Gavekal Research

January 2017

China: propaganda, truth and underlying realities

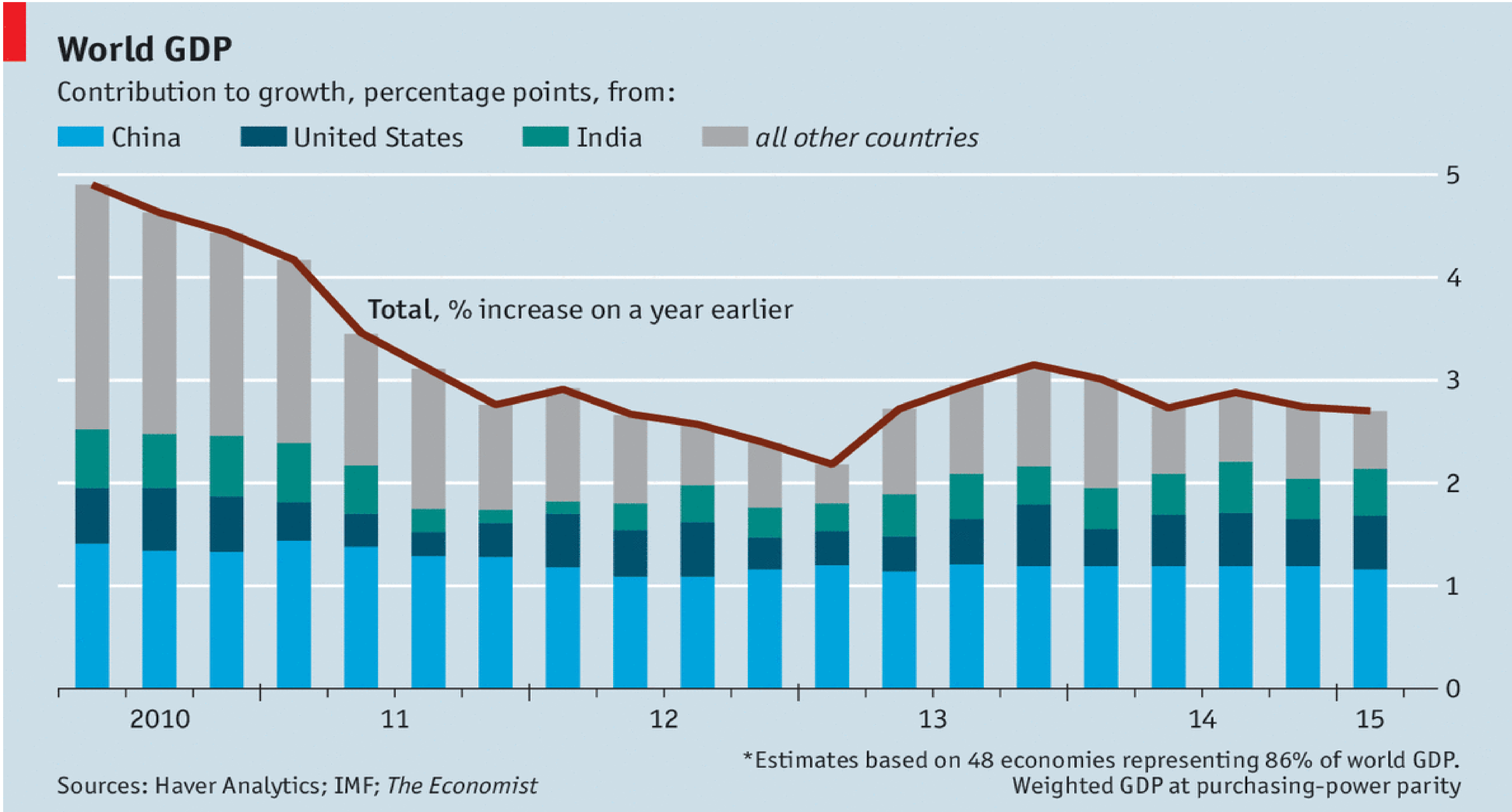
By Louis-Vincent Gave

Q1: Do you trust Chinese data?

Of course not! After all, China still has a ministry of propaganda!

Q2: What does the staff of the 'Publicity bureau' do all day?

Q3: After all, when was the last time you read something positive on China?



Economist.com

Which brings us back to Q2: what do China's spin doctors do all day?

Option 1: *Make the best of a very bad situation but situation is deteriorating too fast and Chinese spin doctors do not have enough lipstick for that pig*

Option 2: *Hide China's reckless mercantilism as the country continues to export deflation into a slow growing world*

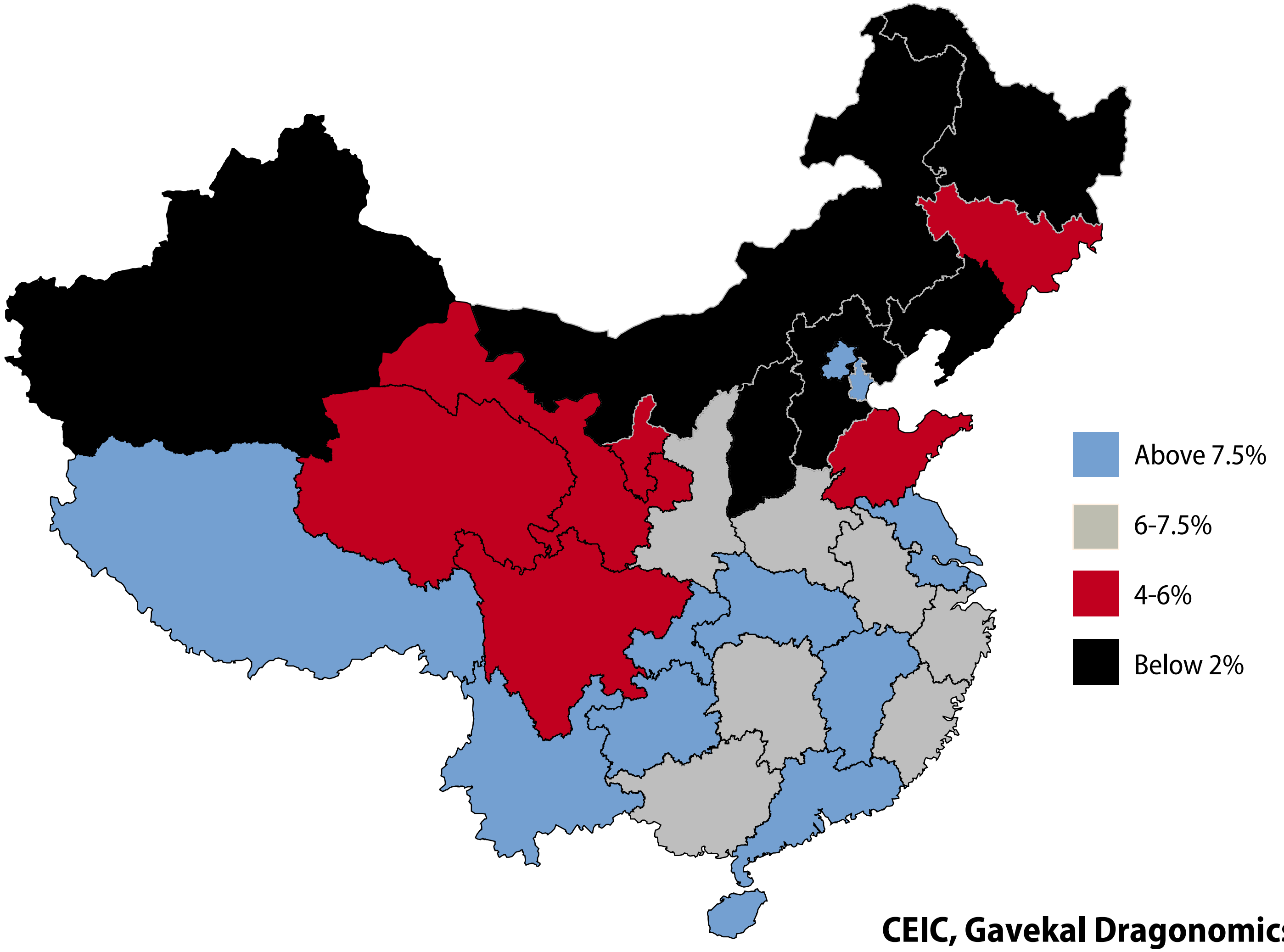
Option 3: *Hide China's growing imperialism and desire to push the US out of the greater Asia region*

1- Is the Chinese economy spinning out of control of spin doctors?

Behind the growth slowdown: massive regional disparities

China's northern and western provinces are the worst off

Provincial nominal GDP growth in the first half of 2015

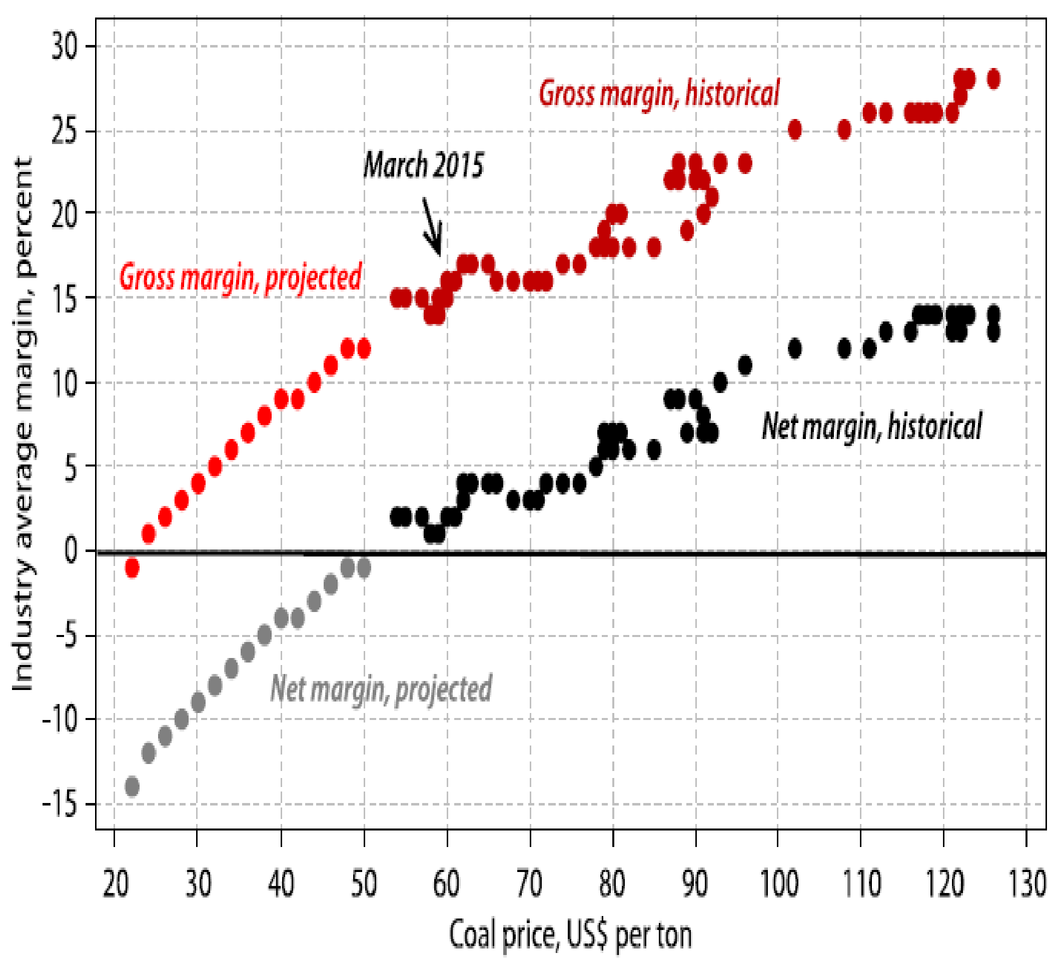


CEIC, Gavekal Dragonomics

- The economic slowdown China has experienced since 2012 has been marked by an enormous regional disparity.
- A group of northern provinces that are heavily reliant on energy, mining and heavy industry are bearing the brunt of the slowdown. Three provinces had negative nominal GDP growth in the first half of 2015: the coal mining regions of Shanxi, and Liaoning, and Heilongjiang in the northeast rust belt.
- The wealthy centers of Beijing and Shanghai, as well as the coastal provinces, have been doing much better.

Coal & steel in China are where they were in the US/Europe in early 1980s?

The coal sector as a whole loses money at US$50 and below



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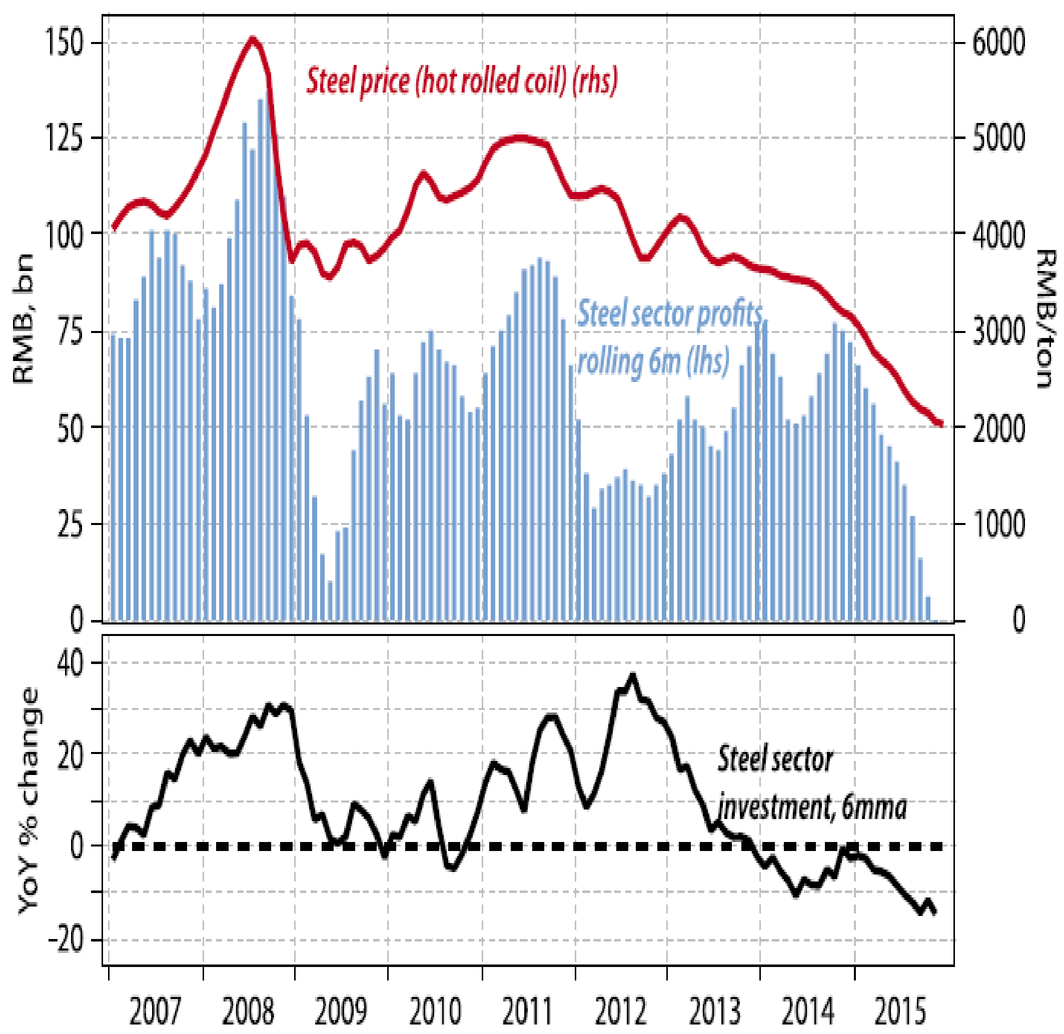
Total profits for the steel sector turned negative in 2015



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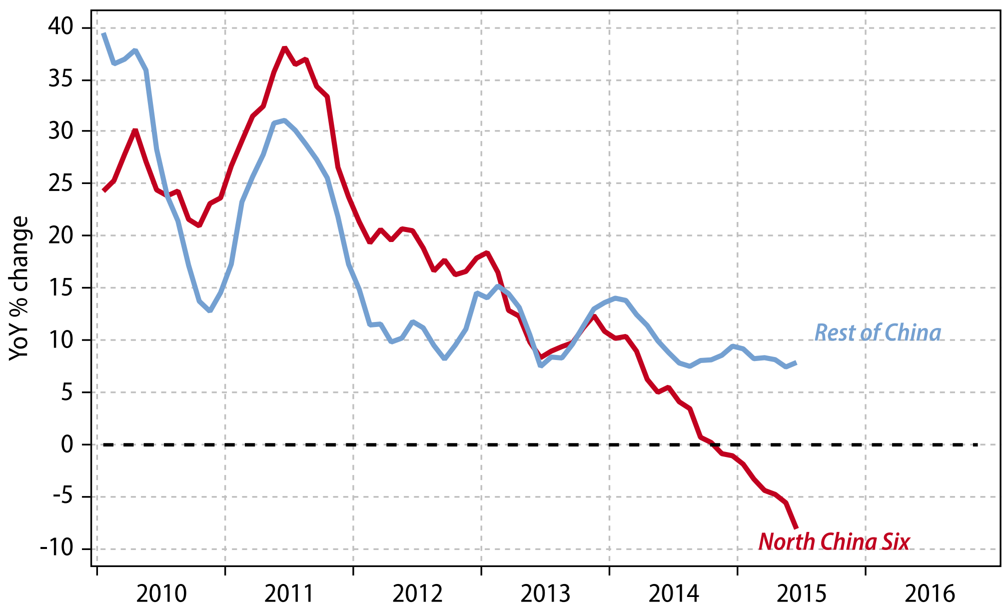
This creates its own fiscal challenges

Government revenues are declining in Northern China

Fiscal revenue by region, 6mma

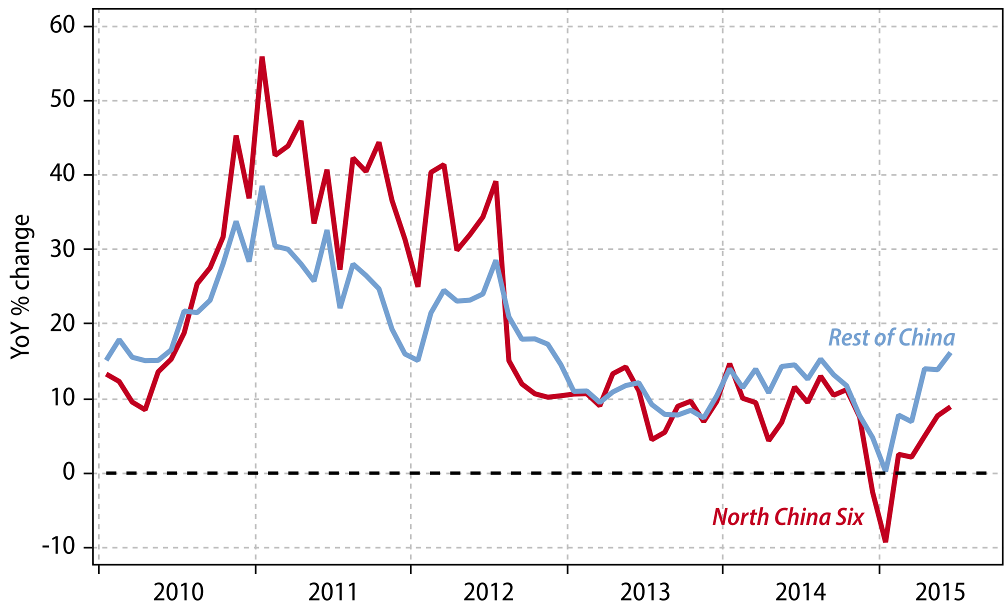


CEIC, Gavekal Data/Macrobond

The sharp slowdown in economic activity in north China has resulted in falling tax revenues, as the value-added tax and other corporate levies are the main source of government revenue. This decline in local fiscal income means the local government has fewer resources with which to cope with the downturn, either by supporting local companies or expanding social services.

Northern China cannot ramp up spending as quickly as other provinces

Fiscal expenditure by region, 6mma



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Fiscal expenditure has rebounded this year as the central government tries to support growth, and spending has also risen in north China. But the depressed region probably needs a bigger increase in spending than the rest of the country. China's fiscal transfer system may not be responding flexibly enough to these localized economic troubles.

If you were the Chinese government, how would you deal with such disparity?

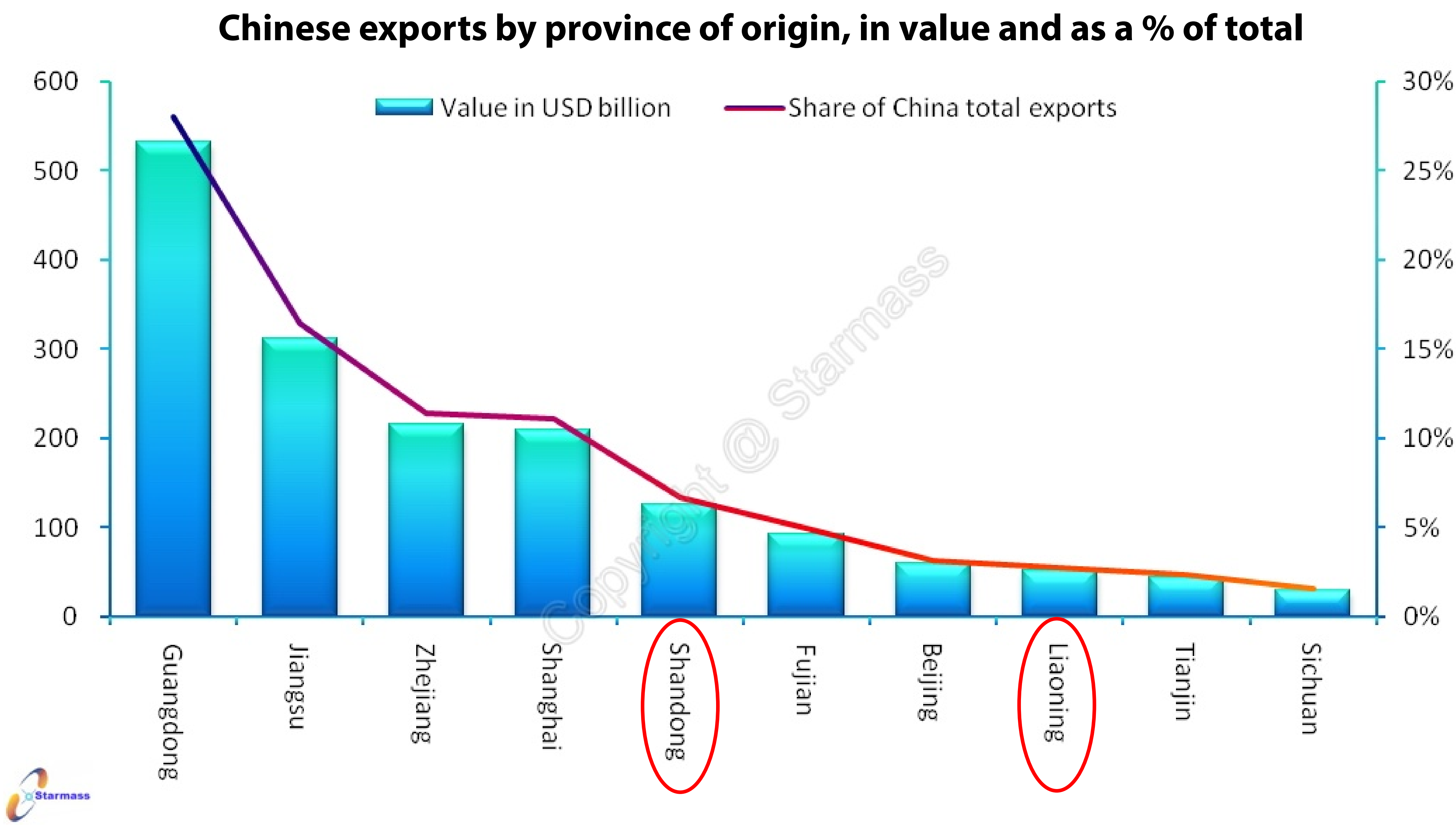
vs

Option 1: *Devalue the RMB and export your way back to prosperity*

Option 2: *Close down inefficient producers, encourage more internal migration and turn entire North-East into economic wasteland for a generation…*

Option 3: *Send good money after bad and subsidize the North-East through debt-financed economic stimulus.*

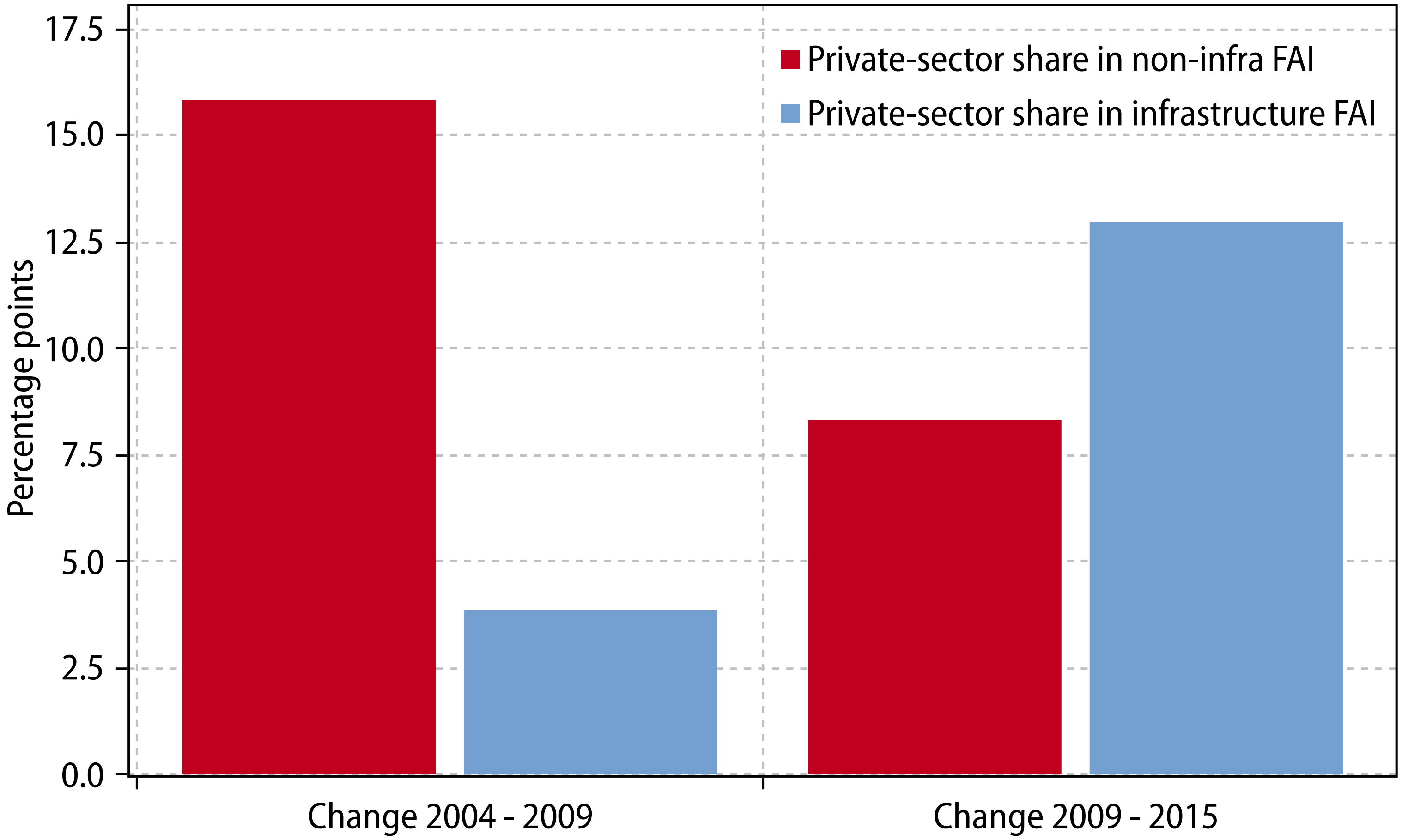
Gaining growth through exports is not an option for the North-East



