The Issues

October 1, 2011

HOW FAST IS CHINA SLOWING?

China's recently released, August export component of the PMI (Purchasing Managers' Index) showed a fall to 48.3%. A reading above 50% indicates expansion and, below that, contraction. The decline has raised investor anxiety over a sharp slowdown in China, and various commodities plunged on the news. Just how fast might China's economy be slowing?

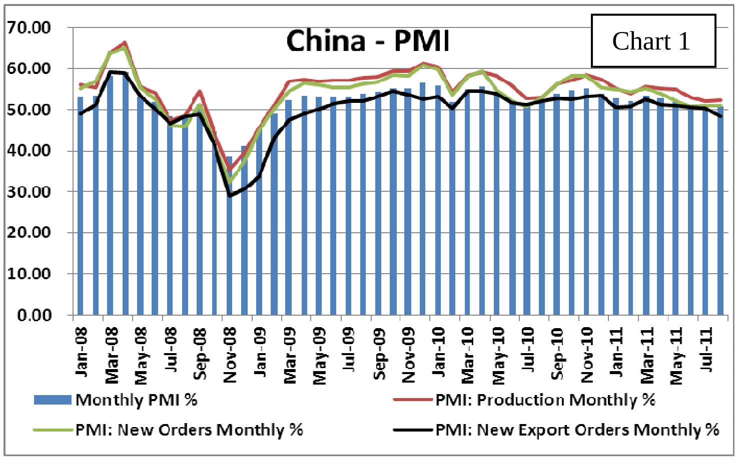
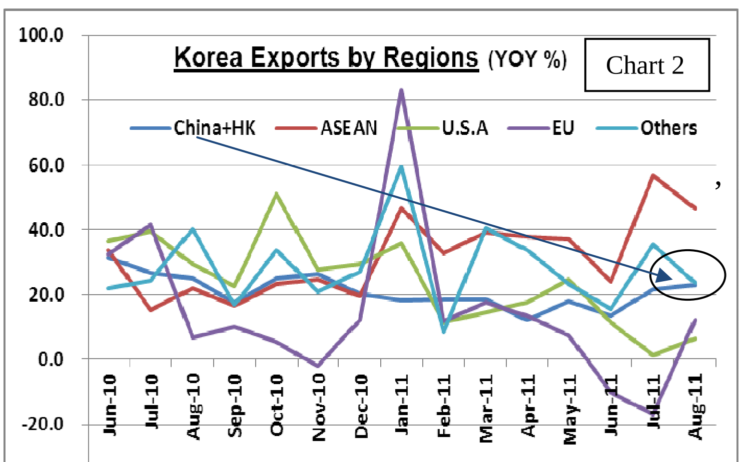


Chart 1 shows the PMI and three of its sub-components: production, new orders and new export orders.

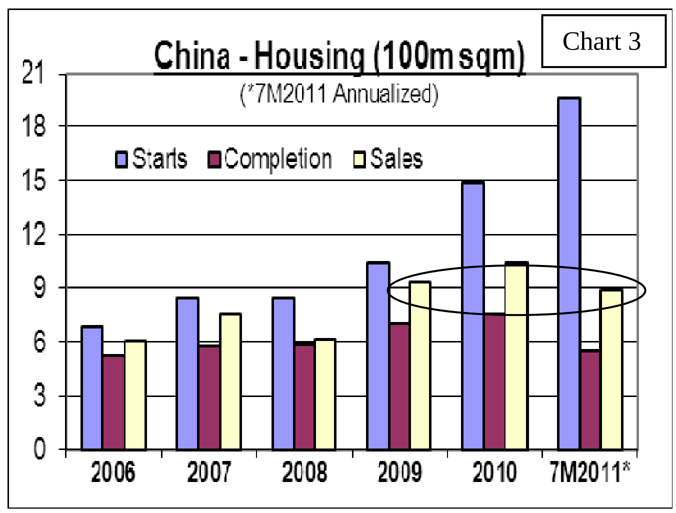
Note the modest rise in the overall PMI in 2009, when China went into a major spending boom and massive credit stimulus. And note the sharp, volatile dip from April to July 2010, followed by a subsequent rebound.

Based on its track record, PMI does not seem to be a very good indicator of economic activities. We believe a number of other indicators better suggest the direction of China's economy. Below, we discuss a few of them.

Source Charts 1 and 3-5: Wind Data.



Source: Bank of Korea.

