

May 2019

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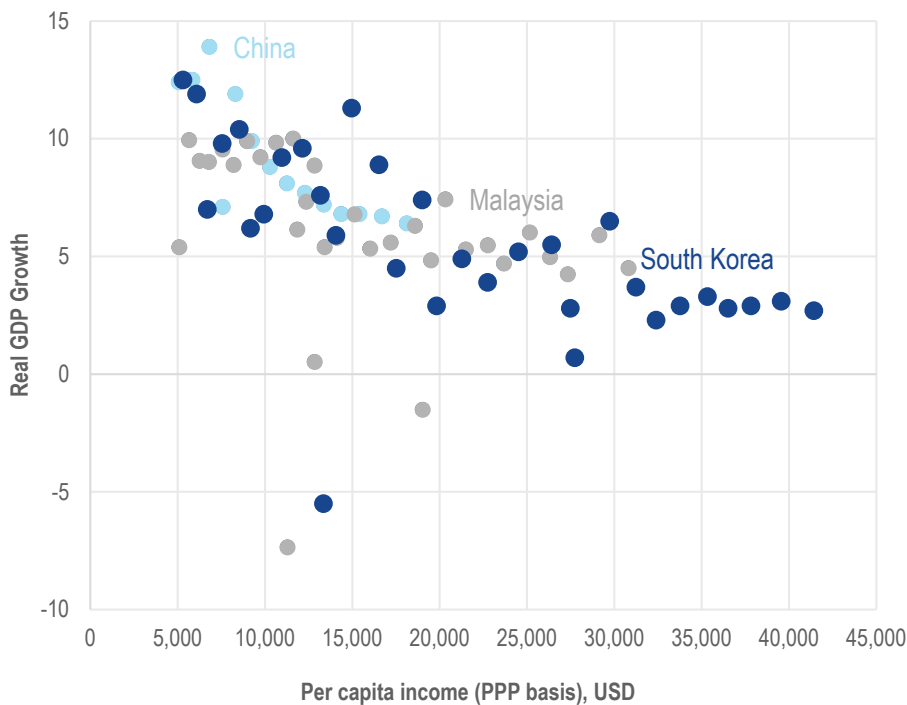
## **China in 2019: Pursuing a middle-income growth model**

# Natural slowdown, bigger global contribution

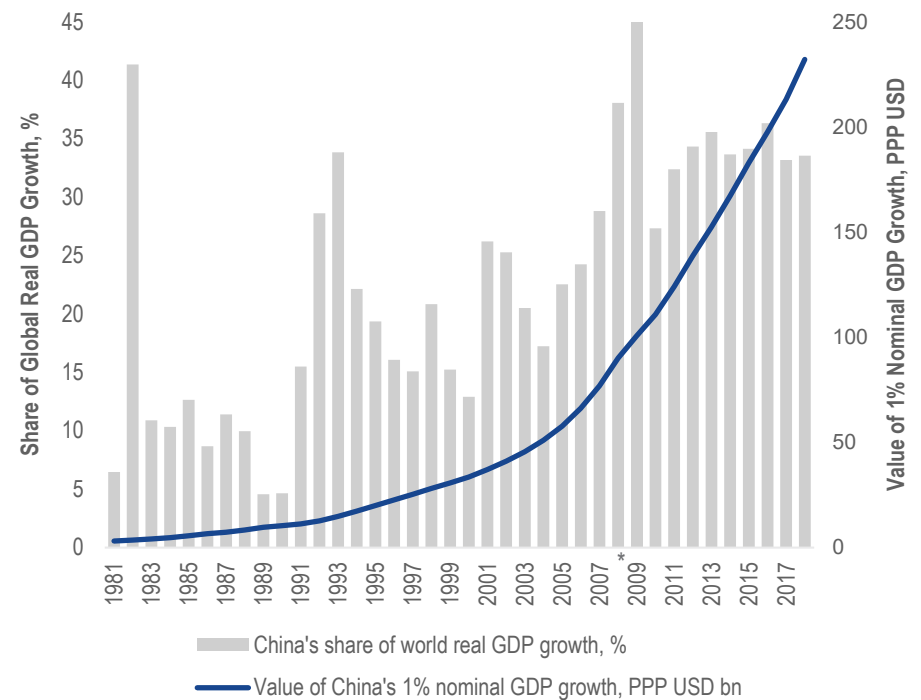


- We believe China's economy is bound to slow as it matures and relies more on consumption – similar to what happened with regional peers
- China's contribution to global growth will still remain significant, in our opinion

