WHITEHELM ADVISERS

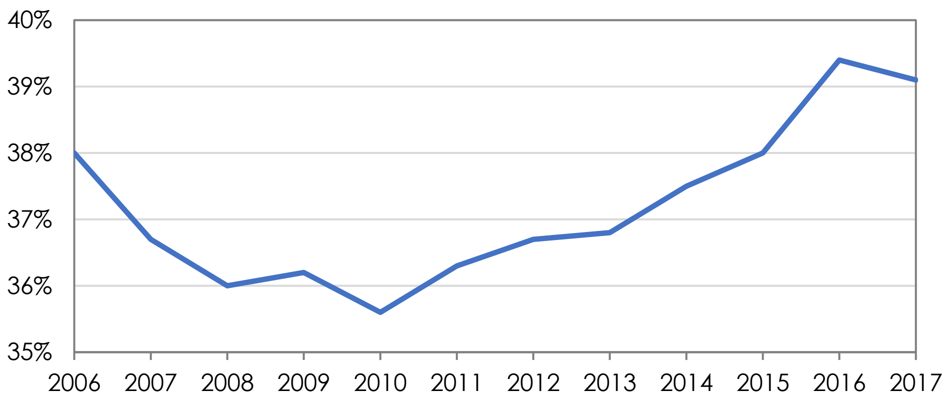
FEATURE ARTICLE:
PLACING HOPE IN THE CHINESE CONSUMER

Introduction

There is a great deal riding on the Chinese consumer in the first part of 2019. Consumption has been widely touted as the key to a prosperous China and, in turn, a prosperous world as it gradually increases as a component of GDP. Ominous reports of slower industrial production and reduced consumption of key goods, such as cars and iPhones, have caused many to focus on whether consumption is slowing materially enough to reduce GDP growth itself, and world GDP growth along with it. This research article explores the short-term and long-term implications of an incipient trend of slower consumption growth in China.

The growth of domestic consumption in China has been long cited as the primary support to rebalance China's large economic production, improve its import capacity for foreign suppliers of goods and services, and to contribute to world economic growth. Domestic consumption has risen moderately over the past ten years as a percentage of GDP, as shown in Figure 1. However, a combination of factors, from financial to economic to demographic, has led many to begin to doubt that China domestic consumption – both as a percentage of GDP and as an absolute amount – will continue to grow as strongly in the future, particularly in the short term. This article explains the causes and potential effects of a revision in domestic consumption expectations.

Chart 1: China Domestic Consumption as % of GDP



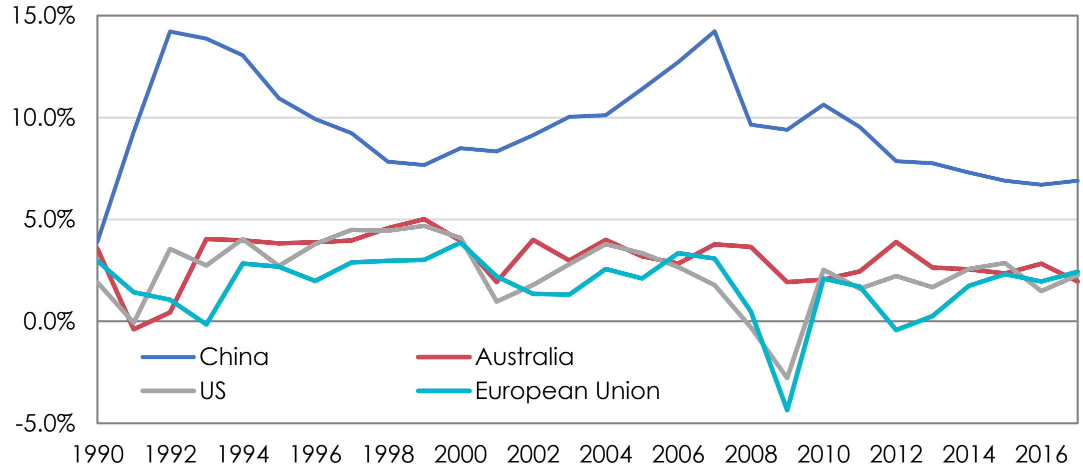
Source: CEIC

Economic Growth and Consumption

Domestic economic consumption in China has increased significantly since 2008. Growth has increased at approximately the rate of the country's average GDP growth (6-7% annually) over this period. Chart 1 above shows that, based on official statistics, China's estimated domestic consumption has also increased moderately as a percentage of GDP over time. It is still below the level of other developed economies (which average 60% or more).

