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# Recovery on track, inflation less of a problem

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## Highlights

- The recovery of the world economy remains on track. The European debt crisis is showing signs of intensifying. Optimism about inflationary developments in emerging markets is on the rise.

- Equities will probably continue to find it difficult to move forward in the months ahead. Most negative economic surprises have probably now occurred. But the eurozone debt crisis rumbles on and it is increasingly likely that markets have to deal with a default sooner rather than later. Although earnings growth is a positive factor, further downgrades could hurt sentiment in the short term. Valuation is in neutral territory, despite increasing market talk about stocks being cheap.

- The outlook for corporate bonds has become more challenging. We are still positive on investment grade corporate bonds, but during the month we lowered the outlook for high yield to neutral.

- Within equities, emerging markets remain our favorite region. The economies are cooling but growth is still decent. Inflationary risks are decreasing; we thus expect monetary tightening to end in the second half of 2011.

- One could take the view that after having negotiated a cluster of negative economic surprises, it is now time to move back into cyclicals. But we maintain a slight preference for defensives for two reasons. First, defensives such as consumer staples and telecom may benefit from the ongoing uncertainty about the eurozone debt crisis. Second, the seasonal factor is supportive; the May-to-October period is generally good for defensive stocks.

- **This month's special: The Chinese economy is slowing. Inflation will peak soon. A Chinese credit crisis thus remains unlikely, despite reckless lending by local governments.**

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## Summary

**The recovery of the world economy remains on track. The European debt crisis is showing signs of intensifying. Optimism about inflationary developments in emerging markets is on the rise.**

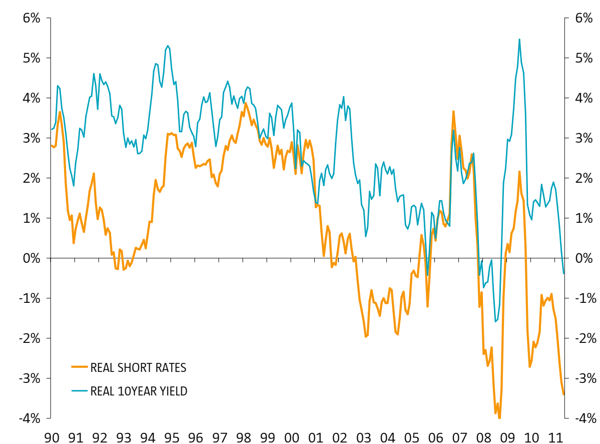
## Macroeconomic view

The recovery of the world economy remains on track. The slowdown in developed markets is probably close to its end, given the acceleration in industrial production in Japan and the unexpected rise in the ISM manufacturing index. The European debt crisis is showing signs of intensifying. Optimism about inflationary developments in emerging markets is on the rise.

### North America

Just as headlines about a double dip are starting to proliferate, we are actually becoming a bit more optimistic on the medium-term prospects for the US economy. For one thing, headwinds have receded in recent months. Oil prices have declined by 15% from the peak reached at the end of April, leaving oil trading close to the levels at the start of the year. Bond yields—although volatile—trended lower during Q2, following the strong spike in Q4 2010. The 25 basis points (bps) decline over the quarter may not seem much, but if the rise in consumer prices is taken into account, real yields have dropped by more than 200 bps since the start of the year. Skeptics may point out that the last time real rates were as negative as they are now was in 2008, prior to the collapse of the US economy (see chart right). It should be noted that the economic downturn at that time was closely linked to the sub-prime crisis and the demise of Lehman Brothers. More than a year before Lehman's bankruptcy, US banks had been significantly tightening loan standards, thereby preventing low real yields from having a positive impact on the economy. Although there are still numerous troubled regional banks in the US, the overall banking system is currently much stronger than it was back in 2007/08. This is also clearly reflected in the steady loosening of loan standards reported in the most recent Senior Loan Officers Survey. In other words, whereas the accommodative rates environment was not passed on to consumers and producers back in 2008, the situation looks much friendlier this time around.

**REAL YIELDS IN THE US ARE CLOSE TO 2008 LOWS**




*SOURCE: BLOOMBERG, ROBECO*

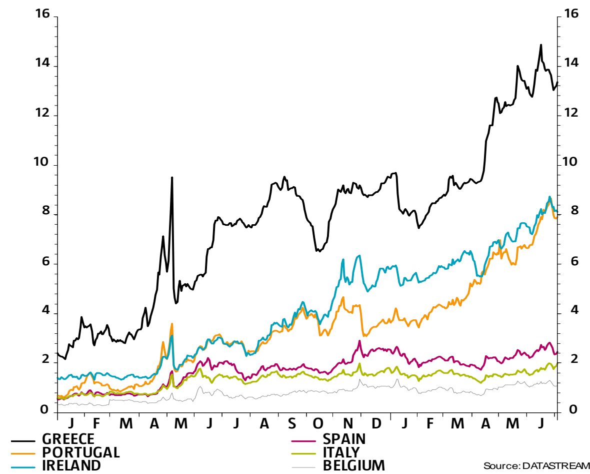
Another factor behind the recent slowdown was the disruption in the Japanese supply chain of the auto industry. The auto industry is always an important economic driver in the US, as it impacts industrial production (factories being shut down), labor markets (workers being temporarily sacked) and consumer spending (limited supply). Consumer spending, for example, has slowed in recent months, but given that this slowdown is mostly related to the durable goods area (read: cars), it looks like this is also linked to the disruption in the supply chain. Income has continued to expand at a 4%+ trajectory, which suggests that the risk of a serious growth slowdown has been overstated.

