FOR PROFESSIONAL INVESTORS – 18 December 2018

Chi Time

WHAT'S NEW IN CHINA'S 2019 OUTLOOK?

Problems are not stop signs, they are guidelines.

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Let us consider the four GDP components – consumption (C), investment (I), government expenditure (G) and net exports (NX). The outlook for NX is clouded by the Sino-US trade conflict.

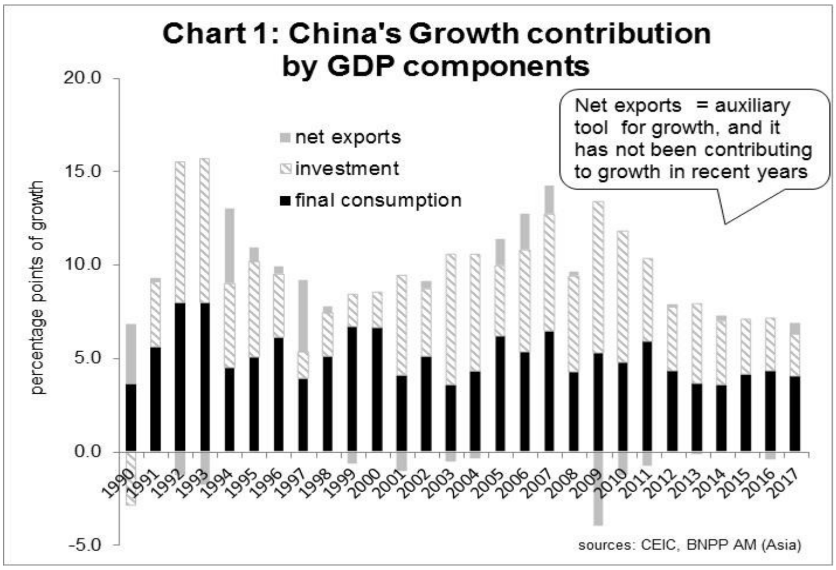
NX: TRADE WAR UNCERTAINTY

Do not expect any contribution to growth.

There are three potential outcomes for Sino-US trade relations in 2019, in our view (with probabilities shown in the parenthesis):

1) China and the US reaching an agreement by March 2019 (when the trade-war truce will expire) on settling all major issues and tariffs are rolled back (10%)
2) Trade talks stalling or getting derailed so that the 10% tariff rate on the USD200 bn Chinese exports to the US will go up to 25%, with US President Trump threatening to levy 25% tariffs on all imports from China (30%)
3) Negotiations continuing beyond March with no further tariff escalation (60%)

The odds for these outcomes may change quickly before 1Q 2019, depending on the political tug of war between China and the US. Even under our base case scenario 3), Chinese net exports would likely not contribute to GDP growth next year, as they have mostly been dragging on GDP growth in recent years (Chart 1). Some players even forecast a current account deficit for China in 2019, though we are not that pessimistic.



G: FISCAL SUPPORT VIA TAX CUTS

The stimulus from tax cuts could amount to 0.9% - 1.6% of GDP, with VAT cuts in focus.

There is a new policy initiative for tax (particularly VAT) cuts to support growth. Tax reform started in May 2018 when Beijing cut some of the VAT rates by 1 ppt., followed by a cut in social security taxes in September and an increase in the tax-free income thresholds and introduction of special deductions for individuals in October.

More tax cuts are expected in 2019 with the focus on the VAT, which accounted for more than a third of total government revenues in 2017. Chinese corporate taxes average 67% of profits, far higher than many other countries. Further, China's VAT cuts are supposed to be permanent, so they should help stimulate investment[1].

China has a tiered VAT system comprising three brackets: 16%, 10% and 6%:

1) Manufacturing pays 16% VAT and accounts for about 68% of all VAT payments.
2) Construction, real estate, agriculture, utilities, telecom and transport pay 10% and account for about 18% of total VAT payments.
3) The services sector pays 6% and accounts for about 14% of all VAT payments.

The market estimates that the economic stimulus from the VAT cuts would range between 0.9% and 1.6% of China's GDP in 2019, depending on which tax brackets the cuts would focus on. The tax cuts could push Beijing's fiscal deficit to a projected 4.0% of GDP (versus 2017's 3.0% and 2018's target of 2.6%). But the ultimate impact on the fiscal deficit could be lessened by spending cuts[2] and/or drawing down of the fiscal deposits which is estimated at RMB2.8 trn as of August 2018[3].

