THE CHINESE ECONOMY IN TRANSITION

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Summary and Major Conclusions:

Because of growing risks to China's financial system, the government has suppressed credit creation, implementing a deleveraging campaign in 2017. The resulting slowdown in GDP growth has been compounded by trade policy and the coronavirus epidemic. Policymakers now have no choice but to reflate China's economy through aggressive monetary and fiscal policies to revive spending and output. The government's deleveraging campaign and other long-term structural reforms have been placed on hold and new stimulus measures have been put into effect.

- The Chinese economy has been in a powerful transition over the past two decades, and has changed markedly when compared with 2005. Whereas China was more dependent upon the rest of the world in previous decades, the world economy has now become more dependent upon China.

- As a developing country in the 1990s and 2000s, China was deeply engaged in industrialization, with an emphasis on manufacturing. China's industrialization process is now well advanced, diminishing the relative importance of manufacturing and increasing the importance of the service sector and private consumption.

- Because of an abundance of cheap labor, China was able to develop a highly competitive export machine, mainly in the first decade of the 2000s. However, explosive growth in wages has reduced China's competitiveness in world export markets, though it has also supported consumer spending.

- As a consequence, the composition and internal structure of the Chinese economy has changed dramatically over the past 15 years. Manufacturing, mining, and exports have declined in *relative* importance, while private consumption and services have increased as a share of GDP.

- China's GDP growth has been in a steady decline since 2010, when its growth rate peaked at 12.5%. The Chinese economy grew by 10.2% during the decade ending in 2015, but has risen at an annual rate of only 6.8% since then.

- My forecast assumes annualized growth of only 5.5% over the next five years. A progressively slower growth rate can be attributed to a diminishing role of China's industrialization process; a slower pace of rural migration; a vastly increased debt burden; and the sheer size of its economy (the law of large numbers).

- Explosive growth in Chinese debt over the past 12 years has significantly weakened the country's economy and financial system. As a share of GDP, China's total debt has risen from 125% of GDP in 1999 to nearly 300% last year.

- The government understands that debt has risen to dangerous levels and has responded accordingly. Policymakers have suppressed credit creation and implemented a deleveraging campaign in 2017 to mitigate the growing risks to the banking and broad financial sectors.

- The clampdown on credit growth since 2017 has profoundly affected the economy, as growth has slowed significantly amid rising deflationary pressures. The policy-induced slowdown has been accentuated by the trade war with the US and the spreading coronavirus.
- Exports have thrived since China joined the World Trade Organization (WTO) in 2001, although much of China's success in export markets has resulted from use of unfair trading practices. For the purpose of national security, it is likely that the US will move aggressively to protect US intellectual property rights, which would be a threat to world trade and globalization.
- The coronavirus will have a pronounced impact on first quarter GDP, with potential spillover effects in Q2. An anticipated end of the government's strict containment efforts should spark a recovery in China's economy during the second quarter and a strong rebound in GDP during the second half of this year.
- The government now has no choice but to reflate China's economy through aggressive monetary and fiscal policies to counteract the current decline in spending and output. Although the outlook remains murky, policy stimulus should be successful in reversing the Chinese economy in coming quarters.
- It is unlikely that the significant hit to the Chinese economy in Q1 will derail the global economic expansion. The sizable impact on consumption, services, travel, and manufacturing will likely be temporary, with each of these sectors stabilizing during the second quarter.
- Financial markets should recover when the number of new coronavirus cases peaks and begins to decline. The key metric for investors is not the number of total cases but the number of new cases *outside* the epicenter in Hubei Province.
- *A China-led acceleration in world economic growth could be the catalyst for a shift in leadership within world financial markets*. Under this scenario, bond yields could enter a sustained cyclical uptrend, resulting in large losses in fixed-income portfolios.
- Non-US stocks could finally begin to outperform domestic equities, while economically sensitive stock groups could outperform defensive, safe-haven stocks. Value managers could also outperform growth/momentum managers. The multi-year rally in the US dollar would reverse along with a rally in commodity prices.

The Chinese economy has been in a powerful transition over the past two decades, and has changed markedly when compared with 2005. This transformation is plainly evident in several key aspects of the Chinese economy. This week's *Economic Perspective* provides an analysis of shifting trends within China as a means of better understanding the future direction of world financial markets.

CHINA IN TRANSITION

There are five overarching themes pertaining to the Chinese economy that are highly relevant for world financial markets:

- China's *economic growth model* has undergone massive change since it joined the World Trade Organization (WTO) in 2001.
- The *composition and internal structure* of China's economy has been in a marked state of transition over the past 10 to 20 years.
- The role of China vis-à-vis the rest of the world has changed dramatically. *Whereas China was heavily dependent upon the rest of the world in previous decades, the world economy has become extremely dependent upon China*.
- As China transitions from a low- to *middle-income country*, policymakers must be careful to strike a balance between attainment of growth targets and implementation of *long-term structural reforms*.
- *Relations between China and the US* will become increasingly strained in future years, as the two superpowers compete for world supremacy. In particular, tensions regarding trade relations are likely to become more contentious over time.

