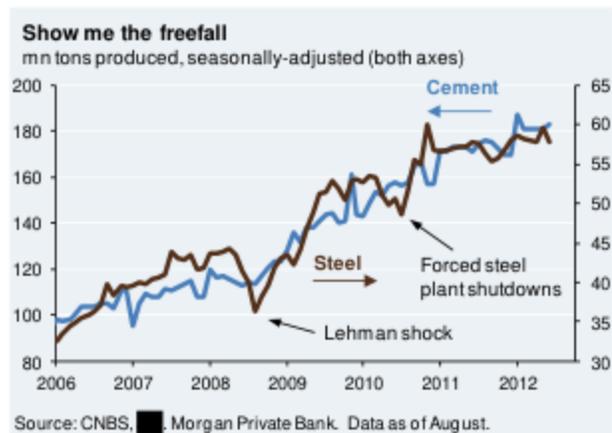


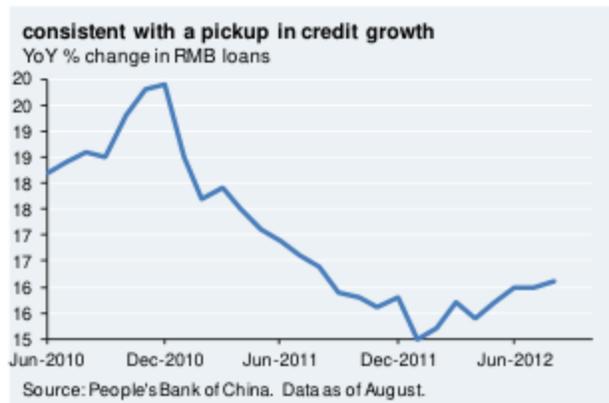
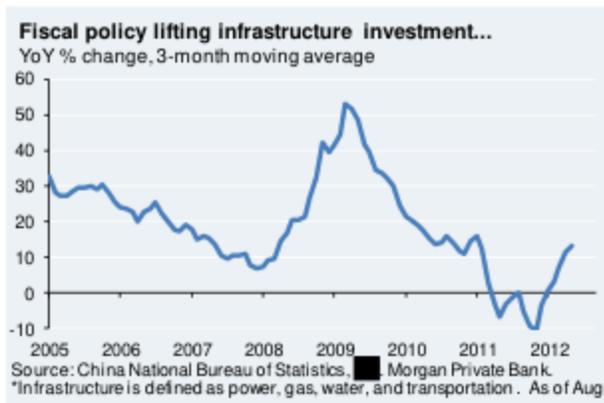
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## China: this is not what a hard landing looks like

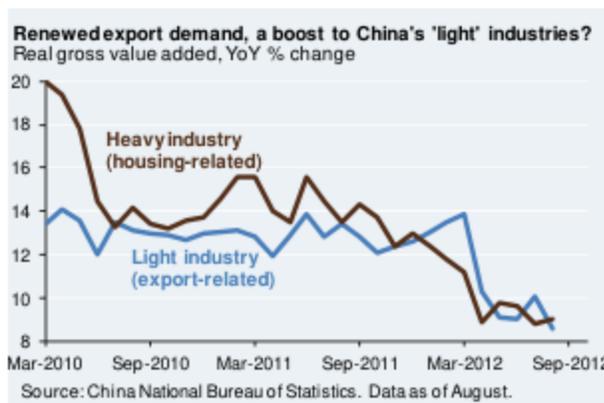
1/ Chinese activity seems to be stabilizing at weak levels, but not free-falling. Yet most of the street is still assigning a relatively high probability of a hard landing scenario, predicated on a severe real estate bubble collapse. The housing market has admittedly lost steam since late last year, but more recently, momentum has turned positive again. Indeed residential prices and home sales are pointing up (left chart), while cement and steel production are far from suggesting a free-fall scenario (right chart). Importantly, housing momentum is turning without any direct fiscal or monetary help. When true bubbles (like the US, Spanish and Irish ones) were ‘ready to explode’, nothing could stop them from doing so. **The stabilization in Chinese housing markets rejects the bubble hypothesis and the hard landing case along with it.**



