



Sinology

by Andy Rothman

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- * The disconnect between weak market performance in China, on the one hand, and strong macro conditions and corporate earnings, on the other hand, is likely to narrow.
- * China remains the world's best consumer story, and manufacturing is also healthy, which is why there hasn't been significant stimulus.
- * I expect resolution of the U.S.-China trade dispute in the coming quarters, but if it does escalate into a trade war, Beijing has the resources to mitigate the impact on its economy.

THE GREAT CHINA DISCONNECT

"Give me a one-handed economist! All my economists say, 'on one hand ... on the other.'"

—U.S. President Harry S. Truman

On the one hand, China market sentiment and performance are weak. On the other hand, macroeconomic conditions and corporate earnings are strong. This great China disconnect is likely to narrow, although it isn't possible to say exactly when that will happen.

Macro data published last night for the third quarter reflects a healthy Chinese economy, driven by domestic demand, limiting any leverage the Trump administration believes it will gain via tariffs. Beijing has not undertaken significant stimulus, but will do so if the tariff dispute escalates into a trade war.

MARKET WEAKNESS, CORPORATE STRENGTH

The Shanghai Composite Index was down by 25% year to date through October 18, but corporate earnings growth remains healthy.

For larger Chinese industrial firms, including many that are not listed on a stock exchange, profits rose 16.2% year-over-year (YoY) during the first eight months of 2018, compared to 21.6% during the same period last year. This slower, but still quite strong, pace is due in part to a tough base, and remains significantly better than the same periods in 2016, when earnings rose 8.4%, and 2015, when earnings declined 1.9%.

Industrial margins in the first eight months of this year are at the highest levels in eight years for the same period.

Industrial value-added rose 5.8% in September (vs. 6.6% a year ago), and 6.4% for the first three quarters (vs. 6.7% during the same period last year), reflecting a cooler but still healthy manufacturing sector.

Matthews Asia focuses more on Chinese companies in the consumer and services sectors, and over the last year, the median growth rate of earnings before interest and taxes (EBIT) for all of our China holdings was 29% as of July 31.

These figures are all, of course, backward-looking, but my point is that this disconnect between the market, on the one hand, and macro and corporate performance, on the other hand, is likely to realign at some point, especially as valuations have become more attractive. (The median forward price-to-earnings ratio of China holdings across Matthews Asia portfolios was 13, as of the end of September.)

STILL THE WORLD'S BEST CONSUMER STORY

The rebalancing of the Chinese economy continues, and in the first nine months of the year, consumption accounted for 78% of GDP growth, up from a 46% share during the same period in 2013.

As we've pointed out many times in the past, this consumer story is not immune from the overall trend of decelerating economic growth. Inflation-adjusted (real)

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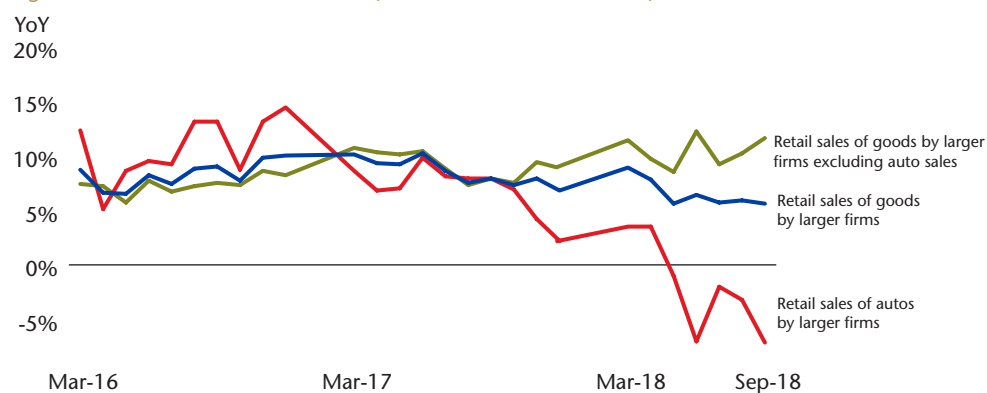


retail sales rose 7.3% during the first three quarters, down from 9.3% during the same period last year and 9.8% two years ago. This is still a very fast pace (in comparison, real retail sales in the U.S. rose 2.9% during the first eight months of this year), and the base effect is worth noting. For example, 9% real retail sales growth for the full year of 2017 generated an incremental expansion in nominal consumer spending that was 135% larger than the increase resulting from 12.4% growth in 2007. In other words, the opportunity for selling goods and services to Chinese consumers at the slower growth rate is far larger than the opportunity 10 years ago, at the faster growth rate.

The main reason real retail sales growth has cooled this year has been a sharp fall in the growth rate of auto sales, a consequence of the government's efforts to de-risk the financial system. Auto sales by larger firms rose 0.2% YoY during the first nine months of this year, after rising 6.2% during same period last year. Consumers in smaller cities who previously relied on financing from Peer to Peer (P2P) and shadow banking channels found themselves cut off from credit, leading to a sharp fall in sales of mass market models. Premium models, however, continued to register strong sales across the country, as those are usually all-cash transactions. Electric vehicles remained popular, with sales up 81% during the first three quarters.

Retail sales by larger firms *excluding* autos were up 11.6% YoY in September, compared to 7.9% a year ago.

