

Goldman Sachs Asset Management

Fundamental Equity:

Outlook for China: *A View from Within*

0811



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Robust economic growth has been the driving force behind China's ascension to the world's second largest economy. China is now facing a slowdown in growth due to tighter monetary policies and weaker global demand. Investors are seeking to determine whether a "hard" or "soft" landing is in store for China's economy.

Alina Chiew, Chief Investment Officer of GSAM's Greater China Equity team, addresses this issue and offers her views on the outlook for China's economy.

What are your views on China's macroeconomic outlook?

We expect China's GDP growth in the 12th Five-Year Plan period to hover around 7-9%. This represents a deceleration from the double-digit growth that China experienced in most years over the last decade. We view this slowdown as a natural occurrence as China re-calibrates its economic structure and as the coastal region experiences more muted growth going forward. The slower growth also takes pressure off indiscriminate fixed asset investments (FAI) expansion, and instead allows China to focus on higher-quality growth via domestic consumption, higher-value industries and the development of the Hinterland regions in China. We believe this secular process was set in motion by various measures related to credit and property that were introduced since 2010 in an effort to normalise monetary conditions after the massive stimulus program in 2008 and 2009. In the short term, however, the growth deceleration may be aggravated by temporary disruptions such as severe weather conditions, seasonal power shortages, and inflationary pressures from commodity prices.

Do you foresee a "hard landing" or a "soft landing" for China's economy?

We expect China's economy to experience a "soft landing," which we would define as GDP growth of 7% and above. Despite the challenges we have noted, we believe there are factors in place to support China's continued growth. These factors include social housing programs, higher consumption due to increases in disposable income, and infrastructure development involving the development of Central and Western China and water, irrigation and high speed rail projects.

To sustain healthy economic growth, in our view, China should not "flip-flop" on its current policies. It should allow a mild natural adjustment by corporations and consumers to occur as China's economic expansion moves beyond the coastal areas and low-cost manufacturing and export-oriented industries and is increasingly driven by domestic consumption.

When do you expect the inflation rate to peak and at what level? What is your forecast of the Consumer Price Index (CPI) at the end of 2011?

We expect CPI to peak in mid-2011 at around 6-6.5%, then trend downwards. For 2011, we expect CPI to average 5-6%.

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Looking at the mortgage loan books, household credit and property developers' balance sheets, we believe China's leverage at various levels - government, banking system, corporate and household - is well within a manageable range.

Do you expect policy tightening to continue?

Monetary policies, in our view, will remain unchanged in the short term. On the one hand, we believe that the government will not tighten any further because it will not want to aggravate the short-term challenges faced by the economy. On the other hand, we believe China is unlikely to loosen monetary conditions, unless GDP, CPI, or both sharply collapse.

How will China's monetary policy be affected by the leadership change that will occur next year?

We do not believe that the change in leadership will have drastic implications for monetary policy. First, China's 12th Five-Year Plan period began in 2011 so the proposals under the current plan are likely to continue for several years. Second, some of the recent policies, such as more prudent banking regulations and property-related measures, appear to have taken into account structural considerations. This may signify that the influence of the impending leadership group is already becoming apparent.

How do you see China's equity markets and your investment strategy evolving based on your macroeconomic outlook?

In our view, both the China A- and H-share markets may continue to be plagued by short-term concerns until inflation shows signs of abating, and there is more clarity on earnings growth. At the same time, we believe the market will be sensitive to any real or perceived policy changes. The H-share market may look to the A-share market as a leading indicator of domestic sentiment. Valuations have moved to more attractive levels recently and our strategy is to look for stocks with better earnings visibility, driven by pricing power and cost efficiency, that trade at reasonable multiples.

What's your view on China's property market? If the property market bubble were to burst, how would this affect China's real economy?

In the past 12 months, we believe the tightening policies directed towards the property market were intended to achieve several objectives: to realign the economy as part of the secular process we have discussed, to prevent prolonged overheating arising from 2009's massive economic stimulus, and to help maintain social stability. Looking at the mortgage loan books, household credit and property developers' balance sheets, we believe China's leverage at various levels - government, banking system, corporate and household - is well within a manageable range.

That said, over the last decade, the rise of house prices has outstripped the growth of household income and general wealth. Hence, the issues that will demand longer-term solutions will require the creation of a more balanced level of home ownership across income segments, and an increased supply of a more diversified pool of residential housing. As a result, we believe social housing programs will feature prominently over the next few years. This means that the existing commercial housing industry and the developers are likely to experience more moderate price and volume movements than we have seen in the last decade.

A violent bursting of the property market bubble would have far-reaching negative implications for the economy. Property-related peripheral industries such as building materials, consumer, household goods and services, and bank credit quality would be particularly effected. At this point, the bursting of the China property bubble is not included in our base case scenario. Ironically, this round of proactive credit- and property-related measures designed to rein in over exuberance in the housing sector should help mitigate the risk that the property bubble will burst in an abrupt manner.

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