China's Growth to Slow in 2015

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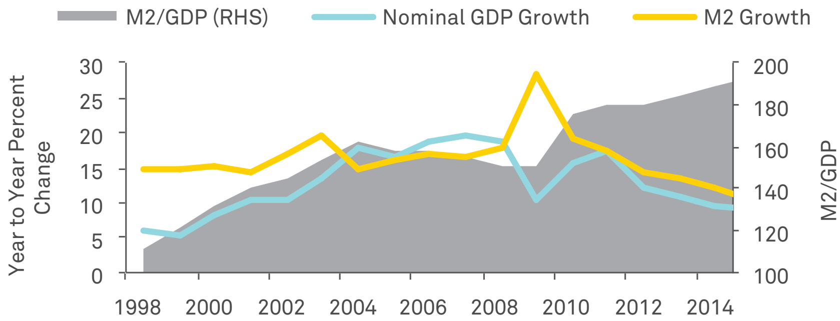
EXECUTIVE SUMMARY

We expect some further moderation in Chinese economic growth in 2015 as policymakers try to gradually address the build-up of leverage and excess capacity. Several critical reforms will be expedited in the coming year, but their impact on near-term growth will be neutral at best and could raise the need for further countercyclical policy support. We expect further monetary and fiscal policy easing and, we are looking to take tactical advantage of the cyclical boost to credit fundamentals of listed Chinese corporate issuers. However, we doubt if the size and nature of this stimulus will be sufficient to provide much of a boost to commodity prices or global demand.

CHINESE GROWTH TO SLOW AS STRUCTURAL PRESSURES DOMINATE

We are anticipating a further moderation of China's GDP growth in 2015 amid excess financial leverage and overcapacity. The build-up of leverage is particularly evident in the rate of money and credit growth which, despite a recent slowdown, has continued to outpace nominal GDP (Figure 1). We estimate that including the shadow banking system, which takes into account the debts incurred by local governments but not the central government, would push up total financial leverage to around 220% of GDP. The most worrying measure of overcapacity is in the real-estate sector where the inventory overhang of unsold properties in tier 2 and tier 3 cities hovers around 15 to 18 months of sales.

Figure 1: M2 Growth Remains Higher Than Nominal GDP Growth



Source: CEIC and Standish as of December 2014

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The ongoing slump in the property sector and slowing industrial production will be the main drags on growth next year. Oversupply and unsteady demand are the key reasons for the property sector's weakness and will likely spill over into the manufacturing sector. Policies aimed at supporting the property market—such as lower down payment requirements for first-time home buyers and reduced property taxes—may help stabilize the market, but they are unlikely to reverse the weakness. A stronger government-led push on infrastructure investment should limit the industrial downturn, though it is unlikely to provide significant stimulus. This is because ongoing fiscal reforms alongside the property market slump will constrain the extent to which land sales and local government balance sheets can be used to boost infrastructure and pump-prime the economy.

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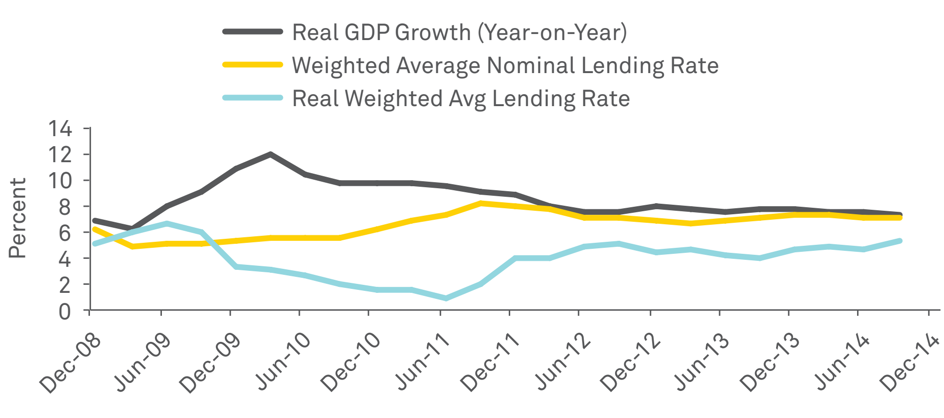
Households are unlikely to ride to the rescue since the shift away from investment and toward consumption has been slow. One reason for this is that low and rigid deposit rates have provided savers with paltry returns. Another is that social safety nets remain weak, forcing average Chinese to save more for healthcare and retirement. Fortunately, overall employment rates and wage growth have held steady and should limit downside risks to consumption. Moreover, lower inflation could provide a bit of a boost to near-term purchasing power. Nonetheless, consumption accounts for less than 40% of GDP and has failed to take-off meaningfully despite the authorities' longstanding rhetoric about rebalancing the economy.

