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Sinology
by Andy Rothman
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A BUMPY CHINA RIDE, THEN A SAFE LANDING

I expect the first half of 2017 will deliver significant volatility to investor sentiment toward China. We can’t prevent this volatility, but we can prepare for it and understand its limited implications for long-term investors.

In this issue of Sinology, I discuss the four scary China stories investors are likely to encounter in the coming months, explain why these stories will result in short-term anxiety about the health of China’s economy, and why I believe that anxiety should fade by the second half of the year, with the domestic demand story remaining resilient.

We also explore the wildcard possibility of President Trump blowing up America’s long-standing “one China” policy. That would be a very dangerous outcome, but I believe that the CEOs and retired generals who advise Trump are likely to dissuade him from taking that step.

The first half scary stories will include China’s FX (foreign exchange) reserves falling below US$3 trillion; Trump designating China as a currency manipulator; Trump raising tariffs on a few categories of Chinese goods; and new home sales declining year-on-year. By the summer, however, I expect most investors to realize that China will still have more than enough reserves; that Trump’s steps will have little concrete impact on the Chinese economy; and that even if new home sales fall 10%, that would make 2017 the second-best year in the brief history of China’s commercial housing market, with sales of more than 11 million homes.

Also by the summer, I expect sentiment should improve as it becomes clear that China’s transition from a high-speed, heavy industry-based economy to a moderately fast consumer and services-based economy is well underway. The challenges of completing this transition will result in gradually slower growth rates and increased volatility, but the risks of a hard landing are very low. China is likely to once again account for about one-third of global economic growth, a higher share than from the U.S., Europe and Japan combined. Investors, however, will have to be patient during a turbulent first half of the year.

Scary Story #1: China’s FX Reserves Fall Below US$3 trillion in 1Q17
Scary Headline: China Runs Out of FX Reserves

Background: You may recall that at the start of 2016, the media was peddling a similar scary story, with a few hedge fund managers predicting that by the end of last year, China would run out of FX reserves and that the Chinese currency, the renminbi (RMB), would devalue by 25% to 30% against the U.S. dollar.

That scary story didn’t turn out to be so scary. By November 2016, China’s FX reserves had decreased by 8.4% from the start of the year, leaving the country with more than US$3 trillion in reserves, the largest amount of any country.
The RMB fell by 6% against the dollar last year, far from forecasts of dramatic devaluation, and roughly the same as the level of devaluation during 2015. In both years, RMB weakness was driven by U.S. dollar strength, rather than by underlying weakness in the Chinese economy. In fact, about one-third of the full-year devaluation in 2016 came just in the last 53 days of the year, as the dollar surged after Election Day.

Back at the start of 2016, I explained that we weren’t worried about capital outflows because most of the flows were the result of Chinese corporates moving money from the mainland to Hong Kong to repay dollar-denominated debt issued there, in preparation for re-issuing that debt in RMB in China. Speaking with Chinese companies, we learned that that process of unwinding that carry trade in Hong Kong was itself almost done, giving us confidence that the pace of outflows would soon slow, as was the case.

We define capital “flight”—as opposed to capital “outflow”—as Chinese losing confidence in their economy, selling assets and moving the cash off-shore. I don’t see significant evidence of that. In fact, onshore FX bank deposits held by Chinese households rose 39% year-on-year (YoY) in November, the latest month for which we have data. Those deposits rose by 25% or more in each of the first 11 months of 2016. Moreover, household bank deposits in RMB (which account for 99% of household deposits) rose by almost 10% YoY in November, faster than the pace of nominal GDP growth, another indicator that individual Chinese are not moving funds offshore at a worrying pace.

