China Pivots to Face an Imperfect Storm

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Even before the threat of a trade war, China's economy was steadily slowing as the bang to growth from increasing debt diminished, creating a heavy stimulus hangover as capacity excesses are worked out. Beijing knows the old playbook to fuel growth—housing, infrastructure, and credit—is tapped out. So it's shifting to deploy new growth drivers, incentivizing consumers and corporates with tax and pension contribution reforms. The market-focused drivers should, together with other measures, counter the impact of the trade conflict and support growth.

Executive Summary

- The importance of exports to China's economy has declined in recent years, while that of consumer spending has increased. Also, many exports are sourced from partially finished imported goods, reducing their contribution to the country's GDP.
- Beijing can also reduce the impact of escalating U.S. tariffs by depreciating China's currency and increasing export rebates for affected companies.
- The government has also implemented personal income tax cuts and reduced mandatory corporate pension contributions in exchange for greater compliance, which in aggregate equate to nearly 3% of GDP.
- The new growth drivers should result in more sustainable, healthier economic growth, and benefit consumer-oriented sectors. Given attractive valuations and perhaps too low expectations, these sectors appear poised for a rebound.

Slower growth and a potential trade war are tough headwinds for China but manageable under most reasonable scenarios. It's true that, compared to prior soft patches, China is unwilling and, for the most part, unable to resort to the old playbook to stimulate growth. Instead, Beijing is supporting local consumption and corporate profitability through personal income tax cuts, value-added tax reductions, and lower mandatory pension contributions. While in theory these should be enough to offset the headwinds, the new playbook is different, which may make it harder for outsiders to verify that the stimulus is working. A 2017-type economic rebound is less likely than sustained growth at current levels or a slight uptick.

The most likely winners from an investment perspective are consumer sectors and policy priority industries, mainly electric vehicles, semiconductors, and automated manufacturing components.

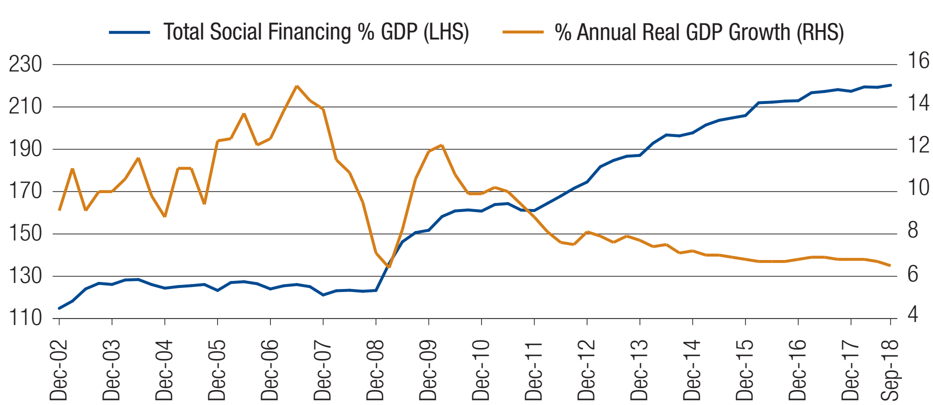
An Umbrella or a Storm Shelter?

China's annual output of $12.5 trillion makes it the second-largest economy in the world. It is the single-largest contributor to global GDP growth at just more than 40%. Together with the U.S., the two countries represent 40% of global GDP and 70% of world GDP growth. Yet as both economies are set to slow off high bases amid the additional headwinds from the self-inflicted trade war, the single-most important question for global markets today is the forecast for the Chinese economy. Do we need an umbrella or a storm shelter?

In the late 1990s and the early part of the last decade, exports were important for the Middle Kingdom's economy, but their contribution is less so today. China has historically used three levers to boost growth and employment: the housing market, infrastructure investments, and credit growth—regardless of the return on investment. During the Global Financial Crisis, it rapidly increased total social financing, which attempts to capture formal and informal credit growth. For about a year, credit was growing much faster than underlying double-digit nominal GDP growth. As some excesses in the economy grew, the limitations of the model became apparent starting in late 2011. Without a doubt, China navigated the crisis with a brief economic slowdown at the time, but the excesses have led to harder choices today.

