ChinaIntelligence
Investment and business advice on China

themonthlydragon #3

June 1, 2015

Wrong direction – let's do a U-turn!

China's economy is sliding downwards. Beijing puts a renewed focus on the funding of local infrastructure investment and domestic demand.

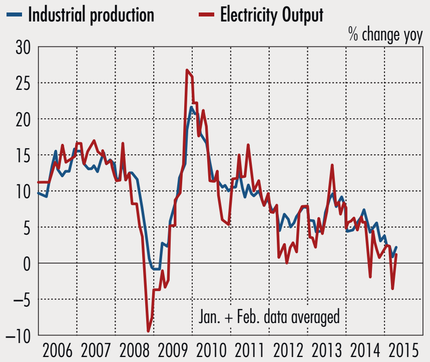
The Chinese economy is slowing down. Beijing's goal is to continue structural reforms and at the same time to avoid a hard landing of the economy. But Beijing seems to accept that in order to keep economic growth at tolerable levels, it must continue to rely on a proven tool: infrastructure investments. This does not mean that the rebalancing of the economy — which is well under way — has been abandoned. But it means that necessary reforms are being deferred, and, therefore, the danger of cementing structural imbalances and costly public policies is increasing.

HIGHLIGHTS

- *GDP: less downward pressure on growth*
- *PMI: stays in slightly expansionary territory*
- *PBoC: aims for lower real interest rates*
- *Credit growth: further slowdown*
- *Real estate: decoupling of home sales and real estate investment*
- *Trade data: still disappointing*
- *Equity markets: rally showing nerves*

Purchasing managers' indexes (PMI), the earliest available and most prominent indicators for economic activity and industrial output in China, showed a further stabilization in May. Values in January and February below the growth lines were replaced by slightly better readings of 50.1 in March and April. The official PMI for manufacturing in May came in at 50.2, in line with market expectations. While there is absolutely no reason to get enthusiastic about that — 50.2 is just barely in the expansion zone, and the value is heavily biased in favor of large enterprises and

Electricity output and industrial production ❶



Source: CEIC, Capital Economics / Chart: ChinaIntelligence

does not represent the state of the whole economy — it shows that the downward pressure on growth is easing and that the worst may be over. This assumption is backed by electricity output, domestic freight volumes and other indicators that show a partial recovery and support the stabilization of the economy (see chart #1). The newest PMI was driven by a pickup in new orders and employment. However, these new orders mainly originated from solid domestic demand, as foreign demand remained quite weak.

Sluggish external demand is also responsible for trade data, which disappointed once more, although the decline in exports has lost speed. Trade to the ASEAN member countries and Hong Kong held up better than the exports to the USA due to softer-than-expected US growth and despite the pronounced trade-weighted RMB appreciation (+8.5% between September 2014 and April 2015). Exports may recover in the coming months, but only if the economies in the USA, Europe and Japan gather strength. This is something Beijing cannot control; therefore, the government again puts more focus on stimulating the domestic economy (see below).

From the inflation front, there is no real news. In April, consumer price inflation was at 1.5% (yoy), up from 1.4% in the previous month. Food price inflation was solely responsible for this increase, which came in at 2.7% (2.3%), while non-food prices stayed at 0.9%. Producer prices (–4.6% yoy) still are on an absolute steep decline, caused by low commodity prices and lingering overcapacities.

Wanted: Lower interest rates

Credit growth also shows continued and significant weakness, not least due to tighter regulation of shadow banking. Last month's cut of the reserve requirement ratio (RRR) by 1 percentage point has not yet had an effect on the data. It was followed by a 25-basis point (bps) cut in the benchmark lending and deposit rate. The deposit rate floating range was increased from the previous 1.3 to 1.5 times the benchmark rate. The one-year benchmark lending rate is now 5.1%, and the corresponding deposit rate is 2.25%. **In the last six months, the benchmark lending rate has been cut by 90 basis points, but the average financing costs for banks sank much less at an estimated 15 bps because money market rates increased.** Although this newest step is in line with the government's interest liberalization plan, it is also clearly targeted at reducing real interest rates and reducing overall financing costs. We expect another 25 bps cut in benchmark lending rates later this year and a large reduction in the RRR.

