

A PICKUP IN THE CHINESE ECONOMY – WHAT TO WATCH

Over the past 12 months, growth and inflation have generally improved globally and China has been no exception to this trend. Analysis of primarily ‘traditional’ economic statistics in China could have underestimated this strength, as many traditional indicators are relatively stable and consistent through time. However, by including alternate measures of growth in our analysis we believe that a more nuanced picture of the Chinese economy can emerge.

The Importance of China

Chinese statistics are often seen by markets to be unreliable as they have a remarkable ability to meet consensus forecasts and generally suffer little volatility. A good example of this is Real GDP which rarely deviates from the stated party goals and has ranged between 6.7% and 7.9% since 2013 despite large changes in commodity prices over the same period. Due to this strong growth the Chinese economy continues to rise in importance and in many years has achieved more growth in outright US dollar (USD) terms than the US. This means investors should not ignore the economic signs based on an assumption that ‘it is made up anyway’, as China is quickly becoming one of the most important economies globally.

Chart 1: Commodity prices vs China GDP



Source: Bloomberg

Chart 2: Change in nominal GDP (YoY) in USD



Source: Bloomberg

What else can we watch?

To help bridge this gap between the perceived unreliability of Chinese statistics and the importance of analysing the world’s second largest economy, we look for measures which have less potential to be manipulated. Many of these indicators show that the improved trajectory of Chinese growth has been in motion for 18 months and could have been a major factor behind the pickup in global growth. These measures include monetary statistics, commodity prices, trade volumes and exchange rates.

The first sign of an improving economy can be found in the monetary statistics, particularly M1 which began to rapidly expand through the end of 2015 and peaked in late 2016. Over the past 10-15 years the M1 statistic has led producer prices by approximately five months and hence saw Chinese input prices rise from -5% to +7% over the same period (Chart 3). Given China is the world’s largest manufacturer and low cost exporter, the prices with which it can fuel its industrial capacity represent an important metric for both global demand and inflation. In addition, the M1 statistic gives a relatively strong lead to residential property prices, which rose from -6% in 2014 to +10% in 2017. Using these two measures, an early sign of the Chinese economy beginning to stabilise could have been observed as an inflationary pulse was set to turn up at the end of 2016. These improved metrics have allowed Chinese corporates to see increased top line revenue growth and improved net profit margins, a notion which was hard to come by from 2012 to 2015.

Chart 3: China M1 vs Producer Prices



Source: Bloomberg

Chart 5: Chinese Freight vs Oil Price



Source: Bloomberg

Chart 4: China M1 vs Property Prices



Source: Bloomberg

Chart 6: Chinese Imports vs Freight



Source: Bloomberg

The second metric to watch is commodity prices, which have also been signaling an improving Chinese economy. An example of this can be seen in the comparison of the oil price to rail freight volumes (Chart 5), which is an indicator of industrial activity occurring in China. As oil prices fell through 2014/2015 it was mirrored by a reduction of freight tonnage and coincidentally a reduction in import volumes. With oil prices stabilising in 2016/2017 a large rebound in both rail volumes and import volumes occurred, pointing to improved demand from China. Given oil prices continue to hover around USD 50 per barrel, this implies that trade volumes in China should begin to level out over the next six months. While this is lower than the growth observed in the recent past, it would be a vast improvement to the falling volumes of 2014/2015.

Given the slowdown in global trade and the world economy that occurred throughout 2014/2015 it is likely that the rising USD, with which the Chinese Yuan (CNY) was pegged, was contributing to a slow-down of the Chinese economy. This can be seen below as an appreciating trade-weighted CNY slowed export volumes. Throughout 2016 the trade-weighted CNY was devalued by approximately 10% which subsequently led to an increase in exports. The increase in exports that has occurred so far during 2017 does not match the usual expansion associated with a 10% devaluation, however it is another welcome sign of improvement in the Chinese economy given export volumes were falling throughout 2015.

