IMA ASIA

China Forecast Book
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CONFIDENTIAL

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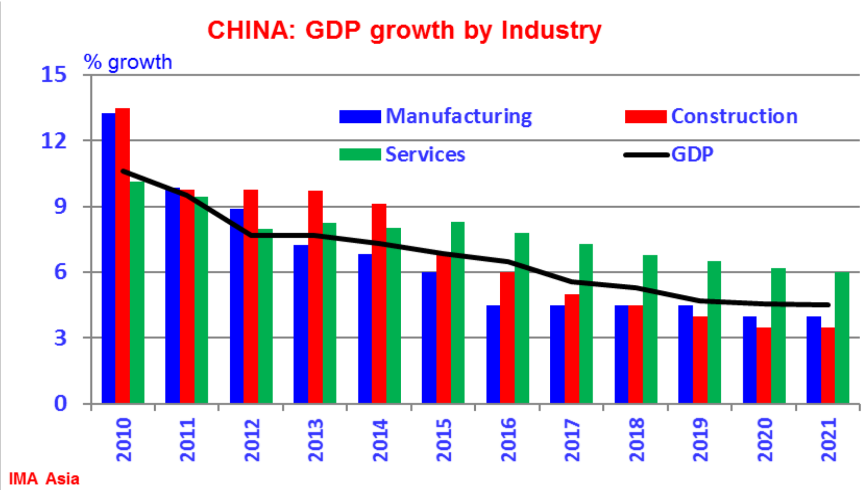
Summary: Slowing & Rebalancing



	2015	2016	2017	2018	2019
GDP, % real	6.9	6.5	5.6	5.3	4.7
- Consumer	7.2	6.9	6.0	5.5	5.0
- Fixed investment	6.0	6.0	5.0	4.5	4.0
- Manufacturing	6.0	4.5	4.5	4.5	4.5
- Construction	6.8	6.0	5.0	4.5	4.0
- Services	8.3	7.8	7.3	6.8	6.5
Export growth, %	-2.6	-3.1	4.3	6.0	10.0
Import growth, %	-14.4	-6.4	3.6	6.0	10.0
Inflation,%	1.4	2.0	1.8	1.8	1.6
Yuan to US$1, avg	6.23	6.58	6.78	6.64	6.51

After real growth of 10.2%pa for the 20 years to 2014, growth will halve to 5.3%pa for the 2015-20 period and drop to 4.5% by 2021. Our forecast is below the 6.5%pa assumed in China's 13th 5-year plan (2016-20).

The slowdown is abrupt, and has caused turmoil in global demand for commodities, such as iron ore and coal, as well as in many sectors related to the construction industry, both inside and outside China.

The abrupt nature of the slowdown reflects negative structural and cyclical factors coinciding. Foremost among the structural factors is a dramatic slow down in growth of the working age population. Of the cyclical factors, the biggest is a build up of excessive debt in the corporate sector alongside a collapse in return on investment.

There's little that can be done about the structural changes (moving to a two-child policy in urban areas has a minor impact). Of the cyclical factors, the key issues are the timing, scale, and nature of the next phase of the cycle, which involves deleveraging and capacity consolidation.

China's GDP numbers, with their smooth deceleration, are partly fiction. Yet in our accompanying table and chart, the rise in services as manufacturing and construction cool captures the rebalancing that is underway.

Key Themes

- Demographic headwinds
- Slower growth on a bigger base
- Rebalancing the economy
- A risky surge in corporate debt
- Beijing’s debt strategy
- Reducing excess industrial capacity
- A tighter employment market
- Slowing wage growth
- Keeping cheap cash flowing
- Deflating China’s investment bubble
- Over-investment varies by sector

Market Perceptions

What our clients tell us:

"The economy's geographical and sector-wise divergence is widening. Some of our traditional business lines face structural declines, but we keep a close watch on some fast-growing new sectors."

"More foreign enterprises are building R&D centres in China to tailor their products to fast changing consumer preferences. It's not as simple as a rise in consumer sophistication leading to greater demand for US or European products."

"We've seen a major relocation of textile and shoe business out of China to Vietnam and particularly to Bangladesh. We are also worried about potential over-capacity in China's automotive production."

"Private firms are reluctant to make investments and are holding onto cash due to the uncertain business outlook."

