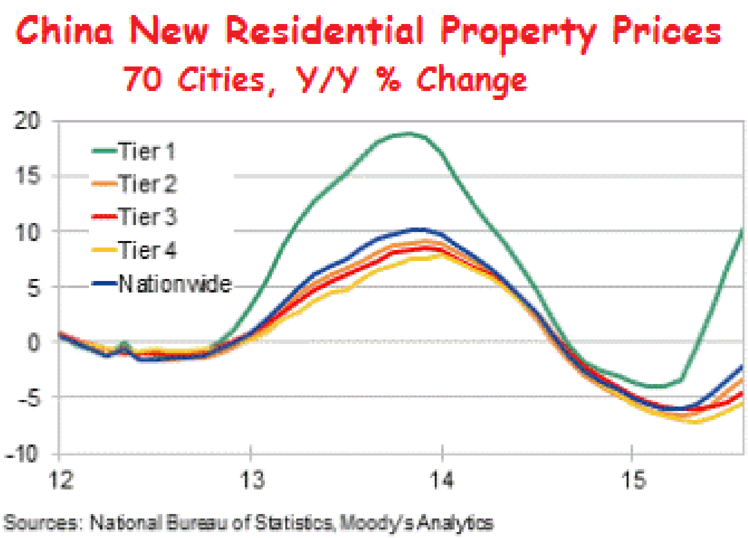
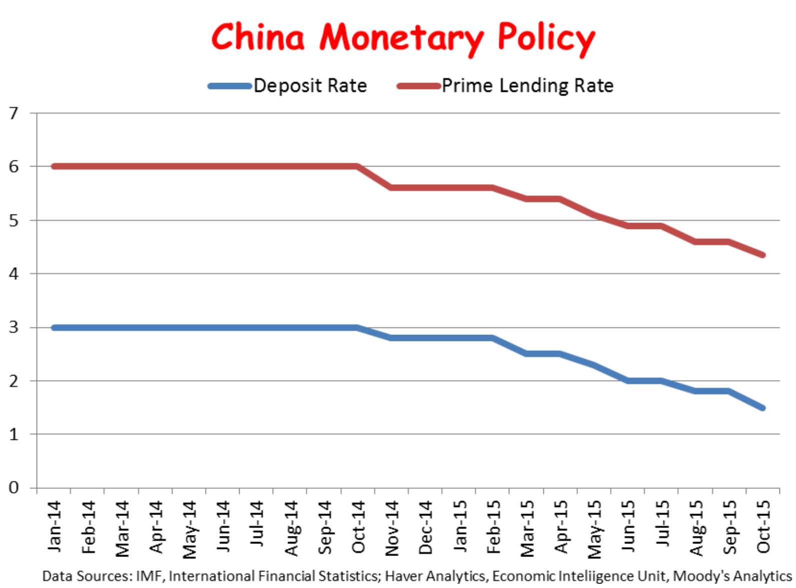
China's Economic Outlook

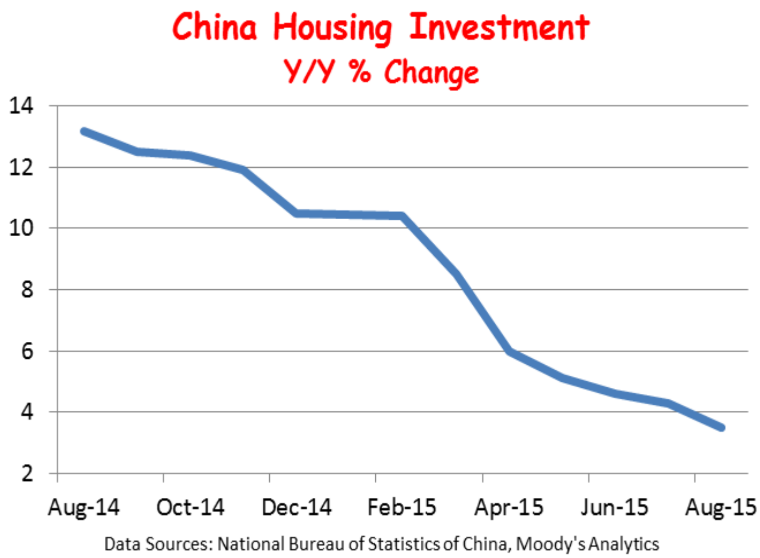
The Chinese economy is slowing. After reaching double-digit rates in 2010, economic growth has been on a downward trend and is now at its slowest pace since the global downturn. Given that China is the second-largest economy and largest trader in the world, the slowdown is raising concerns. Conditions are expected to weaken further this year, with growth falling to around 6.5%, down from 7.4% in 2014 and 7.7% in 2013.

