Matthews Asia

Sinology

by Andy Rothman
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- Third quarter macroeconomic data shows that Chinese consumers shrugged off the A-share market fall, with a small acceleration in spending.
- For the first time ever, services and consumption account for over half of China's GDP, an important milestone in the rebalancing process.
- Unprecedented income growth is the most important factor supporting consumption. This year, real urban household income is up 6.8%, while over the past decade it rose 137%.

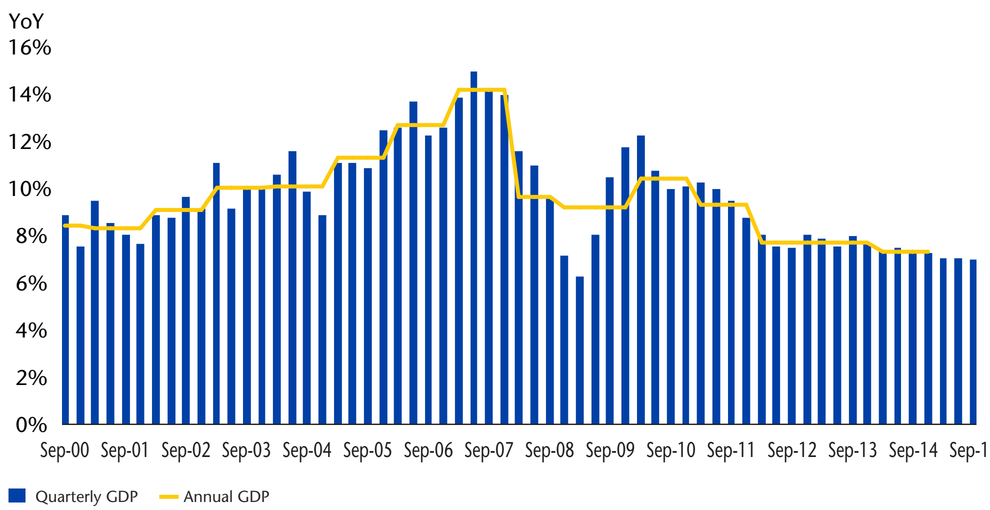
AN IMPORTANT REBALANCING MILESTONE

The Wall Street Journal and *Financial Times* share a pessimistic view of China's third quarter macroeconomic results, with headlines declaring that 6.9% GDP growth was the slowest since 2009. From our perspective, however, the most important points are that retail sales growth accelerated slightly, signaling that consumers shrugged off the A-share market fall, and that for the first time ever, services and consumption accounted for over half of China's GDP—an important milestone in the rebalancing process. Oh, and that 6.9% growth, on a base that is about 300% bigger than it was a decade ago (when GDP growth was 10%) means that the incremental expansion in China's economy this year is about 60% bigger than it was back in the day.

Let's Start by Dispensing with the Least Important Statistic

The 6.9% GDP growth number was the least important number published Monday, October 19 in Beijing. We don't base investment decisions on GDP growth in any market.

Figure 1. **GRADUAL DECELERATION IN GDP GROWTH**



Source: CEIC

The figure is just a tad below the 7% pace of GDP growth for the first two quarters of this year, and is 0.3 percentage points slower than the 3Q14 pace of 7.2%—which was 0.6 percentage points slower than the 7.9% rate in 3Q13. This is the inevitable deceleration of China's growth due to changes in demographics, slower growth in construction activity and the base effect. The financial media will likely be able to write headlines about the slowest GDP growth rates since the Tang Dynasty for many quarters to come. But is that really the most important part of the story?

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.

