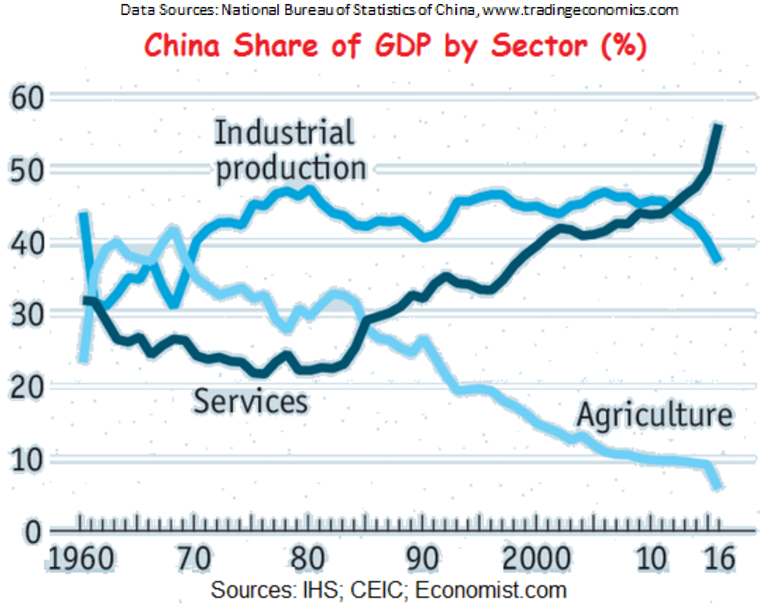
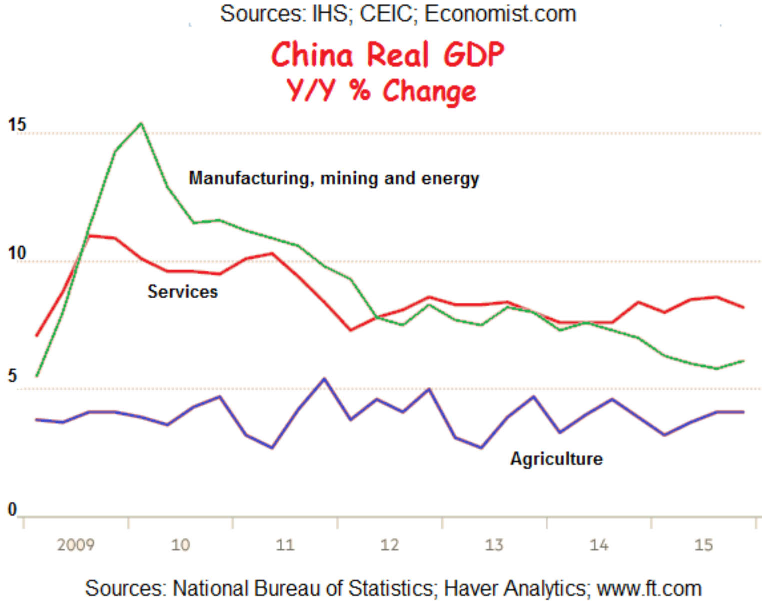
China's Long Term Economic Outlook