New Growth Model: As a developing country in the 1990s and 2000s, China was heavily reliant on *industrialization*, which resulted in an economy with an emphasis on mining, manufacturing, and capital formation. And because of an abundance of extremely cheap labor, China developed a highly competitive *export machine*.

- **Consumption and Services**: The industrialization of China has reached an advanced stage. At the same time, wage growth was explosive during this period, rising at a compound annual rate of 15% between 1995 and 2015. The result was a reduction in China's competitiveness in world export markets; as an offset, the rapid growth in wages provided increased support for private consumption. *The key point is that China's economic growth model has shifted from basic industries and exports to consumer spending and services*.

Evolving Sector Structure: The composition of China's economy has shifted dramatically over the past two decades: As a share of GDP, manufacturing has declined from 50% to 38%; *exports have been cut in half, from a peak of 36% in 2005 to 18%*. At the same time, services have increased from 35% to 50%, while consumer spending has risen from 30% to near 40%. (Numbers exceed 100% because of overlapping sectors) (see chart 1).

Chart 1: Chinese Exports: Diminishing Role in China's Economy
Annual Exports From China, Percent of GDP
Source: World Bank

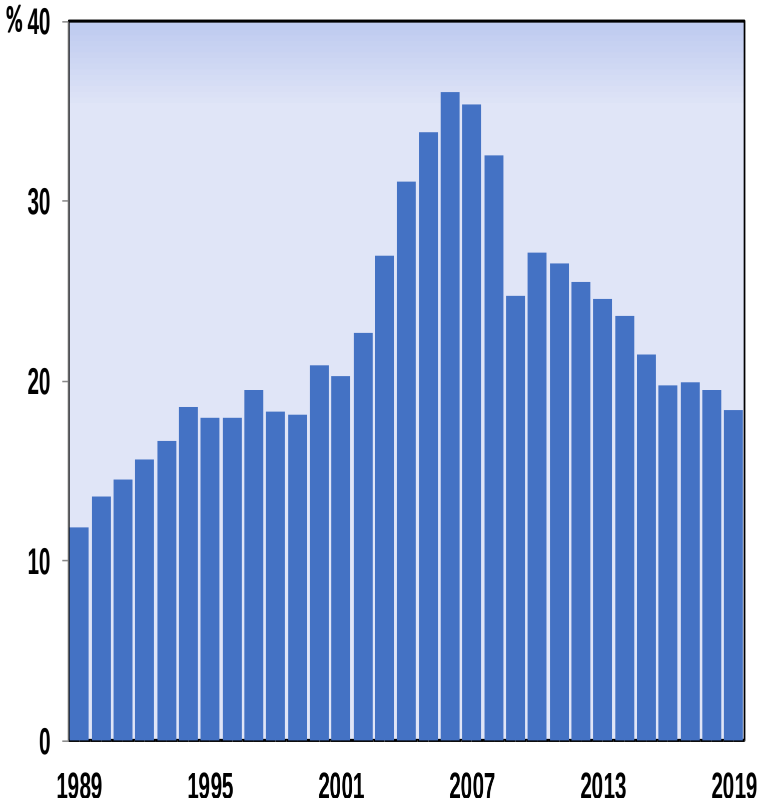
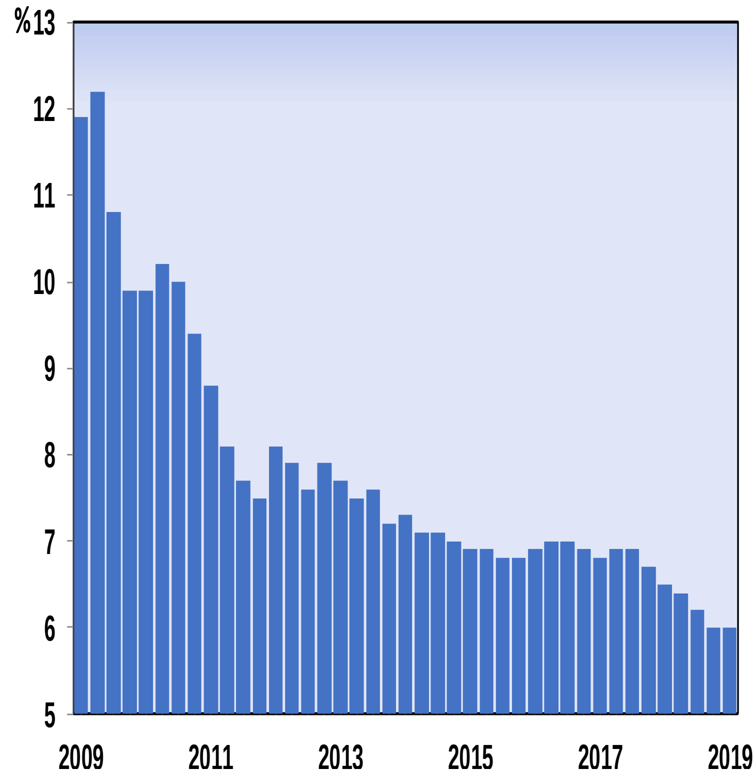


