"Recent news on Chinese economy"

As the biggest economy in the world, news about the Chinese economy is at the center of attention of the world, particularly emerging economies in the region. Therefore, here we would like to discuss recent news and policy changes by the Chinese government on its economic performance.

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Current performance of Chinese economy

The latest quarterly economic figures for China have been released.

In the third quarter of 2014, China's gross domestic product expanded 7.3 percent year-on-year, slumping to a five-year low. (Chart 1) The slowdown was driven by lower property investment, dwindling credit growth and weakening industrial production. Quarter-on-quarter, the GDP expanded 1.9 percent, compared with a 2 percent from April to June. Year-to-date the economy grew 7.4 percent.

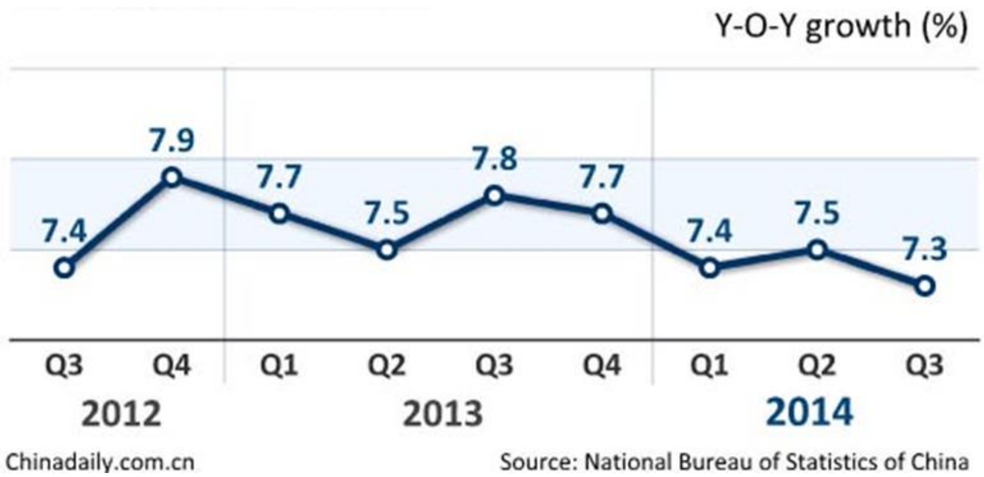


Chart 1. GDP growth trend of China

Growth in nominal retail sales decelerated from 12.3% in Q2 to 11.9% in Q3. In addition, urban fixed -asset investment, which includes capital and construction investment, expanded an accumulated 16.1% in nominal terms in the first three quarters of this year, which was down from the accumulated 17.3% increase recorded in the first half of this year. Also, in September inflation rate slowed for the second straight month to an annual 1.6 percent, down from 2.0 percent in the previous month and reaching the lowest level in nearly five years.

Housing sales for the first three quarters of this year have fallen 10 percent, while property development growth in general dropped 12.5 percent for the same period. Manufacturers as well as certain commodities have also taken a hit, with industrial production declining by 0.3 percent from the previous six months. Steel in particular has taken a large hit due to the recent course change of China's economy. *The Nikkei* reported on Wednesday that the price of reinforced steel has dropped around 20 percent since the beginning of the year to 1.5 yuan ($0.24) per 500 grams, or "roughly the price of Chinese cabbages."

At the beginning of October, The World Bank has cut China's growth forecast for the next three years and projected the GDP would slow down in 2014 to 7.4 percent from a previous estimate of 7.6 percent. Yet, Chinese officials have pledged the government would tolerate growth slightly lower than the targeted 7.5 percent for 2014.