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***Industries defined as:**

Primary industry refers to agriculture, forestry, animal husbandry and fishery and services in support of these industries

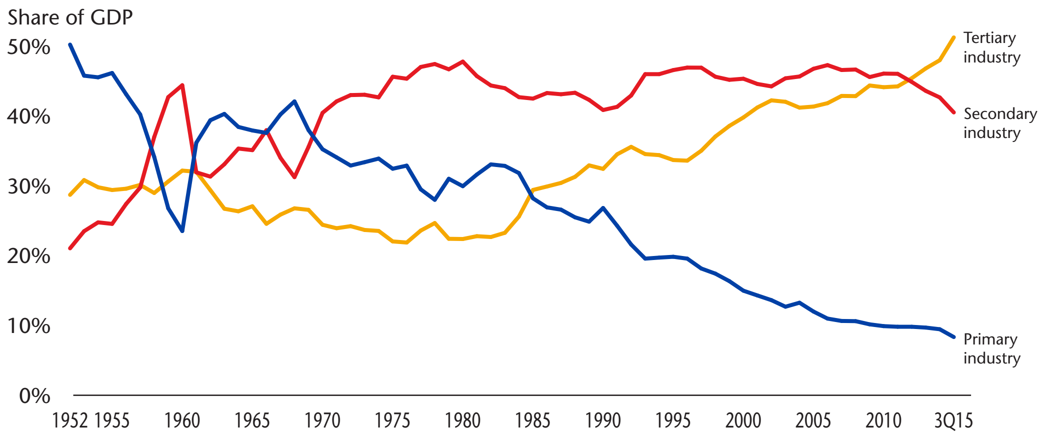
Secondary industry refers to mining and quarrying, manufacturing, production and supply of electricity, water and gas, and construction

Tertiary industry refers to all other economic activities not included in the primary or secondary industries, including real estate, finance, wholesale and retail, transportation and other service industries

There are Two Far More Important Parts of the China Story

We are pleased to see that the rebalancing of China's economy toward consumption and away from exports and investments continues to make significant progress. This rebalancing is key to our investment strategy.

Figure 2. **REBALANCING WELL UNDERWAY**



Source: CEIC

For the first time ever, services and consumption (the tertiary* part of the economy) accounted for more than half of China's GDP, at 51.4%, up from 41.4% a decade ago. This mitigates weakness in manufacturing and construction (the secondary* part), and, if this rebalancing continues, it should mean that macro deceleration will be gradual.

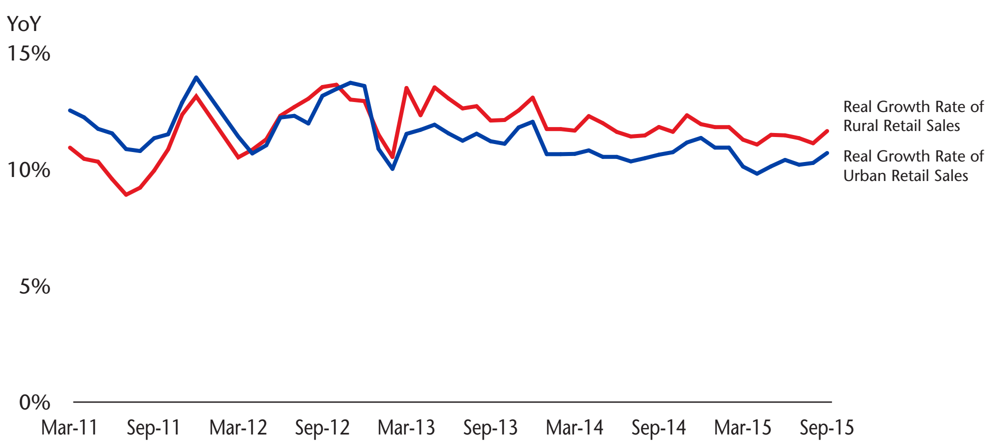
Net exports (the value of exports minus that of imports) contributed a small (-1.8%) negative drag on GDP growth.

The World's Best Consumption Story

The rebalancing is driven by China's consumers, with consumption accounting for 58% of GDP growth during the first three quarters of this year.

Shrugging off the mid-June fall in the stock market, real (inflation-adjusted) retail sales actually accelerated to 10.8% last month, up from 10.4% in August, and the fastest pace since March.

Figure 3. **CONSUMERS CONTINUE TO CONSUME**



Source: CEIC

The consumer story is not, however, immune from the overall deceleration trend, with real retail sales up 10.5% over the first three quarters of this year, down from 10.7% during the same period last year, and 11.4% and 11.6% two and three years ago, respectively. We expect this number—and most economic data points in China—to continue to grow more slowly every year, but we also expect this deceleration to continue to be gradual.