However, China's economic growth has slowed considerably since the 2008 financial crisis. China's latest GDP release showed annual growth of 6.4% over the year to December 2018; other indicators, such as industrial production, have also declined. While GDP growth is still much larger than virtually all developed economies and many emerging economies, this latest figure is the slowest rate of growth in several decades (except for a very brief period in 2009). In addition, there is good reason to be sceptical of official Chinese statistics. GDP figures are released soon after the end of each quarter, and are not usually subject to subsequent revisions, as they are for most developed economies. The large component of state controlled or state managed companies in the China economy also makes the state more able to directly influence industrial production. Economic production is widely viewed as being heavily influenced by political objectives, such as the Communist Party's strong desire to be seen as managing the economy well. Actual economic growth is likely to be lower than reported figures.

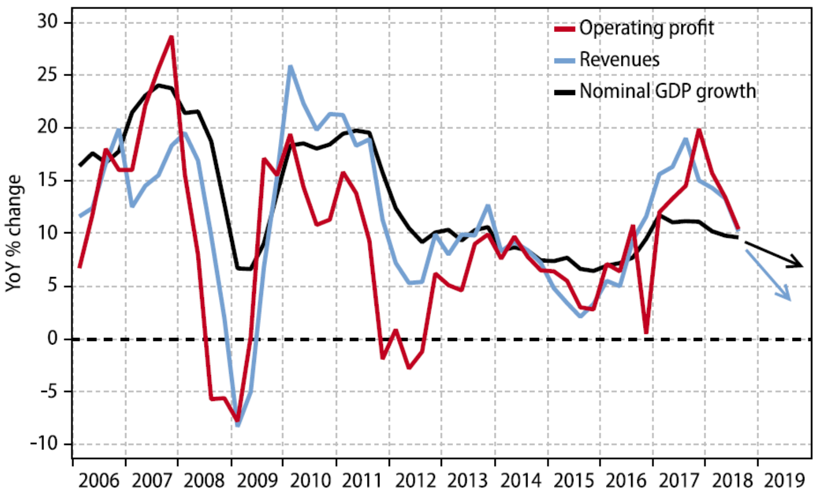
Chart 2: China Annual GDP Growth (%), 1990 – 2017



Source: World Bank

It is therefore important to look at a wide range of economic indicators to gain perspective on the performance of the Chinese economy. Different indicators give vastly different impressions of the economy's performance, depending on which elements of economic activity they emphasise. While it is difficult to obtain accurate data on sector performance, recent data on the revenues companies listed on China's Hong Kong exchange – a majority of which are still 'old economy' companies – points to a much less smooth path for GDP. As shown in Chart 3, aggregate revenue and operating profit growth of Hong Kong listed companies, while rising in the latter half of 2016 and 2017, appears to have fallen sharply in 2018.

