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Sinology

by Andy Rothman

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- New macroeconomic data shows that the Chinese consumer has continued to be the primary engine of growth for the country, illustrated by a 28% rise in online retail sales last month.
- China's debt problem is serious, but the risk of a hard landing or banking crisis is low.
- Profits at larger industrial firms, excluding commodities-related sectors, are up 14% YoY compared to 8.6% a year ago.

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.

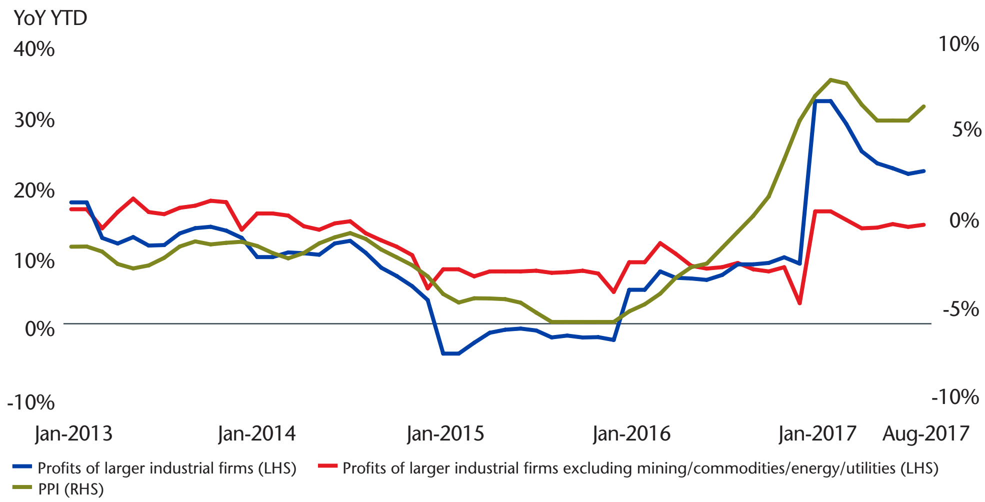
CHINA'S ECONOMY: BORING IS GOOD

The Chinese economy remained healthy for the third quarter of the year, with industrial profit growth accelerating at a pace we haven't seen since 2012, despite slightly slower credit growth and aggressive regulation of financial sector risks. Macroeconomic data released this week confirmed that the Chinese consumer continued to be the primary engine of growth, illustrated by a 28% rise in online retail sales last month. In this issue of *Sinology*, we discuss those topics as well as the property sector, corporate debt and the Communist Party leadership meeting now underway in Beijing.

Profits Still Strong

Profits at larger industrial firms rose 14% year-over-year (YoY) during the first eight months of the year, up from an 8.6% growth rate during the same period in 2016. (Note that these firms include many not listed on a stock exchange, and exclude commodities-related sectors, where profits rose even faster.)

Figure 1. **PROFITS OF LARGER INDUSTRIAL FIRMS AND PRODUCER PRICE INDEX (PPI)**



Source: CEIC, Matthews Asia

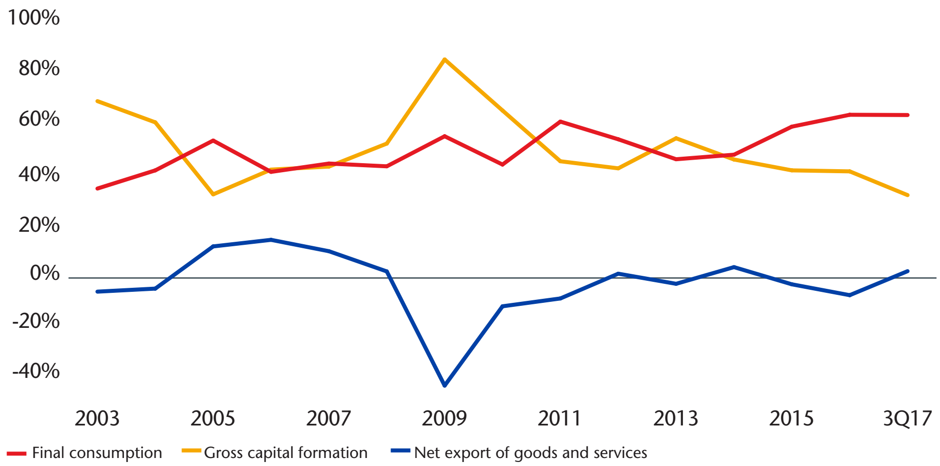
The key drivers of this earnings improvement were increases in construction activity (infrastructure and residential) leading to stronger demand for materials and equipment, as well as supply-side constraints, which led to higher raw material prices.

Improved profitability supported strong wage growth, and is likely to be behind the rise in confidence among entrepreneurs surveyed by China's central bank—reflective in a confidence index that reached a five-year high last month.

Still the World's Best Consumption Story

The rebalancing of China's economy continued, with consumption accounting for 64.5% of GDP growth in the first nine months of 2017, up from a 55% contribution during the same period in 2012, just before Xi Jinping became Communist Party chief.

Figure 2. **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 9.3% in the first nine months of the year. This compares to U.S. real retail sales growth of 2.1%[1] for the same period.

