ASIA'S EVOLVING GEOPOLITICS

Why Investors Are Paying Attention to China

By Andy Rothman

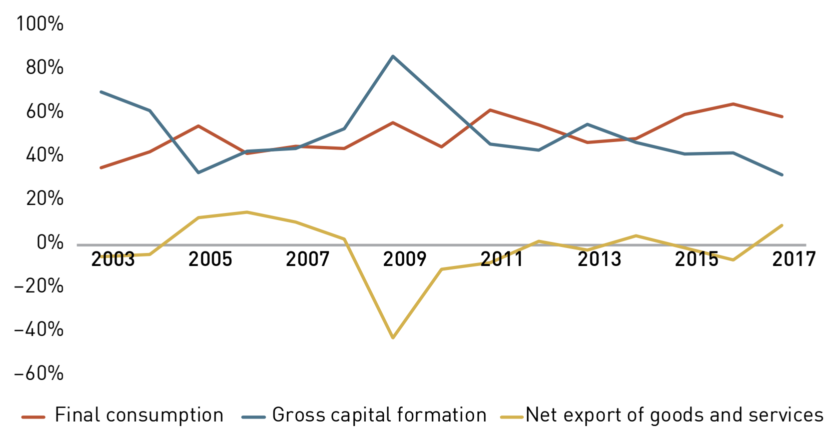
Global investors continue to pay keen attention to issues in China such as the pace of growth, property investment, potential bank debt woe, and regional political tensions, and now is a good time to examine the dynamics and impact of the country's engineered slowdown and economic rebalancing.

In recent years, China has undertaken intriguing initiatives to inject greater transparency and market forces into economic activity. The country is at a stage of development in which its per capita gross domestic product (GDP) is roughly equivalent to that of the United States in the 1950s. And although China lags in critical areas of institutional developments such as capital markets, monetary policy, governance, and the rule of law, China's industrial profit growth recently accelerated at a pace not seen since 2012 (despite slightly slower credit growth and aggressive regulation of financial sector risks). Recent macroeconomic data also has made it clear that the Chinese consumer continues to be the primary engine of growth, as illustrated by a 28-percent rise in online retail sales for 2017.

WORLD'S BEST CONSUMPTION STORY

The rebalancing of China's economy has been ongoing, with consumption accounting for 58.8 percent of GDP growth in 2017, up from a 54.9-percent contribution in 2012, when Xi Jinping became Communist Party chief (see figure 1).

Figure 1 **CONTRIBUTION TO GDP GROWTH BY EXPENDITURE APPROACH**



Source: CEIC

Strong wage growth, low household debt, mild inflation, and consumer optimism resulted in real inflation-adjusted retail sales growth of 9 percent in 2017 compared with U.S. real retail sales growth of 2.4 percent for the same period.

CONSUMER UPGRADES

With China's per capita GDP level reaching roughly US$9,000 today versus about US$2,700 a decade ago, consumer preferences and behaviors notably have risen in tandem. Consider outbound tourism, which has grown significantly over the years. Chinese travelers are much more willing today to spend money on leisure abroad, and popular destinations have been shifting from Hong Kong and Southeast Asia to Europe and the United States.

The home-appliance industry in China also benefits from consumer upgrades. The penetration rate for air conditioners in China is approximately 48 percent in rural areas and continues to rise in urban areas as city households become more prosperous and install more than one unit in their homes. Small appliances such as rice cookers and pressure cookers are being increasingly adopted. Pricing has become somewhat less important in such purchasing decisions. Consumers instead increasingly value quality, durability, and functionality. As a result, home-appliance manufacturers have been able to raise prices and improve profitability.

Consumers are now more inclined to purchase products such as insurance policies. In past years, insurance policies in China were viewed largely as investment vehicles. As affluence levels increase, however, Chinese consumers are seeking more protection for themselves and their families. Protection coverage as well as health insurance policies are becoming more popular, which bodes well for insurance companies in China (see figure 2).

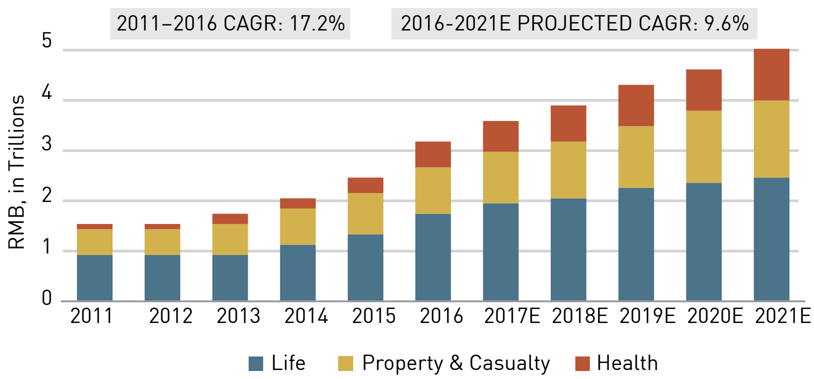
Xi Jinping's anti-corruption campaign continues, but its impact on Chinese consumer spending clearly has faded. According to the consulting firm Bain, domestic Chinese spending on luxury goods rose 20 percent in 2017, after having contracted in 2014 and 2015, the early years of the anti-corruption campaign.

