13 October 2017

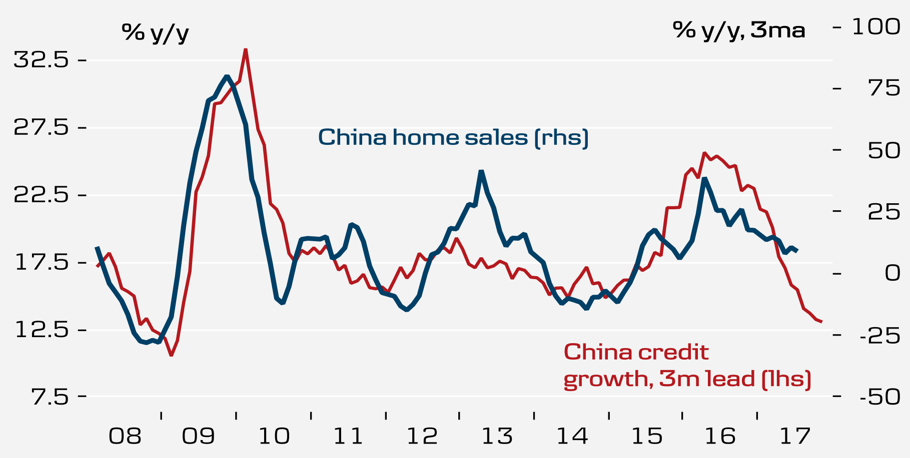
China outlook

Moderate slowdown and CNY stabilisation

- **We look for a moderate slowdown in China over the next year due to financial tightening and measures to cool housing. We forecast GDP growth to be 6.8% in 2017 and to fall to 6.3% in 2018. A hard landing is not likely, though, as residential inventories are low and exports are supported by robust global growth.**
- **We believe the 19th Party Congress will lead the way for more implementation of economic reforms. Inefficient indebted SOE's and overcapacity is at the core of the problem.**
- **We expect more steps to contain financial risks over the next year, but it will likely continue in a 'two steps forward - one step back' fashion.**
- **China's rebalancing is progressing but too slowly in our view. The economy is still too dependent on construction and infrastructure investments. This could eventually lead to a crisis but it is not likely to happen in the next few years.**
- **We expect the CNY to be broadly stable versus the USD over the next year but to weaken versus the EUR. Chinese stocks will see less tailwind as growth slows and bond yields have likely peaked for now.**

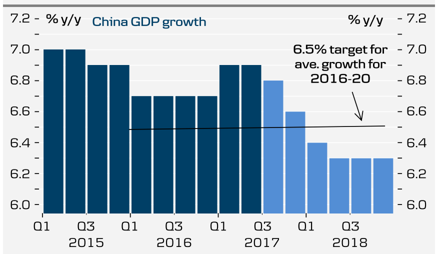
When China's political leaders meet for the 19th Congress of the Communist Party on 18 October, they are likely to be very satisfied with the economic and financial developments. After going through a financial storm in 2015 and early 2016 that caused fears of a very hard landing, the situation has turned to one of calm and robust growth. GDP in the first two quarters came in at a higher-than-expected 6.9% and the currency has turned around and strengthened 5% against the USD this year - contrary to market expectations. The goal of stability ahead of the Congress has been achieved.

Chinese housing set to slow on the back of financial tightening



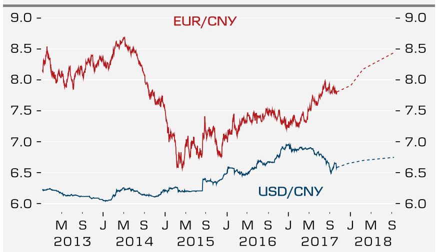
Source: Bloomberg, Danske Bank, Macrobond Financial

China growth outlook



Source: Macrobond Financial, NBS, Danske Bank

CNY outlook



Source: Macrobond Financial, Danske Bank

Recent China research

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CNY outlook: Stabilisation versus USD, weaker versus EUR, 6 October 2017

Flash Comment China: Mixed PMIs - moderate slowdown ahead, 2 October 2017

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Xi Jinping is also on track to deliver on the goal of making China a 'moderately prosperous society' by 2020. This was formulated as a doubling of income from 2010 to 2020 and when launched in 2015 it required an average growth rate of 6.5%. As China's economy is set to grow 6.75% on average in 2016 and 2017, the goal will be reached even with a decline in growth to 6.3% on average from 2018-2020. This is clearly within reach.

