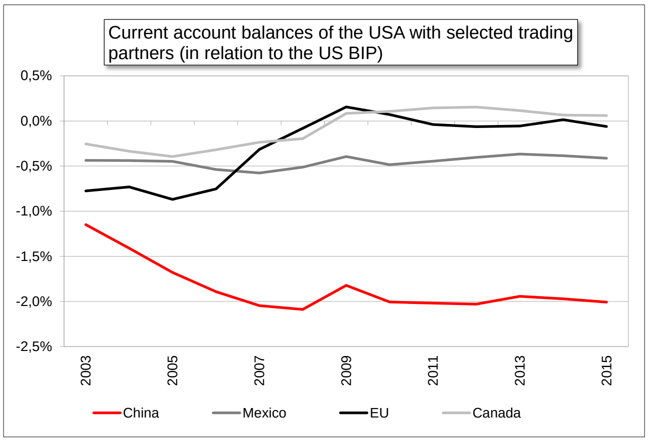
China: Economic tailwind, growing challenges

The Chinese government is not having an easy time, as it has to deal with multiple fronts simultaneously. Politically, its relationship with the United States is tense, not overtly, but beneath the surface. The new US administration is clearly critical of China, and close Trump advisors Peter Navarro, Steve Bannon, and Stephen Moore are actually almost hostile to China. That has to do with political issues like the status of Taiwan and Chinese territorial claims in the South China Sea, but also with possible currency manipulations by China. Above all, US politicians object to their country's high current account deficit with China, which, at about 2% of US GDP, is by far the largest of all national economies.



The issue is so volatile for China that the government has imposed a nationwide ban on public criticism of the new US administration to avoid giving the country's most important trading partner a verbal pretext for sanctions. President Trump seems to acknowledge this restraint, recently expressing the desire for "a constructive relationship" with China. Compared with Mexico, he has behaved more moderately towards China since taking office than he had declared in his election campaign. Nevertheless, US tariffs or special taxes on Chinese products will probably become a topic again. A small trade war is still not out of the question.

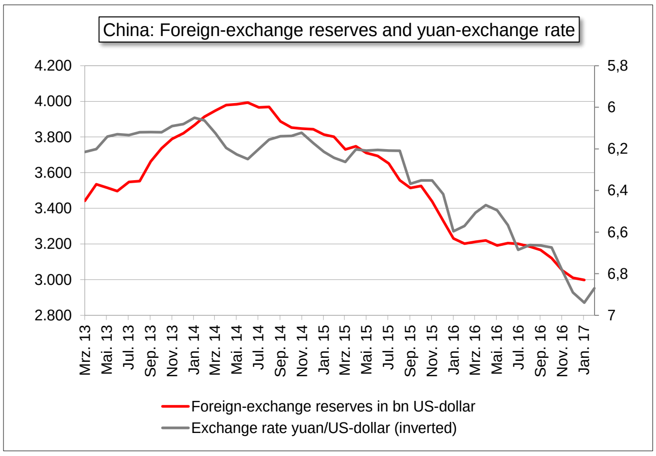
However, the Chinese government also faces great economic challenges. On the one hand, the creeping slowdown must be absorbed, which means the speed of the catch-up process, involving further integration of the rural population into the labor market and already significantly expanded employment of capital, must gradually slow. On the other hand, speculative bubbles on the capital and real estate markets must also be avoided.

Government leaders are trying to find a "happy medium" through active management. To that end, the exchange rate, bank lending, and the savings interest rate are being tightly controlled. But it has become evident in the past months that managing these three factors requires a great deal of tact and skill and keeping everything under control has become difficult.

