

China – soft landing, slow easing, shares cheap

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Oliver's Insights

Key points

- China's growth rate has slowed to 8.1%. Given monetary easing it is likely to stabilise at around 8% this year, consistent with a soft landing.
- China's growth is likely to be around 7 to 8% p.a. over the medium term, reflecting strong catch-up potential, high productivity growth and low debt levels.
- Chinese shares are cheap, but probably require further monetary easing for sustained gains.

Introduction

Chinese economic data for March contained something for everyone. The bears could point to the weaker-than-expected gross domestic product (GDP) growth rate, the slowdown in property sales and dwelling starts, and the slow response of the authorities to the growth slowdown. By contrast, the bulls could point to signs that the authorities have already quietly eased-up on monetary conditions and that this is evident in a pick-up in lending and money supply growth, and in demand growth later in the quarter. This divergence was reflected in initial share market reactions. While Asian and Chinese markets leant to the bullish interpretation, US and European share markets initially fell. So what is really going in China – a hard or soft landing? And what does it mean for investors?

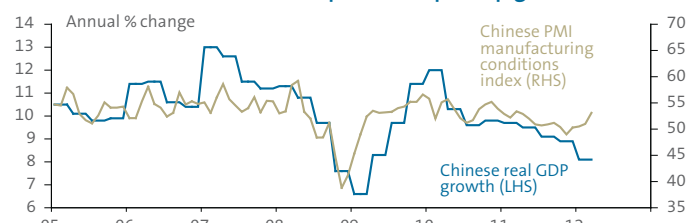
Growth has slowed but not collapsed

Six to 12 months ago the perennial China bears were arguing that it was a bubble about to burst and a broad-based collapse was likely. The argument went that China had over-invested, leading to a surge in public debt centred on local governments, that a credit crunch was commencing and that thanks to high inflation the authorities will be too slow to respond, resulting in a collapse in the economy.

Now arguments about a bursting bubble appear to have faded. By the same token there is no doubting growth in China has slowed. GDP growth over the year to 31 March slowed to 8.1% (from 8.9% in the December quarter). Growth in the quarter itself was just 1.8%, which suggests that annualised growth has actually slipped below 8%. In addition there was a further loss of momentum in fixed asset investment in March (to +20.4% year-on-year from +21.5% in Jan/Feb) and falls in residential starts (down 10% year-on-year) and new home sales (down 15.2% year-on-year). However, there is still no sign of a hard landing.

- The slowdown in GDP growth looks benign unlike the steep drop off that occurred in 2008. See next chart.
- Business conditions indicators (or PMIs) have stabilised or improved, pointing to a possible pick-up in growth.

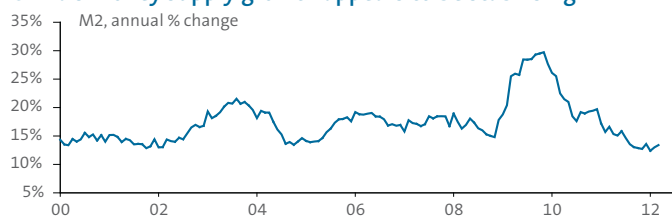
Business conditions indicators point to a pick up growth



Source: Thomson Reuters, AMP Capital

- Bank lending picked up in March and money supply growth has stabilised. This is consistent with monetary easing from late February as the People's Bank of China injected liquidity into the banking system. Reflecting this, short-term interest rates have fallen to their lowest level in a year.

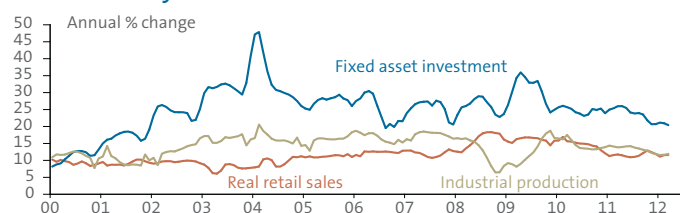
China's money supply growth appears to be stabilising



Source: Thomson Reuters, AMP Capital

- The easing in monetary conditions in March has been reflected in a stabilisation and slight improvement in March data for retail sales and industrial production.

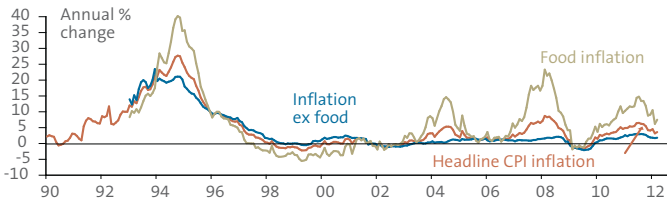
Chinese activity indicators



Source: Thomson Reuters, AMP Capital

- The property market is probably the biggest threat to Chinese growth. Recent headline data has been poor, with sales and starts down year-on-year and average city house prices down for seven months in a row. However, the conditions are not in place for a major property bust. House price gains over the last decade lagged income gains, mortgage debt at 15% of GDP is low (in the US it's 65% of GDP and in Australia it's 80% of GDP), only 11% of residential property buyers are investors, average deposits are around 40% of values and 20% of buyers pay in cash. Hardly a giant property bubble. More broadly, it would be unlikely for the Chinese leadership to allow a residential housing slump to lead to a slump in fixed asset investment. Consistent with this, there are signs of a stabilisation emerging, reflecting an easing in lending conditions including discounts on mortgage rates for first home buyers. New home sales are showing signs of stabilising and actually improving in larger cities.
- Meanwhile, inflation is back under control. Having peaked at 6.5% last July it has since fallen back to 3.6%. Non-food inflation has fallen to 1.8% from a peak of 3%.

