4 Is China shaping a new three-year global upturn cycle?

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The direct investment implication of China's stabilisation in 2016 is to invest in cyclical, commodity, and emerging markets, but that does not mean you have to invest directly in China. Given our view that **China's stabilisation is sustainable** to at least the end of 2017, we believe that those trades that worked in 2016 will continue to work in 2017, i.e., **an extended rally in cyclical, commodity and emerging markets**. China's stabilisation throughout 2017 is still a non-consensus call. Views regarding a further rally with a time horizon of full 2017 in cyclical, commodity and emerging markets are still being fiercely debated, and hence markets are still under-positioned in these areas. And that is why there is further upside for the markets in cyclical, commodity and emerging markets.

We think China is helping shape a new three-year global upturn cycle from 2016 to 2018, and that this cycle is truly in the making. Our call this time on an extended rally in cyclical, commodity and emerging markets is still non-consensus, high-conviction, and with a time horizon of one year, to the end of 2017 at least.

Why an extended cyclical rally?

1. **The three-year global upturn cycle is being formed by Chinese economic stabilisation from 2016 to 2018.** The global cycle has been short and shallow, especially from 2011 to 2015, when global monetary and fiscal easing faced deteriorating marginal effects. . Chinese economic stabilisation in 2016 was a total surprise to the whole market, but not to us. One year of economic stabilisation provides a slight upturn cycle for global economy/market. However, as we are extending the China stabilisation call for another year, in 2017, the length of the cycle is getting longer. We increasingly have this view, even it is only February of 2017. Usually we develop our one-year view around September. Chinese economic stabilisation will be sustainable even to the end of 2018. What does this mean? A three-year economic stabilisation in the Chinese economy is already long enough to create a solid upturn cycle for the global economy, which is much longer than in recent previous years. **Hence, the global upturn cycle this time is at least three years, from 2016 to 2018, with a stabilisation in the Chinese economy.**

2. **The cyclicals sector globally is still inexpensive vs. defensives.** Even though defensives' valuation is from 4x P/B in 2016 to 2.5x P/B in 2017, it is still high vs. cyclicals.

3. **Low positioning:** markets are not ready for an upturn cycle, given that the view on China stabilisation is still divided and participation is very low, with cyclical sectors such as financials and energy still being weighted at -2.5% vs. the benchmark, materials at -1%, and industrials at -0.8%.

4. **Investment implications:** Global cyclical sectors will continue to work in 2017. And we believe commodity sectors (which are cyclical) in emerging markets should outperform.

Why an extended commodity rally?

1. **Fundamental on-the-ground commodity demand from China stabilisation:** commodity demand lies in infrastructure (public capex expansion), property (low inventories boosts investment and new starts), and manufacturing upgrading (private capex expansion happening strongly where market has not yet priced it in).

2. **Why import commodities instead of producing domestically, which would be more efficient?** In order to avoid exceeding over-capacity reduction targets and further harm to the environment, China has to import commodities to meet the on-the-ground commodity demand, which is much higher than expected, given capacity expansion in both private and public sectors. That

The essential

We believe that a longer-than-expected Chinese economic stabilisation from 2016 to 2018 is helping to shape an upturn in the global cycle, which is much longer and also stronger than expected. This upturn in the global cycle clearly benefits global cyclical sectors, commodities and emerging markets. We believe that those are the trades that worked in 2016 and will continue to work in 2017 and 2018.

PPI recovery in China implies real interest rates' going to negative, continuous upward earnings revision, and declining NPL ratios, which are hugely positive. And positive surprises in China from strong private capex expansion, public capex expansion and property inventory destocking are not yet priced in by the market, this also provides a window to enter the market to participate in trades involving cyclical sectors, commodities and emerging markets.

A three-year global upturn cycle is in the making!

China stabilisation call in 2017 is still non-consensus

is why we have seen historical imports in all categories, iron ore, steel, coal and etc. The Chinese government has cut even more over-capacity in China in 2016, including 65mn tonnes in steel (target: 45mn) and 290mn tonnes in coal (target: 250mn). The just released targets are for a 140mn reduction in steel and an 800mn reduction in coal over the next three to five years.

