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China's prospects in the coming economic slowdown
What is Brazil's stake?

Lawrence Brainard

20 September 2011

Outlook for H2/2011

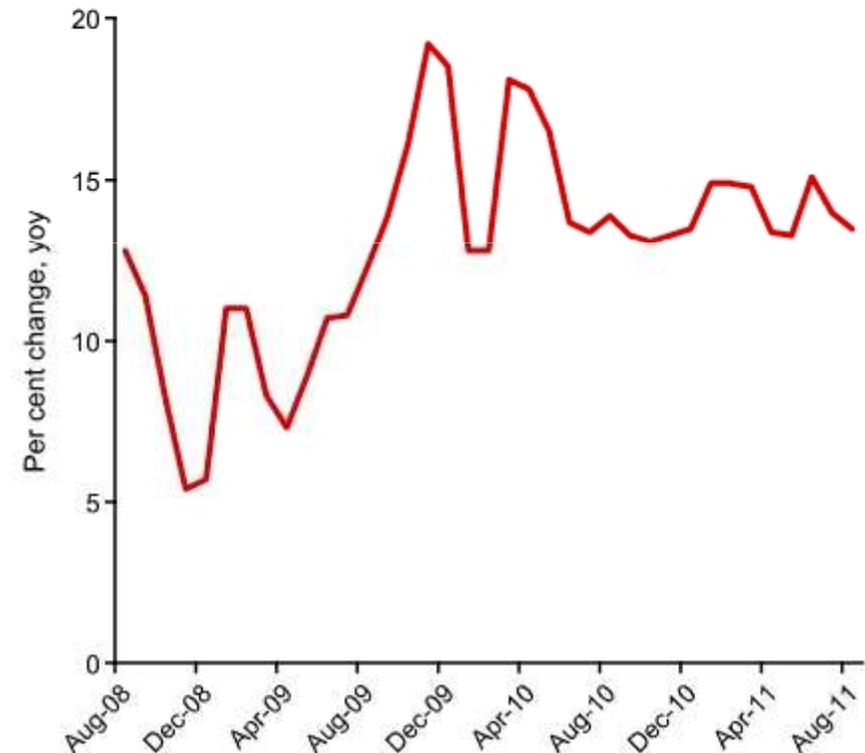
No signs of a slowdown yet ...

Q3/Q4 GDP growth will remain robust at 9-9.5% as the domestic inventory cycle ends and restocking resumes.

... but the global economic slowdown will hit next year

A managed Greek default and ad hoc bank recapitalizations in the Eurozone will destabilize markets and force Chinese policy adjustments as we move into 2012.

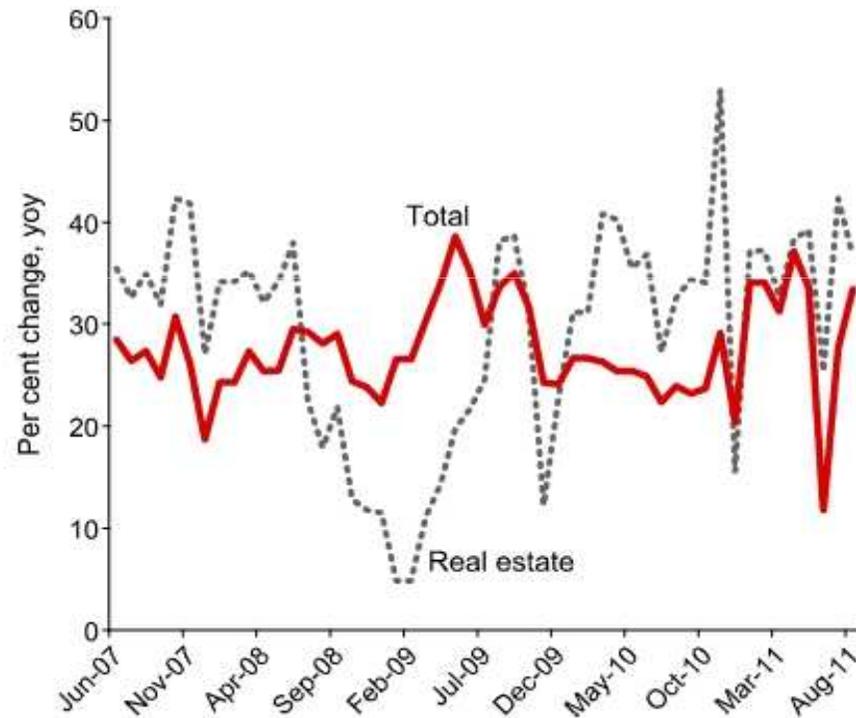
Growth rate of industrial production



Source: Bloomberg.

