China's Delicate Balance, Risk Reduction and Economic Growth

China is set to grow in 2018 but regulatory crackdowns continue to threaten expansion.

Regulatory Environment Continues To Tighten

China began the calendar New Year with changes to its bond trading rules. The changes were part of a coordinated set of initiatives launched by the PBOC in conjunction with the banking, securities and insurance regulators. New bond rules include restrictions on leverage and bans on under the table dealings and "shadow" banking that threatens to undermine the country's financial stability.

The effort is seen as the first moves in a much larger plan to create a sort of super-regulators. Current plans include a merger of the banking, securities and insurance regulators in one of several incarnations. The final plan could be announced as early as March at the National People's Congress.

Other moves by the PBOC include changes to the way they manage the yuan and a diversification of their foreign currency reserves. The change to yuan management was the removal of "counter-cyclical factors" that have been in place since last year. By removing the factors the bank is allowing the yuan to float more freely on the open market. The current float window is 2% to either side on a daily basis, the yuan dropped on the news but has since retreated to a 2+ year low versus the dollar.

Diversification in the foreign currency reserves was sparked by two things; unfavorable conditions for US treasuries and a desire to retain value gained over the past year. The bank revealed that its reserves had increased in value by 20.7 billion yuan in December, up 129 billion for all of 2017, reaching 3.14 trillion after 11 months of gains. Gains are attributed to tighter capital controls and a strong yuan. The news caused a stir for about a day as traders around the world thought it meant China would stop buying US bonds. Government officials came out quickly, allaying those fears, simply stating that they were not halting purchases but under current conditions some other bonds were more attractive. Officials went so far as to call those reports "fake news".

Fund managers at Value Partners Asia-Pacific Fund (APB) had this to say in their latest monthly fact sheet:

"*In China, deleveraging and risk control remain a key policy focus in 2018, as evidenced by the tightening of local government financing after the 19th Party Congress. Although there are concerns that the continued moderation of growth may weigh on market performance, these worries are unfounded because China is entering a new economic cycle where index performance decouples from gross domestic product (GDP) growth.*"

Economic Outlook Remains Positive

Economic outlook remains positive in China. The country produced 6.9% annualized growth in the 4th quarter of 2017 and expected to remain strong in 2018. Some economists believe growth will remain under pressure as government regulations crack down on risky activities but estimates remain strong. The government's official GDP estimate for 2018 is 6.5%, the same it has been for the past few years. Most estimates see growth in the range of 6.8% with a real chance of this coming in low. The reason is twofold. Strong demand domestically and strong demand from abroad.

December manufacturing data was a mixed bag in terms of expectations and the difference between official and non-official readings. The official government read on PMI came in at 51.6. This is a positive reading, the 18th positive reading in a row and a sign of continued expansion. It is down 0.2 from the previous month but the loss is attributed to anti-pollution regulation and not to weakness in demand. Data within the report shows positive increase to both output and new orders.

The non-official Caixin/Markit PMI came in 51.5 and up from the previous 50.8. This was a surprise in that it was very near to the official read and rose when the other fell. The Markit data typically lags the official read and suffers larger losses and smaller increases. Looking forward, the latest estimates to quarterly and annualized GDP growth show expansion accelerating. Quarter to quarter growth is expected to edge up towards 2% by the second half of the year with full year growth trending upwards of 7%.

Big Trouble with China's Largest Partner

There are still shadows overhanging China's bright future, domestic woes notwithstanding. Number one is brewing trouble with its largest trading partner, the US. President Trump has been broadcasting a message of protectionism that could cause trouble down the road. He is calling for a crackdown on unfair trade practices and possible fines if the two nations are to move forward. While alarming at the outset it is most likely bluster and misdirection as part of his unique negotiating style. The President has said on numerous occasions he wouldn't tip his hand in any negotiation by telling the public what he really thinks.

President Trump's keynote speech delivered to the Davos World Economic Forum seemed to support this idea. He still wants to crack down on unfair trade practices but for the benefit of all. The statement which rang the loudest was “American is open for business”, a statement that surely includes China. While America is to be his first priority he says we can't do it alone and that all nations become stronger when they cooperate on free, fair and reciprocal trade.

About The Asia-Pacific Fund

The Asia-Pacific Fund is a closed end fund focusing on China and the greater China economic region. This includes but is not limited to Singapore, Hong Kong and Taiwan. The fund’s strategy is capital appreciation with a lesser focus on income derived through undervalued stocks with solid fundamentals in growth markets. It trades on the NYSE under the ticker APB.

Primary exposure is to the Hong Kong markets with a slightly smaller 20% invested in Hong Kong listed China “H” shares. South Korea accounts for about 18% with smaller holdings spread around the region. The 5 largest sector holdings of the fund by the end December 2017 were industrial, real estate, consumer discretionary and financials.