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THE TRIPLE TRANSITION

By Simon Cox

Managing Director and Investment Strategist

BNY Mellon Investment Management Asia Pacific

Future historians may remember 2014 as an epochal year for China's economy: the moment when the country regained its position as the world's biggest economy, by one measure, for the first time since the 19th century.[1]

This momentous historical achievement was, however, overshadowed by more immediate concerns. China's economy last year was beset by falling property sales, deflating producer prices and sporadic defaults. One might have expected these problems to weigh on China's stockmarkets. But mainland markets strengthened in the final six months of 2014 and soared spectacularly in its final six weeks.[2]

China's economy, its leaders insist, is undergoing a "triple transition". That phrase, which is our translation of 三期叠加 (san qi die jia), peppers official commentary almost as frequently as the term "the new normal"[3]. It sums up three new facts of life for China's economy. First, the country's natural rate of growth is slowing, as its population ages and its economy matures. That first transition necessitates a second: China must embark on another round of reforms to give market forces a more "decisive" role in allocating resources. That will help China's third transition, which is to "digest" the excess capacity, including large inventories of property, left behind by its stimulus efforts after the global financial crisis.

CHINA'S TRIPLE TRANSITION (三期叠加)

1. A slowdown in the natural rate of growth
2. Structural reforms that give market forces a more decisive role in the economy
3. The digestion of excess capacity left behind by the post-crisis stimulus

This triple transition will shape the economy's prospects in 2015. The phrase reflects a welcome recognition that the breakneck growth of the past is unsustainable, further reform is necessary and the 2008-9 stimulus efforts had unwelcome side-effects. That is a message well worth communicating to

[1] In April 2014 the World Bank published the results of a worldwide comparison of prices. Based on these numbers, the IMF calculated that China's output of goods and services in 2014 would be worth more than America's if similar items were priced similarly. In practice, China's prices tend to be lower than America's when converted at market exchange rates. Therefore China's GDP is still considerably smaller than America's when converted into dollars at the prevailing exchange rate, which averaged 6.14 in 2014, according to Oanda. There is one final wrinkle: China's National Bureau of Statistics will soon adopt a more modern method of calculating GDP, known as the 2008 System of National Accounts. This may result in an upward revision of China's GDP, according to the Rhodium Group and other scholars. If the restatement is big enough, it may show that China's GDP overtook America's a year earlier—in 2013—if similar items are priced similarly. It's worth emphasizing that none of these calculations is terribly precise.

[2] The CSI 300 index rose by 63% in the second half of 2014 and by 39% from November 20th to December 31st, according to Thomson Reuters Eikon.

[3] See, for example: http://cnews.chinadaily.com.cn/2014-12/10/content_19058024.htm

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provincial party chiefs and local leaders who might otherwise strive too hard to restore the double-digit growth of yesteryear. China should emerge on the other side of this transition with a more efficient economy, albeit one that may be harder to stabilize. The only danger is that the leadership's preoccupation with this triple transition in 2015 complicates their efforts to shore up demand in the economy, which remains unnecessarily weak. China should accept the new normal of slower trend growth. But in doing so, it should not fall prey to a new subnormal of below-trend growth.

China's natural rate of growth is indeed slowing. And stimulus will not change that fact. But far from denying this slowdown, China's leaders seem keen to embrace it.

CHINA HAS A JOBS TARGET NOT A GROWTH TARGET

Some critics of China's economy have accused its leadership of trying to "fight the trend"[4]. They argue that China's slowdown is entirely structural. Its maximum, sustainable growth rate has dropped, a trend its leaders cannot defy by easing credit in a bid to stimulate demand. Economic historians point out that South Korea made just such a mistake in 1989. It faced a structural slowdown, which it misinterpreted as a cyclical dip. Its efforts to fight this new reality only made things worse[5].

China's natural rate of growth is indeed slowing. And stimulus will not change that fact. But far from denying this slowdown, China's leaders seem keen to embrace it. They have spoken ad nauseam about a "new normal" of slower growth. This gentler pace of expansion is "normal" both in the sense that it is here to stay and in the sense that it is nothing to get too exercised about.

