ChinaIntelligence
Financial and business advice on China

themonthlydragon #10

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2016 got off to a difficult start, and the year of the monkey won't change that anytime soon; rising interest rates in the US are causing a significant dilemma for China's policymakers; equity markets will remain volatile

The sluggish economy, rising interest rates in the United States, volatile equity prices and market expectations of an ongoing depreciation of the RMB vs. the USD have created an unappealing cocktail short-term. The start of the year of the monkey on February 8th probably won't change that yet. But various stimuli by the government and continued consumption growth will ensure that China's US$11 trillion economy continues to grow.

HIGHLIGHTS

- *GDP: 2016 growth at around 6%*
- *RMB: further weakness vs. the USD likely*
- *Equity markets: will remain volatile and influenced by government / regulatory stabilization measures*
- *PMI: at 49.7 in December, contracting for the fifth month in a row; weakness primarily in the manufacturing sector*
- *Consumers: retail sales growth in stable double-digit territory*
- *Interest rates: expect two more rate cuts of 25 bps each in 2016, after the six cuts since November 2014*
- *Overall: no meltdown, but the slowdown continues*

After its Fed funds rate increase by 25 bps last December, the US central bank will continue to raise interest rates during 2016/17. In the past, it has never made just one rate increase, instead, the first increase after previously falling interest rates always was followed by many more. And herein lies **a big risk for China,** as for other emerging markets, **if the US$ gets stronger as a result.**

A stronger US$ is a **problem for China's export industry** if the RMB/US$ exchange rate remained unchanged, because many of China's trading partners would let their currencies devalue vs. the US$ under this scenario. This would add to the already pronounced strength of the RMB on a real trade-weighted basis (the RMB appreciated by 30% over the last 5 years, see Chart #1). On the other hand, a devaluation of the RMB vs. the US$ in order to stay more competitive increases the **risks of capital outflows.** If wealthy Chinese think in a currency other than RMB, then it is the US$. And they prefer not to see their wealth shrink in US$ terms, so their propensity to shift money into US$ increases under this scenario. As a result, the «path in the middle», i. e. a **controlled devaluation of the RMB vs. the US$ is the likely policy choice.**

De-linking the RMB from the USD

After the introduction of a more market-based pricing mechanism in August 2015, the People's Bank of China (PBoC) introduced a **trade-weighted index** for its currency, consisting of 13 currencies. The USD (26.4%), Euro (21.4%) and Yen (14.7%) are its largest components. While no clear statement was made how this basket will be used, the underlying message was clear: **the PBoC is ready to further de-link the Renminbi from the USD** if the USD were to strengthen further as a result of interest rate increases in the US.

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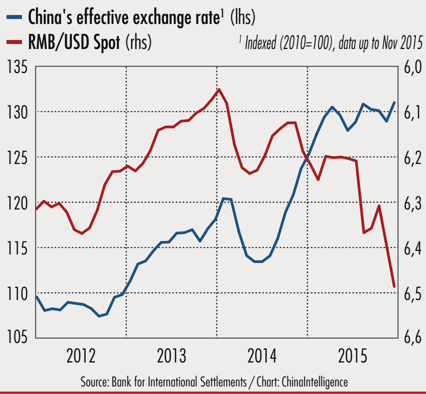
In such a case, the RMB's development against the trade-weighted basket will be the PBoC's focus in setting exchange rates, possibly leading to a depreciation of the RMB vs. the USD.

Let's not forget that **the RMB/USD has been a relatively stable currency pair so far.** Despite all the talk of a weak RMB, it has declined only 9% vs. the USD since its peak 2 years ago. We do not expect the PBoC to participate in a «race to the bottom» with its currency. But **keeping the RMB from appreciating further** is one element of addressing economic weakness. The IMF's decision to include the RMB in its basket of currencies used to calculate its «Special Drawing Rights» starting October 1, 2016 also gives the PBoC a bit more flexibility to manage its currency. **We expect a gradual weakening of the RMB vs. the USD by 7.5% over the next 12 months to an exchange rate of approx. 7.00.** So does the market: the spread between the US$ exchange rates of the Renminbi traded onshore (CNY) and offshore (CNH) has widened in early 2016 to a record, probably signaling that offshore investors are concerned about further RMB weakness.

Memories are short and the «sell» button is on everyone's smartphone

«Confidence is returning to A-shares» was a frequently heard comment at the end of last year about the equity market development since August 2015. And, indeed, money started flowing into equities again towards the end of last year. The only question was: **confidence in what? In the value of the underlying companies or the government's ability to influence the market?** This question is hard to address as both elements continue to be important to A-shares.