Given the rebound in the ISM (from 53.5 to 55.3) and the more significant jump in the auto-linked Chicago PMI (up from 56.6 to 61.1), the worst supply-chain problems appear to be in the past. If we add to this the improved environment (lower oil prices, negative real rates), the likelihood of a strong second half of 2011 is improving rather than deteriorating. In the absence of an unexpected event—such as a default by the US government, in the event that the Democrats and Republicans fail to reach a compromise in the US debt talks—fears of double dip are set to decline.

## Europe

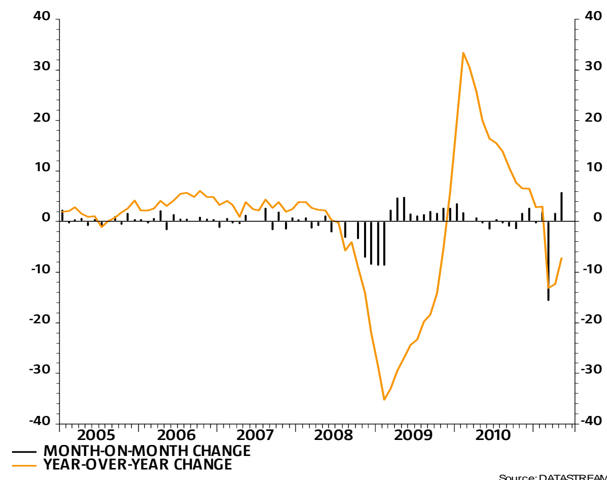
The UK economy is continuing to slow. There is little sign of any private-sector improvement to compensate for the brutal fiscal contraction that is taking place. Growth in the second quarter will probably be lower than in the first quarter, although still positive. The Bank of England will see no need to increase interest rates for the foreseeable future.

The eurozone economy is also slowing. Germany and France are still leading the pack, but manufacturing growth in both countries slowed sharply in June. Moreover, service sector growth in France declined as well. Services activity in core Europe will probably deteriorate in the coming months. A worrying development is the continuing divergence within the eurozone, with the periphery performing relatively weakly, in part due to the impact of austerity measures. Particularly worrying is the loss of momentum in Italy, where the services industry contracted for the first time in five months. The mounting signs that the eurozone economy is cooling haven't prevented the European Central Bank (ECB) from hiking rates for a second time. But we believe that the ECB is now on hold for the foreseeable future. An additional reason for restraint is the likely intensification of the European debt crisis. Greece has been saved for a couple of months, but a more substantial longer-term package that includes private-sector participation will be difficult to finalize. The crisis seems to be broadening out towards other peripheral countries. As the EU's leaders do not—at this stage—seem to be considering large-scale, top-down strategic initiatives to stop the rot, the crisis will probably worsen. This will most likely damage producer confidence further, although a weakening of the euro could offer some relief.




## Pacific

Last month, we wrote that if one country deserved some good news is was Japan. Some good news on the Japanese economy has indeed been released in recent weeks. Data has generally been better than expected. One notable exception, though, was the important Tankan report. This quarterly business survey conducted by the Bank of Japan dropped more than expected, with the headline number falling from +6 to -9. Given that this was the first reading since the earthquake, financial markets did not pay too much attention to the missed forecast; instead, they focused on the better-than-expected industrial production (+5.7% mom) and retail sales (+2.4% mom) numbers. It is a start, but both measures are still decisively below last year's level. Whether this up-tick will be enough to get Japan out of its current predicament remains to be seen. Far less positive are the developments in Japan's political arena, where the ruling DPJ and the major opposition party, the LDP, are locked in a standoff. As part of a deal to survive a no-confidence vote, the prime minister, Naoto Kan, has promised to step down, but only—and much to the chagrin of the LDP—after three bills have been passed by parliament. How will this play out? Speculation ranges from Kan's resignation to the dissolution of parliament and a snap election.



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As a rule, the commodity-rich Australian economy is susceptible to a slowdown of the world economy. That explains the more cautious tone of the latest press release from the Reserve Bank (RBA). The drop in commodity prices and the slower-than-expected recovery from the floods earlier this year prompted the RBA to caution that its growth expectations for 2011 may not be met. No further rate hikes are to be expected for some time. The virtually flat FRA curve reflects this expectation.

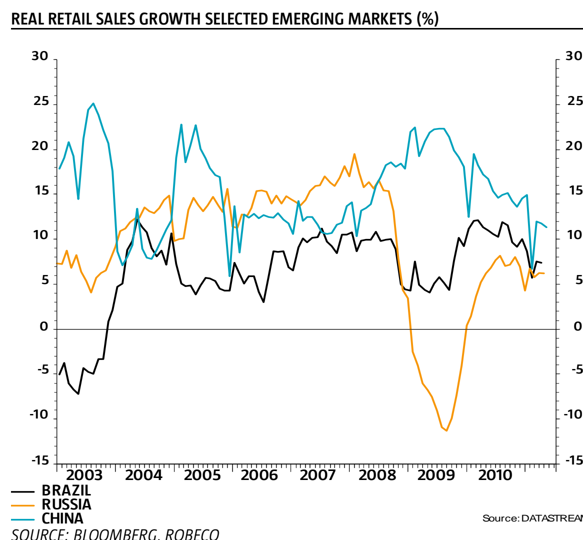
## Emerging markets

In July, the Chinese authorities raised interest rates for the fifth time in eight months. They did so to counter inflation, which had risen to 5.5% in May. As the evidence that the economy is slowing is mounting, this will probably be the last hike for the foreseeable future. One-year lending rates are now 6.56%, while one-year deposit rates are 3.5%.