**China Has High Real GDP but Low Per Capita Income**



**China Has Been a Major Contributor to Global Growth**

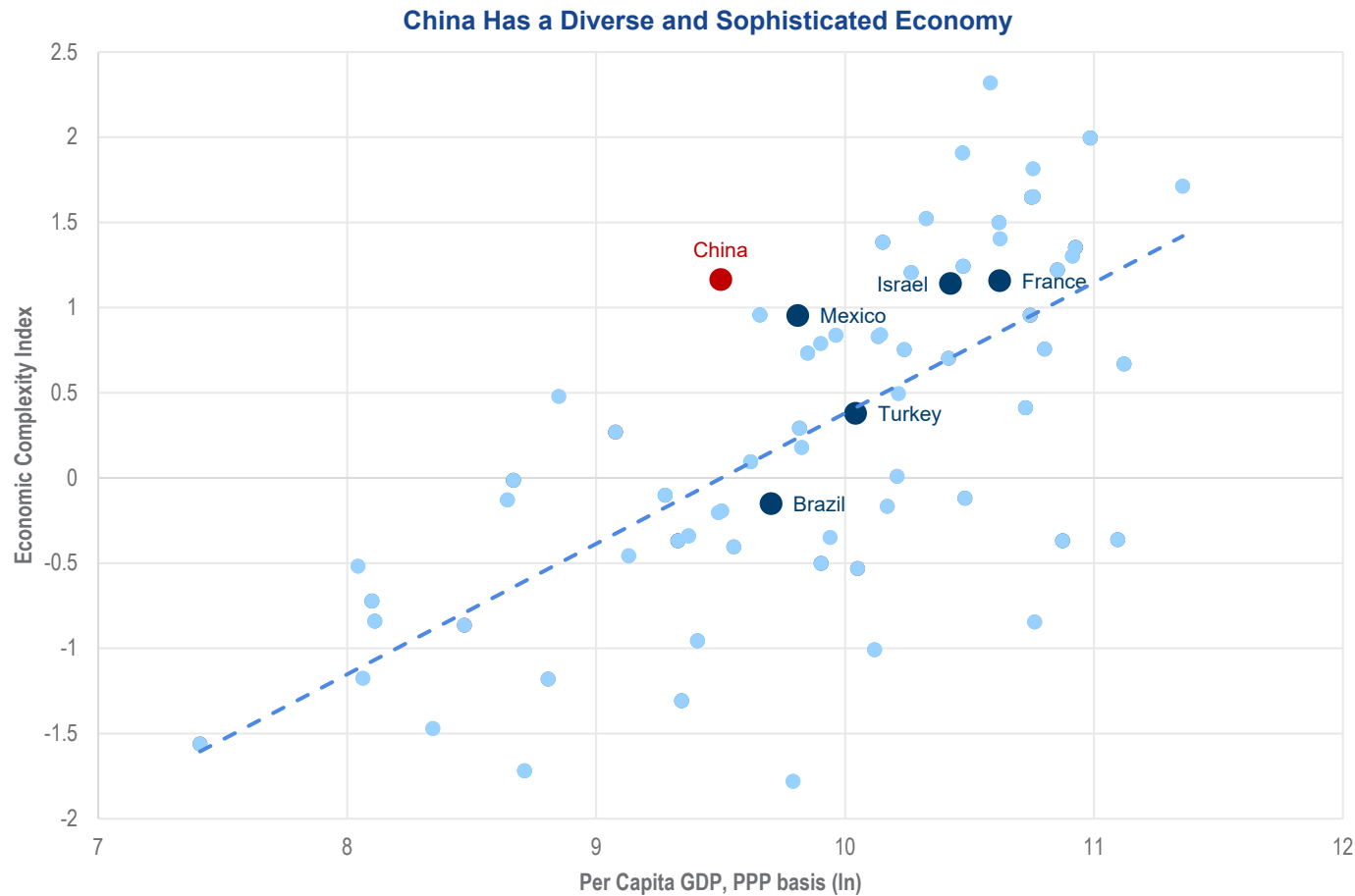


Source: VanEck; Bloomberg. GDP: gross domestic product. PPP basis: Adjusted based on purchasing power parity, which accounts for differences in price levels.

\*Although not shown, china accounted for 100% of Global Real GDP in 2009.

# Innovation, economic complexity ahead of peers

- We believe China's innovation record is impressive
- Economic complexity is significantly above the peer group

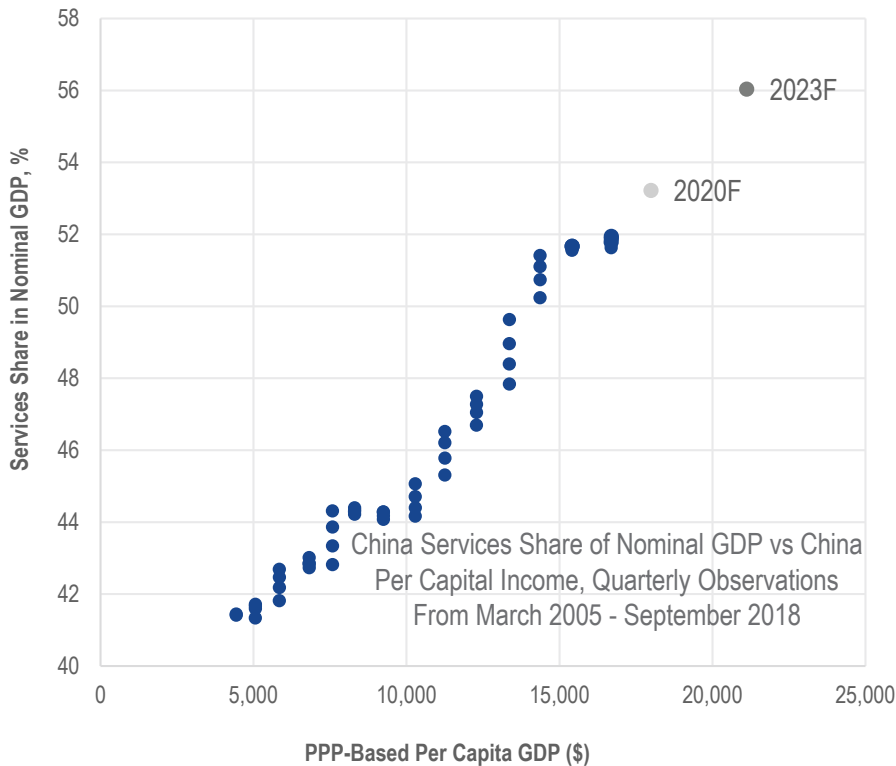


Source: VanEck, Bloomberg LP (left). The **Economic Complexity Index (ECI)** is a holistic measure of the productive capabilities of large economic systems, usually cities, regions, or countries. In particular, the ECI looks to explain the knowledge accumulated in a population and that is expressed in the economic activities present in a city, country, or region. To achieve this goal, the ECI defines the knowledge available in a location, as the average knowledge of the activities present in it, and the knowledge of an activity as the average knowledge of the places where that economic activity is conducted.

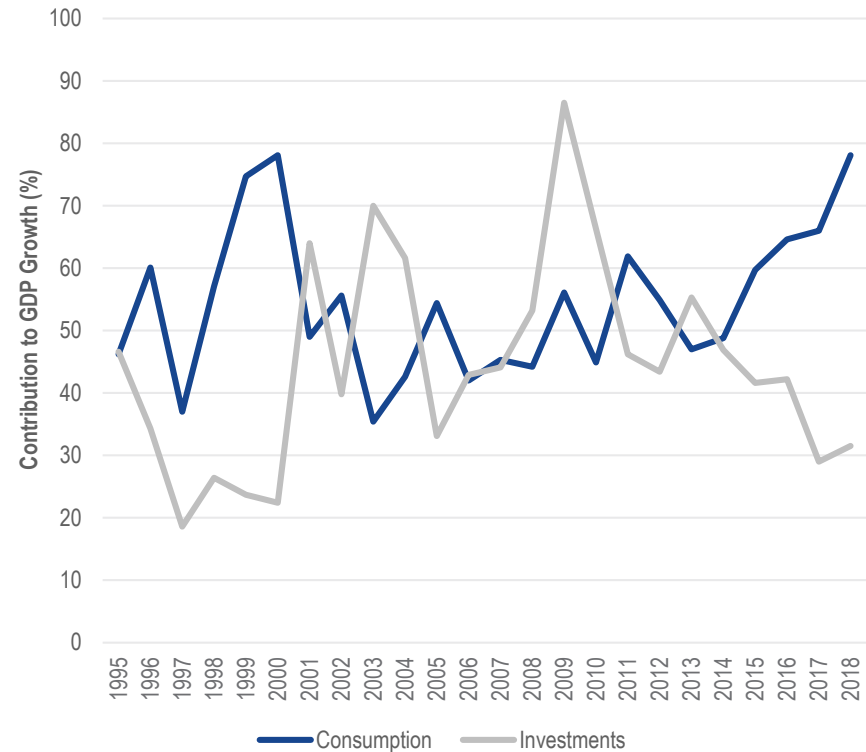
# Secular transformation to consumption-based economy

