5 Is the China-led upturn cycle peaking out?

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Why do markets get increasingly worried?

Markets reacted positively to China's first-quarter 2017 and March 2017 data releases, however, worries still persist and the markets are increasingly doubtful as to whether the current economic momentum will continue given the increasing number of signs that a peak is being reached.

1. **Iron ore** prices dropped 28% from their recent high point in February 2017, and markets are worried this marks the peak, and the downtrend will continue. However, in our view, the markets should remember iron ore prices rose +147% from December 2015 to reach their February 2017 peak. The current correction is needed given relative excess supply, but we believe it is temporary.

2. **Chinese PPI** fell slightly to 7.6% in March 2017 (vs. 7.8% in February 2017) leading the markets to think that Chinese PPI had peaked by ending its 18 consecutive months of improvement dating back to the September reading released in October 2015, when we first made the call that the Chinese market was bottoming out. However, we think the slight decline in PPI **may be temporary** and is being driven by current commodity price corrections. As long as the Chinese real economy enjoys widespread "recovery", i.e. stabilising at its current level, we believe that PPI can come back up again.

3. **Chinese property sales** have dropped significantly YTD as of 23 April for the 22 major cities with available data. Property sales volume is down 17% yoy, with Tier 1 cities down 31% and Tier 2 cities down 27%. However, property sales volume for Tier 3 cities has picked up by 11%. The question is whether the recovery in property sales in Tier 3, 4 and 5 cities, as well as smaller towns and villages, can offset the slowdown in Tier 1 and Tier 2 cities. This doubt is clouding the market. In our view, we think it can, and we will explain why later.

Property sales

YTD as of 23 Apr 2017	No. of cities	Property Sales Volume (ksqm*)	YoY%
Major cities	22	45890,5	-17%
Beijing	1	1717,3	-29%
Shanghai	1	4172	-44%
Shenzhen	1	474,5	-73%
Guangzhou	1	3799,3	14%
Tier-1	4	11050,7	-31%
Tier-2	8	16394,7	-27%
Tier-3	10	18445,1	11%

*Thousand square meters

Source: Bloomberg, Amundi Research, Soufun

4. **Will more stringent regulations** squeeze out liquidity and result in a further commodity price correction and, as a result, a correction in the financial markets? When commodity prices are down, financial institutions have to cut their positions which will bring commodity prices down even further. However, we think tighter regulations will curb liquidity temporarily, most likely in the second quarter, but this is unlikely to be the case in the third quarter. This is because the third quarter is the quarter before the political transition happening in October/November, liquidity is assumed and has to be abundant to ensure a stable transition. But there are also fundamental reasons behind it.

Why do we think the China-led upturn cycle is not reaching its peak?

1. **The current recovery is widespread and has momentum.** Our logic is that without fundamental demand, there would be **widespread** private and public capex expansion.

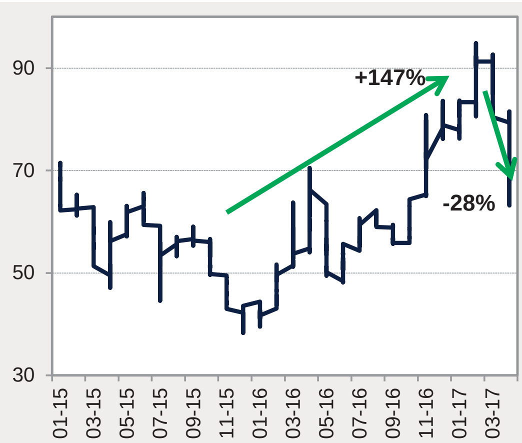
The essential

We think the market is overly concerned about the commodity price correction, Chinese PPI reaching a peak, property sales declining in Tier 1 and Tier 2 cities in China, and lower liquidity as a result of more stringent regulations.

However, we believe the current China-led cycle will continue, for the following reasons: 1. The current recovery in the Chinese economy is widespread and has momentum as both private and public capex expansion are very strong; 2. Liquidity has and will continue to support private and public capex expansion as M1 growth is still much faster than M2 growth; 3. The Chinese property sector, which is the only pillar industry that continues to surprise to the upside, will continue to do so as property inventory is facing widespread lack of supply; 4. PPI, the very important price indicator for this round of Chinese economic recovery, will continue to be very positive, as it indicates negative real interest rates, which will lead to upward earnings revisions and further NPL reduction.

"Is the commodity price correction hinting that the cycle is close to an end?"

1 China Iron Ore Price, USD/ton



Source : Bloomberg, Amundi Research

a. **Chinese private investment** is a good example of private capex expansion. The market has been worried about **private investment when its growth dipped into negative territory. However,** after it bottomed out last July, it continues to reach new highs, hinting at very strong private capex expansion.

b. **Excavator sales** is a good proxy for public capex expansion. Komatsu excavator sales returned to positive growth from last May at +25%, started to shoot up from last September at +97%, and even jumped to +262% this February. Without a pipeline of orders for the next two to three years, huge public capex expansion like this would not be happening.

