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Ready. Set. Slowdown?

Why there is more to China's growth than meets the eye

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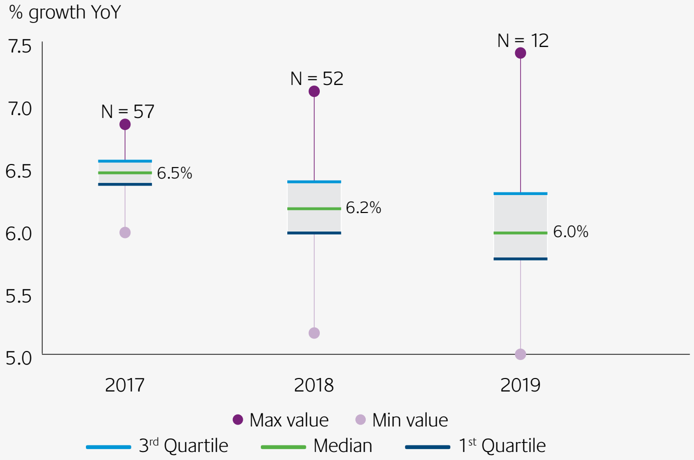
China's emergence from its growth slowdown has surprised many. In the December quarter of 2016, China's year on year growth rate accelerated from 6.7% to 6.8%. Small as it was, it is the first improvement in growth since 2014. But the market remains unconvinced; growth in China is likely to continue to decelerate according to the consensus of surveyed economists. This is highlighted in Chart 1.

Chart 1: Consensus forecasts for China GDP growth CY2017-2019

Consensus estimates, submitted 23 Mar-7 Apr



Source: Bloomberg.

Our own assessment suggests, however, that there's potentially more to China's current growth than meets the eye. Growth certainly has been driven by both a monetary and political cycle. Monetary policy was eased substantially for the first time since 2010 in 2015 and the political cycle is gearing up for an "election". But it's also set in train a significant program of works, both property and infrastructure, that might sustain an upturn in economic growth beyond 2017.

This period of growth acceleration has important investment implications. We explain our view of the acceleration from a macro and sector perspective and provide some insight into its impact on investment strategy.

Macro Outlook

In 2015 we wrote that monetary policy in China has been exceedingly tight and that this policy has constrained growth. It was the easing in policy through 2015 and 2016 that has allowed nominal growth to move higher. At a macro level, this has been important in raising inflation and removing the spectre of deflation from China and the global economy. China's policy stimulus has been a key reason for the emergence of the *reflation* theme in 2016.

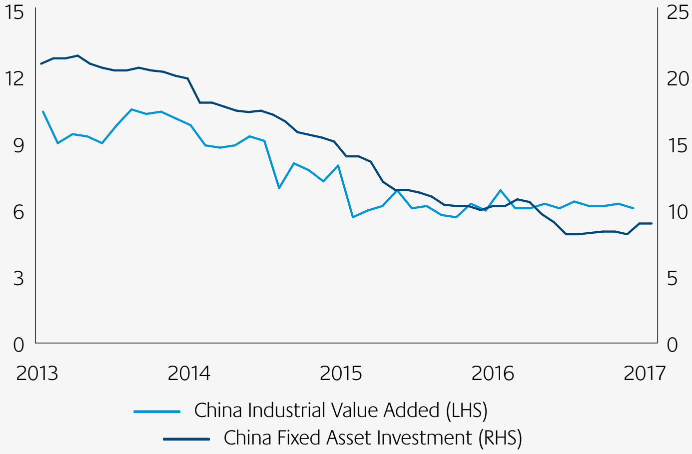
Chart 2: China Nominal GDP Growth YoY vs.Monetary Conditions Index

China MCI = 100 (base year 2007), Sep 2004-Feb 2018

Source: National Bureau of Statistics, Bloomberg, CFSGAM.

This improvement in growth can be observed in a number of indicators including industrial production, property and auto sales and some investment indicators.

