view from the OUTER

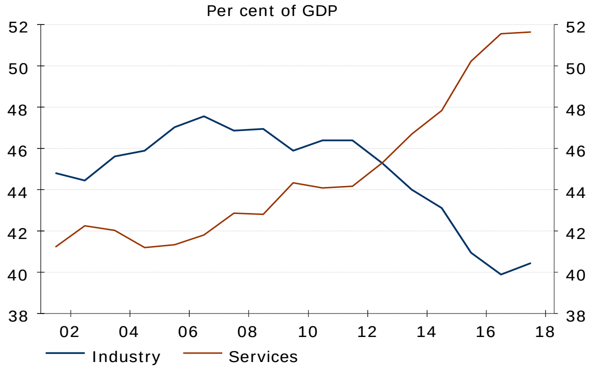
EVANS & PARTNERS

Tim Rocks
Chief Investment Officer
Timothy Rocks

# Chinese reform 2.0

China is entering a new phase of reform with a key focus on improving financial stability and reducing government debt. Measures that have already been announced include banning state-owned banks from lending to local governments and the cancellation of some major projects.

**China GDP by Sector**
Per cent of GDP




Source: Thomson Reuters Datastream, Evans & Partners

While reform is a long term positive, it raises the risk of a weaker economy in the short term, similar to what occurred during the last reform drive from 2012-2015. Given the tight link between construction and debt issuance, the slowdown in the industrial economy might exceed this earlier episode.

The silver lining from these changes is that China is introducing a number of measures to encourage further expansion in the consumer side of the economy including tax cuts and deregulation of the consumer finance sector.

## Recommendations

Concerns about the implications of Chinese reform are one of the reasons we have been recommending investors reconsider exposure to riskier investments including commodities, resource stocks and emerging market equities.

On the positive side, Australian beneficiaries will be those companies exposed to improving Chinese consumption. These include:

- Tourism providers such as airlines, airports, attractions, casinos and retailers.
- Education providers. Australia is the third-largest market for international students and this will expand further.
- Food exporters. Food exports have grown exponentially since 2012 due to changing diets, higher incomes and food safety concerns. Going forward we expect there are going to be many more opportunities.

Stocks covered by Evans and Partners that we recommend on this theme are **Sydney Airport** (SYD, EAP: Positive) and **Scentre Group** (SCG, EAP: Positive) on tourism. Other opportunities are **Blackmores** (BKL, EAP: Positive) on vitamins and **BWX** (BWX, EAP: Positive) on skincare.

# Chinese reform 2.0

Chinese structural and financial reforms are entering a new phase that may dominate economic and market outcomes over the next few years.

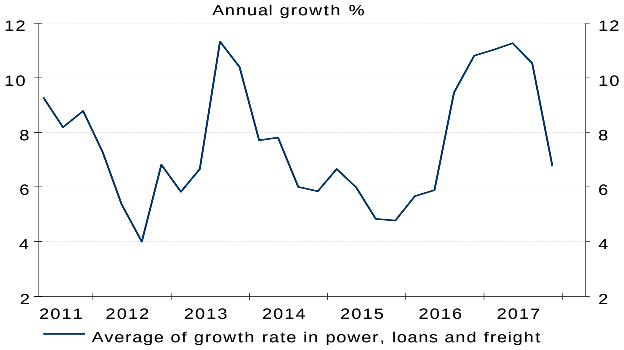
Since the opening up of China in the early 1990s cycles in reform have been a major influence on the economy. The macro slowdown from 2012-15 was reform driven and the recovery in 2016-17 was made possible by a politically-enforced pause in reform. Importantly, the last two years of resurgence in the industrial economy and construction should be seen as an aberration; now that the reform process has restarted activity in these sectors is likely to soften. The better news is that for the overall economy this is likely to be offset by strengthening consumption.

