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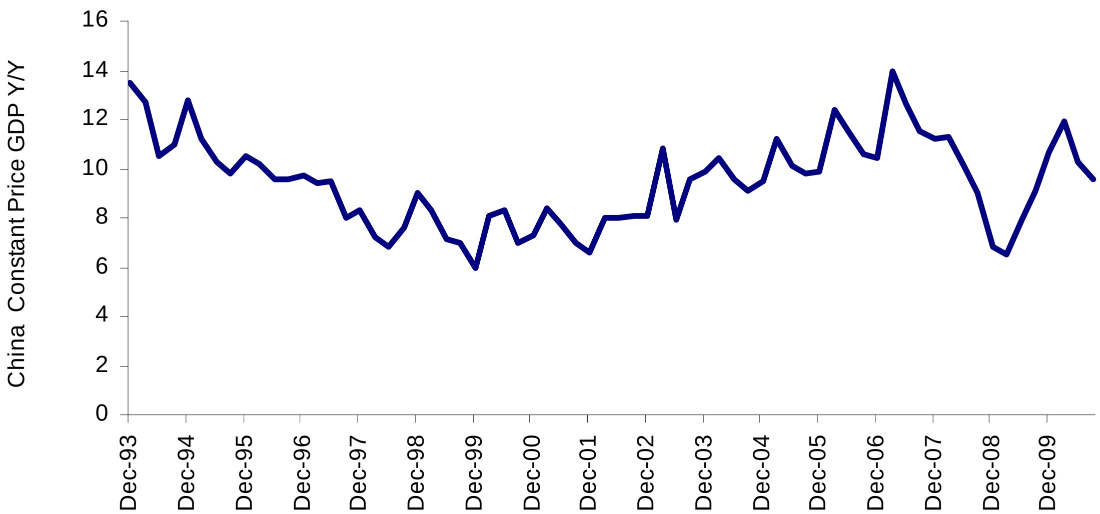
China Outlook: Growth and Monetary Tightening to Continue

President Obama is scheduled to meet with China's President Hu Jintao on January 19 in Washington. We participated in meetings in New York this week as part of China's economic dialogue with the U.S.

- While much of the Obama-Hu discussion will be on foreign policy issues like North Korea, Pakistan and Iran, there will be detailed discussion of economic issues including differences of opinion on exchange rates, intellectual property, China's inflation problem (it's been hiking interest rates and bank reserve requirements and holding down administered prices), and the linkage between China's inflation and the Fed's easy money policy (which has been weakening the dollar and driving up commodity prices). The U.S. wants China to liberalize its economy more and to encourage domestic consumption while China wants the U.S. to reduce the fiscal deficit, stop QE2 and begin monetary policy tightening.

- We expect China to continue growing fast in 2011 and have assumed 10% real growth in our 2011 outlook (down slightly from 2010.) China's new five-year "program" (they used to be called "plans") seeks 7.5% real growth. The IMF forecasts 9.5% average real growth for the next five years, which would dramatically increase China's share of world GDP.

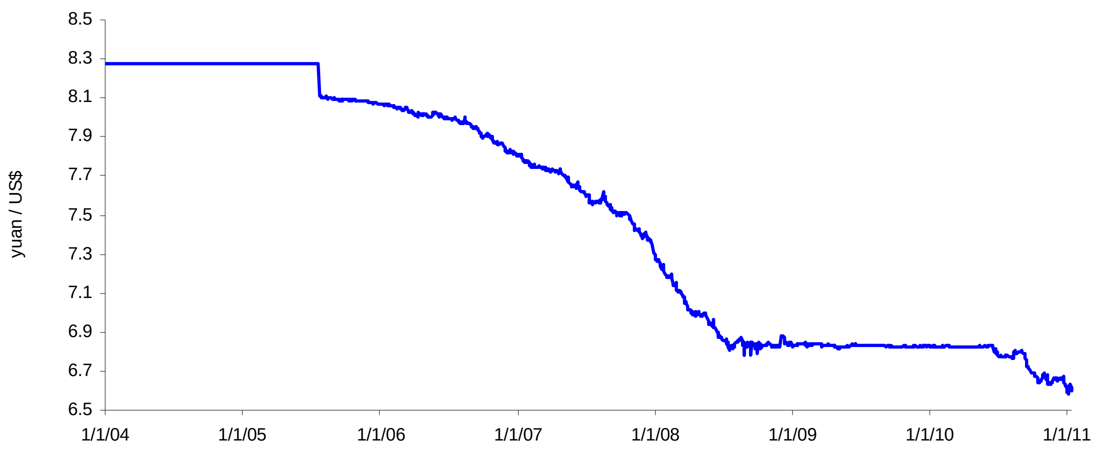
China GDP Y/Y (last obs. Q3 2010)



