

Trade War & Slowdown in China



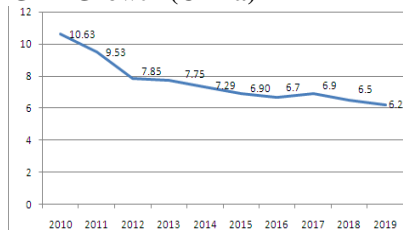
Trade War & Slowdown in China

The world economy is set to feel the pains of the trade war in 2019. The lasting damage caused by President Trump's fight with China may be far more than meets the eye. China is experiencing a slowdown in industrial production. According to Trading Economics, China's industrial production is projected to decline to 5.20 percent by 2020. In response to slow growth, China's Central Bank has eased monetary policy by reducing the cash reserve ratio requirements by 100 bps on Jan 4. Qian Wang, Managing Director and Chief Economist, Vanguard Investment Strategy Group (Asia-Pacific) said "This round of economic decline to a large degree is due to, a downturn in individual and private sector confidence. In this situation, we are concerned that stimulative economic policy may be slowly losing its effectiveness, and may not work as quickly." Hence, the main priority for China in the short term will be to restore confidence of the private sector.

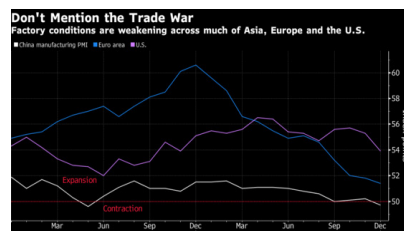
While campaigning for the Republican Party, Trump made a series of China bashing statements including one where he said that United States can't allow China to continue exploiting them and that this is one of the biggest thefts in history. Since then, it has been no secret that Trump has not backed off from the situation. Thereafter, Trump's visit to China, in February of 2018, as part of 'global safeguard tariffs', US imposed tariffs worth USD 8.5 billion on solar panels followed by a series of tariffs in the coming months on Chinese products such as aerospace, information communication technology and machinery.

What followed was a big one; US imposed 25% tariff on steel imports and 10% on aluminium late in March 2018. Both sides kept exchanging blows in the following months increasing the amount of tariffs imposed on China by the US totaling to about USD 250 billion. There have been several discussions after that but nothing concrete has been concluded. Last month, at the G-20 Summit in Buenos Aires, US and China reached a temporary truce not to increase tariffs on any existing items or impose tariffs on new items until March 1 as the two sides work on a larger trade deal.

GDP Growth (China)

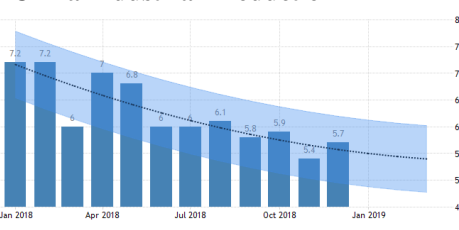


Source: World Bank



Source: IHS Markit

China Industrial Production



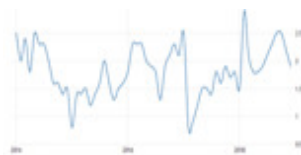
Source: Trading Economics

There has been a major decline in factory activity in China and a Chinese manufacturing gauge is signaling a contraction for the first time since mid 2017. Growth is set to slow across the leading economies this year and the trade war is hurting demand in Asia's manufacturing hubs. The major indicators like inflation, property investments and policy changes signal a slowdown. America is the biggest economy in the world, but despite that China's ongoing troubles had an effect on them. Exporters who were increasingly dependent on China for orders are under huge pressure.

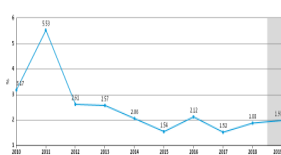
Indicators of Slowdown

Inflation

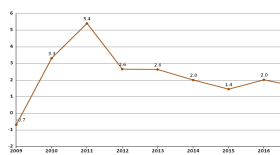
Inflation rate in China dropped to a 6 month low of 1.9% y-o-y in December 2018 in comparison to a 2.2% last year. Food Inflation was at 2.5% while the core inflation was at 1.8% in December, remaining unchanged from last month. However, the whole year inflation was up to 2.1%, up from 1.6% in 2017. For now, Chinese economists say there is little cause for alarm but a rising inflation could cause problems for Beijing while they tackle the issue of a trade war. The OECD has forecasted an inflation rate of 1.98% for 2019 while IMF has forecasted 2.4%

