year ago;
- Money supply and loan growth are running well below year ago levels; and there are
- Numerous anecdotes of business failures amongst east coast exporters (for example, half of China's toy exporters closed in the first seven months of this year);

The slowdown is primarily being driven by three factors:

- A slowdown in export volumes in response to the US and European slumps;
- A property slump which resulted from policy measures designed to slow the economy and property development that were put in place since 2004; and
- Production restrictions in the Beijing area associated with the Olympics and Paralympics have exaggerated the recent weakness in production.

Leading indicators suggest a further deceleration ahead - the OECD's leading indicator for China suggests a slowdown in growth to around 8%.



Source: Thomson Financial, AMP Capital Investors

This is likely to be led by a further slump in export growth to around 10% from 21% currently on the back of the global slump and a sharp rise in the trade weighted value of the Renminbi in recent months. The impact of the property downturn will also feed through to business investment (where property construction accounts for about 25% of fixed asset investment) and consumer confidence.

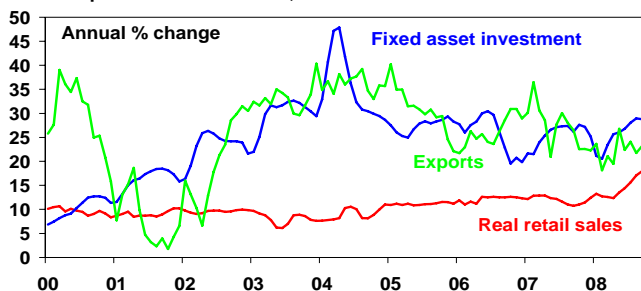
But why not a hard landing?

While China is slowing significantly **it's unlikely to have a hard landing**, which given China's potential growth rate of around 8 to 10% and need to find jobs for roughly 10 million rural workers each year would mean growth of around 5%.

- **The Chinese banking system looks solid compared to that in the developed world.** Loan to valuation ratios have been falling, there are limited linkages to global banks, there is no dependence on foreign capital, there is no confidence crisis and credit availability has only been an issue to the extent that the Government has restricted it.
- **The Chinese corporate sector is in good shape.** Leverage has been falling and the level of retained earnings is high as is the return on equity. The equity market only accounts for 15% of corporate financing.
- **Consumer spending is likely to remain robust.** Despite the 70% slump in the Chinese share market and falling house prices, consumer spending has actually accelerated recently. See the next chart. Chinese consumers have very high saving rates, are not very geared and only 5% of Chinese households have a significant share exposure. On top of this the authorities have been trying to boost consumer

spending via a range of policies including social security reforms, labour reforms and assistance for rural workers; these policies seem to be working.

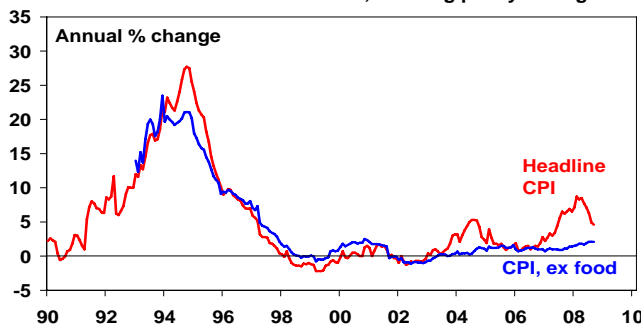
Exports have moderated, but retail sales have accelerated



Source: Thomson Financial, AMP Capital Investors

- **Monetary conditions are now being eased aggressively** with two interest rate cuts in less than two months. This has been made possible by a sharp fall in inflation. In fact, after years of plus 20% pa investment growth it's likely that the slump in demand for China's exports will see deflation become more of an issue as excess capacity starts to build up. With China's key lending rate at 6.93% there is plenty of scope for further easing and this is likely to occur soon.

China's inflation rate has fallen, allowing policy easing



Source: Thomson Financial, AMP Capital Investors

- **Fiscal easing is now on the agenda with the Government looking set to increase spending on infrastructure** related to agriculture, energy, transport and urban development. Increased social spending and increased subsidies for farmers are also likely. There is a lot of room for fiscal stimulus in China as the budget surplus is running around 2% of GDP.
- **Policies are also set to be introduced to specifically boost the property sector** including increased public housing construction, reduced transaction taxes and support for home purchases. Some cities are already moving to stimulate their local property markets.
- Finally, further increases in export tax rebates for exports such as textiles are also likely.

The Chinese Government has switched focus from worrying about inflation to trying to stabilise and maintain fast growth. While China's economy has slowed and is likely to slow further a hard landing is unlikely.

Furthermore, it should be noted that the current slowdown in China should be seen as cyclical. Structural forces driving growth remain very strong. These include strong productivity growth, huge competitive advantages, rapid urbanisation, surging consumer demand and very strong investment. With per capita income levels still very low China's rapid growth phase has a long way to go, probably over several decades.

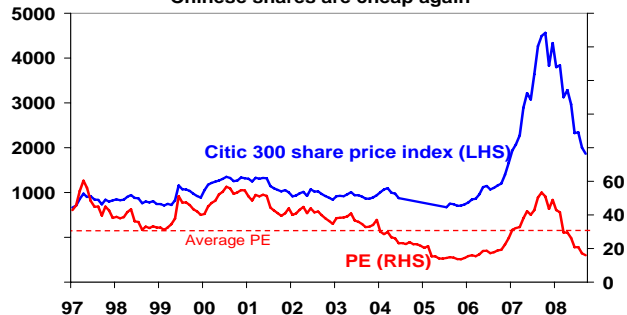
China's slowdown will cut into commodity demand

While China's growth is unlikely to collapse, a slowdown from 12% last year to 8% in 2009 coming on top of the recession in the US, Europe and Japan will cut sharply into commodity demand. Stockpiles of iron ore and coal are already building up in China's ports and it has reportedly asked some resource companies to slow their supply down. In fact, it's likely 2009 will see demand running below supply in the case of several commodities. Commodity prices (and resource shares) are currently very oversold after recent sharp falls and due for a decent short term rally, but the unfolding slump in global growth (made worse by slower growth in China) suggests they are yet to see their cyclical bottom. Commodity prices normally lag the economic cycle and are only likely to resume their long term bull market once it becomes clear global growth is starting to head higher. This is unlikely for at least another six to nine months. **For Australia, this suggests a falling terms of trade and softening export demand growth.**

What about the Chinese share market?

From its high in October last year to its recent low the Chinese share market has fallen nearly 70%. This has restored value to Chinese shares, with the price to earnings multiple falling from over 50 times back to 16 times which is below its long term average.

Chinese shares are cheap again



Source: Thomson Financial, AMP Capital Investors

Additionally: the liquidity cycle for shares is turning more positive with easier monetary conditions; the Government is becoming active in trying to boost the market with moves to abolish stamp duty on share purchases, allow margin trading, encourage buybacks and delay the sale of non-tradeable shares; and investor sentiment in China seems to have reached the despair often seen around bear market lows. **While it's too early to be confident the market has bottomed, particularly with earnings estimates still falling and investor panic feeding on itself, Chinese shares are looking attractive from a long term perspective.**

Concluding comments

China's economy has slowed from over 12% growth to 9% and is likely to slow even further. On top of the recession now unfolding in developed countries this will cut into commodity demand over the year ahead and suggests commodity prices may still fall further. However, China's downturn is unlikely to turn into a hard landing and does nothing to detract from China's positive long term outlook, which, if anything, is being enhanced in a relative sense by the debilitating problems the US faces.

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