As in China, inflation in India will probably peak in the coming months. Growth is slowing as well but is likely to stabilize. A last rate hike at the end of July is generally expected.

The Russian economy is doing well. Inflation stabilized in the second quarter, while unemployment came down to the lowest level since the start of the credit crisis.

REAL RETAIL SALES GROWTH SELECTED EMERGING MARKETS (%)




*SOURCE: BLOOMBERG, ROBECO*

The strong *real* and the continuing tightening measures in Brazil have raised optimism that inflation will peak in the coming months and decline to around 5.0% next year. That would fit nicely with the central bank's target range of around 4.5%.

**GDP GROWTH BY REGION (%)**

| | 2010 | 2011 | 2012 | Δ -1M 2011 | ROBECO* |
|---|---|---|---|---|---|
| US | 2.9 | 2.5 | 3.1 | -0.4 | + |
| EUROZONE | 1.7 | 2.0 | 1.7 | 0.2 | - |
| UK | 1.3 | 1.6 | 2.1 | -0.3 | - |
| JAPAN | 3.9 | -0.7 | 3.2 | -1.0 | = |
| | | | | | |
| CHINA | 10.3 | 9.2 | 8.8 | -0.1 | = |
| INDIA | 8.6 | 8.0 | 8.4 | -0.2 | + |
| BRAZIL | 7.5 | 4.1 | 4.3 | 0.0 | + |
| RUSSIA | 4.0 | 4.6 | 4.6 | 0.0 | + |
| | | | | | |
| WORLD | 3.8 | 3.0 | 3.6 | -0.2 | = |

* INDICATES WHETHER WE EXPECT A HIGHER (+), MATCHING (=) OR LOWER (-) GROWTH RATE THAN THE CURRENT CONSENSUS ESTIMATE FOR 2011

*SOURCE: CONSENSUS ECONOMICS, ROBECO*

**CPI BY REGION (%)**

| | 2010 | 2011 | 2012 | Δ -1M 2011 | ROBECO* |
|---|---|---|---|---|---|
| US | 1.6 | 3.0 | 2.1 | 0.4 | = |
| EUROZONE | 1.6 | 2.6 | 1.9 | 0.2 | + |
| UK | 4.7 | 5.1 | 3.1 | 0.4 | + |
| JAPAN | -0.7 | 0.3 | 0.2 | 0.1 | - |
| | | | | | |
| CHINA | 3.3 | 4.8 | 3.8 | 0.1 | = |
| INDIA | 10.5 | 7.8 | 6.7 | -0.2 | = |
| BRAZIL | 5.9 | 6.2 | 5.1 | 0.2 | = |
| RUSSIA | 8.8 | 8.4 | 7.5 | -0.1 | = |
| | | | | | |
| WORLD | 2.3 | 3.3 | 2.5 | 0.2 | = |

* INDICATES WHETHER WE EXPECT A HIGHER (+), MATCHING (=) OR LOWER (-) CPI THAN THE CURRENT CONSENSUS ESTIMATE FOR 2011

*SOURCE: CONSENSUS ECONOMICS, ROBECO*

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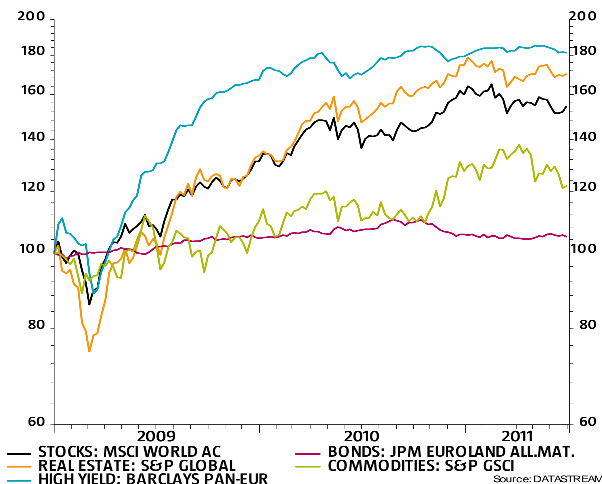
## Outlook financial markets

### Asset mix

*Last month's review*

The first half of the year has been disappointing. Risk premiums have been negative. The market has been affected by economic worries, which decreased somewhat over the last month. As a result, stocks were up by 2.7% over the month, while real estate rose by 2.0%. However, commodities and high yield declined, as did eurozone government bonds. The euro remains surprisingly strong, given the lingering debt crisis, only falling from 1.46 against the US dollar to 1.44. The two interest-rate hikes by the ECB have made a huge difference in the currency markets. The VIX index is currently trading around 16. On balance, volatility decreased a little during the last month.

