**Sinology**

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**BETTER PROFITS, LESS TENSION WITH TRUMP**

The Chinese economy is off to a healthy start in 2017, with corporate earnings trending up and concerns about trade tensions with the Trump administration trending down. Steady growth provides Beijing with an opportunity to focus on reducing financial sector risks.

**Profit Prospects**

Profits at larger industrial firms (including many companies not listed on a stock exchange) rose 32% year-over-year (YoY) during the first two months of 2017, up from a 5% growth rate during the same period in 2016.

This has provided the central bank with an opportunity to tighten monetary policy a bit, but their objective is to reduce liquidity and speculation in the bond market rather than to rein in economic growth.

This trend began to develop in the fourth quarter of last year, when median earnings growth for the Chinese companies held by Matthews Asia continuously for the last two years rose 26.4% YoY, up from 11.3% during the fourth quarter of 2015.

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 is likely behind the jump in confidence among entrepreneurs surveyed by China’s central bank, with that confidence index last month hitting a two-year high.
The combination of stronger profits and sentiment may deliver higher business investment spending in the coming quarters. Fixed-asset investment by privately owned industrial firms rose 7.6% YoY in March, the fastest pace since 2015. And a recent survey of privately owned small and mid-sized manufacturers by the broker CLSA found an uptick in capex plans for 2017. Those manufacturers also reported that in the first quarter they raised wages for unskilled workers by 4.5%, up from 3% in 3Q16.

While the YoY growth rates for all of these data points are likely to slow in the coming months, we expect activity levels and raw material prices to remain relatively high through the rest of the year, which may support stronger earnings growth for several more quarters, particularly in light of a weak base during the first three quarters of last year.

It is worth noting that higher factory gate prices have not spilled over into higher consumer price inflation. In March, CPI rose 0.9% YoY.
Domestic Demand Still Healthy

While China remains the world’s best consumption story, some YoY growth rates continue to decelerate. Following a decade in which real (inflation-adjusted) income rose 130% (compared to 11% in the U.S.), real urban income increased 6.3% in 1Q17, up from 5.8% a year ago. Real rural income rose 7.2%, up from 7%. As a result, while real retail sales growth was still fast at 8.7% during the first quarter, it was down from 9.7% a year ago and 10.8% two years ago.

All of this contributed to GDP growth of 6.9% during the first quarter, up from the 6.7% pace during 1Q16. China’s fiscal revenue rose 14.1% YoY in 1Q17, compared to 6.5% YoY in 1Q16, in line with the improvement in overall economy.

A Modest Tightening Bias

A healthy start to the year has provided the People’s Bank of China (PBOC) with an opportunity to tighten monetary policy a bit, but their objective is to reduce liquidity and speculation in the bond market rather than to rein in economic growth.

The central bank pushed up the 7-day repo rate to 3% as of April 13, an increase of 60 basis points (0.60%) from three months ago, in an effort to limit speculation in China’s interbank market. At the same time, there has been no change to the benchmark lending rate of 4.35%. Moreover, as the index for factory gate prices has risen sharply, real borrowing rates have fallen and have been negative since December.

The growth rate of total credit has slowed a bit, but nominal GDP growth has accelerated, leading to a narrowing of the gap between those two growth rates, signaling modest tightening. This is consistent with ongoing, gradual efforts by the government to deal with high levels of debt among state-owned companies. (For more details on China’s debt problems, please see https://matthewsasia.com/resources/docs/pdf/Sinology/Sinology_0916.pdf)
Additionally, in February the PBOC and regulators for the banking, insurance and securities sectors jointly published new draft regulations to further address risk in wealth management products.

“I’m very capable of changing to anything I want to change to.”
—Donald Trump

During the presidential campaign, the fifth point in Donald Trump’s “7 Point Plan to Rebuild the American Economy by Fighting for Free Trade” was to “Instruct the Treasury Secretary to label China a currency manipulator.”

This year, on April 2, Trump told the Financial Times, “When you talk about currency manipulation … [the Chinese] are world champions.”

Ten days later, Trump said to the Wall Street Journal, “They’re not currency manipulators.”

That, along with several other policy U-turns, signals important victories by White House pragmatists in their ongoing battle with the Trump administration’s nationalist faction, resulting in a significantly lower risk of trade tensions with China. In the near term, this trend—paired with strengthening corporate profits in China—should lead to improved investor sentiment towards the country which accounts for about one-third of global economic growth.

**Will Trump Change His Mind Again?**

There is, of course, no guarantee that Trump will not revert to the China-bashing rhetoric of his campaign. Disagreements with President Xi Jinping over dealing with North Korea could fuel retaliation on economic issues. (On Sunday, the President tweeted, “Why would I call China a currency manipulator when they are working with us on the North Korean problem? We will see what happens!”)

Another potential problem could be lack of progress towards reducing the bilateral trade deficit by July 16, the end of the 100-day period agreed to by the two presidents during their summit.
But, even if Trump were to make another U-turn and pursue currency manipulation and punitive tariffs on Chinese imports, those steps would have only a modest impact on the Chinese economy.

As we’ve explained in recent issues of *Sinology*, the concrete consequences of China being labeled a currency manipulator are, well, nothing.

And if Trump were to apply a broad 15% tariff on imports from China—the highest rate permitted under U.S. law on an emergency basis—the impact on the Chinese economy would be significant, but it would be much lighter than most people expect, because China is no longer an export-led economy. Last year, domestic consumption accounted for two-thirds of China’s economic growth. Moreover, only about 18% of China’s exports go to the U.S., while Europe, Japan and ASEAN countries combined take more than a one-third share, limiting the impact of any new barriers to the American market.

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