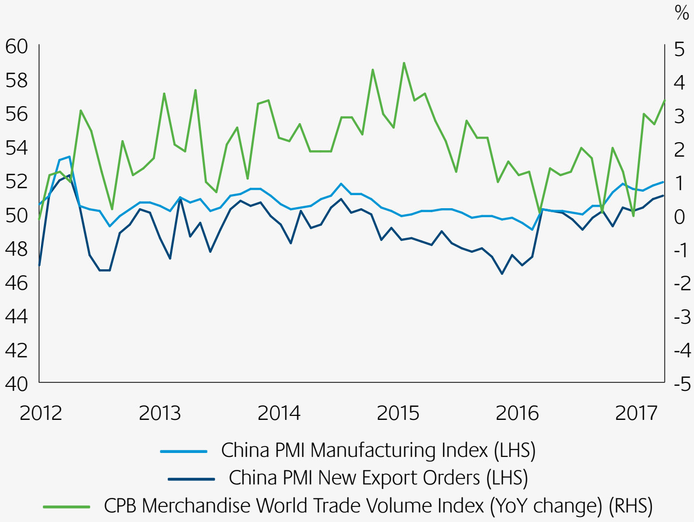
Chart 3: China Industrial Value Added v Fixed Asset Investment
% change YoY, Jan 2013-Feb 2017



Source: National Bureau of Statistics, CEIC, Bloomberg, CFSGAM.

There has also been a corresponding improvement in the global economy, particularly trade, reflected in the China PMI's new export orders index. This will also be positive for the Chinese economy.

Chart 4: China Manufacturing PMI vs. Global Trade
LHS: (Neutral = 50), Jan 2012-Mar 2017



Source: National Bureau of Statistics, CPB Netherlands Bureau for Economic Policy, Bloomberg, CEIC, CFSGAM.

Undoubtedly this data presents a more upbeat picture of China than may have been expected just six months ago. The challenge is determining the longer-term picture. Where does the current cycle lead? There has been a tightening in Chinese monetary conditions in early 2017, as observed in Chart 2, that would suggest a resumption of the growth slowdown. But sector data suggests the planned activity in China for 2017 and, probably, 2018 remains substantial.

Sector data

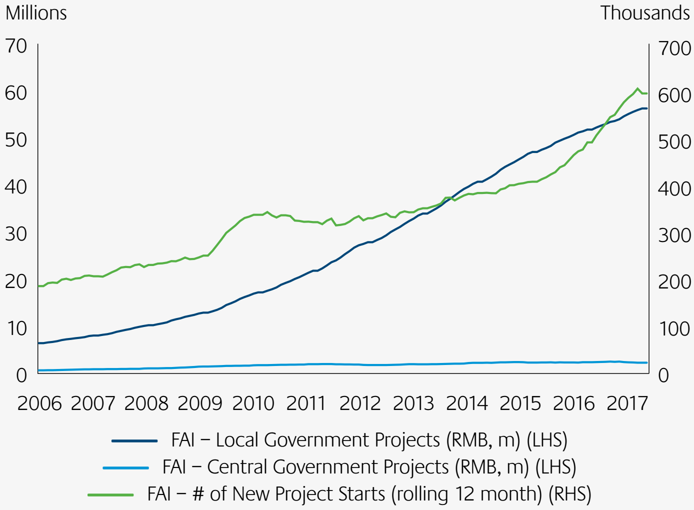
China's economic outlook for 2017 and beyond will be driven, in part, by conditions in infrastructure, property and the consumer sector. The evidence points to continued improvement in activity in 2017 and 2018.

Infrastructure

China's infrastructure spending has long been part of the country's growth model. The value of infrastructure to China's structural productivity improvement has been a topic we've discussed extensively over the last six years. It's also provided cyclical support to the economy during the global financial crisis and at the end of the extensive policy tightening we're experiencing now.

The scale of the current infrastructure cycle in China is important to consider. Chart 5 highlights infrastructure spending by both central and local government (local government is the lion's share) and the number of new projects started. Two things from the chart stand out. First, while the initial rise in new projects peaks relatively quickly, the associated spending takes time. For instance, in 2009 new projects peaked in 2010 but infrastructure spending maintained growth of 30% per annum to 2012. Second, the number of new projects started between 2015 and 2017 is substantially higher than was the case in 2009 but we've yet to observe the associated acceleration in spending. Based on the new project data and experience from 2009, infrastructure spending growth could maintain a solid pace for another two years.

Chart 5: China Fixed Asset Investment by Local and Central Gov'ts
Rolling 12 months, Jan 2006-Feb 2017



Source: National Bureau of Statistics, CEIC, CFSGAM.