Real estate continues to lead overall fixed asset investment

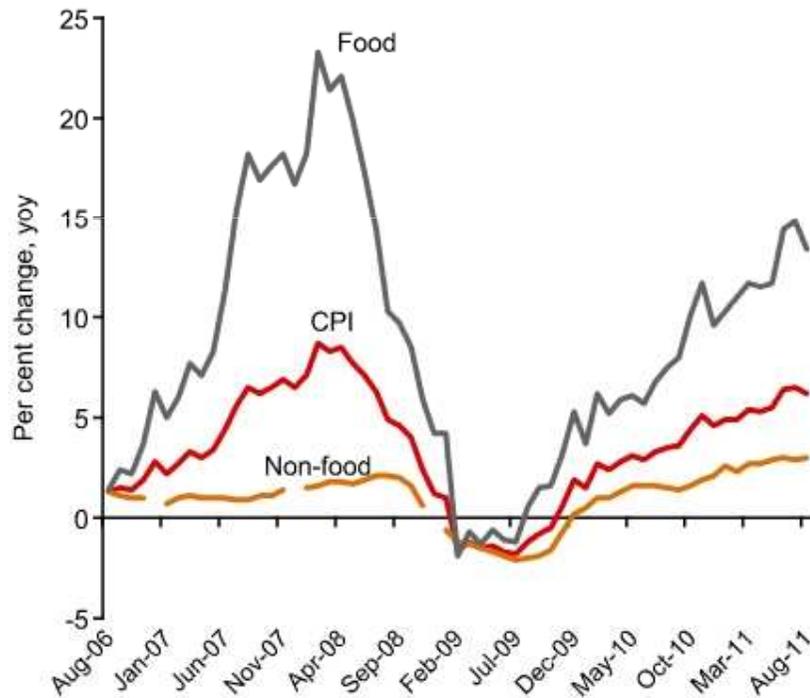
Growth rate of total FAI and real estate FAI



Source: CEIC.

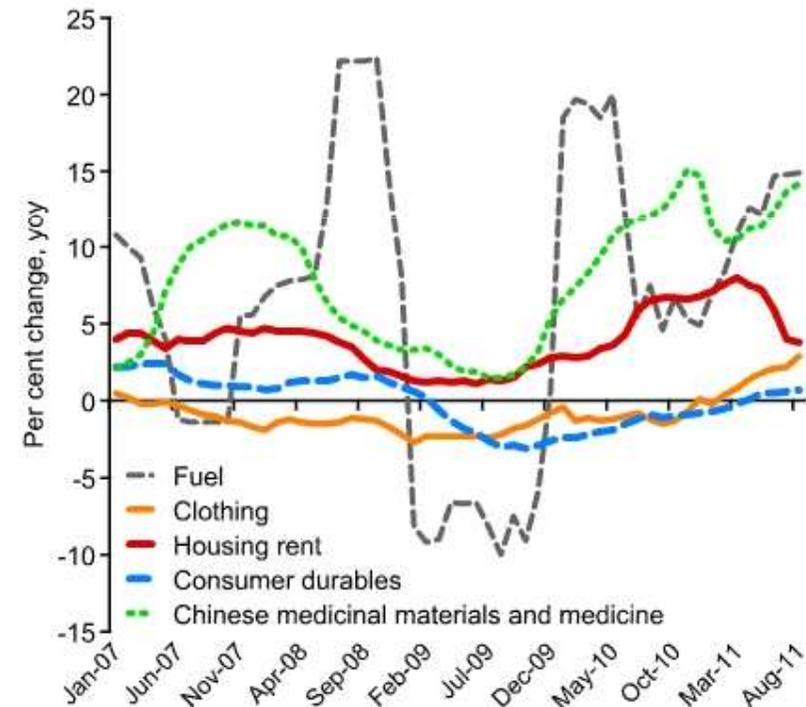
Inflation will decline over next 6 months to 4.5-5% but remain at or above these levels in 2012 due renewed food price pressures

CPI, CPI-food and CPI-non-food



Source: CEIC.

