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WEEK 15 2018

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CHINA'S ECONOMY – **CONTROL** VERSUS **DYNAMICS**

China is for several reasons back in the limelight where the trade dispute with the U.S. is just one of many dimensions.

Many around the world were surprised when China's leader Xi Jinping was appointed as president until he decides to step down from the position. The political change has already resulted in many changes among ministries and commissions within China. One of my main considerations about the changes is how the concentration of power affects the country's economic dynamics.

Lately, most conversations I have with investors of course, are focused on the trade dispute between U.S. and China, so just a few sentences about how I see the impact on the stock market.

Prior to the Chinese New Year in mid-February, majority of Chinese market participants and investors I have contact to were quite optimistic concerning China's stock market in the new Chinese year. When the U.S. central bank began to talk about four interest rate hikes this year, it changed the mood in the Chinese stock market.

So much that the positive momentum disappeared, and I actually still regard the U.S. interest rate moves as an important factor for the Asian stock markets, including the Chinese. Naturally, any escalation in the trade dispute leads to negative reactions in the stock markets, and it can be momentarily stormy, but I expect that a solution will be negotiated.

Long term, the political changes in Beijing are much more interesting and more significant. Firstly, it is clear that President Xi really is in power of the party right now.

It is not always the case that a Chinese president has such a strong position as Chinese domestic politics can be pretty fierce. But the current situation means it is Xi Jinping's ideas that weigh heaviest, which alone is a good argument for listening to what he says.

Along with the approval of President Xi's extended term in the office, Xi has for example already downplayed Prime Minister Le Keqiang position. The Premier was otherwise seen as the reformer of the economy, but never succeeded, and for some time it seems that President Xi has not had the necessary confidence in Prime Minister Le.

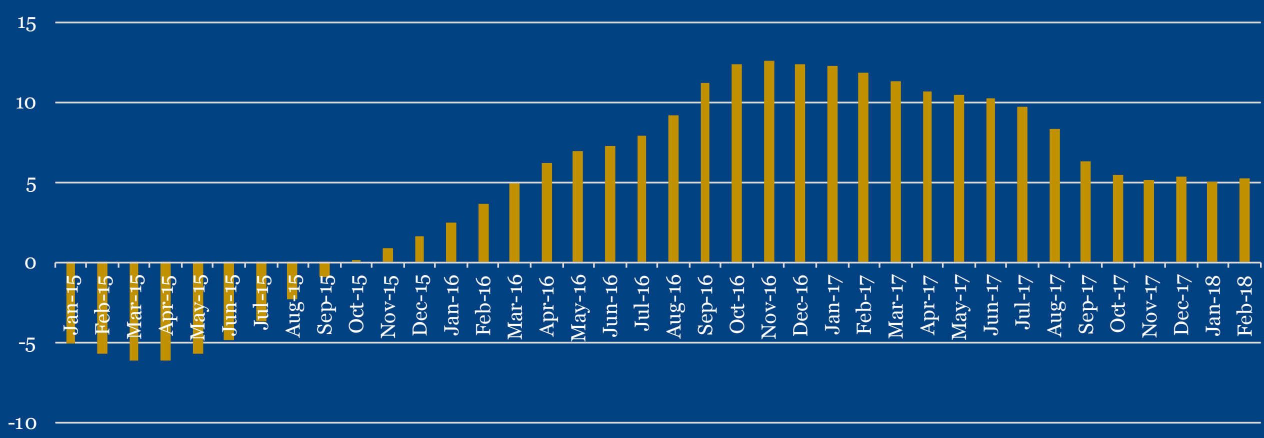
Instead, Xi Jinping has appointed Liu He as one of four deputy prime ministers and furthermore with responsibility for the new powerful Financial Stability and Development Commission. For the financial market and investors, it is a key person to keep an eye on.

The Chinese economy is incredibly dynamic due to the growth in the privately controlled share of the economy, and of course also due to the overall high GDP growth. But when the leadership starts to be centred around one person and a narrow circle close to this person, the dynamics becomes highly dependent on those people's decisions.

