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Economic Commentary

MARKET MUSINGS & DATA DECIPHERING

China with Dave

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PUTTING CHINA INTO PERSPECTIVE

The law of large numbers.

So China is slowing down — this is evident in the overnight release of the manufacturing purchasing managers' index (PMI) which showed that factory activity hit a 6½-year low.

It is a very mainstream view. Mainstream, but way overdone.

China's "growth" in percent terms is down to 7%, but it is now off a massive base, so the statistic is misleading.

I could have said that in the past year, China expanded by 973 billion yuan. This is actually slightly more than what it expanded by in 2007 but look — that was the growth peak at over 14%.

In the past year, China expanded GDP by twice as much as in 2003 when it was a "miracle"

The Chinese economy actually added twice as much to its GDP in dollar or yuan terms in the past year than it did in 2003 when it was all about a "miracle," and that year "growth" in "percent change" terms was in excess of 10%.

So after becoming the world's second largest economy, a $10 trillion economy, what does anyone expect? After seeing the size of its economy double in an eight-year span (it's taken the uber-sophisticated U.S. economy nearly two decades to accomplish that — again, the problem with being too big), what does anyone expect?

Part of China's overall economic rebalancing is the move to become a more mature and less of an "emerging" economy. Slower "growth" means this is the new trend. The percent shifts are getting smaller, and it is actually completely normal in this context and at the same time, the level rise in economic activity is still very impressive.

This is the story beneath the story.

Let's add this. As I have been saying, Japan was China back in the 1980s. It expanded 5% per year and accounted for one-quarter of global growth that decade — ultimately hitting a 16% share of total world GDP.

Japan, like China, also accounted for a quarter of global GDP growth and 16% share of total world GDP

China, for the past decade, grew more strongly, but from a lower base and its contribution to global growth was accentuated by the weak U.S. economy of 2002 to 2004 and again from 2008 to 2012.

But why nitpick? It too accounted for a quarter of global growth and hit a 16% share of global GDP.

Now I don't think China is going to follow the multi-year phase of fatigue that Japan did, but if this were to occur, the 1990s offers a good template that so long as the U.S. keeps it together, that is all that will matter.

After all, Japan went from a 5% growth region to 1% growth region, and that would be like China going from 10% to 2% in proportional terms.

We all feared Japan in the 1980s

For some reason, we all feared Japan in the 1980s (*dōmo arigatō, misutā Robōto*), and yet its stagnation did not prevent — maybe it even helped — the 1990s having belonged to the good ol' U.S. of A.

This is not a story that could have been sold in the early part of the decade when we were being warned of the U.S. economy losing its way to that giant "sucking sound" (thanks, Ross Perot!) south of the border.

This was one of the worst calls of all time by any presidential hopeful (about to be surpassed, or so it seems), but it did give us eight very entertaining Clinton years.

FROM THE SUBLIME TO THE RIDICULOUS

It is fascinating to see how this corrective phase has unfolded.

The first leg, of course, started on May 21st which was the nearby peak for the S&P 500.

The trap door opened up on August 17th

Until the trap door opened up on August 17th, in the aftermath of the Chinese devaluation and ensuing soft data releases, the market was down 1.3% — it was a correction in time (duration) as opposed to space (magnitude).

At that point, it was really a sector rotation story with roughly half the sectors down and half of them up.

Overall, the S&P 500 was only down 1.3% as the "P" (price) paused and allowed the "E" (earnings; excluding Energy, earnings are still rising) to play catch-up.

The leg after was more pernicious.

China gets all the blame!

Since August 17th to September 2nd the market was down 7.3% and all 10 sectors are were in the red — and yet China gets the blame.

Yet the areas of the market that one would normally associate with China sold off harder in the May 21st to August 17th phase than in the ensuing corrective phase.

Energy stocks in the S&P 500 sank 13.7% in the first phase when few were talking about China (except for those who had been for years) and the TSX comparable was 17.6%. S&P Materials in the initial phase slumped 10.1% and the TSX sector plunged 18.2%.

Both sectors continued to falter but in relative terms they actually outperformed (oil, gold and copper are all faring better since August 17th, despite all the China angst, than they did in the prior three months).

Now in this leg down, it makes sense for areas like Technology and Industrials to join in the selling since these are areas exposed to China and Emerging Markets.

But what is amazing is how the domestic-oriented sectors have been the underperformers and by a huge margin since China grabbed the headlines, even though these areas — Consumer Discretionary, Health Care, Financials and even Utilities — have practically no correlation to what is happening in these far-away places.

