Matthews Asia

# Sinology

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- 1H17 macro data published over the weekend once again surprised those who predicted a hard landing.
- China's healthy economy is driven by impressive wage growth and consumer spending, supported by strong earnings growth.
- This issue of *Sinology* looks ahead to the economic and political challenges of 2H17, including the Party congress, North Korea and Trump policies.

**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 SURPRISES

The Chinese economy delivered many surprises in the first half of the year, disappointing (yet again) the pundits who predicted a hard landing. Macroeconomic data published over the weekend is consistent with a healthy economy, driven by impressive wage growth and consumer spending, and supported by strong earnings growth. This issue of *Sinology* reviews those surprises and looks ahead to the economic and political challenges of the second half of 2017.

### Foreign exchange (FX) reserves and currency

In early 2016, the media was full of predictions that by the end of last year, China would run out of FX reserves and its currency would devalue sharply against the dollar. Neither of those events took place, and this year FX reserves have risen and the renminbi (RMB) has strengthened.

China's FX reserves rose during each of the last five months, increasing by US$46.3 billion during the first half of the year, to amount to more than US$3 trillion. This increase was due to several factors, including tighter enforcement of capital account controls. But the more important reason was the strength of the RMB against the dollar.

The direction of the RMB is determined primarily by the strength or weakness of the dollar, rather than the health of the Chinese economy. In 2016, when the dollar index (DXY) rose 3.6%, the RMB fell by 6.4% against the dollar. In the first half of this year, however, the dollar index weakened by 6.4%, resulting in the RMB appreciating by 2.4% against the dollar.

*What to watch in 2H:* Capital outflows may accelerate a bit in the coming months as Chinese tourists head abroad and parents pay tuition for children who study overseas. Despite that flow, FX reserves will remain far larger than what China really needs. We expect the dollar to remain fairly soft, so the RMB should continue to strengthen, but Beijing will also continue to intervene to limit the extent of that appreciation against the dollar.

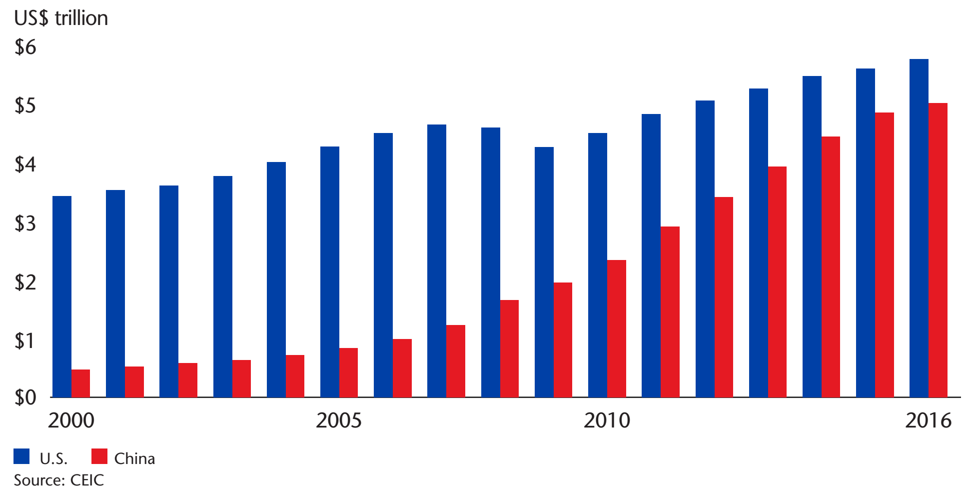
### Still the world's best consumer story

Strong wage growth, low household debt, mild inflation and consumer optimism resulted in real (inflation-adjusted) retail sales growth of 9.3% in 1H17. This compares to U.S. real retail sales growth of 2.3% during the first five months of the year, and we note that while spending by Chinese consumers was equal to only 22% of U.S. retail sales a decade ago, it was equal

to 87% of American consumer spending last year and is likely to surpass U.S. retail spending by the end of the decade.

Per capita urban household income rose 6.5% in 1H17, up from a 5.8% pace during the first half of 2016, driven by improved profitability of industrial firms.

*Figure 1.* **RETAIL SALES U.S. VS. CHINA**




Source: CEIC

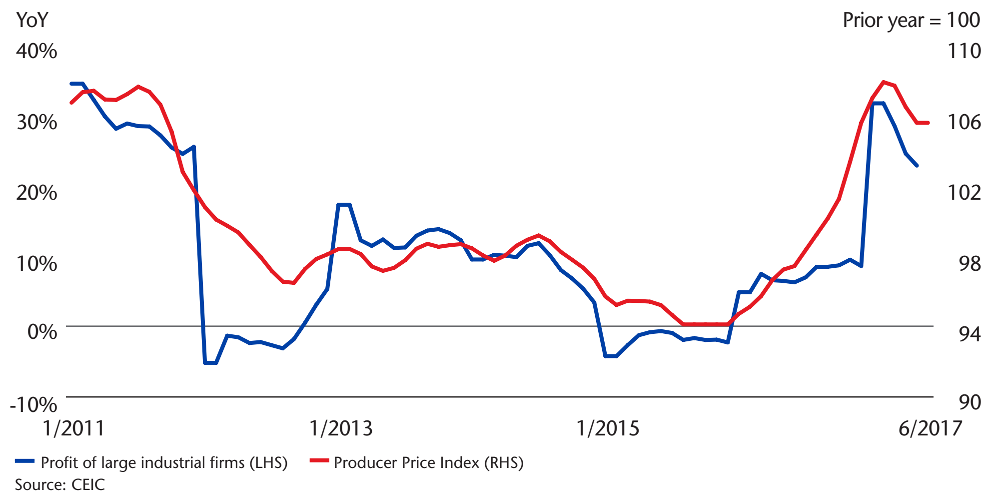
The rebalancing of the Chinese economy continued, with consumption accounting for 63.4% of GDP growth in the first half of 2017, up from a 44.7% contribution during the same period in 2010.