Figure 1. YOY GROWTH RATE OF HOUSEHOLD BANK DEPOSITS AND NOMINAL GDP

![Graph showing YOY growth rate of household bank deposits and nominal GDP]

Sources: People’s Bank of China, CEIC

The stock of FX reserves has, of course, continued to decline. In the 12 months ending November 2016, the last month for which data is available, China’s FX reserves decreased by 11.2% to US$3,051.6 billion. That followed a 10.6% decline during the previous 12-month period. This gradual outflow is being driven by two factors. The first is a sharp rise in overseas non-financial investment by Chinese companies, which jumped by 55% YoY in the first 11 months of 2016, to US$161.7 billion—equal to roughly two-thirds of the overall decline in FX reserves during the same period.

(A new study of Chinese investment in the U.S., commissioned by the U.S.-China Economic and Security Review Commission, found that by the end of 2015, nearly 2,000 Chinese-owned subsidiaries in the U.S. employed more than 100,000 Americans, up from less than 20,000 four years earlier. The study also reported that privately owned firms accounted for almost 80% of total Chinese investment in the U.S. in recent years.)
The second factor has been a very strong dollar, which has led to a weak RMB (against the dollar). It is clear that the direction of the RMB against the dollar is driven by the strength or weakness of the dollar.

Significant dollar strength since the U.S. election has weakened many emerging market (EM) currencies, although the Chinese government has intervened—drawing down on its FX reserves—to prevent the RMB from falling as much against the dollar as many other currencies. Weakness in other currencies, including developed market currencies in which China has invested an estimated 40% of its FX reserves, has also resulted in valuation losses which have contributed significantly to the overall decline in FX reserves.

Why This Won’t Really Be a Scary Story

The scary story will arrive during the first quarter, when the media will get very excited as China’s FX reserves fall below the US$3 trillion level. But there is nothing scary or significant about this level.

Even if FX reserves were to decline by another 10% during 2017, taking the stock down to roughly US$2.7 trillion, that would still leave China with far
more reserves than it needs (and far more than any other country’s; Japan’s FX reserves, the second largest, were US$1.16 trillion in November 2016).

It is also worth noting that the gradual decline in FX reserves has had little impact on liquidity in China, with the benchmark lending rate barely moving over the past 18 months.

And it is important to remember that the objective is not for a country to hold the most possible reserves, but rather to hold enough to manage potential problems. The International Monetary Fund (IMF) explains that holding an adequate level of reserves can:

“...reduce the likelihood of balance-of-payments crises, help preserve economic and financial stability against pressures on exchange rates and disorderly market conditions, and create space for policy autonomy. While reserves have these important benefits, they also carry an opportunity cost—from reserves earning a lower rate of return than could be achieved if the resources were used differently. These costs are an important consideration as countries decide on their ‘appropriate’ level of reserves for precautionary purposes.”

And the IMF, in a 2015 staff paper, “Assessing Reserve Adequacy – Specific Proposals,” describes, for EM economies, three common benchmarks for determining an adequate level of FX reserves, while noting that all of these have limitations:

- **IMPORT COVER:** “Traditionally, the measure has been based on months of prospective imports, with three months’ coverage typically used as a benchmark.” As of November, China’s reserves were equal to about 24 months of 2016 average imports.

- **RESERVES TO SHORT-TERM DEBT:** According to the IMF paper, “The ‘Greenspan-Guidotti’ rule of 100 percent cover of short-term debt is the most widely used standard of adequacy for EMs.” China’s reserves now provide a cover of more than 350% of its short-term debt.

- **RATIO OF RESERVES TO BROAD MONEY (Typically M2):** “The upper end of a prudent range for reserve holdings is typically set at 20%.” China’s reserves are a bit below that level, at 14% of M2, but that 20% upper end is for countries with open capital accounts, while China maintains significant capital account controls, limiting the risk of capital flight.
Finally, another reason I do not believe capital outflows will be any scarier in 2017 than they were in 2016 is my view that markets are expecting far more inflation in the U.S. than is likely, leading to overly aggressive expectations for rates and for the strength of the dollar.