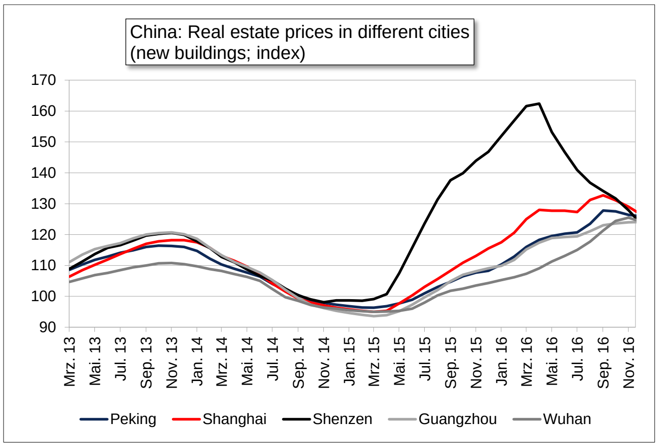
Fearing an economic hard landing, Chinese authorities eased restrictions on lending, which had become quite rigid, at the beginning of 2015. They are able to regulate credit volume comparatively well thanks to state control of key banks. The expansionary monetary policy had the desired effect of reviving demand. The downswing on the real estate market was cushioned, as was the creeping decline of growth rates for retail sales and industrial production.

However, there were soon undesired side effects as well. For one thing, real estate prices jumped sharply in some cities such as Shenzhen and Shanghai, threatening another bubble in that sector. For another, many Chinese investors started seeking alternative asset classes. Because uniform, administratively set interest rates on savings were not very attractive, many investors had just been burned by a burst stock market bubble, real estate prices were booming too fast, and alternative asset classes were in short supply domestically, many Chinese sought to invest their money abroad. The ensuing export of capital put pressure on the Chinese currency and on foreign exchange reserves, since the Chinese central bank was intervening on the foreign exchange market to keep the exchange rate stable.

Finally, foreign exchange reserves shrank to below US 3 trillion and thus by so much that the government introduced additional restrictions to stem the flight of capital. It has become difficult now even for many foreign companies to move money out of China. In view of that, new tricks are constantly being sought to get capital out of the country. Recently, increased use has even been made of the crypto-currency Bitcoin as a flight medium.

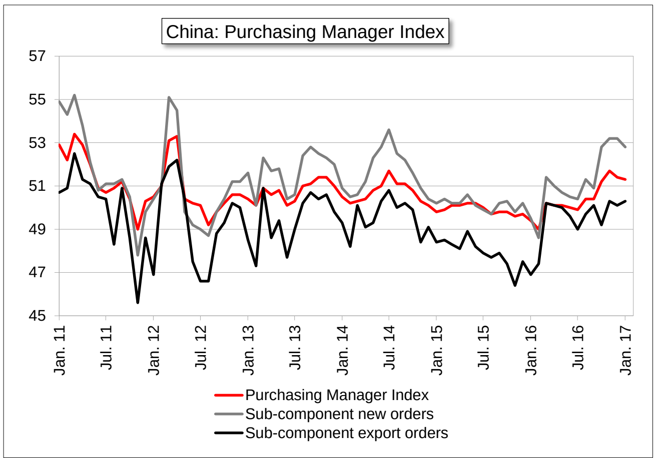


Pressure on the currency is more likely to increase than decline in the course of the year. Rising US interest rates and a creeping revaluation of the greenback will make investment abroad more attractive. At the same time, the Chinese government is under pressure not to allow the yuan to devalue too sharply, since otherwise that might lead to political tensions with the United States. Moreover, the Chinese real estate market appears to have passed its peak. Real estate prices are falling in almost all major cities. The housing market is thus no longer an attractive investment target. Further capital is therefore seeking a way to move abroad.

