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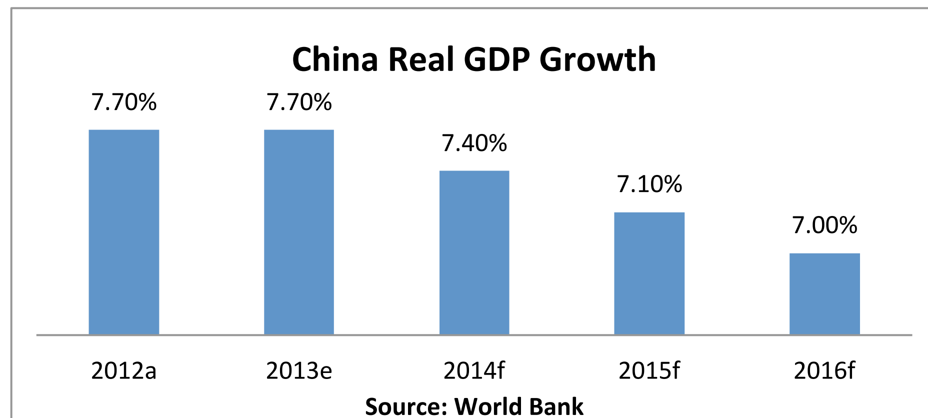
China's "New Normal"—Economic Growth Slows But Doesn't Stall

The law of large numbers was always destined to come into play and slow the rate of growth. The World Bank forecasts China's real GDP growth slowing to 7.1% this year followed by a more modest 0.1% slowdown to 7.0% in 2016. Estimates for China and most other countries have been steadily dialed back by the World Bank (along with the IMF, OECD and virtually every other economic forecasting organization worldwide) since last spring. This has once again emboldened China's naysayers who have repeatedly called for a hard landing or outright collapse of China's economy for years. Sunday's much weaker than expected trade figures reported for January only add fuel to the fire.

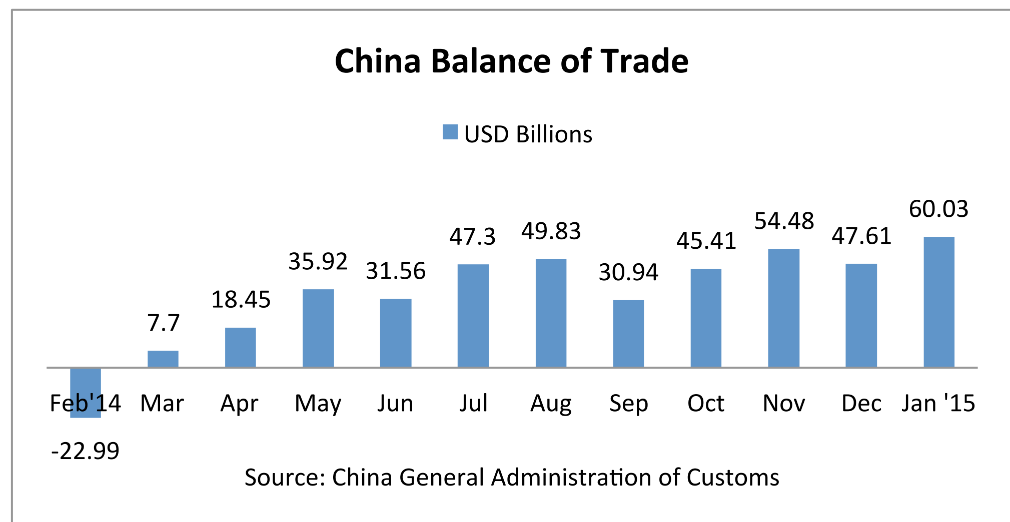


China's economic growth slowed slightly in the fourth quarter. Real GDP rose at an annualized rate of 7.3%, which beat the consensus estimate of 7.2%. The economy grew 1.5% quarter-over-quarter versus a consensus estimate of 1.7% and compared to a rate of 1.9% the previous quarter. As we detailed back in July, we believed that China would enact selective stimulus measures during the fall sufficient for economic growth to achieve the government's growth target of 7.5%. However, for the full year GDP grew 7.4%, down from 7.7% in 2013. The shortfall really shouldn't be viewed as much of a surprise given the relatively weaker than expected economic data releases over the past three months along with comments from various government officials increasingly distancing Beijing from the idea of measuring economic success by a single number. But from Beijing's perspective, 7.4% was in line since, as Ma Jiantang, chief of the National Bureau of Statistics put it "The 2014 target was set at about 7.5%. A little higher or a little lower is around 7.5%." Going forward, real success is more likely to be measured in terms of implementing structural and fiscal reforms along with directional progress at rebalancing the economy. **This need not be bad for investors.**

