

China Business Forecast Report Q4 2013

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Abstracts

Core Views

China's economy appears to be finally buckling under the weight of its credit binge. Despite record new credit issuance in recent months, the manufacturing sector has once again entered contraction in line with our view. Efforts to reform and rebalance are too little too late to avoid the hangover effects of past stimulus measures, and we believe that a recession is at hand. Expectations for a robust recovery in 2014 are likely to be met with disappointment as the rebalancing process proves to be a long and drawn out affair.

Opposing inflationary and deflationary forces will complicate Chinese monetary policy over the coming quarters. Excessive credit growth and record property prices suggest the need for tightening, while subdued headline CPI, banking sector stress, and plunging equity prices suggest there is a case to be made for easing policy.

We believe that deflation is more likely than a spike in inflation, and believe that the central bank will act accordingly, easing interest rates and providing support to the banking system as credit growth slows, negatively impact the real economy.

China is at a major inflection point with regards to the ongoing degradation of its environment, and with the tide of public sentiment rapidly shifting, we believe that the time is nigh for the government to adopt more meaningful and wide-reaching reforms. As China begins to enter a more mature stage of development, we note that opportunities abound in the healthcare, agribusiness, energy, and even automotive sectors, with aggressive government targets as well as increasing consumer awareness set to drive new areas of growth in the economy.

The Chinese media's questioning of Japan's sovereignty over Okinawa and the other

Ryukyu Islands will increase Sino-Japanese tensions at an already sensitive time. In addition, the move will raise concerns in other Asian countries facing claims to its territory by China, leading to a backlash against Beijing.

Major Forecast Changes

We have not made any significant changes to our China economic forecasts since the Q3 report. Our long-held view that the bounce in economic activity seen in early 2013 would fade by mid-year is playing out, and we continue to see negative shocks on the horizon as the fragile banking system buckles under a slowdown in credit growth.

Key Risks To Outlook

The main downside risk to our economic outlook remains another collapse in external demand, such as the one that occurred at the height of the global financial crisis. This would seriously undermine growth in trade-dependent industries and hasten a fall in the property market, potentially leading to an outright recession. There is also a risk that continued fiscal and monetary stimulus by government and the People's Bank of China could usher in stagflation.

The major political risk comes from a rise in social unrest and a surge in public demonstrations against government corruption, inflation and housing affordability, which could be triggered by overseas events or an economic slump. While we do not see the rule of the Communist Party of China (CPC) as being at risk, such events would still have a detrimental impact on the business environment and could see the CPC strengthen its grip on the economy to the detriment of growth.

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China is at a major inflection point with regards to the ongoing degradation of its environment, and with the tide of public sentiment rapidly shifting, we believe that the time is nigh for the government to adopt more meaningful and wide-reaching reforms. As China begins to enter a more mature stage of development, we note that opportunities abound in the healthcare, agribusiness, energy, and even automotive sectors, with aggressive government targets as well as increasing consumer awareness set to drive new areas of growth in the economy.

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