The lag between new project starts and spending reflects a couple of issues. First, projects take time to get moving. Second, there is a financing issue. The financing issue is most pressing. As opposed to the 2009 stimulus, China is taking a more balanced approach to funding its infrastructure spend. To date, it has not sanctioned aggressive bank credit growth and instead looked at new funding mechanisms such as PPPs. Data and anecdote suggest funding channels have seemed to loosen up in recent months.

On the assumption that projects started are finished, there is a substantial medium term growth support for the Chinese economy. For instance, the increased high-speed rail infrastructure target is likely to take multiple years to achieve.

The same may be true for property.

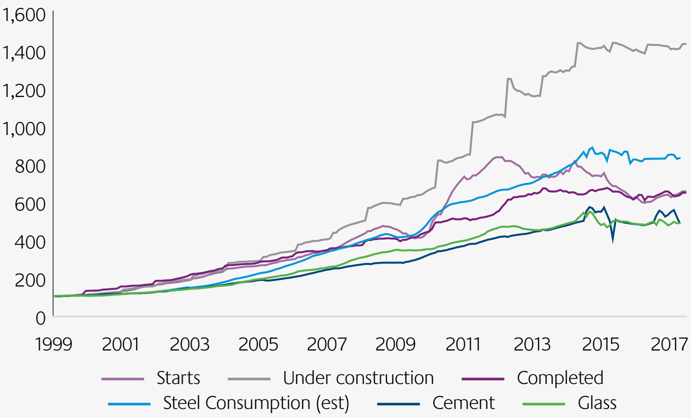
The property sector

It's our belief that the property sector will provide further support for China's growth in 2017 and 2018. China's urbanisation, a process that has shifted 200mn from rural registrations to urban registrations in the last 20 years, requires considerable new building. (We've explained the benefits of urbanisation a number of times.) Our analysis suggests new building should accelerate again in coming years. This analysis is supported by our focus on completions – not sales.

At an investor conference in Shenzhen last year a large listed Chinese property developer, China Vanke, mentioned their outlook for new property completions in 2017 is 15-20% higher than 2016. This comment may point to a significant piece of the future activity puzzle: property investment, economic activity and the demand for commodities from physical property is driven by completions, not sales.

This is borne out in the following chart. It shows a number of different property statistics relative to the consumption of common building materials; steel, glass, cement, etc. The data seems to show that property completions, rather than starts and properties under-construction, are best correlated with the consumption of materials, though this correlation has changed over time. In turn, the correlation with materials consumption should drive economic activity correlations.

Chart 6: China property under construction
Index 100 = 1 Jan 1999, monthly, ending Dec 2016



Source: National Bureau of Statistics, China Iron and Steel Association, Customs General Administration, CEIC, CFSGAM.

The challenge is to determine the leading indicator for completions.

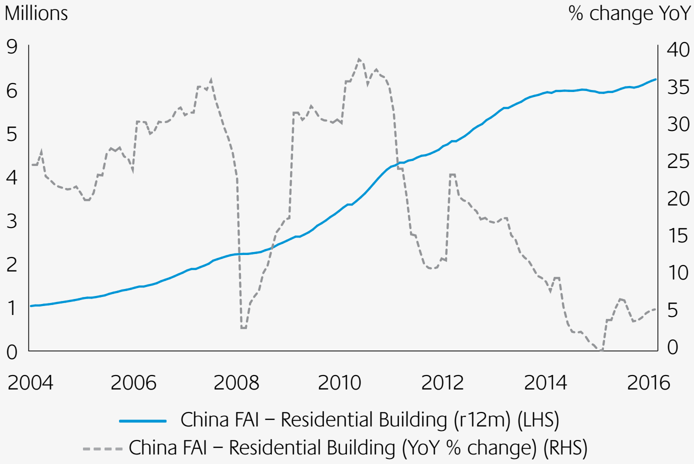
We currently believe the best statistic for leading completions is advanced sales. Advanced sales or pre-sales are allowed in China if the following criteria are fulfilled; a developer must have the rights to the land, it must have 25% of the project's funding in place, it must have sufficient architectural plans and a target end-date for the completion of construction. There may be further requirements at a city or provincial level. Generally, however, an advanced sale does not require building and so should lead completions or the majority of building activity in the absence of excess inventory.

