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Are China Fears Justified? A Clarification on Unwarranted Economic Concerns



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- Chinese Economic Growth to Moderate, but Remain Strong
- Chinese Housing Market: No Bubble
- Systemic Risk in Chinese Banking System is Extremely Low
- Chinese Stock Market Fairly Valued

In large part due to a massive stimulus plan, the Chinese economy grew by 8.7% in 2009, accelerating to a 10.7% pace for the year. That is even more impressive when you consider the fact that the total global economy shrank by 0.8%, its first contraction since World War II. However, many now worry that China's economy has grown too fast and that substantial asset and lending bubbles have been created. The consensus is that such growth is unsustainable and bound to burst, causing negative feedback to the US economy, which is still somewhat fragile.

A close examination of the data and evidence indicates that, at least for the intermediate term, these concerns are largely unwarranted. While the extent of last year's lending and investment spending was, in some cases, an oversized government response to the global shock of late 2008, Chinese authorities appear to have become appropriately preemptive in an attempt to prevent an economic overheating. A slowing of overall credit growth and fiscal stimulus bodes well for China's economic stability and decreases the likelihood of a hard landing or sharp growth slowdown. Looking forward, we expect China's economy will likely moderate in 2010 to a still strong 7% to 8% growth rate.

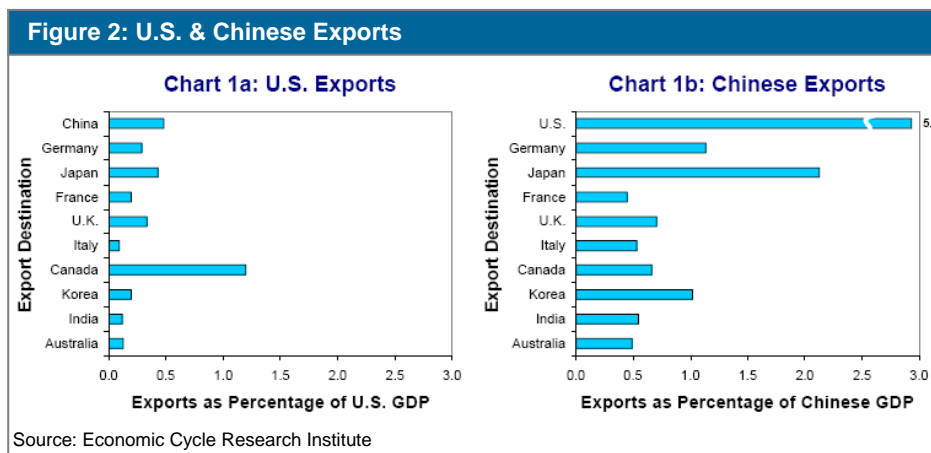
**Are China Fears Justified?
A Clarification on Unwarranted Economic Concerns**

By Garrett D'Alessandro

As the Great Global Recession began to unfold, the mission statement for the Chinese central planners was to do whatever was necessary to avoid a deflationary experience or a serious and prolonged economic downtrend. Last year's extraordinary stimulus plan accomplished that goal, and then some. In retrospect, Chinese authorities probably overestimated the extent of the downturn and provided too much support for the economic growth. With the resulting lending and capital spending boom threatening to overheat the economy and ignite inflation, they've now begun removing excess stimulus to slow GDP to around 7% to 8%. But, in our view, a "moderation" in Chinese economic stimulus and growth should not be viewed with apprehension by investors.

Just this month, China passed Japan to become the world's second largest economy, leading many to worry about the effects of slowing Chinese economic growth on the recovery of the global economy. Indeed, the Chinese economy is forecasted to contribute a quarter of total global growth in 2010, as much as the US. In trade, China has surpassed Germany as the biggest global exporter and has become the leading economic power in many other areas including annual car sales, steel production, the purchasing of US Treasury bonds, and the holding of foreign currency reserves. All of this means that the impact of the Chinese economy and its policy direction will have implications for the global economy and financial markets.

Yet, at least for the foreseeable future, the US will remain the main driving engine of the world economy. The importance of US demand is evident when trade flows to actual economies are examined. For example, the single biggest export destination for the US is Canada, which accounts for well over 1% of US GDP. China, in second place, accounts for over twenty times less than that, or 0.05%. This suggests that even if reduced Chinese economic stimulus results in weaker demand for US exports, it would still only amount to only a small fraction of 1% of total US GDP (Figure 2: Chart 1a). On the other hand, Chinese exports to the US are much more critical to their economy, accounting for over 5% of China's GDP (Figure 2: Chart 1b).



