Sinology

by Andy Rothman
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- China's economy is seemingly in turmoil. But is this a hard landing or a stumble along the rebalancing path? *Sinology* explores.
- The main Chinese stock index is down 37% from its June 12 peak, but it still beats the S&P 500 Index on both year-to-date and year-on-year bases.
- Manufacturing and construction is weak and will remain so. But the biggest part of China's economy—services and consumption—is very healthy. We see opportunity.

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: DOUBLE, DOUBLE TOIL AND TROUBLE/ FIRE BURN, AND CAULDRON BUBBLE?

China's economy is seemingly in turmoil. Markets are down, manufacturing is weak and the government has yet to provide a coherent explanation for last month's tiny devaluation. Many argue that the economy is descending into policy chaos and a witches' brew (a hard landing). In my view, however, these are stumbles along the path toward growth rates that are continuing to decelerate (but are still quite fast) from an economy that is increasingly "rebalanced," with reform and restructuring to continue. This latest issue of *Sinology* explores the thinking behind this non-consensus conclusion.

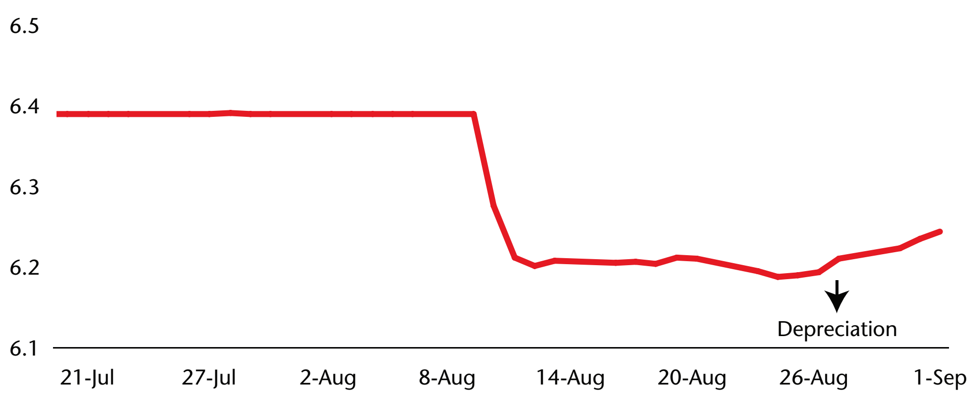
The Market

The government's efforts to prop up the A-share market were clumsy, misguided and unnecessary. Hopefully, China's leaders understand that now, and won't repeat that mistake in the future.

While the A-share market is down sharply from its recent peak, the story isn't quite as bad as some make it out to be. As of the September 9, 2015 close, the Shanghai Composite Index (SHCOMP) was down 37% from its June 12 peak. But it was flat from the start of the year, and this index was actually *up* 39% from a year ago. The Shanghai Composite Index is outperforming the S&P 500 Index on a year-to-date basis (with the S&P down 5.7% as of September 9) and on a one-year basis (with the S&P down 2.3%).

It is important to acknowledge that the recent A-share rally didn't reflect China's economic fundamentals—the market's earlier rapid rise was accompanied by a decelerating macro environment—and the following SHCOMP slump was due to excessive valuations, not a significant change to the fundamentals.

Figure 1. **RMB EXCHANGE RATE AGAINST USD SINCE MID-JULY**



Source: CEIC

Matthews Asia

The A-share Market and Your Investments

Very few foreigners are exposed directly to the A-share market, where foreign holdings are less than 1% of total market capitalization. Most of us are exposed to China via companies listed in Hong Kong, where valuations and volatility have been much lower.

For example, the median forward P/E (price-to-earnings) of the A-share market (for companies covered by at least one brokerage analyst, to remove the most speculative stocks) was 56 at the end of May, but fell to 30 at the end of August. For China stocks listed in Hong Kong, however, the median forward P/E was only 10 at the end of August, down from 14 at the end of May.

Our portfolio managers continue to find opportunities, with a median forward P/E of 13 for all of Matthews Asia's China holdings at the end of August, compared to 17 at the end of May. (For context, the median forward P/E of the S&P 500 Index was 16.6 at the end of August.)

The A-share Market and Chinese Consumers

Even more important than the absence of foreigners in the market is the fact that relatively few Chinese have been playing A shares.

There are about 50 million active individual investors in China, which is equal to only about 4% of the total population, or 7% of the urban population.

And most of those investors have been punting a fairly small amount of money: 73% of individual investors have less than the renminbi (RMB) equivalent of US$15,000 in their accounts and less than 1% of accounts have more than US$1 million. Very few Chinese are likely to be betting anything close to their life's savings. Another interesting indicator is that as the market soared, the growth rate of bank deposits slowed only slightly, to an average of 10.4% year-on-year (YoY) during the second quarter of 2015, from 11.4% during the same period a year ago, before the market took off.