Chart 3: China Corporate Revenues and Operating Profit versus GDP



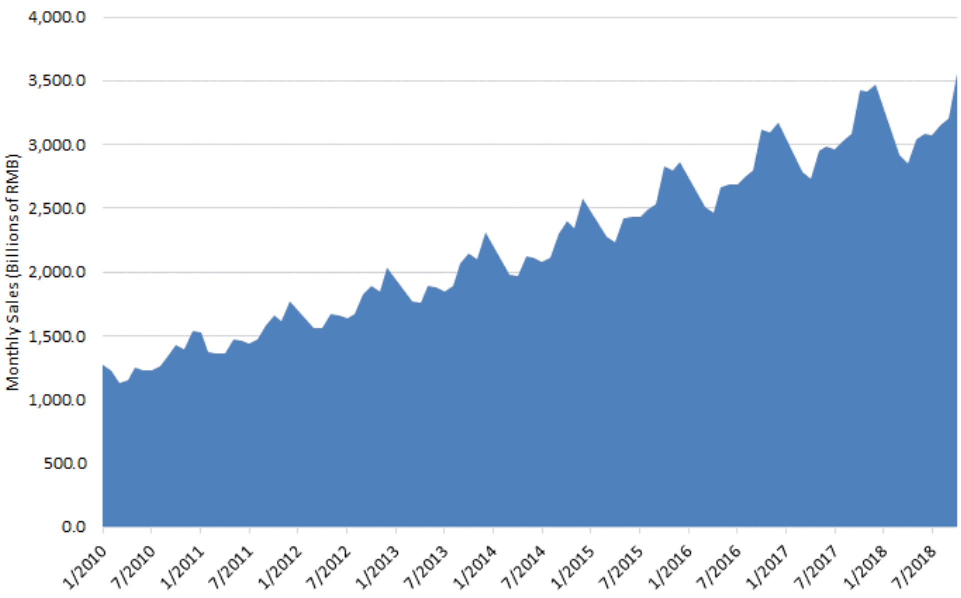
Source: *Gavekal*

Consumption Redefined

Consumption as a component of GDP has traditionally been thought of as essential purchases of goods and services. Under this traditional view, population growth in any country will necessarily lead to increased consumption. The number of people considered middle class in their home countries, including China, has grown tremendously in the past 50 years, and this has helped significantly increase purchases of consumer goods, both from developed countries and from emerging ones.

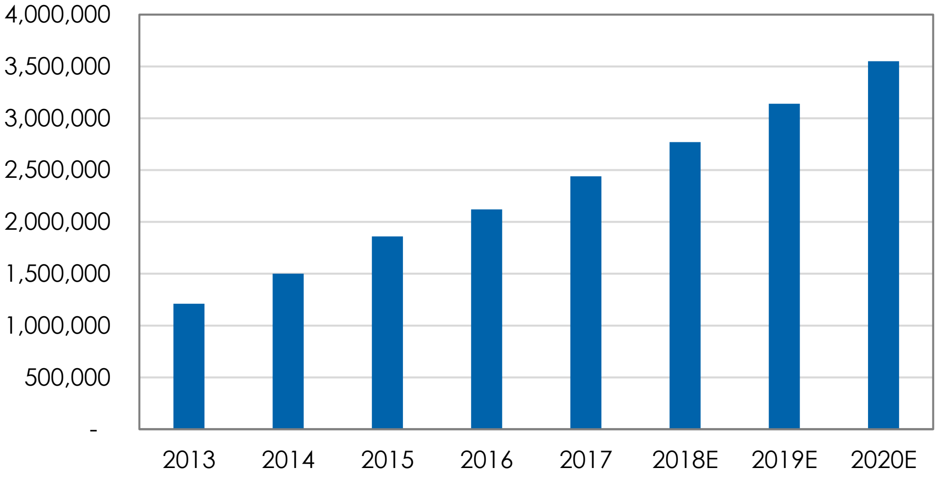
As shown in Chart 4, nominal annual China retail sales growth has increased an average of 12.5% since 2010, when government statistics first became available (Note that the time series is not seasonally adjusted and excludes each February). By contrast, retail sales in most developed countries have largely tracked GDP growth; US annual retail sales growth over the 10 years through 2017 has been a nominal 2.6% per annum.