In my view, Congress will push back hard against President Trump’s proposal for a massive infrastructure construction program. Republicans have typically opposed such programs because they smack of “big government,” would raise the federal deficit, and because the largest share of the money would be spent in urban areas that vote Democratic.

Moreover, even if Trump gets Congress to accept a smaller infrastructure program (possibly by tying the funds to more popular legislation to cut taxes), it will take a very long time for the money to be spent, delaying any impact on inflation. A recent study by the non-partisan reform coalition Common Good found that:

“Even projects to repair or update existing infrastructure require years of process from multiple agencies. ... The Federal Highway Administration estimated that the average time for approval of major highway projects was over six years. Five to ten years is a common timeframe for interstate transmission lines, and for wind farms and solar fields on federal lands on either coast. ... Even replacement-in-kind infrastructure projects are negatively impacted by extensive regulatory delays.”

House Republicans have already begun voicing opposition to some of Trump’s fiscal plans, and I expect this opposition to mount after the inauguration. Before long, markets will recognize that infrastructure spending isn’t likely to push inflation higher during 2017, and that the impact of tax cuts on inflation isn’t clear. This should lead to lower inflation expectations, lower expectations for Fed rate hikes, and a weaker dollar. That will mean less pressure on the RMB (and other EM currencies), and less pressure on capital outflows from China.

**Conclusion**

Be prepared for a lot of media noise in 1Q17 when China’s FX reserves dip below US$3 trillion. As was the case at the start of 2016, this story will be overhyped, and may lead to weaker market sentiment towards Chinese equities for a few months, until investors realize that China will still have plenty of reserves on hand.

**Scary Story #2: Trump Declares China a Currency Manipulator**

**Scary Headline: Trade War with China Over Currency Manipulation**

**Background:** During the presidential campaign, the fifth point in Donald Trump’s “7-Point Plan to Rebuild the American Economy by Fighting for Free Trade” was to “Instruct the Treasury Secretary to label China a currency manipulator.”

I think odds are very high that Trump will take this step soon after taking office. He can accomplish this easily, without involving Congress, simply by instructing his Treasury Secretary to make that finding.

But, what few people seem to recognize is that the process of designating a country as a currency manipulator is governed by U.S. law, with the criteria and consequences spelled out clearly in that law.
Criteria for Being Labeled a Currency Manipulator

The law requires the Secretary of Treasury to provide Congress with a report on currency manipulation twice a year, and these are the conclusions of the most recent report, published in October 2016:

“The 2015 Act requires that Treasury undertake an enhanced analysis of exchange rates and externally-oriented policies for each major trading partner that has: (1) a significant bilateral trade surplus with the United States, (2) a material current account surplus, and (3) engaged in persistent one-sided intervention in the foreign exchange market. Pursuant to the 2015 Act, Treasury has found in this Report that no economy satisfied all three criteria.”

Treasury maintains a “monitoring list” of major trading partners who meet two of the three criteria listed above, and once added, a country remains on that list for at least one year. In the October 2016 report, six countries were on the “monitoring list”: China, Japan, South Korea, Taiwan, Germany and Switzerland.

China met two of the three criteria in Treasury’s April 2016 report (a large bilateral trade surplus with the U.S. and a current account surplus above 3% of GDP), but by the time of the October 2016 report, China met only one of the three criteria, because its current account surplus fell below 3% of GDP. Treasury noted that as of October, Japan, South Korea and Germany met two of the three criteria.

Treasury went on to note that “China’s intervention in foreign exchange markets has sought to prevent a rapid RMB depreciation that would have negative consequences for the Chinese and global economies.” In other words, China was in 2016 manipulating its currency for purposes which are aligned with U.S. interests.

The IMF has no say in the U.S. Treasury’s decision-making process, but in its most recent annual review of the Chinese economy, it also determined that Beijing has not been manipulating its currency for nefarious purposes. “The RMB remains broadly in line with fundamentals,” the IMF reported, and “China has made progress over the past year in moving toward a more flexible, market-determined exchange rate system.”

