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CHINA: UNLOVED AND UNDER-OWNED

With the Chinese economy slowing, are you still bullish on the domestic stock market?

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ASK TYLER

We get it. China is slowing. The country's GDP growth averaged 11% in the 2002-2011 decade. It's now under 7% and further moderation is almost certain in the years ahead.

But let's separate fact from fiction. Importantly, much of China's slowdown has been coordinated by policy. Many starry-eyed China watchers predicted real GDP growth of 10% plus indefinitely. But there are limits to linear thinking. While trends can stay in place for some time, lines often bend, or even break and gallop off in unexpected directions.

China's new path is driven by broad recognition that the growth model of the last 30 years is neither balanced nor sustainable. The new model must rebalance away from export and investment-led production toward private consumption. "Made in China" and Western consumerism can no longer be intimately linked. This is a necessary shift if China is to avoid the so-called middle income trap, which ensnares most emerging economies that rely on cheap labor for growth.

GDP per head in China is now approaching USD $10,000. To move beyond this level, policymakers know productivity must dramatically improve. That requires a litany of change — reduced corruption, middle class rights and an improved operating environment for the private sector. A critical next step is to establish a robust social safety net and thereby reduce fear-driven high household savings rates. This will lead to a virtuous cycle of consumption, job growth and, ultimately, higher real wages and corporate profits.

China is also moving from the rapid industrialization stage of growth (where the main objective was to build up infrastructure and heavy industry) to the resource efficiency stage (where the main goal is to maximize the return on investment). Therefore, over the next several years China will see slower but better growth — due to reduced capital waste and improved profitability.

INVESTMENT IMPLICATIONS

Investors naturally worry whether equity prices can keep rising even as the economy keeps slowing. This is the wrong question. Headline GDP should not be the focus. In fact, GDP growth tends to be negatively correlated with equity markets (most likely because investors overpay for headline growth).

The most important facts about China today are not the problems of slowing growth and high leverage. Rather they are the shift away from exports and capital spending to consumer-led growth, improving margins and financial liberalization. The makeup of China's stock market is also rapidly changing. January 2017 saw the most IPOs of any month in the market's history. The upshot is that the Chinese stock market will come to more closely resemble the underlying economy as a whole, rather than being dominated by state-owned enterprises. Now is the time to be investing in an unloved sector. As China makes progress in face of the many naysayers, equities have much room to be revalued upward.

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