The People's Bank of China cut interest rate; first cut in more than two years

The People's Bank of China (PBoC) has announced an interest rate cut effective from 22 Nov 2014. This is the first rate cut since Jul 2012. One-year benchmark deposit rate is cut by 25bp to 2.75% and one-year benchmark lending rate is cut by 40bp to 5.60%. Meanwhile, banks are now allowed to offer deposit rates up to 120% of benchmark (from 110% previously) and tenor brackets are simplified, as another step for interest rate liberalization. The PBoC liberalized lending rates in July 2013, so the PBoC wishes to use this cut as policy guidance for banks to cut lending rates. The impact of this deposit rate cut is actually quite small. Given that the PBoC also relaxes ceiling of deposit rates and all banks are likely to raise rate to the ceiling, effectively there could be no change in one-year deposit rate at banks (at 3.3%). In comparison, the magnitude of lending rate cut is bigger, at 40bp for 1y and 5y loans.

Table 1: Interest rate change details

	New %	Prev. %	Chg. bp	New %	Prev. %	Chg. bp
Deposit rate	Benchmark			Maximum		
Demand	0.35	0.35	0	0.42	0.39	3.5
3 Month	2.35	2.60	-25	2.82	2.86	-4.0
6 Month	2.55	2.80	-25	3.06	3.08	-2.0
1 Year	2.75	3.00	-25	3.30	3.30	0
2 Year	3.35	3.75	-40	4.02	4.13	-10.5
3 Year	4.00	4.25	-25	4.80	4.68	12.5
Lending rate	Benchmark					
6M-1 Year	5.60	6.00[1]	-40[1]			
1-5 Year	6.00	6.40[2]	-40[2]			
5 Year+	6.15	6.55	-40			

Note: 1 - For 1 year tenor; 2- For 5 year tenor.Source: PBoC, BofA Merrill Lynch Global Research.

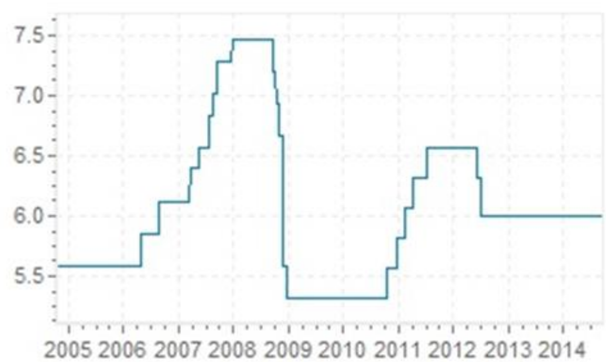


Chart 2. PBoC Interest rate for last 10 years

The special timing of rate cut could be related to the lackluster launch of Shanghai Hong Kong Stock Connect and falling A share prices.

Positive for the real economy and corporate

This rate cut is surely positive for big State Owned Entities and home mortgage borrowers, who could enjoy the minimum lending rates. Small and medium sized enterprises will benefit from an overall looser liquidity condition and lower rates.

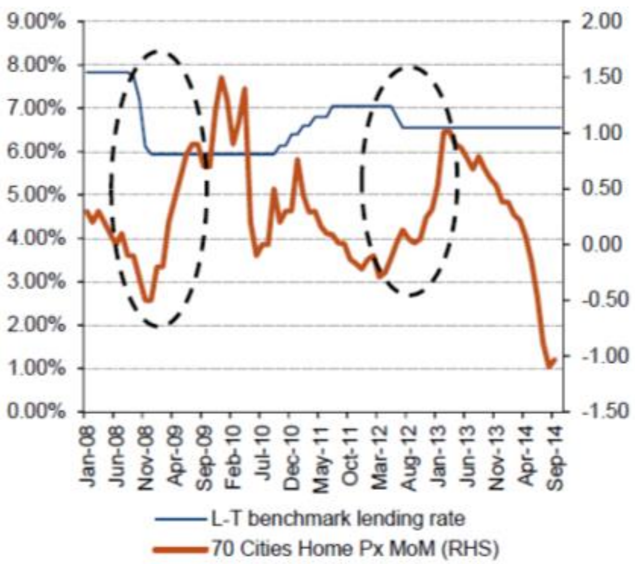
With the rate cut the China property sector has potentially reached the infection point. As credit and monetary policy has been crucial leading indicators or key drivers in the past cycles, China property stocks, along with volume and home prices, did rebound substantially and bottomed out with various degree of time lag, in the last two interest rate down-cycles in late 2008, and mid-2012.

