China – the usual worries, but no boom and no bust

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Key points

> Chinese economic data is off to a soft start this year.

> However, there are reasons for optimism that growth this year will still come in "around 7%". Monetary policy is easing, the Government is alluding to more stimulus and the threat from the property slump is receding a bit.

> While a re-run of last year's 50% gain is unlikely Chinese shares remain attractive.

> Slower Chinese growth isn't a major threat to Australia. The main dampener on commodity prices is supply.

Introduction

In some ways I find analysing China amusing. First, as long as I can recall numerous commentators have been calling for a Chinese hard landing. And for as long as I can recall they have been wrong. Second, Chinese economic data has been running hot and cold for years but each meaningless wiggle sees a breathless media, and sometimes an over-the-top market, response. Finally, the Chinese authorities themselves seem to sometimes add to a bit of confusion – the Peoples' Bank of China (PBOC) is about the most opaque major central bank there is and numerous motherhood policy statements about "prudent monetary policy" and "deepening economic reforms" don't help.

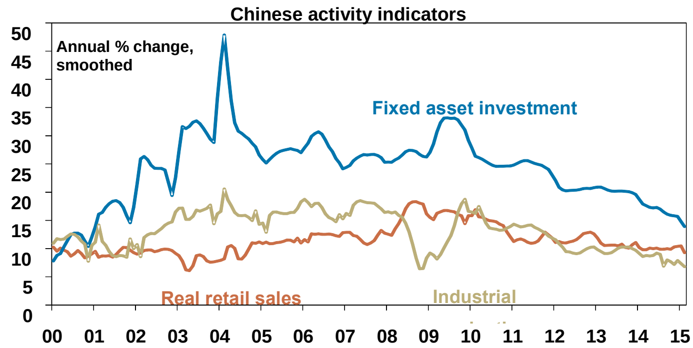
So the perpetual China worry list remains and recent Chinese data has been on the soft side. But last year Chinese shares were amongst the world's strongest. What gives? Is China on the brink of a boom or a bust? Probably neither.

A soft start to the year (or just more noise)

Realising last decades' 10% plus growth was not sustainable the Chinese leadership has been engineering a downshifting in growth to a sustainable pace. This can be seen in the next chart. Most of the growth slowdown occurred over 2010 & 2012.

Source: Bloomberg, AMP Capital

China grew 7.4% last year which was close enough to the Government's 2014 target of "around 7.5%". Well and good, but January and February data show a distinctly soft start to the year, with a range of indicators losing momentum including industrial production, retail sales, fixed asset investment, imports and money supply and credit. See the next chart.



Source: Thomson Reuters, AMP Capital

Of course, this data needs to be treated with caution due to the distortions caused by the timing of China's New Year (best wait for March data before getting too excited) and strong exports look like providing a bit of an offset to soft domestic demand. Nevertheless, growth does appear to have slowed.

The Government's 2015 growth target is "around 7%" with three factors posing downside risks. First, property has gone from boom to bust and this includes property investment. The slump in property investment and prices are all weighing on growth.

Second, the desire to slow lending outside the banking system and a fall in inflation to 0.9% year on year for non-food inflation and to -4.8% year on year for producer prices has led to a de-facto monetary tightening with a rise in real borrowing rates.

Source: Bloomberg, AMP Capital

This monetary tightening has been accentuated by a rise in the Renminbi on a trade weighted basis (due to a rising $US). But I won't push this too far as Chinese exports have been solid.

Finally, Government reforms have been weighing on growth – notably crackdowns on corruption, pollution & excess capacity.

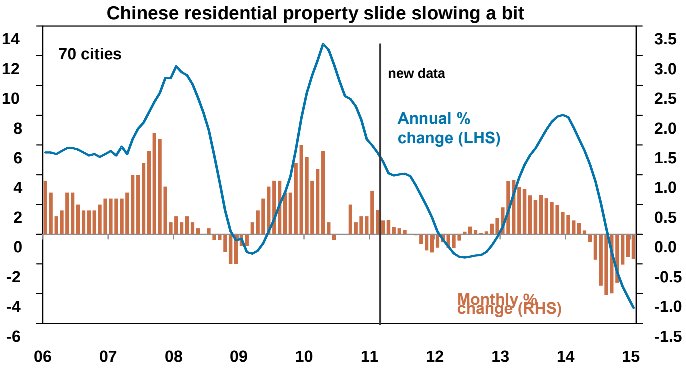
The policy response

However, while the Chinese Government faces a difficult balancing act there are reasons for confidence that growth this year will come in around the 7% target. First, the PBOC has cut interest rates twice starting in November and cut the banks' required reserve ratio. Rate cuts will benefit private sector companies that have been paying very high interest rates and households with housing debt. It won't stop a gradual structural slowing in Chinese growth (due to demographics and as the industrialisation phase slows) but it adds to confidence China will avoid a hard landing. Our assessment is that further rate cuts will be necessary to reduce real lending rates to more reasonable levels. This is likely to see the 12 month benchmark lending rate fall to 4% or possibly below by year end.