And unfortunately, an accelerated pace of reform is not a Xi Jin Ping priority

The pace of liberalization has slowed since the crisis

Change in private share of fixed-asset investment, by sector

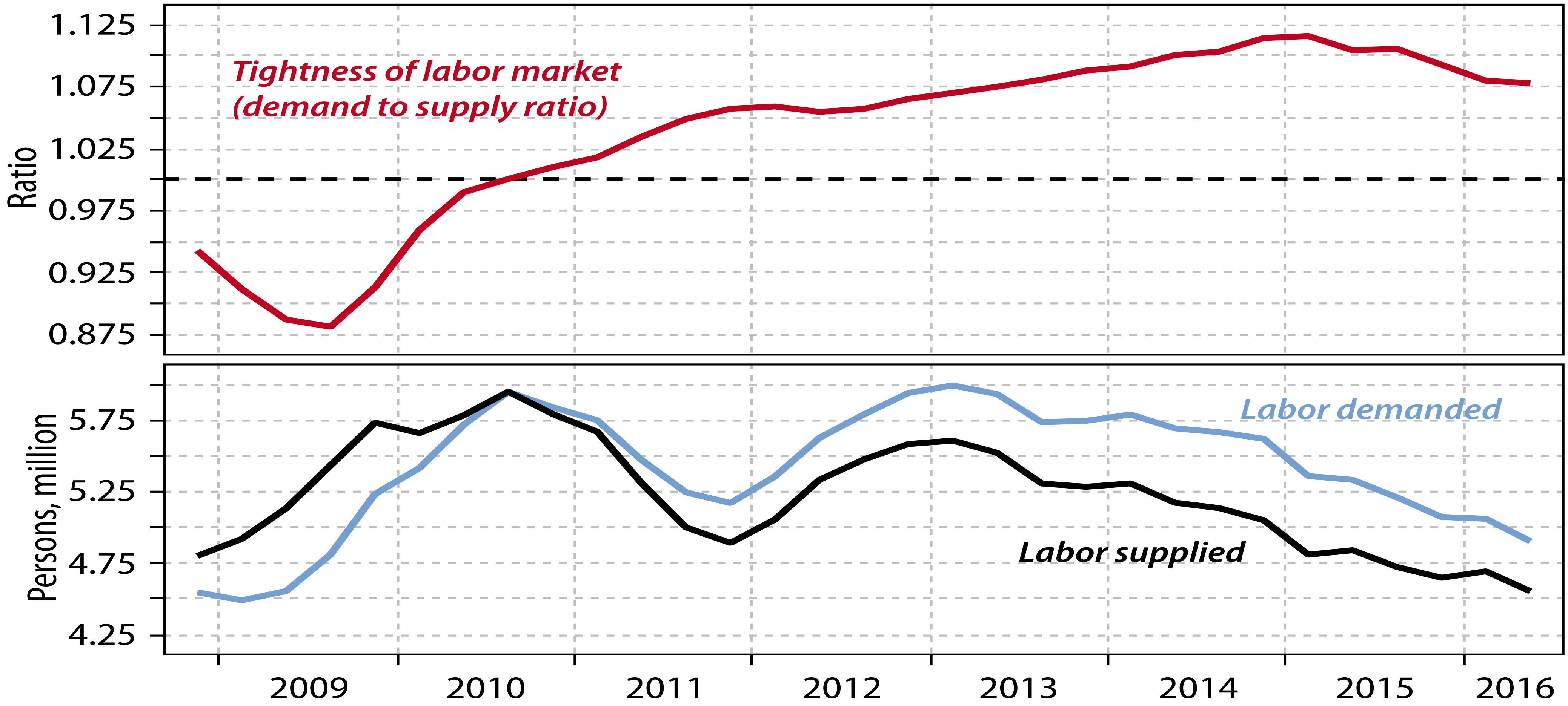


NBS, Gavekal Data/Macrobond

The pace of lay-offs has remained modest

The job market is softening, with labor demand and supply both falling

Labor demand and supply, from urban job placement centers, 1yma



Gavekal Data/Macrobond

Willingness to rock the political boat is limited in run-up to 19th Party Congress

2012
18th Party Congress
Xi takes office

2013
Third Plenum reform plan
"One Belt One Road" initiative

2014
Fourth Plenum on rule by law

2015
Military reform plan
Last year of 12th Five-Year Plan

2016
13th Five-Year Plan
"Supply side reform"

2017
19th Party Congress
Politburo turnover and transition planning

2018
Third Plenum
another reform plan?

2019

2020
End of 13th Five-Year Plan

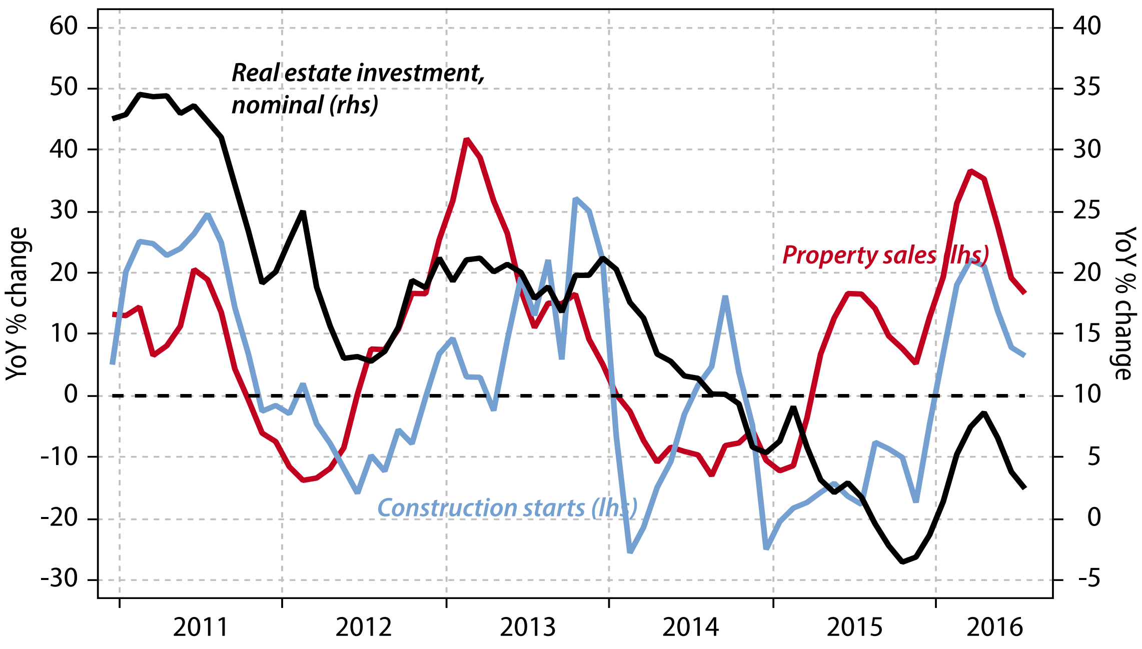
2021
Party's 100th birthday

2022
20th Party Congress
10 years in office for Xi

For social stability, the government went back to working the pump

China's housing sales re-accelerated, and so did construction

Property indicators, 3mma



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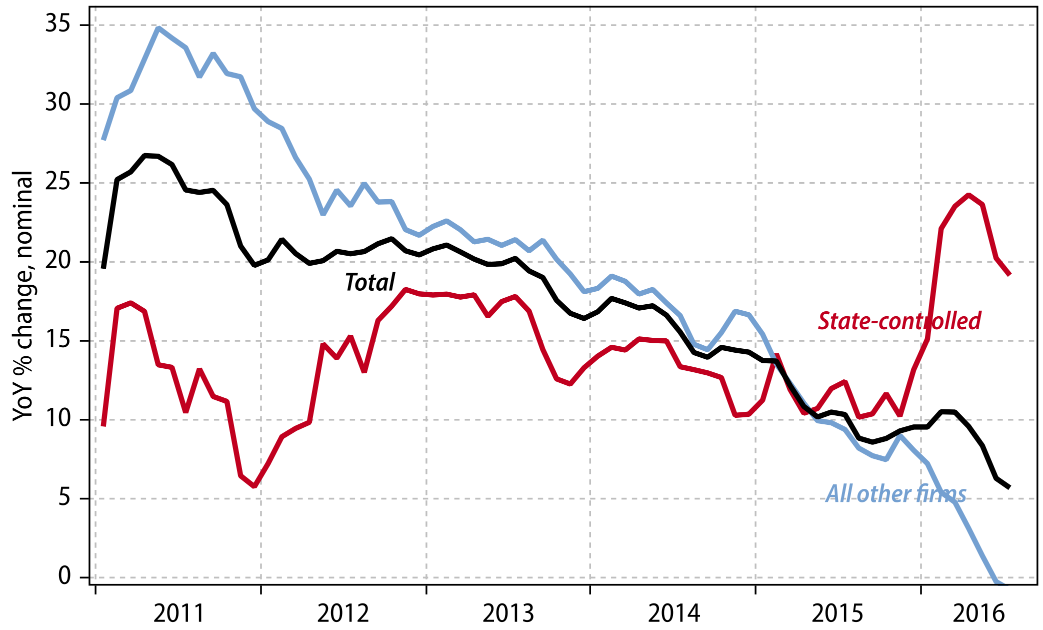
Investment growth has stabilized recently as SOE spending picks up

Fixed-asset investment by ownership of firm, 3mcma



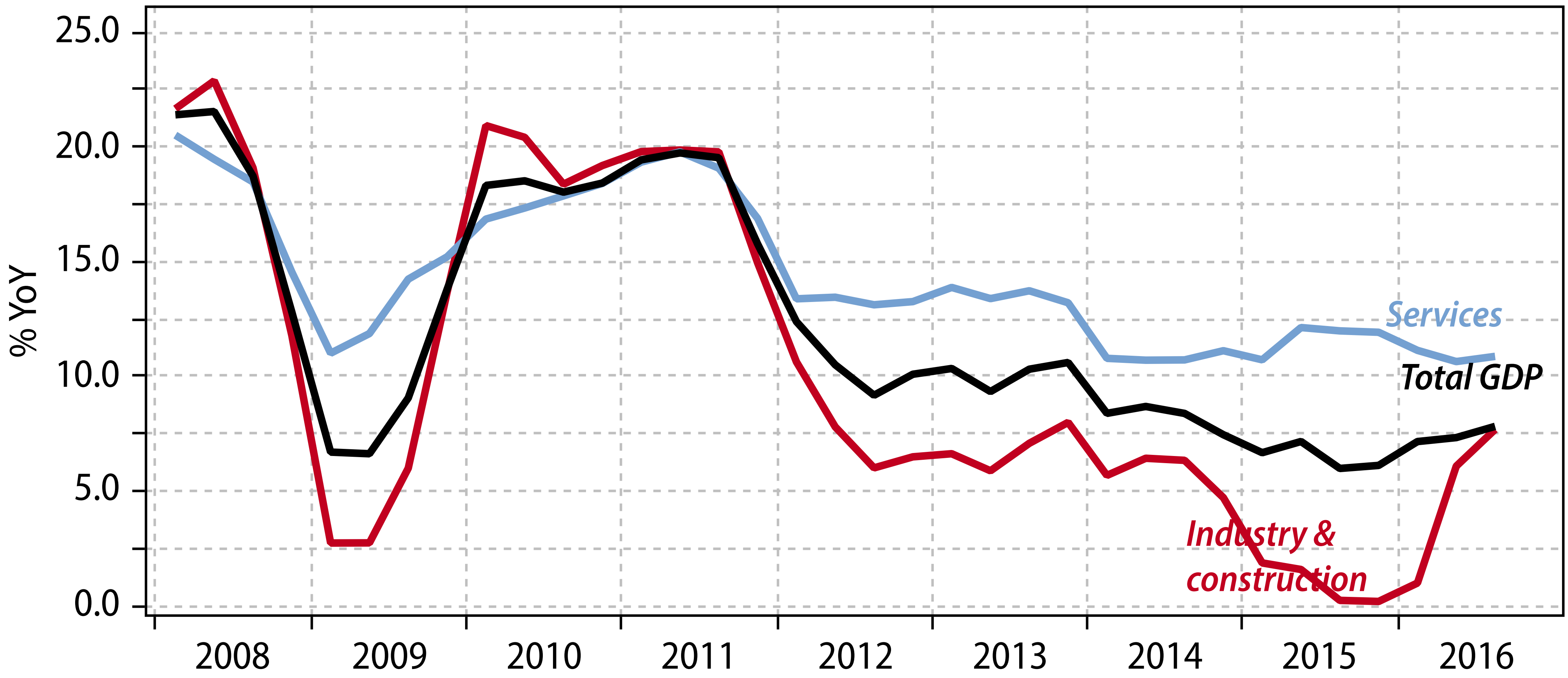
CEIC, Gavekal Data/Macrobond

- This year's rebound in Chinese construction, property sales, and prices is possibly one of the least expected macro developments of 2016.
- Clearly, the government went back to working the pump. In the short term, this covers over the crack. In the longer term, it does raise serious sustainability questions. In the medium term, it means that 1H2017 will be tough for YoY comparisons…

This triggered a big rebound in construction, materials, and real estate activity

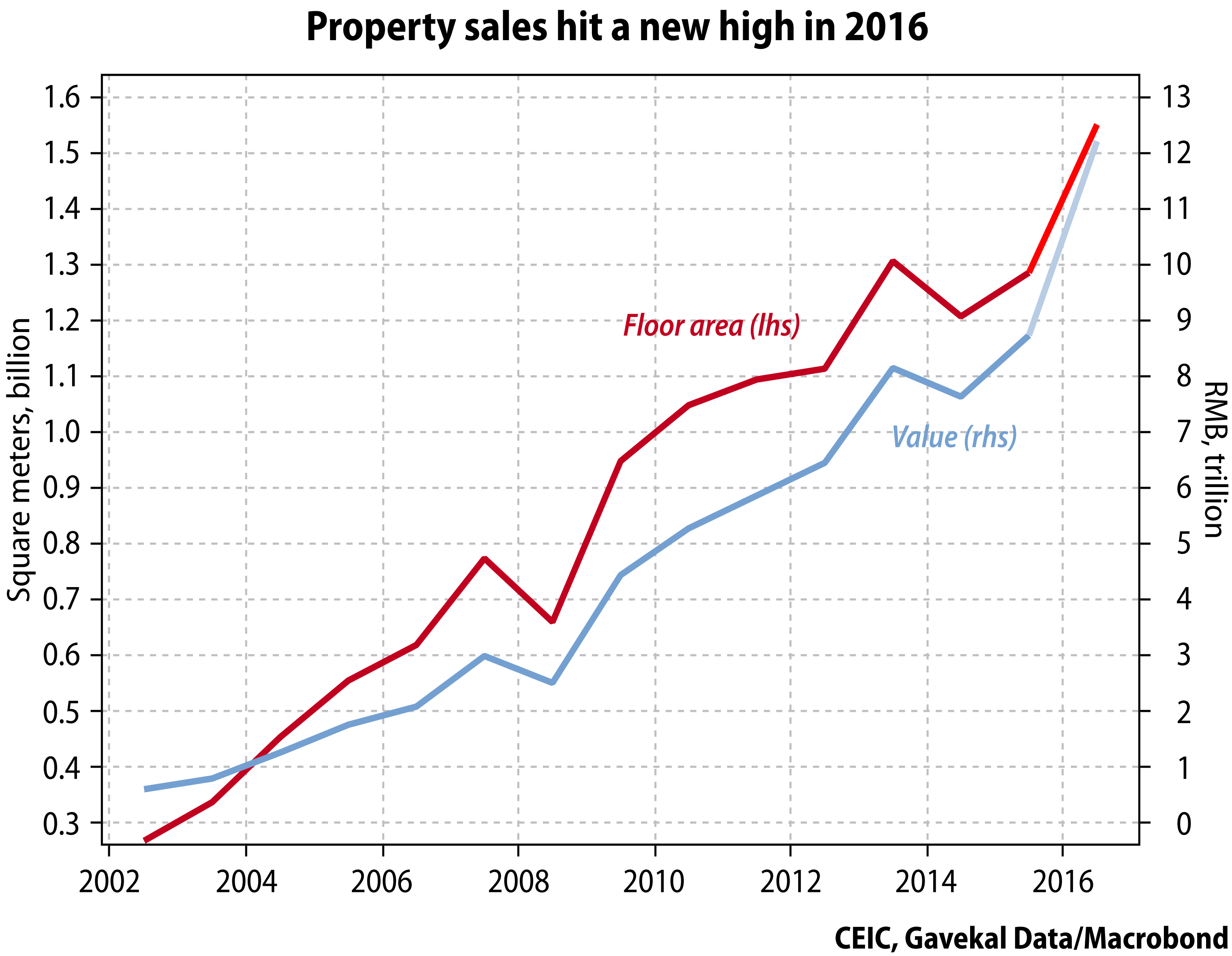
Services remain stable while construction adds volatility

Nominal change in value-added by sector



Gavekal Data/Macrobond

China was supposed to fall apart – instead, real estate is making new highs

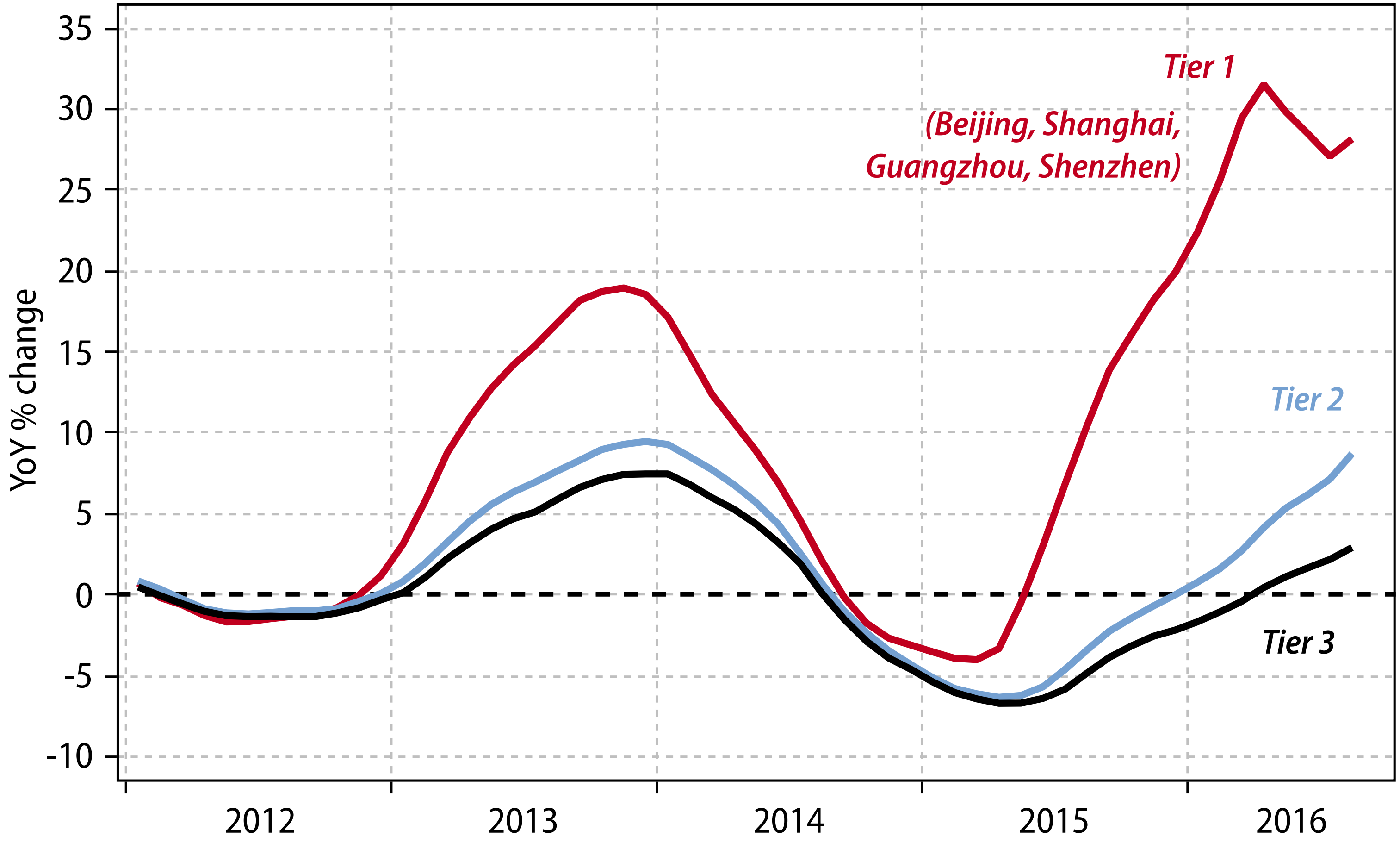


- Property sales surged in 2016 after a decent rebound in 2015. Total sales are on track to reach 1.55bn sq m, well beyond the previous peak of 1.3bn sq m in 2013.
- Behind this extraordinary growth was a huge policy push to support the housing market, under the rubric of "de-stocking" in the "supply-side structural reform" program of end-2015.
- Local governments made all-out efforts to support housing sales, and the banking system delivered an unprecedented surge in mortgage lending. The focus was thus on demand-side stimulus rather than supply-side restraint.

Prices surged in big cities, triggering government restrictions

The price jump in Tier 1 cities is much larger than in the previous cycle

70-city price index for new housing, average by city tier

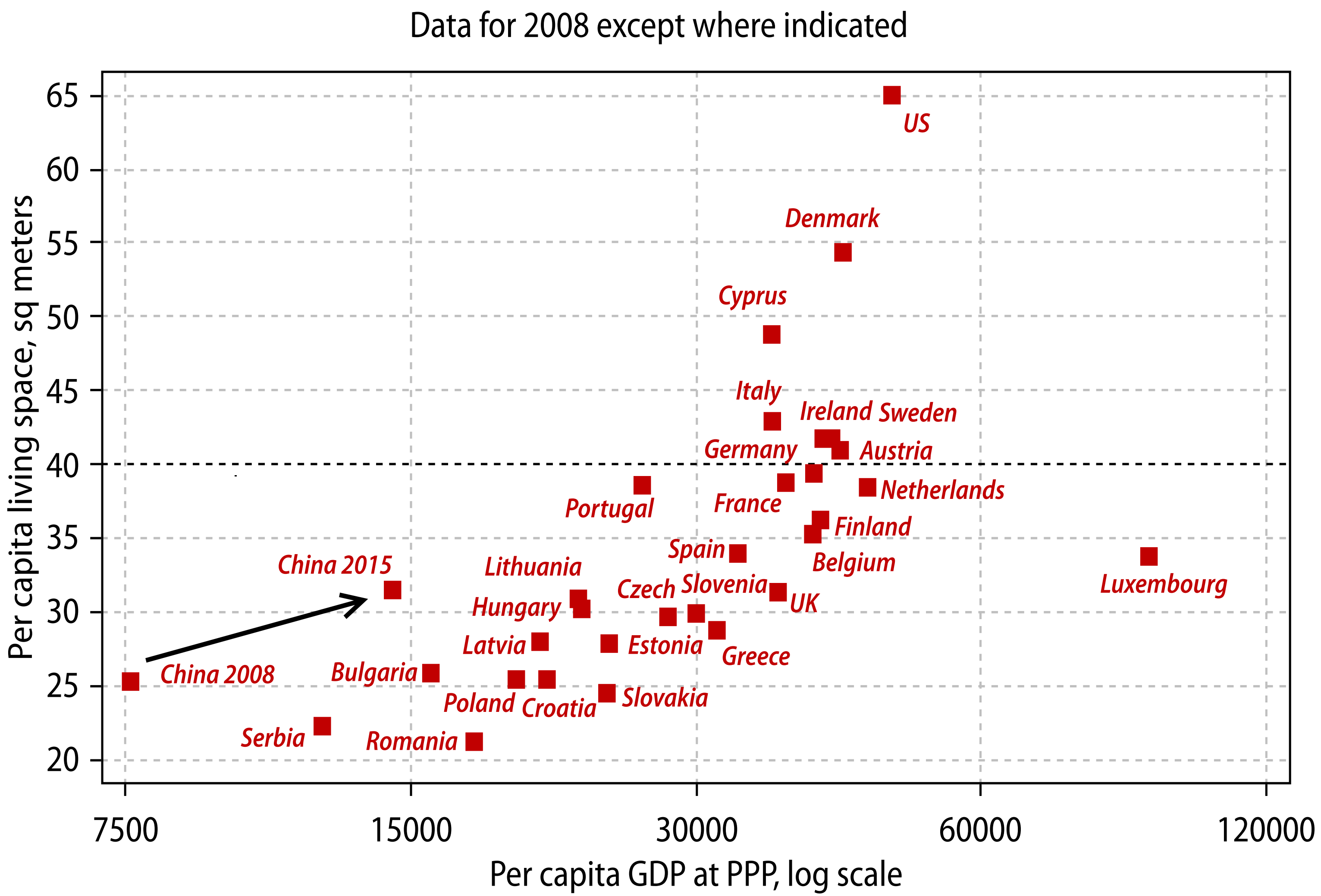


Gavekal Data/Macrobond

- The other consequence of the credit-driven sales boom is sharp price rises in major markets. The big four Tier 1 cities have seen huge gains, but prices have also surged in major Tier 2 cities such as Nanjing, Hefei, Wuhan, Suzhou, Xiamen, Hangzhou.
- The Chinese government has historically managed the housing cycle to avoid prices rising too much faster than income. Six major cities re-imposed purchase restrictions over the summer, and another 14 (including Tianjin, Zhengzhou, Chengdu, Jinan, Wuxi, Zhuhai) also announced tightening measures in October.

