

China Economic Briefing



Partial economic indicators suggest that China's economy has stabilised in recent months. These trends remain in line with our expectations, meaning that our forecasts for economic growth remain unchanged at 7.3% in 2014 and 7% in 2015.

Beijing has encouraged local governments to speed up budget spending, announced investment plans in the railways and social housing sectors and introduced targeted cuts to the reserve requirements for some banks – however the People's Bank of China (in particular) remain resistant to broader stimulus measures.

Moves to allow local governments to issue bonds (initially a pilot scheme limited to 10 better managed authorities) could begin to reduce concerns around capacity of governments to service debt as well as reduce their dependence on shadow banking. That said, careful supervision will be necessary, as mismanagement and scandals in the 1990s resulted in the current regulatory constraints.

Industrial Production and Investment

Industrial production growth was largely unchanged in May – rising by 8.8% yoy (compared with 8.7% in April). This level was in line with expectations, and may point to stabilisation in the secondary sector, following the slowdown since late 2013.

Trends in the PMI surveys were somewhat improved in May. The official NBS PMI – which is more representative of larger, state-owned firms – edged up to 50.8 points (compared with 50.4 points last month). The HSBC Markit PMI (which has stronger coverage of small-to-medium sized firms) moved up to 49.4 points (from 48.1 points previously) – the strongest level since January 2014.

Trends in the major industrial products remained mixed in May. There was a strong acceleration in motor vehicle production – up by 12.2% yoy (compared with 7.9% last month) – and modest pick ups in rolled steel (6.1% yoy versus 5.4% previously) and electricity (5.9% yoy compared with 4.4% in April). In contrast, cement manufacturing increased by 3.2% yoy (down from 3.9% last month).

Fixed asset investment was marginally stronger in May, with the growth rate edging up to 17.0% (on a seasonally adjusted basis), up from 16.8% last month.

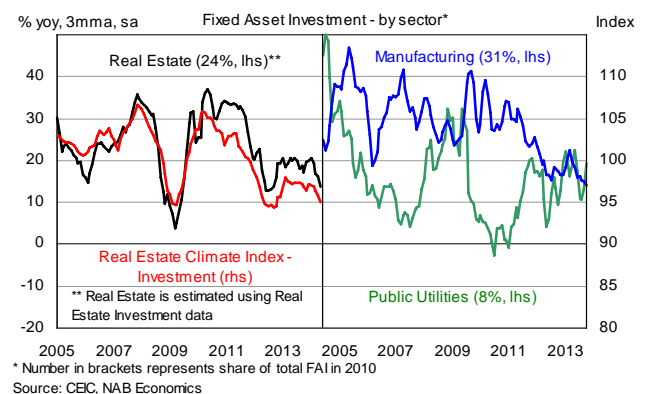
Investment trends were mixed at the sector level. The softening trend in manufacturing investment continued, with the growth rate down to 14% yoy (seasonally adjusted) from 15.1% previously, along with investment in real estate down to 13.7% yoy (from 16.1% in April). In contrast, there was a pick up in public utilities, increasing by 19.4% yoy in May (from 13.1% last month).

Trends in the residential property market appear to remain weak, with property sales continuing to fall in year-on-year terms (down -10.8% yoy in May). Government initiatives

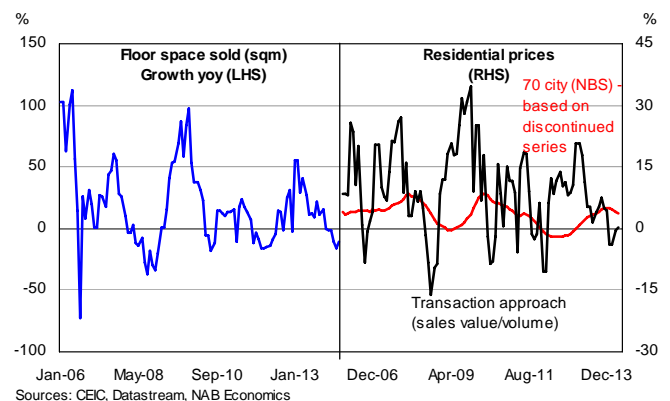
Industrial production trends stabilising after slowdown