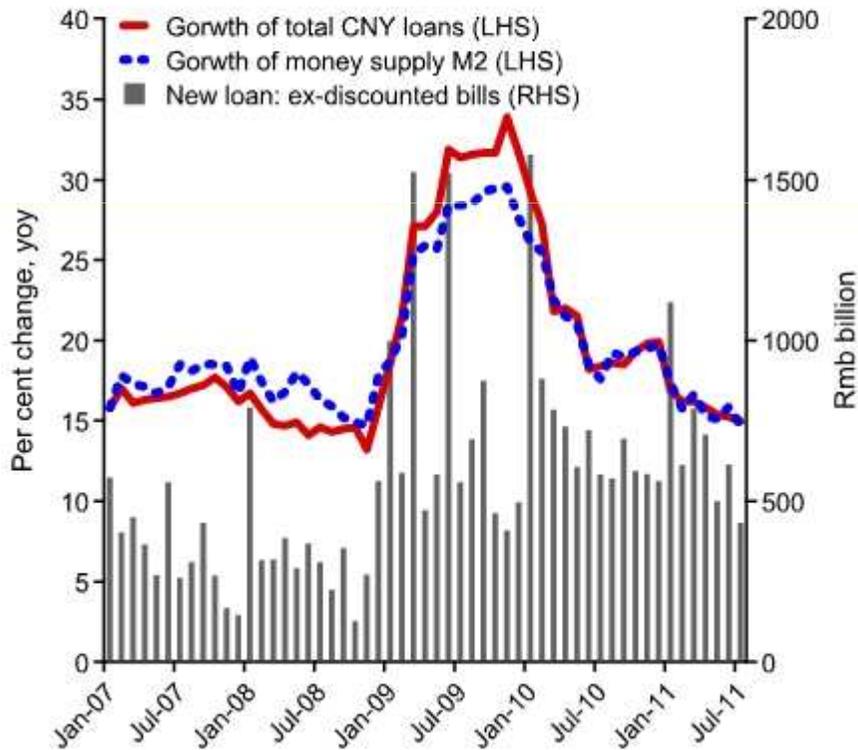
CPI breakdown



Source: Bloomberg.

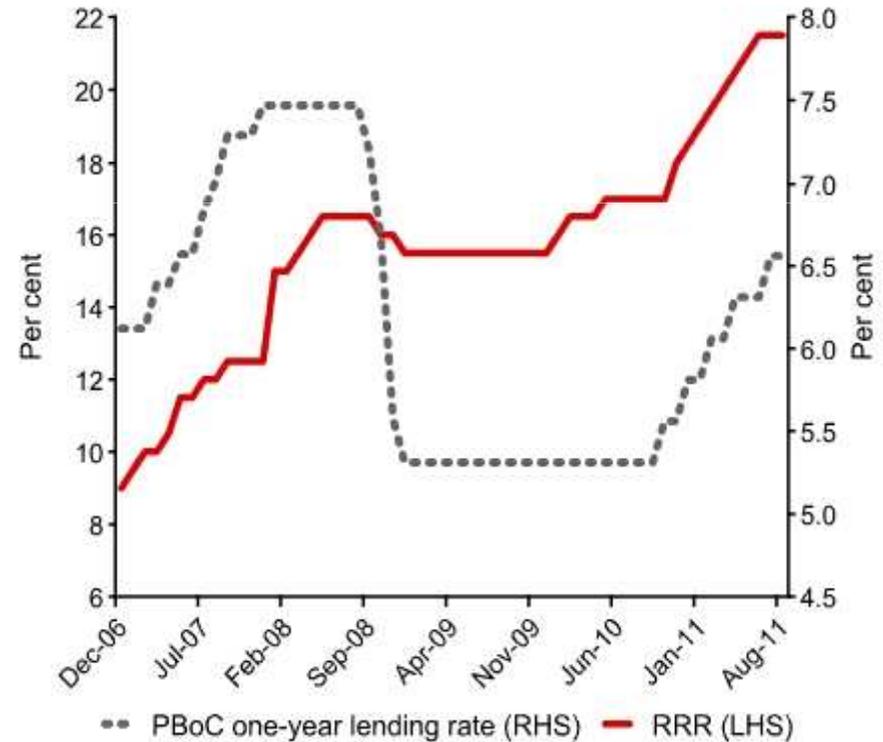
Monetary policy will remain largely unchanged in the coming months despite rising concerns about a global slowdown

New loans vs growth rate of M2 and total Rmb loans



Source: Bloomberg.

