ChinaIntelligence
Investment and business advice on China

the monthly dragon #5

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China: Equities don't matter that much. It's much more about real estate. Real estate prices are stabilizing.

The latest – mediocre – macro data went by almost unnoticed amidst the stock market volatility. However, the impact of the stock market crash on consumption and hence the real economy will be small. More important than the losses incurred by the few who were exposed to stocks is the property market, which affects the economy as no other sector does – while only 4% of the total population and 7% of the urban population are invested in stocks, over 80% of urban residents with a hukou own the property they are living in. And the property market is showing signs of price stabilization and reduced inventories.

But the extreme volatility certainly does not boost investors' confidence, which in regards to Chinese equities has been notoriously low anyway. Our growth outlook for H2 2015 remains stable. We acknowledge the need for serious economic reforms, e.g. the implementation of the announced SOE reforms and facilitating business for private companies.

HIGHLIGHTS

- *GDP: H1 2015 at 7% and on target*
- *PMI: dangerously close to the contraction line*
- *Credit growth: there is hope*
- *Real estate: increasing demand and lower inventories*
- *Trade data: better than expected but opaque*
- *Equity markets: look beyond the volatility*
- *Overall: sentiment darkened*

The equity rally which lasted from mid-2014 until June 12, 2015 can be described as a leverage-driven bubble that was clearly disconnected from corporate earnings and the real economy. The correction is good and will hardly have a meaningful influence on consumption and, if at all, only a very limited wealth effect. Some leveraged investors and companies which jumped on the equity bandwagon too late might suffer, and IPO fantasies at extreme P/E-levels are trimmed down – which may be a development for the better. However, the biggest loser of the recent crash might well be the government: It lost quite some credibility with its somewhat uncoordinated and partly unsuccessful effort to support the market.

July's backward-looking macro data were not really bad. Q2 GDP growth was stronger than expected, H1 GDP growth was right on target with 7%. One might argue that these values are overstated, but even if you subtract 1 or 2 percentage points of growth due to an underestimated GDP-deflator, economic growth is still strong – and more importantly – stable, as such calculation errors do not occur suddenly but have been in place for years. The renewed discussion about the GDP-deflator does in fact support our assumption of GDP growth around 6.5% in 2015 and 5.5% to 6% in 2016.

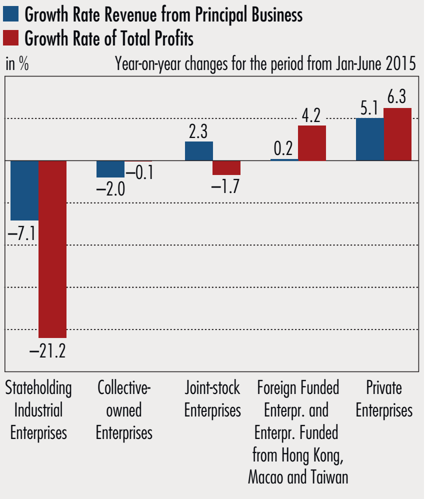
Sentiment and profits down

But the forward-looking data certainly were not encouraging. In July, the industrial sector remained weak. The purchasing managers' indices (PMIs), the earliest available and notably most important indicators for industrial output in China, came in slightly lower than expected. The official PMI for manufacturing in July showed a value of 50, after 50.2 in May and June. The mark of 50 separates growth from contraction and highlights a sluggish demand in China and abroad as well as the need for additional stimulus. It should be noted that this official value is heavily biased in favor of large enterprises and somewhat overstates actual conditions. **The situation for smaller firms has deteriorated again: They have not profited from increased infrastructure investments and suffer from more difficult financing conditions than large companies.** While large firms reported stable activity and a PMI of 50.6, medium sized companies were in line with the 50-mark, and small firms reported a PMI of 46.9.