Chinese inflation is back under control



Source: Thomson Reuters, AMP Capital

Short-term growth outlook

The relatively gradual nature of the growth slowdown, in contrast to the 2008 slump, combined with lingering inflation fears, a desire to see lower house prices and avoid a re-run of 2009 where excessive stimulus led to overheating, have all meant the easing in economic policies has been gradual this time around. However, policy is being eased with the softening in inflation and in the property market providing further scope for gradual easing ahead. Given low debt levels, China is well primed to respond to further easing which is likely to come in the form of cuts in bank reserve requirements, lower interest rates and qualitative measures. Given these factors, our assessment remains that China is on track for a soft landing, with growth of around 8% this year. In fact the delayed response to the easing from late February and the associated pick-up in bank lending suggests the March quarter may mark the low point in Chinese quarterly growth (but not necessarily for year-on-year growth which could dip below 8% in the June quarter). The biggest threat to China would be a deep European recession (not our base case), as 20% of China’s exports go there.

Medium-term outlook

China has clearly signalled that the ‘growth at all costs’ approach of the last decade is behind it. Much has also been made of this year’s official growth forecast of 7.5% and the latest five-year plan which calls for 7% growth. There are several points to make in relation to this: Firstly, while growth is likely to slow down from the 9.7% average of the last decade, the 7.5% growth target for this year and the 7% growth target for the five-year plan are likely the minimum of what is acceptable. The growth target for the last five-year plan was 7.5% and the outcome was 10.5% p.a. Likewise, China’s annual growth target has been exceeded by at least 1% p.a. for each of the last ten years. Secondly, despite the strong growth of the last few decades China is still a poor country. Per capita GDP is \$US5000 compared to \$US41,000 in Australia and \$US48,000 in the US. This indicates a huge catch-up potential in terms of infrastructure and consumer goods.

Huge catch-up potential in China

	Chinese level per person as %	
	of US level	of Aust level
Paved road network	13	11
Rail network	9	4
Airports	2	1.4
Telephone lines	43	NA
Living space	35	NA
Passenger cars	5	5

Source: Bank Credit Analyst, AMP Capital

On a per capita basis, roads, railways, airports, phone lines, living space and cars are well below US and Australian levels. Incidentally, the previous table also highlights that it’s very hard to see any evidence that China has massively over invested in infrastructure (albeit it does appear to have over invested in steel, cement and aluminium).

Thirdly, the key drivers of China’s growth remain in place, via urbanisation (with the urbanisation rate being just over 50% there is still a long way to go) and strong productivity growth (as China’s gross national savings rate of 50% of GDP feeds through to ongoing strength in investment).

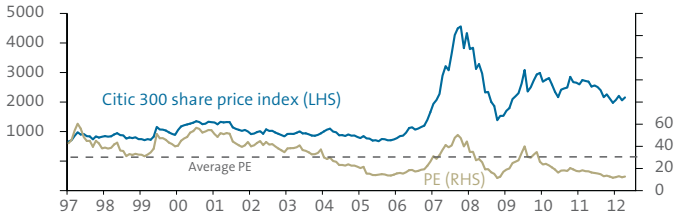
Finally, China lacks the constraints from excessive debt levels that are clearly evident in the US and Europe. In China, mortgage debt is 15% of GDP versus 65% of GDP in the US and 75% of GDP in Australia. Chinese public debt is equal to 50% of GDP, compared to around 100% of GDP in the US.

Certainly risks remain, but we see Chinese growth averaging around 8% p.a. over the next five years or so.

What about Chinese shares & commodities?

Chinese shares have struggled since August 2009 as China moved into a monetary tightening phase. From a longer-term perspective though, valuations are now very attractive – with a historical price-to-earnings ratio of 12.7 times against a long-term average of 32, suggesting a hard landing is factored in and pointing to the potential for attractive returns on a medium-term basis. A decent upswing is probably contingent on further monetary easing though.

Chinese shares are cheap



Source: Thomson Reuters, AMP Capital

Conclusion

Assuming no meltdown in Europe and the US continues growing by around 2-2.5% p.a. then China remains on track for a soft landing. In fact, the easing in policy conditions that has already occurred and likely further easing suggest growth is likely to be around 8% this year. Against this backdrop, Chinese shares are cheap but probably require further easing to see sustained gains.

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