The constraint on advanced sales as a driver of completions has, historically, been inventory.

From 2006 to 2014, completions of property in China have been higher than advanced sales. As a consequence, the ability of the market to absorb inventory has been as important in determining future completions as advanced sales. But from 2015, both existing and advanced sales have been well ahead of completions and are now, in the case of advanced sales, 20% higher. This increase in advanced sales should lead an increase in completions and, consequently, a further increase in economic activity. The decline in property inventory, likely, reflects a combination of an historic inventory overhang that has slowly receded and financing difficulties making building on spec unprofitable.

An analysis of other data supports the view that the scale of advanced sales is yet to show up in activity data. Property fixed asset investment growth, for instance, has only begun to accelerate in the last three months.

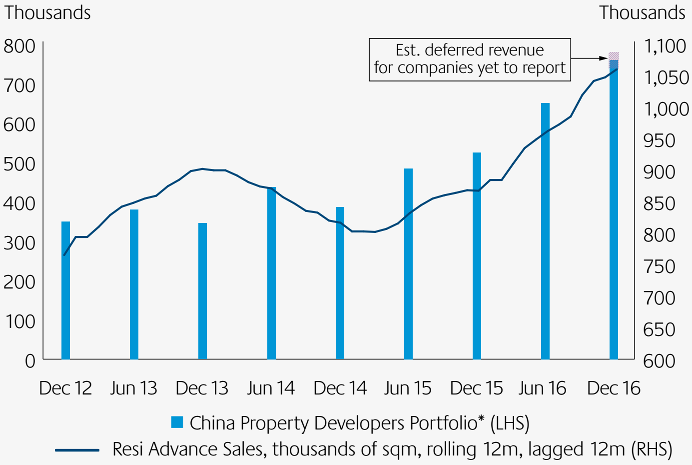
Chart 7: China FAI in Residential Building
RMB mn (rolling 12 months) vs. YoY % change Dec 2004-Dec 2016



Source: Sources: National Bureau of Statistics, CFSGAM.

China property developers show a similar story. Pre-sales emerge as deferred revenue on the liability side of a property developer's balance sheet. (The developer takes a down-payment in return for the promise of a built apartment in the future. The promise becomes the liability). Analysis of major Chinese property developers' balance sheets (accounting for approximately 15% of the market) highlight growing pre-sales. Chart 8 shows deferred revenues rising 50% from December 2015. This data matches the advanced sales data provided above and again indicates the requirement for future building activity to meet liabilities.

Chart 8: China Property Developers
Short Term Deferred Revenues, RMB m, Dec 2012-Dec 2016



* Companies include: China Evergrande, COLI, China Resources Land, China Vanke, CIFI Holdings, Guangzhou R&F, Logan, Longfor, Yuzhou.

Source: National Bureau of Statistics, Bloomberg, CEIC, CFSGAM, various companies.

As liabilities, the developers are obliged to make good the apartment pre-sold. It's unclear, however, how rapidly this must occur. It's likely that developers take their time. This would help them provide smoother earnings for investors and enable them to manage their financing requirements.

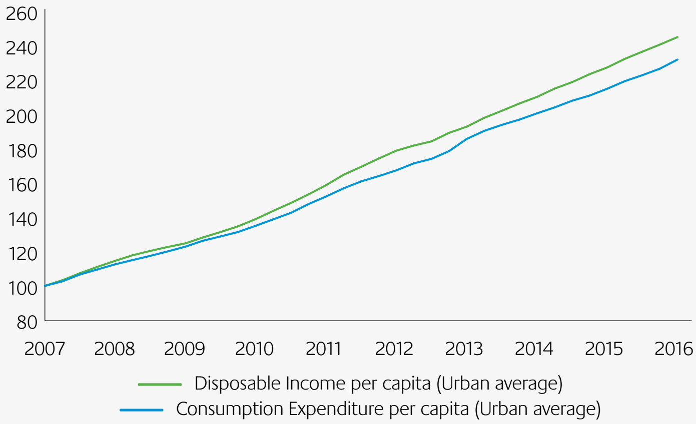
Again, China Vanke highlights the issue well. In 2016, Vanke reported a 24% increase in revenue, a deceleration from the 2011 to 2015 average of 27%. Yet in contrast, it also reported a 39.5% rise in sales attributable to itself and its Joint Venture partners in 2016 from 2015. This is an acceleration from the 21% CAGR of the last four years. It also reported a deferred revenue increase of 29% compared to a CAGR of 14% from 2011. Simply, Vanke has accelerated its pre-selling, but will not book revenue until the product is physically booked (using the steel and cement). The pace of completions will be steady, Vanke is predicting just an 18% increase in completions in 2017, in order to smooth revenue recognition by staggering the building process. Given the increase in sales, this staggered approach probably requires a three year acceleration in building completions.