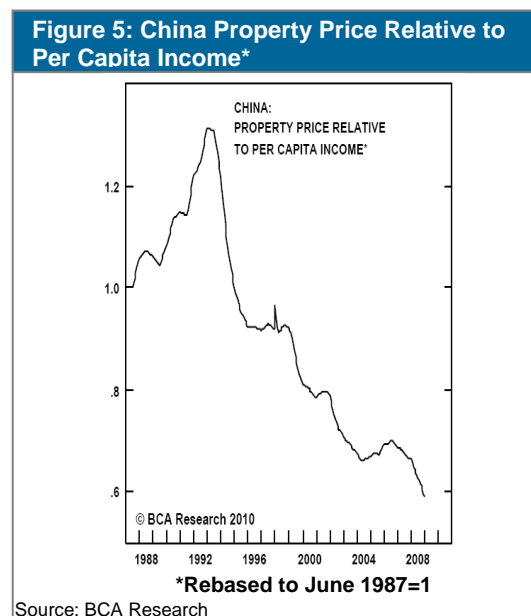
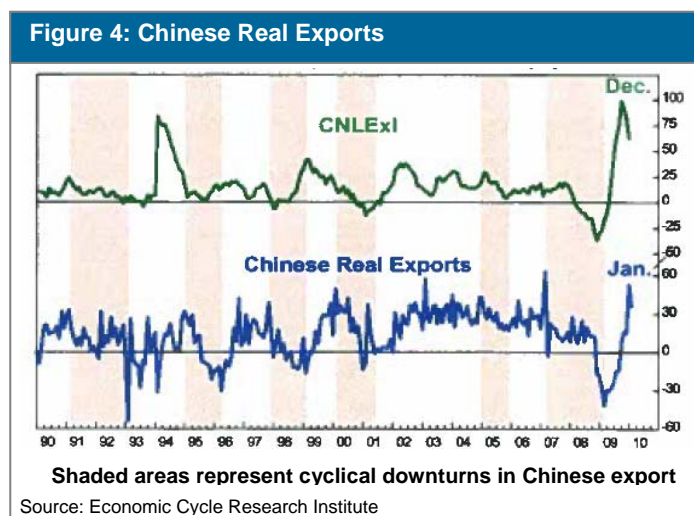
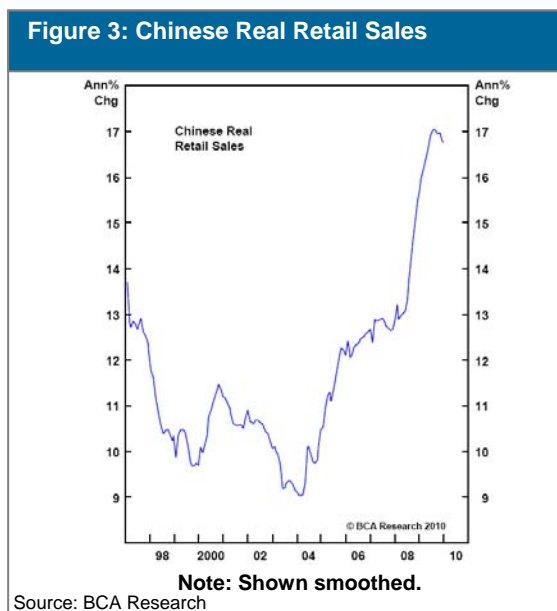
Across the globe, it is US economic demand that is most important. In fact, excluding Japan (a close exception), exports to the US are more significant to every other G7 nation's economy than are those to China. Even in Asia, the impact of US demand, particularly on the Indian and Japanese economies, can rival or exceed that of the Chinese. Overall, China accounts for only 7% of western country exports and, for the vast majority of the world's economies, the demand boost from massive Chinese economic stimulus does not make much more than one or two tenths of a percentage point difference to their GDP growth.

Nonetheless, we feel reports of China's demise have been greatly exaggerated and Rochdale's outlook for the Chinese economy in 2010 remains positive. While it is our expectation that the excesses in lending and capital expenditures will be reduced to levels that are more modest, the rate of credit creation and investment will continue to be quite positive. In addition, final demand, both internally and externally, remains on an uptrend with solid, if not strong, growth (see Figure 3). Wage growth, which is the fuel for the domestic Chinese citizen to increase their consumption and an important growth component, has seen 10% to 15% increases and labor demand remains strong as exports have rebounded significantly with the broadening global recovery. So are the current China fears concerning economic overheating, policy overkill or asset bubbles justified? After a careful review, Rochdale has concluded that the answer is no. Let's examine the evidence.