Figure 4. **CHINA—THE WORLD'S BEST CONSUMPTION STORY**
Year-on-Year changes in some consumer categories

133%	Chinese visitor arrivals in Japan, August
112%	Apple's Greater China revenue, 3Q15
76%	Spending by Chinese at tax-free shops in Europe, August
59%	SUV sales, September
56%	Express parcel deliveries, September
54%	Movie box office revenue, 2Q15
30%	Nike sales in Greater China, three months ending August
19%	Furniture sales, September
14%	Consumption of gasoline, August
11%	Household appliance and electronics sales, September
11%	Inflation-adjusted retail sales, September
9%	New home sales, September
3%	Passenger car sales, September

Sources: Japan National Tourist Office; Company Data; Global Blue; CEIC; CNBC; National Bureau of Statistics of China

Unprecedented income growth is the most important factor supporting consumption. In the first three quarters of this year, real per capita disposable income rose 7.7%, while over the past decade, real urban income rose 137% and real rural income rose 139%. Some of that increase was driven by government policy: the minimum wage in Shanghai, for example, rose 187% over the past 10 years. (In the U.S., real per capita disposable personal income rose 8.4% over the last 10 years.)

And it is worth noting that one reason that the fall in the A-share market didn't depress Chinese consumers is that although the 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 October 19, 2015 close, the Shanghai Composite Index was down 34% from its June 12 peak. But the index is up 5% from the start of the year, and it is up 44% from a year ago. Thus, the Shanghai Composite Index is outperforming the S&P 500 Index on a year-to-date basis (with the S&P down 1.3% as of October 16) and on a one-year basis (with the S&P up 10%).

More Industrial Weakness

The value added of industry (VAI) expanded by 5.7% in September, continuing a weakening trend from 6.1% growth in August and 8% a year earlier. Significant weakness in manufacturing, especially heavy industry related to construction, is taking a toll on the economy, but it is important to keep this in perspective.

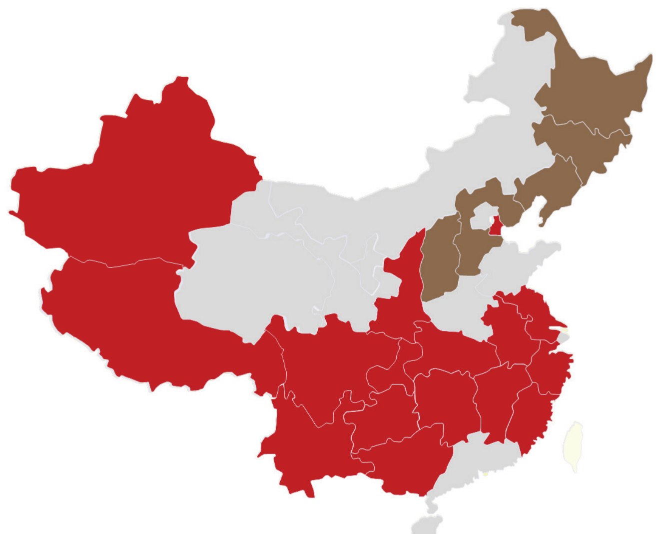
The reasons for this weakness are clear: the growth rate of infrastructure and new home construction has passed its peak, leading to slower demand growth; industrial overcapacity; and a fall in global commodity prices.

This trend is not new: the growth rate of fixed-asset investment peaked at 30% in 2009 and has been cooling gradually ever since, now down to about 10%.

This trend is a key reason why GDP growth has also been decelerating, and we believe is likely to continue decelerating. But the health of the services and consumer sectors—now the largest part of the economy—should ensure that macro deceleration is gradual.

Manufacturing weakness 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).