## *2016-17 was an aberration*

The last major phase of reforms began in 2012 with the ascension of Xi Jinping to the presidency. There were a range of initiatives but the most significant for the economy were the attacks on corruption. These unintentionally led to a collapse in infrastructure spending when local government officials stopped approving projects for fear of attracting attention. Alternative estimates of Chinese GDP (such as the “Keqiang Index”, which combines readings on power production, loans and freight) suggest that the economy dropped from a 10% growth rate to around 5% during this period.

**Alternative estimate of Chinese GDP**

Annual growth %

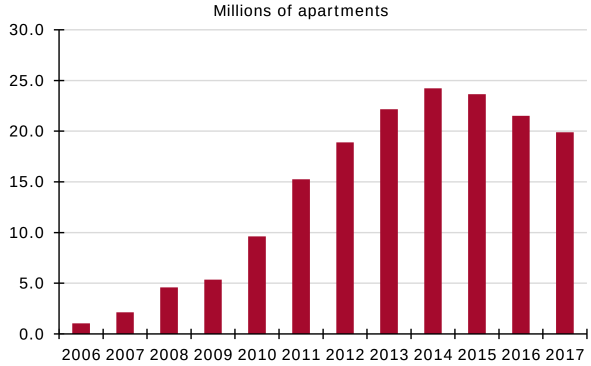



Source: Thomson Reuters Datastream, Evans & Partners

Reflecting this pressure, and in the lead up to the National People’s congress in late 2017, the reform agenda was paused. Local government officials were told that they were no longer the focus of attention. There were also easing measures announced in the property market where apartment sales had slipped at a time when inventory measures were very high. Some estimates put the number of unsold apartments at 25 million, which would be enough to house the entire population of Australia several times over.

**Chinese Unsold Apartments**

Millions of apartments

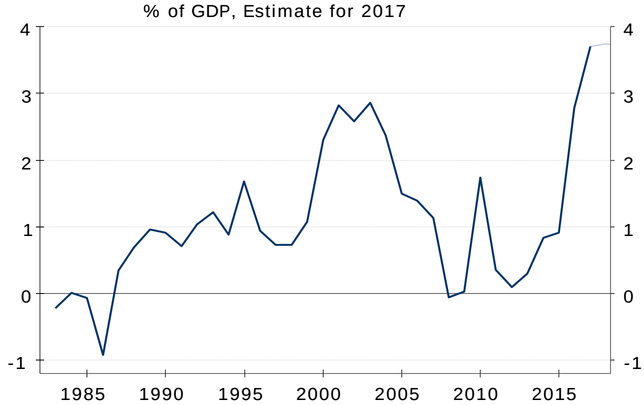



Source: Thomson Reuters Datastream, Evans & Partners

The economic impact of policy stimulus and the bounce in the property market were significant. The fiscal stimulus in 2016 and 2017 was the largest in recent history. As has often been the case, China over-delivered on easing and created buoyant conditions.

**Chinese Fiscal Stimulus**

% of GDP, Estimate for 2017




Source: Thomson Reuters Datastream, Evans & Partners

There were also significant implications for commodity prices. For example, the iron ore price doubled during 2016 and remains elevated relative to historical averages.

**Iron Ore**

$US/MT


Source: Thomson Reuters Datastream, Evans & Partners

## The next phase of reform

China has sent a strong signal that reform is back on the agenda. This began with the high-profile meeting of the Community Party in October and was followed by another high-profile meeting of the leadership group in March which, among other things, removed term limits for Xi Jinping's presidency.

The other main development from this meeting was the establishment of the "Central Committee of Comprehensive Reforms" chaired by the President. Since its first meeting there have been a number of announcements:

- State-owned banks have been banned from lending money to local governments.
- At least 14 cities have had plans for subway cities suspended or cancelled. Subways have become the symbol of excessive local government spending in recent times. Around 50 Chinese cities already have systems in place.

