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Market Update

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FOR PROFESSIONAL INVESTORS AND INFORMATION PURPOSES ONLY

China mired in slow growth, major FX move unlikely

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(as of 31 December 2015)

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As the world's second-largest economy, China is at an important turning point. China's leadership has pledged to put the economy on the right track and be less opaque about its currency moves. Economist Stephen Green and China affairs specialist Andrew Dougherty discuss:

- The outlook for China's economy and why a soft landing is more likely
- The case against China pulling the trigger on a big, one-time devaluation of its currency
- Whether China's leadership can manage the political and social implications of deep structural reforms
- Pockets of strength in the Chinese economy during this transition to consumption-led growth

What are your expectations for China's economy this year and can a hard landing be avoided?

Stephen: I expect China's GDP to grow in the range of 3% to 4% this year (while the official figures show something above 6%). While China faces serious challenges, I think they can avoid a hard landing.

The economy is going through a tough period. There is a real estate bubble in many of the smaller cities. There are large chunks of overcapacity in heavy industry, mostly in steel, shipbuilding and chemicals. We are also seeing very little export growth. Consumption grew at a healthy pace in 2015, but will probably decelerate as household income growth is also losing pace.

On the other hand, there appears to be a pickup in investment activity in the last couple of months. The government has authorised more infrastructure projects over the past six months, and the January–February credit data suggests that the funding is finally flowing through to these projects. Last year, we saw a number of projects approved, but the local governments lacked the cash to fund them.

On the reform front, government leaders have made it a priority to close or restructure many state-owned enterprises that are a drag on the economy. This is going to take some time – and we'll see more demonstrations as a result. Overall, though, unemployment should not be a big problem.

My sense is that China will gradually solve its problems and its economy will bounce back.

Some have suggested that China should implement a large, one-time devaluation of its currency. Is that doable and what would be the implications for China?

Stephen: We think it's more likely China will pursue a gradual depreciation of the renminbi in the range of 5% to 8% against the US dollar this year, rather than a big, one-time devaluation of 20% as some people have called for. Last year, the renminbi fell 4% against the dollar, following a 2.5% decline in 2014. A 20% move would be politically and economically damaging for China. The country's top leaders have said they will not do it and going back on their word would further shake confidence in China's monetary policy. It would also hurt Chinese companies with foreign-denominated debt.

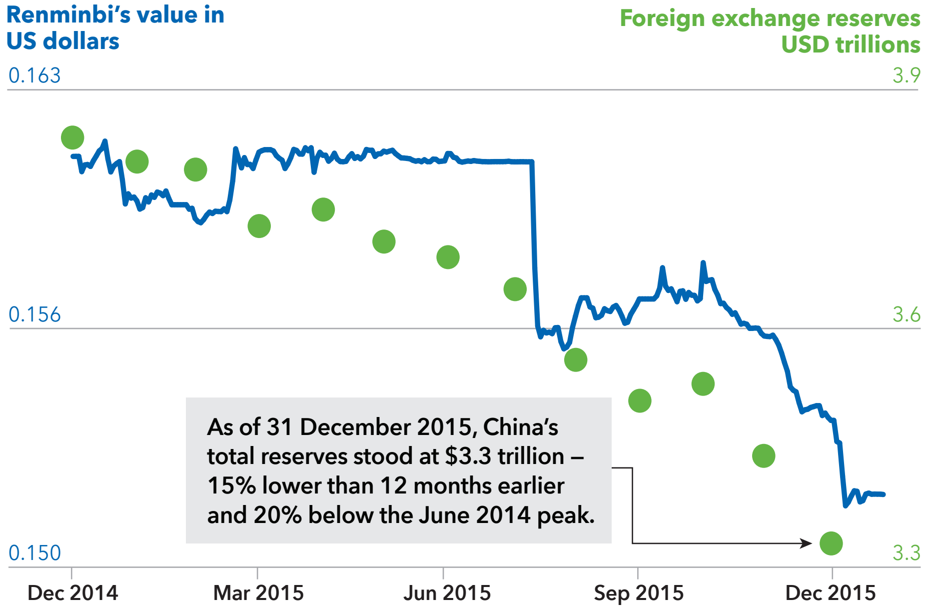
It is also useful to recount that China's central bank has stated that, in its view, the renminbi is not overvalued. They would argue their currency is fairly valued given that they are running the world's biggest trade surplus and the country's current account is around 3% of GDP. The central bank also would probably say no one wins from a currency war. If they depreciate the currency by 20% overnight, investors would panic.

Now, if the central bank cannot manage expectations when it comes to its currency, if unemployment really starts rising, and if its efforts to limit capital outflows are unsuccessful, then a large, one-off depreciation of the currency becomes a more realistic policy outcome. We should know more in the next six months as we watch the pace of decline in the foreign currency reserve levels, which are currently declining at a rate of about US$100 billion a month.

There is excess industrial capacity in China, particularly among its state-owned enterprises. How do you see reforms unfolding as China pursues its stated goal of 6.5% to 7% GDP growth?