Chart 2: Chinese Economic Growth in a Long-Term Slowdown
China GDP, Adjusted for Inflation
Annual Percentage Growth Rate
Source: National Bureau of Statistics of China



Secular Growth Decline: China's GDP growth has been in a consistent decline since 2010, when its growth rate peaked at 12.5%. The Chinese economy expanded at a compound annual rate of 10.2% during the decade ending in 2015, and has risen at an annual rate of only 6.8% since then. My forecast assumes annualized growth of only 5.5% over the next five years. A slower growth rate in coming years can be attributed to several factors (see chart 2):

- An end to its dynamic industrialization process
- A slowdown in rural migration and urbanization (see chart 3)
- A marked shift from manufacturing and exports to services
- A significant build-up of business and local government debt
- The sheer size of its economy (the law of large numbers)

Alarming Debt Burden: Rapid growth in Chinese debt over the past 20 years has significantly weakened the country's economy. As a share of GDP, China's total debt has risen from 125% in 1999 to nearly 300% last year. In previous decades, creation was encouraged to maximize growth in output, employment, and income (see chart 4).

Chart 3: Urbanization Trend in China at an Advanced Stage
Ratio of Urban to Total Population
Source: National Bureau of Statistics of China

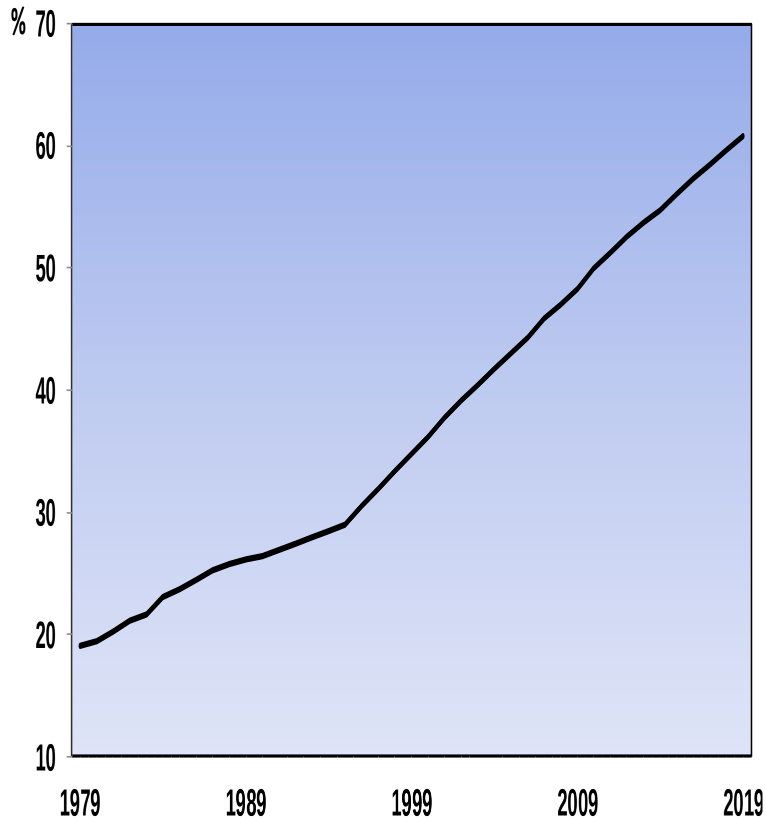
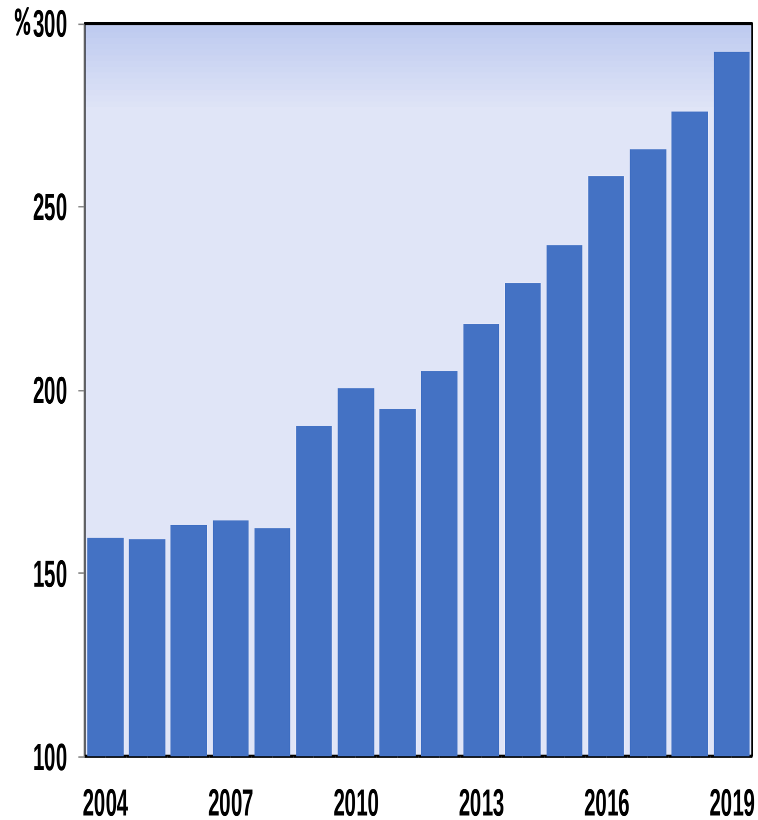