*What to watch in 2H:* The consumer story should remain healthy in the coming quarters, and drive an increasingly larger share of China's economic growth over the coming years.

## Strong Earnings Growth

Profits at larger industrial firms (including many companies not listed on a stock exchange) rose 22.7% year-over-year (YoY) during the first five months of the year, up from a 6.4% growth rate during the same period in 2016.

*Figure 2.* **IMPROVING INDUSTRIAL PROFIT GROWTH**




Source: CEIC

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, which led to higher raw material prices.

Improved profitability supported the strong wage growth described earlier, and is likely to be behind the rise in confidence among entrepreneurs surveyed by China's central bank—with that confidence index last month hitting a three-year high. As a result, fixed-asset investment by privately owned industrial firms rose 6.8% YoY in 1H17, up from 2.4% in 1H16.

*What to watch in 2H:* The YoY growth rate of profits at larger industrial firms will decelerate in the second half of the year, due to a tougher base effect and because the growth rate of raw material prices—which are highly correlated to industrial profits—is slowing. Nonetheless, we expect industrial profit growth and margins are likely to remain very healthy through the rest of the year.

## Healthy Property Market

New home sales rose 13.5% YoY (on a square meter basis) during 1H17. This is even more impressive given that it followed an already high base—sales were up 28.6% in 1H16—and given that many cities have put purchase restrictions in place 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 the Tier 1 cities of Shanghai, Beijing, Shenzhen and Guangzhou, new home prices are up by an incredible 85% since the start of 2011. But those four cities account for only 4% of national new home sales. In the many Tier 3 cities, which account for 65% of sales (by square meter), prices are up by only 10% since the start of 2011, while nominal income has risen by about 10% every year.

*What to watch in 2H:* The growth rate of new home sales should continue to cool as a result of policy tightening and the base effect. We expect full-year sales to rise just a bit YoY, but even if sales were to fall by 10% (a low probability), that would still mean Chinese families this year would buy about 11 million new homes, with a lot of cash down. And, if you are concerned about "ghost cities," please check out our short video: matthewsasia.com/sinology

## Three Other Issues We will be Watching in 2H17

**The 19th Congress of the Chinese Communist Party**—We do not expect the Communist Party's 19th Congress, scheduled for the fall, to have a significant impact on our investment strategy. There are no signs that the Party is artificially boosting growth ahead of the congress. Instead, credit growth has moderated and regulators have been cracking down on risky practices at a wide range of financial institutions.

Many senior officials will retire at the congress, but we do not expect this personnel turnover to result in dramatic policy changes, because none of the departing officials have been obstacles for Xi Jinping, who will start a second term as Party chief at the congress. We anticipate continued, gradual progress toward a more market-driven economy and financial sector de-risking.

**North Korea**—North Korea's leader Kim Jong-un is a brutal dictator. But he doesn't appear to be suicidal, so he is highly unlikely to use his weapons of mass destruction, because he knows that the U.S. military response would destroy his regime. This, of course, assumes that the U.S. does not take actions which Kim believes are an attempt to overthrow him, in which case all bets are off.

To put this in perspective, the Soviet Union had nuclear weapons under Stalin; Mao had nukes during the chaos of the Cultural Revolution; and Pakistan had them during periods of military rule.

Finally, we need to be realistic about Beijing's ability to force Kim to give up his nuclear weapons. Kim probably believes that his possession of weapons of mass destruction is the only reason the U.S. has not attempted to overthrow him, so there is no reason to believe any amount of outside pressure will lead him to disarm.

**Trump Trade War**—President Trump is reportedly considering trade sanctions and a return to the China-bashing rhetoric of his campaign.

If Trump were to make a policy U-turn and pursue currency manipulation and punitive tariffs on Chinese imports, those steps would have only a modest impact on the Chinese economy. As we've explained in recent issues of *Sinology*, the concrete consequences of China being labeled a currency manipulator are, well, nothing.

And if Trump were to apply a broad 15% tariff on imports from China—the highest rate permissible under U.S. law on an emergency basis—the impact on the Chinese economy would be significant, but it would be much lighter than most people expect because China is no longer an export-led economy. Last year, domestic consumption accounted for two-thirds of China's economic growth, and net exports were equal to only 2.2% of GDP. Moreover, only about 18% of China's exports go to the U.S., while Europe, Japan and ASEAN countries combined to take more than one-third of the share, limiting the impact of any new barriers to the U.S. market.

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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