U.S. domestic demand is ripping in a classic impervious mode

The Small-Cap Russell 2000 went down at almost triple the rate than it was before this recent China-induced round of angst and again, this is an area of the market that is purely domestic — and let's face it, after that Q2 GDP revision and the momentum in auto sales and housing activity into Q3, U.S. domestic demand is ripping in classic impervious mode as it did under similar Emerging Market strains in 1997/98.

So it would seem that even the sectors with positive domestic fundamentals are playing the role of a baby being thrown out with the bathwater, but anyone with a view into year-end and for 2016 have a very nice buying opportunity staring them in the face.

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TABLE 1: MARKET PERFORMANCE SINCE THE S&P 500 PEAK

North America
(percent changes)

	May 21 to August 17	August 17 to September 2
S&P 500	-1.3	-7.3
Energy	*-13.7*	*-6.9*
Materials	*-10.1*	*-7.4*
Industrials	*-4.3*	*-6.7*
Consumer Discretionary	*2.7*	*-5.8*
Consumer Staples	*1.5*	*-6.7*
Health Care	*1.4*	*-8.1*
Financials	*1.7*	*-9.2*
Information Technology	*-1.9*	*-6.7*
Telecommunications Services	*-4.5*	*-4.5*
Utilities	*2.6*	*-9.9*
TSX	-6.3	-5.0
Energy	*-17.6*	*-3.9*
Materials	*-18.2*	*-8.1*
Industrials	*-1.6*	*-9.0*
Consumer Discretionary	*0.2*	*-6.2*
Consumer Staples	*11.0*	*-3.0*
Health Care	*13.4*	*-5.2*
Financials	*-4.8*	*-4.2*
Information Technology	*-0.2*	*-0.6*
Telecommunications Services	*3.1*	*-3.1*
Utilities	*-2.8*	*-7.1*
CRB Commodity Price Index	-3.6	-1.1
Gold	*-7.2*	*1.7*
WTI crude oil	*-30.3*	*10.3*
Copper	*-18.3*	*-0.2*
Russell 2000	-2.5	-6.5
VIX	*7.5*	*100.4*

Source: Haver Analytics, Bloomberg, Gluskin Sheff

AS THE WORLD TURNS, BURNS AND CHURNS

Apologies if I do not get sucked into the vortex of negativity surrounding China — I don't see it as crashing and burning, though it is safe to say that China's impact on global economic growth, commodity markets and Emerging Markets is undergoing a semi-permanent change.

Keep in mind that for years China was a trade surplus country and was much more reliant on the demand growth in other countries than the opposite.

China is unlikely to follow in Japan's footsteps since it is already taking steps to liberalize markets, fight corruption, alleviate excess capacity in manufacturing, reforming the debt-laden state-owned enterprises and weaning itself off its massive credit reliance.

China is weaning itself off its massive credit reliance

At the same time, growth is slowing and the transitions underway will ensure that China remains on track in coming years.

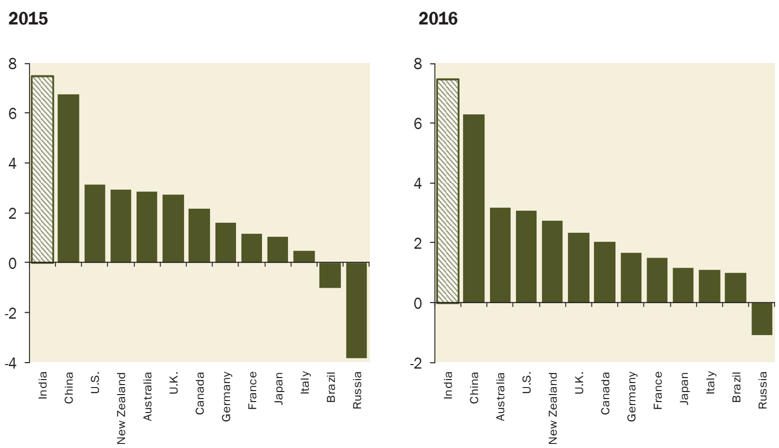
Get used to it — as we did when Japan relinquished its status as the non-U.S. growth leader through the 1980s. Then it was China. And now it may very well be India, even with some of the reform obstacles that Prime Minister Modi has been confronting.

China will remain on track in the coming years

India is a $2 trillion economy (ninth largest), they have a 1.2 billion population base (second largest) with great youth dynamics, an economy that is growing at a sustained 7%+ pace and one of few with no cuts to its 2016 forecast.

CHART 1: IS INDIA READY TO GRAB THE TORCH?

