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China – a «barbell» economy

Large stimuli over the last 9 months have propped up the economy. The country is awash in liquidity, from official and from informal channels. But this has not been able to disguise **major weakness in the manufacturing sector.** Rising costs for all input factors combined with decreased demand in domestic and international markets have eliminated profitability for many. On the other hand, **China's consumers** have been and probably will continue to be a **strong enough counterbalance** to permit resolution of China's major economic problems over time. The Westpac/MNI China Consumer Sentiment rose for a third straight month to levels last seen before the stock market crash in mid-2015. The risk of this delicate balance between a suffering manufacturing sector and booming consumerism? Procrastination by the government to solve the problems, leading to increased debt and much bigger challenges in the future.

A «barbell investment strategy» (barbell = «Hantel» in German) in fixed income investing refers to an investment strategy positioned in short-term and long-term bonds, with no holdings of maturities in between. At this time, China's economy exhibits many elements of a barbell, with some sectors doing well and others doing very poorly.

The list of contrasts goes on, and this is why it is so difficult at times to understand what the major trends in China really are. It also means that newspapers can find evidence to substantiate almost any story and corroborate almost any thesis, no matter how pre-conceived it is. It is also why supposedly smart hedge fund managers can get China so wrong, suffering heavy losses as many did again in the past 9 months due to bets against the Renminbi and China's financial sector. Travelling in China and talking to the Chinese sometimes reminds me of the title of one of the recent books by the German philosopher Richard David Precht: «Wer bin ich – und wenn ja, wie viele?» («Who am I – and if so, how many?») There are so many sides to the same economy in China.

Topic #1 manufacturing vs. consumption

Many manufacturing companies in China are doing terribly. Many are operating without profits. That the Northeastern provinces are going through a structural recession is only one reason for this. Forced relocations of factories, a common occurrence in China for environmental reasons (leading to the desired clustering of companies in the same industry, and a clear separation from resi-

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A land of contrasts

Topic #	Problems at one end of the scale…	… and reason for cautious optimism at the other end
1	**Manufacturing:** weak; many manufacturing companies are not profitable or have shut down altogether	**Consumption:** airplanes, trains and restaurants are full; companies with ties to e-commerce and the digital world are booming
2	**Real estate oversupply:** property purchase subsidies in economically weak provinces	**Real estate craze:** property owners in the four large metropoles are talking about price increases of 25–30% and more in the last 9 months
3	The **perceived cost of living** has strongly increased for a large part of the population due to high housing costs	**Official consumer price** increases remain muted at 2.3% yoy in March
And on a non-economic, but still noteworthy subject:		
4	**Shoddy goods** continue to pop up on a regular basis, like millions of improperly stored vaccine shots and counterfeit milk powder	**Orderly street traffic** – peace and quiet emerge on Shanghai's streets due to a massive traffic re-education program by the city government

Source: ChinaIntelligence

dential areas), often lead to factory shutdowns at the old location, **but no re-opening at the new location.** The owners simply do not see a sound economic case for spending the capital on building the new factory, given the grim profit outlook. Instead, they take the relocation compensation from the government, for giving back the land-use rights on land that has appreciated in price since the factory was built originally, and do something else with the money.

The PMI figures reflect this reality, with the official PMI still weak at 50.1. The Caixin manufacturing PMI, more accurately reflecting the state of smaller companies, fell to 49.4 in April (from 49.7 in the previous month).
Consumption, on the other hand, recently **has improved again** to the levels in H1 2015, before the stock market turbulences. But consumer confidence is not where it was several years ago, caution remains. Nevertheless, areas like movie theaters, tourism and all things «e-commerce» are booming and providing very good business opportunities. The Westpac MNI China Consumer Sentiment Index exhibits the recent improvements, after a volatile year (see chart #1).

Topic #2 the real estate sector

In the economically weak provinces of the Northeast, governments have resorted to issuing **outright subsidies to first-time homebuyers** to reduce the inventories of unsold homes. They include cash, cheaper loans and tax breaks for young buyers of real estate. These are far-reaching measures to try to solve some of these regions' problems. Their success is doubtful, the economic weakness is structural and not cyclical. The Northeast's industries are in decline, with the province of Liaoning recently even admitting that its GDP has started to decline in absolute terms. Other areas with high inventories of unsold real estate include the North and Northwest – all the provinces of China where industrial production is heavily dependent on natural resources. In those areas, a supply overhang is commonplace and is not just centered around the cities.