3. Investment implications: energy and materials sectors, especially in emerging markets, will continue to surprise on the upside in 2017, given that the China stabilisation call is still non-consensus, and given the upturn cycle that could extend to end of 2018.

Commodities within cyclical sectors will continue to outperform

Why an extended EM rally?

1. China. In order to simplify, we believe there are three main factors in deciding on whether to invest in emerging markets – China, oil and the dollar. As for China, we continue to believe the stabilisation is sustainable both bottom-up and top-down. However the key indicator we spotted upon the very initial stabilising in October 2015 is PPI. **What are the implications after 14 months of improvement in PPI?**

- **Real interest rates are negative now in China and down by over 10%, which is significant.** Nothing is more compelling than real funding costs' getting to negative. Real interest rates are calculated by the one-year benchmark lending rate: 4.35% - (-5.9%) = 10.3% in October 2015, vs. 4.35-6.9% = -2.6% in January 2017.
- **Earnings recovery with a surprise.** Ever since PPI recovered, the earnings revision ratio for China has continued to surprise on the upside, with a reading of 0.92 now. It is not far away from 1, which suggests we are entering a bull market. As we believe PPI will stay in positive territory in 2017, earnings revision will continue to surprise on the upside as in 2016.
- **NPL ratio declines unexpectedly.** This is not captured by the market, but banks' fourth quarter NPL ratio is coming down. Why? Given the recovery in corporate customers' earnings, their ability to repay debt or interest is also rising. Hence it is more than encouraging to see NPL is also declining.

Negative real interest rates in China now!

1 China PPI, %

Source: Bloomberg, Amundi Research

2. Oil. Oil price stability will extend through 2017, given a freeze or cut in production, with fundamental demand from China, and a spillover into many other EM and DM countries.

3. Dollar. We forecast relatively moderate strengthening in the dollar from relative improvement in the US economy and also late-year Fed rate hikes. The dollar will therefore show mild appreciation, especially in comparison to previous years in real trade-weighted terms +6.8% (2014), +9.4% (2015), and +4.3% (2016).

What are the positive surprises from China to further support these rallies?

We have seen some positive surprises from China, and we think they have been overlooked, as they are not priced in at all or are very much understated. These positive surprises – both bottom-up and top-down –will continue to help stabilise the Chinese economy and, hence, to help shape the longer-than-expected three-year global upturn cycle from 2016 to 2018.

1. Private capacity expansion: this has been regarded as the fundamental signal that the economy is restarting on a healthy basis, and it has not happened in the past five years. However, it is starting to happen in China. The PPI recovery has spilled over into CPI, and downstream sectors in China have expanded their private capacity, with unexpected growth as high as 60%. Why? During two five-year plans (the 11th and 12th, hence 10 years), the private sector in China has actually shifted and restructured, and their pickup indicates their transformation has been complete. This is encouraging for global economy, as we will see more R&D and productivity gains.

Private capacity expansion in China is coming back!

2. Public capacity expansion: infrastructure investment has been one of the key drivers to stabilising the overall Chinese economy from top-down.

Sales of excavators used for construction have been strong ever since last September with 60% yoy growth and lasting into January 2017. Without a pipeline of construction projects in infrastructure or property for at least the next two to three years, public capex expansion wouldn't be as strong as it is. The positive change in public capacity expansion is also very convincing of a further stabilisation of the Chinese economy into 2018 and beyond.

Property inventory destocking stronger than expected!

3. Strong destocking in property inventory: strong destocking in Tier 1 and Tier 2 cities has been captured by the market. However, and surprisingly so, destocking in Tier 3 and 4 cities is significant as well. Who are the buyers? They are the workers in Tier 1 and 2 cities, and they go back to buy in Tier 3 and 4 cities. Given the low inventories across the board, property new starts and investment will certainly surprise on the upside in 2017. This will contribute strongly to the overall economic stabilisation in China.

Conclusion

We believe that a longer-than-expected Chinese economic stabilisation from 2016 to 2018 is helping to shape an upturn in the global cycle, which will be much longer and also stronger than expected. This upturn in the global cycle clearly benefits global cyclical sectors, commodities and emerging markets. We believe that those are the trades that worked in 2016 and will continue to work in 2017 and 2018.

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