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SLOWDOWN IN CHINA

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China, the manufacturing giant of Asia is expected to witness a slowdown in its growth trajectory. Its growth may lose momentum due to the lack of demand from the developed nations. It can partly be blamed on Euro zone's deteriorating fundamentals. China, the fastest growing economy moderated to its lowest pace in more than two years. China has always been the main source of optimism in the global economy and signs of a slowdown in China, coupled with trouble in Europe, show that industrial commodities are in for a bumpy ride.

Research

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The demand for Chinese goods is continuously worsening due to the economic woes in Europe. Exports rose at the slowest pace in almost two years in October as worsening situation in Europe crumbled demand. The weakness in export demand is expected to continue in the near future due to the economic slowdown across the globe.

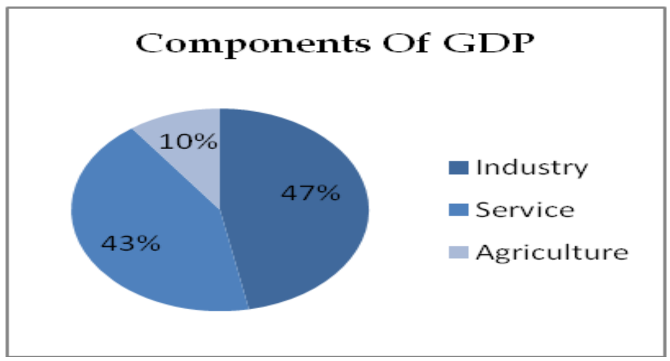
The Chinese economy is expected to register a second year of below-trend growth because of the headwinds from the global slowdown, domestic housing market weakness and limited room for policy stimulus.

A pause in the growth of China:

The *Gross Domestic Product* (GDP) of China started decelerating in early 2010 from 11.9% to 9.1% for the latest quarter. The GDP growth rate of the third quarter of 2011 decreased to 9.1% compared to 9.7% and 9.5% growth rates recorded in the first and second quarters, respectively. China's economic growth rate has declined for three successive quarters and further it is expected to be around 8.7% for the final quarter.

The four major driving forces of the Chinese economy are investment, consumption, imports and exports. Let us look at the constituents of the GDP:-

- ✓ Industry sector contributes 47% to the total GDP (inclusive of Investment, Real Estate, Manufacturing, Mining etc)
- ✓ Services sector contributes to 43% of the total GDP, and
- ✓ Agriculture's contribution to the GDP is 10%



Source: Reuters, NB Research

This indicates that China's economy is heavily relying on the industrial activity and any slowdown in industrial activity will be a pain for the entire economy. China, as an export-oriented economy is dependent on the developed nations (EU, US, UK and Japan). So, if these economies are witnessing a slower growth, then the dependent economies are more likely to face a ripple effect.

The global GDP growth has been revised lower to 1-1.5% from 2.5%, this gives a clear indication that all the major contributors to world GDP will face a slowdown. In 2007, the last year before the international financial crisis, China accounted for only 6.3% of the world GDP. In the following three years the world economy expanded by $7.2 trillion, while China's economy grew by $2.4 trillion, which means China accounted for 33% of world growth.

In contrast, in 2007, the US accounted for 25.1% of world GDP, but in the next three years the US economy grew by only $0.6 trillion.

Therefore, in the last three years, China's economy contributed as much as four times to the global growth compared to the US. On the other hand, EU contracted by $0.7 trillion during the same period.

Going further, if the world economic outlook is deteriorating then the world GDP is going to contract substantially. The economies which contribute majorly to world GDP growth will hit the most as a result of which we will see a fall in the GDP of China to the levels of 7.5-8%. Moreover, Chinese officials are also confirming about the sluggish growth rate for FY12. On account of lower demand from the developed nations, the world GDP is likely to contract for FY12, and thus the demand for Chinese products will witness a slowdown. A drop in the World GDP by 1-1.25% will eventually lead to a massive fall in GDP of China by almost 1.5-2%.