### Subway to nowhere in Chongqing

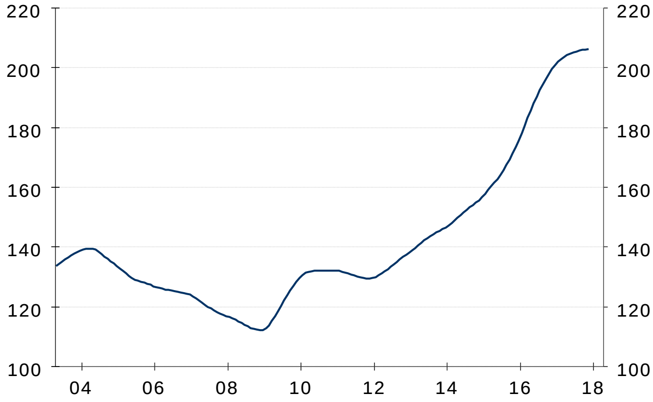
Source: South China Morning Post

- One whole province has suspended all government projects.
- Further rules on shadow banking have been announced.

What this makes clear is that the key focus of the next phase of reform will be to reduce government debt which has ballooned higher over the past few years. Since 2015 domestic credit has increased by 60% of GDP.

**Chinese Domestic Credit**

% GDP




Source: Thomson Reuters Datastream, Evans & Partners

The focus on government debt and financial stability is a long-term positive for the sustainability of the Chinese expansion. Debt levels and the pace of debt accumulation have been a major focus of concern for investors and other foreign observers for many years. However, this focus will increase the risk of a repeat of the industrial slowdown from 2012-2015. In fact, this could cause an even larger slowdown in the industrial economy than during that period since this time China is specifically targeting a lower level of infrastructure and property construction.

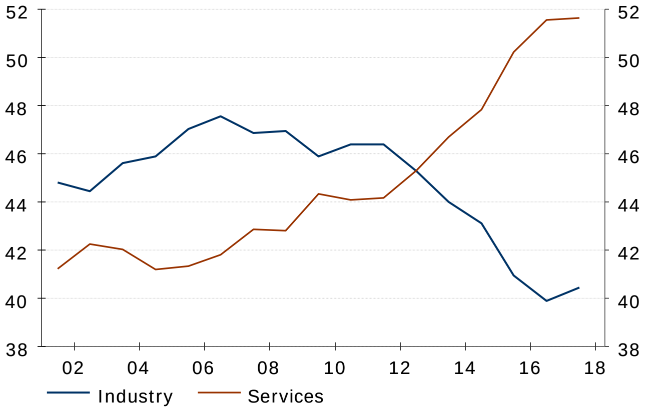
The recent high-level meetings also made clear that China will maintain its focus on environmental issues, particularly improving air quality and reducing pollution. This will continue to be a hindrance to parts of heavy industry including the steel sector.

## The silver lining for the consumer

The silver lining from the reform agenda is that China will complement the attack on heavy industry with further measures to encourage expansion in the consumer side of the economy. To date China has had some success building the services side of the economy to more-or-less offset the decline in the industrial sector.

**China GDP by Sector**

Per cent of GDP



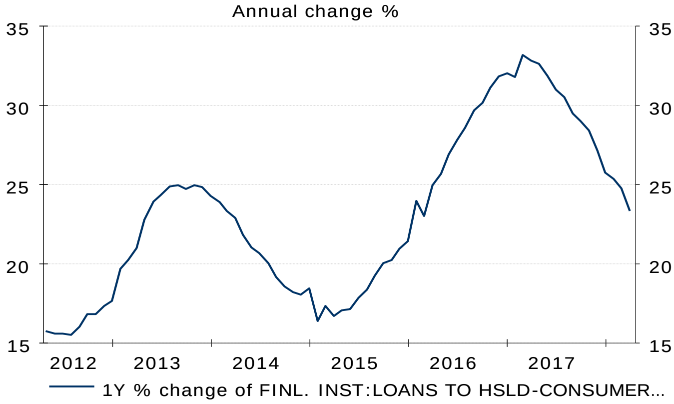

Source: Thomson Reuters Datastream, Evans & Partners

Measures to boost consumption that have been announced or are likely include:

- China will lower VAT rates by 1% from 1 May this year.
- There are expected to be cuts to personal income tax through raising tax-free thresholds.
- Deregulation of the consumer finance market. China removed a ban on non-banks providing consumer loans in 2014 and since that time consumer loans have surged. There is a proliferation of new lenders such as Fenqile and Home Credit that use digital means to undertake quick credit checks and provide point-of-sale lending.

