Slow Growth in US, but an Opportunity in China

Investment Strategy Group
Market Update
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The June jobs report was yet another confirmation of the apparent Q2 slowdown. While the US economy appears to have expanded – albeit slowly – in Q2 and is likely to do so again in Q3, the uncertainty surrounding Europe and the beleaguered condition of the US consumer are taking a toll. Investors should expect slow growth for the remainder of 2012. However, we are more optimistic – although cautiously – on China. The Chinese economy still faces significant headwinds, but we believe the lagged impact of monetary easing and fiscal stimulus should start to be felt by year's end.

US Slowing, Not *Yet* Stalling

June's non-farm payroll report was the third strike for the labor market, and removes any hope that the weak April or May numbers were flukes. Net new jobs came in at 80k, modestly below consensus and the third consecutive month in which job creation has been below 100k. Optimists could claim the glass was half full based on some marginal improvement in hours worked and hourly wages. While other indicators from the labor market – most importantly initial jobless claims – continue to evidence some improvement since last fall, most of the data is tracking lower. The inescapable conclusion is that the burst of hiring seen in Q1 has faded.

However, with the exception of a weak ISM new orders component – new orders witnessed the largest drop since October 2001 – most leading indicators are holding up better; suggesting that the economy is not falling back into a recession. Unfortunately, that is about the best that can be said.

We continue to believe that in the absence of a more acute crisis, Europe will muddle through and the US will continue to grow, but we have modest expectations for the remainder of the year. Our in-house estimates suggest that the economy grew by around 2% in Q2 and should grow by a similar amount in Q3. For investors, this means retaining overweight themes like dividends or minimum volatility that are not dependent on a resurgence of economic growth.

China Can Escape Growth Purgatory

With Europe in an ever-deepening recession and the US stuck in slow growth mode, China's economic problems might seem enviable. But as investors and the Chinese themselves have come to regard +10% growth as almost inevitable, the current economic soft patch in China is frightening. Investors are increasingly worried that the government's new 8% target will turn into a ceiling, rather than a floor. While we don't dismiss the risks of a Chinese hard landing, our own analysis suggests that China should be able to maintain growth in the 7.5% to 8.5% range over the next few quarters. Assuming this is correct, we believe Chinese equities represent an attractive opportunity.

We believe that for the remainder of the year, Chinese leaders will do whatever it takes to spur economic growth. As inflation fades – from 6.5% last fall to 2.2% today – the People's Bank of China is free to ease monetary conditions aggressively. China lowered interest rates twice within a month. We believe this suggests that Beijing is signaling that it is refocusing on growth and it is willing to take additional steps if necessary.

As the lagged impact of last year's monetary tightening wanes, we believe that Chinese growth should begin to stabilize. In addition, we have also seen a number of innovative steps in recent weeks that suggest that China is also accelerating the pace of financial liberalization. While this is unlikely to have a significant impact in the near term, it is a positive for the country's long-term growth prospects.

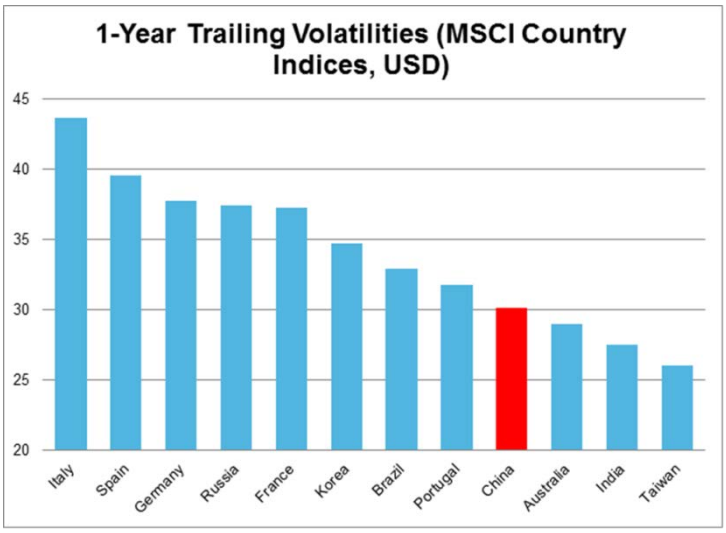
Under a soft-landing scenario, Chinese equities look unambiguously cheap. Stocks in China are trading at less than 1.40x book value. This valuation compares favorably with other Asian emerging market countries as well as its own history. Investors seem to be increasingly discounting a hard landing, the absence of which may provide the catalyst for the next rally (see Figure 1).

Figure 1

Source: Bloomberg 7/9/12

There is a final reason to consider adding Chinese equities: While this might not seem intuitive, for an emerging market China is a relatively low-risk play. Looking at one-year trailing volatility, China's volatility looks reasonable compared to other emerging markets and even low when compared to many of the problem children of southern Europe. In addition, China also enjoys a relatively stable currency, which further reduces the volatility of its returns for dollar- or euro-based investors (see Figure 2).

Figure 2



Source: Bloomberg, as of 7/9/12.

For investors still underweight emerging markets, we would argue that China represents a good opportunity to add to positions. While there is some risk of a hard landing, we believe many of the risks are already reflected in the current valuations. Given all of the pessimism already reflected in current prices, if China does engineer a soft landing in Q3, we believe stocks can move significantly higher.

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