Further slowing in real estate and manufacturing investment



Residential property sales slowing and prices softening



related to social housing are unlikely to have a major impact on the sector (given the relatively modest scale of these developments). However measures to allow some local governments to issue bonds could reduce our broader concerns related to a property slowdown (weaker land sales reducing the capacity to service short term government debt).

International trade

China's trade surplus widened in May – reflecting a recovery in exports and a year-on-year decline in imports – rising to US\$35.9 billion (from US\$18.5 billion in April), a level considerably higher than market expectations.

US dollar denominated merchandise exports increased by 7.0% yoy. Over the first five months of the year, exports remain marginally weaker – down by around -0.3% from the same period last year. Data has been distorted by the crackdown on false invoicing, and is unlikely to show clear trends until the second half of the year.

By destination, the key driver in the stronger export trend was the increase in exports to East Asia – increasing by 5.0% yoy (compared with a fall of -16% yoy in April). Exports to Hong Kong (the main destination for the false invoice schemes) were still lower – at -0.8% yoy in May – but less negative than previously (-31% last month). Export growth to the United States and Europe were slightly softer in May, at 6% yoy and 13% yoy respectively.

By product, the largest improvement was recorded for High Tech products – with exports rising by 4.9% yoy in seasonally adjusted terms (compared with a fall of -11% last month) – followed by Mechanical & Electrical goods (up by 5.7% yoy, from -2.8% in April), while growth in Agricultural products were relatively stable at 7.1%.

China's imports fell in May – down by -1.7% yoy (compared with market expectations for an increase of around 6%), following a marginal increase in April. The rates of growth slowed across commodity categories – with a sharp fall in the volume of coal imports (down -13% yoy), while copper (increasing by 5.9% yoy, from 52% yoy in April), crude oil (up by 8.9% yoy from 21% last month) and iron ore (13% yoy from 24% previous) eased.

Retail Sales and Inflation

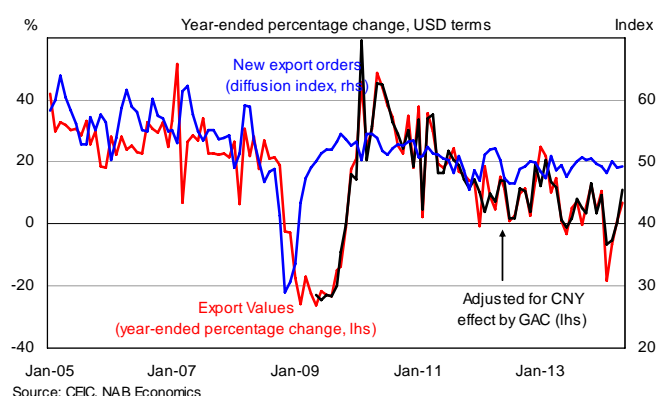
Nominal retail sales growth was a little stronger in May, accelerating to 12.5% yoy, compared with 11.9% in April. This result was stronger than market expectations.

However in retail terms there was a marginal slowing in the growth rate – down to 10.7% yoy from 11.0% last month, reflecting a modest pick up in retail price inflation. Consumer confidence was a little weaker in April, but has remained at strong levels (compared with recent history).

