

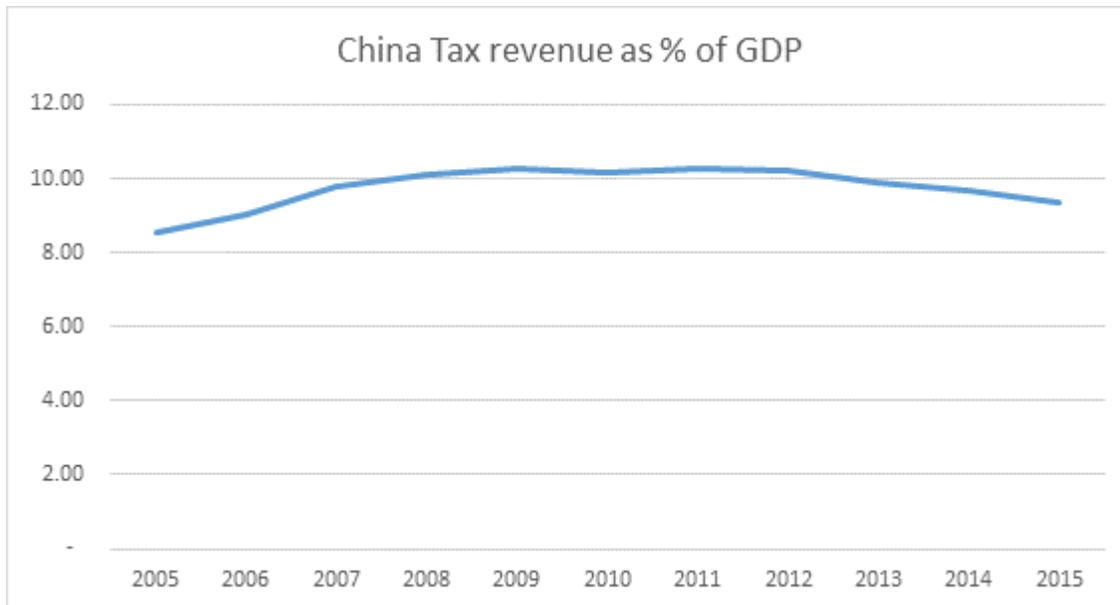
China's Next Infrastructure [Mini] Binge is Coming

I said 4 emails ago that a Chinese infrastructure stimulus package was coming given how futile RRR cuts have proven to be this far in propping up the flagging economy. I re-emphasized this point again in an email last week pointing specifically to the possible upside to steel prices once the infrastructure dollars start flowing and, consequently, the impact on HPG's relative valuation which seems to move in tandem with Chinese steel prices.

If you followed yesterday's data coming out of China, the Chinese infrastructure revival hypothesis appears to be nearing validation. Have a look at the latest Chinese data below – what is astounding is that while exports have taken a hit (as expected, given the trade war), import growth has decelerated at 10x the pace of export growth! This is a real gauge of how fast demand is weakening in the Chinese economy. Granted that some of this discrepancy might be a result of a fast-tracking of exports to the US in response to hoarding by US buyers prior to an anticipated step-up in US tariffs imposed on Chinese imports (originally scheduled for Jan 2019 before the recent truce followed by the fresh round of trade talks) – so if finished goods exports were fast-tracked but new orders have flagged on tariff concerns, then clearly, imports of intermediates and raw materials (which are a sizable chunk of Chinese imports) used for production of finished goods exports would have fallen even while exports would have held up. But my view is that this is only part of the explanation – the sheer size of the gap between import and export growth (as reflected in a record high trade surplus for China) points to flagging local demand conditions.

Have a look at this article below today which explicitly says that Chinese stimulus will take the form of “fiscal expenditure” and, more specifically, infrastructure spend: [China signals more stimulus as economic slowdown deepens](#)

An infra stimulus would seem like an obvious thing to do given that monetary stimulus is not an option in China (rates are already low and currency stability is a key priority) and classic fiscal stimulus in the form of tax cuts are unlikely to move the needle since China's tax net is simply not big enough – if most companies and individuals are not paying taxes then a tax cut can only help so much in stoking growth. Don't expect an all-out spending binge this time round given mounting debt concerns in China but I would not rule out USD 50-100 billion worth of infra stimulus. If this materializes, I expect sentiment on Chinese steel to improve which should lift HPG out of what I believe to be oversold territory.