World: Real GDP Growth Forecasts
(year-over-year percent change)

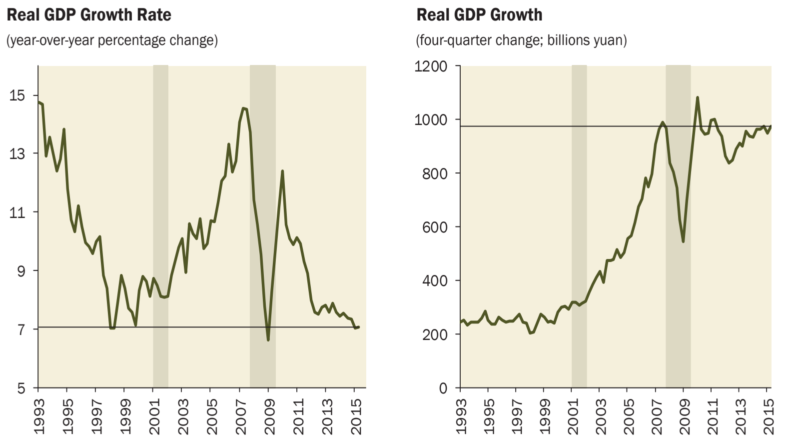


Source: International Monetary Fund, Gluskin Sheff

Even as China slows in percent terms, it is still growing very strongly in dollar or yuan terms — as much as it did in the past when those percent changes were double digits.

CHART 2: PUTTING CHINA INTO PERSPECTIVE

China

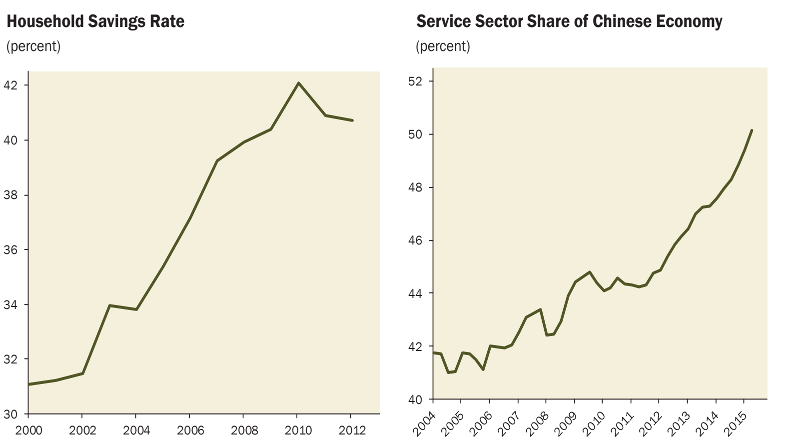


Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff

The headline growth numbers in China mask the move afoot to bring down the personal savings rate from its sky-high levels and boost the service sector share of the economy.

CHART 3: RESTRUCTURING TO A CONSUMER SERVICES ECONOMY

China



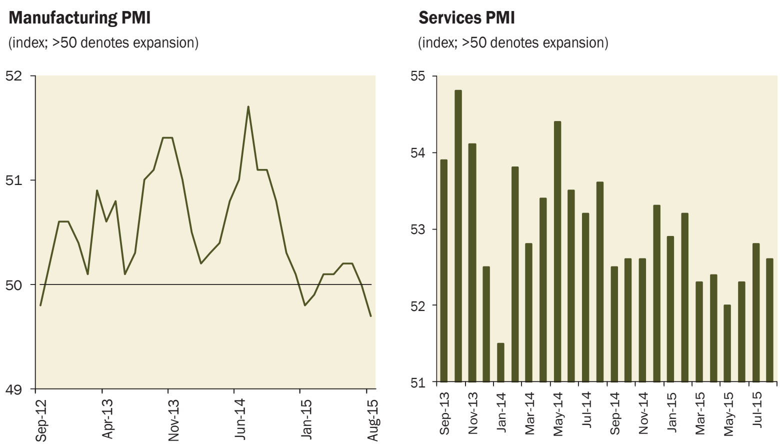
Source: Haver Analytics, Gluskin Sheff

The relative diffusion indices would seem to suggest that even as manufacturing activity falters moderately, this is not the sector of focus for Beijing any longer — indeed, with all deference to market reaction, the recent weakness in the manufacturing PMI is less relevant for an economy rebalancing from goods to services, from industrialization to consumerism.

Activity in the service sector is actually hanging in rather nicely.