While this type of counter-cyclical spending might temporarily reinvigorate an economy, China has continued to grow credit well above GDP growth ever since the crisis. A variety of factors have probably driven the government to use excess credit growth to sustain high GDP growth. China likely pulled forward a significant amount of domestic demand during the crisis in the form of short-term over-investment, which then needed to be absorbed over the next few years. While all countries suffer stimulus hangovers, China's was probably worse as it was chasing growth targets without market forces directing the investments. Moreover, external demand was at best sluggish post crisis, leaving China with excess capacity in many areas and subsequently dampened domestic investment.

Figure 1 | China's Total Social Financing (% GDP) and Real Annual GDP Growth



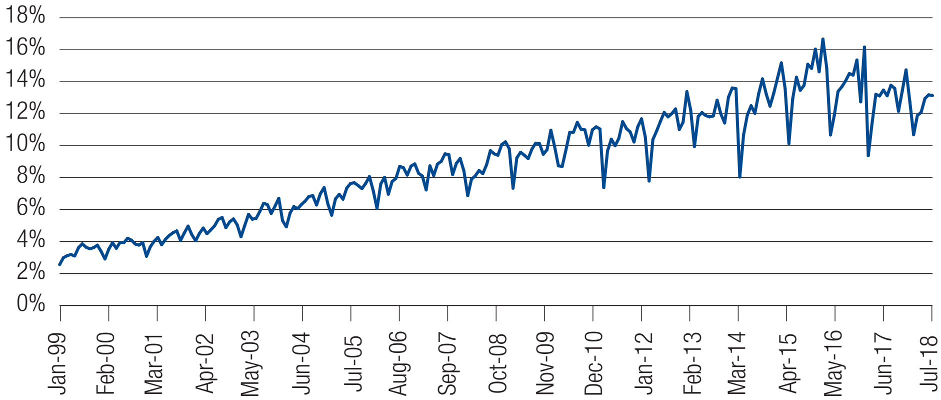
Source: Bloomberg

From the perspective of the Chinese government, it didn't really have a choice. In theory, market-based economies are designed to occasionally pop bubbles and clear the bad debt through bankruptcies and investment losses. But that is harder for the Chinese government to accept given its focus on growth, economic stability, and full employment. So Beijing kicked the proverbial "can down the road," propping up the economy using leverage to stimulate investment even if it was unproductive. The hope was that by pushing out the inevitable slowdown, it might find another way to support growth in the future.

This effort may have worked out fine if the rest of the world was on stronger footing. However, external shocks from the euro crisis in 2012 and the U.S. dollar rally in 2015 forced China to more aggressively stimulate its economy in those periods in a bid to boost confidence and maintain growth. More recently, President Xi Jinping has vowed to reform the Chinese economy to make the growth model more sustainable and less reliant on debt-fueled fixed-asset investment. Fortunately for Xi and his new policy agenda, China was experiencing faster-than-expected growth in late 2017, driven by the aforementioned stimulus. China took the opportunity to accelerate the reform agenda. The result was slower credit growth, especially in informal channels such as wealth management products and peer-to-peer lending. During the first half of 2018, total social financing growth slowed and almost converged with nominal GDP growth. Through the third-quarter of 2018, the Chinese economy grew nicely in the face of slower credit growth. It continued to exceed expectations and internal GDP growth targets. But, once again, the path to more sustainable growth was blocked by external factors, including unexpected U.S. dollar strength and the looming uncertainty of the potential trade war.

