CHINA UPDATE

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MODESTLY FASTER GROWTH NEXT YEAR TO ADD TO GLOBAL EMERGING MARKET BUSINESS CYCLE UPSWING

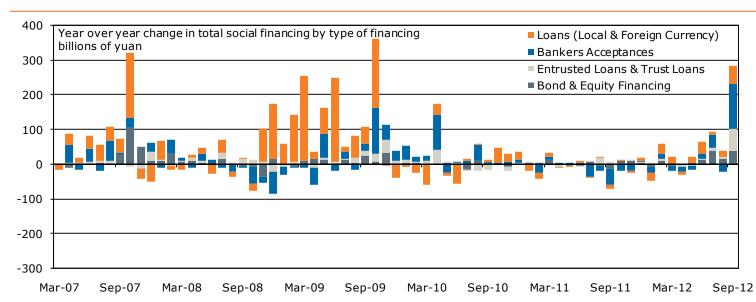
China's growth cycle marks a turning point...

Matching market expectations ahead of China's third guarter economic release, real GDP growth slowed to 7.4 percent in year over year terms, from 7.6 percent in the second quarter and 8.1 percent in the first. Signs of stabilizing growth in September, however, are apparent in the release's details. Industrial and retail sectors both strengthened in September over August, helped along by strong infrastructure investment and consumer spending. And especially encouraging, nominal investment growth accelerated in September to its fastest pace since October 2011; when converted to quarterly terms and deflated, real fixed asset investment accelerated in both the second and third quarters of 2012 from the first. And in a sign economic improvement is persisting, the HSBC flash manufacturing PMI for October rose to its strongest reading in three months. The recovery currently underway, fueled by monetary stimulus, a less-bad real estate sector, infrastructure spending, and stronger emerging market export demand, will continue through the final months of the year and into 2013, when full-year real GDP growth will likely register about 8.2 percent, half a percentage point faster than this year.

...fueled by stronger credit growth

Stronger investment is the result of faster credit growth since mid-year. Yuandenominated loan growth has been moderate by Chinese standards in 2012, averaging 16 percent in year over year terms between January and September – close to the 17 percent average between 2001 and 2010. But growth of other sources

CHART 1: NEW FUNDING FOR NON-FINANCIAL INVESTMENT INCREASES AFTER MID-YEAR INTEREST RATE CUTS





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of financing for the non-financial sector has been relatively fast (See Chart 1), a reflection of financial innovation diversifying the sources of financing available to Chinese firms. Credit growth has accelerated noticeably following the benchmark interest rate cuts of June 7 and July 5, which cumulatively lowered the cost of a one year loan 236 basis points from 6.56 percent to a minimum of 4.20 percent (since June, banks have had increased latitude to set loan and deposit interest rates). These rate cuts leave real (i.e. inflation-adjusted) interest rates roughly unchanged from 2011, since CPI inflation is about 2.5 percentage points lower this year than last.

Real estate sales transactions recover

A stabilizing real estate market is also helping along the recovery. Monthly turnover of commercial a.k.a. "commodity" floor space sold in the third quarter was 18 percent higher than during the first half of the year and 6 percent higher than its 2011 average when measured by the seasonally adjusted national floor space sold statistic (See Chart 2). If anything, this understates the degree of improvement. Daily transaction data reported by city-level title transfer centers show sales in the third quarter up a whopping 46 percent from the first half and 38 percent from 2011 (not seasonally adjusted). Looser credit should continue to fuel stronger sales into 2013, reducing developers' inventories, boosting construction activity, and driving commodity import demand. Despite a rebound in prices – average house prices rose four consecutive months through September in sequential terms, although they were still 1.4 percent lower than September 2011 – the government seems unlikely to tighten restrictions on the real estate sector further in 2013, since double digit income growth is improving affordability despite modest price increases.

Pickup in September exports is unlikely to be sustained

Exports also improved in September, accelerating to 9.8 percent year over year growth from 7.1 percent in the year through August. This follows an uptick in issuance of banker's acceptance bills beginning in June 2012 (See Chart 1), a trade financing instrument that may be a leading indicator for exports. September's improvement will likely prove transitory, given the headwinds to end market demand for Chinese exports: sluggish growth momentum in the advanced economies that account for three fifths of Chinese exports, and rising unit labor costs which discourage the sourcing of labor-intensive products from China. China's era of 20 percent annual export growth is over.

Urban per capita incomes rose 12.9 percent in year over year terms in the first three quarters of 2012, and will likely see further strong advances next year on a tight labor

CHART 2: REAL ESTATE SALES TRANSACTIONS REBOUND AFTER JUNE 2012



Chart sources: NBS, CEIC, The PNC Financial Services Group Note: seasonal adjustment by PNC

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Wage inflation continues to squeeze manufacturers

market. Robust income growth is a positive sign that the Chinese economy can "rebalance" from relying on export and investment demand to serving its domestic consumers, but makes for a very difficult operating environment in 2012. Squeezed between rising wage bills and falling orders, industrial enterprises have seen net profits fall 18 percent in year over year terms between January and August, 2012. Manufacturers in China will continue in 2013 to replace labor with technology and move production away from the coasts to inland regions where wages are lower (although rising at least as fast). Chinese labor costs are now uncompetitive in the lowest value added textile and assembly industries, although economies of scale, supply chain efficiencies, proximity to final demand, and high quality infrastructure will sustain the industrial sector's overall competitiveness.

As real GDP growth improves to between 7.8 and 8.3 percent in 2013, the People's Bank of China will see an opportunity to further liberalize the exchange rate regime, which over the last year has begun targeting a basket of currencies rather than a crawling dollar peg. Between July and September, the yuan appreciated by 1.2 percent against the U.S. dollar (See Chart 3). Over the same period, the dollar depreciated by 2.4 percent on average against currencies of U.S. trading partners. Since around the second quarter of 2012, the yuan has "split the difference" between tracking the dollar and the currencies of China's other trading partners. Given the outlook for a modestly weaker U.S. dollar in 2013, and in particular for stronger emerging market currencies, the yuan is likely to appreciate 3-5 percent against the U.S. dollar to around 6.08 CNY per USD by the end of next year.

Emerging market business cycle on the upswing in 2013

China's stabilizing growth in the third quarter of 2012 follows similar signs from Brazil and India, reinforcing that the global emerging market business cycle is on the upswing: good news for U.S. exporters, but also adding to the risk that negative real interest rates in advanced economies fuel higher global prices of energy and other basic "commodity" materials in 2013, modestly raising global inflationary pressures.

CHART 3: NEW CURRENCY REGIME LEADS YUAN TO APPRECIATE AGAINST DOLLAR BETWEEN JULY AND SEPTEMBER

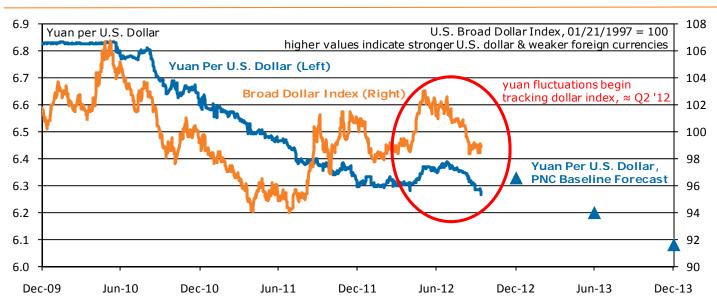


Chart sources: Federal Reserve Board, CEIC, The PNC Financial Services Group

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