ASIA PERSPECTIVE

China Economic Update Report

Quarter 2, 2019

This Issue

China’s economy continues to face headwinds during the second quarter

The Chinese economy slowed to the weakest growth rate in 27 years. The real GDP slowed to 6.2% in the second quarter of 2019. The pace was two tenths of a point weaker than the real GDP in the first quarter.

However, the nominal GDP increased to 8.3% YoY in the quarter from 7.8% in the first quarter, due to accelerating inflation. Industries such as agriculture and mining saw growth rise to a 3.3% YoY pace this quarter, an increase from 2.7% in the first. Output in other industries such as construction and manufacturing decelerated from 6.1% in first quarter to 5.6%.

Furthermore, China’s private sector provided the main driver of industrial growth in June, expanding by 8.3% in June and 8.7% in the first half of the year, in contrast to 6.2% and 5.0% for state-owned enterprises over the same periods, respectively.

One of the key implications effecting the growth rate is the on-going US-China trade war that have caused some global and domestic trade-related uncertainty.

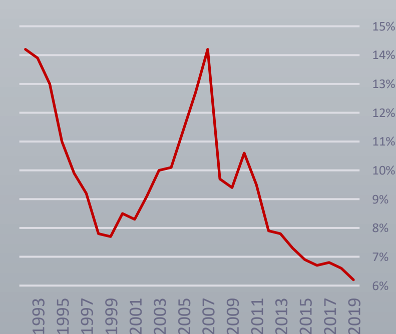
The Chinese consumer confidence remains high over the second quarter

The Chinese consumers are optimistic regarding local job prospects, personal finance and personal financial situation. The willingness to spend have also remained robust in this quarter.

The Chinese retail industry saw a rise of 40.6% in overall deal activity during the second quarter in 2019, comparing with the last four-quarter average.

China's GDP growth, quarterly

As shown in the graph China economy slowed to the weakest growth rate in 27 years.

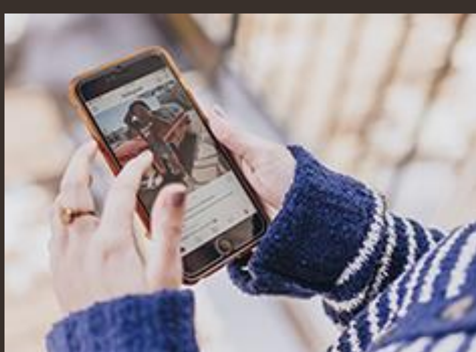


The trade tension

On May 10th the five-month long trade negotiations between the U.S. and China ended abruptly, with the U.S. increasing tariffs from 10% to 25% on Chinese imports.

If the new tariffs were to remain for a long time, China's world factory, global supply chains, and the U.S. import and distribution system could be heavily disrupted .

Also, in May U.S. President Donald Trump ordered the U.S. Department of Commerce to restrict the sale and purchase of telecommunications equipment with foreign firms that might pose a security risk. Huawei and its affiliates noticed that they were subjected to these new restrictions. This notification affected sales and investment plans worldwide.

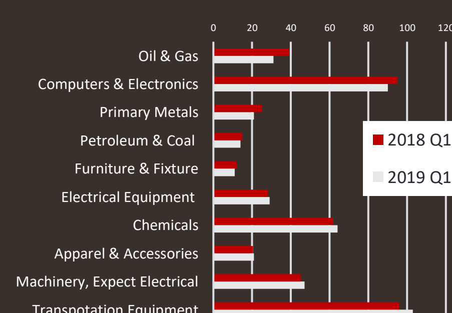


Given this uncertainty of the US-China relationship, there is an expectation of an accelerated relocation of manufacturers from China to avoid the current 25% tariffs and the potential additional 25% tariff on the balance of Chinese exports in the near future. The relocation was a move already underway in China in response to increasing wages and competition from South and Southeast Asia. Depending on the speed of the relocation of labor-intensive manufacturing it will indicate the size of the disruption.

During this last year U.S. tariffs on Chinese goods have been at 10% of value for $200 Billion of imports and 25% of value for $50 Billion of imports. The Chinese tariffs have been at 10% on a smaller, but strategically significant set of U.S. exports.