From our perspective, the most important question has always been whether Premier Li Keqiang can implement the necessary reforms to ensure that the economy will grow in a long term *sustainable* manner. As Beijing continues to deemphasize absolute growth as the prime determinant of success for the Party's economic plan, we believe that the probability of successful implementation of reform materially rises. **The media will surely continue drawing negative inferences and conclusions by highlighting the slowest economic growth in more than two decades juxtaposed to the double digit growth of an earlier era; for them the glass is always half empty.**

The bear story on China is straightforward: a slowing economy sinks under its own weight, bogged down by rising debt which is mixed into a lethal cocktail that sends the country into a financial tailspin. January's just released trade figures have given new life and a renewed sense of immediacy to these fears**. Much like Bill Murray's experience in *Groundhog Day*, this story is not only essentially unchanged for the past five years but, in our view, is destined to be repeated over and over again until this decade is over.**

Given the weakening trend for some of China's economic data series, the sheer magnitude of January's miss on the trade numbers has real shock value. China recorded another record trade surplus in January of $60.03 billion versus $31.86 billion a year ago (+88%), but the manner in which it was achieved is worrisome as both imports and exports fell far more than expected with potentially negative implications for both domestic and global growth.



Imports in January declined by 19.9% versus a year ago and a consensus estimate of -3.0%. Although much of the decline can be attributed to the sharp drop in commodity prices for coal, oil and iron ore, unit volumes for those items fell steeply as well. Coal imports declined by approximately 62% in aggregate value, oil imports fell by about 42% and iron ore by 50%. While China is the world's biggest buyer of commodities, it imports even more by value in electronics and mechanical products. The decline in these items is just as troubling since it could be more indicative of cooling domestic demand.

Exports in January fell by 3.3% versus a year ago and a consensus estimate of +6.3%. We find this perhaps more disconcerting than the drop in imports since we expected a modest bump in January exports due to the Lunar New Year falling in February this year and there should be the usual effort to push orders out prior to the extended holiday shutdown. Many will ascribe the decline in exports to a slowdown in global growth and weakening demand. Exports to Europe (-4.4%) were undoubtedly hurt by its stagnating economy but were just as likely impacted negatively by the sharp appreciation of the yuan versus the euro. Exports to Russia, Brazil, Japan and Australia all fell by double digits. Countering this downtrend and reflecting the growth in southeast Asia, exports to the ASEAN countries rose 15.6% while exports to its largest trading partner, the United States increased by 4.9%. The rise in U.S. exports came in spite of the work slowdown since October at U.S. west coast ports that now threatens to deteriorate into complete gridlock should the dockworkers go on strike. (We note that the slowdown has similarly hurt U.S. exports and business activity.)

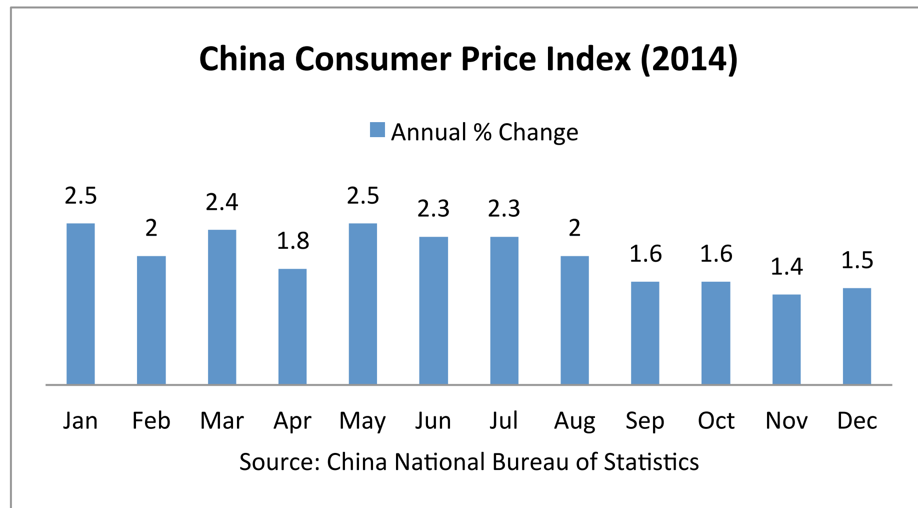
The silver lining for Chinese manufacturers from the fall in commodity prices is a decline in input prices. This may translate into higher operating margins where a competitive advantage can be claimed; in other cases, it may only help to ease margin pressure in a deflationary pricing environment. **Regardless, for now investors appear disinterested in the positive aspects from lower commodity prices.**