At this point, no one is certain how weak Chinese economic growth will be in the next few quarters, in part given the high-base effects of relatively strong growth over the last three quarters. Fixed-asset investment grew 5.4% in the nine months

Figure 2 | China's Market Share of Global Trade



Source: Bloomberg

through September from the year-earlier period, in-line with the recent past. Meanwhile, property under construction jumped an annual 3.9%, which was the fastest growth rate since the second quarter of 2016, despite less credit made available and restrictions on new land sales by local governments in some areas. Manufacturing investment has also jumped in the most recent quarter, rising nearly 12% year-on-year and capping off a 9% increase year-to-date. Despite the relatively strong numbers, the economy is no doubt slowing but continues to perform largely as, if not better than, expected considering the attempt to deleverage. Most expect Chinese growth to ebb to its slowest rate in nearly three decades in 2019, even slower than at the depth of the Global Financial Crisis. The main concern in the markets and on the ground in China is how much a trade war may impact growth and what the government can do to offset this if the economy slows more sharply.

Quantifying the Impact of a U.S.–China Trade War

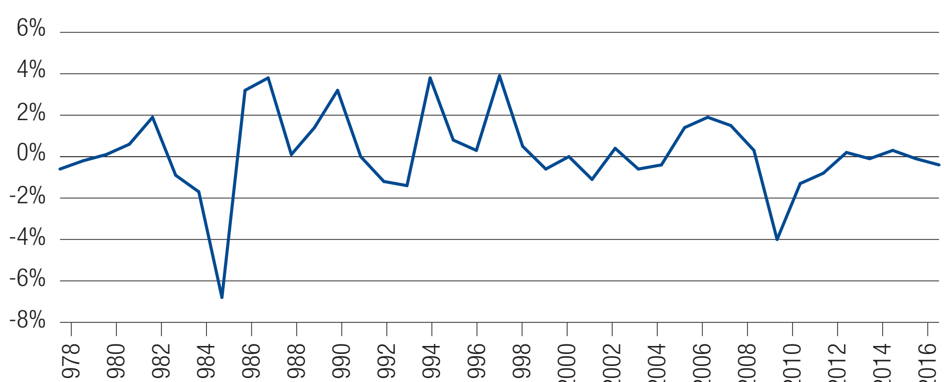
Conventional wisdom suggests China's economic success has largely been driven by a low-cost labor pool and well-calibrated manufacturing infrastructure, enabling the country to take share of global trade and grow its economy. That was true in the past but is less so this decade. ***Figure 2*** shows China's share of global trade since the late 1990s. It grew rapidly last decade as China's share expanded from just 2% to more than 10%. However, it has grown much more slowly this decade and even fallen over the last three years.

Given double-digit wage inflation for at least a decade now, it's understandable that China is no longer competitive in lower-value exports. However, Beijing has been shifting its focus toward more technical manufacturing, including semiconductors and electric-vehicle components, which are a major focus of the government's "China 2025" strategic plan to develop world-leading, high-tech manufacturing. Moreover, exports are less important for GDP growth today than they were in the past. In fact, over the last decade, net exports tended to be neutral to a slight drag on GDP growth. That probably isn't the whole story considering investment in manufacturing, which tends to run between 20% and 25% of GDP. Of course, that is not all exports, and it can be difficult to parse. The main takeaway is the impact on exports is manageable in reasonable scenarios. For simple math, if the entire $500 billion in Chinese goods that went to the U.S. last year were not produced next year, that would equal about 4% of the country's GDP. About half of that value is imported in the form of partially finished goods, which means that China would lose about 2% of GDP. Considering the Chinese government seems willing to weaken the currency and increase export rebates for those affected by U.S. tariffs, an impact of that magnitude is unlikely and would probably end up amounting to less than 1%, including investment and export-related impacts. Using the North American Free Trade Agreement renegotiation as an analogy, a leading Mexican financial institution recently told us that as soon as the new North American trade agreement was reached, local business investment resumed almost immediately. Those making investments just needed more clarity before proceeding.

Table 1 shows three scenarios of the potential impact to China's GDP from the U.S. tariff set at 25%. The main assumptions are that China exports $500 billion to the U.S. and half of the value of the exports is imported into China as a partially finished good before final manufacturing and export. The range of outcomes is between zero percent of GDP and 1.6%.

To put the size of the task in perspective, when GDP growth fell by 10% during the Global Financial Crisis, China stimulated on the order of 15% to 20% of GDP. In this case, it's a potential impact of just 50 to 100 basis points. The key question is whether China can offset the headwind and how it might do so.