A part of the new dynamic are the many new control and contact groups that have been established between the Communist

***Graphic 1*:**

YEARLY CHANGE IN HOUSING PRICES



Source: National Bureau of Statistics of China, China

Party and large companies (including very large privately-controlled companies) during the past 18 months. In many systems, it often happens that decisions are not converted into action, but in general I expect the Chinese leadership's decisions to become reality.

The unusual new formal contact groups between private companies and the Party probably support party decisions to be carried out, meaning the political statements become even more important.

China's exports account for 18.5 pct. of the country's GDP, but just 10 years ago, the number was twice as high. Thus the country's economy already embeds a dynamic towards becoming more domestic oriented.

My expectation is that President Xi will make China's economy even more domestic driven. When China's economy in 10 years is close to become the world's largest economy, it also is the world's largest single market.

But size doesn't make it alone. If a single market should be truly interesting, it must represent a dynamic and flexible economy. I am convinced that China's leadership also can think these thoughts, and therefore, the current dynamic economic development in the private controlled sector is allowed to continue.

In my view, it means that loads of opportunities in China remains and grows.

But I expect that it becomes even more difficult to get into the market than it is today. Connections become even more crucial- which is the kind of infrastructure that takes years to build. In addition, I expect investors will observe that the government takes direct action in managing developments, or hurdles, in the economy – a sort of intervention.

A few examples from the last couple of years can be seen in the two graphics. The housing market had become extremely hot, and many initiatives were taken from official side to cool the market down.

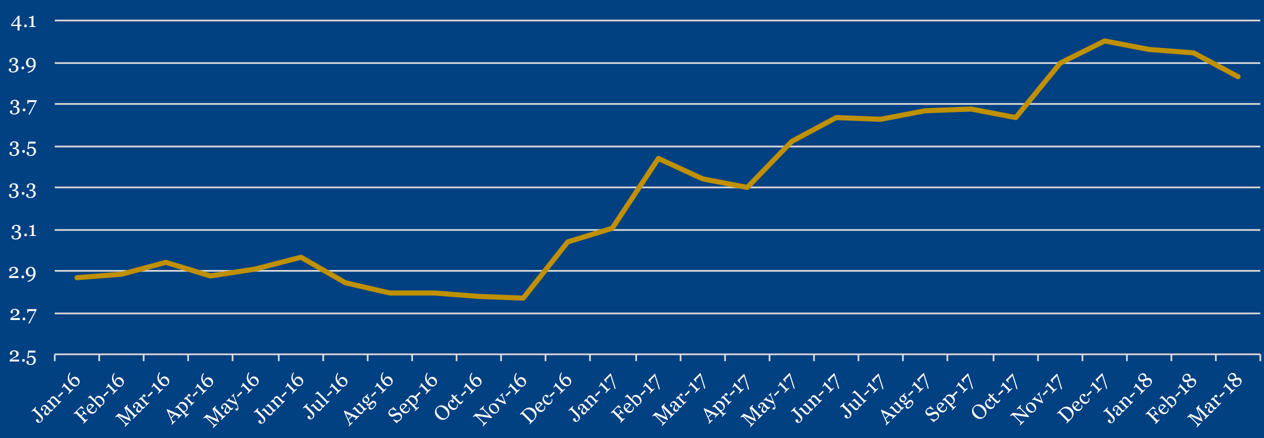
Interestingly enough, one of the actions taken was to push the 10-year interest rate up. But at the same time the country has recovered its 10-year rate back to a natural level which so far has not succeeded for Western countries. Thus, one can argue that the country's financial market is in a more balanced situation than in the West.

In my opinion, there will be a growing government influence on the economy, but the good question is whether it has no consequence at all. Though there is a price to be paid - the bill for government control over the economy is lower economic growth.

Just concerning China, I would argue that if the economy was freed-up completely, Chinas GDP growth could easily exceed 10 pct. per year – a situation where both the economy and the stock market really would take off, despite the current bumps from the trade dispute with U.S.

Graphic 2 :

10-YEARS YIELD ON CHINESE GOVERNMENT DEBT



Source: National Bureau of Statistics of China, China