China: Not out of the woods yet

In brief

• China’s third quarter real GDP growth of 6.9% year-over-year (y/y) was weaker than last quarter as growth from the tertiary (services) industry was unable to offset weakness in the secondary (manufacturing) industry.

• Stable labor market conditions and rising household income should lift consumption in the short term, but further fiscal and monetary stimulus is needed as disinflationary pressure intensifies in China.

• Investors need to accept lower economic growth as the “new normal” for China as the economy rebalances away from manufacturing and towards services.

China’s GDP? Better than expected...

China’s third quarter real GDP came in at 6.9% y/y, down from 7.0% in the second quarter and the lowest since 2009 (consensus 6.8%). On a quarter-over-quarter annualized basis, the economy expanded at the same 7.4% pace as in the second quarter (Exhibit 1). Despite a slowdown in the headline GDP number and a drag on net exports from underwhelming global economic growth this year, there is evidence to suggest that the ongoing rebalance away from manufacturing and towards service-oriented domestic demand is well underway. The share of tertiary industry has risen steadily from 43% in 2006 to 51% in the 3Q 2015, while the secondary industry has declined from 47% to 40%.
The tertiary industry is supporting China’s growth

EXHIBIT 1: REAL GDP GROWTH BY INDUSTRY, YEAR-OVER-YEAR % CHANGE

Source: National Bureau of Statistics, FactSet, J.P. Morgan Asset Management; data as of October 19, 2015. The chart above and the charts, graphs and tables herein are for illustrative purposes only.

Structural concerns regarding the overcapacity of the manufacturing and real estate sectors are expected to continue dragging headline growth in the medium term, as consolidation continues in the quarters ahead. However, we believe that the Chinese economy may be starting to regain a sturdier footing after a disruptive summer, and that support from additional fiscal and monetary policies will feed through to the real economy during the fourth quarter.

Of services and consumption...

A bright spot for the Chinese economy is still the invincible consumer. As the manufacturing industry continues to slow—growth slowed to 6% in the latest quarter from more than 10% in 2011—the services sector has remained relatively robust. Tertiary real GDP growth has outperformed the secondary industry since 2013, expanding by 8.4% in the last quarter (Exhibit 1).

The consumer story is even more apparent in real terms as real retail sales have barely contracted, while real industrial production has completely tanked in recent years (Exhibit 2). Since 2010, the Chinese government has had an urban employment creation target of 10 million new jobs per year. The latest

Consumption has been far more resilient than industrial production

EXHIBIT 2: REAL RETAIL SALES AND INDUSTRIAL PRODUCTION YEAR-OVER-YEAR % CHANGE, THREE MONTH MOVING AVERAGE


September employment data has once again beaten this target, with 10.7 million new jobs created in the first nine months of 2015. Even with the increase in jobs, income growth has remained steady, with per capita disposable income for urban residents at RMB 8,297 in 3Q 2015, a real growth rate of 6.8% (Exhibit 3). Going forward, we believe stable labor market conditions and solid wage growth should continue to provide breathing room for Chinese officials, but consumption alone cannot offset weakness in the manufacturing sector and boost growth.

Stable labor market and solid wage growth to support consumption

EXHIBIT 3: URBAN NEW EMPLOYMENT AND REAL URBAN HOUSEHOLD INCOME, NUMBER OF NEW JOBS, Y/Y % CHANGE

Policy changes work, with a lag

The Chinese government has ramped up targeted fiscal stimulus in recent weeks in an effort to spur growth. In lowering the down payment requirement for first time homebuyers from 30% to 25%, officials hope to encourage buyers and support the real estate market. In fact, the property market has recently seen a rebound, as prices in recent months have been rising in more cities across China. (Exhibit 4).

Sales volume has grown 37% year-to-date, especially in tier-1 cities like Shanghai and Shenzhen. While we do not view the reduction in the down payment requirement as a major stimulus, it signals the intentions of the Chinese government to support the property market, which could provide a more stable base for the broader economy. Even with this support, property construction and investment have remained weak, with developers remaining on the sidelines working through inventories. New housing starts contracted 19% y/y in August, and developers have not improved their land bank since the start of the year.

Further destocking ahead for the property market, but still no investment

EXHIBIT 4: FLOOR SPACE AND PROPERTY PRICE
YEAR-OVER-YEAR % CHANGE, MONTH-OVER-MONTH % CHANGE

With the real estate market providing only a moderate lift to growth, we believe officials will continue to deploy both fiscal and monetary stimulus to boost infrastructure spending. The National Development Reform Commission approved infrastructure projects worth up to RMB 886bn in September alone, compared to RMB 900bn for the first eight months of the year. We expect these initiatives, mainly railway and city-rail projects, highway bridges, hydropower stations and water waste management, to feed through to stronger investment in the fourth quarter of 2015. Lending data has also improved recently, with China’s policy banks, namely China Development Bank and Agriculture Development Bank, issuing up to RMB 300bn in special funding to support additional infrastructure projects. (Exhibit 5).