China's monthly trade figures are often very volatile, especially in the first two months of the year due to the disruptive influence of the Lunar New Year. We're hesitant to make too much out of the surprise January trade figure and inclined to wait for the February data before attempting to call a trend change. There is less clarity than usual in reported economic numbers…and we're referring not only to the China data. **If the economic data out of Europe this week is encouraging, just watch the downward revisions in global economic forecasts get reversed over the next quarter given the pending implementation of QE by the European Central Bank.**

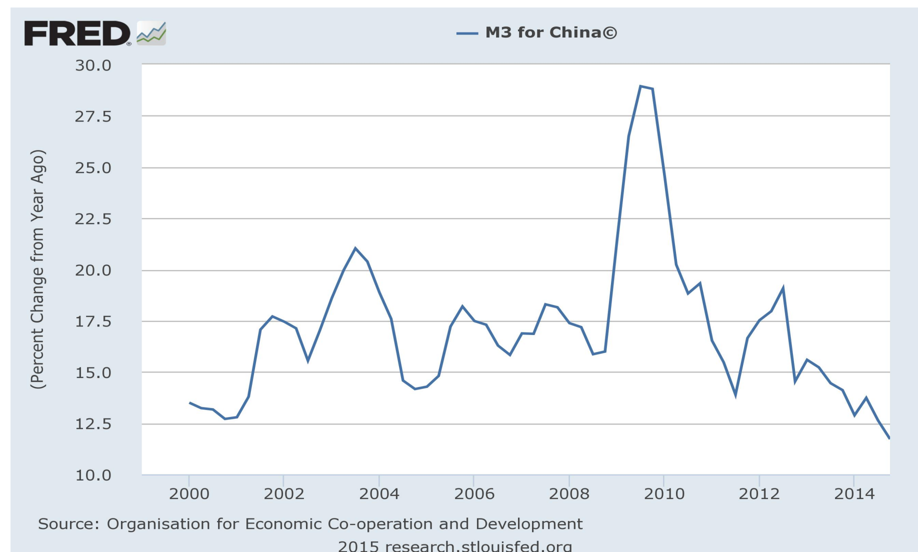
Although we believe that China is achieving substantial progress in implementing reform while managing the economy's transition, skepticism is abundant and doubters unmoved as much of the investment community appears convinced that the country is hurtling headlong toward financial ruin. China's critics draw the inescapable conclusion that the country's rapidly growing debt and property bubble spell disaster. When viewed in the light of past consequences of seemingly similar situations elsewhere, it's not difficult to understand why so many subscribe to that argument. But, as we've pointed out previously, those similarities are superficial in many respects. **Most investors have failed to differentiate between the fundamental differences that exist between China's unique current situation and other instances of rapidly escalating debt levels that have brought countries to financial crisis.**

Inflation remains under control. Inflation is running well below the government's target limit of 3.5%. CPI was just 0.8% y-o-y in January while wholesale prices continued to decline monthly as they have for almost three full years driven by softening demand as the country's investment-led growth degenerated into rampant structural overcapacity in manufacturing and property development (the latter largely through municipal investments). In turn, this contributes to downward pressure on consumer prices, which has become even more pronounced as oil prices have collapsed.

China's lower producer prices will continue to contribute to global deflationary pressure and act as a brake on domestic consumer prices as well. China's exports have long had a deflationary impact on the global economy but as real wages rose, we anticipated that deflationary pressures would abate and China's relative competitive position would begin to erode. This has not played out as we expected. We have only seen a very modest amount of manufacturing that had previously been offshored to China leave the country. The government's effort to rebalance the economy toward a more consumption driven one has inadvertently helped pressure prices even lower within those sectors of manufacturing saddled with excess capacity. That capacity is still slow to go offline or be shuttered due to employment considerations. **Europe's economic stagnation and the (until recently) sub-par U.S. economic recovery have cooled demand, exasperating the downward spiral on prices.**



We remain convinced that any monetary stimulus contemplated by Beijing will not reignite inflation. The concurrent moderation in money supply growth (see graph) has more closely aligned money supply growth with economic growth as some of the excesses in the system are wrung out.