Source: Bloomberg; Encima Global

- We don't expect a change in China's policy of gradual yuan appreciation, which resumed in June 2010. Non-deliverable forwards on the yuan show a market expectation of a 3% appreciation over the next year (to 6.43 yuan in one year's time from the current 6.6 yuan per dollar.) We expect a 5%-6% appreciation rate, a continuation of the appreciation rate in place since mid-2010.

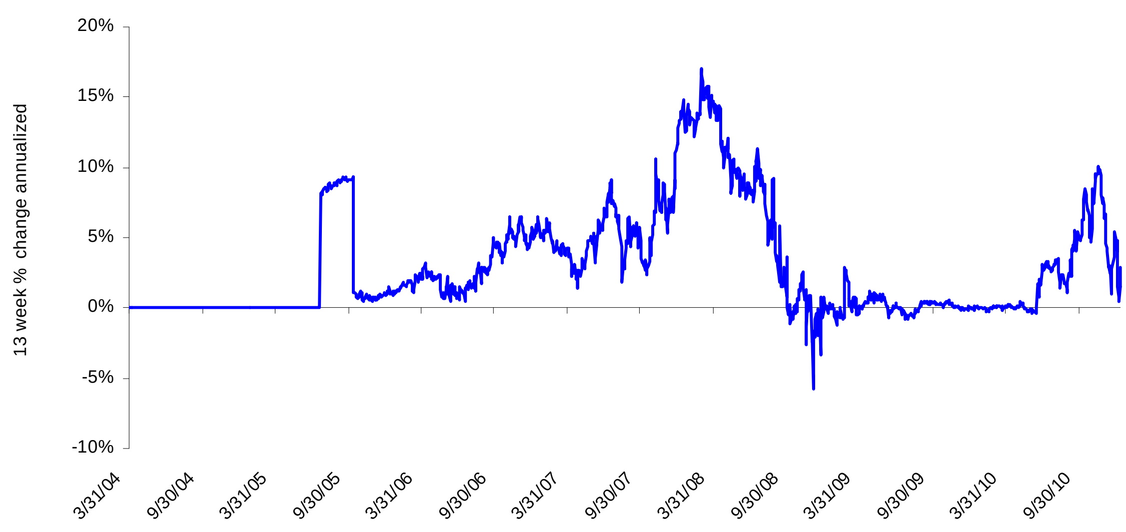
Yuan / US Dollar (last obs. January 12, 2011)



Source: Wall Street Journal; Encima Global

- The yuan's peak appreciation rate was in 2008 leading up to the Summer Olympics. Over the last week, the yuan has strengthened some prior to President Hu's U.S. visit. While the dollar's value against other currencies depends on U.S. monetary and fiscal policy (both weak for now), the yuan-dollar exchange rate is mostly based on China's internal decisions. Coastal exporting regions want less yuan appreciation. The U.S. and Europe push for more yuan appreciation.

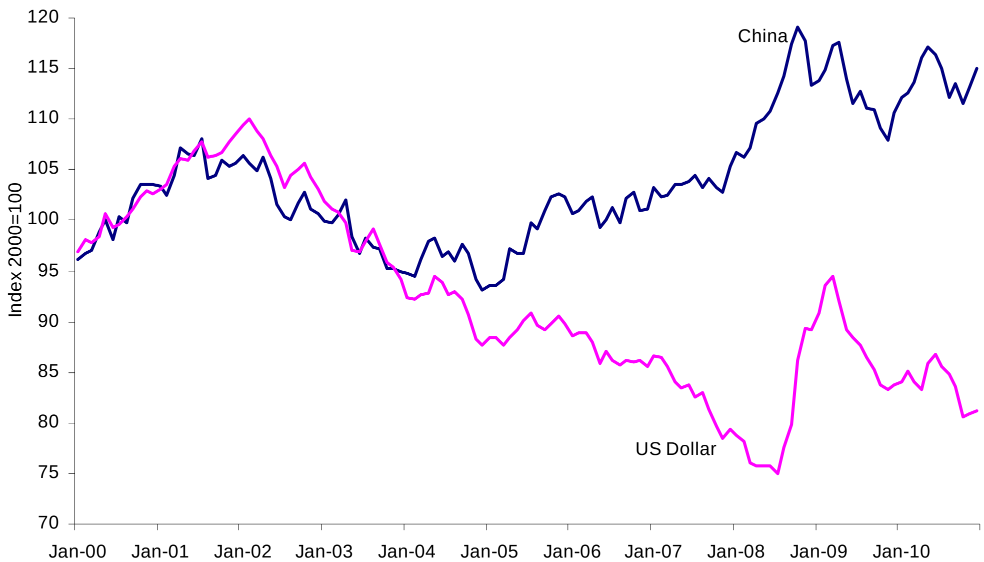
Yuan appreciation 13 week change annualized (last obs. January 12, 2011)