CPI Inflation

Source: Trading Economics

OECD Forecast

Source: OECD

IMF Forecast

Source: IMF

Central Bank Policy Changes

The Central Bank in a bid to influx more capital into the economy announced a reduction in the cash reserve ratio by 100 bps on January 4 2019 bringing it down to 14.50% for large commercial lenders and 12.5% for smaller banks. This happened in two stages on January 15 and January 25 which in turn freed up 116 billion USD for the banks to lend. A PBOC statement later explained that this was done, "in order to maintain reasonable and sufficient liquidity in the banking system." China's top leaders want to keep the monetary policy prudent while striking a right balance in 2019. The PBOC also added that the execution happening in two phases will keep the overall banking liquidity reasonable and sufficient while keeping the yuan's exchange rate at an equilibrium level. Tao Dong, Vice Chairman for Greater China at Credit Suisse Private Banking in Hong Kong said "The central bank has been handing liquidity to the banks, but the banks are unwilling to lend. This is a classic case of banking dis-intermediation amid the down cycle."

Cash Reserve Ratio (Monthly)

Source: Trading Economics

Cash Reserve Ratio (Last 5 Years)

Source: Trading Economics

PMI

The Official Purchasing Managers Index which comprises of 5 major components (new orders, inventory levels, production, supplier deliveries and the employment environment) dipped to 49.4 in Dec 2018 from 50.2 in October and 51.6 in Dec 2017. This was lower than the street estimates which suggested that it would at least hold onto the October levels of 50.2 and is further putting pressure on Beijing to come up with economic support measures. New orders, a sign of future activity, fell for the first time in 30 months, while export orders fell for the ninth month in a row. It is looking increasingly likely that the Chinese economy may come under greater downward pressure said Zhengsheng Zhong, Director of Macroeconomic Analysis at CEBM Group.

China's Manufacturing PMI

Source: ICIS

Manufacturing PMI vs Retail Sales

Source: Trading Economics

Property investments

China's biggest ever overseas spending spree changed course in dramatic fashion when Beijing imposed a forced liquidation of assets for its 4 largest conglomerates in mid 2017 stating they had borrowed too aggressively. They also came up with a 'banned list' which included offshore property and hotels in the restricted basket.

Beijing is expected to keep the capital outflows tight in 2019 as the economy slows down. The deleveraging started in 2018 with Chinese companies dumped assets close to 12.3 billion USD since January, up from 5.3 billion USD the year prior according to Economic Times. The asset sales were "driven in part by the government's push to reign in the most aggressive buyers, but also by a requirement to reduce debt levels," said Jeffrey Langbaum, a commercial real estate analyst at Bloomberg Intelligence.

Economists View

A lot of economists believe that trade wars are not a sustainable option for any economy and ends up harming both or all the parties more than it helps. They create and give rise to constant uncertainties for business and economies. New York-based Citigroup global markets Economist Cesar Rojas wrote in a recent note- "'Trade divergence' since 2018 and the 'Tariffs-Limbo' into 2019 are likely to keep a high degree of uncertainty and continue to have an impact on trade and investment plans."

For the world economy, the threat of trade war has dissipated, not disappeared. Three risks stand out. First, 90 days of talks between China and the U.S. might end in failure, with higher tariffs following. Second, even without an increase in tariffs, front-loading of exports in 2018 will reduce shipments in 2019. Finally, looking beyond the trade war, early warning signs from PMI surveys to FedEx profit warnings flag a softening of demand. --Tom Orlik, Bloomberg Economics.

Correlation between slowdown and trade war

If we look at the trade data, imports in China fell 7.6% y-o-y in December 2018 versus an estimate of 4.5% rise and November's 3%. The export numbers were also down 4.4% y-o-y vs an estimate of 2% rise and November's 5.4%. The trade surplus was at \$57 billion, higher than estimates of \$51 billion and November's \$44 billion. These are worrying signs for what could follow if the trade war continues. Exports fell due to softening global growth and as the drag from U.S. tariffs intensified, while imports also fell due to cooling domestic demand, said Julian Evans-Pritchard, senior China economist at Capital Economics.