I: INFRASTRUCTURE AND PRIVATE INVESTMENT RECOVERY

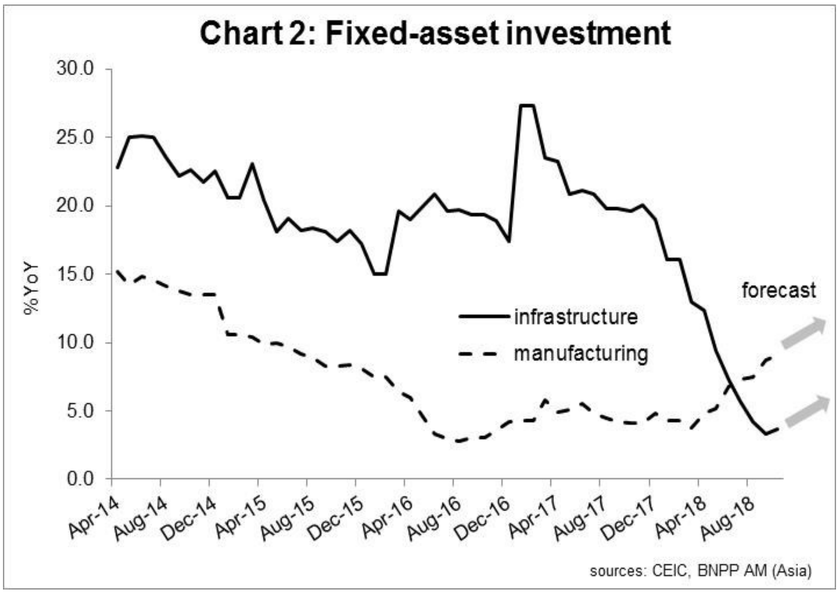
[1] Because the expected tax cut in China is permanent, it is not supposed to suffer from the Ricardian Equivalence, which argues that economic agents are forward-looking so if they receive a temporary tax cut financed by government borrowing, they anticipate future taxes will rise. Thus, their lifetime income remains unchanged and so spending/investment remains unchanged.

[2] If spending cuts are equal to the amount of tax cuts, there will still be a positive balanced-budget multiplier effect on the economy.

[3] These include unspent revenues, profits from land sales, levies or profit from state firms and bond sales revenues and other sources such as government fees. See https://www.bloomberg.com/news/articles/2018-08-10/china-has-a-stealth-410-billion-stash-to-boost-the-economy

Relaxation of the local governments' funding constraint will boost infrastructure investment, while a policy-driven credit support may help private sector "animal spirits" to recover.

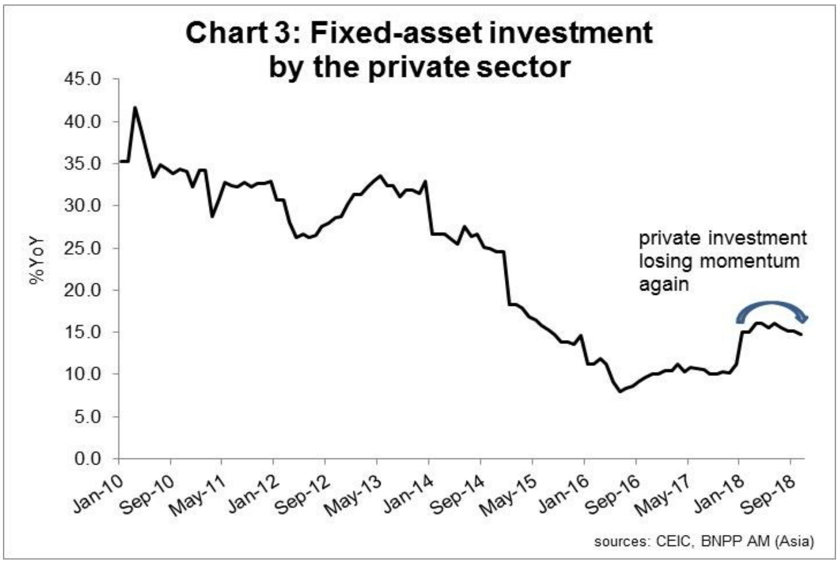
Infrastructure investment, with local governments accounting for over 90% of the total, has started stabilising since October 2018 while manufacturing investment has already been recovering (Chart 2) after months of selective policy easing. Infrastructure investment is expected to continue to recover, albeit moderately to about 10% YoY next year from the current 4.0%, due to:
1) further relaxation of the local governments' budget constraint through an increase in their bond issuance quota in 2019
2) more approvals for Public-Private-Partnership (PPP) projects, and
3) relaxation of asset management rules to increase funding flows.

