

What's Really Going On in China?

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Today's Agenda

- Provide an overview of China's economy, political landscape, US relations, markets, risks, security issues, Hong Kong relations, trade, and its military.
- Discuss the implications for investments as China further develops

Rule Number One

**A Healthy skepticism of China is
indeed healthy.**

**An Unhealthy skepticism of China
can be
detrimental to investment decisions.**

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China's economy may be more resilient than many believe.

- While China's economy is slowing somewhat, it is no longer as dependent on exports as before. 75% of GDP growth now comes from the service industry. China's exports to the US account for only about 4% of GDP, and only about half of that is value added. According to key China economists (Nick Lardy, David Dollar, Jon Anderson, etc.) China's GDP data is more reliable than many think, although some other data is definitely unreliable.
- Much of the data can be verified from external sources, e.g., iron ore imports used in steel production. China's imports grew 15% in 2018 and exports grew about 10%. Alibaba's sales rose 42% over the previous year in its latest quarter, and Nike's China's sales rose 22% vs. only 4% in North America in its latest quarter, hardly signs of an economy that is slowing down as much as markets may think.

What is China's One Belt, One Road initiative?

- This is a massive multi-hundred billion-dollar initiative to connect China across sea and land through Central Asia to Europe and beyond to spur long-term trade growth, with security implications. The record so far is spotty, with some countries (e.g., Sri Lanka) ending up on the short end of the stick, and others benefiting.

What/Who are a reliable sources for China insights?

- There are many reliable economists, think tank experts and journalists who have pretty unbiased opinions on various aspects of China. China definitely deserves harsh criticism in many areas...human rights violations, an increasingly authoritarian government, etc.. Therefore, there is little need to fabricate new ones.
- Reliable sources? Wall St. Journal, NY Times, Financial Times, Washington Post, Reuters, South China Morning Post, Bloomberg?

Whither Hong Kong?

- Hong Kong is an autonomous part of China that has had more freedoms than most Americans realize since the handover 22 years ago (according to senior US govt. officials, senior Hong Kong govt. officials and others).
- Many of Beijing's decisions have been based on pragmatic, economic reasons vs. ideological reasons (i.e. Hong Kong's article 23/anti-subversion legislative controversy in 2003).

- In 2014 Beijing offered HK voters more choice in choosing their chief executive (subject to Beijing's approval, of course), and the offer was turned down, triggering the "Umbrella Movement" protests that demanded universal suffrage. Many consider this a real (self-inflicted) setback for HK voters.
- The recent peaceful, as well as violent, protests were brought on by an accidental, ill-fated extradition legislation idea by HK's government. Protestors now demand universal suffrage, the resignation of the chief executive and other terms, with no near term solution in sight. Beijing thus far has remained fairly calm, but the jury is still out.

Interdependence between the US and Chinese economies

- The two economies are inextricably linked, and near impossible to unwind (e.g., Apple I-phone components from around the world w/ final assembly in China is counted as a Chinese import by US Customs, and this is an easy fix compared to many supply chains). Talk of “decoupling” is somewhat nonsensical.
- There is, however, much talk of a future bifurcated technology environment, in which markets may be forced to choose between US and China standards, but is unlikely to be economically viable.

Equity Market Integrity

- Hong Kong's financial security regulations are far superior to the Mainland's and even stricter than some US rules (e.g., Alibaba's listing was turned down in Hong Kong, so it listed in the US due to more lenient US rules on ownership/governance structure).
- Hong Kong and Shanghai's mutual recognition (HK/Shanghai Stock Connect) rules have improved for Hong Kong and Mainland investors over the last 4-5 years.

HK and China equity markets

The current trailing and forward p/e ratio for Hong Kong's Hang Seng index is just over 10, price to book at 1.2 and dividend yield at 3.8%*. Shanghai's trailing p/e is over 14 and forward p/e is 11.5, with a price to book of 1.5 and yield of 2.4%*. These two markets, however, are not that correlated. The Hang Seng is up only 1% as of September 30 this year and Shanghai is up well over 16%*.

* Source: Bloomberg, Oct. 1, 2019

US/China relations

- China is indeed taking a harder line internally in many areas, with the persecution of Uighurs in western China, and camera surveillance/facial recognition nearly ubiquitous. China has also engaged in “economic coercion” against other countries and foreign companies (i.e. NBA this week).
- China's US relationship has improved for many years in most areas, but has become more difficult in the last 2-3 years according to senior officials on both sides, and would have regardless of the US 2016 election results. There seems to be no solution in sight on trade issues at this point.

US China trade/economic war

While there are quite a few legitimate grievances over China's trade practices, tariffs are a very dangerous, and usually ineffective tactic in addressing them.

Trade talks continue today (Oct. 11) in Washington, and there will be no major trade resolution. However, there is likely to be a mini-trade/truce agreement that hopefully ratchets down hostilities. China will likely buy much more US agricultural product (soy, etc.), and China will likely open up its financial markets further, with additional understanding on currencies. The US will likely pull back on tariffs in some form.



Military/security issues

- China's military has improved capabilities quite a bit this century, but remains far behind the US so far, in expenditures as well as capabilities, with aspirations to achieve a world class military by 2049. China has established military facilities throughout the South China Sea, and now has military operations and naval vessels outside of its home waters for the first time in about 500 years. (i.e. The PLA has a base in Djibouti.)
- The Pentagon considers China a strategic competitor, in which conflict must be avoided. The US/China mil-to-mil relationship is active, and does act as a stabilizing force.

**Does China wish to replace the US as the World's
hegemonic power?**

Or just in Asia?