The Chinese Consumer

The Chinese consumer has been the most stable part of the economy since 2012. This stability reflects a number of key points; sustainable wage growth, low inflation and continued improvement of household balance sheets through property price appreciation.

The combination of wage growth and low inflation has led to a very positive outcome for Chinese urban households. Disposable income by household has risen at an annual rate of 13.6% from 2007 and slowed in the last three years to a rate of 8.3%. While consumption, too, has maintained a solid annual growth rate of 12.7% since 2007, it continues to lag behind income growth. Indeed, the average urban household in China saves approximately 30% of disposable income and the median household about 15%.

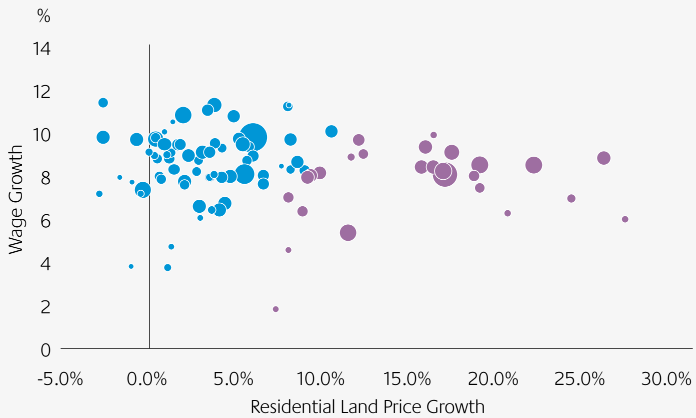
Chart 9: Consumption Expenditure and Disposable income per capita
Index, Dec 2007 = 100, Dec 2007-Dec 2016



Source: National Bureau of Statistics, CEIC, CFSGAM.

Similarly, though property price appreciation has been steep in the past year, over the last five years it is still, broadly, in line with wage appreciation. Data for the last five years, shows property prices in a majority of Chinese cities on a population weighted basis have risen at a slower rate than wages. This is seen in Chart 10. Blue bubbles represent those cities with wages growth that is faster than residential land price growth in the same period.

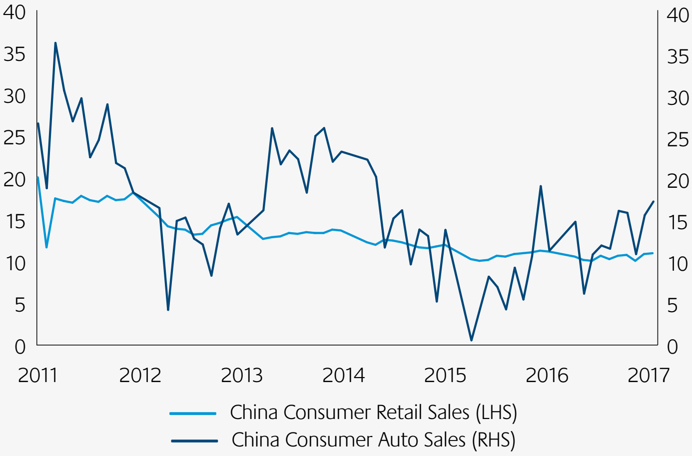
Chart 10: China Wage Growth v Residential Land Price Growth
5 Year CAGRs, 2011 - 2016, bubble size ≈ population size



Source: Sources: National Statistics Bureau, CEIC, CFSGAM.

This positive back-drop for Chinese households argues for continued stability in consumption growth and its contribution to the economy. Retail sales and car sales are likely to remain relatively positive through the next three years. We also expect a continued improvement in luxury goods sales as high income households benefit from a stronger economy.