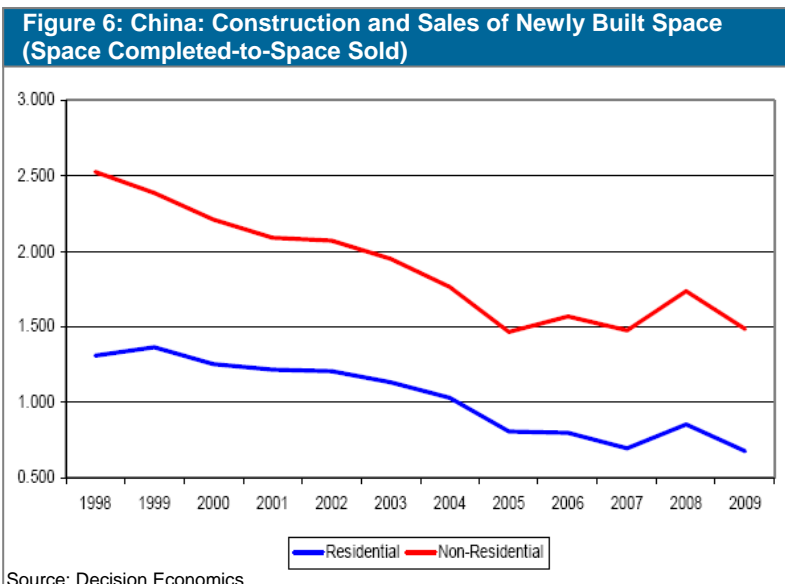
Is A Real Estate Bubble Forming?

The biggest danger perceived by many is a potential home price bubble in China. It is true that particularly larger cities (Tier 1) such as Shanghai and Beijing have seen an excessive run-up in prices and perhaps even the formation of a bubble. However, the majority of the Chinese population lives in smaller or mid-size (Tier 2 & Tier 3) cities where real estate prices remain relatively inexpensive and there is often a shortage of housing. Moreover, although price increases in the Chinese residential market appear rapid, such headline figures should be viewed in the context of rising Chinese incomes. The key determinant of real estate prices is per-capita income growth and, as Figure 5 shows, after peaking in the early 1990s, the property to income ratio has been falling at a constant rate ever since.

It is also important to realize that China's real estate industry differs in several crucial respects from those that led to the meltdown in the US. The US financial crisis was a result of the securitization of over-leveraged, low down-payment mortgages to poor quality borrowers. Chinese real estate development has taken a different path and the impact of a bursting Chinese real estate bubble would likely be muted, limiting the worst effects to real estate developers. Buyers of real estate in China historically have paid for property entirely in cash, and mortgages are a fairly new development. Borrowing is strictly controlled and down-payments of 20% for first homes, and 40% for second homes are legally required. This limited ability to use financial leverage, along with the prohibition on foreign ownership of real estate, helps to slow speculative activity.



Overall, China’s space-under-construction does not confirm a widening excess supply and, at least in recent years, it seems to have paralleled the economy’s pace of activity. The rate of growth of construction has declined on average since the early 2000’s and there was a pronounced deceleration in 2009 as the economy slowed, followed by a moderate recovery during the second half of the year. More importantly, official data shows that the ratio of non-residential real-estate-space-built to space-sold declined steadily between 1998 and 2005. It has remained rather stable since then (at or around 1.5), with the exception of an unsurprising up-tick in 2008.