PERFORMANCE OF ASSET CLASSES (TOTAL RETURN EUR)




PERFORMANCE OF ASSET CLASSES (TOTAL RETURN IN EUROS)

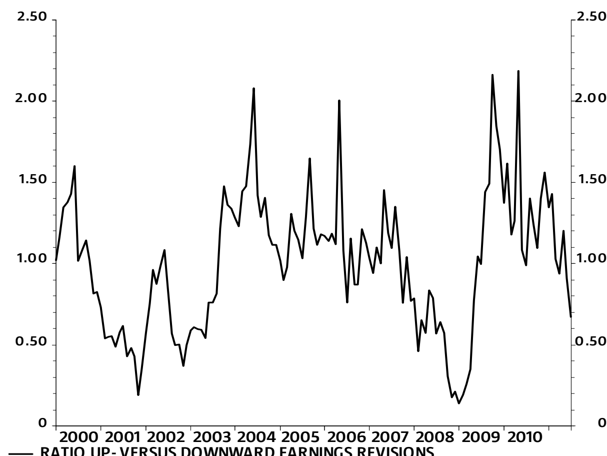
| | -1M | -3M | -6M | -12M | -3Y | -5Y |
|---|---|---|---|---|---|---|
| STOCKS (MSCI AC WORLD) | 2.7% | -1.0% | -3.9% | 15.5% | 18.0% | 7.1% |
| REAL ESTATE (S&P GLOBAL REITS) | 2.0% | 2.3% | -2.4% | 19.4% | 22.2% | -4.3% |
| HIGH YIELD (BARCLAYS PAN-EUR) | -1.0% | -0.8% | 0.9% | 7.1% | 19.6% | -4.7% |
| BONDS (JPM EUROLAND ALL MAT.) | -0.7% | 0.7% | -0.6% | -2.2% | 15.0% | 20.3% |
| COMMODITIES (S&P GSCI) | -2.7% | -10.6% | -5.4% | 13.7% | -49.0% | -36.0% |

*SOURCE: THOMSON FINANCIAL DATASTREAM*

*Equities*

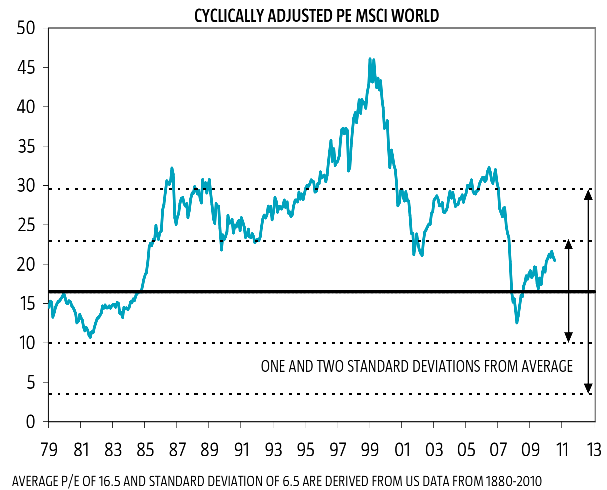
Equities will probably find it difficult to move forward in the months ahead. Most negative economic surprises are probably now in the past. There are two reasons for this. First, oil has declined from its peak and has become less of a negative factor. Second, industrial production in Japan is picking up, solving supply-chain issues. Despite these positive developments, there is reason enough to expect a continuing consolidation. The eurozone debt crisis rumbles on and it is becoming increasingly likely that markets will have to deal with a default sooner rather than later. This will further increase the stress in sovereign debt markets, sending spreads on Irish and Portuguese bonds even higher. But what will ultimately matter is whether Spain and Italy can handle the debt crisis. In the end, the debt crisis may very well demand far more drastic strategic moves by the EU's policymakers than have been in evidence so far.

UPWARD VERSUS DOWNWARD EARNINGS REVISIONS



Just before the second-quarter earnings season takes off, analysts have made downward revisions to their earnings estimates. This is connected to the disappointing macroeconomic data over the last two months, as well as the unrealistically high earnings growth (16%) that they are still forecasting for 2011. With margins close to historical highs, we feel that earnings growth will be at best 10%. Although earnings growth is a positive factor, further downgrades could hurt sentiment in the short term. Valuation is in neutral territory, despite increasing market talk about stocks being cheap. Based on cyclically adjusted earnings, one cannot conclude that stocks are cheap. Comparing P/E ratios with long-term interest rates is not relevant, as relative valuation has no predictive power. Proponents of relative valuation ratios should think about what would happen to equity markets were ten-year interest rates in the US and Germany to fall to 2%. Such a scenario would require a recession.

VALUATION OF EQUITIES

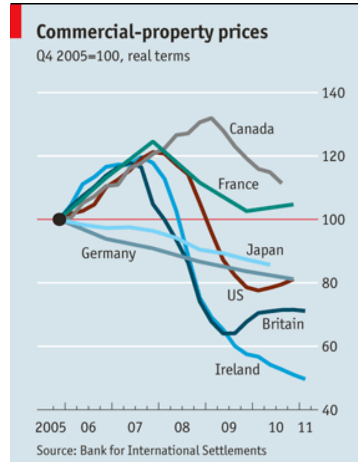



AVERAGE P/E OF 16.5 AND STANDARD DEVIATION OF 6.5 ARE DERIVED FROM US DATA FROM 1880-2010

*Real estate*

The outlook for real estate is in line with the outlook for equities. That said, real estate seems to be better placed for an unexpected downturn, as its cash flow pattern is more stable. Furthermore, earnings downgrades for equities are more significant than for real estate. Commercial property prices have rebounded in major markets such as the US and the UK, but such a turn is by no means universal yet. Valuation remains neutral. The price-to-cash flow ratio for real estate is 1.5x the one for stocks, which is exactly in line with the historical average.