2/ Recent announcements of several infrastructure projects totaling 1trn RMB, and the urgency in which these policies were communicated, are a clear indication that the government is willing to use fiscal policy to put a floor on economic growth<sup>1</sup>. Infrastructure investment growth is already showing up in the data (left chart) and the recent improvement in bank credit suggests that more spending in this area is underway (right chart)<sup>2</sup>. More infrastructure investment won't help the ongoing imbalance between investment and consumption, but more importantly for financial markets, it will support the medium-term growth outlook. Monetary policy also has more room to ease, although the authorities will likely move more slowly on this front. **On balance, while fiscal and monetary policy won't ease as aggressively as in the past, we anticipate the easing will be sufficient to stabilize growth at a 7%-handle.**



3/ With the housing market stabilizing, the bears are now using the manufacturing slowdown as ‘new evidence’ for the hard landing case. But this is misleading: China’s recent manufacturing slowdown was largely triggered by weakness in Europe, not by domestic forces. Indeed, a closer look at the data shows that the services sector has done better than manufacturing, and within manufacturing, export-related industries worsened more than housing-related industries (left chart). **Now that the ECB is getting better at managing the European crisis, we expect global manufacturing sentiment to improve from here, including in China** (right chart).



4/ The household sector is another area where stabilization is apparent. Aside from the pickup in housing demand, retail sales growth has stabilized, thanks to a moderate rebound in auto sales. The resilience of the labor market is another sign that household activity is not falling off the cliff. This is partly because service sector hiring was strong enough to offset the weakness in manufacturing-related employment. **Consumer spending is by no means strong, but here too, activity is forming a bottom.**

5/ To be sure, structural impediments are pulling China’s trend growth gradually lower. But the **policy agenda for the new generation of leaders is likely to be bold - especially in labor, product and financial markets**<sup>3</sup>. Importantly, the new leadership is realizing that the reform dividends from the past 29 years have been largely exhausted and that new supply-side reforms are needed, over and above the current ‘band-aid’ of fiscal and monetary stimulus.

**6/ Despite the apparent stabilization in economic activity, equity markets (both on-shore and off-shore) are still assigning a very high probability of a bad outcome.** The Shanghai A share market, which has the longest trading history, is trading at its lowest valuation ever, lower even than in 2008-09 (measured by trailing price to book). We believe the divergence between markets and the real economy will likely narrow over the next year or so as the eventuality of a soft landing becomes clearer.

Michael Vaknin  
Chief Economist, [REDACTED]. Morgan Private Bank

Fan Jiang  
Chief Investment Strategist - Asia, [REDACTED]. Morgan Private Bank

Dong Chen  
China Economist, [REDACTED]. Morgan Private Bank

[1] Some of these projects (highways, subways and energy-saving projects) were already brought up in the past, but a lot more items were added and the news was boldly telegraphed and timed just before President Hu's speech on infrastructure, which by itself, is an odd topic for the president. All of these signals stress the urgency of the government to stave off downside growth risks from here.

[2] Infrastructure spending is likely to overshoot as Chinese municipalities still have much to catch up on beyond these programs. The recent flood in Beijing showed how underdeveloped the sewage system is even in the most "urbanized" case.

[3] For example, under the new chairman of CSRC (China's SEC), there have been more deregulation and market friendly regulation measures in the past 6 months than the past 5 years. China is also gradually, but consistently, deregulating oil prices -- China just raised oil prices again this week.

#### Acronyms:

CNBS – China National Bureau of Statistics

CSRC – China Securities Regulatory Commission

ECB – European Central Bank

ISM – Institute for Supply Management

PMI – Purchasing Manager's Index

RMB – Renminbi/Chinese Yuan

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