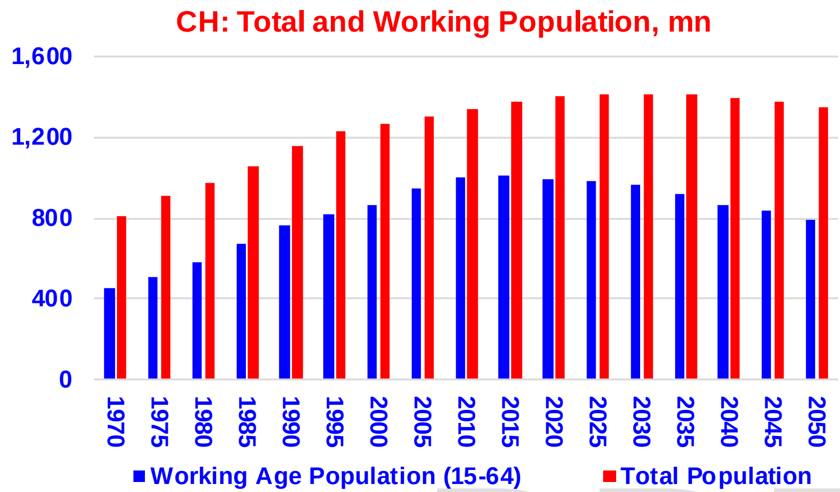
What international organisations are saying:

"The Chinese economy is expected to expand 6.5 percent in 2016 and 6.2 percent in 2017, both up 0.2 percentage point from the IMF's predictions in January. The upgrade reflects China's announced policy stimulus and the trend that robust growth in the service sector offsets recent weakness in manufacturing activity" – **IMF**

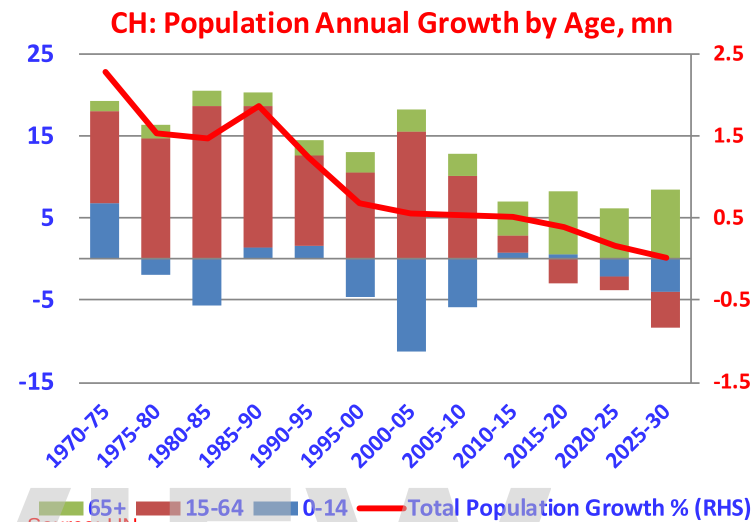
"The near-term growth outlook has turned more buoyant due to recent policy support. The medium-term outlook, however, is more uncertain due to rapidly rising credit, structural excess capacity, and the increasingly large, opaque, and interconnected financial sector. Corporate debt remains a serious and growing problem that must be addressed immediately and with a commitment to serious reforms" – **IMF**

"Baseline projections envisage that growth in China will continue to slow moderately, to 6.7 percent in 2016 and to an average of 6.4 percent in 2017-18, assuming reforms proceed as expected and their impact is smoothed by additional policy action." – **World Bank**