Chart 11: Chinese Consumer Spending – Retail Sales & Auto Sales
% change YoY, Jan 2011-Dec 2016



Source: National Bureau of Statistics, CEIC, CFSGAM.

Conclusion

China's economic activity is well supported through 2018 by a back-log of construction activity associated with both infrastructure and property. This back-log is reflected both in the number of projects commenced and as assets on the balance sheets of listed companies.

We also think that all this activity is taking place against a backdrop that allows for a more sustainable, less frenetic period of economic activity growth in China. First, there has not been the same imperative to accelerate growth in 2016 as there was in 2008/09. China was not facing a catastrophic decline in economic activity as was the case previously. Second, China has also done some important work in creating a better institutional framework for growth. This includes a better understanding of the risks within the banking sector, particularly wealth management, and greater focus on corruption.

Risks

There are risks to this outlook; most of which are broadly understood by the market. China's levels of debt, focus on investment growth and reliance on global trade are oft cited examples of China risk. More specific to our case, financing can disappear, particularly when both property and infrastructure products are sold forward. It's also the case that the market is concerned that stronger activity is simply in anticipation of China's leadership transition, scheduled for November. The argument goes, that the Chinese leadership has engineered a growth recovery to enable a stable power transition but that beyond November the ability to support the economy is considerably lower.

Investment Strategy

Our outlook for the economy is based on a view that stable growth at current levels is likely to continue. Projects have been started and apartments have been sold; it's now the time for these to be delivered. Based on the experience of 2009-2012, the delivery of projects takes time. Furthermore, China is unlikely to want to repeat the mistakes of that period. It's likely, therefore, that project and apartment delivery is more sober than in the previous period. This provides some valuable, long-dated investment opportunities.

This Great Transition research highlights three specific investment opportunities for a medium-term Chinese recovery; property, banks and mining companies.

China Property Developers

Developers are key beneficiaries of this stored economic activity. Their pre-sales in 2016, and early 2017 (that are stronger than expected given house price restrictions) effectively deliver steady double digit earnings growth in the next three years. Other earnings benefits will come from lower financing costs (averaging finance costs are 5.6% and have fallen considerably since 2014) and consolidation in the industry to the benefit of the large listed developers.

The risks to the position are a substantial medium-term decline in the demand for residential property (short-term declines are less worrying given current pre-sales) and higher future land costs. The ability of developers to access land, in the long-term, at viable prices that maintain current margins around 20-30%, may be problematic. Chinese land continues to rise in price and much of the key land is already developed.

Chart 12: China Prop. Developer Valuations – Price to Book
12 Company index (harmonic mean), Cap Weighted, Daily rebal, Apr 2012-Apr 2017

Source: Bloomberg, CFSGAM.

Constituents: Aoyuan, China Evergrande, China Overseas Land, China Resources Land, Vanke, CIFI, Guangzhou R+F, KWG, Logan, Longfor, Times Property, Yuzhou.

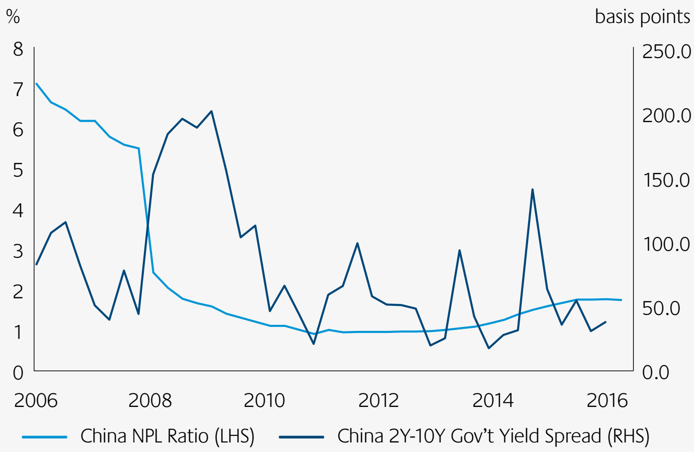
As a consequence, the risk-reward is skewed towards the next two years. We are happy to own the property developers at current valuations.