All of this data helps explain why there was little wealth effect as the market rose sharply, and why there has been little negative wealth effect on the way down.

Still the World's Best Consumption Story

One of the most important aspects of the A-share fall is that Chinese consumers shrugged it off and continued to spend.

It is true that the secondary part of China's economy—manufacturing and construction-related industries—is weak (more on that later), but as a result of significant rebalancing, the tertiary part—services and consumption—is now the largest part of the economy, and it remains very healthy. Even after the SHCOMP Index fell 37% from its peak, China continued, and continues, to be the world's best consumption story.

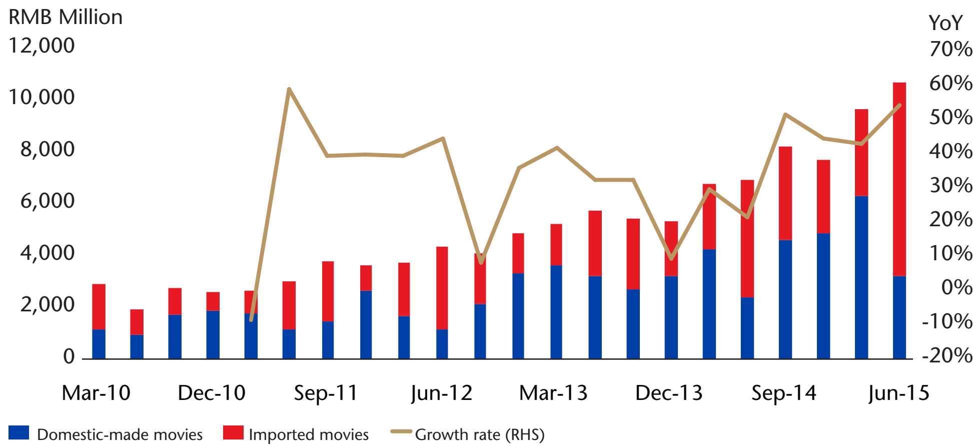
Let's consider the numbers, keeping in mind that the SHCOMP peaked on June 12:

- Inflation-adjusted (real) retail sales rose 10.4% YoY in July, compared to 10.5% a year ago.
- New home sales (by square meters) rose 21% YoY in July, up from 16% in May and from a decline of 18% in July 2014.
- Passenger car sales slumped, down 7% in July, but SUV sales jumped 34%, on top of a 25% rise in July 2014.
- Apparent consumption of gasoline rose 10% in July, compared to a decline of 1% a year ago.
- Movie box office revenues rose 54% in 2Q15, compared to 21% in 2Q14.
- Chinese visitor arrivals in Japan rose 105% YoY in July, and, according to Japanese government data, Chinese spend twice as much as other visitors.

- Express parcel deliveries rose 47% YoY in July, up from 44% in May and compared to 49% last July. Illustrating the boom in online shopping, 10 billion packages were delivered during the first seven months of the year.

This is likely to be the third consecutive year in which services and consumption will be larger, and contribute more to China's GDP growth, than manufacturing and construction. In the first half of this year, consumption accounted for 60% of GDP growth.

Figure 2. **MOVIE BOX OFFICE REVENUE AND GROWTH RATE**



Source: CEIC

The Ugly: Industrial Weakness

The manufacturing and construction parts of the economy are weak, and are likely to remain weak. The reasons are clear: the growth rate of infrastructure and new home construction has passed its peak, leading to slower demand growth; industrial overcapacity; and a fall in global commodity prices.

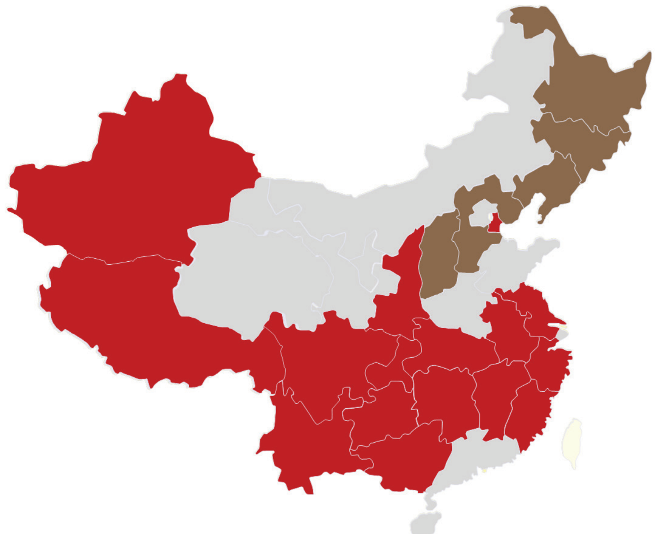
This trend is not new: the growth rate of fixed-asset investment peaked at 30% YoY in 2009 and has been cooling gradually ever since, down to about 11% now.

