



How much does Australia rely on China?

In this Point of View, AXA's Chief Investment Officer Mark Dutton considers the extent to which Australia's growth relies on China and some key implications for investment markets.

In brief

- Australia's exports to China are narrowly based and this could have significant implications for our economic growth in the near to mid term.
- Both the Australian dollar and the Australian sharemarket are heavily influenced by prospects for China's growth.

China's seemingly unstoppable growth path

China's growth story seems never ending. It has recorded average growth of 10 per cent each year over the past 29 years – an achievement which has been very beneficial for Australia.

Much of this growth has come from China's remarkable transition from an agricultural economy to becoming one of the world's major manufacturing centres.

However, early signs are emerging that China may well be undergoing another structural change.

China's exports were not the main driver of its economic expansion in 2008. In fact, a fall in net exports dragged down overall growth by 30 per cent in 2009.

This is a big turnaround from the usual positive contribution of around 20 per cent a year during the period of 2005 to 2007.

Domestic consumer demand is emerging as a key driver of economic growth, as shown by figure 1.

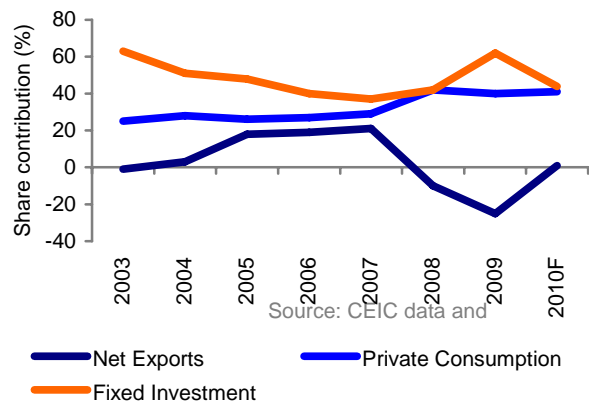
The contribution to growth from private consumption jumped from 15 per cent to 44 per cent in 2008 and stayed high at 40 per cent in 2009.

This trend has been accelerated by the recent economic downturn. China's 2008 stimulus measures were huge, amounting to almost 1.2

trillion US dollars – a whopping 15 per cent of GDP.

By comparison, the stimulus measures announced by other G-20 countries in late 2008 averaged around 2 per cent of GDP.

Figure 1 – Sources of China's GDP growth



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Australia's link

Last year, Australia was the only major western economy to avoid recession and experience positive economic growth.

This outcome was helped by our strong ties with China.

Over the calendar year, Australian gross domestic product (GDP) grew by 1.6 per cent, with 53 per cent of this growth coming from exports to China.

A closer look at Australia's export market reveals that Australia's relationship with China is evolving at a rapid pace.

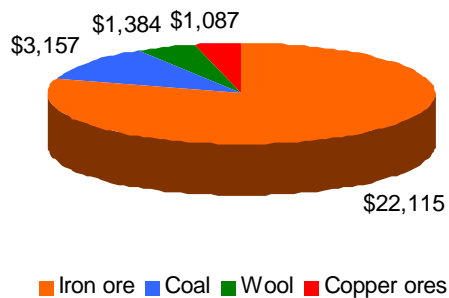
By the end of 2009, China had replaced Japan as Australia's largest export partner and had also become Australia's largest import partner.

But a key risk to Australia's near-term growth is that our exports to China are narrowly focused around iron ore and concentrates.

Exports in iron ore are seven times larger than exports in coal, and 15 times larger than exports in wool, as shown by figure 2.

This means that even small increases or decreases in prices or volumes for iron ore exports will have a material impact on Australia's economic growth.

Figure 2 – Major Australian goods exports to China, 2008-09 (\$ million)



Source: Department of Foreign Affairs and Trade

Market concerns

China is already beginning to unwind some policy measures implemented during the GFC.

Markets are concerned that policy makers may be putting the breaks on too hard as they address the need to contain potential asset bubbles.

Property markets stand out as a key risk. The surge in property prices in some parts of Beijing and Shanghai, at the same time that vacancy rates are rising, is a clear distortion.

Chinese authorities are focussed on implementing direct controls on property lending to ease the risk.

The central bank has already raised reserve requirements three times and large state-owned companies are under pressure to reduce commercial real estate investment.

Given the magnitude of Australia's iron ore exports, Australia has some exposure to any risk of a property market collapse in China.

China's currency policy has been a contentious issue for some time. An artificially low yuan provided a strong stimulus to China's export sectors during the global downturn.

Chinese authorities recently signalled that they are once again easing away from pegging the yuan to the US dollar.

A rise in the yuan would make Chinese exports somewhat less competitive in the global market place, but would strengthen the purchasing power of Chinese consumers.

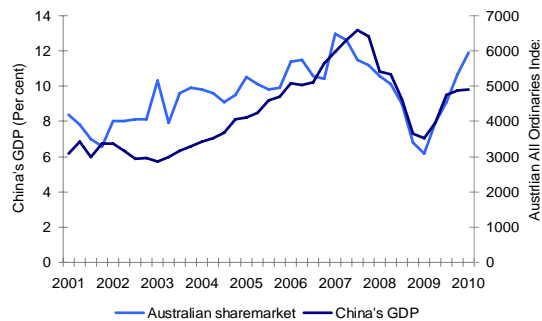
Pressure is building to increase minimum wages, which could also help increase consumption, if the pay increases out-pace inflation. However, inflation risks remain elevated, and ultimately may be exported to economies like Australia.

What this means for investors

Australia's linkages to developments in China are already recognised, implicitly at least by the market.

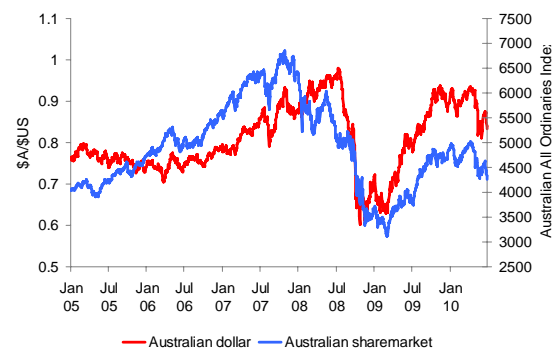
Both the Australian sharemarket and the Australian dollar are heavily influenced by the prospects for China's growth, as shown by figure 3 and figure 4 below.

Figure 3 – Australia's sharemarket closely tracks China's economic growth



Source: Bloomberg

Figure 4 – There is a close correlation between the Australian dollar and Australian sharemarket performance



Source: Bloomberg

For many Australian investors, the issue is amplified by a high portfolio concentration to the Australian sharemarket.

The 25 per cent weighting within our local market to the materials, or resources sectors, along with linkages to China, have seen the Australian sharemarket fall at the same time the Australian dollar falls.

Diversification into foreign currencies can help cushion the impact of a simultaneous weakness in the Australian dollar and the local sharemarket.

This was demonstrated in the first half of 2010 when the Australian sharemarket fell by 10 per cent, while the global sharemarket fell by only 4 per cent.

The nature of Australia's linkages to China's growth means that even a seemingly diversified portfolio may inadvertently have a strong bet on the continuance of China's growth.

The challenge will be to ensure that diversified portfolios include a range of independent drivers to returns that will offset potential disruptions to China's growth.

Diversification opportunities can be found across global markets. Relatively independent trends include the re-emergence of the US manufacturing sector, economic restructuring of Europe, technological developments and the world's ageing populations.

15 July 2010

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