



## ORIGO CHINA ECONOMIC OUTLOOK, JUNE 2009

China's economic outlook has improved over the last 2-3 months. With Q1, 2009 GDP growth at 6.1%, the consensus is that Q2 figures will come in higher. In other words, the slowdown in the Chinese economy has bottomed out. The two key drivers are Fixed Asset Investments and Domestic Consumption.

Fixed Asset Investments (FAI) are by far the most important driver. Historically accounting for about 45% of GDP, we now expect FAI to account for more than 50% of Chinese GDP. Having stood at about 21-22% growth per annum, FAI is now reported to grow at about 31-32%, not adjusting for inflation. In addition, one should remember that this is domestic FAI, and as such does not include Chinese investments abroad (i.e. iron ore mines in Australia).

Domestic Consumption is a smaller component of the rebound in growth, but possibly a more promising element. Retail volumes are growing at the highest rate since 1993, with growth at about 15-16% per annum. Year to date automobile sales, domestic tourism and local retail spending have surprised most China experienced economists. Confidence should also be taken from the fact that 75% of all car purchases are first time buyers, with a staggering 95% of those purchases also fully self-financed from savings/cash. These figures are also believed explain the upward pressure on gas/petrol prices. We are also confident that with 33% of the consumption linked to final products, there will be a flow through to steel and cement companies.

The government's stimulus package is in full work, supported by a veritable explosion in bank lending. Banks are reporting that they in Q1 2009 lent out as much as in the entire year of 2008. We know, however, that this was predominantly to central government guaranteed projects. While large property developers have been able to enjoy favorable terms and refinancing, we remain concerned by many smaller developers with liquidity issues. Overall, the property market, especially the residential market, has seen a u-shaped recovery with volumes and prices picking up to the peak market levels of 2007 with inventories shrinking.

Export oriented coastal regions have been hurt the hardest from the international downturn, with certain southern cities and provinces reporting a flat or marginally shrinking GDP in Q1. However, other regions like Hunan and Guagxi have reportedly enjoyed unprecedented growth on the back of expansions in heavy machinery and construction material manufacturing. As we have indicated in the past, some of this relocation to inland provinces is a trend that started many years ago. An example is the JV between FIAT and Guangzhou Auto, which is an archetypical Pearl River Delta manufacturing star. Even before the JV was formed, it was reportedly agreed that the JV manufacturing facility would be located in Hunan to enjoy even lower costs on all aspects from fixed asset investments to operating cost. Even though, it was a JV between a Guangdong Manufacturer and a European car maker.

Equity markets are up more than 60% since October 2008, but we feel in general that the risk of significant volatility and downward pressure is prevalent, especially in the A-share market. Our belief is due to signals that the IPO market may be about to open up again with significant new offers on hand, as the markets have been effectively closed for more than a year, -combined with signals that certain securities that have earlier been restricted from trading may be now offered into the equity market. We simply believe there will be a lot of new (block) offers into a relatively low liquidity market creating a downward pressure. That said, the current discount on most H-shares seems attractive especially in light of that newly found liquidity in western markets might fall over into the HK market, creating improved liquidity and demand.

We expect the Chinese government to keep rolling out new stimulus initiatives in the summer, as we interpret the government to be very concerned and well updated on the general condition of the economy. A shared concern is to provide enough jobs to the graduating classes of 2008-2009. With an estimated 4.6 million new jobs created this year to date, the government is well on course, and we hope that the class of 2009 will be absorbed throughout the summer while some will extend their studies into master-graduate studies. Indeed, many faculties have had their quotas extended for the next school year. China is investing in its future.

With Timothy Geithner in China this week, among others addressing Beijing University students, we see no “on the ground” signals that China will start selling US treasuries, nor stop buying. We think they will be persuaded to hold, but then we also don’t think there is much pressure on the Chinese to appreciate the Renminbi. Moderate appreciation can be expected, while there might also be domestic moves to provide a 100% VAT rebate to certain exporter sectors.