China's leaders can also be satisfied with the first round of attacking the financial risks in the economy. Over the past year, Chinese authorities have increasingly cracked down on the very rapid growth of shadow banking products. It triggered bouts of financial stress during the spring months - but again without causing systemic problems or a negative spiral. China proved again to have an ability to control the economy and stabilise a situation that could have spun out of control. The downside risks we saw from this six months ago are no longer prevalent. **We do still see big risks from the rapid rise in debt and the growing shadow banking sector but a crisis is not likely in the next few years in our view** (more on this below).

On one front, the authorities cannot be too happy. The **housing market has proved very difficult to tame after the big stimulus in 2015** and early 2016. House prices in the big cities have gone through the roof and have added to affordability issues for Chinese households. It has created increasing inequality in wealth and has added to already high inequality in incomes. In cities like Beijing, Shanghai and Shenzen prices doubled over the past two to three years and in 16 major Chinese cities the price-income ratio is above 10. President Xi Jinping addressed the issue in December last year when he stated 'houses are made for living, not speculating'. China depends a lot on the development in the housing market as both households and a sizeable construction sector have a high stake in housing and a significant part of China's high debt is exposed to the property sector. It is thus crucial that China can manage a sustainable development in housing over the coming years.

Growth set to cool as housing is bound to slow

For this reason, **China has implemented a long range of tightening measures** over the past year. Requirements for downpayment for homebuyers have increased, home purchase restrictions have been imposed, mortgage rates have increased and lending to property developers has been restricted. We expect the measures to have an increasing impact and take the froth out of home sales and house prices. There are already clear signs of this taking place in some surveys and house price inflation has come off the boil.

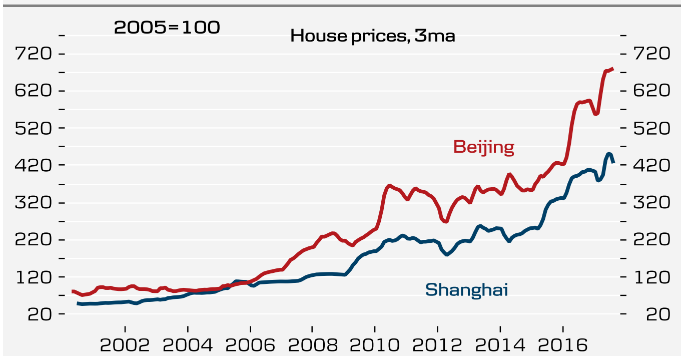
On track to become a 'moderately prosperous society' in 2020

Source: Macrobond Financial, IMF, Danske Bank

Bond markets have stabilised following bouts of stress in H1

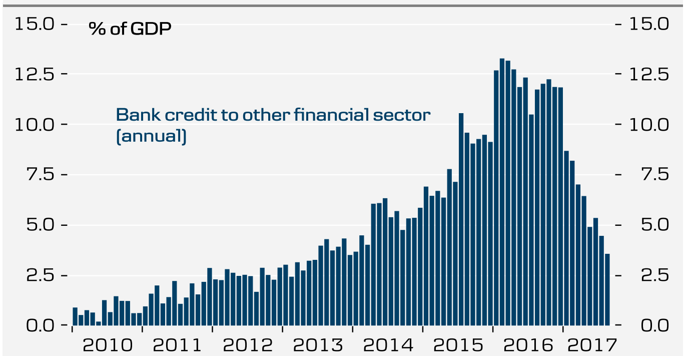
Source: Macrobond Financial, IMF, Danske Bank