China will continue boosting infrastructure to offset weaknesses in the manufacturing and real estate sectors

EXHIBIT 5: FIXED ASSET INVESTMENT
YEAR-OVER-YEAR % CHANGE, THREE MONTH MOVING AVERAGE


*Based on Soufun’s 100-city average property price index.  
The People’s Bank of China (PBoC) has extended the pledged credit asset re-lending program from two provinces (Guangdong and Shandong in 2014) to nine other provinces, allowing commercial banks to use credit assets as collateral to access the central bank liquidity. We believe these targeted monetary policy measures should provide greater liquidity to the SMEs as opposed to just benefiting large SOEs or local governments. Even still, further RRR and interest rate cuts are needed as disinflationary pressures intensify in China (Exhibit 6). Furthermore, we believe future liquidity stimulus needs to be targeted to reduce the interest rate burden of the corporate sector, otherwise the impact on the real economy will remain limited.

Elevated real rates support further monetary easing

EXHIBIT 6: REAL LENDING RATES, PERCENTAGE


Monetary easing does not mean RMB devaluation

When China decided to reform the RMB’s fixing mechanism on August 11, it immediately led to unprecedented Chinese capital outflows and a spike in global volatility. However, the PBoC has clearly sent the message that the RMB will not move materially weaker in the near term and highlighted the fact that economic growth and strong fiscal positions do not warrant substantial devaluation.

While the gap between USDCNH, (the rate on Hong Kong-traded renminbi, i.e. offshore RMB), and USDCNY (onshore RMB) widened substantially after the depreciation, the differential has completely disappeared with the CNH now trading inline with the CNY. The same can be seen in the forward market (3-month non-deliverable forwards) as expectations of further depreciation have narrowed from the August wides (Exhibit 7).

Onshore and offshore differentials are narrowing

EXHIBIT 7: USDCNY (ONSHORE), USDCNH (OFFSHORE) and USDCNY (3-MONTH NON-DELIVERABLE FORWARDS) CHINESE YUAN PER USD


China still has sufficient monetary tools to ensure ample liquidity, and we believe that fears of significant devaluation are behind us. Further devaluation of the RMB could lead to more disadvantages than benefits for China, as trade volumes react with a substantial lag to actual price change. This is particularly true given the current weakness in global trade. RMB depreciation would likely affect local spending power first, a potentially alarming development, as domestic consumption is the last steady pillar of growth for China. Additionally, the negative terms-of-trade effect would put further downward pressure on growth in the short term, before the boost from exports is realized.
All-in-all, China remains committed to opening up its capital account in the near future and the latest reserves figure indicates that intervention pressures have declined. Monthly FX reserves dropped by USD 47.4bn in September, compared to August’s drop of USD 93.9bn, while total FX reserves are at a hefty USD 3.5 trillion. If capital outflows stabilize at a manageable level, it will also effectively improve the domestic liquidity situation, which will help boost economic activity in China (Exhibit 8).

Still ample FX reserves for China

**EXHIBIT 8: CHINA FX RESERVE POSITION**

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<thead>
<tr>
<th>Change in Monthly FX Reserves</th>
<th>Total FX Reserves, USD BILLIONS</th>
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<tr>
<td>Change in monthly FX reserves</td>
<td>Total FX reserves</td>
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**Investment implications**

China will remain in the spotlight as the size of it’s economy continues to have significant implications for the global economy. The October GDP report was unsurprising, as slower growth was widely anticipated, but we expect economic activities to marginally pick up in the coming months as both fiscal and monetary policies start to gain traction in the real economy.

Stabilization of the economy and reduced concerns of further RMB depreciation should help improve market sentiment in the short term, with a good chance of a mild rebound in the equity market. However, structural concerns such as overcapacity continuing to put pressure on margins and earnings growth for many industry-intensive sectors, remain unresolved. We believe investors need to accept what the Chinese officials have repeatedly emphasized—this is the “new normal” for China—and the economy will no longer grow at the pace it did a decade ago.

The continued rebalancing of the economy away from the manufacturing sector to the service-oriented sector means headline growth will be subdued. However, what matters in China is not absolute growth, but sustainable growth, which allows the country to be considered as a valuable investment opportunity over the longer term for both foreign and domestic investors.
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