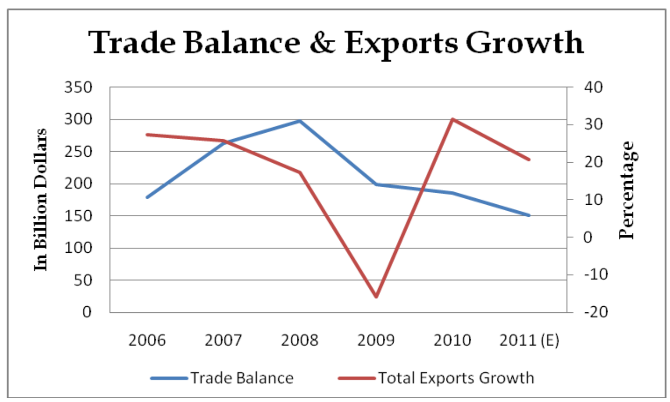
The fall in China's exports will eventually increase the dependency on the local demand. China spends about 50% of the GDP on fixed investments as compare to the world average of under 20%.

Unlike India, the Chinese growth story is investment-led and not consumption-led. Whereas, the current scenario indicates that only 30% of the total GDP comprises of consumer spending from the people of China. Looking at the scenario we feel that domestic consumption will not be sufficient enough to achieve the targeted growth rate of 8% for FY12.

In view of the gloomy developed market outlook, we think that China's export and import growth will weaken substantially in 2012. The shady picture over the housing market in China will eventually lead to a fall in investment demand and the consumption will drop further. China seems to be on the verge of hard landing in FY12.

Shrinking Exports a Cause of Concern:

A slowdown in exports is a major cause of concern for China. The country has managed to store the largest forex reserve on the back of their exports and any significant fall in exports will lead to imbalances in their current account numbers.



Source: Bloomberg, Reuters, NB Research

The current account surplus has shrunk from 10.1% of GDP in 2007 to 5.2% in 2010, and is likely to decline further to 3.5% in 2011.

Meanwhile, the share of China's exports to G3 (US Europe and Japan) has lowered. The weak demand from G3 could still have significant implications for China's exports since G3 still represents the largest destination with the total share exceeding 44%

(about 20% of the total exports are shipped to the EU).

The lower export growth and the relatively higher import growth would lead the trade surplus to narrow further in 2012, turning the contribution of net exports from growth into a drag in 2012.

Chinese officials have also revised their projections for exports growth to 10% till 2015. The trade balance of China accounted for $296.96 billion for the year 2008. For the year 2011, it is estimated to be $150.12 billion. A continuous drop in trade balance will actually lead to a drop in current account numbers and the forex reserves will decline, which may lead to the beginning of the end.

Estimated Growth for Crude Oil and Copper Imports:

Year	GDP (%)	GDP ($bln)	Oil Imports (mln tns)	Copper Imports (mln tns)
31-Dec-04	9.65	1931.64	12102134	101080
31-Dec-05	10.25	2256.90	11265378	60091
31-Dec-06	11.23	2712.95	11564934	95831
31-Dec-07	13.25	3494.06	12876439	111685
31-Dec-08	9.30	4521.83	14370164	211527
31-Dec-09	8.88	4991.26	21263234	244013
31-Dec-10	10.40	5878.63	20857068	228609
31-Dec-11	9.43	6432.98	22694828	343926
31-Dec-12(E)	**8.00**	**6947.62**	**23072583**	**354938**

Source: Bloomberg, Reuters, NB Research

China, a net importer of copper and crude oil, has showed a stable increase in imports on an annual basis. However, the percentage growth year-on-year kept fluctuating. The cumulative annual growth of oil and copper imports in China stood at 9.4 and 19.12% from the year 2004-11 respectively.

We have seen a massive increase in the import numbers of both commodities in the year 2011. Copper imports rose by 50% and oil by 8% compared to 2010. Strong imports were mainly supported by the decent GDP numbers recorded last year which sustained above 9%.

However, we expect a contraction in GDP for FY 12 due to global slowdown. This would ultimately result into lower demand for copper and crude oil.

As per our estimates for FY12, copper imports are likely to grow by 4-5% as compared to 50% growth last year, and crude oil imports may shrink to 1.6% as compared to 8.8% growth in the previous year.

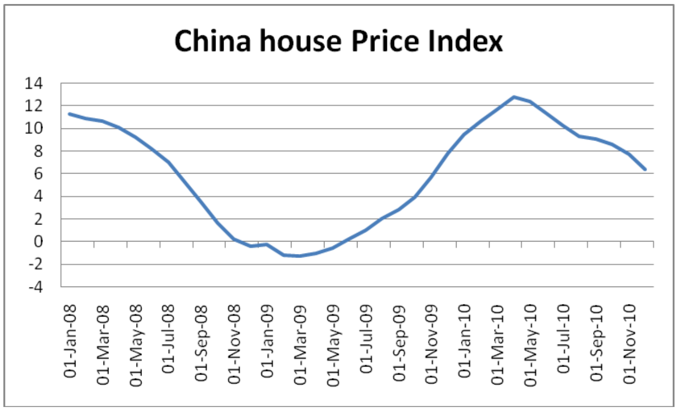
China accounted for exponential demand for commodities since the last three years and now with looming prolonged slowdown, we feel that demand for industrial commodities may drop significantly.