In this spirit the National People's Congress (NPC) is likely to endorse a lower growth target of 7% for this year, we believe. As well as cutting the target, China's leaders also seem keen to downplay its significance. Li Keqiang, China's premier, and Lou Jiwei, its finance minister, have both explained that China's growth target is now subordinate to its jobs target[6]. In other words, the government will aim for whatever growth is necessary to create a sufficient number of urban jobs.

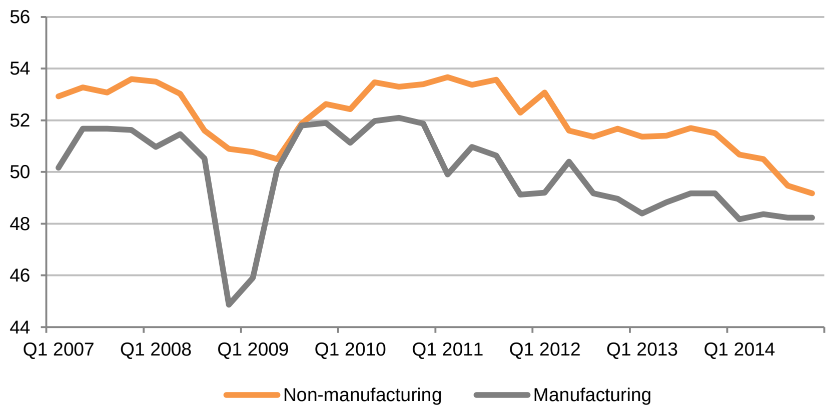
That task is made easier by the growing role of services in China's economy. Its services sector is about 20% more labor-intensive than industry. As services contribute a larger share of China's economy, it will require less growth to generate the same amount of jobs[7].

CHINA'S NEW SUBNORMAL

China's natural rate of growth—the growth rate it requires to sustain full employment without excessive inflation—is therefore lower than it was. But China now appears to be falling short of that lower limit. In the final quarter of 2014, employment in its non-manufacturing sectors was the weakest ever recorded by the official Purchasing Managers' Index (see Figure 1), which began in 2007. This slack is also evident in China's inflation figures. Producer prices fell, year-on-year, in December for the 34th month in a row, according to the National Bureau of Statistics. This downward pressure on prices suggests that demand is insufficient to fully employ China's economy. The country should embrace the "new normal". But its recent economic weakness represents something worse: a new subnormal.

[4] See, for example, the criticism in the latest Geneva Report on the World Economy, published by the Centre for Economic Policy Research: www.voxeu.org/sites/default/files/image/FromMay2014/Geneva16.pdf
[5] "From Miracle to Maturity: The Growth of the Korean Economy", by Barry Eichengreen, Dwight Perkins, Kwanho Shin
[6] http://www.china.org.cn/china/NPC_CPPCC_2014/2014-03/13/content_31773651.htm
[7] One million yuan-worth of output in services creates about 10.7 jobs. The same amount of industrial output creates only nine jobs.

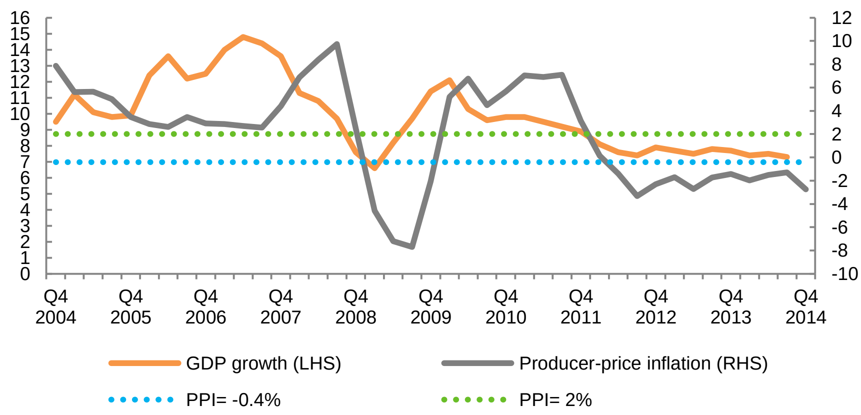
Figure 1: China PMI Employment Subindex



Source: Purchasing Managers Index published by National Bureau of Statistics

Will demand pick up in 2015? The chief economist of the People's Bank of China, Ma Jun, and his colleagues forecast that China's economy will grow by 7.1% this year[8]. But, as they acknowledge, that will not be fast enough to dispel the forces of producer-price deflation: they foresee prices falling by another 0.4% in 2015. A year ago, in his previous role as chief economist for Greater China at Deutsche Bank, Mr Ma argued that the country would have to grow as fast as 8.5% to generate producer-price inflation of 2%[9]. The upper limit on China's growth is presumably lower than that now. But a look at China's recent growth and inflation figures nonetheless suggests that the country has more room to grow than is commonly supposed (see Figure 2).

