

A Disappointing Deal, and a Healthy Economy

December 20, 2019

by Andy Rothman
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President Trump called it “amazing,” and U.S. Trade Representative Lighthizer said the China deal is “remarkable.” In my view, however, it is merely the best trade deal in the last 36 months of Chinese history, and it falls well short of two key objectives. Because the deal sets highly unrealistic goals for U.S. exports to China, the risk of disappointment and a return to tariff battles remains, so corporates in both countries are unlikely to feel secure enough to resume investment spending. Second, there are no signs that the two sides are preparing to use this pause in the tariff dispute to reconsider the poor direction the bilateral relationship is taking, towards decoupling and confrontation.

Despite this disappointing deal, the Chinese government seems relatively comfortable with the pace of economic growth and job creation, and is preparing only a very modest stimulus for 2020, designed to stabilize growth by mitigating the impact of the dispute with the U.S. and weaker global demand. I expect the consumer-driven economy to remain healthy next year, and the risks are largely on the upside: if the trade deal does lift the cloud of uncertainty, business sentiment will improve, leading to stronger CapEx spending and reduced pressure on wages. If the deal collapses, Beijing will implement a larger stimulus, to counter the negative impact on sentiment. The key downside risks next year are policy mistakes by Beijing; and if the trade deal fails, Trump could respond with dramatic efforts to contain China's rise, which would be negative for sentiment.

Deal risks

Based on the few details provided so far, the deal doesn't appear to represent a significant improvement on the current trade framework. Lighthizer said over the weekend that the 86 page agreement—which he described as “totally done”—will be signed in early January, and presumably more details will be available then.

I'm less concerned about the absence of breakthroughs than I am about the agreement's highly unrealistic sales targets, which could set up the deal to fail, leading to a return to tariffs or even a full-blown trade war.

In an interview over the weekend, Lighthizer said that the Chinese government has committed, in writing, to dramatically raise the level of its imports from the U.S. “Overall, it's a minimum of 200 billion dollars. Keep in mind, by the second year, we will just about double exports of goods to China, if this agreement is in place. Double exports. We had about 128 billion dollars in 2017. We're going to go up at least by a hundred, probably a little over one hundred. And in terms of the agriculture numbers, what we have are specific breakdowns by products and we have a commitment for 40 to 50 billion dollars in sales. You could think of it as 80 to 100 billion dollars in new sales for agriculture over the course of the next two years. Just massive numbers.”

Massive, yes. But realistic? U.S. agricultural exports to China peaked in 2012 at US\$26 billion, and none of the American agricultural experts I've consulted think it is possible to double that in the near future. My contacts in Washington say that the US\$40 to 50 billion target was not based on a detailed assessment of China's demand nor on the ability of American farmers to quickly expand output of soybeans and other crops. It was a politically expedient target.

The concept of quickly doubling the value of overall U.S. exports to China is equally dubious—even if the baseline is this year's reduced level of US\$88 billion for the first 10 months of this year. The historical peak was US\$130 billion in 2017.

There are a few ways this could play out. First, China could buy record amounts of U.S. agricultural and manufactured goods, but well short of the targets set out by Lighthizer. Trump may be satisfied, claiming success because historical records were reached.

Second, failure to reach the sales targets may not be enough for Trump, despite the record purchases, and he will escalate the tariff dispute. That may lead Chinese officials to decide that further negotiations are pointless, leading to a trade war which damages both economies, although Beijing has far more resources to mitigate the impact.

Third, Washington may fudge the data to come closer to the sales target. We've heard talk, for example, of counting the

sales of goods produced in third countries with American intellectual property, such as semiconductors made in Singapore and Taiwan, as U.S. exports.

(Never mind the silliness of asking the Chinese government to commit to purchasing a set amount of American goods, irrespective of market conditions, at the same time the U.S. is pressing Beijing to establish a more market-driven economy. It is also worth noting that to date, China has declined to comment publicly on the sales targets. That will presumably change after the deal is signed.)