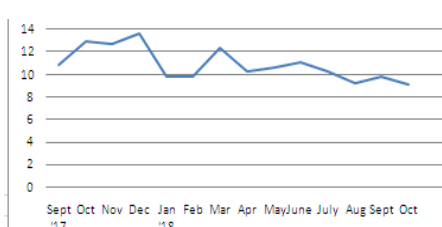
Looking at United States, overall exports fell 0.1% in October 2018 while its exports to China fell 6.7% in comparison to September 2018 and down almost 30% year on year. Naeem Aslam, Chief Market Strategist for Think Markets in London said "If you need any evidence how the trade spat is impacting a country's economic health then look no further than China trade. The lower export number means lower jobs, which means another direct impact on the (Chinese) economy."

China Export Growth (Overall)



Source: China General Administration of Customs

US Exports to China (Billion USD)



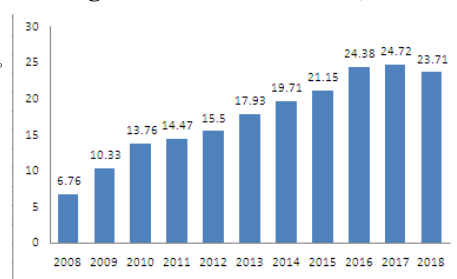
Source: census.gov

Impact/ Tailwinds

Slow growth forecast

China has already indicated on an occasion or two that it could cut its GDP forecast from 6.5% to 6% for 2019. This in itself is a huge statement for one of the fastest growing economies in the world and could have a long term impact on their growth objectives of doubling their GDP and Income in this decade ending 2020. For this, they still require 6.2% for the next 2 years, which seems unlikely at the moment. With the world economy slowing, the last thing that people would want is the slowdown of Chinese economy. Another impact was the drop in sales of passenger cars in China for the first time since 1990, denting the growth forecasts of the car industry. Despite a strong start to 2018, sales fell by 4.1% dragged down in part by a weaker yuan.

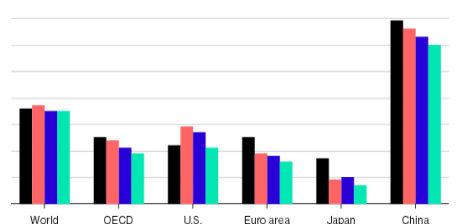
Passenger Car Sales in China (mn units)



Source: statista.com

Global growth is set to decelerate in coming years

■ 2017 ■ 2018 ■ 2019 ■ 2020



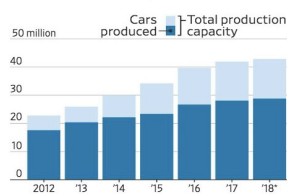
Source: OECD

Capacity Utilization

China for years has spent a lot on building capacity, giving leeway to firms in the form of tax benefits, ease of doing business etc. Now, with the lower cost of capital in the US combined with the tariffs creating parity, the manufacturing jobs that were sucked up by the Chinese, will start going back to the US. These capacities are being rebuilt in United States and other parts of the world. This creates a huge problem for China in that what it does with the excess capacity at its disposal? "With recent tariff battles, companies aren't as eager to have production in China," says Nathan Resnick, CEO of Sourcify. "Labour costs are actually more affordable outside China. So a lot of companies are moving out anyway." Last few years, China has been shifting to a more automated assembly line, shifting the low cost manufacturing to Vietnam and elsewhere. Foxconn has also decided to increase its manufacturing in India. What more, the Taiwanese manufacturer will assemble its flagship product – the iPhone X family in India. They will invest 356 million USD to expand their Xiaomi plant in India.

China Excess Auto Capacity

China has far more car plants than it needs.



*2018 figure is an estimate

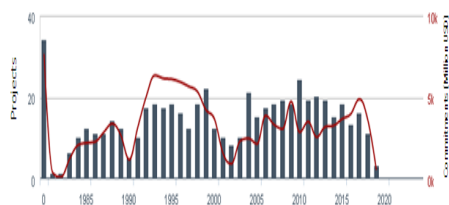
Source: PWC

Real Estate slowdown

Junheng Li, founder of China-focused equity research firm JL Warren Capital said, "simple math shows that continuously building new homes to stimulate investments and meanwhile create the false impression of wealth effect coming with home price appreciation is about to hit the wall." China will experience a sustained slowdown in real estate. In the last quarter of 2018,

the real estate growth slowed to 2% from 5.9% in the previous quarter. "Chinese policy makers are fully aware and highly alert not to send the wrong signal to the home buyers that home prices will continue to hike." Real estate's contribution to growth has dropped to a third in the last quarter of 2018 and it is unlikely that real estate will lead China out of this slowdown. To counter this, the National Development and Reform Commission (NDRC) has approved 16 infrastructure projects between December 2018 and January 2019, totalling to \$162 billion according to South China Morning Post. This is around 10 times more in value than in the same period last year (\$15.69 billion) and already more than the number of projects undertaken last year (11).