Source: Federal Reserve; Encima Global

* The yuan's 'real effective exchange rate' stands at 115.0 in JP Morgan's index while the dollar's is at 81.2. This measure takes into account the appreciation of the yuan against the dollar, the depreciation of both currencies against their other trading partners, and the inflation differentials (rising prices in China weaken the value of foreign currencies in China, reducing the textbook need for a revaluation.) Based on real effective exchange rates, the dollar has become undervalued versus its average while the yuan is more on the overvalued side (meaning prices are attractive in the U.S. and becoming unattractive in China.)

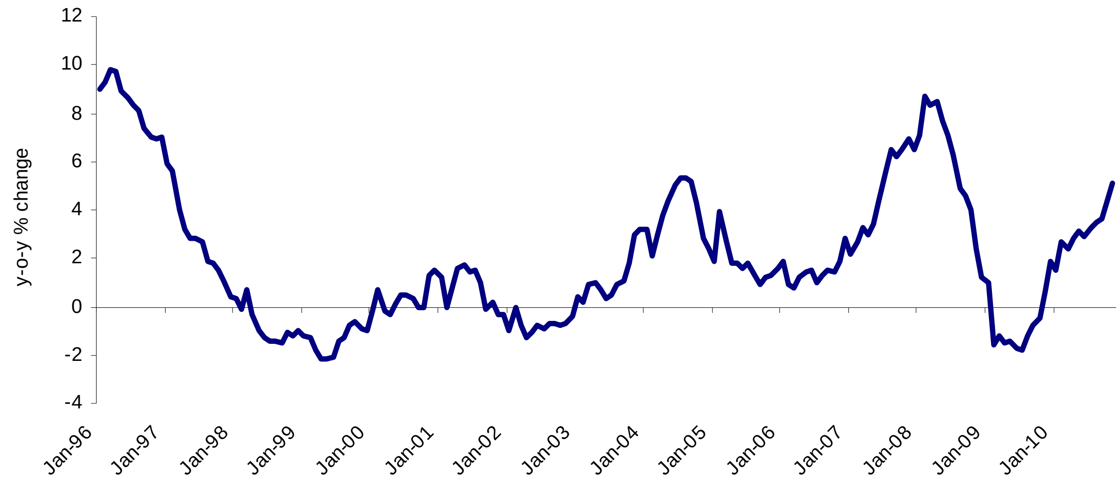
Real Effective Exchange Rates (last obs. December 2010)



Source: J.P. Morgan; Encima Global

* China's CPI inflation is now 5.1% year-over-year. Since China has adequate capacity in most sectors and is running a trade surplus, it's unlikely that inflation will become hot or create bottlenecks or hoarding. In a fast-growing developing country, a portion of CPI inflation is due to rising living standards rather than a failure of monetary policy. China's wage rates are rising for low-end workers, but we don't think that will be a major drag on profit growth because it is not a big portion of value added and is offset by productivity growth.