This trend is a key reason why GDP growth has also been decelerating, and will not reaccelerate. But the health of the services and consumer sectors—now the largest part of the economy—should ensure that the macro deceleration is gradual.

This trend has led to the development of a distinct "rust belt" in China, where industries related to construction and natural resources extraction are concentrated. In these five provinces, GDP growth in the first half of this year was about 5%, and unemployment is undoubtedly higher than the national average. But GDP growth was about 8% across the other 26 provinces (home to 84% of the national population).

Moreover, there is little evidence of a collapse in manufacturing. A survey of privately owned, small- and medium-sized firms found that during the second quarter, wages for unskilled workers rose 6% YoY, and wages for skilled workers increased by 7%. Government data shows that monthly income for the migrant workers who leave the countryside to staff most of the urban manufacturing and construction jobs rose 10% in the first half of this year.

Figure 3. **REGIONAL VARIATIONS IN CHINA'S GROWTH STORY**
Resource extraction and heavy industry concentrated in northeast



1H 2015 GDP growth rate by province
Below 7% 7–8% Above 8%

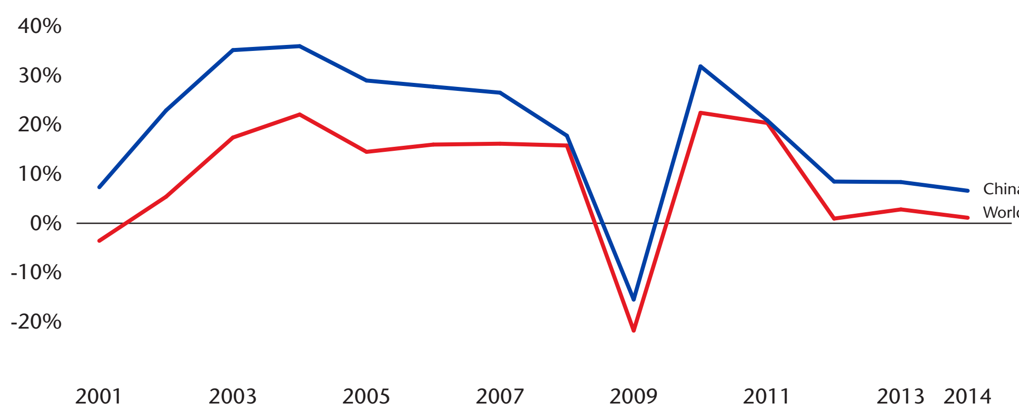
Source: CEIC

Devaluation and Policy Confusion

If the economy is doing reasonably well, then why did the government undertake a tiny devaluation of the RMB last month?

The RMB depreciated by less than 3% against the U.S. dollar over the course of a couple of days. Tiny, especially when viewed in this context: since July 2005, the RMB has appreciated 30% against the dollar, even after last month's depreciation. On a real effective basis, the RMB appreciated by 58% between July 2005 and July 2015—hardly the first salvo in a "currency war."

Figure 4. **CHINA AND THE WORLD'S EXPORT GROWTH RATE OF MERCHANDISE**



Source: World Bank

Some speculate that the devaluation was a response to weak Chinese exports, but that doesn't make sense to me. First, because Chinese exports have done reasonably well. During the first six months of the year, global exports were down 10.7%, but China's exports rose by 0.7%. Despite strong real appreciation of the RMB, China's share of world exports rose from 11.6% in 2011 to 14.3% in June. From 2001–2014, the compound annual growth rate of global exports was 9%, while Chinese exports increased 18.2% Clearly, China's exports didn't suffer from competitiveness problems related to exchange rates.

And, even if the government had wanted to boost exports (which I doubt), it had to know that depreciation of less than 3% would have an insignficant impact.

Was the devaluation designed to persuade the IMF (International Monetary Fund) to include the RMB in the Fund's Special Drawing Rights (SDR) currency basket? Some at the central bank say this was the objective, but I have trouble believing this. Authorities had to know that the IMF would not be impressed with Beijing simply resetting the exchange rate 3% lower. How does this make the currency more market-oriented or more "freely usable?"

So, why did Beijing move the exchange rate? We just don't know, and that's the biggest problem. Typically, when a significant policy move is taken, all of my official contacts provide a consistent explanation. This time, everyone offered a different view.

The move itself changes nothing, but the absence of a coherent explanation is puzzling and troubling, especially to foreign observers. (Also troubling is the recent detention of several Chinese investment professionals and a financial journalist, whom the government apparently has accused of unlawful practices.)

I do not, however, think this indicates that overall economic policy management is in chaos, or that the reform process has been halted. As noted above, the job picture is stable and wages are rising at a good clip, even in manufacturing. Consumer spending is strong and the housing market is healthy, especially in larger cities. Corporate earnings projections are decent and valuations have come down considerably. Through the gloom, we see opportunity over the long term.

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