One year lending rate and RRR



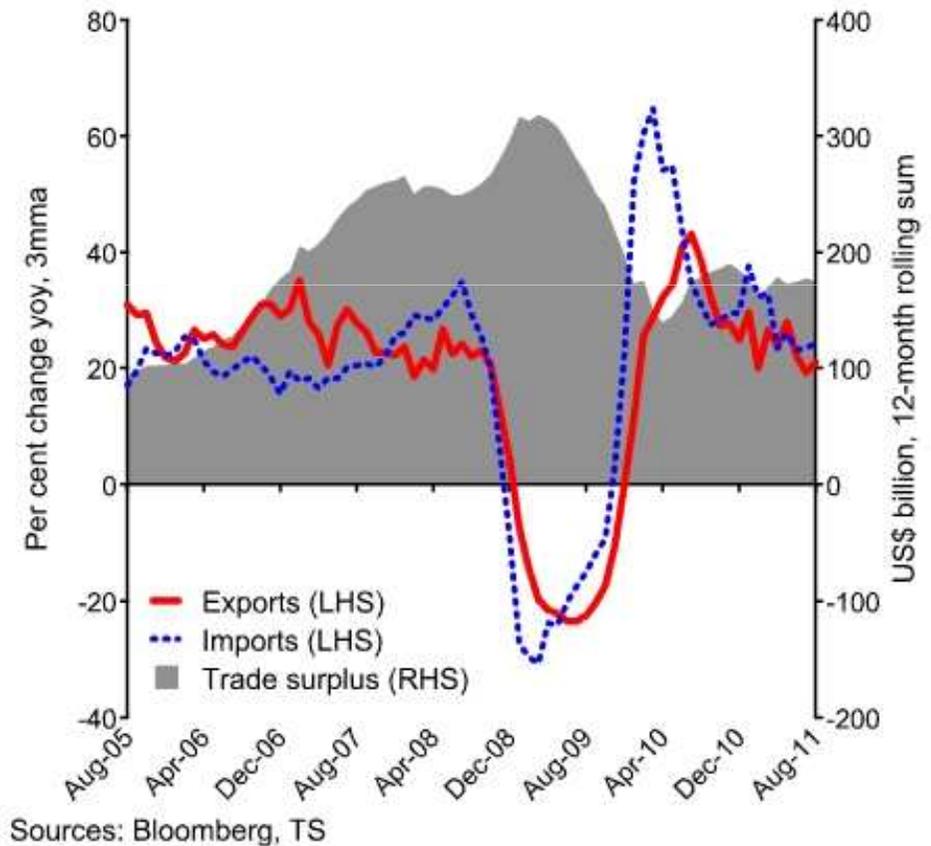
Source: Bloomberg.

Trade – the double dip fear

Economic slowdown can be managed, but double-dip recession will cause pain

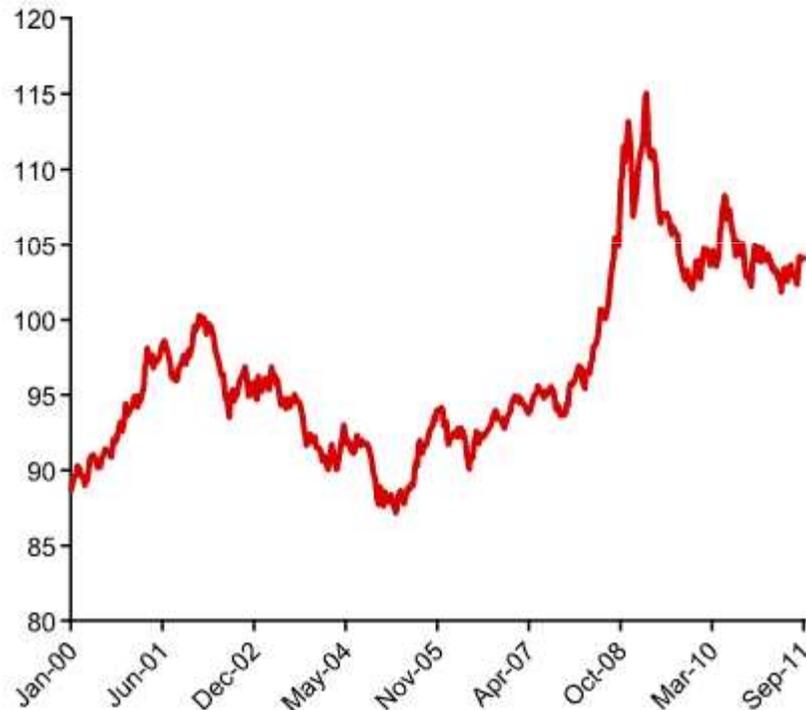
- Exports will continue strong in the near term before weakening next year to 5-10% growth. China still maintains a competitive export price advantage in many top export lines.
- FX policy will remain unchanged with 3.5-4.5% annual Rmb appreciation vs US\$.