Chart 4: China Monthly Retail Sales



Source: *China National Bureau of Statistics*

Chart 5: Number of Affluent Chinese Households



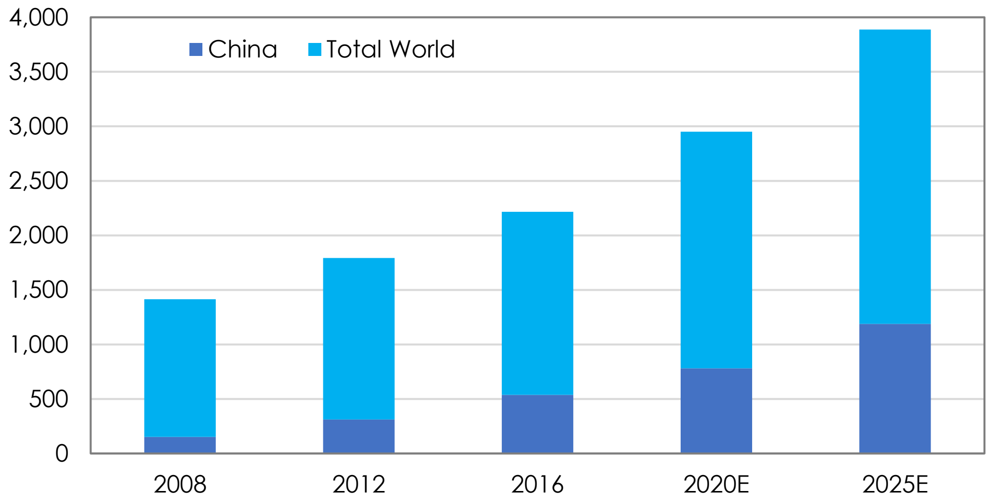
Source: Boston Consulting Group

In addition, the number of affluent people worldwide has grown significantly. This has been particularly true for greater China. According to Boston Consulting Group, the number of affluent households (defined as those with greater than RMB 6 million in assets) grew at an annualised rate of more than 20% in the 10 years from 2007 to 2016, and as shown in Chart 5, is an estimated 3 million households as of the end of 2019. This is still only a small fraction of the total population (the US, for example, has approximately 10 million households with US$1 million in assets), but it is growing fast.

Middle class growth has meant the increased consumption of essential goods and services.

Affluent class growth has meant the increased consumption of luxury goods. The global luxury industry has tripled in size since 1996, and this has been fuelled most recently by Chinese consumers, especially Chinese millennials. Globally, millennials (those born between 1980 and 2000) account for 40 to 60 per cent of global sales for luxury brands such as Louis Vuitton, Gucci and Cartier. Millennials account for an even greater proportion of luxury sales in China. As shown in Chart 6, Chinese consumers overall are expected to account for up to 45% of global luxury sales by 2025, up from 12% in 2008.

Chart 6: China's Estimated Proportion of Global Luxury Goods Consumption (¥ billion)



Source: McKinsey

As China's economic growth continues, consumption of both middle class essential goods and affluent class luxury goods should increase. The question is the future rate of this continued increase. China now leads the world in the number of homeowners, internet users, and college graduates. Prosperity has also brought rising expectations in China; the public wants cleaner air, safer food and medicine, and better health care and schools, in addition to continued economic growth. Many foreign companies have sought to exploit these wants; for those companies who have been able to do so, Chinese consumption growth has proven lucrative. Because these sales are largely repatriated to companies domiciled in other countries (who own the brands), they indirectly assist economic growth in these other countries. This is why China's consumption matters so much.

Consumption Downgrading

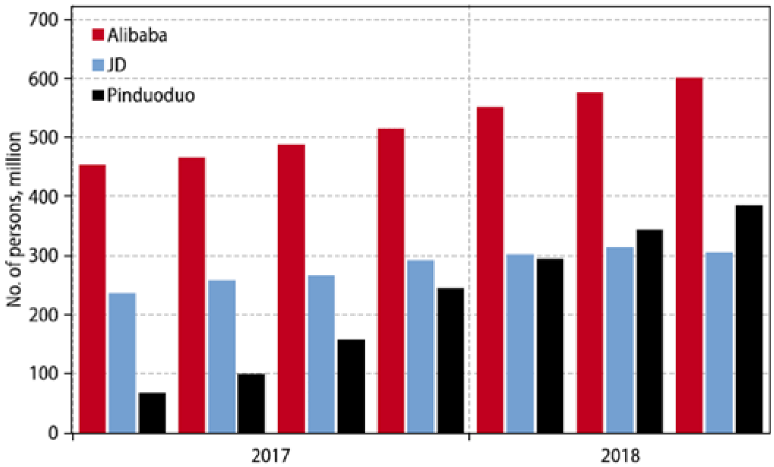
Recently, however, there have been increasing signs that China's consumption growth rate may be declining, particularly in the short term. Retail sales in 2018 grew at their slowest pace in more than a decade. Wages in the private sector are growing at their slowest pace since the global financial crisis. Long-term factors, such as rising housing and education costs, are driving down spending, particularly among young people. Chinese spenders have been a key driver of their country's economic growth in recent years. And China, in turn, has played a major role in global growth. But slowing consumption could reduce the contribution to global growth significantly.

There has been widespread discussion of consumption upgrading in China, whereby sales of luxury goods have been rising faster than essential goods. By the end of 2018, this discussion had shifted to whether consumption downgrading (whereby luxuries are foregone, and even quality brand purchases are substituted for by cheaper alternatives) is happening, as income growth slows and uncertainty rises. But consumption downgrading is probably only a temporary phenomenon: as long as average household income keeps growing, so will the affluent population.

