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Move Over, Rover and Let China Take Over: China's Economy Now Drives Global Growth

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When the winds of change blow, some people build walls and others build windmills.

— *Chinese Proverb*

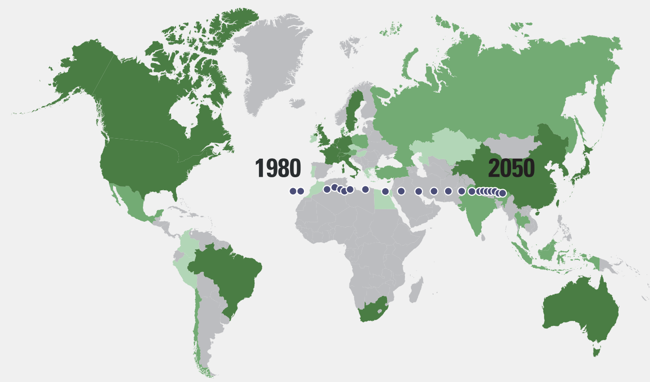
Investors don't know it yet, but China has officially become the world's most influential country for the global economy and capital markets. At the end of World War II, when the United States and other global powers gathered in Bretton Woods to stabilize the world's economies, the US was the clear superpower. As a result, it was decided to base both the International Monetary Fund (IMF) and the World Bank headquarters in Washington, D.C.

However, 73 years later, in July 2017, Christine Lagarde, the current managing director of the IMF, joked about using "dream binoculars" to see the relocation of the group's headquarters to China.[1] Ms. Lagarde may have been joking, but her dream's no fantasy. In fact, she may want to put down those binoculars, brush up on her Mandarin and pack her Louis Vuitton bags for Beijing right now! The reality is that sometime in the aftermath of the global financial crisis, China surpassed the US as the world's most influential country for the global economy and capital markets.

China First

The changing of the economic guard is playing out against the backdrop of a synchronized global growth story that has been a major market theme in 2017. Economic growth in the US, Europe and Japan has started to perk up. What's driving this harmonized growth? Ultra-loose global monetary policy remains the status quo but directionally it hasn't changed much in 2017. If anything, monetary conditions have tightened a little.

Figure 1: The World's Economic Center of Gravity is Shifting



Source: FactSet, as of December 2012. The purple dots represent the world's GDP epicenter as estimated by Danny Quah, while a professor at the London School of Economics. The world's economic center of gravity was in the mid-Atlantic in 1980 and has been gradually moving east. By the year 2050, it is expected to be in between China and India.

Fiscal policy? Thus far, the pro-growth Republican agenda has failed to get off the ground. And December's debt ceiling and budget negotiations now hang like the sword of Damocles over the head of fiscal reform, likely delaying any progress until at least the first half of 2018. Should the upcoming mid-term elections result in additional disruption, Washington may not make any progress on fiscal policy. What's more, this uncertainty about the future path of monetary and fiscal policy continues to keep businesses on the sidelines. Underwhelming capacity utilization, low productivity and subdued spending underscore business leaders' paralysis in the current environment. This mishmash hardly seems the recipe for US-led synchronized global growth. That's because this time it's not the US economy's turn to lead the world. Today, China is the primary driver of global synchronized growth.

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Defying most economists' expectations, China beat GDP growth estimates in the first half of 2017. The world's second-largest economy expanded 6.9 percent, well ahead of the government's full-year target of about 6.5 percent and on pace for its first annual growth acceleration since 2010.[2] This represents a strong rebound from early 2016 when it was feared that a Chinese economic hard landing would derail the global economy and markets. In response to those concerns, the Chinese government stoked the domestic economy's traditional drivers of growth. These often-used government policies had the desired effect, reviving the domestic housing market and igniting both the domestic and global commodities markets. More than a year and a half later, both the Chinese and global economies are still benefiting from that stimulus.

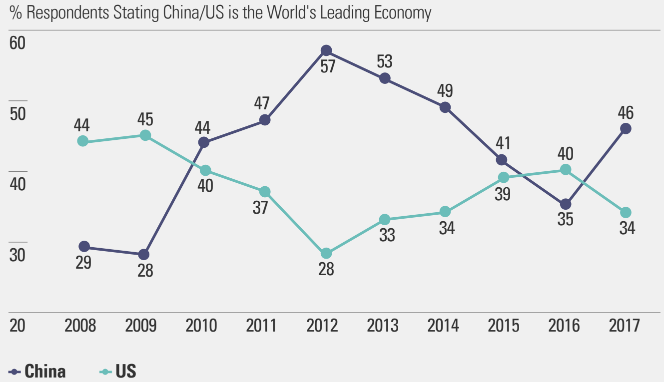
Driving Growth or Stuck in Neutral?

