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KKR Releases Outlook on Chinese Economy by Henry McVey

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NEW YORK--(BUSINESS WIRE)-- Today, KKR released a new Insights piece by Henry McVey, Member & Head of Global Macro and Asset Allocation, "China's Rebalancing Effort: Will It Be Enough?" In the piece, McVey discusses the shift in the Chinese economy and how today it is more focused on services than on fixed investment. Overall, McVey is encouraged about the economic transition that is occurring in China:

"Over the past 10 years, China has been the fastest growing major economy in the world. It has also had among the worst stock market returns as capital was misallocated badly to drive growth and employment in areas of the economy that either lacked competitive advantage and/or did not create productive returns on capital. Today, we envision a different outlook for China. We see a slower growth economy with the potential for a better stock market in the near-term. Key to our thinking is that China now has a fast growing services economy that is larger than its combined construction and export sectors."

The piece outlines important macro-related investment conclusions. These include:

1) **Fixed asset investment as a percentage of gross domestic product (GDP) has peaked**. Environmental concerns – by becoming more important than job creation – are now driving public and private corporate behavior. Consistent with this more conservative projection, decisions over key spending initiatives and growth targets are now increasingly being made by Beijing, not local provinces.

2) **Against this backdrop, the government is prodding the private sector to allocate more resources toward services that can boost overall growth in China without as many environmental issues.** In addition, a larger services sector will help to chip away – in aggregate – at the country's overly leveraged corporate sector.

3) **Despite lower oil prices, energy efficiency remains a major focus.** As of 2014, our research shows that oil demand is growing about 0.69% for every 1.0% of GDP growth, which is significantly lower oil intensity than the 0.94% ratio that prevailed 10 years ago. We see it falling even further, underscoring that China appears to be making progress in the area of energy efficiency at a time when many of its emerging market (EM) peers are not. That said, even with improving efficiency, we still forecast that China will account for a full 36% of incremental global oil demand through 2018.

4) **Contrary to conventional wisdom, we do not view the recent rate cut by the People's Bank of China (PBOC) as providing a large stimulus for the Chinese economy.** In fact, we left Beijing with the view that the rate cut was primarily designed to slow non-performing loan formation in the existing corporate sector, particularly a weakened industrial sector.

5) **Reforms, including anti-corruption initiatives and greater transparency in the financial services arena, continue to gain momentum, despite their near-term chilling effect on GDP growth**. We see signs that the government is finally raising the bar on pricing credit risk properly at the local level. In our view, if China is ever to mend its excessive lending habits, reining in credit at the local level is required.

6) **China's Internet economy is having a profound effect on traditional commerce.** China's online sales effort is already larger than that of the United States. A key reason for the country's rapid success is that China's large Internet companies face much less competition from traditional vendors, retail in particular, than in other countries.

7) **Though it may pause, we do not believe that the current rally in A-shares is over.** Equity issuance is a critical variable in the deleveraging process, so – all else being equal – higher, not lower prices are more desirable for the Chinese leadership. Moreover, from an asset allocation standpoint, a low inflation environment favors stocks over real estate, which has traditionally been viewed as an effective hedge against the "norm" of high inflation and low deposit rates.

Links to access the full report as well as an archive of our previous publications follow:

- To read the latest Insights go to: http://www.kkr.com/global-perspectives/publications/china%E2%80%99s-rebalancing-effort-will-it-be-

enough
- To download a PDF version go to: http://www.kkr.com/sites/default/files/KKR_Insights_28-150223.pdf
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