Managing the Dragon Blog Post

2017 Predictions

By: Jack Perkowski | January 19, 2017

On the eve of the inauguration of President-elect Donald J. Trump, everyone in the world is asking the same question: What will a Trump Presidency mean? Making predictions about a country as large and as complicated as China is perilous in any year. Doing so in a year that begins with such a major unknown is a bit like driving at night without headlights. Whatever the uncertainties, though, government leaders must plan, businessmen must make their forecasts, and individuals need to prepare for what lies ahead---so here goes.

Ever since MTD began making China predictions in 2009, the state of China's economy has been a major question mark. With the financial crisis in 2008, and the subsequent concerns about overheating in the country's property sector, every year at about this time economists have been making predictions about China's growth rate. Every year, more than a few would predict a "hard landing" and a total meltdown of the world's second largest economy. For that reason, I have felt compelled to throw my hat into the ring and make my own prediction for the growth of China's gross domestic product ("GDP").

For the first time in a number of years, an implosion of China's economy does not seem to be a concern this year. In reviewing what economists have had to say, I have not seen a single dire prediction for a hard landing. Instead, most economists are predicting GDP growth to fall into the 6.5 to 7.0 percent range. Therefore, I do not feel compelled this year to make my own growth prediction for growth and will simply go along with the consensus opinion that China's growth will fall somewhere around 6.5 percent.

Prediction #1: The renminbi will end 2017 trading in the range of 7.0 to 7.5 to the US dollar.

The yuan is currently trading at about 6.85 to the US dollar. While China's currency has strengthened in recent days, it has weakened steadily all year after beginning 2016 at 6.5 to 1. In order to prop up its currency, China has been dumping U.S. Treasuries, using the dollars it receives to buy the yuan. As a result, China is now no longer the largest holder of U.S. debt, ceding that title to Japan.

All of the pressures on China's currency appear to be to the downside, and MTD does not see anything that will change the scenario of a weaker yuan in 2017. While we believe that exports will stabilize, they will not grow as in past years; Chinese companies and investors will continue to diversify their holdings by investing outside the country; and the dollar will continue to strengthen as the Federal Reserve raises interest rates.

Look for the yuan to be trading in the range of 7.0 to 7.5 to 1 USD at the end of 2017.

Prediction #2: The Shanghai Stock Exchange Composite Index will end 2017 at 3500 or above, at least 12 percent higher for the year.

After a rocky start to 2016, the SSE Composite index stabilized during the year and is now trading in the area of 3113. China continues to have over $20 trillion in bank deposits, twice the level of deposits in US banks, and Chinese investors want to redeploy those deposits into higher yielding investments. China's stock market is one of the few places they can turn to legally. A more sanguine outlook towards the country's economy; continued earnings growth and the desire by investors to earn more than deposit rates will lead China's stock market higher.

The SSE Composite Index will be trading at 3500 or above by the end of the year.

Prediction #3: With a stronger US economy, China's exports will stabilize in 2017, despite fears of what a Trump presidency might bring.

China's exports fell 7.7 per cent in 2016 from a year earlier, the second annual decline in a row and the worst since the global crisis in 2009. A weak global economy is the major reason for China's export woes.

One of President-elect Trump's campaign pledges is a major overhaul of the US tax code and a substantial reduction in personal and corporate income tax rates. While the impact of such a reduction is widely debated by economists, the World Bank has recently weighed in and estimates that Trump's tax proposals could add up to 0.3 percentage point to American growth in 2017, and up to 0.8 percentage point in 2018, raising the US growth rate to 2.5 percent and 2.9 percent in 2017 and 2018, respectively. A stronger US economy will, in turn, add 0.3 percentage point to global growth.

With a global GDP of around $80 trillion, a 0.3 percent incremental increase adds approximately $240 billion of growth to the world's economy, and China should get its fair share. While MTD is not predicting an increase in China's exports, a stronger US and global economy will be a benefit. As a result, we believe that China's exports will stabilize at current levels in 2017, breaking the two year string of declines.

Prediction #4: China's auto sales will reach 30 million units, aided by the inclusion of low speed vehicles in the calculation.

In 2016, just over 28 million trucks, buses and passenger cars were sold in China, a 13.9 percent increase from the year before. However, this does not include sales of over 700 thousand low speed electric vehicles which are popular in China's Tier 2 and Tier 3 cities. Because they are not officially recognized by China's auto regulators, low speed electric vehicles are not counted in the auto statistics published every year.

In October 2015, China cut the purchase tax on smaller cars in half, from 10 percent to 5 percent, spurring auto demand in 2015's fourth quarter and into 2016. Expectations that the purchase tax would be increased at the end of last year resulted in a certain amount of pre-buying and inflated growth in 2016.

Factoring in the pre-buying that occurred and other factors, Sanford C. Bernstein & Co., a well-regarded equity research firm that does a great job covering China autos, is predicting a 4.6 percent growth rate in auto sales in 2017, with sales increasing to 29.3 million units. Since MTD's crystal ball is no better than Bernstein's, we will go with that estimate. However, including unit sales of low speed electric vehicles would take the number to over 30 million.

According to an old saying: "If it looks like a duck, walks like a duck and quacks like a duck, it must be a duck." The over 700 thousand low speed electric vehicles that are now being produced and sold in China by over 100 companies certainly look and function like passenger cars. There have been persistent rumors that China's auto regulators will officially recognize low speed electric vehicles and establish regulations for this class of vehicle. The growth and size of the low speed electric vehicle market leaves the government no choice but to recognize these vehicles, and we believe that official recognition of low speed vehicles will become a reality in 2017. With this addition, unit sales of autos will top the magic 30 million mark this year.

Prediction #5: Despite all of the rhetoric, there will not be a serious breakdown in the Sino-American relationship in 2017.

Given the hand wringing by many China watchers, this may be MTD's most controversial prediction.

However, we have two good reasons for our view that China and the Trump Administration will be able to work out their differences. First, China is all about business and Chinese are not afraid to negotiate. In that sense, Trump and Chinese government and business officials are of like minds and should be able to address any issues that may come between the two largest economies in the world.

Secondly, Trump has an ace in the hole in the appointment of Iowa Governor Terry Branstad, who enjoys a thirty year relationship with President Xi Jinping, as the new ambassador to China. As an "old friend" of President Xi and China, Branstad will give China someone they can trust to talk to in Beijing and will prove to be an important safety valve for the Sino-American relationship.

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