Our baseline view is that gradual rebalancing alongside rising leverage will cause Chinese GDP growth to moderate to 6.7% next year from 7.3% in 2014. This is below the Bloomberg consensus forecast of 7% growth and reflects our view that nominal and real financing costs (figure 2) could remain on a steady-to-rising path even with the ongoing lowering of the repo rate and SHIBOR (Shanghai Interbank Offer Rate). Amid rising leverage, high credit costs will lower economic activity unless policy-driven reforms or counter-cyclical stimulus surprise on the upside and provide an offsetting boost. Unfortunately, we believe the prospects of such countervailing support are likely to come too late or prove insufficient.

Figure 2: Nominal & Real Financing Costs Rising Relative to GDP Growth



Source: CEIC, Bloomberg and Standish as of December 2014

THE INTENSIFICATION OF REFORM WILL BE GROWTH-NEUTRAL AT BEST

The rhetorical commitment to reform was evident after the Communist Party's Third Plenum at the end of 2013. However, the pace of implementation has lagged market expectations. The most prominent of these have been the effort to advance fiscal reforms and those to deepen market liquidity. The main fiscal reform has been to improve the alignment of the objectives and resources of the local governments. This has been buttressed by a risk-based approach to the management of local government finances, intended to reduce risky, off-balance-sheet activity. Market liquidity is likely to be enhanced by the connection between the Shanghai and Hong Kong stock markets and the establishment of free-trade zones, where capital account restrictions are being eased considerably.

We expect reforms to gather speed in 2015, following delays in several market and social reforms. The primary reason to expect reform intensification is President Xi Jinping's consolidation of his political power base, following a prolonged anti-corruption campaign and efforts to ward off potential threats from competing individuals and institutions. The clearest signal of reform intensification, in our view, comes from the recent introduction of deposit insurance within the financial system and further incremental liberalization of benchmark interest rates. A shift toward market-based pricing of credit-risk is probably the single-most important reform for rebalancing away from investment. If implemented smoothly, this reform will undoubtedly have long-term economic benefits.

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Yet, in the short-term, we doubt if interest-rate reforms will do much for growth or to lower borrowing costs. If anything, less rigid interest rates and elevated credit risks could prompt onshore deposit shifts and place greater pressure on the funding positions of second- and lower-tier banks which cumulatively account for 40% of systemic assets. The absence of virtually any financial defaults within the current system of implicit guarantees makes it all the more difficult to accurately anticipate shifts in depositor behavior, and ultimately, funding conditions in the coming year.

Given the uncertainty about the impact of interest rate reforms on banks' funding or the real economy, the necessity of countercyclical policy easing is likely to be more keenly felt in 2015. Low inflation or further disinflation could aggravate the situation by putting upward pressure on real borrowing costs even as the People's Bank of China (PBoC) moves to lower benchmark rates.

We believe a reduction in the PBoC's reserve rate requirement (RRR) of around 25-50bps by mid-2015 is a clear possibility given a plausible weakening in the policy transmission mechanism. This would also be the most potent channel of support for ongoing macro adjustments amid unfolding reforms. Other forms of monetary easing could include additional measures to provide targeted and more long-term liquidity infusions.

We continue to anticipate a low risk of financial crisis even as the country enters a critical phase of multiple reforms.

Greater central government spending could also help, but it remains unclear to what extent such spending could be kicked into a higher-gear. This is because local government finances will continue to undergo structural adjustments and the delineation of provincial versus central government fiscal responsibilities has yet to be finalized.

We also doubt if exchange rate policy will be altered much to bolster headline GDP growth. Sturdier US growth amid easing domestic demand has already lifted net exports and widened trade surpluses. Indeed, China's growth slowdown has nothing to do with external conditions and is driven almost entirely by domestic factors. In this context, engineering even a modest depreciation of the renminbi would merely weigh on demand elsewhere and come as a setback to the domestic objective of rebalancing the economy away from exports and investment. Moreover, there is the risk that unanticipated depreciation could raise onshore hedging demand and fuel larger capital outflows, which would hurt liquidity and monetary management.

COUNTER-CYCLICAL POLICY TO PROVIDE BOOST

Market sentiment will likely benefit from any monetary policy easing (RRR cuts), which accompanies unfolding reforms. China's expanding global footprint also implies positive spillovers from monetary easing and we would expect financial conditions to be less stringent for major issuers in international capital markets. The share of Chinese issuance in such indices as J.P. Morgan's Asia Credit Index and EMBI Global has increased so we would look to take tactical advantage of the cyclical boost to credit fundamentals of listed Chinese corporates due to prospective monetary easing, while remaining cautious on the high-yield sector.

Counter-cyclical policy easing should also preclude a sharper downturn in China, lessening the risk of financial or social instability that could derail the political appetite for future reforms. A well-managed and gradual growth slowdown is healthy insofar as it fosters macroeconomic rebalancing and deleveraging even if the headline rate of growth undershoots the authorities' 2015 growth target which is likely to be lowered to 7%.

At our projected 6.7% growth rate next year, China's economy should continue to generate around 10 million jobs to keep unemployment stable at around 4-5%. As a result, we do not think that the major Chinese banks' profit margins or their loss absorption capabilities will come under undue stress from a credit standpoint. Furthermore, we would expect an easier liquidity stance to persist should the risk of onshore deposit shifts materialize.