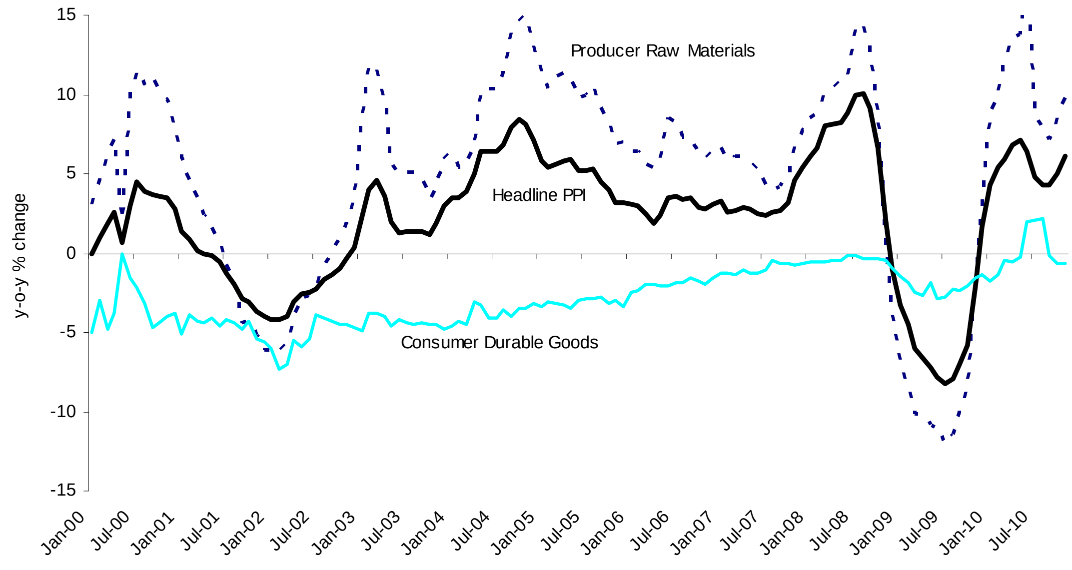
China CPI Y/Y (last obs. November 2010)



Source: Bloomberg; Encima Global

- China's PPI is also elevated at 6.1%, with producer raw materials growing at nearly 10%. Consumer durables PPI, once substantially negative, is now near zero.

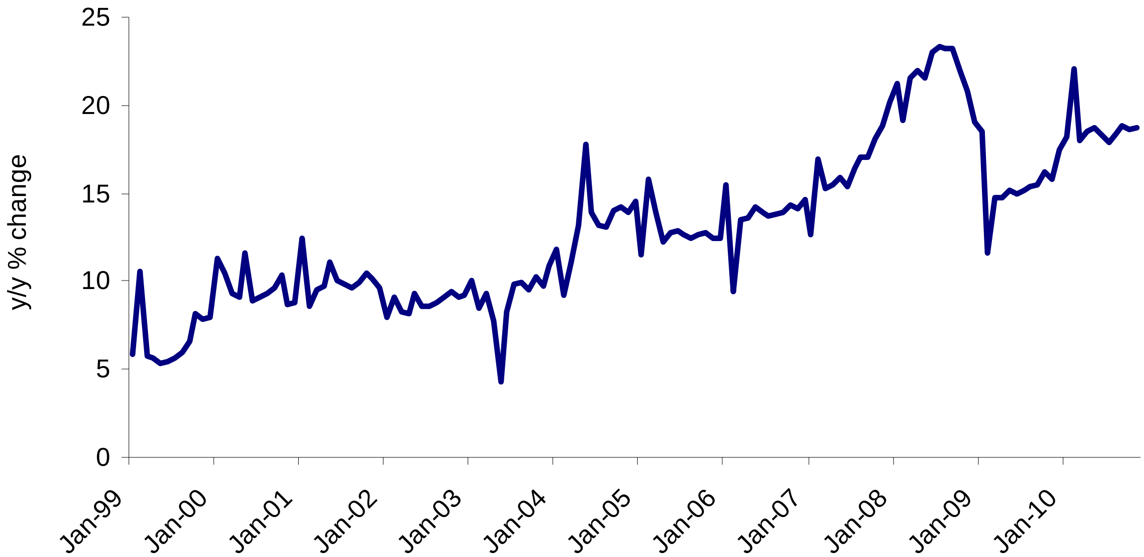
China PPI Y/Y (last obs. November 2010)



Source: Bloomberg; Encima Global

- China's retail sales are growing rapidly, about 18% y/y in nominal terms. We expect several factors to support fast retail sales growth in 2011 – higher incomes in rural areas; an expected increase in bank deposit rates; increased access to credit; and a still-increasing labor force (though the labor force is expected to peak in roughly 2016.)

