

## PRESS RELEASE

### China is set for a 'soft landing'

[20<sup>th</sup> July 2011]: Pan-Asian equities are at an inflection point this summer. The question everyone is asking is; have the Chinese authorities over-tightened, thus causing a hard landing in the economy, or have they finessed their tightening expertly and managed to create the much sought after 'soft landing'.

#### **Rupert Foster, Manager of the Matrix Asia UCITS Fund comments on why he is in the 'soft landing' camp:**

"I disagree with the bears who would point to the bursting of the property market bubble, stubbornly high levels of inflation creating fears of stagflation, and the likelihood of savage bad debt escalation after the credit boom of the last few years".

"Chinese inflation numbers undoubtedly have been higher and more persistent than anticipated, pushed higher by vegetable prices and then global food prices. However these pressures are ameliorating now with the exception of the pork price. Vegetable prices are falling fast, down 30% in the last few months and global food prices are stable. **It should be noted that the oil price has very little effect on Chinese inflation.** However, the recent pork price rise is the main barrier to a rapidly dropping CPI, with some estimates putting the impact at 40% of the month on month rise in CPI food in June. Assuming the government can control the various factors impacting the recent dramatic pork price rises, this autumn we should start to see pork prices falling which will result in CPI finally retreating from recent highs. This in turn will allow the government to relax their monetary tightening policy and loosening should start by the autumn, with the preferred method likely to be a relaxation of the annual loan quota.

"With respect to the property market; it is undeniably slowing, particularly in Tier 1 cities such as Beijing and Shanghai, with volumes and prices falling. Western media usually focuses on Tier 1 cities, as this is where most of the journalists live; or otherwise on the famous ghost city of Kangbashi in Inner Mongolia that gets visited all so often. However, **using data from Tier 1 cities to represent the whole country is always flawed as the pricing in these cities is c.5x higher than the national average,** and the supply/demand dynamics are historically much more volatile as investors make up a larger part of the market, leading to a boom/bust feel in these cities. **Nationwide pricing has risen in line with household incomes for the last 5 years and thus affordability at the national level is not worsening.** The tightening of regulations in the property market has had an effect as the authorities hoped, but a rapid slowdown currently looks unlikely. In addition, the advent of the social housing boom in China will provide a much needed fiscal stimulus to the economy as private property starts to slow.

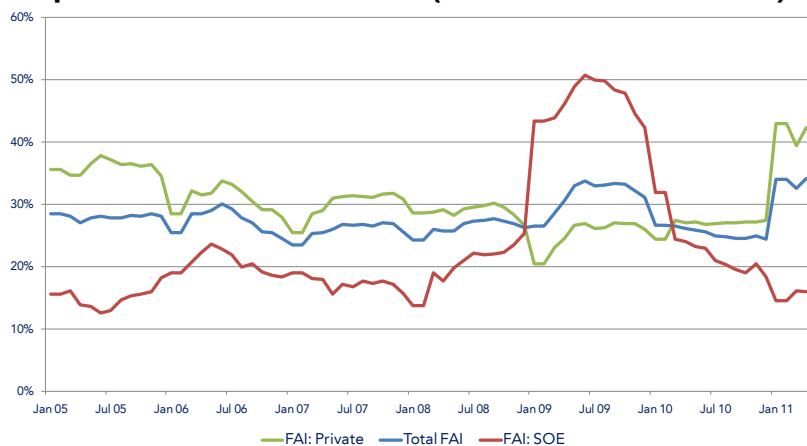
**Lastly, there is little sign that the seasoning of loans originated in the credit boom that started in early 2009 will turn into a full blown debt crisis.** With negative real interest rates in China, meeting payment schedules is not currently onerous, and payment scheduling can be managed going forward with a high proportion of system credit sitting on policy banks' balance sheets. The much highlighted "Local Government Financing Vehicle", LGFV debt, whilst large at an estimated Rmb 10,700-13,500bn (or 28-35% of 2010 GDP), should be manageable given the significant resources available at the federal level and given an economy that continues to grow at c.9.5%pa rate. Additionally, the generally long terms on LGFV debt, as well as the potential for local governments to issue bonds, will be helpful to authorities in managing the situation.

**Finally, if the government in China had over tightened thus causing a 'hard landing' scenario we would be observing two strong effects in the economy – the demise of corporate confidence and consumer confidence.** The first chart below shows private company capex levels (as represented by fixed asset investment) and shows a noticeable

acceleration this year – this is much more emblematic of a late cyclical phase. Additionally the latter chart shows the existing store sales trends at one of the leading retailers in China, Belle. (In this case individual company information is much more useful than the highly massaged official retail sales number.) These numbers show a steady improvement through the last year – **again a sign of improving not declining consumer confidence – and thus a strong indicator of movement into the late cyclical phase.**

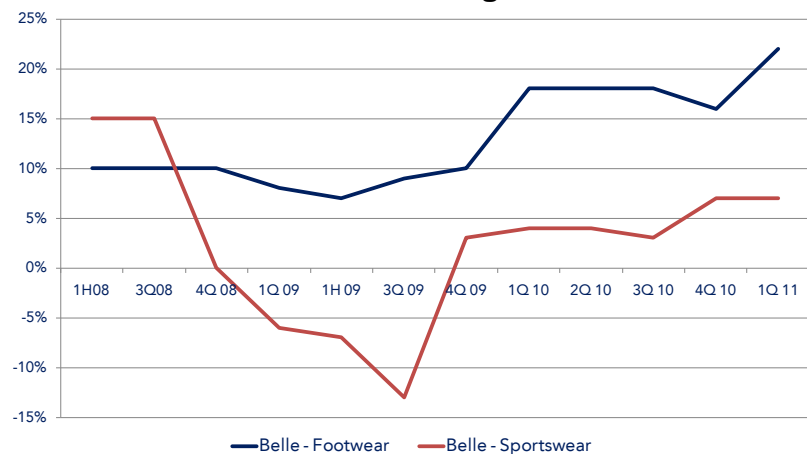
Additionally, China will implement tax cuts from 1 September which it is estimated could increase the disposable incomes of China’s “middle classes” from between c.18% to 27%, and lifting an estimated 50 million people out of the tax system altogether. This should undoubtedly have a positive effect on overall consumer confidence and the related impact to discretionary consumer product purchases.

### Corporate Confidence – FAI (Government & Private)



Source: Daiwa Capital Markets: Q1 2011

### Consumer Confidence – Existing Store Sales at Belle



Source: Daiwa Capital Markets: Q1 2011

“In summary, I believe that in the autumn China will emerge into a strong late cyclical rally as the government loosens monetary policy. We are therefore starting to position our long book in anticipation of this rally whilst remaining vigilant to short term surprises given the fragile and volatile global market environment.

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**Notes for Editors**

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