RMB: weak vs US$, strong vs the rest ❶



Source: Bank for International Settlements / Chart: ChinaIntelligence

For the time being at least, the **strong hand of the government and its associated pools of money** will remain an important factor in China's equity markets and will do almost everything to keep prices relatively stable. Because the **importance of the equity markets** for China lies in the **need of many private, innovative companies to raise equity** to strengthen their balance sheet. Still today, most of them only have access to either private equity or bank loans. Without a diversified funding base their all-important economic potential, namely creating high-end jobs by being competitive globally, cannot be reached.

During the first trading days of 2016, **volatility has returned** to both the A-share and the RMB markets. Retail investors are digitally astute, trading on the smartphone is wide-spread. Approx. **70% of the trading activity in A-shares is in the hands of retail** investors. The recently introduced circuit breaker for trading of shares on Chinese exchanges was activated twice in the first five trading days because of a fall of equity prices (trading is halted for 15 minutes/ the rest of the day once the CSI 300 index falls by more than 5%/7%. The already previously existing 10% daily limit rule continues to exist). As a result, the circuit breaker mechanism has already been suspended by the regulator. Such U-turns in regulatory policy do not help to restore confidence, of course. On the other hand, we have to remember that the financial markets in China still are young (the Shanghai stock exchange in its present form was founded only in 1990), available market instruments are sparse (only five futures contracts and no exchange-traded options exist[1]) and **investors and regulators both are relatively inexperienced.** This will take time to change, but it will change.

Growth rates continue to decline

China's economy is going through difficult but necessary adjustments, leading to pain in certain sectors (mainly manufacturing) and a negative news flow.

- The National Bureau of Statistics' manufacturing PMI stood at 49.7 in December, the Caixin/Markit PMI at 48.2, both indicating a contraction. The official PMI thus continues its track record of many consecutive months in slight contraction territory. The NBS' PMI surveys 3'000 relatively large companies in China, the Caixin/Markit PMI's focus is on 420 SMEs. The bifurcation between permanently shrinking and successful industries continues to grow.
- Labor demand has cooled off, with the FTCR yoy Labor Demand Index falling to 57.0, its lowest level since mid-2012. However, the majority of the companies still have to increase wages for the employees.
- Exports continued their decline during entire second half of 2015.

More Stimuli

Economic growth overall will slow further, although the government will continue to pull many levers to help companies survive difficult times. One recent example is a stimulating **loan program for manufactu-**

Economic and financial predictions for 2016

Weaker growth overall, but no collapse	The manufacturing sector is hurting, but wages continue to rise and consumer spending continues to grow. GDP growth will be approx. 6% in 2016.
Further government stimuli, including a weaker Renminbi	The government will continue to provide active support on all fronts, including providing cheap long-term loans, keeping fixed investments up, weakening the Renminbi, lowering interest rates. RMB/USD may be at approx. 7.00 at year-end 2016.
Further reform steps	Household registration (hukou) reform will progress and secure the economic rights of more people, social security coverage will broaden.
More market in the markets	Further bond, trust and WMP defaults will be allowed to take place in order to increase market discipline. Volatility in the retail investor-driven equity markets will persist.
Continued SOE restructuring	The government does not want to reduce its role in the economy, but will continue to try to reduce the waste and inefficiency at SOEs, through mergers of SOEs, reducing production capacities and the like. If executed forcefully, commercial banks' non-performing-loan ratios will rise as a result, possibly leading to (unjustified) nervousness about the stability of China's financial system.
Digesting property inventories	The real estate construction activity will remain subdued, allowing the elevated level of inventories which exists in some areas to be reduced to more normal levels; no significant price pressures are expected in the real estate market overall.

Source: ChinaIntelligence

[1] *The CSI 300 future, the CSI 500 future, the SSE 50 future, the 5- and 10- year government bond futures.*

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ring companies by the two policy banks China Development Bank and Agricultural Development Bank of China. Under this program, hundreds of billions of USD of loans are made available to companies in the main industrial provinces at conditions which essentially amount to free money, given China's high interest rate levels. **10-year loans at 1.2%** are available, the collateral requirements are much lower than usual, the development banks want the equivalent of an equity stake in the borrower, but this equity stake can be repurchased by the borrower upon repayment of the loan.

Resilient, vast consumer base

The consumer sector continues to provide a **buffer to the slowdown.** After having cooled off in summer 2015, the FTCR economic sentiment index has risen every month since August 2015. However, it remains below the levels of a year ago. Retail sales growth, at 11.2% yoy in November 2015, should continue to grow near 10% yoy in 2016.

