

The Chinese economy and share market



Key points

- Chinese policies focused on cooling growth and rebalancing it away from excessive investment have been largely successful. Non-food inflation remains benign. Further aggressive moves to slow growth are unlikely and we expect 9% to 10% growth this year.
- After rising sharply since late last year, Chinese shares appear to have entered a short-term correction which may have further to run.
- However, the broad trend is likely to remain up. Price to earnings multiples are not extreme, profit growth is likely to remain strong and there is significant scope for individuals to allocate from cash to shares.

Introduction

China recorded another year of booming economic growth in 2006. Its share market was amongst the strongest in the world with shares in Shanghai and Shenzhen rising more than 100% over the last 12 months. Naturally this raises questions about its sustainability. Our longer term view on the Chinese economic outlook is very positive, reflecting strong productivity growth, competitive advantages, rapid urbanisation, surging consumer demand and strong investment. This in turn will underpin solid gains from Chinese shares. This note, however, looks at the shorter-term outlook for the economy and share market.

Headline economic data masks a slowdown

The recent release of Chinese economic data, showing an acceleration in economic growth from 10.4% in 2005 to 10.7% in 2006 (despite measures last year to slow the economy) and a pick-up in inflation have led to concerns that further aggressive moves to slow the economy may be required.

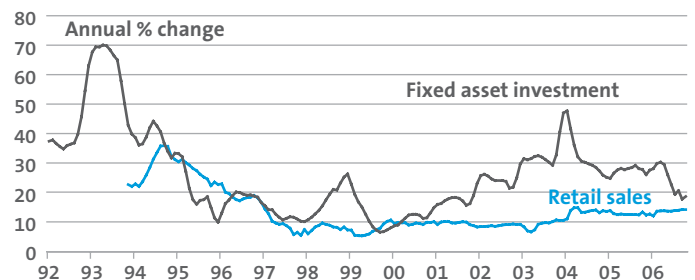
Our assessment though is that these figures mask a more favourable trend and last year's moves to rebalance the economy are working. There are several points to note:

- First, the annual GDP growth data masks a slowdown in the second half of 2006. While the economy grew at an annualised pace of 11.6% during the first half of last year, it slowed to 8.2% during the second half. This reflects a sharp slowdown in the

annual pace of growth in fixed asset investment from around 30% six months ago to around 18% by the end of 2006 (see the next chart).

- Secondly, the slowdown in growth has been masked by stronger exports and weaker imports in response to the investment slowdown. Less investment demand means less imports and Chinese producers exporting more of their goods. Further moves to slow investment will only increase the trade surplus.
- Thirdly, the economy has rebalanced. Just as fixed asset investment growth has slowed, consumption has picked up a notch. The authorities have more work to do to stimulate consumption, but so far it has been moving in the right direction.

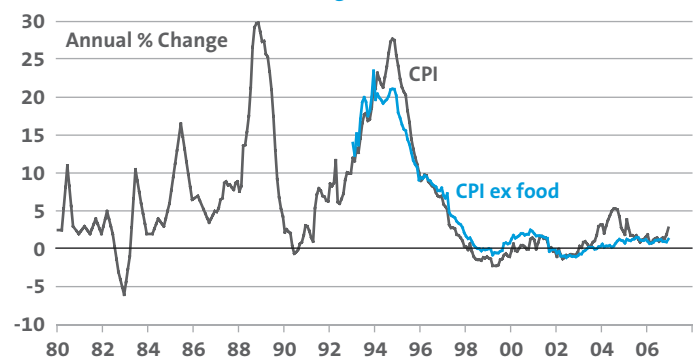
China – slowing investment and more balanced growth



Source: Thomson Financial, AMP Capital Investors

- Finally, the bulk of the recent pick-up in inflation was due to higher food prices. Traditionally the Chinese central bank has been less responsive to increases in food inflation as opposed to non-food inflation because it can't do much about the former.

Chinese inflation remains benign



Source: Thomson Financial, AMP Capital Investors

For these reasons the Chinese authorities are unlikely to be too alarmed by recent economic statistics. We remain of the view that the Chinese economy is on track for a very soft landing with growth of around 9% to 10% this year. This will be helped by a continued pick-up in the pace of consumer spending and a bottoming in the construction cycle. Inflation is likely to remain relatively benign.

However, further moves to mop up the liquidity being generated by China's huge trade surplus and managed exchange rate are

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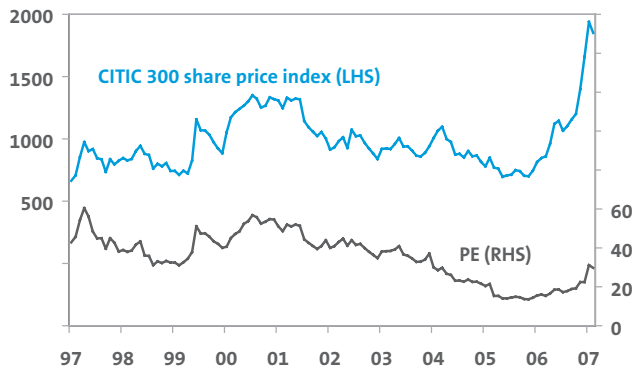
likely. If not, monetary conditions would ease so this should really be seen as continuing to maintain monetary conditions as opposed to tightening them. Furthermore, interest and bond rates of around 2% to 6% are very low for an economy recording nominal growth of around 13% per annum, and will likely drift up to more sustainable levels.