Import and export growth and trade balance



Exchange rate – no change in slow appreciation vs US\$

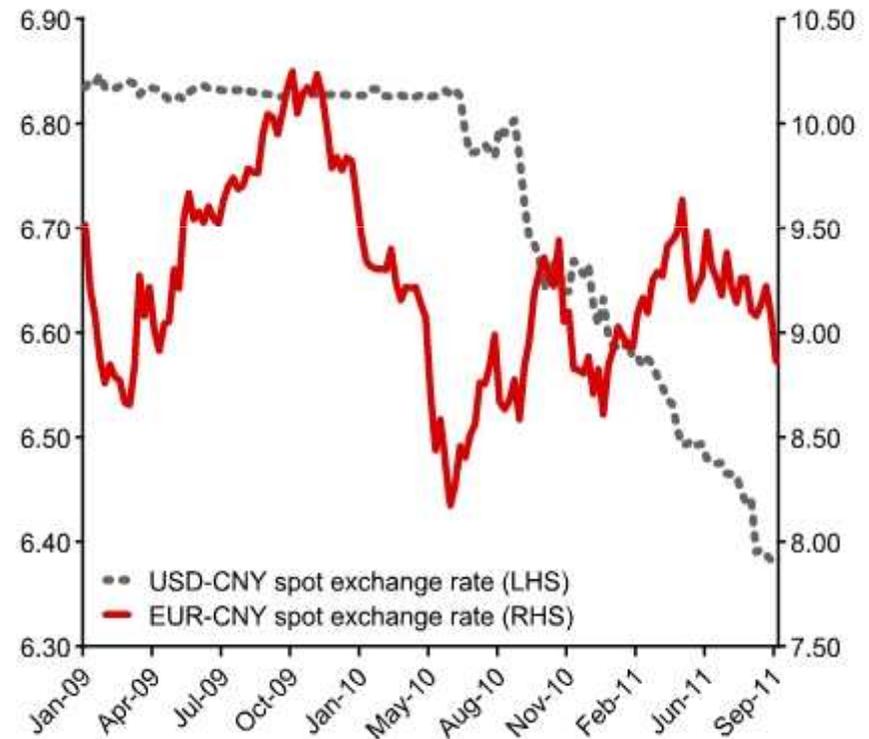
RMB: Nominal effective rate



Note: Against trade-weighted average.

Source: Bloomberg.

USD/CNY vs EUR/CNY



Source: Bloomberg.

