Sinology

by Andy Rothman
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- In 2018, I expect China's economy to return to the long-term trend of gradual deceleration, while remaining one of the world's fastest-growing economies.
- China should remain the world's best consumer story.
- This issue of *Sinology* answers some key investor questions on the year ahead in China.

ANDY ROTHMAN lived and worked in China for more than 20 years, analyzing the country's economic and political environment, before joining Matthews Asia in 2014. As Investment Strategist, he has a leading role in shaping and presenting the firm's thoughts on how China should be viewed at the country, regional and global level.

CHINA'S DIRECTION IN 2018

Many economists expect the Chinese economy to reaccelerate this year, but I am forecasting a return to the long-term trend of gradual deceleration. In my view, China will, however, slow only slightly and remain one of the fastest-growing economies in the world.

The modest deceleration is due primarily to three factors: Last year's boost from strong export growth is unlikely to be repeated; new home sales are likely to slow in response to policy restrictions; and the growth rate of infrastructure investment will cool.

The government will continue to proactively address risks in the financial system, but there are no signs of significantly tighter monetary policy and inflation should remain moderate.

China should remain the world's best consumer story, driven by several sustainable factors: strong income growth, low household debt, high household savings and an optimistic outlook. Inflation-adjusted retail sales growth of 8% to 9% is likely.

Consumer spending and services will continue to be the largest part of the economy, and this area is likely to account for about two-thirds of economic growth. This is where our investment strategy is focused.

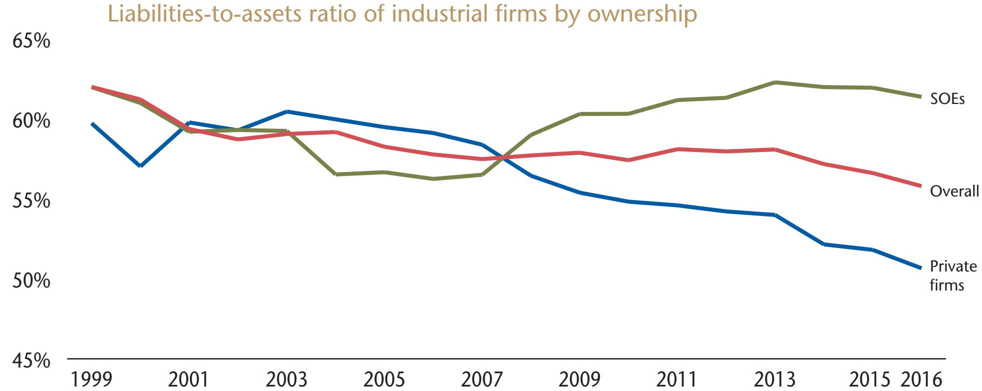
In this issue of *Sinology* we answer some key investor questions on the year ahead in China:

What is the Risk of a Debt Crisis?

China's debt problem is serious, but the risk of a banking crisis is low. The key reason is that the potential bad debts are corporate, not household, and were made in response to the Global Financial Crisis, at the direction of the state, by state-controlled banks to state-owned enterprises. The absence of private participants, and any mark-to-market pressure, provides the state with the ability to manage the timing and pace of recognizing nonperforming loans.

It is also important to note that the majority of potential bad debts are to state-owned firms, while the privately owned companies that employ the majority of the workforce and account for the majority of economic growth have been deleveraging.

Figure 1. **HIGH DEBT LEVELS, BUT MOSTLY WITHIN THE STATE SYSTEM**
Liabilities-to-assets ratio of industrial firms by ownership



Source: CEIC

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Additional positive factors are that China's banking system is very liquid, the process of dealing with bad corporate debts has begun and the government is focused on mitigating financial sector risks. The liabilities-to-assets ratio for larger industrial firms declined to about 56% in November of 2017, from 58% four years ago. Among larger state-owned enterprises (SOEs), the progress is more basic: the liabilities-to-assets ratio is no longer rising, holding steady at about 61% for the past few years.