Domestic Chinese purchases of luxury jewelry, for example, rose 27 percent in 2017 compared to a 2-percent increase in 2014. Chinese consumers accounted for 32 percent of global luxury purchases in 2017 up from a 30-percent share in 2016.

Figure 2

BASIC NECESSITIES, CONSUMER UPGRADES, AND CONSUMER BROADENING

INSURANCE MARKET PROJECTED GROWTH



CAGR = Compound Annual Growth Rate
There is no guarantee any estimates or projections will be realized
Sources: Chinese Insurance Regulatory Commission, Oliver Wyman Report, Report date 2017

CHINA'S DEBT PROBLEM

In recent decades, China's single-party system has successfully navigated its evolution into an economic superpower, steadily improving life expectancy, education levels, and standards of living—the central goals of any economic development strategy. China's economy today might be characterized as a robust system of private enterprise intermediated by a somewhat less efficient government-run financial system.

Government spending on public infrastructure has been a foundation for the booming private sector. A consequence of that government spending, however, has been a significant rise in debt. Although China's debt problem may be serious, we believe the risk of a hard landing or banking crisis is low. The key reason is that the potential bad debts are corporate, not household; and they are debts that 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; the privately owned companies that employ the majority of the workforce and account for the majority of economic growth have been deleveraging. Additional positive factors are that China's banking system is very liquid and that the process of dealing with bad corporate debts has begun.

LIFE UNDER XI JINPING

President Xi Jinping has continued to emphasize quality over the pace of growth; gradual progress toward a more market-driven, entrepreneurial economy; and financial sector de-risking.

The 19th Congress of the Chinese Communist Party, a twice-a-decade event that last occurred in late October 2017, provided a roadmap for economic policy during Xi's second five-year term as party chief.

A significant development of the congress was the decision to change (for the first time since 1981) the party's mission statement, or, in party jargon, the "principal contradiction facing Chinese society."

In 1981, the party's mission was to bridge the gap between people's material needs and insufficient goods to meet those needs. That kicked off three decades of policies intended to achieve the fastest growth and the highest industrial output. China's amazing economic boom followed, and the negative consequences of that approach are well-documented.

During the 2017 congress, Xi explained why the party's mission statement was revised to focus on the quality of growth rather than just speed of growth and quantity of output. "The principal contradiction facing Chinese society has evolved," Xi stated. "What we now face is the contradiction between unbalanced and inadequate development, and the people's ever-growing needs for a better life. ... Not only have their material and cultural needs grown; their demands for democracy, rule of law, fairness and justice, security, and a better environment are increasing."[1]

Xi is not proposing to adopt Western-style rule of law or representative democracy, but he is reaffirming his commitment to dealing with inequality in income, health care, education, and pensions, as well as the consequences of China's horrific air, water, and soil pollution.

This is not a new focus for Xi. Government spending on all these programs rose at double-digit annual rates during his first term. But Xi has confirmed that these issues will remain priorities during his second term.

In our view, when Xi referred to the economy "transitioning from a phase of rapid growth to a stage of high-quality development," he was signaling that he will continue to pursue supply-side reforms, primarily reducing overcapacity and debt levels among state-owned enterprises (SOEs) in heavy industry and making improvements to environmental protection efforts.

Xi also will play a more visible role on the global stage, taking the opportunity to step up on issues where Washington steps back, including climate change. The "One Belt, One Road" project, designed to build infrastructure across much of Asia and the Middle East, is a Chinese-style Marshall Plan. Xi's efforts to project power are likely to deploy "soft power" rather than military force.

THE SHRINKING SOE

Over the past two decades, the role of China's SOEs has continued to shrink as the role of China's entrepreneurs has continued to rise. The Chinese consumer, fueled by incredible income growth, has also surpassed industry as the key driver of growth. So even though Xi praised the role of SOEs, we put more weight on his talk of developing "an economy with more effective market mechanisms, dynamic micro-entities, and sound regulation," and his pledge to "stimulate and protect the spirit of entrepreneurship."

