Investment

China Outlook | 2020

WINTHROP CAPITAL MANAGEMENT

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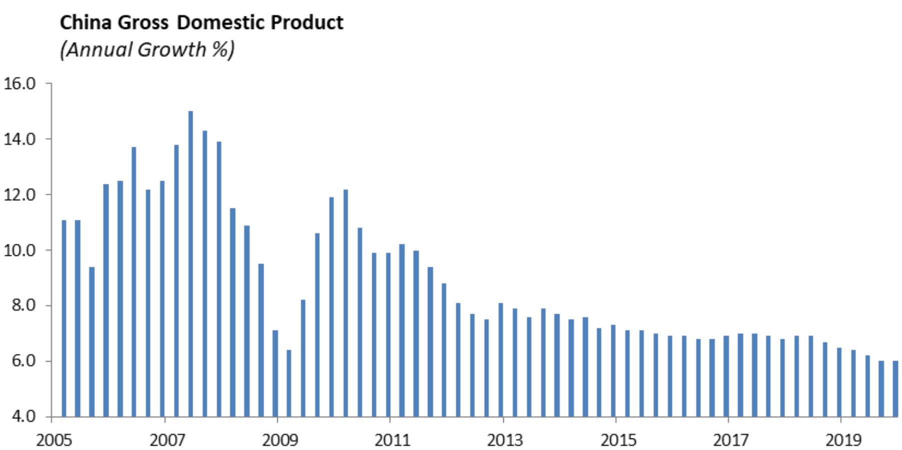
China

With the first phase of a U.S. – China trade deal completed, we believe the economic growth prospects for China will continue to face challenges as global growth remains subdued and the country digests its growing debt burden. However, structural shifts in China's economy will allow for accelerated growth prospects once these challenges are addressed. Ultimately, China is the engine for global economic growth, and addressing phase two trade issues will be important to firing the engine again.

China confirmed last week that its economy, the second largest in the world, grew at its slowest rate of growth in the past 29 years. China's GDP growth slowed to a pace of 6.1% year-over-year according to the release from the National Bureau of Statistics as trade pressures and business confidence declined. The pace of growth, which was lower than the 6.8% pace in 2018, still fell within the government's established range of 6.0% to 6.5% for 2019. China maintains that the pace of growth "laid a solid foundation for completing the building of a moderately prosperous society," which is President Xi Jingping's pointing to his goal of building a strong middle class.



Source: National Bureau of Statisics of China

Up until the 1980's, China's economy was largely agricultural. However, the government has been intentional at economic reforms that focus on manufacturing. Today, the major pillar of China's economy has been the real estate and infrastructure buildout, which is designed to bring its population from the rural areas into the major cities. This, in turn, provides a labor force for the huge manufacturing sector. The trade war with the United States has resulted in tariffs on many goods coming from China, such as electronics, causing a negative effect on manufacturing because export demand is lower.

We expect the current slow growth economy will translate into positive, but lower, returns for China stocks. Given the reduced amount of stimulus in the system last year, we expect the Heng Sang Index (HIS) to return 6% - 9% for the year. The HIS is heavily weighted to the financial sector, and we expect regulatory changes in banking to weigh down overall returns for China stocks.

In addition, China's economy and financial system is suppressed under the weight of a huge debt burden, which further impacts growth and business activity.

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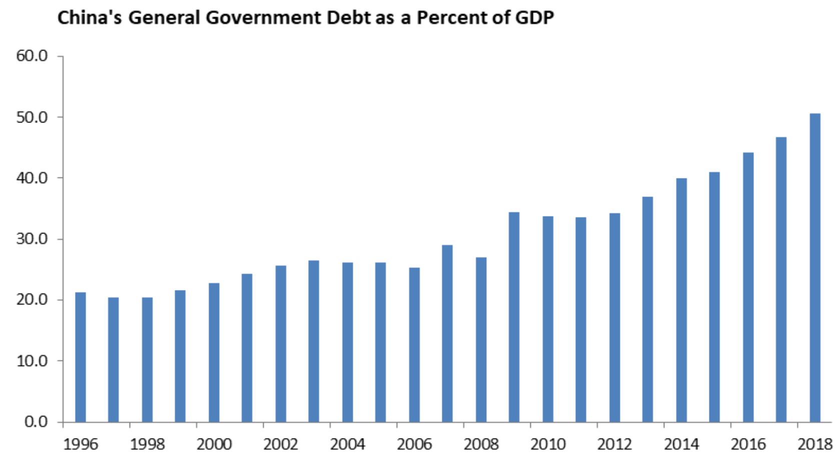
China's Debt Problem

Like the U.S., which has federal and municipal debt, China utilizes both federal and local debt to finance its government programs and infrastructure spending. We estimate that gross federal debt in China has increased modestly to roughly $6.0 trillion, while China's local debt has ballooned an additional $6 trillion. While the general government debt amounts to 50% of GDP, the ratio surges to over 100% total debt as a percent of GDP when combined with local debt. Tax revenue and returns on infrastructure projects that were built with borrowed money aren't enough to pay down this debt. China has over $500 billion of debt that will be due over the next two years that requires refinancing of government, bank loans and local debt. If China is ever perceived to have trouble accessing the public markets for its debt, borrowing costs will increase.



Source: International Monetary Fund

China's Banking System

China's banking system operates differently than the United States, and comparisons between the two countries' systems should be made with some caution. Just as in the U.S., the Chinese banking system is integral to credit expansion. Historically, the government has had a direct say in how much a business should take out on loan. When China has looked to expand, the government would mandate higher loan amounts for business. Recently, banks in China have operated under tighter regulations, which has increased the amount of non-performing loans (NPL's).

China's banking system is weighed down with problem loans, which may restrict the bank's ability to lend. Last year, China bailed out three large banks, including HengFeng Bank and Baoshang Bank, which both were linked to the troubled Tomorrow Group, whose founder disappeared in 2017 following a crackdown on corruption.

In the past, China would inject more capital into its banks, which allowed troubled loans to stay on the books longer. However, recent regulatory reforms appear to address loan impairments quicker. With the industrial sector and real estate market under severe pressure, we expect the amount of NPL's will increase in 2020.

China Exposure in WCM's Asset Allocation

We currently utilize the SPDR S&P China ETF (GXC) in our Tactical Allocation and Core Sector Series Models. GXC has a 0.59% expense ratio and a 1.53% distribution yield. The top 10 holdings represent over 48% of the fund which has 731 total holdings. Alibaba and Tencent Holdings are the two largest holdings, representing 13.8% and 11.6% respectively. The fund is invested in equities in Hong Kong and China, representing 76.7% and 22.1% respectively.