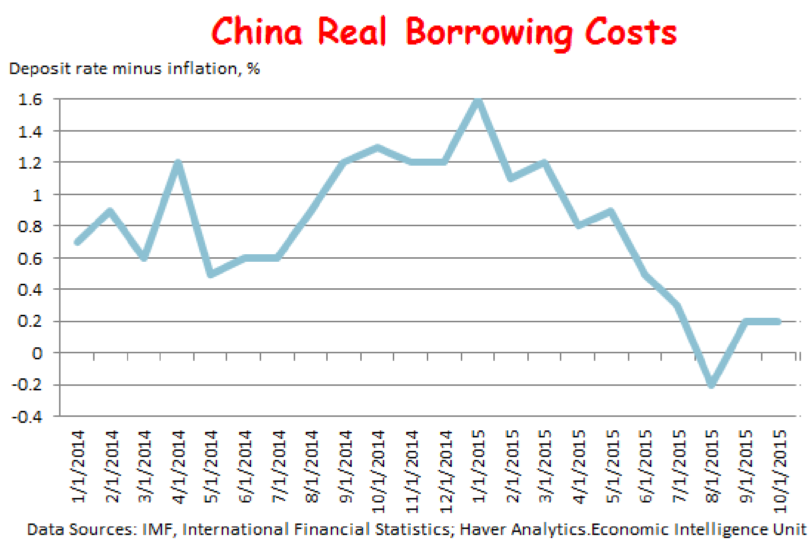


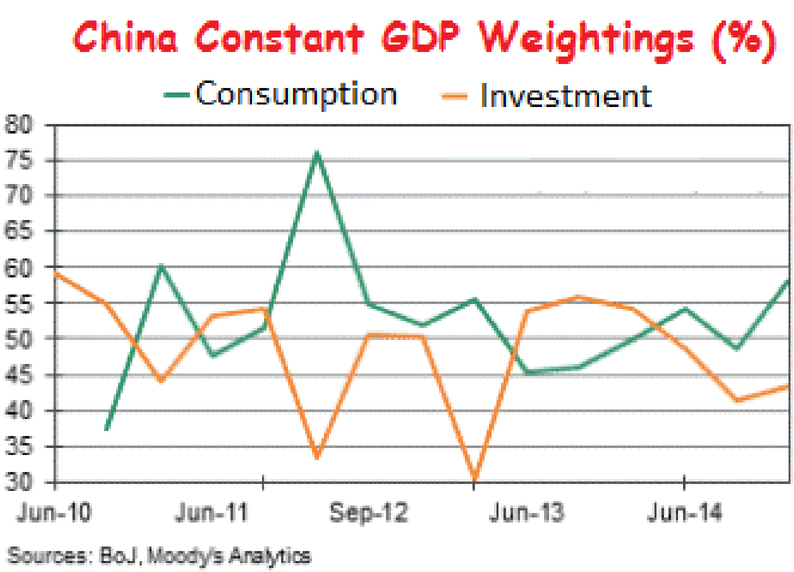
China's slowdown is partly the result of conditions in the housing market. Real estate is important in any country, but it is far more important in China and has been a primary source of economic growth in recent years; by some estimates, almost half of China's GDP is linked to real-estate related activities. Home prices skyrocketed as an aftermath of China's massive stimulus spending earlier, when state-owned banks lent money to many state-owned enterprises and some of the loans were used to finance real-estate purchases.



When the Xi Jinping-Li Keqiang administration took over in late 2012, there was a shift in reforming the economy toward a more sustainable growth model by transitioning from investment-led to consumption-service driven growth. The government implemented tightening policies to cool the nation's housing market, discourage overinvestment and reduce the buildup of risky debt and shadow financing. These efforts contributed to a broad-based economic slowdown.