The reality is that underlying demand for real estate remains solid

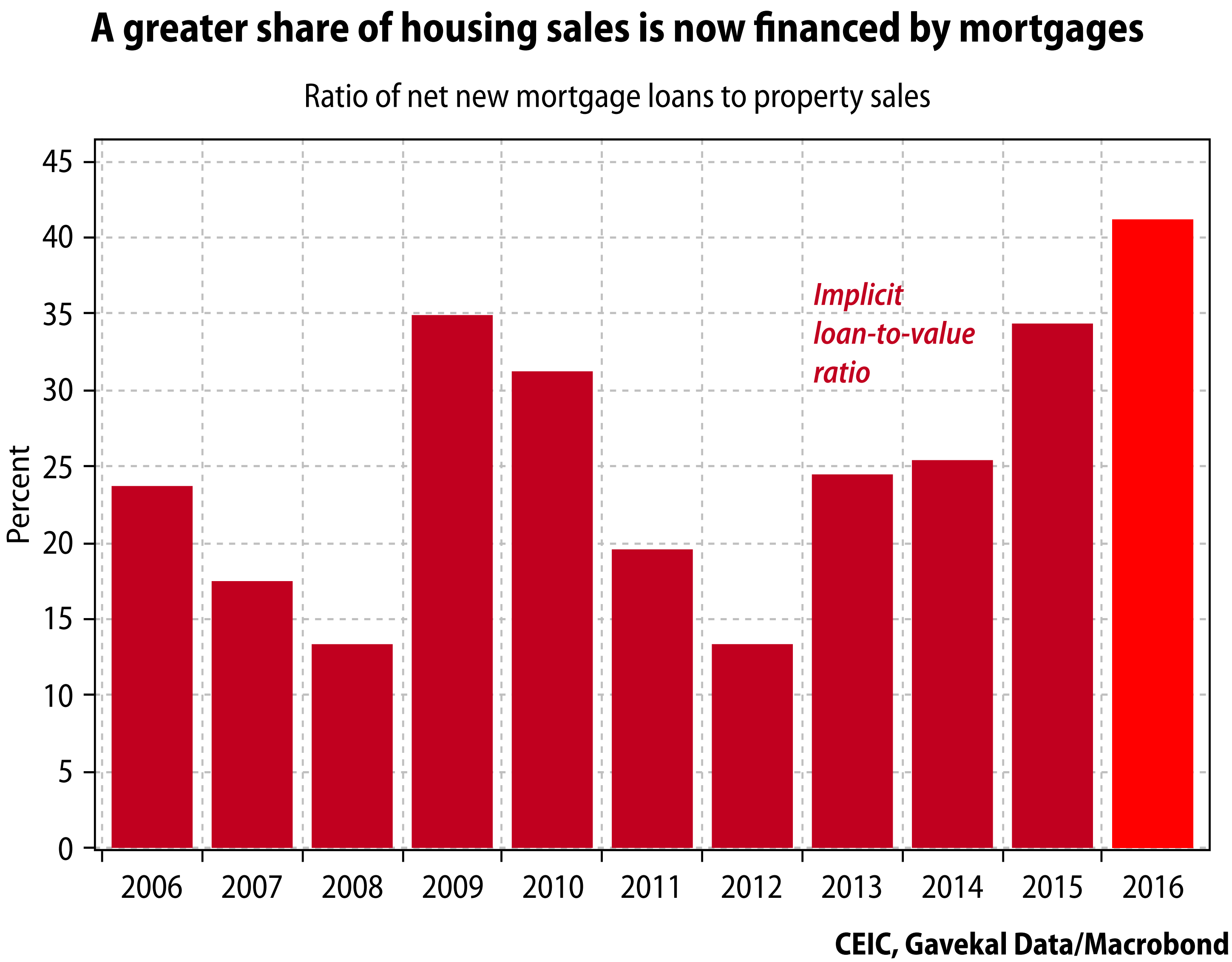
China has a European rather than American style of urban construction



Entranze, Gavekal Data/Macrobond

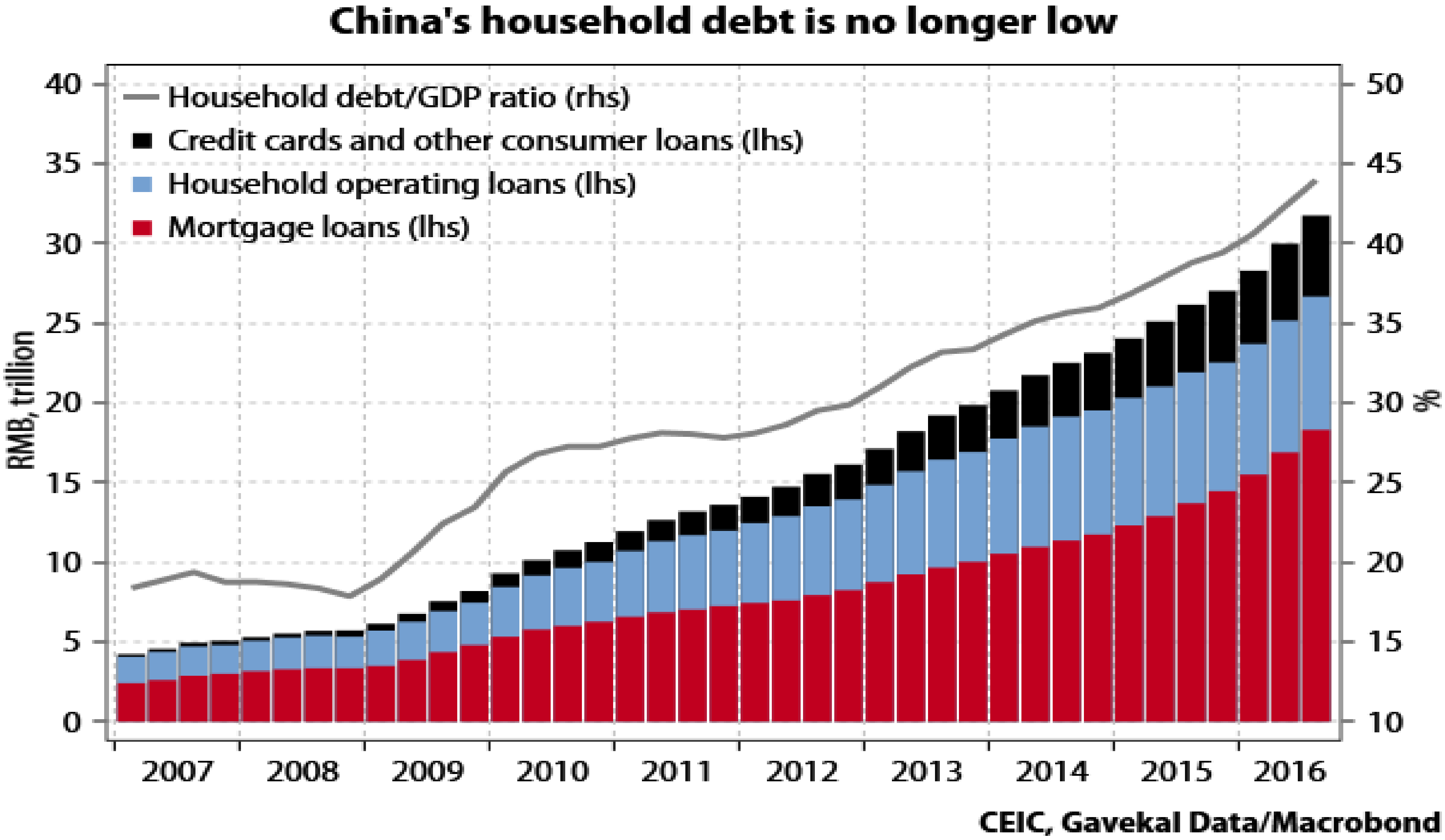
- Though China's landmass is similar in size to the US, its urban density and per capita living space is more like Europe (most of China's population is concentrated in the eastern third of the country). China today has a level of per capita living space similar to Hungary, Latvia and Lithuania in 2008.
- Even if China double its per capita income by 2025, (achieving levels similar to Spain), per capita living space is unlikely to substantially exceed 40 sq m.
- Still, that leaves some room for growth under an 'optimistic scenario'.

Rising mortgages were the key to sales growth in 2016



- Outstanding mortgage loans are on track to grow 30% in 2016 to Rmb17.5trn, equivalent to around 42% of estimated full-year sales value. This is a higher implicit loan-to-value ratio even than during the credit surge in 2009 after the global financial crisis.
- Policymakers believe that with household debt relatively low, there is room to increase leverage in order to clear out the inventory overhang. However the credit surge also has less desirable consequences, as it stimulates demand for housing even in cities with low inventories. This has been driving up prices and creating worries of a speculative bubble.

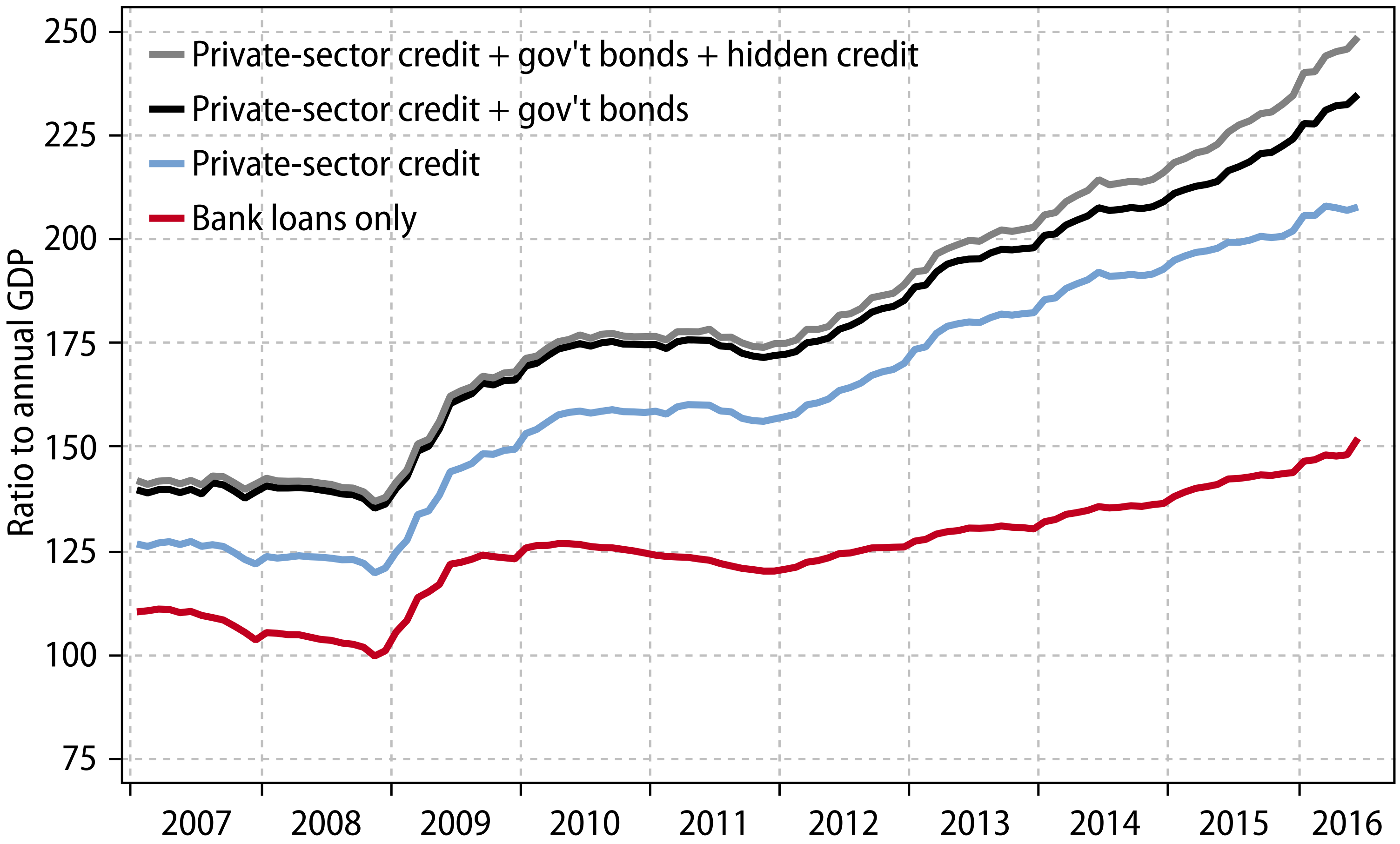
As a result, Chinese household debt is now making new highs



In essence, the Chinese government boosted growth by boosting debt

Different ways of adding up China's debt

Stock of outstanding credit relative to GDP, on various definitions



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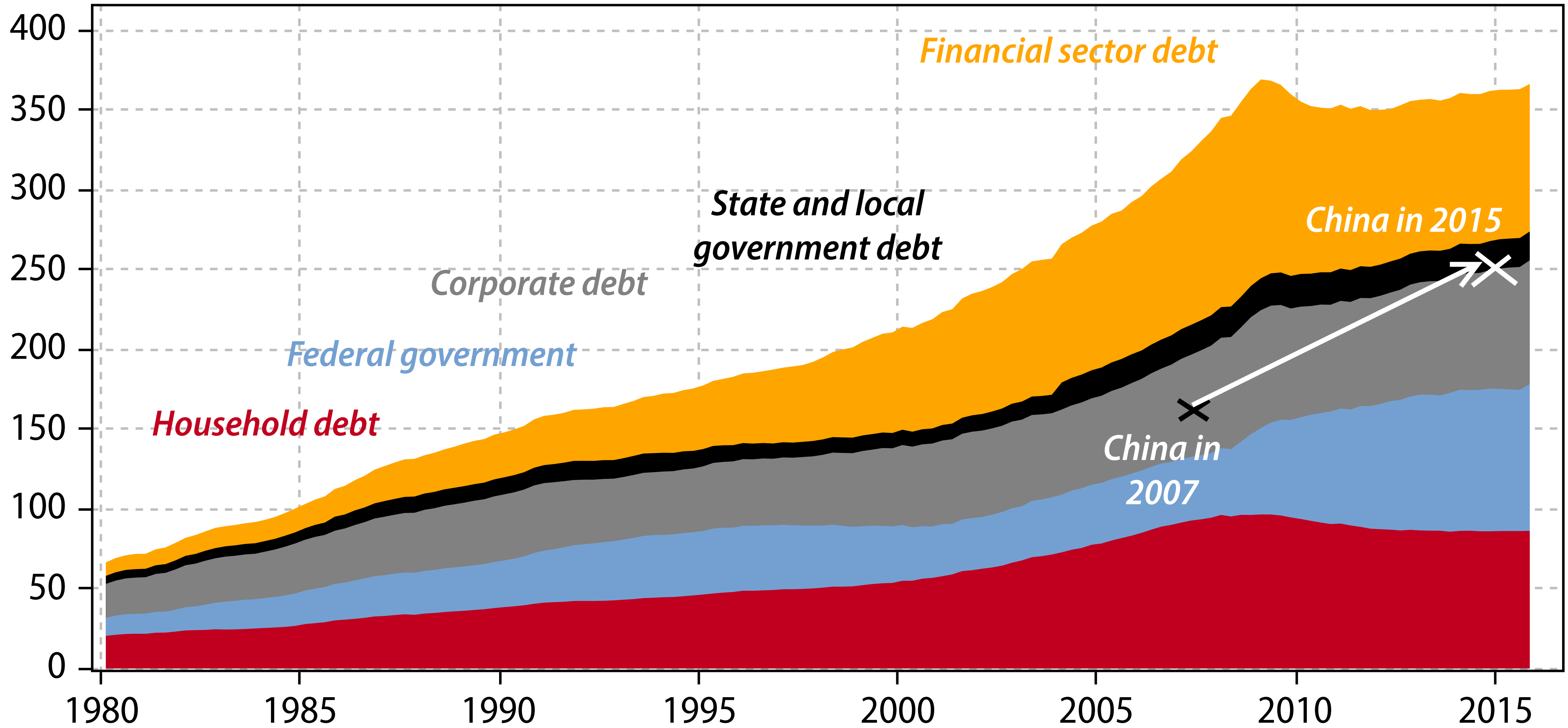
But how long can that last?

The Evolution of US Debt (and China) as a % of GDP



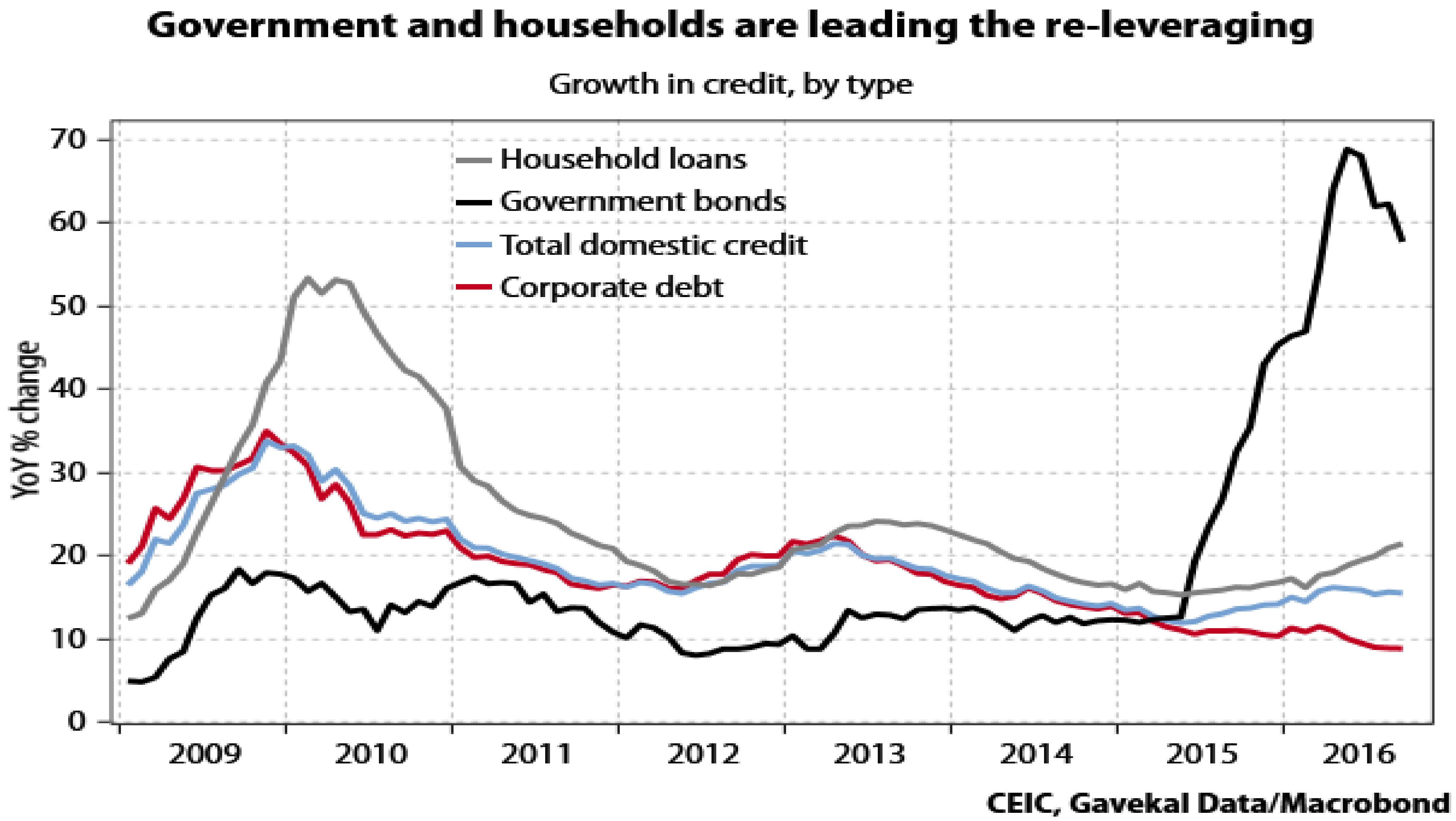
Gavekal Data/Macrobond

Key Take-Aways

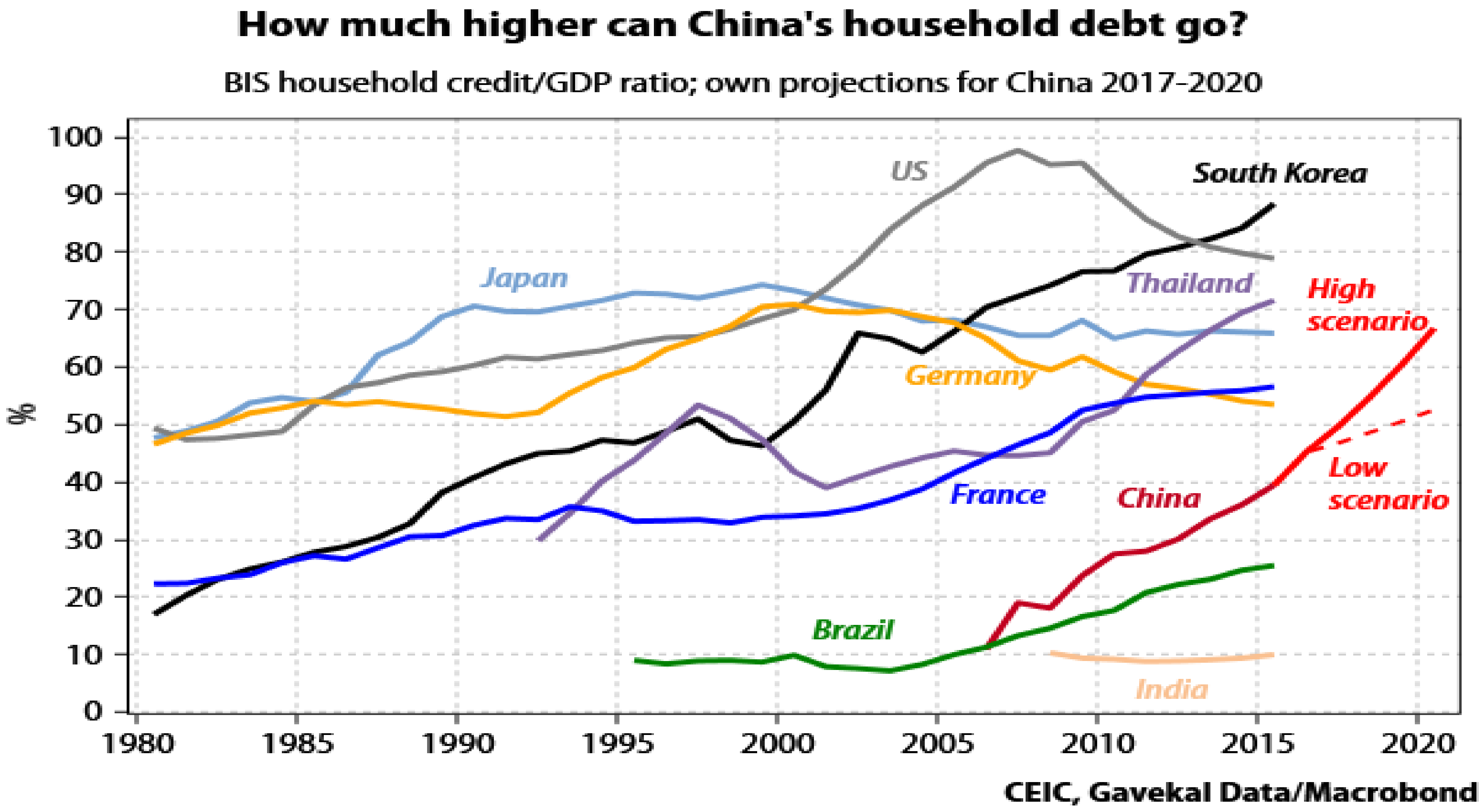
- CCP is focused on keeping growth stable and avoiding potentially risky reforms in the run-up to the 2017 Congress.
- The housing cycle remains the key to the shorter-term outlook, as real estate is the only sector responding much to policy stimulus.
- Capex outside of real estate is weak, and fundamentals limit the growth potential from housing. Overall growth will thus keep slowing.
- Repeated stimulus is increasing stress in the financial system, and weighing down the economy with low-return assets.
- But is a damaging financial crisis imminent? Or is China is in a holding pattern of gradually slowing growth and gradually increasing structural problems? Or maybe something else all together?

2- Does the Chinese economy face a debt & currency crisis?

