



# China Update: Signs of Recovery

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Stunning economic growth and rapid capital market developments over two decades have thrust China into the economic overachiever category in the eyes of many investors around the world. While the global downturn has slowed the pulse of China's economy, signs of recovery - plus the sheer size of the market, potential for further growth and increasing prominence on the world economic stage - keep investors focused on China.

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## Rx one: government stimulus

Late last year, the Chinese government announced an estimated US\$570 billion stimulus package to be spent over two years. This multidimensional package - fiscal and monetary measures, coupled with direct economic support for 10 specific industries - was the government's initial step toward reviving China's economy. The government has also focused on restoring tax rebates and introducing incentives to support the property and export-related sectors of the economy. In addition, with the recent surge in China's foreign exchange reserves to more than US\$2 trillion, the Chinese government has sufficient room for further stimulus and fiscal expansion to sustain the 8% gross domestic product (GDP) growth target for 2009.

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## Rx two: consumption-boosting initiatives

To further boost economic recovery, the Chinese government has put measures in place to encourage people to spend money rather than save it. For example, the government has expanded a program that offers rural consumers subsidies on appliance purchases. In addition, the government has announced a replacement subsidy plan that allows consumers to trade in their old appliances for new ones. As part of a long-term initiative to spur domestic consumption, the government encourages low-income families and visitors to use vouchers and coupons. We expect these consumption measures will remain in place until the Chinese government is convinced that China's economic recovery is on solid footing.

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## Signs of recovery

In our view, there are multiple signs that the stimulus plan is working and that China's economic recovery is under way, including:

- An unprecedented surge in money and loan growth
- A rally in the Purchasing Managers Index (PMI)
- A rebound in electricity generation growth
- An increase in auto and property sales

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Data suggests that efforts to boost consumption are also working. During the first five months of 2009, passenger car sales jumped 29.6% over the same period in 2008 because of government initiatives to:

- Reduce the vehicle purchase tax for passenger vehicles with specified engine capacities
- Increase the vehicle scrappage subsidy to encourage purchase of new vehicles to replace those that meet certain criteria
- Provide farmers with subsidies to purchase vehicles that meet specific criteria

Likewise, property sales have trended upward in large cities, including Beijing, Shanghai and Shenzhen, since January 2009. And we anticipate that domestic consumption will be a key driver of economic growth as government initiatives, such as cash coupons and home appliance subsidies, boost sales in these industries.

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## Chinese equities gaining traction

Muted growth potential in developed markets during the second half of 2008 prodded global investors to reallocate money market investments in the U.S. and Europe to Chinese equities. As a result, Chinese equities, as measured by the MSCI China Index, have surged by more than 50% since March - outperforming their developed-market counterparts by an impressive margin. This significant market rally can be attributed to several factors:

- Improvement in economic indicators
- Increasing liquidity
- Investors' anticipation of an earnings recovery

Although we believe the outlook for Chinese equities remains promising - especially when compared to those of developed markets - we also expect volatility in the near term as investors take profits.

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## Tightening measures unlikely

Global interest rates hover at historic lows as a result of efforts by central banks worldwide to ease the economic crisis. As a result, investors are concerned about potential inflation, which could spark a reversal of the tightening stance. But China, in our opinion, is an exception. Although interest rates in China have fallen since the second half of 2008, the rates aren't as low as those of other major economies in the U.S., U.K. and Europe. We believe it's unlikely that the Chinese government will introduce tightening measures in the foreseeable future and risk dampening the current gradual uptick in economic indicators. The government likely doesn't have immediate concerns and would consider tightening measures only if the consumer price index (CPI) - which dipped in June for the fifth consecutive month - escalates to an alarming level. The CPI is an important gauge for measuring inflation.

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## Positive prognosis for recovery

We believe the Chinese markets' year-to-date strong performance compared with that of developed markets - coupled with positive trends in significant economic indicators - indicates that the government's stimulus package and other economic initiatives are working toward restoring China's economy to robust health.