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LETTER FROM THE PRESIDENT

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China thrusts into world headlines and global financial markets: What to make of it all?

Observations at the Asian Financial Forum
Hong Kong, January 18-19, 2016

HIGHLIGHTS:

China is undergoing a profound change as it transitions from an export-led economy to a modern diversified economy.

The unexpected devaluation of the yuan sent shockwaves through financial markets.

China's policymakers are facing a delicate balancing act–they need to implement difficult reforms while preserving demand and financial stability.

The real opportunities for Canada come as the service sector in China continues to expand and its middle class continues to grow.

At the invitation of the Hong Kong Trade Development Council (HKTDC), I led the Canadian delegation of 80 professionals to the 2016 Asian Financial Forum (AFF) in Hong Kong. The Forum brings together prominent speakers from the Asian region and across the globe, and draws more than 2,600 participants from 39 countries and regions, many from Hong Kong, Mainland China and East Asia.

The theme of this year's conference was "Asia: Shaping the New Paradigm for Growth". It was the appropriate lens through which to discuss the key emerging economic and business trends in Asia, and particularly China.

The headlines have been dominated by the continued deceleration in economic growth in China, the country's transformative shift to a consumer-driven model, the Mainland's impact on the global economy and financial markets, and the "One Belt, One Road" initiative. The latter is a massive infrastructure investment and trade development project spreading from western and inland China, through Central Asia towards Europe, and from coastal China through the South China Sea and beyond.

What does the China growth picture look like?
The AFF delegates were mostly interested in China's growth prospects, and this was the focus of many AFF presentations. The most pressing concern was the extent of economic slowdown in the country and whether domestic consumption can gradually replace the traditional growth engines of investment and exports. Consumption only accounts for 36 per cent of China's GDP, compared to more than 60 per cent of GDP in most industrialized countries.

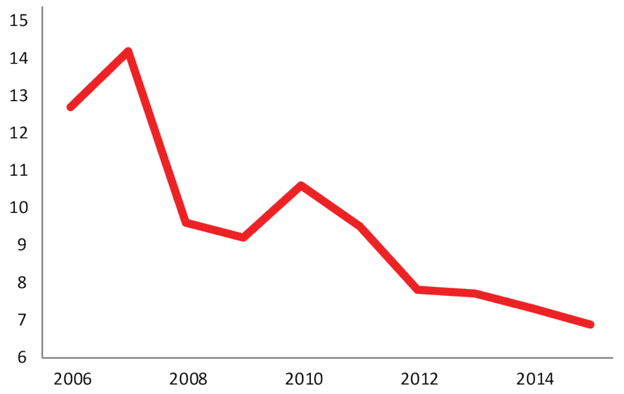
For the first time, China, while still an emerging market economy, has the economic scale and financial depth to have a profound impact on global financial markets. In terms of absolute size, its economy is the second largest in the world. Uncertainties remain: What are the risks that the imbalances in the economy, particularly an overextended banking and shadow banking system, and over-leveraged property sector, will unravel and pull the economy into sudden downward tailspin? What would be the impact on the global economy and financial markets?

The 2007-2008 financial crisis taught us that the size, scope and complexity of the capital markets have made it increasingly difficult for the authorities to engineer effective policy responses to internal economic shocks. If a crisis emerges in China, will it be contained? Moreover, the lack of transparency about policy intentions and direction, notably in financial and currency markets, has complicated the task of policy management, and fueled uncertainty among the global business community and global investors. Former U.S. Federal Reserve Chairman Ben Bernanke commented on this transparency issue in remarks at the AFF. Don't look for global investors to jump back into the Mainland financial markets any time soon.

The consensus among the participants at the AFF was for the Chinese economy to grow in the 6 per cent to 7 per cent range in 2016. The economy is of such scale and scope that momentum will inevitably continue, and policy-makers will muddle their way through the tough patches. The country is likely to avoid a so-called "hard landing".

Investment spending is reaching its saturation point, constrained by overcapacity in heavy industries and excess inventory in the real estate property sector. Growth in exports is slowing, reflecting higher labour costs and the transition to a more services-oriented economy. China's environmental crisis, one of the most pressing challenges to emerge from the country's rapid industrialization, will undermine the country's growth. As pollution and public health worsens, it becomes harder to sustain growth to stave off social unrest. Consumer spending will strengthen only gradually, depending on longer-term factors, such as an expanding middle class. It was interesting to learn at the AFF that spending on domestic goods and services has been restrained by the poor quality of many products and services, particularly foodstuffs and related products. It will take time to rebuild confidence among consumers in Chinese brands. For example, despite the milk and powdered infant formula scandal several years ago, cans of baby formula are still not trusted without English on the label and are swept off the shelves in Hong Kong and Australia. Finally, an aging population, and the resulting slowdown in labour force growth, will limit potential output over the coming decades.