Most of the debt increase has come from the government, and households



Chinese household debt is rising, but from a low base



Two kinds of financial crisis

Country runs large current account deficits for years

Becomes dependent on the willingness of foreigners to fund its lifestyle

Once foreigners want out (Argentina, Greece, Thailand…) the financial system implodes

Banks lean too far above their skis, usually by lending too much to real estate

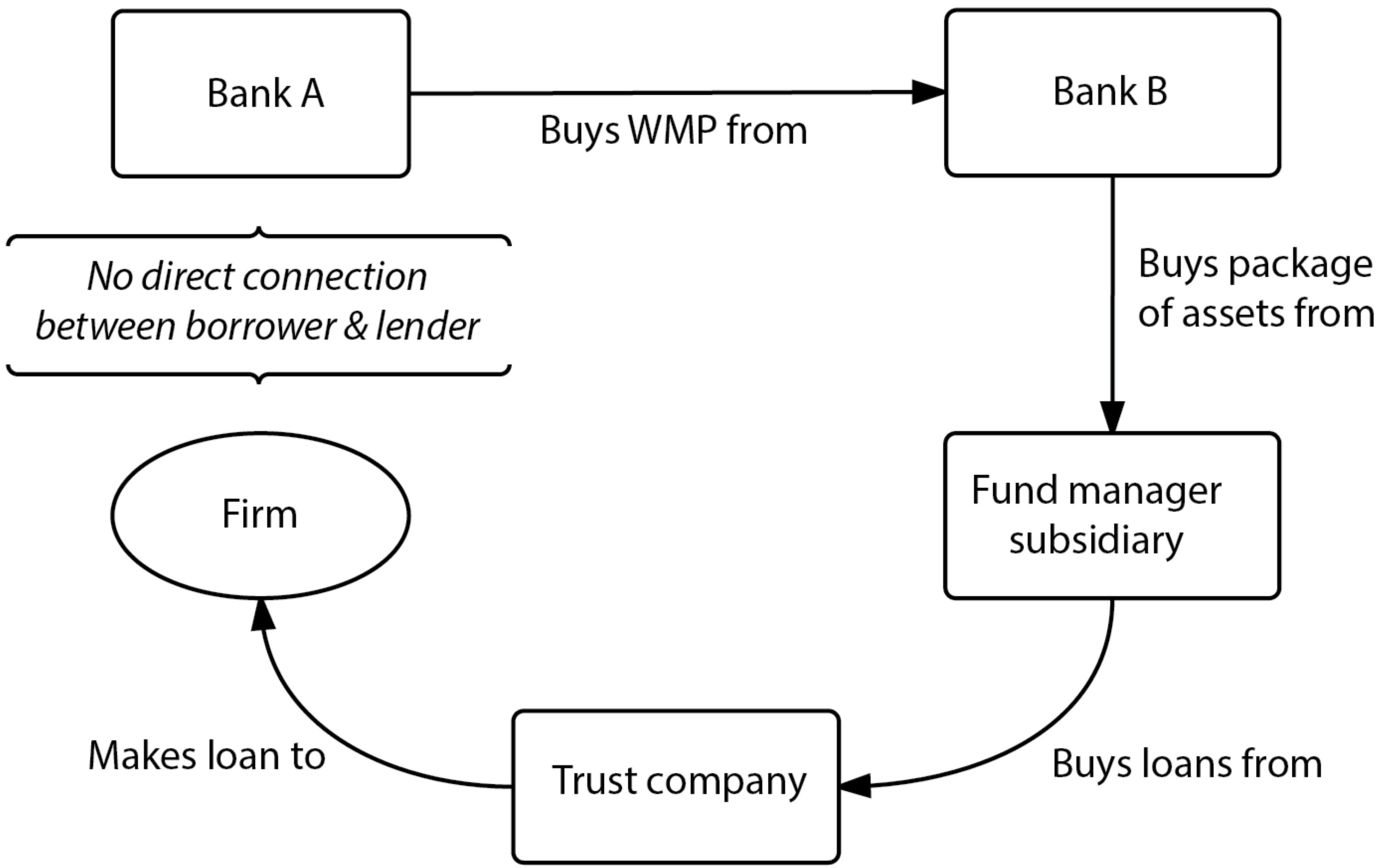
Bank outgrow their own equity and so borrow short (money markets) to lend long

Money markets refuse to lend to banks and so banks need to raise equity quickly

Figuring out the Chinese pyramid of credit is no simple task

Credit creation in China can be extremely complex

Stylized example of a loan involving bank and non-bank institutions



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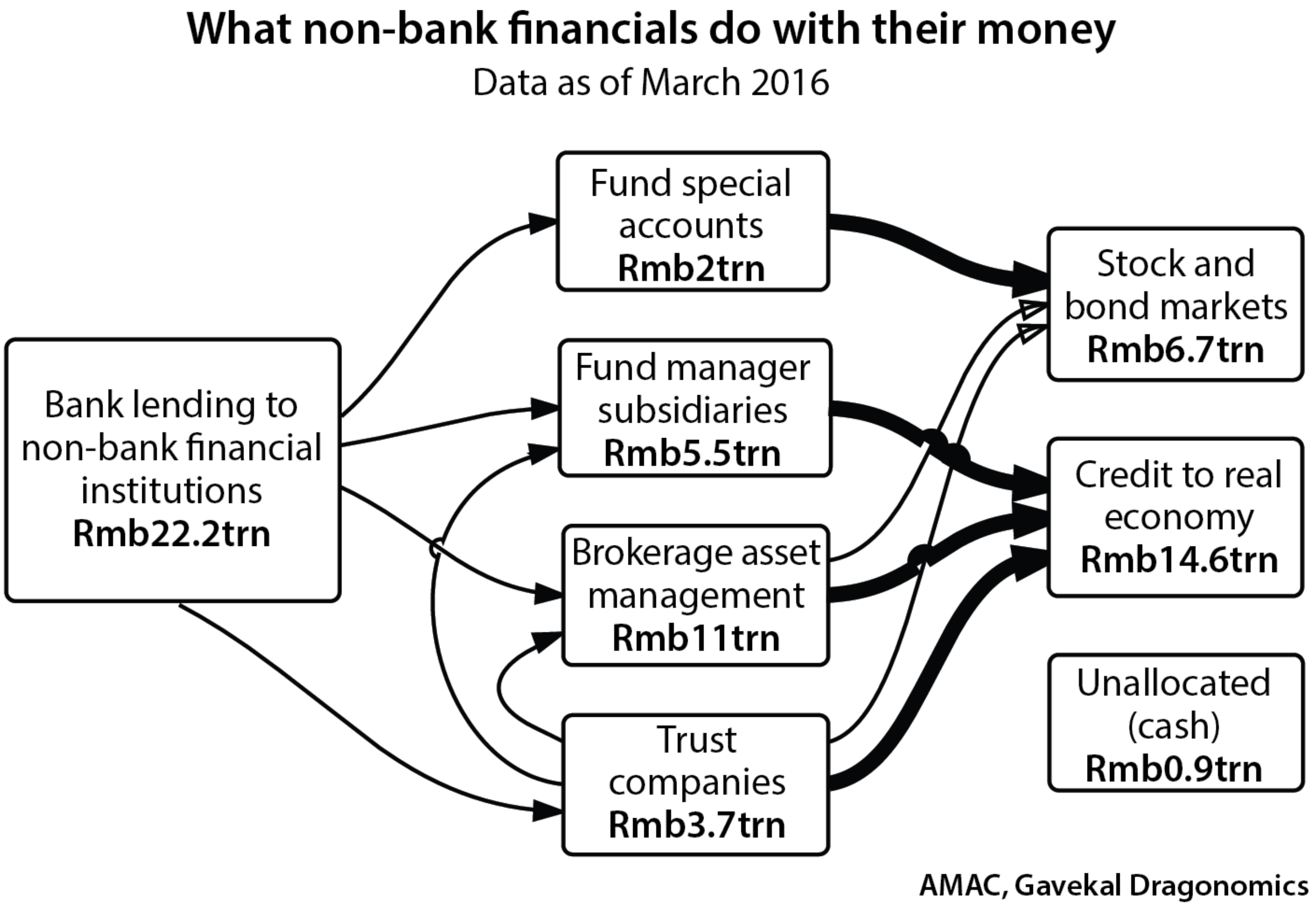
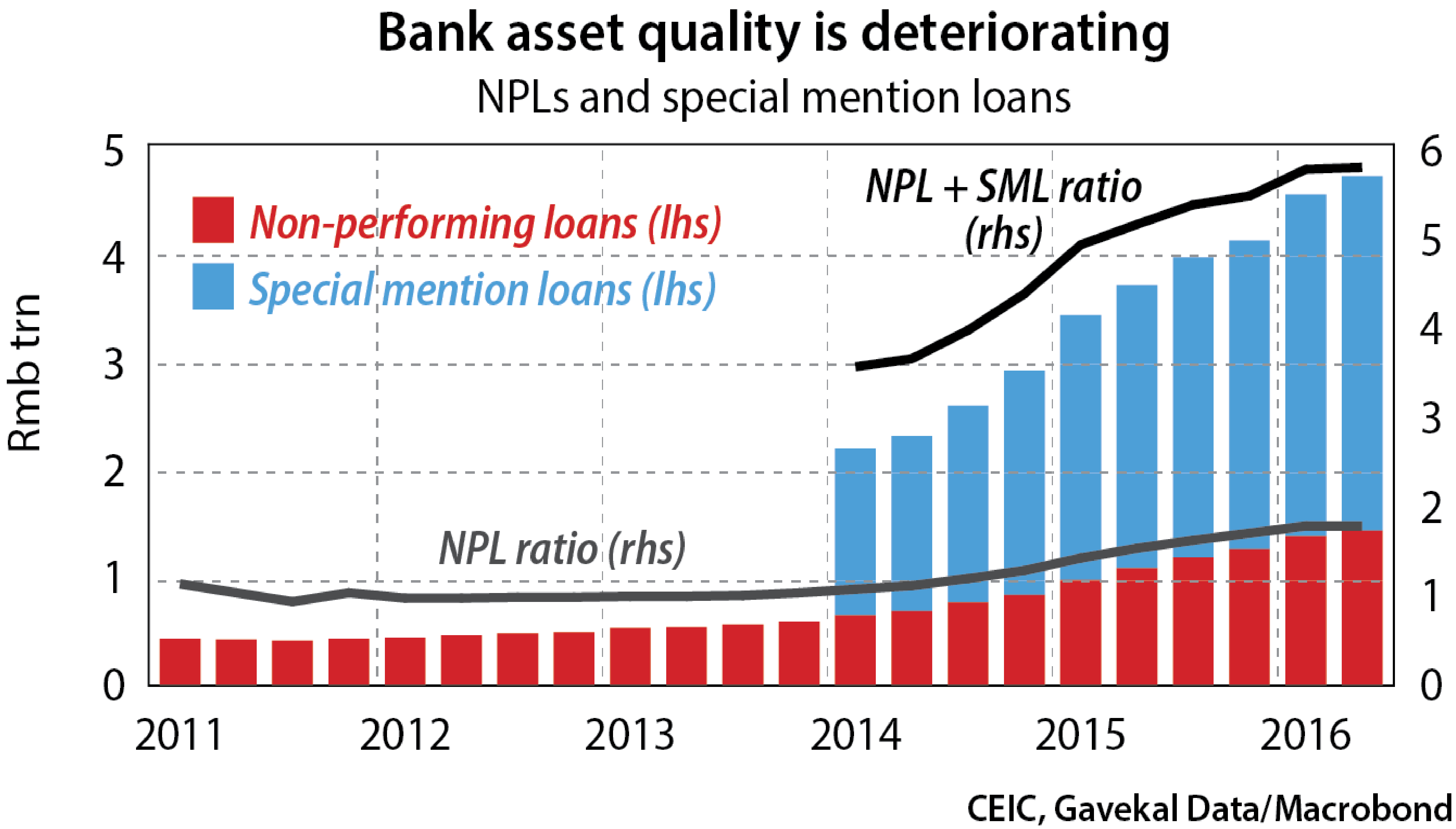
Non-bank lending is a key component of most firms' financing



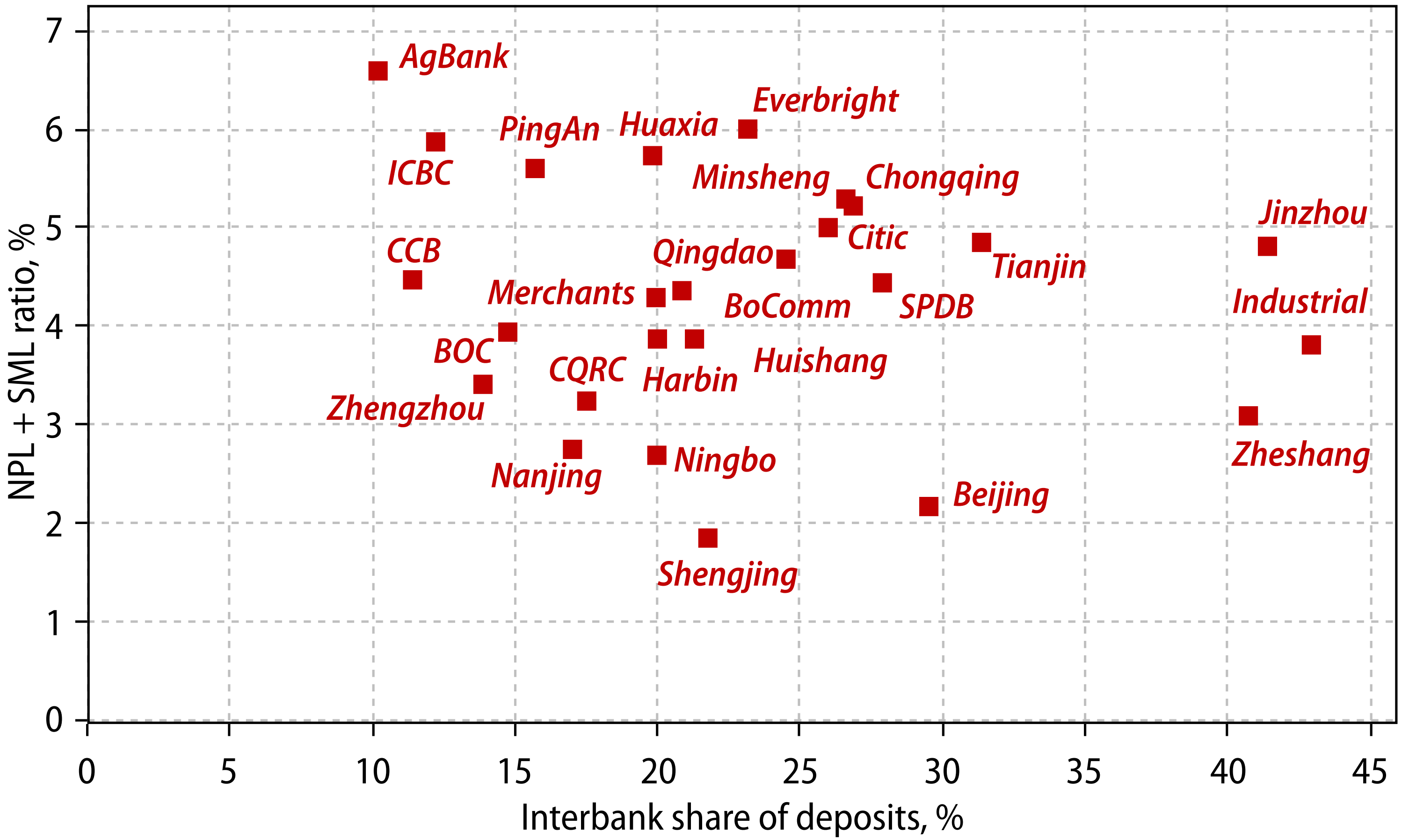
But at the end of the day, NPLs have been on the rise for three years



So how worried should we be?

All banks got riskier in 2015, with more extreme outliers

Bank risk matrix, asset quality vs. funding vulnerability, 2015

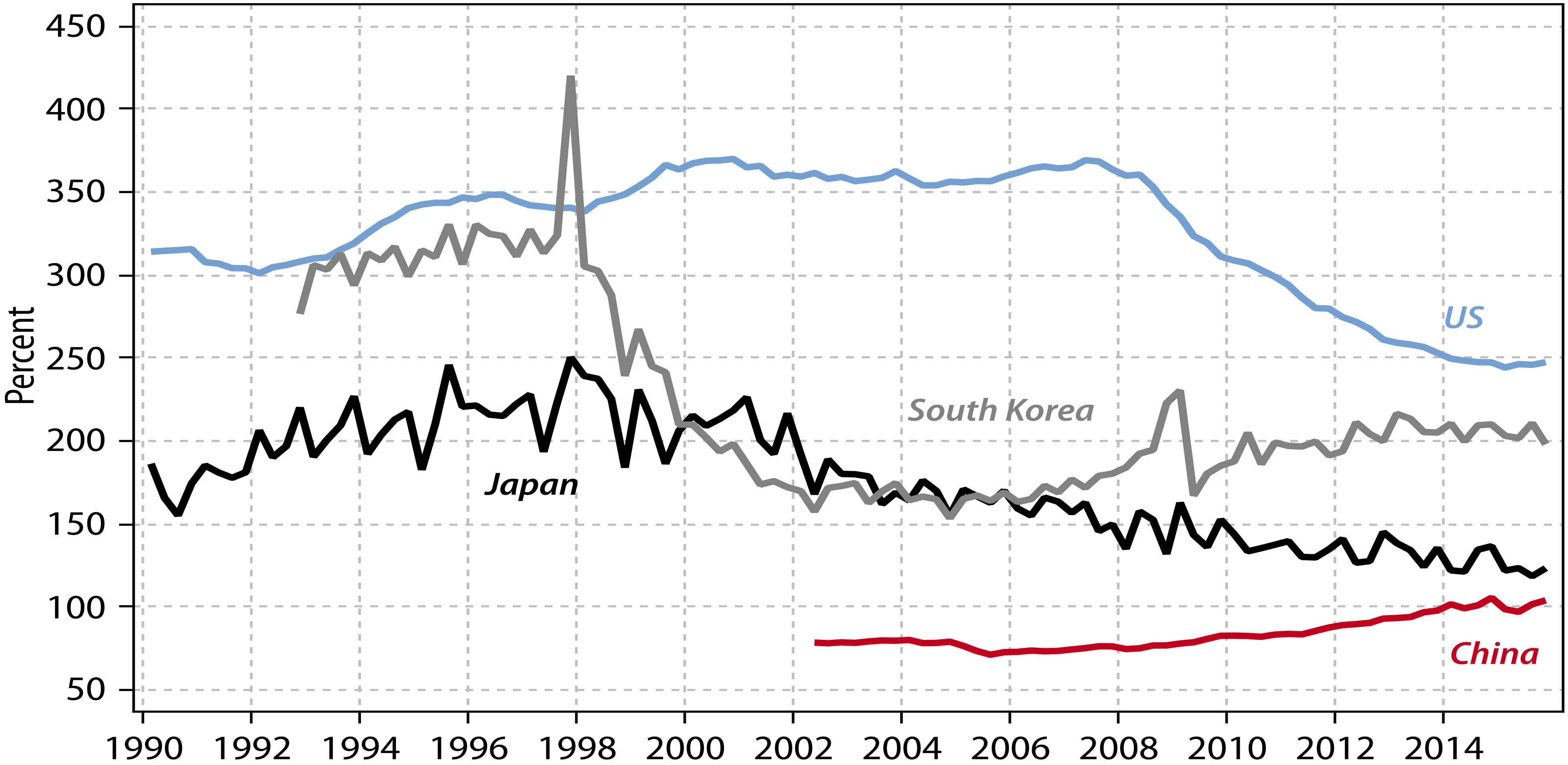


Wind, Gavekal Data/Macrobond

Bank crisis happen because of funding issues

China's bank funding does not look that stretched in a global context

Ratio of credit to the private sector (BIS estimate) to bank deposits, by country



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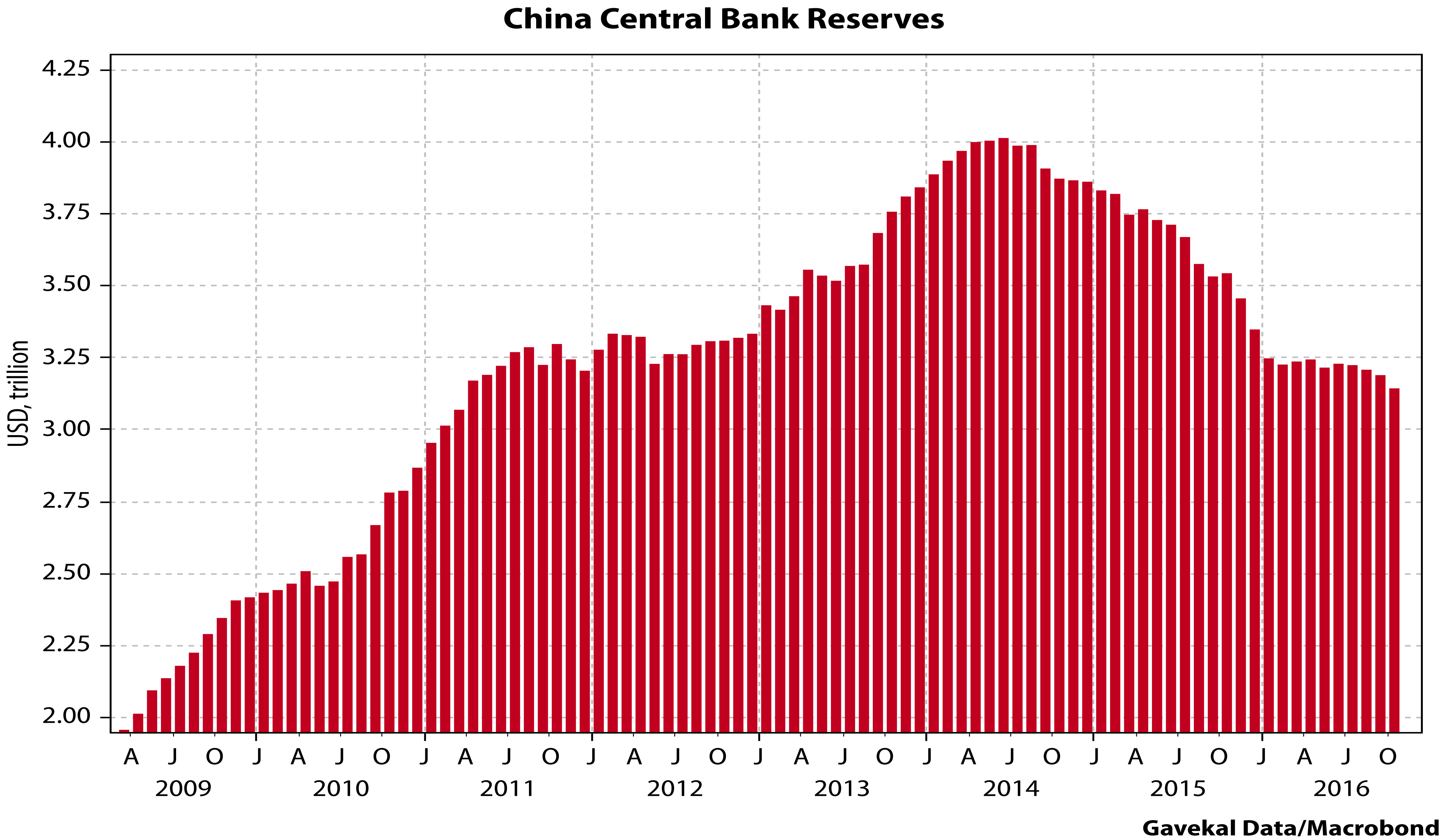
Are falling FX reserves telling us that China suffers from massive capital flight?



Two paths to RMB collapse

Government decides it wants to devalue

Few signs of that so far – quite the contrary

Would likely amplify, rather than solve, China's core problems

Devaluation triggered by massive capital flight

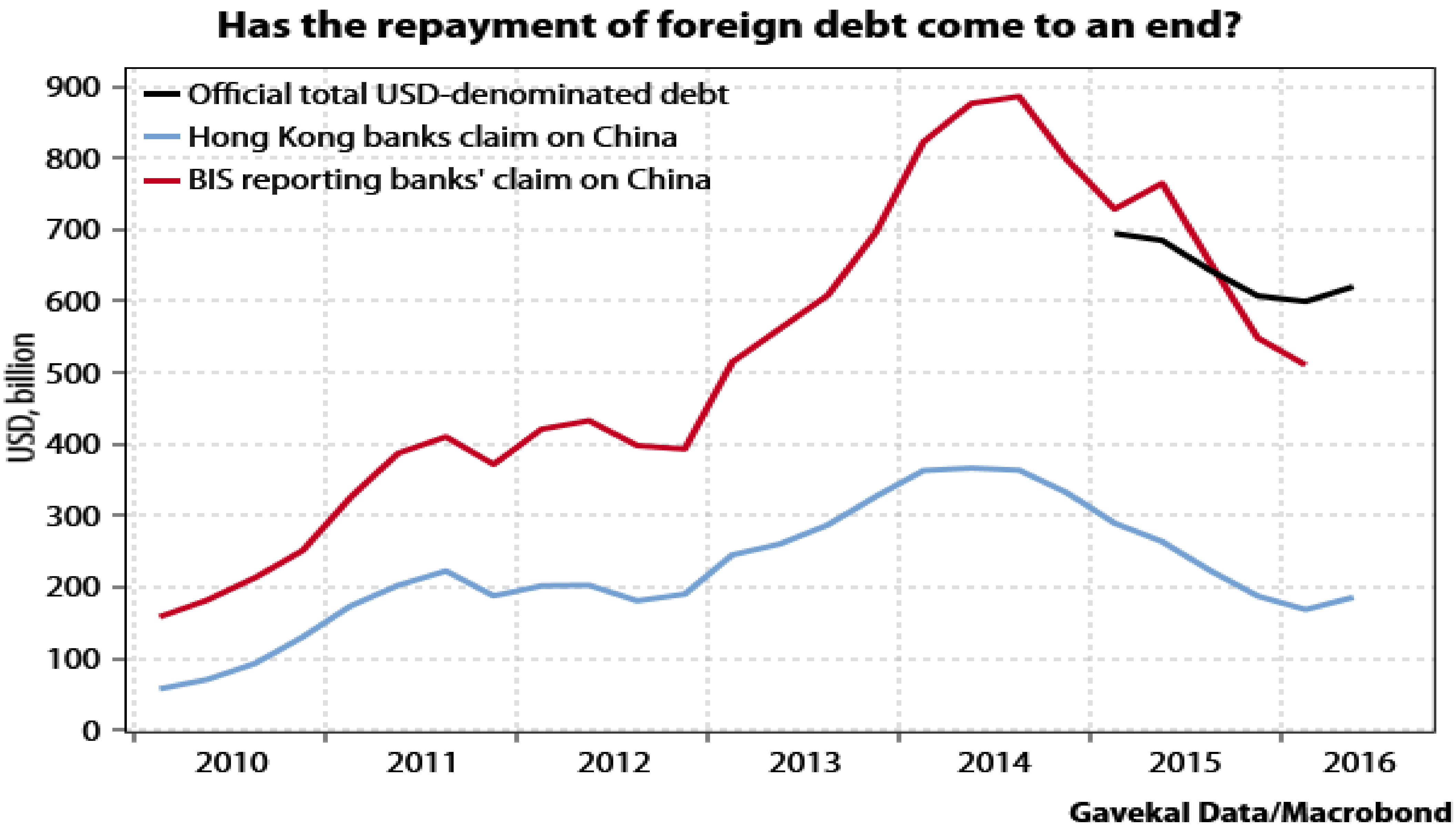
How is the money leaving?

Where is the money going?

Can US$ 1tr really move out without leaving a trace?

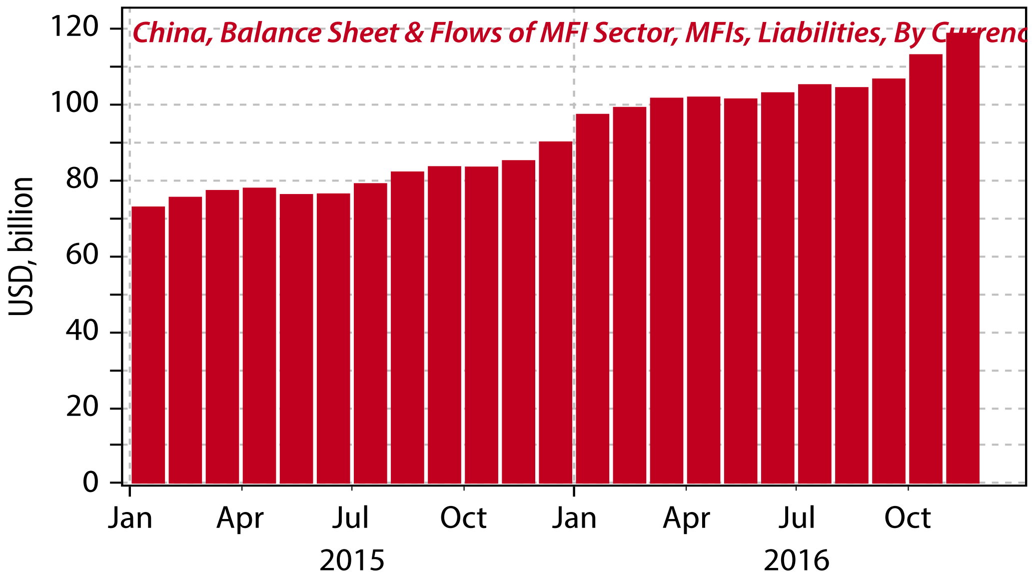
How could reserves fall this much when the trade balance is so high?