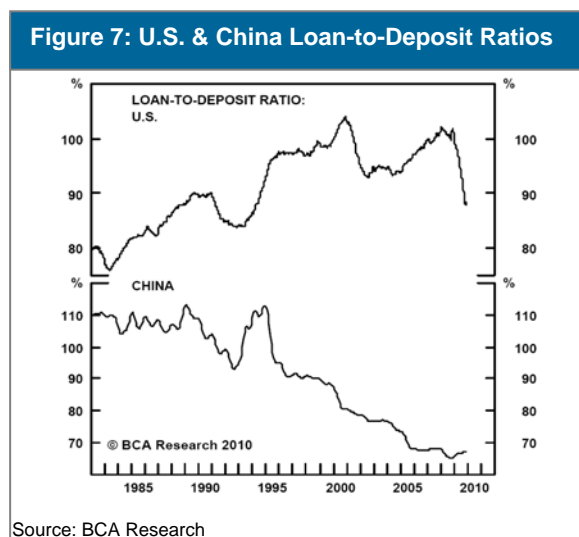
The residential sector exhibits the same pattern, except that the ratio has been below 1.0 since 2004. This not only implies that there is no real estate bubble presently, but that there could even be more potential upside in the residential segment, which comprises 70% to 80% of the total market. In fact, the official figures would suggest that the underlying demand for residential space has been stronger than the flow of production has been able to satisfy for several years. China remains in the midst of a rapid urbanization with 10 to 15 million rural citizens per year expected to migrate to its cities over the next two decades, and the demand pull of this extraordinary influx of people should therefore be able to absorb any excess over a relatively short amount of time. The main implication of this is that, given no artificial constriction of supply and enforceable measures on speculation, continued growth in the overall Chinese real estate market does not need to lead to a bubble.

It is important to remember that China remains in the midst of a rapid urbanization with 10 to 15 million rural citizens per year expected to migrate to its cities over the next two decades. The demand pull of this extraordinary influx of people should therefore be able to absorb any excess over a relatively short amount of time. The main implication is that, given no artificial constriction of supply, and given enforceable measures on speculation, continued growth in the overall Chinese real estate market does not need to lead to a bubble. Instead, it can lead to a sustainable jump in the activity of the residential-construction sector.

Too Much Stimulus?

China’s stimulus program was a response to a major external shock: the collapse of exports due to falling global demand during the recession. Unlike the US, the fact that capital spending and bank lending responded quickly to the policy initiatives indicates that underlying fundamentals of the financial system were strong. Banks could increase lending dramatically because they had not been over-extended in previous years. Even after last year’s strong lending growth, banks loan-to-deposit ratio increased only to 66% as compared with 90% in the US (see Figure 7).

Indeed, systemic risk in the banking system is extremely low. It is important to note that it is a common practice for Chinese commercial banks to be instructed to participate in the central government’s stimulus programs and at least one-third of the net increase in bank lending since 2009 should be considered as a part of the government’s \$586

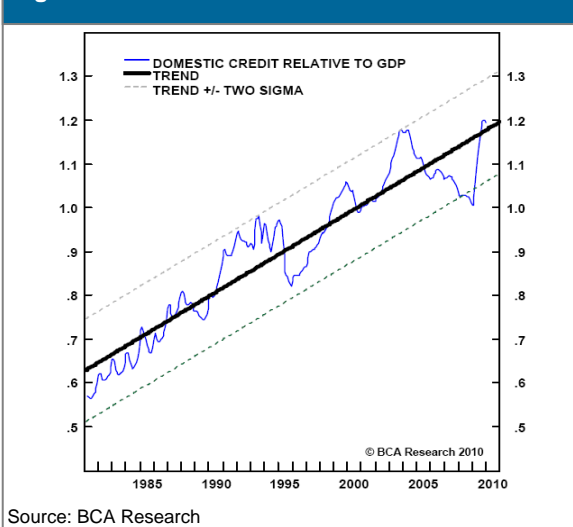


billion stimulus package. Therefore, the current picture of Chinese bank loans represents certain distortions created by fiscal stimulus, as part of the bank loan growth should be attributed to fiscal spending. A more important point is that the credit risks on these loans that belong to the stimulus programs are fairly low because they are guaranteed by the government.

To be sure, last year's doubling of new loans has increased the risk of irresponsible loans that could turn into bad debts. However, it is not correct to say that a massive credit bubble has already been dangerously inflated. Although banks' nonperforming loan (NPL) ratios will likely rise, the average NPL ratio of major commercial banks is currently only 1.6% as compared to more than 20% at the beginning of the last decade. In addition, commercial banks have set aside large reserves to cover potential losses from non-performing assets and regulators are asking banks to continue to increase capital. This means that even if the NPL ratio triples to 5%, it will not have a meaningful impact on the normal functioning of the banking system.

