Economic growth in China stabilized in 2016 after a lackluster 2015, largely driven by monetary and fiscal stimulus. But the Chinese government’s focus on lifting growth in the near term may be increasing the risk of an adjustment period in the intermediate term, during which an economic slowdown or systemic crisis could harm both domestic and global growth. How China navigates a delicate economic situation into 2017 and beyond could have major impacts for the global economy, particularly in sectors tied to consumer spending or manufacturing and construction in China.

It is widely expected that President Xi Jinping will want to ensure a seamless consolidation of power going into his second term in November 2017. This means providing as much monetary and fiscal support as necessary to deliver steady 6.5-7.0% GDP growth without any major hitches. Xi could also seek to shore up certain risk areas in the Chinese economy, such as non-performing loans (NPL) and the growing property bubble. But Xi’s desire for stability before he begins his second term should point to relatively steady economic growth in the year ahead.

To truly rebase the economy for sustainable long-term growth, however, China has much work to do. The world’s second largest economy needs to de-lever its corporate balance sheet, restructure its state-owned enterprises (SOE), resolve the ongoing NPL issue and deflate its housing market without causing a crash. The problem - aside from having so many potholes ahead - is that the more China prioritizes near-term growth over structural reform, the larger the potholes become and the more systemic risk this creates. Will there be a highly disruptive hard landing scenario that could take the global economy down with it? Or will the pace of reform be manageable, with few and relatively minor disruptions to China and international markets?

China has made progress in transitioning its economy for sustained growth. Consumption accounted for more than 70% of GDP growth in 2016, and within consumption, services contributed more than 50%. Furthermore, SOEs only account for 15% of total employment now, down from 60% in 1994. Therefore, SOE reform and privatization can be implemented over time, spreading around an expected negative hit to GDP growth across several years.
Excessive leverage, which is intricately tied to an overheated housing market, poses the biggest systemic risk. China’s private non-financial sector debt has risen from a 10-year low of 115.2% at the end of 2008 to 209.8% as of the first quarter of 2016, according to the Bank for International Settlements, but this could be an understatement, as it does not fully account for local government financing-vehicle debt and shadow credit products. Meanwhile, housing prices across much of China are more than eight times income, which is considered “severely unaffordable” by urban demographics firm Demographia (anything above 5.1 is severely unaffordable). Although real estate investment accounts for 15% of GDP on the surface, according to the IMF, a 2015 McKinsey report estimated that as much as 45% of China’s non-financial sector debt is directly or indirectly related to real estate.

In the event of a hard landing, it’s likely that consumer spending, manufacturing activity and new real estate construction will drop sharply. Such an outcome could raise demand concerns for global companies in the consumer products, energy and materials, industrials and IT sectors.

We’re still a year out from the beginning of Xi’s second term, but 2017 is shaping up to be an important year for economic policy-making in China. Policy uncertainty, protectionism and populist movements in Europe and the United States will undoubtedly add to the complexity of the challenges the country is facing. As an economy that contributes a third of global growth and one that contains significant tail risks, it’s worth keeping a close eye on China’s decisions in the coming year.

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