Chart 4: China's Debt Surges to Dangerous Levels
Total Chinese Debt, Percentage of GDP
Source: Bloomberg Economics



- **Deleveraging**: The government has become greatly concerned in recent years that debt has risen to dangerous levels, driven by massive borrowing on the part of local governments and state-owned enterprises. Debt levels have even risen rapidly in the traditionally cautious household sector, while *China's budget deficit remains in an upward trend*. The coronavirus will exacerbate public finances in the short term, because of lost tax revenues and increased public spending (see chart 5).

- **Swings in Monetary Policy**: In response, *policymakers have suppressed credit creation, implementing a deleveraging campaign in 2017 to mitigate the growing risks to the financial system*. China's credit policy has oscillated massively as policymakers have swung between stimulus and restraint (see chart 6).

Policy Constraint: *The clampdown on credit creation since 2017 has profoundly affected the economy*, as growth has slowed significantly and deflationary pressures have emerged. Two other developments have exacerbated the slowdown: (1) The trade war with the US; and (2) The spreading coronavirus. Because of the latter, first quarter GDP could be the weakest quarterly growth rate in three decades. Social and political unrest has also become widespread in recent months.

Chart 5: China's Government Finances Continue to Deteriorate
Cumulative Government Budget Deficit, Percent of GDP
Source: National Bureau of Statistics of China

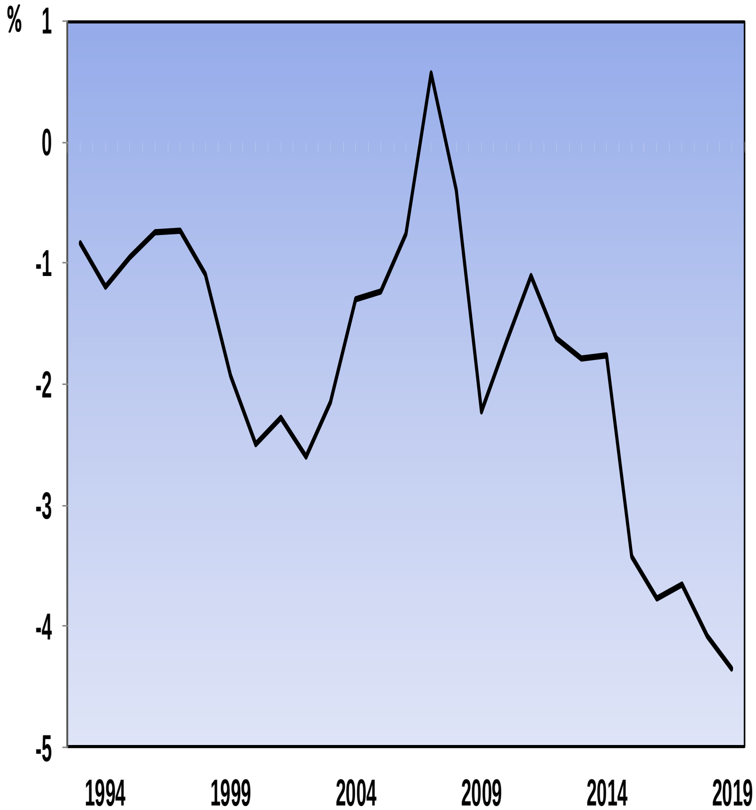
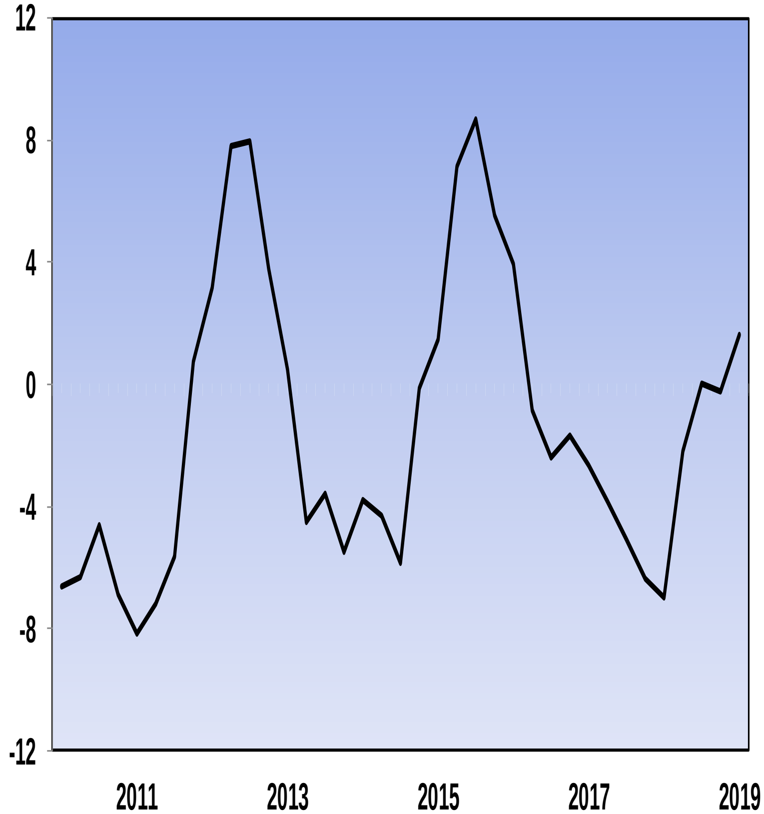


