Is Your China Glass Half Empty or Half Full?

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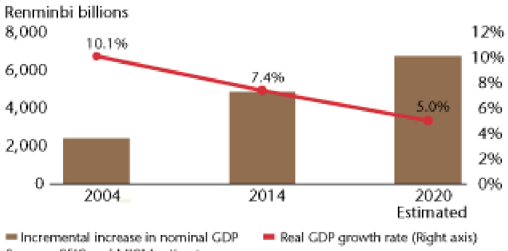
There will be two competing perspectives on China's 2014 economic performance, based on numbers published Monday night. One camp will focus on 7.4% GDP growth being the slowest pace in 24 years. The alternative perspective will note that gradually slower growth was expected and is inevitable after two decades of 10% annual growth. The glass-half-full camp, which includes *Sinology*, also notes that after 7.7% growth in 2012 and 2013, last year's 7.4% doesn't feel like a huge slump. Moreover, because the base on which last year's 7.4% calculation was made was more than 300% bigger than the base from a decade ago (when growth was 10.1%), the incremental increase in the size of China's GDP last year was 100% bigger than the increase at the faster speed 10 years ago.

Figure 1. THE BASE EFFECT:
A BIGGER ADDITION AT A SLOWER GROWTH RATE

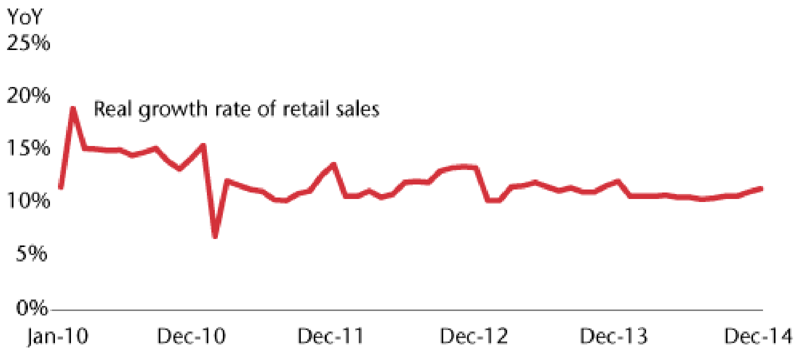


Sources: CEIC and MICM estimates

Consumption Remains Very Healthy

Consumer spending remained very healthy, with inflation-adjusted (real) retail sales up 11.5% year-over-year (YoY) in December, the fastest pace of the year, and up 10.9% for the full year. A particular bright spot was online sales, which rose 50% YoY last year and accounted for almost 11% of all retail sales.

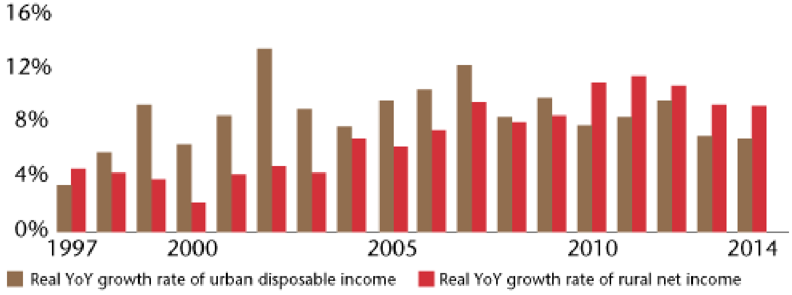
Figure 2. CONSUMERS REMAIN CONFIDENT



Source: CEIC

In our view, China is still the world's best consumption story, especially compared to U.S. retail sales growth of about 2%. But I believe its retail sales growth will continue to decelerate as income growth slows. Real urban income increased 6.8% last year, impressive but down from 7% in 2013 and 9.6% in 2012. Just under half of China's population still lives in the countryside, and real income there rose 9.2%, down from 9.3% in 2013 and 10.7% in 2012. Wages for migrant workers, who move from China's countryside to staff the nation's urban factories and construction sites, rose by almost 10% last year. The country's overall labor market remained stable.