Figure 2: China's Growth and Inflation



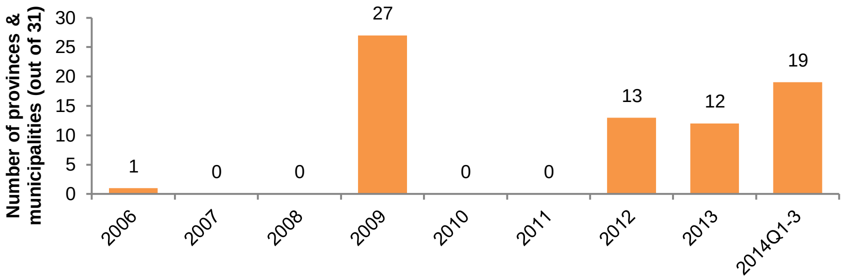
Source: National Bureau of Statistics

China's deflationary pressures are not evenly spread across its economy. Nineteen of China's 31 provinces and municipalities appear to be suffering

[8] http://www.pbc.gov.cn/publish/yanjiuju/4242/2014/20141212092532135653095/20141212092532135653095_.html
[9] https://institutional.deutscheawm.com/content/_media/China_Themes_and_Strategy_for_2014.pdf

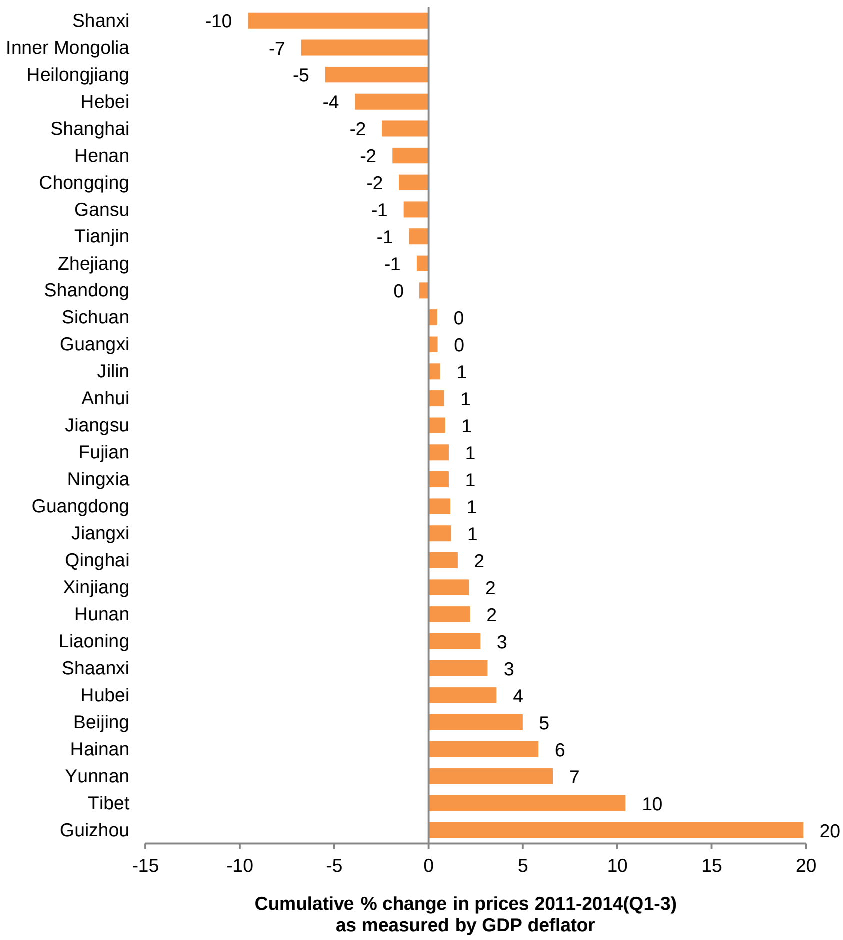
from falling prices, according to the GDP deflator (see Figure 3)[10]. In the coal-mining province of Shanxi, prices have fallen by 4.5% in the first three quarters of 2014, compared with a year earlier. Since 2011, they have fallen by over 9.5% (see Figure 4).