House prices in big cities almost doubled past two years



Source: Macrobond Financial, Danske Bank

Crackdown on shadow banking is very visible in bank claims on other financial institutions



Source: Macrobond Financial, Danske Bank

With housing set to cool, the **construction sector should start to face some headwind** over the next year. Official construction investment data do not suggest there has been a big pick-up in construction but we suspect they underestimate the real impact as a long range of indicators points to a robust pick-up in construction: (1) PMI construction is back at the level in 2012 when the previous housing boom took place and (2) steel production has increased significantly this year, which normally is a sign of a construction boost.

One thing to look out for heading into the winter is a change of seasonality. Earlier this year China announced curbs on steel and aluminium in the coming winter in order to reduce pollution. As a consequence it looks like Chinese companies have produced more steel than usual in Q2 and Q3 (see chart). It means activity will cool and the PMI manufacturing survey could very well make a shift lower as we head into the winter starting in November.

While we look for a slowdown, it should not turn into a hard landing. First, the global economy is in a good shape, fostering robust growth for Chinese exports. Second, housing inventories are quite low after a period of very strong home sales. The picture is still very diverse as especially in the big cities there is a scarcity of housing, whereas inventories are higher in tier-3 and tier-4 cities.

After two decent quarters in the first half of 6.9% y/y, we project growth for 2017 to end up at 6.8%. In 2018 we look for a moderation to 6.3%.

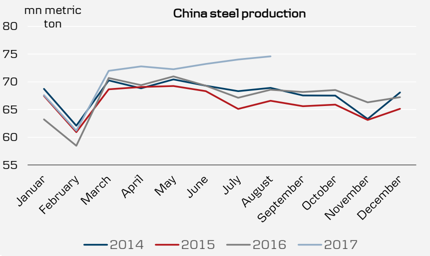
Reform pace not as bad as it seems...

Xi Jinping has gotten a lot of criticism for not delivering on his reform promises. After presenting an ambitious reform agenda following the 3rd Plenum of the Central Committee in the Communist Party in 2013, hopes were high for a reform push. However, on several fronts implementation has lagged. Overcapacity in many sectors is still significant and the State Owned Enterprises (SOEs) have become even more indebted and are still supported by subsidies and favourable lending terms relative to private companies.

We are optimistic, though, that Xi Jinping will put more efforts into economic reforms once he has secured his power base after the Congress. At a party workshop held in July this year Xi stressed that China will 'keep deepening supply-side reform to push forward'. It includes the 'major tasks of deleveraging, destocking, cutting excess capacity, reducing costs and shoring up weak areas', see *press release* by state media Xinhua**.**

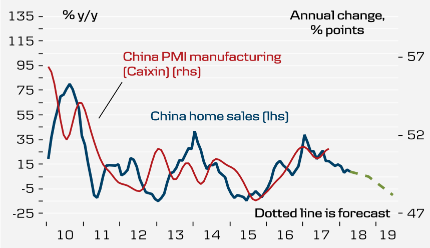
We should not expect the state sector to have much less control than it has today as there are no signs of this, but efforts to make the state sector more efficient alongside strengthening the private sector are set to be reinforced.

Chinese companies have ramped up steel production ahead of winter curbs



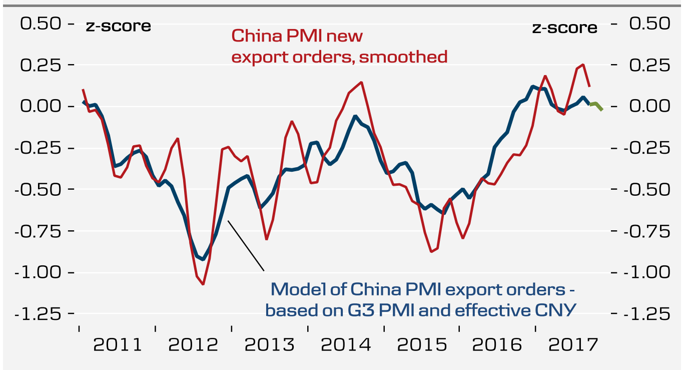
Source: Macrobond Financial, Danske Bank

