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themonthlydragon #7

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China: more of the same and more disparity

Uninspiring PMI data point to a persistently difficult economic slowdown. Disinflationary pressures continue, except in real estate. Housing prices have increased in 2015 while housing supplies have decreased. Real estate construction will grow again in 2016. Retail sales continue to go up. Government stimulus for infrastructure projects appears to be gaining traction.

The economic slowdown continues, but not in a precipitous way. Lower interest rates and government-led support for infrastructure projects have not fed through in a big way yet. But first surveys show that stimulus measures are boosting infrastructure development. Housing construction is low but will increase as housing inventories have declined in Tier 1 cities and financing for housing projects should be more easily available. Mortgage financing conditions are more accommodative than a year ago, contributing to buying activity and the house price increases this year. Labor demand has recovered from the July/August lows to approximately the same level seen during 2014/15.

HIGHLIGHTS

- *GDP: growth slowing*
- *PMI: at 49.8, contracting for the second month in a row*
- *Real estate: stable demand, increasing prices, lower inventories*
- *Consumers: continued double-digit retail sales growth*
- *Interest rates: too high, will decline further*
- *Overall: most data point towards a continued slowdown in growth*

«More of the same» is how the economic news in September could be characterized. Between the military parade in Beijing on September 3 and President Xi's visit to the US, not much economic news made it into the headlines. The purchasing manager index, with a reading of 49.8, pointed towards continued weakness in the manufacturing sector. Housing inventories continued to decrease as a result of solid demand for housing and subdued construction activity.

The increasing purchasing interest led to higher prices, a development that is most pronounced in the big metropolitan areas. Mid-sized cities have experienced similar dynamics, but to a much lesser extent. Housing inventories in Tier 3 cities continue to stay at elevated levels and will keep construction activity at bay. To address exactly this issue in Tier 2 and 3 cities, downpayment requirements for first-time home buyers have been lowered from 30% to 25% – applicable only to cities which currently do not have real estate purchase restrictions.

Government stimulus may save the day

First surveys of infrastructure project managers are pointing towards a rise in activity as the government's stimulus measures begin to filter through. This is crucial because the investment volume still is a very important growth driver despite the increase in the consumption and service sectors.

Policy moves aimed at boosting infrastructure construction always have a time delay. But it appears that we are getting closer to feeling a real impact of such policy initiatives. Easier access to financing from banks and capital markets have led to a more bullish outlook for construction.

The repeated reductions of interest rates since Q4 2014 also are having an accommodative effect.

Retail sales buoyant

Despite the slower economic growth the average consumer still is active, leading to retail sales consistently growing at above 10% (see chart #1). The **very strong growth in the number of households crossing a certain income threshold** leads to a change in spending patterns and to an increasing consumption for basic goods. The fast-paced expansion of e-commerce platforms to rural areas makes an overwhelming product offering available to millions of people who previously only had access to rather small «mom and pop» stores. This motivates them to buy their first washing machine, lets them spend more time working, and gives them the opportunity to also sell their own products across bigger regions served by the same e-commerce platforms.

And let's not forget: approximately half of China's population still lives in poor rural areas, representing a very large potential for economic growth. Retail sales growth is widespread, even across the weak economic areas and provinces (see chart #2). **Even in regions where industrial output is declining, retail sales of consumer goods are growing at a healthy pace.**

No deflation

The soft economy is leading to a decline of most prices in China. The producer price index (PPI) in China declined by 5.9% on an annual basis in August. This is both a result of overcapacities in some sectors, and of lower input prices after the sharp drop in commodities prices since the middle of 2014.

Disinflationary pressures continue in China, outright deflation, however, seems very unlikely. Although official consumer price inflation is low (yoy CPI at +2.0% in August), the «perceived costs of living» are probably increasing at a rate of 4 to 6%. The main discrepancy is the price of housing, which has not been adequately reflected in the CPI basket for a long time. As housing prices go up in urban areas amid a shortage of affordable apartments, they account for the main increase in perceived living costs. And the impact of commodities prices, falling since the middle of 2014, may also decline soon because the yoy-comparison base will adjust for lower commodity prices.

Labor shortages contributing to lower company profits

But not everything is oversupplied in China. Quite to the contrary: skilled labor is one example. **The number of young workers, those most in demand by manufacturers, has been declining for several years and will continue to decline. Consequently, their wages are increasing around 10% every year** – and they are the ones with the highest propensity to consume and substantially contribute to the transition of the Chinese economy from an investment-led to a consumption-led model.

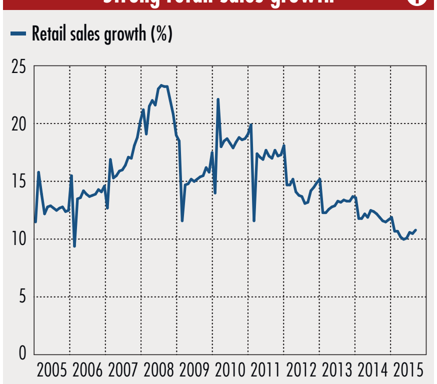
This contributes to **lower operating profits for many companies.** According to the National Bureau of Statistics, industrial profits fell 8.8% in August from a year ago. This was the biggest drop since the government began releasing the monthly data in 2011. State firms' profits also continued to decline. And: the August data probably did not fully capture the effect on earnings from the RMB devaluation, which must have increased the costs of financing for those companies with obligations denominated in foreign currencies.