Operations by Fiscal Year



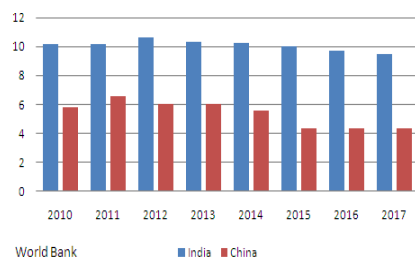
Source: World Bank

Impact on India

The trade war and the imminent slowdown of the Chinese Economy could be a huge opportunity for India. Already Apple is in talks with India to manufacture high end phones in Chennai and other big companies could follow suit. This could have a lasting impact on India as a nation helping it combat the unemployment situation and also increase its per capita income sustainably.

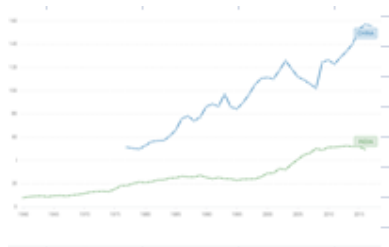
According to World Bank reports, India's GDP is supposed to grow at 7.4% annually compared to China at 6% but as an economy, it still hasn't reached the tipping point yet. Raghuram Rajan, the former Governor of Reserve Bank of India, recently said in an interview, "India will become bigger than China eventually as China would slow down and India would continue to grow. So India will be in a better position to create the infrastructure in the region which China is promising today." The problem for India is that there needs to be more capital creation. We don't have that yet, and it will be increasingly difficult to grow without having availability to low cost capital. India still needs a few structural reforms to kick start the economy and get the private sector involved. The cost of capital from within the industry is still very high and the internal availability of capital is also not there due to the stringency of FRBM Act.

Lending Interest Rate (in %)



Source: World Bank

Domestic Credit to Private Sector (% of GDP)



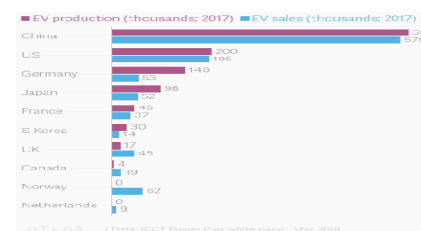
Source: World Bank

If the Indian private sector pounced on the opportunity right now, then the cost of capital would have been very high. Currently, the private sector is debt ridden and it is in the process of putting its books in order. If the government encourages the private sector with a few structural reforms, then this could be a game changer in the long run. We are fundamentally well placed to at least start absorbing and adding capacity for ourselves. India missed the industrial revolution and with the turmoil going on and a labour force of more than 1.2 billion people, this could be the chance for India to step up.

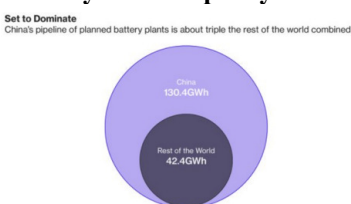
Way Ahead – Tech and Culture

Since the nomination of Trump, globalization has taken a bit of a back seat. A lot of countries including China are unwillingly stepping into the trade war for different reasons. This has led to many countries shifting from having large global supply chains to producing locally and regionally. Growth in technology has played a huge role in making production feasible in some parts of the world where it wasn't a few years ago. Panasonic, one of the first Japanese companies to produce in China, is shifting its production of car stereos to Malaysia, Mexico and Thailand. The company manufactured these U.S. bound products at plants in Suzhou and Shenzhen. According to an executive, the impact of these tariffs on profit could be close to 10 billion yen. Guangdong Province based TCL plans to boost television production at its Mexico plant from 2 million to between 3-4 million to replace items exported from China. Not to say that China is not playing the technology game, but global skill development will take time to catch up. If we consider electric vehicles, a lot of companies are setting up shop in China because China has almost two-thirds of the world's battery capacity which account for almost 40% of the value of the car. It also puts the manufacturing plants closer to the supply chain for batteries. China is also one of the largest markets for electric vehicles and this has encouraged numerous battery and electric car manufacturers to set up shop in China. Tesla one of the pioneers in electric car manufacturing has recently started building a factory that will eventually churn out five hundred thousand cars every year which is 5 times its annual sales in the United States.