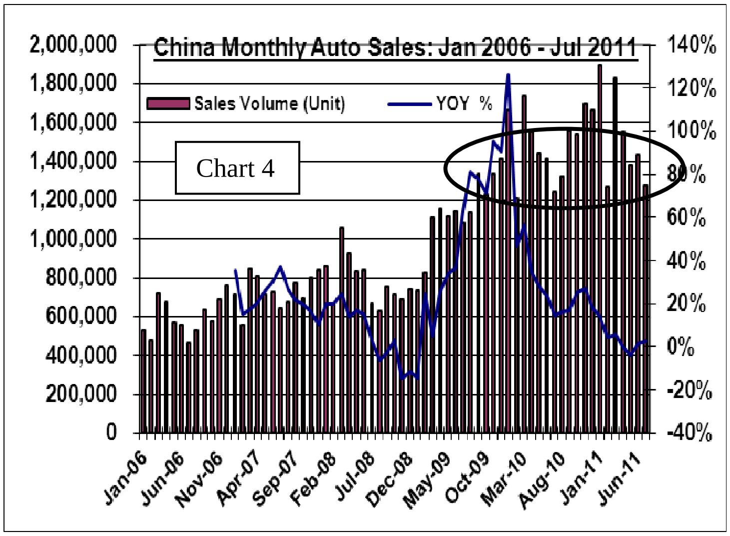


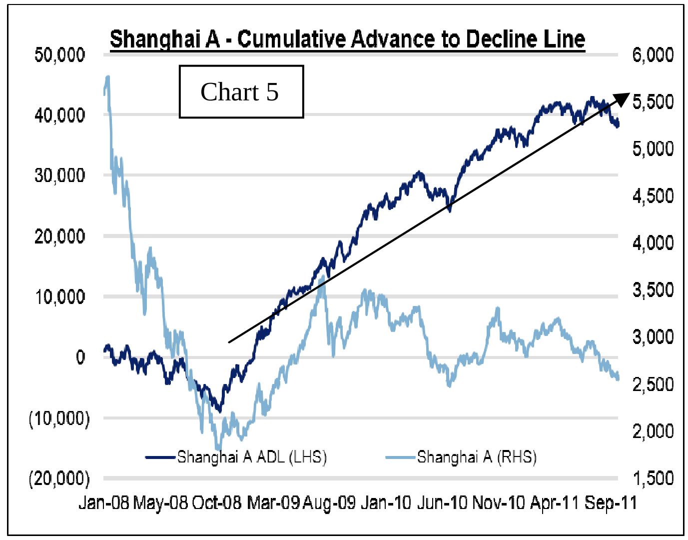
Korean exports to China comprise a diversified list of products, ranging from industrial materials (e.g., petrochemicals and semiconductors) to heavy equipment (e.g., tractors and excavators) to consumer products (e.g., mobile phones and consumer electronics). Korean exports to China are therefore a good indicator of the overall level of consumption and investment demand in China. Chart 2 shows a still healthy level of growth, at +20% YOY.

Housing is an important sector in China. Chart 3 shows active housing sales YTD in 2011, at annualized rates close to levels in 2009 and not far off from peak rates in 2010. This is the case despite loan curbs on home purchases for investment purposes put in place in a number of cities in China, which indicates real demand by end users is strong.

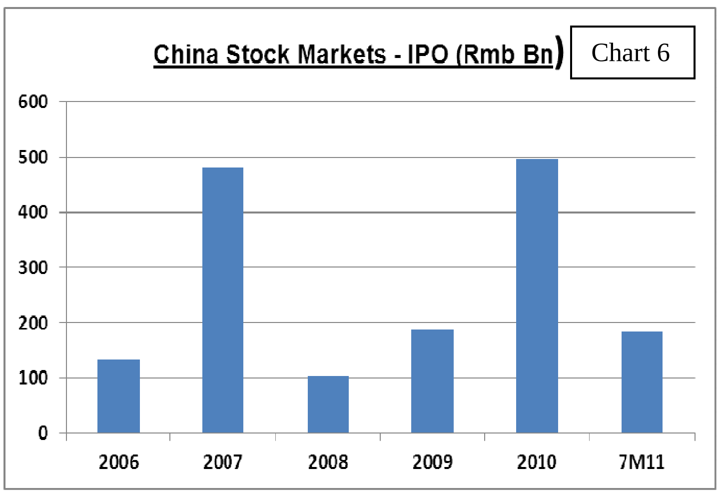
Automobile sales are another useful indicator. Chart 4 shows car purchases remaining at peak levels, as they were in 2009 and 2010, despite the expiration of government subsidies and tax incentive programs that spurred huge sales growth in the last two years. Aug 2011 sales were up 5% YOY.

