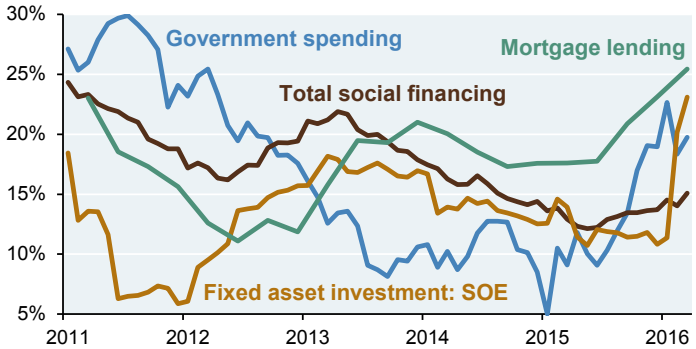
China: stabilization, courtesy of coordinated stimulus

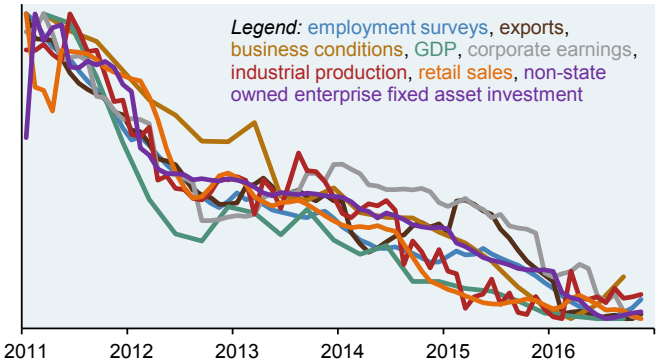
2016 was a year of stabilization in China, and 2017 looks like it will be more of the same. As shown below (left), a massive, coordinated stimulus effort involving bank lending, government spending and fixed investment by state-owned enterprises took place towards the end of 2015. In response, the Chinese economy stabilized in 2016 (see 2nd chart on employment, exports, business surveys, corporate earnings, GDP, industrial production, retail sales, etc).

Pump Up the Volume
Y/Y % change



Source: JPMS, PBOC, CNBS, Haver Analytics. March 2016.

China: stabilization in 2016



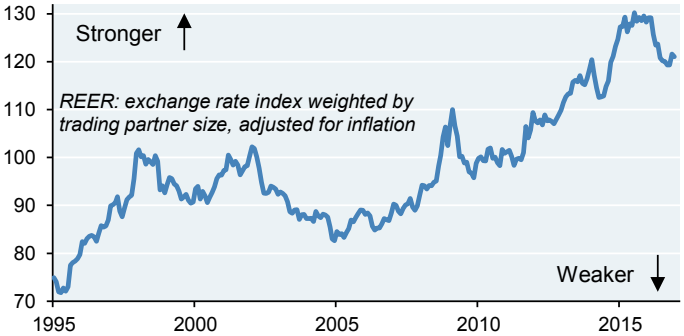
Source: CFLP, Markit, CC, PBOC, CNBS, MSCI, Haver, JPMAM. Nov 2016.

While stabilization is welcome, parts of China's corporate sector are still highly indebted and suffering from both chronic overcapacity and an overvalued exchange rate. China's corporate debt surge is now by some measures as large as the Japanese version of the 1980s. Some consequences: 25% of listed Chinese companies have cash flow that is less than the interest they owe to banks and bondholders[15]; and a meager 1.5% return on assets at state-owned enterprises. All things considered, and given the difficulties involved with running massive stimulus indefinitely, Chinese GDP growth is probably headed to 5.5%-6.0% by 2018.

Corporate debt levels in China
Non-financial corporate debt, % of GDP

Source: Bank for Int'l Settlements, Haver, Gavekal, JPMAM. Q3 2016.

Long-term appreciation of the Chinese RMB
RMB real effective exchange rate index



Source: J.P. Morgan Securities LLC, Bloomberg. December 16, 2016.

CHINA

[15] "*China – avoiding the Japanese sinkhole?*", Lombard Street Research, May 10, 2016.

The good news: markets have come closer to pricing in the realities of Chinese fundamentals. The premium for A shares (onshore stocks trading in Shanghai and Shenzhen) relative to H shares (Hong Kong-listed) has come down by half, indicating less of a frenzy in the local markets. Furthermore, margin balances declined sharply after the boom-bust fiasco in 2015, and institutional protections were put in place (higher reserve requirements, limits on structured finance vehicles). Finally, many of the circuit breakers and trading suspensions have been lifted. As a result, equity-raising has resumed in China, allowing many companies to recapitalize and pay down debt.

However, some remnants of China's reaction to the 2015 equity market collapse remain: corruption investigations into "market manipulators" continue, regulators still tightly control the IPO market, and the government still appears to own a lot of the stock it bought as the equity market was declining. Eventually, the depth of the Chinese equity market should improve as domestic institutional investors such as pension funds increase their allocations. Currently, individuals still account for 80% of the trading and 70% of free float ownership.

China: margin debt vs. onshore equity prices

Source: National statistics offices, Bloomberg, JPMAM. December 16, 2016.