The uncertainty of how this will evolve, and how Trump will respond, means that this deal is unlikely to reassure American and Chinese CEOs, who have been deferring CapEx in response to uncertainty over the bilateral trade dispute. Removing that uncertainty was the negotiators' top job, and they appear to have failed.

I would be delighted to be proven wrong in early January, when the deal is signed and details are published. Maybe there will be a clever plan to explain how China can buy so much American stuff so quickly. Maybe the details will show that the deal is in fact so good that, combined with NAFTA 2.0, it made last Friday, in Lighthizer's words, "probably the most momentous day in trade history ever."

Despite the disappointing deal, China's economy will remain healthy

I'd like to repeat a few important points from the October 18 issue of Sinology. I wrote that if the U.S. and China fail to conclude a trade deal, I will be very concerned about the longer-term relationship between the U.S. and China—the country which accounts for one-third of global economic growth, larger than the combined share of growth from the U.S., Europe and Japan. Failure to reach any deal would have a profound impact on the global economy. But, I will be less worried about the near-term impact on China, as the main engine of its growth— domestic demand—remains healthy, and Beijing has a significant store of dry powder it could deploy to mitigate the impact of an all-out trade war with Washington.

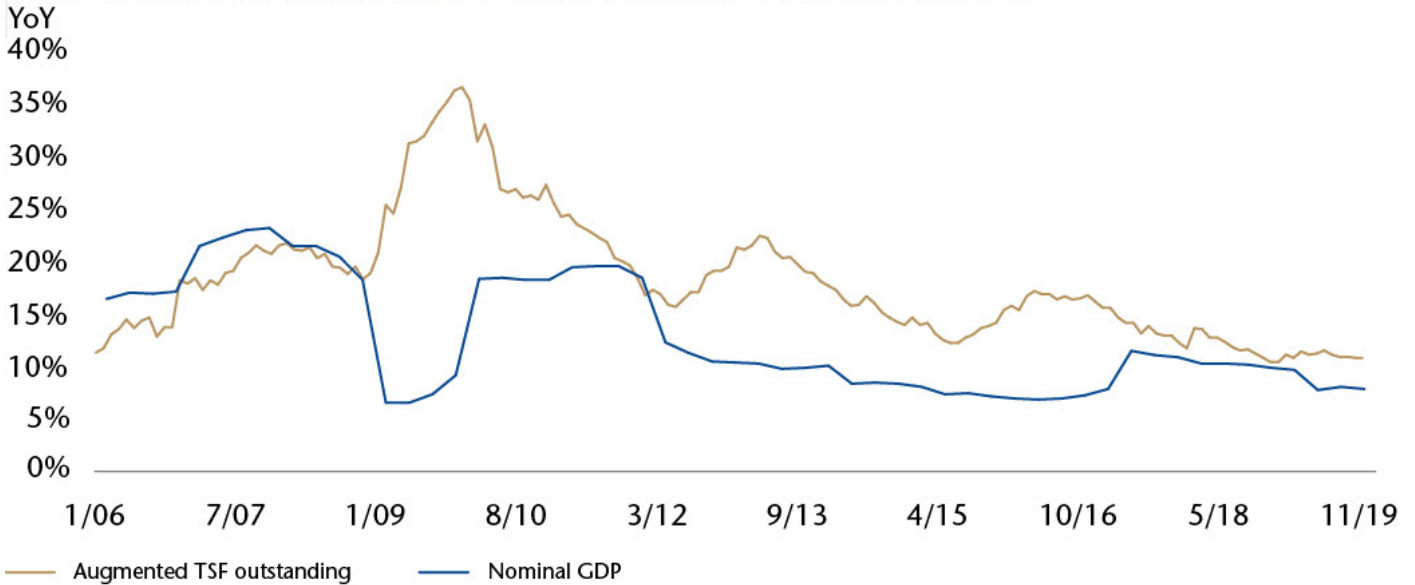
Last year, net exports (the value of a country's exports minus its imports) were equal to less than 1% of China's GDP. And the contribution from the secondary part of GDP, manufacturing and construction, has been declining. This will be the eighth consecutive year in which the tertiary part of GDP, consumption and services, is the largest part; last year, three-quarters of China's economic growth came from consumption.