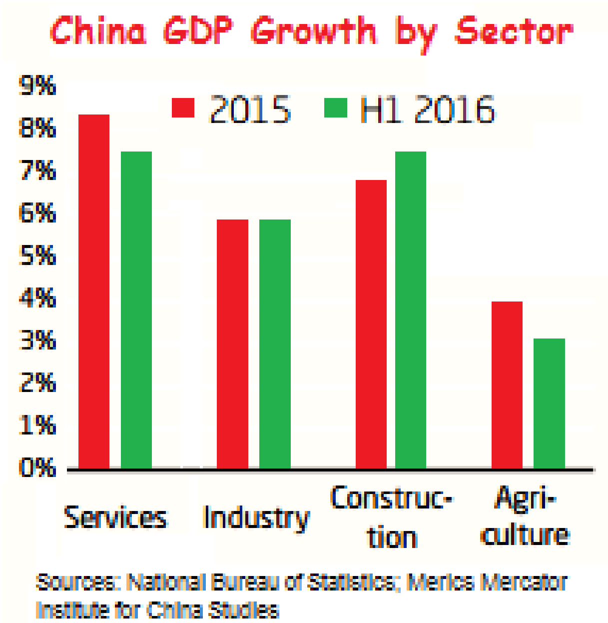


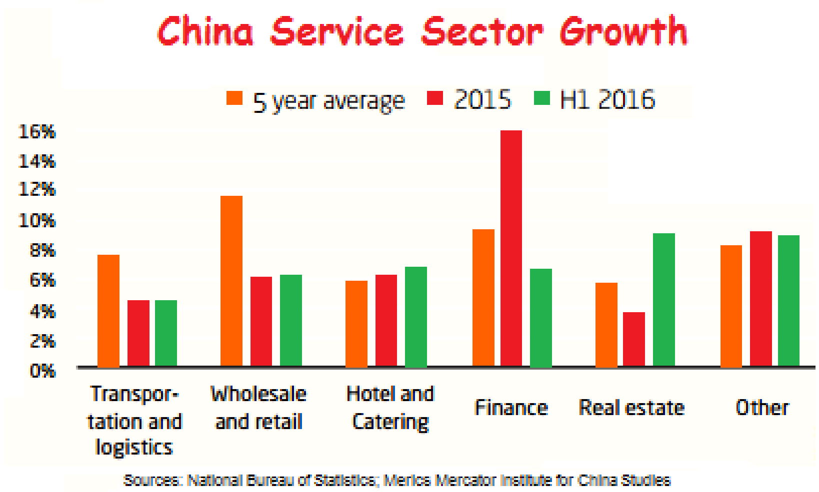


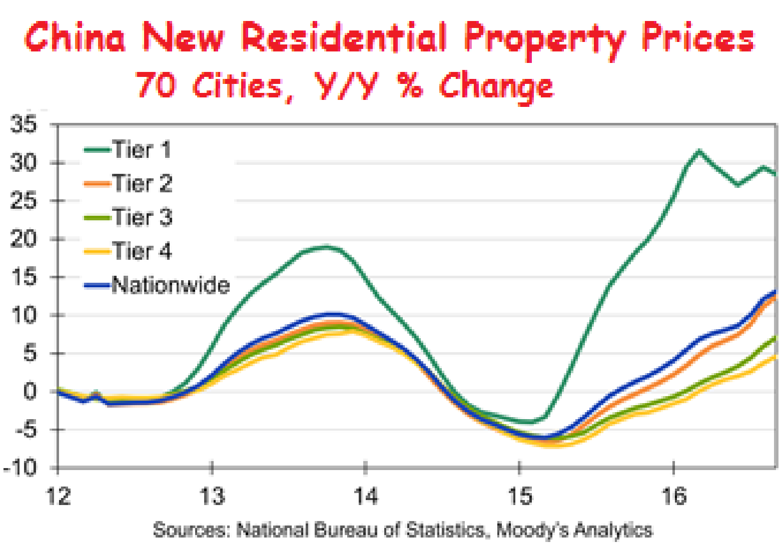
The Chinese economy continues to slow as the government attempts to shift from investment-led to consumption- and services-driven growth. After reaching double-digit rates in 2010, economic growth has been on a downward trend and is now at its slowest pace since the global downturn at 6.7%. Given that China is the second-largest economy and largest exporter in the world, the slowdown has raised concerns; a hard landing for China would have serious international implications. Unfortunately, conditions are expected to weaken further in the coming years, with growth dropping to less than 5% by 2018.

China's transition to a more consumer-oriented economy is necessary because the export-driven growth that has been fueled by low-wage manufacturing jobs is not sustainable; minimum wages are rising and other countries, such as Vietnam, now have more competitive wages. As a result, China is switching gears and focusing on the services sector as its main economic locomotive rather than the industrial sector. As a percent of GDP, China's share of services spiked in 2015 and exceeded 50% for the first time. This year, the services' share of GDP averaged around 55% during the first two quarters. Meanwhile, the share of the industrial sector is declining.

While the rising share of China's services sector suggests that China's economic transition is underway, this is not necessarily the case; looking at the data more closely, we see that the spike in the services' share of GDP is not due to unusually higher activity in the services sector, but rather a decrease in overall GDP following reduced activity in the industrial sector. The growth rate of the services sector has remained relatively stable over the last few years, while the growth rate of the manufacturing sector is declining.