This isn’t to say that once he becomes president, Donald Trump can’t follow through on his campaign pledge to “instruct the Treasury Secretary to label China a currency manipulator.” On that basis, let’s examine the consequences of that decision.

The Legal Consequences

The concrete consequences of China being labeled a currency manipulator are, well, nothing.

Under the law, the first step to be taken after finding a country has manipulated its currency is that the Treasury Secretary “shall commence enhanced bilateral engagement” with that country, to “express the concern of the United States” and to try to persuade them to stop manipulating their currency.

Next, if one year of “enhanced bilateral engagement” doesn’t produce results, specific penalties can be levied against the offending country. The first penalty is banning the U.S. Overseas Private Investment Corporation (OPIC) from
supporting U.S. business investment in China. I’m not sure what Congress had in mind when they wrote this part of the law, as this penalty seems to hurt American companies that would benefit from the U.S. government insuring some of their investments against political risk, rather than hurting China. More importantly, back in 1989, in response to the Tiananmen Square incident, Congress banned OPIC programs in China. So, the main penalty for currency manipulation is banning a program from China that has already been banned from China for more than 25 years.

The other consequences spelled out in the law are even weaker, such as asking the IMF to undertake “additional rigorous surveillance” of the Chinese economy and exchange rate management.

The Chinese have read the law and are well aware that being designated as a currency manipulator would have no concrete impact on them. My expectation is that Beijing would respond to such a designation by Trump with a shrug.

Some commentators have predicted a fiery response from Communist Party chief Xi Jinping, because he would be embarrassed. In my view, however, he will simply point out to his own population that Trump's decision was all about U.S. domestic politics, and Xi would note that the IMF had just blessed China’s currency and exchange rate management, making the RMB only the fifth global currency to be included in its Special Drawing Rights (SDR) basket.

**Conclusion**

I don’t foresee any substantive Chinese retaliation, so this is an easy campaign promise for Trump to fulfill, but without any real impact. If scary stories about Beijing responding with a trade war lead to lower valuations for Chinese equities for a brief period of time, that may be a buying opportunity.

**Scary Story #3: Trump Slaps Tariffs on Chinese Imports**

**Scary Headline: Trump Walls Off Imports, Triggering Crisis in China**

**Background:**

*Trump speaking to the NY Times editorial board, January 2016*

“The only power that we have with China is massive trade,” Trump said.

“I would tax China on products coming in,” Trump said. “I would do a tariff, yes—and they do it to us.”

Trump added that he’s “a free trader,” but that “it’s got to be reasonably fair.”

“I would do a tax. And the tax, let me tell you what the tax should be ... the tax should be 45 percent,” he said.

In my view, Trump is very unlikely to implement a 45% across-the-board tariff on imports from China.

U.S. law permits the president to make only an emergency declaration of 15% tariffs for up to five months, and I imagine that many U.S. CEOs have been calling Trump to advise him of the negative consequences of such a move on their firms. These probably include most of the members of Trump’s new CEO advisory panel, chaired by Blackstone’s Stephen Schwarzman, who recently endowed (with US$100 million of his own money) a very high-profile scholarship program at Tsinghua University in Beijing. Other members of the advisory panel with deep
China ties include Mary Barra of GM, Jamie Dimon of J.P. Morgan, Bob Iger of Walt Disney and Jim McNerney, past CEO of Boeing.

Those CEOs might be pointing out that since China joined the WTO in 2001, U.S. exports to China are up by more than 600%, while U.S. exports to the rest of the world are up by only 80%, and China is now the third largest market for U.S. goods exports. Many American jobs and corporate profits would be lost when China would retaliate against new tariffs, including in the Republican-leaning farm-belt, as China is the second-largest market for American agricultural exports, led by soybeans.