This is especially important right now, because the domestic demand story should continue to be fairly well insulated from the impact of the Trump tariff dispute.

Modest monetary policy changes

This is one of the reasons I expect monetary policy will be only slightly more accommodative next year, and I do not expect aggressive expansion of credit flows or dramatic interest rate cuts. There may be modest easing compared to this year, but the objective will be to stabilize growth in response to trade tensions with the U.S. and slower global demand, not an effort to reaccelerate growth. As has been the case this year, aggregate credit outstanding (augmented Total Social Finance) will likely expand faster than nominal GDP growth, but not to the extent in past years. Beijing is fairly comfortable with the pace of economic growth.

Figure 1. MODEST MONETARY POLICY EASING EXPECTED IN 2020



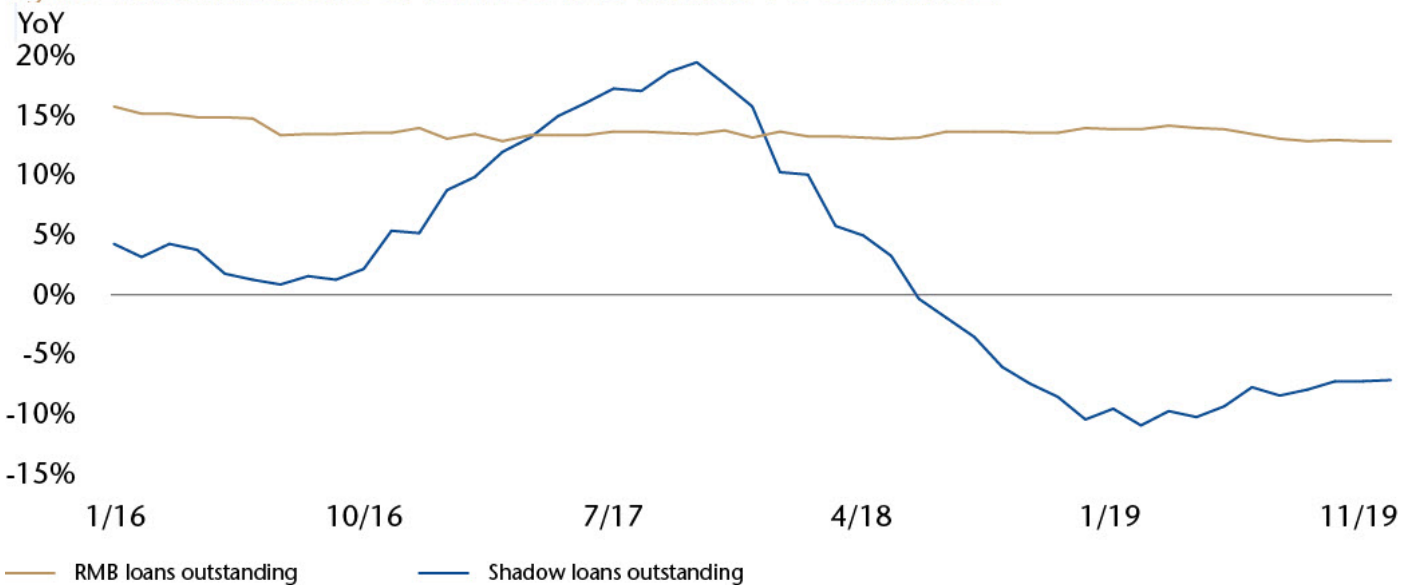
Source: CEIC, Matthews Asia estimates
 Augmented TSF outstanding = total social financing (TSF) outstanding - equity financing + muni bond outstanding

Less focus on deleveraging, more on risks

There will be less focus on deleveraging in 2020, but Beijing is likely to continue to take steps to reduce financial system risks. A modest boost to fiscal spending (see below) will push up the deficit a bit, but because this debt is all within Party-controlled institutions, the risk of a systemic crisis will remain very low. Chinese government economists recently told me they expect the fiscal deficit/GDP ratio to rise to 3% from 2.8%, and after a government that sets economic policy guidance, officials said the focus is on keeping the “macro-leverage ratio basically stable,” rather than on reducing that ratio.

