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SCI China Market Update – August 2012

Dear Friends,

I just returned from another business trip to China. Hard landing or soft, everyone in the media is talking about the Chinese economy. If you visit China, you can feel that the concern is real and is big. This also means that China's robust economy is important to the entire world today. During my visits to Tianjin, Qingdao, Shanghai, Qinhuangdao and Beijing, it became clear that, like many other major economies, China is dealing with challenges.

China's economy grew 7.6% in Q2 year-on-year, the weakest since 6.6% at the start of 2009 during the worst of the global financial crisis. But why does this comparatively strong 7.6% in today's world economy touch so many people's nerves? Although 8 is China's big lucky number and the goal was set at 8% way back in 1993, does 7.6% really mean a "hard landing" or "recession"? To us, these fears are overblown even if China's economic issues are real. The Chinese economy still offers very significant business opportunities, but we may indeed need to adjust market strategies and expectations.

I heard many executives complain about this year's tough market situation, yet at the same time all the fine restaurants and bars were full of customers every evening. Similarly, two months ago, my UA flight from Beijing to Chicago was packed as more and more Chinese come to the U.S. for touring and shopping, and young people come to visit U.S. universities to plan their education at their family's expense. So, in general, China's buying power is still pretty strong. No country can grow at a rate of 8% forever, especially during a global slowdown. We agree that the greatest merit of China's style of policy-based growth targets is a degree of certainty for the market. But for that purpose a sustainable 7% may be preferable to an problematic 8%.

Below is some very recent China market news for your information:

Growth in factory activity at an 8-month low

Manufacturing activity increased in July, but at the slowest rate in 8 months. But another measure which focuses more on small and medium-sized enterprises recorded the largest increase in nearly two years. The two readings tend to suggest stabilization, and analysts actually expect the economy to pick up over the next five months.

The official purchasing managers' index (PMI) in July stood at 50.1. The PMI is a key gauge of manufacturing, according to the National Bureau of Statistics and the China Federation of Logistics and

Purchasing. The number was lower than the expected 50.5, and was a slight drop from 50.2 in June. Still, a reading above 50 tends to indicate expansion, while a reading beneath 50 tends to indicate contraction.

A separate PMI reading by HSBC looks mainly at small and medium-sized businesses. This one indicated an economic slowing with a reading of 49.3 in July, up significantly from 48.2 in June. This was the largest monthly increase in 21 months. The official PMI is derived from data from 820 companies in 31 industries. The “Large enterprise” PMI for July was 50.3, a decline from 50.6 in June, while the “Small-scale business” PMI number was 48.2, compared with 47.2 for June. This figure has stayed below 50 for four months in a row.

The chief economist of China’s Industrial Bank, Lu Zhengwei, said that "Production and construction always slow down in July," He believes the outlook will soon improve, and this view is shared by many, including the China Federation of Logistics and Purchasing.

The government is aware of potential risks and has already begun to take certain measures. For example, the government cut interest rates in July for the second time in a month and lowered the reserve ratio. The government has further pledged to reduce taxes, maintain moderate credit growth, increase support for major projects, and implement policies that allow private capital to play a stronger role. Barclays Capital noted that the central bank is likely to cut interest rates in Q3.

Official forecasts 7% rise in electricity use

China's electricity use, a key indicator of industrial activity, is expected to grow 7% this year to reach 5.1 trillion Kwh as the country's pro-growth policies start to take effect. Yu Yanshan, deputy director of the general office of State Electricity Regulatory Commission (SERC), said China's power use will stabilize slowly despite declining consumption in the first half of the year. "During the January-May period, growth of power use in the eastern regions saw narrower declines, which means the economic downward pressure is easing," he said.

The SERC said that China's power consumption rose 5.5% year-on-year in the first half of 2012, slowing 6.7 percentage points from the rate a year earlier. This statement came as China's GDP growth slowed to 7.6% in Q2, the slowest in three years, dragged down by weak external demand and government policies to cool the property sector.

Alstom boosts hydro power investment in China

With a temporary slowdown in the construction of nuclear plants after the Fukushima disaster, China has pushed ahead aggressively with all forms of renewable energy: solar, wind, bio-energy, geothermal and hydro. Alstom, the world's third-largest power equipment maker, is capitalizing on this trend by increasing its investment in hydro power. Alstom Renewable Power plans to establish a Global Technology Center in Tianjin. This is part of a 100 million euro ($123 million) investment to upgrade Tianjin's hydro industrial facility, which is Alstom's largest in operation. Jerome Pecresse, president of Alstom Renewable Power, said that "Compared with other renewables, hydro power is very stable." Pecresse also said that as wind and solar power grows, there will be increased demand for pumped-storage plants.

Alstom is one of China's leading hydro producers. It has turbine and generator contracts equal to some 47 gigawatts, and about 50% of this capacity is already in operation. Alstom was also deeply involved in the construction of the Three Gorges Dam, the largest power plant on earth.

The China Electricity Council (CEC) said that investment in hydro power in China was about 44.4 billion yuan ($7 billion) in the first five months of 2012, up almost 50% over last year. The National Energy Administration (NEA) says that China's hydropower capacity was 230 gW at the end of 2011, 22% of the total, and another 55 gW are now under construction. The country's hydro power market slowed down during the 11th Five Year Plan period (2006-10) partly due to controversy about its environmental impact. But new approvals grew since 2010 as reduction of carbon emissions became a top government priority. It is also possible that the slowing economy could present some problems for the growing hydro power investment as demand for electricity is cooling down somewhat.

China renews emphasis on nuclear power

Twelve reactors are under construction in China, accounting for 41% of the world's total. Late last year the National Energy Administration (NEA) stated clearly that nuclear energy would be the foundation of the country's power generation system over the next 10 to 20 years.

Why has China made this decision just when nuclear power has become so controversial? There are several reasons. It is well known that China has long depended on coal as its primary source of energy. But China's coal resources are unevenly distributed around China's geography. This has resulted in a huge logistics problem and a heavy burden on road and rail networks. This in turn causes considerable environmental damage. At the same time, the other two fossil resources, natural gas and oil, are limited in China - the proven reserves are 1.3 percent and 1.2 percent of the world's total, respectively.

China currently aims at having an installed base of 40 gigawatts of nuclear power capacity by 2020. It has yet to decide what the 2050 goal should be, which ranges from 120 gW to 360 gW. The latter would be 30% of total energy generation.

Shipbuilding orders fall in H1

According to the Ministry of Industry and Information Technology (MII), new orders received by China's shipbuilders in the first half of 2012 fell 50.3% over a year earlier to 10.74 million deadweight tonnage (DWT). China's shipbuilders finished 32.2 million DWT in the first half of the year, up only 4.2%. At the end of June, orders were 125.87 DWT, down 30.7% year on year.

For more information about today's China market and opportunities please visit our website at www.s-c-i.com or call me at the number below, or Dr. Tim Weckesser at 610-828-8060.

Best regards,

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