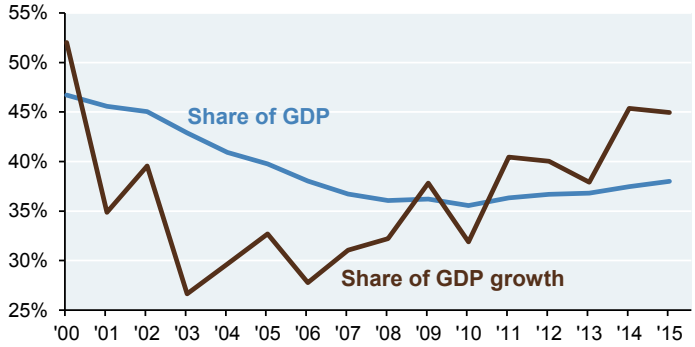
China price-to-earnings multiples

Source: MSCI, Bloomberg, Datastream, JPMAM. December 16, 2016.

Investors should also remember that the Chinese financial system is a work in progress, and that the government continues to clean up the shadow banking system. The government is currently imposing new capital charges and risk provisions on distributors of asset management products. Good news in the long run, but potentially destabilizing in the short run.

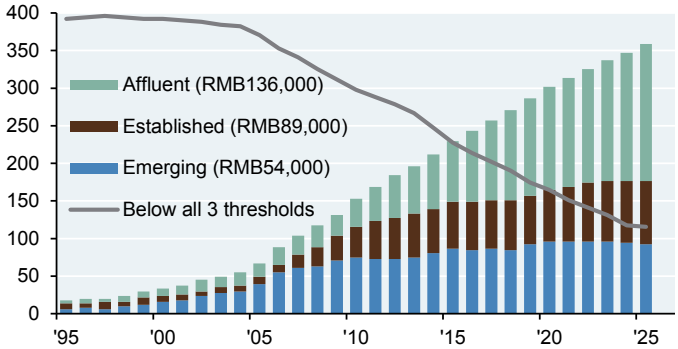
The gradual rebalancing of the Chinese economy should continue in 2017, with consumption growing relative to capital spending. Real incomes and real consumption are still growing at 6%-7% per year, and for investors, it's worth paying attention to the continued rapid growth in the number of affluent Chinese households. One illustrative consequence: faster growth in SUV purchases than sedan purchases, faster growth in overseas travel, preference for fresh coffee (vs. instant) and maturation in the internet penetration rate at around 55%[16].

Chinese household consumption expenditures
Share of GDP & GDP growth, %



Source: China National Bureau of Statistics. 2015.

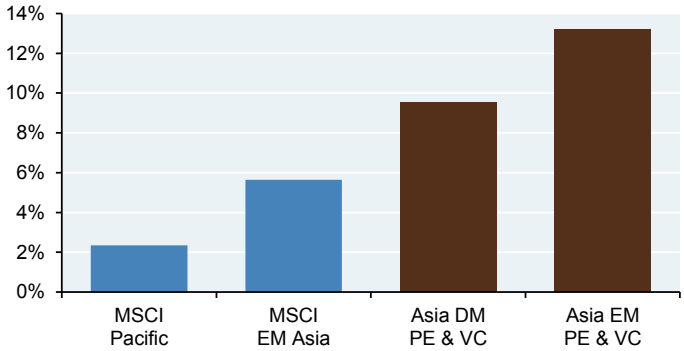
Chinese households by wealth level
Million households



Source: Gavekal Dragonomics Chinese Consumer Outlook, Nov. 2016.

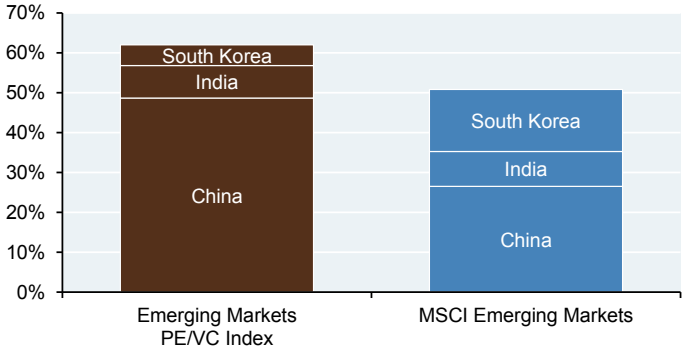
For investors interested in China/Asia consumption, I always caution against looking to Chinese public equity markets as a way of expressing this view. In countries like China[17], Taiwan and Hong Kong, the combined weight of consumer staple and consumer discretionary stocks is **less than 10%** of stock market capitalization. What makes more sense to me: a targeted strategy, either in public or private equity markets. As shown below, on an industry-wide basis, private equity and venture capital managers have outperformed public equity markets in Asia. Part of the explanation lay in manager decisions to overweight consumer-related companies and underweight state-owned enterprises, banks, heavy industry, airlines and utilities.

Private equity performance versus public equity in Asia
10-year annualized return through Q2 2016



Source: Cambridge Associates LLC, MSCI, Bloomberg, JPMAM.

China dominates emerging markets private investments
Index weight



Source: Cambridge Associates, MSCI, Bloomberg. December 2015.

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[16] Gavekal Dragonomics Consumer Chartbook, November 2016.

[17] This comment is based on the MSCI China Index, which includes H shares, B shares, Red chips and P chips.

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