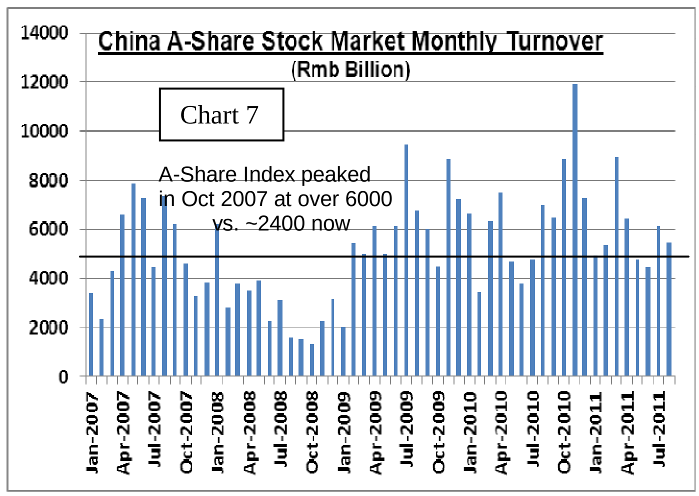
The above **indicators on big ticket items** such as home and auto purchases indicate a high level of **consumer confidence**.





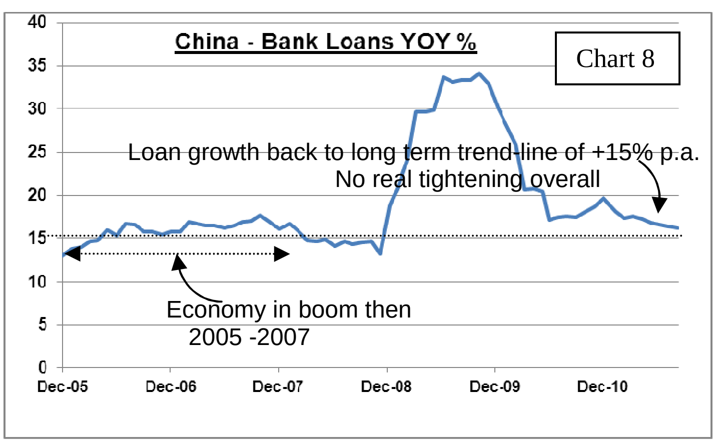
The stock market also provides indicators on consumer confidence, i.e., the 'feel-good-factor' of the public. Chart 5 shows the cumulative advance to decline line for Shanghai's A-share market. An uptrend line means more stocks are advancing than falling. Mainland Chinese investors have driven a bull run in smaller- and mid-cap shares since October 2008 until the consolidation in recent weeks—in stark contrast to the languishing sideways movement in major index stocks; big firms are more government policy prone. YTD the IPO calendar (Chart 6) has been reasonably active, and YTD 2011 stock market turnover (Chart 7) has rivaled that of the 2007 A-share stock market index peak.



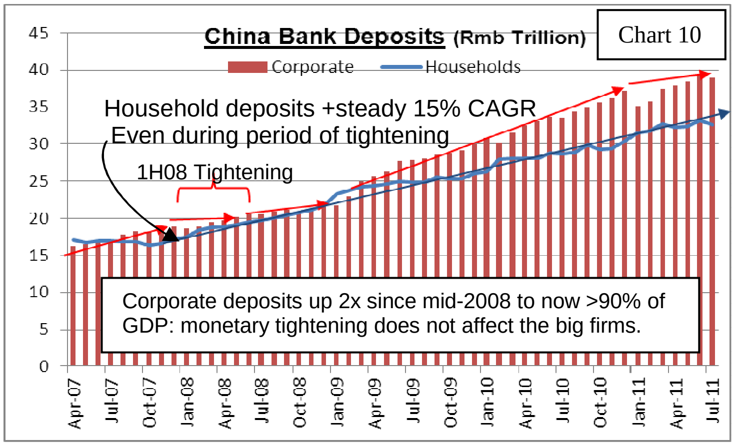


Sources Charts 5-7: Shangahi Stock Exchange; Charts 8-10: Wind Data.

The liquidity squeeze—just how tight has it been? It affects exporter SMEs and over-geared developers.



Using historical trends as yardsticks, the credit tightening of this cycle in nominal terms (Chart 8) and in real terms ex CPI inflation rates (Chart 9) cannot be described as onerous, particularly coming on the back of what's probably the biggest-ever monetary stimulation (2009 to 2010) in China's recent history.

