Invesco

Investment Perspective

Invesco Asia Pacific

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Seeking Greater Economic Stability

Multiple factors influence China's financial outlook

Though 2009 was trying economically, the year of the ox showed China's ability to bear substantial financial burdens. Chinese markets were among the first to recover from the Great Recession and helped pull the global economy forward, returning approximately 62% for the year and almost 10% during the fourth quarter of 2009.[1] But investors entering the year of the tiger may well wonder if such results are sustainable. In our view, China is entering a phase that will allow for steady economic expansion with both moderate growth rates and moderate inflation.

A three-pronged approach

Creating an attractive market environment will have its challenges, but the Chinese government has cited three important factors for moving toward economic stability: an 8% gross domestic product (GDP) growth rate, inflation of about 3% and a stable yuan.

GDP

For years, growth has attracted investors to China. But it hasn't simply been growth for growth's sake. The Chinese government has deemed an 8% GDP growth rate a critical part of the country's economic stability because it serves as a barometer for export rates, employment numbers and internal demand for goods and services. China's GDP grew by 8.7% despite sluggish exports in 2009.[2]

A turnaround in exports will obviously support GDP growth in 2010. Global forecasts reflect that many economies are still recovering, which means demand for Chinese products is somewhat uncertain. But China's export numbers are no longer dependent on relatively basic consumer products, such as clothing and toys. Chinese companies have worked diligently to expand the country's export base, which may help beef up demand in 2010.

While non-Chinese consumer demand is rebuilding slowly, Chinese consumers seem to have opened their wallets again – especially with government subsidies that encourage spending. We expect increased consumption to influence GDP growth as consumers

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Data as of Dec. 31, 2009, unless otherwise stated.

1 Source: Lipper Inc. Returns are those of the MSCI China Index.
2 cnn.com, "China GDP Grows by 8.7% in 2009," Jan. 20, 2010

gain confidence. Subsidy programs for appliances and fuel-friendly automobiles have been two of the biggest contributors to growing consumer demand. In fact, China surpassed the U.S. as the world's largest auto market with 13 million sales last year.[1]

Inflation

Because consumerism's share of GDP is growing, rising inflation levels could claw away at individual purchasing power, which underscores why moderate inflation will be part of economic stability.

Unless the consumer price index surges to alarmingly high levels, the Chinese government will likely fine-tune fiscal policies in specific sectors to curb excess growth. For example, strict mortgage rules for second-time home buyers were recently imposed to discourage speculative property investments. Some investors are concerned that restrictive sector-specific policies could indicate China's monetary policy will be much tighter overall and dampen global economic recovery. We believe China will maintain its proactive fiscal policy and a moderately loose monetary policy until we see more concrete recovery in exports.

Yuan stability

Currency values will also influence inflation and export numbers. We believe the yuan will remain stable or appreciate slightly in 2010.

The People's Bank of China, like other Asian central banks, faces the dilemma of currency direction. On one hand, raising exchange rates may trigger higher capital inflows and currency appreciation, which are positive economically. But higher currency values could curb export competitiveness – an unwanted side effect considering the fragility we see in exports.

That's why we believe it's in the Chinese government's interest to keep the yuan exchange rate near its current level until exports look more stable and sustainable.

Opportunities in 2010

Though questions about Chinese markets remain for 2010, the consensus earnings growth forecast is healthy as measured by the MSCI China Index. We believe cyclical sectors, including materials, information technology (IT) and industrials, will contribute to earnings. Commodity prices have recovered, which has given the materials sector a lift. Higher demand and increased Internet penetration jump-started the IT sector, and some industrials companies, such as freight, have seen demand recover as well.

We believe telecommunication services and utilities companies will deliver below-market earnings because telecom expenditures in 3G network development have lowered available cash levels, and higher coal prices will likely squeeze utility providers' margins.

Overall, we believe companies that have high levels of in-country business will provide attractive opportunities because of government policies that encourage spending. Not all consumer-related companies will flourish with the influence of subsidies and other policies. Company fundamentals will likely be the key to returns in 2010. That's why we believe bottom-up fundamental research is essential to finding quality investment opportunities.

1 Source: cbc.ca, "China Maintains World Lead in Auto Sales," Feb. 9, 2010