COMMERCIAL PROPERTY PRICES

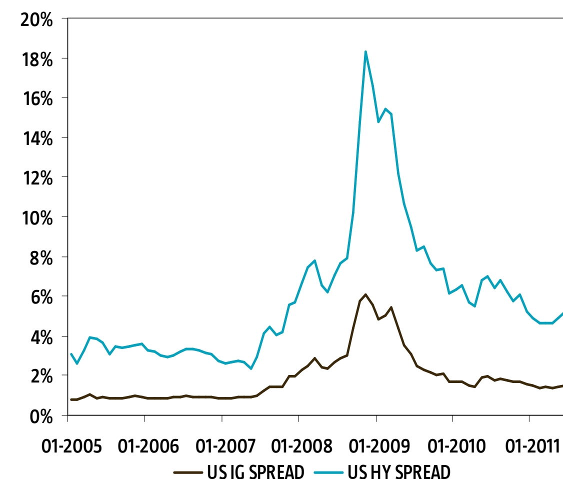



SOURCE: THE ECONOMIST

*Corporate bonds*

The outlook for corporate bonds has become more challenging. We are still positive on investment grade corporate bonds, but during the last month we lowered the outlook for high yield to neutral. Corporate bonds have been affected by negative economic surprises. We believe that most negative economic surprises are now in the past. But the ongoing debt crisis in the eurozone will depress sentiment, as the risks of a default continue to rise. A Greek default would be no surprise, but the sooner it comes, the bigger is the risk that Ireland and Portugal will follow swiftly afterwards. This will increase uncertainty about the markets that really matter, Spain and Italy. In such a scenario, high yield will be hurt the most.

US INVESTMENT GRADE AND HIGH YIELD SPREADS




SOURCE: BARCLAYS, ROBECO

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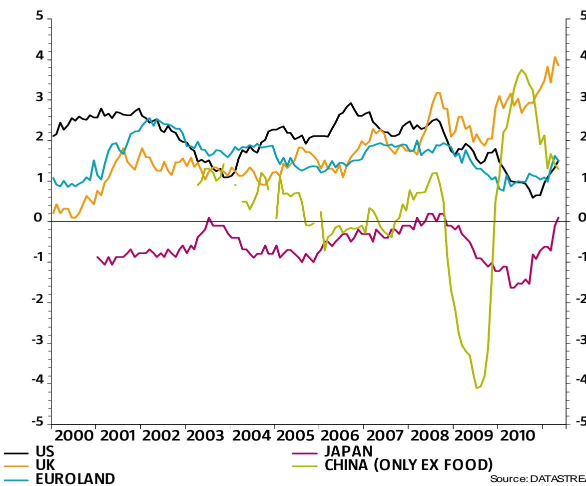
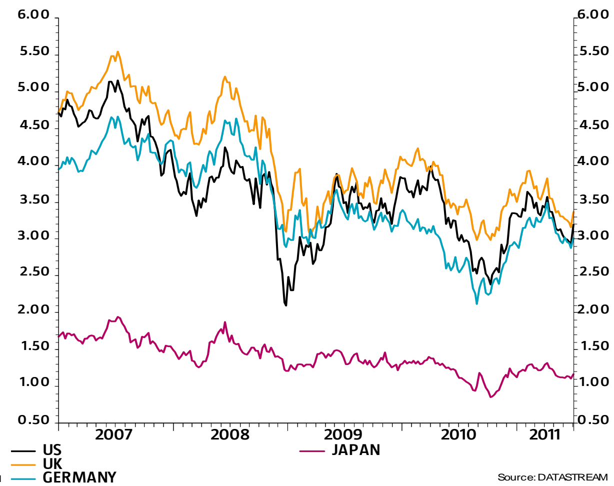
*Government bonds*

Core inflation rates are in a clear uptrend in developed markets. This would be worrying if global growth was not moderate and unemployment was not high. As a result, we believe that inflationary risks in the short term remain low. Monetary policy is thus set to remain loose; we expect the ECB to be on hold for the rest of the year. Before demand from the growing middle class for commodities spurs on commodity price inflation again, and aging affects labor-cost inflation, sovereign bonds could benefit from the lingering debt crisis in the eurozone. On balance, we expect long-term rates to hover around 3%.