Especially the residents in China's smaller cities provide an enormous potential to boost consumption. These **lower-tier cities have a population of over 500 million,** equivalent to the combined population of the United States and Brazil. If urbanization continues as planned, China's small city population number will climb to over 600 million. Currently, very high savings rates of around 30% of income suppress consumption. Safety nets considered inadequate lead to the **high savings rates.** Once pensions are higher and health care coverage is improved, even a slight decline in the savings rate could provide a significant boost to consumption expenditures. Changes in this respect will come gradually and slowly, but the very **large opportunities in the consumption sector in China are obvious.**

Sources of potential trouble

Many manufacturers in China are struggling. Labor, electricity and other costs have increased every year over the past 30 years, while the sales prices of some products have remained unchanged in the last 10 years, for example in textiles. Profit margins have been squeezed or altogether eliminated as a result. The renewal of the manufacturing base by allowing some low-end producers to go bust is part of the government's program to upgrade the economy. China's income per capita cannot grow substantially if the production of cheap textiles remains a major part of the economy, as was the case 20 years ago.

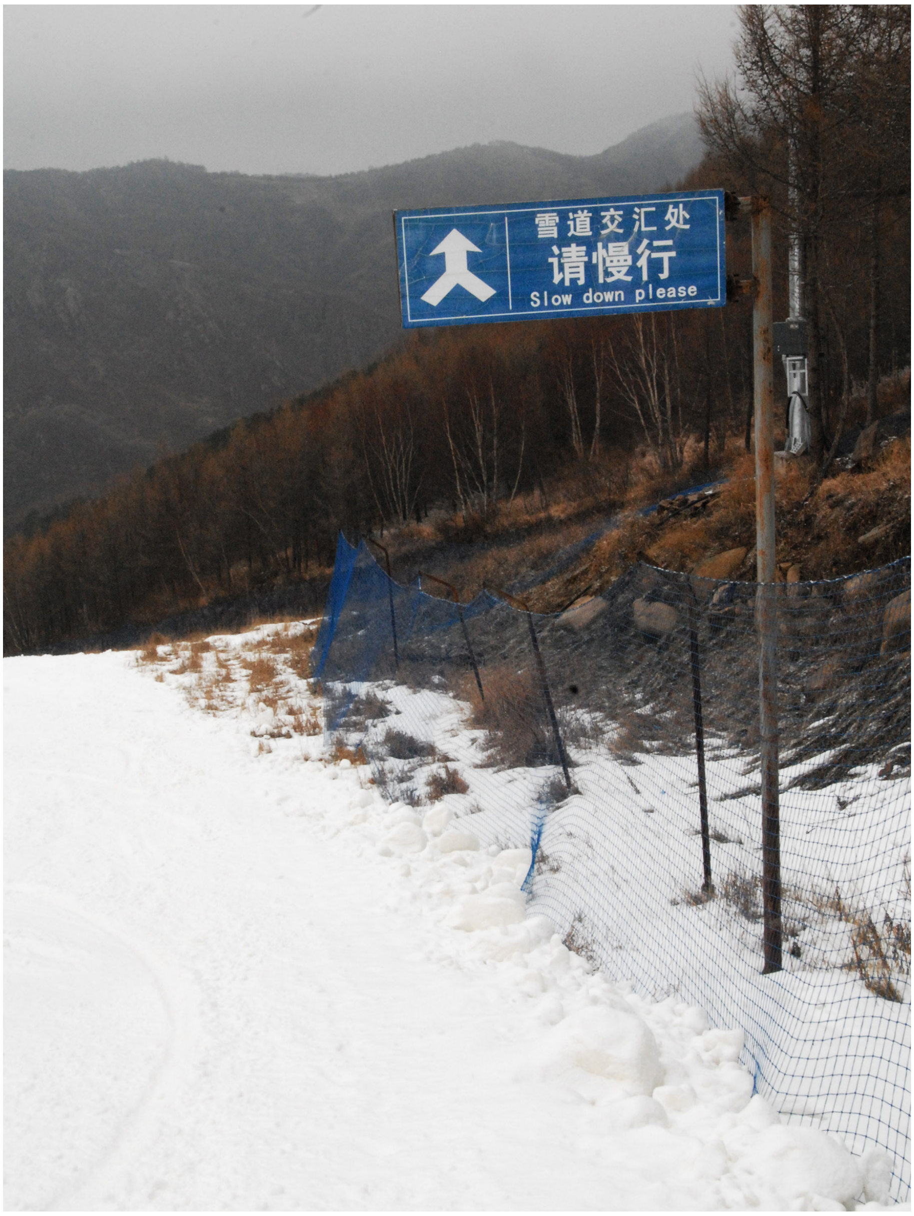

PHOTO: JOACHIM RUDOLF

Ski slope in Chongli, the site of the 2022 Winter Olympics – a message addressed to the stock market volatility?

But the current problem is that even many manufacturers of «desirable» products have trouble surviving.

To help them survive, reinvent themselves and buy time, the government is actively supporting manufacturers. Initiatives include **making available very cheap loans** (10-year money at 1.2%, see above) and **targeted initiatives** like stimulating the car industry (by cutting the purchase tax for new cars with an engine smaller than 1.6 liters from 10% to 5%) or reimbursing half the VAT of 17% to textile manufacturers situated in Xinjiang.

