# Harbour Navigator

## Chinese growth: the prospect of a slowdown

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As central banks contemplate gradual monetary tightening, should we expect the pace of growth to slow a little? There is no doubt that growth has surprised on the upside over the last six to nine months. Most of that growth impetus came from a meaningful lift in Chinese growth, relative to expectations. Equity markets positively responded to that growth; but the surge in growth may have peaked.

In the last week we were able to attend the 24th annual CLSA Conference in Hong Kong. CLSA are owned by CITIC securities, which is part owned by the Chinese government, so the five day conference attracted a broad range of speakers. Many global themes were covered in seven separate streams, with significant content on industry disruption, electric vehicles, battery technology, fintech innovation, artificial intelligence, genetic prediction and precision medicine innovation. Geopolitical and economic risks for markets were also a key focus, with Lord Mervyn King and Steve Bannon providing some of the keynote addresses.

A positive undertone to the conference was the significant optimism in the Asian medium-term growth story, particularly as more societies develop stronger domestic consumer demand.

The strength of the world economy in the last nine months has in part reflected a resurgence in Chinese growth, as a result of both fiscal and monetary stimulus. Chinese GDP provided a positive surprise, and in part the stimulus lifted demand for commodities, and global trade.

The pace of global economic surprises in recent months has eased, global growth appears to be moving along nicely, and in the largest ten countries unemployment has continued to fall (in some countries to levels not seen in many decades). This is one of the issues confronting investors. If global growth is this strong, then surely we should expect some lift in inflation, and **a normalisation of monetary policy**? Equity markets have benefited strongly from excess global liquidity. As that liquidity is withdrawn, and as interest rates ease upwards, equity valuations may (to many) look to be a little high.

Momentum and sentiment can turn sharply at significant turning points for policy, so everyone is beginning to read statements carefully from the Federal Reserve and the European Central Bank particularly. However, it shouldn't really be a surprise for seasoned investors. We are highly unlikely to have near zero interest rates, strong economic growth and low unemployment forever.

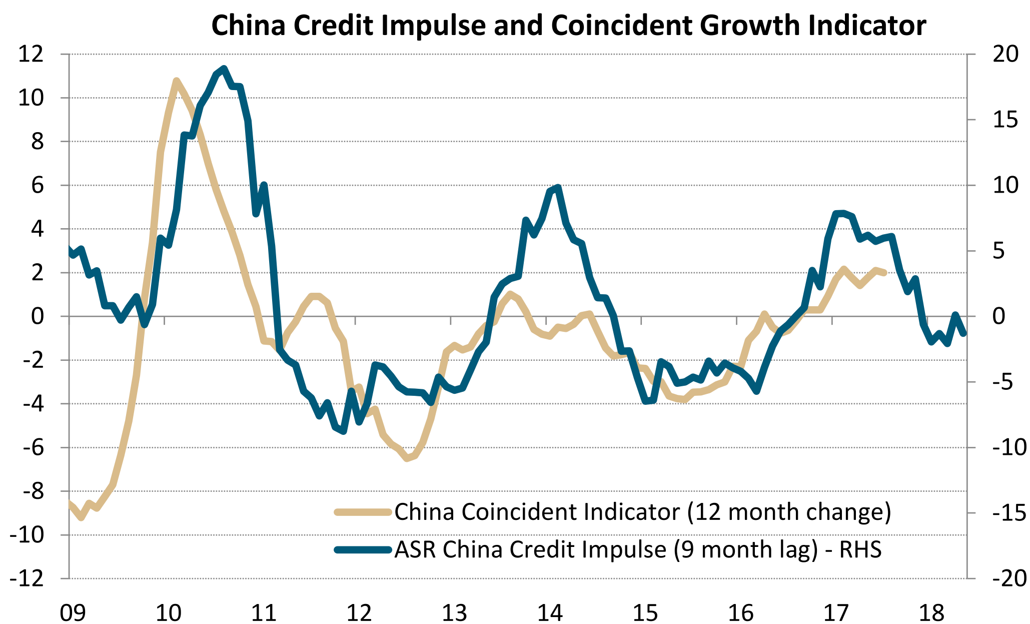
The second and related major issue for markets is the **outlook for Chinese growth** following the upcoming 19th National Congress of the Communist Party (opening on 19 October). The actual meeting itself seems very likely to see a consolidation of President Xi's power, and hence improve the prospect

for China to retain its focus on social housing, the huge One Belt One Road infrastructure programme and financial reform. Some commentators also suggest that China is pivoting towards much higher investment in technology, whilst continuing to pursue environmental reforms. In another bold move, the Government has announced plans to phase out the sale of petrol cars, following in the footsteps of a handful of European nations. Already in the driver's seat, such a move will place China firmly at the front of the electric car revolution.

In the near term, China is also widely expected to attempt de-risking the financial system through ongoing debt-to-equity swaps, and by setting up many 'bad banks' to absorb perhaps more than $300bn of loans from the core financial system. Although this may lift moral hazard, it is similar to some of the central bank balance sheet expansions seen in the US, Europe and Japan. In addition, Xi is expected to continue State Owned Enterprise consolidations and mergers, and perhaps bring the number of large owned government companies down from 100 to nearer 60, to improve efficiency and create companies that have more global relevancy.

Right now Chinese growth remains above 6% and coincident indicators are strong. The transition from an export-led economy to a services and domestic economy is underway, and China is leading the way in mass-market digital transformation, with now by far the largest e-commerce market in the world. For example, WeChat has over 963 million regular users. The structural Asian growth story seems very much intact. Over the next 15 years China's ASEAN neighbours will add around 120 million people – a market growing effectively to 1.5 'Germanys'. This population is one of the youngest globally, with almost half under the age of 25. By 2025 the ASEAN region will have 125 million middle class families, roughly doubling in less than 15 years. This is a huge consumer base for Chinese businesses to focus on.

In the meantime, investors need to consider what a modest cyclical slowdown in China might mean. From a growth perspective, Absolute Strategy Research in their latest quarterly report suggest that a modest slowdown in global growth may be occurring right now, reflecting a more recent tightening of financial conditions in China. This is certainly not the consensus view, but in our opinion it is worth considering as a risk. Chinese indicators showing slowing house price inflation, almost zero M1 growth, and higher interest rates all may lead to a less positive growth outlook in the near term. It could also be the case that politically President Xi may be happier with a moderation in growth, as China turns away from investment in export industries to investment in technology to boost productivity over the medium term.




Source: Absolute Strategy Research: Equity Strategy Quarterly, September 2017.

Although Chinese growth has provided a significant boost to world GDP and corporate earnings growth in the last 12 months, we are becoming more alert to the risk that 'landing' a slight slowdown in growth is not always that easy.

Equity markets in particular have enjoyed buoyant liquidity, strong economic and earnings surprises and have ridden these positive trends. In our opinion the structural rebalance of the Chinese economy is well underway, but the pending National Congress adds uncertainty and the economic pulse is worth monitoring more closely in coming months for signs of a cyclical slowdown.

***Harbour Asset Management***

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