CHART 4: MANUFACTURING DOWN BUT SERVICES UP

China



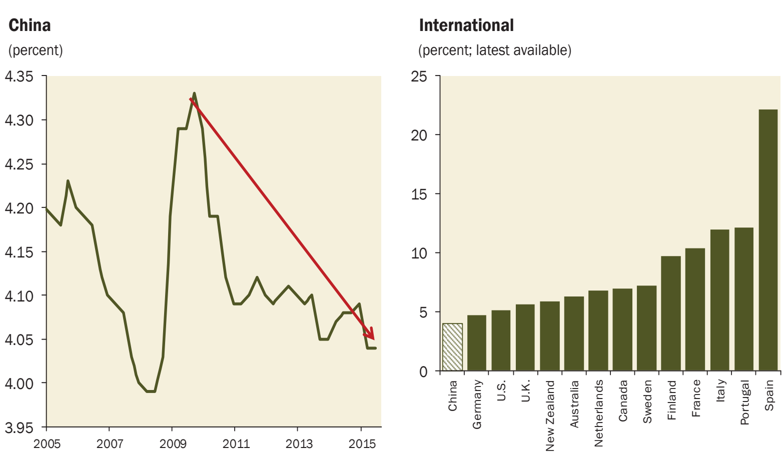
Source: Haver Analytics, Gluskin Sheff

Unfortunately, this is not readily visible on your Bloomberg screen like the CRB commodity price index. For a country with a supposed hard landing, China is seemingly managing to keep its labour market stable — a "hard landing" with a 4% unemployment rate. Interesting combination.

For a country with a supposed hard landing, China is seemingly managing to keep its labour market stable

CHART 5: CHINA HAS A 4% UNEMPLOYMENT RATE!

China



Source: Haver Analytics, Gluskin Sheff

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Hardly the road towards economic carnage

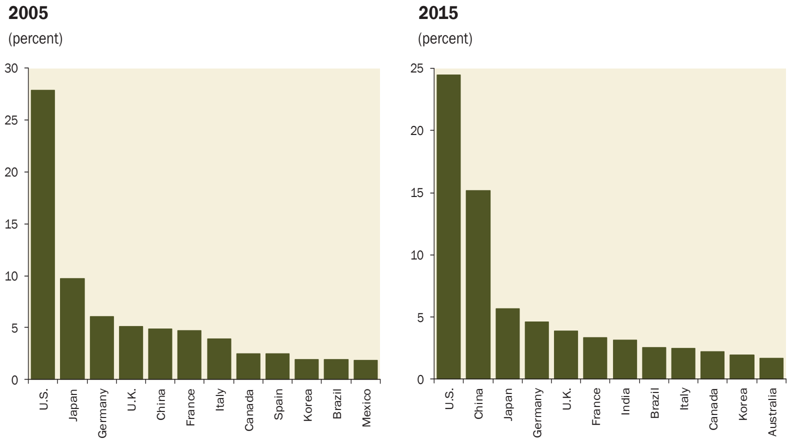
Even as global growth forecasts have been trimmed, mostly out of China and Emerging Markets, at 3% this year and 3.5% next, this is hardly the road towards economic carnage.

Still, enough to probably have the world investor base adjust their multiples to a world of slower potential growth, of that there is no dispute — but this process now looks complete.

The reason why growth is not sagging further is because the largest economy, by far, is actually in acceleration mode. That is the U.S., which even after the ascent of China and Emerging Markets still commands 25% of global GDP.

CHART 6: THE U.S. IS STILL THE ONLY GAME IN TOWN

Share of Global GDP



Source: Haver Analytics, Gluskin Sheff

The U.S. imports 50% more than it exports

Not just that, but 90% of this economy is pure domestic and acts constantly as the relief valve for global producers. The U.S. runs trade deficits of over $500 billion annually with the rest of the world or 3% of its GDP. As a measure of how the U.S. shares its consumer base with the rest of the world, consider that it imports 50% more than it exports (if only Germany did that for the Eurozone as in play the role of consumer of last resort — eliminating its record current account surplus would be a huge remedy for the region's chronic economic imbalances).

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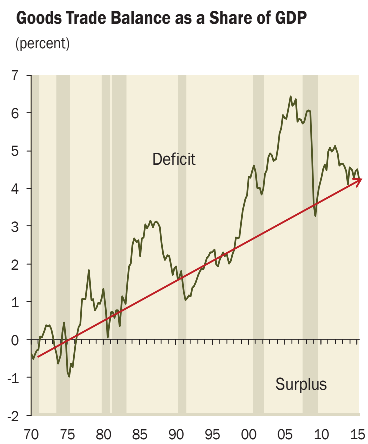
CHART 7: HOW THE U.S. SHARES ITS GROWTH WITH THE WORLD

United States



Source: Haver Analytics, Gluskin Sheff

China, on the other hand, needs the rest of the world more than the rest of the world needs China, seeing as it exports 20% more than it imports.