Figure 3. SLOWER, BUT STILL FAST INCOME GROWTH



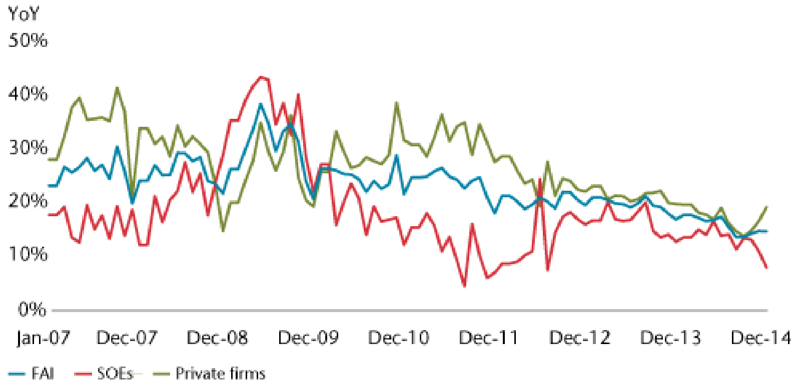
Source: National Bureau of Statistics

I expect wage growth to continue to decelerate gradually, which would lead to steadily slower retail sales growth. The government's anti-corruption campaign has also contributed to slower consumer spending, and that too should continue.

Investments Continued to Cool

One of the main reasons behind the continued economic deceleration is slower growth in fixed asset investment (FAI), which rose 15.7% last year, down from 19.6% in 2013 and 30.1% in 2009. This slower rate of investment growth reflects that so many roads, power plants, houses and factories have already been built. I expect FAI to continue rising at gradually slower rates each year for some time.

Figure 4. INVESTMENT GROWTH SLOWING, BUT INCREASINGLY PRIVATE-SECTOR DRIVEN

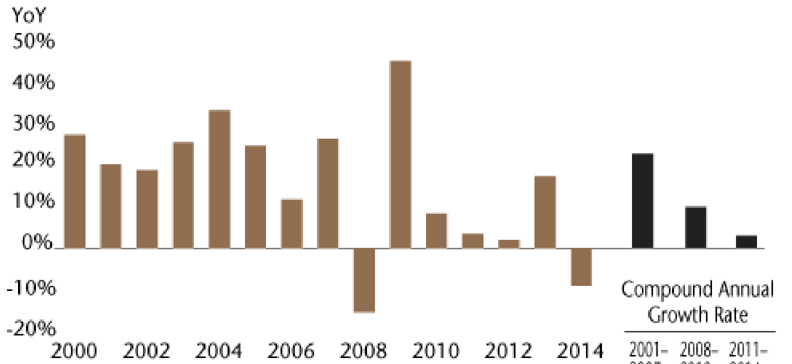


Source: CEIC

Softer Housing Market, but No Crash

A significantly weaker residential property market contributed to slower economic growth. New home sales fell 9.1% YoY last year, in sharp contrast to the 17.5% rise in sales by volume in 2013. (From an investor's perspective, however, it is worth noting that Chinese buyers still purchased more than 10 million new homes last year.) As a result, investment in the housing sector rose by only 9%, down from 19% a year ago.

Figure 5. GROWTH RATE OF NEW HOME SALES (BY SQUARE METER) SLOWS



Source: CEIC

The national average price of a new home rose by only 1.4%, a big drop from the 7.7% increase in 2013. Recent trends have been worse, however, with median new home prices falling on a month-on-month (MoM) basis for seven consecutive months. But the rate of decline has been shrinking, leading me to believe that the market has begun to stabilize. On a YoY-basis, median new home prices have fallen for four months, and were down 4.5% in December. Investors should be aware that because of the base effect (prices rose more 9% last January and were up more than 5% every month through May 2014), even if the MoM price fall continues to shrink, the YoY decline in prices will continue to worsen in the coming months, before improving in the second half of the year. This is why it is important to look at the MoM and YoY trends, and understand the base effect—something the media often neglects.