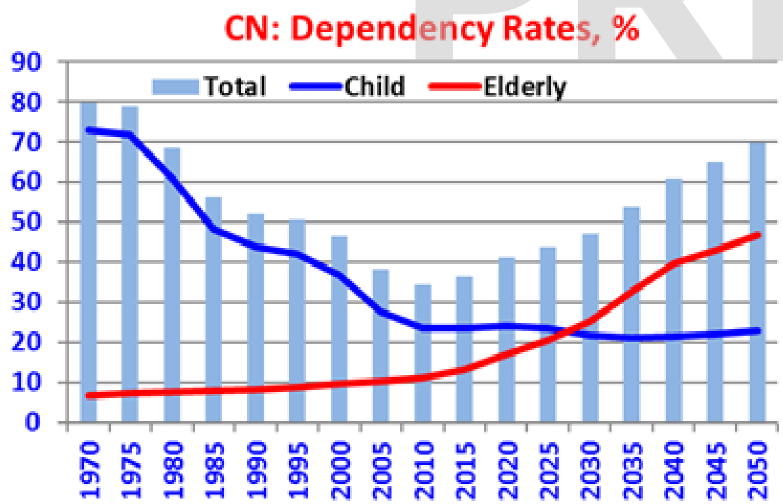
Theme: Demographic headwinds



Source: CEIC



Source: UN

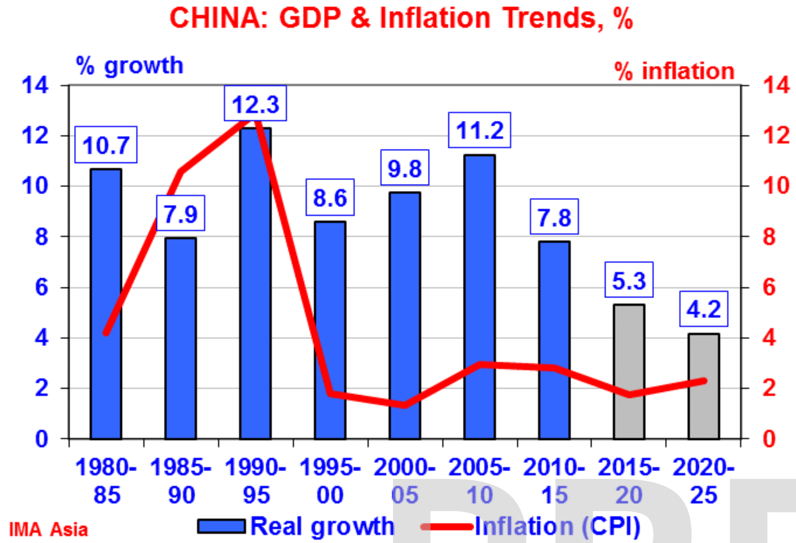


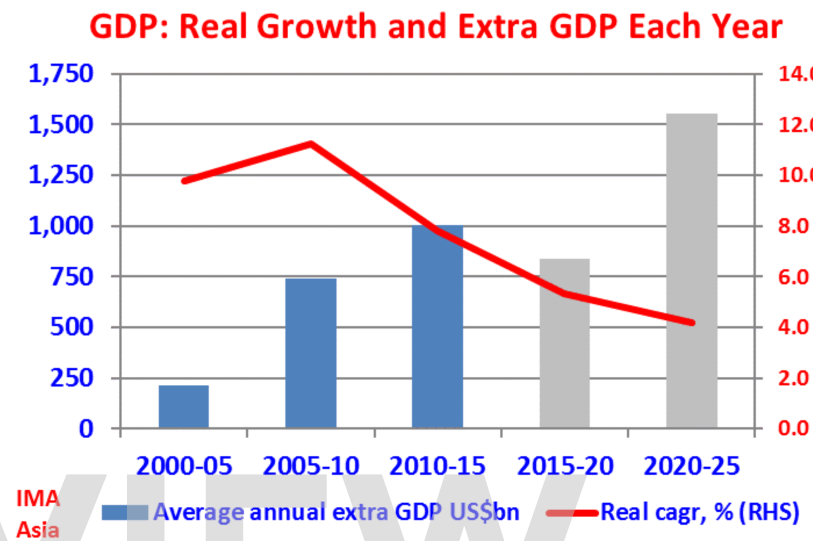
UN 2015, IMA Asia

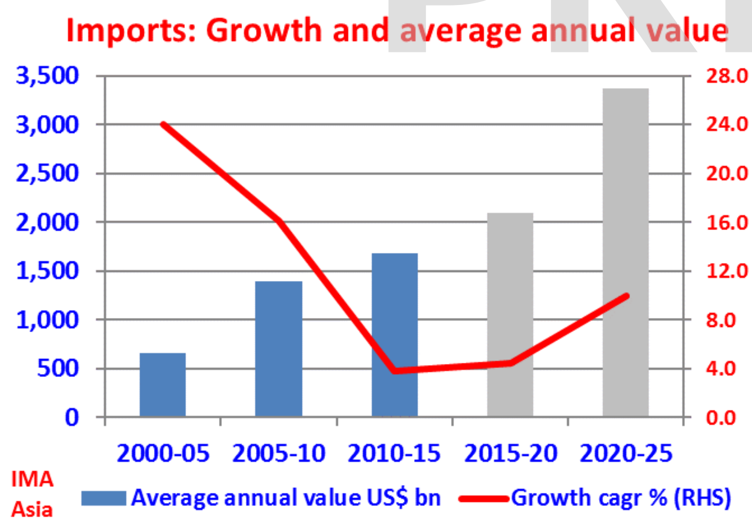
China's working age population will fall by 0.7%pa over 2015-30, while elders (above 65) will grow by 3%pa. The impact of this is likely to be:

- A rising dependency curve that will slow GDP growth, as every year the average household has fewer workers and more (elderly) dependents.
- Demand for housing will cool as annual growth in the working age population falls from 10m for 2005-10 to 2m for 2015-20.
- Labour-intensive industries will need to increase automation or move out of China, with many choosing the latter.
- Aged care, retirement villages, insurance, annuity, reverse mortgage and other services for the elderly face decades long growth opportunities.