The long-term trend for mass market consumption has also been upward. Even though online consumption giants such as Alibaba have experienced rapid revenue growth already, revenues are expected to continue to rise. Online retailing growth in China has stabilised at an annualised growth rate of 25-30%, compared with a 26% average for Amazon, the largest US retailer (Amazon's annual revenues are still 5 times the size of Alibaba's in USD terms; however, Alibaba now has a greater transaction volume). More downmarket online retailers like Pinduoduo are still growing at a rapid rate too.   While online consumption does not directly increase consumption, the availability and ease of online retail purchasing is an indirect contributor to it.

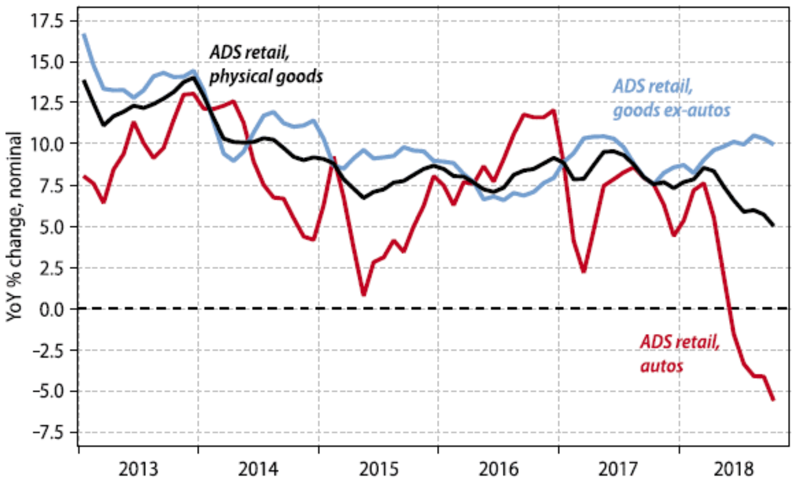
Auto sales have been a volatile indicator of a reduced pace of consumption. As shown in Chart 8, auto sales growth turned negative in 2018, even as consumption of other goods remained positive. The long term trend is still strongly positive. US auto sales, by comparison, have averaged a 0.6% annualised growth rate over the past ten years.

Chart 7: Active Users of Online Retailers



Source: Gavekal

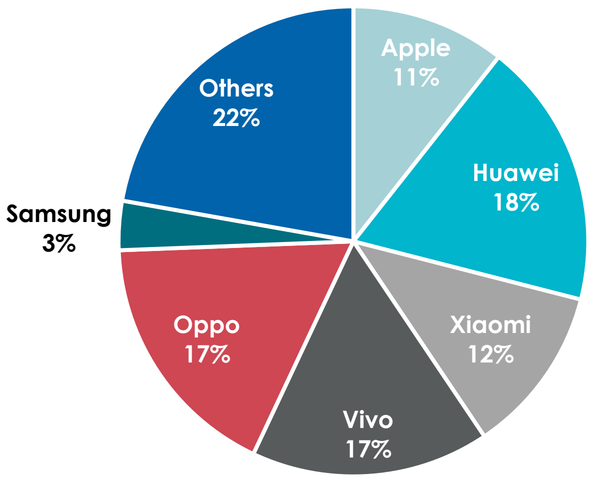
Chart 8: Consumer Goods Sales Growth, 2013-2018



Source: Gavekal

A final harbinger of reduced short-term consumption, and perhaps consumption downgrading, has been smartphone sales. Apple Inc. reported decreased revenue at the end of January 2019, citing 15% reduced iPhone sales primarily in greater China. Overall, greater China accounts for only 20% of Apple's sales. Based on Apple's earnings result, smartphone sales revenue from greater China may have dropped up to 50% from previous quarters. Overall, however, smartphone use in China is still growing at a rate comparable to reported GDP. Apple's iPhones are only the fifth-largest brand held by China consumers, as shown in Chart 9; all of the larger brands are domestic manufacturers. Apple's market share of China's smartphones has been declining for several years, so the news of reduced sales of iPhones is not a complete surprise. However, the scale of the sales decline was seen as severe.