- Rising middle class drives secular transformation to consumption-base economy – higher incomes are associated with a higher share of services in GDP
- The share of GDP driven by investment is slipping below 30% and services account for nearly 60% of fixed investments

As Income Rises, so Does Services Share



China's Growth Increasingly Driven by Consumption\*

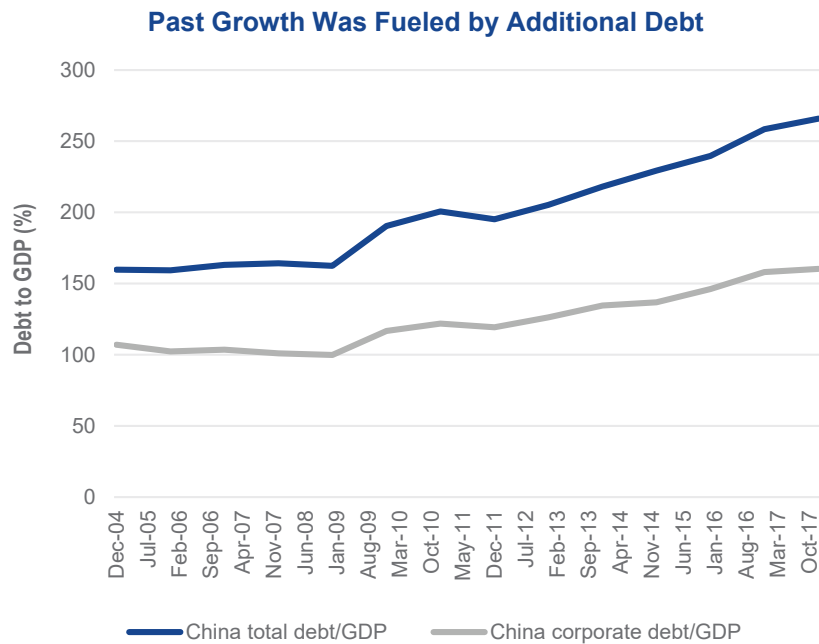


Source: Bloomberg LP. GDP: Gross Domestic Product.

\*Consumption refers to activities that directly provide utility to people, and investment refers to the accumulation of capital goods

# Transformation has costs – widening macro imbalances

- China accumulated multiple macroeconomic imbalances while getting richer
- China's leverage – including corporates – is among the highest in the world
- So is M2/GDP ratio



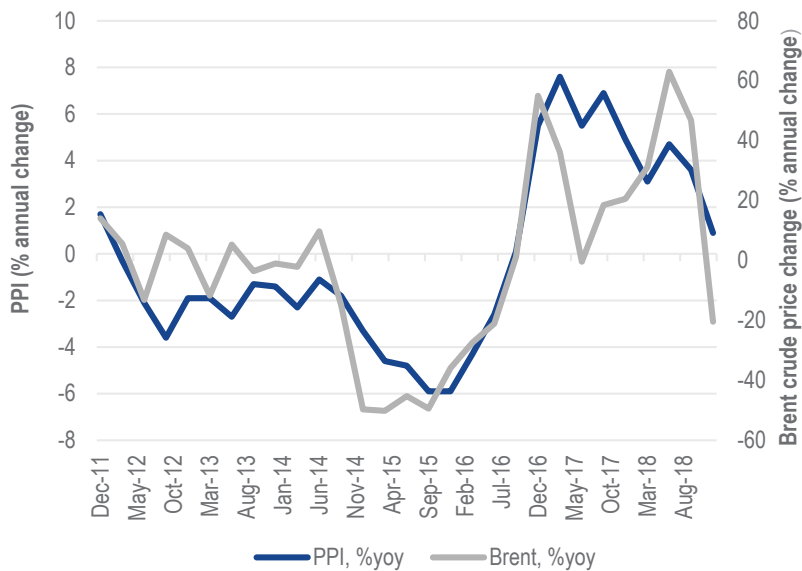
Source: Bloomberg LP (left); Unassuming Economist (right). M2 is a calculation of the money supply that includes cash and checking deposits, savings deposits, money market securities, mutual funds and other time deposits.

# Price deflation reignited debt concerns

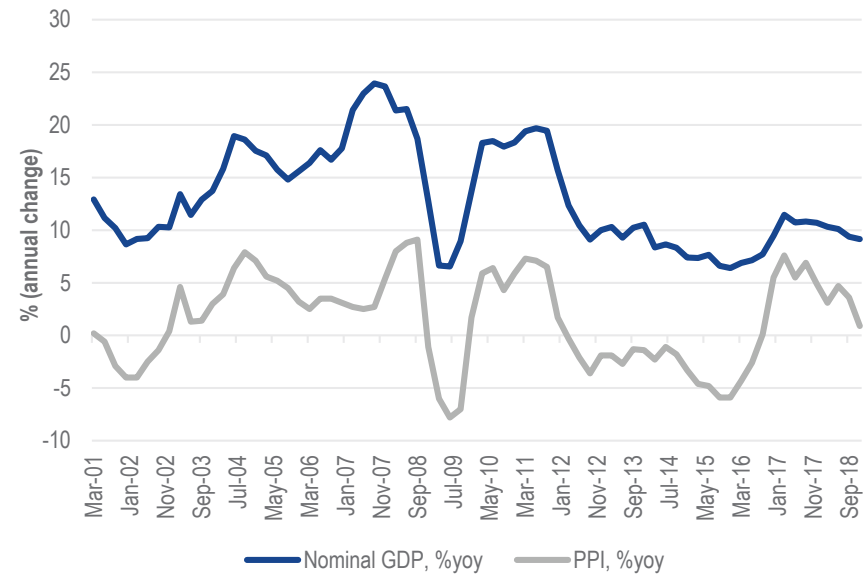


- Even though the producer price index (PPI) is driven mostly by commodity prices...
- ...it pushes nominal GDP lower, worsening China's debt/GDP ratio

**PPI and Oil Prices are Highly Correlated**



**Decreasing Prices Have Pushed Down Nominal GDP**



Source: VanEck Research, Bloomberg LP. PPI: Producer Price Index.