EV Sales and Production



Battery Plant Capacity



Companies setting factories outside China

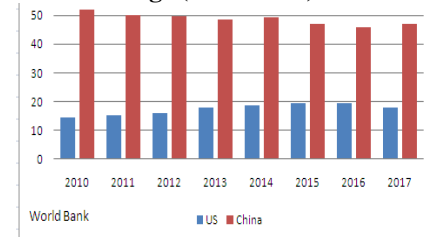
Manufacturers' big swoosh out of China

Company	New locations	Products
Japanese companies		
Nidec	Mexico	Automotive motors, air-conditioner components, etc.
Panasonic	Thailand, Malaysia, Mexico	In-vehicle devices, including audio systems
Yokowo	Vietnam	Automotive antenna components
Sumitomo Electric Industries	Southeast Asia	Automotive-use electrical wires
Daikin Industries	Thailand, Malaysia	Compressors
Chinese companies		
TCL	Mexico	Televisions
Shandong Linglong Tire	Serbia	Tires
Zhejiang Hailide New Material	Vietnam	Polyester
Taiwanese company		
Pegatron	Taiwan	Routers

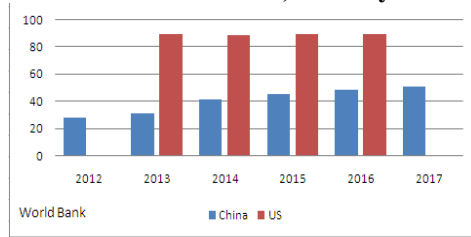
Source: Asian Review

China is not a consumption driven economy and with this slowdown, a lot of talk has been around adopting the Anglo Saxon Model where the Chinese should spend more. The argument for it is to reduce household savings. But the Eastern culture revolves around savings. The Chinese will usually spend more during the Chinese New Year but bringing down savings rates to be similar to some of the Western Economies will not be possible. There is a reason this sort of behaviour has worked for these huge economies like India and China, as then the government can mobilize these savings through the banking and the insurance sectors for Infrastructure development etc. which has helped them achieve this growth.

Gross Savings (% of GDP)

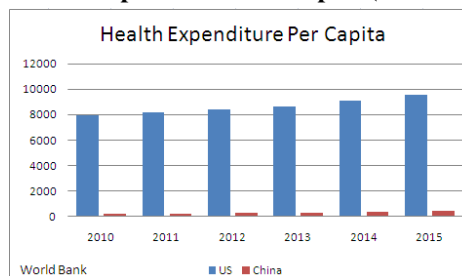


Gross Enrollment Ratio, Tertiary Education



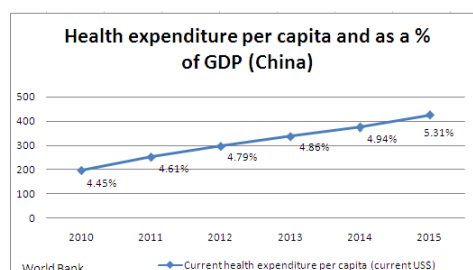
Another point which we've previously looked at is that a lot of investment in Chinese Capacity development has been developed for the Western Markets and the upper echelons of the society but not a lot of investment has been made for grass root consumption. China is a big economy and cannot expect to grow in the same manner that other Western societies have grown. It will have to come up with its own model for boosting growth for the next decades, as the mega industries of today, will not be the mega industries for tomorrow. Industries like education, healthcare etc. need to be given more emphasis. The high savings that are being generated need to be channeled into education. This is a huge behavioral change and will take some time but will work in the long term.

Health Expenditure Per Capita (In US \$)



Source: World Bank

Health Expenditure per Capita and as a % of GDP (China)



Source: World Bank

U.S. health care spending grew 3.9 percent in 2017, reaching \$3.5 trillion or \$10,739 per person. As a share of the nation's Gross Domestic Product, health spending accounted for 17.9 percent. To spur the next stage of growth, China will have to focus on improving education and healthcare in addition to its primary activities.

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