Figure 3: Number of Provinces in Deflation*



Source: BNY Mellon calcluations, based on data from Provincial and National Bureaus of Statistics
* As measured by the year-on-year change in the GDP deflator

Figure 4: China's Provincial Price Pressures



Source: BNY Mellon, based on Provincial Statistical Bureaus.The chart compares the GDP deflator in 2011

[10] These regions reported that their nominal growth rates (which include inflation) were lower than their real growth rates (which strip out the effects of price changes) in the first three quarters of 2014. This suggests the GDP deflator, the broadest measure of inflation, is now negative in these parts of the country.

with the GDP deflator in the first three quarters of 2014

This low inflation gives the Chinese authorities room for further stimulus in 2015. This stimulus is necessary not to fight the trend but to *fulfill* it. Additional cuts in benchmark interest rates and reserve requirements are possible, in our view. Such cuts would help offset the increase in real interest rates entailed by declining inflation.

Rather than allowing credit to slip the leash again, the authorities will also resort to fiscal stimulus. Recent reports by China's Economic Observer newspaper and Bloomberg suggest that China will hasten the implementation of about 300 investment projects in seven "packages", including agriculture and water conservation; transportation; environmental protection; healthcare; information technology networks; clean energy; coal, oil and gas[11].

China is not wrong to vary the timing of its investments in counterpoint to the economic cycle.

For China's critics, these reports revive unhappy memories of China's stimulus efforts after the global financial crisis. But such comparisons can be misleading. These 300 projects are drawn from a larger pipeline of 420 that the National Development and Reform Commission had already scheduled for the period from 2014 to 2016. They are then part of a longer-term plan overseen by China's central planning agency. That distinguishes this infrastructure effort from the local government free-for-all after 2008, which was hastily planned and loosely co-ordinated.

There is a sound economic case for this kind of counter-cyclical spending. Governments should postpone projects in boom times, lest they add to overheating, and hasten them in busts, when financing is cheap, labor is available and opportunity costs are low. China is not wrong to vary the timing of its investments in counterpoint to the economic cycle. In my view, more governments should try it.

INDIGESTION VERSUS STARVATION

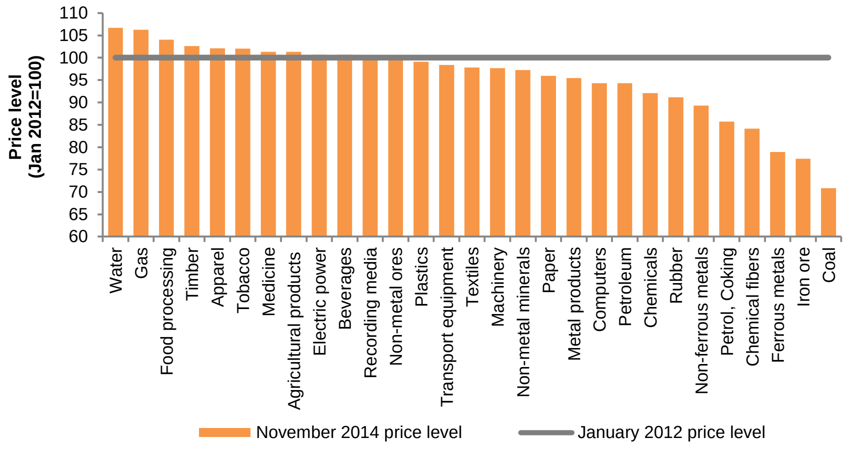
The authorities do not want to replicate the 2008-9 stimulus not least because they are still dealing with the consequences of the original version. Although that lending and investment spree helped rescue China from the financial crisis, it also precipitated a property-price bubble and wasteful additions to capacity in a variety of industries, including steel, cement, aluminum, plate glass, shipbuilding and solar. To give some sense of the scale of China's building boom, note that in just three years, from 2011 to 2013, China produced enough cement to turn the whole of Great Britain and Northern Ireland into a car park.[12]

Digesting this excess capacity represents the third of China's transitions. The process is still weighing on China's property market, where home sales have declined throughout 2014. To stabilize sales, China's local authorities have now lifted home-purchase restrictions in all but a handful of cities. China's central bank has also relaxed its mortgage regulations[13]. It can take up to eight months for cuts in interest rates to translate into increases in sales, according to China Index Academy, a division of Soufun, a Chinese real-estate agency. Sales may therefore pick up towards the second half of 2015.