Source: Bloomberg, AMP Capital

Second, fiscal stimulus is likely. Premier Li Keqiang has indicated that China has "a host of policy tools at our disposal" should growth approach the lower limit which in the past he has said was around 7%, but is probably now 6.5%. This suggests that the various mini-stimulus measures of late could be added too. Premier's Li's comments suggest that the growth slowdown may be getting close to what is considered tolerable. Any more could threaten employment and spark social unrest. Reform remains a focus, but Premier Li has made clear it needs to be balanced against maintaining growth.

Third, while the property downturn is a key risk, it doesn't seem to be spiralling out of control with the 1% monthly price declines seen last year slowing to around 0.4%. The relaxation of limitations on purchases and mortgages has helped.



Source: Bloomberg, AMP Capital

Update on the China worry list

So, where are we at regarding the other China worries? Our view remains that these problems are not as bad as they look:

The investment/consumption imbalance is exaggerated – as consumption is understated relative to investment in China, investment per capita is low and reducing investment too quickly will only risk China going down the same inflation/trade deficit path seen in many other emerging countries.

China is not losing its competitiveness – wages growth is being offset by rapid productivity growth, China is still gaining global export share and inflation is low and falling.

There was no generalised housing bubble – household debt is low at 30% of GDP, house prices didn't keep up with incomes & there's an undersupply of affordable housing. Yes there has been excessive supply in some cities, but not in first tier cities.

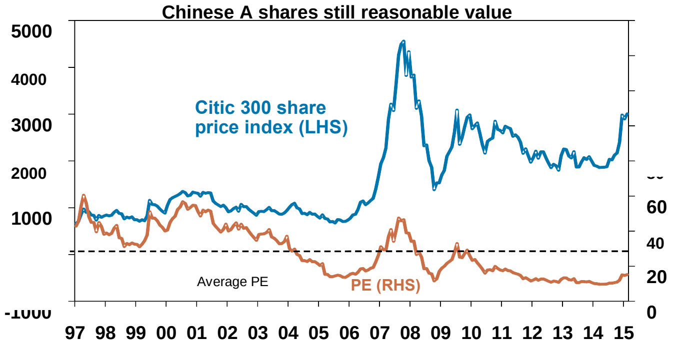
The rapid rise in debt of 22% pa over the last decade is a concern but – public and total debt relative to GDP is not excessive by global standards and strong growth in debt reflects China's 50% savings rate with savings mainly being recycled via debt. Lowering lending and hence investment too quickly without first saving less will risk recession and deflation. Problems associated with excessive local government borrowing via local government financing vehicles at high interest rates with short maturities look like they will be resolved by allowing such debt to be swapped into bonds, which will entail much reduced borrowing costs and longer maturities.

Finally, China's "shadow banking" system (lending outside the banks) has grown rapidly but – it is relatively small (30% of banking assets versus 100% in the US) and lacks leverage, complexity and foreign exposure. So it's not comparable to the risks around US shadow banking that drove the GFC.

Overall our assessment remains that these risks are manageable. Much of what goes on in China is controlled by the Government. And the Government has plenty of firepower to ensure growth holds up.

The Chinese share market

After a 77% gain from its June 2013 low Chinese shares listed in China (A shares) are no longer dirt cheap, with an historic PE of 15 times and forward PE of 13.5 times. However, they are still reasonable value, particularly against their own history.



Source: Thomson Reuters, AMP Capital

Meanwhile, Chinese companies listed in Hong Kong, or H shares, have lagged in the recovery and offer better value with a forward PE of around 8 times. Both mainland and HK listed Chinese shares will benefit from further monetary easing and so both offer good return prospects.

China and Australia

While China has slowed from last decade, it's still consuming record quantities of Australian commodities. In fact, growth in volume demand from 7% GDP growth today is equivalent to 14% GDP growth a decade ago as the Chinese economy has more than doubled in size over that period. Rather the real problem for Australia is that the supply of commodities has now caught up with demand and this will continue to weigh on commodity prices going forward. The good news though is that the risk of a hard landing in China remains low and so a collapse in commodity demand is unlikely.

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