**CORE INFLATION RATES (%)**



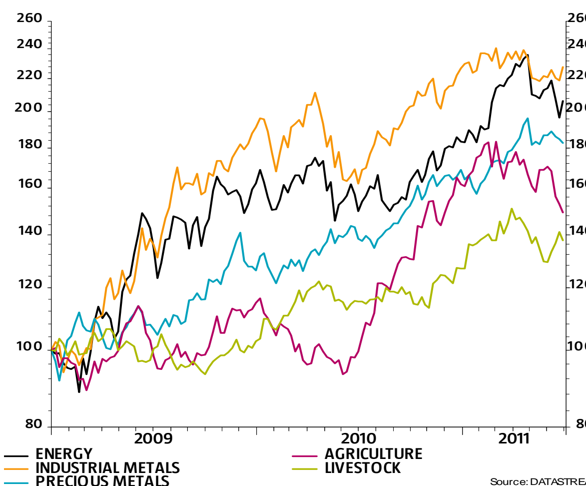

**TEN-YEAR INTEREST RATES (%)**



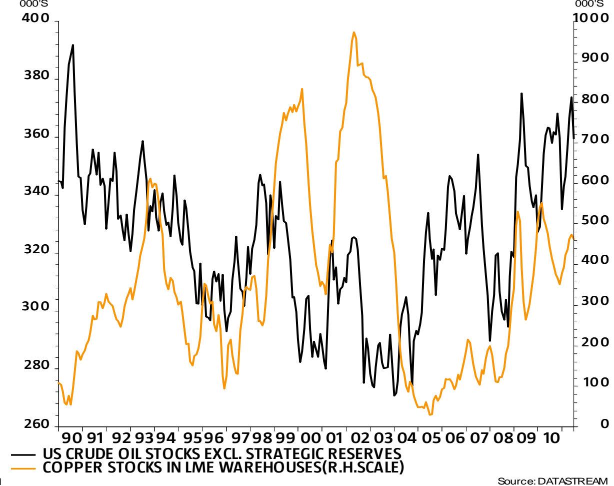

*Commodities*

We believe the correction in commodity prices will be temporary, but we do not expect a recovery in the short term. It is positive for commodities that the slowdown in developed markets probably is close to its end, given the acceleration in industrial production in Japan and the unexpected rise in the ISM manufacturing index. But growth in China is still declining, while stocks of oil and copper remain high. Moreover, increasing tensions on the handling of the debt crisis in the eurozone is not the perfect time for a "risk-on" trade. The outlook for the medium and long term is strengthening, as nuclear power plans are increasingly scaled back. Most important, the long-term uptrend in commodity prices is a reflection of growing demand from the global middle class. Growth in demand will not change and it will take another few years for supply to catch up.

**GSCI COMMODITY SPOT PRICES (USD)**




**GSCI COMMODITY SPOT PRICES (EUR)**



## Regional mix

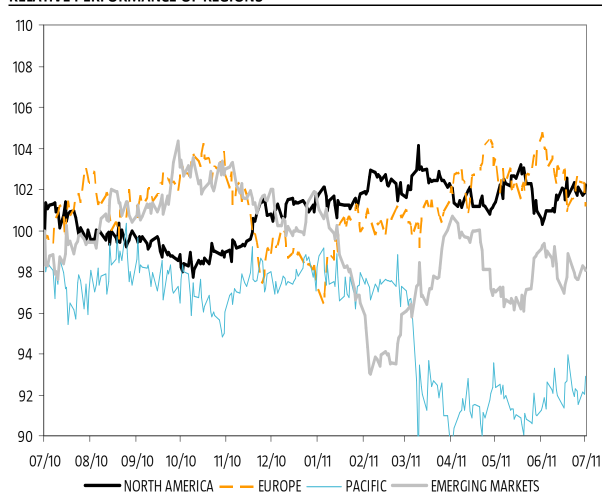
**PERFORMANCE OF REGIONS (MSCI AC WORLD; UNHEDGED TOTAL RETURNS IN EUROS)**

| | -1M | -3M | -6M | -12M | -3Y | -5Y |
|---|---|---|---|---|---|---|
| NORTH AMERICA (47%) | 3.6% | -1.4% | -3.7% | 16.4% | 22.7% | 6.3% |
| EUROPE (26%) | 1.0% | -0.2% | 0.7% | 20.1% | 8.9% | 1.9% |
| PACIFIC (13%) | 3.9% | 1.2% | -8.9% | 6.5% | 9.5% | -7.2% |
| EMERGING MARKETS (14%) | 2.0% | -3.1% | -7.3% | 13.6% | 33.0% | 56.2% |
| | | | | | | |
| AC WORLD (100%) | 2.7% | -1.0% | -3.9% | 15.5% | 18.0% | 7.1% |

*SOURCE: THOMSON FINANCIAL DATASTREAM*

Within equities, emerging markets remain our favorite region. The economies are cooling but growth is still decent. As inflationary risks are decreasing, we expect monetary tightening to end in the second half of 2011. From a valuation perspective, emerging markets equities do not demand a premium. But momentum there seems to be picking up after the correction of six months ago.

**RELATIVE PERFORMANCE OF REGIONS**




*SOURCE: MSCI, DATASTREAM, ROBECO*

We prefer North America to Europe or Japan. In the US, we do not expect the noise surrounding the debt ceiling to be important for financial markets. What really matters are the budget cuts after the presidential elections. With a rebound in the ISM and the continuing growth of the total hours worked in the private sector, the economy continues on its modest growth track. For Europe, we see the debt crisis as a negative factor. Due to the surprising strength of the euro, earnings revisions are far worse than in other regions. European stocks are cheap—but for a reason. Finally, we do not like the Pacific region due to our negative fundamental view on the Japanese economy.