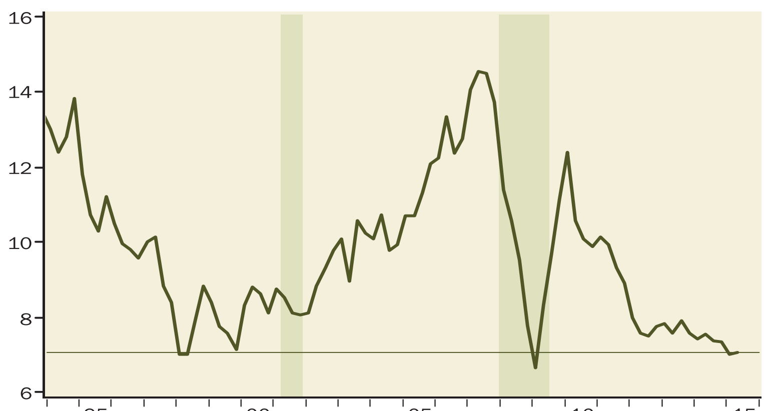
China exports 20% more than it imports

So yes, as we saw in the prior Asian crisis of 1997/98, it is not about whether the rest of the world can drag down the autonomous and mostly service-sector oriented U.S. economy; it is about how the $15 trillion U.S. domestic demand market can act as an antidote to the woes in the overseas economy.

CHART 8: REAL GDP GROWTH

China

(year-over-year percent change)

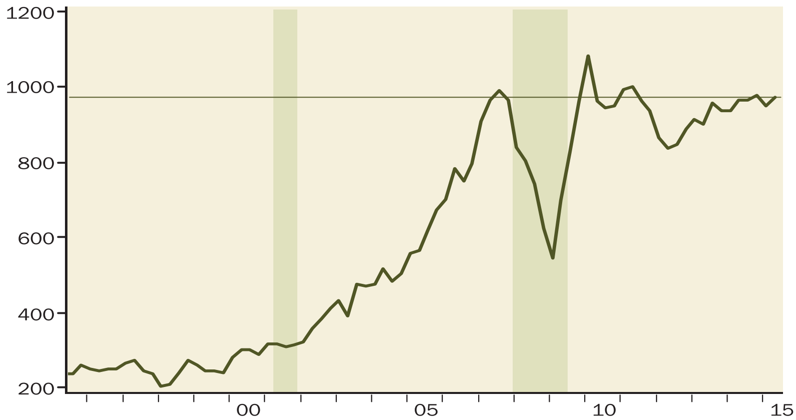


Shaded regions represent periods of U.S. recession

Source: Haver Analytics, Gluskin Sheff

CHART 9: REAL GDP GROWTH

China
(four-quarter change; billions yuan)



Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff

CAN THE U.S. ECONOMY GO AT IT ALONE?

The answer is yes.

- U.S. exports of goods and services total $2.28 trillion — not a small chunk, but final domestic demand is $15.1 trillion or 6.6 times larger.
- National account profits data show that $391 billion of U.S. corporate profits are derived abroad — but $1.67 trillion are domestically oriented, that is a 4.3-times ratio!
- The ADP data show that employment affected by the troubled overseas economy comes to 13.2 million — this is goods sector employment among Mid- and Large-Cap companies; service sector employment that is impervious to the dollar, oil or China, however, exceeds 100 million for a 7.6-times ratio.

Final domestic demand is 6.6 times larger than total exports

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Similarly, many of our other long-standing investment strategies have outperformed their relevant benchmarks.

Our investment interests are directly aligned with those of our clients, as Gluskin Sheff's management and employees are collectively among the largest clients of the Firm.

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Notes:

1. Past returns are not necessarily indicative of future performance. Rates of return are those of the composite of segregated Premium Income portfolios and are presented net of fees and expenses and assume reinvestment of all income. Portfolios with significant client restrictions which would potentially achieve returns that are not reflective of the manager's portfolio returns are excluded from the composite. Returns of the pooled fund versions of the GS+A Premium Income portfolio are not included in the composite.

2. Investment amounts are presented to reflect the actual return of the composite of segregated Premium Income portfolios and are presented net of fees and expenses.

3. The S&P/TSX Total Return Index calculation is based on the securities included in the S&P/TSX Composite and includes dividends and rights distributions. This index includes only Canadian securities.

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