PROPERTY: SALES COOL, INVENTORY CLEARS

New-home sales rose by impressive rates in 2017, especially given that many cities have put in place purchase restrictions to cool the market. Keep in mind that these sales involve a lot of cash: The minimum down payment is 20 percent of the purchase price and most banks require 30 percent.

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 percent since the start of 2011. But those four cities account for only 3 percent of national new home sales. In the smaller cities where two-thirds of new-home sales take place, prices rose by only 14 percent over that seven-year period.

PROTECTIONIST TRADE, GEOPOLITICAL TENSION, AND OTHER WORRIES

In 2016, U.S. President Donald Trump's protectionist campaign platform claimed that China's 2001 entry into the World Trade Organization (WTO) "enabled the greatest jobs theft in history." But it is important to recognize that U.S. trade with China (and the rest of the world) is not a zero-sum exercise. U.S. workers and firms benefit significantly from exports to China. Since China joined the WTO, U.S. exports to China have risen by 500 percent and U.S. exports to the rest of the world were up by only 90 percent. One study found that U.S. exports to China directly and indirectly supported 1.8 million new jobs in 2015.

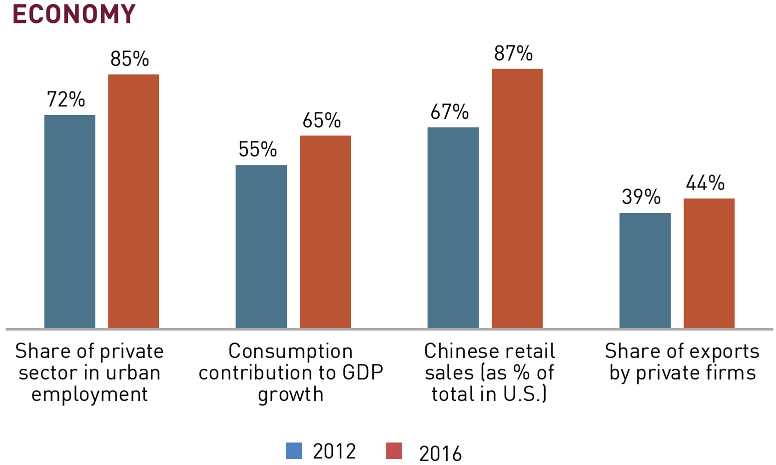
Exports to China are especially important to American farmers. In 2015, for example, soybean exports to China accounted for almost one-third of the value of total U.S. soybean production. China became the largest importer of U.S. agricultural products beginning in 2012; over the past 10 years agricultural exports to China rose by more than 200 percent.

It is true that U.S. firms continue to battle against non-tariff barriers and nontransparent government regulatory policy in China, but many U.S. companies have done well in that market. Boeing, for example, has delivered more aircraft in China than in the United States over the past five years. The American Chamber of Commerce in China recently reported that nearly three-quarters of its member companies are profitable, the highest proportion in three years.

The dramatic rise in income in China has opened up opportunities for many publicly listed U.S. companies. General Motors sells more vehicles in China than it does in the United States, and China accounts for about 20 percent of General Motors' global earnings. China contributes 19 percent of Apple's revenue. Nike shoe sales in China rose 19 percent over the three months ending in November 2017 and accounted for about 15 percent of total revenue. China contributes roughly 15 percent of global earnings for firms such as Nvidia, Dolby, and Tesla.

Figure 3

XI'S FIRST TERM—GRADUAL PROGRESS TOWARD MARKET ECONOMY



Source: CEIC, Matthews Asia

CHINA'S EQUITY MARKET LANDSCAPE

China's investable universe consists of the following segments:

Red chips: Chinese companies that are listed in Hong Kong and incorporated in Hong Kong.

H shares: Chinese companies that are listed in Hong Kong but incorporated in mainland China.

SAR (Hong Kong) companies: Chinese companies listed in Hong Kong that derive the bulk of their revenues from conducting business in Hong Kong and/or mainland China. SAR companies are usually domestic Hong Kong-based companies run by Hong Kong management teams.

Overseas Listed Chinese companies: Chinese companies that are listed outside of China, mainly in the United States (American Depositary Receipts, or ADRs) or Singapore markets. These are often companies seeking either the prestige of being listed on the U.S. market or the ease of listing on the Singapore market.

A shares: Chinese companies that are listed on the country's Shanghai and Shenzhen stock exchanges. A shares are open primarily to domestic investors or foreign institutional investors with a Qualified Foreign Institutional Investor (QFII) quota. The Stock Connect link between the Shanghai and Hong Kong stock exchanges, established in late 2014, also has relaxed restrictions that historically split the Chinese stock market between shares targeted at local investors and those available to international investors. The Shanghai-Hong Kong Stock Connect allows mainland Chinese investors to purchase select Hong Kong and Chinese companies listed in Hong Kong, and it also allows foreigners to buy Chinese A shares listed in Shanghai in a less restrictive manner than before. However, it is important to note that still very few foreigners are exposed directly to the A-share market, where foreign holdings are less than 1 percent of total market capitalization.