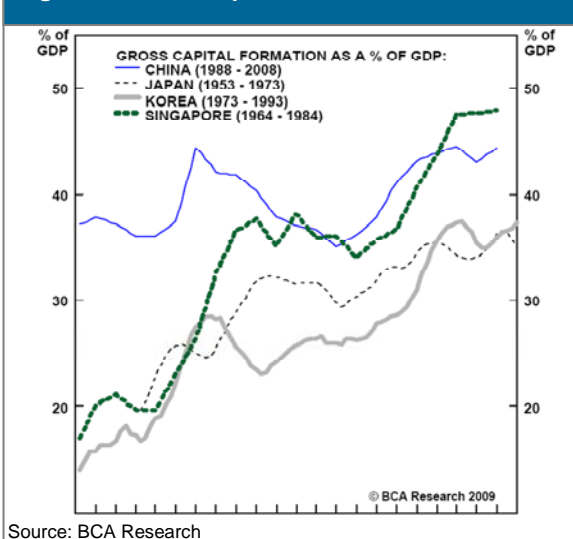
Concerns about a massive "lending bubble" should also be put in proper perspective. It would be more of a concern if lending were to decline, as it is in many developed nations. In fact, a look at China's bank credit-to-GDP ratio shows that it is barely above its long-term trend, even after last year's expansion of credit (see Figure 8). What this means is that instead of having to aggressively step on the brakes on bank lending, Chinese authorities will have the ability to manage credit growth and grow the economy while simultaneously avoiding excesses. The new bank lending target for 2010 is RMB 7.5 trillion, which represents a 19% increase in total bank credit. While this is certainly much lower than last year's RMB 9.5 trillion in new loans and 32% credit growth rate, it is far from restrictive and well above GDP growth estimates.

Figure 8: China's Bank Credit-to-GDP



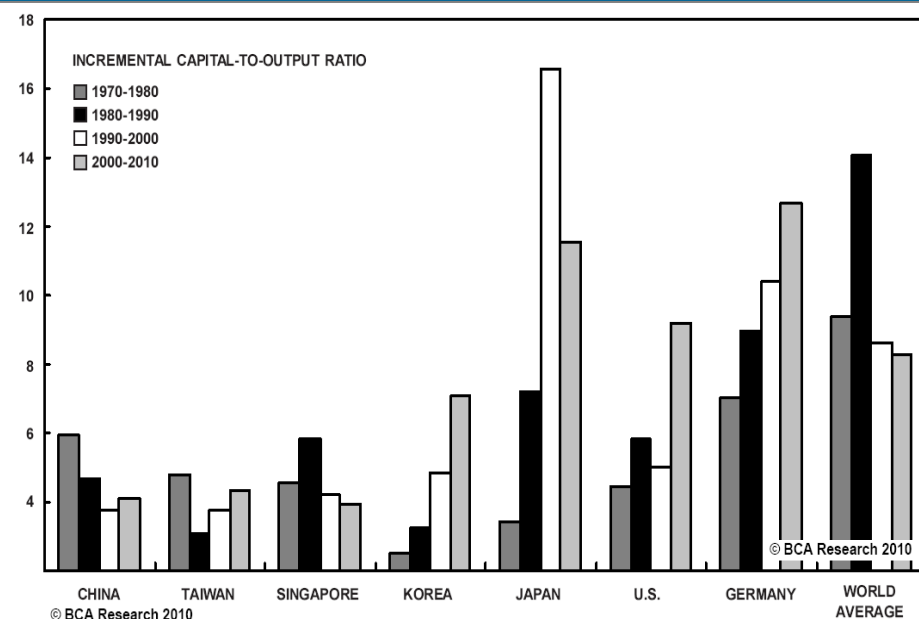
Of course, a result of such a dramatic spending and lending boom will always be a certain misallocation of capital. However, China is still, in most respects, a relatively poor country with a huge need for infrastructure and capital stock. Poorer countries with less capital per worker tend to grow faster because each investment in capital is likely to produce a higher return than in rich countries with ample capital stock. In this sense, as shown in Figure 9, China's investment growth path is not much different from historical experience of other developing economies.

Figure 9: Gross Capital Formation as a % of GDP



Furthermore, though many argue that the past year's investment was terribly inefficient, a closer look at the Incremental Capital-to-Output Ratio (ICOR) of China and some other countries reveals that this is not the case. ICOR measures the marginal amount of investment necessary for an entity to generate the next unit of production. As Figure 10 on the following page shows, from a historical perspective, China's ICOR has been fairly stable over the past three decades and no less efficient than its global peers. In fact, the ratio for the Chinese economy has been much lower than the global average and indicates that the efficiency of Chinese capital spending is actually among the highest of the major global economies.