Source: World Bank

Taxes as % of GDP: China and US versus World

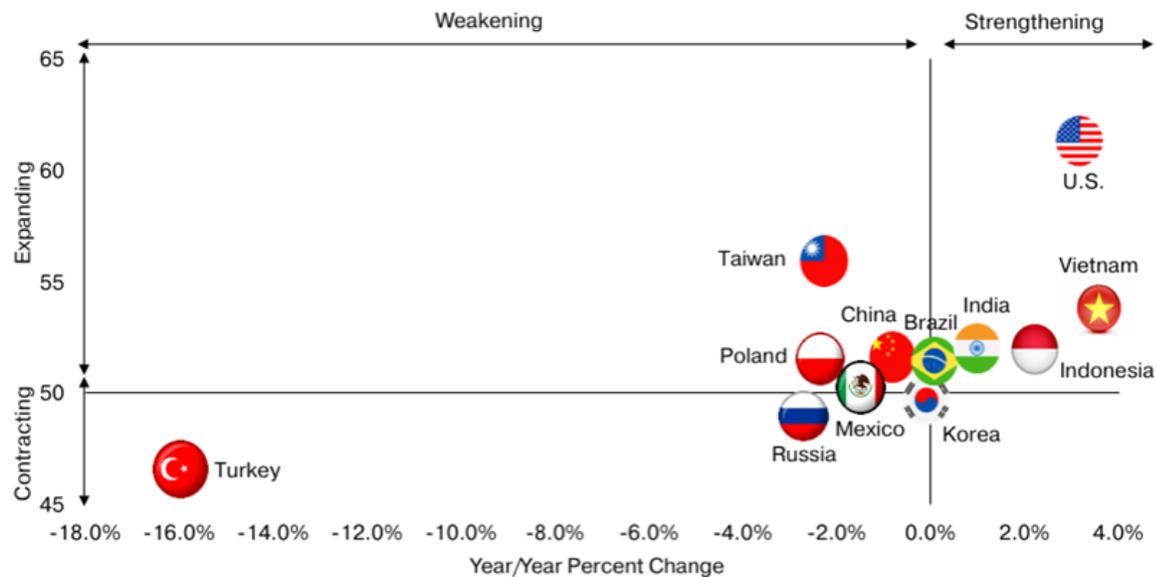


Source: World Bank

To add, the core strength of the Vietnamese economy would also, in my mind, put paid to all manner of comparisons between HPG and Chinese steel companies – it irks me greatly to see Chinese steel makers comprising the majority of the “peer set” in comparable company valuation tables for HPG given how different Vietnam’s dynamics

currently are from China's. The chart below, albeit a bit dated, attests to the fact that domestic manufacturing in Vietnam is rock-solid for now and industrial capacity expansion will help pick up the slack created by a moderating housing market and infrastructure spending when it comes to construction steel demand. Even though the latest PMI reading for Vietnam suggests a slight weakening (Nikkei PMI of 53.8), Vietnamese manufacturing remains fairly in expansion territory.

Exhibit 1: Manufacturing Purchasing Managers' Indices: Select EM Countries



Sources: Bloomberg, Markit, Nikkei, ISM, as of August 2018.

Needless to say, HPG's valuation recovery could be transitory if China's stimulus measures don't actually succeed in restoring growth, if trade tensions resurface or if the US government shutdown starts to spill-over into the real economy. But if either one of these three (god forbid all) become reality, then we have far more to worry about than a Vietnamese steel company.

If you want to talk more about HPG, we can set up a call with our steel analysts Hung and Ha My or even organize a call with a regional steel industry expert (on a first-come-first-serve basis).

Warmly,
Anirban Lahiri

Head of Research