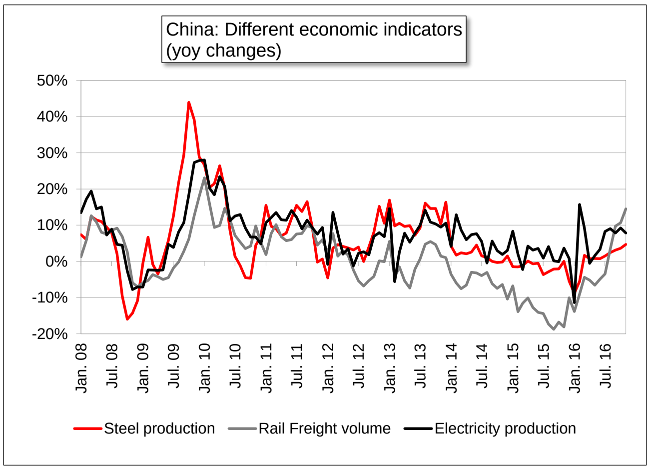


The government has already reacted and made lending more restrictive again, with the result that credit growth rates have even fallen below their level at the end of 2014. However, that raises the risk that the upswing will come to a halt again. The Chinese government cannot escape the dilemma of not being able to control everything at once. China will therefore remain an uncertainty factor in the medium term.

In contrast, things still look positive for the coming months. Many indicators, such as the strong growth of the M1 money supply (including cash and sight deposits), signal an expansion of production. Correspondingly, a large majority of purchasing managers are optimistic about their companies' prospects. Above all, more new hiring is being registered again. Expectations of export orders are still rather moderate, but growing global demand is also likely to bolster the Chinese economy.



That the Chinese economy has gained momentum may also be gathered from various indirect measures of the pace of expansion, since GDP growth rates are to be taken with a grain of salt due to the lack of transparency in official Chinese statistics. Recently, rail freight volume and production of electricity and steel have increased strongly. The OECD leading indicator for China registered the fifth-greatest rise among indicators for 38 national economies. So, primarily positive impetus for the world economy may be expected from China at present. German exports to China are already growing again at double-digit rates, after having shrunk in 2015.



On the other hand, a trade war with the United States would be a considerable burden for China. But the Chinese economy is no longer as dependent on US demand as it was ten years ago. Today, more Chinese exports go to the European Union and Japan combined than to the United States. Also, China has recently coped quite well with a decline of total exports by over 6%. The main reason for this robustness is that the importance of domestic demand has increased strongly in the past few years. Consequently, we expect no huge economic collapse in China as a result of trade restrictions.

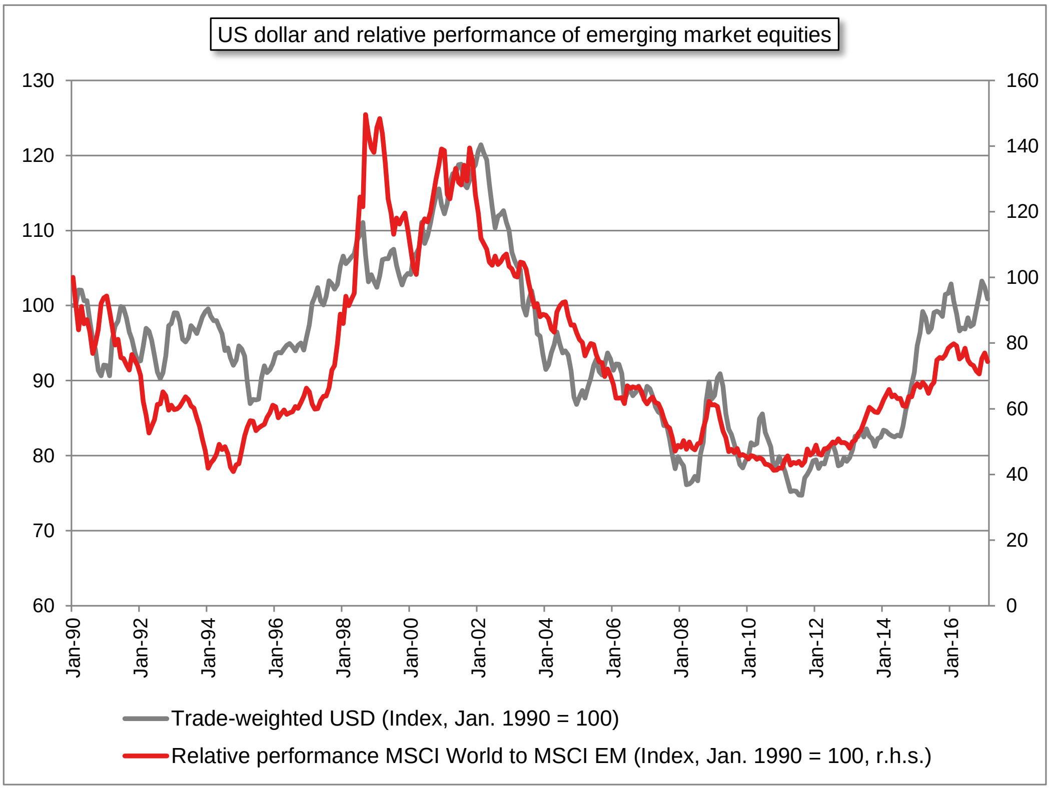
So, we see still strong GDP growth rates ahead, especially in the first half of the year. Overall, we forecast only somewhat lower growth of 6.5% for 2017 compared with last year's 6.7% despite a long-term downtrend in growth rates. The short-term improvements in the economic situation appear to have the upper hand on the Chinese stock market. The Shanghai Composite Index has exhibited a slight uptrend for some time. Price-earnings ratios are still moderate, so for the time being investors may still hope for further stock price advances, since companies are likely to report rising profits. Moreover, rising demand for raw materials may be observed now, which will also give impetus to other emerging countries. As long as purchasing managers in China do not become more skeptical, China is likely to remain a growth engine for the world economy. However, investors should keep the medium-term risks in mind and not hesitate to reallocate if necessary.

