ClearBridge Investments

On the Ground in China: Trade Themes to Watch

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Key Takeaways

- Coverage of the Sino-U.S. trade relationship fails to appreciate factors enabling China to leverage its structural efficiency and vast internal resources to stand its ground as the world's second largest economy.
- China has mobilized the entire country to prepare for a long trade war with the U.S by actively promoting industrial/technology upgrades and internal consumption.
- Costly infrastructure projects are the keystone of a long-term state commitment to shift its economic structure and spur growth through integration with the country's interior regions.

China Has Resolve to Endure Prolonged Trade War

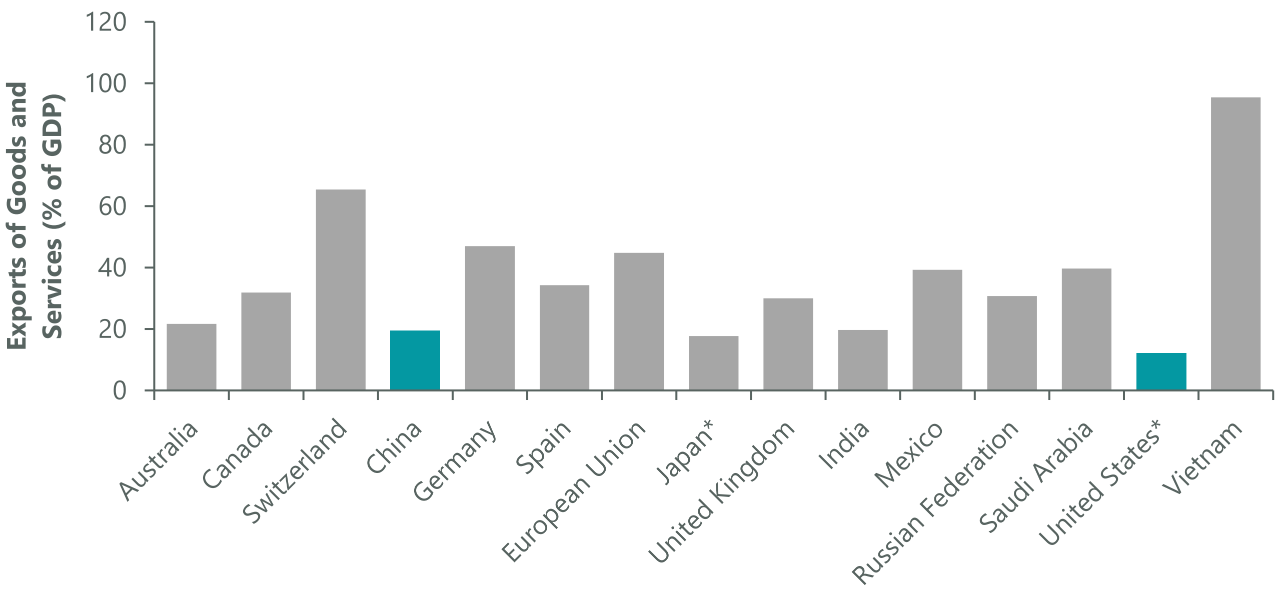
Western focused investors usually emphasize the problems China faces (of which it has plenty) to try to gauge the trajectory of the pending trade war, as well as its economic outlook. Supply chain disruption/relocation could prove to be significantly damaging to China. Also, the already high debt leverage at the local and national level hamstrings the central government's effort to use stimulus to counter the challenges from a full-blown trade war with the U.S.

However, we tend to miss other aspects of the China story that are equally compelling. My recent 15-day trip to the Mainland, including visits to five cities of different sizes, revealed several dynamics that the Western media and some China watchers appear to be missing but are crucial to understanding how the current economic tug of war could ultimately play out. I returned from China with a greater appreciation of the magnitude of complexity of the Sino-U.S. trade relationship, and deeper concerns that there may be a misimpression we have about China, and therefore underestimate China's capacity to withstand the trade war. Barring some unexpected development, it is highly unlikely that a trade resolution will be reached in the foreseeable future and that China will compromise on some of the highly publicized U.S. demands, an outcome for which capital markets might not be well prepared at this point.

The heightening trade war continues to top the headlines and has lately sent global equity markets gyrating on a daily basis. But it's important to look beyond the headlines and appreciate the factors that are enabling China to leverage its structural efficiency and vast internal resources to stand its ground as the world's second largest economy, and as a result, the difficulties for the U.S. to achieve its trade and economic goals.

China has mobilized the entire country to prepare for a long trade war with the U.S. It is actively promoting industrial/technology upgrades, internal consumption, and the eventual trade isolation of the U.S. (rather than the other way around as President Trump has claimed). As per the World Bank, China's exports were only 19% of its GDP in 2018 vs 12% for the U.S. and 44% for the European Union (Exhibit 1). Through a combination of tax relief, currency weakening, interest rate cuts and market share expansions outside the U.S., China's economy is not as vulnerable as commonly thought to the U.S. trade tariffs (although it still hurts, and high debt leverage has so far prevented massive stimulations by the government.) While a quarter of global sovereign bonds are carrying negative yields, the Chinese central bank benchmark rate is still at a hefty level above 4%, giving the Chinese more dry powder to counter and readjust to the damage of the trade war.