Some of the shrinking FX reserves went to pay down US$ debt

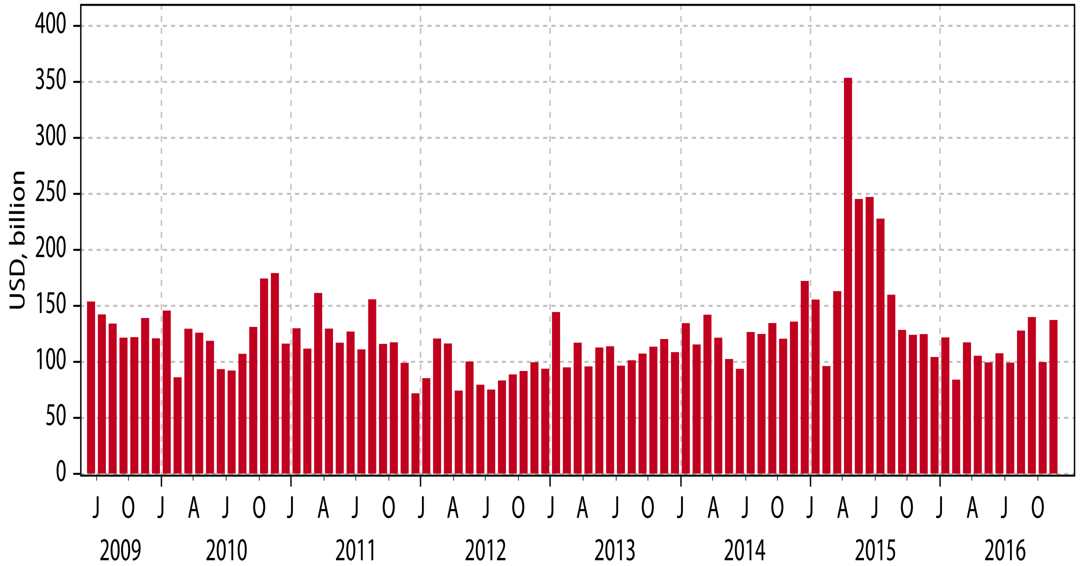


If US$ 1 trillion left China, how did it leave?

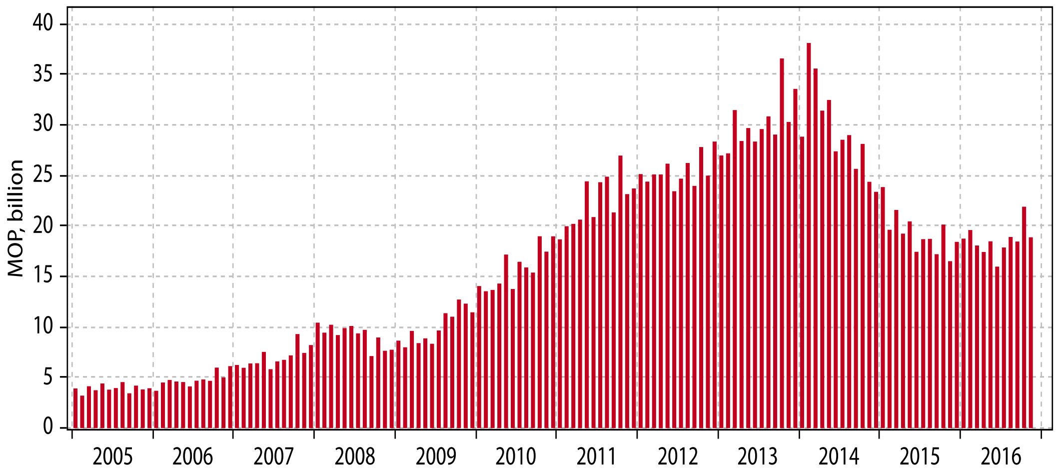
China Household Bank Deposits In Foreign Currency, USD



Hong Kong, Share Trading, Turnover, USD



Macao Gaming Revenue



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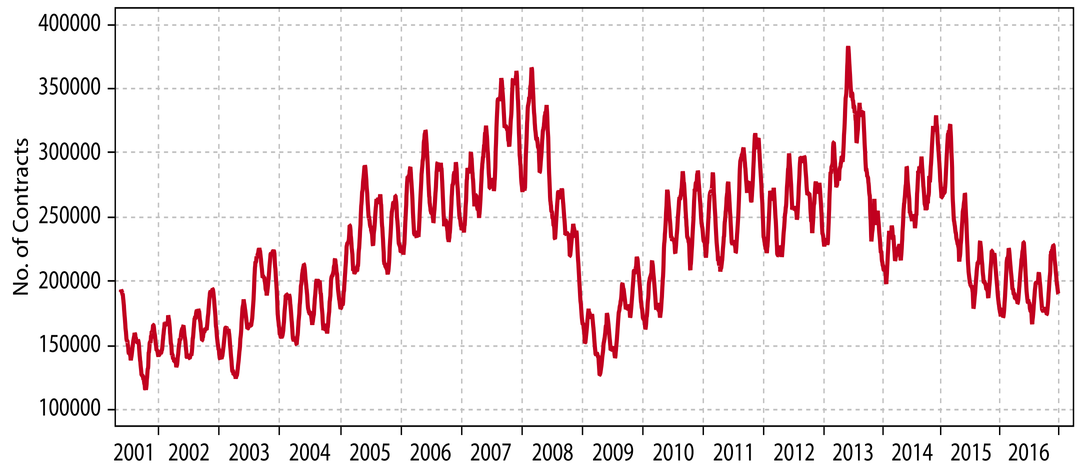
CBOT Treasury Bonds U.S. 30-Year, Future, Volume



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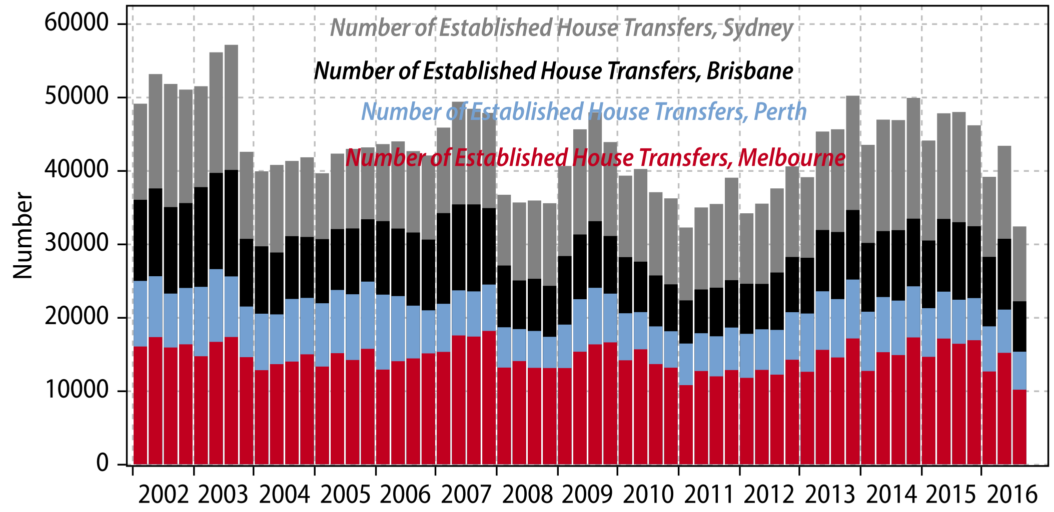
And where did it go?

If money was pouring out of China, you would expect gold to rise?

Gavekal Data/Macrobond

If money is pouring out of China, why are Oz real estate volumes tanking?



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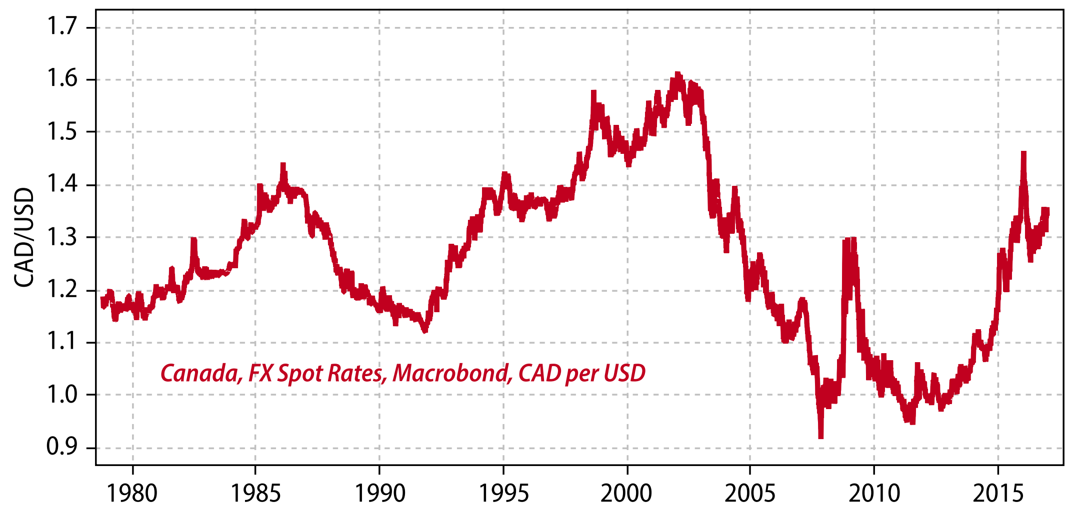
Why is the Loonie at a decade low?



Gavekal Data/Macrobond

Why have returns on Macao casinos been so dismal?

Gavekal Data/Macrobond

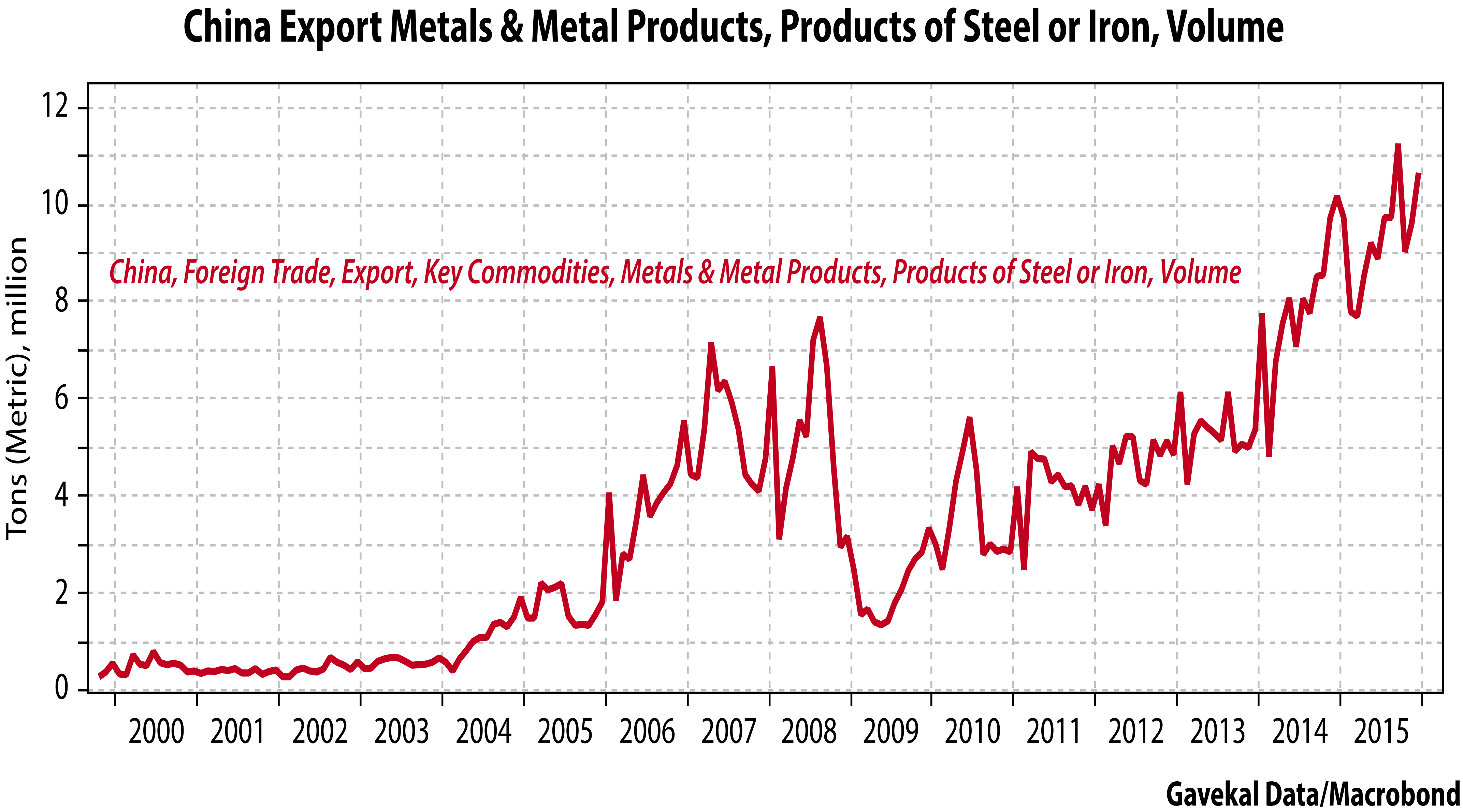
3- Is the Publicity bureau of the CCP simply hiding China's Reckless Mercantilism?

Uncompetitive countries don't have largest trade surpluses ever witnessed

Gavekal Data/Macrobond

Nor do they keep gaining market share against everyone

If you aim to export excess capacity, doesn't projecting weakness make sense?



4- Or could China simply be masking a growing imperialism?

Xi Jin Ping has been very clear about his policy goals

Anti-corruption drive

Put a third of Petrochina management in jail

Stop paying 'wrong' price for commodities

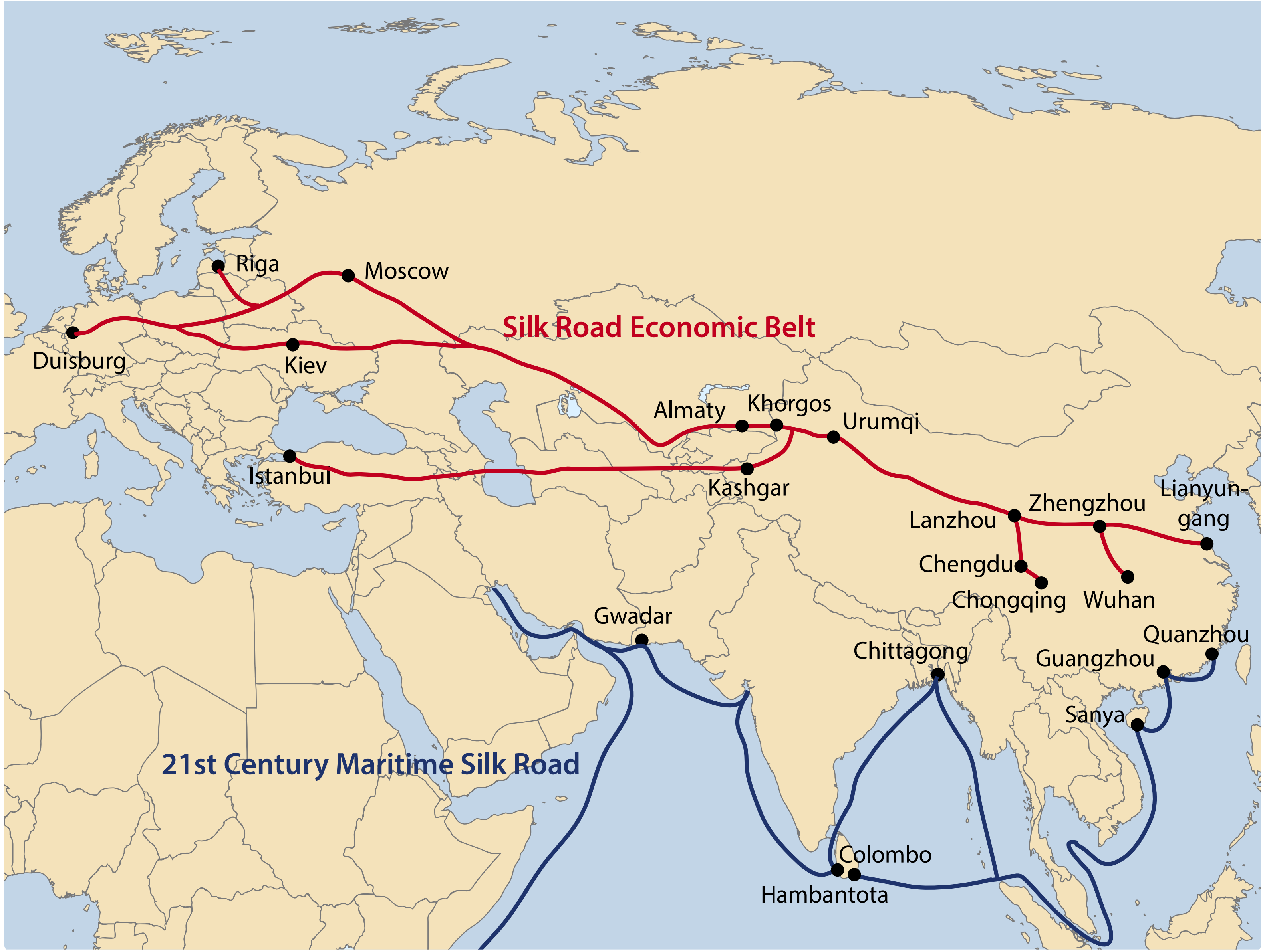
China Dream

Establish China as genuine imperial power within Asia (OBOR, Silk Road, AIIB…)

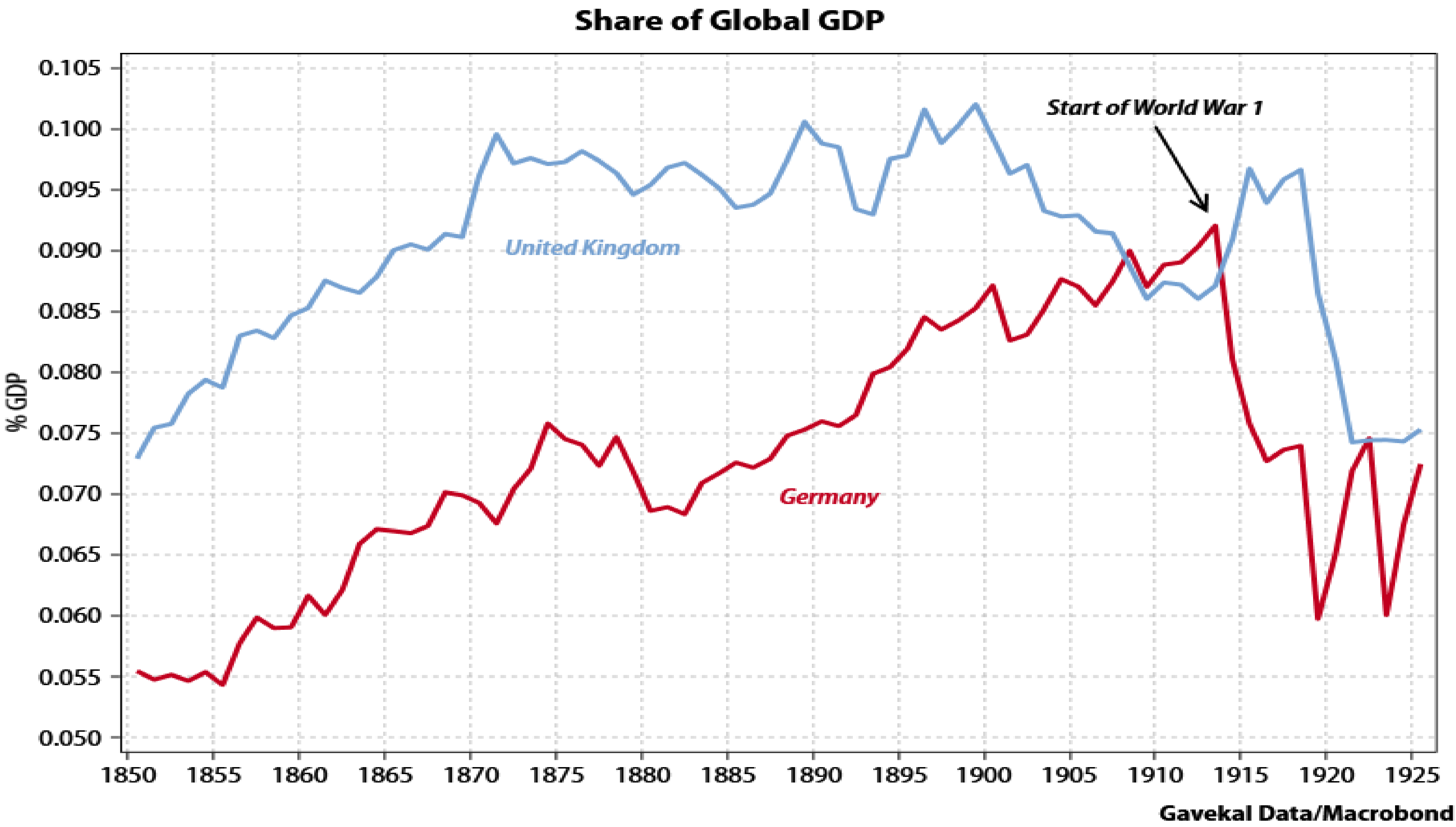
Avoid open conflict with USA

Are those goals moving forward or backwards?

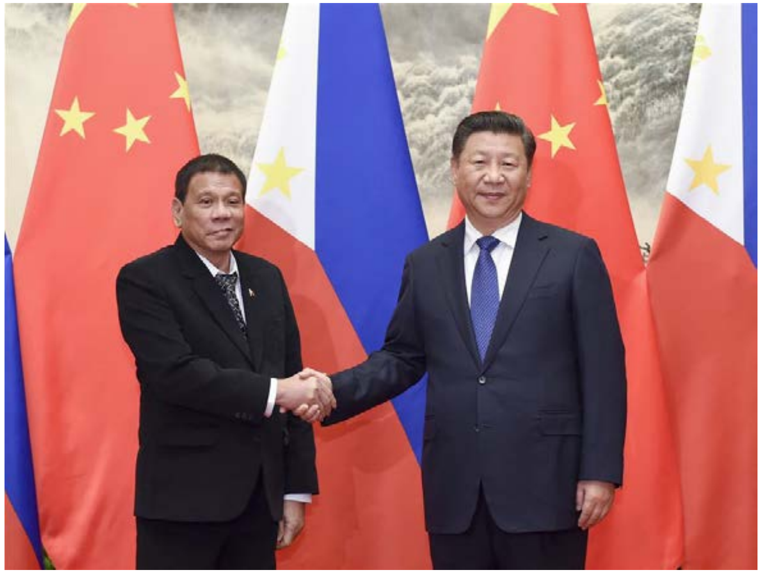
The real threat: will China overplay its hand?