Real Estate Bubble:

Over the years talks of a real estate bubble in China is threatening the world, the decelerating Chinese economy is going to be the theme of the world in the next quarter and the downturn in the housing market is likely to affect the entire financial market for the times ahead. Bursting of the real estate bubble in China which is still under covers will be the worst nightmare for the entire globe.

The GDP of China was rising at the rate of 8-10% for the year 2005 to 2009 and the prices of new homes were rising at an average rate of 100% for 2005-2009. The prices of property were reaching new highs but the income of the people of China was not rising with the same growth rate.

Between 2005 and 2009, the average housing prices had almost tripled. The number of unoccupied residential and commercial units has risen for the same period, indicating that the investment demand was one of major reasons for the surge in property prices.



Source: Bloomberg, Reuters, NB Research

The prices started declining in the month of May 2010. However, the first sign of a downturn emerged in May 2010 when China's top 10 property developers reported unsold inventories totaling $50 billion, up 46% from the previous year. Beijing home sales volume in the first 11 months of 2011 was down 27% year-on-year, to a 10 year record low, according to property agency *Homelink*.

S&P has downgraded its outlook for China's real estate development sector to negative from stable on the back of tight credit conditions in the country and slower sales.

It is estimated that 64 million apartments are vacant in China and construction is still going on (investment led growth). Chinese property developers are now experiencing a severe credit crunch due to Chinese government funding restrictions and we expect fire sales may reduce prices rapidly. Moreover, individual property loans are also drying up, which will further hammer the banking industry of China.

Looking at few fact and figures, in Shanghai, we saw a surge of 150% in real estate prices from 2003 to 2010. In Tianjin, it is also projected to have more prime office spaces, which will be absorbed in the next 25 years at the current rate.

The investment demand which was created in Chinese real estate market would not sustain with slower growth of the economy as the GDP estimate has been revised lower by Chinese officials.

The world has emerged from one of the worst crises of 2007-08, which started with assumptions in the U.S. that "housing prices will never fall" and similar tendencies have been observed in China where real estate prices have doubled over the last 4-5 years. This is a start of housing crises in China and it will worsen and a domino effect of the same will be felt everywhere in the economy.

Conclusion:

The slowdown in China is making things worse for the global economy. The country's weak manufacturing PMI clearly depicts that the growth in the sector is actually contracting.

It reported its purchasing managers index (PMI) as 49.0 for November, which slipped to its lowest level since February 2009 and a minute uptick in PMI numbers in the month of December does not signify growth.

Property prices are also declining at a rapid pace in some of the major cities of China. According to property agency *Homelink*, new home prices in Beijing fell 35% i.e. more than one-third, in November alone.

Looking at the Shanghai Composite Index, investors got a negative return of around 22% in the year 2011, indicating a weak investment scenario in the Chinese economy.

According to the Chinese government website (www.gov.cn), the audit found 10.7 trillion Yuan of government debt as on 2010. The audit also found several companies with false financing. The National Audit office report found 531 billion Yuan (US $ 84 billion) worth of irregularities in local government debt.

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After the rapid rise in interest rates this year, we have seen many commodities traders pledging their commodity stocks to obtain loans from banks and post that we saw a massive correction in prices of many commodities, which may pose problems to banks and may lead to fire sale of such commodity. Collapse in housing prices may lead to rising NPAs in Chinese bank's books leading to more problems in the economy.

Global growth is likely to remain capped in 2012 due to Europe's ongoing debt crisis and the slowdown in China. We may see the Global economy growing around 1.25% and 1.5% in 2012, down from the 2.5% growth rate seen in 2011. Hence, we expect Chinese economy to grow below 8% for the year 2012.

All these factors are heading towards a major slowdown in the Chinese economy. Being the top consumer of commodities we may see demand destruction due to the slowdown in the second largest economy of the world. Chinese slowdown poses serious risks to prices of industrial commodities. The slowdown in China will remain a key issue for the rest of 2012 coupled with the sovereign debt crisis in Europe.

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