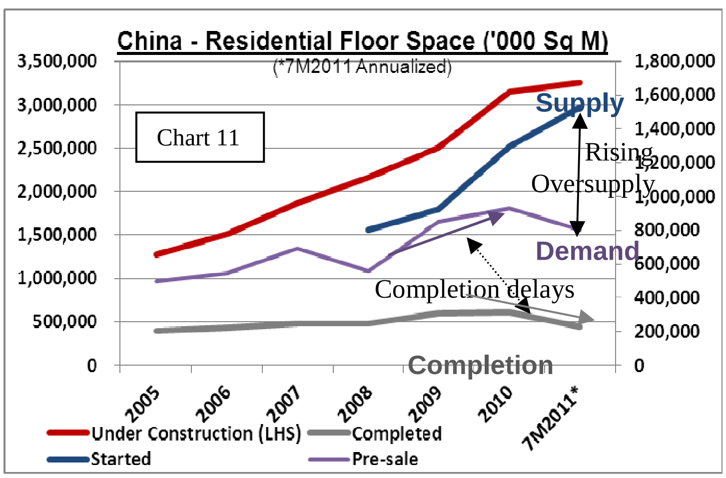


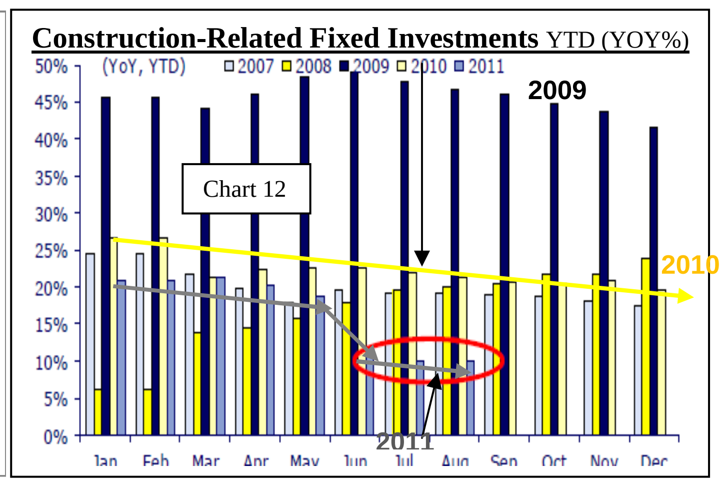
Household bank deposits are growing at a healthy clip of +15% p.a. CAGR (Chart 10). Note how household deposits' growth accelerated at end 07 to 1H08 during the last liquidity squeeze. In China, corporate deposits are the first to rise on easing of credit (a rise in bank loans means an increase in company deposits). When company cash deposits are eventually spent and invested, part of that trickles down to payments to individuals, and bank deposits of the latter rise. With healthy deposit growth, i.e., savings, it is hard to see why households in China would suddenly rein in spending to raise savings further.

Corporate bank deposits, at nearly Rmb40 trillion, are equivalent to 90% of GDP!

What other economy has such a high level of corporate cash? Thus, the so-called credit squeeze is not affecting big companies and well-connected SOEs. These entities are controlling a huge cash pile. They will use opportunities from the current credit-tightening to gobble up weaker players, acquire investment projects and grow even stronger. The small SMEs, those related to the export sector, are being affected by the tightening. Ditto, developers who are over geared.

Housing prices look set to fall. The widening gap between pre-sales and completion (Chart 11) indicates construction delays as developers' cashflows are being squeezed. On Chart 12, the slowdown YTD 2011 in construction-related fixed investment in is also a manifestation of the squeeze. In response, developers have been stepping up supply, i.e., launching pre-sale projects (blue line, Chart 11). But the jump in supply is overwhelming demand (violet line). A price war is developing nationwide and we are looking for a fall in home prices greater than the 10-20% industry consensus.





Conclusions

When home prices fall, we expect buyers to retreat and sales volume to drop. This may well drive fear among investors to over-discount the slowdown in China's economy. However, we see no hard landing. At lower levels, more first-time home buyers will emerge, supported by high savings rates and strong 'feel-good-factor' to bargain hunt. As shown in Chart 8, the long-term trend growth in loans of 15% p.a. was sufficient to drive the boom years 2005-07. With loan growth currently rising at 15% YOY (and on a high base), it is hardly an across-the-board type of tightening. If anything, we would expect inflationary pressure to remain high, making any expectation for early easing premature.

As discussed in our previous notes, wealth in China is very unevenly distributed, with lots of economic power controlled by many types of economic fiefdoms under SOEs and entities connected to local governments. Beijing says one thing, these fiefdoms do another. The major risk facing China is political, not economic: whether the hardliner faction will gain traction to begin chipping away at the fiefdoms. How the political scene may unfold remains to be seen.

Given additional uncertainties in the eurozone, our funds have stayed cautious, holding 45% in cash and 8% in gold.

The Net Asset Value GSI Asian Capital Growth—US$23.35 & the Long Short Fund—US$21.63 (Sep 30, 2011)