A crash in property prices is unlikely during 2011-12

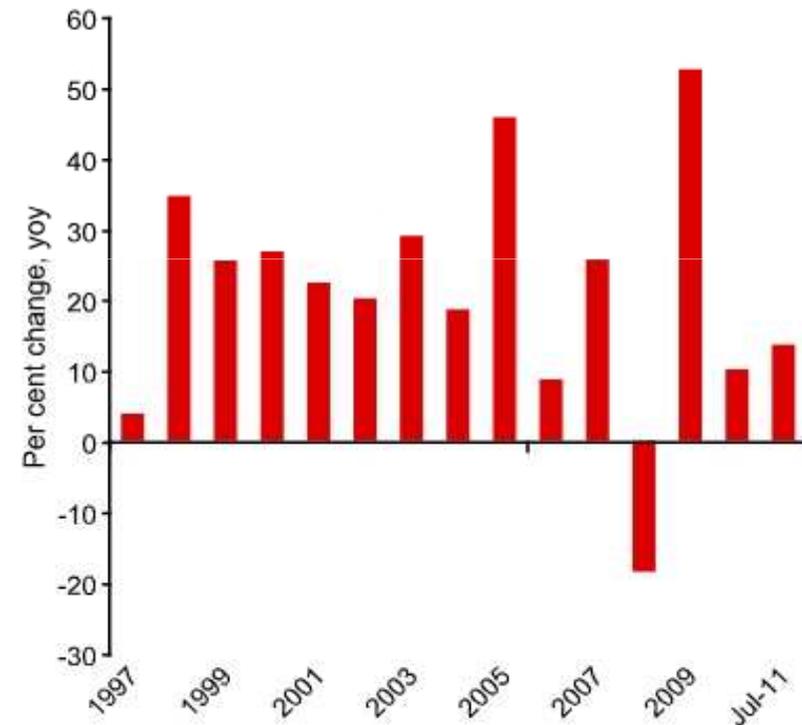
The government is fine tuning policies to limit property price inflation ...

- In the run-up to the leadership transition in late 2012 and early 2013 every effort will be made to keep prices relatively stable, e.g. $\pm 5-10\%$.
- A much-publicized social housing program will fail to meet its target of constructing 10 million new units this year; the government will claim success by focusing on starts rather than completions.

... but a large-scale correction is possible in 5-7 years as demographic changes temper housing demand

- After 2015 the pace of new family formation will likely slowdown and the inheritance of apartment flats from an increasingly elderly population will rise steadily.

Floor space sold 1999 – July 2011



Source: CEIC.

China's banking sector can weather rising NPLs

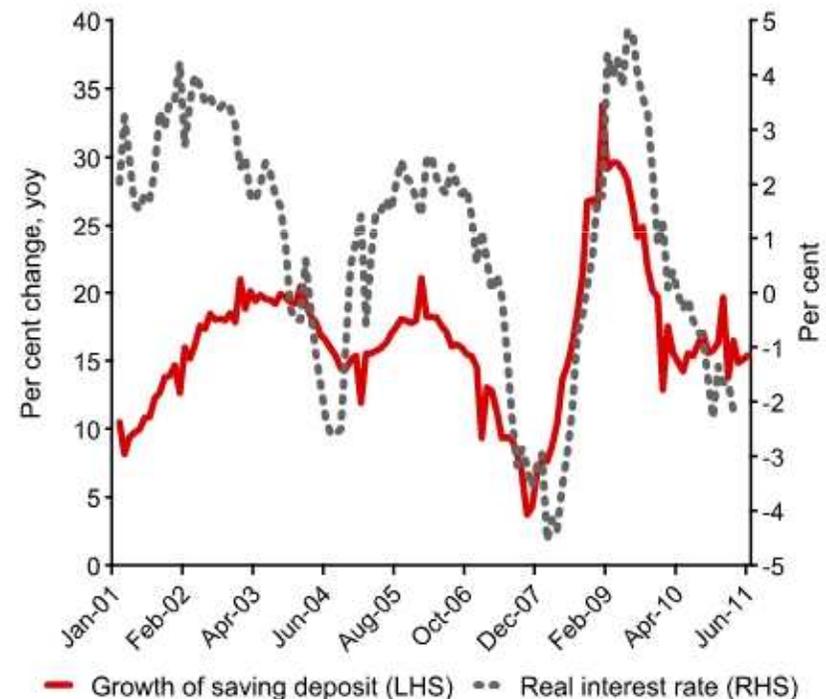
The top banks produced record profits last quarter

- Strong earnings are being used to bolster the banks' capital and reserves; additional borrowings will target Hong Kong's offshore Rmb market.
- We expect significant write-offs of loans to local government financial platforms spread over the next 3-5 years. Bank reserves will be adequate to cover these write-offs without government bail-outs.

China's shadow banking sector will continue growing rapidly but we do not expect this will threaten price and financial stability

- There are both "good" and "bad" shadow banking activities.
- The authorities will crack down on the bad ones – such as off-balance sheet lending and commodity speculation securitized loans – while tolerating the expansion of good ones such as wealth management products.