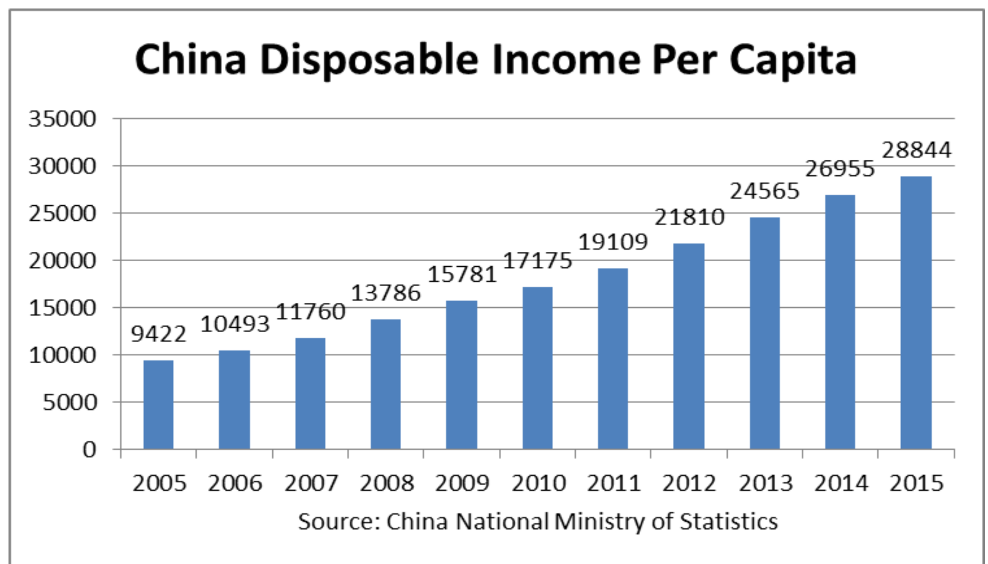
Ample room exists for further stimulus if Beijing deems it necessary [and they will]. Early last year, we stated that Beijing would be forced to make more credit available so its moves during the past few months (including cuts in the reserve ratio) came as no surprise to us. Expanding credit doesn't necessarily contribute to a rising debt problem. Beijing is targeting new loans to fall within regulated financial space with higher quality projects that have more efficient use of capital to contribute more to GDP.

Our view that last summer's strengthening of the yuan would be short lived appears validated. The slowing economy provided cover for Beijing to allow the yuan to weaken further to aid exporters. While the yuan didn't slip to the 6.26-6.28 range by year end as we'd anticipated, it nonetheless moved in the opposite direction to the consensus forecast for 2014 that had called for the yuan to continue strengthening and push through to an exchange rate of 6 to the USD. Nonetheless, on a trade-weighted basis, the yuan has appreciated, particularly versus the euro and yen. While it's hard to depreciate a currency when you're running a trade surplus, we still wouldn't be surprised to see Beijing further widen the trading band with the dollar to weaken the yuan to aid export competitiveness. **However, the European Central Bank's newly announced foray into quantitative easing is likely to cause the latent strength of the yuan to (at least temporarily) reassert itself against most currencies. Longer-term, given the ongoing global concerns over China's slowing growth and the**

probability of further stimulus, China likely becomes another entrant in the race to the bottom through competitive devaluation.

Global risk appetite is rising again on the heels of last week's move by China's central bank to inject liquidity into the financial system through a half point reduction in the bank reserve ratio to 19.5% that should release about 600 billion yuan in reserves, allowing banks to lend an additional two to three trillion yuan to provide a lift to the real estate market and help stimulate consumption. This comes two weeks ahead of the Chinese New Year when there is a normal seasonal increase in the demand for funds.

The Chinese people among the highest savers in the world, principally to prepare for retirement and their care in old age. Once reform of the social security system outlined at the most recent National People's Congress is implemented and gains the confidence of the people, it materially reduces the need to save and potentially diverts a substantial portion of household income to be available for discretionary spending. The country's 39 million public workers (doctors, teachers, etc.) and civil servants are getting their first pay raise in eight years that will be at least 60% of their base salary. These individuals will then begin to contribute about 8% of their salary to fund their pension, which they previously made no contribution to. We believe that the raise will contribute to a stronger base of support for the country's leadership as those public workers see their personal well being tied to the new reforms while helping to limit the temptation of corruption and graft as their standard of living improves.



