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China worries return – but how serious are they?

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Key points

- China worries are overblown. Property tightening is likely to remain highly targeted and unlikely to threaten overall growth with aggressive monetary tightening unlikely.
- On the other hand, reflecting a desire for more sustainable growth there has not been enough stimulus to ensure a strong rebound. Rather, growth this year is likely to come in around 8%, similar to last year's 7.8%.
- Chinese shares remain cheap. While periodic growth worries are likely to constrain returns they are nevertheless likely to be reasonable this year.

Introduction

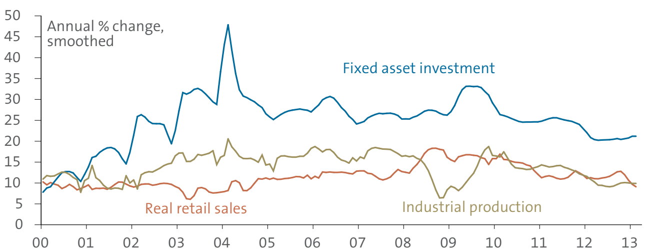
After a brief pause late last year and into early this year where the Chinese share market rallied 25%, worries about China seem to have returned lately. An intensification of measures to rein in the Chinese property market and a mixed round of economic data certainly haven't helped. These worries in turn have weighed on Chinese shares, which are down 8% or so from their recent high in February. Our inclination is to regard this as just a correction and that the Chinese economy remains on track for reasonable growth, albeit not the 10% many still seem to hope for.

China worries

There are several drivers behind current China worries.

- Firstly, the residential property market has rebounded with average price gains intensifying through the first three months of this year. This has led to renewed efforts by the authorities to clamp down on speculators and worries about a flow on to the broader economy. Fears about the Chinese property market haven't been helped by a US CBS 60 Minutes segment on empty cities which helped further fuel all the old fears about a property bubble in China. No matter that it was just a remake of an SBS Dateline report from two years.
- Secondly, January/February data painted a confusing picture with softer-than-expected industrial production and retail sales and higher inflation, fuelling fears of monetary tightening and slowing growth at the same time.

Mixed recent Chinese economic activity indicators



Source: Thomson Reuters, AMP Capital

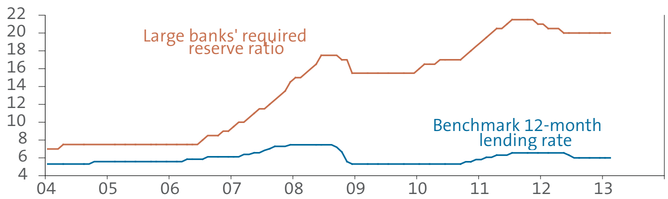
- Thirdly, nervousness about economic reforms under the new leadership has added to worries about what the impact will be. The most recent example being tighter regulation with respect to the funding the banks obtain from what are called wealth management products which further fuelled fears of a sharp slowdown in credit growth. Moves to merge and scrap government departments and reduce bureaucracy have also added to uncertainty.

These developments have fuelled concern regarding Chinese growth. Worries about a property bust have led to renewed concerns about local government financing given much of their revenue comes from land sales. And property controls, regulatory reforms and talk of monetary tightening have all lead to fears of a renewed growth slowdown.

No boom, but solid growth likely

Despite these fears the most likely outcome is for growth of around 8% in China this year. No 10% plus growth boom, but no bust either. In contrast to the growth slowdown during the global financial crisis in 2008-09, there has been no major economic stimulus this time around. There has been no 4 trillion Renminbi stimulus plan, interest rate cuts have been more measured and banks' required reserve ratios have remained higher. A re-run of the March 2009 to March 2010 experience which saw growth rebound from 6.6% to 12% is very unlikely.

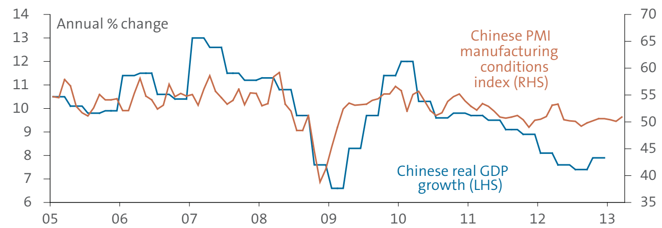
China's lending rate and bank reserve ratio



Source: Bloomberg, AMP Capital

This reflects a shift from a 'growth at any cost' approach to aiming for balanced growth to avoid social tensions, inflation, unsustainable debt and environmental problems.

Business conditions indicators point to stable growth

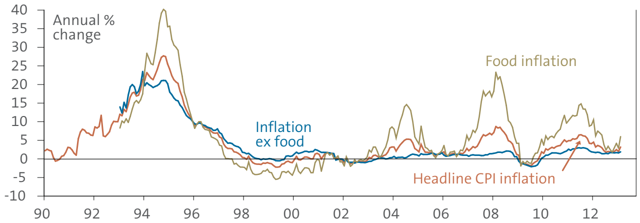


Source: Thomson Reuters, AMP Capital

Secondly, the apparent slowdown in indicators such as retail sales and industrial production in January/February likely owed to China Lunar New Year holiday distortions and a crackdown on extravagant spending by government departments and officials. A pick-up in manufacturing conditions purchasing managers' indices is pointing to steady growth. See the previous graph.

