White Paper
Perspectives

By Matthew J. Kogan, CFP®, CAIA, JD | **09.28.2015**

China's Path to Modernization

Chinese President Xi Jinping's first state visit to the U.S. marks a significant event in the relationship between our nations. The economic and social shifts in China from President Nixon's trip in February 1972 to its powerful presence today have led to constant reinterpretations of its society. I believe China's path to modernization is the most important world event since our own country's urbanization and industrialization over 100 years ago.

This should be the century where the People's Republic of China leads on the world stage alongside the United States. Yet, one worries that China's growth engine is stalling and it is retracing on years of progress. Our own government's polarization on economic and social policies and our difficulty in finding common ground on international issues doesn't help stabilize global leadership. Will the real leaders please stand up?

As we look closer at China's growth, we reexamine our own rise to economic success. The position enjoyed by the U.S. was not achieved in a straightforward trajectory. We gained freedoms after turbulent times much like we see in China today, and we acknowledge important cultural differences: capitalistic socialism is not like our post-peak, mature democracy.

At FMA Advisory, we are cautious on China and related issues for now, but recognize that an uptrend can quickly replace a downtrend and that few get the timing exactly right.

So what should investors know? We are looking for more certainty in the following six areas:

- **"Central/Local" Power and Construction Bubbles**

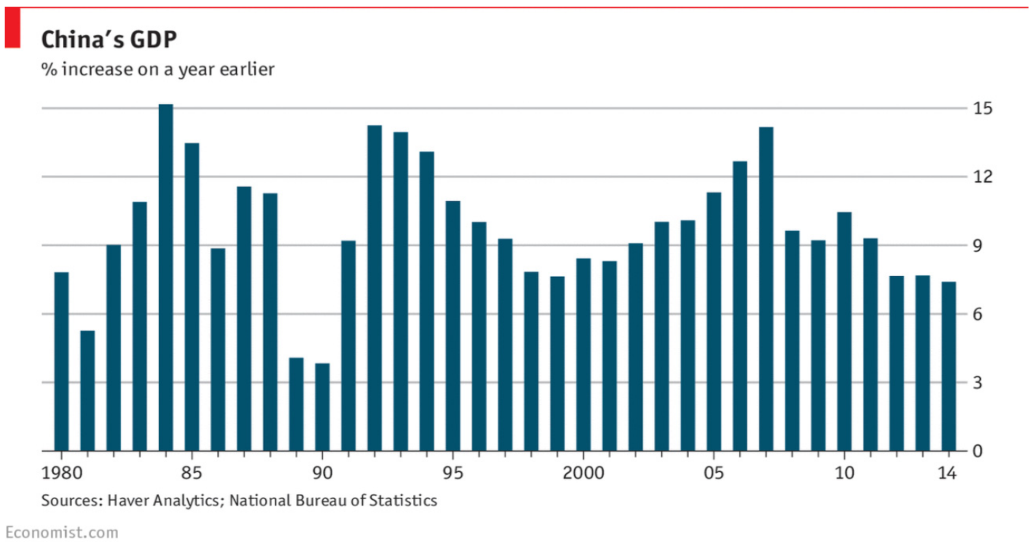
  China's 1.3 billion citizens represent 20 percent of humanity. What's strikingly different about the system of Chinese government is that each province, prefecture, and county has a separate party leadership, government, and court system. This fragmented approach pushes responsibility for heavy infrastructure and services to the local level and results in duplication of efforts as each locale competes to meet centralized targets. Since each area receives only a portion of national tax revenue, gaps in funding are often filled through lightly regulated, regional financing vehicles backed by pledged community property. This makes swaths of the financial system dependent on stable property prices. Stories about overbuilt "empty cities," as well as the risks from the shadow banking system result from this structure. Time will tell if these are growing pains or a disaster.

- **Military & Cyber Warfare Ambitions**

  The armed forces in China have a looming presence, if in the background. China's military spending is around one-quarter of the U.S.'s budget and outwardly it has kept a constrained policy. Yet, bouts of aggression against Vietnam and Japan, and deeper ties with Russia keep the world guessing. China also seems intent on becoming the world's most dominant cyber warfare power and has talked openly about its digital spying and network attack capabilities used to steal corporate and military secrets.

GDP Growth

Underlying China's global influence is its strong economic growth with output now representing 13 percent of global Gross Domestic Product. This has moderated during the recent slump. The question remains whether this settles at a lower level, resumes growth, or collapses.