The PMI does not fully capture the fact that many industrial enterprises – especially in the heavy industry sector – face default risks due to lower margins and declining profitability. **Industrial profits declined from January to June, in some sectors dramatically.** The yoy growth rate of profits for all industries declined 0.7%. The food, textile, chemical and petroleum processing, computer and electronics as well as electric power sectors showed double-digit profit growth; mining and metals profits decreased strongly, that of coal mining by 67%. The profit figures also vary with respect to the type of business: large industrial SOEs at –21.2%, collectively owned enterprises at –0.1%, joint stock enterprises at –1.7%. In contrast, foreign-funded companies increased their profitability by 4.2%, privately owned firms by 6.3% (please see chart #1).

The non-manufacturing PMI increased from 53.8 in June to 53.9 in July and continues to show a solid pace of expansion. For the third year in a row, the services sector is accounting for higher output than the secondary sector (including construction). In 2014, its share was 48.2%, compared with 42.6% from the manufacturing and construction sector. **This shows that the rebalancing of the Chinese economy from an investment-dominated to a more consumption-oriented growth model is well under way, despite various problems.** But services companies are also struggling; they reported lower new orders and cut jobs.

Industrial profits decreasing 1



Source: National Bureau of Statistics / Chart: ChinaIntelligence

In June, consumer price inflation was 1.4% (yoy), up from 1.2% in the previous month. This was slightly stronger than expected. Food price inflation – usually the dominant factor – came in at 1.9% (1.6%), but non-food prices also increased by 1.2% (1.0%). Producer prices declined by 4.8% (–4.6%) yoy, and they still are on an absolute steep decline caused by low commodity prices and lingering overcapacities. **However, the fall of producer prices also reflects a fall in input costs, and the fact that the prices of final consumer goods are edging up could give many firms a break.** The yoy-comparison base will adjust for lower commodity prices soon, which should push up CPI and PPI.

But you can't blame the equity market

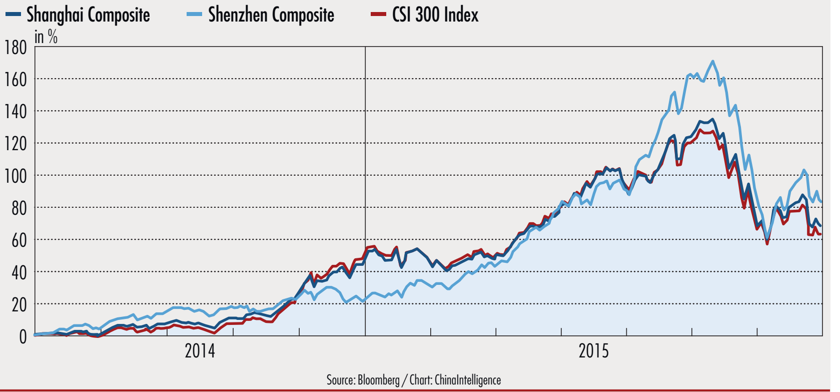
The Shanghai Composite, mainland China's broadest index, declined 29% between its peak on June 12 and July 31. On July 27 alone it lost 8.5%, the largest one-day decline since February 27, 2007, and the second-largest daily loss ever. **Year to date the Shanghai Composite is up 13.3%, and the 12-month increase still is 66.4%.** The performance of the Shenzhen Composite is 49.1% since the beginning of the year and 81.9% from one year ago. From its peak to today it lost 32.8% (please see graph #2). **These figures put the market crash in perspective. Nevertheless, this extreme volatility is not conducive to economic activity and undermines investors' confidence.**

However, who has been affected by the crash and what consequences it has deserve a closer look. Li Xian, a 25-year-old economics student from Shenzhen, explains: «Recently, I lost 5000 yuan (USD 805). This teaches me to be more careful and not only to invest with a time horizon of a week or two. I belong to the young generation that did not experience the crash in 2007. I will now postpone a trip to Hong Kong by a few weeks, but otherwise this crash has no influence on me.» In many ways Xian represents the «typical» Chinese equity investor.

But who exactly is invested in the Chinese equity market?