China - Real GDP
Year-over-year % change



Source: The World Bank

Promising offsetting factors to a growth slowdown
Decelerating growth will be cushioned by several factors:

- First, there is the so-called "base effect". Even as the pace of growth slows, China is contributing more to the world economy than ever before. It's a US$10 trillion economy, up from roughly $2 trillion in 2005. A $10 trillion economy growing at 6 per cent to 7 per cent annually results in much higher output than a 10 per cent growth rate starting from a much smaller base.

- Second, there is a general view that the service sector is understated in the economic numbers, particularly in areas like e-commerce. This means there is more underlying support to the economy than presupposed.

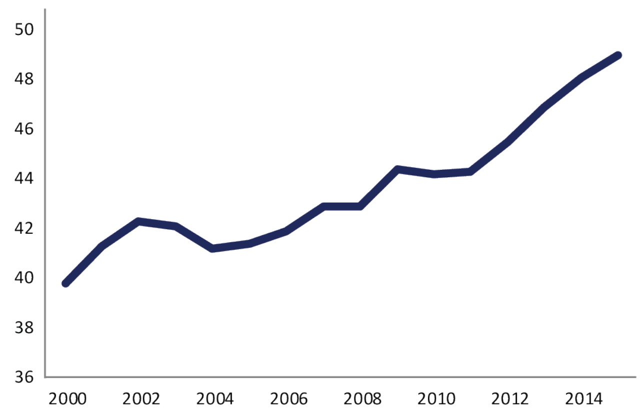
- Third, the strengthening recovery in the United States and improving conditions in Europe, albeit still insipid, will give some boost to exports. The depreciation in the RMB against the dollar will aid exports to the United States, but the RMB trade-weighted index (which consists of 13 currencies) has stayed relatively stable.

- Finally, the priority on employment and social stability in the country means that government will resort to whatever policy measures are necessary to support the economy, including pressure on banks and shadow banks to keep loans flowing and ongoing expansion of state-owned enterprises. Sometimes an authoritarian government has advantages.

The impression from commentary at the AFF was that investors in global markets are not as convinced of a soft landing for the economy as the pundits, influenced by the collapse in the Chinese stock market and the dithered response of Mainland policy-makers. Investors are concerned economic growth will stagnate, with the prospect of an internal negative shock, such as the unraveling of the shadow banking system or collapse in the property markets. These fears may be overstated and are undoubtedly fueled by excessive negativism in the media. Nonetheless, the reality is investors have moved to a "risk-off" mode as far as investments in China is concerned.

So what does all this mean for Canada?
Unprecedented industrial development in China pushed demand and prices for oil and many base metals steadily upward in the years before the 2008 financial crisis. Canada benefited, notably our mining industry. Those markets are unlikely to rebound anytime soon. The Canadian energy sector was never a major factor in the China boom, reflecting difficulties accessing the Chinese market. Even when oil and gas prices recover, it is unlikely Canada will a benefit as China has already signaled increased crude from Saudi Arabia and, as infrastructure gets built out in the "One Belt, One Road" project, from central Asia. Moreover, Canada is still constrained by lack of adequate infrastructure capacity to deliver oil to Asian markets.

China - Service Sector
% Share of GDP



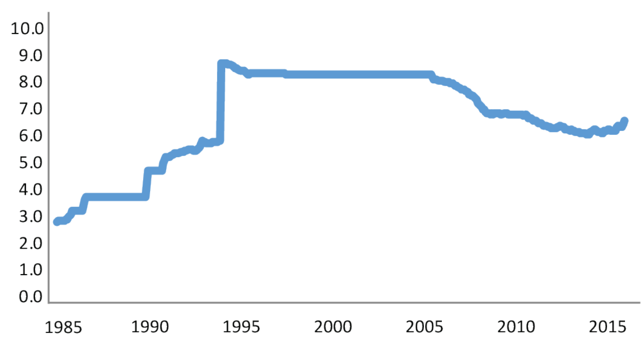
Source: The World Bank

The real opportunities for Canada come as the service sector in China continues to expand and its middle class continues to grow. This presents enormous opportunities for Canadian companies that can tailor their products and services to the rapidly evolving needs, tastes, aspirations and incomes of China's consumers. Canada has demonstrated comparative advantage in areas like agricultural products, foodstuffs, bio-technology, pharmaceuticals, health care, clean tech, environmental services, and financial services such as insurance and wealth management. Growing demand for these products and services in China will provide a needed catalyst for continued expansion of Canadian businesses that specialize in these areas.