More than 900,000 American jobs are supported by U.S. exports of goods and services to China, with 40% of those jobs created between 2009 and 2015, according to the U.S. Department of Commerce.

Figure 5. TOP 15 DESTINATIONS, U.S. JOBS SUPPORTED BY TOTAL (U.S. GOODS AND SERVICES) EXPORTS IN 2015

<table>
<thead>
<tr>
<th>Country</th>
<th>Jobs Supported</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canada</td>
<td>1,598,000</td>
</tr>
<tr>
<td>Mexico</td>
<td>1,169,000</td>
</tr>
<tr>
<td>China</td>
<td>911,000</td>
</tr>
<tr>
<td>U.K.</td>
<td>665,000</td>
</tr>
<tr>
<td>Japan</td>
<td>606,000</td>
</tr>
<tr>
<td>Germany</td>
<td>422,000</td>
</tr>
<tr>
<td>Korea</td>
<td>358,000</td>
</tr>
<tr>
<td>Brazil</td>
<td>308,000</td>
</tr>
<tr>
<td>Ireland</td>
<td>306,000</td>
</tr>
<tr>
<td>Netherlands</td>
<td>280,000</td>
</tr>
<tr>
<td>Switzerland</td>
<td>271,000</td>
</tr>
<tr>
<td>Australia</td>
<td>266,000</td>
</tr>
<tr>
<td>France</td>
<td>252,000</td>
</tr>
<tr>
<td>Singapore</td>
<td>213,000</td>
</tr>
<tr>
<td>Taiwan</td>
<td>208,000</td>
</tr>
</tbody>
</table>

Source: U.S. Department of Commerce

Trump recently complained that China is “taxing us heavy at the borders when we don’t tax them.” But, according to the Office of the U.S. Trade Representative, “China reduced tariffs on goods of greatest importance to U.S. industry from a base average of 25% (in 1997) to approximately 7%, while it made similar reductions throughout the agricultural sector.”

Bringing China into the World Trade Organization 15 years ago, which required them to play by the global trade rules which the U.S. helped write, hasn’t solved all problems, but has clearly benefitted many American workers and companies.

I also imagine some people will advise Trump that a 15% tariff hike would have a significant impact on consumer prices in the U.S., pushing up prices for goods sold at places such as Walmart. That would hurt the spending power of Trump’s working-class political base.

A More Targeted Approach?

These factors are likely to lead Trump to take a more targeted approach, raising import tariffs on a limited number of goods, probably those which are not destined directly for American consumers, such as steel.

Recent history, however, suggests that this approach isn’t likely to have a positive impact on the U.S. workforce or economy.
In 2009, for example, President Obama, responding to union complaints, put an additional 35% tariff on imports of Chinese-made passenger and light truck tires. A 2012 study of the impact of this move by economists at the Peterson Institute for International Economists concluded that:

“The big winners from the 2009 safeguard tariffs were alternative foreign exporters, primarily located in Asia and Mexico, selling low-end tires to the United States. Domestic tire producers were secondary beneficiaries. The members of the labor union that petitioned the ITC’s investigation received only a small share of the money extracted from the pockets of American households. U.S. car and light truck tire consumers are paying higher prices regardless of whether they purchase a Chinese or non-Chinese tire. Jobs created in the tire manufacturing industry were more than offset by the loss of jobs in the U.S. retail sector.”

China, of course, retaliated, although in a measured way. A few months after Obama’s move, Beijing announced tariffs of as much as 135% on imports of chicken feet from the U.S. (This may sound amusing, but think about how much chicken Americans consume, and the number of feet that leaves behind. Easy money for American chicken farmers, who are concentrated in Republican-leaning districts.) These tariffs resulted in a 90% fall in U.S. exports of chicken feet to China, a loss of about US$1 billion to the American poultry industry. (And keep in mind that while China has many alternative sources for the items it imports from the U.S.—it could, for example, buy from Airbus rather than Boeing, and substitute soybeans from Brazil and Argentina—the U.S. has very few alternatives to importing mobile phones, laptops and other electronics gear from China, which has a dominant market share.)