Big disparity in the development of different regions

That being said, we are fully aware that **many people in China have difficulties finding reasonably paid jobs.** This includes the majority of people above 50, who lack marketable skills, and the former employees of companies which operated in low-growth provinces and had to shut down production. Just one example we have known personally from a distance for many years: the largest independent corn refiner in Asia with large operations in the Northeastern provinces. This HK-listed company, having operated loss-making factories for years and probably having overstated reported earnings for years, shut down its factories in September. Like many others, it was the victim of government policies to redistribute income to farmers by effectively doubling corn prices in China in 2010/11 to levels 50% or more above world market prices. It was only a matter of time until companies using corn as a raw material would throw in the towel, leaving the government more and more as the sole buyer of corn.

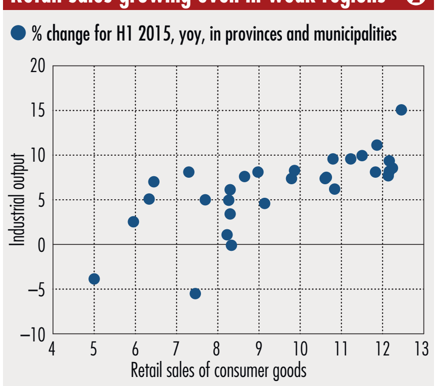
This example underlines one of China's problems: that **economic growth has been very unevenly distributed across different regions.** Structurally weak provinces (predominantly in the Northeast of the country) exhibit low growth, few employment opportunities and income levels significantly below the national average. Metropoles along the coast, which are at the other end of the spectrum, benefit from the booming services sector, are growing much faster and provide incomes far above the national average. This is an economic problem as well as one of social stability, making the solutions of other pressing problems tricky. Turning state-owned enterprises (SOEs) around is only one of them, since many SOEs are located in such economically weak areas (please refer also to «thequarterlydragon» #3, dated October 1, 2015, on this topic).

Strong retail sales growth ❶



Source: National Bureau of Statistics of China / Chart: ChinaIntelligence

Retail sales growing even in weak regions ❷



Source: FT Confidential Research / Chart: ChinaIntelligence

What this means:

- Economic growth is slowing and it appears increasingly likely that the officially reported GDP growth rate during H2 2015 will drop to below the government's target of 7%.
- Consumers appear to keep spending, based on their positive attitude towards the economic environment.
- Property prices are increasing slightly and are likely to edge higher due to inventory constraints.

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- The impact of the RMB devaluation in August on the real economy will be small, but may pave the way to further RMB weakness vs. the USD.
- Industrial activity is weak, the PMI reading of 49.8 keeps this indicator in contraction territory. Industrial profits declined from January to June, in some sectors dramatically. Large SOEs suffer much more than privately owned enterprises.
- The soft economy will motivate the government to implement further stimulus measures and reforms across a variety of areas.

Important Indicators

	Sep 2015	Aug 2015	June 2015	March 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 (%)	–	10.4	10.6	10.2	11.5	10.8
Official Consumer Confidence Index	–	104.0	105.5	107.1	105.8	105.4
FTCR Labor Demand yoy Index	–	58.8	63.2	76.0	72.6	68.1
Real estate floor space newly started, growth yoy (%)	–	–16.8	–15.8	–18.4	–10.7	–9.3
FTCR mom Home Price Index	–	59.7	61.0	55.0	51.5	50.0
CPI, growth yoy (%)	–	2.0	1.4	1.4	1.5	1.6
PPI, growth yoy (%)		–5.9	–4.8	–4.6	–3.3	–1.8
PMI manufacturing	**49.8**	49.7	50.2	50.1	50.1	51.1
Caixin/Markit PMI	**47.2**	47.1	49.4	49.6	49.6	50.2
Fixed-asset investments, growth yoy (%)	–	10.9	11.4	13.5	15.7	16.1
Required ReserveRatio (large banks) (%)	**18.0**	18.0	18.5	19.5	19.5	19.5
Benchmark rate for 1-year loans (%)	**4.60**	4.60	4.85	5.35	5.60	6.00
Benchmark rate for 1-year deposits (%)	**1.75**	1.75	2.00	2.50	2.75	3.00
New total social financing, growth yoy (%)	–	13.0	–6.8	–44.0	35.0	–26.0
New bank loans, growth yoy (%)	–	10.4	23.0	–5.1	44.0	9.0
Exports, growth yoy (%)	–	–5.5	2.8	–15.0	9.7	15.3
Imports, growth yoy (%)	–	–13.8	–6.1	–12.7	–2.4	7.0
Trade balance (USD billion)	–	60.2	46.5	30.8	49.6	30.9
Electricity consumption, growth yoy (%)	–	1.0	1.3	0.8	3.8	3.9
Freight Traffic, growth yoy (%)	–	4.2	4.2	4.5	7.1	7.7
Iron ore imprts (million tons)	–	74.1	75.0	80.5	86.9	84.7
Coal imports (millions tons)	–	17.5	16.6	17.0	27.2	21.2
Crude oil imports (million tons)	–	26.6	29.5	26.8	30.4	27.6
Bloomberg Commodities Index (BCOM)	**87.82**	90.93	102.69	98.12	104.33	118.69
CSI 300 (China Equity Index)	**3'203**	3'366	4'473	4'051	3'534	2'451
RMB trade-weighted, nominal, indexed (2010=100)	–	126.2	126.0	126.1	121.5	116.0
RMB / USD spot	**6.36**	6.37	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 year-end run rate of around 6.5%, 2016: 5.5% to 6%, 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: 2 additional cuts in the benchmark rates by the Chinese New Year 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 of approx. 5% during the coming 12 months from the current rate of 6.36 RMB per USD.*
- *Retail sales growth: approx. 10% p.a.*

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