Chart 6: Rapid Swings in Central Bank Policy Cause Boom-Bust Cycles
Chinese Social Financing: An Index of Credit Stimulus
Source: Bloomberg Economics



- **Policy Reflation**: As a result, *the government now has no choice but to reflate its economy through aggressive monetary and fiscal policies* to counteract the spreading decline in spending and output. The government's deleveraging campaign and other long-term structural reforms have been placed on hold and new stimulus measures have been put into effect. Policymakers have cut interest rates, reduced reserve requirements at banks, and injected liquidity into the economy (see chart 7).

Structural Reforms: Management of China's economy in previous decades was sharply focused on maximizing economic growth. In the process, numerous worrisome economic, social, and political problems have emerged. These include severe air pollution and other environmental problems in the major cities; rampant corruption; glaring income inequality; and an obsolete and highly vulnerable financial system.

- **Growth Versus Reform**: In general, a liberalization of China's economy is badly needed. However, *emerging headwinds to growth have caused President Xi Jinping to make a deliberate decision to postpone his structural reform program announced several years ago to place a greater urgency on current economic growth*.

Chart 7: Policymakers Implement Monetary Stimulus to Revive Growth
Reserve Requirement Ratio (%) at Large Chinese Banks
Source: People's Bank of China

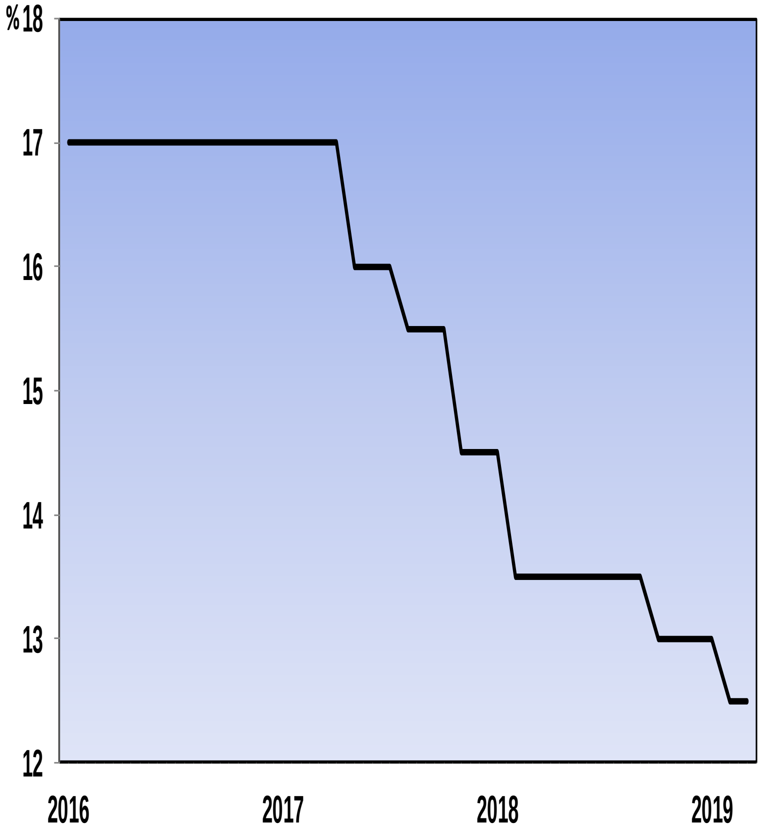
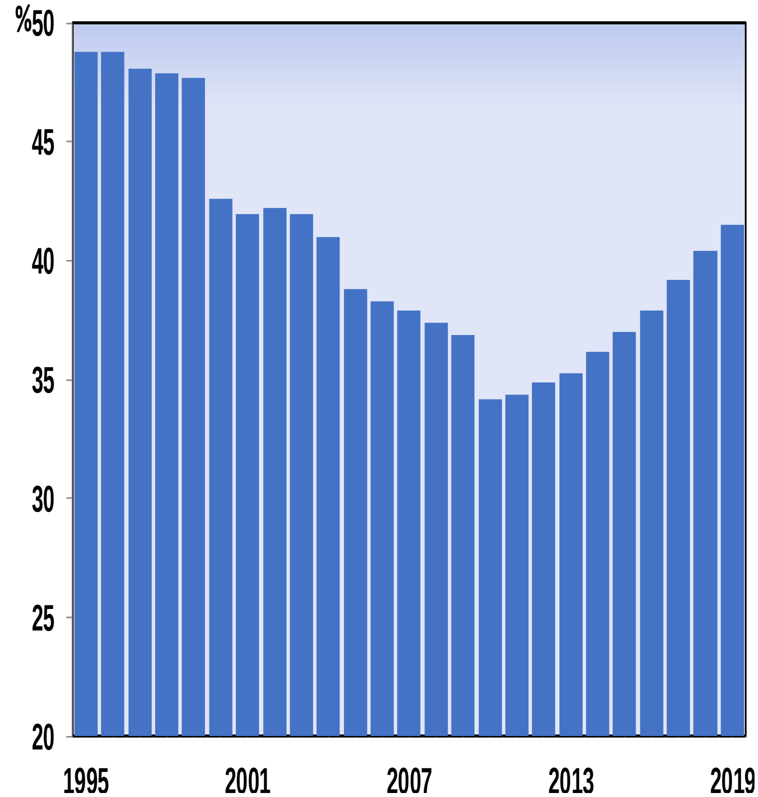