In our judgment, China's biggest near-term challenge remains managing the supply of credit. Regardless of all the talk about becoming more free-market oriented with market-determined pricing, China's decisions ultimately has a political basis. Perpetuation of the leadership cadre and preservation of social order are the paramount goals. We believe that even as China moves to enact sweeping reforms that require selective austerity and sacrifice, Beijing will still be forced to compromise by making more credit available…the leadership can ill afford the risk to stability by draining too much capital from the system. This means that, for example, in spite of the leadership's stated intent, the People's Bank of China (PBoC) will find that it must still be more accommodative in facilitating credit to the large export driven sectors if it hopes to achieve its growth targets and maintain social order by not risking too rapid a disruption to employment. The pace of change is unlikely to be uniform but vary by the situation and conform to what the leadership believes is appropriate. Once growth in consumption and services rise sufficiently, Beijing can proceed with greater alacrity to remove inefficient capacity as it reshapes the investment-driven side of its economy.

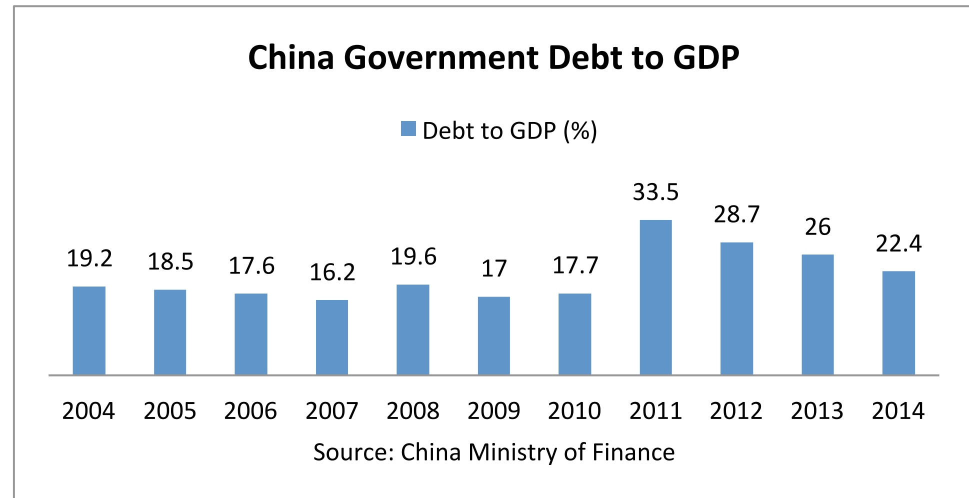
Often overlooked is the advantage that China's closed capital account contributes to managing the burgeoning supply of credit, which is why much of the fear over China instigating another Asian debt crisis (a la 1997) is misplaced. The Asian debt crisis was triggered by countries with overvalued currencies (often pegged to the dollar) that ran current account deficits and which were subsequently crippled by the inability to service the rising level of foreign hard currency liabilities. On the other hand, China's current financial condition is on much more solid footing. China's currency is widely recognized as undervalued and it runs a consistent trade and current account surplus since it has borrowed little in foreign-denominated currencies. The overwhelming majority of borrowing in China's public and private credit markets is in local currency. Also, Beijing's plans to raise tax revenues from China's growing economy will improve its debt servicing capabilities.

However, the country's closed capital account is also why we believe that one shouldn't expect China to liberalize capital controls any time soon in spite of any contrary comments or indications by government officials. While China has $3.85 trillion in foreign liabilities (equal to approximately 40% of GDP), the majority of it is illiquid direct foreign investment with limited ability for repatriation due to China's tight capital controls. Short term foreign liabilities are approximately $1.15 trillion, which equals only about 12% of GDP. This external debt appears even more manageable when one considers that China has $3.8 trillion in foreign currency reserves available to cover those foreign liabilities.