China's unexpected devaluation of the yuan in August 2015 sent shockwaves through financial markets. Fears of a further devaluation, coupled with uncertainty about the mainland economy and capital markets, have accelerated the outflow of capital from China. State-run capital seeks to acquire undervalued corporate assets in the developed economies—hence the linkage of any free trade deal with Canada to unfettered access to direct investment, investment in large-scale infrastructure projects to facilitate exports of oil and liquefied natural gas, and more access to Canadian agricultural products. We see these type of Chinese investments everywhere, from Africa to the West Indies. At the same time, the large Canadian pension funds prominent in Hong Kong and Asia are themselves searching for large scale high-yield investments. It is not surprising India and south-east Asia are on the radar for these Canadian funds.

The challenge for the Canadian financial industry is to tap into the search for offshore investments by Chinese institutions. Diversified managed fund product specialized in high-yield investments in Canadian high-tech, bio-tech and clean-tech companies, health care, and infrastructure could fit the Chinese investment criteria. These funds would need relationships with Hong Kong financial institutions for access and distribution to Chinese investors. The large Canadian banks and insurance companies will continue to build out their existing wealth management and insurance businesses directly into China through joint ventures, or projected through the Hong Kong platform.

China / U.S. Foreign Exchange Rate
Chinese Yuan to One U.S. Dollar, Monthly



Source: Economic Research Division, Federal Reserve Bank of St. Louis

Planning for the longer term

The AFF devoted considerable presentation and discussion time to the "One Belt, One Road" initiative. This initiative came out of the blue at the conference. It is a long-term economic strategy to build infrastructure and trade cooperation among the sixty-five countries along the old "Silk Road" land route through central and western Asia, and "Maritime Silk Road" through the South China Sea and Indian Ocean. Part of the rationale to build a blue-water navy is to protect the sea lanes through this "Maritime Silk Road". China is spearheading this initiative, benefiting from the infrastructure spending, but more importantly from increased trade flows and transportation linkages— strengthening access to plentiful resources in the region. Since the "One Belt, One Road" plan was announced in 2013, $250 billion worth of projects have been contracted. The overall cost of the project is in the neighborhood of some US$1.6 trillion. Hong Kong hopes to play a major role in the project, providing the private market financing, logistical and trading expertise, legal services and expertise in dispute resolution.

At this stage the project, returns are uncertain and the risks are significant, especially country risk. It is clear in the early stages, until the project takes better shape, there will be limited participation of the private sector, and governments will provide the funding, with a key role for the newly established China-led Asia Infrastructure Investment Bank. It was frequently mentioned as a financing partner in the AFF presentations. The profile of this initiative may seem puzzling to outside observers, given its murky economic and financial underpinnings. It is, however, an example of the long-term perspective that characterizes Chinese policy-making.

Conclusion

The financial markets and many commentators and pundits have likely overstated both the deceleration in growth of the Chinese economy, and the likelihood of some cataclysmic event happening in China in the near term. Growth will continue near its current pace and regional and global financial markets will settle down. However, it should be understood the country is undergoing a profound change as it transitions from an export-led economy to a modern diversified economy. Many emerging economies have done the same, notably Japan, Korea and countries in Latin America. Economic history shows that these emerging economies follow an "L shaped" growth pattern, a steady slowing in growth rates and eventual leveling off. China is unlikely to be different. The difference from the other emerging market economies is its massive size and influence on the global economic stage. The reverberations of the economic adjustment will be significant and felt through the global economy. China also has unique problems that could interfere with the smooth adjustment—the need in the next few years to take on massive environmental cleanup, and the need for greater transparency in the workings of the economy and the policy decision-making process.

China's policymakers are facing a delicate balancing act—they need to implement difficult reforms while preserving demand and financial stability.

Yours sincerely,

Ian C. W. Russell, FCSI
President & CEO, IIAC
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