22/ **China and Base metals**

Lately, it has become popular, even chic (to the point of becoming consensual) for market analysts to express concerns about the Chinese economy. The market fear has risen so dramatically that there was a ascending chorus projecting financial and economic collapse.

We have always said that with a heavy corporate debt burden, far heavier than it should, it will take a while for the Chinese economy to gain escape velocity, but we never thought that a financial crisis, much less an economic collapse, was likely. Heavy debt burden encumbers and slows the economy, but it need not lead to a financial crisis. We cited the case of the US which has been battling onerously heavy debt load since the 1970s but had never experienced a financial crisis directly emanating from the consequences of such high level of debt. The concern from a heavy debt load arises from the belief that insolvency is inevitable consequence -- the example being cited by concerned analysts was the case of Greece.

But China is a sovereign currency issuer (unlike Greece), so solvency is never an issue -- the issue is, and always has been, inflation if China decides to print money to pay for debts in avoiding defaults. China has not shown signs that it was going this way, and in fact it as just recently came out of PPI deflation. The basic problem of China, just like the rest of the world, is that there is low aggregate demand. Moreover, fiscal policy has been erratic, spending executed in fits and starts, and government net borrowing change rate has been falling since late 2010. Apparently, it is not the level of borrowing (stock) that makes the difference in generating growth, it is the rate of change (flow) in government borrowing that correlates to growth rates (see graph 1 next page). The conclusion is that China's economy has been starved of needed funds, if this criterion is used as measure. China has taken this issue by the horns, so to speak, and the government›s new focus is on growth in consumption-related and «new economy» sectors. If these sectors continue growing at current rates -- and we expect this to be the most likely outcome -- President Xi Jinping s administration can soon replace the old, contracting sectors of the economy as the main source of demand that will drive economic activity and will keep growth rates high.

The key in understanding the future growth outlook in China is to focus less from what looks like abysmal macro conditions (heavy corporate debt load) and pay more attention to the more optimistic picture at micro level. It has been too easy to be «too pessimistic» about the Chinese economy given the debt load backdrop, but that holds less water if one looks at the «unlimited demand» for everything from entertainment to healthcare sectors, which are growing at double -digit rates and will continue to do so in the foreseeable future. And of course, investment in infrastructure is going strong again.

Nonetheless, many analysts decry China s renewed growth in investment. They say it must be reversed because a large and growing portion of this investment is not productive enough to justify the spending, the result of which is that the value created by the investment is less than the cost of the investment.

However, for us, the argument to abandon investments is a politically inept solution and threatens the primacy of the Communist Party. Investment is such a large share of China s GDP; the growth in investment have pulled China s GDP growth behind it for most of the past 30 years, so abandoning it when the other sectors of the economy are not ready to take over the job, will have politically disastrous consequences -- a factor that is not taken in clinical economic analysis of the Chinese economy. Consumption growth must accelerate and ultimately drive GDP growth if the role of investment is to be reduced without causing GDP growth to stall. That will not happen in a quarter or two – it may take another two years before consumption can take over as a primary growth driver. Investments in infrastructure will be a feature in the Chinese economy for a while, and will continue to underpin commodity prices.

One sign that the government is trying to underpin consumption has been the tremendous growth in money supply in China. China money supply growth not only has domestic, but also international ramifications in that it influences the prices of commodities, especially base metals (see chart below). We believe that the Chinese government will continue to invest in infrastructure because they will not risk the primacy of the Communist Party leadership, until such time as aggregate demand can fully take over the job.

This brings us to the state of the economy at the start of the new year. Chinese business conditions have further improved at year-end 2016, and sustains the significant upturn seen at the start of Q4 2016. The China Composite PMI Output Index, rose from 52.9 in November to 53.5 in December, the highest mom growth since the start of 2011. The latest reading signaled an acceleration in the pace of business activity growth. The average PMI reading for the past three months picked up to 53.1 from 51.7 in the third quarter -- the strongest quarter in almost six years. The composite data was lifted by stronger expansions in both manufacturing and services in December. Manufacturing growth now broadly in line with that seen in the service sector, dispelling stories about weak manufacturing conditions amid ongoing economic restructuring; this goes a long was in rebalancing the Chinese economy.
For a government seeking to reduce excess capacity in the industrial

economy, this is welcome news. But the shift towards a consumption-based economy is far from done. Growth in the service sector, a proxy for domestic consumption, remained below its long-run series average. And modest job creation at service providers failed to offset the losses in manufacturing payrolls. Hiring in the service sector slowed marginally in December, while manufacturing jobs remained in decline. Further expansions in activity and new business in 2017, which we expect, could help reverse the current contraction in China s workforce in coming quarters.

However, although the stronger composite expansion helped to limit job cuts, the upturn was accompanied by a further sharp rise in commodity and raw material prices. The fact is, the Chinese Manufacturing PMI is the best leading indicator for future base metal prices. Prices for raw materials and commodities in China surged, exacerbated by the costs of US$-denominated imports as the CNY weakened. Manufacturing input prices are now at the highest since March 2011. In contrast, cost inflation in the service sector remained comparatively muted despite picking up to the quickest in almost two years.

But make no mistake, inflation is about to pick up significantly in China, a phenomenon that is being seen globally, as higher energy costs percolate into domestic price structures. That should put the economy on normal footing, as disinflationary tendencies are neutralized, and should encourage companies to invest again. This should help hasten China's transition to a consumption economy – but until then, infrastructure spending will continue to underpin the prices of raw materials.