Theme: Slower growth on a bigger base



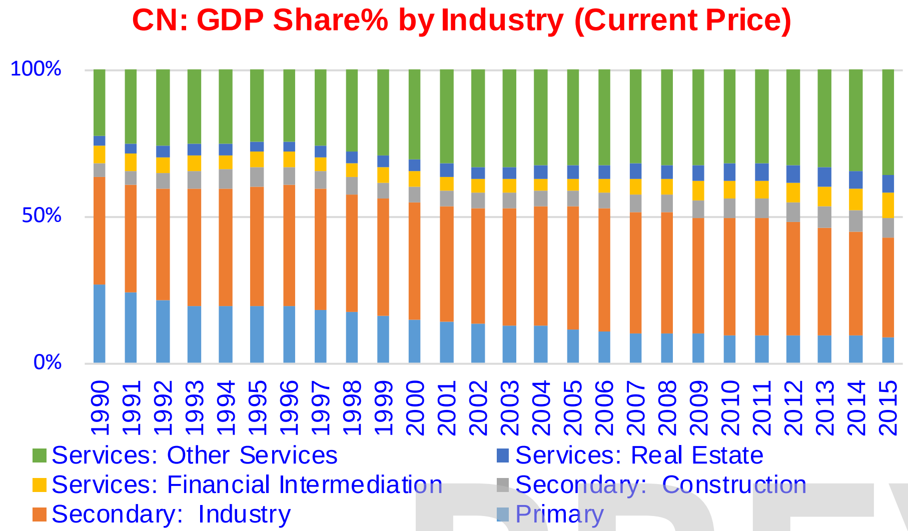


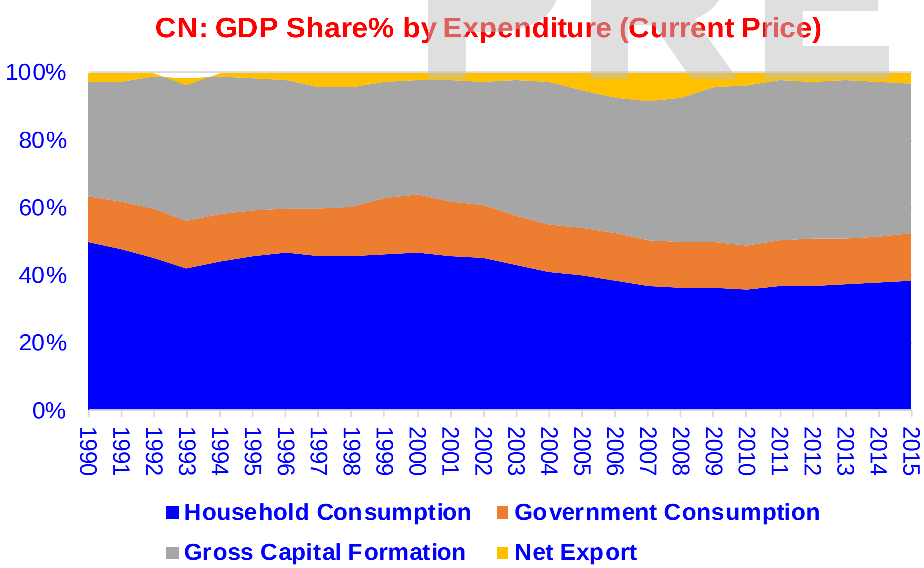


Despite the real growth rate halving between 2005-10 (11.2%pa) and 2015-20 (5.3%pa), the extra GDP created each year – measured in US$ - is about the same ($750bn), as lower growth is occurring on a bigger base. The dip in 2015-20 reflects a weaker Yuan on the US$. By 2018-20, China will be adding about the same to the global economy as the US, and by 2025 it will be adding 50-70% more than the US (we assume a mildly stronger Yuan for 2020-25).

Much the same argument applies to China's import demand. While import growth drops from 16% pa for 2005-10 to around 4% for 2015-20, the annual value of imports rises to US$2tr. For 2020-25 we assume China's growing wealth prompts a recovery in import growth to 8-10%pa (US$ basis).

