China's Transformation

by • ray ryan, CFA

Ray Ryan is the President of Patten and Patten, an investment management firm, and a Registered Investment Adviser in Chattanooga. Ray is a CFA Charter Holder, a member of the Advisory Board for UTC's College of Business, and an Adjunct Professor of Finance at UTC. He is a graduate of Princeton University, where he had the privilege of taking a course taught by former Fed Chairman Ben Bernanke.

Animals get agitated when a volatile weather system approaches. Usually, volatility signifies a change in pressure as a weather front forms the boundary between a high pressure system and a low pressure system. What follows a weather front is an unknown. The unknown fosters uncertainty and apprehension as volatile weather can result in damaging storms. Humans are not as sensitive, but we likewise can sense when change is imminent.

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Volatility in the capital markets is associated with change as well. Change often involves a shift in policy, and the markets become apprehensive about the impact of such shifts. In August of last year, the markets were greeted with an abrupt and unexpected change: China devalued its currency. What did it mean? Why would they do it? Will there be more?

Investors don't wait for comprehensive analysis of these policy shifts. In fact, most of the time, a "sell first and ask questions later" mentality grips the markets, which manifests in extreme volatility. Such was the case in January of this year, the worst opening month for the stock market since 1928.

In the midst of volatility, opportunities emerge as the prices of assets become disconnected from underlying value. Earlier this year, prevailing sentiment was profoundly negative, but an understanding of China's economic model suggests the market's reaction was excessive.

Despite its massive area, China lacks arable land, water, oil, and other basic resources. Consequently, China is quite dependent on imports and low cost financing to facilitate its trade dependent economy. For decades, China has pegged its currency to the US Dollar to reduce borrowing costs. In order to accommodate an overwhelming demand for resources that China lacked, the rest of the world responded with investment of their own. Natural resource abundant economies such as Brazil, Australia, Canada benefited from supplying China with iron ore; coal; fertilizer; soybeans.

China's most abundant resource is people and following the model of other emerging market economies, China offered this resource to Western companies that sought to reduce costs in their supply chains. Securing assembly and manufacturing contracts gradually improved standards of living, but the model required that people move to its cities. That, in turn, required massive investment in infrastructure.

China's urbanization occurred in an accelerated timeframe. In the US, much of what we take for granted in terms of infrastructure was constructed over multiple decades after WWII. China built its in half the time. Fortunately for the rest of the world, and especially for other emerging markets, China's investment boom persisted until recently. China's infrastructure build-out facilitated what is known as a "multiplier effect" on global growth.

The investment required to supply all that China needed was absolutely massive. For the past ten years, China was nearly everybody's largest customer – one that would hoard supplies and would be insensitive to price. From 2006 – 2012, China accounted for 100% of the increase in world steel demand. From 2001 – 2014, China accounted for 40% of the growth in crude oil consumption. China used more cement from 2011 through 2013 than the US did in the entire 20th Century!

In 2014, Chinese consumers purchased 6.7 million more cars than Americans and 5 million more cars than Europeans. China now has more than 100 urban centers greater than 1 million people, and China built 100 airports between 2011 and 2015. However, China's Gross Domestic Product ("GDP") per capita income ranks 81st, behind Greece and Mexico, confirming they remain a very poor country.

Recently, China's policy leaders announced a transformation of its economic model from a dependence on investment to a focus on services and domestic consumption. In the most recent 5 Year Plan, party planners emphasized stable labor markets and the expansion of social welfare benefits. China's labor cost advantage has already dwindled, implying this shift could be involuntary.

Economists at the International Monetary Fund believe the shift to services is about maintaining full employment. The services sector is more labor intensive and offers more low skilled jobs. This will prove a daunting challenge as the country is currently contending with a surplus in low skilled labor, particularly among the migrant population. In fact, some economists have expressed concern that China could be guilty of "premature de-industrialization," implying its economic model is not yet prepared for the shift to services. To the extent the most recent 5 Year Plan is credible, it is interesting to note that China needs to create 14 million new jobs each year to maintain a stable unemployment rate.

In addition to the shift in its economic model, it is arguable that the world is dealing with the aftermath of yet another bubble. There are many parallels, including the last major infrastructure build out in the US – i.e., the telecom bubble. The closest parallel, however, is Japan in the 1980s.

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Bubbles involve assets whose valuations cannot be supported by fundamentals. Bubbles also represent a misallocation of capital and resources. When viewed in this context, comparisons with Japan become more relevant. Both China's and Japan's bubbles were inflated by massive amounts of debt, most of which became non-performing. When leverage reaches an extreme level, the discipline of markets would typically require a restructuring. For a market-based system in which corporations are responsive to shareholders, such restructurings are common.

For countries like China, with many state owned enterprises, there is an aversion to actions that could displace workers. Similarly, it is widely acknowledged that Japan's lackluster economic growth for the past three decades is partly the result of a refusal to eliminate redundant and inefficient operations. Why? Because that would have required laying people off.

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Economists who are decidedly bearish on China argue that the currency remains 30 – 50% overvalued. They advocate the Chinese should undertake a one-time, major devaluation to correct this imbalance. The devaluation would likely trigger competitive devaluations by regional trade partners and wreak havoc on the markets. In the final analysis, China will likely continue to manage a gradual devaluation of its currency. A drastic currency adjustment is, therefore, an "improbable possibility" as China has other policy tools at its disposal.

Given its labor market dynamics, China wishes to avoid any action that could disrupt regional trade. Nevertheless, restructuring is unavoidable and likely inevitable, and to the extent China defers such painful measures, its future could resemble the experience of Japan for the past thirty years. Such an outcome should prove deflationary, but it does not justify the market volatility experienced earlier this year. Moreover, just as there were Western companies that benefited from China's infrastructure build-out, there are companies that will benefit from China's transformation.