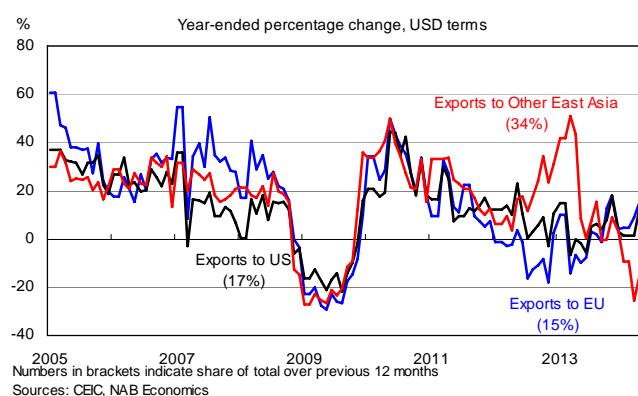
By category, there were gains in food and drink sales – increasing by 13.7% yoy in May (compared with 11.9% last month) – and household goods (up by 6.6% yoy from 2.9% previously). In contrast, growth slowed for motor vehicles, down to 7.6% yoy from 12% in April, while jewellery sales remained negative, down by -12% yoy.

Consumer price growth accelerated in May, with the headline consumer price index rising by 2.5% yoy (compared with 1.8% in April). Food prices remain the main influence on the

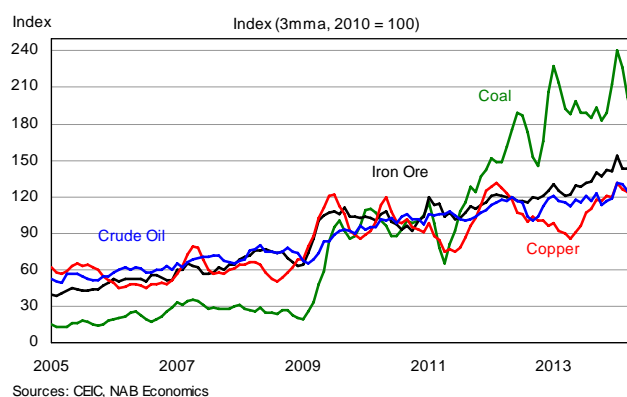
Export trends to remain weak in the first half of 2014



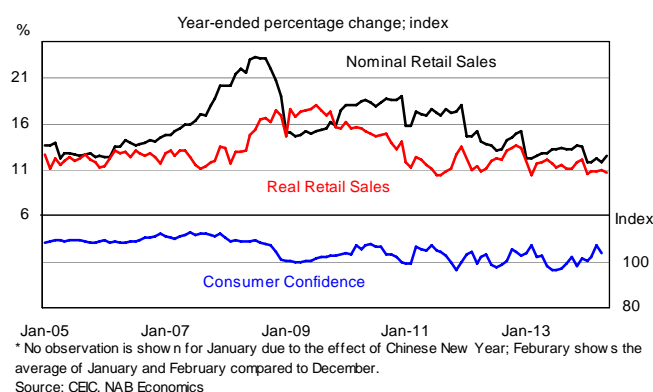
East Asia the key driver of growth in May



Slowing trend across commodities – led by coal



Stable trend in real sales, confidence still relatively strong



headline result – with non-food prices increasing by 1.7% yoy (compared with 1.6% previously).

Food prices rose 4.1% yoy in May (up from 2.3% last month), with fresh fruit (up 20% yoy) and eggs (18% yoy) recording the largest increases.

Producer prices have continued to fall in year-on-year terms, down by -1.4% yoy in May (following on from -2% in April). Producer prices have fallen for twenty-seven months in a row, with heavy industrial producers recording the largest declines – in line with falling US dollar denominated commodity prices.

Policy expectations

The policy response to the slowing trend in China's economy has so far been modest – at least when compared with previous stimulus programs. Limited cuts to reserve requirements (50 basis points) for agricultural and small business-focussed banks fall well below the expectations of some commentators calling for wholesale cuts.

According to Bloomberg, the reserve requirement cut applies to two-thirds of city commercial banks, 80% of non-country level rural commercial banks and 90% of non-country level rural cooperative banks, along with finance firms and financial-leasing and automobile-financing companies. This move could boost liquidity in some markets.

