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Growth in China looks to be bottoming

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Key points

> After surprising on the downside into mid year, recent Chinese economic indicators suggest growth is bottoming and is likely to come in around 7.5% this year.

> However, a sharp growth rebound is unlikely as policy has not been eased enough and export growth will be constrained by recession in Europe and slow growth in the US. Expect growth in 2013 to also be around 7.5%

> Radical changes in policy direction are unlikely under the new leadership. Change will likely remain gradual.

> Chinese shares are cheap and have probably bottomed.

Introduction

China joined Europe and the US this year as a source of consternation for investors with growth slowing more than expected. This fuelled fears about a hard landing (growth of six percent or less) and a focus on China's long term problems. Such fears have been accentuated by the leadership transition. So what's going on in China: has growth bottomed and about to rebound or is a hard landing still likely? Will the leadership change result in a big changes? And what does it mean for Chinese shares which have been in a bear market since August 2009?

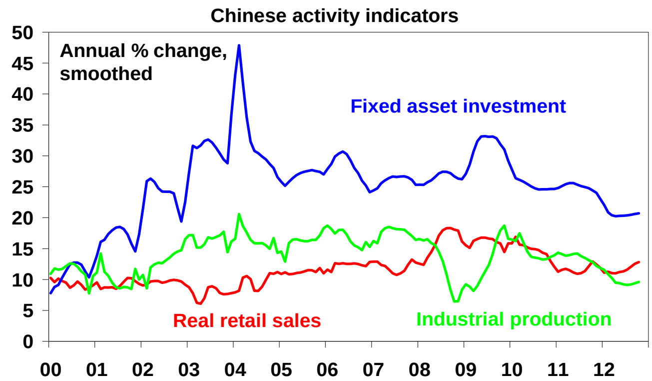
Growth down, but looks to be bottoming

There is no doubt that Chinese economic growth slowed more than expected into mid year. However, there is still no sign of a hard landing. After a few false starts, recent indicators suggest that growth may be bottoming.

- While year ended GDP growth slipped to 7.4% in the September quarter, quarter on quarter growth has risen from 1.5% in the March quarter, to 2% in the June quarter and to 2.2% in the September quarter.

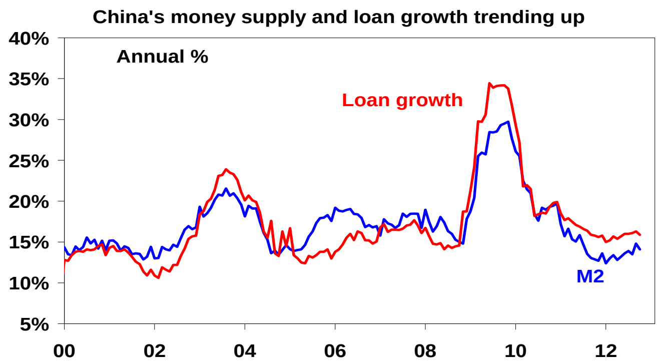
Source: Thomson Reuters, AMP Capital

- Related to this, business conditions indicators (or PMIs) have stabilised or improved pointing to a possible pick up in growth. See the previous chart.
- Retail sales rose 14.5% year on year in October, up from a low of 13.1% in July. Real retail sales are tracing out a gentle rising trend. This is being fuelled by strong growth in disposable incomes, particularly in rural areas.



Source: Thomson Reuters, AMP Capital

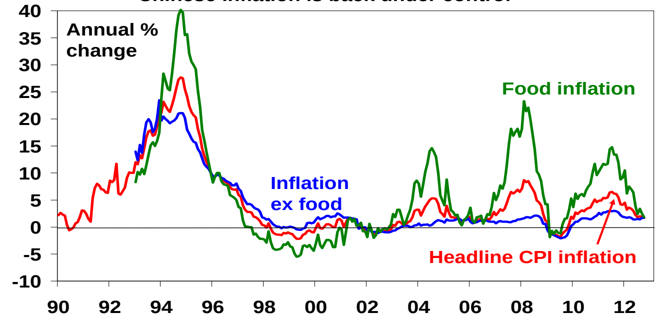
- New home sales rose 25% year on year in October, the fastest pace since March 2010. House prices have also been edging up since May. The bounce back in property demand, despite ongoing property restrictions, highlights that underlying demand remains very strong. In a country where only 11% of property buyers are investors, average deposits are around 40% of values and 20% of buyers pay in cash, it highlights that property conditions in China overall are a long way from being in a bubble.
- Growth in fixed asset investment is also strong, up 22.2% year on year in October, up from a low of 19% in August. A big driver of the renewed strength has come from infrastructure investment, which rebounded to 25% year on year growth in October as the Government sped up project approvals and fixed financing bottlenecks.
- Growth in industrial production has picked up to 9.6% in October, up from a low of 8.9% in August.
- The only fly in the ointment has been lending and money supply growth which slowed in October. However, the trend in both has been up this year reflecting the monetary easing that commenced late last year.



Source: Thomson Reuters, AMP Capital

- Meanwhile, inflation is back under control. Having peaked at 6.5% last July it has fallen to 1.7%. Inflation is no constraint to further monetary easing.
- Chinese export growth has also picked up to 11.6% year on year in October from a low of 1% in July. This is also consistent with an upturn in exports from other Asian countries including Korea.