The Chinese A share market

Since late 2005 China's A share market has surged. While some have made comparisons with the Nasdaq IT bubble of the late 1990s, there are big differences. **Much of the rebound over the last year reflects a recovery from a four-year bear market.** Despite strong economic growth between 2001 and 2005, Chinese shares fell on the back of very high valuations, with average price to earnings multiples pushing 60 times in 2000, and uncertainty over whether non-tradeable state owned shares in companies would be sold down. As a result, individual Chinese investors moved most of their share assets to bank deposits (or cash).

By late 2005 these problems had been largely resolved. Firstly, PE ratios had fallen to reasonable levels (see the next chart which shows a share price index for the top 300 Chinese A shares against their average PE multiple).

Top 300 Chinese A share versus PE

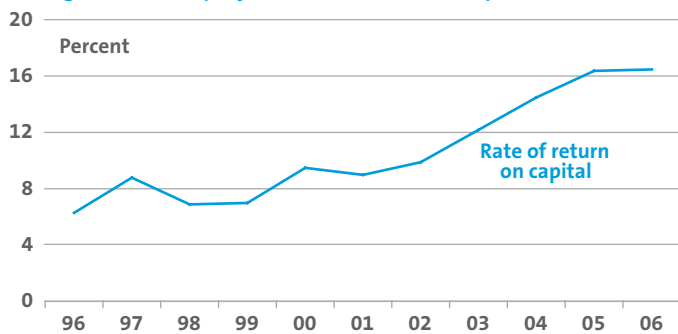


Source: Thomson Financial. AMP Capital Investors

Secondly, the authorities made state-owned shares in companies tradeable (after mandatory holding periods) and compensated minority A shareholders for the estimated losses this may cause.

In the meantime, the profit picture for Chinese companies has improved dramatically since the late 1990s with rising profit margins and return on equity in part due to privatisation, labour market deregulation and improved corporate governance.

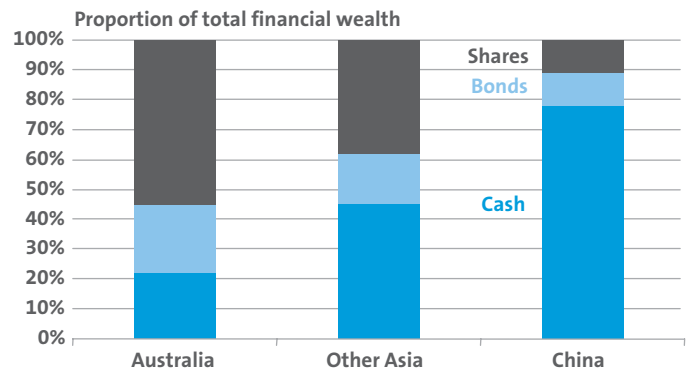
Rising return on equity for Chinese listed companies



Source: Thomson Financial, AMP Capital Investors

The recovery in the share market has in turn seen individual Chinese investors regain their confidence in share investing. Individual investors have more than US\$4 trillion sitting in cash and bank deposits. This compares to market capitalisation of the Chinese share market of just US\$1.3 trillion. Chinese investors have a very low proportion of their financial wealth invested in shares, just over 10% compared to over 50% in Australia and nearly 40% in the rest of Asia. So the long-term potential for a higher allocation to shares is high.

China's high exposure to bank deposits



Source: Thomson Financial, UBS, AMP Capital Investors

The new-found enthusiasm amongst Chinese investors is reflected in 90,000 new A share accounts on average being opened daily on Chinese stock markets. A year ago the daily average was less than 3,000. This in turn partly explains why the recent massive volume of equity capital raising in China has been so easily absorbed by investors.

Near-term correction, but long-term outlook is fine

Notwithstanding these favourable developments, the Chinese share market is due for a short-term correction and this now appears to be unfolding. Exponential gains since late last year suggest the market was starting to run ahead of fundamentals. Jawboning by Chinese authorities worried about a bubble is likely to further cool it down. However, the trend is likely to remain up, albeit a bit slower than has been the case over the last year:

- While PEs are up sharply they are still well below past extremes. For the top 300 A shares the PE calculated using historic earnings is currently 29 times which is below its 10 year average of 35. See earlier chart.
- Profit growth is likely to remain strong reflecting strong economic growth and a rising focus on return on equity.
- There is a significant potential for individual investors to allocate to shares from cash.

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1 See "The China boom has a long way to go", Oliver's Insights, January 2007.

2 China A shares refer to shares issued by Chinese companies listed on the Shanghai and Shenzhen stock exchanges and have only recently become available to foreign investors via fund managers with Qualified Foreign Institutional Investor licences. QFII funds still only amount to just 1% of the Chinese A share market though. H shares are shares issued by Chinese companies listed in Hong Kong.

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