



IMPACT OF THE U.S. SLOWDOWN ON GLOBAL MARKETS: **CHINA**

TOP U.S. TRADING PARTNERS

March 2008, by Total Trade
(Exports and Imports)

CANADA
MEXICO
CHINA
JAPAN
GERMANY
UNITED KINGDOM
SOUTH KOREA
FRANCE
TAIWAN
NETHERLANDS

Source: U.S. Census Bureau,
Foreign Trade Division

Researchers have made it clear that the top U.S. trading partners should expect declining exports and shrinking GDP to continue in the wake of the U.S. economic slowdown. While there are mixed conclusions about how this will play out, most agree that—minimally—there are still cautious days ahead for the major global markets.

Across Asia, reporters and analysts have kept a close eye on the U.S. economy. As a writer for India's national paper described it: "Even without the U.S. Federal Reserve Chairman's recent, mostly pessimistic, assessment of the state of the U.S. economy, the rest of the world would have had ample reasons to worry about the consequences of a slowdown in the world's largest economy."¹

CHINA'S VULNERABILITY

With exports to the United States making up about 19% of its total exports, China lies squarely in the path of significant ripple effects. Frank Gong, Managing Director and Head of JPMorgan Research and Strategy, suggests "a change of one percentage point in US nominal GDP growth leads to around a five-percentage-point change in Chinese export growth."²

According to China's Q1 2008 GDP numbers, direct impacts to China's economy are mixed. GDP continues to grow at a rate of 10.6%, which is 1.1%

higher than the same period last year. However, exports are down more than 6.4% over last year, at 21.4% of GDP.³

The question is how long can China sustain its current growth—and continue to fight off dwindling exports?

David Dollar, the World Bank's Country Director for China and Mongolia, has called 2008 China's "year of living dangerously." In his East Asia & Pacific blog, Dollar suggests China may view a growth rate of 8-9% as sustainable⁴—so we may not see any outwardly cautious measures until growth slows a bit more.

Consumer confidence and domestic production may be mitigating the effects of the slowdown for China. But Dollar continues to be cautious about these factors. "The question that no one can answer for sure," he says, "is what happens to consumer confidence when net exports decline and subtract from GDP growth and when investment falls off."

CHINA BANKS AND OFFSHORE INVESTMENT

In late 2007, two of China's largest banks—Bank of China and Industrial and Commerce Bank of China—were punished by investors on the news that the banks had invested a significant portion of their portfolios in mortgage-backed securities. However, the impact to the banks' Q1 2008 earnings was minimal, as both managed more than 75% growth over the same period in 2007.⁵

So-called "market headwinds"—including RMB appreciation (10% since January 2007) and the impact of the U.S. slowdown on global equity markets—have made it more challenging to raise funds in China for investment abroad, and domestic programs have seen net asset values slip.

Four Qualified Domestic Institutional Investor (QDII) asset management funds were launched in China in the second half of 2007, giving investors new overseas options for equity investments. Since inception, the average NAV for the four funds is down more than 25%. Banking sector QDIIs

have seen an even bigger drop in NAV, with averages ranging from -15% to -40%.

In the most extreme example of a struggling QDII, China Minsheng Banking Corp. was forced to liquidate its fund after its NAV fell more than 50% since inception. According to a *South China Morning Post* article on March 27, Minsheng sold over 100 million RMB worth of the fund, saw its initial value rise over 18% and then drop below 50% of its initial value this year.

QDII ASSET MANAGEMENT FUND LAUNCHES: Q3 AND Q4 2007

FUND	FUNDS RAISED	NAV (AS OF APRIL 9)
China Southern Fund	30 billion RMB/ USD 4.2 billion	.811
China AM	30 billion RMB/ USD 4.2 billion	.768
Harvest Fund	30 billion RMB/ USD 4.2 billion	.69
China International Fund	30 billion RMB/ USD 4.2 billion	.69
TOTAL FUNDS RAISED:		USD 16.8 billion
AVG. NAV SINCE INCEPTION:		.74 (down 26%)

QDII ASSET MANAGEMENT FUND LAUNCHES: Q1 AND Q2 2008

Q1 AND Q2 2008	FUNDS RAISED	NAV (AS OF APRIL 9)
ICBC Credit Suisse	3.2 billion RMB/ USD 457 million	.98
CICC	350 million RMB/ USD 50 million	Unknown
Fortune SGAM	463 million RMB/ USD 66 million	Just launched
TOTAL FUNDS RAISED:		USD 573 million

Source: JPMorgan estimates, April 9, 2008.

“...we see the current market volatility affecting China’s investors’ behavior as part of a healthy process of gradual integration into the global capital markets.”

Three additional QDII funds were launched in Q1 2008. However, the market reaction to these funds was significantly less exuberant than in 2007; subscription rates were much slower, and the sizes of the funds were significantly lower.

A-SHARE TURBULENCE

The Shanghai Composite Index, which tracks Chinese companies listed on the domestic, or ‘A’ share exchange, has seen a 44% drop in performance since hitting a high in October 2007.

According to Jing Ulrich, JPMorgan’s Chairman for China Equities, “average daily turnover on the Shanghai market has fallen 65% below levels seen last summer.” At the same time, Ulrich adds, “households added over RMB 2 trillion in deposits” with banks from December 2007 through March 2008.⁶

This A-share sell-off since late 2007 suggests that local sentiment may have been impacted by a number of issues: fears of the impact of a global market slowdown on China’s GDP; the related effect on corporate earnings for export-oriented companies; a rise in headline inflation in 2008 to a 10-year high of 8.7% in February;⁷ and the rise in price of commodities and oil.

Another issue weighing on the minds of investors in China is the potentially large supply of nontradable A shares that will begin coming to market in 2008 and 2009 as lockup periods expire.

Finally, it can be argued that investor psychology

is the key driver of market volatility in China. The premium of A shares over H shares is one example of a divergence in view by two sets of investors over the same fundamental companies. This premium has recently dropped from over 100% in January to around 50% today. The premium also reflects the limited choice mainland investors have when it comes to choosing local stocks —another reason the

government is looking to push portfolio diversification through international equity holdings and QDII.

“China is arguably the most dynamic growth economy in the world,” says Laurence Bailey, Managing Director, Asia-Pacific Business Executive for JPMorgan Investor Services. “Our view is to the long term; we see the current market volatility affecting China’s investors’ behavior as part of a healthy process of gradual integration into the global capital markets.” As regulators, asset managers and investors look to global markets for investment opportunities and risk diversification, JPMorgan Investor Services will be there to support their needs. ○

1. *The Hindu*, Opinion section, November 16, 2007 (<http://www.thehindu.com/2007/11/16/stories/2007111654421200.htm>).

2. Frank Gong, *China Insights & Strategy: Assessing and Trading the China Slowdown + Inflation Risks*, page 13.

3. National Bureau of Statistics China, April 16, 2008.

4. David Dollar, “China’s Economic Year of Living Dangerously,” World Bank East Asia & Pacific blog, original entry April 22 and follow-up comments April 25, 2008 (<http://eapblog.worldbank.org/content/china%E2%80%99s-economic-year-of-living-dangerously>).

5. JPMorgan analysis of the respective banks’ Web sites and quarterly reports.

6. Jing Ulrich, JPMorgan’s Hands-On China Series, Market Commentary, March 28, 2008.

7. *The Wall Street Journal*, Friday, May 9.