**EARNINGS AND VALUATION DATA OF REGIONS (MSCI AC WORLD)**

| | EARNINGS GROWTH (%) | | | ST.DEV. ESTIMATES (%) | | EARN. REV. INDEX | | P/E ON 12M FWD EARN. | |
|---|---|---|---|---|---|---|---|---|---|
| | FY1 | FY2 | 12M | CURRENT | 10Y AVG. | 3M | 1M | CURRENT | 10Y AVG. |
| NORTH AMERICA | 17.7 | 14.6 | 15.5 | 7.1 | 5.4 | 23.6 | -6.1 | 12.5 | 15.3 |
| EUROPE | 11.5 | 13.0 | 12.1 | 14.9 | 12.7 | -12.7 | -38.6 | 9.9 | 13.4 |
| PACIFIC | 18.9 | 19.1 | 18.1 | 1.1 | 1.3 | -30.6 | -16.0 | 12.4 | 17.0 |
| EMERGING MARKETS | 16.0 | 13.3 | 14.5 | 14.6 | 9.8 | -5.8 | -17.9 | 10.2 | 10.7 |
| | | | | | | | | | |
| AC WORLD | 15.7 | 14.5 | 14.7 | 2.7 | 2.0 | 1.9 | -19.6 | 11.4 | 14.5 |

THE EARNINGS REVISIONS INDEX IS CALCULATED AS THE DIFFERENCE BETWEEN THE NUMBER OF UP- AND DOWNWARD REVISIONS RELATIVE TO THE NUMBER OF TOTAL REVISIONS.
*SOURCE: THOMSON FINANCIAL DATASTREAM*

## Sector mix

**PERFORMANCE OF SECTORS (MSCI AC WORLD; UNHEDGED TOTAL RETURNS IN EUROS)**

| | -1M | -3M | -6M | -12M | -3Y | -5Y |
|---|---|---|---|---|---|---|
| ENERGY (12%) | 2.1% | -7.1% | -1.4% | 26.9% | 0.2% | 18.6% |
| MATERIALS (9%) | 3.4% | -4.2% | -6.2% | 25.8% | 13.1% | 45.3% |
| INDUSTRIALS (11%) | 3.4% | -1.4% | -3.0% | 20.5% | 23.3% | 12.1% |
| CONSUMER DISCRETIONARY (10%) | 5.8% | 4.7% | -1.2% | 24.5% | 53.5% | 16.9% |
| CONSUMER STAPLES (9%) | 1.5% | 4.4% | -0.2% | 12.7% | 45.3% | 43.5% |
| HEALTH CARE (9%) | 1.8% | 6.0% | 3.3% | 13.4% | 33.0% | 12.6% |
| FINANCIALS (20%) | 2.1% | -3.9% | -7.7% | 7.6% | 0.2% | -31.5% |
| IT (11%) | 2.4% | -1.1% | -8.2% | 10.1% | 26.2% | 15.6% |
| TELECOM SERVICES (5%) | 2.2% | -0.4% | -2.9% | 14.6% | 20.3% | 30.9% |
| UTILITIES (4%) | 3.4% | 0.8% | -4.9% | 2.3% | -4.8% | 9.3% |
| | | | | | | |
| AC WORLD (100%) | 2.7% | -1.0% | -3.9% | 15.5% | 18.0% | 7.1% |

*SOURCE: THOMSON FINANCIAL DATASTREAM*

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We maintain our slight preference for defensive sectors over cyclicals or financials. Stocks with a relatively low sensitivity to the economy generally fared well over recent months, but lagged the market somewhat over the last month. One could take the view that after having negotiated a cluster of negative economic surprises it is already time to buy back into cyclicals. But we maintain our view for two reasons. First, defensives such as consumer staples and telecom may benefit from the ongoing uncertainty about the eurozone debt crisis. Second, the seasonal factor is supportive: the May-to-October period is generally good for defensive stocks. These factors also explain our negative view on cyclical stocks. Within cyclicals, we are still positive on industrials due to its late-cycle characteristic and its relatively low beta. Finally, we remain negative on financials. Month after month, the sector has poor rankings in terms of momentum and earnings revisions. A rapid Greek debt restructuring would affect the sector negatively, if only because of the associated uncertainty.