Efforts to address concerns around shadow banking appear to be impacting on the financial sector. For the first five months of the year, new social financing has slowed in year-on-year terms – down -5.9%. New bank loans have increased by 7.0% yoy, while non-bank (which includes some, but not all, components of shadow banking) fell by -20% yoy. The falls are particularly evident in new trust and entrusted loans over this period.

The 7-day Shanghai Interbank Offered Rate was comparatively stable across May and early June, tracking between 3% and 3.5% across this period, a range considerably below the trends evident across most of 2013. This was in stark contrast to April, where the SHIBOR fluctuated a 150 basis point range.

Monetary policy was more accommodating across this period, with the PBoC injecting liquidity into money markets over the past five weeks.

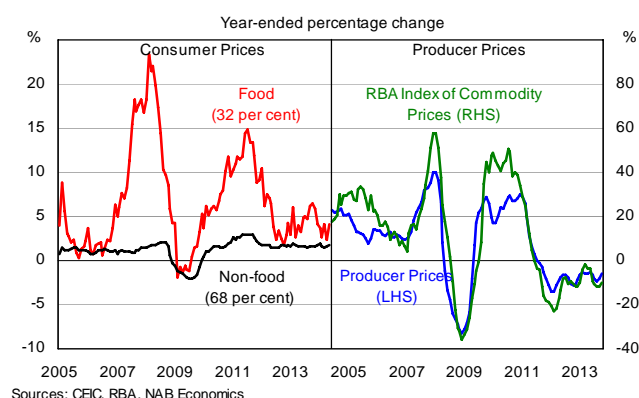
Longer term rates trended downwards across the month, with 5 year rates falling below 4% for the first time since October 2013. Spreads between the 5 year and 3 year rates remained around the typical levels observed across most of 2012 and 2013.

Lower interest rates (compared with late 2013) continue to highlight the challenges facing policy makers, attempting to arrest weakening economic trends and cool concerns in the property market while also attempting to slow rampant credit growth.

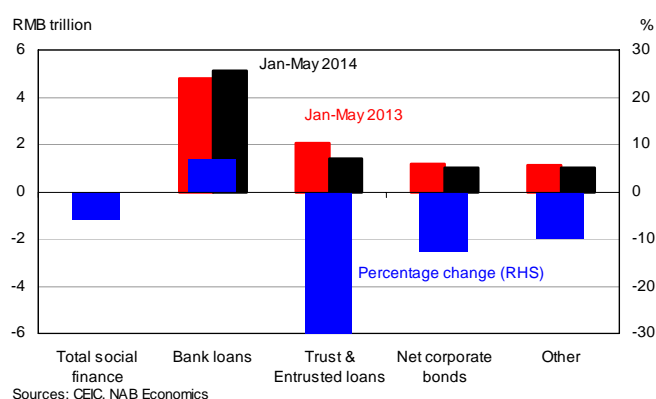
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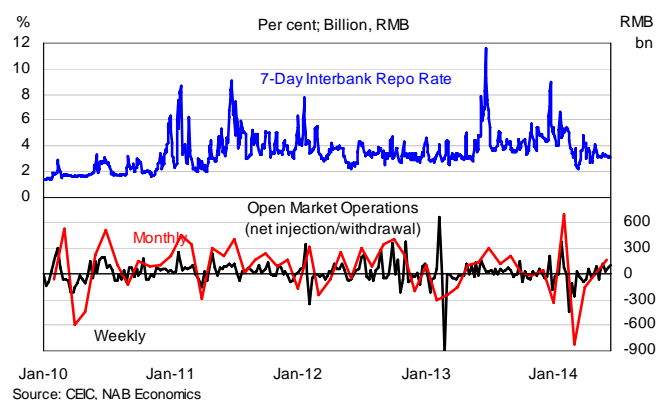
Consumer and Producer Prices



Banking sector the only growing component of social finance



SHIBOR comparatively stable in recent weeks



Longer term rates



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