Property markets in the large metropoles, on the other hand, are booming. Employment is healthier and optimism about rising prices in real estate is wide-spread. People have money, earned through hard work, and they see no better investment than to buy an apartment to live in. Purchase requirements for first-time home buyers were loosened in 2014, and mortgage interest rates have declined in the last 18 months. It should come as no surprise that since the stock market crash in summer 2015, property prices in Beijing, Shanghai, Shenzhen and Guangzhou have exploded. After all, **there are few reasonably attractive investment alternatives to real estate and stocks in China today.** Anecdotal evidence points to price increases of 25–30% or more in less than a year. Price developments in more peripheral cities have been much lower, but are still substantial. Property sales have increased in recent months and are **helping clear some of the excess apartment inventory in non-core cities. This is good news.**

Of course, after such price advances the risk of a price correction has increased. Such a price correction, however, most likely will not do systemic damage, it will not rattle the economy to its core. The requirements for down-payments are at least 20% for new purchases, and most apartments in China carry no mortgage at all. **But a fall in prices may lead to a drop in consumer sentiment and thus a (temporary) dip in economic activity.** Basic human psychology also works in China: what one once had (elevated real estate prices) is soon seen as normal; when some of this is taken away (by a drop in real estate prices), one feels that there is a problem, although in reality one still has more than at the beginning of the real estate boom and still has enough money to go on living as before.

Topic #3 official and perceived inflation

Consumer prices increased 2.3% yoy in March. This was the result of non-food inflation at a continued low 1.0% yoy, among other reasons because of continued low oil and commodity prices. Food prices, on the other hand, increased by 7.8% yoy due to a substantial increase in the important pork prices (see chart #2). The shortage of pork products in China has provided a boost to imports of pork products from Europe and the US. Increasingly, retail-size pork portions are being sold through the cross-border e-commerce channels of Alibaba Global and other companies. **Producer prices,** meanwhile declined by 4.3% yoy in March, a lesser decline than the month before (–4.9% yoy).

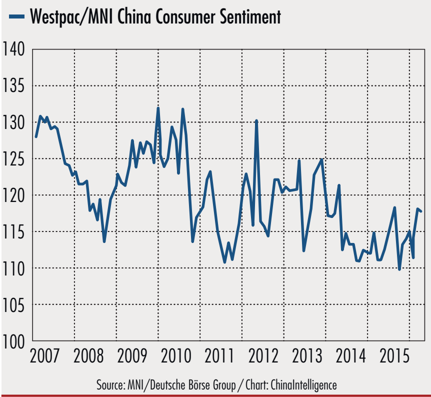
But these consumer price numbers only reflect half the story. The property boom in many cities has made many people wealthy, at least on paper, to an extent they never dared to dream of. **Younger people who purchase an apartment today or have done so in recent years,** on the other hand, are struggling to save up the down payment necessary and to meet the mortgage obligations. **For them, the cost of living has increased much more,** year after year, than the official CPI numbers suggest.

Topic #4 order and disorder

The government continues **to struggle to ensure reliable quality of products** made available to consumers. The problems do not only affect consumer, but also healthcare products. Scandals involving tons of counterfeit milk powder and 2 million of vials of vaccines, stored improperly and used long after their expiration dates, have unsettled consumers again in recent months. Unfortunately, it is usually the less well-off who suffer the most. The wealthy let their friends bring baby milk products directly from abroad or can afford to get healthcare products of a more reliable quality.

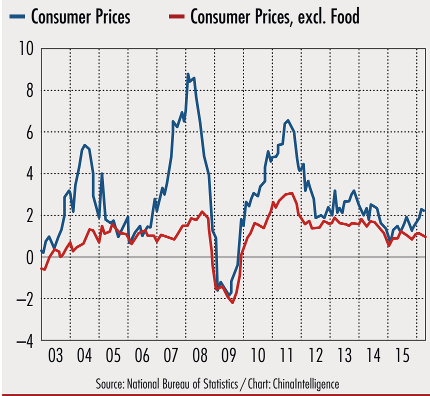
All the more surprising is an initiative by the Shanghai municipal government in the recent few weeks: the **implementation of no-honking rules** and actually keeping cars from blocking cross-traffic by pulling into intersections despite a traffic jam at the other side of the intersection. After having successfully forbidden the burning of fireworks in the center of Shanghai, the government apparently decided that the behavior of car drivers can also be improved. Whether the government should focus on these areas can be debated – more important issues appear to wait for a solution.