Chart 8: China Suffers From Unfavorable Demographic Trends
Chinese Dependency Ratio
Ratio of Children and Retirees as a Percent of Total Population
Source: National Bureau of Statistics of China



- **Demographics**: Demographic trends within China are deteriorating, as China's population growth has slowed markedly and as its *dependency ratio* has begun a long-term incline. For China to thrive as a world economic power in the 21st century, reforms in all these areas must be addressed (see chart 8).

Trade Relations: The Chinese economy has thrived since joining the WTO in 2001, with export trade contributing mightily to overall growth. However, it is a well-known fact that a significant portion of China's export success has resulted from a flagrant reliance on unfair trading practices, which are vulnerable to remediation efforts.

- **Unfair Trade Practices**: China has continuously subsidized inefficient local producers, engaged in intellectual property theft, placed arbitrary limits on foreign imports, and forced foreign firms doing business in China to transfer technology to their Chinese partners. According to the Cato Institute, the cost to the US economy from pirated software, counterfeit goods, and theft of trade secrets could be as high as $600 billion annually. These unfair trade practices are unsustainable.

- **Threat of Trade War**: It is highly likely that the US and other governments will force China to reform in coming years, thereby undermining China's competitive position in world markets. The drive for world supremacy in technology in future decades could lead to a deterioration in normal trade relations between China and the US beginning as soon as 2021, along with a further breakdown in world trade. Investors should not expect a "phase two" trade deal anytime soon.

Manufacturing Hub: China's ascendance to a world-class manufacturing hub since 2001 has been jeopardized by recent developments, including the trade war with the US and the coronavirus epidemic. Business firms covet stability and predictability above all else and China has become less attractive in both areas. As a result, some foreign companies have redirected their Asian manufacturing sites away from China to Vietnam, Thailand, and Cambodia, each of which offers lower costs, greater ease of doing business, and a friendlier government. It is impossible to know whether this structural trend will persist in future years.

China and the World: Until recently, China's economy was heavily dependent upon the world economy. Because of its sheer size and powerful shifts in the composition of its economy, ***China is currently far less dependent upon the rest of the world. At the same time, the world economy has become heavily dependent upon China***:

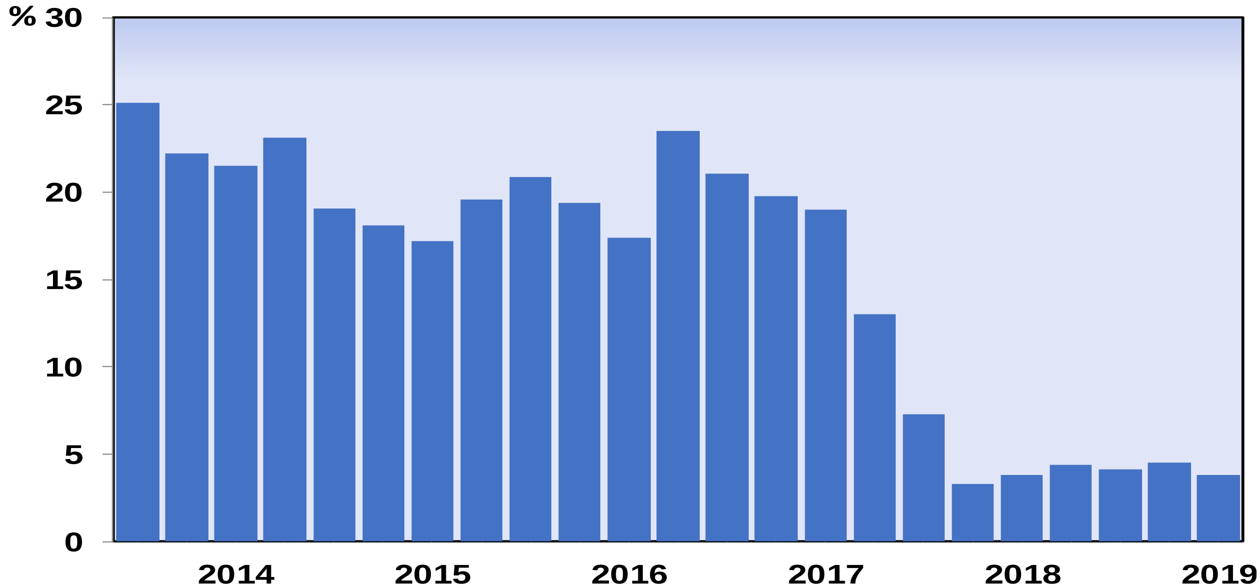
- China's GDP constitutes 16% of world GDP, up from only 5% in 2005
- China's manufacturing sector comprises 25% of world manufacturing
- Chinese GDP growth accounts for 30% of world GDP *growth* annually
- Certain export-oriented economies are critically dependent upon Chinese imports, most notably Germany, South Korea, Japan, and Taiwan

*My economic forecast for 2020 and 2021 assumes that a healthy and sustained recovery in the world economy can **only** occur alongside a strong rebound in Chinese GDP growth.*

ECONOMIC OUTLOOK

Stringent containment measures taken by China and other countries to contain the coronavirus are beginning to have an increasingly pronounced economic effect. Because the number of confirmed cases of COVID-19 is still rising, it is impossible to accurately gauge the cumulative economic impact on China and the rest of the world. In tracking the epidemic, it is crucial for investors to differentiate between Hubei Province and the remainder of China.

Chart 9: Declining Growth Rate in Infrastructure Spending
Total Spending on Infrastructure, Annual % Growth Rate
Source: National Bureau of Statistics of China



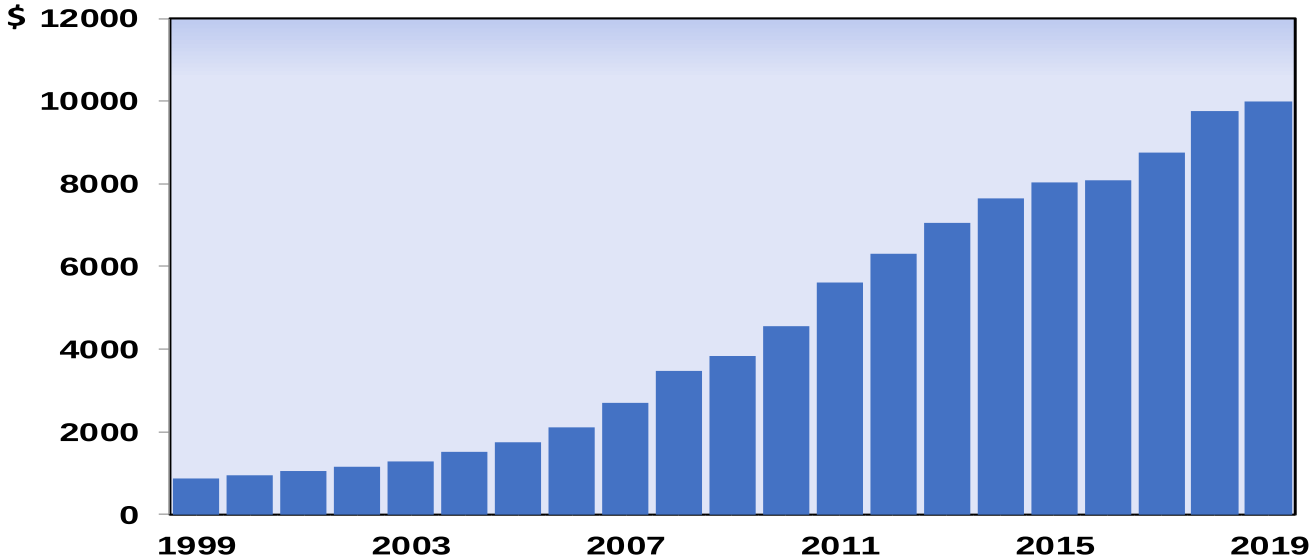
Hubei Province: While the epidemic in Hubei is far from contained — the virus continues to spread — the *number of cases outside of the epicenter* appears to be forming a plateau. The percentage of all cases in China originating in Hubei has been in a rising trend, increasing from only 52% in late January to 75% in mid-February to 81% currently. *This trend suggests progress in the government's effort to contain the outbreak **beyond** Hubei*.

