Weekly Market Commentary

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Change in China and What it Means for Investors

Jeffrey Kleintop, CFA
Chief Market Strategist
LPL Financial

Highlights

The debate over a soft landing versus a hard landing misses the point—China's high-flying economy is landing either way and unlikely to take off again.

Last week's economic reports from China for July added fuel to the fiery debate over whether China's economy is slowing rapidly, possibly forming a sharp "hard landing," or slowing more gradually and likely forming a more shallow dip or "soft landing," which could already be stabilizing. This debate focuses primarily on the pace of the decline and all sides assume an eventual rebound. However, the debate misses the point: whatever the landing, there may not be a rebound.

One of the key reasons growth in the world's second-largest economy is irrevocably slowing from the 10% per year pace of the past 30 years made headlines last week: China's policymakers are studying changes to the controversial "one-child" policy. Possible reform will involve new exemptions to the one-child rule intended to redraw China's demographic profile. Change is needed. China's working-age population, defined as those between ages 15 and 64, is at a critical turning point.

demographics are destiny

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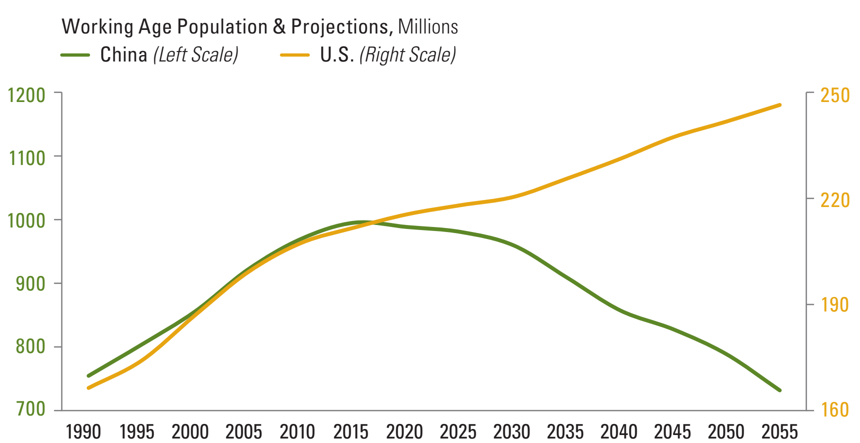
1 China's Working Population at Turning Point



Source: LPL Financial, United Nations 08/12/13

The available number of Chinese workers is peaking and set to decline in the years ahead, according to data compiled by the United Nations [Figure 1]. Demographics are destiny. The one-child policy, introduced in the late 1970s, has taken its toll in preventing over 400 million births since 1979, according to the Chinese agency charged with population planning.

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To put that number in perspective, the entire U.S. labor force totals only about 144 million people. The United States, by contrast, is not expected to face this kind of demographic imbalance. Unlike nearly every other developed and developing nation, the United States is projected to have a steadily growing population of available workers in the years to come.

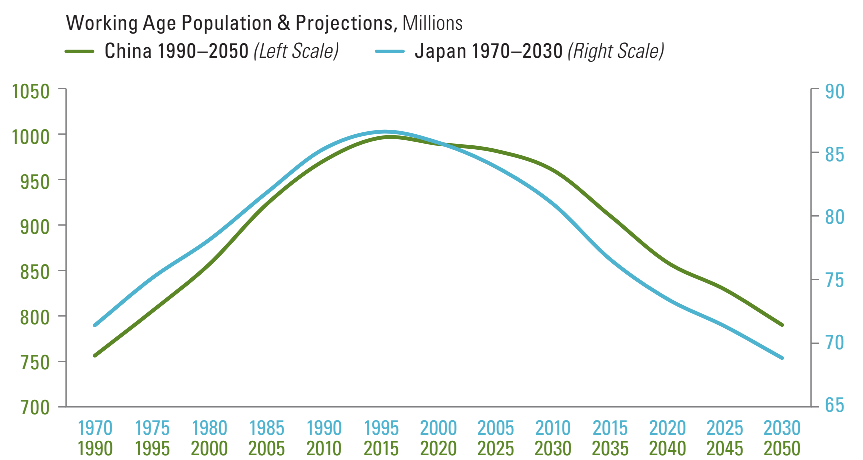
China's growth was built on a well-worn economic model: a surplus of laborers willing to work at wages far below other countries', allowing for the production of goods more cheaply than possible elsewhere. Since Chinese workers have an annual per capita income of about $3,000 a year, placing it between Mexico and Romania (and only half that of the Czech Republic), wages are insufficient to provide a basis for demand of their own goods, so growth depends on exports to the rest of the world.