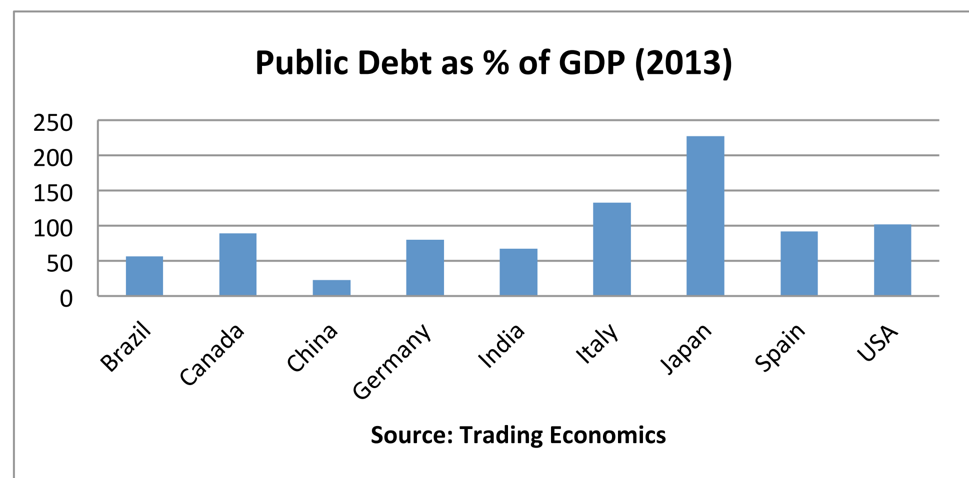
On the other hand, China's low public debt-to-GDP is often cited as one reason why a financial crisis isn't imminent and the following graph would certainly appear supportive of such claims. The country's exceptional rate of economic growth coupled with reasonable fiscal discipline by the central government is primarily responsible. However, it is local government debt that has been skyrocketing and in China the central government has ultimately been viewed as responsible for all public sector debt. **To obtain a true picture of the government's debt, one must therefore adjust upward the numbers below to account for the local government liabilities, which we believe takes public debt-to-GDP to approximately 55%.**

The Third Plenum's new reforms look to break the linkage that has contributed to the upward spiral in local government debt. The presumed implicit central government guarantee on all government debt coupled with growth (regardless of the economic value added) being the primary determinant of success for local government officials created an environment that lacked fiscal responsibility. Last August, the National People's Congress amended the budget law so that local governments can issue bonds to raise debt for public investment projects, subject to central government approval. Guidelines were subsequently issued that spelled out the purposes for which local governments can borrow. While public work projects can now be financed by locally issued bonds, **commercial projects must now be financed privately, entirely separate from the local governments' budget.**

The State Council also declared that the central government will not bail out local governments. Local officials will be held accountable for their actions, which will be that much easier to evaluate given the expected rise in transparency for the budgetary and capital raising processes. **While undoubtedly there will be resistance from those officials and entities that benefited from past practices, we have little doubt that Beijing will be successful in implementing these changes over the next few years to put local government finances on a more sustainable path of fiscal responsibility.**



Even an adjusted public debt-to-GDP ratio of 55% compares very favorably with most major countries. In a worst case scenario, Beijing has sufficient financial capacity to bail out local governments and much of the corporate sector by assuming the impaired debt of state-owned-enterprises, if required, while still maintaining a debt-to-GDP ratio that doesn't exceed the upper end of the range for other countries.



General disbelief of published government data, slowing economic growth and rising financial stress have combined to help dissuade international investors from putting money to work in China despite compelling valuations that have produced discounts as high as 50% relative to historic valuations and emerging markets generally. Last July we noted that from a technical perspective the Shanghai Composite appeared to be attempting to carve out a long term bottom. The subsequent rise through the end of the year was spectacular. But notwithstanding a few strong countertrend rallies, investing in China's stock market has been a losing proposition for the past three years until that sharp rally in China 'A' shares during the latter half of last year that was driven principally by local retail investors. **Underweighting China has been a relatively easy decision for most international portfolio managers and continues to be the consensus view.**

Eventually, many [if not most] of those waiting for China to fail will capitulate. Just as Bill Murray in *Groundhog Day* finally awoke to a new day, we aver that the endless loop of doubt and pessimism over China that clouds investor sentiment will lift. That decision will most likely be predicated upon conviction that rebalancing the Chinese economy will lead to sustained growth without a collapse in the credit market leading to a new financial panic.

Progress toward rebalancing the economy is apparent from the accelerating growth of the services sector, which is outpacing manufacturing to become the country's biggest source of growth. While this conforms to policy objectives, it is also a natural consequence of rising consumption from the rapid urbanization of China's population driving demand for increased services.

Are the dire predictions of China's financial collapse warranted? Credit markets are subject to cyclical influences just like the broad economy. Someday, China will be faced with a financial shock that will likely cause severe stress on its financial system just as any other country can be expected to experience. We believe that when that day comes, it will likely be beyond today's investment horizon for most investors. When one looks past the sensationalist headlines, it is increasingly evident that China's leadership is achieving success in overcoming any internal pockets of opposition to reform. Specifically, as the liberalization and reform of the country's financial system gains traction, fear of financial collapse will dissipate, supplanted by the growing realization that China has implemented the financial mechanisms with sufficient oversight through a system of checks and balances to manage future economic growth.

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