Weekly outlook for February 13-17, 2017

	Sept.	Oct.	Nov.	Dec.	Jan.	Feb.	Release
DE: Consumer prices, m/m - final	0.1%	0.2%	0.1%	0.7%	-0.6%		February 14
DE: Consumer prices, y/y - final	0.7%	0.8%	0.8%	1.7%	1.9%		February 14
DE: ZEW economic expectations	0.5	6.2	13.8	13.8	16.6	14.8	February 14
DE: ZEW current assessment	55.1	59.5	58.8	63.5	77.3	72.0	February 14
EUR19: Industrial production, m/m	-0.8%	0.1%	1.5%	-0.8%			February 14
EUR19: Industrial production, y/y	1.4%	0.8%	3.0%	2.4%			February 14
	Q2 16		*Q3 16*		*Q4 16*		
DE: GDP, q/q	0.4%		0.2%		0.5%		February 14
DE: GDP, y/y	3.1%		1.5%		1.7%		February 14
EUR19: GDP, q/q	0.3%		0.3%		0.5%		February 14
EUR19: GDP, y/y	1.6%		1.6%		1.8%		February 14

MMWB estimates in red

Chart of the Week: Depends on the dollar



A strong US dollar is a burden for emerging countries for several reasons. First, many emerging country currencies are more or less closely coupled to the US dollar, so that a revaluation of the greenback makes exports to other currency areas like the European Union or Japan more expensive. Second, a firmer US dollar in most cases entails rising US interest rates, thus making it more attractive to invest in the United States and causing money to flow out of emerging economies and to that country. Third, many central banks in emerging countries are forced to raise interest rates to stem the outflow of capital and devaluation of the local currency. However, that is detrimental to capital spending and hence to economic growth. For these reasons, a close connection has been observed in the past between the trade-weighted US dollar and the price performance of stock indexes of industrialized countries in relation to those of emerging countries. When the US dollar strengthens, industrialized country stocks have achieved relatively better performance than emerging country stocks. Consequently, surprisingly sharp interest rate hikes by the US central bank would entail a risk for emerging country stocks.