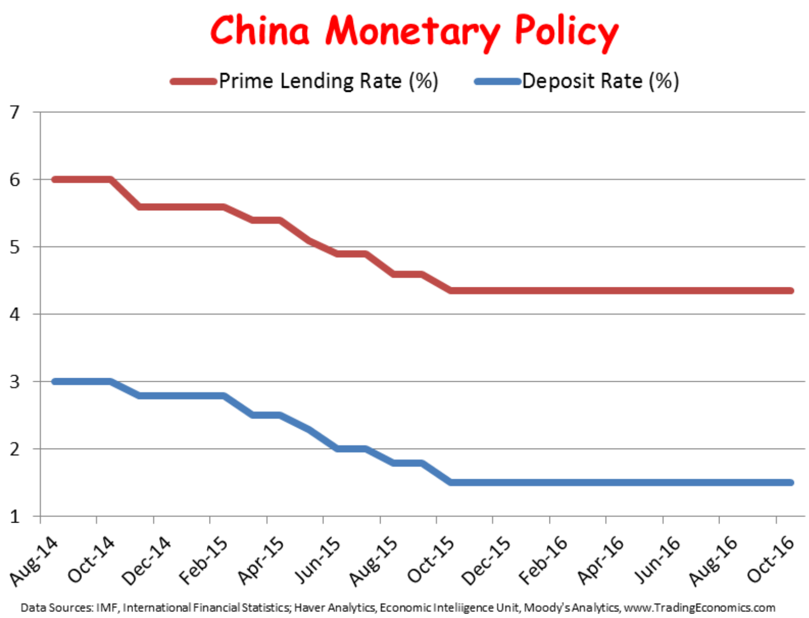


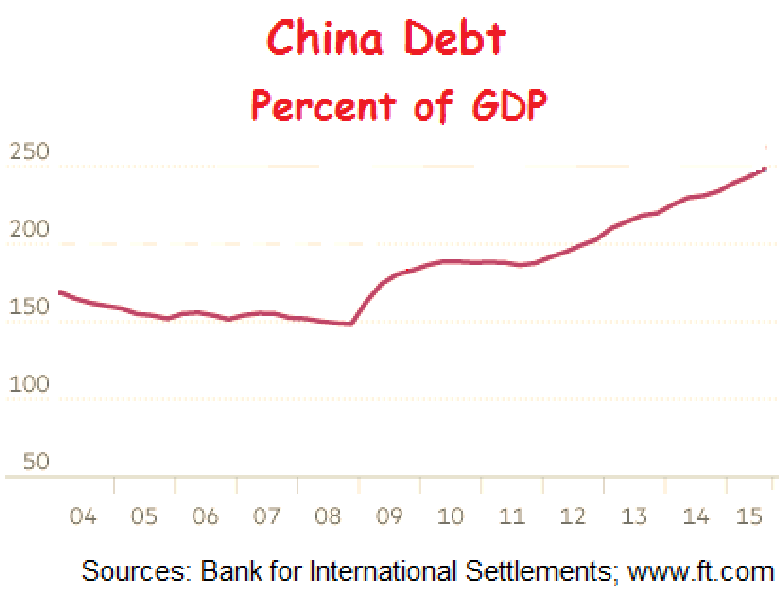


Further, the main driver of China's services sector growth in 2015 was the financial sector, stemming from a spike in stock market activity during the first half of the year. As a result, year-over-year growth of China's financial services sector reached almost 16%, nearly double its five-year average of around 9%. Unfortunately, however, hyperactivity in the stock market resulted in a bubble that burst as investors grew more and more concerned about low oil prices and China's slowdown. Higher risk aversion following China's stock market crash in the summer of 2015 has caused trading activity to slow significantly, causing year-over year growth in the financial sector to average just 6.7% during the first two quarters of 2016.

As activity in the stock market has declined, many investors have turned to the real estate market, resulting in bubble-like conditions in China's housing market. After experiencing a downward trend for around three years, housing investment growth has been on the rise since the beginning of this year. Although housing activity has been concentrated in the large Tier 1 cities of Beijing, Guangzhou, Shanghai and Shenzhen, smaller cities are also seeing gains.

Rising activity in China's real estate market has increased services related to real estate as well as activity in the nation's construction sector. As the housing market continues to works its way out of its current oversupply problem, particularly in the lower-tier cities, housing construction and investment should pick up more rapidly. Although this trend has given some hope that the Chinese economy is approaching a trough and that growth will stabilize over the next year or two, it is unlikely to be sustainable as bubble-like conditions have already caused the Chinese government to try to cool home prices.





Another factor to keep in mind is that over half of the services sector is related to the industrial sector. This means that as the industrial sector slows, the services sector will likely slow as well. All of these findings suggest that China's services sector is unlikely to be strong enough to make up for slowing activity in the industrial sector and be the main driver of growth for the government's economic growth target of 6.5% through 2020. As a result, the Chinese government must choose between pushing reforms to shift to consumption and services-driven economy and continuing to rely on investment and exports to reach its growth target.

Although it might seem like a better idea to begin with more aggressive structural reforms and make progress on the economic transition rather than continuing with unsustainable means of growth and postponing an inevitable slowdown, it appears the Chinese government is choosing the latter and prioritizing its growth target over restructuring. This is evident from the fact that the government has eased its policy stance by cutting interest rates five times during the course of a year. China's prime lending rate, which is now at a record low of 4.35%, has remained unchanged since November 2015 and there are no signs that it will be raised any time soon. In addition, housing restrictions have also been eased while government infrastructure spending and investment by state-owned enterprises have risen.

Unfortunately, relying on investment-driven growth to temporarily lift growth has serious long run consequences. China's debt has risen at a rapid rate over the last few years and has now reached 250% of GDP. Relying on the same means of growth to ensure its growth target will only worsen China's debt problem and put the country at risk of a serious financial crisis and significant economic slowdown after 2020. Therefore, by avoiding a slight slowdown in the near term, the government is increasing the likelihood of a more severe slowdown in the long-run.