- **Business Activity**: Many cities in China's other 31 provinces are beginning to resume business activity. Conversely, Hubei Province could remain in lockdown for another two or three months. While Hubei Province is a very large manufacturing hub, its total output comprises less than 5% of China's overall GDP.

- **Quarterly GDP**: My forecast for China assumes that the current quarter will suffer a major setback, followed by a modest recovery in Q2. Second half GDP should rebound strongly, as economic conditions return to normal. My preliminary quarterly forecast for 2020 assumes GDP growth of only 3.5% in Q1, rebounding to 5.5% in Q2 and 7.5% in the second half of the year.

- **More Aggressive Stimulus**: A critical assumption in my forecast is that policymakers will ramp up stimulus on both the monetary and fiscal fronts, in the form of an easing in credit conditions and introduction of *tax cuts and infrastructure spending*. Beyond the short term, my forecast assumes trendline GDP growth of 5.5% over the next five years (see chart 9).

Chart 10: Rapid Chinese GDP Growth, But Lagging on a Per Capita Basis
China Per Capita GDP, Denominated in US Dollars
Source: World Bank



INVESTMENT CONCLUSION

Although the Chinese economy is now the world's second-largest by a wide margin, the country will face numerous challenges in the years ahead. Many of these problems can be summarized in China's transition from a developing to a middle-income economy. Whereas China's GDP has increased to greater than 50% of US GDP, its *per capital GDP of approximately $10,000 is only 15% of that of the US*, currently greater than $64,000. The greatest challenge is transforming its economy from a rigid, highly centralized command economy to a more flexible and dynamic economy achieved through massive free market reforms (see chart 10).

Since the end of 2017, the global bull market in equities has persevered through a number of threats, including Brexit, several recession scares, the risk of a major trade war, increased tensions in the Middle East, an inverted yield curve, a presidential impeachment, and periodic spikes in bond yields. In each instance, the economy and equity market remained resilient, followed by a recovery once the crisis appeared to be contained. The current world health crisis should prove to have a similar outcome.

World financial markets should respond favorably to a healthy and sustained economic recovery in China, along with a rebound in world trade. An improvement in investor sentiment could be reinforced by further easing by world central banks. More importantly, *a China-led acceleration in world economic growth could be the catalyst for a shift in leadership within world financial markets*. Under this scenario, bond yields could enter a sustained cyclical uptrend, resulting in large losses in fixed-income portfolios, while world equity markets would prosper.

In addition, non-US stocks could finally begin to outperform domestic equities, economically sensitive stock groups could outperform defensive safe-haven stocks, and value managers could outperform growth/momentum managers. In the US, industrials, financials, materials, and transports could become market leaders, while utilities, consumer staples, and real estate would lag. The multi-year rally in the US dollar would reverse and commodity prices would rally, led by copper and crude oil. Under this auspicious scenario, equities in Europe, Japan, and emerging Asia would outperform those in the US.

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Bloomberg Barclays U.S. Treasury Inflation-Protected Securities (TIPS) Index: Measures the performance of rules based, market value-weighted inflation protected securities issued by the U.S. Treasury. It is a subset of the Global Inflation-Linked Index (Series-L).

CBOE Volatility Index: An index of implied equity market volatility, reflecting the market estimate of future volatility for the S&P 500 Stock Index over the next 30 days, using options.

MSCI Emerging Market Index: An index of equity market performance for developing markets, primarily in Asia, Latin America, and Eastern Europe. The index tracks both large-cap and small-cap stocks and is weighted by market capitalization.

MSCI World Ex US Index: Measures the performance of the large and mid-cap segments of world, excluding US equity securities. It is free float-adjusted market-capitalization weighted.

Russell 2000 Small-Cap Index: Is an index measuring the performance of approximately 2,000 small-cap companies within the United States.

S&P 500® Index: Measures the performance of 500 widely held stocks in US equity market. Standard and Poor's chooses member companies for the index based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility, and transportation companies. Since mid-1989, this composition has been more flexible and the number of issues in each sector has varied. It is market capitalization-weighted.

State Street Investor Confidence Index: measures investor confidence or risk appetite quantitively by compiling actual buying and selling patterns of institutional investors.

US Trade-Weighted Dollar Index: An index that measures the value of the US dollar in relationship with other currencies, statistically weighted on the basis of importance to the US as trading partners.