Figure 3 | Contribution of Net Exports to China's GDP Growth



Source: Bloomberg

Table 1 | Scenarios: 25% U.S. Tariff, $500B of Chinese Exports, 50% China Net Value Add

SCENARIO	EXPORTS TO U.S.	REDIRECTED EXPORTS	NET EXPORT IMPACT	INVESTMENT IMPACT	TOTAL % OF GDP
China Bull	$500B	$0B	$0B	$0B	$0B or 0%
China Bear	$0B	$200B	$150B	$50B	$200B or 1.6%
China Base	$350B	$75B	$33B	$20B	$55B or 0.4-.5%

Source: Thornburg Investment Management Inc.

China Moves from the Old Growth Model as Consumer Takes the Lead

The Chinese government clearly wants to avoid the moral hazard created when stimulus leads to both the A-share market and "Tier 1"–city home prices skyrocketing. It hopes to continue deleveraging or at the least to slow credit growth. With Beijing home prices now among some of the most expensive in the world, China is trying desperately to restrict transactions to reduce speculation. The central government has put pressure on local governments to cap new home sale prices, crimping property developer enthusiasm for new projects. Local governments receive much of their cash flow from land sales to developers. With fewer land sales and fairly high levels of debt in many areas, local governments will not be able to execute large-scale infrastructure plans.

That doesn't sound encouraging. The old levers of growth are jammed. But, China is creating a new lever with consumer demand. This is a narrative that has been discussed over the last few years as the country looked for the next growth driver. The high personal savings rate and low household leverage are an obvious choice for new economic leadership.

While that transition has started, it has primarily been driven by slower fixed-asset investment growth rather than more robust consumption, which nonetheless has driven a mix shift in the economy. This is the first time when China really needs to see consumer demand remain resilient and even strengthen during a period of stress.

The government has made several changes to the tax code to support consumer demand and corporate investment. The first was a cut to the personal income tax rate enacted in June that should boost take-home income by 10% for the upper middle-class and 6% to 7% for lower middle-class workers, or roughly RMB 500 billion in total. The government is also supporting businesses with a cut to the value-added tax rate, (VAT) which was cut 1% already and is expected to be cut a few more percentage points, as needed. So far, the VAT cut is worth approximately RMB 1.3 trillion. Beijing has also announced a probable cut to the pension contribution rate, generating some RMB 600 billion. Thanks to a lower pension rate, employer adherence to the contribution obligation is expected to climb substantially. All in, these efforts add up to almost 3% of GDP. That doesn't take into account the apparent acceleration of investment in some of the "China 2025" initiatives, which could provide additional support for the economy, including investments in semiconductor manufacturing and electric vehicle production.

Not a Perfect Storm

To be sure, concerns about China's economic outlook are legitimate and domestic sentiment is weak, although it apparently troughed in late autumn. The headwinds seem manageable without leaning on the old levers of fixed-asset investment, property, and excess credit growth. China's economy isn't likely to bounce back as it did in 2016, when the old playbook was last deployed. Yet if the impact from the new playbook is less obvious in the near term, it may become more so in hindsight. Beijing's focus on incentivizing the private sector to take the lead through consumption and productive investment is encouraging. That should lead to better quality, more sustainable economic growth, and could set the stage for a nice rebound in Chinese and emerging market equities more broadly, based on currently low valuations and market expectations that are perhaps too low.

From a thematic perspective, that implies a wide range of consumer-oriented sectors—from domestic travel and leisure, to gaming, sportswear, education, cosmetics, even electric vehicles—may be well positioned to perform in both relative and absolute terms. But the quality and prospects of local companies within these sectors can vary dramatically, implying that bottom-up, fundamental, company-specific analysis remains crucial to investor returns. ■

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Basis Point (bp) – A unit equal to 1/100th of 1%. 1% = 100 basis points (bps).

Gross Domestic Product (GDP) – A country's income minus foreign investments: the total value of all goods and services produced within a country in a year, minus net income from investments in other countries.

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