China: Trading with the Gen Z

Market Insights by Stefano Chao, General Manager AZ Investment Management China - Senior Leader Azimut Global Investment Committee

Over the last few months, the US-China trade war has dominated newsflow in the global markets. Is a resolution finally in sight and what are the possible economic policy implications should that not be the case?

Although there has been some posturing recently, there is political pressure for both sides to reach an agreement rather sooner than later. We believe cooler heads will prevail shortly and eventually differences will be ironed out. Should a final agreement not be finalized quickly, the Chinese government still holds many tools at its disposal to stimulate the economy. From a fiscal policy perspective, as of May, both central and local governments still have RMB 25 trillion (US$3.6 trillion) of un-spent amounts set for the 2019 budget year – to put this figure in perspective, it's equivalent to Germany's GDP. These amounts also include borrowing quotas allocated to local governments, which can be drawn on to spend in the short-term. Additionally, many of the previously announced corporate or personal income tax cuts haven't fully kicked in yet, which should provide further cushion.

Monetary policies are often seen as part of the trade discussions and currency war has become a synonymous of trade disputes. To which extent, interest rates and currency can be used by China across the range of potential outcomes in the current discussions? Is the large holding of US Treasuries by the Central Bank a bargaining tool?

From a monetary policy perspective, while the Central Bank, PBOC, has been using targeted rate cuts and adding liquidity through its open market operations over the past few years, the important benchmark lending rate (currently at 4.35%) hasn't been cut since October 2015. In addition, with a less hawkish Fed, this leaves the PBOC with plenty of policy tools at its disposal to counter any pressures to the economy should any agreement fail to materialize. Additionally, if the Chinese decided to depreciate the RMB as a trade weapon, this would only bring short-term reprieve to trade with the U.S., while bringing significant tension with China's other big trading partners and causing pricing pressure within China by increasing the cost of imports. Furthermore, depreciating the currency would bring undue pressure on capital outflows, further constraining the Central Bank's ability to maintain the currency stability. Lastly, as the single largest foreign holder of US Treasuries, any intention to dramatically reduce such position would certainly bear the risk of significant losses. Additionally, any conversion of the resulting liquidity position in RMB would trigger a significant appreciation of the local currency, thus making Chinese economy far less competitive.

Is China's economy sensitivity to its currency fluctuations a key factor to drive growth in the medium term because of its dependence on exports?

This is a common misconception about China. While this may have been true 10-15 years ago, over the past decade the Chinese economy has already transitioned to a one driven by domestic demand. The bulk of the growth in China since the global financial crisis in 2008 was derived from domestic consumption and investment – as of last year, net exports (exports minus imports) accounted for only ~3% of China's entire economy, down from the double digits before the global financial crisis. Meanwhile, many of the jobs that once were in the manufacturing export sector have transitioned to the service economy focused on domestic de-mand – in fact, over the past few years, for the first time ever; the tertiary sector has become the biggest component of Chinese economy and the biggest employer.

As domestic demand is adding significant strength to Chinese economy, how he-althy is the Chinese consumer?

The absolute growth figure for internal consumptions still stands at a remarkable 7.3%, albeit demand has been undoubtedly softening over the past years. Beyond lower economic growth, part of this slowdown is driven by early growth originally led by first-time adoption of large ticket discretionary consumption goods, such as white goods (washing machines, microwaves, ACs), black goods (TVs, DVD players, etc.) and automobiles, which having spread to the poorest regions, has now finally reached the saturation point. Indeed, an interesting trend emerging in China is the eventual replacement cycle of the same goods being accompanied by significant upgrades. This is very clear in the automotive industry that has seen Germany luxury automakers (BMW, Mercedes, Porsche, etc.) posting double digit growth rates amid flat growth for the overall industry. However, the most interesting aspect of Chinese consumers, and one which leads us to be long-term bullish on China's consumption story, is that while older Chinese generations were relatively "thrifty", the younger generations haven't inherited any of these traits. China's Gen Z, i.e. youngsters born after 1998, now account for a disproportionate percenta-ge of spending in China and one of the highest percentages in the whole world. China's Gen Z accounts for 13% of household spending in China, whereas the equivalent figure in the US is only 3%. We believe the Gen Z will be the most relevant internal counterbalancing economic factor against any potential disruption arising from the current trade disputes.

Stefano Chao

Stefano Chao is the General Manager of AZ Investment Management, the fund management company of Azimut Group in China. Azimut operates in China since 2011 and AZ Investment Manage-ment is the 11th foreign asset manager to have been granted a wholly-owned fund management license in China. This license has been awarded to a handful of foreign asset management firms al-lowing them to directly launch, distribute and manage China domiciled funds for onshore investors. Aside from obtaining a Chinese private fund management license, Azimut has historically been a pioneer in the management of Chinese assets, being the first in Europe to laun-ch funds dedicated to invest in the off-shore RMB market and among the first in utilizing a QFII license to invest in local equities and bonds. Azimut currently manages US$350 million assets in funds exclusively dedicated to Chinese mar-kets. Before joining Azimut, Stefano was a VP in the Fixed Income Division of Leh-man Brothers New York. Stefano holds a BA in Economics from Yale University and an MBA from China Europe International Business School.