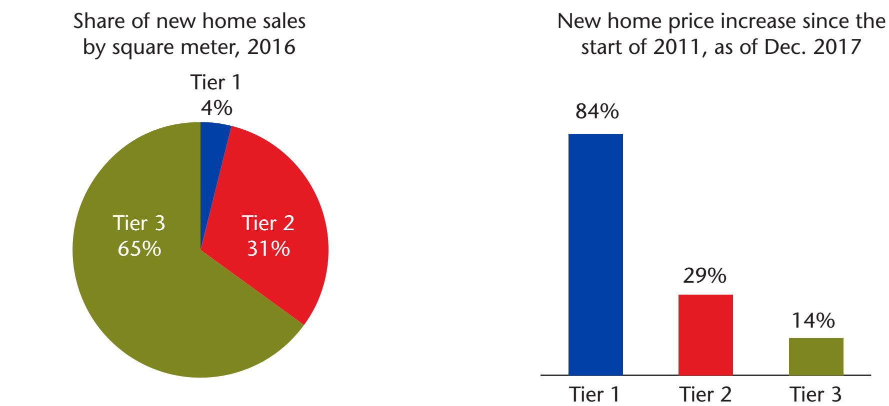
Cleaning up China's debt problem will be expensive, but this process is likely to result in gradually slower economic growth rates, greater volatility, and a higher fiscal deficit/GDP ratio, not the dramatic hard landing or banking crisis scenarios that make for an alluring media story.

Is There a Property Bubble?

New home sales rose 5.3% YoY (on a square-meter basis) last year, which is impressive given the high base—sales were up 22.4% in 2016—and given that over 100 major cities have put in place purchase restrictions to cool the market. And keep in mind that these sales involve a lot of cash: the minimum down payment is 20% of the purchase price, and most banks require 30%.

Prices are up, but the picture is not as scary as some make it out to be. In China's major, or Tier 1, cities of Shanghai, Beijing, Shenzhen and Guangzhou, new home prices are up by an incredible 84% since the start of 2011. But those four cities account for only 4% of national new home sales. In the many smaller, Tier 3, cities, which account for 65% of sales (by square meter), prices are up by only 14% since the start of 2011 while nominal income has risen by about 10% every year.

Figure 2. **RESIDENTIAL PROPERTY BUBBLE?**



Note: Tier 1 includes Shanghai, Beijing, Guangzhou and Shenzhen
Sources: National Bureau of Statistics, Matthews Asia estimates

The growth rate of new home sales should continue to cool this year as a result of policy tightening and the base effect. But even if sales were to fall by 10% (a low probability), that would still mean Chinese families this year would buy about 12 million new homes, with a lot of cash down.

What About Exchange Rate Risk?

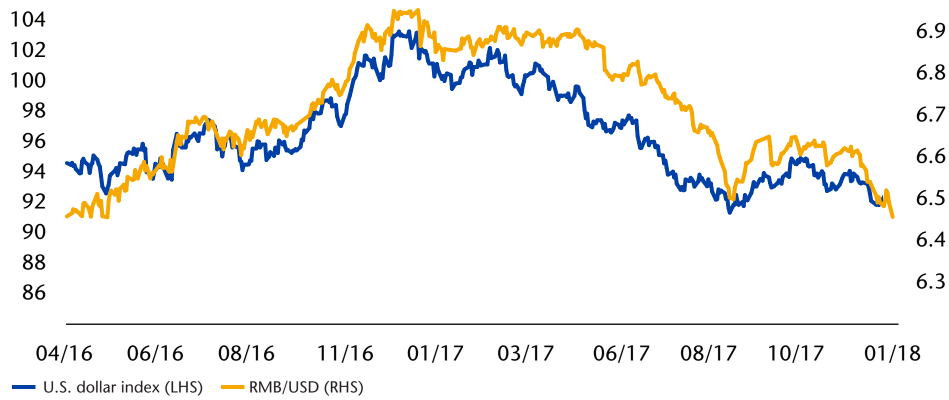
The year began with media speculation about the tools China's central bank uses to manage the exchange rate, but I think it is more productive to focus on the central bank's exchange rate objectives and the probability of achieving those goals. In my view, the two key objectives this year will be the same as in 2017.