China Banks

China banks are substantial beneficiaries of this cyclical up-turn, particularly if, as expected, growth can be sustained over the next three years and it is managed better than in 2010-2013. Already, we are observing some important drivers of earnings improvement for the Chinese banks. These include, a steepening yield curve, rising loan growth and an improvement in the profitability of key clients. Further, with 70% of the asset book collateralised or associated with land, the improvement in land prices is contributing towards a substantial improvement in credit quality. Finally, we think there's a chance China is developing stronger equity markets. An improvement in equity issuance will drive improved balance sheets for debt investors. Key statistics to watch are seen in Chart 13.

Chart 13: Risk indicators – China Non Performing Loan Ratios and 2-10Y yield spreads

%, bps, quarterly data, Dec 2006-Dec 2016



Source: China Banking Regulatory Commission, Bloomberg, CFSGAM.

The risks to this view are perceived as substantial by the market. The market views credit quality in China as very problematic and sees the economic recovery as being limited in nature. We would argue these risks are close to being priced-in given current discounts to book value. We would regard more aggressive regulatory changes as being the bigger risks to this position.

As a consequence, the risk-reward to China banks is skewed towards the long-term. Policy-makers are supporting economic activity, land prices support collateral values and there's still substantial demand for credit. Again, valuations support ownership.

Chart 14: China Bank Valuations – Price to Book

4 Bank Index (harmonic mean), Cap Weighted, Daily rebal, Apr 2012-Apr 2017

Sources: Bloomberg, CFSGAM.

Constituents: Agricultural Bank of China, BOCOM, CCB, ICBC.

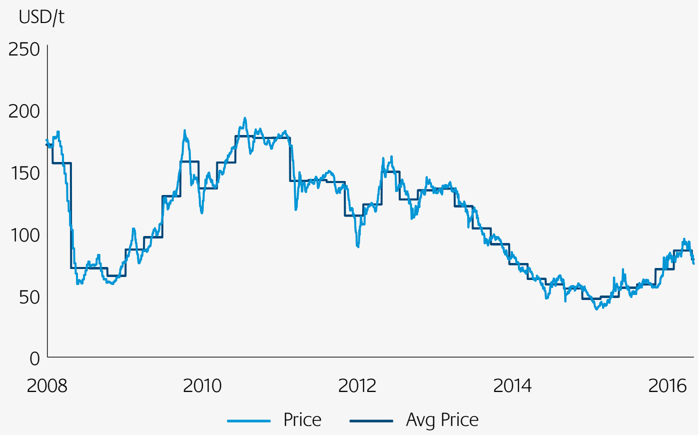
Miners

Mining companies are our final China related position. The miners, clearly, will benefit from stronger than expected property and infrastructure sector activity. Already, the market has been surprised by the strength of commodity prices in the last twelve months. We expect that in the next twelve months prices will continue to be relatively positive.

There are risks. Recent volatility has added a substantial cost to holding these assets. But in the absence of evidence discounting the likelihood of stable growth, the position looks to offer positive risk-reward. Indeed, if the market can absorb the increased capacity in iron ore in the coming months, a lack of future supply growth coupled with stronger than expected demand should result in a sustained environment of higher prices.

Chart 15: Iron ore price history

USD/metric tonne, weekly data from 2 Jun 08 to 10 Apr 17



Source: Bloomberg.

Greater confidence in the sustainability of the Chinese economic cycle will support higher valuations for mining companies and a better long-term outlook for commodity prices. While valuing highly cyclical businesses is difficult we would make a couple of comments. First, we don't believe a more sustained recovery is currently priced-in to these assets. Second, we believe discipline on the supply-side by large miners is likely to mean that higher than expected demand leads to greater operating leverage in 2018 and, perhaps, 2019 for these companies. Coupled with the prospect of further capital returns to shareholders, the sector looks attractive.

Other Opportunities

There are other potential opportunties we are keeping our eyes on where a round of profit-taking may offer alternatives to the positions outlined above. In particular, luxury goods makers, car makers and capital goods providers would offer positive risk-reward outcomes at lower prices.

Conclusion

China's economic cycle appears to be on the up. Monetary policy in 2015 and 2016 primed the pump and now the economy is in the early stages of delivering a substantial construction cycle. This is highlighted in statistics showing planned infrastructure projects and the pre-sales of apartments. In turn, this will support economic activity in China and, probably, globally for the next two to three years.