# Price deflation has implications for corporates

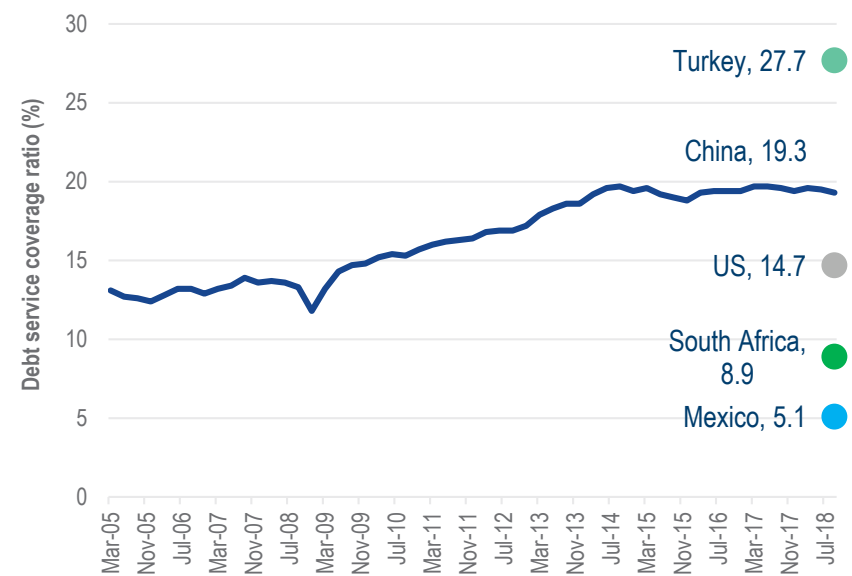


- Lower PPI and nominal GDP growth may eat into corporate profits...
- ...which can be problematic as debt servicing ratios remain high

**Declining Prices Reflected in Corporate Profits**



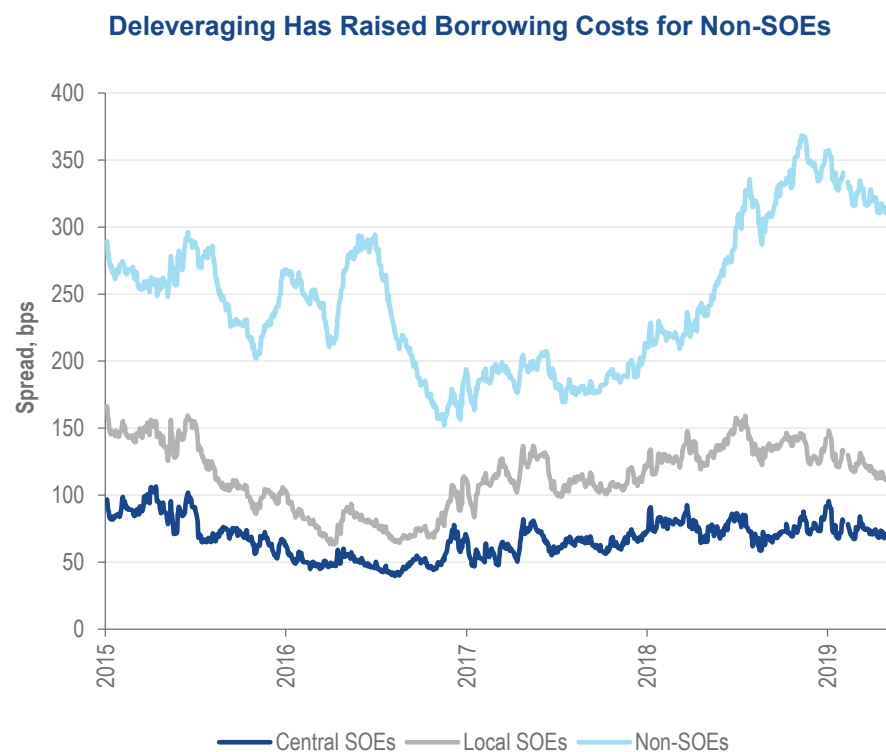
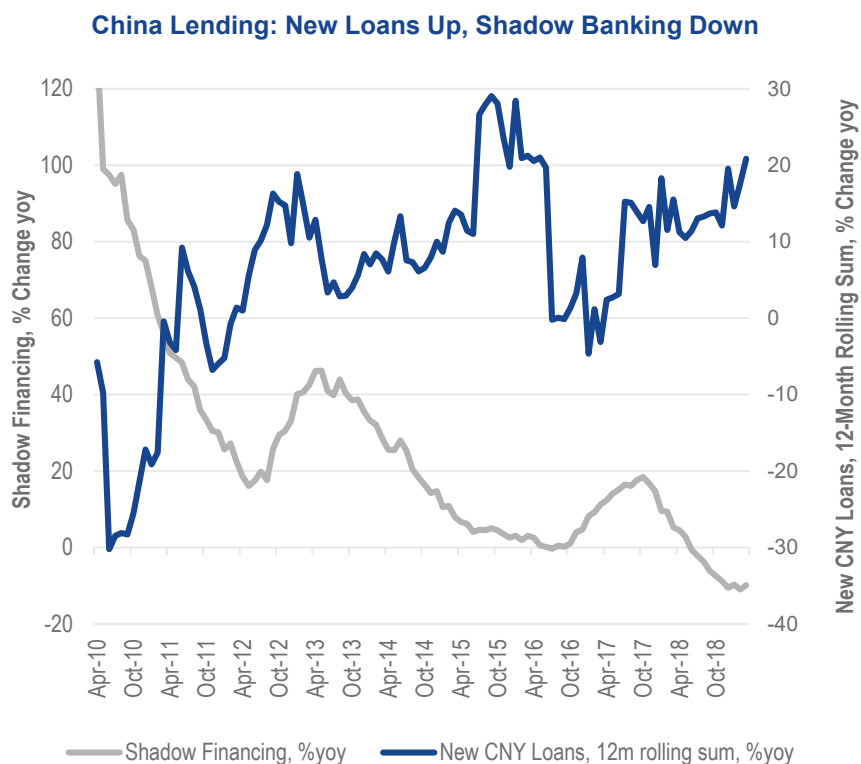
**Private Debt Service Coverage Ratio is Elevated**



Source: VanEck Research, Bloomberg LP. Debt service coverage ratio is the ratio of cash available to debt servicing for interest, principal and lease payments.

# Dealing with imbalances is painful

- China has begun to address some of the most pressing issues – high leverage and shadow banking
- However, the deleveraging drive hit the private sector and smaller companies the hardest in our opinion, while State Owned Enterprise (“SOE”) borrowing costs remained almost untouched