Figure 1. RETAIL SALES RESILIENT (EXCLUDING AUTO SALES)



Source: CEIC

New home sales rose 3.3% (on a square meter-basis) during the first three quarters, compared to 7.6% during the same period last year. That is impressive 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% cash.

The consumer story continued to be supported by strong real income growth (6.6% YoY during the first three quarters of this year, vs 7.5% during the same period last year), mild consumer price inflation (2.5% in September), high household savings and low household debt.

Over the last 10 years, real per capita income rose 123% in China, compared to a 9% growth rate in the U.S. This pace is slowing, but consumer spending in the coming quarters should be boosted by a few recent policy changes, including reductions in import taxes and changes to requirements for personal income tax, which will deliver tax cuts to most workers.

AN INFRASTRUCTURE TURNING POINT

In an effort to better manage spending by local governments, the central authorities hit the pause button on infrastructure investment, which rose by only 4.2% during



the first eight months of the year, compared to a 19.8% pace during the same period in 2017. But Beijing allowed work on previously planned projects to resume last month, and while infrastructure investment still declined 1.8% YoY, the decline was 2.5 percentage points less than the decline in August.

This is not stimulus. Rather, this is the start of a catch-up effort, as the government tries to complete infrastructure projects that were originally planned for 2018. As infrastructure spending accounts for about 22% of total fixed asset investment (FAI), this catch-up should deliver a modest boost to overall growth in the fourth quarter.

The other two major components of FAI remained healthy in the third quarter. Manufacturing capital expenditure, which accounts for about 31% of FAI, rose 8.7% in the first three quarters, up from 6.8% during the first half of this year and 4.2% in the first three quarters of last year. Investment by privately owned (as opposed to state-owned) firms rose 8.7% during the first three quarters.

Investment in real estate, which accounts for about 22% of total FAI, rose 7.9% during the first eight months of the year (the latest available data), compared to 5.1% during the same period last year, as inventories of new homes declined.

NO CREDIT STIMULUS (YET)

There are no signs of credit stimulus because the government seems comfortable with the health of the economy. The growth rate of aggregate credit has slowed gradually, in line with slightly slower nominal GDP growth.

In September, bank loans outstanding rose 13.2% YoY, the same pace as a month earlier and roughly the same as a year ago (13.1%). Another key metric, outstanding augmented total social finance, which includes non-bank credit and municipal bonds, was up 11.2% YoY at the end of last month, slower than the 12.9% rate a year ago.

As I noted in our analysis of the second quarter data, there has been a dramatic change in the composition of credit, as China's central bank has worked to reduce systemic risk. New issuance of bank wealth management products and other shadow banking activities have been sharply curtailed. As a result, the share of total credit coming from traditional bank lending has surged to more than 80%, up from 51% five years ago.

This has reduced financial system risks, but it has also meant that the companies and consumers who relied on non-standard credit sources have struggled to get access to credit. The central bank has acknowledged this unintended consequence and has begun efforts to mitigate the problem, without turning the shadow banking taps back on.

TRUMP TARIFF UPDATE

The short-term direction of U.S.–China relations is difficult to predict. There are clearly many in the Trump administration who advocate disengagement from China and escalating the tariff tantrum into a trade war. Others, however, are working to negotiate a better trade deal, ahead of a planned meeting between Trump and Xi Jinping at the end of November, at the G-20 Buenos Aires summit.

My base case is that Trump and Xi will reach an agreement in the coming quarters, but if I'm wrong, and the dispute does escalate into a real trade war, there are a few key points to keep in mind. Most importantly, the Chinese economy is no longer export-driven, so the impact of a trade war with the U.S. would be modest. Net exports (the value of a country's exports minus the value of its imports) account for only 2% of China's GDP, down from a peak of 9% in 2007. In contrast, domestic consumption now accounts for the majority of China's economic growth and more than half of its GDP.

Moreover, China's exports to the U.S. accounted for only 19% of total Chinese exports in 2017.

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Much of the impact of Trump’s import taxes will not be borne by Chinese companies. About two-thirds of the largest exporting companies based in China are foreign-owned. (American firms will be among the casualties in a trade war. For example, according to The Economist, “of the production facilities operated by Apple’s top 200 suppliers, 357 are in China. Just 63 are in America.”)

Chinese exporters are not yet suffering. Exports to the U.S. rose 14% YoY in September, the fastest pace of the last seven months, and roughly the same as a year ago. But when exports to the U.S. do decline, I have no doubt that Xi’s government will step in to provide financial aid to any Chinese companies that are hurt by the Trump tariffs. With central government fiscal revenue up by about 10% YoY this year, the fastest growth rate in seven years, Beijing has the resources, as well as the political will, to support domestic firms and mitigate the impact of weak exports, just as it did a decade ago during the Global Financial Crisis. As a result, I do not believe a trade war would cause significant damage to the Chinese economy.

And, at Matthews Asia, we are focused on Chinese companies selling goods and services to Chinese consumers—the largest and fastest growing part of the economy. The impact of a trade war on earnings growth of these companies should be modest. *Across all of our strategies as of July 31, 2018, less than 5% of our China holdings had significant exposure (greater than 15% of total revenue) to the U.S. market.* The impact of a trade war on our strategies should be modest.

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