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Econotes is a free research publication available on request. It is not a solicitation for business. It is devised and written by Dr. Andrew F. Freris based on 46 years of market experience which included senior positions with GT Capital, Salomon Brothers, Bank of America and BNP Paribas as well as senior academic posts with universities in London and Hong Kong

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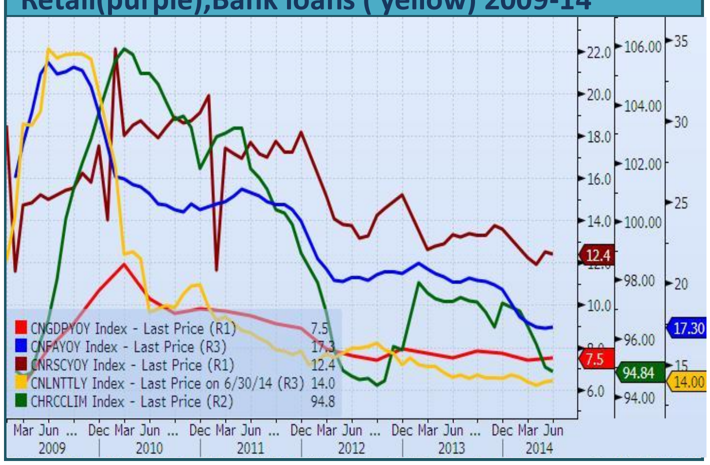
CHINA:DELAY BUYING EQUITIES TILL END 1Q.2015

Summary	Investment Conclusions
The Chinese economy is slowing down, but will likely start bottoming out by early 2015.The authorities managed the present deceleration quite well, avoiding major economic or financial dislocation. The likelihood of a systemic financial crisis in China is nonexistent as China has none of the characteristics found in past major domestic or international systemic financial crises. The role of the “shadow banking” has been misunderstood and exaggerated. The slowdown in the property sector will be a major factor in the deceleration of the economy, but will not be a trigger for a crisis, except that it will keep the equities sector down for quite a while yet.	“Highest Asian GDP growth rates, worst Asian equities market” summarizes aptly China’s performance since 2009.This is unlikely to change till mid 2015, as the economy slows down further and then bottoms out while the property market stays weak. The cheap equity valuations and other metrics are not now relevant, neither is there any near prospect of a truly loose monetary policy to boost equities. Avoid the property, construction, cement and steel sectors and hold some non-property related consumer and consumer-services The RMB to stay within predictable trading ranges,

The cyclical slowdown likely to bottom in 2015

Purely in terms of GDR growth, the Chinese economy moved progressively from 7.8% yoy in 3Q.13 to 7.7% in 3Q.13 then further down to 7.1% in 1Q.14 rebounding slightly in 2Q.14 to 7.2%.As the data in Chart 1 show, investment spending (blue line) may not have bottomed yet, as are retail sales (purple, a proxy for consumer spending) These two key components of GDP, accounting for nearly 90% of it, will continue to cap any faster recovery. Bank lending growth has flattened out (yellow line) after recent efforts by the authorities to be more selective on the squeeze and especially after off- balance sheet lending was brought under control (see our comments on shadow banking).Sentiment in the property sector (green line) continue to deteriorate reflecting the falling prices of residential accommodation. At this stage, the role of exports (always wildly exaggerated as growth drivers, missing out the real drivers which are NET exports!) are not of immediate significance. They add, on average well less than 20 bps for every 100 bps of GDP growth and, hence, the role of a cheap RMB in this cyclical phase will be of secondary importance. Inflation is under control as is imported inflation given the subdued state of world commodities markets(both soft and hard).The next stage in the these developments will be the gradual bottoming of the property sector which will keep consumer spending subdued as well as having other sectoral implications. Economic policy will remain cautiously supportive as long as there are no sign of the economy slipping below the 7.0% GDP growth mark. Monetary policy will remain selectively and cuatiously loose but no cuts in rates are expected at this stage.

Chart 1:GDP (red),Invest.(blue)Property (green), Retail(purple),Bank loans (yellow) 2009-14



Source: Bloomberg

Property and shadom banking

Property prices in China are now falling in most markets and most property indices are declining such as sales in value and volume, investment and land purchases. The reasons for the property boom are well-known: overinvestment helped by credit availability, rising demand because of urbanization and closed external capital markets, which coupled with poor equities returns, made residential property an attractive alternative. The economy slowed down for cyclical reasons (excess capacity build-up) and by progressively tighter monetary policies.Property industry accounts for about 15% of GDP and property related investment takes up about 25% of all invesmtnet or 7% of GDP.At present trends of the deceleration of property investment ,this could knock off during 2014-5 up to 50bps from GDP growth.

ACTBOX :China and a systemic financial crisis

China can not have a systemic financial crisis such as that of the US (2008-9),Argentina (2001),Thailand (1997) and Greece (2012) because all these crises had one or more of the following in common NONE of which is encountered in China: (1)Banking system highly geared to property, (2) Growing current account deficit, (3) Growing fiscal deficit, (4) Both these deficits funded by foreign loans, (5) Overvalued and inflexile forex rate. China's USD 4.0 tr forex reserves marks its role as a global lender, especially to the US,and with its four major banks state owned,a banking crisis would become a fiscal issue.

The impact of this on the banking system is likely to be modest. Mortgages are of unimportance to the funding of property with mortgages accounting in 2013 for about 27% of the total value of transactions. Gearing is very low with down payments rising up to 60% of the property value. Loans to property developers account at present for 6.5% of all the loans of banks. Even a steep increase in all delinquencies will have little impact on most banks. Which bring us to shadow banking, which is nothing more than the recycling of existing bank deposits and NOT the creation of new ones! The loans thus created are off-balance sheet for banks, but those to property account for only 10.5% of all these loans.

Chart 2: SHCOMP (red),Index MovAv (green), 12M forward P/E(blue),Rel.Str.(black),2013-4

Source: Bloomberg

Investment implications

As Chart 2 indicates, the SHCOMP index shows no signs of recovery, trading above its moving average. In terms of valuation, the index is the cheapest in Asia at 12M forward P/E of 7.9 with an equally low P/B at 1.1.The index is currently reverting to a mildly oversold position.

While the property sector is under pressure and it thus keeps consumer spending under pressure too, and while there is no reason to expect lowered interest rates anytime soon, there is also no reason to be bullish on Chinese equities.

We expect that the economy may start bottoming out in the start of 2015, and then the combination of the expected recovery with low valuations could make attractive to re-enter the China shares market. Until then stay defensive and avoid the obvious weak spots of construction, steel, cement and housing-related consumer durables.

(Writing completed 20/7/2014)