Chart 7: Chinese Exports vs Trade Weighted CNY



Source: Bloomberg

Flowing through to the rest of the world

In light of this improvement in the Chinese economy it is also important to appreciate how this travels around the world. The most obvious place to look for this is through trade, as China imports large amounts of materials to manufacture goods and completes vast amounts of infrastructure and construction. This can be seen in commodity exporting countries like Australia, where corporate profit growth has directly mirrored the amount of exports flowing to China. Additionally when focusing on other Australian metrics, a similar relationship can be found in the terms of trade and Gross National Income. Looking at Europe there is also a loose relationship between Chinese imports from the European Union (EU) and EU Inflation. As China increasingly becomes an important location for European exports, trade statistics have been steadily moving in line with EU prices as seen in the chart below.

Chart 8: Australian Profits vs Exports to China



Source: Bloomberg

Chart 9: Chinese Imports from EU



Source: Bloomberg

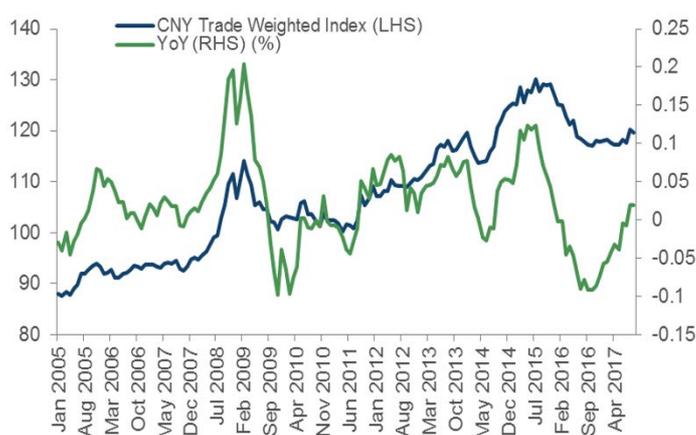
These relationships show how the Chinese economy can filter out into global economies and aid global growth. For this reason, it is becoming increasingly important to determine how strong the Chinese economy is and what direction it is likely heading. Fortunately, alternate growth measures can be monitored in real time and potentially forecast into the future based on the current environment.

Looking Forward

Over the past 12 months the alternate indicators have been showing that a growth pulse would be imminent in China and this has subsequently been mirrored in Nominal GDP. At present these indicators are pointing to a slowing economy, albeit from relatively robust levels. Looking forward these metrics should also be watched with caution as the reactive decisions of both overseas central banks and the Chinese authorities can quickly affect their direction.

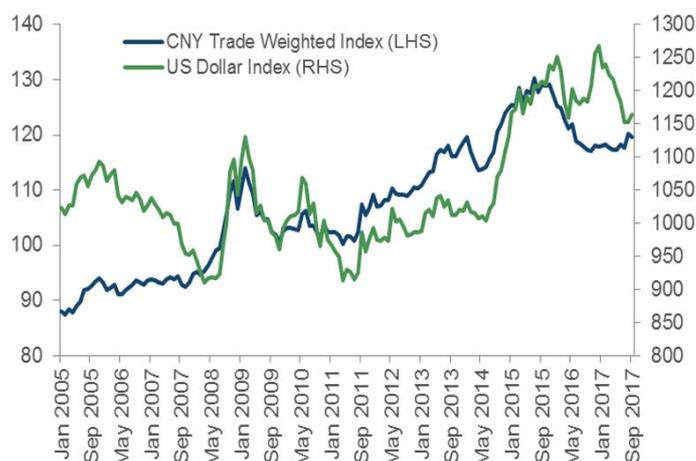
With regards to the trade-weighted CNY, the current trend suggests the currency will stabilise on a year-on-year basis as the prior devaluation washes out. This would represent a relatively benign outlook for export growth over the coming 12 months, potentially comparable to 2012/2013. The complication with this however is that the CNY is loosely pegged to the USD, meaning a rising USD would create further appreciation of the CNY and potentially lower export volumes. Hence going forward, as the US unwinds Quantitative Easing, it will be important to monitor both the USD and the CNY's reaction to that.