[11] http://industry.cfi.cn/p20141227000142.html ; http://www.bloomberg.com/news/2015-01-05/china-said-to-accelerate-1-trillion-in-projects-to-spur-growth.html
[12] BNY Mellon calculations based on National Bureau of Statistics, China, and "Designing Quality Concrete Parking Areas" by National Ready Mixed Concrete Association. Calculations assume 280kg of cement per cubic meter of concrete and a parking surface 100mm thick.
[13] http://www.wsj.com/articles/pboc-eases-mortgage-lending-rules-1412071028

What about other industries blighted with excess capacity? In a number of these industries prices have fallen substantially from their peaks (see Figure 5). These price declines are an obvious symptom of overcapacity. But they also represent the beginnings of a solution to it.

Figure 5: China's Producer Prices



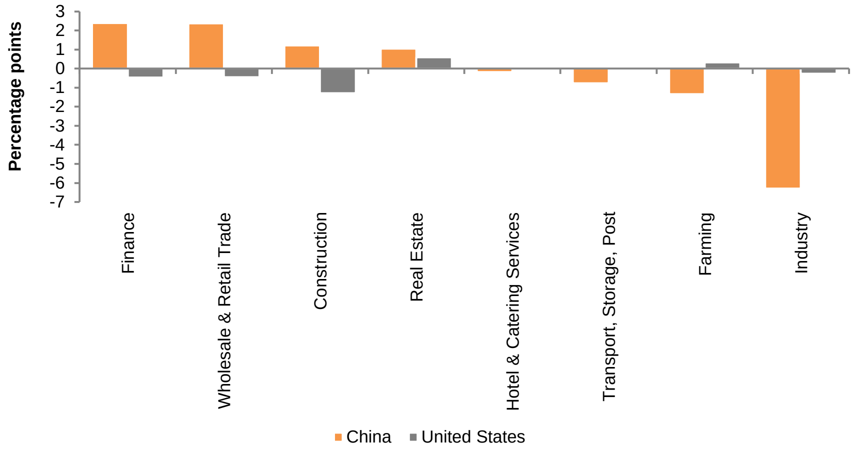
Source: National Bureau of Statistics

Lower prices will improve demand. In principle, they should also curtail supply: unremunerative prices should discourage further investment in these industries and force some existing producers to exit altogether. In practice, many firms soldier on with the help of forgiving banks and indulgent local governments.

This indulgence slows the pace of corporate restructuring in China. But it would be wrong to assume that China's industrial mix is therefore preserved in aspic. Labor is highly mobile across industries and regions, much more so than in many other countries. And although the banking system in China is less ruthless than elsewhere, bank loans are not the biggest source of finance for many Chinese firms, which rely instead on retained earnings. This kind of internal finance naturally accumulates in profitable industries and evaporate in unprofitable ones. There is, therefore, a natural tendency for retained earnings to gravitate towards industries with the highest returns.

As China's GDP has increased vastly in size, it has also changed considerably in shape. China's economy has evolved as it has expanded. Despite all of the fuss about industrial overcapacity, industry's share of China's GDP has declined by 6.3 percentage points over the past eight years. The share of retail and wholesale trade has increased by 2.4 points (see Figure 6). By this measure, indeed, China's economy appears to have enjoyed far more creative destruction than America's.

Figure 6: Sectoral Shares of GDP
(Percentage Point Change 2006–2014)



Source: National Bureau of Statistics, Bureau of Economic Analysis

THE STOCKMARKET RESPONSE

In the past two months, China's stockmarkets have enjoyed a dramatic rally. Is this bull run an endorsement of China's "triple transition" and the reforms it represents?

In truth, China's transition is a mixed blessing for its stockmarket. The first transition reflects a slowdown in China's underlying rate of growth, which is unwelcome, even if it is also inevitable. By digesting excess capacity (the third transition), China should restore profitability to some industries cursed by falling margins. That will be good news for the surviving firms. But it also implies that many firms will not persist in their present form.

