

WHAT'S NOT TO LOVE ABOUT CHINA?



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The current infatuation with China bears a striking resemblance to the American admiration and fear of Japan in the late 1980s. As Japanese auto companies aggressively took market share from American car-makers and Japanese property investors began to buy American landmarks such as Pebble Beach and Rockefeller Center as well as American farmland, much was written about America conceding its power to Japan. Within the corporate world, American businesses were desperately trying to copy Japanese management techniques for fear of falling behind. All of this occurred just before the Nikkei and the Japanese real estate market entered a deflationary cycle that still exists today, some 20 years later.

There is no denying the explosive growth of China over the past several years, which has catapulted the country to its current position as the world's second largest economy. Despite this growth, China's economy is still just a fraction of the size of the U.S.'s economy. At the end of 2009, the World Bank reported the GDP of China as \$4.9 trillion, or 35% of the U.S.'s \$14.1 trillion. Even in terms of total manufacturing output, China still lagged the U.S. by \$100 billion, according to the same data. When these numbers are put in per capita terms, China's deficit widens due

to its current population of 1.3 billion compared to the U.S.'s 300 million. In other words, it takes four Chinese workers to equal one third of the production of one American worker.

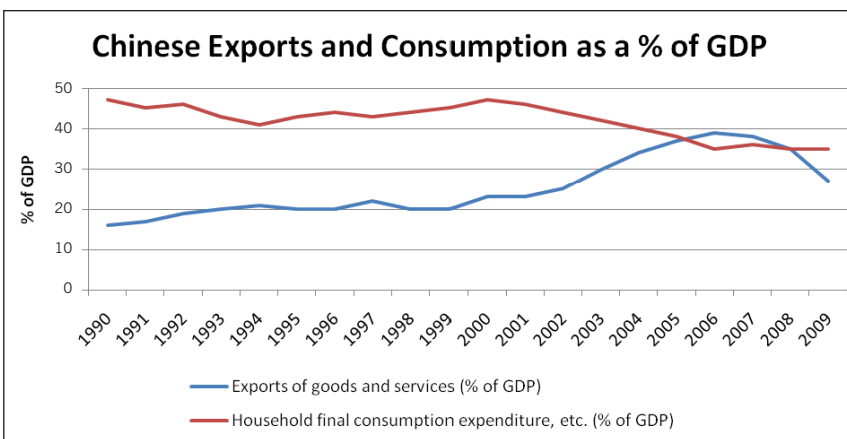
China's recent double-digit growth rate is likely unsustainable mainly due to two main factors: demographic constraints and problems pertaining to its recent and ongoing credit bubble. As A. Gary Shilling wrote in his February 2011 newsletter, "In most ways, however, China is still an underdeveloped country with political and economic policy structures that are primitive by Western standards."

The main demographic challenge for China is a complete and total absence of a middle class. Consider this comparison from A. Gary Shilling on the topic: "Our analysis back in 2007 revealed that in China, it took about \$5,000 per capita to have meaningful discretionary spending power. About 110 million Chinese had that much or more, but they constituted only 8% of the population . . . In contrast, it took \$26,000 per capita in the U.S. to have discretionary spending power and 80% of Americans had at least that much in that year. China's upper and middle classes have only 6% of Americans' purchasing power." (Source: *Insights*,

February 2011) China's strict one-child policy is also expected to have a major impact on its seemingly indefinite supply of cheap labor, which some predict is set to peak in 2014.

Chinese manufacturers rely almost exclusively on exports to the U.S. In fact, according to the CIA World Factbook, in 2009 China exported 20% of its total production to the U.S. In 2008 and 2009, as American consumers retrenched and focused on deleveraging, the Chinese economy slowed. Shilling notes that, "Her [China] middle class isn't yet big enough to lead domestic-focused growth. After consumers save almost 30% of their income, their spending is a tiny 34% of GDP, less than half the U.S. level." (Source: *Insights*, February 2011) In other words, the Chinese middle class is not big enough to fuel economic growth internally. Therefore, the country has come to rely on the world, and specifically the U.S., to fuel its economic growth externally. For the foreseeable future, China's economic well-being will be intimately linked to the health of the U.S. consumer.

Consider the chart below obtained from the World Bank showing Chinese household consumption and exports as a percentage of GDP



Source: The World Bank, A. Gary Shilling

over the last 20 years. The graph clearly shows that exports, the main driver of the Chinese economy, has been in decline since its peak in 2006. At the same time, household consumption has been steadily falling, failing to take up the slack caused by falling exports.

The most immediate economic challenge currently facing China stems from the effects of the massive stimulus program implemented in response to the global economic slowdown in 2008-2009. The Chinese stimulus measured some three times the size of the U.S.'s stimulus, an amount roughly equal to 12% of the country's GDP. The result of this program has been a sharp rise in inflation and

a property bubble. In May, the Chinese government reported that its inflation rate rose 5.5% from a year earlier, the fastest rate since the index rose 6.3% in July 2008. The bulk of this rise was attributed to a sudden increase in food prices. In addition, according to the Chinese Bureau of Statistics, property prices in Beijing now stand at an average price of 22 times median household income. This number dwarfs the high reached in the U.S. in 2007 of 5.2 times average household income, according to data from Ned Davis Research.

In short, China has many issues to resolve internally before it can consider taking the reins from

the U.S. as the world's economic leader. Its massive stimulus program in 2009 has left the country with serious inflation and an enormous property bubble. Combine those factors with problematic demographics, human rights issues, a socially oppressive government, crude economic policy tools, heavy dependency on energy intensive manufacturing, a controlled currency, lax intellectual property rights, and rising wages and, suddenly, serious questions begin to arise about the strength of China's future. Whether or not the Chinese government can orchestrate a soft landing from here will certainly be an issue to consider over the coming years.



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