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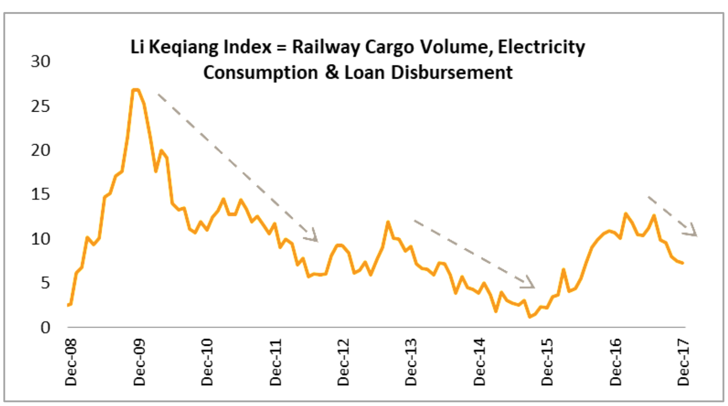
China Update

BY CAROLYN MEKHAIL, SENIOR ANALYST, RESEARCH

Slowing But Far From Sluggish

Official data coming out of China is notoriously circumspect, with the country consistently hitting or beating its growth targets. Li Keqiang, a government official in China, apparently told a US ambassador in 2007 there are three indicators that are more reliable than putting blind trust into the "man-made" dataset: railway cargo volume, electricity consumption and loan disbursement by banks[1]. As seen in the chart below, the Li Keqiang index does have cyclical tendencies, but the general trend over the past ten years has been lower. Though not the most rigorous of indices,

FIGURE 1:

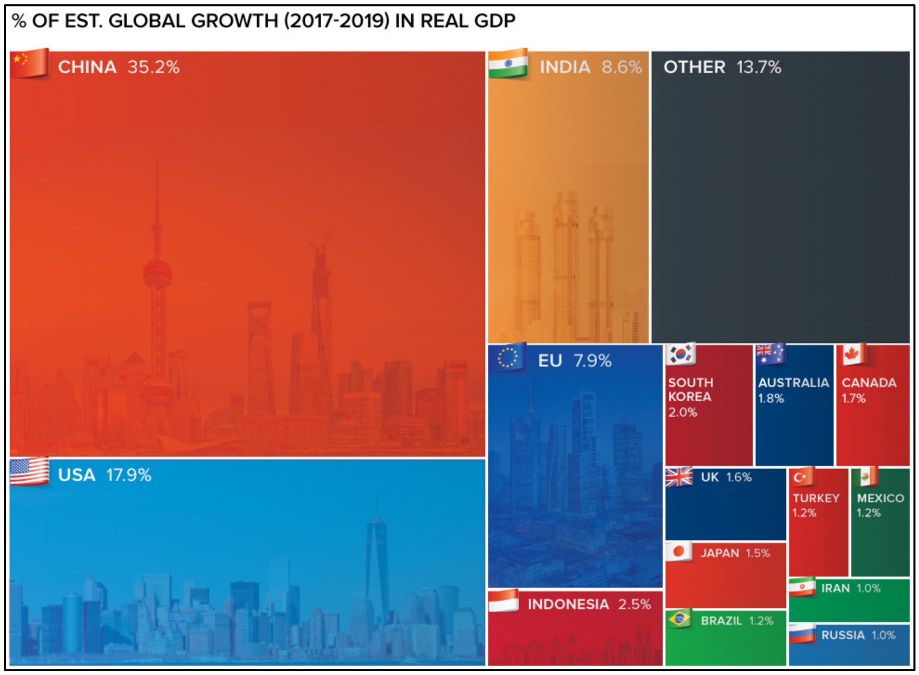


it is reflective of the challenges China has been facing as it fights for its spot as a major global power, despite headwinds such as massive debt levels and a government-guided slowdown. However, a "slowing China" must be put into global context. On March 4th, the 2018 GDP growth goal of 6.5% was announced[2]. While this may be slower than the 14% growth observed in 2007, 6.5% growth is still leagues ahead of global GDP at 2.5% in 2016[3].

The Juggernaut

Perhaps more importantly, China is the second largest economy after the US, making its contribution to global economic growth enormous. The chart on the right illustrates World Bank estimates of contribution to real global GDP growth between 2017 and 2019. Even though the Chinese economy has been growing more slowly recently, about 35.2% of global GDP growth is expected to come from China. Given its outsized role in the global economy, many eyes are on the administration's handling of this carefully controlled slow-down.