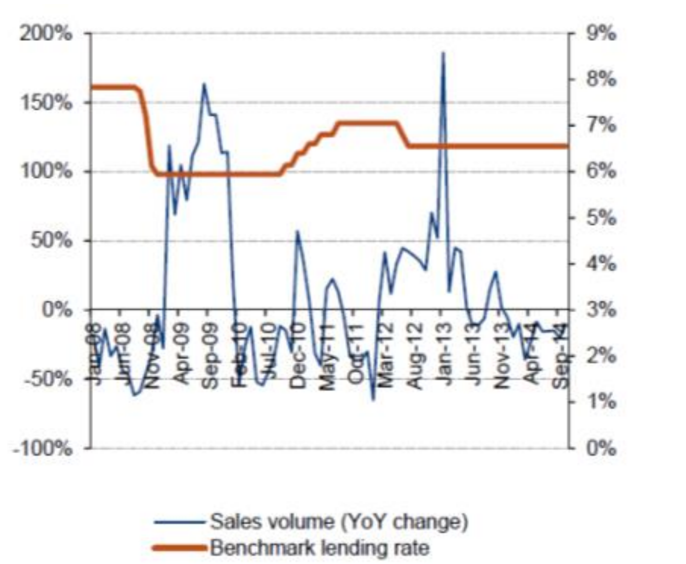
Developers with higher percentage of onshore debt should benefit more from the saving in cash interest expense. Merrill Lynch upgraded Guangzhou R&F, and Country Garden (CG) from Neutral to 'Buy', due to the debt structure and/or undemanding valuations. Both R&F and Country Garden have seen their share prices dropping 28% and 38%, respectively YTD compared with 13% drop for the sector. R&F is trading at only 2.9x FY15 PE and 6.3% dividend yield and Country Garden at 4.5x FY15 PE and 7.8% yield.

After a long bull run, China's property market, which makes up about 15 percent of its economy and is the main driver of demand in some 40 industries from cement to steel, has grappled with soft prices and mounting inventories for at least six months.

Stocks and physical market reacted significantly in past cycles

In the past two cycles, both volume and average selling price showed marked recovery after the rate cut (Chart 3 & 4). Volume could react faster as the rate cut in 2012 was followed by an almost immediate increase in volume (42-45% YoY in June/July-12), though there was a time lag of about 3 months for the rate cut in 2008. Home price initially stabilized, and then showed more noticeable recovery in about 6 months in both '08 and '12. This time, Merill Lynch acknowledged that volume to continue to recover on the back of rate cut, home price may stabilize for a longer period considering the prevailing inventory situation. China property stocks had rallied significantly from trough to peak following the rate cuts, by 200% in '08-09, and by 42% in '12-13 (Chart 5).