**Chinese consumer loans**

Annual change %




Source: Thomson Reuters Datastream, Evans & Partners

## Implications for Australia

Concern over the implications of Chinese reform is one of the reasons we have been recommending investors reconsider exposure to riskier investments including commodities and emerging market equities.

More specifically for Australian investors we see this as a good time to review exposure to Australian resources, particularly the iron ore suppliers.

Australian beneficiaries will be those companies exposed to improving Chinese consumption. These include:

- Tourism providers. Our view is that Australia is at the early stages of a second great tourism boom. Tourism Australia forecasts that Chinese arrivals will triple by 2025 which will have a pervasive effect through airlines, airports, hotels, attractions, casinos and the retail sector. Hotel and attraction construction will benefit developers and materials companies.
- Education providers. Australia is the third-largest market for international students and this market is expected to double over the next decade according to UNESCO.
- Food exporters. Food exports have grown exponentially since 2012 due to changing diets, higher incomes, food safety concerns and the recent free trade agreement. Beef, wine and milk have been the main beneficiaries so far. Going forward we expect there are going to be many more opportunities. The extent of online shopping in China means that Australian companies can access Chinese consumers with relative ease.

Stocks covered by Evans and Partners that we recommend on this theme are **Sydney Airport** (SYD, EAP: Positive) and **Scentre Group** (SCG, EAP: Positive) on tourism. Other opportunities are **Blackmores** (BKL, EAP: Positive) on vitamins and **BWX** (BWX, EAP: Positive) on skincare. Copies of the full research reports on these stocks are available from your adviser or by visiting [www.evansandpartners.com.au/research](www.evansandpartners.com.au/research).

# DISCLAIMER

This document is provided by Evans and Partners Pty Limited (ABN 85 125 338 785), holder of AFSL 318075 (Evans and Partners).

This document is not a product of the Evans and Partners Research Department and is not intended to be a research report (as defined in ASIC Regulatory Guide 79). Any express or implicit opinion or recommendation about a named or readily identifiable investment product is merely a restatement, summary or extract of another research report prepared by Evans and Partners that has already been broadly distributed. You may obtain a copy of the original research report from your adviser or from our website at www.evansandpartners.com.au/research.

The information in this document is general information only and does not take into consideration any particular investor's objectives, financial situation or needs. Before acting on any information within this document you should consider the appropriateness of it having regard to your own particular circumstances, objectives, financial situation and needs.

The material contained in this document is for information purposes only and does not constitute an offer, solicitation or recommendation with respect to the purchase or sale of securities. It should not be regarded by recipients as a substitute for the exercise of their own judgment. If the material relates to a financial product that is the subject of a Product Disclosure Statement or offer document investors should obtain a copy of the relevant disclosure document and consider it before making any decision about whether to acquire the product. Readers should be aware that past performance should not be construed as an indication of future performance and that future returns are not guaranteed.

Any opinions and/or recommendations expressed in this material are subject to change without notice and Evans and Partners is not under any obligation to update or keep current the information contained herein. References made to third parties are based on information believed to be reliable but are not guaranteed as being accurate. This document is provided to the recipient only and is not to be distributed to third parties without the prior consent of Evans and Partners.

Except for any liability which cannot be excluded, Evans and Partners, its directors, employees and agents accept no liability or responsibility whatsoever for any loss or damage of any kind, direct or indirect, arising out of the use of all or any part of this material. All information is believed to be correct at the time of publication; additional information may be available upon request.