The reforms implied by the second transition also have mixed implications for the share prices of incumbent firms. Financial reforms, for example, aim to bring greater diversity and discipline to China financial system. If they succeed, these reforms could increase pressure on both sides of the balance sheets of incumbent banks. By giving banks greater leeway to raise deposit rates, they will oblige banks to fight more fiercely for depositors. By nurturing the bond market, these reforms may also force banks to compete harder for corporate borrowers, who will otherwise raise funds from the capital markets. These reforms could therefore put pressure on banks' interest margins, hurting their future earnings.

Ultimately, these financial reforms should make Chinese capital more productive, but also less patient. Banks will become more discerning in their lending decisions, which will improve the return on capital to the economy's benefit. But banks will also become more skittish, quicker to pull loans that might otherwise turn sour. China will become less prone to credit binges, but also newly vulnerable to credit crunches.

Beijing is also seeking to impose greater fiscal discipline on local governments. The State Council sketched out its plans in October in its "No.43 document"[14]. The new rules will allow local governments to issue bonds in their own name, subject to a quota overseen by the central

[14] http://news.xinhuanet.com/english/china/2014-10/02/c_133688904.htm

government. But the regulations will also prohibit local governments from financing their ambitions indirectly through financing vehicles and other implicitly guaranteed entities.

These plans will ultimately increase the efficiency and transparency of local-government spending, which is emphatically a good thing. But in the short term, the overhaul may also inhibit local-government spending. That is not necessarily welcome in an economy that appears to be suffering from weak demand. It may therefore fall to the central government to offset weaker spending at the local level with stimulative measures of its own.

THE SHANGHAI-HONG KONG DISCONNECT

China's stockmarket rally is marked by two great ironies. For all the talk of the new normal, the sectors that have performed best in recent months include traditional capital-intensive industrial stalwarts, such as oil and gas, coal, and construction, according to Thomson Reuters. Thus far the "new normal" has been remarkably good for "old China" stocks.

The other great irony is that the bull run has been largely confined to onshore markets. The CSI 300 index, which spans both Shanghai and Shenzhen bourses, rose by over 50% in 2014, even as the offshore MSCI China index, closely followed by global investors, rose by less than 5%. Similarly, 'A' shares listed on the mainland are now substantially more expensive than the same companies' 'H' shares, listed in Hong Kong. This premium amounted to almost 30% at the end of 2014, according to an index calculated by Hang Seng, which weights companies by their market capitalization. We are not the only ones to note that this disconnect between A- and H-shares coincides with the November launch of the Shanghai-Hong Kong Connect scheme, which was supposed to bring the two exchanges closer together.

This outperformance suggests that something has changed for mainland investors, not for mainland companies.

THE POPPING OF PESSIMISM

If the prospect of economic reform were responsible for China's stockmarket rally, the gains should have been shared by all the companies exposed to its economy, wherever they were listed. Instead, mainland indices have massively outperformed their offshore counterparts. This outperformance suggests that something has changed for mainland *investors*, not for mainland *companies*.

The sharpest gains were triggered by the Chinese central bank's decision to cut its benchmark interest rates in November. Such cuts make more difference to local valuations than to offshore valuations, because offshore investors discount returns by the world interest rate not the mainland rate. The November cut was not enough by itself to warrant the extraordinary run-up in share prices in the weeks that followed. But if investors expect further cuts in the coming quarters, it was enough to provide a trigger. The share-price gains then appeared to feed on themselves. The fire created its own fuel, tempting Chinese retail investors to open accounts and buy shares on margin.

There are, then, a variety of reasons to be cautious about the mainland bull market. The price gains reflect revised valuations, not revised earnings. This rerating has been remarkably sudden. The rally has been both cause and consequence of an influx of new investors, many of whom appear to be investing on margin.

Despite the strong rally, however, Chinese shares are still not conspicuously expensive, as judged by their price-earnings ratios. The ratio for the CSI 300 was 15.55 on January 6th 2015, according to CSI, hardly a forbidding figure. Recent price gains follow a long period of undervaluation. If valuations are mean-reverting, they must sometimes revert upwards as well as downwards. It is possible that what we are witnessing on the mainland is not a bubble of optimism, but the popping of a three-year bubble in pessimism.

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