Beacon Trust

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Assessing Global Growth Risks Part III - China: Quiet Storm or Tsunami?

By Alan Segars, Chief Investment Officer

Parts I and II of this series are available in the Commentary section of the Beacon Trust website. In Parts I and II, we discussed risks to growth in the US with an emphasis on the housing market, and risks to growth in the eurozone, with potential deflation consequences. Our expectations are playing out with the US housing recovery stalling and eurozone growth prospects dimming. We now turn to China with its attendant complexities and opacity. We ask metaphorically if China's economic outlook will resemble a "quiet storm," which Smokey Robinson describes in his song of the same name as "a power source of tender force"? Or, will it be more akin to a "tsunami," a power source of seismic force (our description). The latter has also been characterized as a "hard landing." Fast forwarding to the last chapter, we believe the near-term storm pattern will be more the quiet variety. But stay tuned to the weather forecast. We have updated several of the economic barometers we use to forecast China's growth to reach this conclusion, which is consistent with our prior viewpoint. (In commentary published January 24, 2014, we stated "we still maintain that China will avoid a hard landing.") The casual observer might ask why the obsession with China's growth prospects. For starters, China is the second largest economy in the world behind the US. Second, China accounts for nearly 20% of global GDP and 25% of global economic growth in recent years. Third, China's imports of base metals and other commodities are an important revenue source for many emerging market countries such as South Africa, Colombia, Chile, Russia, Brazil, India, and Peru.

We look at China's economy from several angles. Because official GDP statistics have been labeled by at least one high ranking Chinese leader as unreliable, we forecast both the official figure and an alternative GDP measure. Official GDP growth has slipped only marginally from 7.7% on average in 2013 to 7.5% in the first half of this year. Perhaps not so coincidentally, 7.5% is the government's growth target for this year. Based on the recent trend in the Purchasing Managers Index (PMI), Manufacturing, it seems that this target is achievable. However, our alternative GDP model forecasts growth closer to 7.0%. This model takes into account trends in electric energy production, residential real estate floor space sold and iron ore prices. These variables have a very high (83%) correlation with official GDP data over time. (See accompanying chart.) We also factor in China's export and import volumes. As China is gradually transitioning from an investment led export economy to private consumption, it is important to stay on top of the export situation. Thus far in 2014, exports have held up fairly well. Shipments to Europe were up 10.5% in the first half and 17.0% in July. Europe is China's second largest market, and if our recent downward revision of eurozone growth prospects is close to reality, this market will be less buoyant going forward.

alan.segars@beacontrust.com
973.410.3117

Market Facts

1) China accounts for nearly 20% of global GDP.
2) GDP grew 7.5% during the first half, in line with the government's target.
3) The total debt-to-gross domestic product ratio is 251%

Research Contributors

Alan D. Segars, CFA
Chief Investment Officer

William J. Cashin, CPA, CFA, CMT
Senior Vice President
Fixed Income Portfolio Manager

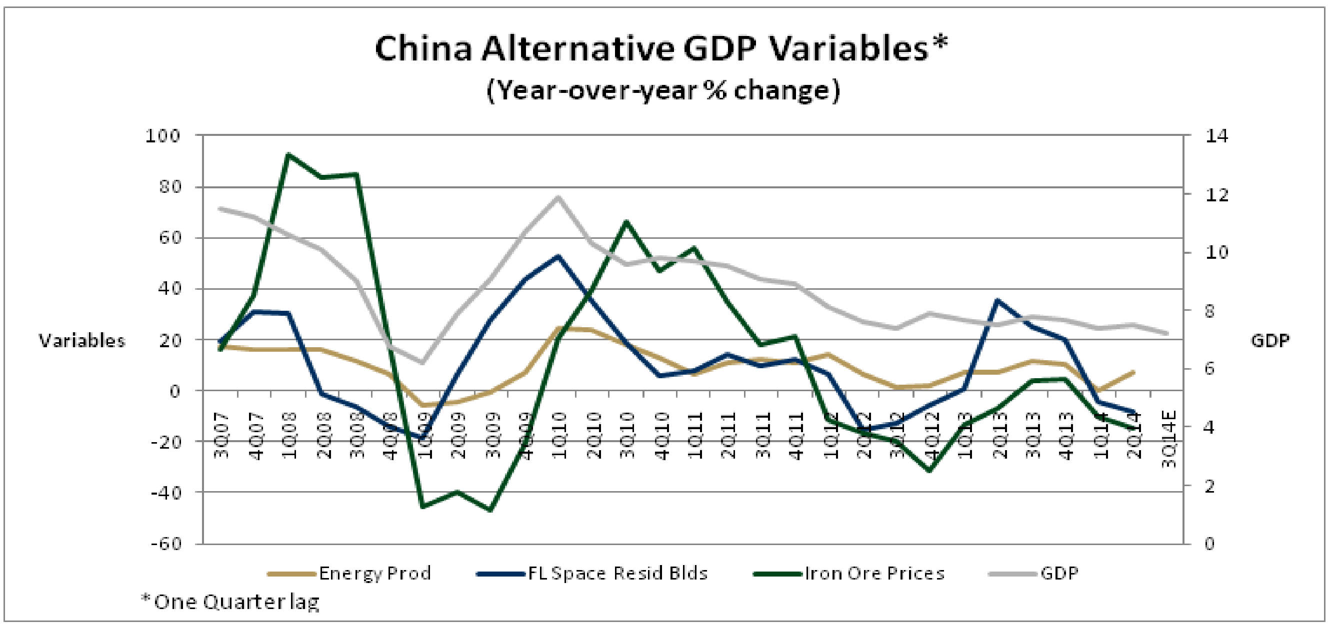
Joseph F. Healy, CFA
Manager of Research Analysis

Linell T. Bigelow
Portfolio Manager

Andrew J. Massey
Research Analyst:
Industrials, Information Technology, Telecommunication Services, Financials, Utilities

China's biggest export market is Asia, and shipments have been much more subdued with negative 8.3% results in 1Q14 and a 2.6% gain in 2Q14. Shipments to the US, China's third largest market, were roughly flat in 1Q14 and higher by 8.6% in 2Q14. This mixed picture for exports is confirmed by similar results for imports, which give an indication of future production and exports. Imports from the important Asian region were down 1.0% in the first half. Some of the emerging market commodity exporters previously mentioned experienced particularly poor order flow from China. Year-to-date China imports were -11.4% for S. Africa, -13.3% for Indonesia, and 1.8% for Russia. On balance, however, results were mixed, so we are not in panic mode yet.

The near-term outlook is not devoid of risks. Chief among these is the property market, which is plagued by overbuilding and plummeting prices. While local government and shadow banks are exposed, the main threat appears to be the traditional banking sector. Again, Beijing's policy options could provide a temporary palliative. These could include cutting interest rates and increasing liquidity to the system. Another risk is China's total debt-to-gross domestic product ratio, which experienced a rapid advance from 147 percent in 2008 to 251 percent last June. Growth of debt in excess of growth of incomes is dangerous. Thankfully, foreign ownership of total debt represents only 10% of GDP. In summary, perpetuation of the quiet storm scenario could give Beijing time to batten down the hatches.



Source: Bureau of Economic Analysis; Beacon Trust

To contact Beacon Trust, please call 866.377.8090