Moreover, even in sectors such as steel, which Trump has highlighted, the impact of Chinese imports is probably not huge. We estimate that in 2015, steel imported from China was equal to 2% of total U.S. steel consumption (and less than 1% of China’s steel production).

**Potential Impact on China**

Finally, I want to emphasize that if Trump were to apply a broad, 15% tariff on imports from China, the impact on the Chinese economy would be significant, but it would be much lighter than most people expect, because China is no longer an export-led economy.

These days, exports contribute very little to China’s economy.

I estimate that only about 10% of China’s manufacturing output is exported (by value), with 90% of goods made in China consumed in China.

The gross value of China’s exports may be equal to almost 20% of its GDP, but that figure dramatically overstates the role of exports. If we subtract the value of parts that China itself imports to produce its exports (for example, the brains of mobile phones which are assembled in China), those ‘net exports’ are equal to less than 4% of China’s GDP.

Domestic consumption and domestic services are now the largest part of China’s economy.

2016 was the fifth consecutive year in which the services and consumption (or tertiary) part of the economy was larger than the manufacturing and construction (or secondary) part of the economy.
During the first three quarters of last year, domestic consumption accounted for 70% of China’s economic growth.

It’s also worth noting that of China’s exports, only about 18% go to the U.S., while Europe, Japan and ASEAN countries combined take more than a one-third share, limiting the impact of any new barriers to the American market.

World’s Best Consumer Story

China is the world’s best consumer story, with inflation-adjusted retail sales up by almost 10% last year.

This consumer story is driven by a high savings rate, low household debt and amazing income growth.

Over the last decade, inflation-adjusted urban income in China rose by 130%, compared to increases of about 11% in the U.S. and 2% in the U.K.

This is why, at Matthews Asia, we’ve long viewed our investments in China as investments in that country’s dynamic domestic market.

Protectionist policies in the U.S. will not alter that domestic consumer story, and that is where our investment strategy is focused, with 87% of the Chinese equities we hold, across all strategies, in consumer and services sector companies, which should be well insulated against any trade barriers.

Conclusion

While Trump is unlikely to enact across-the-board tariffs against Chinese imports, even more targeted tariffs against a limited number of items may generate headlines predicting a trade war and dramatic damage to China’s economy.

Neither of those predictions are likely to materialize, because Beijing is likely to respond in a proportionate, measured way—as was the case with the tire and chicken feet spat—and because China is no longer an export-led economy. If scary stories about Beijing responding with a trade war lead to lower valuations for Chinese equities for a brief period of time, that may be a buying opportunity.
Wildcard: Trump Blows up the “One China” Policy

Scary Headline: Trump Returns U.S.-China Relations to Cold War Days

Background: My expectation of calm, measured responses by Beijing to the Trump policies described earlier in this paper applies only if Trump does not blow up the political environment by discarding the “one China” policy that has governed U.S. relations with Beijing and Taipei since 1972.

“One China” is a diplomatic dance in which the U.S. recognizes the de facto, but not de jure authority and independence of the government on Taiwan. This means that although Washington and Taipei maintain an extensive range of diplomatic, military and economic ties, the U.S. refers to Taiwan as an economy rather than as a country, and the two sides exchange only unofficial ambassadors. For example, when I served as deputy director of the State Department’s office for Taiwan affairs 20 years ago, I met frequently with my counterpart from Taiwan’s unofficial embassy in Washington, D.C., but only in restaurants—not inside of the State Department or his “embassy.” (I ate very well in that job.)

This “one China” diplomatic dance seems silly and unfair to Taiwan, but it has created a framework under which Taiwan has become secure, wealthy, and democratic, and under which U.S.-China economic relations have thrived and political ties have matured.