Tight credit is also a problem for real estate investment. **The long-lasting correlation between home sales growth and real estate investment has decoupled.** Home sales continue to pick up, notably not only in Tier-1 cities but also outside the metropoles, where home sales were up 8.3% yoy last month (7.8% in Tier-1 cities). Demand is strong, but real estate investment decreased by 1.2%, financing fell 1%, and developers bought 30% less land than a year ago. As inventories of completed but not yet sold housing units are at unobtrusive levels (approx. 15%), this decoupling cannot be explained by housing inventories but is based on funding difficulties. **Despite stronger home sales, construction activity remains weak, and there is a danger that this weakness will continue to have strong effects on the economy as a whole.**

U-turn for LGFV

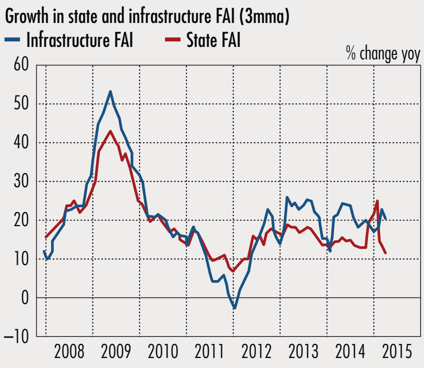
Construction activity is key for the Chinese economy. Beijing has proven that it is willing to rebalance this structural overweight towards a more consumption-oriented growth model. **But recent policy shifts have also shown that the government is willing to slow down or even partially reverse certain reforms to keep the economy going. This development is most pronounced in the area of local governments' infrastructure investments.**

In the last months, local governments' revenues from land sales have been decreasing sharply and tax income is significantly lower due to slower nominal economic growth and tax reforms. Concerns about the highly over-indebted local government financing vehicles (LGFV) had previously led to restrictions on their debt-raising and their liabilities being extended.

At the beginning of the year, many LGFV lost their government guarantee. In addition, local governments were forbidden to use LGFV to finance new projects, as long as the funding for existing projects was not solved. The respective fiscal reform aims to moderate local governments' excessive spending. **Subsequently, local governments showed great difficulties in finding new sources of funding,** a problem that has been addressed by the People's Bank of China (PBoC), which is considering additional measures to boost the credit flow to heavily indebted local governments in order to recapitalize the provinces. The PBoC apparently will be willing to accept bonds issued by local governments as collateral for loans to banks, which in turn are meant to purchase the bonds issued by the local governments (see monthlydragon #2, dated May 1, 2015).

Monetary easing alone has not yet led to the desired results. And the government does not want to repeat the credit glut from 2009. But the **policy makers resort to proven measures, including infrastructure investments.**

State infrastructure fixed asset investments ❷



Source: NBS, China Confidential / Chart: ChinaIntelligence

The restrictions of the financing of LGFV by banks, which were implemented at the beginning of the year, have been partly reversed. A new policy announcement in mid-May calls on the banks to increase lending to LGFV. The financing of existing infrastructure projects shall be supported. The initial lack of demand for municipal bonds led to a slowdown in state investment: state-fixed asset investment (FAI) growth slowed from 14.4% in Q1 15 to 7.1% in April. Growth in infrastructure FAI slipped from 22.8% in Q1 15 to 16.1% (see chart #2).

Encouraging banks to increase lending to LGFV and increasing the demand for municipal bonds are measures directly aimed at securing the funding for infrastructure investments. Short-term, infrastructure investment is the key to mitigate the economic slowdown, which is largely driven by the weakness in the real estate sector.

Last but not least: jittery stock markets

The A-share market rally shows signs of speculation. Margin loans have exploded in 2015, and so have newly opened brokerage accounts. Most of those who have recently opened a brokerage account are younger than 40 years old. Margin lending values for equities are as high as 76%. Even apart from one-off stories about exaggerated valuations and market manipulations, the overall market's P/Es in the mid-20s start looking high. The risk of high volatility and severe corrections has increased. But the rally can continue, since some supporting factors like easier monetary policy and ample liquidity in the market will continue for a while. **We will focus on the topic of the recent rally in Chinese equities in «thequarterlydragon», which will be released in July.**

What does this mean:

- The stabilization of the industrial sector is good news; the worst may be over.
- Electricity output, domestic freight volumes and other indicators show a partial recovery and support the stabilization of the economy.
- Consumption and service sector activity held up well.
- The policy measures aimed at boosting consumption and the domestic market seem to work.

- But these measures are controversial; Beijing made a U-turn regarding its policy towards local government financing. Sufficient funding for infrastructure investment is pivotal for stabilizing growth but slows some of the more important reform efforts.
- Tight credit conditions for developers hinder real estate investment. There is a decoupling of home sales growth and real estate investment.
- Lower nominal GDP growth burdens the economy's debt repayment capacity.
- Overall, the trade-weighted RMB appreciation hurts external demand, and the all-important property sector continues to be a drag on the economy.