Thirdly, inflation fears are overblown. The rise in inflation in February largely reflected holiday distortions and a sharp rise in food prices which has largely reversed. With heavy investment having led to expanded capacity, growth now trending around the lowest levels in over a decade, non-food inflation running at less than 2% and factory prices still falling, barring a disruption to food supplies, it is hard to see an inflation problem anytime soon. As a result it is hard to see significant monetary tightening this year.

Expect Chinese inflation to remain benign



Source: Thomson Reuters, AMP Capital

In addition, property tightening measures are likely to remain selective rather than being part of a general tightening. There is also a danger in generalising from reports of "ghost cities". If the problem is a generalised property oversupply then why do prices have a natural inclination to rise? The reality is far more complex with an undersupply of affordable housing, low home ownership and low levels of household gearing where average deposits are around 40% of values and 20% of buyers pay in cash. Household debt is low at 30% of gross domestic product (GDP) versus 85% in the US and 100% in Australia. Overall conditions are a long way from a bubble that's about to burst.

Finally, the government's GDP growth target for this year is 7.5%, the same as for 2012. This should be seen as a minimum acceptable level. Over the last 13 years actual growth has exceeded the annual target every year. The authorities are unlikely to do anything, whether in terms of property measures or banking reforms that threaten the achievement of this growth target and will most likely aim for growth a little bit above it, say around 8%.

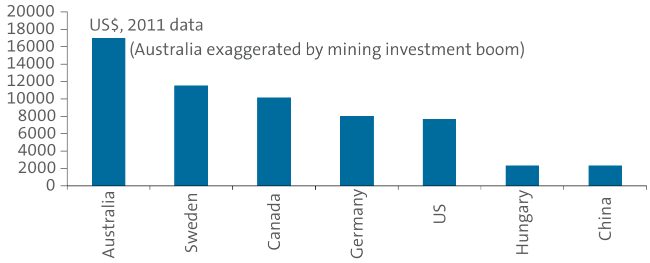
Perhaps a problem for Chinese investors is that many have been assuming a quick return to double digit growth and so they have been left a bit twitchy with growth hovering around 8%, even though most policy announcements just relate to fine tuning the working and regulation of the economy.

Longer-term growth

The desire for balanced growth in China means that the days of sustained double digit growth are likely over. However, the official target for a doubling in real GDP by 2020 implies annual growth of 7.5% per annum, which is still very strong. In order to achieve this the new government leadership, amongst other things, is focusing on reducing the size of government and opening the economy more to market forces and continuing the urbanisation process. China's urban population has increased from around 20% of the population in 1980 to just over 50% today, but if Korea is any guide its likely on its way to 80% over the next 30 years. This means an extra 400 million people moving into cities. To achieve this will require massive ongoing investment in housing, urban infrastructure, etc.

Over time it is inevitable that the contribution of investment to growth will slow in favour of consumption, but this will be a very slow process. China has only been able to grow so strongly without experiencing the inflation and balance of payments crises experienced periodically by many emerging countries because it has favoured investment over consumption. Continued urbanisation will only be achieved and successful if investment remains high otherwise its urban centres simply won't have the required capacity. On this front it is worth noting that China's annual level of capital investment per person is low compared to developed countries including the US and Australia.

Gross capital investment per capita



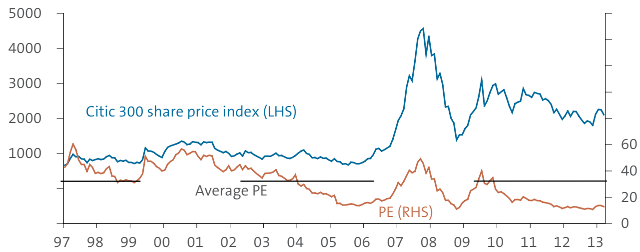
Source: BCA Research Inc

In other words, talk that China is massively overinvested and that investment needs to fall sharply relative to consumption is misplaced. Investment (and the productivity it drives) is likely to remain a key growth driver in the years ahead.

The Chinese share market

The absence of an unambiguous growth surge in China, at a time of new reform announcements has clearly unnerved investors in Chinese shares and likely precludes a 2006-07 or 2008-09 surge. However, this is probably a good thing as both those surges proved unsustainable. Rather, more sustainable growth around 8% should help underpin reasonable medium-term returns without triggering the stop/start policies that have caused a volatile share market ride in recent years. Moreover, Chinese shares remain relatively cheap with a price to historic earnings ratio of 12.8 times which is well below its long-term average and a price to forward earnings ratio of just 10 times.

Chinese shares still very cheap



Source: Thomson Reuters, AMP Capital

Concluding comments

China not having the deep V growth rebound that investors have become used to seems to have left plenty of room for misplaced worries that something is wrong. The reality is that growth in China is probably running right where the authorities want it.

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