FIGURE 2:



Nobody Puts Xi Jinping in the Corner

China has long been synonymous with the concept of "government control," which has recently become even more evident. China's Communist Party announced on February 25th its intention that term limits will no longer apply to the presidential position[4]. Two separate five year terms have restricted presidential power ever since they were put in place after the 27 year rule of Mao Zedong ended in 1976. Eliminating this rule now means that the Chinese leader has the legal grounds to rule indefinitely. China's president, Xi Jinping, has recently entered his second term, though rumors abounded about his intention to extend his time in office. The well-known crackdown on corruption in China coincidentally served to target several of Jinping's political adversaries, meaning this newest change to the constitution has met virtually no political resistance. Xi effectively wears three hats: that of the president, as the general secretary and as the chairman of the party's central military commission. Only the presidential position had term limits, but the prospect of a different individual serving as president would have threatened Xi's grip on these other two roles. The implications of this change towards a more autocratic government are yet to be seen, but it may provide Xi the runway needed to realize his long term visions of an expanded middle class, reduction of inequality within China, a cleaner environment, and expansion through investment and development in countries outside China.

Wealthier Citizens Become More Demanding Citizens

China's government is walking a tightrope of preventing social instability (and thus maintaining government control) while simultaneously shifting the country's economic drivers away from capital-intensive exports to a more consumer-based economy. Though the Chinese population is facing a similar dilemma as other developed nations in that the population is aging, this is not quite an apples-to-apples comparison. The major difference is that the middle class is growing rapidly, allowing the Chinese government to shift the economic drivers to be more consumer-oriented in nature. As recently as 2016, household consumption comprised only 39.0% of GDP, compared to 68.8% in the US and 55.1% in the Eurozone[3]. China's middle class is accumulating wealth, which is fueling industries within retail, financial services and tech, just to name a few. According to a 2013 study conducted by consulting firm McKinsey, 54% of the Chinese population fell into the "mass middle class" category in 2012, meaning they earned between $9,000 and $16,000 per year. By 2022, McKinsey estimates that 54% of the populace will be considered "upper middle class," bringing in between $16,000 and $34,000 annually[5]. Even more encouragingly, Dr. Homi Kharas of the Brookings Institution estimates that by 2030, Chinese spending will reach $14.3 trillion (in US dollar terms), which would amount to 22% of the global total. US spending would make up only 7% of the world's total, and India would reach 17%. Of course, shifting an economy this massive away from exports and towards services and consumerism is harder than steering the Titanic through the Corinth Canal, but at least there are forces working in the nation's favor.

FIGURE 3:

Middle class consumption - top 10 countries, 2015, 2020, and 2030 (PPP, constant 2011 trillion $ and global share)

Country	2015	Share (%)	Country	2020	Share (%)	Country	2030	Shares (%)
U.S.	4.7	13	China	6.8	16	China	14.3	22
China	4.2	12	U.S.	4.7	11	India	10.7	17
Japan	2.1	6	India	3.7	9	U.S.	4.7	7
India	1.9	5	Japan	2.1	5	Indonesia	2.4	4
Russia	1.5	4	Russia	1.6	4	Japan	2.1	3
Germany	1.5	4	Germany	1.5	4	Russia	1.6	3
Brazil	1.2	3	Indonesia	1.3	3	Germany	1.5	2
U.K.	1.1	3	Brazil	1.2	3	Mexico	1.3	2
France	1.1	3	U.K.	1.2	3	Brazil	1.3	2
Italy	0.9	3	France	1.1	3	U.K.	1.2	2

Source: Author's calculations

The recently announced 2018 initiatives include annual GDP growth of 6.5%[2], alongside financial de-risking, poverty alleviation and environmental-based goals. The party's willingness to include quality of life issues as official targets supports Xi Jinping's vision of an expanded middle class, and a China moving on from its commodity-centric past. The image to the right encapsulates the severity of the pollution issues in modern China. A larger, wealthier middle class will be more demanding of the government's readiness to make these improvements on their quality of life.

FIGURE 4:

Buildup of Debt

It is fair to say that China's debt load is a legitimate risk to long term, steady economic growth, especially if it is not handled correctly. Aside from the social initiatives, a major component of the 2018 initiatives is a 2.6% deficit target[2].

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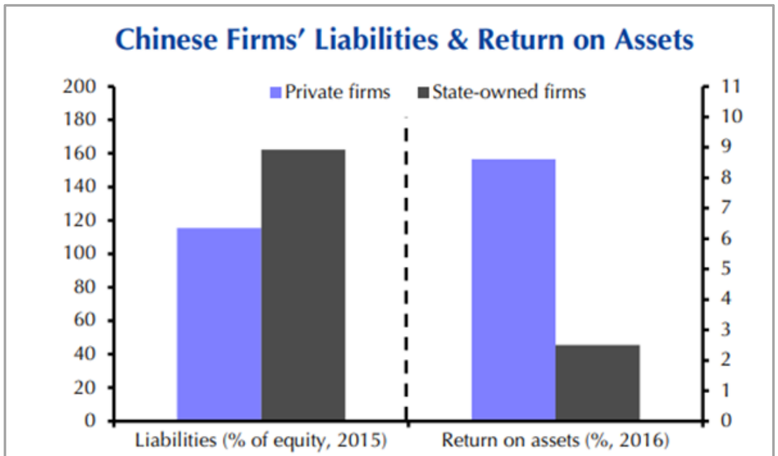
A cloud has been hanging over the outlook for China due to its heavy debt load, so it is necessary for the government to publicly address this issue in a proactive way. They have already begun making headway in reducing the debt burden within the shadow banking sector, but investors are not yet assuaged. Working in China's favor is that the majority of the nation's debt is held in local currency (see chart on right). Given the government's extensive control of the economy, the nation is positioned to manage a debt load of this magnitude. According to Capital Economics, there is "little risk of a sharp withdrawal of foreign funding," since it has a current account surplus and its external debt is low. The government's authority within the financial sector offers additional support to the expectation of banks remaining solvent.

