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CHINA'S ECONOMIC STRATEGY FOCUSES ON SHORT-TERM GAINS

CAN THE NATION'S LEADERS ENGINEER SUSTAINABLE LONG-TERM GROWTH?

Commentary as of April 2016

A more-stable U.S. dollar has helped reduce recession worries in the U.S., but some demand assistance from the emerging markets (particularly China) would provide additional relief. In fact, the entire global economy could use some help from an unleashed consumer sector in China. But getting to that point may take some time, as China's government resorts to familiar interventionist strategies designed to boost short-term gross domestic product (GDP), rather than focusing on long-term sustainable economic reforms.

Edward Trafford, Northern Trust's basic materials and industrials analyst believes China's transition from an investment-led, low-cost manufacturing and export economy (which benefited from low-cost labor) to a consumer, services, and innovation-driven economy will prove challenging. For example, we believe recent government intervention — including restructuring state-owned enterprises (SOEs) and shuttering underperforming manufacturing companies that were plagued by overcapacity — is likely to increase unemployment and social unrest.

LEADERS STRADDLE THE FENCE

It appears China's government may be straddling the fence. That is, its leaders are articulating a shift to a sustainable long-term economic model while reverting to the nation's previous strategy for generating near-term economic growth — infrastructure spending and overly accommodative monetary policy.

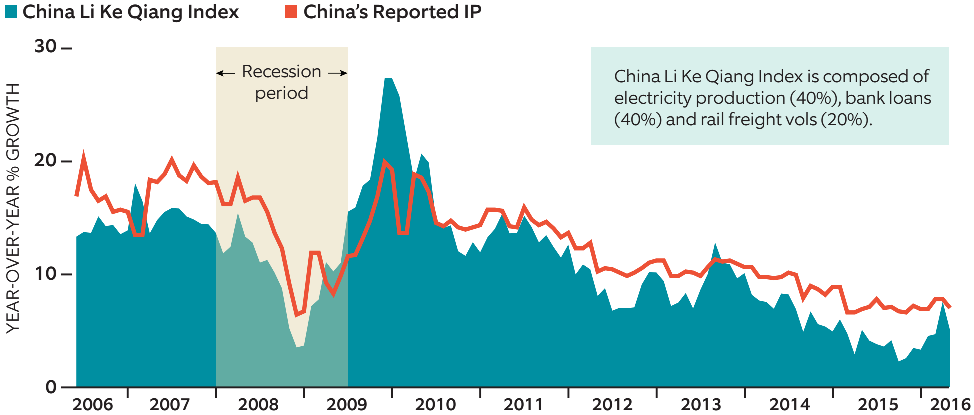
Earlier this year, China's government lifted the fixed asset investment growth target for 2016 to 10.5% versus the 9.6% it reported in 2015. Recent gains in sales of heavy-duty trucks and excavators suggest further infrastructure improvements are in store during 2016. Sales for such heavy equipment declined in 2015.

We do not view government intervention as a driver of long-term, sustainable economic growth. Instead, to gauge true economic growth, we examine fundamental data points, including power generation, freight volumes, truck sales, cement production, and private construction activity — stats the government is less able to manipulate. While manufacturing activity and retail spending growth recently have slowed, government-related infrastructure-activity inflected upward.

GOVERNMENT INTERVENTION AND MANUFACTURING EXCESS

A key element of China's long-term growth strategy is the "one belt, one road" initiative the nation's government launched in October 2013. This policy aims to increase trade by leveraging the domestic manufacturing and labor force to sell products and services into global

CHINA'S REPORTED INDUSTRIAL PRODUCTION (IP) GROWTH OVERSTATES FUNDAMENTAL FACTORS



Sources: National Bureau of Statistics of China Bloomberg: Bloomberg Intelligence and Bloomberg data

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markets. Recently, one of China's SOEs invested capital to build manufacturing capacity in a high-cost region. This practice may reflect an increased focus on short-term growth at the expense of long-term sustainable economic reform.

We believe pursuing projects in regions that lack a competitive advantage, such as low-cost labor or the ability to export competitively, only compounds China's excess manufacturing capacity problem. It also does little to address another key concern — increasing unemployment.

SHORT-TERM OPTIMISM, LONGER-TERM UNCERTAINTY

In early March, China's premier targeted a GDP growth rate of 6.5% to 7.0% for 2016. We have increasing confidence that China will hit the upper end of this range in the second half of 2016, supported by shorter-term growth and stability initiatives which rely on infrastructure spending, accommodative monetary policy, and government involvement in the stock and real estate markets. Nevertheless, we question whether this will translate into sustainable economic activity.

Although we remain optimistic toward China's near-term growth outlook, we are concerned about the nation's ability to meet the longer-term 6.5% GDP growth target outlined in China's 13th Five-Year Plan (2016-2020). With legacy industries (low-value-add manufacturing, infrastructure, commodity mining/refining) comprising a larger component of GDP than new industries (private enterprise, technology, medicine, etc.), it currently remains unclear how China will reach this longer-term target.

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