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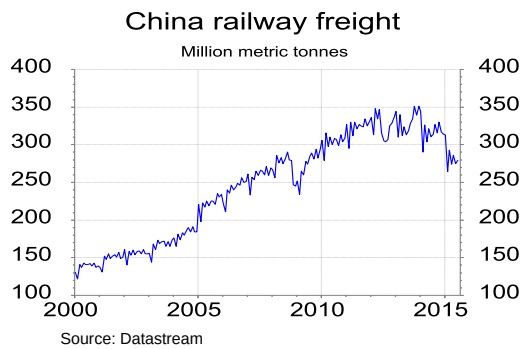
ADVANCE ECONOMIC SPOTLIGHT ON…

THE CHINESE ECONOMY

AUGUST 2015

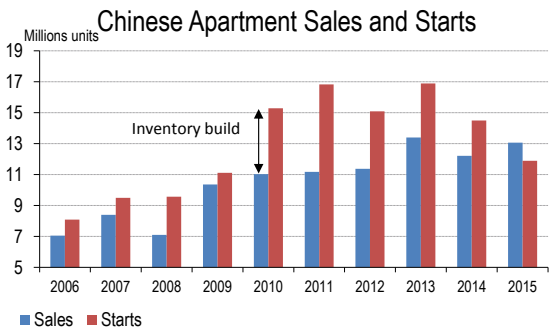
Growing concerns about the Chinese economy are causing some weakness across the globe in equity markets. Tim Rocks, Head of Market Strategy and Research, discusses the implications.

The Chinese economy has been weakening for a year, as has been clear from a broad range of indicators such as electricity use and domestic freight movements.



Source: Datastream

It has been inevitable for some time that the Chinese economy was going to slow. The exponential rate of apartment building in recent years could never be sustained. At its peak, between 2011 and 2013, China was building 15-17 million apartments per year, well in excess of underlying demand that is around 10-12 million per year. Apartment construction had to slow to a pace more in line with underlying demand, and to clear the large backlog in unsold apartments that had accumulated.



Source: Datastream

Chinese authorities have also been keen to rebalance the economy away from investment towards consumption.

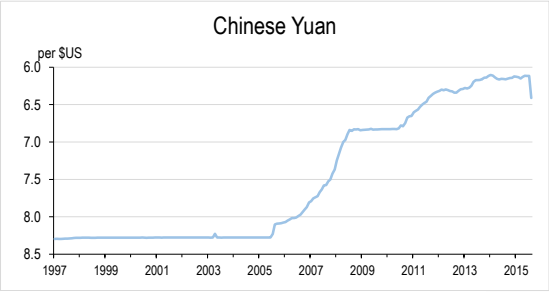
However, the economy is now weakening more rapidly than the authorities intended. This is partly due to the poor implementation of a number of well-intentioned and necessary policy changes.

> Changes to rules around local government financing were introduced in September last year. These were meant to improve the transparency of local government finances, but instead deprived local governments of funds for several months and forced a decline in infrastructure spending. The rule changes have since been reversed.

> The government encouraged the share market higher over the past two years believing that a strong equity market would facilitate more equity issuance and allow heavily-indebted corporates to improve their balance sheets. Unfortunately, this resulted in a booming equity market that went bust very quickly.

> Anti-corruption measures had a surprisingly large impact on retail spending. Spending on banquets, luxury goods and vehicles has slumped since the anti-corruption drive started in 2013 given officials wanted to avoid attracting attention. Most political commentators expect that the anti-corruption drive will not be as aggressive going forward.

A more recent implementation error was the way the Chinese government conducted the exchange rate depreciation. Such a depreciation will ultimately be positive, but historically, a slow and steady depreciation causes rapid capital outflows. This is because corporates with excess cash seek to avoid losses from holding assets in a currency likely to fall further. Capital is currently leaving China at an aggressive rate and causing added financial strains domestically.

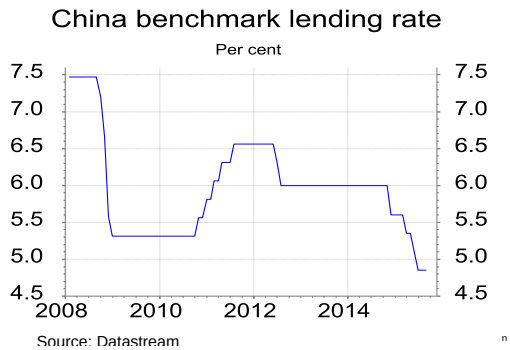


Source: Datastream

As a result of these policy errors, investors have lost some confidence in Chinese policy makers. The ineffectiveness of policy is driving a turn in the share market has not helped.

The better news is that we expect Beijing will respond aggressively to address these concerns. There is much it can do to support growth, and we expect it to make this clear over the coming months. Several supportive measures have already been implemented, and more will follow.

- Monetary policy easing through interest rate cuts and changes to reserve ratio requirements that free up more money for banks to lend.
- Further exchange rate depreciation.
- A reversal of changes to local government financing rules.
- An increase in funding for infrastructure.



Source: Datastream

Some or all of these proposed changes should be formally endorsed by the Central Committee at the next major meeting scheduled for October this year. This meeting is likely to make a clear shift in focus from corruption and market reforms towards growth. There remain plenty of longer term opportunities for investment, particularly from the New Silk Road initiative under which China is championing a range of infrastructure initiatives to boost trade both within the region and in Europe. These include substantial investment in pipelines, shipping routes and high-speed rail links between China, Europe and Asia.

Concerns in China could also cause more policy easing across the globe. Falling Chinese export prices and lower commodity prices could cause further falls in inflation in the US, Europe and Japan. This could cause the US to delay its planned tightening in monetary conditions, and cause further quantitative easing in Europe and Japan where inflation rates are still very weak.

We will continue to monitor these developments closely. One of the reasons that we have maintained a relatively conservative positioned portfolio in relation to global equities is that we have long believed Chinese risks were underestimated. However, if the market overreacts to these changes, we will use this as an opportunity to increase our exposure to growth assets.

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