Chart 9: China Smartphone Market Share



Source: Statistica. Data as of year-end 2017

Stimulus Measures – China's Response to Tariffs

A growing trade war with the United States has so far been the most visible exogenous threat to China consumption. In September 2018, the United States imposed tariffs on $200 billion in goods from China. Slowing economic growth and the threat of a trade war with the United States have also caused the Chinese government to continue to take steps to maintain its economic stability. It has pared back a high-profile campaign to tackle credit, at least through regular bank channels, and has restarted big infrastructure projects, a traditional economic engine. It has brought forward the issuance of local government bonds, whose overall amount outstanding has continued rising. The government is also aiming to help small and midsize businesses, which have had trouble obtaining loans, and continues to backstop the stock market through fund managers and brokerages affiliated with state-controlled banks.

China has used these methods for years to spur growth, but they do represent a retreat from more recent government efforts to pare back debt. China lent heavily a decade ago to internal local governments and to businesses (through state-controlled banks) in a concerted effort that rescued its economy from the global economic downturn. This left many of its companies and local governments heavily burdened with debt. Corporate debt, at an estimated 160% of GDP (both private and state-owned companies including banks), is far higher than the United States and closer to Japan's at 230%.

Economists continue to warn that China must address its debt problems if it hopes to keep its economy stable and growing over the medium term. While China appeared to be listening earlier in the first half of 2018, it has since changed its stance. The People's Bank of China has since stated it would ensure that money flowed from its state-controlled banking sector to companies in need (particularly exporters and small and medium sized enterprises). The government has promoted rail and other infrastructure projects that were previously stalled or blocked because of concerns about increasing debt. In addition, the People's Bank of China has continued to cut the bank reserve ratio, which frees up more money for China's state-controlled banks to lend; it has done so four consecutive times through January 2019. The government has also continued to implement consumption-focused macro-economic measures to manage economic growth and consumption.

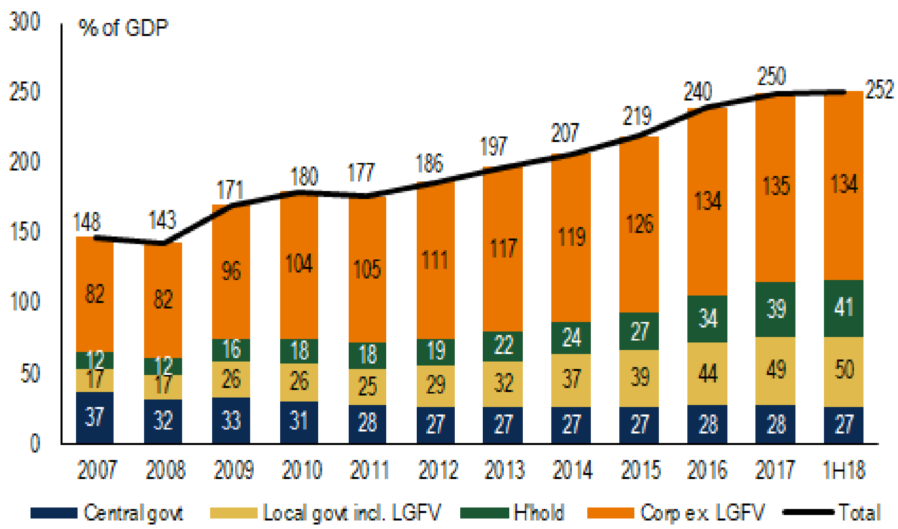
China's Debt to Itself

In the wake of the global financial crisis, the Chinese government acted quickly to avoid the full effects of the global economic meltdown. The government provided an RMB 4 trillion stimulus package to business; the People's Bank of China reduced interest rates significantly, causing credit to suddenly become much more affordable. While most demand-side stimulus in developed countries has traditionally been provided through federal government spending, China's stimulus differed in that nearly 70% of the funding came from loans made to local governments (or bonds issued by these local governments) from the country's state banking system.

China's resulting debt composition is thus different from Western countries. As shown in Chart 10, most of it is corporate and government (including local government) debt (note that the announced increase in local government and corporate debt is not yet reflected in this chart). Arguably, China's monetary and fiscal policy responses were successful in preventing a financial crisis in China in 2008-09, just as quantitative easing and government funding provided to banks helped some other developed market countries do so. China was one of the first nations to recover from the financial crisis, with GDP growth recovering by early to mid-2009.