2. Liquidity has and will continue to support private and public capex expansion.

a. **M1 growth** in China bottomed out in March 2015, then picked up momentum, and surpassed M2 growth in October 2015, right when we made the call that the Chinese economy was bottoming out. **What does it imply when M1 growth is higher than M2**?

M1 simply includes cash and demand deposits, whereas M2 includes M1 and also term deposits. The difference between demand deposits and term deposits clearly explain whether households, corporates or the government intend to use the cash now or rather in the future.

The significant jump in M1 growth, which rose as high as 25.3% in August 2016, **clearly indicates both private and public sectors' capex expansion expectations, and this is hugely important**. This is also why we have been making the call for capex expansion ever since last September.

The difference between M1 and M2 growth is still huge – it has been as high as 15.2% last July, and currently stands at 8.2%. **Closing the gap between M1 and M2 growth takes time, and we believe the fundamental driver will be the slowdown in capex expansion, which we do not think will slowdown anytime soon, as this time capex expansion is real and widespread.**

We believe that when the M1 and M2 growth lines cross again, that is the signal that the cycle is turning.

b. **Total social financing** in China reached CNY 6.9trn in Q1 2017 (vs. CNY 6.7trn in Q1 2016, and only CNY 4.6trn in Q1 2015). However, the market should focus on the scale of this financing, rather than the growth, because the scale is already sufficiently large to provide liquidity for the system, for capex expansion.

3. The Chinese property sector, which is the only pillar industry that continues to surprise to the upside. The market has been wrong on Chinese **real estate investment** given that the forecast during last October's tightening was that it would slow down. But it hasn't, and in March 2017 showed very solid growth at 9.4% yoy. Why?

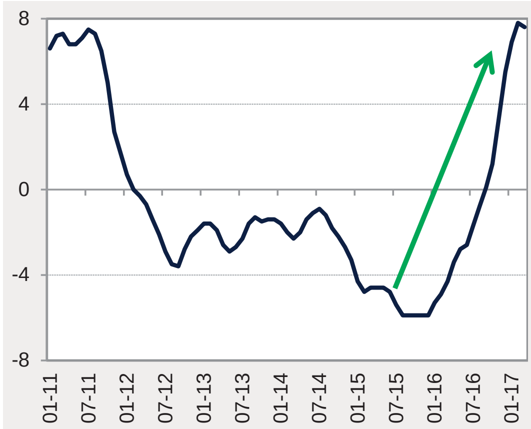
As we have argued since last September, Tier 1 and 2 property inventory is low. Furthermore, given the significant destocking that occurred in the first quarter of 2017 in Tier 3, 4 and 5 cities, inventory in those markets is also low.

According to cities' **months of available inventory** data, we can see that most Tier 1 and Tier 2 cities are experiencing a lack of supply (Shanghai, Guangzhou, Hangzhou, Nanjing), while Beijing is around equilibrium, and only Shenzhen is experiencing slight oversupply.

We believe that lack of inventory is the main factor driving fixed asset investment in real estate, new starts, and even sales. The pickup in sales in Tier 3, 4 and 5 cities are robust, which is likely to compensate for the slight sales slowdown in Tier 1 and 2 cities. We also have to look at volume i.e. square metres sold, rather than the value, as prices in Tier 1 and 2 are too expensive, but prices are all up around 10% YTD as of 23 April 2017.

"Will Tier 3 and 4 cities make up for sluggish property sales in Tier 1 and 2 cities?"

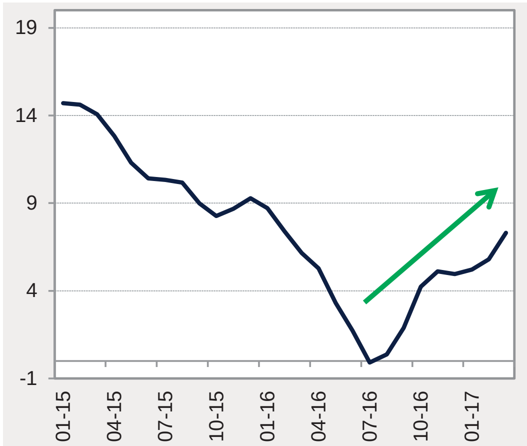
2 China PPI, yoy % change



Source: Bloomberg, Amundi Research

"Will more stringent regulations lead to tighter liquidity later?"

