China is on the right track

May 2016

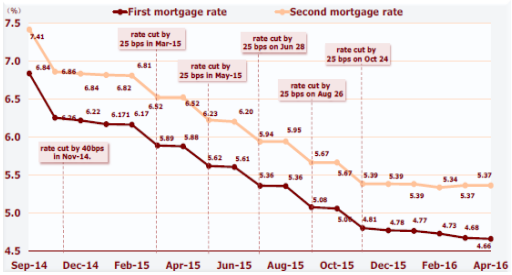
China has been a front of mind concern for investors over the past year and had a heavy influence on the behaviour of sharemarkets in recent times. Many investors may be questioning China's outlook. Tim Rocks, Head of Market Research and Strategy, recently toured China and provided his thoughts.

I recently visited a range of cities in China, including Chengdu, Xian and Nanjing, and returned confident in the policy measures introduced over the past year. I was also struck by the broadening range of investment opportunities provided by China. China is driving innovation in areas like clean energy and e-commerce, and there are substantial opportunities from the growth of new industries including tourism and healthcare that are at the forefront of China's transition to a more modern economy.

The Chinese economy has strengthened in recent months, driven by significant policy initiatives that have created a solid pipeline of activity. Some of these measures have included:

+ Hukou (residency permit) reforms are being used to help clear the inventory of unsold apartments. Rural residents have been promised an urban Hukou if they buy an apartment, which is very attractive as it gives them access to better healthcare, pensions and schools.

Chart 1:



Source: CLSA

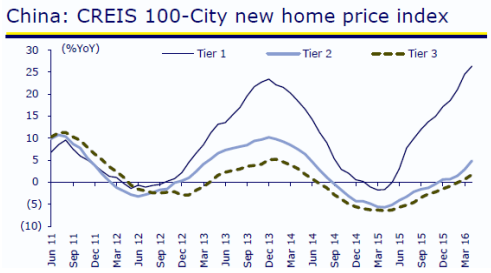
+ Mortgage rates have dropped to record lows and lending is growing at more than 20% per year (see Chart 1).

+ Auto sales are surging in tier 3 cities because auto-financing is being offered in these cities for the first time*.

+ A new wave of infrastructure spending is underway focused on subways, universities, hospitals and water projects. Funding is coming from rule changes that have removed the ban on local governments issuing bonds.

There is plenty of evidence that the policy measures are starting to have an impact. Property prices and new project starts have lifted even in the cities with large oversupplies (see Chart 2). This is starting to filter through to cement and steel sales. It could be supportive for some time considering that it takes around two years to build new apartment blocks and even longer for major infrastructure projects.

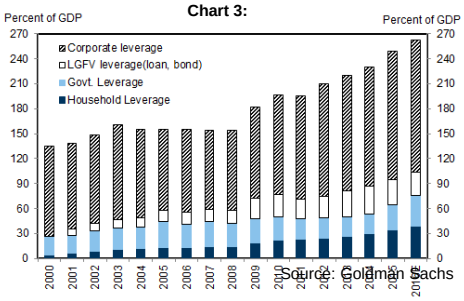
Chart 2:



Source: CLSA

Despite these improving signs, most investors are sceptical on the Chinese outlook. Many are fixated on potential financial stresses like debt sustainability, non-performing loans and the risk of capital flight (see Chart 3 for Chinese debt to GDP). These are legitimate long term issues but the timing and severity of any pressure is less clear given China's significant financial resources.

Chart 3:



Source: Goldman Sachs

*China's cities are ranked in tiers based on population size, development of services, infrastructure and cosmopolitan nature. Shanghai is considered a Tier-1 city, Chengdu a Tier-2 city while Wenzhou is a Tier 3 city.

Domestic politics will dominate the agenda leading into the next Party Congress in August 2017. Five of the seven-person Politburo Standing Committee must retire and this is creating a power struggle. The structural reform process is on hold and there is an enhanced desire for economic stability. President Xi's position has been weakened by recent policy embarrassments around the sharemarket and currency depreciation so he cannot afford anymore missteps. However, reform could then accelerate from 2018, which could create some economic pressure.

There are other developments that are positive drivers of long term growth.

+ The transition to consumption and services is now pronounced. There is demand for a new range of products and services, such as domestic tourism, sports goods and more extensive healthcare. The strongest evidence of this is the excitement over the opening of Disneyland in Shanghai, with 91% of the population planning to visit.
+ Improvements in healthcare, pensions and social security are also rapidly occurring. This is an important step to reduce the need for precautionary savings.
+ New industries are being created such as electric vehicles, solar, healthcare and e-commerce.

Your correspondent driving a Chinese electric vehicle.

I return confident the Chinese economic recovery will continue through 2016, even though there will not be new stimulus from here. This will be a positive for asset markets, particularly given sentiment and positioning towards China remains negative. The situation becomes more challenging from 2018, as reforms may accelerate and financial strains may build. China will still present some opportunities after this time, but the overall economy could weaken again.

For more information on the impact of China on your clients' investments, please contact your BT relationship manager.