Chart 10: China CNY



Source: Bloomberg

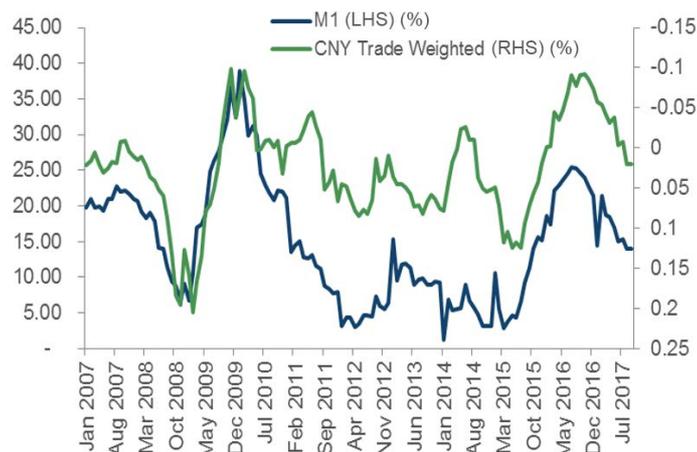
Chart 11: CNY vs USD



Source: Bloomberg

On M1, the trend has begun to slow and at current rates would take approximately 6-9 months to reach levels associated with 2013-2015. This implies that we could begin to see some of the air come out of the property sector and producer prices. Forecasting beyond this period is relatively difficult as Chinese officials need to balance sustainability against increased leverage, as increasing the money base can encourage greater lending. This makes the probable outcome a slow-down from the current levels in M1, which is also being corroborated by the slowing of the depreciation in the trade-weighted CNY.

Chart 12: M1 vs CNY



Source: Bloomberg

Combining the outlook for the currency and M1 statistics suggests that nominal growth should begin to slow over the next 12 months, albeit from a strong pace which has been supportive of the global economy.

Clearly, the alternative growth measures can change rapidly and flow through to the economy in a relatively fast manner. As such it is important to monitor these growth measures and be aware of shifts which could change the investment landscape in China and ultimately the global economy. At the moment we believe these measures are indicating that we have likely just passed the peak of Chinese growth in the short term, but the momentum should remain robust.

Important Information

This document is prepared by Nikko Asset Management Co., Ltd. and/or its affiliates (**Nikko AM**) and is for distribution only under such circumstances as may be permitted by applicable laws. This document does not constitute investment advice or a personal recommendation and it does not consider in any way the suitability or appropriateness of the subject matter for the individual circumstances of any recipient.

This document is for information purposes only and is not intended to be an offer, or a solicitation of an offer, to buy or sell any investments or participate in any trading strategy. Moreover, the information in this material will not affect Nikko AM's investment strategy in any way. The information and opinions in this document have been derived from or reached from sources believed in good faith to be reliable but have not been independently verified. Nikko AM makes no guarantee, representation or warranty, express or implied, and accepts no responsibility or liability for the accuracy or completeness of this document. No reliance should be placed on any assumptions, forecasts, projections, estimates or prospects contained within this document. This document should not be regarded by recipients as a substitute for the exercise of their own judgment. Opinions stated in this document may change without notice.

In any investment, past performance is neither an indication nor guarantee of future performance and a loss of capital may occur. Estimates of future performance are based on assumptions that may not be realised. Investors should be able to withstand the loss of any principal investment. The mention of individual stocks, sectors, regions or countries within this document does not imply a recommendation to buy or sell.

Nikko AM accepts no liability whatsoever for any loss or damage of any kind arising out of the use of all or any part of this document, provided that nothing herein excludes or restricts any liability of Nikko AM under applicable regulatory rules or requirements.

All information contained in this document is solely for the attention and use of the intended recipients. Any use beyond that intended by Nikko AM is strictly prohibited.