Cooling housing market to weigh on manufacturing



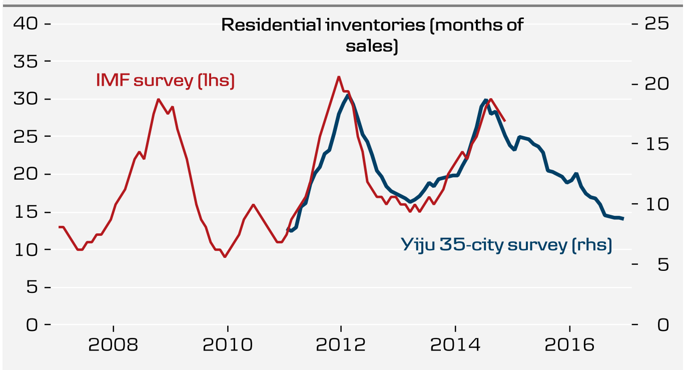
Source: Macrobond Financial, Danske Bank

Export surveys and our model point to robust export growth



Source: Macrobond Financial, Danske Bank

Low housing inventories to avoid hard landing in construction



Source: Macrobond Financial, Danske Bank

In many areas, China has already made reforms that have gotten less recognition than they deserve

First, **fighting corruption** is key to make the economy more efficient. China's patronage and vested interests in the state sector have been well documented (see for example "China's crony capitalism" by Minxin Pei (2016)). Corruption creates entry barriers into markets and limits the 'creative destruction' needed to allow for new technologies to take over from old. With its serious corruption campaign launched by Xi Jinping in 2013, China has taken serious steps to improve the efficiency of the economy.

Second, China is putting a lot of focus **on industrial upgrading** through technology investment and innovation. The '*Made in China 2025'* strategy is aiming directly at this. In addition, China has increased *R&D spending* significantly over the past 10 years; in 2015 China filed the most *patent applications* in the world. The many studies done of how to avoid the 'middle income trap' put a lot of emphasis on the need for technological upgrading, see for example the study by Asia Development Bank: *Growing beyond the low-cost advantage – how the PRC can avoid the Middle-Income Trap*.

Finally, China has put focus on improving **conditions for small businesses and stimulating entrepreneurship and innovation**. As late as this month PBoC lowered the Reserve Requirement Ratio for banks that allocated a certain part of the liquidity to small and medium-sized businesses. Last year China also implemented a tax reform that has reduced business taxes in exchange for VAT, a reform that got a lot of praise by the *OECD*. According to the *State Council* an average of 15,600 new enterprises registered on a daily basis this year with 95% being in the private sector.

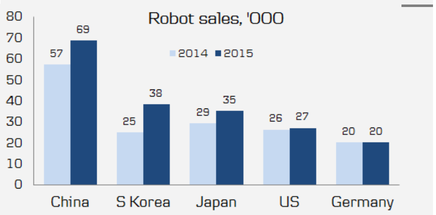
There are no signs, though, that China will move away from having a strong state control with SOEs playing a critical role in the so-called strategic industries. These are for example in the sectors of banking, infrastructure and resource extraction. China's strategy is mostly to consolidate and create even bigger SOEs - not reduce their role. Mixed private-public ownership is growing as an attempt to force through more efficiency, but still with the state having majority control.

While China still has a long way to go to make the SOEs more efficient, the fight of corruption, continued technological upgrading, focus on innovation and education of the Chinese workforce are in our view more critical in driving China's economy forward in the years ahead.