I expect further consolidation of smaller banks as well as a continuation of this year's experiments of selected defaults by state-owned and private firms, in an effort to push investors to price risk. I do not expect the government to relax their tight controls over off-balance-sheet (shadow) financial activity.

Figure 2. RESTRICTIONS ON SHADOW BANKING TO CONTINUE



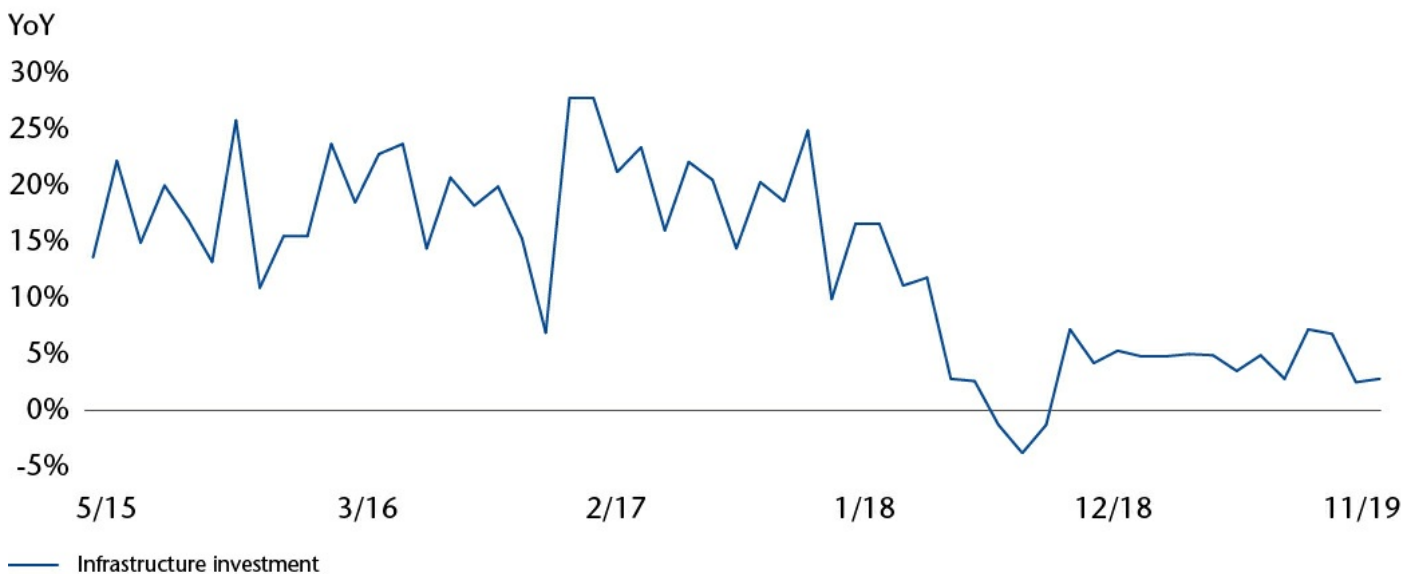
Sources: CEIC, Matthews Asia

Modest infrastructure boost

Officials I met with in Beijing this month indicated that there will be a modest increase in infrastructure investment next year

following this year's surprisingly slow growth rate. But I do not expect this to return to the much higher levels seen a few years ago. Some of the infrastructure will be financed by an increase in "special construction bonds," which may rise to about RMB 3 trillion from the current RMB 2.15 trillion. If this happens, it will support modestly stronger industrial activity and materials demand.

Figure 3. MODEST PICKUP IN INFRASTRUCTURE INVESTMENT LIKELY



Source: CEIC

Residential resilient

Residential property should remain resilient, although I do not expect significant policy changes. The property market has held up better than expected this year, and I think the government feels that policy is about right: not too tight or too loose. Over the first 11 months of the year, new home sales by square meter are up 1.6%, vs 2.1% a year ago and 5.4% two years ago. New home prices in 70 major cities were up 7.6% YoY in November (basically in line with nominal income growth), compared to 10.8% a year ago and 6% two years ago. Inventory levels are reasonable. Residential property investment has been rising at a double-digit pace for 23 consecutive months, but that is likely to cool off a bit next year. The government continues to reiterate the policy that "houses are for living, not for speculation," and there is no sign that the government will relax the current policies related to property.