Finally, we continue to anticipate a low risk of financial crisis even as the country enters a critical phase of multiple reforms in 2015. This is because policy and financial buffers are bolstered by the country's high domestic savings, a net foreign creditor position, a largely closed capital account, continuing low leverage on the part of the central government, and widespread state-ownership of the banks and major enterprises.

THE IMPACT OF CHINA'S GROWTH SLOWDOWN

The incremental increase in China's nominal GDP, estimated at around US$900 billion for 2015, is still significant. Indeed, it is equivalent to the size of the entire Indonesian economy (figure 3) assuming a stable nominal exchange rate. However, this contribution is less than in recent years when the nominal size of the incremental contribution from China had exceeded US $1 trillion.

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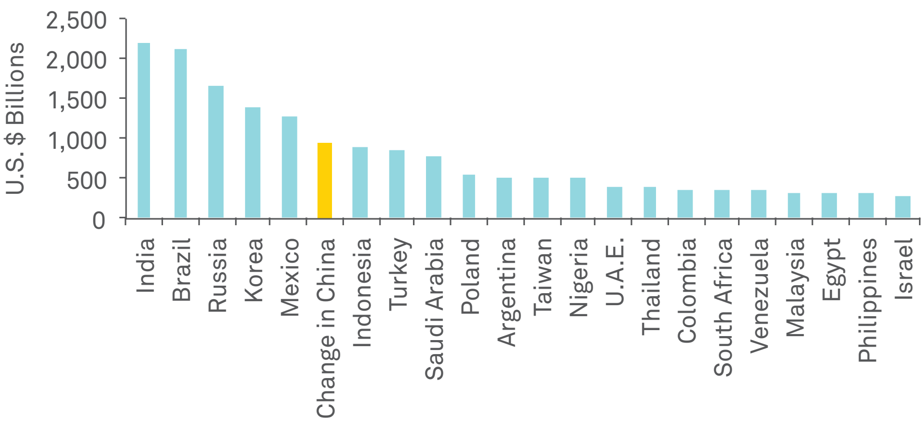
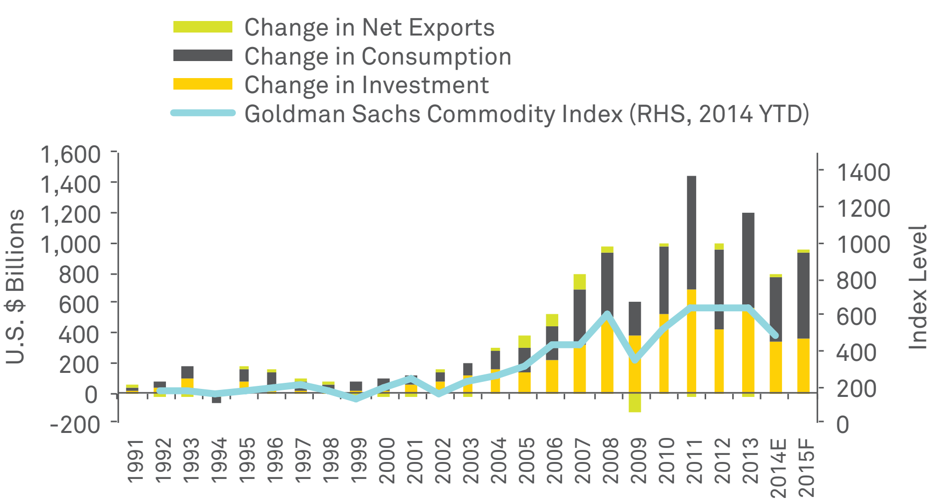
Figure 3: Estimated Emerging Market GDP Size in 2015 versus Incremental Chinese GDP Growth



Source: IMF, Moody's and Standish as of December 2014.

The waning proportion of investment demand in China will exacerbate the impact of the slowdown on the global economy (figure 4). For example, past trends highlight a tight correlation between the incremental contribution from China's investment and the percentage change in the broader Goldman Sach's Commodity Index. This suggests that as China's investment impetus wanes, the likelihood of any major demand-side pressure on global commodity prices is also likely to remain muted.

Figure 4: Chinese Consumers Playing A Larger Role



Source: CEIC, Bloomberg and Standish as of December 2014. F=forecast

The silver lining for regional and global growth is the steadier incremental contribution from Chinese consumption, which could provide greater opportunities for consumer goods exports to China. Yet, the projected positive contribution of net exports to GDP growth in 2015 suggests domestic demand in China is unlikely to be a key driver of global growth.

The bottom line is that China's "long landing" is largely policy-induced and will be managed more intensively in 2015 through a combination of speedier reforms and greater countercyclical support. This will raise glimmers of market optimism and enhance the political viability of further reform. However, it is unlikely to bolster commodity prices or provide a huge boost for regional or global demand. On the contrary, the global economy will by-and-large have to accommodate China's ongoing macroeconomic rebalancing and financial deleveraging effort.

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