... but China still invests too much

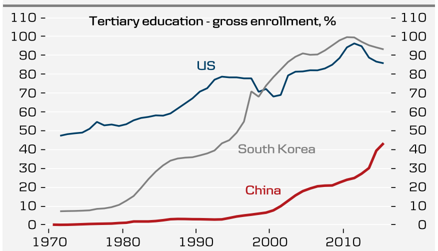
When it comes to rebalancing of the Chinese economy, there are still some challenges. Although consumption is taking up a rising part of GDP, investments still dominate with a share of more than 40%. It is not a problem in the short run as China can still justify more infrastructure and housing but the pace at which new houses are built and new roads and railways are constructed is very high and it means that a significant part of Chinese companies are employed in these sectors. At some point the need for new housing and infrastructure will come down and a lot of these companies will not survive. Many of them are highly indebted and a significant amount of debt losses will likely be the result. **This is the main reason why we believe it will be hard for China to avoid a crisis at some point down the road.** However, for the next few years, the investment spree is likely to continue and it is set to keep profits growing enough for the debt servicing costs to be paid. China is also likely to continue the push for deleveraging and the crackdown on shadow banking started last year. It will be in the usual Chinese 'two steps forward, one step back' fashion but it will help to diminish the risk of a crisis in the next couple of years.

China now biggest market for robots as it upgrades its industries



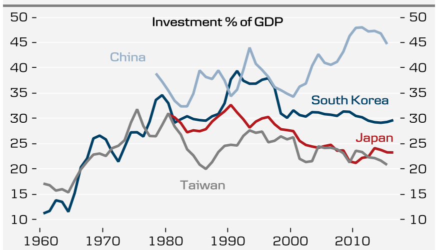
Source: International Federation of Robotics, World Robotics Report 2016

Chinese workforce is also getting an upgrade as more enter universities



Source: World Bank, Macrobond Financial

Investment rate still much higher than Asian peers during their catching up



Source: Macrobond Financial, Danske Bank

CNY stabilisation, equities to see less tailwind

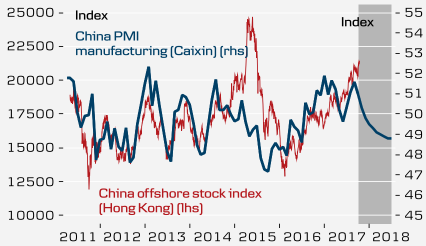
The development in the CNY took most China watchers by surprise this year (including ourselves) as the renminbi reversed course from the weakening trend against the USD that started in 2014. Since January the CNY has strengthened 5% against the USD as capital outflows have been sealed and financial tightening led to rising Chinese interest rates relative to US rates. At the same time a general weakening of the USD weighed on the USD/CNY.

Looking ahead, we believe the *relative rates* will start to put upward pressure on USD/CNY again. We expect another three Fed hikes over the next year to lift US money market rates while Chinese money market rates are projected to be stable or even decline a bit in response to lower growth. Chinese inflation is currently below 2% and thus clearly below the 3% target with no need for monetary tightening. On the other hand, as we expect more general *USD weakness* this will exert a continued downward pressure on USD/CNY. **We believe the two opposing forces will more or less even each other out and we expect USD/CNY to move up only very little to 6.75** in one year from the current rate around 6.60. Given our expectations for EUR/USD it implies a continued weakening of the CNY against the EUR.

Chinese equities have performed extremely well this year. The MSCI China index is up close to 50% while the offshore index is up more than 25%. Rising profit growth and high expectations for a new reform push after the Congress have been key drivers behind the strong rally.

However, the strong profit growth is driven by the economic recovery and increases in producer prices. Looking ahead, our expectation of slower Chinese growth and a peak in producer price inflation means that the strong tailwind to Chinese stocks will fade. We could thus see a **reversal of the strong Chinese market once we get on the other side of the Congress and PMI manufacturing heads lower over the winter**.