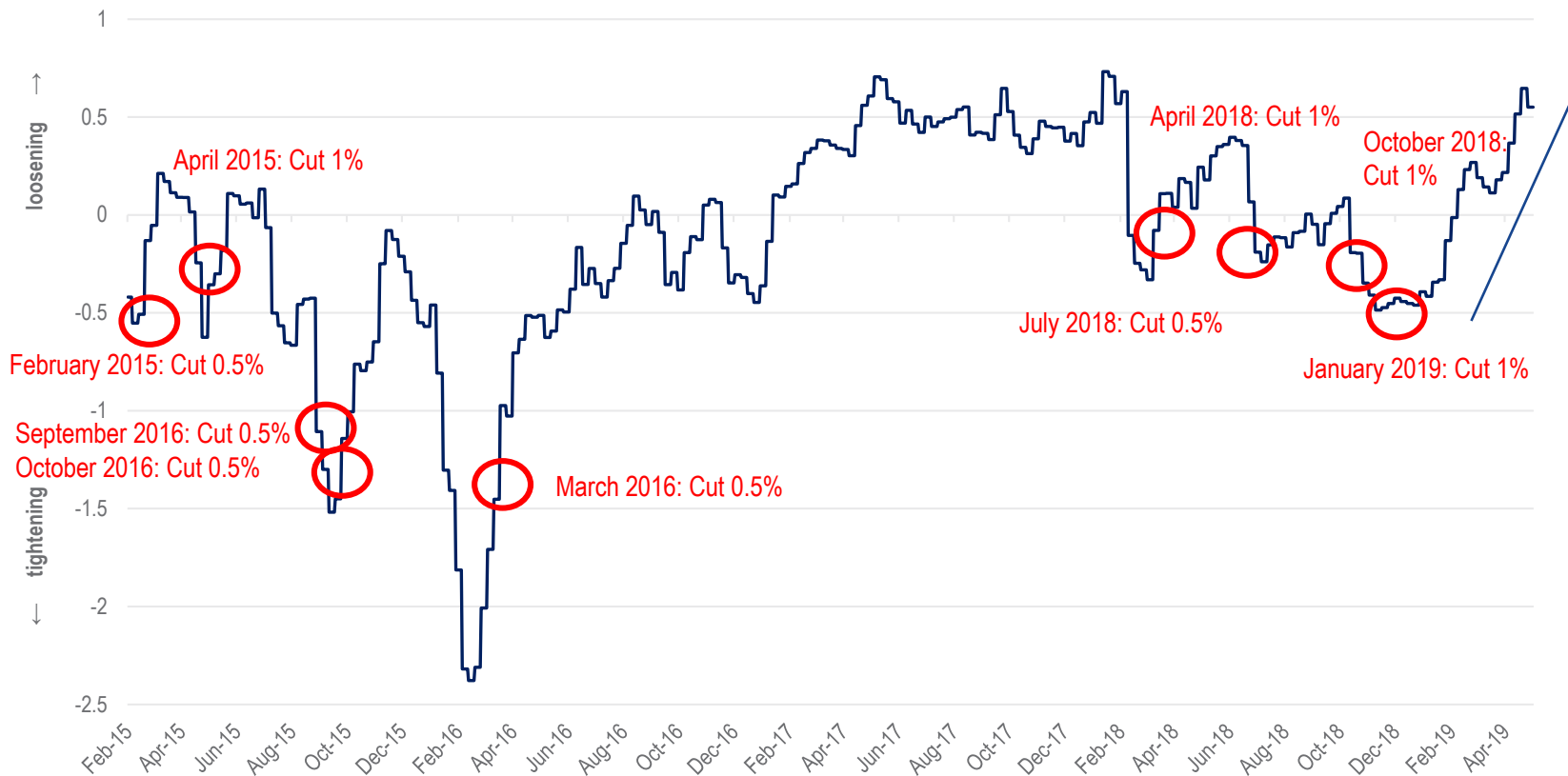
Source: VanEck, Bloomberg LP (left); UBS (right). SOE: State-Owned Enterprise. Shadow banking comprises private credit intermediation occurring outside the formal banking system.



# Some traditional policy tools appear less effective

- We believe the transmission mechanism is not working properly in 2018, as past policy moves (2018 RRR cuts) failed to ease China's financial conditions as they had in the past easing cycles
- The PBoC, however, persevered, and the “drip stimulus” approach is finally bringing fruit

Citi China Financial Conditions Index

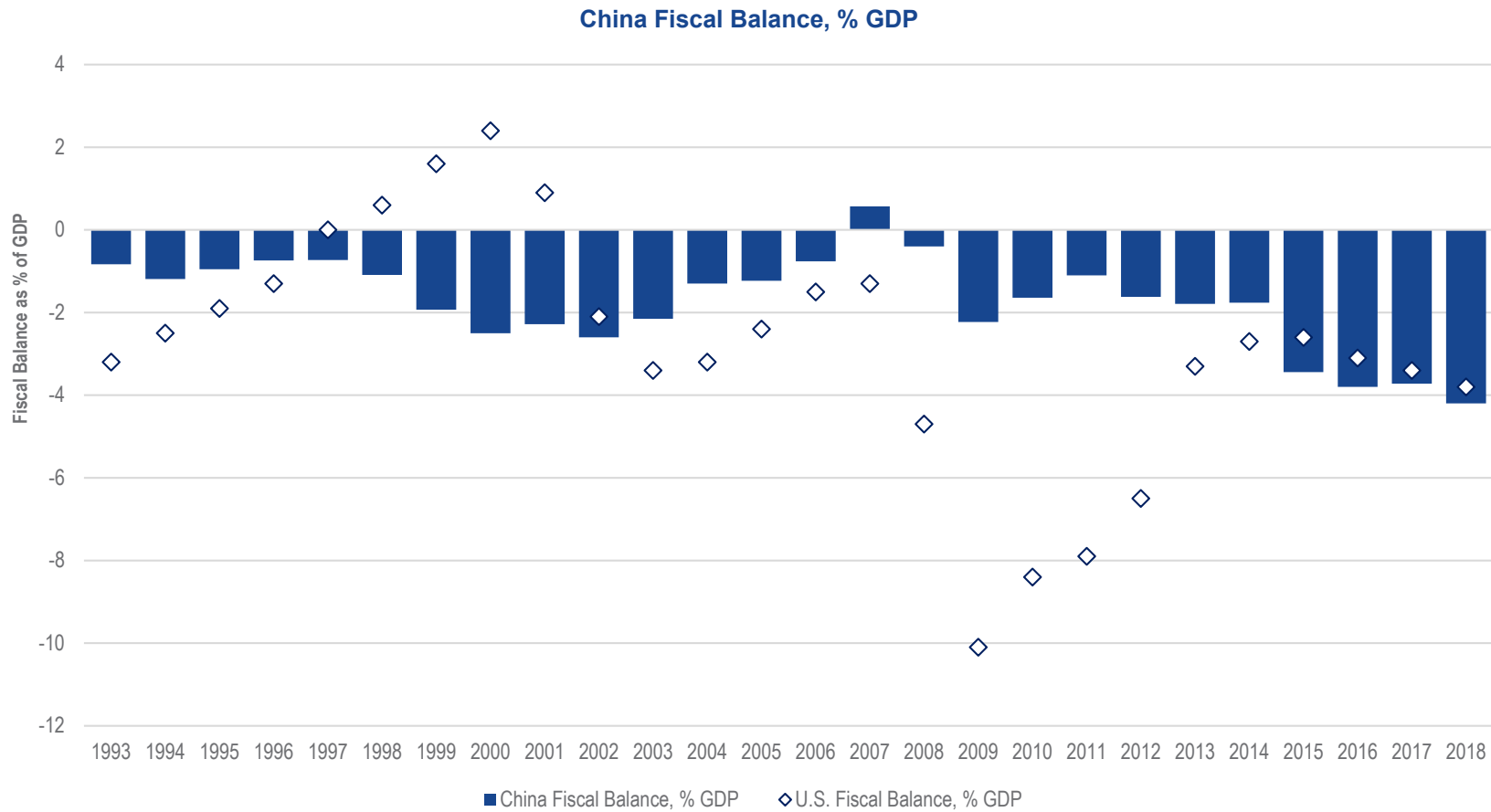


Source: Bloomberg. RRR: required reserve ratio.