In December, Trump suggested that he might shake up that framework, saying, “I fully understand the one-China policy, but I don’t know why we have to be bound by a one-China policy unless we make a deal with China having to do with other things, including trade.”

Trump may believe that he can turn “one China” into a bargaining chip, and that negotiating with Beijing is akin to negotiating over Manhattan real estate, but it is almost impossible to imagine Xi Jinping sitting at that negotiating table.

I agree with the way President Obama characterized the issue in a late December press conference:

“What I understand for China, the issue of Taiwan is as important as anything on their docket. The idea of One China is at the heart of their conception as a nation. And so if you are going to upend this understanding, you have to have thought through the consequences because the Chinese will not treat that the way they’ll treat some other issues.

They won’t even treat it the way they treat issues around the South China Sea, where we’ve had a lot of tensions. This goes to the core of how they see themselves.

And their reaction on this issue could end up being very significant. That doesn’t mean that you have to adhere to everything that’s been done in the past...it does mean that you’ve got to think it through and have planned for potential reactions that they may engage in.”
We don’t know what Trump is really thinking on this issue, but my assumption is that Trump will not blow up the “one China” policy because many people in two groups who seem to have influence with Trump (CEOs of major American companies and retired generals) are presumably working hard to persuade the president-elect that doing so would severely damage U.S. corporate interests, kill jobs (900,000 American jobs support exports to China), make Beijing unwilling to cooperate with Washington on geostrategic issues such as North Korea and Iran, as well as put Taiwan’s security at risk. It is also positive that Trump appears to respect Henry Kissinger, the architect in 1972 of the “one China” policy, and they have met recently.

But, if I’m wrong, and Trump does try to use “one China” as a bargaining chip with Beijing, then China’s reaction to the currency manipulation and tariff steps will be far stronger than what I’ve outlined above. There would be very serious damage to U.S.-China economic and political relations.

Scary Story #4: New Home Sales Fall YoY
Scary Headline: China Property Market Crashes!

Background:
The final China scary story is likely to hit in the spring, when sales of new homes (on a volume basis) are likely to decline on a YoY basis. This will lead to screaming headlines about the coming collapse of China’s housing market.
Those headlines will be completely inaccurate, but they will contribute significantly to investor anxiety about China.

2016 was a very hot year for the property market, and 2017 will be a very soft year, both because of the base effect (new home sales rose by about 25% YoY in 2016) and because the government is tapping on the brakes, primarily by raising minimum cash down payment requirements for luxury homes to 70% in some cities. As a result, new home sales may fall by as much as 10% YoY in 2017, and the first negative YoY numbers may appear in the spring.

But put this in context: if sales fall 10% in 2017, this would be the second-best year in the brief history of China’s commercial housing market, after 2016. A fall of 10% would still mean that Chinese developers would sell more than 11 million new homes (vs. 13 million in 2016), primarily to owner-occupier buyers who will generally put down at least 30% cash. Hardly a crash, but the media will go wild. Lower valuations for developers may present a buying opportunity for us, but many investors will be scared.

It is also useful to keep in mind that this level of volatility in new home sales is not unusual in China. In 2012, sales (by volume) rose 2%, before jumping up 17% in 2013. Then, in 2014, sales fell by 9%, without sparking a crisis. The following year, sales rebounded, rising 7%.

For more details on China’s residential property market, please see our November 2016 Sinology: Does China Have A Housing Bubble?

Wrapping Up—A Soft Landing in 2H17

By the summer, as investors realize that these stories are not nearly as scary as they may appear in the media, anxiety should fade and it will be easier to recognize that the Chinese economy has continued on its transition from a high-speed, heavy industry-based economy to a moderately fast consumer and services-based economy. By then, I believe it should become clear that China remains the world’s best consumer story, and that China is likely to once again account for about one-third of global economic growth, a higher share than from the U.S., Europe and Japan combined.

Andy Rothman
Investment Strategist
Matthews Asia