FIGURE 5:

Sources: Thomson Reuters, CEIC

What may be more disconcerting than the level of debt is that much of it has not been utilized in a way that would result in highly profitable ventures. State Owned Enterprises (SOEs) are government-funded and managed commercial institutions that run the gamut from steel and coal production to airlines and telecommunications. The number of SOEs has dropped to 98 from 117 over a five year period after a series of mergers and reorganizations[6], but analysts are still concerned about the bloated debt levels of these companies. The chart below illustrates the results of disproportionate lending to SOEs, which report significantly lower levels of profitability.

FIGURE 6:



Sources: CEIC, Wind Info, Economist, Capital Economics

MSCI estimates that SOEs comprise 50% of China's stock market as of June 2017[7]. Chinese equity weight has recently exceeded 30% of the MSCI Emerging Markets equity index, having grown exponentially from an inconsequential 0.2% only twenty years ago[8]. China is only growing in influence, especially considering the local A-Shares equities will be incrementally added to the index beginning this June. This is in part why active management is so essential in emerging markets investing: government-run enterprises are not motivated to align their best interests with those of the shareholders. Passively managed products are designed to track the index, which would include these types of stocks.

A Whole New World

The existence of SOEs does not change the fact that China's influence on the world (and its presence in investor portfolios) is set to grow alongside the nation's burgeoning middle class. Though the Chinese economic growth is indeed slowing, its importance as a global powerhouse and the opportunities this market presents to investors should not be underestimated. In a nation where the government's influence on the economy's direction and rate of growth is all-consuming, it is essential for investors to understand the underlying drivers of these investments.

Sources:

Figure 1: Bloomberg, Data as of 12/31/17.

Figure 2: Desjardins, Jeff. “Where is Global Growth Happening?” *Visual Capitalist: Chart of the Week* June 2, 2017.

Figure 3: Kharas, Homi. “The Unprecedented Expansion of the Global Middle Class: An Update.” *The Brookings Institution* February 2017.

Figure 4: Getty.

Figures 5 & 6: Brown, Stephen. “Ten Years After the Crisis: Will High Levels of Debt Weight on Global Growth?” *Capital Economics* November 10, 2017.

(1) “Some Alternative Methods for Tracking Chinese GDP.” *Federal Reserve Bank of St. Louis* September 2017.

(2) “China Turns Fiscal Screws While Maintaining 6.5% Red Line on GDP.” *Bloomberg News* March 5 2018.

(3) The World Bank, Data as of 12/31/16.

(4) Clover, Charles & Tom Mitchell. “China Poised to End Two-Term Limit on Presidency.” *The Financial Times* February 25, 2018.

(5) Barton, Dominic, Yougang Chen & Amy Jin. “Mapping China’s Middle Class.” *McKinsey Quarterly* June 2013.

(6) Miller, Matthew & Fang Cheng. “China Says Framework for State-Owned Enterprise Reform ‘Basically Complete.’” *Reuters* September 28, 2017.

(7) Wei, Zhen & Chin Ping Chia. “Are You Ready for China A Shares?” *MSCI Research Insight* June 2017.

(8) Morningstar, Data as of 02/28/18.

MARKET BENCHMARK RETURNS

April 30, 2018		1M	3M	12M	YTD
US Large Cap	S&P 500	0.4%	-5.8%	13.3%	-0.4%
US Small Cap	Russell 2000	0.9%	-1.8%	11.5%	0.8%
Developed Intl	MSCI EAFE	2.3%	-4.1%	14.5%	0.7%
Emerging Intl	MSCI Em Mkt	-0.4%	-6.8%	21.7%	1.0%
Real Estate	NAREIT	0.6%	-3.0%	-0.9%	-6.1%
Core Fixed	BarCap Agg	-0.7%	-1.1%	-0.3%	-2.2%
Short Fixed	BarCap 1-3Yr	-0.1%	0.0%	-0.1%	-0.3%
Long Fixed	BarCap LT G/C	-1.9%	-3.5%	1.5%	-5.5%
Corp Debt	BarCap Corp	-0.9%	-2.1%	0.6%	-3.0%

Source: Bloomberg

The performance data shown represent past performance. Past performance is not indicative of future results. Current performance data may be lower or higher than the performance data presented.