Figure 5. **REGIONAL VARIATIONS IN CHINA'S GROWTH STORY**
Resource extraction and heavy industry concentrated in northeast



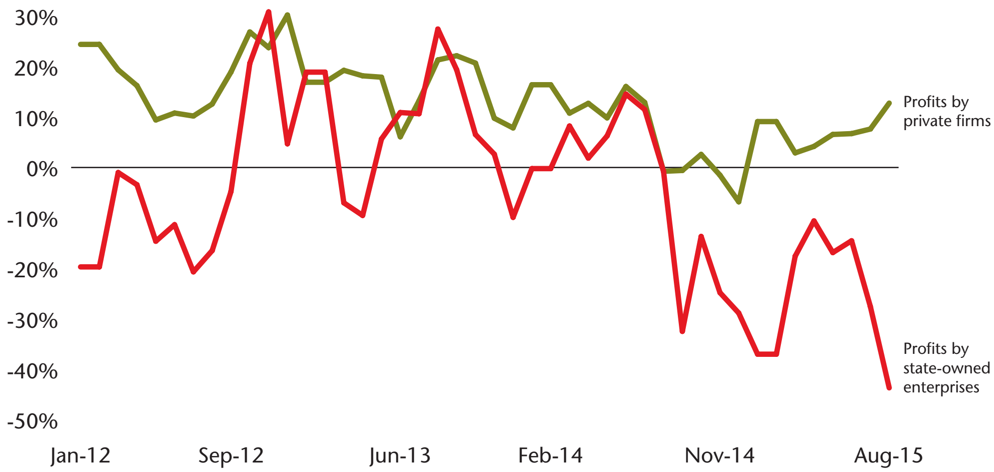
1H 2015 GDP growth rate by province
Below 7% 7–8% Above 8%
Sources: CEIC, MICM

Moreover, there is little evidence of a collapse in manufacturing. A survey of privately owned, small- and medium-sized firms found that during the third quarter, wages for unskilled workers rose 5%, and wages for skilled workers increased by 6%. 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 9% in the third quarter of this year.

Not Surprisingly, Private More Profitable

One of few bright spots in China's industrial sector is that profits at *privately owned* firms were up 13% year-over-year (YoY) in August, the eighth consecutive month of profit growth. In contrast, state-owned enterprise (SOE) industrial profits were down 44% in August, the 13th consecutive month of declining profitability. Privately owned industrial firms now account for 35% of total profits of larger industrial firms, up from a 12% share a decade ago. (Overall, private firms account for more than 80% of employment and all of China's new job creation.)

Figure 6. **PROFIT GROWTH AT LARGER INDUSTRIAL FIRMS BY OWNERSHIP**



Sources: CEIC, MCIM estimates

The sectoral differences are stark and explain much of the difference between private and SOE profitability, with SOEs dominating the worst sectors. For example, during the first eight months of the year, profits were down by more than 60% in the coal and oil & gas sectors, and down more than 40% in ferrous metals. On the other hand, there was double-digit profit growth in chemicals, electrical machinery, computers and communications equipment, and agricultural/food processing.

A Modest Stimulus

There are signs of a small government stimulus. Outstanding bank loans rose 15.4% through September, up a bit from 13.4% through June and 13.2% a year ago. Overall credit growth, known as Total Social Finance (TSF), however, rose 12% through September, up from 11.6% in June and down from 14.2% a year ago. This difference reflects two factors. First, bank loans are a larger share of TSF this year (75%) compared to last year (60%) and in 2013 (51%), as the Communist Party has cracked down on so-called shadow banking. Second, many local government loans, which were included in TSF calculations, have been converted to government bonds, but those bonds are not included in TSF.

On the other hand, the growth rate of investment in public infrastructure—the Party's main stimulus lever in 2009—slowed last month to 14.6%, compared to 19.5% in August, 17.2% in July and 18% a year ago.

These numbers signal that the Communist Party leadership remains relatively comfortable with the state of the economy, and has taken only small steps over the past few months to stabilize the growth rate of investment, which has cooled a bit more than expected, in part because an inventory overhang in property has resulted in a 14% decline in new home starts this year. Although that has contributed to slower economic growth, it is a positive sign that developers are waiting for the recent sales pickup to draw down inventory before resuming new construction.

The modest rise in credit growth, along with the healthy consumer story, should result in continued modest macro deceleration in the coming quarters—far from the hard landing some have anticipated.

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Note: All growth rates are year-over-year (YoY) unless otherwise specified.

As of Oct. 19, 2015, accounts managed by Matthews Asia did not hold positions in Apple, Inc., or NIKE, Inc.

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