Figure 10: The Efficiency of Chinese Investment Compares Favorably to Global Peers



Note: The years were omitted when the respective economies were in recession. 2008 was not included in all other countries except China. For the world average, the last period of calculation is between 2000 and 2005 due to availability.

Source: BCA Research

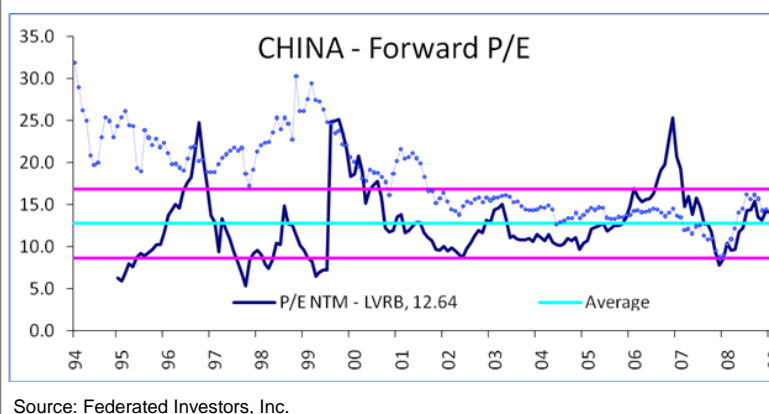
Conclusion

Although China policy tightening measures will likely continue, it is our view that they will remain gradual and sector-specific. Chinese authorities have smartly and correctly begun to slow lending as a way to avoid over stimulating real estate and construction in certain hot areas while simultaneously maintaining more than enough credit growth to finance 7% to 8% GDP growth. Overall, this means the policy environment should be appropriately controlled versus last year’s ultra-stimulative settings, but not restrictive by any measure. Inflation remains a key risk factor to monitor. However, if we are right and a period of growth moderation is currently unfolding, this will most likely dampen inflationary pressures and further reduce the risks of over-tightening.

With the steep sell-off in Chinese shares since late last year, it seems that the market has already discounted a slowing of the Chinese economy and other potential negative surprises. The evidence compiled by Federated Investors, Inc. indicates that this has been more of a consolidation of 2009 gains, rather than a correction.

Current valuation of 12.6 times forward P/E implies that stocks are fairly valued compared to historical figures, but not overvalued and not in a bubble (Figure 11). When compared to forecasted earnings growth of 27% for the next 12 months, valuations still look very attractive (Figure 12 on the following page).

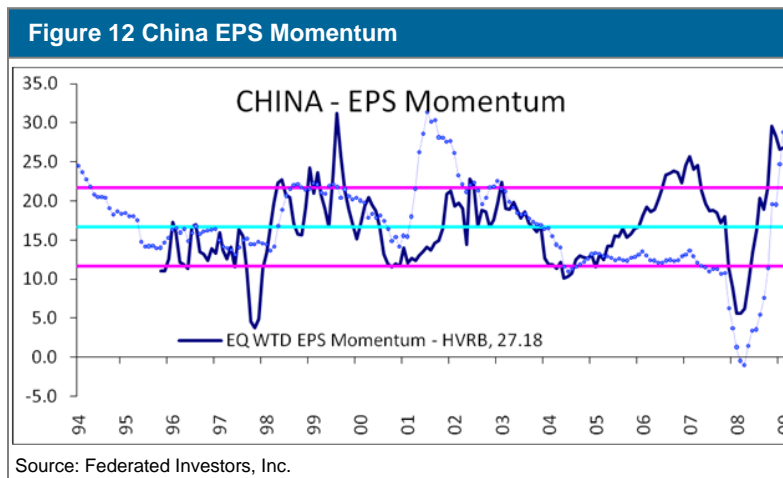
Figure 11: China Forward Price-to-Earnings



Source: Federated Investors, Inc.

China's attempt to ward off this potential asset bubble before it takes hold is the correct response to last year's stimulus and investors should be reassured by the government's proactive measures. If our view is correct that policy tightening does not equate to overkill and growth ultimately moderates rather than collapses, then Chinese stocks should continue to advance after the volatility settles. The lessons from past tightening episodes suggest that a meaningful correction based on unfounded fears of China risks eventually turn into buying opportunities. We will be monitoring the data carefully over the next several

months to assess the effectiveness of the government's decisions. However, we view the recent stock market weakness on the back of a hard landing scenario to be a buying opportunity for long-term investors.



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