Japan: The information contained in this document pertaining specifically to the investment products is not directed at persons in Japan nor is it intended for distribution to persons in Japan. Registration Number: Director of the Kanto Local Finance Bureau (Financial Instruments firms) No. 368 Member Associations: The Investment Trusts Association, Japan/Japan Investment Advisers Association/Japan Securities Dealers Association.

United Kingdom and rest of Europe: This document constitutes a financial promotion for the purposes of the Financial Services and Markets Act 2000 (as amended) (FSMA) and the rules of the Financial Conduct Authority (the FCA) in the United Kingdom (the FCA Rules).

This document is communicated by Nikko Asset Management Europe Ltd, which is authorised and regulated in the United Kingdom by the FCA (122084). It is directed only at (a) investment professionals falling within article 19 of the Financial Services and Markets Act 2000 (Financial Promotions) Order 2005, (as amended) (the Order) (b) certain high net worth entities within the meaning of article 49 of the Order and (c) persons to whom this document may otherwise lawfully be communicated (all such persons being referred to as relevant persons) and is only available to such persons and any investment activity to which it relates will only be engaged in with such persons.

United States: This document is for information purposes only and is not intended to be an offer, or a solicitation of an offer, to buy or sell any investments. This document should not be regarded as investment advice. This document may not be duplicated, quoted, discussed or otherwise shared without prior consent. Any offering or distribution of a Fund in the United States may only be conducted via a licensed and registered broker-dealer or a duly qualified entity. Nikko Asset Management Americas, Inc. is a United States Registered Investment Adviser.

Singapore: This document is for information only with no consideration given to the specific investment objective, financial situation and particular needs of any specific person. You should seek advice from a financial adviser before making any investment. In the event that you choose not to do so, you should consider whether the investment selected is suitable for you. Nikko Asset Management Asia Limited is a regulated entity in Singapore.

Hong Kong: This document is for information only with no consideration given to the specific investment objective, financial situation and particular needs of any specific person. You should seek advice from a financial adviser before making any investment. In the event that you choose not to do so, you should consider whether the investment selected is suitable for you. The contents of this document have not been reviewed by the Securities and Futures Commission or any regulatory authority in Hong Kong. Nikko Asset Management Hong Kong Limited is a licensed corporation in Hong Kong.

Australia: Nikko AM Limited ABN 99 003 376 252 (**Nikko AM Australia**) is responsible for the distribution of this information in Australia. **Nikko AM Australia** holds Australian Financial Services Licence No. 237563 and is part of the Nikko AM Group. This material and any offer to provide financial services are for information purposes only. This material does not take into account the objectives, financial situation or needs of any individual and is not intended to constitute personal advice, nor can it be relied upon as such. This material is intended for, and can only be provided and made available to, persons who are regarded as Wholesale Clients for the purposes of

section 761G of the Corporations Act 2001 (Cth) and must not be made available or passed on to persons who are regarded as Retail Clients for the purposes of this Act. If you are in any doubt about any of the contents, you should obtain independent professional advice.

New Zealand: Nikko Asset Management New Zealand Limited (Company No. 606057, FSP22562) is the licensed Investment Manager of Nikko AM NZ Investment Scheme and the Nikko AM NZ Wholesale Investment Scheme.

This material is for the use of researchers, financial advisers and wholesale investors (in accordance with Schedule 1, Clause 3 of the Financial Markets Conduct Act 2013 in New Zealand). This material has been prepared without taking into account a potential investor's objectives, financial situation or needs and is not intended to constitute personal financial advice, and must not be relied on as such. Recipients of this material, who are not wholesale investors, or the named client, or their duly appointed agent, should consult an Authorised Financial Adviser and the relevant Product Disclosure Statement or Fund Fact Sheet (available on our website www.nikkoam.co.nz).

