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Sinology

by Andy Rothman
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- In 1Q18, China remained the world's best consumer story.
- The domestic consumption-led economy should be insulated from trade tensions.
- The probability of a trade "war" is low as Chinese President Xi wants to make a deal and President Trump is likely to conclude that a successful negotiation is preferable to the negative political and economic consequences of bilateral strife.

THE OTHER CHINA STORY

It is reasonable to be focused on the prospects of a trade war, but don't forget a more important investment factor: in the first quarter of 2018, China remained the world's best consumer story.

Strong income growth, moderate inflation, healthy corporate earnings and low dependence on exports should insulate China's economy from any potential trade conflict and provide opportunities for equities investors.

In this edition of *Sinology*, we provide an update on the trade tantrums, but first, let's discuss the first quarter numbers for the more important aspects of the Chinese economy.

Still the World's Best Consumer Story

The rebalancing of the Chinese economy continued in 1Q18, with consumption accounting for 77.8% of GDP growth.

This great consumer story is not, however, immune from the trend of decelerating economic growth. Real retail sales were up 8.1% over the first quarter of this year, down from 8.6% during the same period last year, and 9.7% and 10.8% two and three years ago, respectively. We expect this number—and most economic data points in China—to grow more slowly every year, but we also expect the deceleration to continue to be gradual.

Real per capita urban household income rose 5.7% in the first quarter, down from 6.3% a year ago, largely because inflation was a bit higher. This, along with mild consumer price inflation (2.1%), underpins the consumer story. Online retail sales of goods, for example, rose 34.4%, despite the very strong base of 25.8% growth a year earlier.

We also note that while spending by Chinese consumers was equal to only 27% of U.S. retail sales a decade ago, it was equal to about 90% of American consumer spending last year and is likely to surpass U.S. retail spending by the end of the decade.

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

Housing Cooler, but Healthy

New home sales rose 2.5% year over year (on a square-meter basis) during the first quarter. This is impressive given that it followed a very high base—sales were up 16.9% during the same period last year—and given that more than 100 cities have implemented purchase restrictions designed to cool the market. And 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 83% since the start of 2011. But those four cities account for only 3% of national new home sales. In the many smaller, Tier 3, cities, which account for 72% of sales (by square meter), prices are up by only 15% since the start of 2011 while nominal income has risen by about 10% every year.

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Inventory of unsold residential units has fallen sharply in response to strong sales and more disciplined investment by developers. In Tier 3 cities, unsold inventory has fallen to only 14.5 months (based on a six-month moving average of sales rates) from a peak of 39 months in July 2014. This low level helps explain why new housing starts rose 12.2% during 1Q18 (down from 18.1% a year ago), despite slower sales growth.

Earnings Growth Slower YoY, But Still Strong

After rising 21% last year, profit growth at larger industrial firms is likely to cool in 2018 on a year-over-year basis. But a growth rate of 16.1% during the first two months of the year (the latest data available), off of a base of 31.5% during the first two months of 2017, is still satisfying. Operating margins for these firms (many of which are not listed on a stock exchange) reached levels not seen since 2011.

Several factors should support continued strong earnings growth this year, across a wide range of sectors: tax cuts; enforcement of policies designed to reduce excess capacity ("supply side reforms") and to reduce pollution; as well as strong domestic demand.

Another important consequence of supply side reforms has been a small, first step in dealing with China's debt problem. The liabilities-to-assets ratio among state-owned industrial firms—which account for most of the total debt burden—peaked in 2013 and has begun a modest decline.

Trade War Risks

The rhetoric from the Trump administration about China trade is hot, but I believe the odds of a trade "war" are low, for two reasons. First, Xi Jinping doesn't want this conflict and is, in my view, prepared to deal. After many years of protecting his domestic services and financial firms, he can now further open those markets, and better protect foreign intellectual property, without fear. I think Xi is prepared to offer concessions that will be sufficient for Trump to declare victory.

Second, many in the U.S.—from farmers to manufacturers to Republican legislators—seem opposed to Trump's aggressive approach, and the stock market tends to fall every time someone mentions the prospect of a trade war.

I expect that political pressure from those constituencies, nudged along by Xi's well-targeted retaliation list, will lead Trump to decide that a negotiation that enables him to declare victory, as he did with the renegotiation of a free trade agreement with South Korea, will be preferable to continued bilateral strife. Additionally, Trump understands that he needs Xi's help with two of the most challenging strategic issues on his agenda: nuclear weapons programs in North Korea and Iran. Please see the March 27 issue of *Sinology* for more details on the trade dispute.

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Sources: CEIC and China's National Bureau of Statistics

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.