Chinese inflation is back under control



Source: Thomson Reuters, AMP Capital

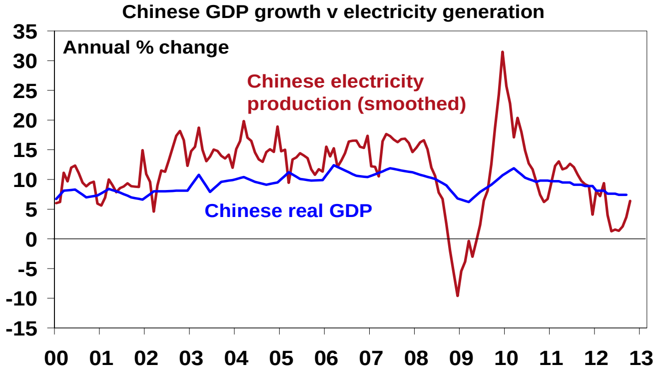
A big concern in recent years is that China will have a hard landing. The basic argument has been that China has overinvested leading to a surge in debt, that a credit crunch was on the way and thanks to high inflation the authorities would be too slow to respond and the economy would implode as the property market and investment collapsed. In the event none of this has occurred. The growth slowdown looks more by design than accident. Inflation has cooled providing plenty of policy flexibility and property and investment have slowed but not collapsed.

The range of indicators referred to above suggests growth may have bottomed and is likely to come in around 7.5% this year. By the same token, for 2013 it's hard to see growth accelerating much beyond this given that the soft global backdrop will likely constrain exports and policy stimulus has not been strong enough to drive a renewed growth surge. So no hard landing, but no growth surge either.

But is Chinese growth data overstated?

An oft stated concern is that Chinese economic data is unreliable. During the strong years last decade China was frequently accused of understating growth. In recent times it has been claimed that it has overstated growth. As evidence for this many cite electricity production which had been running well below the official growth rate. However, it's worth noting that electricity production is traditionally more cyclical than GDP growth – reflecting its link to the energy intensive and volatile manufacturing sector. As a result electricity production slows more when growth slows. The next chart suggests this relationship is normal.

Chinese GDP growth v electricity generation



Source: Bloomberg, AMP Capital

While Chinese economic data is unlikely to be as precise as that seen in rich countries, the fact it shows both good and bad times, lines up with surveys conducted by foreign organisations (eg the HSBC/Markit PMI) & cross checks against other countries export data suggests its roughly right.

What about the leadership transition?

Will it result in abrupt policy changes? The short answer is no. The new Chinese leadership likely headed by Xi Jinping as President and Li Keqiang as Premier have been involved in policy setting for the last five years. They are unlikely to announce abrupt changes in policy from day one. Rather policy change will likely continue towards a greater reliance on market forces but is likely to remain gradual.

The outgoing President announced a target to double GDP by 2020, which implies annual GDP growth of 7% pa. While such a growth rate is well down on the 10.8% of the last decade, it is still very strong. China's catch up potential remains immense. On a per capita basis, roads, railways, airports, phone lines, living space and cars are well below US and Australian levels. The next table highlights that it's very hard to see any evidence that China has massively overinvested in infrastructure.

Huge catch up potential in China

	Chinese level per person as %	
	of US level	of Aust level
Paved road network	13	11
Rail network	9	4
Airport capacity	2	1.4
Telephone lines	43	NA
Living space	35	NA
Passenger cars	5	5

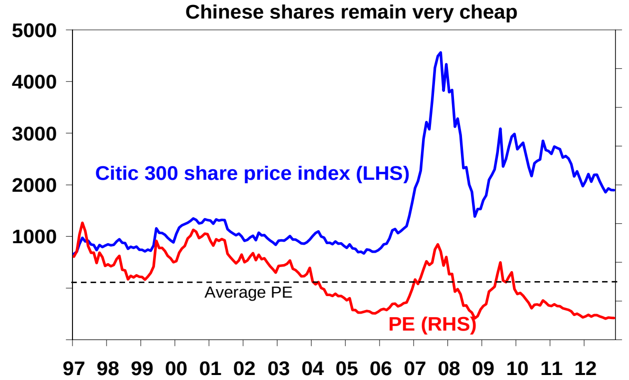
Source: Bank Credit Analyst, AMP Capital

Consistent with this, the key drivers of China's growth remain in place, via urbanisation (with the urbanisation rate being just over 50% there is still a long way to go) and strong productivity growth (on the back of high levels of investment).

What about Chinese shares?

Chinese shares have been in a bear market since August 2009 and have seen a fall of 41%. This has seen valuations become very cheap – with a price to historic earnings ratio of 11.2 times against a long term average of 31, and a forward PE of just 9.6 times, suggesting a hard landing is factored in and pointing to the potential for attractive returns on a medium term basis. This suggests Chinese shares are very attractive as a long term investment destination.

Chinese shares remain very cheap



Source: Thomson Reuters, AMP Capital

Concluding comments

Recent indicators suggest that Chinese economic growth is bottoming around 7.5%. While we don't expect a strong rebound or radical changes following the leadership changeover, a hard landing is looking less and less likely. This should ultimately be positive for Chinese shares. A stabilisation in Chinese growth around 7.5% should also be positive for the Australian economy and resource stocks.

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