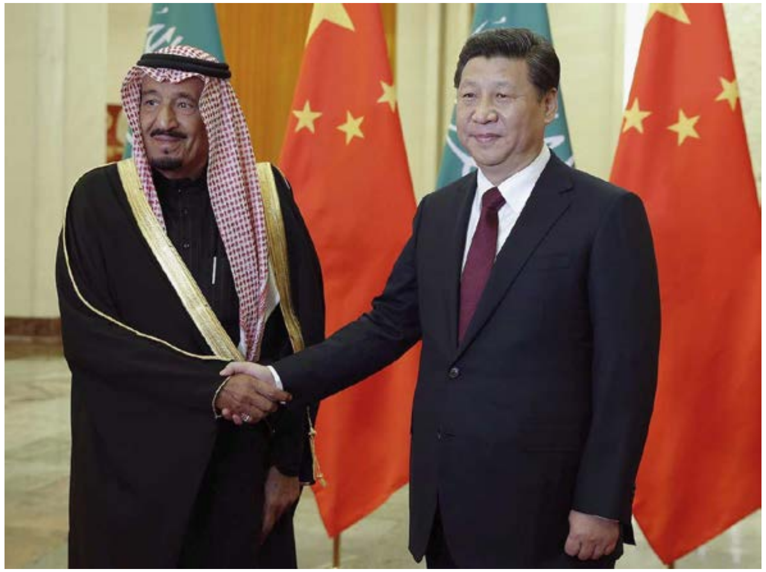


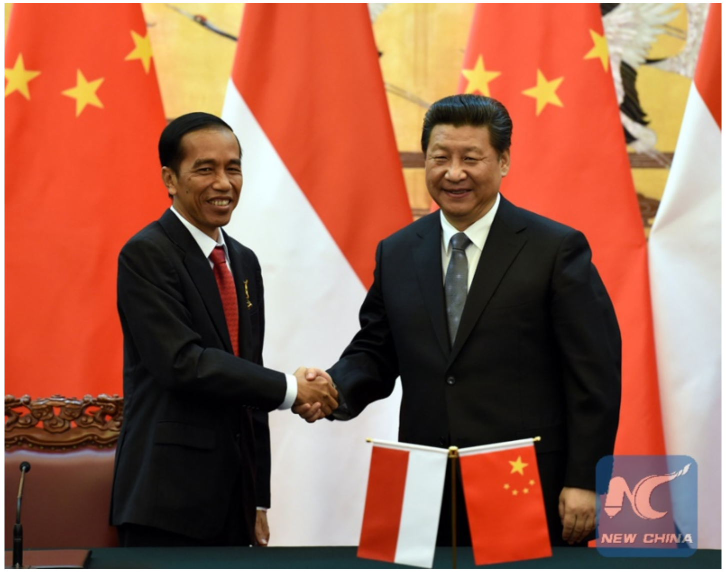
History: if you want to eclipse leading power, do so discreetly



The geopolitical shifts are already happening at full speed







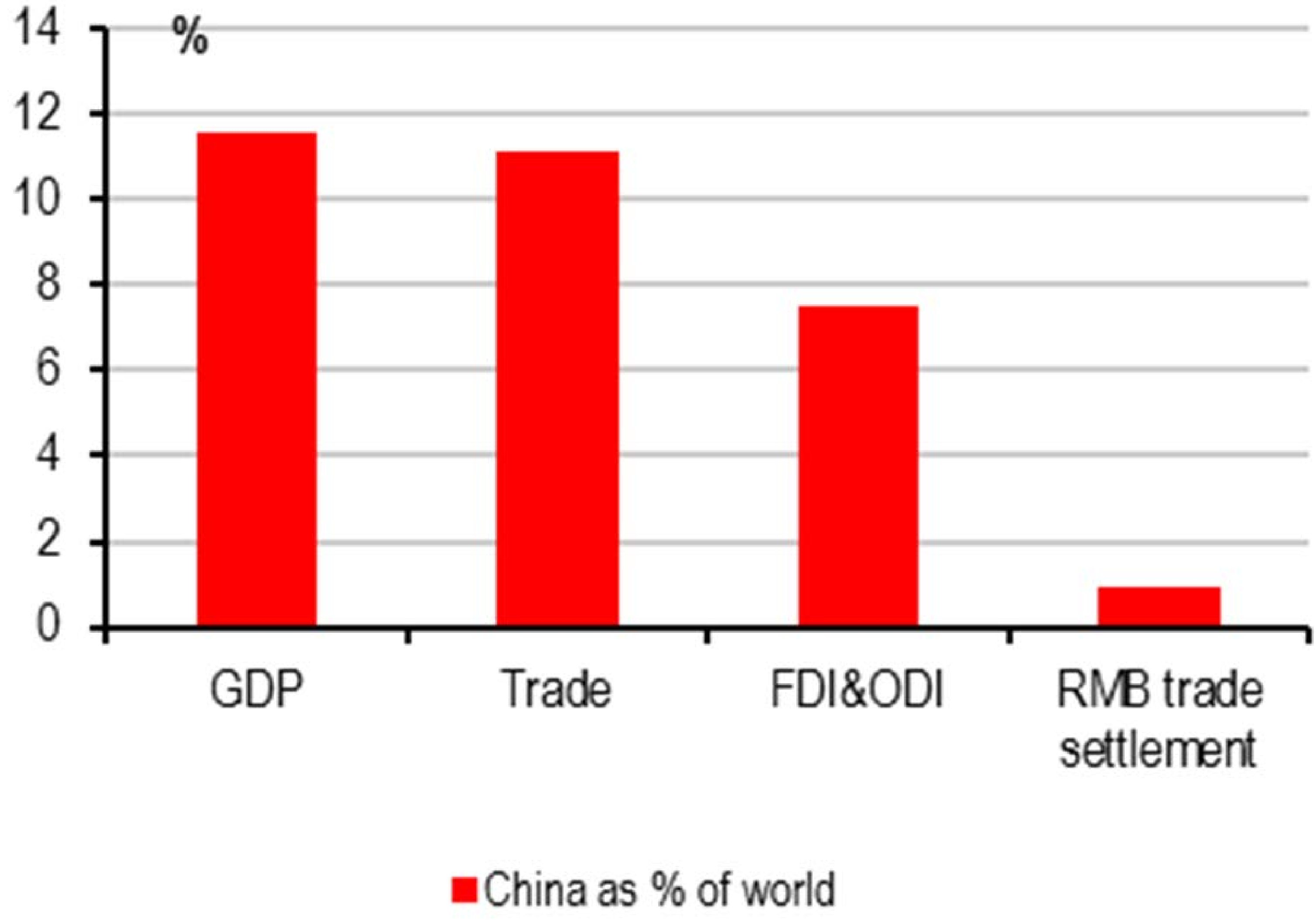
And if you want to replace US$, offer better risk-returns than US Treasuries

Evolution of a US$100 invested in 5 year govt bonds in China, USA, Germany

Gavekal Data/Macrobond

- Over the past five years, RMB bonds have offered some of the best risk-adjusted returns in the fixed income world.
- The excess returns against US Treasuries were provided by higher yields, and steady currency gains.
- **Is this combination likely to last?**
- If so, maintaining a position in Chinese fixed income makes sense for portfolio diversification and capital gains.

The big bet: will Chinese all sell their RMB? Or foreigners start to use RMB?



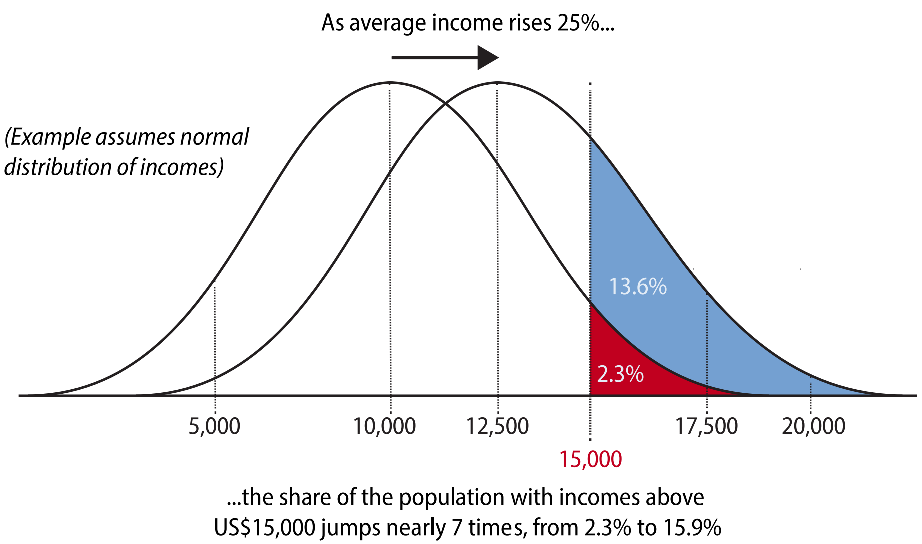
Source: World Bank, UNCTAD, SWIFT, 2012 data

5- China's sources of growth

The framework of the acceleration phenomenon

Illustrating the acceleration phenomenon

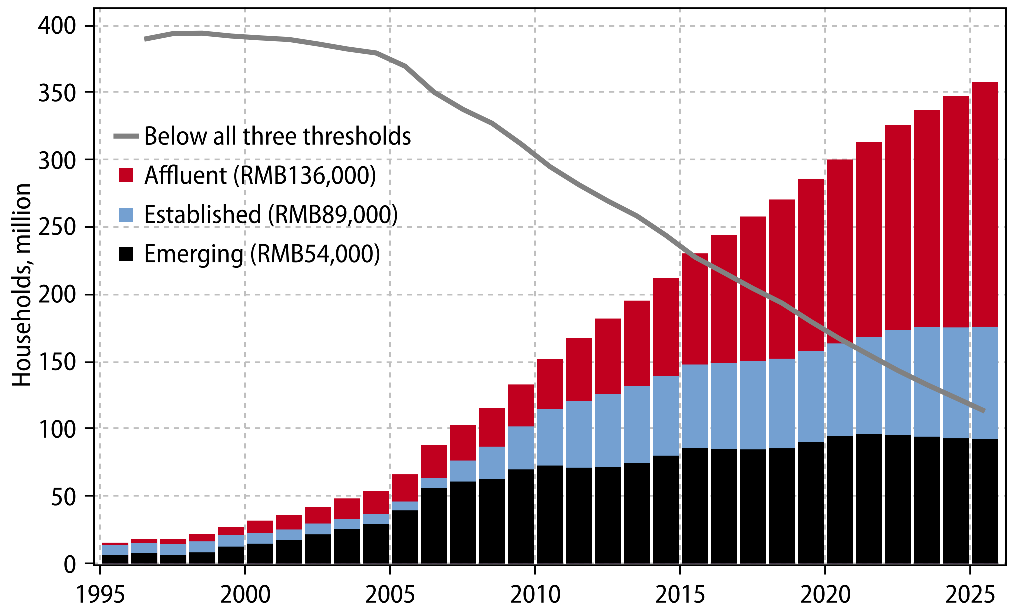
Why growth in some markets can be much faster than total income growth



Gavekal Dragonomics

Affluent households are now the fastest-growing consumer group

Number of households in each income group; projections for medium growth scenario



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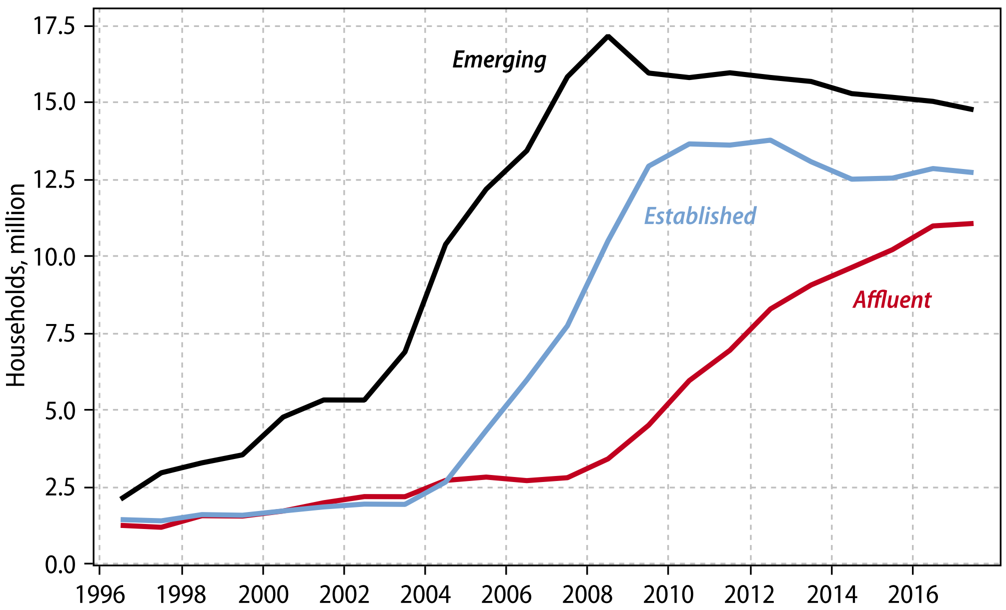
Our framework to identify winners and losers in the consumer market is the "acceleration phenomenon": the fact that spending on particular goods and services can accelerate sharply when lots of households cross the appropriate threshold of affordability. As the diagram above illustrates, markets for individual goods and services can grow many times faster than average income when lots of households are crossing the right threshold. And the markets that are not accelerating must, by definition, be decelerating.

We use three income thresholds that can be linked to broad categories of goods and services. "Emerging" consumers are starting to purchase basic mass-market products; "established" consumers are buying their first car and branded consumer goods; "affluent" consumers are branching out into higher-end goods and services. In 2015, we estimate there were roughly 86mn emerging households, 62mn established households and 82mn affluent households; a further 228mn households were below all of these thresholds.

Affluent consumers experience the acceleration phenomenon

The three waves of the acceleration phenomenon

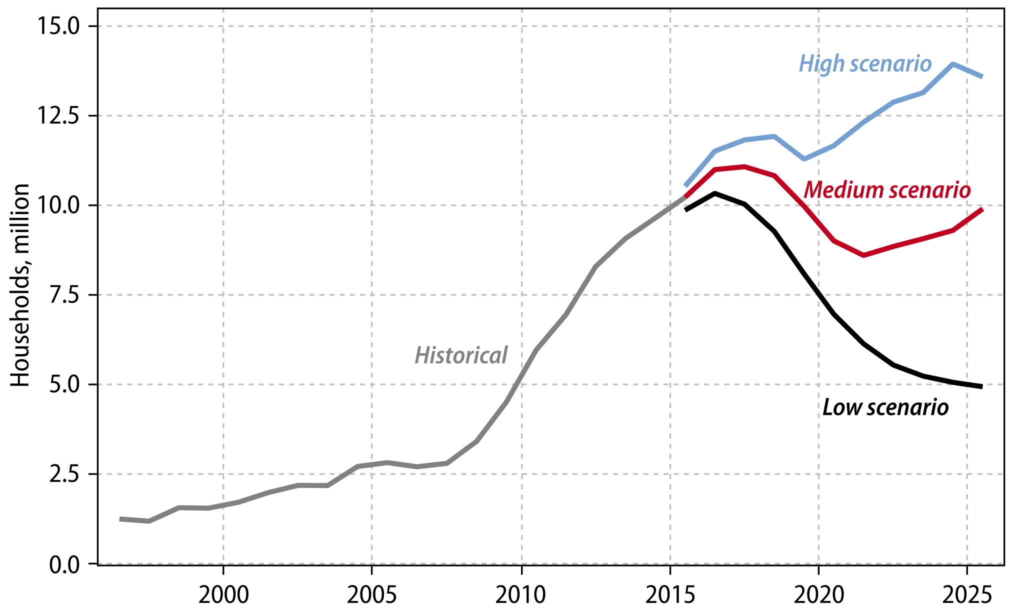
Number of households crossing each income threshold, 5ycma



Gavekal Data/Macrobond

The acceleration in affluent consumers will likely peak soon

Households crossing affluent income threshold, 5ycma, by growth scenario



Gavekal Data/Macrobond

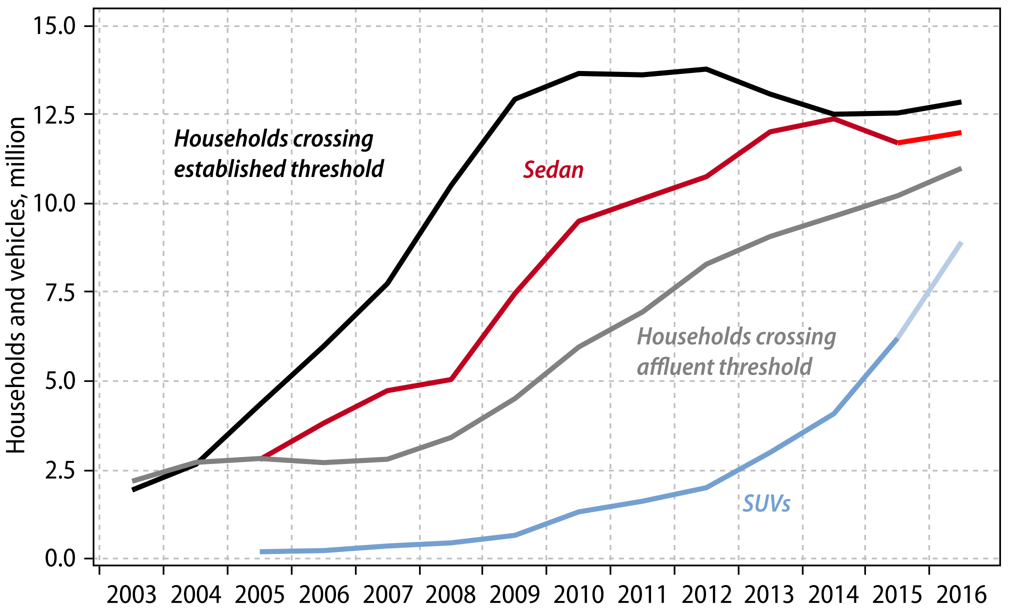
The key to the acceleration phenomenon is pinpointing when growth in each group is fastest. The acceleration in emerging consumers got started in the early 2000s and reached its peak around 2007. The acceleration in established consumers was about three years behind, peaking around 2010. The acceleration in affluent consumers has been steadily building, and on our estimates 2016-17 should be close to the peak. The next couple of years should therefore be a very strong period for products favored by newly-affluent households.

How long the acceleration phenomenon in affluent households lasts depends a lot on how long rapid GDP growth can be sustained. A high-growth scenario (in which GDP growth only slows to 6% by 2025) points to a steady acceleration. In more plausible slower-growth scenarios, the acceleration in affluent consumers eventually fades, particularly after 2020. But note that this is not a projection of growth in total consumer spending, but of how much affluent-household spending outperforms the aggregate.

The acceleration phenomenon in automobiles

Established households buy sedans, affluent households buy SUVs

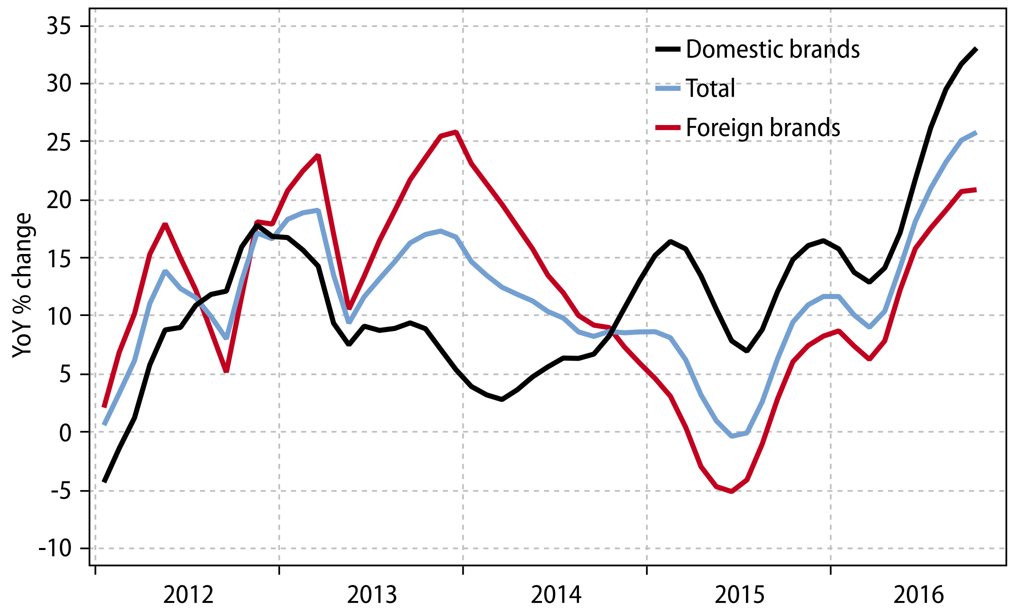
Number of households crossing thresholds (5ycma) vs. auto sales



CEIC, Gavekal Data/Macrobond

SUVs have enabled domestic brands to outgrow foreign brands

Sales volume of passenger cars, by brand source, 6mcma



CEIC, Gavekal Data/Macrobond

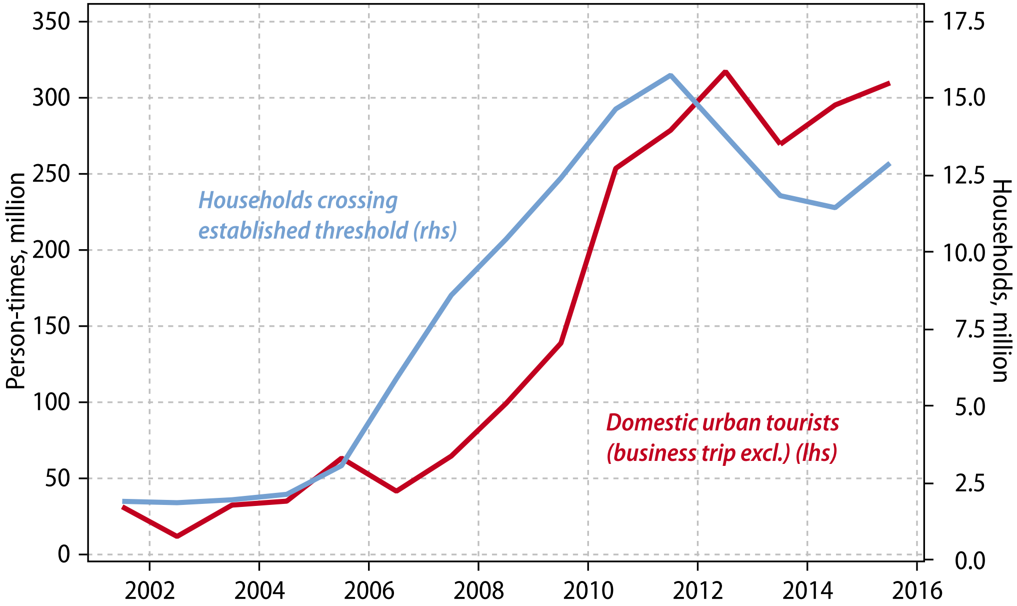
The acceleration phenomenon helps explain big recent changes of leadership in consumer markets. Cars are a good example: growth in sedan sales has slowed since 2010, at the same time that the acceleration phenomenon in established consumers peaked. As the acceleration phenomenon has shifted to affluent households, sales of higher-end SUVs have exploded from 1.3mn in 2010 to 6.2mn in 2015. The acceleration phenomenon illustrates how higher-income consumers are now dominating the auto market.

The shift in brand market share in the auto market is also a reflection of this phenomenon. In the early years of the SUV boom, foreign brands dominated. But now domestic brands have figured out how to produce decent-quality SUVs at a much more reasonable price, just as many more affluent households demand these high-prestige vehicles. Sales of Chinese-branded SUVs grew by 52% YoY in 1H16, well above the 34% achieved by foreign brands. As a result, total domestic-branded sales also outperformed foreign brands.

The acceleration phenomenon in tourism

Domestic tourism has plateaued along with established households

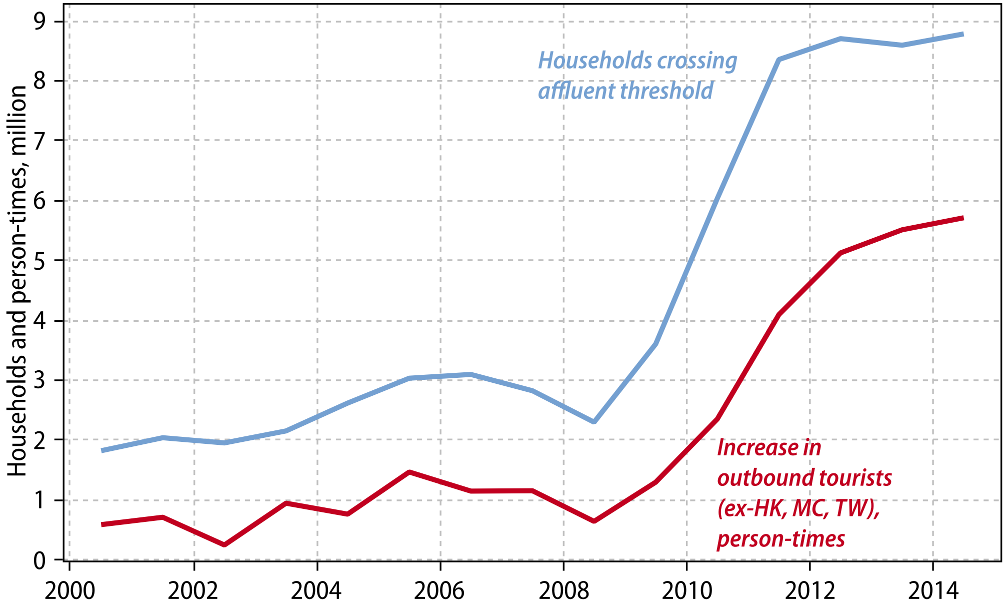
Annual increase of tourist visits vs. households crossing thresholds, 3ycma



Wind, Gavekal Data/Macrobond

Affluent households are driving the recent surge in overseas travel

Annual increase of tourist visits vs. households crossing thresholds, 3ycma



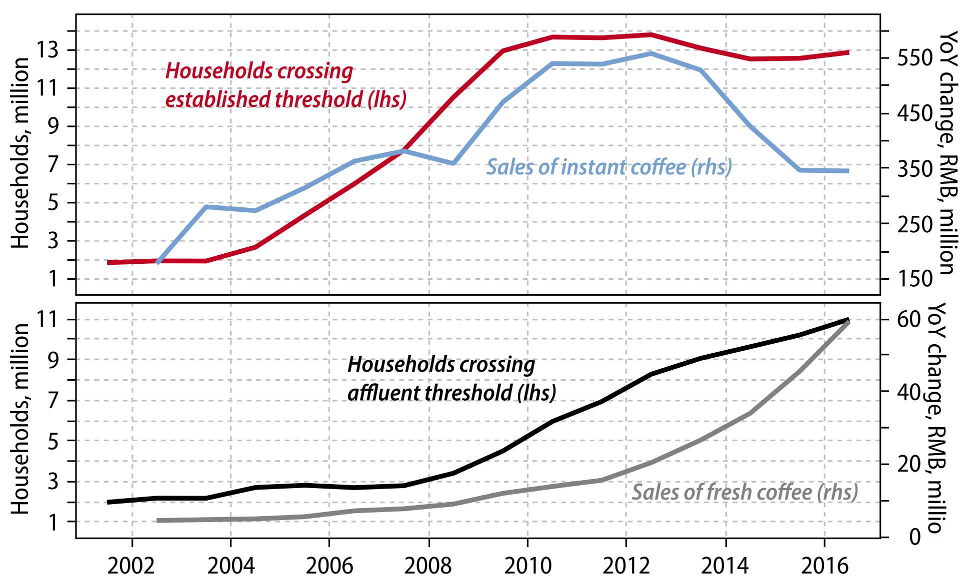
UNWTO, Wind, Gavekal Data/Macrobond

A similar dynamic is playing out in tourism, one of the biggest consumer services. Domestic tourism excluding business trips was about 500mn trips a year in 2005, and then increased by 40-60mn trips a year to 2008. Then growth in domestic tourism exploded as the number of established consumers also accelerated. But since 2010, growth in the number of established households has stopped accelerating, and so has growth in domestic tourism.

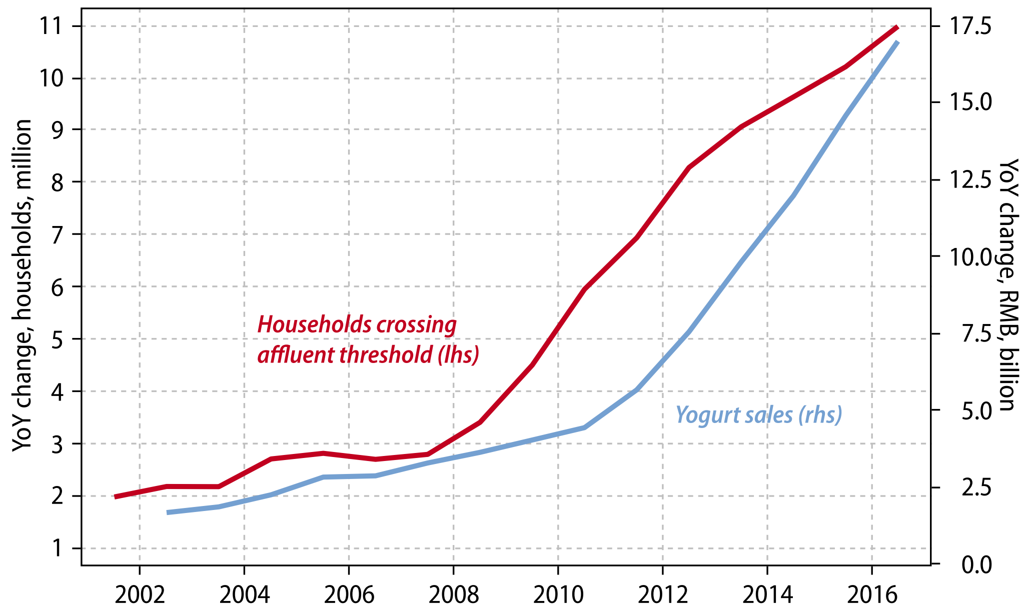
The acceleration phenomenon is now strongest for affluent households, who seem to thirst for the new experience of foreign travel. As households crossing the affluent threshold surged from around 2mn in 2008 to over 9mn since 2012, the annual growth in foreign tourists also surged from 0.6mn to nearly 6mn. The trajectory of the acceleration phenomenon should mean that foreign tourism has a few more years of rapidly accelerating growth before it starts to cool down.

