China Rings in the New Lunar Year with Disconcerting Headline Numbers and Underlying Strengths
February 11, 2016
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Six hundred million alcohol consumers celebrate the year of the Fire Monkey, and baijiu, China's $100 billion spirits industry, will benefit. As the country's "old economy" industries lose steam, its services sector is going gangbusters. Consumption now constitutes two-thirds of China's GDP.

Chinese New Year Parade Celebration in Beijing, China

Investors could be forgiven for thinking China has become an unappealing place. Economic growth slowed again in the fourth quarter to 6.8%, bringing the annual rate for 2015 to 6.9%, lower than the 7.3% in 2014 and the slowest pace in a quarter century. And, as discussed in Emerging Views last
week, the leading index in China’s retail-driven equity market dropped nearly 20% in January and is down more than 14% over the last 12 months. It would seem China's transition to a consumption-led economic growth model from one based on manufacturing, infrastructure and housing isn't going well.

Yet hundreds of millions of Chinese are gearing up to splurge on gifts for relatives and hongbao—the red envelopes containing cash for kids; on wining and dining; and on travel for the Spring Festival, as the week-long Chinese Lunar New Year, which begins Feb. 8, is also known.

Traditional Envelopes for hongbao
MouTai a type of baijiu

China's dire headline numbers of late disguise the dynamism in those sectors representing the country's "new economy," and the opportunities arising from the structural shifts taking place. Consumption as a percentage of China's $10.77 trillion gross domestic product (GDP) amounted to 66% at the end of 2015, up 15 percentage points from 51% in 2014. So, while industrial production growth last year ebbed to 5.9% from 7.9% the year before, retail sales of consumer goods rose an annual 11% in 2015, while online sales jumped 33%.

Some disaggregated "old economy" indicators such as electricity, cement and steel production have trended down since 2013, and ended 2015 with annual output in each declining in the mid-single digits. While such data points may prompt some observers to question the credibility of official GDP growth near 7%, there's no doubt they reflect China's economic transition away from fixed asset investment to a significant degree. On the flip side, there's also no doubt other real-activity indicators reflect strong, structural growth drivers in the services sector, which reached about 51% of GDP in the fourth quarter of 2015, up from 48% at the end of 2014.

As the economic contributions China's old-growth industries decline, and its new growth drivers gain economic weight, investors would do well to look beneath the macro headlines. They should focus on what Chinese consumers want, and which businesses are best catering to them. The opportunities in the world's second-largest economy are immense. China has 1.4 billion people, with per capita GDP running around $4,000, less than one-tenth that of the U.S., while average incomes among them rose 7.4% last year, far outstripping the stagnant wage growth across the developed world. What are Chinese consumers spending their money on?

Apart from the robust retail sales, many of China's migrant population of some 250 million will head
home to ring in the Lunar Year of the "Fire Monkey." China's transportation ministry is estimating more than 2.9 billion passenger trips, with roughly 332 million via rail, 55 million by air, and 2.5 billion on the road—cars, buses and motorcycles. Toward the end of 2015, passenger air and rail traffic was growing at an annual rate of roughly 11% and 10%, respectively. Production and sales of automobiles in 2015 hit 24.5 million and 25 million, respectively, both annual records.

"In the past three decades, along with rapid economic growth in China, there has been a striking increase in alcohol consumption, greater than in most other parts of the world," the Lancet journal reported. Average per capita consumption of pure alcohol among Chinese age 15 and up climbed to 6.7 liters in 2010 from 2.5 liters in 1978, according to the World Health Organization's 2014 database. But excluding the abstainers, average per capita alcohol consumption among the tipplers of age—some 600 million—reached 15.1 liters, exceeding levels in alcohol-indulgent Australia (14.5 liters), the U.K. (13.8 liters), Germany (14.7 liters) and the U.S. (13.3 liters). China's baijiu spirits market alone is worth $100 billion, according to Barclays.

China is the world's largest smartphone market, with 4G and 3G handset shipments in the mainland reaching a record 460.5 million units in 2015, up 18% from the year before, according to a recent South China Morning Post citing research from Bernstein and the state-run China Academy of Telecommunications Research. In November, annual volume growth of postal and telecommunications services reached 36%.

Rapid growth is taking place in a host of service industries in China, from education to health care; insurance and wealth management to Internet services and networking; from tourism and entertainment, to food and, yes, beverage companies.

China's still growing fast, just not in the same ways that it used to. Thornburg's investments in China largely involve its new growth drivers.

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