Theme: Rebalancing the economy





One of the biggest challenges for corporate strategy in China is the rebalancing of the economy. China's economy is rebalancing on three fronts:

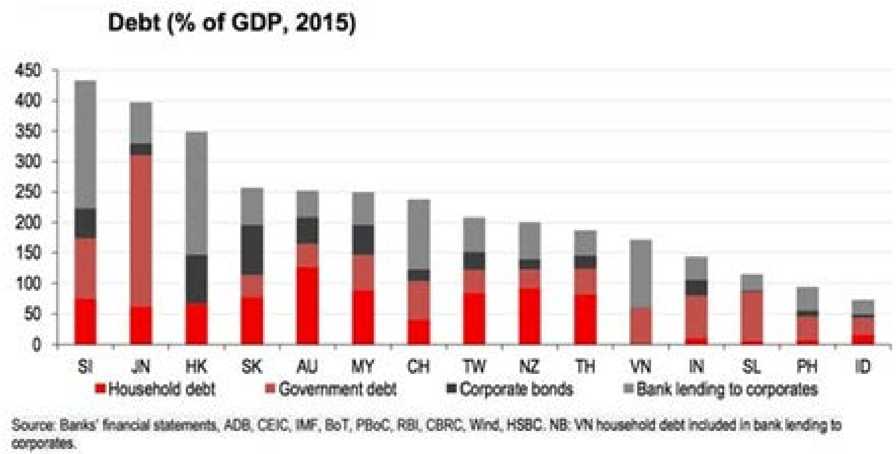
- Less investment driven to more consumption driven;
- Less manufacturing driven to more service driven;
- Less labour-intensive to more technology driven.

Mounting challenges in 2016 will likely push each of these transitions faster in the next few years. Those challenges include a surge in corporate debt, falling investment returns, and low capacity utilization.

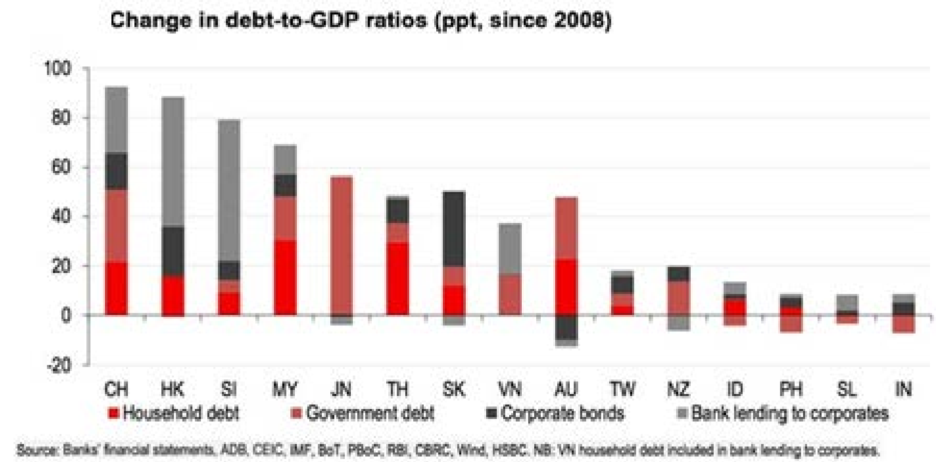
Meanwhile, household and government cconsumption remain steady at 50% of GDP, while the services sector has lifted its GDP share from one-quarter in the early 1980s to over 50% in 2015.