Property: Sales Cool, Inventory Clears

New home sales rose 7.6% YoY (on a square-meter basis) during the first three quarters. This is even more impressive given that it followed an already high base—sales were up 27.1% during the same period last year—and given that many cities have put in place purchase restrictions 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 China's major, or 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 smaller, Tier 3, cities, which account for 65% of sales (by square meter), prices are up by only 12% since the start of 2011 while nominal income has risen by about 10% every year.

Inventory of unsold residential units has fallen sharply in response to strong sales and more disciplined investment by developers. In the smaller cities that account for about two-thirds of new home sales, unsold inventory has fallen to only 13 months (based on a six-month moving average of sales rates) from a peak of 39 months in July 2014. At this low level, we expect a modest rise in new home starts next year.

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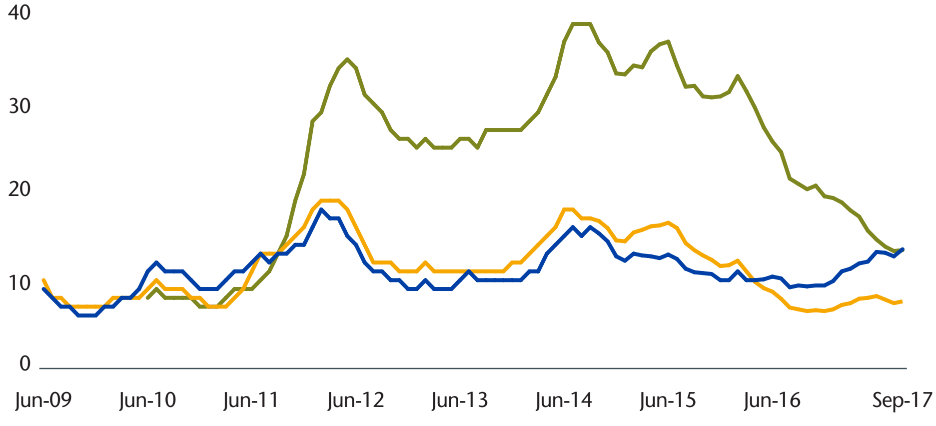
Figure 3. **PROPERTY INVENTORY LEVELS BY TIER OF CITIES**



*calculated on a six-month moving average basis
Source: CLSA

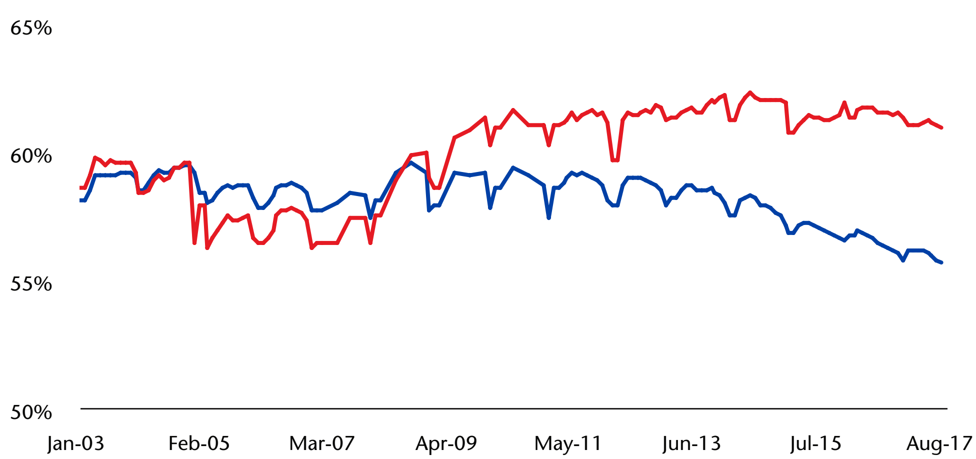
Progress with China's Debt Problem

As we've written in the past, China's debt problem is serious, but the risk of a hard landing or banking crisis is low. The key reason is that the potential bad debts are corporate, not household debts, and 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, while 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.

The liabilities-to-assets ratio for larger industrial firms declined to about 56% in August of 2017 from 59% four years ago. Among larger state-owned enterprises (SOEs), the progress is more basic: the liabilities-to-assets ratio is no longer rising, holding steady at about 61% for the past few years.

Figure 4. **LIABILITIES-TO-ASSETS RATIO OF OVERALL LARGER INDUSTRIAL FIRMS AND LARGER SOEs**



Source: CEIC

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Cleaning up China's debt problem will be expensive, but this process is likely to result in gradually slower economic growth rates, greater volatility, and a higher fiscal deficit/GDP ratio, not the dramatic hard landing or banking crisis scenarios that make for an alluring media story.

Surprises Unlikely from the Party Congress

We do not expect the Communist Party's 19th Congress, underway now in Beijing, to have a significant impact on our investment strategy.

There are no signs that the Party artificially boosted 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. Thus, there is no stimulus to withdraw in the coming quarters. Additionally, one senior official told me that even if GDP growth were to slow to 6.5% in the near future (from 6.8% in 3Q17), that would be acceptable as long as unemployment (now estimated by the government to be close to 5%) does not spike.

Party chief Xi Jinping has already consolidated his political power over the past few years and faced no political obstacles to carrying out his economic policy agenda. Many senior Party officials will retire this month, but none of them has blocked Xi's programs, so we do not expect to see significant changes to macro policy in the coming quarters under the new leadership lineup. Look for more of the same: gradual progress toward a more market-driven, entrepreneurial economy and financial sector derisking.

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Sources: CEIC unless otherwise noted
1 Federal Reserve Bank of St. Louis