- **The Chinese only allocate a small amount of their wealth to the equity market, typically less than 5% of their net worth, which is equivalent to approx. 20% of their financial assets.**
- A little over 50 million brokerage accounts exist in China – this means that, at most, less than 4% of the total population and 7% of the urban population are directly invested in stocks
- Those who invest in the Chinese stock market are the relatively well off: Over 80% of individual investors have invested more than the equivalent of USD 1,600, which is half of China's median annual salary.
- According to Andy Rothman from Matthews Asia, 69% of individual investors have less than the Renminbi equivalent of 15,000 USD in their (trading) accounts.
- The free float is less than 30% of the market capitalization since government holdings represent over 50%.
- Foreigners own only 2% of Chinese A-shares.

A-share indices last twelve months 2



Source: Bloomberg / Chart: ChinaIntelligence

And what consequences does this have?

First, investors outside China do not suffer, and there is no contagion. Warnings of a global meltdown due to a stock market crash in China lack any foundation. Second – and more importantly – the effect on China's real economy via consumption is marginal.

- Low-income households, whose spending is most likely to be affected by a decline in wealth, are not influenced by the equity crash, as they did not invest significantly in stocks.
- China's household savings rate is 50%, which levels out consumption.
- Households which have re-allocated money from deposits to the equity market have not changed their consumption pattern.
- Historically, in China there is hardly any evidence that stock prices influence consumption; this was the case for the boom and bust in 2007, and also this year: Retail sales growth declined somewhat (with the exception of healthy growth of 10.6% in June) despite skyrocketing equity prices.
- **A booming equity market may induce households to move assets from deposits to equities, but this does not affect their consumption patterns much.**
- The yoy growth rate of bank deposits in Q2 2014 – before equity prices surged – was 11.4%; in Q2 2015 – after a spectacular equity rally - it was almost unchanged at 10.4%.

The property market is stabilizing

In addition to these arguments, we would like to point out that in China, the stock market does not represent the economy. More than 80% of all new jobs are created in the private sector. But the Shanghai Composite still consists mainly of large SOEs – from finance to aviation to mining. Also, the crash was not induced by economic problems. **The stock market does not mirror the real economy, but the property market does to a significant extent.**

Few Chinese are invested in the stock market, but over 80% of urban hukou holders own the property they are living in. **The price development of the homes they own is far more important to the average Chinese's financial well-being than anything else.** Home prices have been increasing slightly in June, in a reversal of the price decays witnessed earlier in 2015. This is attributed primarily to the combination of increasing demand and lower inventories. While the amount of residential floor space sold increased 4.5% yoy in H1 2015 according to the National Bureau of Statistics, completed residential floor space fell by 16.5% yoy during the same period.

Increasing demand for residential real estate would normally trigger increased housing investment and construction activity. But both measures during H1 2015 are still below the respective levels in 2014, although bank financing for real estate developers increased by 14.6% yoy in June. So the stronger demand side has not led to an economic boost. **The residential property prices may continue to stabilize or slightly increase, supporting the average Chinese's most important investment class.**

Recent government measures to support equity markets

When	Who	Measure
June 28	PBoC	Reduction of RRR and interest rates
July 3	CSFC	The CSFC increases its registered capital from RMB 24 billion to 100 billion (USD 16 billion)
July 5	CSRC	28 IPOs are postponed Restrictions on some index futures accounts Crack down on rumors about the stock market in the media
July 6	CSRC	21 brokerage firms increased their stock holdings by RMB 128 billion (USD 20 billion)
July 8	PBoC	Official declaration of support for the stable development of the stock market
July 8	CSFC	The CSRC confirmed that the CSFC provided a RMB 260 billion (USD 42 billion) loan to 21 brokerage firms
July 8	CSRC	Encouraged major stock holders, the board of directors and senior management to increase stock holdings
July 8	CFFEX	The CFFEX increased margin requirements for CSI500 index futures
July 9	CSFC	The CSRC confirmed that the CSFC began to buy public equity funds
July 13	CSRC	The CSRC began an inquiry into Hundsun, the biggest off-exchange margin lending supplier
July 20	CSRC	The CSRC states that it is irresponsible for the media to issue influential reports without confirmation with the CSRC
July 27	CSFC	The CSFC states that market stabilization efforts will continue, that malicious short-selling will be pursued

PBoC (People's Bank of China)
CSRC (China Securities Regulatory Commission)
CSFC (China Securities Finance Company)
CFFEX (China Financial Futures Exchange)