# Fiscal stance remains stimulative



- Authorities are relying more on policy support through fiscal channels, in our view
- China's budget deficit was at historic wide in 2018...
- ...albeit not as wide as it was in the U.S. after the global financial crisis

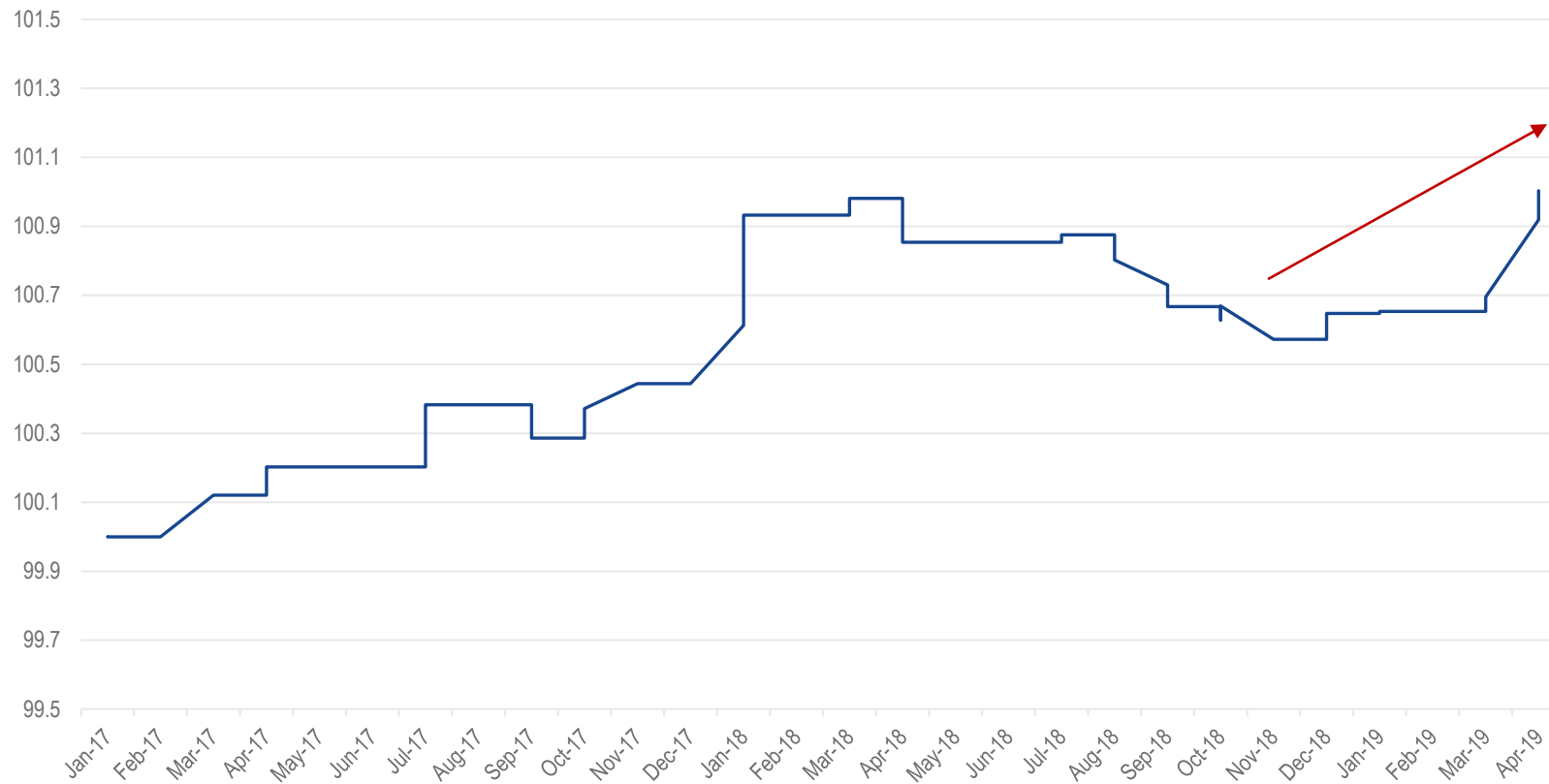


Source: Bloomberg.

# China growth forecasts becoming less pessimistic

- Downward revisions to GDP growth forecasts appear to have bottomed out
- We believe drip stimulus is kicking in

China Growth Forecast Revisions Show Drip Stimulus Effect

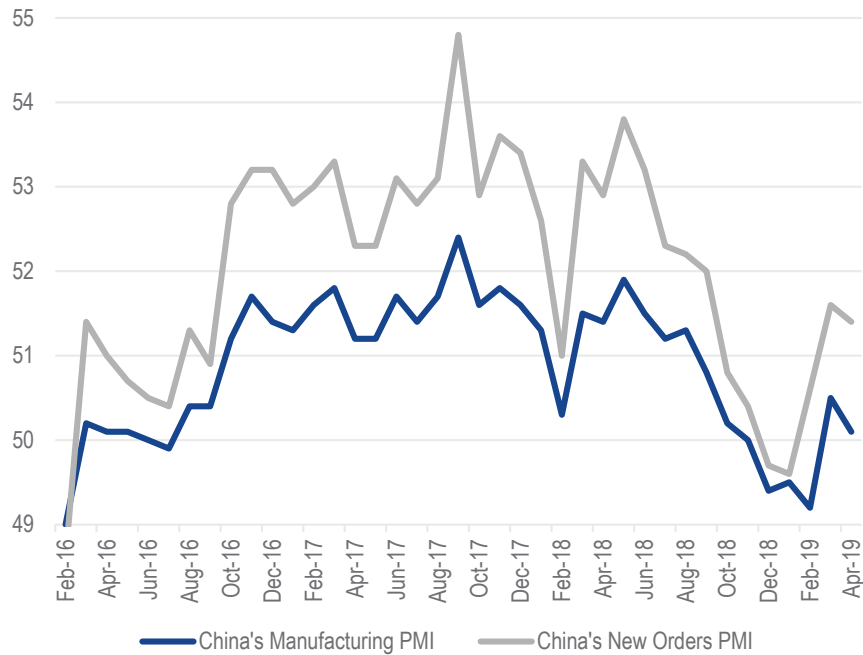


Source: VanEck; Bloomberg LP.