China is not the first country to rise economically using this model. Japan took that path 20 years earlier. In the 1970s and 1980s, Japan's low-cost, export-driven economic growth elevated the country to the second-largest economy in the world. But Japan's economic model had to change as the number of workers began to decline. That decline, which began 20 years ago, is the pattern China is set to follow [Figure 2].

japan's pattern

In the 1970s and 1980s Japan's economy elevated to the second largest in the world, but the economic model had to change as the number of workers began to decline.

2 20 Years Later China Following Japan's Pattern



Source: LPL Financial, United Nations 08/12/13

A large portion of economic growth in China has come from aggressive spending (so big it averages nearly half of the size of the entire Chinese economy every year) to build the massive infrastructure, factories, and residences required to facilitate production. But, for all this to continue, China has to continue to rapidly grow its supply of cheap labor. Such growth is simply no longer possible. China's economy is not merely going through a temporary dip, whether hard or soft, but very likely embarking upon a new and permanent downtrend in economic momentum: not just the decline from 10% to 8% already witnessed, but potentially down to 7% in the coming years, and down to 5% and below over the coming decade.

China's attempts to stimulate domestic consumption and investment-driven efforts to produce higher valued-added goods will likely keep the economy from recession, or shrinking, but it will be insufficient to produce a return to double-digit growth.

The changes in China's economy may mirror Japan's or South Korea's when their economic model began to change. A couple of the major consequences of this change for investors may occur in the markets for Treasuries and commodities.

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The Chinese have been big investors in U.S. Treasuries. In contrast to the often-mentioned fear that the Chinese may pull their money out of Treasuries, they may be increasingly less likely to sell as their economic growth slows. In part, China's export-driven growth model required them to ensure their biggest customers had the capital to continue to buy. But primarily, this investment was the result of a need to place excess capital outside China, in a safe, liquid security that had a market big enough to handle the massive amounts of money the Chinese economy was creating that was not needed within its borders. Now that the Chinese economic model is changing, resulting in a slower pace of growth over the long term, there is even less need for capital inside China and repatriating the money would only increase inflationary pressures.

As a result, China's demand for U.S. Treasuries will likely continue. Although China will be growing more slowly, it should still be generating a tremendous amount of money. Even at a 5% growth rate, China generates the same amount of new economic output as it did about six years ago, when it grew 10%, simply because the economy has doubled in size. U.S. Treasuries, the world's largest and most liquid market, should continue to be the beneficiary of Chinese investment. China's holdings of U.S. Treasuries have risen 13% or $150 billion in the past year, according to the latest data from the U.S. Treasury. This pattern of rising demand by China would be similar to Japan's, whose investment in U.S. Treasuries increased when the country's economic model changed in the early 1990s.

China's economic change will reduce demand for industrial commodities such as copper, aluminum, and iron ore. Prices for these metals have already weakened from the early effects of a slowing China, though this slowdown is thought by many market participants to be only temporary. As expectations for China's growth and internal construction are ratcheted down, so too will commodity demand forecasts, and commodity prices will likely continue to slide. Australia, a major metal exporter, has already experienced slowing demand from China, just as it felt the drag from Japan's economic transition 22 years ago.

China's economic model no longer fits, but it is not outmoded. A new group of countries will take on the economic model with their own surplus of workers who are willing to work for wages lower than those in China. These countries may include smaller Asian neighbors along with African and South American nations, together often labeled frontier markets. Those countries that replace China as primary sources of low-cost labor will experience

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rapid, though not necessarily profitable, growth. That is an important consideration to keep in mind, given the relatively paltry 1.7% annualized return on Chinese stocks over the past 16 years, measured by the Hang Seng Index in US dollars, despite powerful economic performance. As the Chinese economic transition matures, an increasing focus on the efficiency of growth—rather than the growth itself—may lead to better profitability and performance for investors over the long term. In the short term, Chinese stocks may be bouncing on better-than-expected economic data as the economy appears to stabilize along a slower growth trajectory. Nevertheless, risks remain high for investors in China. ■

INDEX DESCRIPTIONS

The Hang Seng Index is a market capitalization-weighted index of 40 of the largest companies that trade on the Hong Kong Exchange. The Hang Seng Index is maintained by a subsidiary of Hang Seng Bank, and has been published since 1969. The index aims to capture the leadership of the Hong Kong exchange, and covers approximately 65% of its total market capitalization. The Hang Seng members are also classified into one of four sub-indexes based on the main lines of business including commerce and industry, finance, utilities and properties.