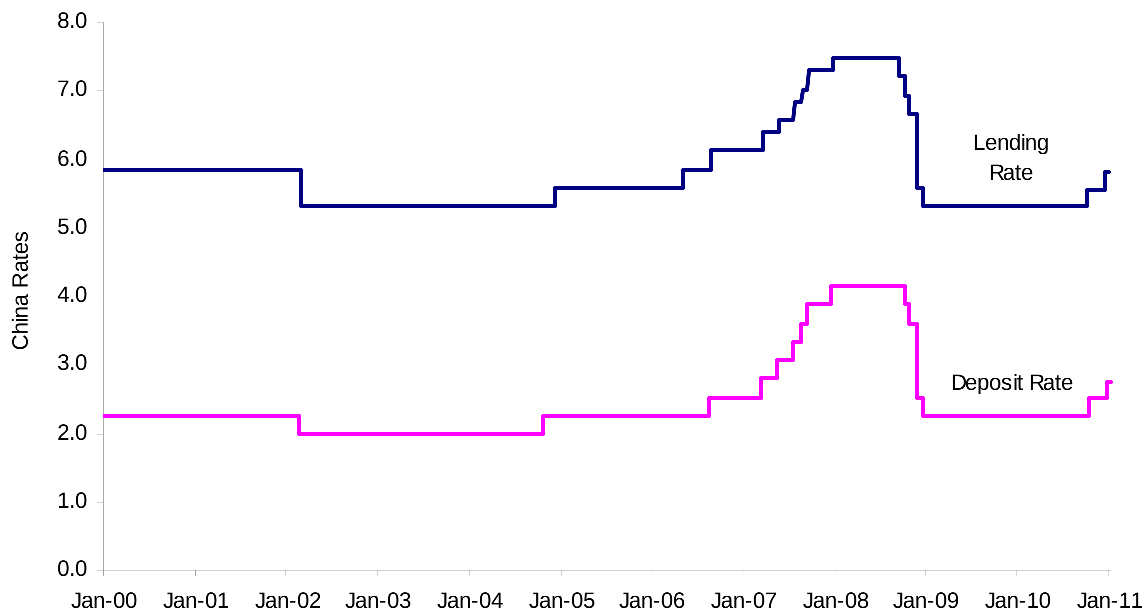
China Retail Sales Y/Y (last obs. November 2010)



Source: Bloomberg; Encima Global

- In response to inflation and fast growth, China raised bank reserve requirements repeatedly in 2010 and hiked interest rates on October 20 and December 26. We expect more interest rate hikes after Chinese New Year and, possibly, bigger hikes in the deposit rate than the lending rate to narrow the spread.

China Deposit and Lending Rate (last obs. January 12, 2011)



Source: Bloomberg; Encima Global

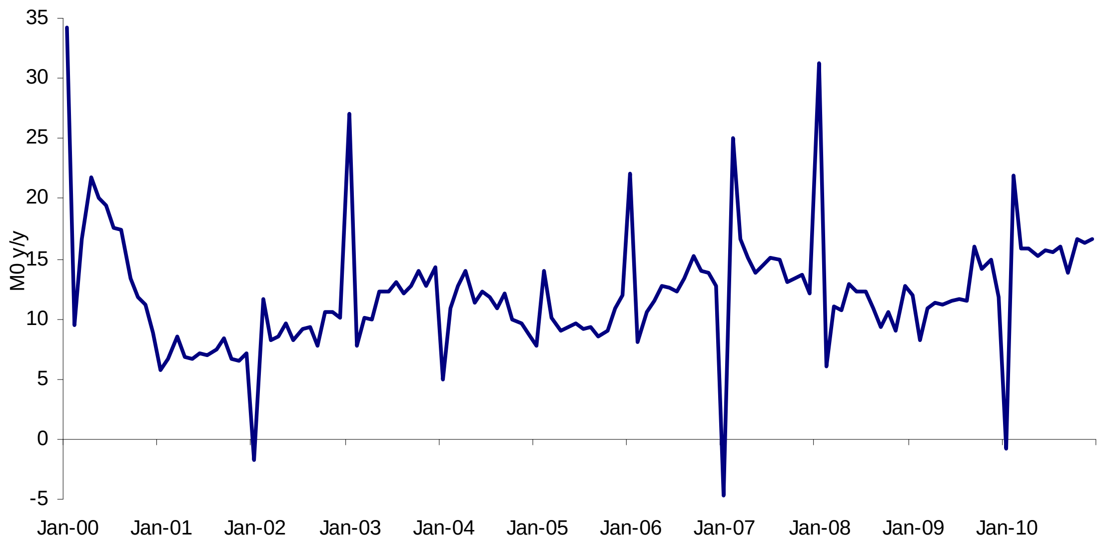
- M2 growth has slowed some from the 30% annual rate hit in 2009 when China expanded bank lending to counter the global downturn (a sharp and successful contrast with the credit crunch implemented in the U.S. during the downturn.) We think the current 20% growth in M2 will be maintained, though China will make an effort to improve the quality of bank lending by reducing loans to state-owned enterprises and local governments.