Decline in Chinese PMI to create headwinds for equities



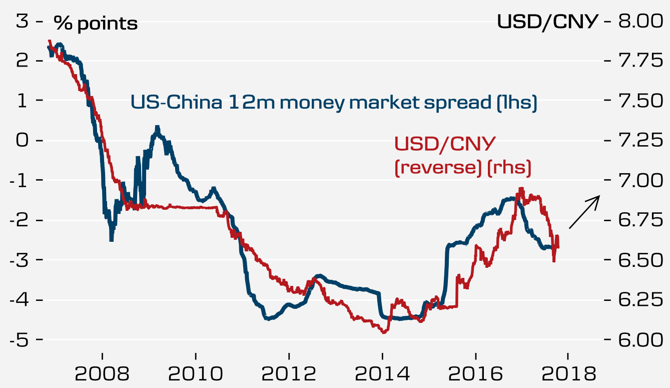
Source: Macrobond Financial, Markit, Danske Bank

CNY forecast

	Danske	Forward
EUR/CNY		
13-Oct	7.79	
+3M	7.91	7.88
+6M	8.17	7.97
+12M	8.44	8.15
USD/CNY	Danske	Forward (NDF)
13-Oct	6.58	
+3M	6.65	6.62
+6M	6.70	6.65
+12M	6.75	6.73

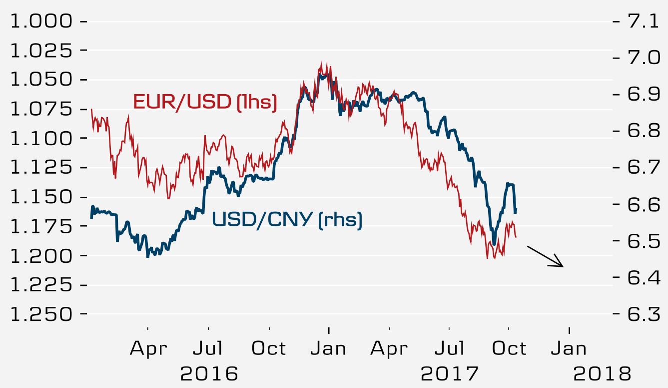
Source: Bloomberg, Danske Bank

Relative rates to work against the CNY again...



Source: Macrobond Financial, Danske Bank

... but the weaker USD will work the other way



Source: Macrobond Financial, Danske Bank

China outlook

	2015	2016	2017	2018	2019
GDP[1]	6.9	6.7	6.8	6.3	6.2
Private consumption[1]	8.3	8.4	8.5	8.0	7.7
Investment[1]	6.1	6.3	5.2	5.0	5.0
Net exports[2]	-0.1	-0.5	-0.3	-0.2	-0.2
Total investment share[3]	44.7	44.2	43.7	43.2	42.8
Total savings rate[3]	47.5	45.9	45.1	44.3	44
Current account balance[3]	2.8	1.7	1.4	1.1	1.2
CPI[1]	1.4	2.0	2.0	2.4	2.5
Household income (real)[1]	8.2	7.8	8.0	7.5	7.0
Household savings rate, % of disp income	35.5	36.0	35.5	34.0	33.0
Wage growth (nominal, urban)[1]	10.3	10	10.1	9.0	8.5
Government budget balance[3]	-2.8	-3.7	-3.7	-3.4	-3.4
Augmented fiscal balance (IMF)[3,4]	-10.2	-12.4	-12.6	-12.6	-12.6
USD/CNY[5]	6.5	6.96	6.7	6.5	-
EUR/CNY[5]	7.1	7.3	8.0	8.4	-
PBoC 1-year lending rate, %[5]	4.35	4.35	4.35	4.10	-

Notes: 2017-2019 is forecast. 1: % y/y, 2: contribution % to GDP, 3: % of GDP, 4: Includes local gov and off-budget activity plus excludes land sale proceeds, 5: end of year

Source: IMF, Danske Bank, Bloomberg

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None.

Date of first publication

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Report completed: 13 October 2017, 07:36 CEST
Report first disseminated: 13 October 2017, 08:10 CEST