Coincidentally, this wave of unexpected good news for China appeared about the same time as all those headlines trumpeting synchronized global growth. Lost in the newsfeed has been how China, after years of signaling its eagerness to play a greater role on the world stage, managed to wrestle the most influential country mantle out of the US's grip. Certainly, Donald Trump's foreign policy rooted in nationalism and anchored by "America First" principles has illuminated a path to global leadership for China. As Michael Moritz, a partner at Sequoia Capital, wrote in a September 10 *Financial Times* article, "A week in China is enough to persuade anyone that the world has spun back to front. The benefits of immigration, the quest for fresh discoveries, the desire for education, the recognition of the benefits of stability, purpose and enterprise are flourishing in China at the very time they are being maligned, belittled or ignored in the US by Donald Trump."[3]

On immigration, Moritz notes that the Chinese government has expanded a program that allows qualified foreign graduates to obtain work and residency permits. The government has also considered broadening the program to include the potential for foreign students to establish permanent residency. Contrast that with the early September announcement from the Trump administration to possibly end the Deferred Action for Childhood Arrivals (DACA) program which protects immigrants without legal status who came to the US as children. And while the Trump administration has proposed cutting the Department of Education's budget, Chinese central and provincial governments are building thousands of new schools in rural areas to keep pace with the nation's unquenchable thirst for education.[4]

A similar dichotomy exists in the manufacturing sector. While the US spends an exorbitant amount of time pining over how to restore the manufacturing jobs of the 1950s, China is investing in the future. That is, instead of placing more workers on assembly lines, the Chinese government

Figure 2: China is the Leading Global Economy in the Eyes of Many Europeans



Source: Pew Research Spring 2017 Global Attitudes Survey

Medians across five European nations identifying the world's leading economic power. Note: Percentages are 5-country medians based on France, Germany, Poland, Spain and the United Kingdom.

plans to further automate factories over the next decade.[5] Unlike the US, China has stopped pretending it's possible to return to the past.

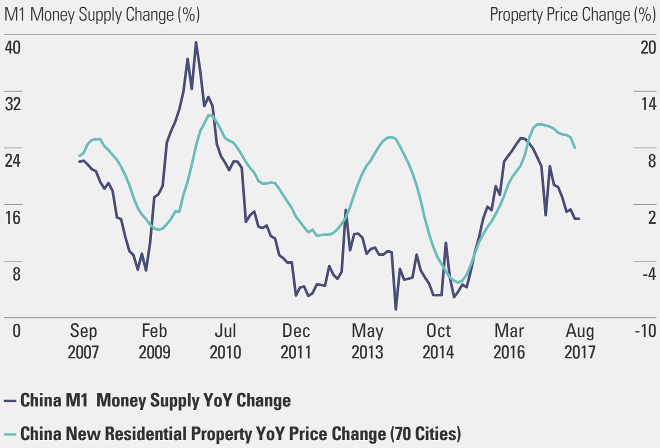
To Whom Much Is Given, Much Is Expected

Of course, being the chief driver of the global economy or the major influencer of capital markets isn't easy to sustain. Chinese leadership recognizes it can ill afford civil or economic unrest, especially with the 19th National Congress of the Communist Party of China scheduled to begin on October 18 where President Xi Jinping likely will secure another five-year term. Domestic stability should be supported by a combination of economic stimulus maneuvers put in place in 2016 and additional policies Chinese officials implemented this year to quiet the domestic economy before the National Congress. That is, after 2016's stimulus program fueled blockbuster growth in real estate and infrastructure, Chinese leadership put a series of new initiatives in place to control risk and cool an overheated real estate market. They tightened capital controls to stabilize declining reserves and promoted a concerted effort by all the regulatory agencies to crack down on excessive risk taking and eradicate the most outlandish financial transgressions. Also earlier this year interest rates rose steadily, with bond yields rising nearly 1 percent.

The impact of some of these policy moves is starting to show up in data releases, reinforcing the notion that the expansion that supported the synchronized global growth narrative has peaked for this cycle.

Despite a strong first half of the year, tighter credit conditions have begun to curtail economic growth. For example, China's industrial output grew 6 percent year-

Figure 3: A Slowdown in Money Supply Expansion May Indicate Cooling in the Chinese Housing Market



Source: Blomberg Finance LP as of 09/19/17.

over-year in August compared with 6.4 percent in July, below forecasts of 6.6 percent. Moreover, retail sales grew 10.1 percent year-over-year in August compared with 10.4 percent in July. A major growth driver for the Chinese economy, fixed-asset investment, grew 7.8 percent in the January-August period compared with 8.3 percent in the January-July period.[6] And while earnings for Chinese industrial firms have been impressive drivers of growth due to rising cement and steel prices, recent data suggests slowing momentum.

We Have All Been Here Before

All this data indicates that rising borrowing costs and property restrictions are impacting the Chinese economy more than expected. But, wait. Haven't we been down this road before? If China's growth is rolling over, then global growth will roll over, too.

What does this unexpected slowdown mean for investors? I expect that recent feel-good global GDP numbers will likely begin to fade over the remainder of the year. Markets may experience an inflation head fake brought on by higher oil prices, hurricane disruptions and a shrinking US dollar that has helped boost commodity prices. As a result, US market and sector leadership has begun to shift to more traditional value factors and late stage cyclicals that benefit from higher inflation, such as energy, materials and industrials. Investors have bought into the synchronized global growth with higher inflation story, but don't be fooled. Instead, stay the course by continuing to pair growth investments with stable income producing investments for the next chapter of the New Abnormal.

1 Avantika Chilkoti, "International Monetary Fund based in Beijing? Maybe Its Director Says." *The New York Times.* July 24, 2017.

2 Zacks Equity Research, September 16, 2017.

3 Michael Moritz, "China is leaving Donald Trump's America behind." *Financial Times.* September 10, 2017.

4 Ibid.

5 Ibid.

6 Zacks Equity Research, September 16, 2017.

Glossary

GDP or Gross Domestic Product The monetary value of all the finished goods and services produced within a country's borders in a specific time period.

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