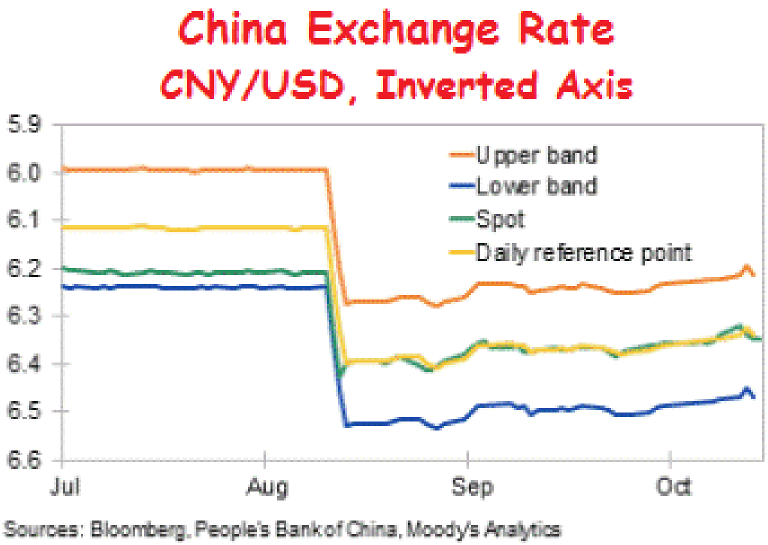


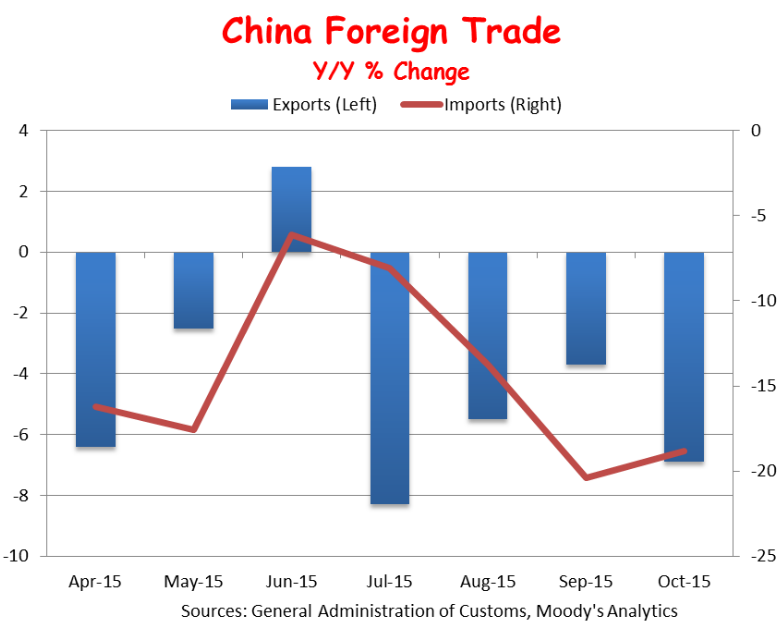


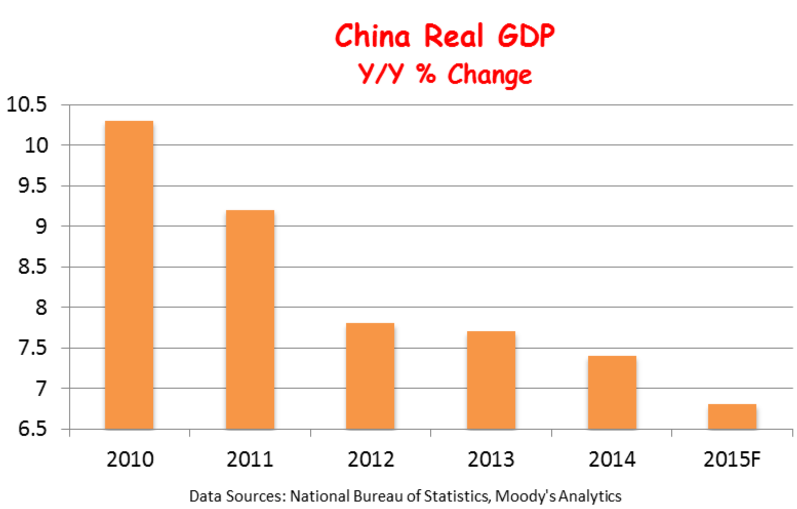
To cushion the economic slowdown, the government has eased its policy stance by cutting interest rates six times over the past year. Housing restrictions have also been eased, with down payments for second-time homes and some taxes being reduced. Although these efforts have lifted housing activity, a significant amount of inventory remains on the market, causing investment spending to decelerate significantly. Lower investment growth is the main culprit for the economy's current slowdown. Unfortunately, this trend is expected to continue until the housing market works its way out of its oversupply problem and excess capacity is addressed over the next couple of years. As a result, economic growth will continue to decline in the near term.

Thankfully, the government's objective to shift growth drivers from the industrial sector to the consumer sector appears to be underway. The central bank's stimulus efforts have resulted in significantly lower real borrowing costs compared to a year ago, leading to an increase in consumer spending. Household spending has particularly risen on durable goods that are often financed, including cars, appliances and furniture. The rise in household spending has prevented sharper declines in China's economic growth.

Conditions in the household sector are expected to continue gradually improving in the near term as the government transitions to a more pro-growth stance. A recovery in the real estate market working its way out of its oversupply slump and overall economic conditions improve will be important.







Despite rising consumer spending, China is still heavily dependent on external demand for growth; exports alone account for about a quarter of the country's GDP. Although the government devalued the Chinese currency in August by 3.3% against the dollar, China's trade-weighted exchange rate was still about 8.5% higher in September compared to a year earlier. Lower price-competiveness, along with falling demand from Europe and Japan, has resulted in China's exports growth to drop to negative territory despite rising sales to the U.S. Unfortunately, this trend is expected to continue in the near term given the uncertain economic conditions in Japan and Europe. As a result, further devaluations of the yuan are expected by the central bank in the coming months.

Meanwhile, lower investment spending continues to weigh on China's imports. Imports growth has remained in negative territory for a year and recently plunged as a result of reduced commodity imports following lower oil prices and oversupply in many of China's industrial sectors. Imports growth is expected to remain weak until conditions in the real estate market improve and investment activity picks up.

In short, the Chinese government is trying to find the balance between promoting a consumption-driven economy and avoiding a significant slowdown. Weak investment, along with declining exports, will continue to weigh on economic growth in the near term. The economy is expected to stabilize at a new lower average growth rate in a couple of years after oversupply issues are resolved.