Exhibit 1: Exports as a Percentage of GDP



Source: The World Bank. *Japan and U.S. data is for 2017.

In China, people over 40 years old (those who control wealth) remember and understand the hardship of their childhood and have witnessed the stellar rise of their living standard over the last two decades. They are psychologically and physically able to withstand a dip in living standards in a full blown trade war with the U.S. if they need to answer the patriotic calls by the government to defend its economic interest. The state media has shaped their hearts and minds that the U.S. is on a path to contain and deny China's rise, and will do everything to stand in the way of its "China dream." The highly patriotic citizens there have extremely high confidence that China is able to win the trade war long term and surpass the U.S. in the next generation or two (at least economically.)

Domestic Consumption A Key Lever of Government Policy

In preparing for a long fight with the U.S., China is actively shifting its economic structures. While there is a coordinated central government push to upgrade China's technological platforms across industries, another lever the Chinese government is pulling is internal consumption. Domestic tourism is a visible example.

Over the years, while in China, I never saw any TV commercials to promote domestic tourist destinations. Now they have become one of the top TV advertising categories. This is made possible by concerted central government efforts to promote domestic tourism, as well as by a massive infrastructure build over the past two decades, which is now showing payback in a macro way. I went to Guiyang, a tertiary city of 4.5 million in southwest China, a four-hour high-speed railway ride away from Guangzhou. The speed of the train was about 150 miles per hour, which is a feat because the entire route is in a mountainous region. I counted more than 200 tunnels during the trip (ranging from a few hundred meters to over nine miles long.) I was amazed by the cost of the train line and the massive scale of the construction, and it is only one of the six to seven lines into the same region. The train was packed, as people in summer are flocking to places all over the country for tourist trips. I visited the Forbidden City in Beijing in 2008 with no issue at all. Fast forward to today, the place regularly sells out its daily 80,000 tickets by noon. This is one example of how massive expansion of internal consumption has taken place as China is rapidly shifting from an export reliance to an internal, consumer-driven economic model.

While many China experts are concerned about the extreme cost of such buildup and maintenance, and it is true that most high-speed lines are losing money, it is incorrect to look at the infrastructure projects in isolation. China is playing a long game. These railway projects help social and economic integration of interior China, lifting the local economies to reduce regional development imbalances and create and expand internal consumer consumption. These infrastructure projects help to pull the economy up and shift the economic structure. If calculated on an aggregated basis, including the overall economic impact of the infrastructure projects, they are not money-losing spending sprees any more.

Manufacturing Shifting But Still Robust

Another narrative we have heard is that massive manufacturing capacity is leaving China. That is very misleading. I travelled to Nansha, a fourth-tier city roughly halfway between Guangzhou and Hong Kong, and also only a 30-minute drive from Dongguan, the export manufacturing hub of China. There is no panic in Nansha, and restaurants, shops, railways and malls are packed with locals on weekdays. The population mix is also changing, with IT workers replacing sweatshop labor in the area. A recent Wall Street Journal article about manufacturers moving to Vietnam pointed out that it will take a long time to move the entire supply chain out of China. One of the featured manufacturers in the article is a pump company, which can only manage to move the production of 20 of over 70 parts of a pump from China to Vietnam, as it is impossible to move the entire supply chain built in China over the past 20 years. As a result, multinational companies are adopting a "China +1" model, where they use locations outside China to ship to the U.S., and continue to use China for the Chinese internal market and other markets outside the U.S. In addition, the One Belt One Road project by China will come in handy here as well, where any relocation of the manufacturing capacity to a new, developing country requires infrastructure build, and the Chinese are more than ready to help. From Greenland to Serbia, to Myanmar, to South America, it is happening.

State-Directed Capitalism Model is Formidable Tool

The other way China is countering U.S. pressure is the coordinated action plan based on state-directed capitalism. While a Soviet style central planning regime failed in the past, the current China model of state-directed capitalism uses free market elements as a base, plus central planning execution capability, to produce a hybrid economic system. Both private and state-owned enterprises, combined with basic market economic forces, are promoted with state-coordinated efforts to help increase planning and execution efficiency, and to reduce the "friction" sometimes caused by the pure free market economy. For instance, many of the 30 provinces are given specific, yet different targeted industrial/economic development plans based on available resources or local advantages. The Guangdong/Shenzhen/Macau region seems to be designated as a high tech/biotech hub for China, Shanghai is a shipping and financial hub, other provinces are auto production, AI/automation and e-commerce hubs, etc. The whole economic system is mobilized to pool resources with a clear division of labor (without duplication and waste) to help the national agenda. This is the most formidable part of the Chinese model that can be very hard to compete against by any country or big corporation.

Conclusion

A more balanced and nuanced approach in analyzing the dynamics of the current Sino-U.S. trade war is a prerequisite for a more insightful analysis of the macro environment, as well as its impact on our investment strategies. No one can predict the outcome of the trade war, but we should try to stay informed and avoid both conscious and unconscious bias in our investment analyses, in order to navigate through the unchartered territory we are in right now.

About the Author

Martin Ji, CFA
Director, Senior Portfolio Analyst

- 28 years of investment industry experience
- Joined ClearBridge Investments in 2007
- MBA from the UCLA Anderson School of Management
- BS in Economics from the University of International Business and Economics, Beijing, China