B shares: Chinese companies that are listed on the Shanghai and Shenzhen stock exchanges, and available to both Chinese and non-Chinese investors. Contrary to A shares, B shares were created as a means for foreigners to participate in China's domestic market.

Despite all of this progress, many challenges remain. China, for example, continues to restrict market access for foreign firms in sectors such as technology, pharmaceuticals, financial services, and accounting. The Trump administration should focus on this rather than on reducing the U.S. trade deficit with China. The trade deficit has little impact on U.S. employment and is determined by balances between savings and investments, not by trade policy.

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.

IF KIM DOESN'T PLAN TO USE HIS NUKES, WHY DOES HE BUILD THEM?

More recently, in another area of geopolitical concern, North Korea's leader has been testing nukes and long-range missiles, as well as exchanging schoolyard taunts with Donald Trump. How worried should we be? First, it is important to note that we believe Kim Jong Un understands that launching an attack against the United States or one of its allies would result in a swift U.S. military response that would destroy him and his regime. At the same time, Trump's military advisors appear to understand that a preemptive strike by the United States would result in conflict that would be, according to U.S. Defense Secretary Jim Mattis, "tragic on an unbelievable scale."[2]

Many U.S. and Chinese experts believe that Kim will be prepared to negotiate with the United States once he has successfully tested a long-range missile capable of carrying a nuclear warhead. The current stalemate scenario suggests that negotiations are the only realistic solution to the North Korean problem, and that Pyongyang is very unlikely to use its nuclear weapons.

The consensus among U.S. and Chinese experts is that Kim is developing nuclear weapons with two objectives in mind. First is to ensure the survival of his regime. He believes that possessing weapons of mass destruction means the United States will not attempt to overthrow or assassinate him. Kim's second objective is to build an arsenal powerful enough to force Washington to take him seriously at the negotiating table.

In May 2017, Trump's director of national intelligence, Dan Coats, told Congress, "We have long assessed that Pyongyang's nuclear capabilities are intended for deterrence, international prestige, and coercive diplomacy."[3]

Chinese experts with whom I met recently told me they believe that Kim's ultimate objective is to negotiate a formal peace treaty with the United States, as the first step toward building a diplomatic and economic relationship that will help lift North Korea out of isolation and poverty. I also spoke with U.S. government officials, who said that the Kim regime proposed bilateral talks soon after Trump's election, but they were rebuffed.

Rather than focusing on immediate denuclearization—a goal that Kim certainly would reject—the initial stages of U.S.–North Korea talks should be designed to gradually build bilateral trust and confidence in order to reduce the risk of misunderstanding and miscalculation.

Concerns about North Korea and U.S.–China relations will linger throughout 2018, but in my view they are unlikely to blunt the continued health of domestic-based demand in China. Strong income growth, moderate inflation, high savings, and low household debt levels accompanied by very positive consumer sentiment should enable China to remain the world's best consumption story. We will continue to look for opportunities to invest in Chinese companies selling goods and services to Chinese consumers.

ENDNOTES

1. Resolution of the 19th National Congress of the Communist Party of China on the Report of the 18th Central Committee, *Xinhua* (October 24, 2017), http://news.xinhuanet.com/english/2017-10/24/c_136702625.htm.
2. Phil Stewart and David Brunnstrom, "U.S.: Military Solution to North Korea Would Be 'Tragic on an Unbelievable Scale,'" (May 19, 2017), https://www.reuters.com/article/us-usa-northkorea-mattis/u-s-military-solution-to-north-korea-would-be-tragic-on-an-unbelievable-scale-idUSKCN18F26M.
3. Kathleen J. McInnis, Andrew Feickert, Mark E. Manyin, Steven A. Hildreth, Mary Beth D. Nikitin, and Emma Chanlett-Avery, "The North Korean Nuclear Challenge: Military Options and Issues for Congress," Congressional Research Service (October 27, 2017), https://lieu.house.gov/sites/lieu.house.gov/files/CRS%20Report%20-%20The%20North%20Korean%20Nuclear%20Challenge%20-%20Military%20Options%20and%20Issues%20for%20Congress%20%282017-10-27%29.pdf, page 10.

Andy Rothman is an investment strategist at Matthews Asia, where he is responsible for developing research focused on China's ongoing economic and political developments as well as in-depth analysis on Asia. He earned an MA in public administration from the Lyndon B. Johnson School of Public Affairs at the University of Texas Austin and a BA from Colgate University. Contact him at clientservices@matthewsasia.com.

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