It is important to understand that if, for several months, new home prices are down by say 5% YoY, there are a few reasons why this may not precipitate a crisis. First, because prices rose at an average annual pace of 8.4% over the last nine years, very few homeowners ought to be in the red. Second, new home buyers must put down at least 30% cash, far from the 2% median cash down payment made by first-time homebuyers in the U.S. in 2006.

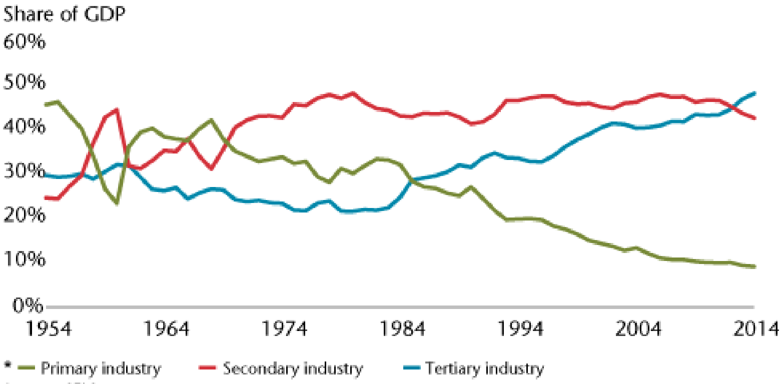
Moreover, the products that broke Lehman Brothers—and caused havoc through the U.S. financial system—do not exist in China. There are no subprime mortgages and there are very few mortgage-backed securities. There is no secondary securitization, so no collateralized debt or loan obligations (CDOs and CLOs). China's residential market is clearly soft, but I believe a housing crisis is very unlikely.

Rebalancing Progress

China continued to rebalance and restructure its economy last year. Consumption contributed more to GDP growth than did investments, as was the case in 2011 and 2012. The tertiary sector (services, retail and wholesale trade in addition to finance and real estate) was larger than the secondary sector (manufacturing and construction), as was the case in 2013.

The most important "rebalancing" is the shift toward an economy that is driven by private sector entrepreneurs, and away from the model of an economy led by state-owned enterprises. Last year, state firms accounted for 32% of total FAI, down from a 58% share in 2004. Investment by private companies has grown faster than that by state firms in 57 of the past 58 months, which should lead to far better investment decisions. (See Figure 4)

Figure 6. A RISING SHARE OF GDP FROM SERVICES



Source: CEIC

I expect this reform process to continue, in part because China's leaders have no choice. They must continue to improve the operating environment for private firms, which account for about 80% of all urban employment and almost all new job creation. I have modest expectations, however, for further progress on the reform of state firms, as the government remains concerned about job losses.

Get Used to Deceleration

Investors must become accustomed to steadily slower rates of growth in almost all parts of China's economy. Deceleration is inevitable for many reasons: the end of China's "catch up" phase; the urbanization rate has hit 55%, up from 36% in 2000, and that process is slowing; the end of the demographic dividend, as the young working age population is shrinking; basic reforms, which have the most dramatic impact, have been completed; construction activity has peaked as infrastructure and housing have matured; and productivity gains are increasingly harder to achieve. I expect to see GDP growth in the 6.5% to 7% range this year, and 5% to 6% by 2020.

We are now in an odd period of time in which China's Communist Party is comfortable with this deceleration, while many in the West are increasingly worried by that trend. One of the most positive economic developments last year was that the Party refrained from deploying significant stimulus. The growth rates of bank lending and total credit outstanding, as well as of fiscal spending all slowed as expected. The Party seems to understand that gradually slower growth is inevitable, and that as long as the job market remains steady and income growth rapid (faster than GDP in recent years), most Chinese will feel that their standard of living is rising despite slower GDP growth. Eventually, the market will come around to this perspective.

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