**EARNINGS AND VALUATION DATA OF SECTORS (MSCI AC WORLD)**

| | EARNINGS GROWTH (%) | | | ST.DEV. ESTIMATES (%) | | EARN. REV. INDEX | | P/E ON 12M FWD EARN. | |
|---|---|---|---|---|---|---|---|---|---|
| | FY1 | FY2 | 12M | CURRENT | 10Y AVG. | 3M | 1M | CURRENT | 10Y AVG. |
| ENERGY | 25.0 | 10.3 | 15.6 | 3.6 | 2.6 | 14.8 | -4.0 | 9.7 | 12.1 |
| MATERIALS | 39.6 | 14.6 | 21.8 | 4.0 | 2.5 | 0.7 | -31.9 | 10.3 | 13.1 |
| INDUSTRIALS | 17.1 | 15.7 | 16.1 | 1.0 | 0.7 | 7.6 | -19.0 | 12.4 | 15.4 |
| CONSUMER DISCRETIONARY | 15.9 | 22.1 | 18.4 | 0.9 | 0.7 | 5.9 | -2.6 | 13.3 | 16.8 |
| CONSUMER STAPLES | 8.2 | 11.3 | 10.4 | 0.5 | 0.3 | -7.0 | -26.5 | 14.4 | 16.2 |
| HEALTH CARE | 5.4 | 5.9 | 5.9 | 0.5 | 0.3 | 20.7 | -11.1 | 11.8 | 16.1 |
| FINANCIALS | 13.7 | 19.4 | 17.4 | 0.9 | 0.9 | -11.3 | -49.1 | 9.9 | 11.9 |
| IT | 12.4 | 13.7 | 12.2 | 0.6 | 0.4 | 0.8 | 1.0 | 12.0 | 20.1 |
| TELECOM SERVICES | 5.1 | 8.4 | 6.9 | 0.5 | 0.5 | -19.5 | -7.4 | 11.5 | 19.6 |
| UTILITIES | 5.2 | 16.5 | 11.9 | 1.2 | 0.7 | -20.6 | -23.3 | 13.5 | 13.3 |
| AC WORLD | 15.7 | 14.5 | 14.7 | 2.7 | 2.0 | 1.9 | -19.6 | 11.4 | 14.5 |

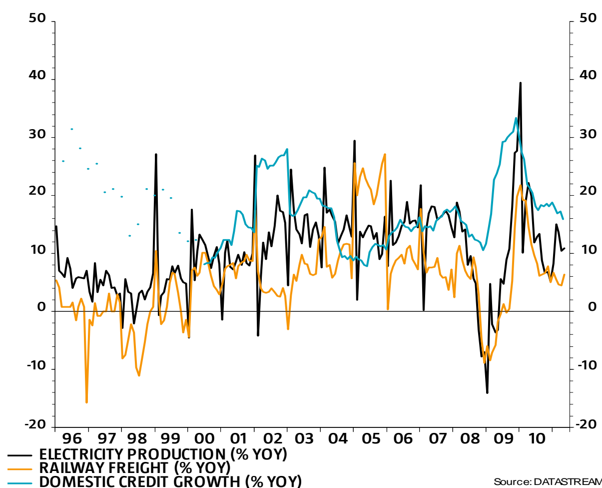
THE EARNINGS REVISIONS INDEX IS CALCULATED AS THE DIFFERENCE BETWEEN THE NUMBER OF UP- AND DOWNWARD REVISIONS RELATIVE TO THE NUMBER OF TOTAL REVISIONS.

*SOURCE: THOMSON FINANCIAL DATASTREAM*

## Special: Chinese debt crisis unlikely

For three decades, the Chinese economy has grown by well over 9% a year on average. Despite its still rather low GDP per capita level, this incredible performance is unlikely to be repeated in the decades ahead, if only because of unfavorable demographics. In a couple of years, the Chinese working-age population will peak. In this sense, China is probably a good example of Herbert Stein's Law: "If something cannot go on forever, it will stop." Recently, signs of a slowdown in the Chinese economy have increased. One has to be careful when interpreting Chinese economic indicators, but if the three preferred indicators of Li Keqiang—one the nine members of the Politburo Standing Committee—are examined, growth is clearly heading down. This slowdown is a consequence of a series of tightening measures that have been implemented by the Chinese authorities to get a grip on rising inflationary pressures, which could easily threaten political stability if they ran out of control. The Chinese authorities have acted in their usual cautious and gradual way, in order not to derail growth, another necessary condition to ensure relative political stability. These efforts seem to be relatively successful. Although inflation is still rising (the May figure was 5.5%, June will be still higher) and is above the recently adjusted target rate of 4.0%, the consensus expects a peak in the coming months, now that the economy is clearly slowing. And an inflation rate of around 6.0% for a strongly growing emerging market is not that worrying, especially compared with earlier inflationary episodes in China in the late 80s and early 90s. The long string of tightening measures does not mean that a savage monetary crackdown is taking place. In real terms, interest rates currently are not that high: the one-year lending rate is 6.56%, the one-year deposit rate 3.5%. The yuan has indeed been allowed to rise against the US dollar. But the dollar has weakened globally. On a trade-weighted basis, the yuan has actually declined. Monetary policy is therefore perhaps better described as broadly accommodating and is therefore not a threat to growth.

ECONOMIC INDICATORS PREFERED BY LI KEQIANG



Source: DATASTREAM

Worries have been expressed about the amount of froth in the Chinese property market and the lending behavior of local governments. As banks are controlled by the government and as the priority of policymakers during the world financial crisis has been to keep the economy on a fast growth track (by investing in infrastructure through local government, for example), it is highly likely that bad debts have accumulated on the balance sheets of banks. The consequences of reckless lending by local governments have to be addressed at some point. But when a broad definition of general government debt is examined, although the level of local-government loans has increased sharply, the total amount of debt as percentage of GDP remains generally stable. It also appears to be at a sustainable level when the growth rates of around 9% are borne in mind. Even with slightly lower growth rates—say 7%—the debt burden could be reduced rapidly, as long as new debt is kept in check. A Chinese credit crisis therefore seems unlikely.

Source: *The Economist*

In conclusion: Chinese growth is slowing somewhat, inflation is set to peak soon and credit problems remain manageable.

Closing date text and tables 07 July 2011.
In our text and data tables, we do not refer to calendar months but look back from this closing date.

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