The acceleration phenomenon in food and drink

Affluent households favor fresh coffee over instant



Yogurt also seems to be a favored snack for affluent households



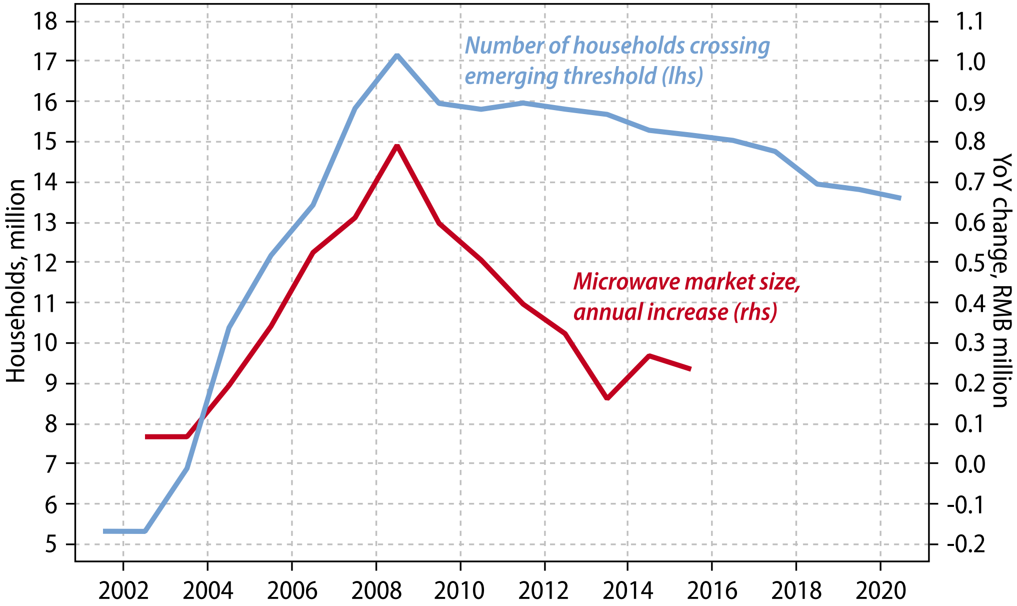
The acceleration phenomenon does not say anything about how fast China's total consumer spending will grow, but it is very useful for understanding which products are going to over- or under-perform. With the acceleration phenomenon shifting from established to affluent households, in most markets this means the high end will outperform the low end. For instance, since 2010 consumption of instant coffee has slowed down, while sales of more-expensive fresh coffee have begun to surge.

Another way of putting this shift is that the fastest growth is no longer in basic staples, but in those affordable luxuries that less price-conscious affluent households are more likely to throw into the shopping basket. The acceleration in the number of affluent households after 2010 also parallels the acceleration in sales of yogurt. Of course, this trend is also related to a cultural shift in which dairy products are perceived as healthy. But affluent households are the ones who have more money to express these changing tastes.

Losers from the acceleration phenomenon

Appliance growth has slowed as the acceleration phenomenon fades

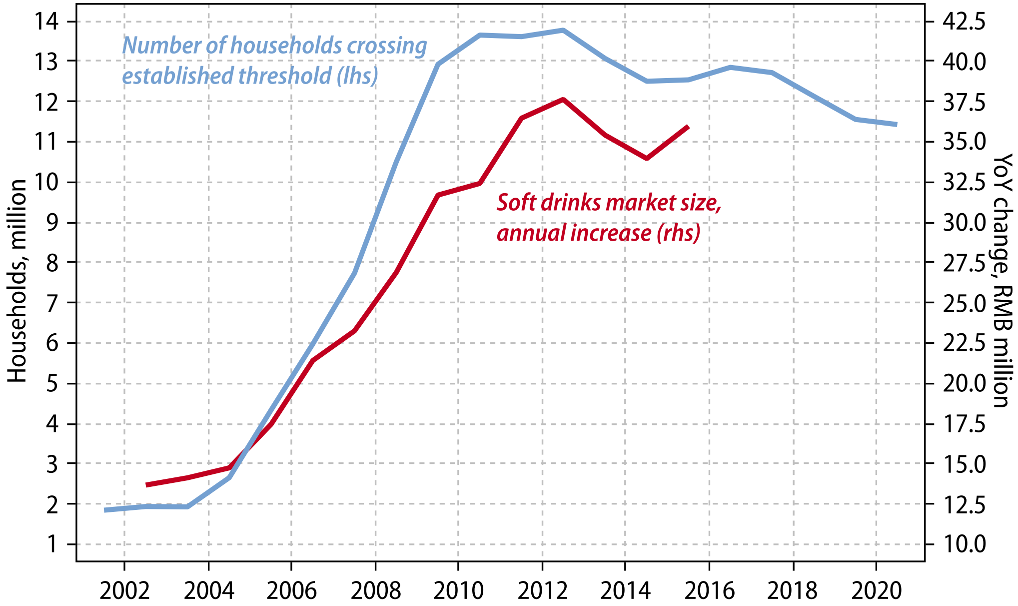
Growth in households and market, 5ycma, medium growth scenario



Euromonitor, Gavekal Data/Macrobond

Soft drinks growth has slowed as the acceleration phenomenon fades

Growth in households and market, 5ycma, medium growth scenario



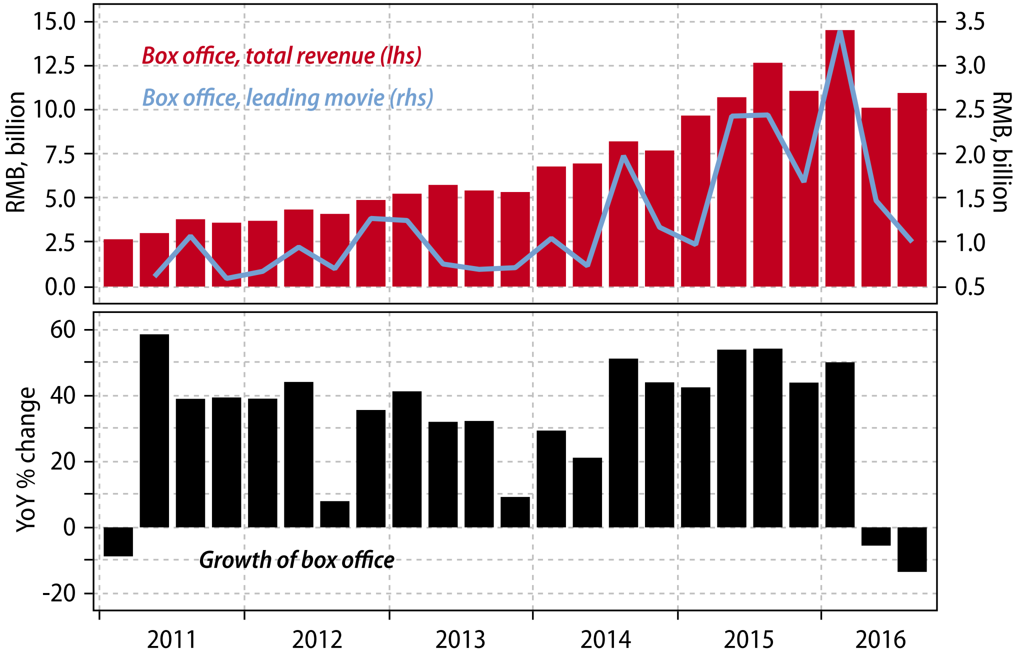
Euromonitor, Gavekal Data/Macrobond

For every product in which the acceleration phenomenon is driving above-average growth, there must be another that is experiencing below-average growth. So the counterpart of accelerating growth in the products favored by affluent consumers is slowing growth in products favored by emerging and established consumers. The acceleration in emerging consumers drove purchases of basic home appliances, such as microwave ovens. As the acceleration in such households is over, growth in that market has slowed.

Similarly, the acceleration phenomenon for established consumers drove particularly rapid growth in many fast-moving consumer goods, like soft drinks and other bottled drinks. The makers of such goods are now struggling to adapt to a slower-growing environment as support from the acceleration phenomenon fades. One strategy is to target new product segments that are more appealing to health-focused higher-income consumers: sales of sports nutrition products for instance have been accelerating.

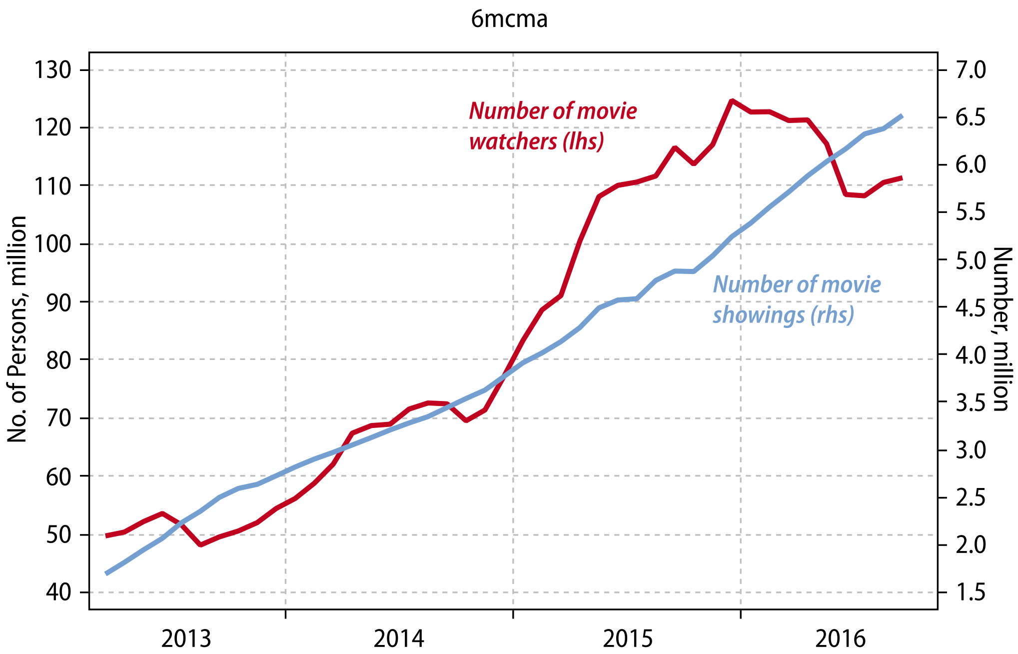
Entertainment is a booming but volatile sector

After a long rise, China's box office receipts were down in Q2 & Q3



CEIC, China Box Office, Gavekal Data/Macrobond

The supply of movies has steadily risen, but demand has softened



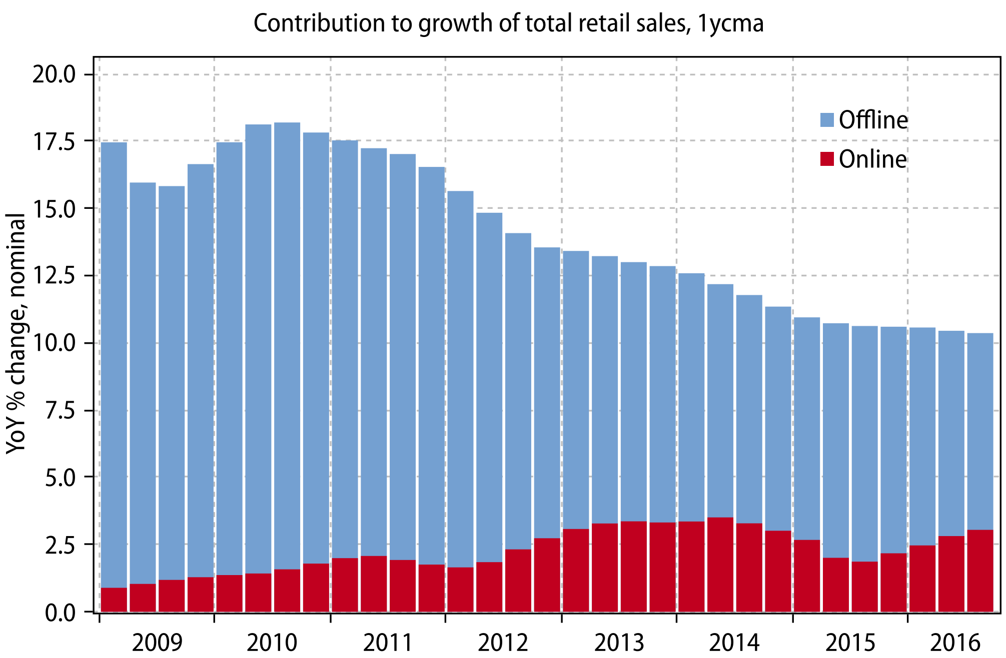
Wind, Gavekal Data/Macrobond

Entertainment and other services should also benefit from the acceleration phenomenon in affluent consumers, but not all of these sectors are growing in a straight line. China's box office has been growing by 40-50% on average in recent years. However in 2016 box office receipts declined sharply in Q2 and Q3 after a strong Q1. This was probably caused more by a recent lack of compelling movies than any economic shift; the share of movies with a top rating on Douban (a Chinese movie-reviewing platform) has declined in 2016.

The strong growth in box office receipts has attracted a lot of investment into the movie industry, both in terms of new movies and new theaters. This has generated a large number of new domestic productions, few of which have turned out to be widely popular. The supply of movies (number of showings) has been growing by 40%, while the number of people going to movies has fallen this year. While the fundamentals suggest demand for entertainment should be strong, there is still a risk of over-investment in the sector.

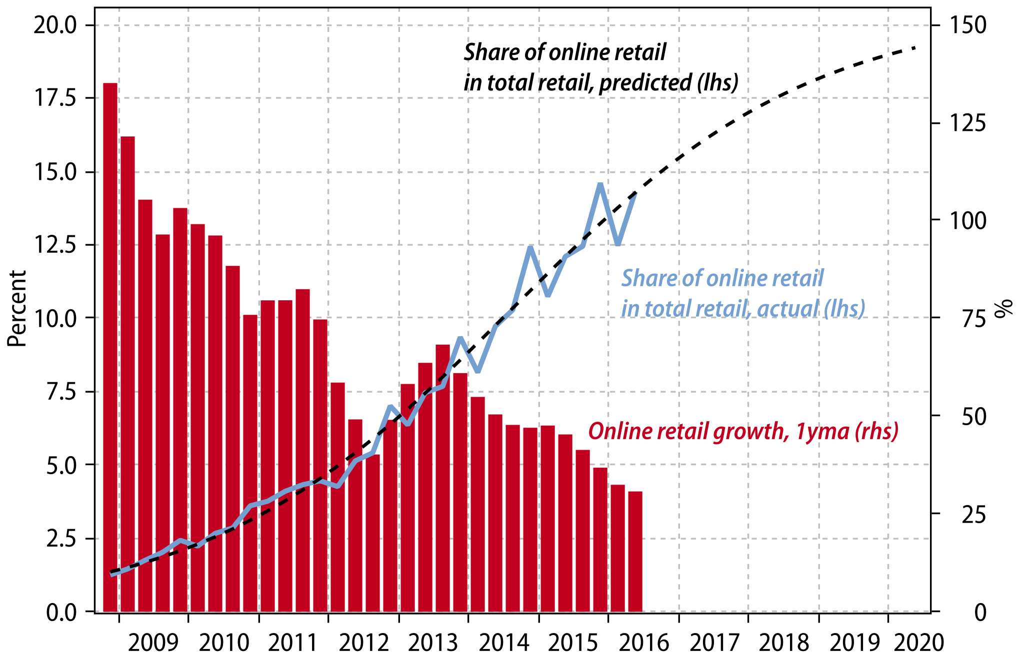
Online shopping is a big growth driver, but it is also slowing

Nearly one-third of retail growth comes from online shopping



Wind, CEIC, Gavekal Data/Macrobond

Online retail is also shifting onto a slower growth trajectory



Wind, CEIC, Gavekal Data/Macrobond

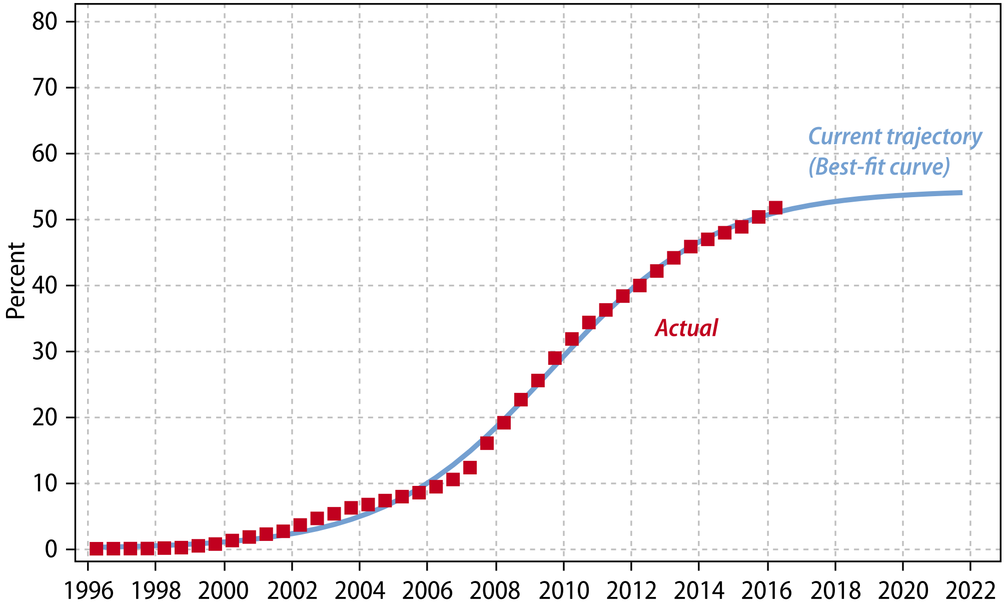
The boom in online shopping is the most significant new growth story to emerge during the gradual slowdown of consumer spending. Total retail sales growth has come down to around 10% currently from over 15% in the early 2010s; over this period the growth contribution from online retail has doubled. By 3Q16, nearly one-third of the growth in total retail sales came from online. E-commerce in China now has both enormous scale and still quite fast growth rates.

Yet online shopping is increasingly mainstream and mature. Growth in online retail has slowed down to 20%-30% YoY over the past year, from 50-75%. That growth trajectory indicates that online retailing has likely reached the second half of its S-curve, where growth slows rather than accelerates. The share of online retail sales in the total is 12-14% today, and the curve that best fits the historical data indicates it will reach a ceiling of 15-20% in the next few years.

The internet economy is already very mature in urban China

China's internet penetration rate is no longer rising rapidly

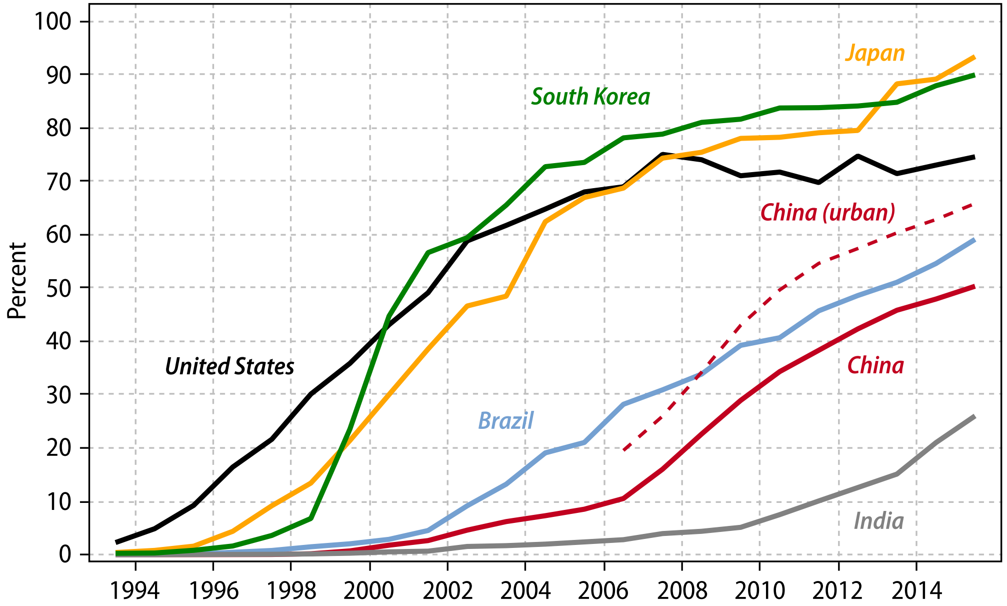
Share of internet users in total population



Wind, Gavekal Data/Macrobond

China's urban internet penetration rate is comparable to other countries

Share of internet users in total population



World Bank, CNNIC, Gavekal Data/Macrobond

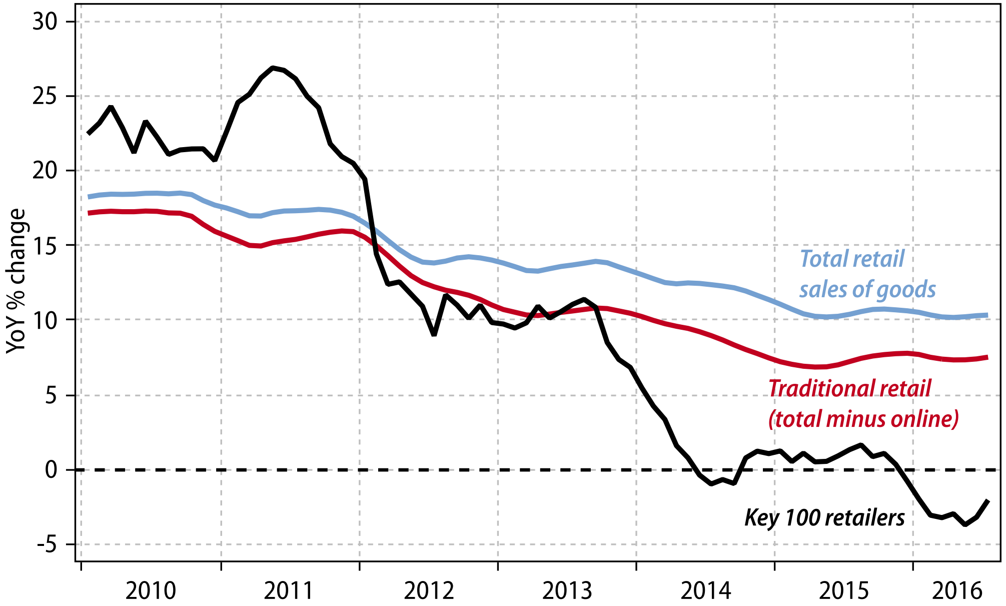
One of the fundamentals behind the slowing growth of online sales is a slowdown in the spread of internet use. As the internet penetration rate has passed 50%, the growth in the number of new users has also slowed; again, the second half of the S-curve has been reached. Much of the remaining Chinese population that is not online are either urban elderly or rural people with low education levels, and these groups will not go online quickly without technological changes that further lower barriers to internet use.

The internet penetration rate of China's urban population is in fact quite high at 67%, near the 70% where the US and Japan plateaued for a while in the 2000s. This reinforces the (fairly obvious) point that Chinese cities have a large and mature internet economy where most people are accustomed to doing things online. With internet penetration slowing down, future growth in online businesses will come from ever-more intensive use by existing urban internet users rather than a new boom in rural e-commerce.

Online growth has been bad news for malls and traditional retailers

Traditional retailers are underperforming as purchases shift online

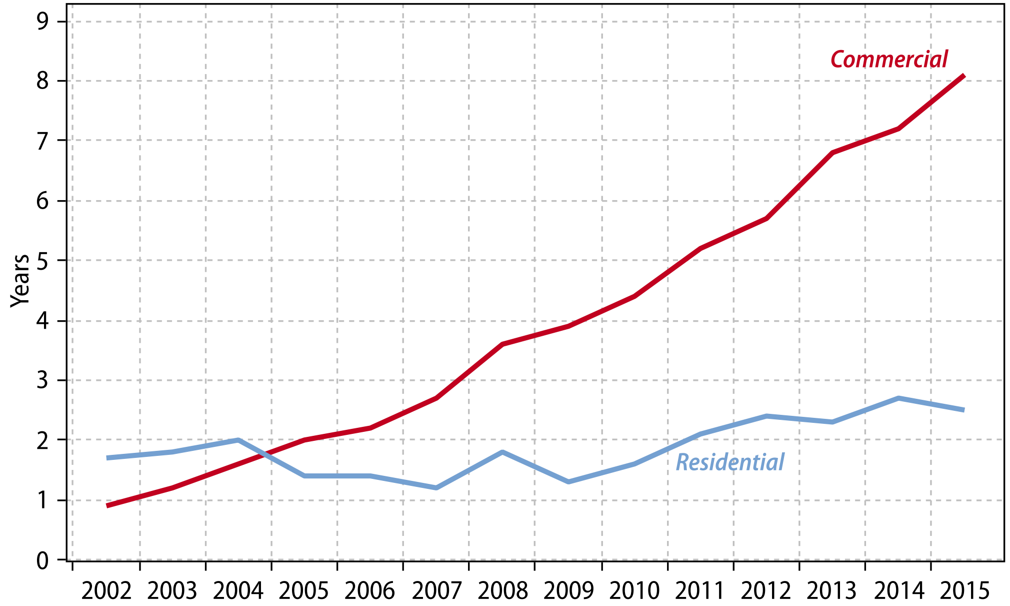
Nominal growth, 6mcma



CEIC, Wind, Gavekal Data/Macrobond

There is an enormous inventory of unwanted commercial real estate

Estimated inventory, years of completions (years of sales for residential)



Wind, CEIC, Gavekal Data/Macrobond

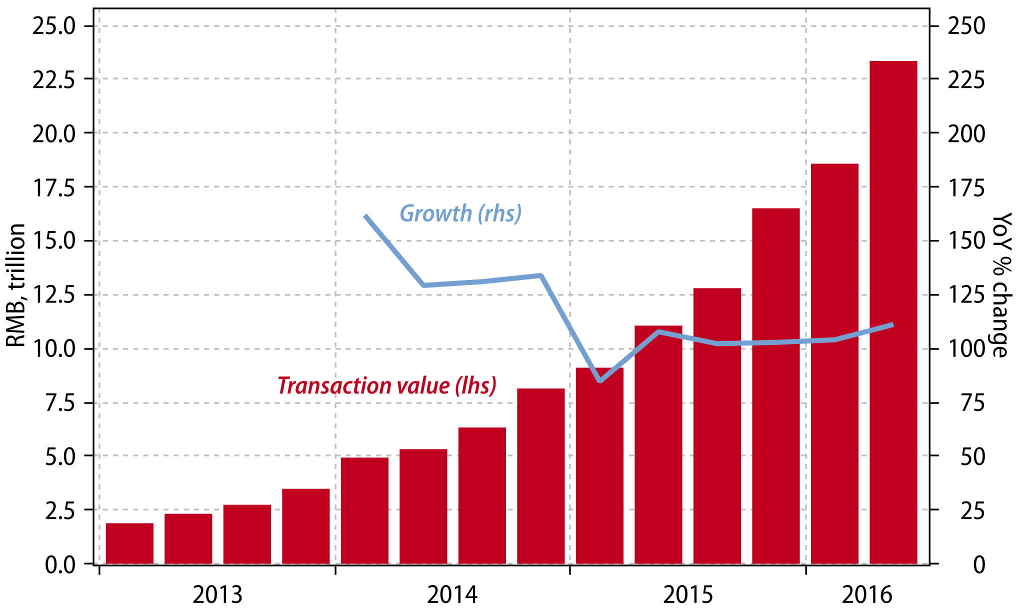
While growth in online shopping is slowing, it is still fast enough to do huge damage to traditional retailers who are not adapting. As consumer purchases shift to online channels, established outlets like department stores and supermarkets are hurting. Measures of retail sales that exclude online shopping, or focus on a subset of major offline retailers, are increasingly underperforming total retail sales. Traditional retail channels are a declining industry rather than a proxy for total consumer spending.