Saving deposits growth vs real interest rate

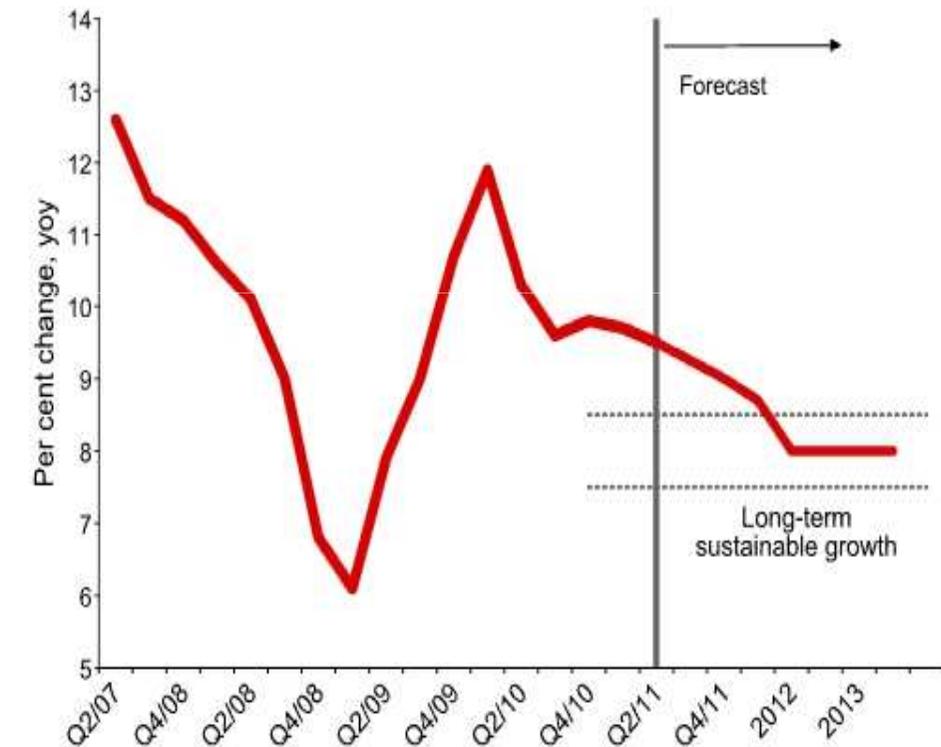


Source: CEIC.

Outlook for 2012 and beyond

- Sustaining growth is a high priority for the leadership during the political transition next year. Policymakers will do everything to avoid a hard landing.
- Nonetheless, growth will moderate next year to 8-8.5% due to slower growth in exports and property starts.
- The authorities will react to the inevitable weakening of export demand with targeted subsidies for consumption, not another push of infrastructure spending.
- China's "going-up-the-value-chain" strategy for the 2011-15 5-year Plan could backfire due to overly rapid expansion in high-tech sectors as happened with high-speed trains.

GDP growth slowing



Sources: Bloomberg, TS Research.

China faces a difficult economic transition over the medium term

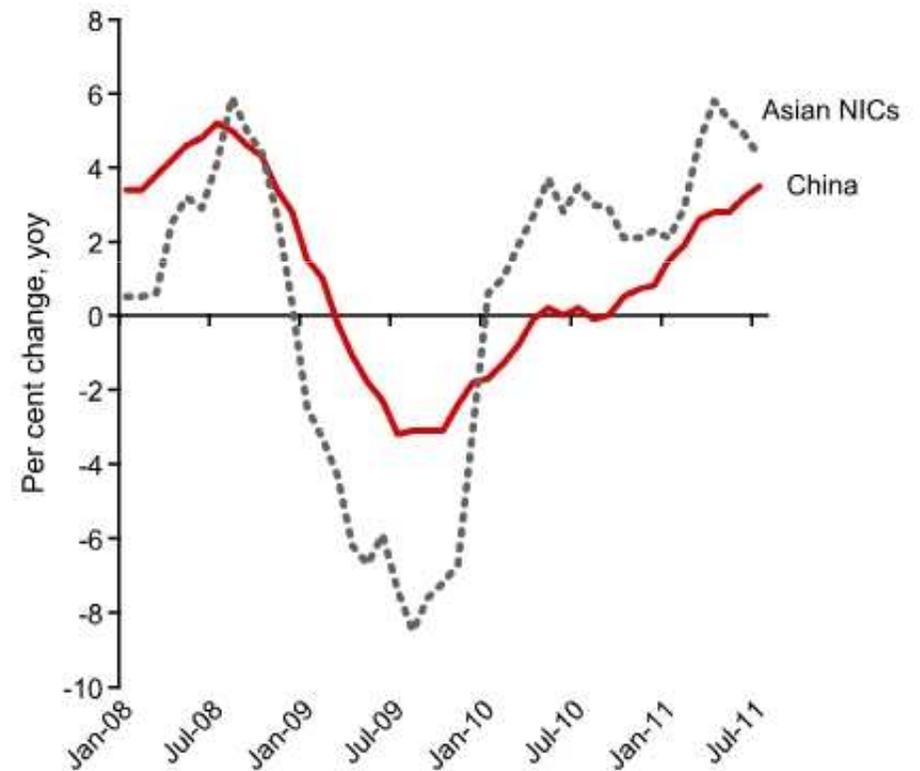
China's economic model is facing diminishing returns