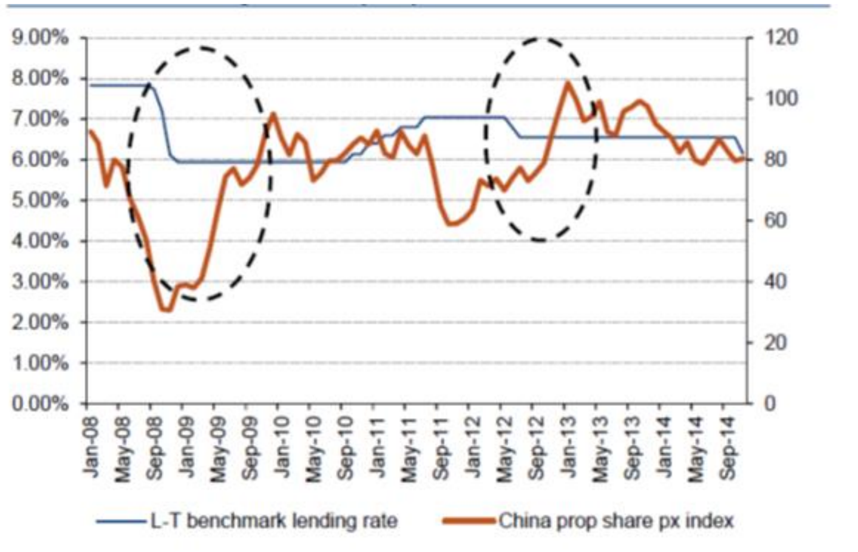




Source: BofA Merrill Lynch Global Research

Chart 3: Interest rate change vs. home price trend cities

Chart 4: Interest rate change vs. sales volume in key



Source: BofA Merrill Lynch Global Research

Chart 5: Interest rate changes vs. share price performance

With interest rate cut and mortgage easing in place, the property sector will be stabilized, with sales volume picking up gradually over the next few months and price decline moderating. According to the Merrill Lynch, property sales in Nov and Dec in 14 key cities will stay strong. Besides, property price drop has decelerated from -1.1% MoM in September to -0.8% MoM in October, according to 70 cities property price index. Property sales and price have a strong correlation to stock performance as can be seen in the two charts above. After two years of underperformance in 2013 and 2014, the sector is likely to rebound with the roll out of policy loosening to support the property market. Developers which are more highly geared and with bigger percentage of total debt coming from onshore channels will get more benefit in the interest rate down cycle.

Table 2: Sector share-price performance during tightening and loosening cycle

	Stock up/down	Sector share price performance	Hang Seng Index	Property policy
2009	↑	131%	52%	Loosen
2010	↓	-9%	5%	Tighten
2011	↓	-29%	-20%	Tighten
2012	↑	68%	23%	Loosen
2013	↓	-8%	3%	Tighten
2014 (YTD)	↓	-13%	1%	Loosen
2015				Loosen

Source: Bloomberg and BofAML Global Research

Impact of the PBoC interest rate cut on outside world

The PBoC official stated that this interest rate cut decision focused on enabling the benchmark interest rates to guide market interest rates and financing cost of the real sector to move downward, so that the real interest rates will gradually return to normal levels to ease the high financing cost of enterprises and provide a neutral and appropriate monetary and financial environment to support sustainable economic development. Therefore this interest rate cut is less likely to have a permanent impact on global economy or commodity market. The Wall Street Journal concluded that China's surprise interest rate cut, coupled with a free-trade deal between Canberra and Beijing, gave only a short-lived lift to Australia's mining sector. On following Monday of the interest rate cut, stocks like Fortescue Metals Group Ltd., BHP Billiton Ltd. and Rio Tinto Ltd., rose strongly. But by Tuesday morning, they were giving up gains. Copper price has also shown the same movement on the following few days after the decision announced. Many economists note that the China's rate cut would not have a major impact on massive oversupply in China's property market and a demand shortage. Therefore, it hardly influences the bearish commodity market and the price of the oversupplied commodities. Iron ore, for example, is in such significant oversupply, so slightly better demand in China will not likely be enough to make a difference in price movement.

Conclusion

Recent decision of interest rate cut of PBoC is mainly aimed at supporting slow growth of the economy through the low cost financing for its local manufacturer and property sector. Last two interest rate cuts in 2008 and 2012 showed significant positive effects on property sector generally, however this time, many economists doubt that interest rate cut, without any supplement economic stimulus, may not have a major impact on China's property developer and real estate market. In that sense, some economists and analysts, including Chief China economist of Merrill Lynch, are expecting more economic stimulus from China.

Although, Chinese leaders repeatedly stressed that they would tolerate somewhat slower growth as long as the jobs market remained resilient. In a speech to chief executives at the Asia Pacific Economic Cooperation CEO Summit, the President Xi Jinping noted even if China's economy were to grow 7 percent, it would still rank at the forefront of the world's economies. Thus, China is having more tolerance on economic performance volatility and probably will not take dramatic measures, unless the economy performs far below than its projections.

The possible impact of current interest rate cut on global economy and commodity market shall be extremely narrow. Especially for the over supplied commodities, price gaining as a result of this event is improbable.

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