Widespread hopes that China was becoming a "consumption driven" economy have over the past several years led local governments to encourage more development of commercial property. But the shift to online from offline shopping has instead led to a collapse in demand for new commercial real estate of retail and a huge excess supply. According to our estimation, the pipeline of commercial property will take at least eight years to digest—a far bigger problem in relative terms than inventories of housing.

Services are the fastest growing part of the internet economy

China's online payments are growing by more than 100%

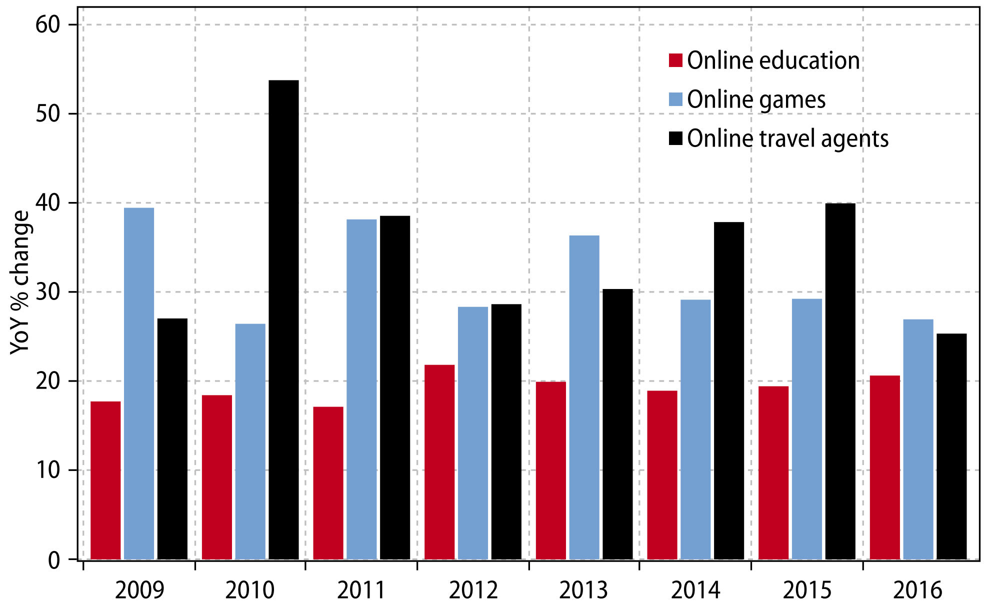
Transactions on third-party online payment platforms



PBOC, Gavekal Data/Macrobond

Online services are booming at high double digits

Growth of market size of online service sectors



Wind, Gavekal Data/Macrobond

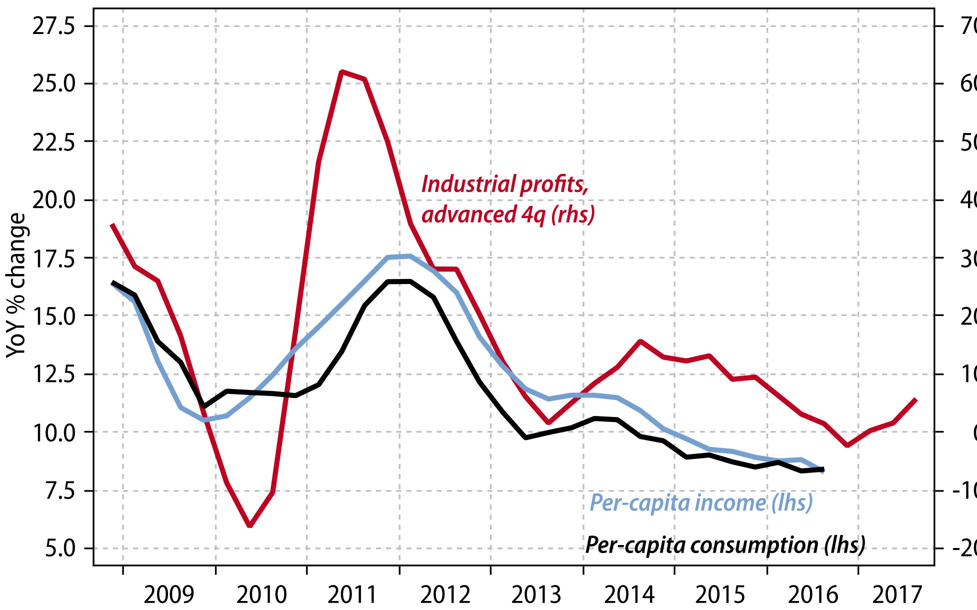
The slowdown of internet penetration and online retail sales does not mean that growth in the total internet economy is weakening, as new applications are allowing more and more transactions to move online. For instance, PBOC data shows that transactions through online non-bank payment platforms are growing by more than 100% annually. Internet companies are already reorienting their investments toward finance and services, focusing their attention on these super-high-growth sectors rather than more mature ones.

There is also clearly explosive growth in new services like ride-hailing apps and online games, and traditional businesses such as movie tickets and trip planning are rapidly transitioning online. The pattern of growth areas in the internet economy thus in some ways mirrors that in consumer spending overall: the fastest growing areas are those catering to the needs of the more affluent and more technologically savvy, and not in sales of basic mass-market goods to lower-income households.

An improving outlook for consumption in 2017

The profit cycle points to a consumer upturn in 2017

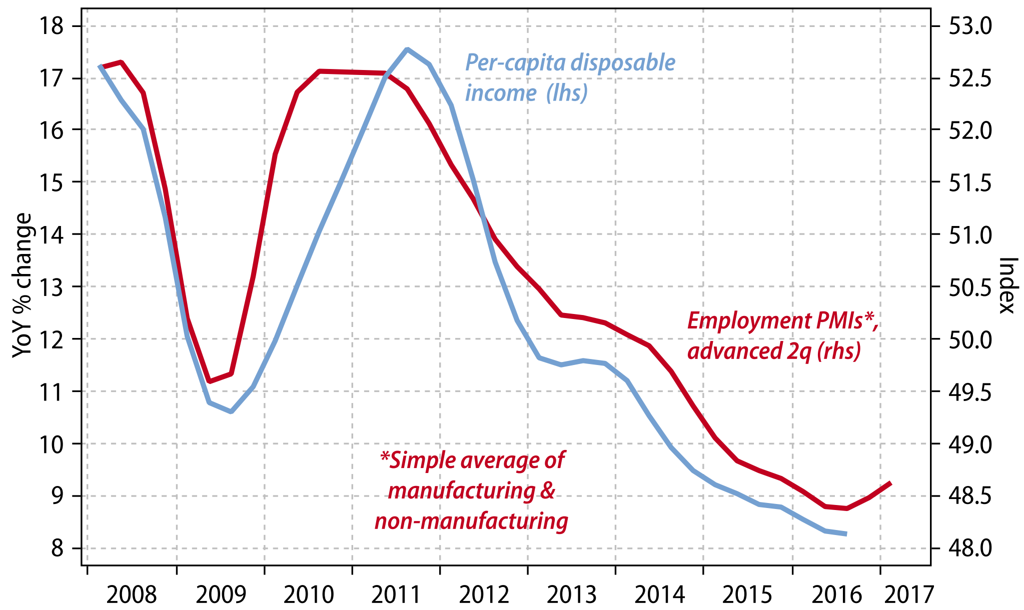
Nominal growth, 1yma



CEIC, Gavekal Data/Macrobond

Employer surveys also point to a recovery in household income

1ycma



CEIC, Gavekal Data/Macrobond

Although car sales are likely to be softer in 2017, overall household consumption is likely to pick up. The basis for this forecast is a simple framework: consumption growth is determined by the growth of income and wages, and the corporate profit cycle has a major influence on wages (with a lag of 3-4 quarters). The upturn in corporate profitability in 2016 should therefore be followed by an upturn in household income and consumption growth in 2017.

The channel by which corporate profitability influences household income is the labor market, and high-frequency labor market indicators also point to an improvement in 2017. The employment components of the monthly PMI surveys are a decent leading indicator for household income, and these seem to have reached a turning point in 2Q16. The real-estate stimulus and commodity boom this year should therefore support the household sector in 2017.

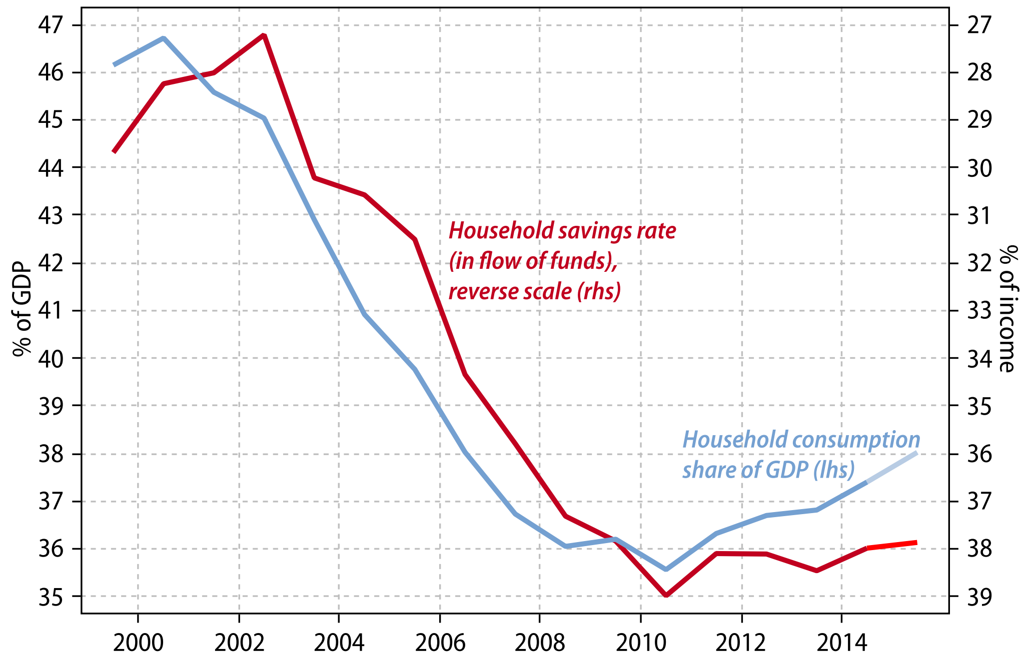
The consumption share of GDP should keep rising

A turn in China's consumption trend

Household final consumption expenditure's share of GDP and GDP growth

CEIC, Gavekal Data/Macrobond

Household savings have plateaued, so the consumption share can rise



CEIC, Gavekal Data/Macrobond

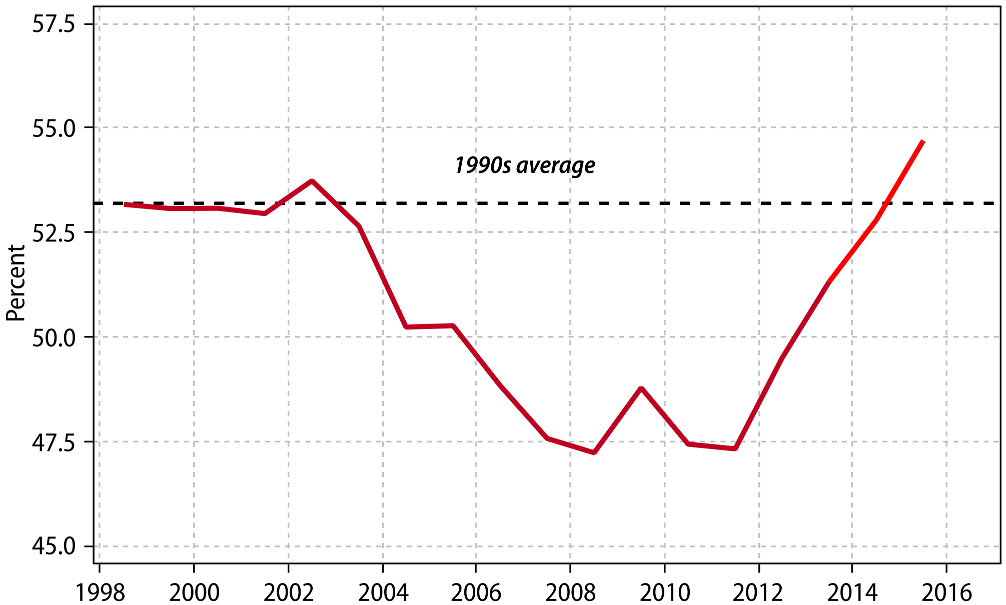
China's household consumption share declined during the decade-long investment boom, but as investment has slowed down sharply since 2009, the consumption share has started to increase. In 2015, household consumption was 38% of GDP, which is still much lower than the 50-60% usual in other major economies. 2016 was a relatively strong year for investment so the consumption share will not rise much, but investment should be weaker and consumption stronger in 2017.

The rising consumption share of GDP is closely related to changing savings dynamics. A rising household savings rate in the previous decade led to a falling consumption share of GDP, as household savings were channeled into housing investment. Now that fundamental demand for housing is plateauing and demographics are changing, the household savings rate is no longer rising and is even falling somewhat. This allows the consumption share of GDP to increase.

Wages and the wage share of GDP will also keep rising

Labor's share of the Chinese economy has bounced back

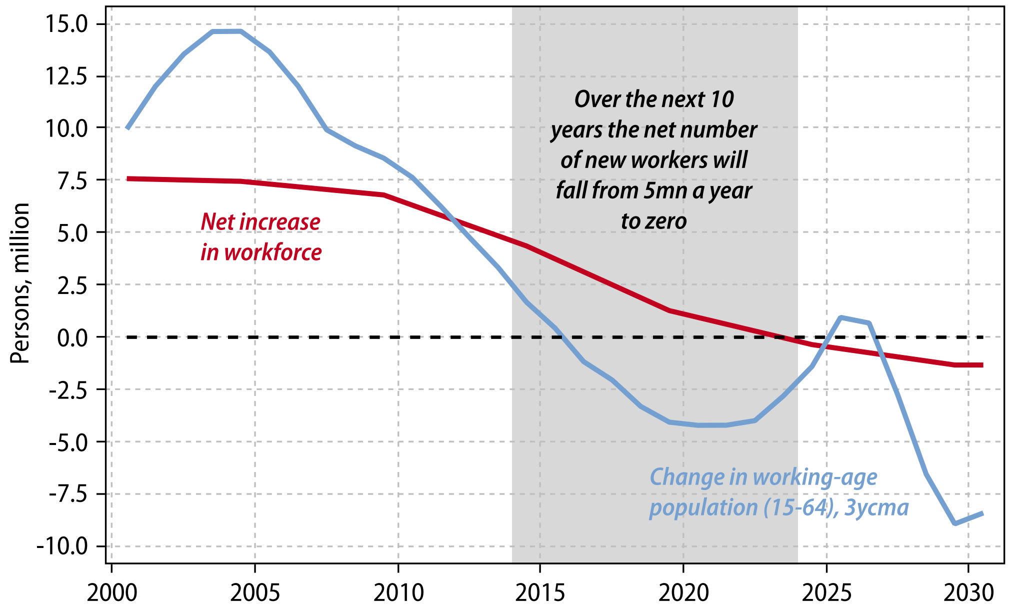
Labor compensation share of national income; estimates for 2014 & 2015



CEIC, Gavekal Data/Macrobond

China's annual supply of new workers is falling fast

Estimated net addition to the working age population and workforce



US Census Bureau, ADB, Gavekal Data/Macrobond

The rising consumption share of GDP is fundamentally supported by wages. The share of labor compensation in China's national income reached a historic low in 2011, but has been rising since then—another effect of the end of the investment boom. I estimate the labor share is now around 55%, which is already higher than the level in the 1990s. China today can probably sustain a higher labor share of GDP than it could in the 1990s, since the labor-intensive service sector is now so much larger.

China's working-age population (15-64 years old) has started to decline since 2013, and will keep declining for the next decade. Even accounting for an expected rise in the participation rate through 2030, the number of new workers will fall continuously over the next decade, and the workforce will start shrinking outright in the mid-2020s. Since demand for labor is still growing along with the overall economy, this points to continued upward pressure on wages for the foreseeable future.

6- So where to from here?

The probable paths forward

Growth

China

Low odds

Strong growth on back of large productivity gains thanks to investments in education & infrastructure
Buy energy, copper, commodity currencies

Range of most likely outcomes against which investing makes sense

Decent growth thanks to policy support and the steady increase in 'affluent' consumers
Buy China consumption & financials, tourism…

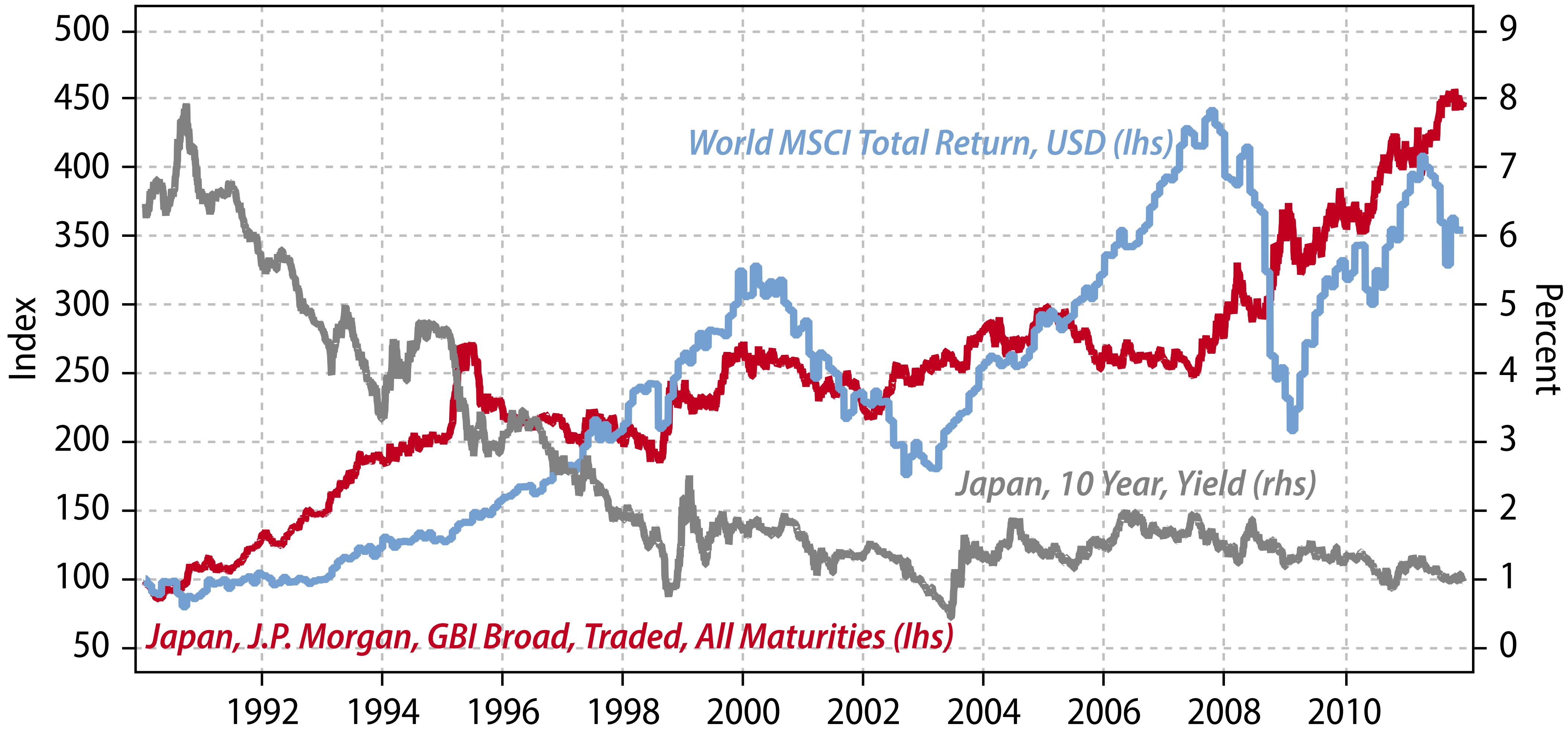
Long, slow-moving Nipponification of Chinese economy with deflation, ever-more zombies, ageing population, rising debt…
Buy long-dated Chinese government bonds

Low odds

Financial crisis on back of massive capital flight
Buy: UST 30 years, Gold

If China's future looks like Japan's recent past, we have a slam dunk opportunity

A look-back at recent history: JGBs vs World MSCI, 1990 to 2012



Gavekal Data/Macrobond

Are deflationary-busts fundamentally bearish for currencies?

Yen per US$ during Japan's long deflationary bust 1990-2013

Gavekal Data/Macrobond

Is the 'short RMB' trade the new widow-maker?

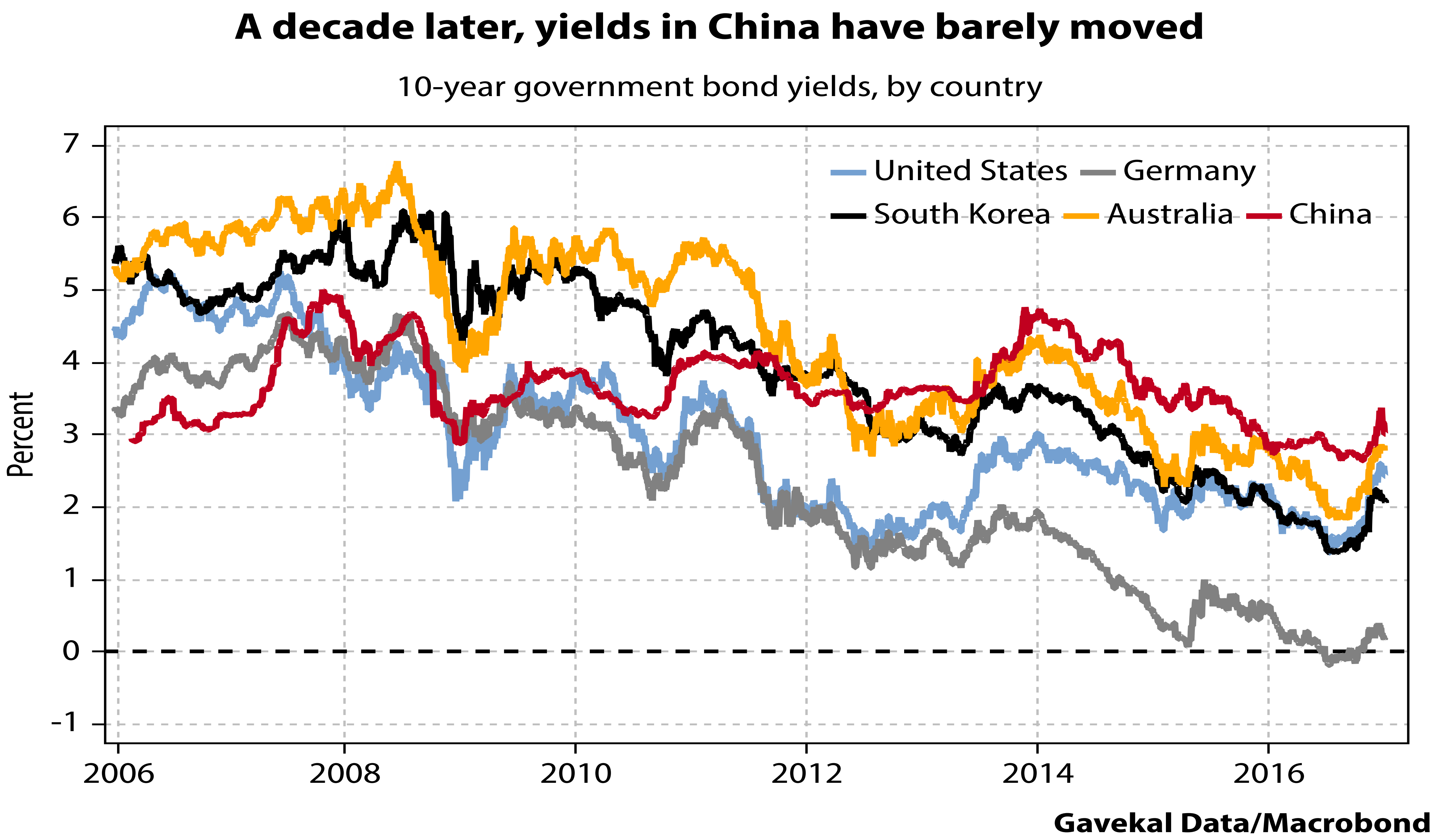
A RMB devaluation is not the one-way bet most seem to believe

The RMB has been very stable against its basket over the past six months

Gavekal Data/Macrobond

- Now that the PBOC is targeting a trade-weighted basket, rather than stability against the USD, the direction of USD/CNY depends mainly on happens to dollar against other currencies. **A stronger dollar now means a weaker USD/CNY, not a stable rate as in the past.**
- On a long term view, the RMB remains a strong currency against almost any currency.

As China moves to a lower-growth & inflation trajectory: good for bonds



Head Office
Suite 3101, Central Plaza
18, Harbour Road, Wanchai, Hong Kong
Tel: +852 2869 8363 | Fax: +852 2869 8131

Beijing Office
603 Soho Nexus Center
19A Dongsanhuan Beilu, Beijing 100020
Tel: +86 10 8454 9987 | Fax: +86 10 8454 9984

www.gavekal.com

For more information contact sales@gavekal.com