One outcome is a two-speed China, as sectors that were dominant slow while new growth sectors accelerate. The net result is slower growth.

Theme: A risky surge in corporate debt



Source: HSBC



Source: HSBC

IMF Global Financial Stability Report, April 2016
Debt at Risk in a Sample of Chinese Non-Financial Firms

Industry	Number of Companies	Total Borrowing (US$ millions)	Number of Companies at Risk	Debt-at-Risk (US$ millions)	Debt-at-Risk over Total Borrowings (percent)
Information Technology	377	147,229	71	12,576	9
Retail and Wholesale	321	157,113	73	55,145	35
Manufacturing	1,231	501,659	240	88,525	18
Leasing/Commercial	43	5,342	6	142	3
Utilities	109	369,881	9	3,086	1
Steel	72	115,484	28	45,396	39
Construction Materials	43	59,841	9	11,625	19
Transportation	104	152,096	10	27,548	18
Mining	52	135,163	15	47,598	35
Energy	43	224,845	15	2,357	1
Real Estate	407	850,737	100	96,412	11
Others	69	55,558	14	1,642	3
Total	2,871	2,774,948	590	392,053	14

Sources: S&P Capital IQ; and IMF staff estimates.
Note: Debt-at-risk is defined as the debt of corporates with interest coverage ratio of below 1. Interest coverage ratio is EBITDA/interest expense of the corporate. EBITDA = earnings before interest, taxes, depreciation, and amortization.

Source: IMF

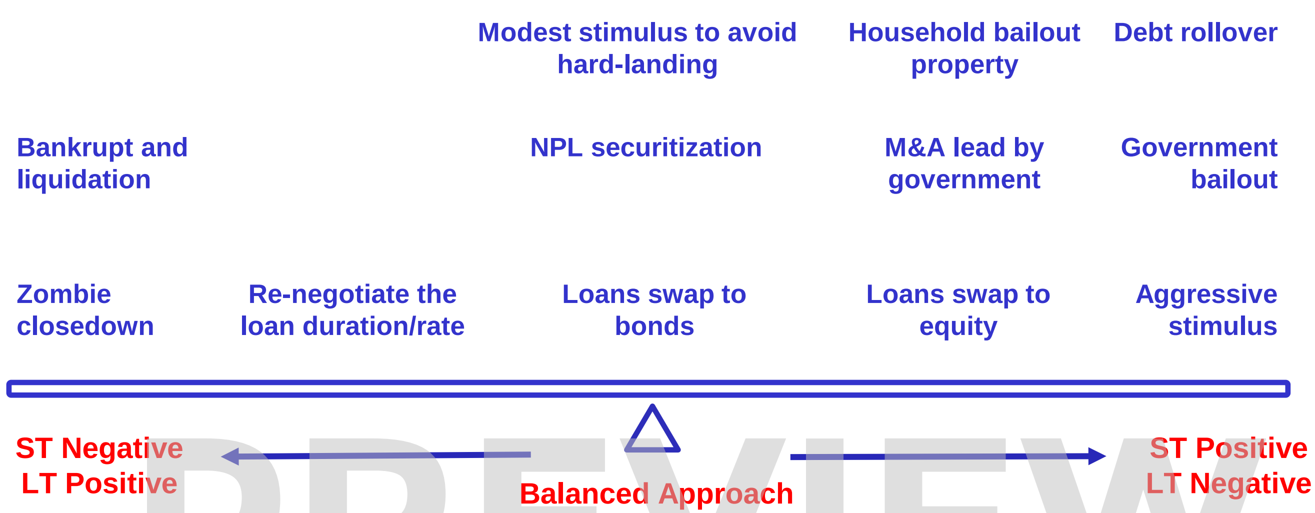
The biggest risk in China is a financial crisis not unlike the global financial crisis (2008-07) or the Asia financial crisis (1997-99).

As the two charts above from HSBC show, it is the speed with which debt has grown (particularly corporate debt), that is worrying rather than its overall level, which is in line with many other countries.