Source: ChinaIntelligence

What does this mean:

- Economic growth in H1 2015 met the government's target of 7% and is quite stable due to policy-driven stronger demand in domestic activity.
- Industrial activity stalled. Industrial profits declined from January to June, in some sectors dramatically. Large SOEs suffer much more than privately owned enterprises.
- The service sector is expanding but shows some signs of wear-and-tear and is shedding jobs.
- **The sharp equity market correction should have only a marginal impact on consumption and therefore the real economy. Year-to-date stock market gains are still positive.**
- The stock market does not represent the real economy, but the property market does. And the property market is resilient; it is even showing signs of improvement.
- **Overall, the downside risks to the economy intensified and sentiment darkened.**
- However, fiscal stimulus should support growth in the coming months and the four interest rate cuts since last November will fully show their effect.
- Long term, serious economic reforms (e.g. SOE-reform and facilitating business for private companies) are long overdue.
- **And last but not least:** Credit growth, which in recent months has hindered the economic recovery, could rebound soon due to the sharp increase in the monetary base since the beginning of the year – there usually is a time lag of three to six months.

Important Indicators	July 2015	June 2015	May 2015	Mar 2015	Dec 2014	Sep 2014
Quarterly GDP, growth yoy (%)	–	7.0	––	7.0	7.3	7.3
Retail sales of consumer goods, growth yoy, real (%)	–	10.6	10.2	10.2	11.5	10.8
Official Consumer Confidence Index	–	–	109.9	107.1	105.8	105.4
FTCR Labor Demand yoy Index	–	63.2	67.5	76.0	72.6	68.1
Real estate floor space newly started, growth yoy (%)	–	–15.8	–16.0	–18.4	–10.7	–9.3
FTCR mom Home Price Index	–	61.0	58.4	55.0	51.5	50.0
CPI, growth yoy (%)	–	1.4	1.2	1.4	1.5	1.6
PPI, growth yoy (%)	–	–4.8	–4.6	–4.6	–3.3	–1.8
PMI manufacturing	**50.0**	50.2	50.2	50.1	50.1	51.1
Caixin/Markit PMI	**47.8**	49.4	49.2	49.6	49.6	50.2
Fixed-asset investments, growth yoy (%)	–	11.4	11.4	13.5	15.7	16.1
Required ReserveRatio (large banks) (%)	**18.5**	18.5	18.5	19.5	19.5	19.5
Benchmark rate for 1-year loans (%)	**4.85**	4.85	5.10	5.35	5.60	6.00
Benchmark rate for 1-year deposits (%)	**2.00**	2.00	2.25	2.50	2.75	3.00
New total social financing, growth yoy (%)	–	–5.5	–12.9	–44.0	35.0	–26.0
New bank loans, growth yoy (%)	–	23.0	–2.3	–5.1	44.0	9.0
Exports, growth yoy (%)	–	2.8	–2.5	–15.0	9.7	15.3
Imports, growth yoy (%)	–	–6.1	–17.6	–12.7	–2.4	7.0
Trade balance (USD billion)	–	46.5	60.0	30.8	49.6	30.9
Electricity consumption, growth yoy (%)	–	1.3	1.1	0.8	3.8	3.9
Freight Traffic, growth yoy (%)	–	–	4.1	4.5	7.1	7.7
Iron ore imprts (million tons)	–	75.0	70.9	80.5	86.9	84.7
Coal imports (millions tons)	–	16.6	14.3	17.0	27.2	21.2
Crude oil imports (million tons)	–	29.5	23.2	26.8	30.4	27.6
Bloomberg Commodities Index (BCOM)	**91.78**	102.69	100.95	98.12	104.33	118.69
CSI 300 (China Equity Index)	**3 817**	4 473	4 841	4 051	3 534	2 451
RMB trade-weighted, indexed (2010=100)	–	126.0	124.9	126.1	121.5	116.0
RMB / USD spot	**6.21**	6.20	6.20	6.21	6.20	6.15

Source: ChinaIntelligence

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: 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 6.21 RMB per USD.*
- *Retail sales growth: approx. 10% p.a.*

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