These actions attempt to break the potentially dangerous combination of weak industrial demand, continuously falling prices and high levels of debt, which is expensive to service. By reducing debt costs and attempting to stimulate consumption the **negative spiral may not be stopped, but its turning speed can be slowed.**

Other things to worry about

But not all is lost! A survey by FT Confidential Research shows that, indeed, economic concerns are on people's minds, but are not their main concern. Instead, the #1 concern was food safety[2]:

- Food safety 36.9%
- Stagnant wages 28.0%
- The Chinese economy 24.9%
- The cost of living 22.8%
- Paying for healthcare/education 19.3%
- Pollution 17.7%

[2] *FT Confidential Research, December 17, 2015, survey of 1'000 household regarding their biggest concerns for 2016.*

Important Indicators

	Dec 2015	Nov 2015	Sept 2015	June 2015	Dec 2014	Sep 2014
Quarterly GDP, growth yoy (%)	**–**	–	6.9	7.0	7.3	7.3
Retail sales of consumer goods, growth yoy (%)	**–**	11.2	10.8	10.6	11.5	10.8
Official Consumer Confidence Index	**–**	104.1	105.6	105.5	105.8	105.4
FTCR Labor Demand yoy Index	**57.0**	75.2	67.3	63.2	72.6	68.1
Real estate floor space newly started, growth yoy (%)	**–**	–14.7	–12.6	–15.8	–10.7	–9.3
FTCR mom Home Price Index	**–**	57.5	59.5	61.0	51.5	50.0
CPI, growth yoy (%)	**–**	1.5	1.6	1.4	1.5	1.6
PPI, growth yoy (%)	**–**	–5.9	–5.9	–4.8	–3.3	–1.8
PMI manufacturing	**49.7**	49.6	49.8	50.2	50.1	51.1
Caixin/Markit PMI	**48.2**	48.6	47.2	49.4	49.6	50.2
Fixed-asset investments, growth yoy (%)	**–**	10.2	10.3	11.4	15.7	16.1
Required ReserveRatio (large banks) (%)	**17.0**	17.0	18.0	18.5	19.5	19.5
Benchmark rate for 1-year loans (%)	**4.35**	4.35	4.60	4.85	5.60	6.00
Benchmark rate for 1-year deposits (%)	**1.50**	1.50	1.75	2.00	2.75	3.00
New total social financing, growth yoy (%)	**–**	–11.0	14.5	–6.8	35.0	–26.0
New bank loans, growth yoy (%)	**–**	4.1	21.3	23.0	44.0	9.0
Exports, growth yoy (%)	**–**	–6.8	–3.7	2.8	9.7	15.3
Imports, growth yoy (%)	**–**	–8.7	–20.4	–6.1	–2.4	7.0
Trade balance (USD billion)	**–**	54.1	60.3	46.5	49.6	30.9
Electricity consumption, growth yoy (%)	**–**	0.7	0.8	1.3	3.8	3.9
Freight Traffic, growth yoy (%)	**–**	4.2	4.1	4.2	7.1	7.7
Iron ore imprts (million tons)	**–**	82.1	86.1	75.0	86.9	84.7
Coal imports (millions tons)	**–**	16.2	17.8	16.6	27.2	21.2
Crude oil imports (million tons)	**–**	27.3	27.9	29.5	30.4	27.6
Bloomberg Commodities Index (BCOM)	**78.56**	81.07	87.82	102.69	104.33	118.69
CSI 300 (China Equity Index)	**3'731**	3'366	3'203	4'473	3'534	2'451
RMB trade-weighted, nominal, indexed (2010=100)	**–**	125.6	125.9	126.0	121.5	116.0
RMB / USD spot	**6.49**	6.37	6.36	6.20	6.20	6.15

Source: ChinaIntelligence

Key developments we expect for 2016/17

We expect political, economic and financial stability despite all the looming challenges. Regarding some key topics our expectations are:

- *GDP growth: 2016: around 6%, 2017: around 5.5%, below 5% for 2018–2020.*
- *Labor market: stable to slightly weaker, but with continued wage growth of between 4–7% p.a., at the lower end for high-wage earners, at the higher end for low-wage earners.*
- *Interest rates: at least two additional cuts in the benchmark rates in 2016, each by 25 bps.*
- *No big stimulus program, but a multitude of smaller and targeted measures and reforms to support the economy.*
- *Real estate prices: a stabilization of prices and demand throughout 2016.*
- *RMB: further weakness vs. the USD of approx. 7.5% during the coming 12 months, leading to RMB/USD near 7.00 by year-end 2016.*
- *Retail sales growth: approx. 10% p.a.*

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