The below chart shows U.S. imports by sector in the last year. The largest decline at -19% is in oil & gas imports. This, due to the oil production boom in the U.S. The sector that had the second largest decline was the computer and electronic products sector, decreasing -5% from $95B to $90B, due to tariffs on Chinese imports. The third sector that was largely affected was metal imports going from $25B to $22B. Tariffs on steel and aluminum imposed in March 2018 are most likely the major contributory factor for this effect. The transportation equipment sector had the largest increase going from $97B to $102B, with automobiles from Mexico paving the way.

U.S Imports by Products *(Billions, Current Dollars)*



Source: U.S Trade Online

Tesla Gigafactory 3

As the trade war between China and the US keeps going on and become more complicated, it's more important than ever for Tesla to have manufacturing capacity in China.

With the import fees as of today the cheapest version of the Model 3 in China is priced from about $70,000, compared with a U.S. base price of $44,000. Tesla Gigafactory 3 will aim to decrease this price in China.

The site is located in Pudong District, Shanghai and will produce battery cells along with Tesla Model 3 cars.

As of August 2019, the building exteriors were nearly complete, and the general assembly building was being fit with manufacturing equipment.

According to CEO Elon Musk the production is set to start in early Q4 2019. The factory will only manufacture vehicles for the "greater China region".

This is Tesla's first large-scale plant outside the U.S.

Hong Kong protests may have an even bigger impact on markets than the US-China trade war

The entire quarter has been dominated by the Hong Kong anti-extradition bill protests. The protests are a series of demonstrations in Hong Kong against an extradition bill proposed by the Hong Kong government. If it was to become law, those wanted in territories without extradition treaties with Hong Kong could still be detained and extradited by local authorities, including to mainland China and Taiwan.

The fear is that the bill would place the Hong Kong people and visitors under mainland Chinese jurisdiction, undermining the autonomy of the region and citizens' rights.

With these ongoing protests the economy has taken a hit crippled Asia’s main financial hub. In mid-August, Hong Kong announced that it had lowered its 2019 GDP growth forecast to between 0% and 1%, changing from the original range of 2% to 3%.

As the demonstrations have turned increasingly violent various sectors have been affected. Airline, retail, and the real estate sector have taken the biggest hit, and seen significant sales decline.

The unrest has also been affecting the financial markets. The Heng Seng index has fallen more than 1,75% during the second quarter.

These implications are not limited to Hong Kong alone. The Majority of China´s outbound investment, nearly 60%, is channeled through Hong Kong. However, the overall Hong Kong economy only constitutes 3% of China´s total GDP. With that said, the $5 trillion Hong Kong Exchange market continues to be an important source of funding for mainland firms, such as Xiaomi and Tencent.

As of last year, the Hong Kong Stock Exchange changed its listing rules to attract more Chinese tech companies and compete with U.S. exchanges. This yielded in Hong Kong reclaiming the global IPO crown in 2018. But as the demonstrations turn increasingly violent, companies may grow worried about listing their business in Hong Kong, and the IPO pipeline may start to dry up.

Over the last decades, Hong Kong’s geographical location, its relationship to mainland China and its special economic status has been attracting financial institutions and multinational corporations alike. The previously so beneficial special relationship with China has however now turned to be somewhat of a potential liability.

Moving to other part of Asia

When the Trade War’s impact kicked in, global companies started to look for other sourcing regions as alternatives to China.

South-East Asia has turned out to be a beneficiary of this trend, and constitutes a promising future sourcing region. Countries in South-East Asia, such as Vietnam, Thailand, Malaysia, Indonesia, and Myanmar, are all growing in importance.

Eastern Europe and Central Europe are both notable for sourcing potential, and Eastern Europe is expected to improve its importance consistently

Rearrangement of sourcing locations does not necessarily mean companies free themselves of risks. While looking for sourcing elsewhere it is important to consider other risks, such as the start-up costs, a potential increase in price level. the total costs due to reduced volume, and the insufficient knowledge of the new suppliers.

Regardless of the trade war, China is still recognized as the most important sourcing country globally looking forward.

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