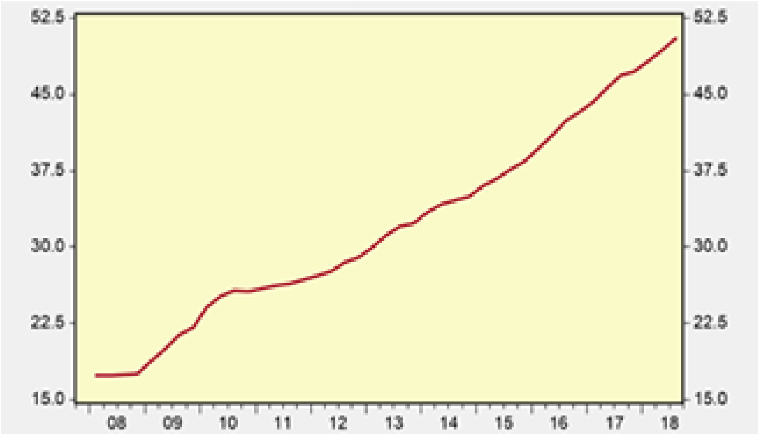
However, the longer-term implications of China's policy responses have created a larger problem than originally intended. Overall debt has continued to increase significantly over the past decade, as shown in Chart 10 and Chart 11. Developed market country stimulus was primarily market-related: governments bought existing government and government-related debt securities. While the amount of Chinese local government debt (RMB 21 trillion) is close to the size of US Federal Reserve balance sheet, the difference is that unlike government securities, there is no ready market for a significant amount of the local government debt and bank debt issued in China. The two main options to reduce debt, beyond distressed sales and auctions of impaired debt, are to pay it off or to write it off.

Chart 10: China Debt Composition



Source: Wellington Management

Chart 11: Outstanding Household Credit

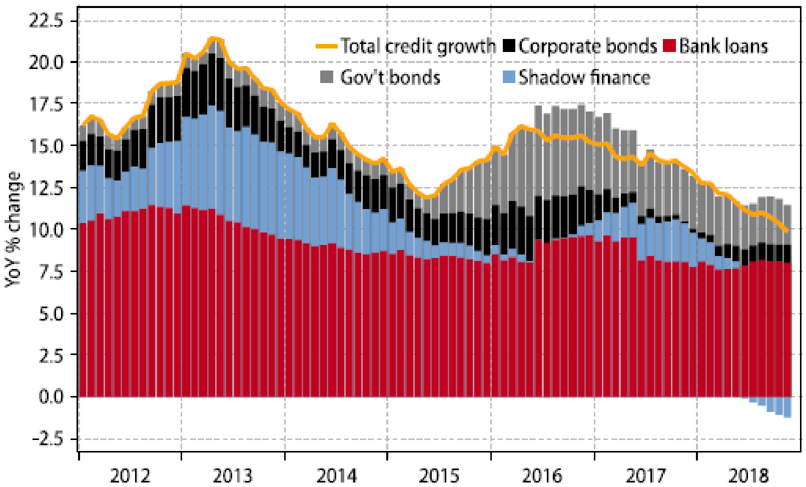


Source: Haver Analytics

Second, a rapid rise in China's household debt (particularly since 2015) has also become an increasing focus of market and policy concern, as shown in Chart 11. The main component of household debt is residential mortgage loans. However, mortgage growth has been slowing since 2016; the more recent concern is the spike in consumer credit in late 2017 and 2018. Short-term consumer credit (excluding credit cards) rose 40% in 2017. Such debt tends to have high rates and a short duration, making it costly for households. At below 60%, household debt to GDP is still below countries such as the United States (77%) or Australia (above 120%). However, US household debt to GDP has reduced significantly in five years; China's has close to doubled.

On any aggregate measure, therefore, China credit growth is higher than nominal GDP growth, and may continue to be for the foreseeable future. The government is allowing a large increase in national leverage in hopes of stabilizing growth. But in the short term, it is likely that the rapid credit acceleration since mid-2015 has peaked, as official concerns about the property market and risky lending by non-bank financials are rising. If credit growth continues, it is more likely to be from China's traditional channels like state-controlled banks. Overall credit growth has been slowing since mid-2016, as shown in Chart 12.