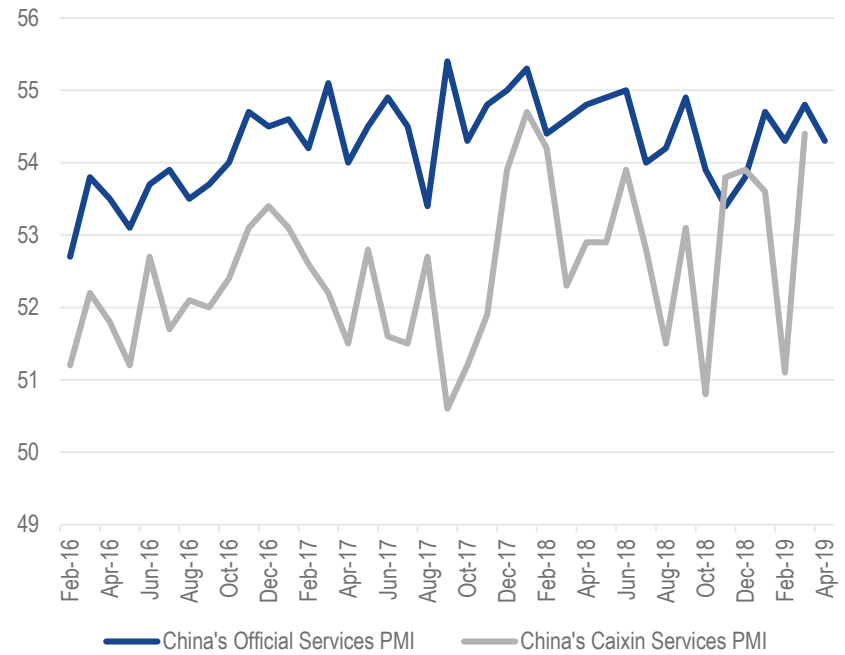
# Services look fine and manufacturing may be turning

- We believe China's manufacturing investments are rebounding
- Services look steady and new orders are rebounding

China Manufacturing PMIs



China Services PMIs

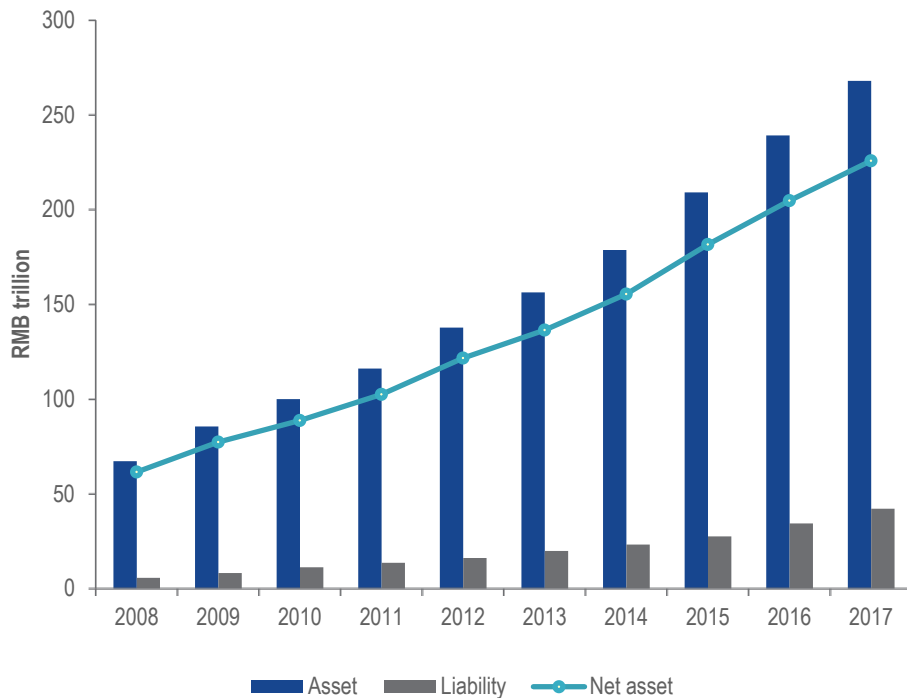


Source: Bloomberg. Purchasing Manager Index: is an indicator of economic health of a sector.

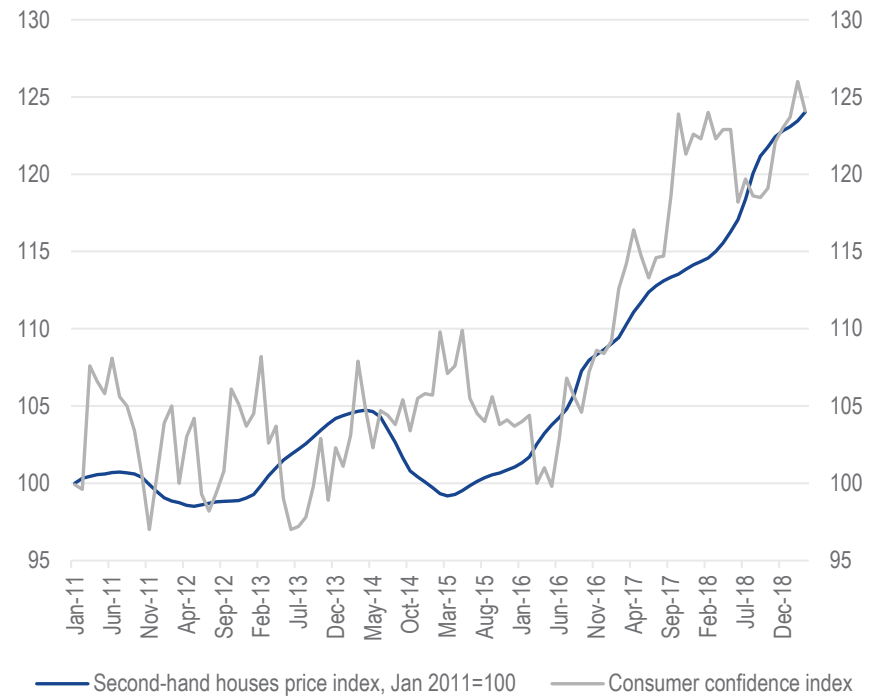
# Important policy buffer: household balance sheets

- We believe household balance sheets are currently in good shape
- However, property comprises a large portion of household assets and consumer confidence shows strong correlation with housing sector
- A sustained drawdown in housing prices could have an outsized impact on consumer confidence and spending