Andrew: These supply-side reforms are focused on reducing overcapacity in certain heavy-industry sectors. At the moment, coal and steel are the primary targets for those capacity reductions. Aluminum, cement and shipbuilding are targets too. These industries showed substantial profitability during the credit boom from 2009 to 2011, but now demand has weakened. So the regulators and the policymakers know that they have to reduce capacity. They know that these industries are creating bad loans and are a drag on the banking system. The challenge policymakers confront is to reduce capacity while avoiding huge unemployment in certain areas.

Amid renminbi devaluation, China has tapped reserves to steady the currency



Sources: Capital Group, MSCI

We know supply-side reforms can be a complicated process economically and politically. For instance, we learned that a state-owned mining company in Beijing wanted to close a mine, but the local government officials didn't want that to happen, and so it hasn't. This doesn't make sense to us in the West. Why can't a powerful state-owned company close a small asset of theirs in a small town? It is just the complexity of local versus central government relations and how powerful local government officials are. This is why supply-side reforms could be a multiple year process and be a drag on GDP growth for the next several years.

However, if they are successful in the next three to five years, a number of macroeconomic woes will have been addressed. Poorly performing companies will be absorbed or eliminated, bad loans will be resolved, and deflationary sectors will likely see pricing power return and profitability boosted – all good outcomes from an investment perspective.

Should we expect any big policy changes as the government seeks to revive the economy?

Andrew: Investors should keep an eye on the political transition in 2017, when five of the seven members of the Communist Party's Politburo Standing Committee face mandatory retirement. It will be an opportunity for President Xi Jinping to consolidate power. So his success in getting his key people into place will really determine the direction of policy going forward.

What do you see in terms of monetary stimulus? Does China have enough financial levers to pull to keep the economy going and to prevent capital flight?

Stephen: I see room for more interest rate cuts. I believe that authorities can cut interest rates by at least another 100 basis points without causing massive capital outflows. Most ordinary people would like to keep their money onshore as they need it for day-to-day living. The wealthy people have already taken a lot of money offshore and bought real estate in the US, Hong Kong and other places around the world. Moreover, authorities have been making it really hard for people to take money offshore and this should slow outflows.

In addition to interest rate cuts, the central bank could also continue to further reduce the amount of deposits banks must hold with the People's Bank of China as reserves. The central government could also absorb local government debt onto its balance sheet.

China's economic growth is slowing

Credit growth and GDP growth have lost momentum

[1] Monthly through 31 January 2016.
[2] Quarterly through 31 December 2015.

Sources: Capital Group, Barclays Research, CEIC Data

What is your assessment of the real estate market, which is mired in an inventory glut?

Stephen: China had a great year for housing sales in 2015. The sector is in recovery. Housing sales remained pretty strong in January, up 10% year-over-year. Sales are good in the tier 1 and tier 2 cities, and we are beginning to see better sales growth in the tier 3 cities. However, I don't see a rebound in housing starts. They will probably contract again for the first six months of this year. There is still around 15 months of inventory nationwide.

Longer term, I think more real estate will have to be built as more people move into the cities. Roughly 55% of the Chinese population lives in urban areas. That compares with a ratio above 70% for developed Asian countries like Japan, Taiwan and South Korea. In China's less-developed cities, the housing infrastructure is old and dilapidated. A number of these old apartment blocks will have to be upgraded.

Are there any reforms China could pursue that would be reassuring to long-term investors like us?

Stephen: A financial bailout or recapitalisation programme for the banks would be reassuring. However, at the moment, there doesn't seem to be much appetite – or planning – for it among the government leaders in Beijing. The banks report non-performing loans at about 2% of total loans on their balance sheets. But no one really believes that number. In the view of some of our analysts, the non-performing loans are more in the 8% to 14% range. Based on that assumption, it means you are looking at bad debt of about US$3 trillion, or approximately 30% of GDP. That's very big. On the positive side, China has a very high savings rate of 50% and not much foreign debt.

At this point, the banks are writing off 1% of those bad loans a year. If you believe these non-performing loans are really closer to 10%, then it will take 10 years to wipe those debts off the books. That's too long. I think at some point over the next two to three years, the government will have to organise a bailout programme.

Longer term, what makes you optimistic about China?

Andrew: China's service sector has surpassed the manufacturing and agricultural sectors as the leading sector in the economy and now represents more than half of China's GDP. So, that's a good indicator that the economy is rebalancing away from manufacturing and investment and toward services and consumption. The recent consumer surveys we've seen in terms of spending expectations have remained quite strong, suggesting that weakness is regional or sector-focused.

There are some bright spots. The sportswear sector is doing really well, with revenue and profit growth in the double digits. The cosmetics, travel and e-commerce sectors are all doing really well. Healthcare is also on the rise. So we see some structural growth opportunities.

Stephen: As China makes its transition to a services-led economy and more people move into the cities, the government will need to build more infrastructure. While they have come a long way in a short amount of time, the infrastructure China has built is only at 20% of the level that Japan, the United States and Europe are. They need things like intercity metro systems, better schools, hospitals and water treatment sites. So I see a really long runway for infrastructure demand.