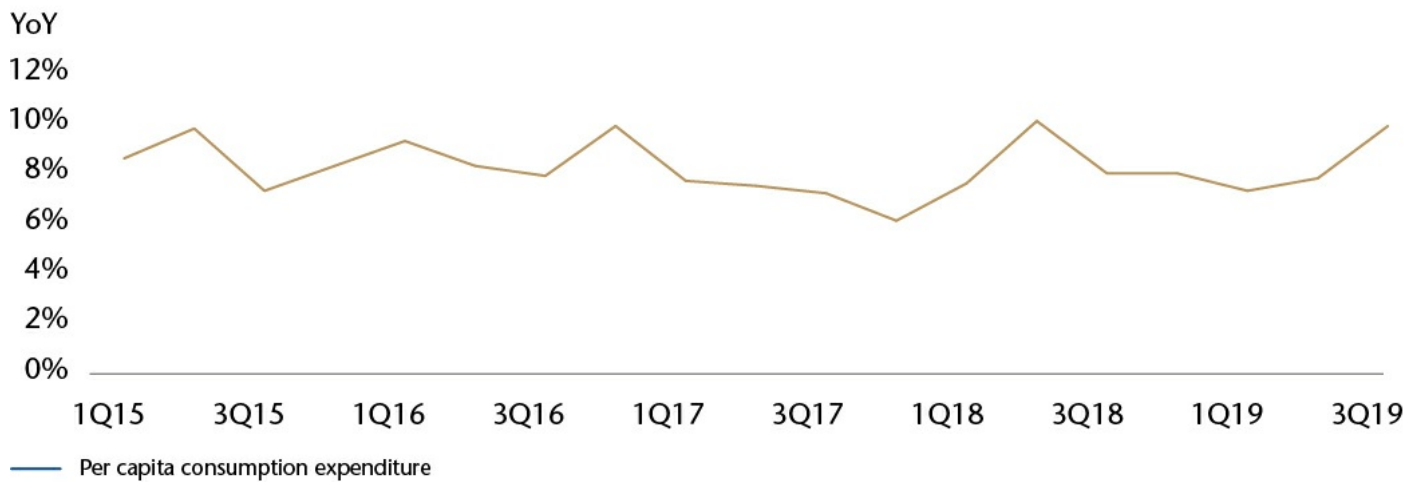
Modest improvement in CapEx likely

Investment spending by private firms has been weak, largely due to uncertainty resulting from the ongoing Trump tariff dispute. I expect modest improvement next year: if the trade deal is successful, that will reduce uncertainty. If the deal fails, Beijing is likely to take policy steps to encourage capex spending.

The China consumer story should remain strong in 2020

This is important because the consumer and services (tertiary) part of the economy is the largest part, and last year accounted for 75% of China's GDP growth. (Figure 4 shows the growth in per capita consumption expenditure, which includes a wider range of services compared to the retail sales data. Services now account for 50% of household consumption.)

Figure 4. HOUSEHOLD CONSUMPTION ROSE 9.9% IN 3Q19 VS. 7.3% IN 1Q19



Source: CEIC

A continuing outbreak of African Swine Fever has led to lower pork supply, which has pushed up the price of pork, China's primary protein source. Headline consumer price inflation will remain elevated next year, driven entirely by pork. Core inflation, at 1.4% YoY now, should continue to be low, and inflation should not have a significant impact on consumer sentiment.

Although monetary policy will not have much impact on live pig supply, as was the case during previous hog disease outbreaks, Beijing will cautiously limit policy expansion so that higher food inflation will not change people's inflation expectations and spread food inflation to other areas.

Regards,

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Sources: Matthews Asia, CEIC

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