Chart 12: Credit Growth by Sector



Source: Gavekal

Finally, one key difference in objectives should be highlighted. Relative to its other objectives, China's focus on whether consumption increases or decreases as a percentage of GDP is not likely to be its highest priority. The West does view it as a priority, because increased Chinese consumption of global goods and services contributes to global economic growth. In our view, China's primary objective is to maintain internal political control, which is aided by avoiding economic hardship. Its second objective is to secure key natural resources for its population. A third is to maintain and increase China's global economic and political power. Consumption of goods and services enables these objectives, particularly if there is a rebound effect from reduced production and consumption in the West. However, it is by no means China's sole medium-term objective.

Source: KPMG

Potential Investment Implications

With an economic slowdown in China well underway, the implications for a range of investments could be significant. Greater China already accounts for approximately 30% of the MSCI Emerging Market IMI index, and a severe slowdown could have a large short-term effect on this index (both the Hong Kong index and Shanghai indices fell significantly in 2018). Most large US companies, ranging from Boeing to HP to Nike to Ford to Apple, derive a significant portion of revenue from greater China. Most European luxury brands, as noted above, also derive a significant portion of their revenue growth from China. Already, US companies from Nvidia to Caterpillar have reported weaker quarterly revenues as of calendar year-end 2018 due to reduced sales to China.

There are two key scenarios that could play out in a consumption slowdown scenario. One is a soft landing, under which China continues to provide short-term stimulus, using its broad range of tools, to keep employment, production and consumption stable. In this scenario, sales of foreign-provided goods and services may slow in China, but in the medium term will continue growing. This scenario also presupposes a partial resolution to the mutual imposition of tariffs between the US and China. Under a soft landing scenario, all else equal, developed and emerging market equities may continue to experience moderate growth, while interest-rate sensitive bonds may continue their recent mediocre performance due to stable or rising interest rates.

The second scenario is more serious: in this scenario, tariffs on goods continue to be imposed (and potentially increased) between the US and China. Consumption, particularly of foreign products, declines, and internal corporate and local government debt would be allowed to decumulate through a combination of repayments and defaults. Reduced economic growth (still positive but far below the target minimum 6.0-6.5%) and the prospect of social unrest, might be mitigated by a combination of increased nationalism and social control measures. Under a hard landing scenario, equity market declines across both developed and emerging markets are very likely. Interest-rate sensitive bonds would likely perform well, although credit-sensitive bonds would likely not.

Overall Consumption Outlook

Short-term consumption growth in China, particularly of imports, may slow further in 2019. A combination of retaliatory tariffs and government-promoted domestic consumption, if they occurred, would reduce imports from countries such as the United States and European Union countries such as France, Germany and Switzerland. Over the medium term, however, consumption is expected to keep growing. This article has illustrated many of the central macroprudential economic tools that the Chinese government can use to promote economic growth, including sales tax changes and tax rebates, bank reserve ratio requirements, and state-directed lending, equity market, or infrastructure investment support. Absent political change or specific political directives against it, consumption – including of foreign luxury goods and services – is expected to continue to grow.

However, the two risks to this outlook are not inconsiderable. The first is debt. Credit growth has not been used to finance consumption directly, and consumption itself would theoretically continue to grow even if total debt were to begin shrinking. However, high country debt overall – particularly foreign debt - has historically ended in either an economic collapse (in some emerging markets) or a long, slow reduction in economic growth. This is because the weight of debt depresses growth through the effects of high interest payments and high corporate gearing makes investments more heavily scrutinised. Most of China's debt has been issued to entities over which it has a significant influence, so an emerging market style collapse is very unlikely. However, over the medium term, a scenario of slowing growth weighed down by internal debt is possible, even if the government continues to direct banks to lend and investors to buy. This, over the medium term, would lower growth significantly, particularly as the country's population growth slows.

This leads to the second risk. Average economic growth of more than 8% annually for almost 30 years has made China – and the average Chinese - richer than could be imagined a generation ago. But China has left itself open to the same forces of populism that are on the rise in the West by hollowing out the country's former Communist political and economic system and a replacement of state-directed capitalism with nationalism and material progress as its centre-points. The government's drive to use technology for internal surveillance may mitigate this risk, but the government may still have difficulty controlling it. Nationalism, which is the only other pillar that the government has leant on besides economic prosperity, has a nasty habit of getting out of hand. For now, though, we expect growth-led consumption to continue, even if at a slower pace.

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