Credit has flowed too freely into sectors with excess capacity, so its repayment is at risk. On the table to the left the IMF calculates that 14% of lending to non-financial firms in China is at risk of non-payment – much higher than the official non-performing loan ratio of 1.9% at the end of 2015.

Theme: Beijing's debt strategy – corporates (the risky bit)

Beijing's Policy Options



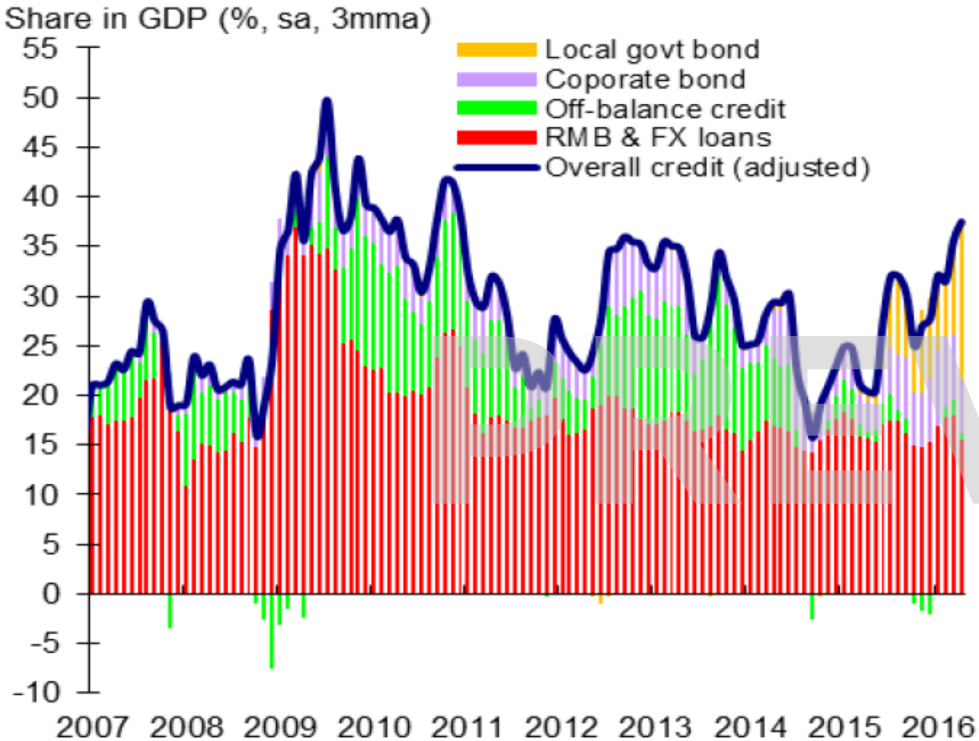
China wants to resolve its corporate debt crisis without a collapse in growth or a surge in unemployment. Its chosen path is restructuring by administrative guidance, rather than allowing market forces to bankrupt firms, with the goal of resolving the debt crisis over the medium term.

Beijing is betting that high domestic savings, a closed capital account, and tight control over banks and debtors (mostly SOEs) will allow it to resolve debt in a "domestic closed-loop credit chain". It is making progress, but there are plenty of risks with the strategy. They include:

- The snow ball problem. Essentially the collapse of over-indebted firms starts to move faster that China can manage.
- The black swan problem. An unexpected event distracts Beijing (e.g. a health crisis) or breaks the closed-loop credit cycle (e.g. a bank run or property market collapse).

Theme: Beijing's debt strategy – local governments

UBS: Local Government Debt Swaps Drive up Credit Growth in 1H'16



Beijing's policies to restructure local government debt since 2013 appear to be working. In the chart to the left, UBS's China team show that local government use of off-balance sheet credit (the "back door" borrowing) has largely been replaced by local government bonds ("front door" borrowing).

Key steps in this plan are:

- Capping local government debt at Rmb16tn.
- Banning local governments from using local government finance vehicles (LGFVs) and SOEs to raise debt.
- Banning local governments from guaranteeing local corporate and financial institutions.
- Ensuring that funds raised by local governments can only be used for specified projects rather than for operational spending.
- A massive debt swap plan covering Rmb3.2tn in 2015 and another Rmb3.5tn in 1H'16. Local governments have swapped 50% of loans into bonds so far, and will likely exceed 60% of their loans by the end of 2016. This is quicker than we'd expected.