Improved consumer sentiment ❶



Source: MNI/Deutsche Börse Group / Chart: ChinaIntelligence

Low official inflation (% yoy) ❷



Source: National Bureau of Statistics / Chart: ChinaIntelligence

So an army of police, traffic assistants and other security forces, re-assigned to the streets from more cozy tasks like guarding government offices, swarm key intersections and enforce the rules and traffic signals that have already been there for a long time – but always were regarded more as suggestions than as imperatives. As a result, the streets are much quieter all of a sudden, honking has died down, and pedestrians can cross the streets without being molested by cars. As with many developments in China, such changes can be seen as «progress» or as a «loss of cultural identity». Take your pick.

Important Indicators

	April 2016	March 2016	Dec 2015	June 2015	Dec 2014	Sep 2014
Quarterly GDP, growth yoy (%)	–	–	6.8	7.0	7.3	7.3
Retail sales of consumer goods, growth yoy (%)	–	10.2	11.1	10.6	11.5	10.8
Official Consumer Confidence Index	–	104.4	103.7	105.5	105.8	105.4
FTCR Labor Demand yoy Index	–	50.7	57.0	63.2	72.6	68.1
Real estate floor space newly started, growth yoy (%)	–	13.7	–14.0	–15.8	–10.7	–9.3
FTCR mom Home Price Index	–	74.6	58.0	61.0	51.5	50.0
CPI, growth yoy (%)	–	2.3	1.6	1.4	1.5	1.6
PPI, growth yoy (%)	–	–4.3	–5.9	–4.8	–3.3	–1.8
PMI manufacturing (official)	**50.1**	50.2	49.7	50.2	50.1	51.1
Caixin/Markit PMI	**49.4**	49.7	48.2	49.4	49.6	50.2
Fixed-asset investments, growth yoy (%)	–	10.2	10.0	11.4	15.7	16.1
Required ReserveRatio (large banks) (%)	**17.0**	17.0	17.0	18.5	19.5	19.5
Benchmark rate for 1-year loans (%)	**4.35**	4.35	4.35	4.85	5.60	6.00
Benchmark rate for 1-year deposits (%)	**1.50**	1.50	1.50	2.00	2.75	3.00
New total social financing, growth yoy (%)	–	–	6.9	–6.8	35.0	–26.0
New bank loans, growth yoy (%)	–	–	19.4	22.7	44.0	9.0
Exports, growth yoy (%)	–	11.5	–1.4	1.6	9.7	15.3
Imports, growth yoy (%)	–	–7.6	–7.6	–6.8	–2.4	7.0
Trade balance (USD billion)	–	29.9	59.4	46.5	49.6	30.9
Electricity consumption, growth yoy (%)	–	2.0	0.5	1.3	3.8	3.9
Freight Traffic, growth yoy (%)	–	0.7	4.4	4.2	7.1	7.7
Iron ore imprts (million tons)	–	85.8	96.3	75.0	86.9	84.7
Coal imports (millions tons)	–	19.7	17.6	16.6	27.2	21.2
Crude oil imports (million tons)	–	32.6	33.2	29.5	30.4	27.6
CSI 300 (China Equity Index)	**3'156**	3'218	3'731	4'473	3'534	2'451
RMB trade-weighted, nominal, indexed (2010=100)	–	123.0	125.9	126.0	121.5	116.0
RMB / USD spot	**6.47**	6.45	6.49	6.20	6.20	6.15
RMB / USD spot	**6.54**	6,49	6,36	6,20	6,20	6,15

Source: ChinaIntelligence

Key developments we expect for 2016/17

We expect political, economic and financial stability despite all the looming challenges. Regarding some key topics, our expectations are:

- *GDP growth: 2016: around 6%, 2017: around 5.5%, below 5% for 2018–2020 (official government figures may indicate higher growth rates).*
- *Labor market: stable to slightly weaker, but with continued wage growth of between 4–7% p.a., at the lower end for high-wage earners, at the higher end for low-wage earners.*
- *Interest rates: one additional cut in the benchmark rates in 2016 by 25 bps.*
- *RMB: controlled weakness vs. the USD, leading to RMB/USD near 7.00 by year-end 2016.*
- *Retail sales growth: approx. 10% p.a.*

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