Kingdom of Bahrain: The document has not been approved by the Central Bank of Bahrain which takes no responsibility for its contents. No offer to the public to purchase the Strategy will be made in the Kingdom of Bahrain and this document is intended to be read by the addressee only and must not be passed to, issued to, or shown to the public generally.

Kuwait: This document is not for general circulation to the public in Kuwait. The Strategy has not been licensed for offering in Kuwait by the Kuwaiti Capital Markets Authority or any other relevant Kuwaiti government agency. The offering of the Strategy in Kuwait on the basis a private placement or public offering is, therefore, restricted in accordance with Decree Law No. 7 of 2010 and the bylaws thereto (as amended). No private or public offering of the Strategy is being made in Kuwait, and no agreement relating to the sale of the Strategy will be concluded in Kuwait. No marketing or solicitation or inducement activities are being used to offer or market the Strategy in Kuwait.

Kingdom of Saudi Arabia: This document is communicated by Nikko Asset Management Europe Ltd (Nikko AME), which is authorised and regulated by the Financial Services and Markets Act 2000 (as amended) (FSMA) and the rules of the Financial Conduct Authority (the FCA) in the United Kingdom (the FCA Rules). This document should not be reproduced, redistributed, or sent directly or indirectly to any other party or published in full or in part for any purpose whatsoever without a prior written permission from Nikko AME.

This document does not constitute investment advice or a personal recommendation and does not consider in any way the suitability or appropriateness of the subject matter for the individual circumstances of any recipient. In providing a person with this document, Nikko AME is not treating that person as a client for the purposes of the FCA Rules other than those relating to financial promotion and that person will not therefore benefit from any protections that would be available to such clients.

Nikko AME and its associates and/or its or their officers, directors or employees may have or have had positions or material interests, may at any time make purchases and/or sales as principal or agent, may provide or have provided corporate finance services to issuers or may provide or have provided significant advice or investment services in any investments referred to in this document or in related investments. Relevant confidential information, if any, known within any company in the Nikko AM group or Sumitomo Mitsui Trust Bank group and not available to Nikko AME because of regulations or internal procedure is not reflected in this document. The investments mentioned in this document may not be eligible for sale in some states or countries, and they may not be suitable for all types of investors.

Oman: The information contained in this document neither constitutes a public offer of securities in the Sultanate of Oman as contemplated by the Commercial companies law of Oman (Royal decree 4/74) or the Capital Markets Law of Oman (Royal Decree 80/98, nor does it constitute an offer to sell, or the solicitation of any offer to buy non-Omani securities in the Sultanate of Oman as contemplated by Article 139 of the Executive Regulations to the Capital Market law (issued by Decision No. 1/2009). This document is not intended to lead to the conclusion of any contract of whatsoever nature within the territory of the Sultanate of Oman.

Qatar (excluding QFC): The Strategies are only being offered to a limited number of investors who are willing and able to conduct an independent investigation of the risks involved in an investment in such Strategies. The document does not constitute an offer to the public and should not be reproduced, redistributed, or sent directly or indirectly to any other party or published in full or in part for any purpose whatsoever without a prior written permission from Nikko Asset Management Europe Ltd (Nikko AME). No transaction will be concluded in your jurisdiction and any inquiries regarding the Strategies should be made to Nikko AME.

United Arab Emirates (excluding DIFC): This document and the information contained herein, do not constitute, and is not intended to constitute, a public offer of securities in the United Arab Emirates and accordingly should not be construed as such. The Strategy is only being offered to a limited number of investors in the UAE who are (a) willing and able to conduct an independent investigation of the risks involved in an investment in such Strategy, and (b) upon their specific request.

The Strategy has not been approved by or licensed or registered with the UAE Central Bank, the Securities and Commodities Authority or any other relevant licensing authorities or governmental agencies in the UAE. This document is for the use of the named addressee only and should not be given or shown to any other person (other than employees, agents or consultants in connection with the addressee's consideration thereof).

No transaction will be concluded in the UAE and any inquiries regarding the Strategy should be made to Nikko Asset Management Europe Ltd.