China M2 Y/Y (last obs. December 2010)

Source: Bloomberg; Encima Global

- M0 growth is now 16.7% year-over-year. It mostly reflects the issuance of paper currency as China's economy shifts from barter to cash.

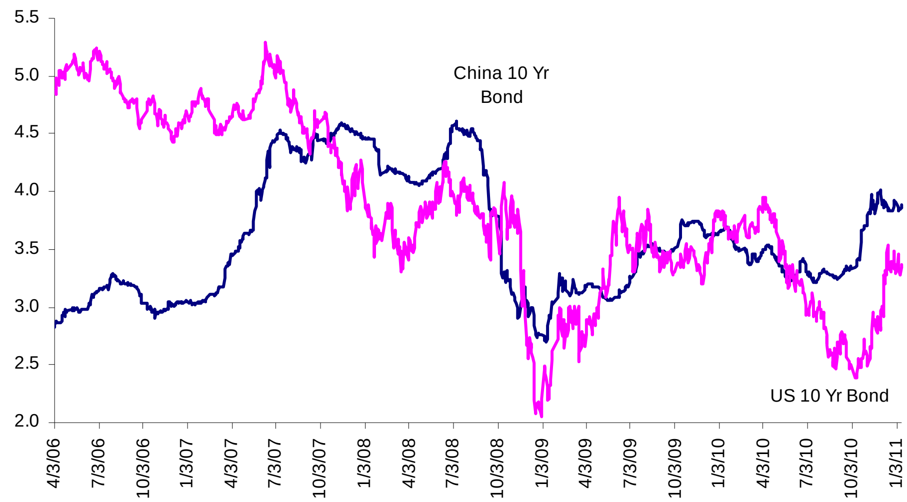
China M0 Y/Y (last obs. December 2010)



Source: Bloomberg; Encima Global

- China's ten-year bond yields have risen with PBOC rate hikes and the global economic recovery.

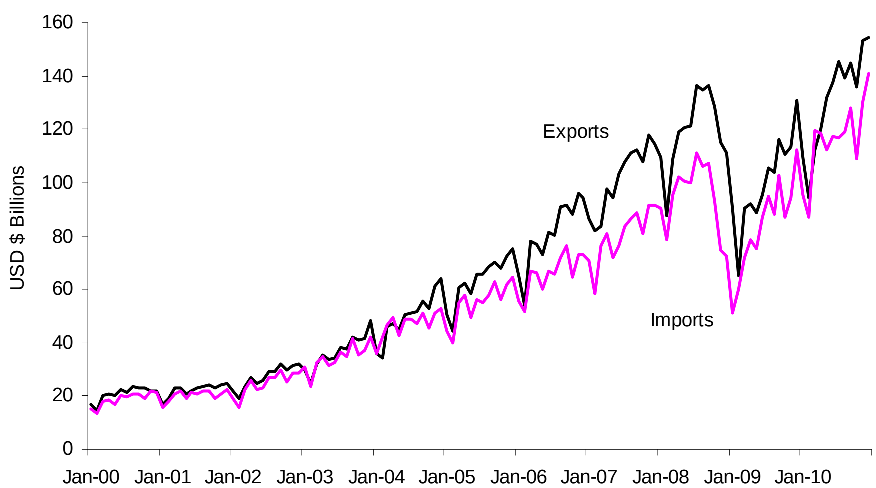
China 10 Yr bond yield (last obs. January 12, 2011)



Source: Bloomberg; Encima Global

- China's trade surplus (exports minus imports) has widened with the upturn in the global economy and the pickup in China's exports to meet the late 2010 U.S. acceleration. Exports in 2010 were 31% above 2009 while imports were up 39%. We expect these growth rates to moderate in 2011, with China's imports continuing to grow faster than exports, reflecting China's fast growth.

China Imports and Exports (last obs. December 2010)



Source: Bloomberg; Encima Global

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