**Balance Sheets Have Grown Steadily**



**Consumer confidence and housing prices are closely linked**



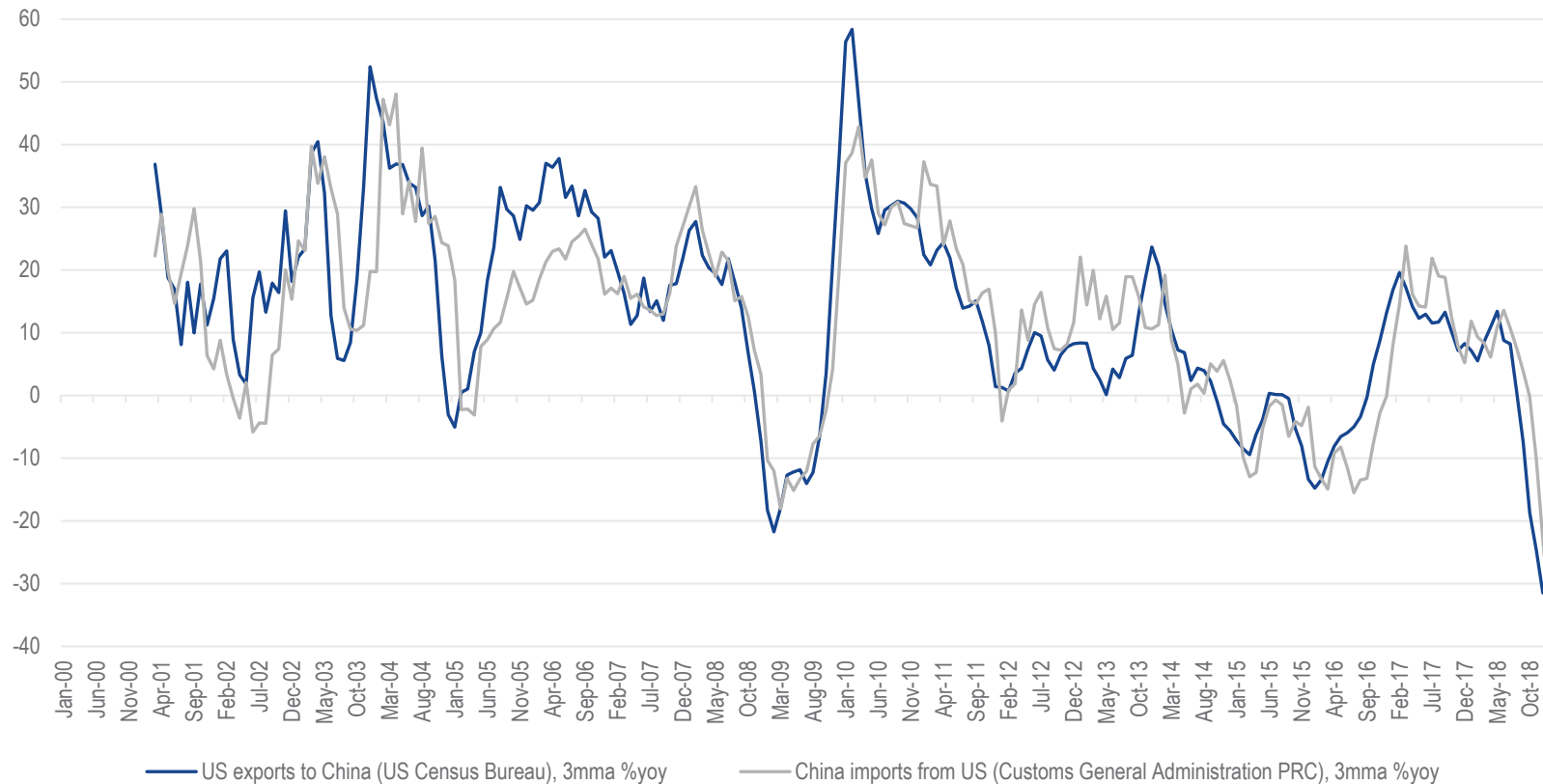
Left chart: Source: BofA Merrill Lynch Global Research, CEIC.

Right chart: Source: BofA Merrill Lynch Global Research estimates, CEIC, Wind, PBoC. Other financial assets include stock, bond, insurance, trust and peer to peer investments.

# Geopolitical considerations to grow in importance

- Trade dispute with the U.S. is affecting trade flows and confidence
- We believe geopolitical issues will not disappear any time soon as U.S. demands strike at the heart of China's growth/social model
- Some supply chains may shift out of China
- China establishing alternative geopolitical networks/structures

US-China Trade: Exports to China



Sources: Bloomberg as of 1/25/2019. Past performance is not indicative of future results.

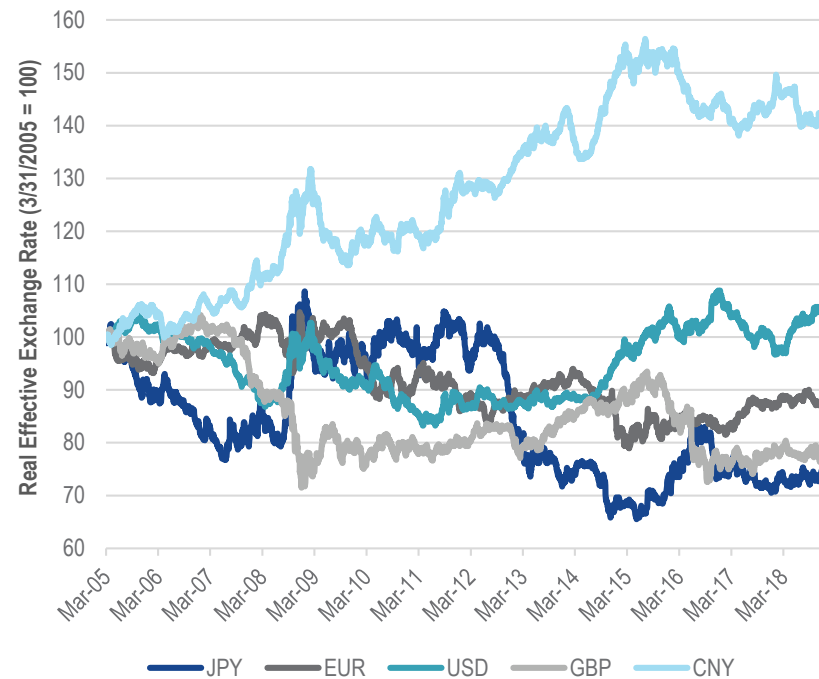
# U.S. currency demands may create problems down the road

- The U.S.' "CNY stability" demand is in contradiction with fundamentals (slower growth, smaller current account surpluses)
- Renminbi appreciated a lot relative to regional peers and other reserve currencies in the past several years

**Past Current Account Surpluses Have Disappeared**



**CNY Levels Contracted with Fundamentals**



Sources: Bloomberg. Real effective exchange rate is an index that describes the strength of a currency relative to a basket of currencies of a country's trading partners, taking into account differences in price levels in each country. Current account: the current account consists of the balance of trade, net primary income or factor income and net cash transfers, that have taken place over a given period of time. Past performance is not indicative of future results. Index performance is not representative of fund performance. See disclaimers at the end of this presentations.

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