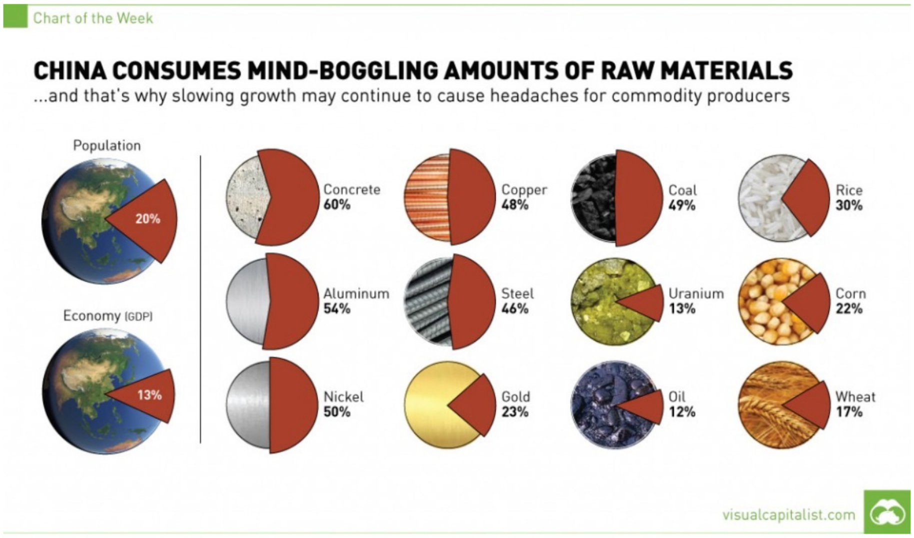
Central Planning: Progress Not Perfection

China is nearing the end of its current 5-year central plan. Goals of the plan include protecting the environment and improving energy efficiency, moving up the production value chain, transitioning toward domestic consumption instead of exports, and improving quality of life.

The results from this period highlight both progress and paradoxes. For example, China is both the world's largest polluter and most dominant renewable energy market player with almost $70 billion of investment. Universal healthcare is growing, yet has uneven coverage. Tiananmen Square may be a distant memory, but there remains substantial repression of free speech and a belief that one is "being watched." As industrial producers and service companies have moved up the value chain, there seems little regard for intellectual property.

One undeniable point about China is the amount of commodities required to support its growth trajectory. The debate rages on for whether the future requires more or less of these inputs, and we are watching demand numbers closely.

The chart below demonstrates China's commodities consumption.

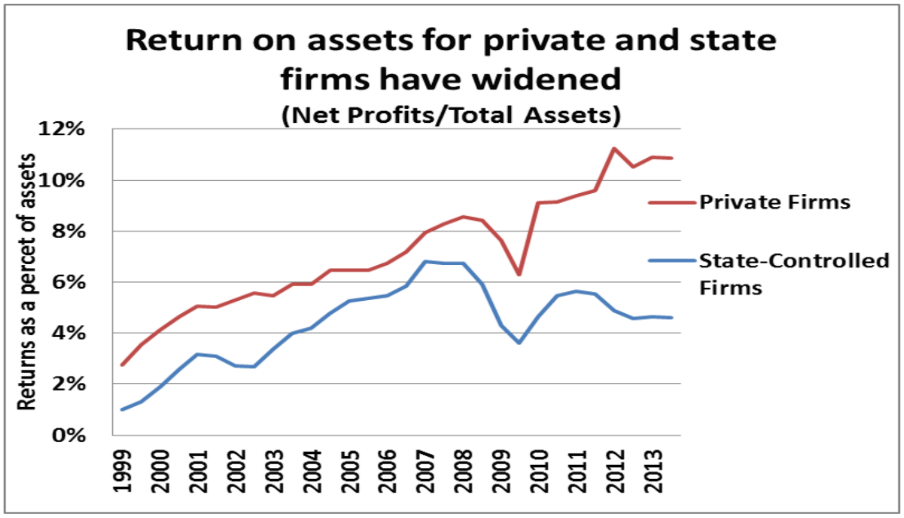


Currency and Stock Markets Open Up

China is unique in having a major global currency (the Yuan) not broadly available for exchange. The government has prevented most of the natural appreciation which would make Chinese goods less competitive abroad. To achieve this, the Yuan is tied to a basket of currencies dominated by the U.S. dollar instead of freely floating. Additionally, incoming and outgoing capital flows are blocked by a limited exchange mechanism (although plenty of Chinese wealth has been siphoned to urban property markets such as London, New York, and Sydney). More recently, currency reforms have invited greater investment and permit officially sanctioned withdrawal of funds.

The Mainland stock market has begun to open up as well. Domestic "A Shares" have become available to international investors. Mainland stocks have a market capitalization equivalent to 50 percent of Europe combined so this had been a substantial gap for the global investor. At least one emerging market index, the FTSE benchmark used by several large fund sponsors, has included China A Shares with a roughly 6 percent weighting.

Despite these liberalizations, it remains challenging to trust the numbers and ignore high levels of state involvement in China's markets. Frauds and off-balance sheet activity is substantially higher than in developed countries. Many companies--even those outside critical energy, telecom, and airline sectors–constitute SOEs, which are partially or fully state-owned enterprises. The track record of China SOEs leaves much to be desired.



Source: ft.com

Emergence of Consumer Culture and the Middle Class

Many believe that China can guide to a softer landing by balancing its export-driven success while growing the middle class. A recent Pew Research study found that three-quarters of Chinese are still low-income, but that the middle class segment doubles every 10 years. The behavior of today's middle class consumer provides some clues to the future. These consumers, particularly the younger cohort, have begun to buy technology items, consumer staples, and luxury goods in line with their Western peers. The big question is whether the bulk of the middle class moves beyond the previous generations' values that emphasize saving, avoidance of borrowing, and work versus leisure.

China is changing and adapting. Until the results are in, we are left to binge watch all of the episodes–good, bad, and ugly. If the U.S. plays a larger role in leading China through the transition, we would probably all be stronger.

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