The first objective is to maintain a stable rate for the Chinese currency, the renminbi (RMB), against its trade-weighted (CFETS) basket. The central bank was very successful at this in 2017, with that exchange rate flat for the full year.

Second, the central bank will continue to accept that the direction of the RMB/USD rate will be determined by the direction of the U.S. dollar, but with the bank intervening to limit the scale of the movement of the RMB in either direction. My assumption is that the central bank wants to limit this movement to +/- 5% to 6% for any one calendar year. Last year, they were pretty successful, with the RMB up 6.8% against the dollar, while the dollar index (DXY) was down 10.4%.

This chart illustrates that the direction of the dollar drives the direction of the RMB vs the dollar:

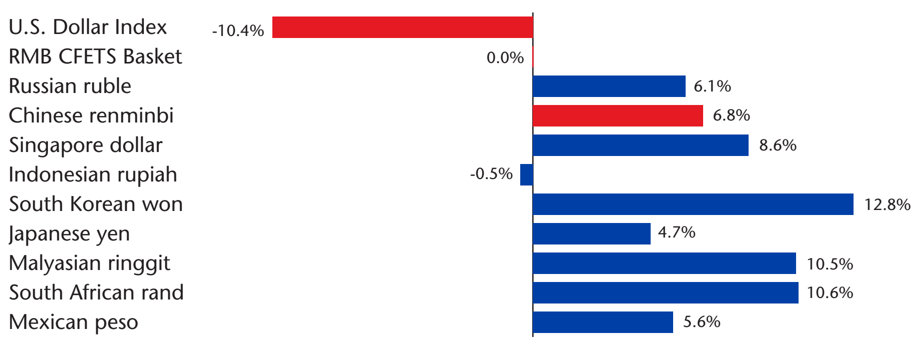
Figure 3. **U.S. DOLLAR DRIVE THE RMB EXCHANGE RATE**



Source: CEIC

And in this chart, you can see that in 2017, China intervened enough to prevent the RMB from appreciating as much as many other Emerging Market (EM) currencies:

Figure 4. **CHANGE OF SELECT EM CURRENCIES AGAINST USD YTD 2017**



Source: Bloomberg, CFETS
All the change in currency exchange rate is year-to-date through Dec. 29, 2017

I expect more of the same this year, with the RMB to move modestly in whichever direction the dollar sends it.

Will De-Risking the Financial Sector Create a Credit Crunch?

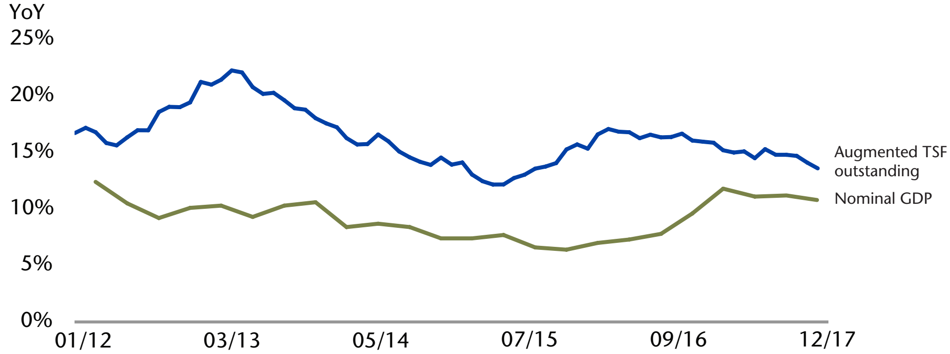
I expect China's regulators to continue their proactive approach to cleaning up risks in the financial sector, but this is unlikely to result in significantly tighter credit conditions.

In 2017, supervisors cracked down hard on some of the riskiest parts of the financial sector, including products sold by banks and insurers which were not compliant with regulations.