- Failure to implement essential reforms of the land and labour markets will become binding constraints on growth and fuel inflation.
- The top leadership's reluctance to shift the distribution of national income toward personal incomes and away from capital will slow the emergence of consumption growth drivers and perpetuate wide-spread investment inefficiencies.

China's biggest vulnerability is its growing inability to feed itself

- Policies to sustain rapid increases in basic wages of over 20%/year will fuel strong demand for improved diets, especially consumption of pork and dairy products.
- Official policy will focus on expanding modern farming operations with growing dependence on imported feedstuffs (corn, soybeans), not pork or milk.

US import prices: China vs Asian NICs

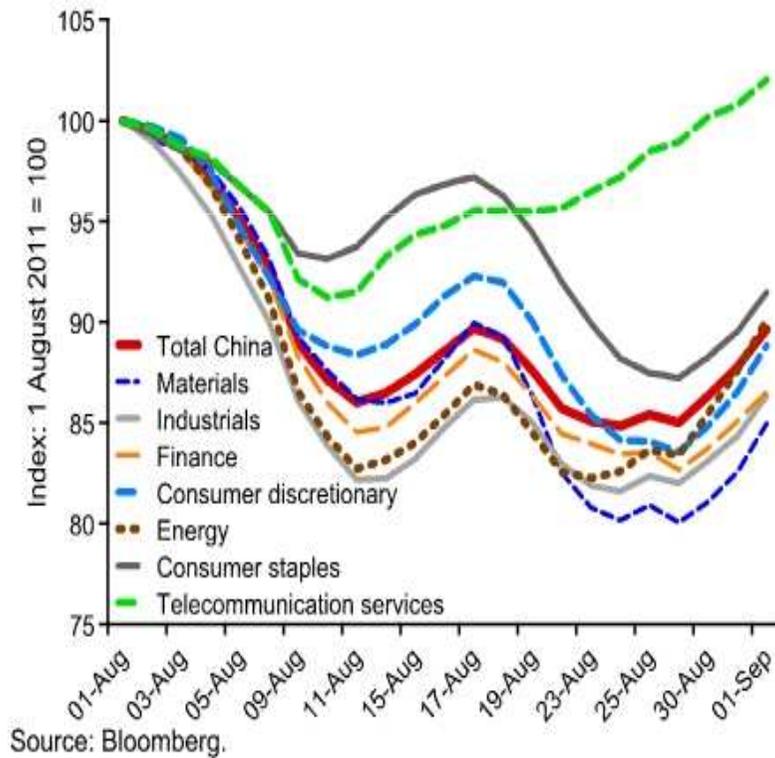


Source: U.S. Bureau of Labor Statistics.

Our outlook is moderately positive for equities over next 3-6 months vs other EM markets

September *Sector calls*

Equity markets: Relative preferences



	Local index weights	Last time	Next 3-6 months	Change
Financials	34.6%	0	0	0
Energy	18.3%	+1	+1	0
Telecommunication services	11.1%			
Industrials	7.6%	0	0	0
Basic materials	6.7%	+1	+1	0
Information technology	6.1%			
Consumer discretionary	5.9%	0	0	0

The men in charge – now.....



...and in 2012-13



Xi Jinping



Li Keqiang



Bo Xilai



Wang Qishan



Li Yuanchao



Yu Zhengsheng



Wang Yang