3 China Private Investment, % yoy



Source: Bloomberg, Amundi Research

"M1 growth is still significantly faster than M2 growth"

Chinese property inventory, months to clear						
		Peak	Average*	Current	Diff b/w current & average	Implication
Tier 1	Beijing	50,4	12,8	13,7	0,9	around equilibrium
	Shanghai	20,2	7,5	5,7	-1,8	lack of supply
	Shenzhen	75,8	13	23,8	10,8	oversupply
	Guangzhou	35,7	10,1	5,3	-4,8	lack of supply
Tier 2	Hangzhou	23,3	6	2,7	-3,3	lack of supply
	Nanjing	42,2	9,1	4	-5,1	lack of supply
Tier 3	Ningbo	129,6	24,7	3,5	-21,2	lack of supply
	Suzhou	34,3	9,5	7,3	-2,2	lack of supply
Tier 4	Huizhou	42,2	9,1	5,5	-3,6	lack of supply

* 2007-2017 average

Source: Bloomberg, Amundi Research, Soufun

4. **PPI, the very important price indicator for this round of Chinese economic recovery, will continue to be very positive.** Most importantly, it has caused a significant drop in **real interest rates** (from as high as +10.3% to as low as -3.25%, i.e. a 13.6% decline!).

   We believe, as long as PPI remains above 4.35%, i.e. the one-year benchmark lending rate in China, the real interest rate in China will stay negative or close to zero. This continues to be hugely positive for upward revisions to corporate earnings and further NPL reduction.

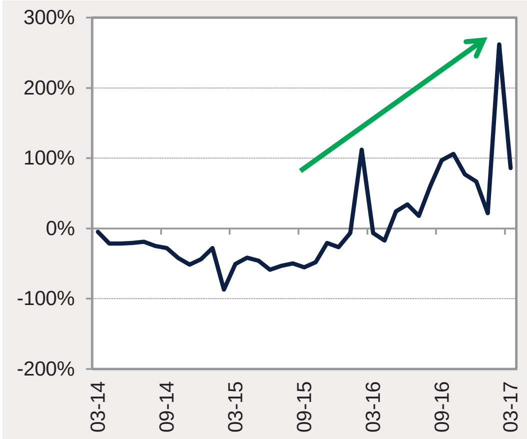
1 Year Benchmark Lending rate	-	PPI	=	4,35%	-	7,60%	=	-3,25%
1 Year Benchmark Ledning rate	-	CPI	=	4,35%	-	0,90%	=	3,45%
1 Year Benchmark Deposit rate	-	CPI	=	1,50%	-	0,90%	=	0,60%

Source: Bloomberg, Amundi Research

Conclusion

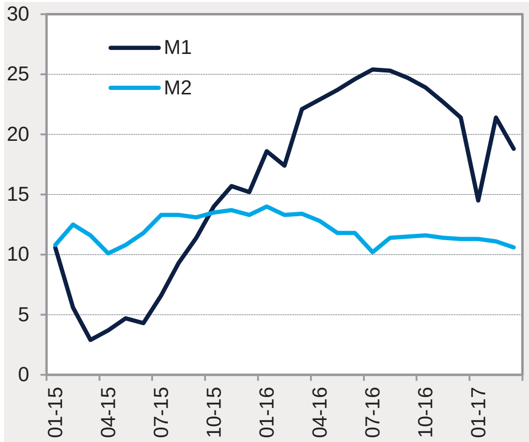
We think the market is overly concerned about the commodity price correction, Chinese PPI reaching a peak, property sales declining in Tier 1 and Tier 2 cities in China, and lower liquidity as a result of more stringent regulations. However, we believe the current China-led cycle will continue, for the following reasons: 1. The current recovery in the Chinese economy is widespread and has momentum as both private and public capex expansion are very strong; 2. Liquidity has and will continue to support private and public capex expansion as M1 growth is still much faster than M2 growth; 3. The Chinese property sector, which is the only pillar industry that continues to surprise to the upside as property inventory is facing widespread lack of supply; 4. PPI, the very important price indicator for this round of Chinese economic recovery, will continue to be very positive, as it indicates negative real interest rates, which will lead to upward earnings revisions and further NPL reduction.

4 Komatsu Excavator sales in China, yoy growth



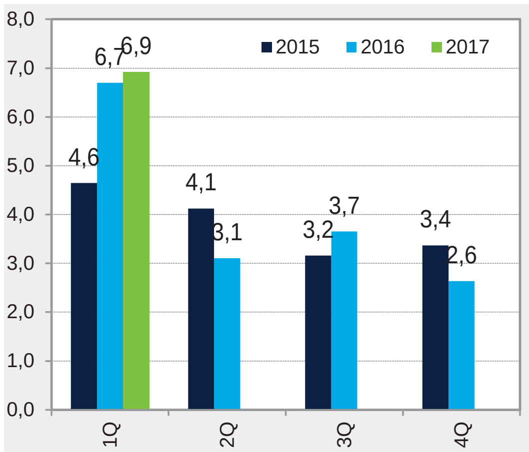
Source: Komatsu company data, Amundi Research

5 China M1 & M2, yoy % growth



Source: Bloomberg, Amundi Research

6 China Total Social Financing, CNY trn



Source: Bloomberg, Amundi Research

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