Stock marktes	As of 10.02.2017 12:04	Change versus 27.01.2017 -1 week	02.01.2017 -1 month	02.11.2016 -3 months	30.12.2016 YTD
Dow Jones	20172	0,4%	2,1%	12,3%	2,1%
S&P 500	2308	0,6%	3,1%	10,0%	3,1%
Nasdaq	5636	-0,4%	4,7%	10,4%	4,7%
DAX	11667	-1,2%	0,6%	12,5%	1,6%
MDAX	22968	0,4%	2,5%	10,9%	3,5%
TecDAX	1869	0,6%	1,6%	10,9%	3,2%
EuroStoxx 50	3273	-0,9%	-1,1%	9,8%	-0,5%
Stoxx 50	3035	0,1%	0,5%	10,2%	0,8%
SMI (Swiss Market Index)	8421	0,5%	2,4%	9,4%	2,4%
Nikkei 225	18915	-2,8%	-1,0%	10,4%	-1,0%
Brasilien BOVESPA	64965	-1,6%	9,0%	2,6%	7,9%
Russland RTS	1162	-2,8%	0,9%	19,5%	0,9%
Indien BSE 30	28334	1,6%	6,5%	2,9%	6,4%
China Shanghai Composite	3197	1,2%	3,0%	3,0%	3,0%
MSCI Welt (in €)	1808	0,6%	1,4%	12,7%	2,2%
MSCI Emerging Markets (in €)	926	1,4%	5,6%	8,4%	6,3%
Bond markets					
Bund-Future	163,96	211	-51	139	-19
Bobl-Future	133,77	101	1	254	14
Schatz-Future	112,37	22	8	37	8
3 Monats Euribor	-0,33	0	-1	-2	-1
3 Monats $ Libor	1,03	0	4	16	4
Fed Funds Future, Dec 2017	1,11	-2	-2	37	0
10 year US Treasuries	2,41	-7	-2	62	-3
10 year Bunds	0,33	-13	24	28	23
10 year JGB	0,09	1	4	14	4
10 year Swiss Government	-0,13	1	8	24	8
US Treas 10Y Performance	568,11	0,1%	-0,2%	-4,9%	-0,2%
Bund 10Y Performance	604,18	0,4%	-1,6%	-1,9%	-1,4%
REX Performance Index	485,38	0,8%	0,0%	-0,1%	0,0%
US mortgage rate	0,00	0	0	0	0
IBOXX AA, €	0,79	-4	12	24	12
IBOXX BBB, €	1,61	-2	12	22	11
ML US High Yield	6,22	1	-24	-56	-24
JPM EMBI+, Index	788	0,5%	2,0%	-1,0%	2,0%
Convertible Bonds, Exane 25	6902	0,4%	-0,5%	3,0%	-0,2%
Commodities					
CRB Index	431,27	0,1%	2,5%	2,0%	2,5%
MG Base Metal Index	301,80	1,5%	7,9%	14,0%	7,9%
Crude oil Brent	56,28	1,5%	-0,8%	20,6%	-0,8%
Gold	1226,42	3,2%	6,0%	-6,0%	6,0%
Silver	17,55	2,8%	9,3%	-6,0%	9,3%
Aluminium	1817,75	0,1%	6,7%	5,5%	6,7%
Copper	5870,50	-0,2%	6,3%	19,7%	6,3%
Iron ore	83,50	0,0%	4,4%	25,6%	4,4%
Freight rates Baltic Dry Index	707	-14,5%	-26,4%	-15,2%	-26,4%
Currencies					
EUR/ USD	1,0642	-0,4%	1,7%	-4,1%	1,0%
EUR/ GBP	0,8516	-0,2%	-0,2%	-5,7%	-0,2%
EUR/ JPY	120,83	-1,8%	-1,7%	5,4%	-2,1%
EUR/ CHF	1,0663	-0,2%	-0,4%	-1,1%	-0,7%
USD/ CNY	6,8789	-	-1,1%	1,8%	-1,1%
USD/ JPY	113,25	-1,6%	-3,6%	9,6%	-3,1%
USD/ GBP	0,80	0,4%	-1,1%	-1,4%	-1,1%

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