Key developments we expect for the coming 12–24 months

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

- *GDP growth: 2015 around 6.5%, 2016: 5.5% to 6%.*
- *Labor market: stable, 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: 1-2 additional cuts in the benchmark rates in 2015, each by approx. 25 bps.*
- *No big stimulus program, but a multitude of smaller and targeted measures and reforms to support the economy.*
- *Real estate prices: worrisome news on falling real estate prices in H1 2015 due to the base effect, but a stabilization of prices and demand towards the end of 2015 and 2016.*
- *Property developers: some will face liquidity difficulties and may have to restructure their outstanding bonds.*
- *RMB: slightly weaker (2-3%) from the current rate of 6.19 RMB per USD.*
- *Retail sales growth: approx. 10% p.a.*

Important Indicators

	May 2015	Apr 2015	Mar 2015	Jan 2015	Dec 2014	Sep 2014
Quarterly GDP, growth yoy (%)	**–**	–	7.0	–	7.3	7.3
Retail sales of consumer goods, growth yoy, real (%)	**–**	9.9	10.2	11.0	11.5	10.8
Official Consumer Confidence Index	**–**	–	107.1	105.7	105.8	105.4
China Confidential Labor Demand yoy Index	**–**	85.4	76.0	68.4	72.6	68.1
Real estate floor space newly started, growth yoy (%)	**–**	–17.3	–18.4	–17.7	–10.7	–9.3
ChinaConfidential mom Home Price Index	**–**	60.6	55.0	51.7	51.5	50.0
CPI, growth yoy (%)	**–**	1.5	1.4	0.8	1.5	1.6
PPI, growth yoy (%)	**–**	–4.6	–4.6	–4.3	–3.3	–1.8
CFLP PMI	**50.2**	50.1	50.1	49.8	50.1	51.1
HSBC/Markit PMI	**–**	48.9	49.6	49.7	49.6	50.2
Fixed-asset investments, growth yoy (%)	**–**	12.0	13.5	13.9	15.7	16.1
Required ReserveRatio (large banks) (%)	**18.0**	18.0	19.0	19.5	19.5	19.5
Benchmark rate for 1-year loans (%)	**5.10**	5.35	5.35	5.60	5.60	6.00
Benchmark rate for 1-year deposits (%)	**2.25**	2.50	2.50	2.75	2.75	3.00
New total social financing, growth yoy (%)	**–**	–31.0	–44.0	–21.0	35.0	–26.0
New bank loans, growth yoy (%)	**–**	3.9	–5.1	11.0	44.0	9.0
Exports, growth yoy (%)	**–**	–6.4	–15.0	–3.3	9.7	15.3
Imports, growth yoy (%)	**–**	–16.2	–12.7	–19.9	–2.4	7.0
Trade balance (USD billion)	**–**	34.1	30.8	60.0	49.6	30.9
Electricity consumption, growth yoy (%)	**–**	0.9	0.8	2.5	3.8	3.9
Freight Traffic, growth yoy (%)	**–**	–	4.5	7.9	7.1	7.7
Iron ore imprts (million tons)	**–**	80.2	80.5	78.8	86.9	84.7
Coal imports (millions tons)	**–**	20.0	17.0	16.8	27.2	21.2
Crude oil imports (million tons)	**–**	30.3	26.8	28.0	30.4	27.6
Bloomberg Commodities Index	**100.95**	102.91	98.12	100.84	104.33	118.69
CSI 300 (China Equity Index)	**4840.8**	4749.0	4051.0	3434.4	3533.7	2451.0
RMB trade-weighted, indexed (2010=100)	**–**	125.9	126.1	123.1	121.5	116.0
RMB / USD spot	**6.12**	6.11	6.13	6.13	6.13	6.15

Source: ChinaIntelligence

ChinaIntelligence AG – investment and business advice on China

China is becoming more and more important and affects all of us. But China is different. We offer information and tools to help you understand China and to invest successfully. We support your financial investments and business projects in China. We specialize in:

- developing investment strategies and monitoring and managing financial portfolios
- evaluating, monitoring and implementing business projects
- providing tailor-made communication content for you and your clients

ChinaIntelligence AG 中国智慧咨询公司 Forchstrasse 2/Kreuzplatz CH-8008 Zürich/Switzerland
+41 79 678 5568 info@chinaintelligence.com www.chinaintelligence.com