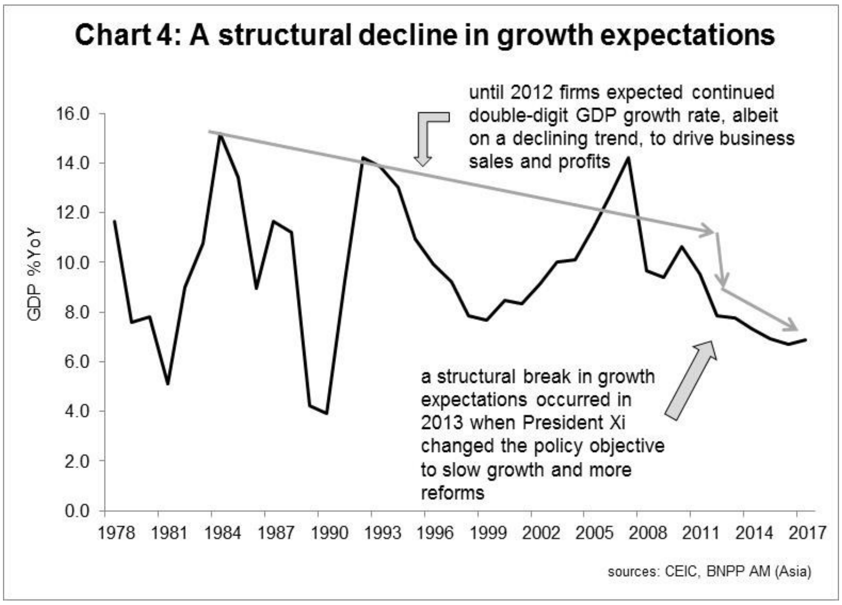


Private sector investment growth has been falling (Chart 3), in my view, due to a structural downward shift in growth expectations (Chart 4) since President Xi took office in 2013 and changed the country's policy objective from chasing growth quantity (the "old" China model) to achieving growth quality through structural reforms (the "new" China model)[4].

The old China followed a supply-expansion development model, in which economic agents build/invest/produce first to expand supply that creates jobs and income. This model worked for more than 30 years when high growth rates created swift demand catch-up. But it broke down when President Xi took office and started implementing his "new normal" policy to keep GDP growth at 6%-7% a year and to push structural reforms. This means no more swift demand growth to absorb all that supply/production/investment excesses that economy has built up.

[4] See *"Chi on China: China Loses its "Animal Spirits",* 10 August 2016.





To revive "animal spirits", the private sector needs to adapt to the new China model and Beijing needs to implement genuine supply-side reforms to unlock private investment incentive. But in the short-term, credit availability and profitability determine the ability of firms to invest. So Beijing is trying to increase credit support for the private firms through:

1) the use of the PBoC's re-lending facility to fund the private sector
2) the imposition of lending targets on banks for private firms[5], and
3) discriminatory cuts in the bank reserve requirement ratio (RRR) whereby banks that lend more to the private sector will get bigger RRR cuts than the average.

[5] The CBIRC is mulling to introduce a "1-2-5" target to support the private sector, with loans to private firms accounting for 1/3 of new corporate loans at large banks, 2/3 at mid- and small-sized banks and 50% in the entire banking system in three years.

C: CONSUMPTION TO BENEFIT

Consumption upgrade to continue

Sustained, though moderate, income growth, improvement in household access to credit and continuation of reforms focusing on creating jobs and improving the social safety net should add to the above policies to keep consumption growth resilient. Key downside risk comes from escalation of the trade-war risk and a deeper-than-expected property market downturn.

The long-term trend of consumption upgrade should continue as the income of the population outside the rich cities grows towards the rich-income threshold and beyond[6].

A NEW STRUCTURAL REFORM DIRECTION

Beijing will start using "competitive neutrality" as the guiding principle for SOE reform and industrial policy.

The OECD has developed this framework to guide a country's structural reform and industrial policy based on experience of developed markets, such as France and Australis, which also have SOEs. Its principle states that a public sector business, or agency, should not have any competitive advantage or disadvantage over the private sector due to their public ownership status.

Beijing intends to apply this framework to reform the SOEs so as to create a level playing field for the various players, including the domestic private sector and foreign firms. Potential focus areas include enhancing transparency, reducing subsidies and reforming corporate governance to separate the government from the business.

If implemented properly, this will also go a long way to reduce trade tensions with other countries. The key challenge, as always, is implementation. The hope is that the prevailing international trade pressure on Beijing to change its structural behaviour would lead to proper implementation of the competitive neutrality principle.

THE BOTTOM LINES

China is walking into 2019 on a fine balance between structural reforms that are deflationary and cautious policy stimulus to support growth on the back of trade-war uncertainty. We expect GDP growth to slow to 6.2% YoY next year. Inflation is expected to remain benign at 2.5% YoY in such an environment.

Such a macroeconomic backdrop is bond positive. It seems that China's bond market sentiment has turned from worrying about defaults to cheering about disinflation, as CGB yield has fallen towards 3.0% from almost 5.0% a few months ago and corporate yield has also rolled over. The question is supply. While we expect most of the funding will come from provincial government bond issuance, thus expanding the Chinese "municipal government" bond market – a development that international investors have been hoping for – Beijing can also tap its fiscal saving or cut spending to contain the expansion in its fiscal deficit.

[6] See "*Chi on China: Mega Trends of China (1): Domestic Demand for Financial Assets*", 5 August 2015.

Trade tension with the US is the biggest uncertainty overhanging China's equity market. Its impact falls not just on the affected exporters but also on capex and employment/wages in export-related sectors, such as machinery, home appliances, auto and parts and electronics. Consumer discretionary also faces headwinds under slowing economic growth exacerbated by the negative impact of trade. Expected policy easing should favour big cap and old industry stocks first before spilling over to other sectors.

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