As in the past, the objective will be to reduce risk rather than to tighten monetary policy. There is always a risk that this crackdown will result in an *inadvertent* credit crunch, but given the government's control over the major financial institutions, it is hard for me to see how any accidental tightening could last for more than a couple of months.

I expect the central bank to continue with its modest tightening bias, while also focusing on improving credit quality.

Figure 5. **CENTRAL BANK HAS A MODEST TIGHTENING BIAS**



Sources: CEIC, Matthews Asia estimates
Augmented TSF outstanding = total social financing (TSF) outstanding - equity financing + muni bond outstanding

Will the Chinese Consumer Remain Healthy?

The rebalancing of China's economy continued last year, with the service industry accounting for 51.6% of GDP, up from 45.3% in 2012, the year in which Xi Jinping became Communist Party chief.

Strong wage growth, low household debt, mild inflation and consumer optimism resulted in real (inflation-adjusted) retail sales growth of 9%. This compares to U.S. real retail sales growth of 2.4%, and we note that while spending by Chinese consumers was equal to only 22% of U.S. retail sales in 2006, it was equal to 87% of American consumer spending in 2016 and is likely to surpass U.S. retail spending by the end of the decade.

Per capita urban household income rose 6.5% in 2017, up from a 5.6% pace in 2016, driven by improved profitability of industrial firms.

The consumer story should remain very healthy in the coming quarters, and drive an increasingly larger share of China's economic growth over the coming years.

Is Last Year's Corporate Profit Rally Sustainable?

Profits at larger industrial firms rose 21.9% year-over-year (YoY) during the first 11 months of last year, up from a 9.4% growth rate during the same period in 2016. Operating margins for these firms reached levels not seen since 2011. (Note that these firms include many not listed on a stock exchange.)

The key drivers of this earnings improvement were increases in construction activity (infrastructure and residential) leading to stronger demand for materials and equipment, as well as supply-side constraints and stricter enforcement of pollution controls, which led to higher raw material prices.

Many of these factors will remain in place this year, including government policies which will promote consolidation, and thus pricing power, in heavy industry. As a result, corporate earnings growth is likely to remain healthy, although the tougher base means that on a year-over-year basis, the growth rates will be a bit slower.

Will Trump Start a Trade War with China?

President Trump is reportedly considering trade sanctions and a return to the China-bashing rhetoric of his campaign. I don't think this is a big risk.

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It is clear that many of Trump's advisors advocate a confrontational approach to trade with China, but it is far from clear that the president himself shares that view. Despite his harsh campaign rhetoric, he did not take protectionist measures against China during his first year in office, and he highlighted what he considered to be a warm relationship with Xi Jinping. Trump may also be reluctant to launch a trade war against America's largest trading partner, which could have a negative impact on U.S. economic growth and on U.S. equity markets.

In my view, Trump is more likely to apply penalties or restrictions to a very limited range of Chinese goods, while claiming that he has taken dramatic action to make his political points. If the real impact on Chinese exports is minor, I expect Chinese leaders to respond in a moderate, proportionate way. Beijing is not looking for new problems with Washington.

It is also important to recognize that China is no longer an export-led economy. Last year, domestic consumption accounted for 58.8% of China's economic growth, and net exports contributed only 9.1% of GDP growth. Moreover, about 19% of China's exports go to the U.S., while Europe, Japan and ASEAN countries combined to take more than 30% of the share, limiting the impact of any new barriers to the U.S. market.

Finally, serious protectionist policies by the Trump administration would not further open Chinese markets for U.S. firms. Rather, such steps would lead to retaliation, which would reduce U.S. exports and harm the many American jobs they support. Protectionism would hurt American families because imports have resulted in more affordable prices for many consumer goods.

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Sources: CEIC and China's National Bureau of Statistics unless otherwise noted

Investments involve risk. Past performance is no guarantee of future results. Investing in international and emerging markets may involve additional risks, such as social and political instability, market illiquidity, exchange-rate fluctuations, a high level of volatility and limited regulation.